Week 11

7/12/12 Monopolistic Competition Chapter 13

Monopolistic competition is a market structure where:
- A large number of firms compete
- Each firm produces a differentiated product
- Firms compete on product quality, price and marketing
- Firms are free to enter and exit.

1 Large Number of firms.

Small market share - each firms supplies small part of total output
- each firm limited market power to influence price
- relatively small price deviation

Ignore other firms: - firm must be sensitive to average market price but does not pay attention to any other individual firm
- Firms small - small market share - no one dictates market price

Collusion impossible - would like to conspire to fix a higher price - called collusion
But because there are so many firms collusion is impossible

2 Competing on quality, price and Marketing

Quality: Physical attributes of product which make it different
- design, reliability, service provided, ease of access

Price: Downward sloping demand curve - firm can decide price and output
But there is a tradeoff between product quality and price

Marketing: 2 main forms: advertising and packaging
- To sell at high price must convince buyers of the

3 Entry and exit: free entry and exit - firm cannot make economic profit in long run
When existing firms make profit → new entrant

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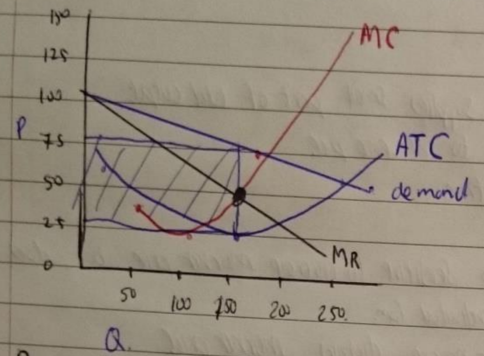
4 Product Differentiation: Producing a product slightly different to competitors
-A differentiated product is one that is a close substitute but not a perfect sub.

Price and Output in Monopolistic Competition

Firms ~~decision~~ short run output and price decision:



Profit maxed when $MR = MC$
= 125q and 50p

Blue rectangle = Profit
50 x quantity

Profit Maximising Might be Loss Minimising:
Occurs when $MR = MC$ is less than average price.
Price is less than average total cost.
Max profits to min loss

Long Run - zero economic Profit

When $MR = MC$ the price is equal to Average Total Cost.

Monopolistic Competition and Perfect Competition pg 304 diagram

Excess Capacity: Firm has excess capacity if it produces below its efficient scale (q which ATC is minimum)
-Average Total cost is the least possible only in perfect competition
-Monopoly has excess capacity

Markup: Amount by which price exceeds marginal cost.
In perfect Comp Price = MC = no markup
In monopoly higher price => markup

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Chapter 13 Monopolistic Competition

Is Monopolistic Competition Efficient?

Making the Relevant Comparison:
- Markup that drives gap between price and marginal cost in monopoly arises from product differentiation - demand not perfectly elastic

The Bottom Line: Product Variety is both valued and costly
Loss that arises because Q produced is less than efficient Q is offset by a gain from greater degree of variety
- Compared to alternative - complete product uniformity - monopolistic competition is probably efficient

Innovation and Product Development:

Profit maximising Product Innovation:
- Decision to innovate and develop new/improved product is based on some type of profit maximising calculation
- Innovation + product development costly but bring in extra revenue
- When MC = MR of product development firm is undertaking profit-maximising amount of product development

Efficiency and Product Differentiation:
- Marginal Social benefit from an innovation is the increase in the price that consumers are willing to pay
- MS cost is amount that firm must pay to make innovation
- Efficient when MR = MC but in monopoly MR is less than price

Advertising:

Advertising Expenditure: Encure large costs to ensure buyers appreciate value of differences between own products and that of competitor
- Biggest cost is retailing - up to 50%
- Advertising - increase costs and change demand

Selling costs and Total costs:
- Selling costs are fixed costs and increase total costs
- Advertising cost per unit decreases as production increases
- By increasing advertising the q sold by a large amount, it can lower average total cost.

Selling costs and Demand:
- Natural answer; advertising increases demand - but all monopolyl advertise
- When one firm advertises all will ~~driving up~~ lowering markup and price

Using Advertising to Signal quality:
- Advertising is a signal to customer of a high-quality product
- lower price firms don't advertise as they cannot compete with quality
- Need to be expensive and hard to ...

Brand names:
- Brand name - information about quality of a product to customers and an incentive to producer to have high/constant quality standard.

Efficiency of Advertising and Brand Name
- Enable better product choice to be made
- But oportunity cost of the additional info must be weighed against gain to consume.
- Final verdict is ambiguous