Chapter 16: Monopolistic Competition

Discussion section 4

December 2023

Outline

Most markets are neither perfectly competitive nor monopolies.

Most will contain some elements of both:

- Oligopolies (next chapter)
- Monopolistic competition (this chapter)

Monopolistic competition

A monopolistically competitive market has:

- Many sellers
- Differentiated products
- Free entry an exit
- Similar production technologies

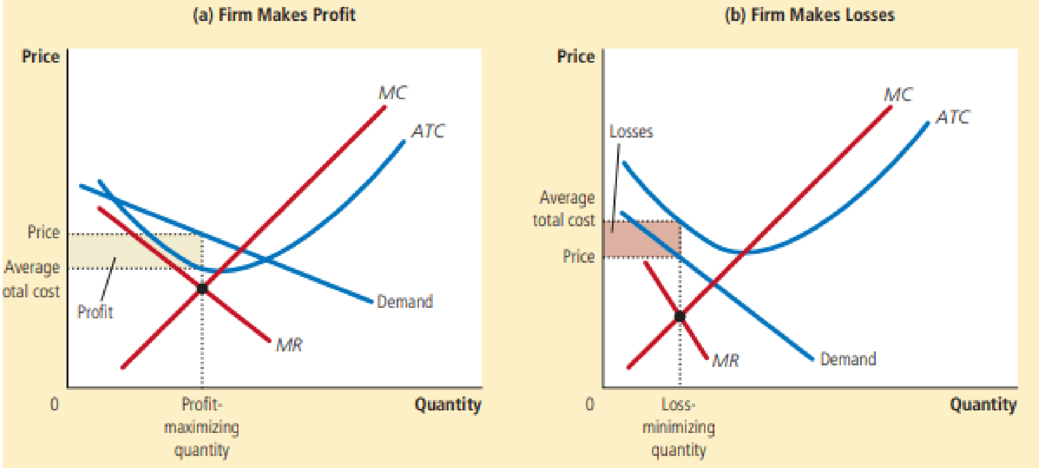
How does a monopolistically competitive firm choose its price?

Price

- Monopolistically competitive firm wants to maximize profits
- Does so by setting MR=MC
- This means P $>$ MC and there may be positive profits

Is this sustainable?

Demand curve



Entry/exit

- Of course, non-zero profits cannot be sustained
- Negative profits lead to exit
- Positive profits lead to entry *for substitute goods*
    - What do we have to assume here?

What does entry for substitute goods do to the profits of the monopolistically competitive firm?

Entry

What does entry for substitute goods do to the profits of the monopolistically competitive firm?

- Introduction of substitute goods shifts the demand curve
- Process will continue until profits fall to 0
- When will this occur? Specifically, relationship between P, MC, and MR?

Profit-maximizing point

- We know profits will be 0: this happens when P=ATC
- We know firms will maximize profits: this occurs when MR=MC
- Since maximum profits are 0, firm will choose Q such that MR=MC and P=ATC

Then we're ready to answer:

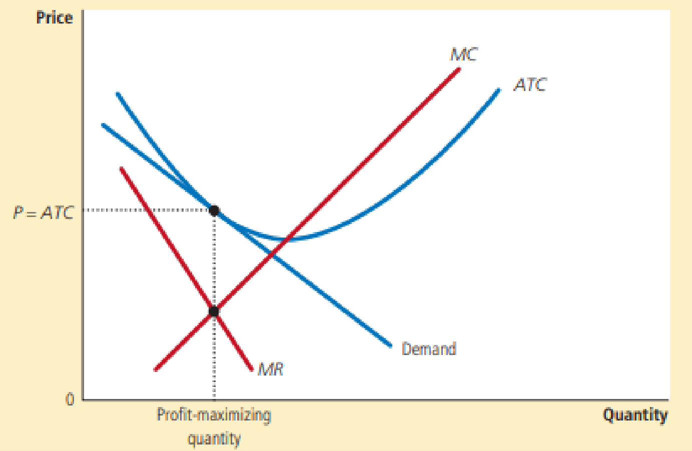
1. What characteristic of a monopoly does monopolistic competition have?
2. What characteristic of perfect competition?

Characteristics

What characteristic of a monopoly does this have? What characteristic of perfect competition?

1. Like a monopoly, P>MC
2. Like a competitive market, P=ATC and profits are 0
3. Q is lower than the efficient (perfectly competitive) level

Demand curve



Efficiency

- The *efficient production* minimizes ATC; not what happens here
- There is a *markup* over the MC: some gap by which P $>$ MC.
    - Does this mean there are positive profits?
- Is there deadweight loss? How do we know?

Efficiency

- The *efficient production* minimizes ATC; not what happens here
- There is a *markup* over the MC: some gap by which P $>$ MC.
  - Does this mean there are positive profits?
  - No! Just means not at the efficient point.
- Is there deadweight loss? How do we know?
  - Yes! There are consumers who value the good at greater than MC, would enjoy it in the free market, but can't buy in the monopolistically competitive market.

Entry/exit

Monopolistic competition may exhibit an inefficient level of firm entry/exit.

What is the effect of firm entry?

Entry/exit

What is the effect of firm entry?

- Since consumers have a taste for variety, there is a *positive externality* to introducing new products: consumer surplus goes up
- Since new firms will decrease profits from existing firms who lose business, there is a negative externality on other firms

Net effect is ambiguous.

Advertising

- Does advertising exist in a perfectly competitive market?
- What is the impact of advertising?
- Is it good or bad for society?

Advertising

- Does advertising exist in a perfectly competitive market?
  - No! No point.
- What is the impact of advertising?
  - Informs consumers
  - Or... *misleads* consumers
- Is it good or bad for society?
  - Don't know! Can't even say if it impedes or helps competition.