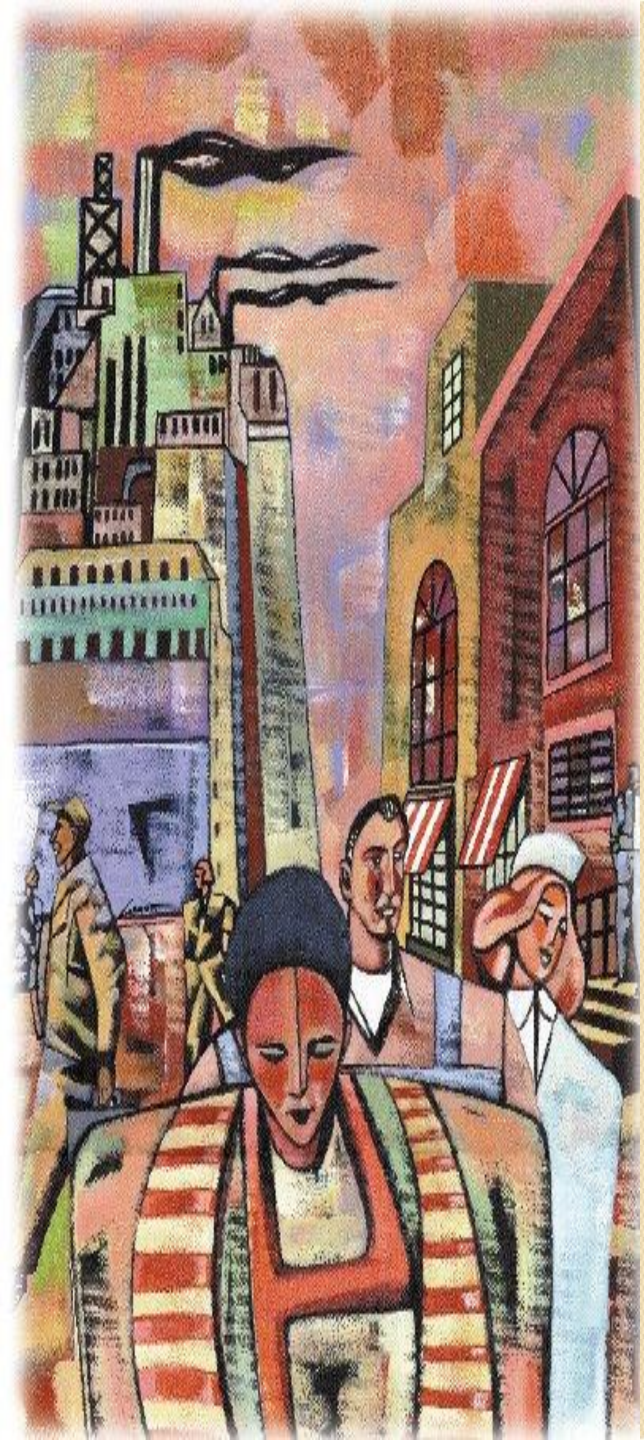
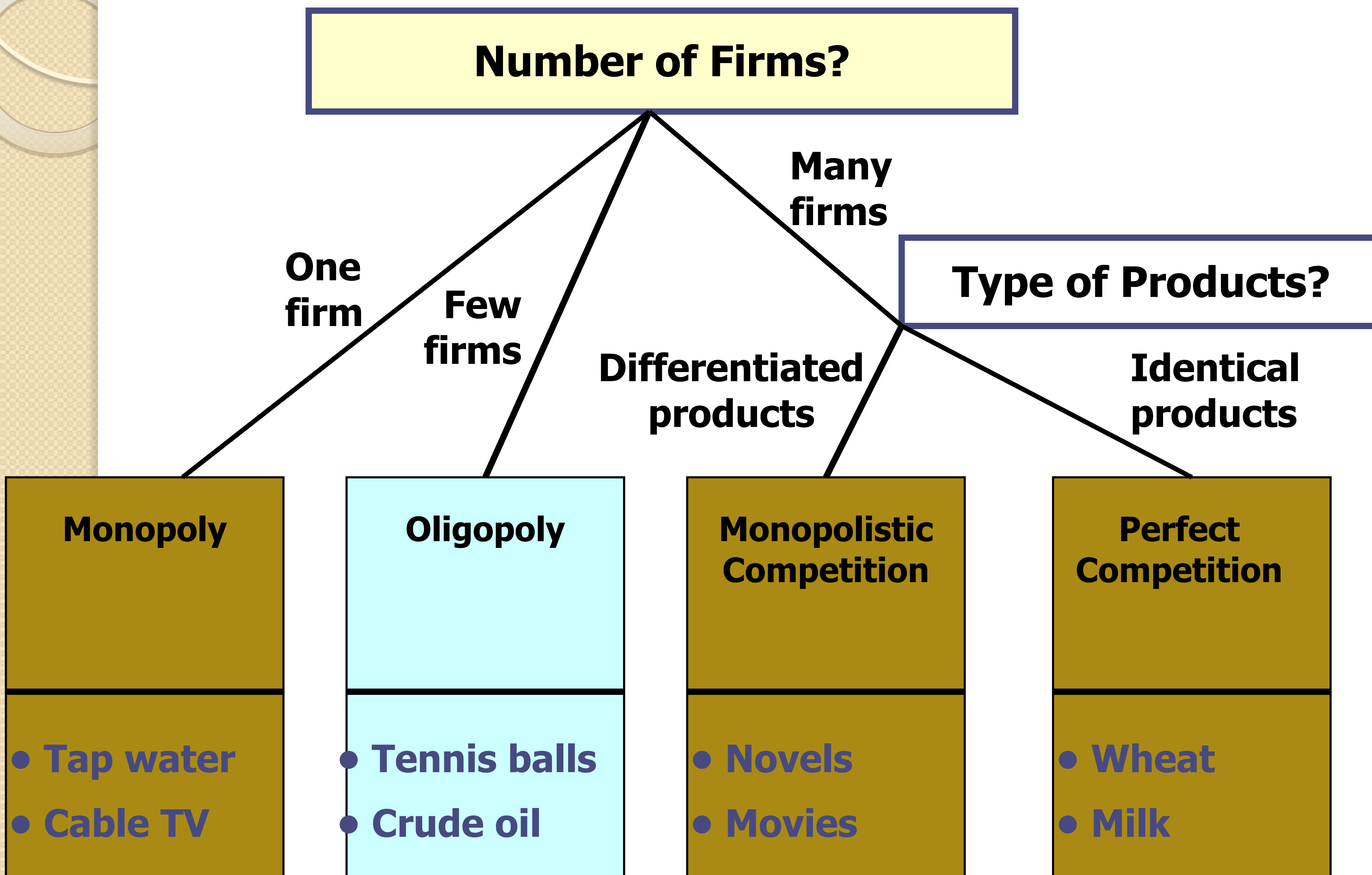


Monopolistic Competition

Chapter 16

The Four Types of Market Structure



Types of Imperfectly Competitive Markets

- Monopolistic Competition
  - Many firms selling products that are similar but not identical.
- Oligopoly
  - Only a few sellers, each offering a similar or identical product to the others.

Monopolistic Competition

Markets that have some features of competition and some features of monopoly.

Attributes of Monopolistic Competition

- Many sellers
- Product differentiation
- Free entry and exit

Many Sellers

There are many firms competing for the same group of customers.

- Product examples include books, CDs, movies, computer games, restaurants, piano lessons, cookies, furniture, etc.

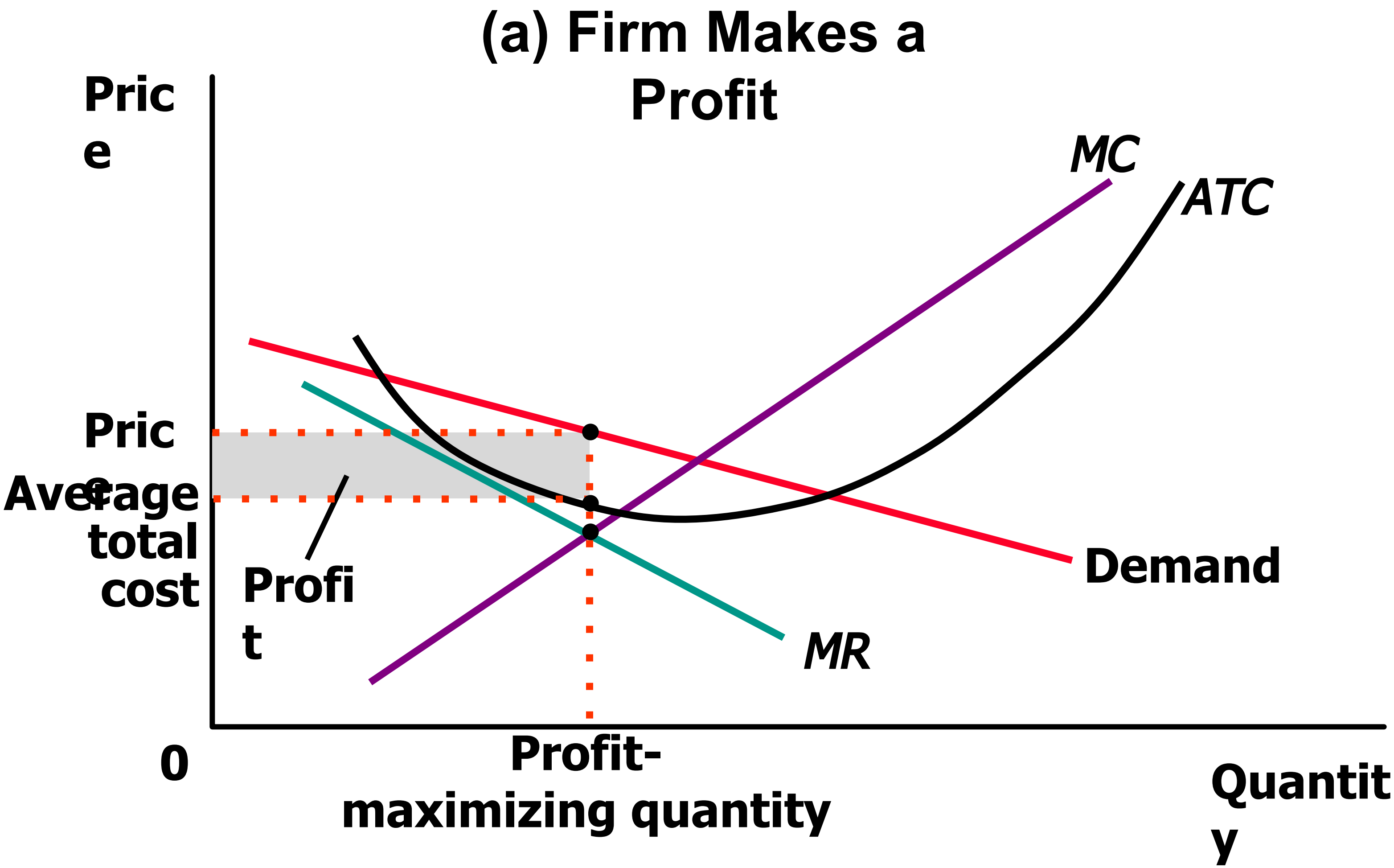
Product Differentiation

- Each firm produces a product that is at least slightly different from those of other firms.
- Rather than being a price taker, each firm faces a downward-sloping demand curve.

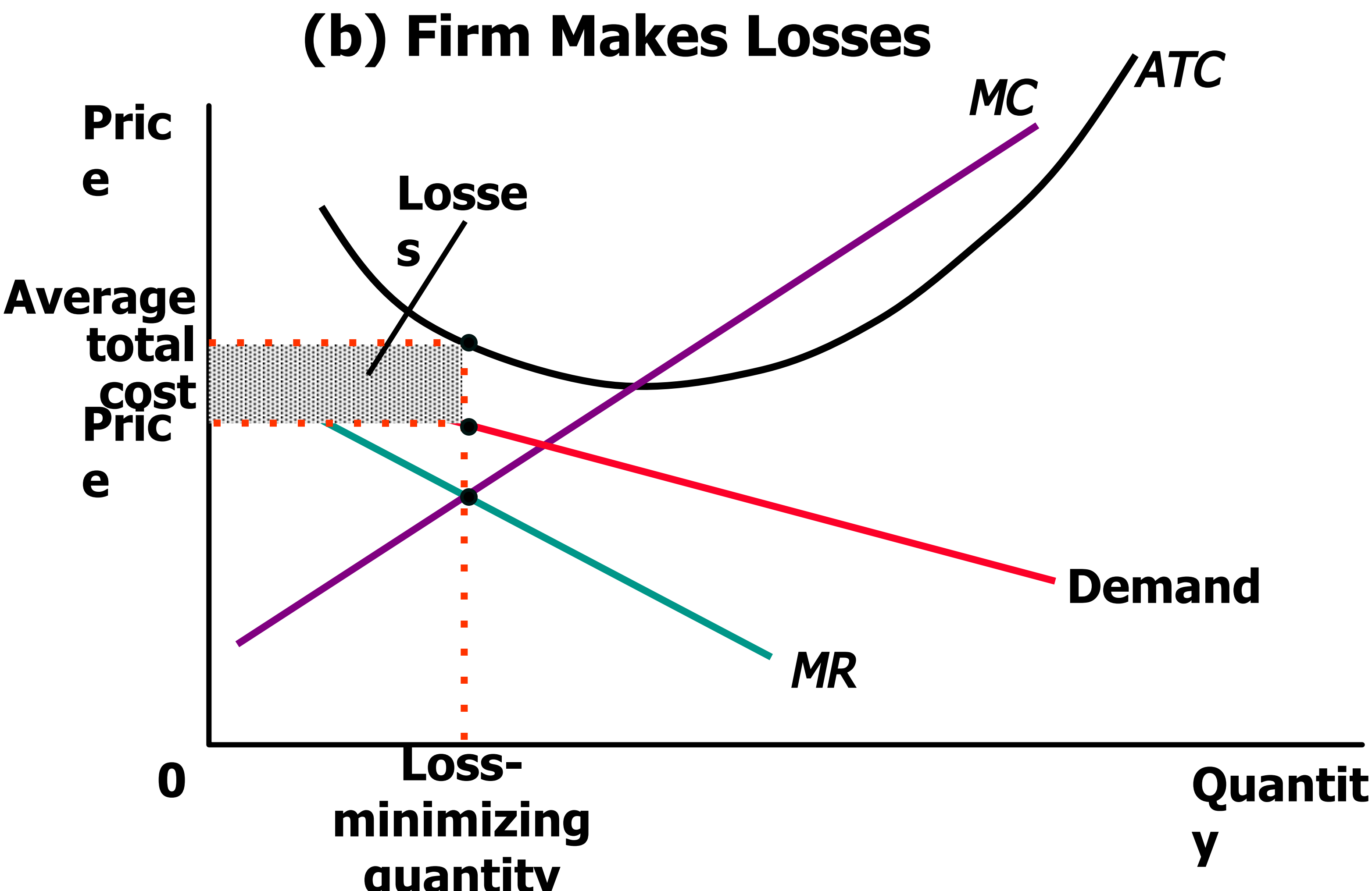
Free Entry or Exit

- Firms can enter or exit the market without restriction.
- The number of firms in the market adjusts until economic profits are zero.

Monopolistic Competitors in the Short Run…



Monopolistic Competitors in the Short Run…



Monopolistic Competition in the Long Run

Short-run economic profits encourage new firms to enter the market in the long run. This:

- Increases the number of products offered.
- Reduces demand faced by firms already in the market.
- Incumbent firms' demand curves shift to the left.
- Demand for the incumbent firms' products fall, and their profits decline.

Monopolistic Competition in the Long Run

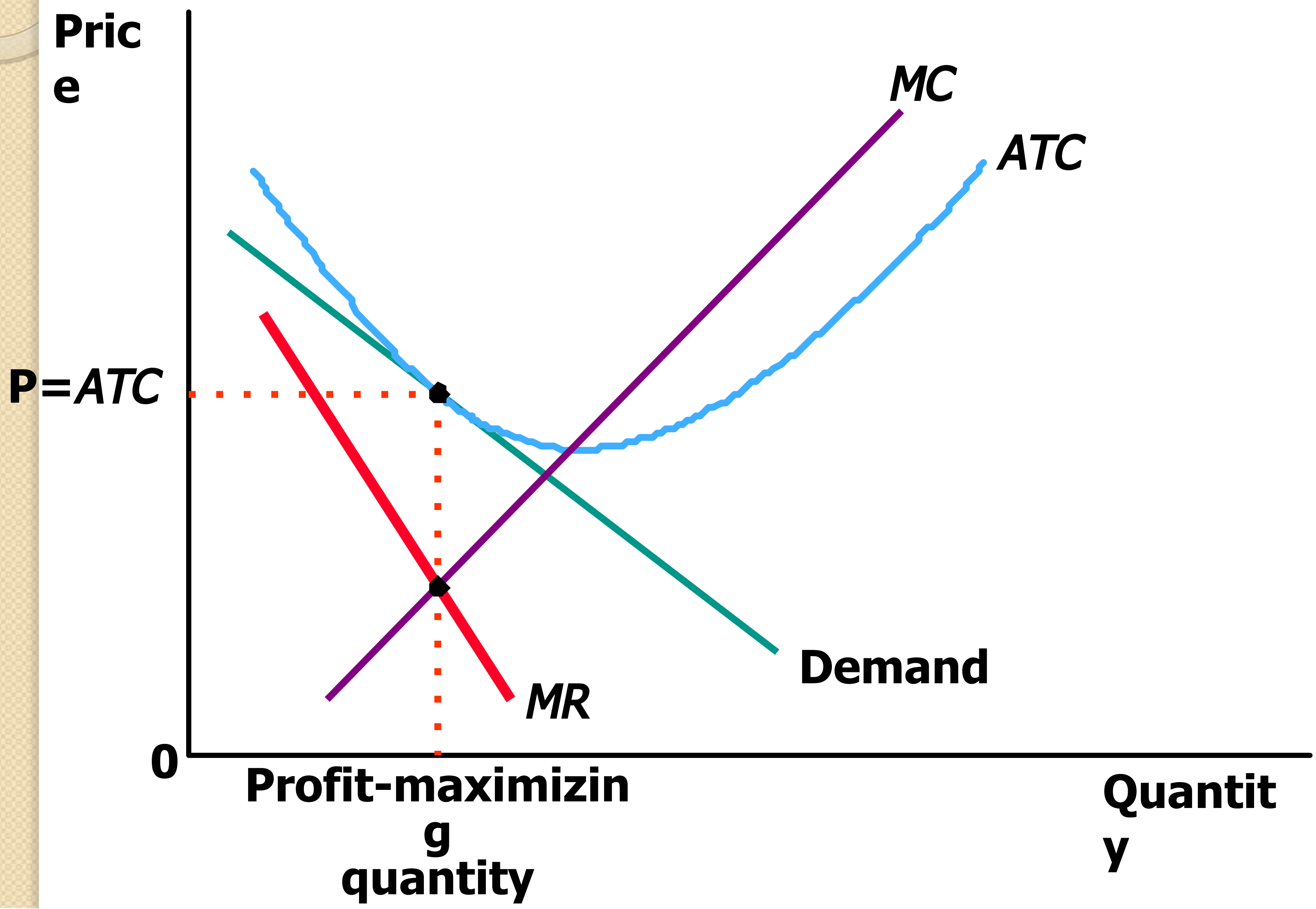
Short-run economic losses encourage firms to exit the market in the long run. This:

- Decreases the number of products offered.
- Increases demand faced by the remaining firms.
- Shifts the remaining firms' demand curves to the right.
- Increases the remaining firms' profits.

The Long-Run Equilibrium

Firms will enter and exit until the firms are making exactly zero economic profits.

A Monopolistic Competitor in the Long Run…



Two Characteristics of Long-Run Equilibrium

- As in a monopoly, price exceeds marginal cost.
  - Profit maximization requires marginal revenue to equal marginal cost.
  - The downward-sloping demand curve makes marginal revenue less than price.

Two Characteristics of Long-Run Equilibrium

- As in a competitive market, price equals average total cost.
  - Free entry and exit drive economic profit to zero.

Monopolistic versus Perfect Competition

There are two noteworthy differences between monopolistic and perfect competition—**excess capacity** and **markup.**

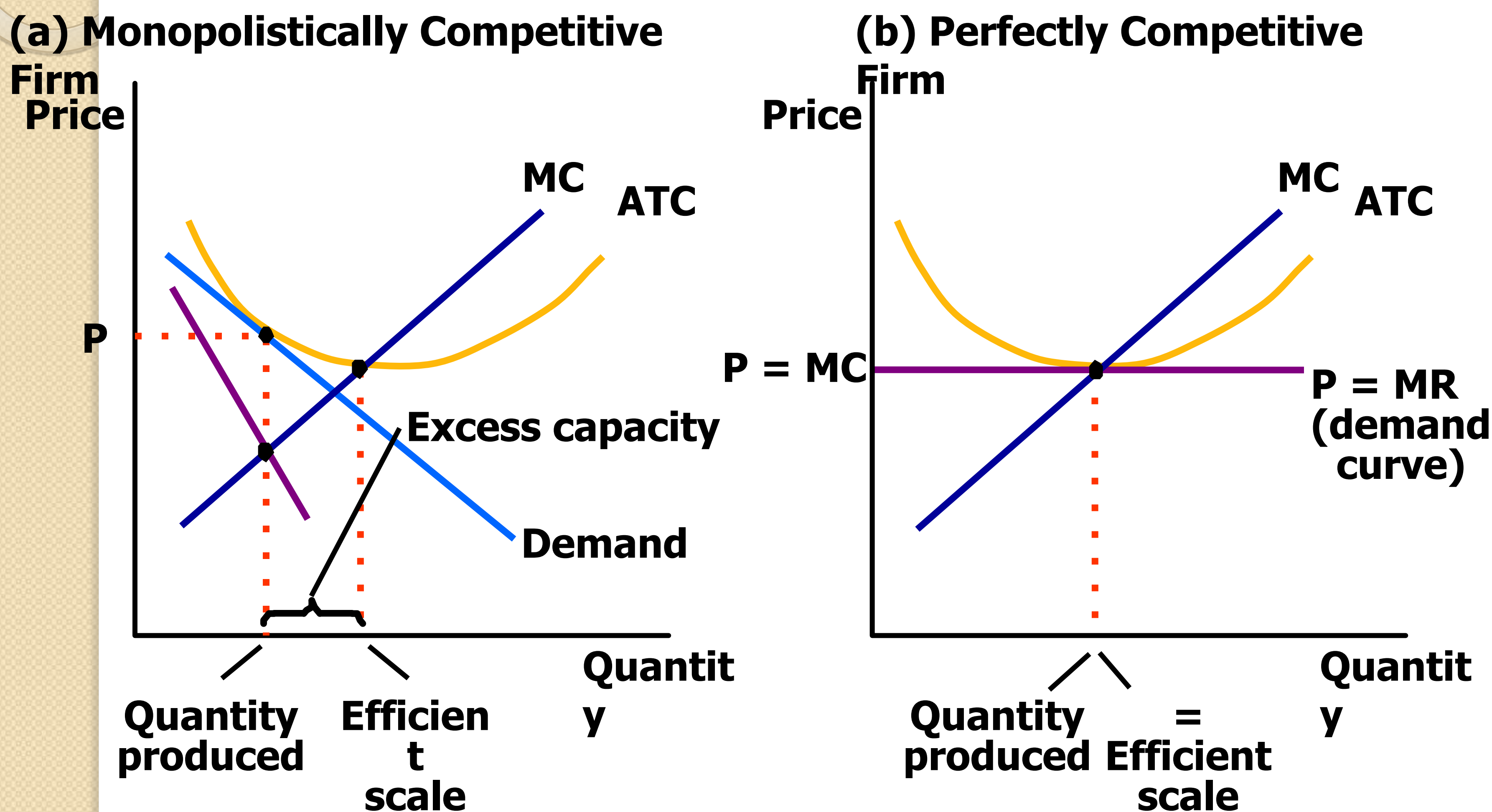
Excess Capacity

- There is no excess capacity in perfect competition in the long run.
- Free entry results in competitive firms producing at the point where average total cost is minimized, which is the efficient scale of the firm.

Excess Capacity

- There is excess capacity in monopolistic competition in the long run.
- In monopolistic competition, output is less than the efficient scale of perfect competition.

Excess Capacity…



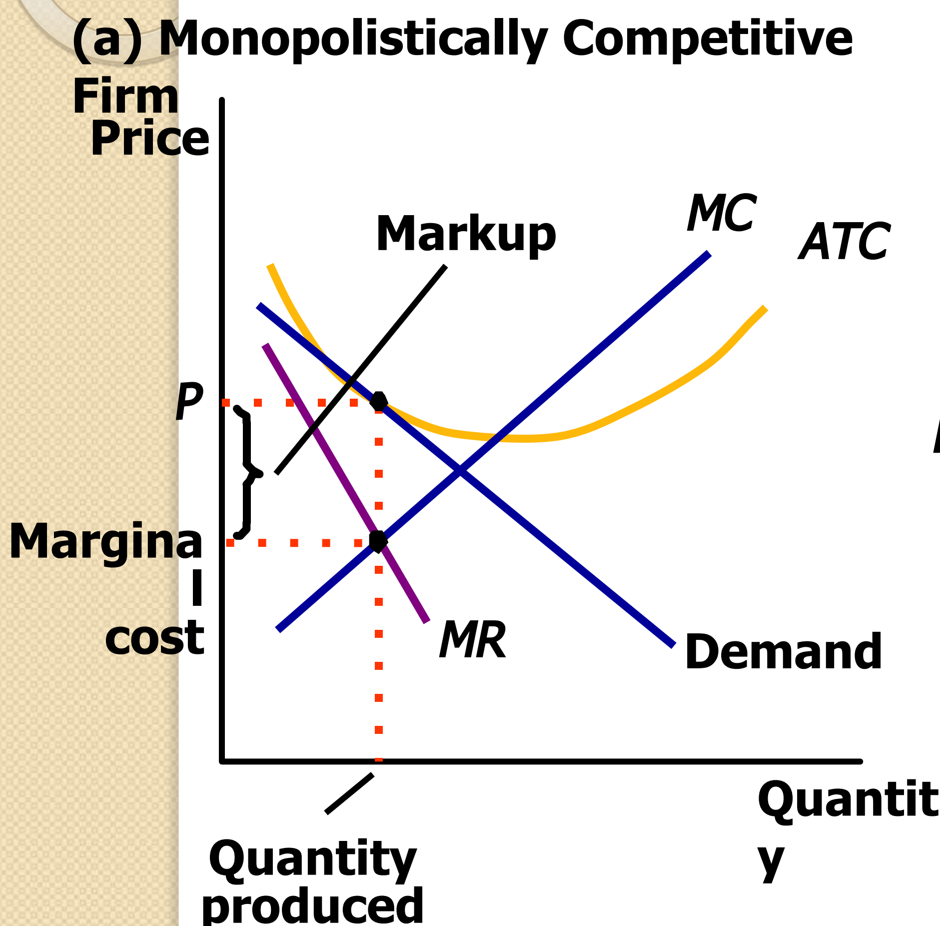
Markup Over Marginal Cost

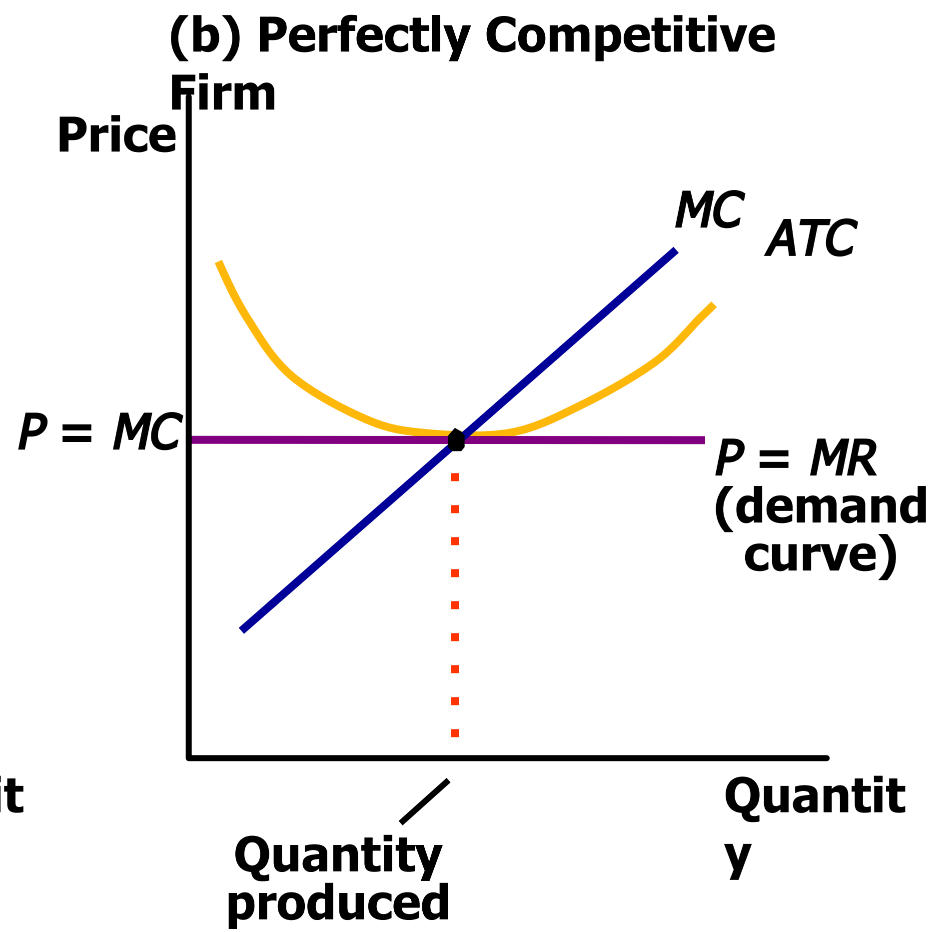
- For a competitive firm, price equals marginal cost.
- For a monopolistically competitive firm, price exceeds marginal cost.

Markup Over Marginal Cost

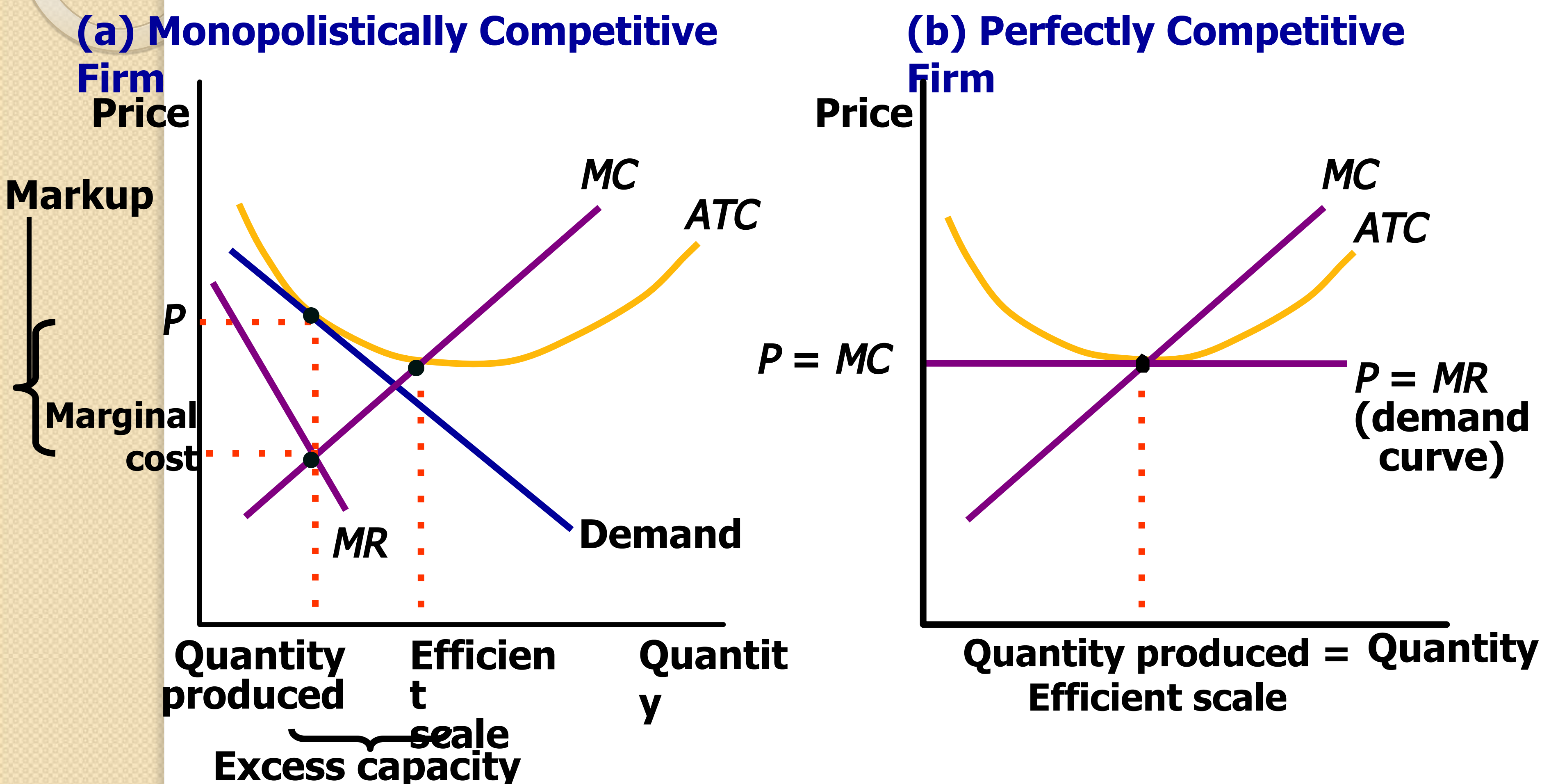
Because price exceeds marginal cost, an extra unit sold at the posted price means more profit for the monopolistically competitive firm.

Markup Over Marginal Cost…





Monopolistic versus Perfect Competition…



Monopolistic Competition and the Welfare of Society

Monopolistic competition does not have all the desirable properties of perfect competition.

Monopolistic Competition and the Welfare of Society

- There is the normal deadweight loss of monopoly pricing in monopolistic competition caused by the markup of price over marginal cost.
- However, the administrative burden of regulating the pricing of all firms that produce differentiated products would be overwhelming.

Monopolistic Competition and the Welfare of Society

Another way in which monopolistic competition may be socially inefficient is that the number of firms in the market may not be the "ideal" one. There may be too much or too little entry.

Monopolistic Competition and the Welfare of Society

Externalities of entry include:

- product-variety externalities.
- business-stealing externalities.

Monopolistic Competition and the Welfare of Society

The <u>product-variety externality</u>: Because consumers get some consumer surplus from the introduction of a new product, entry of a new firm conveys a *positive externality* on consumers.

Monopolistic Competition and the Welfare of Society

The **business-stealing externality:** Because other firms lose customers and profits from the entry of a new competitor, entry of a new firm imposes a *negative externality* on existing firms.

Advertising

When firms sell differentiated products and charge prices above marginal cost, each firm has an incentive to advertise in order to attract more buyers to its particular product.

Advertising

- Firms that sell highly differentiated consumer goods typically spend between 10 and 20 percent of revenue on advertising.

Advertising

- Critics of advertising argue that firms advertise in order to manipulate people’s tastes.
- They also argue that it impedes competition by implying that products are more different than they truly are.

Advertising

- Defenders argue that advertising provides information to consumers
- They also argue that advertising increases competition by offering a greater variety of products and prices.
- The willingness of a firm to spend money on advertising can be a <u>signal</u> to consumers about the quality of the product being offered.

Summary

- A monopolistically competitive market is characterized by three attributes: many firms, differentiated products, and free entry.
- The equilibrium in a monopolistically competitive market differs from perfect competition in that each firm has excess capacity and each firm charges a price above marginal cost.

Summary

- Monopolistic competition does not have all of the desirable properties of perfect competition.
- There is a standard deadweight loss of monopoly caused by the markup of price over marginal cost.
- The number of firms can be too large or too small.

Summary

- The product differentiation inherent in monopolistic competition leads to the use of advertising and brand names.
- Critics of advertising and brand names argue that firms use them to take advantage of consumer irrationality and to reduce competition.

Summary

- Defenders argue that firms use advertising and brand names to inform consumers and to compete more vigorously on price and product quality.