MONOPOLISTIC COMPETITION

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Monopolistic Competition: Introduction

- Perfect competition, with an infinite number of firms, and monopoly, with a single firm, are polar opposites.

- **Monopolistic competition and oligopoly lie between these two extremes.**

Introduction

Monopolistic competition is a market structure in which many firms sell a discriminated product and entry into and exit from the market are relatively easy.

- Examples: furniture, jewelry, leather goods, grocery stores, restaurants, clothing stores and medical care.

Characteristics of Monopolistic Competition

- *Relatively large number of sellers* – firms have small market shares, collusion is unlikely and each firm can act independently
- *Differentiated products* – the product is slightly different and is often promoted by heavy advertising
- *Easy entry to, and exit from, the industry* – economies of scale are few, capital requirements are low but financial barriers exist

Differentiated Products

- **Product differentiation** is a form of non-price competition in which a firm tries to distinguish its product or service from all competing ones on the basis of characteristics such as design and quality.
- Production differentiation entails product characteristics, service, location, brand name and packaging, and some control over price.

Advertising

- The goal of product differentiation and advertising is to make price less of a factor in consumer purchases and make product differences a greater factor.
- The objective is to increase the demand for a product and to make demand less elastic.

Pricing and Output in Monopolistic Competition

- The demand curve of a monopolistically competitive firm is highly, but not perfectly, elastic.
  - The price elasticity of demand for a monopolistic competitor depends on the number of competitors and the degree of product differentiation.
  - The larger the number of competing firms and the weaker the product differentiation, the greater the price elasticity of each firm's demand.

The Short Run: Profit or Loss

The monopolistically competitive firm maximizes profit or minimizes loss in the short run. It produces a quantity Q at which $MR = MC$ and charges a price *P* based on its demand curve.

- When P > ATC, the firm earns an economic profit.
- When P < ATC, the firm suffers a loss.

The Long Run: Only a Normal Profit

- In the long-run, firms will enter a profitable monopolistically competitive industry and leave an unprofitable one.
- A monopolistic competitor will earn only a normal profit and price just equals average total cost at the MR = MC output.

The Long Run: Only a Normal Profit

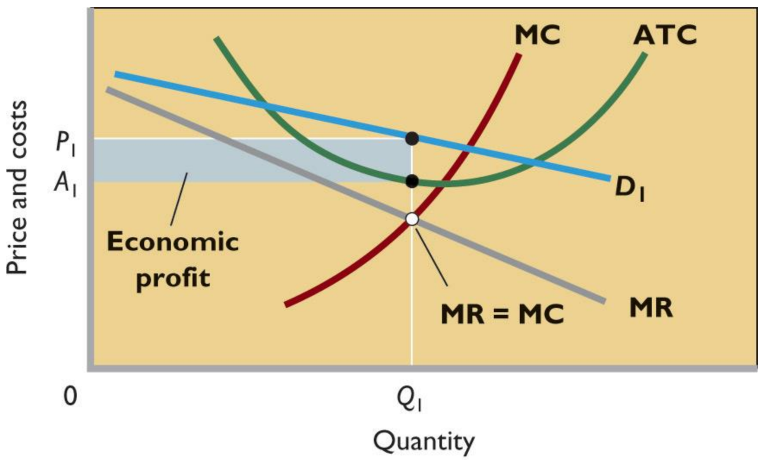
- Because entry to the industry is relatively easy, economic profits attract new competitors.
  - As new firms enter, the demand curve faced by the typical firm shifts to the left, reducing its economic profit.
  - When entry of new firms has reduced demand to the extent that the demand curve is tangent to the ATC curve at the profit-maximizing output, the firm is just making a normal profit, leaving no incentive for new firms to enter.

The Long Run: Only a Normal Profit

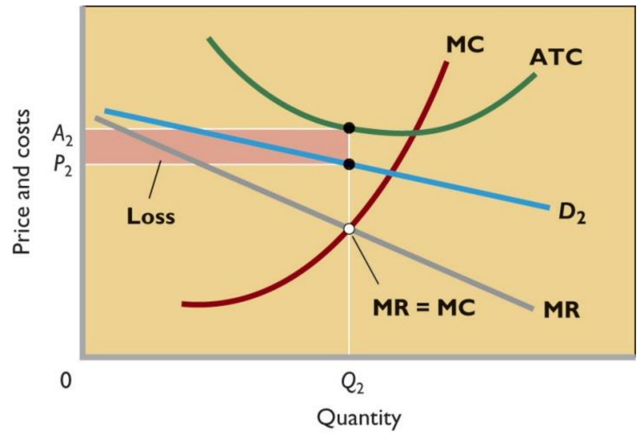
When the industry suffers short-run losses, some firms will exit in the long run.

- As firms exit, the demand curve of surviving firms begins to shift to the right, reducing losses until the firms are just making normal profit.

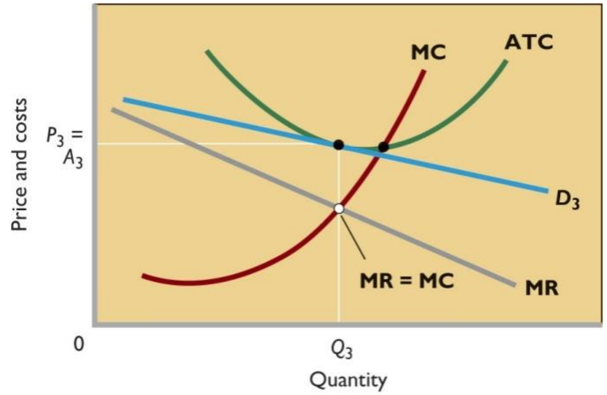
Pricing and Output in Monopolistic Competition



(a)
Short-run profits

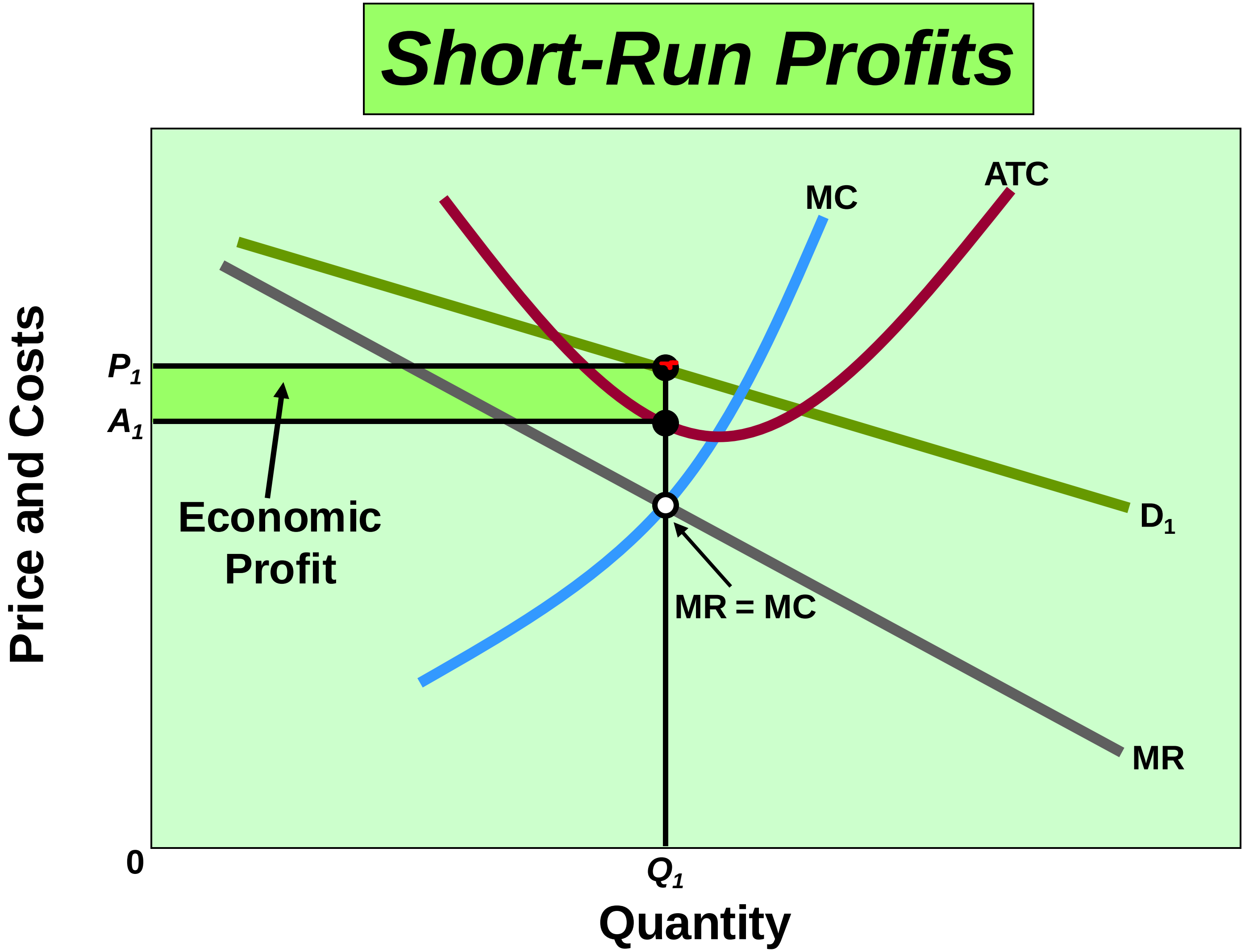


(b)
Short-run losses

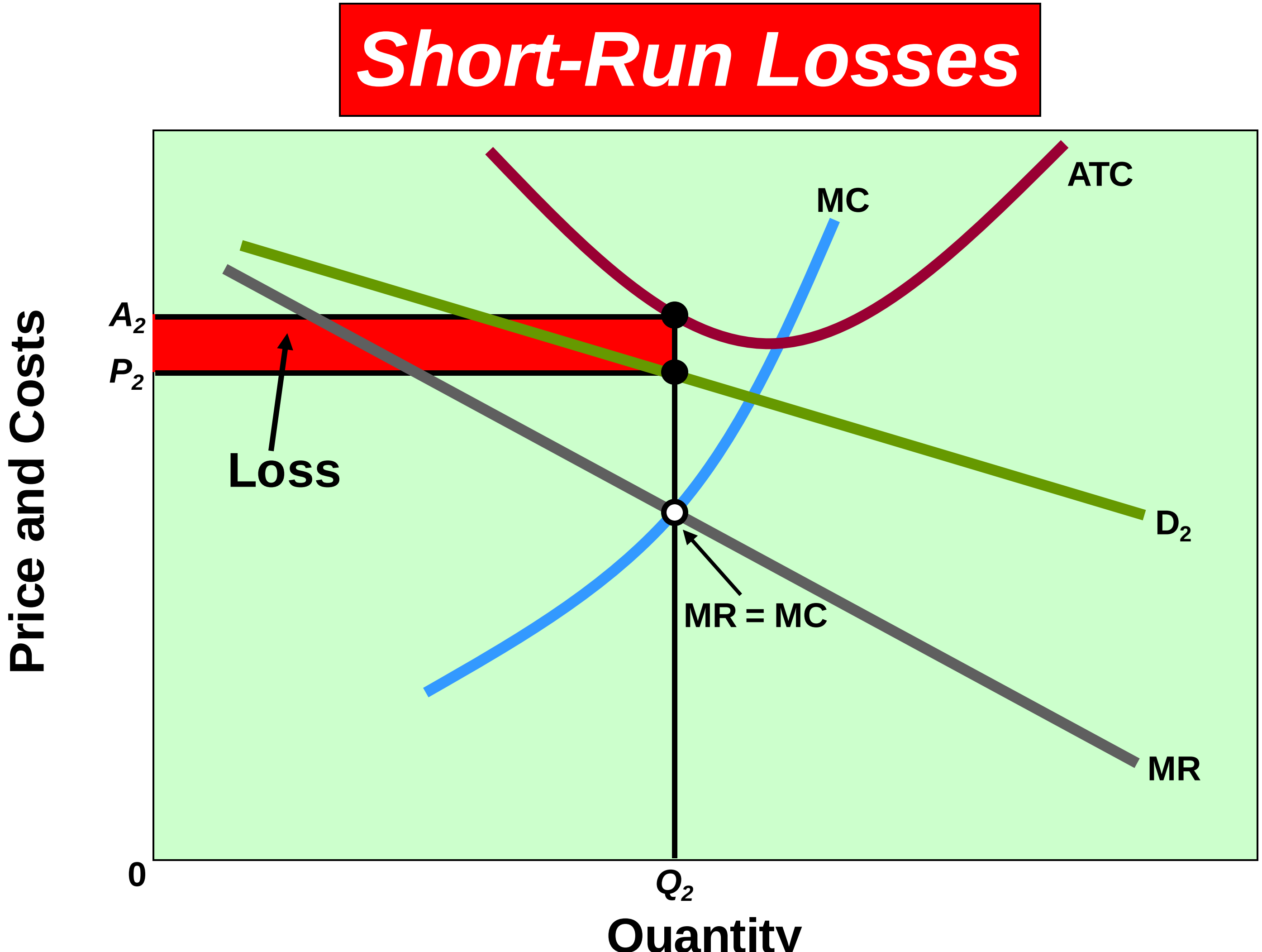


(c)
Long-run equilibrium

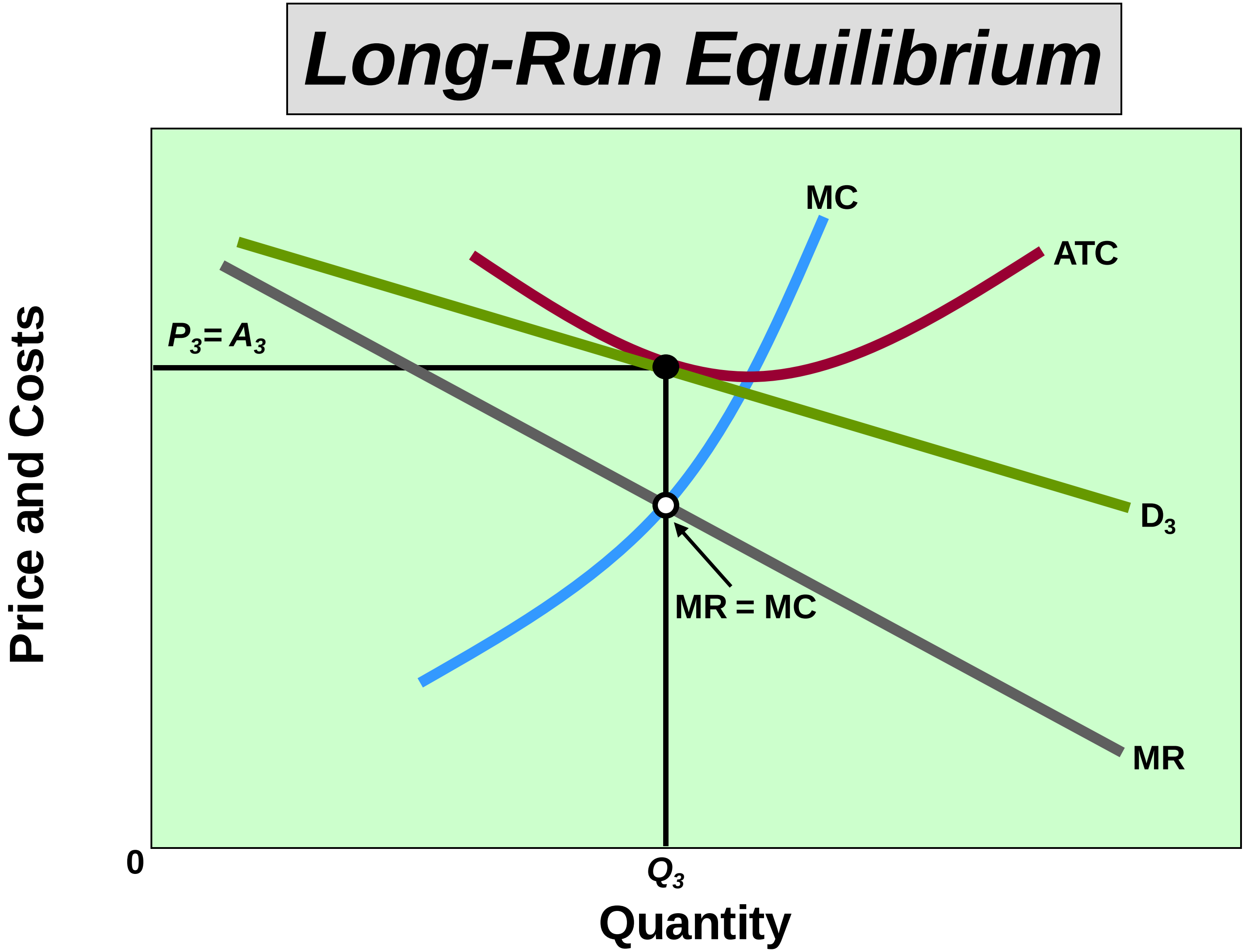
Monopolistic Competition



Monopolistic Competition

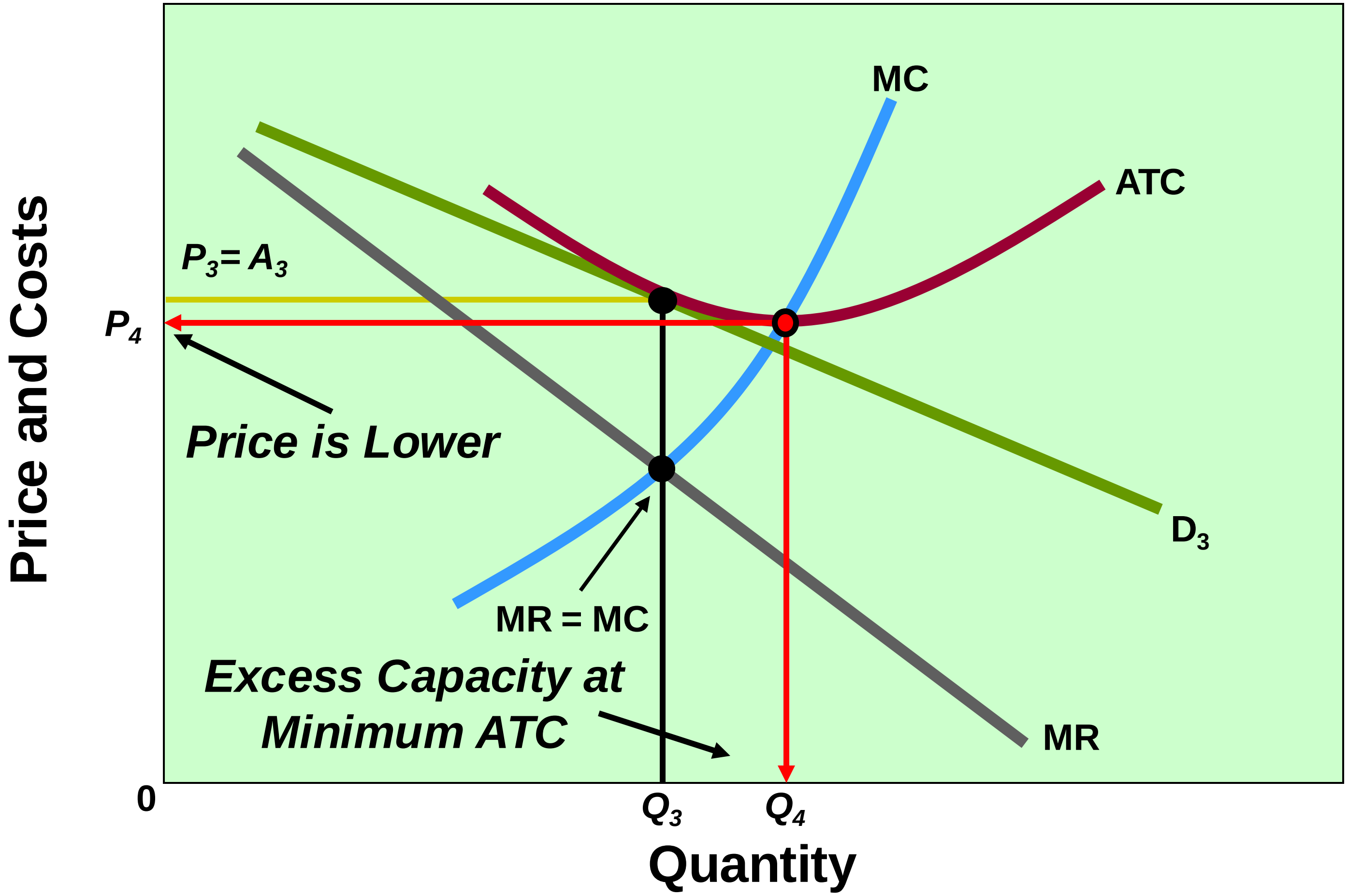


Monopolistic Competition



Monopolistic Competition

P=MC=Min ATC for pure competition (recall)



Monopolistic competition is not efficient

Monopolistic Competition and Efficiency

- In monopolistic competition, neither productive nor allocative efficiency occurs in long-run equilibrium.
  - Since the firm's profit-maximizing price (and average total cost) slightly exceed the lowest average total cost, productive efficiency is not achieved.
  - Since the profit-maximizing price exceeds marginal cost, monopolistic competition causes an underallocation of resources.

Excess Capacity

- The gap between the minimum ATC output and the profit-maximizing output is a monopolistically competitive firm's **excess capacity**.
  - Plants and equipment are unused because the firm is producing less than the minimum- ATC output.
  - Monopolistically competitive industries are overcrowded with firms each operating below its optimal capacity.

Product Variety and Improvement

- Despite the overcrowded feature, monopolistic competition does promote product variety and product improvement.
  - A firm earning a normal profit will develop and improve its product in order to regain its economic profit.
  - Successful product improvements by one firm obligates rivals to imitate or improve on that firm's temporary market advantage or else lose business.

NEXT

OLIGOPOLY