Chapter 12 Q and A with Answers

(1) One critical characteristic of monopolistic competition is that
a. one firm dominates the industry
b. a few firms collude with each other by agreeing on price
c. a few firms compete without agreeing on price
d. there are many small firms in the industry

(2) Which of the following is the best example of a firm operating in a monopolistically competitive market?
a. corn
b. retail clothing
c. wheat
d. electric utilities

(3) We could state correctly that the minimum characteristic necessary to distinguish among price-making firms is
a. product differentiation
b. price discrimination
c. the level of the concentration ratio
d. the number of firms in the industry

(4) In long-run equilibrium for both a competitive market and monopolistic competition
a. accounting profit is zero
b. price equals marginal revenue
c. long-run average cost is minimized
d. economic profit is zero

(5) If monopolistically competitive firms are incurring losses, existing firms would
a. reduce their costs
b. charge higher prices
c. make demand more inelastic
d. leave the industry

(6) Profit-maximizing, monopolistically competitive firms
a. are guaranteed an economic profit in the short run.
b. never lose money.
c. Necessarily earn long-run economic profits.
d. Cannot be guaranteed an economic profit in any period and might incur losses.

(7) Fast-food, bottled water, and cereal markets are all examples of
a. perfectly competitive markets
b. monopolies
c. monopolistically competitive markets
d. oligopolies

(8) The greeting card industry is

a. most likely to be a competitive market and has low markups.
b. most likely a monopoly and has high markups.
c. most likely monopolistically competitive and has substantial markups.
d. most likely an oligopoly with low markups.

(9) The marginal revenue of a monopolistically competitive firm will always be

a. less than the price.
b. more than the price.
c. the same as the price.
d. identical to the marginal cost curve.

(10) In a monopolistically competitive industry, price

a. will be lower than the competitive price due to cost savings.
b. is contingent on the behavior of other firms because they are mutually interdependent.
c. is most likely a bit higher than the competitive market price because of the cost of variety.

(11) Monopolistic competition is inefficient because

a. the firms' marginal costs and marginal revenues are not equal.
b. price is not equal to the minimum average total cost.
c. entry is difficult.

(12) Advertising is designed to

a. make the price elasticity of demand for the firm more inelastic and shift the firm's demand curve to the right.
b. make the price elasticity of demand for the firm more elastic and shift the firm's demand curve to the right.
a. make the price elasticity of demand for the firm more inelastic and shift the firm's demand curve to the left.
b. make the price elasticity of demand for the firm more elastic and shift the firm's demand curve to the left.

(13) Sort the following outcomes of product differentiation by whether they are costs or benefits of monopolistic competition.

#	**Items**	**Cost/benefit**
1	long-run production at a point tangent to the average total cost (ATC) curve	Cost
2	prices set above the marginal costs of production	Cost
3	competition based on location	Benefit
4	increased variety	Benefit
5	competition based on quality	Benefit

Explanation:

Product differentiation leads monopolistically competitive markets to compete on things other than price. Increased variety is good for consumers, as it allows everyone to find goods that match their individual tastes. Competition based on location is also good, because firms try to locate near their customers, which reduces travel time and increases convenience. Similarly, competition based on quality benefits consumers by increasing the overall quality of goods and services provided.

Product differentiation also has some downsides for consumers. We end up paying more for goods than we would in a competitive market because we pay a price above the marginal cost of production. Firms in monopolistically competitive industries end up not producing as efficiently as they would in competitive markets, as indicated by the long-run production occurring where the demand curve is tangent to the average total cost curve. Because firms in monopolistically competitive markets face downward-sloping demand curves, they produce above the minimum average total cost in the long run, which is inefficient.

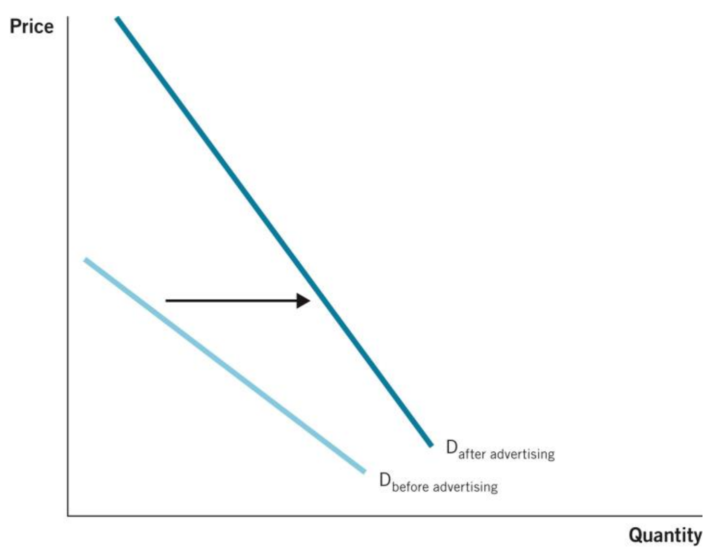
(14) Because monopolistically competitive firms produce differentiated products, advertising is widespread as firms try to attract new customers or to capture customers from rival firms. However, advertising can have both benefits and costs.

(a) A successful advertising campaign will cause the firm's demand to ___________.

Answer: increase

(b) The firm's demand curve becomes more __________.

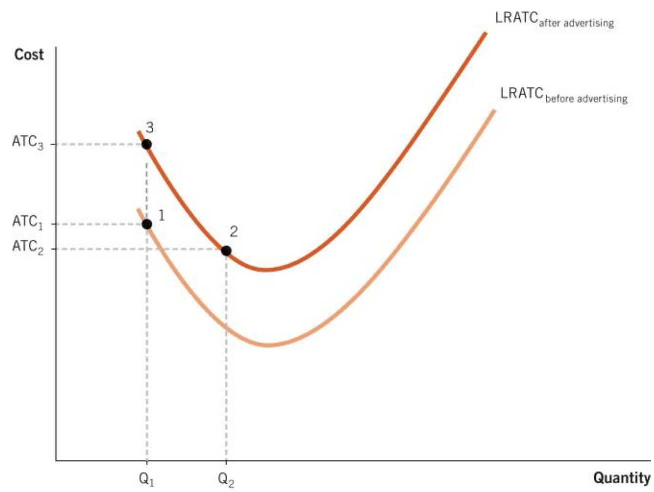
Answer: inelastic



(c) In the short run, a successful advertising campaign will enable the firm to charge a price __________ average costs.

Answer: greater than

Although there are potential benefits to advertising, it does not come without costs. Suppose the figure below shows the average cost curves of American Eagle before and after advertising.



(a) If American Eagle advertises, it wants to move from point ____________.

Answer: Q_1 to Q_2

(b) But American Eagle competes with many other rivals, who will also advertise. Each firm's advertising campaign cancels out the others. The net effect is for American Eagle's average cost to move from ____________.

Answer: ATC_1 to ATC_3 If American Eagle were the only firm to advertise, the demand for its product would increase. Sales would increase from Q_1 to Q_2, and due to greater economies of scale, its average costs would fall from ATC_1 to ATC_2. Rival firms, such as Hollister or The Gap, will respond with their own advertising campaign. Each firm's advertising will cancel out the others. As a result, American Eagle's sales remain the same, and its average costs increase from ATC_1 to ATC_3.

(15) Which product below would have the highest markup (as a percentage of price)?

A. iPhones

Answer: Demand for iPhones is relatively more inelastic than the demand for red compact cars or potatoes. The more inelastic demand is, the higher the markup.

B. red compact cars

Answer: Many different manufacturers make red compact cars, which gives consumers the ability to choose a slightly different product if the price goes up. This availability of substitutes makes consumer demand more elastic. Because demand is more elastic, consumers are price sensitive and the markup is lower.

C. potatoes

Answer: Potatoes are provided by a competitive market. There is no markup in competitive markets.

(16) Advertising allows firms to

a. lower the price to attract more customers.
b. lower the price to attract more customers with elastic demand.
c. raise the price to attract more customers.
d. raise the price because demand is more inelastic.
e. lower the price to attract more customers with inelastic demand.

(17) In the long run, when you compare monopolistic competition with perfect competition, the price charged is ________ and economic profits are ________.

a. the same; the same.
b. higher; higher.
c. higher; the same.
d. the same; lower.
e. higher; lower.

(18) What is true about the long-run equilibrium for firms in a monopolistically competitive industry?

a. P = ATC, P > MC
b. P = MR = MC = min(ATC)
c. P > ATC, P = MC
d. MR < MC, P < min(ATC)

(19) Which of these businesses is in a monopolistically competitive industry?

a. A soybean farmer
b. Domino's Pizza
c. a large automobile manufacturer
d. the only towing service in an isolated town