

Monopolistic Competition

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Old model from the 1930s and before game theory. Probably the most common market.

If you can remember a brand, it is probably monopolistic competition.

- smartphones
- toothpaste
- The cereal aisle in the grocery store (if you ignore they are made by the same company)

Assumptions

- Many buyers and sellers
- Heterogeneous goods. There are non-price differences.
- Firms have price setting behavior.
- Free entry and exit
- All firms effect all other firms. Nothing is local.

The model is used a lot of macroeconomics but only at the EC312 and higher level.

Good Things About Monopolistic Competition

- Good at small innovation
- More personalized, while still mass produced
- Preserves historical variety

Small Innovation

Technical Rain jackets

- Napoleon pockets
- Pit zips
- Low cut in back

American Hefeweizen

More Personalized

- Shoes and foot models
- Cut of pants

Preserve Historical Variety

- Tomatoes
- The Porter
- Modelo Negra

The Graphs are the same as Monopoly

The Bad Things

- Price and quantity effects
 - Price is higher
 - Less is sold
- Welfare Effects
 - DWL
 - Reduction in CS

The long-run effects are a little different.

What is Different?

- Entry and exit, yes but how they enter and exit.
- Entry and exit means that profits are competed down to zero.

Try drawing a monopoly graph with zero economic profit.

MC in Long-Run

Why and How Does That Happen?

Every time a firm leaves or enters, all the other firms' demand functions change.

- Entry and exit cause decreases and increases in demand.
- It also changes the elasticity depending on how similar.

Lets Talk Beer

Imagine I own the only brewery in a small town. People can either drink the one beer I make, a pilsner, here or they can sit at home and drink water (moist county).

- If I increase the price of beer – more people stay home.
- If I decrease the price of beer – more people come in

In other words it is a demand curve but pretty inelastic.

A New Brewery Comes to Town

They make a stout.

Now people have three choices:

- Drink pilsner here.
- Drink stout there.
- Drink water at home.

Pretend people have strong beer tastes

- They either like pilsner or stout
- Some are willing to switch sides because – beer.

You lose some customers, decreasing demand.

Decrease Demand

What if ...

They make a pilsner too?

We make the same beer. They are perfect substitutes.

- If my price is higher – no customers
- If my price is lower – all the customers

We are now perfect competitors and take price as given.

$P = AR = MR = D_{firm}$ Again

Now Perfect Competitors

What if ...

They made and IPA?

Similar to, but not the same, and people that like pilsners also like IPAs

Customers become more sensitive to price:

- If I raise price, some go home and drink water, others leave to drink IPA.
- If I lower price, some water drinkers come back, and some IPA drinkers come back.

The more similar the new product, the more your demand curve rotates, becomes more elastic.

How Entrant Changes Your Demand

Now Pretend You are the Entrant

What kind of beer do you make?

- Similar enough to steal customers
- Not so similar so that you have market power

Beerspace

Each New Entrant

- Picks a spot where there is profit.
- Lowers everyone's profit
- Sooner or later there are no more profitable spots – everyone has zero economic profit.

This is an evolutionary equilibrium

In the Long-Run

- Profits are zero, same as PC.
- Costs are higher than the minimum of average cost, different than PC.
- They produce less than quantity at min of AC. They have excess capacity