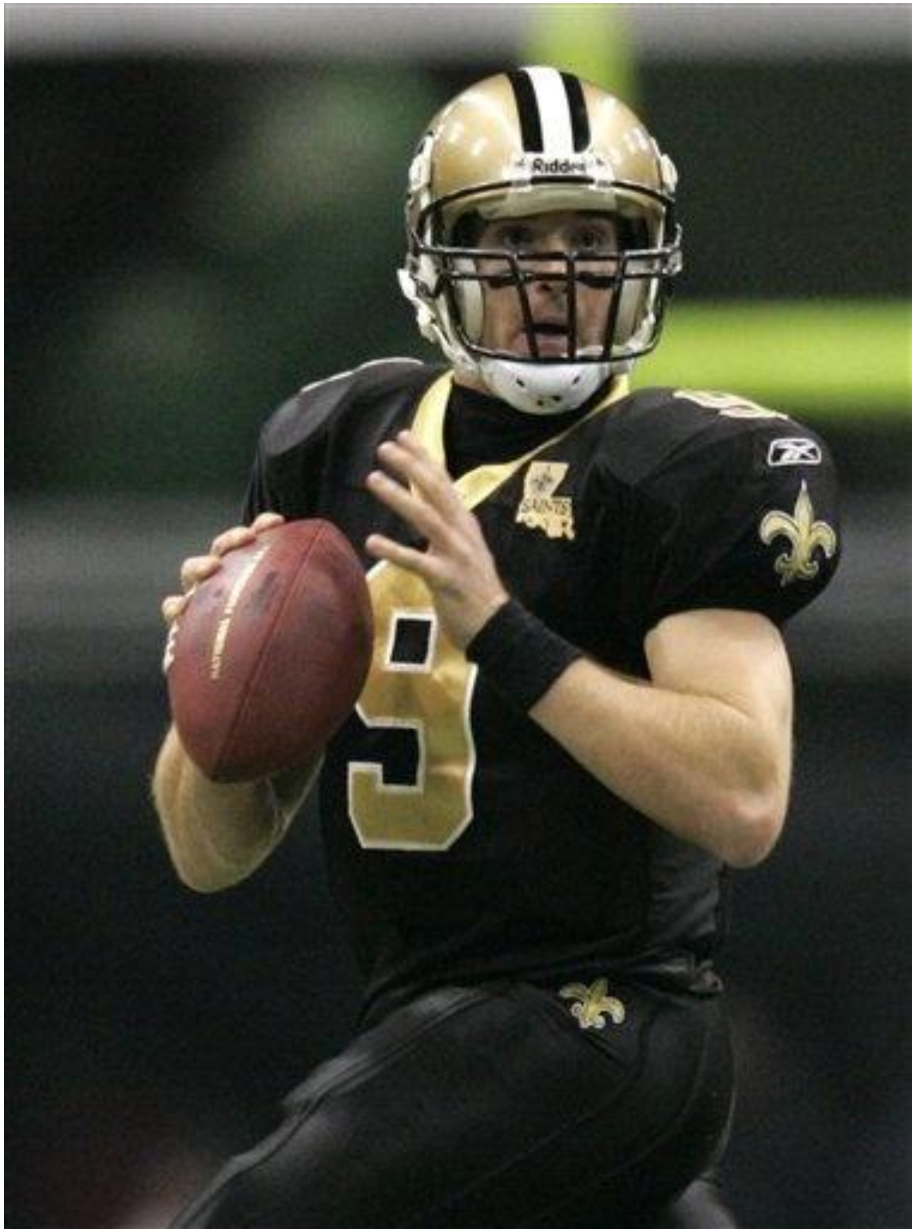
Chapter 16

Monopolistic Competition



Imperfect Competition

- Imperfect competition refers to those market structures that fall between perfect competition and pure monopoly.
- There are 2 which we study.
- The first is:

Monopolistic Competition

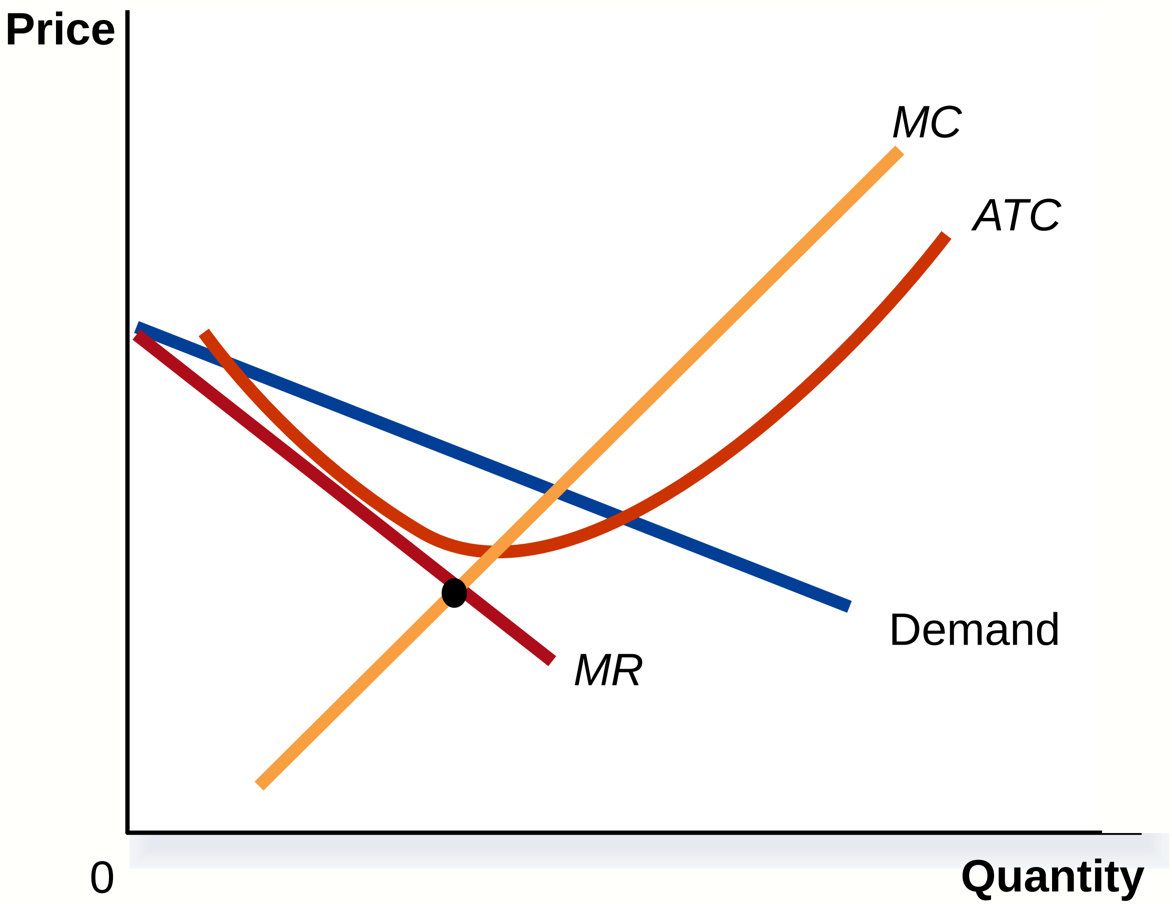
- Many sellers.
- Product differentiation: each firm's product is at least slightly different from another firm's.
    - So, each firm faces a downward sloping demand curve, like a monopolist.
- Free entry and exit (no barriers to entry).
- Firms are price setters to some degree.

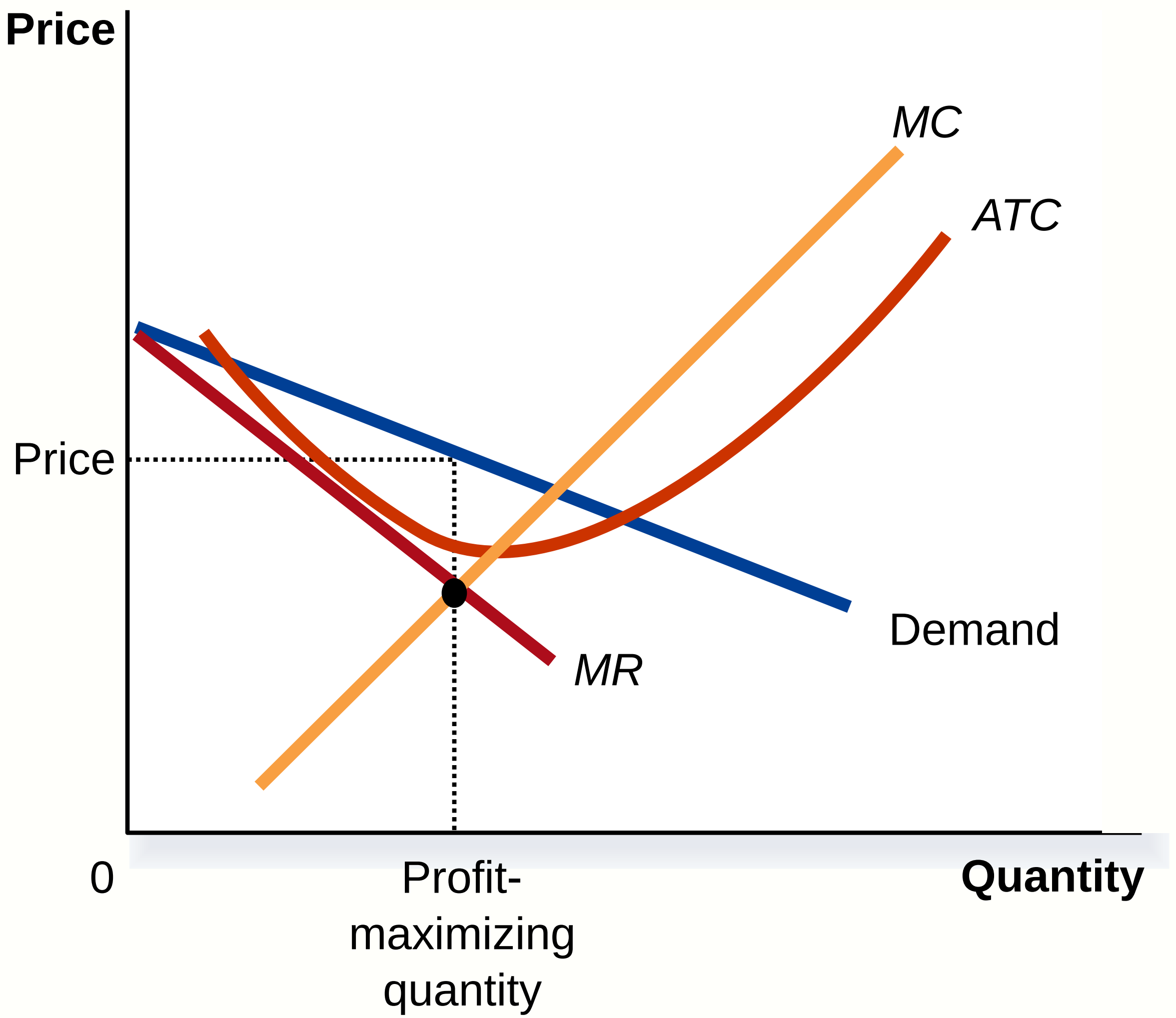
- Examples: restaurants, most retailers

- The monopolistically competitive firm will maximize profits when it produces where its MC = MR and charge a price based on demand (just like a monopoly).

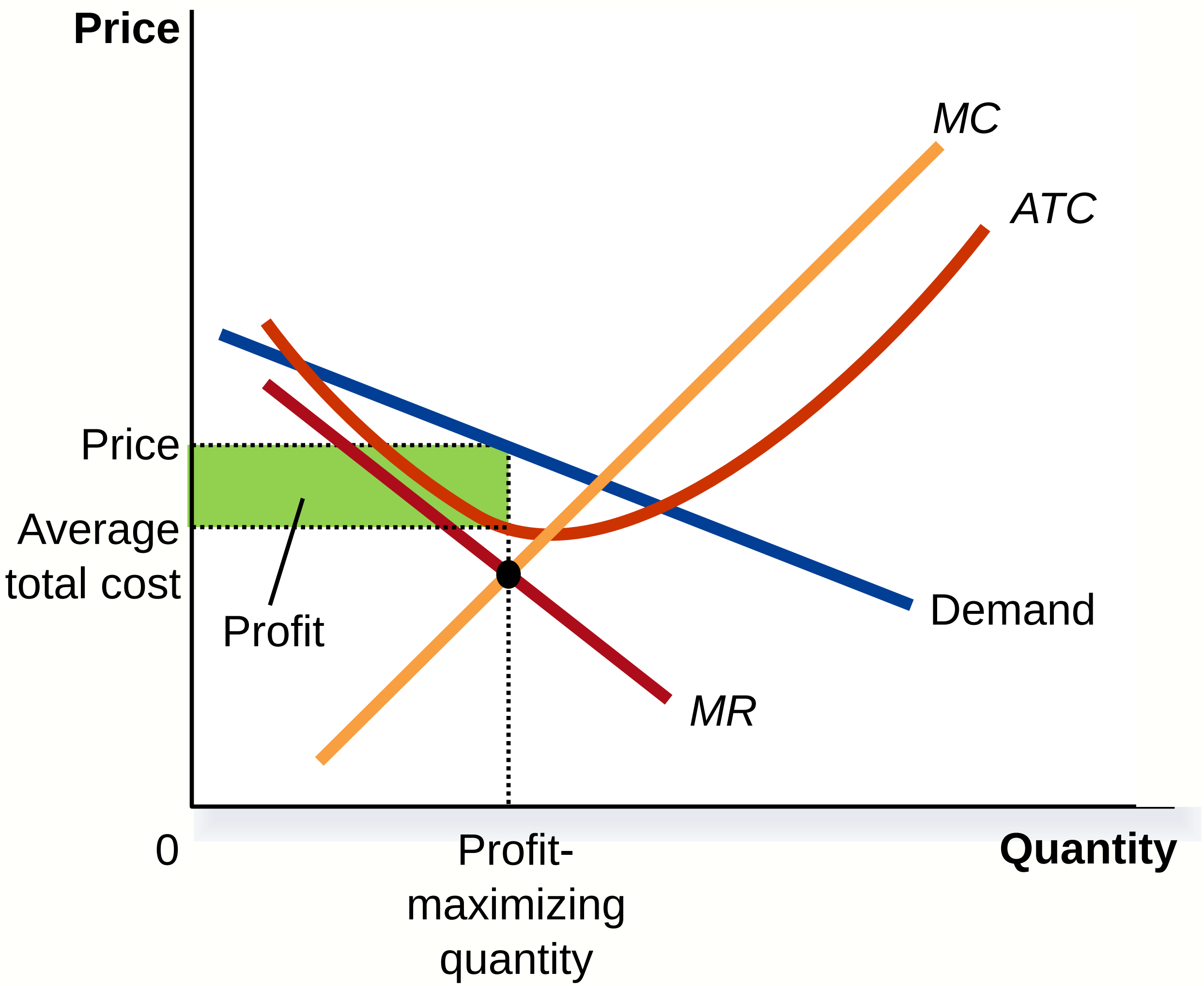
- In the SR, a monopolistically competitive firm behaves just like a monopolist.

Monopolistic Competition in the SR

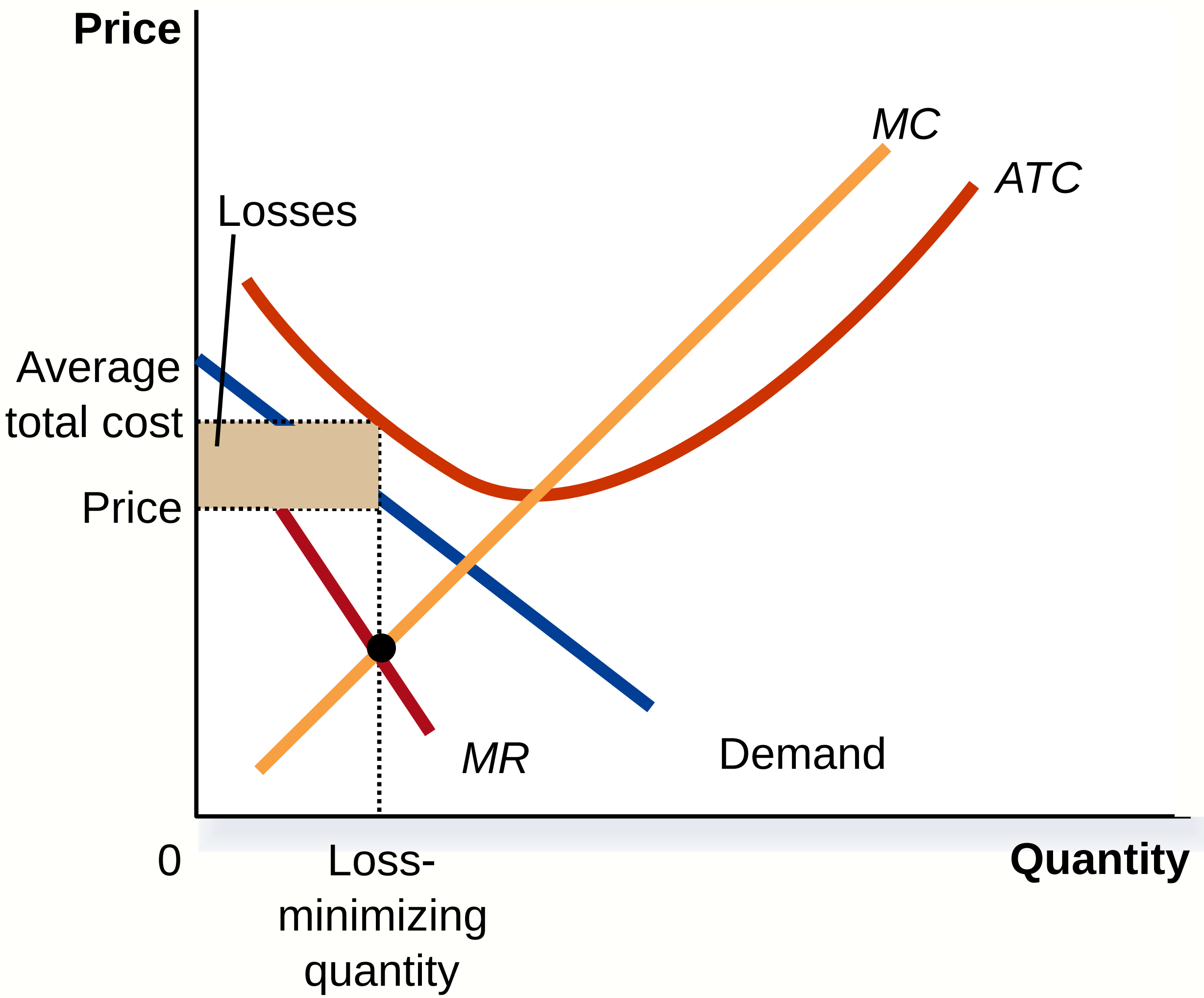



Price
MC
ATC
Price
Demand
MR
0
Profit-maximizing quantity
Quantity

Firm Makes Profit



Firm Makes Losses

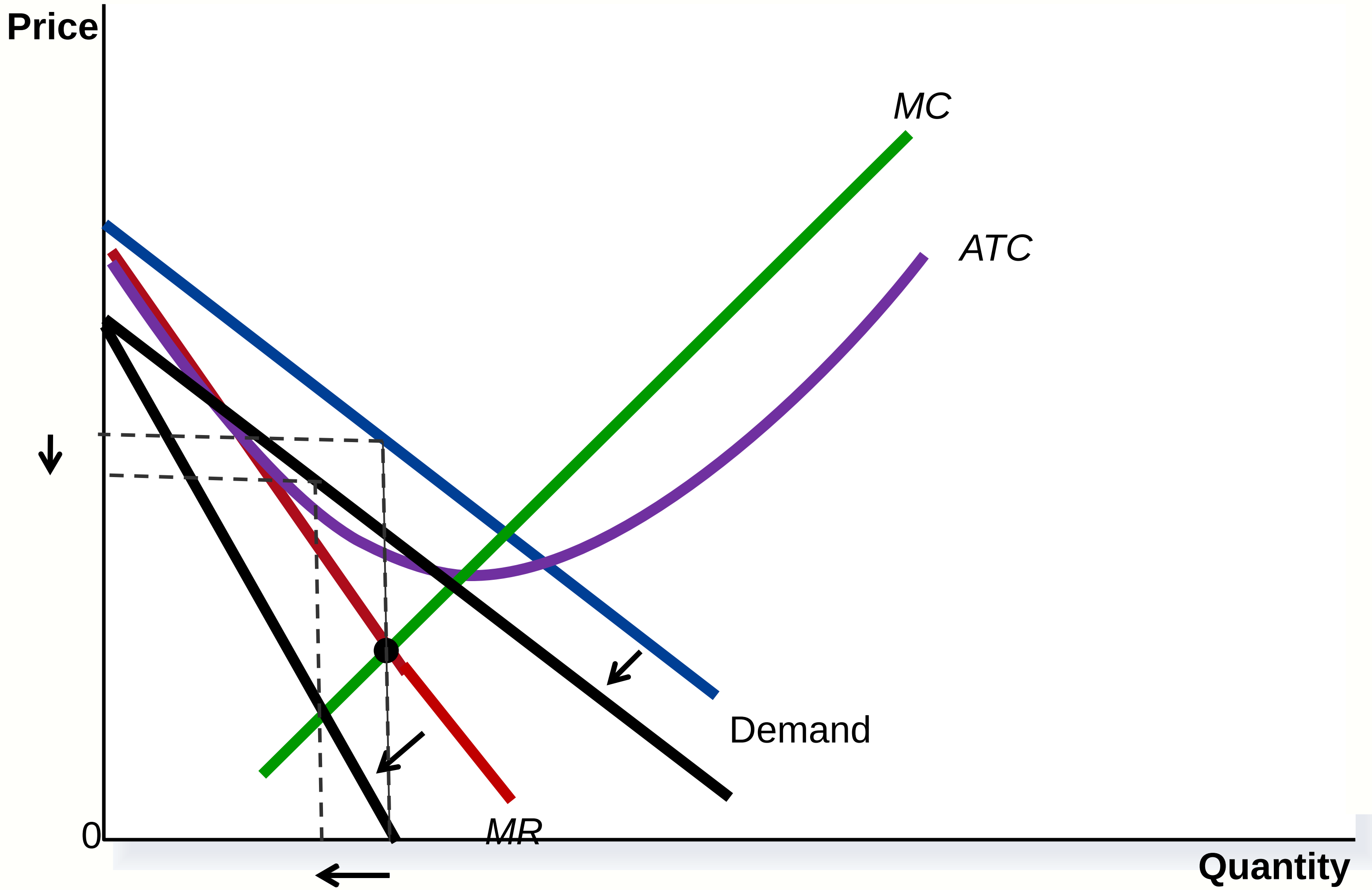


In the Short Run,

SR economic profits encourage new firms to enter the market. This:

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

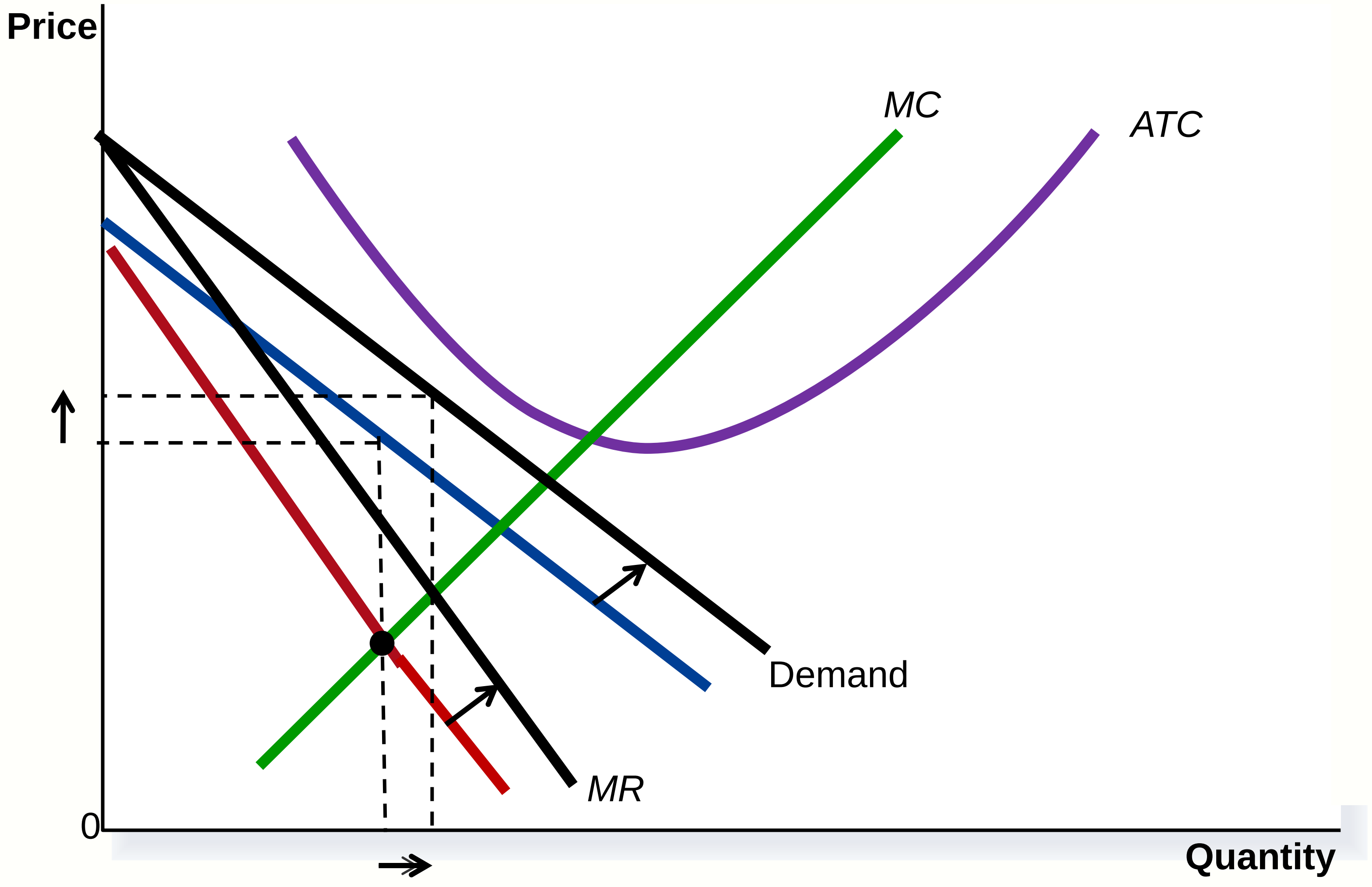
When New Firms Enter, Existing Firms' Demand Decreases



SR economic losses encourage firms to exit the market. This:

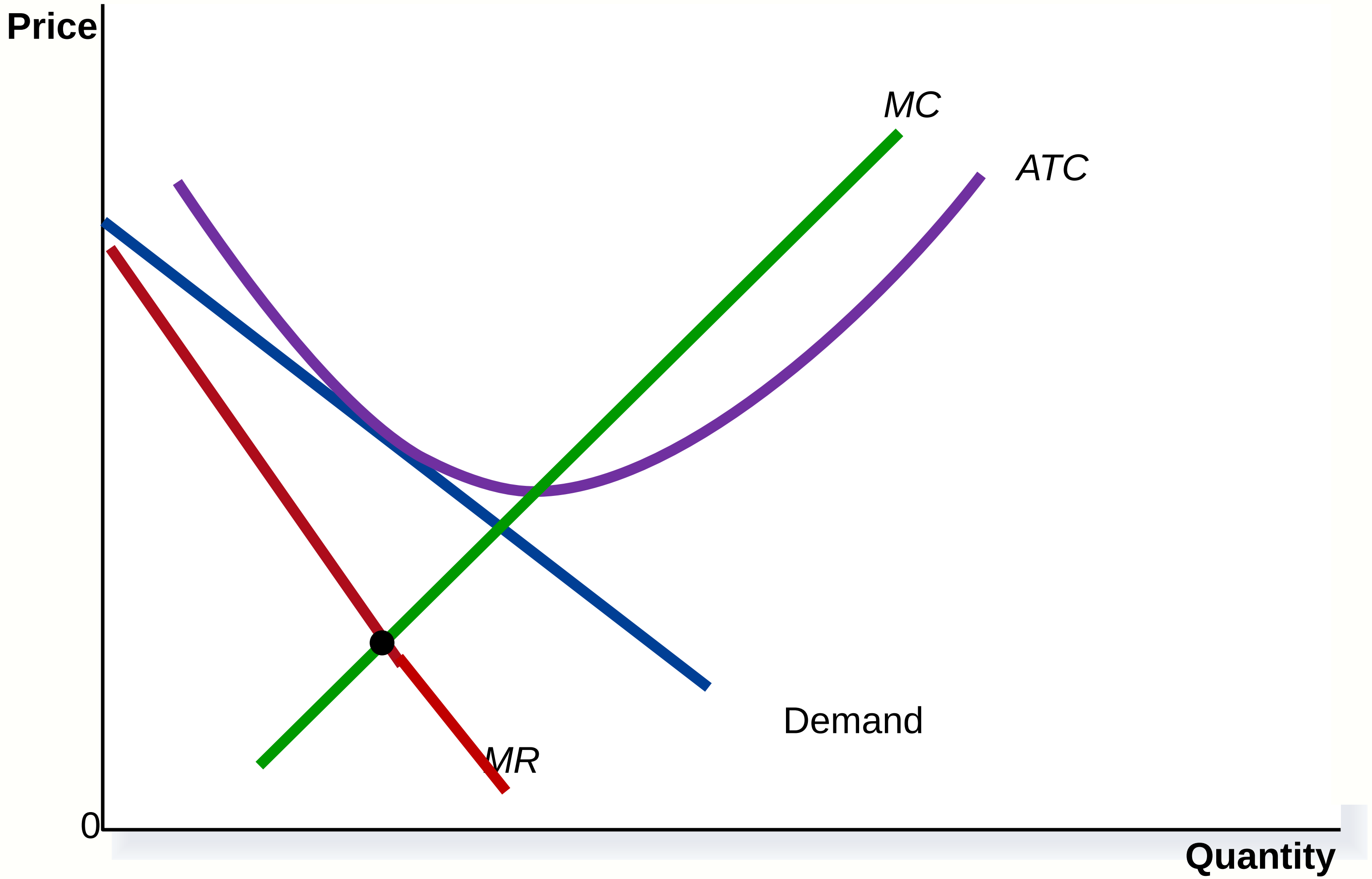
- Decreases the number of products offered.
- Increases demand faced by the remaining firms.
- Shifts the remaining firms’ demand curves to the right.
- Increases the remaining firms’ profits.

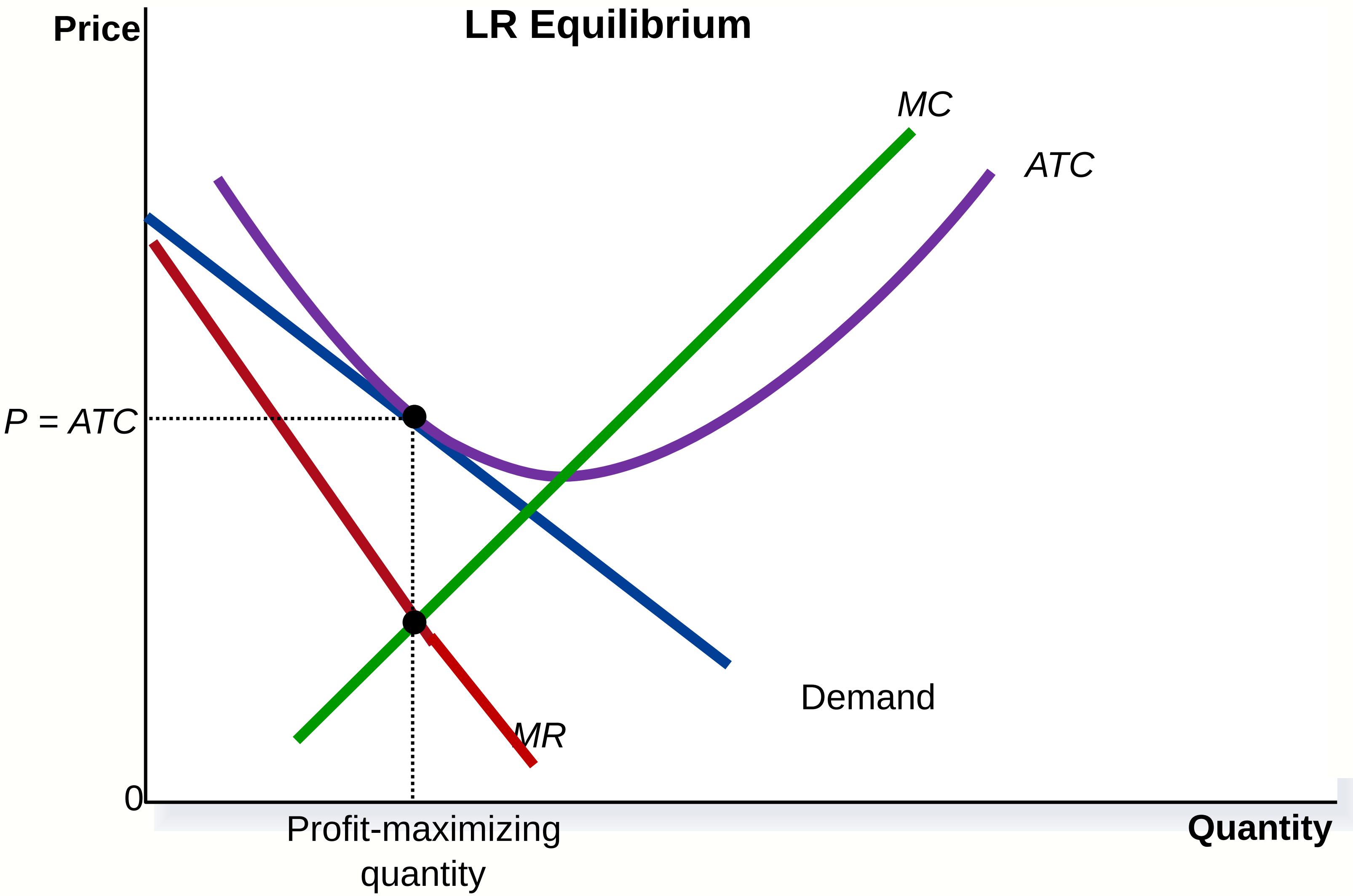
When Firms Exit, Existing Firms' Demand Increases

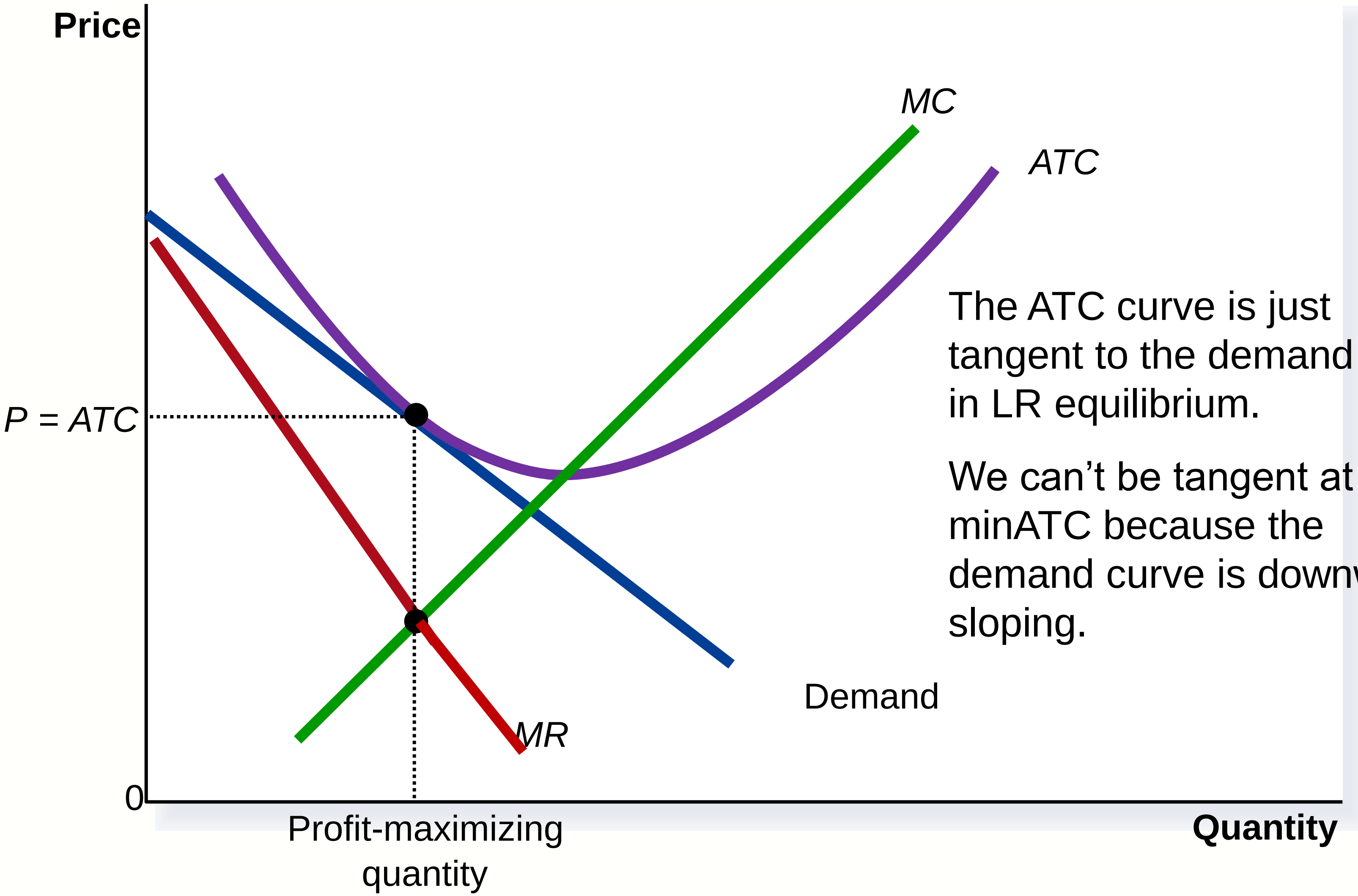


- Firms will enter and exit until the firms are making exactly zero economic profits, just like perfect competition.
- Firms make zero economic profits when P = ATC.

Monopolistic Competition: Firm in LR Equilibrium




LR Equilibrium
Price
MC
ATC
P = ATC
Demand
MR
0
Profit-maximizing
quantity
Quantity



The ATC curve is just tangent to the demand curve in LR equilibrium.

We can't be tangent at minATC because the demand curve is downward sloping.

Two Characteristics of Monopolistic Competition

- 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.

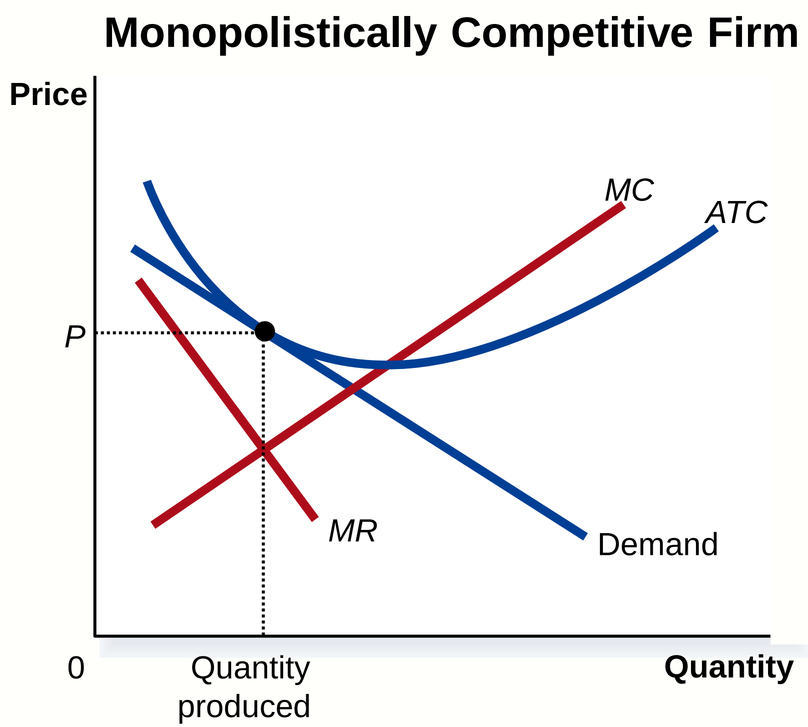
- As in a competitive market, price equals average total cost in LR equilibrium.
  -Free entry and exit drive economic profit to zero.

- One big difference between perfect competition and monopolistic competition is the Q produced in the LR.

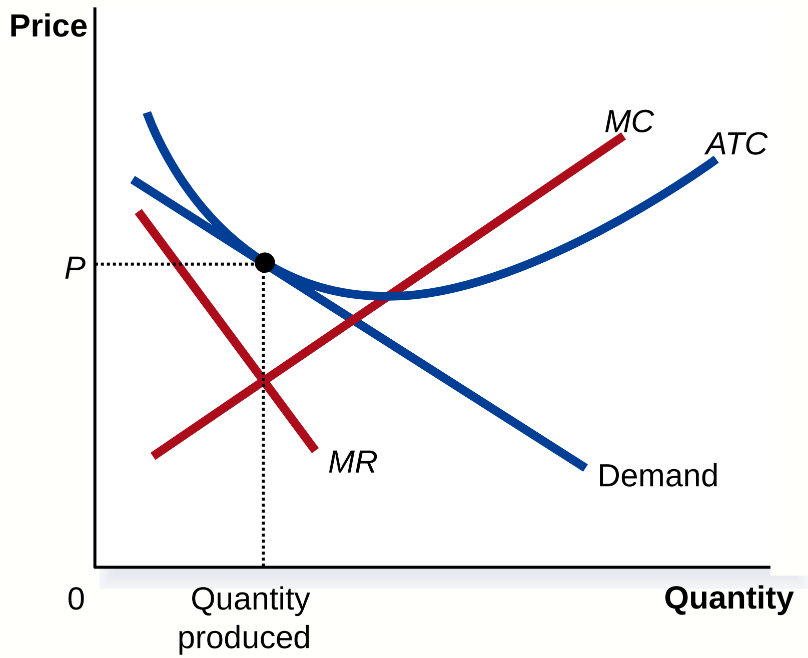
- Monopolistically competitive firms produce at a level we call excess capacity.

  -They produce a level of Q where ATC is above min ATC, unlike perfectly competitive firms.

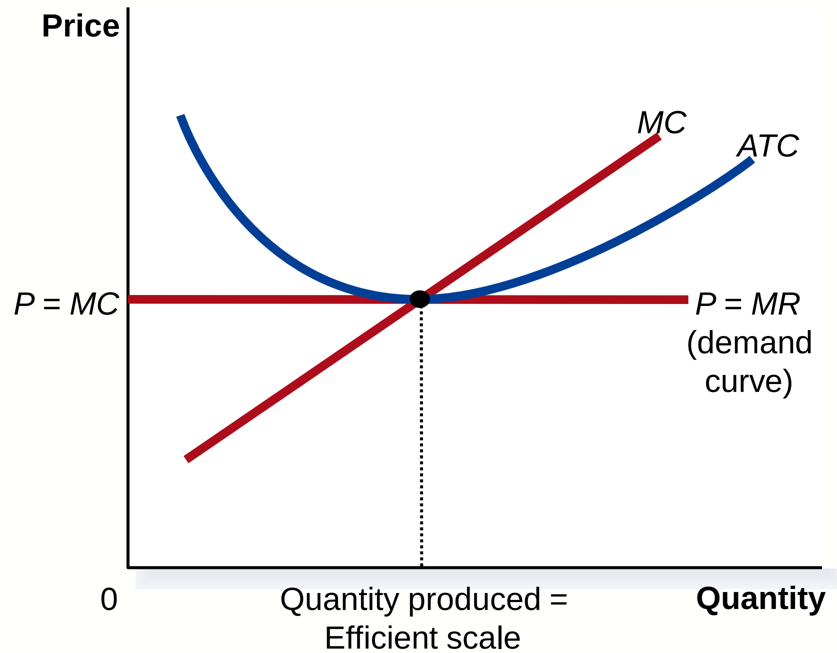
Monopolistic Versus Perfect Competition in LR Equilibrium

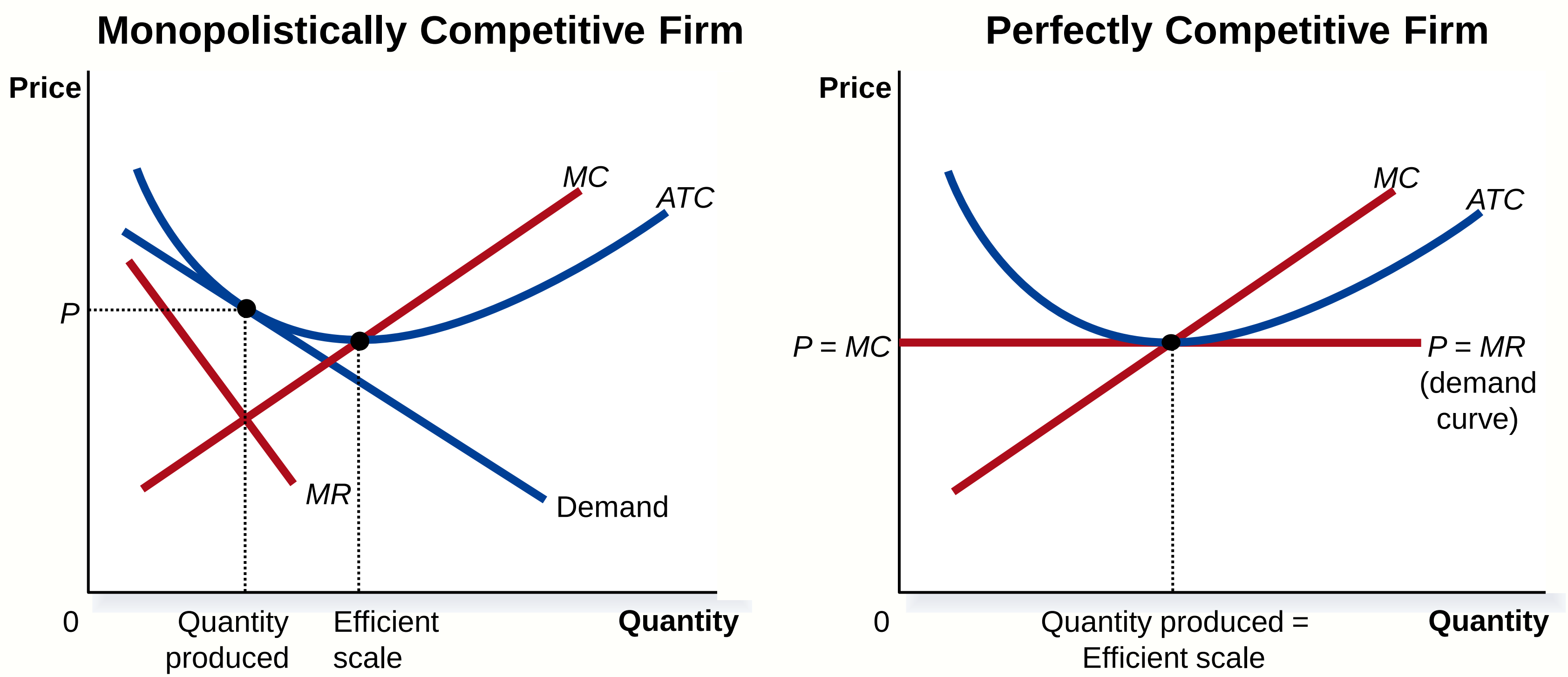


Monopolistically Competitive Firm



Perfectly Competitive Firm





The monopolistically competitive firm has the ability to produce more Q (excess capacity) and lower its ATC. However, it would be making a loss because its ATC would be greater than the price it could get for that quantity.

A monopolistically competitive firm also enjoys a markup over MC.

- For a competitive firm, P= MC.
- For a monopolistically competitive firm, P > MC.
- Because price exceeds marginal cost, an extra unit sold at the going price means more profit for the monopolistically competitive firm.
- A firms wants more customers, so it will advertise to get them!

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, allowing firms to charge higher prices.

- Defenders argue that advertising provides information to consumers.
- Consumers can “shop around” for deals more easily.
- They also argue that advertising increases competition by offering a greater variety of products and prices.

- The willingness of a firm to spend advertising dollars can be a *signal* to consumers about the quality of the product being offered.
- Ads may convince buyers to try a product once, but the product must be of high quality for people to become repeat buyers.
- The most expensive ads are not worthwhile unless they lead to repeat buyers.
- When consumers see expensive ads, they think the product must be good if the company is willing to spend so much on advertising.

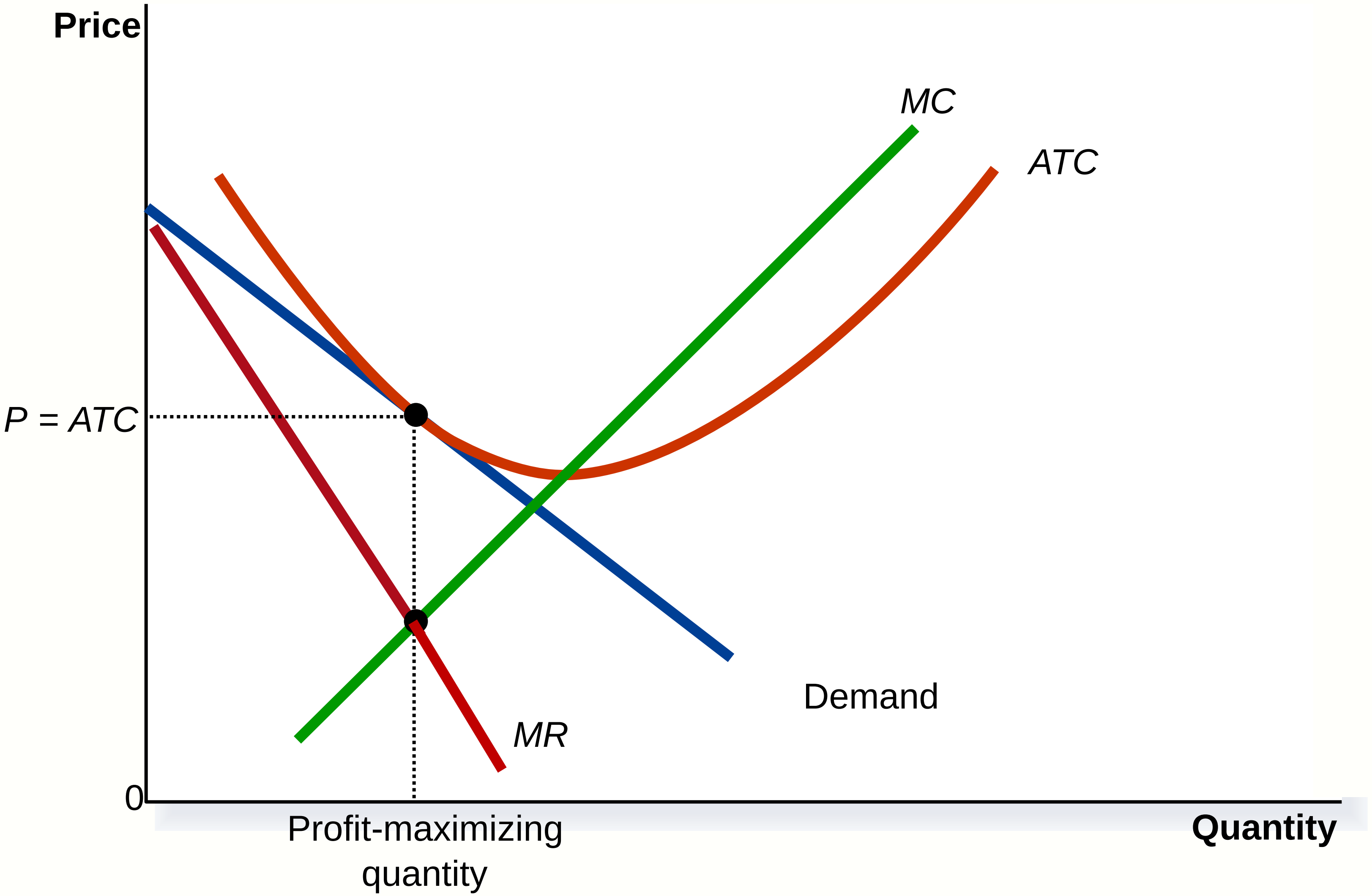
Brand Names

- Critics argue that brand names cause consumers to perceive differences that do not really exist.
- Consumers' willingness to pay more for brand names is irrational, fostered by advertising
- Economists have argued that brand names may be a useful way for consumers to ensure that the goods they are buying are of high quality.
- Brand names signal information about quality.
- Companies with brand names have incentive to maintain quality, to protect the reputation of their brand names.

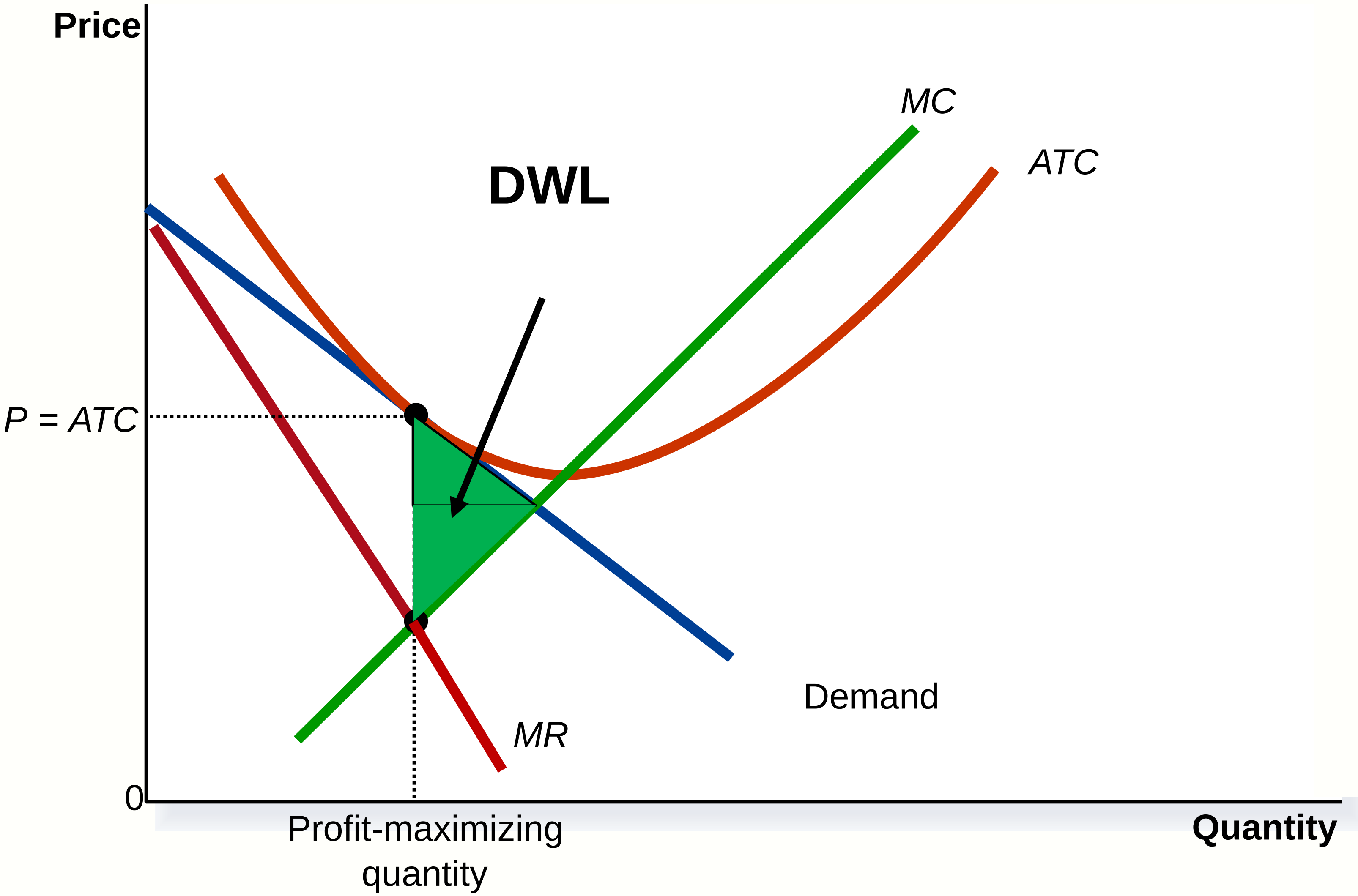
Deadweight Loss

- Just like monopoly, there are deadweight losses due to monopolistic competition that make it socially inefficient:

DWL in Monopolistic Competition



DWL in Monopolistic Competition



Another way in which monopolistic competition may be socially inefficient is:

- the number of firms in the market may not be the “ideal” one; and
- there may be too much or too little entry.
- there may be externalities.

- A <u>product-variety</u> externality:
- Because consumers like the introduction of a new product which adds to their choices, entry of a new firm can be a *positive externality* on consumers.

- A <u>business-stealing</u> 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.

- Whichever externality is greater determines whether too many or too few firms exist.

- If the product-variety externality is greater than the business-stealing externality, more firms are desirable.

- If the business-stealing externality is greater than the product-variety externality, fewer firms are desirable.

- The big thing to remember about monopolistic competition is that:

- In the SR, firms resemble monopolies.
- In the LR, firms resemble perfect competition.

Summary of Market Structures (so far)

	Market Structure		
	Perfect Competition	Monopolistic Competition	Monopoly
Features that all three market structures share			
Goal of firms	Maximize profits	Maximize profits	Maximize profits
Rule for maximizing	$MR = MC$	$MR = MC$	$MR = MC$
Can earn economic profits in the short run?	Yes	Yes	Yes
Features that monopoly and monopolistic competition share			
Price taker?	Yes	No	No
Price	$P = MC$	$P > MC$	$P > MC$
Produces welfare-maximizing level of output?	Yes	No	No
Features that perfect competition and monopolistic competition share			
Number of firms	Many	Many	One
Entry in long run?	Yes	Yes	No
Can earn economic profits in long run?	No	No	Yes