Principles of Economics

ECON F211

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Monopolistic Competition

- A common form of industry (market) structure characterized by a large number of firms, no barriers to entry, and product differentiation

TABLE 15.1 Percentage of Value of Shipments Accounted for by the Largest Firms in Selected Industries, 2002

Industry Designation	Four Largest Firms	Eight Largest Firms	Twenty Largest Firms	Number of Firms
Travel trailers and campers	38	45	58	733
Games, toys	39	48	63	732
Wood office furniture	34	43	56	546
Book printing	33	54	68	560
Curtains and draperies	17	25	38	1,778
Fresh or frozen seafood	14	24	48	529
Women’s dresses	18	23	48	528
Miscellaneous plastic products	6	10	18	6,775

Product Differentiation & Advertising

A strategy that firms use to achieve market power. Accomplished by producing products that have distinct positive identities in consumers' minds

- **Horizontal differentiation** – Products differ in ways that make them better for some people and worse for others

- **Vertical differentiation** – A product difference that, from everyone's perspective, makes a product better than rival products

Differentiated products and advertising give the market system its vitality and are the basis of its power

Advertising: The case for & Against

Case for –

- Product differentiation **helps to ensure high quality and variety**, and advertising **provides consumers with valuable information on product availability, quality, and price** that they need to make efficient choices in the marketplace

Case against –

- The bottom line, critics of product differentiation and advertising argue, is waste and inefficiency. Enormous sums are spent to create minute, meaningless, and possibly nonexistent differences among products. **Advertising raises the cost of products** and frequently contains very little information. Often, it is merely an annoyance. **Advertising can lead to unproductive warfare** and **may serve as a barrier to entry, thus reducing real competition**

Price & Output Determination in Monopolistic Competition

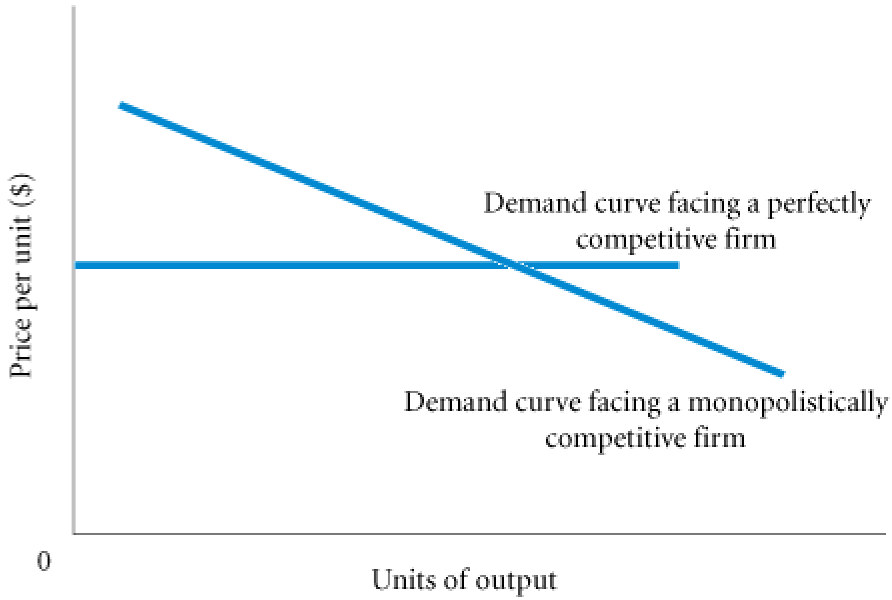
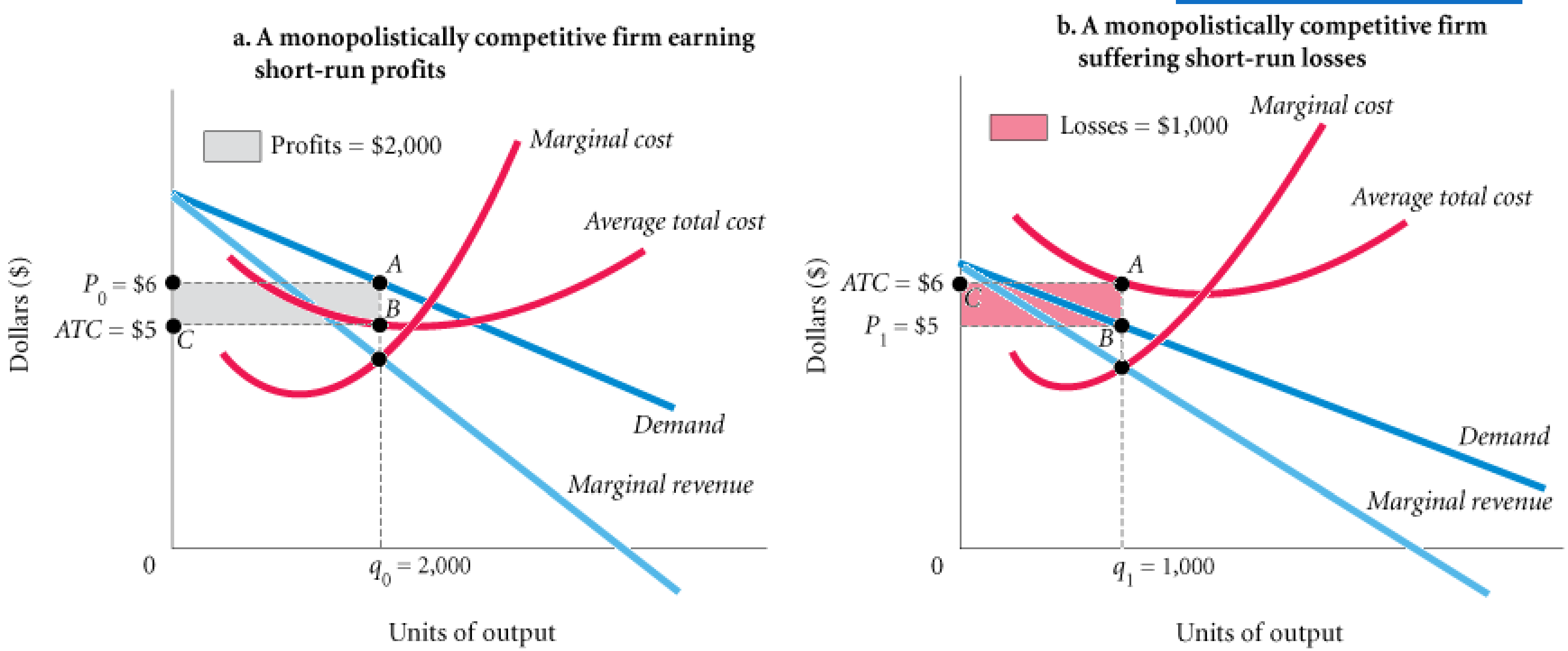


FIGURE 15.2 Product Differentiation Reduces the Elasticity of Demand Facing a Firm

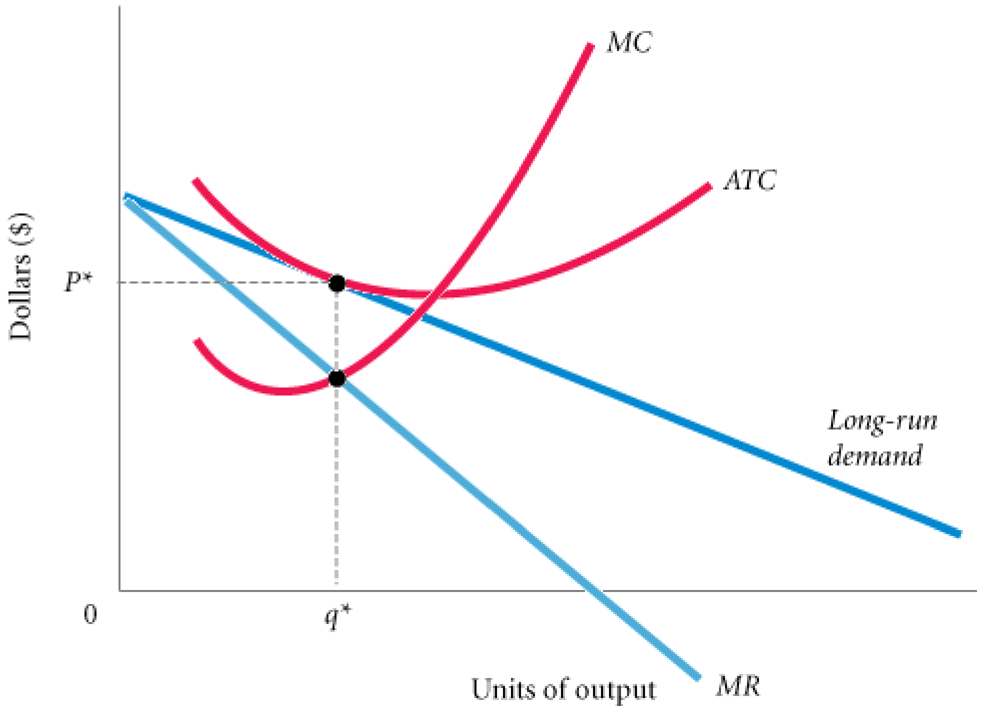
- The demand curve that a monopolistic competitor faces is likely to be less elastic than the demand curve that a perfectly competitive firm faces
- Demand is more elastic than the demand curve that a monopolist faces because close substitutes for the products of a monopolistic competitor are available

Price & Output Determination in Monopolistic Competition – Short run



- In the short run, a monopolistically competitive firm will produce up to the point $MR = MC$
- At $q_0 = 2{,}000$ in panel a, the firm is earning short-run profits equal to $P_0ABC = \$2{,}000$
- In panel b, another monopolistically competitive firm with a similar cost structure is shown facing a weaker demand and suffering short-run losses at $q_1 = 1{,}000$, equal to $CABP_1 = \$1{,}000$

Price & Output Determination in Monopolistic Competition – Long run



- As new firms enter a monopolistically competitive industry in search of profits, the demand curves of existing profit-making firms begin to shift to the left, pushing marginal revenue with them as consumers switch to the new close substitutes

- This process continues until profits are eliminated, which occurs for a firm when its demand curve is just tangent to its average total cost curve

Economic Efficiency & Resource Allocation

- Because entry is easy and economic profits are eliminated in the long run, we might conclude that the result of monopolistic competition is efficient. There are two problems, however

- First, once a firm achieves any degree of market power by differentiating its product (as is the case in monopolistic competition), its profit-maximizing strategy is to hold down production and charge a price above marginal cost

- Second, the final equilibrium in a monopolistically competitive firm is necessarily to the left of the low point on its average total cost curve, which means a typical firm in this industry will not realize all the economies of scale available

Industry Characteristics

	Number of firms	Products differentiated or homogeneous	Price a decision variable	Easy entry	Distinguished by	Examples
Perfect competition	Many	Homogeneous	No	Yes	Market sets price	Wheat farmer Textile firm
Monopoly	One	One version or many versions of a product	Yes	No	Still constrained by market demand	Public utility Patented drug
Monopolistic competition	Many	Differentiated	Yes, but limited	Yes	Price and quality competition	Restaurants Hand soap
Oligopoly	Few	Either	Yes	Limited	Strategic behavior	Automobiles Aluminum

▲ **FIGURE 15.1 Characteristics of Different Market Organizations**

Reference

Case, K.E., Fair, R.C., & Oster, S.E. (2018). *Principles of Economics*. 12th Edition, Pearson India Education Services Pvt. Ltd.