Chapter 16: Monopolistic Competition

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Discussion section 4

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Outline

Today we will talk about:

- monopolistic competition
  - short vs. long run
  - entry and exit
  - efficiency and externalities
- Advertising

Monopolistic Competition

What is monopolistic competition?

Many firms sell products that are similar but not identical

- Many buyers and sellers
- Products are *similar but not identical*
- Free entry and exit (in the long run)

What are some examples?

Monopolistic Competition

Just like any other type of market...

Firms maximize profit when they set $MR = MC$!

What will the firms demand curve look like?

Monopolistic Competition

Just like any other type of market...

Firms maximize profit when they set $MR = MC$!

What will the firms demand curve look like?

- Firms are not price takers - they have some market power due to differentiated products
- Firm demand will resemble that of a monopoly
- It is downward sloping!

Let's draw this market...

Short vs. Long run

In the short-run:

- If $P > ATC \implies$ positive π
- If $P < ATC \implies$ loss As long as $P > AVC$, the firm continues to operate

In the long-run:

- When firms make losses in the SR $\implies$ exit
  - $\rightarrow$ increases demand for each existing firm
  - $\rightarrow \uparrow P \quad \& \uparrow \pi$
- When firms make positive $\pi \implies$ new firms enter & produce close substitutes
  - $\rightarrow$ reduces demand for each existing firm
  - $\rightarrow \downarrow P \quad \& \downarrow \pi$

**** entry/exit $\implies$ all firms earn 0 economic π in LR!! ****

In the long run...

Two important characteristics of monopolistic competition:

1. As in a monopoly market: $MC < P$ - **Markup**
   - maximizing π means setting $MR = MC$, and $MR <$ demand curve, which gives us price
   - So $MR < P$
2. As in a competitive market: $P = ATC$ - **No profits**
   - free entry and exit drive economic profit to 0

The optimal Q for a monopolistically competitive firm is Q such that:

1. $MR = MC$
2. ATC is tangent to (kisses) the firms demand curve

Monopolistic vs. Perfect Competition

Two key differences:

Excess capacity:

The **efficient scale** is the Q which minimizes ATC

- A monopolistically competitive firm has excess capacity:
  - They could $\uparrow Q$ and that would $\downarrow ATC$

Markup:

A monopolistically competitive firm operates where:

- ATC is decreasing $\rightarrow$ where $MC < ATC$
- $\implies MC < P$
- firms want to induce additional demand

Monopolistic competition and welfare

Externality: uncompensated impact of one person/firms actions on a bystander person/firm

- Positive externality: surplus of bystander goes up
- Negative externality: surplus of bystander goes down

How does firm entry affect a monopolistically competitive market?

Product-variety externality: positive externality on consumers

Business-stealing externality: negative externality on sellers

Advertising

What is the point of advertising?

- *Informs*: conveys prices and locations of goods, introduces new products
- *Misleads*: convinces that substitutes are more distinct than they really are
- *Signals*: willingness to spend money to advertise indicates high quality

Is this good or bad for welfare? We don't really know!