ETH zürich

Section 14
Monopolistic Competition

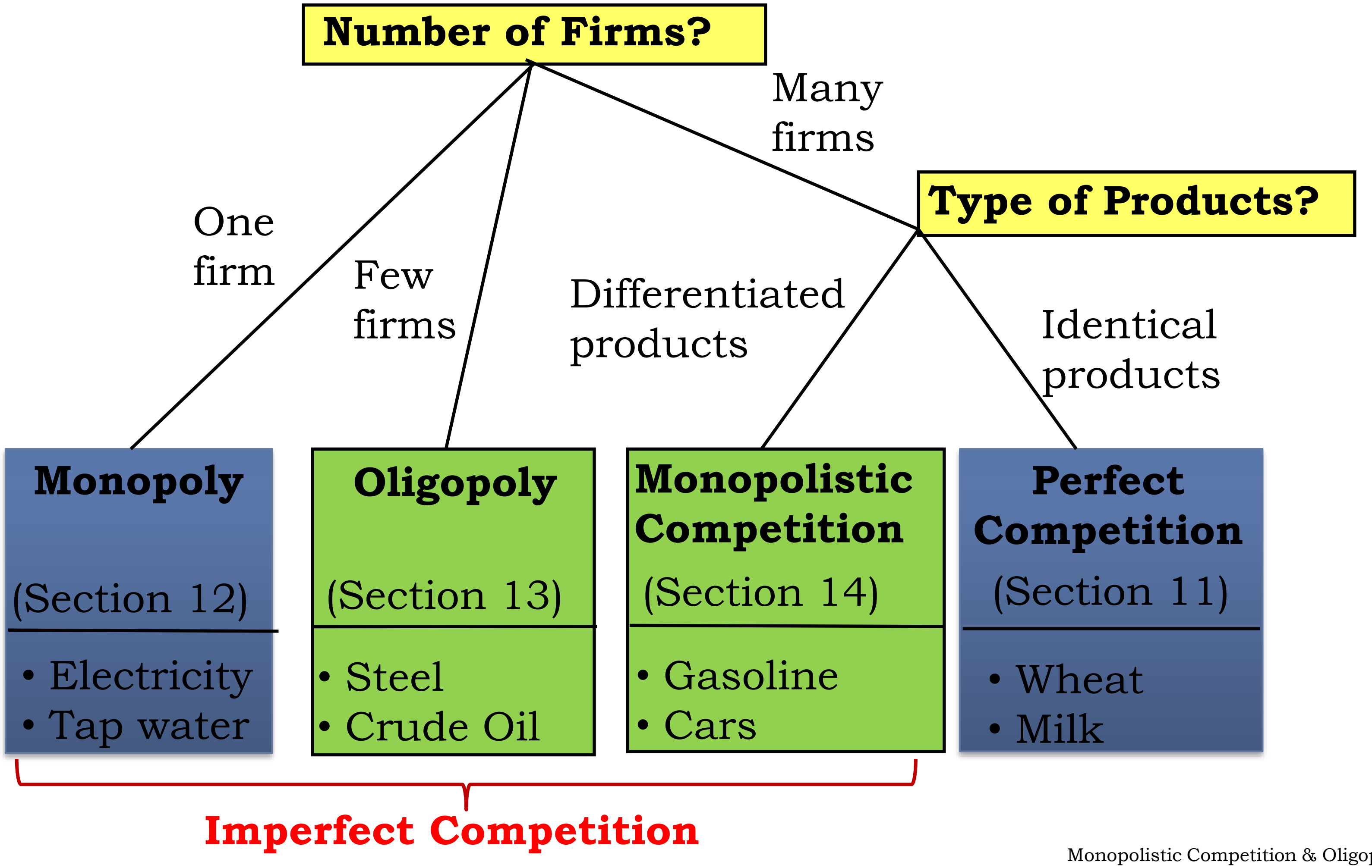
Reference:

N. Gregory Mankiw and Mark P. Taylor (2020), *“Microeconomics”*, Cengage Learning, Chapters 12

Goodwin et al. (2019), *“Microeconomics in Context”*, Routledge, Chapter 8

The slides of this section are mainly based on the 6th edition of the book by Mankiw and Taylor (2023). In some slides we reproduce figures, sentences and definitions given in the book.

Models of Imperfect Competition



Contents

A. Monopolistic Competition

Monopolistic Competition

Monopolistic Competition: Many firms selling products that are similar but not identical.

Attributes of Monopolistic Competition:

- **Many sellers**: There are many firms competing for the same group of customers (e.g. Books, CDs, restaurants).
- **Product differentiation**: Each firm produces a product that is at least slightly different from those of other firms. Rather than being a price taker, each firm faces a downward-sloping demand curve.
- **Free entry and exit:** Firms can enter or exit the market without restriction, i.e. the number of firms in the market adjusts until economic profits are zero.
- The **cross-price elasticities** of demand are large but not infinite.

TABLE 12.1 Examples of Markets Which Have Characteristics of Monopolistic Competition

Computer games	Vets
Restaurants	Hotel accommodation
Conference organizers	Air conditioning systems
Wedding planners	Pest control
Plumbing	Removal services
Coach hire	Beauty consultants
Funeral directors	Shop fitters
Fabric manufacturers	Waste disposal
Tailors	Dentists
Music teachers	Children's entertainers
Books	Gas engineers
CDs/DVDs	Steel fabricators
Landscape architects	Driving schools
Environmental consultants	Opticians
Furniture manufacturers	Chimney sweeps

Source: Mankiw & Taylor (2020), table 12.1, p. 268

B. Monopolistic Competition in the Short Run

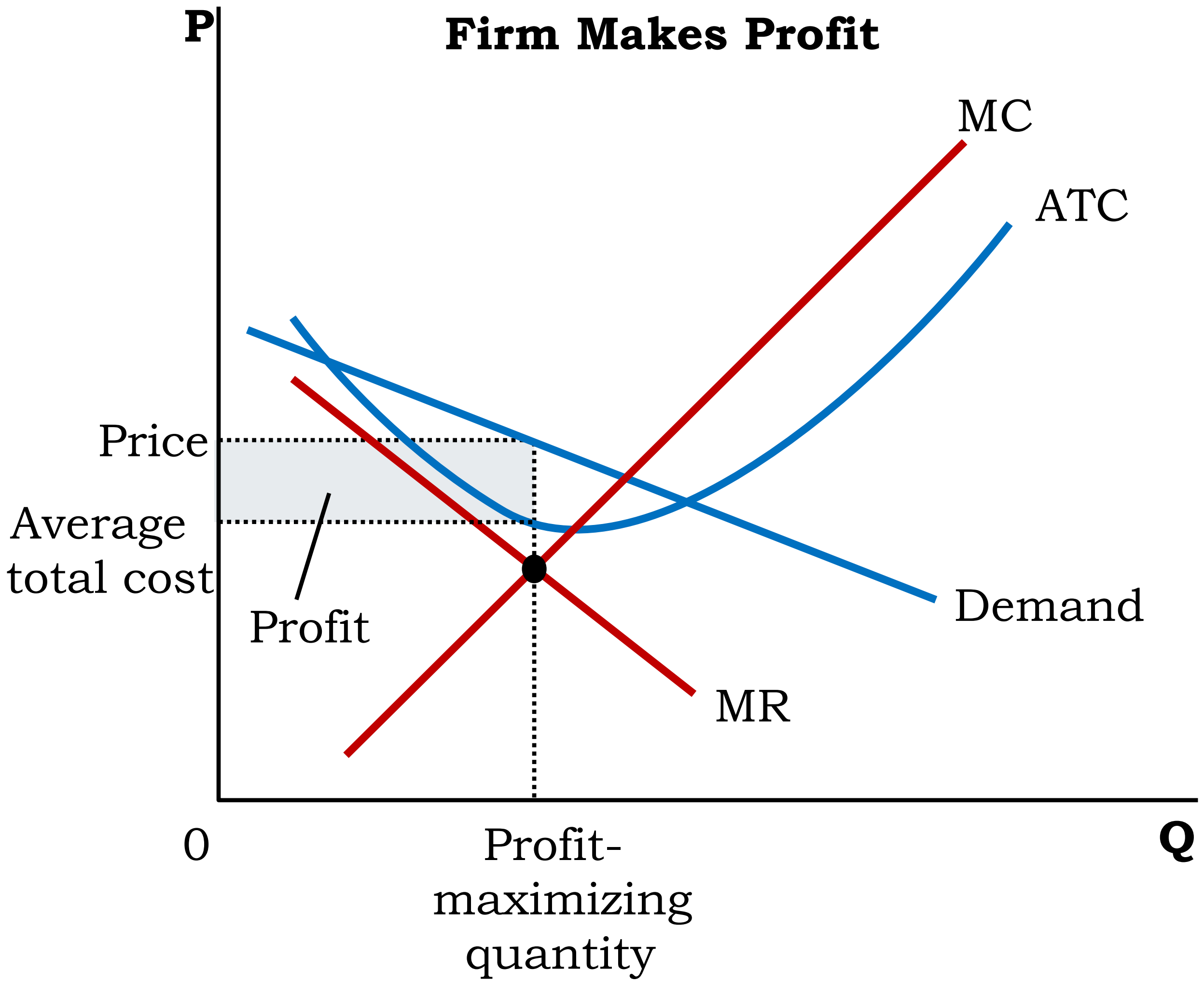
Monopolistic Competition in the Short Run

- A monopolistically competitive firm chooses its quantity and price just as a monopoly does.

- **In the short-run, these two types of market structure are similar!**

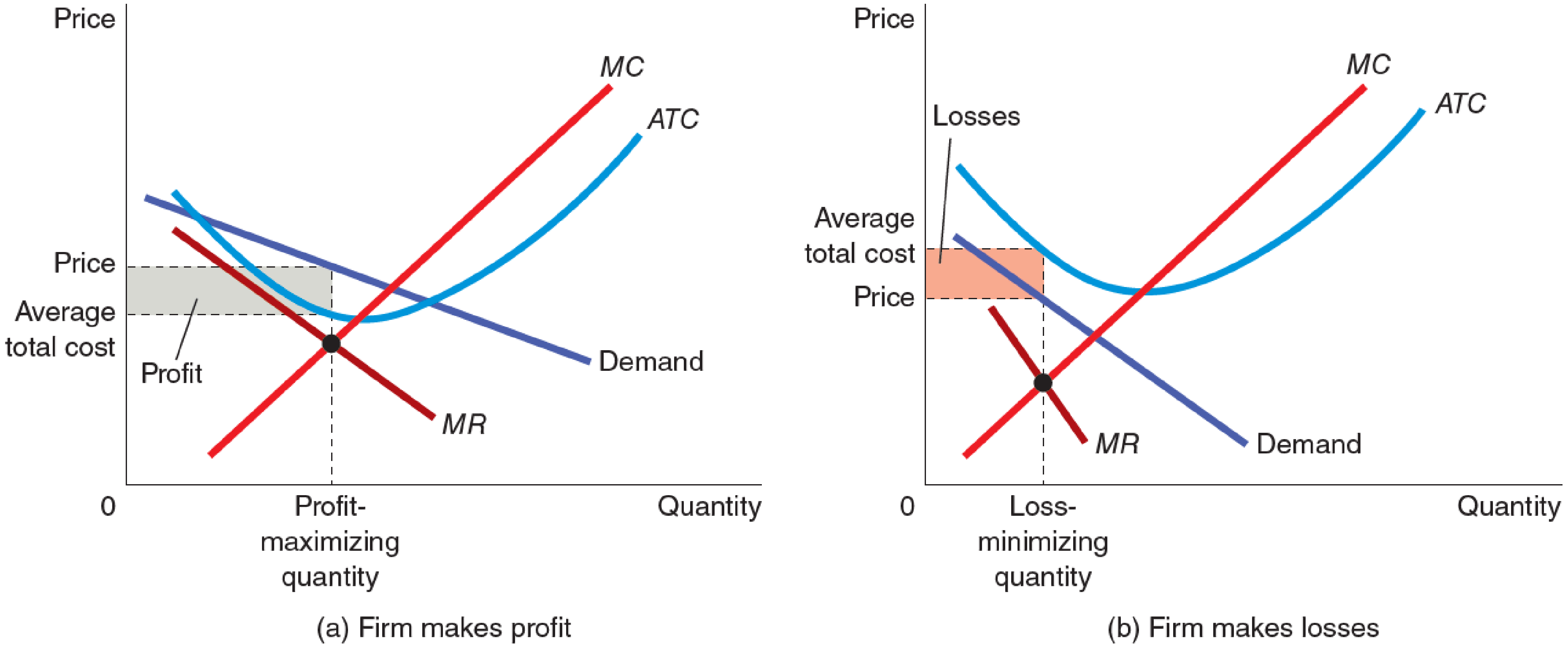
Monopolistic Competition in the Short Run

Quiz: How much profits will a firm in a monopolistic market make in the short-run?



Source: Mankiw & Taylor (2023), "Microeconomics"

Monopolistic Competitor in the Short Run



Source: Mankiw & Taylor (2023), “Microeconomics”

Monopolistic Competition in the Short Run

Short-run 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.
- Incumbent firms' demand curves shift to the left.
- Demand for the incumbent firms' products fall, and their profits decline.

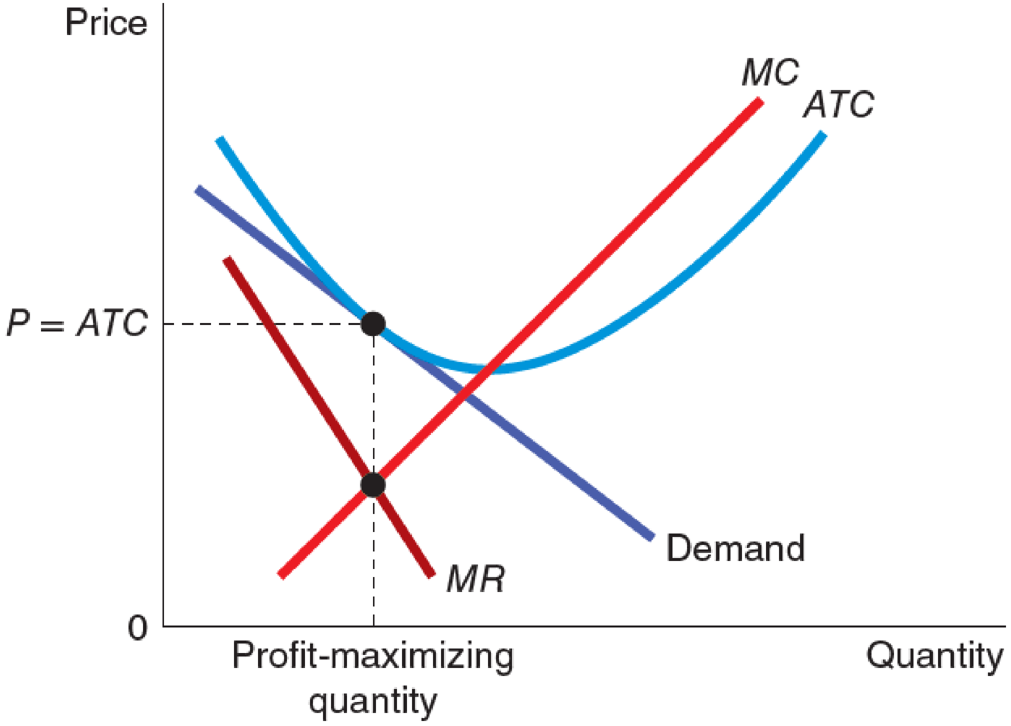
Monopolistic Competition in the Short Run

Short-run 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.

C. Monopolistic Competition in the Long Run

Monopolistic Competitor in the Long Run



Source: Mankiw & Taylor (2023), “Microeconomics”

D. Monopolistic vs. Perfect Competition

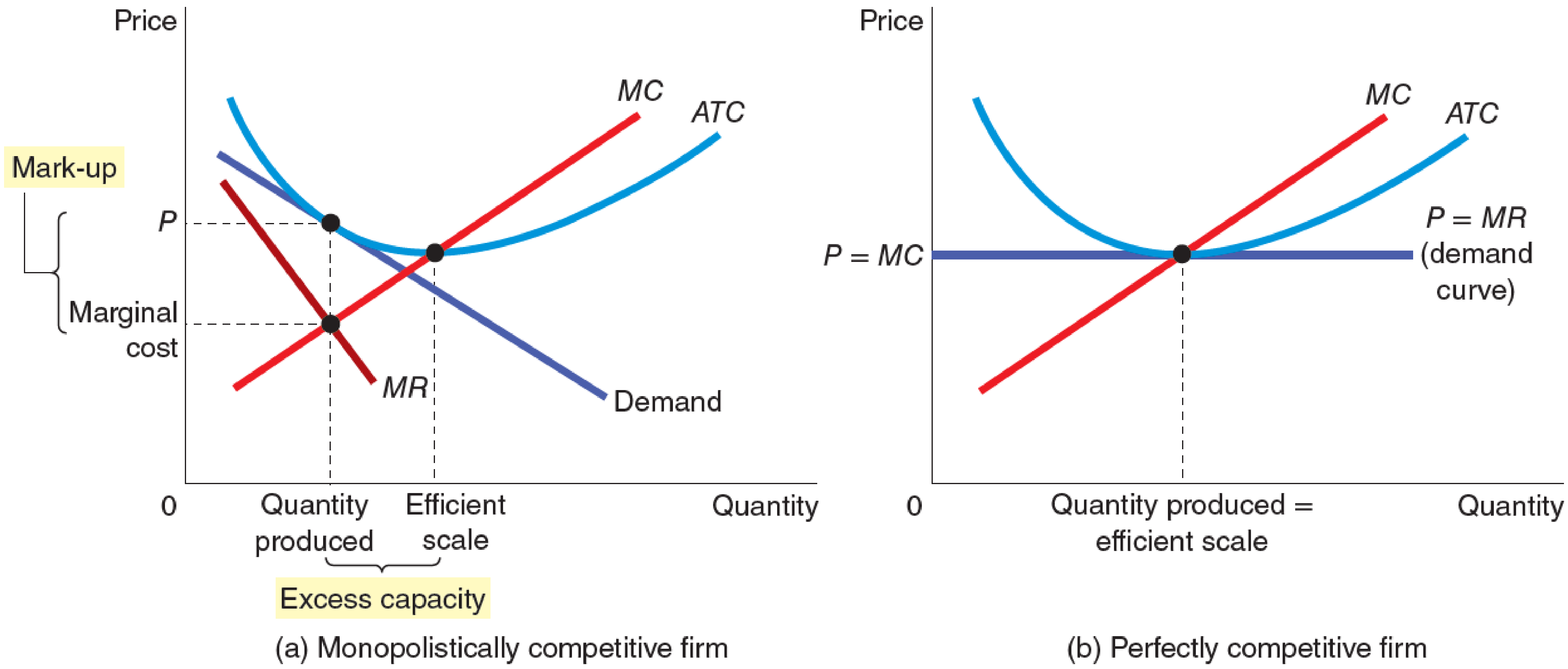
Monopolistic vs. Perfect Competition

There are two noteworthy differences between monopolistic and perfect competition in the long-run: **mark-up** and **excess capacity**.

Mark-up over Marginal Cost ➔ Deadweight loss

- For a competitive firm, price equals marginal cost.
- For a monopolistically competitive firm, price exceeds marginal cost.

Monopolistic versus Perfect Competition



Source: Mankiw & Taylor (2023), "Microeconomics"

Monopolistic Competition and the Welfare of Society

- Monopolistic competition does not have all the desirable properties of perfect competition.
  - ↳ There is the **normal deadweight loss** of monopoly pricing in monopolistic competition caused by the mark-up of price over marginal cost.
  - ↳ The **number of firms** in the market may not be the "ideal" one. There may be too much or too little entry.

- The **administrative burden** of regulating the pricing of all firms that produce differentiated products would be overwhelming.

Summary

TABLE 12.2 **Monopolistic Competition: Between Perfect Competition and Monopoly Market Structure**

	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

Source: Mankiw & Taylor (2020), "Microeconomics"

Advertising

- When firms sell differentiated products and charge prices above marginal cost, each firm has an **incentive** to advertise in order to attract more buyers to its particular product.

- Firms that sell highly differentiated consumer goods typically spend between 10 and 20 percent of revenue on advertising.

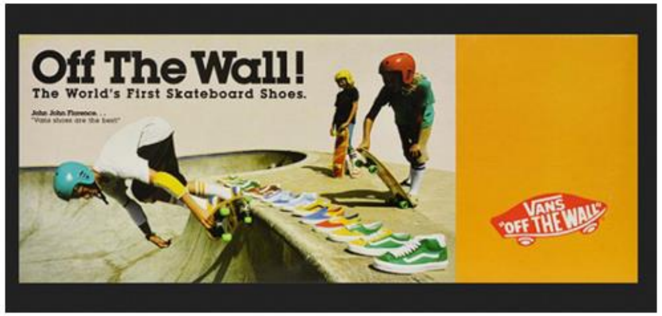
Source: www.flickr.com

Advertising

- **Critique** of Advertising:
  - Firms advertise in order to manipulate people's tastes.
  - Advertising impedes competition by implying that products are more different than they really are.
  - Advertising plays a major role in promoting a *consumer* society with a high ecological footprint and low level of sustainability
- **Defence** of Advertising:
  - Advertising provides information to consumers.
  - 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.

Sneakers


February, 1928
THE ATHLETIC JOURNAL
39
"Footwork"
the secret of power and speed"
says a world's champion athlete
in a booklet written for boys
INDOORS and outdoors—on the hard wood of the gymnasium floor as well as on the grass or clay of the tennis court—in every game where you have to cover ground fast—the saying of this great player holds good: "Shoes must be exactly right."
It's no wonder that this great athlete plays in Keds! And that most champion players in many sports—championship teams from coast to coast—choose Keds.
This new Keds special basketball shoe has a sure grip on the fastest floor. Its sole is non-slipping, light and springy. It is specially built to absorb shocks that tire muscles.
Here's a shoe that's built for speed!
For samples, get in touch with your supplier or the United States Rubber Company, 1790 Broadway, New York City.
Keds
REG. U.S. PAT. OFF.
United States Rubber Company
US
NON-CHAFING FLARE TOP
SUPPORTS YOUR INSTEP
GIVES SNUGGER FIT
THESE TOE STRIPS MEAN LONGER WEAR
SPECIAL SPONGE RUBBER ARCH CUSHION
FELTEX INNER-SOLE—KEEPS YOUR FEET COOL AND COMFORTABLE
ABSORBS THE SHOCKS THAT TIRE LEG MUSCLES
Keds
"SPRING-STEP"
This new special Keds basketball shoe is just what he's been looking for, says one of America's most famous basketball coaches. The diagram shows you why. The "Spring-Step" has a tough, sure-gripping sole and is shaped to fit your feet. Comes in white with black trim.


Off The Wall!
The World's First Skateboard Shoes.
VANS
"OFF THE WALL"

Advertising **and consumer society**

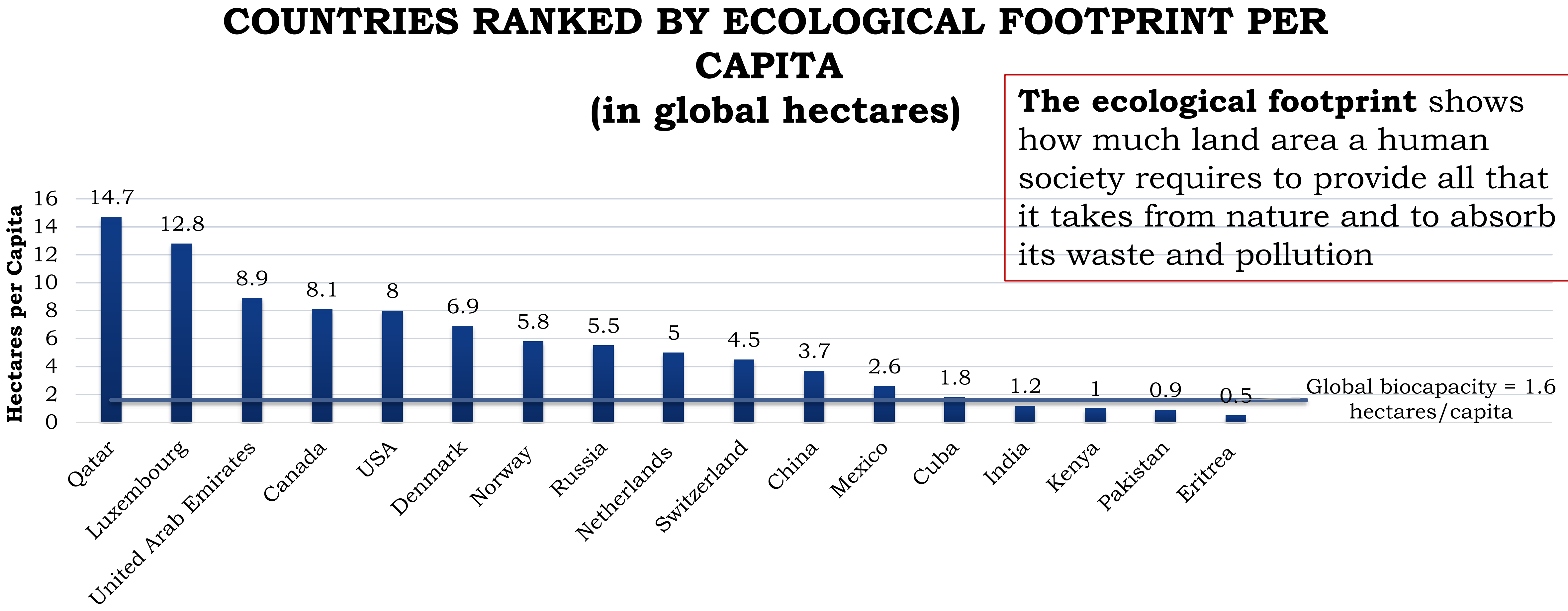
- **Advertising plays a central role in the current consumer societies:**

- **Consumer society**: A society that buys and consumes goods that are not of primary importance, partially superfluous goods that many times go to satisfy needs created by advertising or other components of society (social imitation)

- **Consumerism**: The purchase of goods and services of secondary importance, in part even superfluous and in larger quantities than necessary

- Consumer societies are characterized by a high value of **the ecological footprint** and, therefore, far from a society that promotes a sustainable development

The link between consumption and the environment



The ecological footprint shows how much land area a human society requires to provide all that it takes from nature and to absorb its waste and pollution

Source: https://data.footprintnetwork.org

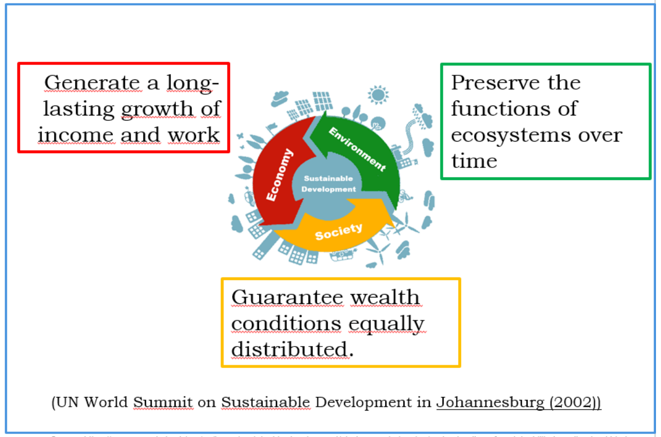
Consumers and sustainable development

- We need to promote a sustainable consumption and production, we need to reduce our ecological footprint

- Consumers are

➢ crucial in driving sustainable production

➢ play a central role in sustainable development



FROM THROWAWAY SOCIETY TO CIRCULAR ECONOMY

THROWAWAY SOCIETY – A LINEAR ECONOMIC SYSTEM

Today's throwaway society is the result of a linear economic system. Many raw materials are extracted and products are made, used and disposed. This leads to a raw material shortage, large volumes of waste and the resultant environmental problems.

The linear economic system

CIRCULARITY INSTEAD OF A LINEAR ECONOMIC SYSTEM

The circular economy aims to solve the problems of the throwaway society. Instead of products being thrown away after use (graphic above), cycles are created by sharing, reusing, repairing, remanufacturing, refurbishing and recycling (green arrows in the right-hand graphic). In a circular economy, products, materials and resources are used or reused for as long as possible and their value is retained. Fewer primary raw materials are consumed and less waste is generated than in the linear economic system.

The circular economy is an integrated approach which considers the cycle as a whole from raw material extraction, through design, production, distribution and a use phase which is as long as possible, through to recycling. So that products and materials remain in the cycle, all the stakeholders must view it as a whole and act accordingly.

PRODUCT CYCLES

Share: Several users benefit from a product and intensity of use is increased.
Reuse: : A product in working order is passed on to other users.
Repair: Longevity is extended.
Remanufacture, refurbish: Defective or obsolete products are reconditioned and made to function again.

Using products for as long as possible is environmentally beneficial in almost all cases, because energy, water and chemicals are also needed for recycling. A product is only sent for recycling if it cannot be shared, reused, repaired, remanufactured or refurbished.

MATERIAL CYCLES

Recycling: Dismantle and separate products and remove pollutants so that the secondary raw materials are of high quality and can be marketed.

RENEWABLE AND NON-RENEWABLE RESOURCES

Renewable resources from agriculture, forestry or fisheries are used in ways which conserve the natural cycles and ecosystems.

Non-renewable resources are used in line with the vision of a circular economy, so that they are not dispersed in the environment. They then retain their quality and are used again and again in product and material cycles.

USE OF RENEWABLE ENERGY

The circular economy only uses renewable energy. It should be used as efficiently and economically as possible, because raw materials and natural resources are also required for the supply of renewable energy.

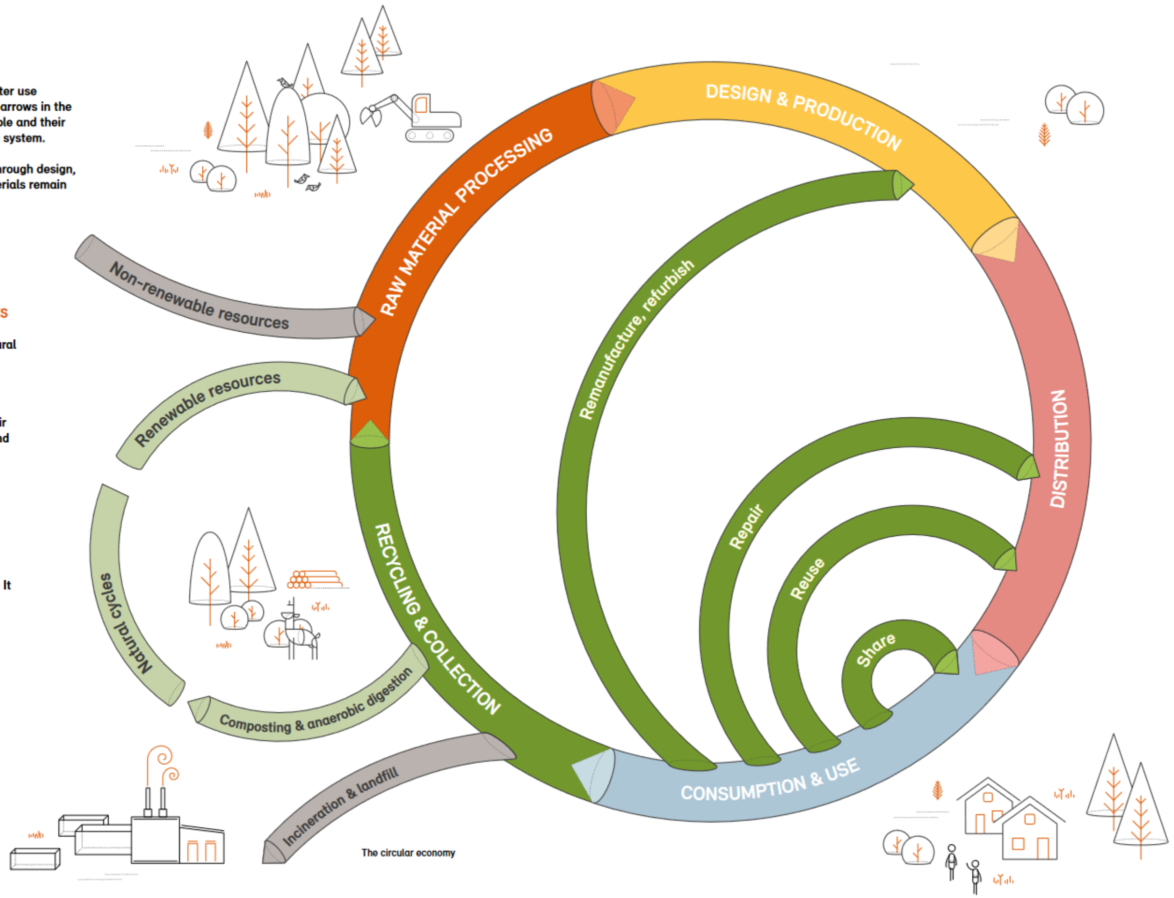
Key:
Transport
Renewable energy
Avoid where possible

BENEFICIAL FOR THE ENVIRONMENT? PERFORM A LIFE-CYCLE ASSESSMENT

A life-cycle assessment is the only way to ensure that projects or measures in the circular economy actually help to reduce the environmental impact. A life-cycle assessment includes all the relevant environmental effects over the full life-cycle of products.

CHARACTERISTICS OF CYCLABLE PRODUCTION - ECODESIGN

- Durable, repairable, modular design and products which can be dismantled
- No chemicals hazardous to the environment and health
- Separable, safe, recyclable materials



The circular economy