Monopolistic Competition and Product Differentiation

November 9, 2006

Reading: Chapter 16

The final market form we examine in monopolistic competition, which combines features of perfect competition and monopoly. We have many firms and free entry and exit, but because products are differentiated each firm can set its own price. Product differentiation leads to advertising and brand names, which we also briefly discuss.

Monopolistic Competition and Product Differentiation

a. Meaning of monopolistic competition

b. Understanding monopolistic competition
   - i. Short run
   - ii. Long run
   - iii. Compared to perfect competition

c. Controversies regarding monopolistic competition
   - i. Advertising
   - ii. Brand names

Edward Hastings Chamberlain and Joan Violet Robinson independently developed models of imperfect competition with monopolistic competition in the 1930s

Meaning of Monopolistic Competition

Monopolistic competition is a type of market in which

1. There are **many producers** in an industry.
2. There is **free entry** into **and exit** from the industry in the long run.
3. Each producer sells a **differentiated product**.

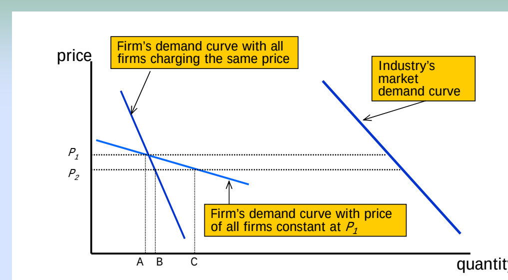
Examples: restaurants, clothing, books

First two are like perfect competition. Third point new.

Types of product differentiation.

1. Differentiation by **type and style**. Ex: books, restaurants.
2. Differentiation by **location**. Ex: gas stations, grocery stores, dry cleaners.
3. Differentiation by **quality**. High and low quality Ex: Restaurants, coffee, chocolate.

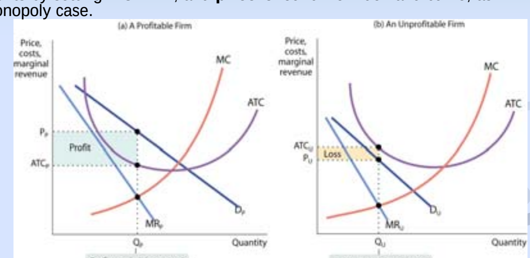
Meaning of Monopolistic Competition
Demand curves



Each firm has a small (and perhaps constant) share of total market demand if all firms charge the same price. But if all other firms keep their price fixed, and one firm changes its price, its demand will be more elastic: buyers will move between sellers. Firm will make decisions based on more elastic demand curve – it will ignore the effects of its decisions on other firms because it is small.

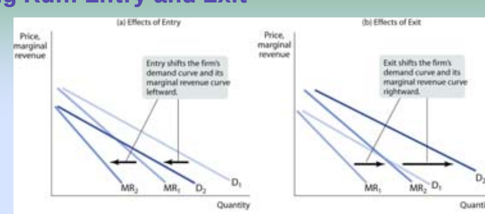
Understanding Monopolistic Competition
Short Run

In the **short run**, firms have given fixed costs and the number of firms in the industry is given. Costs shown by **ATC** and **MC**. Each firm has a **demand curve**, D_F, which is the one in which other firms have a given price. From demand curve, obtain **MR**, just like the case of monopoly. Firms maximize profits by setting **MC=MR**, and **price** is found from demand curve, as in monopoly case.



Firms can make profits or losses in the short run.

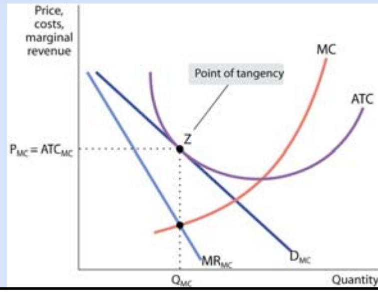
Understanding Monopolistic Competition
Long Run: Entry and Exit



In the long run firms can change fixed costs (ignore this change, for simplicity) and firms can enter and exit. If firms make **positive profits**, new firms will **enter**, and the **demand curve** for each firm will **shift to the left** (as each firm has a smaller share of the total, with more firms). If firms make **losses**, firms **exit** and the **demand curve shifts to the right**. MR shifts in the same way. These changes will continue as long as profits are not zero.

Understanding Monopolistic Competition
Long Run: Zero Profit Equilibrium

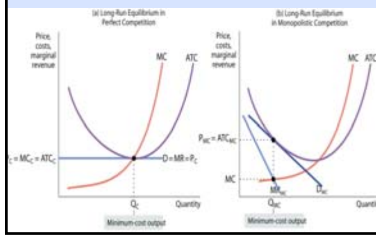
In long-run equilibrium there will be no entry or exit. Profits will be zero, so that **price = ATC**. **MC = MR** for profit maximization. Demand curve for the firm must be tangential to the ATC; it shifts till this happens. Why **tangency**? Otherwise, profits can be increased with a change in output. Demand curve must lie everywhere below ATC.



Understanding Monopolistic Competition
Comparison with Perfect Competition

In long-run equilibrium, with perfect competition, firms are at the minimum point of the ATC curve, and P=MC. With monopolistic competition:

1. firms produce on downward-sloping part of ATC, not where ATC is at mimimum. Sometimes referred to as **excess capacity**.
2. **P > MC**, so that firms would like to sell more at going price. Why don't they increase output? Because they know that it will drive down the price. So they engage in advertising and other sales promotion activity. P>MC means that some mutually beneficial trades are not exploited.



Is monopolistic competition **inefficient**? May seem to be so from these two points. Also, argue there is wasteful duplication. Too many producers of very similar things. But if consumers like variety, not inefficient. Is variety good for consumers? Sometimes too much choice may be bad for consumers: information costs, post-purchase regret.

Controversies

Monopolistic competition and product differentiation leads to firms trying to differentiate their products from those of other firms through **advertising** and creation of **brand names**. Is that good for the economy?

Advertising

Firms advertise in order to increase the demand for their products.

Advertising is not a waste of resources when it gives consumers useful information about products. Advertising that simply touts a product without giving real information may imply a waste of resources. It is also harder to explain. Either consumers are not fully rational, or expensive advertising communicates that the firm's products are of high quality. But maybe they are not really – higher profits based on market power based on perceptions and status motives.

Brand names

A brand name is a name owned by a particular firm that distinguishes its products from those of other firms.

Social value of brand names can be positive or negative. Positive if names convey real information when they assure consumers of the quality of a product. But they may not do that: simply create unjustified market power, higher prices without any better quality, which consumers do not understand. Then effect is negative.