



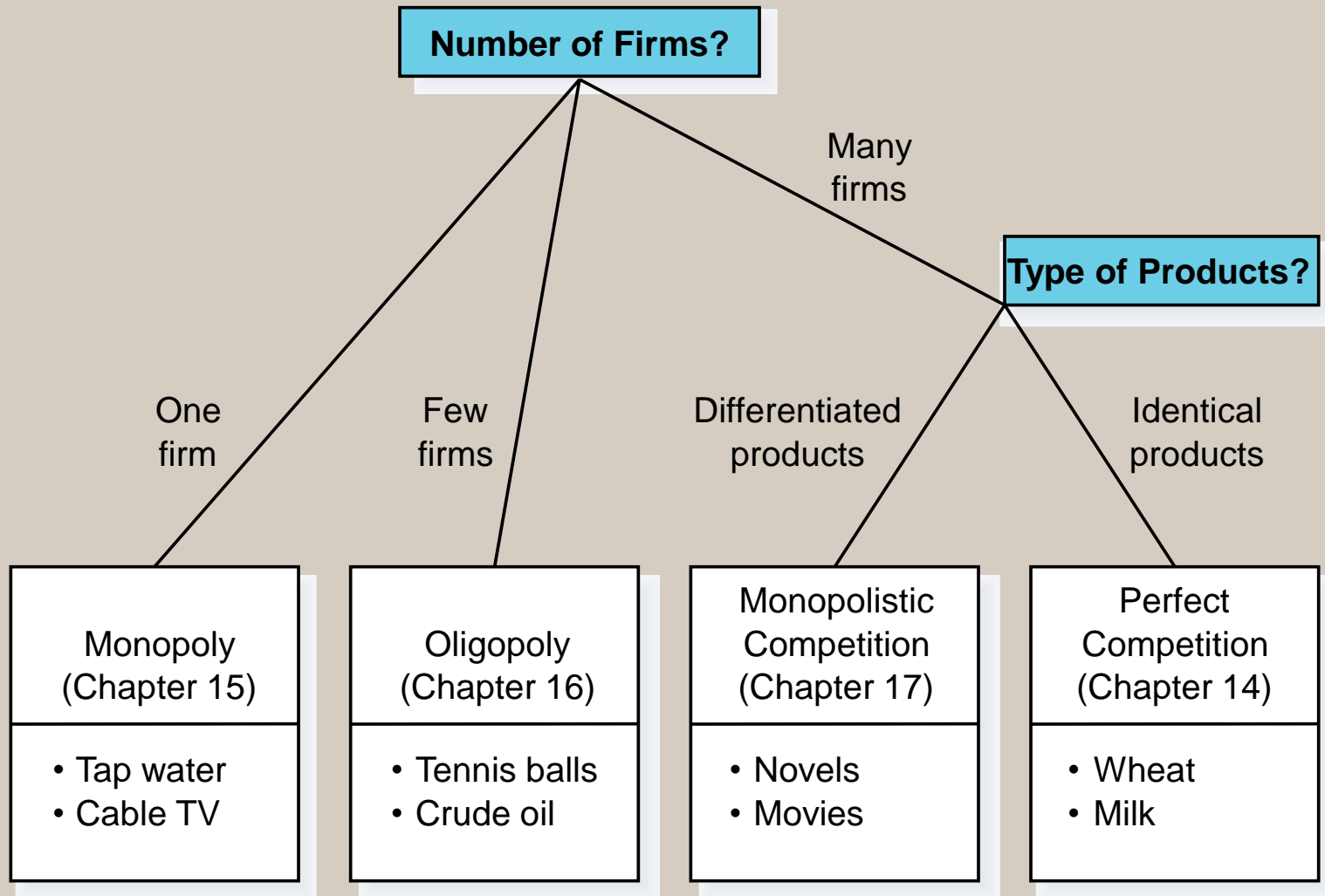
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Monopolistic Competition

Monopolistic Competition

- Imperfect competition refers to those market structures that fall between perfect competition and pure monopoly.

The Four Types of Market Structure



Monopolistic Competition

- Types of Imperfectly Competitive Markets
 - *Monopolistic Competition*
 - Many firms selling products that are similar but not identical.
 - Oligopoly
 - Only a few sellers, each offering a similar or identical product to the others.

Monopolistic Competition

- Markets that have some features of competition and some features of monopoly.

Monopolistic Competition

- Attributes of Monopolistic Competition
 - Many sellers
 - Product differentiation
 - Free entry and exit

Monopolistic Competition

- Many Sellers
 - There are many firms competing for the same group of customers.
 - Product examples include books, CDs, movies, computer games, restaurants, piano lessons, cookies, furniture, etc.

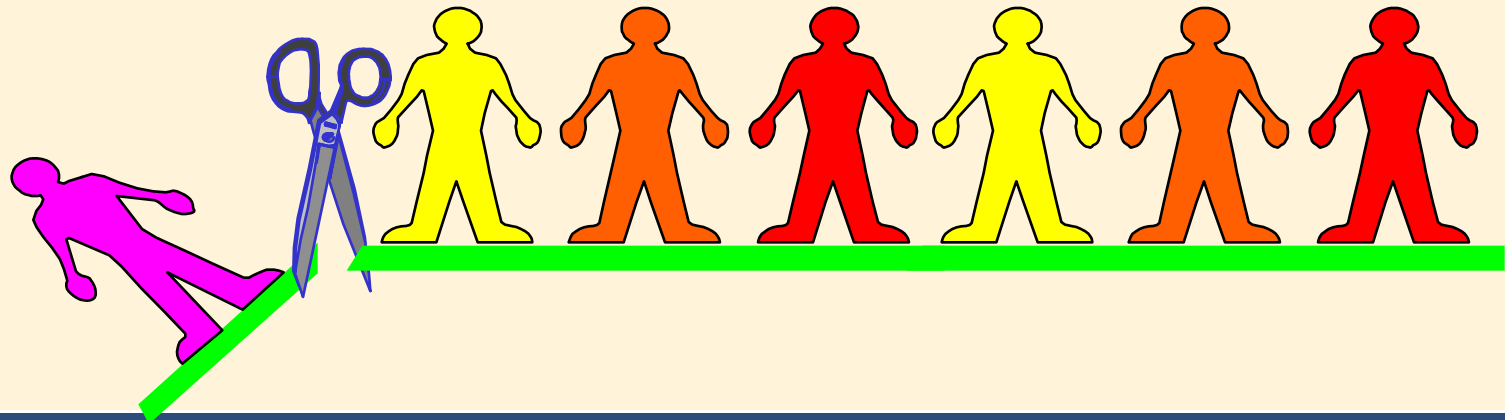


Monopolistic Competition

- 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*.

Monopolistic Competition

- Free Entry or Exit
- Firms can enter or exit the market without restriction.
- The number of firms in the market adjusts until economic profits are zero.

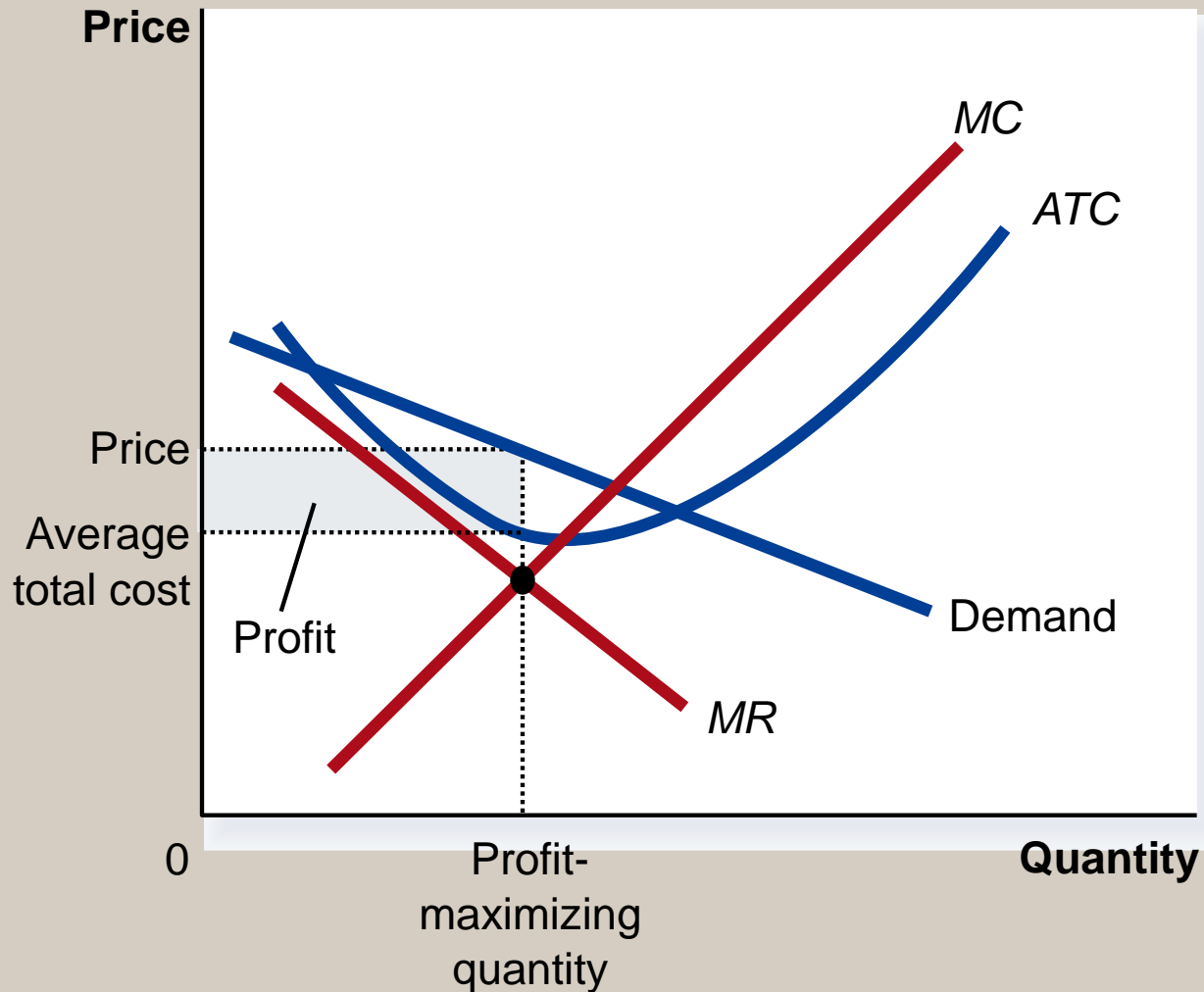


COMPETITION WITH DIFFERENTIATED PRODUCTS

- The Monopolistically Competitive Firm 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.

Figure 1 Monopolistic Competition in the Short Run

(a) Firm Makes Profit

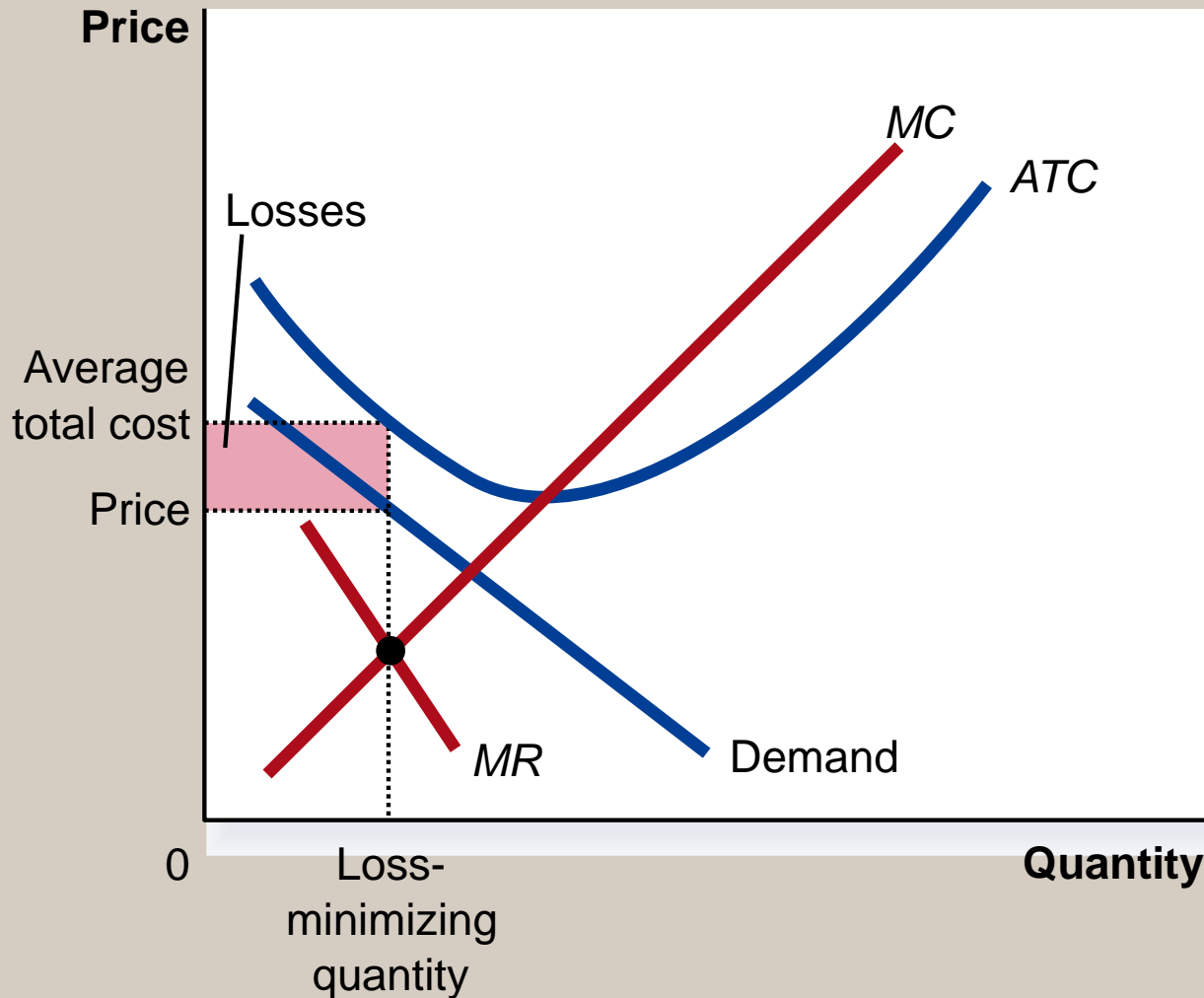


COMPETITION WITH DIFFERENTIATED PRODUCTS

- The Monopolistically Competitive Firm 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.

Figure 1 Monopolistic Competitors in the Short Run

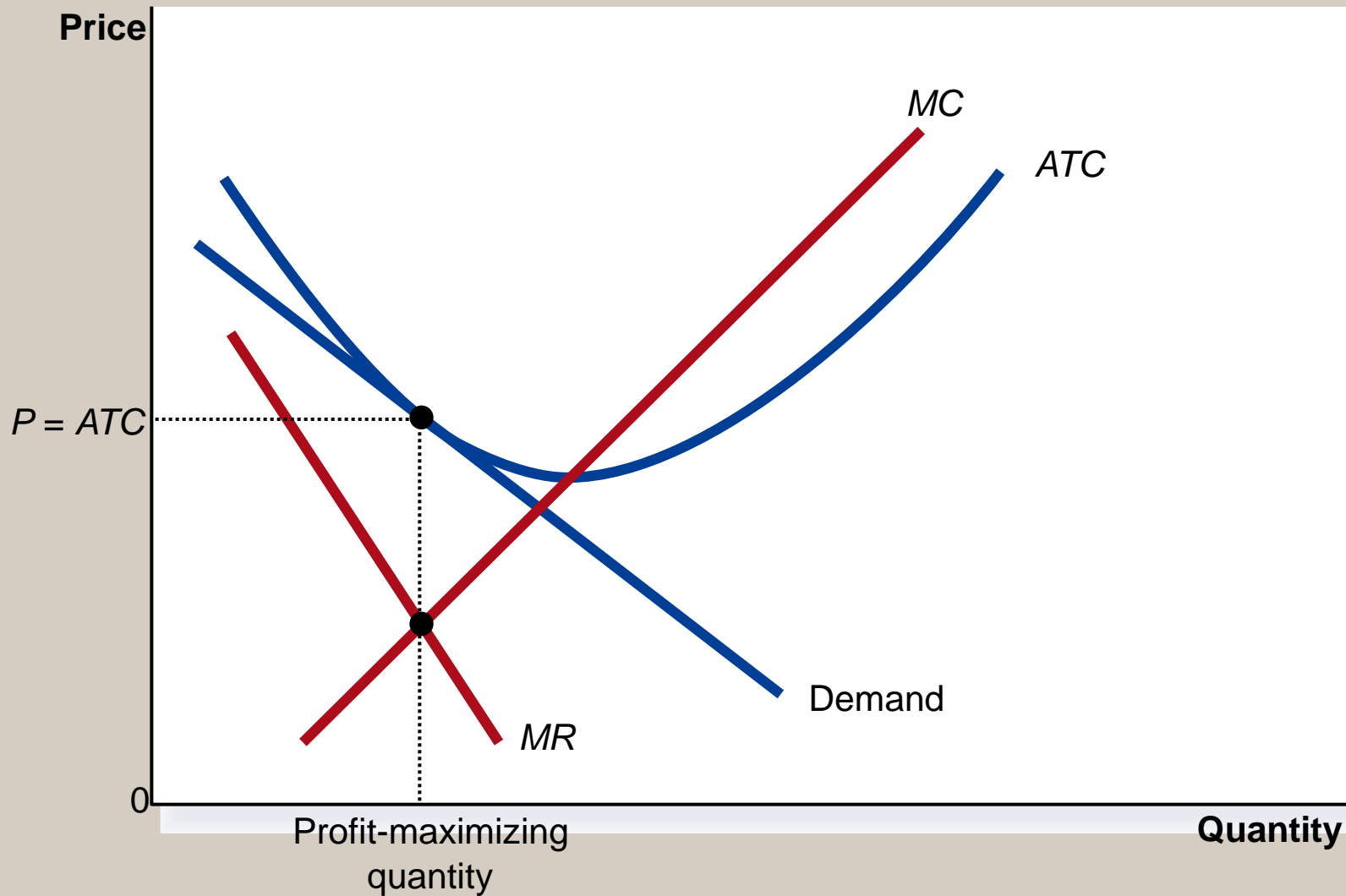
(b) Firm Makes Losses



The Long-Run Equilibrium

- Firms will enter and exit until the firms are making exactly zero economic profits.

Figure 2 A Monopolistic Competitor in the Long Run



Long-Run Equilibrium

- Two Characteristics
 - 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.
 - Free entry and exit drive economic profit to zero.

Monopolistic versus Perfect Competition

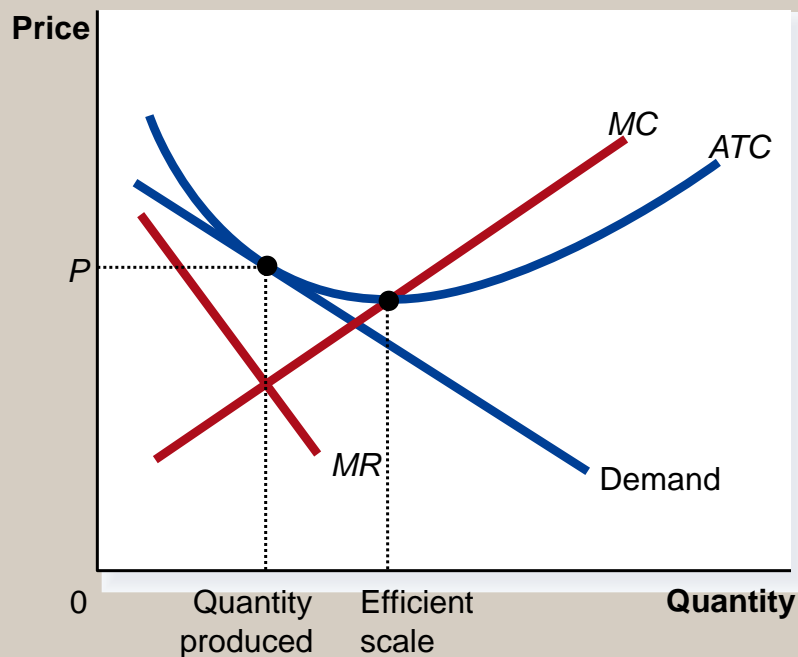
- There are two noteworthy differences between monopolistic and perfect competition—excess capacity and markup.

Monopolistic versus Perfect Competition

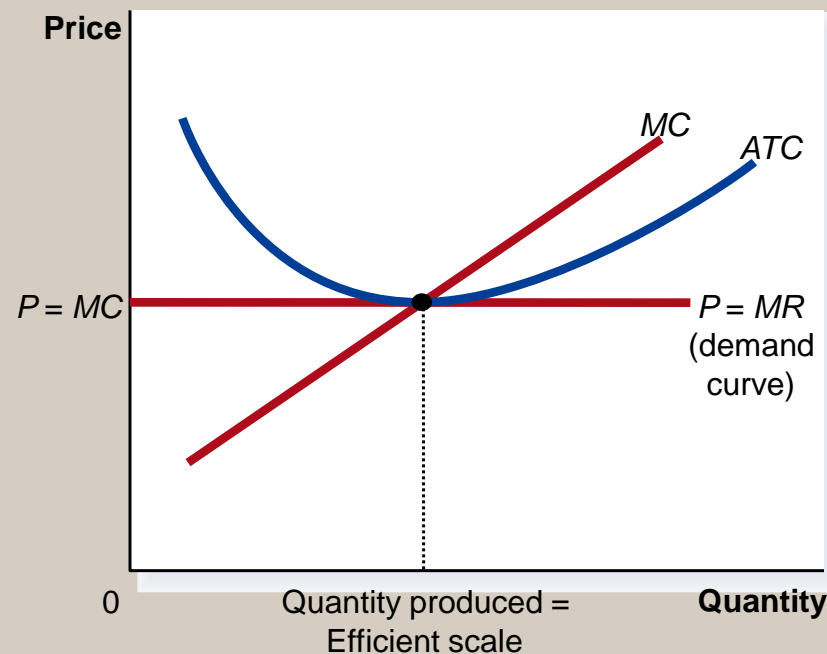
- Excess Capacity
 - There is no excess capacity in perfect competition in the long run.
 - Free entry results in competitive firms producing at the point where average total cost is minimized, which is the efficient scale of the firm.
 - There is excess capacity in monopolistic competition in the long run.
 - In monopolistic competition, output is less than the efficient scale of perfect competition.

Figure 3 Monopolistic versus Perfect Competition

(a) Monopolistically Competitive Firm



(b) Perfectly Competitive Firm

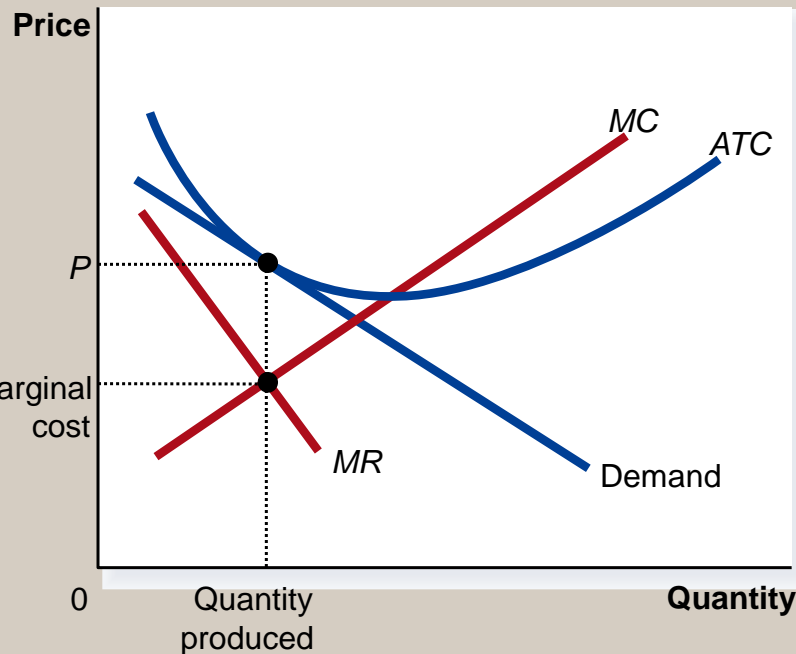


Monopolistic versus Perfect Competition

- Markup Over Marginal Cost
 - For a competitive firm, price equals marginal cost.
 - For a monopolistically competitive firm, price exceeds marginal cost.
 - Because price exceeds marginal cost, an extra unit sold at the posted price means more profit for the monopolistically competitive firm.

Figure 3 Monopolistic versus Perfect Competition

(a) Monopolistically Competitive Firm



(b) Perfectly Competitive Firm

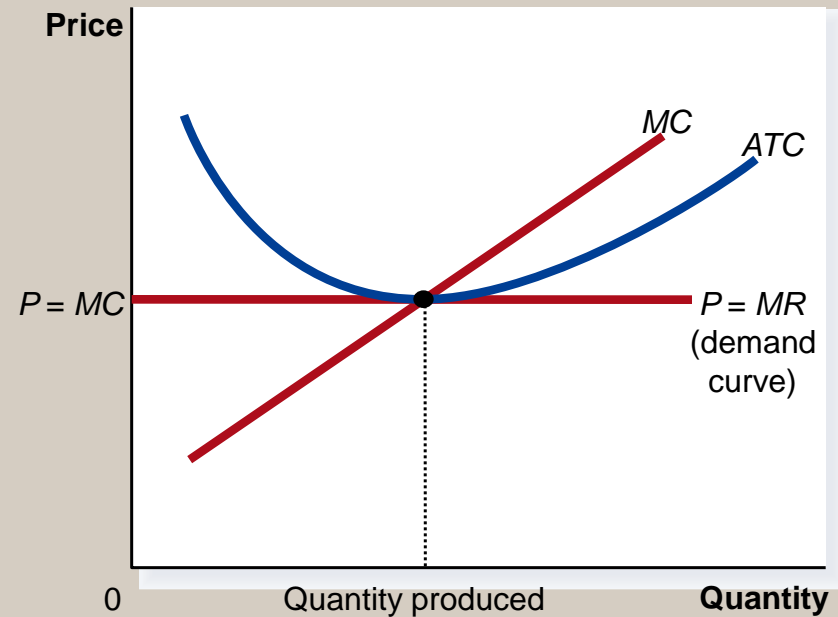
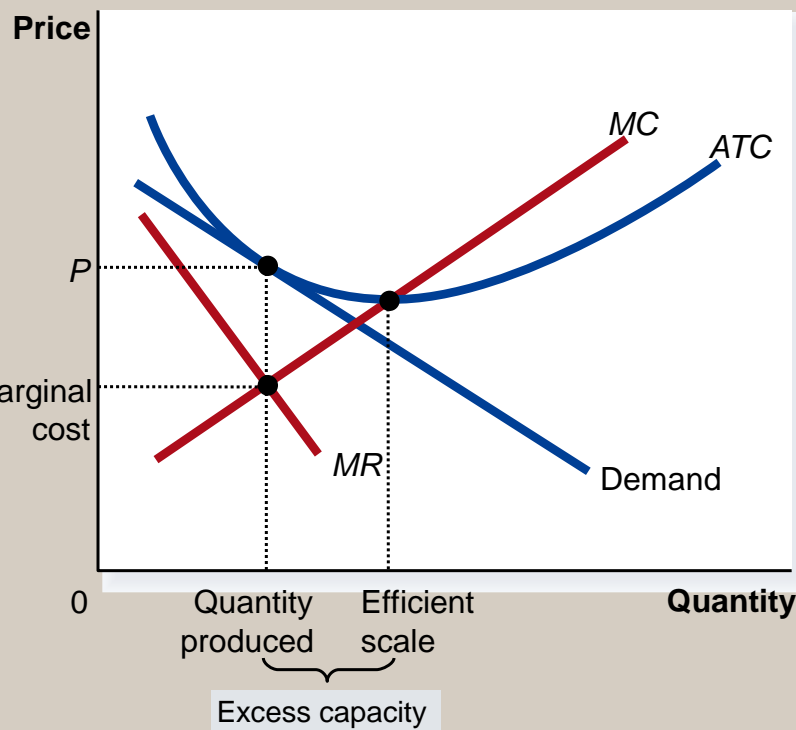
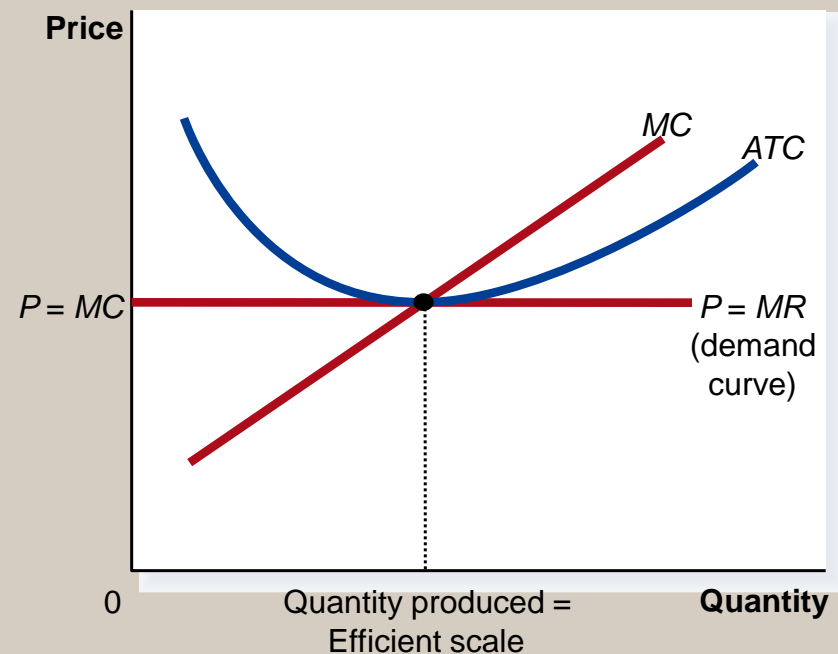


Figure 3 Monopolistic versus Perfect Competition

(a) Monopolistically Competitive Firm



(b) Perfectly Competitive Firm



Monopolistic Competition and the Welfare of Society

- Monopolistic competition does not have all the desirable properties of perfect competition.

Monopolistic Competition and the Welfare of Society

- There is the normal deadweight loss of monopoly pricing in monopolistic competition caused by the markup of price over marginal cost.
- However, the administrative burden of regulating the pricing of all firms that produce differentiated products would be overwhelming.

Monopolistic Competition and the Welfare of Society

- Another way in which monopolistic competition may be socially inefficient is that the number of firms in the market may not be the “ideal” one. There may be too much or too little entry.

Monopolistic Competition and the Welfare of Society

- *Externalities of entry include:*
 - product-variety externalities.
 - business-stealing externalities.

Monopolistic Competition and the Welfare of Society

- The *product-variety externality*:
 - Because consumers get some consumer surplus from the introduction of a new product, entry of a new firm conveys a *positive externality* on consumers.
- The *business-stealing 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.

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.

ADVERTISING

- Firms that sell highly differentiated consumer goods typically spend between 10 and 20 percent of revenue on advertising.
- Overall, about 2 percent of total revenue, or over \$200 billion a year, is spent on advertising.

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.

ADVERTISING

- Defenders argue that advertising provides information to consumers
- 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.

Brand Names

- Critics argue that brand names cause consumers to perceive differences that do not really exist.

Brand Names

- 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.
 - providing information about quality.
 - giving firms incentive to maintain high quality.

Summary

- A monopolistically competitive market is characterized by three attributes: many firms, differentiated products, and free entry.
- The equilibrium in a monopolistically competitive market differs from perfect competition in that each firm has excess capacity and each firm charges a price above marginal cost.

Summary

- Monopolistic competition does not have all of the desirable properties of perfect competition.
- There is a standard deadweight loss of monopoly caused by the markup of price over marginal cost.
- The number of firms can be too large or too small.

Summary

- The product differentiation inherent in monopolistic competition leads to the use of advertising and brand names.
 - Critics argue that firms use advertising and brand names to take advantage of consumer irrationality and to reduce competition.
 - Defenders argue that firms use advertising and brand names to inform consumers and to compete more vigorously on price and product quality.