Monopolistic Competition

Chapter 16-1

Introduction

- Market structure is the focus real-world competition.
- ***Market structure*** refers to the physical characteristics of the market within which firms interact.

Introduction

- Market structure involves the number of firms in the market and the barriers to entry.

Introduction

- Perfect competition, with an infinite number of firms, and monopoly, with a single firm, are polar opposites.
- Monopolistic competition and oligopoly lie between these two extremes.

Introduction

- ***Monopolistic competition*** is a market structure in which there are many firms selling differentiated products.
- There are few barriers to entry.

Introduction

- ***Oligopoly*** is a market structure in which there are a few interdependent firms.
- There are often significant barriers to entry.

Characteristics of Monopolistic Competition

Four distinguishing characteristics:

1. **Many sellers** that do not take into account rivals' reactions
2. **Product differentiation** where the goods that are sold aren't homogenous
3. ***Multiple dimensions of competition** make it harder to analyze a specific industry, but these methods of competition follow the same two decision rules as price competition
4. **Ease of entry of new firms in the long run** because there are no significant barriers to entry

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Output, Price, and Profit of a Monopolistic Competitor

- Like a monopoly,
  - The monopolistic competitive firm has some monopoly power so the firm faces a downward sloping demand curve
  - Marginal revenue is below price
  - At profit maximizing output, marginal cost will be less than price
- Like a perfect competitor, zero economic profits exist in the long run

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What is Monopolistic Competition?

- **Monopolistic competition** is a market structure in which:
  - There are a large number of firms
  - The products produced by the different firms are differentiated
  - Entry and exit occur easily

Product Differentiation

- **Product differentiation** implies that the products are different enough that the producing firms exercise a "mini-monopoly" over their product.
- The firms compete more on product differentiation than on price.
- Entering firms produce close substitutes, not an identical or standardized product.

Monopolistic Competition

- The four distinguishing characteristics of monopolistic competition are:
  - Many sellers.
  - Differentiated products.
  - Multiple dimensions of competition.
  - Easy entry of new firms in the long run.

Many Sellers

- When there are many sellers, they do not take into account rivals' reactions.
- The existence of many sellers makes collusion difficult.
- Monopolistically competitive firms act independently.

Differentiated Products

- The "many sellers" characteristic gives monopolistic competition its competitive aspect.
- Product differentiation gives monopolistic competition its monopolistic aspect.

Differentiated Products

- Differentiation exists so long as advertising convinces buyers that it exists.
- Firms will continue to advertise as long as the marginal benefits of advertising exceed its marginal costs.

Multiple Dimensions of Competition

- One dimension of competition is product differentiation.
- Another is competing on perceived quality.
- Competitive advertising is another.
- Others include service and distribution outlets.

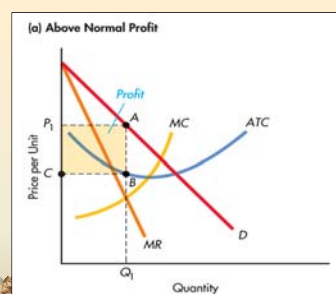
Easy Entry of New Firms in the Long Run

- There are no significant barriers to entry.
- Barriers to entry prevent competitive pressures.
- Ease of entry limits long-run profit.

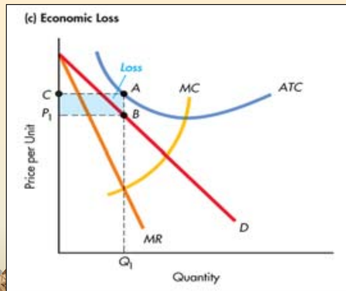
Output, Price, and Profit of a Monopolistic Competitor

- A monopolistically competitive firm prices in the same manner as a monopolist—where *MC* = *MR*.
- But the monopolistic competitor is not only a monopolist but a competitor as well.

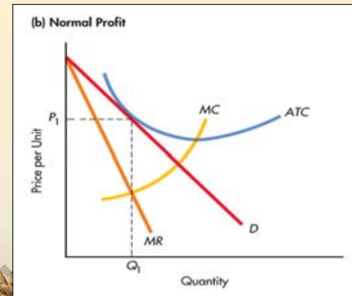
A Monopolistically Competitive Firm: Above Normal Profit



A Monopolistically Competitive Firm: Economic Loss

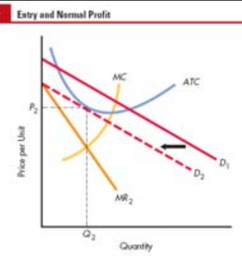


A Monopolistically Competitive Firm: Normal Profit



Entry and Normal Profit

FIGURE 2 Entry and Normal Profit

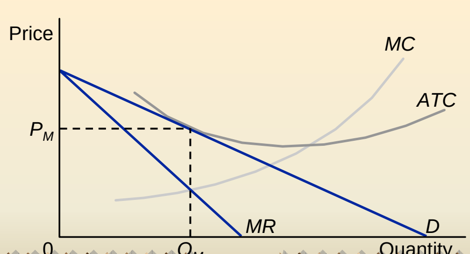


In the long run, the firm in monopolistic competition earns a normal profit. Entry shifts the firm's demand curve in from D_1 to D_2. Entry, which takes the form of a differentiated product, continues to occur as long as above-normal profits exist. When the demand curve just touches the average-total-cost curve, as at P_2 and Q_2, profit is at the normal level.

Output, Price, and Profit of a Monopolistic Competitor

- At equilibrium, *ATC* equals price and economic profits are zero.
- This occurs at the point of tangency of the *ATC* and demand curve at the output chosen by the firm.

Monopolistic Competition



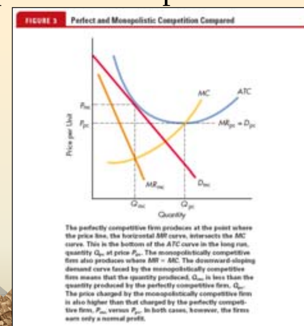
Comparing Perfect and Monopolistic Competition

- Both the monopolistic competitor and the perfect competitor make zero economic profit in the long run.

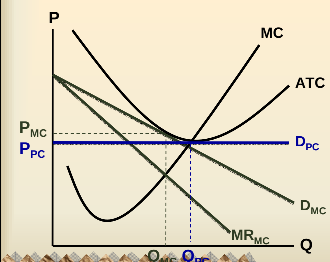
Comparing Monopolistic Competition with Monopoly

- It is possible for the monopolist to make economic profit in the long-run.
- No long-run economic profit is possible in monopolistic competition.

Perfect Competition and Monopolistic Competition Compared



Monopolistic Competition Compared with Perfect Competition Graph



- In monopolistic competition in the long run, P > min ATC,
- In perfect competition in the long run, P = min ATC

Outcome:
Monopolistic competition *output is lower* and *price is higher* than perfect competition

Comparing Monopolistic Competition with Monopoly

- It is possible for the monopolist to make economic profit in the long run because of the existence of barriers to entry
- No long-run economic profit is possible in monopolistic competition because there are no significant barriers to entry
- For a monopolistic competitor in long-run equilibrium, **(P = ATC) ≥ (MC = MR)**

Advertising and Monopolistic Competition

- Perfectly competitive firms have no incentive to advertise, but monopolistic competitors do
- The goals of advertising are to increase demand and make demand more inelastic
- The increase in cost of a monopolistically competitive product is the cost of "differentness"
  - Advertising increases ATC

Nonprice Competition

- The firm attempts to establish its product as a different product from that offered by its rivals.
- **Differentiation** means that in the consumer's mind, the product is not the same. Marketing is often the key to successful differentiation.

Nonprice Competition

- Firms may differentiate products by perceived quality, reliability, color, style, safety features, packaging, purchase terms, warranties and guarantees, location, availability (hours of operation) or any other features.
- **Brand names** may signal information regarding the product, reducing consumer risk.

Goals of Advertising

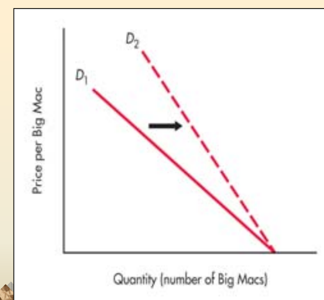
- The goals of advertising include shifting the demand curve to the right and making it more inelastic.
- Advertising shifts the *ATC* curve up.

Does Advertising Help or Hurt Society?

- There is a sense of trust in buying brands we know.
- If consumers are willing to pay for "differentness," it's a benefit to them.

Advertising, Prices, and Profits

Product differentiation *reduces the price elasticity* of demand, which appears as a *steeper demand* curve. Successful product differentiation enables the firm to charge a higher price.



Location under Monopolistic Competition

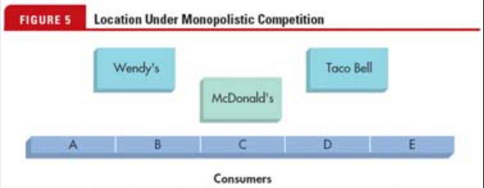


FIGURE 5 Location Under Monopolistic Competition

Five customers—A, B, C, D, and E—reside along a straight line. Customer C is in the middle, equidistant from B and D and from A and E. McDonald's decides to locate a restaurant at the spot that is closest to all five customers. This is the median position, where consumer C resides. Other fast-food firms locate nearby because any other location will increase the total distance of some consumers from the fast-food restaurant, thereby causing some customers to go elsewhere.

Brand Name

- A brand name is valuable to a firm; it makes the demand less elastic and can enable the firm to earn higher profits.
- Once a consumer has had a positive experience with a good, the price elasticity of demand for that good typically decreases—the consumer becomes loyal to the product.