Monopolistic Competition

Chapter 16

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

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

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

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

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.

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

Outcome:

Monopolistic competition output is lower and price is higher than perfect competition

Comparing Monopolistic Competition with Monopoly

- For a monopolistic competitor in long-run equilibrium, \( P = ATC \geq MC = MR \)

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

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.