Chapter 16 – Monopolistic Competition

In this chapter, look for the answers to these questions:

- What market structures lie between perfect competition and monopoly, and what are their characteristics?
- How do monopolistically competitive firms choose price and quantity? Do they earn economic profit?
- In what ways does monopolistic competition affect society's welfare?
- What are the social costs and benefits of advertising?

INTRODUCTION:
Between Monopoly and Competition

Two extremes

- Perfect competition: many firms, identical products
- Monopoly: one firm

In between these extremes: imperfect competition

- **Oligopoly**: only a few sellers offer similar or identical products.
- **Monopolistic competition**: many firms sell similar but not identical products.

Characteristics & Examples of Monopolistic Competition

Characteristics:

- Many sellers
- Product differentiation
- Free entry and exit

Examples:

- apartments
- books
- bottled water
- clothing
- fast food
- night clubs

Comparing Perfect & Monop. Competition

	Perfect competition	Monopolistic competition
number of sellers	many	many
free entry/exit	yes	yes
long-run econ. profits	zero	zero
the products firms sell	identical	differentiated
firm has market power?	none, price-taker	yes
D curve facing firm	horizontal	downward-sloping

Comparing Monopoly & Monop. Competition

	Monopoly	Monopolistic competition
number of sellers	one	many
free entry/exit	no	yes
long-run econ. profits	positive	zero
firm has market power?	yes	yes
D curve facing firm	downward-sloping (market demand)	downward-sloping
close substitutes	none	many

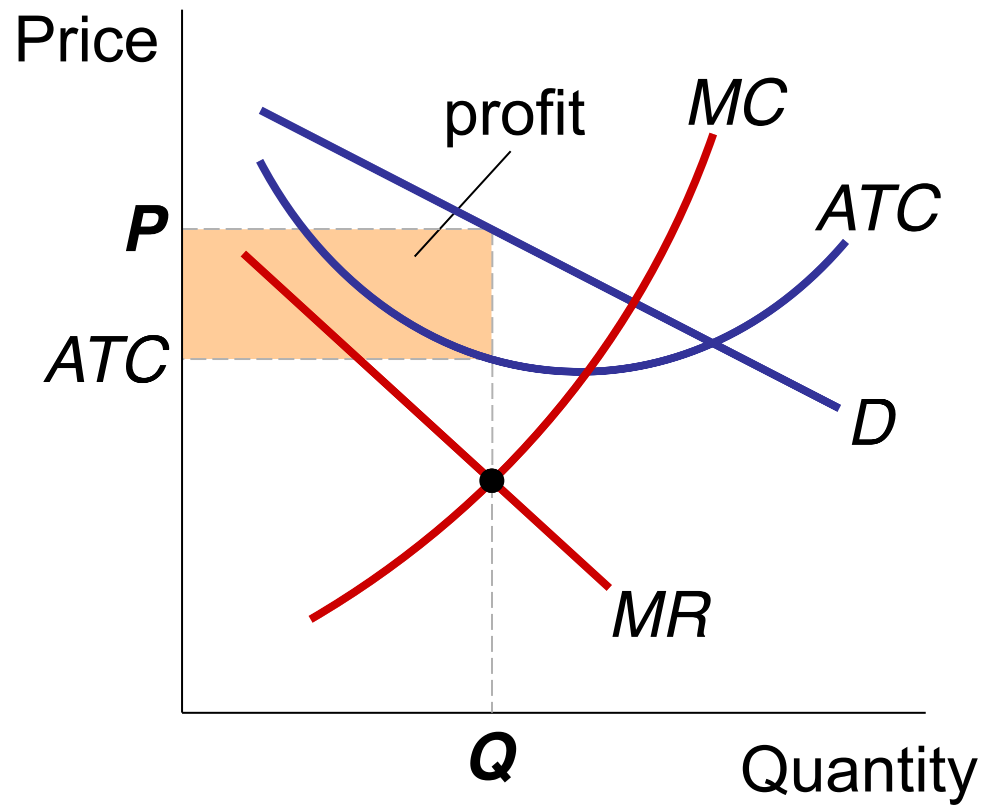
A Monopolistically Competitive Firm Earning Profits in the Short Run

The firm faces a downward-sloping *D* curve.

At each ***Q***, *MR* < *P*.

To maximize profit, firm produces ***Q*** where *MR* = *MC*.

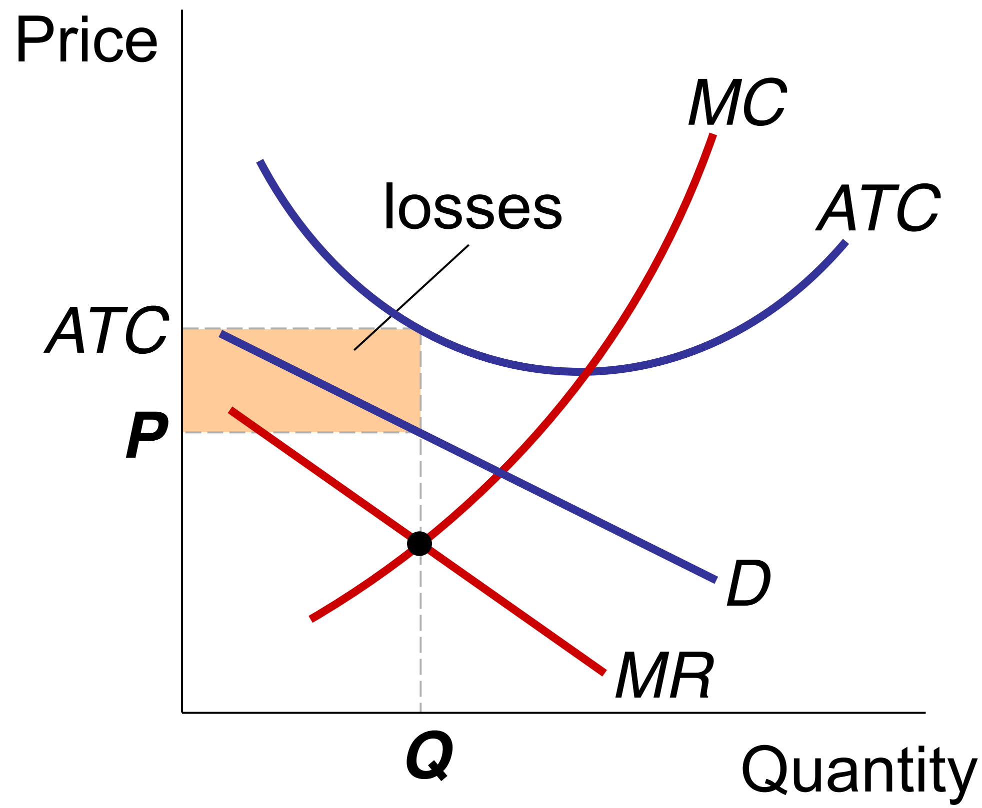
The firm uses the *D* curve to set *P*.



A Monopolistically Competitive Firm With Losses in the Short Run

For this firm,
$P < ATC$
at the output where
$MR = MC$.

The best this firm can do is to minimize its losses.



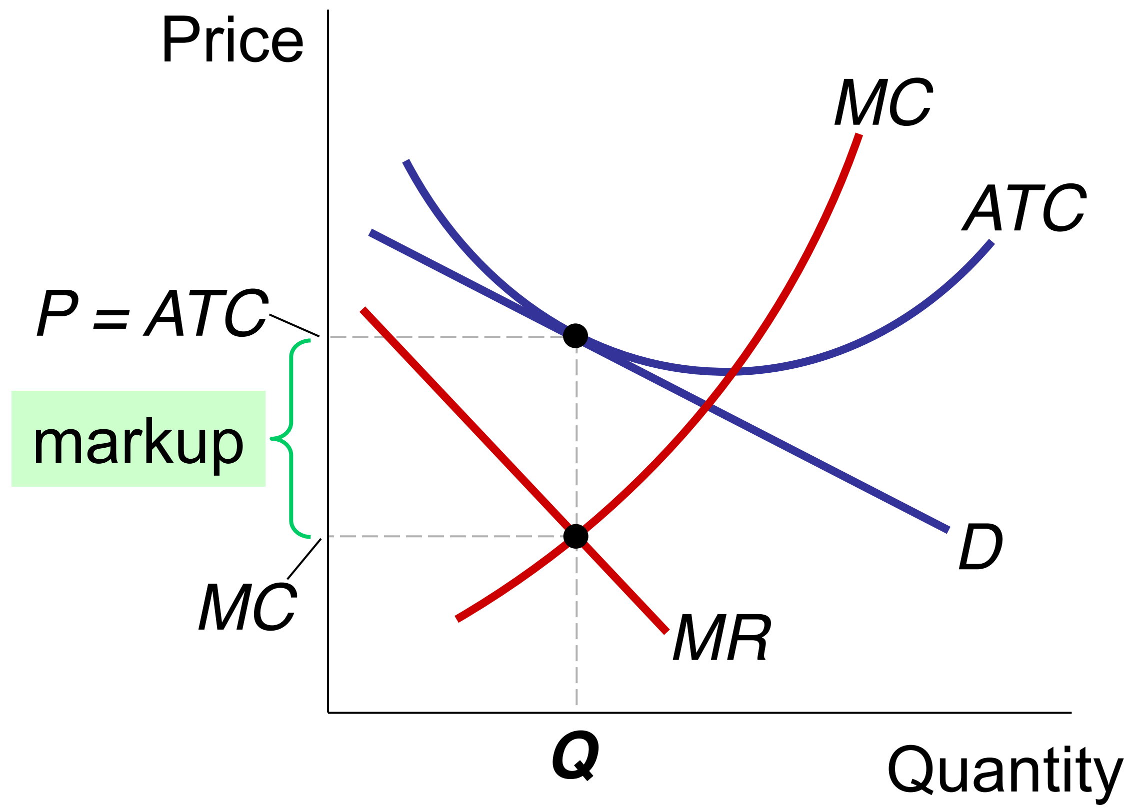
Monopolistic Competition and Monopoly

- *Short run*: Under monopolistic competition, firm behavior is very similar to monopoly.
- *Long run*: In monopolistic competition, entry and exit drive economic profit to zero.
  - If profits in the short run: New firms enter market, taking some demand away from existing firms, prices and profits fall.
  - If losses in the short run: Some firms exit the market, remaining firms enjoy higher demand and prices.

A Monopolistic Competitor in the Long Run

Entry and exit occurs until $P = ATC$ and profit = zero.

Notice that the firm charges a markup of price over marginal cost and does not produce at minimum *ATC*.



Why Monopolistic Competition Is Less Efficient than Perfect Competition

1. ***Excess capacity***
   - The monopolistic competitor operates on the downward-sloping part of its *ATC* curve, produces less than the cost-minimizing output.
   - Under perfect competition, firms produce the quantity that minimizes *ATC*.
2. ***Markup over marginal cost***
   - Under monopolistic competition, $P > MC$.
   - Under perfect competition, $P = MC$.

Monopolistic Competition and Welfare

- Monopolistically competitive markets do not have all the desirable welfare properties of perfectly competitive markets.
- Because $P > MC$, the market quantity is below the socially efficient quantity.
- Yet, not easy for policymakers to fix this problem: Firms earn zero profits, so cannot require them to reduce prices.

CONCLUSION

- Differentiated products are everywhere; examples of monopolistic competition abound.
- The theory of monopolistic competition describes many markets in the economy, yet offers little guidance to policymakers looking to improve the market's allocation of resources.

SUMMARY

- A monopolistically competitive market has many firms, differentiated products, and free entry.
- Each firm in a monopolistically competitive market has excess capacity—it produces less than the quantity that minimizes *ATC*. Each firm charges a price above marginal cost.

SUMMARY

- Monopolistic competition does not have all of the desirable welfare properties of perfect competition. There is a deadweight loss caused by the markup of price over marginal cost. Also, the number of firms (and thus varieties) can be too large or too small. There is no clear way for policymakers to improve the market outcome.

SUMMARY

- Product differentiation and markup pricing lead to the use of advertising and brand names. Critics of advertising and brand names argue that firms use them to reduce competition and take advantage of consumer irrationality. Defenders argue that firms use them to inform consumers and to compete more vigorously on price and product quality.