Masaryk University

Microeconomics I

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Wojciech Gerson (1831-1901)

Lecture

10

Monopolistic Competition

Chapter 16

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?
- How 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 (location)
- 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

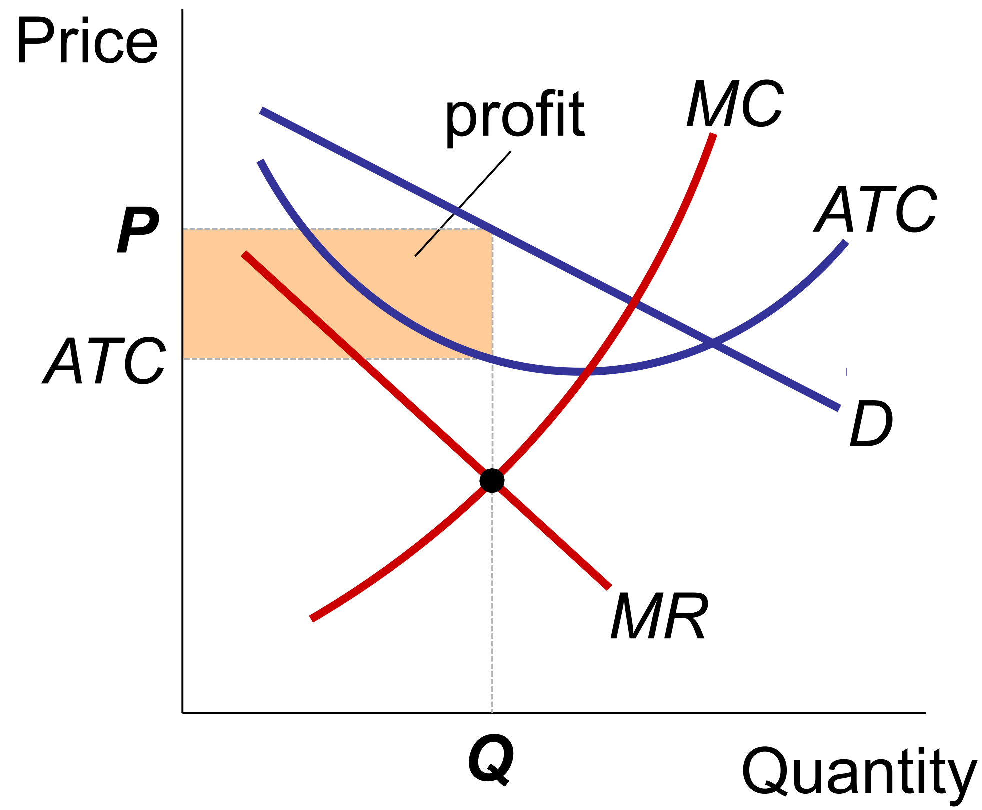
A Monopolistically Competitive Firm Earning Profits in the Short Run

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

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

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

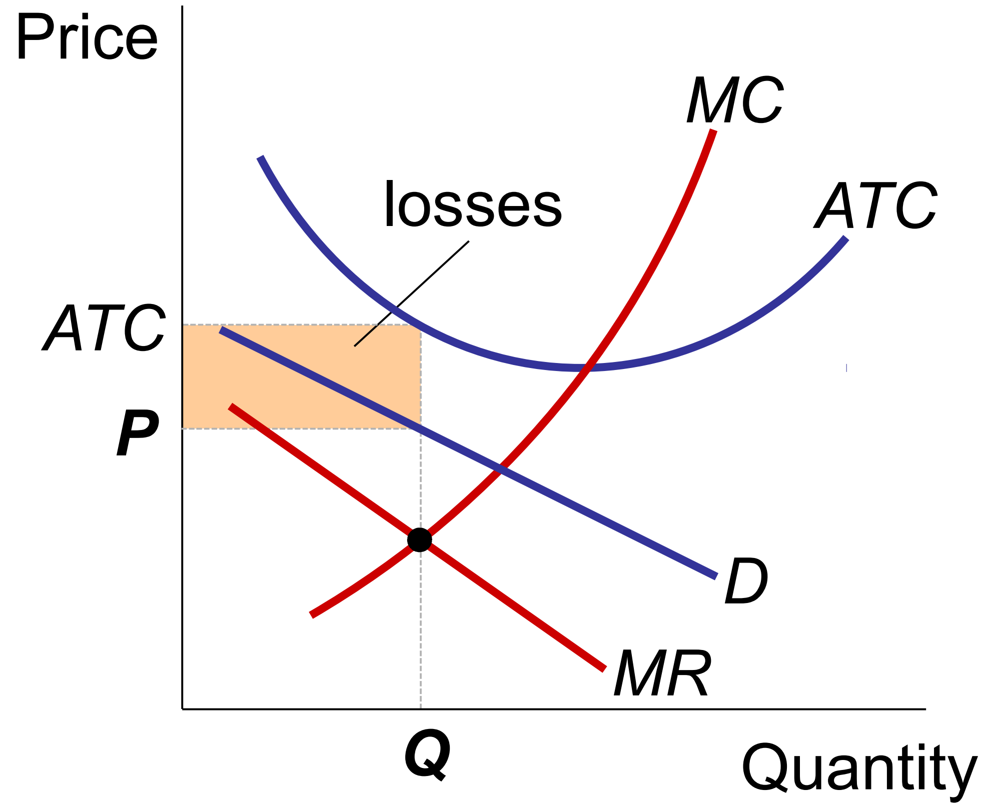
The firm uses the *D* curve to set *P*.



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.



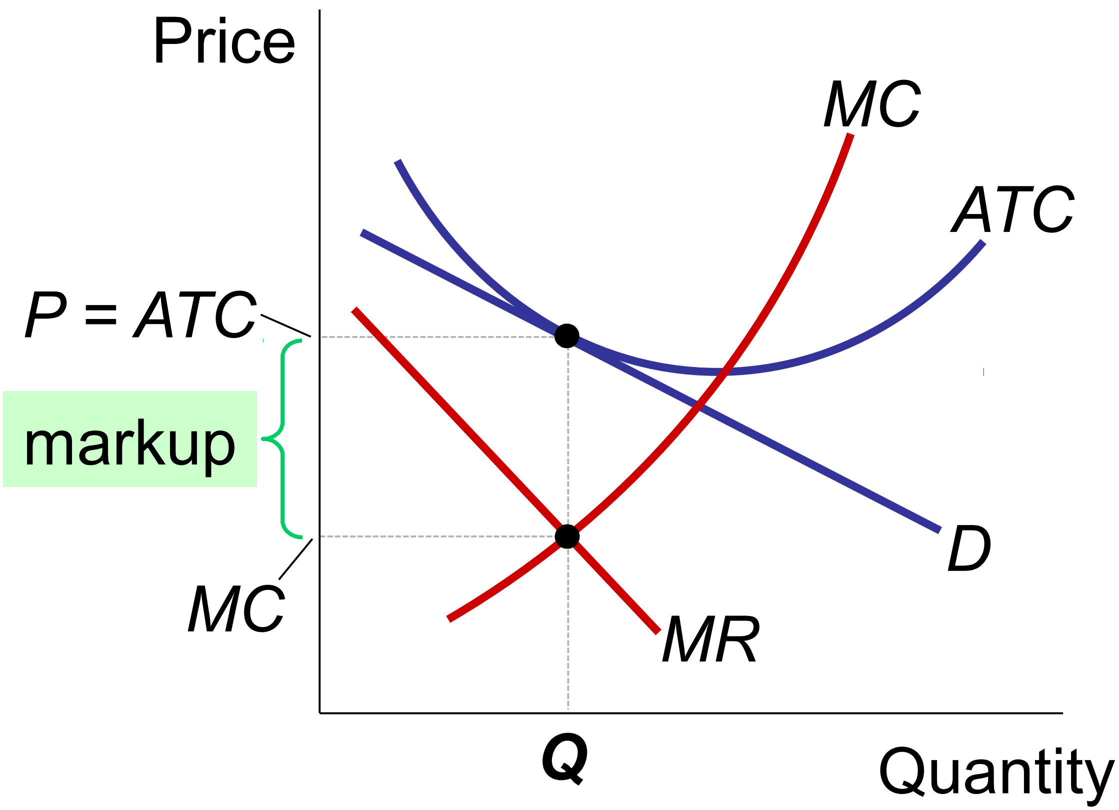
Monopolistic Competition and Monopoly

- *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 $P > MC$,
  market quantity < socially efficient quantity.
- Yet, not easy for policymakers to fix this problem: Firms earn zero profits, so cannot require them to reduce prices.

Number of firms in the market may not be optimal, due to external effects from the entry of new firms:

The product-variety externality:
surplus consumers get from the introduction of new products

The business-stealing externality:
losses incurred by existing firms when new firms enter market

The inefficiencies of monopolistic competition are subtle and hard to measure. No easy way for policymakers to improve the market outcome.

ACTIVE LEARNING 1

Advertising

1. So far, we have studied three market structures: perfect competition, monopoly, and monopolistic competition. In each of these, would you expect to see firms spending money to advertise their products? Why or why not?
2. Is advertising good or bad from society's viewpoint? Try to think of at least one "pro" and "con."

Defenders of advertising believe:

It provides useful information to buyers.

Informed buyers can more easily find and exploit price differences.

Thus, advertising promotes competition and reduces market power.

Results of a prominent study:

Eyeglasses were more expensive in states that prohibited advertising by eyeglass makers than in states that did not restrict such advertising.

A firm's willingness to spend huge amounts on advertising may signal the quality of its product to consumers, *regardless of the content of ads*.

Ads may convince buyers to try a product once, but the product must be of high quality for people to become repeat buyers.

The most expensive ads are not worthwhile unless they lead to repeat buyers.

When consumers see expensive ads, they think the product must be good if the company is willing to spend so much on advertising.

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.