Monopolistic Competition

Chapter 16

Hussain Hadah
University of Houston | 06 August 2021

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Introduction

Monopolistic Competition Example

- You walk into a bookstore
- There are many books by many authors
- At first glance, the market for books seems competitive
- There are many authors and publishers
- There are also many buyers
- At second glance, the market for books could be monopolistic
- Each book is unique, publishers have some latitude in choosing what price to charge
- The sellers in this market are price makers rather than price takers
- The market for novels fits neither the competitive nor the monopoly model
- It is best described by the model of *monopolistic competition*

Between Monopoly and Perfect Competition

What is a Monopolistic Competition?

- We saw examples of perfectly competitive markets and monopolistic markets
- Competition and monopoly are two extreme forms of market structure
- Most markets in the economy include elements of both these cases
- Economists call this *imperfect competition*
- *Oligopoly* is an example of an imperfectly competitive market with only a few sellers that offer a similar or identical product in a market
- Economists often measure a market's domination by a small number of firms with a statistic called the *concentration ratio*, which is the percentage of total output in the market supplied by the four largest firms
- *Monopolistic competition* is another example of an imperfectly competitive market structure in which there are many firms selling similar but not identical products
- Each firm has a monopoly over its product, but many other firms are competing for the same customers

Attributes of a monopolistic competition

1. Many sellers: Many firms are competing for the same group of customers

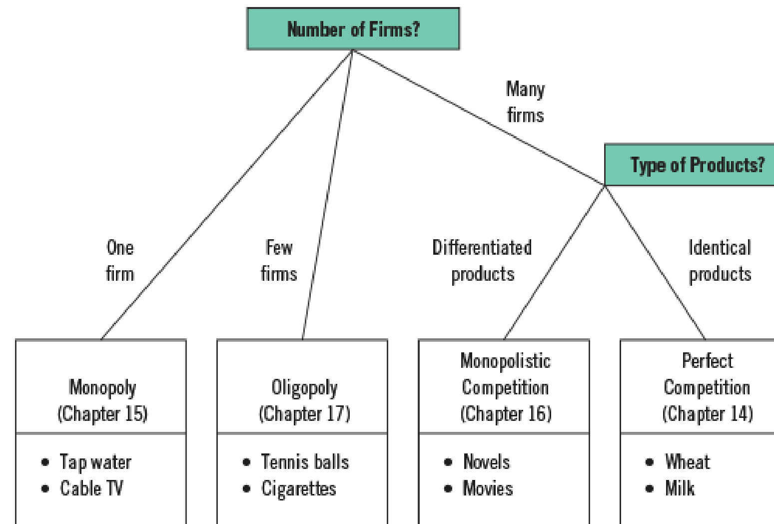
2. Product differentiation: Each firm produces a product that is at least slightly different from those of other firms. Thus, rather than being a price taker, each firm faces a downward-sloping demand curve

3. Free entry and exit: Firms can enter or exit the market without restriction. Thus, the number of firms in the market adjusts until economic profits are driven to zero

Monopolistic competition vs Oligopoly

- Both lie between the extreme cases of perfect competition and monopoly
- Oligopoly departs from the perfectly competitive ideal of Chapter 14 because there are only a few sellers in the market
- The small number of sellers makes rigorous competition less likely and strategic interactions among them are vitally important
- A monopolistically competitive market has many sellers, each of which is small compared to the market
- It departs from the perfectly competitive ideal because each of the sellers offers a somewhat different product

4 types of markets



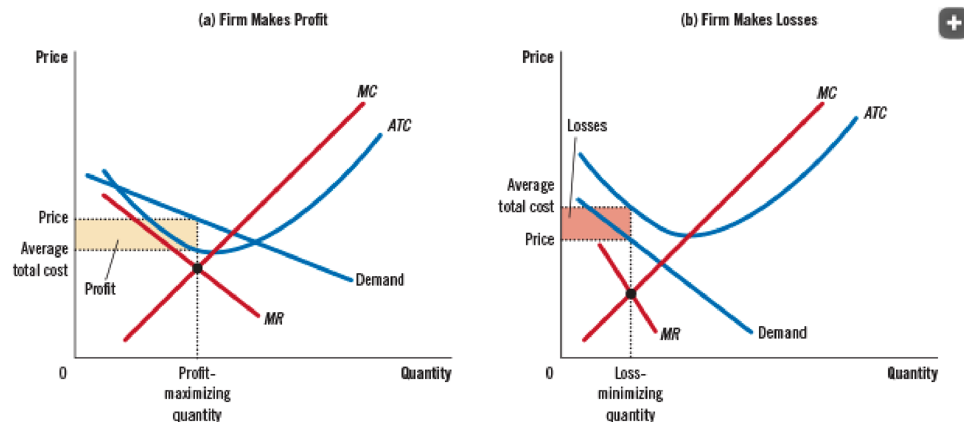
Competition with Differentiated Products

Monopolistically Competitive Firm:

In the short run

Figure 2 Monopolistic Competitors in the Short Run

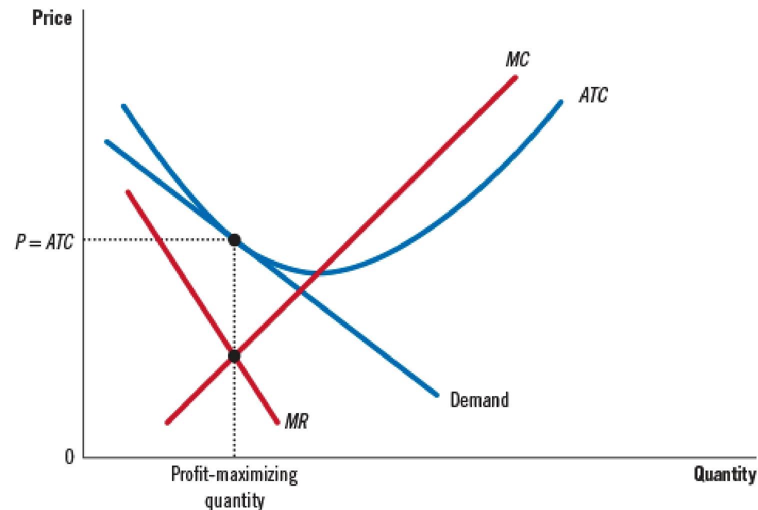
Monopolistic competitors, like monopolists, maximize profit by producing the quantity at which marginal revenue equals marginal cost. The firm in panel (a) makes a profit because, at this quantity, price is greater than average total cost. The firm in panel (b) makes losses because, at this quantity, price is less than average total cost.



The LR Equilibrium

Figure 3 **A Monopolistic Competitor in the Long Run**

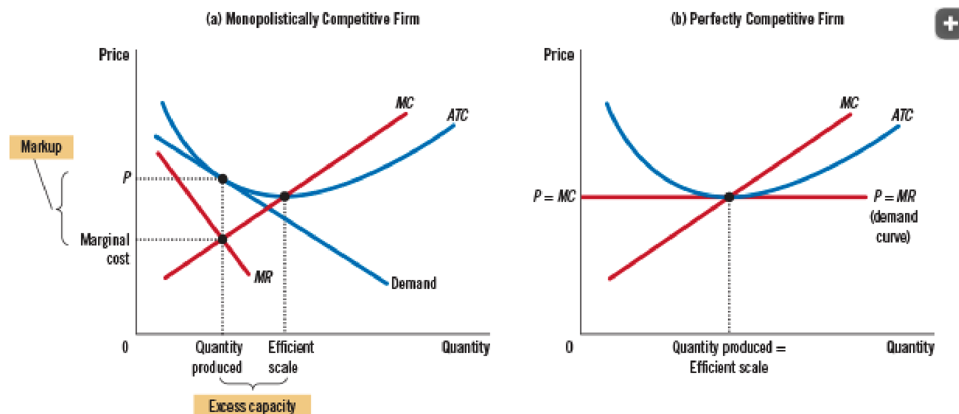
In a monopolistically competitive market, if firms are making profits, new firms enter, causing the demand curves for the incumbent firms to shift to the left. Similarly, if firms are making losses, some of the firms in the market exit, causing the demand curves of the remaining firms to shift to the right. Because of these shifts in demand, monopolistically competitive firms eventually find themselves in the long-run equilibrium shown here. In this long-run equilibrium, price equals average total cost, and each firm earns zero profit.



Monopolistic vs. Perfect Competition

Figure 4 **Monopolistic versus Perfect Competition**

Panel (a) shows the long-run equilibrium in a monopolistically competitive market, and panel (b) shows the long-run equilibrium in a perfectly competitive market. Two differences are notable. (1) The perfectly competitive firm produces at the efficient scale, where average total cost is minimized. By contrast, the monopolistically competitive firm produces at less than the efficient scale. (2) Price equals marginal cost under perfect competition, but price is above marginal cost under monopolistic competition.



Monopolistic Competition and Welfare

Sources of inefficiency in a monopolistically competitive market:

1. Markup: it causes the same DWL caused by a monopolistic pricing

2. The number of firms in the market: There may be too much or too little entry. One way to think about this problem is in terms of the externalities associated with the entry. Whenever a new firm considers entering the market with a new product, it takes into account only the profit it would make. Yet its entry would also have the following two effects that are external to the firm:

- The *product-variety externality*: Because consumers get some consumer surplus from the introduction of a new product, the entry of a new firm confers a positive externality on consumers
- The *business-stealing externality*: Because other firms lose customers and profits when faced with a new competitor, the entry of a new firm imposes a negative externality on existing firms

Monopolistic Competition and Welfare

- Monopolistically competitive markets do not have all the desirable welfare properties of perfectly competitive markets

- Inefficiencies are subtle, hard to measure, and hard to fix, there is no easy way for public policy to improve the market outcome

Advertising

The Debate over Advertising

Is society wasting the resources it devotes to advertising? Or does advertising serve a valuable purpose?

The Critique of Advertising

- Firms advertise to manipulate people's tastes
- Advertising is psychological rather than informational
- Advertising impedes competition
- Advertising often tries to convince consumers that products are more different than they truly are

The Defense of Advertising

- Advertising to provide information to customers
- Advertising fosters competition

Advertising (cont.)

Advertising as a signal of quality

Advertising and brand name