Economics 2010-100
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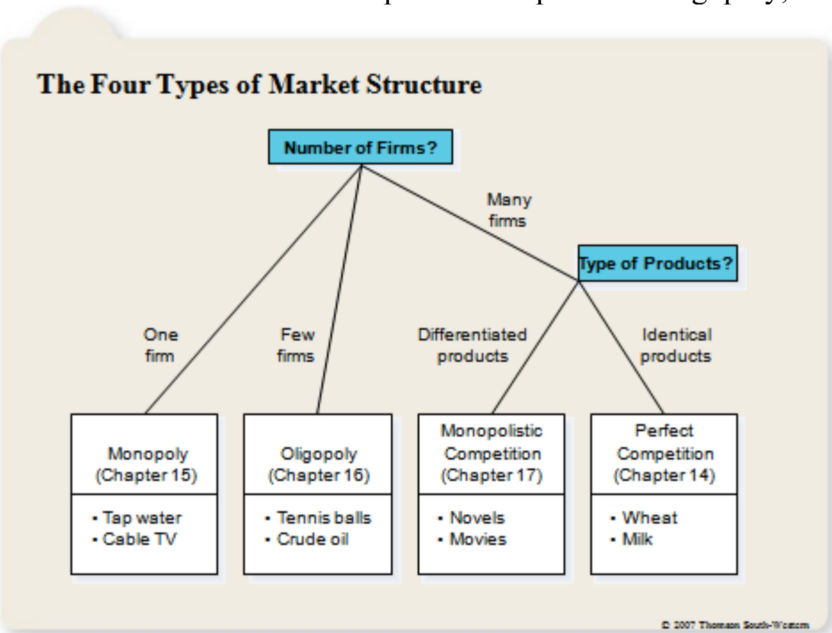
Chapter 16: Monopolistic Competition

- 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?

Two extremes: Perfect competition, Monopoly
In between these extremes - imperfect competition: Oligopoly, Monopolistic competition



<u>Characteristics of Monopolistic Competition:</u>

Examples:

Comparing Perfect & Monop. Competition

	Perfect competition	Monopolistic competition
number of sellers		
free entry/exit		
long-run econ. profits		
the products firms sell		
firm has market power?		
D curve facing firm		

Comparing Monopoly & Monop. Competition

	Monopoly	Monopolistic competition
number of sellers		
free entry/exit		
long-run econ. profits		
firm has market power?		
D curve facing firm		
close substitutes		

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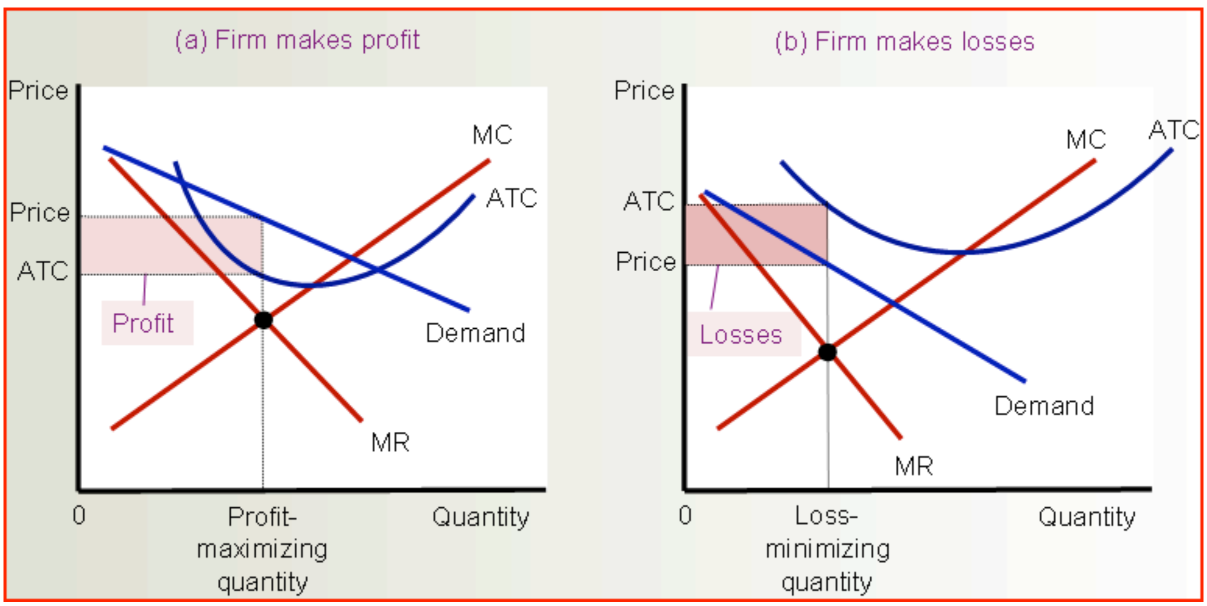
A. The Monopolistically Competitive Firm (MCF) in the Short Run

1. Each firm faces a downward-sloping demand curve. P > MR
2. To maximize profit, firm produces Q where MR = MC. How to set P?



B. Monopolistic Competition and Monopoly

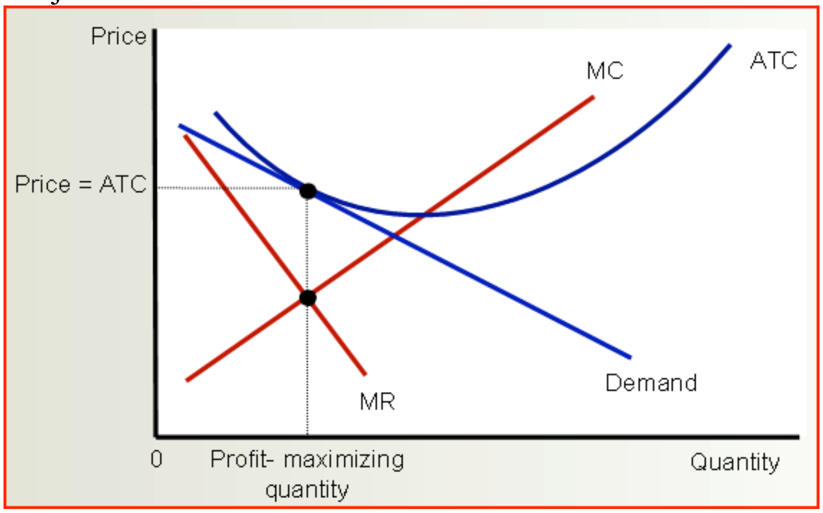
1. SR: very similar to monopoly
2. LR: entry and exit drive economic profit to zero

If profits in the SR:

If losses in the SR:

C. The Long-Run Equilibrium

Entry and exit occurs until P = ATC and profit = 0, Markup of price?

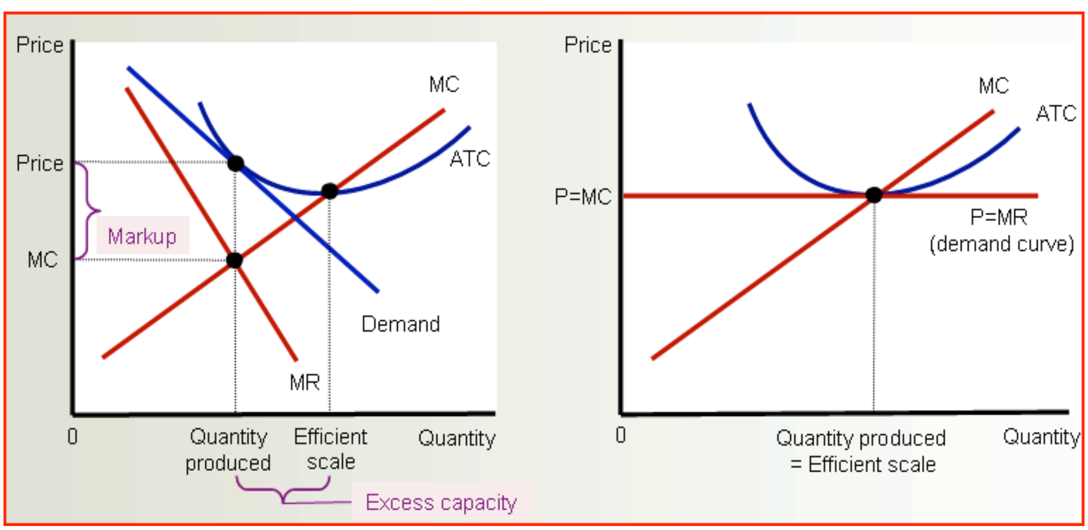


1. Exit and entry process continues until all firms in the market are earning zero (economic) profit.
    a. Demand and ATC curves are tangent to each other.
    b. At tangency point, P = ATC and firm is earning zero economic profit.
2. Two characteristics of long-run equilibrium in a monopolistically competitive market
    a. Price > MC
    b. Price = ATC (due to the freedom of entry and exit).

C. Why Monopolistic Competition is Less Efficient than Perfect Competition?

1. ____________________________
    a. The monopolistic competitor operates on the downward-sloping part of its *ATC* curve, produces less than the cost-minimizing output.
    b. This implies that firms in monopolistic competition have ________________________: Increase output and lower ATC of production.
    c. Firms in perfect competition; firms produce the Q that minimizes ATC.

2. ____
    a. In monopolistic competition, P > MC because firm has some market power.
    b. In perfect competition, P = MC.



D. Monopolistic Competition and Welfare

1. One source of inefficiency is the markup over marginal cost (P > MC). This implies a deadweight loss.

2. Because there are so many firms in this type of market structure, regulating these firms would be difficult.

3. Also, forcing these firms to set P = MC would force them out of business.

4. There are also externalities associated with entry.
    a. The ________________________________ occurs because as new firms enter, consumers get some consumer surplus from the introduction of a new product. (+)
    b. The ________________________________ occurs because as new firms enter, other firms lose customers and profit. (-)
    c. Depending on which externality is larger, a monopolistically competitive market could have too few or too many products.

<u>Advertising</u>

In monopolistically competitive industries, product differentiation and markup pricing lead naturally to the use of advertising.

A. The Debate over Advertising

1. The Critique of Advertising

2. The Defense of Advertising

B. Advertising as a Signal of Quality

1. The willingness of a firm to spend a large amount of money on advertising may be a signal about the quality of the product being offered.

2. Note that the content of the advertisement is unimportant; what is important is that consumers know that the advertisements are expensive.

C. Brand Names

1. In many markets there are two types of firms;
    a. some firms sell products with widely recognized brand names
    b. while others sell generic substitutes.

2. Critics of brand names argue that they cause consumers to perceive differences that do not really exist.

3. Economists defend brand names as a useful way to ensure that goods are of high quality.

Suggested problems: Problems and Applications- 1, 3, 5