Pinciples of

Microeconomics

Sixth Edition

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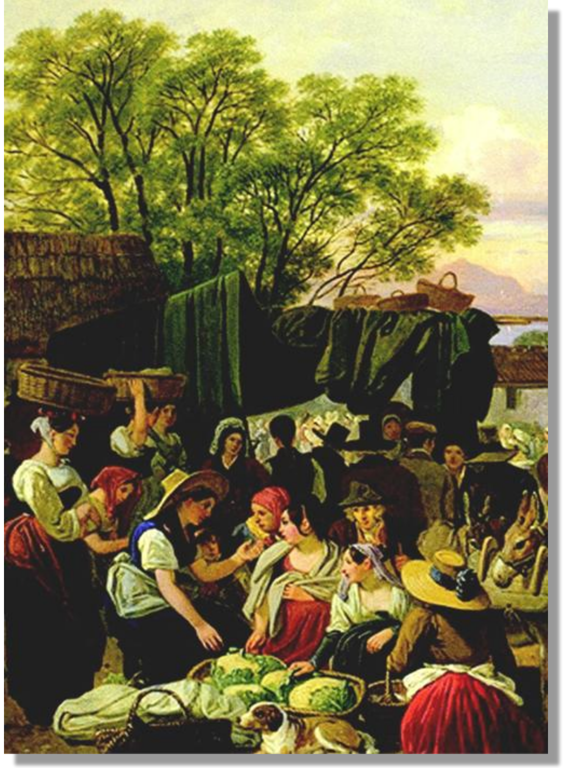


Chapter : Monopolistic Competition

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?

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 (Not identical)
- 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

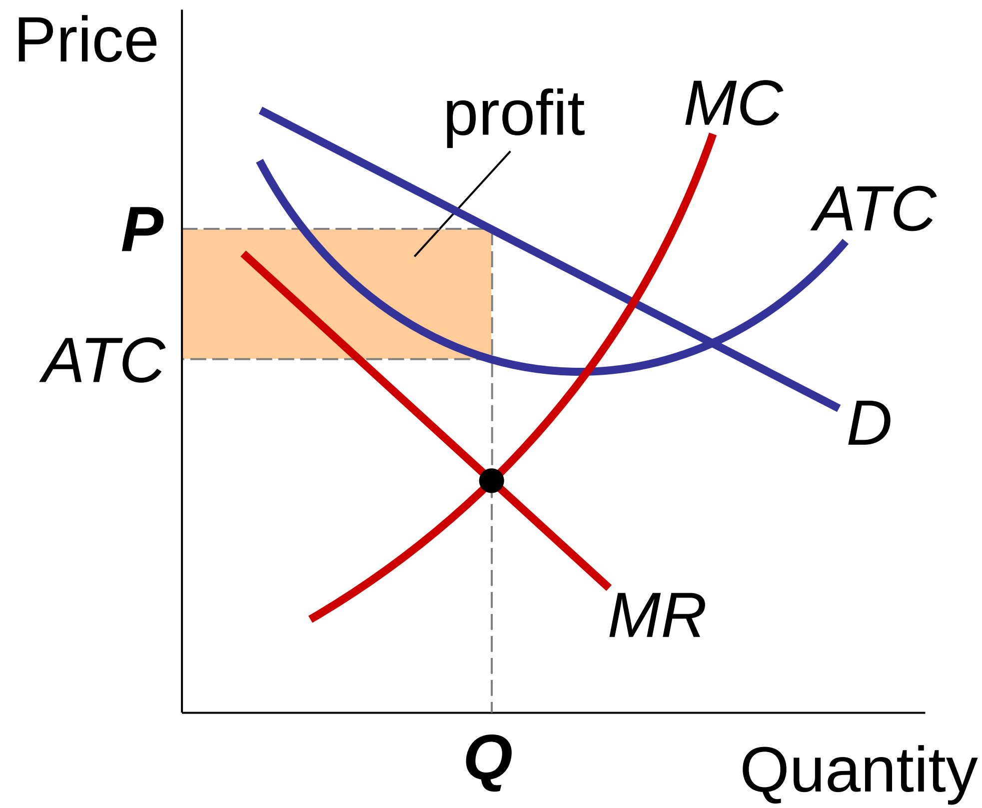
A Monopolistically Competitive Firm Earning Profits in the Short Run

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

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

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

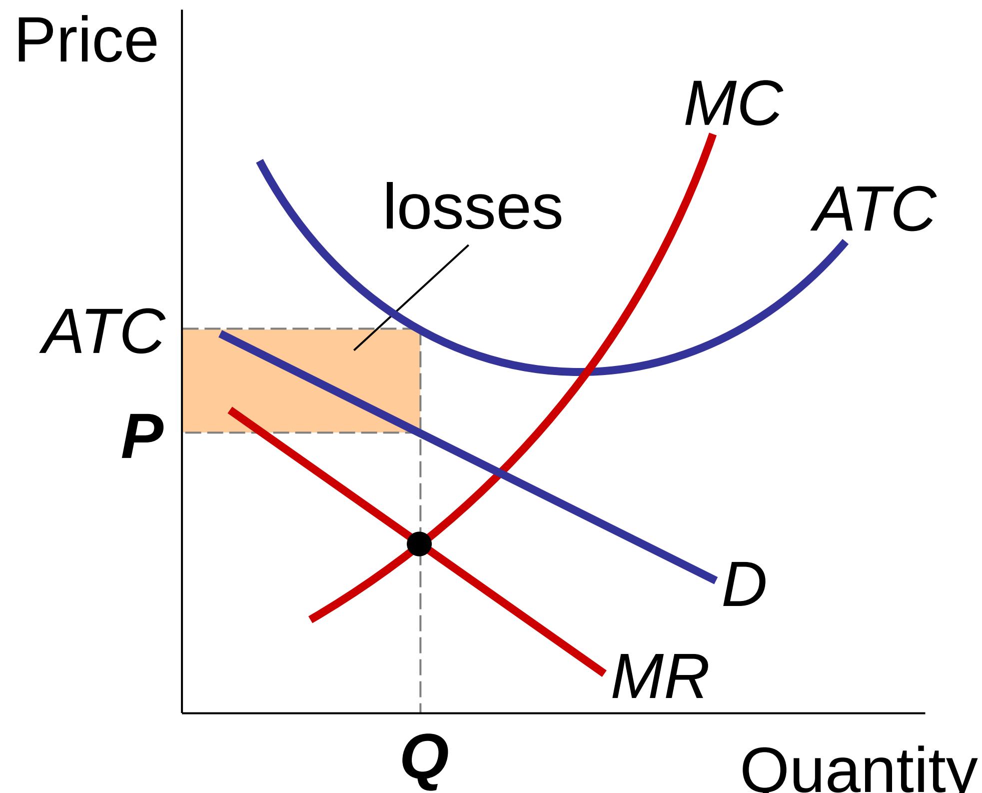
The firm uses the *D* curve to set *P*.



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.



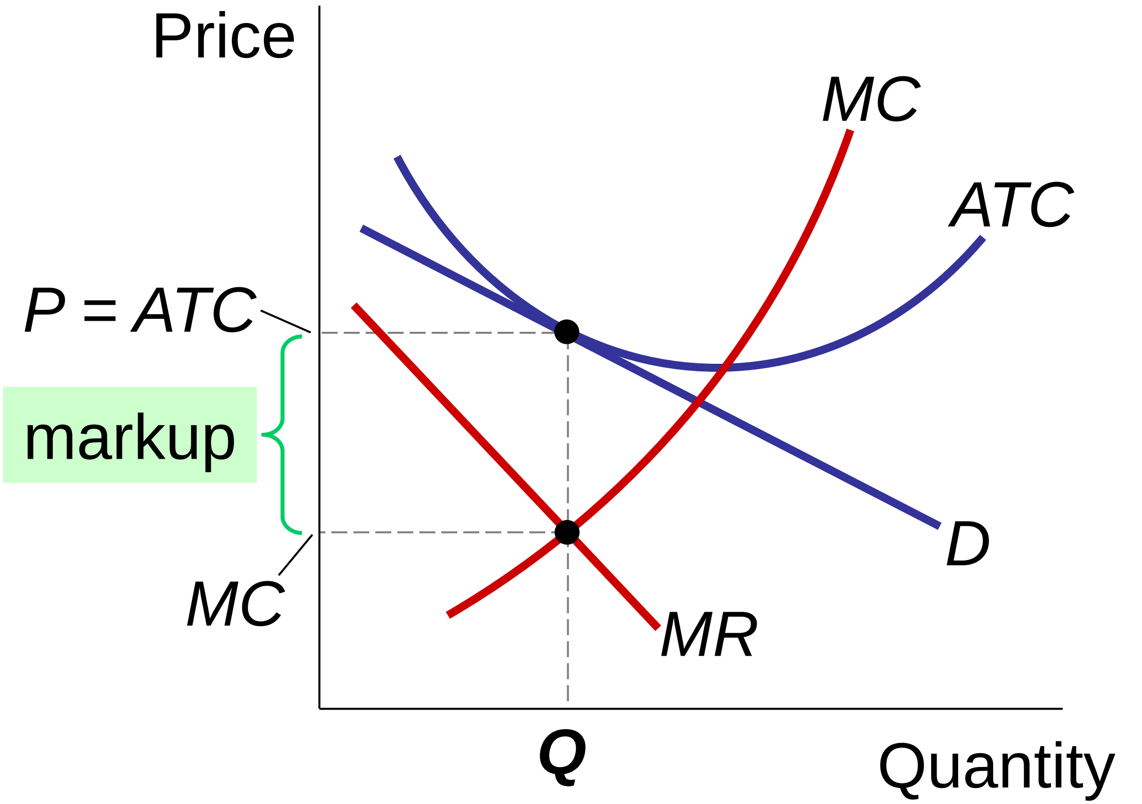
Monopolistic Competition and Monopoly

- *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.

CHAPTER SUMMARY

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