Monopolistic competition

Is Starbuck's coffee really different from any other?

Monopolistic competition

- A *monopolistically competitive* producer is one amongst many producers of goods or services that are *differentiated*.
- The industry has the structure of *monopolistic competition*.
  - A *differentiated product* is slightly different from the goods or services offered by other close competitors.
    - Differentiation by style or type or location
      - "horizontal product differentiation"
    - Differentiation by quality
      - "vertical product differentiation"
  - Substitutes are available for the monopolistic competitors product

Elasticity of Demand

Perfect Competition:

- The demand curve is a horizontal line (perfectly elastic)
  - Goods are homogeneous
  - Firms can't price above the market price

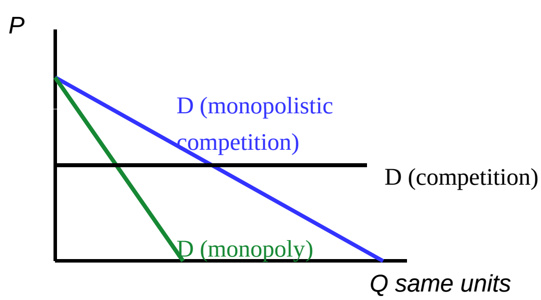
Monopoly:

- Demand curve is industry demand (downward sloping)
- Much less elastic than under perfect competition
  - Single firm with no close substitutes for its good

Elasticity of Demand

Monopolistic Competition:

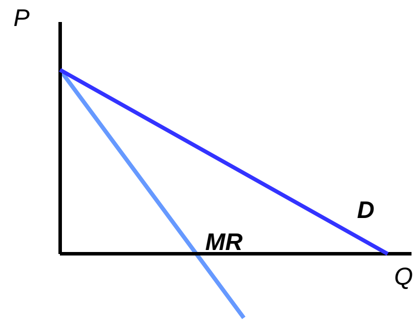
- Only producer of a "unique" product
- Unlike monopoly there are many close substitutes
- How will the elasticity of demand compare?



- Less elastic than competition
- More elastic than monopoly
- Downward sloping

Marginal Revenue Curve

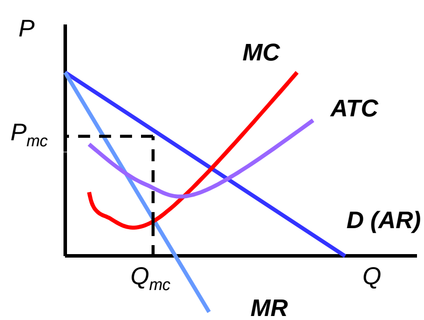
- What will the monopolistic competitors marginal revenue curve look like?
- Similar to the monopolists



- Lies below the demand curve
  - Price and quantity effects
- Marginal revenue is zero at the midpoint of the demand function
  - Linear demand functions

Profit Maximization

- The monopolistic competitor also faces perfect competition in input markets
  - Thus, cost curves are similar to competition and monopoly



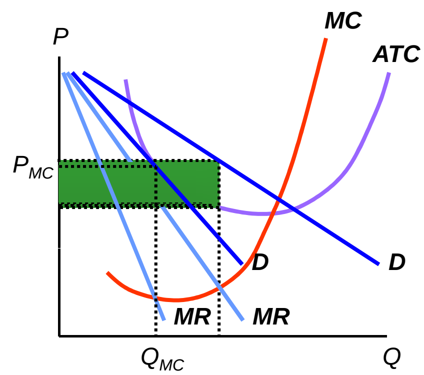
- What quantity and price should the firm choose?
- As in all cases, the firm should set MR=MC
- Price is read off of the demand function

Long-Run Equilibrium

- Unlike under monopoly firms can enter or exit
- However, firms that enter/exit produce close substitutes <u>not the same good</u>
- This results in a shift in demand for the goods produced by existing firms in the industry
  - Example, short-run profits
  - Firms will enter the industry and demand will fall
  - So will marginal revenue

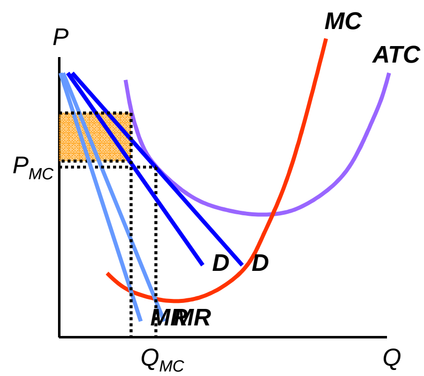
Profits and entry

- With profits other firms enter the industry (in the long run).
- Demand for each producer's output falls.
- Demand falls until economic profits are zero.
  - When the demand curve is tangent to ATC



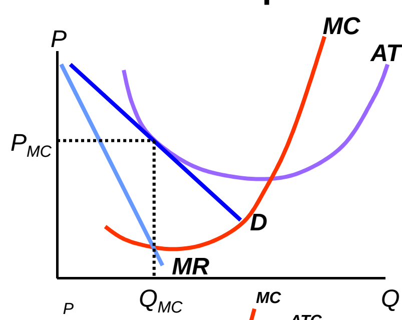
Losses and exit

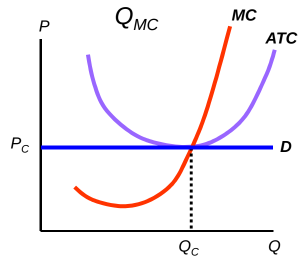
- With losses existing firms leave the industry (in the long run).
- Demand for each producer's output increases.
- Demand rises until economic profits are zero.
  - When the demand curve is tangent to ATC



Monopolistic vs perfect competition

- Monopolistic competition:
  - $P_{MC} > MC$
    - inefficiency
    - advertising
  - Q_{MC} < minimum-cost output
    - *excess capacity*
  - Product diversity
  - Zero profit
- Perfect competition:
  - $P_C = MC$
    - efficiency
  - Q_C = minimum-cost output
    - *no excess capacity*
  - Standardized product
  - Zero profit





The assessment

- When there is monopolistic competition, the unregulated “market” outcome creates some inefficiency.
  - Excess capacity, $P > MC$
- Compared to perfect competition it may or may not be “better”:
  - Inefficiency, but product diversity