Ch. 16 Learning Targets

- The meaning of monopolistic competition.
- Why oligopolies & monopolistically competitive firms differentiate their products.
- How prices & output are determined in monopolistic competition in the short run and in the long run.
- Why monopolistic competition poses a trade-off between lower prices and greater product diversity.
- The economic significance of advertising & brand names.

Monopolistic Competition

What is the purpose & function of toothpaste?

- What features do you look for in choosing a toothpaste? Ignore?
  - Gel v. Paste
  - Flavors
  - Whitening
  - Plaque fighting
  - Pump v. tube
- If you forgot your toothpaste would you borrow another kind or go without?

Monopolistic competition is a market structure in which:

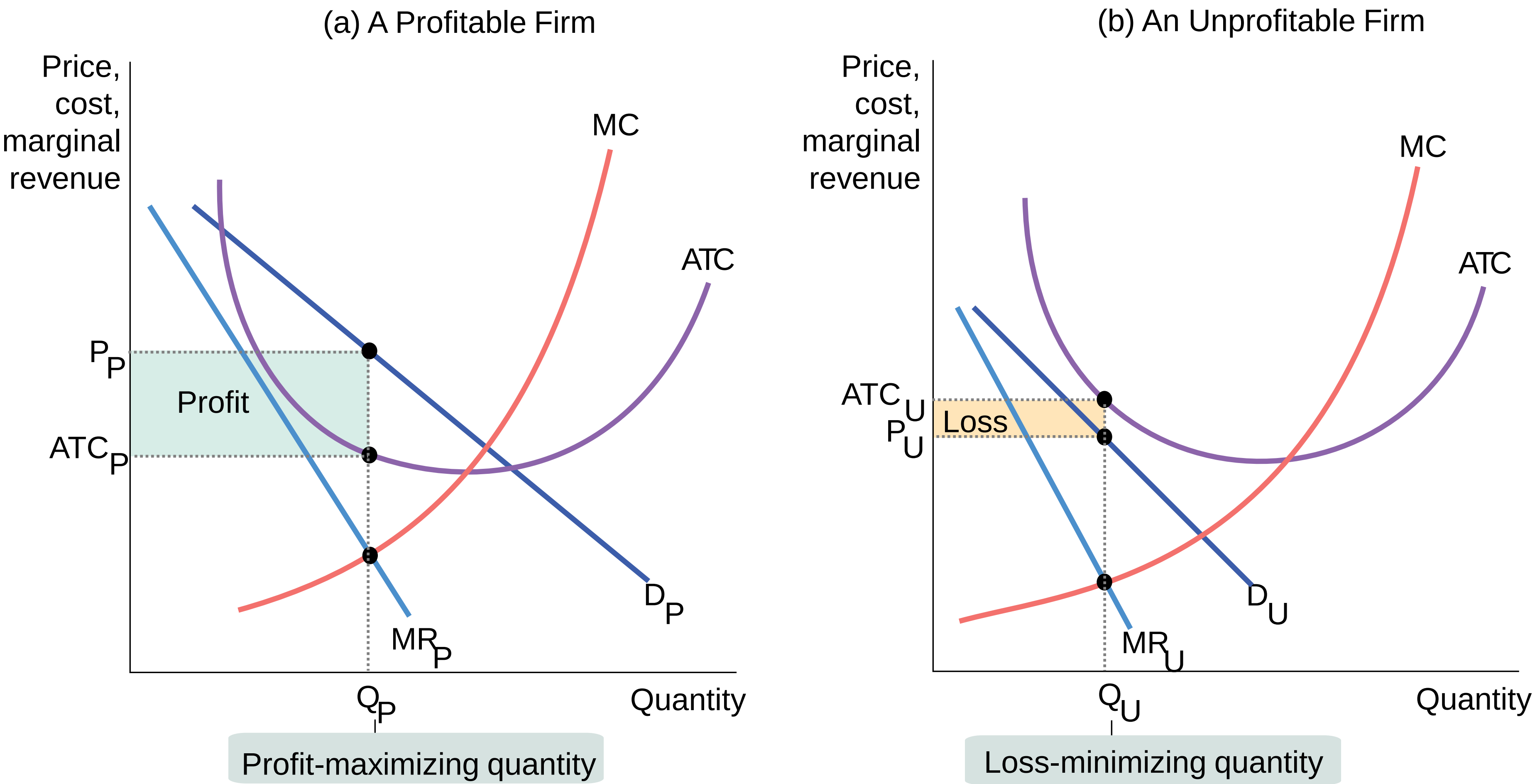
- there are ***many*** competing producers in an industry
- each producer sells a ***differentiated product***
- there is ***free entry into and exit*** from the industry in the long run

The MC Firm in the **Short Run**

The following figure shows two possible situations that a typical firm in a monopolistically competitive industry might face **in the short run**.

- In each case, the firm looks like any monopolist: it faces a downward-sloping demand curve, which implies a downward-sloping marginal revenue curve.
- We assume that every firm has an upward-sloping marginal cost curve, but that it also faces some fixed costs, so that its average total cost curve is U-shaped.
- Firms earn a profit by differentiating their product.

The MC Firm in the Short Run



Profit Maximization: MR=MC

Monopolistic Competition in the Long Run

Firm's long-run result is the same as in perfect competition (normal profit)

If the typical firm earns economic profits:

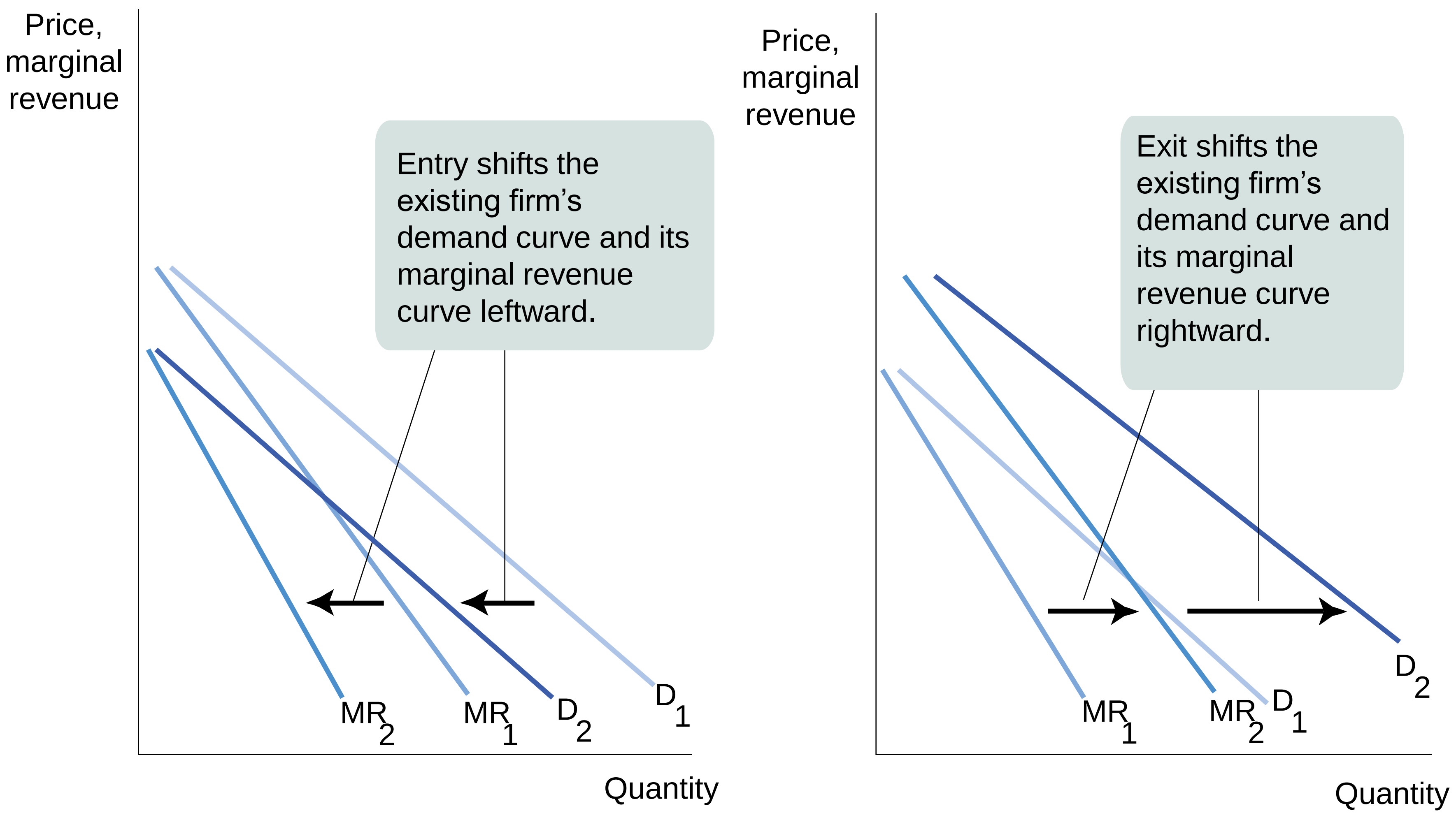
- New firms will enter (substitute) the industry in the long run
- Decreasing existing firm's demand curve to the left
- Existing firm's demand more elastic (substitute)

If the typical firm incurs losses:

- some existing firms will exit the industry in the long run
- shifting the demand curve of each remaining firm to the right.

Entry and Exit Shift Existing Firm's Demand Curve and Marginal Revenue Curve

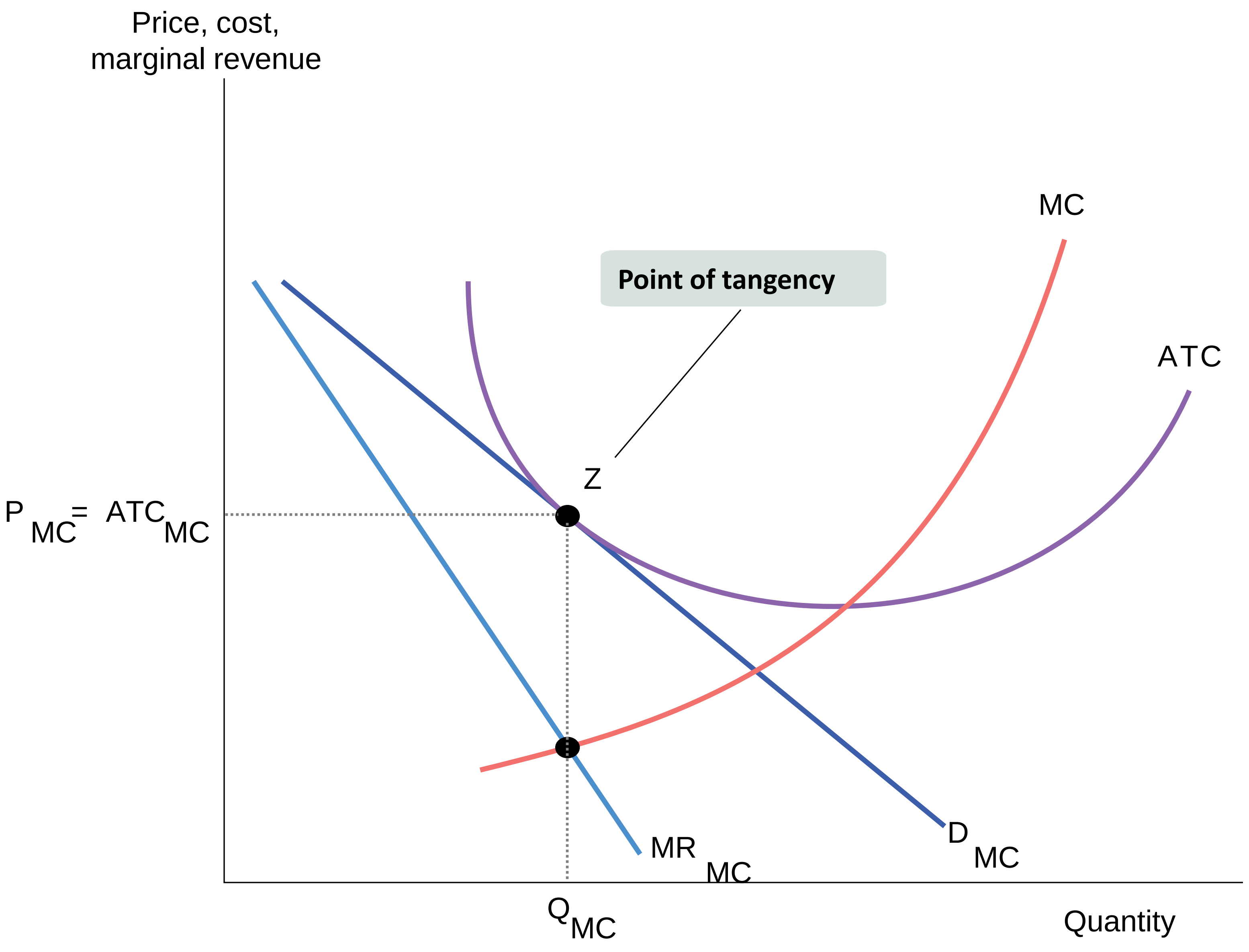
(a) Effects of Entry **(b) Effects of Exit**



Monopolistic Competition in the Long Run

- ***zero-profit-equilibrium*** *or zero economic profit*
- Demand curve (price) exceeds Marginal Cost
- Demand curve (price) equals Avg Total Cost
- Demand curve (price) is just tangent to its average total cost curve at its profit-maximizing output (MR=MC)

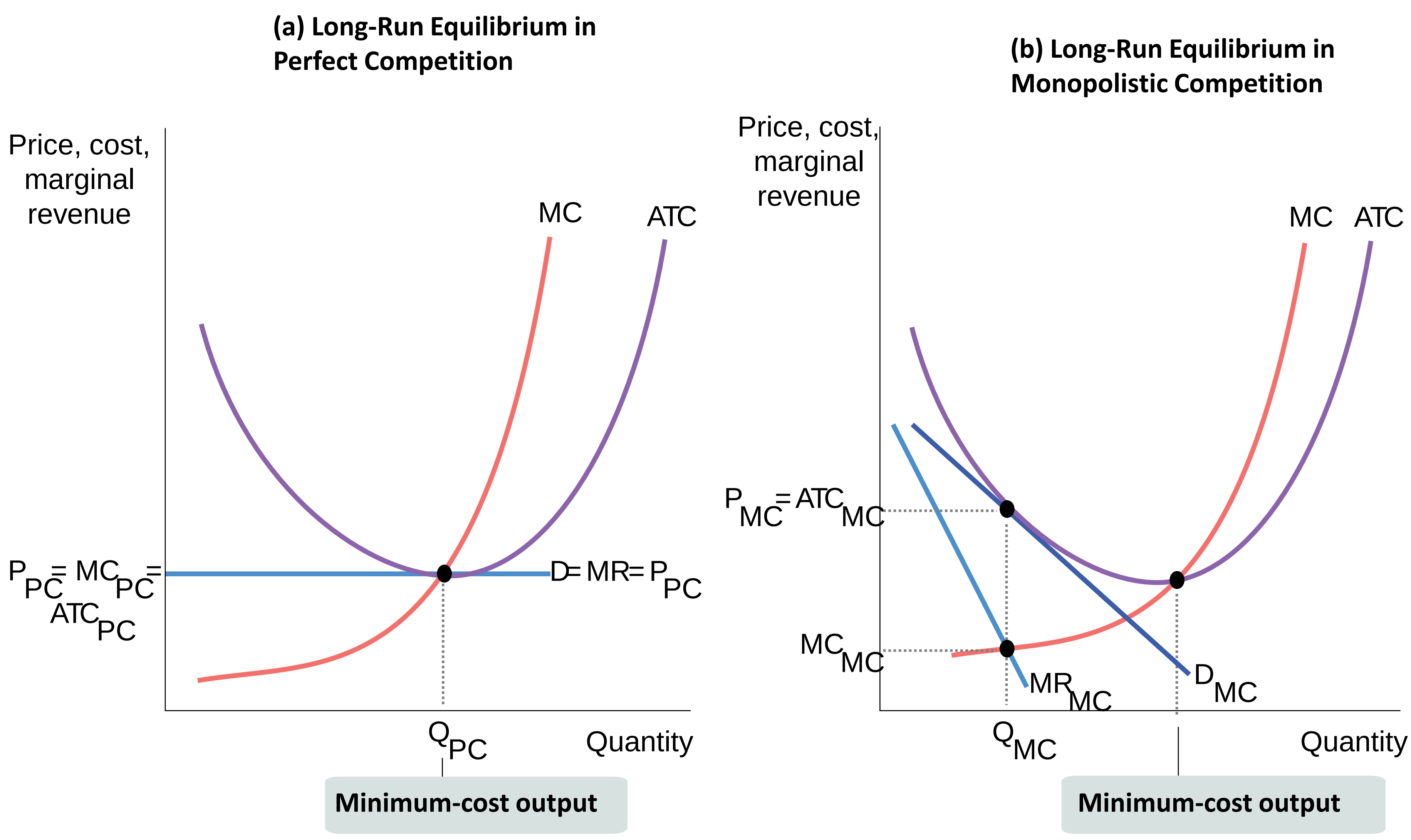
The Long-Run Zero-Profit Equilibrium



Monopolistic Competition versus Perfect Competition

- In the long-run equilibrium of a monopolistically competitive industry, there are many firms, all earning zero economic profit.
- Price exceeds marginal cost so some mutually beneficial ***trades are exploited***.
- The following figure compares the long-run equilibrium of a typical firm in a perfectly competitive industry with that of a typical firm in a monopolistically competitive industry.

Comparing LR Equilibrium in PC and MC



Is Monopolistic Competition Inefficient?

- Firms in a monopolistically competitive industry have **excess capacity**: they produce less than the output at which average total cost is minimized.
  - **Decrease output & Increase Price**

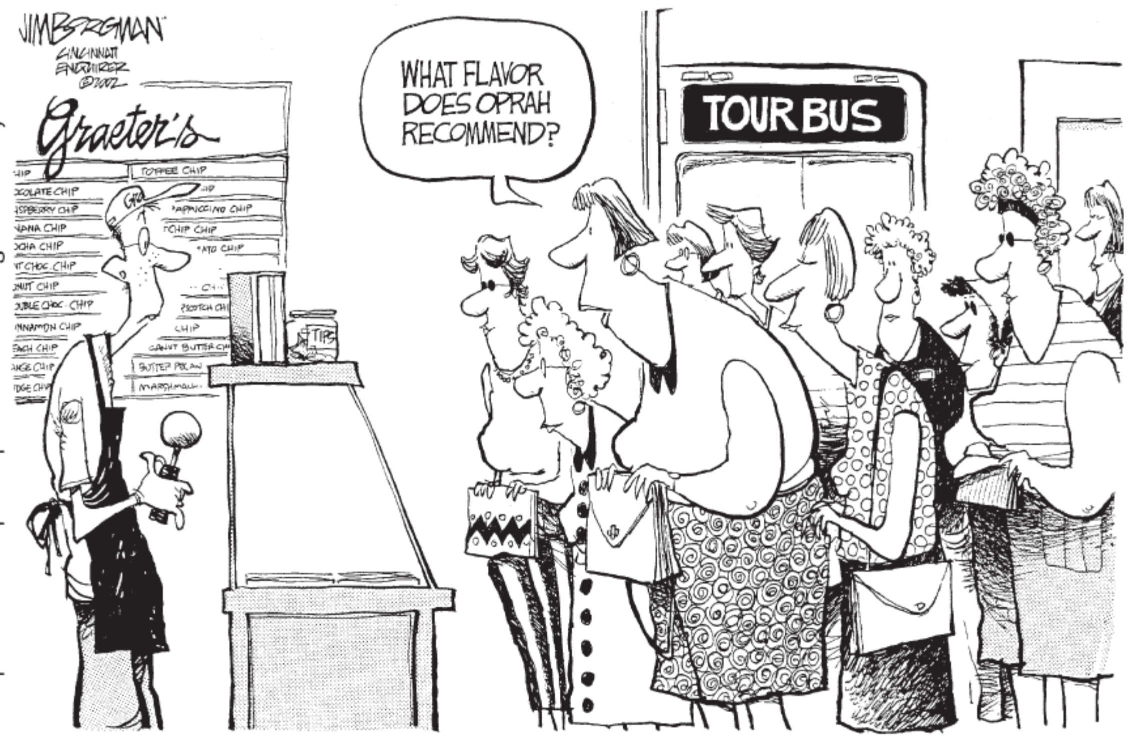
- **Price exceeds marginal cost, so some mutually beneficial trades are unexploited.**

- The higher price consumers pay because of excess capacity is offset to some extent by the value they receive from greater diversity.

- Hence, it is not clear that this is actually a source of inefficiency.

Controversies About Product Differentiation

No discussion of product differentiation is complete without spending at least a bit of time on the two related issues—and puzzles—of *advertising* and *brand names*.



Advertising and Brand Names

- Product differentiation leads to advertising and brand names.
- Some critics of monopolistic competition contend that advertising and brand names exploit consumers and reduce competition.
- Defenders argue that advertising increases competition by offering a greater variety of products and prices.

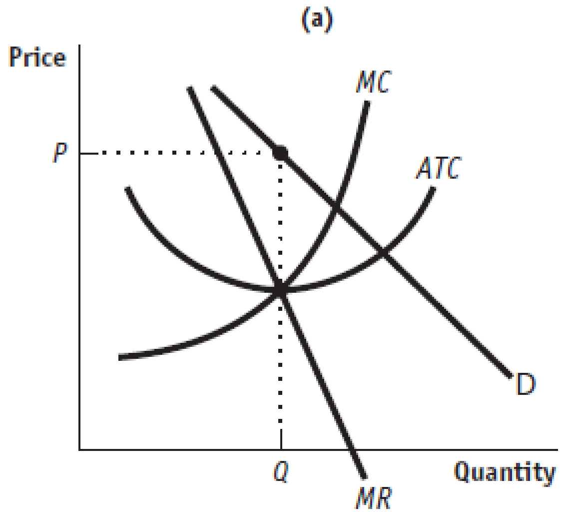
Monopolistic Competition: Advertising

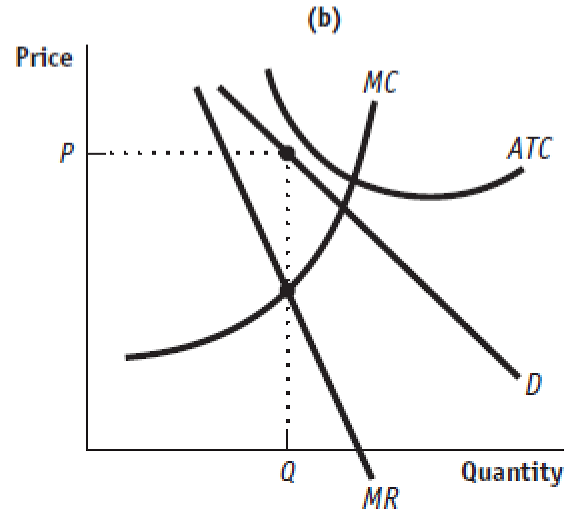
- Firms that sell highly differentiated consumer goods typically spend between 10 and 20 percent of revenue for advertising.
- As a whole (total economy) about 2 percent of total firm revenue is spent on advertising.

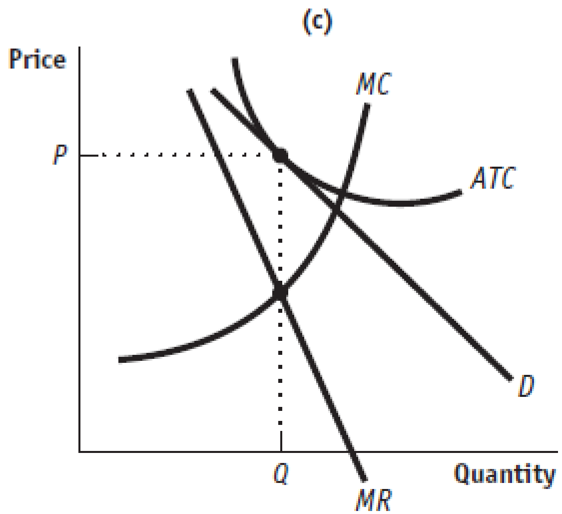
Advertising and Brand Names

- Brand Names may provide two benefits to consumers:
  - Provide consumers information about quality when quality cannot be easily judged in advance of purchase.
  - Give firms an incentive to maintain high quality.

Label the following:







Loss
Economic Profit
Normal Profit