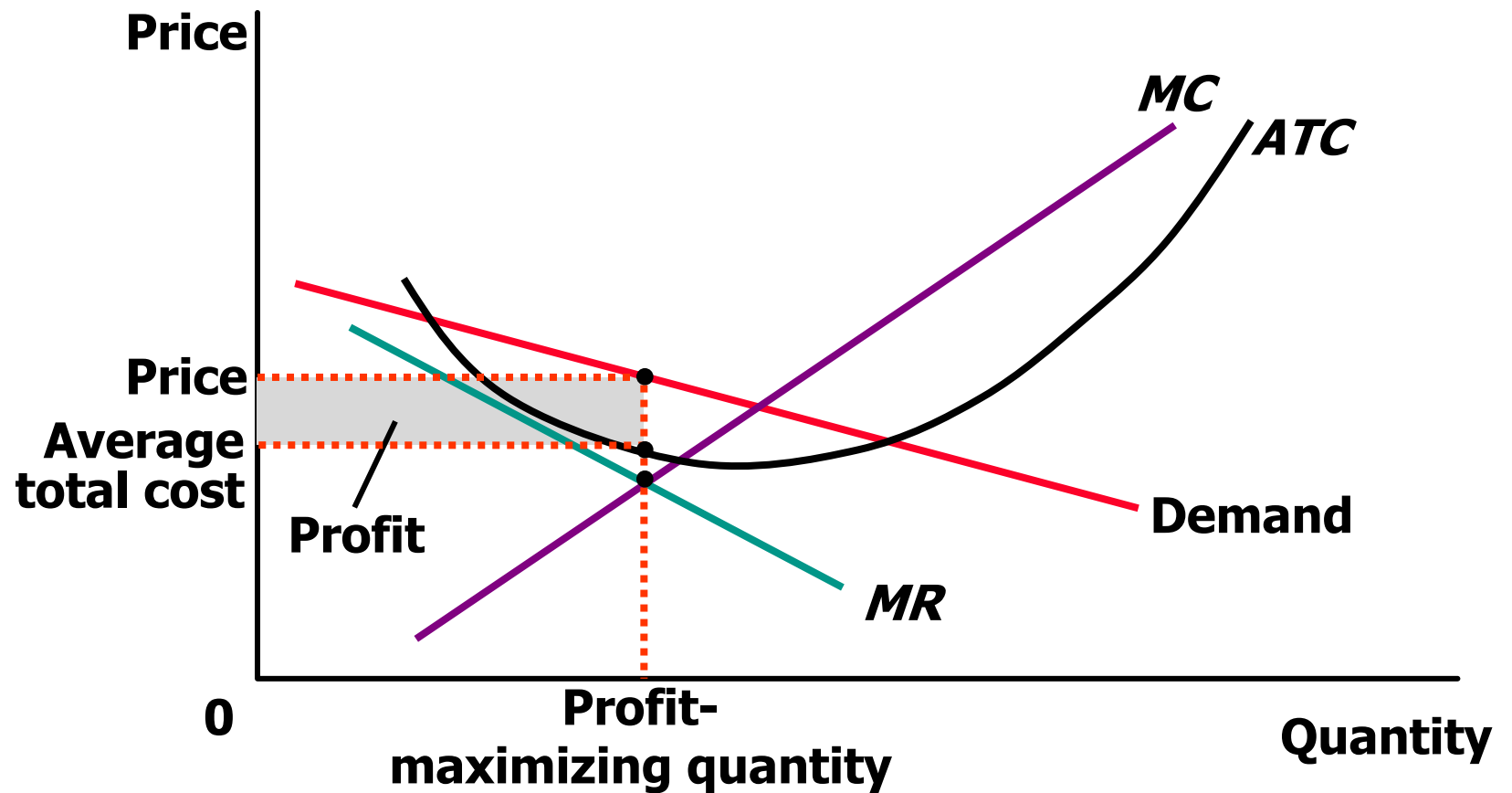


Characteristics of Monopolistic Competition

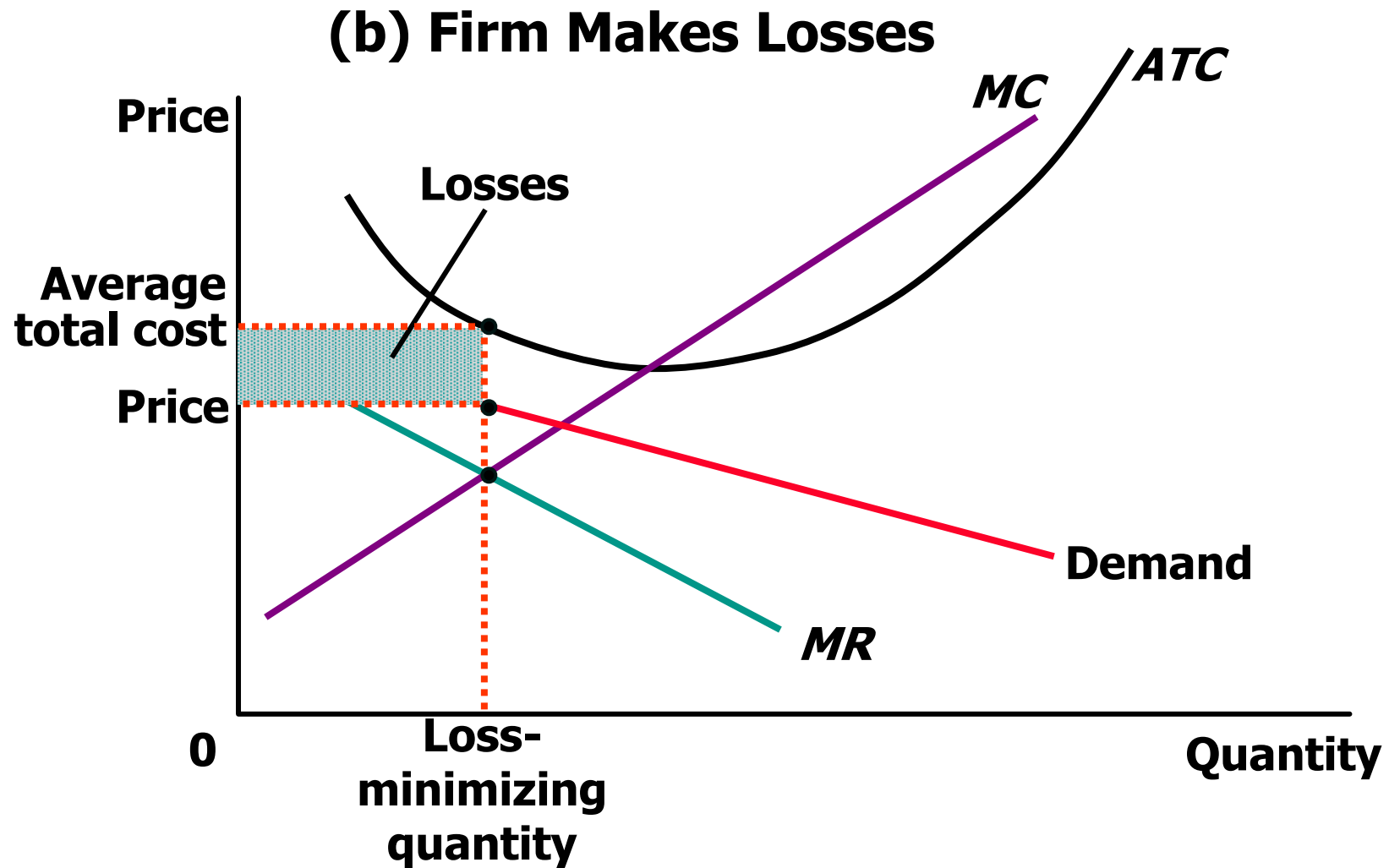
- ◆ Many sellers - many firms competing for the same group of customers.
 - ◆ examples include books, CDs, movies, computer games, restaurants, piano lessons, cookies, furniture, etc.
- ◆ Product differentiation - each firm produces a product that is at least slightly different from those of other firms - each firm faces a downward-sloping demand curve.
- ◆ Free entry and exit - firms can enter or exit the market without restriction.

Monopolistic Competitors in the Short Run...

(a) Firm Makes a Profit



Monopolistic Competitors in the Short Run...



Monopolistic Competition in the Short Run

Short-run economic profits encourage new firms to enter the market. This:

- ◆ Increases the number of products offered.
- ◆ Reduces demand faced by firms already in the market.
- ◆ Incumbent firms' demand curves shift to the left.
- ◆ Demand for the incumbent firms' products fall, and their profits decline.

Short-run economic losses encourage firms to exit the market. This:

- ◆ Decreases the number of products offered.
- ◆ Increases demand faced by the remaining firms.
- ◆ Shifts the remaining firms' demand curves to the right.
- ◆ Increases the remaining firms' profits.

Monopolistic versus Perfect Competition

There are two noteworthy differences between monopolistic and perfect competition—**excess capacity** and **markup**.

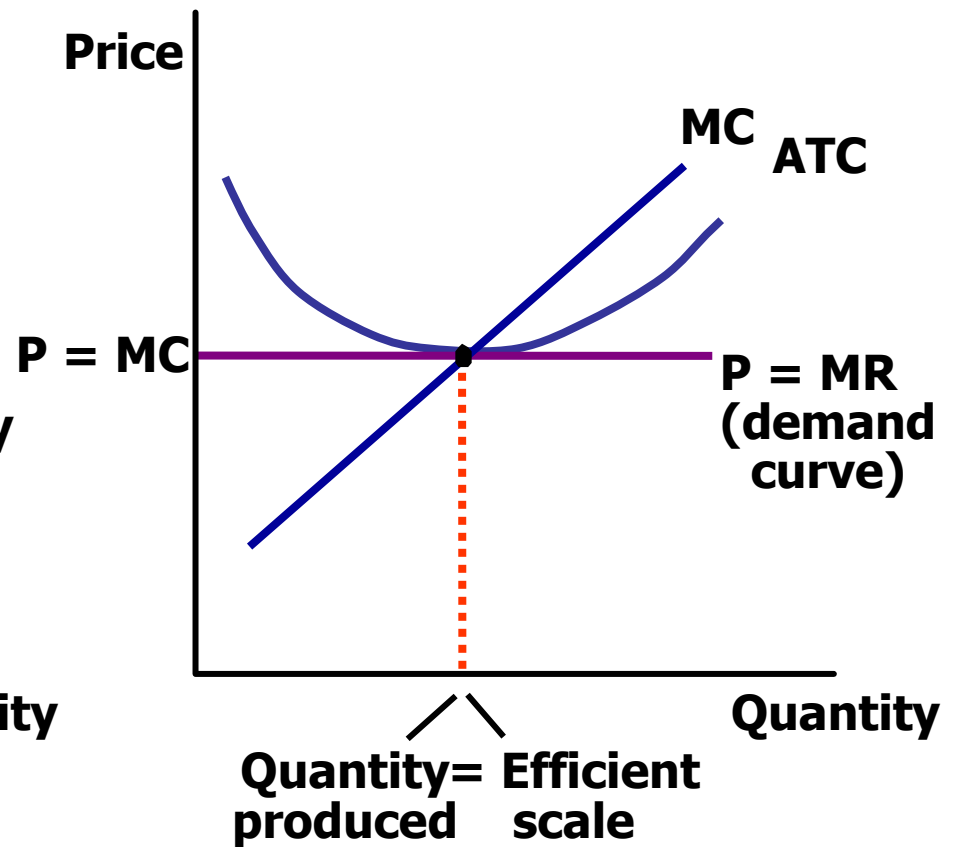
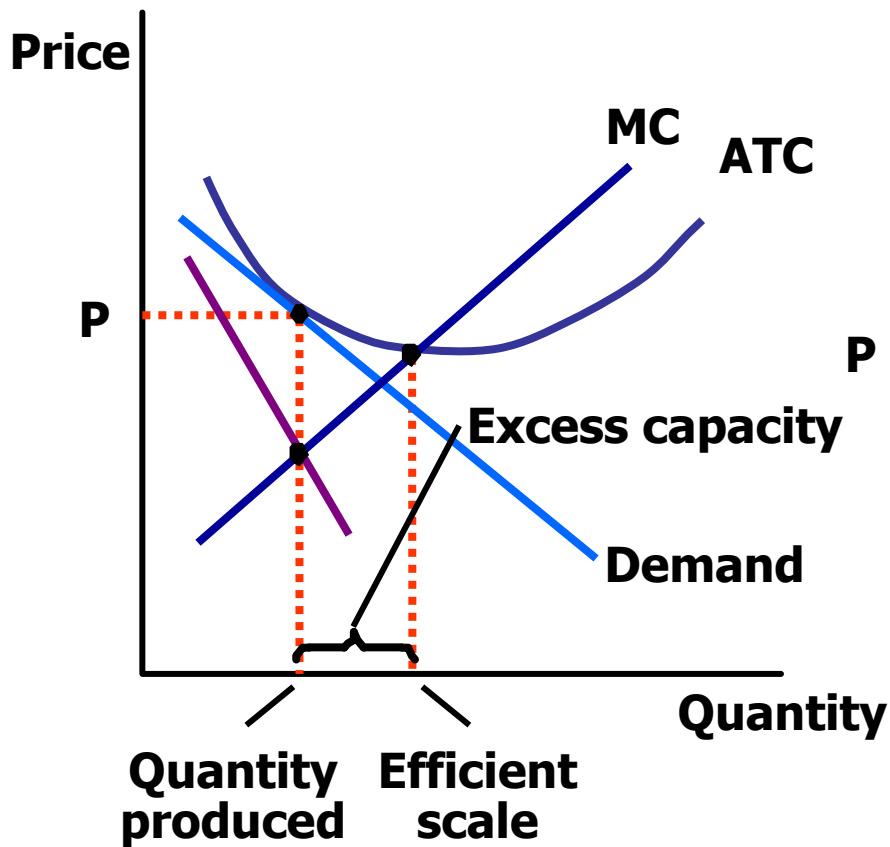
There is no excess capacity in perfect competition in the long run. Free entry results in competitive firms producing at the point where average total cost is minimized, which is the **efficient scale** of the firm.

There is excess capacity in monopolistic competition in the long run. In monopolistic competition, output is less than the efficient scale of perfect competition.

Excess Capacity...

(a) Monopolistically Competitive Firm

(b) Perfectly Competitive Firm



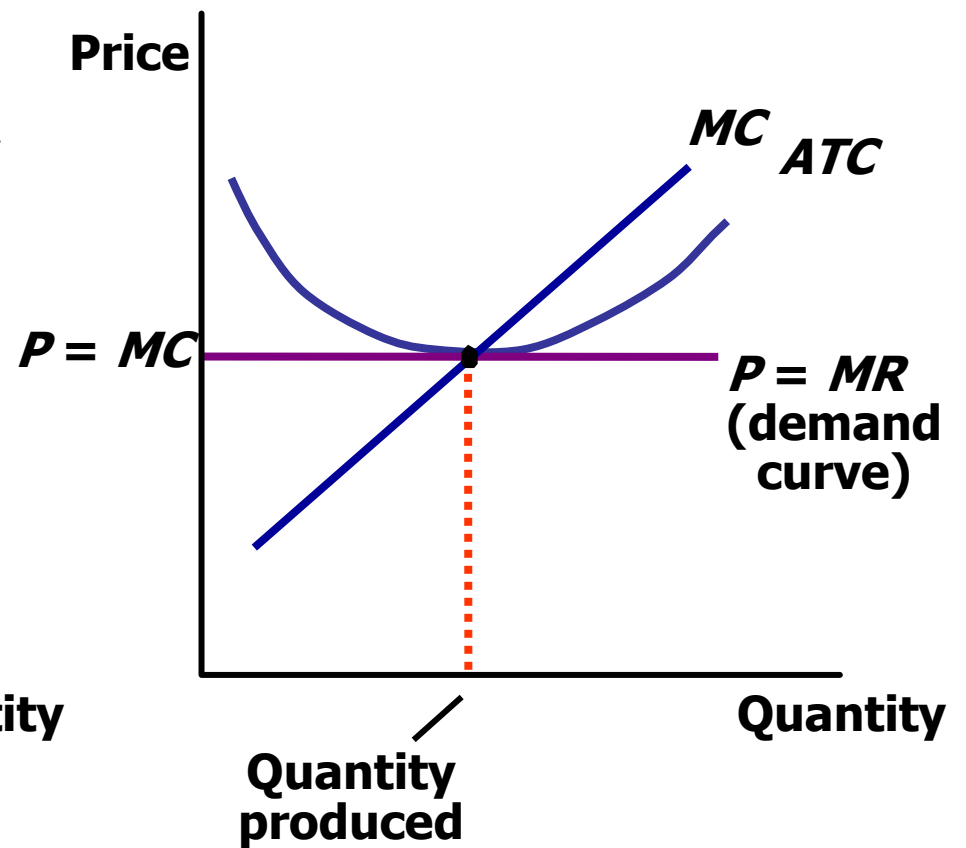
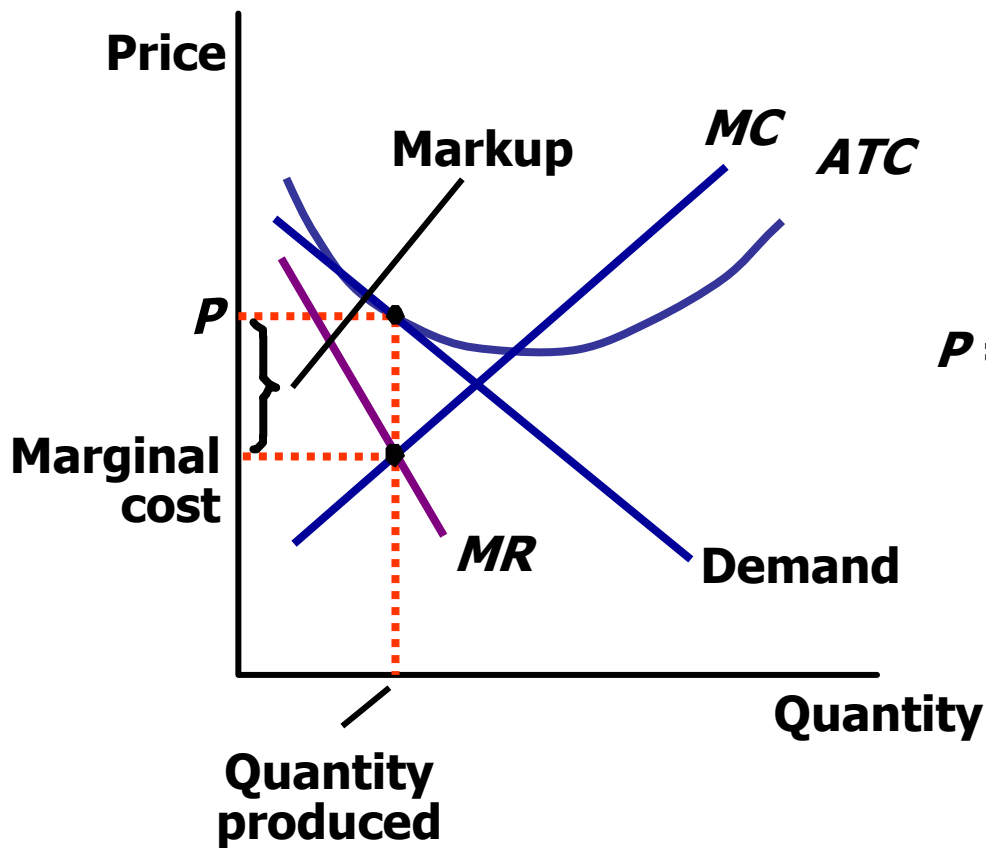
Markup Over Marginal Cost

- ◆ For a competitive firm, price equals marginal cost.
- ◆ For a monopolistically competitive firm, price exceeds marginal cost.
- ◆ Because price exceeds marginal cost, an extra unit sold at the posted price means more profit for the monopolistically competitive firm.

Markup Over Marginal Cost...

(a) Monopolistically Competitive Firm

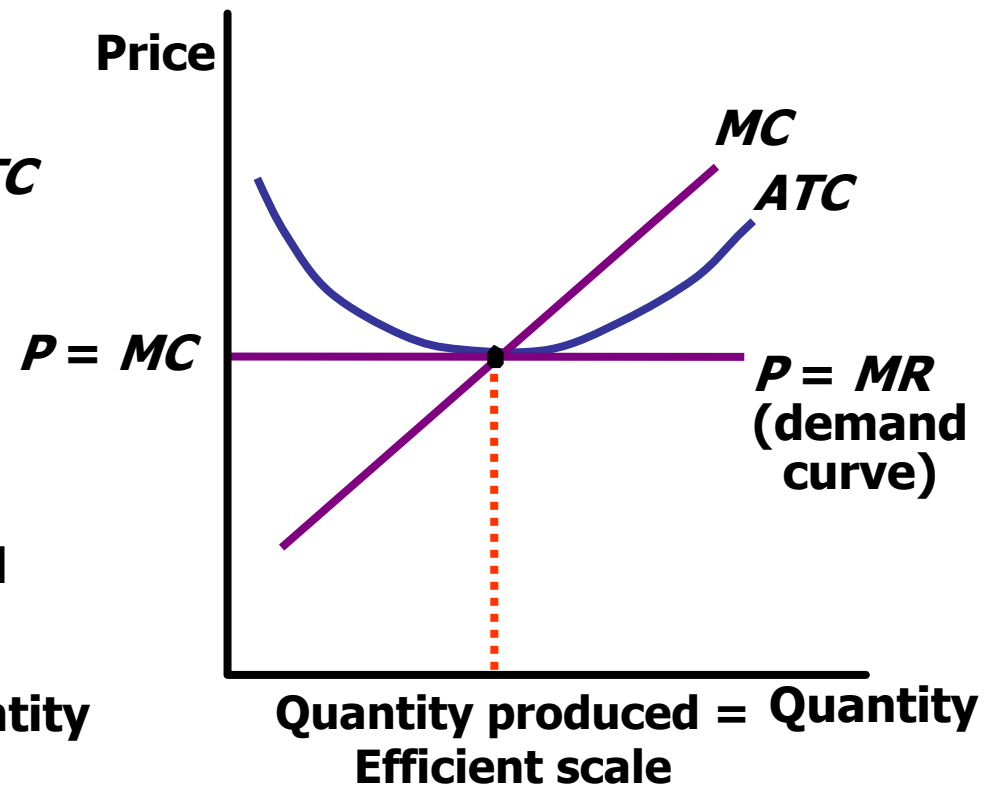
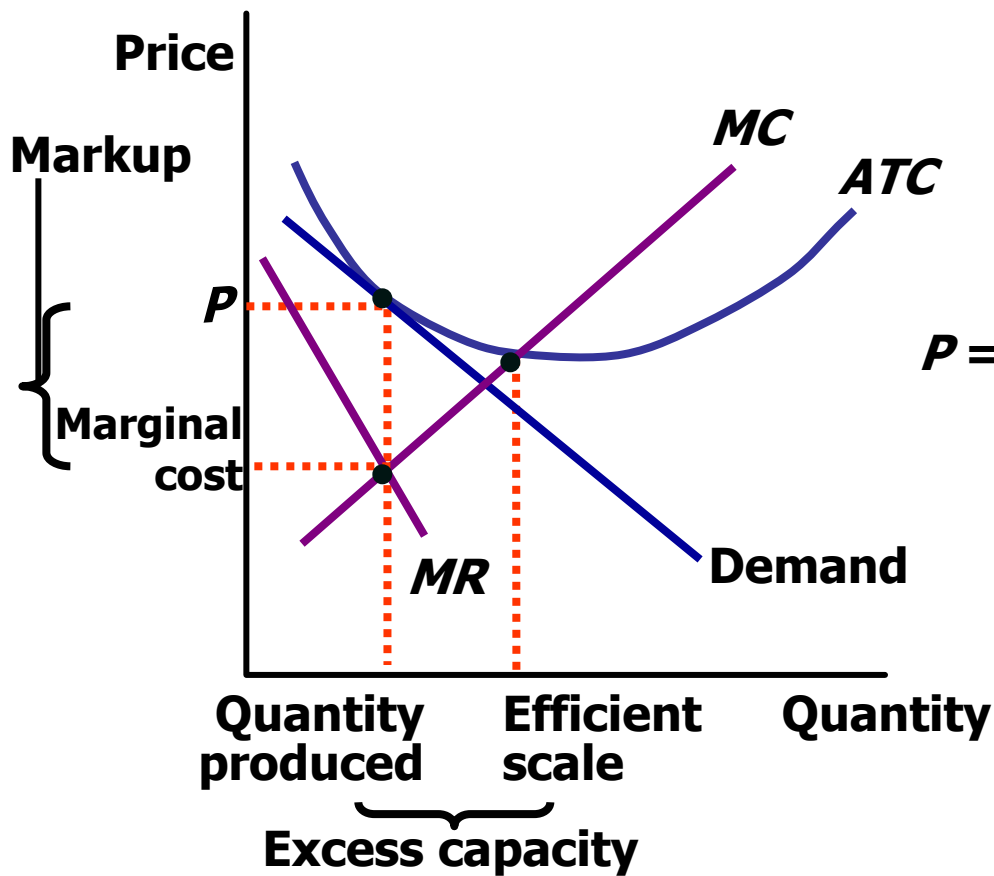
(b) Perfectly Competitive Firm



Monopolistic versus Perfect Competition...

(a) Monopolistically Competitive Firm

(b) Perfectly Competitive Firm



Monopolistic Competition and Welfare of Society

Monopolistic competition does not have all the desirable properties of perfect competition.

There is the normal deadweight loss of monopoly pricing in monopolistic competition caused by the markup of price over marginal cost.

However, the administrative burden of regulating the pricing of all firms that produce differentiated products would be overwhelming.

Another way in which monopolistic competition may be socially inefficient is that the number of firms in the market may not be the “ideal” one. There may be too much or too little entry.

Advertising

When firms sell differentiated products and charge prices above marginal cost, each firm has an incentive to advertise in order to attract more buyers to its particular product.

Firms that sell highly differentiated consumer goods typically spend between 10 and 20 percent of revenue on advertising.

Overall, about 2 percent of total revenue is spent on advertising.

Critics of advertising argue that firms advertise in order to manipulate people's tastes. They also argue that it impedes competition by exaggerating product differentiation.

Defenders argue that advertising provides information to consumers

They also argue that advertising increases competition by offering a greater variety of products and prices. The willingness of a firm to spend advertising dollars can be a signal to consumers about the quality of the product being offered.

Brand Names

- ◆ Critics argue that brand names cause consumers to perceive differences that do not really exist.
- ◆ Economists have argued that brand names may be a useful way for consumers to ensure that the goods they are buying are of high quality.
 - ◆ providing **information** about quality.
 - ◆ giving firms **incentive** to maintain high quality.