

Monopolistic Competition

Econ 102: Introduction to Microeconomics

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1.1 Goals of today's class

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- Learn about one of most common types of markets: monopolistic competition.
- Learn how monopolistically competitive firms maximize profits.
- Learn long-run outcomes of monopolistic competition.
- Learn about non-price forms of competition.

2 What is Monopolistic Competition

2.1 Characteristics

Characteristics of Monopolistic Competition

- Large number of firms.
- Differentiated products: each firm's product is a little different.
 - Could simply be perceived as different.
 - May differ on location.
- Free entry and exit.
- Examples: restaurants, clothing brands, food name brands, maybe even gas stations along the interstate.

2.2 Product Differentiation

Product Differentiation

- **Product differentiation:** ability to make a product look slightly different than competitors.

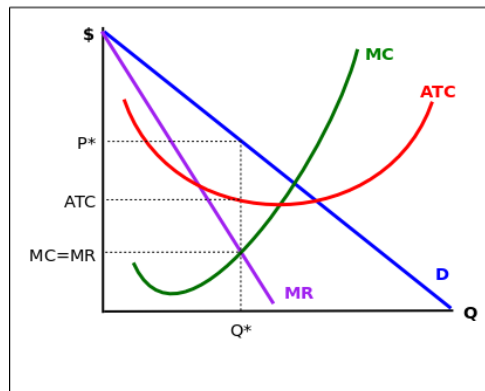
- Firms do compete over price.
 - Competitors products are close substitutes.
 - Downward sloping demand curve: consumers may be willing to pay more for certain brands, features.
- Firms may compete over quality.
 - Design, features, reliability, service, friendliness, etc.
- Firms may compete over marketing.
 - Need to convince / educate buyers about differentiation.

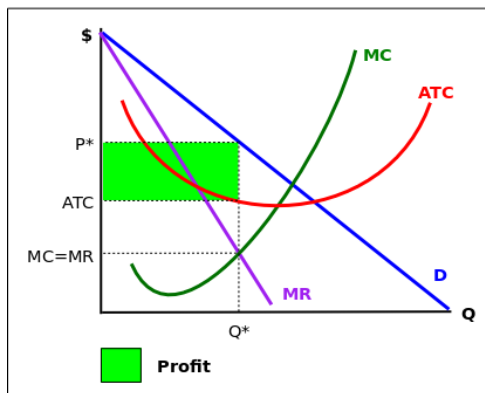
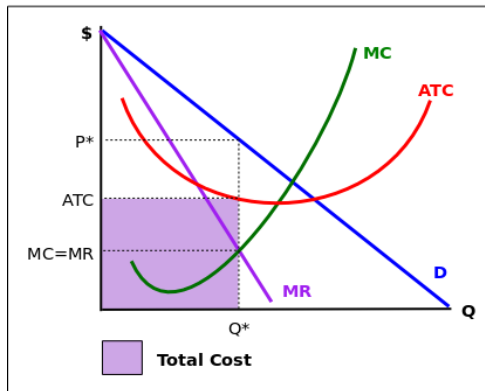
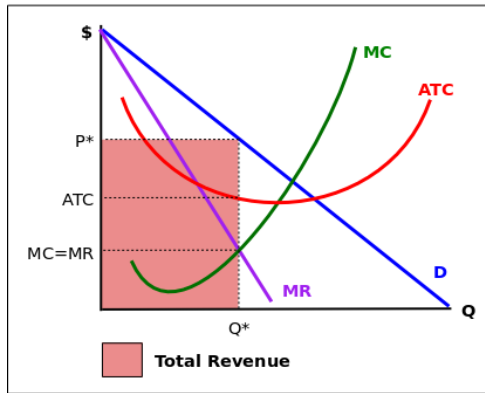
3 Production Decisions

3.1 Short Run Profit Maximization

Short Run Profit Maximization

- As usual firms set $MR=MC$.
- Total Revenue is $P \times Q$.
- Total Cost is $ATC \times Q$.
- Profit is difference.



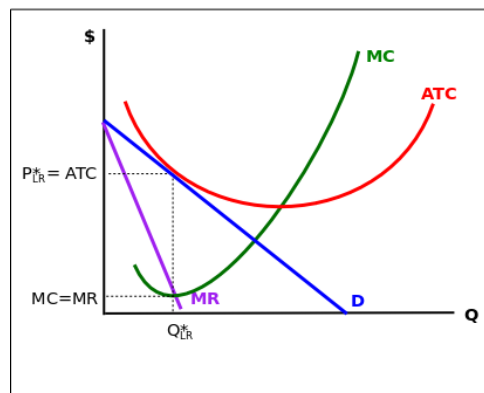
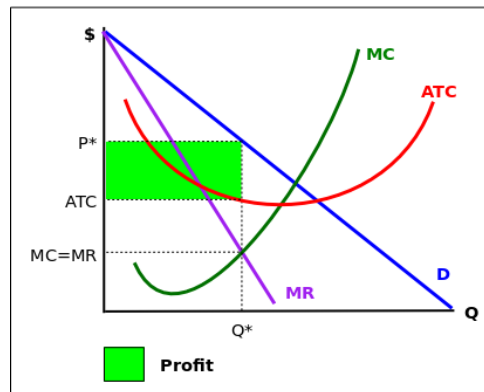


3.2 Long Run Zero Profits

Long-Run Zero Profits

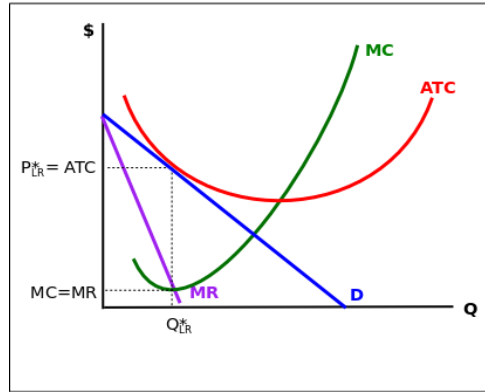
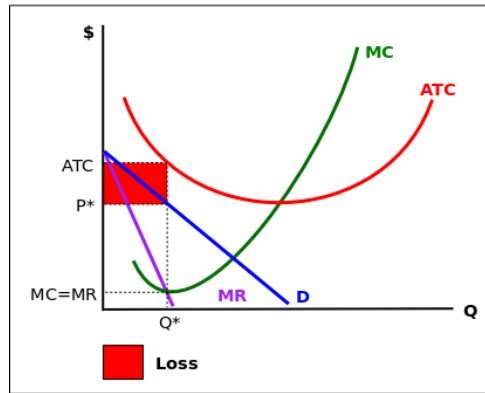
- If making a profit, in long run new firms enter the market.

- More substitutes causes demand curves facing individual firms to shift leftward.
- Continues to happen until profits are driven to zero.



Long-Run Zero Profits

- If making a loss, firms exit the market.
- Fewer substitutes causes demand curves facing individual firms to shift to the right.
- Continues to happen until profits go up to driven to zero.



3.3 Comparison with perfect competition

Comparison with perfect competition

- In long run, which type of market has more production?
- In long run, which type of market has lower ATC? Which is more efficient?
- In long run, which type of market makes more profits?

4 Non-Price Competition

4.1 Quality Improvement

Quality Improvement

- Objective: increase demand, thereby increasing prices and hopefully profits.

- If successful improvement in quality will shift demand curve to the right.
- Increases cost: marginal cost and average total cost shift upward.
- How will an improvement in quality,
 - affect quantity?
 - affect price?
 - affect total revenue?
 - affect total cost?

4.2 Advertising

Advertising

- If products are always changing, it is necessary to inform buyers of differences in your product.
- Objective: increase demand, thereby increasing prices and hopefully profits.
- If successful, advertising will shift the demand curve to the right.
- Advertising usually only increases *fixed cost*, not marginal cost or variable costs.
- How will advertising,
 - affect quantity?
 - affect price?
 - affect total revenue?
 - affect total cost?

4.3 Benefits and Drawbacks

Benefits and Drawbacks

- Drawbacks of monopolistic competition:
 - Average total costs above the minimum.
 - Resources spent on advertising.
- Benefits:
 - Incentive for innovation, research and development.
 - Improvements in technology may lead to higher economic growth in long-run.

- Incentive for **co-operatives**: consumer owned, member based organizations that produce products for its members.
 - Objective: maximize production and efficiency, provide best product to its members (customers) at lowest cost.
 - Still necessary to compete against substitutes, innovation and research and development still essential.
 - Examples: utility cooperatives, consumer cooperatives, banking cooperatives.