

Monopolistic Competition

GCE A-LEVEL & IB ECONOMICS

What is Monopolistic Competition?

Think of a 'real life version' of perfect competition

- ~~Perfect~~ **Imperfect** Information
- ~~Unlimited~~ **Large** number of buyers (consumers) and sellers (firms)
- ~~Homogeneous (Same) Goods~~ **Differentiated** Goods
- Price taking firms (but can set their **own prices**, not the industry)
- ~~No~~ **Low** barriers to entry or exit
- Branding, advertising and product development is important

Market Structures & Competition

Perfect
competition

Oligopoly

**More
competitive**

Monopolistic
competition

Monopoly **Less
competitive**

Markets in Monopolistic Competition



Tuition Lessons



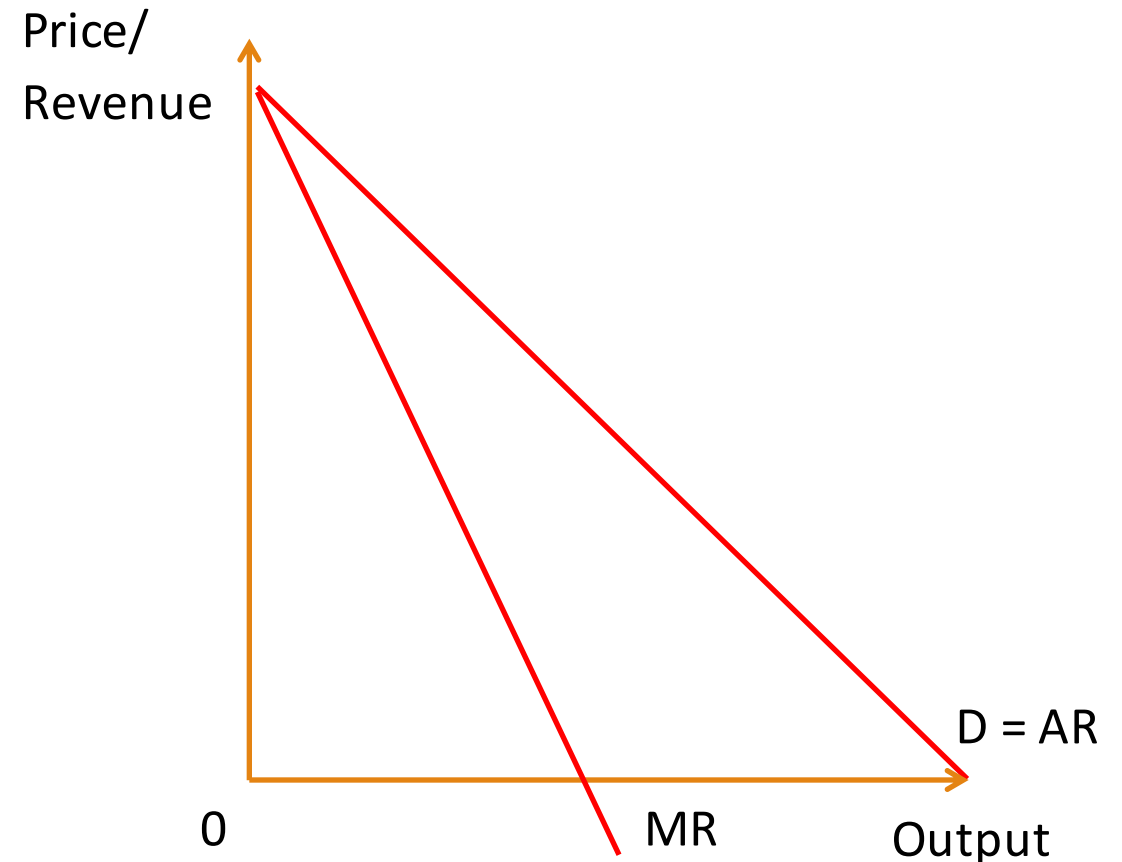
Pizza Shops



Chinese Restaurants

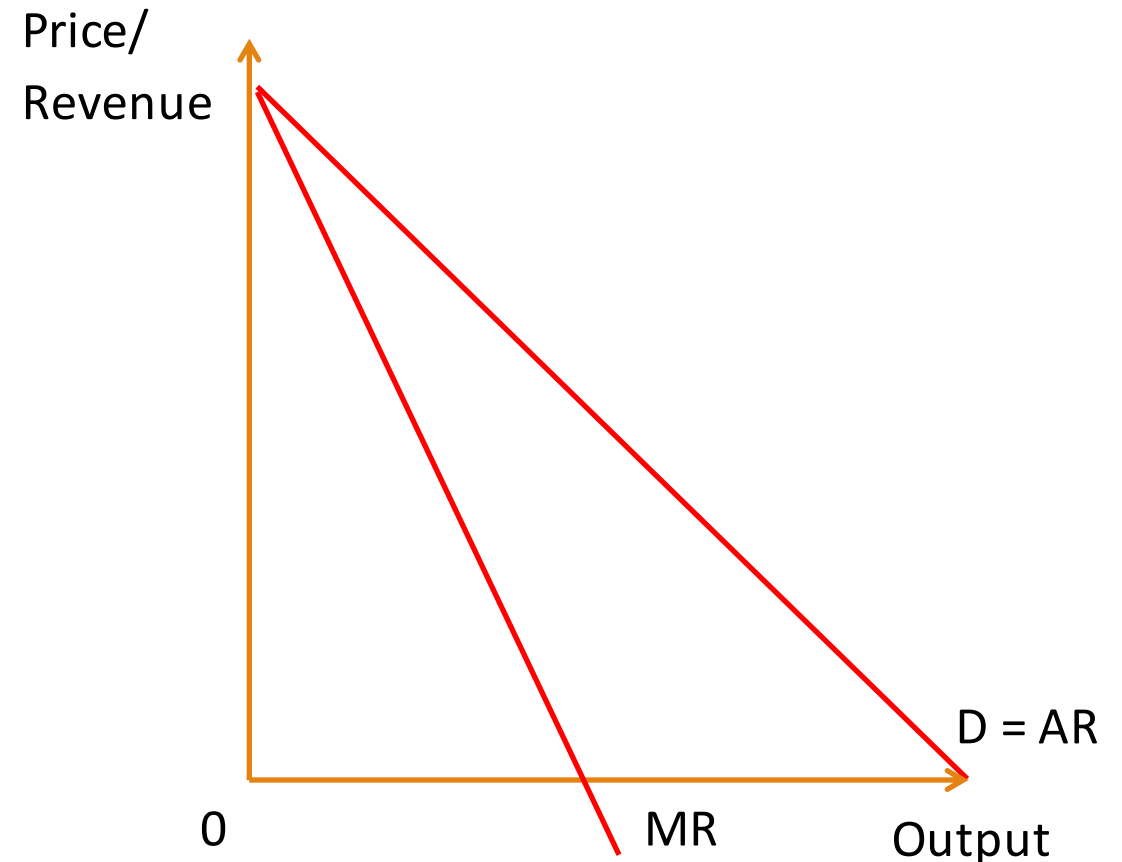
Revenues Under Monopolistic Competition

Under monopolistic competition, there are more substitutes than in a monopoly but less substitutes than in perfect competition due to product differentiation. Therefore, the demand curve is more elastic than that of a monopoly but less elastic than perfect competition.



Revenues Under Monopolistic Competition

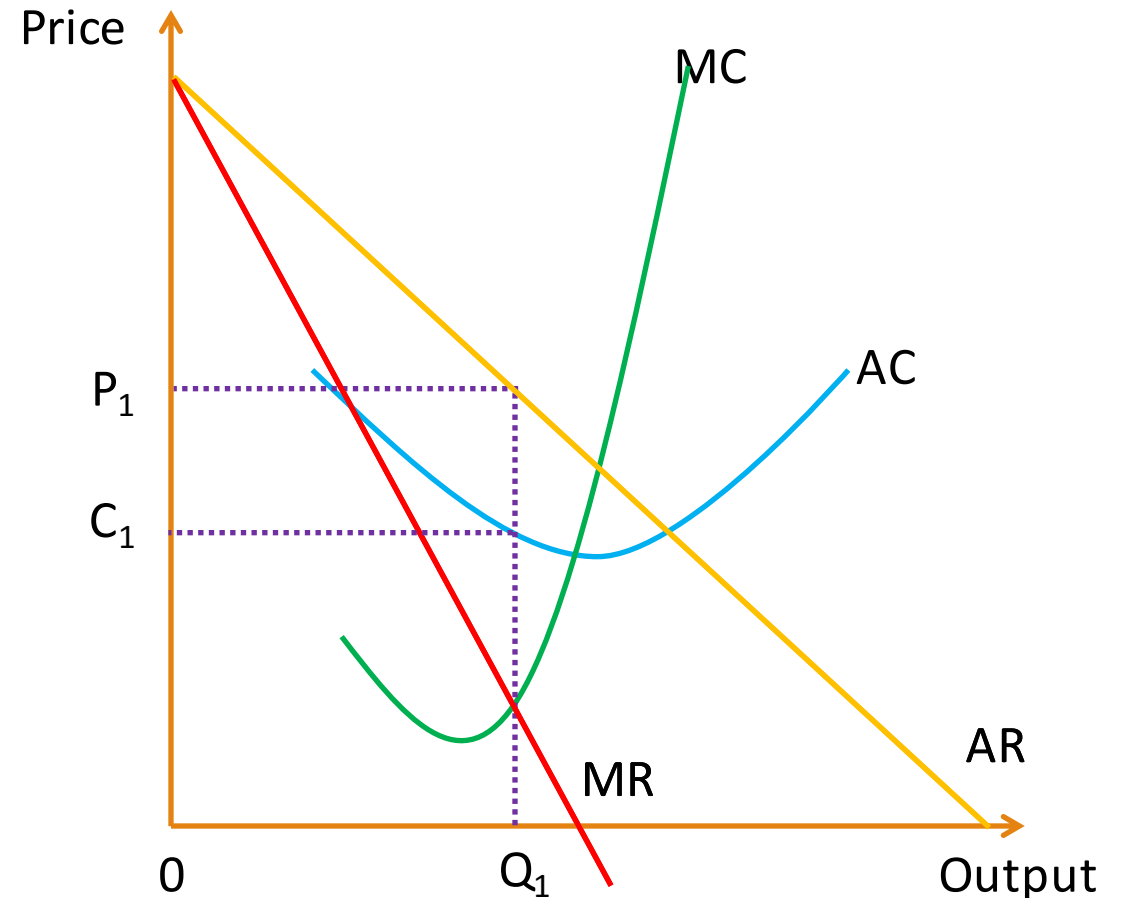
Firms have some degree of monopoly power, can set their own prices and hence the demand will be downward sloping. More will be bought and produced when price charged per unit is low, and vice versa.



Monopolistic Competition Short Run Diagram

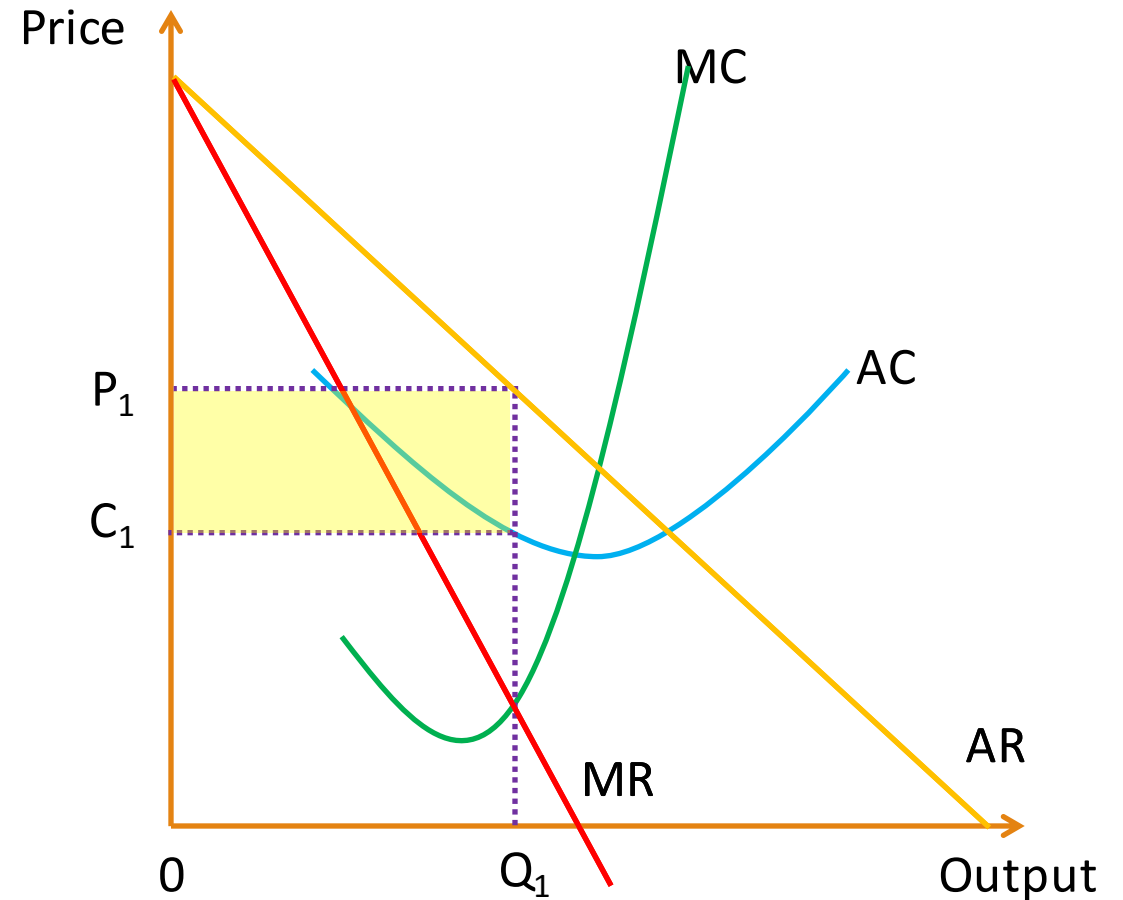
In the short run, the monopolistic competition diagram will be similar to the monopoly diagram.

Firms can maximize profits at the output of $MC=MR$. Which assumption allows them to do this?



Monopolistic Competition Short Run Diagram

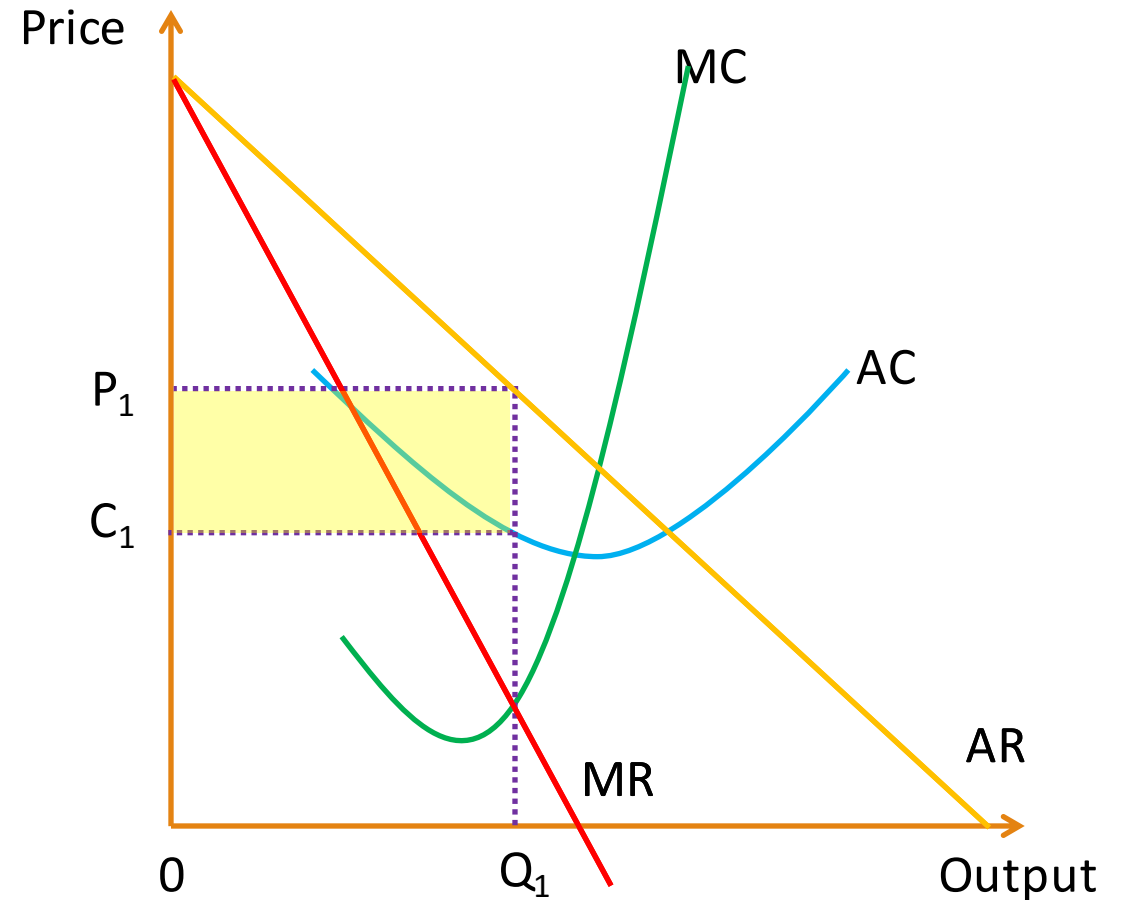
By having differentiated goods, they will be able to act like a monopoly to some degree and make abnormal profits in the short run.



Monopolistic Competition Short Run Diagram

What do you think will happen to profits in the long run?

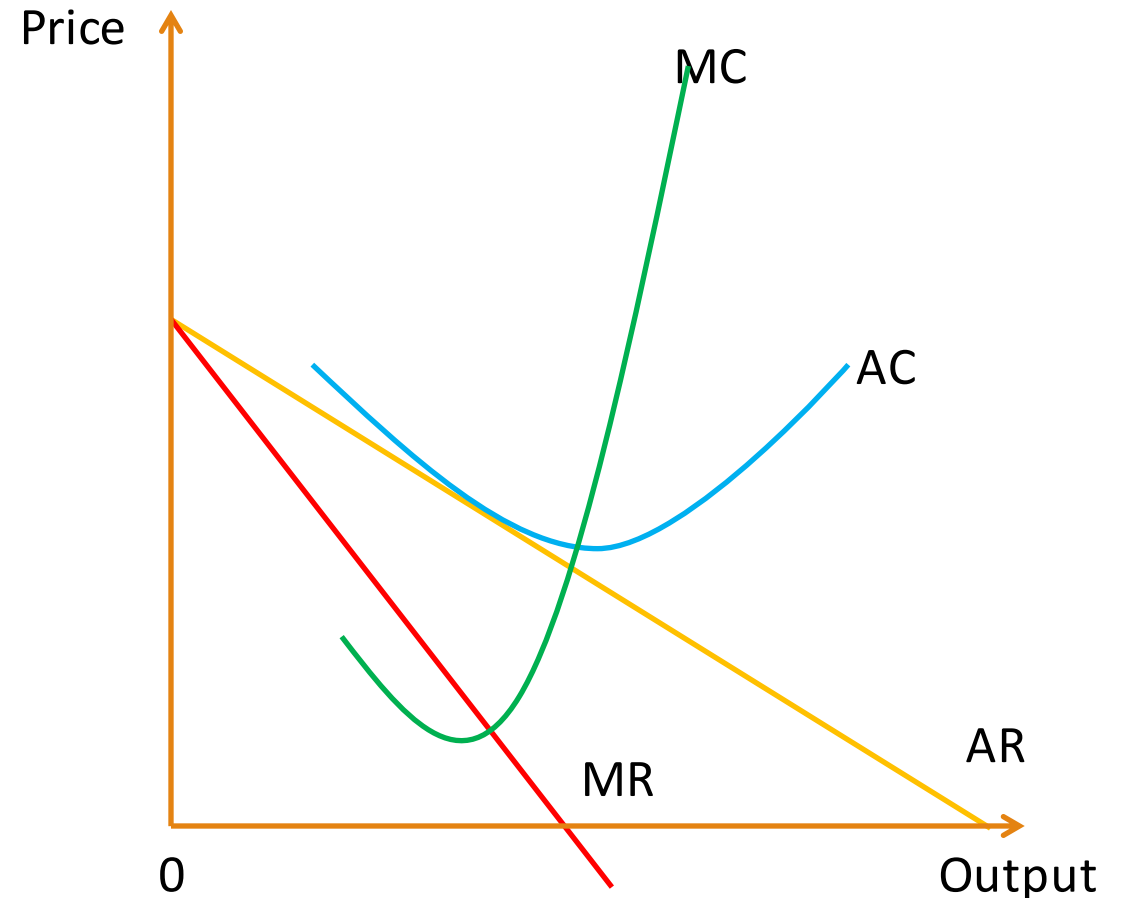
What about the elasticity of demand/revenue and costs?



Monopolistic Competition Long Run Diagram

In the long run where all factors of production are variable (no fixed factors), new firms will be able to enter the market (low barriers).

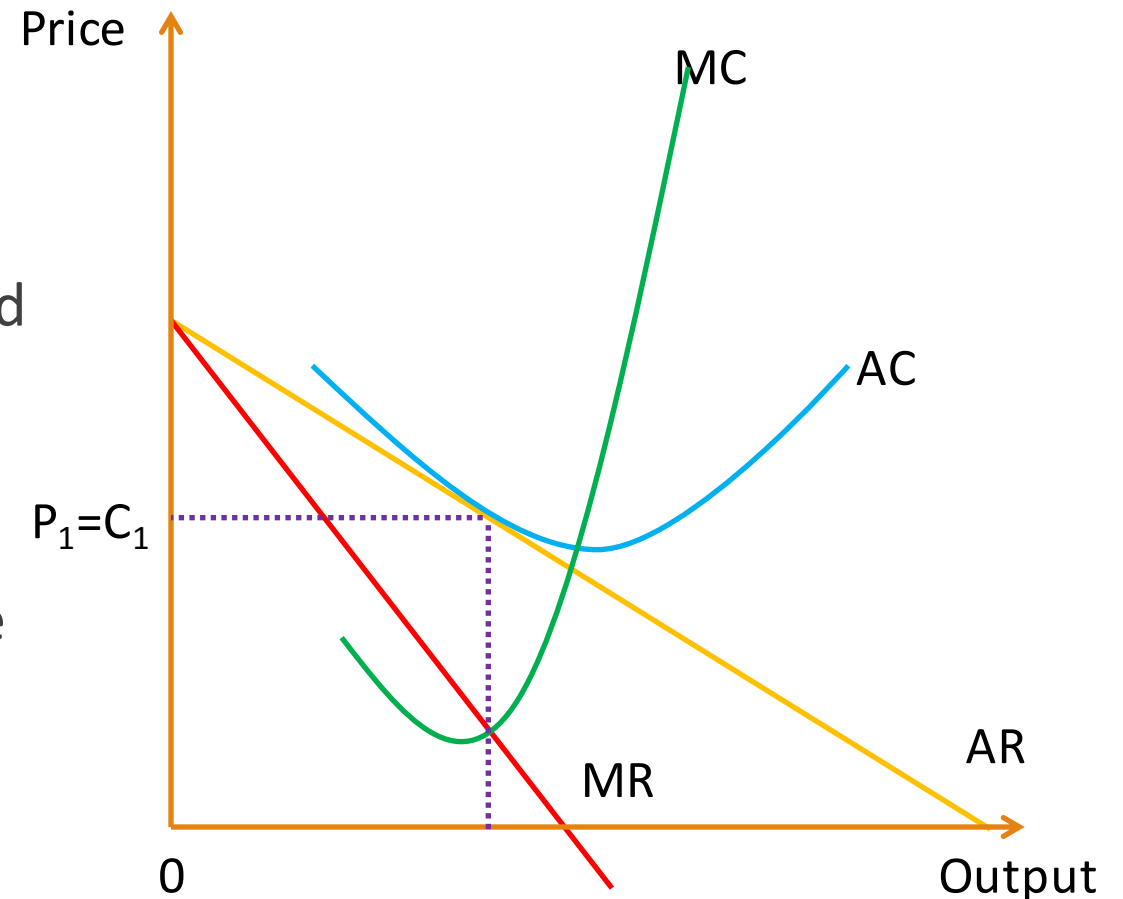
Hence, there will be more substitutes and demand (average revenue) will be more elastic. Average costs are also likely to be higher as firms produce a lower amount of output due to higher competition in the industry.



Monopolistic Competition Long Run Diagram

As a result of the demand and cost changes, firms will only earn normal profits in the long run. The abnormal profits in the short run will be competed away given the increase in industry supply.

Note that due to the increase in the PED, the AC curve will be tangent to the AR at the point where the firms maximize profits.



Evaluating Monopolistic Competition

To what extent does monopolistic competition benefit consumers?

- Differentiated goods allow for choice of consumers
- Product differentiation requires a need for product development, and firms in the market can afford it with short term supernormal profits
- Effect depends on the size/number of firms and rate of product differentiation

Evaluating Monopolistic Competition

How much does the theory apply in real life?

- Not as extreme as the perfect competition model and relatable to real life
- Some things to think about:
 - How long is the long run? Consumer tastes are ever-changing and new substitutes may not enter the market fast enough.
 - Will firms continue to compete by product differentiation when more substitutes are available? How will the market change?

Short Questions - Monopolistic Comp.

- Suggest 2 assumptions under monopolistic competition?
- Why is the monopolistic competition in the short-run similar to that of a monopoly?
- How will profits of the monopolistic firm in the long run change? Why?
- Think of 1 advantage and 1 disadvantage under the monopolistic competition structure.