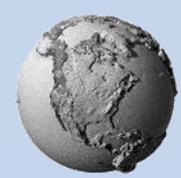


Monopolistic Competition

Perhaps half of the economy's total production comes from monopolistically competitive firms.

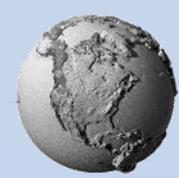
AmosWeb



Monopolistic Competition

Monopolistic competition is a type of imperfect competition such that many producers sell goods and services that are similar but differentiated from one another (e.g. by branding or quality) and hence are not perfect substitutes.





Monopolistic Competition

- A large number of firms
- Similar but differentiated products
- Low barriers to entry
- Market power
 - Limited
- Examples
 - Restaurants
 - Hotels



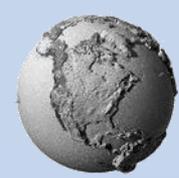
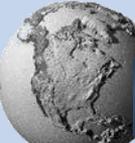


Chart: The Model of Monopolistic Competition

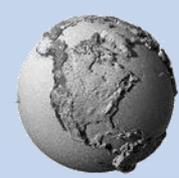


See next slide for chart explanation.



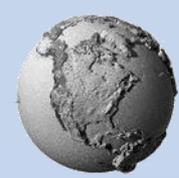
Model of Monopolistic Competition

- The model of monopolistic competition (previous slide) shows a seller with a **downward-sloping demand curve** and a conventional marginal cost curve.
- Because the demand curve slopes downward, the marginal revenue curve lies below it. The seller maximizes profit by selecting that output at which **marginal revenue equals marginal costs** and charges as much as he can, which is price **P2**.
- In the long run, there can be no economic profit because there is free entry into the industry. If there are any profits, others will enter the industry, positioning themselves to take away customers from the most profitable sellers.
- The zero profit condition implies that at **equilibrium**, average revenue (which is demand) must just equal average cost.
- When average revenue equals average cost, average profit is zero, and so total profit must also be zero.



Assumptions of the Market

- There are **many producers and many consumers** - the concentration ratio is low.
- **Concentration ratio** is a measure of the total output produced in an industry by a given number of firms in the industry. The most common concentration ratios are CR_4 and CR_8 , which means the market share of the four and the eight largest firms. Concentration ratios range from 0% (competitive market) to 100% (monopoly).
- **Consumers perceive that there are non-price differences among products** i.e. there is product differentiation. Competition is strong, plenty of consumer switching takes place.



Assumptions of the Market (cont)

- Producers have some independent control over price (market power) -- they are **price makers** not price takers -- but the price elasticity of demand is higher than it would be under a monopoly, i.e. they can lose customers if they raise prices too much.
- **Market Power** – The ability to alter the market price of a good or service.
- The barriers to entry and exit into and out of the market are low.
- **Barriers** to entry and exit are obstacles that make it difficult or impossible for would-be producers to enter and leave a particular market.

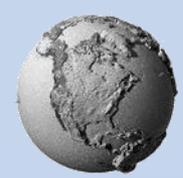
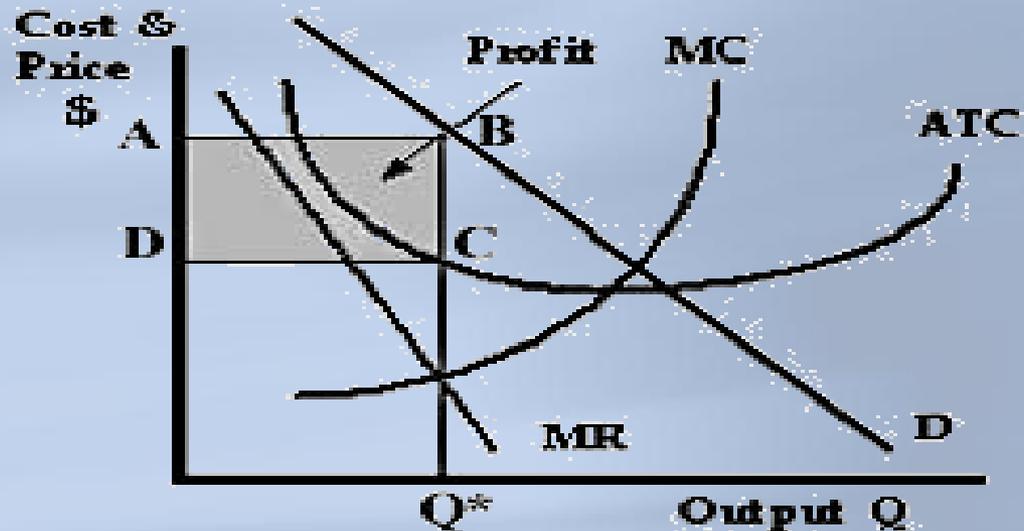
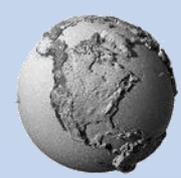


Chart: Market Power

A monopolistically competitive firm confronts a downward-sloping demand curve for its output.

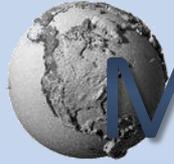
Under monopolistic competition firms have some control over the price. In the short-run they can earn an economic profit.





Market Structure

- A distinguishing structural characteristic of monopolistic competition is that there are many firms in the industry.
- **Many** is somewhere between the few of oligopolies and the hordes that characterize perfect competition.



Monopolistic Competition Examples

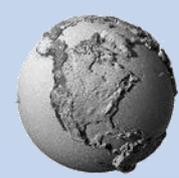


[Monopolistic Competition on You Tube](#)



Independent Production Decisions

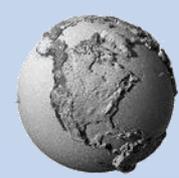
- Modest changes in the output or price of any single firm will have no perceptible influence on the sales of any other firm.
- The relative independence of monopolist competitors means that they don't have to worry about retaliatory responses to every price or output change.



Behavior

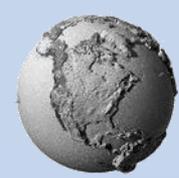
Monopolistic competition has distinctive behavior, including:

- product differentiation
- brand image
- brand loyalty
- different short-run and long-run product decisions
- no long-run profits
- inefficiency
- price signals
- advertising



Product Differentiation

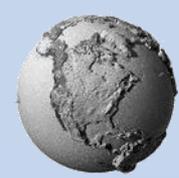
- One of the most notable features of monopolistically competitive behavior is product differentiation.
- **Product differentiation** refers to features that make one product appear different from competing products in the same market.
- Product differentiation helps to ensure high quality and efficient production.
- Advertising provides consumers with the valuable information on product availability, quality and price that they need to make efficient choices in the market place.



Product Differentiation

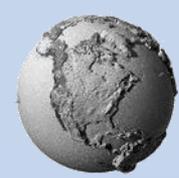
- product attributes
- service
- brand names and product packaging
- some control over price
- location
- easy entry and exit
- advertising





Product Differentiation

- The case against product differentiation and advertising:
 - Critics of product differentiation and advertising argue that differentiation and advertising amount to nothing more than waste and inefficiency.
 - Enormous sums are spent to create minute, meaningless and possibly nonexistent differences among products.
 - The debate over the environmental impact of product packaging is linked strongly to this aspect of monopolistic competition.



Example: McDonald's Coffee War

Forget Starbucks and Coffee Bean, says McDonald's. Or at least, that's what the burger giant is punctuating in its latest local ad blitz, which sends one key message to consumers: cheap coffee can be good.

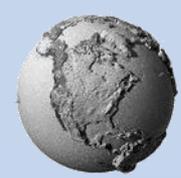
Promoting its new line of cappuccinos, lattes and mochas, the world's largest fast food chain has come out this week directly challenging coffee-shop chain leaders Starbucks, Hollys and Coffee Bean in a bid to steal a piece of the lucrative java market.

McDonald's biggest edge over its well-established rivals is price, and McDonald's is making sure consumers know about its value with its aggressive media campaign, airing television commercials and plastering posters featuring the drinks at subway stations and bus stops. The ads take a direct aim at Starbucks and Coffee Bean, saying, "Forget the star and the bean."

Despite the bold move, competitors are quick to downplay McDonald's threat.

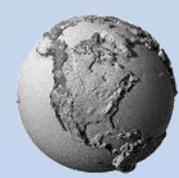
The Korea Times





Brand Image

- Each firm has a distinct identity – a **brand image**.
- Consumers perceive its output to be somewhat different than others in the industry.
- Each firm only has a monopoly on its brand image.
- It still competes with other firms offering close substitutes.



Brand Loyalty

- By differentiating their products, monopolistic competitors establish **brand loyalty**.
- Brand loyalty gives producers greater control over the price of their products.
- Give-aways and promotions are usually used to strengthen brand loyalty and convince consumers that the product is special.





What Is the Difference in a Trademark and Brand Monopoly?

When you're competing with other companies for customers, **brand identification** is critical. Customers have to be able to tell which products and services are yours. **Trademarks** help them make the distinction. If your brand grows strong enough that customers are willing to pay more for your offerings than those of other companies, you've developed a brand monopoly.

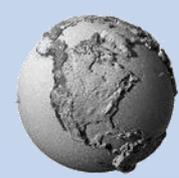
A **brand name** can be a trademark, but so can a logo, a design, a phrase -- even a color scheme or distinctive sound. To use an example recognized around the world, the name "Coca-Cola" is a trademark of the Coca-Cola Co. "Coke," when used to describe a beverage, is also a trademark. The shape of the Coke bottle is trademarked, too, and so is the company's "dynamic ribbon device," which is the stripe that appears on Coke cans.



What Is the Difference in a Trademark and Brand Monopoly? (cont)

A company's trademarks are legally protected. Once a company has established a trademark, no other company can use it. Trademark protection applies only to the identifiers used to market products, however, not to the products themselves.

Brand monopolies occur when one company's products have achieved a high enough status that the company can charge a premium for them simply because of the name. This can be the case even if the product itself is no better than competitors' products. It may even be worse. A brand monopoly, in other words, usually exists without an asset monopoly. Think about a white T-shirt made by a famous designer that sells for \$50. It may be no different from a white T-shirt you can get at a department store for \$5, but because of the strength of the brand, the manufacturer can dictate the higher price.



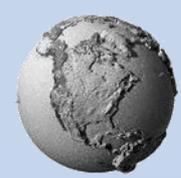
Brand Loyalty

Brand loyalty makes the demand curve facing the firm less price-elastic.

Brand loyalty implies that consumers shun substitute goods even when they are cheaper.

Each monopolistically competitive firm will establish some consumer loyalty.

An example of brand loyalty is the price differences between computers which are essentially the same.

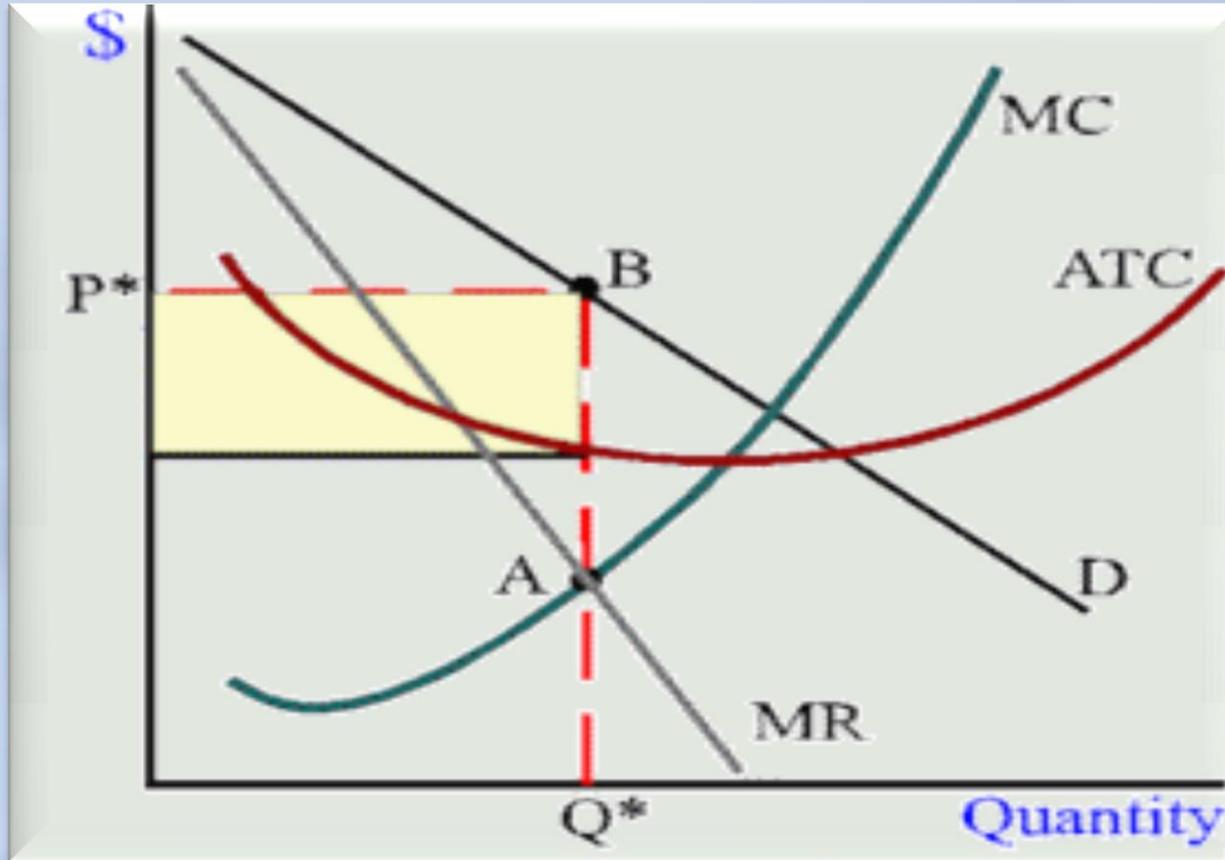


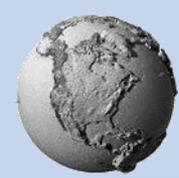
Short-Run Price and Output

- The monopolistically competitive firm's production decision is similar to that of a monopolist.
- **Production decision** - the selection of the short-run rate of output using existing plant and equipment

Chart: Short-Run Price and Output

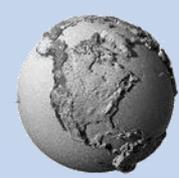
As always, the profit-maximizing rate of output is achieved by producing the quantity where $MR = MC$.





Long-Run Profits and Equilibrium

- The long-run equilibrium decision is similar to perfect competition.
- Barriers to entry are low or weak and therefore new firms will be attracted to enter. New entrants will continue to enter as long as there are profits.
- As soon as profits are competed away by new firms, equilibrium will be attained in the market and no new firms will be attracted to the market.
- Economic profits are eliminated in the long run, which is the only equilibrium consistent with low barriers to entry. This occurs at an output where price is equal to the long-run average cost.



Entry and Exit

- With low barriers to entry, new firms will enter the market if there is economic profit.
- **Economic profit** is the difference between total revenues and total economic costs.
- When firms enter a monopolistically competitive industry:
 - The market supply curve shifts to the right.
 - The demand curves facing individual firms shift to the left.



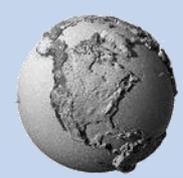
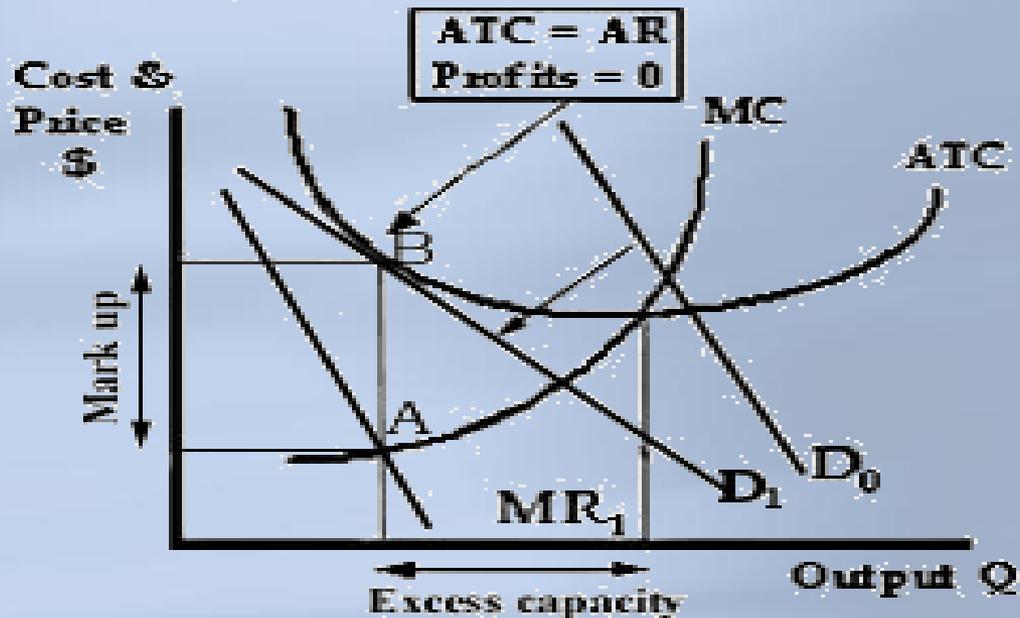
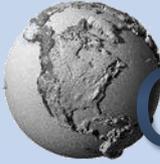


Chart: No Long-Run Profits

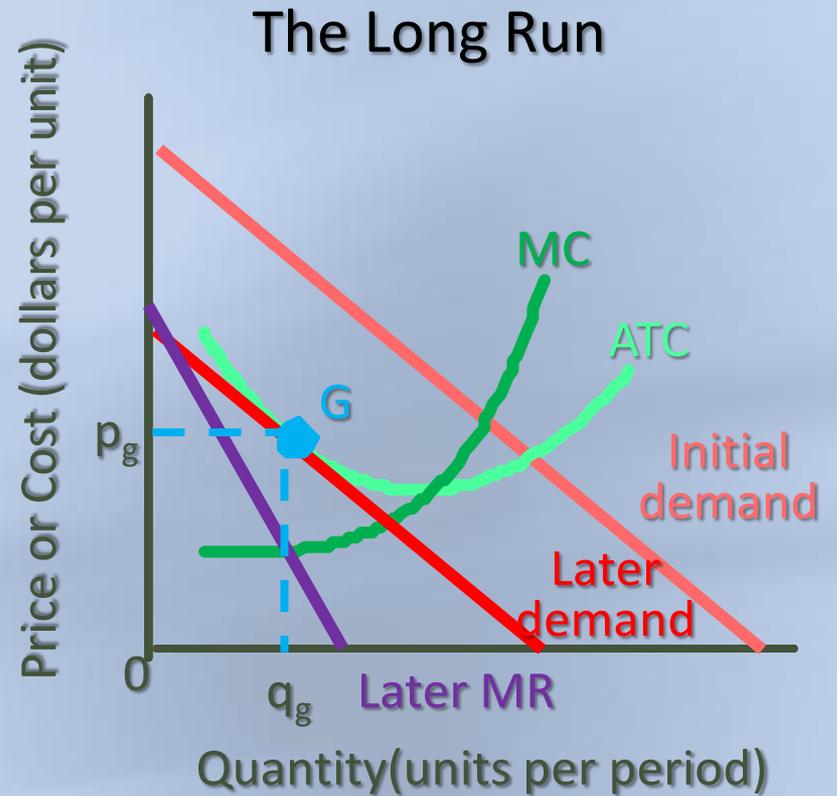
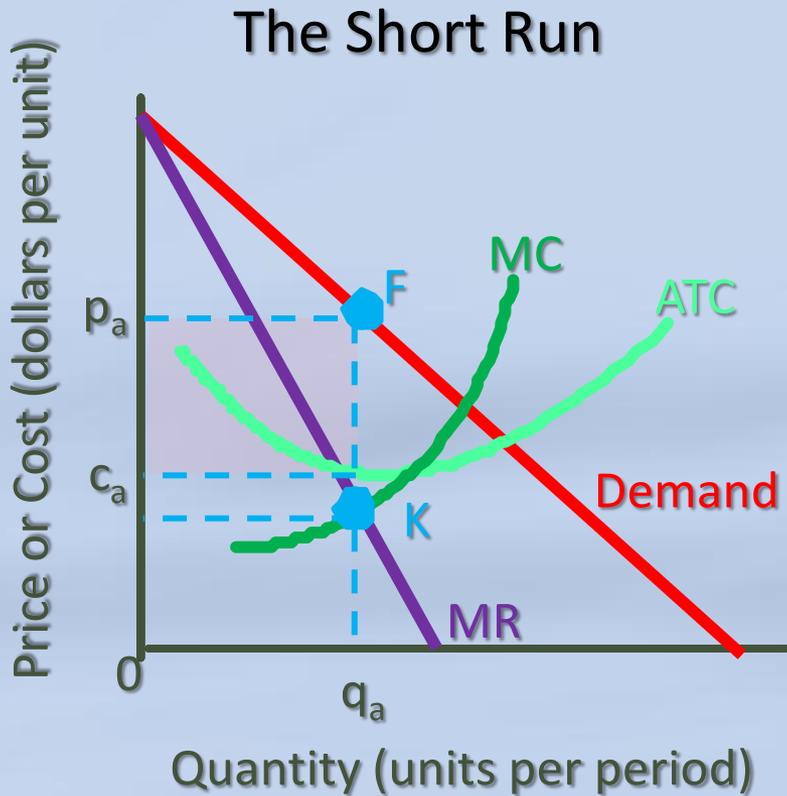
In the long run, there are no economic profits in monopolistic competition.

In the long-run, new entry shifts the firm's demand downward and makes it more elastic, thus, eliminating economic profit.





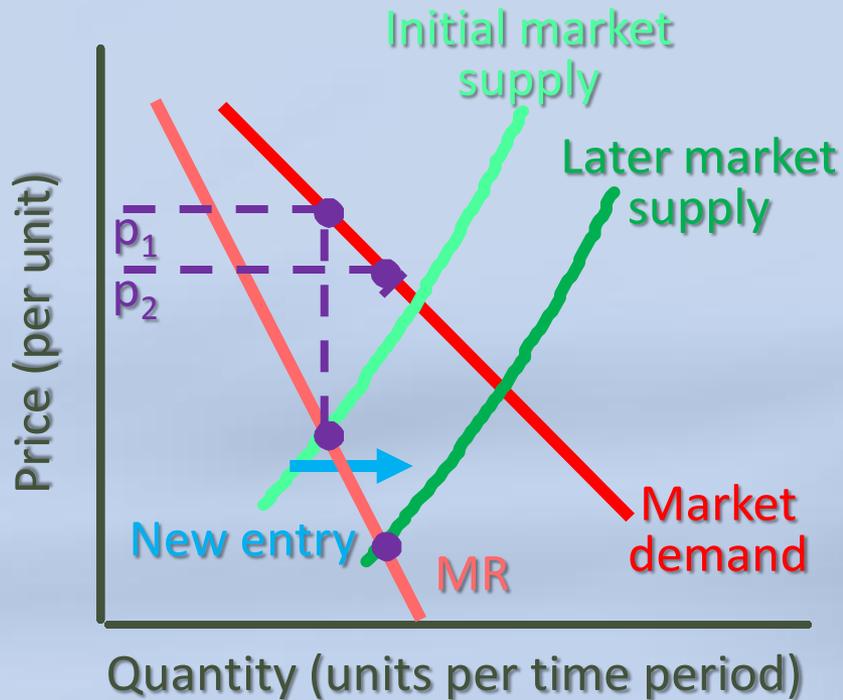
Charts: Equilibrium in Monopolistic Competition



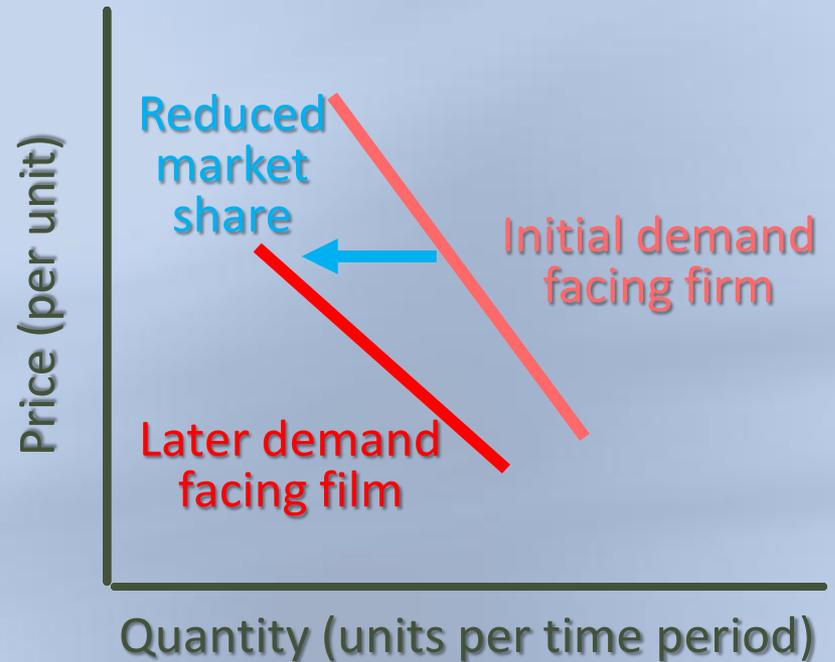


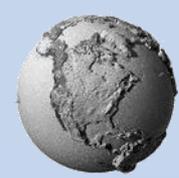
Charts: Effects of Entry on Industry and Firm

Effect of Entry on the Industry



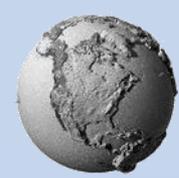
Effect of Entry on the Monopolistically Competitive Firm





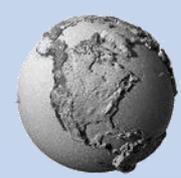
Inefficiency

- Monopolistic competition tends to be less efficient in the long run than a perfectly competitive industry.
- Prices are above marginal cost, meaning the equilibrium is not allocatively efficient.
- But the markup of price above marginal cost arises from product differentiation. People value variety but variety is costly. Monopolistic competition brings the profitable and possibly efficient amount of variety to market.



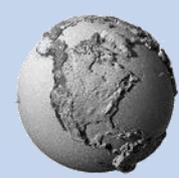
Inefficiency (cont)

- Saturation of the market may lead to businesses being unable to exploit fully economies of scale causing average cost to be higher than if less firms and products were in the market.
- Critics of heavy spending on marketing and advertising argue that much of this spending is wasted and is an inefficient use of scarce resources.
- The debate over the environmental impact of packaging is linked strongly to this aspect of monopolistic competition.



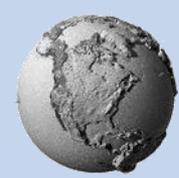
Excess Capacity

- Because of the industry-wide excess capacity, each firm produces a rate of output that is less than its minimum ATC.
- Thus, the same level of industry output could be produced at lower cost with fewer firms.



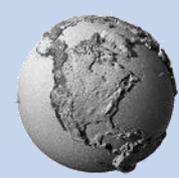
Price Signals

- The monopolistically competitive firm will always price its output above the level of marginal cost.
- Monopolistic competition results in both **production inefficiency** (above-minimum average cost) and **allocative inefficiency** (wrong mix of output).
- But...



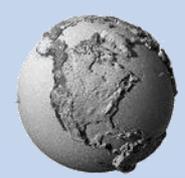
Price Signals (cont)

- Why do Coke and Pepsi spend millions of dollars a month advertising products that everyone knows? One answer is that these firms use advertising to signal the high quality of their products. A **signal** is an action taken by an informed person or firm to send a message to uninformed persons.
- For example, Sprite is a high quality cola and Prite is a low quality cola. If Sprite spends millions on advertising, people think “Sprite must be good.” If it is really good when they try it, they will like it and keep buying it.



Price Signals (cont)

- If Prite spends millions on advertising, people think “Prite must be good.” If it is really bad when they try it, they will hate it and stop buying it.
- If Prite knows its product is bad, it will not bother to waste millions on advertising it.
- And if Sprite knows its product is good, it will spend millions on advertising it.
- Consumers will read the signals and get the correct message.



No Cease-Fire in Advertising Wars

- In truly (perfectly) competitive industries, firms compete on the basis of price.
- Imperfectly competitive firms engage in **nonprice competition** – the most prominent form being **advertising**.
- Advertising may be more responsible for brand loyalty than the quality of the product.
- Having a recognizable name is worth billions in sales.

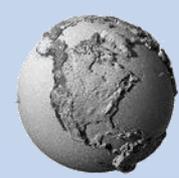
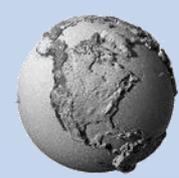


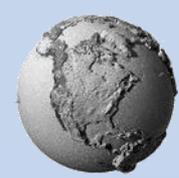
Table: The Advertising Debate

Negatives	Positives
<p>Advertisements psychologically create a desire that might not otherwise exist.</p>	<p>Provides info to customer e.g. price, health benefits</p>
<p>Hinders competition between products as everything is about advertising.</p>	<p>Shows new products to customers that they could utilise but were previously unaware of.</p>
<p>Creates an illusion of difference.</p>	<p>Fosters competition between firms</p>
	<p>Gives entrants a mean to attract customers from different firms</p>
	<p>Signal of Quality - If firms are willing to put money into advertising it must be a good product in order for the firm to earn a return over a sustainable period.</p>



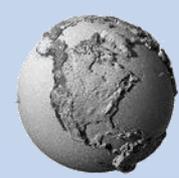
Product Development and Innovation

- To keep making an economic profit, a firm in monopolistic competition must be in a state of continuous **product development**. New product development allows a firm to gain a competitive edge, if only temporarily, before competitors imitate the innovation.
- **Innovation** is costly, but it increases total revenue. Firms pursue product development until the marginal revenue from innovation equals the marginal cost of innovation.



Product Development and Innovation (cont)

- The **marginal social benefit** of an innovation is the increase in the price that people are willing to pay for the innovation.
- The **marginal social cost** is the amount that the firm must pay to make the innovation.
- Profit is maximized when marginal revenue equals marginal cost.
- In monopolistic competition, price exceeds marginal revenue, so the amount of innovation is probably less than efficient.

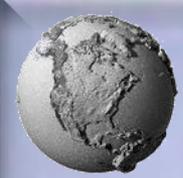


Increased Variety Availability

One of the interesting features of the monopolistically competitive market is the variety available due to product differentiation.

Although firms in the long run do not produce at the minimum point of their average cost curve, and thus there is excess capacity available with each firm, economists have rationalized this by attributing the higher price to the variety available.

Consumers have shown that they are willing to pay a higher price for the availability of more variety in the market.



The End

