Test Yourself: Monopolistic Competition

I have to keep testing myself.
Eartha Kitt

What is
imperfect competition?

Imperfect competition is a market structure between the extremes of perfect competition and monopoly.

What are some of the characteristics of a monopolistic competition market?

A monopolistic market is characterized by

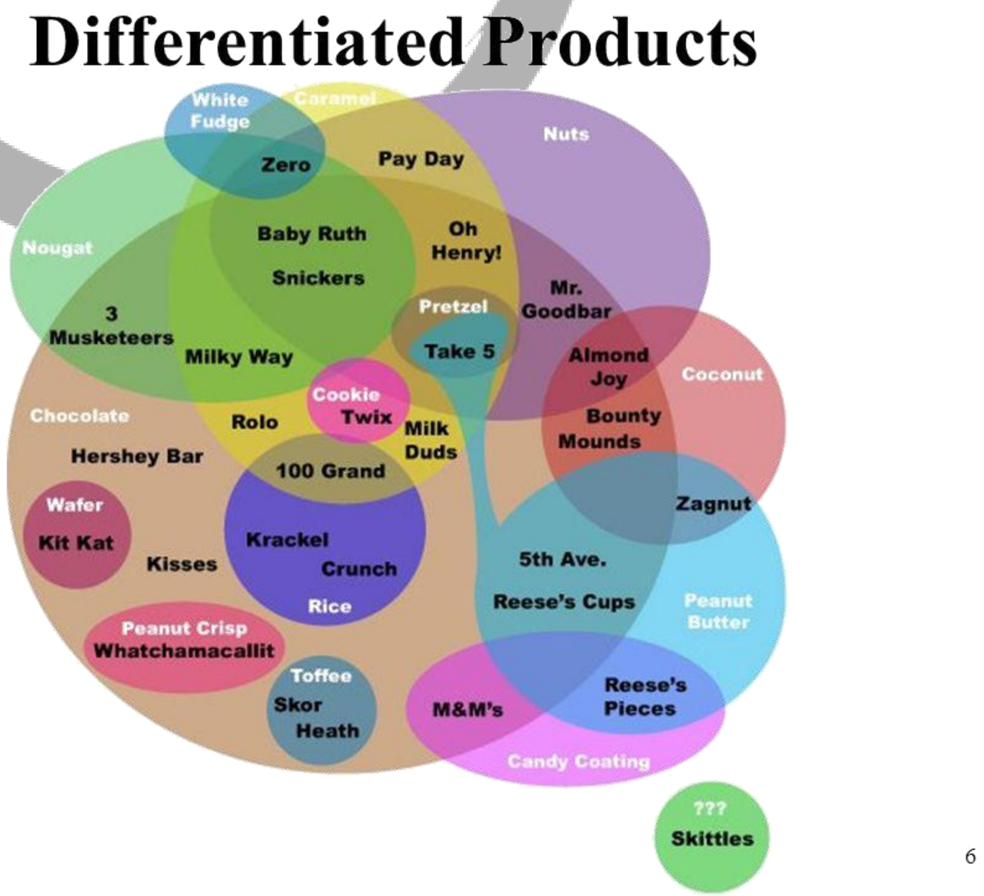
- many sellers with limited market power
- similar but differentiated (by branding, quality, etc) product
- low entry and exit barriers

How many is *many* sellers?

The *many* sellers condition is met when each firm is so small relative to the total market that its pricing decisions have a negligible effect on the market price.

What is
product differentiation?

Product differentiation is the process of creating real or apparent non-price differences between goods and services.



What does *easy entry - easy exit* mean?

Easy entry - easy exit means there are low barriers to enter and exit the market.

Entry and exit are not quite as easy as in a perfectly competitive market but they are a lot easier than in a monopoly or oligopoly market.

What is a barrier to entry in monopolistic competition?

In a monopolistic competition, market barriers to entry and exit are few and none are significant but they can include:

- government regulation
- startup costs
- resource ownership
- brand loyalty
- need for product differentiation through advertising, packaging, etc
- bundling

What is non-price competition?

Non-price competition refers to firms competing through their advertising, packaging, product development, quality, service, etc rather than competing by lowering prices.

Why is a firm in a monopolistic competitive market a price-maker?

A firm in a monopolistic competitive market is a *price-maker* because product differentiation gives it some independent control over price (market power). It is a price-maker not a price-taker as in a competitive market.

However, the price elasticity of demand is higher than it would be under a monopoly, so the firm can lose customers if it raises prices too much.

What does a firm's demand curve look like in a monopolistic competitive market?

In a monopolistic competitive market a firm’s demand curve is *less* elastic (steeper) than that of a firm in a perfectly competitive market but *more* elastic (flatter) than that of a firm in a monopolistic market.

What are examples of monopolistic competition?

Some general examples of monopolistic competition are:

- grocery stores
- hair salons
- gas stations
- video rental stores
- restaurants
- cosmetics
- coffee
- laundry detergent
- shoes
- clothing

How effective is advertising?

Advertising is the most prominent form of non-price competition.

Advertising may be more responsible for brand loyalty than the quality of the product.

Firms use advertising to signal the high quality of their products. Advertising provides consumers with valuable information on product availability, quality and price needed to make efficient choices in the market place.

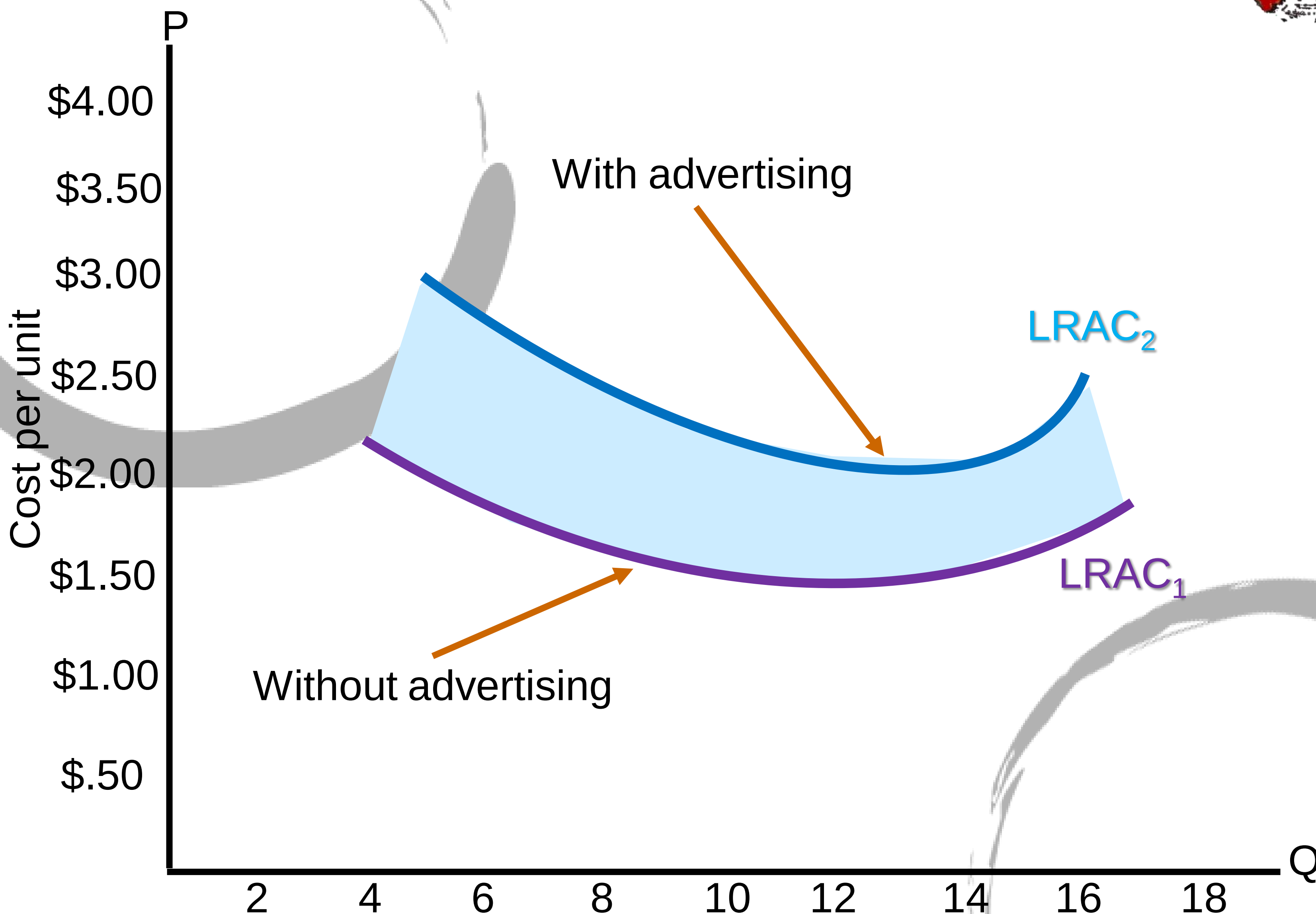
Advertising is very important in a monopolistic competition market and is effective in the short-run.

It seems to be less effective in the long-run.

What effect does advertising have on average costs?

Advertising raises the long-run average cost curve (and the price to the consumer).

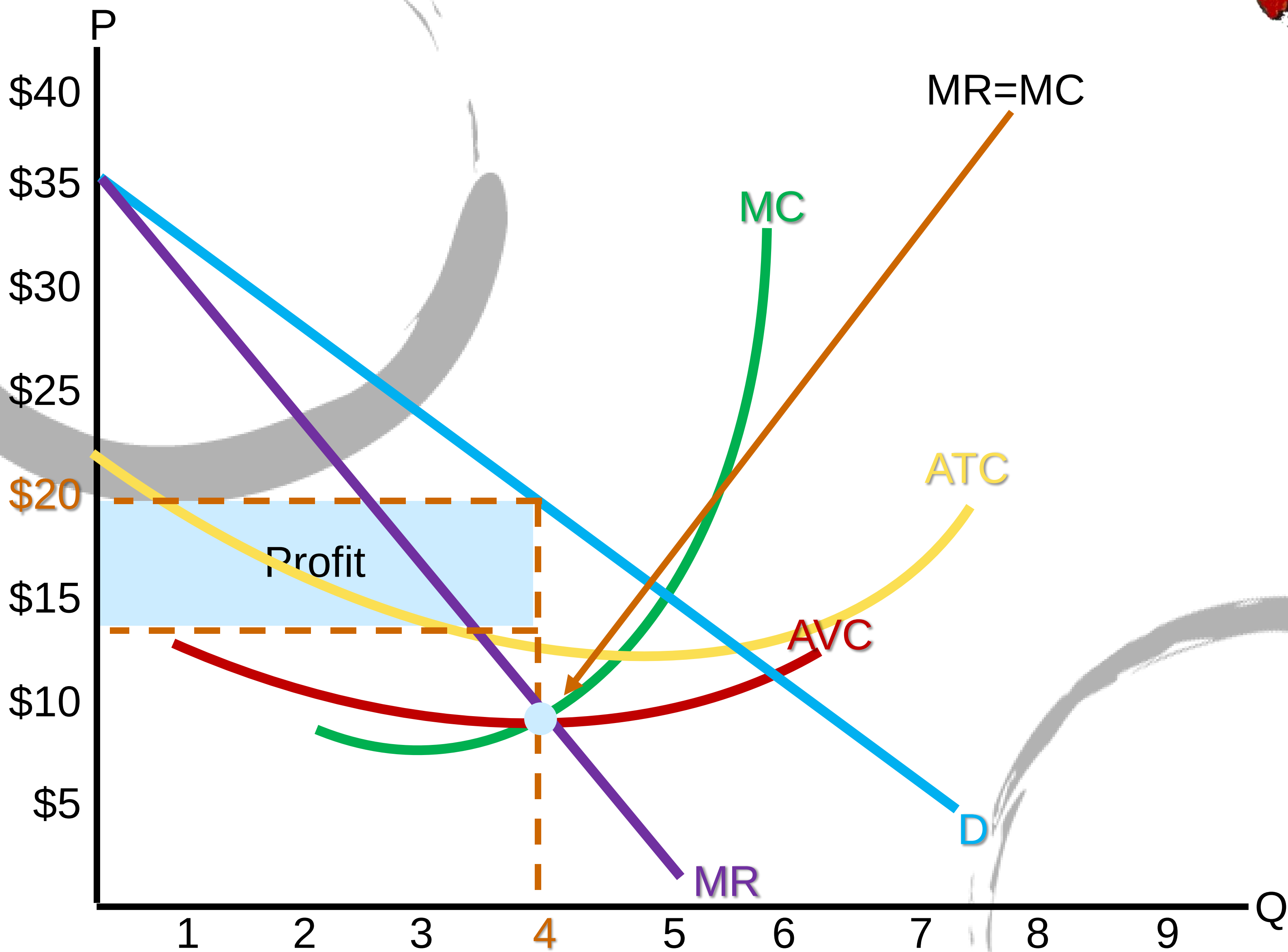
Chart: The Effect of Advertising



How does a firm decide what price to charge and how many units to produce?

Production and pricing are set at the point at which MR = MC.

Chart: MR = MC



What is a normal profit ?

Normal profit is the minimum amount of money that will keep a firm in the market.

Why is a normal profit made in the long-run?

Normal profit is made in the long-run because of the relatively easy entry - easy exit characterizing monopolistic competition markets.

New entrants will continue to enter as long as there are profits.

What happens when economic profits are being made?

Because of the low barriers to entry and exit, some firms will leave the industry.

Demand shifts to the right for each firm left, market price increases and profits are restored.

At what point is the market tending toward?

The market tends toward a *normal profit*, which is a zero economic profit.

Diagram: Zero Economic Profit

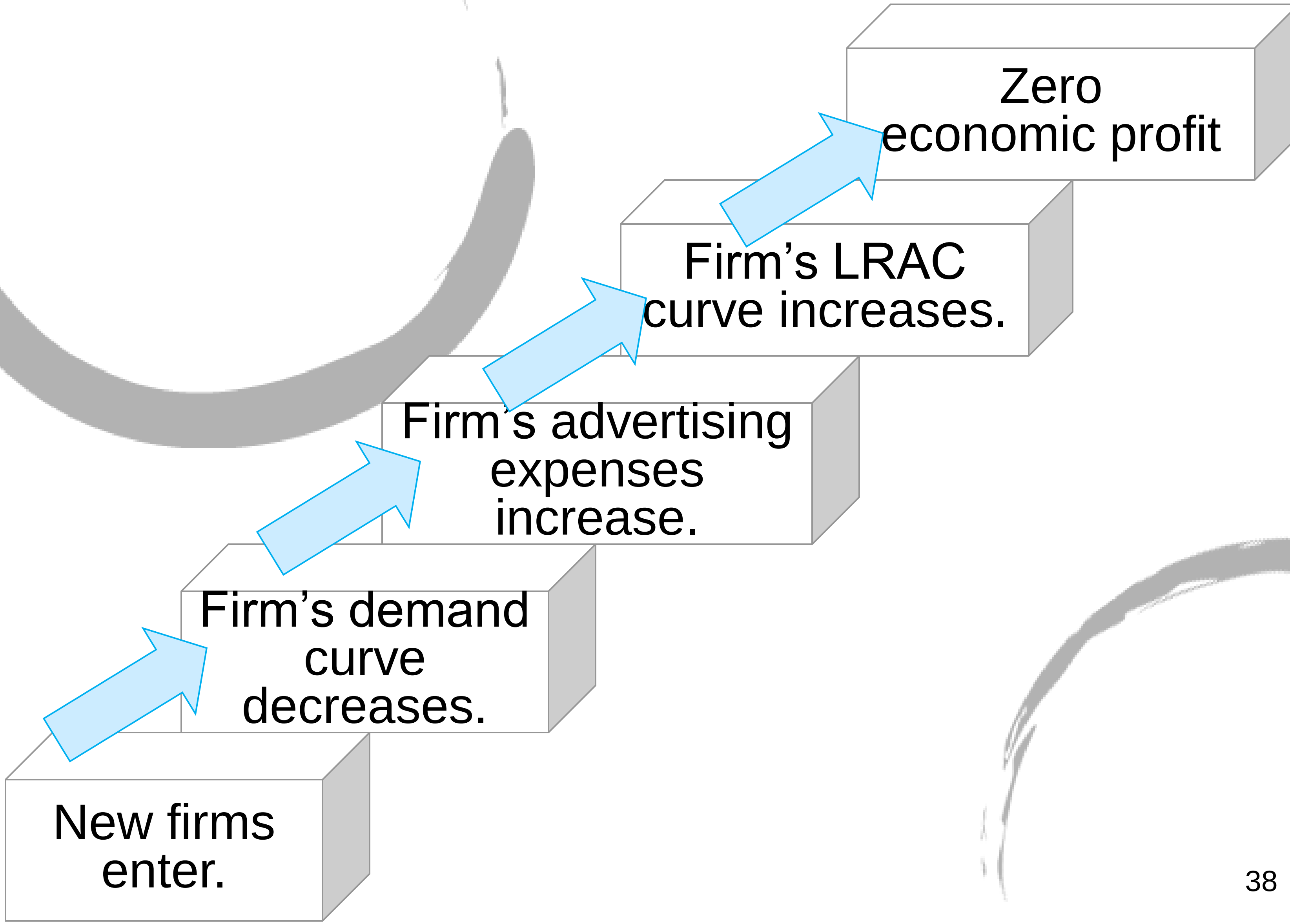


Chart: Monopolistic Competition in the Long Run

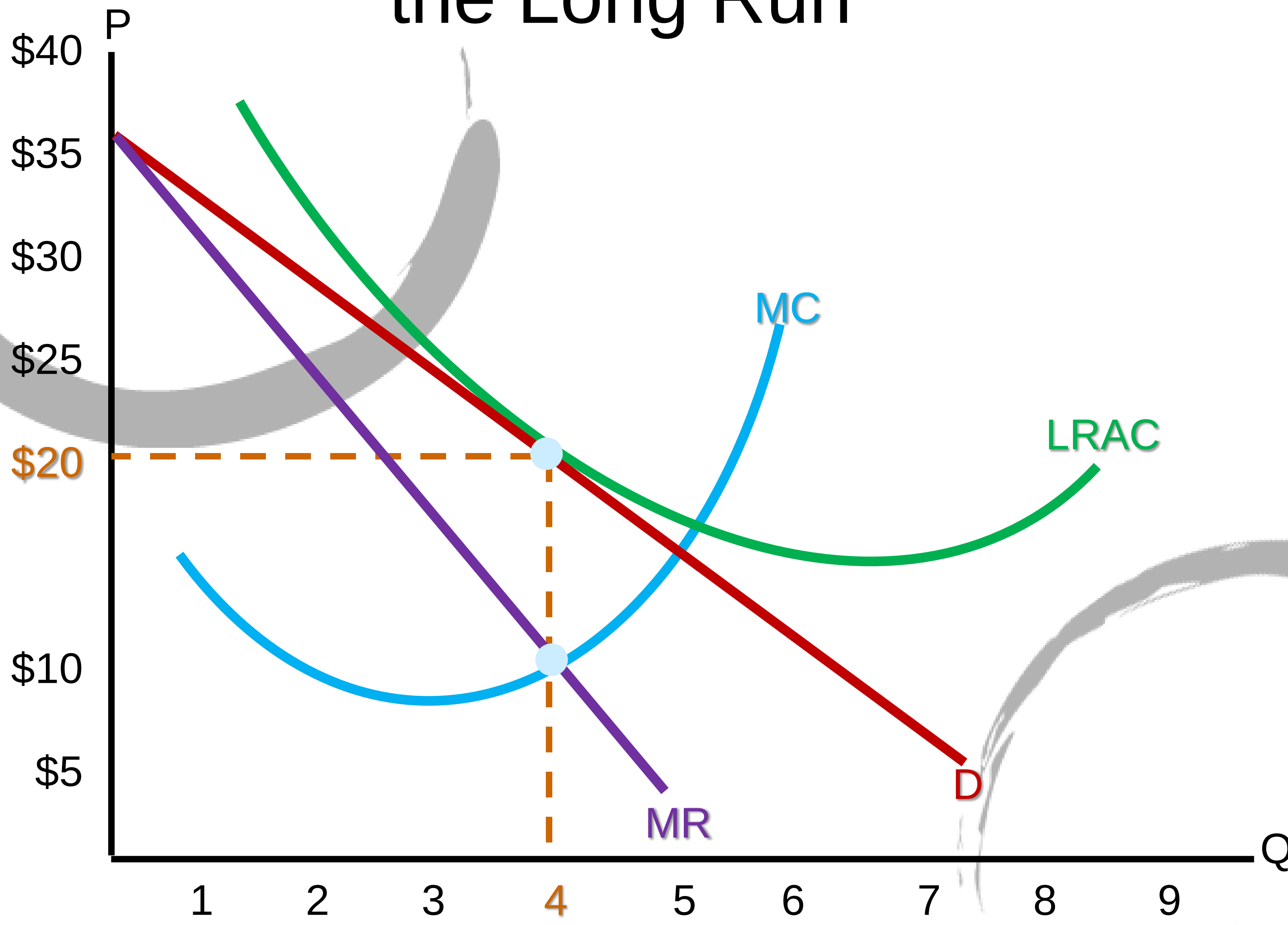
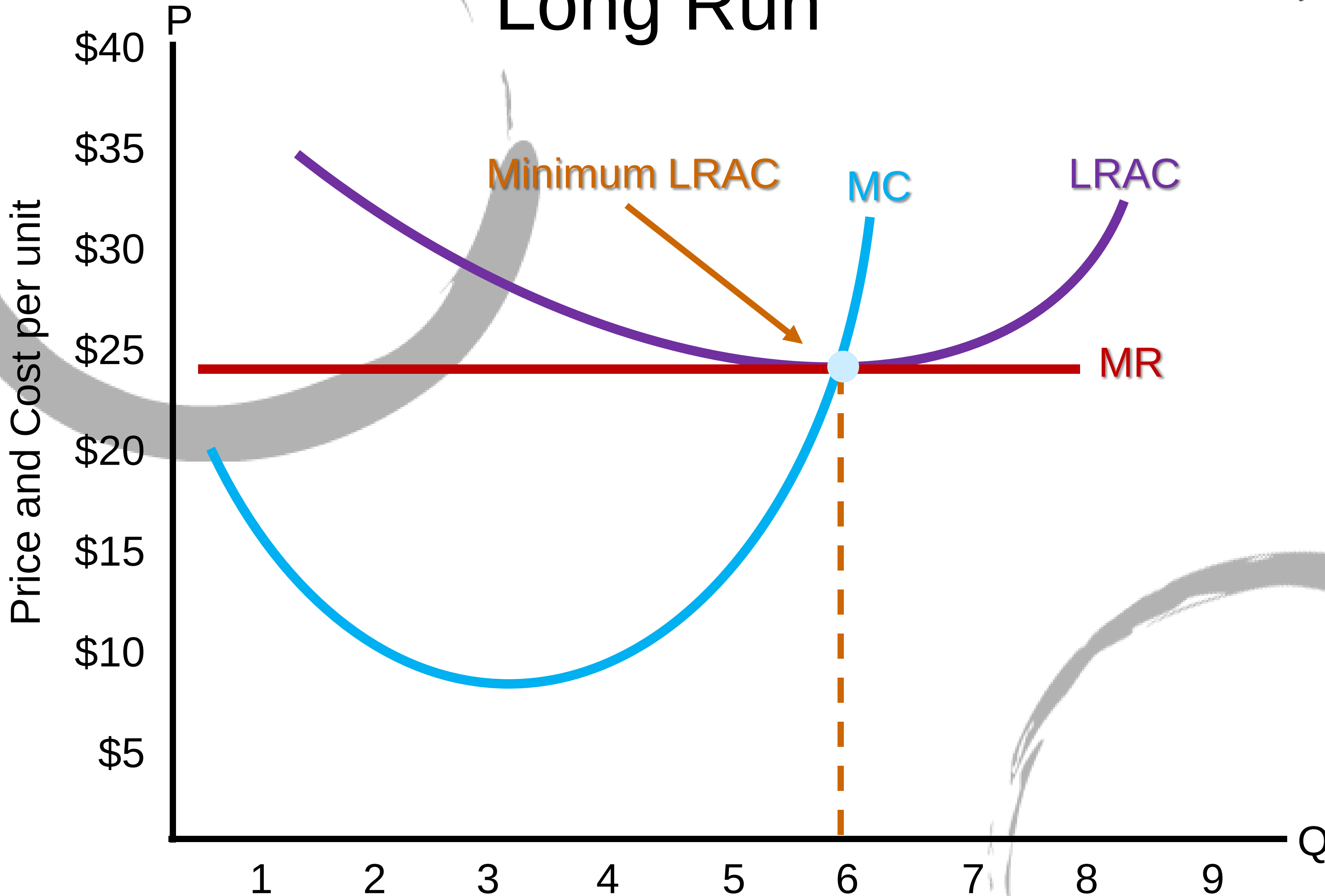


Chart: Perfect Competition in the Long Run



What is
one way monopolistic competition compares to perfect competition?

Price is higher and quantity is lower, firms have some market power and products are differentiated (not standardized) in monopolistic competition.

Type of Market	Quantity Produced	Price	Marginal Revenue	Marginal Cost	Demand	Average Total Cost
Pure Competition:	Expand output until MC is equal to price	Take market price	Same as market price	Will equal market price	Firm is small compared to overall market; can sell as much as it wants at market price	In the long-run, market price must equal or exceed ATC; will expand production if expected long-term price exceeds ATC
Monopolistic Competition:	Expand output until MC=MR	Search for best price until MC=MR	MR will be less than AR (price)	P > MC in short run	May face highly elastic demand	In long-run profit-maximizing price must equal or exceed ATC to stay in business; will tend to expand long-term output if price exceeds ATC

Why is price higher and quantity lower in monopolistic competition compared to perfect competition?

Firms engaged in monopolistic competition invest in product development and marketing so as to differentiate themselves from other firms in the industry. Since advertising increases costs, it will shift supply curves up and to the right. Ultimately, over the long run, consumers pay for the advertising in the form of higher prices.

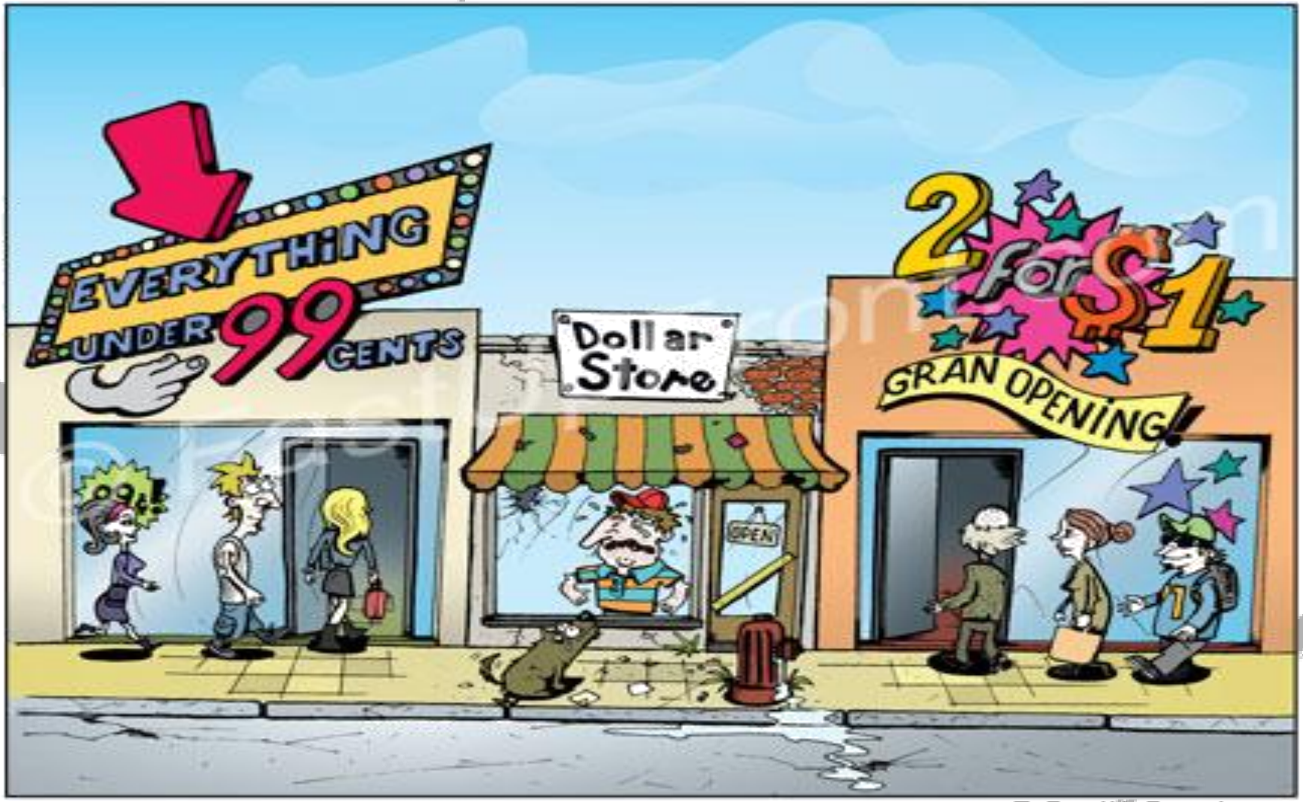
In comparison to the pure competitive market, prices will be higher and quantities produced will be lower when there is monopolistic competition. However, there will be a greater variety of goods.

How efficient is monopolistic competition?

Less resources are used and a higher price is charged than would be the case under perfect competition.

Under perfect competition, an inefficient firm won’t survive in the industry. Under monopolistic competition inefficient firms continue to survive.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



© FastUpFront.com

CONTINUED IN
TEST YOURSELF: OLIGOPOLY