

MONOPOLISTIC COMPETITION

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Features of monopolistic competition

- Many sellers

There are many producers of a particular good, which is why this market structure is competitive.

- Differentiated products

The products sold by all the firms are not exactly similar (they are not perfect substitutes). Each firm attempts to make its products more attractive to customers.

Features of monopolistic competition (2)

- Low barriers to entry and exit

Barriers to entry/exit exist (unlike the perfectly competitive case); however, they are not as high as in a monopoly. Entrepreneurs can still enter the market if it is lucrative to do so.

Product differentiation

- We learned that perfectly competitive firms have no market power (i.e. they have no control over the product's price)
- Monopolistic firms, on the other hand, enjoy a very high market power – they are price makers.
- As far as monopolistically competitive firms are concerned, they also have market power.
- They have control over the price of their product because because it is not exactly similar to what other firms sell.
- It is a differentiated product.

Product differentiation (2)

- Style or Type

One way monopolistically competitive firms differentiate their product is by having special designs on their products.

For example, it is easy to recognize an Apple laptop (Macbook) because of the design.

Firms design their products such that they will be appealing to customers.

Product differentiation (3)

- Location

Many businesses attract customers because of their locations.

Many people go to gas stations, barber shops, car wash services... because of how conveniently they are located.

A good location provides a higher market power. An example is the price of goods sold in malls or downtown.

Product differentiation (4)

- Quality

Firms also compete on the basis of quality.

Fast food restaurants and actual restaurants charge different prices and attract different kinds of hungry customers.

The price a firm charges depends on the quality of the product it makes.

The demand and marginal revenue curves in a monopolistically competitive market

- Firms in monopolistic competition have market power – they have control over the price of their products.
- If a firm sets a relatively high price for its products, the quantity demanded of the product will be low. On the other hand, if the price is relatively low, the quantity demanded will be high (i.e. this is the law of demand).
- Therefore, firms in this market face a downward demand curve.
- Consequently, the marginal revenue curve is also downward sloping.

The demand and marginal revenue curves in a monopolistically competitive market (2)



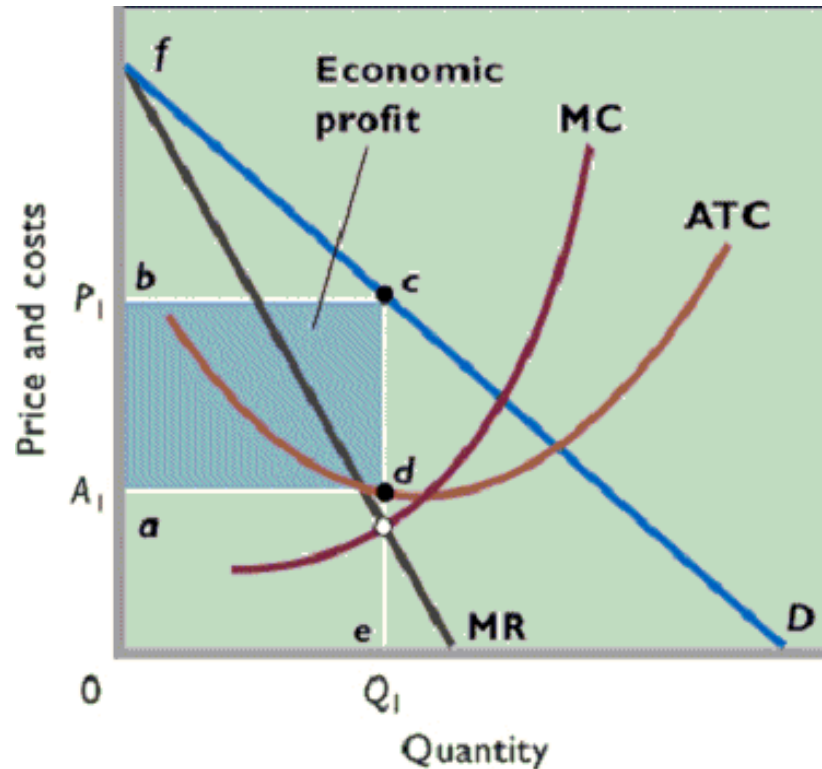
The profit-maximizing rule

- Just like the competitive firm and the monopolist, firms in monopolistic competition maximize profit where marginal revenue is equal to marginal cost ($MR = MC$).
- This is the point where the firm has no more profit potential.
- Producing beyond this point hurts the firm because it decreases its total profit.
- The monopolist has the same short-run cost curves as a competitive firm or a monopolist:
 - The Average Variable Cost (AVC) curve
 - The Average Total Cost (ATC) curve
 - The Marginal Cost (MC) curve
 - The Average Fixed Cost (AFC) curve

Understanding Average Total Cost, Price and Average Profit/Loss

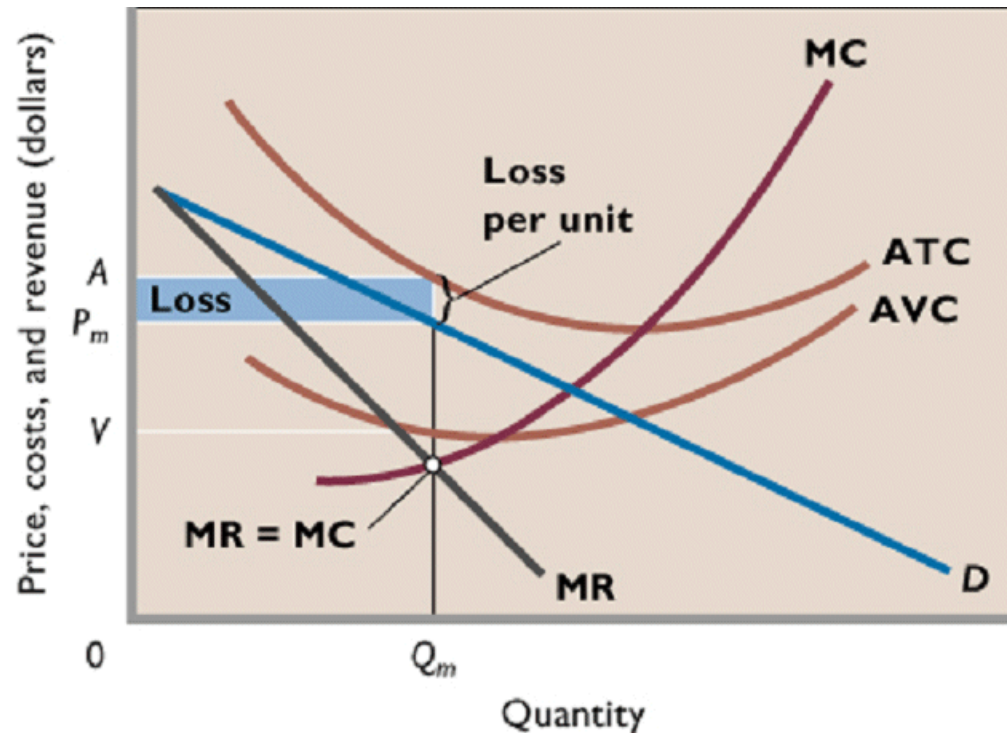
- Remember that $ATC = TC/Q$
- Average Total Cost is the cost per unit of output produced.
- In other words, it is the amount of money the producer spends on average to produce one unit of output.
- The price of a good (P) is the money the producer receives for selling one unit of output.
- Therefore, $P - ATC = \text{Average Profit/Loss}$
- This is the profit/loss made by selling one unit of output.
- Total Profit/Loss can then be calculated by multiplying the Average Profit/Loss by the number of goods sold.
- $\text{Total Profit/Loss} = (P - ATC) * Q$

Monopolistically competitive firm in the short-run: Economic profit



- The profit-maximizing condition is $MR = MC$.
- At this point, the corresponding profit-maximizing output is Q_1 .
- Given the demand curve and Q_1 , the price of the product is P_1 .
- The corresponding Average Total Cost given Q_1 is A_1 .
- In this case, the price of the good is higher than the Average Total Cost (i.e. $P_1 > A_1$), so the monopolist makes an average profit equal to $P_1 - A_1$.
- The total profit made by the monopolist is the area of the abcd rectangle in blue.

Monopolistically competitive firm in the short-run: Economic loss

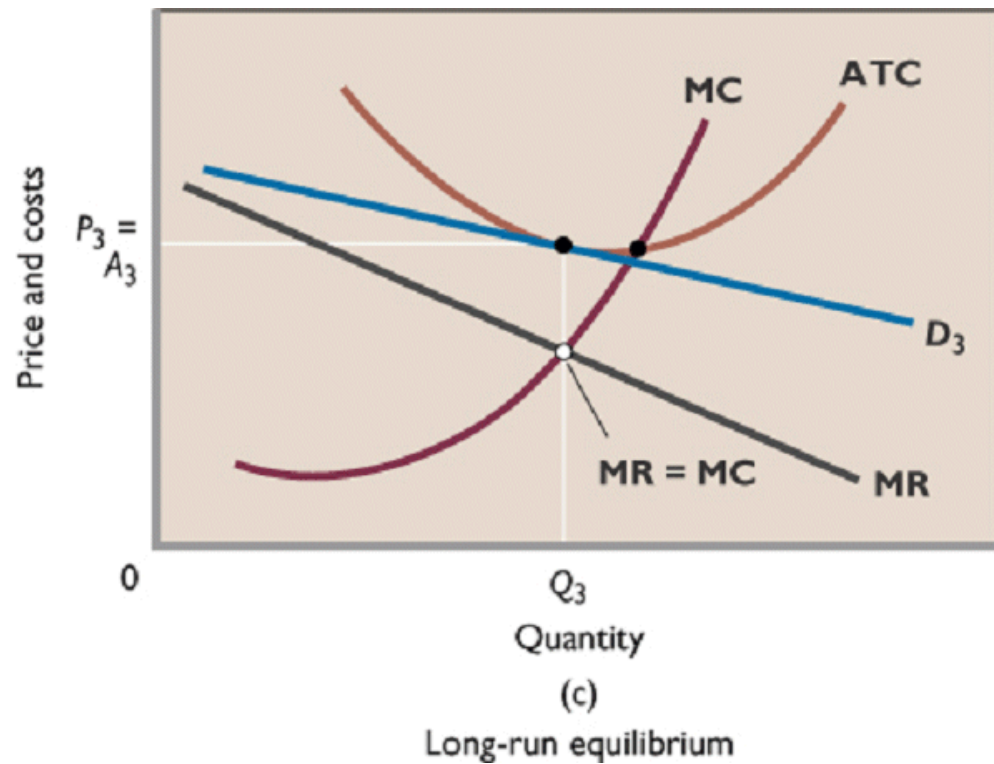


- The profit-maximizing condition is $MR = MC$.
- At this point, the corresponding profit-maximizing output is Q_m .
- Given the demand curve and Q_m , the price of the product is P_m .
- The corresponding Average Total Cost given Q_m is A .
- In this case, the Average Total Cost of the good is higher than the price (i.e. $A > P_m$), so the monopolist makes an average loss equal to $A - P_m$.
- The total loss made by the monopolist is the area of the rectangle in blue.

Monopolistically competitive firm in the long-run

- One of the features of monopolistic competition is its low barriers to entry/exit.
- This means that if the market is profitable, businessmen can enter it and make profit as well.
- As more and more firms open up in a profitable market, the profitability slowly declines.
- In the long run, there is zero economic profit for each firm.
- Graphically, the ATC curve shifts up as more firms enter the market.

Monopolistically competitive firm in the long run: zero economic profit



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You should now be able to...

- Identify and explain the features a monopolistically competitive market.
- Understand and explain what product differentiation is
- State and explain the profit-maximizing condition for a monopolistically competitive firm
- Determine the slope of the demand curve in a monopolistically competitive market and explain it (i.e. the slope)
- Show graphically how such firms make an economic profit/loss in the short-run
- Explain why it is impossible to make an economic profit in the long-run under monopolistic competition