

# Market Structures: Monopolistic Competition

## Principles of Micro, Lecture 9

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# Monopolistic Competition

## Core characteristics

What defines Monopolistic Competition?:

- ① Number of firms: many small producers
- ② Similarity of the products: similar but not identical products → there are close substitutes but producers try to appear unique (**product differentiation**)
- ③ Entry and exit: **free!**
- ④ Market power: price maker (market power significant)

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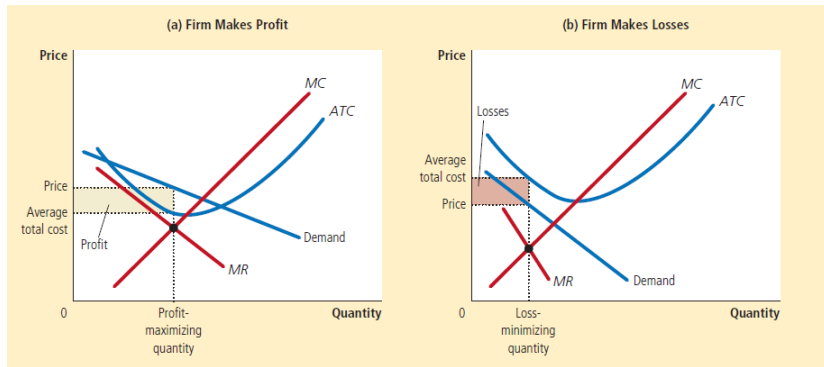
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Examples of Monopolistic Competition?

# Downward sloping MR

Implications for profits  $\pi$  in the short-run

Similar trends to a monopolist in the short run.



But the Free Entry/Exit condition ensures zero profits in the long-run.

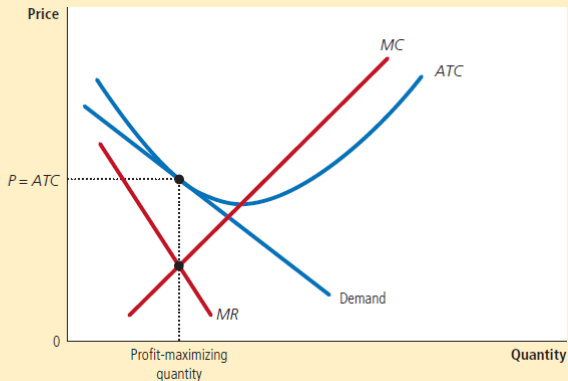
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## FIGURE 3

### A Monopolistic Competitor in the Long Run

In a monopolistically competitive market, if firms are making profits, new firms enter, and the demand curves for the incumbent firms shift to the left. Similarly, if firms are making losses, some of the firms in the market exit and the demand curves of the remaining firms shift to the right. Because of these shifts in demand, monopolistically competitive firms eventually find themselves in the long-run equilibrium shown here. In this long-run equilibrium, price equals average total cost and each firm earns zero profit.



There is NO monopoly profit which stays there in the long-run! Why?

# Differences between Mon. Comp. and Perfect Comp.

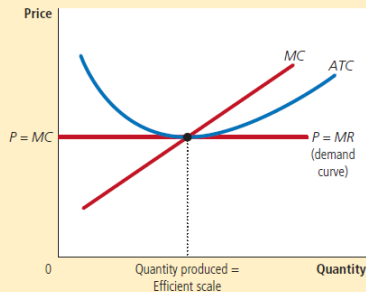
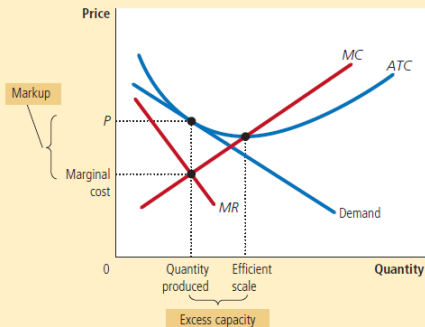
Panel (a) shows the long-run equilibrium in a monopolistically competitive market, and panel (b) shows the long-run equilibrium in a perfectly competitive market. Two differences are notable. (1) The perfectly competitive firm produces at the efficient scale, where average total cost is minimized. By contrast, the monopolistically competitive firm produces at less than the efficient scale. (2) Price equals marginal cost under perfect competition, but price is above marginal cost under monopolistic competition.

**FIGURE 4**

**Monopolistic versus Perfect Competition**

**(a) Monopolistically Competitive Firm**

**(b) Perfectly Competitive Firm**



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Questions to consider

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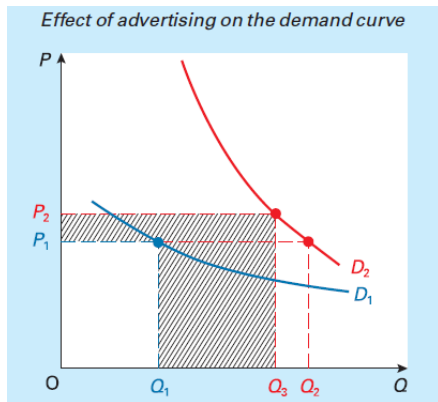
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- 4 Think like a producer: Would you prefer having another competitor? Why / Why not? → a negative business-stealing externality

# Advertising and Total Sales

Why do firms advertise?



Three main changes after advertising:

- 1 Demand shifts to the right
- 2 Demand becomes less **elastic**
- 3 Total revenues increase

Does this happen for free? Pros and Cons of advertising?

# Competitive, MC and Monopoly Markets

## A revision

	Market Structure		
	Perfect Competition	Monopolistic Competition	Monopoly
<b>Features that all three market structures share</b>			
Goal of firms	Maximize profits	Maximize profits	Maximize profits
Rule for maximizing profit	$MR = MC$	$MR = MC$	$MR = MC$
Can earn economic profits in the short run?	Yes	Yes	Yes
<b>Features that monopolistic competition shares with monopoly</b>			
Price taker?	Yes	No	No
Price	$P = MC$	$P > MC$	$P > MC$
Produces welfare-maximizing level of output?	Yes	No	No
<b>Features that monopolistic competition shares with competition</b>			
Number of firms	Many	Many	One
Entry in the long run?	Yes	Yes	No
Can earn economic profits in the long run?	No	No	Yes

# Further Info

Reading:

M-T, ch.15 (about: Monopolistic competition): 314-328

Do not miss:

[economist.com](http://economist.com); [wsj.com](http://wsj.com); [cnbc.com](http://cnbc.com)