Monopolistic Competition

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Assumptions

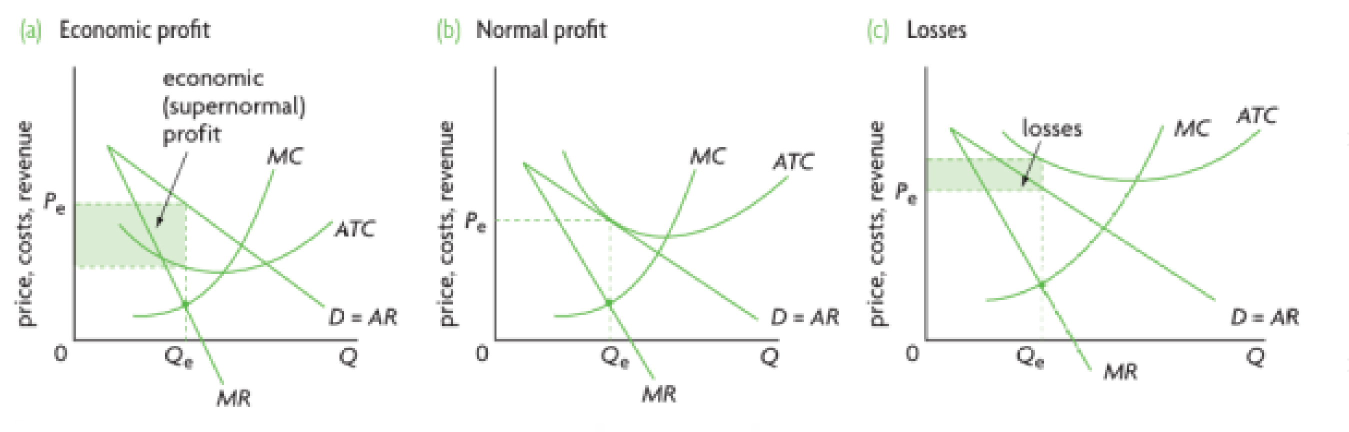
- Large number of firms — each firm hold small share of the market
- Low barriers to entry & exit
- Products - differentiated
  - Physical differentiataion
  - Quality differentiations
  - Locations - better access
  - Additional Services — e.g home delivery etc
  - Product Image — Celebrity endorsement / advertising

Elements

- Each firm is a small monopoly (depending on the extent of differentiation)
  - Demand curve us elastic due to availability of substitute
  - However they are not perfect substitutes
    - due to differentiations (small monopoly)
- Price vs non price competition
  - often indulge in non price competitions — Increases differentiation, increases monopoly power, demand becomes less elastic

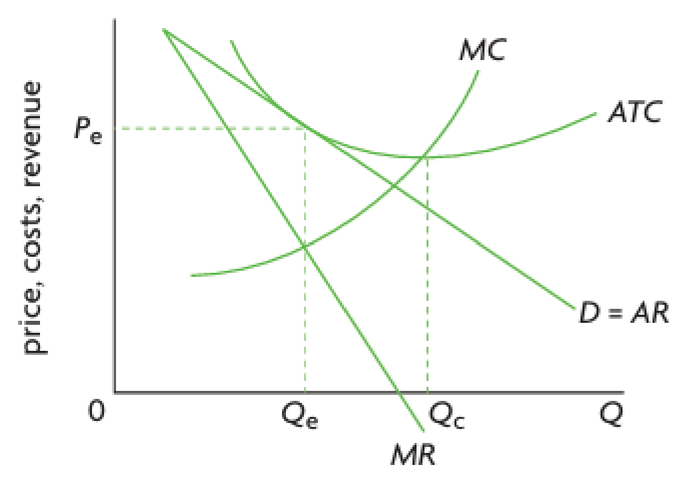
Profit maximisation

- MC = MR — Profit maximisation



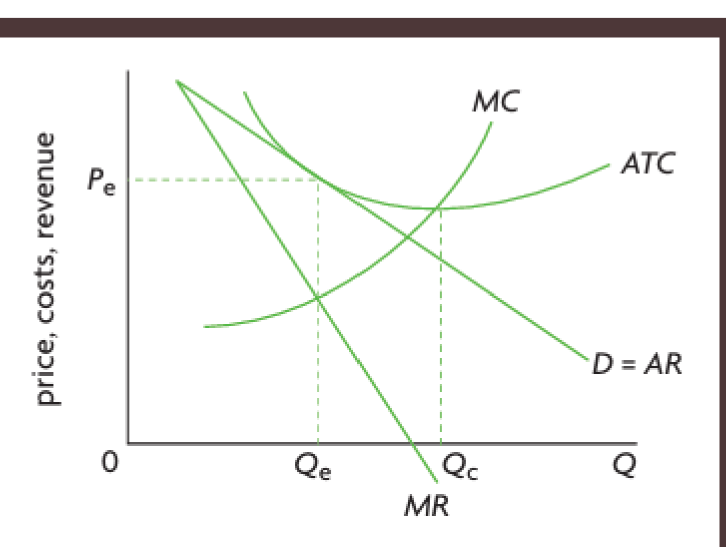
Short Run

- Normal profit
- Supernormal profit
- Losses



Long Run

- Normal profit — Any short run profit will cease due to low barrier to entry



Efficiency

- Allocative inefficiency
  - the condition where Price is not equal to MC
  - At the equilibrium level of output, Qe, the price is higher than MC, indicating that there is an underallocation of resources to the production of the good - society would have liked to have more units of the good produced.
- Productive inefficiency
  - production does not take place at minimum ATC
  - Productive efficiency output is Qc, yet by the profit-maximising rule MR = MC the firm produces output Qe which is smaller than Qc.
  - The difference between capacity output and profit-maximising output is called excess capacity
    - amount of output that is lost when firms underuse their resources and produce an amount of output that does not minimise ATC
    - examples of excess capacity: restaurants with empty tables, petrol (gas) stations with no one at the pump, retail outlets of all kinds with few customers, hotels with empty rooms.

Monopolistic competition vs perfect competition

- Number of firms — Both industry has large number of firms
- Free and entry and exit — Both industry has this characteristic
- Normal profit in the long run, supernormal profit or loss in the short run. — Applies to both industry
- Market power & the demand curve.
  - Perfect competition — no market power
    - unable to influence price, since they are price-takers, as reflected in the perfectly elastic (horizontal) demand curve they face
  - Monopolistic competition — do have some market power (ability to influence price), and this is reflected in their downward-sloping demand curve.
- Productive & allocative efficiency.
  - Perfect competition — achieves both productive and allocative efficiency in long-run equilibrium
  - Monopolistic competition — achieves neither
    - Fewer than optimal resources are allocated to the production of the good
    - average cost is not minimum at the point of production
    - consumers pay a higher price for the good than in perfect competition.
- Excess capacity.
  - Perfect competition — produces the level of output where ATC is minimum
    - makes full use of its plant and has no excess capacity.
  - Monopolistic competition — produces a lower level of output than that where ATC is minimum, and therefore has excess capacity.
- Product variety
  - Perfect competition — produce the identical product
  - Monopolistic competition — differentiate their products
- Economies of scale
  - Perfect competition — cannot achieve economies of scale because they are very small
  - Monopolistic competition — may have some small room for achieving economies of scale but only to a relatively small degree as these firms also tend to be relatively small.