

MONOPOLISTIC COMPETITION

Up to now, we have outlined the two polar market structures of:

- **Perfect Competition** - large # of buyers/sellers of a commodity; and
- **Monopoly** - single producer of a good with no close substitute.

In reality, the most common market structure is a *combination* of both of these

Monopolistic Competition

Competition:

- several (or many) firms exist producing differentiated products
- entry and exit exist into this product group

Monopoly:

- each firm has a monopoly on its own (unique) brand name

Product differentiation takes many forms:

- quality of product
- location of facility (store)
- features of product
- brand name

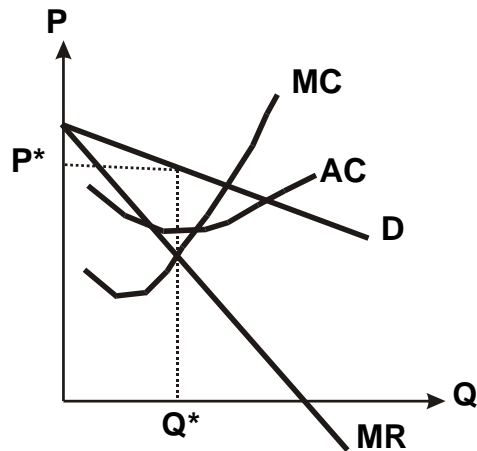
Ex: local grocery stores, drug stores, or car dealerships

These products are similar, due to differentiation (ex: Shaw's is not the same as Stop & Shop) but not viewed as identical

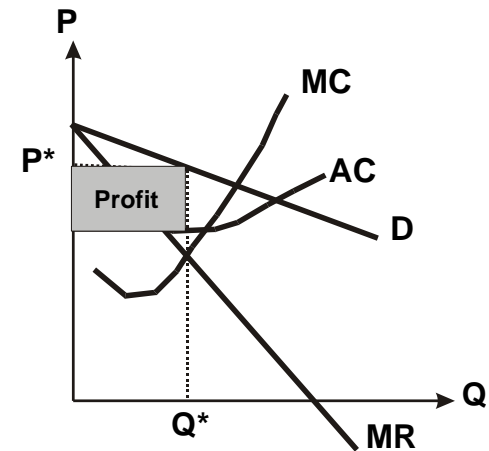
Stores/producers of a *similar* product are called the *product group, not industry*

- ⇒ downward sloping demand curves
- ⇒ steepness depends on extent of product differentiation (real or perceived)
- ⇒ the greater the differentiation, the fewer the number of close substitutes, and steeper is demand (i.e., greater pricing power since not a “commodity”)

⇒ graphing this structure is similar to monopoly, except that demand is flatter



- Use “typical” AC and MC curves
- To determine P^* and Q^* , use procedure from monopoly:
 - (1) Q^* : where $MR = MC$
 - (2) P^* : at Q^* , draw line straight up to demand curve then left to price axis
 - (3) Profit/loss: compare P^* and AC at Q^* , this gives per-unit profit/loss, then multiply by Q^* - get total profit/loss



THERE IS NO GUARANTEE OF PROFIT
- product differentiation defines a *niche* for this firm – determining steepness of demand and potential pricing power

SHORT-RUN:

- can be normal profit, economic profit, or economic loss
- true for all market structures

What about the long-run?

- There is entry into the product group – firms with similar products enter into this product group when economic profit exists
- Entry => lower demand for this firm AND demand becomes flatter (more elastic demand)
- Profit for this firm decreases

For the product group, however:

- not all firms will see economic (i.e., above-normal) profit eliminated

For the *marginal firm* (highest cost firm in the product group), economic profit is diminished until it earns normal profit

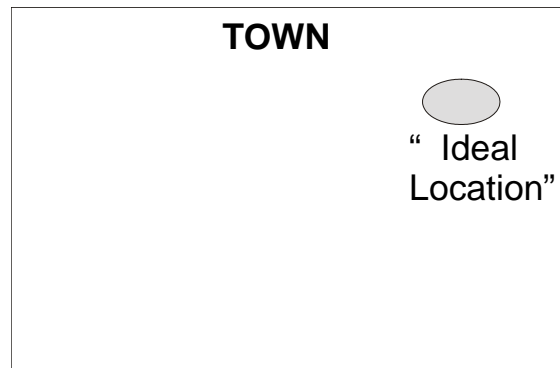
- *this is the long-run equilibrium for the product group*
- *demand is tangent to LAC => normal profit only (no economic rent)*

Other firms can sustain or even increase economic profit in long-run equilibrium

SUCCESSFUL FIRMS:

- **Those with greatest (or most highly valued) product differentiation and/or lower production costs (ex: better management methods or more effective entrepreneurship, or more favorable locations)**

EXAMPLE:



If a single firm locates here => major differentiation

- generally leads to profit in short-run

In the long-run, the economic profit signals other firms that above-normal profit can *potentially* be earned in this product group and location

- expect new firms to enter into this location
- this lowers demand and demand becomes more elastic for the original firm

GENERAL TENDENCY

- product groups tend to over-expand
- firms with higher cost and/or less differentiation then go out of business
- remaining firms – have higher demand and some pricing power => can raise price now to help profitability (since less competition)
- *firms generally do not reach minimum efficient scale* – not all economies of scale are realized (as was true for Perf. Comp.), called the Excess Capacity Theorem
- the variety of products has a cost – firms don't produce at lowest possible cost

Forecasting implication:

Often hear when retail firms go out of business that economy too weak right now. But, aggregate retail sales \$ strong and growing => over-expansion, beyond what local economy can sustain, or stagnant niche, NOT a weak economy

Examples of this market structure:

- Office supply stores (Office Max, Staples, Office Depot, etc)
- Home goods stores (Home Depot, Lowe's, local hardware stores, etc.)
- Grocery stores (Shaw's, Stop & Shop, Dave's, WalMart, small specialty stores)
- Local gasoline stations
- Local drug stores

Application 1:

- Choose a product group locally (or where you live)
- Identify, for the main sellers: (1) their niche (how are they differentiated); (2) the cost advantages they have; (3) how they survive; and (4) future prospects

Application 2:

- Choose a company *you* would like to start
- Identify: (1) your niche; (2) potential cost advantages; (3) how you will compete – strategies (demand side and/or supply and cost side); (4) how you can gain market share from the competition

(Remember past topics: control of fixed costs, both level and by pricing, unit labor costs, elasticity of demand and determinants, short-run versus long-run)

PRACTICE QUESTIONS

Monopolistic competition is characterized by

- A) few dominant firms and low entry barriers.
- B) large number of firms and substantial entry barriers.
- C) large number of firms and low entry barriers.
- D) few dominant firms and substantial entry barriers.

Under monopolistic competition, entry is:

- A) completely free of barriers.
- B) more difficult than under pure competition but not nearly as difficult as under pure monopoly.
- C) more difficult than under pure monopoly.
- D) blocked.

Nonprice competition refers to:

- A) competition between products of different industries, for example, competition between aluminum and steel in the manufacture of automobile parts.
- B) price increases by a firm that are ignored by its rivals.
- C) advertising, product promotion, and changes in the real or perceived characteristics of a product.
- D) reductions in production costs that are not reflected in price reductions.

Use your basic knowledge and your understanding of market structures to answer this question. Which of the following companies most closely approximates a monopolistic competitor?

- A) Subway Sandwiches.
- B) Pittsburgh Plate Glass.
- C) Ford Motor Company.
- D) Microsoft.

A monopolistically competitive firm has a:

- A) highly elastic demand curve.
- B) highly inelastic demand curve.
- C) perfectly inelastic demand curve.
- D) perfectly elastic demand curve.

The monopolistically competitive seller's demand curve will become more elastic the:

- A) more significant the barriers to entering the industry.
- B) greater the degree of product differentiation.
- C) larger the number of competitors.
- D) smaller the number of competitors.