3.1 Monopolisitic Competition

At the end of this section a student should be able to:

- describe and critique the main features of monopolistically competitive product markets
- demonstrate and analyse how a change in demand or supply in a market structure impacts on equilibrium
- graphically represent, describe and compare market equilibrium under monopolistic competition in the short and long run
- graphically represent and evaluate the point of profit maximisation for a firm in a monopolistically competitive market
- examine the implications of changing levels of competition and market power on price and output under monopolistic competition

A monopolistically competitive market is a market with features of both monopoly and perfect competition. The products supplied are similar with slight differences. They are been sold by a large number of profit-maximizing sellers in a market where there is freedom of entry and exit. It follows that monopolistic competition is a market structure which closely mirrors the conditions under which the vast majority of firms operate in a modern economy.

Assumptions underlying Competition

The characteristics or assumptions underlying monopolistic competition are identified below:

- **There are many buyers**
    - An individual buyer, by his/her own actions, cannot influence the market price of the goods.
- **There are many sellers in the industry**
    - An individual seller can influence the quantity sold by the price it charges for its output.
- **Product differentiation exists**
    - The goods supplied by the firm are not homogenous but are close substitutes. Firms use branding to distinguish their products from one another.
- **Freedom of entry and exit**
    - No barriers to entry exist within the industry. It is possible for firms to enter/leave the industry as they wish.
- **Reasonable knowledge**
    - Within the industry each firm has reasonable knowledge of profits made by other firms. Consumers have a reasonable knowledge of the prices being charged for different products.
- **Each firm attempts to maximise profits**
    - Firms produce where MC = MR. Each firm will attempt to minimise costs of production.

Monopolistic Demand Curve versus Perfect Demand Curve

- The demand curve facing a firm in monopolistic competition is downward-sloping. This is because each firm sells a differentiated product, which creates scope for brand loyalty. Each firm has a product that consumers view as somewhat distinct from the products of competing firms. If the firm increases the product price there will be a reduction in demand as some consumers will switch to rival firms' goods (close substitutes) that have become relatively cheaper.

- The demand curve facing a perfectly competitive firm is horizontal or perfectly elastic (D=AR=MR). This is because each firm is selling an identical (i.e. homogeneous) product and each firm's quantity sold is small relative to the total market size. Any attempt to undercut the market price will result in complete switching to identical products of competitors.

Equilibrium Position Of A Firm In Monopolistic Competition

- **Short-Run Equilibrium Position**

The Short-Run Equilibrium Position of a Firm in a Monopolistically Competitive Market

- Equilibrium occurs in the long run at point *e* where MR=MC, and MC continues to rise.
- That is the quantity that ensures profit maximisation, Q1.
- P1 is the price charged.
- AR > AC therefore supernormal profits are made.
- The average cost of production of Q1 is at point B. The firm is not producing at the minimum AC in the long run.
- As the firm is not producing at the lowest point on the AC curve it is wasteful of resources.
- MC cuts/equals AC at the point W, the lowest point on the AC curve

Helpful video here

- **Long-Run Equilibrium Position**

The Long-Run Equilibrium Position of a Firm in a Monopolistically Competitive Market

- **Long Run Equilibrium Position**
    - Existence of SNPs attracts new firms
    - D/AR shifts to the left

- Equilibrium occurs in the long run at point *e2* as follows:
- Q2 is produced where MR=MC, and MC continues to rise. That is the quantity that ensures profit maximisation.
- P2 is the (lower) price charged.
- At Q2, AR = AC. Normal profits are made. SNPs are eroded. (If AR falls below AC then firms will make a loss, causing some firms to leave the market until AR rises and normal profits are made.)
- The firm is not producing at the minimum AC in the long run. Q2 is supplied at the lowest point on the AC curve in the graph (point B2).
- MC cuts/equals AC at the point W, the lowest point on the AC curve

Helpful video [here] & [here]

What are the Advantages of Monopolistic Competition?

- **Contestable Markets**
    - There are few barriers to entry, making markets quite competitive and thus benefiting the consumer with lower price or better quality goods and services
- **Choice of goods**
    - Differentiation creates diversity of goods and services for consumers, although this may mean higher prices. Consumers like to have a wide variety of goods and services to choose from, e.g. many types of restaurants in a town
- **Normal Profit**
    - In the long run consumers are not being exploited, as the firm is earning normal profit (AR=AC)
- **Access to Information**
    - Consumers have more information available to them because of the extensive competitive advertising used within the industry

What are the Disadvantages of Monopolistic Competition?

- **Production is not at the minimum point on the AC**
    - In equilibrium the firm is not producing at a level where costs are at their lowest. This is because money is spent on advertising, differentiated packaging, etc, which increases the cost of production and is inevitably passed on to the consumer.
- **Excess capacity**
    - Production is not where average costs are at a minimum and this is considered to be wasteful of scarce resources. The firm could produce greater output than it does, meaning that is has overcapacity.

Wasting Resources

- **Why are firms in Monopolistic Competition considered to be wasteful or resources?**
    - A monopolistically competitive firm does not produce at the socially efficient lowest point on its AC curve, point W.
    - They are not producing at the lowest point of AC due to product differentiation. Product differentiation makes a firm's product appear different through additional costs such as advertising and branding.
    - Price exceeds the marginal cost of production. The extent of the difference between P and MC represents the degree of monopoly power the firm is able to exert in the market for its differentiated product.
    - Because it is not producing at the lowest point of the average cost curve, there is spare/excess capacity in its operations and society does not benefit from maximum utilisation of resources. Consumers gain variety at the expense of social efficiency.

Features common to perfect and monopolistic competition

- In the short run, firms in both markets earn supernormal profits, i.e. the quantity is produced where AR>AC.
- The absence of barriers to entry and perfect knowledge of profits in both markets ensure that new suppliers are attracted and supernormal profits are eroded until only normal profits are to be made in the long run. That means that Q is produced where AR= AC in the long run in both markets.

Features common to monopoly and monopolistic competition

- Both are inefficient in the use of resources - Firms in both markets produce at a point that is above the minimum possible point on the AC curve.
- Firms in both industries are subject to the law of demand and therefore face downward sloping demand curves.

Helpful video here