MANAGERIAL ECONOMICS

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Lecture No - 30 : Monopolistic Competition

Recap from last Session

- Social costs of Monopoly Power
- Monopsony
- Bilateral monopoly
- Comparison between monopoly and perfect competition
- Monopoly – real world evidence

Session Outline

Monopolistic Competition

- Imperfect competition refers to those market structures that fall between perfect competition and pure monopoly.
- Markets that have some features of competition and some features of monopoly

Monopolistic Competition

- Concept of monopolistic competition – Prof Chamberlin's theory of monopolistic competition.
- The basic assumptions of monopolistic competition is same as perfect competition except homogenity of product.

Attributes of Monopolistic Competition

- Large number of firms each satisfying a small , but not microscopic. Share of market demand for a similar not identical.
- Products are close (not perfect) substitutes- seller of each product group can be considered competing firms within industry.

Attributes of Monopolistic Competition

- Market is monopolistic
  - Product differentiation creates a degree of market power
- Market is competitive
  - Large number of firms, easy entry

Attributes of Monopolistic Competition

- Product Differentiation
  - Each firm produces a product that is at least *slightly different* from those of other firms.
  - Rather than being a price taker, each firm faces a *downward-sloping demand curve*.

Attributes of Monopolistic Competition

- The firm in the market do not consider the reaction of rivals when choosing their product prices or annual sales target.
- Relative Freedom of Entry or Exit
- Neither opportunity nor the incentive exists for the firm sin the market to cooperate any ways that decrease competition.
- The number of firms in the market adjusts until economic profits are zero.

Product Differentiation

- Product quality
- Services
- Location
- Advertising and Packaging

Price and output determination under monopolistic competition

- Pricing and output decision similar to monopoly as
- It face a downward sloping demand function which is because of
- a strong preference of a section of consumers for the product and
- Quasi monopoly of the seller over supply

Price and output determination under monopolistic competition

- Brand loyalty or strong preference of the consumer gives seller the opportunity to raise price and yet retain some consumer.
- Since each product is a substitute for the other, the firm can attract the consumer of other products by lowering price.

Price and output determination under monopolistic competition

- Short run – super normal profit
- Normal profit
- Loss

Competition with differentiated products

- Short-run economic profits encourage new firms to enter the market. This:
  - Increases the number of products offered.
  - Reduces demand faced by firms already in the market.
  - Incumbent firms’ demand curves shift to the left.
  - Demand for the incumbent firms’ products fall, and their profits decline.

Competition with differentiated products

- Short-run economic losses encourage firms to *exit the market*. This:
  - Decreases the number of products offered.
  - Increases demand faced by the remaining firms.
  - Shifts the remaining firms’ demand curves to the right.
  - Increases the remaining firms’ profits.

Price and output determination in the long run

- The super normal profit in the long run attracts new firms in to the industry – loss of market share – normal profit
- Increasing number of firm intensifies the price competition between them.
- Price competition increases – existing firm cut down price to retain or regain market share – new firms lower to penetrate the market
- Demand curve more elastic

Excess capacity in the monopolistic competition.

- Each firm will be equilibrium at the falling portion of AC not at the minimum point
- Excess capacity theorem
- There is excess capacity with each firm- more output can be produced at a lower cost

Advertising and Brand name

- The product differentiation inherent in monopolistic competition leads to the use of advertising and brand names.
  - Critics argue that firms use advertising and brand names to take advantage of consumer irrationality and to reduce competition.

Advertising and Brand name

- Defenders argue that firms use advertising and brand names to inform consumers and to compete more vigorously on price and product quality.

Impact of advertising and other cost of production and selling

- These types of cost incurred to sell more of a product without reducing its price must be added to production costs to compute the average cost and contribute to higher price.

Impact of advertising and other cost of production and selling

- This leads to increase in average cost
- Consumer buys more of the advertised goods, however resources are diverted from the production of other goods to provide the advertising.

Non price competition – product innovation and advertisement

Two common form of non-price competition is

1.Product innovation and

2.Advertisement

Both go on simultaneously.

Cost incurred on these-selling cost

Non price competition – product innovation and advertisement

Increase in selling cost – ASC initially decreases but ultimately increases – ASC is u shaped like AC curve

Non price competition through selling cost leads all the firms to an almost similar equilibrium.

Firm's group equilibrium

Critical appraisal of Chamberlin's theory

1. Assumption of independent pricing and output decision – firms are bound to get affected by decisions of rivals since their products are close substitutes.
2. Firms do not learn from past experience – difficult to accept
3. Product group is ambiguous – each firm is an industry by virtue of its specialized and unique product.

Critical appraisal of Chamberlin's theory

4. Heroic assumption of identical cost and revenue curves are questionable.
5. Assumptions of free entry is considered incompatible with product differentiation.
6. It is difficult to find any example in the real world to which his model of monopolistic competition is relevant

Session References

Micro Economics :ICFAI University Press
Managerial Economics – D N Dwivedi
Managerial economics – Geetika, Ghosh and Choudhury