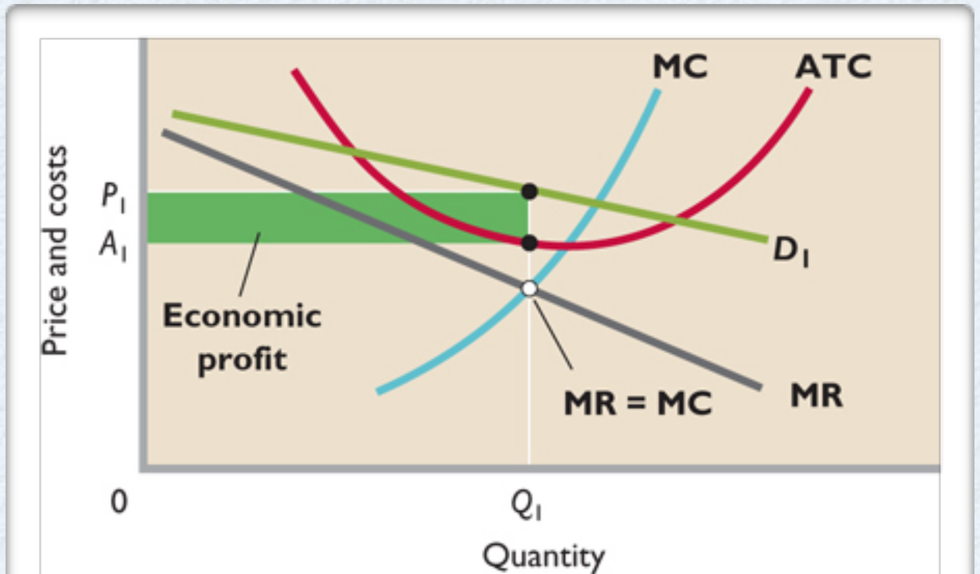
CHAPTER 13

Monopolistic Competition

- **Monopolistic competition**
    - Relatively large number of sellers in the market
        - small market shares
        - no collusion - to restrict output and set prices is unlikely
        - independent action
    - Differentiated products
    - Easy entry and exit
    - Advertising -heavy
- Monopolistically competitive industries - computers, leather goods, aircraft manufacturing ...

Monopolistic Competition

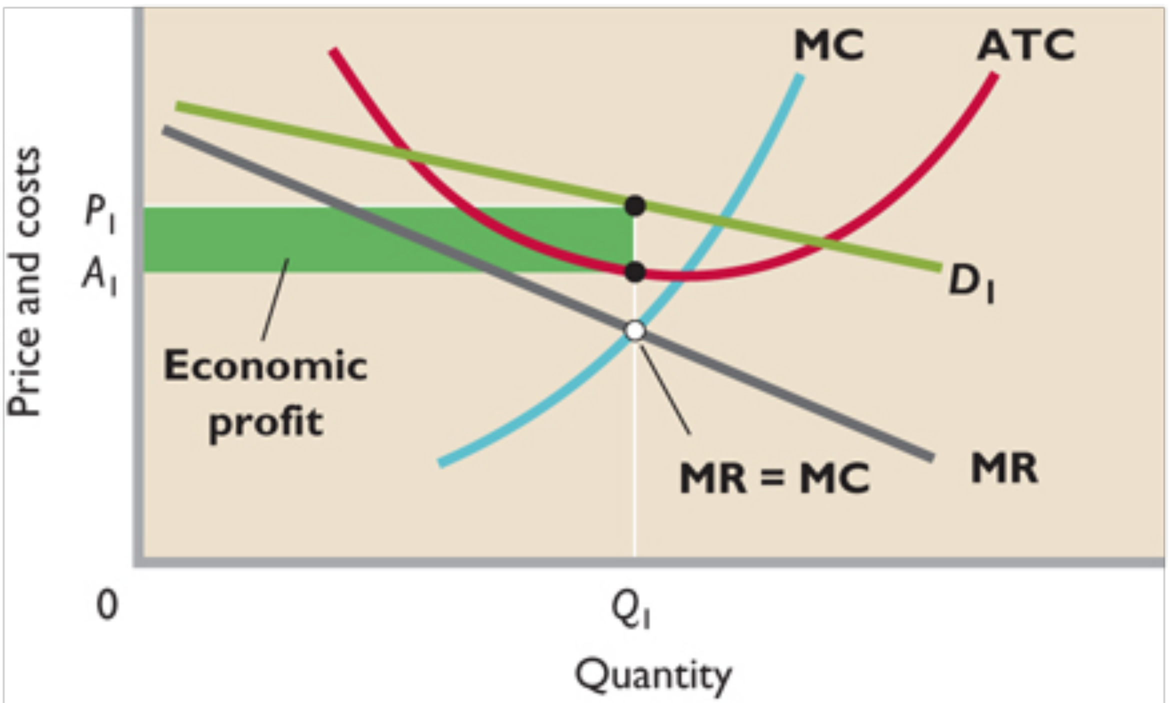
- **Price and output in monopolistic competition**
  - The firm's demand curve
    - The demand curve is highly but not perfectly elastic - reason:
      1. Monopolistic competition has fewer rivals
      2. Products are differentiated, no perfect substitutes



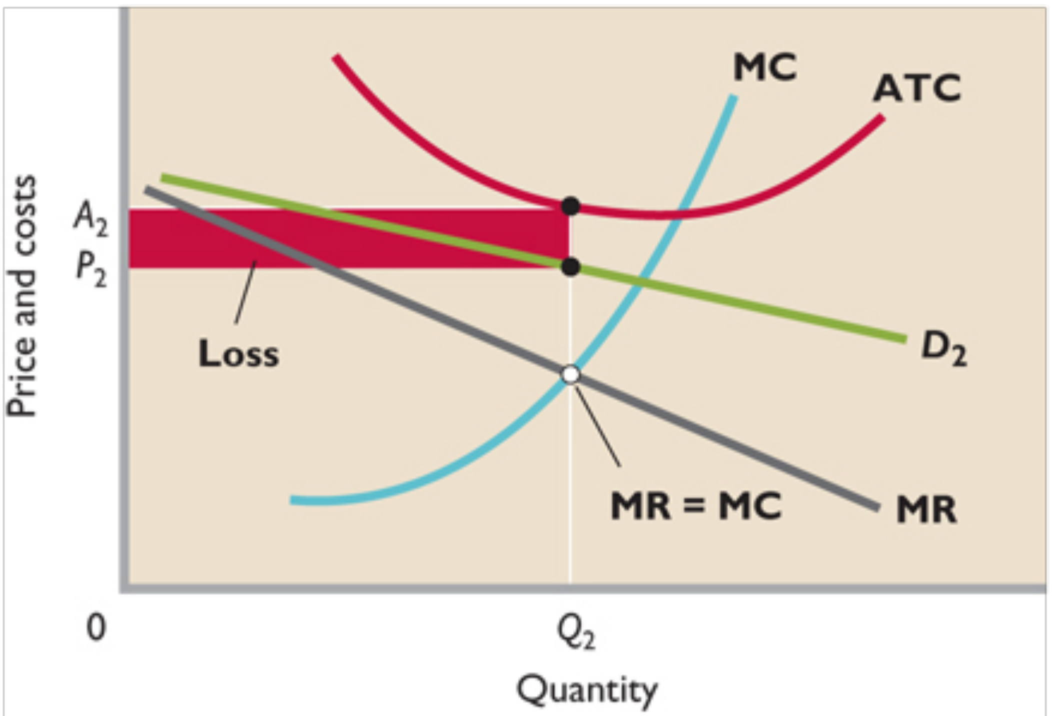
(a)
Short-run profits

Monopolistic Competition

- **Short-run profit/loss**



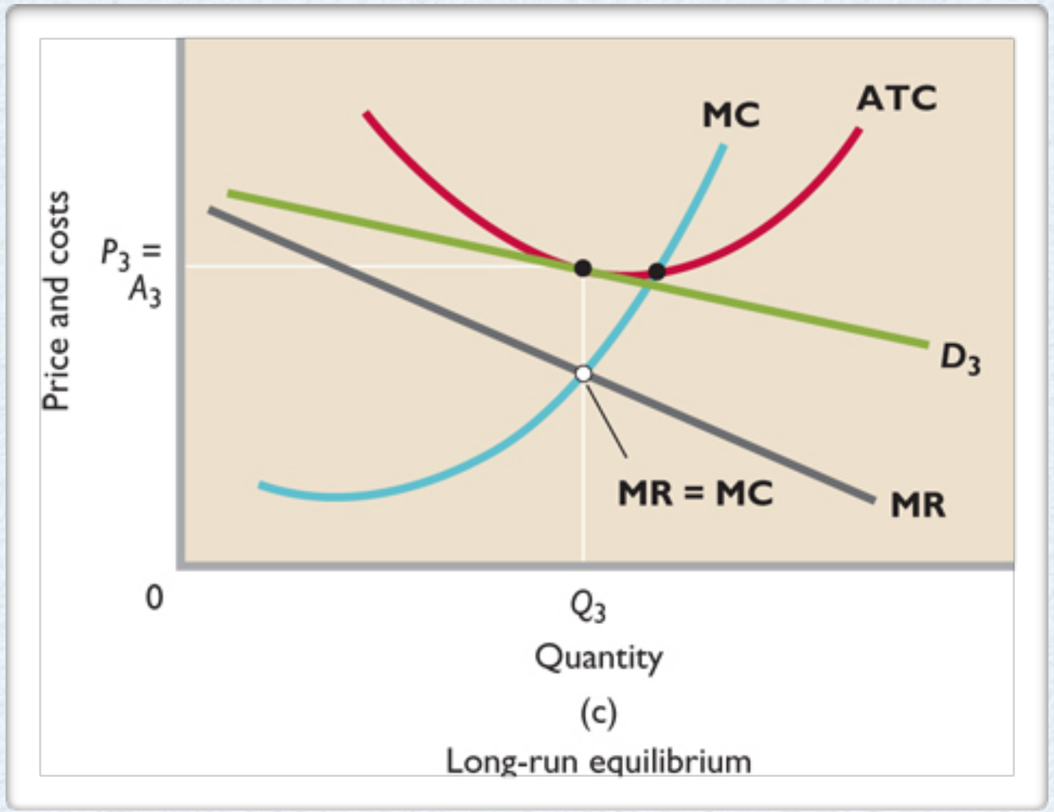
(a)
Short-run profits



(b)
Short-run losses

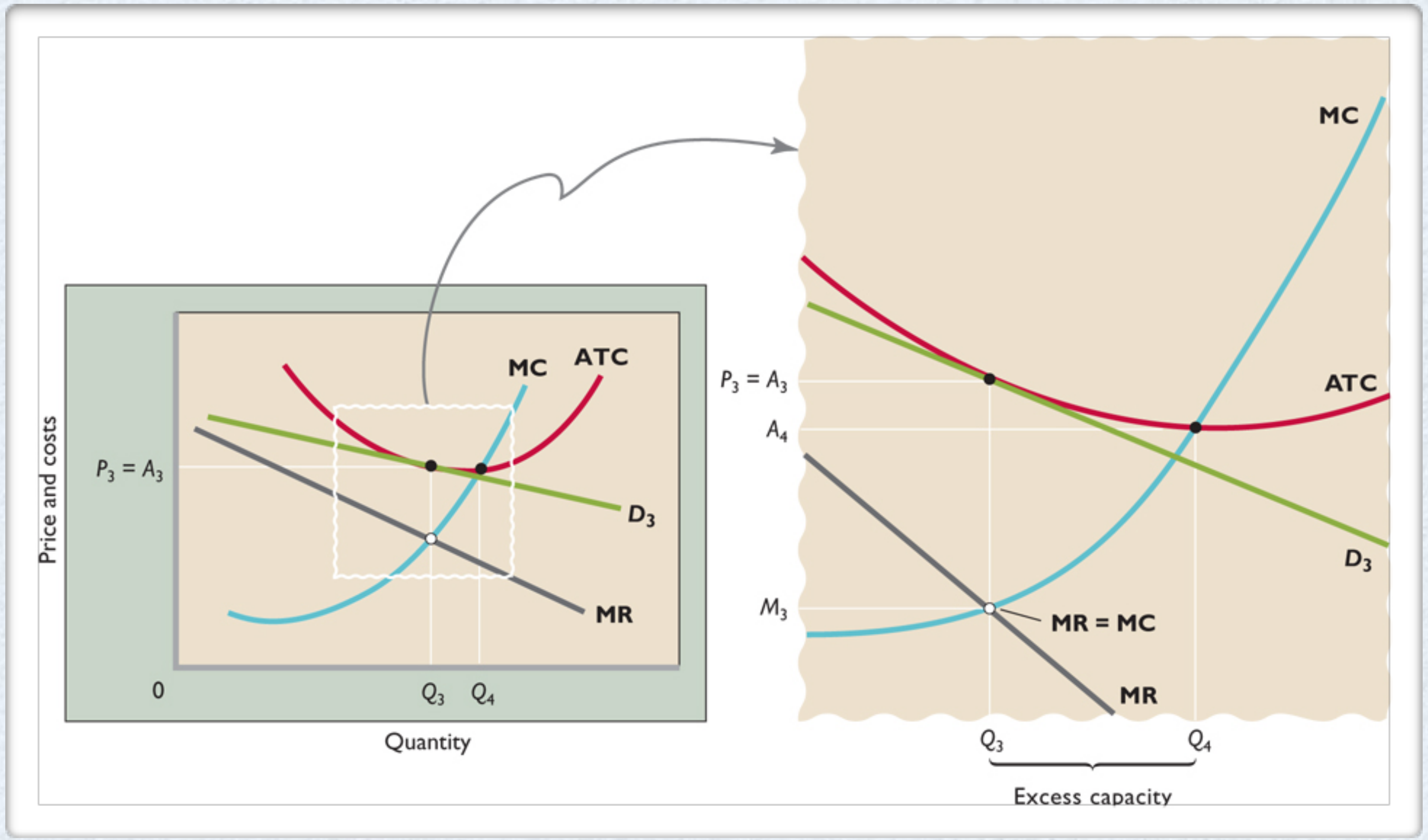
Monopolistic Competition

- **Long-run - in the long-run, for the monopolistic competitor there is only normal profit.**
  - **If there is a profit**, firms will enter into the industry, D curve shifts to the left (each firm has a smaller share of the total demand and now faces a large number of close substitute products), D will eventually be tangent to ATC, hence in the long-run only normal profit exists.
  - **If there is a loss**, firms will leave, D curve shifts to the right, D will reach ATC, only normal profit exists.



Monopolistic Competition

- **Monopolistic competition and efficiency**
  - **Neither productive nor allocative efficiency**
    - **Production efficiency (P = MC)** is not realized because production occurs where the ATC - A_3 exceeds the minimum ATC -A_4
    - **Allocative efficiency (P = min ATC)** is not achieved because the product price P_3 exceeds the marginal cost M_3
  - The result is under allocation of resources and excess production capacity of Q_4-Q_3



Oligopoly

- **Characteristics of oligopoly**
  - There are a few large producers
  - Homogeneous or differentiated products (considerable non-price competition - heavy advertising
  - The individual firm is a “price maker” but there is still mutual interdependence
  - Entry into the industry is difficult
  - Mergers

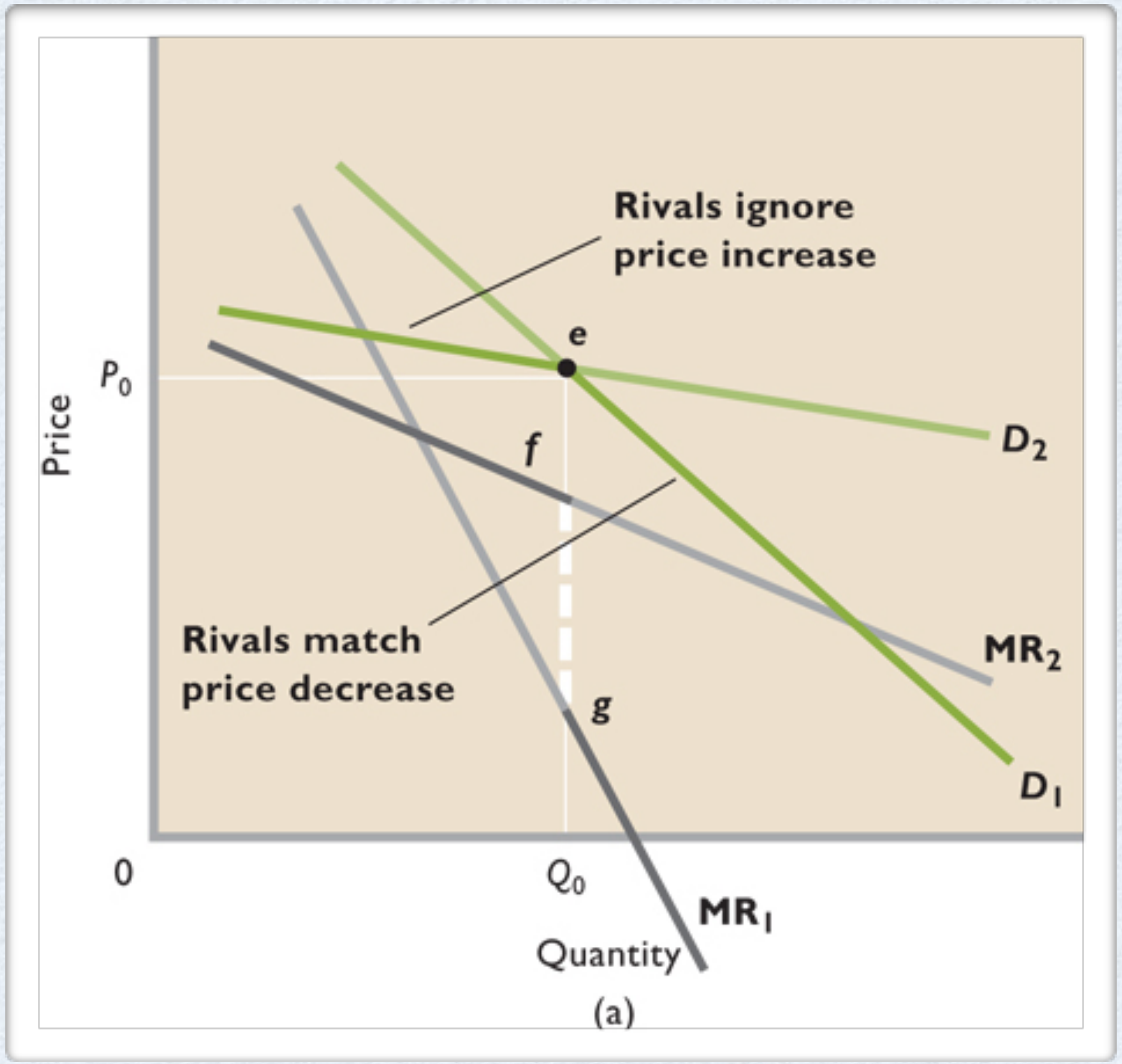
Oligopoly

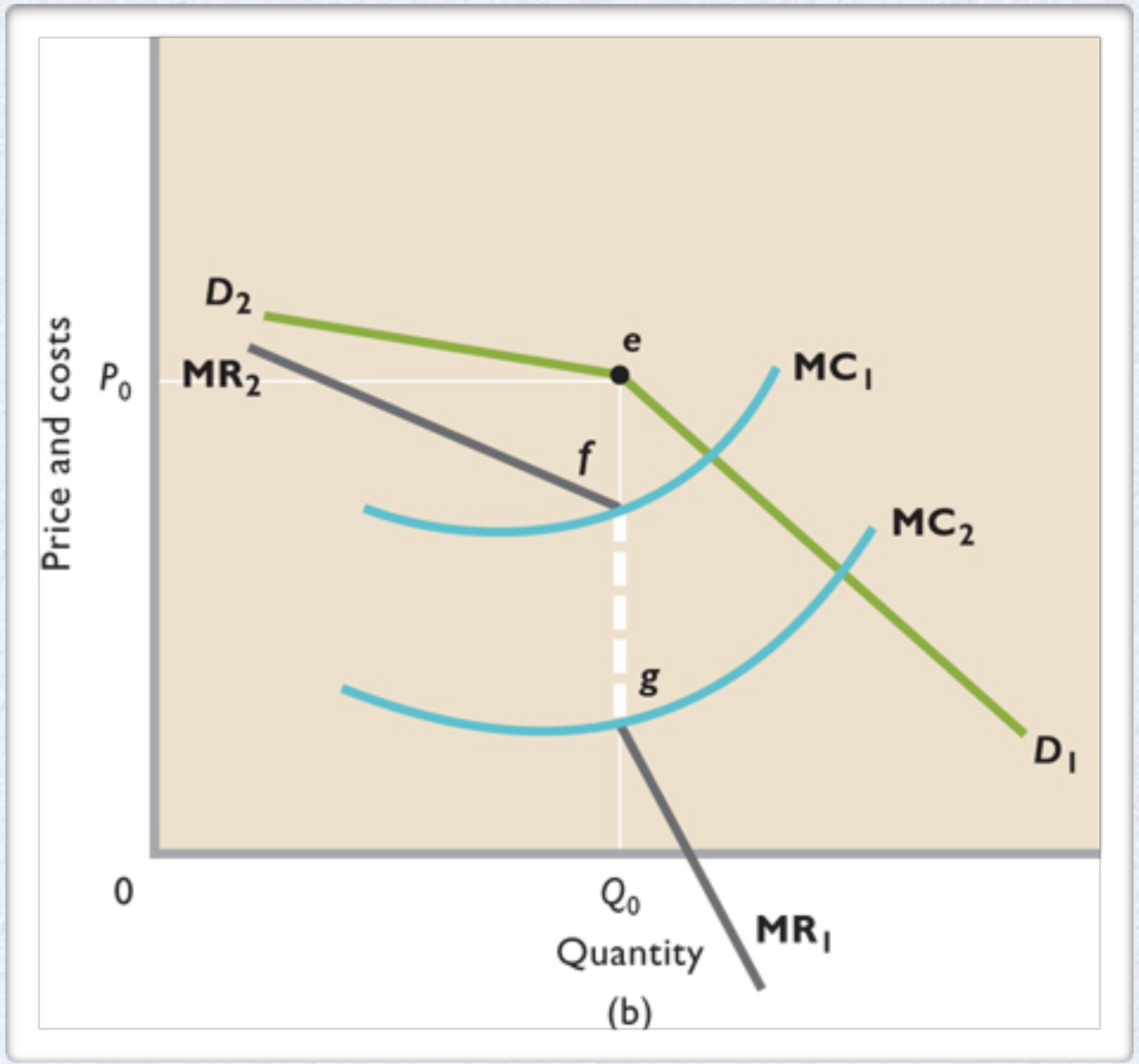
- **Measures of industry concentration**
  - Concentration ratio (eg. 4 firm concentration ratio)
  - Herfindahl index - takes the sum of squared percentage market shares $(\%S_1)^2 + (\%S_2)^2 + (\%S_3)^2$ ...
- **Kinked demand curve - noncollusive oligopoly**
  - ***Assumptions:*** *Firms are independent and the shape of the demand curve depends on how the firm's rivals will react to a price change*
  - **Match price changes - price changes will be matched by firms**
    - If a firm **lowers the price**, it has not much to gain because it will be matched. If **firms increase the price**, they will loose customers to other industries
  - **Ignore price changes - price changes will not be matched by rival firms**
    - If a firm **lowers its price**, it will gain significantly as rival firms will not match the price change
    - If the firm increases its price, it will loose because rivals will not match the price change

Oligopoly

- **Cartels - a form of collusion - OPEC**
  - Output must b controlled in order to maintain the agreed upon price
  - Cartels are illegal in the US

D1 - match; D2 - ignore;





Oligopoly

- **Price leadership** - a dominant firm initiates price changes and the rest of the firms follow
- **Oligopoly and advertising** - Advertising is preferred than competition based on price
  - They are less easily duplicated
  - Must have sufficient financial resources
- **Oligopoly and efficiency** - neither productive nor allocative efficiency