

CHAPTER 16

Monopolistic Competition

PRINCIPLES OF
Economics
N. Gregory Mankiw

Premium PowerPoint Slides
by Ron Cronovich

© 2009 South-Western, a part of Cengage Learning, all rights reserved

**In this chapter,
look for the answers to these questions:**

- § What market structures lie between perfect competition and monopoly, and what are their characteristics?
- § How do monopolistically competitive firms choose price and quantity? Do they earn economic profit?
- § In what ways does monopolistic competition affect society's welfare?
- § What are the social costs and benefits of advertising?

1

**Introduction:
Between Monopoly and Competition**

Two extremes

- § Perfect competition: many firms, identical products
- § Monopoly: one firm

In between these extremes: imperfect competition

- § **Oligopoly:**
- § **Monopolistic competition:**

MONOPOLISTIC COMPETITION

2

Characteristics & Examples of Monopolistic Competition

Characteristics:

Examples:

- § apartments
- § books
- § bottled water
- § clothing
- § fast food
- § night clubs

MONOPOLISTIC COMPETITION

3

Comparing Perfect & Monop. Competition

	Perfect competition	Monopolistic competition
number of sellers		
free entry/exit		
long-run econ. profits		
the products firms sell		
firm has market power?		
D curve facing firm		

MONOPOLISTIC COMPETITION

4

Comparing Monopoly & Monop. Competition

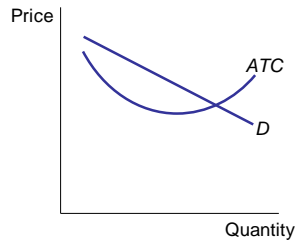
	Monopoly	Monopolistic competition
number of sellers		
free entry/exit		
long-run econ. profits		
firm has market power?		
D curve facing firm		
close substitutes		

MONOPOLISTIC COMPETITION

5

A Monopolistically Competitive Firm Earning Profits in the Short Run

The firm faces a downward-sloping D curve.
 At each Q ,
 To maximize profit, firm produces Q where



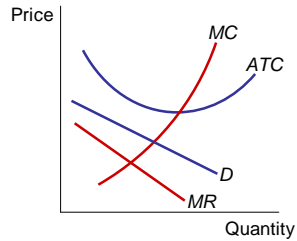
MONOPOLISTIC COMPETITION

6

A Monopolistically Competitive Firm With Losses in the Short Run

For this firm,

The best this firm can do is



MONOPOLISTIC COMPETITION

7

Monopolistic Competition and Monopoly

§ *Short run:* Under monopolistic competition,

§ *Long run:* In monopolistic competition,

§ If profits in the short run:

§ If losses in the short run:

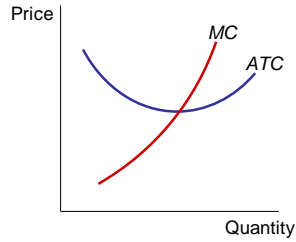
MONOPOLISTIC COMPETITION

8

A Monopolistic Competitor in the Long Run

Entry and exit occurs until

Notice that the firm charges a markup of price over marginal cost and does not produce at minimum ATC.



MONOPOLISTIC COMPETITION

9

Why Monopolistic Competition Is Less Efficient than Perfect Competition

1.

§ The monopolistic competitor operates on the downward-sloping part of its ATC curve,

§ Under perfect competition, firms produce the quantity that

2.

§ Under monopolistic competition,

§ Under perfect competition,

MONOPOLISTIC COMPETITION

10

Monopolistic Competition and Welfare

§ Monopolistically competitive markets do not have all the desirable welfare properties of perfectly competitive markets.

§ Because $P > MC$,

§ Yet, not easy for policymakers to fix this problem:

MONOPOLISTIC COMPETITION

11

Monopolistic Competition and Welfare

§ Number of firms in the market may not be optimal, due to external effects from the entry of new firms:

§ **The product-variety externality:**

§ **The business-stealing externality:**

§ The inefficiencies of monopolistic competition are subtle and hard to measure. No easy way for policymakers to improve the market outcome.

MONOPOLISTIC COMPETITION

12

ACTIVE LEARNING 1

Advertising

1. So far, we have studied three market structures: perfect competition, monopoly, and monopolistic competition. In each of these, would you expect to see firms spending money to advertise their products? Why or why not?
2. Is advertising good or bad from society's viewpoint? Try to think of at least one "pro" and "con."

13

Advertising

§ In monopolistically competitive industries,

lead naturally to the use of advertising.

§ In general,
the more advertising firms buy.

§ Economists disagree about the social value of advertising.

MONOPOLISTIC COMPETITION

14

The Critique of Advertising

§ Critics of advertising believe:

MONOPOLISTIC COMPETITION

15

The Defense of Advertising

§ Defenders of advertising believe:

§ Results of a prominent study:

Eyeglasses were more expensive in states that prohibited advertising by eyeglass makers than in states that did not restrict such advertising.

MONOPOLISTIC COMPETITION

16

Advertising as a Signal of Quality

A firm's willingness to spend huge amounts on advertising

§ Ads may convince buyers to try a product once, but the product must be of high quality for people to become repeat buyers.

§ The most expensive ads are not worthwhile unless they lead to repeat buyers.

§ When consumers see expensive ads, they think the product must be good if the company is willing to spend so much on advertising.

MONOPOLISTIC COMPETITION

17

Brand Names

§ In many markets, brand name products coexist with generic ones.

§ Firms with brand names

§ As with advertising, there is disagreement about the economics of brand names...

The Critique of Brand Names

§ Critics of brand names believe:

The Defense of Brand Names

§ Defenders of brand names believe:

CONCLUSION

- § Differentiated products are everywhere; examples of monopolistic competition abound.
- § The theory of monopolistic competition describes many markets in the economy, yet offers little guidance to policymakers looking to improve the market's allocation of resources.
