Course Title: Microeconomics-II

Course Code: ECON4006

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Topic: Characteristics of Monopolistic Competition

Monopolistic Competition

- It is a form of market characterised by imperfect competition.
- It is a middle ground between monopoly and perfect competition and combines elements of each.
- Monopolistic competition is a form of competition that characterizes a number of industries that are familiar to consumers in their day-to-day lives. Examples include restaurants, hair salons, clothing, and consumer electronics.

Many Number of Firms

- There are many producers and many consumers in the market, and no business has total control over the market price.
- Also there are many firms on the side lines prepared to enter the market always posing the threat of entry in the longrun.
- The fact that there are "many firms" gives each MC firm the freedom to set prices without engaging in strategic decision making regarding the prices of other firms and each firm's actions have a negligible impact on the market. For example, a firm could cut prices and increase sales without fear that its actions will prompt retaliatory responses from competitors.
- The number of firms in the longrun depends on factors such as fixed costs, economies of scale and the degree of product differentiation.

Differentiated Product

- Firms under monopolistic competition sell products that have real or perceived non-price differences.
- However, the differences are not so great as to eliminate other goods as substitutes. The goods are best described as close but imperfect substitutes.
- The goods perform the same basic functions but have differences in qualities such as type, style, quality, reputation, appearance, and location that tend to distinguish them from each other.
- Technically, the cross price elasticity of demand between goods in such a market is positive

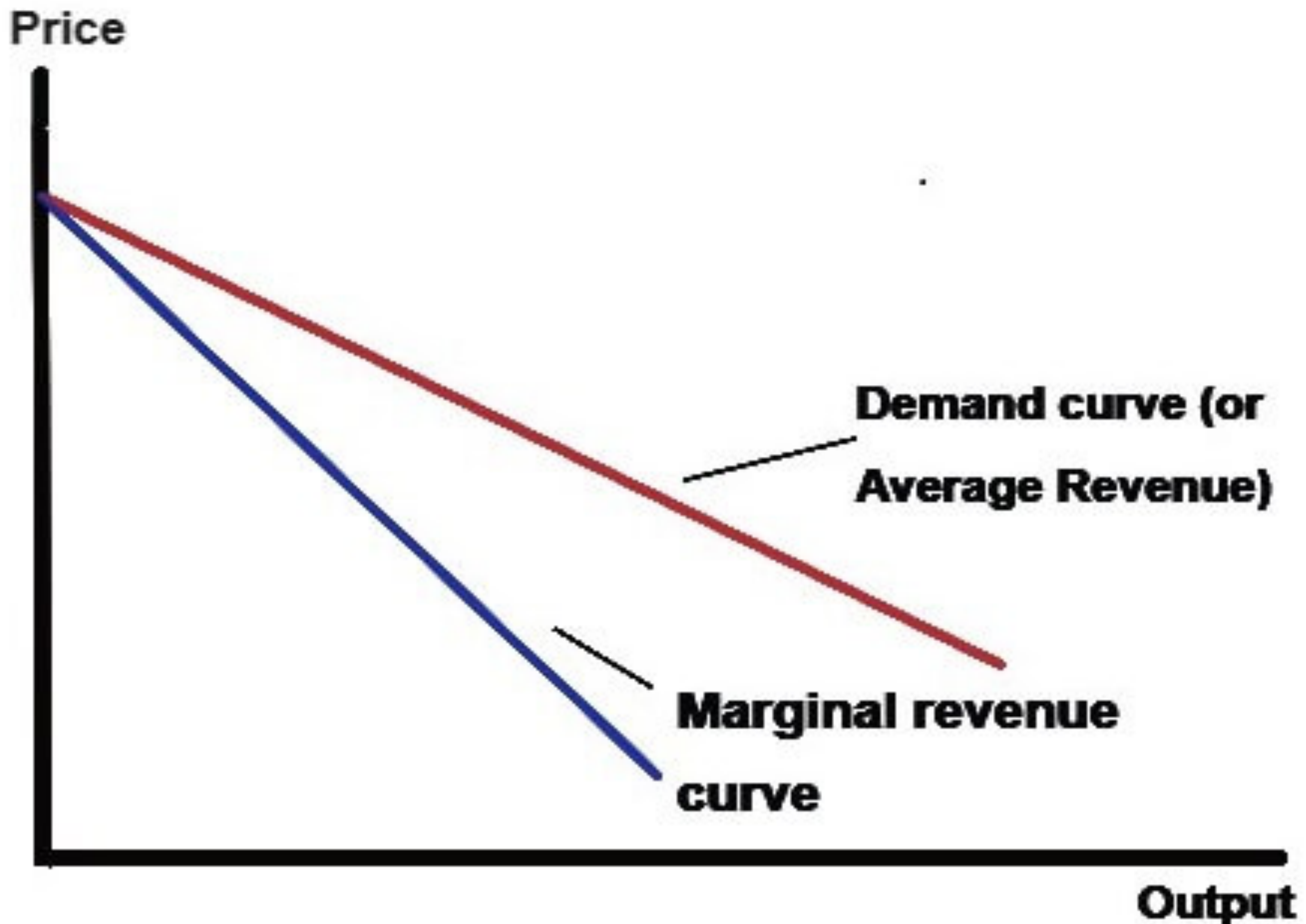
Freedom of Entry and Exit

- Like perfect competition, under monopolistic competition also, the firms can enter or exit freely in the longrun.
- The firms will enter when the existing firms are making super-normal profits. With the entry of new firms, the supply would increase which would reduce the price and hence the existing firms will be left only with normal profits.
- Similarly, if the existing firms are sustaining losses, some of the marginal firms will exit. It will reduce the supply due to which price would rise and the existing firms will be left only with normal profit.

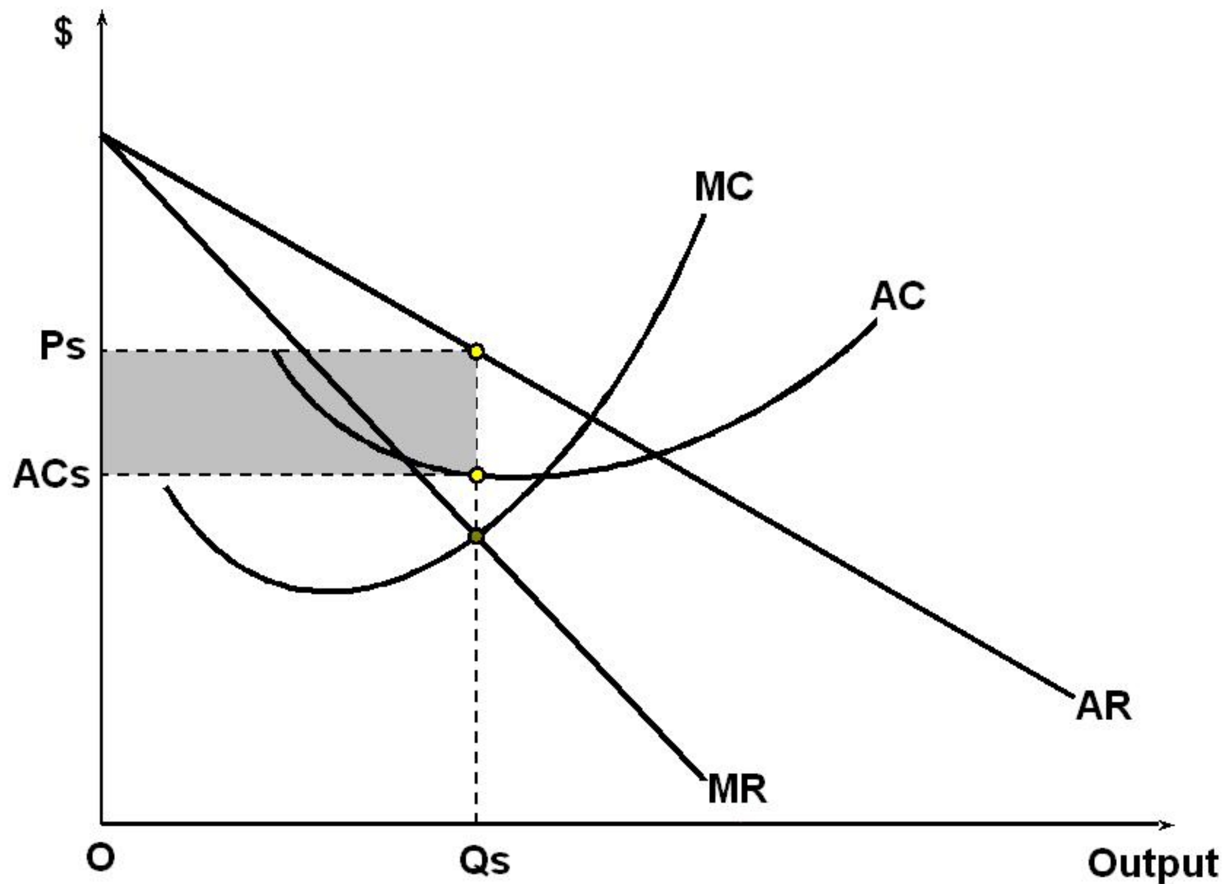
Market Power

- Monopolistic competition firms have some degree of market power. Market power means that the firm has control over the terms and conditions of exchange.
- The firms can raise its prices without losing all its customers. The firm can also lower prices without triggering a potentially ruinous price war with competitors. So they are not just price takers like perfectly competitive firms.
- Market power also means that an MC firm faces a downward sloping demand curve. The demand curve is highly elastic although not "flat".
- The basic source of market power lies in product differentiation.

Average and Marginal Revenue Curve



Equilibrium Condition



- In the above figure the equilibrium occurs at the point where the marginal cost is equal to the marginal revenue.
- The price is determined according to the AR curve.
- Profit or loss is determined according to the average revenue and average cost curves.