

Subject: Microeconomic Theory I

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Semester: Fall

Class: BS 4th

Session: 2018-22

Lecture Notes: 20th

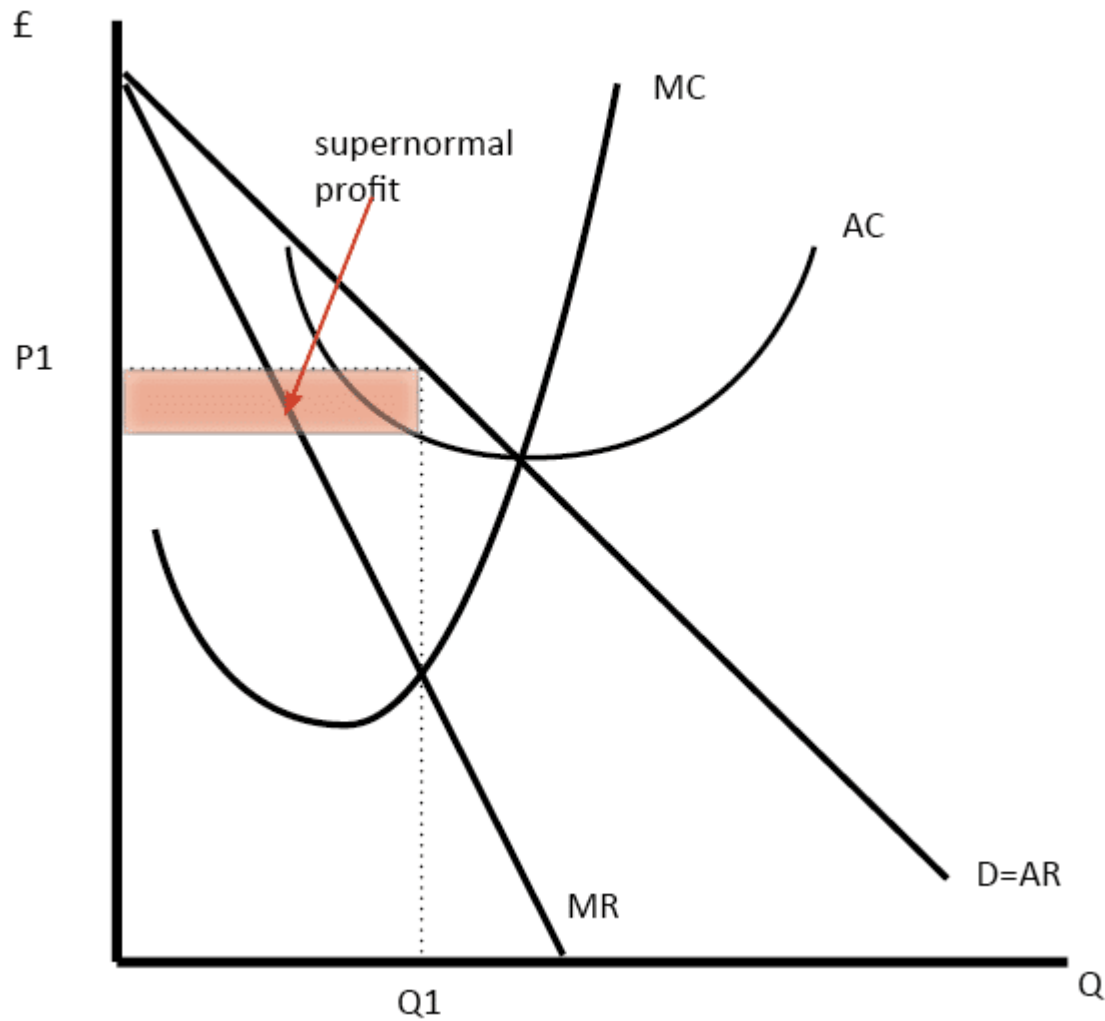
Monopolistic Competition and Economic Efficiency

Definition: Monopolistic competition is a market structure which combines elements of monopoly and competitive markets. Essentially a monopolistic competitive market is one with freedom of entry and exit, but firms can differentiate their products. Therefore, they have an inelastic demand curve and so they can set prices. However, because there is freedom of entry, supernormal profits will encourage more firms to enter the market leading to normal profits in the long term.

A monopolistic competitive industry has the following features:

- Many firms.
- Freedom of entry and exit.
- Firms produce differentiated products.
- Firms have price inelastic demand; they are price makers because the good is highly differentiated
- Firms make normal profits in the long run but could make supernormal profits in the short term
- Firms are allocatively and productively inefficient.

Diagram monopolistic competition short run

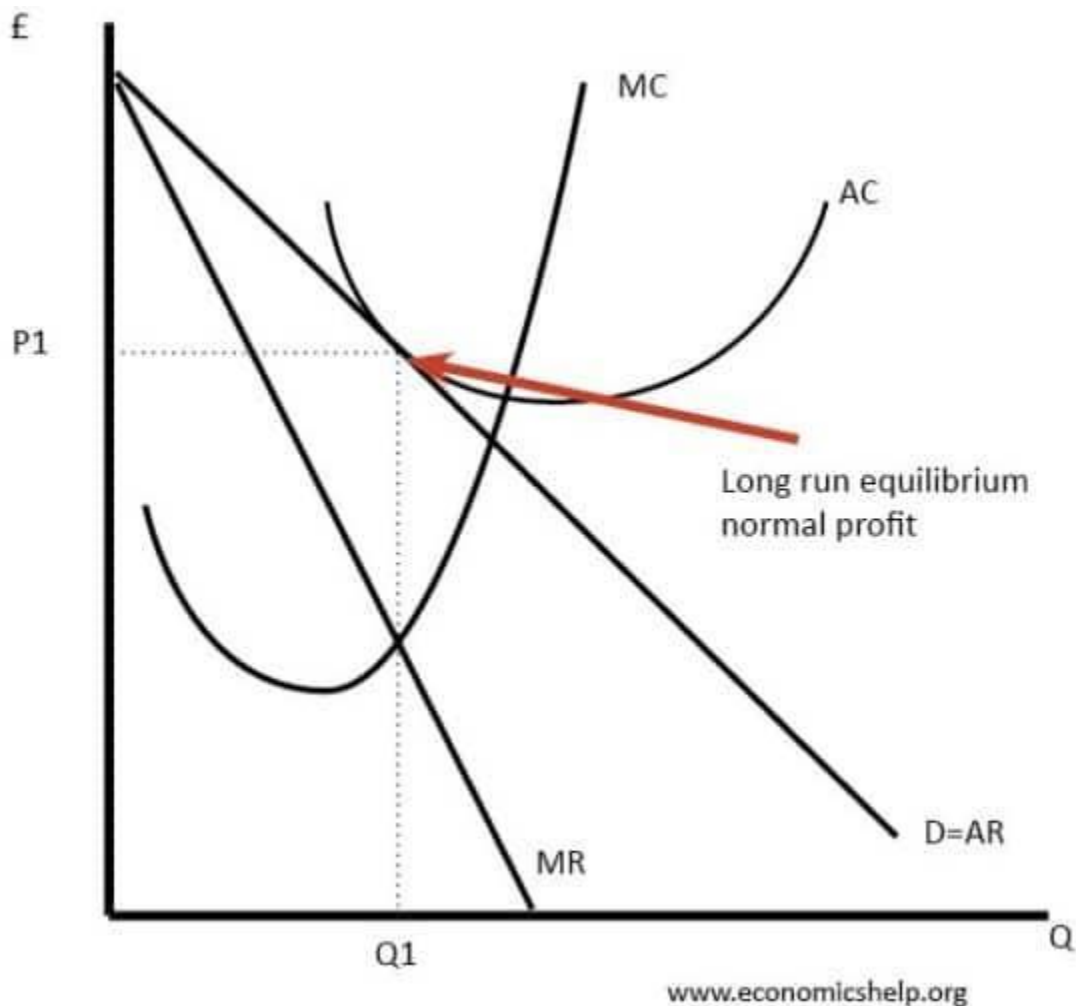


In the

short run, the diagram for monopolistic competition is the same as for a monopoly.

The firm maximises profit where $MR=MC$. This is at output $Q1$ and price $P1$, leading to supernormal profit

Monopolistic competition long run



Demand curve shifts to the left due to new firms entering the market.

In the long-run, supernormal profit encourages new firms to enter. This reduces demand for existing firms and leads to normal profit. I

Efficiency of firms in monopolistic competition

- Allocative inefficient. The above diagrams show a price set above marginal cost
- Productive inefficiency. The above diagram shows a firm not producing on the lowest point of AC curve
- Dynamic efficiency. This is possible as firms have profit to invest in research and development.

- X-efficiency. This is possible as the firm does face competitive pressures to cut cost and provide better products.

Examples of monopolistic competition

- Restaurants – restaurants compete on quality of food as much as price. Product differentiation is a key element of the business. There are relatively low barriers to entry in setting up a new restaurant.
- Hairdressers. A service which will give firms a reputation for the quality of their hair-cutting.
- Clothing. Designer label clothes are about the brand and product differentiation
- TV programmes – globalisation has increased the diversity of tv programmes from networks around the world. Consumers can choose between domestic channels but also imports from other countries and new services, such as Netflix.

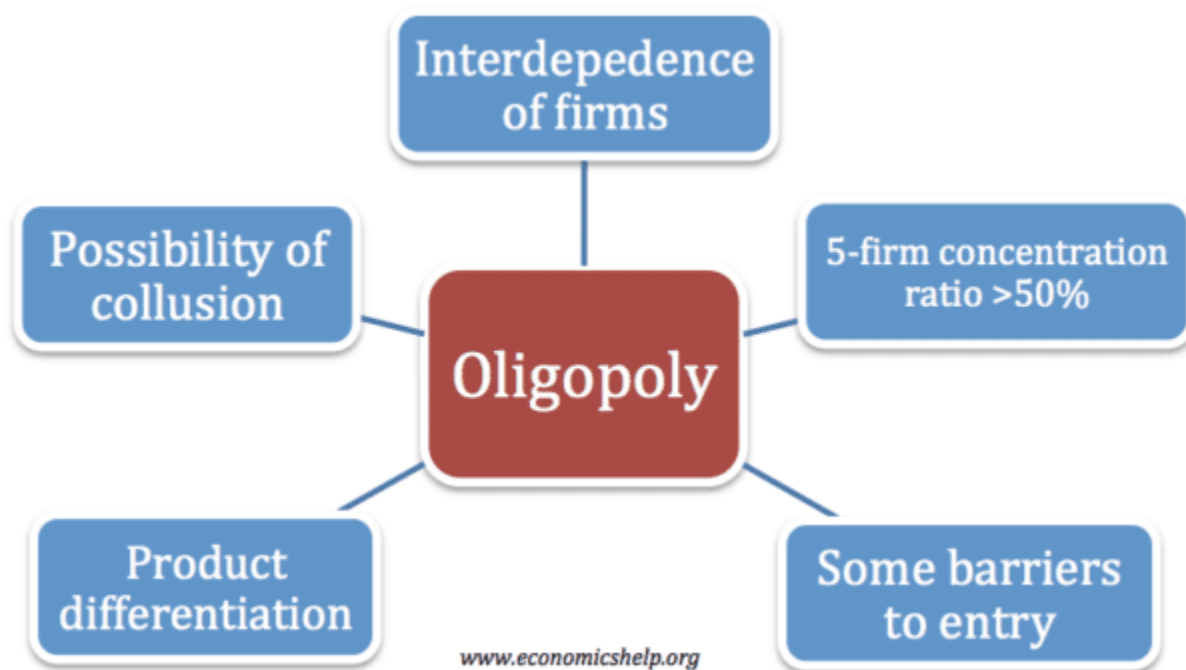
Limitations of the model of monopolistic competition

- Some firms will be better at brand differentiation and therefore, in the real world, they will be able to make supernormal profit.
- New firms will not be seen as a close substitute.
- There is considerable overlap with oligopoly – except the model of monopolistic competition assumes no barriers to entry. In the real world, there are likely to be at least some barriers to entry
- If a firm has strong brand loyalty and product differentiation – this itself becomes a barrier to entry. A new firm can't easily capture the brand loyalty.
- Many industries, we may describe as monopolistically competitive are very profitable, so the assumption of normal profits is too simplistic.

Oligopoly

Definition of oligopoly

An oligopoly is an industry dominated by a few large firms. For example, an industry with a five-firm concentration ratio of greater than 50% is considered a monopoly.



Examples of oligopolies

Car industry – economies of scale have caused mergers so big multinationals dominate the market. The biggest car firms include Toyota, Hyundai, Ford, General Motors, VW.

- Petrol retail – see below.
- Pharmaceutical industry
- Coffee shop retail – Starbucks, Costa Coffee, Cafe Nero
- Newspapers – In UK market share dominated by tabloids Daily Mail, The Sun, The Mirror, The Star, Daily Express.
- Book retail – In UK market share is dominated by Waterstones, Amazon and smaller firms like Blackwells.

The main features of oligopoly

An industry which is dominated by a few firms.

- **Interdependence of firms** – companies will be affected by how other firms set price and output.
- **Barriers to entry.** In an oligopoly, there must be some barriers to entry to enable firms to gain a significant market share. These barriers to entry may include brand loyalty or economies of scale. However, barriers to entry are less than monopoly.

- **Differentiated products.** In an oligopoly, firms often compete on non-price competition. This makes advertising and the quality of the product are often important.
- Oligopoly is the most common market structure

Books

1. Pindyck and Rubinfeld with Mehta (2005), Microeconomics- latest available Edition in market.
2. D.N Dwivedi (2016), Microeconomics Theory and Application-- latest available Edition in market.
3. Walter Nicholson, Microeconomic Theory, Tenth Edition, Thomas Learning New York
4. Koutsoyiannis, A., Modern Microeconomics, Macmillan, London.