



CHAPTER 16 Monopolistic Competition and Product Differentiation

The Meaning of Monopolistic Competition

Monopolistic competition is a market structure in which

- there are many competing producers in an industry,
- each producer sells a differentiated product, and
- there is free entry into and exit from the industry in the long run.

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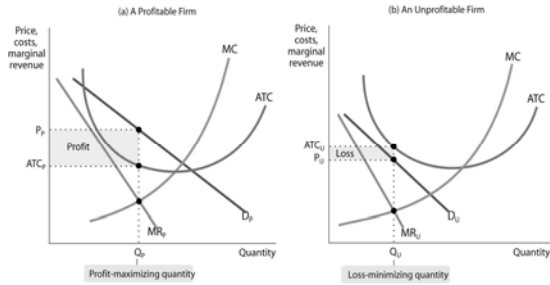
Product Differentiation

There are three important forms of product differentiation:

- **Differentiation by style or type** – Sedans vs. SUV's
- **Differentiation by location** – Dry cleaner near home vs. Cheaper dry-cleaner far away
- **Differentiation by quality** – Ordinary (\$) vs. gourmet chocolate (\$\$\$)

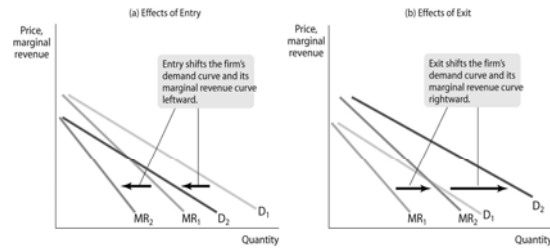
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The Monopolistically Competitive Firm in the Short Run



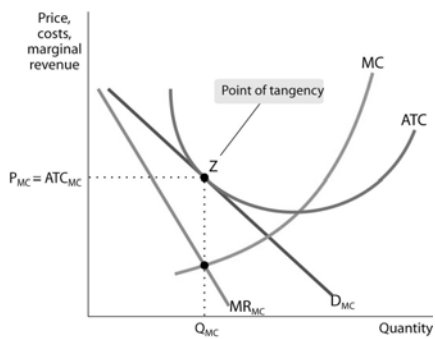
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Entry and Exit into the Industry Shift the Demand Curve of Each Firm



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The Long-Run Zero-Profit Equilibrium



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Monopolistic Competition versus Perfect Competition

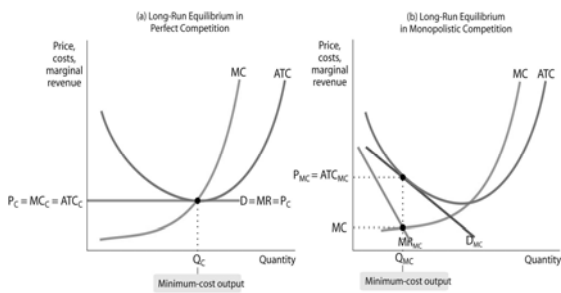
In the long-run equilibrium of a monopolistically competitive industry, there are many firms, all earning zero profit.

Price exceeds marginal cost so some mutually beneficial *trades are not exploited*.

The following figure compares the long-run equilibrium of a typical firm in a perfectly competitive industry with that of a typical firm in a monopolistically competitive industry.

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Comparing Long-Run Equilibrium in Perfect Competition and Monopolistic Competition



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Monopolistic Competition versus Perfect Competition

- In the long run, firms do not make economic profits in either.
- Excess capacity means that each producer could serve more customers.
- The monopolistically competitive firm is not producing at the minimum average cost.
- The marginal value of more output is greater than the marginal cost, so there is a deadweight loss.
- Can the government “fix” this market failure?

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Advertising and Brand Names

- These arguments tie into larger arguments concerning the role that advertising and brand names play in product differentiation.
- How do products that are nearly identical come to be seen as very different in the minds of consumers?
- Monopolistic competition is not only an example of imperfect competition, but also one of imperfect information. Consumers do not have enough information about product quality. Thus, they rely on reputation, experience and brand names to tell them about quality.

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Advertising

- Advertising is used to convince buyers that the advertised product is different, and better than similar products on the market. The firm's demand curve can increase, and become steeper.
- Advertising is also costly. If successful, advertising's marginal benefit exceeds its marginal cost. But it is not always successful.
- Advertising conveys information to the consumer.

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Advertising by type of market

- In perfect competition, products are homogeneous and firms can sell all they want at the market price, but cannot affect that price through their own actions. Advertising does not pay for the firm, even if it might benefit the industry.
- In oligopoly with homogeneous products, advertising is unlikely to pay.
- In oligopoly with differentiated products, advertising is likely to be a prisoner's dilemma, but implicit collusion is possible.
- In unregulated monopoly, advertising can pay if firms can increase overall market demand.
- In regulated monopoly, advertising is less likely to pay since firms are restricted in their prices or profits. Firms are more likely to advertise that they are good citizens, to persuade government to regulate them less.

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In Monopolistic Competition...

- Products are more differentiated and consumers lack information on differences, so advertising is most likely to pay for the firm.
- Advertising is likely to be a prisoner's dilemma, but many firms makes implicit collusion unlikely.
- Advertising may *help* create a reputation by getting consumers to try the product, but reputation will be established based on consumer experiences.
- Advertising is more likely to pay if customers become loyal as a result of their experience. With one-time purchases (house, car), false advertising might work. But for most products, repeat business matters.
- Firms can signal quality with more expensive advertising, since consumers may reason that only a firm with good quality products would be willing to spend so much because they believe that once you try it you will keep buying.

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Brand Names

- Equally important to firms trying to differentiate their product is the ability to establish brand names.
- Brand names are often (but not always) a signal for high quality.
- Brand names are usually registered trademarks, so other firms cannot legally infringe with similar names (Quaker Oaks). They can be traded on markets.
- To be valuable, a brand name must be associated in the consumer's mind with a good reputation. Advertising helps, but the customer's experience matters more in the long run.
- Good reputations and trademarks can lead to economic profits in the long run, called "reputation rents."

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Brand Names

- Consumers will often purchase a brand name (at a higher price) over a non-brand name:
 - Canned tomatoes
 - Mom and pop motel vs. Motel 6
 - Generics
- If brand names are no more than a differentiation of identical products, then, economically, society may be worse off.
- However, brand names can convey information and may be socially beneficial for that reason.
 - You know what you are getting with Motel 6
 - Burger Kings have identical standards for all restaurants

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Search Problem

- When consumers have imperfect information, they do not know which products best meet their desires, and they need to search for the best quality products at the lowest prices.
- Search is costly. Consumers must decide whether the marginal benefit of more search is greater than the marginal cost, but they do not exactly know the marginal benefit of more search.
- Stores that reduce search costs (e.g., supermarkets, Walmarts) can often gain customer loyalty, and this would make them more profitable even without any economies of scale.
- Advertising and brands can help reduce search costs.
- By reducing imperfect information, advertising can (in theory) be welfare-enhancing, even though it might not be.

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In conclusion, a Comparison of Market Structures

	Perfect Competition	Monopoly	Monopolistic Competition	Oligopoly
Number of firms	Most	One	Many	Few
Control over price	None	Complete	Limited	Some
Product differences	None	None	Some	None or some
Barriers to entry	None	Insurmountable	Low	Substantial
Examples	Wheat	Local electricity	Convenience stores	Automobiles

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