

MONOPOLISTIC COMPETITION

It refers to market situation in which relatively large number of small producers offering similar but non identical products. It does not require hundreds or thousands of firms but only a fairly large number say 25, 50, or 70.

Following are the other important features of monopolistic competition.

1. Each firm possesses small proportion of the total market, so it has a limited control over market price.
2. The presence of large number of firms makes it impossible to collude or price rigging.
3. There are numerous firms in the industry; there is no feeling of mutual interdependence among them.
4. It is quite easy to enter to or exit from the industry. This characteristics and presence of large number of firms provide the 'competitive' aspect of monopolistic competition
5. Product differentiation leads to a downward slope in each seller's demand curve.
6. Demand curve is relatively elastic because of the presence of many close substitutes.

Firm's equilibrium point

In our model main objective is profit maximization; therefore firm is in equilibrium at that point where marginal revenue equates marginal cost.

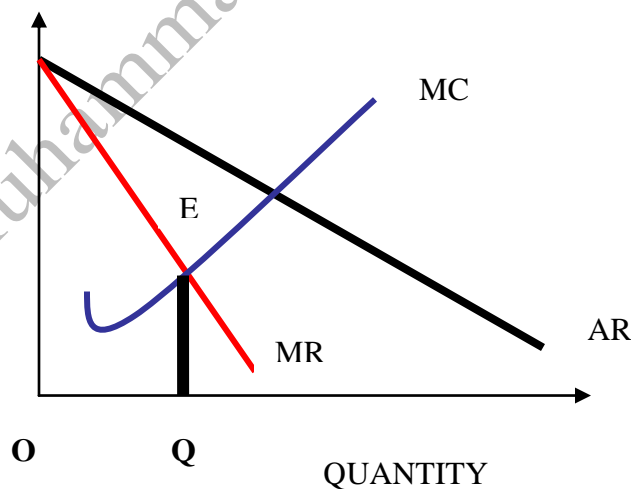


Fig.1

In the above diagram firm is in equilibrium at point E where $MR=MC$. Therefore equilibrium output will be OQ .

The Short Run: Profit or Loss

The firm will maximize its profit or minimize its loss in the short run by producing that output designated by the intersection of marginal cost and marginal revenue. In certain circumstances firm may make abnormal or economic profit because at equilibrium output its AR is greater than its AC as is shown in fig.2. But there is an ease on the entrance of new firms, therefore firm's demand curve (AR) shifts down wards. Now less favourable cost and demand situation may exist, putting the monopolistic competitive firm in the position of to make normal profit ($AR=AC$) as shown in fig.3 or realizing losses in the short run ($AR<AC$) as shown in fig.4

Short Run profits ($AR>AC$)

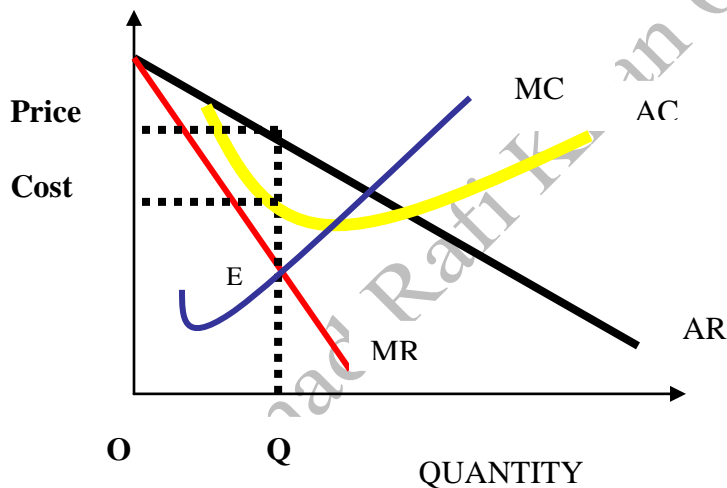


Fig.2

Short Run Normal Profits ($AR=AC$)

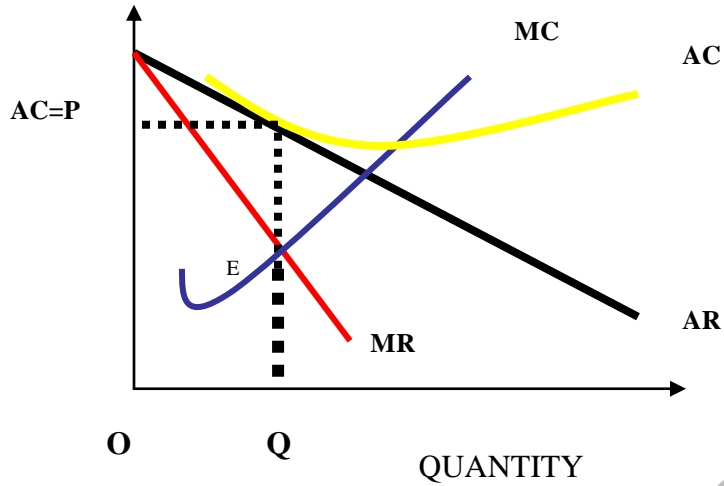


Fig.3

Short Run Losses ($AR < AC$)

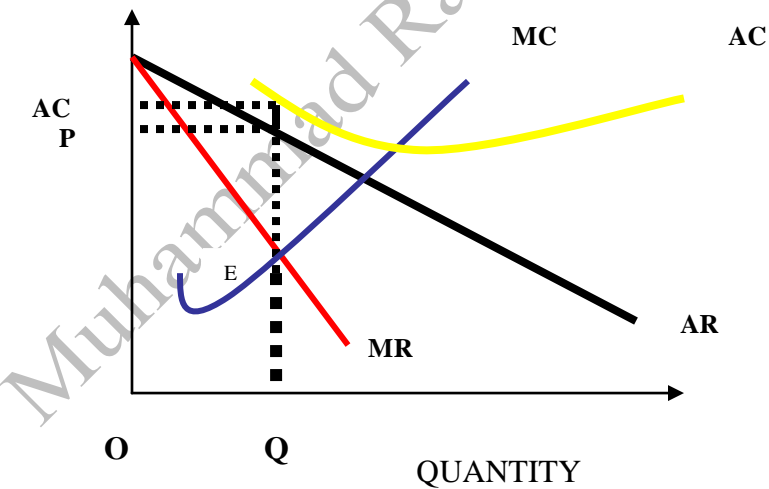


Fig.4

The Long Run: Break even or Normal Profit

In the long run, however, the tendency is for monopolistically competitive firm to earn normal profit or, in other words break even. In the short run abnormal profit may attract new rivals, because entry is relatively easy. As new firms enter, the demand curve faced by the typical firm will fall and shift to the left and become more elastic. Because each firm has a smaller share of the total demand and now faces a large number of close substitute products. This in turn tend to cause the disappearance of economic profit.. When the demand curve is tangent to the AC curve, at the profit maximizing out put, the firm is just breaking even.

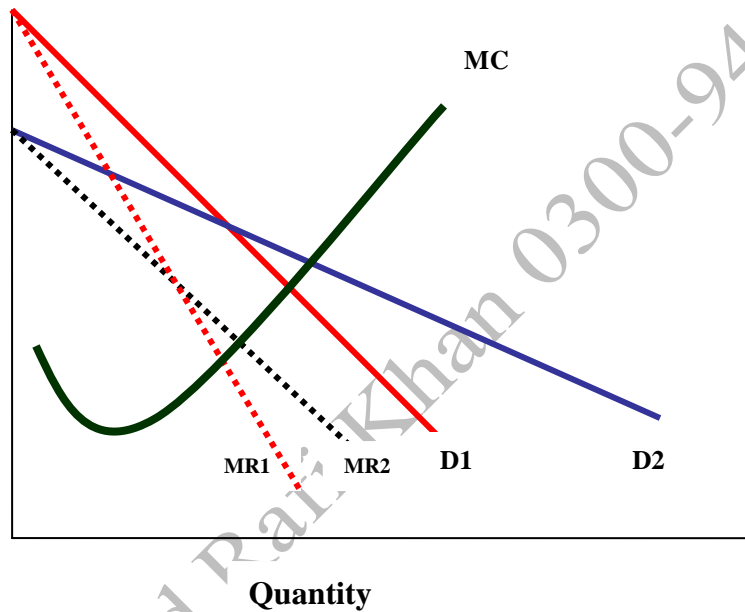


Fig.5

In fig.5 firm's initial demand curve is D1 and their marginal revenue curves is MR1, but as new firms enter its demand curve falls and become more elastic. Therefore new demand curve will be D2 and new marginal curve is MR2. Provided that there is no change in its marginal cost and average cost, firm will make just normal profit and its average cost make tangent to its new average revenue curve as shown in fig.6.

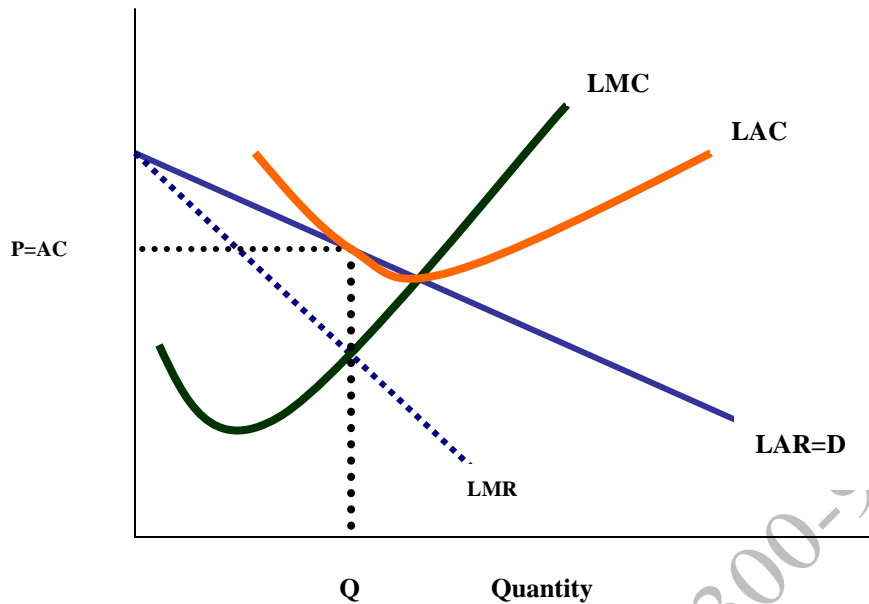


Fig.6

Excess capacity under monopolistic competition:

In fig.6, equilibrium output at point Q , where ATC is still falling. ATC is minimum at that point where MC curve intersect ATC curve. This is a larger output than Q . In other words firms under monopolistic competition do not achieve productive efficiency. They do not produce at minimum average cost as occurs in perfect competition.

Furthermore, in monopolistic competition monopolistic element causes a modest under allocation of resources, as is shown in fig.6, where price is charged above than the marginal cost of the firm, even though firm is making normal profit.