Test Yourself! Monopolistic Competition and Oligopoly

I have to keep testing myself.
Eartha Kitt

What is imperfect competition?

Imperfect competition is a market structure between the extremes of perfect competition and monopoly.

What are some of the characteristics of a monopolistic competition market?

A monopolistic market is characterized by

- many sellers with limited market power
- similar but differentiated (by branding, quality, etc) product
- low entry and exit barriers

How many is *many* sellers?

The *many sellers* condition is met when each firm is so small relative to the total market that its pricing decisions have a negligible effect on the market price.

What is product differentiation?

Product differentiation is the process of creating real or apparent non-price differences between goods and services.

What does *easy entry easy exit* mean?

Easy entry easy exit means there are low barriers to entry and exit the market.

Entry and exit are not quite as easy as in a perfectly competitive market but they are a lot easier than in a monopoly or oligopoly market.

What is a barrier to entry in monopolistic competition?

In a monopolistic competition market barriers to entry and exit are few and none are significant but they can include:

- government regulation
- startup costs
- resource ownership
- brand loyalty
- need for product differentiation through advertising, packaging, etc
- bundling

What is nonprice competition?

Nonprice competition refers to firms competing through their advertising, packaging, product development, quality, service, etc rather than competing by lowering prices.

Why is a firm in a monopolistic competitive market a price maker?

A firm in a monopolistic competitive market is a price maker because product differentiation gives it some independent control over price (market power). It is a price maker not a price taker as in a competitive market. However, the price elasticity of demand is higher than it would be under a monopoly, so the firm can lose customers if it raises prices too much.

What does a firm's demand curve look like in a monopolistic competitive market?

In a monopolistic competitive market a firm’s demand curve is less elastic (steeper) than that of a firm in a perfectly competitive market but more elastic (flatter) than that of a firm in a monopolistic market.

What are examples of monopolistic competition?

Some general examples of monopolistic competition are:

- grocery stores
- hair salons
- gas stations
- video rental stores
- restaurants
- cosmetics
- coffee
- laundry detergent
- shoes
- clothing

How effective is advertising?

Advertising is the most prominent form of non-price competition.

Advertising may be more responsible for brand loyalty than the quality of the product.

Firms use advertising to signal the high quality of their products. Advertising provides consumers with valuable information on product availability, quality and price needed to make efficient choices in the market place.

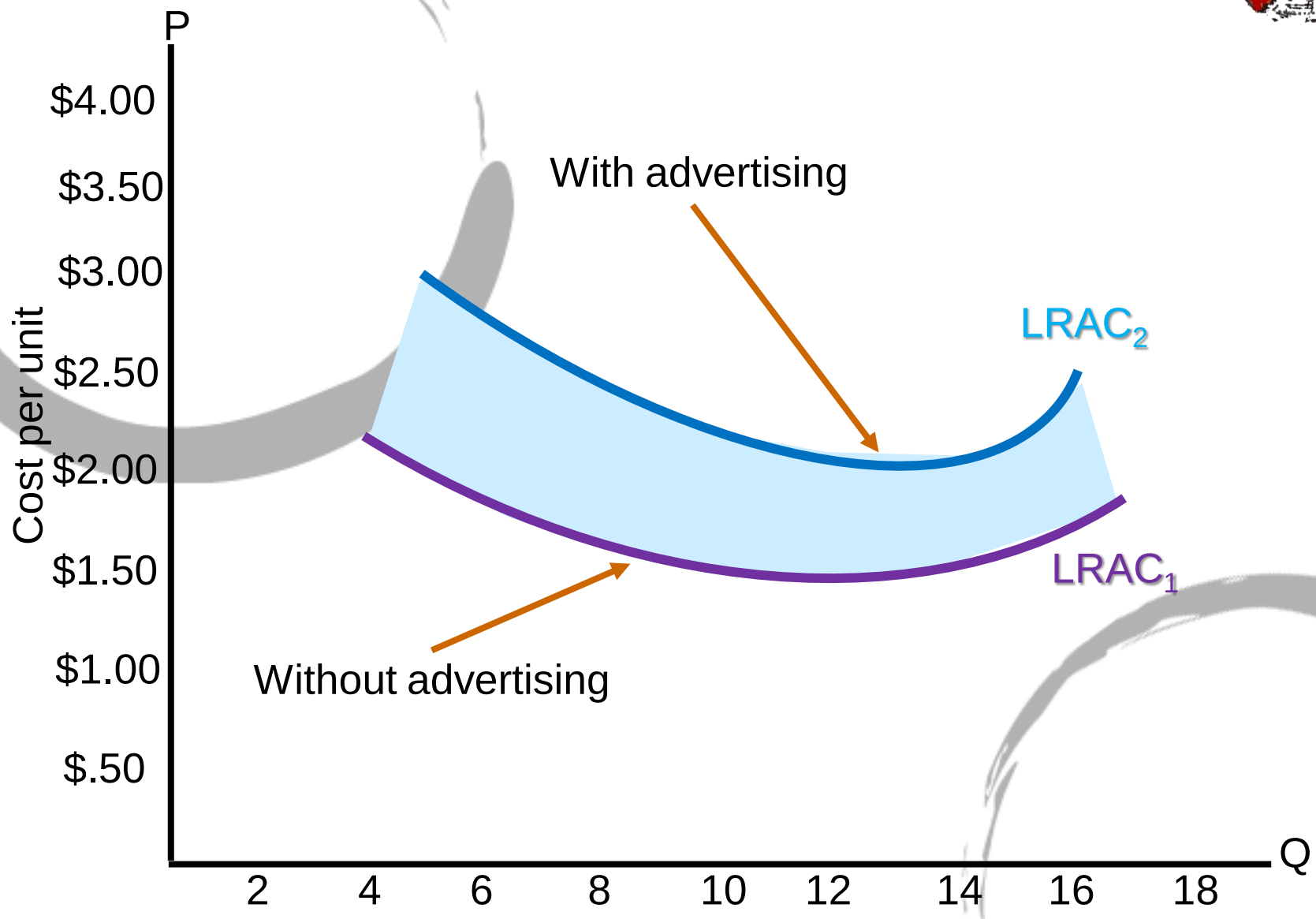
Advertising is very important in a monopolistic competition market and is effective in the short-run.

It seems to be less effective in the long-run.

What effect does advertising have on average costs?

Advertising raises the long-run average cost curve (and the price to the consumer).

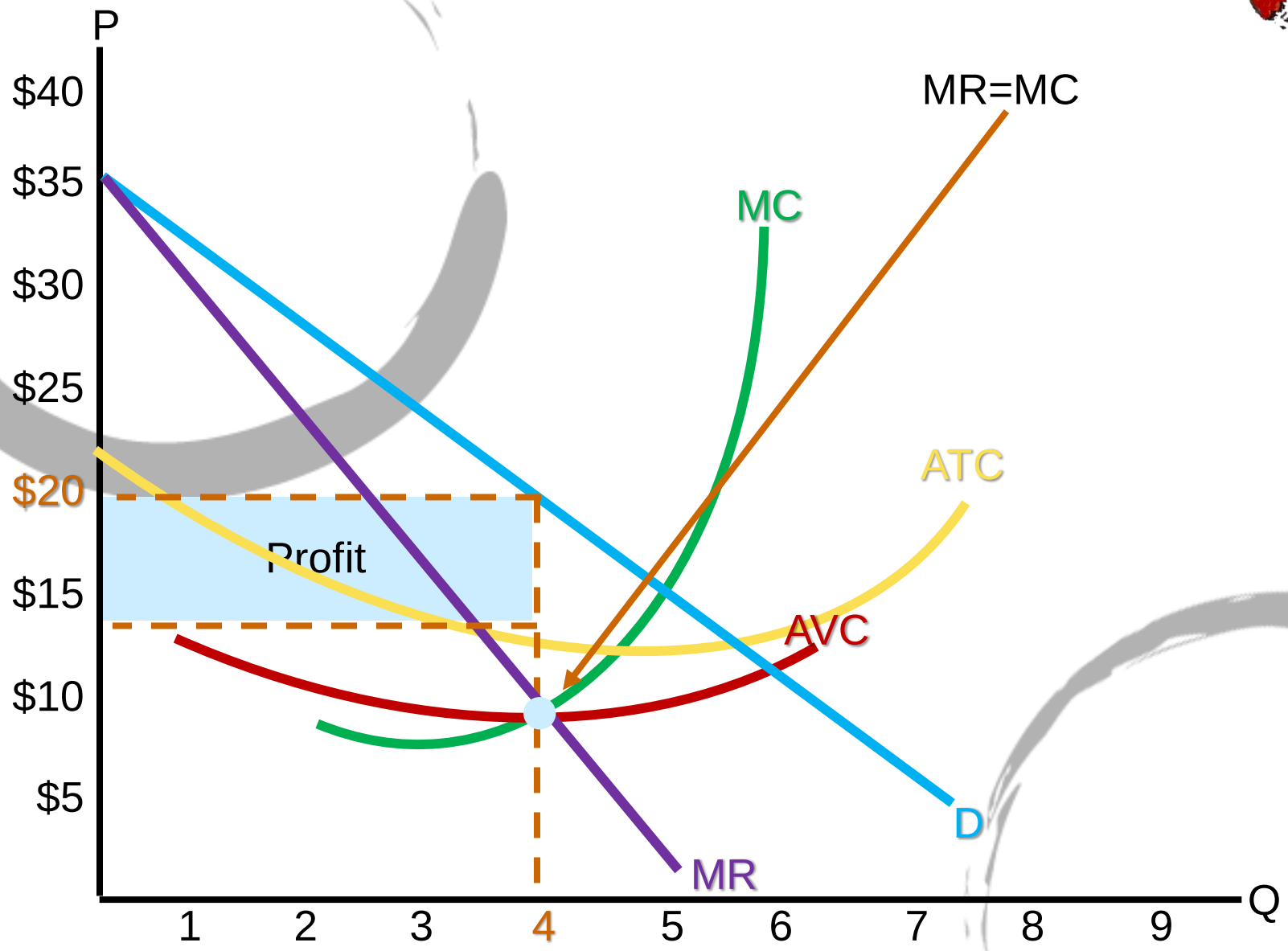
Chart: The Effect of Advertising



How does a firm decide what price to charge and how many units to produce?

Production and pricing are set at the point at which MR = MC.

Chart: MR = MC



What is a normal profit ?

Normal profit is the minimum amount of money that will keep a firm in the market.

Why is a normal profit made in the long-run?

Normal profit is made in the long-run because of the relatively easy entry easy exit characterizing monopolistic competition markets.

New entrants will continue to enter as long as there are profits.

What happens when economic profits are being made?

Because of the low barriers to entry and exit, some firms will leave the industry.

Demand shifts to the right for each firm left, market price increases and profits are restored.

At what point is the market tending toward?

The market tends toward a normal profit, which is a zero economic profit.

Diagram: Zero Economic Profit

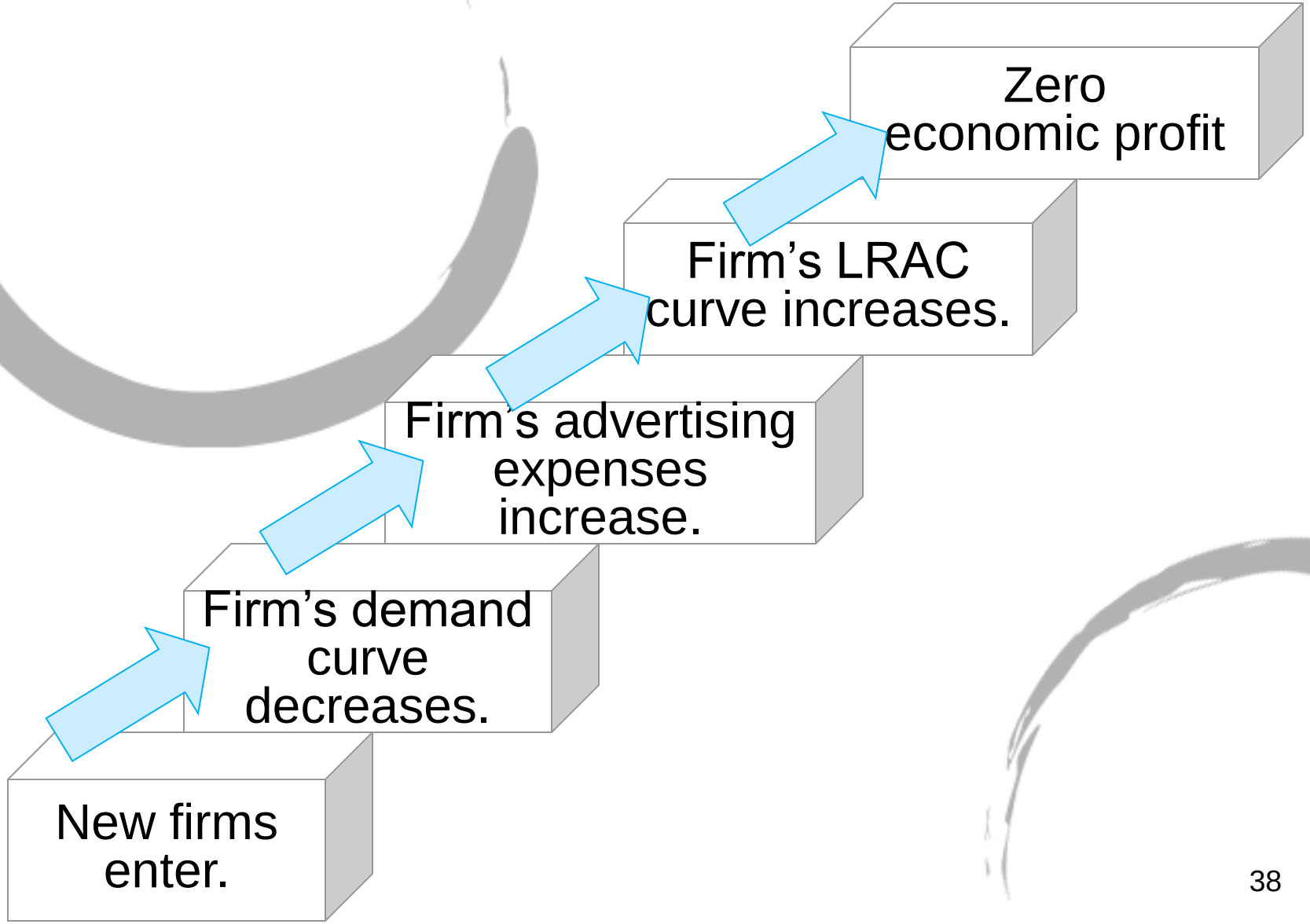


Chart: Monopolistic Competition in the Long Run

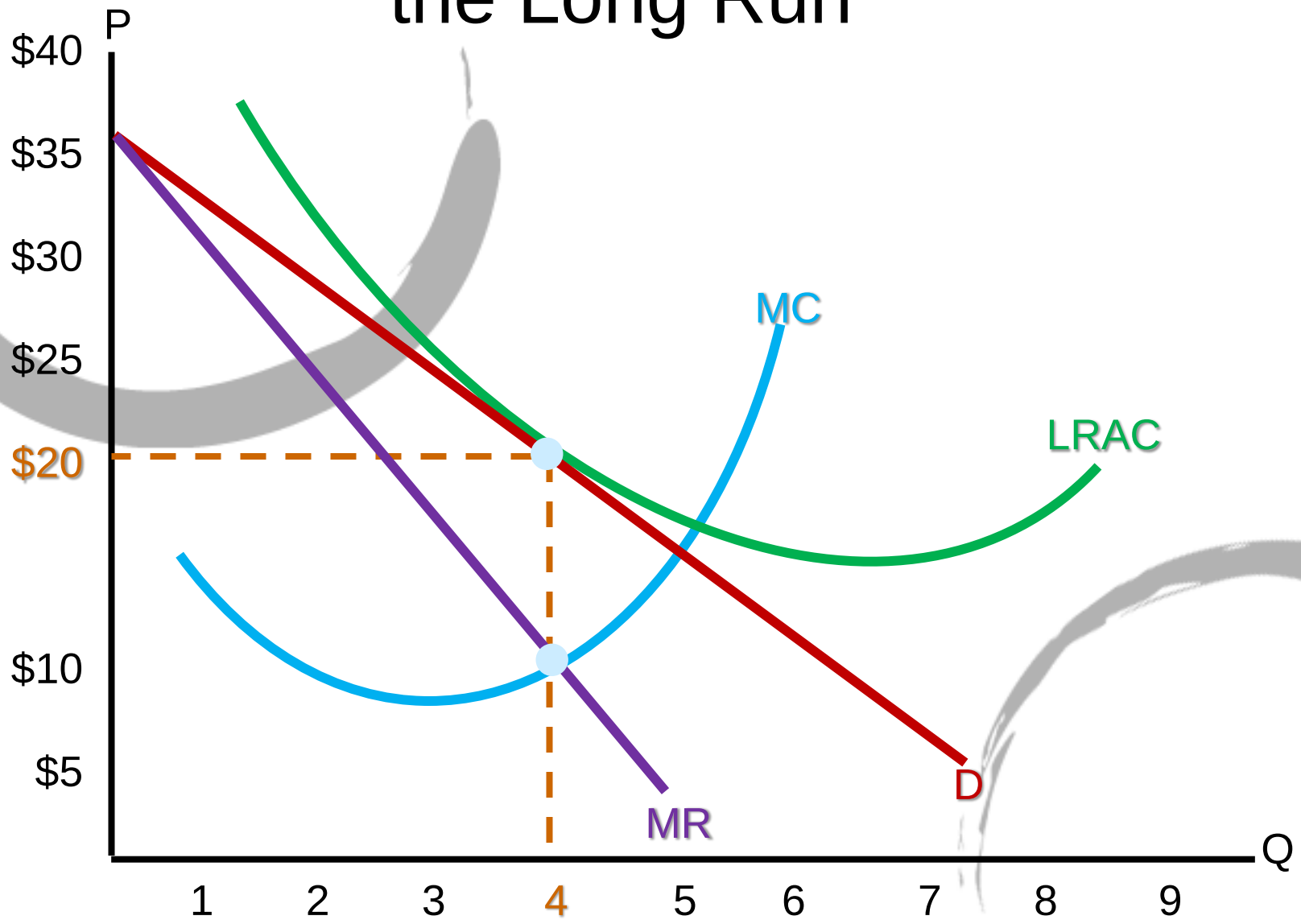
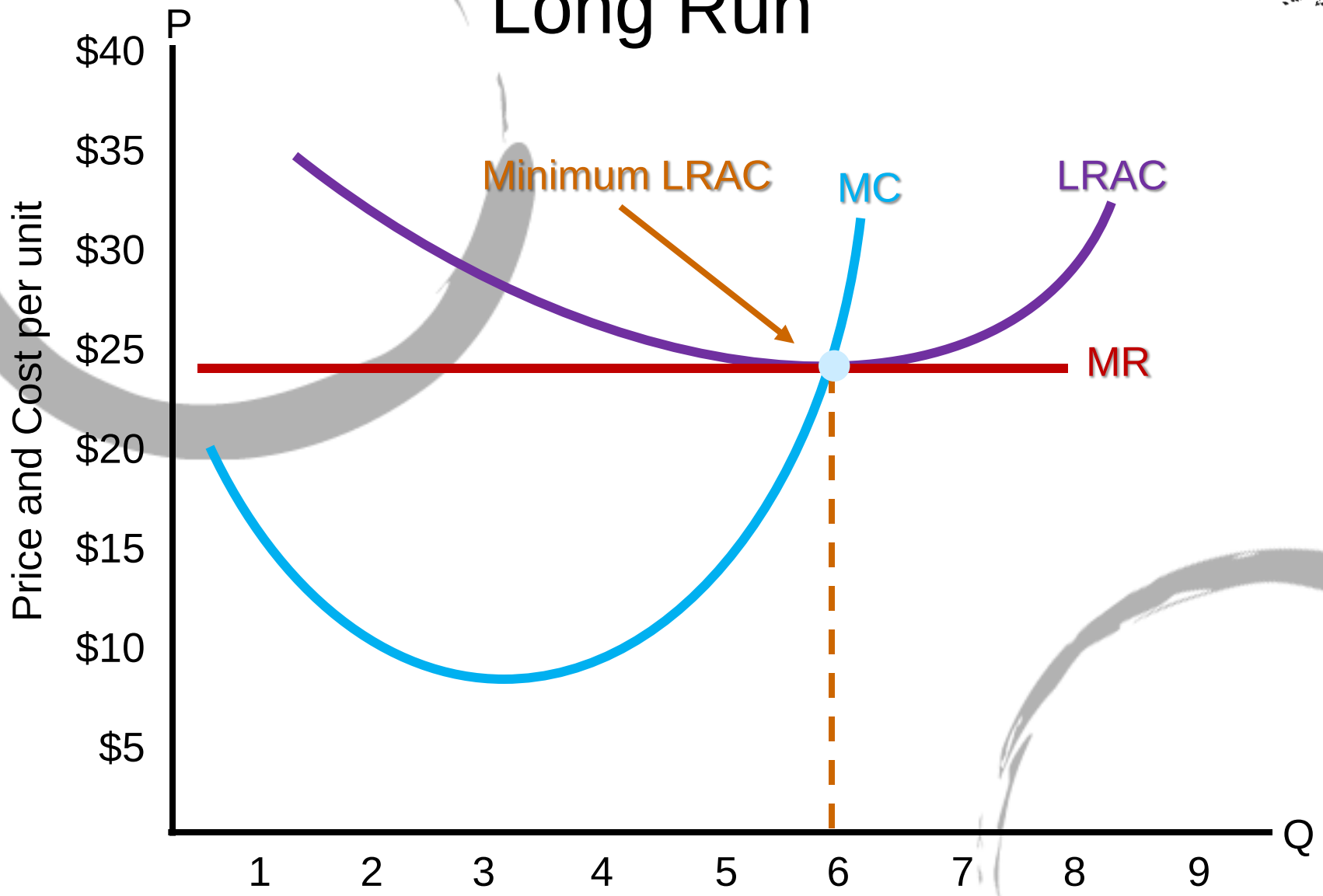


Chart: Perfect Competition in the Long Run



What is one way monopolistic competition compares to perfect competition?

Price is higher and quantity is lower, firms have some market power and products are differentiated (not standardized) in monopolistic competition.

Type of Market	Quantity Produced	Price	Marginal Revenue	Marginal Cost	Demand	Average Total Cost
Pure Competition:	Expand output until MC is equal to price	Take market price	Same as market price	Will equal market price	Firm is small compared to overall market; can sell as much as it wants at market price	In the long-run, market price must equal or exceed ATC; will expand production if expected long-term price exceeds ATC
Monopolistic Competition:	Expand output until MC=MR	Search for best price until MC=MR	MR will be less than AR (price)	P > MC in short run	May face highly elastic demand	In long-run profit-maximizing price must equal or exceed ATC to stay in business; will tend to expand long-term output if price exceeds ATC

Why is price higher and quantity lower in monopolistic competition compared to perfect competition?

Firms engaged in monopolistic competition invest in product development and marketing so as to differentiate themselves from other firms in the industry. Since advertising increases costs, it will shift supply curves up and to the right. Ultimately, over the long run, consumers pay for the advertising in the form of higher prices.

In comparison to the pure competitive market, prices will be higher and quantities produced will be lower when there is monopolistic competition. However, there will be a greater variety of goods.

How efficient is monopolistic competition?

Less resources are used and a higher price is charged than would be the case under perfect competition.

Under perfect competition, an inefficient firm won’t survive in the industry. Under monopolistic competition inefficient firms continue to survive.

What are the characteristics of an oligopolistic market?

The general characteristics of an oligopoly market are:

- few sellers
- product can be differentiated or standardized
- high entry barriers
- substantial market power (price control)

How few are a *few* sellers?

A *few* sellers refers to a situation in which the firms are so large relative to the total market that they can affect the market price.

What is a significant barrier to entry?

Significant barriers to entry might include:

- economies of scale
- patents
- government regulation
- lack of access to distribution outlets
- etc

What is the distinguishing feature of oligopoly?

Mutual Interdependence is a distinguishing feature of oligopoly markets.

a. Market power is substantial but interdependent.
b. Firms interact among themselves.
c. When one firm changes a price, it must take into account how other firms in the industry will respond.

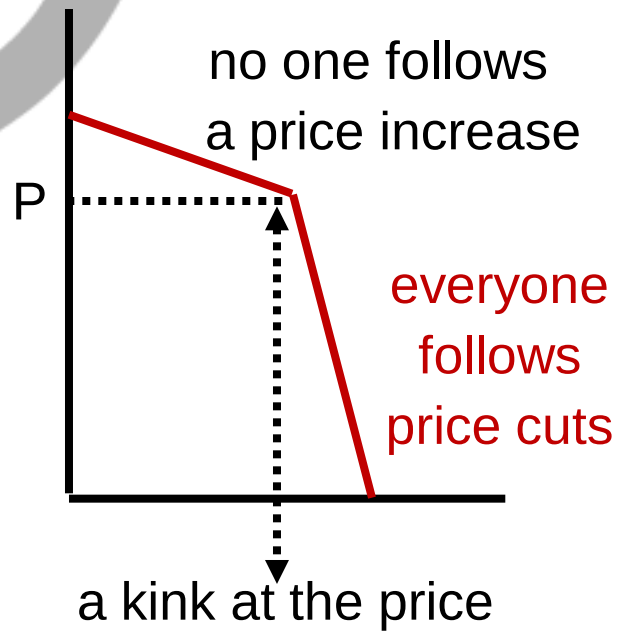
What is mutual interdependence?

Mutual interdependence is a situation in which an action by one firm may cause a reaction from other firms. Therefore firms must display strategic behavior.

It’s not enough for a firm to say “what shall we do?” A firm must also take into account what its rivals will do in reaction.

What does mutual interdependence do to the demand curve?

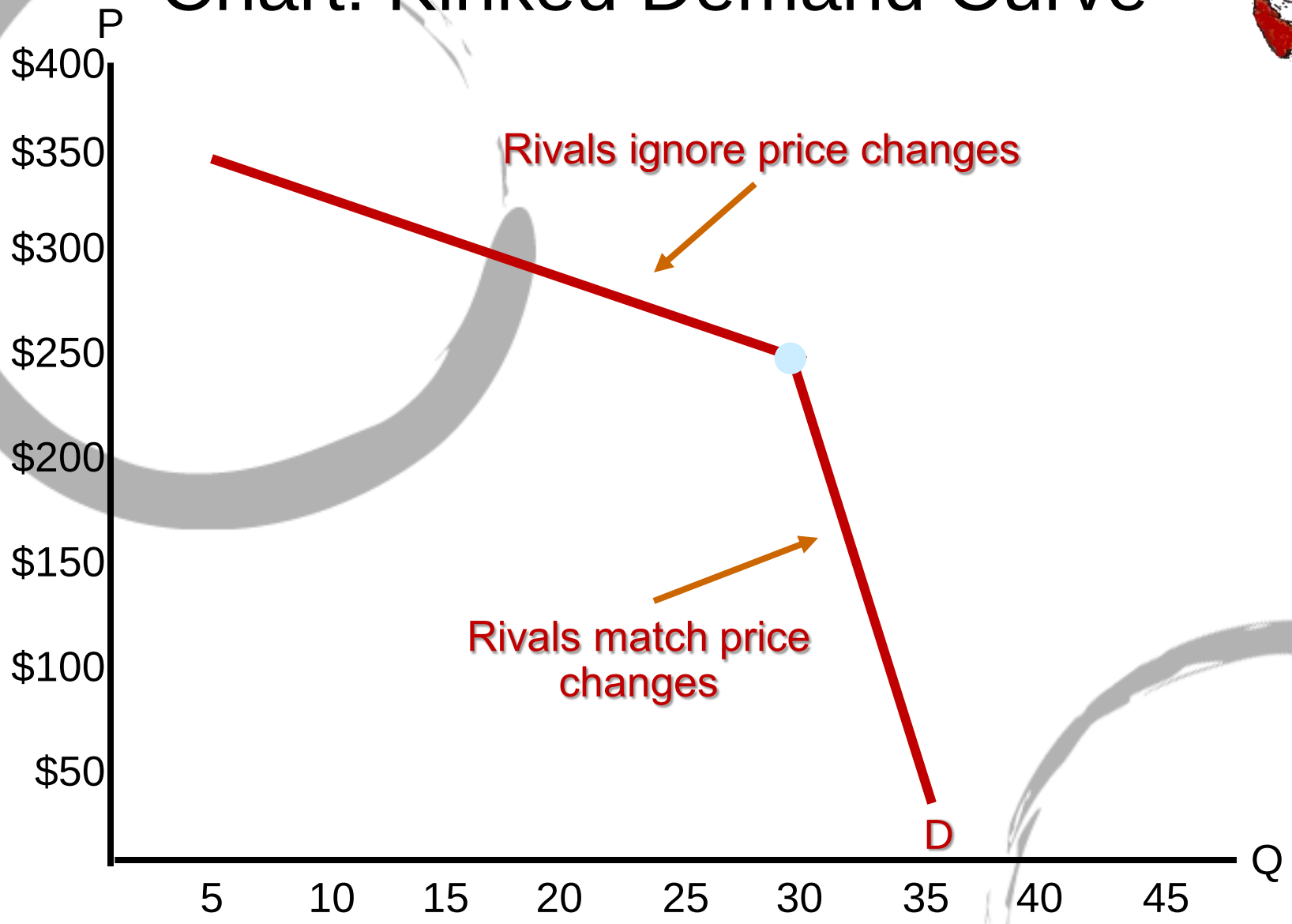
Mutual interdependence can cause the demand curve to be kinked based on the assumption that rivals will match price cuts but not price hikes.



What does a kinked demand curve show?

A kinked demand curve shows that rivals will match a firm’s price decrease, but ignore a price increase.

Chart: Kinked Demand Curve



How do oligopolists determine price?

They play the game “follow the leader,” or price leadership.

Price leadership is an oligopolistic pricing pattern that allows one firm to establish the market price for all firms in the industry.

What is price leadership?

A pricing strategy in which a dominant firm sets the price for an industry and the other firms follow suit.

What is a cartel?

A cartel is a group of firms formally agreeing to control the price and output of a product.

What are examples of cartels?

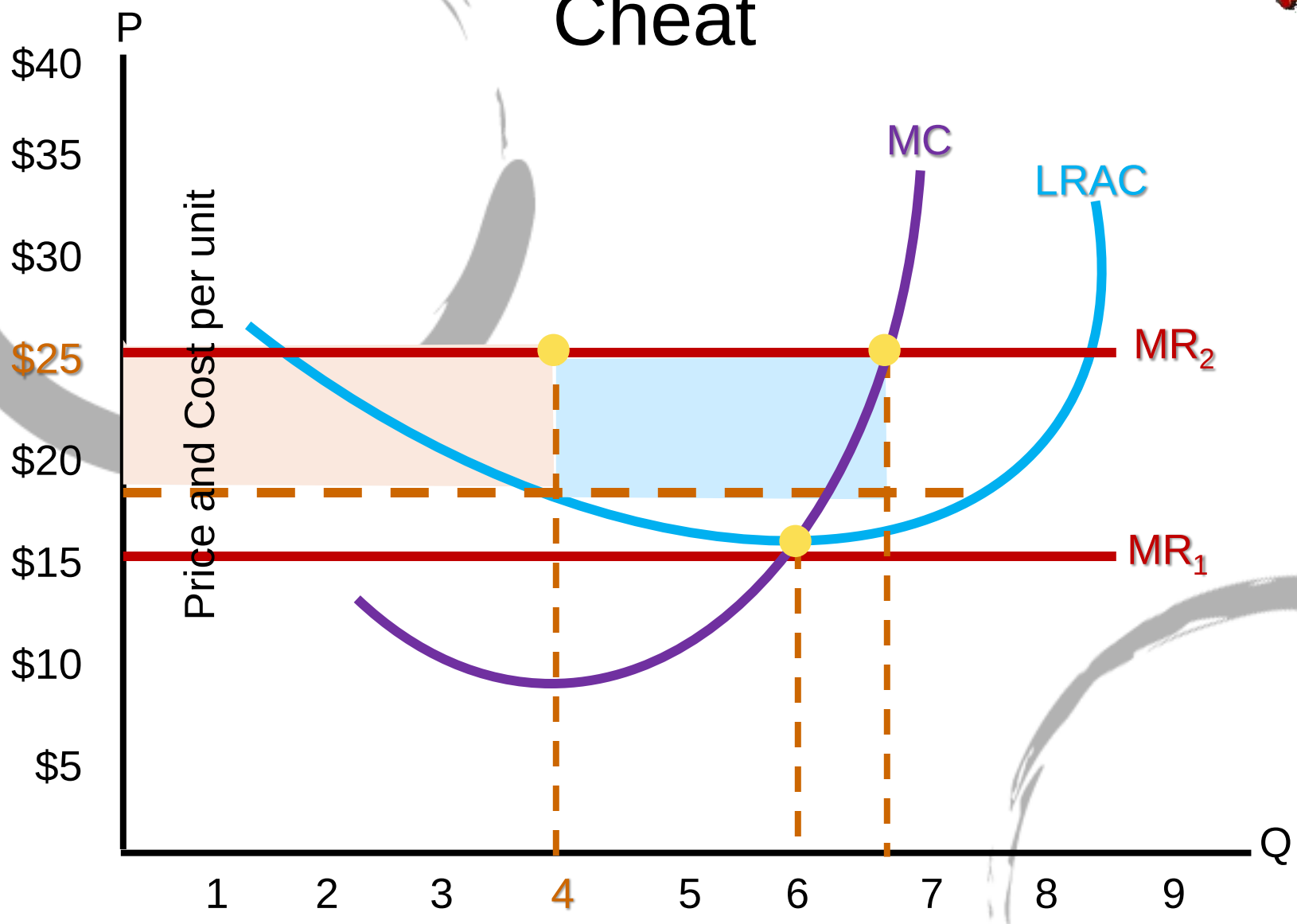
- International Telephone Cartel (CCITT)
- International Airline Cartel (IATA)
- ocean shipping
- De Beers -- diamonds
- OPEC -- oil cartel, with Saudi Arabia making up 33% of the group's exports
- Siemens and Thompson - CSF -- airport radar systems
- major league baseball

What is the major weakness of a cartel?

The major weakness of a cartel is cheating by member firms.

There are a number of ways cartel members can cheat and the temptation to do so is great. It’s not always easy to catch or stop cheaters and their behavior undermines the cartel’s agreements.

Chart: Why Cartel Members May Cheat



What is game theory?

Game theory is the study of decision making in situations where strategic interaction (moves and countermoves) between rivals occurs.

It’s a model of the strategic moves and countermoves of those rivals.

What are two pricing methods in game theory?

Two of the pricing methods in game theory are:

Tit-for-Tat

and

Price Leadership

What is tit-for-tat?

Using a tit-for-tat strategy, a firm will do whatever the rival firm did the last time.

Tit-for-tat strategies are based on the concepts of retaliation and altruism. For example, if provoked, a firm will subsequently respond with retaliation, but if not provoked, the firm will subsequently cooperate.

Tit-for-tat pricing is an extreme form of price following in which a firm matches its rival's price actions at every stage. If the rival lowers its price, the firm does as well. If the rival raises its price, so does the firm. Every price move the firm makes is in reaction to the rival's price actions.

This removes price as a strategic dimension of competition. Done repeatedly, a rival realizes that any price move will simply be matched so that lowering prices only hurts themselves.

What is price leadership?

Price leadership is an oligopolistic pricing pattern that allows one firm to establish the market price for all firms in the industry.

For example, in the airline industry a dominant carrier might announce a price increase on holiday tickets months in advance, giving other carriers time to also announce price increases.

What is formal collusion?

Formal collusion is a situation in which member firms formally meet to set price or output levels and act like a monopoly to maximize joint profits.

What is informal collusion?

Through informal collusion, firms find alternative ways to agree on a price without any tacit communication.

Is formal collusion legal?

Formal collusion is not legal in the US. It is against the law for firms to come together and agree among them what price to charge or what level of output to maintain.

What conclusion can be drawn from collusion?

In an oligopoly market, as long as the benefits exceed the costs, cheating can threaten firms' formal or informal agreements to maximize joint profits.

What conclusion can be drawn from oligopolies?

In an oligopoly market

- the price charged for the product will be higher than under perfect competition.
- more money is spent on forms of nonprice competition.

The End