MONOPOLISTIC COMPETITION AND OLIGOPOLY

I. MONOPOLISTIC COMPETITION
   a. CHARACTERISTICS
      i. RELATIVELY LARGE NUMBER OF SELLERS
         1. Each firm has a relatively small percentage of market share
         2. No collusion by firms to restrict output or set prices
         3. Independent action; no feeling of interdependence
      ii. DIFFERENTIATED PRODUCTS (often promoted by heavy advertising)
         1. PRODUCT ATTRIBUTES: may mean physical or qualitative differences in products themselves
            a. Neapolitan or Chicago style pizza
         2. SERVICE: conditions of sale
            a. 1 day over 3 day dry cleaning
         3. LOCATION
            a. Accessibility to stores; convenience stores
               i. Motel’s proximity to interstate
         4. BRAND NAME AND PACKAGING
            a. Brand names, trademarks, packaging and celebrity connections
            b. Bayer aspirin or Kleenex
         5. SOME CONTROL OVER PRICE
a. Due to product differentiation, monopolistic competitors have some control over pricing.

iii. EASY ENTRY AND EXIT FROM INDUSTRY

1. Easy compared to monopolies and oligopolies
2. Compared to pure competitors, financial barriers might arise in order to differentiate from competitors

iv. ADVERTISING

1. Monopolistic competitors tend to heavily advertise
2. Goal is product differentiation and advertising differences: NON-PRICE COMPETITION

v. MONOPOLISTICALLY COMPETITIVE INDUSTRIES

1. Jewelry, asphalt, wood pallets, commercial signs, leather goods, plastic pipes, grocery stores, gas stations, real estate sales, medical care

II. PRICE AND OUTPUT IN MONOPOLISTIC COMPETITION

a. THE FIRM’S DEMAND CURVE

i. Highly, but not perfectly elastic
   1. 2 reasons why not perfectly elastic
      a. Has fewer rivals
      b. Products are differentiated, not perfect substitutes

b. THE SHORT-RUN: PROFIT OR LOSS

i. Figure 9.1a (economic profit) and 9.1b (economic loss) on page 208
ii. MR=MC

C. THE LONG-RUN: ONLY A NORMAL PROFIT

i. In the long-run, a monopolistically competitive producer will only break even (explicit plus implicit costs; normal profit)

ii. In figure 9.1a, where firms are making an economic profit, firms enter the market

1. When entry of new firms has reduced demand to where demand curve is tangent to the ATC curve at the profit-maximizing output, the firm is just making a normal profit (Long-term definition)

iii. When industry suffers short-run losses (figure 9.1b), demand curve will shift to the right (rise) to D3 (figure 9.1c) and will incur long-run normal profit

III. MONOPOLISTIC COMPETITION AND EFFICIENCY

a. THE EQUALITY OF P AND ATC YIELDS PRODUCTIVE EFFICIENCY

b. THE EQUALITY OF P AND MC YIELDS ALLOCATIVE EFFICIENCY

c. NEITHER PRODUCTIVE OR ALLOCATIVE EFFICIENCY

i. In monopolistic competition, neither occur in long-run equilibrium

ii. Figure 9.2 on page 210; work within section.

d. EXCESS CAPACITY:

i. The gap between the minimum ATC output (Q4 in figure 9.2) and the profit-
maximizing output (MC=MR or Q3) identifies EXCESS CAPACITY.

1. Plant and equipment are underused
2. Monopolistic competitive industries are overcrowded with firms and each is operating below optimal capacity.

e. PRODUCT VARIETY AND IMPROVEMENT

i. Monopolistic competitive firms has two notable virtues
   1. Promotes product variety
   2. Promotes product improvement

ii. Monopolistic competitive firms are rarely satisfied with the situation on figure 9.1c on page 208 because it only yields a normal profit
   1. It will try to gain competitive advantage through further product differentiation, innovation and advertising.
   2. These are benefits to society; ones that may offset the cost of inefficiency associated with this market structure.

IV. OLIGOPOLY

a. CHARACTERISTICS

i. DOMINATED BY A FEW LARGE PRODUCERS OF A HOMOGENEOUS OR DIFFERENTIATED PRODUCT
   1. “Big Three,” “Big Four,” or “Big Six”
2. HOMOGENEOUS OLIGOPOLY
   (steel, zinc or cement) OR
DIFFERENTIATED OLIGOPOLY
   (consumer goods such as autos,
tires, cereals)
3. Considerable non-price competition
   ii. CONSIDERABLE CONTROL OVER
       PRICES
       1. Price maker so it has control to set
           prices and output levels to
           maximize profit
       2. Needs to consider how rivals will
           react
   iii. NEED TO CONSIDER POSSIBLE
        REACTION OF RIVALS TO ITS OWN
        PRICING, OUTPUT AND
        ADVERTISING DECISIONS
       1. Strategic behavior: self-interested
           behavior that takes into account the
           reaction of others
       2. Mutual interdependence: each
           firm’s profit depends on strategies
           of other firms as well as own
b. ENTRY BARRIERS
   i. Same barriers that contribute to
      monopoly contribute to oligopoly
   ii. Economies of scale are important to
       barriers, such as aircraft, rubber, and
       copper industries
c. MERGERS
   i. Some oligopolies have emerged through
      internal growth but others have achieved
      oligopoly status by merger (combining
      two or more firms in the same industry)
       1. Can greatly increase market share
2. Achieve greater economies of scale

V. OLIGOPOLY BEHAVIOR: A GAME THEORY OVERVIEW
a. GAME THEORY - study of how people or firms behave in strategic situations
b. Review The Prisoner’s Dilemma on page 214
c. Review figure 9.3 called the PAYOFF MATRIX
   i. Mutual interdependence is visually depicted in figure 9.3
d. COLLUSION: Figure 9.3 shows that oligopolies could benefit from collusion or cooperation among rivals
   i. In figure 9.3 with collusion, each rival could earn $12MM
   ii. How do the competitors avoid the low profit from cell D? Collude
e. INCENTIVE TO CHEAT
   i. Either rival cheats on collusive pricing agreement, on figure 9.3 can increase profit to $15MM

VI. KINKED-DEMAND MODEL
a. Model where there is no overt collusion
b. Section 1 of Sherman Act of 1890 outlaws conspiracies to restrain trade; known as PER SE VIOLATIONS
c. KINKED DEMAND CURVE
   i. Review figure 9.4 on page 217 with discussion on pages 216-7
   ii. Demand above P0 is highly elastic; below P0 is highly inelastic
   iii. If rivals ignore a price increase but match a price decrease the MR curve of the oligopolist will have an odd shape
   iv. PRICE INFLEXIBILITY
1. Figure 9.4 explains why prices are generally stable in noncollusive oligopolistic industries; there are both demand and cost reasons.
2. The broken MR curve in figure 9.4 suggests that even if an oligopolist’s costs change substantially, the firm will have no reason to change its price (the broken line between f and g).

v. PRICE LEADERSHIP: implicit understanding by which oligopolists can coordinate pricing without outright collusion.
   1. Dominant firm, usually largest and most efficient, initiates price changes and other firms follow.
   2. Follows following tactics:
      a. Infrequent price changes; not made day-to-day.
      b. Communication: release ideas in trade publications; speeches.
      c. Avoidance of Price Wars: damage industry profits.

VII. COLLUSION:
   a. CARTEL: group of producers that typically create a formal written agreement specifying output and price; overt is rare; covert is more common.
   b. JOINT PROFIT MAXIMIZATION;
      i. Analyze figure 9.5 on page 220; example is three oligopolistic firms colluding as if they were one monopolist with three different plants.
      ii. Same outcome for society as a monopoly.
iii. Review Cartels and Collusion on page 221

c. OBSTACLES TO COLLUSION
   i. DEMAND AND COST DIFFERENCES: If oligopolists face different demand and
cost curves, it will be difficult to agree on prices
      1. Most oligopolists have different
demand and cost curves
   ii. NUMBER OF FIRMS: Larger number of
firms, harder for collusion or creating a cartel
   iii. CHEATING: As per Game Theory,
cheating can undermine collusion
   iv. RECESSION: Long lasting recession
serves as enemy to collusion due to
increasing ATC
   v. POTENTIAL ENTRY: Greater prices
and profits that result from collusion will
attract new entrants, especially foreign firms

VIII. OLIGOPOLY AND ADVERTISING
   a. Firm’s share of market is typically determined
through product development and advertising
for two reasons
      i. Product development and advertising
campaigns are harder to duplicate than
price cuts or pricing policy
         1. Can produce more permanent gains
            in market share
      ii. Oligopolists have stronger financial
resources to engage in product
development and advertising campaigns
   b. POSITIVE EFFECTS OF ADVERTISING
i. Low cost means of customers obtaining product information
ii. By providing information, reduces monopoly power
iii. Efficiency-enhancing activity
iv. By increasing sales and output, lowers long-run ATC by increasing economies of scale

c. NEGATIVE EFFECTS OF ADVERTISING
i. Manipulate or persuade consumers
ii. By creating misleading or extravagant claims, will confuse rather than inform consumers
iii. Brand-name loyalty which creates monopoly type power
   1. Kleenex, Tylenol
iv. Over time, consumers lose competition advantage and experience disadvantage of monopoly power
v. When advertising leads to monopoly type power, inefficiencies result

IX. OLIGOPOLY AND EFFICIENCY
a. INEFFECTIVENESS: figure 9.5
i. Oligopolists experience sizeable economic profits year after year
ii. Production is below the output which ATC is minimized.
   1. Neither productive efficiency (P = minimum ATC), or allocative efficiency (P = MC) occurs
iii. Informal collusion may yield price and output results similar to a monopoly

b. QUALIFICATIONS TO THE INEFFECTIVENESS VIEW
i. INCREASED FOREIGN COMPETITION: example is the auto industry
ii. LIMIT PRICING: lower pricing to create barriers to entry
iii. TECHNOLOGICAL ADVANCE: economic profits go to increased R & D; barriers to entry may allow oligopolists to reap rewards of successful R & D
iv. In short-run economic inefficiencies of oligopolists may be partly or wholly offset by their contributions to better products, lower prices and lower costs over time (technology)
c. Review the Oligopoly in the Beer Industry example on page 226