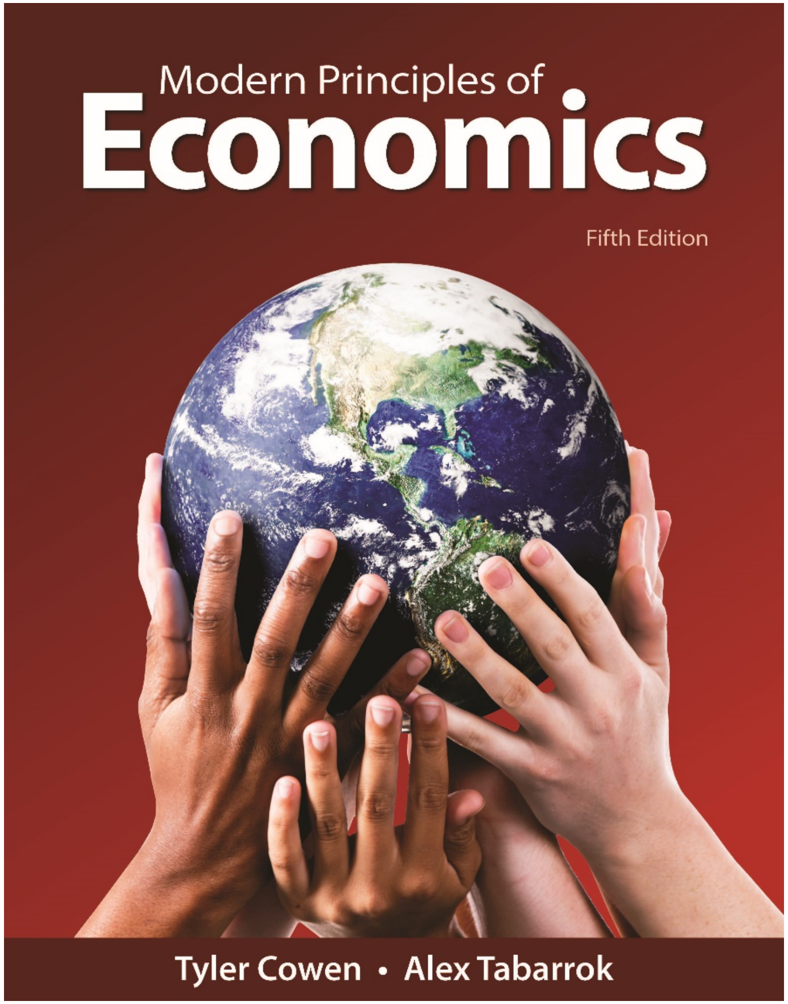
MODERN PRINCIPLES OF ECONOMICS

Fifth Edition



Chapter 17
Monopolistic Competition and Advertising

Outline

- Sources of Product Differentiation
- The Monopolistic Competition Model
- The Economics of Advertising
- Takeaway

Introduction

- Monopolistic competition combines some features of competitive markets with some features of monopoly.

- Monopolistic competition is a market with:
  - Many sellers
  - Free entry and exit
  - Product differentiation

- Monopolistic competitors face a downward-sloping demand curve.

Definition

Monopolistic competition:

A market with a large number of firms selling similar but not identical products.

Product Differentiation (1 of 2)

Can you tell the difference?

Product Differentiation (2 of 2)

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How about now?

Sources of Product Differentiation (1 of 2)

- Products can be differentiated along any dimension that people care about, such as taste, style, features, or location.
- Products can also be differentiated by location or by ease of purchase.
  - Milk sold at 7-Eleven and at the grocery store is the same.
  - Customers pay slightly more at 7-Eleven for convenience.

Sources of Product Differentiation (2 of 2)

- Differentiated products are often highly advertised.
- Firms want consumers to perceive their products as different and better because that increases the firms' market power.

Self-Check (1 of 2)

Under monopolistic competition, there:

a. are many firms.

b. are a few firms.

c. is one firm.

Self-Check (1 of 2) (Answer)

Under monopolistic competition, there:

a. are many firms.

b. are a few firms.

c. is one firm.

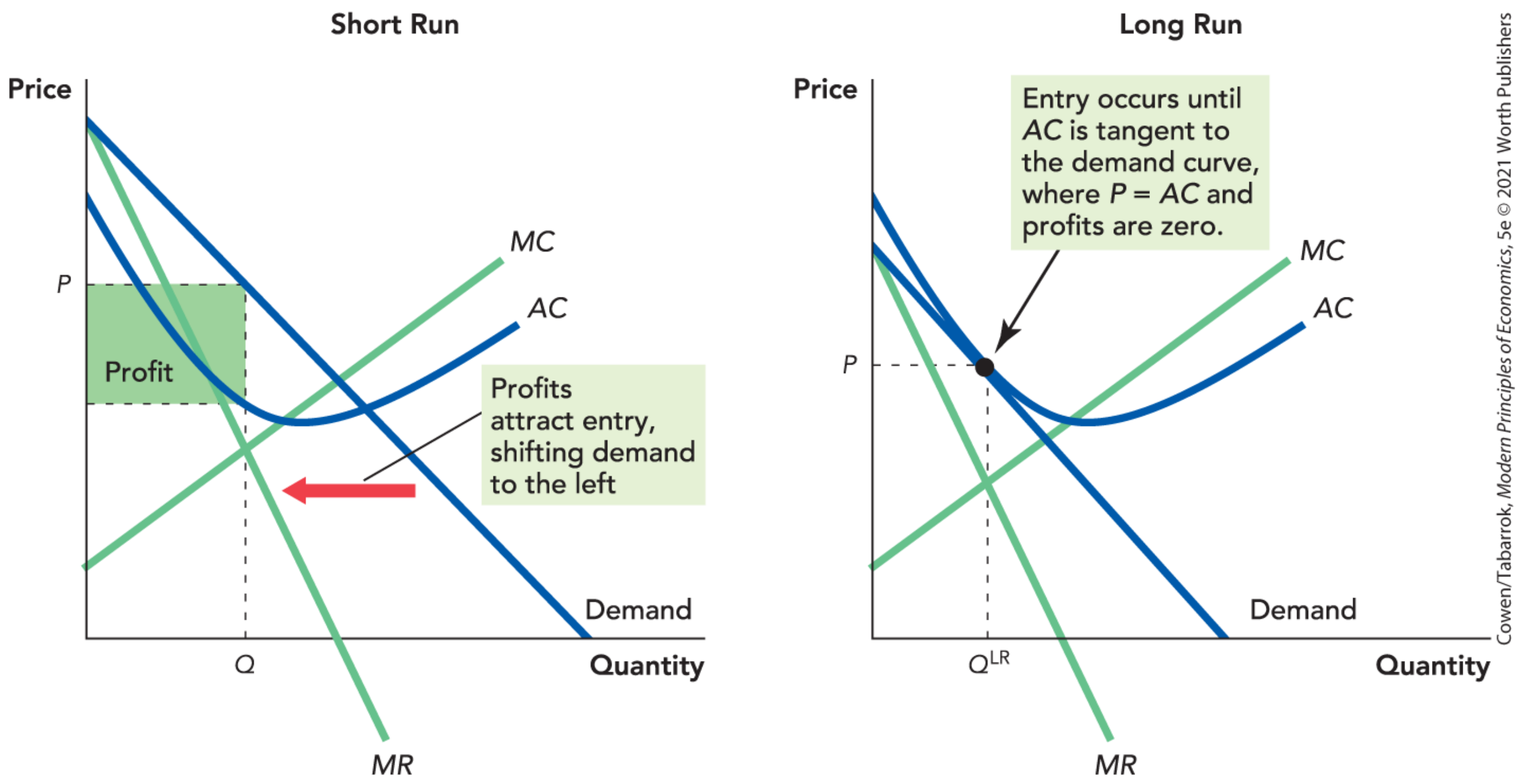
Answer:

a. Under monopolistic competition, there are many firms.

Monopolistic Competition Model (1 of 5)

- A monopolistically competitive firm can reduce output and raise the price without losing all of its customers.
- Product differentiation means the firm is able to charge $P > MC$.
- It also means that a firm does not produce at the minimum of its *AC* curve.
- In the longer run, consumers are better off because of new features and products.

Monopolistic Competition Model (2 of 5)



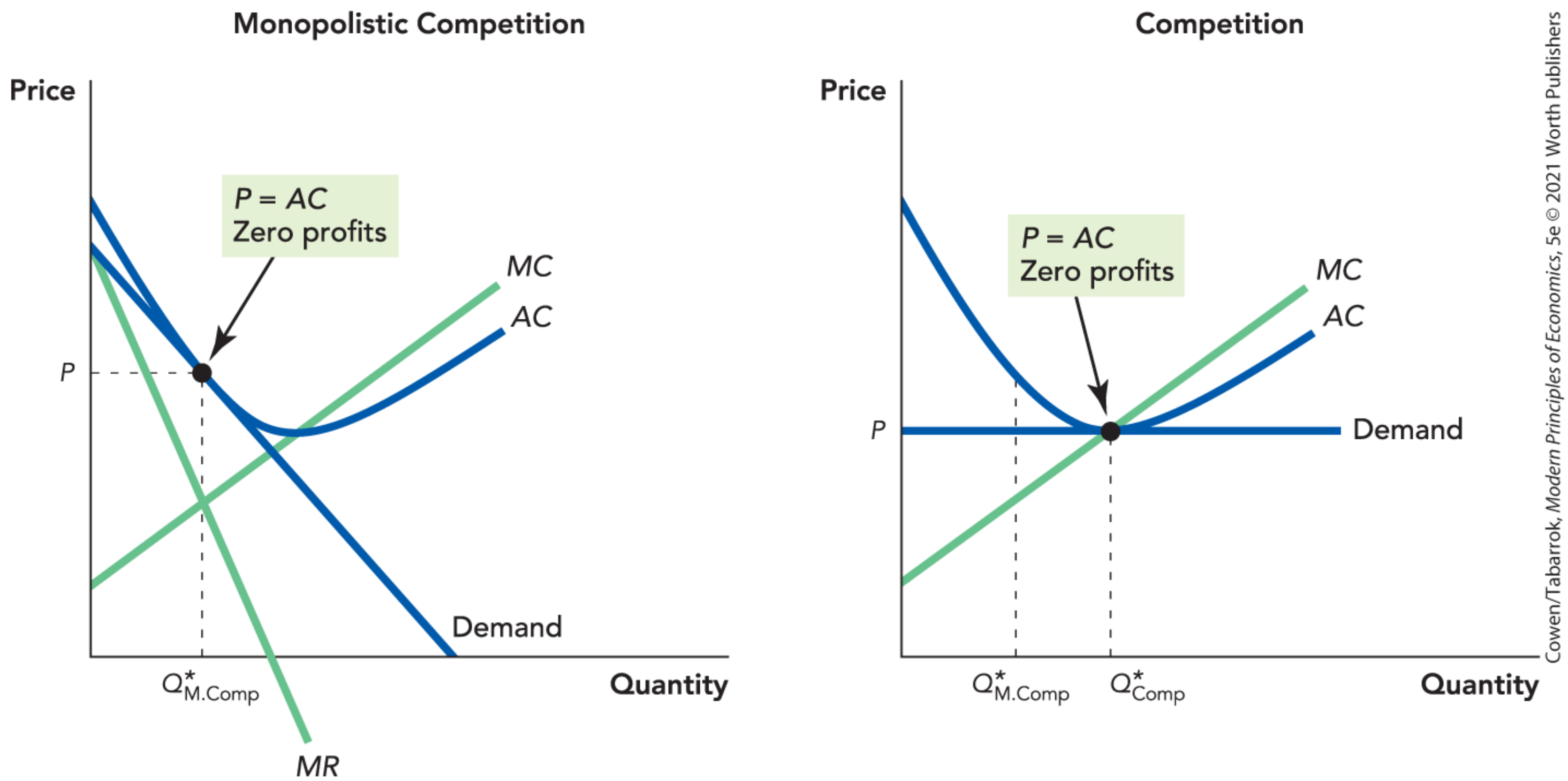
Monopolistic Competition Model (3 of 5)

- In the long run, competitive and monopolistically competitive firms produce where $P = AC$ and earn zero profits.
- Firms under monopolistic competition:
  - Charge prices above marginal cost
  - Produce a smaller quantity compared with competitive firms
  - Q^* is not at minimum average cost.

Monopolistic Competition Model (4 of 5)

- Competitive firms:
  - All produce exactly the same product, so there are perfect substitutes for each firm's products.
  - As a result, the demand curve is perfectly elastic.
  - Production quantity is higher than under monopolistic competition.
  - Output is at the point that minimizes average costs.

Monopolistic Competition Model (5 of 5)



Self-Check (2 of 2)

Firms in which of the following markets will produce at the minimum *AC*?

a. monopoly

b. monopolistic competition

c. competition

Self-Check (2 of 2) (Answer)

Firms in which of the following markets will produce at the minimum *AC*?

a. monopoly

b. monopolistic competition

c. competition

Answer:

c. A competitive firm will produce at the minimum average cost.

Economics of Advertising (1 of 5)

- Firms that sell undifferentiated goods don’t advertise very much.
- Benefits from advertising would flow mostly to other firms in the same industry.
- Milk, pork, and cotton are exceptions.
  - The government requires firms in these industries to pay a special tax that pays for the advertising.
  - The industry as a whole benefits.

Economics of Advertising (2 of 5)

- Monopolies are also unlikely to advertise because they have no competitors.
- Firms with differentiated products are the most likely to advertise.
  - They want more customers.
  - They can advertise their specific product rather than the industry category.

Economics of Advertising (3 of 5)

- One reason that advertising increases sales is because it informs consumers about price, quality, and availability.
- Evidence indicates that advertising lowers prices and improves consumer welfare.
- Advertising can also signal that the seller expects the product to be a success.

Economics of Advertising (4 of 5)

- Persuasion can give us tastes that appear silly or unjustified.
- Persuasion also can deepen our enjoyment and our memories.
  - In a blind taste test, subjects were given labeled and unlabeled glasses of Coke.
  - They reported greater enjoyment from drinking the beverage labeled Coke.
  - Brain scans showed activity in the memory regions of the brain.

Economics of Advertising (5 of 5)

- Persuasive advertising can create market power by brand differentiation.
- Advertising helps people enjoy a lot of products.
- Facebook, Instagram, and Twitter are all free to consumers because of advertising.

Takeaway (1 of 2)

- A monopolistically competitive industry has many sellers, free entry, and differentiated products.
- Each firm retains a downward-sloping demand curve and price remains above *MC*.
- Free entry drives price down to $P = MC$, where economic profits = 0.
- Firms do not produce at the minimum *AC*.

Takeaway (2 of 2)

- Advertising can inform consumers about price, quality, and availability.
- Advertising can also increase perceptions of product differentiation, which allows firms to increase prices.