Monopolistic Competition

Monopolistic Comp. refers to a market structure in which a large number of sellers sell differentiated products, which are close substitutes for one another.

The main features of monopolistic comp. are

(1) Large number of sellers: The number of sellers is large. It is so large that a firm retains to be a price maker.

(2) Product differentiation: The firms differentiate their products from one another in respect of their shape, size, colour etc.

(3) Free entry and free exit: There is no barrier on the entry of new firms and exit of old ones from the industry.

(4) Selling Cost: The firms undertake heavy expenditure on advertisement and other sales promotion schemes for their product.

(5) Downward sloping Demand curve: A firm faces a downward sloping curve.

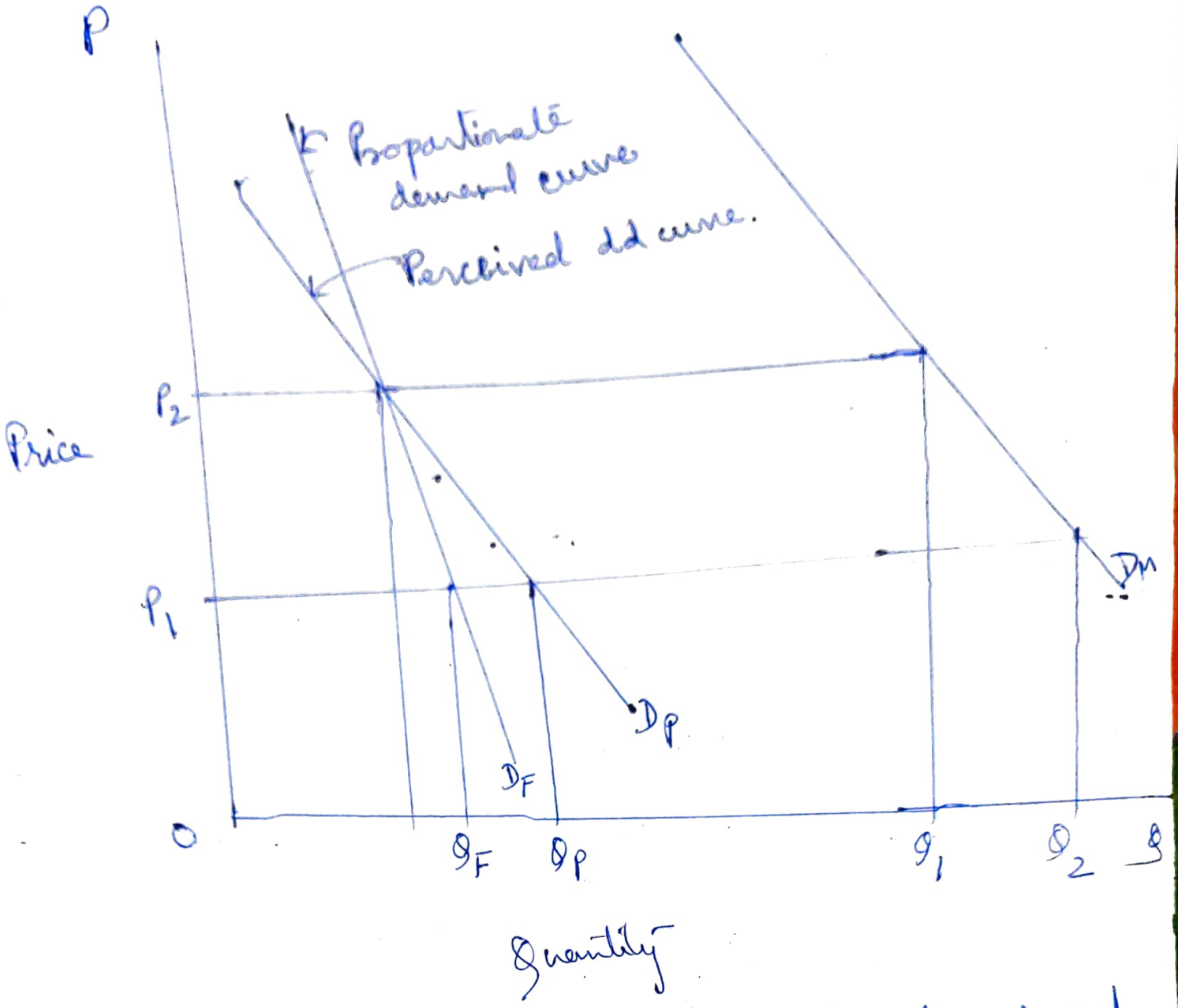
Price output determination under monopolistic competition :

Here we explain Chamberlin's theory of monopolistic competition. First we explain perceived and proportionate demand curve.

Under monopolistic competition, product differentiation is the basis of competition among the firms. With product differentiation, each firm perceives that the demand curve for its own product is more elastic than that of the rival firms. That is why we get a perceived demand curve. ~~as we~~ over and above a proportionate demand curve.

Suppose, industry's demand ~~curve~~ (ie market demand curve) is given by the curve D_M. If industry's demand is proportionately divided between the firms, each firm is supposed to have a demand curve shown by D_F. It is called proportionate demand curve.

However, firms under monopolistic



competition do not take D_F to <u>see</u> the demand curve for their individual product. Each firm perceives that the demand curve for its own product is more elastic than that of the others firms. It gives rise to perceived demand curve which is shown by D_P in the figure. It is evident that the perceived demand curve D_P is more elastic than the proportionate demand

curve D_F. The basis of the perceived demand curve is the firm's belief that if it changes the price of its own product, it will go unnoticed by the other firms and they will not react to change the price of their products (as the no. of firms is very large). The assumption lying behind is the belief that the number of firms is so large that price changes made by a single firm is very much likely to go unnoticed by the rival firms.

The perceived demand curve plays an important role in price and output determination in Chamberlin's theory of monopolistic competition.

Assumptions :

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Chamberlin has made the following *explicit* and *implicit* assumptions to develop his theory of monopolistic competition.

1. There are a large number of firms selling slightly differentiated products, which are close substitutes for one another.
2. The number of firms in a product group is so large that their activities, especially, manoeuvring of price and output, go unnoticed by the rival firms.
3. Demand and cost curves for all the products and for all the firms of the group are uniform, i.e., firms face identical demand (including *perceived* one) and cost curves.
4. Consumer's preferences are evenly distributed among the different products and product differentiations are not such that they make a difference in cost.[14]

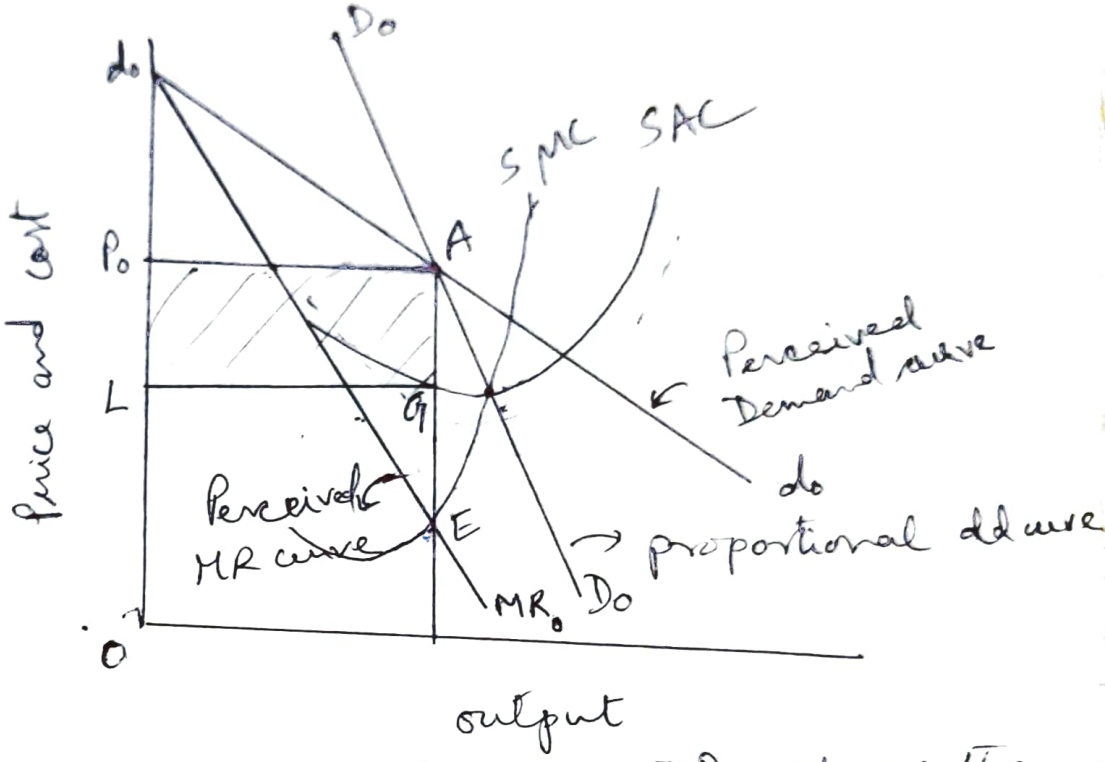
The last two assumptions are called rather 'heroic' in the sense that these are unrealistic. However, it can be assumed, for theoretical convenience, that the differences, wherever they are, are not significant enough to influence the price and output decisions of the rival firms. Given the assumptions, let us discuss first the *short-run equilibrium of the firm*. Firm's *long-run equilibrium* will be discussed in the next section.

Short-run Equilibrium of the Firm

[illegible] monopolistic competition is illustrated in Figures 18.4

Short run Equilibrium

The price-output equilibrium of an firm in the short run is shown in fig (1) below.



The proportional demand curve D_0D_0 shows the quantity demanded at various prices when all firms charge uniform price and each firm gets a proportional share of the total market demand for the product. Suppose the firm is initially at point A on the proportional demand curve D_0D_0. Firm's perceived demand curve d_0d_0 which is more elastic than the proportional

demand curve D_0D_0' has been drawn through point A. The perceived demand curve shows the demand for the product of the firm on the assumption that all other firms in the industry keep the prices of their product constant.

Each firm's ~~of~~ share of demand for its product is equal to OQ_0 and all of them are charging uniform price OP_0.

SAC and SMC are short-run average cost curve and short run marginal cost curve respectively. MR_0 is the marginal revenue curve corresponding to the perceived demand curve d_0d_0. SMC and MR_0 curves intersect at point E and accordingly OQ_0 is the equilibrium output of the firm and OP_0 is the equilibrium price charged with proportional and perceived demand curves cutting each other at point A in the present price-quantity equilibrium. Here price OP_0 exceeds average cost production at OQ_0 output level and therefore the firm is making supernormal

profit equal to the area P_0AGL. Thus according to Chamberlin's alternative approach, short run equilibrium in monopolistic competition is reached when following two conditions are satisfied —

(i) The price-output combination is such that at which perceived marginal revenue curve intersects the marginal cost curve so that $MR = MC$.

(ii) The price-output combination where $MR = MC$ is such that it corresponds to the point at which perceived demand curve ~~and~~ d_0d_0 intersects the proportional demand curve D_0D_0'.

Only when the above two conditions are fulfilled the firm will be maximising its profits and will have no incentive to change its price.