Edexcel Economics A-level

Unit 3: Business Behaviour

Topic 3: Market Structures and Contestability

3.2 Monopolistic competition

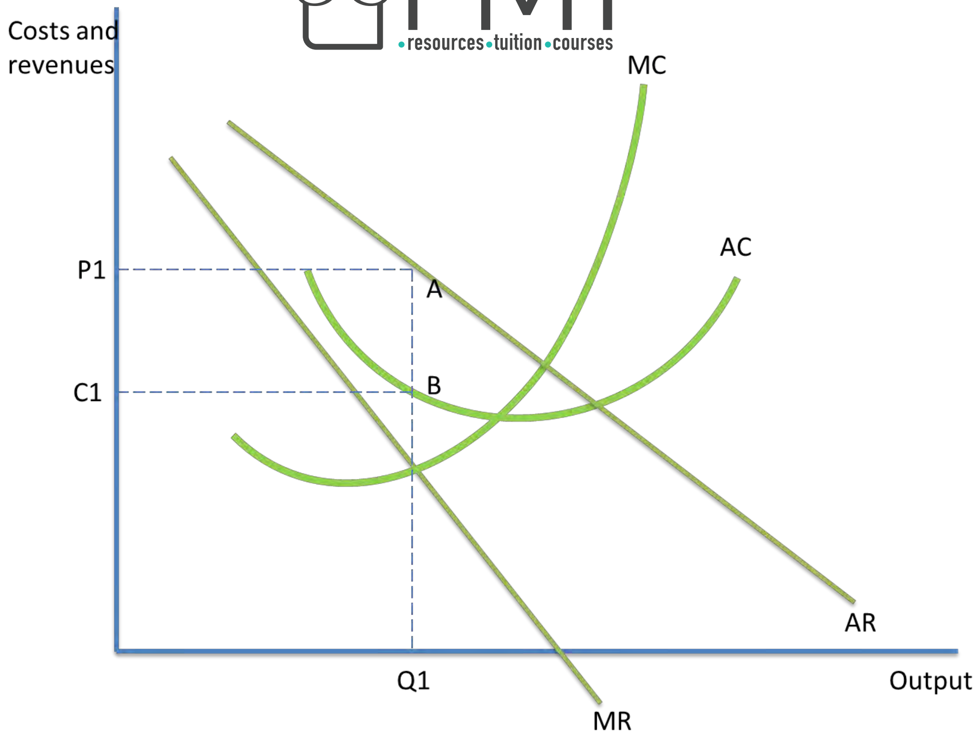
Notes

Characteristics of monopolistically competitive markets:

- A monopolistically competitive market has imperfect competition. Firms are short run profit maximisers.
- Firms sell non-homogeneous products due to branding (there is **product differentiation)**. However, there are a lot of relatively close substitutes. This makes the XED of the goods and services sold high.
- The model is based on the assumption that there are a large number of buyers and sellers, which are relatively small and act independently. Each seller has the same degree of market power as other sellers, but their market power is relatively weak.
- There are low barriers to entry to and exit from the market.
- Since firms have a downward sloping demand curve, they can raise their price without losing all of their customers. This is because firms have some degree of price setting power.
- Buyers and sellers in a monopolistically competitive market have imperfect information.
- Examples of monopolistic competition include hairdressers and regional plumbers.

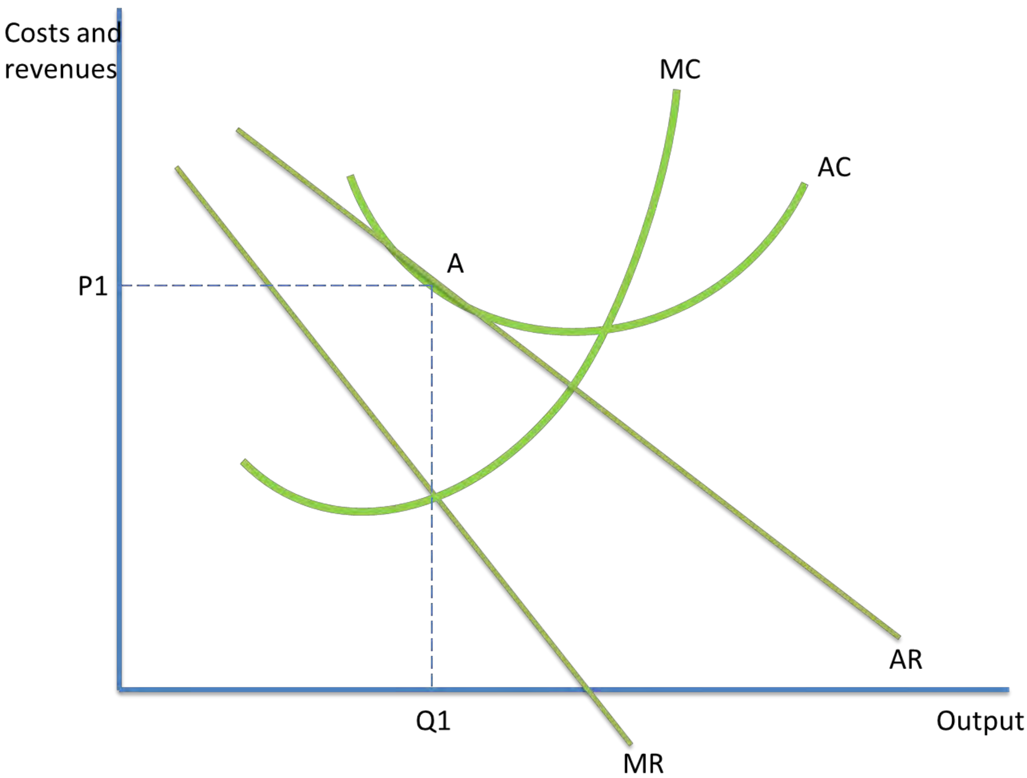
Profit maximising equilibrium in the short and long run:

- In the short run, firms profit maximise at the point MC = MR. The area P1C1AB represents the supernormal profits that firms in a monopolistically competitive market earn in the short run.



- In the long run, new firms enter the market since they are attracted by the profits that existing firms are making. This makes the demand for the existing firms' products more price elastic which shifts the AR curve (the demand curve) to the left. Consequently, only normal profits can be made in the long run. The long run equilibrium point is P1Q1.

- Firms can try and stay in the short run by differentiating their products and innovating.



Advantages and disadvantages of monopolistically competitive markets:

Advantages	**Disadvantages**
Firms are allocatively inefficient in the short and long run (P > MC)	In the long run, dynamic efficiency might be limited due to the lack of supernormal profits.
Since firms do not fully exploit their factors, there is excess capacity in the market. This makes firms productively inefficient (also note: the firm does not operate at the bottom of the AC curve). This is in both the short run and long run.	Firms are not as efficient as those in a perfectly competitive market. In a monopolistically competitive market, firms have x-inefficiency, since they have little incentive to minimise their costs.
Consumers get a wide variety of choice.	
The model of monopolistic competition is more realistic than perfect competition.	
The supernormal profits produced in the short run might increase dynamic efficiency through investment.	