

Economics 1: Fall 2010

J. Bradford DeLong, Michael Urbancic, and a
cast of thousands...

http://delong.typepad.com/econ_1_fall_2010/

Economics 1: Fall 2010: Monopolistic Competition

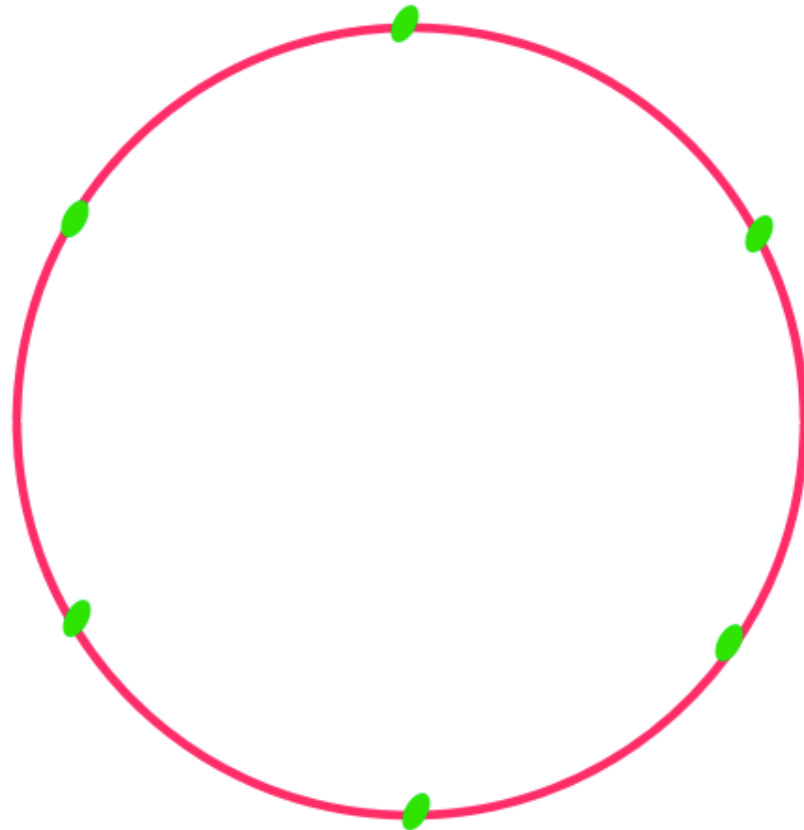
J. Bradford DeLong

November 1, 2010, 12-1
Wheeler Auditorium, U.C. Berkeley

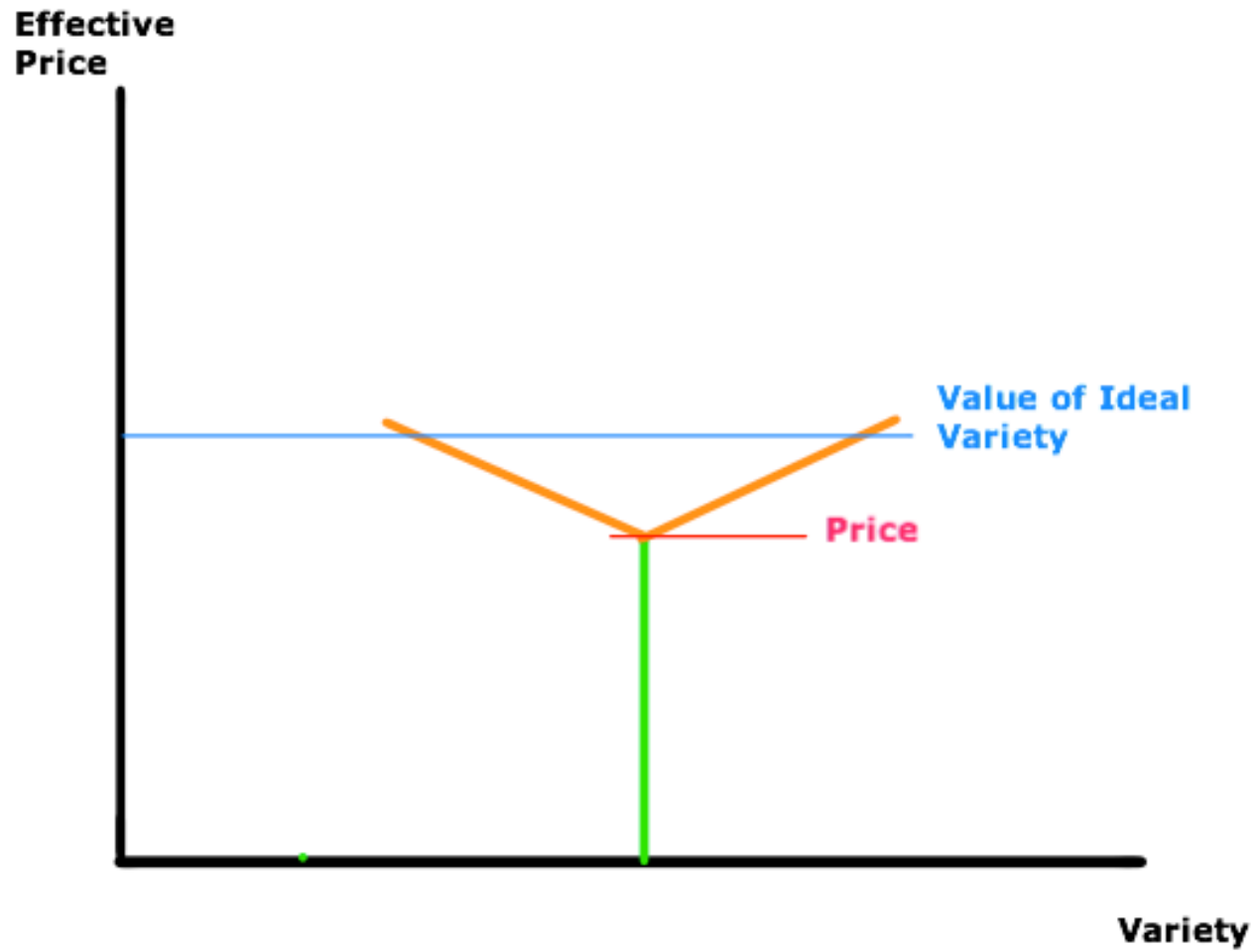
Monopolistic Competition

- Each firm makes its own unique good
- Each good made is a close—but not a perfect—substitute with other goods
 - A different size or a different durability or with different options or a different color
 - Henry Ford and the Model T vs. Chevrolet and General Motors
- Lack of full monopoly power:
 - There is free entry
 - But with a fixed cost
 - You have to set up your production line
 - Assume constant marginal cost thereafter
- This actually describes most of economic life, doesn't it?
 - So why are our standard cases of market structure either competition or monopoly? Good question!

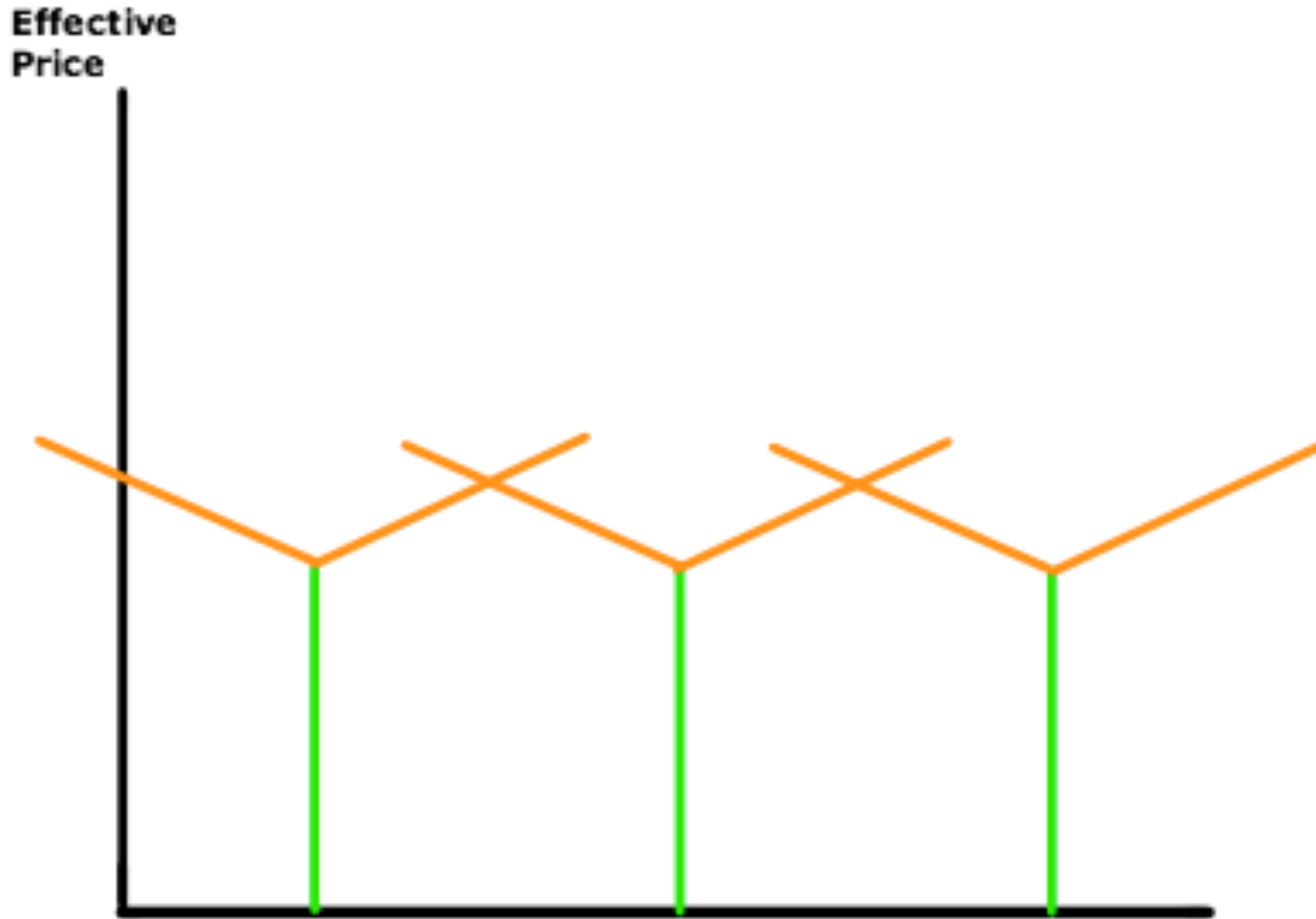
Standard Way of Thinking About Monopolistic Competition



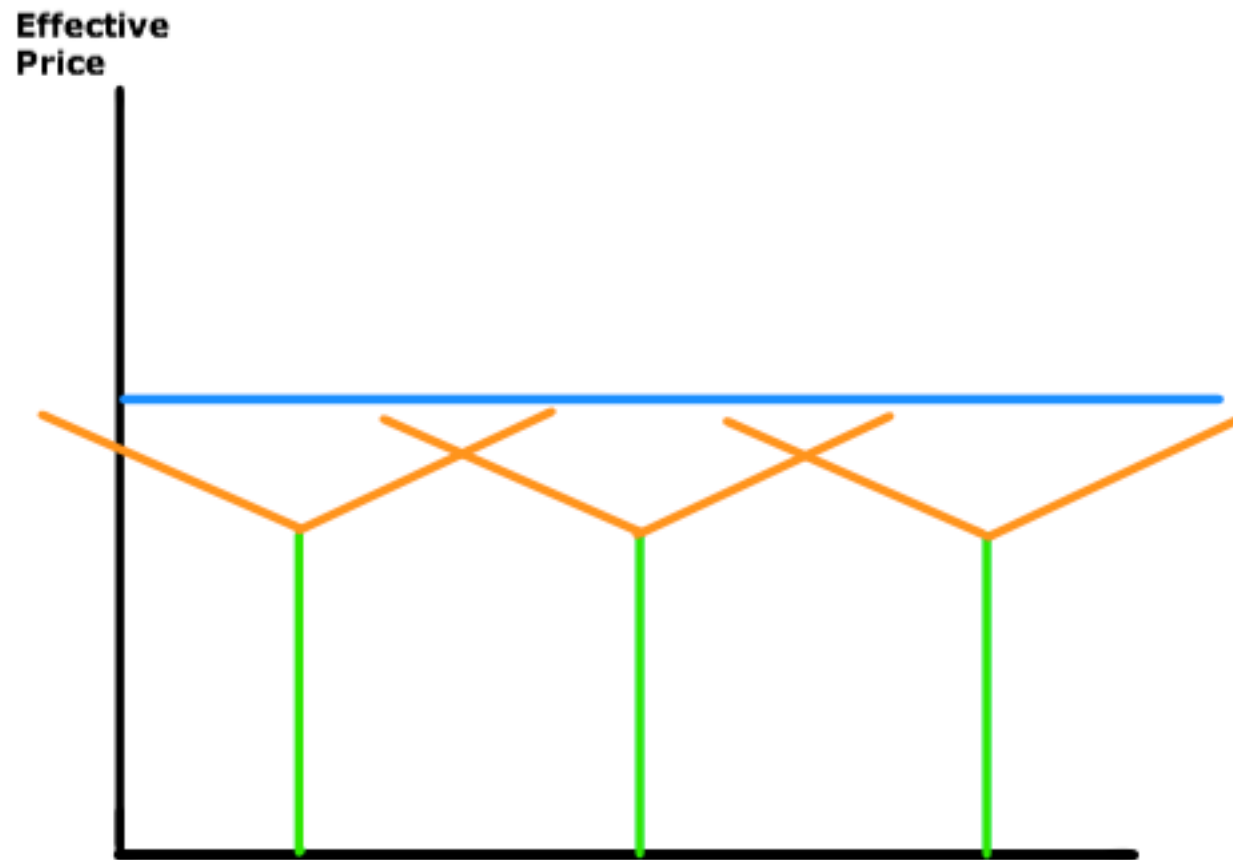
“Effective Price”



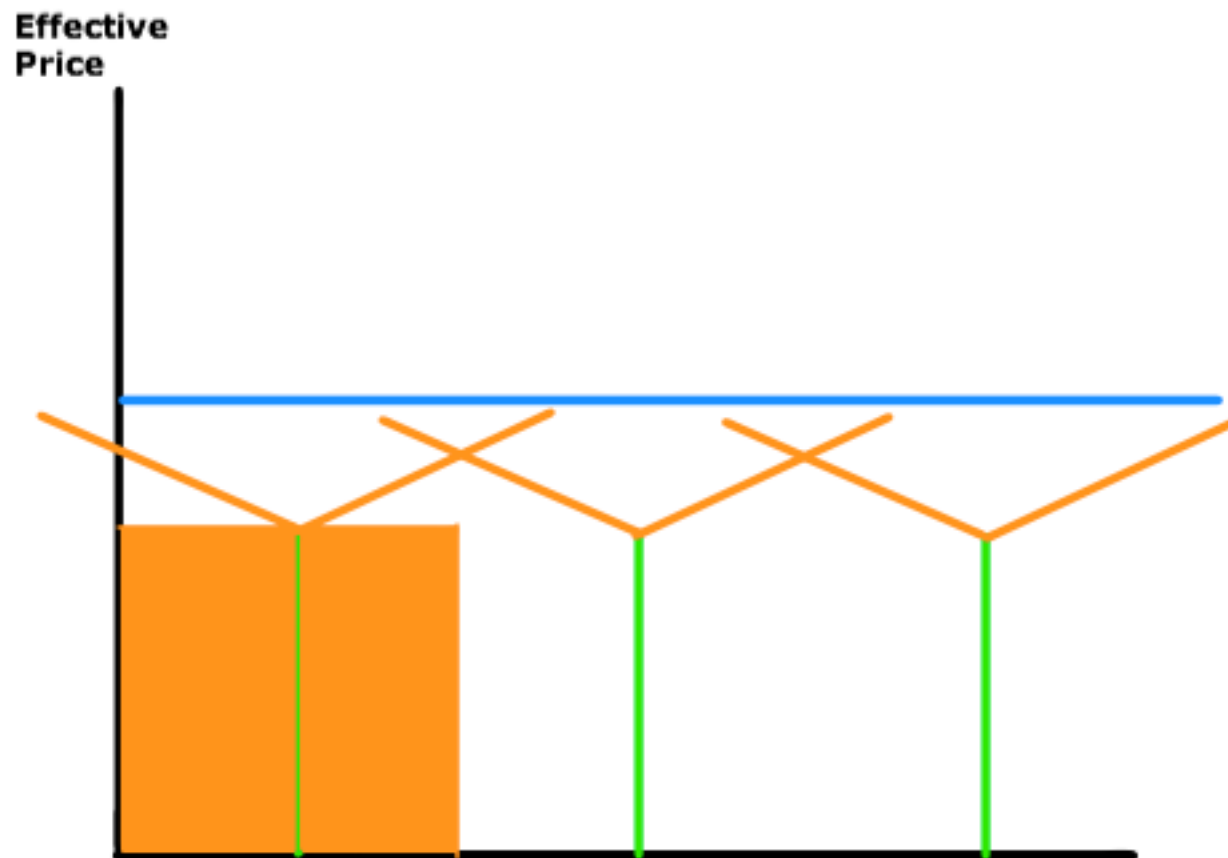
Other Producers Enter..



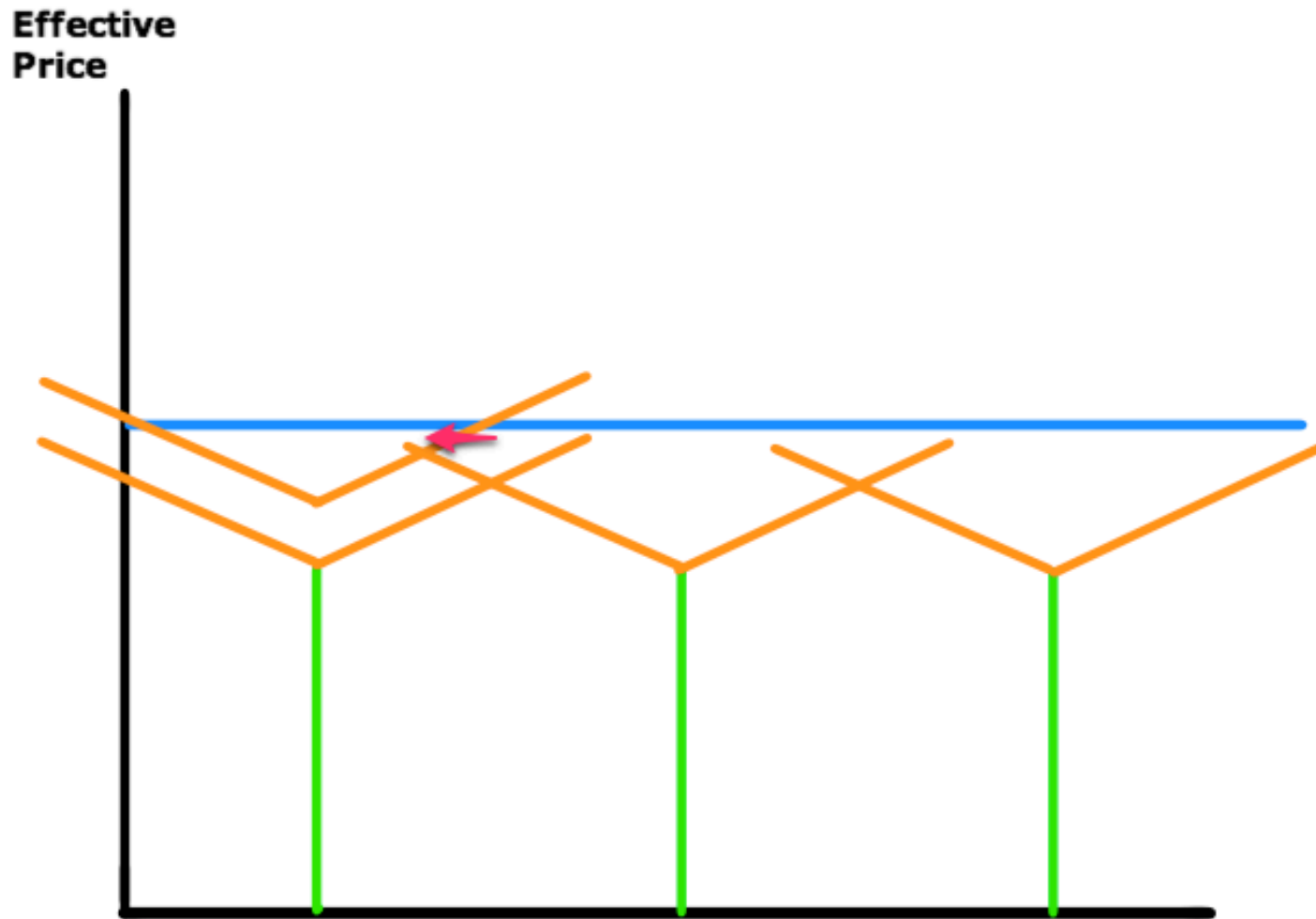
Consumers Have Reservation Prices



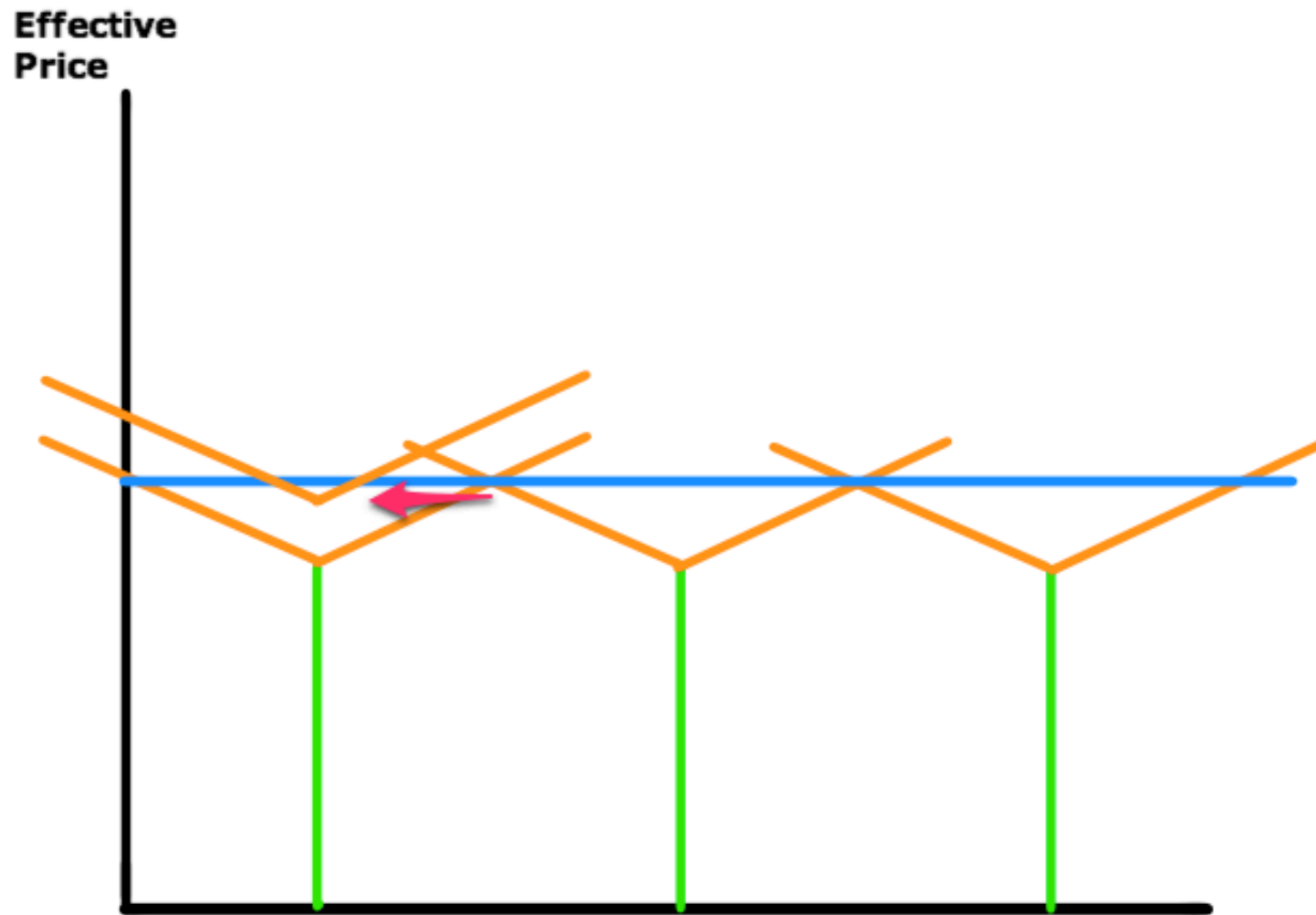
Producers Earn Revenue



Price Changes and Battleground Consumers



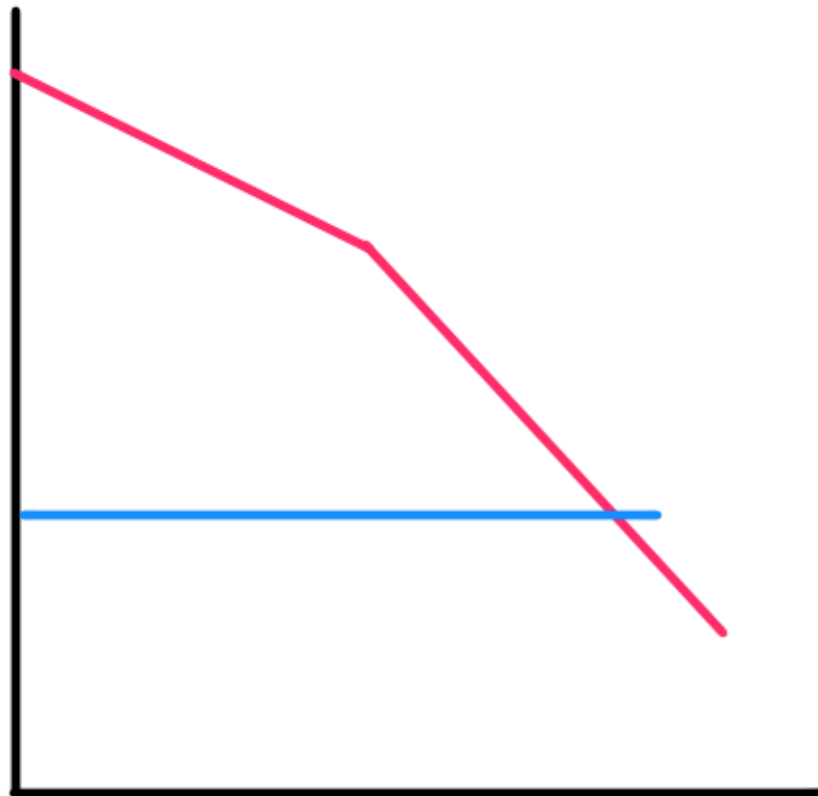
Price Changes and Home Consumers



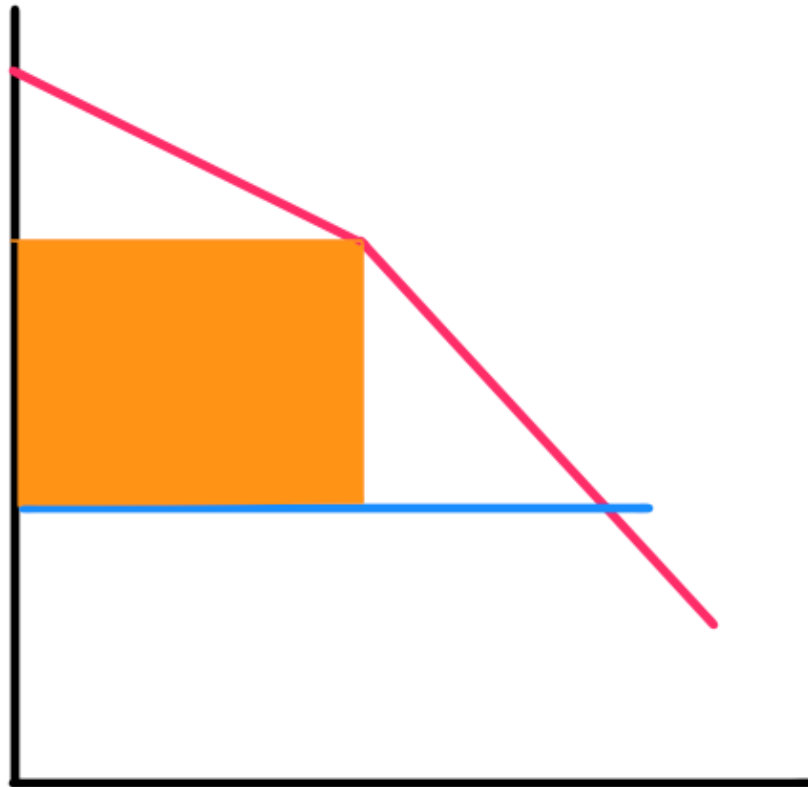
Two Types of Customers

- Your “home customers”—those who like your variety a lot more
- The “battleground customers”—those who might actually prefer some other variety to your variety
- This induces a kink in your demand curve
 - Tendency to try to squeeze as much as you can out of your home customers, and not try to gain extra battleground customers by cutting prices

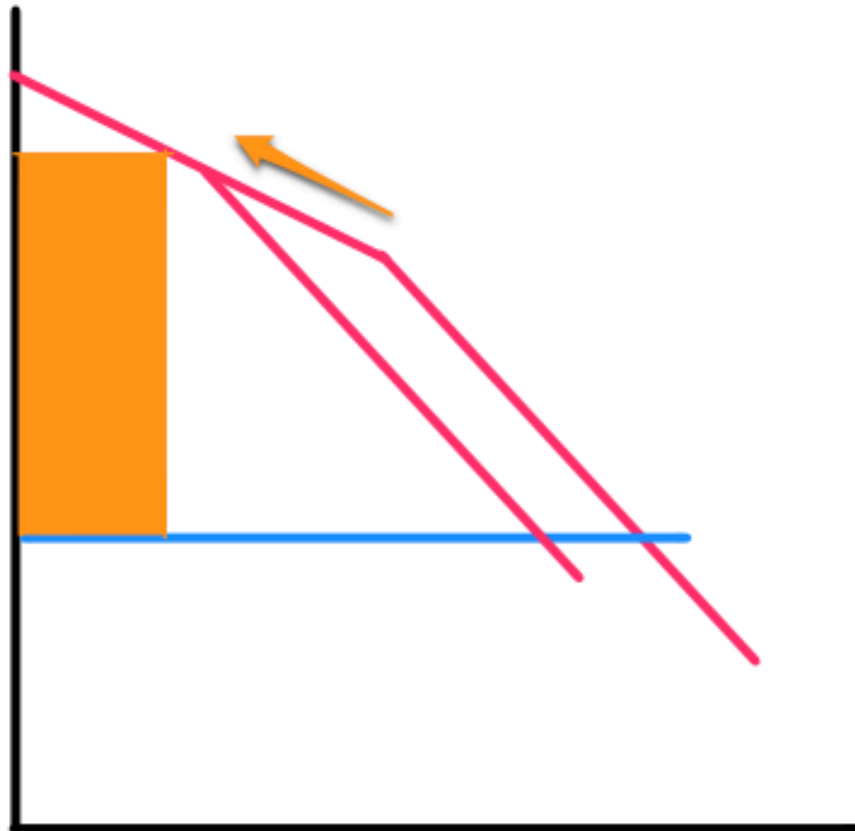
A Kink in the Demand Curve



The Entry Decision: Compare the Profits to the Fixed Cost of Setting Up



Entry Continues Until the Next Entrant
Will Not Cover Their Fixed Costs...



What Can We Say About Long-Run Equilibrium?

- Demand:
 - $Q = Q_0 - \beta P$; $P = (Q_0 - Q)/\beta$
- Entry and symmetry:
 - $Q = M/n$
 - $P = (Q_0 - (M/n))/\beta$
- Revenue of the last new entrant:
 - $R = (Q_0 M/n - (M/n)^2)/\beta$

How Many Producers Will There Be?

- If variable costs are zero
- Then entry will continue until
 - The revenue of the new entrant no longer covers the fixed cost of producing
 - $F > R = PQ = (Q_0M/n - (M/n)^2)/\beta$
- Entry will stop when there are, essentially, no more profits being made.
 - The only surplus from the industry will be the consumer surplus

How Many Producers Should There Be?

- If variable costs are zero...
- Surplus is surplus
- The gain from an extra producer comes from getting people closer to their optimum quality
 - There are M people
 - The average person is $M/2n$ away from their optimum quality
 - And β describes how much they care about it
- - $M^2/2n\beta$ is the cost from not having ideal varieties for everybody
 - Add another producer, and that cost of non-ideal varieties goes down

Overprovision of Variety

- Where does revenue come from?
 - Incumbent producers are collecting a lot of producer surplus from their local market power
 - Some of the gains from adding a variety stem from taking producer surplus away from other producers
- Only some of the gains come from capturing (some of) the value from providing a better fit to customers

And High Prices

- There are lots of producers
- But there is relatively little competition among them
- For they tend to focus on extracting revenue from their home customers
- Strategic interaction questions...

Thus Monopolistic Competition

- Has too many firms
- Each of them producing too little
- The market is not perfect
- How to make things better?
- No, we do not want to make everybody dress in identical blue overalls and sing every morning...

Test Your Knowledge

- Why do monopolists tend to produce too little?
- What are the New Chicago arguments against antitrust?
- What were the Old Chicago arguments for very aggressive antitrust?
- Why do there tend to be too many monopolistic competitors making too many varieties?
- What steps might governments take to improve the allocation of the number of varieties?