

Monopolistic Competition

Monopolistic competition is a market structure containing a large number of firms selling similar but differentiated products.

For Examples the UK features over **12,200 coffee shopw.**

Characteristics of Monopolistic Competition

Large Number of Small Firms

Low Barriers to Entry and Exit

There are low barriers to entry and exit, meaning firms can enter or leave the market relatively easily.

For example, opening an independent coffee shop requires relatively low capital (**around £50,000**).

Product Differentiation

Products are similar but differentiated. This is the key difference between monopolistic competition and perfect competition.

Firms may differentiate their products through:

- Branding and advertising
- Quality
- Loyalty schemes

Product differentiation gives each firm some degree of price-making power because consumers may prefer its particular version of the product.

As a result, the firm's AR (demand) curve is downward sloping.

For example Independent cafes charge **around £4.50+** for a specialty flat white by leveraging niche origin of coffeebeans, oat milk alternatives, and aesthetic store layouts to generate brand loyalty.

Large Number of Substitutes

Although products are differentiated, there are still many close substitutes available.

Therefore, demand is generally more price elastic than for a monopoly.

If one firm significantly increases its price, consumers can switch to a similar product offered by another firm. This limits each firm's price making power.

Written by [udoecon.com](https://www.udoecon.com)

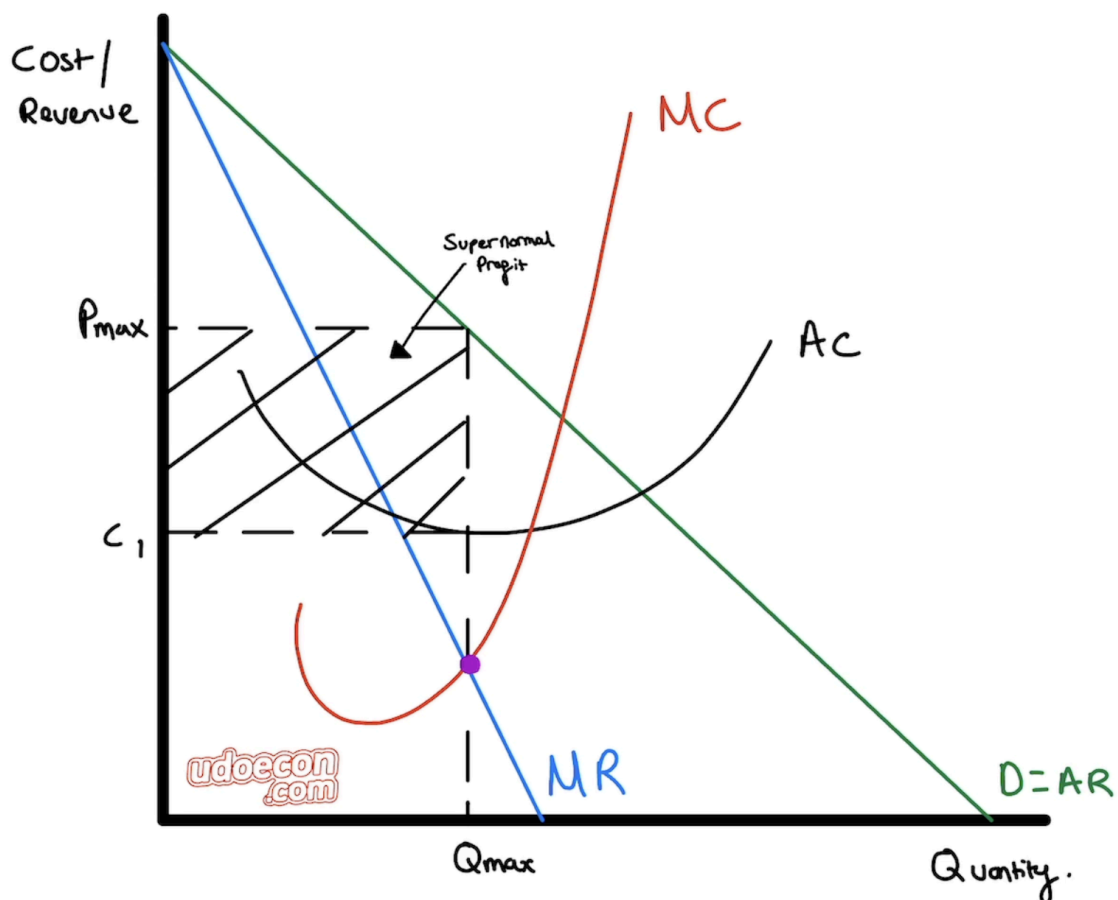
Non-Price Competition

Firms use non-price competition to differentiate their products from competitors.

This may include advertising, branding, improvements in quality, customer service and additional services.

For example **loyalty apps, free WiFi, and interior design rather than undercutting prices to attract customers.**

Short-Run Equilibrium

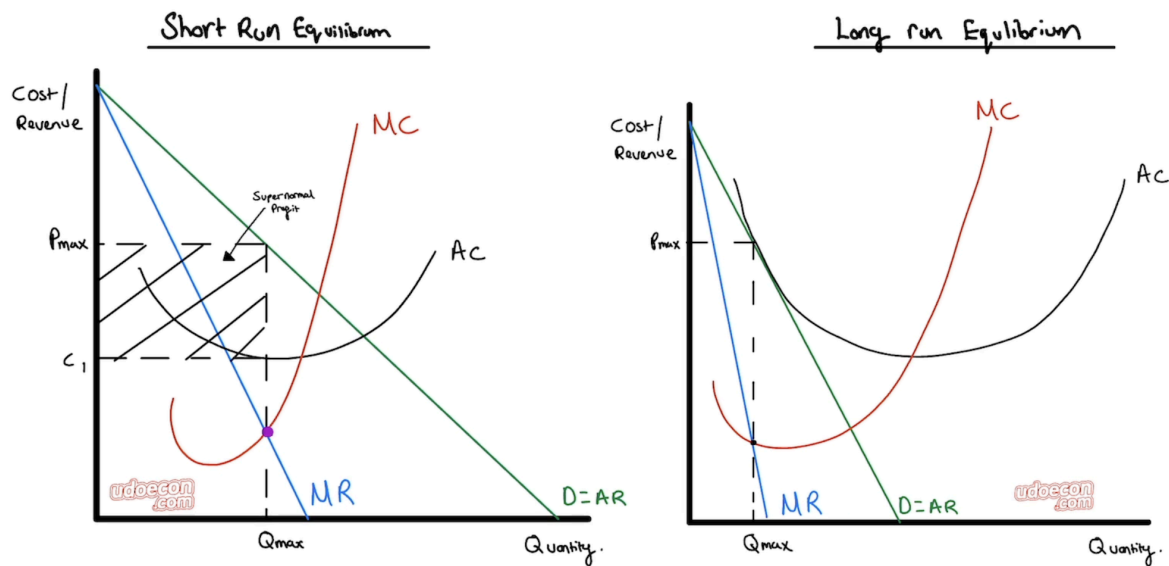


In the short run, a monopolistically competitive firm behaves similarly to a monopoly because it has a downward-sloping AR curve and some price-making power.

The firm profit maximises where:

$MC = MR$. This gives them price P_{max} and Quantity Q_{max} and large box of supernormal profits.

Long-Run Equilibrium

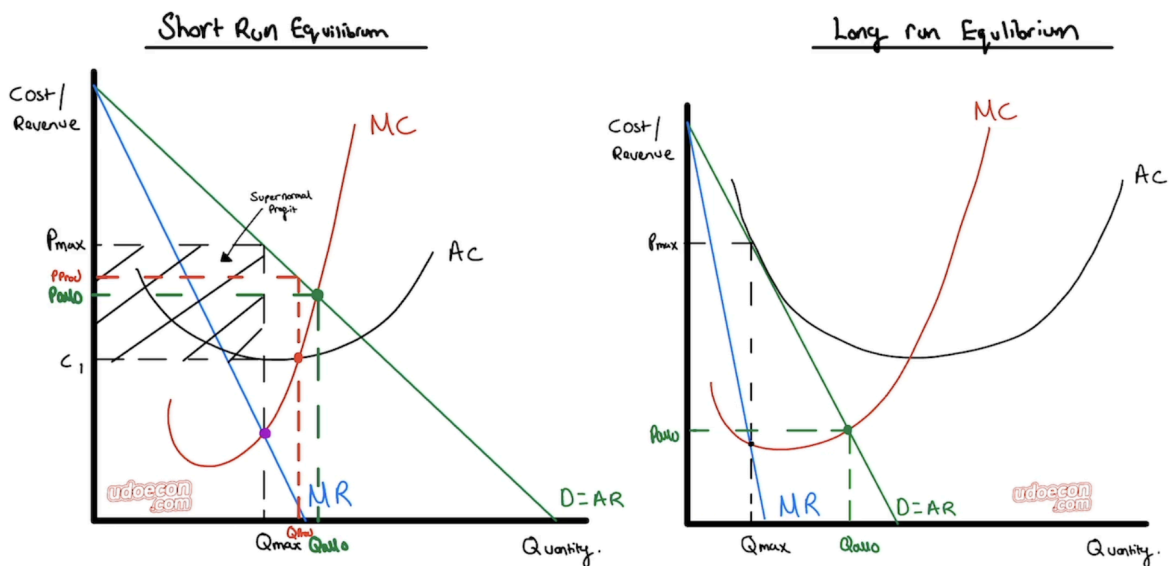


From Supernormal Profit to Normal Profit

If firms are initially earning supernormal profit:

Supernormal profit $\rightarrow$ incentivises new firms to enter $\rightarrow$ low barriers to entry $\rightarrow$ new firms enter and steal demand away from existing firms $\rightarrow$ existing firms lose market share $\rightarrow$ $D=AR$ and MR shift left $\rightarrow$ supernormal profit falls $\rightarrow$ this continues until $AR = AC$ as only normal profit remains $\rightarrow$ no longer any incentives for new firms to join the market (no supernormal profits) $\rightarrow$ we reach our long run monopolistic market equilibrium

Efficiency in Monopolistic Competition



Short Run

- **Allocative efficiency: No** → P_{allo} is less than P_{max}
- **Productive efficiency: No** → P_{prod} is less than P_{max}
- **Dynamic efficiency: ✓ Possible** → firms can earn supernormal profit, which can be reinvested into R&D, innovation or product improvements.

Long Run

- **Allocative efficiency: No** → P_{allo} is less than P_{max}
- **Productive efficiency: No** → firm produces before minimum AC, creating **excess capacity**.
- **Dynamic efficiency: No** → firms earn normal profit only, so there are no supernormal profits to reinvest into R&D and innovation.

So the key difference from **perfect competition** is that monopolistic competition remains **allocatively and productively inefficient even in the long run**.

Advantages and Disadvantages

Advantages

- Greater consumer choice due to product differentiation.
- Non-price competition may improve quality and customer service.
- Competition from substitutes puts pressure on firms to control prices and costs.
- Supernormal profit may allow dynamic efficiency in the short run.

Disadvantages

- Allocative inefficiency because AR is generally above MC .
- Productive inefficiency because firms do not produce at minimum AC
- Advertising and branding may increase costs or create imperfect information.
- Small firms may be unable to fully exploit economies of scale.