Monopolistic competitive market

Finance, Market

Introduction

The term market refers to the place where buyers and sellers meet to engage in transactions that entail the exchange of goods or the provision of services for a consideration. A market is not only characterized by a building where people carry out business transactions. This is because any place that people carry out commerce can be referred to as a market. A market is characterized by various mechanisms that facilitate trade. These mechanisms usually pertain to the supply and demand of products and services (Bergin, 2005).

From this explanation it should be clear that a market is comprised of three main elements. The sellers these are the people who bring the products or services to the market to be procured by the willing buyers. At this stage it is imperative to highlight that in most cases sellers are the produces however in other instances the sellers are not necessarily the producers instead they can be traders. The second element of the market is the buyers. Buyers are individual who are willing and able to acquire the products or services being offered at the prevailing market price.

Buyers are of two types; there are those that buy the products or services for their own consumption and there are those that buy the products or services in order to resell them in different markets. The buyers who buy the products for their own consumption are referred to as consumers whereas buyers who buy the products or services in order to resell them in different market are commonly referred to as trades and they can also be called arbitragers

(Nicholson & Snyder, 2008). The third element of the market is the products that are being traded.

The term product can be used to refer to either goods or services that are being offered in exchange for a consideration. The term product can also be used to refer to commodities only. General Objectives One of the general objectives of this paper is to facilitate the readers of this document to gain an understanding of how markets work and most importantly how a monopolistic competitive market works. This paper will achieve this through briefly discussing various types of markets and their characteristics.

Another general objective of this paper is to compare and contrast the various characteristics of the different forms of market structures. This will serve to enable the readers to carry out a comparative analysis of the various forms of market structures thus they will be able to enhance their knowledge on market structures. This objective will be attained through the analysis of the factors, which are mainly in play for the existence of a particular form of market. The paper will also seek to analyze how the various factors in such markets interrelate in order to develop a market mechanism for that form of market structure.

This is because all forms of markets structures have market mechanisms. These market mechanisms are usually as result of the interaction of various factors that are both internal and external to a particular market. Specific Objectives One of the specific objectives of this paper is to discuss the conceptual theory of a monopolistic competitive market. The discussion of the monopolistic competitive market entails analyzing the various factors that characterize this particular form of market structure. This is will be important form enhance the knowledge of the readers of this paper, on monopolistic competitive market structure.

The discussion of the conceptual theory will also enable the readers to have a good basis for analyzing and responding to questions that relate to monopolistic competitive market structure. Another objective is to discuss the characteristics of a monopolistic competitive market. The discussion of the characteristics of a monopolistic competitive market structure is important because it will serve to explain how the various factors involved in this type of market structure interrelate in order to this unique type of market.

The discussion of the characteristic of a monopolistic competitive market will serve to enhance the understanding of the readers of how companies that operate in such a market carry out their operations. The discussion of these characteristics will serve to inform the readers the various factors that companies operating in this type of market put into consideration during decision-making. This discussion will also enable the readers to be able to identify a monopolistic competitive market in a real business situation.

This paper also aims at establishing how market equilibrium is achieved both in the long – run and in the short run. This is mainly because in a monopolistic competitive market structure, market equilibrium is achieved differently both in the short – run and in the long – run. This analysis is imperative mainly because this knowledge enables the management to have a good basis for decision-making. The analysis will provide factors that the management should put into consideration whenever they are making decisions concerning either the short term or the long – term future of a company.

The illustration of how market equilibriums are achieved in the short run or in the long run will enable the readers to gain understanding of how the various factors in this market structure relate in the determination of the equilibrium market prices. It will also enable to understand how companies that operate in a monopolistic competitive market adapt themselves in order to be able to operate in this particular form of market at minimal costs and manage to obtain maximum profits. This paper will also provide a practical example of a monopolistic competitive market.

In this example, the paper will seek to illustrate how the conceptual theory is exhibited in this form of market structure. This paper will utilize this example in order to enhance the knowledge of the reader on how market equilibrium is attained both in the long – run and in the short – run. This example will illustrate how the various factors are displayed in a real market situation, also this paper will utilize the example to look at the type of decisions that are made by mangers of companies that operate in a monopolistic competitive markets structure. Conceptual Theory

There are four forms of market structure namely, monopoly, perfect competition, monopolistic competition and oligopoly. These forms of market structures are characterized by different market conditions. Markets are mainly classified according to the number of firms in the industry or the form of products sold in them. The number of firms operating in a particular market determines the level of competition in that market. Product markets are mainly categorized according to the number of firms in the industry and the degree of competition that is prevalent in a particular industry.

At this stage it is also important to highlight that equilibrium prices in these markets are subject to the forces of supply and demand. The forces of supply and demand are known as the price mechanism. An individual firm on itself cannot influence the price of a commodity and can therefore only take the price prevailing in the market. Due to this condition a firm is therefore said to be a price taker (Nicholson & Snyder, 2008). The movement along a demand curve is caused by changes in price of a commodity.

An increase in price results in a decrease in quantity demanded hence a movement along the demand curve to the left. A shift in the demand curve is caused by changes in factors other than the price of the commodity in question. Different quantities are therefore demanded at the original price. A shift in the demand curve outwards to the right indicates that more quantities are demanded at the original price whereas a shift inwards to the left indicates that fewer quantities are demanded at the original price (Dwivedi, 2006).

Movement in the supply curve is similar to movement in the demand curve. A shift in the supply curve refers to a relocation of the supply curve either outwards to the right or inwards to the left due to change in the factors that affect supply other than price. This means that at each price, a different quantity will be supplied that was previously supplied. Equilibrium price refers to the price, where the quantity demanded equals that supplied. It is the price at which the amount the customers are able and willing to buy is equal to the quantity producers willing and able to supply.

The equilibrium point, refers to a point at which the demand and the supply curve intersect. Any price above the equilibrium price leads to excess supply, whereas any price below the equilibrium price leads to excess demand. Excess demand or supply causes disequilibrium in the market. Due to the excess demand for a particular commodity in the market, a shortage is created. This shortage causes the consumers to compete for the limited commodity in the market thus making the price of that commodity go up. As he price continues to rise, suppliers put more of the commodity into the market (Mandal, 2007). On the other hand, the high price also discourages some consumers from buying the commodity. This scenario of increased supply and reducing demand continues until the equilibrium price and quantity are set. When there is excess supply of a commodity in the market the prices begins to fall. As the price falls more consumers purchase the commodity. The suppliers also reduce the amount of the commodity they are releasing into the market due to the falling prices.

This scenario of falling supply and increasing demand continues until the equilibrium price and quantity are set. It is also important to highlight that a general assumption in the study of this subject is that firms aim at attaining maximum profits using minimal costs possible. This means during decision making the managers of the firm will always aim at using the least resources possible and utilise them efficiently in order to attain the maximum achievable profits possible. The level of output that will bring about maximum profit in a firm depends on the costs incurred and the revenues earned.

Revenues refers to incomes obtained by a firm from the sale of its outputs and they may be categorized into three namely, total revenue, average revenue and marginal revenue. Total revenue refers to the total income earned by a firm from the sale of its output. Total revenue is obtained through multiplying the total output sold by the price. Average revenue refers to income per unit of output. Average revenue can be obtained by dividing the total revenue obtained by the number of units of output. It is important to note that the average revenue is the same as the price of the commodity (Dwivedi, 2006).

This implies that the average revenue curve, which relates average revenues to output, is the same as the demand curve, which relates prices to output. Marginal revenue refers to the addition to the total revenue arising from the sale of an additional unit of output. Marginal revenue can also be obtained by subtracting the previous total revenue from the current one and can be seen to be equal to the price and average revenue. Characteristics of a monopolistic competitive market This is a market structure that combines aspects of perfect competition and those of a monopoly.

There are many sellers and many buyers just like in perfect competition. The commodities dealt with are similar but each firm tends to differentiate its products from those of its competitors through acts such as branding, packing, wrapping and coloring. A monopolistic competitive market structure is a combination of the features that will be discussed in the succeeding paragraphs. In a monopolistic competitive market there exist many buyers and sellers. This comes in adequately because there is no single firm that can influence the prices of commodities or services in the market.

If a business sells its goods or services above the market price then consumers can buy their goods from other businessmen. If a company sells its products at a lower price then chances of making a loss is very high (Mandal, 2007). Though a business may increase its prices in a perfect competition, the action may be risky since customers will move to another business. This is not the case with a monopolistic business, though a firm may lose some of the customers, some will remain due to the kind of relationship they have with the seller or even the quality of the given products.

All the aforementioned factors are due to the fact that there is a large number of buyers and customers that act independently. In this form of market structure it is assumed that the sellers and the buyers of commodities are well informed about the market. That is they know the prices, quality of products and all the factors affecting the market. In this market the products are differentiated. The products from different producers either vary in quality or the product is a group of commodities which are close substitutes of each other (Mandal, 2007).

For instance, in the toothpaste industry there are different brands such as Colgate, Close– up and Aquafresh. This differentiation of products from different firms enables each firm to enjoy a certain degree of monopoly power. A monopolistic competitive market is characterized by freedom of entry and exit. This means there are no barriers to a business entering or living the market. This means that new firms wishing to supply the same commodity are free to do so (Bergin, 2005). Similarly, existing firms wishing to leave the market are free to do so.

How to determine equilibrium in the short – run and long – run on Monopolistic Competitive Market Structure Price and output determination under monopolistic competition Due to product differentiation, a firm under monopolistic competition is able to exercise some influence on the price of the product. This means that a firm can raise prices yet some customers will still buy at these high prices (Dwivedi, 2006). However, many customers will switch to rivals' products. On the other hand, if the firm lowers the price, it would attract some buyers fromthe rivalfirms, thereby increasing its product's demand.

A monopolistically competitive market has a demand curve that slopes downward from left to right. In a monopolistic competitive market the demand curve is fairly elastic. This means that a small change in price will bring about more than proportionate changes in quantities demanded. This is because there are many substitutes in the market. The demand curve is more elastic than the one faced by a monopolist but less elastic than a perfectly competitive market whose demand is perfectly elastic (Jehle & Reny, 2011). The relationship between average revenue and marginal revenue is similar to that of a monopolist.

For average revenue to be increasing as more units of output are sold, the marginal revenue must be lower than the average revenue. Short – run equilibrium output under monopolistic competition A firm under monopolistic competition will be at equilibrium at an output when profits are maximized. This is the position when marginal revenue is equal to marginal cost. This is at price P1 and quantity Qe. However, there still excess demand and the firm can maximize its profits by changing price Pe. The firm will therefore produce quantity Qe and sell at price Pe (Jehle & Reny, 2011).

Qe represents equilibrium output and P1 represents equilibrium price. The price at which the equilibrium output can be sold is determined by the demand Curve (Average Revenue) and its price. Profits are maximized at a level of output between O (zero) and the equilibrium quantity demanded. Long – run equilibrium output under monopolistic competition A firm under monopolistic competition can make supernormal profits in the short – run. Since there is free entry of new firm into the market, the supernormal profits will attract the new firms with the effect that demand for the old firm's customers will be taken by new firms.

The demand curve for the old firm therefore shifts right to left (Mandal, 2007). A lower quantity is demanded at each price. Firms are likely to increase expenditure on product promotion due to increased competition, which in turn would cause the average total cost curve to shift upwards. New firms will continue to enter the market as long as the existing equilibrium is achieved and all firms would be earning normal profits. The equilibrium point is where the average revenue is equal to the average cost. This point is achieved in the long run when the average revenue curve is a tangent to the average cost curve.

The firm will be at equilibrium when it produces output at the equilibrium quantity demanded (Bergin, 2005). This is where the marginal revenues equal the marginal cost because the firm is in the business of profit maximization. At the point of equilibrium, the average cost is equal to the average revenue. This is so because competitive pressure means that a firm can neither make a loss nor earn supernormal profits. At this point of equilibrium the firm is making normal profits only. Conclusion An example of a monopolistic competitive market is the toothpaste market.

The toothpaste market is characterized by firms that offers products that are similar but they are highly differentiated. Consumers of Colgate toothpaste believe that Colgate is the number one brand of toothpaste that ensures strong teeth. As a result of this the consumers are normally willing to buy toothpaste regardless of the price. Consumers of Aquafresh toothpaste believe that Aquafresh is the number one brand that ensures healthy germs and fresh breathe. As a result of this customers are willing to always procure the Aquafresh toothpaste regardless of the price.

Consumers of the two products believe the products are different and this is because of the way the manufacturers have positioned the brands.

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