Monopolistic competition and oligopoly

Life

The model of monopolistic was a developed by Edward Chamberlain in the 1930's and was mirrored by Joan Robinson at the same time. The theory of monopolist competition makes the same assumptions as the prefect competition model except that it assumes firms produce differentiated or heterogeneous products. Apart from this, it is assumed that there are a large number of buyers and sellers in the market, each of them being relatively small and acting independent, there are no barriers to entry or exit, firms are short run profit-maximizers and that there exists perfect knowledge.

By producing a slightly different product than its competitors, the firm possesses a certain amount of market power and would be able to raise prices without inducing a fall in quantity demanded. Thus, the firm would be a price taker. However, as the product is slightly differentiated and is produced by a large number of firms, small changes in price will lead to large changes in quantity demanded, as consumers will shift to close substitutes. Thus, although demand curve facing a firm in monopolistic competition will be downward sloping, it will be highly elastic.

Prices are set in tandem to the prices set by competitors with marginal differences. Branding and marketing mix may be used to differentiate the product but these are likely to prove ineffective. In the short run, the firm being a profit maximizer would operate at a price where MR= MC. However, for long run equilibrium to be achieved, two conditions will have to be met; profit maximization through selling where MC= MR and AR= AC, so that competitive pressures ensure that a firm cannot make a loss or earn abnormal profits.

Simply said, due to low barriers of entry, firms will be attracted into the industry by abnormal profits. This will increase supply and pull down AR, thus eliminating abnormal profits. Similarly, where abnormal losses are being made, the firms will move out of the industry, reducing supply, increasing AR and hence eliminating losses. Examples of industries that have a monopolistic market structure include the UK retail grocery industry, the hotel industry in Europe and the USA and the life assurance and pension fund industry. The reasoning for these industries being classified as monopolistically competitive are simple.

In each industry, there are a large number of buyers and sellers, each independent of each other (there are thousands of retail shops, pension fund management and life assurance services providers and hotels serving millions of people), there is near perfect knowledge with no industry secrets as such, barriers to entry are low (it does not take much to open a store in a particular locality, banks and asset management companies have now dwelled into pension fund management and life assurance and setting up a hotel or a lodge is relatively easy), the product produced are different from each other yet close substitutes to products of counterparts in the same industry (a hotel room is different from another room in the same hotel yet all one needs is a bed to sleep at night, it doesn’t make much difference if one buys groceries from the local retailer or the supermarket chain although the shopping experience will differ and a life assurance policy is a piece of paper only with competitive rules and pricing acting as a differentiating factor) and that all firms are profit maximizers.