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Show on a diagram how a monopoly firm will make supernormal profits by restricting output. Discuss how the theory of contestable markets could impact on the price and output of a monopoly. Neo-classical theory defines monopoly as a market structure where one dominant firm supplies most or all output in the industry without facing competition because of high barriers to entry to the industry. The monopolist is a short run profit maximiser and due to the demand under a monopoly being moderately inelastic at any given price, the monopolist is said to be a price maker, unlike perfect competition where the firms are price takers.

The diagram below shows the monopoly making supernormal profits by restricting output. The equilibrium profit maximising level of output is 0A where MC = MR, and price will be 0p. Supernormal profits are made, shown by the area on the diagram shaded red. If profit maximisation was not an objective for a monopoly, it might produce at the bottom of its average costs curve (AC). Thus, price being lower than P and quantity produced would be greater. However, because a monopoly is partly defined by wanting to profit maximise in the short run, this is not the case. C AC Price Quantity mR p A Demand 0 Under perfect competition, supernormal profits can only be made in the short run, due to low barriers to entry. The monopolist can earn supernormal profit in the short and long run due to not having to produce at the bottom of the AC curve and having high barriers to entry. These barriers to entry, preventing other potential new entrance from coming in and competing with the monopoly can take various forms. Perhaps the monopoly has control over the source of an essential raw material.

Perhaps the monopoly has extremely strong brandloyaltyand takes great care to protect its brand image and the loyalty of its consumers through extensive marketing. It has been shown that neo-classical theory suggests that high barriers to entry will earn supernormal profits for a monopoly. Contestable market theory, in which states that there is freedom of entry to the industry and where costs of exit are low, suggests that a monopoly will earn supernormal profits dependent to a large extent on the costs of exit from the industry.

If the costs of exit from the industry are low, then the monopoly arguably won't make supernormal profits in the long run. If a monopoly in the short run is charging high prices and earning supernormal profit, a competitor will enter the industry and take some market share from the monopolist by charging a lower price. The monopolist will react by reducing prices, forcing the new competitor out of the industry. This happens because the competitor cannot compete with the new lower prices set by the monopolist due to its costs being too high.

Thus, if the costs of exit from the industry are low, it is worth the competitor entering the market and having earned supernormal profits in the short run. Though, once the competitor has left the industry and the monopolist raises its price again wanting to earn supernormal profits, another competitor will enter the industry reducing the monopolists overall profits and taking market share away from it. Clearly the only way to avoid potential competitors from adopting ' hit and run' tactics would be for the monopolist to price at a level where it only earned normal profits.

In the long run the monopolist will increase output and decrease price, operating at the optimal level of output where MC = AC. Thus in conclusion it has been shown that a monopoly will make supernormal profits by restricting output. The monopoly chooses the output level to produce at, and wanting to profit maximise, it produces at the point where marginal costs equals marginal revenue. In contestable market theory, the established firm, the monopoly, must behave as if it operates in a perfectly competitive market to prevent ' hit and run' tactics by potential competitors, producing where MC = AC.