Economics

ECONOMICS - MARKET STRUCTURE Answers to Questions How do firms in monopolistic competition compete with each other? It is d that monopolisticcompetition differs only from perfect competition with regard to the heterogeneity of products - that is, the buyer thinks a product is somewhat different from every other sellers. Therefore, sellers compete on the basis of quality, packaging, and supplementary services. The monopolistic competitors demand curve has a negative slope; unlike a perfect competitors which is horizontal and who can suffer loss of customers if he increases his price. Products in monopolistic competition differ from every other sellers. If one competitor lowers its price it may attract some - but not all - buyers because product differentiation makes it possible for some to remain with the sellers product despite the price increase, and they will not switch.

2. What incentives are there to collude in an oligopoly?

Rivalries among oligopolists can be circumvented by some form of open or tacit collusion among members, in the process converting the oligopoly, at least temporarily, into a sort of monopoly. One example is price leadership, where one company, usually the biggest among them, sets the price and the others follow. It is somewhat risky because unless the others expect to benefit or are not harmed by the move, they can undercut the price instead, and a price war among the participants can ensue. A company may also behave in such a way that it does not make things difficult for its competitors. Companies may set their prices so that they are only a few cents apart and thus somehow avoid accusations of having colluded in setting prices.

Open collusion (a cartel) is possible but is illegal in the United States. A

successful cartel can charge a monopoly price at the expense of the consumers and obtain monopoly profits. An exception in the United States applies to regulated industries such as telecommunications and gas pipeline transportation where members are allowed to behave as cartels provided they do not undercut the prices set by government regulatory agencies (Baumol and Blinder, 1997).

3. What happens to output and price if a perfectly competitive market turns into a monopoly? Where do we see that happen?

A monopoly is either a pure monopoly or a natural monopoly. A pure monopoly is one where there is only one supplier of a product that has no close substitutes and where it is impossible or extremely difficult for another firm to coexist. A natural monopoly, on the other hand. is an industry in which advantages in large scale production make it possible for a single firm to produce the entire output of the market at a lower than average cost than a number of firms each producing a smaller quantity. It is the latter kind of monopoly that can evolve from a perfectly competitive market. One well-capitalized firm may dominate because of economies of scale. Other cases can be cited - such as when one firm is able to obtain a patent for a new product.

A larger firm which enjoys economies of scale has a lower cost structure, and it can drive a smaller firms out of business because it can offer its products at a lower price which a smaller firm cannot match, resulting in losses for the latter. The low price can also be a barrier to the entry of new firms; but the danger is that once the small firms are eliminated, the monopolist can increase its price and make huge monopoly profits.

Compared to a perfectly competitive situation, the monopolist can restrict

output and charge a higher price. The monopolist produces fewer units of output under the same demand and cost conditions than in a perfectly competitive market. Since the demand curve of a monopolist is downward sloping, reduced supply means it can charge a higher price, and he is thus open to the charge of " gouging the public."

4. Can a monopolist charge whatever they want for their product?

Let us remember that the monopolist is a price maker, that is, it has the power to set the price or select the combination of price and quantity on its negative-sloping demand curve to suit its best interests. Because competition is eliminated and there is a barrier to entry by new firms, the monopolist can charge almost any price it wants. However, because of its downward sloping curve, when it charges a higher price some consumers will hold back or reduce their purchase of its products. A point is reached when raising the price further can prove unprofitable. Therefore, there is a limit to the amount to how much a monopolist can charge for its products.

When the monopolist has its way, the accumulation of wealth at the expense of the consumers is considered by the public as objectionable, hence the government often intervenes by regulating it to limit the profits it can earn.

(Baumol and Blinder, 2000; Mankiw, 1998)

REFERENCES:

Baumol, W. J. & Blinder, A. S. (1997). Microeconomics, 7th ed. Orlando, FL:

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