Price Determination under Monopolistic Competition

Imperfect competition covers all situations where there is neither pure competition nor pure monopoly. Both perfect competition and pure monopoly are very unlikely to be found in the real world. In the real world, it is the imperfect competition lying between perfect competition and pure monopoly. The fundamental distinguishing characteristic of imperfect competition is that average revenue curve slopes downwards throughout its length, but it slopes downwards at different rates in different categories of imperfect competition. The monopolistic competition is one form of imperfect competition.

FEATURES OF MONOPOLISTIC COMPETITION:

Monopolistic competition refers to the market situation in which many producers produce goods which are close substitutes of one another. Two important distinguishing features of monopolistic competition are:

(a) Product differentiation, and
(b) Existence of many firms supplying the market.

(a) Product Differentiation: In contrary to perfect competition where there is only one homogeneous commodity, in monopolistic competition there is differentiation of products. In monopolistic competition, products are not homogenous nor are they only remote substitutes. These are the products produced by competing monopolists that have separate identity, brand, logos, patents, quality and such other product features. Product differentiation does not mean that goods are completely different. Rather it means that products are different in some ways, but not altogether so. These imaginary differences are created through advertising, marketing, packaging and the use of trademarks and brand names.

(b) Existence of Many Firms: Under monopolistic competition, there is fairly large number of sellers, let say 25 to 70. Each individual firm has relatively small part of the total market so that each has a very limited control over the price of the product. And each firm determines its own price-output policy without considering the reactions of rival firms.

(c) In monopolistic competition, in the long run, there is ***freedom of entry and exit***.

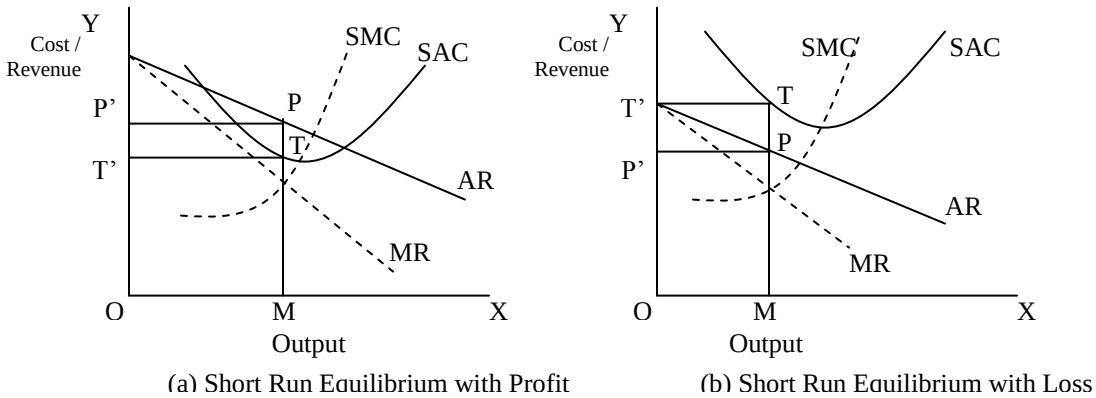
(d) The commodity sold in a monopolistic competitive market is not a standardised product but a differentiated product. Hence competition is no longer exclusive on price basis. Buyers are buying a ***combination of physical product and the services*** which go with it.

(e) Because of consumers' attachment to a particular brand, the seller acquires a monopolistic influence on the market. Thus, the ***demand curve*** facing a firm under monopolistic competition is a downward sloping curve, i.e., if he wants to sell more, he has to lower his price. The demand curve or AR curve under monopoly also slopes downwards, but there is a difference between demand curves facing under monopolistic competition and pure monopoly. The demand curve faced by a '*competing monopolist*' is *more elastic* than the demand curve faced by the '*monopolist*', because there are no close substitutes available for the monopolist commodity.

PRICE DETERMINATION UNDER MONOPOLISTIC COMPETITION:

Under monopolistic competition, the firm will be in equilibrium position when marginal revenue is equal to marginal cost. So long the marginal revenue is greater than marginal cost, the seller will find it profitable to expand his output, and if the MR is less than MC, it is obvious he will reduce his output where the MR is equal to MC. In short run, therefore, the firm will be in equilibrium when it is maximising profits, i.e., when MR = MC.

(a) Short Run Equilibrium: Short run equilibrium is illustrated in the following diagram:



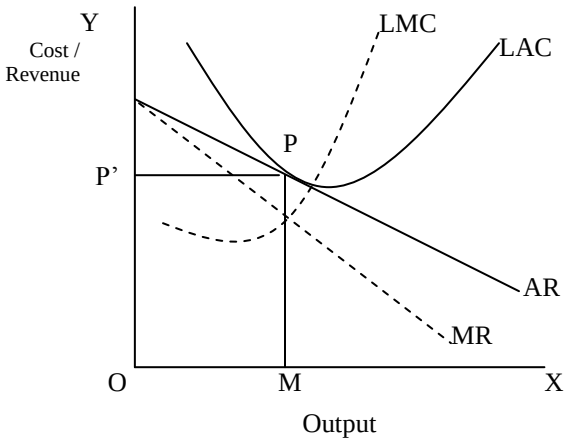
(a) Short Run Equilibrium with Profit (b) Short Run Equilibrium with Loss

Monopolistic Competition Short Run Equilibrium

In the above diagram, the short run average cost is MT and short run average revenue is MP. Since the AR curve is above the AC curve, therefore, the profit is shown as PT. PT is the supernormal profit per unit of output. Total supernormal profit will be measured by multiplying the supernormal profit to the total output, i.e. PT × OM or PTT'P' as shown in figure (a). The firm may also incur losses in the short run if it is facing AR curve below the AC curve. In figure (b) MP is less than MT and TP is the loss per unit of output. Total loss will be measured by multiplying loss per unit of output to the total output, i.e., TP × OM or TPP'T'.

(b) Long Run Equilibrium: Under monopolistic competition, the supernormal profit in the long run is disappeared as new firms are entered into the industry. As the new firms are entered into the industry, the demand curve or AR curve will shift to the left, and therefore, the supernormal profit will be competed away and the firms will be earning normal profits. If in the short run firms are suffering from losses, then in the long run some firms will leave the industry so that remaining firms are earning normal profits.

The AR curve in the long run will be more elastic, since a large number of substitutes will be available in the long run. Therefore, in the long run, equilibrium is established when firms are earning only normal profits. Now profits are normal only when AR = AC. It is further illustrated in the following diagram:



Long Run Equilibrium in Monopolistic Competition