

WEEK 5: MONOPOLY, MONOPOLISTIC COMPETITION AND OLIGOPOLY

IMPERFECT COMPETITION

Imperfect competition differs from perfect competition in that there may be one or small number of firms dominating the market.

There are three main types of imperfect competition:

- a) **Monopoly**
- b) **Monopolistic Competition**
- c) **Oligopoly**

MONOPOLY

In a monopoly, there is only one firm, the sole producer of a good, which has no close substitutes, so the total market supply is identical with the single firm's supply. In other words, a monopoly exists when there is only one firm in the industry.

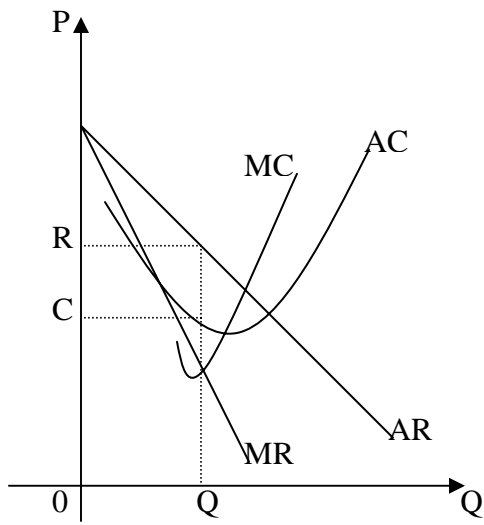
If a monopolist can raise its price and consumers have no alternative firm to turn to within the industry, they either pay a higher price or go without the good altogether.

The monopoly firm is a **price maker**; it can choose what price to charge. Nevertheless, it is still constrained by its demand curve. A rise in price will lower the quantity demanded.

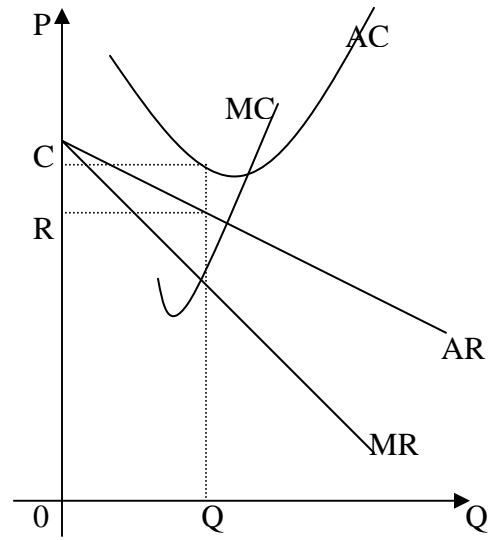
Equilibrium Price and Output

As with firms in other market structures, a monopolist will maximize profit where $MC = MR$. In the short run, the monopolist may make sub-normal profit, normal profit or supernormal profits. However, in the long run, since there are barriers to entry of new firms, the supernormal profits that are made by the monopolist will not be chipped away. As for the monopolist who makes normal profits or abnormal profits in the short run, it will make supernormal profits in the long run.

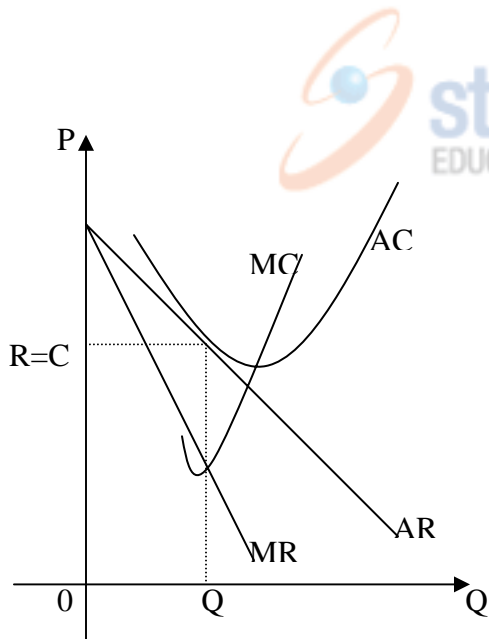
Short run



Supernormal profits



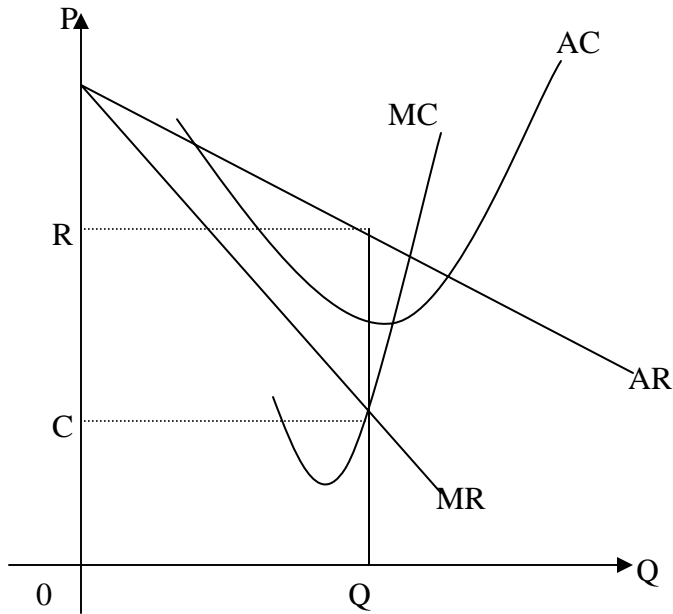
Subnormal profits



Normal profits



Long run



Supernormal profits

In the long run, the firm will make supernormal profits only. This is because there are barriers to the entry of new firms.

PRICE DISCRIMINATION

Discrimination monopoly (price discrimination) is said to exist when a business is able to charge two or more different prices for the same product.

There are three varieties of price discrimination:

- i) *First degree price discrimination*
- ii) *Second degree price discrimination*
- iii) *Third degree price discrimination*

Price discrimination in different markets “separated” by:

- **Time**
- **Distance**
- **Age**
- **Consumer’s ignorance**

MONOPOLISTIC COMPETITION

Characteristics of Monopolistic Competition

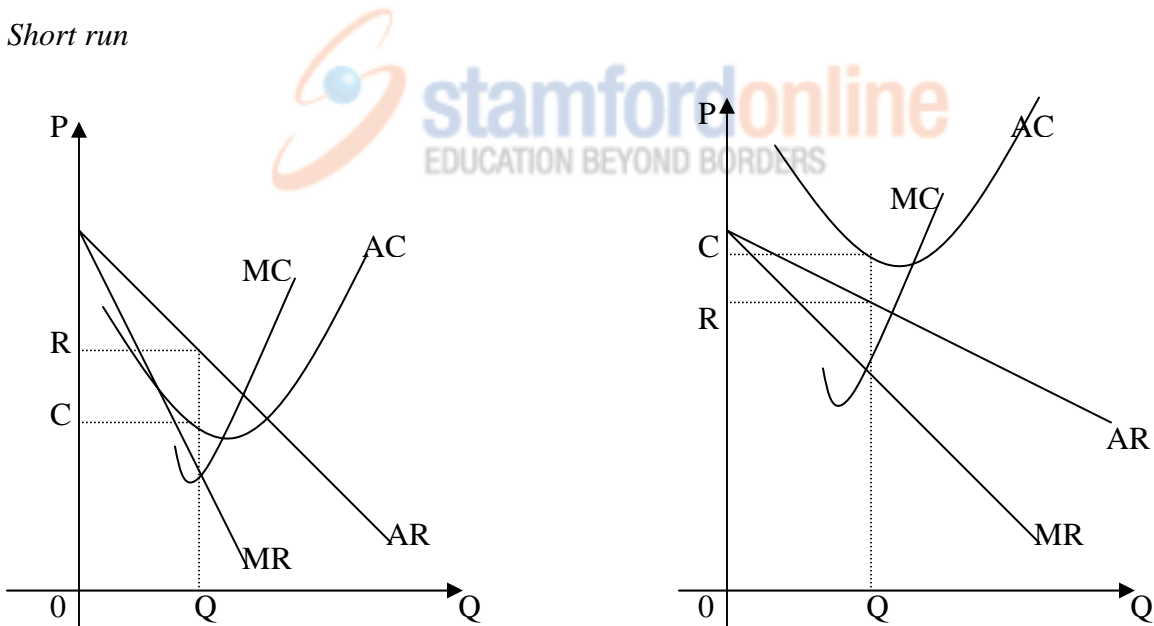
1. *There are quite a large number of firms and buyers*
2. *Product differentiation*
3. *Free entry to and exit from the market*
4. *High selling costs*

Equilibrium level

Short run equilibrium

As with other market structures, firms will maximize their profits where $MC = MR$. The diagram will be the same as for the monopolist, *except the AR (demand curve) and MR curve will be more elastic*. In the short run, firms under monopolistic competition may make **super normal profits or sub normal profits** as shown in the figures below.

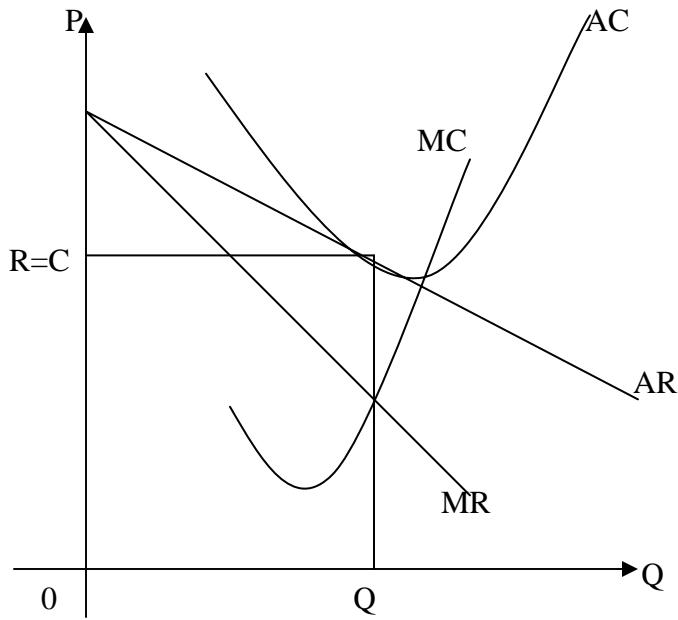
Short run



Supernormal profits

Subnormal profits

Long run



OLIGOPOLY

Oligopoly occurs when just a few firms between them share a large proportion of the industry. That is, there are only a few firms in the industry. In an oligopoly, the firms are known as *price seekers*. In special cases, a duopoly may be classed as an oligopoly.

Note: Duopoly refers to the case where there are only two firms in the industry.

Features of Oligopoly

1. Oligopolies might **produce virtually identical products** and compete with one another through price. It is more common, however, for them to compete through advertising and product differentiation.
2. **Barriers to entry.** There are various barriers to the entry of new firms. They are similar to those under monopoly. The size of the barriers however will vary from industry to industry.
3. **Interdependence of the firms.** Because there are only few firms under oligopoly, each firm will have to take account of the others. This means that they are mutually dependent. They are interdependent. Each firm is affected by its rival's actions. *Each firm will be affected by its rivals' decisions. Likewise, its decisions will affect its rivals. Firms recognize this interdependency. This recognition will affect their decisions.*
4. **Homogeneity / differentiated goods.**
5. **Non-price competition.** Sometimes oligopolies prefer to engage in non-price competition. It takes the form of product differentiation.
 - Physical product differentiation. Produce a product that is more attractive, innovative than the product produced by its rivals.
 - Advertising. An oligopolistic firm advertises to persuade consumers to buy its product rather than those of its rivals so as to increase the demand for its product.
 - After-sales services. Provide delivery facility to customers, such as delivering the product to the homes of customers.
 - Free offers. For example, if customers buy a television, a walkman will be given as a free gift.
6. **Price war.**

Competition and collusion

Oligopolies are pulled in two different directions.

The interdependence of firms may make them wish to collude with each other. If they could come together and act as a monopoly, they could jointly maximize industry profits.

Collusive Oligopoly

Where oligopolists agree (formal or informal) to limit competition between themselves. They may set output quotas, fix prices, limit production or development, or agree not to 'poach' each other's market.

Learning Outcomes:

Students should be able to:

- Identify and demonstrate imperfect competition
- Examine short run and long run equilibrium

Main Reference

Case, K. E., & Fair, R. C. (2007). *Principles of Economics* (8th ed.). Prentice Hall, Chapters 13 & 14.



Other Reference

Sloman, J. (1999). *Essentials of Economics* (3rd ed.). Prentice Hall, Chapters 6 & 7.

Review Questions

1. Define monopoly
2. What is price discrimination?
3. Define monopolistic competition, giving a few examples.
4. Can the monopolistic competitor incur short run losses?
5. What is the single most important characteristic of oligopolistic markets?
6. What is meant by collusion?