

Monopolistic Competition and Oligopoly

Chapter Outline

1. Monopolistic Competition
 - a. Product Differentiation
 - b. Price and Output Determination
 - c. Economic Efficiency
2. Oligopoly
 - a. Oligopoly Models
 - b. Game Theory
 - c. Economic Performance
 - d. Industrial Concentration

Monopolistic Competition

Monopolistic Competition – industry with many firms, easy entry, and product differentiation.

Product Differentiation – creating a product with distinct positive identities in consumers minds.

Demand Curve – downward sloping, more elastic than monopoly but less elastic than perfect competition

Price and output determination in the short-run: looks identical to the monopoly case.

Price and output determination in the long-run: because of entry of other firms profits will not be greater than zero. Therefore, there will be zero economic profits in the long-run.

Efficiency:

1. Productive Efficiency – min AC, does not hold
2. Allocative Efficiency – $P = MC$, does not hold

Oligopoly Models

Oligopoly – industry with few firms, difficult entry, mutual interdependence, and standardized or differentiated product.

Collusion – the act of working together to restrict output. Cartels act like monopolists in the output market.

Cartel – the firms that collude.

-- Prevailing output and price is that of the monopolist.

Cournot Model – duopoly where each firm assumes that output of the other firms are given and the firms maximize profits.

-- Prevailing output is between monopolist and perfect competition.

Kinked Demand – oligopoly where each firm believes that their competitors will match price decreases but not their price increases.

-- Results in downwardly sticky prices at the current price.

Price-Leadership Model – model where the large firm (dominant) sets market price and all the smaller firms match the leaders price.

-- Output and price is between that of monopolist and perfect competition.

Game Theory

Game Theory – analyzes the behavior of firms or individuals when they make strategic decisions.

Strategy – possible actions of each of the firms

Payoffs – amount of profits the firm will receive given the actions of all the firms

Nash Equilibrium – Every firm is maximizing their payoffs (profits) given the actions of the other firms.

Dominant Strategy – the firm has a single best strategy no matter what strategy the other players play.

	Strategies of Firm 2	
Strategies of Firm 1	(Payoff 1, Payoff 2)	(Payoff 1, Payoff 2)
	(Payoff 1, Payoff 2)	(Payoff 1, Payoff 2)