Benjamin Fenster
EC-012 (Gedeon)
22 June 2002

Notes – Module 8 & Module 9

Monopolistic Competition & Oligopoly

I. Monopolistic Competition
  a. Characteristics
    i. Many sellers.
    ii. Products not identical but close substitutes.
    iii. Product differentiation demonstrated to consumers through advertising.
  b. Demand and Output
    i. Firms face a very (but not perfectly) elastic demand curve.
    ii. MC = MR rule still applies and works roughly as it does for a monopoly.
    iii. Because entry is easy for firms, new competition will drive the long-run ATC to intersect with D, meaning only normal profits can be obtained in the long run.
  c. Variety

II. Oligopoly
  a. Characteristics
    i. Possibly many sellers, but only a few control most (or all) of the market.
    ii. Differentiated products, giving firms some control over price.
    iii. Firms must consider the response of other firms before taking any action – will increasing price spark an increase in other producers' prices?
  b. Industry Concentration
    i. Measures how much of the market a few firms control.
    ii. Concentration Ratio
      1. "Four firm concentration ratio" or "eight firm concentration ratio" for example.
      2. Percent of the market controlled by a certain number of firms.
      3. One firm controlling the whole market will appear the same as four firms sharing ¼ each of the market in a four-firm concentration ratio.
    iii. Herfindahl Index
      1. Sum of the squares of all firm's market shares
      2. Pure Monopoly = 100^2 = 10,000
      3. Four firms, each controlling ¼ of the market = $25^2 + 25^2 + 25^2 + 25^2$ = 2500.
      4. Very clear indicator of how concentrated the industry is – higher numbers indicate more concentration.
  c. Demand
    i. Kinked demand curve.
    ii. If a firm lowers its price, its competitors will respond in kind to keep the firm from stealing market share. Demand will be fairly inelastic.
    iii. If a firm raises its price, competitors will keep theirs the same and consumers will defect. Demand will be elastic.
    iv. The demand curve is thus 'kinked' so it's steeper to the right of the current price, and shallower to the left.
    v. Thus very little incentive to change prices – only happens when absolutely necessary.
  d. Collusion
    i. Very tempting to collude in oligopoly.
    ii. If all firms charge higher prices (and know they aren't risking being undercut by a competitor), everyone stands to gain.
    iii. Collusion is illegal in the US, so it must be done stealthily.