Monopolistic Competition

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- Monopolistic competition is a market structure which combines elements of monopoly and competitive markets. Essentially a monopolistic competitive market is one with freedom of entry and exit, but firms can differentiate their products. Therefore, they have an inelastic demand curve and so they can set prices.

- However, because there is freedom of entry, supernormal profits will encourage more firms to enter the market leading to normal profits in the long term.

- A monopolistic competitive industry has the following features:
- Many firms
- Freedom of entry and exit
- Firms produce differentiated products
- Firms have price inelastic demand; they are price makers because the good is highly differentiated
- Firms make normal profits in the long run but could make supernormal profits in the short term
- Firms are allocatively and productively inefficient

Examples

- Restaurants – restaurants compete on quality of food as much as price. Product differentiation is a key element of the business. There are relatively low barriers to entry in setting up a new restaurant.
- Hairdressers- A service which will give firms a reputation for the quality of their hair-cutting.

- Clothing- Designer label clothes are about the brand and product differentiation
- TV programmes – globalisation has increased the diversity of tv programmes from networks around the world. Consumers can choose between domestic channels but also imports from other countries and new services, such as Netflix.

Limitations of the model of monopolistic competition

- Some firms will be better at brand differentiation and therefore, in the real world, they will be able to make supernormal profit.
- New firms will not be seen as a close substitute.
- There is considerable overlap with oligopoly – except the model of monopolistic competition assumes no

- If a firm has strong brand loyalty and product differentiation – this itself becomes a barrier to entry. A new firm can’t easily capture the brand loyalty.
- Many industries, we may describe as monopolistically competitive are very profitable, so the assumption of normal profits is too simplistic.

Key difference with monopoly

- In monopolistic competition there are no barriers to entry. Therefore in long run, the market will be competitive, with firms making normal profit.

Key difference with perfect competition

- In Monopolistic competition, firms do produce differentiated products, therefore, they are not price takers (perfectly elastic demand). They have inelastic demand.