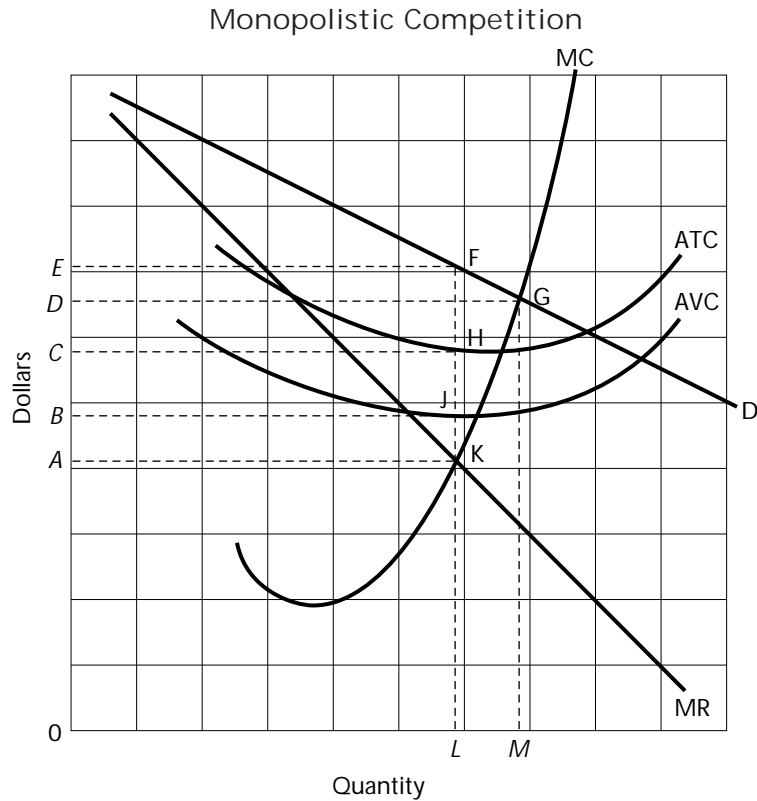


ACTIVITY 44

Monopolistic Competition

1. Use the graph *Monopolistic Competition* to answer the questions that follow.



- At what level of output will this firm operate? _____
 - What is marginal revenue at this level of output? _____
 - What price will this firm charge for its product? _____
 - The area of which rectangle is equal to total revenue? _____
 - What is the firm's average total cost? _____
 - The area of which rectangle is equal to the firm's total cost? _____
 - Is the firm making profits or incurring losses? _____
 - The area of which rectangle is equal to profits or losses? _____
2. Would the demand curve for a monopolistic competitor be more or less elastic than the demand curve for a monopolist? Justify your answer.

ACTIVITY 44 continued

3. What are the characteristics of a monopolistically competitive market? In what sense is there competition, and in what sense is there monopoly in this type of market structure?

4. Is monopolistic competition closer to monopoly or to perfect competition?

5. What are three examples of monopolistically competitive markets?

6. True, false, or uncertain, and why? “Monopolistic competition is just another form of pure monopoly.”

7. True, false, or uncertain, and why? “Monopolistic competition is even better than perfect competition.”

8. True, false, or uncertain, and why? “In the long run, monopolistic competitors produce at their most efficient point.”

ACTIVITY 45

Supply, Demand, and Videotape

Part A.

Read the article below and answer the questions that follow.

Michelle Sedlak remembers the good old days in the videotape rental business.

"I started in the business eight years ago at a store in Palos Verdes, in Southern California. We were charging \$8 for a 24-hour rental for the first tape, \$4 for the second," she says.

Ms. Sedlak is now a manager for Budget Video, a small chain of video stores in Baltimore, Maryland. Her prices today are \$1.99 for new releases and 99¢ to \$1.50 for standard titles.

The difference between then and now, Ms. Sedlak says, is competition. "Eight years ago you had to *look* for a video store. The nearest competition was likely to be several miles away. Now there's a video store in practically every block. The competition has really driven the price down."

The price reduction Ms. Sedlak cites has been typical of the entire industry.

Says Paul Eisele, president of the Fairfield Group, a video industry consulting firm in Connecticut, "Basically, prices vary with the ebb and flow of stores in the industry. As the number of stores increases, prices fall. There have been times, though, when entry of new stores got ahead of growth in the number of families with VCRs, and then prices fell quite sharply. That would force some stores out of business and prices would come back up a little to a new equilibrium."

Mr. Eisele notes that high initial profits and the promise of rapid growth attracted firms to the industry in the first place. The business is an easy one to enter—the number of video stores increased from 5,000 in 1981 to 25,000 today, he says.

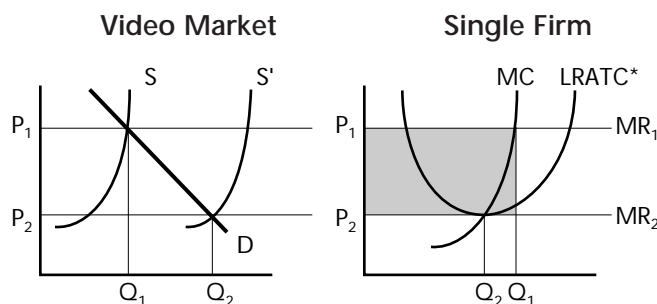
The industry has traditionally been dominated by independents and small chains. But larger chains are growing

fast. Chains with 50 or more stores command 15 percent of the total market; that share is rising, according to *The Wall Street Journal*.

The industry can be thought of as an example of either perfect competition or monopolistic competition. Both models predict that, if firms are making an economic profit, new entry will continue until prices have been driven down to the point that no economic profits remain. The accompanying figure tells the story in terms of the model of perfect competition. That model makes the story seem quite abstract, but the forces it describes are very real indeed.

"Several years ago, our profits were as high as 80 percent of sales," Ms. Sedlak recalls. "That fell pretty quickly to 50 percent. Now, we're lucky to get 10 percent. The business has gotten a lot tougher."

Easy Entry in the Video Biz



High initial profits at Price P_1 , shown by the shaded area in the right panel, attracted entry in the long run, shifting the supply curve to the right (left panel), eliminating economic profits.

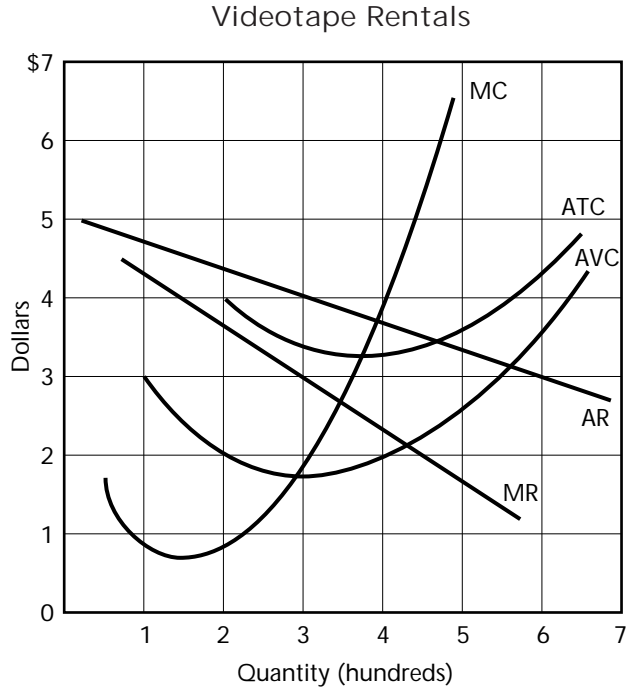
* LRATC = long-run average total cost

1. Is the videotape rental business closer to perfect competition or monopolistic competition? Give reasons for your answer.
2. What has caused profits in the videotape rental industry to be eliminated in the long run?

ACTIVITY 45 continued

Part B.

The graph *Videotape Rentals* represents a short-run equilibrium position for a videotape rental firm using the monopolistically competitive model. Study the graph and answer the questions that follow.



1. At about what output will this videotape rental firm produce? _____ Why?
2. About what price will the firm charge for each videotape rental? _____
3. Is this firm making a profit? _____
4. What will happen to price and output in the long-run for this monopolistic competitor?
5. How much economic profit will this monopolistic competitor make in the long run? _____
6. If this videotape rental firm were a perfect competitor, at about what price and output would this firm produce? Why?
7. How does the long-run equilibrium of a monopolistic competitor differ from the long-run equilibrium of a perfect competitor?

ACTIVITY 46

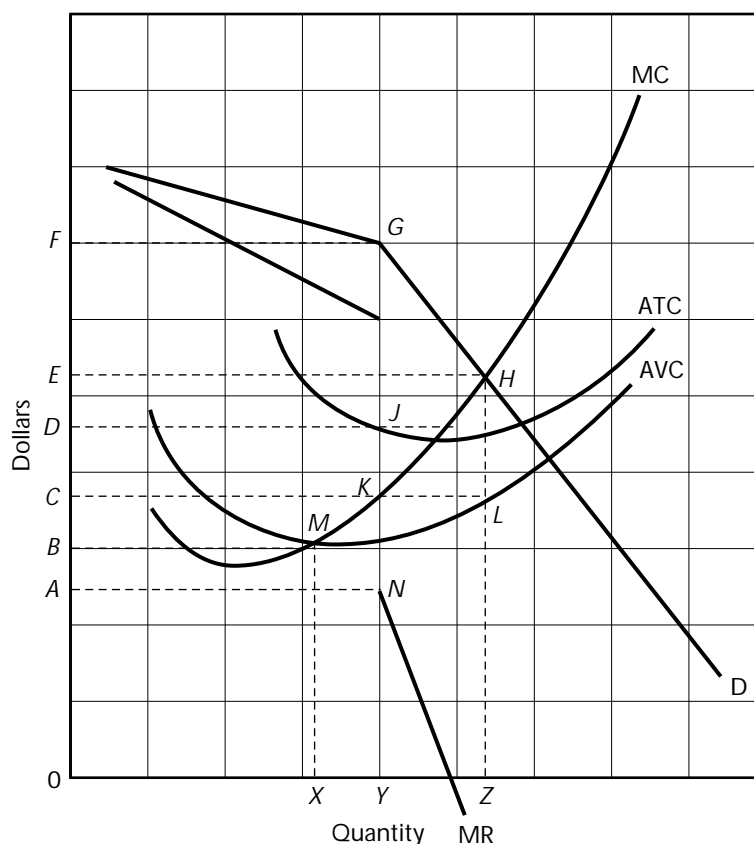
The Kinked Demand Curve of an Oligopolist

The kinked demand curve is a method of analysis designed to explain why oligopolists prefer to compete on quality rather than price. A kinked demand curve illustrates the price rigidity of an oligopolist. The oligopolist, like any other firm, maximizes profits where marginal revenue equals marginal cost. The kinked demand curve shows that if an oligopolistic firm raises its price above the existing price, it will lose market share and have lower profits. This is because the other firms in the industry will not follow the price increase.

If the oligopolistic firm lowers its price, the other firms in the industry will have to follow to avoid losing market share. Therefore, the firm does not gain market share but does receive less revenue. Again, the firm finds that its profits have decreased. For these reasons, oligopolistic firms tend either to have rigid prices or to find a way to collude with each other before raising prices.

Use the *Kinked Demand Curve of an Oligopolist* to answer the questions that follow.

Kinked Demand Curve of an Oligopolist



1. At what level of output will this firm operate? _____
2. What is the marginal cost at this level of output? _____
3. What price will the firm charge for its product? _____

ACTIVITY 46 continued

4. The area of which rectangle equals total revenue? _____
5. What is the firm's average cost? _____
6. The area of which rectangle is equal to the firm's total cost? _____
7. The area of which rectangle is equal to the firm's profit? _____
8. Suppose the firm is operating at an output level of Y units. How low would marginal costs at Y units of output have to drop before the firm would lower its price? _____