Monopolistic Competition

Upto 1920 classical theory of price included two models namely the pure competition nd monopoly. However these two theories did not include the selling cost and the product differentiation. So the economists were getting totally dissatisfied with these theories. It was around this time that E.H. Chamberlin and Joan Robinson worked independently and brought out simultaneously "The theory of Monopolistic Competition" and "The economics of Imperfect Competition" respectively.

Between the two extremes of pure competition and monopoly lies the monopolistic competition. Pure competition the sellers are numerous and there is homogenous product that is available while in monopoly there is just one seller and there is hardly a variety of product available. In between these two lies the monopolistic competition where there are large number of sellers selling differentiated product and incurring selling costs.

Asssumptions:

1) There is a large number of sellers and buyers in the 'group'.

2) The products of the sellers are differentiated, yet they are close substitutes of one another.

3) There is free entry and exit of firms in the group.

4) The goal of the firm is profit maximisation, both in the short run and in the long run.

5) The prices of factors and technology are given.

6) The firm is assumed to behave as if it knew its demand curves and cost curves with certainty.

7) The long run consists of a number of identical short- run periods.

8) Chamberlin makes the assumption that both demand and cost curves for all products are uniform throughout the group.

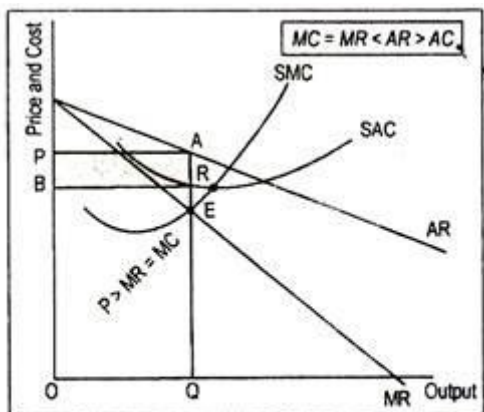## Short-run equilibrium of the firm

1) Supernormal Profit

Fig. 5.15: Short Run Equilibrium
[Supernormal Profit: BRAP rectangle]

This figure shows the supernormal profit of the firm. In this figure SAC is below the AR curve. That means cost is less than the revenue. Cost is equal to the area OQBR and revenue is equal to the area OQPA. Therefore the supernormal profit that is enjoyed by the firm is equal to the area of PABR.

2) Loss
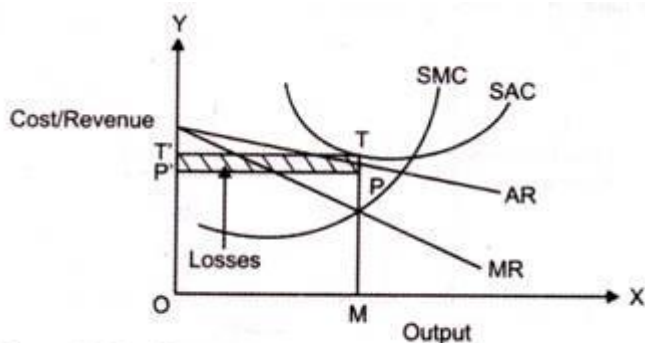

Figure-3: Equilibrium in the Short Run in Case of Losses

The figure shows a situation of loss in monopolistic competition. In this it can seen that SAC is above AR curve. This means that cost is no longer being covered. Revenue is equal to the area OMPP' while the cost if equal to the area OMTT'. The difference between the two PP'TT' is the amount of loss that is being suffered by the firm.
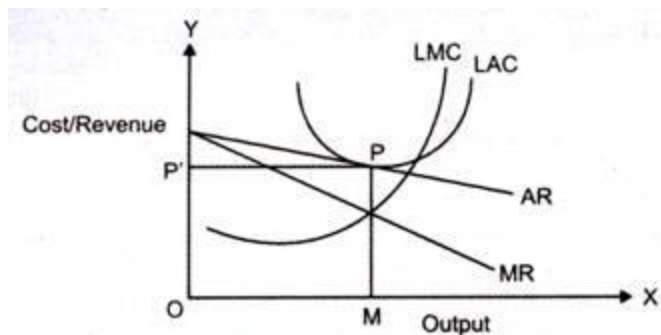
Long –run Equilibrium of the firm

Figure-4: Equilibrium in the Long Run

In the long-run the firms will be earning normal profits. This is because new firms will enter into the market to take advantage of excess profits in the market. In the long run two conditions must be satisfied. MC must be equal to MR and AC must also be equal to AR. Both these conditions are satisfied at the point P. The Firm cost and revenue area are the same OMPP'. So that means that the firm is earning normal profits.