

Exercise walk-through

4.4

Monopolistic Competition

AP Microeconomics

Entry changes demand for an existing restaurant

Monopolistic competition : many firms, **differentiated** products, easy entry and exit.

Explain the adjustment

A restaurant earns positive economic profit. New restaurants offer close substitutes. What happens to demand facing the original restaurant? What attracts the entrants?

Short-run profit, loss or zero profit are possible. In the long-run model, entry and exit remove economic profit, including losses.

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Monopolistic competition : many firms, **differentiated** products, easy entry and exit.

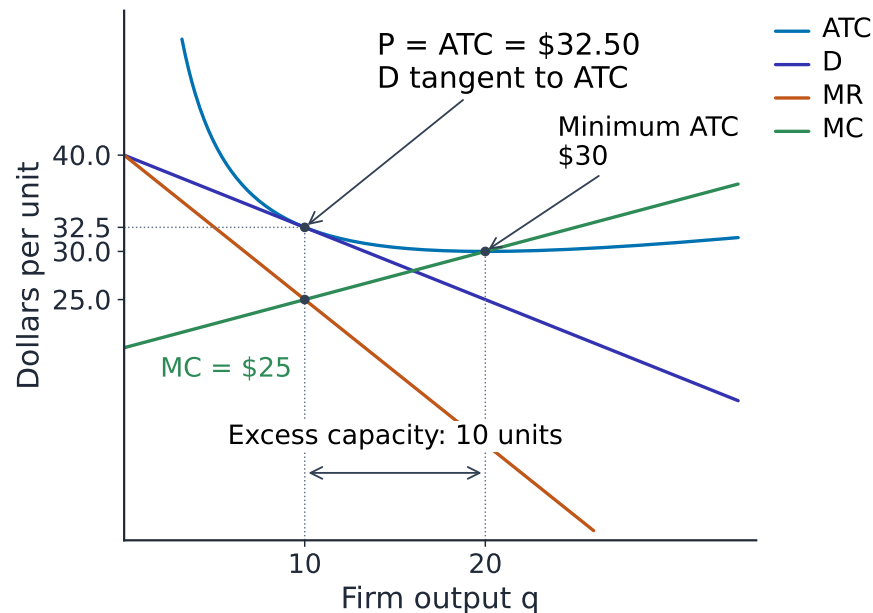
Explain the adjustment

A restaurant earns positive economic profit. New restaurants offer close substitutes. What happens to demand facing the original restaurant? What attracts the entrants?

Profit attracts entry. The original firm's demand decreases and tends to become more elastic as substitutes increase. With losses, exit increases demand for remaining firms.

Short-run profit, loss or zero profit are possible. In the long-run model, entry and exit remove economic profit, including losses.

Zero profit: demand touches ATC away from its minimum



At $q = 10$: $MR=MC=\$25$ and $P=ATC=\$32.50$. Minimum ATC occurs at $q = 20$. Read all three relationships separately.

Zero economic profit still leaves two efficiency gaps

Given the graph: output 10, price and ATC \$32.50, MC \$25; minimum ATC \$30 at output 20.

$$\pi = (P - ATC)q = (32.50 - 32.50) \times 10 = \$0$$

$$\text{Excess capacity} = q_{\min ATC} - q_{\text{actual}} = 20 - 10 = 10 \text{ units}$$

Excess capacity means output below the quantity minimizing ATC; it need not mean unsold stock.

P exceeds MC, so output is allocatively inefficient with no externalities. ATC exceeds its minimum, so it is productively inefficient.

Zero economic profit includes normal return. Product variety is a benefit outside these simple cost-efficiency comparisons.

Exercises 2.1-2.3

2.1 State two characteristics of monopolistic competition. [2]

2.2 State the long-run economic profit level. [1]

2.3 State why monopolistic competition is inefficient. [1]

Exercises 2.1-2.3

2.1 State two characteristics of monopolistic competition. [2]

2.1

- any two of: many firms, differentiated products, free entry and exit
-

2.2 State the long-run economic profit level. [1]

2.2

- zero economic profit (normal profit)
-

2.3 State why monopolistic competition is inefficient. [1]

2.3

- it produces where $P > MC$ and above minimum ATC (excess capacity)

Exercises 3.1-3.2

3.1 In monopolistic competition, products are

[1]

☐

A identical

B differentiated

C free

D unavailable

3.2 In long-run equilibrium, a monopolistically competitive firm earns

[1]

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A economic profit

B a loss

C normal profit

D nothing at all

Exercises 3.1-3.2

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3.1 B

- differentiated.

3.2 In long-run equilibrium, a monopolistically competitive firm earns

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- A economic profit
- B a loss
- C normal profit
- D nothing at all

3.2 C

- normal profit.

Exercise 3.3 (a)

3.3 A café in a town with many cafés is earning short-run economic profit.

(a) State what happens to its demand as new cafés enter.

[1]

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(a) State what happens to its demand as new cafés enter.

[1]

(a)

- its demand falls (shifts left) toward tangency with ATC

Exercise 3.3 (b)

3.3 A café in a town with many cafés is earning short-run economic profit.

(b) State its long-run economic profit.

[1]

Exercise 3.3 (b)

3.3 A café in a town with many cafés is earning short-run economic profit.

(b) State its long-run economic profit.

[1]

(b)

- zero economic profit

Exercise 3.3 (c)

3.3 A café in a town with many cafés is earning short-run economic profit.

(c) Name one form of non-price competition it might use.

[1]

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(c) Name one form of non-price competition it might use.

[1]

(c)

- advertising or product differentiation (any one)