Unit 2:Navigating Market Structures

The Benchmark Model

- **Key Characteristics:**
  - **Many buyers and sellers:** No single buyer or seller can influence the market price.
  - **Homogeneous Products:** Products are identical across firms, meaning consumers perceive no difference between them.
  - **Free Entry and Exit:** Firms can enter or leave the market without significant barriers.
  - **Perfect Information:** All buyers and sellers have complete information about prices, products, and technology.
- **Price Takers:** Due to the above characteristics, firms in perfect competition are **price takers,** meaning they have no control over the market price and must accept the price determined by the forces of supply and demand.
- **Demand Curve Facing a Firm:** The demand curve for a perfectly competitive firm is **perfectly elastic (horizontal)** at the market price. This means the firm can sell any quantity at the market price, but if it tries to charge a higher price, it will sell nothing.
- **Profit Maximization:**
  - **Short-Run:** A firm maximizes profits (or minimizes losses) by producing the quantity where **marginal revenue (MR) equals marginal cost (MC).** In the short run, a firm may earn economic profits, losses, or break even.
  - **Long-Run:** In the long run, free entry and exit drive economic profits to zero. If firms are earning profits, new firms enter, increasing supply and lowering the market price until profits are eliminated. If firms are experiencing losses, some firms exit, decreasing supply and raising prices until losses are eliminated.

Pure Monopoly: The Sole Supplier

- **Key Characteristics:**
  - **Single Seller:** One firm supplies the entire market for a particular good or service.
  - **No Close Substitutes:** There are no viable alternatives for the monopolist's product.
  - **Barriers to Entry:** High barriers prevent other firms from entering the market.
- **Price Makers:** Monopolists are **price makers**, meaning they have considerable control over the price they charge.
- **Demand Curve Facing a Firm:** The monopolist faces the **downward-sloping market demand curve.** To sell more output, the monopolist must lower its price.
- **Profit Maximization:** Like perfectly competitive firms, monopolists maximize profits where **MR = MC.** However, since the monopolist's demand curve is downward sloping, its MR curve lies below its demand curve. Monopolies can earn economic profits in both the short run and the long run due to barriers to entry.
- **Price Discrimination:** Monopolists may engage in **price discrimination,** charging different prices to different consumers for the same product to extract more consumer surplus and increase profits. The sources describe three degrees of price discrimination.

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Monopolistic Competition: Differentiated Products and Many Sellers

- **Key Characteristics:**
  - **Many Sellers:** Many firms compete in the market.
  - **Differentiated Products:** Firms offer similar but not identical products. Product differentiation can be based on product features, branding, location, etc.
  - **Relatively Easy Entry and Exit:** While some barriers to entry may exist, they are generally lower than in a pure monopoly.
- **Downward-Sloping Demand Curve:** Like monopolists, firms in monopolistic competition face a **downward-sloping demand curve** because they have some control over price due to product differentiation. However, the demand curve is **more elastic (flatter) than that of a monopolist** because there are close substitutes available.
- **Profit Maximization:** Monopolistically competitive firms also maximize profits where **MR = MC.**
- **Short-Run vs. Long-Run:**
  - **Short-Run:** Firms may earn economic profits or losses in the short run.
  - **Long-Run:** In the long run, profits attract new firms to enter the market, increasing competition and driving economic profits to zero.

Oligopoly: Strategic Interdependence Among a Few Firms

- **Key Characteristics:**
  - **Few Large Firms:** A small number of firms dominate the market.
  - **Significant Barriers to Entry:** High barriers prevent new firms from easily entering the market.
  - **Products May Be Homogeneous or Differentiated:** Oligopolies can produce either identical or differentiated products.
  - **Strategic Interdependence:** A key feature of oligopoly is that firms are **interdependent** – each firm's actions (pricing, output, advertising) affect its rivals and elicit responses from them.
- **Collusive vs. Non-Collusive Oligopoly:**
  - **Collusive Oligopoly:** Firms in an oligopoly may engage in **collusion,** cooperating to reduce competition and increase joint profits by acting like a monopolist.
  - **Non-Collusive Oligopoly:** In a non-collusive oligopoly, firms compete with each other, independently setting prices and output levels. This can lead to price wars or strategic behavior as firms anticipate and react to their rivals' actions.
- **Analyzing Oligopoly:** Due to the complexity of strategic interactions, there is no single model to analyze oligopoly. Game theory is often used to understand strategic decision-making in such markets.

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