

The New Trade Theory

Monopolistic competition in trade

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Topic 4

Monopolistic competition

Main characteristics and insights:

- ▶ Many firms use **differentiation strategies** to reduce market aggressiveness.
- ▶ With increasing returns production in differentiated products might be spatially concentrated: this can explain the emergence of 'brands'.
- ▶ **Free entry and exit**, n tends to be large and this reduces the role of strategic interaction.
- ▶ It is interesting to study the effect of trade on competition (n should varies)
- ▶ Consumers like to differentiate their consumption
- ▶ Let's start from these last two points: (a) Free entry and (b) the Dixit-Stiglitz (1977) Utility function.

Part I

Monopolistic competition: Free entry

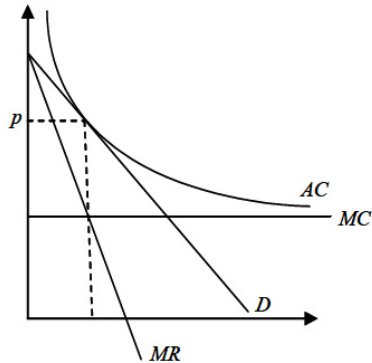
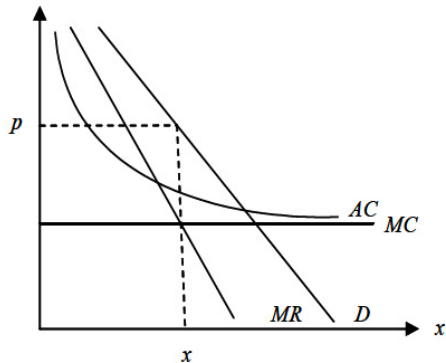
Monopolistic competition: Free entry

With internal economies of scale there cannot be perfect competition. Chamberlain (1933) introduced the notion of monopolistic competition as a market structure.

► Characteristics:

- Every firm has some **market power** and it faces a downward sloping demand curve.
- There is a large number of firms so that a price change by a single firm has no effect on the level of demand faced by the other firms (no strategic interaction).
- With product differentiation a firm has an incentive to differentiate its brand.
- There is free entry so that firms **profits are driven down to zero** (the large group case). The free entry condition (profits are 0) is the standard model's closure.

Monopolistic competition: Free entry and zero profits



Find the mistake!

Part II

Monopolistic competition: Preferences

Dixit-Stiglitz Preferences