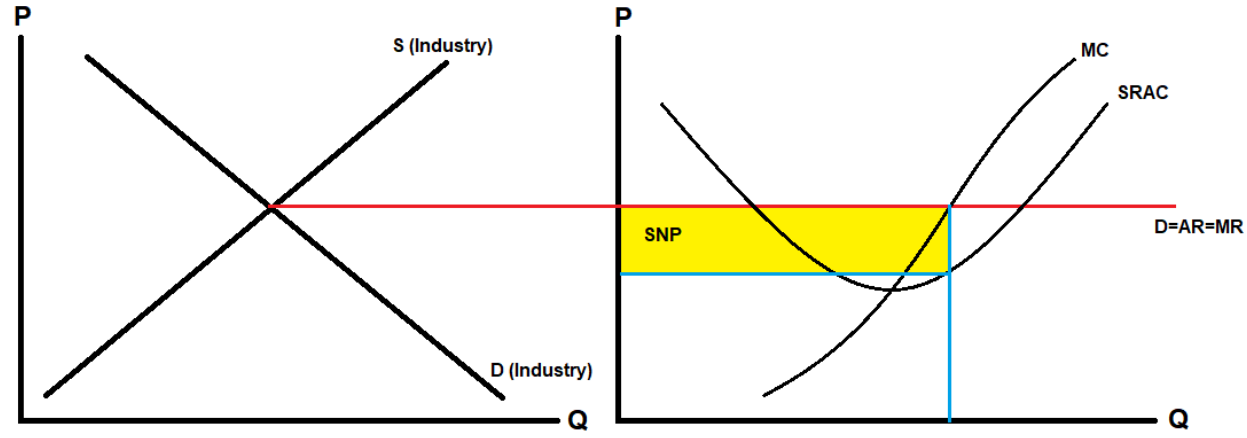
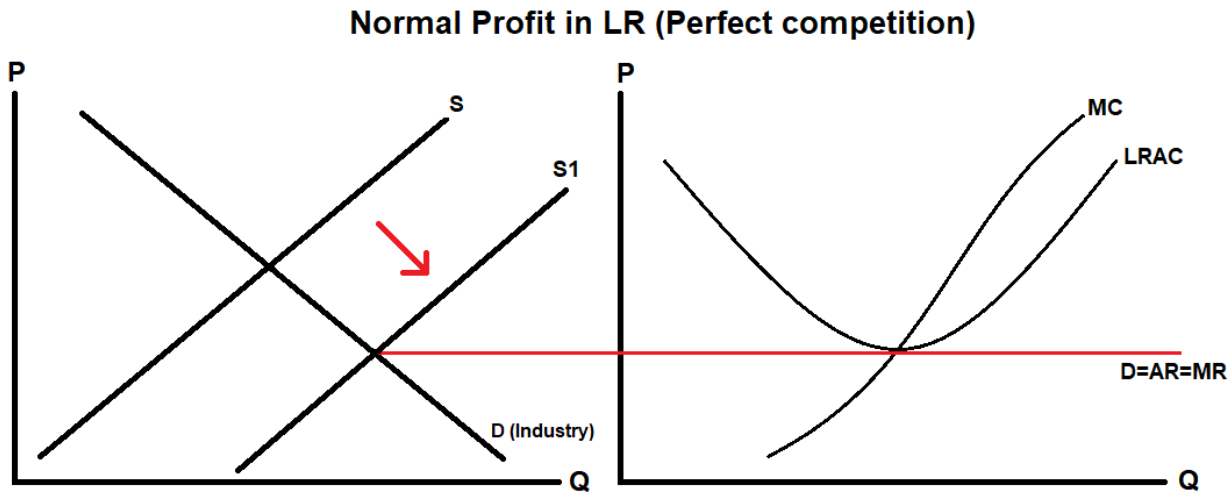
3.4.2 Perfect Competition

- Idealised model of market competition
- Think of huge fish market analogy
- Infinite number of buyers and sellers
- Product is homogenous, no distinction between products
- No barriers to entry/exit
- All firms are price takers, they all take market price since charging more means no one will buy from you and charging less is pointless due to infinite number of buyers and sellers
- Profit maximisers
- SNP only available in SR
- Perfect knowledge (production techniques and cheap raw materials)
- LRAC touches horizontal D curve in LR
- In the SR SNP can be made, in LR firms enter the market and compete this away (SNP is a signal for firms to enter), meaning firms can only make normal profit in LR due to a supply shift leading to a reduced price
- Price is determined by Supply and Demand equilibrium

Supernormal Profit in the SR (Perfect Competition)





- Loss occurs in SR when AC is higher than AR at the Profit maximising level of output (SRAC is floating above)

Does Firm shut down in SR when it makes a loss?

- Fixed costs in SR
- These have to be paid even if firm shuts down
- Will larger cost be incurred by shutting down completely (paying fixed costs) or waiting until they become variable? - Firms ask themselves this
- The answer depends on shut down point
- If firm more thn covers AVC then it is making contribution to fixed costs. Otherwise it is better to shutdown as it will make less loss
- Firms can leave the industry causing a leftwards supply shift reuslting in LR normal profit for remaining firms