CHAPTER 10 : Perfect competition

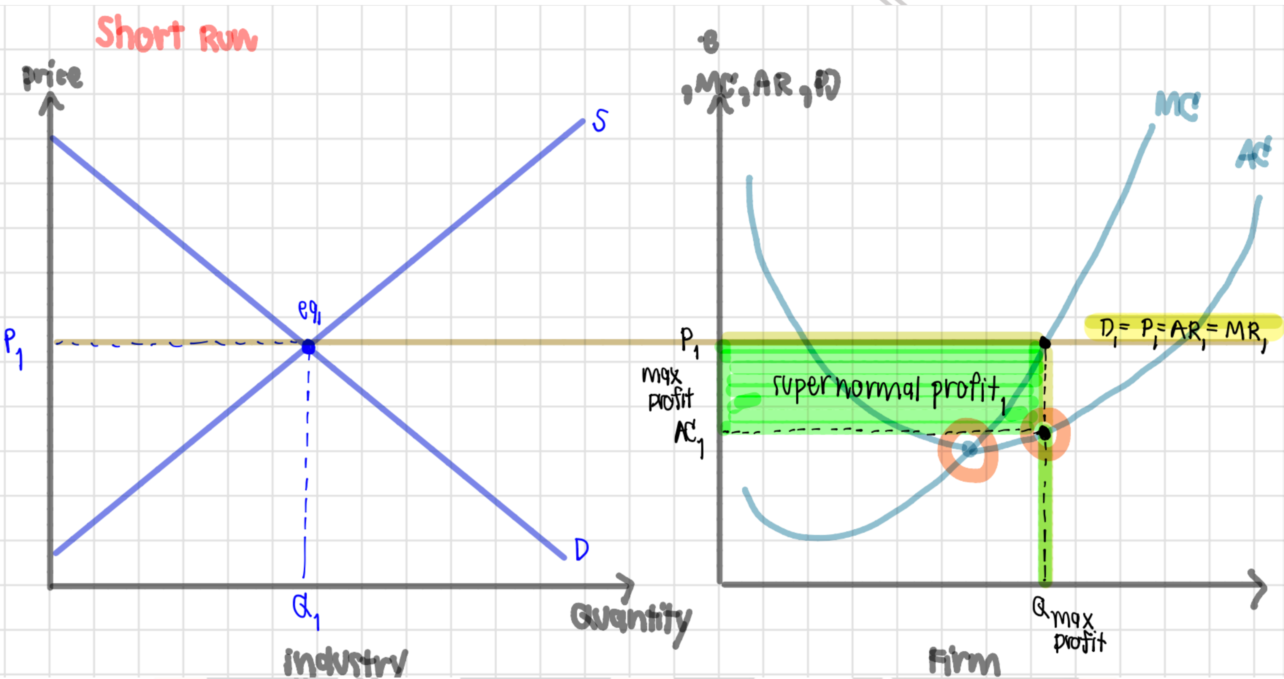
Key terms

1. Perfect competition : a market structure where there are many buyers and sellers, where there is freedom of entry and exit to the market, where there is perfect knowledge and where all firms produce a homogenous product
2. Price taker : a firm which has no control over the market price and has to accept the market price if it want to sell its product

1. Characteristics of perfect competition

- Many small firms in the marker
- Freedom of entry and exit since this will require low sunk cost
- All firms produce identical or homogenous product
- All firms are price takers
- There is perfect information

2. Diagram for perfect competition in short run



: In this case, it is price taker so P = AR = MR =D

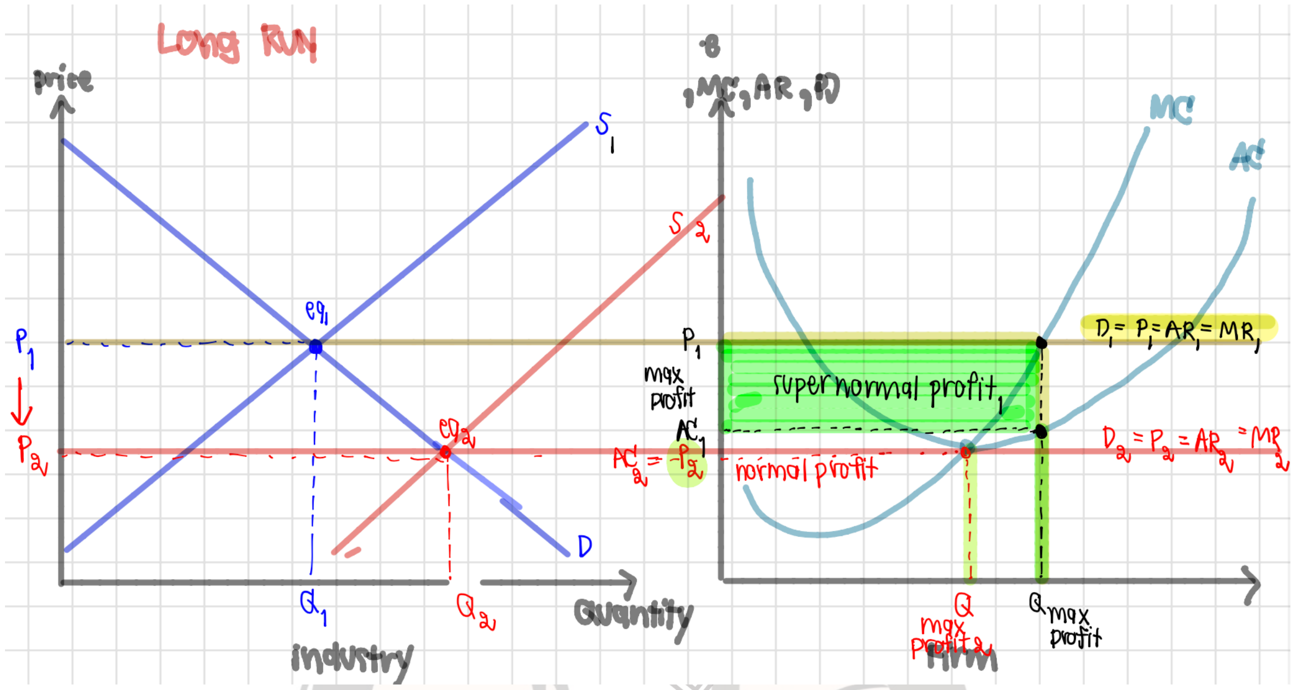
: As it is price taker, firms need to sell at industry price

: To find out max profit, MR =MC At Quantity maximise profit, selling price will be at P1

And quantity at Q max profit

: At this point, it can generate supernormal profit at (P1-AC1)*Qmax profit in short run

3. Diagram for perfect competition in long run



: Since many firms see the supernormal profit in short run, so many firms would like to enter to the market

: Supply in the industry shifts right and reach new EQ2

: Price will be lower and firm need to accept to sell lower price at P2=AR2=MR2=D2

: To find out max profit, MR =MC At Quantity maximise profit, selling price will be at P2 And quantity at Q max profit2

: At this point, it can generate normal profit as P2=AC2 at Q max profit2

4. Advantages and disadvantages of perfect competition

Advantages	Disadvantages
1. Firms can achieve productive efficiency in long run as MC=AC 2. Firms can achieve allocation efficiency both short run and long run (P=MC) 3. Firms can achieve supernormal profit in short run : Firms have more budget to reinvest in innovation and technology so LRAC will be lower in long run 4. It is price taker : Firms sell at lower price and high output : Customers have more afford goods and services : Standard of living will increase 5. High competition : It can creates X-efficient which can create better allocation of resources 6. Resources are not waste through advertising since product are homogenous	1. Firms cannot meet productive efficiency in short run 2. Firms cannot meet or gain supernormal profit in long run : low budget to reinvest in long run : Low quality of products and no innovation and R&D in long run 3. Firms have small market share and unable to take advantages of economies of scale