Qurious Education

Perfect Competition

GCE A-LEVEL & IB ECONOMICS

Lesson Structure

- Perfect Competition
  - Long run vs Short run
  - Diagrams
  - Evaluation

Assumptions Under Perfect Competition

Perfect Competition Assumptions:

- Perfect Information
- Unlimited number of buyers (consumers) and sellers (firms)
- Homogeneous (Same) Goods
- Price taking firms
- No barriers to entry or exit
- Perfect resource mobility

Qurious Education

Markets Close to Perfect Competition

Currency Exchange Markets

Agricultural Markets

#LoveEconDiagrams

10 minute activity

Split into pairs:

- Decide which one of you should draw the perfect competition diagram

- And the other will explain it

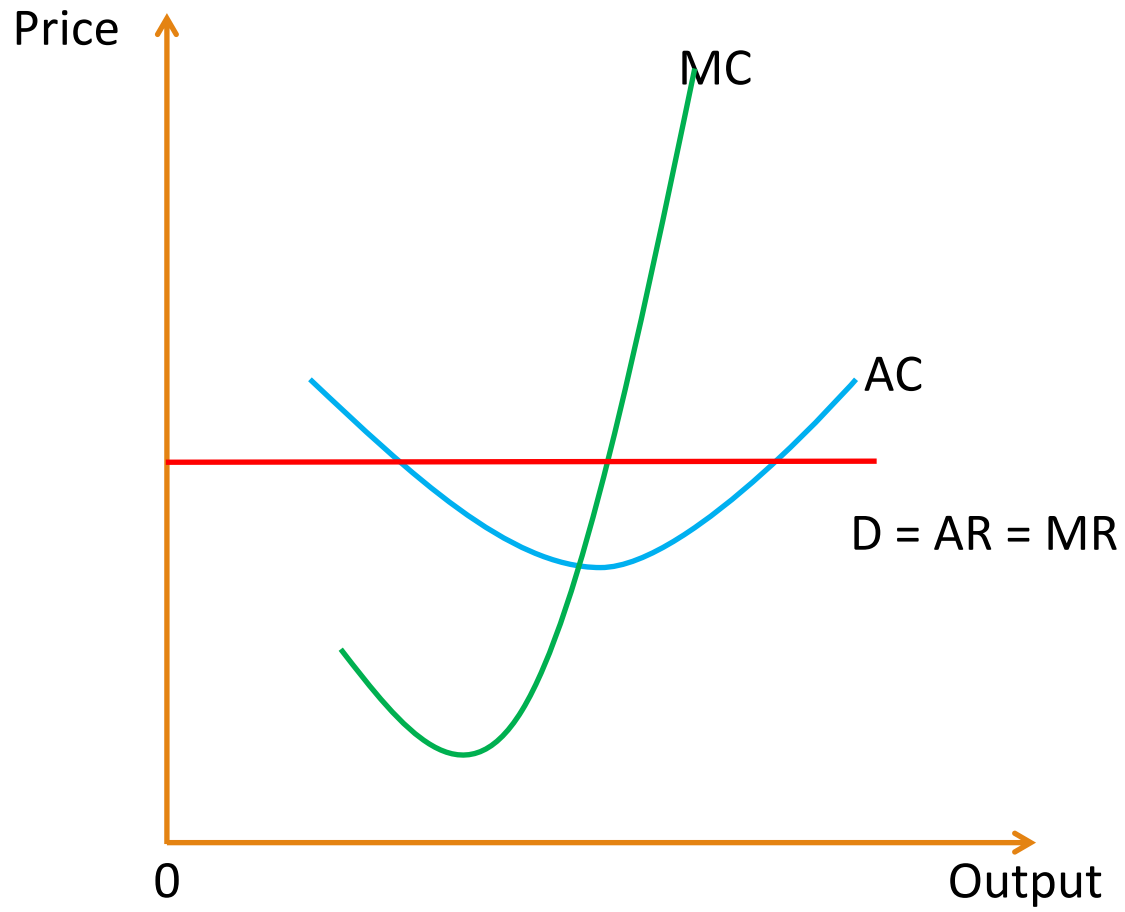
(shape of the curves, how much the firm will produce etc.)

Qurious Education

Short-Run Perfect Competition Diagram

Is this what your diagram looks like? Or did you draw another diagram?

The truth is there are two diagrams for perfect competition.



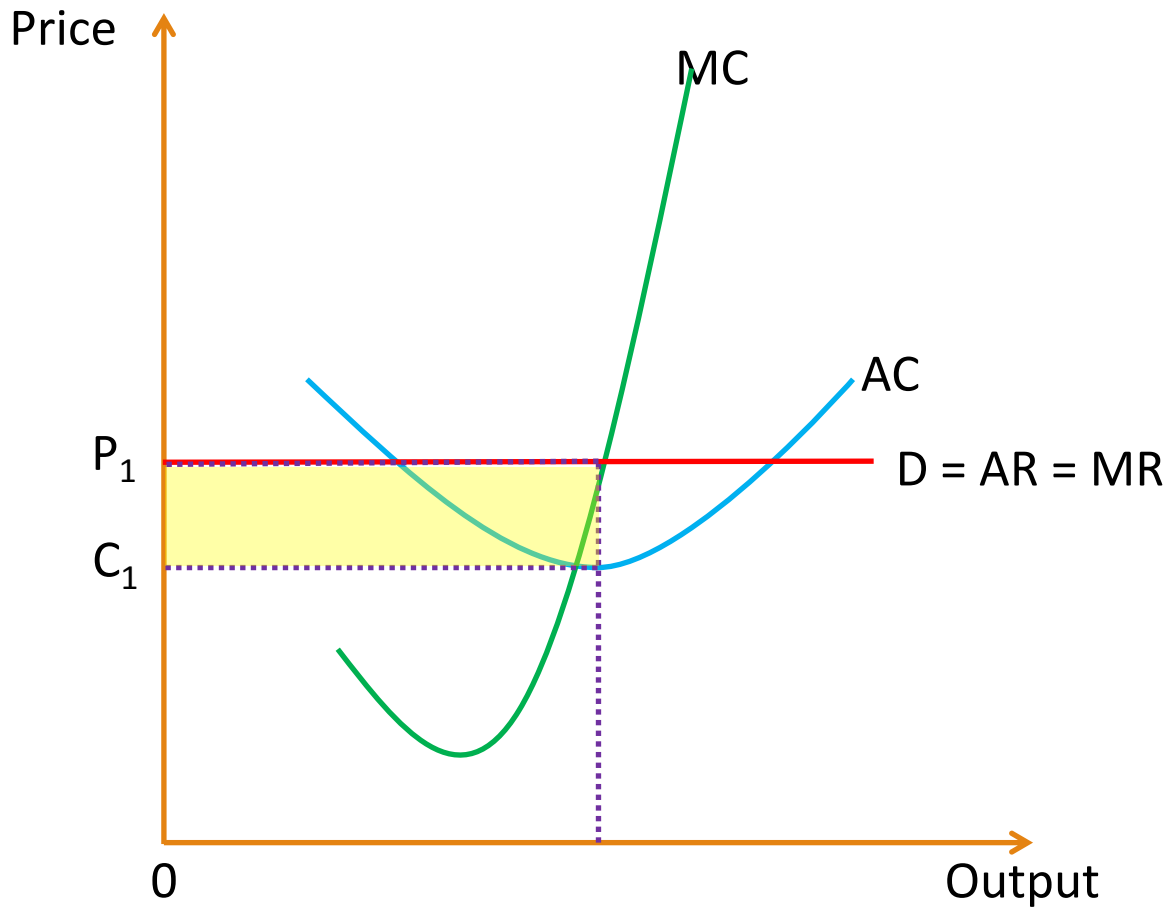
Qurious Education

Short-Run Perfect Competition Diagram

In the short-run, economists assume some factor inputs are fixed. (e.g. it takes time to get specialized machinery, or rent a shop)

Hence, there is only a limited number of firms in the market. Because of this, the market price is comparatively higher.

Hence, firms can gain supernormal (abnormal) profits in the yellow area shown.



Qurious Education

What Would You Do?

There are only 2 shops selling 10kg brussel sprouts in a market at a relatively high price, but the market demands 20kg.

Assuming you can open up and close a shop very easily and without any costs.

What would you do?

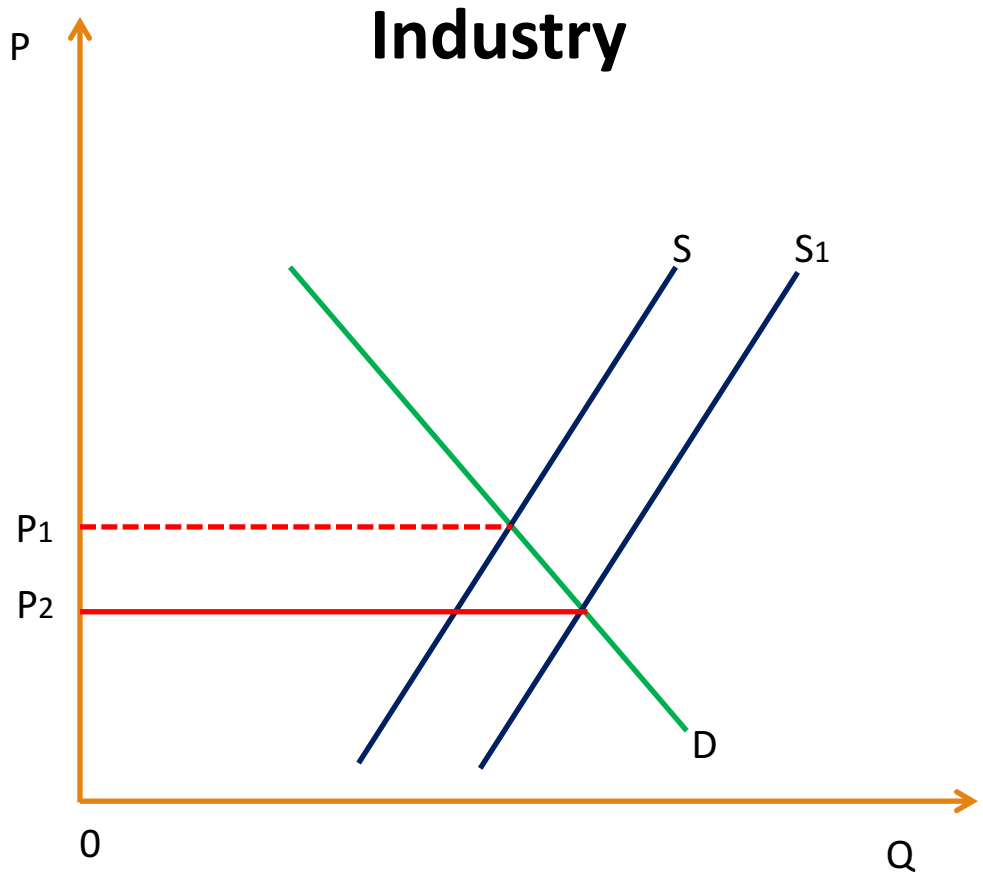
When can you do it?

Qurious Education

Long-Run Perfect Competition Diagram

In the long run, firms can freely enter into the market as all factor inputs can be changed. This means new firms can buy new machinery/rent a place to enter the market. Also remember there are no barriers to entry in perfect competition.

Having more firms will shift the industry supply curve to the right, lowering market price.

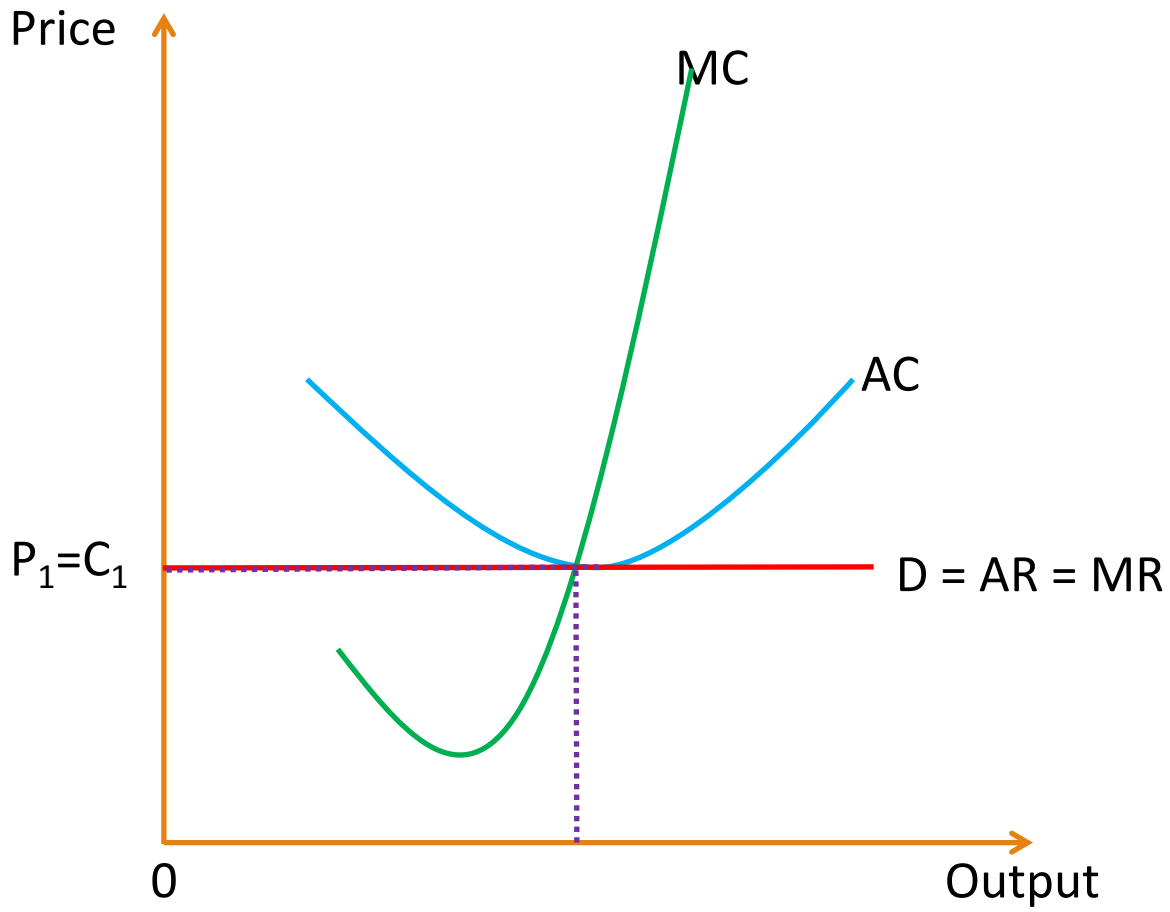


Qurious Education

Long-Run Perfect Competition Diagram

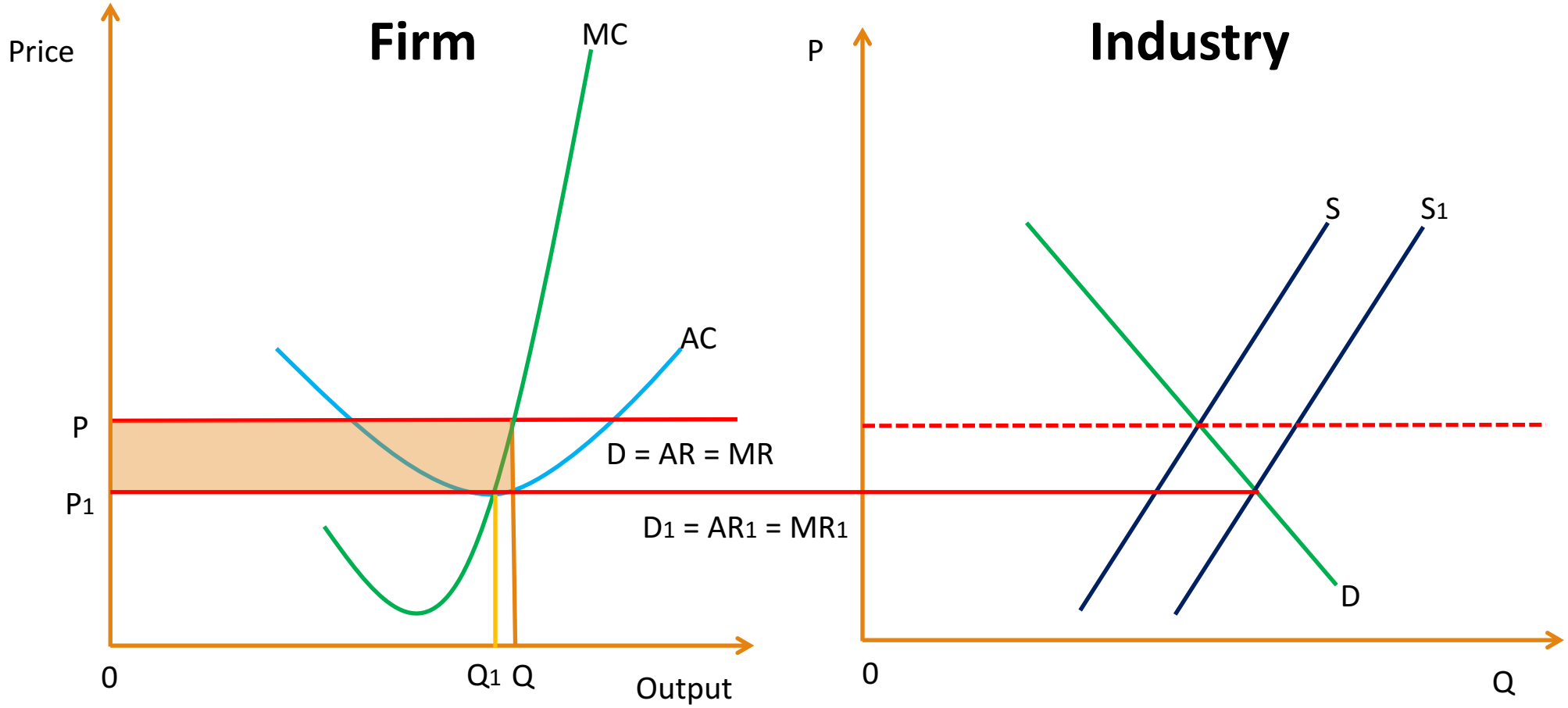
The lower market price means firms in perfect competition will earn less, as they are price takers. Hence, their revenues and profits will fall.

New firms will continue to enter until all firms in the industry are making normal profits. After that, firms are not incentivized to enter the market as they will make a loss if market supply increases further.



Qurious Education

Long-Run Perfect Competition Diagram



Evaluating Perfect Competition

To what extent do you think the perfect competition model is useful in explaining real world markets?

Are there any flaws or limitations of the model?

What assumptions may not hold in the model and why?

Qurious Education

Evaluating Perfect Competition

Discussion points regarding perfect competition:

- When a new firm enters into the market in the long run, market price will fall and all firms will make a loss according to the theory. Does this mean all firms in the industry will exit the market?

- Are there in any situation where all firms just sell at the market price and their products are completely the same (no branding at all)? What about having no barriers to entry and perfect information about market prices by consumers?

- Perfect competition does indicate a way where firms can produce very efficiently. Should we aim to develop all markets this way?

Evaluating Perfect Competition

Are markets becoming more “perfectly competitive” in general? What do you think?

- Perfect Information
  - Technology is making communications more efficient and pricing/product information much more transparent e.g. with customer reviews, online information
- Unlimited number of buyers and sellers & No barriers to entry or exit
  - Technological platforms are enabling individuals to set-up businesses and sell services with little to no cost i.e. no barriers to entry/exit, increasing the number of buyers/sellers and a rise in the number of “freelancers”
- Homogeneous (Same) Goods & Price taking firms
  - Innovation tends to increase over time, allowing differentiation of goods, but not all innovation will survive and is viable in all industries

Short Questions – Perfect Comp.

Who can explain why firms under perfect competition can only earn normal profits in the long run?

Who can draw out the perfect competition diagram in the long run?