Perfect Competition Long Run

Chapter 10-2

The Long Run

• The short run is a timeframe in which at least one of the resources used in production cannot be changed.
• Exit and entry are long-run phenomena.
• In the long run, all quantities of resources can be changed.

An Increase in Demand

• An increase in demand leads to higher prices and higher profits.
  – Existing firms increase output.
  – New firms enter the market, increasing output still more.
  – Price falls until all profit is competed away.

An Increase in Demand

• If input prices remain constant, the new equilibrium will be at the original price but with a higher output.

An Increase in Demand

• The original firms return to their original output but since there are more firms in the market, the total market output increases.

An Increase in Demand

• In the short run, the price does more of the adjusting.
  • In the long run, more of the adjustment is done by quantity.
Normal Profit in the Long Run

- Entry and exit occur whenever firms are earning more or less than "normal profit" (zero economic profit).
  - If firms are earning more than normal profit, other firms will have an incentive to enter the market.
  - If firms are earning less than normal profit, firms in the industry will have an incentive to exit the market.

Economic Profit in the Long Run

- A zero economic profit is a normal accounting profit, or just normal profit.
- Firms produce where marginal cost equals price.
- No one could be made better off without making someone else worse off. Economists refer to this result as economic efficiency.

Who is Better Off?

- Lower labor costs mean Chinese firms can charge 30% to 50% less than their U.S. competitors for the same product.
- Makers of apparel, electric appliances, and plastics have been shutting U.S. factories for decades, resulting in the loss of 2.7 million manufacturing jobs since 2000.
- Meanwhile, America’s deficit with China is likely to pass $150 billion this year.

Long-Run Competitive Equilibrium

- At long run equilibrium, economic profits are zero.
- Profits create incentives for new firms to enter, market supply will increase, and the price will fall until zero profits are made.
- The existence of losses will cause firms to leave the industry, market supply will decrease, and the price will increase until losses are zero.
Long-Run Competitive Equilibrium

- Zero profit does not mean that the entrepreneur does not get anything for his efforts.
- Normal profit is the amount the owners would have received in their next best alternative.
- Economic profits are profits above normal profits.

Market Response to an Increase in Demand Graph

- If the long-run industry supply curve is perfectly elastic, the market is a constant-cost industry.
- If the long-run industry supply curve is upward sloping, the market is an increasing-cost industry.
- If the long-run industry supply curve is downward sloping, the market is a decreasing-cost industry.
- In the short run, the price does more of the adjusting, and in the long run, more of the adjustment is done by quantity.

Application: Kmart

- Although Kmart was making losses, Kmart decided to keep 300 stores open because $P > AVC$.
- After 2 years of losses, Kmart realized that the decrease in demand was permanent.
- They moved from the short run to the long run and closed the stores because prices had fallen below their long-run average costs.