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.

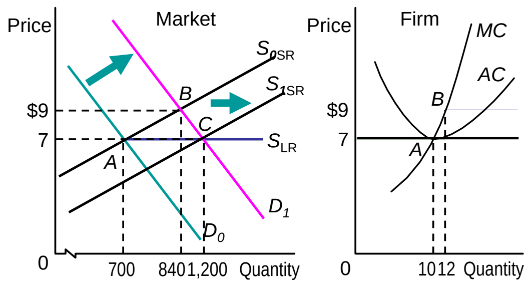
An Increase in Demand

- 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.

Market Response to an Increase in Demand



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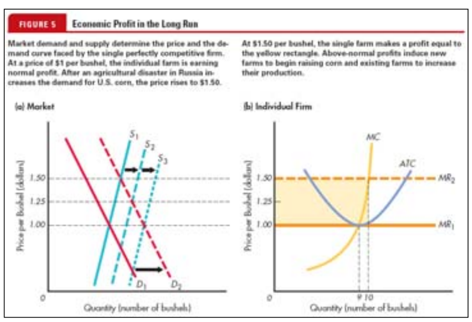
Normal Profit in the Long Run

- 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



The Predictions of the Model of Perfect Competition

- 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

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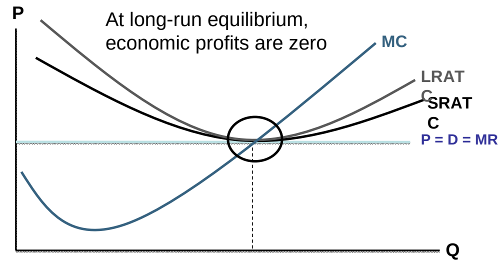
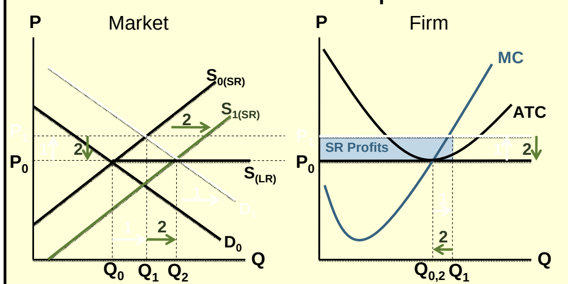
Long-Run Competitive Equilibrium

- 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

Long-Run Competitive Equilibrium Graph



Market Response to an Increase in Demand Graph



Long-Run Market Supply

- 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