

Perfect Competition

Perfect competition is a market structure in which there are many small firms selling identical products, with no barriers to entry or exit.

Individual firms have no market power and are therefore price takers.

Characteristics of Perfect Competition

Many Buyers and Sellers

There are a large number of buyers and sellers in the market.

Each firm accounts for such a small proportion of total market supply that its individual decisions have no significant influence on the market price.

Therefore, firms are price takers and must accept the price determined by market demand and supply.

Homogeneous Products

All firms sell identical or homogeneous products, meaning consumers view the products of different firms as perfect substitutes .

There is no product differentiation or brand loyalty. If one firm charges above the market price, consumers will simply purchase the identical product from another firm.

Therefore, demand for an individual firm's product is perfectly price elastic ($PED=\infty$).

For example in the **UK Agricultural Wheat Market**: Over **18,000 UK cereal farms** act as price takers as all wheat is homogenous .

Perfect Information

Buyers and sellers have perfect knowledge of market conditions, including prices and products.

Consumers therefore know if another firm is offering the same product at a lower price. This prevents individual firms from charging above the market price.

For example **Foreign Exchange Market (FOREX)** instantaneous access to global prices .

No Barriers to Entry or Exit

There are no significant barriers preventing firms from entering or leaving the market.

This process of entry and exit causes firms to earn only normal profit in the long run.

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Price Takers

Individual firms have no market power and cannot influence the market price.

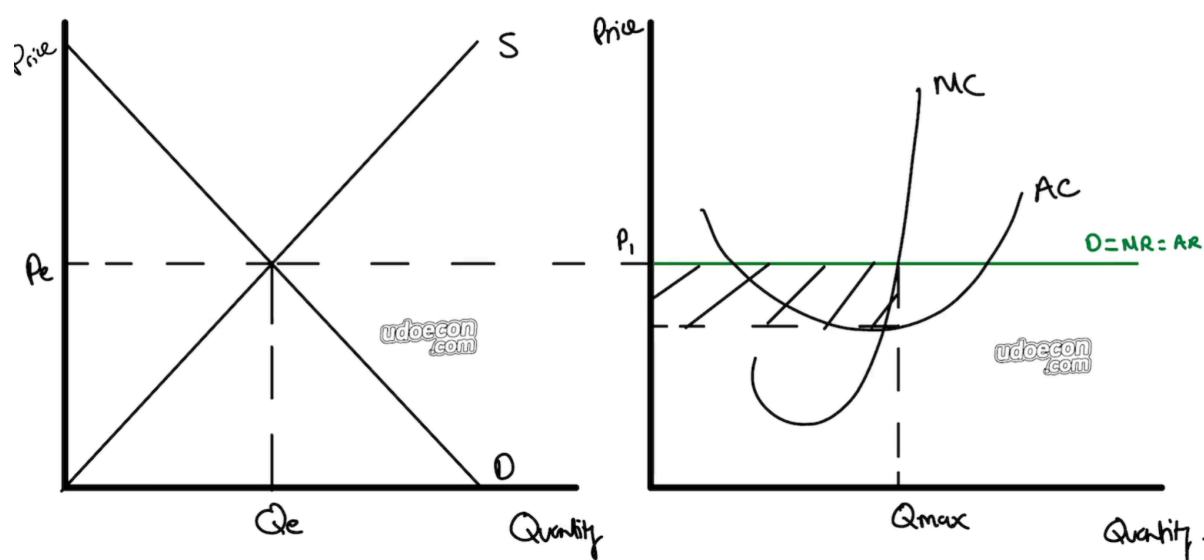
The market price is determined by industry demand and supply, and each individual firm must accept this price.

For an individual perfectly competitive firm:

$$D=MR=AR=P$$

The firm's demand curve is therefore horizontal and perfectly price elastic.

Perfect Competition in the Short Run



We start with the market diagram on the left, which reaches equilibrium where supply = demand thus leading to price P_e and quantity Q_e .

As firms in perfect competition are **price takers**, an individual firm must accept the market price P_e . Therefore, the firm's demand curve is perfectly elastic at this price, giving $D = AR = MR = P_e$.

The firm then **maximises profit where $MC = MR$** , producing at Q_{max} . At this output, $AR > AC$, meaning the firm earns **supernormal profit**.

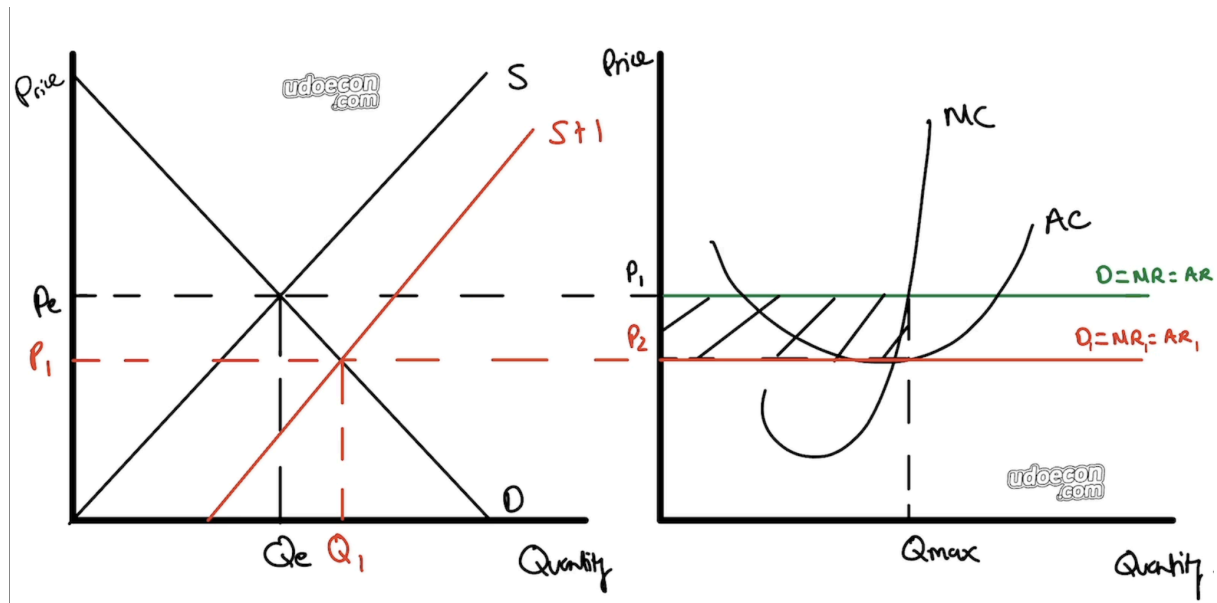
How do Perfectly Competitive markets move from the short run to the long run equilibrium

From Supernormal Profit to Normal Profit

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If SR firms in perfectly competitive markets can earn supernormal profit:

Supernormal profit → incentivises new firms to enter the market → no barriers to entry → market supply shifts right from S to S_1 → market price falls → as firms are price takers, $D = AR = MR$ falls for individual firms → supernormal profit decreases → new firms entry continues as long as supernormal profit exists → market supply continues to shift right until $D = AR = MR$ is equal AC → as this means no longer any supernormal profits → firms earn normal profit only → no further incentive for new firms to enter → we reach our long run equilibrium ($D_1=MR_1=AR_1$)



Short run vs Long-Run Equilibrium

In short-run equilibrium, perfectly competitive firms make losses, normal and supernormal profits.

In long-run equilibrium, perfectly competitive firms earn normal profit only.