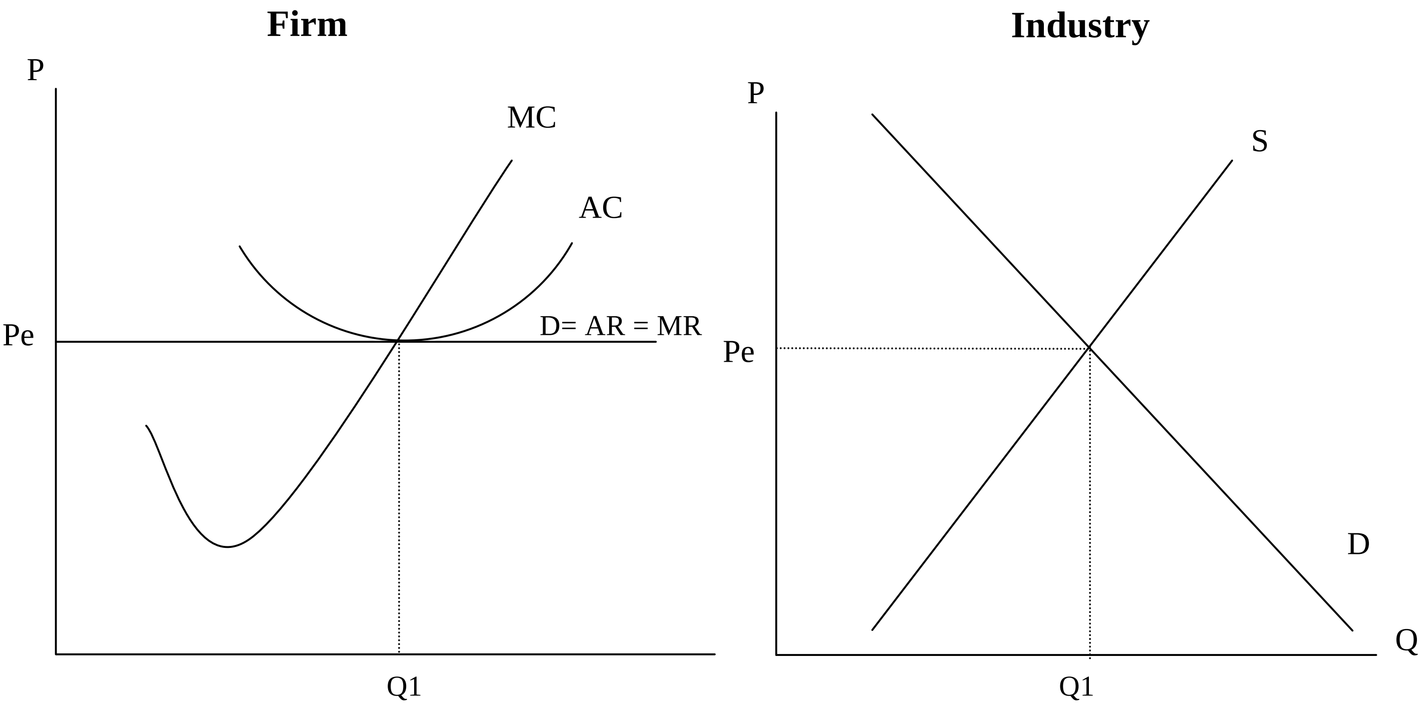
Perfect Competition

Features of Perfect Competition

1. Many firms.
2. Freedom of entry and exit; this will require low sunk (unrecoverable) costs.
3. All firms produce an identical (homogenous) product.
4. All firms are price takers; therefore a firm's demand curve is perfectly elastic.
5. Perfect information and knowledge by buyers and sellers.

Diagram Perfect Competition in Long Run



- In the industry, price will be at the intersection of Supply and Demand (Pe).
- The individual firm will maximise output where MR = MC at output Q1
- If supernormal profits are made, new firms will be attracted into the industry causing market price to fall. If firms are making a loss, then firms will leave the industry, causing price to rise.
- Therefore in the Long Run, firms will make normal profits (AR=AC).

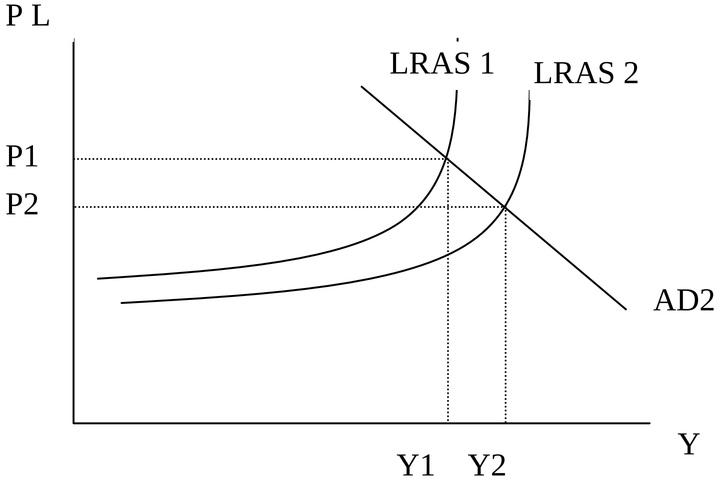
Efficiency Of Perfect Competition

1. **Allocative Efficiency**
   This is because the long run equilibrium occurs where P = MC.
2. **Productive Efficiency**
   This is because firms produce at the lowest point on the SRAC.
3. **X Efficient.**
   Competition between firms will act as a spur to increase efficiency and make sure firms use best combination of factor inputs.

Deflation

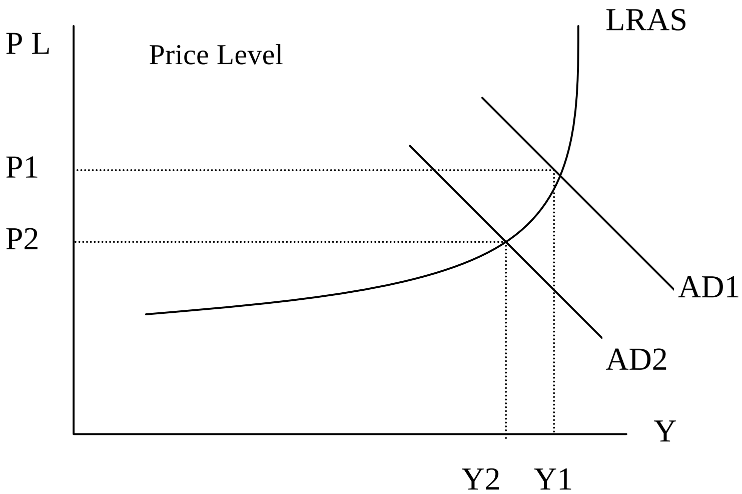
- Definition of Deflation: A fall in prices – A negative inflation rate. (CPI -0.5%)

Deflation caused by Increased Productivity



- If there is a significant increase in productivity, e.g. better technology, then LRAS will shift to the right
- This can cause a fall in the price level but there will also be an increase in Real GDP.This is beneficial for the economy.

Deflation caused by Falling AD



- Lower AD has caused a fall in the price level, but has also caused a fall in Real GDP.
- This kind of deflation can be very damaging to the economy.

Problems of Deflation

1. If prices are falling consumers will be more reluctant to spend because they feel that prices will be lower in the future. This delay in spending will reduce AD and cause lower economic growth.
2. Monetary policy becomes ineffective because interest rates cannot fall below 0. Therefore real interest rates may also be too high causing a further fall in AD.
3. Workers are very reluctant to accept a cut in nominal wages, therefore firms may have to increase real wages by more than they would like. This could increase real wage unemployment.
4. If there is deflation, the real value of debt will increase. This can reduce AD further as firms and consumers struggle to pay the increasing debt burden.