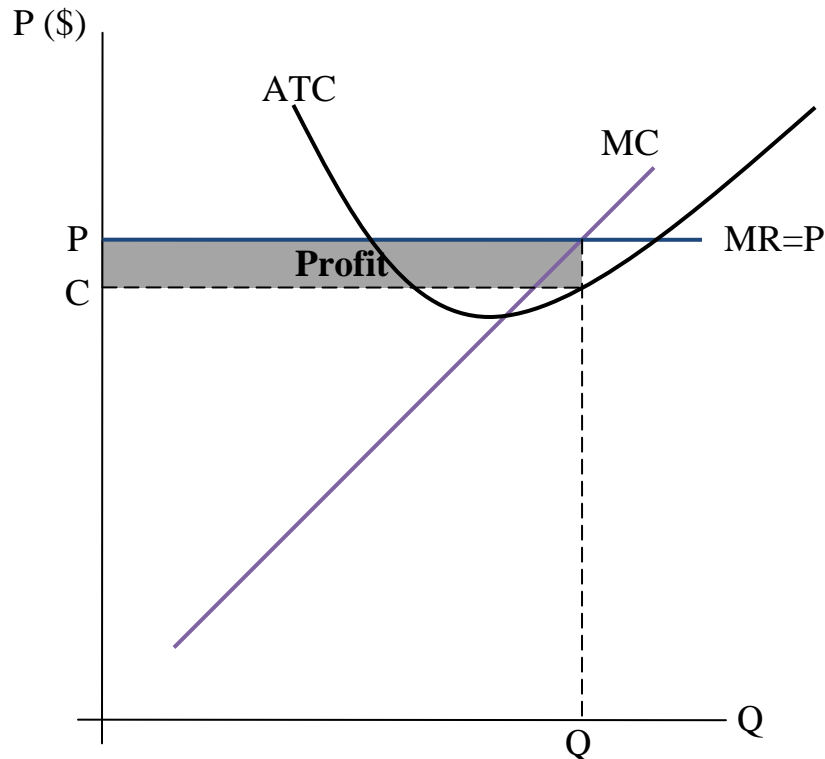


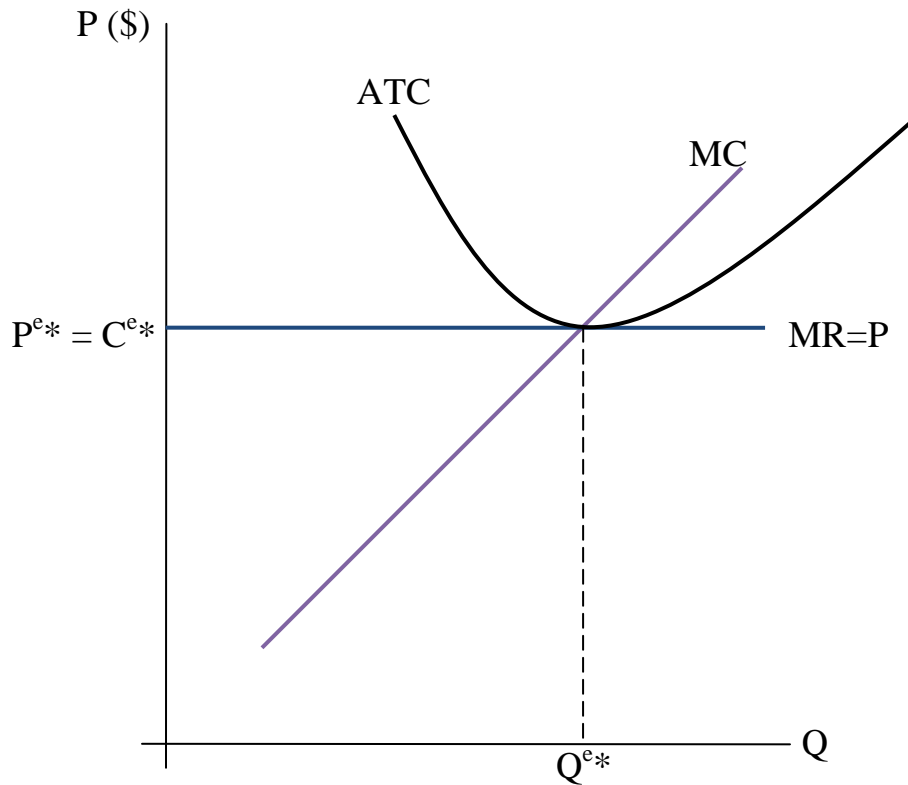
## LECTURE 22: COMPETITION III

### I. Entry and Exit



- In the example from last class, our producer is making a lot of profit by selling used clothes. Other people have used clothes as well; what would you expect people to do?
- As people enter the market, that entry will bid prices down which reduces profits.
- This encourages entry into the market: people with similar costs will start looking for clothes to sell. What does this do to the market for used clothes?
- This continues until each producer makes *zero economic profits*—or normal profits: when  $P = ATC$ . The producer is covering all the operation and opportunity costs.
  - Recall economic profit from when we covered the Broken Window Fallacy.
  - While our hypothetical person will be selling fewer clothes at that lower price (about 4.3 boxes), the market as a whole will be

providing more used clothes. Remember, the graph here is about one person/firm but the supply and demand graph is about *everybody*.



- e. In sum, we have the *elimination principle*—above normal profits are eliminated by entry and below normal profits are eliminated by exit.
  - i. In equilibrium this causes all industries to balance: no industry is strictly more profitable than another.
- f. Note that this is a complex point as there’s a lot that goes into “profitability.” For example, businesses have a standard decision of the kind of trade-off they want to make when they sell their product: high volume or high profit margin.

		Volume	
		<i>High</i>	<i>Low</i>
Profit Margin	<i>High</i>	Unsustainable Due to Entry	Sustainable
	<i>Low</i>	Sustainable	Unsustainable Due to Exit

- i. It's important to remember that this table is a simplification. Riskier businesses should earn more profits.
- ii. And some businesses are very volatile. They have very good years and very bad years; oil companies are like this because their profits are dependent on the price of oil which can change radically.
- iii. And industries are constantly changing. Some industries adapt well and others don't. Some are in decline and others are booming.
- iv. Thus even with industries of similar volume, you might not see similar profit margins. A lot is going on so it's hard to isolate this effect.