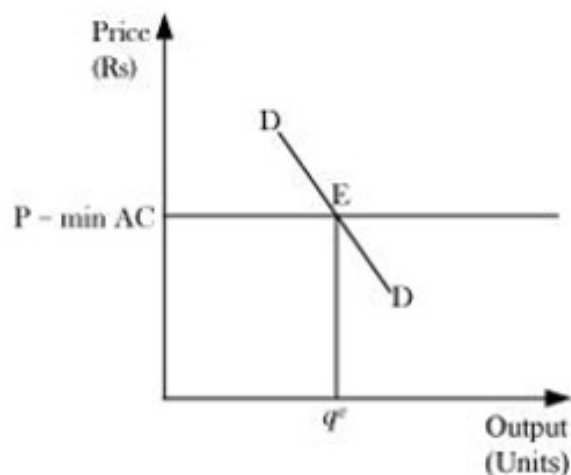




Q6. Suppose the price at which the equilibrium is attained in exercise 5 is above the minimum average cost of the firms constituting the market. Now if we allow for free entry and exit of firms, how will the market price adjust to it?

Ans: If the equilibrium price (Rs 8) in the above figure (of Q-5) is above the minimum of average cost, then it implies that the firm is earning supernormal profits. This situation will attract new firms in the market. As the new firms enter, the industry supply of output will also increase. New firms will continue to enter the industry that will lead the price to fall until it becomes equal to the minimum of the average cost. Thus, the supernormal profits are wiped out and all the firms earn normal profits.

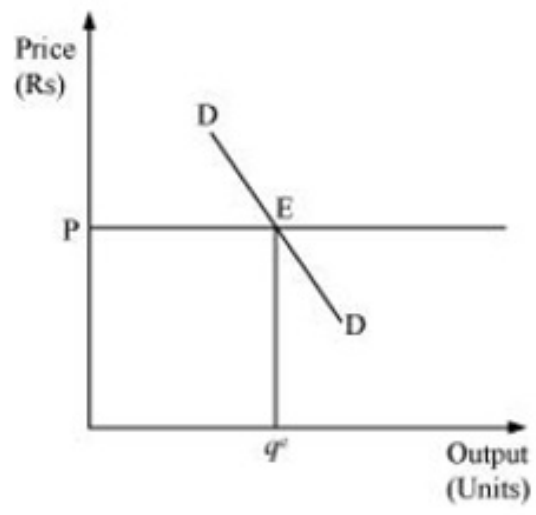
When the free entry and exit of firms is allowed, the equilibrium is determined by the intersection of demand curve and the ' $P = \min AC$ ' line.



Q7. At what level of price do the firms in a perfectly competitive market supply when free entry and exit is allowed in the market? How is the equilibrium quantity determined in such a market?

Ans: In the long run, due to the free entry and exit of firms, all the firms earn zero economic profit or normal profit. They neither earn abnormal profits nor abnormal losses. Thus, the free entry and exit feature ensures that in the long run the equilibrium price will be equal to the minimum of average cost, irrespective of whether profits or losses are earned in the short run.

The equilibrium is determined by the intersection of consumers' demand curve and the ' $P = \min AC$ ' line. At equilibrium point E, quantity supplied by each firm is q^e at the price (P).



***** END *****