

EE481: Industrial Economics

Strategic Behavior (Read Chapter 11, Carlton and Perloff)

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Strategic Behavior

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- Market environment = all factors that influence market outcome.
 - i.e. prices, quantities, profits, welfare
 - beliefs of customers, competitors
 - production capacity
 - costs of competitors, competitors actions, etc.

Noncooperative Strategic Behavior

Firm can use strategic behaviors to harm its rival and benefit itself.
For a strategic behavior to work, firms need to have the followings:

- ① - the firm that uses strategic actions should have some “advantage” over its competitor(s).
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- ② - to succeed, firm should be able to commit to its behavior (credible threats).
 - Otherwise, the competitors would not believe and the strategic actions would not result in desirable outcomes for the firm that use it.

Predatory Pricing

- A firm lowers its price below the rival's marginal cost.
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- After the rival exits, the firm has a choice to increase its price.
 - 1 firm can increase its price in the long-run only if the potential rivals believe that it would do predatory pricing again once there is new entry.
 - 2 If firms have to always keep price low to discourage entries -> more efficient -> good for the consumer.
 - 3 But **less** competition may mean less innovation ? (depends)

Predatory Pricing: identical firms

How possible for predatory pricing to succeed if firms are identical (same cost, same capacity)?

- If firms are identical, then they have as much advantage as the others. They have the same cost, same capacity, same reputation, etc.
- The incumbent's threat is as credible (or non-credible) as the entrant's threat.
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Predatory Pricing: one firm with advantage

- Advantage = lower MC, higher capacity to produce, better reputation, more loyal customers, etc.
 - 1 Lower MC: when under-cutting price, the predating firm wouldn't lose much. This is because predatory pricing is costly (price too low). Thus, the lower the MC, the less money firm loses from doing predatory pricing.
 - 2
- Predatory pricing is more likely to be successful if the predating firm has the advantages above.

Capacity Constraint (Graph)

Predatory Pricing: Legal Standards

Legal Standards of Predatory Pricing

- It is illegal if a firm conduct predatory pricing to
- If $P < MC^{Short-run}$, then the competition authority would investigate the case.
 - When $P < MC^{Short-run}$, firm makes loss. It is not normal for firms to choose to make loss, unless they have a strategic intension.
- But $P < MC^{Short-run}$ does not necessarily imply predatory pricing.

Predatory Pricing: Legal Standards

- In 1986, the US Supreme Court received a complain from US electronic producers that
“the Japanese electronic producers have been practicing predatory pricing for 20 years. They sell their products at $P < MC$!”
- If you were the US Supreme Court, what should you do?

Recall that

- Right after the import quota was abolished, the 9 big firms LOWERED the price of P.S.

From 30 baht/chick to 25-27 baht/chick.

- Wasn't worth it for the new firms to import chicks anymore

Limit Pricing (1)

- An incumbent sets a high quantity/low price as to deter entry.
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- When does a firm choose to do limit pricing?
 - Firm has to compare profits among different scenarios. For example:
 - 1 profit from no entry (do limit pricing forever to discourage entry)
 - 2 profit when there is entry and firms cannot collude (charge Cournot price forever)
 - Firm do limit pricing if scenario 1. gives more profit.

Limit Pricing (2)

Limit Pricing (2)

Question for you

A firm in which industry is more likely to **be able to** commit to limit pricing:

- Flash Memory Industry
- Hotel Industry

Question for you

Is it possible for profit-maximizing quantity (monopoly quantity) to be a limit-pricing quantity as well?

Question for you

Suppose R&D can help lowering your cost (from more efficient production, etc.), but the cost of doing R&D is more than your gain from cost-saving.

- Would you do R&D?

Strategic Investment

Firms can invest in order to gain competitive advantage over the competitors. This would allow them to successfully conduct strategic actions.

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- Investing in R&D (to lower cost)
 - R&D benefits customers.
 - But if the “cost of R&D” $>$ “the gain from lower cost”, firm may not invest in R&D.
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 - The threat of entry increases R&D.

Strategic Investment (cont.)

- Learning by doing
 - Firm can learn to master their production (and lower cost) after some periods of time.
 - The opportunity cost of operating unprofitably in the veryfirst periods can be viewed as investment.
- Preemption
 - 1 Geographical market preemption
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 - 2 Brand preemption
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Raising Rivals' Costs

- ① Direct method
 - Lobbying suppliers of the competitors to ↓quantity or ↑price
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- ② Interference through government regulations
 - Carbon tax, environmental regulations
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- ③ Tie-ins of other products
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- ④ Raise switching costs
 - Mobile network providers in Thailand used to not allow customers to take the number with them when switching.
- ⑤ Raise wages or other input prices
 - Capital-intensive firms may advocate the increase of the minimum wage if their competitors are more labor-intensive.

Advantage of Entrants

- ① More flexible
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- ② The entrant may choose to enter one of the geographical/product markets.
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- ③ The incumbent may not want to enter a price war if it covers a larger geographical/product market.
- ④ But the incumbent may introduce a “fighting brand” to compete.
 - Or have promotions which are specific to the geographical market with competitors.

Welfare implications

- Predatory pricing, Limit pricing may or may not increase welfare.
 - price may be kept permanently low, which is good.
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- If the strategy “lessens competition”, then it decreases welfare.
 - i.e. if firms successfully deter entry and then raise their price in the long-run.

Practice and facilitate collusion (Cooperative Strategic Behavior)

- ① Uniform prices
 - A firm charges to same price from everyone. Costly to lower the price.
- ② Penalty for price discounts
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- ③ Advance notice of price change
 - Supermarket's promotion leaflets, etc.
- ④ Information exchange
- ⑤
 - Sellers may disguise their discounts in the form of low shipping fee.
- ⑥ Swap and Exchanges
 - Have firms that are close to the customer ship to the customer.

Reference and Further Reading I



Carlton, D.W. and J.M., Perloff.
Modern Industrial Organization. 4th Edition.
Pearson Addison Wesley Press, 2005.