

EE481: Industrial Economics

Game Theory (Dynamic Game)

Dr. Wanwiphang Manachotphong

Department of Economics, Thammasat University

29 August 2014

Game Theory

- In many circumstances, there are more than 1 player.
- The decision of 1 player can affect the payoffs to other players.
- Game theory analyzes how each player makes strategic decisions

Strategic decisions =

Static Game = One-shot game. No player can observe the others' decisions.

Dynamic vs. Static

- Static Game = One-shot game. No player can observe the others' decisions.
- Dynamic Game =
 - Repeated Game
 - Finitely repeated
 - Infinitely repeated
 - Sequential Game

Noncooperative vs. Cooperative Games

- Cooperative game = Participants can negotiate binding contracts that allow them to make joint-strategies.

Example:

- Noncooperative game = Negotiation and enforcement of binding contracts between players is not possible.

Example:

Nash Equilibrium

Nash Equilibrium = A solution concept for a game proposed by Prof. John Nash.

- Dominant Strategies: I'm doing the best I can *no matter what another person do*. You're doing the best you can *no matter what I do*.
- Nash Equilibrium: I'm doing the best I can *what you are doing*. You're doing the best you can *what I am doing*.
 - At the Nash Equilibrium, no player has an incentive to unilaterally change their decision.

Finitely Repeated Games

-
- Increase a possibility to enforce an agreement (firms compete in more than 1 period).

Example: Price-fixing Game

		Firm 2	
		Cooperate	Defect
Firm 1	Cooperate	3,3	0,4
	Defect	4,0	1,1

Payoff (Firm 1, Firm 2)

- Suppose this game is played repeatedly for 20 periods.
- What now would be each player's strategy?

Finitely Repeated Games

- Finite number of repetitions
 - Game theory predicts that cooperation will never happen.
- Suppose firm1 and firm2 successfully cooperate until period 19, what would happen in period 20 (last period)?
 - Nash Equilibrium solution suggests that both defect.
- If both would defect in the last period, what benefit there would be to cooperate in the next-to-last period?
 -
- Use the same rational back to the first period.
 - Both defect from the beginning.
 - Cooperate would never be chosen!

Infinitely Repeated Games ($T = \infty$)

- In the real world, we see that firms sometimes cooperate, sometimes defect.
 - Needs to find a better model to explain the situation.
- Infinitely repeated game
 - There is no end period
-

Infinitely Repeated Games (Strategies)

Grim Strategy

- 1 Start by choosing “cooperate”.
- 2 Continue to choose “cooperate” unless some player has chosen “defect”, in which case choose “defect” forever.

Tit-for-Tat

- 1 Start by choosing “cooperate”.
- 2 Thereafter, in period n choose the action that the other player choose in period $(n - 1)$.

Infinitely Repeated Games (In Practice)

Grim Strategy and Tit-for-Tat in Practice

- Could work in practice, although firms don't compete infinitely (there is an end at some point)
- This is because
 - 1
 - 2

- But if there are too many firms, Grim Strategy and Tit-for-Tat would be difficult to enforce.

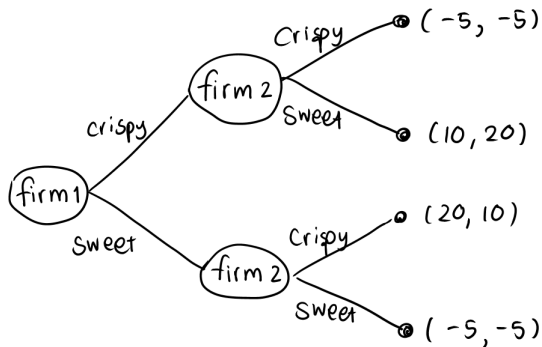
Sequential Games

- Sequential games = game in which players move in turn, responding to each other's actions and reactions.

The **extensive form** representation of a sequential game identifies:

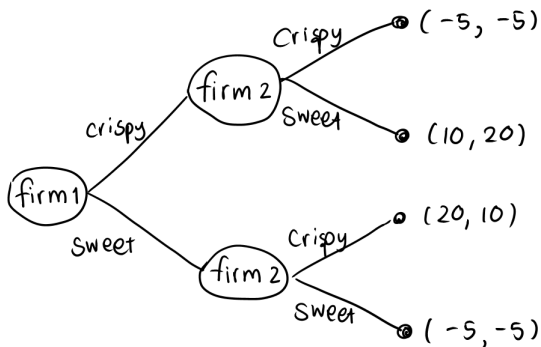
- 1 Identity of each player
- 2 Timing of move
- 3 Choices and actions available to each player
- 4 Information (history of the game)
- 5 Payoffs (all possible outcomes)

A Simple Sequential Game



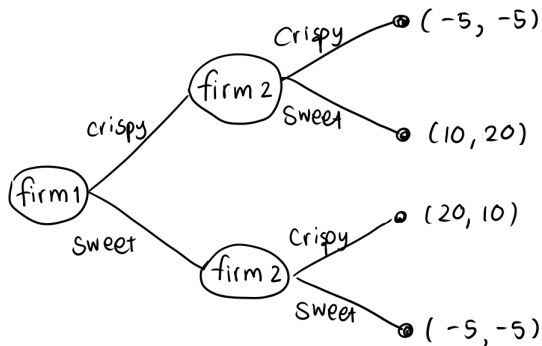
Non-Credible Threats (Empty Threats)

- A non-credible threat is a threat that would never happen if the firm is rational.



Backward Induction and SPNE

- We can use “backward induction” to find the equilibrium of the game.
- The equilibrium found would be called a Subgame Perfect Nash Equilibrium (SPNE). For SPNE, the solution to every subgame is a Nash Equilibrium.



Entry Deterrence Example

Reference and Further Reading I



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



Pindyck, R.S. and D.L., Rubinfeld.
Microeconomics. International Edition.
Pearson Education Press, 2001.



Rasmusen, E. *Games and Information: An Introduction to Game Theory*. 4th Edition.
Blackwell Publishing, 2007.



Green, E.J., and R.H. Porter. Noncooperative Collusion Under Imperfect Price Information.
Econometrica Vol.52, No.1, 1984.



Porter, R.H. A Study of Cartel Stability: The Joint Executive Committee, 1880-1886. *The Bell Journal of Economics* Vol.14, No.2, 1983.



Rotemberg, J. J., and G.Saloner. A Supergame-Theoretic Model of Price Wars During Booms. *The American Economic Review* Vol.70, No.3, 1986.