Predatory pricing
Lecture 6

Dr. Martin Ewers

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Section 1

Definition

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Definition (Predatory pricing)

1. Price is low, meaning
   - strict criterion: $P < MC$
   - weak criterion: $P < AC$
2. The price is intended either
   - to drive competitors out of the market, or
   - to deter market entry by potential rivals.

Section 2

Welfare effects

Welfare effects

Welfare effects of predatory pricing

- ▶ Initial low price (price war) is beneficial to consumers.
- ▶ If price increases due to lack of competition, consumers will loose.

Section 3

Credibility

Credibility

Is a price suitable to drive competitors out of the market or to deter market entry by potential rivals?

The chain store game helps to analyse.

Credibility

Chain store game – payoff matrix. Single-round game: Firm C has the 1st move, I makes the 2nd move

	C – market entry	C – no market entry
I – fight	(70;-10)	(90;0)
I – accommodate	(80;10)	(100;0)

Credibility

Nash equilibrium: No player can do better by unilaterally changing his or her strategy.

	C – market entry	C – no market entry
I – fight		
I – accommodate	Nash equilibrium	

In a single-round game, market entry will take place.

Credibility

Chain store game – finite number of rounds

The incumbent I can not credibly threat to lower prices ('fight') in response to market entry.

Proof by reverse induction:

- Assume there is a finite number n of rounds ('subgame').
- In the n-th round, I will accommodate anyway (subgame equilibrium, see payoff matrix)
- I cannot credibly threat in the $(n-1)$-th round to set low prices in the n-th round.
- Accordingly I will stick to the subgame equilibrium in the $(n-1)$-th round.

Credibility

> Predatory pricing can work despite the chain store paradox.

- ► Infinite number of rounds.
- ► Incumbent *I* can bear more losses over more subgames than any rival firm *C*.

    – Does *I* have the ressources to take losses?

    – Does *C* have the ressources to take losses?

- ► Rival firms do not know *I*'s payoff matrix (they can only guess).

    – It might make sense *I* to invest in building a reputation.