Entry an Exit decisions are determined by more than what was suggested in previous chapters.

We ignored the possibility of strategic behavior at the entry stage.

When making entry decisions firms anticipate the competition they will face when entering, but the entry decision itself is made in a nonstrategic way.

But these entrants must take into account direct retaliation by incumbent firms.

Therefore, we need to examine equilibrium outcomes in which entry and exit arise from strategic behavior by both entrant and incumbent firms.

To begin, we will consider simple methods/models of entry deterrence.
In the model we will consider an industry with one active firm, and one possible entrant.

The possible entrant must decide whether or not to enter, and in case it does enter how much to produce.

Before the possible entrant makes its decisions the active firm gets to choose its own output level.

Once both output levels have been chosen, price is determined as a function of total output.

We can get an idea on what the equilibrium is by looking at 3 profit curves.

One is the active firm's profit in the event it is a monopolist.
Another is the active firm’s profit in the event the possible entrant does indeed enter.

The third is the possible entrant’s maximum profit as a function of the active firm’s output level.

It is no longer clear that the active firm would set output that maximizes its monopoly profits.

That’s because the possible entrant would enter, lowering the active firm’s profits, compared to, say the active firm setting output large enough to deter entry.

However, such an extreme level of output by the active firm might not be the active firm’s optimal strategy.

If entry costs are low enough, the active firm’s optimal strategy is one of entry accommodation.
At the other end, if entry costs are high the active firm can indeed set the monopoly output, and the possible entrant would not enter—this is known as blockaded entry.

But this informal analysis raises the issues of commitment, credibility, ex-ante optimality and ex-post optimality.

For example, what we had before was the active firm announcing its intention of producing a very large output if there was entry; but is that credible?

For this to be true it must be optimal for the active firm to implement what it announces what it will do, when the time comes.

Suppose that the entrant, ignoring the active firm’s announcement, decides to enter and produce the Cournot amount.

Then the active firm would ignore its own announcement and choose the Cournot output as well.
So the original announcement is not credible.

This suggests other strategies to deter entry besides capacity expansion.

One is product proliferation—i.e., a firm can introduce additional products that are horizontally differentiated.

In the entrant/incumbent setting a potential entrant may consider entering but locates differently than the incumbent firm.

So the incumbent firm can deter entry by creating two varieties of its product, so there is no “location” for the potential entrant to be profitable.

So more varieties can deter entry, as is the case with the cereal industry.
Another entry deterrent strategy is signing a contract with buyers.

This way, incumbent and buyer act a monopolist with respect to the potential entrant.

So with the contract, they effectively set a market entry price.

If the incumbent cannot prevent entry is can still gain monopoly power by inducing the exit of its rivals.

This practice is known as predation.

One particular form of this is pricing below cost to induce rival firms to exit.
But what is predatory pricing and how can one be sure it is occurring?

When a firm lowers price is it predatory, or equilibrium?

It is difficult to prove intent by simply looking at price levels and changes.

In fact, one could make the argument that predatory pricing cannot exist if agents are rational.
■ Specifically, rational players would never exit when preyed upon.

■ Consequently, rational predators should never engage in predation.

■ Whether this is true or not depends on how much cash the entrant has to absorb short term losses, and the degree of liquidity in the banking industry.

■ Other explanations for predatory pricing, assuming it exists, are low cost signalling, reputation of "toughness", an growing markets where long term success requires significant market share early on.
Public Policy Towards Predation

- Does it exist? Why is it not a competitive response?
- If it does exist how can it be identified?
- One approach might be that prices are regarded as predatory if they fall below marginal cost?
- Another approach may be to look at post-exit price increases.
- Why should it be illegal? After all, lower prices are usually a good thing from a welfare analysis perspective...
- Short term lower prices may have to be weighed against longer term higher prices following exists and resulting monopolies.