EXAM THE ECONOMICS OF STRATEGY

29 August 2008 Rune Stenbacka

Time limitation: 4 h

Answer (in English or Swedish) all the four questions below! Please observe that the questions do not have equal weight!

1. (a) Define briefly the following concepts: (1) Lerner-index, (2) network externalities, (3) excess inertia, (4) excess momentum, (5) critical mass of a network, (6) customer poaching, (7) pure bundling, (8) mixed bundling, (9) strategic commitment, (10) Herfindahl index. (10 p)

(b) Explain the mechanism behind tacit collusion, i.e. the mechanism for how competing firms might be able to sustain collusion in the absence of a formal cartel agreement. Is tacit collusion prohibited by European competition law? (5 p)

2. (a) During the lectures we demonstrated that the effects on consumers of price discrimination depend on the market structure. Explain why price discrimination intensifies competition in an oligopolistic industry and how this prediction differs from the effects of price discrimination with monopoly. (5 p)

(b) European competition law ("Article 82") specifies predatory pricing as a potential abuse of a dominant market position. Define predatory pricing and explain in which way it may be used to abuse a dominant market position. Explain also which considerations have to be taken into account when evaluating whether a firm has engaged in predatory pricing and when evaluating whether such a practice hurts consumers. (10 p)

3. (a) Are mergers which increase the degree of concentration within an industry always welfare-reducing? Motivate your answer carefully. In case your answer is negative you should specify plausible conditions under which a concentration-increasing merger could be welfare-enhancing. (5 p)

(b) Consider a duopolistic market with linear demand $P = 1 - Q$, where Q denotes industry output. Suppose that the two Cournot duopolists with identical marginal costs $c_1 = c_2 = 0.4$ propose a merger. The firms claim that that the merged firm's costs will fall by x % as a result of the efficiencies attributable to the merger. How large would x have to be in order for the merger to benefit consumers? (15 p)

4. Suppose that two firms, A and B, are Cournot competitors and that their only costs are the salaries for their managers. Assume that each manager is paid 1 Euro per unit of output. Inverse demand is given by $P = 10 - Q$, where Q denotes industry output.

(a) Compute the Cournot equilibrium quantities and profits for each firm. (4 p)

(b) Assume now that the owners of firm 1 decide to direct their manager to maximize sales instead of profits. Assume that the owners of firm 2 instruct their manager to maximize profits. Compute the equilibrium quantities and profits for each firm under this configuration and compare the results to case (a). (12 p)

(c) Explain in detail how this example illustrates how a firm can benefit from strategic delegation. (4 p)

Good luck!