Answers to Questions from Chapter 12

“Discussion Questions”

(4) The price of Ford common stock changes many times a day. The price of a Ford Explorer usually changes once a year --perhaps more often if there are discount schemes or if there is inflation. The continuous movements in supply and demand explain the frequent changes in stock prices on the stock market. The stickiness of the auto price may be due to the "kinked demand curve." Ford knows that if it raises its prices, GM will not follow suit, but if it lowers its price, GM will. Hence the demand curve is kinked and the marginal revenue curve is discontinuous at the current output and price. Even if marginal costs change, it will be advantageous for Ford to hold to its current price.

(6) This is an example of "predatory pricing." Biggie hopes to set a price so low that Bargain will be unable to compete and be driven out of business. Furthermore, other potential entrants will be scared off. Biggie may actually suffer losses while this is happening. Eventually however, when Bargain has left, Biggie hopes to act like a monopolist and set a high price.

(7) If air transportation were perfectly contestable, Bargain could exit the industry while the price was low, use its assets on some other routes for a while, then return to the Eastwich-Westwich route when Biggie raised prices. So Biggie would never succeed in setting high monopoly prices.

(8) Barge transportation is likely to be contestable, because barges can easily be moved into or out of any geographical area, without a big expense. Aluminum and automobile production, however, require large fixed capital investments that are not easily mobile, and therefore those two industries are unlikely to be contestable.

(10) a. If Firm A is a "tough guy," it will always strike back at hostile actions by Firm B, even if those hostile acts harm its own interests. Once B becomes convinced that this will happen, it may cease its hostile behavior against A and A will benefit.

b. If Firm A has a reputation for irrationality, Firm B may think it best to adopt a conservative strategy, not threatening A's profits, lest A strike out against B even at a cost to itself. A may not do this, but B never knows.