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Explain why the kinked demand curve of Paul Sweezy has a kink in it?

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- According to Sweezy's model, each firm is faced with a demand curve which shows a kink at market prices.
- Above the kink, which is at prices above the market price (P_0 see point S), the demand curve is very elastic:
- The reason being that the firm believes that, if it sets its price above the market price (P_0) other firms would not do the same, with the result that its sales would decline sharply and its market share would shrink.
- On the other hand, the demand curve below the kink, that is at prices lower than the market price (P_0), is very inelastic (see section SV) because the firm believes that if it were to price its products lower than its competitors they will immediately do the same to prevent losing part of their market share.
- Therefore the firm cannot increase its market at a rate which is no higher than that of its competitors.

Briefly discuss the criticism of the Sweezy model. Refer to theoretical problems as well as the empirical evidence?

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- It does not provide a full explanation of price formation under an oligopoly. For instance, it does not explain how the firms arrived at the price P_0 in the first place; the model simply takes the prevailing price P_0 as given.
- Empirical research has also questioned the basic premise of the model – the indications are that competitors will imitate both price increases and price decreases. In that the event the demand curve would not show a kink.

COMPETITION VS COLLUSION

- ❑ Nash equilibrium is a non-cooperative equilibrium.
- ❑ Each firm makes the decisions that will realise the highest possible profit, even considering the actions of competitors.
- ❑ The profits of each firm will be higher than it would be under perfect competition.
- ❑ Firms are aware that collusions is illegal.
- ❑ Co-operation could lead to higher profits.

❑ QUESTION

Why do firms not co-operate without explicit collusion?

- ❑ If the two firms (Duopoly) can estimate the profit-maximizing price that would be set if there was collusion, why not just set the price and hope that the competitor would follow.
- ❑ If the competitor follows both firms will make more money.

❑ PROBLEM

The competitor is not likely to follow because it would be better off to set a lower price, even if it is aware that firm 1 will set a price at a collusive level.

- ❑ The Payoff matrix summarises the result of different possibilities.
- ❑ Co-operation means both firms charging R16.00 instead of R4.00 and thus earning R16.00 instead of R12.00.

❑ PROBLEM

Each firm always makes more money at a price of R4.00.

- ❑ The payoff matrix shows if Firm 2 charges R4.00, Firm 1 does best by charging R4.00.
- ❑ If Firm 2 charges R6.00, Firm 1 still does best by charging R4.00.
- ❑ Firm 2 always does best by charging R4.00 no matter what Firm 1 does.

❑ CONCLUSION

Unless Firm 1 and Firm 2 sign an unforceable agreement to charge R6.00 neither firm can expect its competitor to charge R6.00 and both will charge R4.00.

THE PRISONER'S DILEMMA

- ❑ A classical example in game theory.
- ❑ Two prisoners must decide separately whether to confess to crime.
- ❑ If Prisoner A confesses, a lighter sentence will be imposed and Prisoner B will get a heavier sentence.
- ❑ If neither Prisoner A nor B confesses the sentence will be lighter for both.
- ❑ Like the prisoners each one of the two firms has an incentive to undercut its competitor and each knows that its competitor has the same incentive.
- ❑ Thus Firm 1 realises that if it competes passively, Firm 2 might compete aggressively and dominate the market.
- ❑ Both firms will be better off by co-operating.
- ❑ Both firms will face the prisoner's dilemma.

❑ QUESTION

Does the prisoner's dilemma force oligopolists into aggressive competition and low profits?

❑ ANSWER

No – oligopolistic co-ordination and co-operation could prevail.

- ❑ Firms could set prices and output and adjust price and quantity according to the behaviour of the competitor.
- ❑ In the process the two firms could develop a relationship of trust and oligopolistic co-operation and co-ordination will prevail.