Collusive Price Rigidity under Price-Matching Punishments

BACKGROUND

- There has been a long-standing belief in industrial economics that tacit collusion and price rigidity are linked. This belief is formalised in the theory of the kinked demand curve.
- According to the theory, a firm expects its rivals to continue to charge a certain focal price if the firm itself charges *more* than this focal price; but the firm expects its rivals to match any price it charges *below* the focal price. As a consequence, the firm's demand curve is kinked at the focal price, and the resultant discontinuity in its marginal revenue curve implies that prices remain at the focal level for small cost fluctuations.
- The theory has been heavily criticised although there is anecdotal support of price rigidity during periods of collusion.

METHODOLOGY

- The author analyses an infinitely repeated game where unit costs fluctuate stochastically over time and where firms follow a price-matching punishment strategy.

KEY FINDINGS

- There is game-theoretic support for the results of the kinked demand curve: price rigidity can occur for small fluctuations in costs.
- The critical level of high costs under which collusive prices are rigid is shown to depend upon the expected duration of a sequence of high cost periods, the number of firms in the market, and the degree of product differentiation.

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CCP Executive Summary

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The full working paper (11-14) and more information about CCP and its research is available from our website: www.competitionpolicy.ac.uk

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