

LECTURE 4

SEQUENTIAL GAMES



Introduction

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- Lecture 1-3: Simultaneous games:
 - Prisoner's dilemma (Ad, No Ad):
 - Unique PSNE, both players defect.
 - Games without PSNE (shirk/monitor):
 - MSNE is the intuitive outcome.
 - Coordination games:
 - 2 PSNE & 1 MSNE. Players may try to coordinate.

Introduction

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- Lecture 4-5: Sequential games.
 - Games where players move one after another. Sequential games are asymmetric.
 - Games we play: chess
 - Games businesses play: entry, pricing...
- L4: Subgame perfect equilibrium.
- L5: Experimental evidence, and an application to bargaining.

Sequential games

- Looking forward: Players, when make moves, have to consider how other players will react.
- Reasoning backward: Given other players' reaction, what is my optimal strategy?
- Asymmetry in order of play causes asymmetry in payoffs. It matters who plays first and who plays second.

Entry game

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- Two restaurant chains must choose whether to open or no to open a restaurant in a new shopping area.

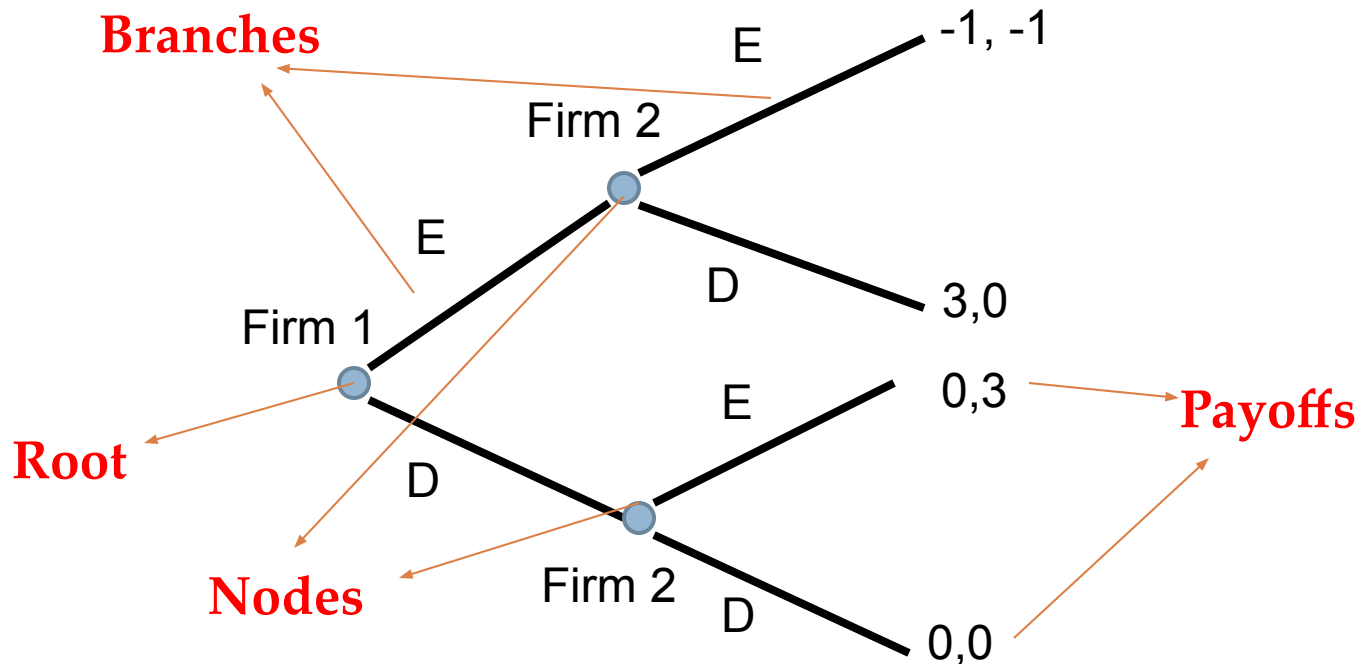
		Firm 2	
		Enter	Don't
Firm 1	Enter	-1, -1	3, 0
	Don't	0, 3	0, 0

- If the game is simultaneous: 2 PSNE, 1 MSNE.

Entry game

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- What if Firm 1 is first mover, and Firm 2 the follower?
- Game Trees: all possible moves, and all possible outcome and payoffs.



Solving the Game Tree

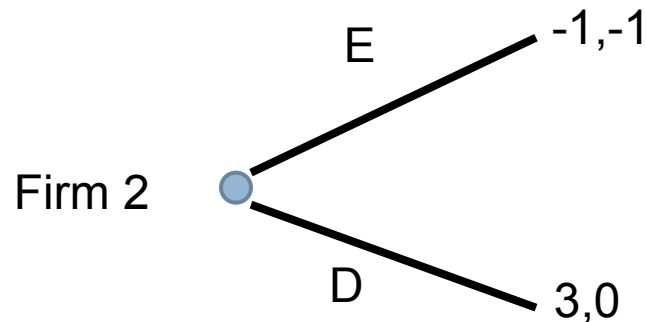
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- Method use to solve game tree:
 - Backward Induction, or rollback
 - Start from the end, and rollback until the root
- Difference with simultaneous game
 - Drop the concept of joint best response
 - There is a hierarchy of actions, of players

Solving the Game Tree

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- Subgame: any node with all subsequent nodes:

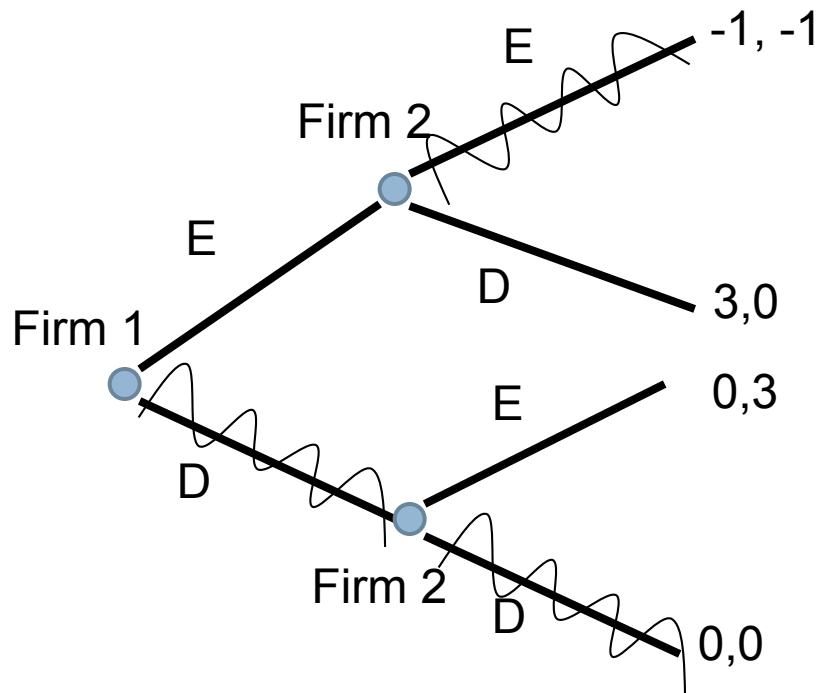


- **Subgame perfect equilibrium (SPE):**
 - The SPE is the equilibrium in sequential games.
 - The SPE is such that players' strategies constitute a Nash equilibrium in every subgame of the original game
 - Start with terminal nodes and eliminate dominated actions from the game

Looking Forward... And Reasoning Back

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- Firm 1 makes the first move, and must take into account how the response of Firm 2:



The SPE is (E,D)

Discussion

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- Compared to the simultaneous version of the game,
 - Firm 1 can obtain the outcome that yields the highest payoff (3), whereas Firm 2 obtains a low payoff (0)
- First-mover advantage:
 - Ability to commit oneself to an advantageous position
 - Firm 1 benefits from taking an irreversible action
- Note: not all games have a first-mover advantage
 - e.g. some bargaining games may have a second-mover advantage (see lecture 5).

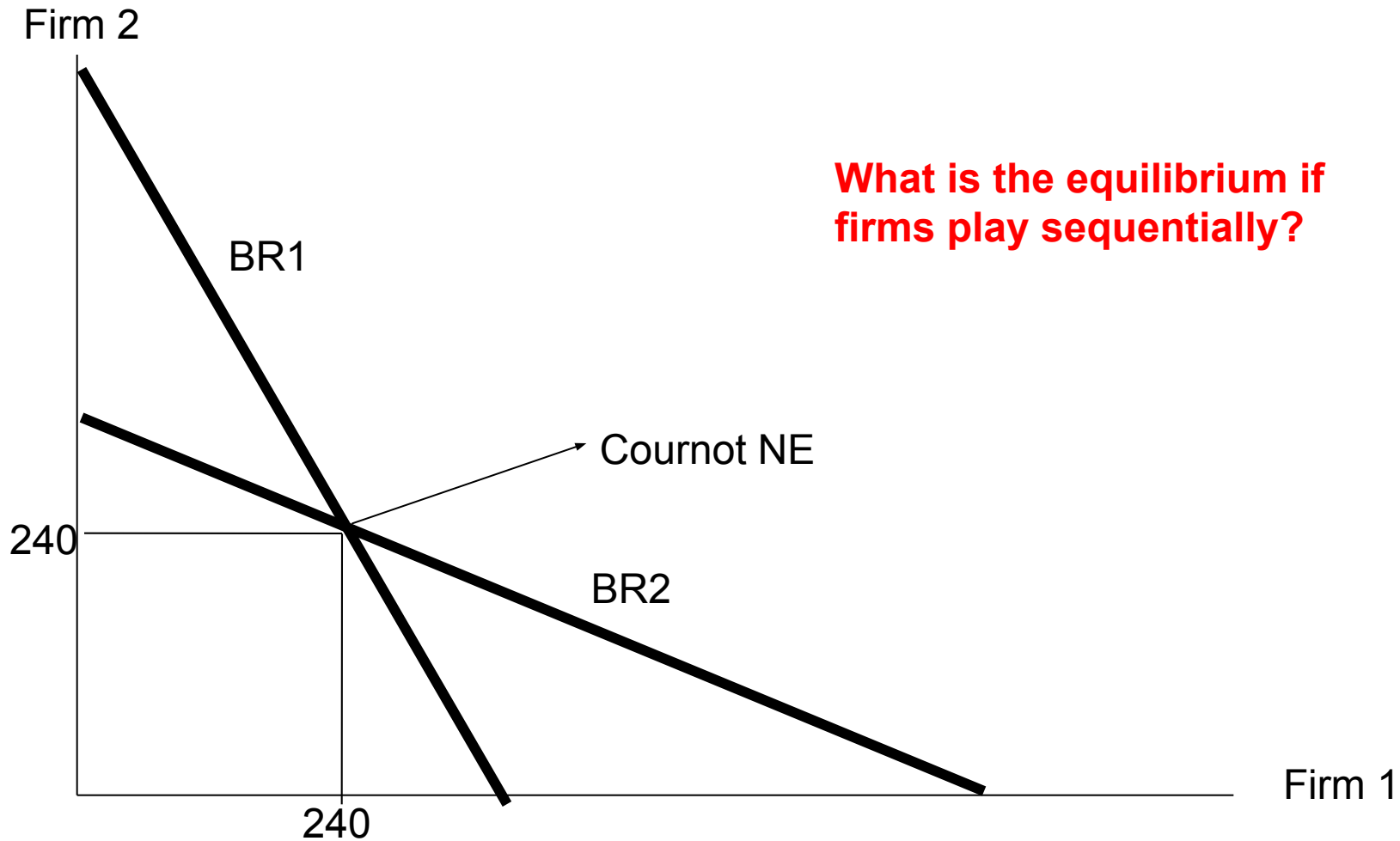
Sequential games and oligopoly

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- Cournot model of oligopoly:
 - Simultaneous game.
 - Producers have market power (profits >0), but less than the monopolist.
 - Producers would be better off if they could cooperate (e.g. OPEC oil cartel), however cooperation is not a stable outcome.
- Decisions of how much to produce can also be sequential □ **Stackelberg model** of oligopoly

Sequential games and oligopoly

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The Stackelberg model

A Cournot game with sequential actions

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- Two producers, Firm 1 and Firm 2.
 - Produce the same goods, and sell on the same market.

$$P(q_1 + q_2) = 1 - 0.001(q_1 + q_2)$$

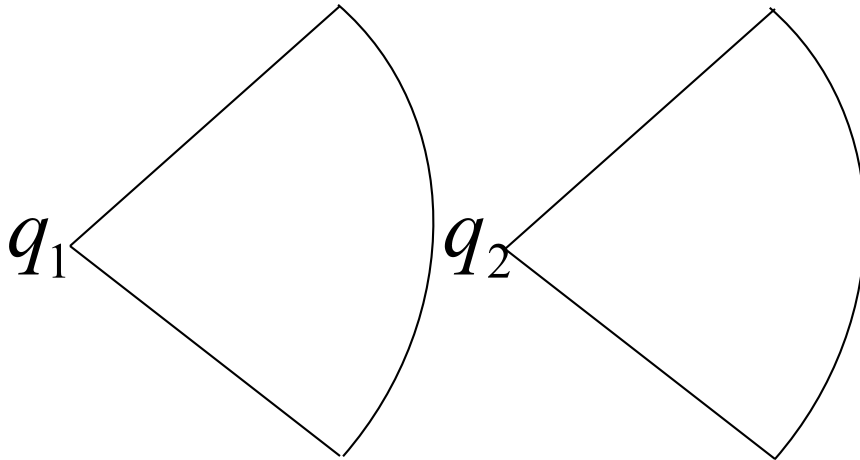
$$C_1(q_1) = 0.28 \times q_1$$

$$C_2(q_2) = 0.28 \times q_2$$

The Stackelberg model

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- Rather than assuming that producers choose quantity simultaneously, the Stackelberg model identifies a leader (who chooses quantity first), and a follower.
- The follower will observe the leader's quantity level before choosing his own quantity.



The Stackelberg model

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- The leader can predict the follower's choice, and will take it into account when making its decision.

$$\Rightarrow \pi_1 = q_1 \times (1 - 0.001 \times (q_1 + q_2)) - 0.28q_1$$

$$\Rightarrow \begin{cases} \pi_1 = 0.72q_1 - 0.001q_1^2 - 0.001q_1q_2 \\ \pi_2 = 0.72q_2 - 0.001q_2^2 - 0.001q_1q_2 \end{cases}$$

The Stackelberg model

Backward induction

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- In a sequential game, Firm 2's output will be its best response to Firm 1's output decision. Best response of Firm 2:

$$q_2 = 360 - 0.5q_1$$

- Substitute into Firm 1's profit function:

$$\begin{aligned}\pi_1 &= 0.72q_1 - 0.001q_1^2 - 0.001q_1(360 - 0.5q_1) \\ &= 0.36q_1 - 0.0005q_1^2\end{aligned}$$

The Stackelberg model

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- Derive the optimal output for Firm 1:

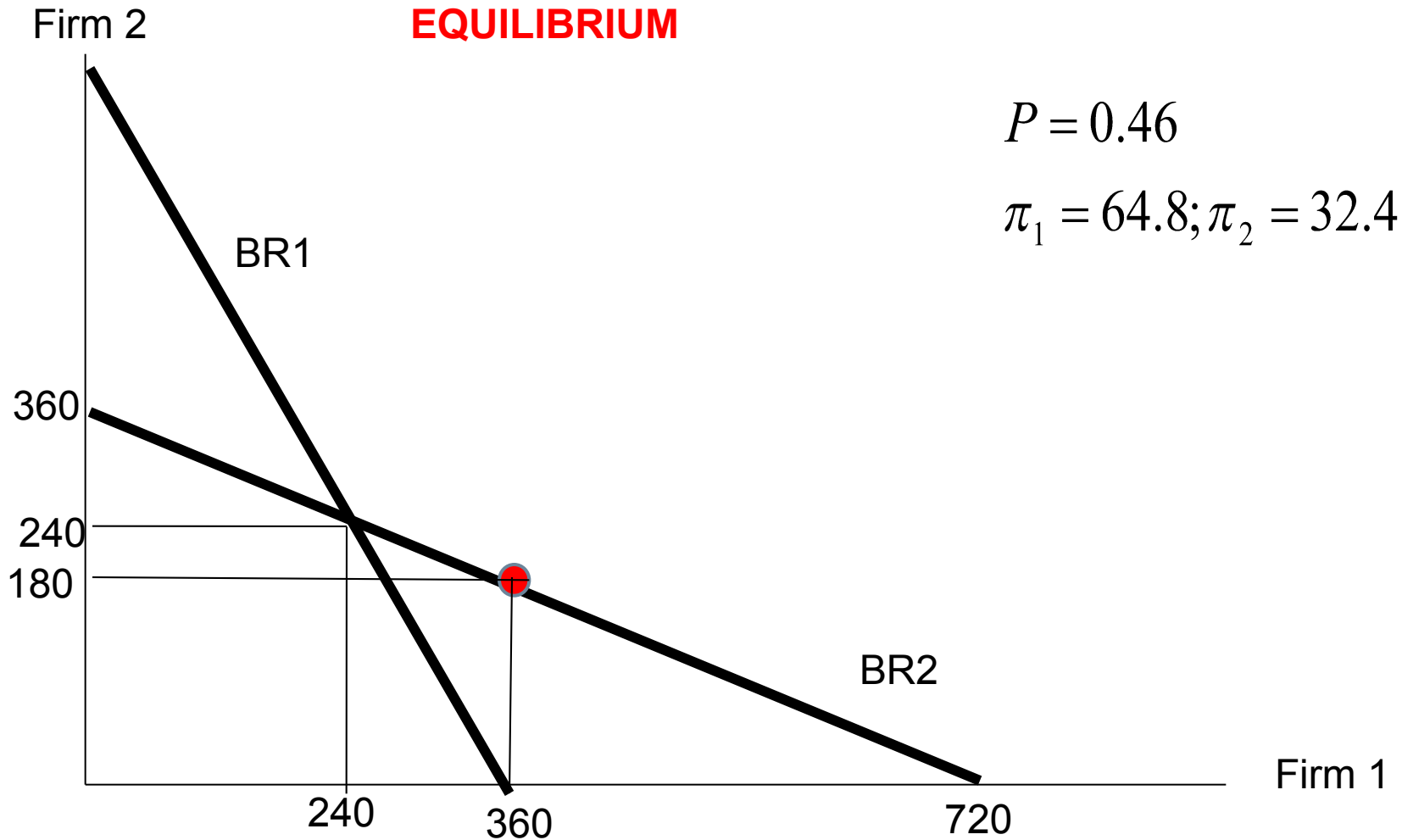
$$\frac{\partial \pi_1}{\partial q_1} = 0.36 - 0.001q_1 = 0 \Rightarrow q_1 = 360$$

- For Firm 2, substitute q_1 in the best response function:

$$q_2 = 360 - 0.5 * 360 = 180$$

The Stackelberg model

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The Stackelberg model

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- Note that the equilibrium is not on Firm 1's Cournot best response function.
 - By playing first, Firm 1 can select the point on Firm 2's best response function that maximizes its own payoff
- First-mover advantage: By committing to a high quantity, Firm 1 can force Firm 2 to produce a low quantity.
- The first-mover has the advantage because his action is irreversible. The Stackelberg leader is the player that makes an irreversible decision first.

Stackelberg vs. Cournot

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	Monopoly	Cournot	Stackelberg	Perfect competition
Industry Output	360	480	540	720
Price	0.64	0.52	0.46	0.28
Industry Profit	129.6	115.2	97.2	0

Stackelberg yields a higher total quantity than Cournot.

To exploit the first-mover advantage, the leader should produce more output than in Cournot. This results into higher total output, and a lower price.

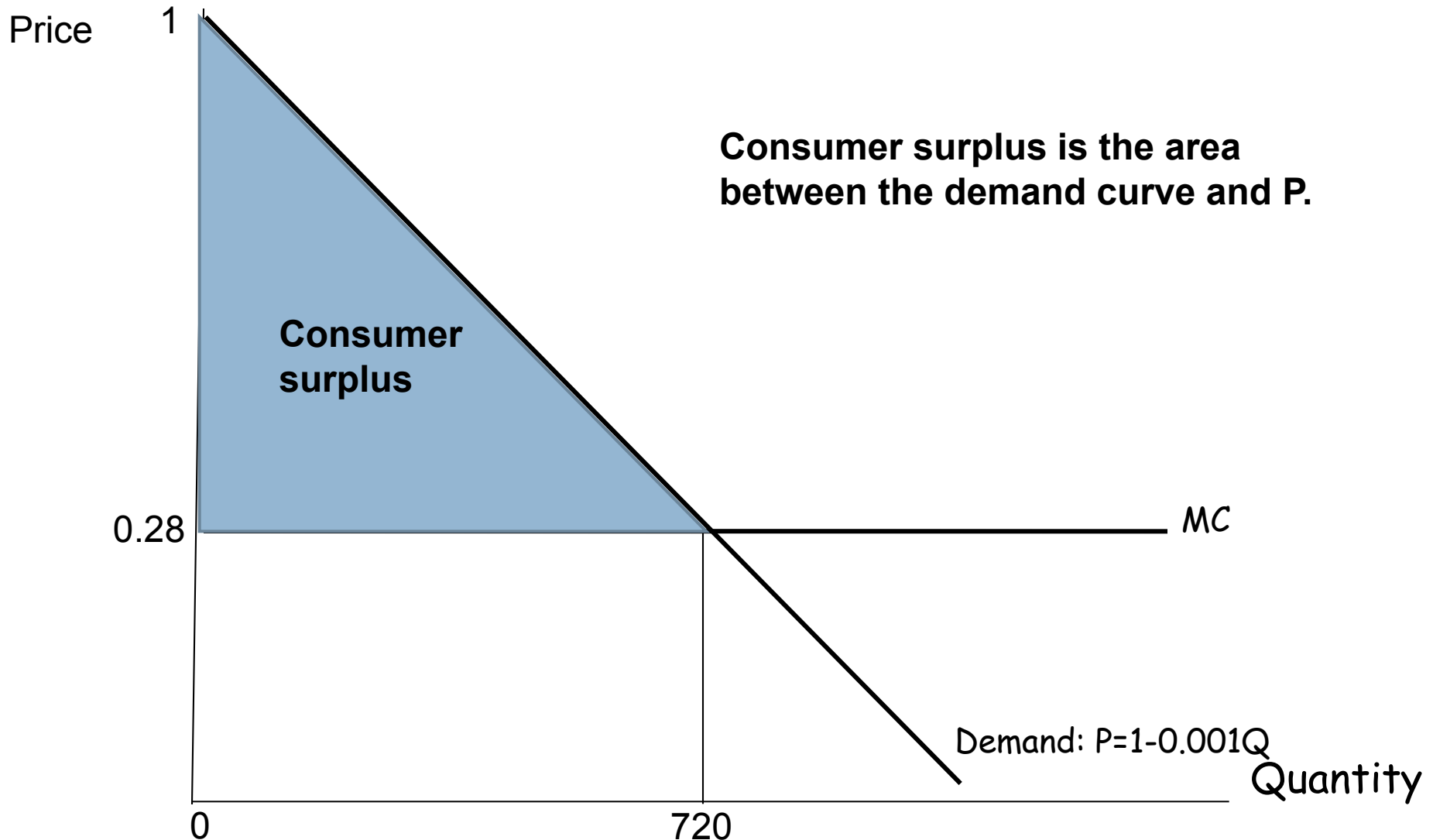
Stackelberg in the pharmaceutical industry

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- Patents for new drugs last up to 20-30 years. During the patent period, the firm that invented the drug has a monopoly and can sell the drug at a high price.
- Once the patent expires, anyone is allowed to produce generic version of drug and sell at a low price.
- Just before the patent expires, brand name pharmaceutical companies enter into the generic drug competition by marketing their brand name drug with a pseudo-generic label before the generic drug manufacturers can enter the generic market.
- This allows the pseudo-generic drug to attain most of the market share and establish itself as the market leader.

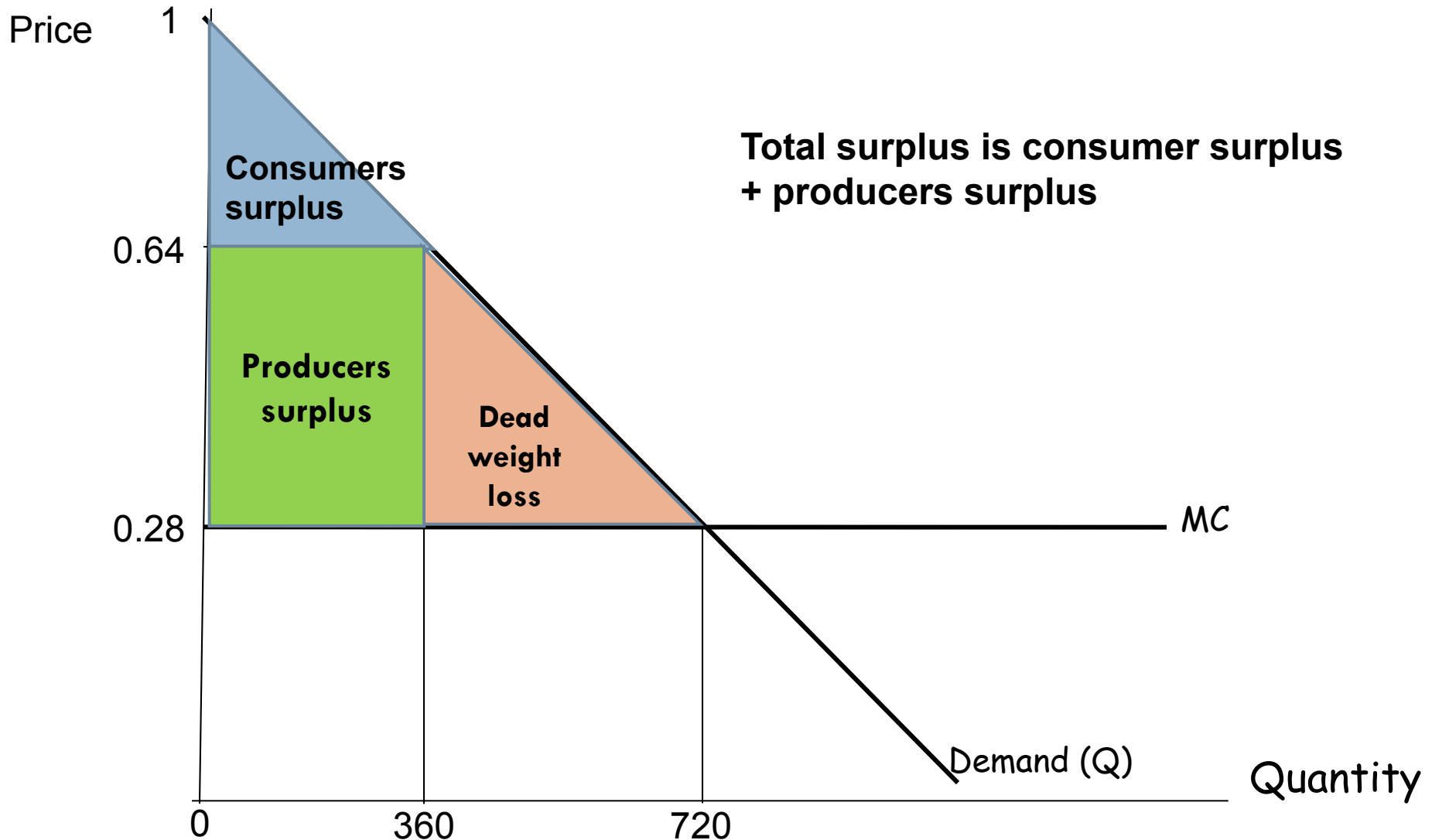
Welfare and perfect competition

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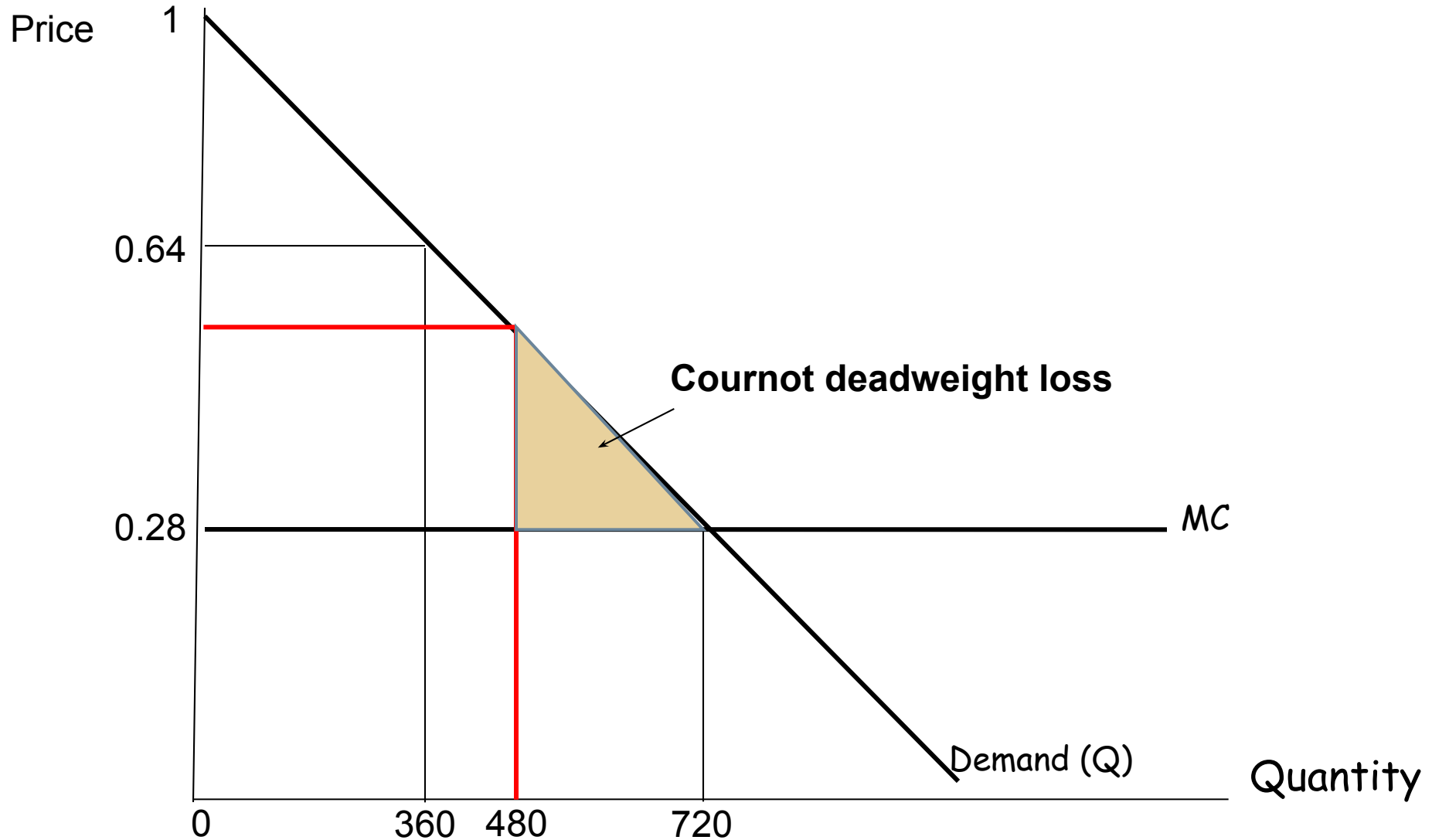
Welfare and monopoly

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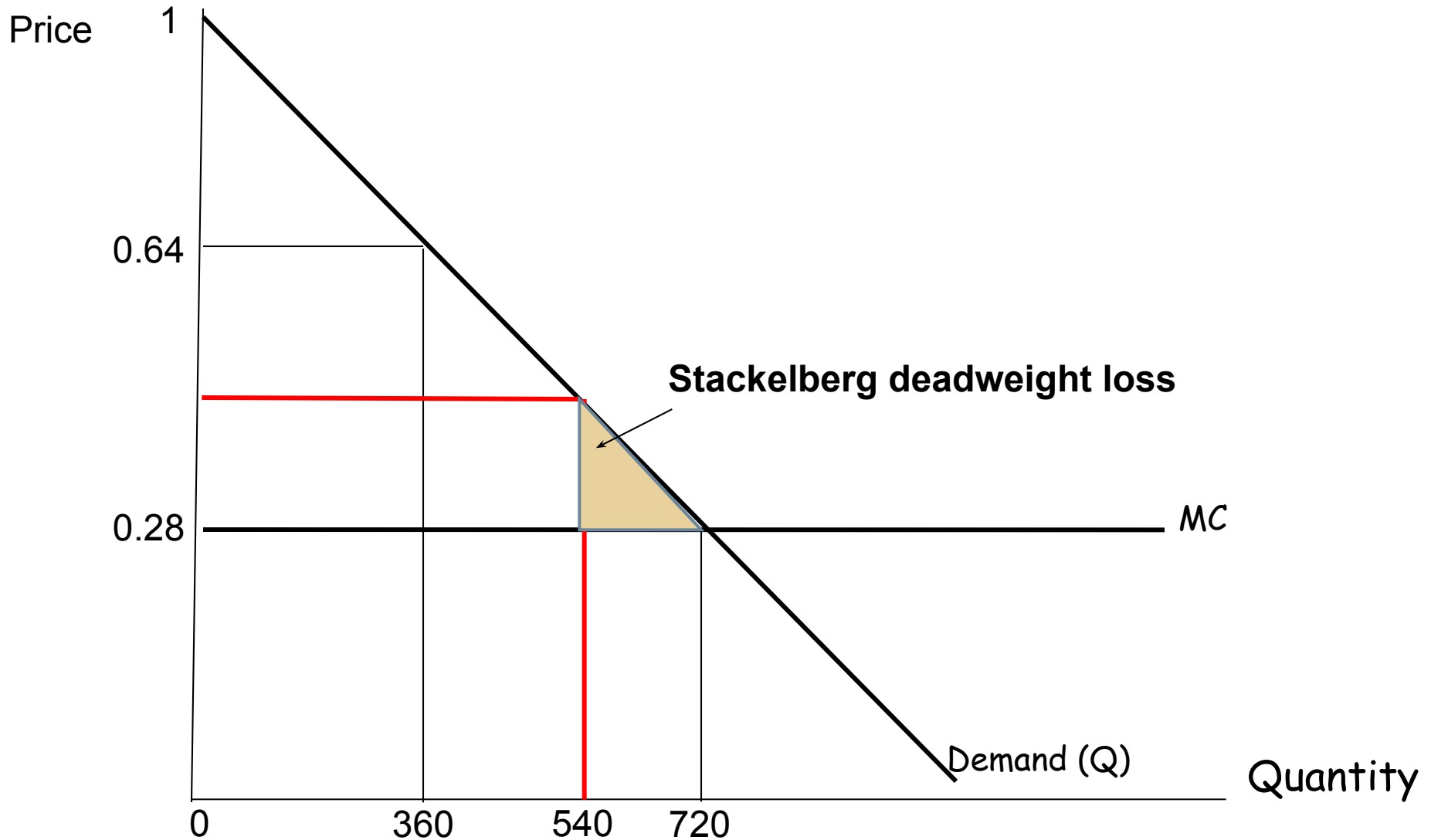
Welfare and Cournot

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Welfare and Stackelberg

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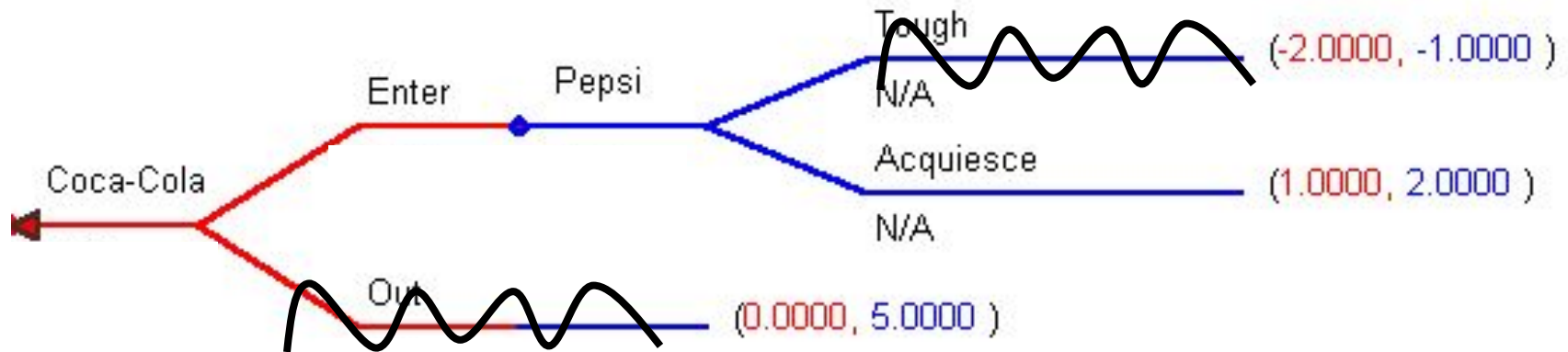
Entry game with incumbent

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- Suppose that Pepsi (the incumbent) is already in the local market, and Coca-Cola is deciding whether to **Enter** or stay **Out**.
- Pepsi: adopt a **Tough** defensive response or **Acquiesce**.
 - Tough: increase production, fight on prices, advertising campaign etc.
 - Acquiesce: no aggressive commercial war with Coca-Cola

Entry game with incumbent

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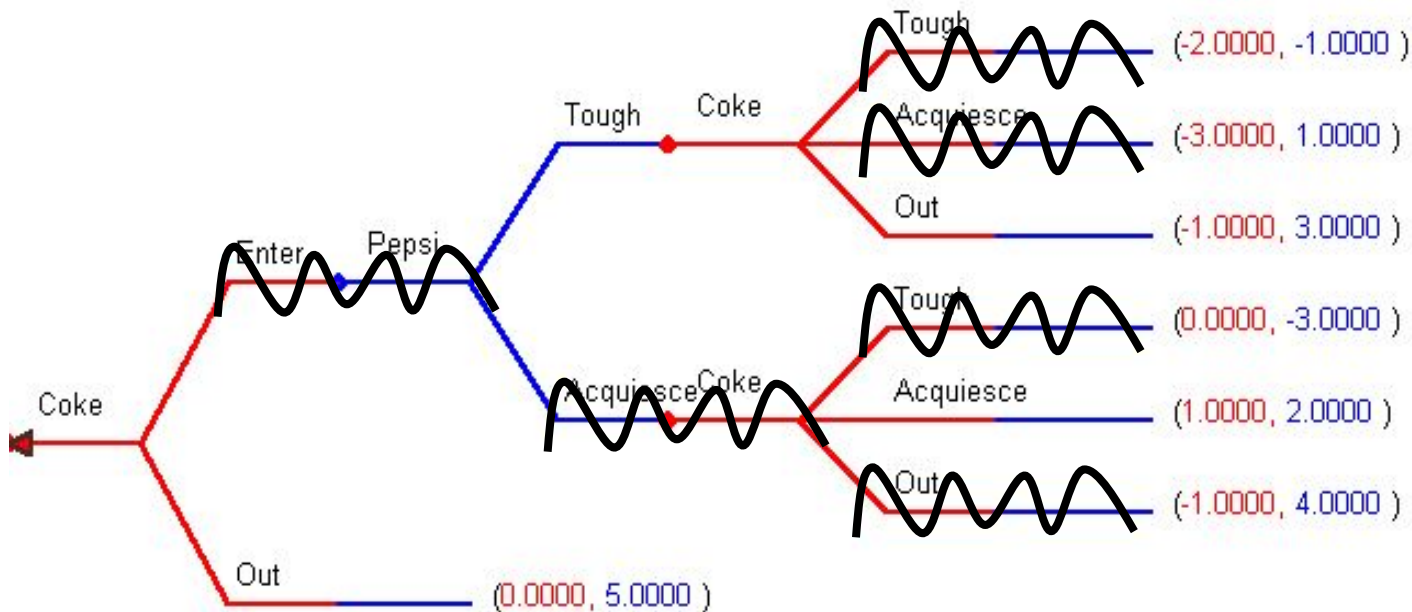


- Pepsi will choose to acquiesce.
- Since Coca-Cola knows that Pepsi will Acquiesce, its best course of action is to Enter.
- First mover advantage

Entry game with incumbent

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- Sequential games may have more than two rounds. After observing Pepsi's stance, Coca-Cola can itself choose to be Tough, Acquiesce, or go Out of the market.



Entry game with incumbent

- Coca-Cola looks at Pepsi's Tough play and should choose to go Out of the market since it then only loses $-\$1$. If Coca-Cola sees Pepsi Acquiesce then it should itself Acquiesce and earn $\$1$.
- Pepsi knows that when it plays Tough Coca-Cola will exit. Its best choice is to act Tough to force Coca-Cola to go Out.
- Coca-Cola reasons backwards: if it enters, then Pepsi will play Tough and the best response is to go Out. Hence, Coca-Cola's best play is to Stay Out since it loses 0 instead of -1 .

Strategic moves

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- Players are rational and know how the game will be played and the subsequent payoff. What can player do to alter the predicted outcome?
 - Strategic moves: Commitment/threat/promise
- Commitment: Commit to take a particular decision unconditionally on the other player's action.
- Having fewer choices is typically worse than having many choices. In sequential games, however, having fewer choices can actually increase your payoff.

Strategic moves

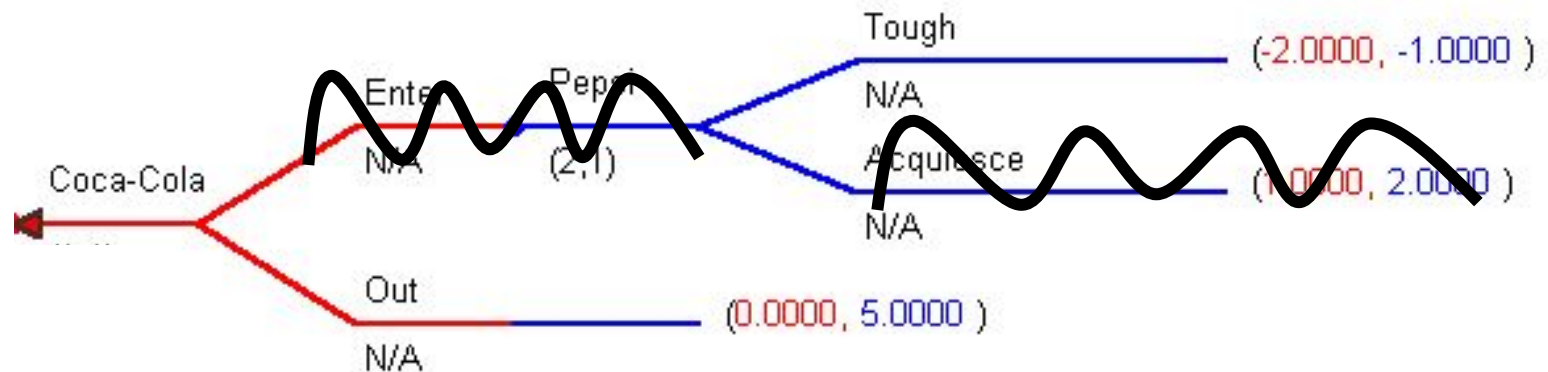
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- Threat: A response rule that leads to a bad outcome for the other player if he acts contrary to your interests.
- Promise: A response rule by which you offer to create a good outcome for the other player if he acts in a way that promotes your interests.

Threat and entry

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- Equilibrium without strategic moves: (Enter, Acquiesce)
- What could Pepsi do? Threaten to be tough if Coca-Cola enters:



- Rollback: Coca-Cola stays out!

Threat and entry: Credibility problem

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- If Coca-Cola enters, it is in Pepsi's best interest to acquiesce.
- Pepsi's threat to be tough if Coca-Cola enters is not credible.
- Coca-Cola, knowing that, will enter.
- "Talk is cheap"

Credible strategic move

How to make a credible strategic move?

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- Binding contract between Pepsi and retailers.
 - We will sell you Pepsi at a lower price than Coca-Cola does.
 - “Tough” becomes credible.
- Decide to expand capacity, in order to reduce the marginal costs of increasing quantity.
- Keep innovating, in order to commit to improve quality and deter entry.

Credible strategic move

How to make a credible strategic move?

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- Pepsi can also make threat credible by acquiring a reputation for toughness. By being tough towards potential entrants today, it may deter other firms from entering.
 - Being tough is not subgame perfect, however the entrant may think the incumbent will be tough if he has such a reputation.
 - If a threat is credible, other firms won't enter, and the threat to be tough is never materialized.

Credible strategic move

How to make a credible strategic move?

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- Polaroid instant photography
 - Refused to diversify out of its core business. With all its chips in instant photography, it was committed to fight against any intruder in the market.
 - In 1976, after 28 years of a Polaroid monopoly on the instant photography market, Kodak entered the fray.
 - Edwin Land, Polaroid founder:
“This is our very soul we are involved with. This is our whole life... We will stay in our lot and protect that lot.”

Summary

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- Sequential games
 - Game trees
 - Subgame perfect equilibrium
- Application to oligopoly
 - First mover advantage
- Strategic moves
 - Issue of credibility