Entry and Exit
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One of the key areas of strategic decision-making relates to entry and exit in competitive markets. In class we used the example of Boeing and McDonnell Douglas deciding to enter the wide-body aircraft market to show how firms must decide whether to enter the market based on predictions of how their rivals will act and how these actions will impact industry profitability. As in other situations of strategic behavior we have studied this semester, firms confronting entry and exit decisions must attempt to see this "game" through their rivals' eyes and reason backwards to decide on an optimal strategy. However, these decisions can be murky—and very risky—and mistakes are not uncommon despite well-intended strategic decisions.

Commitment

Commitment is an extremely important factor in competitive behavior. If an industry like wide-body aircraft, where frequently there is only enough room for one profitable firm and several firms consider entering, the firm that makes a credible, irrevocable commitment to entering the industry may increase its equilibrium profits by convincing rivals to stay out. Thus, we can say that commitment creates value in strategic behavior. We showed this formally in class, but intuitively we can understand why with the following example.

When Spanish conquistador Hernan Cortés arrived in the "New World" of Latin America in the 16th century, his insidious goal was challenging. With only a small army backing him, he intended to conquer and colonize a large population of unknown, potentially hostile indigenous people. Upon his arrival in Mexico, he made the seemingly insensible move of burning his entire flotilla of ships (except for one), ensuring that the local people observed this act. Why did Cortés burn his ships? After all, he was essentially destroying his escape strategy in case he was not victorious in his efforts. He was also destroying assets that could prove valuable from a military point of view. Was Cortés insane or what?

Cortés probably was crazy to some extent. (If you are ever in Mexico City go see Diego Rivera's murals in the Mexican government headquarters where he unflatteringly portrays Cortés as a hideous-looking, shriveled-up pasty-white demon.) Nevertheless, Cortés's ship-burning was not crazy: it was most probably a calculated, rational move. He was demonstrating his unwavering commitment to colonizing the New World. By burning his ships in plain view, he was saying in a matter of words "we are here to stay; and we will either conquer you or die trying to do it." This commitment was credible because he
was destroying his ability to undertake any other course of action besides staying and fighting.

To understand why commitment can be so powerful in competitive behavior, think further of a chain store like Duane Reade. Why does Duane Reade build pharmacies just two blocks away from each other in Manhattan? Perhaps they estimate that the market has enough capacity to generate sufficient demand for two Duane Reades per quarter mile. But suppose that Duane Reade knows that it will not capture enough demand to make these two stores very profitable. Why on earth would they intentionally build excess capacity? One important reason is demonstrating a credible commitment. By building stores everywhere, Duane Reade is signaling-in an observable and irrevocable way-that it intends to dominate the market. This signals to competitors, and especially mom-and-pop operations, that it is a force to be reckoned with. By building up its presence, it is committing to weather the market and remain standing. If other firms correctly perceive this commitment they may decide to exit the market (or not enter). Thus, in the long run, Duane Reade's commitment will create extra value via its competitive impacts.

Note that commitments must be credible in order to work. If Duane Reade decided to signal its commitment by staging a press conference and saying "we intend to be #1", this would not have much competitive cache. After all, we know that talk is cheap. Any firm can make a public statement of its intentions, but only by acting on these commitments in an observable and credible way can firms ensure their commitment has an enduring effect.

**Preemption**

The Duane Reade example also highlights a related strategic dimension of entry and exit, that of preemption. (We explored preemption briefly in last week's lecture notes with our example of the extensive cereal aisle.) Firms can create barriers to entry by increasing their product line in the hopes that they will capture demand that otherwise could be appropriated by a potential entrant. We can say more formally that a preemption strategy by a firm is one that makes entry by one more firm unprofitable. This is different from a straight monopoly strategy because, like we saw with Duane Reade, it may intentionally sacrifice profitability in exchange for controlling the market.

**Predation**

If you can keep'em out, drive'em out. Perhaps a more devious (and usually illegal) strategy to prevent entry by competitors is that of predation. Predatory pricing has a long and infamous history in the United States, ranging from Standard Oil to railroad companies to AT&T's longstanding clench of the telephony market. Predation occurs when a firm prices its products below cost-thus pricing so low that it forces other firms out of the market or prevents their entry. You may wonder why a firm would ever wish
to price below cost and lose money. In a static world, this would make no sense—but in a
competitive landscape, predatory pricing can be an effective deterrent.

Much economic inquiry occurred on predation. At one extreme there is the so-called
Chicago school. According to the Chicago school, predatory strategies cannot be
profitable; if a firm prices low, then this must be considered a competitive, not anti-
competitive, strategy. There are however several explanations of why below cost might
be a successful predatory strategy:

- **Asymmetric information.** If firms know more about their costs than do the public and
rival firms, they are able to exploit this fact by pricing low to convince rivals they are
very efficient and not worth competing against.

- **Reputation-building.** We have talked about how it can be rational to establish a
reputation for irrationality. If firms signal that they are willing to act irrationally from
an economic standpoint to dominate a market (after all, pricing below cost is not a
rational economic decision, at least not in the short run) they may create a reputation
that scares firms off from competing with it.

- **Learning curves and network effects.** We explored earlier in the semester how firms
can reduce cost as output rises through learning effects and other means. Anticipating
these effects, firms may price below cost in the present to stave off rival entry. Once
they attain their cost reductions later they can return to profitability—especially if they
have driven rivals out of the market.

- **Deep Pockets.** If a firm has more cash than its rivals, pricing below cost leads to a
war of attrition where the winner is the firm with deeper pockets. Although we list
this in the fourth place, this is likely the most common reason why predatory pricing
works.

The above discussion notwithstanding, we should add that predation is not always so
clear-cut. (Look at the testimony of the Microsoft trial if you need convincing!) Moreover, it is important to note that pricing below cost is not the only way for a firm to
behave in a predatory fashion. Firms can also enlist predatory strategies such as
capturing demand through product design (i.e. MS Windows) and through striking
exclusive contracts with other members of the value chain that put them at an advantage
with respect to the competition. In the case of John Rockefeller's nefarious Standard Oil
monopoly, that firm struck secret agreements with railroad companies to ship its barrels
of crude at a price way below that of other firms. Why did the railroads agree to this?
Standard Oil was such a large client that its business was crucial to the railroads, and thus
the firm had a great deal of bargaining power. Of course this practice occurred at the
expense of other firms and consumers, and as Standard Oil came to control over 90% of
the exploding petroleum market it was vanquished by seminal antitrust action.

Why is predation illegal and "bad" for consumers if it leads to lower prices? Recall our
earlier discussions of monopoly firms. Once predatory firms drive other firms out of the
market, they can increase prices and act without regard to competitive dynamics that
ensure competition and choice among consumers. In addition, while firms may price below cost in certain competitive arenas, they may actually raise prices in other markets or products to offset these losses. This is called cross-subsidization, and was mastered by AT&T as it sought to keep other telephone networks from developing in certain parts of the U.S. at the expense of captive customers in other regions.

Is Aggression Good?

A final point about entry, exit, and aggressive behavior among firms is to understand that the practices discussed above may not always be beneficial. Sometimes, a less aggressive approach can be more viable if it ensures that future retaliation from competitors will be reduced. Firms must weigh whether it is wiser to pursue a so-called top dog strategy; that is, committing to acting tough (through preemption, predation, etc.) in the hope that it will force other firms to act less aggressively (or to exit). On the other hand, a "softer" strategy that may be wiser in the long run is known as judo economics.

The intuition behind judo economics is as follows: if a firm tries to act as a "top dog" it may escalate the competitive response of rivals who will in turn act aggressively, destroying value in the long run. Thus, judo economics suggests that firms which tread softer may enjoy a more stable, less destructive competitive landscape over time. And beyond encouraging competitive backlash, firms that try to act as top dogs also must be aware that their actions may very well attract the ill-will of regulators and consumers.

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