

## CONCEPT: KINKED DEMAND THEORY FOR OLIGOPOLIES

- The demand curve for oligopolies are not the same across industries because of two main reasons:
  - *Diversity of oligopolies* – the number of firms in an oligopoly affect the demand curve
  - *Interdependence* – the decisions of one firm affect the decisions of other firms in the oligopoly
    - > Firms cannot easily predict rival reactions with certainty, so they cannot estimate demand easily
    - > Profit maximizing price and output is not easily gauged
- The **kinked-demand theory** combines the two possible reactions of rival firms when a firm cuts prices

McDonny's, Burger Queen, and Windy's are rival firms producing Black Bean Burgers in an oligopolistic environment. If McDonny's changes their prices, there are two ways its competitors could react:

*Rivals Match Price Changes* → \_\_\_\_\_ Demand Curve

Price decrease → no advantage gained, Q slight increase

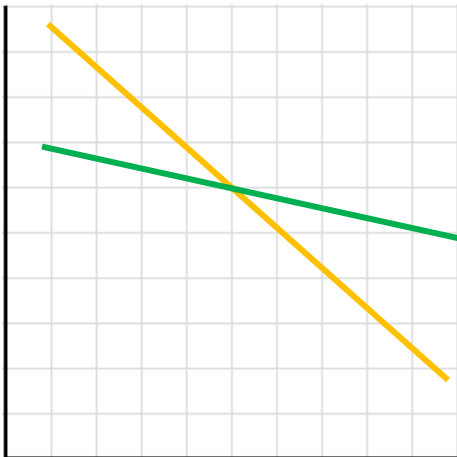
Price increase → only lose sales to other industries

*Rivals Ignore Price Changes* → \_\_\_\_\_ Demand Curve

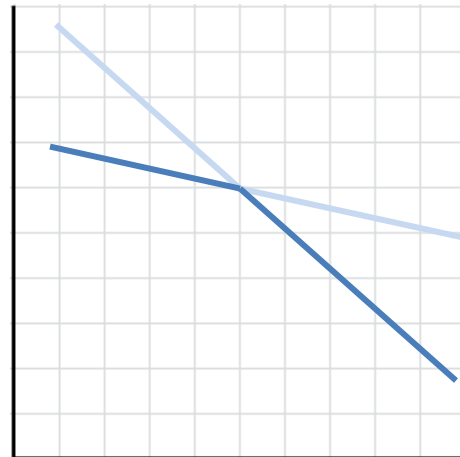
Price decrease → Gain advantage, Q large increase

Price increase → Lose sales to Burger Queen & Windy's

Demand Curves Based on Rival Decisions



Kinked-Demand Theory



- Conclusions related to this model:

- *Shifts in Marginal Cost* – a shift in MC between the two MR segments will \_\_\_\_\_ Price and Quantity
- *Price Inflexibility* – prices are generally stable in oligopolies due to the demand and cost side effects of the kink
  - > Changing prices causes the worst case scenario for demand due to rival reactions
  - > Even if costs change dramatically, the firm may have no reason to change its prices