Economics 101A
(Lecture 22)

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Outline

1. Dynamic Games
2. Oligopoly: Stackelberg
3. General Equilibrium: Introduction
4. Edgeworth Box: Pure Exchange

1 Dynamic Games

- Nicholson, Ch. 8, pp. 255-266 (*better* than Ch. 15, pp. 449–454, 9th)

- Dynamic games: one player plays after the other

- Decision trees
  - Decision nodes
  - Strategy is a plan of action at each decision node

- Example: battle of the sexes game

She \ He	Ballet	Football
Ballet	$2, 1$	$0, 0$
Football	$0, 0$	$1, 2$

- Dynamic version: she plays first

- **Subgame-perfect equilibrium.** At each node of the tree, the player chooses the strategy with the highest payoff, given the other players' strategy

- Backward induction. Find optimal action in last period and then work backward

- Solution

- Example 2: Entry Game

$1 \setminus 2$	Enter	Do not Enter
Enter	$-1,-1$	$10,0$
Do not Enter	$0,5$	$0,0$

- Exercise. Dynamic version.

- Coordination games solved if one player plays first

- Can use this to study finitely repeated games

- Suppose we play the prisoner's dilemma game ten times.

$1 \setminus 2$	D	ND
D	$-4, -4$	$-1, -5$
ND	$-5, -1$	$-2, -2$

- What is the subgame perfect equilibrium?

- The result differs if infinite repetition with a probability of terminating

- Can have cooperation

- Strategy of repeated game:
  - Cooperate (ND) as long as opponent always cooperate
  - Defect (D) forever after first defection

- Theory of repeated games: Econ. 104

2 Oligopoly: Stackelberg

- Nicholson, Ch. 15, pp. 543-545 (*better than* Ch. 14, pp. 423-424, 9th)

- Setting as in problem set

- 2 Firms

- Cost: $c(y) = cy$, with $c > 0$

- Demand: $p(Y) = a - bY$, with $a > c > 0$ and $b > 0$

- Difference: Firm 1 makes the quantity decision first

- Use subgame perfect equilibrium

- Solution:

- Solve first for Firm 2 decision as function of Firm 1 decision:

$$\max_{y_2} (a - by_2 - by_1^*)\, y_2 - cy_2$$

- F.o.c.: $a - 2by_2^* - by_1^* - c = 0$

- Firm 2 best response function:

$$y_2^* = \frac{a-c}{2b} - \frac{y_1^*}{2}.$$

- Firm 1 takes this response into account in the maximization:

$$\max_{y_1} \left(a - by_1 - by_2^*\left(y_1\right)\right) y_1 - cy_1$$

or

$$\max_{y_1} \left(a - by_1 - b\left(\frac{a-c}{2b} - \frac{y_1}{2}\right)\right) y_1 - cy_1$$

- F.o.c.:

$$a - 2by_1 - \frac{(a-c)}{2} + by_1 - c = 0$$

or

$$y_1^* = \frac{a-c}{2b}$$

and

$$y_2^* = \frac{a-c}{2b} - \frac{y_1^*}{2} = \frac{a-c}{2b} - \frac{a-c}{4b} = \frac{a-c}{4b}.$$

- Total production:

$$Y_D^* = y_1^* + y_2^* = 3\frac{a-c}{4b}$$

- Price equals

$$p^* = a - b\left(\frac{3}{4}\frac{a-c}{b}\right) = \frac{1}{4}a + \frac{3}{4}c$$

- Compare to monopoly:

$$y_M^* = \frac{a-c}{2b}$$

and

$$p_M^* = \frac{a+c}{2}.$$

- Compare to Cournot:

$$Y_D^* = y_1^* + y_2^* = 2\frac{a-c}{3b}$$

and

$$p_D^* = \frac{1}{3}a + \frac{2}{3}c.$$

- Compare with Cournot outcome

- Firm 2 best response function:

$$y_2^* = \frac{a-c}{2b} - \frac{y_1^*}{2}$$

- Firm 1 best response function:

$$y_1^* = \frac{a-c}{2b} - \frac{y_2^*}{2}$$

- Intersection gives Cournot

- Stackelberg: Equilibrium is point on Best Response of Firm 2 that maximizes profits of Firm 1

- Plot iso-profit curve of Firm 1:

$$\bar{\Pi}_1 = (a-c)\, y_1 - b y_1 y_2 - b y_1^2$$

- Solve for y_2 along iso-profit:

$$y_2 = \frac{a-c}{b} - y_1 - \frac{\bar{\Pi}_1}{b y_1}$$

- Iso-profit curve is flat for

$$\frac{dy_2}{dy_1} = -1 + \frac{\bar{\Pi}}{b\,(y_1)^2} = 0$$

or

$$y_1 =$$

Figure

3 General Equilibrium: Introduction

- So far, we looked at consumers
  - Demand for goods
  - Choice of leisure and work
  - Choice of risky activities

- We also looked at producers:
  - Production in perfectly competitive firm
  - Production in monopoly
  - Production in oligopoly

- We also combined consumers and producers:
  - Supply
  - Demand
  - Market equilibrium
- Partial equilibrium: one good at a time
- General equilibrium: Demand and supply for all goods!
  - supply of young worker$\uparrow \Longrightarrow$ wage of experienced workers?
  - minimum wage$\uparrow \Longrightarrow$ effect on higher earners?
  - steel tariff$\uparrow \Longrightarrow$ effect on car price

4 Edgeworth Box: Pure Exchange

- Nicholson, Ch. 13, pp. 441-444, 476-478 (Ch. 12, pp. 335–338, 369–370, 9th)

- 2 consumers in economy: $i = 1, 2$

- 2 goods, x_1, x_2

- Endowment of consumer i, good j: ω_j^i

- Total endowment: $(\omega_1, \omega_2) = (\omega_1^1 + \omega_1^2, \omega_2^1 + \omega_2^2)$

- No production here. With production (as in book), (ω_1, ω_2) are optimally produced

- Edgeworth box

- Draw preferences of agent 1

- Draw preferences of agent 2

- Consumption of consumer i, good j: x_j^i

- Feasible consumption:

$$x_i^1 + x_i^2 \leq \omega_i \text{ for all } i$$

- If preferences monotonic, $x_i^1 + x_i^2 = \omega_i$ for all i

- Can map consumption levels into box

5 Next lecture

- General Equilibrium
- Barter
- Lecture on Economics of the Media with Nancy Tellem