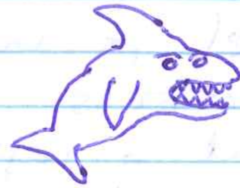
UNDERSTANDING PREDATORY PRICING

Predatory pricing is the practice of grossly undercutting your price so as to drive away competition. In theory it works like this:



MR. PREDATOR
(Big Firm)

PREY
(Little Firm)

MR. PREDATOR has a market monopoly, where no other person can sell. This allows him to charge the monopoly price and exact rents.

PREY, seeing MR. PREDATOR's bounty, try to enter his market to gain profits.

However, MR. PREDATOR reacts by driving his price down below variable cost, now PREY can't make money, so he leaves (allowing MR. PREDATOR to increase prices again.

Hilroy

Neoclassical economists found this problematic because MR. PREDATOR cannot exclude rivals permanently since he hurts himself too much (PREY knows he's bluffing).

One workaround model is in the case of multiple markets. If MR. PREDATOR can build a reputation for predatory pricing, he can enact his threat in one market to scare away entrants in others.