



ADDITIONAL TOPICS CHAPTER 10

Experimental tests of the model of monopoly

How well does the model of monopoly work? Market experiments help provide an answer. In experiments where a single seller, the monopoly, sets a price that *stays constant for the whole trading period*, with all buyers free to buy at that price during the trading period, the model of monopoly predicts the outcome accurately. After a few trading periods, during which the monopoly searches for the profit-maximising price, the number of items sold and the price settle down to exactly what is predicted by the model of monopoly.

A surprising result occurs, however, when the single seller is allowed to call out different bids within the trading period. In these types of experiments, after several trading periods, the price tends to settle down near the competitive price rather than near the monopoly price. The reason

is instructive. The single seller tries to charge different prices to different buyers, but ends up being able to charge only the competitive price! The monopoly figures that some buyers are willing to pay high prices. The monopoly thus asks high prices and sells some goods at these high prices. The monopoly then begins to lower the price to get the buyers who are only willing to pay less for the good. Working down the market demand curve, the monopoly sells the good to the last buyer at close to the competitive price.

The problem with this strategy is that when the trading period is repeated several times, the buyers learn that the monopoly will eventually lower the price, and they therefore refuse to buy at the higher prices. The monopoly ends up losing most of its market power, able to charge only near the competitive price.