

Indeterminacy of free entry equilibria: general approach and macroeconomic applications

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Abstract

Free entry equilibria are usually determined by resorting to the zero profit condition. We plead instead for a strict application of the Nash equilibrium concept to a symmetric one-stage game played by actual and potential producers, who have a decreasing average cost function without sunk costs. Equilibrium then appears as typically indeterminate, with a number of active firms varying between an upper bound imposed by profitability and a lower bound required by sustainability. This indeterminacy may have significant macroeconomic implications, since it opens the way to coordination failures and to the emergence of endogenous fluctuations generated by the coordination process. The paper presents a general framework for the analysis of free entry equilibria, applies this framework to the standard regimes of price and quantity competition used in macroeconomic modelling, and illustrates dynamic aggregate implications in a simple macroeconomic model.

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1 Introduction

Free entry is commonly associated with zero profits. Under free entry and exit, positive profits are supposed to stimulate creation of new firms and negative profits to induce destruction of existent firms. A free entry equilibrium may thus be seen as a stationary state, characterized by the zero profit condition, of a dynamic process of net business formation. This view is implicit in the concept of long run perfectly competitive equilibrium, and is naturally extensive to monopolistic competition, where the relevant scales of individual firms also appear as negligible with respect to market size. As long as profits remain positive, any entrant is then able to reproduce in an unreactive environment the operating conditions and the proceeds of a high number of successful incumbents.

This line of argument ceases to hold, however, when a potential entrant has to compete with a few incumbents only, all producing under *internal* economies of scale. In this context, a simple replication of the incumbents' performance cannot guarantee identical success to the entrant, whose environment may be seriously perturbed by that replication. Entry must now be examined as a *strategic* decision, generally in a complex context, where timing and information considerations are at stake. Faced with this difficulty, a common attitude is to take the zero profit condition as an acceptable approximation, in particular in macroeconomic – or, more widely, general equilibrium – modelling, and to leave more sophisticated approaches, resorting to sequential games with incomplete information, to industrial organization theory. This was already the position adopted in one of the first macroeconomic papers emphasizing the role of increasing returns and imperfect competition, and treating the number of producers as endogenous: “The story [behind the solution concept based on the zero profit condition] can only be defended as an approximation. Entry and exit are complicated phenomena, involving difficult game theoretic issues that defy neat analytic formulation” (Weitzman, 1982, p.797). So, we seem to be trapped in a dilemma: either to force a solution concept devised for non-strategic forms of competition into the domain of oligopoly, or to resort to industrial organization tools that may prove too complex and also too specific for an accurate macroeconomic or general equilibrium use. The point we want to make in this paper is that we are by no means doomed to that dilemma. A straightforward application of the concept of Nash equilibrium to *static* symmetric games reproducing standard regimes of oligopolistic competition offers in fact a simple way out.

We owe to Shubik (1959, 1984) the idea that entry can be modelled as a *simultaneous* game between actual and potential entrants, depicted as “firms-in-being”. At an equilibrium of such a game, along with *active* profit maximizing firms, there may well be *inactive* firms that optimally decide not to produce, on the basis of correct conjectures about the actions of the former. This asymmetry might be the consequence of some advantage of incumbents over potential entrants, creating a barrier to entry. But it can also prevail in a completely symmetric game where all players are *a priori* indistinguishable. *Ex ante* symmetry is in fact required for an accurate representation of a *perfectly contestable mar-*

ket, characterized by costless entry and exit and no disadvantage for potential entrants relative to incumbents (Baumol, Panzar and Willig, 1982).

For a market to be perfectly contestable any observable profile of incumbents' strategies must be *sustainable*, that is, no potential entrant may be able to make a profit by becoming active. This requirement might suggest that, as in the dynamic story of business formation, equilibrium profits are necessarily close to zero as soon as entry is free, or the market perfectly contestable. And this is indeed true if incumbents' capacity to earn positive profits extends to any potential entrant, always in a position to attract enough customers, either by simply imitating incumbents' behavior when firms are small relative to the market, or by slightly undercutting incumbents' prices when competition takes place in the undifferentiated Bertrand oligopoly. An example of the former alternative is competition within the Chamberlinian "large group", where an individual price decision has no sensible repercussions on the industry price level, as in Dixit and Stiglitz (1977). Another example is Cournot competition in an undifferentiated industry, provided the optimal scale of each firm is small with respect to market size, so that the Cournot equilibrium outcome approximates the long run perfectly competitive outcome, characterized by efficiency and zero profits, as in Novshek (1980). In a recent paper, Yano (2006) offers an example of the latter alternative. He uses the same type of free entry equilibrium concept as Novshek – *i.e.* a Nash equilibrium of a single stage game played in a perfectly contestable market – but, by assuming Bertrand-like competition in an undifferentiated oligopoly,¹ he obtains the long run perfectly competitive outcome without assuming a small firm to market ratio. Also, he thus provides a solid game theoretic foundation to the theory of contestable markets.

These examples suggest that sustainability is not independent of the regime of competition. Instead of the "price sustainability" appearing in the original definition of Baumol, Panzar and Willig (1982), which implicitly refers to Bertrand competition, we may think of a "quantity sustainability" referring to Cournot competition, with different implications (Brock and Scheinkman, 1983; Brock, 1983). But preferably, rather than simply opposing price and quantity sustainability, we may completely divorce the concept of sustainability from the specific regime of competition to which it applies (d'Aspremont, Dos Santos Ferreira and Gérard-Varet, 2000). Indeed, along with Cournot competition, price competition within a "small group" producing differentiated goods is another situation where the zero profit condition is not implied by sustainability, and where multiple free entry equilibria may exist in addition to the one at break-even prices. In such equilibria, the strategies of active firms entail positive profits and are nevertheless sustainable because potential entrants, taking those strategies as given, realize that, whatever they do, demand will be insufficient for

¹As a matter of fact, in the game designed by Yano (2006), firms choose simultaneously a price and a set of quantities that are equivalent from the point of view of the profits they generate. Together with free entry, this device allows him to extend Bertrand equilibrium to the case where the average cost function is not constant, without incurring the inexistence problem pointed out by Edgeworth. Yano (2005) extends this analysis to encompass strategic technological choices.

attaining the scale at which production becomes profitable. Also, under these circumstances there is no sensible reason for the incumbents to accommodate entry.

The objective of the present paper is to provide a unified conceptual and analytical framework for the study of free entry equilibria, covering different regimes of oligopolistic competition and different specifications of internal increasing returns. Our starting point is the same as in d’Aspremont, Dos Santos Ferreira and Gérard-Varet (2000): we take as the relevant concept of free entry equilibrium the standard Nash solution of a simultaneous symmetric non-cooperative game, such that active and inactive firms coexist. Sustainability is then just the optimizing condition that applies to inactive firms, given their correct conjectures about the decisions of active firms. In this paper, we go however a step further in the way of unification: we build a canonical model, where firms strategies are always *represented* by prices, but which covers different regimes of *both price and quantity competition*. One advantage of this comprehensive representation is that free entry equilibria can then be generally characterized by the interval between the *break-even* and the *limit* prices, to which the *critical* price maximizing the incumbent profit should belong. This interval induces a range of numbers of active firms which are compatible with a free entry equilibrium – a type of indeterminacy appearing as a robust property of oligopolistic competition in contestable markets.

Our paper is organized as follows. We present our conceptual framework in section 2, by (i) defining the concept of free entry equilibrium, (ii) introducing the canonical model where strategies are represented by prices, and (iii) establishing equilibrium conditions on incumbents’ prices under general specifications of cost and demand functions. These conditions are then applied in section 3 to standard regimes of quantity and price competition in homogeneous and differentiated markets, respectively, and the corresponding outcomes are compared. Section 4 explores some potential macroeconomic implications raised by the multiplicity of free entry equilibria. We conclude in section 5.

2 Oligopolistic competition with free entry

The analysis carried out in this section comprises three steps. In subsection 2.1, we introduce a fairly general, although simple, game theoretic framework applying to perfectly contestable oligopolistic markets, and exploiting symmetry of strategy profiles (in the spirit of Cooper and John, 1988). In this context, we use in a standard way the equilibrium solution of a simultaneous and symmetric game to define the concept of free entry equilibrium, under the additional requirement that some firms optimally decide to remain inactive. Two conditions characterize this equilibrium: *profitability* and *sustainability*. In subsection 2.2, we propose a *canonical model* covering different regimes of competition in which incumbents’ strategies are always *represented* by prices, even when quantities, or locations in some characteristics space, are involved (as in Cournotian or spatial competition, respectively). We further formulate general assumptions

on the cost and demand functions. In subsection 2.3, we translate the two conditions characterizing a free entry equilibrium into the requirement that the common price chosen by the incumbents be a *critical* point of their profit function above the *break-even* price (for profitability) and below the *limit* price (for sustainability). These bounds on incumbents' prices translate in turn into a non-degenerate admissible interval to which the number of active firms should belong.

2.1 The concept of free entry equilibrium

Free entry means absence of any entry barrier accounting for some advantage of incumbents over potential entrants. Under free entry all firms, whether established or not, are supposed to benefit from full equality of opportunities. But this does not imply that they are assured of equality of results. In game theoretic terms, firms are assumed to play a *symmetric game* (equality of opportunities), the equilibria of which need however not be symmetric (possible inequality of results). Equilibria may in any case display a primary kind of asymmetry – the one which concerns us here – involving the distinction between active and inactive firms. A *free entry equilibrium* is just a Nash equilibrium of the symmetric game, such that some firms are active and some inactive. In other words, there is at least a potential entrant optimally deciding not to enter actually.

This free entry equilibrium is usually viewed as a sub-game perfect equilibrium of a two-stage game, with firms deciding at the first stage either to enter or not, and then with entrants competing at the second stage according to some specified regime (typically, quantity or price competition). The first stage entry decision, possibly implying the same sunk cost for any entrant, does however not give the right to an *equal treatment* at the second stage, as implicitly assumed. Under internal increasing returns, there may be active and inactive entrants at a second stage equilibrium. Consequently, we may as well resort to a simultaneous game, and take entry/exit decisions as implicit in quantity and/or price decisions (Novshek, 1980; d'Aspremont *et al.*, 2000; Corchón and Fradera, 2002; Yano, 2005, 2006).

To be explicit, consider a symmetric simultaneous game played by N competing oligopolistic firms, each one with the same strategy space $\mathbb{S}$ and the same payoff function $\Pi : \mathbb{S}^N \rightarrow \mathbb{R}$. A firm is *inactive* if it chooses an element of the subset $\mathbb{S}_0$ of strategies that lead to zero output, and it is *active* if it chooses a strategy in the complementary subset. The nature of the subset $\mathbb{S}_0$ results from the particular specification of the model, $\mathbb{S}_0$ being for instance equal to $\{0\}$ in quantity competition games, or to the set of prices higher than any customer's reservation price in price competition games. We admit that the payoff function is constant with respect to any of its arguments over $\mathbb{S}_0$, if this set has more than one element. Now consider strategy profiles $\mathbf{s} \in \mathbb{S}^N$ that are symmetric within the class of n active firms ($0 < n < N$),² all choosing $s_n \in \mathbb{S} \setminus \mathbb{S}_0$ while

²We admit that $n > 0$ in order to eliminate trivial equilibria, and that $n < N$ to put aside the case where entry is impossible for lack of further participants.

$N - n$ inactive firms indifferently choose some element of $\mathbb{S}_0$. It is clear that the relevant information in $\mathbf{s}$ is completely contained in the pair (s_n, n) . Similarly, as the vector $\mathbf{s}_{-i} \in \mathbb{S}^{N-1}$ of strategies of the $N - 1$ competitors of any firm i has $n - \delta$ elements equal to s_n (with $\delta = 1$ if firm i is active and $\delta = 0$ if it is inactive) and $N - 1 - (n - \delta)$ elements belonging to $\mathbb{S}_0$, it can be fully characterized by the triplet (s_n, n, δ) . The profit $\Pi(s_i, \mathbf{s}_{-i})$ of any firm i , choosing strategy $s_i = s$ and facing a profile $\mathbf{s}_{-i}$ of its competitors' strategies with such characterization, can then be denoted accordingly by $\Pi(s, s_n, n, \delta)$.

If we apply the Nash equilibrium concept to this framework, for a pair (s_n, n) to characterize an equilibrium, the profit $\Pi(s, s_n, n, 1)$ of an active firm must reach a maximum at $s = s_n$, and the profit $\Pi(s, s_n, n, 0)$ of an inactive firm must reach a maximum at any $s_0 \in \mathbb{S}_0$. Furthermore, if we take free entry as comprehending free exit, so that sunk costs are excluded,³ inactivity always results in zero profits, so that any equilibrium (s_n, n) must verify $\Pi(s_n, s_n, n, 1) \geq 0$ and $\Pi(s_0, s_n, n, 0) = 0$.

In the usual approach,⁴ if n is the number of firms having chosen to enter at the first stage, the two conditions for a free entry equilibrium (s_n, n) without sunk costs are: first, that $\Pi(s, s_n, n, 1)$ reach a maximum non-negative value on $\mathbb{S} \setminus \mathbb{S}_0$ at $s = s_n$, and second, that whenever this value is positive there be no equilibrium with $n + 1$ entrants (*symmetric* with respect to *all* of them). The second condition means that, for any strategy $s_{n+1} \in \mathbb{S} \setminus \mathbb{S}_0$, if $\Pi(s, s_{n+1}, n + 1, 1)$ is maximized on $\mathbb{S} \setminus \mathbb{S}_0$ at $s = s_{n+1}$ then $\Pi(s_{n+1}, s_{n+1}, n + 1, 1) < 0$. Putting together these two conditions one obtains the *zero profit condition* commonly seen as implied by free entry ($\Pi(s_n, s_n, n, 1) = \max_{s \in \mathbb{S} \setminus \mathbb{S}_0} \Pi(s, s_n, n, 1) = 0$), provided one neglects the so-called “non-integer problem” (as n belongs to $\mathbb{N}^*$, not to $\mathbb{R}_+$, $\Pi(s_{n+1}, s_{n+1}, n + 1, 1) < 0 < \Pi(s_n, s_n, n, 1)$ is in fact the generic case).

Instead, we use the standard definition of a Nash equilibrium of a single stage game, just characterizing *separately*, as best responses, the decisions of active and inactive firms:

Definition 1 *A non-trivial symmetric **free entry equilibrium** is a pair (s_n, n) in $(\mathbb{S} \setminus \mathbb{S}_0) \times \{1, \dots, N - 1\}$ satisfying two conditions:*

$$\begin{aligned} \max_{s \in \mathbb{S}} \Pi(s, s_n, n, 1) &= \Pi(s_n, s_n, n, 1) \geq 0 \text{ (*profitability*) and} \\ \max_{s \in \mathbb{S}} \Pi(s, s_n, n, 0) &= \max_{s \in \mathbb{S}_0} \Pi(s, s_n, n, 0) = 0 \text{ (*sustainability*)} \end{aligned}$$

For a strategy profile characterized by the pair (s_n, n) to be an equilibrium, it must be *profitable* for any active firm to choose the strategy s_n , meaning that no higher profit is attainable either while staying active ($\Pi(\cdot, s_n, n, 1)$ is maximized at s_n) or through becoming inactive ($\Pi(s_n, s_n, n, 1)$ is non-negative). The

³Exclusion of sunk costs is consistent with our assumption of a simultaneous game, but is not crucial. In a two-stage game, if all (actual) entrants incur the same positive sunk cost k at a first stage, the profit of an inactive entrant $-k$ is negative, instead of 0, but this translation does not fundamentally alter the argument.

⁴See Götz (2005) for a recent example.

strategy profile must also be *sustainable* with respect to inactive firms, meaning that these firms should not be able to obtain a positive profit by becoming active.

2.2 A canonical pricing model

In order to be more specific and yet to cover different regimes of competition with a unified framework, we now introduce a simple model where strategies, whatever their nature, can be *represented* by prices. Take an industry producing either a homogeneous or a composite good sold at price P . Demand for this good is given by a twice differentiable decreasing function $D : (0, \tilde{P}) \rightarrow (0, \infty)$, with $\tilde{P} \in (0, \infty]$, continuously extended for $P \geq \tilde{P}$ as $D(P) = 0$. The good is potentially produced by N firms, under *internal increasing returns*, with the same twice differentiable increasing cost function $C : (0, \infty) \rightarrow (0, \infty)$, extended to $C(0) = 0$ (no sunk costs) and such that average cost $C(y)/y$ is decreasing on $(0, \infty)$. As in the preceding subsection, we restrict our analysis to equilibria which are symmetric with respect to n active firms ($0 < n < N$), all choosing the same strategy $s_n \in \mathbb{S} \setminus \mathbb{S}_0$. This strategy will always be represented by the price p_n at which any active firm intends to sell its output. Thus, any firm deciding to supply quantity y at price p , and facing demand $d(p, p_n, n, \delta)$, has to solve a problem that can be stated as follows:

$$\max_{(p, y) \in \mathbb{R}_+^2} \{py - C(y) : y \leq d(p, p_n, n, \delta)\}. \quad (1)$$

Clearly, a pair (p, y) such that $0 < y < d(p, p_n, n, \delta)$ cannot be a solution to this problem, since the profit is increasing in y if $C(y)/y \leq p$. Thus, the firm will always decide either to produce $y = d(p, p_n, n, \delta)$ or to stay inactive (*i.e.* to choose $y = 0$), so that we may directly refer to the *canonical program* in the single decision variable p

$$\max_{p \in \mathbb{R}_+} \{pd(p, p_n, n, \delta) - C(d(p, p_n, n, \delta))\}, \quad (\text{CP})$$

and then check that the maximum profit is non-negative – taking otherwise $y = 0$ as the optimal decision.

One sees immediately that the canonical program (CP) covers the case where firms produce differentiated goods and compete in prices. It is less evident yet true that it also covers for instance the case of a homogeneous oligopoly with Cournotian firms. Indeed, given symmetry with respect to n active firms, each one of these firms chooses $p_n = P$ and $y_n = D(P)/n$, while $N - n$ inactive firms all choose $y = 0$. The residual demand at price p for any firm, whether active ($\delta = 1$) or inactive ($\delta = 0$) is $D(p) - (n - \delta)y_n = D(p) - (1 - \delta/n)D(p_n) \equiv d(p, p_n, n, \delta)$. As $y = d(p, p_n, n, \delta)$ if and only if $D(p) = (n - \delta)y_n + y$, program (CP) is indeed equivalent to the standard program of the Cournotian firm, namely $\max_{y \in \mathbb{R}_+} \{D^{-1}((n - \delta)y_n + y)y - C(y)\}$.

The specific form of contingent demand to the firm $d(\cdot, p_n, n, \delta)$, of which the Cournotian contingent demand is just an example, depends on the assumed

regime of competition. However, we can establish a general relation between the demand to the active firm $d(p_n, p_n, n, 1)$ as a function of p_n (the price set by all the n active firms) and the demand to the industry:

$$n\alpha(n)d(p_n, p_n, n, 1) = D(P), \text{ with } P = p_n/\alpha(n), \quad (2)$$

where $\alpha(n)$ is a positive *aggregating factor* to be used when the product is a composite good ($\alpha(n) \equiv 1$, otherwise).⁵

We now introduce two general assumptions on the cost and demand functions. The first expresses existence of internal increasing returns to scale (yet not at an increasing rate). Formally:⁶

- A1 The function $C(y)/y$ is twice differentiable and has a negative, non-decreasing elasticity ($\epsilon_y C(y) - 1 < 0$, $\epsilon_{yy}^2 C(y) \geq 0$) in the interval $(0, \infty)$.

The second assumption is introduced to ensure that the profit function is well-behaved and has adequate boundary properties, namely that it takes negative values when the scale of production is either too small or too large. It further ensures that the demand to any firm, hence its average revenue, is larger for the incumbent than for the potential entrant (as the former competes with only $n - 1$ producing firms, while the latter faces one more competitor). Formally:

- A2 For any triplet (p_n, n, δ) , the function $d(\cdot, p_n, n, \delta)$ is twice differentiable in the interval $(0, \tilde{p}(p_n, n, \delta))$ in which it is positive (where $\tilde{p}(p_n, n, \delta) \in (0, \infty]$ is the supremum of customers' reservation prices), and has in this interval a negative, decreasing elasticity ($\epsilon_p d(\cdot, p_n, n, \delta) < 0$, $\epsilon_{pp}^2 d(\cdot, p_n, n, \delta) > 0$), such that

$$\frac{1}{\lim_{p \rightarrow 0} \epsilon_p d(p, p_n, n, \delta)} < \lim_{y \rightarrow \infty} \epsilon_y C(y) - 1 \text{ and} \quad (3)$$

$$\frac{1}{\lim_{p \rightarrow \tilde{p}(p_n, n, \delta)} \epsilon_p d(p, p_n, n, \delta)} > \lim_{y \rightarrow 0} \epsilon_y C(y) - 1. \quad (4)$$

Furthermore, for any p , the function $d(p, \cdot)$ is increasing in p_n and δ , and non-increasing in n , as long as its value remains positive.

Geometrically, as illustrated by Figure 1, assumption (A1) states that the average cost curve $C(y)/y$ is decreasing and convex when represented on a diagram with logarithmic scales (see curve AC, with slope $\epsilon_y C(y) - 1$). Assumption

⁵Deflating the price p_n by the aggregating factor in the definition of the price index P (the price of the composite good) ensures that the aggregate expenditure $PD(P)$ in the industry is indeed equal to the sum $np_n d(p_n, p_n, n, 1)$ of firms revenues. A well known example of the use of such price and quantity indices for industries producing a composite commodity is afforded by the Dixit and Stiglitz (1977) framework (where $\alpha(n) = n^{1/(\sigma-1)}$, with σ the constant elasticity of substitution between elementary goods). For a more general analysis, see d'Aspremont *et al.* (2007).

⁶We denote $\epsilon_x f(x, y) \equiv (\partial f(x, y) / \partial x) x / f(x, y)$ the partial elasticity of f at (x, y) with respect to x . All related elasticity notations are self-explanatory.

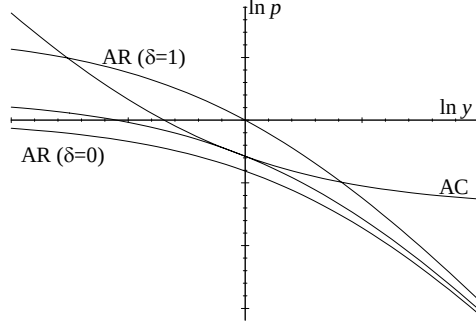


Figure 1: Average cost and revenue curves

(A2) states that the average revenue curve (given by the inverse of the function $d(\cdot, p_n, n, \delta)$) is decreasing, strictly concave, and always lower than the average cost curve for an output either close to zero or close to infinity (see curves AR, with slopes $1/\epsilon_p d(p, p_n, n, \delta)$).

In this diagram, the profitability condition requires that the average revenue curve of an active firm AR ($\delta = 1$) be higher than the average cost curve AC for intermediate values of y , while the sustainability condition requires that the average revenue curve of an inactive firm AR ($\delta = 0$) be lower than the average cost curve AC for all values of y . The two conditions are compatible because average revenue is increasing in δ by assumption (A2).

As a last remark, it should be noticed that twice differentiability of the function $d(\cdot, p_n, n, \delta)$ is more than a technical assumption. Indeed, it excludes the case of Bertrand competition (price competition in a homogeneous oligopoly) since $d(\cdot, p_n, n, \delta)$ has then a discontinuity at $p = p_n$.

2.3 Equilibrium conditions

Under the assumptions of the preceding subsection, we can reformulate the profitability and the sustainability conditions in terms of the price p_n set (or targeted) by *all* the n active firms. Profitability requires that this price be an interior solution to the canonical program (CP) (hence a critical point of the corresponding profit function $\Pi(\cdot, p_n, n, 1)$), and that this *critical* price be at least equal to the *break-even* price, entailing zero profits. By contrast, sustainability requires that the critical price be at most equal to the *limit* price deterring entry. In the following, we are going to give formal definitions of these three reference prices, and to examine sufficiency of the above conditions.

Definition 2 A *critical price* p_n^* is a positive price that, when simultaneously set by n active firms, satisfies the first order condition necessary for an interior

solution of (CP), that is, solves the equation of marginal revenue with marginal cost:

$$p_n (1 + 1/\epsilon_p d(p_n, p_n, n, 1)) = C' (d(p_n, p_n, n, 1)). \quad (\text{FOC})$$

If the critical price p_n^* entails non-negative profits, this first order condition is in fact sufficient, under our assumptions, for an interior solution of program (CP) – in spite of the possible lack of quasi-concavity of $\Pi(\cdot, p_n, n, 1)$, due to the non-convexity of the cost function. Profitability is then satisfied at p_n^* , as stated in the following lemma:

Lemma 1 (Profitability I) *Under assumptions (A1) and (A2), the symmetric strategy profile represented by the pair $(p_n^*, n) \in \mathbb{R}_{++} \times \{1, \dots, N-1\}$ satisfies the profitability condition if and only if p_n^* is a critical price entailing non-negative profits or, equivalently, leading to a revenue-cost ratio at least equal to one:*

$$g(p_n^*, n) \equiv \frac{p_n^* d(p_n^*, p_n^*, n, 1)}{C(d(p_n^*, p_n^*, n, 1))} \geq 1. \quad (\text{PNNC})$$

Proof. See Appendix. ■

Now, notice that for an increasing function $g(\cdot, n)$, condition (PNNC) can equivalently be expressed by requiring that the critical price be at least equal to the break-even price $\underline{p}(n)$, which entails zero profits, or equivalently leads to a unit value of the revenue-cost ratio. We formalize and develop this idea in the following. To begin with, we give a general definition of the break-even price, independently of $g(\cdot, n)$ being an increasing function. To understand this definition, recall that $\tilde{P}$ is the price, possibly infinite, at which demand becomes nil, and that the price P of the composite good is equal to p_n deflated by the aggregating factor $\alpha(n)$.

Definition 3 *The **break-even price** $\underline{p}(n)$ is the lowest price p_n which, when set by all the n active firms, allows them to get non-negative profits: $\underline{p}(n) \equiv \inf \mathcal{P}(n)$, with*

$$\mathcal{P}(n) \equiv \left\{ p_n \in \left(0, \alpha(n) \tilde{P} \right) : g(p_n, n) \geq 1 \right\} \quad (5)$$

(by convention, $\underline{p}(n) = \infty$ if $\mathcal{P}(n) = \emptyset$).

As just observed, the profitability requirement can be equivalently expressed by the inequality $p_n^* \geq \underline{p}(n)$ (where p_n^* is a critical price), provided $g(\cdot, n)$ is an increasing function, a property that is verified when the demand to the industry has an elasticity that is always at least equal to -1 . Otherwise, the market revenue $PD(P)$ may decrease with P , imposing an upper bound on the set $\mathcal{P}(n)$, so that the preceding inequality is only a necessary – but in general not sufficient – condition for profitability. However, under the following additional assumption, implying in particular quasi-concavity of the function $g(\cdot, n)$, that inequality remains in fact a sufficient condition for profitability, as stated in Lemma 2.

A3 Demand to the industry has an elasticity $\epsilon_P D(\cdot)$ which is non-increasing whenever smaller than -1 . The elasticity $\epsilon_y C'(y)$ of marginal cost is larger, for any y , than the least upper bound $1/\lim_{P \rightarrow \tilde{P}} \epsilon_P D(P)$ of the elasticity of inverse demand.

Lemma 2 (Profitability II) *Under assumptions (A1), (A2) and (A3), the symmetric strategy profile represented by the pair $(p_n^*, n) \in \mathbb{R}_{++} \times \{1, \dots, N-1\}$ satisfies the profitability condition if and only if p_n^* is a critical price at least equal to the break-even price: $p_n^* \geq \underline{p}(n)$.*

Proof. See Appendix. ■

Finally, we introduce the concept of *limit price*, to be taken as an upper bound imposed on the critical price so as to ensure sustainability. This price was defined as “the highest common price which the established seller(s) believe they can charge without inducing at least one increment to entry” (Bain, 1949, p.454). This is the price leading to an average revenue curve of the potential entrant which is just below the average cost curve (Modigliani, 1958), as represented by the dotted curve tangent to curve AC in Figure 1. Formally:

Definition 4 *The **limit price** $\bar{p}(n)$ is the highest price p_n which, when set by all the n active firms, prevents an inactive firm from getting positive profits: $\bar{p}(n) \equiv \sup \bar{\mathcal{P}}(n)$, with*

$$\bar{\mathcal{P}}(n) \equiv \left\{ p_n \in \left(0, \alpha(n) \tilde{P} \right) : \max_{p \in (0, \tilde{p}(p_n, n, 0))} G(p, p_n, n) \leq 1 \right\}, \quad (6)$$

with $G(p, p_n, n) \equiv \frac{pd(p, p_n, n, 0)}{C(d(p, p_n, n, 0))}$ and $\tilde{p}(p_n, n, 0)$ as defined in assumption (A2).

Observe that the elasticity with respect to p of the revenue-cost ratio G is

$$\epsilon_p G(p, p_n, n) = 1 + (1 - \epsilon_y C(d(p, p_n, n, 0))) \epsilon_p d(p, p_n, n, 0). \quad (7)$$

Hence, by inequalities (3) and (4) in assumption (A2), this elasticity is positive for p close to zero and negative for p close to $\tilde{p}(p_n, n, 0)$, implying that $G(\cdot, p_n, n)$ has indeed an interior maximum. Thus, we can determine the limit price $\bar{p}(n)$ as the solution in p_n to equations:

$$pd(p, p_n, n, 0) = C(d(p, p_n, n, 0)) \quad (8)$$

$$-\epsilon_p d(p, p_n, n, 0) = \frac{1}{1 - \epsilon_y C(d(p, p_n, n, 0))}, \quad (9)$$

namely the zero profit condition and the first order condition for maximization of $G(\cdot, p_n, n)$, respectively.

Given Definition 4, we can now reformulate the sustainability condition by reference to the limit price $\bar{p}(n)$.

Lemma 3 (Sustainability) *Under assumptions (A1) and (A2), the condition $p_n \leq \bar{p}(n)$ is necessary and sufficient for the pair $(p_n, n) \in \mathbb{R}_{++} \times \{1, \dots, N-1\}$ to satisfy the sustainability condition.*

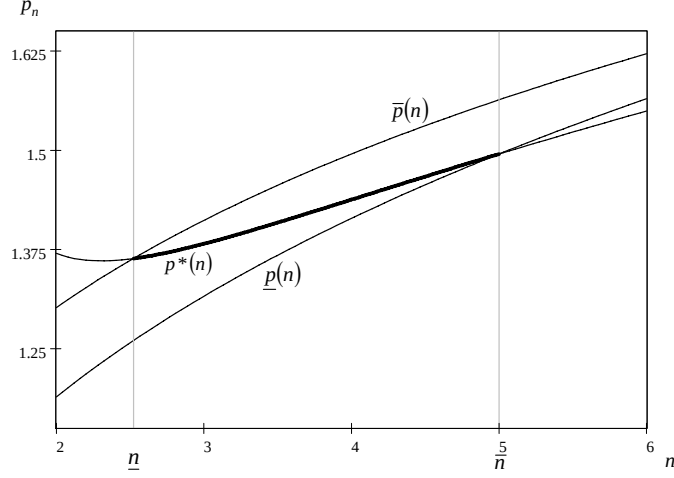


Figure 2: Critical, limit and break-even prices

Proof. See Appendix. ■

We summarize in the following proposition the results stated in the two last lemmata.

Proposition 1 *Under assumptions (A1), (A2) and (A3), a symmetric profile represented by the pair $(p_n^*, n) \in \mathbb{R}_{++} \times \{1, \dots, N - 1\}$ is a free entry equilibrium if and only if p_n^* is a critical price between the break-even price and the limit price: $\underline{p}(n) \leq p_n^* \leq \bar{p}(n)$.*

Figure 2 provides a representation of this equilibrium condition in the space (n, p_n) .⁷ The critical, break-even and limit prices appear as functions $p^*(\cdot)$, $\underline{p}(\cdot)$ and $\bar{p}(\cdot)$ of a real (instead of an integer) number n . Observe how the condition $\underline{p}(n) \leq p_n^* \leq \bar{p}(n)$, resulting in the thick segment of the critical price curve, translates into a restriction on the number n of active firms. This number should belong to the interval $[\underline{n}, \bar{n}]$ with endpoints defined by $p^*(\underline{n}) = \bar{p}(\underline{n})$ and $p^*(\bar{n}) = \bar{p}(\bar{n})$.

Obviously, as soon as the interval $[\underline{n}, \bar{n}]$ contains more than one integer, the profitability and sustainability conditions are compatible with existence of free entry equilibria with positive profits, *along with* the one determined by the zero profit condition (corresponding to a number of active firms equal to the highest integer in the interval – which happens to be exactly $\bar{n}$ in the particular example of Figure 2). It is worthwhile to emphasize that this source of equilibrium

⁷The case represented in Figure 2 corresponds to price competition in a differentiated oligopoly with a CES aggregator (Dixit-Stiglitz), where we have assumed a unit-elastic demand to the industry, with constant expenditure normalized to unity, a constant elasticity of substitution within the industry equal to 6, and a constant elasticity of the marginal cost function equal to -0.2 .

multiplicity differs from the one usually considered in the coordination failures literature and popularized by the seminal paper of Cooper and John (1988). In this literature, multiple symmetric equilibria are associated with the same exogenous number $n = N$ of players (thus resulting, in our framework, in a multi-valued function $p^*(\cdot)$). Such multiplicity relies on strategic complementarity, which amounts to require that the best response of p be an increasing function of p_n . No such condition is necessary in our approach, because symmetry is now imposed only within each class of active and inactive firms. This explains why, as we are going to show, equilibrium multiplicity may prevail even under strategic substitutability, as it is typically the case under Cournot competition.

3 Regimes of competition

In order to illustrate the potential of our analytical framework, we now apply it to two standard regimes of quantity and price competition. As for quantity competition, we limit our analysis to the Cournot homogeneous oligopoly. As for price competition, we must however refer to a market for differentiated products, since the Bertrand homogeneous oligopoly is outside our scope and leads, at free entry equilibrium, to the competitive outcome (Yano, 2005, 2006). We might for instance use the well known Dixit and Stiglitz (1977) model, modified so as to account for manipulability of the industry price index by each one of a “small group” of active firms (d’Aspremont, Dos Santos Ferreira and Gérard-Varet, 1996). However, since this model has already been treated in this perspective by d’Aspremont, Dos Santos Ferreira and Gérard-Varet (2000), we shall devote our analysis of price competition to the Salop (1979) spatial model, where the strategy variables include, besides prices, locations in the characteristics space.

3.1 Quantity competition with product homogeneity: the Cournot model

There are two sources of decreasing average cost, namely the presence of a fixed cost and the existence of internal economies of scale accounting for decreasing marginal cost. These two sources are not equivalent, as attested by their specific effects in the Dixit-Stiglitz model, where multiple free entry equilibria generally exist when marginal cost is an isoelastic decreasing function, but never when it is constant, in the presence of a fixed cost (d’Aspremont *et al.*, 2000).⁸ However, in the two regimes of competition we are going to analyze, the weaker source of decreasing average cost is sufficient to ensure multiplicity of free entry equilibria, and hence to illustrate the use of our framework. We shall accordingly assume for simplicity a positive fixed (non sunk) cost ϕ and a constant positive marginal cost, normalized to one: $C(y) = \phi + y$ if $y > 0$ and $C(0) = 0$, a function that clearly satisfies assumption (A1). On the demand side we assume, also in the

⁸In the latter case, the admissible interval $[\underline{n}, \overline{n}]$ is still non-degenerate, but it contains at most one integer, the one determined by the zero profit condition.

analysis of both regimes, a unit-elastic demand to the industry⁹ $D(P) = b/P$, with $b > 0$, satisfying (A3). One advantage of this specification is that the break-even price becomes independent of the particular regime of competition we are considering, since expenditure b in the industry is not affected by price changes. The break-even price is then given by

$$\underline{p}(n) = \frac{1}{1 - n\phi/b}, \quad (10)$$

an increasing function of the number n of active firms and of the share ϕ/b of individual fixed cost in aggregate expenditure.

With this specification of the demand to the industry and according to what has already been shown in subsection 2.2, the Cournotian contingent demand can be expressed in a symmetric configuration as

$$d(p, p_n, n, \delta) = b \left(\frac{1}{p} - \frac{1 - \delta/n}{p_n} \right), \quad (11)$$

where p is the market price aimed at by the firm and $p_n = b/ny_n$ the price representing the strategy y_n expected from each one of its $n - \delta$ active competitors (with $\delta = 1$ if the firm is itself active, $\delta = 0$ otherwise). This function has a partial elasticity with respect to p (for p in the interval $(0, p_n/(1 - \delta/n))$ in which individual demand is positive and finite) given by

$$\epsilon_p d(p, p_n, n, \delta) = -\frac{1}{1 - (1 - \delta/n)(p/p_n)}. \quad (12)$$

It is easy to check that it satisfies assumption (A2), and that $\epsilon_p d(p_n, p_n, n, 1) = -n$.

>From (11), we see that the contingent demand to the inactive firm is independent of the number n of active firms, so that the limit price is itself constant in n :¹⁰

$$\bar{p}(n) = \frac{1}{(1 - \sqrt{\phi/b})^2}, \quad (13)$$

again an increasing function of the share ϕ/b of individual fixed cost in aggregate expenditure. As to the critical price, it is simply equal to the markup factor $\mu(n) = n/(n - 1)$ on marginal cost (multiplied by 1, the normalized marginal cost):

$$p^*(n) = \frac{n}{n - 1}. \quad (14)$$

Profit non-negativity ($p^*(n) \geq \underline{p}(n)$) requires, by (10),

$$n \leq \sqrt{b/\phi} \equiv \bar{n}, \quad (15)$$

⁹Equilibrium with a single active firm will consequently be excluded.

¹⁰Using (11) with $\delta = 0$, we get from (8) $py = b(1 - p/p_n) = \phi + y$, so that $p_n = [b/(b - (\phi + y))][(\phi + y)/y]$. From (9), we get $p/p_n = y/(\phi + y)$. Hence, $\phi + y = \sqrt{\phi b}$, and finally $p_n = 1/(1 - \sqrt{\phi/b})^2$.

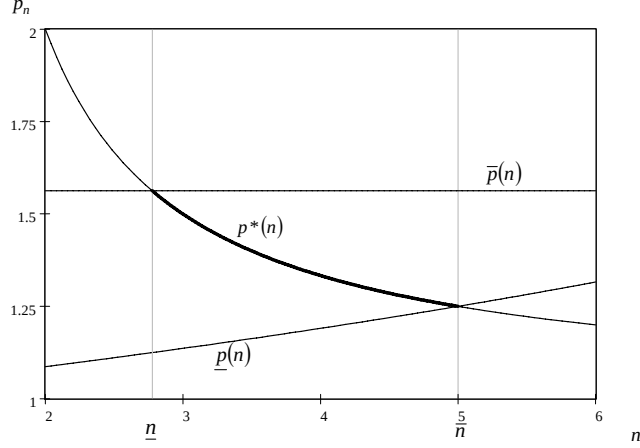


Figure 3: Equilibrium conditions in the Cournot model

an upper bound that must be at least equal to 2, in order for a free entry equilibrium to exist, so that $\phi/b \leq 1/4$ is a necessary condition for existence. Sustainability ($p^*(n) \leq \bar{p}(n)$) in turn requires:

$$n \geq \frac{\bar{n}}{2 - 1/\bar{n}} \equiv \underline{n}. \quad (16)$$

Notice that the admissible interval $[\underline{n}, \bar{n}]$ contains more than one integer for $\bar{n} \geq 3$, that is, for a *small enough* degree of economies of scale, as determined by the share ϕ/b of individual fixed cost in aggregate expenditure, which should not exceed $1/9$. Besides, the degree of indeterminacy increases with $\bar{n}$, that is, it is larger the smaller the degree of economies of scale. However, a low degree of economies of scale results in a relatively large number of active firms, reducing the impact of variations in n on the markup factor (and hence on the equilibrium price). Figure 3 gives an illustration (for $\phi/b = 0.04$ and similarly to Figure 2) of the conditions we impose on the critical, break-even and limit prices in order to ensure profitability and sustainability.

3.2 Price competition with strategic product differentiation: the Salop model

In the industrial organization literature, spatial competition is a popular alternative to non-address models relying on CES or quadratic consumers' utility functions. Although less frequent in macroeconomic modelling, it has for instance already been used by Weitzman (1982), who introduced a macroeconomic version of Salop's (1979) model of the circular city. The space of characteristics of the industry good is represented by a circle with perimeter equal to 1, on

which consumers' locations are uniformly distributed with unit density. A consumer devoting a positive budget b to the purchase of that good and located at point x between two firms j and $j + 1$, which are themselves located at a_j and a_{j+1} respectively, will buy from firm j if $p_j + \tau(x - a_j) < p_{j+1} + \tau(a_{j+1} - x)$, where p_j and p_{j+1} are the prices set by the two firms and τ is the subjective transportation rate in money equivalent units. The marginal consumer who is indifferent between the two suppliers is the one located at point $x_{(j,j+1)} = (a_j + a_{j+1})/2 + (p_{j+1} - p_j)/2\tau$, so that the market area of firm j is

$$x_{(j,j+1)} - x_{(j-1,j)} = \frac{a_{j+1} - a_{j-1}}{2} + \frac{(p_{j-1} + p_{j+1})/2 - p_j}{\tau}, \quad (17)$$

which is independent upon its own location a_j . However, although indifferent about its precise location within its market area, firm j is assumed to set its price p_j on the basis of its conjectures not only about prices p_{j-1} and p_{j+1} but also about the *locations* a_{j-1} and a_{j+1} simultaneously chosen by its neighbors. This implies in particular that, when inactive at the strategy profile taken as reference, a deviating firm *does not* conjecture that the locations of the two competitors between which it decides to locate are going to be benevolently accommodated in response to its decision to deviate into activity. As a consequence, *any* deviating firm is able to manipulate its market area through its pricing decision, within the segment separating its two neighbors, but the length of this segment is $2/n$ if the firm is active and only $1/n$ if it is inactive (assuming that locations are symmetric with respect to the n active firms).

On the basis of symmetry with respect to both locations and prices, we obtain from equation (17) the following expression for contingent demand to the representative firm (with $\delta = 1$ if it is active, $\delta = 0$ otherwise):

$$d(p, p_n, n, \delta) = (b/\tau p) ((1 + \delta) \tau/2n + p_n - p), \text{ with } p \in (0, (1 + \delta) \tau/2n + p_n]. \quad (18)$$

The partial elasticity of $d(p, p_n, n, \delta)$ with respect to p is:

$$\epsilon_p d(p, p_n, n, \delta) = -\frac{(1 + \delta) \tau/2n + p_n}{(1 + \delta) \tau/2n + p_n - p}. \quad (19)$$

All the conditions of assumption (A2) are again satisfied.

Since $\epsilon_p d(p_n, p_n, n, 1) = -(1 + np_n/\tau)$, the markup factor on the marginal cost is $\mu = 1 + \tau/np_n$, so that we obtain the following expression for the critical price as a (decreasing) function of n :

$$p^*(n) = \mu^* = \frac{1}{2} + \sqrt{\frac{1}{4} + \frac{\tau}{n}}. \quad (20)$$

Profit non-negativity ($p^*(n) \geq \underline{p}(n)$) imposes, by this equation and equation (10), an upper bound on the number n of active firms:

$$n \leq \frac{\tau}{\sqrt{\tau\phi/b} (1 + \sqrt{\tau\phi/b})} \equiv \bar{n}, \quad (21)$$

which must be at least equal to 2 for existence of a free entry equilibrium, so that the ratio ϕ/b cannot be too large. The upper bound $\bar{n}$ on the number of active firms is increasing in the transportation rate τ (representing the degree of product differentiation) and decreasing in the share ϕ/b of individual fixed cost in aggregate expenditure (determining the degree of internal economies of scale). Finally, equations (8) and (9) lead to the limit price¹¹

$$\bar{p}(n) = \left(1 + \sqrt{\tau\phi/b}\right)^2 - \tau/2n, \quad (22)$$

and, after a straightforward computation, to the lower bound imposed by sustainability ($p^*(n) \leq \bar{p}(n)$):

$$n \geq \frac{\tau}{\left(\sqrt{2\left(1 + \sqrt{\tau\phi/b}\right)^2 + 1/4} - 1\right)^2} \equiv \underline{n}. \quad (23)$$

It can easily be checked that the ratio $\underline{n}/\bar{n}$ between the endpoints of the admissible interval $[\underline{n}, \bar{n}]$ is a decreasing function of the variable $\sqrt{\tau\phi/b}$, which tends to 3/4 as this variable tends to zero. As a consequence, the admissible interval contains at least two integers if $\bar{n} \geq 4$, which requires a small enough share of individual fixed cost in aggregate expenditure ($\phi/b < 1/4$) and a high enough degree of product differentiation as measured by τ . We represent in Figure 4 (for the same value 0.04 of the ratio ϕ/b and for $\tau = 25/16$, so as to get the same $\bar{n} = 5$ and the same $p^*(\bar{n}) = \mu(\bar{n}) = 1.25$ as in Figure 3)¹² the free entry equilibrium conditions in terms of the critical, break-even and limit prices.

We may now formulate a tentative conclusion of the analysis performed in this section. The degree of internal economies of scale (here determined by the share ϕ/b of the individual fixed cost in the aggregate expenditure) must be low enough to ensure existence, and even more so multiplicity, of free entry equilibria. However, as the share ϕ/b becomes smaller, the amplitude of price variations across equilibria becomes smaller too. Under price competition, existence and especially multiplicity also require a high enough degree of product differentiation (here represented by the rate of transportation τ) and a correspondingly high degree of market power. Sustainability (as indicated by the level of the lower bound $\underline{n}$ on the admissible number of active firms, given the same upper bound $\bar{n}$) is harder to ensure under price competition than under quantity competition, where potential entrants expect incumbents to stick to specific output levels. But price sustainability remains compatible with positive profits under strategic product differentiation, where potential entrants at

¹¹ Using (18) with $\delta = 0$, we obtain from (8) $py = (b/\tau)(\tau/2n + p_n - p) = \phi + y$. Also, using (19) with $\delta = 0$, we get from (9): $p/(p_n - p + \tau/2n) = y/\phi$. These equations together entail: $y = \sqrt{b\phi/\tau}$ and $p = 1 + \sqrt{\tau\phi/b}$, and then $p_n = \left(1 + \sqrt{\tau\phi/b}\right)^2 - \tau/2n$.

¹² Imposing either the same upper bound $\bar{n}$ or the same corresponding markup factor $\mu(\bar{n}) = p^*(\bar{n})$ in the two models leads to the relation: $\sqrt{\tau} = 1/(1 - \sqrt{\phi/b})$. The choice of the numerical value $\phi/b = 0.04$ then implies $\tau = 25/16$.

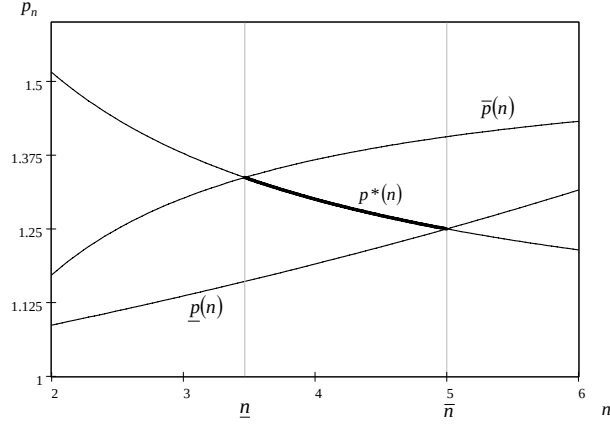


Figure 4: Equilibrium conditions in the Salop model

least expect incumbents to stick to specific locations in the characteristics space. In the non-address model of Dixit and Stiglitz, where potential entrants have no disadvantage relative to incumbents as regards the capacity to benefit from product differentiation, the presence of a fixed cost is however not enough to ensure sustainability along with positive profits.

4 Dynamic aggregate implications

Equilibrium indeterminacy calls for some selection procedure, allowing coordination of firms conjectures and resulting decisions. In this perspective, the usual zero profit condition appears as a particular selection rule, picking up the equilibrium associated with the greatest integer in the admissible interval $[\underline{n}, \bar{n}]$. But, as long as other profitable strategy profiles are sustainable, there is no reason to suppose that firms always coordinate on the least profitable of them. This section explores the potential aggregate implications of this coordination problem, using a very simple macroeconomic model with overlapping generations of identical consumers and a large number of differentiated industries.

4.1 Consumers

The economy is composed by overlapping generations of “young” and “old” consumers. A generation of identical consumers of unit mass is born at each date t and lives for two periods. Consumers work only when young, receiving in this period wage earnings and dividends from firms (which are equally held by young consumers), and can only save in the form of money, which brings no interest. They consume only when old, using past money savings. In addition, we assume that the preferences of old consumers are defined over varieties $i =$

1, ..., m of goods produced by the m industries, with a constant elasticity of substitution that we take equal to unity. This implies that consumption may be represented by the aggregate $\bar{Y} = m \left(\prod_{i=1}^m Y_i^{1/m} \right)$, which can be bought at the corresponding price index $\bar{P} = \prod_{i=1}^m P_i^{1/m}$.

Assuming identical homothetic preferences, we can simply refer to the choices of an aggregate representative young consumer, born at t and wishing to maximize $E_t U(\bar{Y}_{t+1}) - V(L_t)$ subject to the constraints $\bar{P}_{t+1} \bar{Y}_{t+1} \leq M_t$ and $M_t \leq w_t L_t + \mathcal{D}_t$, where M_t is money demand, L_t is labor, supplied at the nominal wage w_t , and $\mathcal{D}_t$ is the total amount of dividends received from firms. The first-order conditions for this program may be written as

$$E_t \left(U'(\bar{Y}_{t+1}) \frac{w_t}{\bar{P}_{t+1}} \right) = V'(L_t), \quad (24)$$

with the two former constraints binding at the optimum. For simplicity, we shall from now on restrict our attention to the case of a utility function which is isoelastic in consumption and linear in labor, i.e. $U(Y) = Y^\rho/\rho$ and $V(L) = vL$, with $\rho \in (0, 1)$ and $v \in (0, \infty)$. With these assumptions, it is easy to see from the optimality conditions that the young consumer will save in the form of money all its income available at t , supplying any positive amount of labor provided that the nominal wage is at least equal to the nominal reservation wage $\underline{w}_t = v/E_t \left(\bar{Y}_{t+1}^{\rho-1} \bar{P}_{t+1}^{-1} \right)$.

4.2 The production sector

We adopt the usual macroeconomic modelling of monopolistic competition (Blanchard and Kiyotaki, 1987) by assuming that the economy is composed of a large number m of industries producing differentiated goods. However, we depart from this modelling by relaxing the assumption that all sectors are represented by a single firm acting in a *monopolistic* position. Instead, as seen in the preceding section, we consider that in each industry a number N of potential producers compete in an *oligopolistic* setting, deciding in particular to be active or not according to their (correct) conjectures of other producers' behavior. Each firm wishes to maximize profits $py - wl$ using the same production function¹³ $y = l^{1/\gamma}$, with $0 < \gamma < 1$, and decides to set its price and to choose its activity level according to these conjectures and to the sectoral demand $D(P_i) = (\bar{P}\bar{Y}/m)/P_i$ (see program (CP) above). At a symmetric free-entry equilibrium with n_i active firms in industry i , each one of these firms chooses the same critical price, equal (or proportional, in the case of an industry producing a composite good) to $P_i = (\bar{P}\bar{Y}/m)^{1-1/\gamma} w^{1/\gamma} [\Psi_i(n_i)]^{1/\gamma}$, where Ψ_i is a decreasing function with a specification depending on the regime of competition prevailing in the industry. For simplicity, we assume symmetry across sectors as concerns the competition regime, so that $\Psi_i = \Psi$ for all i . Also, under appropriate conditions on

¹³We might have chosen the specification $y = l - \phi$ instead, by assuming either Cournot or spatial competition (the CES product differentiation being excluded in this case).

γ , there will typically exist a non-degenerate interval $[\underline{n}, \bar{n}]$ of admissible numbers of active firms at equilibrium, producing a total sectoral amount of good $D(P_i) = (\bar{P}\bar{Y}/m)^{1/\gamma} w^{-1/\gamma} [\Psi(n_i)]^{-1/\gamma}$.

4.3 Equilibrium

It is easy to derive from the previous subsections the general equilibrium of this economy. Assuming a constant stock of money, $M_t = M$ for $t = 0, \dots, \infty$, the total aggregate consumption demand is equal to the real purchasing power of money holdings of old consumers, $M/\bar{P}_t$. Total production, as represented by the index $\bar{Y}_t$, satisfies:

$$\bar{Y}_t = m \left(\frac{\bar{P}_t \bar{Y}_t}{m w_t} \right)^{1/\gamma} \left(\prod_{i=1}^m \Psi(n_{i,t})^{1/m} \right)^{-1/\gamma}. \quad (25)$$

Equilibrium in the output market then requires $\bar{Y}_t = M/\bar{P}_t$. Labor market equilibrium implies that the nominal wage equalizes the nominal reservation wage:

$$w_t = v/E_t \left(\bar{Y}_{t+1}^{\rho-1} \bar{P}_{t+1}^{-1} \right). \quad (26)$$

Finally, the money market clears by Walras law. Combining these two equations and using $\bar{Y}_t = M/\bar{P}_t$ (and $\bar{Y}_{t+1} = M/\bar{P}_{t+1}$), it is straightforward to show that the general equilibrium of this economy may be represented by the following (non-autonomous) one-dimensional dynamic system:

$$\bar{Y}_t = m^{1-1/\gamma} v^{-1/\gamma} \left(\prod_{i=1}^m \Psi(n_{i,t})^{1/m} \right)^{-1/\gamma} \left(E_t \left(\bar{Y}_{t+1}^\rho \right) \right)^{1/\gamma}. \quad (\text{DS})$$

Clearly, if the coordination process selects a time-invariant number of active firms n_i in each sector, the system (DS) has a deterministic stationary equilibrium $\bar{Y}^* = (m^{1-\gamma} v \bar{\Psi})^{1/(\rho-\gamma)}$, with $\bar{\Psi} = (\prod_{i=1}^m \Psi(n_i)^{1/m})$, for each admissible m -uple (n_i) . Obviously, any such equilibrium is indeterminate in the dynamic sense as long as $\rho \geq \gamma$. This indeterminacy condition, imposing a degree of increasing returns to scale high enough compared to the degree of concavity of the utility function, is typical in this kind of model. Although in this very simple setup without capital accumulation and with labor as the unique input in production, indeterminacy may well occur for empirically reasonable degrees of increasing returns and risk aversion, richer dynamic models in line with the Real Business Cycle literature are often found to be indeterminate only for relatively high increasing returns, an assumption which is widely discussed and criticized in the empirical literature (see the survey by Benhabib and Farmer, 1999, for further discussion on this issue).

Since we want to focus on an alternative source of indeterminacy, we will assume in the following that the non-trivial steady state $\bar{Y}^*$ is determinate in the dynamic sense, that is, that $\rho < \gamma$. Given this condition, it is clear that, if the

coordination problem within each industry were implicitly solved by referring to the zero profit condition (*i.e.*, by making n_i equal to the greatest integer value $\lceil \bar{n} \rceil$ in the interval $[\underline{n}, \bar{n}]$, for each $i = 1, \dots, m$), the unique non-explosive trajectory would require that output jump instantaneously and permanently to its long-run stationary value $\bar{Y}^* = (m^{1-\gamma} v \Psi(\lceil \bar{n} \rceil))^{1/(\rho-\gamma)}$. No deterministic or stochastic fluctuations remaining in a compact neighborhood of the steady-state would then be possible. However, as long as the coordination problem is not given such a simple solution (implying that incumbents, despite their interests, are always ready to accommodate entry), neither endogenous fluctuations nor multiplicity of Pareto-ranked deterministic steady states can be excluded.

4.4 Fluctuations driven by sunspots

Let us now illustrate how the fundamental static indeterminacy inherent in free entry equilibria may be the source of important sunspot-driven fluctuations, even when the steady-state is determinate in the dynamic sense (when $\rho < \gamma$). Multiplicity of equilibria requires that firms within each industry find a coordination scheme allowing them to rationalize one equilibrium among the potential ones – a point that has been left implicit when discussing the possibility of coordination failures. We shall therefore consider that firms tackle this coordination problem by referring to some idiosyncratic signal indicating the situation that is about to be realized at some date in this particular sector.

To be explicit, assume that the admissible interval $[\underline{n}, \bar{n}]$ contains $K \in \{2, \dots, N-2\}$ integers $n_k \equiv \lceil \underline{n} \rceil + k - 1$ (where $\lceil \underline{n} \rceil$ is the smallest integer larger than or equal to $\underline{n}$), with $k = 1, \dots, K$. A *signal* for industry i at date t may then be seen as a realization $k_{i,t}$ of a random variable with arbitrary distribution over the discrete support $\{1, \dots, K\}$, ensuring coordination within this sector on the number $n_{k_{i,t}}$ of active firms. Also, we can define a *state* of the economy as a whole at time t as a vector $F_t = (f_{t1}, \dots, f_{tK})$ of proportions of industries that have received the signal k ($k = 1, \dots, K$) at this period. Looking for stationary stochastic equilibria of our economy, we assume that there is an arbitrary number $R \in \mathbb{N} \setminus \{0, 1\}$ of such states, indexed by $r = 1, \dots, R$ and such that with each r we associate the vector of proportions F_r . Besides, we assume that the transition between states across periods is described by a $(R \times R)$ row-stochastic transition matrix $\mathbf{T}$ with elements T_{ij} satisfying $T_{ij} \equiv \Pr(r' = j \mid r = i)$, where a prime stands for next period.

It is now straightforward to derive from equation (DS) the level of output $\bar{Y}_r$ associated with any state $r \in \{1, \dots, R\}$ of the economy in a stationary stochastic equilibrium (with $\bar{Y}_1 \leq \dots \leq \bar{Y}_R$, by convention):

$$\bar{Y}_r = m \left(\frac{1}{mv} \frac{\sum_{r'=1}^R T_{rr'} \bar{Y}_{r'}^\rho}{\prod_{k=1}^K \Psi(n_k)^{f_{rk}}} \right)^{1/\gamma} \equiv \eta_r(\bar{Y}_1, \dots, \bar{Y}_R). \quad (\text{SSE})$$

Since $\bar{Y}_1^\rho \leq \sum_{r'=1}^R T_{rr'} \bar{Y}_{r'}^\rho \leq \bar{Y}_R^\rho$ and $\Psi(n_K) \leq \prod_{k=1}^K \Psi(n_k)^{f_{rk}} \leq \Psi(n_1)$, we

have:

$$m \left(\frac{1}{mv} \frac{\bar{Y}_1^\rho}{\Psi(n_1)} \right)^{1/\gamma} \leq \bar{Y}_1 \leq \bar{Y}_R \leq m \left(\frac{1}{mv} \frac{\bar{Y}_R^\rho}{\Psi(n_K)} \right)^{1/\gamma}, \quad (27)$$

and hence, for $\rho < \gamma$,

$$\underline{\bar{Y}} \equiv (m^{1-\gamma} v \Psi(n_1))^{-1/(\gamma-\rho)} \leq \bar{Y}_1 \leq \bar{Y}_R \leq (m^{1-\gamma} v \Psi(n_K))^{-1/(\gamma-\rho)} \equiv \bar{\bar{Y}}. \quad (28)$$

Thus, η as defined in (SSE) is a continuous mapping of the set $[\underline{\bar{Y}}, \bar{\bar{Y}}]^R$ into itself. By Brouwer's fixpoint theorem, there exists a solution $(\bar{Y}_1^*, \dots, \bar{Y}_R^*) = \eta(\bar{Y}_1^*, \dots, \bar{Y}_R^*)$ to system (SSE).

Obviously, for a non-degenerate transition matrix $\mathbf{T}$, aggregate real output $\bar{Y}$ will fluctuate stochastically among its R potential (generically different) values. It can also be checked that, with degenerate transition matrices (in particular, when all the rows of $\mathbf{T}$ belong to the canonical basis of $\mathbb{R}^R$), real output will necessarily tend to a deterministic cycle of order $q \leq R$ (possibly after a transition period of finite time). Without intrinsic uncertainty, in an economy where the zero profit condition would imply an instantaneous and permanent coordination on a single deterministic steady-state, we see that simple coordination procedures called for by the multiplicity of free entry equilibria may well be the source of periodic or aperiodic, deterministic or stochastic cycles (Dos Santos Ferreira and Dufourt, 2006, exploit this possibility within a fully specified and calibrated model of the business cycle).

5 Conclusion

We have argued in this paper that, in spite of an almost universal convention, zero profits should not be imposed as an equilibrium condition under free entry, beyond the realm of non-strategic forms of competition. A straightforward application of the Nash equilibrium concept to standard simultaneous symmetric games, portraying diverse regimes of oligopolistic competition, typically entails multiple free entry equilibria with various adjacent numbers of active firms and different levels of positive profits. These equilibria are characterized by two conditions: *profitability* (the price should be no smaller than the break-even price) and *sustainability* (the price should be no larger than the limit price). These conditions define a non-degenerate interval of admissible numbers of active firms, that typically contains more than one integer. The zero profit condition then appears as no more than a particular selection criterion, picking up the *least profitable* equilibrium, associated with the highest integer in this interval. Our analytical framework and the indeterminacy results that it allows to establish are quite robust, and apply to both quantity and price competition, although the latter regime, in particular under non-strategic forms of product differentiation, makes sustainability harder to attain when profits are positive.

Beyond industrial organization, the indeterminacy of free entry equilibrium has potentially significant macroeconomic implications. In particular, it raises a coordination problem and consequently favors the emergence, even under dynamic determinacy, of sunspot fluctuations induced by some extrinsic, potentially varying, public signal on which firms in each industry need to coordinate (Dos Santos Ferreira and Dufourt, 2006, and Dos Santos Ferreira and Lloyd-Braga, 2003). Also, taking into account this particular type of indeterminacy enlarges the scope for coordination failures, which cease in particular to depend upon strategic complementarity.

Appendix

Proof of Lemma 1 (Profitability I):

Take a pair $(p_n^*, n) \in \mathbb{R}_{++} \times \{1, \dots, N-1\}$. Equation (FOC) in Definition 2, namely the equality of marginal revenue and marginal cost, is the necessary first order condition for an interior solution of (CP). Hence, the condition that p_n^* be a critical price entailing non-negative profits is clearly necessary for profitability. Let us examine if it is sufficient. A sufficient second order condition for a *local* maximum is that the marginal revenue decrease faster with y (increase faster with p) than the marginal cost, that is, that the elasticity with respect to p of the left-hand side of (FOC) be larger than the corresponding elasticity of the right-hand side:

$$1 - \frac{\epsilon_{pp}^2 d(p_n^*, p_n^*, n, 1)}{1 + \epsilon_p d(p_n^*, p_n^*, n, 1)} > \epsilon_y C'(d(p_n^*, p_n^*, n, 1)) \epsilon_p d(p_n^*, p_n^*, n, 1). \quad (\text{SOC})$$

By assumption (A2) and given (FOC) (implying $1 + \epsilon_p d(p_n^*, p_n^*, n, 1) < 0$), the left-hand side of inequality (SOC) is larger than one, so that the inequality is satisfied if the right-hand side is not larger than one. This is always the case if marginal cost is non-decreasing. Otherwise, if $\epsilon_y C'(y^*) < 0$ (with $y^* = d(p_n^*, p_n^*, n, 1)$), the profit non-negativity condition (PNNC), by (FOC) and assumption (A1), can be expressed for a critical price as

$$\epsilon_p d(p_n^*, p_n^*, n, 1) \geq \frac{1}{\epsilon_y C(d(p_n^*, p_n^*, n, 1)) - 1}. \quad (\text{PNNC}^*)$$

This inequality implies that the right-hand side of (SOC) is indeed at most equal to

$$\frac{\epsilon_y C'(y^*)}{\epsilon_y C(y^*) - 1} = 1 + \frac{\epsilon_{yy}^2 C(y^*)}{\epsilon_y C(y^*) - 1} \leq 1,$$

by assumption (A1), thus verifying condition (SOC). Hence, the profit function has a *local* interior non-negative maximum at any critical price p_n^* satisfying (PNNC). This maximum is in fact a *global* maximum. Indeed, by differentiability of the profit function, if there were two maxima, they would be separated by a minimum satisfying (FOC) and violating (SOC), hence (PNNC) (and (PNNC*)). But, if profit has a negative minimum at some price, then it cannot

have a positive maximum at a higher price, since $\epsilon_P d(\cdot, p_n^*, n, 1)$ (in the LHS of (PNNC*)) is decreasing and $\epsilon_y C(d(\cdot, p_n^*, n, 1))$ (in the RHS) is non-increasing, so that (PNNC*) cannot be satisfied at this higher price. ■

Proof of Lemma 2 (Profitability II):

Using equation (2) relating demand to the active firm and demand to the industry, we can compute the elasticity with respect to p_n of the revenue-cost ratio $g(p_n, n)$ defined in Lemma 1:

$$\epsilon_{p_n} g(p_n, n) = 1 + (1 - \epsilon_y C(D(p_n/\alpha(n))/n\alpha(n))) \epsilon_P D(p_n/\alpha(n)). \quad (29)$$

There are two cases. If $\epsilon_P D(P) \in [-1, 0)$ for any $P \in (0, \tilde{P})$, this elasticity is positive by assumption (A1). The function $g(\cdot, n)$ is then increasing, so that the condition $g(p_n, n) \geq 1$ in Lemma 1 can be immediately replaced by the condition $p_n \geq \underline{p}(n)$, with $g(\underline{p}(n), n) = 1$. If $\epsilon_P D(P) < -1$ for some P , the elasticity $\epsilon_{p_n} g(p_n, n)$ may be non-positive. The right-hand side of equation (29) is then non-increasing in p_n , either through the elasticity of the cost function (by assumption (A1)), or through $\epsilon_P D(p_n/\alpha(n))$ (by assumption (A3)). Hence, once non-positive, the elasticity $\epsilon_{p_n} g(p_n, n)$ can never become positive again. In other words, the function $g(\cdot, n)$ is quasi-concave, and the set $\mathcal{P}(n)$ of prices entailing non-negative profits, defined by equation (5), is an interval.

Next, we show that the joint profit $\hat{\Pi}(P, n) \equiv PD(P) - nC(D(P)/n\alpha(n))$, computed under the constraint that every firm produce the same quantity, is increasing at a price $P = p_n^*/\alpha(n)$, such that p_n^* is a critical price. Consider indeed the derivative with respect to P of the joint profit function:

$$\frac{\partial \hat{\Pi}(P, n)}{\partial P} = D(P) \left[1 + \left(\frac{\alpha(n)P - C'(D(P)/n\alpha(n))}{\alpha(n)P} \right) \epsilon_P D(P) \right], \quad (30)$$

and replace $\alpha(n)P$ by p_n^* , using the first order condition (FOC) that defines a critical price:

$$\begin{aligned} \frac{\partial \hat{\Pi}(p_n^*/\alpha(n), n)}{\partial P} &= D(p_n^*/\alpha(n)) \left[1 - \frac{\epsilon_P D(p_n^*/\alpha(n))}{\epsilon_P d(p_n^*, p_n^*, n, 1)} \right] \\ &= D(p_n^*/\alpha(n)) \left[-\frac{\epsilon_{p_n} d(p_n^*, p_n^*, n, 1)}{\epsilon_P d(p_n^*, p_n^*, n, 1)} \right]. \end{aligned} \quad (31)$$

By assumption (A2), this derivative is positive. Also, $\partial \hat{\Pi}(P, n)/\partial P$ becomes negative at zero by assumption (A3), since $\epsilon_P D(P)$ is non-increasing and since $\epsilon_y C'(D(P)/n\alpha(n)) \epsilon_P D(P) < 1$ for any P . Hence, the joint profit function $\hat{\Pi}(\cdot, n)$ is (strictly) quasi-concave, so that $\sup_{P \in (0, \tilde{P})} \hat{\Pi}(P, n) > p_n^*/\alpha(n)$. Also, $\sup_P \hat{\Pi}(P, n)$, unless infinite, must belong to the set $\mathcal{P}(n)$ of prices entailing non-negative profits. In any case, as this set is an interval, $\underline{p}(n) \leq p_n^* < \alpha(n) \sup_P \hat{\Pi}(P, n)$ implies: $p_n^* \in \mathcal{P}(n)$. ■

Proof of Lemma 3 (Sustainability):

As $d(p, \cdot, n, 0)$ is increasing (by assumption (A2)), and $C(y)/y$ decreasing in y (by assumption (A1)), the revenue-cost ratio $G(p, p_n, n)$ is increasing in p_n . By definition of the limit price $\bar{p}(n)$, $G(\hat{p}, \bar{p}(n), n) = 1$ at $\hat{p}$ maximizing $G(\cdot, \bar{p}(n), n)$. Hence, $p_n \leq \bar{p}(n)$ is clearly a necessary condition for sustainability ($G(\hat{p}, p_n, n) > 1$ if $p_n > \bar{p}(n)$). For sufficiency, consider $p_n < \bar{p}(n)$ and $G(p, p_n, n) > 1$ for some p . Then, $G(p, \bar{p}(n), n) > 1$, contradicting the definition of $\bar{p}(n)$. ■

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