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# Chapter 1: Introduction

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## 1.1 Introduction to the subject

Let us begin this unit with a wager: I bet you that, when opening the business section of your local newspaper, you will find the word 'strategy' at least once per page. A Google search of 'strategy' throws up 430,000,000 hits. Narrowing this down to 'business strategy' leaves us with 10,800,000 hits. That's a lot of business strategy! There are a large number of definitions of strategy, and I will not attempt to write my own. There are also entire research fields of 'business strategy' 'corporate strategy' 'strategy content' 'strategy process' 'management strategy' 'competitive strategy' and so on, and I will not get into the fine distinctions between one and the other. Much more, I will try to boil down 'strategy' to what most definitions have in common, and more importantly, I will introduce a number of techniques that will be helpful in formulating, analysing and implementing a strategy.

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## 1.2 Aims of the unit

In this unit, you will not learn 'how-to' recipes of how to react to specific situations. What you will learn is a way of thinking about such situations. In management, as in economics, the right answer to almost any question is 'it depends'. What you will learn in this unit is what the right answer depends on and, given a particular set of circumstances, how you can analyse the situation.

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## 1.3 Learning outcomes

The syllabus for this unit states the specific learning outcomes. Once you have completed the unit and done the essential reading, you should be able to:

- use tools of strategic analysis and game theory to value and analyse strategic options in real life.

In particular, you should be able to:

- anticipate the actions of a rational (that is, individually profit-maximising) rival and act accordingly.

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## 1.4 The structure of the unit

The unit is structured in three parts: first, the basic building blocks of strategic analysis are introduced: game theory, oligopoly competition and market analysis. We will refer back to these chapters often in later chapters, so you are advised to spend a significant amount of time on these and to make sure you have understood the basic principles and techniques of these chapters. The second part introduces specific topics of strategic analysis. These topics will aim to analyse a number of real-life phenomena – for example, why are firms different and in what way? Why are some firms vertically integrated and some are not, and what are the implications of this? The third part of the guide looks at the stages a product goes through from inception to end consumer – that is, entry, research and development, and technology adoption and diffusion. In this last part, we also pay particular attention to industries with network effects. The last part of the guide will be considerably more demanding technically than the second, but by then you should have had enough opportunity to study, revise and practise the

concepts from previous chapters. See part 3 as the ‘icing on the cake’ – after you have looked at many techniques and topics in isolation, these last chapters give you an opportunity to look at some of them in combination.

## 1.5 Use of the guide and hours of study

To help you get the most out of this unit, you will be given a number of examples and activities throughout each chapter. These will vary in difficulty and style. When you read a chapter, try and do these as you go along, and go back to the ones you had problems with the first time round once you have completed the chapter.

At the end of the chapter, you will find a list of questions or exercises designed to challenge you and to check if you have read and understood the chapter. They are titled ‘Sample examination questions’. These precise questions are unlikely to come up, but they should give you a general impression of the level that is required in this unit. If you are studying this text in a group, you might want to consider discussing these questions in a tutorial-style session at the end of each chapter. Guidance on the activities and on answering the sample examination questions can be found in the Virtual Learning Environment (VLE) at <https://my.londonexternal.ac.uk>.

As a further test of your skills, most chapters will have an ‘extended activity’ in a separate section. This is a longer text, case study, interview, quote etc. that illustrates some of the concepts in the chapter, and gives some concrete questions at the end. These activities will test your overall grasp of the chapter and are often not limited to one chapter or one topic.

The advice normally given to external students is that if they are studying one unit over the course of a year, they should allow at least six hours of study every week. Most of the chapters are relatively short compared with regular textbook chapters. Therefore, a chapter should be read all in one go to give you a general idea of what it is about. After that, you should set some time aside to work through the chapter properly. Times will vary for every student and every chapter.

Sample examination questions and extended activities will probably take very little time if you just glance over them and sketch them out in your mind. It is recommended, however, that you write out some of your answers as you may find that a casual thought will not look as convincing if you write them out on paper and you need to have a clear, coherent and logical argument.

## 1.6 Reading advice

### Essential reading

For many chapters, the essential reading is

Cabral, L.M.B. *Introduction to Industrial Organization*. (United States and United Kingdom, MIT Press, 2000) [ISBN 9780262032865].

The chapters in the book will often clarify points and go a little further, but you will find most of the points covered in the subject guide chapter are also covered in Cabral. Reading further often highlights some specific aspects of the chapters or describes some of the research findings explained in the chapter. If you would like to get another perspective on strategy from an economics viewpoint, you should have a look at

Besanko, D., D. Dranove, M. Shanley and S. Shaefer *Economics of Strategy*. (Wiley, 2006) fourth edition [ISBN 9780471679455].

or

Saloner, G., A. Shepard and J. Podolny *Strategic management*. (Wiley, 2006) revised edition [ISBN 9780470009475].

We also refer you to a number of journal articles as essential reading for this unit. To help you read extensively, all External students have free access to the University of London Online library where you will find the full text or an abstract of some of the journal articles listed in this guide. You will need to use the same username and password to access this resource that you are sent to use for the Student Portal. The Online library can be accessed via the Student Portal at <https://my.londonexternal.ac.uk/> For your ease of reference here is a list of all the essential reading for this unit.

## Books

Cabral, L.M.B. *Introduction to Industrial Organization*. (United States and United Kingdom, MIT Press, 2000) [ISBN 9780262032865]

and either

Besanko, D., D. Dranove, M. Shanley and S. Shaefer *Economics of Strategy*. (United States, Wiley, 2006) fourth edition [ISBN 9780471679455].

or

Saloner, G., A. Shepard and J. Podolny *Strategic management*. (Wiley, 2006) revised edition [ISBN 9780470009475].

## Journals

Dierickx, I. and K. Cool 'Asset stock accumulation and sustainability of competitive advantage', *Management Science* 35(12) 1989, pp.1504–1511.

Dyer, J. and H. Singh 'The relational view: co-operative strategy and sources of interorganisational competitive advantage', *Academy of Management Review* 23(4) 1998, pp.660–679.

Haskel, J. and C. Martin 'Capacity and competition: empirical evidence on UK panel data', *Journal of Industrial Economics* 42(1) 1994, pp.23–44.

Lexecon Ltd 'An introduction to quantitative techniques in competition analysis', Lexecon Ltd. publication, mimeo.

[http://www.crai.com/ecp/assets/quantitative\\_techniques.pdf](http://www.crai.com/ecp/assets/quantitative_techniques.pdf)

Swaminathan, A. 'Entry into new market segments in mature industries: endogenous and exogenous segmentation in the US brewing industry', *Strategic Management Journal* 19(4) 1998, pp.389–404.

## Further reading

Further reading is not essential to pass the unit, but if you are more interested in some topics, the further reading should give you a starting point of where to delve deeper. The chapter titles will give you some help with which ones you should read.

For your ease of reference here is a list of all the further reading for this unit.

Angelmar, R. 'Market structure and research intensity in high-technological-opportunity industries', *Journal of Industrial Economics* 34(1) 1985, pp.69–79.

Arora, Alfonso Gambardella 'Complementarities and external linkages: the strategies of large firms in biotechnology', *Journal of Industrial Economics* 38(4) 1990, pp.361–379.

Benkard, L. 'Learning and forgetting: the dynamics of aircraft production', *American Economic Review* 90(4) 2000, pp.1034–1054.

- Bryson, A., R. Gomez and T. Kretschmer *Catching a wave: the adoption of voice and high-commitment workplace practices in Britain, 1984–1998*. CEP discussion paper DP 0676. (London: Centre for Economic Performance, 2005) (<http://cep.lse.ac.uk/pubs/download/>).
- Cabral, L. 'R&D competition when firms choose variance', *Journal of Economics and Management Strategy* 12(1) 2003, pp.139–150.
- Cabral, L. and M. Riordan 'The learning curve, predation, antitrust, and welfare', *Journal of Industrial Economics* 45(2) 1997, pp.155–169.
- Camerer, C. 'Redirecting research in business policy and strategy', *Strategic Management Journal* 6(1) 1985, pp.1–15.
- Church, J. and R. Ware *Industrial Organisation: A Strategic Approach*. (McGraw-Hill, 2000) [ISBN 9780071166454] Chapter 8, Classic Models of Oligopoly
- David, P. 'Clio and the economics of QWERTY', *American Economic Review* 75(2) 1985, pp.332–337.
- Dixit, A. and S. Skeath *Games of strategy*. (Norton & Company, 2004) second edition [ISBN 9780393924992].
- Emmons, W. and R. Prager 'The effects of market structure and ownership on prices and service offerings in the US cable television industry', *Rand Journal of Economics* 28(4) 1997, pp.732–750.
- Farrell, J. and G. Saloner 'Standardization, compatibility, and innovation', *Rand Journal of Economics* 16(1) 1985, pp.70–83.
- Fudenberg, D. and J. Tirole 'Preemption and rent equalization in the adoption of new technology', *Review of Economic Studies* 52(3) 1985, pp.383–402.
- Geroski, P. 'Early warning of new rivals', *Sloan Management Review* 40(3) 1999, pp.107–116.
- Geroski, P. 'Models of technology diffusion', *Research Policy* 29(4–5) 2000, pp.603–625.
- Geroski, P. 'Thinking creatively about markets', *International Journal of Industrial Organisation* 16(6) 1998, pp.677–695.
- Gilbert, R. and D. Newbery 'Preemptive patenting and the persistence of monopoly', *American Economic Review* 72(3) 1982, pp.514–526.
- Griliches, Z. 'Hybrid corn: an exploration in the economics of technological change', *Econometrica* 1957. Reprinted in Z. Griliches (ed.) *Technology, education, and productivity* pp.27–52 (New York: Basil Blackwell, 1988) [ISBN 9780631156147].
- Hamel, G. and C.K. Prahalad 'The core competence of the corporation', *Harvard Business Review* 68(May–June) 1990, pp.79–93.
- Katz, M. and C. Shapiro 'Systems competition and network effects', *Journal of Economic Perspectives* 8(2) 1994, pp.93–115.
- Kay, J. *Foundations of Corporate Success: How Business Strategies Add Value*. (Oxford: Oxford University Press, 1995) [ISBN 9780198289883], Chapters 5–8.
- Klette, T. 'R&D, scope economics, and plant performance', *Rand Journal of Economics* 27(3) 1996, pp.502–522.
- Koski, H and T. Kretschmer 'Survey on competing in network industries: firm strategies, market outcomes and policy implications', *Journal of Industry, Competition and Trade* 4(1) 2004, pp.5–31.
- Kretschmer, T. and P. Puranam *Integration through incentives within differentiated organisations*. Working Paper, 2006 LSE. (<http://www.lse.ac.uk/collections/IIM/pdf/kretschmerIntegrationThroughIncentives.pdf>).
- Leonard, R. 'Reading Cournot, reading Nash'. *Economic Journal*, 104(424) 1994.
- Lieberman, M. 'Market growth, economies of scale, and plant size in the chemical processing industries' *Journal of Industrial Economics*, 36(2) 1987, pp.175–191.

- Monteverde, K. 'Technical dialog as an incentive for vertical integration in the semiconductor industry', *Management Science* 41(10) 1995, pp.1624–1638.
- Ohashi, H. 'The role of network effects in the US VCR market, 1978–86', *Journal of Economics and Management Strategy* 12(4) 2003, pp.447–494.
- Porter, R. 'A study of cartel stability: the Joint Executive Committee, 1880–1886', *Bell Journal of Economics* 14(2) 1983, pp.301–14.
- Postrel, S. 'Competing networks and proprietary standards: the case of quadraphonic sound', *The Journal of Industrial Economics* 39(2) 1990, pp.169–185.
- Saloner, G. 'Modeling, game theory, and strategic management', *Strategic Management Journal* (12) 1991, pp.119–136.
- Shapiro, C. and H. Varian *Information rules*. (HBS Press, 1999) [ISBN 9780875848631] Chapter 7 Networks and Positive Feedback.
- Spence, A. 'The learning curve and competition', *The Bell Journal of Economics* 12(1) 1981, pp.49–70.

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## 1.7 The examination and examination advice

The examination will be a three-hour unseen written examination covering all aspects of the syllabus. In the examination, you will be asked to:

- reproduce some knowledge. (This will get you close to a pass grade, although some application is needed).
- apply knowledge to new situations. (This will lift you to the high lower second, or low upper second marks (assuming you get all the above questions right)) and
- make new connections between topics and/or phenomena. (This will enable you to obtain a first class mark in this unit).

As with most examinations, try to allocate your time approximately proportional to the marks available. If you are having problems with an analytical question that worth very few points, it's best to let that one go and avoid losing time that you could use on another question.

**Important:** the information and advice given in the following section are based on the examination structure used at the time this guide was written. Please note that subject guides may be used for several years. Because of this we strongly advise you to always check both the current *Regulations* for relevant information about the examination, and the current *Examiners' commentaries* where you should be advised of any forthcoming changes. You should also carefully check the rubric/instructions on the paper you actually sit and follow those instructions.

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## 1.8 The syllabus

If taken as part of a BSc Degree the prerequisite units are **02 Introduction to economics** and **05A Mathematics 1**.

You may find it helpful to study unit **28 Managerial economics** or **66 Microeconomics** before registering for this unit.

**Basic game theory.** Two-player games. Static and dynamic games and some examples. Equilibrium concepts and solution mechanisms - Nash equilibrium, dominant/dominated strategies, backward induction.

**Oligopoly competition.** Perfect competition and monopoly. Price competition and the Bertrand paradox. Quantity competition. Reaction functions. Bertrand versus Cournot.

**Analysis of market structure.** Describing market structure: C4-ratio, Herfindahl index, Lerner index and market power. Market definition – techniques and interpretation.

**Collusion.** Cartels and antitrust. Cartel stability and the discount factor. Market dynamics and stability of collusion.

**Strategic alliances.** Portfolio test. Strategic and business partnerships. Sources of complementarity. Resource accumulation. Absorptive capacity.

**Realising intra-firm synergies.** Incentive-setting: Free riding versus cooperation. Interfaces: Modularity, task separation and task similarity.

**Distinctive capabilities and competitive advantage.** Identifying competitive advantage. Sustainability of competitive advantage. Innovation, architecture, strategic assets, reputation. Leveraging distinctive capabilities.

**Strategic asymmetries.** Economies of Scale, sources and consequences. Scope Economies: Airline Hubs. Learning or experience curve. Firm strategies with EoScale/Scope/Learning. First-mover advantages. Market structure with increasing returns.

**Value chain analysis and vertical relations.** Double marginalisation and its remedies. Vertical foreclosure. Retailer competition and investment externalities.

**Vertical integration and transaction cost.** Make or Buy. Contracts. Relation-Specific Assets and Hold-Up. Economic Rents and Quasi-Rents.

**Entry and entry deterrence.** Structural determinants of entry. Entry barriers and exit barriers. Entry deterrence. Identifying entrants.

**Research and Development.** Market structure and R&D intensity. R&D rivalry. Monopolists' and entrants' R&D incentives. Risk choice of R&D. Benefits of the patent system. Sleeping patents. Spillovers.

**Technology adoption.** Preemption games. Option value and future technological generations. Technology diffusion: Heterogeneity, epidemic, and population ecology approaches.

**Network effects.** Direct and indirect network effects. Systems goods. Excess inertia. Excess momentum. Firm strategies with network effects. Standards Battles.

All topics are supplemented in the subject guide with specially written case studies.

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