Better the Devil you Know: A Dynamic Duopoly Model with Switching Costs

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Abstract

I present a duopoly model of two periods in which the consumers are risk-averse and the switching costs derive from the lack of information. In the first period, the quality of firm B is known to be zero whereas the quality of A is a random variable normally distributed with mean larger than zero. When the consumers learn the quality of the product supplied by A, two effects take place: first, the uncertainty disappears and the willingness to pay increases; and second, the true quality is revealed and the willingness to pay reacts consequently (increases for high qualities and decreases for low qualities). When the consumers do not learn the quality in the second period, the uncertainty keeps being penalized. The model predicts that the bargain-then-ripoff pattern of prices can be reversed but not for the two firms simultaneously. Furthermore, the average price in the first period can be larger in the presence of switching costs than in their absence.

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