Does It Pay To Anticipate Competitor Reactions?

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Abstract

Analyzing and anticipating competitor moves has been central to modern competitive strategy. In contexts involving intense interfirm interaction, the value of a particular strategy depends in large part on how competitors will react to it. Despite many developments, anecdotal evidence indicates that the effective use of techniques to gauge decisions based on competitive considerations has been scant in practice. Our paper intends to fill this void. Using data from the auto insurance industry in Brazil, we compare strategies that do and do not anticipate competitor reactions. Basically we show that it does pay to anticipate those reactions. An optimal strategy will explore both demand elasticities and competitors' patterns of reaction. We show that such "strategic" policy is expected to outperform a "myopic" approach which ignores competitor reactions. We also develop a methodology to compute demand elasticities, reaction functions and numerically compute optimal reaction strategies.

Introduction

Analyzing and anticipating competitor moves has been central to modern competitive strategy. In contexts involving intense interfirm interaction, the value of a particular strategy depends in large part on how competitors will react to it. Thus, Porter (1980, p. 72) has proposed the development of a "competitive intelligence system" aimed at "compiling, cataloging, digesting, and communicating" data about competition. A flurry of research attempting to systematize the process of collection and analysis of data from competitors has recently emerged (e.g., Kahaner, 1996; Prescott and Miller, 2002; Warren, 2002). In parallel, several authors have sought to apply game-theoretic concepts to the assessment and prediction of competitor moves (e.g., Brandenburger & Nalebu., 1996; Ghemawat, 1991; Tirole, 1988). Despite those developments, anecdotal evidence indicates that the effective use of techniques to gauge decisions based on competitive considerations has been scant in practice. Bossidy and Charan (2002, p. 192-193), for instance, report the following case:

"...one December I had a call from a CEO of a $5 billion company... One key division was responsible for the company's failure to meet its earnings forecast. The person who was running it [developed a strategy] to gain market share by cutting prices. . . He calculated that his increased volume from cutting prices would lower costs. When the CEO reviewed it, the strategy made sense to him. We went over all this and finally I asked, 'So what did you miss?' By then the CEO had figured it out. 'I did not ask him what the competitors' reactions would be,' he said. The biggest competitor matched the price cuts almost immediately, and the other followed. Prices for the entire industry went down. . . The CEO replaced the division head, and the new man he brought in gradually rolled the prices back up [and] competitors followed the price increases. . ."

This example illustrates that failing to anticipate competitive reactions can severely undermine the value of certain strategies. Thus, firms may be able to improve performance by developing practices to monitor the competition and act accordingly. Several factors, however, may plague firms' ability to effectively benefit from those practices. First, patterns of competitor reaction may be difficult to predict or may change over time. Second, the development and maintenance of competitive intelligence systems may be costly. At the most fundamental