3.2 Vertical Restraints and Interbrand Competition[22]

Competition in international markets is often among multiple manufacturers. Each producer may source a number of suppliers. Here, in addition to the spillover effects across dealers, there may arise spillover effects and strategic behaviour across manufacturers themselves. Three cases can be distinguished. In the first case, the possibility of service spillovers across brands can be tackled by imposing some vertical restraints that enhance efficiency by encouraging the manufacturer to provide services. In the second case, the effects of vertical contracts on interbrand competition are brought out. In the third case, the effects of vertical restraints on the conditions of entry into the manufacturing stage become important.

Stylized Scenario: Opportunistic Retailer-Manufacturer Behaviour

First, there is the problem of free riding across brands by dealers. Consider the following example. Let each manufacturer produce one brand only. Suppose that the manufacturers rely solely on uniform pricing and that one manufacturer engages in heavy advertising that attracts consumers to the dealer. Once consumers have come into the store, the dealer has the incentives to persuade the consumers to purchase whichever brand offers the largest profit margin. That brand need not be the one that conducted the advertising and got the consumers into the store. Free riding across manufacturers may lead to levels of promotional activity below the level consistent with profit maximization. There are several vertical arrangements that can deal with the problem of free riding across manufacturers.

(1) The advertising manufacturer could lower his wholesale price and compensate for this price reduction by increasing a *franchise* fee. If each manufacturer sets his wholesale price equal to his marginal cost, then there would be no distortions in the dealer's incentives. However, a low wholesale price may lead to unprofitably low prices for retailers due to inter-dealer competition.

(2) Under a RPM imposed by all manufacturers, *a resale price floor* could eliminate this problem. But RPM would fail to mitigate the problems of wholesale price reductions by rival manufacturers that undercut the advertising manufacturer, or inefficient risk-bearing by the dealers.

[22] See footnote 9 above.