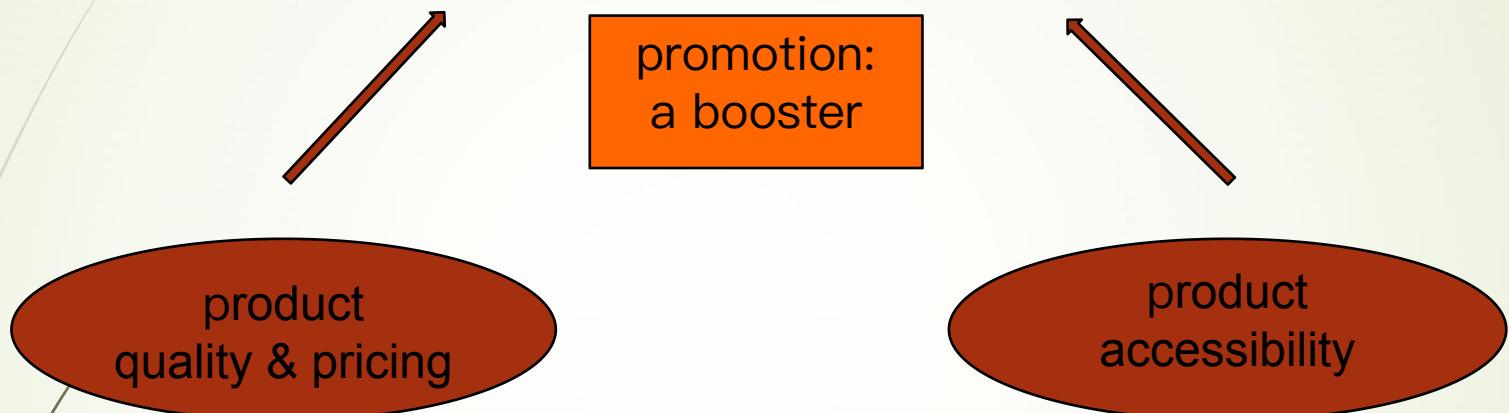


# **Some fundamental economic forces in marketing**

- A profit function of profit margin and sales volume
- Long tail
- Bad money drives out good
- Externality and network effects

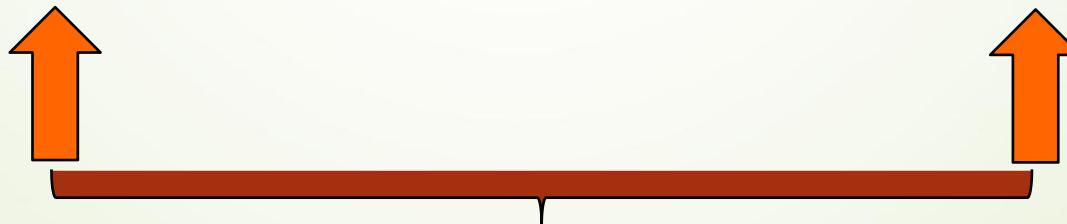
# Let's start with some math

**Profit = Profit margin \* Sales volume**



Low quality and low price for the masses → big sale volume

High quality and premium price for the rich → limited sale volume



**Trade-off:**

which once is more cost effective?

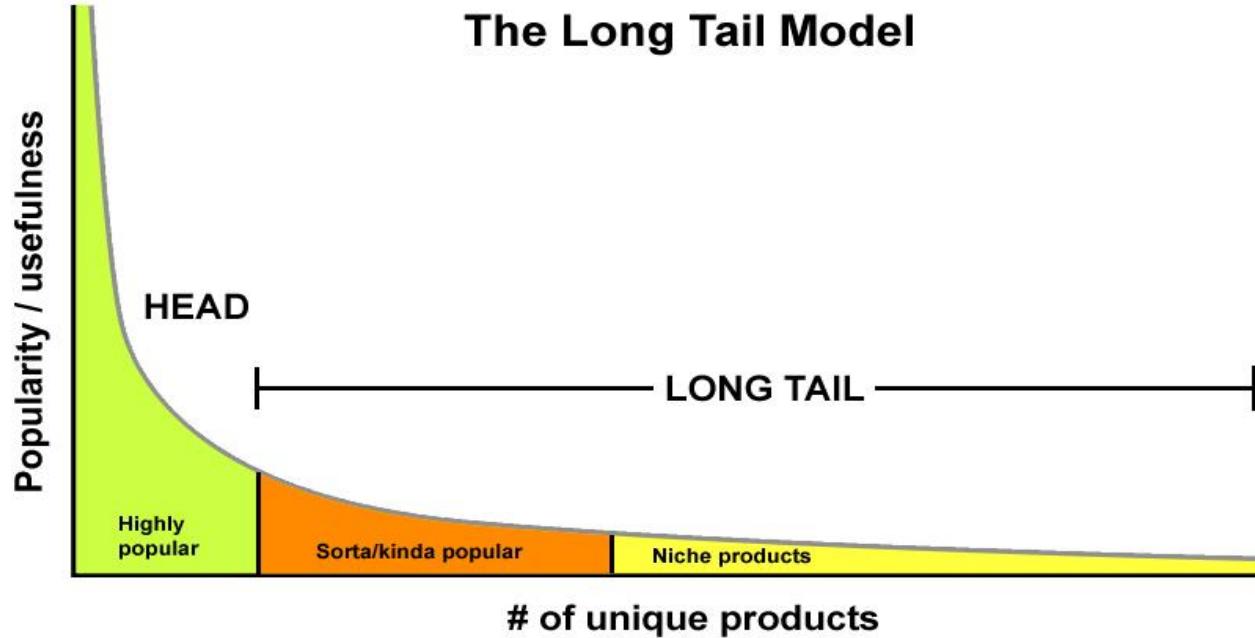
# The Long Tail



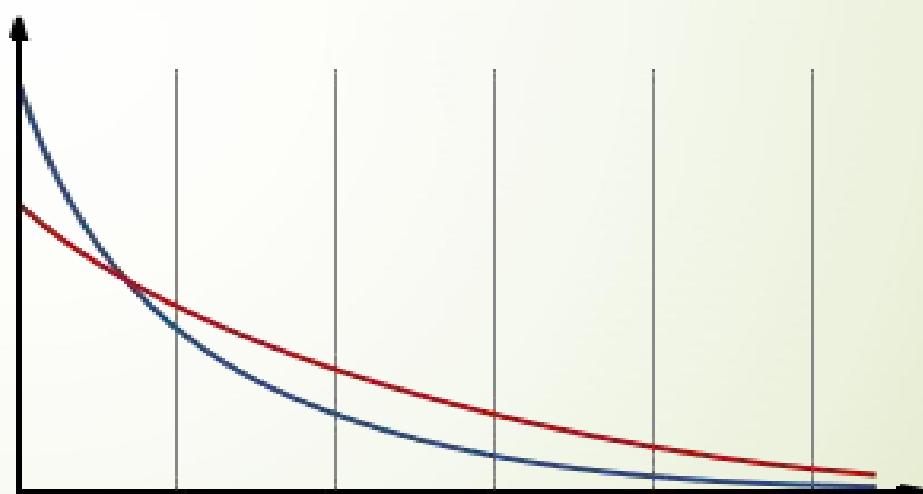
Why the Future of Business  
Is Selling Less of More

CHRIS ANDERSON

"Anderson's insights influence Google's strategic thinking in a profound way.  
READ THIS BRILLIANT AND TIMELY BOOK."  
—ERIC SCHMITT, CEO, GOOGLE



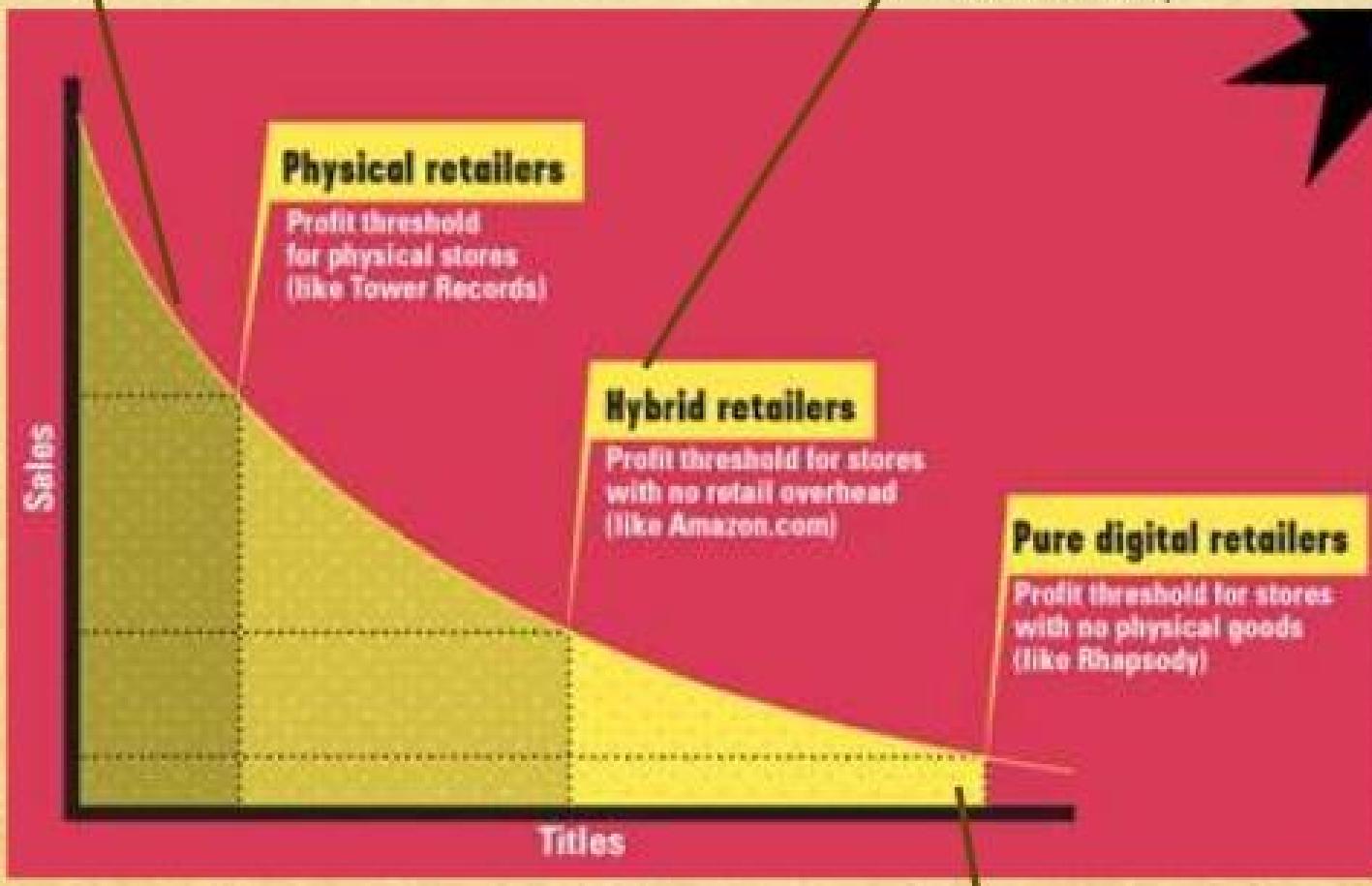
The tail becomes bigger and longer in new markets (depicted in red). In other words, whereas traditional retailers have focused on the area to the left of the chart, online bookstores derive more sales from the area to the right.



In which market is doing business easier?

HMV, Blockbuster (stores)

Amazon (hard copy and digital such as Ebooks or DVDs and Digital Downloads)



Purely online – LoveFilm, Netflix

# "Bad Money Drives Out Good" (Gresham's Law)



**Lemons**  
- worth \$10,000



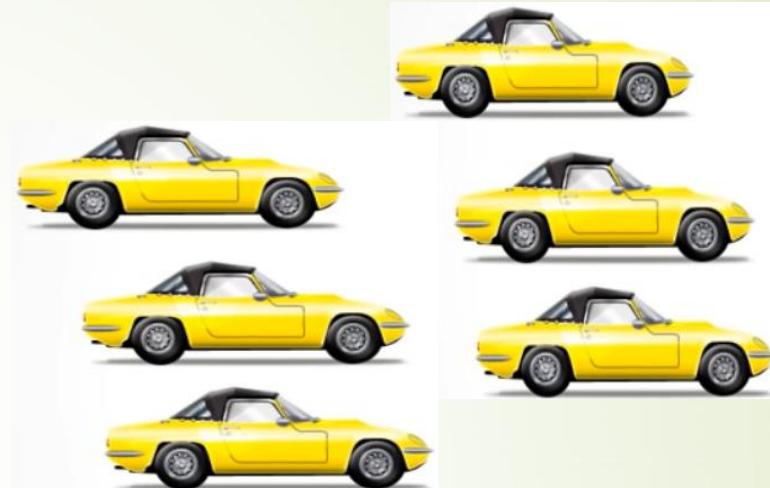
**Good Cars**  
- worth \$15,000

**Information asymmetry**



Which one  
should I buy? I  
can't tell which  
is good or bad.

# "Bad Money Drives Out Good"



Many sellers of Good Cars leave the market and sell only to friends and relatives.

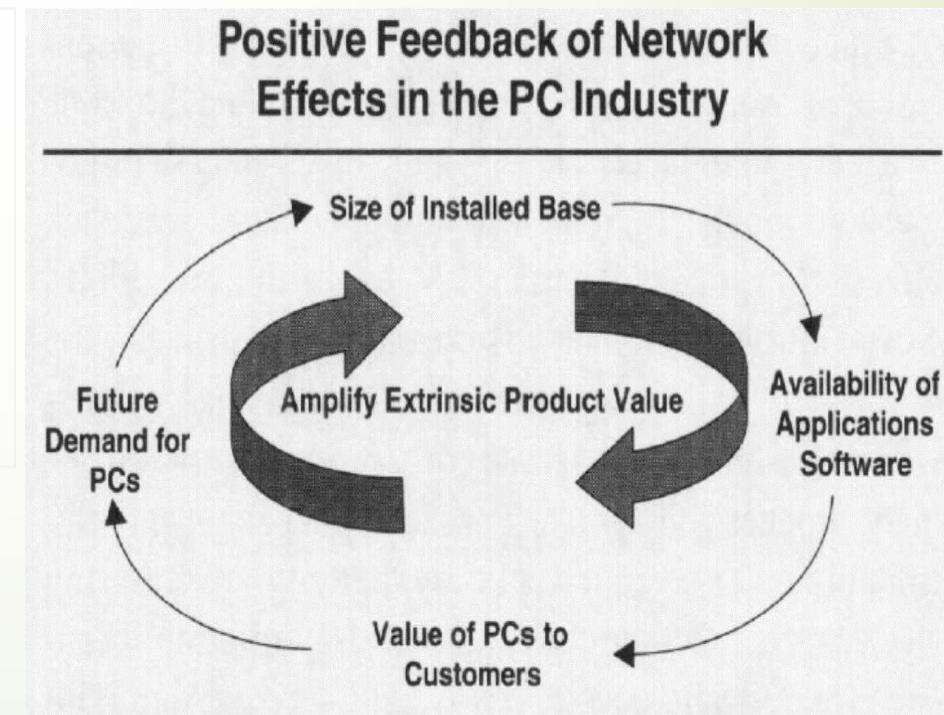
Buyers afraid of buying a lemon drive down the average price for all used cars to \$12,000.

Buyers may not like to pay the avg. price of \$12,500 if they are *risk averse*

## Information Asymmetry

# Externality: Network Effects

- ▶ **Direct network effect** is the increase in utility of a product as the number of users increases (e.g., telephones, fax machines).
- ▶ **Indirect network effect** is the increase in utility of a product as the number of associated accessories to that product increases.



SOURCE: Adapted from Hill (1997).



Coexistence of several network effects:



Direct Network Effects

Indirect Network Effects

Data Network Effects

Product Reviews

Amazon Marketplace

Recommendation System

Can you identify some direct and in-direct network effects that may influence users' choices?

Can you use the notions we just discussed to explain some observations in marketing?

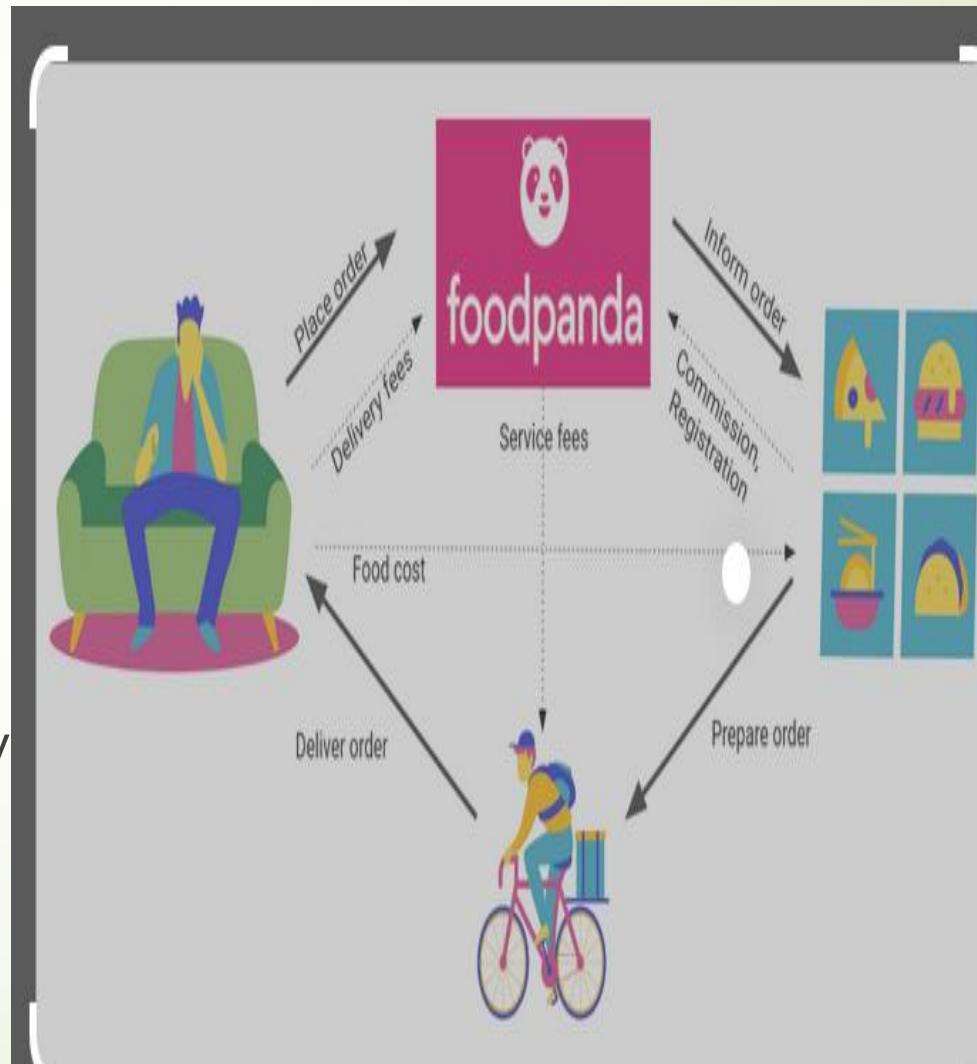
- WhatsApp vs. WeChat
- Free products and versioning, etc.

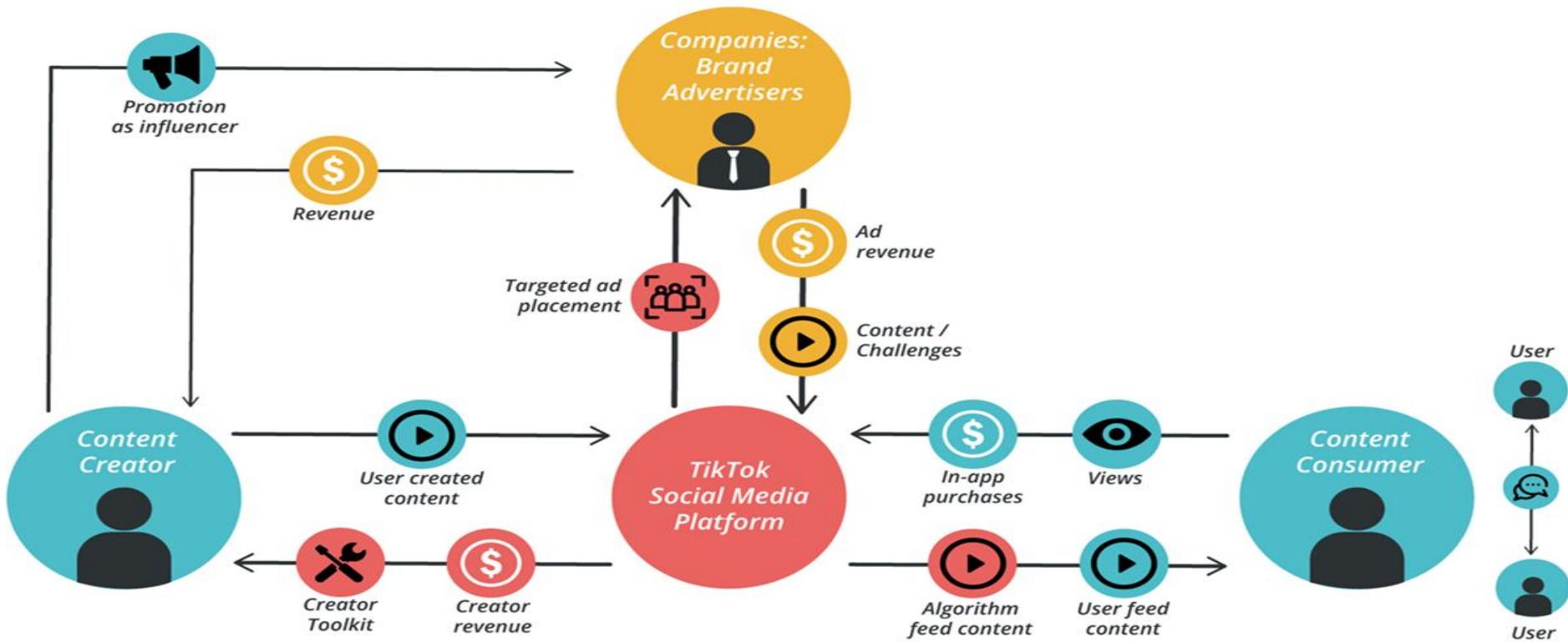


# Two-sided markets

Examples:

- ▶ Matchmaking: match both males and females to date
- ▶ Crowdfunding: attract both campaign creators and backers (buyers & donors)
- ▶ Ride-hailing: drivers and passengers
- ▶ ride- and office-sharing, and other sharing economy





- ▶ Positive cross-side network effects (sequential and simultaneous moves)
- ▶ More competition among participants on the same side
- ▶ Increased heterogeneity in participants' preferences
- ▶ Change in participants' composition
- ▶ Higher cost of matching the two sides
- ▶ Effective matching becomes one of a platform's core competences