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February 6, 2019

Homework #3

1. Are network effects good or bad for innovation? Explain.

Although many critics argue the network effects limits competition, it actually helps foster innovation. The network effect often exhibits the monopolistic tendencies where one big firm dominates all its rivals. This then leads to a positive-feedback loop as the dominant firm attract more users and become even bigger, crushing all its competitors. Thus, this effect limits competition between firms. However, it is important to recognize that the competitors are often firms producing similar services or products, in other words, they are not creating new ideas nor new innovations. Thus, the network effect does not damage innovations. Furthermore, it actually helps foster more innovative ideas as developers need to find ways to innovate within the standard. Instead of trying to outcompete the other, developers can create new and unique services for the dominant firms, often using their innovative ideas to guide them. Similar to the differentiation strategies we learned earlier, facing a dominant firm can motivate smaller organizations to create new services that make them unique. Lastly, the network effect creates a consistent platform for developers. Since the big firm is dominating most of the market, developers can use the firm's platform to bring their ideas into reality. Therefore, the network effect promotes innovation.

2. Identify and describe three strategies that Amazon uses to compete in markets where network effects are present. Hint: you should evaluate the strategies presented in section 5 of chapter 8 and apply them to the case of Amazon.

Alliances and Partnership: Amazon partners with third-party products that are part of the Amazon Marketplace, meaning that Amazon offers products by others along with their own. This creates a two-sided network effect as the sellers (third-party) and buyers expand. Partnering with third-party products allow Amazon to have a long tail of product offerings without having to risk any slow-moving inventory. This gives Amazon a huge advantage as customers can choose from a greater variety and fulfill their demands. Moreover, Amazon still earns money from each sell and collects data with each purchase, giving them valuable information.

Expand by redefining the Market: While Amazon's e-commerce reaches many customers, its new bookstore is targeting university students and book readers to broaden its consumer base. In college campus, Amazon has campus stores with pick-up and drop-off locations for Amazon products. It's website also has information on textbooks for specific classes. This helps students to have easier and faster access to textbooks. Thus, Amazon attracts more customers and broaden its scale.

Subsidize adoption: When the university bookstore just came out, Amazon tried to court students by offering Prime Students, a six-month free membership to Amazon Prime, with the hope to attract more student users. Similarly, Amazon bookstores hope to gain more new Prime members and keep the old ones loyal. Since the store doesn't accept cash payments and do not label prices, customers have to go online to check what each book costs. Prime members can then purchase the book with the lower website price, but those who are not members need to pay the price in full. Thus, Amazon uses giveaways and price reductions to hopefully attract more customers.