Consumer's Enthusiasm and Trade-triggered Short-run Price Increasing Competition of Horizontally Differentiated Goods

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Abstract

What do Hello Kitty, Mickey mouse, Rolling stones, Lady Gaga, Lois Vuitton, and CHANEL have in common? These brands have customers, who show different enthusiasm for their products. Some fans literally live in a Hello Kitty world and their rooms are covered with Hello Kitty from floor to ceiling, while other fans are satisfied with just one plush. Such a link between a consumer's enthusiasm and his/her consumption has been paid little attention in existing studies. Most existing studies on differentiated goods put a unit-demand assumption, where every consumer buys no more than one unit of a differentiated good regardless of his/her enthusiastic level, and therefore, the difference in consumers' enthusiastic levels has no effect on their consumption. In these existing studies, effects of trade liberalization on horizontally differentiated goods have been discussed since Lancaster (1966,1975) and Chamberlain (1933) created theoretical models to analyze differentiated goods. Although models used in these existing studies are different, the heterogeneity of consumers' enthusiasm levels has been ignored, and the same non-surprising conclusion has been reached: trade liberalization spurs competition among horizontally differentiated goods, and therefore their prices will have no chance to increase either in the short-run or in the long-run. However, it is the combination of the unit-demand assumption and homogeneity of consumers' enthusiasm levels that derives the result. This paper relaxes these assumptions and allows consumers to buy different amount of goods depending on their enthusiastic levels. Specifically, this paper incorporates the heterogeneity of consumer enthusiasm for differentiated goods into the Helpman model (1981), a well-known the Lancaster's ideal-variety approach model and shows that trade liberalization can lead to a price-increasing competition at least in the short-run. That can happen because the trade liberalization not only increases the number of rival goods but also changes the composition of consumers each firm sell its product to. On one hand, the trade liberalization allows foreign rival goods flow in the domestic market, which spurs the competition and puts downward pressures on price. On the other hand, the trade liberalization makes each firm sell its product to narrower range of consumers, who show more enthusiastic support for its product and less price elastic, which can give firms a chance to increase their prices. This paper is not the first paper to predict the price-increasing competition after the trade liberalization. Chen and Riordan (2008) derive conditions that the competition does increase price in their unique model with special model settings. The contribution of this paper is to show that the price-increasing competition will be the result in a more general model setting.

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