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Monopolistic Competition when Income Matters (With F. Etro)

Abstract:

We study monopolistic competition with preferences over differentiated goods characterized by a separable indirect utility rather than a separable direct utility as in the Dixit-Stiglitz model, with the CES case as the only common ground. Examples include linear and log-linear direct demands. In equilibrium with free entry, an increase of the number of consumers is neutral on prices, but increases proportionally the number of firms, just creating pure gains from variety. Contrary to the Dixit-Stiglitz model, an increase in consumer income increases prices and more than proportionally the number of varieties if and only if the price elasticity of demand is increasing. We also discuss extensions to an outside good, heterogeneous consumers, heterogeneous firms à la Melitz and endogenous quality. Finally, we provide an application to international trade generating pricing to market in a generalized Krugman model.

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