

3-3: Product Differentiation

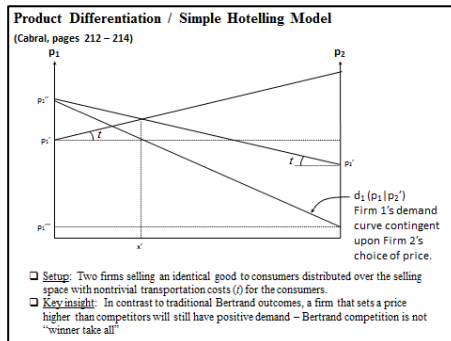
Cabral's chapter 12 provides two explanations for Bertrand competition with positive economic profits:

1. Product differentiation
2. Search or Switching costs

Product differentiation:

To model the effects of product differentiation, we employ a simple Hotelling model of spatial differentiation with consumer transportation costs (see Cabral, pages 212 – 214). The basic conclusions include:

- With differentiation, each firm faces a downward sloping demand curve that is, in part, determined by the competing firm's price.
- A firm that sets a price higher than its competitor still has positive demand.



Product positioning:

An extension of the Hotelling spatial differentiation model: Product positioning.

Think of product positioning as the first stage of a two stage game: In stage 1, firms select their "position"; in stage 2, firms set price.

Product Differentiation / Product Positioning

- Direct effects – leads firms to position themselves close to competitors.
- Strategic effects – leads firms to differentiate.

} Difficult to predict relative strength of these effects.

If price competition is intense, then firms tend to locate far apart (high degree of differentiation). If price competition is not intense, then firms tend to locate close to the center (low degree of differentiation).

Search or Switching costs:

If there are nontrivial costs for the consumer associated with switching from one supplier to another, price will tend to exceed marginal cost. The greater the value of search or switching costs, the greater the degree of monopoly power.

Relevant exercises: Problem Set 3, exercise 6.