Reading:
"*Monopolistic Competition and Optimum Product Diversity*"
by A. Dixit and J. Stiglitz
in AER (1977)
...a workhorse for economics

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Setting

- From J. Tirole (1988):

    Monopolistic competition was introduced by Chamberlin (1933) to formalize the following industry configuration:
    1. A quite large number N of firms,
    2. Each firm faces a downward-sloping demand
    3. A price charged by a firm has only a negligible effect on the demand addressed to other firms (namely: absence of cross-effects).

Definition of the problem

In the standard framework there has been a conventional wisdom according to which monopolistic competition yields too many firms (from a social viewpoint) or the existing firms produce too little to exploit the economies of scale.

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- In equilibrium, we experience a situation in which we tend to include too few products.

- Business stealing: by introducing a new product, a firm steals consumers from other firms. Then, firms that have positive profits loose income from these diverted consumers. Therefore, firms may tend to produce (and introduce) too many products.

Consequences

This contribution had an extremely huge impact on the economic scenario because:

- It impulsed the new trade theory
- It has been the principal theoretical foundation of the modern economic geography
- It has been the foundation of all macro models that not follow the perfect competitive setting (namely, when one needs to model the love for variety).

Complementary issue

- The original version of the model was formalized for a continous setting. This is the proper setting to consider the negligible effect issues....

- Referee reports in AER imposed a change into the descrite setting.

- The authors introduced the device of *the extreme large number of firms N* to meet those requirements.

- However, the continuous version has been retrieved in more recent times

......however, some signal relating to the previous continuous version are still there.....

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- "[....] This is where potential commodities in a group or sector or industry are good substitutes among themselves, but poor substitutes for all the other commodities in the economy." $\implies$ **CLEAR OBJECTIVE.**

Focusing on the

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- "[...] We also assume that all commodities have unit income elasticities. This differ from a similar recent formulation by Michael Spence.[...]" $\implies$ **COMPARISON WITH OTHER THEORIES.**

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Working on Section 1

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- NO: this result has not be explicitely considered in any further study....

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- A clear results for the dichotomy free-entry/number of firms is stated.

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- Asymmetric case: this setting *inspires* the principal building blocks of the two-region framework by Krugman (in the idea of the additionality in firm components.