Worksheet 2.1

Luxury goods: the biggest rip off in the world or the 'must have items' for any self-respecting European?

Unit 1 in IB begins by examining the interaction of supply and demand in product markets, and the importance of these factors in determining the equilibrium price in any particular product market.

In this article from the NY times – 'The Devil Sells Prada' the author reviews a book that exposes the diminished quality and attention to detail among manufacturers of luxury goods (think Prada, Gucci, etc...) The era of globalization and off-shoring of manufacturing has aided luxury firms in their quest for profits, as they've been able to significantly cut costs while maintaining exorbitant prices for their product.

The author takes issue with the alleged demise in the luxury market of attention to detail and craftsmanship, as competition and profit seeking behavior have led to an industry where the back alley workshops of Milan and Paris have been replaced by the factory floors of China and Vietnam. Free trade has allowed European luxury brands to produce more of their products at lower costs, which leads the author to her current question: 'Why is this stuff still so expensive even as the cost of producing it goes down?'

Despite her accusations of poor quality and greedy, profit seeking managers in the luxury goods industry, the author seem unable to resist the luxury goods she claims to despise: read from 'When, I asked myself...' to the end of paragraph 1 and then paragraph 3.

It appears that the author never took an introductory economics course. If she had, she would clearly understand that price is not determined by the level of craftsmanship, the attention to detail, nor the level of exclusivity represented by a particular purse, shoe or dress. Rather, price is determined by the interaction of ***Demand*** *and* ***Supply*** in the market for all goods, *even* luxury goods!

When she claims that 'the merchants who served this pampered class aimed chiefly "to produce the finest products possible"', the reviewer is forgetting some of the basic teachings of capitalism's founding father. Adam Smith himself could have corrected the NYT reviewer when he said 'Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer,' *Source: Adam Smith The Wealth of Nations.*

Smith knew, as any economics student should, that exchanges in any market happen not because of a mutual appreciation for craftsmanship or artistry, rather because a producer (firm) wants to make a profit by charging as high a price as possible to a consumer (household). In the case of luxury goods, Gucci and Prada never made high quality goods because they *loved* making high quality goods, rather they made them cause consumers *demanded* them and were willing to pay top dollar for them.

What the author is missing is a basic understanding of the ***determinants of demand***. The price a good commands in the market has little to do with how much it cost to produce or where it was produced, and everything to do with the level of demand relative to the level of supply.

Discussion questions:

1. Why do Prada, Gucci, Cartier and other luxury brands command such high prices relative to cheaper substitutes widely available to consumers?
2. As nothing else changes and the price of luxury goods goes up, how is demand affected? Explain.
3. What are some of the determinants of demand that have kept the price of luxury brand goods high even as the costs of production have been reduced due to cheap overseas manufacturing?