Demand Elasticity, Demand Spillovers and Industrialization

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This paper expands Murphy-Shleifer-Vishny model by taking demand elasticity into consideration.

I found that when demand is price-elastic, monopolistic industrial firms will charge monopolistic price lower than competitive cottage production price, and industrialization begin to bring about two counteractive demand spillovers. One is through the effect on aggregate market price; the other is through the effect on aggregate demand. When an individual firm chooses to invest in industrialization, on one hand, it will decrease the aggregate market price and hence the demands of other individual sectors, which is a negative demand spillover that have been neglected until now. On the other hand, since the industrialized sector has positive profit (which is the condition of industrialization), it will also increase aggregate demand and the demand and profit of each industrial sector. It is a positive demand spillover, which is the key point in Murphy-Shleifer-Vishny model. Moreover, when the negative spillovers outweighs the positive one, with improvement of industrialization, industrial firm's profit will decrease, which implies a net negative demand spillover of industrialization. If industrialization profit decreases to zero before all sectors have industrialized, partial industrialization equilibrium will arise which well explained the phenomenon of the pervasive coexistence of cottage and industrialized plants in developing country can be well explained.