

PSST. WANNA REAL ROLEX?

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In the Thieves Market you encounter more choices

ABSTRACT. The common perception is that counterfeit products lower the value of the “real thing.” Here I show that this is not true. They do lower the volume of sales of the real thing (hurting the manufacturer), but the remaining real things are worth more.

The Economist tells an interesting story of how real (and expensive) Omega and Rolex watches are selling well in China, acknowledged to be a center of counterfeit production and lax property laws (?). This is curious, since the conventional wisdom is that counterfeits lower the value of the targeted watch. Let’s examine this idea more closely.

1. PRODUCTION

A Rolex costs a lot to make. There are the fixed costs of sponsoring athletes and artists, advertising that fact, and other forms of running a business. Then, there is the labor of making the actual product. Let’s assume that this marginal cost is constant. We then get a cost function that looks like Figure 1.

We can see that a drop in production from the entry of Seiko (a competitor in quality) and counterfeits (a competitor in exclusivity) has lowered demand (next section) and therefore production; thus, average cost is higher.

2. DEMAND

But how do the buyers react to the entry of Seiko and counterfeits? The bottom of the market drops off demand—seekers of performance and status can get it cheaper; the remaining demand comes from those who *really* value Rolex. Rolex, as a price-discriminating monopolist, can charge them more (See Figure 2). So price rises (first effect, pretty clear), but does the value of a Rolex rise or fall in the presence of counterfeits that distort the signal of conspicuous consumption sent by a Rolex?

3. CONSPICUOUS CONSUMPTION

The easy answer is that substitutes for Rolex watches reduce demand. But what if counterfeits are complements? This would imply that makers of both real and fake watches benefit from increases in the prices of their rivals—not such a surprise if you

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After a few beers with two professors who didn’t agree, I had to write something down.

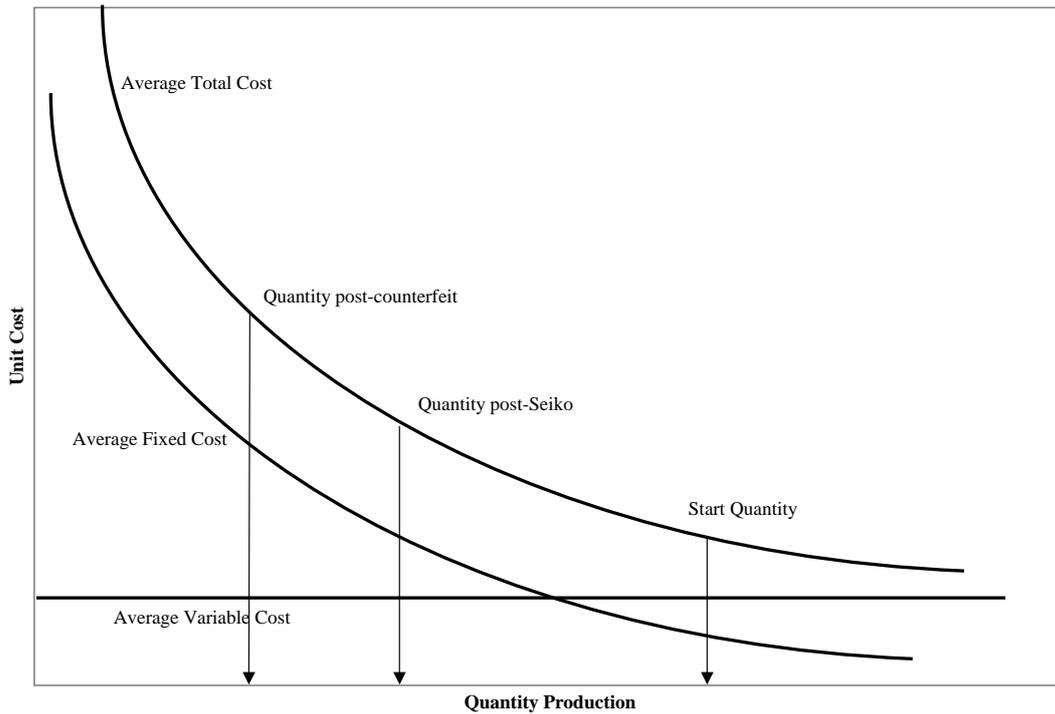


FIGURE 1. We can see that fixed costs, combined with constant marginal cost results in a decreasing average cost. The result of entry by Seiko and counterfeits is an increase in average total cost, to the loss of Rolex if the price per unit does not rise even more. If the price does not rise, then Rolex is determined to stop counterfeiting.

realize that fakes (at least) count on the real things to keep their market alive. Let's look at whether or not real Rolexes benefit from the existence of fakes.

Assume that everyone knows a real from a fake (not by appearance, by psychic powers!). *ceteris paribus*, it is clear that the buyer of a Rolex has spare money, since the performance or brand can be had for less. Relax that idea and assume that people have to be TOLD that the Rolex is real, again—the message is clear (assume no lying). This second case is the most interesting one, since the goal of conspicuous consumption is to affect how people treat you. People who you never interact with or do so only once are uninteresting (is the popcorn guy going to give you extra butter because you have a \$5,000 watch?). The people you want to affect are those who ask: “Is that real?” and then give you the “wow” that you’ve been waiting for. This creates the common knowledge that you have money to burn and that they know you do and so on. You had the option of getting a fake to impress the hoi-polloi; you had the option of getting a Patek Philippe to impress the cognoscenti, you had the option of getting a Seiko, to have the reliability. You bypassed all of them to get something that people have a hard time believing in, but did so anyway, because,

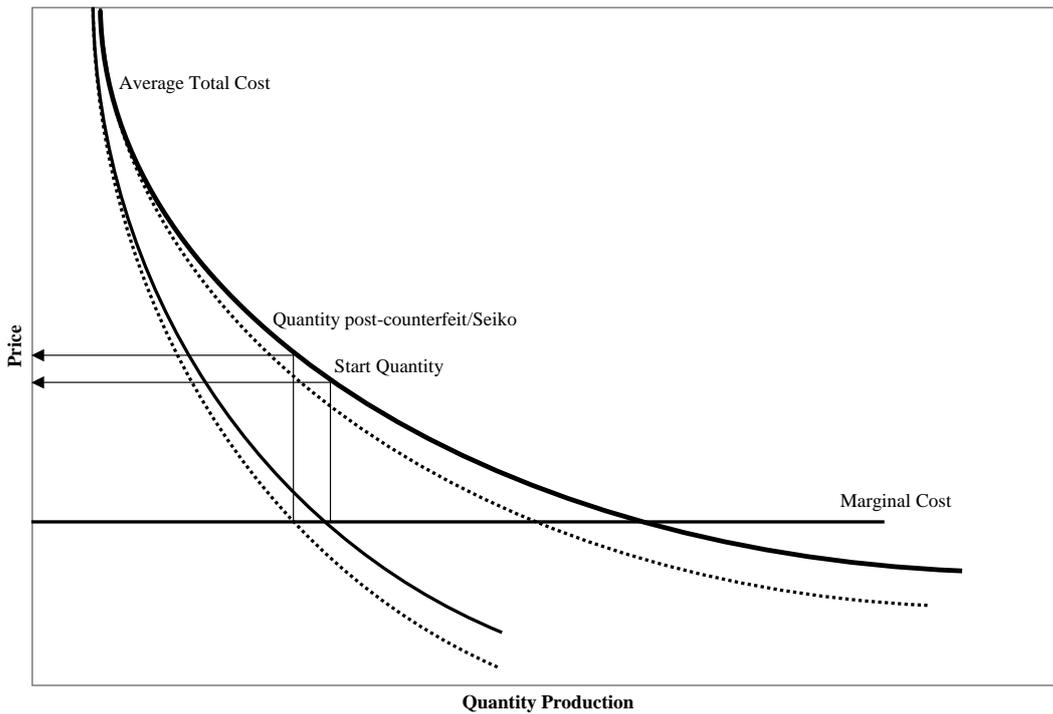


FIGURE 2. On the contrary for the buyers of Rolex watches. Since the Seiko and counterfeit demanders of either performance or brand-name have exited the market, demand has slipped slightly inward (the bottom has fallen out of the market, but high-value demanders are hardly affected.) This means that Rolex can more effectively price-discriminate against the buyers of Rolex watches who are definitely interested in the Rolex, since they have bypassed the alternatives. The result is that the average Rolex can sell for more.

image, exclusivity and performance matter less than having the real Rolex, money be damned. Man—can you burn money! Mission accomplished.