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The elasticity of demand in the luxury market and Gucci's case study

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Academic Year 2018/2019

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INTRODUCTION

The luxury goods and the luxury market

"A necessity that begins when the need ends" [1]

What is luxury? Luxury is research, experimentation, the chance to experience new routes and to find new and not predictable solutions.

In the recent years, the concept of luxury has expanded from materialism to time and passion, and it becomes eventually more available. *"The materialistic view of happiness of our age starkly revealed in our understanding of the word luxury"*. [2]

Today, the demand for luxury goods increases gradually since the individuals can acquire more revenue and enjoy more consumption opportunities, as a result of the new conditions of the modern era. In fact the luxury market has reached € 920 billions in 2018 with an annual expected growth rate of 5% until 2025.[3] Chinese and Millennials are those who drive the luxury growth (they represent the 30% of spending in the luxury market), which is expected to increase up to 50% in 2024.[4]

Luxury products are not necessary ones, but they tend to make life more pleasant for the consumer. In contrast with necessity goods, luxury goods are typically more costly and are often bought by individuals that have a higher disposable income or greater accumulated wealth than the average. In fact the same good can be perceived differently by divergent people based on distinct variables, such as: utility, cultural aspect, level of disposable income, personal motivational drives and lifestyle.

Pam Danziger, a famous expert of consumer behavior in the luxury sector, says:*"Luxury has nothing to do with money, it has to do with meaning. Luxury is anything you think it is a mink coat, a dinner on the town*

[1] Coco, C. [online] quotes. Available at: <img src="//www.azquotes.com/picture-quotes/quote-luxury-is-a-necessity-that-begins-where-necessity-ends-coco-chanel-84-96-43.jpg" alt="Luxury is a necessity that begins where necessity ends - Coco Chanel">

[2] The Botton, A. [online] quotes. Available at: http://www.alaindebotton.com

[3] Altagamma consensus update. (June 2019)

[4] Pianon, N. BCG (managing director)

or a walk in the park and your perspective on it varies according to your life stage, income level…all sorts of other things. It's all about where your passion lies rather than the amount of money you have to spend". [5]

It would seem, therefore, that luxury goods are products neither linked to basic needs nor to essential needs for survival, but rather to self-esteem and self-realization.

This paper is going to analyse how luxury goods affect the overall market demand, through the implementation of online and offline strategies, based on the perceptions deriving from the market.

There are two trends that characterize the strategies of luxury brands: the process of digitalisation of the sector and the emotional aspect of the purchase. Before identifying on which segment of the market to operate and on which consumer target to focus, it is essential to investigate the determining motivations, the perception of value, understanding which key attributes leverage reflect the qualitative expectations of the demand and which elements characterize each segment. In particular the first chapter describes all the different types of economic goods existing in the market and how the behavioural theory affects the purchase of luxury goods with the purpose of responding to new needs, even reaching original ones. In fact the Engel Curve identifies the relationship between real consumer expenditure and disposable income, that influence consumers actions in the purchase of luxury goods.

Industry and the luxury market are evolving from the traditional ostentatious consumption model to new *"experiential"* purchasing methods, reaching the *"mass"*. The products once considered pertinent to a narrow niche, today are consumed by various members of different social classes, although not endowed with an excessive knowledge of the sector or purchasing capacity.

In order to better understand the concept of luxury goods purchased by the *"growing"* society, one cannot ignore its economic and temporal contextualization, that represent the essence of a mordern and evolved luxury industry, from a macro economic point of view. Indeed the second chapter gives a global view of the market demand for luxury goods, comparing different states in different time periods. We must not overlook the fact that today the market is a highly dynamic and changeable one, heterogeneous from a cultural-geographical point of view; on the contrary it includes common elements. In particular, it is important to undertake an analysis of the aggregate demand for luxury goods, how it reacts to the changes in different variables, such as the disposable income, and finally giving an explanation of the different types of elasticities that affect the aggregate demand.

[5] Danzinger, P. (2004). Why people buy things they don't need. *Dearborn Trade*

The market knowledge, on the part of companies, is used as a source of gaining competitive advantage. As a matter of fact the third chapter defines Gucci's elasticity of demand and how it drives the company towards achieving a successful position in the competitive luxury market.

Luxury goods tend to have a positive correlation between income and consumption expenditure. In fact luxury goods have a positive elasticity of demand, as demand increases more than proportionally as income rises, resulting in a high overall cunsumer spending.

On the contrary, Gucci's company faces a negative elasticity of demand, due to the high economies of scale.

For this reason, this thesis states that Gucci's inelasticity of demand represents the key attribute that drove the company towards achieving the most profitable revenues during the last years, lowering its cost of production, maintaining the prices fixed. Enforcing an outsourcing strategy management, breaking down the production value chain and transfering portions of work to outsiders, Gucci has been awarded as *"The brend of the year"* under its CEO Marco Bizzarri.

Luxury goods may behave as inferior goods, like Gucci's case. When a decrease in prices causes a decrease in profits, this means that the demand becomes inelastic ($\varepsilon < 0$). What this thesis is going to demonstrate is that usually luxury goods have a positive elasticity of demand, apart from Gucci. In order to clarify this concept, it is important to evaluate Gucci's management strategy. By this analysis one can conclude that if the price of Gucci's products (i.e. shoes) rises, the quantity falls proportionatelly less, while the total expenditure rises, increasing its profits. Therefore Gucci's inelasticity of demand depends on its price change. Adopting an increase in prices, Gucci represents the *"driver"* of the luxury economy.

Ultimately, the luxury fashion sector does not allow to identify a profile of the typical consumer nor the reasons that lead to the purchase. In undertaking Gucci's strategic profile, it will be useful to consider all the different actions implemented by the company, including marketing segmentation, that helped Gucci to gain a competitive advantage in the global luxury market.

THE ECONOMIC ASSETS

By definition everything that is attributable to quality and value is a good.

In ethics, good refers to the sphere of morality, of individual and social behavior.

In law, the assets are defined as *"things that can be the object of rights"*[5]*;* the subsequent articles contain a specific discipline for legal assets which, in turn, are divided into various categories: movable and immovable, tangible and intangible, public and private, generic and specific, fungible and unreachable to list the fundamental ones.

In economics, an asset is considered economic when it has the following requirements: scarcity, that is, an asset available in nature in limited quantities compared to the needs; utility, an asset suitable for satisfying a specific need; accessibility, in order to take possession of the asset both from a physical and an economic point of view.

Only accessible goods can satisfy a man's need and be the object of exchange in the market, the place where the meeting between the demand and the supply of an asset takes place.

INFERIOR, NORMAL AND LUXURY GOODS

Inferior goods

Inferior goods are economic assets whose demand is reduced with increasing consumer income.

What characterizes an inferior good is the very low price and the much lower quality compared to other goods.

Income growth allows the consumer to change their choices and buy substitutes of superior quality.

[5] Art. 810 c.c

An example of an inferior good is potatoes compared to meat; as income increases, the consumer will prefer higher quality and more expensive food products, such as meat which will replace cheap food products, such as potatoes. Another example of an inferior good is a shack as opposed to a more expensive apartments.

The very low income individuals find that they have to opt for the shacks, as dwellings for shelter, but as income increases, the consumer will leave the shack and replace it with an apartment, of superior quality and cost.

In case of inferior goods, the demand curve is negatively related to income or has a negative elasticity, as it will be discussed later.

A particular type of inferior good is the *Giffen good*, whose consumption increases with the increase in price, causing a paradoxical effect as it clearly contradicts the traditional law of demand, according to which an increase in the price of a good, with the same income, produces a reduction in the quantity demanded; in this case the demand curve will be positively related to income, as will be explained below.

It is, as mentioned, a paradox, a peculiar case that concerns a particular type of inferior goods. It constitutes a negligible share of the total expenditure of an individual. It concerns the not substitutable goods, which are considered as indispensable goods to cover the minimum food requirements of some social classes, that have a very limited income. In England, during 19^{th} century, an English economist had come to these considerations starting from the observation of the behavior of the poorer classes with very limited income.

He had noticed that every increase in the price of bread (irreplaceable vital good) caused an increase in the demand by the lower classes for the same good.

This was due to the fact that an increase in the price of bread, with the same income, had such an harsh effect on the poorest workers, in such a way that the latter was forced to renounce to the purchase of the most expensive food products (for example: meat, fruit and cereals). With the amount saved, the poorest workers could move towards greater consumption of bread despite of the increase in its price.

Normal goods

A normal good (for example, fish), is considered so when the consumption income curve has a positive slope, demand increases with income and the elasticity of demand is positive.

Luxury goods

The term luxury comes from the Latin *luxus,* which indicates overabundance, excess. When we speak of luxury therefore we are referring to something superfluous, unnecessary, which goes beyond what is sufficient or in some way adequate to the normal needs of life. If we consider the excess, of an unessential purchase, it follows that a luxury item in itself represents a display of wealth, of pomp, of magnificence combined with the desire for its possession.

Luxury goods are transversal goods, which belong to various product categories and come from different sectors.

Culturally, a luxury item is subject to changes over time, thus a so called luxury good, in a certain historical period, may not be so in the future and vice versa.

In general, the luxury market communicates an elegant and a refined quality of being and living, which affects various moments in the daily life. The traditional luxury sector (clothing, jewelry, art and cars) is linked to most wide emerging sectors (travel, starred restaurants, exclusive events) that are connected to the experience and the emotional sphere.

Thus, to the traditional luxury consumers who look to be ostentatious (the elderly), add the younger's interest in the unique and rewarding experience (millenials). In this way the luxury good is perceived by the consumer as an object capable of transmitting emotions, such as the amount of money spent to covet their possession.

The intrinsic characteristics of a luxury good are:

- Uniqueness / rarity: it is a crucial characteristic that regards both the demand and the supply side. The uniqueness is given by the quality of the raw materials used and by the peculiar skills required in its production;
- Scarcity: the same reasons that make a luxury item unique determine its scarcity in the market, in fact it does not identify products linked to mass production and consumption;
- High quality: it is found in the exclusivity of the materials used and in the care of production processes. Excellent quality is a guarantee of durability and reliability and it conveys confidence to the consumer;
- Innovative design: luxury goods must convey emotions, strike the senses, be considered as a work of art;

- Elevated price: it is certainly motivated by the high quality, by the perception of the "eternal" character of a luxury good, but surely it is not strictly correlated to the real production costs, but must restrict the context of the subjects who can afford such products.

Analyzing the consumer's behavior in consideration of disposable income and the quantity of luxury goods purchased, it is obvious that luxury goods show a peculiar trend: as the disposable income increases, the purchase of luxury goods increases more than proportionally, creating a potential market which is greater than the one created on equal terms by normal goods and inferior goods.

Based on the different categories of goods: normal goods, luxury goods and inferior goods, it is possible to take a deeper economic analysis regarding their consumption.

THE ENGEL CURVE

In particular the *Engel Curve*, describes how the real expenditure of goods & services varies according to the disposable income. It puts two variables into play: the budget share (portion of household income spent for the purchase of goods & services) and the income itself.

The different shapes of the Engel Curve depend on the consumer preferences and on the demographic constraints. It reflects its income elasticity and it defines whether a good can be classified as: normal, inferior or luxury.

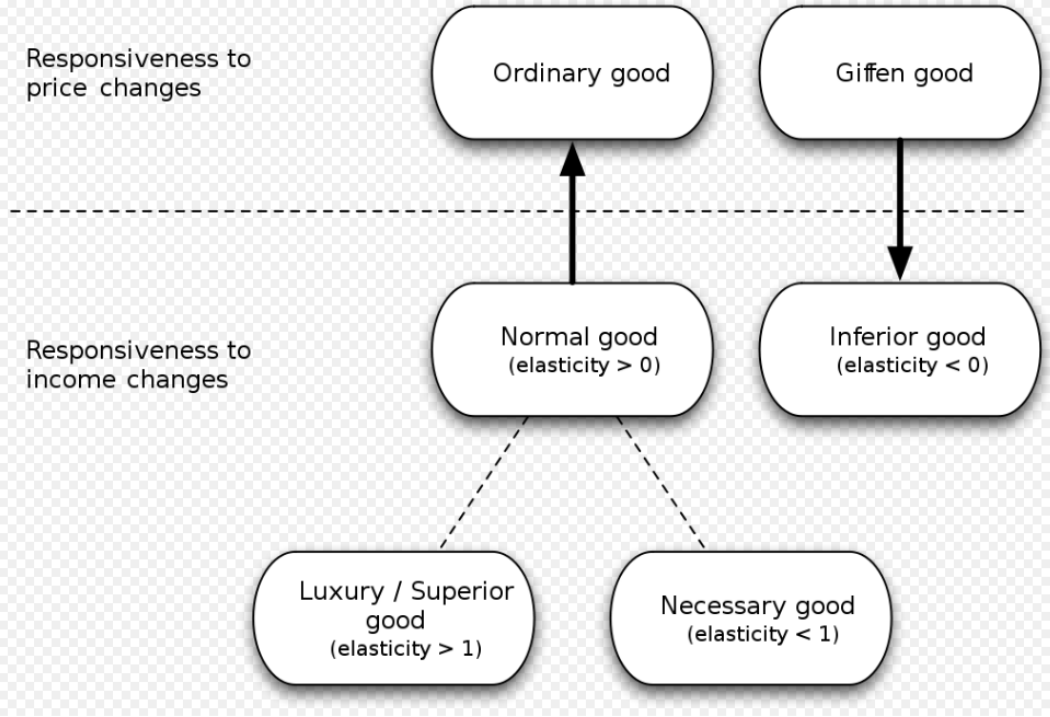


TABLE 1: Types of goods in economics-SOURCE: Mr. Fabs (2009). Available [online] at: https://www.youtube.com/watch?v=0lSc1iNwcGc

A normal good is an ordinary good one that reflects a rise in its demand, as a result of an increase in the consumers' income. Therefore a change in the consumer's income affects the direction of the consumer's demand function for good x, so that they will move in parallel.

$$Y = p_1 x_1 + p_2 x_2$$

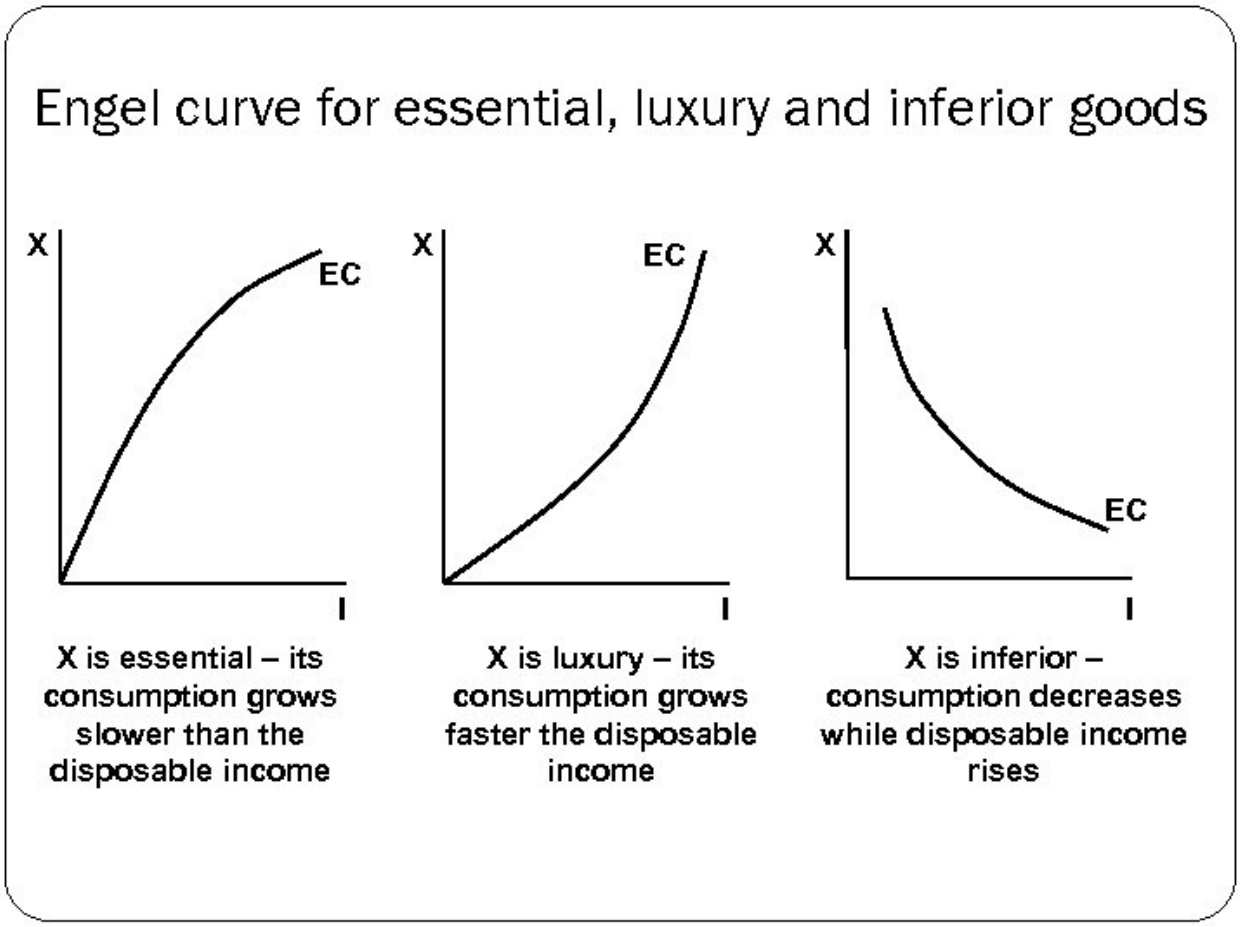


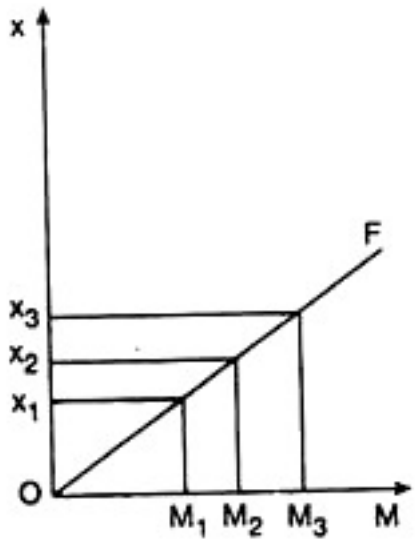
TABLE 2: Breakdown of the Engel curve-SOURCE: The consumer demand analysis (2015). Available [online] at: https://slideplayer.com/slide/7430928/

Therefore normal goods have a positive elasticity of income ($\varepsilon > 0$): as a rise in income leads to an increase in the quantity demanded and consumption decreases while disposable income rises (as it can be observed by the 1st graph on the left hand).

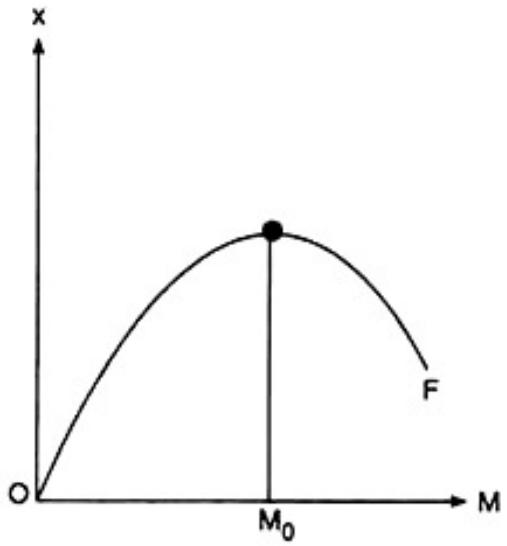
An inferior good is the opposite of a normal good: its demand decreases while the consumer income increases and its consumption grows faster than the disposable income. A type of inferior good is the Giffen good, when the price of a Giffen good increases, the demand for it rises too, violating the Law of Demand.

In case of an inferior good the Engel curve is downward sloping. As the graph above suggests, as income rises the quantity demanded for the good x decreases. For this reason the elasticity is negative related to income. As income rises, the quantity demanded for good x decreases. ($\varepsilon < 0$).

A luxury good or superior good represents those goods whose quantity demand increases more than proportionally as income rises, thereby the expenditure for the purchase of those goods, becomes a greater proportion of the overall spending. Its consumption grows slower than the disposable income.



GRAPH 1: Engel Curve for Good X

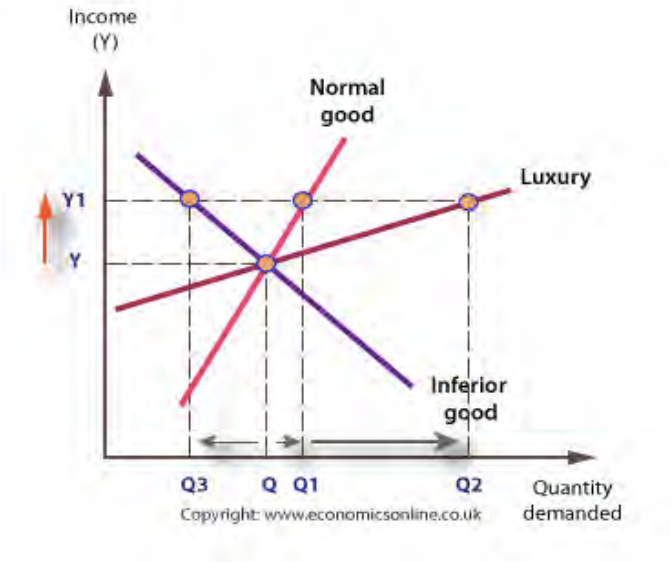


GRAPH 2: The Engel Good for a good becomes eventually inferior

SOURCE: The Engel Curve. Available [online] at: http://www.economicsdiscussion.net/consumer/engel-curve/the-engel-curve-with-diagram/22620

A luxury good has high income elasticity of demand ($\varepsilon > 1$): as people become wealthier, they will purchase more luxury goods. Therefore the quantity demanded increases more than proportionally as income rises. At the beginning of the graph, the greater elasticity of luxury goods is represented by the upward sloping curve, due to a positive correlation between the income and the quantity demanded. At the maximum point M_0, the curve starts to decline as consumers reduce the purchase of that good even if income rises and its demand drops more than proportionately. From this point on, it turns into an inferior good, as the income elasticity of demand is not constant compared to income ($\varepsilon < 0$).

The theory of consumer choice analyzes how consumers maximize their consumption path as a measure of their preferences, subject to some limitations on their expenditures, represented by the budget constraint. By optimizing their utility function at the maximum level, consumers become more satisfied. In case of luxury goods, the consumption path increases as a fraction of income. The rise in prices, for the purchase of luxury goods, will never reduce the demand function. Therefore it is possible to say that the price effect and the quantity demanded are positively related.



GRAPH 3: Consumer demand function: income and demand (2015). Available [online] at: https://www.economicsonline.co.uk/Competitive_markets/Demand_and_income.html

In case of luxury goods the theory of consumers choice is based on the difference between "mass vs. class". The consumer's demand for the purchase of luxury goods is affected by the origins of the social customs that influence the consumer behaviour in the consumption decision making. The theory of consumer choice is based on different key variables: the desire of consumers to be fashionable, attempts to obtain exclusivity and conspicuous consumption. The market demand may be influenced by the impact of non-functional utilities: the static analysis of the order events that have no significance, income and expenditure patterns that repeat themselves in every period.

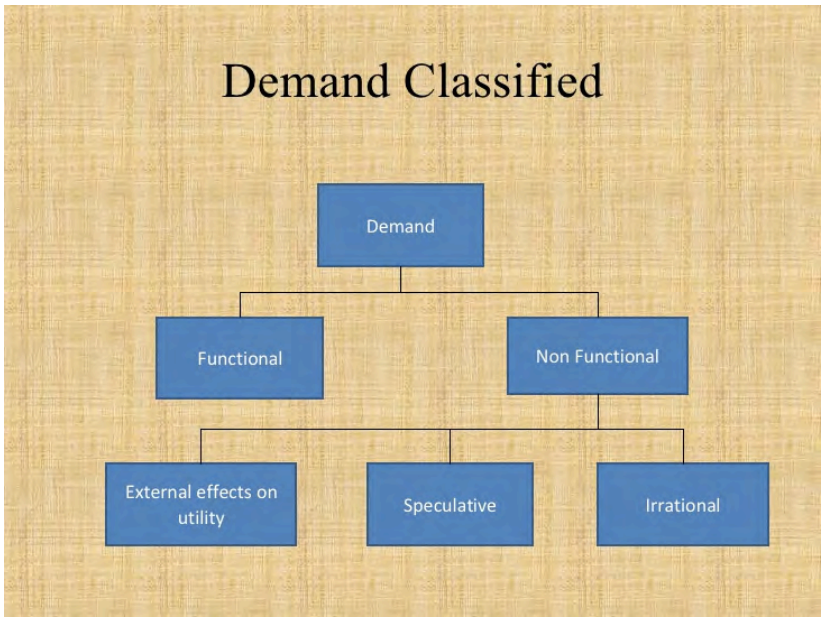


TABLE 3: Demand Classification- SOURCE: The Theory of Consumers' Demand (2008). Available [online] at: https://pt.slideshare.net/maddy3/bandwagon-snob-and-veblen-effects-in-the1-presentation

UNDERSTANDING CONSUMER PURCHASING BEHAVIOUR REGARDING LUXURY GOODS

Luxury brands are a dominant phenomenon in today's marketplace, perhaps constituting *"one of the purest examples of branding"*[6]. The concept of luxury refers to any product or brand that has the potential to become a luxury good, depending on whether consumers perceive it as such or not.

"Luxury brands can be described as premium priced brands that consumers purchase for their psychological values (symbolic and hedonic), and not predominately for their economical and functional value"[7].

While the "*homo economicus"* enjoys absolute rationality in all of his choices, based on economic efficiency and individual utility; traditional luxury might not only be used in enclaved luxurious spaces or contexts but rather it focuses on consumers' everyday lived experiences. This luxury integration is based on the understanding of consumers' actual experiences of luxury and on how luxury is related to consumers' experiences.

The luxury theoretical framework explains four "experiential zones":

- Aesthetic: high on intensity and low on involvement
- Escapist: high on both involvement and intensity
- Entertainment: low on both dimensions
- Educational: high involvement and low experienced intensity

In order to investigate the consumer experience in the luxury consumption practices, it is important to undertake a consumer insight analysis, based on consumers experiences related to luxury perceptions.

6 Keller (2009)

7 Nueno and Quelch (1998) and Stegeman (2006)

The theory of ostentatious consumption

The ostentatious form of wealth was theorized by the American economist Leibenstein, who identified three effects: the Veblen effect (from the name of the scholar Thorstein Veblen), the Snob effect and the Bandwagon effect.

Some economists argue that luxury goods violate the law of demand, as it describes the inverse relationship between the prices and the quantity demanded. Indeed the *Veblen goods* are classified as a category of luxury goods for which the quantity demanded increases as the price increases, leading to an upward sloping curve, violating the conditions stated by the law of demand. Thorstein Veblen, in *"The Theory of Leisure Class"*, identified the Veblen goods as positional goods and therefore a type of luxury goods. The rise in prices for a good, makes it more desirable due to its status symbol, and the consumption for that good becomes conspicuous as a status mode.

The Veblen goods are considered as a function of price: while the real price is paid in monetary terms, conspicuous price is what other people think the consumer paid for the commodity.

Rolls Royce Phantom luxury car (2003-2017)

For instance the Rolls Royce Phantom luxury car is considered as a desirable conspicuous consumption due to its price, which generates a certain idea of status symbol. In spite of its high price, the luxury car is considered as a Veblen good for its precious exclusiveness and singularity.

Indeed consumers are more likely to spend money due to its unique icon and high quality perfomance. For this reason they focus more on the prestige of the brand and on the high quality material, in order to feel comfortable and priviledged.

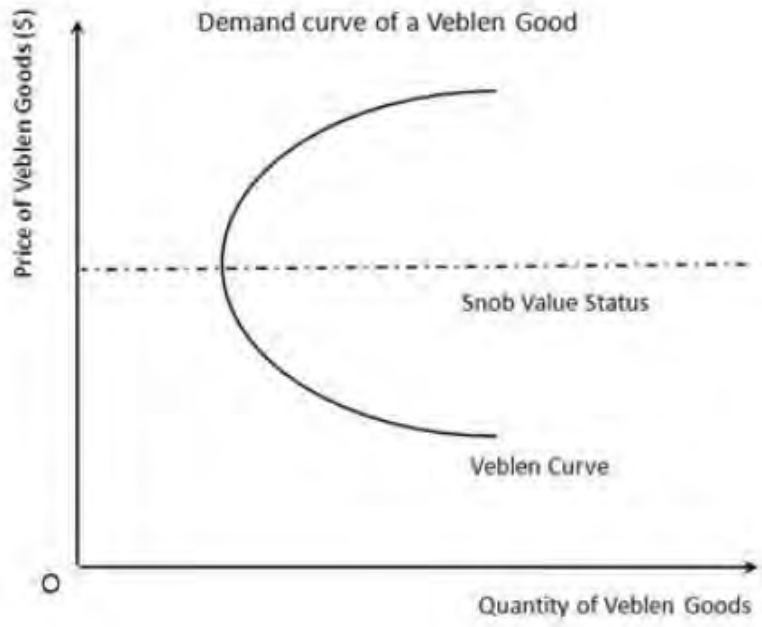
The Veblen goods differ from the Giffen goods, because of their exclusiveness and appearance of success, which is difficult to substitute like the Giffen goods.

The *Veblen effect* describes the so-called *"ostentatious consumption"* typical of the *"leisure class"* (as part of a class view of society), whose positioning within it, is determined by money, a symbol of social prestige and its typical display of life wealthy and plenty of unnecessary consumption. The consumerist tendency spreads throughout the social hierarchy with a top-down logic, from top to bottom, generating an emulative-ostentatious behavior that never finds an end and an unprecedented consumer spiral.

In particular the Veblen goods reflect consumer's preferences and tastes, in which their demand is attributable to an increase in prices. In addition, by comparing Veblen goods with normal goods, the result is that a Veblen good is priced potentially higher than a normal good in the same category. Veblen goods contradict the law of demand because of their *snob appeal*. In fact the *Snob Effect* alters the conditions stated in microeconomics, in which people with higher income demand goods that are inversely related to the demand by those people with lower income.

The Snob effect describes the motivational aspect that drives an individual to buy a luxury item identified by its exclusivity and rarity. The Snob effect can be determined at two different times during the life cycle of a luxury product and with two different motivations. It can in fact manifest itself during the first phase of the life cycle, when a product is placed on the market; in this case the consumer, called innovator, is driven to purchase by the desire to enjoy the good in advance compared to the others. Or it can manifest itself during the phase two, of growth and maturity of the product, now known and commonly used, of mass with the consequent loss of the effect of exclusivity and uniqueness. The Snob effect is, from an economic point of view, a negative externality, because the quantity of goods demanded decreases as the number of people who own it increases. The same verification effect, on the contrary, occurs when the value of an asset decreases with the increase of the people who own it.

Consumers start demanding for exclusive products when the price is the quality (positive demand slope). Usually these goods have high economic value and low practical value, the less available the items, the higher the snob effect. It is called *"the snob effect"* because it is related to the fact that a person seeks to buy what others do not buy. They attempt to *"stand out from the crowd"*, emphasizing their own distinction. The greater the demand for that good, the less likely is the buyer's propensity to buy it. There are people "snobs" who do not want to use consumer goods.

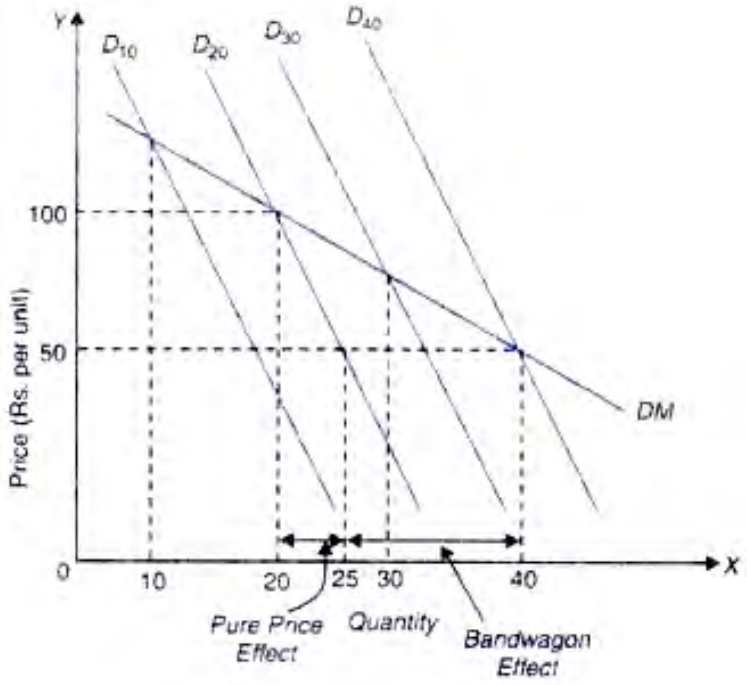


GRAPH 4: The Veblen Effect & Snob Effect-SOURCE: J. Ferguson (2017). Available [online] at: https://jakefergusonblog.wordpress.com/2017/05/08/the-veblen-effect/

In case network externalities are negative, the snob effect arises. It refers to the desire to possess a unique commodity with a prestige value. The snob effect works in the opposite way of the *Bandwagon effect*. The bandwagon effect describes the individual who acquires a luxury good, not to stand out against a mass from which to distance himself (like the snob effect), but to be accepted within a limited social circle.

The badwagon effect is a psychological effect based on the tendency to follow the actions of others, as the single individual prefers to capture information from others. The *Cascades* explains why fragile people with very limited information tend to ignore their personal information to follow the behaviour of others. This concept explains why the demand for a commodity increases because others are also consuming the same commodity at a given price. According to this phenomenn the increase in the popularity for a product

encourages people to “get on the bandwagon” too. Thus a bandwagon effect is an example of a positive externality in which the quantity demanded by an individual increases as a response to an increase in the quantity demanded by other people.



GRAPH 5: Bandwagon Effect-SOURCE: Network Externalities. Available [online] at: http://www.economicsdiscussion.net/essays/economics/network-externalities-bandwagon-effect-and-snob-effect-with-diagram/934

From the graph above the movement along the demand curves (D_{10},$D_{20,}$$D_{30,}$$D_{40}$), represent how much quantity for that good is demanded if there is no bandwagon effect operating. If the price falls from 100 R_s to 50 R_s per unit, the quantity demanded increases to 25 units (represented by D_{20}). As a result of a pure price effect, the band wagon effect is still not working. However the fall in price, increases the quantity demanded by others, creating a bandwagon effect (P = 50 R_s, Q = 40 000 units). The resulting 15 units represent the rise in the quantity demanded as a result of the bandwagon effect. From this analysis it can be seen that the bandwagon effect causes the demand curve to be more elastic (D_M) than the other demand curves (D_{10},$D_{20,}$$D_{30,}$$D_{40}$).

Ultimately, the forms of ostentatious consumption are manifested through the three effects described above: the Veblen effect underlines the desire to show wealth and social status, the Snob effect defines the motivation of the uniqueness and rarity of the luxury product and the Bandwagon effect describes the need for acceptance.

The theory of recreational shopping and hedonistic consumption

The theory of recreational shopping and that of hedonistic consumption can be traced back to the hedonistic forms of consumption as opposed to the forms of ostentatious consumption.

In the first form, shopping is considered a leisure activity regardless of the good purchased which constitutes an additional benefit. The *"recreational"* consumer benefits from the shopping activity itself, generally stimulated by the location of the store and the resulting feelings, independent of any functional needs of the purchased good.

The theory of hedonistic consumption (Hirschman and Holbrook) also places the emotional sphere at the center of the process directed towards the purchase of a luxury good, which must be capable of arousing feelings and emotions.

Ultimately in the forms of hedonistic consumption, the relationship with time is characterized by the propensity for a present to be consumed as such, without memory of the past or experience. "Pleasure" becomes a sociological category, in a system of values in which hedonistic consumption is fundamental for integration into a reference system governed by a social pact that places the achievement of success and pleasure as imperatives.

How does an individual choose between a rich an exclusive watch and basic and an essential one?

These two types of choices are called *"Hedonic consumption vs. Utilitarian consumption"*.

Hedonic Consumption vs. Utilitarian Consumption (2017)

Hedonic consumption is all that exceeds the basic needs. Hedonic consumption represent all those products bought by a consumer that satisfies his emotional and sensory needs, after basic needs have been met (food, shelter or clothing). The emotional pleasure received from products vary for all individuals, as it is unique and personal.

On the contrary, the Utilitarian consumption places more emphasis on the usefulness, practicality, functionality and fulfillment of basic needs. Utilitarian needs are bought without second guessing and have little emotional and sensory attachment. Utilitarian products make it easy every day consumption.

Even though the purpose of the watch is to show time, people purchase an Hybris watch to show of their wealth.

The wealth effect

The wealth effect represents the behavioural economic theory, suggesting that people spend more as the value of their assets increases. Consumers feel more financially secure and confident about their wealth when the investments in their portfolios increase in value. They feel richer even if their income and fixed costs remain constant over time.

This is the reason why consumers prefer to invest in purchasing luxury goods in order to feel steady and wealthy.

The wealth effect reflects the psychological effect influencing the consumer behaviour. It is referred to the consumer confidence, which increases the value of investment in the consumer portfolio, contributing to a high level of spending and a low level of savings.

It can be applicable in a business world and it explains the continuous economic growth in the luxury field.

THE LUXURY MARKET

The Global Luxury Market View

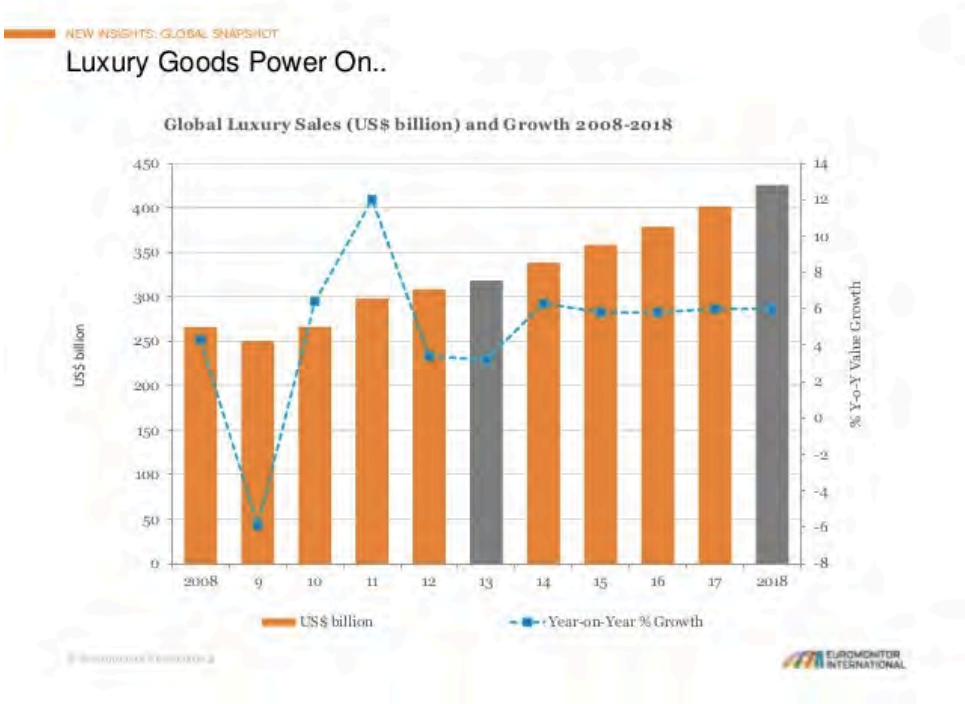
GRAPH 6: S&P GLOBAL LUXURY INDEX TREND-SOURCE: S&P Dow Jones Indices (2008-2018)

The "*S&P Global Luxury Index*" performance allows us to examine the historical market trend of the last 10 years. In particular it represents how the 2008 crises influenced the market and so affecting also the companies return on earnings. This index includes the main listed companies in the production and distribution of luxury goods and in the supply of luxury services. This methodology in estimating the global luxury development was created by the S&P Dow Jones, in order to measure the actual global luxury trend. The index assigns weights and risks to several factors, that will form the luxury exposure score.

USA VS. CHINA VS. EUROPE (2008-2018)

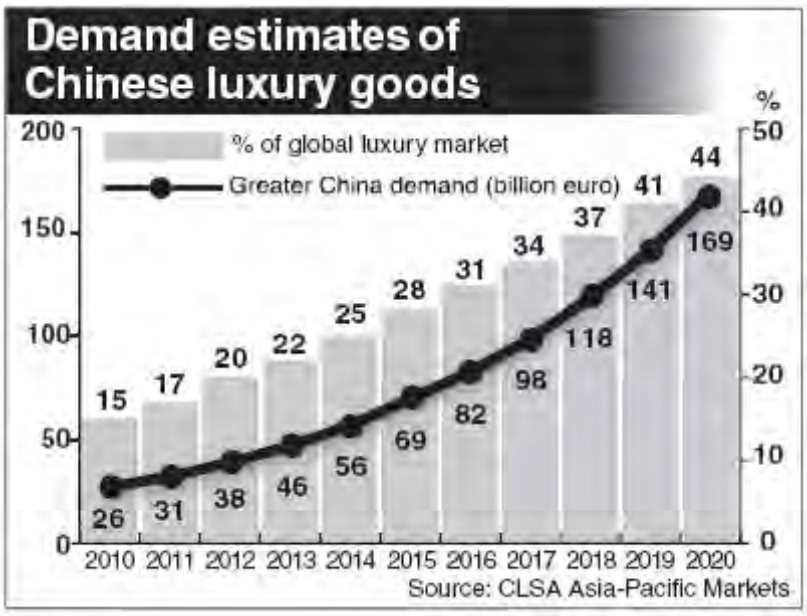
Despite the recent global slowdown of the economic growth in the major markets (USA, China and Europe), the luxury good market has continued to rise. Due to the influence of different externalities, such as: protection policies, restrictions on international trade, the impact of technology and the evolution of the

digital era. All of them have reduced the consumer spending, disrupted the global supply chain and increased prices, affecting the development of the luxury market. Millennials, Gen. Z and the middle classes have been influenced by this global evolution in the luxury market.



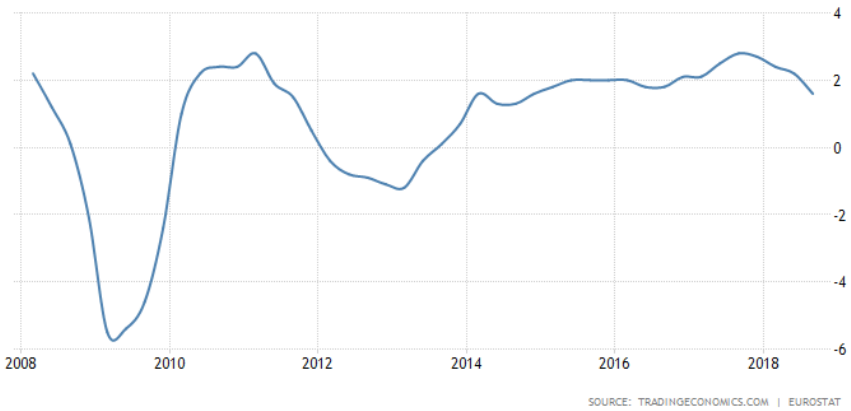
GRAPH 7: State of luxury goods market-SOURCE: Euromonitor International (2014)

With the fiscal policy of 2018, the US has faced a combination between an increase in spending and a tax cut, which have increased the demand and contributed to a temporary acceleration of growth. Luxury goods have experienced this demand, despite any policy implementation. However the fiscal policy lead to a wage acceleration, giving to the economy full employment. For this reason the Federal Reserve (FED) started to raise interest rates, causing a slow down in the economy. With the implementation of taxes, the consumer spending has been negatively affected.



GRAPH 8: CLSA-Chinese to buy 44% of luxury goods by 2020-SOURCE: ChinaDaily (2011)

China has been characterized by a *"Luxury spending boom"*. China is on pace to top Japan as the World's largest market for luxury goods. Luxury goods have grown in China as well as abroad, leading Chinese consumers to consume both at home and outside. China ranks second globally for its contribution in the luxury market. Due to the huge financing support from the Government, China has transformed itself socially and economically over the last 30 years, contributing to the luxury market growth.



GRAPH 9: Eurozone GDP Growth-SOURCE: Eurostat (2008-2018). Available [online] at: tradingeconomics.com

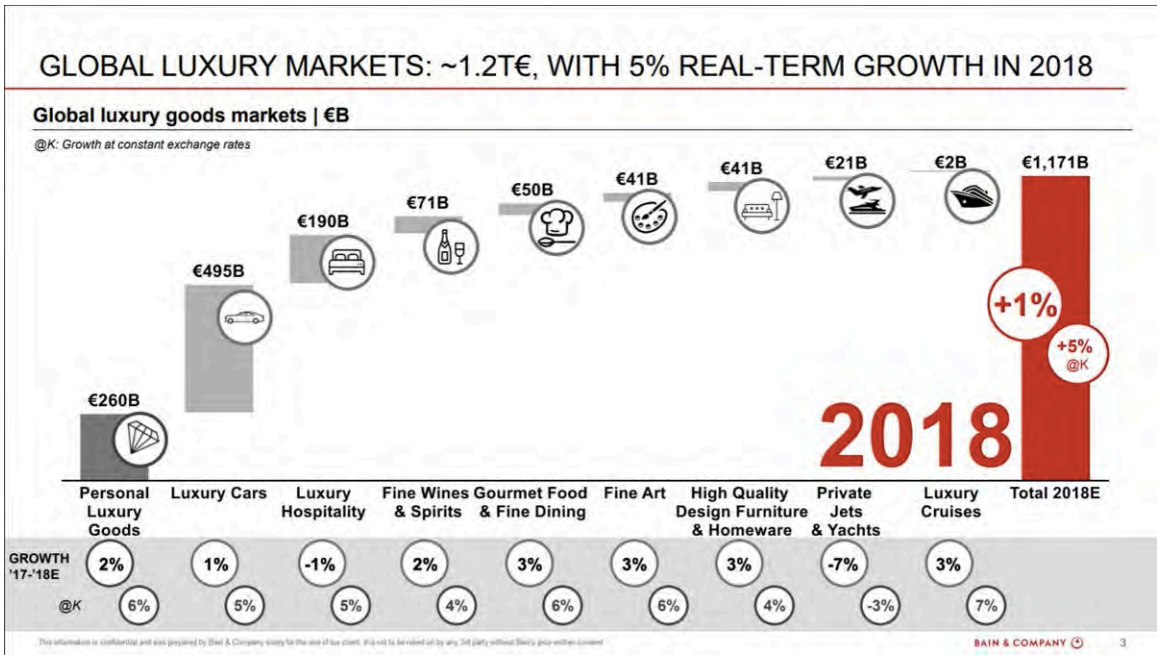
The Eurozone has experienced a moderate slowdown in 2018. Spain and France have outperformed the Eurozone, with Germany and Italy experiencing slight contractions in to growth. The cause of this deceleration are due to higher prices, high valued €, trade uncertainty and weakened global demand. In addition the Eurozone has been impacted by the trade wars that have contributed to a decrease in the economic growth.

The Global Luxury Market Insight

Bridging Gap: OLD VS. NEW

The luxury market analysis is based on attracting new consumers in the luxury environment. A good leader has to implement a refine strategy: through which he is aware of the opportunities and needs in order to make products feel comfortable and innovative to consumers. The industry segmentation is based on stimulating the interests of youngers, for this reason companies are committing huge investments in order to gain a competitive advantage in the luxury market.

Since the *"new"* generations look for individualized and seamless brand relationships, brands are investing in the world digital market in order to interact with new customers through the social media. Meanwhile the companies are re-examining the value of the brand image and its history, consumer demand has become the core focus of the business. To do that and initiate a long term relationship with customers, companies are relying on the digital era. In this path between *"old & new"* companies face an increase in customer's sensitivity towards privacy, which they revert on the opportunity to offer more specified and personalized lines of products & services to their customer base.



GRAPH 10: Altagamma 2018 worldwide luxury market monitor-SOURCE: Bain & Company (2018)

The graph above represents all the different types of luxury goods preferred by consumers in 2018. Globally consumers prefer to spend their disposable income on personal luxury consumption and on luxury cars. As the role of marketers is to increase consumers demand function, there are more likely to invest in such production, creating a new and distinctive line of products, providing something different and better than the rivals. Through an innovative and digital design it is possible to convert a traditional merchandise into an international status symbol, increasing the overall demand for luxury goods in the global market.

The Market Segmentation: The "True Luxury Consumers"

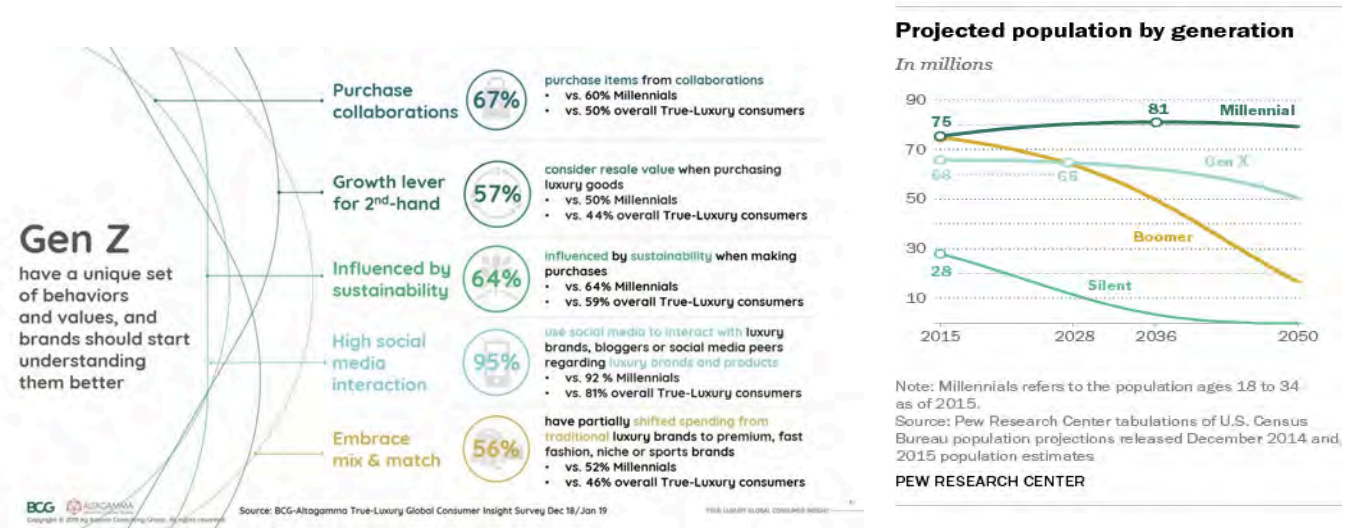


TABLE 4 & GRAPH 11:Purchasing Behaviour-SOURCE: BCG Survey (2019)

The latter segment is composed by Generation X, Millennials and Generation Z. The Millennials of the American generation are 71 million and the Boomers are 74 million.

The forecasts say that the Millennials will be able to overtake the Baby Boomers in 2019, reaching a level of 73 million with a drop of 72 million for the Boomers. The increase is due to young immigrants in the USA, while the decrease is due to the fact that the generation is aging and the number of deaths is increasing.

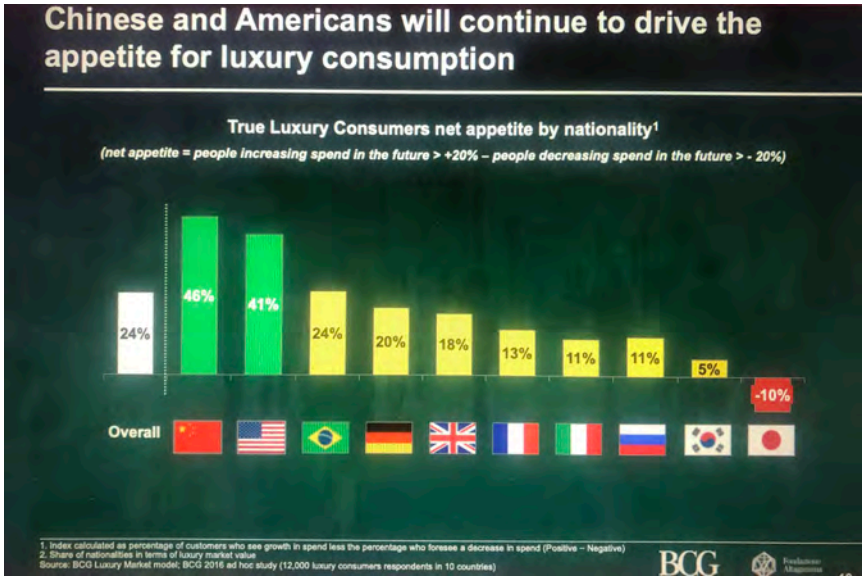
Generation X and Millennials are those who live a luxury lifestyle, are considered as high class people (above 25 years old) with their own income, able to purchase expensive products and who represent the high loyal customer segment. On the contrary Generation Z (*"The experiential luxury customers"*), are those people born in the last two decades, currently owning 4% of the luxury market. Generation Z is considered one-shot purchase, because they buy mainly brand's accessory. These very young consumers interact with brands and their products exclusively on the web through social media, online newspaper, professional websites etc.. Gen. Z is the most receptive aboove all the customer segmentations, as it collaborates with high fashionable trends and it increases the brand's image for the interest of rising their own popularity on the luxury market. The *"True Luxury Consumers"* are interested in the preowned market: they want to empty out their wardrobe in order to fund new purchases or embrace sustainable consumption. In this manner companies are more interested in increasing the consumer purchase power, always offering something additional and innovative, therefore increasing the consumer's demand.

Due to the importance of Gen.Z which governs the 4% of the targeted selling market, it is important to analyse also how international luxury trading occurs in a global macro economic prospective.

The diversification of the targeted selling market, across different generations, represents one of the major reasons that affect the consumer overall demand in a macro prospective. The additional demand, coming from different targeted customers, affects the international trading, lowering the cost of cut off.

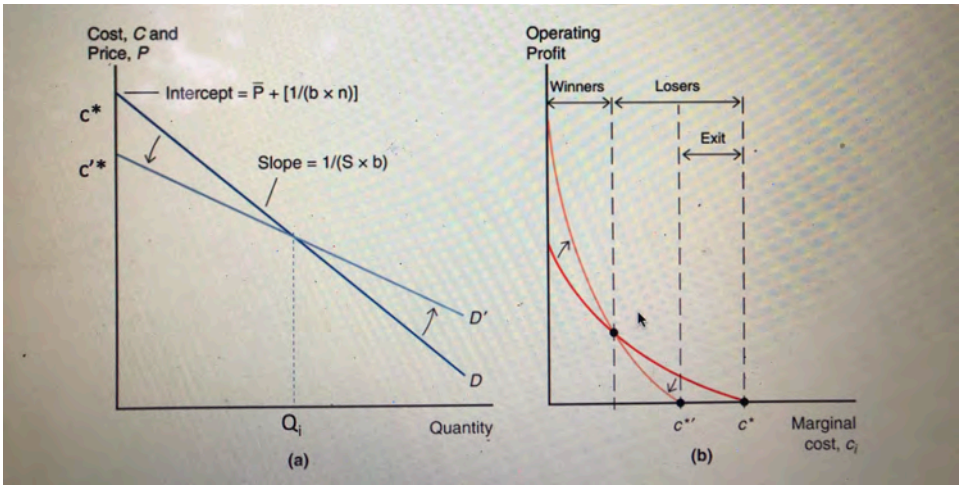
For this reason we will take into account the major countries which determine the exponential increase of the luxury market, strengthening the world's economy: USA and China.

Winners VS. Losers



GRAPH 12: The true-luxury global consumer insight-SOURCE: BCG (2017)

It can be seen that USA and China are considered as the *"winners"* that drive the economy in the luxury market, increasing International trading and the overall aggregate demand function. Due to a decrease in the cost of cut off, the worst firms *("losers"*) such as the Japan, are forced to exit the market, the average firms (the countries in yellow) contract, while the best performing ones (USA and China) expand, as a result of the selection effect. The industry production is more concentrated in the best driving firms and the industry is now more productive in the aggregate, shifting the aggregate demand function outward.

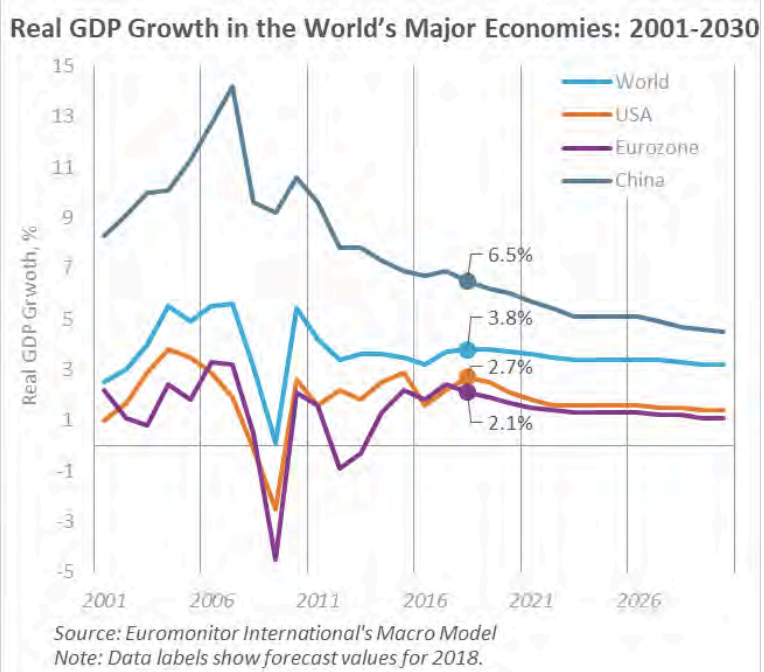


GRAPH 13: Economic Integration-SOURCE: Productivity Selection (2018)

Macroeconomic Empirical Analysis

The Aggregate Luxury Market Demand

Luxury goods account for an increase in consumer expenditure. A strong and an efficient economy bounded with a more desirable income, lead to a significant growth of the luxury market. During the past decades, the increase in wealth and disposable income made the growth rate of luxury goods greater than the aggregate consumption. The desire to purchase the luxury goods has been so strong that consumers have reached a point of no return: they could use all the available resources in their hands (including indebtedness) in order to buy that branded product. Thus the Veblen Effect demonstrates the consumer's trend towards the purchase of prestigious goods, which influence the luxury market demand. By definition a luxury good represents those goods for which demand increases more than proportionally as income rises. For this reason luxury goods have a high elasticity of demand: as people become wealthier, they will buy more luxury goods. Luxury goods are positively related to income, as a rise in the average households income increases their demand.



GRAPH 14: Global Economy-SOURCE: Euromonitor International (2018)

According to the macro-environmental prospective, the *Aggregate Demand* (AD) is the measure of the overall demand for all goods and services produced in the economy.

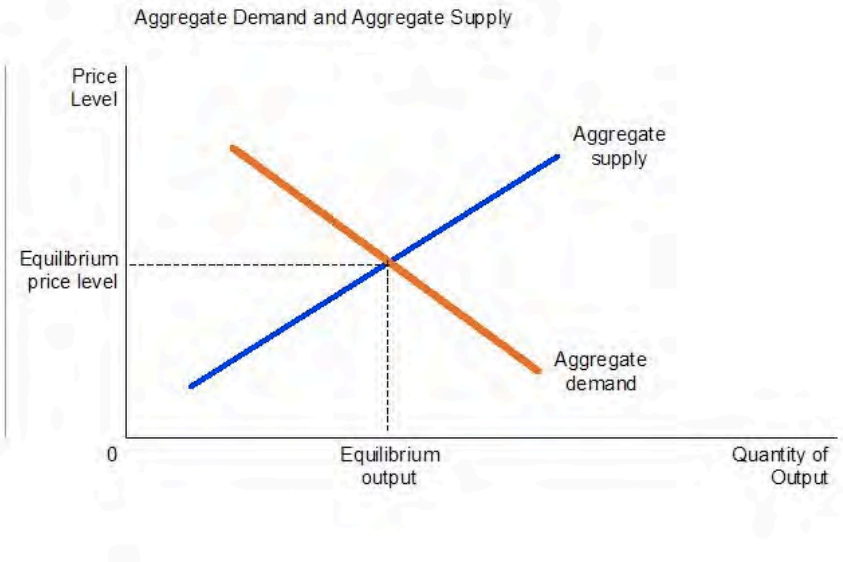
It reflects the total amount of money for the exchange of goods and services at a price level in a given period of time. While the GDP (Gross Domestic Product) measures the total value of all finished goods and services produced within a country in a certain given period of time, the Aggregate Demand represents the desire for those goods.

In the long-term: $GDP = AD$

$$Y = C + I + G + NX$$

The factors that affect the change in the Aggregate demand are:

- *Changes in Interest Rate:* Whether it rises or falls, it will affect the decision of consumers and companies to purchase products & services. Lower interest rate means lower borrowing costs and an increase in capital spending.
- *Income and wealth:* As household's wealth increases, consumers are willing to spend more, reducing their savings and increasing the Aggregate demand.
- *Changes in Inflation Expectations:* If consumers expect inflation to rise in the future (increase in prices), the Aggregate Demand will increase and they will tend to purchase now. The opposite will occur in case of a decrease in inflation.
- *Currency Exchange Rate Changes:* If the $ currency value falls, foreign goods will become more expensive relative to domestic ones, meanwhile the domestic production of US. Goods will become cheaper for foreign countries. Therefore the Aggregate Demand for domestic goods will increase.



GRAPH 15: Equilibrium level between Aggregate Demand & Aggregate Supply-SOURCE: Macroeconomics Review (2016)

The main components in computing the Aggregate Demand are: Consumption, Investment, Government Purchases and Net Exports.

$$AD = C + I + G + NX$$

- *Consumption:* personal consumer's propensity to spend (composed by the Marginal Propensity to Consume/slope of the consumption function ($MPC = c$) and the disposable income $(Y - T)$)

$$C = c\ (Y - T))$$

- *Investment:* spending on investment goods depends negatively on the real interest rate (which is given by the cost of borrowing and the opportunity cost of using one's own funds to finance investment spending)

$$I = I(r)$$

- *Government Purchases:* Government spending on goods and services. It excludes the transfer payments and it assumes government spending and total taxes to be exogenous.

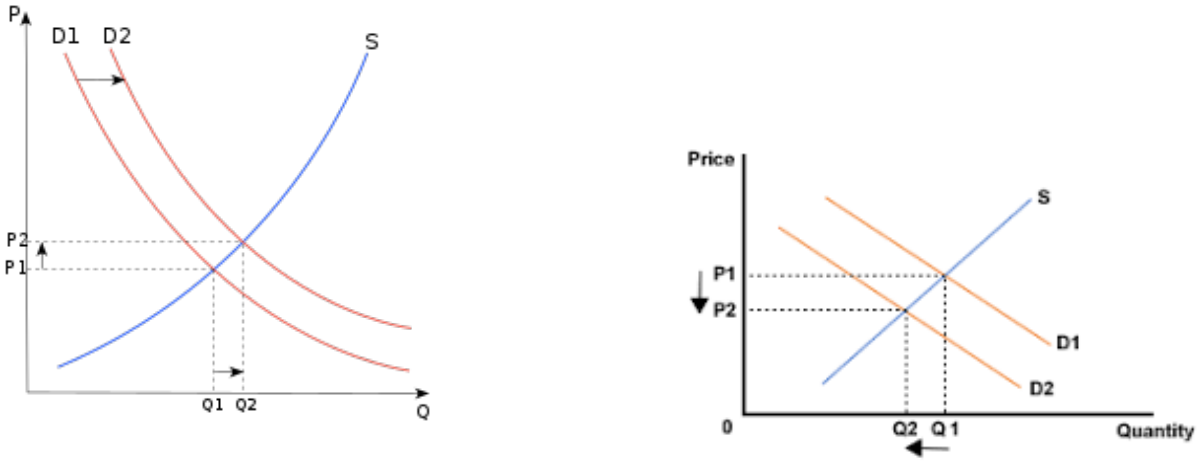
$$G = \bar{G} \ \ and \ T = \bar{T}$$

- *Net Exports:* in a closed economy there are no Net Exports. Net Exports = Exports-Imports

$$NX = EX - IM$$

The consumer disposable income affects the demand for goods and services which causes changes in the Income Effect. The income effect refers to the changes in prices for the purchase on goods & services, and to the changes in taxes on people's consumption behaviour. The income effect also influences the demand for luxury goods. In particular any increase in disposable income, caused either by higher wages, lower taxes

or a fall in prices, will increase the aggregate demand for luxury goods. On the contrary, if the disposable income declines, the demand for luxury goods falls.



GRAPHS 16-17: Shifts in the Aggregate Demand Curve-SOURCE: Types of economic system (2019)

While luxury goods have a positive correlation in demand and income, inferior goods are negative correlated. Speaking of correlation it will be interesting to consider all the potential variables that may affect the aggregate demand, using the OLS model.

In particular the relationship of aggregate consumer expenditure influenced by the different economic variables, reflects a key aspect of the macro-economic world's dynamism. Thus the aggregate demand for luxury goods is affected by different economic variables, such as: real disposable income, income distribution, real GDP, price and real long-term interest rate.

$$y_t = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \beta_5 x_5 - \lambda_1 l_t - \varepsilon_t$$

- y_t represents luxury consumption on an annual basis in million $.
- α is the intercept: the expected mean value of Y when all X=0
- $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ represent the slope of the regression line

- x_1 is the measure of the real disposable income annually in billions of $, affected by a price deflator on personal consmption expenditure. β_1 is the *"Ceteris Paribus"* effect on disposable income on luxury consumption growth.
- x_2 is the measure of the distribution of income, it reflects the share of households income held by individuals. β_2 is the *"Ceteris Paribus"* effect of income distribution on luxury consumption growth.
- x_3 is the real GDP (Gross Domestic Product), measured in billions of $. β_3 is the *"Ceteris Paribus"* effect of GDP on luxury consumption growth.
- x_4 is the measure of the net worth in billions of $. The wealth is deflated by personal consumption expenditure. β_4 is the *"Ceteris Paribus"* effect of real net worth on luxury consmption growth.
- x_5 is the measure of price expenditure, which depends on the annual price index. β_5 is the *"Ceteris Paribus"* effect of price on luxury consumption growth.
- l_t is the measure of the real long-term interest rate. λ_1 is the *"Ceteris Paribus"* effect of the real long term interest rate on luxury consumption growth. An increase in the interest rate affects negatively the aggregate demand for luxury goods. This is due to the fact that the interest rate affects consumption changes due to the elasticity of intertemporal substitution.
- ε_t represents the error term. It is the dummy independent variable that takes the value 0 or 1, to indicate the absence or presence of any effect that may cause the shift in the outcome.

Upon the above regression line it is deductible that the overall demand of luxury goods is attributable to the impact of those variables, having a significant effect on the luxury good consumption.

According to the standard price theory, it can be explained that the rich have more wealth than the poor, and thus they consume more luxury goods; in fact the wealthier allocate higher proportions of their expenditure on luxury goods than the poorer do. High income households spend more on luxury goods than what the poorer do, resulting in an impact on demand for luxury goods. Therefore the income distribution represents a key aspect of a change in the aggregate demand. The higher income inequality of distribution, the higher the proportion of wealthy individuals which leads to an increase in the demand. The health of the economy, measured by GDP, significantly affects the aggregate demand for luxury goods. It is predictable that luxury good demand is positively related to GDP, as people with higher income will purchase more luxury goods, leading to an increase in demand and therefore affecting positively the GDP level.

On the other hand changes in the real interest rate affect changes in consumption. Luxury goods are known to have high income elasticity of demand, as people become wealthier, they will buy more of luxury goods rising the aggregate demand (positive correlation).

Elasticity of Demand

The nature of the goods affects the elasticity of demand. The elasticity of demand depends on whether the commodity is a necessity good or a luxury one. The market elasticity of demand for luxury goods is known to be positively related. For this reason necessity goods tend to have inelastic demand, whereas luxury ones tend to be relatively elastic. People generally react negatively to the increase in prices, rather they prefer not to cut down their consumption path.

In case of luxury goods, a consumer may postpone his decision to buy the product if the price is too high, thereby making the demand for luxury goods more elastic than necessity ones.

The factors that affect the elasticity of demand are:

- *Durability of the product:* non durable goods have inelastic demand as their consumption cannot be postponed. On the other hand durable goods have elastic demand (consumption can be postponed).
- *Availability of substitutes:* substitute goods have elastic demand and viceversa. If there is an increase in price of one good, its demand shifts outward, as it is price sensitive. On the contrary not substitute goods have an inelastic demand function.
- *Habitual goods:* those goods have an inelastic demand. As the price increases, consumers will not reduce their consumption path, as they are used to consume that consumption basket.
- *Income level:* people with low income level, tend to have elastic demand. As a result, a small increase in prices, will affect the monthly budget of those *"poor"* people. Generally, even though people have low income, they will prefer not to cut their consumption necessity even if prices will rise. In case of luxury goods, a consumer may postpone his purchase decision due to the increase in such prices. In this manner, the demand for luxury goods becomes more elastic than the demand for necessity goods.

- *Percentage of income spent:* products on which income is spent, have an elastic demand function. An increase in prices will not lead to a decrease in demand. That is due to the fact that as people will spend a small portion of their income on such products, in case of an increase in prices, they will be not affected on such expenditure because they will not pay so much attention on its negligible effect.
- *Complementary goods:* they have an inelastic demand. As there is an increase in prices, it will not have impacts on the demand function.
- *Multiple Usage:* products with multiple usage (like elasticity) have an elastic demand. If there is an increase in prices, it will be possible to reduce their consumption, by reducing its usage in some areas.

GRAPH 18: Degrees of Elasticity-SOURCE: Degrees of elasticity (2007-2019). Available [online]at: https://www.graduatetutor.com/economics-tutoring/elasticity-in-economics/

The price of elasticity of demand is defined as the percentage change in the quantity demanded due to the percentage change in prices.

$$Price\ Elasticity\ of\ Demand = \frac{\%change\ in\ quantity\ demanded}{\%change\ in\ prices}$$

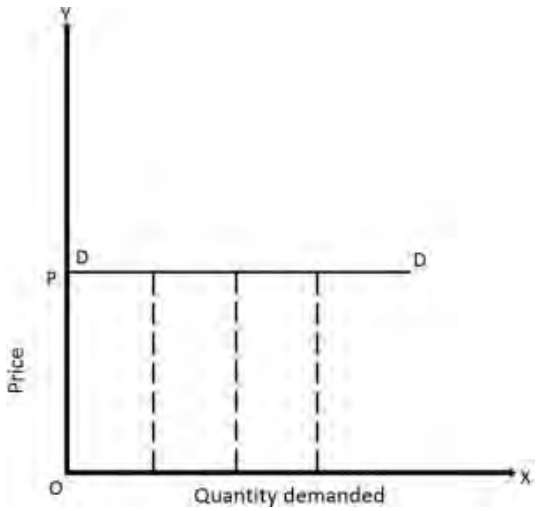
$$E_P = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

- E_P = Price elasticity of demand
- Q = Original quantity demanded

- ΔQ = Change in the quantity demanded
- P = Original price
- ΔP = Change in price

There are five types of elasticity of demand:

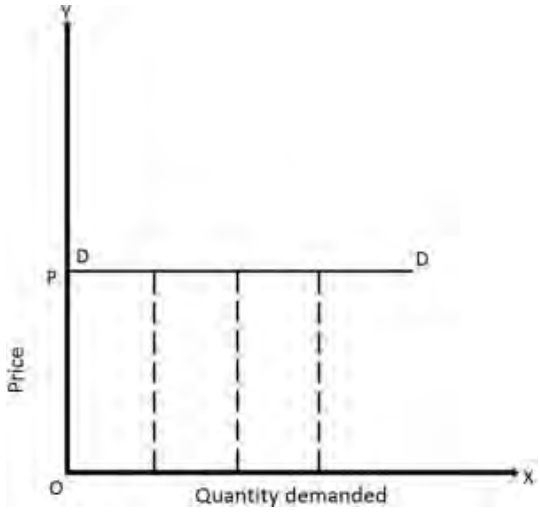
1. *Perfectly Elastic Demand ($E_p = \infty$)/Infinite Elasticity:* if the quantity demanded increases infinitely (or by unlimited quantity), causing a small fall in prices. Conversely the quantity demanded goes close to zero, with an increase in prices.



GRAPH 19: Perfectly Elastic Demand-SOURCE: Businesstopia available [online] (2019)

The DD demand curve parallel to the x-axis shows that a negligible change in prices, causes an infinite fall or rise in the quantity demanded.

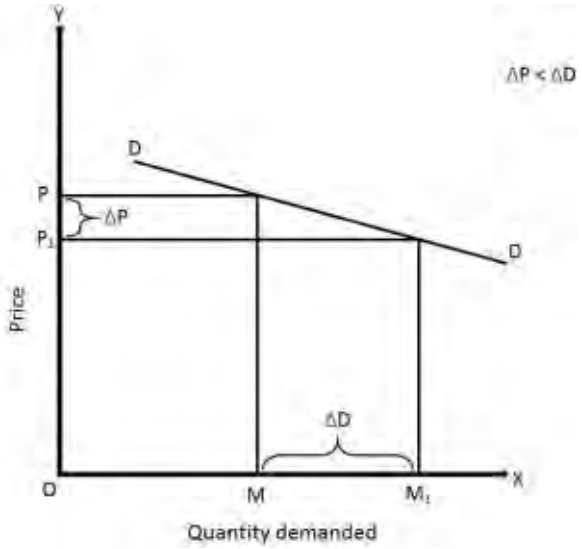
2. *Perfect Inelastic Demand ($E_p = 0$)/ Zero Elasticity:* the demand remains constant whatever is the change in prices.



GRAPH 20: Perfect Inelastic Demand-SOURCE: Businesstopia available [online] (2019)

The DD demand curve parallel to the x-axis shows it remains constant whatever is the change in prices.

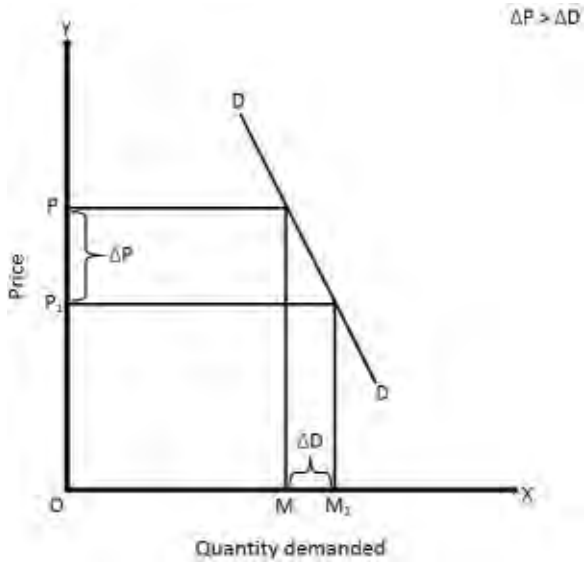
3. *Relatively Elastic Demand ($E_P > 1$):* if the percentage change in the quantity demanded is greater than the percentage change in prices. If there is a great change in the quantity demanded, then there will be a little change in prices. This is the reason why it is called *"high elastic demand or elastic demand"*.



GRAPH 21: Relatively Elastic Demand-SOURCE: Businesstopia available [online] (2019)

The demand curve DD is more flat, which means that it is elastic. A small decrease in price (from OP to OP_1), means a greater increase in demand (from OM to OM_1). Conversely a larger decrease in demand leads to a smaller increase in prices.

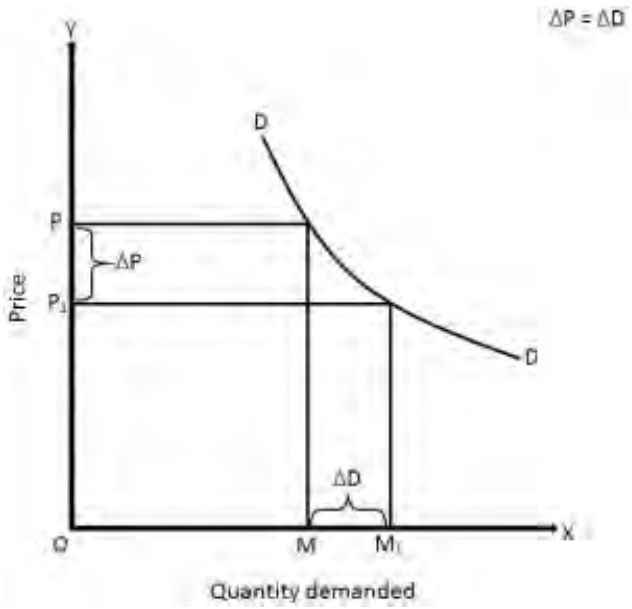
4. *Relative Inelastic Demand ($E_P < 1$):* if the percentage change in the quantity demanded is less than the percentage change in prices. If there is a little change in demand, then there will be a greater change in prices. For this reason it is called *"less elastic or inelastic demand"*.



GRAPH 22: Relative Inelastic Demand-SOURCE: Businesstopia available [online] (2019)

The demand curve DD is steeper, which means that it is less elastic. The greater fall in price (from OP to OP_1), the small increase in demand (from OM to OM_1). On the contrary a greater increase in prices will cause a small fall in demand.

5. *Unitary Elastic Demand ($E_P = 1$):* the percentage change in the quantity demanded is equal to the percentage change in prices. 1% change in prices leads to 1% change in the quantity demanded.



GRAPH 23: Unitary Elastic Demand-SOURCE: Businesstopia available [online] (2019)

The demand curve DD is a rectangular hyperbola, which shows that the demand is unitary elastic. A fall in price (from OP to OP_1), causes a proportionally increase in demand (from OM to OM_1). Similarly an increase in prices, leads to a proportional decrease in demand.

CASE STUDY: ELASTICITY OF DEMAND FOR GUCCI

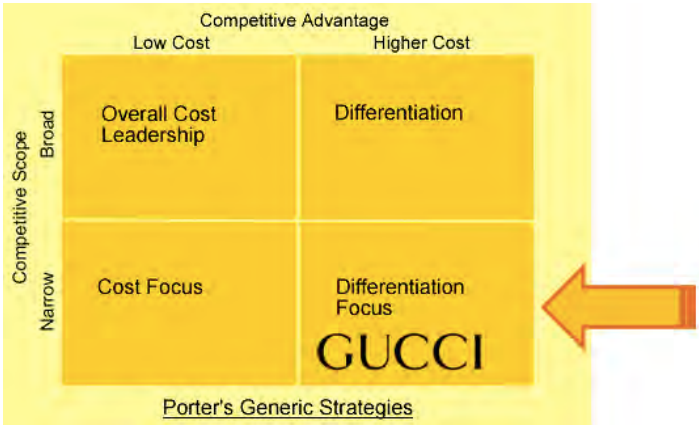
Gucci is an Italian company, founded in Florence by Guccio Gucci in 1921, considered one of the most desirable luxury fashion brands all over the world.

The company has reached the forefront in both areas, learning how to exploit means and market shares (millennials and teenagers) virtually untouched beforehand; all of this thanks to new additions to its management and directing teams, who revolutionised Gucci's image within the Kering group and out of it. Business strategy concerns how a company's specific business should compete, that is, how a firm should operate to gain a competitive advantage.

It relates to the firm's working plan, aimed to achieve its vision and mission, prioritize objectives, compete successfully, and optimize financial performance through the development of a business model.

In the study of strategic management (based on the elasticity of demand), competitive advantage plays a predominant role. It, in fact, results from one firm earning a persistently higher rate of profit over its rivals. To analyse Gucci's competitive advantage, it is necessary to take into account both external and internal environments. Gucci's competitive position in the luxury industry shall be evaluated through the Porter's five forces model and focus strategy is going to be analysed to cover the internal factors.

Gucci's Porter's five forces analysis



MATRIX GRAPH 24: Porter's five forces analysis-SOURCE: Marketing Strategy (2014)

The threat of new entrants: relatively low.

The luxury industry is quite concentrated, with the top 10 companies making up for almost 50% of total sales. Furthermore, all brands have an extremely high image and well-known names, making it hard for a new entry to stand out and establish itself in the market. Another factor playing against newcomers is that haute-couture is one of the most expensive sectors among industries, therefore a substantial initial capital investment is needed. The fact that economies of scales are highly recommended in this business, makes the barriers to entry even tougher to overcome. In conclusion, Gucci does not face a great threat from new entrants.

Suppliers bargaining power: high.

The supplier bargaining power depends on the brand's ability to raise prices and lower quality of goods without losing profit. Gucci's brand image is so well established that even if the company raised prices or reduced the quality of its couture, the majority of their customers would still buy from them.

Buyers bargaining power: low.

Gucci's clientele is likely to be generally wealthy, therefore customers are not *"price sensitive"* and cannot force prices down. Furthermore, businesses in the luxury industry are more concentrated than buyers, who are therefore left with no bargaining power.

The threat of substitutes: high.

Within the brands in the luxury industry, the level of prices for a similar product is also similar therefore the customer's cost of switching brand is low. The threat of substitutes also comes from the wider fashion industry, where medium level couture is gaining market share. Customers are showing interest in similar-

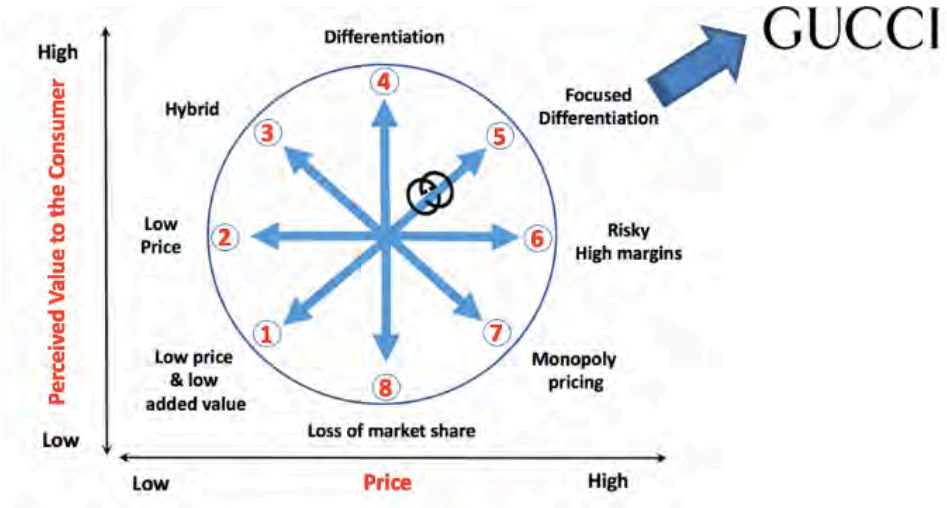
looking but cheaper products, becoming an additional threat for the higher level industry in which Gucci competes.

Rivalry among existing competitors: high.

As mentioned above concentration in this industry is fairly high, 47,2% (concentration ratio of top 10 companies) with a few leading brands or groups heading the market. This oligopolistic-like environment sets the basis for higher levels of rivalry among existing competitors. Furthermore, substantial barriers to entry and high operating expenditures make it difficult to leave the market (barriers to exit), leaving the already performing firms threatening each other. Gucci's strength on this aspect is product differentiation, which gives it a strong brand image and reduces rivalry, at least, on its highly differentiated products.

Gucci is now extending the luxury resale market, and due to its high competitive position, it is reaching a strong and pivotal role in the luxury field, compared to its rivals.

Focus strategy: the importance of "Differentiation"



GRAPH 25: Marketing strategy plan- Gucci's focused differentiation-SOURCE: Bowman's Strategic Clock (2018)

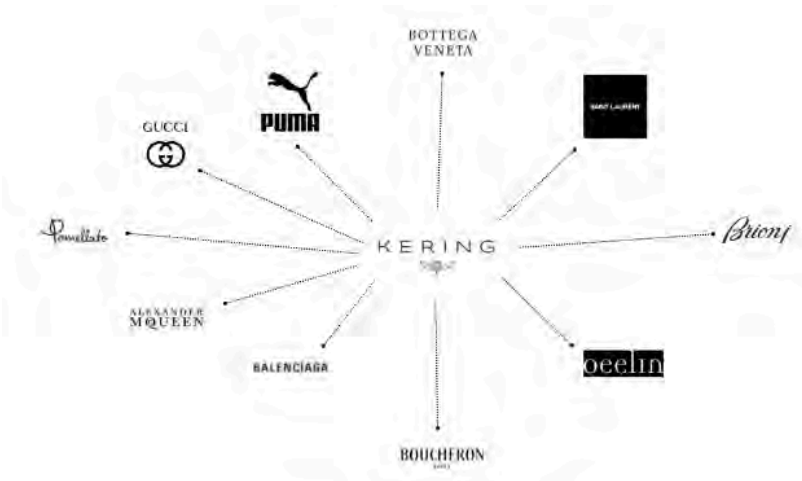
As Porter claims, no firm can manage to achieve full differentiation on every front and enact all types of business strategies at the same time. Every firm needs to focus on a given segment in order to gain a competitive advantage. In fact, the focus strategy is based on the choice of a specific segment.

The scope is to achieve competitive advantage dedicating entirely on the chosen target by tailoring a specific strategy to satisfy the needs attached to it. Even though Gucci does not neglect any aspect of the firm, from all the above it follows that it has chosen to focus mainly on its identity, developing an image focus-differentiation strategy. It could appear that Gucci refers to a fairly young segment, given the extravagance

of the designs. However, Gucci's targeted customers have been chosen through a segmentation strategy that focuses more on lifestyle than directly on the age of the customers. Of course, lifestyle and age can be correlated, but basing segmentation on lifestyle permits Gucci to leave open the chance to attract customers having a lively and urban lifestyle regardless of the age.

Nonetheless, some results from recent researches must be pointed out. Millennials (20-35 years of age range), from 2017, have been found to represent the greater share of sale for Gucci. This is thought to have happened for an increased engagement on social media, which is the primary tool to target millennials as well as representing a major proof of Gucci's efforts in differentiating its identity from its competitors'.

Business Strategy



Positioning Map: the Kering group multi-brand business model-SOURCE:FourWeekMBA (2019)

In order to determine Gucci's position in the global luxury market, we need first to consider the corporate

strategy, as Gucci operates on a multi business level. The corporate strategy focuses on determining in which business a company should compete; business strategy concerns how a company's specific business should compete. The fundamental question to be answered in the latter case is *"who has to be served?"*.

Business strategies define how a firm should operate to gain a competitive advantage. It relates to the firm's working plan to achieve its vision, prioritizing objectives, competing successfully, and optimizing financial performance with its business model.

In the study of strategic management, competitive advantage plays a predominant role, as it is the crucial reason that encouraged Gucci to strive for quality improvement and enhanced organizational performance. Competitive advantage results from one firm earning a persistently higher rate of profit over its rivals.

Forbes' Global 2000 list published in 2018 provides the classification of the world's biggest and most powerful public companies. This list takes in consideration sales, profit margins and market value of 2000 companies. However, we chose to analyze Gucci position in this ranking by comparing it to only a few other behemoths that belong to the same industry (clothing sector).

From Forbes' Global 2000 list illustrated in the following table, we can see that Kering (which ownsmany renowned labels including Gucci) earns a considerably high rate of profit (around 60% of Kering's revenues); therefore, Gucci holds a significant competitive advantage in the worldwide market.

Clothing Company	***Ranking Position in Forbe's list***	***Profits of 2017***
Christian Dior SA	#150	$ 2.5 billion
Inditex	#289	$ 3.8 billion
Nike	#344	$ 1.8 billion
Kering	#349	$ 2 billion
Adidas	#457	$ 1.7 billion
H&M	#583	$ 1.8 billion

TABLE 5: Forbes' Global 2000 list-SOURCE:Forbes (2018)

Management Strategy

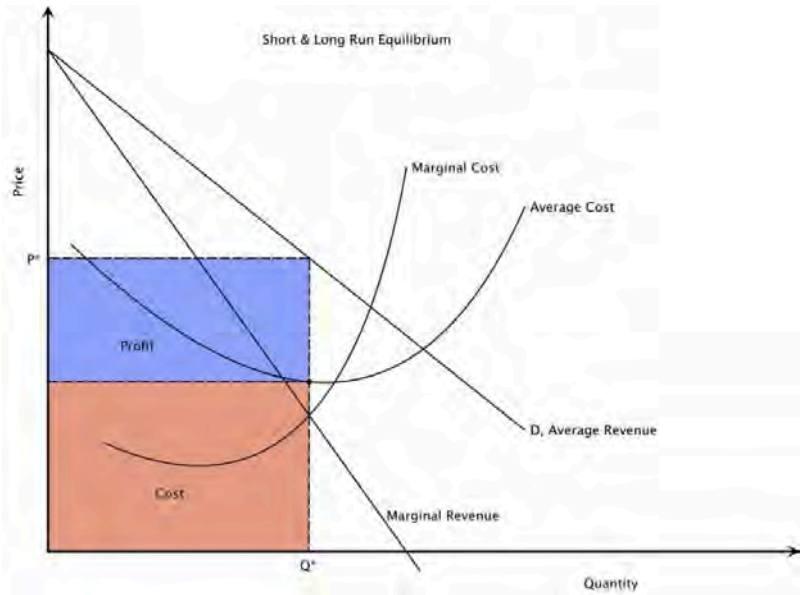
During the brand's evolution from 1921 until nowadays, Gucci has developed its management strategy, strengthening its position in the luxury competitive market all over the world. Historically Gucci based its strategy on the product differentiation, sending the raw materials to the countries which were more labor intensive, such as: China and India, where the manufacturing process was cheaper. Indeed Gucci, outsourced its high labor content of production in different world areas, where the average cost of producing a good was lower than producing it domestically.

$$P > AC$$

According to the profit maximization theory, the price is greater than the average total cost, which means that the total revenue is greater than the total cost ($TR > TC$), resulting in an economic profit.

$$\Pi = TR - TC = (P^M \times Q^M) - (MC - Q^M)$$

Regarding the micro-economic concept, Gucci produces the quantity that equates MR=MC (monopolistic optimum equilibrium), generating a positive economic profit.



GRAPH 26: Monopoly Market Structure-SOURCE: Intelligent Economist (2019)

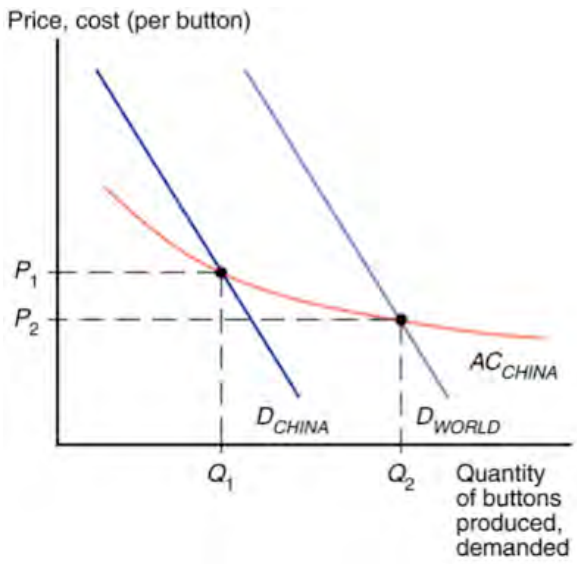
Luxuries companies, such as: Gucci, LV, Chanel and Burberry are competing in the market and the elasticity of demand is the way to evaluate their profits.

In order to increase its profits and gain a competitive advantage over its rivals, Gucci took the advantage of SMEs, importing into Italy those final goods. The SMEs operate in the *"Made in Italy"* manufacturing sectors, so that the *"Made in Italy"* could appear on the cloths label, showing that all the products were produced domestically.

Increasing its economies of scale, Gucci's sales occur all over the world. This means that when inputs to an industry increase at a certain rate, output increases at a faster rate. A larger scale is more efficient when the cost per unit of output falls as a firm or industry increases output.

Trade needs not be the result of comparative advantage, instead, it can result from increasing returns or economies of scale, that is, from a tendency of unit costs to be lower with larger output.

Economies of scale give countries an incentive to specialize and trade even in the absence of differences in resources or technology between countries. In the presence of economies of scale, the quantity produced increases, while the average cost decreases.



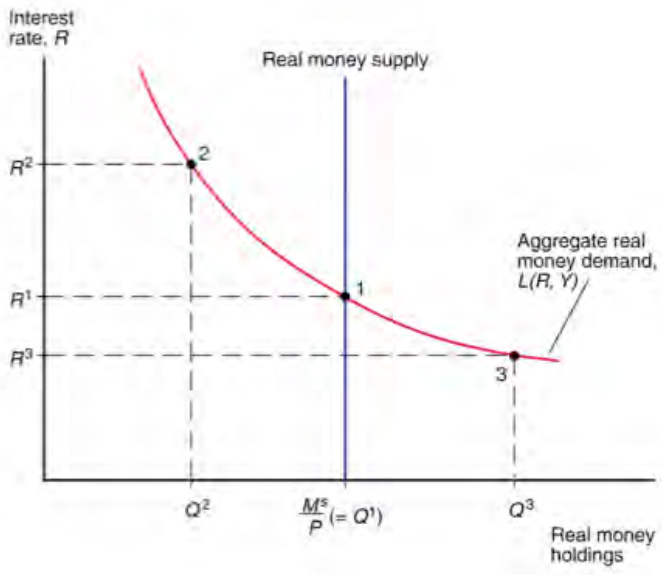
GRAPH 27: External economies of scale-SOURCE: Pearson Education (2012)

As a result, Gucci imported raw materials to produce its products in Florence (made in Italy), increasing the aggregate demand.

As it has been already explained previously, the aggregate demand is primarily determined by interest rates, level of average prices and national income.

The aggregate demand of real monetary assets depends negatively on the interest rate and positively on the level of national income.

$$\frac{M^d}{P} = L(R,Y)$$



GRAPH 28: Aggregate Demand Function for real monetary assets-SOURCE: Pearson Education (2012)

Implementing this strategy Gucci could rapidly reach a global demand for its distinct products.

Due to the European financial crises of 2008, domestic consumption had been affected, therefore the unique growth opportunity for the Italian makers was the exchange in the foreign markets. To take up the international challenge Gucci had first of all to show the new design creations and marketing innovations to the international targeted consumers, secondly it had to adopt adequate channels and techniques to engage them, and finally it had to establish a solid network of business to jointly face the global market throughout the innovative technological and digital tools.

Gucci based its strategy on several core features, such as: the industrial distinct model, unique manufacturing capabilities, the strong impact of Gucci's family heritage and finally the so called *"Made in Italy"*, which contributed to enlighten Gucci's position in the competitive luxury environment.

Indeed Gucci, as the typical Italian luxury industry, could distinguish itself from the international consumer market.

As a matter of fact, Gucci could maintain its prices fixed even if the average cost of production was low, because especially international consumers could benefit from an Italian brand even if they had faced the financial crises. The reason of Gucci's higher demand and fixed prices maintenance, was due to the fact that so high was the consumers' desire to wear that brand, that even in spite of the financial crises, they could run into debt for the willingness to wear it and appear *"cool"* to the society.

On the contrary, according to the *"law of demand"*, the higher is the price of a good, the less the consumers will purchase that product. In order to predict consumer behavior, economists use well-defined techniques evaluating the sensitivity of consumers to changes in price. To better understand how elsaticity varies according to the different variations in prices, it is important to analyse consumer's behavior development, studying various goods and services.

Estimated Price Elasticities of Demand for Various Goods and Services	
GOODS	ESTIMATED ELASTICITY OF DEMAND
Inelastic	
Salt	0,1
Matches	0,1
Toothpicks	0,1
Airline travel, short-run	0,1
Gasoline, short-run	0,2
Gasoline, long-run	0,7

Residential natural gas, short-run	0,1
Residential natural gas, long-run	0,5
Coffee	0,25
Fish (cod) consumed at home	0,5
Tobacco products, short-run	0,45
Legal services, short-run	0,4
Physician services	0,6
Taxi, short-run	0,6
Automobiles, long-run	0,2
Approximately Unitary Elasticity	
Movies	0,9
Housing, owner occupied, long-run	1,2
Shellfish, consumed at home	0,9
Oysters, consumed at home	1,1
Private education	1,1
Tires, short-run	0,9
Tires, long-run	1,2
Radio and television receivers	1,2
Elastic	
Restaurant meals	2,3
Foreign travel, long-run	4,0

Airline travel, long-run	2,4
Fresh green peas	2,8
Automobiles, short-run	1,2-1,5
Chevrolet automobiles	4,0
Fresh tomatoes	4,6

TABLE 6 FROM ECONOMICS: *Private and Public Choice*, James D. Gwartney and Richard L. Stroup, eighth edition1997, seventh edition 1995; primary sources: Hendrick S. Houthakker and Lester D. Taylor, *Consumer Demand in the United States*, 1929-1970 (Cambridge: Harvard University Press, 1966,1970); Douglas R. Bohi, *Analyzing Demand Behavior* (Baltimore: Johns Hopkins University Press, 1981); Hsaing-tai Cheng and Oral Capps, Jr., "Demand for Fish" *American Journal of Agricultural Economics*, August 1988; and U.S. Department of Agriculture.

The above table is an estimate for all different types of price elasticity of demand, for most goods & services. To predict consumer behaviour, economists use well-defined techniques which evaluate the sensitivity of consumers to changes in price. The most commonly used measure of consumers' sensitivity to price is known as *"price elasticity of demand"*. It is simply the proportionate change in demand given a change in price. If prices decrease for 1% of a product, it produces 1% increase in demand for that product, therefore the price elasticity of demand is 1. For most consumer goods and services, the price elasticity tends to be between 0,5 and 1,5, as the price elasticity for most products is around 1,0.

A good with a price elasticity stronger than a negative one is said to be *"elastic";* goods with a price elasticity smaller than a negative one (closer to zero) are said to be *"inelastic"*. Goods that are more essential for everyday consumption and that have fewer substitutes, typically have lower elasticities (such as: staple food). Goods with many substitutes, or that are not essential, have higher elasticities. Goods that are

considered luxuries, or whose purchase can be easily postponed, often have elastic demand.

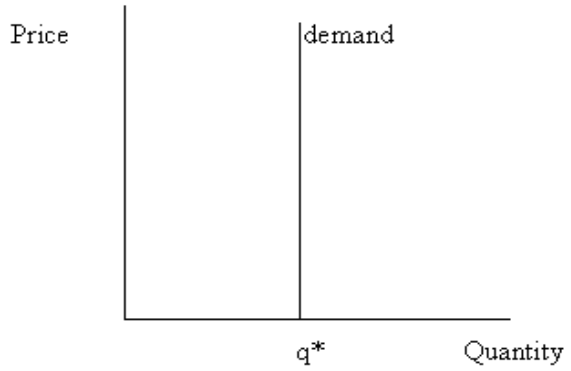
As the price level goes up, due to the inelastic demand function ($\varepsilon \to -1$), M^d increases and Q remains unchanged. This concept describes the opposite nature of a traditional luxury good, known to be relatively elastic.

The demand for luxury goods tends to be very elastic. By not being necessary goods the consumer can live without them at any time. This determines that their demand reacts intensely to price variations.

The elasticity of the demand curve influences how this economic value varies with a price variation.

If the demand is inelastic (the quantity varies little with respect to the price variations), an increase in price leads to an increase in economic value**,** while a decrease in the opposite price.
On the other hand, if the demand is elastic, an increase in the price causes a decrease of the economic value of the transactions, while decrease in the opposite price.

Inelastic demand occurs when consumers will not pay attention on the price level, so that firms are able to increase their prices. The elasticity of demand depends on the quantity demanded that doesn't change as much as the price, for this reason its shape looks steep. Any curve that is steeper than the unit elastic curve, means it is diagonal. The more inelastic the demand, the steeper the curve. If it is perfectly inelastic, then it will be a vertical line.



GRAPH 29: Perfect Inelastic Demand Function-SOURCE: Economics Beta (2015)

The demand curve shows how the quantity changes in response to prices. There are five different factors that determine the demand for each individual, such as: price, the price of alternatives, income, tastes, and expectations. For the aggregate demand the sixth determinant is the number of buyers. If one of the other determinants changes, the entire demand curve will shift. More or less of that good or service will be demanded, even though the prices remain at the same level.

Unit elastic demand and perfectly inelastic demand are the aim for companies to get the highest profits and revenues from customers, but this situation has some obstacles, due to the increase in competition. As the demand for Gucci's products becomes inelastic, its nature of goods is no more luxury but it becomes a necessity one or even an inferior one (with $\varepsilon < 0$).

The necessary goods usually have low income elasticity. The consumer tends to buy the amount he needs irrespective of whether his income goes up or down.

Whereas luxury goods tend to have high income elasticity: their demand varies markedly with variations in consumer income.

$$Income\ Elasticity\ of\ Demand = \frac{\%Change\ of\ Quantity}{\%Variation\ of\ Income}$$

Well needed vs. fine luxury

Regarding the definition of necessary and luxury goods: it is inelastic, when the commodity is classified as a necessary good and it is elastic, when the commodity is classified as a luxury one.

The necessary goods usually have an inelastic demand, as their demand oscillates a little in relation to the price variations (people will continue to buy that good because they need it). On the contrary, the demand for luxury goods tends to be very elastic.

The Engel curve is upward sloping, indicating that the total expenditure elasticity for poor households is elastic. Based on the following findings, considering the characteristics of necessities and luxuries utilizing not only total expenditure elasticity but also own-price elasticity, it is deductible that especially luxury goods are caracterized by an inverse U-shaped Engel curve (as it can be explained in the first chapter).

By not being necessary goods consumers can live without them at any time. This determines that their demand reacts intensely to price variations.

	Total Expenditure Elasticity	Price elasticity	Necessary or Luxury goods(defined by total expenditure)	Necessary or Luxury goods(defined by own-price)
(1) Rice	0.53	-0.34	Necessary	Necessary
(2) Wheat	1.05	-0.61	Luxury	Necessary
(3) Burns (wheat)	0.39	-0.45	Necessary	Necessary
(4) White maize attains	0.59	-1.47	Necessary	Luxury
(5) Maize flour white	0.14	0.30	Necessary	
(6) Beef with bones	0.42	-0.15	Necessary	Necessary
(7) Fresh, chilled or frozen fish	0.95	-0.72	Necessary	Necessary
(8) Dried small fish	0.66	-0.68	Necessary	Necessary
(9) Fresh cow milk	0.58	-0.36	Necessary	Necessary
(10) Sunflower oil	1.32	-2.30	Luxury	Luxury
(11) Oranges	0.66	-0.53	Necessary	Necessary
(12) Broad beans	0.18	-0.36	Necessary	Necessary
(13) Beans dry	0.15	-1.04	Necessary	Luxury
(14) Tomatoes, round	0.82	-0.58	Necessary	Necessary
(15) Cooking bananas, plantains	0.04	-0.46	Necessary	Necessary
(16) Brown sugar	0.58	-0.31	Necessary	Necessary
(17) White sugar	0.29	-2.03	Necessary	Luxury
(18) Tea	1.95	-0.30	Luxury	Necessary
(19) Coca cola	0.42	-0.32	Necessary	Necessary

TABLE 7 ELASTICITY OF DEMAND: Are luxury goods really luxuries? The validity of the Törnqvist world hypothesis-SOURCE: Atsushi, M. and Mlemba Abassy K.(2014)

The above table reflects all commodities as necessary goods evaluated by total expenditure elasticity and own-price elasticity. When we pick up luxury goods, regarding total expenditure elasticity, there are three commodities such as Wheat, Sunflower oil, and Tea. Whereas according to the own-price elasticity there are four commodities that are classified as luxury goods: White maize attains, Sunflower oil, Beans (dried), and White sugar. Sunflower oil is both a total expenditure elastic and ownprice elastic commodity, while Wheat, White maize attains, Beans (dried),White sugar, and Tea, are mixed elasticities.

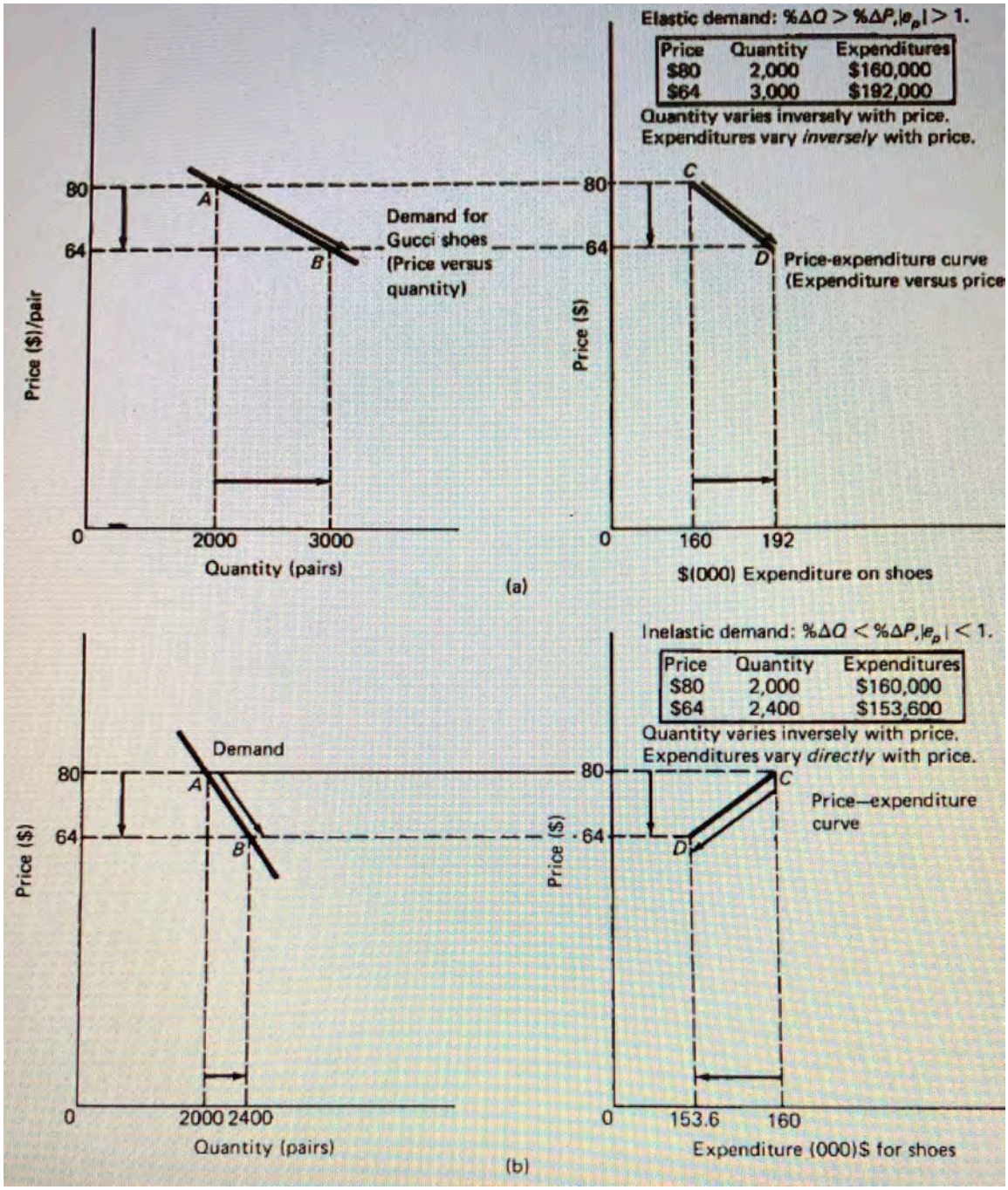
To conduct double-checking on the estimating results, we should consider a particular type of luxury brand: Gucci.

To see if the *"law"* holds when prices increase, we need just to look at the quantity demanded.

Let's consider Gucci's demand for shoes. According to the left hand diagram below, it shows the price-quantity relationship of the demand for shoes. At the price $80, the quantity demanded is 2000 pairs; at the price $64, the demand increases about 50% more. The movement from A to B represents a price reduction,

which is less than a corresponding increase in the quantity demanded when the price and the quantity are explained in a formo f percentages. For this reason the demand curve is considered elastic, as a price reduction leads to greater expenditure (shown by *"the price expenditure line"* on the right). The passage from C to D, shows the inverse relationship for which the quantity purchased at the lower price increases (from 2000 to 3000) leading to $192,000 of expenditure .

This movement is reported by the inelastic demand function (panel b), in which the percentage change in the quantity is less than a percentage change in the price. When the demand is inelastic, a price reduction brings lower expenditure. If the price is $80, the amount of expenditure is $160,000; but at the lower price of $64, the total expenditure is $153,600. The expenditures vary positively or directly with price, if the demand is price inelastic. Whereas when the price elasticity of demand equal unity, the expenditures are unaffected by price changes.



GRAPH 30: Intermediate Microeconomics with Applications-SOURCE: Aroop, K. Mahanty (2014)

When demand is elastic, expenditures vary inversely with price; while when the demand is inelastic, expenditures vary positively with price. Thus panel (a) shows that the demand for Gucci shoes is price elastic and hence the price falls while the expenditure on shoes increases. On the contrary, panel (b) shows an inleastic demand, as the price the price falls, expenditure on shows decreases too.

In particular as the price rises, the quantity falls proportionately less, while the total consumer expenditure rises, increasing Gucci's revenues.

For this reason Gucci is considered as the *"driver"* of the luxury market as it can be stated also by the last reports of Kering's group.

REVENUE

in €m	H1 2019	H1 2018	Reported change €m	Reported change %
Gucci	4,617.1	3,852.8	764.3	+19.8%
Saint Laurent	973.0	808.2	164.8	+20.4%
Bottega Veneta	549.0	552.2	(3.2)	(0.6%)
Other Houses	1,225.3	995.5	229.8	+23.1%
Luxury – Total Houses	**7,364.4**	**6,208.7**	**1,155.7**	**+18.6%**
Corporate & Other	274.0	223.2	50.8	+22.8%
Kering	**7,638.4**	**6,431.9**	**1,206.5**	**+18.8%**

50

TABLE 8: Investor Presentation September-SOURCE: Kering (2019)

Comparing the different results, it is obvious that Gucci is the key element for Kering's success in the luxury market. Gucci revenues are the highest among the different brands over the years and it is deductable that firm's revenues rise if the prices rise (inelastic demand function) and viceversa.

During the years Gucci has developed its glamour design and marketing innovation, maintaining its traditional style. In fact Gucci's aim is to improve the developments in technology and fashion that incorporate every different aspects of the complex multi-manufacturing processes.

Gucci's company, specialized in the manufacturing sector (textiles), implemented the *"ousoucing"*strategy, in which firms in high wage countries send a portion of labor intensive work abroad before shipping back the goods to be sold in the domestic market. But this process involved excessive transportation costs, therefore, firms decided to reduce the barriers to the mobility of labor, by forming common labor markets across national boundaries *("insourcing"*).

From the outsourcing to the insourcing

Gucci's internal factory (2017)

While many other fashion luxury brands have rushed to mass production and outsourcing to keep up, Gucci has instead recognized the importance of investing in the manufacturing chain for the necessity of artisans in the labor sector. For this reason it has developed different laboratories in Italy in the last three years.

Due to this rush in more labor intensive countries, Gucci has instead started producing domestically, in order to avoid any additional trade cost and invest in domestic laboratories, such as the *ArtLab* at Casellina (Florence-Tuscany) that is a futuristic experimentation laboratory in which there are 800 workers employed.

The ArtLab brings together processes and activities that had been previously outsourced.

The high migration flows of high skilled workers to domestic countries, contributed to increase the productivity (due to high levels of education) than workers in developing countries (India and China) where

the production cost and wages were low, due to a low level of human capital and education. Bringing together the different production phases means faster steps from the conception to the production phase. An enormous time saving that in an ultra-competitive market can make a huge difference.

In particular it is characterized by the opportunity to absorb new ideas from best practices around the world, in order to further strengthen Gucci's leadership. Creativity, innovation and sustainability can maximize the sharing of skills and best practices for the research and development of new materials. ArtLab can be linked with the original territory of production and invention.

The passage from outsourcing across different world areas to the experimental laboratories in Italy have contributed to Gucci's awards in the luxury business field, raising its position in the competitive market. In 2018 during the Italian fashion week in Milan, Gucci has been declared as *"the brand of the year"*, under the CEO Marco Bizzarri, known as the *"best business leader"*, for its continuous developments in innovation and marketing design.

Gucci ArtLab

Gucci ArtLab & Sustainable Mode (2017)

Gucci research lab is a project undertaken by Gucci in a three-years partnership with Bocconi University.

The aim is to identify and study the main factors that define the evolving organizational strategies of the 21st century, with a special focus on the luxury industry. For this reason, four professors will develop researches on the topics of: start-up mentality, employee empowerment and risk-taking. Findings and results will then be published at the end of the year. Although this project is not an innovation, as many firms have their own

research and development team, it has given the starting point for many other initiatives, among which, the Gucci ArtLab, an invention that generates other inventions.

As a part of the Gucci Research Lab project, Gucci ArtLab has been inaugurated in 2018 near Florence. It is a 37,000 square-meters futuristic centre of industrial craftsmanship and experimental laboratory employing more than 800 people. Here products will be experimented, developed and tested. The ArtLab was created in response to the impelling need of generating innovating ideas, a key factor in outperforming competitors within any industry. This Lab represents both an organizational and strategic innovation for Gucci. It completely renewed the workplace organization, as the ArtLab is not just a bunch of offices where employees experiment new products, but a pool of stimuli and learning opportunities. Moreover, the inspiring environment permits Gucci to successfully attract and retain talented workers together with their precious knowledge, adding value to the production process and to the firm as a whole.

In 2018, Gucci opened an Art Lab to support the utilization of sustainable materials as well.

Consumers are beginning to question whether the brands they are purchasing products from, are taking care of the planet and are respecting fair labor and wages principles. Gucci is pouring millions of dollars into a programme to become carbon neutral, as scrutiny on fashion's climate impact gains momentum. Kering has

built innovation labs to encourage research of sustainable raw materials, to provide designers with resources to make their creations eco-friendly.

Last year, Gucci said it offset 1.4 million tonnes of carbon dioxide equivalent at a cost of $8.4 million. The money will be split between emissions reduction projects with the aim to conserve critical forests and ecosystems that act as carbon traps.

Kering's strategy for sustainability aims at reducing pollution and waste, and it is working with external suppliers and its innovation laboratories to fulfill this objective.

The French conglomerate is also working with researchers and engineers to spur progress. In 2015, Kering publicly declared its plan to use sustainable raw materials, and its desire to reduce water and energy consumption, which hopefully will reduce by 40% the environmental footprint.

In order to achieve this 10-year plan, Kering must cooperate with suppliers to prioritize environmentally friendly solutions, which eventually will reciprocally increase each other's competitive advantage.

The company is positioning itself as a climate leader within the indtustry. So far, Gucci is the only one, among its stable of luxury brands, considered to be carbon neutral.

"*We still consider the best option is always to reduce the impact, but at the moment it's impossible to achieve in the time necessary to make sure the planet is not going to burn".*[8]

CONCLUSIONS

The present paper has tried to understand and examine how the luxury sector influences the global market.

From the financial markets point of view, the luxury sector represents €1200 billions of earnings in 2018 (+5% of the previous year). 24 Italian luxury companies are ranked in the top 100 of the most profitable firms in the world.[9] The importance of the *"Made in Italy"* written on the clothes label, influences the demand for luxury products, due to its distinct quality of materials.

The study of the law of demand which works with the law of supply, has led to the explanation of how market economies allocate different resources and to determine the prices of goods and services that it can be observed in everyday transactions. Consumers use the first units of an economic good they purchase to serve their most urgent needs firstly, and then use each additional unit of the good to serve successively lower valued ends.

It has been described the concept of the elasticity of demand and how it affects the overall luxury market performance. The nature of the goods affects the elasticity of demand, for this reason it has been important to analyse whether a good can be classified as necessity or luxury, depending on their own elasticity of demand. Luxuries companies, like Gucci, are competing in the market and the elasticity of demand is the right way to evaluate their profits and their influence in the luxury market.

After an analysis of the aggregate demand, that became necessary to get a better understanding of new trends entrance in the luxury market at a global level, it can be explained that the luxury market has not suffered the

[8] Gucci CEO Bizzarri, M. [online news]. Available at: https://www.businessoffashion.com/articles/news-analysis/gucci-looks-to-set-a-new-trend-on-carbon-neutrality

[9] Art. Luxury and Finance (2019) Funds & Sicav

financial crises of 2008, because the arrival of new luxury trends has raised the overall demand for luxury goods market, facilitating a temporary economic growth.

In order to enlighten at best Gucci's competitive position, compared to the entrance of its rivals, and how it determines the aggregate demand, promoting the world-wide economic growth in the luxury market, it would have been interesting to examine more in depth the potential variables that influence Gucci's growth in the luxury field. Undertaking an econometric analysis and studying the regression line of those variables affecting Gucci's growth, it would have been possible to deduce the factors that constitute Gucci's competitive advantage in the luxury market.

As the shape of the elasticity of demand affects the overall market demand for luxury goods, the last chapter has the aim to examine Gucci's case study, based on its elasticity of demand, which differs from the usual luxury elastic demand, as it follows a downward sloping shape ($\varepsilon < 0$).

Subsequently it has been examined how Gucci's elasticity of demand could increase the economies of scale, strengthening its competitive position in the luxury market, even being the key determinant of Kering's success in the superior field. Comparing Gucci's elasticity of demand with the one of its competitors it would have been possible to clarify the reasons of Gucci's competitive advantage in the luxury market. In order to get a better understanding of the factors that encourage the economic growth and conduct Gucci's success in the luxury field, the comparison among the different luxury trends elasticities of demand would have been an additional proof of the reasons why Gucci is considered the *"leader"* of the luxury market, which drives the economic global growth (+66% in 2018, equal to € 19 billions).[10]

Finally, it has been examined how the increase in the economies of scale led to the transition from the outsourcing to the insourcing strategy, importing the manufacturing sectors in the domestic market, creating internal manufacturing laboratories in Italy (ArtLab) and reducing the transportation costs.

Concluding, undertaking the analysis of Gucci's elasticity of demand, based on its management strategy, has been the key for the break down of the aggregate market demand expansion in the luxury business. Through this analysis it could be determined how the elasticity of demand variations, based on own price elasticity, total expenditure and income, affect the overall luxury market demand and thus the consumer behaviour from a business point of view.

[10] BrandZ Top 100 Most Valuable Global Brands (2018)

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