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Journal of Economic Theory 131 (2006) 1–25

JOURNAL OF Economic Theory

www.elsevier.com/locate/jet

Economic integration and agglomeration in a middle product economy

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Received 18 May 2004; final version received 30 June 2005
Available online 18 October 2005

Abstract

We examine the interactions between economic integration and employment agglomeration in a neoclassical-growth, middle-product economy. There are two vertically integrated economies, with competitive final good firms operating plants in both regions and monopolistically-competitive intermediate good firms operating each in only one region. Immobile workers are employed with traded middle products to produce the nontraded final good; mobile workers are used with immobile capital to design and produce differentiated intermediate good inputs. While agglomeration and growth need not be positively related, trade need not enhance regional growth nor widen the skilled–unskilled wage gap.
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JEL classification: D90; F15; O41; R13

Keywords: Economic integration; Agglomeration; Intermediate goods trade; Growth

1. Introduction

Contemporary research focussing on the relationships between growth, trade and the location of economic activity looks like a patchwork of results that cannot be generally reconciled with data. Whereas, there is a large agreement among economists about the

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0022-0531/$ - see front matter © 2005 Elsevier Inc. All rights reserved.
doi:10.1016/j.jet.2005.06.005

positive role of international trade in fostering long-run economic growth, empirical studies fail to identify a robust and significant relation between the two processes [29,15]. Likewise, it is now a well-documented fact that, over the past two decades, wage inequality between skilled and unskilled groups (skill premium) has increased sharply, in both developed and developing countries. [1] During this period, imports of low skill-intensive goods from less-developed economies have increased sharply [35]. Much concern has, therefore, been raised regarding the impact of trade on between-group income disparities [27,42,26], while recent empirical evidence shows that deeper economic integration has an ambiguous impact on regional income gaps [31]. [2] Last, a common finding in modern regional growth is that population agglomeration and output growth are positively related when economies are sufficiently integrated [3]. Here also, such a positive relation cannot be identified empirically in a robust fashion [7]. All of these suggest the existence of a strong tension between diverging economic forces that have not yet been captured within a unified framework. Our purpose is to contribute to the building of such a framework by tackling the problem from a very different angle.

In this respect, we want to stress the fact that most of the literature dealing with the implications of economic integration has been conducted by focussing on the final product market. However, since the seminal work of Sanyal and Jones [36], it has been increasingly recognized that "the bulk of international trade consists of the exchange of intermediate products, raw materials, and goods which require further local processing before reaching the final consumer" (p. 16). More precisely, almost all contemporary final commodities make use of inputs bought on the world markets together with inputs available in national markets. This state of affairs has triggered more and more interest in what is called the *middle product* market. [3] In such a context, economic integration takes the special form of *vertically integrated regions* that trade a growing number as well as larger quantities of intermediate inputs from each other. The empirical relevance of this form of trade in international business is well documented and explains why we focus on it. For example, Yi [44, p. 55] observes that "vertical specialization [integration] has grown about 30 percent and accounts for about one-third of the growth in trade in the last 20–30 years."

This paper examines the interactions between trade and population agglomeration in a neoclassical growth model with two vertically integrated economies in the presence of in-

[1] See, for example, the comprehensive survey by Levy and Murnane [30]. In particular, Juhn et al. [23] find that the real wage for the lowest 20% of the American workforce in the 1990s was 25% below the 1973 level. Over the period from 1963 to 1989, Juhn et al. [22] indicate that the real wage for the least skilled American workers (tenth percentile) decreased by 5%, whereas, the real wage of the most skilled (ninetieth percentile) rose by 40%. Similar trends have been found in Canada and Great Britain [24,6], as well as in Indonesia, Korea, Taiwan and Thailand [38,10] as well as in Chile and Mexico [8,28].

[2] For example, Leamer [27] and Wood [42] claim that the expansion of trade with less-developed countries widens the skill premium, whereas Lawrence et al. [26] and Harrigan [18] counter this conclusion by documenting empirically that trade is not a major factor driving the wage inequality in advanced economies. Compelling arguments suggest that possible major forces for the recent trend in wage disparities include advancements in the skill-biased technology that widens the wage premium [2] and improvements in the general purpose technology that induces within-the-skill-group wage inequality [1].

[3] See the survey paper by Jones and Neary [21, Section 3.1] and the papers cited therein.

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