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Market access, economic geography and comparative advantage: an empirical test

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Abstract

Traditional neoclassical models of comparative advantage suggest that, all else equal, a country with idiosyncratically strong demand for a good will be an importer of that good. However, there is a contrary tradition that emphasizes the advantages of a large home market as a foundation for *exports* of a good. One recent formalization of this home market approach falls within what is termed the new economic geography. This paper integrates core models of Heckscher–Ohlin and Krugman [American Economic Review 70 (1980) 950] to investigate whether such home market effects matter empirically in manufacturing for a set of OECD countries. The evidence suggests that home market effects are important for a broad segment of OECD manufacturing.

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1. Market access, economic geography and comparative advantage: an empirical assessment

The empirical trade literature has focused strongly in recent years on understanding determinants of the pattern of trade. In a seminal contribution, Leamer

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(1984) examines this question in a version of the Heckscher–Ohlin model featuring factor price equalization (FPE) and equal numbers of goods and factors. Leamer identifies a set of twelve productive resources that correlate well with countries' net trade vectors. One limitation of Leamer's approach is the focus on explaining the net trade vector. The reason this is a limitation is that it is well understood that the real intellectual capital of the theory is the predictions about the cross-country pattern of production, which is then coupled with a rudimentary and implausible theory positing identical structures of absorption.

Recognition of this limitation led researchers such as Harrigan (1995, 1997) and Bernstein and Weinstein (2002) to focus directly on the model's ability to predict cross country patterns of production. Within the framework of the frictionless FPE Heckscher–Ohlin model, this divorce between the patterns of production and absorption makes perfect sense. However this makes less sense in a world in which trade frictions matter. And other contributions to the recent research agenda, including inter alia McCallum (1995) and Davis and Weinstein (1999) have emphasized instead the importance of these frictions for understanding trade.

Trade frictions segment markets, giving rise to differences in price indices across locales. Moreover, these frictions imply that the geographical distribution of demand across markets will matter for local production patterns. In such a case, investigation of the pattern of production cannot proceed without attention to underlying demand conditions. In order to investigate this empirically, one needs to commit to specific models. A fundamental divide may be identified between two classes of models. In the first class, unusually strong demand for a good, *ceteris paribus*, makes a country an importer of a good. An example would be a conventional two-sector neoclassical model with strictly downward sloping import demands. However, there is an alternative tradition within the trade literature which emphasizes an important interaction between demand conditions and production opportunities in which the production response to local demand conditions is so powerful that strong local demand for a product leads a country to export that product. When such conditions exist, the literature terms it a home market effect.

It is important to recognize that there are a variety of models which potentially could give rise to such home market effects. For example, the so-called biological model of trade posits that nationally-differentiated products arise in response to peculiarities in local demand (cf. Bhagwati, 1982; Feenstra, 1982), in turn effectively giving rise to Ricardian advantages that lead a country to export that product. It is likewise important to recognize that the exact determinants of the home market effect may well differ across models so that it will be important in subsequent work to consider alternative specifications of the home market effect that correspond to the distinct underlying models.

This paper develops one approach to identifying empirically the existence of home market effects. The foundation for our approach is Krugman (1980) as extended by Weder (1995). The underlying model is Dixit–Stiglitz monopolistic

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