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Geographical Advantage: Home Market Effect in a Multi-Region World

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Geographical Advantage: Home Market Effect in a Multi-Region World<sup>1</sup>By Kiminori Matsuyama<sup>2</sup>

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**Abstract:** I propose a theoretical framework for studying the effects of geographical factors on the distribution of industries across many regions. The geographical feature of each region is summarized by a proximity matrix, whose elements measure the closeness between every pair of regions and depend on the parameters representing the transport and other costs of using a variety of trade routes. A change in these costs of trade affects the distribution of industries by amplifying the geographical advantages and disadvantages of regions. Through a series of examples, I demonstrate how this framework can be used not only to examine the effects of an improvement in transport infrastructure, but also to address some problems from economic history, regional economic integration, and the north-south division, and discuss some geopolitical issues.

**Keywords:** Monopolistic Competition, A Multi-region Model of Costly Trade in Differentiated Goods, Home Market Effect, Regional Economic Integration, Uneven Development, Convergence versus Divergence, Geographical Advantages and Disadvantages, Proximity Matrix, Trade Routes.

**JEL Classification Numbers:** F12 (Models of Trade with Imperfect Competition and Scale Economies), F15 (Economic Integration), O11 (Macroeconomic Analysis of Economic Development), R12 (Size and Spatial Distributions of Regional Economic Activity)

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<sup>1</sup>This paper was originally written and circulated as Matsuyama (1999), the background paper for “Geography of the World Economy,” the Inaugural Fukuzawa Lecture delivered at the 1999 Far Eastern Econometric Society Meeting in Singapore. Since then, it went into hibernation, except recent talks at Princeton and Hitotsubashi Conference on International Trade & FDI under the current title. I am grateful to the audiences at these talks for their comments and to those who suggested that I should try publishing it, including P. Antras, R. Baldwin, D. Donaldson, J. Eaton, G. Grossman, E. Helpman, G.I.P. Ottaviano, D. Puga, S. Redding, T. Tabuchi, and J.-F. Thisse. I hope that the publication at this time will not only make the original lecture more accessible than it has been but also stimulate further research along this line. In preparing for this version, I tried to keep the original lecture as intact as possible, but added some discussions on recent work on this topic and some thoughts on how recent advances in trade and monopolistic competition, such as heterogeneity of firms and non-CES preferences, might affect my analysis.

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