REGIONAL SPECIALIZATION

How to Explain it?

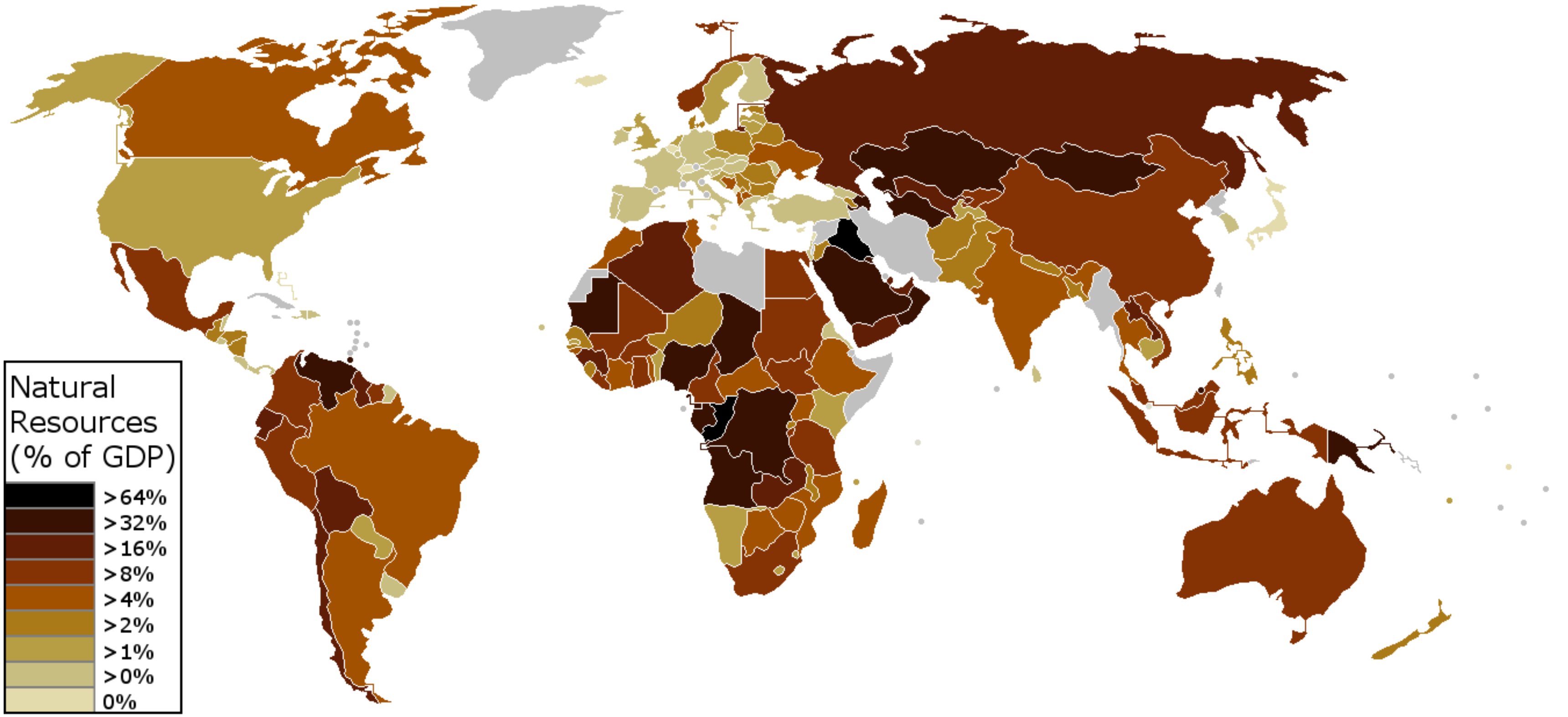
Overview

- There are three main explanations for why there is trade and why it produces the sort of global patterning of development that was noted in the last lecture. All of these rely to one degree or another on the idea of a global "division of labor." This is based in the division of labor that Adam Smith noted with respect to occupations in the 1770s: (a) skills must be honed to be good at something and not everyone can be good at everything and (b) information/knowledge has exploded, so not everyone can have all the knowledge it now takes to be good at something.
- The three explanations: 1.comparative advantage (David Ricardo in the early 1800s); 2. factor endowments (e.g. Hecksher-Ohlin model in the 1940s); and 3. competitive advantage (Michael Porter in the 1980s).

ABSOLUTE VERSUS COMPARATIVE ADVANTAGE

	USA	CANADA
Paper	110	100
Woolen Cloth	120	90

- David Ricardo’s idea: there is an incentive to trade because each country has a relative or comparative advantage in a different sector. The result: it pays to specialize in what you do best relative to others. In the example above the US has an absolute advantage in both products but its resources (labor, land, and capital) are best deployed most efficiently to making woolen cloth and importing paper from Canada.
- But is this really how the world economy actually works? Are countries that extract resources doing so just because they have a comparative advantage or for some other reason? The next map shows how dependent on resource extraction and export some countries actually are. Is this this the best they can do?


Natural Resources (% of GDP)
>64%
>32%
>16%
>8%
>4%
>2%
>1%
>0%
0%

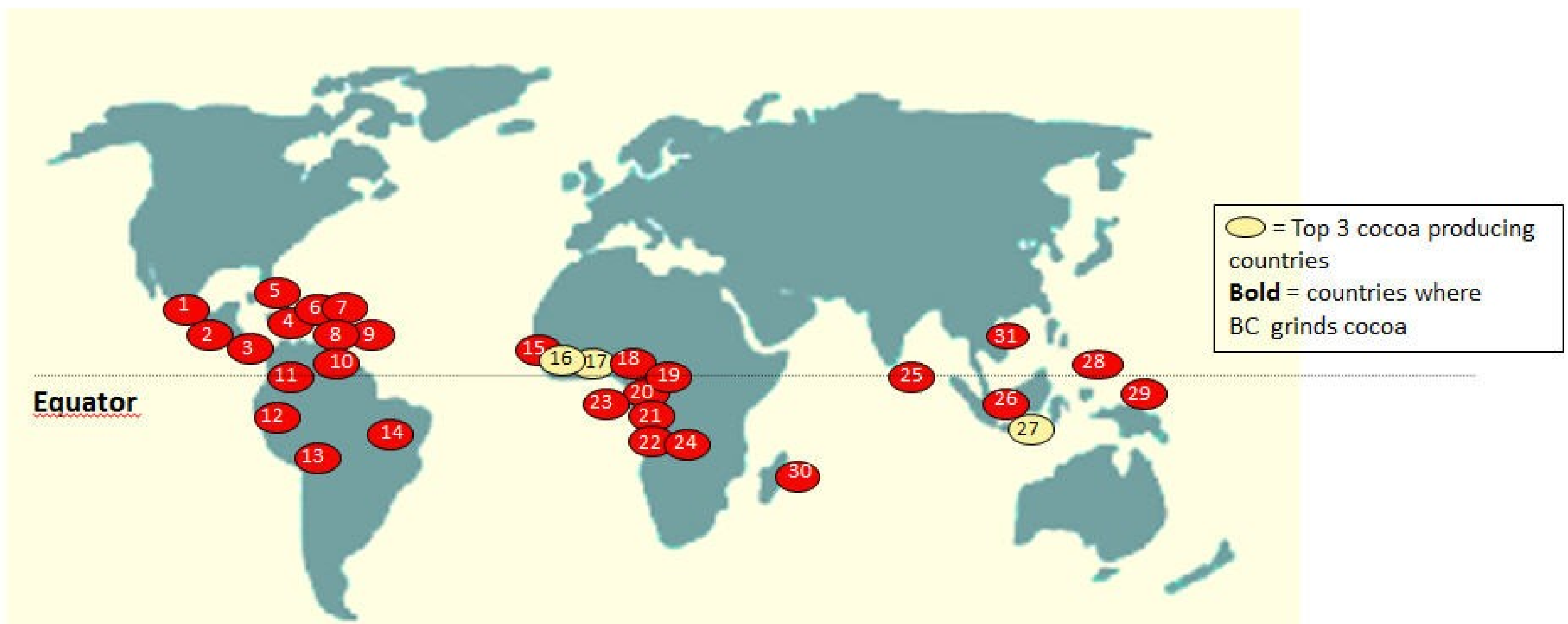
FACTOR ENDOWMENTS

- Alternatively, and more specifically, countries/localities specialize not because of comparative advantage but because they have different mixes of labor, land, and capital that point them towards, say, cattle ranching (lots of cheap suitable land), manufacturing assembly of electronic components (relatively cheap but appropriately skilled labor), or banking and finance (liquid capital markets).
- Land, labor and capital are the factors of production
- Different places have advantages in one or sometimes a combination of the others
- This leads to different economic specializations and incentives to trade (Heckscher-Ohlin model) (assumes constant returns to scale in producing whatever good or service)
- This predicts that capital versus labor intensive industries or phases of production will locate in different places (e.g. high end R&D in electronics in the Bay Area and assembly in southern China).
- This is a definite improvement over comparative advantage but misses the history of how places have come to have the endowments they have.

SPECIFIC PROBLEMS

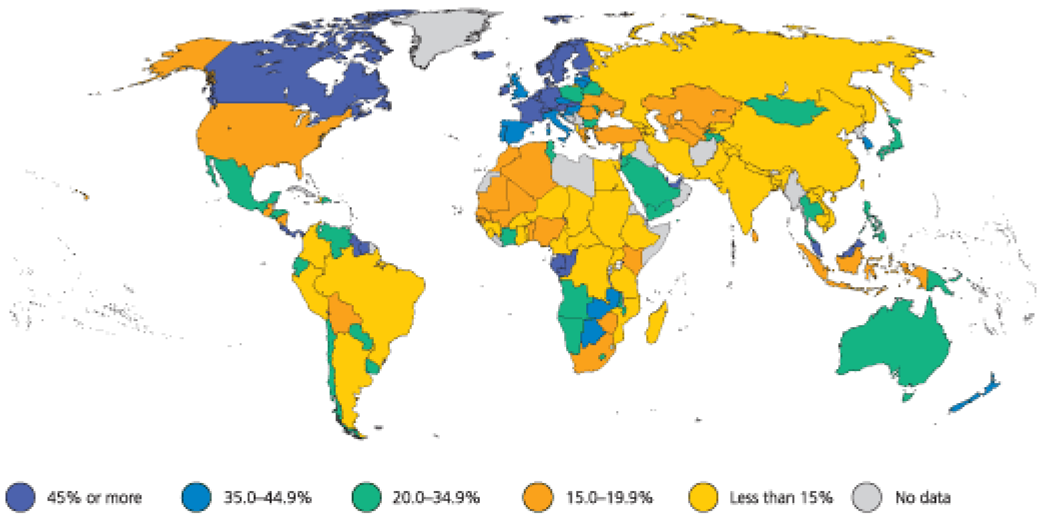
- Presumption (as with comparative advantage) that specialization is always good.
- Specialization is not always advantageous because of volatility of demand (if you specialize in bananas and people stop eating them) and declining terms of trade between sectors (e.g. prices of natural resources go down as prices of manufactured goods go up). Sometimes other places become better at doing what you used to have a monopoly in (e.g. cocoa producers in Ghana and Ivory Coast now face many competitors: all are worse off – see next map)
- Governments worry about self-sufficiency in some basic types of production (Why is rice grown in California? It is subsidized by the US government)
- Much trade has long been **within** businesses even when they are located across countries (components made by subsidiaries or contractors for assembly elsewhere)
- Politics of who decides what a given place will produce (autonomy of firms vs. trade barriers such as tariffs (taxes on imports) imposed by governments to make them more expensive). The whole world not equally involved in world trade (see second map) because most economic activity is locally oriented.

- Cocoa is grown in a narrow belt 20 degrees North and South of the equator



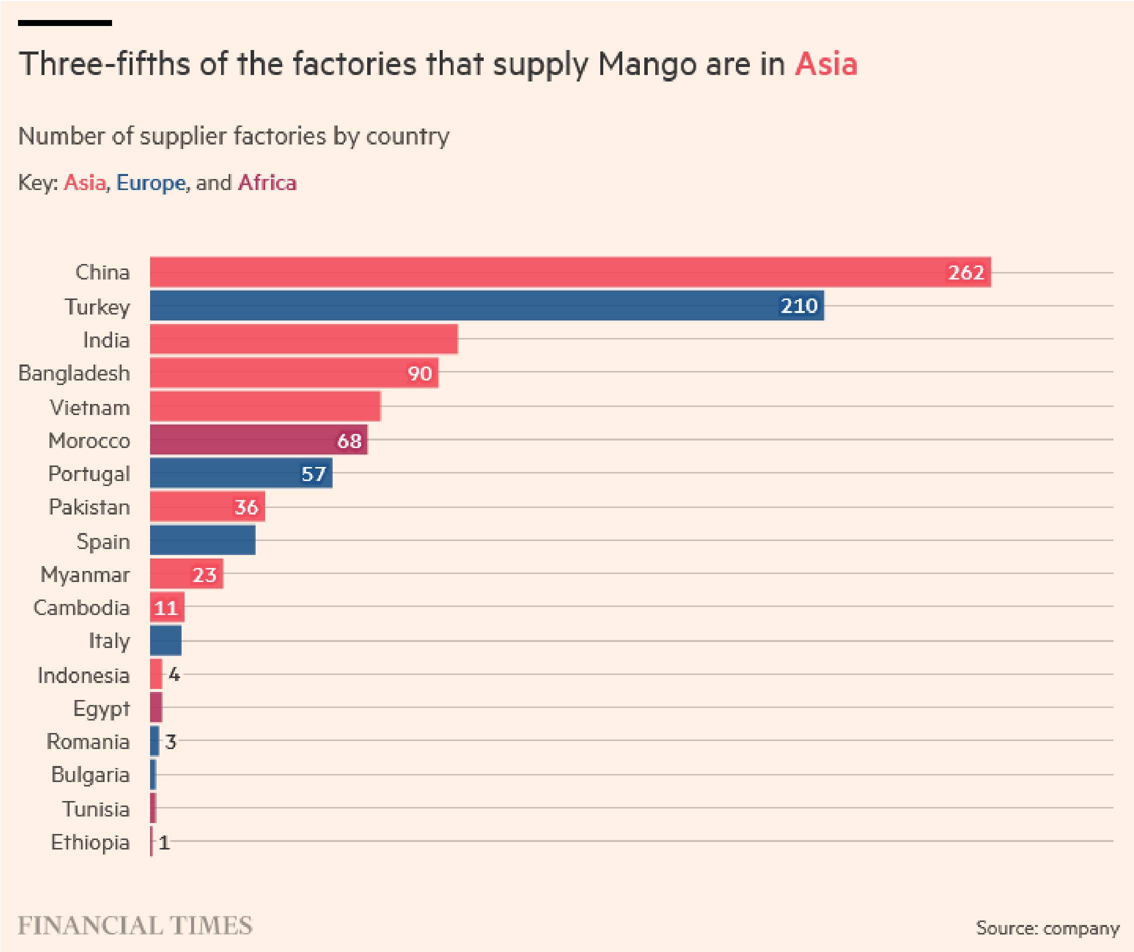
1 **Mexico**
2 Costa Rica
3 Panama
4 Jamaica
5 Cuba
6 Haiti
7 Dominican Republic
8 Grenada
9 Trinidad and Tobago
10 Venezuela
11 Columbia
12 Ecuador
13 Peru
14 **Brazil**
15 Sierra Leone
16 **Ivory Coast**
17 **Ghana**
18 Togo
19 Nigeria
20 **Cameroon**
21 Equatorial Guinea
22 Gabon
23 São Tomé
24 Congo
25 Sri Lanka
26 Malaysia
27 Indonesia
28 Philippines
29 Papua New Guinea
30 Madagascar
31 Vietnam

Map 12.1 **Trade as a percentage of real GDP, 1998**



Note: The ratio of trade to purchasing power parity – adjusted GDP is considered the best available tool for comparing integration with the world economy across countries But the use of this tool is complicated by the different shares of the service sector in the economies of different countries. For example, developed countries appear to be less integrated because a larger share of their output consists of services, a large portion of which are by their nature nontradable.

Global Value/Supply Chains (example of Mango clothing, 2022)



COMPETITIVE ADVANTAGE

- The third explanation focuses more on institutional and political histories as underpinning regional specialization.

  Places have different political and economic histories – "uneven playing field" – more capital accumulated in some places than others, labor more skilled because of education, etc. Some governments – national and local -- invest in infrastructure (ports, roads, education, and innovation) and others do not: Michael Porter.
- Increasing returns to scale over time because of initial advantage (so-called "new trade theory"): Paul Krugman.

Main Elements of Competitive Advantage

- 1. Imperfect competition across businesses and countries
- Not all are born equal, so to speak. Initial advantage pays off, often for many years, when you are the first or an early entry. Others are always playing "catch up."
- 2. National economies of scale and agglomeration economies (localization and urbanization economies)
- Having a large domestic market or having access to large ones elsewhere means you have national "economies of scale" that lowers prices per unit of a product relative to production costs. Locally, being close to others in the same business and the specialized services you need (agglomeration economies) gives you huge advantages over other places.
- 3. Economic crises and shifts in competitive advantage
- Nothing is forever. Shocks such as wars, pandemics, and financial crises can upset established location patterns and open up competition. For example, successful cities can become too expensive for many workers to live in as house prices and rents go up. Over time this can encourage an exodus (e.g. Bay Area denizens moving to Boise, Idaho and Bozeman, Montana).

Conclusion

- So, of the three explanations the third seems the most “in tune” with the real world. Much of the rest of the course is concerned with tracing the global history of competitive advantage.
- The other two are not so much false as partial. In fact, thinking in terms of factor endowments is complementary to competitive advantage.
- Comparative advantage is useful in pointing to the limitations of absolute advantage. Some politicians need to see that there is an economic logic to trade beyond national borders that imposing tariffs will never undermine.