

Commentary: Shifts in Economic Geography and Their Causes

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Tony Venables has given us an admirably clear and succinct overview of the relatively new literature on economic geography. This is a splendid paper for the crispness of its organization, the clarity of its exposition, and its many insights. One could not ask for a better nontechnical summary of some of the major implications of this active area of research.

Since Tony has done such a fine job in exploring the various dimensions of economic geography, I would like to focus on two related issues: (1) what can or should countries do about these changes in economic geography, and (2) should we fear these changes in economic geography?

What can we do about economic geography?

The literature on economic geography has given us many deep insights into the spatial location of economic activity, the forces behind agglomeration, and their implications. For example, Paul Collier's paper at this conference points out the difficulties that Africa will have in gaining a foothold in labor-intensive manufactured articles (such as textiles) now that South Asia has established a high degree of specialization in those industries. But the economic geography literature seems

to be more successful in giving us a positive analysis of agglomeration than in providing normative guidance as to the policy implications.

The various models of economic geography tend to build in a deep structure to the world economy, governed by geography, distance, transport costs, and initial endowments. In such models, there is a tendency to find multiple equilibria. That is, small differences in initial conditions can lead to a multiplicity of outcomes. Of course, such structure is very much the point of economic modeling. However, if taken too seriously, these models can lead to a very nihilistic view of the world. With the determinants of initial conditions set long ago, countries are locked into the present system, stymied in anything they do. One is reminded of the Englishman who, while driving in rural Ireland, stopped by the side of the road to ask a farmer, "What's the best way to get to Dublin?" To which the farmer replied, "Well, if I were you, I wouldn't start from here."

But we should not be nihilistic about the fate of countries because there are many things that they can do to improve their lot, even if they get a bad draw from nature in terms of geography. Contrary to conventional wisdom, as Tony points out, distance is not dead and trading costs still matter hugely for trade flows and other international economic interactions. Yet, as Australia and other countries have shown, even if trading costs can never be completely overcome, they can be significantly reduced with good transport, finance, and communication systems. This is the message of Tony's work with Nuno Limao on the role of transport infrastructure as an important determinant of trading costs, particularly for landlocked countries. For example, they find that Africa has been marginalized in trade by poor domestic infrastructure, not just exogenous distance from markets. There, while distance cannot be vanquished, its effects can be mitigated.

The policy implication Tony mentions at several points is that the productivity-proximity relationship creates a coordination failure, and this suggests a catalytic role for national industrial policy. While he does not elaborate on this point, one suspects that he is resurrecting something like the "big push" idea in development economics. For

example, some economists believe that the East Asian growth miracle over the past few decades proves the importance of "big push" policy interventions. Such interventions, it is believed, help to overcome coordination failure and generated large long-run payoffs as the cumulative causation processes of the proximity-productivity relationship worked its magic.

I am more skeptical about this idea. With respect to Asia, for example, I am not sure what the initial interventions were that eventually overcame the coordination failures. In 1991, according to the International Monetary Fund's *World Economic Outlook* database, Hong Kong overtook the United Kingdom in per capita gross domestic product (at purchasing power parity—PPP). What government intervention did Hong Kong employ to go from utter impoverishment to stunning riches? Since the late 1980s, Vietnam has been incredibly successful in reducing rural poverty. What five-year government plan or intervention enabled this to happen?

Indeed, there seems to be a rather large missing ingredient in the economic geography literature. And that ingredient is governance and a role for economic policy in affecting the fate of nations. (To be fair, Tony points out in his paper several times that economic geography does not explain everything and is one of many approaches to think about economic development and the agglomeration of economic activity.)

The recent shifts in economic geography have demonstrated that the economic status of developing countries is not immutably fixed by nature. Neither the geography nor the institutions of China, India, Korea, or Vietnam changed when they embarked on their policy reforms, and yet their economies have been utterly transformed by changes in government policy and economic liberalization. China's economic rise has not been propelled by a government in search of market failures and coordination problems. It was propelled by Deng Xiou Ping's revolutionary belief: "I don't care if the cat is black or white, just as long as he can catch the mouse." His decisions in December 1978 have changed the world as we know it.

The experience of industrial policy in other Asian countries raises notes of caution as well. In 1983, the Kansas City Fed's Jackson Hole symposium was devoted to industrial policy, and at that time, everyone was enamored with Japan. Yet the two Japanese industries that achieved the most notable success on world markets—automobiles and consumer electronics—did not benefit from extensive government support, unlike some other heavy industries, such as chemicals and steel. The Ministry of International Trade and Industry also had notable failures in promoting its biotechnology and computer industries. Essentially, Japan ran into the Robert Solow problem. Solow has reportedly quipped, "I know there are a lot of industries in which the social returns are vastly greater than the private returns, I just don't know which ones."

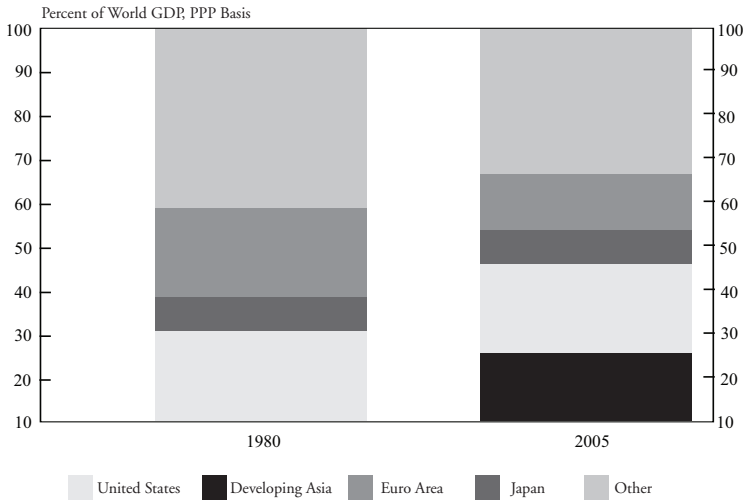
One of the many problems with industrial policy is that the political prerequisites for such judicious intervention are lacking even in southeast Asian countries, such as Malaysia, Thailand, and Indonesia. The economies of these countries have performed well in recent decades, but corruption and rent seeking have given industrial policy there a bad name. In those countries, industrial policy is virtually synonymous with arbitrary interventions to help out political cronies.

I noted in my book *Free Trade under Fire* (p. 183):

There is no single East Asian model of economic development. Singapore and Hong Kong are small island states, the latter pursuing an almost pure free-market approach. Japan and Korea employed more activist industrial policies, but there is little evidence demonstrating their precise contribution (positive or negative) to the country's development. Malaysia and Indonesia have weaker political institutions that do not keep industrial policy free from corruption and rent seeking. Yet, for the most part, all of these East Asian countries have enjoyed macroeconomic stability, relied on private enterprise and market competition, stressed investment in human capital, and adopted outward-oriented policies rather than import substitution. These are the common elements cutting across the countries' vast differences.

Chart 1

Shifts in the Economic Weight of the World, 1980 and 2005



Source: International Monetary Fund's *World Economic Outlook* database

Therefore, I would be skeptical about whether the burdens of economic geography necessarily require a turn to industrial policy.

Should we fear shifts in economic geography?

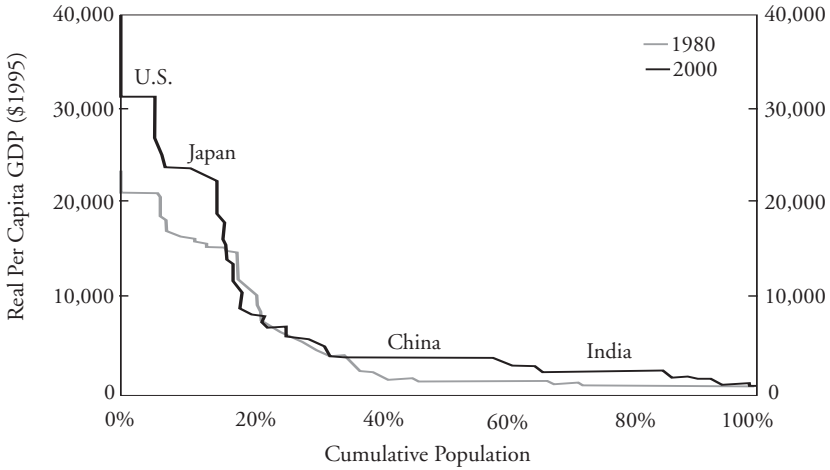
Over the past quarter-century, there has been an unmistakable shift in the economic weight of the world. As Chart 1 illustrates, the biggest shift in economic geography since 1980 has been the economic rise of China and India.

The rapid growth of China and India have raised a multitude of fears in the United States and other Western countries. These fears range from the giant sucking sound of outsourcing, to a scramble over the world's natural resources that could drive commodity prices to record levels, to having American wages set in Beijing because of the global labor market.

Although this is not the place to confront all the litany of fears about trade and globalization, one commonly held view about wages

Chart 2

International Income Distribution in 1980 and 2000



Source: Leamer (2006)

can be addressed with a simple figure. Many in the popular press believe that when the small, high-wage labor market is mixed with the large, low-wage labor market of China, the trade and outsourcing will lead to a pooling equilibrium in which wages will become equalized at a much lower level for the United States and a slightly higher level for China. Is there evidence to support this contention? Chart 2 allows us to examine the international distribution of wages, weighted by country size, in 1980 (before China was a big player in world markets) and in 2000. The figure shows that over this 20-year period that saw the economic rise of China and India, average incomes in the United States and other Western countries grew, and average incomes in China and India grew. There was no tendency for income equalization; most of the distribution shifted upward rather than becoming a flat line. (If there is a problem of a lack of growth, it appears to be with middle-income countries that have not increased their incomes much during this period.)

Why doesn't trade lead to a precipitous drop in U.S. wages to the international level? Why is there no factor price equalization? The

answer is because domestic wages are tied to domestic productivity. As Paul Krugman reminded us a decade ago in his article “International Competitiveness: A Dangerous Obsession,” countries are not in competition with one another. As Krugman (1996) pointed out, “the growth rate of living standards essentially equals the growth rate of domestic productivity—not productivity relative to competitors, but simply domestic productivity. Even though world trade is larger than ever before, national living standards are overwhelmingly determined by domestic factors rather than by some competition for world markets.”

It is the task of economists to confront these fears about globalization—not to dismiss them, but to address them. This is something that economists have done for more than 250 years. In his essay “Of the Jealousy of Trade,” published in 1752, David Hume stated:

Nothing is more usual, among states which have made some advances in commerce, than to look on the progress of their neighbors with a suspicious eye, to consider all trading states as their rivals, and to suppose that it is impossible for any of them to flourish, but at their expense. In opposition to this narrow and malignant opinion, I will venture to assert, that the increase of riches and commerce in any one nation, instead of hurting, commonly promotes the riches and commerce of all its neighbors; and that a state can scarcely carry its trade and industry very far, where all the surrounding states are buried in ignorance, sloth, and barbarism.

Chairman Ben Bernanke has spoken forcefully about the benefits of globalization, as did his predecessor Alan Greenspan. I hope he will continue to speak out on this issue.

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