

1. Different tastes between countries as a determinant of demand.

If everything about production two economies is identical, then each country will import the good for which it has a high preference in demand.

Figure 14.1

However, it is often observed that there is correlation between specialization in consumption and specialization in production.

This is known as “home bias”. Maybe it is as simple as Germans preferring German cars and French preferring French cars.

Figure 14.2

Figure 14.1

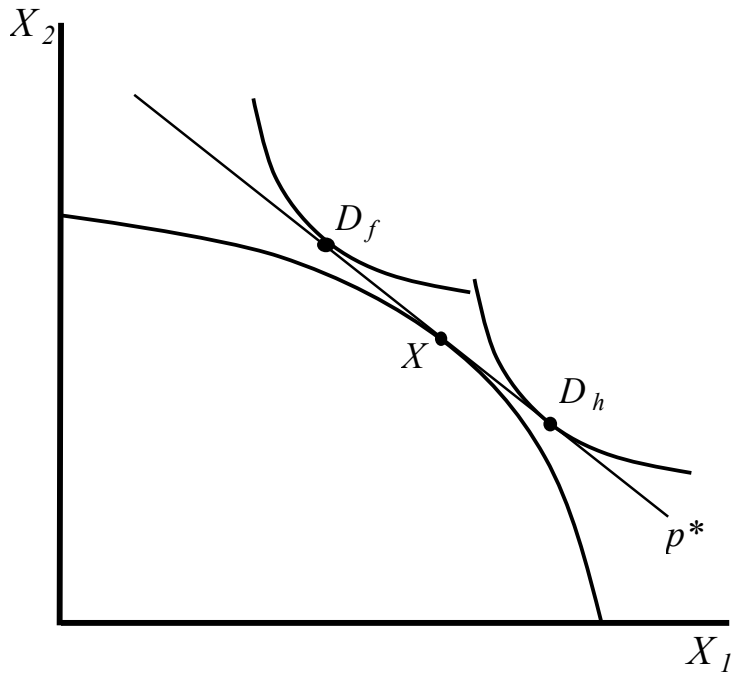
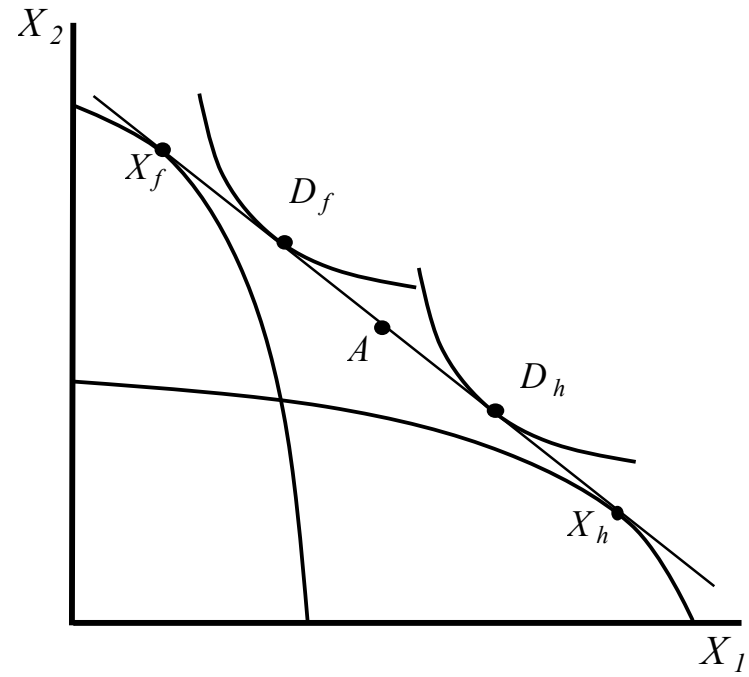


Figure 14.2



## 2. Per capita income as a determinant of demand

Suppose that all consumers in both countries have *identical preferences*, but that they are non-homogeneous.

High income consumers consume more  $X_1$  relative to  $X_2$  than low income consumers.

That is,  $X_1$  is a "luxury" and  $X_2$  is a "necessity".      Figure 14.3

If the countries are identical except for factor productivity, then the high productivity country will export Y and import X.

Per capita income becomes a basis for trade.

Figure 14.3

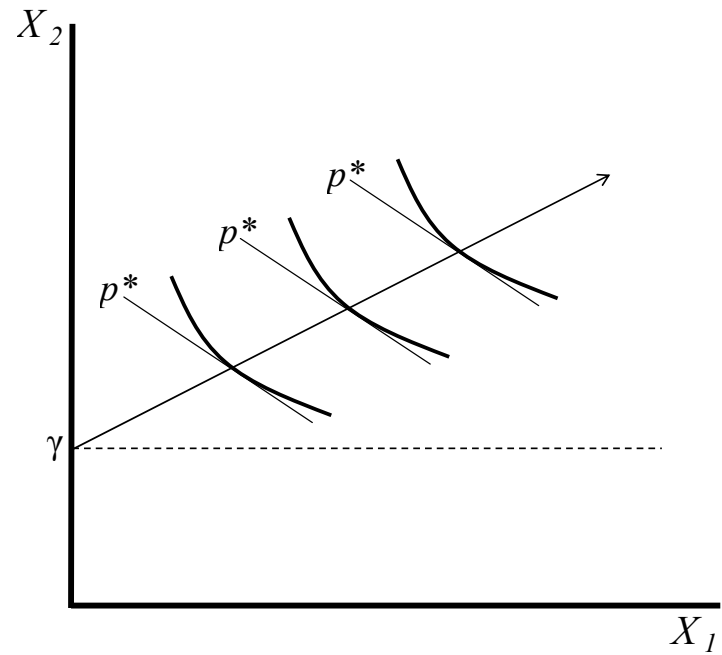


Figure 14.4

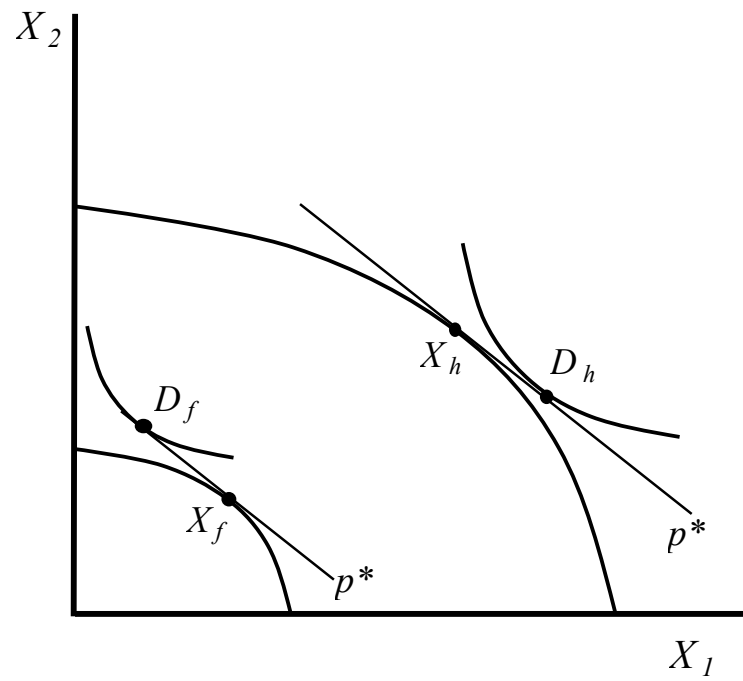


Table 14.1: Income elasticities of demand for various consumption goods and services

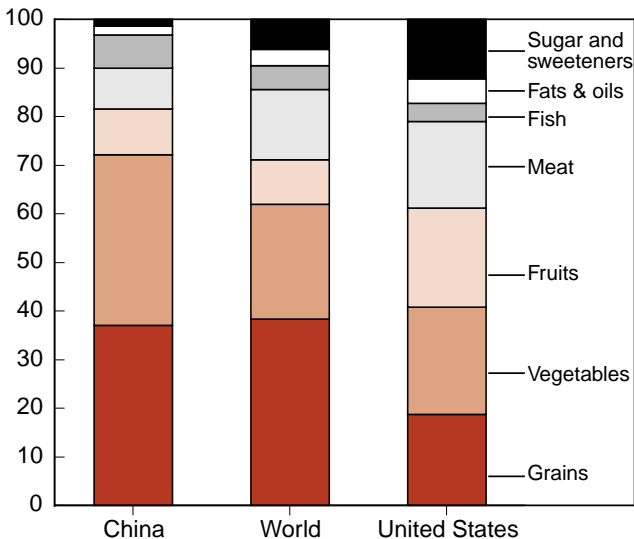
Food	0.45
Household furniture	0.76
Fuel and power	0.81
Education	0.87
Clothing and footwear	1.00
Beverages and tobacco	1.23
Other	1.25
Recreation	1.42
Transportation and communication	1.72
Gross rent	1.74
Medical	1.91

Figure 14.4

Figure B-3

## Food consumption shares by food category, China, world, and United States, 1999

Percent



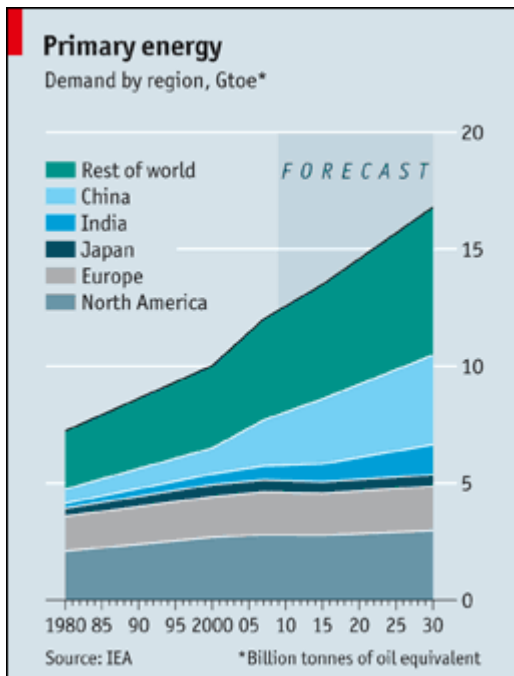
Note: Based on per capita kilograms of consumption.

Source: United Nations Food and Agriculture Organization, FAOSTAT database.

# Primary energy

Nov 12th 2009

From *The Economist* print edition



According to the International Energy Agency, energy demand in OECD countries is expected to fall slightly by 2015. In 2007, these nations used around 5.5 billion tonnes of oil equivalent, compared with 6.2 billion tonnes in non-OECD countries. That gap is expected to widen, because the annual rate of growth of non-members' energy use is predicted to be more than ten times that of member economies between 2007 and 2030. China's energy demand will overtake America's by 2015. By 2030 China and India together are expected to account for almost a third of global energy use. By then, the world will consume 16.8 billion tonnes of oil equivalent. Coal will fuel the bulk of China's increased energy use.

### 3. The Linder hypothesis

- (1) Heckscher-Ohlin theory is fine for primary products.
- (2) However, manufactured goods do not exist "in nature".
- (3) Entrepreneurs create new manufactured goods in response to perceived demand.
- (4) Demands are closely related to per capita income.
- (5) After a product is introduced, where does the entrepreneur look for additional markets?
- (6) Entrepreneurs export to markets with similar per capita incomes.
- (7) This is suppose to help explain the large volume of trade among the high income developed countries.



#### 4. The product cycle (Vernon)

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- (1) New products are first introduced in the high income countries ala Linder.

Production must initially take place near the market: production may require special skills, and critical revision.

- (2) Exports begin to other high income countries.

- (3) As development proceeds, (a) exports begin to lower income countries as incomes grow there, (b) production becomes more standardized, requiring less skilled labor.

- (4) Eventually production shifts to the lower income countries as producers in the high-income countries move on to the next generation of products.

- (5) Finally, the original product may be exported back to the high income country which first introduced it.
  
- (6) This theory does not necessarily contradict HO and Linder: the high income, skilled-labor-abundant country exports the skilled-labor intensive goods.

It is that a given good is skilled-labor intensive at one point in time, unskilled-labor intensive later.

The Linder Hypothesis seems to explain why the high-income developed countries trade so much, but not why the low income countries trade so little.

The following features seem to complete the explanation.

1. The skilled-labor and capital-intensive differentiated goods are high income elasticity goods.

The high-income countries that produce the differentiated manufactured goods also spend a high fraction of their incomes on these goods.

Each differentiated good is sold in each market, so trade among the high-income countries is very high.

The unskilled-labor abundant (poor) countries have a high demand for the low income-elasticity labor-intensive goods.

So instead of exporting a lot of these goods, they are consumed at home.  
The low income countries don't trade much.

2. The low income countries are simply poor - they have a low share of world income. Thus they do not trade much.
3. The pattern of world protection has historically been biased against the low-income countries.

The high-income countries have high protection against the labor-intensive manufactured exports of the low-income countries (regarding them as a threat to local manufacturing).

The low-income countries have high protection against the goods from the high-income countries (regarding them as necessities).

Figure 14.5

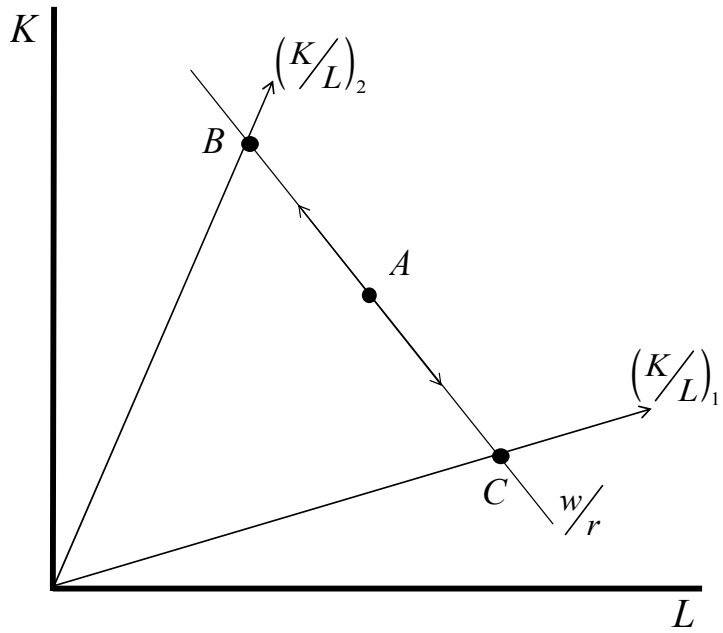
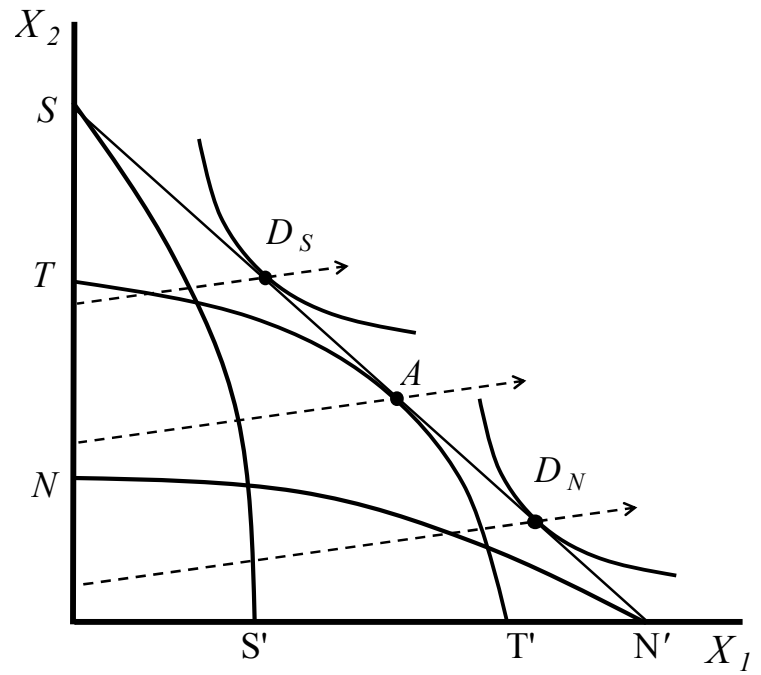


Figure 14.6



# Empirical relationship between $K/L$ in production and income elasticity of demand in consumption

DEPENDENT VARIABLE: LOG OF FITTED INCOME ELASTICITY

regressed on log of indirect (including intermediate use)  $K/L$  ratio and constant

	coefficient	standard error	
(ln) $K/L$ ratio	0.145	0.010	(significant at 1%)
constant	-0.162	0.006	(significant at 1%)
adjusted R2			0.059
observations			6216
F			212.997
correlation between $K/L$ and fitted income elasticities:			0.126
predicted income elasticity at maximum $K/L$			1.217
predicted income elasticity at minimum $K/L$			0.610