Market Size and Industrial Structure: the Home Market Effects Revisited

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Does market size matter for industrial structure? This paper generalises the theory on home market effects to reconcile the recent debate by allowing for an endogenous expenditure share on differentiated goods. The three main results of the paper are as follows. Firstly, we show that even when the homogeneous good and differentiated goods both face transport costs, market size matters for industrial structure. The home market effect for production structure can arise, disappear, or reverse in sign, depending on whether the elasticity of substitution (EOS) between the homogeneous good and the composite of differentiated goods is greater than, equal to, or less than one, respectively. Specifically, when the EOS is greater than one, the larger country again ends up with a more-than-proportionate share of production of differentiated goods.

Secondly, we show that our analysis shall change some common perceptions about “de-industrialization” of small economies due to economic integration. For example, when the smaller economy ends up with a less-than-proportionate share of differentiated industry after markets become integrated, it is often believed that the smaller country becomes “de-industrialised” (though not totally). This is correct in these studies because, with the C-D function, each country produces differentiated goods in exact proportion to its size prior to trade. However, when the share of expenditure on differentiated goods becomes endogenous, market size also matters for industrial structure in autarky. For example, the smaller country could already have a less-than-proportionate share of differentiated industry prior to economic integration. It is shown that although a country’s share of differentiated industry in economic integration is smaller than its relative size, it could be greater than that prior to economic integration. Therefore, it is not always correct to say that the smaller country becomes de-industrialised, even if it ends up with a less-than-proportionate share of manufacturing industry in economic integration.

Thirdly, it is also shown the results that the home market effect may disappear or even reverse in sign should not have any significant implication for the results on agglomeration in the standard models of New Economic Geography (e.g., the core-periphery model). Specifically, welfare

is always higher in the larger economy regardless of the specific home market effect on production structure. With mobile labour (as in most standard models of economic geography), agglomeration would still occur because of the price index effect on welfare. These results should change our common perceptions about how market integration affects national industrial structure and should also have important implications for empirical research strategies in the economic geography literature.