

TASTES AND INCOME

- **Trade theory has paid little attention to determinants of trade based on demand, specifically when consumption patterns vary between countries**

- **This can be broken into two issues:**
 - **national utility functions are non-identical but homogeneous**

 - **identical, but non-homogeneous tastes**

- **Different Tastes**

In Figure 1 assume only difference between countries is in demand conditions

Autarky equilibria are such that tastes in country h are biased towards good Y relative to country f, which has a bias to good X

Under autarky, good Y is relatively costly in country h, while X is relatively costly in f, stronger preferences in each country affecting relative prices under autarky

- With trade, consumers in each country recognize that it is relatively less costly to import that good which they have a consumption bias towards, i.e. Y in h, and X in f

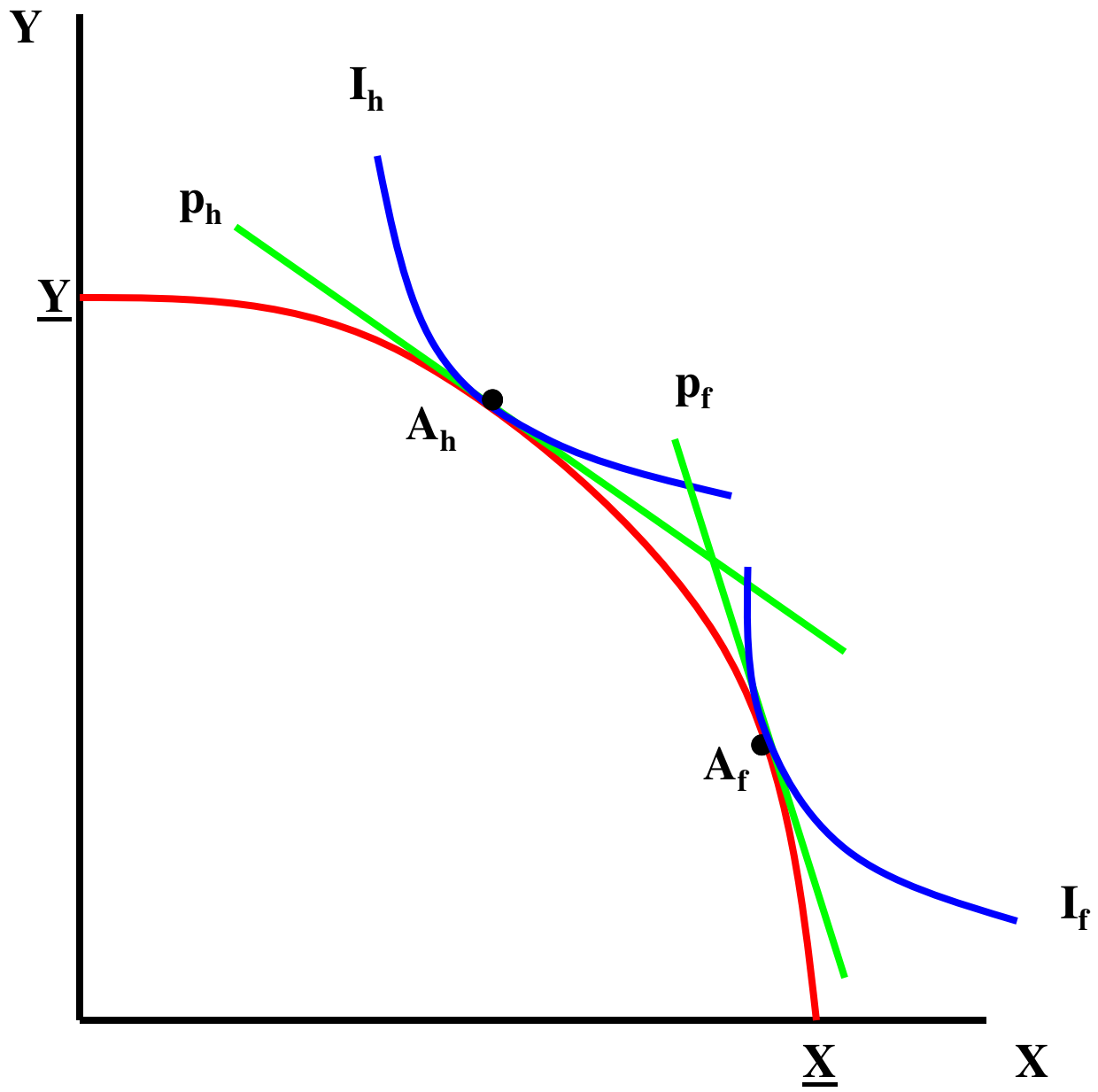
In Figure 2, production point in h moves down the frontier, while that in f moves up the frontier

Adjustments continue until relative prices are equalized at p_w , and common production point is Q; trade is also balanced with trade triangles being the same

- h, whose tastes are biased toward Y, ends up importing Y and exporting X, and vice-versa for country f
- Each country benefits from trade, factor prices are equalized, and the Stolper-Samuelson theorem holds if Y is capital-intensive, and X is labor-intensive
- Non-Homogeneous Tastes

Suppose that tastes are non-homogeneous, but are identical in both countries

FIGURE 1: DIFFERENCES IN TASTES



- **Assume there are quasi-homogeneous preferences where income-consumption curves are linear, but do not go through origin**
- **Suppose there are two countries with identical populations, but country f has uniformly superior technology for producing X and Y (Figure 3) - f's production frontier is just a radial blow up of that for country h, i.e. along a ray from the origin, slope of frontiers are the same**
- **Assume non-homogeneous tastes in that there is a minimum consumption requirement of Y, i.e. origin of system of indifference curves is C_y , and all consumers in both countries have such tastes**
- **Country f has a higher per-capita income than h, implying a relatively high demand for Y in h, and vice-versa in country f for X**
- **Autarky equilibria are given as A_h and A_f respectively**

- Due to similar production structures, there is a relatively high autarky price of Y in h, and vice-versa in country f which has a relatively high autarky price of X - this is driven by differences in per-capita income
- Autarky price differences lead to a trading equilibrium where production points are Q_h and Q_f , which lie on the same ray from the origin, and consumption points are C_h and C_f at free trade prices p , which both lie on the income-consumption ray
- Country h, low in per-capita income, imports good Y, while f, high in per-capita income, imports good X - thus trade is due to differences in demand
- Countries produce the two goods in the same proportions, but consume them in different proportions at same set of relative prices
- As per-capita income rises, proportionately less spent on good Y, which is income-inelastic, and vice-versa for good X, so poorer countries will tend to import good Y

- **These models have shown that differing tastes in a standard trade model can cause countries to import the good they most prefer, but trade is still of an *inter-industry* nature**
- **This is at odds with observation that many developed countries export goods for which there is a sizeable domestic demand, and there is *intra-industry trade***
- **Linder's Hypothesis**

Analysis of the impact of income on trade was due to Linder (1961); argued that principles governing trade in manufactures not the same as those for commodity trade

Observed that a large volume of trade occurs between developed countries who have similar factor endowments

Linder argued that a manufactured good is first created in response to perceived demand in the home country not because of factor endowments

- **Where will such goods be exported? To countries with similar demand patterns, and, by extension, those with similar per-capita incomes - trade will tend to be *intra-industry* in nature**
- **Volume of trade in manufactures will be highest among countries with similar per-capita incomes**
- **One can deduce from this that *inter-industry trade* in commodities will be driven by differences in factor endowments, while *intra-industry trade* in manufactures will be driven by similar patterns of income and demand**
- **Unified Theory of Trade**

Suppose there are two goods, where Y (a basic food commodity) is labor-intensive, and X (manufactured food) is capital-intensive

Good Y has a high minimum-consumption requirement, while X does not, as it is income-elastic in demand

Suppose there are two blocs of countries:

- **a capital abundant “North” (i.e. developed)**

- a labor-abundant “South” (i.e. developing)

The North will be relatively specialized in producing good X as suggested by the Heckscher-Ohlin model; they will also have higher per-capita incomes and so will consume relatively more manufactured goods

In contrast, the South which is labor-abundant will specialize in producing good Y, and consumes relatively less X because of lower per-capita incomes; with taste biases, the South exports good Y and the North exports good X, but less than what the Heckscher-Ohlin model would predict

If X is non-homogeneous, but a collection of differentiated goods produced under scale economies, each firm in the North produces a slightly different good sold to all consumers in the North, i.e. there is *intra-industry trade*

In North there is a taste bias to manufactured goods due to higher per-capita incomes, which increases the volume of *intra-industry trade* in the North

- **Northern firms producing X switch exports from the South to the North where demand is high, i.e. non-homogeneous demand leads to a decrease in volume of North-South trade, and an increase in North-North trade**