

Nonhomothetic Preferences and the Home Market Effect: Does Relative Market Size Matter?

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Abstract

Linder (1961) hypothesized the home market effect (HME), whereby countries would export goods that they had large or well-developed home markets for. This home market effect has been most intensively exploited by incorporating transport costs in the general equilibrium trade model with monopolistic competition and increasing returns to scale (IRS). So far, most studies have primarily focused on the effects of the absolute market size—indicated by total demand of a country—on cross-country industry structures and on the pattern of trade. They tend to ignore the "relative" market size, which can generate distinct implications for the industry structures and trade patterns, although international trade models often emphasize the importance of relative differences across countries. We can determine whether a country has large "relative" market for a particular sector (or commodity) by comparing the country's share of world demand for the sector with its overall demand share. If the demand share for the particular sector is greater than the overall demand share, the country will have a relatively large home market in that sector. In the standard models of HME with homothetic preferences, however, this relative market size would not matter. The only thing that matters in those models is the absolute market size.

By incorporating nonhomothetic preferences into the model, this paper shows how cross-country per capita income differences can affect the implications of HME on the basis of both the absolute and relative market sizes. It seems to be the most interesting case when one country has a bigger relative market for the IRS sector than the other country while its absolute market size is smaller. Our empirical investigation is centered on verifying whether cross-country per capita income levels are positively correlated with the ratios of sectoral output shares of world production relative to demand shares. The result of this investigation can serve to be an evidence for HME, in particular that based on the relative market size.

Key words: Home market effect; Relative market size; Nonhomothetic preferences

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