Chipman, John Somerset

Working Paper

Intra-industry trade, factor proportions and aggregation

Diskussionsbeiträge - Serie II, No. 1

Provided in Cooperation with:
Department of Economics, University of Konstanz

Suggested Citation: Chipman, John Somerset (1986) : Intra-industry trade, factor proportions and aggregation, Diskussionsbeiträge - Serie II, No. 1, Universität Konstanz, Sonderforschungsbereich 178 - Internationalisierung der Wirtschaft, Konstanz

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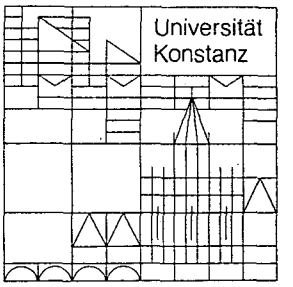
Diskussionsbeiträge



Juristische
Fakultät

Fakultät für Wirtschafts-
wissenschaften und Statistik

John S. Chipman

Intra-Industry Trade, Factor Proportions and Aggregation

Postfach 5560
D-7750 Konstanz

Serie II — Nr. 1
Juli 1986

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John S. Chipman*

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* University of Minnesota, Ständiger Gastprofessor der Universität Konstanz

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ABSTRACT

Some empirical extrapolations are performed which indicate that if the process of disaggregation were to be carried sufficiently far (to approximately the 17th to 23rd SITC level), virtually all intra-industry trade could be expected to disappear from international trade statistics. It is also shown under the assumption of Cobb-Douglas technology and preferences that the amount of intra-industry trade between countries is an increasing function of the closeness of the production functions in the aggregated industry. Finally, in a 3-country 3-commodity 3-factor model it is shown that there will be more trade between countries that are similar than between countries that are dissimilar in their factor endowments provided the commodities in which they have a comparative advantage have sufficiently similar production functions; this tendency is further accentuated if either (1) there is a high relative preference among world consumers for the products of the similar countries, or (2) the similar countries are large in comparison to the dissimilar one, or both.

0. Introduction

In the literature on the empirical explanation of trade flows, it appears to have become a universally accepted dictum that the existence of so-called "intra-industry trade", i.e., trade between countries of products within the same industrial category, is prima facie evidence of the existence of economies of scale or monopolistic competition, or both, and in particular is incompatible with the "factor-proportions theory", by which is meant the theory developed by Heckscher and Ohlin according to which trade flows among countries are explained by differences in their relative factor endowments, it being assumed that production functions among countries are the same.

In this paper I shall argue, both on empirical and theoretical grounds, that there is nothing in the empirical observations of international trade statistics that cannot be explained perfectly easily by the "Heckscher-Ohlin theory" as formulated by Lerner (1933) and Samuelson (1953). (I shall refer to this as the HOLS model.) I do not wish to contend that alternatives to this theory are not worth exploring and developing; but if so, the reason for doing so should not be that the more conventional theory is unable to explain the observed facts. In the last analysis, that theory should be accepted which is able to explain them best; but before this can be done, a clearer understanding is needed of the extent to which the

conventional theory is or is not able to do so. The belief that it is not able to do so is, in my opinion, based on a misunderstanding of the nature of that theory and a lack of appreciation of its rich potentialities.

In section 1 I examine some empirical evidence which points to the conclusion that if commodity classification systems were to carry the disaggregation process sufficiently far, two-way trade could be expected to disappear from international trade statistics. In section 2 I consider the pure theory of international trade in the textbook case of two countries, two commodities, and two factors, and come to the conclusion that if (as is alleged to be the case in the literature on intra-industry trade) production processes are very similar as between the two commodities and factor endowments are very similar as between the two countries, it is possible for each country to export up to 50 percent of the output of its export good, the percentage increasing as the production processes become more similar. Finally, in section 3 I consider the frequently repeated assertion that, when there are three or more countries, one would under the " factor-proportions theory" expect to find less trade between countries with similar than with dissimilar endowments; I find instead that, assuming identical and homothetic preferences within and across countries, if the two countries with similar endowments export goods with similar production processes, they may be expected to trade more with each other than with the third country, this effect being further accentuated when (1) there is a strong relative world preference for the goods which they

export, or (2) when their absolute endowment levels are greater than those of the third country, or both.

1. Some empirical evidence

Grubel & Lloyd (1975, pp. 86-9) distinguish between two types of intra-industry trade: trade in goods which are close substitutes in use but produced by different production processes (e.g., wood and metal furniture); and trade in goods which are not close substitutes in use but are produced by very similar or identical production processes (e.g., steel bars and sheets). They also consider a third type of goods, such as automobiles, which are close substitutes and are also produced by similar processes. They allow that the first type of intra-industry trade is compatible with the HOLS model, and then introduce a second issue, (p. 87): "For this group of goods the intra-industry trade phenomenon is simply the result of statistical aggregation." It is implied but not stated explicitly that intra-industry trade in the other two cases is not a result of statistical aggregation.

Let me now take up this second issue. If it is granted in all the above cases that the goods being traded are physically distinct (and indeed, Grubel & Lloyd themselves emphasize that this is so, pp. 125-6), then a fine enough classification system will recognize the distinction. The fact that trade statistics using existing, cruder classification systems exhibit two-way trade within categories is as much a result of statistical aggregation in the case of one kind of good as in the other; for why should our description (as opposed to explanation) of an empirical phenomenon depend on our theories about it? The only

question, then, is how much disaggregation would be necessary in order for two-way trade to disappear from international trade statistics. In this section I try to form a rough estimate, based on data presented by Grubel & Lloyd (1975) and Gray (1978); and on a new set of data for Sweden.

1.1 The Grubel-Lloyd data

Grubel and Lloyd (1975, p. 50) have presented a table showing the percentage of Australian intra-industry trade in its total trade with various countries and country groups, at various SITC digit levels, using a 7-digit refinement of the 5-digit Standard International Trade classification. For Australia's leading trading partners in 1968-69 (the European Community consisted then of West Germany, France, Italy, Belgium and The Netherlands) their figures for the percentage of intra-industry trade in total trade (adjusted for global bilateral trade imbalances) are reproduced in Table 1, ranked in order of decreasing value of exports to Australia in 1968-69 (except for the last two groups).

Table 1

Australian Intra-Industry Trade
as Percentage of Total Trade, with Major Trading Partners
1968-69

Country or Country Group	SITC level of disaggregation 1	2	3	5	7
U.S.	39.7	25.0	14.6	10.0	3.2
U.K.	31.5	12.5	7.7	4.2	1.3
Japan	18.0	10.6	4.8	2.2	0.2
E.C.	15.3	6.3	4.9	3.2	1.0
Canada	38.6	27.5	17.6	7.2	0.8
New Zealand	79.8	47.5	30.5	19.5	4.4
Hong Kong	50.5	17.3	13.3	6.5	1.4
India	49.5	9.5	5.5	1.8	0.2
South Africa	65.4	30.3	16.3	7.3	0.7
Southeast Asia	17.4	9.8	8.7	4.4	1.5
Rest of World	52.0	27.0	18.9	10.6	3.1
All Countries	42.9	25.9	20.2	14.9	6.2

These figures show a very clear downward trend. It is tempting, therefore, to extrapolate. We do not, of course, possess a theory of how compilers of commodity classification systems decide to associate the number of digits in the classification code with the degree of fineness of the disaggregation. The best we can do at this stage is to fit a reasonably-shaped curve. Accordingly, I have chosen to fit the reciprocal power function[1]

(1.1) $$P = 100 - aS^b$$

where S is the SITC level of disaggregation and P is the percentage of intra-industry trade in total trade. This function has the desirable property that at the null (0-digit) level of disaggregation, when the index has been adjusted for trade imbalances, 100% of trade is intra-industry trade. The curve (1.1) has been fitted to the data of Table 1 by the Fletcher-Powell (1963) method.[2] With two parameters and five data points,

there are only three degrees of freedom; but given the limitations of data, presumably this is the best one can do. Table 2 gives the parameter estimates and the coefficient of determination (R^2), where $1-R^2$ is defined as in Theil (1971, p. 164) as the ratio of the sum of squares of the residuals $P-100+aS^b$ to the sum of squares of the observations on the dependent variable P. Figures 1a, 1b, and 1c show the curves and the corresponding data points (represented as asterisks).

Table 2

Australian Intra-Industry Trade, 1968-69.
Parameters of the reciprocal power function,
coefficient of determination (R^2),
and 0% cutoff point (S^*),
for the data of Table 1.

Country or Country Group	a	b	R^2	S^*
U.S.	63.2151	.226733	.987579	7.56
U.K.	73.8451	.164275	.938998	6.33
Japan	83.2555	.099745	.981524	6.28
E.C.	86.7818	.072194	.958070	7.13
Canada	61.7048	.248759	.998534	6.96
New Zealand	31.8901	.581939	.974533	7.13
Hong Kong	60.1277	.277028	.916313	6.27
India	65.1323	.254798	.806576	5.38
South Africa	47.2589	.411547	.939699	6.18
Southeast Asia	83.4666	.085760	.992714	8.23
Rest of World	54.7025	.308483	.974598	7.07
All Countries	60.3694	.228339	.990105	9.12

The last column of Table 2 provides the solution values of S in equation (1.1) for P = 0. Thus, for all of the individual countries and groups, the curves predict that intra-industry trade will cease to be observed if the SITC is refined to the ninth level of disaggregation; and for all countries together, to the tenth level.

Australian Intra-Industry Trade, 1968-69

Fitted to the function P = 100 - aS^b

US: United States UK: United Kingdom JA: Japan EC: European Community

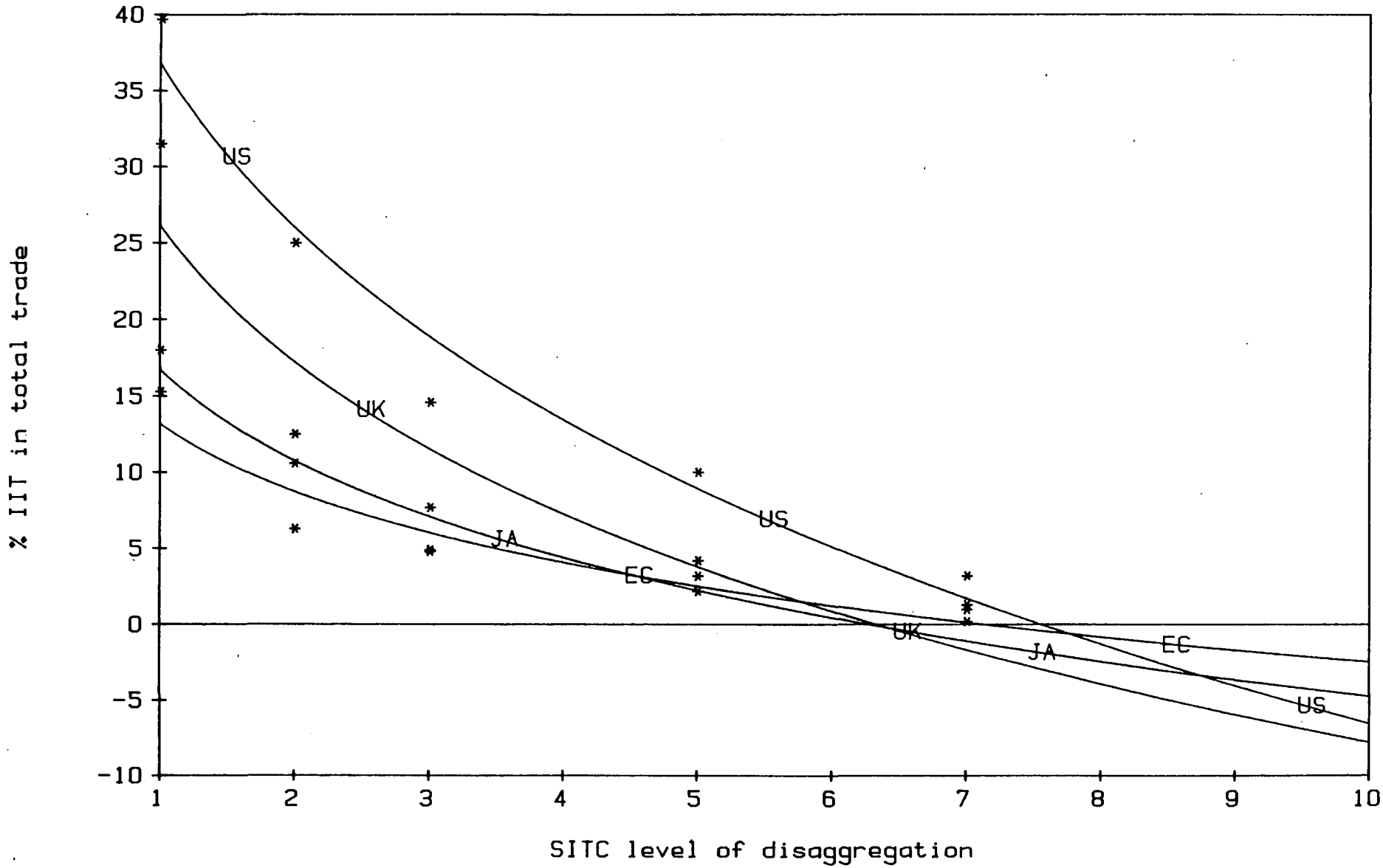

Figure 1a

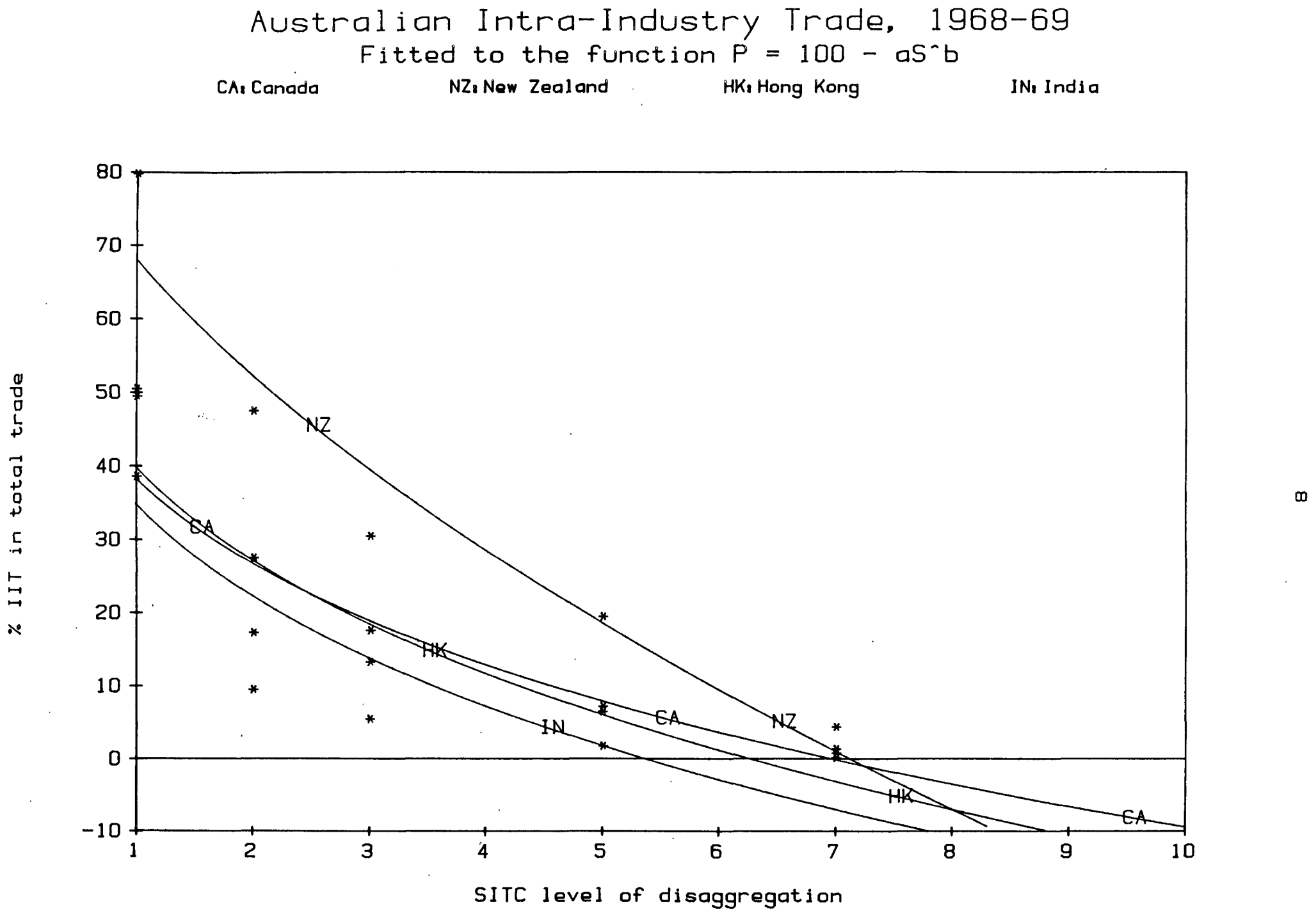
Australian Intra-Industry Trade, 1968-69
Fitted to the function P = 100 - aS^b
CA: Canada
NZ: New Zealand
HK: Hong Kong
IN: India
% IIT in total trade
SITC level of disaggregation
80
70
60
50
40
30
20
10
0
-10
1
2
3
4
5
6
7
8
9
10
NZ
CA
HK
IN
NZ
HK
CA

Figure 1b

Australian Intra-Industry Trade, 1968-69

Fitted to the function P = 100 - aS^b

SA: South Africa EA: Southeast Asia RW: Rest of the World ALL: All Countries

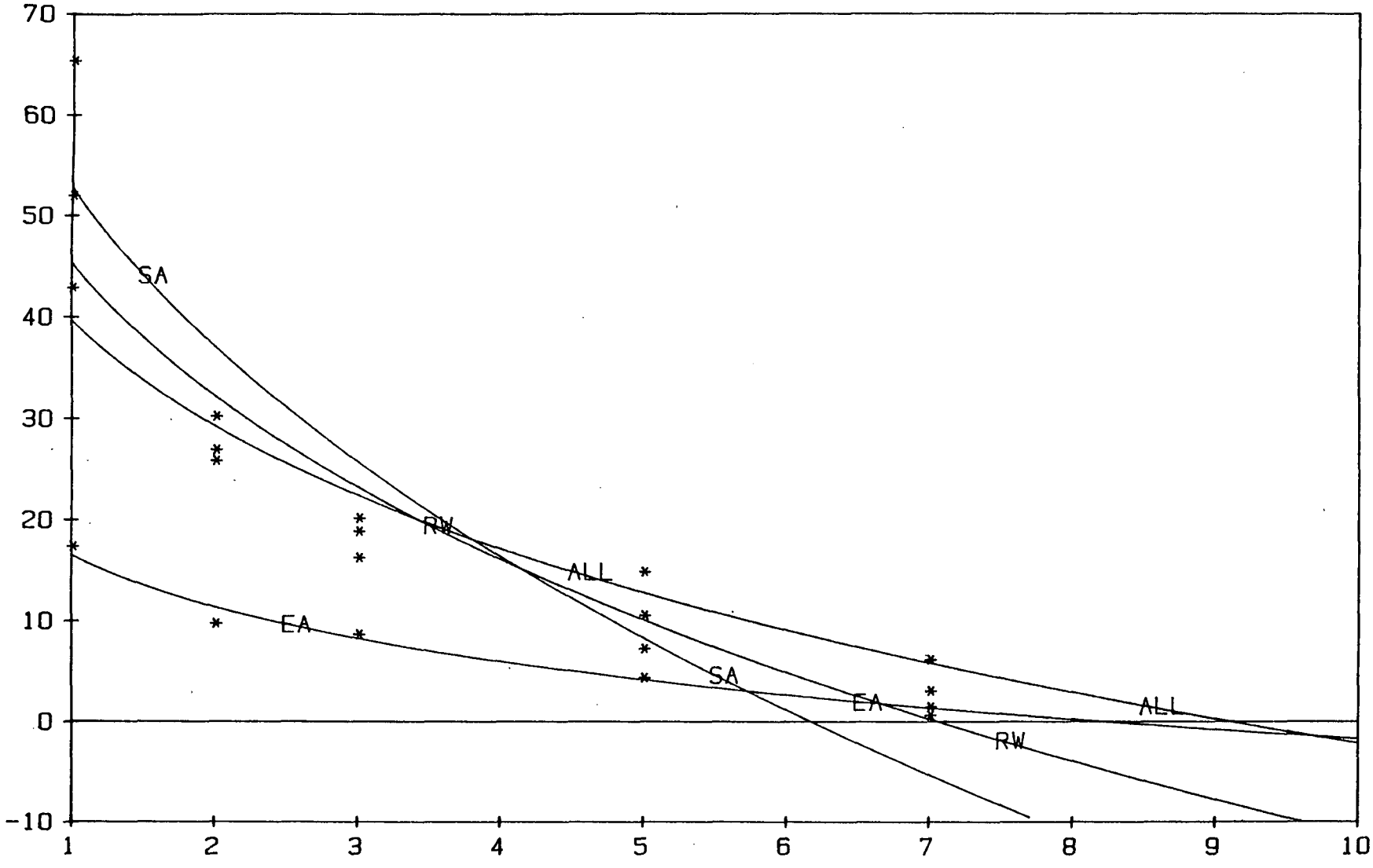

Figure 1c

Taken as a whole, these results support the hypothesis that intra-industry trade is a statistical phenomenon in the sense that it would cease to be observed if sufficiently disaggregated data were obtained, and that this would be achieved with a not unreasonable degree of refinement of existing classification systems.

1.2 Gray's data

The second data set I consider is taken from a study by Gray (1978) of West German and French trade with specified partners, in 1-digit SITC categories at each of the five SITC levels of aggregation.

In the case of West German trade, only for trade with Belgium and France--in SITC categories 6 (manufactured goods classified chiefly by material) and 7 (machinery and transport equipment)--are data furnished by Gray for all five levels of aggregation [cf. Gray (1978, p. 105)]. These are therefore the only series from his table that I have attempted to analyze. The measure of intra-industry trade used by Gray is the Balassa index [cf. Balassa (1966)], defined as

$$B = \frac{1}{n} \sum_{i=1}^{n} \frac{|X_i - M_i|}{X_i + M_i} , \tag{1.2}$$

where X_i and M_i are the values of exports and imports in category i, and n is the number of categories at the given level of aggregation. The index actually measures inter- rather than intra-industry trade; it has the value zero when all trade is intra-industry trade, and unity when none of it is. In the following analysis I have multiplied this index by 100 so as to

express the figures as percentages.

As explained by Grubel & Lloyd (1975, p. 26), the Balassa measure has the disadvantage of being an unweighted average of the ratios $|X_i + M_i|/(X_i + M_i)$; if instead we weight industry i by its importance, $(X_i + M_i)/\sum_{j=1}^{n}(X_j + M_j)$, we obtain

$$(1.3) \qquad C = \frac{\sum_{i=1}^{n} |X_i - M_i|}{\sum_{i=1}^{n} (X_i + M_i)} .$$

The Grubel-Lloyd measure corresponds to 1-C (times 100). The latter has the advantageous property of being necessarily nonincreasing as the degree of aggregation becomes finer [cf. Grubel & Lloyd (1975, p. 23)]. This monotonicity property is lost with the unweighted Balassa measure.

The Balassa coefficient (1.2) has been fitted to the SITC data on inter-industry trade by the power function

$$(1.4) \qquad B = aS^b/100.$$

This has the property that inter-industry trade, corrected for trade imbalance, has the value 0 at the null (S=0) level of disaggregation.

Table 3 reproduces the relevant figures from Gray's table for West German inter-industry trade for the Balassa coefficient (1.2) (times 100) and for the number of aggregated subcategories at each SITC level (the parameter n of (1.2)). Table 4 provides the estimates of the parameters a and b of (1.4), the coefficient of determination (R^2), and the 100% cutoff point (S^*), i.e., the value of S that solves B=1 in (1.4). The fitted curves are shown in Figure 2.

Table 3

West German Inter-Industry Trade
Balassa coefficients (x 100) for trade with Belgium & France in two SITC categories, with numbers of categories at each SITC level
1973

Country	SITC level of disaggregation 1	2	3	4	5
1. SITC 6 -- manufactured goods classified chiefly by material					
No. of categories	1	8	50	53	26
Belgium	31	33	40	49	58
France	9	17	32	42	48
2. SITC 7 -- machinery and transport equipment					
No. of categories	1	3	18	46	52
Belgium	38	41	53	57	61
France	18	27	36	50	52

Table 4

West German Inter-Industry Trade, 1973
Parameters (a,b) of the power function, coefficient of determination (R^2) and 100% cutoff point (S^*), for the data of Table 3

Country	a	b	R^2	S^*
1. SITC 6 -- manufactured goods classified chiefly by material				
Belgium	26.5177	.450626	.994306	19.02
France	9.6109	1.025047	.996071	9.83
2. SITC 7 -- machinery and transport equipment				
Belgium	35.8752	.328844	.998182	22.59
France	17.2730	.707112	.996856	11.98

West German Inter-Industry Trade, 1973

Fitted to the function B = aS^b

B6: Belgium SITC 6 | B7: Belgium SITC 7 | F6: France SITC 6 | F7: France SITC 7

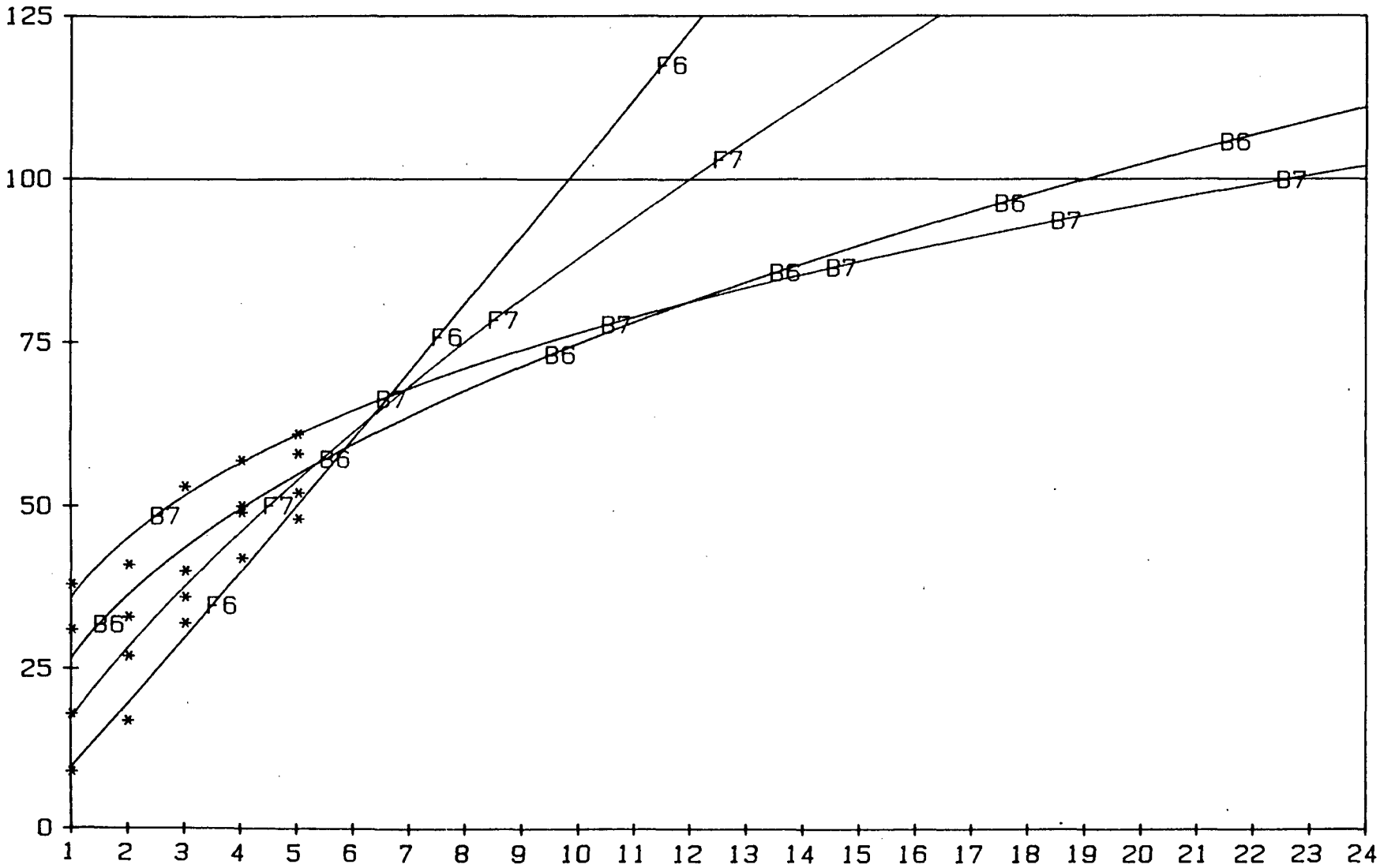

Figure 2

The curves for West German inter-industry trade with Belgium and France lend some support the hypothesis that intra-industry trade in basic materials is more of a "statistical phenomenon" than is intra-industry trade in finished products, since they predict that intra-industry trade in the former will cease to be observed at the twentieth and tenth levels of disaggregation respectively, whereas it will continue to be observed in the latter up to the twenty-third and twelfth levels respectively. But this conclusion depends upon a willingness to extrapolate curves far from the observations used to fit them.

In the case of French inter-industry trade, Gray (1978, p. 106) provides calculations of the Balassa coefficients for French trade with Belgium, West Germany, Italy, and the United Kingdom in SITC categories 6,7, and 8. These figures are reproduced in Table 5. Table 6 furnishes the estimates of the parameters a and b of (1.4), the coefficient of determination (R^2), and the 100% cutoff point (S^*). The fitted curves are displayed in Figures 3a, 3b, and 3c.

Table 5

French Inter-Industry Trade
Balassa coefficients (x 100) for trade with selected partners and SITC categories, with number of categories at each SITC level
1971

Country	SITC level of disaggregation 1	2	3	4	5
1. SITC 6 -- manufactured goods classified by material					
No. of categories	2	7	32	129	21
Belgium	35	17	25	64	32
West Germany	0	27	32	45	48
Italy	3	31	37	49	43
United Kingdom	21	22	40	53	52
2. SITC 7 -- machinery and transport equipment					
No. of categories	1	3	18	73	75
Belgium	13	17	31	32	41
West Germany	20	24	31	49	51
Italy	13	17	29	39	46
United Kingdom	13	27	49	49	50
3. SITC 8 -- miscellaneous manufactures					
No. of categories	1	7	18	57	21
Belgium	1	35	41	46	49
West Germany	6	45	42	53	59
Italy	49	60	56	54	51
United Kingdom	12	32	33	46	49

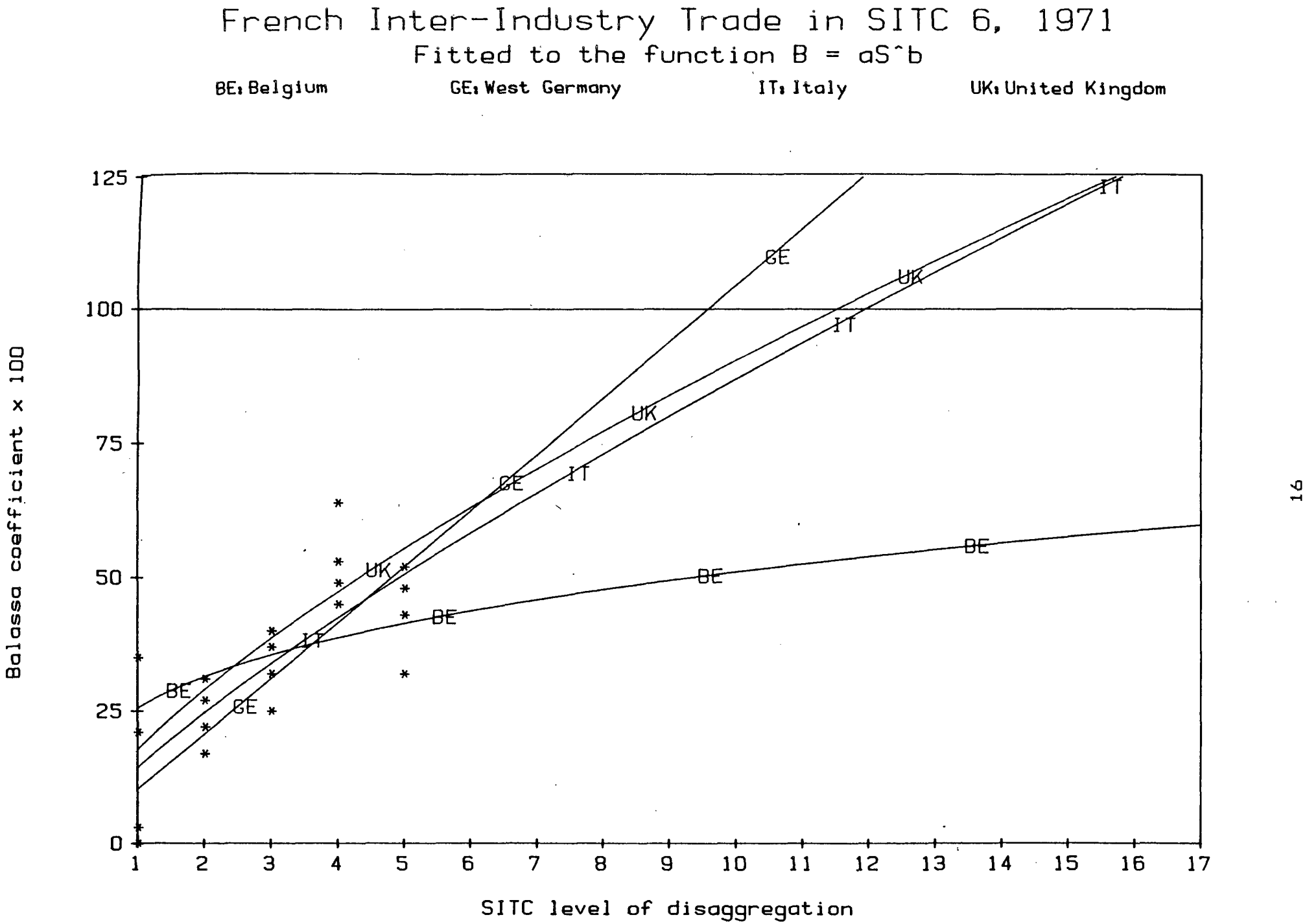
French Inter-Industry Trade in SITC 6, 1971
Fitted to the function B = aS^b
BE: Belgium
GE: West Germany
IT: Italy
UK: United Kingdom
Balassa coefficient x 100
SITC level of disaggregation
0
25
50
75
100
125
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
BE
GE
UK
IT

Figure 3a

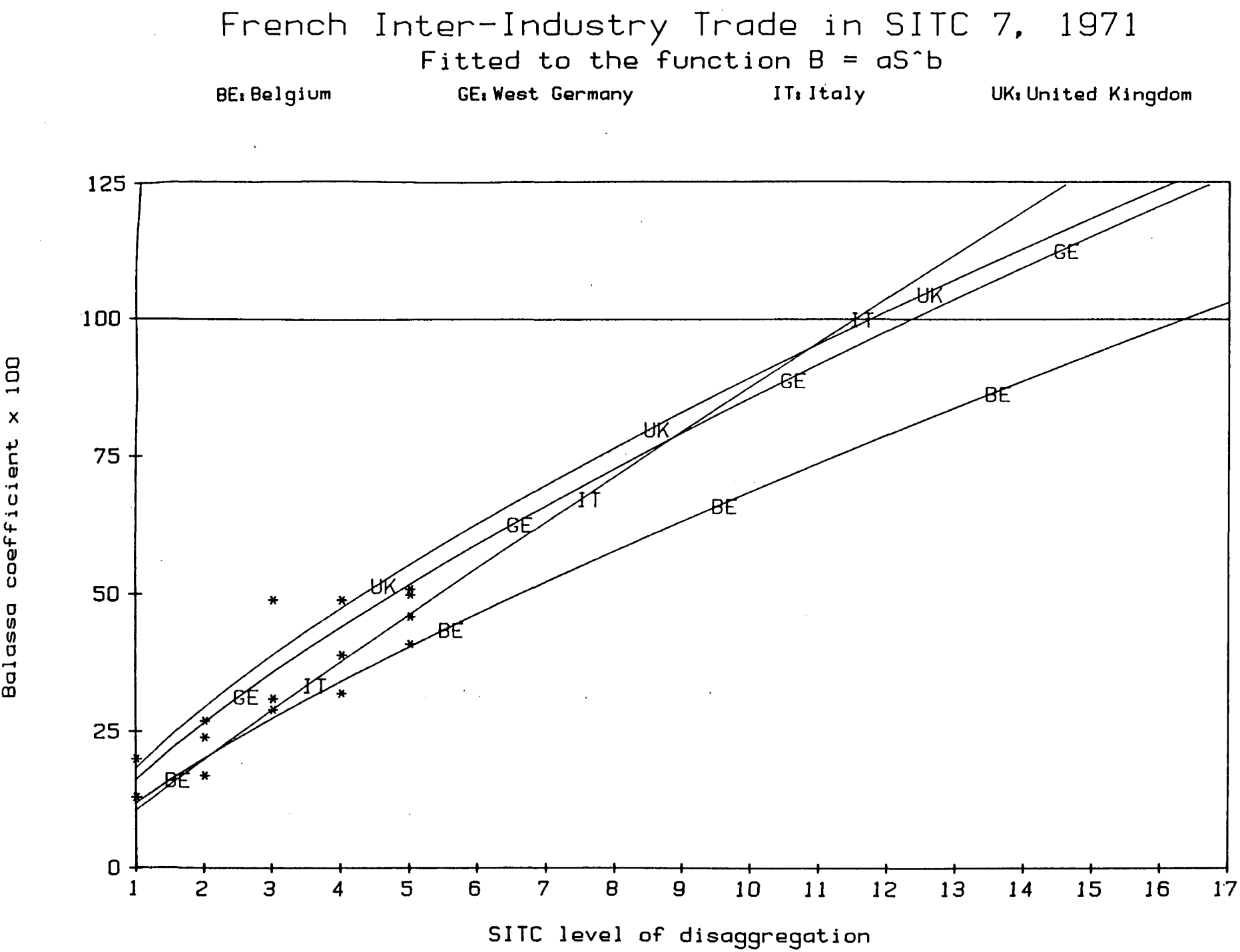
French Inter-Industry Trade in SITC 7, 1971
Fitted to the function B = aS^b
BE: Belgium
GE: West Germany
IT: Italy
UK: United Kingdom
Balassa coefficient x 100
125
100
75
50
25
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
SITC level of disaggregation
BE
GE
IT
UK

Figure 3b

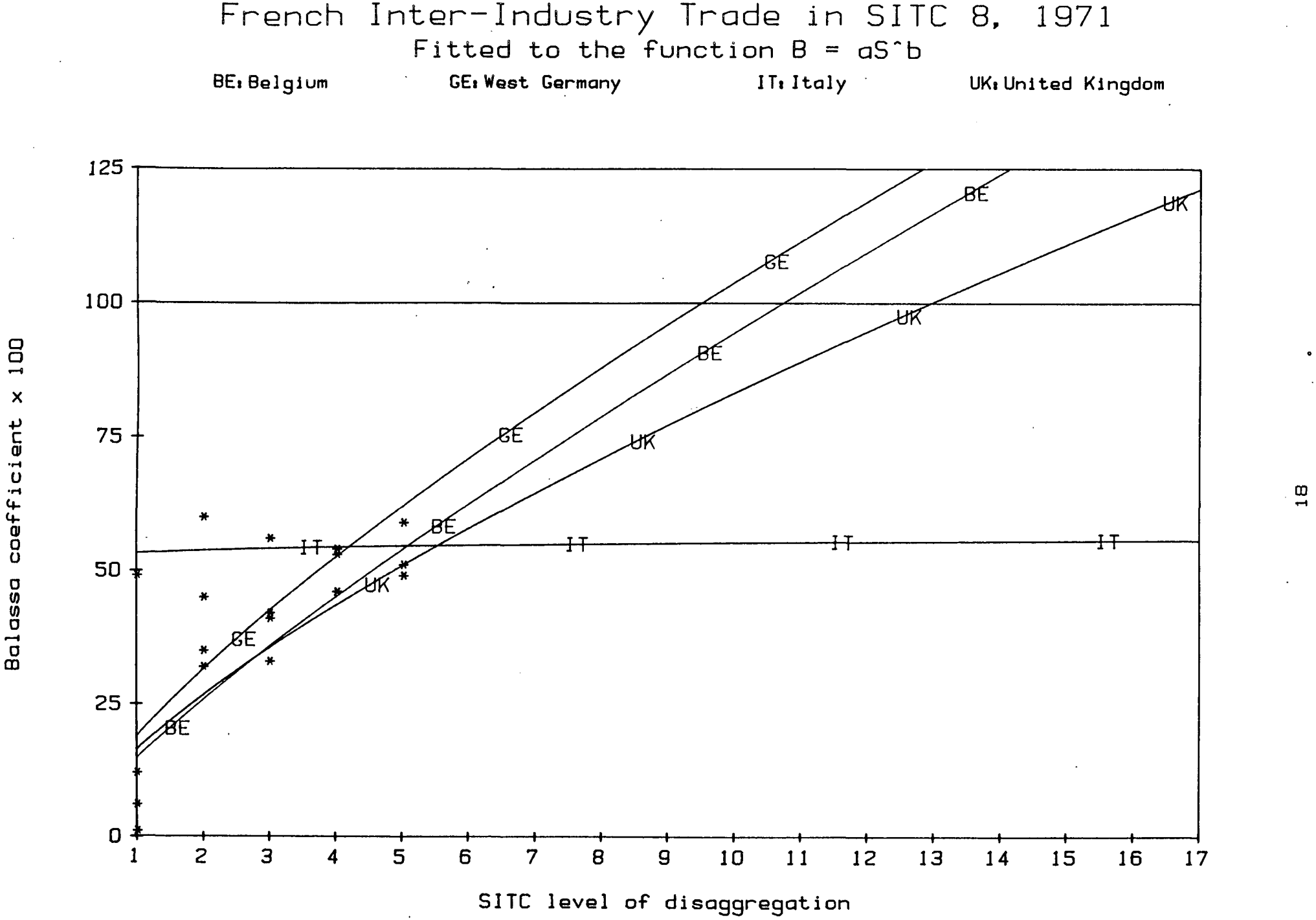
French Inter-Industry Trade in SITC 8, 1971
Fitted to the function B = aS^b
BE: Belgium
GE: West Germany
IT: Italy
UK: United Kingdom
Balassa coefficient x 100
125
100
75
50
25
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
SITC level of disaggregation
BE
GE
UK
IT

Figure 3c

Table 6

French Inter-Industry Trade, 1971
Parameters (a,b) of the power function,
coefficient of determination (R^2),
and 100% cutoff point (S^*),
for data of Table 5

Country	a	b	R^2	S^*
1. SITC 6 -- manufactured goods classified by material				
Belgium	25.5230	.301232	.843465	93.07
West Germany	10.2449	1.008442	.971280	9.58
Italy	14.3065	.784057	.957771	11.94
United Kingdom	17.6951	.708637	.986922	11.52
2. SITC 7 -- machinery and transport equipment				
Belgium	11.8237	.764512	.993027	16.33
West Germany	16.0754	.727198	.989941	12.35
Italy	10.5163	.921781	.996672	11.51
United Kingdom	18.1954	.691905	.979750	11.74
3. SITC 8 -- miscellaneous manufactures				
Belgium	14.7025	.807923	.955960	10.73
West Germany	18.7742	.742835	.964668	9.50
Italy	53.1450	.016625	.995044	3.26E16
United Kingdom	16.2729	.708720	.990619	12.96

It is apparent from Table 6 and the graphs of Figure 3 that, except for two anomalous cases, the fitted curves predict the disappearace of intra-industry trade at reasonable levels of disaggregation. The two exceptional cases are those of trade with Belgium in SITC 6 (for which the curve fit is very poor--.84 being a very low coefficient of determination given that there are only three degrees of freedom) and trade with Italy in SITC 8 (for which the Balassa coefficient is, beyond SITC level 2, monotone decreasing in the SITC level of disaggregation). In the cases of SITC 6 and 8 it is apparent from Table 5 that there are far fewer subcategories in the Balassa coefficient for SITC 5 then for SITC 6, indicating that numerous probably redundant 5-

digit categories (categories for which the fifth digit is zero and no subdivision takes place) have been excluded from the calculations. This adds to the non-monotonicity of the Balassa coefficient itself. Taking account of these considerations, it seems a fair inference that one could expect intra-industry trade to disappear at or slightly above the sixteenth level of disaggregation.

1.3 The new Swedish data

Unpublished monthly data on Swedish imports and exports have been supplied to the author by the Statistiska centralbyrån, Stockholm, covering the period 1977-1984.[3] These data are classified according to the Svensk standard för näringsgrensindelning (SNI), which is a 6-digit refinement of the 4-digit International Standard Industrial Classification of All Economic Activities (ISIC) constructed by the United Nations. The Grubel-Lloyd coefficients have been computed by Joan R. Rodgers and are presented in Tables 7 and 8 for two different modes of calculation. In the first, when a k-digit category is trivially refined to a (k+1)-digit category by adding a zero to the code but not subdividing the category, this (k+1)-digit category is included in the calculations; in the second mode it is excluded.

Tables 9 and 10 furnish the coefficients of the fitted curves, the coefficient of determination, and the 100% cutoff point, corresponding to Tables 7 and 8 respectively. The fitted curves for the pooled data in these two cases are displayed in Figure 4. As the tables and figure indicate, the two modes of calculation provide a striking difference. The very high cutoff points in the first calculation can be interpreted by saying

that, if disaggregation merely consists in adding zeros to the code and not actually subdividing the categories, it may take a long time or even forever to eliminate statistical observations of two-way trade from international trade statistics.

Table 7

Swedish Intra-Industry Trade, 1977-1984
Grubel-Lloyd coefficients
(with repetition of trivial subcategories)
for SNI categories

Year	SNI level of disaggregation 1	2	3	4	5	6
1977	91.08	64.59	63.00	59.70	59.11	58.65
1978	85.70	63.44	61.98	58.95	58.37	57.61
1979	90.37	64.06	62.38	59.01	58.25	57.07
1980	87.17	65.11	63.37	60.20	59.46	58.21
1981	84.01	63.38	62.22	58.73	58.40	57.52
1982	86.58	65.58	64.05	59.67	59.24	58.55
1983	82.97	66.99	65.98	61.84	61.54	60.85
1984	81.85	68.19	67.23	63.07	62.73	61.99

Table 8

Swedish Intra-Industry Trade, 1977-1984
Grubel - Lloyd coefficients
(without repetition of trivial subcategories)
for SNI categories.

Year	1	2	3	4	5	6
1977	91.08	64.59	66.04	64.88	61.74	46.15
1978	85.70	63.44	64.91	62.61	59.29	44.25
1979	90.37	64.06	65.36	64.05	60.52	44.20
1980	87.17	65.11	68.26	66.00	62.05	46.06
1981	84.01	63.38	67.28	64.05	60.47	46.33
1982	86.58	65.58	68.62	64.37	60.66	47.27
1983	82.97	66.99	70.59	64.80	61.59	47.46
1984	81.85	68.19	71.50	65.43	61.36	47.59

Table 9

Swedish Intra-Industry Trade, 1977-1984
Parameters (a,b) of the power function,
coefficient of determination (R^2),
and 0% cutoff point (S^*) for data of Table 7.

Year	a	b	R^2	S^*
1977	19.5211	.475726	.991660	31.00
1978	22.4189	.400879	.994390	41.68
1979	19.9229	.478432	.991958	29.14
1980	20.8818	.429991	.994833	38.19
1981	23.1913	.379543	.995366	47.01
1982	20.9289	.427409	.995397	38.84
1983	22.1701	.353183	.997731	71.18
1984	22.1639	.332268	.998537	93.19
Pooled	21.3379	.411247	.994496	42.78

Table 10

Swedish Intra-Industry Trade, 1977-1984
Parameters (a,b) of the power function,
coefficient of determination (R^2),
and 0% cutoff point (S^*) for data of Table 8.

Year	a	b	R^2	S^*
1977	16.3428	.619753	.991455	18.59
1978	19.1203	.547961	.993529	20.48
1979	16.6576	.626580	.991254	17.47
1980	17.1347	.579884	.993090	20.95
1981	19.7004	.504332	.993971	25.06
1982	17.5331	.568340	.994906	21.40
1983	18.2338	.530882	.995756	24.68
1984	18.0543	.532134	.996123	24.95
Pooled	17.8127	.564111	.993473	21.29

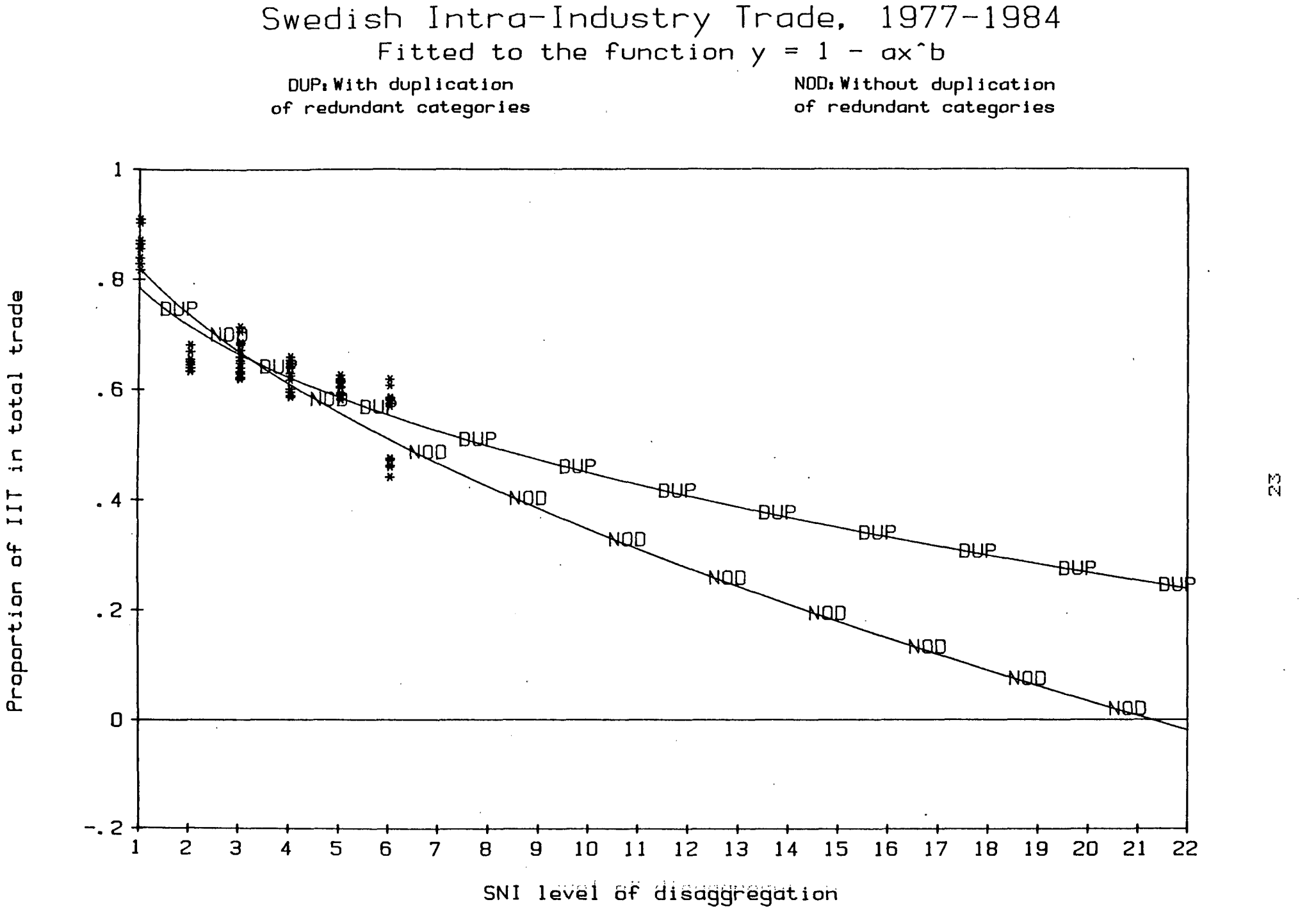
Swedish Intra-Industry Trade, 1977-1984
Fitted to the function y = 1 - ax^b
DUP: With duplication of redundant categories
NOD: Without duplication of redundant categories
Proportion of IIT in total trade
1
.8
.6
.4
.2
0
-.2
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22
SNI level of disaggregation
DUP
NOD

Figure 4

2. The two-commodity, two-factor, two-country case

The thesis was presented by Grubel and Lloyd (1975, pp. 88-91) that (1) a preponderant amount of intra-industry trade takes place in industries within which production functions are very similar to one another, between countries with very similar factor endowments, and that (2) this fact is inconsistent with the Heckscher-Ohlin theory with its assumptions of perfect competition and constant returns to scale. In this section I take issue with the second of these propositions, and show that this type of intra-industry trade is readily explained in terms of the HOLS model.

In their words (Grubel & Lloyd, 1975, pp. 88-89):

> ... in certain industries, developed countries tend to produce large numbers of substitute products with input requirements ... so similar that they may be considered identical. The Heckscher-Ohlin model also assumes the identity of production functions across countries. ... therefore [sic] the constant rates of transformation between these products and their relative prices must be the same across countries. As a result the exchange of these commodities with identical input requirements for each other is not profitable, because profits arise from the exploitation of differences in relative prices among countries. Yet we observe the exchange of such products. The inconsistency between the theory and reality can be explained by relaxing either the assumption that the production functions are identical across countries or the assumption that there are no economies of scale.

The assumption that the rates of transformation will be the same across countries requires the additional assumption of identical factor endowments; however, this seems to be implicitly assumed, since the authors subsequently state (p. 91) that "countries trading in these products have similar endowments with human, knowledge and real capital relative to labour and land."

In terms of the standard two-commodity, two-factor, two-country model, the case discussed by Grubel and Lloyd may easily be analyzed in terms of the well-known "Lerner diagram" [cf. Lerner (1933), Chipman (1966)]. In Figure 5 a case is shown in which the production isoquants (which are the same for the two countries) are extremely close and the diversification cone very narrow. It is assumed that commodity i uses factor i relatively intensively (i=1,2). Suppose country 1's endowments lie at one edge of this cone (with the higher ratio of factor 1 to factor 2) and country 2's at the other. Then country 1 will specialize in the production of commodity 1, and country 2 will specialize in the production of commodity 2; both countries will be on the verge of diversifying. Now suppose the two production functions are completely symmetric to each other in their arguments, and suppose further that consumers in both countries have identical and homothetic, and also symmetric, preferences. Then it is clear that in world equilibrium the prices of the two commodities will be the same. To specialize the assumptions still further (for simplicity), suppose consumers have Mill-Cobb-Douglas preferences generated by a utility function

$$(2.1) \qquad U(x_1, x_2) = x_1^{\theta_1} x_2^{\theta_2} \qquad (\theta_j > 0,\ \theta_1 + \theta_2 = 1)$$

where (by symmetry) $\theta_1 = \theta_2 = \frac{1}{2}$, x_j being the consumption of commodity j. Then in each country, one-half of each country's output is exported. This is true no matter how wide or narrow the diversification cone.

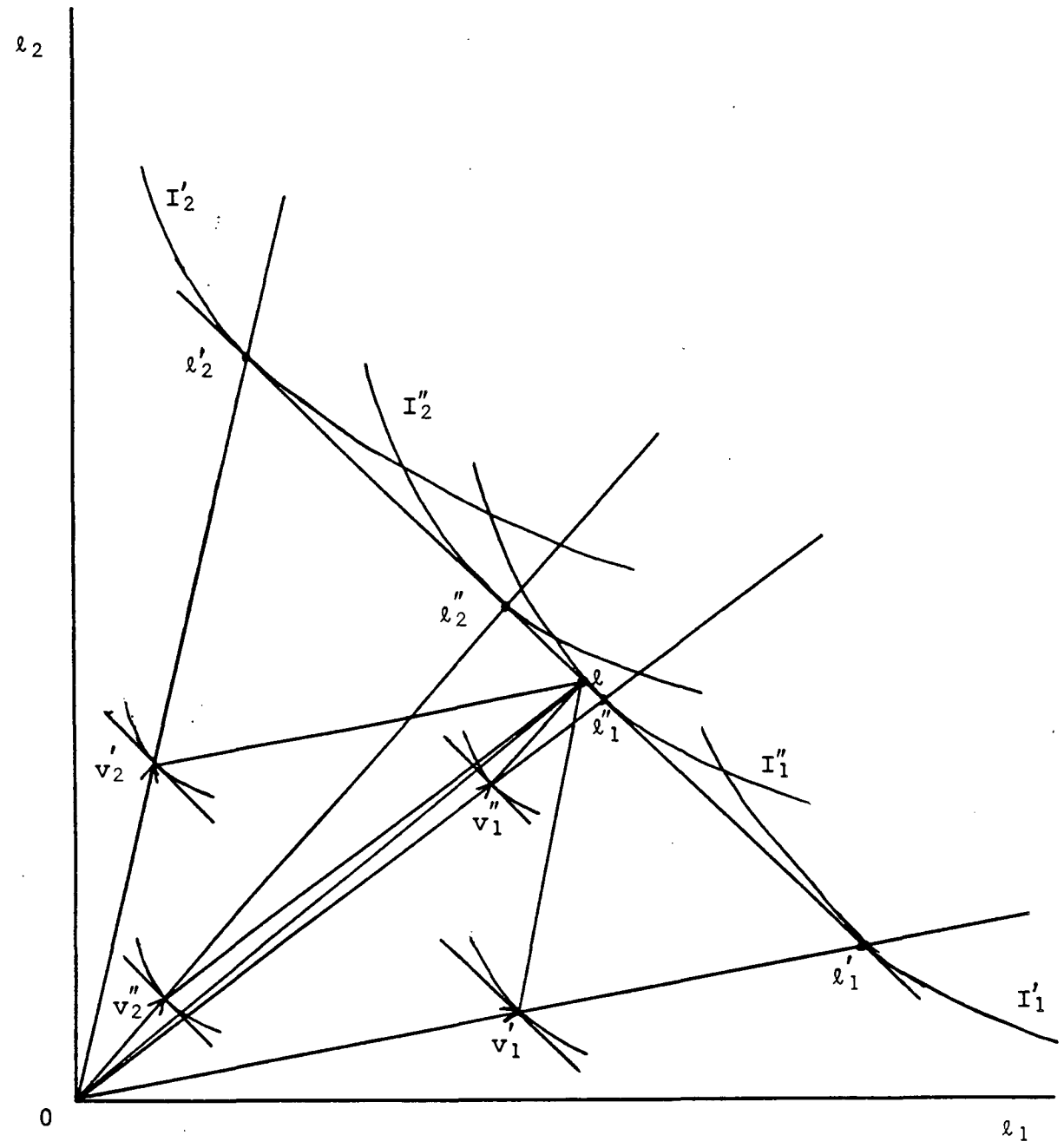

Figure 5

A country with resource endowments $\ell = (\ell_1, \ell_2)$ has technology characterized by isoquants I'_1, I'_2 in situation 1 and $I'_1{}'$, $I'_2{}'$ in situation 2. In situation 1, the endowment vector ℓ is allocated between industries according to $v'_1 + v'_2 = \ell$, where $v'_j = (v'_{1j}, v'_{2j})$; the diversification cone is $\ell'_1 0 \ell'_2$. In situation 2, this cone shrinks to $\ell'_1{}' 0 \ell'_2{}'$ in such a way that ℓ is close to the lower edge of the cone; the endowment vector ℓ is now allocated between the two industries according to $v'_1{}' + v'_2{}' = \ell$. A much larger fraction of resources is devoted to industry 1 (the export industry) in the second situation than in the first. In the limit, as $\ell'_1{}'$ approaches ℓ, all the country's resources are allocated to industry 1, and since (with unit prices) half of the export good is consumed, the other half is exported.

Now suppose we make the following construction. Let production functions be quite disparate (but still symmetric to each other), as indicated by the outside isoquants in Figure 5, but let the factor endowments remain close as before. Then the respective countries' resource allocations will be very close, and there will be very little trade. Now let the isoquants become closer and closer, until they reach the narrow diversification cone, that is, until the diversification cone is bounded by the given endowment vectors. Then each country will export a larger and larger proportion of the good in which it has a comparative advantage, up to the limit of one-half of its export good.

Let us now make this argument more precise. Using the model of Chipman (1985), suppose that there are two Cobb-Douglas production functions (identical between countries)

$$(2.2) \qquad f_j(v_{1j},v_{2j}) = \mu_j v_{1j}^{\beta_{1j}} v_{2j}^{\beta_{2j}} \qquad (j=1,2),$$

where $\beta_{ij}>0$ and $\beta_{1j}+\beta_{2j}=1$ and v_{ij} denotes the allocation of factor i to industry j, and let the resource-allocation constraints (in each country)

$$(2.3) \qquad v_{11} + v_{12} = \ell_1^k, \quad v_{21} + v_{22} = \ell_2^k$$

be satisfied, where ℓ_i^k denotes the endowment of country k in factor i ($i,k=1,2$). Let preferences be given by (2.1) for both countries. World equilibrium may then be computed as follows. First, denoting the rental of factor i by w_i, and assuming diversification of production in both countries, factor rentals are solved for by setting prices equal to minimum unit costs. The

cost functions dual to (2.2) are

$$(2.4) \qquad g_j(w_1,w_2) = \nu_j w_1^{\beta_{1j}} w_2^{\beta_{2j}} \quad \text{where } \nu_j = 1/f_j(\beta_{1j},\beta_{2j})$$

[cf. Chipman (1985, p. 293)]; equating each of these to p_j we obtain

$$(2.5) \qquad \begin{bmatrix} \log w_1 \\ \log w_2 \end{bmatrix} = \begin{bmatrix} \beta_{11} & \beta_{21} \\ \beta_{12} & \beta_{22} \end{bmatrix}^{-1} \begin{bmatrix} \log(p_1/\nu_1) \\ \log(p_2/\nu_2) \end{bmatrix} .$$

The cost-minimizing factor-output matrix is

$$(2.6) \qquad B = \begin{bmatrix} b_{11} & b_{12} \\ b_{21} & b_{22} \end{bmatrix} = \begin{bmatrix} w_1 & 0 \\ 0 & w_2 \end{bmatrix}^{-1} \begin{bmatrix} \beta_{11} & \beta_{12} \\ \beta_{21} & \beta_{22} \end{bmatrix} \begin{bmatrix} p_1 & 0 \\ 0 & p_2 \end{bmatrix} .$$

Denoting its inverse and that of $[\beta_{ij}]$ by

$$(2.7) \qquad B^{-1} = \begin{bmatrix} b^{11} & b^{12} \\ b^{21} & b^{22} \end{bmatrix} = \begin{bmatrix} b_{11} & b_{12} \\ b_{21} & b_{22} \end{bmatrix}^{-1}, \begin{bmatrix} \beta^{11} & \beta^{12} \\ \beta^{21} & \beta^{22} \end{bmatrix} = \begin{bmatrix} \beta_{11} & \beta_{12} \\ \beta_{21} & \beta_{22} \end{bmatrix}^{-1}$$

respectively, we find from (2.4), (2.5), and (2.7) that

$$(2.8) \qquad w_i = \prod_{h=1}^{2} \left(\mu_h \beta_{1h}^{\beta_{1h}} \beta_{2h}^{\beta_{2h}} p_h \right)^{\beta^{hi}} ,$$

hence the elements of the inverse factor-output matrix are

$$(2.9) \qquad b^{ji} = w_i \beta^{ji}/p_j = \left[\prod_{h=1}^{2} \left(\mu_h \beta_{1h}^{\beta_{1h}} \beta_{2h}^{\beta_{2h}} p_h \right)^{\beta^{hi}} \right] \beta^{ji}/p_j .$$

Now, country k's Rybczynski function for commodity j is, in the region of diversification, given by

$$(2.10) \qquad y_j^k = \hat{y}_j(p_1,p_2,\ell_1^k,\ell_2^k) = b^{j1}(p_1,p_2)\ell_1^k + b^{j2}(p_1,p_2)\ell_2^k$$

(as is seen by substituting $v_{ij}=b_{ij}y_j$ in (2.3) and inverting), where the functions $b^{ji}(p_1,p_2)$ are given by (2.9). (The

dependence of the b^{ji} on the parameters μ_j, β_{ij} is not explicitly indicated but should be kept in mind). Let world outputs, world consumption, and world factor endowments be denoted

$$(2.11) \qquad y_j = \sum_{k=1}^{2} y_j^k, \quad x_j = \sum_{k=1}^{2} x_j^k, \quad \ell_i = \sum_{k=1}^{2} \ell_i^k .$$

Given that both countries are assumed to be diversifying, and that the production functions (2.2) satisfy the hypothesis of absence of factor-intensity reversal, we obtain from (2.10) and (2.11) the world Rybczynski functions

$$(2.12) \qquad \tilde{y}_j(p_1,p_2,\ell_1,\ell_2) = b^{j1}(p_1,p_2)\ell_1 + b^{j2}(p_1,p_2)\ell_2 .$$

Since preferences in both countries are assumed to be generated by the same utility function (2.1), which can be aggregated, equilibrium world consumption must satisfy

$$(2.13) \qquad \frac{x_2}{x_1} = \frac{\theta_2}{\theta_1}\,\frac{p_1}{p_2} .$$

Setting $x_j = y_j$ for world equilibrium, and taking account of the homogeneity of degree 0 of the functions b^{ji}, we obtain from (2.12) and (2.13) the equation

$$(2.14) \qquad \frac{b^{21}(p_1/p_2,1)\ell_1 + b^{22}(p_1/p_2,1)\ell_2}{b^{11}(p_1/p_2,1)\ell_1 + b^{12}(p_1/p_2,1)\ell_2} - \frac{\theta_2}{\theta_1}\,\frac{p_1}{p_2} = 0.$$

Standard methods, such as Newton's method or the secant method, may be used to solve this equation for the world price ratio p_1/p_2.

Once the equilibrium world price ratio has been obtained,

each country's export-output ratio is readily computed. Assuming that commodity j uses factor j relatively intensively (i.e., that $\beta_{11} > \beta_{12}$), the output of each country's export good is computed from the Rybczynski function (2.10), for j = k (say, setting $p_2 = 1$). The value of the national-product function

$$(2.15) \qquad \Pi(p_1,p_2,\ell_1^k,\ell_2^k) = \sum_{j=1}^{2} p_j \hat{y}_j(p_1,p_2,\ell_1^k,\ell_2^k)$$

is then computed, and the consumption of commodity j in country k is

$$(2.16) \qquad x_j^k = \theta_j \Pi(p_1,p_2,\ell_1^k,\ell_2^k)/p_j \ .$$

For each country, the export-output ratio is then

$$(2.17) \qquad \frac{y_k^k - x_k^k}{y_k^k} = 1 - \theta_k\left(1 + \frac{p_j y_j^k}{p_k y_k^k}\right) \qquad (j \neq k) \ .$$

Our object is now to show that, at least under certain additional hypotheses, these export-output ratios will increase as production functions become more similar. The additional hypotheses will impose complete symmetry as between the two commodities, factors, and countries. Specifically, I shall assume that $\mu_1 = \mu_2 = 1$ and $\beta_{12} = \beta_{21}$; the latter of course implies $\beta_{11} = \beta_{22}$, providing complete symmetry as between production functions. To obtain symmetry in consumption we set $\theta_1 = \theta_2 = 1/2$, and to have symmetry as between the countries' factor endowments we set $\ell_1^1 = \ell_2^2$ and $\ell_2^1 = \ell_1^2$, where $\ell_1^1 > \ell_2^1$ (country k is relatively well endowed in factor k). With these symmetry assumptions, the solution of (2.14) may be bypassed, since clearly $p_1 = p_2$. Without loss of generality it will be

assumed that $p_1 = p_2 = 1$, and for convenience we shall denote $\beta = \beta_{12} = \beta_{21}$ and $1-\beta = \beta_{11} = \beta_{22}$. Since we assume $\beta_{11} > \beta_{12}$, this is equivalent to $\beta < 1/2$.

With these symmetry assumptions, (2.8) reduces to

$$(2.18) \qquad w_1 = w_2 = (1-\beta)^{1-\beta}\beta^{\beta} .$$

Thus, it is interesting to note that for $\beta < 1/2$ both factor rentals are decreasing functions of β; that is, factor rentals decrease as production functions become more similar. The inverse factor-output matrix now becomes

$$(2.19) \qquad B^{-1} = \frac{(1-\beta)^{1-\beta}\beta^{\beta}}{1-2\beta}\begin{bmatrix} 1-\beta & -\beta \\ -\beta & 1-\beta \end{bmatrix} ,$$

and we find that

$$(2.20) \qquad \frac{dB^{-1}}{d\beta} = \frac{(1-\beta)^{1-\beta}\beta^{\beta}}{1-2\beta}\begin{bmatrix} (1-\beta)\psi(\beta)-1 & -\beta\psi(\beta)+1 \\ -\beta\psi(\beta)+1 & (1-\beta)\psi(\beta)-1 \end{bmatrix}$$

where

$$(2.21) \qquad \psi(\beta) = \log \beta - \log(1-\beta) + 2(1-2\beta)^{-1} .$$

The Rybczynski functions (2.10) reduce to

$$(2.22) \qquad y_j^k = \frac{(1-\beta)^{1-\beta}\beta^{\beta}}{1-2\beta}\left[\ell_j^k - \beta(\ell_1^k+\ell_2^k)\right] \qquad (j=1,2).$$

From (2.22) and (2.17)(with $\theta=1/2$ and $p_1=p_2=1$), it follows that country k's export-output ratio is equal to

$$(2.23) \qquad \frac{y_k^k - x_k^k}{y_k^k} = \frac{\ell_k^k - \ell_j^k}{2\left[\ell_k^k - \beta(\ell_1^k+\ell_2^k)\right]} \qquad (j\neq k) ,$$

which is an increasing function of β since $\ell_k^k > \ell_j^k$ for $j \neq k$. This proves the

Theorem. If the symmetry conditions $\mu_1 = \mu_2 = 1$, $\beta_{12} = \beta_{21} = \beta$, $\theta_1 = \theta_2 = 1/2$, $\ell_1^1 = \ell_2^2$, $\ell_2^1 = \ell_1^2$ hold in the model (2.1), (2.2), (2.3), if commodity j uses factor j relatively intensively ($\beta < 1/2$) and country k is relatively well endowed in factor k ($\ell_k^k > \ell_k^j$ for $j \neq k$), and if both commodities continue to be produced in both countries, then as the production functions become more similar (i.e., β increases), each country's exports increase as a proportion of the output of the export good.

Figure 6 depicts the export-output ratio (2.23) (expressed as a percentage) as a function of β ($=\beta_{12} = \beta_{21}$) for selected values of the endowment ratio $L = \ell_k^k/\ell_j^k$ ($j \neq k$). This diagram brings out an interesting aspect of the situation: not only does the percentage exported increase as the production functions become closer, but when production functions are already very close, the percentage exported increases very dramatically when the distance between the production functions decreases only slightly. It was stated by Grubel and Lloyd (1975, p. 91) that "it is highly unlikely that the minor differences in input requirements between goods within ... industries could lead to the large observed trade if production were subject to constant returns to scale." But, as the above theorem and figure show, the more minor the differences in input requirements, the greater is the percentage of output exported, and the more sensitive is the percentage exported to narrowing of the differences between production functions.

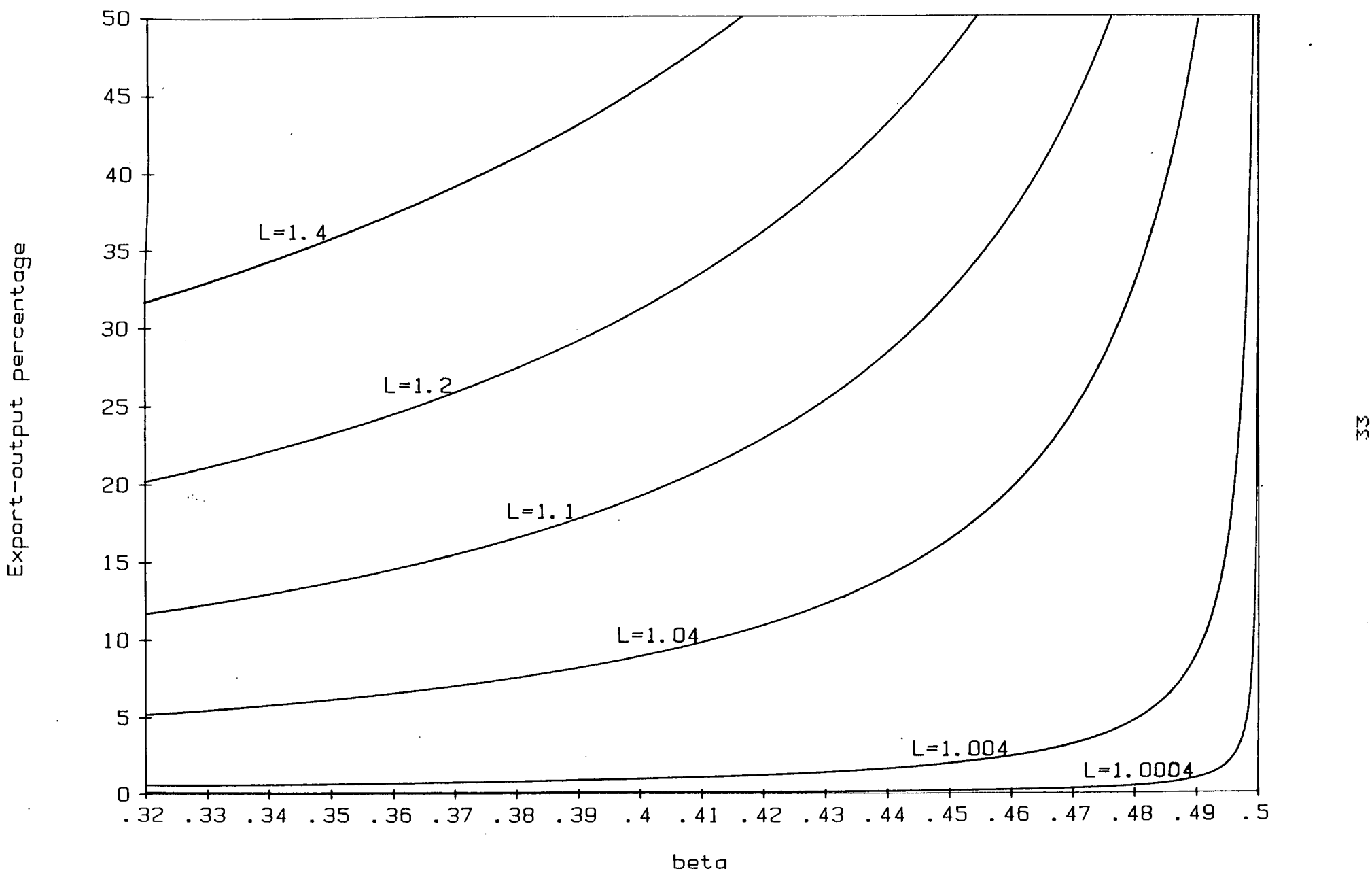
Percentage of Export Good Exported
as a function of beta
Export-output percentage
50
45
40
35
30
25
20
15
10
5
0
L=1.4
L=1.2
L=1.1
L=1.04
L=1.004
L=1.0004
.32 .33 .34 .35 .36 .37 .38 .39 .4 .41 .42 .43 .44 .45 .46 .47 .48 .49 .5
beta

Figure 6

What happens in the limit as both the production functions for the two commodities and the factor endowments of the two countries become identical? In particular, what happens when $\beta_{12} = \beta_{21} = .5$ and $\ell_1^1 = \ell_2^1 = 1$? It is clear that the curves of Figure 6 approach a discontinuous correspondence in the shape of a backward L. The diversification cone shrinks to a ray on which lie both countries' endowment vectors; the countries' production-possibility frontiers become parallel straight lines. World trade becomes indeterminate.

The issue of indeterminacy was raised by Corden (1978, p. 4):

> Suppose that all goods in an "industry" used factors in identical proportions--that is, had identical factor-intensities. In this case factor proportions theory could not explain intra-industry trade. For this purpose an industry must be defined in terms of the statistical classification used in the intra-industry calculations. Usually the SITC three-digit classification is used though, with even narrower definitions, substantial intra-industry trade apparently remains. It follows that, in such a case, other theories must explain intra-industry trade.

One could argue by analogy with the indeterminacy in the size distribution of firms in an industry under constant returns and competitive equilibrium, that either the constant-returns or the competitive assumption (or both) must be relaxed in order to yield a determinate theory.

But the indeterminateness involved in the present case results from the totally improbable assumption that production functions and resource endowments are exactly the same; let them differ in only the slightest degree, as in the above example, and determinacy is restored.

The indeterminacy of this limiting case points to what is a fallacy in Grubel and Lloyd's argument when they state (p. 89) that "exchange of these commodities with identical input requirements for each other is not profitable, because profits arise from the exploitation of differences in relative prices among countries." It is a confusion between conditions for existence and conditions for uniqueness of equilibrium. Zero profits, and equal prices in the same market, are part of the defining conditions of competitive equilibrium in general and the HOLS model in particular. A competitive equilibrium certainly exists in this limiting case, but it is a neutral equilibrium, with each country's exports indeterminate--anywhere between zero and fifty percent of either good may be exported. Far from being inconsistent with the observation that there is a large and haphazard amount of trade between similar countries, the model is entirely in conformity with it.

3. The three-commodity, three-factor, three-country case

The following statement by Hufbauer and Chilas (1974, p. 3) appears to express a widely-held and unchallenged point of view:

> Neoclassical trade theory once predicted that trade would wither between similar nations. After all, trade supposedly compensates for factor endowment disparities or differences in tastes, and if these disparities or taste differences are modest, the need for trade is small.

No references to "neoclassical trade theory" were cited to support this contention, and I doubt whether they could be easily found. Ricardo discussed the question of the direction of trade between two countries, but as far as I know he never concerned himself with explaining the amount of trade. The same appears to

be true of neoclassical and, in particular, the Heckscher-Ohlin theory. But whether or not sources could be found for such a proposition, the result of the previous section shows it to be incorrect.

Somewhat similar contentions are frequently made in contexts that are relevant only if trade among more than two countries is involved. Fairly typical is the following argument put forward by Gray (1980, p. 447):

> ... a preponderant amount of international trade takes place among industrial nations with relatively similar resource endowments. ... this pattern of international trade cannot be readily accounted for by the orthodox, factor-proportions theory of international trade even in its multiple-factor version. The standard theory would suggest that the larger trade flows would take place among nations with markedly different factor endowments.

The only proposition known to me that relates trade patterns to relative factor endowments is the "Heckscher-Ohlin theorem", which states that if there are two countries, two factors, and two commodities produced competitively under constant returns to scale and freely traded with zero transport costs, and if (1) preferences are identical and homothetic within and between countries, (2) production functions are identical as between countries, (3) there are no factor-intensity reversals, and (4) trade is balanced, then each country will export the commodity in which its relatively abundant factor is used relatively intensively. If any of the above four conditions is removed, it is easy to construct a counterexample to the proposition; in fact, much of the literature on the "Leontief paradox" was devoted precisely to such exercises. Thus, very special assumptions are required even in the simple 2 × 2 × 2 case to

obtain unequivocal results; and even then, the results concern only the direction of trade, not the amount of trade.

Let us consider now a model of three countries, each producing three commodities with three factors. Countries 1 and 2 will be "similar" in their factor endowments, and they will have a comparative advantage in producing commodities 1 and 2, which have "similar" production functions. The object is to show that countries 1 and 2 may trade more, even much more, with each other than with the third country.

To produce some definite examples, I shall as in the previous section assume that production functions in each country have the Cobb-Douglas form

$$(3.1)\qquad y_j^k = f(v_{1j}^k, v_{2j}^k, v_{3j}^k) = \mu_j v_{1j}^{\beta_{1j}} v_{2j}^{\beta_{2j}} v_{3j}^{\beta_{3j}} \qquad (\beta_{ij}>0,\ \sum_{i=1}^{3}\beta_{ij}=1) \quad (j=1,2,3)$$

and that the resource-allocation constraints

$$(3.2)\qquad v_{i1}^k + v_{i2}^k + v_{i3}^k = \ell_i^k \qquad (i=1,2,3)$$

are satisfied. Here, $v_{ij} = v_{ij}^k$ denotes the input of factor i into the production of commodity j in country k (the superscript is omitted in (3.1) for notational simplicity); y_j^k is the output of commodity j in country k, and ℓ_i^k is the endowment of factor i in country k. I shall finally assume that preferences in each country are identical and homothetic, generated by the Mill-Cobb-Douglas utility function

$$(3.3)\qquad U(x_1,x_2,x_3) = x_1^{\theta_1} x_2^{\theta_2} x_3^{\theta_3} \qquad (\theta_j>0,\ \sum_{j=1}^{3}\theta_j=1).$$

Now we must define "similarity". Since in the examples to follow I shall assume $\mu_1 = \mu_2 = \mu_3 = 1$, the dissimilarity between two production functions f^j and $f^{j'}$ may be defined simply as the Euclidean distance between the vectors of exponents β_j and $\beta_{j'}$, where $\beta_j = (\beta_{1j},\beta_{2j},\beta_{3j})$, i.e.,

$$(3.4) \qquad \sqrt{\left(\sum_{i=1}^{3} (\beta_{ij}-\beta_{ij'})^2\right)} .$$

In the case of factor-endowment vectors ℓ^k and $\ell^{k'}$, where $\ell^k = (\ell_1^k,\ell_2^k,\ell_3^k)$, I shall define the relative dissimilarity between them as the normalized distance

$$(3.5) \qquad \sqrt{\left(\sum_{i=1}^{3} (\ell_i^k/\|\ell^k\| - \ell_i^{k'}/\|\ell^{k'}\|)^2\right)}, \text{ where } \|\ell^k\| = \sqrt{\left(\sum_{i=1}^{3} (\ell_i^k)^2\right)} ,$$

i.e., the distance between them after they have both been normalized to unit length.

World equilibrium is solved for in the following manner. It is assumed that the equilibrium is one in which each country produces all three commodities, hence in view of the assumption that the countries have identical production functions, and of the form (3.1) (ruling out factor-intensity reversal), factor rentals are equalized; therefore, each country produces according to the same technical coefficients. World national product is then determined by the world national-product function

$$(3.6) \qquad Y = \Pi(p_1,p_2,p_3,\ell_1,\ell_2,\ell_3) = \sum_{k=1}^{3} \Pi(p_1,p_2,p_3,\ell_1^k,\ell_2^k,\ell_3^k),$$

where $\ell_i = \sum_{k=1}^{3} \ell_i^k$, and world output of commodity j is determined according to the world Rybczynski function

$$(3.7) \qquad y_j = \hat{y}_j(p_1,p_2,p_3,\ell_1,\ell_2,\ell_3) = \sum_{k=1}^{3} \hat{y}_j^k(p_1,p_2,p_3,\ell_1^k,\ell_2^k,\ell_3^k) ,$$

where $\hat{y}_j = \partial\Pi/\partial p_j$. To compute (3.6) and (3.7), we first obtain the factor rentals; this is done by solving from the system of minimum-unit-cost functions

$$(3.8) \qquad p_j = g_j(w_1,w_2,w_3) = \nu_j w_1^{\beta_{1j}} w_2^{\beta_{2j}} w_3^{\beta_{3j}} \qquad (j=1,2,3)$$

where $\nu_j = 1/f_j(\beta_{1j},\beta_{2j},\beta_{3j})$, given that this system is linear in the logarithms of the p_j/ν_j and w_i.

From these factor rentals, the matrix of factor-output coefficients $b_{ij} = \beta_{ij}p_j/w_i$ is obtained, and the world outputs (3.7) are obtained by solving the system of equations

$$(3.9) \qquad \sum_{j=1}^{3} b_{ij}y_j = \ell_i \qquad (i=1,2,3)$$

World national product, (3.6), is then obtained from

$$(3.10) \qquad Y = \sum_{j=1}^{3} p_j y_j \ .$$

From (3.10) and the assumption that world preferences are identical and homothetic and are generated by (3.3), world consumption is given by

$$(3.11) \qquad x_j = \theta_j Y/p_j \ .$$

The system of equations to be solved to obtain world equilibrium prices is obtained by setting demand equal to supply for two out of the three commodities (since the third equality will follow by Walras' law); we may write this in the form

$$(3.12) \qquad p_j y_j = \theta_j Y \qquad (j=1,2),$$

where y_j and Y are obtained from (3.9) and (3.10), and x_j from

(3.11).

To solve the equations (3.12), Wolfe's (1959) algorithm has been used. Setting $p_3 = 1$, three trial solutions p^1, p^2, p^3 are chosen, to form the matrix

$$P = \begin{bmatrix} p_1^1 & p_1^2 & p_1^3 \\ p_2^1 & p_2^2 & p_2^3 \end{bmatrix} . \tag{3.13}$$

The matrix

$$A = \begin{bmatrix} p_1^1 y_1^1 - \theta_1 Y^1 & p_1^2 y_1^2 - \theta_1 Y^2 & p_1^3 y_1^3 - \theta_1 Y^3 \\ p_2^1 y_2^1 - \theta_2 Y^1 & p_2^2 y_2^2 - \theta_2 Y^2 & p_2^3 y_2^3 - \theta_2 Y^3 \\ 1 & 1 & 1 \end{bmatrix} \tag{3.14}$$

is formed, where y_j^k and Y^k are obtained from (3.9) and (3.10) using the factor-output coefficients $b_{ij} = \beta_{ij} p_j^k / w_i^k$, the w_i^k being obtained from the p_k^k via (3.8). The norm of $p^k = (p_1^k, p_2^k)'$ is defined as

$$\|p^k\| = \sum_{j=1}^{2} \left(p_j^k y_j^k - \theta_j Y^k \right)^2 . \tag{3.15}$$

The Wolfe algorithm then proceeds as follows. A new average price vector $\bar{p}$ is obtained from the formula

$$\begin{bmatrix} \bar{p}_1 \\ \bar{p}_2 \end{bmatrix} = \begin{bmatrix} p_1^1 & p_1^2 & p_1^3 \\ p_2^1 & p_2^2 & p_2^3 \end{bmatrix} \begin{bmatrix} p_1^1 y_1^1 - \theta_1 Y^1 & p_1^2 y_1^2 - \theta_1 Y^2 & p_1^3 y_1^3 - \theta_1 Y^3 \\ p_2^1 y_2^1 - \theta_2 Y^1 & p_2^2 y_2^2 - \theta_2 Y^2 & p_2^3 y_2^3 - \theta_2 Y^3 \\ 1 & 1 & 1 \end{bmatrix}^{-1} \begin{bmatrix} 0 \\ 0 \\ 1 \end{bmatrix} . \tag{3.16}$$

One of the columns, p^k, of (3.13) of maximal norm (3.15) is then dropped and replaced by $\bar{p}$; from the new price vector, the factor rentals w_i, the factor-output coefficients b_{ij}, the outputs y_j,

and the national product Y are recomputed and the new column of coefficients of A is substituted for the dropped one. When the maximal norm (3.15) has reached a prescribed small number, the process converges.

This algorithm assumes diversification by all three countries, but this assumption may be incorrect. That is, for a particular choice of matrices of exponents β_{ij} in (3.1) and factor endowments ℓ_i^k (i,j,k=1,2,3), it could happen that the algorithm yields negative outputs for some commodities. This solution would have to be rejected, of course. In the examples to be given below, positive production has been verified for all cases.

I shall choose initially the matrix of exponents

$$(3.17) \qquad \begin{bmatrix} \beta_{11} & \beta_{12} & \beta_{13} \\ \beta_{21} & \beta_{22} & \beta_{23} \\ \beta_{31} & \beta_{32} & \beta_{33} \end{bmatrix} = \begin{bmatrix} .49 & .46 & .1 \\ .46 & .49 & .1 \\ .05 & .05 & .8 \end{bmatrix},$$

the matrix of factor endowments

$$(3.18) \qquad \begin{bmatrix} \ell_1^1 & \ell_1^2 & \ell_1^3 \\ \ell_2^1 & \ell_2^2 & \ell_2^3 \\ \ell_3^1 & \ell_3^2 & \ell_3^3 \end{bmatrix} = \begin{bmatrix} 1180 & 1120 & 725/t \\ 1120 & 1180 & 725/t \\ 300 & 300 & 1300/t \end{bmatrix}$$

(where t is a positive parameter), and the vector of constant expenditure shares

$$(3.19) \qquad (\theta_1, \theta_2, \theta_3) = (r/(2r+1),\ r/(2r+1),\ 1/(2r+1))$$

where $0 < r \leq 1$. Then, countries 1 and 2, as well as commodities

1 and 2, are completely symmetric in their differences, and the prices of commodities 1 and 2 in world equilibrium will necessarily be equal to one another. If t = 1 in (3.18), the length of country 3's endowment vector (1655.7) is just slightly larger than that of countries 1 and 2 (1654.3)--giving this country the benefit of the doubt.

For t = 1 and r = 1 we find that the prices are[4]

(3.20) $$p_1 = p_2 = .984441846365,\ p_3 = 1.$$

The pattern of world outputs is given by

(3.21) $$\begin{bmatrix} y_1^1 & y_1^2 & y_1^3 \\ y_2^1 & y_2^2 & y_2^3 \\ y_3^1 & y_3^2 & y_3^3 \end{bmatrix} = \begin{bmatrix} 908.11 & 71.94 & 224.42 \\ 71.94 & 908.11 & 224.42 \\ 150.32 & 150.32 & 885.09 \end{bmatrix};$$

and the pattern of world consumption is

(3.22) $$\begin{bmatrix} x_1^1 & x_1^2 & x_1^3 \\ x_2^1 & x_2^2 & x_2^3 \\ x_3^1 & x_3^2 & x_3^3 \end{bmatrix} = \begin{bmatrix} 377.58 & 377.58 & 449.31 \\ 377.58 & 377.58 & 449.31 \\ 371.71 & 371.71 & 442.32 \end{bmatrix}.$$

The row sums of the output and consumption matrices are equal to one another (except for rounding error). The matrix of world trade values is

(3.23) $$\begin{bmatrix} p_1z_1^1 & p_1z_1^2 & p_1z_1^3 \\ p_2z_2^1 & p_2z_2^2 & p_2z_2^3 \\ p_3z_3^1 & p_3z_3^2 & p_3z_3^3 \end{bmatrix} = \begin{bmatrix} -522.27 & 300.89 & 221.39 \\ 300.89 & -522.27 & 221.39 \\ 221.39 & 221.39 & -442.77 \end{bmatrix},$$

where $z_j^k = x_j^k - y_j^k$. Thus we see that countries 1 and 2 trade more with each other than with country 3. Nevertheless, their

factor endowments are closer to one another than to those of country 3 as measured by the indices of relative dissimilarity (3.5), yielding the matrix

$$(3.24) \qquad \begin{bmatrix} 0 & .0513 & .7054 \\ .0513 & 0 & .7054 \\ .7054 & .7054 & 0 \end{bmatrix} .$$

Likewise, the production coefficients of commodities 1 and 2 are much closer to each other than to that of commodity 3, as measured by the dissimilarity criterion (3.4), yielding the matrix

$$(3.25) \qquad \begin{bmatrix} 0 & .0424 & .9188 \\ .0424 & 0 & .9188 \\ .9188 & .9188 & 0 \end{bmatrix} .$$

As r increases, i.e., as the relative share of world expenditure devoted to commodities 1 and 2 increases, the ratio of trade between countries 1 and 2 to trade between countries 1 and 3 increases. The same is true as t increases, i.e., as countries 1 and 2's absolute endowments increase relative to country 3's. Table 12 gives the ratio of trade between the similar countries and trade between dissimilar countries as a function of t and r; note that the relationship between this ratio and the scale factor t is linear, for each r.

It seems quite reasonable to assume that there is a preponderance of world expenditure on the products of industrial countries which are similar to each other in both their endowments and in the production processes on which they concentrate; and that these countries have higher absolute

productivity (whether measured by t in (3.18) or by the μ_j in (3.1)--which we have assumed = 1). Thus, there are three forces all of which lead to greater trade between similar countries: (1) similarity in the production functions for the goods which they export--a circumstance which (as we saw in the previous section) makes for more intra-industry trade; (2) greater world demand for their products; and (3) greater absolute productivity of the similar industrial countries compared to the dissimilar one.

Table 12

Ratios of trade between similar countries (1 and 2) and dissimilar countries (1 and 3, 2 and 3) for the model (3.17) - (3.19), for various values of the endowment ratio (t) and expenditure ratio (r).

Endowment Ratio	Expenditure Ratio 1	2	3	4	5	6	7	8	9	10
1	1.359	2.289	3.049	3.683	4.219	4.679	5.077	5.426	5.733	6.007
2	1.946	3.169	4.170	5.004	5.710	6.314	6.839	7.297	7.702	8.062
3	2.533	4.050	5.291	6.325	7.200	7.950	8.600	9.169	9.670	10.116
4	3.120	4.931	6.412	7.646	8.690	9.585	10.361	11.040	11.639	12.171
5	3.707	5.811	7.532	8.967	10.180	11.221	12.122	12.911	13.607	14.226
6	4.295	6.692	8.653	10.288	11.671	12.856	13.884	14.783	15.576	16.281
7	4.882	7.572	9.774	11.609	13.161	14.492	15.645	16.654	17.544	18.336
8	5.469	8.453	10.895	12.930	14.651	16.127	17.406	18.525	19.513	20.390
9	6.056	9.334	12.016	14.250	16.142	17.763	19.167	20.397	21.481	22.445
10	6.643	10.214	13.136	15.571	17.632	19.398	20.929	22.268	23.450	24.500

FOOTNOTES

*Research supported by the Riksbankens Jubileumsfond, Stockholm. Especial thanks are due to Joan R. Rodgers for criticisms, suggestions, and assistance.

[1]I had originally chosen the form $P=a+bS^c$ for both intra- and inter-industry trade, but in the latter case this resulted in highly correlated estimates of a and b. The forms (1.1) and (1.4) were suggested by Joan Rodgers.

[2]Calculations were performed on the HP-71B handheld computer, equipped with mathematics and curve-fitting modules and additional 100K RAM.

[3]I wish to thank Professor Sten Johansson, General Director of the Statistiska centralbyrån (SCB), Mr. Gunnar Stolpe, Head of the Foreign Trade and Prices Division of the SCB, Dr. Edward Palmer and Mr. Randall Bowie of the Konjunkturinstitutet (National Institute of Economic Research), and Ms. Anna Odhner of the Sveriges Riksbank, for all their efforts and copperation in helping me acquire this data set at an affordable cost.

[4]Computations were carried out on the HP-71B handheld computer. A listing of the BASIC program is available from the author on request.

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