

MARKET POTENTIAL AND DEVELOPMENT

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NON-TECHNICAL SUMMARY

Providing explanations for cross-country differences in development levels is perhaps one of the most important questions in economics. A large number of alternative frameworks have been proposed, and the literature has recently focused on whether physical geography, culture or institutions matter most in the long term economic performance of countries. Acemoglu et al. 2005 provide a nice summary of the different theories in competition, arguing strongly in favor of the institutions' view. Tabellini (2008) recently proposed that the institutions themselves were linked to a set of "cultural values" like the belief in the importance of trust and respect reported by respondents to surveys in different countries. He then goes further to show that history is an important determinant of those cultural values and therefore economic development in the end, a point shared by Nunn (2009).

I focus here on a different explanation, where **economic geography**, synthesized and measured through a market potential index is key in economic development. Since the early 1990s' international trade analyses has emphasized how proximity to large markets determines economic development and shapes international trade patterns. Geography matters in a number of ways. Being close to large markets where firms can sell their products provides an advantage for increasing return to scale (IRS) industries. Moreover, the distance from countries supplying capital equipment and intermediate goods influences production cost and firms' competitiveness.

The paper derives from this literature a structural estimation where the level of factors' income of a country is related to its export capacity, labeled Market Access (MA) by Redding and Venables (2004), or Real Market Potential (RMP) by Head and Mayer (2004). The empirical part evaluates this market potential for all countries in the world with available trade data over the 1960-2003 period and relates it to income per capita. The dataset resulting from this research is now made available at <http://www.cepii.fr/anglaisgraph/bdd/marketpotentials.htm>

Overall results show that market potential is a powerful driver of increases in income per capita and average wages. I generalize the theoretical and empirical finding of Redding and Venables (2004) in many directions, and find very robust evidence that the economic geography of countries matter greatly in their income per capita trajectory. To illustrate, my results show that

in 2003, bringing the market potential of the Congo Democratic Republic to the one of Thailand is predicted to increase its GDP per capita by a factor of around 24. The average growth of market potential due to neighbor countries between 1993 and 2003 in our sample is estimated to have raised income per capita by around 105%.

Then I run the following experiment: Suppose that in 2003, all RTAs in the world were ended, everything else staying unchanged. What would be the predicted loss of wage / income per capita predicted by the economic geography model? I do the experiment for both RTAs and the WTO and report results for the 50 biggest drops. The global effect then depends naturally on the size and locations of your partners in those agreements. In a world with no RTA, the countries that would be notably poorer are a group of mostly small but relatively rich economies. The small EU countries would notably lose (Ireland has a predicted loss of 20%), but also Canada and Mexico. The picture is radically changed however if the no-WTO world is considered. The most important losses in this case are for the poorest economies in 3 CEPII, WP No 2009 – 24 Market Potential and Development the world, that we have seen have a very low “local” RMP, and depend very much on demand from far away larger markets of WTO members. For instance, the Malian loss would for instance be 36%.

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