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The Quaid-i-Azam Lecture

Regional and Domestic Political Economy

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This lecture should deal with the sub-theme of this session "Domestic and Regional Political Economy", it propose to focus on an area of economics that is particularly useful in thinking and analysing regional issues. The area is New Economic Geography (NEG). The qualification "new" in the title refers to the method of analysis; not the subject matter, which is old.

It's tough to cover the whole topic so it's not useful for me to talk about the whole topic so I thought that instead talking about CPEC about which a lot of you in the audience already know so much or heard so much it's better to maintain a distance or I purpose is to take step back and look at the type of question which are being asked probably from abstract point of view so what I propose to do to is mention the talk in terms of what is called new economic geography. So if you think of it, then all the question we ask in terms of CPEC are in some way related to CPEC economic activity. One purpose and important question is what impact CPEC will have on development of backward regions, which alternative output will be produced, what policy can do in order to encourage the relocation of economic activity from developed to developing region. That's why I think new political and economic geography is important in providing an answer just to provide a background of new economic geography. Its origin from the person identified in this discipline is Paul Krugman, who won the Nobel Prize in economics in 2008 for developing the discipline 'New Economic Geography'. The interesting thing is that it reminds me as somebody mentioned two days ago that what economic does is give conclusion which is rather obvious to some extent, economic geography also gives answer which are simple and already known. But the interesting thing is that it uses simple answer and provides simple concept in order to point something a bit more complicated which we haven't sought about it.

So let me just get on to the subject and try to answer the question what can we learn from new economic geography and how it may be patterned to analyse the question of the impact of CPEC on regional development. On political economy rather to relate to say because it's a big subject as you know the political economy is the old name of economics but modern day it is not, now defined as part of whole of economics. What is used in different sense by different school of economics, for some it actually refer to political discussion of political factors in economic analysis in comparison of systems such as capitalism and socialism. So that was used to be quite important filed of inquiry until the down fall of berlin war in 1989, since then the subject is slightly uplifted and

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then various question about various types of organisation and production and the social and the political importance also arose. It is also associated with free school of economics and the name of cannon which actually analyses the political question in economic terms exactly in terms of that is each operator maximise his utility. It is usefully may not be agreed with its assumption but it is useful in focusing attention on implementation. So I would strongly recommend for purposing the subject for concentration on empirical analysis.

Let me go on further and say that the starting point of the founding text of need new geography is called geography and trade, started by Paul Krugman and it starts with simple question. The question is what is the most important feature of geography it is distribution of economic activity so one thing which come out and then its creates the problem, is that we haven't thought about it but any economic factor if you think carefully the most striking feature of distribution is the uneven distribution. That is economic activity is very unevenly distributed, this is as much true for the whole world. It is also true in the whole continent context or for any large country it's also true. So it means that we have something to explain. So theory was initially to explain the pattern of international trade. The traditional explanation is simple interpretation for the pattern of trade. That is that countries export the good which they are better at manufacturing or producing, so land intensive or labour intensive countries are producing labour intensive goods and capital intensive countries are producing capital intensive goods. If you think of it in terms of wine and England trade example, then UK sale wine to Portugal and Portugal in return sale textile to UK.

But the interesting thing is that if you look at the pattern of world trade which has developed since 1960 then the most striking feature is that most of the international trade is not between countries producing the dissimilar products so it's not like natural resources. In fact most of the trade in world are consistent of similar product like take European Union. The biggest trade item in the European Union are cars, machine tools, which is not produced by any particular European country but actually several European countries like Germany and France. Germany export car to France and France in return export cars to Germany and this is a puzzle which can't be explained in terms of some ordinary analysis. So this is example of something rather a simple fact. It actually is a problem for economics to explain. So what new economic geography did is actually it use simple concept that's what I will be discussing, that is returns to scale and transport cost which is to explain this pattern.

One reason to choose the economic geography is to talk about is because the transport cost is very important part of this discussion. It has provided me the direct link to what the discussion here that is CPEC. One major effect of CPEC is to improve transportation, which is the direct link by CPEC and other road transport and rail transport eventually. So the question we asked is what will be the impact of this on lowering the transportation cost in the economy by passing through this region through the road and railway path. The obvious question you might ask is that it passes through underdeveloped region, then it will do a lot for development of that underdeveloped region .What is argued and shown also that that it doesn't happen like that, i.e. in many cases improvement of transport, rather than leading to development of backward region is actually concentrated in trade development which is more focused in developed region.

Because a firm think that rather than producing it at a point where the local consumer resides, because transport cost is lower so it can simply produce in one location and ship it to other location.

This is not to deny that transport cost does have impact on development of backward region, this is just to say that only one policy is not enough we should not just take it for granted that improvement in transport will automatically lead to the development of backward region. I can give some Chinese example of that; some other policies are needed if you want to have development in the underdeveloped region. So this is the point where I must say is the relevant point for the new economic geography and the CPEC.

The next point is uneven distribution, First is already mentioned, what is striking feature is that if you take population into picture as well. The world population is very unevenly distributed across continents or countries. Most of the Pakistani population is concentrated on the eastern side of the country. The size of the local market crucially depends on the distribution of population. So its means that if you want to develop sparsely populated areas you have to create something which is actually favourable in those areas. Just provision of simple infrastructure will not bring investment to that area. Around 40 percent of China's massive population is crowded along its eastern seaboard. China spans a large territory, but most of it is uninhabited. This assumes some significance in analyses of regional economic disparities because poor regions are often sparsely populated.

The second point is which also lead to most uneven distribution is urbanisation. China 50 percent population live in urban area and most developed countries also have the same situation. Urbanisation, which involves a shift of population from low density countryside to high density urban settlements using non-agriculture activates as a source of income. So urbanisation also lead to concentration of population in to congested area putting people in to that area without an economic importance. That is if we look at the proportion about output producing economy is in urban area. This covers most of the proportion of total output like the United States, the estimate is that something like 70 percent of United States population is actually producing in the large urban centre. So this alone account for very substantial proportion of GDP.

I would also say in order to be rather careful and not to generalise because urbanisation is historically changing. The urbanisation today in the developing country is actually different in many ways from urbanisation in 19th century in Europe and United State. What is different about it is as follows: in the past urbanisation meant migration of population to urban areas where improvement in wage and income and also transfer from agriculture to manufacturing happened. But today the migration and urbanisation takes many different forms especially in African countries, that is in most cases that is not the migration which necessarily brings high income. It may be because of very depressed condition in rural areas. Second is much of urbanisation is not migration for switching to manufacturing activities because many third world countries have very little to manufacturing sector. So the question of development is now different and scale of urbanisation is also very different because the beginning of the 19th century or 20th century all the largest city in the world were in the developed countries. London use to be the largest city in the world. But now you look at the largest city in the world most of them will be in the developing countries. So Karachi is now registered as a mega city which probably have no boundary control for expansion and similarly all other cities. This is the same as Shanghai and Beijing growing very rapidly whereas the policy actually was to control the growth. So the Japanese just say that the development question is becoming different. We say that development go through phases the first phase is development of manufacturing and industry and transfer of labour from auricular to industry.

The second phase we say that is decentralisation, which is migration of labour from manufacturing to services sector and relative growth in services sector but now for developing countries the problem is not how to transfer labour from manufacturing to services is how to transfer labour from low value added service to high value added services sector. The problem is that there is no road roll to shift low to high valued services. We have to go through manufacturing, unfortunately it is the root through which people get high valued services. So for Pakistan I would draw on an example of about the Indian transformation from high value added in services to low value added in services. In fact this is not the case with manufacturing activity in Pakistan which still have its importance. Even the trend is from high value added in services. However the world is in low to high services but we have to go through manufacturing. Uneven geographical distribution is also a salient characteristic of most manufacturing. But this is less true of services because many of them are produced as they are consumed. This is partially changed by the development of information and communication technology.

To look at the causes of unequal distribution in the cases of the extraction of natural resources, their geographical distribution mirrors that of the deposits of resources. Depending upon transport cost, this may also hold for activities that involve the processing of natural resources. In the past steel factories were often located in the vicinity of iron ore and/or coal mines. But with the lowering of transport cost steel factories can be located anywhere that is easily accessible by ships. Much more interesting case is the geographical distributions of economic activities which could in principle be located at a number of places. These include population and many branches of manufacturing. So really that’s the focus of any regional policy.

How to redistribute the activities which could be located to one place to another, to put this in other way how would government policy improve the interaction of particular localities so economic activities and industry is located there, rather than any other point and this is where I would suggest we have to be aware of reality and learn from other cases. The world provide lots of example of disaster, failure in regional policy and waste of lots of resources, just to take some example from Europe, Italy may try very hard to redistribute industry to the south and establish plants e.g. power plants and steel plants but in reality not much to show. But on the other hand there is no general principle here. If we take country like Finland which is high income economy and at the beginning of the fifties Finland used to be a poor economy. Actually was a depressed region of Europe. So Europe is not simply some other poor region which have done better. So this is looking at the determination of location and there are three factors eventually.

Location of economic activity is jointly determined by looking at the transport cost and production cost. There is trade-off between transport cost and economy of scale. Geographers and economists agree that economic space is best seen as an outcome of scale economies and transport costs. This trade-off holds across geographical tiers of various scales and also as regards the cost of transporting persons, goods and information.

In the extreme case of zero transport costs, it would be efficient to concentrate whole production in one locality so as to maximise economies of scale. In the converse case of no economies of scale but with some transport cost, it would be efficient to disperse production to match the distribution of users. The outcome will be an extreme subsistence economy with very low productivity and very limited trade with other localities. So other case is completely equal distribution.

In some case you pay a price to even the distribution of economic activity in terms of loss of efficiency. Zero transport costs and no economies of scale are extreme cases; actual cases lie between these two. It is also important to note that both determinants of location depend on technology, and alter with changes in technology. Further, transport cost depends crucially on the transport infrastructure, which in turn depends on investment in infrastructure. The third detriment of location is the size of the market which may be calibrated in terms of population. In New Economic Geography the market size matters, but also important is how this market is distributed geographically.

Now let me put just one caveat here, when we talk about the size of the population if people have different per capita incomes, people with high per capita income would count more. For example if United States per capita income is 10 times that of say Pakistan, this means Americans are considered 10 consumer and Pakistan consumer is considered as one consumer and this is just due to difference in per capita income. The interaction and trade-off between three factors: economies of scale, transport cost and market size and its distribution determine the location.

The chosen location may not be unique, as a number of locations may have same characteristics. The choice among them may be based on some contingent factor. There is also a historical dimension to location, it does not change every year. But the choice of a particular location serves as a reason for maintaining the location. So this is when we look at the actual cases for example if consider Sialkot, actually it specialise to production of sports goods. Simple answer is that it's not unique in Sialkot, many of the attribute that Sialkot has are also present in other places in Punjab but on the other hand historical factor is in Sialkot. Because for whatever reason, Sialkot start producing these goods and become known. It also acquire the expertise in producing goods in some sense there is not only inertia but also called accumulated causation in location and activities. So this is not like destiny is fix for ever, it just can change. For example USA have car production which is concentred in Michigan but now it has all new plants which are far away from Michigan and produce cars outside Michigan rather than in Michigan.

China also provide lots of examples; when Chinese economic reform started the northeast of China was the centre of heavy industry and huge amount of investment in support was provided before the reform period. What happened after the reform period is that the importance of northeast provinces has constantly gone down and some of them actually has closed. So the centre of economic activity has moved to south and the reason why this has happened is that in the pre reform period with the fear of war with Taiwan reforms started. While this is completely gone away now and central government under took very little investment in that province earlier and in other provinces most of the investment was actually located. After the economic reform started this traditional imbalance was restored but with aligned investment in southeast region. Here let me again give an example of China of disastrous failure in regional policy. In early 1970 Chinese government decided purely for strategic reasons to relocate this industry towards the west which is far away from any threat or war and huge amount of investment and skill labour was actually was shifted from costal region to interior region. I worked on the project of World Bank in the industry and found that most of the firms which are located in the west actually turn out to be loss making rather than to contributing in development of the region. These actually remained in a trap so again that was the reason why economic logical was not much taken into account and it was done purely for political reason.

Now I want to say something about increasing return to scale, this might seem the simple idea e.g. services provided by public utility. Once you established a hospital and the hospital capacity is 500 patients at a time that mean the cost of hospital is if it has only 100 patients, so providing facilities to additional patient is particularly at a zero cost. So up to the limit cost declining as scale increasing is common, e.g. It's very well known in power industry if you serving many consumer before the capacity utilisation your average cost decline as scale increasing but these are both technical possibilities. But really it is much more important and this is what the economies of scale which are external to the firm and does not depend on technology of firms. Often we notice that firms locate where some industries already are located so you get activity like traditionally you have in the rural valley although heavy duties and now the modern example of Silicon Valley in California which is heavy concentration of electronic firms are present. Marshall in his book "Principles of Economics" has an illuminating discussion of such externalities, all caused by the clustering of firms in close vicinity, the clustering of firms in one locality provides a number of advantages.

So what I suggest may be the external economies which also apply in case of agglomeration of economies also apply to lot of city punched together so what we see in observing China. We may also be observing in Pakistan. Some example that are in China are e.g. what happens if Chinese government was actively opposed to growth of main cities. They wanted to restrict the growth of large city and promote the growth of small city but the reality is, what turn out to be very different that is what we see in China is emergence of mega urban regions. The cities are formed and joined together through the economic logic. There seems to be a case that certain big cities have certain advantages. We went to observe similar trend around the Lahore, where combination of agglomeration of economies is in vicinity of city. So what is important the emergence of mega region rather than smaller cities. So the important policy question is what policy government should follow in order to facilitate the function of these mega urban regions.

Just to see agglomeration economies in computer industries, is not an in terms of say biochemical industry agglomeration. Infect that is the question which Alfred Marshall who was the famous British economist who wrote at the beginning of 20th century which actually provides some of the clear analysis. It says that there are three factors which are important in agglomeration of an economy: one is labour market pooling; the concentration of firms by pooling the demand and supply of labour. This makes it easy for labourers in search of a job to find an employer and in turn, make it easy for firms to find labour with requisite skill. In one place it is conducive to the emergence of a market for specialised labour. May be the reason why the firm may not want to relocate. Similarly second is the agglomeration of firms by concentrating the demand for intermediate goods, which is conducive to the emergence of a market in intermediate goods which might remain untraded. It is like we have a carpet industry and availability of wool and materials, which is necessary for making carpet is more easily available. In case of steel industry lots of good which are provided in the intermediate input markets. So it is the market where the concentration of firms exists. Third is the clustering of firms using similar technology provides possibilities for mutual learning.

A main tenet of NEG is that lower transport costs which foster greater spatial concentration of economic activity. The implication is that improving transport facilities, which lowers transport cost to and from backward regions of a country, may on its own promote regional development but, on its own, is not sufficient to reduce the economic gap between the backward region and the rest of the economy. On the contrary it may encourage greater concentration as a result of the migration of activities from less developed to developed regions. This does not negate upgrading of transport network, but implies that it should be coupled with policies designed to enhance the economic attraction of the targeted region.

Let me just state the conclusion that is the transport cost has been falling very rapidly. Infect the reason is told by the history of economic development in terms of transport cost especially in USA and Europe. Previously it used to cost to transport a ton of coal from USA to Europe or vice versa as much as the value of the coal itself which is transported. Which is 100 percent, now actually it is something like less than 5 percent of the total cost as the cost of transporting coal. Now it is possible to produce goods in one place and consumption in other place with more economic efficiency.

One thing I point out at when you look at cost of transport is to see that transport cost is always lower in land transport. Generally we take into account that CPEC will never replace American transport coming from Shanghai or in city of China. As for most of industrial production the transportation will still remain important issue because low transportation cost is not competing with the ways of rail transport. Rail transport is comparable with air transport cost and delivery days but not in terms of American transport. So again we have to be careful when we see that people say that rout through Gwadar to China is alternative for all transportation of goods. It can only happen to some degree but not much. Having said that the importance of sea transport still remain, secondly if Chines companies are already located in the sea region then this will not help.

Let me review some of the Chines example when the Chines reforms started. China had a policy that some areas should be made rich first and other will follow soon. This is what is called as the trickle down approach. So the Chines leadership is focusing on prosperity in one area and costal belt which gradually converts to prosperity in the neighbouring provinces. It did happen but with limited effects obviously a lot of people migrated to the coastal provinces and the wages increased. So after that they actually realised that an activity requires a regional policy. Which should first emphasises the development of central region and then developed the coastal provinces. But on the other hand lot more investment were actually already made in these provinces. The third area is a developed western region policy I actually work a bit on it and this policy work for building huge infrastructure in the western provinces. Now every western provinces in China has an international airport. China has more airports then practically in any other country. Second improvement is in road transport. What is important is that it is important in each province and what are also noticed is building an express way. But if you don’t construct a complementary network of local transport then the ability of area to benefit from express way is very limited. So the important point of all western region development was of complementary local road network. What is the outcome; the development of western region has not uniformly help everyone. Some localities in the west have done quite well and developed. With well sophisticated industry in some of the regions in the western provinces. This change of having better infrastructure may not change the relative position might. So I want to suggest that this is very quick summary but actually New Economic Geography suggests an answer, as it provides a frame work for looking at the locational problem. So analysing situation such as CPEC; it can play quite important and productive role.