MEASURING EXPORT CONCENTRATION: THE IMPLICATIONS FOR SMALL STATES

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Abstract. Theoretically countries that specialise in the production of goods and services according to the principle of comparative advantage should experience gains from trade. However, as many small states have come to learn, dependence on a limited range of exports and a few trading partners is not always beneficial. If the demand for a main export falls, these countries would experience excessive fluctuations in export receipts that would destabilise their economy. This study presents empirical evidence of this phenomenon by measuring concentration of export goods, services and destinations through eight different export concentration measures. Export concentration, as measured by these indices, exhibits a negative link with country size variables, indicating higher export concentration in smaller countries. The results of this study results also point towards higher export concentration in less developed countries, indicating that both size and the stage of economic development are relevant factors in determining export concentration.

Introduction

The aim of this study is to empirically analyse the phenomenon of export concentration and test whether its incidence can be linked to country size and the stage of economic development. Even though small states are particularly vulnerable to economic shocks (Briguglio et al. 2006), smallness does not necessarily render a country under-developed, as evidenced by the fact that many small countries have performed well economically.

Small states tend to have limited possibilities to reap the benefits of economies of scale in production and in public administration. Many government
functions are not divisible in proportion to the number of users, while
government may also have to assume a greater role in stabilising income
streams and consumption patterns, as well as making up for the greater
incidence of market failure. Due to the limited size of the internal market,
trade takes a more magnified dimension in small economies. Small states
tend to rely heavily on imports due to the lack of natural resource endow-
ments. They also tend to rely heavily on exports to overcome the constraints
of their very small markets and to generate foreign exchange to finance their
large import bill. These countries often have to concentrate on a narrow
range of exports and to depend on a small number of client countries, mostly
due to the problems associated with further fragmenting their already small
volume of exports.

**Measures of Concentration**

In this study, eight concentration indices are derived for export categories,\(^1\) namely (i) the Concentration Ratio, (ii) the Herfindahl-Hirschman Index,
(iii) the Hall-Tideman Index, (iv) the Rosenbluth Index, (v) the Comprehen-
sive Concentration Index, (vi) the Hannah and Key Index, (vii) the Entropy
measure, and (viii) the Diversification Index. Most of these concentration
indices exhibit the general form:

\[
CI = \sum_{i=1}^{n} s_i w_i ; \quad i = 1, 2, ..., n
\]

where

\[w_i=\text{the weight attached to the export share of a particular export category}
\]
\[s_i = \text{the share of export category } i\]
\[n = \text{the number of export categories.}\]

There are four major types of weights:

• Weights of unity are attached to the shares of an arbitrarily determined

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\(^1\) Export categories comprise both products and services. Most concentration indices only
refer to merchandise trade and therefore do not capture concentration in specific services,
like tourism and the finance sector. This is not suitable for service-oriented countries,
particularly small island states. This study takes into account the eleven service categories
and 239 merchandise groups present in the UNCTAD *Handbook of Statistics*. 
number of product and service categories \((w_i = 1)\) and zero weights are attached to the remaining categories \((w_i = 0)\). An example of this ratio is the Concentration Ratio.

- Products’ export shares are used as their own weights \((w_i = s_i)\). These indices take account of all export categories. An example is the Herfindahl-Hirschman Index.
- Product and service groups are ranked in ascending or descending order, and these rankings are used as weights. All export categories are included in computing this index, and examples of such measures are the Hall-Tideman Index and the Rosenbluth Index.
- Each export share is weighted by the negative of its logarithm \((w_i = -\log s_i)\), such that a smaller absolute weight is attached to larger export shares. The Entropy Index uses this scheme.

**The Concentration Ratio (CR)**

The Concentration Ratio (CR) measures the export share of only the largest export categories. It is calculated as follows:

\[
CR(x) = \sum_{i=1}^{n} s_i ; \quad i = 1, 2, ..., n
\]

where \(x\) is less than the total number of export commodities \(n\).

This ratio gives equal emphasis to the \(x\) largest export categories but neglects the remaining categories in the export market. If the ratio value is close to unity, this means that the \(x\) categories included in the ratio make up the entire export bill and hence concentration is high.

In most applications CR(4), CR(8) or CR(12) are used, but there is no rule for the determination of the value of \(x\), so that the number of categories included in the Concentration Index is a rather arbitrary decision. This is this ratio’s main disadvantage but it is still widely used because of its simplicity of calculation and limited data requirements.

**The Herfindahl-Hirschmann Index (HHI)**

The Herfindahl-Hirschmann Index (HHI) is calculated by taking the square of export shares of all export categories in the market:
\[ HHI = \sum s_i^2 ; \ i = 1, 2, ..., n \]

This index gives greater weight to the larger export categories and reaches a value of unity when the country exports only one commodity or service (high concentration).

**The Hall-Tideman Index (HTI)**

In this index the number of export categories is included in the calculation of the index to reflect the starting conditions when exporting a new product or service. This is similar to the concept of entry barriers in an industry. The HTI takes the following form:

\[ \text{HTI} = (2 \sum i s_i - 1) \cdot i = 1, 2, ..., n \]

where the export share of each category is weighted by its ranking in descending order to ensure that the emphasis is on the absolute number of categories, and also that the largest export category receives a weight equal to one. The HTI reaches a value of unity in the case of high concentration.

**The Rosenbluth Index (RI)**

The Rosenbluth Index (RI) resembles the Hall-Tideman Index since the same formula is used but export categories are ranked in ascending order. This index is therefore sensitive to changes in the size distribution of the smaller categories, with small values of the HTI indicating high concentration.

**The Comprehensive Concentration Index (CCI)**

This index reflects both relative dispersion and absolute magnitude of the categories. As with the Hall-Tideman Index, the CCI requires the export share \( s_i \) to be sorted in descending order. However, this index’s main focus is on the largest \( s_i \) share of export of a particular category. The remaining \( s_i \)'s are used to adjust \( s_i \) according to this formula:

\[ \text{CCI} = s + \sum s_i^2 \cdot (1 + (1 - s_i)) \quad i = 1, 2, ..., n \]

This index also produces a value of unity in the case of high concentration.
Measuring Export Concentration: The Implications for Small States

The Hannah and Kay Index (HKI)

Hannah and Kay (1977) propose a summary index of the form:

\[
HKI = \left(2 \sum s_i^\alpha \right)^{1/(1-\alpha)}; \quad i = 1, 2, ..., n \quad \alpha > 0 \text{ and } \alpha \neq 0
\]

where export shares are raised by a power \(\alpha\), which is a parameter that reflects changes in concentration arising from the exportation of new products or the ceasing of previously exported products. The fact that the choice of \(\alpha\) is left to the investigator (Hannah and Kay suggest a value in the range 0.6 to 2.5 points) allows for alternative views on what is the appropriate weighting scheme. Therefore, in addition to the distribution of the export categories, the value of the index is sensitive to the parameter \(\alpha\). The value for the HKI gives an approximation of the number of large export categories of a country. Consequently a small number indicates high concentration.

The Entropy Measure (ENT)

In this measure, export shares are weighed by the logarithms of the export share of each category, as follows:

\[
\text{ENT} = \sum S_i \log s_i; \quad i = 1, 2, ..., n
\]

Small values of the Entropy Index reflect high concentration.

The Diversification Index (DIV)

The term ‘diversification’ refers to the spreading of operations over dissimilar economic activities and takes place in order to mitigate the effect of cyclical instability, to come closer to a full utilisation of resources, and to expand the export share. It is measured through the number of export categories in which the country is active. It is specified as follows:

\[
W = 2 \sum is_i - 1; \quad i = 1, 2, ..., n
\]

A result close to one indicates that the country is completely specialised in its exports, while if \(W\) is, say, equal to four this would imply that the country is equally active in four export industries.
The Concentration Measures

The Concentration Ratio used in this study is based on the 12 biggest merchandise export categories of each country \((CR_8)\). The results shows that on average, countries in North Africa (81 per cent) and Oceania (77 per cent) experienced about twice the export concentration of the developed countries of America (38 per cent) and Europe (33 per cent). Small states, measured in terms of population size, had extremely high ratios (about 90 per cent) compared to a world average of about 36 per cent.
Results of the Herfindahl-Hirschman Index confirm the tendency for higher export concentration to be inversely related to population. Export concentration also seems to be related to economic development, with the indices of countries like Gabon (0.78), Angola (0.56) and Liberia (0.32) all pointing to this conclusion.

In terms of country analysis, small states exhibited the largest Hall-Tideman Index values, as evidenced by the results for Iceland (0.12) and Malta (0.07).

The results of the Rosenbluth Index also support the hypothesis that smaller states experience higher export concentration. Iceland (0.07) and Malta (0.13) are again the countries with the lowest index results.

For the Comprehensive Industrial Concentration Index calculations, the groups with the highest CCI values are transition economies and LDCs, in particular the African developing countries. Landlocked economies also exhibited a high value, while there was a sharp decline in the CCI figures of high-income countries from 1980 to 2004.

In the Hannah and Kay Index, the average number of large product export groups is 42, so the export values for countries such as the Faeroe Islands (5), Sudan (6), Saudi Arabia (11) and Papua New Guinea (18) show a marked tendency for higher export concentration.

The Entropy measure also supports the hypothesis that smaller economies experience a higher degree of export concentration. For instance, the smallest Entropy values belong to Netherlands Antilles (2.17) and Gabon (3.21), two countries with populations of less than 1.5 million.

Most landlocked countries have a Diversification Index which is very close to one, indicating a sharp difference from the values of developing countries (0.139), the EU (0.17) and the major exporters of manufacturers (0.40), to mention just a few examples of country groupings.

In general the results show that small states tend to register higher export concentration scores than larger states. There are a number of reasons that explain this observed tendency, including their limited resources endowments, the reduced possibility of benefiting from economic of scale in production, and the fact that it is not viable to fragment the already small export volumes originating from these states.
The Inclusion of Services in the Indices

The inclusion of services in the concentration calculations results in higher ratios for small states. In all cases, the CR₈ increases, sometimes even considerably, as in the case of Luxembourg (+27.4 percentage points), Cyprus (+21.6), Barbados (+18.5), Aruba (+11.7) and the Bahamas (+11.6). Similar changes are also evident in the other seven measures. For instance, the EU average for the HHI increased by approximately 72 per cent. Likewise, the results of the regression analysis between the percentage difference in the indices brought about by the inclusion of services against variables of country size and economic development also point towards this conclusion.

Export Destinations

The eight concentration measures used above were also applied to calculate the concentration in trading partners/ export destinations. The results indicate that states that exhibit above-average (or below-average in the case of the HKI, ENT and RI) values in most indices are either small or developing countries.

Intra-Country Comparisons

The results obtained for each country at any one point in time were also compared in order to check for consistency of index values. For instance, all the concentration measures for the Maltese merchandise exports and trade destinations indicate a high degree of concentration when compared to the EU average. The measures that exhibit a positive relationship with concentration (CR, HHI, HTI, RI, CCI, ENT and DIV) are above the EU average, while the indices that have a negative relationship with concentration (HKI, ENT and RI) are all below the EU average.

Composite Index of Concentration

An attempt was made at constructing a composite index that comprises all the eight export concentration measures discussed above. All indices were normalised² to give value ranging from zero to one, while the collective weighting was used for the HTI.

² The formula used was \( I_{nj} = (I_j - \text{MinI}) / (\text{MaxI} - \text{MinI}) \) where \( I_{nj} \) is the normalised index score for country j, \( I_j \) is the actual score, \( \text{MaxI} \) and \( \text{MinI} \) are the maximum and minimum scores for that index.
### Table 2
Composite Index of Concentration in Merchandise Goods
(selection of 20 countries)

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (1000s)</th>
<th>$CR_s$</th>
<th>$HHI$</th>
<th>$HTI$</th>
<th>$RI$</th>
<th>$CCI$</th>
<th>$HKI$</th>
<th>$ENT$</th>
<th>$DivI$</th>
<th>Composite Index</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>139215</td>
<td>0.8547</td>
<td>0.1214</td>
<td>0.0258</td>
<td>0.9050</td>
<td>0.3308</td>
<td>0.8641</td>
<td>0.4953</td>
<td>0.8916</td>
<td>0.5611</td>
<td>79</td>
</tr>
<tr>
<td>Belarus</td>
<td>9811</td>
<td>0.2392</td>
<td>0.0409</td>
<td>0.0281</td>
<td>0.9021</td>
<td>0.1791</td>
<td>0.2932</td>
<td>0.1433</td>
<td>0.4090</td>
<td>0.2794</td>
<td>163</td>
</tr>
<tr>
<td>Bolivia</td>
<td>9009</td>
<td>0.6191</td>
<td>0.0903</td>
<td>0.0216</td>
<td>0.8883</td>
<td>0.2809</td>
<td>0.7270</td>
<td>0.3694</td>
<td>0.7289</td>
<td>0.4657</td>
<td>115</td>
</tr>
<tr>
<td>Comoros</td>
<td>777</td>
<td>0.9883</td>
<td>0.8268</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.9157</td>
<td>0.9901</td>
<td>0.9216</td>
<td>0.9846</td>
<td>0.7034</td>
<td>31</td>
</tr>
<tr>
<td>Ecuador</td>
<td>13040</td>
<td>0.7510</td>
<td>0.2047</td>
<td>0.0348</td>
<td>0.9283</td>
<td>0.4640</td>
<td>0.7768</td>
<td>0.4821</td>
<td>0.7205</td>
<td>0.5453</td>
<td>87</td>
</tr>
<tr>
<td>Germany</td>
<td>82645</td>
<td>0.1384</td>
<td>0.0162</td>
<td>0.0482</td>
<td>0.9460</td>
<td>0.0992</td>
<td>0.0842</td>
<td>0.0576</td>
<td>0.0524</td>
<td>0.1803</td>
<td>193</td>
</tr>
<tr>
<td>Ghana</td>
<td>21664</td>
<td>0.8479</td>
<td>0.2692</td>
<td>0.0097</td>
<td>0.7779</td>
<td>0.5722</td>
<td>0.8639</td>
<td>0.5894</td>
<td>0.8794</td>
<td>0.6012</td>
<td>61</td>
</tr>
<tr>
<td>Italy</td>
<td>58033</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0341</td>
<td>0.9270</td>
<td>0.0000</td>
<td>0.0080</td>
<td>0.0000</td>
<td>0.1608</td>
<td>0.1412</td>
<td>199</td>
</tr>
<tr>
<td>Kenya</td>
<td>33467</td>
<td>0.5343</td>
<td>0.0830</td>
<td>0.0128</td>
<td>0.8232</td>
<td>0.2543</td>
<td>0.5555</td>
<td>0.2937</td>
<td>0.6869</td>
<td>0.4055</td>
<td>136</td>
</tr>
<tr>
<td>Maldives</td>
<td>321</td>
<td>0.9965</td>
<td>0.2644</td>
<td>0.0155</td>
<td>0.8501</td>
<td>0.5637</td>
<td>0.9663</td>
<td>0.6786</td>
<td>0.9831</td>
<td>0.6648</td>
<td>47</td>
</tr>
<tr>
<td>Mauritius</td>
<td>1233</td>
<td>0.6725</td>
<td>0.1028</td>
<td>0.0222</td>
<td>0.8909</td>
<td>0.3037</td>
<td>0.7028</td>
<td>0.3785</td>
<td>0.7448</td>
<td>0.4773</td>
<td>109</td>
</tr>
<tr>
<td>Myanmar</td>
<td>50004</td>
<td>0.7219</td>
<td>0.1121</td>
<td>0.0248</td>
<td>0.9012</td>
<td>0.3244</td>
<td>0.8103</td>
<td>0.4338</td>
<td>0.8347</td>
<td>0.5204</td>
<td>93</td>
</tr>
<tr>
<td>Portugal</td>
<td>10441</td>
<td>0.1111</td>
<td>0.0086</td>
<td>0.0312</td>
<td>0.9205</td>
<td>0.0508</td>
<td>0.1589</td>
<td>0.0611</td>
<td>0.2552</td>
<td>0.1997</td>
<td>185</td>
</tr>
<tr>
<td>St Kitts &amp; Nevis</td>
<td>42</td>
<td>0.9207</td>
<td>0.3012</td>
<td>0.0536</td>
<td>0.9532</td>
<td>0.6241</td>
<td>0.9279</td>
<td>0.6700</td>
<td>0.8947</td>
<td>0.6682</td>
<td>43</td>
</tr>
<tr>
<td>St Vincent &amp; Grenadines</td>
<td>118</td>
<td>0.6781</td>
<td>0.1547</td>
<td>0.0147</td>
<td>0.8430</td>
<td>0.3906</td>
<td>0.7794</td>
<td>0.4309</td>
<td>0.7680</td>
<td>0.5074</td>
<td>99</td>
</tr>
<tr>
<td>Serbia &amp; Montenegro</td>
<td>10510</td>
<td>0.1066</td>
<td>0.0090</td>
<td>0.0219</td>
<td>0.8893</td>
<td>0.0579</td>
<td>0.1530</td>
<td>0.0587</td>
<td>0.4072</td>
<td>0.2129</td>
<td>18</td>
</tr>
<tr>
<td>Tonga</td>
<td>102</td>
<td>0.9022</td>
<td>0.1938</td>
<td>0.0154</td>
<td>0.8493</td>
<td>0.4647</td>
<td>0.9043</td>
<td>0.5725</td>
<td>0.8975</td>
<td>0.6000</td>
<td>62</td>
</tr>
<tr>
<td>Uganda</td>
<td>27821</td>
<td>0.7296</td>
<td>0.1068</td>
<td>0.0058</td>
<td>0.6778</td>
<td>0.3089</td>
<td>0.7701</td>
<td>0.4147</td>
<td>0.8655</td>
<td>0.4849</td>
<td>105</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>83123</td>
<td>0.5044</td>
<td>0.0648</td>
<td>0.0295</td>
<td>0.9160</td>
<td>0.2246</td>
<td>0.5463</td>
<td>0.2663</td>
<td>0.5805</td>
<td>0.3915</td>
<td>138</td>
</tr>
<tr>
<td>Zambia</td>
<td>11479</td>
<td>0.7462</td>
<td>0.2990</td>
<td>0.0187</td>
<td>0.8723</td>
<td>0.5450</td>
<td>0.8168</td>
<td>0.5358</td>
<td>0.8282</td>
<td>0.5828</td>
<td>69</td>
</tr>
</tbody>
</table>
A simple average of these eight measures was then computed, and subsequently the countries were ranked accordingly. Table 2 presents the results obtained for a selection of countries, as well as a rank derived from these scores.

From this selection of countries shown in Table 2, there is an indication that export concentration is related to country size and the level of economic development.

Table 2 also shows that the higher a country is ranked (one being the highest value possible), the greater the tendency for concentration to be exhibited in the country’s merchandise exports. The three large EU countries shown in Table 2 have very high scores (185 or higher), indicating that export concentration is not a characteristic of their economies.

On the other hand, the Comoros, the Maldives and Saint Kitts and Nevis are in the top 50 of this classification due to their dependence on a small number of goods for their exportation.

Regression Analysis

The regression results shown in Table 3 relate to a composite index derived for 198 countries. Developed larger countries like Italy, Germany and Portugal exhibit lower scores in all the eight measures, while at the same time small countries like Saint Kitts and Nevis and the Comoros exhibit high concentration values.

Regression analysis of the Concentration Ratio against country size (measured in terms of population) and economic development (measured in terms of GDP per capita) shows clear and statistically-significant evidence of an inverse relationship between country size and export concentration. The coefficients for population negatively relate to the Concentration Ratio. A negative relationship is also observed for GDP per capita, both when it is regressed separately and when regressed together with population.

The Herfindahl-Hirschman Index and the Hall-Tideman Index provide similar results to those obtained for the Concentration Ratio since the negative coefficients reflect an inverse relationship between the HHI and both population and GDP per capita.
Table 3
Regression Results for Concentration Measures
(Merchandise and Services)

<table>
<thead>
<tr>
<th>Separate Regressions</th>
<th>Multiple Regression</th>
</tr>
</thead>
<tbody>
<tr>
<td>(-8.245)</td>
<td>(-5.485)</td>
</tr>
<tr>
<td>HHI</td>
<td>-0.034</td>
</tr>
<tr>
<td>(-5.379)</td>
<td>(-3.064)</td>
</tr>
<tr>
<td>HTI</td>
<td>-0.019</td>
</tr>
<tr>
<td>(-5.321)</td>
<td>(-3.952)</td>
</tr>
<tr>
<td>CCI</td>
<td>-0.0495</td>
</tr>
<tr>
<td>(-7.351)</td>
<td>(-4.092)</td>
</tr>
<tr>
<td>(8.465)</td>
<td>(6.734)</td>
</tr>
<tr>
<td>ENT</td>
<td>0.379</td>
</tr>
<tr>
<td>(8.428)</td>
<td>(5.279)</td>
</tr>
</tbody>
</table>

Note: RI results were statistically insignificant and hence not shown in this table, while DivI could not be applied for merchandise and services together since data on services did not include data by regions. The data pertains to year 2004 and the number of countries covered is 198.

The results for the Rosenbluth Index, though having positive signs in front of the coefficient as expected a priori, were statistically insignificant. The parameter values for the CCI have negative signs, confirming the hypothesis that smaller countries experience a higher degree of export concentration in merchandise goods, services and trading partners.

The relationship was relatively strong and significant for both population and GDP per capita. The positive coefficient values obtained for the Hannah and Kay Index (which displays lower values for higher export concentration) provide further empirical evidence on the tendency for smaller states to have higher export concentration. The Entropy measure also gives positive coefficient values. This is in line with theory in that lower values of this measure indicate higher export concentration.
Concluding Remarks

The main policy recommendations that emerge from this paper deal with the effective measurement of export concentration and the diversification of trade.

Measuring Export Concentration Effectively

For a measurement index to be applied successfully to economic analysis, certain criteria need to be satisfied. These include simplicity, affordability, suitability for international and temporal comparisons and transparency.

The Concentration Ratio and the Herfindahl-Hirschman Index are the simplest and most affordable indices due to their ease of comprehension and availability of data. The simplicity criterion also applies to composite indices since they must clearly capture the facets of the individual variables that they represent. This is the case of the composite index suggested in this study. In terms of suitability for comparison and transparency, all eight indices pass this test due to the homogenous and verifiable manner of the export data collected by UNCTAD.

When attempting to measure export concentration, the policymaker will be faced with the choice of absolute and relative measures. In some way, absolute measures are superior to relative measures because they take account of exports from new product groups. Moreover, absolute measures are also better than relative measures since two countries could have identical Concentration Ratios but different product shares. There is also the choice between summary and discrete measures.

The main discrete measure, that is, the Concentration Ratio, has a number of defects, namely (i) it ignores relative size variations in commodity groups; (ii) it could equally describe a country exporting one product and a country exporting $x$ product groups with similar shares; and (iii) it neglects the non-$x$ products in a country’s export portfolio.

In view of these points, country concentration results should ideally be based on summary measures rather than the discrete or semi-discrete measures. In this way, it is possible to get a clearer picture of the peaks and shifts in country concentration over time.
Nevertheless, summary measures can also be defective. For instance, the same HHI values can be obtained for different product groups with different shares. The Hannah and Key Index is equally defective since the value of the power is chosen arbitrary. In this regard, there are a number of axioms which describe the desirable features a concentration measure should have.

These important features include:

1. *Concentration curve ranking criterion*: if the concentration curve of country A lies above the concentration curve of country B, than country A’s exports are more concentrated than the other country’s.
2. *Exports transfer principle*: the value of the measure of concentration should change if countries start exporting products which previously had smaller market shares.
3. *Exportation of new products*: if a country starts exporting a new commodity previously untapped and this new product’s export share is below the average size of existing product shares, then concentration should be reduced, always assuming that the relevant shares of existing product groups remain unchanged.

Only the Herfindahl-Hirschman and the Hannah and Key indices satisfy all of the above axioms but, given the defects of summary measures mentioned previously, it has to be said that there is no optimal measure. The policymaker has to choose according to the specific aspects being researched. It needs to be stated, however, that one cannot use concentration measures in isolation. First of all, there could be inter-linkages between product groups and, secondly, concentration measures will only reveal the export pattern of a country in previous time periods; they do not take account of the complexities of the changing economic environment.

*Diversification of Trade*

Investors are often advised to diversify their portfolio in order to manage their risk. On the contrary, developing countries are instead given the recommendation to liberalise their trade regimes in order to maximise the benefits from specialising according to their current comparative advantage, as expected under standard Ricardian theory. There are certainly costs associated with too much specialisation, mostly related with having too many eggs in one basket.
Comparative advantage should not be thought of primarily in static terms. The endowment of resources and skills can and does develop and change over time. In addition, there is a learning potential to acquire skills and productive capacity in new industries. A country’s comparative advantage can be intentionally altered such that it is acquired in new fields. This is the role of industrial policy, but a number of current and proposed rules under the WTO severely curtail the use of interventions aimed at extending the comparative advantage of a country (Parris, 2005). In sum, blanket liberalisation may not be optimal if it increases specialisation beyond a certain point.

Diversification can lower earnings volatility if the country diversifies into products with price movements that are not strongly correlated with current exports (Love, 1986). However, if the new products are of lower value, there can be a trade-off between greater stability and lower overall value of export earnings. Consequently, diversification offers the potential but not the guarantee of greater stability and higher earnings.

The choice of whether to opt for specialisation or diversification depends on the country’s economic structure. The question of appropriate trade and industrial policies remains open and becomes a matter of carefully weighing the long-term costs, benefits and risks of alternative strategies.

References


