Vertical Specialization, Global Expansion of Supply Chain, and Convergence*

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Revised: November 2023

Abstract

In this paper, we construct an elaborate general equilibrium model with a continuum of production fragments for an intermediate good, then incorporate it in a growth model to address the effects of global production fragmentation, vertical specialization and trade on growth and inequality for a small developing country. Among other things, we show that a small developing economy grows faster than the rest of the world as a result of global fragmentation and trade in intermediates if it is skilled-labor scarce. We further address the effects of such a trade opening on wage inequality.

Keywords: Vertical specialization, trade, growth, inequality

JEL: F1

*We are grateful to the editor of this journal and two anonymous referees for their invaluable comments and suggestions.

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1 Introduction

Although numerous arguments have been made in the literature on positive role of trade on economic growth, disputes remain (see Baldwin and Robert-Nicoud, 2008; Frankel and Romer, 1999; Krueger, 1999; Lucas, 1990, among others). While the canonical (neoclassical) theory may seem to suggest that trade opening and reforms have a positive impact on economic growth, numerous trade theorists cast doubt on this proposition (see Krueger, 1999; Rodrik, 1995, among others). Extensive empirical literature also provides mixed evidence (see , Rodriguez and Rodrik, 2000; Sachs and Fischer, 1995; Winters and Masters, 2013, among others).[1] On the other hand, the phenomenon of growth in international trade concurrent with widening income inequality in recent decades has brought an additional dimension to these debates (see Baldwin and Cain, 2000; Bound and Johnson, 1989; Cline, 1997; Jones, 1996; Katz and Murphy, 1992; Oladi and Beladi, 2008, among others). Despite the fact that these debates span about half a century, the subject matter is still unsettled both in academia and in policy circle. The recent populist waves of nationalism and protectionism have only intensified the public discourse both in developed and developing countries. The current paper is an attempt to go beyond the canonical models to present a theory of trade, growth and inequality. It also contributes to a branch of literature that deals with global production fragmentation and offshoring (see Antras and Helpman, 2004; Grossman and Rossi-Hansberg, 2008, among others). In particular, our paper is closely related to Nakanishi and Long (2020) that address the impact of virtual mobility of labor and global task fragmentation on endogenous growth rate as well as the effects of R&D offshoring on skilled wages and to Bandyopadhyay and Mitra (2020) that consider the impacts of international task fragmentation and offshoring on wages in developed and developing economies.

In particular, we attempt to address the effects of vertical specialization, global production fragmentation and global expansion of supply chain on economic growth and income inequality. In doing so, we construct an elaborate dynamic general equilibrium model of trade with continuum of production fragments (or productive services) and supply chain. We first set up a model with three goods, two final goods and an intermediate. The intermediate good itself consists of a continuum of fragments in the spirit of Dornbusch et al. (1977), each produced with Ricardian production technology. We show that the level of capital is consequential in determining the skilled-unskilled wage gap in our setup with trade in fragments.

[1] For extensive review of literature see Krueger and Berg (2003) and Irwin (2019).

Hence, it is paramount to cast our general equilibrium within a growth model. Despite the fact that the literature is rich and extensive, a number of important issues including the impact of trade on economic growth, its differential effects on south visa-a-vie north, and its effect on inequality are still in dispute. The current paper addresses these three aspects and contributes to these branches of literature. Although the literature on growth and trade theory is somewhat rich (e.g., Grossman and Helpman, 1990 and Rivera-Batiz and Romer, 1991), this literature seldom provides a model that explains a direct relationship between trade and growth. In contrast, our paper provides such a direct link whereby trade by itself allows growth rate to increase. In other words, there is a subtle and significant difference between our model and those models of trade and endogenous growth. For instance, the key driving force in Rivera-Batiz and Romer (1991) is technological progress while product innovation and research R&D are the driving force in Grossman and Helpman (1990), and not trade as such. Trade is the facilitator of technical progress and R&D. Hence, trade plays an indirect role. There is no growth without innovations and just trade opening does not stimulate growth. On the other hand, the link between growth and trade is direct in our model as the driving force is just trade. We do not need innovation to grow faster. Notably, in terms of casual observations, the fastest growing countries in the world during the past few decades (i.e., China and India) are not global leaders in innovation. A direct link between trade and growth that our model provides is the access to the global supply chain. In fact, trade in final goods in our setup will not affect growth rate and only lead to gains from trade, but trade in intermediates and accessing global supply chain will lead to dynamic gains. It is a unique theoretical structure where the direct link between supply chain driven gains from trade trade and growth is very cleanly demonstrated. Well accepted stylized empirical facts are theoretically shown under the umbrella of a unified model.

First, we show that vertical specialization, global fragmentation and global extension of supply chain induce economic growth. As elaborated in Section 2, our model assumes constant labor supplies for both skilled and unskilled workers. This raises the question: what drives growth in our framework? The answer lies in the relationship between the marginal product of capital and the price of the intermediate good. Opening up to trade and the expansion of the value chain will lead to a permanent reduction in the price of the intermediate good. This reduction is the principal catalyst for growth in our economic model. This is in contrast to the view held by those trade critics that question the validity of trade being pro development (see Rodriguez and Rodrik, 2000; Rodrik, 1995, among others). Our model provides yet another additional theoretical foundation that supports the old idea advocated by Krueger (1999) and Sachs and Fischer (1995), among others. In particular, we provide a theoretical channel for explaining the empirical evidence that vertical specialization and enhancement of global value chains have induced economic growth (see Hermida et al., 2022).

Second, we revisit the catch-up hypothesis, stating that developing countries grow faster and ultimately will catch up with developed countries. Here again, the debate has not yet been settled although it is a decades-old idea. The premise of the hypothesis is based on the basic principle of productivity. As economies grow, their growth rates converge in the long-run (see Abramovitz, 1990; Baumol, 1986). Implied by the neoclassical assumption of diminishing marginal productivity of capital, there is a limit to the rate of capital accumulation in the long run (see Baily et al., 1990, for such evidence in the US data). Hence, it is argues that developing countries must experience a higher growth rate that the developed world. Lucas (1990) famously criticized this hypothesis by raising the question of why capital does not move to the south. We contribute to this old unsettled question by providing the conditions under which the hypothesis holds. Particularly, we show that a small developing economy grows faster than the rest of the world due to vertical specialization, production fragmentation and the global extension of supply chain if it is skilled-labor scarce both relative to capital and unskilled labor. We also address the effects of production fragmentation and global extension of supply chain on skilled-unskilled wage inequality. Hence, our paper also contributes to an important growing literature on international production and task fragmentation (e.g, see Nakanishi and Long, 2015).[2]

Finally, to illustrate our theoretical results numerically, we calibrate our model and conduct a numerous computational experiments. These computational exercises are meant to provide qualitative insights and to facilitate visualizing our results.[3]

The rest of our paper is organized as follows. Section 2 lays out our general equilibrium framework. Then, in Section 3, we cast our general equilibrium model within a dynamic

[2]Our paper is related to Feenstra and Hanson (1996) that consider the impacts of global production fragmentation on wage inequality in the US. They *empirically* studied the impacts of imports of fragments by the United States on wages in the US. Our paper is first and for-most is a theoretical attempt. Moreover, a central feature of our model is a case of reciprocal outsourcing as in Oladi et al. (2014), but within a dynamic and growth theoretic setup. Home country imports foreign fragments while foreign country imports home fragments. That is, both countries participate in the global value chain. Second, there is a one-shot gain from trade in standard outsourcing models, where outsourcing increases the real income (i.e., the level effect) and there does not exists the growth effects. In contrast, the mechanism is altered in such a way in our setup that outsourcing raises marginal productivity of capital permanently that activates a process of endogenous growth. Put differently, level effect is what trade theory has been focused on. We demonstrate how level effect also leads to growth effect.

[3]We are grateful to an anonymous referee for suggesting this.

growth model, where we also present our main results. Section 4 and 5 provide some numerical analysis and Section 6 concludes our paper.

2 A general equilibrium model of vertical specialization

Consider a small open economy that produces two final goods, denoted by X and Y. Good X uses capital and intermediate good M as inputs with Cobb-Douglas production technology $X = AK^{\alpha}M^{1-\alpha}$. Good Y uses unskilled labor and skilled labor as inputs with production technology $Y = S_Y^{\beta}L_Y^{1-\beta}$, where S_Y is the usage of skilled labor and L_Y denotes the unskilled labor employed by sector Y. Sector M uses a continuum of services or components $Z = [0, 1]$ to produce the intermediate good with costless assembly technology. Finally, let service z be produced both at home country and abroad using skilled labor with Ricardian production technology. In particular, let Ricardian unit labor demand be $a_S(z), \forall z \in Z$, where $a_S(1) = 1$. For any $z \in Z$, let $\delta(z) \equiv a_S^*(z)/a_S(z)$, where an asterisk denotes foreign variables in the remainder of the paper. We assume that $\delta'(z) < 0, \forall z \in Z$. Define $\tilde{z} \in Z$ such that $\delta(\tilde{z}) = w_S/w_S^*$, where w_S denotes skilled wage rate. Therefore, all $z \in [0, \tilde{z}]$ will be produces at home and all $z \in (\tilde{z}, 1]$ will be produced in the rest of the world. Then, given our setup, the total skilled labor whose service will be assembled in M, denoted by S_M, can be given by:

$$S_M = M \int_0^{\tilde{z}} a_S(z)dz \tag{1}$$

We maintain full employment of labor, implying that $L_Y = \bar{L}$ and:

$$S_M + S_Y = \bar{S} \tag{2}$$

where $\bar{L}$ and $\bar{S}$ are constant endowments of unskilled and skilled labor, respectively. The equilibrium price of intermediate good M is given by:

$$p_m(\tilde{z}) = B(\tilde{z})w_S + [1 - B(\tilde{z})]w_S^* \tag{3}$$

where $B(\tilde{z}) \equiv \int_0^{\tilde{z}} a(z)dz$ is share of home made components $z \in Z$ in M.[4] By our small open economy assumption, prices of X and Y, denoted by p_x and p_y, as well as w_s^* are all given.

[4]Note that the share of any component $z \in Z$ in M is trivially $a(z)M/M = a(z)$.

Hence, w_s and w will be determined with $p_x = p_y = w_s^* = 1$ by appropriate choice of units. Note also that, following the definition of δ and equation (3), we have $p_m(\tilde{z}) < 1$.[5].

Profit maximization implies the demand for intermediate as $M = [(1-\alpha)X/p_m(\tilde{z})$. Hence, equilibrium output of X for any amount of capital can be obtained as:

$$X = \left(A(1-\alpha)^{1-\alpha}\right)^{\frac{1}{\alpha}} \left(\frac{1}{p_m(\tilde{z})}\right)^{\frac{1-\alpha}{\alpha}} K \tag{4}$$

Using the above derived demand for M and equation (4), we can obtain instantaneous equilibrium quantity of M for any given level of capital as:

$$M = \tilde{A}K\tilde{p}_m^{-\frac{1}{\alpha}} \tag{5}$$

where $\tilde{A} \equiv [A(1-\alpha)]^{1/\alpha}$ and $\tilde{p}_m \equiv p_m(\tilde{z})$ for notational simplicity. Therefore, it follows from equations (1) and (5) that the equilibrium level of employment for skilled labor, used in production of domestic components $[0, \tilde{z}]$ for any given level of capital, can be given as:

$$S_M(w_s) = \frac{\tilde{A}KB(\tilde{z})}{(B(\tilde{z})w_s + [1 - B(\tilde{z})])^{\frac{1}{\alpha}}} \tag{6}$$

Differentiating equation (6), it can be shown that:

$$\frac{\partial S_M}{\partial w_s} = \tilde{A}K \frac{B'(\tilde{z})\frac{d\tilde{z}}{dw_s} - \frac{1}{\alpha}[B(\tilde{z})]^2[\tilde{p}_m]^{-1}}{p_m^{\frac{1}{\alpha}}}$$

where we have used $(d[B(.)w_s + (1-B^*(.))]/d\tilde{z})\,(d\tilde{z}/dw_s) = 0$, since $d[B(.)w_s + (1-B^*(.))/d\tilde{z} = 0$ due to the envelope theorem. Recall also that $B'(.) > 0$ and $d\tilde{z}/dw_s < 0$. Hence, we conclude that $\partial S_m/\partial w_s < 0$.

Next, consider sector Y. Equilibrium in this sector implies:

$$S_Y(w_s, \bar{L}) = \left(\frac{w_s}{\beta\bar{L}^{1-\beta}}\right)^{\frac{1}{\beta-1}} \tag{7}$$

where $\partial S_Y/\partial w_s < 0$. Therefore, the market clearing condition for skilled labor can be re-written as:

$$S_M(w_s) + S_Y(w_s, \bar{L}) = \bar{S} \tag{8}$$

[5]See Sanyal (1983) and Marjit (1987).

which determines equilibrium w_s, for any given level of K, hence sectoral skilled labor demand will be determined. Then, unskilled labor market clearing condition determines unskilled wage, i.e., $w = (1-\beta)[S_Y(w_s)]^\beta / \bar{L}^\beta$. Moreover, skilled-unskilled wage gap is given by:

$$\frac{w_s}{w} = \frac{\beta \bar{L}}{(1-\beta) S_Y(w_s, .)} \tag{9}$$

implying that any change that leads to a decrease in demand for skilled labor in sector Y will increase the skilled-unskilled wage gap. Clearly, capital accumulation has consequences on skilled-unskilled wage gap and on inequality. Particularly, equations (6) and (8) imply that an increase in capital will increase (decrease) the demand for skilled labor whose services are used in sector M (Y). Hence, we have the following result.

Proposition 1. *Any increase in capital raises the skilled-unskilled wage gap in this small open economy.*

Thus, it is crucial to study capital accumulation. We shall consider this in the next section.

3 Economic Growth and Inequality

Our model and its analysis in the previous section is for any given capital level. We shall now allow capital to be endogenously determined and grow over time for any given initial value. Let the representative consumer's utility function be given by $u = u(c_t)$, where c_t denotes the consumption of Hicksian composite good at time t and all neoclassical assumptions are maintained. Moreover, we also assume throughout the rest of the paper that u exhibits constant inter-temporal elasticity of substitution. Our dynamic optimization problem can be written as:

$$\max_{\{c_t\}_{t=0}^{\infty}} \sum_{t=0}^{\infty} \xi^t u(c_t)$$

$$s.t. \quad K_{t+1} - K_t = \frac{\tilde{A} K_t}{\phi(\bar{S}, K_t)} - c_t$$

$$K_0 = \bar{K}$$

where $\phi(\bar{S}, K_t) \equiv (1-\alpha)\tilde{p}_m^{(1-\alpha)/\alpha}$ and $\xi = 1/(1+\rho)$ is the discount factor and $\rho > 0$ is the discount rate. Recall that at a temporal equilibrium w_s depends on $\bar{S}$ and K_t, implying that

$\tilde{p}_m$ also depends on $\bar{S}$ and K_t. Bellman equation for this dynamic programming problem can be written as:

$$v(K_t) = \max_{c_t}\{u(c_t) + \xi v(K_{t+1})\} + \lambda_t \left[\frac{\tilde{A}K_t}{\phi(\bar{S}, K_t)} - c_t - (K_{t+1} - K_t)\right]. \tag{10}$$

The first order conditions for this problem can then be obtained as:

$$u'(c_t) = \lambda_t \tag{11}$$

$$\xi v'(K_{t+1}) = \lambda_t \tag{12}$$

$$v'(K_t) = \lambda_t \left(\frac{\tilde{A}}{\phi} - \frac{K_t}{\phi^2}\frac{\partial \phi}{\partial K_t} + 1\right) \tag{13}$$

Rewrite equation (13) for $t+1$, to get:

$$\xi v'(K_{t+1}) = \xi \lambda_{t+1} \left(\frac{\tilde{A}}{\phi}\left[1 - \frac{\varepsilon_{p_m k}(1-\alpha)}{\alpha}\right] + 1\right)$$

where $\varepsilon_{p_m k}$ is the elasticity of p_m with respect to capital. It directly follows from equation (5) that $\varepsilon_{p_m k} = \alpha$. Hence, by using equation (12), we can re-write the above equation as:

$$\frac{\alpha \tilde{A}}{(1-\alpha)\tilde{p}_m^{\frac{1-\alpha}{\alpha}}} + 1 = (1+\rho)\frac{\lambda_t}{\lambda_{t+1}} \tag{14}$$

Then, given the constant inter-temporal elasticity of substitution, it follows from equations (11) and (14) that:

$$\frac{\alpha \tilde{A}}{(1-\alpha)\tilde{p}_m^{\frac{1-\alpha}{\alpha}}} + 1 = (1+\rho)(1+g)^{\sigma} \tag{15}$$

where $\sigma \equiv u''(.)/u'(.)$ is the (constant) inter-temporal elasticity of substitution and g is the growth rate. Recall that $u'(c^*(k_t))/u'(c^*(k_{t+1})) = [c^*(k_{t+1}/c*(k_t))]^{\sigma} = (1+g)^{\sigma}$, where k is capital-skilled labor ratio. By solving equation (15), we obtain:

$$g(t) = \Delta \left[1 + \frac{\alpha \tilde{A}}{(1-\alpha)\tilde{p}_m^{\frac{1-\alpha}{\alpha}}}\right]^{\frac{1}{\sigma}} - 1 \tag{16}$$

where $\Delta \equiv [1/(1+\rho)]^{1/\sigma}$. Recall that ϕ is monotonically increasing in p_m. Hence, we have the following result.

Proposition 2. *Vertical specialization and opening of international trade in components and global expansion of supply chain at time t will lead to an increase in temporal growth rate.*

To see this more clearly, let us consider an example where $u(c_t) = \ln c_t$, i.e., $\sigma = 1$. Then, it follows form equation (15) that approximately $g(t) \approx \alpha\tilde{A}/[(1-\alpha)\tilde{p}_m^{1-\alpha/\alpha}] - \rho$. Therefore, growth rate crucially depends on the price of intermediate. Vertical specialization and trade opening in components will lower this price, resulting in higher temporal growth rate.

Now, turning to the catch-up hypothesis, we need to establish whether our small open developing economy experiences a greater reduction in price of the intermediate good as a result of vertical specialization and trade in components. To do this, first we have to derive autarky equilibrium price of M, denoted by p_m^a. It is evident from (3) that $p_m^a = w_S$ since $B(1) = 1$. Hence, we have to evaluate the change in skilled wage due to trade opening. Using $p_m^a = w$ and equations (6)-(8) as well as their equivalence in the rest of the world, we can show that at autarky we have:

$$\frac{\tilde{A}}{w_S^a}\bar{k}_S + \left(\frac{\beta}{w_S^a}\right)^{\frac{1}{1-\beta}}\bar{l}_S = 1 \tag{17}$$

where $\bar{k}_s \equiv \bar{K}/\bar{S}$ and $\bar{l}_s \equiv \bar{L}/\bar{S}$. Using equation (17) and its equivalence for rest of the world, recalling that $w_s^* = 1$, we obtain:

$$\frac{\tilde{A}}{w_S^a}\bar{k}_S + \left(\frac{\beta}{w_S^a}\right)^{\frac{1}{1-\beta}}\bar{l}_S = \tilde{A}\bar{k}_S^* + \beta^{\frac{1}{1-\beta}}\bar{l}_S^* \tag{18}$$

Thus, it follows from equation (18) that $w_S^a > w_S^* = 1$ if $\bar{k}_S > \bar{k}_S^*$ and $\bar{l}_S > \bar{l}_S^*$. Hence, we have the following result.

Proposition 3. *Autarky skilled wage is higher at home economy if it is skilled-labor scarce both relative to capital and unskilled labor.*

The condition of the above proposition is sufficient for skilled wage to be higher in the home economy. However, it is not a necessary condition. The necessary condition is that one of these skilled labor intensity conditions to be met. As it is evident from equation (18), for $w_S > w_S^*$ under autarky, it must be the case that $\bar{k}_S > \bar{k}_S^*$ or $\bar{l}_S > \bar{l}_S^*$. That is, killed labor must be scarce at home at least relative of the other primary production factors.

A crucial corollary to Proposition 3 follows from equation 3: $p_m^a > p_m^{a*}$ if home country is skilled-labor scarce both relative to capital and unskilled labor. Suppose this sufficient condition is met. Then, home country will experience a bigger price drop for the intermediate good as a result of vertical specialization, global production fragmentation and trade in fragments. That is, $dp_m = p_m^a - p_m(\tilde{z}) > p_m^{a*} - p_m(\tilde{z})$ if home country is skilled-labor scarce both relative to capital and unskilled labor. This, in turn, implies from equation (16) that $g(t) > g^*(t)$ if home country is skilled-labor scarce both relative to capital and unskilled labor. Hence, we have the following formal result that addresses the catch-up hypothesis.

Proposition 4. *With vertical specialization, trade opening for components and global expansion of supply chain, a small home economy grows faster than the rest of the world if the home country is skilled-labor scarce both relative to capital and unskilled labor.*

This result is compatible with the observation of cross-country growth convergence (e.g., see Baldwin and Robert-Nicoud, 2016). A small developing country with skilled labor scarcity grows faster than the developed world so that ultimately the cross-country per capita income converges.

We have already established in preceding section that a higher level of capital will increase the skilled-unskilled wage gap. Hence, this and Proposition 2 conclude the following important result on skill-unskilled wage inequality.

Proposition 5. *Vertical specialization, production fragmentation, trade opening and global expansion of supply chain raise within country skilled-unskilled wage gap.*

Intuition of this result deserves attention. Following proposition 2, vertical specialization and trade in components will increase growth rate, hence raises the capital level. As K accumulates and S does not expand at that rate, w_s/w will go up in each group of countries. Again, this explains within country divergence that we observe from empirical evidence. This result contributes to the literature on rising inequality (e.g., Acemoglu and Restrepo, 2018; Autor and Murnane, 2003).

While the effect of global production fragmentation and vertical specialization on wage inequality is generally unambiguous, its extent differs between home country and the rest of the world. This follows from the implication of catch-up hypothesis in our setup. The following result highlights the differential effects of vertical specialization on inequality.

Proposition 6. *Skilled-unskilled wage inequality widens more in home country than the rest of the world if home country is skilled-labor scarce both relative to capital and unskilled labor.*

As a final note, it must be emphasized that Results of our paper are robust to many alterations of the simple model we develop in the paper. Everything hinges on the price of

M, where a lower p_m via trade increases the marginal product of capital. As long as trade in intermediates leads to a decline in the world price of M, affecting the marginal product of capital, trade will lead to growth. One could bring in unskilled labor in production of M and define comparative advantage appropriately to generate this result.

4 Parametrization

In this section, we outline the calibration strategy for our general equilibrium model, discussed in previous sections. The primary aim of this calibration is to serve as a heuristic tool for visualizing theoretical outcomes and gaining intuitive insights into the relationships and phenomena under study.

Table 1: Parameter Values

Parameter	Value	Description
α	0.34	capital intensity
A	1	TFP for good X, normalized
β	0.5	skilled labor intensity
σ	1	intertemporal elasticity of substitution
ξ	0.96	discount factor
T_h	1	scale parameter for Frechet dist. for home
T_r	3	scale parameter for Frechet dist. for rest of the world
θ	4	shape parameter for Frechet dist. (common for both countries), (Simonovska and Waugh (2014))
$\overline{S}$	1	skilled labor supply, (normalized)
$\overline{L}$	2.3	unskilled labor supply, relative to skilled labor supply, (avg. for low-income countries)

Note: This table summarizes values of parameters with brief descriptions.

It's important to note that our approach is more qualitative in nature and not geared toward precise parametric estimation. To guide our calibration, we adhere to established conventions in the literature, sourcing parameter choices from existing research to maintain consistency with mainstream approaches.

A crucial element of our model is the labor demand in both the home country and the rest of the world, which represents the trade partner in our model, for each unit of good M. To discipline $a_s(z)$ and $a_s^*(z)$, we follow Eaton and Kortum (2002). In a multi-country context, they formulated $Z_i(j)$ as the amount of good j that a bundle of inputs can produce in country i. In our framework, this corresponds to the inverse of labor demand for each unit of good M, expressed as $\frac{1}{a_s(z)}$. We posit that the productivity distribution for each good j in country i follows a Frechet distribution:

$$Pr(Z_i(j) \leq z) = F_i(z) = e^{-T_i z^{-\theta}}$$

with $T_i > 0$ governing the location of the distribution or the state of the technology in i, meaning that a higher T_i implies a higher efficiency draw for good j. We choose this parameter to capture the distinctions between the developed (rest of the world) and the developing country under focus. Specifically, we assign a smaller T for the home country and a larger T for the rest of the world. Parameter θ is responsible for dictating the variability in productivity; a higher θ leads to lower variability. Consistent with existing literature, we set a common θ for both locations. Consequently, we have two Frechet distributions that generate $a_s(z)$ and $a_s^*(z)$ for home country and the rest of the world, respectively.

Table 1 summarizes parameter choices employed in our model.

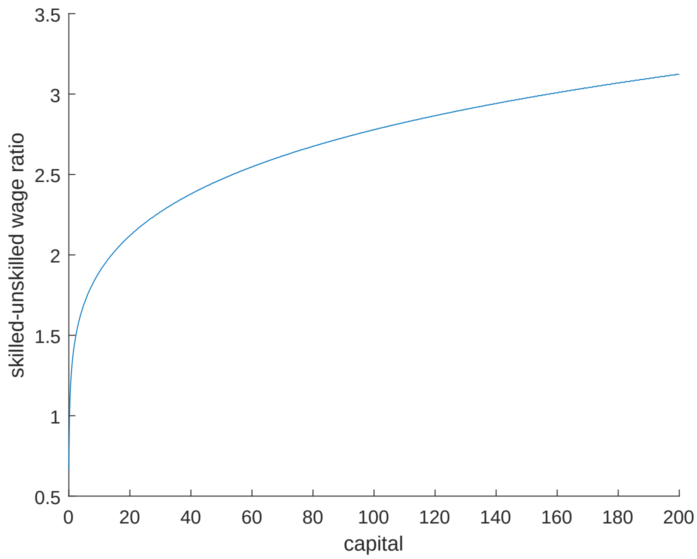
5 Exploratory experiments: from theory to visualization

We conducted a series of computational experiments to visualize the theoretical predictions made by our model. These experiments should be viewed as illustrative, providing qualitative insights into the effects of global production fragmentation, vertical specialization, and trade on economic growth and wage inequality.

The first result in section 2 reveals that, within the context of our small open economy, an increase in capital correlates with a widening skilled-unskilled wage gap. To visualize this relationship, we conducted model simulations over varying levels of capital, capturing the respective values of skilled-wage, ω_s, and unskilled wage, ω. Figure 1 depicts the ratio of skilled to unskilled wages across these capital levels. As illustrated, the wage gap – measured as the ratio of $\frac{\omega_s}{\omega}$ – expands as capital increases.

Another key finding presented in Section 3 is that the vertical specialization and opening of international trade in components, along with the global expansion of supply chains, contribute to an increase in the temporal growth rate $g(t)$. This is mediated through their impact on the price of the intermediate good M. Specifically, vertical specialization and trade liberalization lead to a decline in the price $\tilde{p}_m$, which in turn boosts the temporal growth rate both at the time of opening and in subsequent periods, compared to a no-trade

Figure 1: Skilled-unskilled wage gap



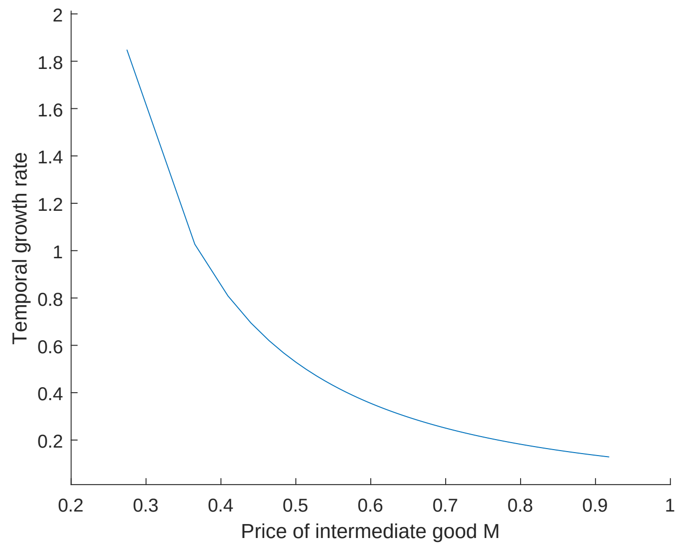
Note: This figure illustrates an expanding wage gap between skilled and unskilled labor as the level of capital investment rises, which is consistent with the outcomes presented in Proposition 1.

scenario. To illustrate this inverse relationship between $\tilde{p}_m$ and $g(t)$, we simulate our model across a range of $\tilde{p}_m$ values to calculate the corresponding growth rates. Figure 2 highlights this inverse relation, showing that an increase in the price of intermediate goods results in a reduced temporal growth rate. Consequently, any period in which the economy opens up to trade—and thus experiences a decrease in $\tilde{p}_m$ – will see a surge in temporal growth rate

A further set of findings elaborated in the previous section underscores the influence of skilled-labor scarcity on a country's response to vertical specialization and trade. To illustrate these outcomes, we simulate our model for two countries with identical levels of capital, unskilled labor supply, and technology, but divergent levels of skilled labor supply. Specifically, one of those countries has a skilled labor supply twice as large as the other. The country with the smaller skilled-labor supply serves as a proxy for higher skilled-labor scarcity, relative to its counterpart. In the accompanying graphs, this country is labeled as 'Low Skilled-Labor Supply' and is represented by a dashed blue line. Conversely, the country with the larger skilled-labor supply signifies lower skilled-labor scarcity and is labeled as 'High Skilled-Labor Supply,' depicted by a solid red line in the graphs.

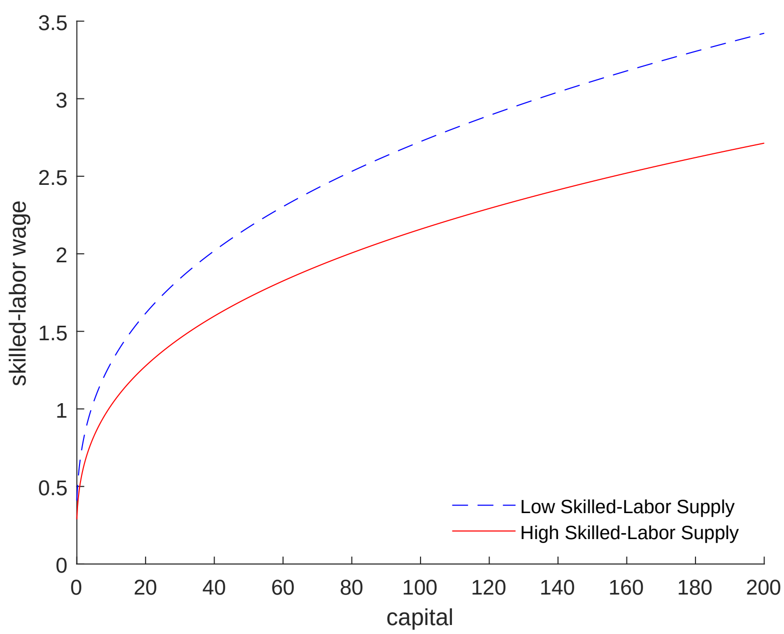
Figure 3 displays the skilled-labor wages, ω_s in autarky – i.e., in the absence of trade – across a range of capital levels for two countries, with a high skilled-labor supply and

Figure 2: Temporal growth rate and price of intermediate good



Note: The figure demonstrates the inverse correlation between the price of the intermediate good $\tilde{p}_m$, which declines as the country engage in vertical specialization and trade, and the temporal growth rate, $g(t)$.

Figure 3: Autarky skilled-labor wage



Note: The figure demonstrates that at autarky, the skilled-labor wage is higher for the country which is more skilled-labor scare both relative to capital and unskilled labor.

a low skilled-labor supply. As evident from the graph, the skilled-labor wage is higher in the country with relative skilled-labor scarcity. It's important to note that this scarcity is relative to both capital and unskilled labor by its setup.

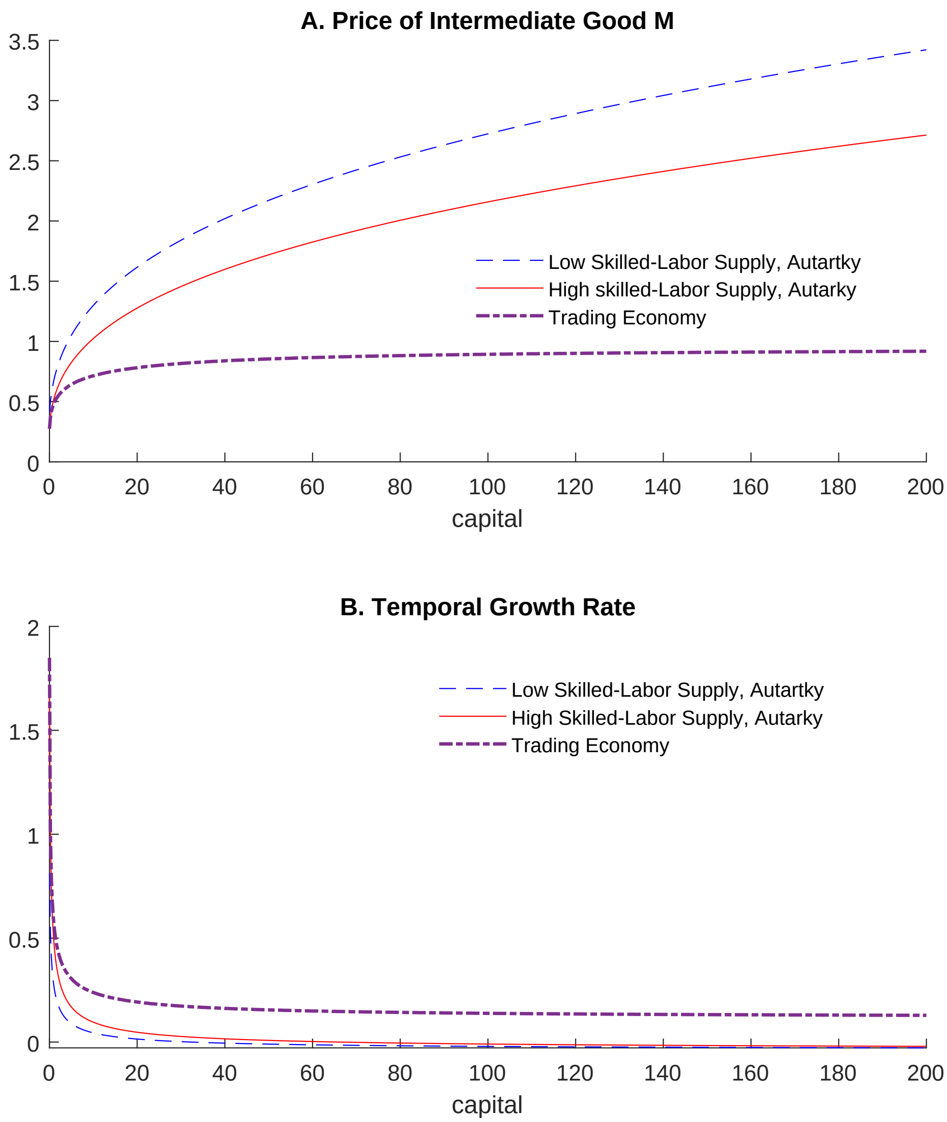
Skilled-labor intensity is one of the significant factors when considering the impact of trade and vertical specialization on an economy. In the absence of trade, i.e. autarky, higher skilled-labor scarcity results in a relatively higher price for intermediate goods. Consequently, when economies open up to trade, the country with lower skilled-labor supply experiences a more substantial decline in the price of intermediate goods compared to its higher skilled-labor supply counterpart. This is demonstrated in Panel A of Figure 4, which compares $\tilde{p}_m$ under autarky and post-trade conditions for both types of countries. The gap between autarky and trade-induced prices is wider for the country with skilled-labor scarcity. This suggests that upon opening up to trade, such a country will experience a more pronounced increase in its temporal growth rate, as illustrated in Panel B of Figure 4. In essence, with vertical specialization and the global expansion of supply chains, a small economy with skilled-labor scarcity—relative to both capital and unskilled labor—will grow faster than the rest of the world.

As previously outlined and illustrated in Figure 1, the skilled-unskilled wage gap expands as capital increases. Building on the discussion of the impact of skilled-labor scarcity, we show in section 3 that capital accumulation has a more pronounced effect on this wage gap, which is quantified as the ratio of skilled to unskilled labor wages in a skilled-labor scarce country. Figure 5 contrasts the evolution of this wage gap as capital grows, comparing countries with high and low skilled-labor supply. The figure reveals that the skilled-unskilled wage inequality intensifies more significantly in the country experiencing skilled-labor scarcity as its capital stock expands.

6 Conclusion

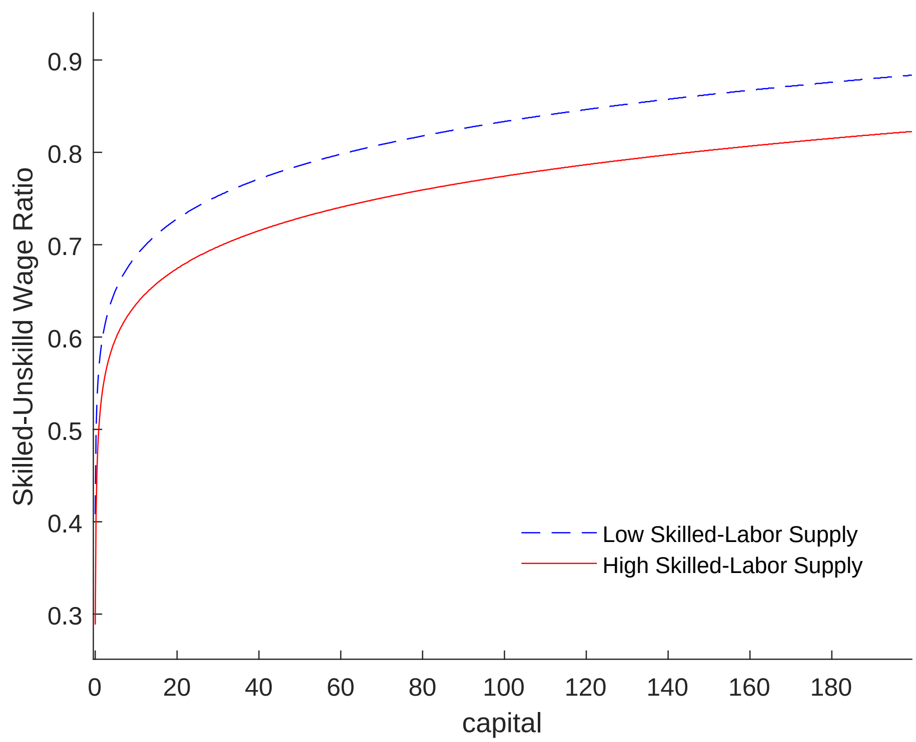
We constructed an elaborate general equilibrium model of trade with vertical specialization, whereby two final goods and intermediate, with potential global production fragmentation, are produced. Our objective is to employ this general equilibrium model to study the within country as well as the cross-country consequences of vertical specialization, global production fragmentation on inequality and economic growth. In order to analyze growth consequences, we also cast our general equilibrium model in a growth theoretic framework. We derive a number of interesting results on the within country divergence and the cross-

Figure 4: Influence of Skilled-Labor Supply on Trade Openness



Note: Panel A compares the price of the intermediate good M under autarky across a spectrum of capital levels for both high and low skilled-labor supply countries. The purple line illustrates how this price evolves when the country engages in trade. Panel B follows a similar structure, but focuses on representing the temporal growth rate across the same range of capital for both types of countries.

Figure 5: Influence of Skilled-Labor Supply on Skilled-Unskilled Wage Inequality



Note: This Figure illustrates the evolution of the skilled-unskilled wage gap as capital increases, contrasting cases with high and low skilled-labor supply.

country convergence (i.e., catch-up hypothesis).

We showed that changes in capital level is consequential for skilled-unskilled wage gap, hence inequality. Our results indicate that global production fragmentation, vertical specialization and trade in fragments will have positive effect on growth. Depending on the endowment differences in skilled labor, catch-up hypothesis may hold true. Hence, our paper contributes to a controversial issue on cross-country convergence by providing a mechanism through which the hypothesis hold, given the conditions of our results. We also showed that global production fragmentation, vertical specialization and trade in fragments cause widening skilled-unskilled wage gap. We also calibrated our model to present numerical analyses that are consistent with our theoretical results.

Our paper can be extended in a number ways. One can include unskilled labor as a factor in production of M and redefine comparative advantage. Moreover, one can endogenize the relative commodity prices with identical and homothetic demand structure. As long as elasticity of substitution in demand is not too low , small country type results should prevail. Yet as another possible extension, non-traded fragments can be introduced as in Beladi and Oladi (2011).

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