Some Thoughts on Comparative Advantage

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In this issue of *Region Focus*, the articles share a common theme. They all illustrate one of the most fundamental ideas in economics – the principle of comparative advantage. Simply stated, comparative advantage suggests that an individual, company, community, or country tends to specialize in areas and activities where it can excel and perform at a lower cost than others. This principle is most familiar in the realm of international trade, as demonstrated in our cover story on the furniture industry. The principle also can be used to analyze the fortunes and misfortunes of communities, as is evident in our feature story on flood recovery efforts in some of West Virginia's hardest-hit communities.

In the cover story, the Fifth Federal Reserve District and particularly North Carolina have been associated with furniture manufacturing since colonial times. Once thriving and profitable, furniture manufacturers now face challenges similar to those of other traditional manufacturing industries: loss of market share and a smaller work force. I've commented previously in *Region Focus* on the effects of changing economic fundamentals on workers facing increased foreign competition, including disruption to households and communities. But evidence and logic suggest that resistance to change often has significant and detrimental effects on the long-term economic health of a community, and ultimately on the workers themselves.

In our story, furniture makers seem to be accepting of change, even optimistic about the transformation of the industry. Manufacturing industries that relocate businesses to areas with lower labor costs are typically responding to real business needs, another example of the comparative advantage principle at work. But the furniture business presents an interesting twist. As we note, geographic specialization due to the availability of particular resources is increasingly important to this industry. Although a good deal of production activity occurs in China, U.S. manufacturing companies still produce parts of the furniture products and then market and distribute these products stateside. A lack of sufficient domestic lumber supplies also requires Chinese manufacturers to import wood from the United States, adding time and doubling transportation costs. Chinese companies may have a substantial comparative advantage in furniture manufacturing, but it seems limited to the parts of the production process that use inexpensive, low-skilled labor. The parts of the process that require unique natural resources and a higher level of skill, or *human capital,* tend to remain in the United States.

Our feature article demonstrates the principle of comparative advantage as it applies to the way communities respond to fundamental changes in the economic environment. We show that the ability of southern West Virginia communities to recover from last year's devastating floods is related to the progress they've made in moving away from their traditional dependence on natural resources. As we've stressed before, the region's employment in the coal mining industry has contracted significantly, forcing local communities to seek new sources of economic growth. There are towns that appear to have greater economic opportunities because the overall educational level of the community is higher. Differences in educational levels seem to be an important factor in the relative progress that towns made before the floods, as well as the relative success of particular towns in recovering from the floods. In community development then, just as in industrial evolution, human capital is the key to retaining a comparative advantage.

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