

Productivity Improvements and Falling Trade Costs Revisited

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Abstract

Does trade liberalization contribute to a welfare gain? In a variant of the standard Melitz model, the answer is yes; within-industry reallocation of resources always generates a welfare gain. Developing an asymmetric two-country Melitz model, however, Demidova (Int Econ Rev 49(4):1437-1462, 2008) demonstrates that the answer may be no. It shows that, when a productivity distribution in the Home stochastically dominates that in the Foreign, while trade liberalization is unambiguously welfare-improving in the Home, it isn't in the Foreign. We revisit this finding and draw two conclusions: (i) when productivity differences are minor, trade liberalization delivers welfare gains in the Home, but welfare losses in the Foreign (ii) when productivity differences are great, trade liberalization delivers welfare losses in the Home, but welfare gains in the Foreign. Our analysis provides insights into the debate regarding the appropriate trade policy in light of recent greater pressure on free trade.

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