In trade negotiations between World Trade Organization members, coordinating the interests of member countries tends to become more complicated as the number of members increases, making it difficult to respond quickly to new challenges and rule-making. Consequently, bilateral or regional trade agreements continue to play an important role today, as they allow for relatively easy coordination of interests. However, this raises the question: When a country enters into a bilateral trade agreement, how should the agreement be designed? Should it be concluded between countries that are similar in terms of market size and technology, or should it take the form of a free trade agreement? Although much attention has been devoted to studying international trade models that consider heterogeneous firms since the seminal work of Melitz (2003), little is known about the effects of bilateral trade policy in such models since previous studies mostly focus on the effect of unilateral trade policy.

This study examines the impact of bilateral trade policy on welfare in a two-country model with heterogeneous firms and variable markups a la Melitz and Ottaviano (2008). In this model, an increase in a country's import tariff affects its welfare through three channels: term-of-trade effect, profit-shifting effect, and volume-of-trade effect. Although the first two channels increase the welfare level of a tariff-imposing country, these two effects generate externalities that affect the welfare of the tariff-imposed country. In particular, the profit-shifting externality has two opposite effects: an increase in a country's import tariff shifts export profits from less productive exporters to more productive exporters within the tariff-imposed country.

Main findings of this study are summarized as follows. First, Nash tariffs are positive and higher than the efficient import tariffs that the countries adopt to maximize the total welfare level of the countries. Second, if countries cooperatively set import tariffs, the efficient tariff that maximizes the total welfare level of the two countries is positive when an introduction of a country's import tariff generates only a small negative profit-shifting externality or when it generates a positive profit-shifting externality. Third, starting at global free trade, a simultaneous introduction of import tariffs can improve the welfare of both countries not only when countries are close to symmetric, but also when the degree of asymmetry across countries is large: when one country has a relatively larger population size and more high-productivity firms compared to the other country.