Market Size, Firm Sourcing, and Vertical Specialization

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Abstract

This paper studies how market size shapes vertical specialization when heterogeneous firms jointly choose whether to export final goods and import inputs. We show that market size alone can generate specialization across production stages, even without technological differences. A larger country specializes relatively more in downstream activities and exports relatively more final goods, while a smaller country specializes upstream and exports relatively more intermediate inputs. This pattern arises because market size changes firms' joint trade decisions, the composition of firms across production modes, and the allocation of activity across stages. When input trade costs are high, the model generates a conventional home-market effect in which larger countries sustain higher relative wages. When these costs become sufficiently low, greater reliance on foreign inputs makes wage reversal possible; even then, the larger country continues to export relatively more final goods. Numerical results further show that lower input trade costs attenuate the welfare gains from larger markets and redistribute income across countries in global value chains.

Keywords: Market size; home-market effects; vertical specialization; input trade; heterogeneous firms
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