

work). In this view, networks are compensating for problems in contract enforcement in international trade. The recent literature on contracting [see Spencer (2005) for a review] suggests that problems in contract enforcement may also influence the decision by firms to set up affiliates in foreign markets; hence there is some reason to expect that the Combes et al. use of affiliates as a proxy for business networks may be capturing the contracting effect.

Rauch and Trindale (2002) use data on ethnic Chinese networks to try to distinguish between these two channels. They estimate a gravity model and ask if trade is enhanced by the presence of larger ethnic Chinese populations in both the importing and exporting countries. Moreover, they distinguish between homogeneous goods that are traded on organized exchanges and differentiated manufactured goods. The argument is that information problems are unlikely to be important for those goods traded on organized exchanges, and so a positive network effect here would lend support for the contract enforcement hypothesis. If the network effect is larger for differentiated products, they interpret this as support for the market information hypothesis.

They find that for all types of goods, the presence of ethnic Chinese networks tends to increase trade; and that the effect is larger for differentiated goods than for goods traded on organized exchanges. There is thus support for both the contract enforcement and market information hypotheses. Moreover, since there is a positive effect on trade arising from the presence of ethnic Chinese networks, this suggests that private sector responses to information or contract enforcement problems that would be available to all producers are not successful in fully dealing with all of the information problems. This suggests a potential role for policy.

Information costs and the organization of firms

The recognition of the importance of vertical specialization for trade flows has led to a recent and still developing literature which integrates theories about the organization of firms with