

The WTO (2008) reported on several case studies that found significant price impacts arising from trade liberalization for several developing countries. For example, India posted important decreases in price-cost margins for most industries in response to a range of liberalization measures undertaken in 1991 (Krishna and Mitra 1998). Similar results were obtained for Côte d'Ivoire following the implementation of a comprehensive trade reform in 1985 (Harrison 1990). The relationship between the exposure to trade and price-cost margins at both the industry and plant levels was also examined across several developing countries—in particular, Chile, Colombia, Mexico, Morocco, and Turkey—and findings suggested that the price effects of increased import penetration were particularly strong in highly concentrated industries where firms had a degree of market power prior to trade opening (Roberts and Tybout 1991).

The trade literature therefore provides overwhelming evidence that trade liberalization fosters increased intra-industry competition. Exporting firms expand their production to serve a larger market, but given that most firms operate at an efficient plant size where output can be shifted considerably with minimal impact on costs, evidence of pronounced economies of scale is weak. Consumers, however, gain access to an increased range of product varieties following trade liberalization. Moreover, as competition in differentiated but substitutable products becomes more heated, prices fall.

The “New” New Trade Theory

The new trade theory, however, has one major drawback: it is based on the assumption of a representative firm. This contradicts the evidence generated by micro-level datasets

covering firms and plants, which shows that differences among firms are crucial to understanding world trade.

Equally important, the predictions arising out of the new trade theory did not coincide with some features of trade in the real world. In particular, exporting industries do not export to all countries as implied by their theoretical cost advantage and import-competing industries sometimes experienced productivity gains following trade liberalization, despite smaller scales of production. The analysis thus shifted from the industry level to the firm level in order to better understand trade flows (e.g., Melitz 2003).

Melitz showed that differences between firms were an additional source of comparative advantage: although, on average, no firm within a specific sector might be productive enough to export, given the dispersion of firm productivities, there might still be some firms left which would be productive enough to do so. This insight was important as it explained why countries might export (or import) in sectors where they may have a comparative disadvantage (advantage). Another major insight was that trade liberalization not only led to resource reallocations between sectors but also to allocative efficiency gains within sectors as resources are reallocated from lower-efficiency firms to higher-efficiency firms (Melitz 2003). These insights laid the foundation for the “new” new trade theory.

Under “new” new trade theory, comparative advantage can be determined at a very low level of aggregation—even within the firm at the component or task level. Such an approach can thus help us understand the increasingly granular nature of international trade and the emergence of global value chains.