

bour intensive goods tend to be imported at arms length, as consistent with theories that the hold-up problem affects the decision of firms regarding how to organize their activities in foreign markets.

One of the most important themes of this literature is that the organizational form of the firm responds endogenously to the structure of trade costs and the institutional environment. Changes in trade costs will affect not just the volume of trade flows, but also decisions about whether to decentralize production and whether to set up foreign affiliates or enter into contracts with independent suppliers. This suggests that one must be cautious in interpreting evidence on the effects of trade costs on trade flows. On the one hand, high trade costs may encourage firms to organize in different ways which can mitigate the effects of trade costs—for example they may use a less fragmented production structure which could lead to much less trade but not necessarily a large drop in welfare. That is, one should not assume that welfare is proportional to trade flows. On the other hand, because of the cumulation of trade costs when intermediate goods cross borders repeatedly during the various stages of production, small trade costs can have a bigger dampening effect on trade flows than one might initially expect.

Trade costs and the Internet

The development of new information and communications technologies has increased the flow of information across borders and should therefore have contributed towards reductions in some of the trade costs discussed above. There are numerous examples that suggest this has happened. Niche markets, such as those for various collectible items have been linked by Internet auction sites such as Ebay; this has turned many individuals into exporters operating out of their home. On a much larger scale, there are many business-to-business websites that link global suppliers.

A few recent studies have begun to try to quantify these effects. Freund and Weinhold (2004) hypothesize that Internet usage will reduce the fixed costs of entering foreign markets by