

Trading Costs, Trade, and Social Welfare

Variya Kunapasut

Graduate School of Economics, Osaka University

Abstract

The standard model of international trade explains all basic matters we need to know about trade: the pattern of trade, trading volume, and prices of traded goods. However, the standard model is still missing some important piece that happens in the real world. Trade costs both formal and informal can matter to international trade in a large degree. In the 3x2 Heckscher-Ohlin-Samuelson (HOS) framework with two small-open economies, we introduce trading costs in the standard model of international trade. The *domestic* trading costs in the model include any expenses occurred in any stages of goods relocation within the border. The third sector which does not engage in production but only in trading activities is introduced in the model, and all the trading costs will go to this sector. We found that an increase in domestic trading costs will positively affect the production of capital-intensive goods but is harmful to the production of labor-intensive goods. Moreover, a reduction of trading costs in a relatively labor-abundant country will increase the country's volume of trade and its national welfare, whereas a reduction of trading costs in a capital-abundant country will lead to a decline of its volume of trade given the terms of trade constant.