"Globalisation as a good times phenomenon: a search-based explanation"

by Huw Edwards

Referee Report

This paper builds a model of heterogeneous outsourcing and search in a North-South two-country world. In the expanding globalisation scenario ("Phase 2"), which is the most relevant to the paper, the Northern firms look for a cheaper Southern upstream supplier of the good to be sold in the Northern market, which entails a match specific extra fixed cost. Good pairwise matching is crucial for survival, but it takes time, during which firms should sink resources in rather suboptimal pairs. A simple and yet elegant search and matching framework is adopted, which implies that the least cost effective, and hence marginal, firms are those that are temporarily suboptimally matched. The monopolistic equilibrium price guarantees that the unsatisfactorily matched firms will costlessly keep searching in order to find a better partner in the next period: if, due to a tariff or adverse demand conditions, the price was lower, firms will choose not to search, and only existing matches will produce. However, this cannot persist, as in the long run all firms would search anyway, due to a positive match hazard rate. Simplifying the dynamics quite a bit, the author stylizes the "good" or "bad" periods, as characterized by relatively large or small fringes of searching firms. These firms, still searching for a better partner, will supply only at the equilibrium price, whereas inframarginal successfully matched firms are more able to weather storms arising from negative demand shocks or sudden increases in the cost of credit. As a consequence, "good times" are characterized by a long tract highly elastic supply, whereas "bad times" are more likely to entail less elastic supply, with mainly inframarginal firms supplying the market. Imposing tariffs when a large part of supply is infinitely elastic ("good times") translates into lower demand, without reducing the import prices: this likely certainly reduces welfare and would not be advised. However, in "bad times", imposing a tariff might more easily reduce import prices, with potentially beneficial effects on the country. This leads the author to predict protectionism as a response to "bad times", with potentially dangerous international coordination failures.

The model is original and well motivated and the results are, to some degree of approximation, rather correct.

I have a major criticism of the main economic argument:

1. The whole mechanism that differentiates whether the tariffs are desirable or undesirable hinges on the relevance of the most elastic tract of the cost curve, that represents the aggregate mass of marginal searching firms. Are we sure that this group of firms is large enough to matter? In the stylized facts about globalisation stated in the Introduction to motivate the paper, this crucial quantitative aspect – i.e. the presence of a large mass of networks destined to break up in the next period - is never quantified. The paper would offer a very successful and pathbreaking explanation of trade policy if the author could calibrate the ratio of searching to non-searching pairings to convincingly realistic values.

And a few technical points:

1. The analysis misses a dynamic dimension, which may lead the reader to doubt about the actual time span in which the effects mentioned work. Moreover, in a fully modelled expansionary scenario (phase 2), the search model sketched in the Appendix would need qualification, as the searcher's value functions should take into account that prices in period t+1 might not be identical to prices in period t. While I conjecture that the main insight of the paper is robust enough, resolving the apparent contradiction between steady state arguments and macroeconomy transition could be helpful for the more technically oriented reader.
2. Page 24: in figure A2, shouldn't the probability of future separation be MUr instead of 1-MUr?