

The Aggregate Welfare and Trade Implications of Contracting Frictions in Global Sourcing

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Abstract

How much do contracting frictions between global firms and their suppliers impact country welfare and trade? We answer this by developing a model of global sourcing under partial contractibility, where firm-supplier relationships are exposed to a bilateral holdup problem. Sourcing decisions aggregate into a gravity equation for trade flows by organizational mode (intrafirm vs. arm's length), which we take to structural estimation. We can then evaluate welfare changes with an extended Arkolakis, Costinot and Rodriguez-Clare (2012) formula that incorporates these contracting frictions. Our counterfactual analysis reveals a sizeable average country welfare gain of 9.2% from eliminating contracting frictions in global sourcing. We further show how accounting for these frictions significantly reshapes quantitative assessments of the welfare gains from trade, including the stakes in a US-China decoupling scenario.