



[The Home Market Effect and Patterns of Trade Between Rich and Poor Countries](#)

CFM-DP2015-19

Kiminori Matsuyama

Northwestern University

This paper proposes a new theoretical framework for studying the patterns of trade between rich and poor countries by incorporating nonhomothetic preferences into the standard home market effect models of trade. It has a continuum of Dixit-Stiglitz monopolistic competitive sectors with iceberg trade costs. There are two countries, which may differ in their per capita labor endowment and the population size. Preferences across sectors are such that, as per capita income goes up, the households shift their expenditure shares towards higher-indexed sectors. In equilibrium, the Rich country, whose households achieve higher standard-of-living, runs a trade surplus in higher-indexed sectors through the home market effect, and hence becomes a net-exporter of high income elastic goods. The framework is flexible enough to allow for a variety of comparative statics. For example, a uniform productivity improvement causes the Rich to switch from a net exporter to a net importer in some middle sectors. The Rich gains relatively more (less) from such changes than the Poor when the goods produced in different sectors are substitutes (complements). The effects of globalization, captured by a reduction in the trade cost, are similar to those of uniform productivity improvements, except that it has additional effects of the terms of trade change when the two countries are unequal in size.