# Problem Set 5: Trade with monopolistic competition and increasing returns to scale

1. Consider two identical countries. Beer manufacturers in each country compete under monopolistic competition.

a) Suppose the two countries engage in trade. Determine the impact of free trade on consumers in each country

b) How does free trade affect domestic producers in each country?

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a) Suppose the two countries engage in trade. Determine the impact of free trade on consumers in each country

Consumers benefit from increased variety and lower prices

b) How does free trade affect domestic producers in each country?

The number of firms in each country falls. Each firm that survives becomes larger, and hence produces at a lower average costs (benefiting from economies of scale).

The total number of firms in both countries after trade is larger than the number of firms in each country before trade, but smaller than the sum of the number of firms in each country before trade.

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Large economies produce more product varieties. Thus, when two countries trade differentiated product as is the case in the monopolistic competition model, the larger countries will have more to export. More- over, larger economies will also have a higher import demand for the number of product va- rieties. Thus, trade is greater between two large countries.

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Trade creates a firm exit, which may result in short-term adjustment costs to workers.