Relationship Specificity, Market Thickness, and International Trade

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Does an increase in final-good trade stimulate offshoring and component trade? Does the effect, if any, systematically vary across industries? To address these questions, we develop a dynamic industry model in which relationship specificity endogenously determines the market thickness. In our model, downstream firms randomly match with upstream firms to obtain a customized component, and matched pairs can produce higher-quality products relative to unmatched counterparts in industries that rely on relationship-specific investments to raise the quality of a final good. We find that in a closed economy, an industry with higher relationship specificity has a thinner market. In an open economy, the reduction of trade costs leads to a thinner market, and this effect is greater the higher the relationship specificity.