Intersectoral markup divergence and welfare

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**Abstract**

We develop a general equilibrium model of monopolistic competition with a traded

and a non-traded sector. Using preferences that generate variable markups and procompetitive

effects, we show how trade liberalization reduces markups in the traded

sector and increases markups in the non-traded sector. Hence, while markups in

the traded sector converge across countries due to trade liberalization, they diverge

across sectors within countries. The welfare effects of trade liberalization are therefore

ambiguous: the direct positive effects in the traded sector may be dominated by the

indirect negative effects in the non-traded sector, especially when trade costs are large

and the non-traded sector is small.

**Keywords:** monopolistic competition; implicitly additive preferences; variable

markups; trade liberalization; non-traded goods.

**JEL Classification:** F12, F15.

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