Dynamic Effects of Industrial Policies Amidst Geoeconomic Tensions*

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November 2024

Abstract

Amid ongoing geoeconomic tensions, industrial policy has emerged as a prominent tool for policymakers. What are the dynamic and welfare effects of these policies? How does the short-sightedness of policymakers influence their choice of instruments? What are the distributional consequences of these protectionist measures? We address these questions with a dynamic two-country open-economy macro framework that incorporates firm heterogeneity, trade, and the offshoring of tasks. By calibrating the model to the contexts of the US and China, we explore the effects of four popular industrial policies: import tariffs, offshoring friction, domestic production subsidies, and entry subsidies. Our findings indicate that myopic policymakers are incentivized to subsidize production, while more forward-looking policymakers favor imposing import tariffs. Although all of these policies initially reduce wage inequality, some result in aggregate welfare losses, either in the short run or the long run.

JEL Classification: F23, F41, F51, F62, L51

Keywords: Macroeconomic dynamics; Firm heterogeneity; Trade; Trade-in-tasks; Industrial policies; Welfare; Global value chains

*We would like to thank Jake Bradley, Matteo Cacciatore, Juan Carluccio, Florence Huart, Wolfgang Lechthaler, Julien Martin, Isabelle Méjean, Michael Nower, Ludovic Panon, and Andrei Zlate for their helpful conversations. We are also grateful to the seminar and conference participants at Tianjin University, the CEBRA Annual Meeting 2024, Lisbon Macro Workshop, PSE Macro Days 2024, MMF Annual Meeting 2024, 14th Conference on "Economics of Global Interactions", Baltic Central Bank Research Meeting, Bank of Lithuania and the National Bank of Ukraine. The views expressed in this paper are those of the authors and do not necessarily reflect the position of the Bank of Lithuania or the Eurosystem. All errors are ours.

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1 Introduction

After decades of reaping the benefits of globalization, the world has begun to witness significant backlash. Following the slow recovery after the global financial crisis, the US-China trade war further strained world trade and investment. This trend was again exacerbated by the Covid-19 pandemic and Russia's war against Ukraine. Amid these waves of geoeconomic tension, industrial policy has emerged as a popular tool for policymakers to fuel rivalry between nations and safeguard national interests.[1] The effects of these policies extend far beyond national borders, influencing the global economy through complex, interrelated channels, which vary over time, making it challenging to discern their intended and unintended consequences. This study aims to shed light on these policies using a dynamic open-economy macro model with trade and offshoring as its micro-foundation.

We begin our analysis by extending the two-country model proposed by Zlate (2016). We embed trade-in-task (as in Grossman and Rossi-Hansberg, 2008) into Zlate's framework and extend the model to allow offshoring activity in both countries.[2] In our setting, both countries are endowed with high-skilled and low-skilled labor, with the North relatively more abundant in the former and the South in the latter. These differences in labor endowments result in wage disparities across skill classes in both countries. For simplicity, we assume each country has a single sector that produces differentiated varieties, with production requiring inputs from both types of labor. The key model ingredients include endogenous firm entry, heterogeneous firm productivity, endogenous export, and offshoring decisions. While the extensive margin of export in each country depends on the costs of both types of effective labor, that of offshoring is determined mainly by the cost of the effective labor in which the country is less abundantly endowed. The asymmetry in the labor endowment between the two countries, together with fixed offshoring cost, thus gives rise to endogenous offshoring activities; more productive firms in the North offshore low-skilled task to the South whereas those in the South offshore high-skilled task to the North.[3]

[1] Take the economic conflicts between the US and China as an example. The Biden administration's CHIPS Act is widely seen as a direct response to China's "Made in China 2025" initiative. In retaliation, China imposed export controls on gallium and germanium in July 2023, following the U.S.'s export restrictions on cutting-edge chips in October 2022.

[2] In Zlate (2016), only firms in the North offshore their production to the South to take advantage of the lower labor costs. Firms in the South only access the North market via export.

[3] The cost of effective high-skilled (low-skilled) labor is defined as the real high-skilled (low-skilled) wage normalized by aggregate productivity.

The dynamic welfare effects of industrial policies are driven by several features of in our model. First, the time-to-build assumption in the firm creation process causes the number of firms to adjust sluggishly. This sluggish adjustment drives the endogenous, persistent macro dynamics in our framework. Meanwhile, consumer preference exhibits love of variety. As firm creation takes time and requires resources to finance, industrial policies may generate different trade-offs between short-run consumption versus more varieties in the long-run, thus leading to a wide range of welfare implications at different time horizons.

We then calibrate the model to the context of the US and China and utilize it as a laboratory to quantitatively evaluate the welfare effects of four popular industrial policies: import tariff, offshoring friction, domestic production subsidy, and entry subsidy. Leveraging the dynamic structure of the model, we account for policymakers with differing horizons of interest.[4] We study the welfare gains along the entire transition path and scenarios for myopic policymakers, with horizons of one and four years. These shorter policy horizons proxy for the notion of decision-making with an eye toward favorable macro indicators in the face of an upcoming election. We study several combinations of unilateral, as well as bilateral policy actions, designed to capture the idea of policy wars.

Our framework reveals stark differences in macroeconomic outcomes depending on the industrial policies implemented, highlighting that a "one-size-fits-all" response is inadequate when foreign countries employ a variety of policies. For example, an increase in Northern tariffs acts as a demand shifter by making imported varieties more expensive. This not only directly impacts Southern exporters but also raises the relative price of goods between the two regions, leading to an appreciation of the real exchange rate. This, in turn, generates general equilibrium effects that influence Northern firms' dynamic decisions regarding exporting and offshoring. In contrast, production subsidies incentivize local production, reducing the number of exporters and offshoring firms. However, this policy also discourages entry by favoring incumbent firms, diverting resources from investment in new firms to existing production. As production rises, firms' demand for both high- and low-skilled labor increases, pushing up wages and ultimately boosting consumption in the North.

Two important policy implications arise in our study. First, the short-sightedness of policymakers heavily influences their choice of policy instruments. At both one and four year

[4] For a similar approach, see Akcigit, Ates and Impullitti (2018) and Milicevic, Defever, Impullitti and Spencer (2022).

time horizons, using a production subsidy is the dominant policy instrument for each country, regardless of their opponent's policy action. This result is mainly driven by the subsidy's positive effect on labor demand and wages, which boosts consumption in the short run. However, if both countries continue this strategy over time, the negative effect on firm entry starts to materialize, resulting in joint welfare losses at an infinite horizon. When policymakers instead consider the entire transition path, the dominant strategy for each country becomes import tariffs. Tariffs support firm entry by creating a protective environment and, unlike entry subsidies—which also promote firm entry but reduce consumption—tariffs redistribute resources from foreign exporters to local consumers. In times of economic conflict, these two aspects make tariffs the best single instrument in a policymaker's toolbox. If policymakers in each country made this choice, however, they incur mutual welfare losses at almost every time horizon of the implementation. The fact that each country has the option of taking zero action shows this scenario resembles a "race to the bottom" in terms of policy actions.

Second, our results show that all four policy instruments reduce the skill premium for the North, with the quantitative effects particularly strong for offshoring friction and production subsidy. Regardless of the time horizons the Northern policymakers consider, this may provide an additional incentive for them to choose these two policy instruments. For the case of offshoring friction, however, tension exists between the distributional gain and the aggregate welfare losses at long-run time horizon.

Related Literature. This paper is related to several strands of literature. The first strand focuses on the macroeconomic impact of geoeconomic fragmentation. In recent years, with the intensification of geopolitical conflicts, the global economy has gradually shown signs of geoeconomic fragmentation (Aiyar et al., 2023). As a result, a new body of literature has emerged on the macroeconomic implications of the potential decoupling between different geopolitical blocks. Among them, some of them focus on the aggregate impacts of trade and supply chain decoupling (Bolhuis et al., 2023; Attinasi et al., 2023; Javorcik et al., 2024) and find geoeconomic fragmentation could lead to a substantial losses in global GDP. Some others focus on the macroeconomic impact of technology decoupling (Bekkers and Góes, 2022; Cerdeiro et al., 2021) and find technology decoupling could amplify the welfare losses of fragmentation. We contribute to this strand of literature by presenting a dynamic quantitative analysis of various industrial policies, in a canonical international macroeconomic framework with trade and offshoring as its micro-foundation.

Our paper also relates to the strand of literature that focuses on the "trade war" between China and the United States. Existing studies have presented various aspects of the impact of the US-China trade war, such as welfare (Amiti et al., 2019, 2020), the labor market (Benguria and Saffie, 2020), the trade balance (Tu et al., 2020; Ma and Meng, 2023) and others. However, only a few articles have explored the distributional aspect. Among them, Waugh (2019), Fajgelbaum et al. (2020), and Caliendo and Parro (2022) focus on the impacts of the trade war on either consumption or wages across different counties/states in the US. Chor and Li (2021) analyzes the impact of the trade war on the intensity of economic activity across different regions in China. Our contribution to this strand of literature is twofold. First, we study the impact of tariffs on workers with different skill classes in a dynamic macro framework. Second, we compare the effects of tariffs on wages and skill premiums with other industrial policies and discuss their welfare implications.

This paper is also related to the literature on new economics of industrial policy (Juhász et al., 2023). Early research on industrial policies focused on the output, earnings, and growth rates of the industries or countries (Baldwin and Krugman, 1988; Head, 1994; Luzio and Greenstein, 1995; Irwin, 2000; Hansen et al., 2003), while more recent studies have turned to the assessment of productivity effects and cross-sectoral spillovers, among others (Aghion et al., 2015; Lane, 2022; Liu, 2019; Manelici and Pantea, 2021; Choi and Levchenko, 2021; Juhász et al., 2022). More recently, there has been a new literature that integrates industrial policy and trade policy into a unified theoretical framework to quantitatively study the synergies between the two. For example, Lashkaripour and Lugovskyy (2023) study optimal trade and industrial policies in a quantitative trade model. They find that internationally coordinated industrial policies are more effective than any unilaterally implemented policies to reduce the misallocation of resources. Ju et al. (2024) evaluate the impact of the US-China trade war and subsidies on high-tech industries on welfare through a quantitative trade model. They find that properly-implemented industrial subsidies may produce fewer distortions than the imposition of tariffs. In contrast to this literature, our paper takes the underlying steady-state distortions as given, and explores the potential gains and losses of industrial policies along the entire transition path.

Our paper also contributes to the literature on international macroeconomic models with microfoundations, which evolved following work by Melitz (2003) and Ghironi and Melitz (2005). Several studies have extended this line of framework to address several questions in international macroeconomics. These include works by Auray and Eyquem (2011), Bergin and Corsetti (2020), Cacciatore and Ghironi (2021), Corsetti et al. (2013), Hamano and Zanetti (2017), Imura and Shukayev (2019), Jiang (2023), Kim (2021), and Zlate (2016) among others. Our contribution to this literature is embedding two-way trade-in-tasks into this class of models. We then utilize this model to examine the dynamic and distributional effects of various industrial policies.

The rest of the paper is organized as follows: Section 2 presents the two-country model. Section 3 presents the calibration. Section 4 studies the dynamics and welfare implications of industrial policies. Section 5 concludes. The Appendix contains our computation method and additional figures and tables.

2 The Model

Overview

Our framework consists of two countries, North (N) and South (S), all variables for the South are denoted with an asterisk. Each country has one sector, featured with heterogeneous firms producing differentiated varieties. The production of each variety requires two types of labor: high-skilled labor and low-skilled labor, both are supplied inelastically. The North has a relatively higher endowment of high-skill labor, whereas the South has a relatively higher endowment of low-skill labor. The building blocks of our exercise are trade-in-tasks as in Grossman and Rossi-Hansberg (2008), and offshoring as in Zlate (2016).

Our goal here is not to exactly model all kinds of policies, but through some combinations of various policy instruments, we can obtain a good approximation of the ongoing geoeconomic tensions. For this reason, our model is featured with the following four sets of popular policy instruments (Juhász et al., 2022): (i) ad valorem import tariffs (τ^{IM}, τ^{IM*}), (ii) iceberg friction on offshoring low-skill task (τ^{V}) faced by North, and iceberg friction on offshoring high-skill task (τ^{V*}) faced by South, (iii) domestic production subsidies (s_D, s_D^*), and (iv) entry subsidies (s_E, s_E^*).

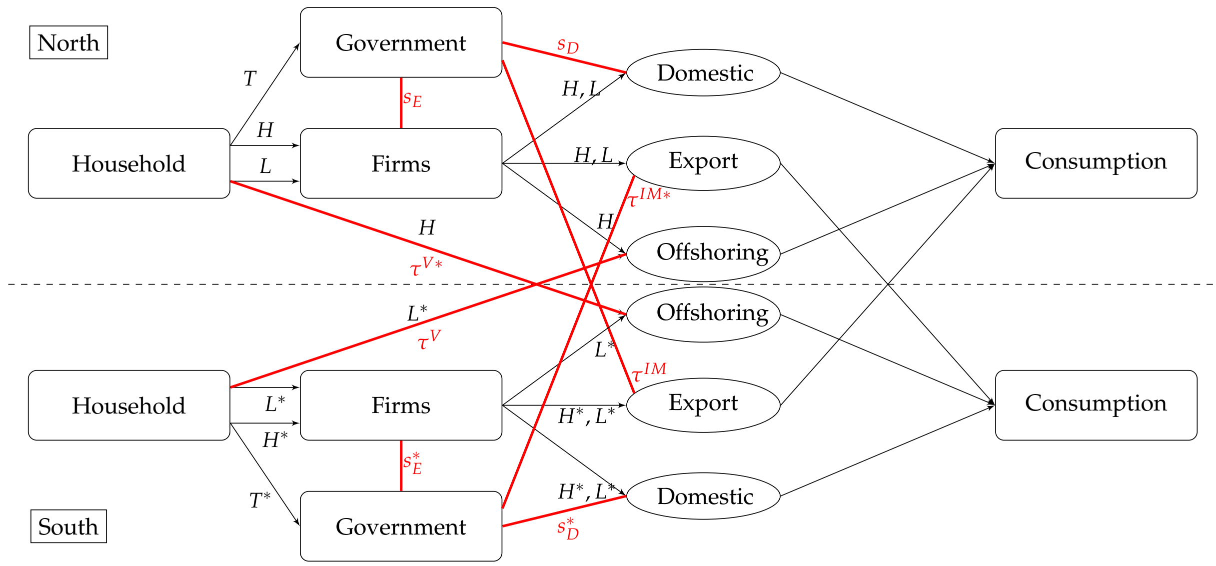

Figure 1. Model structure

2.1 Households

There are two countries – North and South. We denote the Northern endowments of high-skilled labor by H and low-skilled labor by L. The North is assumed to be more high-skilled labor abundant than the South, so that the relative skill abundance is higher for the North than for the South: $H/L > H^*/L^*$. Each economy consists of a unit mass of atomistic households and a continuum of monopolistically competitive firms with heterogeneous levels of labor productivity. As in Ghironi and Melitz (2005), all contracts are written in nominal terms. Since prices are flexible, the variables solved for are all in real terms. Here we mostly focus on presenting the model setup for the North, noting that those for the South hold analogously.

The representative household maximizes expected lifetime utility:

$$\max_{\{C_s, B_{s+1}, x_{s+1}\}_{s=t}^{\infty}} E_t \sum_{s=t}^{\infty} \beta^{s-t} \frac{C_s^{1-\gamma}}{1-\gamma},$$

where $\beta \in (0,1)$ is the subjective discount factor, C_t is the aggregate consumption basket, and $\gamma > 0$ is the inverse of the inter-temporal elasticity of substitution. The budget constraint is:

$$C_t + (N_t + N_{E,t})\, \tilde{v}_t x_{t+1} + B_{N,t+1} = \left(\tilde{v}_t + \tilde{d}_t\right) N_t x_t + (1 + r_t)\, B_{N,t} + w_{h,t} H + w_{l,t} L + T_t. \quad (1)$$

The household purchases two types of assets. First, it purchases x_{t+1} shares in a mutual fund of Northern firms, which includes N_t incumbent firms producing either domestically or offshore at time t, and also $N_{E,t}$ new entrants in period t. The date t price of a claim to the future profit stream of the mutual fund of $N_t + N_{E,t}$ Northern firms is equal to the average nominal price of claims to future profits of Northern firms, $P_t\tilde{v}_t$. The mutual fund pays a total profit that is equal to the average total profits of all Northern firms that produce in that period, $P_t\tilde{d}_tN_t$. The household also receives dividends equal to the average firm profit $\tilde{d}_t$ proportional to the mass of firms N_t. The household also purchases the risk free bond issued by its own country $B_{N,t+1}$, denominated in units of the issuing country's consumption basket. The domestic risk-free bond pays interest rate r_t. Entering period t, the household has share holdings x_t in a mutual fund of N_t Northern firms whose average market value is $\tilde{v}_t$. There are two types of labor – high-skilled labor and low-skilled labor, supplied inelastically, earning real wages $w_{h,t}$ and $w_{l,t}$, while pooling income together. The household also receives transfers from the Northern government.

The consumption basket for the Northern household includes varieties produced by the Northern firms (some of which are offshoring firms), as well as goods produced by the Southern exporters, with the elasticity of substitution $\theta > 1$:

$$C_t = \left[\int_{z_{\min}}^{z_{V,t}} y_{D,t}(\omega)^{\frac{\theta-1}{\theta}} d\omega + \int_{z_{V,t}}^{\infty} y_{V,t}(\omega)^{\frac{\theta-1}{\theta}} d\omega + \int_{z_{X,t}^*}^{\infty} y_{X,t}^*(\omega)^{\frac{\theta-1}{\theta}} d\omega\right]^{\frac{\theta}{\theta-1}}. \tag{2}$$

Each variety $\omega \in \Omega$ is produced by a different firm. As explained below, Northern firms with productivity above the offshoring cutoff $z_{V,t}$ will offshore the low-skilled tasks to the South, whereas firms with productivity above $z_{\min}$ but below $z_{V,t}$ produce their varieties using domestic high-skilled and low-skilled labor tasks. The consumption-based price index for the North is then $P_t = \left(\int_{\omega\in\Omega_t} p_t(\omega)^{1-\theta}d\omega\right)^{1/(1-\theta)}$. Setting the consumption basket C_t as numeraire, the price index for the North is $1 = \left[\rho_t(\omega)^{1-\theta}d\omega\right]^{\frac{1}{1-\theta}}$, where $\rho_t(\omega)$ is the real price of goods of different varieties. The household's demand for each individual good variety ω is $c_t(\omega) = \rho_t^{-\theta}C_t$.

The Southern household earns real wage rate $w_{l,t}^*$ and $w_{h,t}^*$, in units of Southern consumption basket. It maximizes a similar utility function. However, the composition of the consumption basket is different. The subset of goods available for consumption in the South Ω_t^* consists of goods produced by the Southern firms (some of which are offshoring firms), as well as goods produced by the Northern exporters, which is expressed as:

$$C_t^* = \left[\int_{z_{\min}}^{z_{V,t}^*} y_{D,t}^* (\omega)^{\frac{\theta}{\theta-1}} d\omega + \int_{z_{V,t}^*}^{\infty} y_{V,t}^* (\omega)^{\frac{\theta}{\theta-1}} d\omega + \int_{z_{X,t}}^{\infty} y_{X,t} (\omega)^{\frac{\theta-1}{\theta}} d\omega \right]^{\frac{\theta}{\theta-1}}.$$

Northern household's utility maximization problem delivers the following Euler equation for bonds,

$$1 = \beta (1 + r_{t+1}) E_t \left[\left(\frac{C_{t+1}}{C_t} \right)^{-\gamma} \right] \tag{3}$$

and the Euler equation for stocks

$$\tilde{v}_t = \beta (1 - \delta) E_t \left[\left(\frac{C_{t+1}}{C_t} \right)^{-\gamma} \left(\tilde{d}_{t+1} + \tilde{v}_{t+1} \right) \right], \tag{4}$$

where δ is firms' exogenous exit rate, which reflects the random exit shock that can hit all firms including the entrants every period. Similar equations also hold for the Southern households.

2.2 Firms

Firm entry in the North (South) requires an entry cost that is equal to f_E (f_E^*) effective labor units, which is equal to $\frac{f_E}{Z_t} \left(\frac{w_{l,t}}{1-\alpha} \right)^{1-\alpha} \left(\frac{w_{h,t}}{\alpha} \right)^{\alpha}$ units of the Northern consumption basket. Part of the entry cost is subsidized by Northern government with the rate equal to s_E. After paying the sunk entry cost, each firm is randomly assigned an idiosyncratic productivity z which is drawn from a Pareto distribution over the interval $[z_{\min}, \infty)$. This productivity stays the same for the firm's entire term of operation. Southern firms draw productivity levels from an identical distribution over the same interval. Therefore, there are $N_{E,t}$ new firms entering the market every period and start producing in the next period. With all firms including the new entrants being subject to a random death shock with probability δ at the end of every period, the law of motion for the mass of firms is $N_{t+1} = (1 - \delta) (N_t + N_{E,t})$. Similar to Ghironi and Melitz (2005), the sunk entry cost together with the time to build assumption is crucial in generating endogenously persistent dynamics in our model.

Every period, the new entrants form expectation of their post-entry firm value $\tilde{v}_t$, which is a function of the stochastic discount factor, the probability of exit δ and the expected monopolistic stream of profits $\tilde{d}_t$. Equation (4) yields the expected post-entry value of the average firm:

$$\tilde{v}_t = E_t \sum_{s=t+1}^{\infty} [\beta(1-\delta)]^{s-t} \left(\frac{C_s}{C_t}\right)^{-\gamma} \tilde{d}_s \tag{5}$$

As a result, every period, potential entrants make their decision of entering or not by comparing the sunk entry cost that they need to pay upfront before entry with the expected profits after entry. In equilibrium, firm entry takes place until the expected value of the average firm value is equal to the sunk entry cost : $\tilde{v}_t = (1-s_E)\frac{f_E}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$, which is $(1-s_E)f_E$ times the cost of effective labor.

Firms' Production Location and Market Decisions

The structure of firms' offshoring decisions is based on Zlate (2016), with the main difference being that there are two types of labor in our setting. There is one final-good sector.[5] Firms are all final-good producers with heterogeneity in their productivities, each producing a different variety of the final goods. Production of the final good requires two tasks – y_h and y_l. Task y_h uses high skilled labor only and task y_l uses low skilled labor only. The production function is assumed to take the following form: $y_t(z) = [y_{h,t}(z)]^{\alpha}[y_{l,t}(z)]^{1-\alpha}$.[6]

The high and low-skilled endowments of each country are set up to deliver a cost relationship, where some firms in the North have incentive to offshore the low-skilled task to the South, to utilize the associated cost advantage. Similarly, some firms in the South have incentive to offshore the high-skilled tasks to the North. Each task is subject to its source country's aggregate productivity. Each firm has a different relative productivity z, with which it transforms the two tasks into the final output. The productivity differences across firms translate into differences in the unit cost of production. Every period, firms choose to produce each task either domestically or offshore.

Production Location Strategies for Firms in the North

For a firm in the North, if it decides to produce both tasks domestically, then $y_{h,t}(z) = zZ_th_t(z)$ and $y_{l,t}(z) = zZ_tl_t(z)$. If the firm instead decides to offshore the low-skilled task, $y_{h,t}(z) =$

[5] In the same spirit as Melitz (2003), the model is best thought of as that of the tradable sector, part of which turns out to be non-traded in equilibrium.

[6] In Antras and Helpman (2004), the output of a firm z is a Cobb-Douglas function of two inputs that use domestic and foreign inputs respectively, $y_{V,t} = \left[\frac{Z_tzl_t}{\alpha}\right]^{\alpha}\left[\frac{Z_t^*zl_t^*}{1-\alpha}\right]^{1-\alpha}$.

$zZ_t h_t(z)$ but $y_{l,t}(z) = zZ_t^* l_t^*(z)$. Offshoring the low-skilled task to the South incurs an iceberg cost τ^V, which is reflected on the cost side of firm's profit maximization problem. Therefore, the output of producing both tasks domestically is $y_{D,t}(z) = zZ_t \left[h_t(z)\right]^{\alpha} \left[l_t(z)\right]^{1-\alpha}$. In contrast, keeping the high-skilled task produced in-house and offshoring the low-skilled tasks generates output $y_{V,t}(z) = z\left[Z_t h_t(z)\right]^{\alpha} \left[Z_t^* l_t^*(z)\right]^{1-\alpha}$.

Cost minimization pins down the number of high-skilled and low-skilled workers each firm hires to produce one unit of output, depending on the wages, firms' relative productivity z and aggregate productivities Z_t and Z_t^*. For the firms in the North, the marginal costs of production for the two strategies then follow — $mc_{D,t}(z) = \frac{1-s_D}{Z_t z}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$ for domestically producing firms, where s_D stands for the production subsidy received from the Northern government. To separate out the effect of import tariff from that of offshoring friction, we assume tariff is only levied on final goods, not on tasks. Thus, the marginal cost of offshoring firms is given by $mc_{V,t}(z) = \frac{1}{z}\left(\frac{\tau^V Q_t w_{l,t}^*}{Z_t^*(1-\alpha)}\right)^{1-\alpha}\left(\frac{w_{h,t}}{Z_t \alpha}\right)^{\alpha}$, where $w_{l,t}$ is the real wage for low-skilled labor and $w_{h,t}$ is the real wage for high-skilled labor.[7] Similarly, $w_{l,t}^*$ is the real wage for the Southern low-skilled labor. The monopolistically competitive firms maximize profits for the two different production strategies:

$$\max_{\rho_{D(z)}} d_{D,t}(z) = \rho_{D,t}(z)y_{D,t}(z) - mc_{D,t}(z)y_{D,t}(z) \tag{6}$$

$$\max_{\rho_{V(z)}} d_{V,t}(z) = \rho_{V,t}(z)y_{V,t}(z) - mc_{V,t}(z)y_{V,t}(z) - f_V \frac{Q_t}{Z_t^*}\left(\frac{w_{l,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}^*}{\alpha}\right)^{\alpha} \tag{7}$$

where $\rho_D(z)$ and $\rho_V(z)$ are the real prices of the two production strategies. Offshoring firms also need to pay the fixed offshoring cost f_V units of Southern effective labor, which is associated with building and running maintenance of the factories and facilities offshore. Following Zlate (2016), we assume that Northern offshoring firms hire workers from Southern labor market to cover these fixed offshoring costs. Therefore, the fixed offshoring cost is $f_V \frac{Q_t}{Z_t^*}\left(\frac{w_{l,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}^*}{\alpha}\right)^{\alpha}$ units of the Northern consumption basket. It can be interpreted as a friction (e.g., a non-tariff trade barrier) or productivity disadvantage (less control and monitoring over the products) due to distance.

The demand for variety produced by firm z using the two production strategies are $y_{D,t}(z) =$

[7] Although our model features a one-sector setting, the two tasks could be interpreted as two intermediate goods. Hence, friction on offshoring tasks can be viewed as trade friction on intermediate goods, and thus as a targeted intervention in the intermediate good sector.

$\rho_{D,t}(z)^{-\theta}C_t$ and $y_{V,t}(z) = \rho_{V,t}(z)^{-\theta}C_t$. Prices are at a markup over marginal costs, with pricing conditions: $\rho_{D,t}(z) = \frac{\theta}{\theta-1}mc_{D,t}(z)$ and $\rho_{V,t}(z) = \frac{\theta}{\theta-1}mc_{V,t}(z)$. Profits are $d_{D,t}(z) = \frac{1}{\theta}\rho_{D,t}(z)^{1-\theta}C_t$ for domestic production and $d_{V,t}(z) = \frac{1}{\theta}\rho_{V,t}(z)^{1-\theta}C_t - f_V \frac{Q_t}{Z_t^*}\left(\frac{w_{l,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}^*}{\alpha}\right)^{\alpha}$ for offshoring the low-skilled task.

The offshoring cutoff $z_{V,t}$ is pinned down by equalizing profits of the two strategies for firms' production: $z_{V,t} = \{z|d_{D,t}(z_{V,t}) = d_{V,t}(z_{V,t})\}$. It indicates that at this productivity level $z_{V,t}$, producing both tasks domestically and offshoring the low-skilled task generate the same profit. Every period, a firm compares, based on its productivity level, whether the strategy of producing both tasks domestically or that of offshoring the low-skilled task yields higher profits. The cutoff is time-varying; it is responsive to changes in the labor cost of two types of labor across the two countries as well as the iceberg trade cost. The set of offshoring firms fluctuates over time with changes in the profitability of offshoring. A lowering of the trade cost or the wage cost of the low-skilled workers abroad increases the profitability of offshoring and thus lowers the offshoring cutoff, incentivizing more firms to offshore.

Consistent with the implications of Zlate (2016), firms with productivity level above the cutoff productivity self select into offshoring since the benefit of offshoring outweighs the cost. In order to ensure the existence of the offshoring cutoff, the slope of offshoring profit function must exceed the slope of domestic profit function. This gives the following condition:

$$\tau^V (1 - s_D)^{\frac{1}{\alpha-1}} \, TOL_l < 1 \tag{8}$$

where $TOL_l = \frac{Q_t w_{l,t}^*/Z_t^*}{w_{l,t}/Z_t}$ stands for the ratio between the cost of effective low-skill labor in the South and the North expressed in the same currency. This condition states that effective low-skill wage in the South must be sufficiently lower than in the North, so that the North still finds it profitable to offshore these tasks abroad amidst all the industrial policies driven by geoeconomic tension.

Production Location Strategies for Firms in the South

Similarly, for a firm in the South, if it decides to produce both tasks domestically, then $y_{D,t}^*(z) = zZ_t^*\left[h_t^*(z)\right]^{\alpha}\left[l_t^*(z)\right]^{1-\alpha}$. The South offshoring firms share a very similar production with North offshoring firms, the only difference comes from the fact that now the offshoring of high-skilled task to the North will incur iceberg cost τ^{V*}, which is reflected on the cost side of firm's profit maximization problem. The corresponding marginal costs of production for the two strategies then follow — $mc^*_{D,t}(z) = \frac{1-s^*_D}{Z^*_t z}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$ for domestically producing firms. The marginal cost of offshoring firms is $mc^*_{V,t}(z) = \frac{1}{z}\left(\frac{w^*_{l,t}}{Z^*_t(1-\alpha)}\right)^{1-\alpha}\left(\frac{\tau^{V*}Q_t^{-1}w_{h,t}}{Z_t\alpha}\right)^{\alpha}$. The monopolistically competitive firms set optimal prices to maximize profits for the two different production strategies:

$$
\begin{aligned}
&\max_{\rho^*_{D(z)}} \ d^*_{D,t}(z) = \rho^*_{D,t}(z)y^*_{D,t}(z) - mc^*_{D,t}(z)y^*_{D,t}(z) \\
&\max_{\rho^*_{V(z)}} \ d^*_{V,t}(z) = \rho^*_{V,t}(z)y^*_{V,t}(z) - mc^*_{V,t}(z)y^*_{V,t}(z) - f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}
\end{aligned}
$$

The corresponding condition to ensure the existence of the offshoring cutoff is the following:

$$
(\tau^{V*})^{-1}(1-s^*_D)^{\frac{1}{\alpha}}TOL_h > 1 \tag{9}
$$

where $TOL_h = \frac{Q_t w^*_{h,t}/Z^*_t}{w_{h,t}/Z_t}$ stands for the ratio between the cost of effective high-skill labor in the South and the North expressed in the same currency. This condition states that effective high-skill wage in the North must be sufficiently lower than in the South, so that the South still finds it profitable to offshore these tasks abroad in the midst of all the geoeconomic tensions generated by industrial policies. We will set the high-skilled and low-skilled endowment of labor of each country such that both condition (8) and condition (9) are satisfied.

Exporting

Firms in the North and the South not only serve their domestic market, but can also choose to serve the foreign market through exports, as in Ghironi and Melitz (2005). In the North, the firm with productivity level z produces goods for exporting using domestic low-skilled and high-skilled labor $l_{X,t}(z)$ and $h_{X,t}(z)$, generating output $y_{X,t}(z) = zZ_t\left[h_{X,t}(z)\right]^{\alpha}\left[l_{X,t}(z)\right]^{1-\alpha}$. The Southern exporters produce output in a similar fashion, $y^*_{X,t}(z) = zZ^*_t\left[h^*_{X,t}(z)\right]^{\alpha}\left[l^*_{X,t}(z)\right]^{1-\alpha}$. Profit maximization implies that the price of exports for a firm with productivity level z is $\rho_{X,t}(z) = \frac{\theta}{\theta-1}\frac{\tau Q_t^{-1}}{zZ_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$. Notice that $\rho_{X,t}(z)$ is the dock export price, i.e. it does not include Southern import tariff. The profit function is thus given by: $d_{X,t}(z) = \frac{1}{\theta}(1+\tau^{IM*})^{-\theta}\rho_{X,t}(z)^{1-\theta}C^*_tQ_t - \frac{f_X}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$, where C^*_t is aggregate consumption in the South,

τ^{IM*} is the ad-valorem tariff imposed by South on North exporters' sales. In terms of a firm's export decisions, a firm will export if and only if the export profit it would earn is nonnegative, giving export cutoff for firms of $z_{X,t} = \inf\{z|d_{X,t}(z) > 0\}$. Firms with productivity level above the export cutoff $z_{X,t}$ choose to export whereas firms with productivity level below $z_{X,t}$ choose to serve the domestic market only.

2.3 Averages

The model is isomorphic to a framework with three representative firms in the North: one produces both tasks domestically. A second offshores the low-skilled task and only produces the high-skilled task in the North (both serving the domestic market). A third produces both tasks domestically and engages in exporting.

Average Productivities

Firms' productivities are drawn from the Pareto distribution over the interval $[z_{\min}, \infty)$, where the common distribution is $G(z)$ with density $g(z)$. Every period in the North, there are $N_{D,t}$ firms, whose idiosyncratic productivities are below the offshoring cutoff $z_{\min} < z_t < z_{V,t}$, that produce both tasks domestically. Then there are $N_{V,t}$ firms with productivity levels above the cutoff $z_t > z_{V,t}$ that choose to offshore. We denote average productivity of domestically producing firms as $\tilde{z}_{D,t}$ and that of offshoring firms as $\tilde{z}_{V,t}$. The average productivity levels follow as:

$$\tilde{z}_{D,t} = \left[\frac{1}{G\left(z_{V,t}\right)} \int_{z_{\min}}^{z_{V,t}} z^{\theta-1} g(z) dz\right]^{\frac{1}{\theta-1}} \text{ and } \quad \tilde{z}_{V,t} = \left[\frac{1}{1-G\left(z_{V,t}\right)} \int_{z_{V,t}}^{\infty} z^{\theta-1} g(z) dz\right]^{\frac{1}{\theta-1}}.$$

With the assumption that the Pareto distribution of the productivity has p.d.f. $g(z) = kz_{\min}^k / z^{k+1}$ and c.d.f. $G(z) = 1 - \left(z_{\min}/z\right)^k$, the average productivity levels $z_{D,t}$ and $z_{V,t}$ can both be expressed as functions of the offshoring productivity cutoff $z_{V,t}$:

$$\tilde{z}_{D,t} = \nu z_{\min} z_{V,t} \left[\frac{z_{V,t}^{k-(\theta-1)} - z_{\min}^{k-(\theta-1)}}{z_{V,t}^k - z_{\min}^k}\right]^{\frac{1}{\theta-1}} \text{ and } \quad \tilde{z}_{V,t} = \nu z_{V,t}$$

where $\nu = \left[\frac{k}{k-(\theta-1)}\right]^{\frac{1}{\theta-1}}$, $k > \theta - 1$, and the cutoff is $z_{V,t} = z_{\min}\left(N_t/N_{V,t}\right)^{1/k}$.

Similarly, in the South, the average productivity for the firms which produces both tasks domestically and the average productivity for those which offshore the high-skilled task to the

North are:

$$\tilde{z}^*_{D,t} = \nu z_{\min} z^*_{V,t} \left[\frac{{z^*_{V,t}}^{k-(\theta-1)} - z_{\min}^{k-(\theta-1)}}{{z^*_{V,t}}^{k} - z_{\min}^{k}} \right]^{\frac{1}{\theta-1}} \quad \text{and} \quad \tilde{z}^*_{V,t} = \nu z^*_{V,t}$$

where $z^*_{V,t}$ is the offshoring productivity cutoff for firms in the South.

The average productivity of exporting firms in the North and the South are:

$$\tilde{z}_{X,t} = \nu z_{\min} \left(\frac{N_t}{N_{X,t}} \right)^{1/k} \quad \text{and} \quad \tilde{z}^*_{X,t} = \nu z^*_{\min} \left(\frac{N^*_t}{N^*_{X,t}} \right)^{1/k}$$

Average Price Indices

The average price indices for the North and the South follow as

$$\begin{aligned} 1 &= N_{D,t} \left(\tilde{\rho}_{D,t}\right)^{1-\theta} + N_{V,t} \left(\tilde{\rho}_{V,t}\right)^{1-\theta} + N^*_{X,t} \left((1+\tau^{IM}) \tilde{\rho}^*_{X,t} \right)^{1-\theta} \\ 1 &= N^*_{D,t} \left(\tilde{\rho}^*_{D,t}\right)^{1-\theta} + N^*_{V,t} \left(\tilde{\rho}^*_{V,t}\right)^{1-\theta} + N_{X,t} \left((1+\tau^{IM*}) \tilde{\rho}_{X,t} \right)^{1-\theta}. \end{aligned}$$

Average Profits

The total profits of firms in the two countries are $N_t \tilde{d}_t = N_{D,t}\tilde{d}_{D,t} + N_{V,t}\tilde{d}_{V,t} + N_{X,t}\tilde{d}_{X,t}$ and $N^*_t \tilde{d}^*_t = N^*_{D,t}\tilde{d}^*_{D,t} + N^*_{V,t}\tilde{d}^*_{V,t} + N^*_{X,t}\tilde{d}^*_{X,t}$. The linkages between the average profit of offshoring and that of domestically producing both tasks are:

$$\begin{aligned} \tilde{d}_{V,t} &= \frac{k}{k-(\theta-1)} \left(\frac{z_{V,t}}{\tilde{z}_{D,t}} \right)^{\theta-1} \tilde{d}_{D,t} + \frac{\theta-1}{k-(\theta-1)} f_V \frac{Q_t}{Z^*_t} \left(\frac{w^*_{l,t}}{1-\alpha} \right)^{1-\alpha} \left(\frac{w^*_{h,t}}{\alpha} \right)^{\alpha} \\ \tilde{d}^*_{V,t} &= \frac{k}{k-(\theta-1)} \left(\frac{z^*_{V,t}}{\tilde{z}^*_{D,t}} \right)^{\theta-1} \tilde{d}^*_{D,t} + \frac{\theta-1}{k-(\theta-1)} f^*_V \frac{Q_t^{-1}}{Z_t} \left(\frac{w_{l,t}}{1-\alpha} \right)^{1-\alpha} \left(\frac{w_{h,t}}{\alpha} \right)^{\alpha}. \end{aligned}$$

From the above relationships, it can be noted that the average profit of offshoring firms is higher than that of domestically-producing firms, because firms above the productivity cutoff self select into offshoring.

Exploiting the property that the firm at the productivity cutoff $z_{X,t}$ obtains zero profits from exporting, the average profits from exports can be expressed as:

$$\begin{aligned} \tilde{d}_{X,t} &= \frac{\theta-1}{k-(\theta-1)} \frac{f_X}{Z_t} \left(\frac{w_{l,t}}{1-\alpha} \right)^{1-\alpha} \left(\frac{w_{h,t}}{\alpha} \right)^{\alpha} \\ \tilde{d}^*_{X,t} &= \frac{\theta-1}{k-(\theta-1)} \frac{f^*_X}{Z_t} \left(\frac{w^*_{l,t}}{1-\alpha} \right)^{1-\alpha} \left(\frac{w^*_{h,t}}{\alpha} \right)^{\alpha}. \end{aligned}$$

2.4 Closing the Model

There are labor market clearing conditions for both high-skilled and low-skilled labor, governments in both countries balance their budgets, aggregate accounting across households and balance of international payments. A full summary of the model equations is in Table A.1.

Labor Market

Here we explicitly set out the high-skilled labor market clearing conditions, noting that those for the low-skilled will be implicitly implied by all other equilibrium conditions in the model. Denote $\tilde{h}_{D,t}$ as the amount of high-skilled labor used by the representative domestically producing firms that serve the domestic market, $\tilde{h}_{V,t}$ as that used by the representative offshoring firms, and $\tilde{h}_{X,t}$ by the representative exporter. The high-skilled labor market clearing conditions for the two countries then are:

$$
\begin{aligned}
H =& N_{D,t}\tilde{h}_{D,t} + N_{X,t}\tilde{h}_{X,t} + N_{V,t}\tilde{h}_{V,t} + N^*_{V,t}\tilde{h}^*_{V,t}\tau^{V*} \\
&+ \left(N_{E,t}\frac{f_E}{Z_t} + N_{X,t}\frac{f_X}{Z_t} + N^*_{V,t}\frac{f^*_V}{Z_t} \right) \left(\frac{\alpha w_{l,t}}{(1-\alpha) w_{h,t}} \right)^{1-\alpha} \\
H^* =& N^*_{D,t}\tilde{h}^*_{D,t} + N^*_{X,t}\tilde{h}^*_{X,t} + \left(N^*_{E,t}\frac{f^*_E}{Z^*_t} + N^*_{X,t}\frac{f^*_X}{Z^*_t} + N_{V,t}\frac{f_V}{Z^*_t} \right) \left(\frac{\alpha w^*_{l,t}}{(1-\alpha) w^*_{h,t}} \right)^{1-\alpha}
\end{aligned}
$$

Northern high-skilled labor is used for production by domestically-producing firms (serving either the domestic or export market), Northern offshoring firms and Southern offshoring firms, as well as for sunk entry costs, fixed exporting costs and fixed offshoring costs.[8] In contrast, the Southern high-skilled labor is used for production by only the domestically producing firms and for sunk entry costs, fixed exporting costs and fixed offshoring costs. Similarly, the low-skilled labor market clearing conditions for the two countries are:

$$
\begin{aligned}
L_t =& N_{D,t}\tilde{l}_{D,t} + N_{X,t}\tilde{l}_{X,t} + \left(N_{E,t}\frac{f_E}{Z_t} + N_{X,t}\frac{f_X}{Z_t} + N^*_{V,t}\frac{f^*_V}{Z_t} \right) \left(\frac{(1-\alpha) w_{h,t}}{\alpha w_{l,t}} \right)^{\alpha} \\
L^*_t =& N^*_{D,t}\tilde{l}^*_{D,t} + N^*_{X,t}\tilde{l}^*_{X,t} + N_{V,t}\tilde{l}_{V,t}\tau^{V} + N^*_{V,t}\tilde{l}^*_{V,t} \\
&+ \left(N^*_{E,t}\frac{f^*_E}{Z^*_t} + N^*_{X,t}\frac{f^*_X}{Z^*_t} + N_{V,t}\frac{f_V}{Z^*_t} \right) \left(\frac{(1-\alpha) w^*_{h,t}}{\alpha w^*_{l,t}} \right)^{\alpha}.
\end{aligned}
$$

Government

[8] With a slight abuse of notation, we define the South's demand of high-skill labor from North as $\tilde{h}^*_{V,t}$. A similar definition is also made for North's demand of low-skill labor from South.

The Northern government keeps a balanced budget for each period:

$$
\begin{aligned}
&\tau^{IM} N^*_{X,t} \tilde{\rho}^*_{X,t} [(1+\tau^{IM})\tilde{\rho}^*_{X,t}]^{-\theta} C_t \\
&= s_E N_{E,t} \frac{f_E}{Z_t} \left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha} \left(\frac{w_{h,t}}{\alpha}\right)^{\alpha} + s_D N_{D,t} \tilde{\rho}_{D,t}^{-\theta} C_t \frac{1}{Z_t \tilde{z}_D} \left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha} \left(\frac{w_{h,t}}{\alpha}\right)^{\alpha} + T_t,
\end{aligned} \tag{10}
$$

which states that the sum of ad valorem tariffs must be equal to the sum of entry subsidy, production subsidy and transfer to the households in each period. Similarly, the balanced budget for the Southern government is given by:

$$
\begin{aligned}
&\tau^{IM*} N_{X,t} \tilde{\rho}_{X,t} [(1+\tau^{IM*})\tilde{\rho}_{X,t}]^{-\theta} C^*_t \\
&= s^*_E N^*_{E,t} \frac{f^*_E}{Z^*_t} \left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha} \left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha} + s^*_D N^*_{D,t} \tilde{\rho}_{D,t}^{*-\theta} C^*_t \frac{1}{Z^*_t \tilde{z}^*_D} \left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha} \left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha} + T^*_t.
\end{aligned} \tag{11}
$$

Aggregate Accounting

Aggregating the budget constraint (1) across Northern households and imposing the equilibrium conditions of bonds and shares ($B_{t+1} = B_t = 0$ and $x_{t+1} = x_t = 1$) yields the aggregate accounting equation $C_t = w_{l,t}L + w_{h,t}H + T_t + N_t\tilde{d}_t - N_{E,t}\tilde{v}_t$. A similar equation holds in the South. Consumption in each period must equal labor income plus government transfer plus investment income net of the cost of investing in new firms.

Balance of Payments

The balance of international payments (expressed in units of the Northern consumption basket) requires that the trade balance equals the net aggregate fixed offshoring cost:

$$
TB_t = N_{V,t} f_V \frac{Q_t}{Z^*_t} \left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha} \left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha} - N^*_{V,t} f^*_V \frac{1}{Z_t} \left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha} \left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}.
$$

The trade balance, TB_t, is given by the value of regular exports and the value offshoring exports of high-skilled tasks minus the value of offshoring imports of low-skilled tasks and the value of regular imports:

$$
\begin{aligned}
TB_t \equiv\ & \underbrace{N_{X,t} \tilde{\rho}_{X,t} \left((1+\tau^{IM*})\tilde{\rho}_{X,t}\right)^{-\theta} C^*_t Q_t}_{\text{Regular exports}} + \underbrace{\tau^{V*} N^*_{V,t} w_{h,t} \tilde{h}^*_{V,t}}_{\text{Offshoring exports}} \\
& - \underbrace{\tau^{V} N_{V,t} w^*_{l,t} \tilde{l}_{V,t} Q_t}_{\text{Offshoring imports}} - \underbrace{N^*_{X,t} \tilde{\rho}^*_{X,t} \left((1+\tau^{IM})\tilde{\rho}^*_{X,t}\right)^{-\theta} C_t}_{\text{Regular imports}}.
\end{aligned} \tag{12}
$$

Model Summary

The equations listed above constitute a system of 57 equations in 57 endogenous variables: C_t, r_t, $\tilde{v}_t$, $\tilde{d}_t$, $w_{l,t}$, $w_{h,t}$, N_t, $N_{E,t}$, $N_{D,t}$, $N_{V,t}$, $N_{X,t}$, $\tilde{\rho}_{D,t}$, $\tilde{\rho}_{V,t}$, $\tilde{\rho}_{X,t}$, T_t, $\tilde{d}_{D,t}$, $\tilde{d}_{V,t}$, $\tilde{d}_{X,t}$, $\tilde{z}_{D,t}$, $z_{V,t}$, $\tilde{z}_{V,t}$, $\tilde{z}_{X,t}$, $\tilde{h}_{D,t}$, $\tilde{h}_{V,t}$, $\tilde{h}_{X,t}$, $\tilde{l}_{D,t}$, $\tilde{l}_{V,t}$, $\tilde{l}_{X,t}$, their Southern counterparts and the real exchange rate Q_t. We list all the model equations in Appendix A and describe our computation methods in detail in Appendix C.

3 Calibration

We interpret the skill-abundant North as the United States and the skill-scarce South as China. Our model and calibration are developed with a view towards demonstrating the mechanisms of firm entry and comparative advantage of producing different tasks in driving the welfare trade-offs across different time horizons and the distributional implications. For this reason, we keep the asymmetries across the two countries to a minimum.

In particular, we take one period in the model to be a quarter and set the discount factor $\beta = 0.99$ to match an average annualized interest rate of 4%. We calibrate the (inverse) intertemporal elasticity $\gamma = 2$-standard choice for quarterly business cycle models. Following Ghironi and Melitz (2005), elasticity of substitution between varieties is $\theta = 3.8$, the shape parameter of productivity distribution is $k = 3.4$ and physical iceberg cost is $\tau = 1.3$. We set the quarterly death rate of firms $\delta = 0.025$, which is consistent with the yearly exit rates reported in U.S. firm data around of 10% (see Tian (2018)). We set the production function parameter $\alpha = 0.4$, which implies the wage share of high skilled workers to be 40%.

The set of parameters $\{f_X, f_X^*, f_V, f_V^*\}$ are calibrated internally to approximately match the fractions of exporting and offshoring firms, of around 9% and 1%, which are the steady-state values obtained in Zlate (2016), respectively in each country. This procedure leads to the choice of the values of $f_X = f_X^* = 0.25$, $f_V = 0.191$ and $f_V^* = 0.04$. The sunk cost of entry in the North f_E is chosen to normalize the high-skilled wage in the North to unity; we then take the counterpart in the South to be identical $f_E^* = f_E$.

The main source of asymmetry between the North and the South in the calibration is the relative endowments of the two types of labor. To reflect the context of US and China, we follow Lechthaler and Mileva (2021) to use the average production workers to managers ratio over 1990 and 2005 for the US as 3.5 to 1, and China as 9.5 to 1, respectively, to set the relative endowments of low-skill to high-skill labor, while the total endowment is normalized to unity. Together with the choices of other parameters, this ensures the offshoring conditions for both the North and the South are met. Thus, in our model offshoring occurs endogenously due to the comparative advantage in producing different tasks driven by the different relative endowment of labor.

Lastly, the four policy instruments in each country (import tariff, offshoring friction, production subsidy and entry subsidy) are assumed to follow an AR(1) process. To make the comparison of the dynamic effects across these policy instruments transparent, we set their persistence to be the same and calibrate $\zeta = 0.56$ as in Barattieri, Cacciatore and Ghironi (2021). The steady-state values of these instruments are set to reflect no government intervention. Table 1 summarizes the calibration.

Parameter	**Meaning**	**Value**	**Source/target**
β	discount factor	0.9900	average interest rate
γ	(inverse) intertemporal elasticity	2.0000	Ghironi and Melitz (2005)
θ	elasticity of substitution between varieties	3.8000	Ghironi and Melitz (2005)
k	shape parameter of productivity distribution	3.4000	Ghironi and Melitz (2005)
τ	melting-iceberg trade cost	1.3000	Ghironi and Melitz (2005)
z_{min}	lower bound of productivity	1.0000	normalization
δ	exogenous firm exit shock	0.0250	firm exit rate
α	skill intensity in production	0.4000	wage share of high-skilled
Z	steady state aggregate productivity	1.0000	normalization
ζ	persistence of policy process	0.5600	Barattieri, Cacciatore and Ghironi (2021)
H	endowment of high-skilled labor in North	0.2220	US production workers to managers ratio
L	endowment of low-skilled labor in North	0.7780	US production workers to managers ratio
H^*	endowment of high-skilled labor in South	0.0955	China production workers to managers ratio
L^*	endowment of low-skilled labor in South	0.9045	China production workers to managers ratio
f_V	fixed cost of offshoring in North	0.1910	fraction of offshoring firms
f_X	fixed cost of exporting in North	0.2500	fraction of exporting firms
f_V^*	fixed cost of offshoring in South	0.0400	fraction of offshoring firms
f_X^*	fixed cost of exporting in South	0.2500	fraction of exporting firms
f_E	sunk entry cost	14.522	normalization of high-skilled wage N
τ^{IM}	import tariff	0.0000	no steady state intervention
τ^V	iceberg friction on offshoring	1.0000	no steady state intervention
s_E	entry subsidy	0.0000	no steady state intervention
s_D	domestic production subsidy	0.0000	no steady state intervention

Table 1. Benchmark calibration

4 Industrial Policies Amidst Geoeconomic Tensions

In this section, we investigate the dynamic and welfare impacts of various industrial policies by solving for the transitional dynamics of the model to a first-order approximation around the steady state. We begin by looking at the impulse responses of the model, following a one-time shock of each industrial policy. We then explore the model's behavior when the policymaker explores all the possible combinations of industrial policies. Finally, we discuss the welfare implications of unilateral policy actions, as well as bilateral policy actions between the two countries, spanning over different time horizons.

4.1 Individual industrial policies

North increases import tariff τ^{IM}

The increase in the North's tariff makes the imported Southern varieties more costly to the Northern consumers, thus reducing their the demand for imported goods. It in turn implies a rise in the export cutoff (z_X^*) and a drop in the number of exporters (N_X^*) in the South. In the meantime, the real exchange rate (Q) appreciates (fall) in response to the decline in the demand for imported Southern goods, which renders the Northern exporters less competitive, thus also leading to a rise in the export cutoff (z_X) and a drop in the number of exporters (N_X) in the North, albeit slightly.

Note that the tariff is only levied on the imported goods (varieties), not on imported tasks[9], so the appreciation of the real exchange rate implies that the terms of labor for low-skilled (TOL_l) appreciates (fall), reducing the cost for importing low-skilled task from the South faced by the Northern offshoring firms. As a result, the offshoring cutoff (z_V) drops and the number of offshoring firms (N_V) rises in the North. Meanwhile, it raises the cost of offshoring high-skilled task to the North for the Southern offshoring firms, and thus causing a rise in the offshoring cutoff (z_V^*) and a drop in the number of offshoring firms (N_V^*) in the South.

Due to the higher average price (inclusive of tariff) of imported goods, the households in the North increase their demand for domestic goods (expenditure switching effect). This raises the profitability of the firms serving the domestic markets, inducing more firm entry. As firm entry demands investment, resources left for consumption decline on impact. However, as more firms/varieties are being created, consumption rises because of the love of variety of their preference. For the South, lower demand for its exports reduces the profitability of its firms, discouraging firm entry, and the number of firms drops. Moreover, as market share

[9]In our policy design, the cost of imported tasks is governed by the policy instrument of offshoring friction.

is reallocated towards less efficient domestic firms, it tends to depress the real income of its households. This, coupled with the higher average price of imports driven by the change in the real exchange rate, reduces the consumption in the South. The effects on the skill premium in both countries are small.

North increases offshoring friction τ^V

The increase in the North's offshoring friction directly raises the cost of offshoring imports of low-skilled task, lowering the profits of Northern offshoring firms. Consequently, it increases the offshoring cutoff (z_V) and reduces the number of offshoring firms (N_V) in the North. As these firms reshore their low-skilled task, it raises the demand for low-skilled labor in the North, while reducing that in the South. As a result, low-skilled wage rises in the North but falls in the South. The increase in the low-skilled wage in the North, together with the slight decline of its high-skilled wage, leads to a fall in the skill premium. Meanwhile, the reabsorbing of low-skilled labor into the domestic firms in the South drives up the wage for the high-skilled labor, which implies a rise in the skill premium of the South. This in turn depreciates the high-skilled terms of labor, thus raising the incentive to offshore high-skilled task to the North. It then leads to a drop in the offshoring cutoff (z_V^*) and a rise in the number of offshoring firms (N_V^*) in the South.

As the cost of offshoring imports from the South to the North rises, the demand for it drops, which results in an appreciation (fall) of the real exchange rate (Q) to reach the balance of payment. The appreciation of the real exchange rate in turn increases the competitiveness of the Southern exporters while reducing that of the Northern ones. Consequently, there is a decrease in the export cutoff (z_X^*) and a rise in the number of exporters (N_X^*) in the South, but an opposite response occurs in the North. As the prospects of both offshoring firms and exporters in the North deteriorate, firm entry declines. On the contrary, the boom of those firms in the South encourages firm entry. In order to finance the new entry, consumption in the South declines on impact.

North increases domestic production subsidy s_D

The increase in the production subsidy in the North reduces the marginal cost of production for the domestic firms, which raises their profits. As producing domestically and serving the domestic markets become more profitable, the cutoff values of both offshoring (z_V) and export (z_X) rise and the numbers of offshoring firms and exporters drop. In this sense, production subsidy induces firms to reshore.

More domestic production increases the demand for labor, which drives up both the low-skilled and high-skilled wages (w_l, w_h), with the latter increasing relatively less. The significant decline in the number of offshoring firms in the North (N_V) reduces the demand for Southern low-skilled labor, which imposes downward adjustment pressure on their wages (w_l^*). However, as these low-skilled labor being reabsorbed into the domestic firms and exporters in the South, they drive up the marginal product of high-skilled labor which implies higher high-skilled wages (w_h^*). Changes in these wages imply a decline in the skill premium of the North but a rise in that of the South.

Higher labor cost in the North reduces the competitiveness of Northern exporters. As the demand for Northern export declines, real exchange rate (Q) depreciates. It in turn causes the terms of labor for high-skilled (TOL_h) to depreciate slightly, which boosts the southern offshoring as reflected by as a drop in the offshoring cutoff (z_V^*) and a rise in the number of offshoring firms (N_V^*), albeit slightly.

Lastly, increases in the wages of the North, coupled with cheaper domestically produced varieties due to the production subsidy, raise the consumption of Northern households substantially on impact, while the higher price of imported goods and the decline in the low-skilled wage in the South depress the Southern consumption.

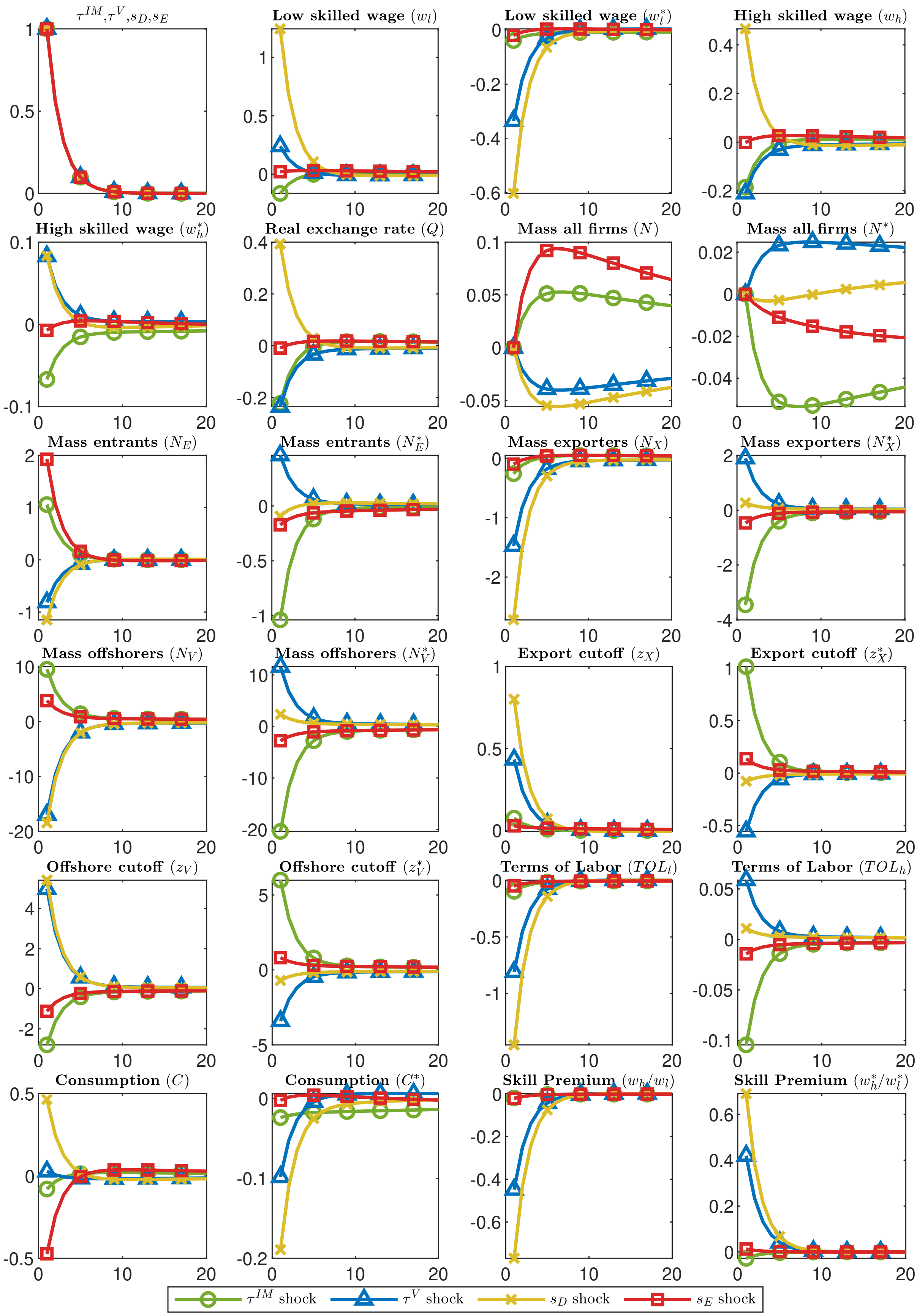

Figure 2. Impulse responses of North and South variables to 1% of individual industrial policy shocks in the North. The policy instrument is presented as absolute percentage points, while all other variables are presented as percentage deviations from the initial steady state (all after multiplication by 100).

North increases domestic entry subsidy s_E

The increase in the entry subsidy of the North immediately encourages firm entry (N_E) and leads to a gradual increase in the number of firms in the North (N) in the quarters after the shock. In order to finance the entry of new firms, Northern consumption (C) declines. Firm entry tends to raise the demand for labor, and it causes a slight appreciation (fall) in both TOL_l and TOL_h. The appreciation of TOL_l makes offshoring low-skill tasks to the South more profitable, which implies a drop in the North offshoring cutoff (z_V) and a rise in the North offshoring firms (N_V). Meanwhile, the appreciation of TOL_h makes offshoring high-skill tasks to the North less profitable, and it results in a rise in the South offshoring cutoff (z_V^*) and a drop in the number of South offshoring firms (N_V^*).

As the costs of effective low-skill and high-skill labor are now lower in the South compared to the North, it makes the exporters in the North less competitive, which implies a small rise in the export cutoff in the North (z_X) and a slight drop in the number of North exporters (N_X). While this tends to bolster the competitiveness of Southern exporters, the reduction in Northern consumption (hence the reduction in demand for imported goods from the South) has the opposite effect and dominates. As such, we observe an increase in the South export cutoff (z_X^*) and a drop in the number of South exporters (N_X^*).

Among the four instruments, the increase in the North's entry subsidy has the minimum impact on the wages for the two countries. Its effect on the skill premium is also negligible.

4.2 Combinations of Industrial Policies

In this subsection, we present the combined impact of several industrial policies that are introduced simultaneously.[10] In particular, we consider the following eight cases: (1) import tariff (τ^{IM}) + production subsidy (s_D), (2) import tariff (τ^{IM}) + entry subsidy (s_E), (3) import tariff (τ^{IM}) + offshoring friction (τ^V), (4) production subsidy (s_D) + offshoring friction (τ^V), (5) entry Subsidy (s_E) + offshoring friction (τ^V), (6) import tariff (τ^{IM}) + offshoring friction (τ^V) + production subsidy (s_D), (7) import tariff (τ^{IM}) + offshoring friction (τ^V) + entry subsidy (s_E), (8)

[10] We conduct the analysis of this section, as in the previous, through a first order perturbation around the steady state. Therefore, combinations of policies have linearly additive effects on endogenous variables, leaving no scope for amplification. As such, IRFs for multiple policies can be thought of as being linear combinations of those for the individual instruments; we explore these here as an accounting. We intend to study potential amplification, through higher order approximations, in future versions of this paper.

import tariffs (τ^{IM}) + offshoring friction (τ^{V}) + production subsidy (s_D) + entry subsidy (s_E).

In Figure 3, we present the impulse responses for the key variables in our model for the first four possible combinations of industrial policies from the North: (1) – (4). The combination of the import tariff (τ^{IM}) and production subsidy (s_D) (green line marked with circle) drives an appreciation (fall) in the low-skilled terms of labor (TOL_l) by over 1.5% on impact, while their offsetting effects on the high-skilled terms of labor (TOL_h) drive a more muted drop of around 0.1%. These policy actions give a 10% drop in the mass of offshorers (N_V), a 3% drop in the mass of exporters, and a tiny drop in entry (N_E) in the North on impact. This drives a lower short-term need for fixed costs, which releases resources for a boom in consumption (C) in the North for several quarters. As a consequence, the drop in the masses of Southern exporters (N_X^*) and offshorers (N_V^*) is less severe quantitatively than when the Northern tariff is used in isolation.

Combining the Northern tariff (τ^{IM}) and entry subsidy (s_E) (blue line marked with triangle) yields a substantial boom in the mass of Northern entrants (N_E) of over 3% and that of Northern offshorers (N_V) of over 10% on impact. The effect on the Southern cross-section is contractionary: the mass of Southern entrants (N_E^*) falls by 1%, while that of the Southern offshorers (N_V^*) falls by over 20% on impact.

The Northern Government's use of the import tariff (τ^{IM}) and offshoring friction (τ^{V}) together (yellow line marked with cross) inflicts a drop in Southern consumption (C^*) over 0.1%, while leaving Northern consumption (C) relatively unchanged. Note that the rise in the low-skilled wage (w_l) is much smaller in magnitude than the drop in the high-skilled wages (w_h) in the North, while a much more substantial drop in the Southern low-skilled wage (w_l^*) outweighs a modest increase in the high-skilled wage (w_h^*).

The Northern production subsidy (s_D) and offshoring friction (τ^{V}) have roughly the same quantitative impact on the mass of offshorers (N_V) when used individually (see Figure 2). When combined (red line marked with square), Figure 3 depicts a substantial contraction in this measure by close to 40% on impact. The mass of Northern entrants (N_E) contracts by 2% on impact, which gives a decline in the overall measure of firms (N) of around 0.1%, realized after around one year. Opposite qualitative effects follow for the mass of Southern entrants (N_E^*) and all firms (N^*), this rising investment of firms results in less resources for consumption and the Southern consumption (C^*) falls by around 0.3% on impact.

In Figure 4, we present the impulse responses for the key variables in our model for the second four possible combinations of industrial policies from the North: (5) – (8). Consider first the combination of the Northern entry subsidy (s_E) and offshoring friction (τ^V) (green line marked with circle). See that these instruments individually move the measures of entrants (N_E), all firms (N) and offshorers (N_V) in the North in opposite directions (see Figure 2); the entry subsidy pertains to new firms, the offshoring friction affects active incumbents. As such, when combined, Figure 4 shows relatively muted responses of cross-sectional variables. At the household level, Northern consumption (C) mostly tracks the IRF of the entry subsidy, while Southern consumption (C^*) instead follows that of the offshoring friction.

A key point to notice when combining the Northern tariff (τ^{IM}), offshoring friction (τ^V) and production subsidy (s_D) (blue line marked with triangle) is the asymmetry in consumption effects across the two countries. This combination of instruments gives around a 0.5% Northern consumption (C) boom, coupled with over a 0.3% contraction of that in the South (C^*), on impact. This latter effect follows from a powerful contraction in the low-skilled wage in the South (w_l^*) of close to 1% at the time of the shocks. When instead combining τ^{IM} and τ^V with the entry subsidy s_E (yellow line marked with cross), consumption drops in both countries. Lastly, when all four policy instruments are combined, consumption's path in the North (C) is almost unaffected, while the maximal decline in the low-skilled terms of labor (TOL_l) drives a contraction in Southern consumption (C^*).

4.3 Welfare

In this subsection, we first define how we calculate welfare in our model with and without geoeconomic tensions triggered by our industrial policies, both in the short-run and in the long-run. We then explore the welfare implications of each unilateral industrial policy, as well as their possible combinations, over different time horizons. In the end, we study the welfare of bilateral individual policy (i.e. one policy each time) as a proxy for countries that engage in policy war against each other.

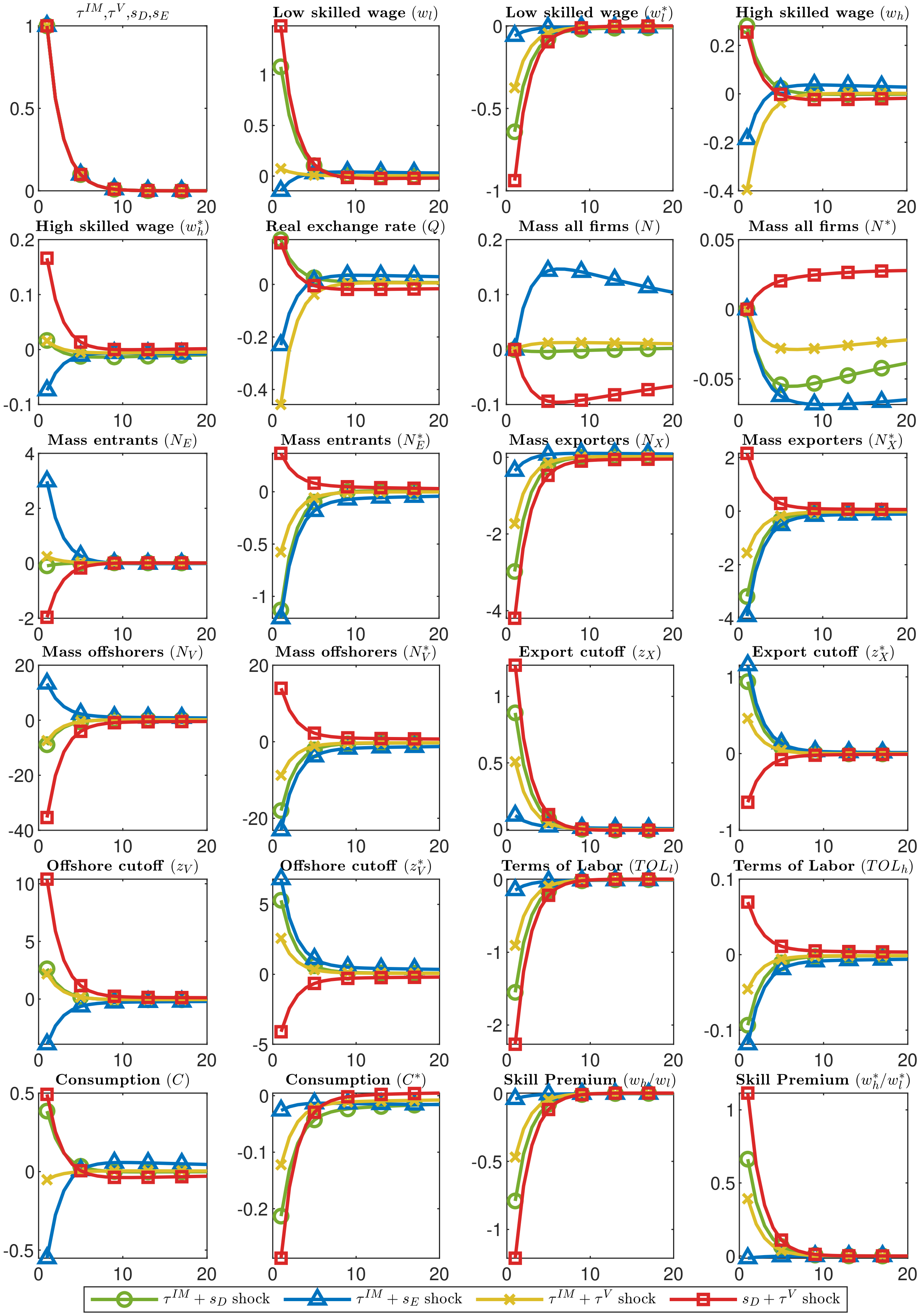

Figure 3. Impulse responses of North and South variables to 1% of combinations industrial policy shocks in the North. The policy instrument is presented as absolute percentage points, while all other variables are presented as percentage deviations from the initial steady state (all after multiplication by 100).

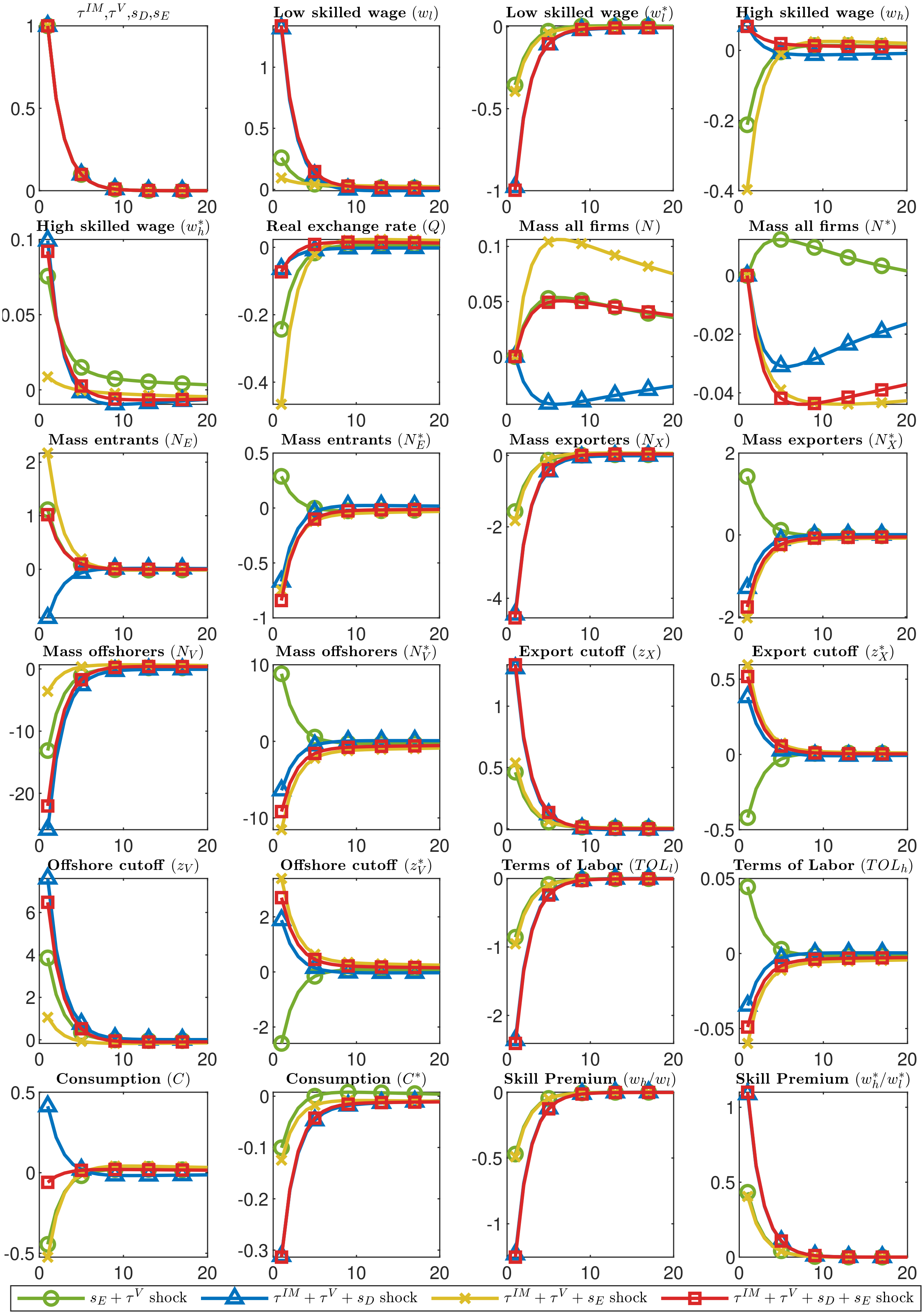

Figure 4. Impulse responses of North and South variables to 1% of combinations industrial policy shocks in the North. The policy instrument is presented as absolute percentage points, while all other variables are presented as percentage deviations from the initial steady state (all after multiplication by 100).

4.3.1 Welfare Metrics

We consider welfare in terms of the representative household from each country, in response to 1% shocks to various combinations of policy instruments. The simulations of geoeconomic tension (henceforth GT) are designed such that the economy is shocked in period $t = 1$, where it then takes X periods to return to its initial steady state. To illuminate the effect of policy-maker myopia, we study several different policy horizons (T) — considering horizons of one year ($T = 4$), four years ($T = 16$) and the entire transition path ($T \to \infty$). When considering the whole transition, the lifetime utility measures with and without geoeconomic tension are given by

$$
\begin{aligned}
\mathbb{W}_0^{\mathrm{GT}}(T \to \infty) &= \sum_{t=1}^{X} \beta^{t-1} \frac{C_t^{1-\gamma}}{1-\gamma} + \frac{\beta^X}{1-\beta} \times \frac{C_{X+1}^{1-\gamma}}{1-\gamma} \\
\mathbb{W}_0^{\text{No GT}}(T \to \infty) &= \frac{1}{1-\beta} \times \frac{C_0^{1-\gamma}}{1-\gamma}
\end{aligned}
$$

where C_0 is North's consumption level without geoeconomic tension. The expressions for South are defined similarly. For horizons $T < X$, we instead compute

$$
\begin{aligned}
\mathbb{W}_0^{\mathrm{GT}}(T) &= \sum_{t=1}^{T} \beta^{t-1} \frac{C_t^{1-\gamma}}{1-\gamma} \\
\mathbb{W}_0^{\text{No GT}}(T) &= \frac{1-\beta^T}{1-\beta} \times \frac{C_0^{1-\gamma}}{1-\gamma}
\end{aligned}
$$

where note that the same (full) transition path is computed as when $T \to \infty$, the policymaker simply disregards welfare information for longer time horizons. Note that there may be long-term costs that come with these policies, but myopic policymakers will abstract away from these costs when making their choices.

4.3.2 Unilateral Policies

In Table 2, we present the welfare effects of various combinations of unilateral policies. Consistent with the results in the earlier part of this section, see that welfare inferences can differ markedly across consideration of short- and long-run horizons.

	Time horizon (T)		
	$T = 4$	$T = 16$	$T \to \infty$
τ^{IM}	(-0.0290, -0.0207)	(0.0062, -0.0173)	(0.0054, -0.0070)
τ^{V}	(0.0046, -0.0478)	(-0.0102, -0.0097)	(-0.0047, 0.0008)
s_D	(0.2250, -0.1015)	(0.0489, -0.0330)	(0.0033, -0.0042)
s_E	(-0.2201, 0.0017)	(-0.0366, 0.0019)	(0.0015, -0.0020)
τ^{IM}, s_D	(0.1961, -0.1222)	(0.0552, -0.0503)	(0.0087, -0.0112)
τ^{IM}, s_E	(-0.2492, -0.0190)	(-0.0305, -0.0154)	(0.0070, -0.0090)
τ^{IM}, τ^{V}	(-0.0244, -0.0686)	(-0.0040, -0.0270)	(0.0007, -0.0061)
τ^{V}, s_D	(0.2295, -0.1493)	(0.0387, -0.0427)	(-0.0015, -0.0034)
τ^{V}, s_E	(-0.2154, -0.0461)	(-0.0468, -0.0078)	(-0.0032, -0.0012)
τ^{IM}, τ^{V}, s_D	(0.2006, -0.1701)	(0.0450, -0.0600)	(0.0040, -0.0104)
τ^{IM}, τ^{V}, s_E	(-0.2445, -0.0668)	(-0.0406, -0.0251)	(0.0022, -0.0081)
$\tau^{IM}, \tau^{V}, s_D, s_E$	(-0.0190, -0.1683)	(0.0087, -0.0582)	(0.0055, -0.0124)
τ^{IM*}	(-0.0237, -0.0565)	(-0.0168, 0.0077)	(-0.0067, 0.0086)
τ^{V*}	(-0.0145, 0.0176)	(-0.0009, -0.0064)	(0.0015, -0.0044)
s_D^*	(-0.0576, 0.2276)	(-0.0172, 0.0464)	(-0.0012, 0.0015)
s_E^*	(-0.0005, -0.2195)	(-0.0006, -0.0344)	(-0.0024, 0.0030)
τ^{IM*}, s_D^*	(-0.0813, 0.1712)	(-0.0340, 0.0542)	(-0.0079, 0.0101)
τ^{IM*}, s_E^*	(-0.0242, -0.2762)	(-0.0174, -0.0269)	(-0.0091, 0.0116)
τ^{IM*}, τ^{V*}	(-0.0382, -0.0389)	(-0.0177, 0.0013)	(-0.0052, 0.0042)
τ^{V*}, s_D^*	(-0.0721, 0.2451)	(-0.0181, 0.0399)	(0.0003, -0.0029)
τ^{V*}, s_E^*	(-0.0150, -0.2018)	(-0.0016, -0.0408)	(-0.0008, -0.0014)
$\tau^{IM*}, \tau^{V*}, s_D^*$	(-0.0957, 0.1888)	(-0.0349, 0.0478)	(-0.0064, 0.0057)
$\tau^{IM*}, \tau^{V*}, s_E^*$	(-0.0387, -0.2585)	(-0.0183, -0.0332)	(-0.0076, 0.0072)
$\tau^{IM*}, \tau^{V*}, s_D^*, s_E^*$	(-0.0963, -0.0303)	(-0.0355, 0.0136)	(-0.0087, 0.0088)

Table 2. Welfare for unilateral policy actions. Numbers in parentheses are (welfare gain North, welfare gain South) expressed in consumption equivalent variation. Numbers are percentages (after multiplication by 100) of initial steady state consumption level.

The use of tariffs (τ^{IM}) typically yields losses at short time horizons, as a sudden contraction in import leads to limited consumption options for households. However, as more time goes by, positive effects on firm creation will start to dominate, thereby leading to lifetime welfare gains for the tariff-imposing country.[11] The finding that, over time, import tariffs lead to a welfare gain appears to contradict recent literature. For instance, Boer and Rieth (2024) identify persistent negative effects of import tariffs on trade, investment, and output. While both frameworks incorporate tariff revenue rebates within an open-economy macroeconomic setting, two key distinctions exist. First, in our framework, firm heterogeneity and endogenous firm entry imply that the equilibrium number of firms directly impacts consumer welfare (i.e., , love of variety). Import tariffs protect domestic firms from foreign competition, increas-

[11] In Appendix B, we perform a robustness check and find the model's dynamics as well as the baseline results are robust under alternative parameter values.

ing their profitability and inducing more firm entry, which enhances welfare over time. Second, through general equilibrium effects, import tariffs affect the real exchange rate, which in turn promotes offshoring activity by the tariff-imposing country. The cost reductions achieved through offshoring also mitigate the negative impacts of tariffs, exerting upward pressure on output.

An increase in the offshoring friction faced by the North (τ^V) can be interpreted as a reshoring policy, reducing the North's reliance on the South's low-skilled tasks and potentially enhancing the North's supply chain resilience. This policy offers a short-term gain but results in a long-term loss. In the immediate term, reshoring low-skill tasks back to the North prevents Northern firms from benefiting from the South's low-cost labor, diminishing their expected profits and discouraging new firm entry. Although reshoring increases demand for low-skilled labor in the North, leading to higher wages in that segment, its effect is nearly offset by a decline in high-skilled wages, resulting in only a mild increase in consumption. Over time, the reduction in firm entry leads to fewer product varieties in the North, ultimately causing welfare losses throughout the transition. In a recent study using a multi-country trade model with complex input-output linkages, Eppinger et al. (2021) predicts that decoupling from the global value chain would reduce U.S. national welfare by 2.2%. Despite clear differences between the two models, the main driver behind the short-term gain outcome in our model is its dynamic features. The assumptions of sunk entry costs and time-to-build slow firm adjustment in our setting. Although reshoring policy initially dampens investment in new firms, the decline in the number of firms (or product varieties) takes significantly longer to materialize. This delay allows consumption to increase in the short run.

Overwhelmingly, the production subsidy (s_D) is the strongest single instrument the two governments have at their disposal with regard to short time horizons. This follows for both positive welfare gains accrued to the levying country, as well as losses inflicted on the opposing. This result comes from the fact that this is the only instrument, which delivers a positive impact response of wages to both types of workers in the levying country. As the policy horizon is extended, from one to four years, the levying country's gains are driven down in magnitude, before eventually turning just slightly above zero when accounting for the entire transition. This is mainly because production subsidy benefits the incumbents at the cost of potential entrants, causing the economy to suffer from less variety in the long run. In a recent paper, Du et al. (2023) find a negative aggregate productivity effect of state subsidies, driven by the fact that the adverse impact on non-subsidized firms outweighs the positive impact on subsidized firms. Our findings complement theirs, showing that while production subsidies benefit incumbents, they disadvantage potential entrants. Nonetheless, the substantial short-term welfare benefits stem from rising wages and reduced costs of goods, which outweigh the negative effects on firm entry and variety.

The entry subsidy (s_E) results in significant short-term welfare losses for the levying country. The initial cost required to support the surge in new firm entry imposes a substantial burden on household resources, with Northern losses reaching 0.22% over a one-year horizon from the Northern subsidy. A longer time horizon is needed for the benefits of an increased mass of firms to materialize; while welfare losses remain persistent in the short term, gains are eventually realized over an infinite horizon. In contrast to the static findings in Pflüger and Südekum (2013), which demonstrate that the unilateral optimal entry subsidy initially rises and then falls with increasing trade openness, our results suggest that even with trade freeness held constant, the welfare implications of entry subsidies vary between the short and long run due to the dynamic feature in our model.

The specific combination of an import tariff and production subsidy inflicts losses on the opposing country, while retaining positive gains for the levying country, at all time horizons for both countries. This leverages the time profiles for realising gains for the two instruments. The large gains are realized in the short-run from the subsidy, while the long-run losses from the subsidy are outweighed by the gains from the tariff starting to take effect. Note finally that the largest unilateral lifetime welfare gain for the North is realized with the combination of tariff and production subsidy, while for the South it's the combination of tariff and entry subsidy.

4.3.3 Bilateral Actions: Policy Wars

Table 3 presents welfare numbers, at differing horizons, for all possible single-instrument combinations for North and South. One can take these numbers in the spirit of a policy war between the two countries.[12] There is considerable variation across combinations and time horizons, highlighting the need to use dynamic analysis when studying this particular question.

[12] Given the simple nature of our policy exercises, these numbers are meant to be illustrative, rather than a rigorous strategic analysis of the policy wars.

One year horizon ($T = 4$)

		South				
		—	τ^{IM*}	τ^{V*}	s_D^*	s_E^*
North	—	(0.0000, 0.0000)	(-0.0237, -0.0565)	(-0.0145, 0.0176)	(-0.0576, 0.2276)	(-0.0005, -0.2195)
	τ^{IM}	(-0.0290, -0.0207)	(-0.0527, -0.0773)	(-0.0435, -0.0031)	(-0.0866, 0.2068)	(-0.0295, -0.2402)
	τ^{V}	(0.0046, -0.0478)	(-0.0191, -0.1044)	(-0.0099, -0.0302)	(-0.0530, 0.1798)	(0.0041, -0.2674)
	s_D	(0.2250, -0.1015)	(0.2013, -0.1580)	(0.2105, -0.0838)	(0.1675, 0.1263)	(0.2244, -0.3211)
	s_E	(-0.2201, 0.0017)	(-0.2438, -0.0548)	(-0.2346, 0.0194)	(-0.2778, 0.2293)	(-0.2206, -0.2177)

Four year horizon ($T = 16$)

		South				
		—	τ^{IM*}	τ^{V*}	s_D^*	s_E^*
North	—	(0.0000, 0.0000)	(-0.0168, 0.0077)	(-0.0009, -0.0064)	(-0.0172, 0.0464)	(-0.0006, -0.0344)
	τ^{IM}	(0.0062, -0.0173)	(-0.0106, -0.0096)	(0.0053, -0.0237)	(-0.0110, 0.0291)	(0.0056, -0.0517)
	τ^{V}	(-0.0102, -0.0097)	(-0.0270, -0.0020)	(-0.0111, -0.0160)	(-0.0274, 0.0368)	(-0.0108, -0.0442)
	s_D	(0.0489, -0.0330)	(0.0322, -0.0254)	(0.0480, -0.0394)	(0.0318, 0.0135)	(0.0483, -0.0676)
	s_E	(-0.0366, 0.0019)	(-0.0534, 0.0095)	(-0.0376, -0.0045)	(-0.0539, 0.0482)	(-0.0372, -0.0326)

Infinite horizon ($T \to \infty$)

		South				
		—	τ^{IM*}	τ^{V*}	s_D^*	s_E^*
North	—	(0.0000, 0.0000)	(-0.0067, 0.0086)	(0.0015, -0.0044)	(-0.0012, 0.0015)	(-0.0024, 0.0030)
	τ^{IM}	(0.0054, -0.0070)	(-0.0013, 0.0016)	(0.0070, -0.0113)	(0.0043, -0.0055)	(0.0031, -0.0040)
	τ^{V}	(-0.0047, 0.0008)	(-0.0115, 0.0094)	(-0.0032, -0.0035)	(-0.0059, 0.0023)	(-0.0071, 0.0038)
	s_D	(0.0033, -0.0042)	(-0.0035, 0.0044)	(0.0048, -0.0086)	(0.0021, -0.0027)	(0.0009, -0.0012)
	s_E	(0.0015, -0.0020)	(-0.0052, 0.0066)	(0.0030, -0.0064)	(0.0003, -0.0005)	(-0.0008, 0.0010)

Table 3. Welfare of policy wars between North and South. Numbers in parentheses are (welfare gain North, welfare gain South) expressed in consumption equivalent variation. Numbers are percentages (after multiplication by 100) of initial steady state consumption level. Policy actions of North are indexed by rows and those of South are by columns (note that — means no policy action). Top panel considers a one year time horizon, second panel considers four years and the third panel considers an infinite horizon.

At both one and four year time horizons, using a production subsidy is the dominant policy instrument for each country, regardless of their opponent's policy action. Moreover, this instrument will inflict losses on the opponent at these horizons, unless they also choose to subsidize. When both North and South levy the production subsidy, they realize mutual gains of 0.17% and 0.13%, respectively at a one year horizon. At a four year horizon, the magnitude of mutual gain drops to 0.03% and 0.01%. At no other combination of North-South single policy instruments are mutual gains possible at any time horizon.

When looking at the infinite horizon setting, instead the import tariff arises as the dominant policy instrument for each country. If policymakers in each country made this choice, they incur mutual, albeit decreasing, welfare losses at almost every time horizon of the implementation.[13] The fact that each country has the option of taking zero action shows this scenario

[13] The only exception is that the south get a gain in the infinite horizon, but the magnitude is negligible.

resembles a ”race to the bottom” in terms of policy actions. This finding complements the insightful results of Larch and Lechthaler (2013), who demonstrate that the Nash tariff in a dynamic trade model differs from that in a static trade model.

A similar ”race to the bottom” scenario arises if both countries pursue decoupling from offshoring activities, with short-term losses reaching three times the magnitude of long-term losses. This finding aligns with Baqaee et al. (2024), where the authors, using a multi-sector trade model with complex input-output linkages, demonstrate that an abrupt decoupling between Germany and China could lead to significantly greater welfare losses in the short run compared to the long run.

A popular combination in the policy arena is imposing import tariffs on those subsidized imports, such as European Union (EU)'s tariff on Chinese solar panel and more lately, the electric vehicles.[14] This setting can be represented by the North imposing import tariff while the South imposing production subsidy in our setting. Our study shows such a policy causes the South to benefit at the cost of the North in the short to medium term, but eventually benefit the North at the cost of the South.

In terms of other possible outcomes, the largest overall losses come about, with an infinite horizon, when both the North and the South add offshoring frictions. This will incur losses to the North of -0.0032% and the South of -0.0035%, giving overall losses close to 0.01%. For shorter horizons, jointly choosing the entry subsidy drains worldwide resources, leading to overall losses of 0.07% and 0.44% at four years and one year, respectively.

5 Conclusion

In this paper, we studied the effects of various industrial policies in a two-country DSGE model featuring firm heterogeneity, trade-in-tasks, endogenous export, and offshoring decisions. Our focus was to understand the dynamic and welfare implications of each individual industrial policy as well as their possible combinations, both on impact and over time. This sets the model apart from the traditional approaches to studying industrial policies.

Our results emphasize the importance of using a dynamic general equilibrium framework to assess the impacts of industrial policies. The rich micro-foundations of our model place

[14] EU countries to pledge help for solar sector, but no trade curbs on China, EU duties on Chinese electric cars are a rule-respecting response to subsidies.

producer dynamics at the forefront of the policy debate, particularly when countries use industrial policies to intensify economic competition. While short-term gains may appear beneficial, they may not offset long-term losses. This is because firm creation is both costly and time-consuming. If impatient policymakers prioritize short-term benefits, their policy choices could lead to long-term welfare losses, despite temporary improvements in welfare or income equality across different skill classes.

Our framework can be easily modified in several ways. For example, by introducing nominal rigidities into our framework, one can investigate what are the monetary policy implications amid these geoeconomic tensions and could monetary policy interact with industrial policies to tackle possible externalities in such a framework. In addition, our framework can be extended to a multiple-sector setting and investigate the dynamic and distributional impacts of industrial policies on different types of households. Lastly, there are many more countries in the world besides the North and South in our framework. An extension toward a three-country model can shed important insights for the rest of the world when big nations are in rivalry with each other. Exploration of these issues will contribute valuable insights to ongoing discussions on geoeconomic tensions and their effects on the global economy.

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APPENDIX

A Additional figures and tables

Table A.1. Model equations

Euler equation, bonds	$1=\beta\left(1+r_{t+1}\right)E_t\left[\left(\frac{C_{t+1}}{C_t}\right)^{-\gamma}\right]$
	$1=\beta^*\left(1+r^*_{t+1}\right)E_t\left[\left(\frac{C^*_{t+1}}{C^*_t}\right)^{-\gamma}\right]$
Euler equations, stocks	$\tilde{v}_t=\beta\left(1-\delta\right)E_t\left[\left(\frac{C_{t+1}}{C_t}\right)^{-\gamma}\left(\tilde{d}_{t+1}+\tilde{v}_{t+1}\right)\right]$
	$\tilde{v}^*_t=\beta^*\left(1-\delta^*\right)E_t\left[\left(\frac{C^*_{t+1}}{C^*_t}\right)^{-\gamma}\left(\tilde{d}^*_{t+1}+\tilde{v}^*_{t+1}\right)\right]$
Free entry conditions	$\tilde{v}_t=\left(1-s_E\right)\frac{f_E}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{v}^*_t=\left(1-s^*_E\right)\frac{f^*_E}{Z^*_t}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
Law of motions, firms	$N_{t+1}=\left(1-\delta\right)\left(N_t+N_{E,t}\right)$
	$N^*_{t+1}=\left(1-\delta^*\right)\left(N^*_t+N^*_{E,t}\right)$
Price indices	$1=N_{D,t}\left(\tilde{\rho}_{D,t}\right)^{1-\theta}+N_{V,t}\left(\tilde{\rho}_{V,t}\right)^{1-\theta}+N^*_{X,t}\left[(1+\tau^{IM})\tilde{\rho}^*_{X,t}\right]^{1-\theta}$
	$1=N^*_{D,t}\left(\tilde{\rho}^*_{D,t}\right)^{1-\theta}+N^*_{V,t}\left(\tilde{\rho}^*_{V,t}\right)^{1-\theta}+N_{X,t}\left[(1+\tau^{IM*})\tilde{\rho}_{X,t}\right]^{1-\theta}$
Aggregate accounting	$C_t+N_{E,t}\tilde{v}_t=w_{l,t}L+w_{h,t}H+N_t\tilde{d}_t+T_t$
	$C^*_t+N^*_{E,t}\tilde{v}^*_t=w^*_{l,t}L^*+w^*_{h,t}H^*+N^*_t\tilde{d}^*_t+T^*_t$
Total profits	$N_t\tilde{d}_t=N_{D,t}\tilde{d}_{D,t}+N_{V,t}\tilde{d}_{V,t}+N_{X,t}\tilde{d}_{X,t}$
	$N^*_t\tilde{d}^*_t=N^*_{D,t}\tilde{d}^*_{D,t}+N^*_{V,t}\tilde{d}^*_{V,t}+N^*_{X,t}\tilde{d}^*_{X,t}$
Number of firms	$N_t=N_{D,t}+N_{V,t}$
	$N^*_t=N^*_{D,t}+N^*_{V,t}$
Offshoring profit links	$\tilde{d}_{V,t}=\frac{k}{k-(\theta-1)}\left(\frac{z_{V,t}}{\tilde{z}_{D,t}}\right)^{\theta-1}\tilde{d}_{D,t}+\frac{\theta-1}{k-(\theta-1)}f_V\frac{Q_t}{Z^*_t}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{d}^*_{V,t}=\frac{k}{k-(\theta-1)}\left(\frac{z^*_{V,t}}{\tilde{z}^*_{D,t}}\right)^{\theta-1}\tilde{d}^*_{D,t}+\frac{\theta-1}{k-(\theta-1)}f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
Export profit links	$\tilde{d}_{X,t}=\frac{\theta-1}{k-(\theta-1)}\frac{f_X}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{d}^*_{X,t}=\frac{\theta-1}{k-(\theta-1)}\frac{f^*_X}{Z^*_t}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
Average productivity	$\tilde{z}_{D,t}=\left(\frac{k}{k-(\theta-1)}\right)^{\frac{1}{\theta-1}}z_{\min}z_{V,t}\left[\frac{z_{V,t}^{k-(\theta-1)}-z_{\min}^{k-(\theta-1)}}{z_{V,t}^{k}-z_{\min}^{k}}\right]^{\frac{1}{\theta-1}}$
	$\tilde{z}^*_{D,t}=\left(\frac{k}{k-(\theta-1)}\right)^{\frac{1}{\theta-1}}z_{\min}z^*_{V,t}\left[\frac{{z^*_{V,t}}^{k-(\theta-1)}-z_{\min}^{k-(\theta-1)}}{{z^*_{V,t}}^{k}-z_{\min}^{k}}\right]^{\frac{1}{\theta-1}}$
	$\tilde{z}_{V,t}=\left(\frac{k}{k-(\theta-1)}\right)^{\frac{1}{\theta-1}}z_{\min}\left(\frac{N_t}{N_{V,t}}\right)^{1/k}$
	$\tilde{z}^*_{V,t}=\left(\frac{k}{k-(\theta-1)}\right)^{\frac{1}{\theta-1}}z_{\min}\left(\frac{N^*_t}{N^*_{V,t}}\right)^{1/k}$
	$\tilde{z}_{X,t}=\left(\frac{k}{k-(\theta-1)}\right)^{\frac{1}{\theta-1}}z_{\min}\left(\frac{N_t}{N_{X,t}}\right)^{1/k}$
	$\tilde{z}^*_{X,t}=\left(\frac{k}{k-(\theta-1)}\right)^{\frac{1}{\theta-1}}z_{\min}\left(\frac{N^*_t}{N^*_{X,t}}\right)^{1/k}$

Table A.1. Model equations, continued

Offshoring cutoff productivity	$z_{V,t} = z_{\min}\left(\frac{N_t}{N_{V,t}}\right)^{1/k}$
	$z^*_{V,t} = z_{\min}\left(\frac{N^*_t}{N^*_{V,t}}\right)^{1/k}$
Average prices at N	$\tilde{\rho}_{D,t} = \frac{\theta}{\theta-1}\frac{1-s_D}{Z_t\tilde{z}_{D,t}}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{\rho}_{V,t} = \frac{\theta}{\theta-1}\frac{1}{\tilde{z}_{V,t}}\left(\frac{\tau^V Q_t w^*_{l,t}}{Z^*_t(1-\alpha)}\right)^{1-\alpha}\left(\frac{w_{h,t}}{Z_t\alpha}\right)^{\alpha}$
	$\tilde{\rho}_{X,t} = \frac{\theta}{\theta-1}\frac{\tau Q_t^{-1}}{Z_t\tilde{z}_{X,t}}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
Average prices at S	$\tilde{\rho}^*_{D,t} = \frac{\theta}{\theta-1}\frac{1-s^*_D}{Z^*_t\tilde{z}^*_{D,t}}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{\rho}^*_{V,t} = \frac{\theta}{\theta-1}\frac{1}{\tilde{z}^*_{V,t}}\left(\frac{w^*_{l,t}}{Z^*_t(1-\alpha)}\right)^{1-\alpha}\left(\frac{\tau^{V*}Q_t^{-1}w_{h,t}}{Z_t\alpha}\right)^{\alpha}$
	$\tilde{\rho}^*_{X,t} = \frac{\theta}{\theta-1}\frac{\tau^* Q_t}{Z^*_t\tilde{z}^*_{X,t}}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
Average profits at N	$\tilde{d}_{D,t} = \frac{1}{\theta}\tilde{\rho}_{D,t}^{1-\theta}C_t$
	$\tilde{d}_{V,t} = \frac{1}{\theta}\tilde{\rho}_{V,t}^{1-\theta}C_t - f_V\frac{Q_t}{Z^*_t}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{d}_{X,t} = \frac{1}{\theta}(1+\tau^{IM*})^{-\theta}\tilde{\rho}_{X,t}^{1-\theta}C^*_t Q_t - \frac{f_X}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
Average profits at S	$\tilde{d}^*_{D,t} = \frac{1}{\theta}\tilde{\rho}_{D,t}^{*1-\theta}C^*_t$
	$\tilde{d}^*_{V,t} = \frac{1}{\theta}\tilde{\rho}_{V,t}^{*1-\theta}C^*_t - f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
	$\tilde{d}^*_{X,t} = \frac{1}{\theta}(1+\tau^{IM})^{-\theta}\tilde{\rho}_{X,t}^{*1-\theta}C_t Q_t^{-1} - \frac{f^*_X}{Z^*_t}\left(\frac{w^*_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{h,t}}{\alpha}\right)^{\alpha}$
High-skilled demand by N	$\tilde{h}_{D,t} = \frac{1}{Z_t\tilde{z}_{D,t}}\left(\frac{\alpha}{1-\alpha}\frac{w_{l,t}}{w_{h,t}}\right)^{1-\alpha}\tilde{\rho}_{D,t}^{-\theta}C_t$
	$\tilde{h}_{V,t} = \frac{1}{Z_t^{\alpha}Z_t^{*1-\alpha}\tilde{z}_{V,t}}\left(\frac{\alpha}{1-\alpha}\frac{\tau^V Q_t w^*_{l,t}}{w_{h,t}}\right)^{1-\alpha}\tilde{\rho}_{V,t}^{-\theta}C_t$
	$\tilde{h}_{X,t} = \frac{\tau}{Z_t\tilde{z}_{X,t}}\left(\frac{\alpha}{1-\alpha}\frac{w_{l,t}}{w_{h,t}}\right)^{1-\alpha}\left[(1+\tau^{IM*})\tilde{\rho}_{X,t}\right]^{-\theta}C^*_t$
High-skilled demand by S	$\tilde{h}^*_{D,t} = \frac{1}{Z^*_t\tilde{z}^*_{D,t}}\left(\frac{\alpha}{1-\alpha}\frac{w^*_{l,t}}{w^*_{h,t}}\right)^{1-\alpha}\tilde{\rho}_{D,t}^{*-\theta}C^*_t$
	$\tilde{h}^*_{V,t} = \frac{1}{Z_t^{\alpha}Z_t^{*1-\alpha}\tilde{z}^*_{V,t}}\left(\frac{\alpha}{1-\alpha}\frac{w^*_{l,t}}{\tau^{V*}Q_t^{-1}w_{h,t}}\right)^{1-\alpha}\tilde{\rho}_{V,t}^{*-\theta}C^*_t$
	$\tilde{h}^*_{X,t} = \frac{\tau^*}{Z^*_t\tilde{z}^*_{X,t}}\left(\frac{\alpha}{1-\alpha}\frac{w^*_{l,t}}{w^*_{h,t}}\right)^{1-\alpha}\left[(1+\tau^{IM})\tilde{\rho}^*_{X,t}\right]^{-\theta}C_t$

Table A.1. Model equations, continued

Low-skilled demand by N	$\tilde{l}_{D,t} = \frac{1}{Z_t \tilde{z}_{D,t}} \left(\frac{1-\alpha}{\alpha}\frac{w_{h,t}}{w_{l,t}}\right)^{\alpha} \tilde{\rho}_{D,t}^{-\theta} C_t$
	$\tilde{l}_{V,t} = \frac{1}{Z_t^{\alpha} Z_t^{*1-\alpha} \tilde{z}_{V,t}} \left(\frac{1-\alpha}{\alpha}\frac{w_{h,t}}{\tau^V Q_t w_{l,t}^*}\right)^{\alpha} \tilde{\rho}_{V,t}^{-\theta} C_t$
	$\tilde{l}_{X,t} = \frac{\tau}{Z_t \tilde{z}_{X,t}} \left(\frac{1-\alpha}{\alpha}\frac{w_{h,t}}{w_{l,t}}\right)^{\alpha} \left[(1+\tau^{IM*})\tilde{\rho}_{X,t}\right]^{-\theta} C_t^*$
Low-skilled demand by S	$\tilde{l}_{D,t}^* = \frac{1}{Z_t^* \tilde{z}_{D,t}^*} \left(\frac{1-\alpha}{\alpha}\frac{w_{h,t}^*}{w_{l,t}^*}\right)^{\alpha} \tilde{\rho}_{D,t}^{*-\theta} C_t^*$
	$\tilde{l}_{V,t}^* = \frac{1}{Z_t^{\alpha} Z_t^{*1-\alpha} \tilde{z}_{V,t}^*} \left(\frac{1-\alpha}{\alpha}\frac{\tau^{V*} Q_t^{-1} w_{h,t}}{w_{l,t}^*}\right)^{\alpha} \tilde{\rho}_{V,t}^{*-\theta} C_t^*$
	$\tilde{l}_{X,t}^* = \frac{\tau^*}{Z_t^* \tilde{z}_{X,t}^*} \left(\frac{1-\alpha}{\alpha}\frac{w_{h,t}^*}{w_{l,t}^*}\right)^{\alpha} \left[(1+\tau^{IM})\tilde{\rho}_{X,t}^*\right]^{-\theta} C_t$
Labor market clearing (H)	$H = N_{D,t}\tilde{h}_{D,t} + N_{X,t}\tilde{h}_{X,t} + N_{V,t}\tilde{h}_{V,t} + \tau^{V*} N_{V,t}^* \tilde{h}_{V,t}^*$
	$+ \left(N_{E,t}\frac{f_E}{Z_t} + N_{X,t}\frac{f_X}{Z_t} + N_{V,t}^*\frac{f_V^*}{Z_t}\right)\left(\frac{\alpha w_{l,t}}{(1-\alpha) w_{h,t}}\right)^{1-\alpha}$
	$H^* = N_{D,t}^*\tilde{h}_{D,t}^* + N_{X,t}^*\tilde{h}_{X,t}^* + \left(N_{E,t}^*\frac{f_E^*}{Z_t^*} + N_{X,t}^*\frac{f_X^*}{Z_t^*} + N_{V,t}\frac{f_V}{Z_t^*}\right)\left(\frac{\alpha w_{l,t}^*}{(1-\alpha) w_{h,t}^*}\right)^{1-\alpha}$
Gov budget constraints	$\tau^{IM} N_{X,t}^* \tilde{\rho}_{X,t}^* [(1+\tau^{IM})\tilde{\rho}_{X,t}^*]^{-\theta} C_t - T_t$
	$= s_E N_{E,t}\frac{f_E}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha} + s_D N_{D,t}\tilde{\rho}_{D,t}^{-\theta} C_t \frac{1}{Z_t \tilde{z}_{D,t}}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$
	$\tau^{IM*} N_{X,t}\tilde{\rho}_{X,t}[(1+\tau^{IM*})\tilde{\rho}_{X,t}]^{-\theta} C_t^* - T_t^*$
	$= s_E^* N_{E,t}^*\frac{f_E^*}{Z_t^*}\left(\frac{w_{l,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}^*}{\alpha}\right)^{\alpha} + s_D^* N_{D,t}^*\tilde{\rho}_{D,t}^{*-\theta} C_t^* \frac{1}{Z_t^* \tilde{z}_{D,t}^*}\left(\frac{w_{l,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}^*}{\alpha}\right)^{\alpha}$
Balance of payments	$N_{X,t}\tilde{\rho}_{X,t}\left((1+\tau^{IM*})\tilde{\rho}_{X,t}\right)^{-\theta} C_t^* Q_t + \tau^{V*} N_{V,t}^* w_{h,t}\tilde{h}_{V,t}^* - \tau^V N_{V,t} w_{l,t}^* \tilde{l}_{V,t} Q_t$
	$-N_{X,t}^*\tilde{\rho}_{X,t}^*\left((1+\tau^{IM})\tilde{\rho}_{X,t}^*\right)^{-\theta} C_t$
	$= N_{V,t} f_V \frac{Q_t}{Z_t^*}\left(\frac{w_{l,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}^*}{\alpha}\right)^{\alpha} - N_{V,t}^* f_V^* \frac{1}{Z_t}\left(\frac{w_{l,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{h,t}}{\alpha}\right)^{\alpha}$

The above equations constitute a system of 57 equations in 57 endogenous variables: C_t, r_t, $\tilde{v}_t$, $\tilde{d}_t$, $w_{l,t}$, $w_{h,t}$, N_t, $N_{E,t}$, $N_{D,t}$, $N_{V,t}$, $N_{X,t}$, $\tilde{\rho}_{D,t}$, $\tilde{\rho}_{V,t}$, $\tilde{\rho}_{X,t}$, T_t, $\tilde{d}_{D,t}$, $\tilde{d}_{V,t}$, $\tilde{d}_{X,t}$, $\tilde{z}_{D,t}$, $z_{V,t}$, $\tilde{z}_{V,t}$, $\tilde{z}_{X,t}$, $\tilde{h}_{D,t}$, $\tilde{h}_{V,t}$, $\tilde{h}_{X,t}$, $\tilde{l}_{D,t}$, $\tilde{l}_{V,t}$, $\tilde{l}_{X,t}$, their Southern counterparts and the real exchange rate Q_t.

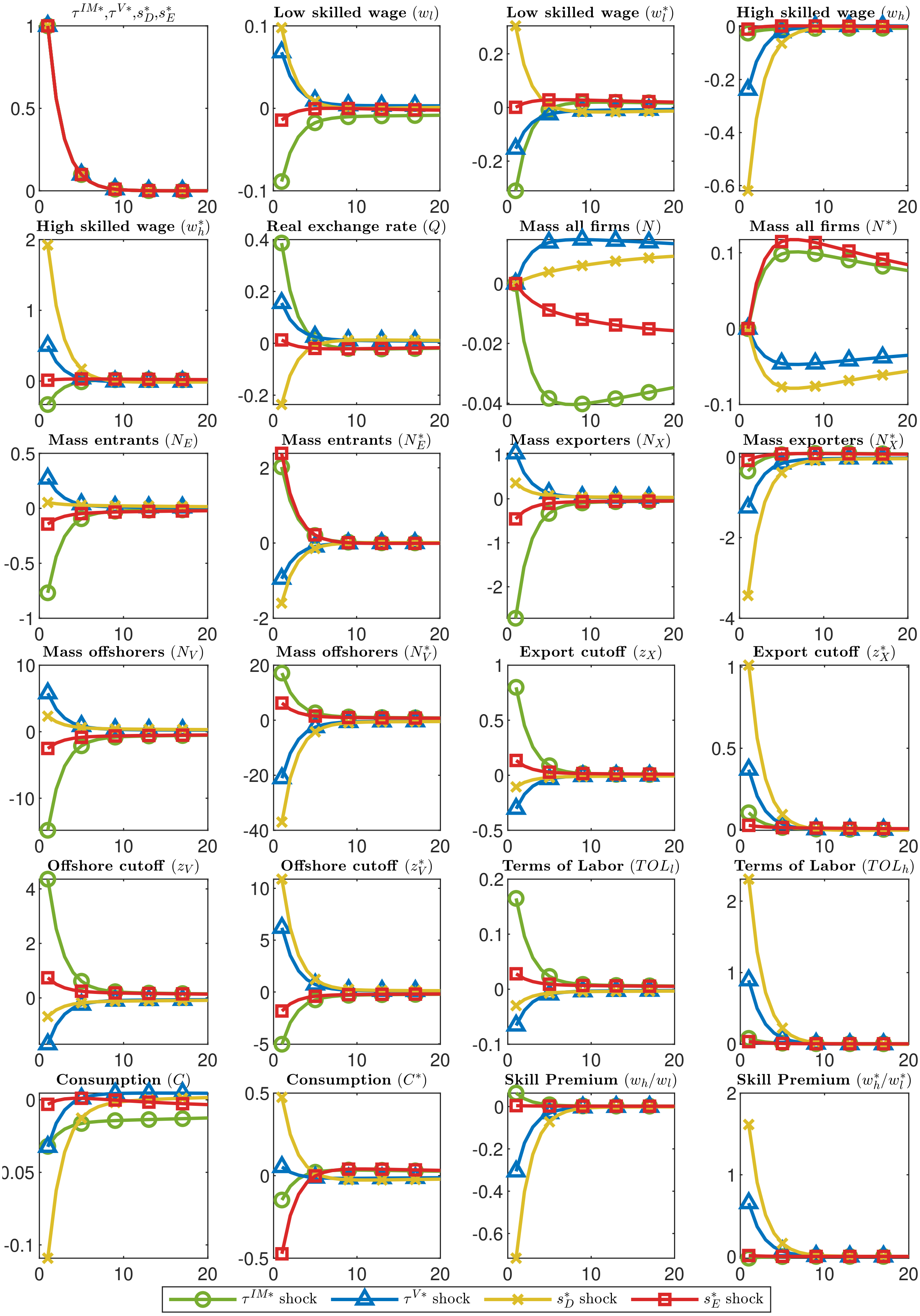

Figure A.1. Impulse responses of North and South variables to 1% of individual industrial policy shocks in the South. The policy instrument is presented as absolute percentage points, while all other variables are presented as percentage deviations from the initial steady state (all after multiplication by 100).

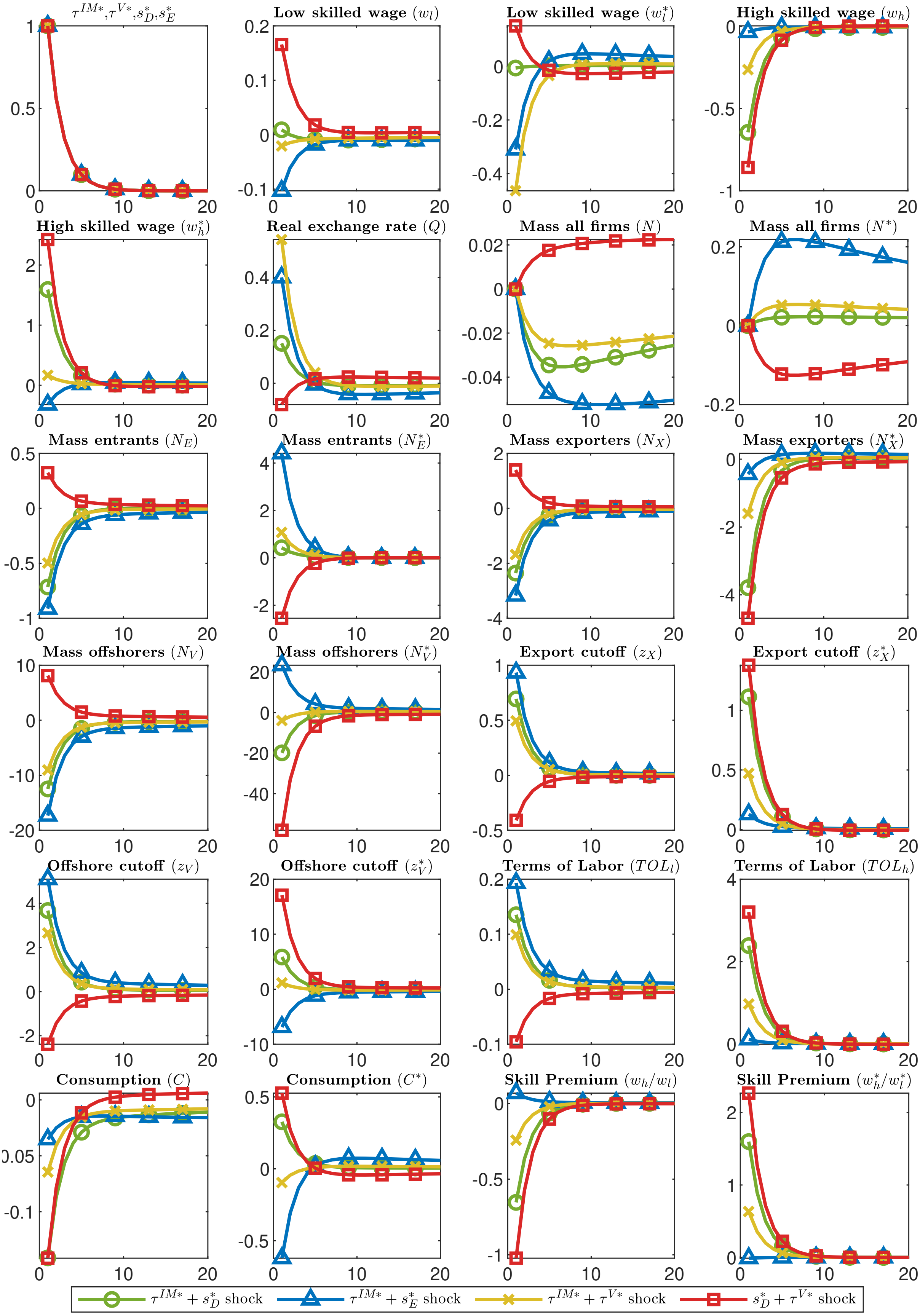

Figure A.2. Impulse responses of North and South variables to 1% of combinations industrial policy shocks in the South. The policy instrument is presented as absolute percentage points, while all other variables are presented as percentage deviations from the initial steady state (all after multiplication by 100).

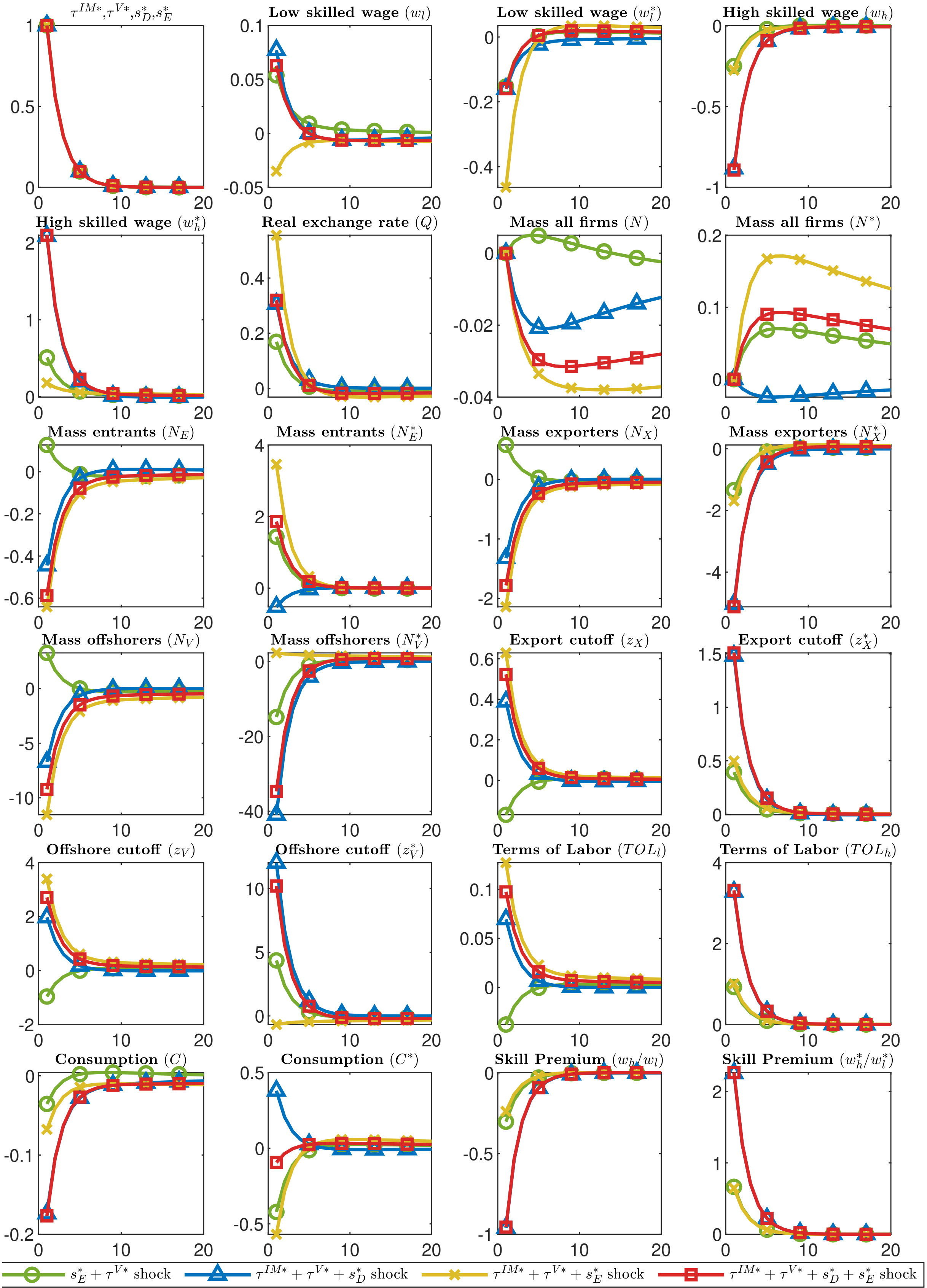

Figure A.3. Impulse responses of North and South variables to 1% of combinations industrial policy shocks in the South. The policy instrument is presented as absolute percentage points, while all other variables are presented as percentage deviations from the initial steady state (all after multiplication by 100).

B Robustness

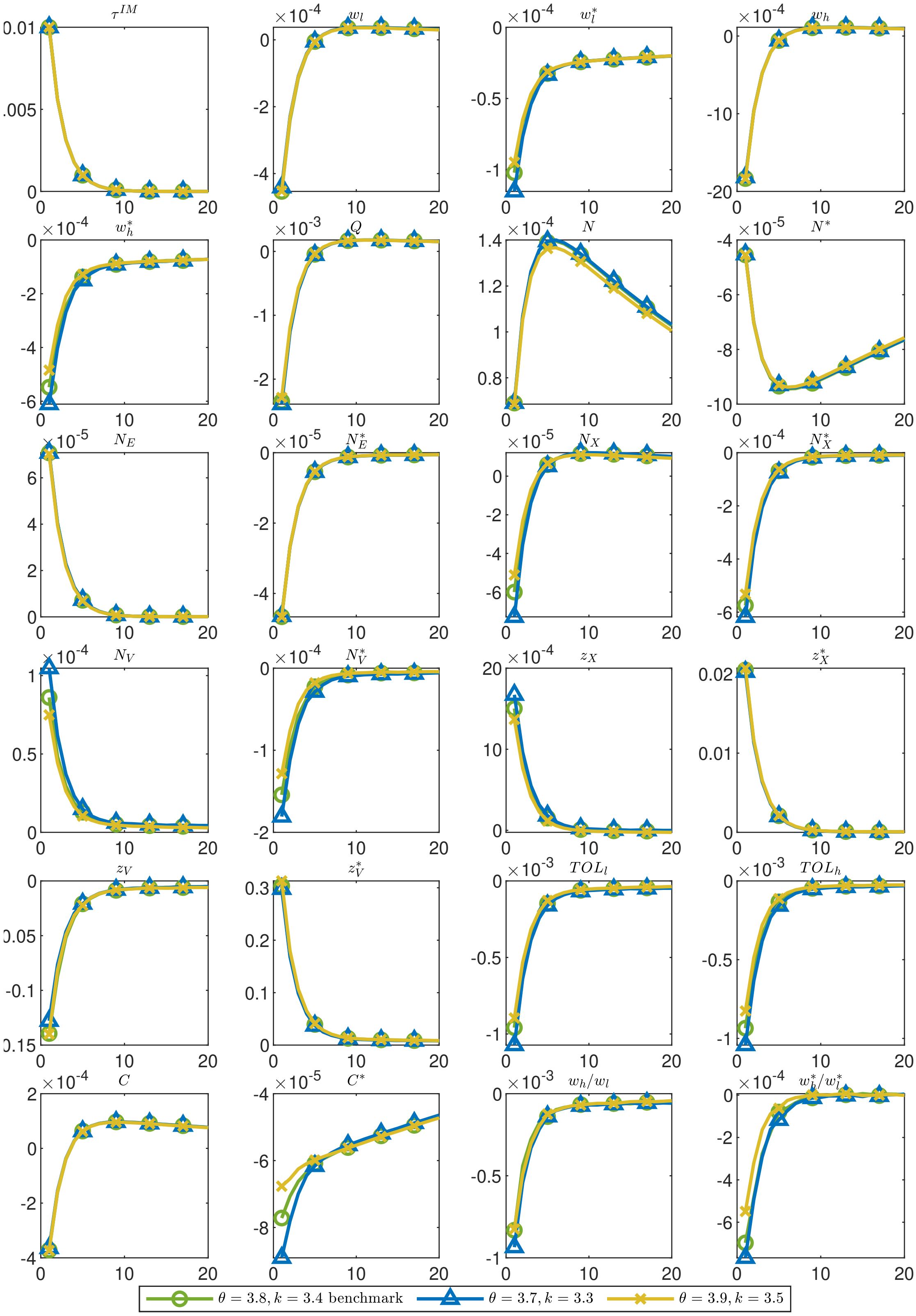

Figure A.4. Impulse responses of North and South variables to 1% tariff shocks under alternative values for the elasticity of substitution. The Pareto shape parameter is also varied in order to keep the standard deviation of log firm sales fixed at 1.67, which is according to Bernard et al. (2003). The policy instrument is presented as absolute percentage points, while all other variables are presented as deviations from the initial steady state.

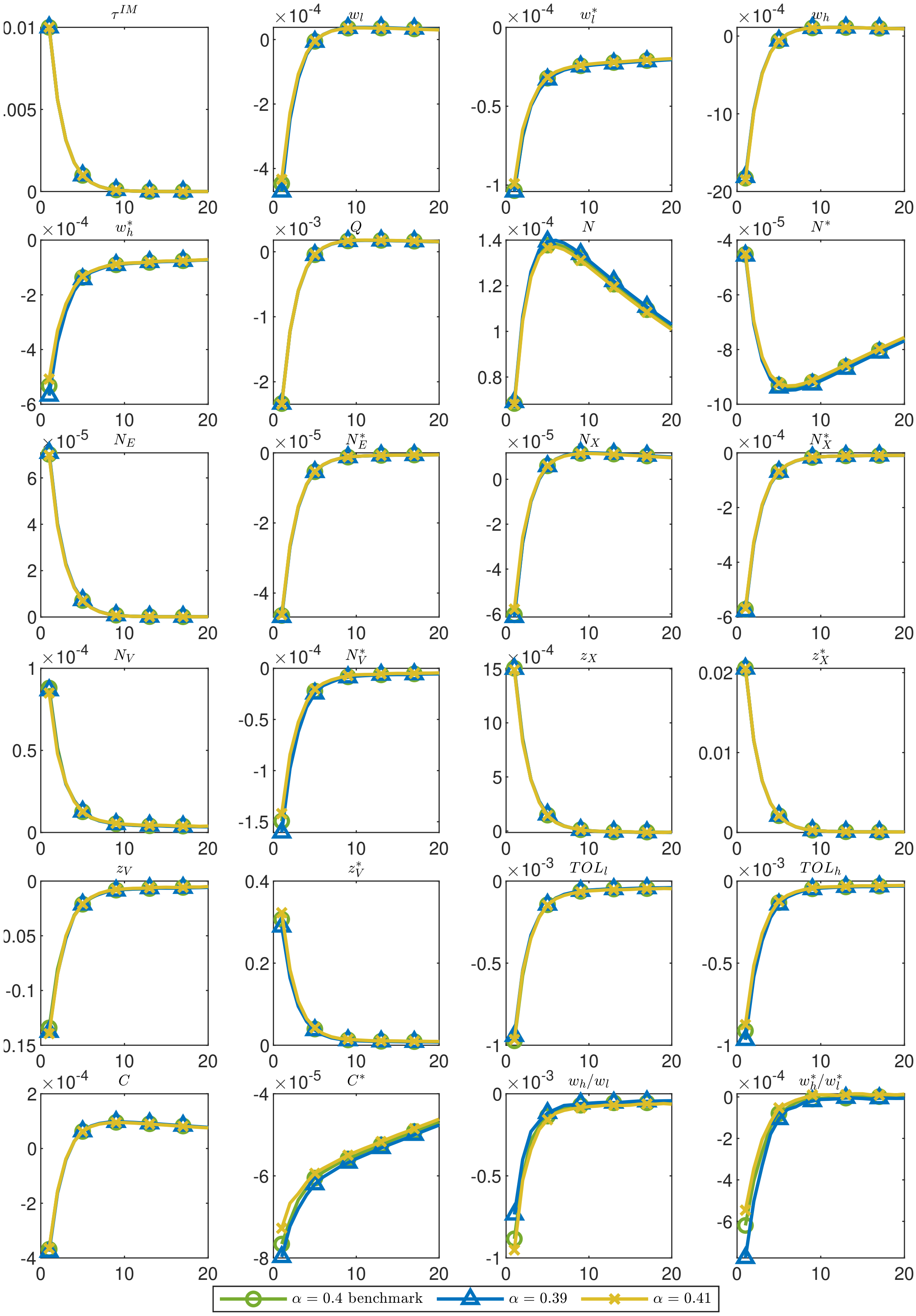

Figure A.5. Impulse responses of North and South variables to 1% tariff shocks under alternative values for skill intensity in production. The policy instrument is presented as absolute percentage points, while all other variables are presented as deviations from the initial steady state.

	Time horizon (T)		
	$T=4$	$T=16$	$T\to\infty$
	Benchmark: ($\theta = 3.8, k = 3.4$)		
τ^{IM}	(-0.0290, -0.0207)	(0.0062, -0.0173)	(0.0054, -0.0070)
τ^{V}	(0.0046, -0.0478)	(-0.0102, -0.0097)	(-0.0047, 0.0008)
s_D	(0.2250, -0.1015)	(0.0489, -0.0330)	(0.0033, -0.0042)
s_E	(-0.2201, 0.0017)	(-0.0366, 0.0019)	(0.0015, -0.0020)
	Lower EOS ($\theta = 3.7, k = 3.3$)		
τ^{IM}	(-0.0290, -0.0214)	(0.0063, -0.0177)	(0.0055, -0.0071)
τ^{V}	(0.0031, -0.0461)	(-0.0105, -0.0092)	(-0.0048, 0.0009)
s_D	(0.2230, -0.1009)	(0.0487, -0.0329)	(0.0033, -0.0043)
s_E	(-0.2198, 0.0007)	(-0.0366, 0.0014)	(0.0016, -0.0021)
	Higher EOS ($\theta = 3.9, k = 3.5$)		
τ^{IM}	(-0.0290, -0.0201)	(0.0061, -0.0169)	(0.0054, -0.0069)
τ^{V}	(0.0060, -0.0493)	(-0.0099, -0.0101)	(-0.0047, 0.0008)
s_D	(0.2268, -0.1019)	(0.0491, -0.0331)	(0.0032, -0.0042)
s_E	(-0.2203, 0.0027)	(-0.0366, 0.0023)	(0.0015, -0.0019)

Table A.2. Welfare for unilateral policy actions. Numbers in parentheses are (welfare gain North, welfare gain South) expressed in consumption equivalent variation. Numbers are percentages (after multiplication by 100) of initial steady state consumption level.

	Time horizon (T)		
	$T=4$	$T=16$	$T\to\infty$
	Benchmark: ($\alpha = 0.4$)		
τ^{IM}	(-0.0290, -0.0207)	(0.0062, -0.0173)	(0.0054, -0.0070)
τ^{V}	(0.0046, -0.0478)	(-0.0102, -0.0097)	(-0.0047, 0.0008)
s_D	(0.2250, -0.1015)	(0.0489, -0.0330)	(0.0033, -0.0042)
s_E	(-0.2201, 0.0017)	(-0.0366, 0.0019)	(0.0015, -0.0020)
	Lower EOS ($\alpha = 0.39$)		
τ^{IM}	(-0.0284, -0.0202)	(0.0061, -0.0168)	(0.0053, -0.0068)
τ^{V}	(0.0056, -0.0481)	(-0.0101, -0.0096)	(-0.0048, 0.0009)
s_D	(0.2256, -0.1009)	(0.0490, -0.0326)	(0.0032, -0.0041)
s_E	(-0.2203, 0.0018)	(-0.0367, 0.0018)	(0.0015, -0.0020)
	Higher EOS ($\alpha = 0.41$)		
τ^{IM}	(-0.0296, -0.0213)	(0.0063, -0.0178)	(0.0055, -0.0072)
τ^{V}	(0.0036, -0.0475)	(-0.0103, -0.0097)	(-0.0047, 0.0008)
s_D	(0.2243, -0.1020)	(0.0489, -0.0334)	(0.0033, -0.0043)
s_E	(-0.2199, 0.0017)	(-0.0366, 0.0019)	(0.0015, -0.0020)

Table A.3. Welfare for unilateral policy actions. Numbers in parentheses are (welfare gain North, welfare gain South) expressed in consumption equivalent variation. Numbers are percentages (after multiplication by 100) of initial steady state consumption level.

C Solution Methods

We adopt an iterative approach to solve for the steady state of the model. In this section, we first derive analytical expressions of the offshoring and export cutoffs. We then leverage these expressions in developing our solution algorithm.

Northern firms

The period profits for a domestic firm are

$$\begin{aligned}
d_{D,t}(z) &= \frac{1}{\theta}\{\rho_{D,t}^{1-\theta}\}C_t \\
&= \frac{1}{\theta}\left\{\left(\frac{\theta}{\theta-1}\right)\left(\frac{1-s_D}{zZ_t}\right)\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha}\right\}^{1-\theta} C_t \\
&= \frac{1}{\theta}\left(\frac{\theta}{\theta-1}\right)^{1-\theta}\left(\frac{1-s_D}{zZ_t}\right)^{1-\theta}\left(\frac{w_{L,t}}{1-\alpha}\right)^{(1-\alpha)(1-\theta)}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha(1-\theta)} C_t
\end{aligned}$$

and those for offshoring firms are

$$\begin{aligned}
d_{V,t}(z) =& \frac{1}{\theta}\left\{\rho_{V,t}(z)^{1-\theta}C_t\right\} - f_V\left(\frac{Q_t}{Z_t^*}\right)\left(\frac{w_{L,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}^*}{\alpha}\right)^{\alpha} \\
=& \frac{1}{\theta}\left\{\frac{\theta}{\theta-1}\frac{1}{z}\left[\frac{\tau^V Q_t w_{L,t}^*}{Z_t^*(1-\alpha)}\right]^{1-\alpha}\left(\frac{w_{H,t}}{Z_t\alpha}\right)^{\alpha}\right\}^{1-\theta} C_t \\
&- f_V\left(\frac{Q_t}{Z_t^*}\right)\left(\frac{w_{L,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}^*}{\alpha}\right)^{\alpha} \\
=& \frac{1}{\theta}\left(\frac{\theta}{\theta-1}\right)^{1-\theta}\left(\frac{1}{z}\right)^{1-\theta}\left[\frac{\tau^V Q_t w_{L,t}^*}{Z_t^*(1-\alpha)}\right]^{(1-\alpha)(1-\theta)}\left(\frac{w_{H,t}}{Z_t\alpha}\right)^{\alpha(1-\theta)} C_t \\
&- f_V\left(\frac{Q_t}{Z_t^*}\right)\left(\frac{w_{L,t}^*}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}^*}{\alpha}\right)^{\alpha}.
\end{aligned}$$

So an expression for the cutoff $z_{V,t}$ comes from $d_{D,t}(z) = d_{V,t}(z)$

$$
\begin{aligned}
&\Rightarrow \frac{1}{\theta}\left(\frac{\theta}{\theta-1}\right)^{1-\theta}\left(\frac{1-s_D}{z_{V,t}Z_t}\right)^{1-\theta}\left(\frac{w_{L,t}}{1-\alpha}\right)^{(1-\alpha)(1-\theta)}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha(1-\theta)} C_t \\
&= \frac{1}{\theta}\left(\frac{\theta}{\theta-1}\right)^{1-\theta}\left(\frac{1}{z_{V,t}}\right)^{1-\theta}\left[\frac{\tau^V Q_t w^*_{L,t}}{Z^*_t(1-\alpha)}\right]^{(1-\alpha)(1-\theta)}\left(\frac{w_{H,t}}{Z_t\alpha}\right)^{\alpha(1-\theta)} C_t \\
&- f_V\left(\frac{Q_t}{Z^*_t}\right)\left(\frac{w^*_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{H,t}}{\alpha}\right)^{\alpha}
\end{aligned}
$$

$$
z_{V,t}^{\theta-1} = \frac{f_V\left(\frac{Q_t}{Z^*_t}\right)\left(\frac{w^*_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{H,t}}{\alpha}\right)^{\alpha}}{\frac{1}{\theta}\left(\frac{\theta}{\theta-1}\right)^{1-\theta} C_t\left\{\left[\frac{\tau^V Q_t w^*_{L,t}}{Z^*_t(1-\alpha)}\right]^{(1-\alpha)(1-\theta)}\left(\frac{w_{H,t}}{Z_t\alpha}\right)^{\alpha(1-\theta)} - \left(\frac{1-s_D}{Z_t}\right)^{1-\theta}\left(\frac{w_{L,t}}{1-\alpha}\right)^{(1-\alpha)(1-\theta)}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha(1-\theta)}\right\}}.
$$

Then similarly, the exporting profits are given by

$$
d_{X,t}(z) = \frac{1}{\theta}(1+\tau^{IM*})^{-\theta}\rho_{X,t}(z)^{1-\theta}C^*_t Q_t - \frac{f_X}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha}
$$

where the cutoff is then given as $d_{X,t}(z) = 0$

$$
\begin{aligned}
&\frac{1}{\theta}(1+\tau^{IM*})^{-\theta}\left\{\frac{\theta}{\theta-1}\frac{\tau Q_t^{-1}}{z_{X,t}Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha}\right\}^{1-\theta} C^*_t Q_t - \frac{f_X}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha} = 0 \\
&\Rightarrow z_{X,t}^{\theta-1} = \frac{\frac{f_X}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha}}{\frac{1}{\theta}(1+\tau^{IM*})^{-\theta}\left\{\frac{\theta}{\theta-1}\frac{\tau Q_t^{-1}}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha}\right\}^{1-\theta} C^*_t Q_t}.
\end{aligned}
$$

Southern firms

The optimal price for a domestic firm is

$$
\rho_{D,t}(z) = \frac{\theta}{\theta-1}\frac{(1-s^*_D)}{Z^*_t z}\left(\frac{w^*_L}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_H}{\alpha}\right)^{\alpha}
$$

and their profits are

$$
\begin{aligned}
d^*_{D,t}(z) &= \frac{1}{\theta}\rho^*_{D,t}(z)^{1-\theta}C^*_t \\
&= \frac{1}{\theta}\left\{\frac{\theta}{\theta-1}\frac{(1-s^*_D)}{Z^*_t z}\left(\frac{w^*_L}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_H}{\alpha}\right)^{\alpha}\right\}^{1-\theta} C^*_t.
\end{aligned}
$$

The optimal price for an offshoring firm is

$$\rho^*_{V,t}(z) = \frac{\theta}{\theta-1}\frac{1}{z}\left(\frac{w^*_{L,t}}{Z^*_t(1-\alpha)}\right)^{1-\alpha}\left[\frac{\tau^{V*}Q_t^{-1}w_{H,t}}{Z_t\alpha}\right]^{\alpha}.$$

Then we can write their profits as

$$\begin{aligned} d^*_{V,t}(z) = \rho^*_{V,t}(z)y^*_{V,t}(z) - \frac{1}{z}\left(\frac{w_{L,t}}{Z^*_t(1-\alpha)}\right)^{1-\alpha}\left(\frac{\tau^{V*}Q_t^{-1}w_{H,t}}{Z_t\alpha}\right)^{\alpha} y^*_{V,t}(z) - \\ f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha} \\ = \frac{1}{\theta}\rho^*_{V,t}(z)^{1-\theta}C^*_t - f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha} \\ = \frac{1}{\theta}\left\{\frac{\theta}{\theta-1}\frac{1}{z}\left(\frac{w^*_{L,t}}{Z^*_t(1-\alpha)}\right)^{1-\alpha}\left[\frac{\tau^{V*}Q_t^{-1}w_{H,t}}{Z_t\alpha}\right]^{\alpha}\right\}^{1-\theta} C^*_t \\ - f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha} \end{aligned}$$

So we can find the cutoff $z^*_{V,t}$ as

$$z^{*(\theta-1)}_{V,t} = \frac{f^*_V\frac{Q_t^{-1}}{Z_t}\left(\frac{w_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w_{H,t}}{\alpha}\right)^{\alpha}}{\frac{1}{\theta}\left(\frac{\theta}{\theta-1}\right)^{1-\theta}\left\{\left(\frac{w^*_{L,t}}{Z^*_t(1-\alpha)}\right)^{(1-\alpha)(1-\theta)}\left[\frac{\tau^{V*}Q_t^{-1}w_{H,t}}{Z_t\alpha}\right]^{\alpha(1-\theta)} - \left(\frac{(1-s^*_D)}{Z^*_t}\right)^{1-\theta}\left(\frac{w^*_{L,t}}{1-\alpha}\right)^{(1-\alpha)(1-\theta)}\left(\frac{w^*_{H,t}}{\alpha}\right)^{\alpha(1-\theta)}\right\}C^*_t}$$

Then the exporting cutoff is

$$z^{*(\theta-1)}_{X,t} = \frac{\frac{f^*_X}{Z^*_t}\left(\frac{w^*_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{H,t}}{\alpha}\right)^{\alpha}}{\frac{1}{\theta}(1+\tau^{IM})^{-\theta}\left\{\frac{\theta}{\theta-1}\frac{\tau^*Q_t}{Z^*_t}\left(\frac{w^*_{L,t}}{1-\alpha}\right)^{1-\alpha}\left(\frac{w^*_{H,t}}{\alpha}\right)^{\alpha}\right\}^{1-\theta}C_tQ_t^{-1}}$$

Algorithm

The solution for the steady state is iterative, taking aggregate variables as inputs and then solving different parts of the problem in sequence.[15]

1. Conjecture objects $\widehat{\Psi} = (\hat{Q}, \hat{C}, \hat{C}^*, \hat{w}_L, \hat{w}^*_L, \hat{w}^*_H)$. Fix $\hat{w}_H = 1$, (can then treat the fixed cost of entry as a free parameter below).

2. Find the associated cutoffs z_V, z_X, z^*_V, z^*_X.

[15]Such is a common approach in macro models of firm dynamics, (e.g. see Spencer (2022)).

3. Find the average productivity levels $\tilde{z}_D, \tilde{z}_V, \tilde{z}_X, \tilde{z}^*_D, \tilde{z}^*_V, \tilde{z}^*_X$.

4. Find average real price levels $\tilde{\rho}_D, \tilde{\rho}_V, \tilde{\rho}_X, \tilde{\rho}^*_D, \tilde{\rho}^*_V, \tilde{\rho}^*_X$.

5. Find average profits $\tilde{d}_D, \tilde{d}_V, \tilde{d}_X, \tilde{d}^*_D, \tilde{d}^*_V, \tilde{d}^*_X$.

6. Find high skilled demand $\tilde{h}_D, \tilde{h}_V, \tilde{h}_X, \tilde{h}^*_D, \tilde{h}^*_V, \tilde{h}^*_X$ and low skilled demand $\tilde{l}_D, \tilde{l}_V, \tilde{l}_X, \tilde{l}^*_D, \tilde{l}^*_V, \tilde{l}^*_X$.

7. Compute the value of entry $\tilde{v}$. Then back-out the fixed cost of entry (given the wage normalization) as $f_E = \tilde{v}\frac{1}{1-s_e} Z \left(\frac{1-\alpha}{w_L}\right)^{1-\alpha} \left(\frac{\alpha}{w_H}\right)^{\alpha}$. Then set $f^*_E = f_E$.

8. Using the average labor demand levels found above, find the masses of firms N and N^* that clear the high skilled labor market in each country.

9. Aggregate to find total profits and entry costs as well as government tax collections.

10. Compute the following metrics of distance

$$\begin{aligned}
\Delta^C &= |C - \hat{C}| \\
\Delta^{C*} &= |C^* - \hat{C}^*| \\
\Delta^Q &= |BOP| \\
\Delta^L &= |L - L^D| \\
\Delta^{L*} &= |L^* - L^{D*}| \\
\Delta^{H*} &= |H^* - H^{D*}|
\end{aligned}$$

    where Δ^C captures the difference of consumption good supply C and that conjectured, Δ^{C*} is the same but for the foreign country, BOP is the balance of payments, Δ^L captures the distance of the low skilled labor market clearing (supply L equals demand L^D), Δ^{L*} is the analogue for the South and Δ^{H*} is the distance of high skilled labor in the South H^* meeting the corresponding demand H^{D*}.

11. Update the conjecture of $\widehat{\Psi}$ in accordance with the distance metrics and repeat the process until convergence.