

Research Seminar "Quantitative Economics"

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Abstract

Financial Frictions, Markups, and Unilateral Trade Liberalization

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Abstract

We study a response of a small open economy with credit constraints and variable markups to unilateral trade liberalization by a more developed trading partner. We use a dynamic heterogeneous agents model based on Kohn et al. (2020) to quantify the welfare and allocative efficiency effects of enacting Autonomous Trade Preferences by the EU countries for Ukraine in 2014 year. To obtain a better match with the data, we allow for variable markups in the domestic market, endogenous trade imbalances, and interest rate increasing with the level of foreign debt. We find that better market access improves welfare but lowers allocative efficiency in the economy, as reduction in markup dispersion is too weak to offset increase in capital misallocation. Variable markups exacerbate worsening allocative efficiency in the presence of credit constraints.