



WORKING PAPERS

RESEARCH DEPARTMENT

**WORKING PAPER NO. 12-16
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INTERNATIONAL BUSINESS CYCLES**

George Alessandria
Federal Reserve Bank of Philadelphia

Joseph Kaboski
University of Notre Dame

Virgiliu Midrigan
New York University

May 2012

RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF PHILADELPHIA

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Trade Wedges, Inventories, and International Business Cycles^{*†}

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George Alessandria

Federal Reserve Bank of Philadelphia
George.Alessandria@phil.frb.org

Joseph Kaboski

University of Notre Dame and NBER
jkaboski@nd.edu

Virgiliu Midrigan

NYU, NBER, Federal Reserve Bank of Minneapolis
Virgiliu.Midrigan@nyu.edu

Abstract

The large, persistent fluctuations in international trade that can not be explained in standard models by changes in expenditures and relative prices are often attributed to trade wedges. We show that these trade wedges can reflect the decisions of importers to change their inventory holdings. We find that a two-country model of international business cycles with an inventory management decision can generate trade flows and wedges consistent with the data. Moreover, matching trade flows alters the international transmission of business cycles. Specifically, real net exports become countercyclical and consumption is less correlated across countries than in standard models. We also show that ignoring inventories as a source of trade wedges substantially overstates the role of trade wedges in business cycle fluctuations.

JEL classifications: E31, F12.

Keywords: Inventory, Net Exports, Trade Volatility, International Comovement.

*The views expressed here are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Philadelphia, the Federal Reserve Bank of Minneapolis, or the Federal Reserve System. This paper is available free of charge at www.philadelphiafed.org/research-and-data/publication/workingpapers/.

†Nils Gornemann and David Richards provided excellent research assistance. We thank Sam Kortum, Jonathan Heathcote, Paolo Pesenti, Mario Crucini and seminar participants at Wharton, Yale, Wisconsin, Notre Dame, and Duke for their comments and suggestions.

1. Introduction

The recent global collapse and rebound of international trade has renewed interest in understanding both the determinants of the cyclical fluctuations of international trade and the role of international trade in transmitting business cycles across integrated economies. Our understanding of international business cycles is limited, however, by the failure of standard models to account for the dynamics of international trade. As Levchenko, Lewis, and Tesar (2010) forcefully document, international trade tends to fluctuate much more than can be explained in standard models by the changes in expenditures on traded goods and relative prices. This is true even once one carefully controls for the different composition of the goods that are traded or consumed.¹ Since nearly all models of international business cycles fail to generate the magnitude of trade fluctuations observed in the data, these models lack a potentially important channel in the international propagation of business cycles.

In this paper, we consider a model of international trade and inventory management that can generate sizable fluctuations in international trade flows, similar to those observed in the data. We then use our model to re-examine the role of trade in propagating business cycles internationally. We find that the model predicts that real net exports are countercyclical and there is relatively less comovement of consumption across countries. Hence, adding inventory frictions allows us to make progress on two dimensions along which standard models fail poorly: the cyclicity of real net exports and the consumption-output anomaly.

We focus on inventories in a business cycle setting because inventory management decisions have been shown to be an important feature in international trade. Since international trade takes time and is relatively costly, firms that engage in international trade tend to hold much larger stocks of inventories. Our previous work, Alessandria, Kaboski and Midrigan (2010a, 2010b, hereafter AKM), documents the role of inventories in international trade empirically. We document, using various sources of data, that importers hold much larger inventory stocks than non-importers do and order goods much less frequently. Moreover, we also show that inventories account for a sizable fraction of the import collapses following large devaluations or in the recent global recession. For example, AKM 2010b show that at

¹Eaton, Kortum, Neiman and Romalis (2010) also study the recent trade collapse. They focus on the changes in the ratio of trade to GDP and attribute a large fraction of these movements to trade being relatively intensive in durables. Engel and Wang (2011) also focus on the role of durables in the volatility of trade. In our analysis, we focus on the movements of trade that cannot be accounted for by composition.

the height of the trade collapse, US imports of automobiles fell more dramatically than final sales of imported autos in the US. Similarly, during the rebound of US trade, US imports of autos grew much faster than final sales of imported autos. US inventories of imported cars followed suit, falling during the collapse and being restocked during the trade recovery.

Motivated by these observations, we develop a model with domestic and foreign inventories that allows us to quantify the role of inventories in trade movements. In doing so, we introduce a dynamic component into the interpretation of trade wedges garnered from static (within-period) optimality conditions. We take a standard two-country real business cycle model and introduce a retail sector that has a stockout avoidance motivation for holding inventories.² Our model is quite tractable as it introduces a small number of additional equilibrium conditions with analytical solutions. The additional parameters are disciplined by the salient facts on the inventory holdings of imported and domestically-produced goods in the data. Since we find that inventories are important, we emphasize that, given its simplicity, our approach can be easily applied to other work on international business cycles.

Our first goal is to see whether a plausibly calibrated model of inventory management and international trade can generate volatile and persistent fluctuations in international trade that are largely attributed to movements in a trade wedge of the type documented by Levchenko, Lewis, and Tesar (2010). We find that with the inventory mechanism we propose and international business cycles driven by productivity shocks, our model generates sizable fluctuations in inventories. These movements in inventories generate, in turn, large fluctuations in international trade and the trade wedge. Moreover, we find that the sources of these wedges matter a great deal. Our inventory-generated wedges imply fluctuations in consumption and output that are in line with the data. With wedges from “exogenous” taste or trade cost shocks, consumption becomes three times as volatile as in the data and these shocks account for an unreasonably high one-third of all aggregate fluctuations in output.

Our second goal is to explore whether a model with the appropriate fluctuations in international trade can generate international business cycles that match the data along

²Our earlier quantitative work on the recent recession (AKM, 2010b) applied a model without capital investment. It therefore lacked an important element for a quantitative analysis of international business cycle properties. The option of investing in capital and inventories, and their relationship with interest rates, has been shown to be important in analyzing the role of inventories in business cycles (Khan and Thomas, 2007a).

other dimensions. Specifically, we consider two well-known failures of standard international business cycle models. First, as Raffo (2008) points out, standard models do not generate countercyclical real net exports, when the movements in investment in the model are constrained to match the data. With this constraint, exports expand more than imports and real net exports are procyclical. Second, Backus, Kehoe and Kydland (1994, BKK hereafter) show that standard trade models predict consumption to be more correlated across countries than output, the opposite of what is observed in the data. This anomaly is now referred to as the consumption-output anomaly.³

We find that our model with inventories can make substantial progress regarding both of these failures of the standard model. Our model generates net exports that are countercyclical despite the fact that it accounts well for the variability of investment in the data. With inventories, following a good shock, imports expand more strongly and exports are dampened as domestic firms build their inventories of both goods. These dynamics reflect the different dynamics of net inventory investment and investment in equipment. In both the data and the model, net inventory investment movements are sharp but not very persistent, while investment in equipment has smaller and more persistent fluctuations.

In terms of the consumption-output anomaly, we find that inventories reduce the correlation of consumption across countries. The idea is simple. It is cheaper to consume from the stock of goods held locally than from goods that must be shipped internationally. Thus, consumption will depend on both the shocks and the stock of goods available. Since the stocks can move differently across countries, consumption becomes less correlated. For the same reasons, we also find that inventories tend to reduce the synchronization of production across countries, but the effect on consumption is much stronger.

Our paper is related to many papers that study trade dynamics and business cycles empirically and theoretically.⁴ In terms of quantitative work, our paper is closely related to the work by Backus, Kehoe and Kydland (1992, BKK hereafter) and Stockman and Tesar (1995). BKK show that standard trade models imply a very tight link between relative quantities and relative prices and that, given this tight link, it is impossible for equilibrium business

³See Baxter and Crucini (1995) who propose one resolution to this puzzle, namely, incomplete markets and adding permanent productivity shocks.

⁴Husted and Kollintzas (1984) study import dynamics in the presence of inventory dynamics in a partial equilibrium model.

cycle models to generate relative prices and quantities that match the data. Stockman and Tesar show that shocks to tastes can break the link between relative quantities and prices and create a trade wedge. They consider the role of these shocks in the propagation of business cycles. Unlike their work, which takes the wedge as exogenous, we focus on understanding the source of the wedge. In our analysis, we show that the transmission of business cycles looks markedly different with endogenous wedges arising from inventories than with exogenous wedges arising from taste shocks or trade costs. Indeed, with only exogenous wedges, these taste shocks become an important driver of aggregate fluctuations. Lastly, this paper is related to our own work on inventories and trade. Similar to AKM (2010b), we also develop a general equilibrium model of international trade and inventory adjustment. That paper studies the fluctuations in trade in the global downturn in 2008-09 using a model that lacks capital and only considers transition dynamics following aggregate shocks. In contrast, here we work with a slightly simpler two-country general equilibrium model of inventory holdings and trade with capital accumulation. This model is linearizable, making it quite tractable for considering business cycle fluctuations.

The paper is organized as follows. In the next section, we discuss some evidence on the cyclical behavior of international trade. We also present some evidence about the relationship between the adjustment of inventories and the synchronization of production in the motor vehicle industry in the US, Europe and Japan. In Section 3 we build a model of international trade and inventory management. In Section 4 we calibrate the model. In Section 5 we discuss the main properties of the model and in Section 6 we consider alternative parameterizations. Section 7 concludes.

2. Theory and Evidence

In this section, we provide clear evidence of the important role of inventory adjustment for import dynamics, define the trade wedge, and summarize the key cyclical properties of trade for the US. We also examine the role of inventories for the synchronization of global production of autos from 2008 to 2011. Specifically, we quantify empirically the contribution of changes in the stock of Japanese-produced autos held overseas on production in Japan.

A. Evidence from Japanese Autos

First, to clearly show that inventory investment decisions influence import dynamics, we consider the dynamics of US imports of autos from Japan from January 2007 to December 2011. The data are normalized relative to the 2007 average. These data are useful because we can separately measure imports, sales, and inventory of imported Japanese autos (as opposed to transplanted production). This period is interesting since it includes two major events: the collapse and rebound of trade in the global recession from 2008 to 2010 and the tsunami in Japan in March 2011.

The top panel of Figure 1 shows these dynamics clearly. The two big trade collapses in autos are clear. In the depths of both trade collapses, imports fall substantially below sales of cars from Japan, and inventories fall precipitously. There are also three periods of rising inventories, however: (1) the period preceding and continuing into the early stages of the trade collapse of 2008-2009, (2) the build-up during the trade recovery but after the “cash-for-clunkers” program in July 2009, and (3) the period during the post-tsunami trade recovery. During each of these periods, imports were rising and tended to exceed sales. These dynamics in trade and inventories are associated with large movements in measured trade wedges, as we discuss below.

B. Trade Wedges and Cyclical Properties of Trade

Trade wedges measure the departures in trade flows from those predicted by theory. This approach involves deriving a simplified aggregate import demand equation, calibrating its parameters, and then measuring deviations of actual imports from those predicted from fundamentals. Using this approach, Levchenko, Lewis, and Tesar (2010) document large deviations in trade flows from the predictions of the theory for the US and other countries. These deviations, or wedges, in import demand can be interpreted as changes in tastes (as in Stockman and Tesar, 1995), trade barriers, export participation by producers (Alessandria and Choi, 2007, and Ghironi and Melitz, 2005), or the inventory adjustment decision of exporters and importers (Alessandria, Kaboski, and Midrigan, 2011). We show, however, that inventory adjustments are important for the magnitude and interpretation of these wedges because they imply that trade flows and consumption of traded goods may differ substantially in the short run.

To motivate our analysis, consider the following accounting identity:

$$(1) \quad M_t = C_{mt} + S_{mt} - S_{mt-1},$$

where M_t is imports, C_{mt} is sales of imported goods, and S_{mt} is the inventory stock of imported goods at the end of period t so that $S_{mt} - S_{mt-1}$ is net inventory investment. We also assume a constant elasticity demand for imported goods:

$$(2) \quad C_{mt} = T_t (P_{mt}/P_t)^{-\gamma} C_t,$$

where P_{mt} is the price of imported goods, P_t is the price of the composite bundle, C_t denotes total sales (or absorption) and T_t is a demand shifter that we call the trade wedge.⁵ Equation (1) is an accounting identity, while (2) characterizes a large class of models of international trade in which preferences or production is Armington (CES) over imported and local goods.

We assume that in the long run, sales of foreign goods equals imports, $\bar{C}_m = \bar{M}$, so that inventory investment is zero.⁶ Then we have:

$$\frac{M_t - \bar{M}}{\bar{M}} = \frac{C_{mt} - \bar{C}_m}{\bar{C}_m} + \frac{\bar{S}_m}{\bar{C}_m} \frac{S_{mt} - S_{mt-1}}{\bar{S}_m},$$

where \bar{S}_m is the long-run stock of imported inventories and \bar{S}_m/\bar{C}_m is the inventory-to-sales ratio of imports. Combining (1) and (2), using a log approximation for small deviations, and letting lower-case variables denote log-deviations, yields what we call the “actual” import wedge:

$$(3) \quad \tau_t = m_t - \frac{\bar{S}_m}{\bar{C}_m} (s_{mt} - s_{mt-1}) - c_t + \gamma (p_{mt} - p_t).$$

Setting inventory adjustment to zero yields the traditional measure of the import, which we call the “naive” import wedge, $\hat{\tau}_t$,

$$(4) \quad \hat{\tau}_t = m_t - c_t + \gamma (p_{mt} - p_t).$$

⁵An alternative interpretation of τ_t is as an international trade cost that pushes the retail price of imported goods up above P_m . In such a case the movements in the trade cost would equal τ^γ .

⁶This assumes that physical depreciation of inventories is negligible relative to sales.

To get a sense of the magnitude of these two wedges, we plot the wedges for Japanese motor vehicles in the US in the bottom panel of Figure 1. We measure the wedges using an elasticity of substitution⁷ of $\gamma = 3$ and proxying for the relative price of Japanese-produced cars with the ratio of the US import price index of Japanese goods to the new vehicle CPI. The wedges are clearly strongly associated with the fluctuations in trade. Here, from the actual wedge we clearly see that Japanese autos actually gained market share in the early part of the crisis and then only lost market share in the second half of the downturn. Similarly, following the tsunami the import wedge is substantially smaller than the naive wedge. In general, movements in the actual import wedge are quite minor compared to the naive wedge that ignores inventory movements. Indeed, the variance of the actual import wedge is about 20 percent of the naive import wedge in this period.

The top panel of Table 1 reports some properties of fluctuations in wedges, imports, sales, and relative prices of Japanese motor vehicles in the US from 2007m1 to 2011m12. In general, we see that imports are twice as volatile as final sales of all autos, while sales of Japanese autos are only 40 percent more volatile than final sales. The naive wedge is almost 50 percent more volatile than sales, while the actual wedge is 40 percent less volatile. The naive import wedge is quite correlated with imports (0.83), while the actual wedge is not very correlated at all (0.25).

We next turn our focus away from just cars to measure the naive import wedge for overall US imports. For this calculation, we assume a conventional value of the Armington elasticity of $\gamma = 1.5$ and measure the relative price of imports, $(p_{mt} - p_t)$, as the ratio of the non-petroleum import price index relative to a price index on final expenditures of goods. Specifically, we measure the price of goods as

$$p_t = \alpha p_{gt} + (1 - \alpha) p_{xt}.$$

where p_{gt} is the price of consumer goods and p_{xt} is the price of investment in equipment and software (from the BEA). We let $\alpha = 0.75$ to match the importance of the consumption of goods in goods expenditure. Our measure of aggregate expenditure, C_t , is real domestic

⁷We actually estimate the elasticity of demand for Japanese cars over this period and find it is close to 3. When looking at more disaggregated data, it is common to find that imported goods tend to be more substitutable than they are with the aggregate data.

consumption of goods plus investment in equipment and software. We focus on the period 1995q1 to 2010q4.

Figure 2 plots the deviations from an HP-filtered trend (with a smoothing parameter of 1600) of US imports, the naive import wedge, and the actual import wedge. While imports are more volatile than the wedge, clearly, a substantial fraction of the fluctuations of imports is explained by the fluctuations in the naive wedge. The bottom panel of Table 1 summarizes the fluctuations in trade variables over the business cycle. Imports are about 1.4 times as volatile as US manufacturing industrial production (IP). Imports are strongly procyclical, with a correlation with IP of 0.92. The import wedge is slightly more volatile than IP and is also procyclical, with a correlation with IP of 0.86. Imports and the import wedge are persistent, with an autocorrelation of 0.86 and 0.78, respectively. The price of imports relative to final goods is about one-third as volatile as production and is not very correlated with either the import wedge or imports.

To measure the actual import wedge requires a measure of the inventory-to-sales ratio of imported goods as well as the changes in imported inventory. Unlike with autos, we lack direct measures of imported inventories and thus use the entire stock of US inventories as a proxy. Consistent with the micro evidence in AKM (2010a) that importers hold about double the inventory of non-importers, we set \bar{S}_m/\bar{C}_m equal to 2.25, about twice the average inventory-to-sales ratio since 1997. We assume that fluctuations in imported inventories are perfectly correlated with fluctuations in aggregate inventories and then use equation (3) to calculate the actual import wedge.

Fluctuations in the actual import wedge, τ_t , are generally smaller than fluctuations in the naive wedge that ignores inventory adjustments, $\hat{\tau}_t$. Indeed, in the current recession, nearly one-third of the decline and all of the increase in the import wedge disappears and the size of the actual import wedge appears less unusual. Thus, inventory adjustments made a sizable contribution to recent trade fluctuations. In the last line of Table 1 we report the cyclical properties of the actual import wedge. With this adjustment, the actual wedge is 30 percent less volatile, 10 percentage points less persistent and 10 percentage points less correlated with imports than the import wedge.

This evidence clearly suggests that trade wedges are big and that the inventory management decisions of importers are an important source of these wedges. However, a key

shortcoming of our approach to estimating the role of inventory adjustment in fluctuations in trade at the aggregate level is that it requires a very strong assumption that imported inventories move one for one with total inventories. This is likely to not be the case in the data; it certainly is not the case for autos. Thus, we require a model of optimal inventory adjustment to accurately estimate the role of inventory adjustments in trade flows. That is what we do in Section 3.

C. Global Motor Vehicle Production and Sales

To shed light on production and the global propagation of shocks, we turn again to the motor vehicle industry, a large and globally integrated industry. Figure 3 plots the quarterly production and sales of motor vehicles since 2007 in the US, Europe (the 27 countries in the EU), and Japan, the three largest markets prior to the Great Recession.

There are three key things to notice. First, production is quite synchronized. There was a synchronized global collapse and rebound in production in 2008 and 2009 and a smaller reduction in production in the US and EU around the tsunami in 2011. Indeed, the decline in production in 2008Q4 to 2009Q1 was very sharp and severe, with production falling 70 log points in Japan and 42 log points in the EU and 49 log points in the US. The bounceback was quite sharp in all three countries, although US production took longer to recover. Second, sales fell less than production in each market. Peak-to-trough, relative to the decline in production, US sales fell 60 percent, Japanese sales fell 30 percent, and EU sales fell 40 percent. From the dynamics of US imports of Japanese autos, we know this reflects in part the drawing down of inventories. The relatively sharp decline in production relative to sales in Japan and Europe compared to the US could partly reflect a reliance on sales in the US market as well as a relatively large inventory adjustment of Japanese and EU cars in the US. Third, sales are less correlated across countries than production. These very different sales dynamics in part reflect large differences in the size and timing of different national motor vehicle scrappage programs.⁸

To shed light on the role of inventories and trade in the international propagation of shocks, we consider the dynamics of production and absorption of Japanese-produced autos

⁸The US allocated \$3 billion and the program ran from July 1, 2009 to August 24, 2009. The German program spent about \$7 billion and ran from January 2009 to the end of the year. The Japanese program allocated \$3.7 billion and ran from April 2009 to September 2010.

in a bit more detail. As we have already seen from Figure 1, Japanese auto exports to the US fell much more than sales in the US Table 2 reports the change in average exports, production, sales in Japan and outside of Japan. The first column reports the change in the average activity in the collapse period (November 2008 to August 2009) versus average activity prior to the collapse (May 2008 to October 2008). The second column reports the change in the average activity in the rebound (September 2009 to August 2010) against the collapse. During the collapse, production was on average 42 percent lower while sales fell 12 percent and exports fell 63 percent. To get a sense of the role of domestic inventories in the decline in production, we see that the decline in production is 3 percentage points greater than the decline in domestic sales plus exports, which fell 39 percent. Thus, 3 percentage points of the decline in production were a result of reducing inventories in Japan. In terms of the export margin, we can examine the role of inventories by comparing the changes in exports with sales of exported Japanese autos in the US. Here we see that sales were on average 26 percent lower, while exports to the US were about 65 percent lower. Thus, a substantial share of the collapse in exports reflects a reduction in inventories in the US. If the US inventory adjustment is typical of Japanese export markets, and this is likely since the US accounts for about 40 percent of exports,⁹ then the decline in production would have been only 20 percent if there had been no inventory adjustment. Thus, the adjustment of inventories held overseas nearly doubled the size of the downturn in Japanese auto production. Focusing next on the rebound, we see that production rose 25 percent, exports rose 27 percent, and domestic sales rose 21 percent. However, US sales were actually 11 percent lower in the latter period, while exports were 28 percent higher. Again, if the US market is typical, then global sales only rose 5 percent. Thus, potentially 80 percent of the change in production in this latter period reflected inventory accumulation in foreign markets.

The last thing we consider is the dynamics of Japanese net exports in this period. Here we scale real exports by total trade flows, so $nx = 2(ex - im) / (ex + im)$. Figure 4 plots the dynamics of real and nominal net exports as well as net exports of passenger cars (scaled by aggregate trade). Clearly, we see that in the 2008-09 period, real net exports

⁹Indeed, one may actually expect that the inventory adjustment in the US market might understate the role of inventory adjustment in other countries as the US is a large, well-integrated market with relatively small frictions. Also, as such, in a large market the incentive to build an efficient distribution system is magnified.

dramatically moved from surplus to deficit and then back to surplus. The adjustment was large and sudden. Real net exports fell 30 percentage points from 2008Q3 to 2009Q1. The recovery was as large and almost as sudden, with net exports increasing 25 percentage points from 2009Q1 to 2009Q4. The movements in nominal net exports are more gradual and reflect in part the movements in energy prices. Net exports of autos show similar dynamics that are not as large, given autos' share in trade. Given our evidence from the auto industry, it is clear that the inventory adjustment overseas contributed to these net export dynamics.

In sum, the motor vehicle industry shows substantial synchronization of production in the recent recession. It also shows that production tends to fluctuate more than sales so that inventory stocks play an important role in the decline in production. Focusing on Japan, we see that the decline in exports drove the collapse and recovery in production and that overseas inventory dynamics strongly influenced the movements in exports. Indeed, based on the US, overseas inventory dynamics may have doubled the decline in production in Japan and lead to a rebound that was 5 times stronger.

3. Model

We now extend the two-country general equilibrium model of international trade of Backus, Kehoe, and Kydland (1994) to include a monopolistic retail sector that holds inventories of both domestic and imported intermediates. Inventories are introduced through a friction, and orders must be placed before idiosyncratic demand is realized. This gives retailers a stockout avoidance motive for holding inventories and allows for straightforward linearization. Specifically, in each country, a continuum of local retailers buy imported and domestic goods from a competitive intermediate goods sector in each country, and each retailer acts as a monopolist supplier in selling its particular variety of the good. Consumers purchase these varieties and then use an aggregation technology to transform home and foreign varieties into a final good used for consumption and investment.

A. Environment

Formally, consider an economy with two countries, Home and Foreign. In each period, t , the economy experiences one of finitely many states η_t . Let $\eta^t = (\eta_0, \dots, \eta_t)$ be the history of events up to date t , with the initial state η_0 given. Denote the probability of any particular history η^t as $\pi(\eta^t)$.

The commodities in the economy are labor, a continuum of intermediate goods (indexed by $j \in [0, 1]$) produced in Home, and a continuum of intermediate goods produced in Foreign. These intermediate goods are purchased and sold as retail goods to consumers. Finally, consumers combine intermediate goods to form final goods (consumption and capital), which are country-specific because of a bias for domestic intermediates. We denote goods produced in Home with a subscript H and goods produced in Foreign with a subscript F . (Foreign allocations and prices are denoted with an asterisk.) In addition, there are a full set of Arrow securities.

Consumers

The consumer's preferences over final consumption $c(\eta^t)$ and leisure $l(\eta^t)$ are

$$(5) \quad \sum_{t=0} \sum_{\eta^t} \beta^t \pi(\eta^t) U [c(\eta^t) - hC(\eta^{t-1}), l(\eta^t)].$$

The consumer chooses his consumption but utility can also depend on past aggregate consumption $C(\eta^{t-1})$ for $h \neq 0$, which allows for habit formation. Habit formation is external in that the consumer does not take into account how its current consumption decision affects its future habit. Habit helps generate persistent fluctuations in consumption as in the data.

Using Home consumers as an example, the final consumption, $c(\eta^t)$, and investment, $x(\eta^t)$, good is produced by aggregating purchases of a continuum of domestic retail goods $y_H^d(j, \eta^t)$ and a continuum of imported retail goods $y_F^d(j, \eta^t)$ (where $j \in [0, 1]$ indexes the good in the continuum).

$$(6) \quad D(\eta^t)^{\frac{\gamma-1}{\gamma}} = \left(\int_0^1 v_H(j, \eta^t)^{\frac{1}{\theta}} y_H^d(j, \eta^t)^{\frac{\theta-1}{\theta}} dj \right)^{\frac{\theta(\gamma-1)}{(\theta-1)\gamma}} + \tau^{\frac{1}{\gamma}} \left(\int_0^1 v_F(j, \eta^t)^{\frac{1}{\theta}} y_F^d(j, \eta^t)^{\frac{\theta-1}{\theta}} dj \right)^{\frac{\theta(\gamma-1)}{(\theta-1)\gamma}}$$

The weights $v_H(j, \eta^t)$ and $v_F(j, \eta^t)$ are subject to idiosyncratic shocks that are iid across j and t . We assume that these shocks are distributed Pareto, with domestic taste shocks drawn from $G^D(v) = 1 - v^{-a_{DOM}}$ and the taste shocks on imported goods from $G^I(v) = 1 - v^{-a_{IMP}}$. These stochastic idiosyncratic demand shocks lead to the precautionary stockout avoidance motive for holding inventories. Allowing a_{DOM} and a_{IMP} to differ allows

incentives to carry inventory to differ across imported and domestic goods.¹⁰

The parameter $\tau \in [0, 1]$ captures the lower weight on Foreign goods (i.e., a Home bias). For simplicity, we make the innocuous assumption that the shocks to retail varieties are identical across consumption and investment.¹¹ The Foreign consumer uses analogous technologies except that the lower weights τ multiply the Home goods.

The final composite good is used for consumption, investment, and investment adjustment costs so that

$$c(\eta^t) + x(\eta^t) \left(1 + \frac{\xi}{2} \left(\frac{x(\eta^t)}{x(\eta^{t-1})} - 1 \right)^2 \right) = D(\eta^t).$$

The left-hand side of the resource constraint shows that investment is subject to quadratic adjustment costs on the change in investment, parameterized by ξ . This type of adjustment cost is useful to get investment to be hump-shaped as in the data.

The law of motion for country-specific capital, which depreciates at rate δ , is:

$$(7) \quad k(\eta^{t+1}) = (1 - \delta) k(\eta^t) + x(\eta^t).$$

The consumer purchases domestic and imported retail goods at prices $p_H(j, \eta^t)$ and $p_F(j, \eta^t)$, respectively, supplies labor at a wage $W(\eta^t)$, and earns capital income at the rental rate $R(\eta^t)$ and profits $\Pi(\eta^t)$ (from retailers). In addition, it trades Arrow securities $B(\eta^{t+1})$ that are purchased at time t and pay off one unit next period in state η^{t+1} . We denote the price of the security in state η^t that pays one unit in state η^{t+1} as $Q(\eta^{t+1}|\eta^t)$. Suppressing the dependence of all variables on η^t for brevity, the consumer's period t budget constraint is therefore expressed:¹²

¹⁰In AKM (2010a) the different inventory holdings of retailers of domestic and imported goods arise from differences in the transaction costs (fixed order costs and delivery lags) between international and domestic orders. We find that the dynamic properties of our stockout-avoidance inventory model are quite similar to those of the micro-founded transaction cost model in a variation where both models lack capital accumulation.

¹¹It is straightforward to introduce different inventory holdings for investment and consumption goods as well as different levels of tradability in consumption and investment.

¹²We also need to set a borrowing limit in order to rule out Ponzi schemes, $B(\eta^t) > \underline{B}$, but this borrowing limit can be set arbitrarily large, i.e., $\underline{B} \ll 0$.

$$(8) \quad \sum_{i=\{H,F\}} \int_0^1 p_i(j) y_i(j) dj + \sum_{\eta^{t+1}} Q(\eta^{t+1}) B(\eta^{t+1}) = Wl + Rk + \Pi + B$$

The foreign consumers is analogous except that prices and profits are those in the Foreign country. The prices of Arrow securities $Q(\eta^{t+1}|\eta^t)$ are the same in both countries, since they can be traded internationally at no cost. The consumer takes prices and profits as given and maximizes (5) by choosing a series for labor supply, retail purchases, investment, and Arrow securities subject to (6), (7), and (8).

Producers

For each country, we model a single representative producer that supplies both the Home and Foreign markets. Intermediate goods in the Home country are produced by competitive firms using the following technology:

$$(9) \quad M(\eta^t) = A(\eta^t) K(\eta^t)^\alpha L(\eta^t)^{1-\alpha}$$

where $M(\eta^t)$ is output of intermediates, $K(\eta^t)$ is aggregate capital and $L(\eta^t)$ is aggregate labor used for production of intermediates.

Aggregate productivity in Home evolves according to

$$\log A(\eta^t) = \rho \log A(\eta^{t-1}) + \varepsilon(\eta^t)$$

Finally, we assume an analogous production function for Foreign-produced intermediates with a country-specific aggregate productivity shock. Producers are competitive, maximizing static profit-taking prices as given.

Retailers

In Home there is a unit mass of retailers selling goods that were produced in Home, and another unit mass of retailers selling goods that were produced in Foreign. Retailers purchase intermediates from producers and sell them to consumers. For a Home retailer of good j produced in Home, retail sales are denoted $y_H(j, \eta^t)$, while purchases from intermedi-

ate goods producers are denoted $z_H(j, \eta^t)$. We focus on Home retailers operating in Home; retailers operating in Foreign face an identical problem, as do Foreign retailers operating in Home. (The subscript F continues to distinguish goods *produced* in Foreign, while an asterisk continues to denote the corresponding arguments for the *retailers* in the Foreign market.)

The key friction motivating the holding of inventories is that a retailer must choose the amount of goods to have in its store at time t *before* learning $v_H(j, \eta^t)$. We denote this stock on hand as $z_H(j, \tilde{\eta}^t)$, where $\tilde{\eta}^t$ signifies the history up to date t excluding the retailer's demand realization at t . However, the retailer chooses its price $p_H(j, \eta^t)$ *after* learning $v_H(j, \eta^t)$. We also allow the retailer to return the unsold stock, but only at $t + 1$ so the retailer will be able to sell it at next period's price $\omega(\eta^{t+1})$ after incurring the inventory carrying costs of depreciation. Allowing the resale of unsold goods in the following period at the market price means we do not need to keep track of the distribution of inventory holdings.

The profit maximization problem of a Home retailer selling home goods is:

$$(10) \quad \begin{aligned} \max_{z_H(j, \tilde{\eta}^t), p_H(j, \eta^t)} \sum_{t=0}^{\infty} \sum_{\eta^t} Q(\eta^t) [p_H(j, \eta^t) y_H(j, \eta^t) - \omega(\eta^t) [z_H(j, \tilde{\eta}^t) - s_H(j, \eta^{t-1})]] \\ \text{s.t. } y_H(j, \eta^t) \leq z_H(j, \tilde{\eta}^t) \\ s_H(j, \eta^t) = (1 - \delta_s(\eta^t)) [z_H(j, \tilde{\eta}^t) - y_H(j, \eta^t)] \end{aligned}$$

where $Q(\eta^t) = Q(\eta^t | \eta^{t-1}) Q(\eta^{t-1} | \eta^{t-2}) \dots Q(\eta^1 | \eta^0)$ is the date 0 Arrow-Debreu price of 1 unit of the numeraire to be delivered in state η^t , and $y^H(j, \eta^t)$ is the demand the retailer faces at price $p_j^H(\eta^t)$. Unsold inventory $z_H(j, \tilde{\eta}^t) - y_H(j, \eta^t)$ can be carried forward, but this entails a cost from physical depreciation, captured by $\delta_s(\eta^t)$. The end-of- t stock of inventories of undepreciated inventories is denoted $s_H(j, \eta^t)$. Thus the retailer will optimally choose inventories to trade off being able to satisfy demand when demand is high with the costs of carrying unsold inventories into the next period when demand is low.

The Home retailer that sells Foreign goods faces a similar problem, except for its wholesale cost is $\omega^*(\eta^t)$. Foreign retailers also face analogous problems.

B. Equilibrium

We first define and then show some preliminary characterization of the equilibrium, which will be solved numerically.

Definition

In this economy, an equilibrium is defined as (i) an allocation of aggregate and individual quantities $\{C(\eta^t), c(\eta^t), L(\eta^t), l(\eta^t), K(\eta^t), k(\eta^t), M(\eta^t), y(\eta^t), B(\eta^t), \Pi(\eta^t)\}_{t=0}^\infty$, and disaggregate goods $\{y_i(j, \eta^t), s_i(j, \eta^t), z_i(j, \tilde{\eta}^t)\}_{i=H,F}\}_{t=0}^\infty$ for both Home and Foreign, and (ii) prices of goods $\left\{ \{p_i(j, \eta^t)\}_{i=H,F}, \omega(\eta^t) \right\}$ and factors in $\{W(\eta^t), R(\eta^t)\}_{t=0}^\infty$ for both Home and Foreign, and (iii) Arrow security prices $\{Q(\eta^{t+1}|\eta^t)\}_{t=0}^\infty$, such that:

- Given prices, the allocations satisfy the consumers' problems, the intermediate producers' problems, and retailers' problems in Home and Foreign;
- Individual consumption $c(\eta^t)$ equals aggregate consumption, $C(\eta^t)$; and
- The retail goods, labor, and capital markets clear in each country, and the intermediate goods markets and Arrow security markets clear for the world economy.

We briefly describe the market clearing conditions. First, Arrow securities are in zero net supply, so the bond market clearing condition requires $B(\eta^t) + B^*(\eta^t) = 0$. Second, all capital and labor is used in intermediate goods production.

$$\begin{aligned} L(\eta^t) &= l(\eta^t) \\ K(\eta^t) &= k(\eta^t) \end{aligned}$$

The resource constraint for intermediate goods requires that production equal orders:

$$(11) \quad M(\eta^t) = \int_0^1 [z_H(j, \tilde{\eta}^t) - s_H(j, \eta^{t-1})] dj + \int_0^1 [z_H^*(j, \tilde{\eta}^t) - s_H^*(j, \eta^{t-1})] dj$$

Notice that intermediate goods produced in Home, $M(\eta^t)$, have two uses: they go to domestic retailers of Home goods, $z_H(j)$, and to foreign retailers of exported Home goods, $z_H^*(j)$. The resource constraint for individual retail goods $y_H(j, \eta^t)$ involves those sold as consumption goods $c_H(j, \eta^t)$ and investment goods $x_H(j, \eta^t)$:

$$y_H(j, \eta^t) = c_H(j, \eta^t) + x_H(j, \eta^t)$$

A parallel set of market clearing constraints holds for foreign goods.

Preliminary Characterization

We briefly offer a preliminary characterization of the features of the equilibrium. Notationally, expressions are simplified by dropping the η^t dependence where it does not cause confusion (e.g., static conditions). Perfectly competitive producers simply pay factors their marginal products and price at marginal cost, $\omega = r^\alpha w^{1-\alpha}/A$.

The consumer's maximization can be solved step-wise, with the consumer choosing an allocation of retail purchases $y_H^d(j)$ and $y_F^d(j)$ to minimize the expenditure necessary to deliver D units of the final composite good. With respect to aggregates, the consumer's optimization conditions are standard. The zero net supply condition on Arrow securities leads to the following pricing $Q(\eta^t) = \beta^t \pi(\eta^t) \frac{U_c(\eta^t)/P(\eta^t)}{U_c(\eta^0)/P(\eta^0)}$.

The cost-minimizing first-order conditions define the demand for the retail varieties:

$$(12) \quad \begin{aligned} y_H^d(j) &= v_H(j) \left(\frac{p_H(j)}{P_H} \right)^{-\theta} \left(\frac{P_H}{P} \right)^{-\gamma} D \\ y_F^d(j) &= v_F(j) \tau \left(\frac{p_F(j)}{P_F} \right)^{-\theta} \left(\frac{P_F}{P} \right)^{-\gamma} D \end{aligned}$$

where we have defined the following aggregate price indexes for Home-produced output, Foreign-produced output, and output overall:

$$(13) \quad P_H = \left(\int_0^1 v_H(j) p_H(j)^{1-\theta} dj \right)^{\frac{1}{1-\theta}}$$

$$(14) \quad P_F = \left(\int_0^1 v_F(j) p_F(j)^{1-\theta} dj \right)^{\frac{1}{1-\theta}}$$

$$(15) \quad P = [P_H^{1-\gamma} + \tau P_F^{1-\gamma}]^{\frac{1}{1-\gamma}}$$

We characterize the optimal decisions for retailers of Home goods in Home, but the other retailers are analogous. Given the ex ante symmetry of the problem, all j retailers have the same desired stock-on-hand, $z_H(j) = z_H$. The retailers' pricing decision rule depends on its idiosyncratic demand shock relative to a threshold value, \hat{v}_H , and is:

$$(16) \quad p_H(j) = \begin{cases} \hat{p}_H = \frac{\theta}{\theta-1} \sum_{\eta^{t+1}} (1 - \delta_s(\eta^t)) \frac{Q(\eta^{t+1})}{Q(\eta^t)} \omega(\eta^{t+1}) & \text{if } v_H(j) \leq \hat{v}_H \\ \left(\frac{z_H}{v_H(j) \left(\frac{P_H}{P} \right)^{-\gamma} \left(\frac{1}{P_H} \right)^{-\theta} D} \right)^{-\frac{1}{\theta}} & \text{if } v_H(j) > \hat{v}_H \end{cases}$$

For a low demand shock, it sets the price, \hat{p}_H , as a $\theta/(\theta - 1)$ markup over its marginal shadow cost, the expected discounted value of carrying the inventories forward. For a sufficiently high demand shock, the retailer sells at the price to just sell its entire inventory.

Given this pricing policy, our assumption of Pareto-distributed taste shocks leads to an analytical solution for optimal stock-on-hand, z_H . Equating the two branches of the pricing function yields the stockout threshold of demand, \hat{v}_H :

$$\hat{v}_H = \frac{z_H}{\left(\frac{P_H}{P}\right)^{-\gamma} \left(\frac{\hat{p}_H}{P_H}\right)^{-\theta} D}$$

Notice that the price of firms that stock out is now equal to $p_H(j) = \hat{p}_H [v_H(j)/\hat{v}_H]^{\frac{1}{\theta}}$, and so the price index for home goods sold in Home equals:

$$P_H = \hat{p}_H \left[(\hat{v}_H)^{1-a_{DOM}} \left(\frac{a_{DOM}}{1-a_{DOM}} - \frac{a_{DOM}}{\frac{1}{\theta} - a_{DOM}} \right) - \frac{a_{DOM}}{1-a_{DOM}} \right]^{\frac{1}{1-\theta}}$$

The prices are all functions of the threshold values and can be substituted into the expressions for optimal stock on hand. Continuity of the prices at \hat{v}_H (i.e., again equating both branches of (16)) yields the threshold value:

$$\hat{v}_H = \left(\frac{\frac{1}{\theta}}{a_{DOM} - \frac{1}{\theta}} \right)^{1/a_{DOM}} \left(\frac{\omega_t}{E_t(1 - \delta_s) \frac{Q_{t+1}}{Q_t} \omega_{t+1}} - 1 \right)^{-1/a_{DOM}}$$

We can substitute this to solve for the z_H , which is the product of three terms:

$$(17) \quad z_H = \left(\frac{P_H}{P} \right)^{-\gamma} \left(\frac{\hat{p}_H}{P_H} \right)^{-\theta} D \\ \times \left(\frac{1/\theta}{a_{DOM} - 1/\theta} \right)^{1/a_{DOM}} \\ \times \left(\frac{\omega(\eta^t)}{\sum_{\eta^{t+1}} (1 - \delta_s(\eta^t)) \frac{Q(\eta^{t+1})}{Q(\eta^t)} \omega(\eta^{t+1})} - 1 \right)^{-1/a_{DOM}}$$

Desired stock-on-hand is increasing in the average level of demand (first term) and the stockout avoidance motive (second term) but decreasing in the price today relative to the expected price tomorrow (third term). This last term gives insight into inventory investment

motives in response to transitory productivity shocks; there is an incentive to invest when goods are cheap or interest rates are low.

The aggregate stock of inventories held in Home is given by

$$(18) \quad S = S_H + S_F = \int_0^1 s_H(j) dj + \int_0^1 s_F(j) dj$$

Additionally, inventory depreciation is assumed to depend on the stock of local inventories:

$$\delta_s = \delta_{s,0} + \delta_{s,1} e^{(S/\bar{S}-1)}$$

where \bar{S} is the steady-state level of inventories. If $\delta_{s,1} < 0$, there are economies of scale to holding inventories, while with $\delta_{s,1} > 0$, there are congestion costs.

We stress here that the equilibrium equations are a minimum departure from the standard international business cycle literature. The retailers' problem and the taste shocks introduced into the consumer's demand problem result in only two changes in equilibrium conditions. The pricing formula in (16) replaces the simple markup over marginal cost. Second, we have the additional equations that track inventories: the optimal stock-on-hand equation (17), and the definitions of retailer and aggregate end-of-period inventories (equations (10) and (18), respectively.) Finally, since the model has no fixed costs or occasionally-binding constraints complicating the decision rules or laws of motion of aggregates, the aggregate equilibrium is linearizable.

4. Calibration

We now describe the functional forms and parameter values considered for our benchmark economy. The parameter values used in the simulation exercises are reported in Table 3. Similar to Raffo (2008) we use a GHH instantaneous utility function. Unlike Raffo, we allow for habit persistence in consumption.

$$U(c, l) = \log \left((c - hC_{-1}) - \frac{\psi}{1 + \eta} l^{1+\eta} \right).$$

With external habit the household takes the path of C_{-1} as given.

For several parameters, we assign typical values that are relatively standard in the international real business cycle literature. These parameters include the preference parame-

ters $\{\beta, \gamma, \psi, \eta\}$ and technology parameters $\{\delta, \alpha\}$. Our period is a quarter so $\beta = 0.99$. We set the depreciation rate of capital to $\delta = 0.025$ and the capital share to $\alpha = 0.33$. We choose ψ , the relative weight on leisure in the utility function in order to match a labor supply of one-third. We set η so that the Frisch elasticity is 2. We assign the elasticity of substitution between domestic and imported goods $\gamma = 1.5$, a standard value.

The remaining parameters $\{\theta, \delta_{s,0}, \delta_{s,1}, a_{DOM}, a_{IMP}, \tau_F\}$ are particular to our inventory/retailing set-up. We start by assigning $\theta = 3$, which implies that the ratio of manufacturing to total sales is 40 percent, as in the US. Although all four moments are jointly determined by all parameters, the parameter τ is the main determinant of trade flows, while $a_{DOM}, a_{IMP}, \delta_s$ primarily determine the trade share, stock of inventories, and premium of imported inventories relative to domestic inventories. We target three moments for the US from 1997 to 2010. First, imports are 26.5 percent of manufacturing sales. Second, inventory holdings are equal to 1.5 times final quarterly expenditures on consumption plus investment. The third target is that importing firms hold twice the inventory (relative to sales) as firms that source domestically. This ratio is consistent with inventory-to-sales ratios for importers vs. domestic firms that we observe for Chilean plants and for US manufacturing industries (AKM 2010b). We set depreciation to be $\delta_{s,0} = 0.016$. This implies inventory holding costs, including interest costs, of about 2.6 percent per quarter. This is quite low relative to estimates in the literature. Of course, our model misses out on some key channels that lead to inventory holdings. We undertake sensitivity to δ_s , however.

The technology shock process follows much of the literature. The persistence of national productivity shocks is 0.95 and the correlation of innovations across countries is 0.25. The size of the shocks is set to match the volatility of industrial production.

The investment adjustment costs and cyclicity of inventory holding costs are chosen to target the volatility of investment in equipment and overall investment. Matching the cyclicity of inventory investment requires $\delta_{s,1} = -0.00445$, which implies that, in booms, the costs of managing inventories fall and this encourages additional investment in inventories.¹³ Finally, we set our habit parameter to match the autocorrelation of consumption in our benchmark model. This requires a habit parameter h of 0.30.

¹³An alternative approach to affect the cyclicity of net inventory investment is to introduce a physical cost of managing inventories and let this cost vary over the cycle.

To clarify the role of inventories, we also consider the properties of a model with no inventories. This is a version of the BKK model with retailers charging a constant markup over marginal cost. In the model with no inventories, we set the investment adjustment cost so that total investment, which includes net inventory investment, is 2.89 times as volatile as production, as in the data.

5. Results

We now discuss the properties of our benchmark model economy and compare the results to the benchmark model without inventories and the data. Tables 4 and 5 report some key cyclical properties of the model. Figure 5 plots the impulse response to a positive (one standard deviation) productivity shock of key variables in the benchmark inventory model and the no inventory model, respectively. In short, we find that our benchmark model can capture some key features of trade dynamics without doing too badly on the new inventory dimensions.

Specifically, in Table 4, we find that imports and exports are now about 7 percent more volatile than production (compared to 40-49 percent in the data and 11 percent less volatile than production with no inventories). These fluctuations in trade generate a sizable import wedge, with relative volatility of 0.79 (compared to 1.08 in the data). The large increase in wedge volatility despite the moderate increase in trade volatility arises because the inventory model generates smaller relative price fluctuations. For instance, the relative volatility of the terms of trade is 0.4 in the benchmark model against 0.57 in the no inventory model (and 0.27 in the data).

With inventories, imports are substantially more procyclical in the benchmark model (0.85) than in the model without inventories (0.69) as shown in Table 5. Neither is as procyclical as in the data, however, where the correlation with production is 0.92. The wedge is procyclical in the benchmark model (0.68) but less so than in the data (0.86). However, the model matches the correlation of the wedge with imports (0.86, model, 0.88, data).

In terms of real net exports, the inventory model generates somewhat larger fluctuations in net exports compared to the no inventory model (0.33 vs 0.21 in Table 4), but both are similar to the data (0.28). With inventories, however, net exports (normalized by sales) are countercyclical (-0.25). This is in strong contrast to the model without inventories,

where they are procyclical (0.33), and substantially closer to the data (-0.42). Net exports are procyclical primarily because inventories make exports considerably less procyclical. The correlation of exports with production is 0.63, as compared to 0.90 with no inventories.

In both models there is a consumption-output anomaly, in that consumption is more correlated across countries than output. However, we find that the anomaly, measured by the difference between the consumption and output cross-correlation, is smaller in the inventory model (0.21) than in the no inventory model (0.33). In terms of the comovement of business cycles, whose correlations are presented in the bottom panel of Table 5, we find that there is actually less synchronization of business cycles in the inventory model than in the no inventory model. For instance, the cross-correlation of production is 0.35 in the inventory model and 0.43 in the no inventory model. Similarly, the cross-correlation of consumption in the inventory model is 0.56 and 0.71 in the no inventory model. One reason for the weaker comovement is that inventories provide another way to smooth production (and consumption). We explore this in greater detail in our sensitivity analysis.

A key problem with both models, however, is that the fluctuations in trade they generate are not persistent enough. For instance, the autocorrelation of imports in Table 6 is 0.67 with and without inventories and 0.86 in the data. The model with inventories does generate wedges, but these are also not persistent enough, with an autocorrelation of 0.57 that is lower than the 0.78 in the data. Nevertheless, movements in net exports are relatively persistent, with an autocorrelation of 0.71, similar to the 0.76 in the data. Again, the model without inventories cannot match the persistence of net exports.

The source of these transitory fluctuations is clear from Figure 5. Following a productivity shock at home, the need to build up inventory in the more productive location leads to an initial jump in imports but a much weaker export response in the model with inventories relative to the model without inventories. Consequently, initially net exports go into a deficit and that deficit is reversed in later periods when imports fall sharply and exports expand.

6. Sensitivity

In this section, we perform further analysis to examine the role of inventories for the cyclicity of trade and the propagation of business cycles. First, we consider how the cyclicity of real net exports affects the transmission of business cycles in these models.

Second, we evaluate the model's response to a global productivity shock that hits both countries symmetrically. Third, we introduce exogenous taste shocks to imports that yield exogenous trade wedges and evaluate the relationship between these exogenous wedges and the endogenous wedges driven by inventories. Finally, we change the correlation of shocks in the model of inventories in order to more closely examine the role of inventories in alleviating the comovement puzzle.

A. Balanced Real Net Exports

We consider how the cyclical nature of real net exports influences the propagation of shocks by constraining real trade flows to be balanced each period. In order to better understand propagation, we do not recalibrate the adjustment costs on investment or inventories. The results are reported in the columns *Balanced Real Trade* for the inventory and no inventory models.

The first thing to notice is that, with balanced real trade, consumption is more correlated across countries than production in the inventory model (0.47 vs. 0.40) and less correlated in the no inventory model (0.39 vs. 0.40). The higher comovement of consumption in the inventory model reflects the use of inventories to smooth out consumption. By comparing the balanced trade to our benchmark models, we can more easily see the role of the cyclical movements in net exports. In the inventory model, where net exports are countercyclical, the consumption-output anomaly only increases 14 percentage points, while it increases 34 percentage points in the no inventory model, where net exports are procyclical. Thus, the procyclical net exports in the inventory model clearly generate substantially less synchronization in consumption across countries. Viewed differently: given a particular consumption correlation across models, we would expect output to be more correlated in the inventory model than in the no inventory model.

B. Global Shocks

Figure 6 shows the impulse response to a global positive productivity shock. That is, we shock both countries with a symmetric and synchronized positive productivity shock. The model with inventories leads to a large increase in trade, with imports and exports, of course, increasing symmetrically. This boom in trade exceeds the boom in production, and the increase in production is partially used for inventory investment. Hence, the increase in

production exceeds the increase in absorption (consumption plus capital investment). The wedge is consequently sizable, but these inventory-driven dynamics are short-lived. In contrast, the model without inventories yields no wedge, and the increases in trade, production, and absorption are equally sized and follow the identical pattern.

Although the figures evaluate the response to a *positive* productivity shock and global boom, similar, but opposite, dynamics would arise in a global recession like that described in Section 2. They also demonstrate how correlated shocks can lead to greater volatility in trade than in production observed in the data (Table 5).

C. Exogenous Wedge Shocks

To show that the source of the trade wedge matters, we introduce exogenous shocks that lead to trade wedges. Specifically, we allow the home bias parameter τ to be subject to a stochastic shock $\hat{\tau}_t$ as follows

$$\tau(\eta^t) = e^{\hat{\tau}(\eta^t)} \bar{\tau}$$

These wedges are similar to the taste shocks introduced by Stockman and Tesar (1995), but here the shocks are only on foreign goods, which more closely approximates a shock to trade costs, where decreased trade costs resemble import-specific productivity shocks. Indeed the results we discuss below from this simple formulation are essentially the same as those from a more involved model with explicit shocks to iceberg trade costs.¹⁴

We assume the shock $\hat{\tau}(\eta^t)$ follows a first-order autoregressive process

$$\begin{aligned} \hat{\tau}(\eta^t) &= \rho \hat{\tau}(\eta^{t-1}) + \sigma_w \varepsilon(\eta^t) \\ \hat{\tau}^*(\eta^t) &= \rho \hat{\tau}^*(\eta^{t-1}) + \sigma_w \varepsilon^*(\eta^t) \end{aligned}$$

where σ_w governs the variance of the wedge shocks relative to the shock to productivity $\varepsilon(\eta^t)$.

We calibrate the shock to match the volatility of the trade wedge in the inventory and no inventory models. For the inventory model, $\sigma_w = 0.28$, while the no inventory model requires $\sigma_w = 2.7$, nearly ten times the size of shocks needed in the model with inventories. The results of this exercise are in the columns denoted “Trade Shocks” in Tables 4 and 5.

¹⁴This assumes the trade costs are not included in the export price. Details of this model and the results are available upon request.

In the inventory model, these trade shocks bring trade more in line with the data without doing much harm to the business cycle properties of the model.¹⁵ Specifically, output is only slightly more volatile (3.53 vs. 3.33), while trade is substantially more volatile (1.30 vs. 1.07) and quite close to the data (1.30 vs. 1.4). The real exchange rate and terms of trade become more volatile as well. Net exports become slightly less countercyclical (-0.23 vs. 0.25), while output comovement increases slightly (0.35 to 0.37), and consumption comovement falls slightly (0.56 to 0.53).

In the no inventory model, these trade shocks bring trade more in line with the data but substantially alter the business cycle properties of the model. Specifically, output is much more volatile (5.12 vs. 3.40), trade is substantially more volatile (1.63 vs. 0.89), and the terms of trade are substantially more volatile (1.03 vs. 0.57 and 0.27 in the data). Consumption becomes 1.34 times more volatile than IP compared to 0.46 in the data. Net exports become slightly less procyclical (0.29 vs. 0.33), while output and consumption comovement both fall 8 percentage points. Given the movements in output and consumption, these trade shocks become a major driver of international business cycles. In short, we find that the trade dynamics from endogenous wedges reflecting inventory adjustment lead to a substantially better fit than those reflecting exogenous shocks to trade.

D. Equalized Comovement

The final columns in Tables 4 and 5 present the results for the model with no inventories, where the correlation of productivity shocks across the two countries has been set in order to match the comovement in production across countries in the model with inventories. This facilitates an easier comparison of the impact of inventories on the relative comovement of production and consumption. Clearly, even after the comovement in production is equalized, the model with inventories is yielding much less comovement in consumption. Again, this is because the presence of inventories impacts the cost of consumption. Thus, consumption will depend on both productivity shocks and the stock of available inventories. While productivity shocks hit the costs of goods symmetrically, inventory stocks move differently across countries, especially since inventory motives differ across imported and domestic goods. This

¹⁵Impulse response functions in the model verify this. Other than the movements in trade wedges and trade, they are nearly identical to the model without wedges (see our earlier working paper, Alessandria, Kaboski, and Midrigan, 2012).

allows consumption to be less correlated across countries.¹⁶

E. Additional Sensitivity

We consider a variety of alternative calibrations. Specifically, we consider how the imported inventory premium, depreciation rate of inventories, and asymmetries in inventory holdings affect our results.¹⁷ The results of these alternative calibrations are also reported in Tables 4 and 5.

We first consider the impact of eliminating the inventory premium on imported goods. The results are reported in the column *No Import Premium*. As one should expect, eliminating the import premium reduces the volatility of trade flows from 1.07 to 0.92. The lower volatility of trade arises primarily from a smaller wedge as this is reduced from 0.79 to 0.61. Real net exports are now more countercyclical than in the benchmark (-0.31 vs. -0.25) as exports become slightly less procyclical and imports slightly more procyclical.

We next consider how our choice of inventory depreciation affects our results. In the column titled *Low Inventory Depreciation* we consider the case with $\delta_{0s} = 0.008$. With this lower depreciation rate, we must reduce the idiosyncratic uncertainty to hit the same inventory targets as before. The low depreciation rate lowers the volatility of the inventory stock from 0.54 to 0.49. The volatility of trade flows falls slightly from 1.07 to 1.04. The wedge also becomes slightly less volatile. Net exports become slightly less countercyclical.

Lastly, we consider the properties of the model when there are asymmetric inventory holdings across countries. Specifically, we consider the case where the Foreign country produces and exports a good that requires more inventory holdings than the Home country. An example of this might be Japan intensively producing and exporting autos while the US intensively produces and exports less inventory-intensive services. Specifically, we calibrate the model so that the retailers of Home goods in the foreign country face the same idiosyncratic uncertainty as retailers of locally produced goods in the Foreign country. The last two columns of the table report the statistics from the *Asymmetric Countries* (High denotes the

¹⁶With the presence of retailers and inventories there are issues with measuring the shocks hitting the economy that make the measured correlation of shocks in the inventory model lower than the actual shocks. In the no inventory model the bias goes the other way. Thus, in this experiment the correlation of measured Solow residuals in the two models is about the same.

¹⁷We also consider the role of the elasticity of substitution and assets trade for propagation in our working paper. These generally have a moderate impact in our framework.

country with high final good inventories and Low denotes the country with low final good inventories). With the asymmetric inventory holdings, import and export volatility are no longer equal as the incentive to adjust inventories differs across destinations. Indeed, Home imports are more volatile than Home exports and the wedge is larger in the Home country than in the Foreign country. Business cycle correlations do not change dramatically, although the High inventory country now has real net exports that are more countercyclical, while the Low inventory country has slightly less countercyclical net exports.

7. Conclusions

Over the business cycle, fluctuations in international trade involve substantial, persistent departures from theory in that the movements in trade generally cannot be fully explained by movements in final expenditures and relative prices. We show empirically and theoretically that an important reason for the failure of standard models to explain these trade flows is that they ignore the inventory management decisions of importers. We show a two-country GE model with an inventory management decision, business cycles driven by productivity shocks can generate some of the explained and unexplained movements in international trade over the business cycle.

In terms of the propagation of business cycles, we find that bringing trade flows more in line with the data alters some key features of international business cycles. Specifically, with inventories, real net exports are countercyclical as in the data. Following a positive productivity shock in the home country, inventory investment motives give the home country a stronger desire to import and a weaker desire to export than in a standard model without inventories. Moreover, with countercyclical net exports, inventories lead consumption to become less correlated across countries for a given amount of comovement in production. This occurs because the stock of inventories is local and influences the consumption decision. Lastly, we find that introducing shocks to preferences for foreign goods, a natural stand-in for changes in trade costs and alternative sources of the trade wedge, into our benchmark inventory model can generate all of the movements in the trade wedge without dramatically altering international business cycles. Introducing these same shocks in a model without inventories requires much larger shocks to trade costs and implies that fluctuations in trade costs are a major driver of aggregate fluctuations.

The importance of inventories in the international transmission of business cycles suggests several avenues for further investigation. Our model of inventories has an explicit supply chain, but it would be interesting to introduce a more involved input-output structure, where manufacturing production involves intermediates. The differing importance of inventories across sectors may also have implications for how shocks filter through the input-output structure. Such an analysis would require disaggregate data on industry-level holdings of imported and domestic inventories that are more broadly representative than our automobile case study. Assembly and analysis of informative disaggregate data on sales and inventory of imported goods would be helpful.

Finally, our analysis only considers business cycles arising from supply shocks. In practice, monetary, government, and financial shocks are likely to matter as well. To the extent that these shocks affect inventory investment, they will generate trade wedges as well, though. The framework we have developed is tractable enough to consider these types of shocks as well.

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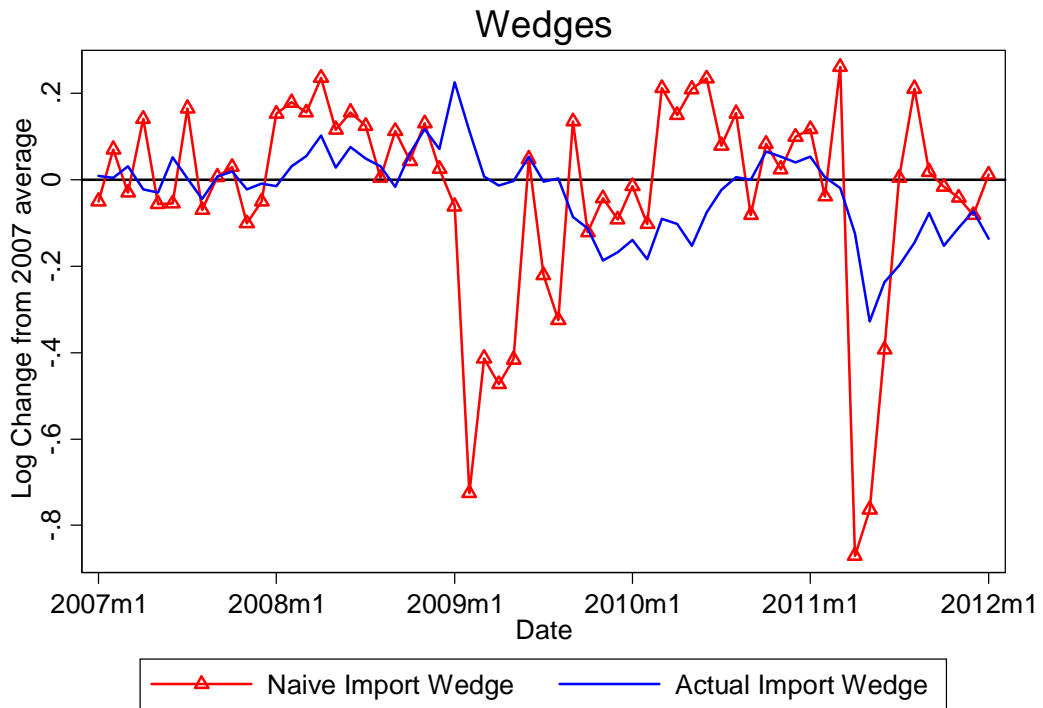
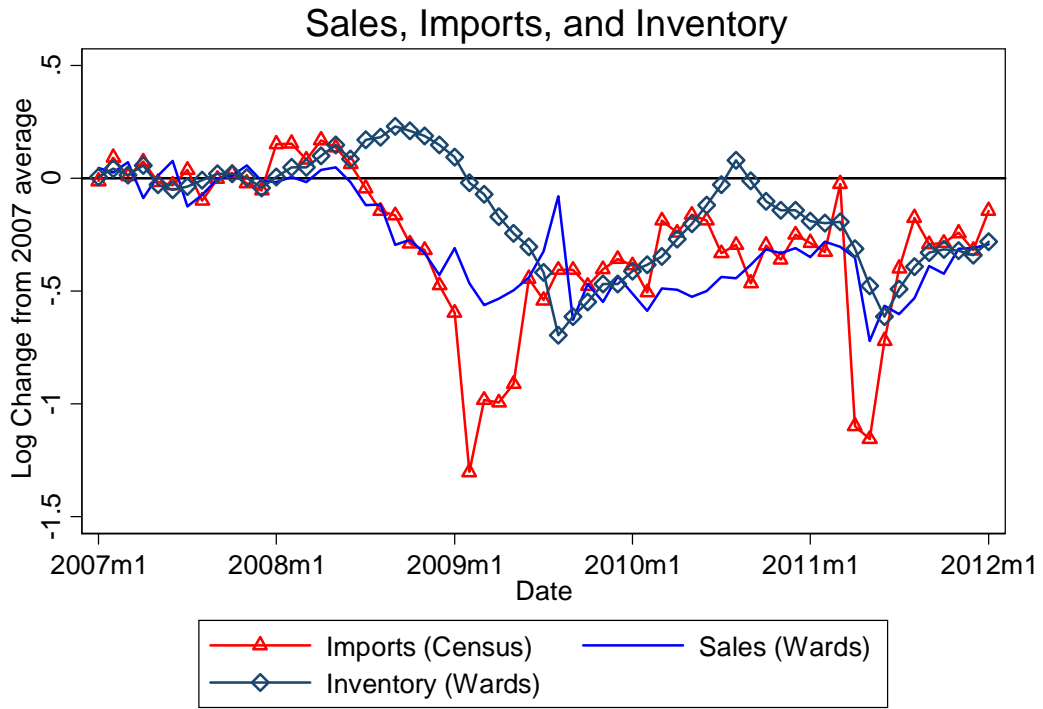


Figure 1: US Car Sales, Imports, and Inventory of Japanese cars

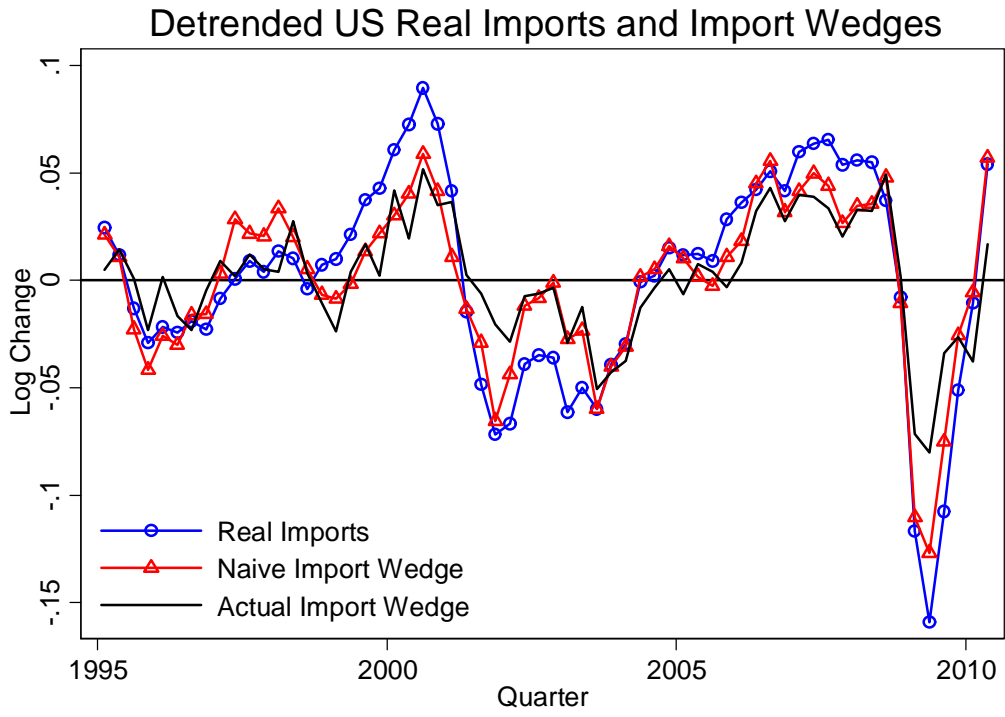


Figure 2: Deviations from Trend of US Imports, Wedge, and Import Price

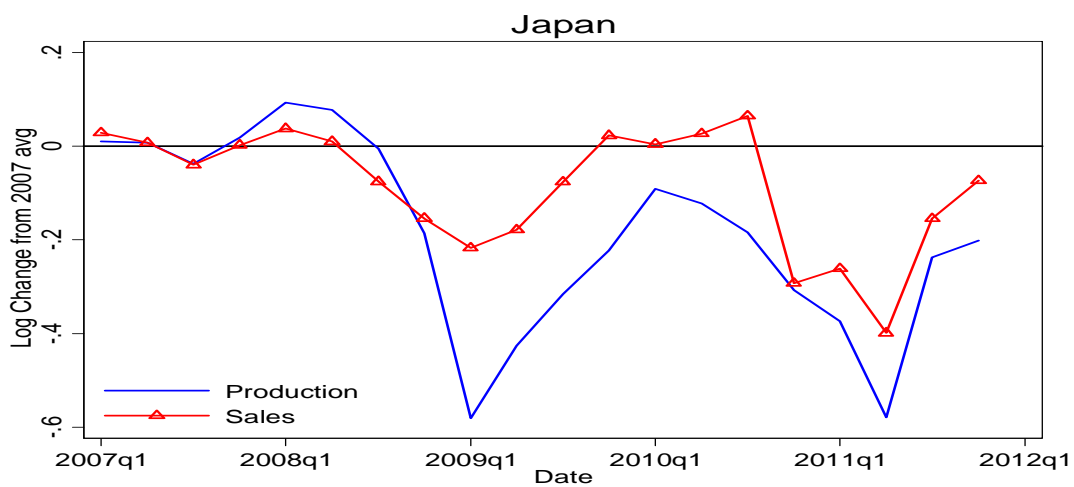
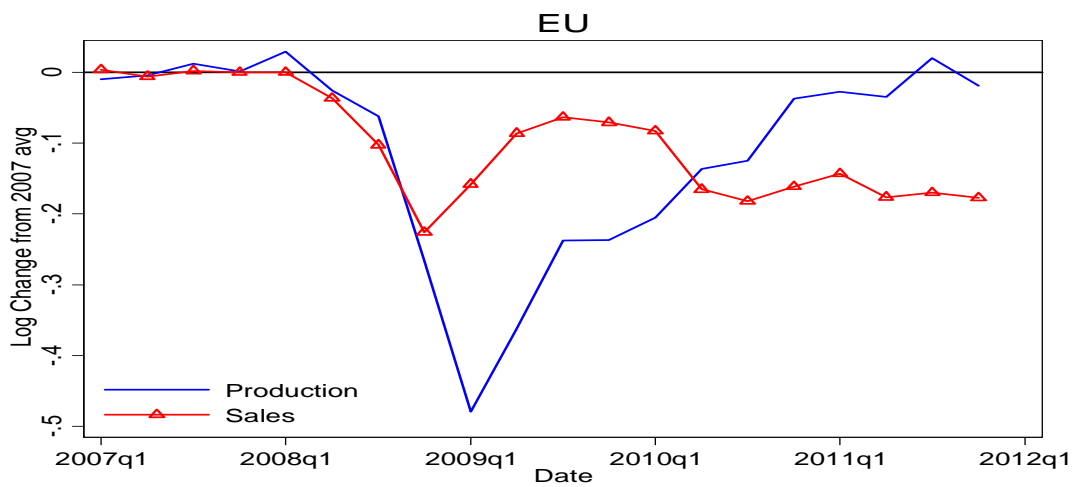
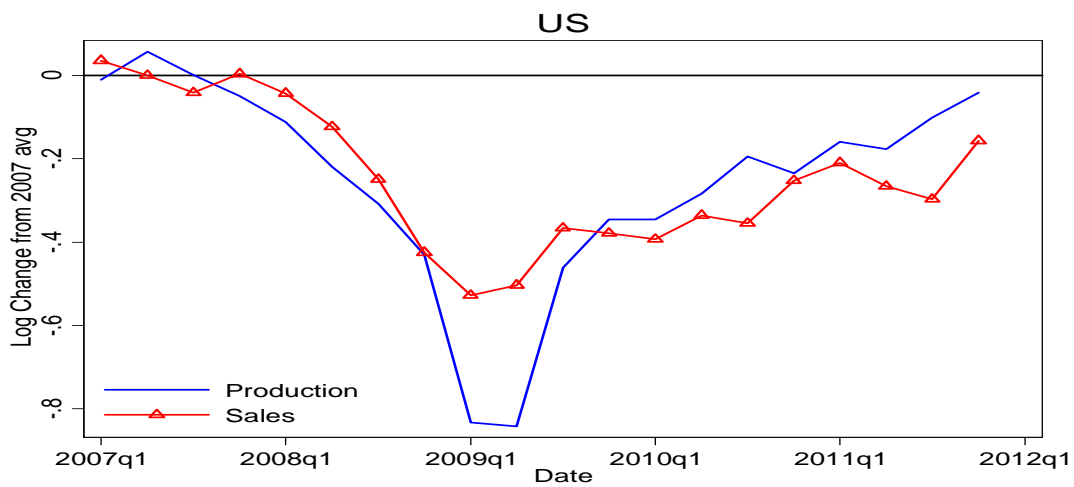


Figure 3: Production and Sales by Market

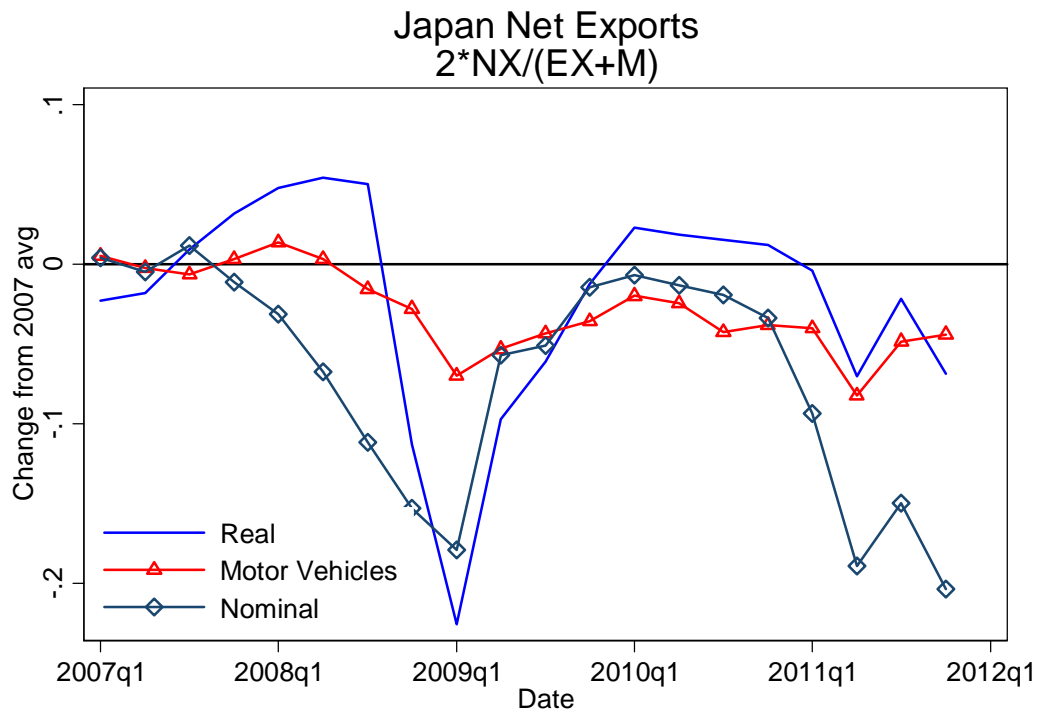


Figure 4: Real Net Exports in Japan

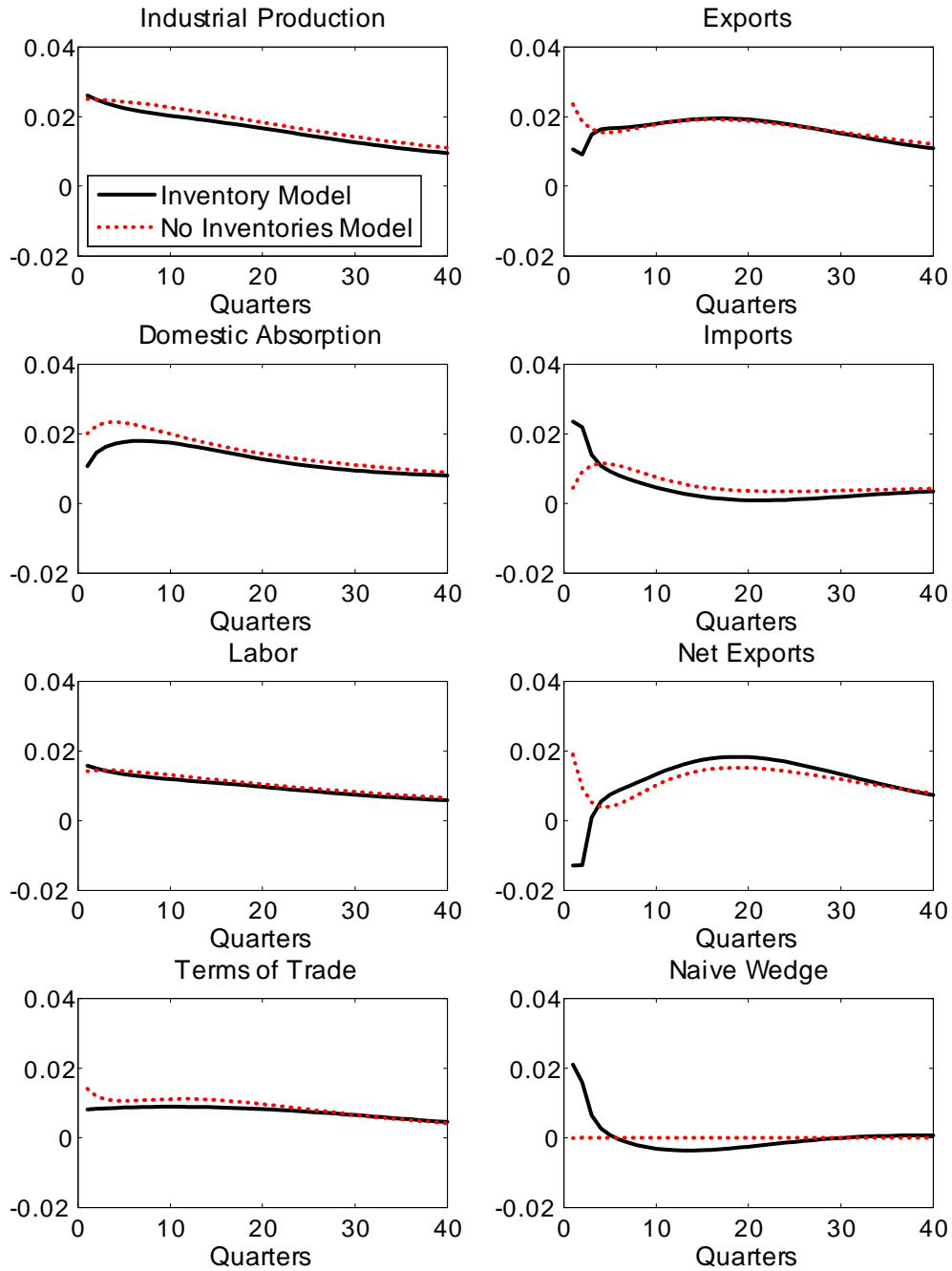


Figure 5: Impulse Response of Positive Home Productivity Shock

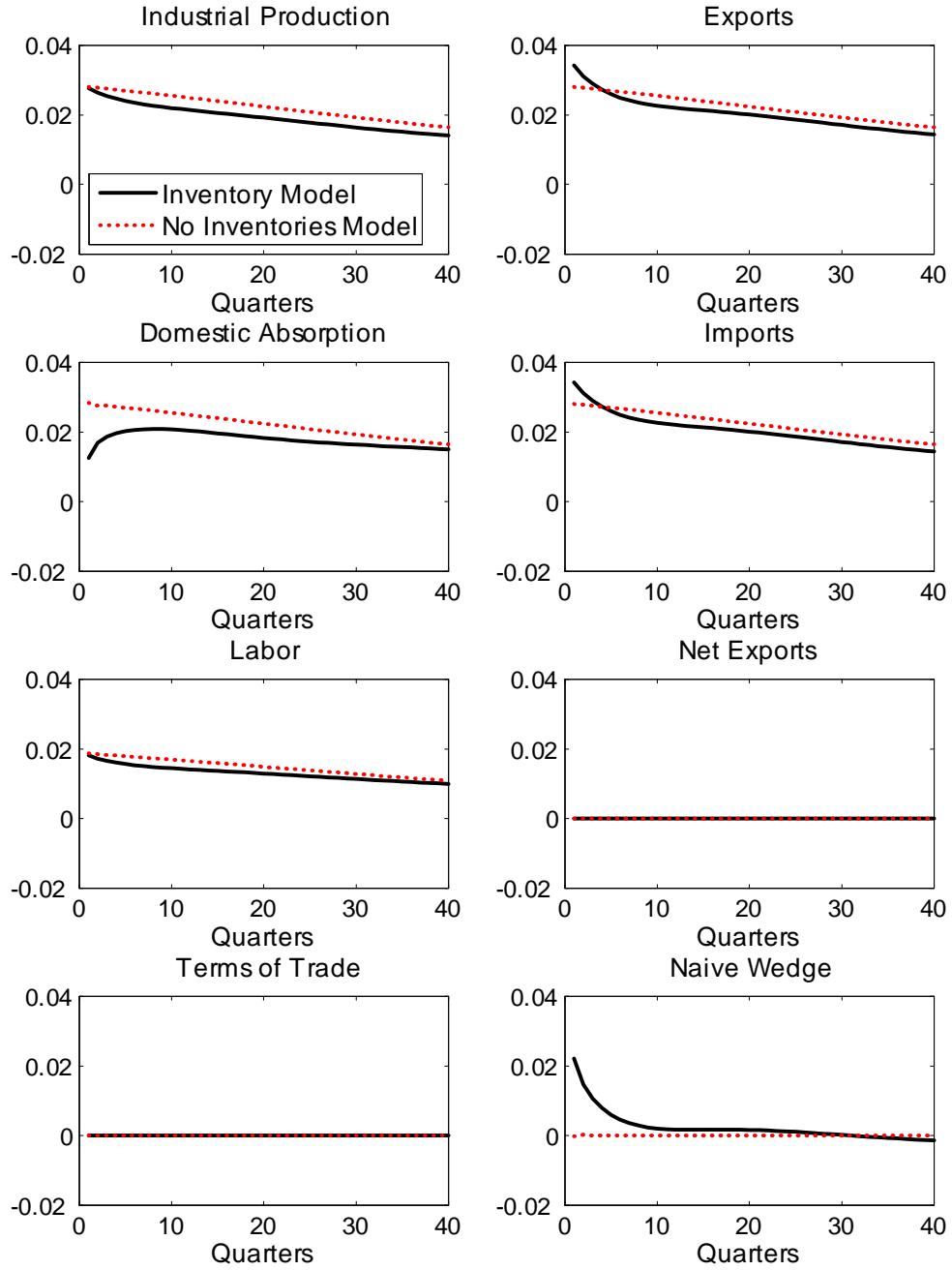


Figure 6: Impulse Response to Positive Global Productivity Shock

Table 1: US Business Cycle Statistics on Imports

US Imports and Sales of Japanese Motor Vehicles (2007m1 to 2011m12)				
	Volatility rel. to Sales	Autocorrel.	Correlation with Sales	Correlation with Imports
Sales (all cars)*	16.4	0.81	1	
Imports (Census)	2.06	0.78	0.71	1
US Sales Japan cars'	1.38	0.85	0.90	0.72
Import Price	0.09	0.94	-0.54	-0.47
Naïve Import Wedge	1.47	0.49	0.22	0.83
Actual Import Wedge	0.60	0.79	0.15	0.25

US Aggregate Imports (1995Q1 to 2010q4)				
	Volatility rel. to IP	Autocorrel.	Correlation with IPMFR	Correlation with Imports
Industrial Production (IP)*	3.44	0.91	1.00	
Imports Goods	1.40	0.86	0.92	1.00
Import Price	0.36	0.83	0.08	0.21
Naïve Import Wedge	1.08	0.78	0.86	0.94
Import Ratio	0.84	0.73	0.78	0.93
Actual Import Wedge	0.80	0.67	0.81	0.85

* Sales and IP volatility are absolute, not relative. Import Price measured relative to price of final basket.

Table 2: Change in Japan Passenger Car Production, Sales, and Exports

Change from	Nov. 08 to Aug. 09 vs May 08 to Oct. 08	Sep. 09 to Aug 10 vs Nov. 08 to Aug. 09
Export share of production in previous period	0.59	0.48
Production	-0.42	0.25
Domestic Sales	-0.12	0.21
Exports	-0.63	0.27
Exports plus Domestic sales	-0.39	0.23
Global Sales*	-0.20	0.05
US Sales	-0.26	-0.11
US Exports	-0.65	0.28

* Global Sales measures the change in Domestic Sales + Foreign Sales where US Sales is a proxy for sales outside of Japan

Table 3: Parameter Values

		Benchmark	No Habit	No Inventory
Assigned Parameters				
β	discount factor	0.99	0.99	0.99
γ	Armington elasticity of H vs. F	1.5	1.5	1.5
θ	elasticity across varieties in H & F	3	3	3
δ_0s	inventory depreciation	0.016	0.016	
δ_1s	Elasticity of inventory depreciation	-0.0044	-0.0045	
μ	Elasticity of inventory costs	0	0	
η	Frisch Elasticity	0.5	0.5	0.5
h	Habit	0.30	0	0.3
δ	Capital Depreciation	0.025	0.025	0.025
α	Capital Share	0.33	0.33	0.33
Calibrated Parameters				
ad	home taste shocks	1.3	1.3	1.3
af	foreign taste shocks	1.0001	1.0001	1.3
τ	foreign weight	0.335	0.335	0.36

Table 4: Business cycle statistics model and data

Standard Deviations:	Inventory Model - Endogenous Costs								No Inventory			
	Data	Benchmark	Balanced RNX	Trade shocks	No Import Premium	Low Depreciation	Asymmetry - Asymmetry -		Benchmark	Balanced RNX	Trade shocks	Comove fixed
							High	Low				
Production	3.44	3.33	3.27	3.53	3.34	3.33	3.33	3.35	3.4	3.45	5.12	3.39
NX, NX/(EX+M)	2.67	3.08	0	2.98	2.79	2.51	3.01	3.01	1.96	0	6.45	2.44
NX/sales	0.28	0.33	0	0.32	0.29	0.26	0.32	0.29	0.21	0	0.68	0.26
NII/sales	0.45	0.82	0.62	0.88	0.80	0.77	0.86	0.72				
<i>Standard Deviations (rel. to IP):</i>												
Consumption, C	0.46	0.53	0.56	0.61	0.53	0.54	0.55	0.52	0.63	0.69	1.34	0.62
Employment, L	0.82	0.62	0.61	0.68	0.62	0.62	0.62	0.62	0.62	0.62	0.96	0.61
Total investment, X + Delta S	2.89	2.89	2.3	2.89	2.89	2.88	2.89	2.89	2.9	2.69	2.88	2.89
Investment, X	1.62	1.62	1.31	1.62	1.62	1.62	1.62	1.62	2.9	2.69	2.87	2.89
Inventory Stock	0.63	0.54	0.44	0.55	0.51	0.49	0.56	0.47				
Exports	1.49	1.07	0.99	1.3	0.92	1.04	0.95	1.08	0.89	0.84	1.63	0.9
Imports	1.4	1.07	0.99	1.3	0.92	1.04	1.09	0.94	0.89	0.84	1.63	0.9
RER	0.89	0.2	0.24	0.32	0.18	0.19	0.19	0.19	0.27	0.23	1.18	0.29
TOT	0.27	0.4	0.54	0.45	0.37	0.40	0.38	0.38	0.57	0.49	1.03	0.61
Inventory Sales Ratio	0.82	0.52	0.52	0.53	0.53	0.53	0.48	0.56				
Sales (incl Mfr)	0.72	0.78	0.76	0.81	0.78	0.78	0.78	0.77	0.97	1	1.29	0.97
Wedge	1.08	0.79	0.66	1.09	0.61	0.74	0.85	0.58			1.07	
<i>AutoCorrelations:</i>												
Production, IP	0.91	0.7	0.69	0.69	0.70	0.69	0.69	0.70	0.72	0.72	0.7	0.73
NX, NX/(EX+M)	0.78	0.71		0.56	0.70	0.71	0.61	0.61	0.4		0.47	0.32
NX, NX/sales	0.76	0.71		0.56	0.70	0.71	0.61	0.61	0.4		0.47	0.32
NII/salesM	0.61	0.55	0.52	0.58	0.53	0.54	0.49	0.60				
Consumption, C	0.82	0.82	0.82	0.82	0.82	0.82	0.82	0.82	0.63	0.72	0.64	0.74
Employment, L	0.91	0.69	0.69	0.69	0.69	0.69	0.69	0.69	0.73	0.72	0.71	0.74
Total investment, X + Delta S	0.79	0.64	0.63	0.65	0.64	0.63	0.58	0.71	0.86	0.73	0.92	0.81
Investment, X	0.9	0.95	0.95	0.95	0.95	0.95	0.95	0.95				
Inventory Stock	0.92	0.92	0.93	0.93	0.92	0.92	0.91	0.93				
Exports	0.85	0.67	0.66	0.51	0.69	0.66	0.76	0.55	0.68	0.72	0.67	0.66
Imports	0.86	0.67	0.66	0.51	0.69	0.66	0.55	0.76	0.68	0.72	0.67	0.66
RER	0.76	0.78	0.75	0.75	0.78	0.76	0.77	0.77	0.65	0.72	0.67	0.61
TOT	0.71	0.74	0.74	0.74	0.75	0.74	0.74	0.74	0.65	0.72	0.62	0.61
Inventory Sales Ratio	0.78	0.73	0.71	0.71	0.73	0.72	0.70	0.76				
Sales (incl Mfr)	0.91	0.79	0.78	0.79	0.79	0.79	0.79	0.80	0.74	0.72	0.72	0.75
Wedge	0.78	0.57	0.56	0.43	0.55	0.56	0.48	0.59			0.72	

Balanced RNX denotes a case where real exports = real imports. Trade shocks denotes a shock to trade weight that matches the volatility of the trade wedge in the inventory and no inventory models. Asymmetry High and Low denote countries with high and low retail inventory levels. Comove fixed means choosing the international correlation of productivity shocks to achieve the same cross-correlation of output as in our benchmark inventory model.

Table 5: Business cycle statistics model and data: Cross Correlations

Correlation with IP:	Data	Inventory Model - Endogenous Costs							No Inventory			
		Benchmark	Balanced RNX	Trade shocks	No Import Premium	Low Depreciation	Asymmetry - Asymmetry -		Benchmark	Balanced RNX	Trade shocks	Comove fixed
							High	Low				
NX, NX/(EX+M)	-0.04	-0.25		-0.23	-0.31	-0.18	-0.32	-0.19	0.33		0.25	0.29
NX/sales	-0.42	-0.25		-0.23	-0.31	-0.18	-0.32	-0.19	0.33		0.25	0.29
NII/sales	0.56	0.71	0.82	0.73	0.73	0.71	0.69	0.74				
Consumption, C	0.8	0.96	0.96	0.96	0.96	0.96	0.96	0.95	0.97	1	0.97	0.97
Employment, L	0.91	1	0.99	1	1.00	1.00	1.00	1.00	0.99	0.99	0.99	0.99
Total investment, X + NII	0.86	0.94	0.99	0.95	0.95	0.95	0.94	0.95	0.95	0.99	0.81	0.95
Investment, X	0.92	0.67	0.6	0.62	0.70	0.66	0.66	0.70	0.95	0.99	0.82	0.95
Inventory Stock	0.81	0.71	0.64	0.69	0.70	0.74	0.77	0.64		-0.31		
Exports	0.85	0.63	0.83	0.68	0.59	0.70	0.67	0.57	0.9	0.84	0.91	0.87
Imports	0.92	0.85	0.83	0.83	0.87	0.83	0.85	0.83	0.69	0.84	0.72	0.64
RER	-0.38	0.55	0.54	0.56	0.54	0.56	0.61	0.49	0.53	0.55	0.45	0.55
TOT	0.69	0.56	0.55	0.55	0.56	0.56	0.60	0.52	0.53	0.55	0.44	0.55
Inventory-Sales Ratio (IS)	-0.03	-0.96	-0.98	-0.96	-0.95	-0.97	-0.95	-0.96		-0.33		
Sales (incl Mfr)	0.97	0.97	0.97	0.97	0.98	0.97	0.97	0.97	1	1	0.99	0.99
Wedge	0.86	0.68	0.83	0.74	0.65	0.67	0.65	0.66		-0.01	0.97	
<i>Correlations:</i>												
IP and IPs*	0.6	0.35	0.4	0.37	0.34	0.35	0.35	0.35	0.42	0.4	0.57	0.35
L and Ls*	0.39	0.49	0.61	0.51	0.47	0.50	0.35	0.35	0.65	0.61	0.72	0.6
C and Cs*	0.38	0.56	0.47	0.53	0.55	0.58	0.48	0.48	0.75	0.39	0.71	0.67
X and Xs*	0.33	0.09	0.73	0.16	0.20	0.26	0.23	0.23	0.22	0.42	0.25	0.17
IS and Sales	-0.13	-0.91	-0.93	-0.9	-0.90	-0.92	-0.89	-0.92				
Total Investment and NII	0.87	0.56	0.58	0.54	0.60	0.56	0.52	0.65				
Exports and Imports	0.85	0.63	1	0.79	0.59	0.74	0.61	0.61	0.79	1	0.7	0.68
TOT and RER	-0.16	1	1	1	1.00	1.00	1.00	1.00	1	1	0.99	1
NIIY AND X	0.47	0.04	0.05	0.02	0.10	0.01	-0.01	0.15				
Wedge and TOT	0.09	0.24	0.41	0.27	0.29	0.20	0.29	0.25			0.6	
Wedge and Imports	0.88	0.86	0.78	0.91	0.79	0.84	0.87	0.77			0.57	

*Taken from Chari, Kehoe, and McGrattan (2002) based on the US and Europe

Appendix to Trade Wedges, Inventories, and the International Business Cycles

May 2012

Not for Publication

George Alessandria

Federal Reserve Bank of Philadelphia
George.Alessandria@phil.frb.org

Joseph Kaboski

University of Notre Dame and NBER
jkaboski@nd.edu

Virgiliu Midrigan

NYU, NBER, Federal Reserve Bank of Minneapolis
Virgiliu.Midrigan@nyu.edu

1. Summary

The appendix describes the data used in the paper, the equations of the model, some additional sensitivity, and presents impulse response functions for the models with wedge shocks.

A. Data Appendix

Source: US Data

1. Output: Industrial Production: Manufacturing [SIC] (SA, 2007=100)
2. Investment = $NII + I_E$
 - (a) NII = Real Change in Private Inventories (SAAR, Bil.Chn.2005\$)
 - (b) I^{eqs} = Real Private Nonresidential Investment: Equipment & Software (SAAR, Bil.Chn.2005\$)
3. Real Exports of Goods (SAAR, Bil.Chn.2005\$)
4. Real Imports of Goods (SAAR, Bil.Chn.2005\$)
5. Aggregate Hours: Nonfarm Payrolls, Manufacturing (SAAR, Bil.Hrs)
6. PCEG = Real Personal Consumption Expenditures: Goods (SAAR, Bil.Chn.2005.\$)
7. Real Expenditures on Tradeable Goods = Investment + PCEG
8. Real Manufacturing & Trade Inventories: All Industries (EOP, SA, Mil.Chn.2005\$)
9. Real Manufacturing & Trade Sales: All Industries (SA, Mil.Chn.2005\$)
10. Real Broad Trade-Weighted Exchange Value of the US\$ (Mar-73=100)

11. Terms of Trade: Price of Exports of nonagricultural goods/Price of Imports of nonpetroleum goods from the BEA
12. Price of Goods = $PCE^{0.75}P_I^{0.25}$
 - (a) Personal Consumption Expenditures: Goods: Price Index (SA, 2005=100)
 - (b) Private Nonresidential Fixed Investment: Chain Price Index (SA, 2005=100)

Source Data: Motor Vehicles.

1. Japan

- (a) Exports of Passenger Cars. JAMA: Active Matrix Database System. Seasonally adjusted using X-12.
- (b) Production of Passenger Cars. JAMA: Active Matrix Database System. Seasonally adjusted using X-12.
- (c) New Car Registrations Sales. JAMA: Active Matrix Database System. Seasonally adjusted using X-12.
- (d) Real and Nominal Exports and Imports:
 - i. http://www.esri.cao.go.jp/en/sna/sokuhou/qe/gdemenu_ea.html
- (e) Nominal Motor Vehicle Imports and Exports (Ministry of Finance/Japan Tariff Association)

2. US

- (a) Production: IP: Motor Vehicles (SA, 2007=100) from Federal Reserve (IPG61@IP)
- (b) Sales: US: Light Vehicle Sales (NSA, Units) - Seasonal Adjustment, All from WARDS (sa(UV@WARDS))
- (c) Japanese Exports of Passenger Cars to the U.S. (NSA, Number), JAMA: Active Matrix Database System. Seasonally adjusted using X-12.
- (d) U.S. Light Vehicle Sales Imported from Japan (NSA, Units), Wards Automotive Group/Haver Analytics (UVJP@WARDS). Seasonally adjusted using X-12.
- (e) U.S.: Light Vehicle Inventory Imported from Japan (NSA, Units), Wards Automotive Group/Haver Analytics (UZJP@WARDS). Seasonally adjusted using X-12.
- (f) US CPI New Vehicles: CPI-U: New Cars (SA, 1982-84=100) (UTWC@CPIDATA))
- (g) US Import Price Deflators of Japanese cars proxied for by Japan: All Goods: US Import Price Index (NSA, 2000=100) (sa(PMOJAP@USINT))

3. EU

- (a) EU 27: IP: Motor Vehicles (SA, 2005=100) Eurostat (S997Q291@EUDATA)
- (b) EU 27: New Car Registrations (SA, 2006=100) Eurostat (S997CVRI@EUDATA)

2. Sensitivity

We describe the effect of having habit in preferences, restricting asset trade to a non-contingent bond, and the elasticity of substitution on the quantitative properties of the model. The results are in Tables 6 and 7.

A. Role of Habit

Focusing on Table 6, introducing habit persistence allows consumption to be as persistent as in the data. The persistence of consumption leads to more persistent movements in international trade in the model with inventories. With habit the volatility of imports falls from 1.13 to 1.07 in our benchmark inventory formulation and the autocorrelation rises from 0.55 to 0.67. The less volatile imports lead to less volatile and less countercyclical real net exports. Without inventories, adding habit has little effect, except to lower both the cyclical (Table 5) and persistence (Table 6) of net exports slightly. Overall the impact of habit is relatively minor.

B. Incomplete Markets

In the next three columns we consider a model with incomplete asset markets. Specifically, we assume that the only asset traded across countries is a non-contingent bond that is in zero net supply. To keep the economy stationary, we introduce a small quadratic adjustment cost on the bond position relative to the steady-state bond position, \bar{B} , which is set to zero. The home country budget constraint then becomes

$$\sum_{i=\{H,F\}} \int_0^1 p_i(j) y_i(j) dj + Q_{t+1} B_{t+1} + \phi_D \left(\frac{B_{t+1}}{\bar{B}} - 1 \right) = Wl + Rk + \Pi + B_t.$$

For simplicity we assume that the retailers are owned by the agents in the country whose good they sell. With this convention, profits here are equal to retailers' profits plus intermediate producer profits.

$$\Pi = \int_0^1 p_H(j) y_H(j) dj + \int_0^1 p_H^*(j) y_H^*(j) dj - Wl + Rk$$

From the column titled *Bond* we see that introducing the non-contingent bond has a very small impact on our quantitative results. This is not surprising as it is well known that incomplete asset markets tend to have a small impact when shocks are not permanent so that wealth effects are fairly minor.

To allow for more substantial wealth effects, we next examine the properties of the bond economy when shocks are close to permanent ($\rho = 0.995$). The final two columns report the statistics of the Benchmark economy with permanent shocks and the Bond economy with permanent shocks. Once again the role of market incompleteness is fairly moderate. The largest impact is on the cyclical of net exports, which is about 10 percentage points more countercyclical with incomplete markets. This difference arises because in the bond economy consumption is substantially less correlated than in the complete markets economy (0.56 vs. 0.70).

C. Elasticity of Substitution

We next consider how the elasticity of substitution affects our results. There is a wide range of estimates for this parameter. Lowering the elasticity to 0.5 leads to less substitution following a shock and this increases the volatility of trade from 1.07 to 1.14 and the wedge from 0.79 to 0.81. Net exports become less countercyclical as comovement increases substantially (the correlation of output rises from 0.35 to 0.47). Increasing the elasticity of substitution to 2.5 actually lowers the volatility of trade flows slightly to 1.04 and makes the wedge slightly less volatile. Real net exports are slightly more countercyclical as business cycles become less correlated (the correlation of output drops to 0.31).

3. Full set of equilibrium conditions

Home Consumer Optimality:

$$\begin{aligned}\frac{w_t}{P_t} &= -\frac{U_{l,t}}{U_{c,t}} \\ 1 &= \beta E_t \frac{U_{c,t+1}}{U_{c,t}} \frac{\left[\frac{r_{t+1}}{P_{t+1}} + \left((1-\delta) + \xi \left(\frac{x_{t+1}}{k_t} - \delta \right) + \frac{\xi}{2} \left(\frac{x_{t+1}}{k_t} - \delta \right)^2 \right) \right]}{1 + \xi \left(\frac{x_t}{k_{t-1}} - \delta \right)} \\ x_t &= [k_t - (1-\delta) k_{t-1}]\end{aligned}$$

Foreign Consumer Optimality

$$\begin{aligned}\frac{w_t^*}{P_t^*} &= -\frac{U_{l,t}^*}{U_{c,t}^*} \\ 1 &= \beta E_t \frac{U_{c,t+1}^*}{U_{c,t}^*} \frac{\left[\frac{r_{t+1}^*}{P_{t+1}^*} + \left((1-\delta) + \xi \left(\frac{x_{t+1}^*}{k_t^*} - \delta \right) + \frac{\xi}{2} \left(\frac{x_{t+1}^*}{k_t^*} - \delta \right)^2 \right) \right]}{1 + \xi \left(\frac{x_t^*}{k_{t-1}^*} - \delta \right)} \\ x_t^* &= [k_t^* - (1-\delta) k_{t-1}^*]\end{aligned}$$

Home Producer's Optimality:

$$\begin{aligned}M_t &= A_t k_t^\alpha l_t^{1-\alpha} \\ \alpha \omega_t \frac{m_t}{k_{t-1}} &= r_t \\ (1-\alpha) \omega_t \frac{m_t}{l_t} &= w_t \\ \omega_t &= \frac{r_t^\alpha w_t^{1-\alpha}}{A_t}\end{aligned}$$

Foreign Producer's Optimality:

$$\begin{aligned}
M_t^* &= A_t^* k_t^{*\alpha} l_t^{*1-\alpha} \\
\alpha \omega_t^* \frac{m_t^*}{k_{t-1}^*} &= r_t^* \\
(1-\alpha) \omega_t^* \frac{m_t^*}{l_t^*} &= w_t^* \\
\omega_t^* &= \frac{r_t^{*\alpha} w_t^{*1-\alpha}}{A_t^*}
\end{aligned}$$

Home Pricing:

$$\begin{aligned}
\hat{p}_{H,t} &= \frac{\theta}{\theta-1} E \left[(1-\delta_{s,t}) \frac{Q_{t+1}}{Q_t} \omega_{t+1} \right] \\
\hat{p}_{F,t} &= \frac{\theta}{\theta-1} E (1-\delta_{s,t}) \frac{Q_{t+1}^*}{Q_t^*} \omega_{t+1}^* \\
P_{H,t} &= \hat{p}_{H,t} \left[\hat{v}_{H,t}^{1-a_{DOM}} \left(\frac{a_{DOM}}{1-a_{DOM}} - \frac{a_{DOM}}{\frac{1}{\theta}-a_{DOM}} \right) - \frac{a_{DOM}}{1-a_{DOM}} \right]^{\frac{1}{1-\theta}} \\
P_{F,t} &= \hat{p}_{F,t} \left[\hat{v}_{F,t}^{1-a_{IMP}} \left(\frac{a_{IMP}}{1-a_{IMP}} - \frac{a_{IMP}}{\frac{1}{\theta}-a_{IMP}} \right) - \frac{a_{IMP}}{1-a_{IMP}} \right]^{\frac{1}{1-\theta}} \\
P_t &= [P_{H,t}^{1-\gamma} + \tau P_{F,t}^{1-\gamma}]^{\frac{1}{1-\gamma}} \\
(1) \quad \hat{v}_{H,t} &= \left(\frac{\frac{1}{\theta}}{a_{DOM}-\frac{1}{\theta}} \right)^{1/a_{DOM}} \left(\frac{\omega_t}{E_t (1-\delta_{s,t}) \frac{Q_{t+1}}{Q_t} \omega_{t+1}} - 1 \right)^{-1/a_{DOM}} \\
(2) \quad \hat{v}_{F,t} &= \left(\frac{\frac{1}{\theta}}{a_{IMP}-\frac{1}{\theta}} \right)^{1/a_{IMP}} \left(\frac{\omega_t^*}{E_t (1-\delta_{s,t}) \frac{Q_{t+1}^*}{Q_t^*} \omega_{t+1}^*} - 1 \right)^{-1/a_{IMP}}
\end{aligned}$$

Foreign Pricing:

$$\begin{aligned}
\hat{p}_{H,t}^* &= \frac{\theta}{\theta-1} (1-\delta_{s,t}^*) E_t \frac{Q_{t+1}}{Q_t} \omega_{t+1} \\
\hat{p}_{F,t}^* &= \frac{\theta}{\theta-1} (1-\delta_{s,t}^*) E_t \frac{Q_{t+1}^*}{Q_t^*} \omega_{t+1}^* \\
P_{H,t}^* &= \hat{p}_{H,t}^* \left[\hat{v}_{H,t}^{*1-a_{IMP}} \left(\frac{a_{IMP}}{1-a_{IMP}} - \frac{a_{IMP}}{\frac{1}{\theta}-a_{IMP}} \right) - \frac{a_{IMP}}{1-a_{IMP}} \right]^{\frac{1}{1-\theta}} \\
P_{F,t}^* &= \hat{p}_{F,t}^* \left[\hat{v}_{F,t}^{*1-a_{DOM}} \left(\frac{a_{DOM}}{1-a_{DOM}} - \frac{a_{DOM}}{\frac{1}{\theta}-a_{DOM}} \right) - \frac{a_{DOM}}{1-a_{DOM}} \right]^{\frac{1}{1-\theta}} \\
P_t^* &= [\tau P_{H,t}^{*1-\gamma} + P_{F,t}^{*1-\gamma}]^{\frac{1}{1-\gamma}}
\end{aligned}$$

$$(3) \quad \hat{v}_{H,t}^* = \left(\frac{\frac{1}{\theta}}{a_{DOM} - \frac{1}{\theta}} \right)^{1/a_{DOM}} \left(\frac{\omega_t}{E_t(1 - \delta_{s,t}) \frac{Q_{t+1}}{Q_t} \omega_{t+1}} - 1 \right)^{-1/a_{DOM}}$$

$$(4) \quad \hat{v}_{F,t}^* = \left(\frac{\frac{1}{\theta}}{a_{IMP} - \frac{1}{\theta}} \right)^{1/a_{IMP}} \left(\frac{\omega_t^*}{E_t(1 - \delta_{s,t}) \frac{Q_{t+1}^*}{Q_t^*} \omega_{t+1}^*} - 1 \right)^{-1/a_{IMP}}$$

Home Inventory Stocks:

$$z_{H,t} = \hat{v}_{H,t} \left(\frac{\hat{p}_{H,t}}{P_{H,t}} \right)^{-\theta} \left[\left(\frac{P_{H,t}}{P_t} \right)^{-\gamma} D_t \right]$$

$$z_{F,t} = \hat{v}_{F,t} \left(\frac{\hat{p}_{F,t}}{P_{F,t}} \right)^{-\theta} \left[\tau \left(\frac{P_{F,t}}{P_t} \right)^{-\gamma} D_t \right]$$

$$(5) \quad S_{H,t} = (1 - \delta_{s,t}) \left[z_{H,t} - \frac{z_{H,t}}{\hat{v}_{H,t}} \left[\frac{1}{1 - a_{DOM}} \hat{v}_{H,t}^{1-a_{DOM}} - \frac{a_{DOM}}{1 - a_{DOM}} \right] \right]$$

$$(6) \quad S_{F,t} = (1 - \delta_{s,t}) \left[z_{F,t} - \frac{z_{F,t}}{\hat{v}_{F,t}} \left[\frac{1}{1 - a_{IMP}} \hat{v}_{F,t}^{1-a_{IMP}} - \frac{a_{IMP}}{1 - a_{IMP}} \right] \right]$$

$$(7) \quad S_t = S_{H,t} + S_{F,t}$$

$$(8) \quad \delta_{s,t} = \delta_{s,0} + \delta_{s,1} e^{(S_t/\bar{S}-1)}$$

Foreign Inventory Stocks:

$$z_{H,t}^* = \hat{v}_{H,t}^* \left(\frac{\hat{p}_{H,t}^*}{P_{H,t}^*} \right)^{-\theta} \left[\tau \left(\frac{P_{H,t}^*}{P_t^*} \right)^{-\gamma} D_t^* \right]$$

$$z_{F,t}^* = \hat{v}_{F,t}^* \left(\frac{\hat{p}_{F,t}^*}{P_{F,t}^*} \right)^{-\theta} \left[\left(\frac{P_{H,t}^*}{P_t^*} \right)^{-\gamma} D_t^* \right]$$

$$(9) \quad S_{H,t}^* = (1 - \delta_{s,t}^*) \left[z_{H,t}^* - \frac{z_{H,t}^*}{\hat{v}_{H,t}^*} \left[\frac{1}{1 - a_{IMP}} \hat{v}_{H,t}^{*1-a_{IMP}} - \frac{a_{IMP}}{1 - a_{IMP}} \right] \right]$$

$$(10) \quad S_{F,t}^* = (1 - \delta_{s,t}^*) \left[z_{F,t}^* - \frac{z_{F,t}^*}{\hat{v}_{F,t}^*} \left[\frac{1}{1 - a_{DOM}} \hat{v}_{F,t}^{*1-a_{DOM}} - \frac{a_{DOM}}{1 - a_{DOM}} \right] \right]$$

$$(11) \quad S_t^* = S_{H,t}^* + S_{F,t}^*$$

$$(12) \quad \delta_{s,t}^* = \delta_{s,0} + \delta_{s,1} e^{(S_t^*/\bar{S}-1)}$$

Good Market Clearing:

$$M_t = z_{H,t} + z_{H,t}^* - S_{H,t-1} - S_{H,t-1}^*$$

$$M_t^* = z_{F,t} + z_{F,t}^* - S_{F,t-1} - S_{F,t-1}^*$$

Asset Market Clearing:

$$\begin{aligned} Q_t &= \frac{u_{c,t}}{p_t} \\ Q_t^* &= \frac{u_{c,t}^*}{P_t^*} \\ Q_t &= Q_t^* \end{aligned}$$

The numbered equations represent the additional equations from a standard model of BKK with monopolistic retailers. The variables $(\hat{v}_{H,t}, \hat{v}_{F,t}, \hat{v}_{H,t}^*, \hat{v}_{F,t}^*)$ described in equations (1 to 4) are useful to describe both the distribution of prices and the inventory sales ratio. The next two groups of 4 equations (equations 5 to 12) summarize the law of motion for retail stocks of domestic and imported goods in each country (equations 5, 6, 9, and 10) and the influence of inventories on the holding costs of inventories (equations 7, 8, 11, and 12).

4. Impulse Responses to Productivity in Model with Wedge Shocks

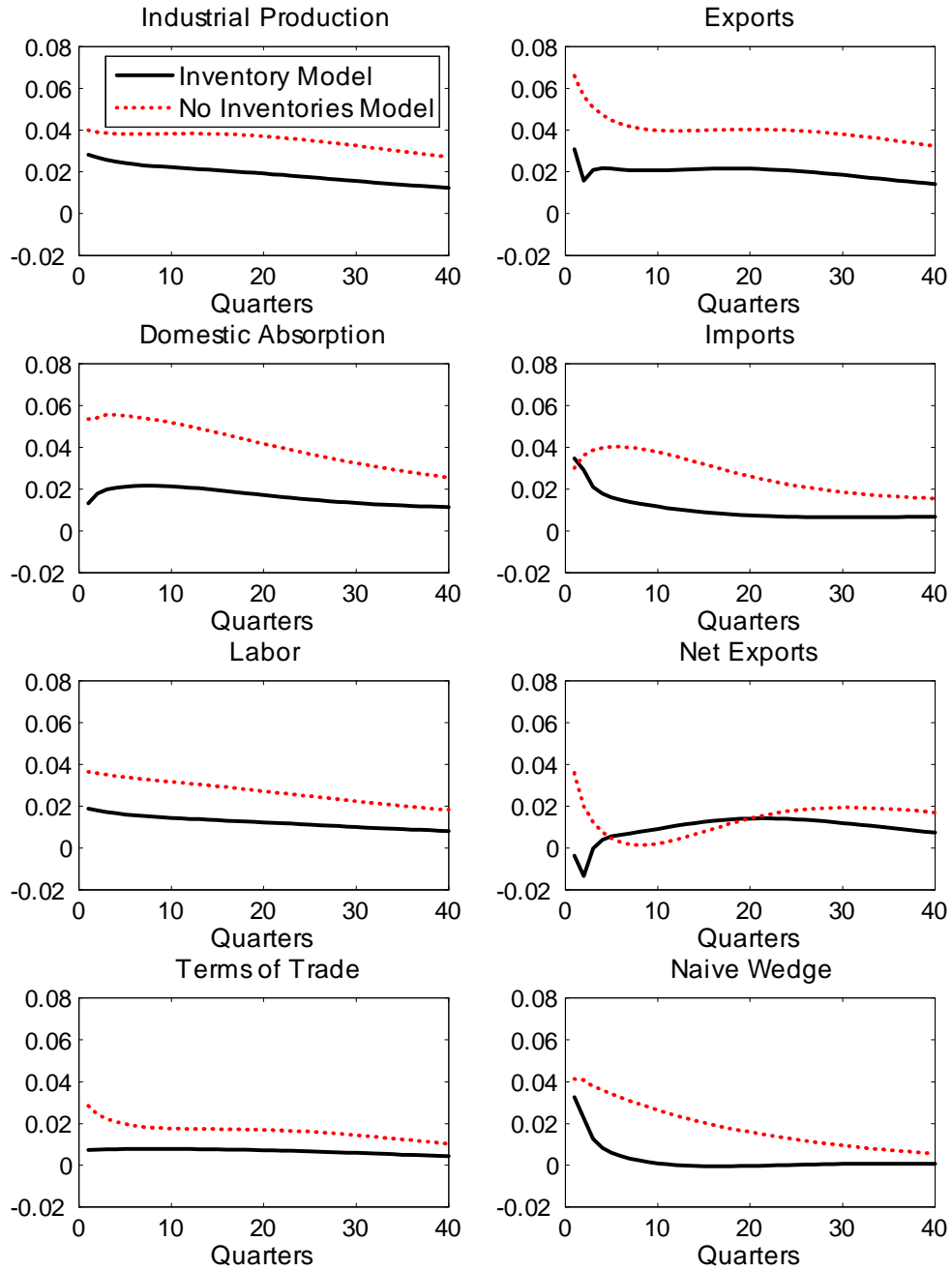


Table 6: Business cycle statistics model and data

<i>Standard Deviations:</i>	<i>Data</i>	<i>Benchmark</i>	<i>No Habit</i>	<i>Low elasticity ($\gamma = 0.5$)</i>	<i>High elasticity ($\gamma = 2.5$)</i>	<i>Bond Model</i>	<i>Benchmark: Permanent</i>	<i>Bond Permanent</i>
Production	3.44	3.33	3.32	3.19	3.38	3.33	3.23	3.25
NX, NX/(EX+M)	2.67	3.08	3.91	3.35	2.99	3.25	4.23	4.35
NX/sales	0.28	0.33	0.41	0.35	0.32	0.34	0.45	0.46
NII/sales	0.45	0.82	0.8	0.75	0.84	0.82	0.80	0.83
<i>Standard Deviations (rel. to IP):</i>								
Consumption, C	0.46	0.53	0.51	0.53	0.54	0.54	0.62	0.65
Employment, L	0.82	0.62	0.62	0.59	0.63	0.62	0.60	0.60
Total investment, X + Delta S	2.89	2.89	2.87	2.89	2.88	2.89	2.89	2.89
Investment, X	1.62	1.62	1.62	1.62	1.62	1.62	1.62	1.62
Inventory Stock	0.63	0.54	0.49	0.47	0.55	0.53	0.56	0.55
Exports,	1.49	1.07	1.13	1.14	1.04	1.08	1.13	1.13
Imports,	1.40	1.07	1.13	1.14	1.04	1.08	1.13	1.13
RER	0.89	0.20	0.2	0.42	0.13	0.20	0.27	0.26
TOT	0.27	0.40	0.42	0.87	0.26	0.40	0.55	0.53
Inventory Sales Ratio	0.82	0.52	0.56	0.59	0.50	0.53	0.62	0.64
Sales (incl Mfr)	0.72	0.78	0.76	0.78	0.77	0.78	0.82	0.84
Wedge	1.08	0.79	0.82	0.81	0.77	0.80	0.94	0.96
<i>AutoCorrelations:</i>								
Production, IP	0.91	0.70	0.70	0.70	0.69	0.70	0.70	0.70
NX, NX/(EX+M)	0.78	0.71	0.13	0.72	0.67	0.68	0.34	0.67
NX, NX/sales	0.76	0.71	0.13	0.72	0.67	0.68	0.34	0.67
NII/salesM	0.61	0.55	0.33	0.51	0.54	0.53	0.62	0.60
Consumption, C	0.82	0.82	0.71	0.82	0.82	0.82	0.82	0.82
Employment, L	0.91	0.69	0.70	0.69	0.69	0.69	0.70	0.70
Total investment, X + Delta S	0.79	0.64	0.51	0.63	0.62	0.62	0.69	0.65
Investment, X	0.90	0.95	0.95	0.94	0.95	0.95	0.95	0.95
Inventory Stock	0.92	0.92	0.91	0.91	0.92	0.92	0.94	0.93
Exports,	0.85	0.67	0.55	0.66	0.67	0.66	0.56	0.66
Imports,	0.86	0.67	0.55	0.66	0.67	0.66	0.56	0.66
RER	0.76	0.78	0.77	0.75	0.79	0.78	0.77	0.76
TOT	0.71	0.74	0.74	0.74	0.75	0.75	0.72	0.73
Inventory-Sales Ratio	0.78	0.73	0.67	0.78	0.71	0.73	0.77	0.77
Sales (incl Mfr)	0.91	0.79	0.76	0.80	0.79	0.79	0.80	0.80
Wedge	0.78	0.57	0.31	0.55	0.56	0.55	0.57	0.62

Table 7: Business cycle statistics model and data: Cross Correlations

<i>Correlation with IP:</i>	<i>Data</i>	<i>Benchmark</i>	<i>No Habit</i>	<i>Low elasticity ($\gamma=0.5$)</i>	<i>High elasticity ($\gamma=2.5$)</i>	<i>Bond Model</i>	<i>Benchmark: Permanent</i>	<i>Bond Permanent</i>
NX/sales	-0.42	-0.25	-0.11	-0.14	-0.28	-0.25	-0.22	-0.32
NII/sales	0.56	0.71	0.68	0.66	0.72	0.69	0.61	0.59
Consumption, C	0.80	0.96	0.98	0.96	0.96	0.96	0.96	0.97
Employment, L	0.91	1.00	1	0.98	1.00	1.00	0.99	0.99
Total investment, X + Delta S	0.86	0.94	0.91	0.92	0.94	0.93	0.86	0.87
Investment, X	0.92	0.67	0.66	0.76	0.63	0.69	0.66	0.68
Inventory Stock	0.81	0.71	0.68	0.71	0.71	0.73	0.59	0.67
Exports,	0.85	0.63	0.64	0.69	0.61	0.61	0.55	0.48
Imports,	0.92	0.85	0.75	0.82	0.85	0.84	0.81	0.86
RER	-0.38	0.55	0.55	0.50	0.56	0.56	0.54	0.55
TOT	0.69	0.56	0.56	0.50	0.57	0.56	0.55	0.55
Inventory-Sales Ratio	-0.03	-0.96	-0.94	-0.93	-0.96	-0.97	-0.98	-0.98
Sales (incl Mfr)	0.97	0.97	0.98	0.98	0.97	0.98	0.97	0.98
Wedge	0.86	0.68	0.61	0.59	0.70	0.67	0.59	0.59
<i>Correlations:</i>								
IP and IPs*	0.60	0.35	0.35	0.47	0.31	0.35	0.40	0.40
L and Ls*	0.39	0.49	0.49	0.78	0.39	0.49	0.60	0.39
C and Cs*	0.38	0.56	0.62	0.65	0.53	0.51	0.70	0.57
X and Xs*	0.33	0.09	0.15	0.63	-0.06	0.16	0.16	0.21
IS and Sales	-0.13	-0.91	-0.89	-0.91	-0.90	-0.92	-0.98	-0.98
Total Investment and NII	0.87	0.56	0.58	0.61	0.54	0.56	0.55	0.50
Exports and Imports	0.85	0.63	0.45	0.58	0.64	0.59	0.33	0.30
TOT and RER	-0.16	1.00	1	1.00	1.00	1.00	0.99	1.00
NIIY AND I_eqpt	0.47	0.04	0.06	0.11	0.02	0.04	0.02	-0.03
Wedge and TOT	0.09	0.24	0.16	0.12	0.24	0.23	0.52	0.53
Wedge and Imports	0.88	0.86	0.89	0.86	0.87	0.86	0.80	0.81