Diversification through Trade

CFM-DP2015-18

Francesco Caselli[2,3,4,6,8], Miklos Koren[1,7], Milan Lisicky[5], Silvana Tenreyro[2,3,4,6]

[1]Central European University , [2]Centre for Economic Performance, [3]Centre For Macroeconomics, [4]Centre for Economic Policy Research, [5]European Commission, [6]London School of Economics and Political Science, [7]MTA KRTK, [8]National Bureau of Economic Research,

A widely held view is that openness to international trade leads to higher GDP volatility, as trade increases specialization and hence exposure to sector-specific shocks.

We revisit the common wisdom and argue that when country-wide shocks are important, openness to international trade can lower GDP volatility by reducing exposure to domestic shocks and allowing countries to diversify the sources of demand and supply across countries.

Using a quantitative model of trade, we assess the importance of the two mechanisms (sectoral specialization and cross-country diversification) and provide a new answer to the question of whether and how international trade affects economic volatility.