

## Accepted Manuscript

Restoring the Product Variety and Pro-competitive Gains from Trade with Heterogeneous Firms and Bounded Productivity

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PII: S0022-1996(17)30123-X  
DOI: doi:[10.1016/j.jinteco.2017.10.003](https://doi.org/10.1016/j.jinteco.2017.10.003)  
Reference: INEC 3088

To appear in: *Journal of International Economics*

Received date: 13 April 2016  
Revised date: 20 October 2017  
Accepted date: 24 October 2017



Please cite this article as: Feenstra, Robert C., Restoring the Product Variety and Pro-competitive Gains from Trade with Heterogeneous Firms and Bounded Productivity, *Journal of International Economics* (2017), doi:[10.1016/j.jinteco.2017.10.003](https://doi.org/10.1016/j.jinteco.2017.10.003)

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with Heterogeneous Firms and Bounded Productivity\***

by

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Revised, October 23, 2017

**Abstract**

The monopolistic competition model in international trade offers three sources of gains from trade beyond that of traditional comparative advantage: an endogenous expansion in product variety; a pro-competitive reduction in the markups charged by firms; and the self-selection of more efficient firms into exporting. Recent literature on trade with heterogeneous firms has emphasized the third of these effects, while the first two effects are ruled out when using a Pareto distribution for productivity with a support that is unbounded above, and no fixed costs. The goal of this paper is to restore a theoretical role for product variety and pro-competitive gains from trade by using a bounded Pareto distribution for productivity, and to demonstrate their empirical importance. For the U.S. economy over 1992 – 2005, we find that product variety and the reduction in markups jointly contribute about 75% to the increase in welfare resulting from trade expansion, whereas an upper bound to the selection effect is that it contributes the remaining 25% to the increase in U.S. welfare.

\* Thanks are due to Costas Arkolakis, Andrés Rodríguez-Clare, Kadee Russ, Ina Simonovska and seminar participants at Boston College, MIT, UCLA, and the NBER, along with the referees for helpful comments. Vladimir Tyazhelnikov provided excellent research assistance. Financial support from the National Science Foundation is gratefully acknowledged.

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