PRODUCT MIX AND FIRM PRODUCTIVITY RESPONSES TO TRADE COMPETITION

Thierry Mayer, Marc J. Melitz, and Gianmarco I. P. Ottaviano*

Abstract—We document how demand shocks in export markets lead French multiproduct exporters to reallocate the mix of products sold in those destinations. In response to positive demand shocks, French firms skew their export sales toward their best-performing products. We develop a theoretical model of multiproduct firms and derive the specific demand conditions (with endogenous price elasticities) needed to generate these product-mix reallocations. Under those demand conditions, the increased competition from demand shocks in export markets also induces productivity changes within the firm. We empirically test for this connection between demand shocks and the productivity of multiproduct firms. We find that this connection is economically substantial.

I. Introduction

Ever since Krugman (1980), the constant elasticity of substitution (CES)/monopolistic competition model has been the workhorse model of new trade theory. It combines intratrade trade, imperfect competition, and returns-to-scale in a general equilibrium setting, and it has been extended in myriads of directions (with much of this research still ongoing). However, this very tractable analytical framework has a major drawback: it cannot be used to investigate “competitive” effects of trade. Price elasticities for all goods are constant, and there can be no markup responses to the trading environment.

In order to analyze competitive effects (response of markups to trade, market size, and geography), trade theory in parallel has developed models with endogenous price elasticities. Maintaining monopolistic competition in general equilibrium, an early approach followed by Dixit and Stiglitz (1977) and Krugman (1980) has been to consider preferences featuring Marshall’s second law of demand (MSLD), according to which the price elasticity of demand falls with quantity consumed.1 These models then predict pro-competitive effects of trade: falling markups in response to trade integration, as highlighted by Krugman (1980).2 The welfare gains from these pro-competitive effects are amplified when firms are heterogeneous. Dhingra and Morrow (2019) show that the pro-competitive reallocations generate an additional channel that magnifies the welfare gains from any given trade liberalization.3

These models have also played a crucial role in explaining aggregate empirical patterns that are incompatible with the workhorse CES/monopolistic competition model: incomplete pass-through of cost shocks to prices and pricing to market (most prominently for the adjustment to exchange rate shocks; see Burstein & Gopinath, 2014, for a survey); increasing trade elasticities with lower trade volumes,4 and tougher selection (and higher firm turnover rates) in larger markets.5

At the microeconomic level, a long literature documents a strong, positive correlation between firm/plant/product performance and markups and how those markups and associated pass-through rates respond to trade shocks.6 In our theory section, we describe how all these empirical patterns are intrinsically linked to MSLD and thus cannot be reconciled with CES/monopolistic competition.

The first contribution of our paper is to derive new testable implications of MSLD using sales data at the finest level of disaggregation (by market, firm, and product). In contrast, the other microeconomic ways of testing for MSLD entail substantially more onerous data requirements. Data on firm-product prices or quantities (which are typically very noisy) are needed in order to estimate the shape of demand directly. And the recovery/estimation of marginal cost shocks to measure markups entails additional functional form assumptions for demand and/or production.7 In this paper, we

1Pro-competitive effects of trade have also been extensively studied using oligopoly models. These models also feature endogenous price elasticities and share many similar equilibrium properties with monopolistic competition/MSLD models.

2The contribution of these reallocations to welfare is first-order whereas they are second-order in the CES case (because the market equilibrium is then efficient).

3See Novy (2013) and Arkolakis et al. (2018). Novy (2013) uses translog preferences, which satisfy MSLD; Arkolakis et al. (2018) use a general family of preferences with endogenous price elasticities and estimate coefficients that validate MSLD.

4See Syverson (2004), Campbell and Hopenhayn (2005), and Asplund and Nocke (2006).

5See De Loecker et al. (2016) and Dhyne et al. (2017) for recent evidence on the strong, positive correlation between product-level markups and performance (within firms); there is also a long literature estimating this correlation at the firm level. Berman, Martin, and Mayer (2012), Li, Ma, and Xu (2015), Amiri, Itsokoki, and Konings (2014), and Chatterjee, Dix-Carneiro, and Vichyanond (2013) all find evidence of incomplete pass-through at the producer level.

6See De Loecker and Goldberg (2014) for a survey of this literature and a discussion of these data and functional form requirements. One significant exception is the work by Aitkin et al. (2015), who directly obtain markup

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develop and implement a new complementary methodology for testing MSLD based on trade-induced reallocations across products (measured in terms of changes in revenue shares) and their impact on firm productivity. In so doing, we introduce a flexible theoretical framework with general additive separable preferences and multiproduct firms to highlight how certain properties of demand, which relate to the curvature of demand and marginal revenue curves underpinning MSLD, are crucial in generating predictions for reallocations that are consistent with the data. Empirically, we show that the reallocations induced by destination-level trade shocks are quantitatively important at the level of the firm (aggregating across destinations). Thus they have the potential to influence firm-level productivity (as confirmed by our theoretical model). Our second contribution is to document a very large impact of those trade shocks on multiproduct firm productivity.

The emphasis on multiproduct firms is crucial. Measuring the direct impact of trade on reallocations across firms is a hard task. On the one hand, shocks that affect trade are also likely to affect the distribution of market shares across firms. On the other hand, changes in market shares across firms likely reflect many technological factors (not related to reallocations). Looking at reallocations across products within firms obviates many of these problems. Recent theoretical models of multiproduct firms highlight how trade induces a similar pattern of reallocations within firms as it does across firms (see the survey by Bernard, Jensen et al., 2018). Our theoretical model fits within this literature. In order to focus on the impact of competition on within-firm product reallocations and productivity, we abstract from economies of scope (across products) and cannibalization effects (see Bernard, Redding & Schott, 2011; Dhingra, 2013; Eckel & Neary, 2010; Nocke & Yeaple, 2014). In our empirical work, we directly check that such firm-wide interactions do not affect our main results on product reallocations.

On the empirical side, measuring reallocations within multiproduct firms has several advantages: trade shocks that are exogenous to individual firms can be identified much more easily than at a higher level of aggregation; controls for any technology changes at the firm level are also possible; and reallocations can be measured for the same set of narrowly defined products sold by the same firm across destinations or over time. In addition, impediments to factor reallocations are likely to be substantially higher across firms than across product lines within firms. Moreover, multiproduct firms dominate world production and trade flows.

For all these reasons, reallocations within multiproduct firms have the potential to generate large changes in aggregate productivity. We find very strong empirical confirmation for this link between trade shocks in export markets (which induce the reallocations) and productivity for multiproduct French exporters. Although we measure firm productivity using deflated sales (value-added), we recover the changes in real productivity at the industry and aggregate level using the observed changes in firm-level employment. We show counterfactual predictions for the impact of the trade shocks on real output per worker at the industry level. This impact is very large: between 1995 and 2005, the trade shocks account for a 1% yearly average increase in French manufacturing productivity.

Our paper is also related to the empirical literature on trade-induced reallocations. In a previous paper (Mayer, Melitz, & Ottaviano, 2014), we investigated the mechanics of product reallocations within multiproduct firms across export destinations. We used the term skewness to refer to the concentration of the export market shares of different products in any destination and showed that this skewness consistently varied with destination characteristics such as GDP and geography: French firms sold relatively more of their best-performing products in bigger, more centrally located destinations (where competition from other exporters and domestic producers is tougher). Baldwin and Gu (2009), Bernard et al. (2011), and Iacovone and Javorcik (2010) analyze similar reallocations over time for Canada, Mexico, and the United States following CUSFTA/NAFTA liberalization. They find that multiproduct firms in all three countries reduced the number of products they produce following liberalization. Baldwin and Gu (2009) and Bernard et al. (2011) further report that CUSFTA induced a significant increase in the skewness of production across products. Iacovone and Javorcik (2010) separately measure the skewness of Mexican firms’ export sales to the United States. They report an increase in this skewness following NAFTA: they show that Mexican firms expanded their exports of their better-performing products (higher market shares) significantly more than those for their worse-performing exported products during the period of trade expansion from 1994 to 2003. Relative to these papers (including our previous one), a significant innovation in our current paper is to directly connect the evidence on trade-induced reallocations to the empirical validity of MSLD and to measure the impact of those reallocations on firm-level productivity.

These findings have important consequences for the nascent literature analyzing the increasing concentration of market share among industry-leading firms (see Autor et al., 2020, for a recent example). Our model explains how rising concentration may not stem from changes in competition regimes (linked to antitrust policies) but can alternatively come from demand-side growth, including access to new or growing export markets.

The rest of the paper is organized as follows. Section II introduces our data set on French exporters and provides novel evidence on reallocations over time with a special emphasis on the skewness effect. It shows that positive demand shocks in any given destination market induce French exporters to skew their product-level export sales to that destination toward their best-performing products. These demand shocks also lead to strong, positive responses in both the

information via a firm survey. They also find a very strong, positive correlation between firm size and markups.
intensive and extensive margins of export sales to that destination. Section III introduces our flexible theoretical framework with multiproduct firms and shows how MSLD can rationalize this empirical evidence (along with the prior evidence we just described). It also shows how MSLD implies that positive demand shocks engender increases in multiproduct firm productivity as firms reallocate market and labor shares toward better-performing products. Sections IV and V take these predictions to the data and measure large responses in multiproduct firm productivity to demand shocks in export markets.

II. Reallocations over Time

We now document how changes within a destination market over time induce a similar pattern of reallocations as the ones we previously described (holding across destinations). More specifically, we show that demand shocks in any given destination market induce firms to skew their product-level export sales to that destination toward their best-performing products. In terms of first moments, we show that these demand shocks also lead to strong, positive responses in both the intensive and extensive margins of export sales to that destination.

A. Data

We measure firm-product-destination export sales using French customs data spanning the period 1995 to 2005. All firms operating in the French metropolitan territory must report their export sales according to the following criteria: exports to each EU destination whenever within-EU exports exceed 100,000 euros; and exports to non-EU country whenever exports to that destination exceed 1,000 euros or a ton. Despite these limitations, the database is nearly comprehensive. For instance, in 2005, 103,220 firms report exports across 234 destination countries (or territories) for 9,873 products. This represents data on over 2.2 million shipments. We restrict our analysis to firms whose main activity is classified as manufacturing to ensure that firms take part in the production of the goods they export. This leaves us with data covering more than a million shipments by firms across all manufacturing sectors.

Matched balance-sheet data provide us with information on variables that are needed to assess firm productivity such as turnover, value added, employment, investment, raw material use, and capital. However, we can only measure product reallocations in terms of sales in export markets as the breakdown of sales across products for the domestic market is not available to us. We will have to take this into account in designing our estimation strategy. The balance-sheet data we have access to come in two sources where the official identification number of the firm can be matched with customs information. The first source is the Enquête Annuelle d'Entreprise (EAE), produced by the national statistical institute, and exhaustive for manufacturing firms with more than twenty employees. The second is Bénéfice Réel Normal (BRN), which comes from tax authorities and includes a broader coverage of firms, since it is based on the firm’s legal tax regime and a relatively low sales threshold. Whenever firm data are available from both sources, we give precedence to the EAE data (which is more closely monitored by the statistical authorities). Table 1 provides some descriptive statistics relevant to the match between customs and balance sheet data. The overall match is not perfect but covers between 88% and 95% of the total value of French exports. The match with firms declaring manufacturing as their main activity is still very good, although there is a clear trend of declining quality of match, particularly after 2000. This is also visible in the aggregate growth rate of exports in our sample (column 5) that overall provide a quite good match of the overall exports growth rate in column 4, but deteriorating over time. Our investigations suggest that the increasing propensity of large French manufacturers to declare their main activity as retail or some other service activity might provide part of that explanation. Overall our matched data set is comparable to papers using the same primary sources as in by Eaton et al. (2011), Berman, Martin,
and Thierry Mayer (2012), or di Giovanni et al. (2014) for instance.

B. Measuring Export Demand Shocks

Consider a firm $i$ exporting a number of products $s$ in industry $I$ to destination $d$ in year $t$. We measure industries ($I$) at the three-digit ISIC level (35 different classifications across French manufacturing). We consider several measures of demand shocks that affect this export flow. At the most aggregate level, we use the variation in GDP in $d$, log GDP$_{d,t}$. At the industry level $I$, we use total imports into $d$ excluding French exports, $log M^I_{d,t}$. We can also use our detailed product-level shipment data to construct a firm-$i$ specific demand shock:

$$log \text{ trade shock}_{i,d,t} = log M^I_{d,t}$$

where $M^I_{d,t}$ represents total imports into $d$ (again, excluding French exports) for product $s$ and the overline represents the (unweighted) mean. For world trade, the finest level of product level of aggregation is the HS-6 level (from UNCOMTRADE and CEPII-BACI), which is more aggregated than our NC8 classification for French exports (roughly 5,300 HS products per year versus 10,000 NC8 products per year). The construction of the last trade shock is very similar to the one for the industry-level imports $log M^I_{d,t}$, except that we only use imports into $d$ for the precise product categories that firm $i$ exports to $d$. In order to ensure that this demand shock is exogenous to the firm, we use the set of products exported by the firm in its first export year in our sample (1995, or later if the firm starts exporting later on in our sample) and then exclude this year from our subsequent analysis. Note that we use an unweighted average so that the shocks for all products exported by the firm in $t-1$.

C. The Impact of Demand Shocks on Trade Margins and Skewness

Before focusing on the effects of the demand shocks on the skewness of export sales, we first show how the demand shocks affect firm export sales at the intensive and extensive margins (the first moments of the distribution of product export sales). Table 2 reports how our three demand shocks (in first differences) affect changes in firm exports to destination $d$ in ISIC $I$ (so each observation represents a firm-destination-ISIC combination). We decompose the firm’s export response to each shock into an intensive margin (average exports per product) and an extensive margin (number of exported products). We clearly see how all three demand shocks induce very strong (and highly significant), positive responses for both margins. This confirms that our demand shocks capture important changes in the local demand faced by French exporters.

We now investigate the consequences of those demand shocks for the skewness of export sales (independent of the level of product sales). In Mayer et al. (2014), we focused on

\begin{table}[h]
\centering
\begin{tabular}{lccc}
\hline
Dependent Variable & $\Delta \log$ Exports per Product & $\Delta \log$ # Products Exported \\
\hline
$\Delta$ GDP Shock & 0.493$^a$ & 0.149$^a$ \\
 & (0.048) & (0.016) \\
$\Delta$ trade shock & 0.277$^a$ & 0.076$^a$ \\
 & (0.009) & (0.004) \\
$\Delta$ trade shock - ISIC & 0.039$^a$ & 0.014$^a$ \\
 & (0.005) & (0.002) \\
Observations & 401,575 & 404,572 & 401,575 \\
\hline
\end{tabular}
\caption{Demand Shocks and Local Exports}
\end{table}

\footnotesize{Standard errors in parentheses: $^a$ < 0.01, $^b$ < 0.05, $^c$ < 0.01. All regressions include year dummies and standard errors clustered at the level relevant for the variable of interest: destination country for columns 1 and 4, firm destination for columns 2 and 5, and SIC destination for columns 3 and 6.}

\footnotesize{\textsuperscript{3}See Gaulier and Zignago (2010).}

\footnotesize{\textsuperscript{4}There is a one-to-many matching between the NC8 and HS6 product classifications, so every NC8 product is assigned a unique HS6 classification. We use the same $M^I_{d,t}$ data for any NC8 product $s$ within the same HS6 classification.}

\footnotesize{\textsuperscript{5}Thus, positive idiosyncratic demand shocks to high market-share products (which mechanically contribute to increase the skewness of product sales) are given the same weight as positive idiosyncratic shocks to low market-share products (which mechanically contribute to decrease the skewness of product sales), and vice versa for negative shocks.}

\footnotesize{\textsuperscript{6}Switching to first-difference growth rates measured as $\Delta \log X$ (and dropping products with zero trade in the trade shock average) does not materially affect any of our results.}
those effects in the cross-section across destinations. Here, we examine the response of skewness within a destination over time using our new demand shocks. In order to avoid capturing effects driven by income shocks that could affect the demand for quality, we focus on the trade shocks and add income per capita as a control. We rely on the Theil index as our measure of skewness due to its aggregation properties. We later aggregate the export responses at the destination-ISIC level up to the firm level in order to generate predictions for firm-level productivity. Thus, our measure of skewness for the distribution of firm $i$'s exports to destination $d$ in industry $I$, $x_{idt}^I$, is the Theil index (computed over all $N_{idt}^I$ products $s$ that firm $i$ exports to $d$ in year $t$):

$$T_{idt}^I = \frac{1}{N_{idt}^I} \sum_{s \in I} \frac{x_{idt}^s}{x_{idt}^I} \log \left( \frac{x_{idt}^s}{x_{idt}^I} \right), \quad \lambda_{idt}^I = \frac{\sum_{s \in I} x_{idt}^s}{N_{idt}^I}. \quad (2)$$

Table 3 reports regressions of this skewness measure on both export demand shocks at the firm-destination-ISIC level. In the first two columns, we use a specification in (log) levels (FE), and use firm-destination-ISIC fixed effects to isolate the variation over time. In the next two columns, we return to our specification in first differences (FD). In the last two columns we add the firm-destination-ISIC fixed effects to this specification in first differences (FD-FE). This controls for any trend growth rate in our demand shocks over time. All specifications include a control for income per capita (not reported). Across all three specifications, we see that positive export demand shocks induce a highly significant increase in the skewness of firm export sales to a destination.

Table 3 focuses on the contemporaneous response of skewness to the demand shocks. In figure 1, we show the dynamic response of skewness by including two years of leads and lags for the demand shocks. The figure shows the regression coefficients for each lead and lag along with its 95% confidence interval. This regression framework requires us to drop the first and last two years in our sample in order to measure the response of skewness two years before and after the demand shock. This is why our contemporaneous coefficients (along the vertical dotted line) are different from those reported in table 3. Figure 1 shows that no significant pretrends are associated with the response of skewness to the demand shock. The bulk of the response is contemporaneous and remains significant for only a single year following the shock.

We now return to the contemporaneous response of skewness and investigate its robustness to alternate measurement methods. The first column of table 4 replicates the FD-FE specifications from table 3, columns 5 and 6, using our Theil measure for skewness. This is our most demanding specification. Each entry in table 4 represents a separate regression with the same additional controls that we previously described. The next three columns of table 4 explore alternative measures of skewness using the Atkinson index. This index was developed to allow for greater flexibility in quantifying the contribution of different parts of the distribution to overall inequality. It is defined as

$$A_{idt}^{I, \eta} \equiv \begin{cases} 
1 - \frac{1}{\bar{x}_{idt}} \left[ \frac{1}{N_{idt}} \sum_{s \notin I} (x_{idt}^s)^{1-\eta} \right]^{\frac{1}{1-\eta}}, & \text{for } 0 \leq \eta \neq 1 \\
1 - \frac{1}{\bar{x}_{idt}} \left[ \prod_{s \notin I} x_{idt}^s \right]^{\frac{1}{\eta - 1}}, & \text{for } \eta = 1.
\end{cases} \quad (3)$$

The parameter $\eta$ is often called the inequality aversion parameter as higher values put more weight on the low end of the distribution. When $\eta$ gets close to 0, more weight is given to high values—in our case, to the firm’s best-performing products. As $\eta$ increases, more weight is given to the distribution of the firm’s worse-performing products relative to the best-performing ones. This Atkinson index is also equal to $1 - \frac{\mu}{\bar{x}_{idt}}$, where $\mu$ is the mean of the distribution of the $x_{idt}^s$.

As we do throughout the paper, we use skewness as an index of inequality for the distribution of product sales. This is distinct from the statistical definition of skewness as a measure of asymmetry. Hence, all of our empirical measures for skewness will be based on entropy indices (such as the Theil and Atkinson inequality measures).
Table 4.—Skewness and Shocks: Robustness

<table>
<thead>
<tr>
<th>RHS</th>
<th>$\Delta T_{t,d,t}^I$</th>
<th>$\Delta A_{t,d,t}^{1.5}$</th>
<th>$\Delta A_{t,d,t}^{1}$</th>
<th>$\Delta A_{t,d,t}^{2.5}$</th>
<th>$\Delta T_{t,d,t}^I$</th>
<th>$\Delta A_{t,d,t}^{1.5}$</th>
<th>$\Delta A_{t,d,t}^{1}$</th>
<th>$\Delta A_{t,d,t}^{2.5}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\Delta$ trade Shock</td>
<td>0.034$^a$</td>
<td>0.014$^a$</td>
<td>0.019$^a$</td>
<td>0.018$^a$</td>
<td>0.013$^a$</td>
<td>0.007$^a$</td>
<td>0.010$^a$</td>
<td>0.009$^a$</td>
</tr>
<tr>
<td>$\Delta$ trade Shock - ISIC</td>
<td>(0.005)</td>
<td>(0.002)</td>
<td>(0.003)</td>
<td>(0.003)</td>
<td>(0.003)</td>
<td>(0.002)</td>
<td>(0.003)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>$\bar{\Delta}$ trade Shock - ISIC</td>
<td>0.006$^a$</td>
<td>0.003$^a$</td>
<td>0.004$^a$</td>
<td>0.004$^a$</td>
<td>0.005$^a$</td>
<td>0.002$^a$</td>
<td>0.004$^a$</td>
<td>0.004$^a$</td>
</tr>
<tr>
<td>$\bar{\Delta}$ trade Shock - ISIC</td>
<td>(0.002)</td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.002)</td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.001)</td>
</tr>
</tbody>
</table>

This table presents the results of individual regressions where the columns indicate the LHS variable and the rows indicate the RHS variables. All regressions include a control for income per capita shocks in the destination country and year dummies. Standard errors clustered at the level relevant for the variable of interest: Firm destination for trade shock and ISIC destination for trade shock-ISIC.

when $\eta = 0$, it is the arithmetic mean, in which case there can never be any inequality ($A_{t,d,t}^{1.5} \equiv 0$ for any distribution of product sales $x_{idt}^3$). Table 4 reproduces our skewness results for a wide range of inequality parameters $\eta$, starting with a low value of $\eta = .5$ along with the special cases of $\eta = 1$ and $\eta = 2$. Those results, reported in columns 2 to 4, clearly show that the effect of the demand shocks on skewness does not rely on the Theil functional form or on a specific weighing scheme for the Atkinson index.

All the skewness measures so far in table 4 combine changes to both the intensive product mix margin (the relative sales of different products exported in both $t-1$ and $t$) and the extensive margin (products sold in one period but not the other). In the next set of columns, we isolate the skewness response that is driven only by the intensive product mix margin. To do this, we recompute the same skewness measures on the restricted subset of products that are exported in both $t-1$ and $t$ (denoted by $T$ and $\bar{A}$). Results using these intensive margin skewness measures are reported in the following four columns of table 4. Across all those different skewness metrics, there remains a positive and significant (beyond the 1% level) response of skewness at the intensive margin: within a constant set of exported products, positive demand shocks skew market shares toward better-performing products.

### III. Theoretical Framework

In the previous section we documented the pattern of product reallocations in response to demand shocks in export markets. We now develop a theoretical model of multiproduct firms that highlights the specific demand conditions needed to generate this pattern. These demand conditions imply MSLD and generate all of the microlevel evidence on firm/product selections, prices, and markups presented in section I. In particular, those demand conditions highlight how demand shocks lead to changes in competition for exporters in those markets (which lead to the observed reallocations). Those reallocations in turn generate changes in firm productivity. We directly investigate the empirical connection between demand shocks and productivity in the following sections.
We represent a fraction of the labor endowment as units of product indices both the number of consumer and the choice of labor as numeraire: aggregate account- ing then implies that this normalized number of consumers represents a fraction of the labor endowment. In both scenarios, we model a demand shock as an increase in the number of consumers. This increases aggregate expendi- ture one-for-one, given our assumptions of unitary consumer income. In our GE scenario, this increase is associated with a proportional increase in labor supplied. In our PE sce- nario, the labor supply response is left unrestricted, isolating the demand-side effects.

In both scenarios, each consumer’s utility is assumed to be additively separable over a continuum of imperfectly sub- stitutable products indexed by , where is the measure of products available. The representative consumer then solves the following utility maximization problem,

\[
\max_{q_i \geq 0} \int_{0}^{M} u(q_i) d\lambda \text{ s.t. } \int_{0}^{M} p_i q_i d\lambda = 1,
\]

where is the subutility associated with the consumption of units of product . We assume that this subutility exhibits the following properties:

\[
(A1) \quad u(0) = 0; \quad u'(q_i) > 0 \text{ and } u''(q_i) < 0 \text{ for } q_i \geq 0.
\]

The first-order condition for the consumer’s problem determines the inverse residual demand function (per consumer),

\[
p(q_i) = \frac{u'(q_i)}{\lambda}, \tag{4}
\]

where \( \lambda = \int_{0}^{M} u'(q_i) q_i d\lambda > 0 \) is the marginal utility of income. Given our assumption of separable preferences, this marginal utility of income is the unique endogenous aggregate demand shifter: higher shifts all residual demand curves inward. We refer to this as an increase in competition for a given level of market demand. Concavity of ensures that the chosen consumption level from equation (4) also satisfies the second-order condition for the consumer’s problem. This residual demand curve, equation (4), is associated with a marginal revenue curve,

\[
\phi(q_i) = \frac{u'(q_i) + u''(q_i) q_i}{\lambda}. \tag{5}
\]

As we will restrict our analysis to additively separable preferences, which are nonhomothetic, changes in consumer income will have different effects from will changes in the number of consumers. We focus on this functional form for tractability and do not wish to emphasize its properties for income elasticities. As first highlighted by Deaton and Muellbauer (1980), additively separable preferences imply a specific relationship between price and income elasticities. We emphasize the properties of demand for those price elasticities. Thus, we analyze changes in the number of consumers holding their income fixed. This is akin to indexing the preferences to a given reference income level.

Our theoretical model contributes to the growing literature emphasizing demand systems with variable price elasticities for models of monopolistic competition, such as Zhelebodko et al. (2012), Bertoletti and Epifani (2014), Fabinger and Weyl (2014), Mrazova and Neary (2017), and Parenti, Ushchev, and Thissé (2017). Our main point of departure relative to those papers is that we seek to connect the demand conditions on variable elasticities (and MSLD) directly to the evidence on the product reallocations that we document and our additional goal of empirically connecting those to firm-level productivity.13

We use the same class of separable preferences as Zhelebodko et al. (2012), which allow for both MSLD and non-MSLD demand. We then show how the restriction to the MSLD subset is both necessary and sufficient for consistency with the empirical evidence. In order to highlight this connection between demand conditions (MSLD) and product skewness, we focus in this paper on a closed economy setup. In our companion working paper, we fully flesh out an open economy version of this model where exporters from multiple countries compete in a given destination market. In that paper, we show how demand shocks in that destination market induce very similar product reallocations as in the closed economy (but for exporters to that market).

A. Closed Economy

We develop both a general equilibrium (with a single differentiated good sector for the whole economy) and a partial equilibrium version focusing on a single sector among many in the economy. In the latter, we also introduce a short-run version where entry is restricted (general equilibrium is inherently a long-run scenario). We show how demand shocks induce the same skewness pattern in all of these modeling alternatives. This highlights the critical role of the demand system in shaping the pattern of reallocations.

Multi product production with additive separable utility. We consider a sector with a single productive factor, labor. We distinguish between two scenarios. The first is the standard general equilibrium (GE) setup with a single sector. The exogenous labor endowment indexes both the number of workers (with inelastic supply) and consumers. The endogenous wage is set to 1 by choosing labor as the numeraire. Aggregate expenditures are then given by the exogenous labor endowment. In our partial equilibrium (PE) scenario, we focus on the sector as a small part of the economy. We take the number of consumers as well as their individual expenditures on the sector’s output as exogenously given. The supply of labor to the sector is perfectly elastic at an exogenous

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13In this spirit, our paper is most closely related to Arkolakis et al. (2018) and Asplund and Nocke (2006), who also directly connect their theoretical modeling of endogenous markups with empirical moments; Arkolakis et al. (2018) focus on the implications for the welfare gains from trade and Asplund and Nocke (2006) on the implications for firm turnover in a dynamic setting.
Let \( \varepsilon_p(q_i) \equiv -\phi'(q_i) q_i / p(q_i) \) and \( \varepsilon_\phi(q_i) \equiv -\phi'(q_i) q_i / \phi(q_i) \) denote the elasticities of inverse demand and marginal revenue. Thus, \( \varepsilon_p(q_i) \geq 0 \) is the inverse price elasticity of demand (less than 1 for elastic demand). Although the demand and marginal revenue curves are residual (they depend on \( \lambda \)), their elasticities are nonetheless independent of \( \lambda \). These preferences nest the CES case where the elasticities \( \varepsilon_p(q_i) \) and \( \varepsilon_\phi(q_i) \) are constant; using the additively separable functional form for CES, the marginal utility of income \( \lambda \) is then an inverse monotone function of the CES price index.

Products are supplied by firms that may be single- or multiproduct. Market structure is monopolistically competitive as in Mayer et al. (2014): each product is supplied by a single firm, and each firm supplies a countable number of products (among the continuum of consumed products). Technology exhibits increasing returns to scale associated with a fixed overhead cost, along with a constant marginal cost of production. We assume that the fixed cost \( f \) is common for all products, while the marginal cost \( v \) (variety level cost) is heterogeneous. For a given firm, products are indexed in increasing order \( m \) of marginal cost from a core product indexed by \( m = 0 \). Firm entry incurs a sunk cost \( f^* \). After this cost is incurred, entrants randomly draw the marginal cost for their core product from a common continuous differentiable distribution \( \Gamma(c) \) with support over \([0, \infty)\); we refer to this cost draw as the firm’s core competency.\(^{15}\) This gives an entrant the exclusive blueprint used to produce a countable range of additional products indexed by the integer \( m \) (potentially zero) at marginal cost \( v(m, c) \equiv cz(m) \) with \( z(0) = 1 \) and \( z'(m) > 0 \).\(^{16}\)

Product-level performance and selection. A firm owning the blueprint for product \( i \) with marginal cost \( v \) and facing demand conditions \( \lambda \) chooses the optimal output per consumer \( q(v, \lambda) \) to maximize total product-level profits \( L^v f'(q_i) q_i / q_i - f \), so long as those profits are nonnegative or do not produce product \( i \) otherwise.\(^{17}\) The first-order condition whenever production occurs equals marginal revenue with marginal cost:

\[
\phi(q(v, \lambda)) = v.
\] (6)

In order to ensure that the solution to this maximization problem exists (for at least some \( v > 0 \)) and is unique, we further restrict our choice of preferences to satisfy

\[
(A2) \ 2 u''(q_i) + u'''(q_i) q_i < 0.
\]

This assumption ensures that marginal revenue \( \phi(q_i) \) is decreasing for all output levels and is positive for at least some output levels. This ensures elastic demand along a top portion of the demand curve.

The profit-maximizing price associated with the output choice, equation (6), can be written in terms of the chosen markup \( \mu(q) \equiv 1 / (1 - \varepsilon_p(q)) \):

\[
p(q(v, \lambda)) = \mu(q(v, \lambda)) v.
\] (7)

Those output and price choices are associated with the following product-level revenues and operating profits per consumer: \( r(v, \lambda) = p(q(v, \lambda)) q(v, \lambda) \) and \( \pi(v, \lambda) = [p(q(v, \lambda)) - v] q(v, \lambda) \). Total product-level sales are then given by \( L^v r(v, \lambda) \), while total product net profits are \( L^v \pi(v, \lambda) - f \). Using the first-order condition for profit maximization, equation (6), and our derivations for marginal revenue, equation (5), and markup, equation (7), the elasticities for all these product-level performance measures can be written in terms of the elasticities of demand and marginal revenue,

\[
\begin{align*}
\varepsilon_{q, v} & = -\frac{1}{\varepsilon_\phi}, \\
\varepsilon_{r, v} & = -\frac{1 - \varepsilon_p}{\varepsilon_\phi}, \\
\varepsilon_{\pi, v} & = -\frac{1}{\varepsilon_p}, \\
\varepsilon_{q, \lambda} & = -\frac{1}{\varepsilon_\phi}, \\
\varepsilon_{r, \lambda} & = -\frac{1 - \varepsilon_p}{\varepsilon_\phi} - 1, \\
\varepsilon_{\pi, \lambda} & = -\frac{1}{\varepsilon_p}.
\end{align*}
\] (8)

where we use the elasticity notation \( \varepsilon_x \) to denote the elasticity of the function \( g \) with respect to \( x \). All of the elasticities with respect to the product marginal cost \( v \) are negative, indicating that lower marginal cost is associated with higher output, sales, and profit (both operating and net). As expected, an increase in competition \( \lambda \) (for any given level of market demand \( L^v \)) will result in lower output, sales, and profit for all products.

Since operating profit is monotonic in a product’s marginal cost \( v \), the production decision associated with nonnegative net profit will lead to a unique cutoff cost level \( \hat{b} \) satisfying

\[
\pi(\hat{b}, \lambda) L^v = f.
\] (9)

All products with cost \( v \leq \hat{b} \) will be produced. Since \( v(0, c) = c \) (recall that \( v(m, c) = cz(m) \); \( z(0) = 1 \)), any firm with core competency \( c \leq \hat{\hat{c}} \) will produce \( M(c) = \max \{ m \mid cz(m) \leq \hat{b} \} \) additional products (potentially none, and then \( M(c) = 0 \)) and earn firm-level net profits: \( \Pi(c, \lambda) = \sum_{m=0}^{M(c)} [\pi(cz(m), \lambda) L^v - f] \). Since \( \varepsilon_{x, v} \) and \( \varepsilon_{x, \lambda} \) are both negative, increases in competition \( \lambda \), holding market demand \( L^v \) constant, will be associated with lower cutoffs \( \hat{b} = \hat{\hat{c}} \). Tougher competition thus leads to tougher selection: the least productive firms exit and all surviving firms shed (weakly) their worst-performing products.

\(^{15}\)This assumption of infinite support is made for simplicity in order to rule out the possibility of an equilibrium without any firm selection. We could also introduce an upper-bound cost draw so long as this upper bound is high enough that the equilibrium features selection (some firms do not produce).

\(^{16}\)The assumption \( z'(m) > 0 \) will generate the within-firm ranking of products discussed in section 1. In the limit case when \( z'(m) \) is infinite, all firms produce only a single product.

\(^{17}\)As we have assumed that any firm’s set of products is of measure zero relative to the set of available products \( M \), there is no product interdependence in the firm’s pricing/output decision (no cannibalization).
Free entry in the long run. In the long run when entry is unrestricted, the expected profit of the prospective entrants adjusts to match the sunk cost:

$$
\int_0^c \Pi(c, \lambda) d\Gamma(c)
= \sum_{m=0}^\infty \left\{ \int_0^{\hat{c}/z(m)} \left[ \pi(z(m), \lambda) L^e - f \right] d\Gamma(c) \right\} = f^e. \tag{10}
$$

This free entry condition, along with the zero cutoff profit condition, equation (9), jointly determine the equilibrium cutoffs \( \hat{\theta} = \hat{c} \) along with the competition level \( \lambda \). The number of entrants \( N^e \) is then determined by the consumer’s budget constraint:

$$
N^e \left\{ \sum_{m=0}^\infty \left[ \int_0^{\hat{c}/z(m)} r(z(m), \lambda) d\Gamma(c) \right] \right\} = 1. \tag{11}
$$

These conditions hold in both our GE and PE scenarios.

Since labor is the unique factor and numeraire, we can convert the firms’ costs (both per-unit production costs and the fixed costs) into employment. Aggregating over all firms yields the aggregate labor demanded:

$$
L^w = N^e \left( f^e + \sum_{m=0}^\infty \left[ \int_0^{\hat{c}/z(m)} q(z(m), \lambda) L^e + f \right] d\Gamma(c) \right) .
$$

As the free entry condition, equation (10), entails no ex ante aggregate profits (aggregate revenue is equal to the payments to all workers, including those employed to cover the entry costs), this aggregate labor demand \( L^w \) will be equal to the number of consumers \( L^e \). This ensures labor market clearing in our GE scenario. In our PE scenario, this implies that the endogenous labor supply adjusts so that it equalizes the normalized number of consumers (recall that this is an exogenous fraction of the economy-wide labor endowment).

In these long-run scenarios, the impact of an increase in demand \( L^e \) on the cutoffs will depend on some further assumptions on demand, which we discuss in detail following the introduction of our short-run scenario. However, we note that the impact for the level of competition \( \lambda \) is unambiguous: higher demand leads to increases in competition \( \lambda \).\(^{18}\)

Short run scenario. We now consider an alternative short-run situation in which the number of incumbents is fixed at \( N \) in the PE scenario (with the same exogenous distribution of core competencies \( \Gamma(c) \)). In this case, free entry, equation (10), no longer holds: firms with core competencies below the profit cutoff in equation (9) produce while the remaining firms shut down. However, the budget constraint, equation (11), still holds with the exogenous number of incumbents \( N \) now replacing the endogenous number of entrants \( N^e \). Together with the zero cutoff profit, equation (9), those two conditions jointly determine the endogenous cutoffs \( \hat{\theta} = \hat{c} \) and competition level \( \lambda \).

As was the case in the long-run scenarios with free entry, an increase in demand \( L^e \) must lead to an increase in competition \( \lambda \).\(^{19}\) However, the response of the cutoffs is now unambiguous: the increase in demand must raise profits for all products (given their cost \( \pi \)) since there is no induced response in entry, leading to an increase in the cutoffs \( \hat{\theta} = \hat{c} \).\(^{20}\) In this short-run scenario, it is the production of these new varieties (previously unprofitable) that generates the increased competition. In the long run, the increased competition is driven by the entry of new firms (and the varieties they produce).

Curvature of demand. Up to now, we have placed very few restrictions on the shape of the residual demand curves that the firms face, other than the conditions A.1 and A.2 needed to ensure a unique monopolistic competition equilibrium. In particular, the rates of change of the elasticities of residual demand and marginal revenue (the signs of \( \epsilon'_p(q_i) \) and \( \epsilon'_q(q_i) \)) were left unrestricted. We now show how further restrictions on those rates of change (or alternatively the curvature of demand and marginal revenue) are intrinsically tied to product-level reallocations in addition to their better-known consequences for prices, markups and pass-through. We then highlight the reverse connection from the pattern of product reallocations we documented in section II back to their necessary conditions for demand. Throughout, we assume that conditions A1 and A2 hold in our monopolistic competition equilibrium. Thus, a necessary condition for an empirical pattern is an additional condition that must hold (to generate that empirical prediction) conditional on those initial assumptions.

The further restrictions on the shapes of demand and marginal revenue are both related to MSLD:

\[(\text{MSLD})\epsilon'_p(q_i) > 0 \text{ for } q_i \geq 0 \quad \text{and} \quad (\text{MSLD})\epsilon'_q(q_i) > 0 \text{ for } q_i \geq 0.\]

\(^{18}\)Competition \( \lambda \) must strictly increase for the free entry condition to hold. If \( \lambda \) decreased (even weakly), then net profit for a given variety \( \pi(o, \lambda) L^e - f \) should strictly increase (given \( dL^e > 0 \) and \( \epsilon_{\lambda} < 0 \)). The cutoffs \( \hat{\theta} = \hat{c} \) must then strictly increase, given equation (9), along with the average firm profit (the left-hand side) in the free-entry condition, equation (10). Thus, this condition could not hold if \( \lambda \) weakly decreased.

\(^{19}\)Competition \( \lambda \) must strictly increase in order to satisfy the budget constraint, equation (11), with a fixed number of incumbents. As we argued in note 18, \( \lambda \) weakly decreasing would imply a strict increase in the cutoffs \( \hat{\theta} = \hat{c} \). This would entail both a strict increase in the number of products consumed, as well as a weak increase in expenditures per product \( r(o, \lambda) \) for each consumer (recall that \( \epsilon_{\lambda} < 0 \)). This would necessarily violate the consumer’s budget constraint.

\(^{20}\)Note that with a fixed number of incumbents, the budget constraint, equation (11), implies an increasing relationship between the cutoff \( \hat{c} \) and the level of competition \( \lambda \) (which reduces product-level revenues \( r(o, \lambda) \) for all products).
Under MSLD, demand becomes more inelastic with consumption: it is log concave in log prices. It is a necessary and sufficient condition for better-performing products (lower \(v\)) to have higher markups and for tougher competition (higher \(\lambda\)) to lower markups for any given product (given a cost \(v\)). Thus, the evidence discussed in section I linking better product and firm performance to higher markups implies that MSLD must hold. It is also consistent with the estimates of Arkolakis et al. (2018) for bilateral trade demand. In our model with monopolistic competition, MSLD is also equivalent to an alternate condition that the pass-through elasticity from marginal cost to price \(\theta \equiv \partial \ln p(q(v, \lambda))/\partial \ln v = \varepsilon_p/\varepsilon_q\) is less than 1 (see our companion paper for proof). Thus, the vast empirical evidence on incomplete pass-through (see the survey by Burstein & Gopinath, 2014) also requires this demand condition MSLD. Most important, we will show that MSLD is a necessary condition for the evidence we documented on product reallocations for French exporters. This provides an independent confirmation for this demand condition that does not rely on the (very noisy) measurement of product prices and the estimation of markups (or alternatively marginal costs).

Assumption MSLD’ is more restrictive than MSLD: it requires that the log marginal revenue curve be concave. This implies that the log demand curve be concave (see our companion paper for proof). If only MSLD holds, then log marginal revenue curve need not be globally concave. However, it would still have to be everywhere steeper than log demand: \(\varepsilon_q(q_i) > \varepsilon_p(q_i)\) for all \(q_i \geq 0\) (see our companion paper for proof). In the following section, we show that MSLD’ is a sufficient condition for the product reallocations we previously described for French exporters, in addition to all the evidence from the existing literature on prices, markups, and pass-through.

Finally, we note that conditions MSLD and MSLD’ exclude the CES case, where the derivatives of the elasticities \(\varepsilon_q(q_i)\) and \(\varepsilon_p(q_i)\) are zero. In this limiting case, the log demand and log marginal revenue curves are linear. Nevertheless, MSLD and MSLD’ are consistent with most of the functional forms that have been used to explore endogenous markups in the theoretical trade literature.

Demand shocks and product reallocations. We have already described how an increase in demand \(L^c\) induces an increase in the toughness of competition \(\lambda\) in both the long run (GE and PE) and the short run. We now highlight how the demand conditions MSLD and MSLD’ generate a link between increases in the toughness of competition and product reallocations toward better-performing products.

First, we note that the increase in competition \(\lambda\) induces a downward shift in output sales \(q(v, \lambda)\) per consumer (though not necessarily overall as the number of consumers is increasing). This decrease in output sales \(q(v, \lambda)\) in turn generates changes in the price and marginal revenue elasticities \(\varepsilon_p\) and \(\varepsilon_q\), which depend on conditions MSLD and MSLD’. Changes in those two elasticities then determine the changes in the elasticities of output, sales, and profit with respect to marginal cost \(v\) (see equation [8]), which govern the reallocation of output, sales, and profit across firms with different costs \(v\). We can now determine exactly how conditions MSLD and MSLD’ affect these reallocations:

**Proposition 1.** MSLD is a necessary and sufficient condition for a positive demand shock to reallocate operating profits to better-performing products: \(\pi(v_1, \lambda)/\pi(v_2, \lambda)\) increases whenever \(v_1 < v_2\).

**Proof.** \(|\varepsilon_{\pi, v}|\) increases for all products \(v\) whenever \(\lambda\) increases if and only if \(\varepsilon_{\pi}(q_i)\) is increasing (see equation [8]).

**Proposition 2.** MSLD’ is a necessary and sufficient condition for a positive demand shock to reallocate output to better-performing products: \(q(v_1, \lambda)/q(v_2, \lambda)\) increases whenever \(v_1 < v_2\).

**Proof.** \(|\varepsilon_{q, v}|\) increases for all products \(v\) whenever \(\lambda\) increases if and only if \(\varepsilon_{q}(q_i)\) is increasing (see equation [8]).

**Proposition 3.** MSLD’ is a sufficient condition for a positive demand shock to reallocate revenue to better-performing products: \(r(v_1, \lambda)/r(v_2, \lambda)\) increases whenever \(v_1 < v_2\). The necessary condition is that \(1 - \varepsilon_{r}(q_i)/\varepsilon_{q}(q_i)\) is decreasing.

**Proof.** \(\varepsilon_{r, v}\) increases for all products \(v\) whenever \(\lambda\) increases if and only if \(1 - \varepsilon_{r}(q_i)/\varepsilon_{q}(q_i)\) is decreasing (see equation [8]). MSLD’ implies that \(1 - \varepsilon_{r}(q_i)/\varepsilon_{q}(q_i)\) is decreasing.

We have derived these reallocations using the per consumer measures of performance, but since they are all evaluated as ratios, multiplying those by the number of consumers \(L^c\) would lead to identical outcomes (even though \(L^c\) is changing). Thus, we see that MSLD’ is a sufficient condition for all performance measures (profit, output, revenue) to be reallocated toward better-performing products. In this case, an increase in competition (higher \(\lambda\)) induces a steeper relationship between a product’s cost \(v\) and its profit, output, and revenue outcome (higher elasticities \(|\varepsilon_{\pi, v}|, |\varepsilon_{q, v}|, |\varepsilon_{r, v}|\)). A given percentage reduction in cost \(v\) then translates into a higher percentage increase in those performance outcomes. In the case of CES preferences, all those performance elasticities would be constant, and hence changes in demand (and corresponding changes in competition \(\lambda\)) would have no
effect on the relative performance of products (conditional on selection into production).

The reallocation of output toward better-performing products has a direct consequence for firm productivity: the allocation of firm employment to products must respond proportionately to the product-level output changes. Thus, for a given set of products, average productivity (an employment-weighted average of product productivity $1/v$) must increase whenever output is reallocated toward better-performing products.

**Selection.** In the short run, we have already discussed how an increase in demand $L^c$ and the corresponding increase in competition $λ$ induce an increase in the cutoffs $\hat{c} = \hat{d}$. In this scenario, net profit per product $L^c \pi(v, λ) - f$ is increasing for the high-cost products with cost $v$ close to the cutoff, even though the operating profit per consumer $\pi(v, λ)$ is decreasing for all products (the increase in demand $L^c$ dominates the negative impact of the increase in competition $λ$). Condition MSLD then implies that the profits for the better-performing products (with lower cost $v$) increase disproportionately relative to the high-cost products. Thus, net operating profit per product increases for all products.

In the long run, we mentioned that the change in the cutoffs in response to an increase in demand could not be determined without making additional assumptions on demand. Under MSLD, such a demand increase induces a disproportionate increase in operating profits for the best-performing products; thus, total firm profit $\Pi(c, λ)$ becomes steeper (as a function of firm competency $c$). The free entry condition, equation (10), then requires a single crossing of the new, steeper total firm profit $\Pi(c, λ)$ curve with the old, flatter one (ensuring that average profit in both cases is still equal to the constant entry cost $f^*$). This crossing defines a new profitability cutoff $\hat{c}$ whereby better-performing firms with $c < \hat{c}$ enjoy a profit increase, whereas worse-performing firms with $c > \hat{c}$ suffer a profit loss. Hence, the zero profit cutoff $\hat{c}$ (and the associated product-level cutoff $\hat{d}$) decreases, leading to the exit of the worse-performing firms (and the low-performing products for all firms). The product-level net-profit curve $L^c \pi(v, λ) - f$ (as a function of product cost $v$) rotates in a similar fashion to the firm-level profit curve: profits for the best-performing products increase while they decrease for the worse-performing products. For those high-performing products with low cost $v$, the increase in demand $L^c$ dominates the effect of tougher competition (higher $λ$) on per-consumer profits $\pi(v, λ)$, whereas the opposite holds for the low-performing products.

We further note that MSLD is also a necessary condition for this selection effect in the long run. If MSLD were violated, then the profit curves would rotate in the opposite direction, reducing (increasing) profits for the best- (worst-) performing firms and products. This would result in an increase in the cutoffs $\hat{c} = \hat{d}$. In the limiting CES case, the cutoffs would be unaffected by changes in demands: the increase in demand $L^c$ is exactly offset by the increase in competition, leaving net profits $L^c \pi(v, λ) - f$ unchanged for all products.

**B. Open Economy**

In our companion paper, we develop a three-country version of our model. Exporters from both France and the “Rest of the World” (a third country) compete along with domestic firms in a destination country $D$. A demand shock in that destination is then captured by changes in the “number” of consumers $L_D^{***}$ in that destination. Just like the closed economy case, an increase in demand $L_D^{***}$ induces an increase in competition $λ_D$ in $D$ for both the long run and short run. All of our previous results regarding the impact of such a demand shock on the reallocation of profits, output, and revenue toward better-performing products therefore apply (propositions 1–3). Thus, for exporters to $D$, we can connect demand conditions MSLD and MSLD′ to the reallocation of export sales and profits (in market $D$) toward better-performing products.

Demand condition MSLD is sufficient for the demand shock to increase the net profit for the sales of the best-performing products in $D$ (the profits generated by sales in $D$) in both the long and short run. So long as the fixed export cost for destination $D$ is high enough, all exported products will fall into this category and experience a profit increase following the increase in demand. This in turn implies that an increase in demand induces the export of new products into $D$: existing exporters increase their range of exported products to $D$, and some firms start exporting to $D$.

**C. Connecting Back to Empirical Measures of Product Reallocations in Export Markets**

Demand condition MSLD′ across export destinations $D$ thus explains all of the evidence on the response of French exporters to demand shocks that we documented in section II. It explains how positive demand shocks induce the entry of new exported products and the reallocation of output and revenues toward the best-performing products. The reallocation of output contributes positively to a firm’s productivity (by shifting employment shares toward products with higher marginal products). And the reallocation of revenues generates an increase in the skewness of a firm’s export sales to that destination.25 Demand condition MSLD′ and the weaker version MSLD are also directly connected to the empirical evidence on firm/product markups and pass-through. In the limiting case of CES preferences, demand shocks in export market would have no impact on the skewness of export sales; markups are constant across products, and pass-through is complete (equal to 1) for all products.

25 We showed how the ratio of export sales for any two products (with the better-performing product in the numerator) increases in response to a demand shock. This clearly increases the skewness of export sales. In our companion paper, we confirm that such an increase in skewness is reflected in the Theil and Atkinson indices that we use in our empirical work.
On its own, the evidence on the positive relationship between demand shocks and export skewness requires that $[1 - \epsilon_p(q_t)] / \epsilon_y(q_t)$ is decreasing over the range of exported output $q_t$ that we observe. We have pointed out that condition MSLD' ($\epsilon_y(q_t)$ increasing) is sufficient for this outcome. However, since it is not a necessary condition, our evidence for the skewness of exports does not imply that MSLD' must hold. On the other hand, we show in our companion paper that the weaker condition MSLD ($\epsilon_y(q_t)$ increasing) must nevertheless hold. In particular, we show that even if MSLD were violated over a portion of the relevant demand curve ($\epsilon_y(q_t)$ decreasing over some range), then this would result in a reverse prediction for export skewness over this portion of the demand curve. This result also fits with what we know about the limiting case of CES preferences, where demand shocks have no impact on the skewness of export sales.

Thus, our empirical evidence on the impact of demand shocks for export skewness provides an independent confirmation for the empirical relevance of this critical property of demand—without relying on the measurement of prices and markups.

IV. Trade Competition and Product Reallocations at the Firm Level

Our theoretical model highlights how our measured demand shocks induce increases in competition for exporters to those destinations and how the increased competition generates increases in productivity by shifting market shares and employment toward better performing products. We seek to directly measure this connection between demand shocks and productivity. Since we cannot measure the productivity associated with products sold to a particular destination, we need to show that the connection between demand shocks and product reallocations aggregates to the firm level, before examining the link with firm-level productivity changes (which we can directly measure). Our results in section II highlighted how demand shocks lead to reallocations toward better-performing products at the destination-industry level. We now show how the destination-industry demand shocks can be aggregated to the firm level and how this firm-level demand shock strongly predicts product reallocations toward better-performing products (higher market shares) at the firm level—that is, changes in skewness to the firm’s global product mix (the distribution of product sales across all destinations).

Intuitively, since there is a stable ranking of products at the firm level (better-performing products in one market are most likely to be the better-performing products in other markets, as we previously discussed), then reallocations toward better-performing products within destinations should also be reflected in the reallocations of global sales/production toward better-performing products, and the strength of this link between the skewness of sales at the destination and global levels should depend on the importance of the destination in the firm’s global sales. Our chosen measure of skewness, the Theil index, makes this intuition precise. It is the only measure of skewness that exhibits a stable decomposition from the skewness of global sales into the skewness of destination-level sales (see Jost, 2007). This leads to a prediction that the market-share weighted average of the destination Theil index, makes this intuition precise. It is the only measure of skewness that exhibits a stable decomposition from the skewness of global sales into the skewness of destination-level sales (see Jost, 2007). This decomposition property is similar, but not identical, to the within/between decomposition of Theil indices across populations. In the latter, the sample is split into subsamples. In our case, the same observation (in this case, product sales) is split into “destinations” and the global measure reflects the sum across “destinations.” See our companion paper for additional derivations.

This high correlation between destination and global skewness of product sales enables us to move from our previous predictions for the effects of the demand shocks on skewness at the destination level to a new prediction at the firm level. To do this, we aggregate our destination-industry measures of demand shocks to the firm level using the same weighing scheme by the firms’ export shares across destinations. We thus obtain our firm-level demand shock in (log) levels and first difference:

$$\text{log shock}_{i,t} = \sum_{d,I} x_{i,d} \times \text{log shock}_{i,d,t},$$

$$\Delta \text{shock}_{i,t} = \sum_{d,I} \frac{x_{i,d,1}}{x_{i,1}} \times \Delta \text{shock}_{i,d,t},$$

where $x_{i,d} = \sum_{d,I} x_{i,d,I}$ represents firm $i$’s total exports in year $t$. As was the case for the construction of our firm-level destination shock (see equation [1]), we only use the firm-level information on exported products and market shares in prior years (the year of first export sales $t_0$ for the demand shock in levels and lagged year $t-1$ for the first difference between $t$ and $t-1$). This ensures the exogeneity of our constructed firm-level demand shocks (exogenous to firm-level actions in year $t > t_0$ for levels, and exogenous to firm-level changes $\Delta_t$ for first differences). In particular, changes in the set of exported products or exported market shares are not reflected in the demand shock. This decomposition property is similar, but not identical, to the within/between decomposition of Theil indices across populations. In the latter, the sample is split into subsamples. In our case, the same observation (in this case, product sales) is split into “destinations” and the global measure reflects the sum across “destinations.” See our companion paper for additional derivations. From here on out, we focus exclusively on our trade shock constructed with the product-level export flows and drop the version constructed using the ISIC industry-level flows. Once we aggregate the destination trade shocks to the firm level, we have found that the explanatory power of this ISIC shock is greatly reduced (its explanatory power at the destination level was also always lower than the product-level trade shock version). In addition, the trade shock using the product-level trade is the only shock that exhibits variation across firms within a destination, a feature that we will use for some robustness checks later on. The first three columns of table 5...
report the regression of the firms’ global skewness (global Theil $T_{i,t}$) on this firm-level trade shock. We see that this trade shock has a very strong and significant (well beyond the 1% significance level) impact on the skewness of global exports.

Our global Theil measure $T_{i,t}$ measures the skewness of export sales across all destinations, but it does not entirely reflect the skewness of production levels across the firm’s product range. That is because we cannot measure the breakdown of product-level sales on the French domestic market. Ultimately, it is the distribution of labor allocation across products (and the induced distribution of production levels) that determines a firm’s labor productivity, conditional on its technology (the production functions for each individual product). As highlighted by our theoretical model, the export market demand shocks generate two different types of reallocations that both contribute to an increased skewness of production levels for the firm: reallocations within the set of exported products, which generate the increased skewness of global exports that we just discussed, but also reallocations from nonexported products toward the better-performing exported products (including the extensive margin of newly exported products that we documented at the destination level). Although we cannot measure the domestic product-level sales, we can measure a single statistic that reflects this reallocation from nonexported to exported goods: the firm’s export intensity. We can thus test whether the demand shocks also induce an increase in the firm’s export intensity. Those regressions are reported in the last three columns of Table 5 and confirm that our firm-level trade shock has a very strong and highly significant positive impact on a firm’s export intensity.28 Thus, our firm-level trade shock predicts the two types of reallocations toward better-performing products that we highlighted in our theoretical model (as a response to increased competition in export markets).

V. Trade Competition and Productivity

We just showed that our firm-level trade shock predicts increases in the skewness of global exports and increases in export intensity. Holding firm technology fixed (the productivity of each individual product), this increase in the skewness of global production will generate productivity increases for the firm as they reallocate their factors of production toward products with higher productivity. Empirically, product skewness is affected by many different types of shocks. In particular, technological changes to individual products will induce both skewness and productivity changes at the firm level that have nothing to do with the demand-side mechanism that is highlighted by our theoretical model. Thus, we do not test for a direct relationship between skewness and productivity. Instead, we test for a connection between the demand-driven trade shock and productivity at the firm level. We show that there is a strong and significant response of productivity to this demand shock and that the dynamics of this response closely mirror the dynamic response of skewness to the demand shock.

We obtain our measure of firm productivity by merging our firm-level trade data with firm-level production data. This latter data set contains various measures of firm outputs and inputs. As we are interested in picking up productivity fluctuations at a yearly frequency, we focus on labor productivity. We then separately control for the impact of changes in factor intensities and returns to scale (or variable utilization of labor) on labor productivity.

We compute labor productivity at the firm level as deflated value added per worker assuming a sector-specific price deflator $P_i$. Note that this measure aggregates to the overall deflated value-added per worker for manufacturing. This aggregate productivity measure accurately tracks a welfare-relevant quantity index even though we do not have access to firm-level prices. The effects of pure markup changes at the industry level are netted out of our productivity measure.29

More formally, we can write the welfare-relevant aggregate industry labor productivity—the ratio of industry deflated value-added ($VA_i/P_i$) over industry employment $L_i$—as the labor share weighted average of firm productivity using that same industry price deflator $P_i$ for firm revenue:

$$\Phi_i = \frac{VA_i/P_i}{L_i} = \sum_{i \in I} \frac{L_i}{L} \frac{VA_i/P_i}{L_i}. \quad (12)$$

28Since the export intensity is a ratio, we do not apply a log transformation to that variable. However, specifications using the log of export intensity yield very similar results.

29At the firm level, an increase in markups across all products will be picked up in our firm productivity measure even though this does not reflect a welfare-relevant increase in output. But if this is the case, then this firm’s labor share will decrease, and its productivity will carry a smaller weight in the aggregate index.
In other words, the revenue-based firm productivity measure \( \left( \frac{VA_i}{P^i} \right) / L_i \) aggregates up to a quantity-based industry measure, using the empirically observed firm labor shares \( L_i / L \) and without any need for a quantity-based output or productivity measure at the level of the firm (which would require measures of firm-product-level prices and qualities). This implicitly assumes the existence of an industry price aggregator \( P^i \), though its functional form is left completely unrestricted. Consequently, we run all of our specifications with sector-time (two-digit NACE) fixed effects, thus eliminating the need for any direct measures of those sector-level deflators. Our productivity results therefore capture within-sector effects of the demand shocks, over and above any contribution of the sector deflator to a common productivity change across firms. We will thus report a welfare-relevant aggregate productivity change by aggregating our firm-level productivity changes using the observed changes in labor shares.

Our firm-level trade shock only aggregates across export destinations. It therefore does not incorporate a firm’s exposure to demand shocks in its domestic (French) market. This is not possible for two reasons: most important, we do not observe the product-level breakdown of the firms’ sales in the French market (we only observe total domestic sales across products); in addition, world exports into France would not be exogenous to firm-level technology changes in France. Therefore, we need to adjust our trade shock using the firm’s export intensity to obtain an overall firm-level demand shock relevant for overall production and hence productivity: \( \log \text{shock\_intens}_{i,t} = \frac{x_{i,t}}{x_{i,t} + x_{i,F,t}} \times \log \text{shock}_{i,t} \), \( \Delta\text{shock\_intens}_{i,t} = \frac{x_{i,t-1}}{x_{i,t-1} + x_{i,F,t-1}} \times \Delta\text{shock}_{i,t} \), where \( x_{i,F,t} \) denotes firm \( i \)'s total (across products) sales to the French domestic market in year \( t \) (and the ratio thus measures firm \( i \)'s export intensity).\(^\text{30}\) Once again, we use only the prior year’s information on firm-level sales to construct this overall demand shock. Note that this adjustment using export intensity is equivalent to assuming a demand shock of 0 in the French market and including that market in our aggregation by market share relative to total firm sales \( x_{i,t} + x_{i,F,t} \).

A. Impact of the Trade Shock on Firm Productivity

In this section, we investigate the direct link between this firm-level demand shock and firm productivity. Our measure of productivity is the log of value-added per worker. All regressions include industry-year fixed effects, which will capture in particular different evolutions of price indexes across industries. In order to control for changes in capital intensity, we use the log of capital per worker. We also control for unobserved changes in labor utilization and returns to scale by using the log of raw materials (including energy use). Then, increases in worker effort or higher returns to scale will be reflected in the impact of raw materials used on labor productivity. As there is no issue with \( 0 \)s for all these firm-level variables, we directly measure the growth rate of those variables using simple first differences of the log levels.

We begin with a graphical representation of the strong positive relationship between firm-level productivity and our constructed demand shock. Figure 2 illustrates the correlation between those variables in first differences for the largest French exporters (representing 50% of French exports in 1996). Panel a is the unconditional scatter plot for those variables, while panel b shows the added-variable plot for the first-difference regression of productivity on the trade shock, with additional controls for capital intensity, raw materials (both in log first-differences), and time dummies. Those figures clearly highlight the very strong positive response of the large exporters’ productivity to changes in trade competition in export markets (captured by the demand shock).

Table 6 shows how this result generalizes to our full sample of firms and our three different specifications (FE, FD, FD-FE). Our theoretical model emphasizes how a multiproduct firm’s productivity responds to the demand shock via its effect on competition and product reallocations in the firm’s export markets. Thus, we assumed that the firm’s technology at the product level (the marginal cost \( v(m, c) \) for each product \( m \)) was exogenous (in particular, with respect to demand fluctuations in export markets). However, there is a substantial literature examining how this technology responds to export market conditions via various forms of innovation or investment choices made by the firm. We feel that the timing dimension of our first difference specifications, especially our FD-FE specifications, which net out any firm-level growth trends, eliminates this technology response channel. It is highly unlikely that a firm’s innovation or investment response to the trade shock in a given year (especially with respect to the trade shock’s deviation from trend growth in the FD-FE specification) would be reflected contemporaneously in the firm’s productivity. However, we will also show some additional robustness checks that address this potential technology response.

The first three columns of table 6 show that across our three timing specifications, there is a stable and very strong response of firm productivity to the trade shock. Since our measure of productivity as value added per worker incorporates neither the impact of changes in input intensities nor the effects of nonconstant returns to scale, we directly control for these effects in the next set of regressions. In the last three columns of table 6, we add controls for capital per worker and raw material use (including energy). Both of these controls are highly significant; not surprisingly, increases in capital intensity are reflected in labor productivity, and we find that increases in raw materials use are also associated with higher labor productivity. This would be the case if there are increasing returns to scale in the value-added production function or if labor utilization/effort increases with scale (in the short run). However, even when these controls...
Figure 2.—Exporters Representing 50% of French Trade in 1996: First Differences, 1996–2005

Table 6.—Baseline Results: Impact of Trade Shock on Firm Productivity

<table>
<thead>
<tr>
<th>Specification</th>
<th>log prod.</th>
<th>Δ log prod.</th>
<th>log prod.</th>
<th>Δ log prod.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FE</td>
<td>FD</td>
<td>FD-FE</td>
<td>FE</td>
</tr>
<tr>
<td>log trade shock_intens</td>
<td>0.061a</td>
<td>0.051a</td>
<td>0.106a</td>
<td>0.112a</td>
</tr>
<tr>
<td></td>
<td>(0.016)</td>
<td>(0.016)</td>
<td>(0.019)</td>
<td>(0.020)</td>
</tr>
<tr>
<td>Δ trade shock_intens</td>
<td></td>
<td>0.106a</td>
<td>0.106a</td>
<td>0.117a</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.019)</td>
<td>(0.023)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>log capital stock per worker</td>
<td></td>
<td></td>
<td>0.086a</td>
<td>0.125a</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.003)</td>
<td>(0.005)</td>
</tr>
<tr>
<td>Δ log capital stock per worker</td>
<td></td>
<td></td>
<td></td>
<td>0.092a</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.003)</td>
</tr>
<tr>
<td>log raw materials</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Δ log raw materials</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>213,001</td>
<td>185,688</td>
<td>185,688</td>
<td>203,977</td>
</tr>
</tbody>
</table>

FE refers to firm-level fixed effects. All regressions also include industry-year dummies. Standard errors (clustered at the firm level) in parentheses. a < 0.1, b < 0.05, and c < 0.01.

are added, the very strong effect of the trade shock on firm productivity remains highly significant well beyond the 1% significance level (from here on, we keep those controls in all of our firm-level productivity regressions).

Table 6 focuses on the contemporaneous response of productivity to the firm-level demand shock. In figure 3, we show the dynamic response of productivity by including two years of leads and lags for the demand shock (in a very similar way to our dynamic specification for the response of skewness to the demand shock at the firm-destination level). The contemporaneous coefficients along the vertical dotted line replicate the regressions from the last three columns of table 6, dropping the first and last two years of our sample. Figure 3 shows that there are no significant pretrends associated with the response of productivity to the demand shock. All of the response is contemporaneous and quickly returns to its baseline level the following year. This dynamic pattern closely mirrors the response of skewness (to the same trade shock), reinforcing the case for a connection from the latter to the former that we previously argued for.

As was the case with the response of skewness to the trade shock, the response of productivity to the trade shock at the firm level is significantly strengthened when those four years are dropped from our sample.
In our companion paper, we explore several robustness checks that further single out our theoretical mechanism operating through the demand-side product reallocations for multiproduct firms. We regress our capital intensity measure on our trade shock and show that there is no response of investment to the trade shock. This represents another way to show that the short-run timing for the demand shocks precludes a contemporaneous technology response: if this were the case, we would expect to see some of this response reflected in higher investment (along with other responses along the technology dimension).

Next, we use a different strategy to control for the effects of nonconstant returns to scale or variable labor utilization: we split our sample between year intervals where firms increase or decrease employment. If the effects of the trade shock on productivity were driven by scale effects or higher labor utilization or effort, then we would expect to see the productivity responses concentrated in the split of the sample where firms are expanding employment (and also expanding more generally). Yet we show that this is not the case: the effect of the trade shock on productivity is just as strong (even a bit stronger) in the subsample of years where firms are decreasing employment, and in both cases, the coefficients have a similar magnitude to our baseline results.

In order to further single-out our theoretical mechanism operating through the demand-side product reallocations for multiproduct firms, we also show that the link between productivity and the trade shocks is only operative for multiproduct firms. We run a similar regression (with controls) to our baseline results from table 6, but only for single-product exporters. There is no evidence of this link among this subset of firms. Finally, we now show that this productivity-trade link is only operative for firms with a substantial exposure to export markets (measured by export intensity). Similar to single-product firms, we would not expect to find a significant productivity-trade link among firms with very low export intensity. This is indeed the case. In table 7, we re-run our baseline specification using the trade shock before it is interacted with export intensity. The first three columns report the results for the quartile of firms with the lowest export intensity and highlight that there is no evidence of the productivity-trade link for those firms. On the other hand, we clearly see from the last three columns that this effect is very strong and powerful for the quartile of firms with the highest export intensity.32

The firms with high export intensity therefore have a response of productivity to trade shocks estimated around 10% (columns 5 and 6 of table 7). How should we interpret this number in terms of the impact of our mechanism on the productivity of the French economy as a whole? In our companion paper, we show how we can use this 10% coefficient to compute a counterfactual contribution of the trade shocks to physical labor productivity at the industry and overall manufacturing levels, aggregating over those firms with the highest export intensity using equation (12). This aggregation uses the firms’ observed labor shares, which magnifies the contribution of firms with growing labor shares and, conversely, reduces the contribution for those with shrinking labor shares.33 The contribution of each sector is reported in our...
companion paper, along with the contribution to aggregate French manufacturing. This contribution is substantial, accounting for a 1.2% average productivity growth rate for the entire French manufacturing sector (working only through the productivity linkages for the firms with the highest export intensities; by construction, the contribution of all firms in the lowest three quartiles of export intensity are set to 0). This amounts to a 12% productivity gain over our ten-year sample period from 1995 to 2005.

VI. Conclusion

This paper uses detailed firm-level data to assess the relevance and magnitude of demand shocks in export markets for product reallocations within firms and ultimately for multiproduct firm productivity. We find that the impact of those shocks on both reallocations (French firms skew their market shares toward better performing products) and productivity is substantial. We show that this evidence on reallocations provides a new test and validation for endogenous price elasticities that satisfy Marshall’s second law of demand (price and quantity responses within firms, we can control for many alternative explanations that might be correlated with foreign demand shocks, a strategy that would not be possible when evaluating the effects across firms. Our baseline results show that the elasticity of labor productivity to trade shocks is between 5% and 11%. This order of magnitude is very robust to controls for short-run investment by the firm, scale effects, and possibly correlated import shocks. Our measured productivity effect for single-product firms is nil, further highlighting the importance of changes in product mix for multiproduct firms. We also show that this productivity response is concentrated within the quartile of exporters with the highest export intensities. Taking into account the weight of those firms in the whole economy, we calculate that the average annual increase in French manufacturing productivity, in response to growth in world trade, over our ten-year sample (from 1995 to 2005) is slightly over 1% per year.

REFERENCES


TABLE 7.—ROBUSTNESS: LOW/HIGH EXPORT INTENSITY

<table>
<thead>
<tr>
<th>Sample</th>
<th>exp. intens. quartile # 1</th>
<th>exp. intens. quartile # 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specification</td>
<td>log prod.</td>
<td>Δ log prod.</td>
</tr>
<tr>
<td>log trade shock</td>
<td>0.003</td>
<td>(0.006)</td>
</tr>
<tr>
<td>log capital stock per worker</td>
<td>0.117a</td>
<td>(0.009)</td>
</tr>
<tr>
<td>log raw materials</td>
<td>0.070a</td>
<td>(0.005)</td>
</tr>
<tr>
<td>Δ trade shock</td>
<td>0.004</td>
<td>(0.008)</td>
</tr>
<tr>
<td>Δ log capital stock per worker</td>
<td>0.125a</td>
<td>(0.011)</td>
</tr>
<tr>
<td>Δ log raw materials</td>
<td>0.084a</td>
<td>(0.006)</td>
</tr>
<tr>
<td>Δ log prod.</td>
<td>0.092a</td>
<td>(0.014)</td>
</tr>
<tr>
<td>Δ log prod.</td>
<td>0.107a</td>
<td>(0.008)</td>
</tr>
<tr>
<td>Δ log prod.</td>
<td>0.108a</td>
<td>(0.006)</td>
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<tr>
<td>Δ log prod.</td>
<td>57.267</td>
<td>48.716</td>
</tr>
<tr>
<td>Observations</td>
<td>38,806</td>
<td>30,909</td>
</tr>
</tbody>
</table>

Standard errors (clustered at the firm level) in parentheses: a 0.01, b 0.05, and c 0.001.