

2. Global setting and outlook

Swift policy responses to contain the US and Swiss banking sector problems, and a successful resolution of the US debt ceiling brinkmanship, both contributed to reducing the immediate threats to global financial stability. However, risks to global growth remain tilted to the downside, as major central banks continued to signal a “high for longer” policy rate outlook in view of the sticky core inflation. A sustained period of restrictive global monetary policy could weigh on the global economy, sow the seeds to financial market volatility in case of inflation surprises, and expose vulnerabilities built up during earlier periods of accommodative monetary policy.

In emerging Asia, economic growth continued to be dragged by lacklustre external demand. Headline inflation moderated significantly along with lower food and energy prices, but core inflation remained firm in some economies. This, together with the major AEs’ “high for longer” interest rate outlooks, suggests that regional interest rates may also end up being “high for longer” and increase the debt service burden on indebted sectors.

In Mainland China, while the economy saw faster year-on-year growth in the first half of the year, its sequential recovery momentum moderated during the second quarter alongside fragile private-sector confidence, renewed weakness in the property market and a slowdown in exports. Looking ahead, economic recovery is expected to continue, but the economy is still facing headwinds from the challenging external environment and soft domestic demand. The authorities introduced counter-cyclical policy adjustments including cuts in interest rates and the required reserve ratio and pledged to invigorate the capital market, boost consumption and push forward the development of the private economy to support confidence.

2.1 External environment

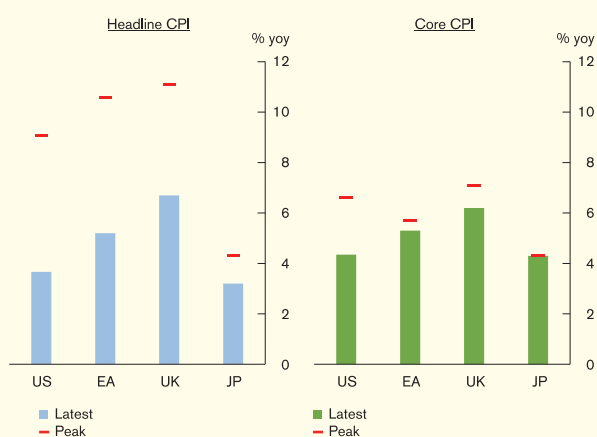
During the review period, two immediate threats to global financial stability, namely, the banking sector problems in the US and Switzerland and a potential US sovereign default amid another debt ceiling brinkmanship, were successfully averted by swift policy responses and by last-minute compromises in the US Congress respectively.

However, downside risks to global growth persist. Even though global headline inflation has eased, thanks to lower commodity prices and normalising supply chains, the fight against inflation continued as core inflation remained sticky on the back of tight labour markets (Chart 2.1). Against this background, major central banks generally signalled that “high for longer” interest rates were likely necessary to

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achieve a timely return of inflation to target, which would likely weigh on global growth. In July, the International Monetary Fund projected a slowdown in global growth from 3.5% in 2022 to 3.0% in 2023, partly reflecting the impact of the cumulated interest rate hikes.

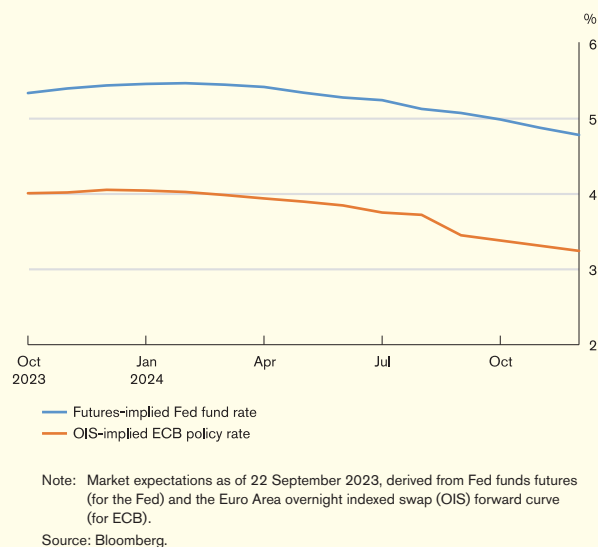
Chart 2.1
Headline and core consumer price index (CPI) inflation in selected major advanced economies



Note: EA = Euro area, JP = Japan. Latest data as of August 2023.
Source: CEIC.

Going forward, the “last mile” of disinflation in major advanced economies could prove tricky. If the cumulated monetary tightening is unable to cool down wage growth and its pass-through to services inflation in a timely manner, core inflation could be stickier than expected. In this scenario, central banks may not have much leeway to adjust monetary policy even if growth slows markedly later on. Given that financial markets have already priced in rate cuts starting next year (Chart 2.2), upside surprises to inflation may trigger a repricing of risky assets and a spike in market volatility.

Chart 2.2
Market expectations of policy rate paths of the US Federal Reserve (Fed) and the European Central Bank (ECB)

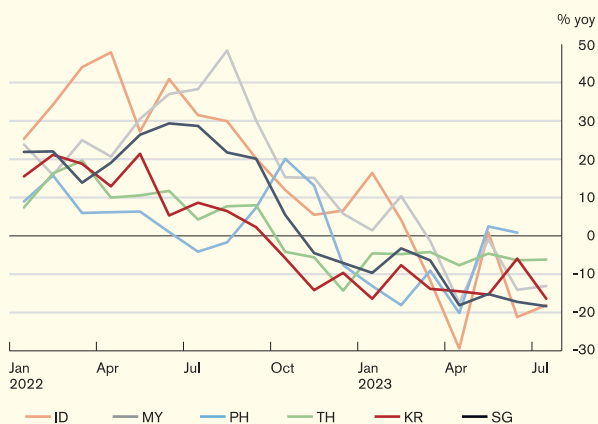


In addition, there is a risk that the high interest rate environment could expose hidden vulnerabilities in the financial system that were accumulated during the earlier low interest rate environment. As a case in point, the US commercial real estate (CRE) sector has been under pressure in the midst of rising interest rates and post-pandemic structural changes (e.g. shift towards hybrid working), leading to rising delinquency rates in commercial mortgage-backed securities since early 2023. Given small US banks' high degree of exposure to CRE loans, a sharper-than-expected CRE downturn may lead to stress in some US banks.

The growth of most emerging Asian economies softened in the first half of 2023 amid weak external demand, with regional exporters of electrical machinery, consumer electronics and semiconductors being the hardest hit (Chart 2.3). On services trade, the release of pent-up demand for tourism services in Mainland China rendered support to the region's services exports (Chart 2.4). This positive impact would be felt increasingly by more economies alongside the improvement in the international flight capacity of Mainland China.

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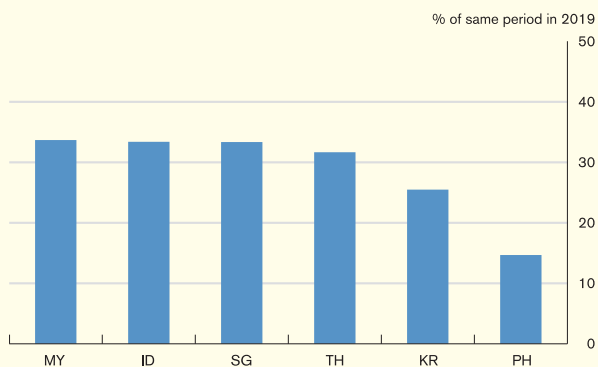
Chart 2.3
Emerging Asia: Goods exports



Note: Latest observation is Jun 2023 for the Philippines, Jul 2023 for the other economies.

Source: CEIC.

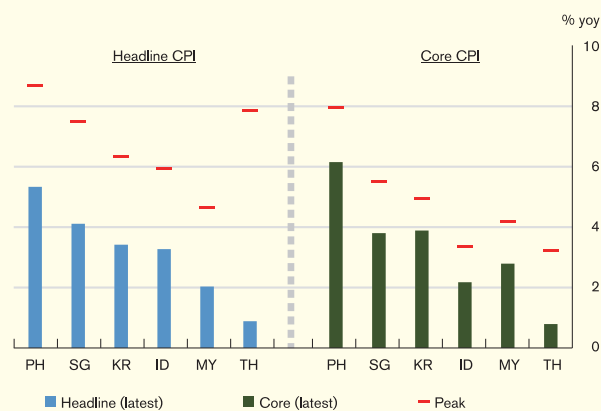
Chart 2.4
Visitor arrivals from Mainland China



Note: For Malaysia, the period refers to Feb-May 2023; for the other economies, the period refers to Feb-Jul 2023.

Sources: CEIC and staff calculations.

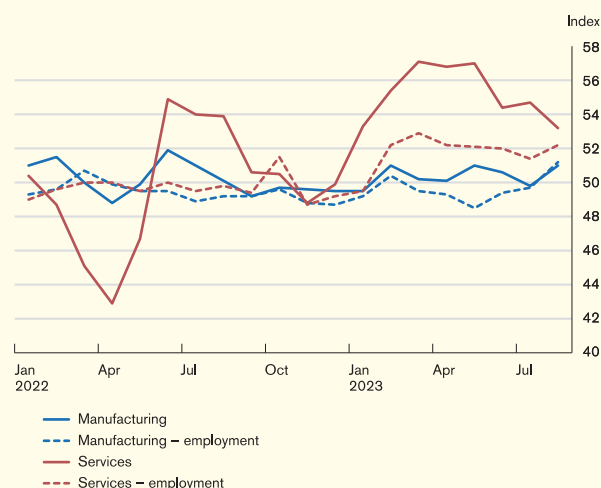
Chart 2.5
Emerging Asia: Headline and core Consumer Price Index (CPI) inflation



Note: Latest observation is Jul 2023 for Malaysia and Singapore, Aug 2023 for the other economies. Peak refers to the highest level of headline/core inflation since Jan 2022.

Sources: CEIC and HKMA staff calculations.

Chart 2.6
Asia: Manufacturing and services Purchasing Managers' Index (PMI)



Source: CEIC.

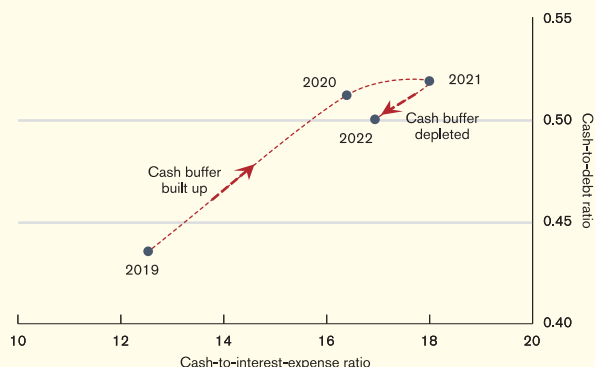
The headline CPI inflation of regional economies eased in the first half of 2023 alongside lower global food and energy prices. However, core inflationary pressures remained firm in some regional economies amid the still-elevated service inflation (Chart 2.5). Given that both the service Purchasing Managers' Index (PMI) and its employment sub-index remained high, service inflation may persist in the near term (Chart 2.6).

Looking ahead, to curb the still-elevated core inflationary pressures and maintain the interest rate differentials vis-à-vis the US to reduce foreign exchange pressures, regional central banks may need to keep interest rates “high for longer”. However, there is a risk that high interest rates could stabilise inflation at the cost of raising the debt-servicing burden, triggering a further correction in the housing price and dampening growth. As the debt levels in the region have increased in recent years, the “high for longer” interest rates may pose loan repayment and

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refinancing challenges down the road. Such development warrants close monitoring especially given signs that the cash buffer of regional corporates has eroded somewhat due to tightening monetary conditions and subdued earnings growth (Chart 2.7).

Chart 2.7
Asia Pacific: Corporate cash buffers



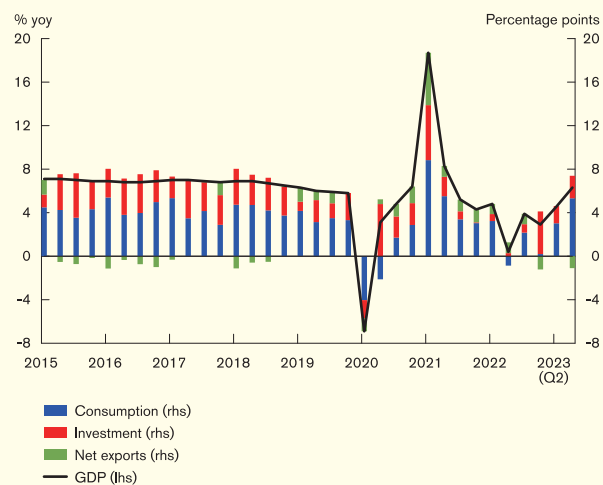
2.2 Mainland China

Economic performance and policy responses

Mainland China's year-on-year real GDP growth recovered to 4.5% in the first quarter and 6.3% in the second quarter due to the post-COVID reopening and a favourable base effect (Chart 2.8). However, the economic recovery was uneven, with the services sector generally outperforming the goods sector. Sequentially, the pace of recovery moderated during the second quarter reflecting fragile private sector confidence, renewed weakness in the property market and a slowdown in exports.¹ Altogether, the Mainland economy grew by 5.5% year on year in the first half of 2023, slightly above the official target of around 5% set for the whole year.

¹ On a quarter-on-quarter basis with seasonal adjustments, real GDP growth slowed from 2.2% in the first quarter to 0.8% in the second quarter.

Chart 2.8
Mainland China: Contribution to GDP growth by demand component



In the period ahead, Mainland's economic recovery is expected to continue but the economy is still facing headwinds from the challenging external environment and soft domestic demand. On the external front, exports may stay sluggish amid faltering external demand and ongoing worries about geo-economic fragmentation, even though exports of certain items, such as automobiles and new-energy products, showed some strength (Box 1 discusses how Mainland China can maintain export competitiveness in more sophisticated goods as the economy moved up the value chain alongside its expanding domestic market). Domestically, the property market is likely to remain soft, as it may take time for homebuyers' confidence to return. According to the latest consensus forecasts, the Mainland economy is expected to grow by 5.0% in 2023.

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After a slight pickup at the beginning of the year following the economic reopening, headline consumer price index inflation edged down to around zero in recent months as goods inflation declined amid decreased pork and energy price pressures, and services inflation also stayed moderate.²

In light of recent headwinds facing the economy, the Mainland authorities reduced interest rates and the required reserve ratio (RRR)³, boosted domestic consumption of electric vehicles, and emphasised the need to boost consumption of durable goods such as automobiles and electronics as well as services such as recreation and tourism. To strengthen business confidence, the authorities pushed forward the development and growth of the private economy through a series of measures⁴ and announced measures to

invigorate the capital market and shore up investors' confidence⁵.

Asset and credit markets

Despite a small rebound in the first quarter due to pent-up demand, Mainland property market conditions weakened in the second quarter along with impaired homebuyers' confidence and the stalled economic recovery. Housing prices softened in all tiers of cities recently (Chart 2.9), while residential floor space sold, real estate investment and government land sales revenue saw deepened declines (Chart 2.10). Amid decreased revenues from land sales, some pressure on local government financing vehicles (LGFVs) emerged⁶, raising concerns about their second-round effects on the real economy.

² This, combined with the weak consumer confidence lately, has raised concerns that Mainland China may enter a deflationary downward spiral. However, given that (i) the slowing inflation may be attributed to temporary factors such as seasonality and drops in certain food and energy prices, which are not expected to persist in the long term; (ii) the economy continues to grow and monetary supply is expanding, two key features that do not support a deflationary environment, the foundation of persistent deflation does not appear to exist in Mainland China.

³ The PBoC cut both the seven-day reverse repo rate and the Standing Lending Facility rates by 10 basis points each on 13 June and 15 August, and lowered the one-year Medium-term Lending Facility rate to 2.65% on 15 June and further to 2.50% on 15 August. The one-year and five-year Loan Prime Rates (LPRs) were also reduced to 3.55% and 4.2% respectively on 20 June to support economic recovery. On 21 August, the one-year LPR was reduced by 10 basis points to 3.45%, while the five-year LPR remained unchanged. On 14 September, the PBoC announced a second cut this year in the RRR for financial institutions by 25 basis points, effective from 15 September.

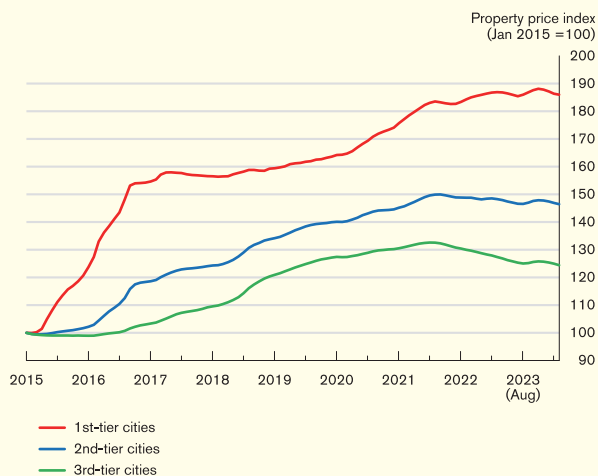
⁴ See the State Council's recent "guideline on boosting the growth of the private economy", which included 31 measures on removing barriers in market access, fully implementing policies and mechanisms for fair competition, protecting legal rights of private business and entrepreneurs, and facilitating their financing via share listings, bond sales and overseas expansion. In addition, the National Development and Reform Commission along with other seven departments released a document with 28 measures including (i) encouraging the participation of POEs in identified industries and key projects; (ii) extending a package of tax-relief measures; and (iii) expanding debt financing tools to all eligible POEs.

⁵ The Ministry of Finance and the State Taxation Administration cut stamp duty on stock trades by half on 27 August. Meanwhile, the China Securities Regulatory Commission also announced three measures to stabilise the stock market, including tightening the launch of IPOs and refinancing, restricting major shareholders' reductions of shareholdings, and lowering the margin requirements for financing.

⁶ In particular, the LGFV bond yield spread over policy bank bonds picked up recently in some provinces such as Yunnan and Guizhou. Regarding policies, the Central Government continued to emphasise controlling incremental debt, resolving existing debt (e.g. debt swapping), strengthening the governance of financing platforms and facilitating their transformation (through commercialising), while the local governments indicate stronger efforts to resolve the debt problem, including lowering interest rate burden, loan extension or restructuring and consolidation of financing vehicles. At the July meeting, the Politburo pledged to roll out a comprehensive local government debt resolution plan.

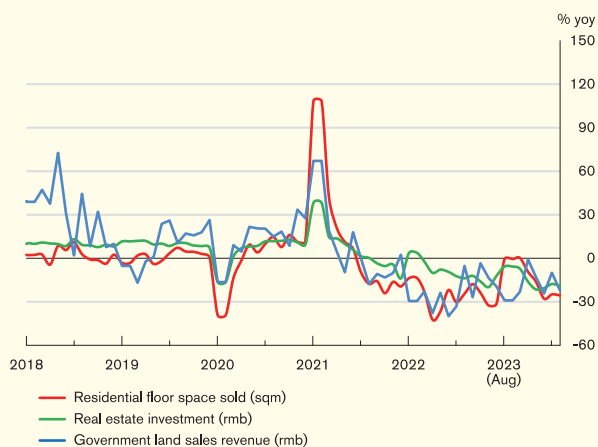
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Chart 2.9
Mainland China: Residential property prices by tier of cities



Sources: CEIC and HKMA staff estimates.

Chart 2.10
Mainland China: Residential property market activities



Sources: CEIC and HKMA staff estimates.

In response to the sluggish property market, the authorities implemented a range of policies to secure delivery of presold homes, support the demand for first-time purchases and upgrades, and shore up market confidence. Such policies include the establishment of relending facilities to ensure home delivery⁷, the extension of two

measures⁸ from the “16 measures” released in last November and a tax rebate scheme introduced in last October⁹, cuts in the interest rates for both new and existing mortgages as well as reductions in the minimum down payment ratios for both first- and second-home purchases¹⁰. The Politburo also pledged at the July meeting to adapt to the new demand and supply conditions of the property market and adjust or optimise property policies in a timely manner. At the city level, local authorities continued to lift restrictions on both home purchases and sales, recognised homebuyers who have repaid their mortgages as first-time buyers, and introduced pilot schemes for selling ready-for-occupancy homes to boost homebuyers’ confidence¹¹. To help build a new development mode for the real estate sector in the long run, the authorities also rolled out policies aimed at broadening the direct funding channels for developers¹².

⁸ On 10 July, the PBoC and the National Financial Regulatory Administration (NFRA) jointly announced to extend the expiration date of the two measures to end-2024, essentially facilitating (i) the extension of developers’ outstanding loans and (ii) the conditional exemption of lenders’ liabilities in extending special loans to support the completion of pre-sold houses with delivery delay. The remaining “16 measures” without expiration date were announced to be long-term effective.

⁹ On 25 August, the Ministry of Finance, the State Administration of Taxation, and the Ministry of Housing and Urban-Rural Development jointly announced the extension of a tax refund programme for residents who sell their homes and buy another within a year.

¹⁰ For new mortgages, the five-year LPR (i.e. the benchmark rate for new mortgages) was lowered by 10 basis points on 20 June. Regarding existing mortgages, the PBoC and the NFRA announced on 31 August the cuts of existing mortgage rates, effective from 25 September. The minimum down payment ratios for first- and second-home purchases were lowered nationwide to 20% and 30%, respectively.

¹¹ Recently, Shenzhen and Beijing have imposed ready-for-occupancy conditions for land transfer transactions.

¹² In February, the authorities announced a pilot programme to allow qualified private equity funds and foreign investors to invest in commercial properties, residential units and infrastructure projects.

⁷ In January, two relending facilities were established by the PBoC to (i) back the mergers and acquisitions activities by asset management companies with stalled projects and (ii) support the purchase of existing apartments for rental housing in eight pilot cities.

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The overall risk in the Mainland banking sector remained manageable. The non-performing loan (NPL) ratios of state-owned banks further declined to 1.29% in June 2023 from 1.31% six months earlier. Moreover, the provision coverage ratio of large Mainland banks improved to 250% in June 2023 from 245% in December 2022, well above the regulatory requirement. That said, the non-performing loan ratio of some smaller banks, such as rural commercial banks, increased slightly, but remained at a manageable level (Table 2.A).

Table 2.A
Mainland China: non-performing loan (NPL) ratio by bank type

NPL ratio (%)	Jun 2022	Dec 2022	Jun 2023
State-owned commercial banks	1.34	1.31	1.29
Joint-stock commercial banks	1.35	1.32	1.29
City commercial banks	1.89	1.85	1.90
Rural commercial banks	3.30	3.22	3.25

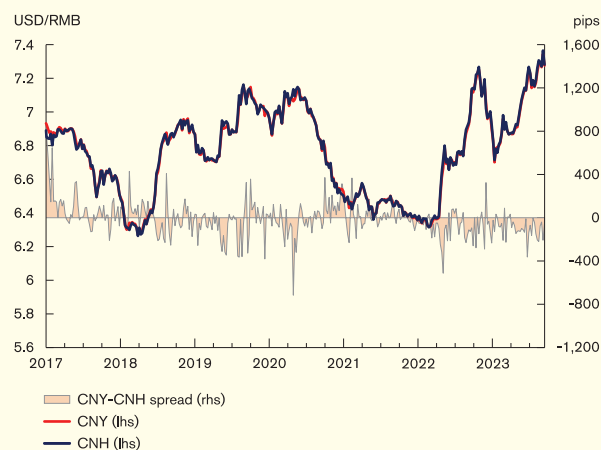
Source: CEIC.

Exchange rate

Amid concerns about the weaker-than-expected domestic economic recovery and widened interest rate differentials vis-a-vis the US, the onshore RMB (CNY) generally depreciated against the USD during the review period with its offshore counterpart (CNH) generally trading lower during the same period (Chart 2.11). With renewed depreciation pressure, the PBoC announced to lower the foreign exchange RRR by 2 percentage points to 4%, effective from 15 September. On 1 August, the PBoC and the State Administration of Foreign Exchange (SAFE) pledged to strengthen the dual management of “macro-prudential and micro-supervision” in the foreign exchange market to ensure RMB exchange rate stability during the work conference for the second half of 2023. The central bank also reiterated that it will firmly prevent large fluctuations in the RMB exchange rate and correct the pro-cyclical, one-sided market actions when necessary. In addition, the PBoC and the SAFE raised the cross-border macro-prudential adjustment ratio for corporates

and financial institutions to 1.5 from 1.25 on 20 July, making it easier for domestic companies to raise USD funds from overseas.

Chart 2.11
Mainland China: Onshore and offshore RMB exchange rates against the USD



Sources: Bloomberg and HKMA staff estimates.

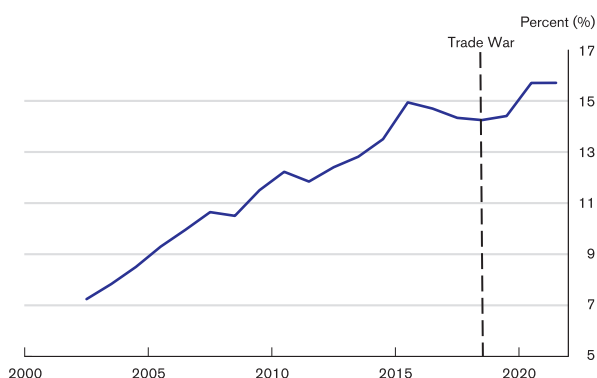
Box 1

Does Mainland China's competitiveness in exports benefit from its large domestic market?

Introduction

Since joining the World Trade Organization (WTO), Mainland China has grown to become the world's leading manufacturer, with its share in global merchandise exports rising to more than 15% by the end of 2021 (Chart B1.1). Amid headwinds from dwindling global demand, relocation of supply chains and prolonged trade tensions between China and the US, Mainland's exports saw notable declines in recent months, which raised some questions on whether Mainland China can remain as a global export hub over the longer term.

Chart B1.1
Mainland China's share in global exports since accession to World Trade Organization (WTO)



Note: Shares are calculated in terms of value for each year.

Sources: Base Analytique du Commerce International (BACI) and HKMA staff estimates.

There is a view that the large and still expanding Mainland domestic market may help Mainland manufacturers achieve economies of scale, thereby maintaining a competitive edge in exports. This argument resonates with the idea of “home-market effect” in international trade

literature¹³. In this box, we examine ways in which an economy's export competitiveness, at both aggregate and product level, is related to the size of its domestic market. We then discuss how Mainland China's export success over the past two decades, especially in more sophisticated goods, can be connected with international experiences.

What do cross-country regressions tell us about the home-market effect on export competitiveness?

We adopt a simple and intuitive measure of export competitiveness: a country's share of total global exports in a given year. It operates at two levels: the aggregate level $Share_{c,t}$, and the product level $Share_{c,p,t}$. The size of a country's domestic market $Market Size_{c,t}$ is measured by the country's domestic absorption or the two key components of GDP, income per capita and population, all in real (purchasing power parity) terms. Additionally, we are interested in whether the relationship between export competitiveness and market size varies across products of different levels of complexity, $PCI_{p,t}$ (see footnote 14 below for explanation).

¹³ The large literature on the home-market effect dates back to the influential work of Linder (1961) and Krugman (1980), who hypothesised and formalised the idea that strong domestic demand for certain goods can stimulate exports of those goods. More recent studies, such as Fajgelbaum, Grossman, and Helpman (2011), Fieler (2011) and Matsuyama (2015), focus on how growth of income per capita could generate the changes in patterns of trade and specialisation between countries under non-homothetic consumer preference.

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Specifically, we estimate the following two equations to examine the empirical relationship at the aggregate and the product level separately:

$$Share_{c,t} = \alpha + \beta Market Size_{c,t} + \delta_c + \lambda_t + \varepsilon_{c,t} \quad (1)$$

$$Share_{c,p,t} = \alpha + \beta_1 Market Size_{c,t} + \beta_2 PCI_{p,t} + \beta_3 Market Size_{c,t} \times PCI_{p,t} + \delta_c + \xi_p + \lambda_t + \varepsilon_{c,p,t} \quad (2)$$

We control for country and year fixed effects (FE), which capture time-invariant unobserved country characteristics and time-varying shocks common to all countries, respectively. Product fixed effects are also added in the second equation to control for unobserved product characteristics that might influence the results¹⁴.

Table B1.1
Export performance and size of domestic market:
country and product level evidence

Dependent variable	Share _{c,t}		Share _{c,p,t}	
	(1)	(2)	(3)	(4)
Market Size	0.326*** (0.031)		0.334*** (0.011)	
Income		0.330*** (0.031)		0.334*** (0.011)
Population		0.378*** (0.080)		0.260*** (0.027)
PCI			-1.092*** (0.022)	-2.117*** (0.022)
Market Size x PCI			0.091*** (0.001)	
Income x PCI				0.216*** (0.002)
Population x PCI				0.032*** (0.001)
Year FE	Yes	Yes	Yes	Yes
Country FE	Yes	Yes	Yes	Yes
Product FE	N/A	N/A	Yes	Yes
R-squared	0.97	0.97	0.31	0.32
Observations	2,214	2,214	2,186,727	2,186,727

Note: The sample period is 2002 to 2019. Shares are in % terms. PCI ranges from -3 to 3. All other variables are in log terms. Standard errors in parentheses.
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Regression results of equation (1) are reported in columns (1) and (2) of Table B1.1. Not surprisingly, countries with greater domestic expenditure, higher income per capita and larger population size tend to acquire greater shares in global exports. The coefficients (β) suggest that a 100% increase in any of these three variables is associated with an increase of 0.3–0.4 percentage points in a country's share in global exports.

Columns (3) and (4) report the regression results of equation (2). While the positive correlation between export shares and market sizes holds strongly at the product level, the positive coefficient on the interaction term (β_3) in column (3) suggests that the impact of market size on export share is larger for products with higher PCI, i.e., the more sophisticated goods. Moreover, coefficients in column (4) indicate that it is mainly the income component of market size that drives the latter relationship, though population also plays a positive albeit much smaller role. In other words, it is higher income per capita, rather than bigger population

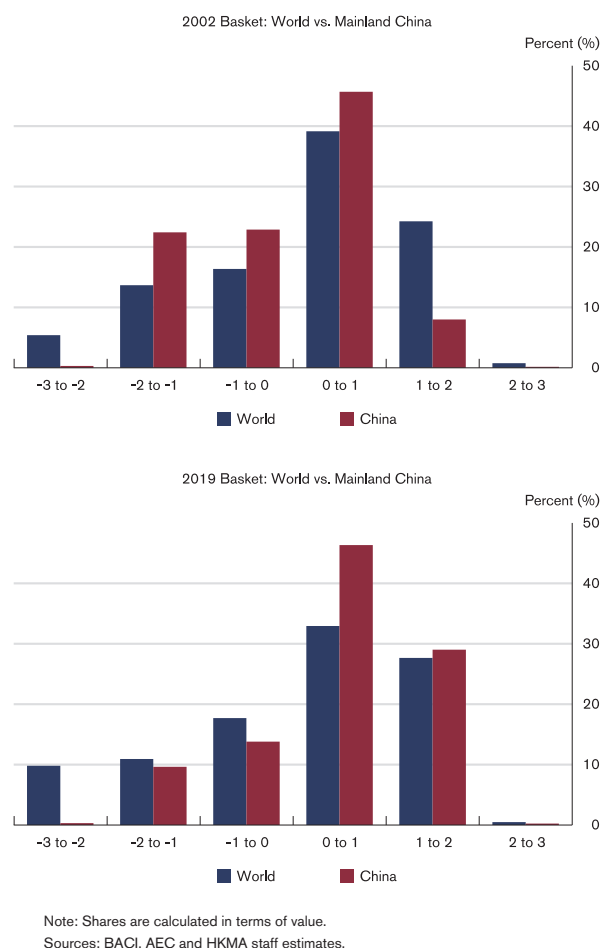
¹⁴ Exports shares are constructed using the BCAI dataset, which provides data on bilateral trade flows for over 200 countries and 5000 products at the Harmonized System six-digit (HS6) level. The dataset has an annual frequency and we consider trade data since 2002, the year following Mainland China's accession to the WTO. Data on market size-related variables are sourced from Penn World Table (PWT) 10.0. Product Complexity Index (PCI) measures the sophistication of know-how required to produce each HS4 product, which is taken from Atlas of Economic Complexity (AEC) database constructed by Harvard's Growth Lab. Countries with population less than one million or the average annual trade volume less than US\$1 billion, or countries that do not exist in any of our three main data sources, are excluded from our sample. The consolidated dataset is a panel comprising of 123 countries and 1,234 products over the period of 2002–2019.

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size, that dictates the export shares of more complex products.

To illustrate the importance of owning a larger export share in sophisticated products and how it can benefit Mainland China, in Chart B1.2 we divide the export baskets of the world and Mainland China respectively into six bins by product complexity (measured by PCI), and compare their distribution of value shares in 2002 versus 2019. In both years, the more sophisticated products (with $PCI > 0$) make up for a larger share of global trade in terms of value, implying that all else equal, countries that specialise in exporting higher PCI products can increase their shares of the pie in global trade. Relative to the world distribution, Mainland China's export basket was clearly restructured towards the higher complexity segments (i.e. PCI in between 1 to 2) over this period, which contributes to the increase in its global export share through raising its share in higher-valued products.

Chart B1.2
Distribution of products by Product Complexity Index (PCI) in Mainland China and world export basket: 2002 vs 2019



Connecting Mainland China's experiences with cross-country evidence

A major empirical challenge facing our cross-country analysis is that a country's measured market size may depend on not just its domestic demand conditions, but also the supply-side factors such as the size of labour force and productivity. Therefore, it is arguable that the positive link between the export performance and market sizes cannot be simply interpreted as a home-market effect. However, exogenous

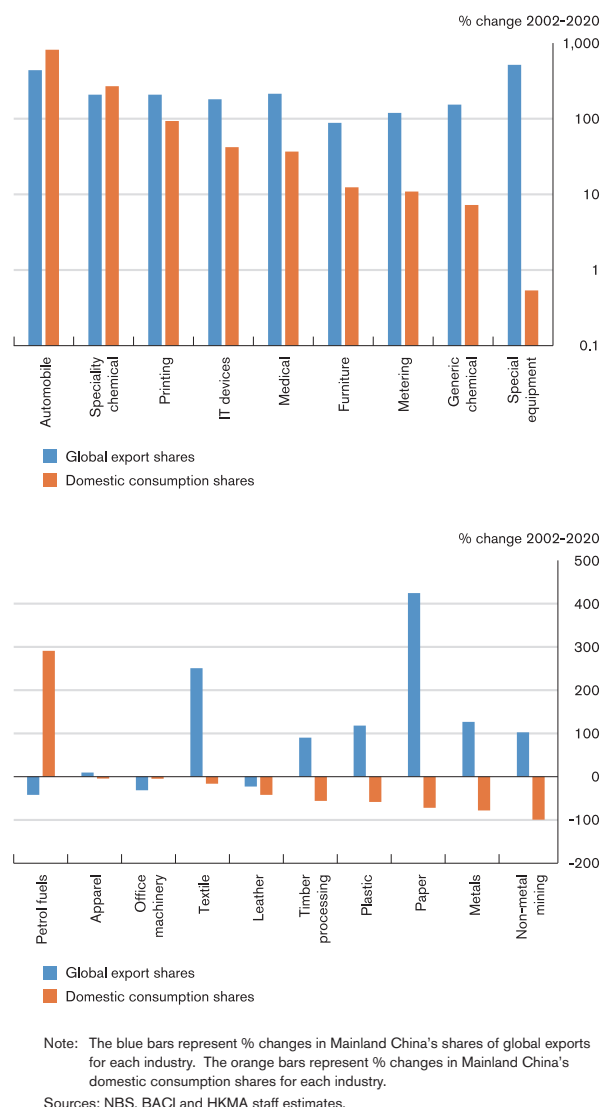
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shifters that can be used to distinguish demand and supply-side drivers of home market sizes are rarely observable in practice, especially at the country level¹⁵.

To investigate the potential role that the domestic market forces may have played in shaping Mainland's export patterns, we delve further into industry-level data on domestic consumption expenditure sourced from the National Bureau of Statistics (NBS) Input-Output tables and match the industry classification to our trade data using a concordance provided by Brandt et al. (2017).

In Chart B1.3, we plot for each industry the change in domestic consumption shares against the change in global export shares over the period of 2012 to 2020. First, domestic expenditure shares of sophisticated industries (top chart) such as automobiles, specialty chemicals and IT devices tend to rise over time, while those of more basic industries (bottom chart) such as shoes and clothing tend to see declines. Second, for the sophisticated industries, their growth in export shares was often accompanied by expansions in domestic consumption shares, while there is no obvious correlation between the two among basic industries.

Chart B1.3
Long-run changes in domestic consumption shares and global export shares: “sophisticated” vs “basic” industries



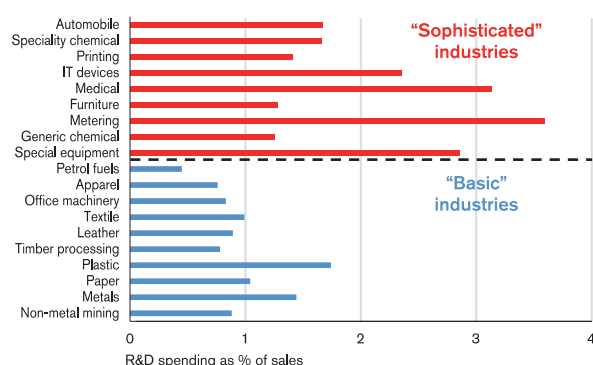
As a natural consequence of the rising income level, the accompanied shift in Mainland's demand structure towards higher-end goods may have in turn induced a “home-market” effect on its exports: the fast-expanding domestic markets for sophisticated goods attract more competition and research and development (R&D) investments (Chart B1.4) into those sectors, bringing higher productivity growth and lower costs of production, which ultimately leads to greater competitiveness in exports of those goods. In comparison, exports of the basic goods

¹⁵ Recent studies have attempted to construct exogenous demand shifters to identify the causal impact of local demand on exports. For example, Costinot et al. (2019) developed a simple test of the home-market effect using detailed drug sales data from the global pharmaceutical industry based on cross-country variation in demographic characteristics.

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sectors would rely more on external demand as their domestic markets shrink on a relative basis, resulting in a lower correlation between exports and domestic expenditure.

Chart B1.4
R&D spending: “sophisticated” vs “basic” industries



Source: NBS.

Conclusion

Our cross-country analysis indicates a positive correlation between a country's share of global exports and its home market size. Once we look beneath the aggregate level, our analysis points to the crucial role of income growth in explaining Mainland China's success in exports, especially of more sophisticated goods over the past two decades. In particular, the substantial increase in the income level has shifted domestic demand in Mainland China towards more sophisticated goods, which in turn leads to higher R&D and productivity growth in those industries and hence greater competitiveness in exports. In this sense, Mainland China will likely be able to remain as an export hub in the longer term by sustaining its export competitiveness in sophisticated products, as its domestic market for those products continues to expand along with a rising income level.

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