

Poor Substitutes? Counterfactual methods in IO and Trade Compared

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Monopolistic competition with constant-elasticity-of-substitution preferences (CES-MC), is a widely-used tool in many fields of economics. A major reason for this success in International Trade and Macro is that it yields predictions that are simple to interpret, easy to implement, and particularly well-suited for counterfactual analysis of policy changes with minimal data requirements. Industrial Organization economists however view CES-MC as irredeemably unrealistic both on the demand and supply sides. They overwhelmingly prefer random coefficients demand structures that feature rich substitution patterns, combined with multiproduct oligopoly. The lack of account for oligopolistic markups and cannibalization effects in CES-MC can be corrected while maintaining most of the tractability advantages for estimation and counterfactual analysis, a framework we label CES-Oly. We present simulation-based evidence that even if the IO models are the true data generating process, CES-Oly and even CES-MC can be used with remarkable accuracy as an approximation to conduct counterfactuals for aggregations over multiple varieties, even when allowing for realistic amounts of consumer preference heterogeneity and market power.