

# **Product Dynamics and Aggregate Shocks: Evidence from Japanese Product and Firm Level Data<sup>1</sup>**

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## ABSTRACT

We examine the effects of shocks to real exchange rates, foreign demand, government expenditures and total factor productivity on product dynamics and GDP growth. We first construct unique firm level data on products and exports from the Japanese *Census of Manufactures* in the period from 1999 to 2009. The data are more disaggregated than comparable U.S. data and available at an annual frequency (while U.S. product level data are only available at five year intervals), which makes our data more suited to examining the interaction between the business cycle and firm-product dynamics. Using this dataset, we are able to observe the change in the composition of products at the firm level in Japan. Our unique data set shows how product adding and dropping behavior in incumbent firms affects fluctuations in the aggregate shipments more than firm entry and exit. When we divide our dataset into exporters and non-exporters, we find that exporters produce more products than non-exporters. In addition, the product switching behavior of exporters is more dynamic than non-exporters.

Following the Dekle, Jeong, and Kiyotaki model, we regress the change in the number of products on the several aggregate variables such as foreign demand, government expenditures and aggregate productivity. Our estimation results show that foreign demand strongly affects product dynamics. Government expenditures affect product dynamics in all specifications. The depreciation of the real effective exchange rate increases the number of products significantly in some specifications. Aggregate TFP shocks do not seem to affect the dynamics of products.

Keywords: Product switching, Entry and exit, TFP, Foreign demand shock, Government expenditure shock, Real effective exchange rate

JEL classification: E32, F12, F14, F41, L11, L25, O31

## 1. Introduction

Models of firm dynamics developed by Hopenhayn (1992) and Melitz (2003) imply that the entry of high productivity firms and the exit of low productivity firms enhance total factor productivity (TFP) in the aggregate economy. Empirically, however, the effects of firm entry and exit on aggregate productivity improvements are not large in the U.S. and in Japan. Hsieh and Klenow (2017) find that most productivity improvements arise from new product introductions by incumbent firms, not by new firm entry and exit. For Japan, Fukao and Kwon (2006) find that TFP fluctuations by incumbent firms dominate aggregate TFP movements, and the effects on TFP through reallocation effects of the entry and exit of firms are minimal. Aghion et. al. (1992) and Bernard, Redding, and Schott (2010) have also shown that product dynamics are a major source of productivity movements over the medium- and long-runs.<sup>2</sup>

These empirical results suggest that research should focus on the role of product entry and exit, rather than on the entry and exit of firms. Figure 1-1 show the movements of shipments in the manufacturing sector in Japan from 1999 to 2009, which are highly cyclical. The first recession which occurred from 2000 to 2002 was affected by the collapse of the IT bubble economy in the U.S. The second recession starting in 2007 was affected by the global financial crisis. We see that during both recessions, the growth in manufacturing shipments was negative (solid line). These movements in total shipments can be decomposed into the following components: new firm entry, firm exit, product adding of incumbent firms, product dropping of incumbent firms, and changes in continuing products by incumbent firms. An exiting firm is defined as a firm that drops from

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<sup>2</sup> See also Kawakami and Miyagawa (2013) who show for Japan that the contribution rate of product adding and dropping to labor productivity growth is large.

one or more products to zero products.

Focusing on just the two recessionary periods, we find that the movements in the components are much larger than the decline in total shipments. The decline in total shipments was driven by large decreases in continuing products of incumbents, the net dropping of products by incumbents, and the net exit of firms (exit minus entry).

From Figure 1-1, we can see that the contributions of product adding or dropping (or the sum of the contributions of firm entry and exit and the dropping and adding of products by incumbent firms) is much larger than the contributions of simply the entry and exit of firms. Between 00-09, on average, the contributions of entry and exit were 4.5 percent and -7.3 percent, while the contributions of the adding and dropping of products were 13.0 percent and -13.0 percent. Thus, it is important to not only examine the entry and exit of firms, but to focus on the adding and dropping of products by existing incumbent firms.

(Insert Figure 1-1 here)

The key takeaway is that on average between 1999 and 2009 and even just during downturns, firms are entering and adding products at the same time as they are exiting and dropping products. There is, however, scant theoretically grounded empirical work on how macroeconomic shocks affect the entry and exit of products at the business cycle frequency.

The main concern of this paper is how business cycle shocks such as total factor productivity, foreign demand, and government demand affect product dynamics at the firm level: the entry and exit of firms, and the adding and dropping of products by incumbent firms. Thus, in analyzing product dynamics at the firm level, we need macroeconomic models that allow for the simultaneous adding and dropping of products of incumbent firms at the business cycle frequency—or of multiproduct firms in dynamic general equilibrium.

In this paper, we empirically relate firm-level product dynamics to macroeconomic shocks

such as aggregate productivity, foreign demand, government expenditures and real exchange rates at the business cycle frequency.<sup>3</sup> Our empirical specifications are motivated by the Dekle, Jeong and Kiyotaki (2014) (referred as DJK hereafter) multiproduct firm model.<sup>3</sup> DJK develop a dynamic general equilibrium model in which the products added and dropped at the firm level depends upon aggregate shocks<sup>4</sup> Firms are heterogeneous, facing recurrent firm-product specific shocks and aggregate shocks, such as shocks to aggregate productivity, foreign demand and liquidity preference. Each firm potentially can produce multiple products and decides whether and how much to produce each product in domestic and export markets. From their model, we can trace how certain macroeconomic shocks can determine product entry and exit, and thus the evolution of the-number of products and product adding and dropping rates. The authors show that an aggregate productivity improvement lowers the costs of the entry of new establishments and products and raises the total number of products. Shocks to increase foreign demand and government expenditures also encourage entry and raise the total number of products.

Our aim is estimating the impact of macroeconomic shocks on product entry and exit at the firm level. To the best of our knowledge, this paper is one of the first to estimate a model of product adding or dropping at the firm level at the business cycle frequency, with well identified macroeconomic shocks, such as total factor productivity, foreign demand, and government demand. The estimated equations are “structural” in the sense that the specifications are based on a dynamic general equilibrium model and that the explanatory variables are exogenous or predetermined (if the model is true).

While there is a large theoretical and empirical growth literature examining the long-run

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<sup>3</sup> Bilbie, Ghironi and Melitz’s (2012) impressive paper also relates product level dynamics to macroeconomic shocks. They do not, however, relate macroeconomic shocks to product adding and dropping at the firm level, since the authors model only single-product firms.

determinants of innovation and introduction of new products, the literature on the short-run or business cycle frequency determinants of the number of new products is scant. In an important paper, Shleifer (1986) developed a model in which in times of high aggregate demand, entrepreneurs innovate and introduce new products. The idea is that only during favorable macroeconomic conditions are implementing new products profitable. In a series of industry level case studies, Schmookler (1966) showed that the more intense the aggregate demand, the more patentable ideas were generated. In this paper, we estimate an empirical specification structurally linked to a conventional business cycle model and show that positive macroeconomic shocks stimulate new product introductions.

We obtain our product level data used in this paper from the Japanese *Census of Manufactures*. The Japanese *Census of Manufactures* is unique in that the value of shipments can be obtained all the way down to the 6-digit level (which we “products”), and the product level shipment data and establishment (and firm) level accounting data are available at the annual frequency, making the data suitable for analysis at the business cycle frequency. Moreover, to use the framework of DJK, we need to aggregate the product level data up to the firm level. *The Census of Manufactures* allows this aggregation. Products can be aggregated into establishments (plants), and plants can be matched to the parent firm using firm identifiers.<sup>4</sup>

Empirical results using our unique dataset show the plausibility of crucial parts in the DJK

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<sup>4</sup> In U.S. Census data, the usual product level data are only available down to the 5-digit level and are not available at the annual frequency (Bernard, Redding, and Schott, 2010). Also, although available at a higher frequency, U.S. store scanner-type product level data as used by Broda and Weinstein (2010) and U.S. Bureau of Labor Statistics individual producer price level data used by Nakamura and Steinsson (2012) need to be first matched to firm level accounting data at the annual frequency before performing the empirical work that we do here.

model. Key aggregate variables such as foreign demand, and government expenditures increase number of products. In the DJK model, they assume that opportunities to produce new products are given by the probabilistic parameters, although these parameters do not affect the effect of aggregate variables on the total number of products. However, as we use firm-level data in the empirical studies, we examine the effect of firm-level TFP on the number of products beyond the framework of DJK model. Firm-level TFP is measured from a production function with multiple products developed by De Loecker (2012). In the empirical studies including a firm-level variable, we find that not only high productivity firms but also low productivity firms produce new products aggressively. We guess that low productivity firms create new products for their survival.

Our paper is organized as follows. In the next Section, we motivate the empirical specifications in this paper. In Section 3, we explain the construction of our product-firm level dataset. We also explain how we construct aggregate variables such as total factor productivity, foreign demand, government demand and the real effective exchange rates at the industry levels. In Section 4, using our constructed data set, we provide an overview of product dynamics and exports in Japanese manufacturing firms. In Section 5, we present our estimates on the effects of shocks to aggregate productivity, foreign demand, government spending, and the real exchange rate on the number of products at the firm level. We also examine how the firm-level productivity affects the movements in number of products. In the last section, we summarize our results and consider future agenda.

## **2. Product Dynamics and Macroeconomic Shocks**

Dekle, Jeong, and Kiyotaki (2014) construct a dynamic general equilibrium model of a small open economy with a rich production structure. Firms are heterogeneous and potentially produce many differentiated products. The firm is defined as a collection of differentiated products, each product having heterogeneous productivity.

Their model differs from the usual general equilibrium, dynamic models of firm entry and exit in that their focus is on the addition and deletion of products by incumbent firms. The authors model the product evolution mechanism of both entering and incumbent firms. The product innovation mechanism described below by necessity is highly stylized, to permit clean aggregation into a dynamic general equilibrium model. Here we summarize only the key features of their model relevant for estimating the relationship between aggregate shocks and product dynamics..

When a new firm or a new product line of an incumbent firm pays a sunk cost  $\kappa_E$  to enter, it draws an opportunity to produce a new differentiated product with a certain probability of success. The productivity of a new product is heterogeneous and is distributed according to a Pareto distribution with success. The firm with the production opportunity must pay a fixed cost in order to produce the product and maintain the productivity. Firms that pay the maintenance cost may succeed to maintain the productivity of the product with probability  $1-\delta$  and lose the productivity of the product completely with probability  $\delta$ .

In addition, independently from the success or failure of maintaining the existing product, each product that the firm pays the maintenance cost yields an opportunity to produce another new product with certain probability  $\lambda\delta$ , and the productivities of new products are distributed according to a similar Pareto distribution,<sup>5</sup> Through these birth and death of differentiated products, the firm may add new products, maintain the existing products, replace the products, or drop the existing products.

We can express this product evolution mechanism in terms of the change in the number of products ( $\Delta N_t$ ) in the following way. Let  $N_{Et}$  be the total number of new product line at time  $t$ .

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<sup>5</sup> The idea here is that new products “spin-out” from old products. Say, Apple is working on the I-pod. Whether the I-pod will continue to be successful or not is stochastic, but only by working on the I-pod will there be a chance that the I-phone will be “spun-out” (they are based on similar technologies).

Each new product line draws the opportunity of producing a new product from date  $t+1$ , with probability  $\lambda_E$ . A new product line can be started by incumbent firms or new firms entering with a new product. Let  $1-\omega$  be the exogenously given proportion of new product lines started by newly entering firms (as opposed to incumbent firms). Then the number of new products produced by new firm entrants will be:

$$(1 - \omega)\lambda_E N_{Et} \quad (1).$$

Incumbent firms on the other hand will have two means of increasing the number of products: (1) by starting new product lines,  $\omega\lambda_E N_{Et}$ ; and (2) by spinning out new products from existing products,  $\delta\lambda N_t$ . At the same time, incumbent firms will be dropping products through failed maintenance,  $\delta(1-\delta\lambda)N_t$  and the closing of existing product lines, reducing the number of their products by:  $(-\delta\omega\lambda_E N_{Et})$ .

Thus, the expected total number of products added by incumbent firms are:

$$(1 - \delta)[\delta\lambda N_t + \omega\lambda_E N_{Et}] \quad (2)$$

where  $1-\delta$  is the probability that the productivities of the existing products will be maintained.

The expected total number of products dropped by incumbent firms are:

$$\delta[(1 - \delta\lambda)N_t - \omega\lambda_E N_{Et}], \quad (3)$$

where  $\delta$  is the probability that the productivities of the products drop to zero. Thus, the total change in the number of products  $\Delta N_t$  is the net number of products added by existing firms and the number of products added by the setting up of new establishments and by new firm entrants.

Subtracting (3) from the sum of (1) and (2), and collecting terms, we have:

$$\Delta N_{it} = (-\delta + \delta\lambda)N_{it} + \lambda_E N_{Et} \quad (4)$$

where we subscript by  $i$  to denote firm  $i$   $(-\delta + \delta\lambda) < 0$ .<sup>6</sup> Note that existing firms are

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<sup>6</sup>This assumption is necessary in DJK to guarantee the existence of the steady-state in the model.

heterogeneous, differing by their number of products at time  $t$ . This is because each incumbent firm will have a different sequence (history) in the draws of new products and the maintenance of existing products, resulting in different  $N_{it}$ .

## 2-1. Aggregate Shocks and New Products.

The entry of new firms and the introduction of new product lines in incumbent firms,  $N_{Et}$ , depends on the free entry condition of the model, where the new product lines in entrants or existing firm when the costs of entry are lower than the expected present discounted value of profits:

$$\kappa_{Et} = \lambda_E E_t(\Omega_{t,t+1} V_{t+1}) \quad (5)$$

where  $\kappa_{Et}$  is the sunk cost of entry of the firm;  $\lambda_E$  is the probability of drawing a new product;  $\Omega_{t,t+1}$  is the stochastic discount rate of consumers; and  $V_{t+1}$  is the value function of firms, or the present discounted value of profits from time  $t+1$  onwards.

Importantly, aggregate shocks affect the evolution of the number of products through the above free-entry condition. These aggregate shocks include aggregate productivity ( $Z_t$ ), foreign demand ( $Y_t^*$ ), and government demand ( $G_t$ ) shocks. Suppose that a positive macroeconomic shock such as  $Y_t^*$  hits the firm. The shock raises the present discounted value of profits facing

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That is, there are negative scale effects in the introduction of new products by incumbent firms. In fact, this negative scale effect—or decreasing returns to scale at the firm level—is a necessary condition for the DJK model to have a steady-state. Only through the entry of new firms and establishments will the total number of products be maintained or increasing over time. The DJK model is a neoclassical growth model with a well-defined steady-state. As in such models, the steady-state aggregate number of products,  $N^*$ , is invariant to business cycle shocks. When a positive macroeconomic shock hits and raises  $N(t) > N^*$ , over time  $N(t)$  decreases from above to return back to steady-state  $N^*$ . Between the time of the macroeconomic shock and reaching the steady-state,  $N(t)$  is higher than at the steady state. There are more products and the level of GDP is higher after the positive macroeconomic shock than in the steady-state.

the firm, and the firm starts a new product line. At the same time, through unsuccessful maintenance, the firm loses products. Thus, as observed in Figure 1-1, we can simultaneously see the adding and dropping of products on average throughout the sample period and firms are dropping products even in response to a positive macroeconomic shock.

To close the model, consumers supply labor, consume final goods (which is produced from many differentiated intermediate products), and hold home and foreign bonds to maximize expected utility. The state of the economy can then be described by the set of variables  $M_t = (N_t, D_t^*, Z_t, G_t, Y_t^*, \zeta_t)$ , where  $N_t$  is the aggregate number of products,  $D_t^*$  is the level of net foreign assets, and  $\zeta_t$  is the liquidity shock to holding net foreign assets. The first two are endogenous and the last four are exogenous. The aggregate state variables are respectively, the total number of products in the economy, the aggregate stock of net foreign assets, total factor productivity, foreign demand, and the liquidity shock from holding foreign bonds. All of the other endogenous variables in the model such as aggregate consumption, labor supply, and the exchange rate are functions of  $M_t$  through all the equilibrium equations of the DJK model, including the free entry condition (5).

Equation (4) above can be estimated by firm level data with information on the number of products by firms. As summarized in Equation (4),  $N_i(t + 1) - N_i(t) = \Delta N_i(t)$  depends on the exogenous stochastic shocks that affect the firm's draws of maintenance and spinouts from the existing products, as well as the endogenous choice of the firm to add new product lines. The endogenous choices depend on the entire general equilibrium structure of the DJK model and are driven by macroeconomic shocks such as total factor productivity, government spending and foreign demand shocks. As mentioned, we expect  $\Delta N_i(t)$  to be a decreasing function of  $N_i(t)$  as existing firms tend to have a smaller number of positive spinouts and innovation than the unsuccessful maintenance of existing products.

## **2-2. Estimation Strategy of the Model.**

In the estimation, the aggregate shocks that affect the evolution of  $\Delta N_{it}$  are included at the *industry level* to increase the cross-section variation and the precision of the estimates. For the two demand shocks, government ( $G_t$ ) and foreign demand ( $Y_t^*$ ), let  $y_{tk}^*$  and  $g_{tk}$  be the industry-level foreign and government demand shocks for industry k (such as television and radio receivers). For the aggregate TFP supply shock ( $Z_t$ ), let  $z_{tk}$  be the k sector-level TFP shock. Assume that the impact of sector level shocks on the dependent variable are proportional to the impact of aggregate level shocks:  $g_{tk} = \gamma_{gk}G_t$ ,  $y_{tk}^* = \gamma_{y^*k}Y_t^*$ , and  $z_{tk} = \gamma_{zk}Z_t$ , where the constant of proportionality differs by sector.<sup>7</sup> Then after taking logs of the above expressions of these sector level shocks, we obtain, say for government demand shocks,  $\ln g_{tk} = \ln G_t + \ln v_{gk}$ . Then we can substitute sector-level shocks for aggregate shocks, provided that we also include intercepts that differ by industry ( $\ln v_{gk}$  or industry level dummy variables) in the estimation.

In DJK, shocks to aggregate government spending, foreign demand, and aggregate TFP are modelled as an AR(1) process. In our estimation below, we include the sector-level shocks,  $g_{tk}$ ,  $y_{tk}^*$ , and  $z_{tk}$  by themselves. The assumption is that the total levels of these variables represent a “shock” or “surprise” to the agents in the model.

### 2-3. Inclusion of Firm Level TFP

The specification (4) that we estimate is deliberately stylized. This stylized structure was necessary to allow the aggregation of heterogeneous firms with product innovations into a standard stochastic business cycle model. In reality, other variables would certainly influence the

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<sup>7</sup> DiGiovanni, et. al. (2014) use sectoral level shocks to capture the impact of aggregate shocks. We use the narrower measure of industry level shocks to capture the impact of aggregate shocks. Foerster, et. al. (2011) develop a standard multisectoral neoclassical growth model and shows that the vector of industry output growth rates follow the factor time-series model:  $\varepsilon_{kt} = \beta_k S_t + v_t$ , where  $\varepsilon_{kt}$  is the shock to the output industry k,  $\beta_k$  is the matrix of coefficients that reflects how the vector of aggregate shocks  $S_t$  affect industry k's output. Thus, in Foerster et. al.'s (2011) real business cycle model, industry level shocks are also proportional to aggregate shocks.

product evolution process at the firm level. In our alternate empirical specification (6), we add the ratio of firm level TFP to aggregate (industry) TFP ( $Z_t$ ) to (4).

$$\Delta N_{it} = (1 - \delta + \delta\lambda)N_{it} + H\left(\frac{TFP_{ijt}}{TFP_{jt}}\right)\lambda_E N_{Et} \quad (6)$$

Firm level TFP depends on the entire history of product draws and the successful maintenance of the products of firm  $i$  and is predetermined. In the DJK model,  $N_{it}$  summarizes this evolution of products; firm level TFP adds no new information, and in theory, should be perfectly correlated with the number of products. In reality, however, the productivity of a firm may depend on other variables than past product draws such as corporate location and physical capital. To capture the effects of these other variables on product dynamics, we include firm-level TFP as an additional explanatory variable in our alternate specification. That is, if firm  $i$  has high TFP relative to other firms, then the firm is more likely to maintain its menu of existing products to induce spinouts and give birth to new establishments that can satisfy the free entry condition (5). Although not directly related to this paper, many growth models stress the importance of firm level TFP for product innovation (see Acemoglu, Akcigit, and Kerr, 2015). While specification (6) cannot be as easily and cleanly aggregated as specification (4) into a standard business cycle model, it would be interesting to see whether more productive firms introduce more products at the business cycle frequency.<sup>8</sup>

#### **2-4. Product Dynamics of Exporters.**

While the focus of this paper is on the evolution of the total number of products of firm  $i$ , the DJK model also has predictions on how macroeconomic shocks impact the number of products

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<sup>8</sup> Foster, Haltiwanger, and Syverson (2008) and Syverson (2011) found persistent productivity differences across a cross-section of U.S. firms. The same productivity differences are also found across Japanese firms by Fukao and Kwon (2006) and Kawakami, Miyagawa, and Takizawa (2012).

that are exported. The DJK paper shows that all products with productivity greater than  $a_t = \left[ \frac{\alpha(\theta-1)\varphi}{\alpha+1-\theta} \frac{N_t^{\frac{\theta-1}{\theta}} Z_t}{\varepsilon_t Y_t^*} \right]^\gamma$  will be exported.  $\gamma$  is a function of the parameters,  $\theta$  is the elasticity of substitution of goods (both domestic and foreign), and  $\varepsilon_t$  is the real exchange rate between foreign and domestic goods.  $N_t$  and  $\varepsilon_t$  are endogenous and are affected by the exogenous shocks,  $Z_t$  and  $Y_t^*$  in the general equilibrium model.

On impact, a positive shock to  $Z_t$  will raise the total number of products in the economy  $N_t$  as more product lines are started and will depreciate the real exchange rate, as home goods become cheaper than foreign goods. However, the net effect of a positive shock to  $Z_t$  on  $a_t$  is ambiguous and depends on the parameter values and on the general equilibrium effects. We must rely on model simulations to ascertain the general equilibrium effects. Simulations in DJK show that as  $Z_t$  rises and  $a_t$  increases, the fraction of goods that are exported falls.

A positive shock to foreign demand,  $Y_t^*$  raises  $N_t$  and appreciates the real exchange rate. Again, the net effect on  $a_t$  depends on the parameter values and the general equilibrium effects. Simulations in this case show that in this case,  $a_t$  and the fraction of goods that are exported rises.

The structure of our data, the *Japanese Census of Manufacturers*, does not permit a direct observation of exported products. We only observe whether a firm is an exporter or not and the total number of products produced by the firm. In our estimation below, we form a panel of firms that are only exporters. Firms that meet the lower bound of exporting in a given year—exporters—are more productive than the average firm, because of higher  $N_{it}$  or higher  $TFP_{it}$ . This accords with the well-known empirical finding that exporters tend to be larger and more productive than non-exporters. Thus, estimating the model on only the sample of exporters provides another way to see how firm level productivity affects how a firm responds to aggregate shocks.

### 3. The Japanese Census of Manufacturers Data and the Construction of Explanatory

#### Variables.

We construct our firm-product data using *the Census of Manufacturers* conducted by the Japanese Ministry of Economy, Trade and Industry. The *Census* is in principle, a survey of all establishments (plants) in the Japanese economy. The data are now available in the format that we require from 1998-2009 annually. Importantly, unlike in the U.S., where usable product and establishment level data are available for only every 5 years (Bernard, Redding, and Schott, 2010), in Japan, we can collect product and establishment level Census data for every year, which is more conducive to analysis at the business cycle frequency, where peaks to troughs can occur in a period as short as 2 years. We examine versions of the Census that surveys establishments at and above 5 workers, since the data covering establishments below that number of workers are not made publicly available. In 2008 for example, 263,061 establishments of 5 or more employees responded to the Census, representing over 59 percent of all Japanese manufacturing establishments.

We define “Sectors” as goods at the 2-digit Japanese Standard Industry Classification (JSIC) level; “Industries” as goods at the 4-digit JSIC level, and “Products” as goods at the 6-digit JSIC level<sup>9</sup>. In the data, each establishment reports the usual accounting data, such as the number of employees, raw material costs, fuel and electricity costs, tangible fixed assets, and the value of shipments (output) of the different types of “products” that the establishment produces. Examples of sector, industry, and product level classifications are shown in Table 1.<sup>10</sup> Sector classification

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<sup>9</sup> Industry classification in *the Census of Manufacturers* follows the Japan Standard Industry Classification (JSIC) in the case of 2-digit and 4 –digit levels. JSIC that started in 1949 is revised every five years. Every version of JSIC is adjusted to adhere to the International Standard Industry Classification (ISIC). However, in the case of the 6-digit classification, *the Census of Manufacturers* adopts its own classification. The classifications used in our paper follows the 2002 version of JSIC.

<sup>10</sup> Note that what we call “products” is a much broader category than what are typically called “products” in scanner-type data. For example, in our data, a box of cereal and a bag of rice crackers will be the same product, but in scanner type data, they will be different products. Thus, the introduction of a newer product

number 27 indicates the electric machinery sector. Industry classification number 2711 shows the industry which produce storage batteries. The industry consists of five 6-digit products. In the 6-digit level, we find not only usual lead storage battery but also lithium ion battery which is used for technology products such as mobile phones and personal computers. This means that if we want to examine whether a firm produces new innovative products, we have to capture movements at least at the 6-digit level.

(Insert Table 1 here)

Given that decisions on adding and dropping products and on output volumes of each product are made at the firm level and not at the establishment level, both in reality and in the DJK model, we need to identify the “firm”. One problem with the Japanese Census data is that the data do not record a firm level identifier that would allow the grouping of establishments into firms (Bernard and Okubo, 2013). Abe et. al. (2012) develop a procedure to match establishments (plants) to their parents by using information on establishment codes, address codes, and industry classifications. Using their procedure, we aggregate establishment level data into firm-level data.

Stylized facts of the Census data concerning multiple product firms are documented in Kawakami and Miyagawa (2013). Briefly, according to Kawakami and Miyagawa, in the Japanese Census, the share of multiple product firms in the total number of firms is about 40 percent, and the average multiple-product firm in Japan produces about 3 products (i.e., three different 6-digit JSIC level products). While multiple product firms represent a minority of firms, they account for 78 percent of total shipments by Japanese firms. The output (shipments) of an average multiple product firm is 50 percent higher than the average single product firm; and average employment is

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in our data is a more significant innovation than simply introducing a newer brand of cereal in scanner data.

28 percent higher than a single product firm. Output per worker is 30 percent higher on average in multiple product firms than in single product firms.

In the Census, we can also identify whether a particular establishment is an exporter (export value > 0) and the total value of their exports in that year. However, export values or quantities are only available at the establishment level and not at the product level. At the product level, only total (not broken down into domestic and export) shipment quantities and values are available.

For our empirical analysis, we need to construct some aggregated variables using both the Census of Manufacturers and other, mostly sector level data. Sector-level government expenditures,  $g_{tk}$ , are obtained from the Input- Output Tables in the Japan Industrial Productivity Database (JIP database).<sup>11</sup> We use data for only the government's direct demands for sector k. We construct sector level foreign demands,  $y_{tk}^*$ , by first obtaining exports from Japan to 4 of Japan's main export partners (in yen), the U.S., China, the European Union, and Russia in each sector (these countries account for over 90 percent of Japan's total exports). We then obtain the value added in each of Japan's export partners in each sector from the IMF's *International Financial Statistics* (converted to yen at the prevailing exchange rate). For each sector, we then sum Japan's exports and value added over the 4 countries. Finally, for each sector, we take the ratio of Japan's summed exports to our summed value added measure, and use this ratio as our sector level foreign demand variable. Applying Good, Nadiri, and Sickels (1996) to the industry level, we measure sector level TFP,  $Z_{tj}$ , as follows,

$$\ln Z_{tj} = (\ln Q_{tj} - \overline{\ln Q_t}) - \sum_{h=1}^3 \frac{1}{2} (s_{tjh} - \overline{s_{th}}) (\ln X_{tjh} - \overline{\ln X_{th}})$$

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<sup>11</sup> Hitotsubashi University and RIETI constructed the JIP database to estimate productivity at the industry level. The construction of this database is consistent with other productivity databases such as Jorgenson, Gollop, and Fraumeni (1987) and EUKLEMS..

$$+ \sum_{k=1}^t (\overline{\ln Q_k} - \overline{\ln Q_{k-1}}) - \sum_{k=1}^t \sum_{h=1}^3 \frac{1}{2} (\overline{s_{hk}} + \overline{s_{hk-1}}) (\overline{\ln X_{hk}} - \overline{\ln X_{hk-1}}). \quad (7)^{12}$$

In Equation (7),  $Q_{jt}$  is output in sector  $j$ .  $X_{jht}$  represents a production factor ( $h$  is labor, capital, or intermediate input) in sector  $j$  and  $s_{jht}$  shows share of production factor  $h$ .  $\overline{\ln Z_{tj}}$  is a geometric average of  $Z_{tj}$  ( $Z$  is  $Q$ ,  $X$ , or  $s$ ) in the manufacturing sector.

In most general equilibrium models, as in DJK, actual real exchange rate movements are dominated by aggregate shocks such as productivity, foreign demand, and government demand. In these models, real exchange rates are endogenous. In particular, in DJK, liquidity shocks importantly drive fluctuations in real exchange rates. However, it is difficult to find variables that capture aggregate exogenous liquidity shocks in the data. There is also a tradition in international finance starting from Meese and Rogoff (1981) that include exchange rates as exogenous variables in estimations. Meese and Rogoff justify this practice by pointing out that exchange rates are a random walk process and fundamental variables such as productivity and monetary shocks have little explanatory power in predicting exchange rates. Thus, in our estimations below, we include industry-level real effective exchange rates ( $\epsilon_{tk}$ ) as an additional explanatory variable, being fully aware that this variable could be endogenous.<sup>13</sup>

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<sup>12</sup> We use the JIP productivity data to obtain Good, Nadiri, and Sickles TFP measure, The simple JIP productivity TFP measure is an index and does not allow for intersector comparisons of productivity levels. The productivity measures arising from the Good, Nadiri, and Sickles procedure corrects for this index number problem and allows for interindustry comparisons. Foster, Haltiwanger, and Syverson (2008) and Syverson (2011) found persistent productivity differences across a cross-section of U.S. firms. The same productivity differences are also found across Japanese firms by Fukao and Kwon (2006) and Kawakami, Miyagawa, and Takizawa (2012).

<sup>13</sup> We obtain the sector-level real effective exchange rates,  $\epsilon_{tk}$ , from RIETI from 2005 to 2009. Since our firm-product database runs from 1999 to 2009, we have to construct real effective exchange rate data ourselves from 1999 to 2004. As for this data from 1999 to 2004, we choose China, EU, Russia, and the US as Japan's trade partners. We obtain trade data from the Trade Statistics published from the Ministry of Finance in Japan. The industry-level output price data are obtained from the World KLEMS database (<http://www.worldklems.net/>). We use nominal exchange rates from the IMF's *International Financial*

Finally, in some specifications, we add the ratio of firm-level productivity to sector-level productivity as another explanatory variable. We estimate firm-level total factor productivity by using the method of De Loecker (2011) for multiproduct firms. To obtain the necessary accounting data such as the number of employees and the value added at the firm level from the Census data, we simply aggregate the data for all the establishments that the firm manages. Using the estimated coefficients, we measure total factor productivity at the firm level (as described in the Appendix).

#### **4. Stylized facts of Japanese Product Dynamics.**

##### **4-1. Stylized Facts Using All Samples**

Using the firm-product level data as constructed above, here we provide an overview of product level dynamics in Japan. We have already showed an example of 2-digit, 4-digit, and 6-digit classifications in Table 1. Table 2 depicts how sectors can be divided into industries and products. For example, the food sector has 41 industries and 87 products, ships 24 billion JPY worth of goods and has over a million workers. We find that the value of shipments (output) per employee is higher in industries with high capital intensity, such as the coal and the petroleum sector.

(Insert Tables 2 here)

As shown in Introduction, Figure 1 depicts the decomposition over time of the total change in shipments (output, solid line). Over the entire period, the biggest contributor to total shipment movements is the fluctuation in continuing products made by incumbent firms. Some continuing products expand their shipments while others contract, and their difference is pro-cyclical.

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*Statistics.* Our estimates of real effective exchange rates thus constructed runs from 1999 to 2007. We link our constructed data to the RIETI data in 2005. Our measure increases when the Japanese yen depreciates against other currencies.

The second most important contributor to the movement in total shipments is the adding and dropping of products by incumbent firms. Compared to the contribution of products added and dropped by incumbent firms, the contribution of the entry and exit of firms to total shipment fluctuations is small. The shipment of new products by incumbent firms dominates the shipment of new products by new firm entrants. In addition, during booms, product adding dominates product dropping, suggesting that positive macroeconomic shocks stimulate net product adding and increase the number of products. In accounting for the total change in shipments between 1999-2009, the contribution of new product shipments by incumbent firms was 13.0 percent, while the contribution of new firm entry was only 4.5 percent.

These stylized facts argue for models that allow for the adding of dropping of products of incumbent firms—or of multiproduct firms. In terms of the multiproduct DJK model, this would mean that the entry of new product lines by existing firms and the spinouts from the existing products dominate the entry of new firms in the movement of total shipments.

As further evidence for the importance of multiproduct firms, we divide Figure 1 into two types of firms: high productivity firms and low productivity firms as shown in Figure 2<sup>14</sup>. In both types of firms, product adding and dropping behavior play more important roles for the fluctuations in total shipments. Interestingly, we find that product switching behavior in low productivity firms is more aggressive than that in high productivity firms. In high productivity firms, the contribution of increases in incumbent products is always larger than that of product adding except between 2001 to 2002. On the other hand, in low productivity firms, the contribution of product adding is often larger than the contribution from the increase in incumbent products. Similarly, the contribution of product dropping is also larger than the contribution of the decrease in incumbent

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<sup>14</sup> We divide the distribution of firm level TFP into three categories: upper 25% TFP, TFP in 25% to 75% from bottom, and lower 25% TFP. Firms which belong to the first category are called as high productivity firm, and firms that belong to the third category are called as low productivity firms.

products except in the period of the Global Financial Crisis. This finding suggests that high productivity firms are more conservative than low productivity firms in changing the composition of their products, because of inertia—since they have achieved success in their current product mix, they may not see a reason to change. However, low productivity firms have to replace their low productivity mix of incumbent products, which prods them to introduce new products.

(Insert Figure 2 here)

To emphasize, regardless of whether the economy is in a boom or a recession, there are simultaneously a large number of products added and dropped by incumbent firms. Incumbent firms added products especially strongly between 2003 and 2006. In contrast to the pro-cyclical nature of product adding and firm entry, product dropping and firm exit behaviors are relatively noncyclical or even slightly countercyclical.

#### **4-2. Exporting Firms.**

Since we do not observe exports at the product level in the data, we can only infer the relationship between say macroeconomic shocks and the number of exported products by examining how macroeconomic shocks affect the total number of products by exporting status. In Figure 2, we compare the number of products over time between exporters and non-exporters. It is well-known from earlier work that exporters are larger and more productive than non-exporters (Bernard, Eaton, Jenson, and Kortum, 2003). These predictions hold in the data. Figures 3 show that Japanese exporters produce a larger variety of products than non-exporters and that exporters are larger.

Compared to that of the average Japanese firm, the average number of products of exporting firms fluctuates more pro-cyclically (Figure 4). This is not only because exporting firms on average produce more products. It is also because exporters added products more rapidly over the business cycle than non-exporters. Between 2003 and 2004, exporters on averaged added 0.3

products while non-exporters added essentially none. On average, the number of added products equals to 2 for exporters and 1.4 for non-exporters.

(Insert Figures 2, 3, and 4 here)

We also find that when total exports rise, it is not the increase in the number of firms, but the increase in the number of products that is the driving force. In Figure 5, the share of firms adding products and share of entrants (both weighted by shipments) are positively correlated with movements in average export values by firm. Both shares increased when export growth accelerated in the period from 2002 to 2004, and decreased after 2009, when total Japanese exports collapsed, owing the global financial crisis. However, the fluctuations in the share of firms adding products were much larger than the fluctuations in the share of entrants.

(Insert Figures 5 here)

To summarize, these stylized facts show that a significant adjustment in Japanese output is comprised of the adding of new products, rather than the entry and exit of firms (in addition to the expansion and contraction of the shipments of existing products). This adding of new products appears more pronounced for Japanese exporters.<sup>15</sup> We also find that consistent with DJK, firms add and drop products at all states of the business cycle. These long-run or acyclical features of product adding and dropping are a robust characteristic of the data and capture how firms add and drop products through the normal innovative processes of product “spinouts” and “failed maintenance” that occur in all states of the business cycle.

Finally, although we do not observe exports at the product level, we find that exporters tend to be multiproduct firms and that exporters add products at a much more rapid rate than non-exporters. Product adding rates are highly correlated with average firm exports. Thus, while the

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<sup>15</sup>Although not observed at the business cycle frequency, these features are also present in U.S. data (Bernard, Redding, and Schott, 2010).

total cyclical change in shipments is dominated by the change in continuing products made by incumbent firms, the cyclical change in export sales is highly correlated with the adding of new products, mostly by incumbent firms.

## 5. Estimation of Product Dynamics

In our estimates below, we focus on the extensive margin of adjustment in the total number of products. The estimated equations are “structural” in the sense that if the DJK model is correct, then the explanatory variables are predetermined (the firm-level variables) or exogenous (the macroeconomic shocks).

### 5-1. Empirical Specifications with only Aggregate Explanatory Variables.

Our baseline specification is adopted from (4):

$$\Delta N_{it} = const. + a_1 * \ln FD_{kt-1} + a_2 \ln G_{kt-1} + a_3 * \ln Z_{kt-1} + a_4 * \ln REER_{kt-1} + a_5 * N_{it-1} + \varepsilon_{it} \quad (8),$$

The dependent variable, the change in the number of products is  $\Delta N_{it} = N_{it} - N_{it-1}$ . To exclude outliers, we take  $\Delta N_{it}$  whose value is between -3 and +3 as dependent variables.  $\ln FD_{kt}$  is the log of foreign demands at sectoral level,  $\ln G_{kt}$  is the log of government expenditures at the sectoral level,  $\ln Z_{kt}$  is the log of sectoral TFP,  $\ln REER_{kt}$  is the log of real effective exchange rate at the sectoral level. While we are fully aware of the endogeneity of the real exchange rate in general equilibrium models, there is enough empirical randomness in the real exchange rate at the yearly frequency, that the real exchange rate is effectively divorced from model fundamentals in at least the short-run. Moreover, given the external dependence of Japan’s economy, it would be important to estimate the effect of changes in the real exchange rate on new product innovations.  $* N_{it-1}$  is the number of products at time t-1 for all firms in existence at time t-1, including firms that exited at time t-1. Since firms are continuously entering and exiting, the panel is unbalanced.

$N_{it}$  is the number of products at time  $t$  for all firms in existence at time  $t$ , including those that entered at time  $t$ .

The fixed effects estimator with AR1 is used to estimate equations (8), and sectoral dummy variables are included to control for sectoral heterogeneity.<sup>16</sup> As for equation (8), we also conduct instrumental variable estimations. Instruments are two year lagged variables of explanatory variables. The theory developed above predicts that  $a_1$ ,  $a_2$ ,  $a_3$ , and  $a_4$  are positive, and  $a_5$  is negative.

Following Davis, Haltiwanger, and Schuh (1996), we also conduct an alternative estimation where the dependent variable is instead the rate of change in the number of products:

$$\frac{N_{it}-N_{it-1}}{\frac{N_{it}+N_{it-1}}{2}} = \text{explanatory variables} \quad (9)$$

All of the explanatory variables in (9) above are the same as those in (8). Like  $\Delta N_{it}$ , we take the Davis=Haltiwanger= Schuh measure that belongs to the inertia between -4 and 4. Statistical data of all variables used in the following estimations are summarized in Table 3. The observations of firm level relative TFP are much less than those of other variables, because we are not able to obtain capital data of firms with less than 30 employees.

(Insert Table 3 here)

## 5-2. Estimation Results using change in number of products as a dependent variable

In Table 4-1, we show the estimates using all samples from (8), where the dependent variable is  $\Delta N_{it}$ . The sample size is measured as the sum of the number of firms in each year. Since firms

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<sup>16</sup> Instead of industry-level dummy variables to control for industry-level effects, we include sectoral-level dummy variables. Recall that “sectors” are much broader than “industries.” A typical sector contains about 20 industries (In Table 2).

enter and exit from the sample every year, the sample is unbalanced. We find that foreign demand shocks are always highly significant and positive in all estimations, suggesting that Japanese firms respond strongly to foreign demand, by entering the market and introducing new product lines. We also see that domestic government spending is always significant and positive in affecting the number of new products. However, aggregate productivity induces a negative response to product dynamics. The coefficients on real effective exchange rate are also negative. As hypothesized, the number of products last period,  $N_{it-1}$ , is negative and highly significant in each period, implying that the change in the number of products is mean reverting. Recall that a negative coefficient on  $N_{it-1}$  is necessary to ensure a stationary steady-state in the model, and implies that absent aggregate shocks, the aggregate number of products in the economy will be declining. We also find the above estimation results in instruments variable estimations as well as fixed effects estimations..

In Table 4-2, we focus on exporters. Firms are included in the exporter sample in a given year, only when the firm has exported in that year and in the previous year, in time  $t$  and in  $t-1$ .<sup>17</sup> Thus, the exporter panel is also unbalanced. Since a minimum level of productivity is required to export in any given year, the sample of exporters has, on average, higher productivity than the broader sample. Again, foreign demand makes a positive and significant impact on product dynamics in the fixed effects estimations. However, domestic government spending and aggregate productivity are always insignificant. In contrast to the results in Table 34-1, the depreciation in the real effective exchange rate stimulates product innovation. These results show that product dynamics in exporters is affected by international variables. The coefficient on  $N_{it-1}$  is again negative and highly significant.

(Insert Tables 4-1 and 4-2)

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<sup>17</sup> To calculate  $\Delta N_{it}$  in any given year for the exporter sample, we need two consecutive years of  $N_{it}$  for exporters, the current and the previous year.

### 5-3. Estimation Results using Davis =Haltiwanger= Schuh measure

Next, we examine estimation results of Equation (9). Estimation results using all samples shown in Table 5-1 are similar to those in Table 4-1. Foreign demand and domestic government spending show positive and significant impacts on product innovation, although the coefficients on government spending in IV estimations are not significant. On the other hand, aggregate productivity and real effective exchange rate does not have a positive impact on product dynamics.

The estimation on a sample of exporters using the Davis=Haltiwanger= Schuh measure is shown in Table 4-2. We find a positive and significant impact of foreign demand in the fixed effects estimations. In this estimation, the signs of government spending are ambiguous.

(Insert Tables 5-1 to 5-2)

### 5.4 Estimations including firm level TFP

As shown in Equation (6) in Section 2, firm-level TFP affects the entry and spinout decisions of firms. As these decisions are affected by the real exchange rate and existing number of products in the DJK model, the firm level TFP is an endogenous variable. However, many articles on economic growth and industrial organization literature such as by Acemoglu et al. (2015) and Raymond et al. (2013) stress the role of productivity on product innovation. With this, we estimate the following equation including relative TFP (RTFP=firm level TFP/sector level TFP) as an explanatory variable.

$$\Delta N_{it} = const. + a_1 * \ln FD_{jt-1} + a_2 \ln G_{jt-1} + a_3 * \ln Z_{jt-1} + a_4 * \ln REER_{jt-1} \\ + a_5 * RTFP_{it-1} + a_6 * (RTFP)_{it-1}^2 + a_7 * N_{t-1} \quad (10)$$

Usually, we assume that relative TFP monotonically increases the number of products. However, we do not find significant and positive coefficients on relative TFP in our estimations including relative TFP. Then, we add not only relative TFP but also the square term of relative

TFP to the right hand side of Equation (8). When  $a_5$  is negative and  $a_6$  is positive, higher TFP firms create new products aggressively and lower TFP firms also try to create new products for their survival. Middle level TFP firms want to keep their current products. On the other hand, when  $a_5$  is positive and  $a_6$  is negative, middle class TFP firms try to create new products, while higher TFP firms want to keep their products and lower TFP firms quit creating new products.

As shown in the Appendix, the measurement of RTFP is based on the estimated parameters of the production function with multiple products developed by DeLoecker (2011). The estimation results of Equation (10) are shown in Table 6. As in the previous estimations, we conduct not only fixed effect estimations with AR1 but also instrumental variable estimations.

(Insert Tables 6-1, and 6-2)

In Table 6-1, the results in foreign demand are almost the same as those in Tables 4 and 5. The coefficients of the real effective exchange rate are positive and significant in the fixed effects estimations, which means that the depreciation of the real effective exchange rate increases the number of products. Coefficients in government spending are also positive and significant in the fixed effects estimations. However, the results in aggregate productivity are not stable. As for firm level variables, we find negative coefficients on RTFP and positive coefficients on the square term of RTFP. The results imply that the relationship between product innovation and firm level TFP is U-shaped, which means not only higher TFP firms but also lower TFP firms are aggressive in product innovation. These results are consistent with our findings in Figure 2, where low productivity firms conduct product switching more aggressively than high productivity firms.

When the Davis=Haltiwanger= Schuh measure is a dependent variable, we do not obtain better results than those in Table 6-1. Although foreign demand, government spending and depreciation of the real effective exchange rate has positive impacts on product innovation in the case of fixed effects estimations, some variables are not significant. As for the firm-level variable, we find a U-shaped relationship between the change in number of products and relative TFP in only instrumental variable estimations.

## 5-5. Estimation Results with Shock Variables

Replacing the level of aggregate variables to their shock variables, we estimate Equation (11).

$$\Delta N_{it} = const. + b_1 * z_{kt-1} + b_2 * y_{kt-1}^* + b_3 * g_{kt-1} + b_4 * e_{kt-1} + b_5 * N_{it-1} + \varepsilon_{it} \quad (11)$$

$z_{kt}$  are log TFP shocks in industry k;  $y_{kt}^*$  are log foreign demand shocks in industry k; and  $g_{kt}$  are log government demand shocks in industry k.  $e_{kt}$  are the log real effective exchange rate shocks. Like Equation (8), we expect  $b_1$ ,  $b_2$ ,  $b_3$ , and  $b_4$  are positive, and  $b_5$  is negative. As these expository variables are shock variables, we estimate Equation (11) by fixed effects estimations with AR1. The estimation results are shown in Tables 7.

(Insert Tables 7-1, and 7-2)

In Table 7-1, the dependent variable is  $\Delta N_i$ , we find that foreign demand shocks and government spending shocks are positive and significant in all samples, which imply that those shocks stimulate net increase in products, as the DJM model expected. However, we do not find positive effects of the aggregate TFP shocks on product dynamics. In the estimations using samples of exporters, the coefficient of real effective exchange rate is positive, which implies that the depreciation of real effective exchange rate stimulates new product innovation in exporting firms.

In Table 7-2, we use the Davis =Haltiwanger= Schuh measure as a dependent variable as a dependent variable. The estimation results in Table 7-2 are similar to those in Table 7-1. Foreign demand and government spending are positive and significant in all samples. When we focus on the estimation results in exporters, the depreciation of real exchange rate stimulate product dynamics significantly.

As shown in Equation (10) we add firm level variables as dependent variables to Equation (11) and estimate the revised equation. The estimation results are shown in Table 8. As for the foreign demand, we obtain the robust results. The increase in foreign demand gives positive and significant impacts on product dynamics as in the previous results. However, the increase in government spending does not show the expected results. The depreciation in real effective

exchange rate stimulates product dynamics significantly. Although the signs of aggregate productivity are positive, they are not significant.

The estimated results on firm-level TFP are similar to Tables 6-1 and 6-2. We find negative coefficients on RTFP and positive coefficients on the square term of RTFP, which implies the U-shaped relation between product innovation and productivity.

(Insert Table 8)

## 5-6. Comparisons with the Results from the Aggregate Impulse Responses

In product level general equilibrium models such as DJK, common macroeconomic shocks such as aggregate productivity, government expenditure, and foreign demand shocks alter product dynamics and exporting behavior. To analyze their model, DJK shock their model with an AR(1) process of an aggregate shock such as TFP. In their impulse responses, DJK show that a one standard deviation (0.9 percent) increase in aggregate TFP (with auto-correlation of 0.55 in annual data) raises output by 1 percent, and depreciates the real exchange rate by 0.9 percent. Exports increase by 0.7 percent, and correspondingly, the total number of products increases vigorously in 3 to 7 years to 0.4 percent. A 1.4 percent increase in foreign demand (with auto-correlation of 0.94) increases GDP by 0.2 percent and exports by 0.8 percent. The real exchange rate appreciates by 0.8 percent, and the number of products increases slowly by 0.15 percent in 7 to 20 years. A 0.8 percent positive government expenditures shock (with auto-correlation of 0.95) raises GDP by 0.15 percent, depreciates the real exchange rate by 0.1 percent, and increases exports by 0.07 percent and the number of products by 0.08 percent. Thus, quantitatively, DJK find that aggregate TFP shocks have the greatest impact on the number of products, followed by foreign demand and government spending shocks.

In our estimates above, we have regressed the changes in the number of products ( $\Delta N_{it}$ ) at the firm level on macroeconomic shocks. The estimates above are not identical to what is measured in the impulse responses, where interest lies in how the aggregate number of products

( $\Delta N_t$ ) respond to aggregate shocks. Still, in expectation or on average, changes in  $\Delta N_{it}$  should correspond to changes in  $\Delta N_t$ . In our estimates above, we show that the number of products at the firm level responds very strongly to foreign demand shocks. The response of  $\Delta N_{it}$  to government demand shocks is more muted.

## 6. Concluding remarks

Policy makers in many countries are especially concerned about promoting new products produced within their borders. For example, the Abe administration in Japan has undertaken expansionary fiscal and monetary policies, partly in the hope of encouraging the introduction of innovative products.<sup>18</sup> The recent expansionary monetary policy in the Euro area is related in part to the desire to stimulate innovation and introduction of better products (Bergin and Corsetti, 2014).

Conceptually linking business cycles with product adding and dropping behavior at the firm level is not new; the idea goes back at least to Schumpeter. To the best of our knowledge, this paper is one of the first to estimate a model (DJK, 2014) of product adding and dropping behavior for the multiproduct firm at the business cycle frequency. To estimate such a model, we need product level data that can be matched with firms at a minimum at the business cycle or annual frequency.

We construct a unique firm-product database in Japan using *the Census of Manufactures*. The products in our database are classified down to six-digits, which is more detailed than what is available in the U.S. Census of Manufactures.

In Japan, firms change their product compositions quite frequently, although the average number of products per firm is very stable. This stability, however, hides some significant product adding and dropping behavior. The average number of products of exporters is larger and more

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<sup>18</sup> In addition to improving overall productivity, new products increases consumer utility in a “love of variety” model.

volatile than non-exporting firms. Sales of exporters are larger than the sales of non-exporters. We also find that product adding and firm entry behavior are highly cyclical.

In our estimates, we find that foreign demand increases the number of products. Government spending also has positive impacts on product innovation. When we focus on exporters, we find that the depreciation of the real effective exchange rate stimulates product innovation. This producer level behavior is consistent not only with the DJK model but also the recent Japanese experiences. As the Japanese population has gradually decreased, the foreign demand has more affected the Japanese innovative behavior than the domestic demand. Although the government spending partly affects product dynamics in Japanese firms, it does not recover the Japanese potential growth as in the 1990s, when the large fiscal stimulus did not solve the non-performing loans through the increase in economic growth. We also find that the depreciation in real effective exchange rate stimulates the Japanese economy in the Koizumi and the 2<sup>nd</sup> Abe cabinets, which is shown in our estimation results for exporters.

However, the effects of other aggregate variables are ambiguous. When we add firm-level TFP to our estimation, we find the relationship between product innovation and relative TFP is U-shaped. The result means that not only higher TFP firms but also lower TFP firms are aggressive in product innovation. These findings are consistent with Figure 2 where low productivity firms conduct product switching more aggressively than high productivity firms.

Our empirical results suggest that creative destruction of adding new products and dropping old products by incumbent firms is an important contributor to aggregate fluctuations, and much more important than the entry and exit of firms for business cycle fluctuations. This creative destruction of products is more active under favorable macroeconomic conditions of high total factor productivity, government spending and foreign demand, and a depreciated real exchange rate. To revitalize stagnant industrialized countries such as Japan's, it is important for the government to implement policies that raise aggregate productivity, government, and foreign demand, such as

improving education, research and development, and stimulating infrastructure and foreign direct investment and trade, in addition to reducing the structural obstacles that slow down the product innovation process.

## Appendix

We estimate a production function with multi products developed by De Loecker (2011) to obtain firm-level TFP. In his paper, the output at firm  $i$  ( $q_i$ ) depends on aggregate demand in industry  $k$  ( $Q_k$ ) and relative price ( $\frac{P_i}{P_k}$ ).

$$q_{it} = Q_{kt} \left( \frac{P_{it}}{P_{kt}} \right)^{\eta_s} \exp(\xi_{it}) \quad (\text{A-1})$$

In Equation (A-1),  $\xi_{it}$  is an unobservable demand shock and  $\eta$  is the elasticity of substitution.

From (A-1), the revenue function in firm  $i$  is

$$R_{it} = Q_{it}^{(\eta_s+1)/\eta_s} Q_{kt}^{1/\eta_s} P_{kt} \exp(\xi_{it})^{-1/\eta_s} \quad (\text{A-2}).$$

Assuming a production function of  $Q_{it} = L_{it}^{\alpha_l} M_{it}^{\alpha_m} K_{it}^{\alpha_k} \exp(\omega_{it} + u_{it})$  and log-linearizing

Equation (A-2), we obtain

$$\bar{r}_{it} (= r_{it} - p_{kt}) = \beta_l l_{it} + \beta_m m_{it} + \beta_k k_{it} + \beta_q q_{kt} + \omega_{it}^* + \xi_{it}^* + u_{it} \quad (\text{A-3}).$$

$L$  is labor input,  $M$  is intermediate input, and  $K$  is capital input.  $\omega$  is the productivity shock at firm  $i$ . Lower case letters represent the log values of upper case letters.

Assuming that production factors are allocated for the production of each product in

proportion to the output in each product, De Loecker leads to the following revenue function.

$$\bar{r}_{it} = \beta_n n_{it} + \beta_l l_{it} + \beta_m m_{it} + \beta_k k_{it} + \beta_q q_{kt} + \omega_{it}^* + \xi_{it}^* + u_{it} \quad (\text{A-4})$$

In Equation (A-4),  $n_i$  is the log of the number of products at firm  $i$ .<sup>19</sup>

We estimate Equation (A-4) by using two digit-level industry classifications.<sup>20</sup> Using estimated parameters, we measure productivity as follows,

$$\omega_{it} = (\bar{r}_{it} - \hat{\beta}_l l_{it} - \hat{\beta}_k k_{it} - \hat{\beta}_m m_{it} - \hat{\beta}_q q_{kt}) \left( \frac{\hat{\eta}_k}{\hat{\eta}_k + 1} \right) \quad (\text{A-5}).$$

The estimation results are shown in the Appendix table.

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<sup>19</sup> In the case that firm  $i$  produces multi products where each product belongs to different industries, Equation (A-4) becomes more complicated. However, as most Japanese firms produce multi products within one industry (two digit level), we focus on the estimation of Equation (A-4).

<sup>20</sup> Estimations were conducted by the Levinsohn=Petrin method.

## Appendix tables

	Food	Beverages, tobacco and feed	Textile products	Lumber and wood products	Furniture and fixtures	Pulp, paper and paper products	Printing and allied industries	Chemical and allied products
InL	0.237 *** 40.31	0.269 *** 13.97	0.399 *** 51.42	0.378 *** 27.07	0.411 *** 21.13	0.437 *** 18.11	0.428 *** 44.63	0.233 *** 17.51
InK	0.0943 *** 6.67	0.138 *** 3.7	0.0943 *** 4.98	-0.001 -0.04	0.0574 *** 4.25	0.0157 0.54	0.0686 *** 11.12	0.0825 *** 3.67
InM	0.488 *** 30.75	0.525 *** 11.46	0.366 *** 29.71	0.467 *** 12.8	0.451 *** 22.78	0.326 *** 8.34	0.354 *** 28.85	0.59 *** 13.65
number of product	-0.159 -0.7	0.0092 0.38	-0.0074 -0.35	-0.0307 ** -2.18	0.00505 0.26	0.00954 0.51	0.0108 0.52	0.0302 ** 2.26
Inq	0.0794 *** 3.37	-0.0161 -0.75	0.057 ** 2.14	0.00672 0.36	0.0112 0.56	-0.082 *** -3.04	0.237 *** 8.12	0.0139 0.62
Number of observations	91277	10512	47800	15123	12248	20438	34400	21708
Number of group	23725	3407	15519	5677	4562	5817	9984	5196

	Petroleum and coal products	Plastic products	Rubber products	Leather tanning, leather products and fur skins	Ceramic, stone and clay products	Iron and steel	Non-ferrous metals and products	Fabricated metal products
InL	0.17 *** 3.02	0.312 *** 32.11	0.354 *** 20.79	0.386 *** 17.9	0.316 *** 31.28	0.308 *** 23.64	0.304 *** 15.41	0.398 *** 63.18
InK	0.127 *** 3.53	0.069 *** 4.78	0.0389 ** 2.01	0.0442 1.38	0.0843 *** 3.68	0.0342 1.44	0.0285 1.25	0.0412 *** 3.18
InM	0.627 *** 13.74	0.45 *** 15.41	0.506 *** 19.74	0.473 *** 8.96	0.462 *** 15.27	0.575 *** 18.15	0.581 *** 26.37	0.41 *** 37.92
number of product	0.0187 0.84	0.00376 0.3	0.0159 0.79	-0.0195 -0.73	0.0149 0.83	0.00039 0.03	-0.0236 -1.23	-0.0369 * -1.83
Inq	0.0597 1.11	0.0224 1.09	0.0501 ** 2.1	0.012 0.42	0.0428 ** 2.27	0.0905 *** 4.16	-0.105 *** -3.28	-0.0074 -0.39
Number of observations	1463	38943	8170	3506	32887	16832	10246	63563
Number of group	546	12276	2495	1278	10918	5549	3530	22255

	General- purpose machinery	Production machinery	Business oriented machinery	Electronic parts, devices and electronic circuits	Electrical machinery, equipment and supplies	Information and communication electronics equipment	Transportation equipment	Miscellaneous manufacturing industries
InL	0.363 *** 32.57	0.348 *** 48.24	0.331 *** 22.35	0.367 *** 35.59	0.316 *** 31.11	0.363 *** 18.15	0.376 *** 38.24	0.342 *** 26.8
InK	0.0263 ** 2.19	0.0227 ** 2.12	0.0712 *** 2.75	0.0758 *** 4.04	0.0709 *** 3.42	0.0816 *** 4.01	0.0777 *** 3.86	0.0665 *** 2.61
InM	0.501 *** 28.1	0.53 *** 39.97	0.491 *** 18.23	0.432 *** 30.1	0.454 *** 21.51	0.433 *** 28.87	0.408 *** 17.29	0.447 *** 11.08
number of product	-0.0188 -1.34	-0.0239 *** -3.75	-0.003 -0.11	-0.0148 -0.7	0.00407 0.23	0.0378 * 1.84	-0.0133 -1.4	0.00093 0.04
Inq	0.0463 *** 3.24	0.0194 1.29	-0.0294 -0.69	-0.0826 ** -2.42	-0.0382 * -1.68	0.0142 0.98	0.00609 0.47	0.0588 ** 2.26
Number of observations	22965	48134	16507	23118	36593	12351	34040	16255
Number of group	8478	16600	5971	7375	12334	4701	10637	6200

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Table 1 An example of product classification

Sector		Industry		Product	
2-digit classification		4-digit classification		6-digit classification	
27	Electric machinery	2791	Storage batteries	279111	Lead storage batteries
				279112	Alkali storage batteries
				279113	Lithium ion batteries
				279114	Parts, attachments and accessories of storage batteries
				279191	Storage batteries, and parts, attachments and accessories ( piecework )

Table 2

Sector	Industries	Products	Industries/ Products	Goods Shipments (million yen)	Number of Employees	Shipments per Employees (million yen)
9 FOOD	41	87	2.1	23784327	1049968	22.7
10 BEVERAGES, TOBACCO AND FEED	13	31	2.4	9802268	91072	107.6
11 TEXTILE MILL PRODUCTS	64	177	2.8	3493573	257219	13.6
12 LUMBER AND WOOD PRODUCTS, EXCEPT FURNITURE	18	43	2.4	1824205	75766	24.1
13 FURNITURE AND FIXTURES	9	22	2.4	1402558	77669	18.1
14 PULP, PAPER AND PAPER PRODUCTS	15	52	3.5	6895796	177263	38.9
15 PRINTING AND ALLIED INDUSTRIES	7	19	2.7	5724091	262370	21.8
16 CHEMICAL AND ALLIED PRODUCTS	38	160	4.2	24096231	340916	70.7
17 PETROLEUM AND COAL PRODUCTS	5	18	3.6	10241165	21956	466.4
18 PLASTIC PRODUCTS, EXCEPT OTHERWISE CLASSIFIED	25	54	2.2	9669225	383831	25.2
19 RUBBER PRODUCTS	13	40	3.1	2577212	108561	23.7
20 LEATHER TANNING, LEATHER PRODUCTS AND FUR SKINS	9	30	3.3	328166	20288	16.2
21 CERAMIC, STONE AND CLAY PRODUCTS	44	101	2.3	6186607	223326	27.7
22 IRON AND STEEL	22	65	3.0	15751510	210931	74.7
23 NON-FERROUS METALS AND PRODUCTS	17	55	3.2	6847263	136256	50.3
24 FABRICATED METAL PRODUCTS	33	127	3.8	11383456	488184	23.3
25 GENERAL-PURPOSE MACHINERY	19	97	5.1	9604354	301692	31.8
26 PRODUCTION MACHINERY	26	127	4.9	11389401	474074	24.0
27 BUSINESS ORIENTED MACHINERY	23	84	3.7	6951459	206822	33.6
28 ELECTRONIC PARTS, DEVICES AND ELECTRONIC CIRCUITS	15	68	4.5	14819858	453435	32.7
29 ELECTRICAL MACHINERY, EQUIPMENT AND SUPPLIES	23	111	4.8	13485422	453686	29.7
30 INFORMATION AND COMMUNICATION ELECTRONICS EQUIPMENT	15	55	3.7	11427859	214300	53.3
31 TRANSPORTATION EQUIPMENT	16	66	4.1	46946916	923495	50.8
32 MISCELLANEOUS MANUFACTURING INDUSTRIES	32	114	3.6	3521578	132655	26.5

Note) We calculate these values of report by industry of the 2009 census.

Table 3 Summary of statistics

	Obs	Mean	Std. Dev.	Min	Max
Number of products (N)	2703406	1.707	1.251	1.000	108.000
Change of number of products between t, t-1 ( $\Delta N$ )	2298430	0.000	0.547	-30.000	23.000
Industry-level TFP (lnZ)	2703406	0.169	0.146	-0.175	1.499
Log of foreign demand (ln FD)	2703406	13.816	0.306	12.826	14.362
Log of government expenditure (ln G)	2702998	4.959	4.785	0.000	13.760
Log of real effective exchange rate (ln REER)	2703409	1.015	8.501	-21.545	28.963
Davis-Haltiwanger-Schuh index	2298430	0.000	0.226	-1.852	1.840
Firm level relative TFP	639079	0.000	0.417	-5.147	4.028

Table 4-1

Dependent variable:  $\Delta$ number of products

	All firms	All firms	All firms	All firms	All firms	All firms
	Fixed effects (AR1)			IV		
<b>lnFD(t-1)</b>	0.159 *** 7.74	0.166 *** 8.05	0.152 *** 7.20	0.165 *** 7.97	0.173 *** 8.33	0.140 *** 6.57
<b>lnG(t-1)</b>	0.028 *** 8.80	0.031 *** 9.57	0.030 *** 9.26	0.036 *** 9.96	0.039 *** 10.47	0.037 *** 9.83
<b>lnZ(t-1)</b>		-0.047 *** -5.18	-0.046 *** -4.99		-0.050 *** -4.81	-0.045 *** -4.23
<b>lnREER(t-1)</b>			-0.168*e-3 *** -3.070			-0.397*e-3 *** -6.940
<b>Num of Products(t-1)</b>	-0.808 *** -1062.63	-0.808 *** -1062.64	-0.808 *** -1062.60	-0.496 *** -83.45	-0.496 *** -83.48	-0.496 *** -83.46
<b>Sample Size</b>	1941729	1941729	1941729	1899754	1899754	1899754
<b>Number of Groups</b>	310112	310112	310112	267550	267550	267550
<b>R2(within)</b>	0.409	0.409	0.409			
<b>R2(between)</b>	0.003	0.003	0.003			
<b>R2(overall)</b>	0.038	0.038	0.038			
<b>F statistics</b>	376512.20	282394.60	225908.80	2422.70	1829.60	1476.80
	0.00	0.00	0.00			
<b>Log likelihood</b>	-904643.10	-904627.00	-904619.00	-881963.80	-881948.40	-881922.60

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 4-2

Dependent variable:  $\Delta$ number of products

	Exporters	Exporters	Exporters	Exporters	Exporters	Exporters
	Fixed effects (ARI)			IV		
<b>lnFD(t-1)</b>	1.079 *** 4.66	1.075 *** 4.63	1.543 *** 5.33	0.010 0.05	0.021 0.10	0.054 0.22
<b>lnG(t-1)</b>	-0.012 -0.32	-0.012 -0.32	-0.005 -0.12	-0.053 -1.43	-0.053 -1.42	-0.052 -1.39
<b>lnZ(t-1)</b>		0.019 0.24	0.004 0.06		-0.036 -0.51	-0.039 -0.54
<b>lnREER(t-1)</b>			0.002 *** 2.70			0.197*e-3 0.270
<b>Num of Products(t-1)</b>	-0.632 *** -101.93	-0.632 *** -101.93	-0.633 *** -101.95	-0.491 *** -8.64	-0.491 *** -8.64	-0.491 *** -8.64
<b>Sample Size</b>	31183	31183	31183	38112	38112	38112
<b>Number of Groups</b>	8515	8515	8515	8088	8088	8088
<b>R2(within)</b>	0.314	0.314	0.315			
<b>R2(between)</b>	0.022	0.022	0.022			
<b>R2(overall)</b>	0.023	0.023	0.023			
<b>F statistics</b>	3464.10	2598.10	2080.50	24.87	18.82	15.06
	0.00	0.00	0.00			
<b>Log likelihood</b>	-22572.40	-22572.70	-22567.70	-27794.60	-27794.50	-27794.60

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 5-1

Dependent variable:  $(N(t)-N(t-1))/(N(T)+N(t-1))/2$ 

	All firms	All firms	All firms	All firms	All firms	All firms
	Fixed effects (AR1)			IV		
<b>lnFD(t-1)</b>	<b>0.006 ***</b> 39.52	<b>0.006 ***</b> 39.99	<b>0.006 ***</b> 40.01	<b>0.001 ***</b> 4.21	<b>0.001 ***</b> 4.42	<b>0.001 ***</b> 2.83
<b>lnG(t-1)</b>	<b>0.668*e-4 ***</b> 2.53	<b>0.465*e-4 *</b> 1.75	<b>0.464*e-4 *</b> 1.74	<b>0.829*e-5</b> 0.23	<b>0.467*e-5</b> 0.13	<b>0.359*e-5</b> 4.96
<b>lnZ(t-1)</b>		<b>-0.004 ***</b> -6.90	<b>-0.004 ***</b> -6.92		<b>-0.001</b> -1.09	<b>-0.001</b> -0.80
<b>lnREER(t-1)</b>			<b>-0.243*e-4 ***</b> 3.87			<b>-0.284*e-4 ***</b> -4.47
<b>Num of Products(t-1)</b>	<b>-0.032 ***</b> -319.80	<b>-0.032 ***</b> -319.83	<b>-0.032 ***</b> -319.84	<b>-0.026 ***</b> -32.96	<b>-0.026 ***</b> -32.97	<b>-0.026 ***</b> -32.96
<b>Sample Size</b>	1704935	1704935	1704935	1694912	1694912	1694912
<b>Number of Groups</b>	297062	297062	297062	259496	259496	259496
<b>R2(within)</b>	0.068	0.068	0.068			
<b>R2(between)</b>	0.002	0.002	0.002			
<b>R2(overall)</b>	0.006	0.006	0.006			
<b>F statistics</b>	34164.10	25635.80	20511.00	366.50	279.40	228.00
	0.00	0.00	0.00			
<b>Log likelihood</b>	3104218.60	3104247.30	3104265.50	3070693.60	3070694.70	3070705.80

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 5-2

Dependent variable:  $(N(t)-N(t-1))/(N(T)+N(t-1))/2$ 

	Exporters	Exporters	Exporters	Exporters	Exporters	Exporters
	Fixed effects (AR1)			IV		
<b>lnFD(t-1)</b>	0.005 *** 3.31	0.005 *** 3.67	0.006 *** 3.91	-0.008 ** -2.28	-0.007 * -1.93	-0.009 * -2.22
<b>lnG(t-1)</b>	0.345*e-03 1.50	0.413*e-03 1.35	0.382*e-03 1.24	0.421*e-03 1.18	0.416*e-03 1.16	0.412*e-03 1.15
<b>lnZ(t-1)</b>		-0.012 * -1.77	-0.011 -1.57		-0.003 -0.35	-0.002 -0.31
<b>lnREER(t-1)</b>			0.140*e-03 1.56			-0.122*e-03 -0.32
<b>Num of Products(t-1)</b>	-0.035 *** -46.75	-0.035 *** -46.78	-0.035 *** -46.81	-0.023 *** -5.44	-0.023 *** -5.45	-0.023 *** -5.45
<b>Sample Size</b>	26960	26960	26960	33546	33546	33546
<b>Number of Groups</b>	7864	7864	7864	7516	7516	7516
<b>R2(within)</b>	0.103	0.103	0.103			
<b>R2(between)</b>	0.017	0.017	0.017			
<b>R2(overall)</b>	0.010	0.010	0.010			
<b>F statistics</b>	729.20	547.70	438.90	10.41	8.01	6.52
	0.00	0.00	0.00			
<b>Log likelihood</b>	39933.20	39935.40	39935.50	48202.40	48202.60	48204.40

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 6-1

Dependent variable:  $\Delta$ number of products

	All firms	Exporters	All firms	Exporters
	Fixed effects (AR1)		IV	
<b>relativeTFP(t-1)</b>	<b>-0.024 ***</b>	<b>-0.018</b>	<b>-0.021 ***</b>	<b>-0.106 ***</b>
	<b>-6.19</b>	<b>-0.72</b>	<b>-5.13</b>	<b>-3.91</b>
<b>relative TFP(t-1)*2</b>	<b>0.018 ***</b>	<b>0.025</b>	<b>0.015 ***</b>	<b>0.092 ***</b>
	<b>4.92</b>	<b>0.94</b>	<b>3.97</b>	<b>3.56</b>
<b>lnZ(t-1)</b>	<b>-0.047 ***</b>	<b>-0.199 ***</b>	<b>-0.035 **</b>	<b>-0.077</b>
	<b>-3.18</b>	<b>-2.65</b>	<b>-2.36</b>	<b>-1.25</b>
<b>lnFD(t-1)</b>	<b>0.097 ***</b>	<b>0.181 ***</b>	<b>0.015 ***</b>	<b>0.092 ***</b>
	<b>127.38</b>	<b>23.43</b>	<b>3.97</b>	<b>3.56</b>
<b>lnG(t-1)</b>	<b>0.003 ***</b>	<b>0.007 ***</b>	<b>-0.002</b>	<b>-0.211 ***</b>
	<b>5.23</b>	<b>2.28</b>	<b>-0.34</b>	<b>-5.72</b>
<b>lnREER(t-1)</b>	<b>0.001 ***</b>	<b>0.002 ***</b>	<b>-0.145e*-3</b>	<b>-0.002 ***</b>
	<b>4.21</b>	<b>1.46</b>	<b>-0.93</b>	<b>-2.61</b>
<b>Num of Products(t-1)</b>	<b>-0.691 ***</b>	<b>-0.656 ***</b>	<b>-0.367 ***</b>	<b>-0.428 ***</b>
	<b>-383.66</b>	<b>-75.07</b>	<b>36.61</b>	<b>-9.57</b>
<b>Sample Size</b>	<b>416517</b>	<b>17921</b>	<b>390511</b>	<b>22200</b>
<b>Number of Groups</b>	<b>126098</b>	<b>4978</b>	<b>91366</b>	<b>4821</b>
<b>R2(within)</b>	<b>0.339</b>	<b>0.306</b>		
<b>R2(between)</b>	<b>0.019</b>	<b>0.029</b>		
<b>R2(overall)</b>	<b>0.030</b>	<b>0.022</b>		
<b>F statistics</b>	<b>21293.40</b>	<b>816.30</b>	<b>261.30</b>	<b>31.44</b>
	<b>0.000</b>	<b>0.000</b>		
<b>Log likelihood</b>	<b>-164376.80</b>	<b>-9809.40</b>	<b>-161903.80</b>	<b>-12407.50</b>

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 6-2

Dependent variable:  $(N(t)-N(t-1))/(N(T)+N(t-1))/2$ 

	All firms	Exporters	All firms	Exporters
	Fixed effects (AR1)		IV	
relativeTFP(t-1)	-0.002 -3.82	-0.005 -1.94	-0.002 *** -4.41	-0.01 *** -2.96
relative TFP(t-1)*2	-0.229e*-3 -0.53	0.018 *** 6.58	0.110e*-3 0.26	0.012 *** 2.72
lnZ(t-1)	-0.006 *** -3.62	-0.024 *** -2.68	-0.003 * -1.69	-0.005 -0.59
lnFD(t-1)	0.006 *** 41.03	0.009 *** 6.43	-0.300e*-3 -0.52	-0.018 ** -2.39
lnG(t-1)	0.810e*-4 1.16	0.114e*-3 -0.29	-0.517e*-4 -0.66	0.528e*-3 -1.31
lnREER(t-1)	0.280e*-4 1.62	0.170e*-3 1.57	-0.125e*-4 -0.68	0.149e*-3 -1.54
Num of Products(t-1)	-0.033 *** -145.83	-0.037 *** -37.2	-0.022 *** -18.93	-0.018 *** -5.71
Sample Size	370625	16132	349399	20198
Number of Groups	116664	4673	82655	4535
R2(within)	0.078	0.109		
R2(between)	0.011	0.028		
R2(overall)	0.010	0.014		
F statistics	3066.8	200.3	69.31	6.829
	0	0		
Log likelihood	673734.50	25473.70	625536.50	30877.10

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 7-1

Dependent variable:  $\Delta$ number of products

	All firms	All firms	Exporters	Exporters
	Fixed effects (AR1)		Fixed effects (AR1)	
FDshock(t-1)	0.166 *** 8.05	0.152 *** 7.20	1.075 *** 4.63	1.543 *** 5.33
Gshock(t-1)	0.031 *** 9.57	0.030 *** 9.26	-0.012 -0.32	-0.005 -0.12
sectoral TFP shock(t-1)	-0.047 *** -5.18	-0.046 *** -4.99	0.019 0.24	0.004 0.06
REER shock (t-1)		-0.168*e-3 *** -3.070		0.002 *** 2.70
Num of Products(t-1)	-0.808 *** -1062.64	-0.808 *** -1062.60	-0.632 *** -101.93	-0.633 *** -101.95
Sample Size	1941729	1941729	31183	31183
Number of Groups	310112	310112	8515	8515
R2(within)	0.409	0.409	0.314	0.315
R2(between)	0.003	0.003	0.022	0.022
R2(overall)	0.038	0.038	0.023	0.023
F statistics	282394.60	225908.80	2598.10	2080.50
	0.00	0.00	0.00	0.00
Log likelihood	-904627.00	-904619.00	-22572.70	-22567.70

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 7-2

Dependent variable:  $(N(t)-N(t-1))/(N(T)+N(t-1))/2$ 

	All firms	All firms	Exporters	Exporters
	Fixed effects (AR1)		Fixed effects (AR1)	
<b>FDshock(t-1)</b>	<b>0.019 ***</b>	<b>0.019 ***</b>	<b>0.045</b>	<b>0.116 ***</b>
	<b>8.42</b>	<b>7.97</b>	<b>1.55</b>	<b>3.06</b>
<b>Gshock(t-1)</b>	<b>0.002 ***</b>	<b>0.002 ***</b>	<b>0.004</b>	<b>0.006</b>
	<b>4.56</b>	<b>4.45</b>	<b>0.88</b>	<b>1.21</b>
<b>sectoral TFP shock(t-1)</b>	<b>-0.004 ***</b>	<b>-0.003 ***</b>	<b>-0.001</b>	<b>-0.004</b>
	<b>-3.29</b>	<b>-3.21</b>	<b>-0.13</b>	<b>-0.35</b>
<b>REER shock (t-1)</b>		<b>-0.543*e-4 ***</b>		<b>0.334*e-03 ***</b>
		<b>-0.850</b>		<b>2.94</b>
<b>Num of Products(t-1)</b>	<b>-0.031 ***</b>	<b>-0.031 ***</b>	<b>-0.034 ***</b>	<b>-0.034 ***</b>
	<b>-317.11</b>	<b>-317.10</b>	<b>-46.57</b>	<b>-46.62</b>
<b>Sample Size</b>	<b>1705235</b>	<b>1705235</b>	<b>26960</b>	<b>26960</b>
<b>Number of Groups</b>	<b>297095</b>	<b>297095</b>	<b>7864</b>	<b>7864</b>
<b>R2(within)</b>	<b>0.067</b>	<b>0.067</b>	<b>0.102</b>	<b>0.103</b>
<b>R2(between)</b>	<b>0.002</b>	<b>0.002</b>	<b>0.017</b>	<b>0.017</b>
<b>R2(overall)</b>	<b>0.006</b>	<b>0.006</b>	<b>0.010</b>	<b>0.010</b>
<b>F statistics</b>	<b>25172.70</b>	<b>20137.20</b>	<b>544.00</b>	<b>437.10</b>
	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Log likelihood</b>	<b>3103610.10</b>	<b>3103625.60</b>	<b>39928.00</b>	<b>39934.00</b>

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Table 8

Deapnedenta variable	Anumber of products		Davis=Haltiwanger index	
	All firms	Exporters	All firms	Exporters
	FE(AR1)	FE(AR1)	FE(AR1)	FE(AR1)
relativeTFP(t-1)	-0.683 ***	-0.068 ***	-0.003 ***	-0.007 ***
	-17.57	-2.62	-7.28	-1.94
relative TFP(t-1)*2	0.069 ***	0.646 ***	0.001 ***	0.019 ***
	18.86	2.39	2.83	6.58
sectoral TFP shock(t-1)	0.006	0.107	0.823e*-5	-0.006
	0.33	1.30	0.00	-0.49
FDshock(t-1)	2.327 ***	1.651 ***	0.071 ***	0.13 ***
	43.47	4.94	10.97	2.83
Gshock(t-1)	-0.287 ***	-0.007	-0.012 ***	0.002
	-38.98	-0.16	-13.45	0.40
REER shock (t-1)	0.004 ***	0.001	0.733e*-4 ***	0.330e*-3 ***
	28.92	1.46	4.06	2.43
Num of Products(t-1)	-0.615 ***	-0.592 ***	-0.031 ***	-0.037 ***
	-352.12	-69.66	-139.97	-36.7
Sample Size	416798	17921	370870	16132
Number of Groups	126154	4978	116719	4673
R2(within)	0.302	0.276	0.072	0.106
R2(between)	0.019	0.029	0.011	0.028
R2(overall)	0.030	0.022	0.010	0.014
F statistics	17953.90	704.40	2823.9	184.9
	0.000	0.000	0	0
Log likelihood	-175836.00	-10202.30	672997.30	25453.40

The lower cell in each estimation result shows t-value.

Standard errors are expressed in parentheses. \*, \*\*, and \*\*\* show significance at 10%, 5%, and 1% levels, respectively.

Figure 1. Decomposition of shipment change

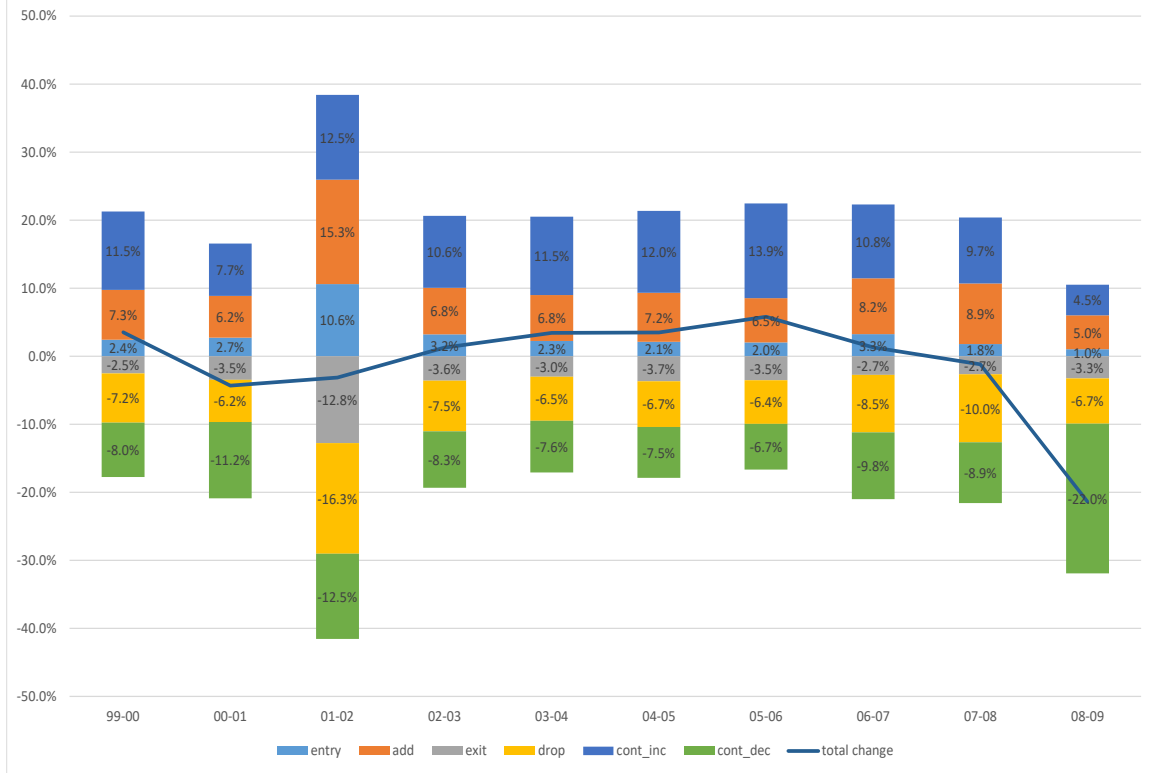


Figure2-1. Decomposition of shipment change (high productivity firms)

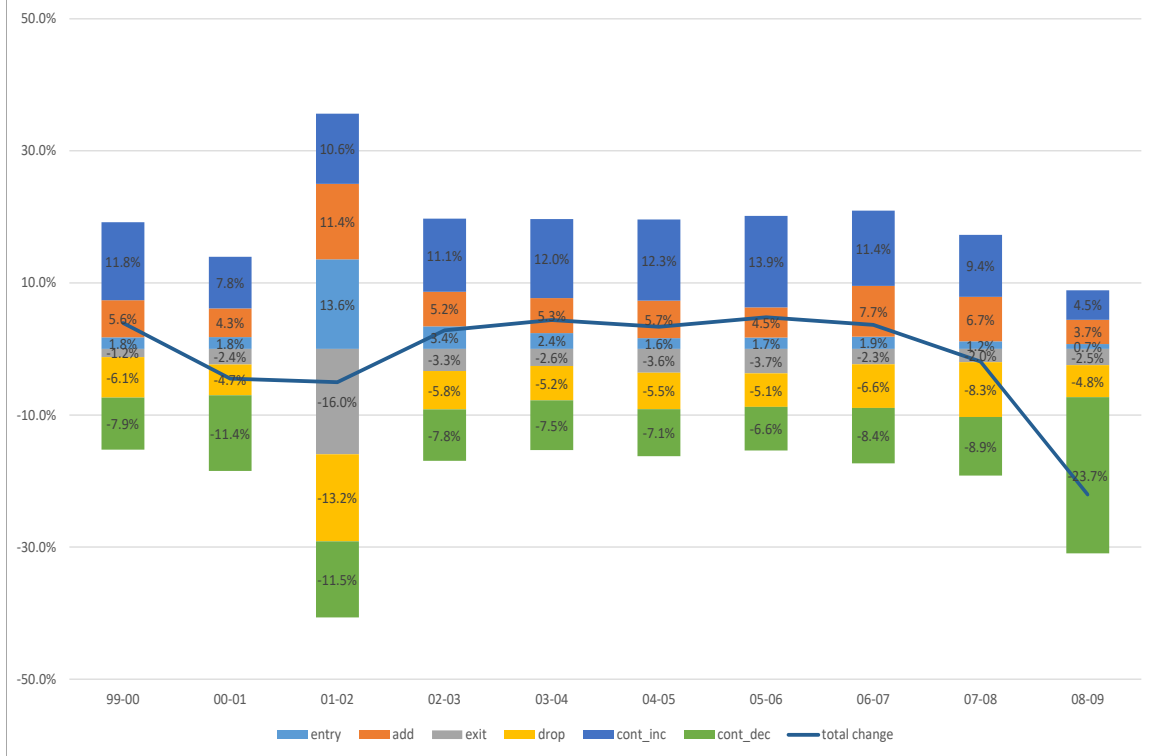


Figure 2-2. Decomposition of shipment change (low productivity firms)

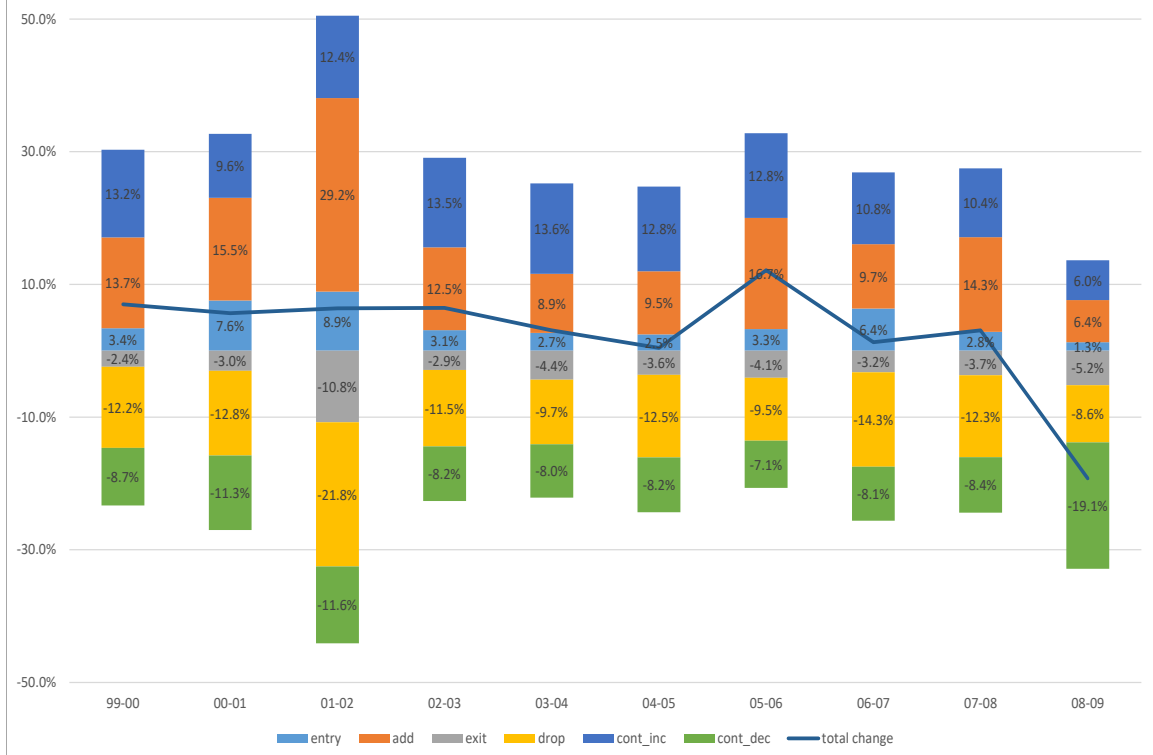
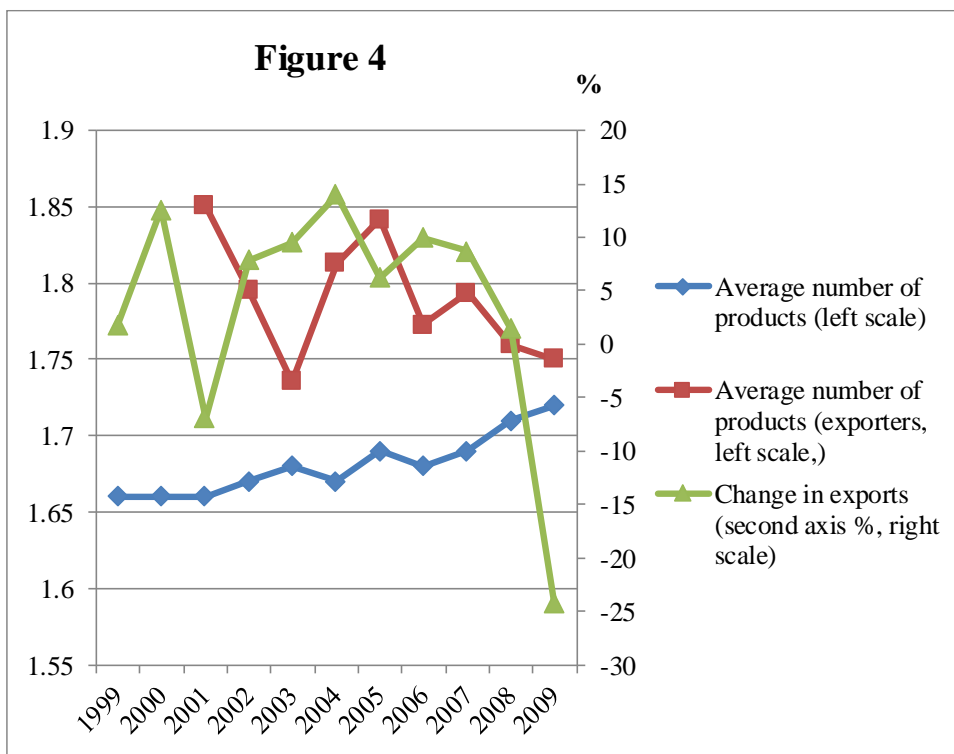
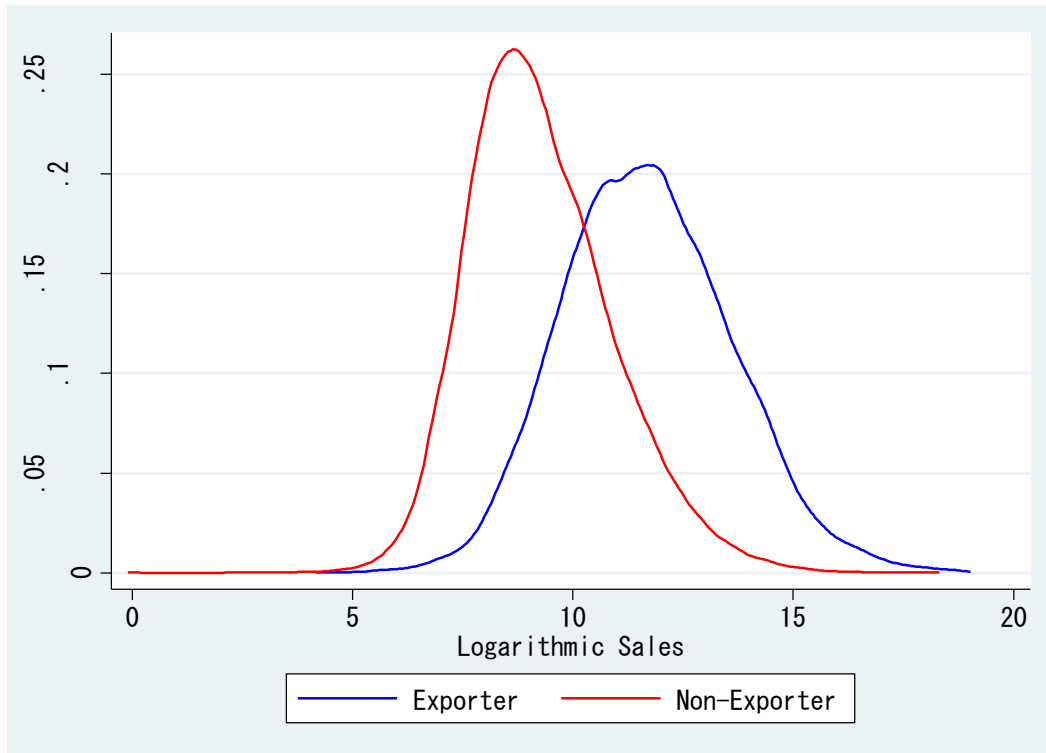
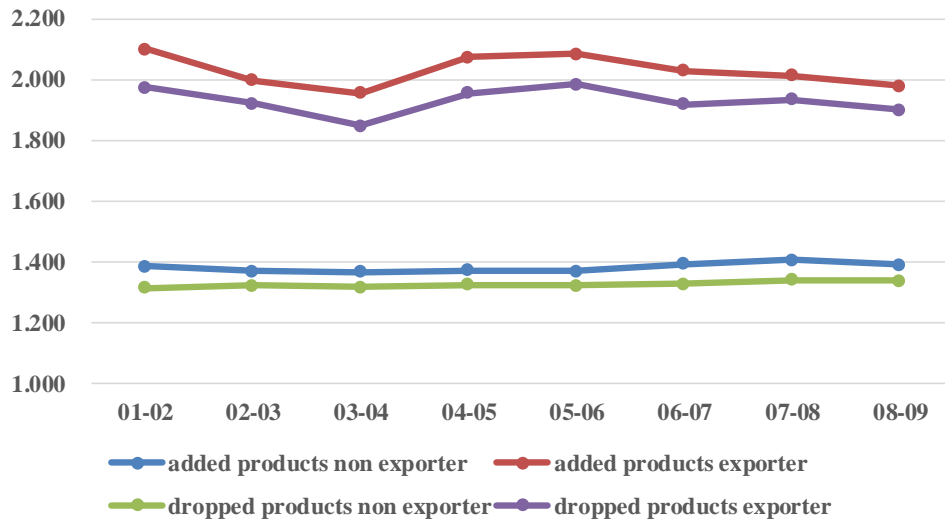


Figure 3



**Figure 5 Number of added and dropped products**



**Figure 6**

