

# Firm reactions to extreme weather and implications for policy design

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## Abstract

Climate change and extreme weather events are a global problem but especially affect poor countries, including non-agricultural firms in these countries. Weather shocks may affect these firms through both a demand and supply channel. Depending on which channel dominates, firm reactions to the shocks differ, and understanding these reactions can help in designing better policy to reduce the impact of climate change on poor countries. I combine firm-level World Bank data with high-resolution weather data, using year-to-year weather variation to identify the effect of weather shocks. I show that weather shocks are primarily supply shocks, affecting non-agricultural firms across sub-Saharan Africa and South Asia by reducing their productivity. I then show that firms react to these shocks by scaling back their expenditures on productive capability, hiring less machinery, less office space and fewer non-production workers. These reactions further reduce firm productivity. I develop a simple international trade model featuring hired productive capability that includes this channel. Combining the model with machine learning estimates of the impact of climate change, I highlight the importance of productivity reactions for policy design: Productivity responses make trade cost reductions 1.4 times more effective at countering welfare losses from climate change, compared to a model without these responses.

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Climate change and extreme weather events are a global problem but especially affect poor countries. While there is an extensive literature on the effects of extreme weather on agricultural production in poor countries, we know relatively little about the effects of weather shocks on non-agricultural firms in these countries. We do know that weather affects non-agricultural firms, with extreme temperatures decreasing their sales, and that this effect can operate both through a demand channel, by reducing local demand, and through a supply channel, by decreasing firm productivity (Adhvaryu, Kala, & Nyshadham, 2019; Costinot, Donaldson, & Smith, 2016; Nath, 2020; Santangelo, 2019; Somanathan, Somanathan, Sudarshan, & Tewari, 2021; Zhang, Dêschenes, Meng, & Zhang, 2018). We do not yet, however, have a good understanding of firm reactions to these shocks. Understanding firm reactions, and how we can leverage these reactions in policy design, could significantly improve our ability to help poor countries cope with the impact of climate change.

In this paper, I show that firms react to weather shocks by endogenously adjusting their productivity and that these reactions are quantitatively important for policy design. I combine World Bank data on firms across Africa and South Asia with global weather data sets and projections of future weather, using well-identified reduced form regressions to quantify the effects of weather shocks on non-agricultural firms, and the firms' reactions. I then develop and estimate a model of international trade capturing key reduced form relationships. Finally, I combine the model with machine learning estimates of the effect of climate change on firms to highlight the importance of firm productivity reactions for policy design.

My argument proceeds in five steps. First, I use World Bank Enterprise Surveys data combined with high-resolution weather data to test whether, across sub-Saharan Africa and South Asia, weather shocks are predominantly supply or demand shocks. (Knowing whether firms are facing supply or demand shocks is a necessary first step for understanding their reaction, since firms would react to both types of shocks differently.) The test I use is based on a basic open economy intuition about exporters: They are somewhat insulated from local demand shocks, but less able to pass on marginal cost increases to their international buyers, and thus more exposed to supply shocks. I regress log sales on a temperature index combining mean temperature, temperature variance the number of days with temperatures exceeding 32°C (89.6°F), using location fixed effects to isolate random year-to-year weather variation, and check whether exporters see a smaller or larger effect on sales. I find that negative weather shocks have a significantly larger relative impact on exporters' total sales than on purely domestically active firms' total sales: An 80<sup>th</sup> percentile weather shock

decreases non-exporters' sales by 3.9 percent, but exporters' sales by 6.9 percent. For comparison, these effect sizes are similar in size to the effects of ethnic conflict on Kenyan flower packers' or mobile phone access on Indian fishers' output, for example (Hjort, 2014; Jensen, 2007). The key takeaway is that exporters are more affected by extreme weather; this implies that weather is, on net, a supply shock for these firms, rather than a local demand shock.

Second, I turn to firm reactions to the shock. Since weather shocks are supply shocks, I first test for a basic characteristic of the production structure firms face: I assess whether they operate under constant returns to scale. To do this, I check whether exporters also see a larger impact of weather shocks on domestic sales. I find that this is the case, suggesting that a firm's performance in one market affects its performance in other markets. The key question is, where does that link come from?

I argue that it is due to a key firm reaction to the shock: adjusting spending on *productive capability*. Productive capability comprises rented or hired equipment, facilities and non-production personnel. For example, it includes rented machinery, rented office space or a sales team. Productive capability improves overall performance across all markets a firm is active in, by increasing labor productivity (through providing workers with sufficient equipment or space) or by making it easier to sell the firm's output — it lowers the cost of providing the firm's products across all markets the firm serves. Faced with higher temperatures, firms scale back expenditures on productive capability, since these kinds of productivity-enhancing expenditures are complementary to firm productivity. I see this reaction in the data: In response to an 80<sup>th</sup> percentile weather shock, domestic producers reduce their expenditure on productive capability by 2.9 percent, while exporters reduce their expenditure by 6.7 percent. A mediation analysis shows that controlling for productive capability, fully interacted with exporter status and the temperature index, removes the differential impact on exporters' domestic sales. This provides strong evidence that productive capability is causing the market linkage. (I also run a battery of robustness check showing that the differential impact is not due to well-known differences between exporter and non-exporters, such as the sectors they are active in, firm size, or the complexity of their production process.)

Third, based on these reduced form results and adapting the basic framework of Hyun and Kim (2022), I develop an international trade model that features one simple addition to Melitz (2003) — allowing firms to hire productive capability. The model immediately generates the patterns I observe in the data: In reaction to a negative productivity shock, firms scale back productive capability expenditures, reducing their productivity and therefore their sales across all markets they

are active in. The effect is larger for exporters, because exporters may no longer want to incur the cost of trading with some of their export destinations. When they exit those markets, they see a discontinuous fall in total sales and productive capability, which then leads to a discontinuous fall in sales to the domestic market. Adding productive capability makes the model computationally more challenging, since firms' decisions to enter various markets are no longer independent: If a firm enters a new market, the additional demand it can now reach makes it worthwhile to hire additional productive capability, which in turn can make it profitable to enter additional markets. The usual approach to this kind of problem is to find bounds on the set of active markets and check all possible combinations of markets between the bounds (Antràs, Fort, & Tintelnot, 2017; Jia, 2008). I show that in my setting, I can find tighter and computationally more efficient bounds on the set of active markets. I also develop a novel and efficient algorithm for finding the optimal set of markets when the lower and upper bound do not coincide. Instead of searching over all possible combinations of markets between the bounds, which for some firms is a very high dimensional combinatorial problem, I invert the problem. I find bounds on the optimal productive capability the firm hires and do a grid search across productive capability between those bounds. Finally, while the model remains computationally more burdensome than a standard Melitz (2003) model, I show that it can be readily estimated using novel small open economy methods (Bartelme, Lan, & Levchenko, 2023; Demidova, Naito, & Rodríguez-Clare, 2022). I use Zambia as a small open economy, and am able to estimate large parts of the model using reduced form approaches, which reduces the complexity of the estimation considerably without sacrificing key insights from the model. I find that the estimated model matches targeted and non-targeted moments well.

Fourth, I then turn to estimating the causal effect of climate change, based on an array of high-resolution weather projections covering a range of climate change scenarios. I use the causal forest (CF) algorithm (Athey, Tibshirani, & Wager, 2019) to estimate the average firm's change in sales under different climate scenarios. CFs are especially well suited to this high dimensional, inherently out of sample exercise. The estimation uses a wide range of temperature and precipitation measures, including averages, variances and day counts for temperature and precipitation; an important feature of CFs is that they perform well even with such a large selection of right hand side variables. I incorporate adaptation to climate change into the estimation by also including long-term means and variances of all weather measures. I take uncertainty about future climate into account, estimating the impact of climate change on firms under three different climate change scenarios and combining predictions from 27 different climate models for each scenario. Under a

severe climate change scenario, I estimate that the average firm faces an almost eleven percent decrease in sales by the late 2080s. Even under a mild scenario, I find that the average firm’s sales would drop by over six percent.

Finally, I combine these projections with the model to calibrate a counterfactual baseline scenario under climate change, matching the estimated impact on the average firm to a shift of the productivity distribution. I conduct trade policy experiments based on this scenario, comparing my model’s results to a modified version shutting down firm productivity reactions. I show that trade policy is markedly more effective when I take productive capability reactions into account: The welfare impact of a ten percent reduction in variable trade cost is 1.4 times larger due to these productivity responses. This effect is strongest for firms in countries with smaller domestic markets, where purely domestic producers do not find large productive capability expenditures worthwhile, but access to large foreign markets warrants considerable increases in productive capability. My findings are especially relevant as richer countries consider onshoring and consciously shortening their supply chains (Goldberg & Reed, 2023). I highlight that such policies can have especially negative consequences for poor countries and should be well-targeted to avoid collateral damage.

I contribute to the literature on the impact of climate change on poor countries, especially its impact on firms and trade (e.g., Conte, 2022; Costinot et al., 2016; Nath, 2020; Santangelo, 2019; Somanathan et al., 2021; Zhang et al., 2018). I add two important stylized facts to this literature, namely that weather is, on net, a supply rather than a demand shock, and that non-agricultural firms in poor countries react to weather shocks by adjusting their productive capability. I show that this means trade policy can increase firm productivity, because improved access to foreign markets makes it worthwhile for firms to invest in additional productive capability. Since climate change decreases firm productivity, trade policy can directly counteract its effects. Existing studies have conceptualized weather shocks as either demand (Santangelo, 2019) or supply shocks (Nath, 2020; Somanathan et al., 2021; Zhang et al., 2018) for firms, but have not tried to assess which of the two dominates. Knowing that weather is, on net, a supply issue is helpful because firm reactions to either kind of shock can differ. Additionally knowing that firms react by adjusting their productive capability, and thus endogenously changing their productivity, helps model firm responses to climate change. I provide a tractable way of doing this which, in turn, can inform policy design around leveraging firm responses to climate change. For example, this suggests that reducing trade cost raises firm productivity and thus directly counteracts some of the negative effects of climate change.

I further contribute to the broader literature on estimating the effects of weather shocks and

climate change (e.g., Auffhammer, Hsiang, Schlenker, & Sobel, 2013; Burke & Emerick, 2016; Burke, Hsiang, & Miguel, 2015; Burke & Tanutama, 2019; Carleton & Hsiang, 2016; Carleton et al., 2022; Dell, Jones, & Olken, 2012; Deschênes & Greenstone, 2007, 2011; Lin, Schmid, & Weisbach, 2019; Nath, 2020; Ortiz-Bobea, 2021; Somanathan et al., 2021; Zhang et al., 2018), highlighting a novel approach to estimation using CFs (Athey et al., 2019). These are especially well-suited to the problem, since they can easily handle high-dimensional weather data and are optimized for out of sample performance (future climate change is necessarily out of sample). Not having to pick specific weather measures to keep estimation feasible or tractable reduces the risk of results depending on the inclusion of a specific weather variable. The CF relates current outcomes to current weather data and estimates the causal effect of moving to a new set of weather realizations, for example drawn from a future climate. Results can then easily be summarized as the average change in outcomes under the new climate.

The closest paper to mine is Nath (2020), who shows that under climate change, labor is drawn into agriculture, because countries need to grow sufficient food to feed their population. This labor reallocation is inefficient, because climate change especially reduces agricultural productivity. Improved trade policy allows countries to import more food and to operate closer to an efficient allocation of labor, reducing overall damages from climate change. My paper is different, since I focus on firm-level reactions to extreme weather rather than aggregate reallocations. I also use a different approach to estimating the effects of climate change, turning to causal forests, which I argue are especially well-suited to this task. Nevertheless, my paper is complementary to Nath (2020). His model does not feature the endogenous productivity reactions I find in the data and include in my model. I, on the other hand, abstract away from agricultural production. One could combine his and my model and have both channels operate at the same time, which would lead to an even larger role for trade policy in reducing the impact of climate change. Not only would reduced trade costs allow countries to shift labor into manufacturing and services, as he shows, but they would also allow firms in those sectors to recoup some of the productivity lost to climate change, as I show. This, in turn, would lead to additional labor being drawn into these more efficient sectors, further reinforcing the effect.

The rest of the paper is organized as follows: Section 1 describes the data I use. Section 2 presents motivating evidence, showing that weather acts as a net supply shock, highlighting the importance of productivity responses, and ruling out alternative explanations and informing my modeling choices. Section 3 lays out an international trade model informed by my reduced form

results, which can generate the pattern I see in the data using a parsimonious mechanism: firms are able to hire productive capability, such as machinery, office space, or a sales team. Section 4 estimates the causal impact of climate change on firms, taking seriously the challenges involved in this, including the high dimensionality of weather data, the inherently out of sample nature of the problem and firm adaptation to climate change. Section 5 combines the climate change results with the model, presenting counterfactual simulations that show how productivity reactions increase the effectiveness of, for example, trade policy at counteracting some of the negative effects of climate change. Section 6 summarizes my main findings and concludes.

# 1 Data

## 1.1 Firm data: World Bank Enterprise Surveys

For data on firm outcomes and characteristics I use the World Bank Enterprise Surveys (ES).<sup>1</sup> The ES data include formal companies with at least five employees in the manufacturing and service sectors. Interviews cover specific fiscal years; I obtained meta data from the World Bank that allow me to fill in fiscal year dates where they are missing in the ES data. I use the harmonized data set provided by the World Bank, comprised of surveys between 2006 and 2020, and combine this with location data provided to me by the ES unit in the World Bank. For firms that lack location data, I further use information on the city, state and country the firm is located in to geocode the firm’s location, using three different web services (OpenStreetMap, GeoNames and Google Maps) accessible via `Python`.

Table 1 shows basic summary statistics for firms across sub-Saharan Africa and South Asia; Figure 1 shows the locations of all firms across sub-Saharan Africa and South Asia. I focus on these two regions for two reasons. First, they contain the countries on Earth with the highest fraction of people living in absolute poverty and the largest number of people living in absolute poverty. As climate change stands to be especially damaging to these regions (Costinot et al., 2016), mitigation policy needs to take into account how their economies work. Second, my main argument is most relevant to countries with relatively small domestic markets compared to world markets — relatively poor countries. The ES data for sub-Saharan Africa and South Asia cover many of the poorest countries on Earth.

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<sup>1</sup> More information on the ES data and how to access them is available at <https://www.enterprisesurveys.org/>

## 1.2 Weather data: CHIRPS and Berkeley Earth

I use precipitation data from the Climate Hazards Group InfraRed Precipitation with Stations (CHIRPS) data set (Funk et al., 2015).<sup>2</sup> CHIRPS is a global, daily, high resolution (0.05° grid) precipitation data set going back to 1981. I combine these with daily maximum temperature data from the Berkeley Earth (BKE) data set (Rohde et al., 2013).<sup>3</sup> These data are at a lower resolution (1° grid) but cover recent years, which is important since my most recent data points come from 2020. Figure 2 shows daily maximum temperature on April 24, 1991, to illustrate the resolution of the temperature data.

Since the World Bank provides firm locations that are slightly randomly offset from the actual firm location, it happens in some cases that firm locations are over the water, where CHIRPS and BKE do not cover them. For these firms, I interpolate their data using weather data from the closest firm that does not have this problem.

## 1.3 Climate projections: NEX-GDDP-CMIP6

I obtain projections for future weather (weather drawn from a changed climate) from the NEX-GDDP-CMIP6 data set (Thrasher, Wang, Michaelis, Melton, Lee, & Nemani, 2022; Thrasher, Wang, Michaelis, & Nemani, 2021). These are results of climate model runs that are part of Coupled Model Intercomparison Project Phase 6 (CMIP6), downscaled to a higher resolution and bias corrected by the NASA Center for Climate Simulation. The data contain daily projections for temperature and precipitation, though I do not need them to accurately project temperature on any given day; I just need them to produce reasonable projections of expected weather patterns in future years.

I use projections for three different climate change scenarios; these scenarios are called Shared Socioeconomic Pathways (SSPs). Each SSP describes a different path for future climate change based on different assumptions about greenhouse gas emissions, population and international cooperation. The three different scenarios I consider, which are the most commonly used SSPs, are SSP1/2.6, which is a very optimistic scenario featuring climate change mitigation and sustainable development, SSP2/4.5, which is a middle of the road scenario featuring some mitigation, and SSP5/8.5, which features the most rapid climatic change.<sup>4</sup> Studying results for different SSPs allows me to incorporate deep uncertainty about the broad parameters governing the future path of climate change.

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<sup>2</sup> More information on CHIRPS is available at <https://www.chc.ucsb.edu/data/chirps>

<sup>3</sup> More information on BKE is available at <https://berkeleyearth.org/data/>

<sup>4</sup> See O'Neill et al. (2017) and Riahi et al. (2017) for more detail on the SSPs.



Beyond this deep uncertainty, the NEX-GDDP-CMIP6 data contain results for 27 different climate models for each SSP that feature temperature and precipitation variables comparable to those from CHIRPS and BKE. These 27 different models reflect uncertainty about modeling climate even for a given broad climate trajectory. I combine all of these different models when projecting the causal impact of climate change in Section 4. My results therefore incorporate modeling uncertainty about future weather as well. See Appendix C for more detail on data processing for the weather projections.

Figure 4 shows the trajectory of yearly average daily maximum temperature in the actual data and across SSPs (taking the average across all models within SSP). Starting in 2040, the differences between the three scenarios become apparent, with temperature rising fastest in SSP5/8.5, and plateauing (in fact slightly decreasing towards the end of the century) in SSP1/2.6.

## 2 Motivating reduced-form evidence

This section presents simple reduced form results that make two main points. First, weather shocks are primarily a supply shock, rather than a demand shock. While the two are generally hard to disentangle, I can tell them apart by checking for differential impact of weather shocks on exporters and non-exporters. As I explain below, a more negative impact on exporters implies that weather is, predominantly, a supply shock. Second, firms' sales across different markets are linked, and the link is due to spending on productive capability, such as machinery, office space, or a sales team. In response to negative productivity shocks, firms cut back on these expenditures, reducing their productivity further and decreasing sales across all active markets.

The functional forms I use in this section are simple, and are not meant to capture the full effects of weather, or the effects of climate change, on firm outcomes. I propose a solution to that challenge in Section 4. Instead, this section provides the key motivation for my modeling choices in Section 3, and uses parsimonious weather summary variables and an easy to interpret functional form for clarity.

### 2.1 Identification

When regressing firm outcomes on weather, the key challenge to identification is that more or less productive firms could be more likely to be located in places with specific climates, such as hotter or colder places (e.g., Burke & Emerick, 2016). To overcome this, firm or location fixed effects

can be used to isolate random year-to-year variation in weather variables. I do not have panel data on firms, so I group firms into clusters based on geographic proximity and average weather variables within each cluster-year combination. Conditional on cluster fixed effects, there is then no correlation between unobserved firm characteristics and weather shocks.

I group firms into clusters using the Density-Based Spatial Clustering of Applications with Noise (DBSCAN) algorithm, which I implement using the `Python` package `scikit-learn` (Pedregosa et al., 2011). This algorithm takes a distance parameter to determine core groups of firms that are located close to each other, and in a second step adds periphery firms to a cluster if they are close enough to a set of core firms. Note that I do not cluster firms by year: I use all locations of all firms ever in the sample to group firms into clusters, so the clusters do not vary over time. The core trade-off here is that large clusters introduce measurement error due to the cluster averaging of weather variables (the cluster-average shock is different from the shock at the firm’s exact location), but small clusters include fewer firms and leave some firms out of any cluster altogether (dropping them from the analysis).

An additional econometric challenge is correlation of errors across space, an issue raised for the historical persistence literature in Kelly (2020). Fortunately, I use variation over time rather than just cross-sectional variation across space; by choosing an appropriate clustering distance, I can ensure that errors are correlated within, but not across clusters. As a result, clustered errors are sufficient for correct inference, which helps with inference for the more complicated estimation of the effects of climate change in Section 4. My preferred clustering distance is 10.0 km, since the fraction of firms included in any cluster plateaus at this distance and it is still relatively small. Therefore, the measurement error induced by clustering at this distance should likewise be small. I also cannot reject the null that errors at this clustering distance are uncorrelated across clusters. See Appendix Table 13 for a formal test of error correlation at various clustering distances, as well as the fraction of firms included in the clusters.

With firms grouped into clusters, I estimate regressions of the form

$$y_{jt} = \beta_1 x_{jt} + \gamma_{n(j)} + \delta_t + \varepsilon_{jt}$$

where  $y_{jt}$  is an outcome for firm  $j$  in cluster  $n$  at time  $t$  and  $x_{jt}$  is a measure of weather over the preceding year. I include location fixed effects  $\gamma_{n(j)}$  for identification, as explained above, and year fixed effects  $\delta_t$  purely to gain precision in my estimates. (As I mention below, I present results

without year fixed effects in an appendix.) To explore heterogeneity, I interact weather with firm characteristics  $\mathbf{z}_{jt}$ ,

$$y_{jt} = \beta_1 x_{jt} + \mathbf{z}_{jt}' \beta_2 + x_{jt} \mathbf{z}_{jt}' \beta_3 + \gamma_{n(j)} + \delta_t + \varepsilon_{jt}$$

To provide motivating evidence, I use a weather measure that is parsimonious, easy to understand and captures weather dynamics over the entire year: an index of three commonly used temperature variables. The index combines average temperature over the year, variance of temperature over the year and the number of days with temperatures exceeding 32°C (89.6°F). These three measures provide different lenses on how hot a year is, and each have their own strengths and weaknesses. Combining them into a single index provides a parsimonious combined measures of temperature. To make the index components comparable, I calculate location-specific  $z$ -scores for each of the three components  $x_{jt}$  as

$$\tilde{x}_{jt} = \frac{x_{jt} - \bar{x}_{jt}}{\sqrt{\hat{V}}(x_{jt})}$$

where  $\bar{x}_{jt}$  is the average of the variable at firm  $j$ 's location over the last 20 years and  $\sqrt{\hat{V}}(x_{jt})$  is the corresponding standard deviation.<sup>5</sup> The index is then just the average of the three  $z$ -scores.

To make the effect size more interpretable, I scale the index by its standard deviation across locations after partialling out cluster fixed effects. (I use the standard deviation after removing fixed effects since that is the identifying variation the regressions use.) This does not affect significance of any of the estimates, it simply is a first step to making results more interpretable: A one unit increase in the re-scaled index now corresponds to a one standard deviation weather shock.

Figure 3 shows a histogram of the resulting standardized index after partialling out fixed effects; the figure also indicates the 20<sup>th</sup> and 80<sup>th</sup> percentiles of the variable. A one standard deviation weather shock in either direction is quite large; most shocks are smaller in absolute magnitude than this. To give a sense of scale, I will convert the one standard deviation effect sizes into 80<sup>th</sup> percentile weather shocks, or 0.318 standard deviations, in the following discussion.

Since I do not care about the impact of temperature compared to some other weather variable, I do not control for precipitation, for example. The idea is not to isolate the effect of this specific

<sup>5</sup> Another advantage of the location-specific de-meaning is that, since my estimations include cluster fixed effects, I now effectively use deviations of location-specific shocks from a linear growth trend to identify the effects of weather shocks on firms, rather than relying purely on the randomness of weather shocks.

variable. Rather, I am interested in the effect of weather over the year on firm outcomes, and a higher temperature index serves as an indicator of generally unfavorable weather conditions.

## 2.2 Results

### 2.2.1 Overall effect of weather on firms

Table 2 shows the effect of weather on firms' log total sales. An 80<sup>th</sup> percentile weather shock leads to a 7.2 percent decline in total sales. This is a substantial effect, but note again that I use a very simple functional form here which does not distinguish between small weather variations and truly extreme events — the idea is to highlight that weather affects firms, rather than to exactly quantify its effect, which I turn to in Section 4.

### 2.2.2 Weather is a supply shock

To understand firms reactions, I first need to test whether weather is, on net, a demand or supply shocks, since firm reactions to either could differ markedly. We know that weather shocks affect local demand (Santangelo, 2019), but we also have evidence that they affect firms' marginal cost (Nath, 2020; Somanathan et al., 2021; Zhang et al., 2018). The question I want to answer is, does one of the two dominate?

I do this by checking whether exporters see a larger or smaller effect of weather shocks on total sales. If weather is predominantly a demand shock, then exporters should be less affected by it, since they have access to a foreign source of demand that is insulated from the local shock. If weather is predominantly a supply shock, on the other hand, they should see a larger effect. This is because in the domestic market, firms can pass on some of the marginal cost increase to local consumers. Internationally, however, we usually think that it is harder to pass on cost increases. This could be, for example, because competition is tougher or because, since higher marginal cost means lower profit, firms choose to leave certain markets in response, leading to a discontinuous fall in sales. As a result, exporters will respond to a negative productivity shock by reducing total sales more than non-exporters.

Table 3 shows that purely domestic firms see a 3.9 percent decline in total sales in response to an 80<sup>th</sup> percentile weather shock, while currently exporting firms see a 6.9 percent decrease, with the difference significant at the one percent level. Appendix A.3 shows that this exporter interaction is not sensitive to using alternative ways of measuring exporter status (for example,

using past exporter status instead of current exporter status). The estimate of the base effect for domestic producers is somewhat noisy, but as Section 4 shows, using estimation methods that can fully capture the complexity of weather data, I do estimate a significant overall effect of weather on firm performance.<sup>6</sup> The key takeaway is that the supply effect of weather shocks outweighs their demand effect.

### 2.2.3 Production structure: Sales across markets are linked

Since weather is a supply shock, I consider firm margins on the supply side to investigate firm reactions. Firms in this literature have so far been modeled as operating under constant returns to scale (e.g., Nath, 2020), and this model is consistent with supply shocks having a larger impact on exporters’ total sales, as discussed above. Under that production structure, the margins firms can use to react to weather shocks are limited, so I test whether it is a reasonable approximation. To do this, I check whether exporters also see a differential impact on domestic sales. Under constant returns to scale, firms’ operations across active markets are independent. In the domestic market, exporters should therefore react no differently than non-exporters when faced with the same supply shock.

Table 4 shows that exporters’ domestic sales also see a larger decline in response to negative weather shocks, however. Purely domestically active firms see a 5.4 percent decline in domestic sales in response to an 80<sup>th</sup> percentile weather shock, but exporters see a 7.7 percent decrease. This suggests a link between exporters’ international and domestic sales, which the constant returns to scale model cannot explain. I now turn to showing where that link comes from.

### 2.2.4 Key mechanism: Spending on productive capability

Firms spend money on what I call productive capability. Productive capability comprises rented or hired equipment, facilities and non-production personnel. For example, it includes rented machinery, rented office space or a sales team. Productive capability improves overall performance across all markets a firm is active in, by increasing labor productivity (through providing workers with sufficient equipment or space) or by making it easier to sell the firm’s output — it lowers the cost of providing the firm’s products across all markets the firm serves. Faced with a negative supply shock, firms scale back expenditures on productive capability, since these kinds of productivity-enhancing

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<sup>6</sup> To highlight that year fixed effects are present purely to increase precision, and do not affect point estimates much, Appendix Table 14 shows an estimation without year fixed effects. Results for the effect on non-exporters are much less precise. The difference in the effect for exporters remains highly significant and similar in magnitude, however.

expenditures are complementary to firm productivity. My claim is that this key reaction explains the differential impact on exporters' domestic sales I see in the data, and which a constant returns to scale model could not explain.

To preview the theoretical intuition, exporters reach a larger total market size than purely domestic producers. This incentivizes them to spend additional money on hired productive capability. When a negative supply shock decreases their productivity, they may no longer be able to profitably serve some foreign markets, because the profit they would make there is smaller than the fixed cost of accessing the market (e.g., keeping a up-to-date export license or maintaining relationships with their buyer). Exporters exit those markets, losing a whole chunk of demand they previously served, leading them to also drop a whole chunk of productive capability. This reduction in productive capability further increases their marginal cost, raises their prices and leads to lower sales even in the markets they can still profitably sell to. This leads to a larger relative decrease in domestic sales in response to weather shocks for exporters compared to non-exporters, explaining the pattern in Table 4. (I show formally that a simple international trade model can generate this comparative static in Section 3.)

To provide direct support of the hypothesis that expenditures on fixed productive capability are the key firm reaction behind the differential impact on exporters' domestic sales, I walk through each step in this intuition. First, do exporters reduce productive capability more than non-exporters in response to supply shocks? Table 5 shows the effect of weather shocks on productive capability expenditures by exporter status. Productive capability expenditures combine the cost of communications, sales, transportation, and rent for buildings, equipment and land, which I can see due to the richness of the ES data. I see a 2.9 percent decrease in productive capability expenditures for domestically active firms in response to an 80<sup>th</sup> percentile weather shock, but a significantly larger 6.7 percent decrease for exporters.<sup>7</sup> I only have detailed cost breakdowns for a sub-sample of firms, which is why this analysis uses fewer observations than the preceding results, but this nevertheless provides direct evidence of productive capability reactions when faced with negative weather events. Exporters scale back fixed expenditures considerably more than non-exporters in response to negative weather shocks.

Second, does this larger loss of productive capability translate into larger productivity effects for

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<sup>7</sup> A potential worry could be that weather shocks lead firms to report a lower valuation of their productive capability, even though they have not reduced its physical quantity. Appendix Table 19 shows, however, that weather has no effect on firms' valuation of their stock of machinery, where I should see that same effect at play if it mattered. This suggests the productive capability effect I find is due to a reduction in its quantity, rather than just due to a change in reported valuation.

exporter? The second column of Table 5 shows that sales per employee see a significantly larger relative decline for exporters compared to non-exporters (a 2.6 vs. 1.1 percent decline in response to an 80<sup>th</sup> percentile weather shock). While not a perfect proxy for productivity, this gives a clear indication that exporters see larger productivity decreases in response to weather shocks.

Is it *because* of these productive capability cutbacks that exporters see a larger decline in domestic sales? Table 7 shows a mediation analysis which adds log productive capability expenditures, fully interacted with exporter status and the temperature index, to the national sales regression from Table 4. The interaction between exporter status and the temperature index flips signs and is longer statistically significantly different from zero, even at the ten percent level. (I de-mean log productive capability expenditures, so all coefficients shown are evaluated at mean log productive capability, not at zero log productive capability, which would not be defined.) Since mediation analyses like this one add clearly endogenous regressors, I am careful in over-interpreting these results. Nevertheless, this strongly suggests productive capability ‘explains’ the larger impact of weather on exporters’ domestic sales.

Together with the results from Table 5 showing that exporters scale back productive capability more than non-exporters in response to weather shocks and that their productivity declines more, I take the evidence as very consistent with the theory that productive capability expenditures are the key firm reaction explaining why sales across markets are linked.

### 2.3 Possible mechanisms for weather effect on productivity

Before turning to a model that incorporates this reaction, I tie up two loose ends. My results show an effect of weather on output, which I interpret as evidence of a net productivity reduction because of the differential impact on exporters. This begs the question, through what mechanism does weather affect firm productivity? I will not be able to determine a single channel through which this happens, and I think it is reasonable to assume that multiple channels are important here. There is a large literature on productivity effect of weather in different contexts, highlighting multiple ways in which weather can decrease productivity.

For example, Adhvaryu et al. (2019) find direct evidence for lower worker productivity on assembly lines during hot days, exacerbated by heat-generating lighting, Somanathan et al. (2021) find lower worker productivity in Indian manufacturing firms on hot days, and Zhang et al. (2018) find reduced total factor productivity in Chinese manufacturing during hotter years. In their wide-ranging literature summary, Carleton and Hsiang (2016) note negative impacts of temperature

on labor supply, which are also found to be important in Somanathan et al. (2021) and Santangelo (2019). If workers supply less labor at each wage level, for example because they need to work on their own subsistence farms, that has an effect similar to lower worker productivity — to produce a given quantity, the firm needs to incur higher labor cost. These arguments may pertain more to employees in lower skilled jobs, but as Carleton and Hsiang (2016) note, previous research also finds that extreme temperatures reduce cognitive performance, e.g., lowering math test scores. With imperfect climate control, even workers in an office setting would face lower productivity due to extreme heat. Through this cognitive performance channel, temperature can reduce worker productivity even for firms in the service sector, for example. Ultimately, working in extreme heat makes it hard for anyone to perform their best, is at best unpleasant and at worst outright dangerous.

Table 6 shows evidence that several of these channels are present in my data, albeit the estimates are all somewhat noisy. For example, I see sales per employee declining by 2.4 percent following an 80<sup>th</sup> percentile weather shock, which is a direct indication that labor productivity is reduced. I also see firms’ total operating hours increasing by 4.3 percent in response to a 80<sup>th</sup> percentile weather shock. Since firms’ sales are falling, this suggests lower output per hour, as for example found by Adhvaryu et al. (2019). I further find that hotter years lead to more power outages, with an 80<sup>th</sup> percentile weather shock increasing the likelihood of an outage by 1.7 percentage points (again, the estimate is somewhat noisy). Outages can directly decrease firm productivity (Hardy & McCasland, 2019).

## 2.4 Alternative explanations for differential impact on exporters’ sales

Of course, exporters are different from other firms in many ways; Table 8 shows a comparison of exporting and non-exporting firms’ characteristics. It could be that these differences simply make them more susceptible to weather shocks, explaining the larger impact on sales seen in Table 3. To address this concern, I run an extensive battery of robustness checks that regress log total sales on the temperature index interacted with exporter status and additionally interacted with other firm characteristics, plus base effects for those characteristics. If it were the case that another firm characteristic is the ‘true’ reason for the effects I find, I would expect that once I include that characteristic in the regression, the interaction between exporter status and weather shocks loses significance and/or sees a drastically smaller point estimate. I find that neither happens for any of the three alternative hypotheses I describe in the rest of this section. Appendix Table 20 summarizes



these robustness checks.

First, exporters tend to be large firms, which could be more reliant on short-term hired labor that can get drawn into agriculture when negative weather shocks hit (Santangelo, 2019); accordingly, I check whether the initial number of employees or the number of employees three years ago can explain the exporter effect. Second, since exporters are more likely to be in large-scale manufacturing, where temperature control can be a problem (Adhvaryu et al., 2019), I control for two- and four-digit ISIC sectors, fully interacted with weather shocks. This also addresses concerns around an effect through input prices — if it were true that exporters simply use a different import structure, I would expect firms in similar sectors to face the same issue. Third, exporters could potentially be using more complex production processes (Costinot, 2009), so I control for measures of complexity: whether a firm has an international quality certification, the firm’s ownership structure, and the manager’s years of experience. None of these alternative hypotheses alone can explain the different effects for exporters, and I find that weather has a differential impact on exporters even when including them all in the regression at once.<sup>8</sup>

I conclude from this that the effect I find is not due to a correlate of being an exporter, but is instead about the production structure of exporting firms, and specifically about firms reacting to negative supply shocks by scaling back productive capability. As I show in Section 3, a simple extension of Melitz (2003) immediately yields the reduced form comparative statics I highlighted. All that is required is that firms can hire productive capability and the model generates the comparative statics I find. This provides a parsimonious explanation of the patterns I see in the data, including the greater decrease in productive capability seen in Table 5 and the results of the mediation analysis in Table 7.

### 3 Model

I now develop a simple international trade model that captures two core reduced form results I highlight in the previous section: the greater impact of productivity shocks on exporters’ total and domestic sales. The core mechanism, also built on reduced form results, is firms’ ability to hire productive capability, such as machinery, office space, or a sales team. The standard Melitz (2003) model this will be based on can also explain why exporters see a larger effect on their total sales, but it

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<sup>8</sup> A final concern would be differential measurement error for exporters and non-exporters. To rule out this possibility, I estimate the main regression using only data on firms coming directly from the firms’ books. Appendix Table 15 shows the results; point estimates become noisier but remain very similar to my main results.

cannot explain why exporters' domestic sales see a differential impact.

### 3.1 Demand

There are  $N$  countries and a mass of goods  $\mathcal{G}_n$  is available in each country  $n$ . Consumers in  $n$  have CES preferences with elasticity of substitution  $\sigma$ , a budget of  $X_n$  and solve

$$\max_{\{q_n(j)\}} \left( \int_{\mathcal{G}_n} q_n(j)^{\frac{\sigma-1}{\sigma}} dj \right)^{\frac{\sigma}{\sigma-1}} \text{ s.t. } X_n = \int_{\mathcal{G}_n} q_n(j) p_n(j) dj \quad (1)$$

This yields quantity demanded as

$$q_n(j) = \underbrace{X_n \mathcal{P}_n^{\sigma-1}}_{\equiv \alpha_n} p_n(j)^{-\sigma} = \alpha_n p_n(j)^{-\sigma} \quad (2)$$

where

$$\mathcal{P}_n \equiv \left( \int_{\mathcal{G}_n} p_n(j)^{1-\sigma} dj \right)^{\frac{1}{1-\sigma}}$$

is the optimal price index in  $n$ . I introduce the shorthand  $\alpha_n$  to denote demand factors. These depend on total expenditures and the price index in country  $n$ . From the perspective of firms selling in market  $n$ , a higher  $\alpha_n$  translates into higher sales in that market at any given price they charge there, either because consumers in  $n$  spend a lot of money, or because products in  $n$  tend to be expensive, lowering the firm's relative price. These demand factors will be important in solving the model.

### 3.2 Supply

Firms are located in their home country  $i$  and export to other countries  $n$ . Each country has an infinite mass of potential entrants. Firm  $j$ , producing the proprietary variety  $j$ , is characterized by its core productivity  $a_j \sim F_i$ , drawn from a country specific distribution. I adapt the framework of Hyun and Kim (2022), which is an extension of Melitz (2003) allowing firms to choose a common quality level (a demand shifter) across all markets they are active in. Instead of linking decisions across markets via demand, I let firms purchase or hire productive capability  $c_j$ , which represents factors like machinery, office space, or a sales team. Additional productive capability makes it cheaper to provide goods in all markets and links choices, including entry decisions, across markets. The cost of acquiring  $c_j$  is  $f(c_j)$  and measured in units of labor. Firm  $j$ , active in a set of markets

(countries)  $\mathcal{M}_j$ , has effective productivity  $a_j c_j^\delta$  and incurs variable cost

$$v(\{q_n(j)\}) = \sum_{n \in \mathcal{M}_j} d_{ni} q_n(j) \frac{w_i}{a_j c_j^\delta}$$

which also includes an iceberg trade cost  $d_{ni}$  and the wage  $w_i$ . (Since Hyun and Kim (2022) focus on entry in various domestic markets within one country instead of international trade, their model does not feature an iceberg cost.) The firm's profit maximization problem is

$$\begin{aligned} & \max_{\{p_n(j), q_n(j)\}, c_j, \mathcal{M}_j} \left[ \sum_{n \in \mathcal{M}_j} p_n(j) q_n(j) - d_{ni} q_n(j) \frac{w_i}{a_j c_j^\delta} - f_{ni} w_i \right] - f(c_j) w_i - f_i w_i \\ & \stackrel{(2)}{\Leftrightarrow} \max_{\{p_n(j)\}, c_j, \mathcal{M}_j} \left[ \sum_{n \in \mathcal{M}_j} \alpha_n p_n(j)^{1-\sigma} - d_{ni} \alpha_n p_n(j)^{-\sigma} \frac{w_i}{a_j c_j^\delta} - f_{ni} w_i \right] - b \beta c_j^{\frac{1}{\beta}} w_i - f_i w_i \end{aligned} \quad (3)$$

where I follow Hyun and Kim (2022) and set  $f(c_j) = b \beta c_j^{\frac{1}{\beta}}$ . Unlike Hyun and Kim (2022) I explicitly consider market entry and exit, so I include a fixed cost  $f_{ni}$ , measured in units of labor, for operating in each market, as in Melitz (2003). These fixed costs are costs that need to be paid every period in order to retain market access, so they include things like maintaining an export license, maintaining relationships with buyers, and maintaining any certifications required by the destination country. I do not explicitly model dynamics because that would make the model intractable, and because I do not observe entry and exit directly in the data. I will consider comparative statics in which a firm faces a productivity shock and changes its decisions as a result. In these comparative statics, the firm will have to pay  $f_{ni}$  again in order to retain market access. This mirrors a dynamic model in which firms play a static equilibrium every period.

I assume  $f_{ii} = 0$  and  $d_{ii} = 1$  for simplicity, because it makes the model computationally easier to solve and because the data I use cover only active firms. I further include a fixed start-up cost  $f_i$ , also measured in units of labor, which entrants have to pay once to discover their productivity  $a_j$ , again as in Melitz (2003). For a given  $c_j$ , optimal prices  $p_n(j)$ , quantities  $q_n(j)$  and sales  $S_n(j)$  for firm  $j$  in market  $n$ , as well as profits across all markets  $\pi(j)$ , follow from first order conditions as

$$p_n(j) = \underbrace{\frac{\sigma}{\sigma-1}}_{\equiv \mu} d_{ni} \frac{w_i}{a_j c_j^\delta} \quad (4)$$

$$q_n(j) = \alpha_n \left( \mu d_{ni} \frac{w_i}{a_j c_j^\delta} \right)^{-\sigma} \quad (5)$$

$$\begin{aligned}
S_n(j) &= \alpha_n \left( \mu d_{ni} \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} \\
\pi(j) &= \frac{1}{\sigma} \left( \mu \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) - \left( \sum_{n \in \mathcal{M}_j} f_{ni} \right) w_i - b \beta c_j^{\frac{1}{\beta}} w_i - f_i w_i
\end{aligned} \tag{6}$$

After solving for prices and quantities, the FOC for the optimal distribution network gives<sup>9</sup>

$$c_j = \left[ \frac{1}{b} \delta (\mu w_i)^{-\sigma} a_j^{\sigma-1} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) \right]^{\frac{\beta}{1-\beta(\sigma-1)\delta}} \tag{7}$$

Analogous to Hyun and Kim (2022), the parameter restrictions to ensure an interior solution are  $\sigma > 1$ , which is a standard CES assumption and ensures that goods are substitutes,  $\delta > 0$ , which ensures that additional productive capability decreases marginal cost, and  $\beta(\sigma - 1)\delta < 1$ , which ensures that the optimal  $c_j$  is finite, because the increase in the cost of acquiring productive capability outpaces the decrease in marginal cost. As I discuss in Section 3.5, I find that these restrictions are fulfilled in the data.

### 3.3 Model reproduces key comparative static

I showed in Section 2 that exporters see a larger decline in total sales and domestic sales in response to higher temperatures. This implies that weather is, on net, a negative supply shock. (Otherwise, I would expect exporters to see a smaller decline in total sales in response to weather shocks.) Matching these reduced form results, in the model, exporters tend to see a larger decline in domestic sales as a result of a negative productivity shock. (The total sales result follows from this immediately.)

Let firm  $j$  in country  $i$  experience a shock shifting its productivity to  $a'_j < a_j$ , and compare what it would have done prior to the shock to what it does when faced with the shock. Let  $\mathcal{M}_j' \subseteq \mathcal{M}_j$  denote the set of markets the firm is active in after the shock. Using primes to denote post-shock variables, the relative decline in domestic sales is

$$\frac{S_i(j)'}{S_i(j)} \stackrel{(6)}{=} \left( \frac{a'_j c_j'^\delta}{a_j c_j^\delta} \right)^{\sigma-1} \stackrel{(7)}{=} \left[ \left( \frac{a'_j}{a_j} \right) \left( \frac{\sum_{n \in \mathcal{M}_j'} d_{ni}^{1-\sigma} \alpha_n}{\sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n} \right)^{\beta\delta} \right]^{\frac{\sigma-1}{1-\beta(\sigma-1)\delta}}$$

Note that the parameter restrictions ensure the overall exponent is positive. The first term in

<sup>9</sup> Detailed derivations for this and all following results can be found in Appendix D.

parentheses depends solely on the change in  $a_j$ . The second term in parentheses depends on the change in active markets  $\mathcal{M}_j$ ; it represents an indirect effect of the productivity shock which occurs if lower productivity leads the firm to exit some markets it was previously active in. For domestic producers,  $\mathcal{M}_j' = \mathcal{M}_j$ , since they will not exit altogether given that  $f_{ii} = 0$ . For exporters, their profit in some markets may now be below the fixed cost of entry for the period  $f_{ni}$ , leading them to exit the market. That means  $\mathcal{M}_j' \subset \mathcal{M}_j$ , so the second term in parentheses is smaller than one, exacerbating the effect of the shock and leading to a larger relative decline in domestic sales. The firm will similarly see a larger relative decline in total sales.

This model therefore generates the comparative statics I observe in the data. The standard Melitz (2003) model, in contrast, generates only the comparative static for total sales. In that model, when an exporter leaves a market following a productivity shock, they see a discontinuous drop in total sales, and thus a larger relative decline in *total* sales than a purely domestic producer. For *domestic* sales, however, exporters and non-exporters see the exact same relative decline, because the productivity shock only has a direct effect on domestic sales, and that direct effect is the same for both firms.

### 3.4 Equilibrium

**Definition 3.1** *For a given a CES elasticity  $\sigma$ , start-up costs  $f_n$ , entry costs  $f_{ni}$ , iceberg trade costs  $d_{ni}$ , cost parameters  $b$ ,  $\beta$  and  $\delta$ , and productivity distributions  $F_i$ , an equilibrium for this model is a set of prices  $p_n(j)$ , quantities  $q_n(j)$ , productive capacities  $c_j$ , active markets  $\mathcal{M}_j$ , masses of entrants  $N_n$  and active firms  $n_n$ , incomes  $X_n$  and wages  $w_n$  such that, for all firms  $j$  and all countries  $n$ ,*

- *Consumers are maximizing utility (1)*
- *Firms are maximizing profits (3)*
- *Labor supply  $L_n$  equals labor demand in all countries*
- *Expected profits prior to entry are zero in all countries*
- *Income equals expenditure in all countries, i.e. trade is balanced*

#### 3.4.1 Optimal choice of active markets

The first step in finding the equilibrium is determining active markets  $\mathcal{M}_j$  for each firm, for a given set of demand factors  $\alpha_n$ . This is a high-dimensional combinatorial problem. Antràs et al.

(2017) confront a similar problem when modeling input sourcing and use the algorithm developed by Jia (2008). This relies on finding an upper bound on  $\mathcal{M}_j$  by assuming the firm is active in all  $N$  markets and determining whether leaving an individual market  $n$  would increase firm profits. If so, as Jia (2008) shows,  $n$  cannot be part of the optimal set of markets. A similar procedure yields a lower bound, starting from the firm being active in no markets at all and checking where entry increases profits. To find the optimal  $\mathcal{M}_j$ , you then calculate profits across all combinations of markets between the bounds (all combinations of the markets which are present in both the lower and upper bound).

In my setting, I can use a more computationally efficient algorithm for finding upper and lower bounds. To find an upper bound, start by assuming the firm is active in all markets, and set that as the initial  $\mathcal{M}'_j$ . Then,

1. Calculate  $c_j$  if the firm were active in  $\mathcal{M}'_j$  and calculate variable profits in each market, that is, sales in each market minus variable cost and the entry cost  $f_{ni}$  (ignoring the cost of  $c_j$ )
2. Drop all markets where the firm would be earning negative variable profits from  $\mathcal{M}'_j$ , and use those where it makes weakly positive profits as the new  $\mathcal{M}'_j$

Iterate until the firm makes weakly positive variable profits in all markets in  $\mathcal{M}'_j$ ; this gives the upper bound  $\mathcal{M}_j^{\text{ub}}$  (see Appendix D.3 for a proof that this is an upper bounds).

To find a lower bound, start by assuming the firm is active only at Home, and set that as the initial  $\mathcal{M}'_j$ . (Since I assume  $f_{ii} = 0$ , firms will always be active in the Home market.) Then,

1. Calculate  $c_j$  if the firm were active in  $\mathcal{M}'_j$  and calculate variable profits in each market, that is, sales in each market minus variable cost and the entry cost  $f_{ni}$  (ignoring the cost of  $c_j$ )
2. Add all markets where the firm would be earning positive variable profits to  $\mathcal{M}'_j$ , and use these plus the markets in  $\mathcal{M}'_j$  as the new  $\mathcal{M}'_j$

Iterate until the firm cannot enter additional markets where it would make weakly positive variable profits when  $c_j$  is chosen optimally under  $\mathcal{M}'_j$ ; this gives the lower bound  $\mathcal{M}_j^{\text{lb}}$  (see Appendix D.2 for a proof that this is a lower bound).

In simulations, I find both bounds in many fewer steps than I can find the bounds from Jia (2008). This is largely because finding the bounds from Jia (2008) always requires as many steps as there are markets, whereas my bounding algorithms can often exclude or include multiple markets in one step. I also find that my bounds are usually tighter than those from Jia (2008). Both of

these factors speed up computation considerably. The core feature of my model that enables me to use these more efficient bounds is that the link between entering or exiting different markets ultimately comes down to an optimal firm decision on  $c_j$ .

Having found the bounds, I know the optimal set of active markets for all firms with  $\mathcal{M}_j^{\text{lb}} = \mathcal{M}_j^{\text{ub}}$ , which is the case for the majority of firms. For firms where the bounds do not coincide, I could check all possible combinations of markets in between the two bounds. Unfortunately, unlike Antràs et al. (2017), I find that the cardinality of that difference can be large: Though most firms only need to decide between a few markets, some have over 100 different markets ( $\approx 1.23 \times 10^{30}$  combinations) to choose from. Therefore, I cannot feasibly solve the optimal market problem by checking profit across all combinations of markets between the bounds.

Instead of searching over sets of active markets  $\mathcal{M}_j$  and determining the optimal profit for each set, I invert the problem. I search across  $c_j$  (productive capability) to find optimal profits across possible choices of productive capability. Determining  $\mathcal{M}_j$  for a given  $c_j$  is easy, since with a known productivity, market entry decisions just boil down to Melitz (2003): Firms enter markets in which they make a variable profit (markets where sales exceed variable cost plus the entry cost). The lower and upper bounds for markets the firm could be active in,  $\mathcal{M}_j^{\text{lb}}$  and  $\mathcal{M}_j^{\text{ub}}$ , also yield lower and upper bounds on  $c_j$ , since as firms increase  $c_j$ , they only ever enter additional markets; they do not exit markets they are already active in. (Leaving a market the firms is making positive variable profit in cannot increase its total profit for a given  $c_j$ .) The  $c_j$  the firm would optimally choose if it were active in  $\mathcal{M}_j^{\text{lb}}$  thus is a lower bound on the optimal  $c_j$ , and similarly the optimal  $c_j$  at  $\mathcal{M}_j^{\text{ub}}$  yields an upper bound. I then simply conduct a grid search between those two bounds. Once I have found the  $c_j$  that maximizes profits, I get the associated set of activate markets  $\mathcal{M}_j$  and re-calculate the optimal  $c_j$  for that set of markets, to ensure I am at the firm's true optimal choice.

### 3.4.2 Remaining equilibrium objects

To determine  $\alpha_n$ , I turn to the free entry condition for country  $i$ . It states that expected profits before paying the fixed start-up cost  $f_i$ , required to discover firm productivity, should be zero. Let  $\underline{a}_i$  denote the least productive firm that finds it profitable to operate in country  $i$  (instead of shutting down after discovering  $a_j$ ), then the free entry condition is

$$f_i w_i = \int_{\underline{a}_i}^{\infty} \frac{1}{\sigma} \left( \mu \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) - \left( \sum_{n \in \mathcal{M}_j} f_{ni} \right) w_i - b \beta c_j^{\frac{1}{\beta}} w_i \, dF_i(a_j) \quad (8)$$

The integral cannot be solved analytically because it depends on the sets of active markets  $\mathcal{M}_j$  (directly but also, non-linearly, through  $c_j$ ). These sets are a function of  $a_j$  and (being sets) do not have an easily computable antiderivative. This condition nevertheless pins down the equilibrium  $\alpha_n$  terms, given wages and sets of active markets, in a computationally attractive form: When numerically solving the model (using a sum to simulate the integral), this becomes a system of linear equations in  $\alpha_n$ .

The full employment condition for country  $i$  yields the mass of entrants

$$N_i = \frac{\mu^{\sigma-1} w_i^\sigma L_i}{\int_{a_i}^\infty (a_j c_j^\delta)^{\sigma-1} \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n dF_i(a_j)}$$

which can be used to find the mass of active firms  $n_i = [1 - F_i(a_i)] N_i$ . To derive the gravity equation, I first calculate the price index for country  $n$  as

$$\mathcal{P}_n = \mu \left( \sum_{i=1}^N n_i (d_{ni} w_i)^{1-\sigma} \int_{a_{ni}}^\infty (a_j c_j^\delta)^{\sigma-1} dF_i(a_j) \right)^{\frac{1}{1-\sigma}}$$

Plugging this into aggregate trade flows from  $i$  to  $n$  leads to the gravity equation

$$X_{ni} = \frac{n_i (d_{ni} w_i)^{1-\sigma} \int_{a_{ni}}^\infty (a_j c_j^\delta)^{\sigma-1} dF_i(a_j)}{\sum_{k=1}^N n_k (d_{nk} w_k)^{1-\sigma} \int_{a_{nk}}^\infty (a_j c_j^\delta)^{\sigma-1} dF_k(a_j)} X_n \quad (9)$$

where  $a_{ni}$  is the least productive firm from  $i$  selling in  $n$ . This has the typical gravity structure, but the integrals of effective productivity across producers selling from  $i$  to  $n$  again cannot be solved analytically. The gravity equation nevertheless pins down wages, closing the model with world GDP as the numeraire.

### 3.5 Estimation

#### 3.5.1 Reduced form

I follow the common practice of assuming that core productivities come from a Pareto distribution with shape parameter  $\theta$ , shifted by a country-specific scale parameter  $T_i^{\frac{1}{\theta}}$ , where  $T_i$  captures differences in technology across countries. (I estimate both  $\theta$  and  $T_i$  using the method of simulated moments, as explained below, but need to set up the parameterization here.) I simulate firm



productivities using draws  $u_j$  from a uniform distribution on  $(0, 1]$ , since

$$u_j = T_i a_j^{-\theta}$$

is uniformly distributed and can be used to back out  $a_j$  given the dispersion parameter and technology shifters (Eaton, Kortum, & Kramarz, 2011).

Following Eaton et al. (2011), I estimate  $\sigma$  based on the ratio of firms' sales to their variable costs. Variable costs include the cost of labor, raw materials, fuel, water, electricity, goods for resale, and other costs of production. I first calculate the mark-up for each firm and then use the average across firms to calibrate  $\sigma$ , which yields  $\hat{\sigma} = 3.016$  with a standard error of 0.043. Table 9 shows estimates for all parameters of the structural model.

Next, I turn to the parameters governing firms' optimal productive capability,  $\beta$  and  $\delta$ . Log sales in firm  $j$ 's home market  $i$  can be written as

$$\log(S_i(j)) = I + \log(\alpha_i) + (\sigma - 1) \log(a_j) - (\sigma + \beta\delta - 1) \log(w_i) + (\sigma - 1) \beta\delta \log(\mathcal{S}(j)) \quad (10)$$

with  $I$  a constant. This shows that the elasticity of home market sales with respect to total sales identifies  $\beta\delta$  for a known  $\sigma$ . I make the simplifying assumption that  $\beta = \delta$  to ease the computational burden during the structural estimation described below.  $\beta$  and  $\delta$  both discipline firms' choices of productive capability  $c_j$ , and equilibrium wages and welfare depend only on the product of both parameters, though they have slightly different implications for price distributions. Normalizing the two is therefore without great loss of generality.

I can then directly estimate  $\delta$  and  $\beta$  by regressing log home market sales on log total sales, country-year fixed effects (to deal with  $\alpha_i$  and  $w_i$ ) and proxies for core productivity  $a_j$ . I proxy for core productivity using country-sector-year fixed effects (obviating the need for country-year fixed effects), the manager's years of experience, log initial number of employees, log number of employees three years ago, whether the firm uses an international quality certification, whether the firm experienced power outages, whether the firm competes against the informal sector, whether the firms introduced a new product or service during the last three years, whether the firm introduced a new process during the last three years, whether the firm had any R&D expenditures, whether the firm is part of a larger firm, whether the firm was formal when it was founded, whether the firm applied for an electricity connection over the last three years, whether the firm applied for a water connection over the last three years, the firm age, and legal status indicators. To allow for more

flexibility in the estimation, I add all pairwise interactions as well as fourth-degree polynomials of all continuous variables.

I estimate (10) using only data on exporters, since purely domestically active firms mechanically yield an elasticity of one (their home sales and total sales are identical); see Appendix Table 21 for a summary of the results. Since the estimate for  $\beta\delta$  depends on  $\hat{\sigma}$ , I obtain its standard error via a pairs bootstrap, estimating  $\sigma$  and  $\beta\delta$  for 999 bootstrap samples. I find  $\widehat{\delta\beta} = 0.388$  with a standard error of 0.016, which results in  $\hat{\delta} = \hat{\beta} \approx 0.623$ . Regardless of the assumption that  $\beta = \delta$ , these parameter estimates satisfy the crucial restriction that  $\beta(\sigma - 1)\delta < 1$ , ensuring an internal solution for firms' productive capability  $c_j$ .

Finally, I need to fix the productive capability cost shifter  $b$ . This is not separately identified from the technology shifters  $T_i$ , because making productive capability overall much cheaper has the same effect as shifting overall productivity. I assume that  $b = 1$  to resolve this set identification problem. The interpretation of this assumption is simply that workers can do production work and administrative work equally well.

### 3.5.2 Structural estimation

All remaining parameters — technology shifters  $T_i$ , the technology scale parameter  $\theta$ , start-up costs  $f_i$ , iceberg costs  $d_{ni}$  and entry costs  $f_{ni}$  — are estimated via the method of simulated moments (MSM). Estimating the model for the entire set of economies I have in my data is computationally infeasible, since finding a single equilibrium of the model for many countries and with a large number of simulated firms takes considerable time even with my efficient algorithm for finding active markets. Instead, I estimate the model for a small open economy Home ( $H$ ), building on the theoretical work by Demidova et al. (2022) and the estimation strategy in Bartelme et al. (2023). Specifically, I solve (8) only for the Home price index  $\alpha_H$ , taking all other countries'  $\alpha_n$  as given. I take the labor force size  $L_H$  from the World Development Indicators (World Bank, 2023).

I recover  $\alpha_n \equiv X_n \mathcal{P}_n^{\sigma-1}$  for all other countries from the ITPD data on total expenditures  $X_n$  and a gravity estimation using data on all countries but Home, similar to Bartelme et al. (2023). I model all other countries' economies as following the model in Melitz (2003), which means their price indices are

$$\mathcal{P}_n = \frac{\sigma}{\sigma - 1} \left( \frac{\theta_F}{\theta_F - \sigma + 1} \right)^{-\frac{1}{\theta_F}} \left( \frac{\sigma}{X_n} \right)^{\frac{\theta_F - \sigma + 1}{\theta_F(\sigma - 1)}} \left( \sum_{i=1}^N T_i n_i (d_{ni} w_i)^{-\theta_F} (f_{ni} w_i)^{\frac{\theta_F - \sigma + 1}{1 - \sigma}} \right)^{-\frac{1}{\theta_F}}$$

where  $\theta_F$  is the dispersion parameter for other economies' core productivity distributions, which I take from Melitz and Redding (2015) as  $\theta_F = 4.25$ .<sup>10</sup> Everything else in this expression is either data or a parameter I can estimate via the reduced form approaches above, while the final term in parentheses can be recovered from a gravity estimation. Specifically, the model in Melitz (2003) yields the gravity equation

$$X_{ni} = \frac{T_i n_i (d_{ni} w_i)^{-\theta_F} (f_{ni} w_i)^{\frac{\theta_F - \sigma + 1}{1 - \sigma}}}{\sum_{l=1}^N T_l n_l (d_{nl} w_l)^{-\theta_F} (f_{nl} w_l)^{\frac{\theta_F - \sigma + 1}{1 - \sigma}}} X_n \quad (11)$$

for trade flows from  $i$  to  $n$ , which allows me to recover  $\sum_{i=1}^N T_i n_i (d_{ni} w_i)^{-\theta_F} (f_{ni} w_i)^{\frac{\theta_F - \sigma + 1}{1 - \sigma}}$  from the importer fixed effect of country  $n$  in a standard gravity estimation. I estimate this gravity equation using pseudo-Poisson maximum likelihood estimation (Santos Silva & Tenreyro, 2006), based on data for all countries except Home. Following Bartelme et al. (2023), I use distance and an indicator for contiguity to approximate the bilateral term

$$\tau_{ni} \equiv d_{ni}^{-\theta_F} f_{ni}^{\frac{\theta_F - \sigma + 1}{1 - \sigma}} \quad (12)$$

To minimize measurement error in the trade data, I calculate average real flows across all years from 2000 to 2019 (the most recent year in the data). Appendix Table 22 shows estimation results for the gravity equation.

The results from this gravity estimation also make it easier to estimate  $d_{ni}$  and  $f_{ni}$ . The estimates for  $\tau_{ni}$  combine iceberg trade cost and entry cost. I parameterize iceberg cost  $d_{ni}$  as a function of the same variables I include in the gravity equation, distance and the contiguity indicator,

$$d_{ni} = 1 + \exp \{ \mathbf{X}_{ni} \boldsymbol{\gamma} \}$$

where  $\mathbf{X}_{ni}$  also contains a constant term. For a guess of  $\boldsymbol{\gamma}$ , I can then recover  $f_{ni}$  from (12). I maintain the assumptions that  $d_{ii} = 1$  and  $f_{ii} = 0$ . Parameterizing  $d_{ni}$  in this way is an exact analogue to estimating parameters via a gravity equation beforehand and feeding the results into the structural algorithm, as done for example in Antràs et al. (2017).

The parameters  $T_H$ ,  $\theta$ ,  $f_H$  and  $\boldsymbol{\gamma}$  are estimated via MSM. The targeted moments are Home's

<sup>10</sup> The technology scale parameters  $\theta$  and  $\theta_F$  capture the dispersion of core productivities, one for Home, the other for all other countries. I take  $\theta_F$  from the literature since good estimates of this parameter exist, but allow  $\theta \neq \theta_F$  because those existing estimates are for the dispersion in firm productivity when  $a_j$  completely captures firm productivity. In my model, total firm productivity is  $a_j c_j^\theta$ , which has a different distribution than core productivity  $a_j$  by itself. I therefore allow for a different dispersion of core productivity.

share of exporters, exports from Home to each other country,<sup>11</sup> the ratio of Home’s trade with itself to its total exports, and the ratio of the 75<sup>th</sup> to the 25<sup>th</sup> percentile of domestic sales (75/25 ratio). In simulated data, these moments are exactly sufficient to identify all model parameters. To minimize measurement error in the trade data, I again use average real flows across all years from 2000 to 2019 (the most recent year in the data), as I did when estimating (11). In the firm data, productive capability combines the cost of communications, sales, transportation, and rent for buildings, equipment and land. In the model, it is simply the value of firms’ productive capability,  $\beta c_j^{\frac{1}{\beta}} w_H$ .

While all parameters are identified by all moments, the share of exporters and ratio of Home’s trade with itself to total exports are especially helpful for identifying  $f_H$  and  $T_H$ , the export flows are especially useful for identifying  $\gamma$  and the 75/25 is needed to identify  $\theta$ . Table 9 also shows which variation in the data is especially important for identifying which parameters. I simulate the model using one million firms.

### 3.6 Estimation results

I implement the estimation in `Julia`, using `BlackBoxOptim` to find an initial set of estimates and refining those with the Nelder-Mead Subplex implementation from `NLopt`, an improved version of the standard Nelder-Mead algorithm (Bezanson, Edelman, Karpinski, & Shah, 2017; Feldt, 2023; Johnson, 2023; Rowan, 1990). I estimate the model using Zambia as the small open economy, Home, because I have three rounds worth of Enterprise Surveys data (2007, 2013 and 2019) and because it could reasonably be described as a small open economy. It has a ratio of total exports to total domestic trade (trade with itself) of  $\approx 58$  percent, so trade makes up a large fraction of its economy, and it exhibits roughly balanced trade: Its trade imbalance (exports minus imports) as a fraction of its total trade (exports plus imports) is only six percent. Finally, when I estimate a gravity model with and without it, results basically do not differ, implying that trade dynamics among all other countries do not depend crucially on their trade with Zambia.

Table 9 shows the parameter estimates. I estimate a core productivity dispersion parameter  $\theta = 7.706$ , which is somewhat higher than, for example, the preferred estimate for the standard Melitz (2003) of 4.25 from Melitz and Redding (2015). (A higher  $\theta$  means a less dispersed distribution.) That my model finds a larger value makes sense, however. In Melitz (2003),  $\theta$  governs the dispersion

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<sup>11</sup> In order not to overweight a few large export destinations, I take the log of exports and add the fraction of countries Home does not export to as an additional moment.

of *total* productivity, whereas in my model, it governs only the dispersion of *core* productivity  $a_j$ , whereas total productivity  $a_j c_j^\delta$  also depends on productive capability  $c_j$ . In my model, firms' productive capability choices multiply core productivity and lead to additional dispersion in total productivity, so  $\theta$  no longer captures the full dispersion of total productivity.

The model fits targeted moments well. Figure 7 shows a comparison of Zambian log exports and model results. The model matches the data well — the correlation coefficient is 0.68. In addition, figure 8 shows Zambian log imports, which are not a targeted moment in the MSM estimation, compared to the model simulation. The correlation here is even stronger, at 0.80. This is encouraging, since imports depend on the iceberg cost parameters from the MSM estimation and other countries'  $\alpha_n$ , which I estimate outside the model. That imports are well approximated suggests that the theoretical model captures key relationships in the data, that the estimates of that model reproduce those relationships for untargeted data moments, and that the MSM estimation and estimations outside the model combine well. Comparisons of the data and estimated values for the other three targeted moments are shown in Table 10. The model produces a share of exporters of 15.7 percent, which is almost identical to the share of 15.2 percent in the data, a ratio of own trade to total exports of 1.818, which is also essentially identical to the data moment of 1.819, and a 75/25 ratio for domestic sales of 4.788, which is similar to the data moment of 3.596.

An important difference between my model and a standard Melitz (2003) model is that my model generates a more complex distribution of total productivity,  $a_j c_j^\delta$ , since this depends both on core productivity  $a_j$  and productive capability  $c_j$ . Figure 9 shows the CDF of log core productivity and log total productivity. Log total productivity is much more dispersed and has jumps at places where firms' core productivity allows them to access export destinations, leading to larger purchases of productive capability.

## 4 Estimating the impact of climate change

### 4.1 Setup

For counterfactual simulations, including policy experiments, that take climate change into account, I require a realistic estimate of the impact of climate change on firms. Three key challenges arise in this context. First, weather is a very high-dimensional object, and I thus need to flexibly estimate how weather affects firm outcomes. Second, projecting the causal impact of climate change is inherently an out of sample exercise and I need to estimate firms' responses to climate change in a

way that takes this seriously. Third, firms adapt to climate change and my estimation needs take this into account.

To formalize the problem, I observe firm outcomes  $\mathbf{y}$  and weather data from the current climate,  $\mathbf{X}^{\text{now}} \sim F_{\text{now}}$ ; those depend on each other as

$$\mathbf{y} = g(\mathbf{X}^{\text{now}}) + \varepsilon$$

Rather than trying to isolate the effect of a specific  $x_{ij}$  on  $\mathbb{E}[y_i|\mathbf{X}_i]$ , I am interested in the combined effect that moving to a new set of weather realizations  $\mathbf{X}^{\text{future}} \sim F_{\text{future}}$  has on the expected  $\mathbf{y}$ , but I do not see outcomes for these new weather realizations — I need to estimate them.

One solution is to pick a set of weather variables and estimate a relationship using a regression, perhaps including splines or other somewhat flexible function forms. However, the choice of weather variables is not obvious and gives researchers a lot of leeway. Instead, I use the causal forest (CF) algorithm developed by Athey et al. (2019). CFs are designed to incorporate high-dimensional data and can be tuned to protect against overfitting and to improve out of sample performance. CFs are generally used to estimate heterogeneous treatment effects. However, I thank Stefan Wager and Erik Sverdrup for pointing out to me that they can also be used to estimate and do inference on unobserved means. Let  $D_i = 1$  for data with observed outcomes (the ‘treatment’ group) and  $D_i = 0$  for data without (the ‘control’ group). Keep  $y_i = y_i(1) = y_i$  for observed data and set  $y_i = y_i(0) = 0$  for unobserved outcomes. Then, the conditional average treatment effect for the control group is

$$\mathbb{E}[y_i(1) - y_i(0)|D_i = 0] = \mathbb{E}[y_i - 0|D_i = 0] = \mathbb{E}[y_i|D_i = 0]$$

which is the expected outcome among data points with unobserved outcomes. CFs provide efficient cluster-robust confidence intervals for this expected outcome and can easily be estimated using the `grf` package in R (Tibshirani et al., 2023). They provide a solution to the first two challenges: they are able to incorporate high-dimensional weather data and flexibly relating them to firm outcomes, and they perform well out of sample, which is highly desirable when estimating the impacts of climate change.

The third challenge, incorporating adaptation, can be addressed by including long-term moments of weather in the estimation. Adaptation means reacting differently to an identical weather shock depending on the climatic environment. For example, a firm that is used to an average yearly temperature of 28°C may be severely affected by a year that averages 30°C. If over time, the average

temperature rises to 30°C, the same firm may adapt to the changed climatic environment, for example by installing climate control measures (Adhvaryu et al., 2019). It may then be less affected by a 30°C year.<sup>12</sup> To capture this, I include longer-term moments of contemporary weather variables in the estimation, akin to Carleton et al. (2022). Specifically, I include the mean and variance over the preceding 20 years for each weather measure I use in the estimation.

## 4.2 Results

I use de-meaned log sales as my outcome of interest. By construction, this has an average of zero for data with observed outcomes. The estimated mean for each SSP can therefore be interpreted as the relative change in sales the average firm sees due to climate change. The weather measures I use include yearly averages, yearly averages of daily values raised to the second, third, fourth, fifth and sixth power (that is, the second to sixth non-centered moments of each variable), as used in Carleton et al. (2022), the corresponding centered moments, and counts for days in specific intervals and above certain thresholds. As I described above, I also include long-term means and variances to capture adaptation. I partial out cluster fixed effects from all variables, including the outcome, before conducting the estimation. The CF flexibly estimates the response of firm outcomes to all of these weather measures, including their interactions.

My main reference period for which I estimate the effects of climate change is 2086–2090. That is, for each SSP, I include projections from all 27 climate models and for each year in the 2086–2090 range and predict the causal effect on average sales. I choose this period because at that time, differences between the three SSPs are clearly visible in the data.<sup>13</sup> Table 11 shows the estimated change in sales under the three different SSPs as well as 90 percent confidence intervals. I consistently estimate negative effects, with larger magnitudes under more extreme climate change scenarios. The impacts range from a 6.6 percent decrease in sales for the average firm under SPP1/2.6 to an 8.3 percent decrease under SSP2/4.5 to a 10.8 percent decrease under SSP5/8.5. The latter two are significant at the ten percent level, while the change under SSP1/2.6 is not (though the confidence interval only barely includes zero). I want to highlight again that the confidence intervals I present incorporate two sources of uncertainty. First, they of course reflect uncertainty in fitting the model (statistical uncertainty). Second, since I combine data for many different model projections of future

<sup>12</sup> It is also conceivable that rising average temperatures could make firms more vulnerable to weather shocks, for example if they negatively affect local labor markets (Santangelo, 2019). My solution here can take either effect into account.

<sup>13</sup> Appendix A.7 shows results for additional periods.

weather under each scenario, the intervals are also affected by scientific uncertainty regarding the path of future weather.

## 5 Counterfactuals

I now combine the model estimates from Section 3 with the estimated impacts of climate change from Section 4 to show how productivity reactions change policy effectiveness. Specifically, I show that trade policy is especially suited to help poor countries mitigate the effects of climate change.

I first calibrate a counterfactual that changes the technology parameter  $T_H$  to match the estimated impact of climate change under SPP5/8.5 from Section 4. That is, I calibrate  $T_H$  so the average firm experiences a real sales decline of 0.108 log points.<sup>14</sup> The rationale for setting the counterfactual up this way is that, since weather shocks are primarily supply shocks, climate change primarily shifts the productivity distribution. My counterfactual therefore finds the shift in the distribution of core productivity  $a_j$  which would lead to the estimated impact on firms' real sales. I call this the *climate change baseline* counterfactual. I can then conduct policy experiments under this climate change scenario and calculate welfare impacts.

To estimate the impact of productivity reactions on the welfare impact of different policies, I compare results for my model to a modified version of my model in which I shut down productivity reactions. That is, I fix the distribution of productive capability  $c_j$  at the status quo and do not allow it to adjust when moving to counterfactuals. I calibrate the climate change baseline scenario for this modified model in the same way, finding the shift in  $T_H$  that leads to sales losses matching the estimated impact of climate change. Appendix Table 26 further shows a comparison between my model and the model of Melitz (2003), estimated in the same way as my model.<sup>15</sup> I find that the Melitz (2003) model has difficulty fitting the Zambian data as well as my model, especially with accounting for the observed dispersion of firm sales. I also find that the comparison between my model and Melitz (2003) only exacerbates the results I present here — where I find that productivity reactions make a policy more beneficial, the comparison with Melitz (2003) makes the difference even larger. Thus, to be conservative in what I consider my main results, I present comparisons between my model with and without productivity reactions, rather than to Melitz (2003).

<sup>14</sup> I use the change in firms' total quantity produced to measure impacts on real sales, since measuring quantities directly gets around price changes.

<sup>15</sup> For more details on the estimated Melitz (2003) model, Appendix Table 23 shows parameter estimates, Appendix Table 24 shows moment comparisons, and Appendix Figures 12 and 13 further show comparisons for log exports and imports.



I first calculate the change in welfare resulting from moving to the climate change baseline scenario for each model. This welfare change is also the change in real GDP, using the consumer price index (rather than, for example, the GDP deflator) to convert nominal to real GDP. As the first row of Table 12 shows, I find that with productivity reactions, welfare declines by 6.8 percent. Shutting down productivity reactions, I estimate a 9.4 percent welfare decrease. Note that both models are calibrated so that the average firm sees an 0.108 log point decrease in sales between the status quo and the counterfactual — the difference is entirely due to productivity reactions and their effects on the distribution of firm sales. Note also that these decreases keep the rest of the world at its status quo production levels, since I want to study the implications for policy effectiveness of Zambia. Changing the rest of the world’s equilibrium would result in worse outcomes for Zambia with or without productivity adjustments. It would not, however, affect how much more or less effective policies become as a result of firm productivity reactions, so I abstract from it here.

Also note that I focus heavily on the relative welfare change stemming from different policy interventions compared to the climate change baseline, rather than comparing level changes in the baseline scenario with and without productivity reactions. The reason is that I mostly care about which policies are most effective at counteracting the effects of climate change, which is a question about welfare changes between the climate change baseline scenario and different policy experiments under that baseline scenario. To briefly highlight why the level results are different, however, I turn to Figure 10, which shows how each percentile of log real sales shifts when moving from the status quo to the climate change baseline, with and without productivity reactions. (Real sales are calculated using the optimal consumer price index.) The figure shows the ratio of the new to the old percentile; all percentiles are shifted down in both cases. With productivity reactions, however, larger firms hire productive capability let go by smaller firms and manage to retain more of their status quo sales. On the flip side, smaller firms see a larger decline in sales, since they cannot afford to retain productive capability. Overall, this allows Zambian firms to remain more productive and retain a better connection to export destinations, which leads to a smaller welfare decline. The cost is that smaller firms are more severely affected by climate change.

I now turn to policy experiments under the climate change baseline. I focus on two policy experiments, both reducing trade costs, either iceberg (variable) or entry cost (fixed) cost of trade. For each scenario, I calculate the welfare change compared to the status quo, and the relative welfare improvement compared to the climate change baseline. I then compare those improvements to assess how effective each policy is at reducing the negative impacts of climate change.

The first policy change is a reduction in iceberg trade cost from Home to all other countries,  $d_{nH}$ , by 10 percent across the board. (This is an asymmetric reduction — I keep trade costs from all other countries to Home,  $d_{Hn}$ , fixed.) The results are presented in row two of Table 12. Compared to current welfare, when productivity is allowed to react, Zambia now experiences only a 3.8 percent decline compared to the status quo, which means trade policy reduces the impact of climate change by 3.0 percentage points, or 44 percent ( $\approx 3.0/6.8$ ). Without productivity reactions, Zambia still sees a 6.5 percent welfare decline under this scenario, a 2.9 percentage point or 31 percent ( $\approx 2.9/9.4$ ) improvement.

Thus, I find that almost a third of the welfare impact of iceberg cost reductions, or 30 percent ( $\approx (44 - 31)/44$ ), is due to productivity responses, making trade policy 1.4 times ( $\approx 44/31$ ) more effective. A key reason for this is that variable trade cost reductions allow very productive firms, which are already exporting, to increase their productive capability. This may hurt smaller firms, which may not be able to retain some of their productive capability, but increases efficiency overall. Figure 11 shows the change in the distribution of real sales when moving from the climate change baseline scenario to the iceberg cost reduction policy experiment. With and without productivity adjustments, smaller firms lose sales while larger firms increase sales. This is because trade cost reductions benefit existing exporters, who hire additional production labor to expand their operations. This puts upwards pressure on wages, which leads to sales losses for smaller firms. Productivity reactions exacerbate this, leading small firms to lose additional sales because they cannot afford to retain their productive capability, while larger firms purchase additional productive capability and become more efficient. Since large firms have considerably higher sales than smaller firms, the overall impact is positive for the Zambian economy.

The second policy change is a reduction in entry cost  $f_{nH}$  by 10 percent across the board. Here, both with and without productivity reactions, the effects are negligible. The reason is that most of the benefit from entry cost reductions goes to relatively unproductive firms — those who were not productive enough to reach export destinations before. Variable trade cost reductions, on the other hand, benefit already exporting firms, leading to the dynamics discussed above.

## 6 Conclusion

I show that weather shocks are, predominantly, supply shocks rather than demand shocks for non-agricultural firms in poor countries, using a test comparing exporters and non-exporters: Exporters

see a larger negative effect of weather shocks on sales. I further show that firm sales across markets are linked, since even exporters’ domestic sales are more severely affected by these shocks. I show that this link is due to firms’ expenditures on productive capability, such as machinery, office space, or a sales team. Productive capability lowers the cost of providing their products across all markets they serve. In response to a negative productivity shock, firms reduce productive capability, which in turn makes them less productive across all markets they are active in, reducing sales there as well. I support this by showing that exporters scale back productive capability more than non-exporters in response to negative weather shocks, and via a mediation analysis showing that once I control for productive capability spending, the differential effect on exporters’ domestic sales disappears. I rule out competing explanations based on well-known differences between exporters and purely domestic producers, such as their size, sector or complexity of their production structure.

I then develop an international trade model featuring hired productive capability and show that it reproduces these comparative statics. I estimate it using a novel algorithm that overcomes computational issues common in models with dependent market entry decisions, and leveraging a small open economy framework, which allows me to simplify this otherwise computationally complex model. I combine the model with causal forest estimates of the impact of climate change, taking the large dimensionality of weather as well as firm adaptation into account. Policy simulations under this climate change scenario show that trade policy is considerably more effective at mitigating the impact of climate change when I take productive capability responses into account. I find that the welfare effect of a ten percent reduction in variable (iceberg) trade costs is 1.4 times larger due to these responses, compared to a version of my model that shuts down productivity responses.

This is important as we consider what policies both rich and poor countries can adapt so poor countries can better mitigate the impact of climate change. The endogenous productivity response I highlight means trade policy is more effective than we might have assumed, is especially well-suited to counteracting the negative productivity effects of climate change, and should play a significant role as we work on coping with climate change. My results are especially important for poor countries, since the key mechanism is especially pronounced when the domestic market is small relative to foreign markets. My results also highlight that as rich countries consider onshoring and shortening supply chains (Goldberg & Reed, 2023), they should ensure those policies do not impose unnecessary collateral damage on poor countries. Ill-targeted, such policies could in fact greatly reduce poor countries’ ability to deal with climate change.

Of course, none of this detracts from the fact that trade policy can also play a key role in

preventing or reducing the severity of climate change (Farrokhi & Lashkaripour, 2021). More generally, there are good reasons to think that prevention is preferable to accepting climate change and resolving ourselves to dealing with it when it happens. Nevertheless, some amount of climate change is already occurring and will continue to occur over the near and medium term, and poor countries will be affected by it. Understanding what policies are especially suited for allowing them to deal with that reality is a crucial task for contemporary social science. Understanding firm reactions to extreme weather events will be an important part of this.

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# Tables

Table 1: Firm summary statistics

Variable	Count	Mean	P25	Median	P75
Sales (real 2009 USD)	37,100	44,451,183.54	27,648.78	104,665.36	500,123.04
Cost (real 2009 USD)	38,358	2,309,691.81	8,393.78	30,651.68	134,594.01
Labor cost (real 2009 USD)	36,664	221,888.62	4,747.38	14,736.47	56,391.69
Number of employees	46,347	40.21	6.00	10.00	23.00
Initial number of employees	39,455	24.36	4.00	6.00	12.00
Exporter	45,884	0.12	0.00	0.00	0.00
Manufacturing	46,694	0.32	0.00	0.00	1.00
Internat. quality cert.	45,302	0.13	0.00	0.00	0.00
Manager experience (years)	45,949	14.17	7.00	12.00	20.00
Yearly mean temperature (°C)	26,309	29.68	26.72	30.56	33.15
Yearly total precipitation (1,000 mm)	26,309	1.03	0.56	0.92	1.28

*Note:* The lower observation counts for weather variables stem from the fact that I can only match firm and weather data for firms that have non-missing location information.

Table 2: ATE of weather shocks

Variable	Log sales
Temperature index	−0.223* [0.091]
Year FE	Yes
Cluster FE	Yes
Clusters	587
Observations	18,273

*Note:* *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific *z*-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 3: Effect of weather shocks by exporter status

Variable	Log sales
Temperature index	−0.125 [0.296]
Temperature index $\times$ Current exporter	−0.094*** [0.006]
Current exporter	1.603*** [0.000]
Year FE	Yes
Cluster FE	Yes
Clusters	376
Observations	17,024

*Note:* *Current exporters* are firms that export in the current fiscal year. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific  $z$ -scores for each variable (using the 20-year mean and standard deviation of reach variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round.  $p$ -values in brackets.

Table 4: Effect of weather shocks on domestic sales

Variable	Log domestic sales
Temperature index	−0.186 [0.118]
Temperature index $\times$ Current exporter	−0.071** [0.013]
Current exporter	0.886*** [0.000]
Year FE	Yes
Cluster FE	Yes
Clusters	362
Observations	16,196

*Note:* *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific  $z$ -scores for each variable (using the 20-year mean and standard deviation of reach variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round.  $p$ -values in brackets.

Table 5: Effect of weather shocks on productive capability and productivity

Variable	Log productive capability	Log sales/employee
Temperature index	−0.049 [0.753]	−0.036 [0.722]
Temperature index × Current exporter	−0.117*** [0.001]	−0.048** [0.019]
Current exporter	1.233*** [0.000]	0.631*** [0.000]
Year FE	Yes	Yes
Cluster FE	Yes	Yes
Clusters	201	375
Observations	7,510	16,920

*Note:* *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific z-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Productive capability expenditures combine cost of communications, sales, transportation, and rent for buildings, equipment and land. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 6: Indications of productivity impact

Variable	Log sales/employee	Log weekly hours	Outage
Temperature index	−0.074 [0.491]	0.142* [0.088]	0.065* [0.075]
Year FE	Yes	Yes	Yes
Cluster FE	Yes	Yes	Yes
Clusters	587	522	595
Observations	18,133	11,837	22,327

*Note:* *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific z-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Each column shows results for a different outcome. *Log weekly hours* is the log of the firm's total operating hours per week. *Log female employment* is the log of the firm's number of female employees. *Outage* is an indicator for whether the firm experienced power outages. Outcomes winsorized at the 95<sup>th</sup> percentile, except indicators. *p*-values in brackets.

Table 7: Effect of weather shocks on domestic sales, mediation via productive capability

Variable	Log domestic sales
Temperature index	−0.182 [0.139]
Temperature index × Current exporter	0.041 [0.438]
Current exporter	0.179 [0.112]
Log productive capability controls	Yes
Year FE	Yes
Cluster FE	Yes
Clusters	375
Observations	7,447

*Note:* *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific z-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. *Log productive capability controls* comprises log productive capability expenditures fully interacted with exporter status and the temperature index. I do not show the coefficients on these endogenous regressors. *(DM)* indicates the variable is de-measured to center interaction terms. Productive capability expenditures combine cost of communications, sales, transportation, and rent for buildings, equipment and land. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 8: Exporters compared to non-exporters

Variable	Mean non-exporter	Mean exporter	<i>p</i> -value
Sales (real 2009 USD)	870,913.66	2,646,253.68	0.000***
Cost (real 2009 USD)	267,630.22	1,093,091.57	0.000***
Labor cost (real 2009 USD)	74,375.21	232,004.51	0.000***
Number of employees	23.14	66.31	0.000***
Initial number of employees	11.68	23.97	0.000***
Manufacturing	0.29	0.49	0.000***
Internat. quality cert.	0.10	0.28	0.000***
Manager experience (years)	13.65	15.45	0.006***
Yearly mean temperature (°C)	29.61	29.69	0.593
Yearly total precipitation (1,000 mm)	0.98	0.98	0.561

Table 9: Parameter estimates for structural model

Parameter	Source/identifying variation	Estimate
<i>Panel A: Reduced form and data</i>		
$\sigma$	Sales, variable cost	3.016 (0.043)
$\beta\delta$	Sales regression (10)	0.384 (0.016)
<i>Panel B: Structural estimation</i>		
$\theta$	75/25 ratio for domestic sales	7.706
$T_H w_H$	Ratio of Home sales to Foreign sales	0.000
$f_H w_H$	Fraction of exporters	0.002
$\gamma_0$		-1.553
$\gamma_{\text{dist}}$	Export flows	0.605
$\gamma_{\text{contig}}$		0.402

Note: Standard errors in parentheses where available. I present the minimum productivity  $T_H$  and start-up cost  $f_H$  times the estimated Home wage  $w_H$  to convert them into an easier to interpret unit, millions of USD, rather than presenting them in units of labor. The three components of  $\gamma$  are the intercept  $\gamma_0$ , the coefficient on log distance  $\gamma_{\text{dist}}$  and the coefficient on the contiguity indicator  $\gamma_{\text{contig}}$ .

Table 10: Moment comparisons for structural model

Moment	Data	Model
Fraction exporting	0.152	0.155
Ratio own trade/total exports	1.819	1.536
75/25 domestic sales ratio	3.596	4.788

Note: 75/25 ratio is the ratio of the 75<sup>th</sup> to the 25<sup>th</sup> percentile. The other set of targeted moments, log exports, is shown in Figure 7.

Table 11: Causal forest estimates for 2086–2090

Scenario	Change in log sales
SSP1/2.6	−0.066 (−0.131, 0.000)
SSP2/4.5	−0.083 (−0.160, −0.006)
SSP5/8.5	−0.108 (−0.188, −0.028)

Note: Standard errors clustered by firm cluster. 90 percent confidence intervals in parentheses.

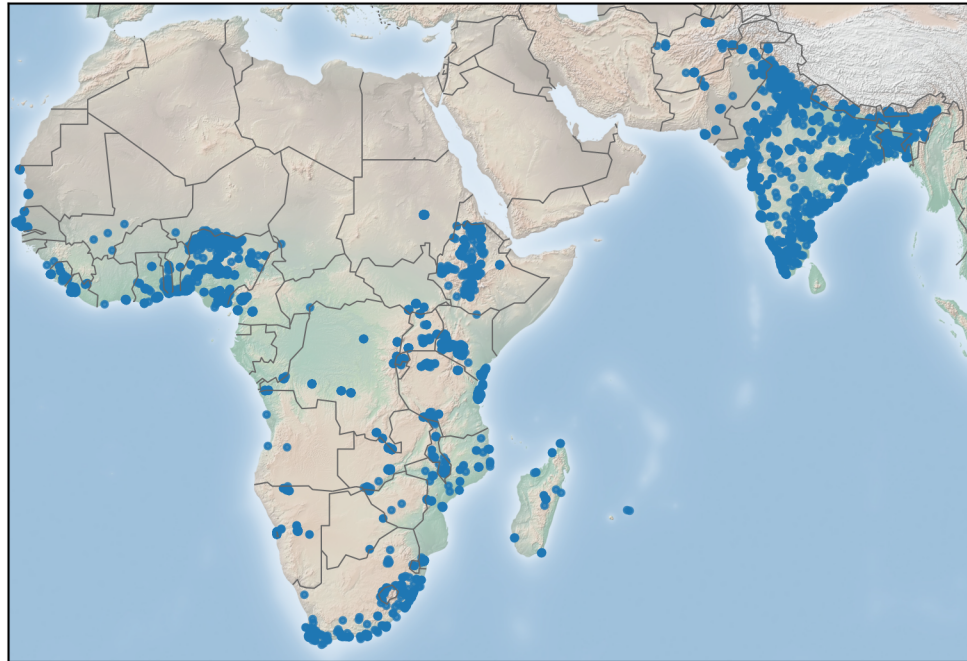
Table 12: Counterfactual change in welfare

Scenario	Full model	Fix $c_j$
Climate change baseline	-0.068	-0.094
Iceberg cost reduction	-0.038	-0.065
Entry cost reduction	-0.068	-0.094

*Note:* Each column presents results for a different model. Each row presents the relative change in welfare under a different counterfactual scenario compared to the status quo. These welfare changes are also changes in real GDP, using the optimal consumer price index to convert nominal to real values. *Full model* shows results for my model and *Fix  $c_j$*  shows results for my model with productivity reactions shut down (fixing the distribution of productive capability at the status quo). *Climate change baseline* uses the technology parameter  $T_H$  to match the estimated impact of climate change on the Zambian economy. Starting from that scenario, *iceberg cost reduction* reduces variable trade costs from Zambia to all other markets by ten percent, while *entry cost reduction* reduces entry cost for Zambian firms to all other markets by ten percent.

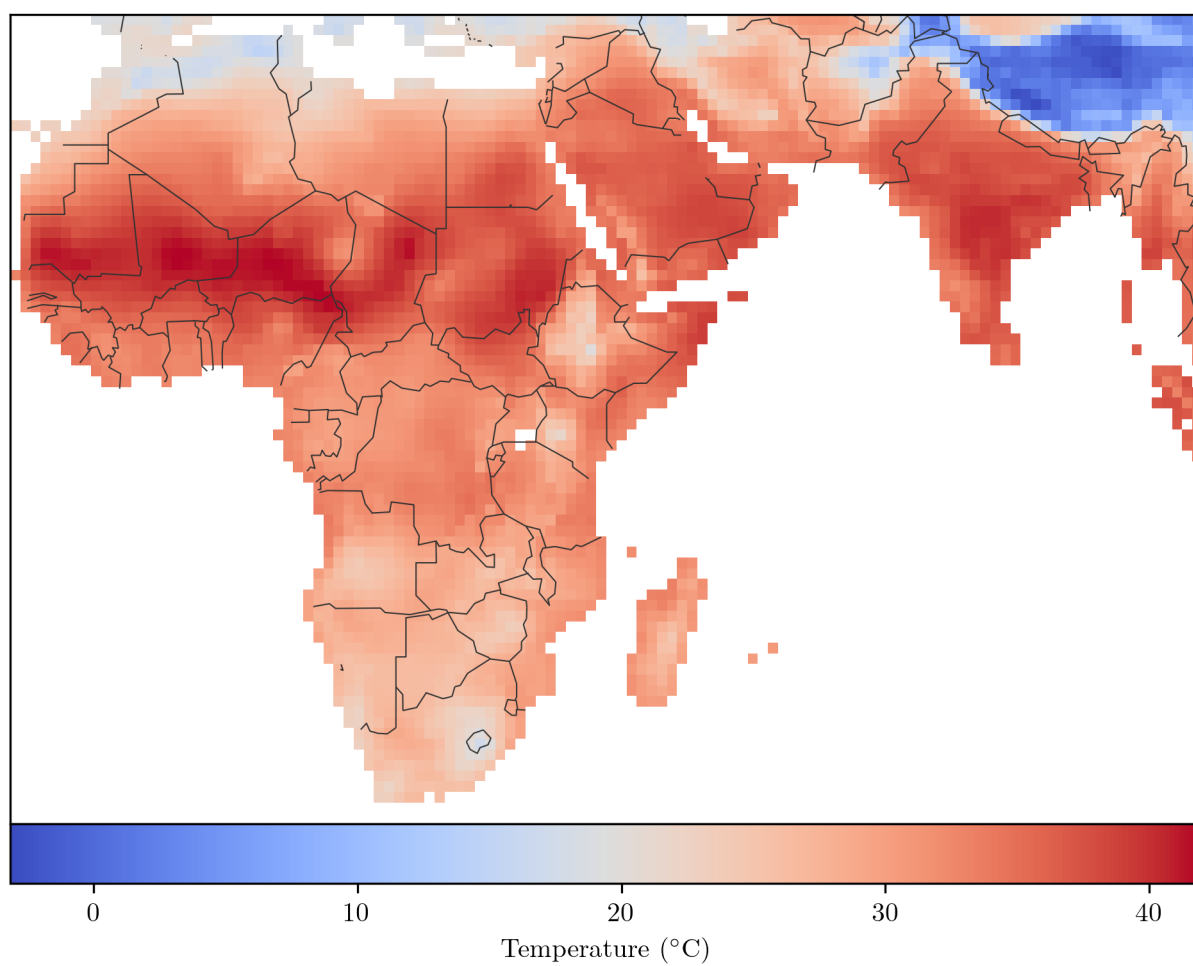
## Figures

Figure 1: Locations of firms and firm clusters across Africa and South Asia



*Note:* Each dot is either the location of a single firm or the location of a firm cluster. Clusters appear if several firms were recorded as having the same location in the Enterprise Surveys data or if I was able to determine the firms' location via geolocation methods based on the city firms are located in.

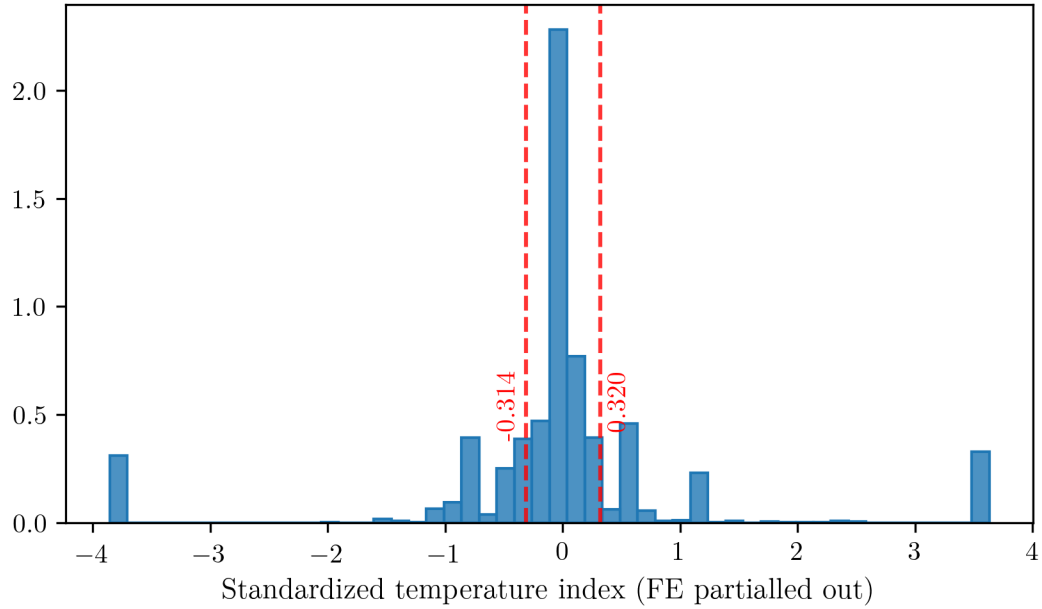
Figure 2: Maximum temperature on April 24, 1991



*Note:* The figure shows temperature from the Berkeley Earth dataset.

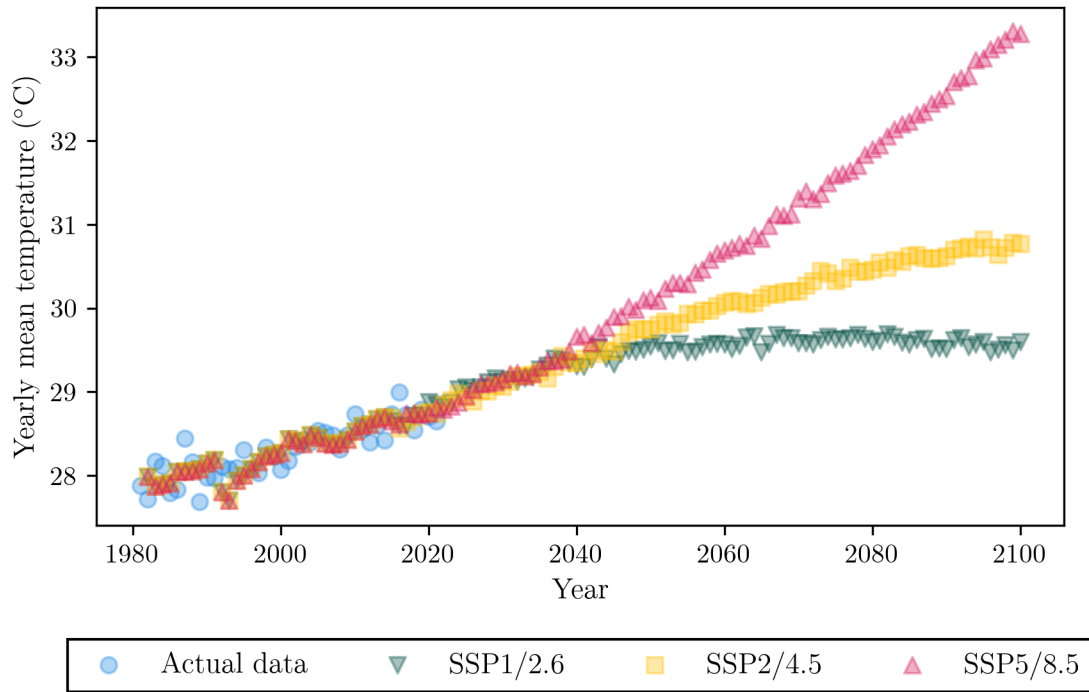


Figure 3: Histogram of temperature index after partialling out cluster FE



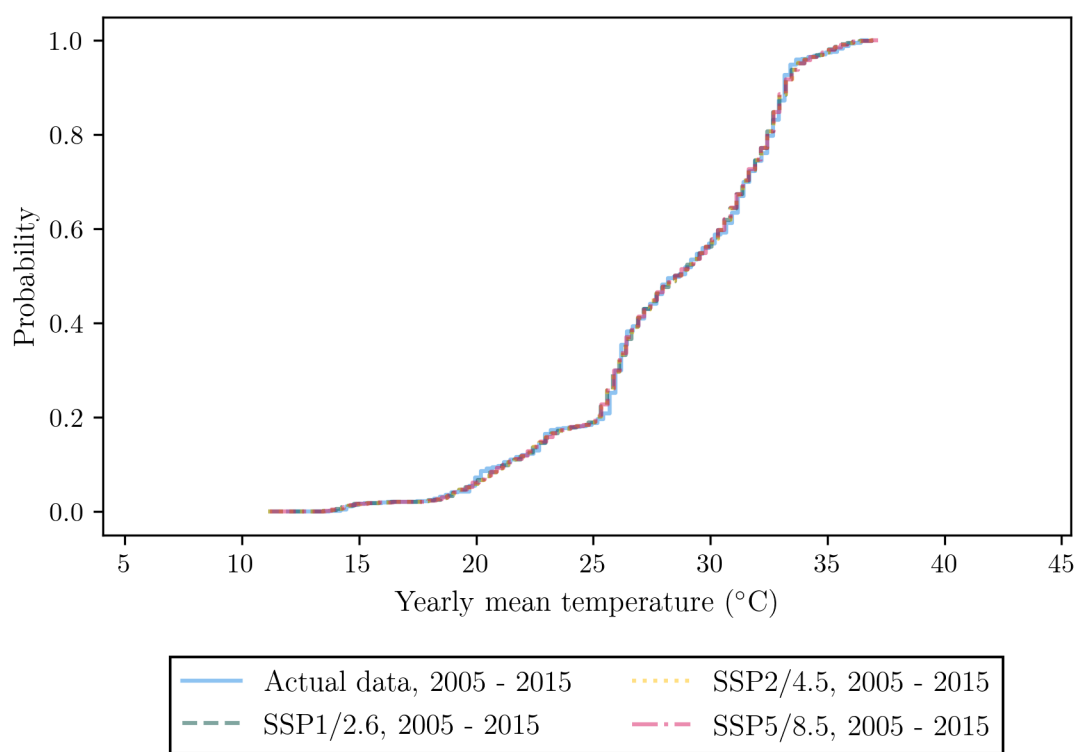
*Note:* The figure shows the temperature index after partialling out cluster fixed effects. This is the same identifying variation used in the regressions I estimate — the variation remaining in the standardized temperature index after cluster fixed effects are taken into account. Dashed lines indicate the 20<sup>th</sup> and 80<sup>th</sup> percentile. Observations without variation after partialling out FE not shown.

Figure 4: Yearly average daily maximum temperature across climate change scenarios



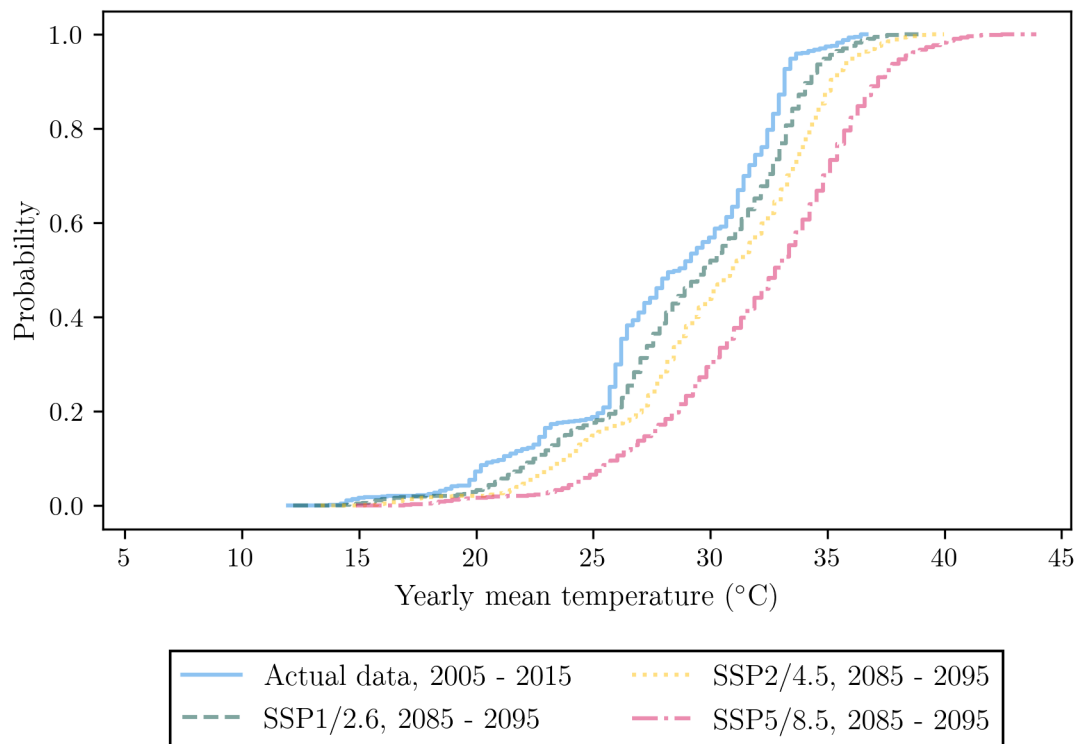
*Note:* The figure shows yearly averages of daily maximum temperatures. The climate change projections are adjusted for differences in baseline temperature means for each day of the year, as described in Appendix C.

Figure 5: Distribution of yearly average daily maximum temperature, 2005–2015, for actual data and climate change projections



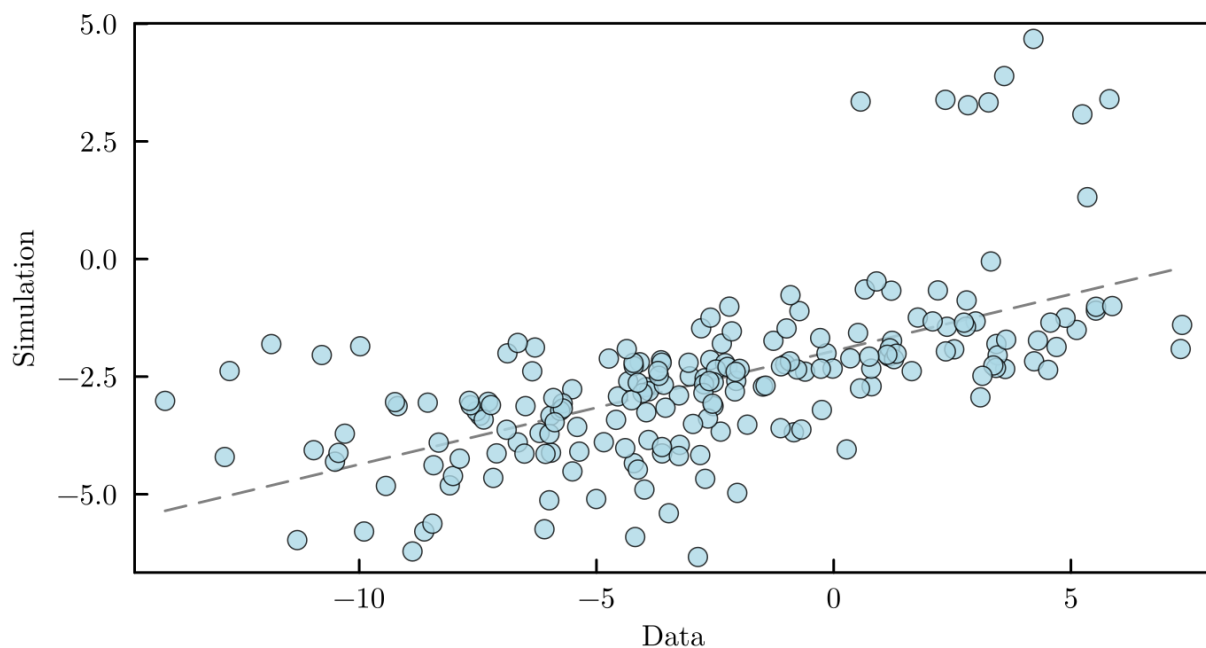
*Note:* The figure shows the empirical CDF of the yearly average of daily maximum temperatures across firms. The climate change projections are adjusted for differences in baseline temperature means for each day of the year, as described in Appendix C.

Figure 6: Distribution of yearly average daily maximum temperature, 2005–2015 for actual data and 2085–2095 for climate change projections



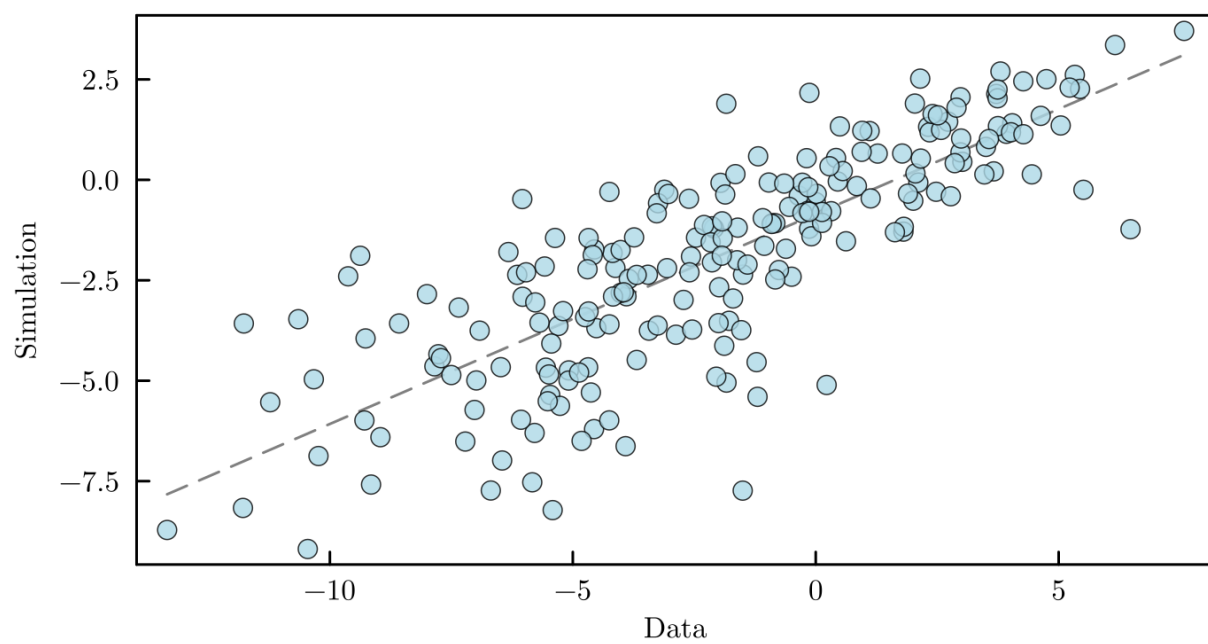
*Note:* The figure shows the empirical CDF of the yearly average of daily maximum temperatures across firms. The climate change projections are adjusted for differences in baseline temperature means for each day of the year, as described in Appendix C.

Figure 7: Zambian log exports vs. model simulation



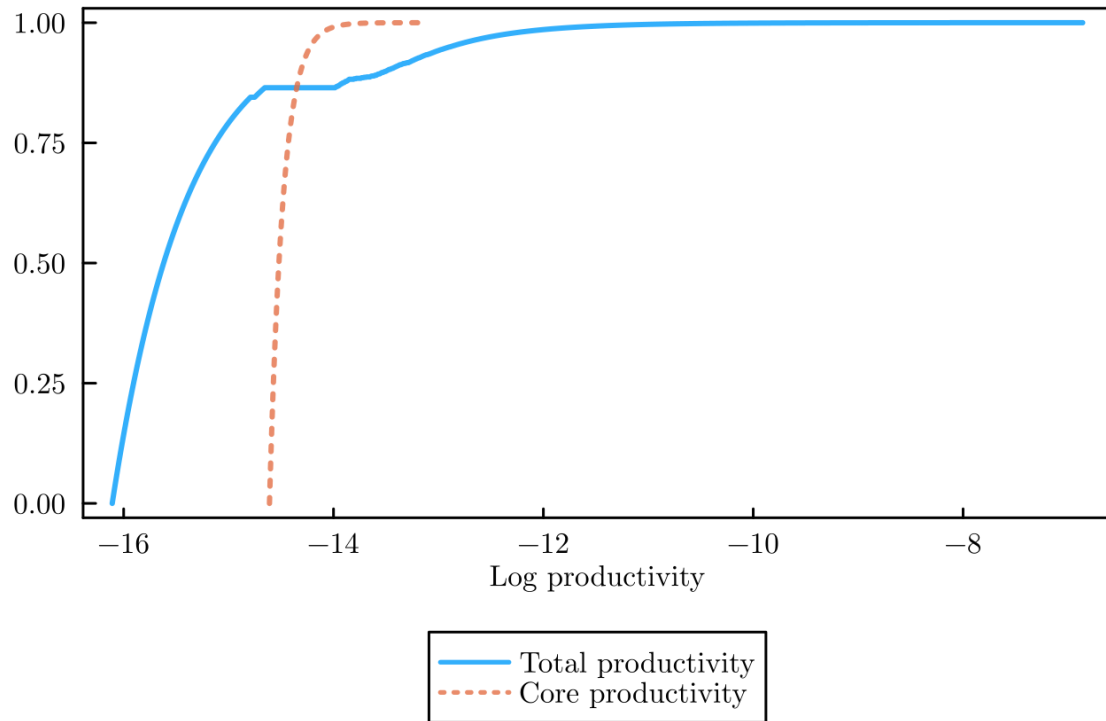
*Note:* Log exports are a targeted moment, together with the fraction of countries with zero exports.

Figure 8: Zambian log imports vs. model simulation



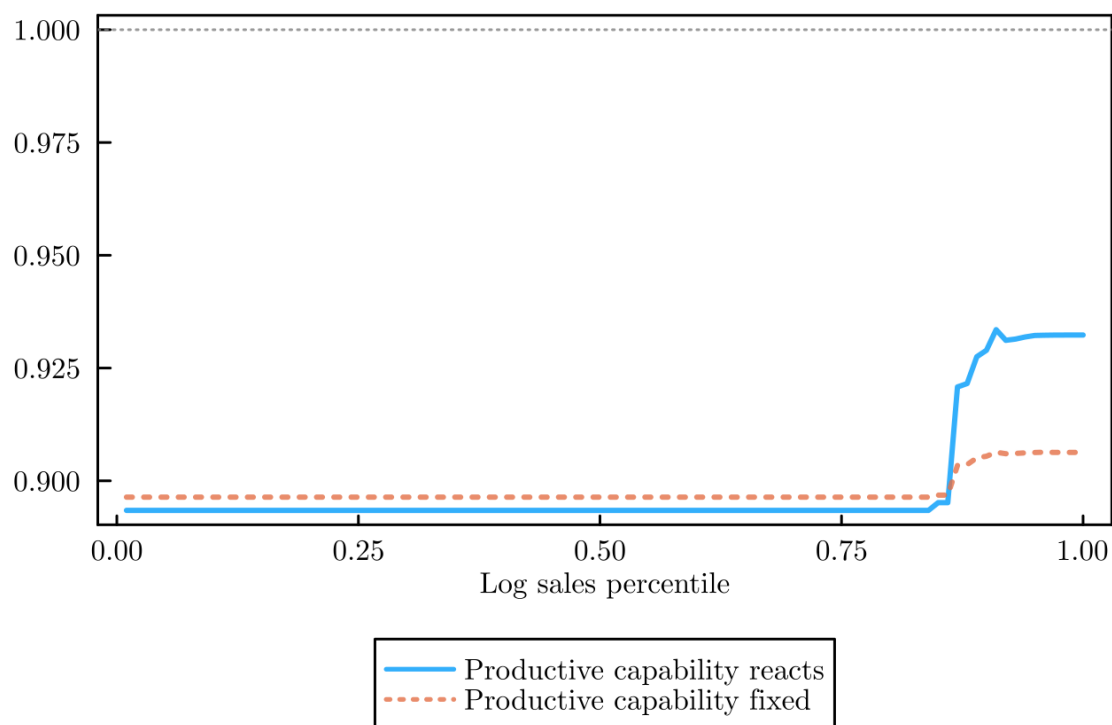
*Note:* Log imports are an untargeted moment.

Figure 9: Log total productivity compared to log core productivity



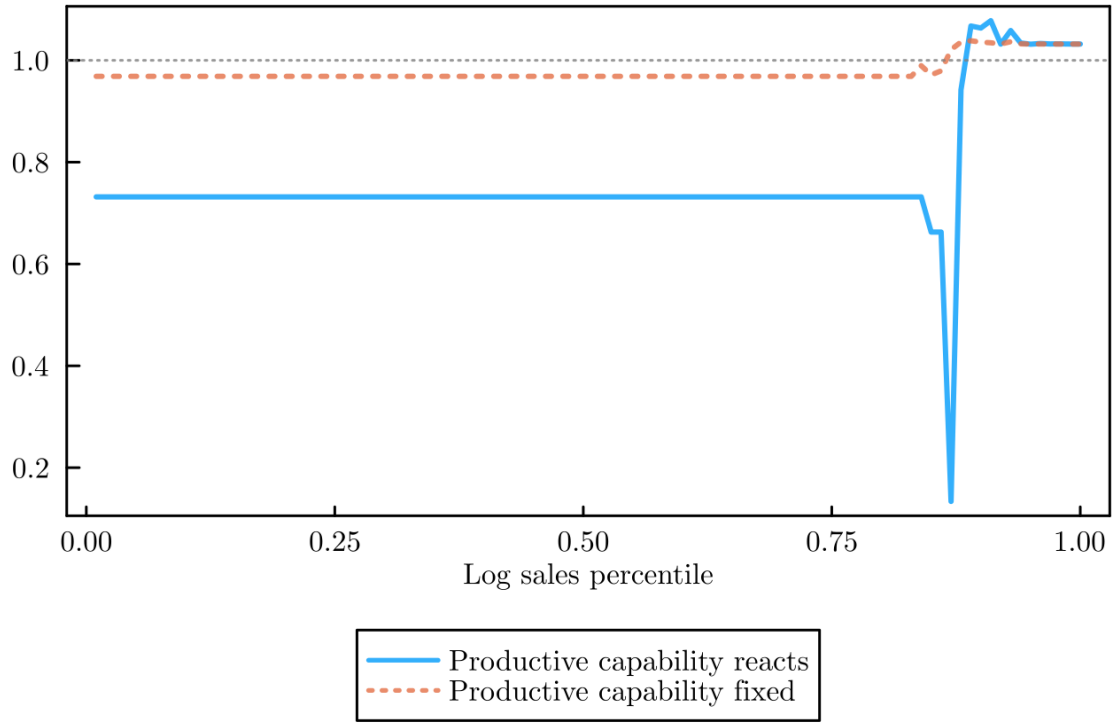
*Note:* The figure shows log total productivity  $a_j c_j^\delta$ , which depends on core productivity  $a_j$  and productive capability  $c_j$ . Log core productivity also shown for comparison.

Figure 10: Change in log real sales under climate change baseline scenario



*Note:* The figure shows the change in real sales at each percentile of the real sales distribution. I calculate the ratio of each percentile in the climate change baseline scenario to the same percentile in the status quo. Values less than one thus indicate that the percentile shifts to the left. The grey dotted line at 1.0 indicates no change. Real sales are calculated using optimal consumer price indices.

Figure 11: Change in log real sales with iceberg cost reduction



*Note:* The figure shows the change in real sales at each percentile of the real sales distribution. I calculate the ratio of each percentile in the iceberg trade cost reduction scenario to the same percentile in the climate change baseline scenario. Values less than one thus indicate that the percentile shifts to the left. The grey dotted line at 1.0 indicates no change. Real sales are calculated using optimal consumer price indices.

## Appendix A Additional tables

### A.1 Clustering distance choice

Table 13: Moran test for spatial correlation

Clustering distance	$p$ -value	Adjusted $p$ -value	Fraction included
0.25 km	0.116	1.000	0.110
0.5 km	0.686	1.000	0.215
1.0 km	0.535	1.000	0.325
2.5 km	0.147	1.000	0.399
5.0 km	0.582	1.000	0.406
10.0 km	0.130	1.000	0.414
15.0 km	0.161	1.000	0.416
20.0 km	0.422	1.000	0.417
25.0 km	0.440	1.000	0.423
50.0 km	0.678	1.000	0.430
100.0 km	0.605	1.000	0.432
200.0 km	0.757	1.000	0.440
500.0 km	0.500	1.000	0.509

*Note:* The Moran test is for the null that residuals from a regression of log sales on a temperature index are not correlated across clusters. The index combines mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific  $z$ -scores for each variable (using the 20-year mean and standard deviation of reach variable). Standard errors clustered by firm cluster. *Adjusted  $p$ -values* are adjusted for multiple hypothesis testing using the Holm-Bonferroni correction.



## A.2 Alternative specifications for exporter effect

Table 14: Effect of weather shocks by exporter status, no year FE

Variable	Log sales
Temperature index	−0.004 [0.938]
Temperature index × Current exporter	−0.094*** [0.006]
Current exporter	1.630*** [0.000]
Cluster FE	Yes
Clusters	586
Observations	17,975

*Note:* *Current exporters* are firms that export in the current fiscal year. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific *z*-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 15: Effect of weather shocks by exporter status, most reliable numbers only

Variable	Log sales
Temperature index	−0.120 [0.308]
Temperature index × Current exporter	−0.069 [0.216]
Current exporter	1.473*** [0.000]
Year FE	Yes
Cluster FE	Yes
Clusters	244
Observations	5,746

*Note:* This estimation uses only data that came directly from firm records, as opposed to being estimates, for example. *Current exporters* are firms that export in the current fiscal year. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific *z*-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

### A.3 Alternative indicators for exporter status

Table 16: Exporter effect using past exporter status

Variable	Log sales
Temperature index	0.119 [0.358]
Temperature index $\times$ Past exporter	-0.074** [0.036]
Past exporter	1.208*** [0.000]
Year FE	Yes
Cluster FE	Yes
Clusters	587
Observations	18,273

*Note:* *Past exporter* is an indicator for firms reporting a past year as their first year of exporting. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific *z*-scores for each variable (using the 20-year mean and standard deviation of reach variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 17: Exporter effect using ever exporter status

Variable	Log sales
Temperature index	0.141 [0.269]
Temperature index $\times$ Ever exporter	-0.079** [0.022]
Ever exporter	1.384*** [0.000]
Year FE	Yes
Cluster FE	Yes
Clusters	586
Observations	17,975

*Note:* *Ever exporter* is an indicator for firms which exported in the past and/or report international sales this year. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific *z*-scores for each variable (using the 20-year mean and standard deviation of reach variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 18: Effect on continuing, discontinuing, and first-time exporters

Variable	Log sales
Temperature index	−0.143 [0.178]
Temperature index × Continuing exporter	−0.097*** [0.005]
Temperature index × Discontinuing exporter	−1.451*** [0.002]
Temperature index × First-time exporter	0.092 [0.573]
Year FE	Yes
Exporter status FE	Yes
Cluster FE	Yes
Clusters	586
Observations	17,975

*Note:* *Continuing exporters* are firms that exported in the past and do so in the observed year. *Discontinuing past exporters* are firms that exported in the past and are not doing so in the observed year. *First-time exporters* did not export in the past, but are doing so now. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific z-scores for each variable (using the 20-year mean and standard deviation of reach variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

## A.4 Additional regressions

Table 19: Effect of weather shocks on cost of repurchasing machinery

Variable	Log value of re-purchasing machinery
Temperature index	0.121 [0.656]
Temperature index $\times$ Current exporter	0.035 [0.465]
Current exporter	1.635*** [0.000]
Year FE	Yes
Cluster FE	Yes
Clusters	215
Observations	6,312

*Note:* *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific z-scores for each variable (using the 20-year mean and standard deviation of reach variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

Table 20: Checks for alternative explanations

Variable	Log sales	Log sales	Log sales	Log sales	Log sales	Log sales	Log sales	Log sales
Temperature index	-0.269** [0.023]	-0.049 [0.671]	-0.113 [0.240]	-0.077 [0.378]	-0.105 [0.303]	-0.050 [0.611]	-0.101 [0.357]	0.064 [0.312]
Temperature index $\times$ Current exporter	-0.088*** [0.006]	-0.063** [0.025]	-0.089** [0.015]	-0.101*** [0.000]	-0.079** [0.014]	-0.099*** [0.000]	-0.098*** [0.003]	-0.049*** [0.002]
Temperature index $\times$ Initial no. of employees > median	-0.017 [0.516]							-0.014 [0.444]
Initial no. of employees > median	1.208*** [0.000]							0.434*** [0.000]
Temperature index $\times$ No. of employees 3 yrs. ago > median		-0.036 [0.146]						-0.042* [0.094]
No. of employees 3 yrs. ago > median		1.772*** [0.000]						1.321*** [0.000]
Temperature index $\times$ International certification					-0.026 [0.646]			0.008 [0.789]
International certification					1.251*** [0.000]			0.597*** [0.000]
Temperature index $\times$ Manager's years of experience > median							-0.060*** [0.000]	-0.014 [0.394]
Manager's years of experience > median							0.563*** [0.000]	0.241*** [0.000]
ISIC2 FE			Yes	Yes				
ISIC2 FE $\times$ weather variables			Yes	Yes				Yes
ISIC4 FE								Yes
ISIC4 FE $\times$ weather variables				Yes				Yes
Legal status FE						Yes		Yes
Legal status FE $\times$ weather variables						Yes		Yes
Current exporter	1.277*** [0.000]	1.050*** [0.000]	1.494*** [0.000]	1.419*** [0.000]	1.365*** [0.000]	1.286*** [0.000]	1.568*** [0.000]	0.733*** [0.000]
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Cluster FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Clusters	584	582	584	583	586	586	586	573
Observations	16,169	16,554	16,446	16,221	17,537	17,903	17,774	13,417

*Note:* *ISIC2 FE* and *ISIC4 FE* are indicators for two-digit and four-digit ISIC sectors, respectively. *International certification* is an indicator for firms reporting that they have an international quality certification. *Legal status FE* are indicators for the legal status of the firm. The omitted status are sole proprietorships. *Temperature index* is an index combining mean temperature, temperature variance and the number of days with temperatures exceeding 32°C (89.6°F). The index is an average of location-specific z-scores for each variable (using the 20-year mean and standard deviation of each variable). An 0.318 increase in the index is an 80<sup>th</sup> percentile weather shock. Standard errors clustered by firm cluster. Outcomes winsorized at the 95<sup>th</sup> percentile for each survey round. *p*-values in brackets.

## A.5 Reduced form parameter estimation for structural model

Table 21: Sales regression

Variable	Trade flows
Log sales	0.816*** [0.000]
Manager's years of experience	0.037*** [0.000]
Log initial no. of employees	0.333*** [0.000]
Log no. of employees 3 yrs. ago	-0.668*** [0.000]
International certification	0.124*** [0.000]
Had power outage	0.060*** [0.000]
Competes against informal sector	-0.103*** [0.000]
Introduced new product	0.238*** [0.000]
Introduced new process	0.174*** [0.000]
Had RD expenditure	-0.131*** [0.000]
Part of larger firm	0.133*** [0.000]
Formal when founded	0.183*** [0.000]
Applied for grid connection	-0.085*** [0.000]
Applied for water connection	-0.103*** [0.000]
Firm age	0.021*** [0.000]
4 <sup>th</sup> degree polynomials	Yes
Pairwise interactions	Yes
Country-sector (ISIC4)-year FE	Yes
Observations	4,160

*Note: Fourth degree polynomials* are included for all continuous variables besides log sales. *Pairwise interactions* include only level variables, not variables raised to a power as part of the polynomials. Standard errors are robust. *p*-values in brackets.

Table 22: Gravity estimation

Variable	Trade flows
Log distance	$-1.167^{***}$ [0.000]
Contiguous	$0.661^{***}$ [0.000]
Importer FE	Yes
Exporter FE	Yes

*Note:* Standard errors are robust.  $p$ -values in brackets.

## A.6 Results for Melitz (2003) estimation

Table 23: Parameter estimates for Melitz (2003)

Parameter	Source/identifying variation	Estimate
<i>Panel A: Reduced form and data</i>		
$\sigma$	Sales, variable cost	3.016 (0.043)
$\beta\delta$	Sales regression (10)	0.384 (0.016)
<i>Panel B: Structural estimation</i>		
$\theta$	75/25 ratio for domestic sales	4.304
$T_H w_H$	Ratio of Home sales to Foreign sales	0.000
$f_H w_H$	Fraction of exporters	0.768
$\gamma_0$		-7.894
$\gamma_{\text{dist}}$	Export flows	0.421
$\gamma_{\text{contig}}$		5.876

*Note:* Standard errors in parentheses where available. I present the minimum productivity  $T_H$  and start-up cost  $f_H$  times the estimated Home wage  $w_H$  to convert them into an easier to interpret unit, millions of USD, rather than presenting them in units of labor. The three components of  $\gamma$  are the intercept  $\gamma_0$ , the coefficient on log distance  $\gamma_{\text{dist}}$  and the coefficient on the contiguity indicator  $\gamma_{\text{contig}}$ .

Table 24: Moment comparisons for structural estimation of Melitz (2003)

Moment	Data	Model
Fraction exporting	0.152	0.153
Ratio own trade/total exports	1.819	1.807
75/25 domestic sales ratio	3.596	1.673

*Note:* 75/25 ratio is the ratio of the 75<sup>th</sup> to the 25<sup>th</sup> percentile. The other set of targeted moments, log exports, is shown in Figure 12.



## A.7 Additional causal forest results

Table 25: Causal forest estimates for 2091–2095

Scenario	Change in log sales
SSP1/2.6	−0.048 (−0.121, 0.026)
SSP2/4.5	−0.059 (−0.133, 0.015)
SSP5/8.5	−0.101 (−0.176, −0.026)

*Note:* Standard errors clustered by firm cluster. 90 percent confidence intervals in parentheses.

## A.8 Additional counterfactual results

Table 26: Counterfactual change in welfare compared to Melitz (2003)

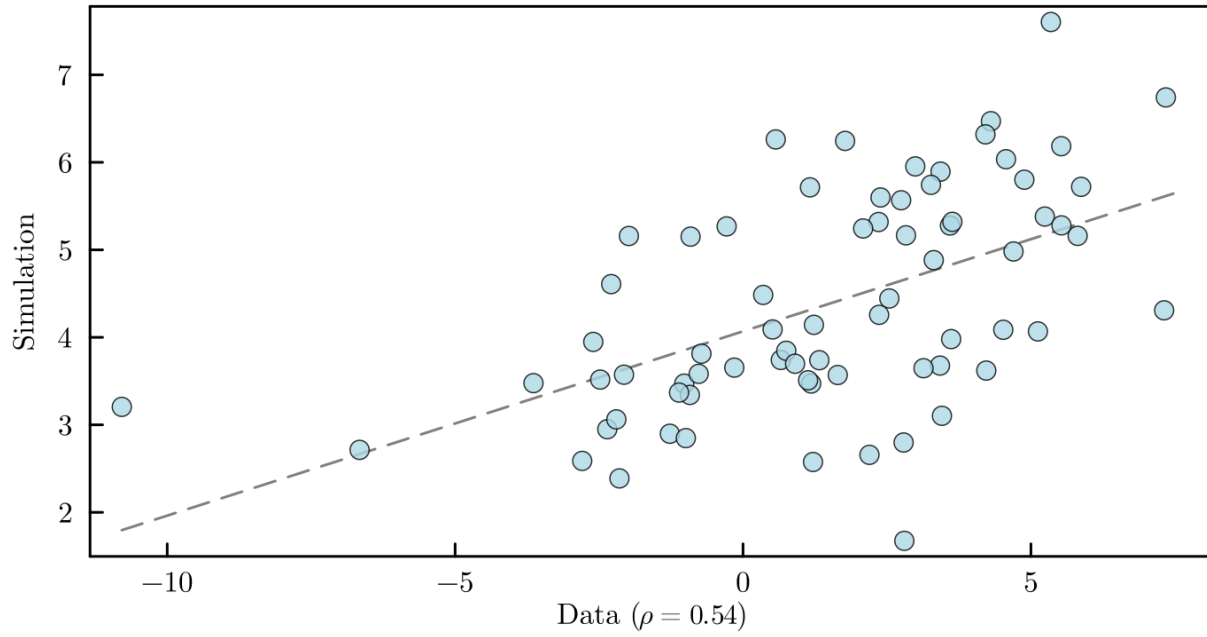
Scenario	Full model	Melitz (2003)
Climate change baseline	-0.068	-0.097
Iceberg cost reduction	-0.038	-0.090
Entry cost reduction	-0.068	-0.090

*Note:* Each column presents results for a different model. Each row presents the relative change in welfare under a different counterfactual scenario compared to the status quo. These welfare changes are also changes in real GDP, using the optimal consumer price index to convert nominal to real values. *Full model* shows results for my model and *Melitz (2003)* shows results for the model of Melitz (2003). *Climate change baseline* uses the technology parameter  $T_H$  to match the estimated impact of climate change on the Zambian economy. Starting from that scenario, *iceberg cost reduction* reduces variable trade costs from Zambia to all other markets by ten percent, while *entry cost reduction* reduces entry cost for Zambian firms to all other markets by ten percent.

## Appendix B Additional figures

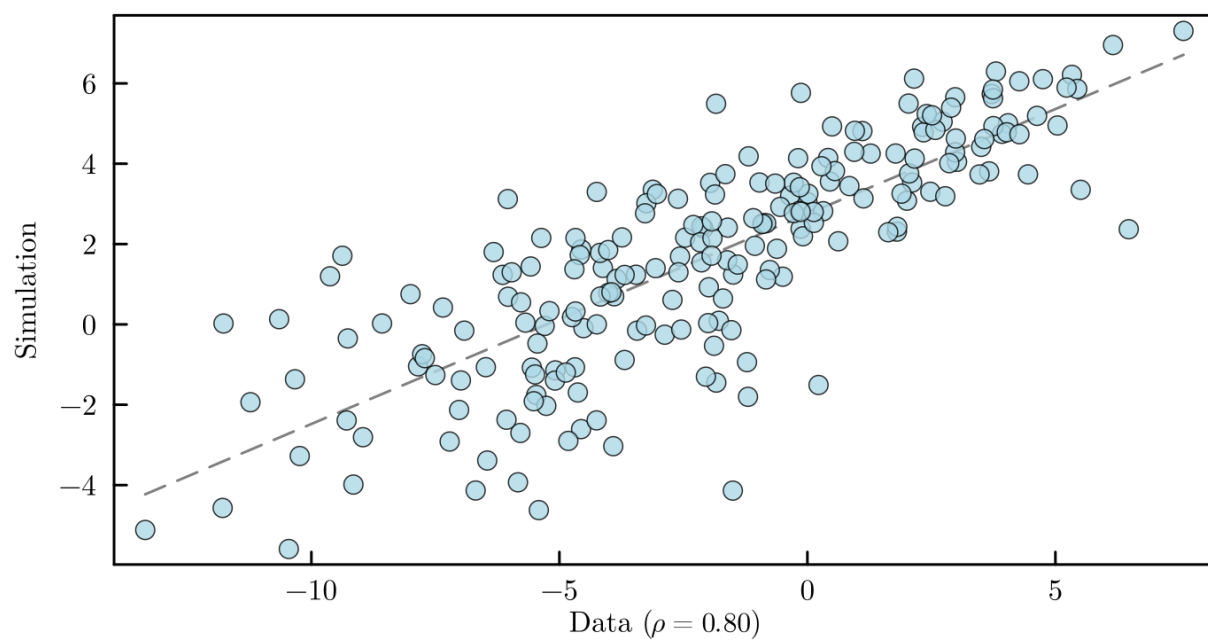
### B.1 Moment comparisons for Melitz (2003) estimation

Figure 12: Zambian log exports vs. model simulation from Melitz (2003) estimation



*Note:* Log exports are a targeted moment, together with the fraction of countries with zero exports.

Figure 13: Zambian log imports vs. model simulation from Melitz (2003) estimation



*Note:* Log imports are an untargeted moment.

## Appendix C Climate data processing

For firms that, due to their offset locations, ended up with interpolated data from CHIRPS or BKE, I also interpolate projection data in the same way to ensure that observed changes in weather are due to differences in weather over time at the same location, rather than weather data and projections coming from different locations. Since I combine weather data (CHIRPS and BKE) with the NEX-GDDP-CMIP6 projections, I need to take care to remove underlying differences in average weather at baseline, to isolate the effect of changes in weather patterns over time (Auffhammer et al., 2013). To this end, I also download historical runs of each model for the period from 1980–2014. This gives me an overlapping period of 34 years to assess existing biases across models and correct for them. For both temperature and precipitation, I calculate the average value for each day of the year (e.g., January 1) across this overlapping period and subtract the difference from projection data, as recommended by Auffhammer et al. (2013). For one of the climate models, TaiESM1, temperature jumps significantly between the historical run and climate change projection, making it impossible to adjust for bias and making me question the validity of the projection. I thus exclude the TaiESM1 projections for both temperature and precipitation from my analyses. No other model has this issue.

## Appendix D Proofs and derivations

### D.1 Optimal $c$

The FOC for the optimal distribution network gives

$$\begin{aligned}
0 &= \delta \frac{w_i}{a_j} c_j^{-\delta-1} \left( \sum_{n \in \mathcal{M}_j} d_{ni} \alpha_n p_n(j)^{-\sigma} \right) - b c_j^{\frac{1}{\beta}-1} w_i \\
\Leftrightarrow c_j^{\frac{1}{\beta}+\delta} &= \frac{1}{b} \delta \frac{1}{a_j} \left( \sum_{n \in \mathcal{M}_j} d_{ni} \alpha_n p_n(j)^{-\sigma} \right) \\
\stackrel{(4)}{\Leftrightarrow} c_j^{\frac{1}{\beta}+\delta} &= \frac{1}{b} \delta (\mu w_i)^{-\sigma} a_j^{\sigma-1} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) c_j^{\delta\sigma} \\
\Leftrightarrow c_j &= \left[ \frac{1}{b} \delta (\mu w_i)^{-\sigma} a_j^{\sigma-1} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) \right]^{\frac{\beta}{1-\beta(\sigma-1)\delta}}
\end{aligned} \tag{13}$$

### D.2 Proof that $\mathcal{M}_j^{\text{lb}}$ is a lower bound

I need to show that there is no set of markets  $\mathcal{M}_j^{\text{cand}}$  included in  $\mathcal{M}_j^{\text{lb}}$  such that exiting these markets would increase firm profits. I first show that there is no single market included in the lower bound that the firm could profitably exit, and then show that this also implies there is no set of markets included in the lower bound that the firm could profitably exit.

Suppose firm  $j$  is active in markets  $\mathcal{M}_j \supseteq \mathcal{M}_j^{\text{lb}}$  with  $c_j$  optimally chosen and considers whether exiting a market  $n \in \mathcal{M}_j^{\text{lb}}$  could increase its profit. Let  $\widetilde{\mathcal{M}}_j = \mathcal{M}_j \setminus \{n\}$  and let  $\tilde{c}_j$  be the corresponding optimal productive capability. Since  $c_j$  is increasing in  $|\mathcal{M}_j|$ , I know that  $\tilde{c}_j < c_j$ . I also know that at the iteration of the algorithm during which  $n$  was added to  $\mathcal{M}_j^{\text{lb}}$  the firm was active in a set of markets  $\mathcal{M}'_j$  not including  $n$  and would have made a variable profit in  $n$  at the optimal  $c'_j$ . Since the algorithm only ever adds markets at each iteration and  $\mathcal{M}_j \supseteq \mathcal{M}_j^{\text{lb}}$  I know that every market in  $\mathcal{M}'_j$  must also be in  $\widetilde{\mathcal{M}}_j = \mathcal{M}_j \setminus \{n\}$ . I therefore have  $\mathcal{M}'_j \subseteq \widetilde{\mathcal{M}}_j$  which implies  $c'_j \leq \tilde{c}_j$ . That is, the firm made a variable profit in  $n$  at some  $c'_j \leq \tilde{c}_j < c_j$ . Therefore, it will certainly make a variable profit in  $n$  at  $c_j$  or  $\tilde{c}_j$ , and variable losses incurred in  $n$  cannot be the reason to exit it (since there are none). Exiting  $n$  could still increase the firm's total profit because at  $\widetilde{\mathcal{M}}_j$ , the fact that  $\tilde{c}_j < c_j$  decreases its cost of acquiring productive capability. But there is nothing stopping the firm from choosing  $\tilde{c}_j$  at  $\mathcal{M}_j$  while still incurring a variable profit in  $n$ . Since at  $\mathcal{M}_j$ , the firm instead optimally chooses  $c_j$ , deviating to  $\tilde{c}_j$  cannot increase profits. Therefore, the firm would

never want to exit any market  $n \in \mathcal{M}_j^{\text{lb}}$ .

This argument extends to exiting a set of markets  $\mathcal{M}_j^{\text{cand}}$  that the algorithm included in  $\mathcal{M}_j^{\text{lb}}$ , because  $c_j$  depends only on the total effective demand of all markets in  $\mathcal{M}_j^{\text{cand}}$  (not on their indices, for example). The firm would make a profit in any market  $n \in \mathcal{M}^{\text{cand}}$ , so direct losses cannot be the reason to exit. For the firm's choice of  $c_j$ , exiting several markets at once is just like exiting one large market, because  $c_j$  depends only on the sum of  $\alpha_n$  across all markets the firm is active in. For the same reason as above, choosing a different  $c_j$  cannot increase profits.

### D.3 Proof that $\mathcal{M}_j^{\text{ub}}$ is an upper bound

I need to show that there is no set of markets  $\mathcal{M}_j^{\text{cand}}$  excluded from  $\mathcal{M}_j^{\text{ub}}$  such that entering these markets would increase firm profits. I first show that there is no single market excluded from the upper bound that the firm could profitably enter, and then show that this also implies there is no set of markets excluded from the upper bound that the firm could profitably enter.

Suppose firm  $j$  is active in markets  $\mathcal{M}_j \subseteq \mathcal{M}_j^{\text{ub}}$  with  $c_j$  optimally chosen and considers whether entering a market  $n \notin \mathcal{M}_j^{\text{ub}}$  could increase its profit. Let  $\widetilde{\mathcal{M}}_j = \mathcal{M}_j \cup \{n\}$  and let  $\tilde{c}_j$  be the corresponding optimal productive capability. Since  $c_j$  is increasing in  $|\mathcal{M}_j|$ , I know that  $\tilde{c}_j > c_j$ . I also know that at the iteration of the algorithm during which  $n$  was dropped from  $\mathcal{M}_j^{\text{ub}}$  the firm was active in a set of markets  $\mathcal{M}'_j$  including  $n$  and did not make a variable profit in  $n$  at the optimal  $c'_j$ . Since the algorithm only ever drops markets at each iteration and  $\mathcal{M}_j \subseteq \mathcal{M}_j^{\text{ub}}$ , I know that every market in  $\widetilde{\mathcal{M}}_j = \mathcal{M}_j \cup \{n\}$  must also be in  $\mathcal{M}'_j$ . I therefore have  $\mathcal{M}'_j \supseteq \widetilde{\mathcal{M}}_j$  which implies  $c'_j \geq \tilde{c}_j$ . That is, the firm made a variable loss in  $n$  at some  $c'_j \geq \tilde{c}_j > c_j$ . Therefore, it will certainly make a variable loss in  $n$  at  $c_j$  or  $\tilde{c}_j$  and variable profits made in  $n$  cannot be the reason to enter it (since there are none). Entering  $n$  could still increase the firm's total profit because at  $\widetilde{\mathcal{M}}_j$ , the fact that  $\tilde{c}_j > c_j$  increases its profit in other markets. But there is nothing stopping the firm from choosing  $\tilde{c}_j$  at  $\mathcal{M}_j$  without incurring a variable loss in  $n$ . Since at  $\mathcal{M}_j$ , the firm instead optimally chooses  $c_j$ , deviating to  $\tilde{c}_j$  cannot increase total profits. Therefore, the firm would never want to enter any market  $n \notin \mathcal{M}_j^{\text{ub}}$ .

This argument extends to entering a set of markets  $\mathcal{M}_j^{\text{cand}}$  that the algorithm excluded from  $\mathcal{M}_j^{\text{ub}}$ , because  $c_j$  depends only on the total effective demand of all markets in  $\mathcal{M}_j^{\text{cand}}$  (not on their indices, for example). The firm would make a variable loss in any market  $n \in \mathcal{M}^{\text{cand}}$ , so variable profits cannot be the reason to enter. For the firm's choice of  $c_j$ , entering several markets at once is just like entering one large market, because  $c_j$  depends only on the sum of  $\alpha_n$  across all markets the

firm is active in. For the same reason as above, choosing a different  $c_j$  cannot increase profits.

#### D.4 Mass of entrants

Letting  $\Omega_i$  denote the set of entrants in  $i$ , so  $N_i = |\Omega_i|$ , country  $i$ 's full employment condition is that

$$\begin{aligned}
L_i &= \int_{\Omega_i} \mathbb{1}[a_j \geq \underline{a}_i] \left\{ \left[ \sum_{n \in \mathcal{M}_j} d_{ni} q_n(j) \frac{1}{a_j c_j^\delta} + f_{ni} \right] + b\beta c_j^{\frac{1}{\beta}} \right\} + f_i \, dj \\
&= N_i \left( \int_{\underline{a}_i}^\infty \left[ \sum_{n \in \mathcal{M}_j} d_{ni} q_n(j) \frac{1}{a_j c_j^\delta} + f_{ni} \right] + b\beta c_j^{\frac{1}{\beta}} \, dF_i(a_j) + f_i \right) \\
\Leftrightarrow w_i L_i &= N_i \left( \int_{\underline{a}_i}^\infty \left[ \sum_{n \in \mathcal{M}_j} d_{ni} q_n(j) \frac{w_i}{a_j c_j^\delta} + f_{ni} w_i \right] + b\beta c_j^{\frac{1}{\beta}} w_i \, dF_i(a_j) + f_i w_i \right) \\
&\stackrel{(5)}{=} N_i \left( \int_{\underline{a}_i}^\infty \left[ \sum_{n \in \mathcal{M}_j} \mu^{-\sigma} \left( d_{ni} \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} \alpha_n + f_{ni} w_i \right] + b\beta c_j^{\frac{1}{\beta}} w_i \, dF_i(a_j) + f_i w_i \right) \\
&\stackrel{(8)}{=} N_i \int_{\underline{a}_i}^\infty \sum_{n \in \mathcal{M}_j} \left( \frac{1}{\mu} + \frac{1}{\sigma} \right) \left( \mu d_{ni} \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} \alpha_n \, dF_i(a_j) \\
\Leftrightarrow N_i &= \frac{\mu^{\sigma-1} w_i^\sigma L_i}{\int_{\underline{a}_i}^\infty (a_j c_j^\delta)^{\sigma-1} \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \, dF_i(a_j)}
\end{aligned}$$

#### D.5 Price index

The price index of country  $n$  is

$$\mathcal{P}_n = \left( \int_{\mathcal{G}_n} p_n(j)^{1-\sigma} \, dj \right)^{\frac{1}{1-\sigma}}$$

Letting  $\mathcal{E}_{ni}$  denote the set of goods produced in  $i$  and exported to  $n$ ,

$$= \left( \sum_{i=1}^N \int_{\mathcal{E}_{ni}} p_n(j)^{1-\sigma} \, dj \right)^{\frac{1}{1-\sigma}}$$

Dealing with  $\mathcal{E}_{ni}$  directly is cumbersome, because it involves conditional probabilities. Instead, let  $\mathcal{O}_i$  denote the set of goods produced in  $i$ , regardless of where they're shipped to. Then,

$$= \left( \sum_{i=1}^N \int_{\mathcal{O}_i} \mathbb{1}[j \in \mathcal{E}_{ni}] p_n(j)^{1-\sigma} \, dj \right)^{\frac{1}{1-\sigma}}$$



which, using that  $j \in \mathcal{E}_{ni} \Leftrightarrow n \in \mathcal{M}_j$ , switching to integrating over the CDF of productivities and remembering that there is a mass  $n_i$  of firms active in country  $i$ ,

$$\begin{aligned} &= \left( \sum_{i=1}^N n_i \int_{\underline{a}_i}^{\infty} \mathbb{1}[n \in \mathcal{M}_j] p_n(j)^{1-\sigma} dF_i(a_j) \right)^{\frac{1}{1-\sigma}} \\ &\stackrel{(4)}{=} \left( \sum_{i=1}^N n_i \int_{\underline{a}_i}^{\infty} \mathbb{1}[n \in \mathcal{M}_j] \left( \mu d_{ni} \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} dF_i(a_j) \right)^{\frac{1}{1-\sigma}} \end{aligned}$$

Since there will also be a cutoff  $\underline{a}_{ni}$  such that all firms in  $i$  with  $a_j \geq \underline{a}_{ni}$  will sell in  $n$ , and all other firms in  $i$  will not,

$$= \mu \left( \sum_{i=1}^N n_i (d_{ni} w_i)^{1-\sigma} \int_{\underline{a}_{ni}}^{\infty} (a_j c_j^\delta)^{\sigma-1} dF_i(a_j) \right)^{\frac{1}{1-\sigma}} \quad (14)$$

## D.6 Gravity equation

Sales from firms in  $i$  to  $n$  are

$$\begin{aligned} X_{ni} &= \int_{\mathcal{E}_{ni}} S_n(j) dj \\ &= n_i \int_{\underline{a}_{ni}}^{\infty} S_n(j) dF_i(a_j) \\ &\stackrel{(6)}{=} n_i \int_{\underline{a}_{ni}}^{\infty} \alpha_n \left( \mu d_{ni} \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} dF_i(a_j) \\ &= n_i (\mu d_{ni} w_i)^{1-\sigma} \alpha_n \int_{\underline{a}_{ni}}^{\infty} (a_j c_j^\delta)^{\sigma-1} dF_i(a_j) \end{aligned}$$

which, by definition of  $\alpha_n$ ,

$$\begin{aligned} &= n_i (\mu d_{ni} w_i)^{1-\sigma} X_n \mathcal{P}_n^{\sigma-1} \int_{\underline{a}_{ni}}^{\infty} (a_j c_j^\delta)^{\sigma-1} dF_i(a_j) \\ &\stackrel{(14)}{=} \frac{n_i (d_{ni} w_i)^{1-\sigma} \int_{\underline{a}_{ni}}^{\infty} (a_j c_j^\delta)^{\sigma-1} dF_i(a_j)}{\sum_{k=1}^N n_k (d_{nk} w_k)^{1-\sigma} \int_{\underline{a}_{nk}}^{\infty} (a_j c_j^\delta)^{\sigma-1} dF_k(a_j)} X_n \end{aligned}$$

## D.7 Home sales as a log-linear function of total sales

From (13), the optimal  $c$  can be written as

$$c_j^{\frac{1}{\beta} + \delta} = \frac{1}{b} \delta (\mu w_i)^{-\sigma} a_j^{\sigma-1} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) c_j^{\delta \sigma}$$

$$\begin{aligned}
&\Leftrightarrow c_j^{\frac{1}{\beta}} = \frac{1}{b} \delta (\mu w_i)^{-\sigma} a_j^{\sigma-1} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) c_j^{\delta(\sigma-1)} \\
&\Leftrightarrow c_j = \left[ \frac{1}{b} \frac{\delta}{\mu w_i} \left( \mu \frac{w_i}{a_j c_j^\delta} \right)^{1-\sigma} \left( \sum_{n \in \mathcal{M}_j} d_{ni}^{1-\sigma} \alpha_n \right) \right]^\beta \\
&\stackrel{(6)}{=} \left[ \frac{1}{b} \frac{\delta}{\mu w_i} \underbrace{\left( \sum_{n \in \mathcal{M}_j} S_n(j) \right)}_{\equiv \mathcal{S}(j)} \right]^\beta
\end{aligned} \tag{15}$$

Plugging (15) into sales to the Home market (6) and remembering that  $d_{ii} = 1$  by assumption,

$$\begin{aligned}
S_i(j) &= \alpha_i \left( \mu \frac{w_i}{a_j} \left[ \frac{1}{b} \frac{\delta}{\mu w_i} \mathcal{S}(j) \right]^{-\beta\delta} \right)^{1-\sigma} \\
&\Leftrightarrow \log(S_i(j)) = \log(\alpha_i) + (\sigma-1) \left[ \log\left(\frac{1}{\mu} \frac{a_j}{w_i}\right) + \beta\delta \log\left(\frac{1}{b} \frac{\delta}{\mu w_i} \mathcal{S}(j)\right) \right] \\
&\Leftrightarrow \log(S_i(j)) = I + \log(\alpha_i) + (\sigma-1) \log(a_j) - (\sigma + \beta\delta - 1) \log(w_i) + (\sigma-1) \beta\delta \log(\mathcal{S}(j))
\end{aligned}$$

with

$$I \equiv (\sigma-1) \left[ \log\left(\frac{1}{\mu}\right) + \beta\delta \log\left(\frac{1}{b} \frac{\delta}{\mu}\right) \right]$$