

The Small Open Economy in a Generalized Gravity Model

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Abstract

To provide sharp answers to basic questions in international trade, a standard approach is to focus on a small open economy (SOE). Whereas the classic tradition is to define a SOE as an economy that takes world prices as given, in the modern trade literature a SOE is defined instead as one that takes foreign-good prices and export demand schedules as given. In this paper we develop a generalized gravity model that nests all of its standard microfoundations (e.g., Armington and Melitz-Pareto) and show how to take the limit so that an economy that becomes infinitesimally small behaves like a SOE. We then show how the resulting model of a SOE can be used to understand comparative statics and the optimal tariff in a way that is robust across the different microfoundations consistent with the gravity model.