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Abstract

A large empirical literature has shown that countries that trade more with each other have more correlated business cycles. We show that previous estimates of this relationship are biased upward because they ignore common trade exposure to other countries. When we account for common trade exposure to foreign business cycles, we find that (1) the effect of bilateral trade on business cycle comovement falls by roughly 25 percent and (2) common exposure is a signi cant driver of business cycle comovement. A standard international real business cycle model is qualitatively consistent with these facts but fails to reproduce their magnitudes. Past studies have used models that allow for productivity shock transmission through trade to strengthen the relationship between trade and comovement. We find that productivity shock transmission increases business cycle comovement largely because of a country-pair's common trade exposure to other countries rather than because of bilateral trade. When we allow for stronger transmission between small open economies than other country-pairs, comovement increases both from bilateral trade and common exposure, similar to the data.