Moderation in Output Volatility in the Least Developed Countries

Abstract: While the sources of the great moderation for the industrialized and middle-income countries have been examined by many researchers, less attention has been paid to the subject in the case of the poorest countries. This paper contributes to the literature by looking at output fluctuations in the least developed countries (LDC). On the empirical front, I find evidence of a moderation in aggregate output volatility that started in the late eighties. In particular, for a sample of 32 countries, I find that 78% of them observed a decline. Moreover, I find support for the view that trade openness has been an important factor driving the moderation. Specifically, a one percent increase in openness – measured as the ratio of total trade over GDP - is associated with a 2.6 percent reduction in volatility. Finally, I show that incorporating trade costs in a dynamic stochastic real business cycle model can qualitatively account for such observed behavior.