Emerging Economies Business Cycles: The Role of the Terms of Trade Revisited

Nadav Ben Zeev†  Evi Pappa‡  Alejandro Vicondoa§

April 5, 2016

Abstract

Common wisdom and standard open economy models suggest that terms-of-trade (TOT) shocks are an important source of business cycle fluctuations in small open economies. Recently, Schmitt-Grohe and Uribe (2015) challenge this hypothesis by showing that unexpected TOT shocks explain only 10% of output movements in poor and developing countries. We confirm their findings for a sample of Latin American countries and show that TOT news shocks explain a bigger fraction of cyclical fluctuations. News shocks are identified as the shocks that best explain future movements in the TOT over an horizon of one year and that are orthogonal to current TOT. Unexpected and news TOT shocks account on average for 37% of output fluctuations. Feeding the standard small open economy model with both shocks, we can match reasonably well model and empirical predictions for news shocks, while the model exacerbates the role of unexpected TOT shocks.

JEL classification: E32, F41

Keywords: Terms-of-Trade Shocks, Small Open Economy DSGE Models, News Shocks, Maximum Forecast Error Variance

---

*We are grateful to participants at the GPEFM Alumni meeting 2015, the University of York and LUISS Guido Carli for helpful comments and suggestions.

†Department of Economics, Ben-Gurion University of the Negev, Beer-Sheva, Israel. E-mail: nadavbz@bgu.ac.il.

‡Department of Economics, European University Institute, Florence, Italy; UAB, BGSE, and CEPR. E-mail: evi.pappa@eui.eu.

§Department of Economics, European University Institute, Florence, Italy. E-mail: alejandro.vicondoa@eui.eu.
1 Introduction

Until recently it has been commonly accepted in the international macroeconomics literature that terms of trade shocks - shocks to the price of exports relative to the price of imports - were an important determinant of macroeconomic dynamics in most emerging market economies (EMEs) (See, e.g., Mendoza (1995) and Kose (2002)). In their latest article, Schmitt-Grohe and Uribe (2015) have challenged this traditional view by estimating annual country-specific SVARs for 38 poor and emerging countries and showing that terms-of-trade shocks explain only 10% of movements in aggregate activity on average. The literature on the important role of the terms of trade in propagating business cycles in EMEs countries is basically based on the analysis of calibrated business-cycle models. Indeed, Schmitt-Grohe and Uribe (2015) show that in standard estimated small open economy models terms-of-trade (TOT) shocks explain on average 30% of the variance of key macroeconomic indicators, three times as much as in their SVAR model.

To address this disconnect between empirical and theoretical models, the starting point of our analysis is that many terms of trade movements are anticipated. For example, the increases in the TOT observed during the 2000s for many economies were largely due to rising commodity prices, driven by strong economic growth in countries such as China and India (Kilian and Hicks (2013)).

To the extent that agents recognize the underlying causes of changes in the TOT, it is reasonable to assume that they are able to forecast these changes. Also, the existence of futures prices for many commodities confirms that part of the terms of trade movements are anticipated. Futures prices can be thought of as providing “forecasts” of future commodity prices (Chinn and Coibion (2014)). Hence, it is important to examine whether anticipated movements in the terms of trade matter for business cycle dynamics of small emerging countries.

There has recently been a renewed interest in theories of expectation-driven business cycles, focusing in particular on the effects of news shocks: shocks which are realized and observed before they materialize. Beaudry and Portier (2006) and Jaimovich and Rebelo (2009) present theoretical models in which news about future productivity is a primary source of business cycle fluctuations. Beaudry and Portier (2006) were the first to provide empirical evidence in favor of this hypothesis.
in the context of structural VARs. Schmitt-Grohé and Uribe (2012) estimate a closed economy DSGE model with flexible prices, which incorporates news about future fundamentals, and show that anticipated shocks account for around half of aggregate fluctuations in the U.S.

In the current paper, we first try to examine whether the empirical findings of Schmitt-Grohé and Uribe (2015) can be challenged by analysing different SVAR models. We repeat their analysis using quarterly data for seven Latin American countries and confirm their results and establish their robustness when using alternative: a) TOT series, b) data sample and frequency c) specifications that control for omitted variables. We then study the macroeconomic effects of anticipated shocks to the terms of trade and their sensitivity to the empirical model specification.

In their work, Beaudry and Portier (2006) use variations in stock prices to identify news about TFP. Following their approach, we could use variations in commodity future prices to extract news shocks about the terms of trade. However, the accuracy of those forecasts is not high since the options markets tell us that we should not put a lot of confidence in the price forecasts that can be obtained from the futures markets. Commodity prices are difficult to forecast because their expected price depends on both the spot price of the commodity in the future but also on a risk premium associated with the commodities risk exposure.

Given the shortcomings of using futures on commodity prices to identify future shocks in the terms of trade, we employ an alternative identification scheme for extracting news about terms of trade movements in the data. Our identification strategy relies on “medium-run” constraints and builds on Uhlig (2003) and Barsky and Sims (2011). We identify TOT news shocks as the shocks that best explain future movements in the TOT over a horizon of one year, and that are orthogonal to current TOT movements. In particular, we estimate country-specific VARs for Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, and Peru and construct average responses to anticipated and surprise shocks to the TOT by using the mean responses weighted by their relative precision. The benchmark VAR includes, the TOT, real output, consumption, investment, the trade balance to GDP ratio, the real exchange rate and one year ahead (future) commodity prices.

Individual and mean responses confirm the findings of Schmitt-Grohé and Uribe (2015): un-
expected changes in the TOT explain on average 12% of business cycles fluctuations in EMEs. Yet, in those countries, our identified TOT news shock explains on average 25% of cyclical fluctuations. Unanticipated improvements in the terms of trade improve significantly on impact the trade balance, induce prolonged increases in private investment and consumption, and cause the country to become more expensive vis-a-vis the rest of the world. Similarly, anticipated increases in the TOT induce significant and persistent increases in output, trade balance and consumption. Investment drops on impact after the realisation of the news but bounces back quickly and increases persistently until reaching its peak after five quarters. Notably, the TOT news shocks induces a significant impact response of the unrestricted futures prices. As in the case of unexpected shocks, news TOT shocks appreciate the real exchange rate but with a significant lag.

We perform various robustness analysis and show that our results hold even when we use annual data and the extended sample of developing countries considered in Schmitt-Grohe and Uribe (2015). They also hold when alternative commodity based TOT series are used in the VAR to identify the shocks and when we control for TFP movements, the conduct of fiscal policy, or variations in the world interest rate.

Hence, the TOT hypothesis as a source of business cycle fluctuations in emerging markets is not dead. TOT news matter more than unexpected TOT shocks for business cycle fluctuations in emerging countries. Turning to theoretical results, we show that incorporating news about TOT in the model suggested by Schmitt-Grohe and Uribe (2015) helps us replicate some empirical findings. To be able to compare consistently model and data predictions, we simulate series from our model and use our identification strategy in these series in order to recover the two types of TOT shocks identified in the empirical exercise. In particular, we simulate 1000 sets of data with 83 observations each using as the data generating process the standard small open economy model. For each simulation, we apply our identification method on the artificial data and include in the Monte Carlo VAR the same variables that we use in the empirical exercise. The two structural shocks in the model are the unanticipated and anticipated TOT shocks, which we calibrate by using the estimated TOT process for each country (see, for example, Otrok and Kurmann (2011)).
theoretical model matches reasonably well the empirical predictions for TOT news shocks. Yet, as in the case of Schmitt-Grohe and Uribe (2015), it overstates the role of unexpected TOT shocks. Unexpected TOT shocks explain on average 32% of output fluctuations in the MC exercise while in the data they explain only 12% of output variations. On the contrary, TOT news explain on average 25% of output fluctuations both in the theoretical and the empirical model.

The remainder of the paper is organized as follows. Section 2 describes the econometric framework. Section 3 presents the benchmark empirical results and also reports results from additional robustness exercises and extensions. Section 4 describes briefly the small open economy model, presents forecast error variance decompositions based on simulated data and compares them with their empirical counterpart. Finally, Section 5 concludes.

2 Econometric Strategy

To identify news and surprise TOT shocks, we need to estimate first a SVAR that includes the main transmission channels of both shocks. In particular, we estimate a baseline VAR that includes: terms of trade series, which are defined as the price of exports relative to the price of imports; the trade balance, measured as net exports over output; GDP; consumption; investment; a real exchange rate index; and an indicator of one-year ahead future commodity prices, computed as the principal component of the future prices of the main commodities. Our identification strategy relies on the Maximum Forecast Error Variance (MFEV) identification approach put forward by Uhlig (2003) and later extended by Barsky and Sims (2011). The TOT news shock is identified as the shock that best explains future movements in TOT over an horizon of one year and that is orthogonal to current TOT. Our underlying identifying assumption is that the TOT news shock is the only shock that affects future TOT while having no impact effect on current movements of TOT. This assumption is consistent with the reasonable notion that TOT does not respond to domestic economic variables in a small open economy, which implies that it is driven by only two shocks, one being the traditional unanticipated TOT shock which moves TOT on impact and the
other being the TOT news shock which moves TOT with a lag. An example of a process that would satisfy this condition is:

\[
TOT_t = \rho TOT_{t-1} + \varepsilon_t^{sTOT} + \varepsilon_{t-s}^{TOTnews}
\] (1)

where \(0 < \rho < 1\), \(\varepsilon_t^{sTOT}\) and \(\varepsilon_{t-s}^{TOTnews}\) are the surprise and anticipated innovations in TOT, respectively, and the news shock is realized \(s > 0\) periods in advance. As explained in Barsky and Sims (2011), an appealing way to identify news shocks to a fundamental that is driven by an unanticipated shock and a news shock, is to estimate a reduced-form multivariate VAR where all variables, including the fundamental itself, are regressed on their own lags as well as the other variables’ lags, and then use the resulting reduced-form VAR innovations to search for the structural shock that is i) contemporaneously orthogonal to the fundamental and that ii) maximally explains the future variation in the fundamental over some finite horizon. We therefore consider a VAR that includes TOT together with other domestic macroeconomic variables.

Specifically, let the VAR in the observables be given by

\[
y_t = F_1 y_{t-1} + F_2 y_{t-2} + \ldots + F_p y_{t-p} + F_c + e_t
\] (2)

where \(y_t\) represents the vector of observables, \(F_i\) are \(7 \times 7\) matrices, \(p\) denotes the number of lags, \(F_c\) is a \(7 \times 1\) vector of constants, and \(e_t\) is the \(7 \times 1\) vector of reduced-form innovations with variance-covariance matrix \(\Sigma\). The reduced form moving average representation in the levels of the observables is

\[
y_t = B(L)e_t
\] (3)

where \(B(L)\) is a \(7 \times 7\) matrix polynomial in the lag operator, \(L\), of moving average coefficients and \(e_t\) is the \(7 \times 1\) vector of reduced-form innovations. We assume that there exists a linear mapping
between the reduced-form innovations and structural shocks, $\varepsilon_t$, given as

$$\varepsilon_t = A\varepsilon_t. \quad (4)$$

Equation (3) and (4) imply a structural moving average representation

$$y_t = C(L)\varepsilon_t, \quad (5)$$

where $C(L) = B(L)A$ and $\varepsilon_t = A^{-1}\varepsilon_t$. The impact matrix $A$ must satisfy $AA' = \Sigma$. There are, however, an infinite number of impact matrices that solve the system. In particular, for some arbitrary orthogonalization, $\tilde{A}$ (we choose the convenient Cholesky decomposition), the entire space of permissible impact matrices can be written as $\tilde{A}D$, where $D$ is a 7x7 orthonormal matrix ($D' = D^{-1}$ and $DD' = I$, where $I$ is the identity matrix).

The $h$ step ahead forecast error is

$$y_{t+h} - E_t y_{t+h} = \sum_{\tau=0}^{h} B_{\tau} \tilde{A}D \varepsilon_{t+h-\tau}, \quad (6)$$

where $B_{\tau}$ is the matrix of moving average coefficients at horizon $\tau$. The contribution to the forecast error variance of variable $i$ attributable to structural shock $j$ at horizon $h$ is then given as

$$\Omega_{i,j} = \sum_{\tau=0}^{h} B_{i,\tau} \tilde{A} \gamma' \tilde{A}' B_{i,\tau}', \quad (7)$$

where $\gamma$ is the $j$th column of $D$, $\tilde{A}\gamma$ is a 7x1 vector corresponding to the $j$th column of a possible orthogonalization, and $B_{i,\tau}$ represents the $i$th row of the matrix of moving average coefficients at horizon $\tau$. We index the unanticipated TOT shock as 1 and the TOT news shock as 2 in the $\varepsilon_t$ vector. TOT news shocks identification requires finding the $\gamma$ which maximizes the sum of contribution to the forecast error variance of the TOT over a range of horizons, from 0 to $H$ (the truncation horizon), subject to the restriction that these shocks have no contemporaneous effect on
the TOT. Formally, this identification strategy requires solving the following optimization problem

\[
\gamma^* = \arg\max \sum_{h=0}^{H} \Omega_{1,2}(h) = \arg\max \sum_{h=0}^{H} \sum_{\tau=0}^{h} B_{1,\tau} \tilde{A} \gamma \gamma' \tilde{A}' B_{1,\tau}^t
\]

subject to \( \gamma(1,1) = 0 \)

\( \gamma' \gamma = 1. \)

The first constraints impose on the identified news shock to have no contemporaneous effect on the TOT. That is, our news shock is orthogonal to the unanticipated TOT shock. The second restriction that imposes on \( \gamma \) to have unit length ensures that \( \gamma \) is a column vector belonging to an orthonormal matrix. This normalization implies that the identified shocks have unit variance.

We follow the conventional Bayesian approach to estimation and inference by assuming a diffuse normal-inverse Wishart prior distribution for the reduced-form VAR parameters. Specifically, we take 1000 draws from the posterior distribution of reduced form VAR parameters \( p(F, \Sigma | \text{data}) \), where for each draw we solve optimization problem (8); we then use the resulting optimizing \( \gamma \) vector to compute impulse responses to the identified shock. This procedure generates 1000 sets of impulse responses which comprise the posterior distribution of impulse responses to our identified shock. Our benchmark choices for the number of lags and truncation horizon are \( p=4 \) and \( H=5 \), respectively.

3 Empirical Evidence

3.1 Data


Note that \( F \) here represents the stacked \((7 \times (p + 1)) \times 7\) reduced form VAR coefficient matrix, i.e., \( F = [F_1, \ldots, F_p, F_c]' \).

We have confirmed the robustness of our results to different VAR lag specifications and truncation horizons. These results are available upon request from the authors.
Ecuador 2000:Q1-2013:Q4, Mexico 1994:Q1-2014:Q2, Peru 1994:Q1-2014:Q3. Appendix A contains a detailed description of the data. We focus on Latin America, but later we draw comparisons with samples with more emerging countries when relevant. We found that pooling all set of Latin American and Asian countries together in the benchmark regression, as Schmitt-Grohe and Uribe (2015) do, was not a good idea for several reasons: a) the two regions are different both in terms of trade performance and in terms of output dynamics, b) in Latin America there is a lack of potential supply conditions to determine the terms of trade by smaller economies – instead in Asia some economies have become in a few years star cases in terms of export performance in manufactured products, and c) TOT shocks appear to be more important in Latin America than in the typical developing country.

3.2 The Identified News Shock

Following the identification strategy outlined in section 2, we identify news and surprise TOT shock series for all the countries included in our sample. One way to assess the identification procedure is to see whether the identified TOT news shock matches some events in the data. To provide an example, Figure 1 displays this series for Brazil. In particular, we can see that the storm 'El Niño', which affected Brazil and other South American countries during the period under analysis, is associated with a positive news shock in this country. This storm generated changes of temperatures and increases in rainfalls that affected negatively the supply of many agricultural products and, therefore, was reflected in higher expected prices of these products (i.e. better TOT for Brazil). This series also peaks in the expected way with the two main collapses of financial markets: the burst of the Dot-Com Bubble and the collapse in the end of 2008. In both cases, markets were uncertain about future demand for commodities and this is reflected as a negative peak in our news series. The series also reflects the recent oil discoveries in Brazil. These episodes, which occurred in years of higher oil prices, generated a wealth effect in the economy and are captured as positive news shocks in our series. We conclude that our identified news series captures important events that affected the Brazilian TOT during the sample period.
Another important characteristic of the recovered news shocks for each country is that they have a very low correlation with each other, implying that what is identified as a news shock in one country does not reflect a factor which is global, like changes in world demand or supply. For example, the anticipated shock identified for Brazil has on average low correlation (0.19) with the shocks identified in the other six Latin American countries that vary from (0.32 for the pair Brazil-Peru to 0 for the pair Brazil-Mexico). This result is encouraging to us because it implies that our TOT news shocks are not common future world productivity or demand shocks that we mislabel as TOT news shocks.

### 3.3 Impulse Responses and Forecast Error Variance Decomposition

Figure 2 shows the estimated cross country average of impulse responses of all variables to a one standard deviation unanticipated TOT shock from the benchmark VAR. The bands in the figures are one standard error bands, where the standard error is the one corresponding to the standard error of the average estimate obtained from using the variances of the individual countries impulse responses. All responses should be interpreted as the typical responses of a Latin American country to an unexpected increase in the terms of trade. We present the individual responses in the Online Appendix.

The identification of the unexpected TOT shock does not actually differ from what other researchers have studied in the literature. In particular, Figure 2 is comparable with the findings of Schmitt-Grohe and Uribe (2015). Our responses are not qualitatively very different from theirs besides the fact that the sample and frequency of the data as well as the computation of average responses (we used weighted averages instead of simple averages) are different. The TOT shocks appreciates the real exchange rate and moves positively on impact the trade balance. Contrary to their findings, the initial consumption, investment, and output responses to the unexpected TOT positive disturbance are small but positive and they increase with a lag. Since Schmitt-Grohe and Uribe (2015) do not provide confidence bands for their responses we cannot appreciate whether the
responses are significantly different, apart from the lag response of output and the real exchange rate the identified shocks seem to invoke similar dynamics to the macroeconomic variables. All variables seem to react in the same direction but less strongly to our identified innovation relative to the TOT shock identified in Schmitt-Grohe and Uribe (2015). Turning to the variance decompositions (see Table 1) we also confirm the Schmitt-Grohe and Uribe (2015) findings. Unexpected terms of trade shocks explain over a two-year horizon on average 10%-13% of fluctuations in output, consumption, investment, and the trade balance and they explain approximately 35% of terms of trade fluctuations. Those numbers are similar for all the countries apart from Ecuador and Peru. In the case of Ecuador, surprise terms of trade shocks seem to affect very slightly aggregate fluctuations, while in the case of Peru unexpected shocks to the terms of trade appear to matter a lot for aggregate fluctuations.

Turning to the news shock, in Figure 3 we plot the estimated average impulse responses of all variables to a positive news shock in the terms of trade. News about TOT increase terms of trade gradually and the TOT response reaches its peak before the horizon for which news shocks explain the biggest share of terms of trade variations. In response to the news about the positive shock to the terms of trade, future prices increase on impact and continue growing, following the actual path of the terms of trade. Since we have not imposed any restrictions on those series, their impulses imply that our identified shocks seem to capture news about future movements in the terms of trade pretty well. The response of output and the trade balance is significant and economically important on impact. Consumption increases on impact and investment declines initially, while it bounces back in later periods, after the increase in the TOT. The real exchange rate sluggishly appreciates. Turning to the variance decomposition in Table 2, we observe that TOT news shocks explain on average 25% of output fluctuations and 37% of terms of trade fluctuations, while they explain a considerable amount of future prices fluctuations (33% approximately).\footnote{The fact that the sum of the share of the variances of unexpected and expected shocks does not add up to one has to do with the fact that some domestic shocks (such as TFP, as we also show in subsection 3.4.6) affect still the variability of the TOT. In subsection 3.4.7 we do not allow for such a feedback from domestic variables to examine the sensitivity of our results to this assumption.}

There is more heterogeneity in the responses at the country level relative to the unanticipated
shocks. TOT news seem to be an important source of fluctuations in Argentina and Chile and less important for the variations in output in Colombia and Ecuador. The case of Ecuador seems to stand out for both types of TOT shocks considered: TOT movements unexpected or anticipated explain a very small fraction of output fluctuations in Ecuador. Since petroleum is Colombia’s main export, making over 45% of Colombia’s exports and is a net oil exporter, production of oil might be adjusting to hedge against the news TOT shocks in this country. For Argentina, since agricultural goods still account for a relevant share of exports when processed foods are included (soy products alone - soybeans, vegetable oil- account for almost one fourth of the total exports) it is not surprising to find that news shocks to the TOT might affect significantly the Argentinian economy. Similarly Chile is mostly exporting mining products, news about changes in the price of cooper might make firms adjust the production in the mining industry in advance affecting significantly the cyclical fluctuations in Chile.

3.4 Alternative SVAR Specifications

To clear any doubt about the robustness of our results, in this section we consider alternative VAR specifications for our empirical exercise. The impulse responses of all the exercises performed in this section are included in the Online appendix. Here, for ease of exposition, we only present the share of variance explained by the TOT unanticipated and news shocks in every exercise on average in Tables 3 and 4, respectively.

3.4.1 Country Spreads

According to Uribe and Yue (2006) country spreads respond endogenously to business cycle conditions in emerging economies and might be affected by external and anticipated shocks, such as the shocks in the terms of trade. For that reason, it is important to include this series in the VAR. We construct country spreads for each country by using the JPMorgan EMBI Global Index (Stripped Spread). Details of the series used are described in Appendix A. We estimate the baseline SVAR including spreads instead of future prices as an endogenous variable in the system. The first row
of Tables 3 and 4, respectively, presents the share of variance explained by the two identified TOT shocks in this exercise. The addition of country spreads in the analysis does not change results regarding the importance of the two identified shocks in explaining aggregate fluctuations in emerging countries. On average, surprise shocks explain 15% of output fluctuations and news TOT shocks explain 24% of output fluctuations. The numbers for the rest of the variables included in the SVAR are similar.

Shousha (2016) suggests that commodity price shocks are important in Latin American countries because they reduce country spreads causing a larger expansion that would otherwise occur. The impulse responses presented on the Online Appendix confirm that TOT shocks, unexpected or anticipated, reduce significantly the country spread. Moreover, according to our findings in Tables 3 and 4, news TOT shocks explain 37% of variations in country spreads while unexpected TOT shocks explain 17% of spread fluctuations. Taking the findings of Shousha (2016) and ours together suggests that news TOT shocks might have a more important role in generating output fluctuations since they affect significantly movements in spreads that feedback in the small open economy.

3.4.2 Federal Funds Rate

Recent literature has identified variations in the world interest rate as an important source of business cycle fluctuations in emerging economies. Lubik and Teo (2005) estimate a small open economy model using full information Bayesian methods and find that interest rate shocks are a more important source of business cycles than terms of trade shocks. Shousha (2016) uses a similar empirical model to ours, controlling for the U.S. interest rate in an exogenous block together with a commodity price index, and investigates the importance of both commodity prices and world interest rate shocks in generating cyclical fluctuations in emerging countries. Following his modelling, we introduce the Federal Funds rate in our baseline regressions and investigate how much the introduction of this additional source of variations affects our results about the role of TOT surprises and news shocks as a source of business cycle changes. Adopting his assumptions, we postulate that foreign variables are completely exogenous and that TOT have no effect on the
U.S. interest rate. While, innovations in the U.S. interest rate have a contemporaneous effect on the TOT to take into account the phenomenon of financialization of commodity markets (see for example Cheng and Xiong (2014)). Results of this exercise appear in the second row of Tables 3 and 4. Introducing an additional variable in the VAR mechanically decreases the predictive power of TOT shocks: TOT surprise shocks explain on average 9% of cyclical fluctuations, while news TOT shocks explain 15% of output fluctuations on average. On the other hand, when we look at the capacity of world interest rate shocks in explaining cyclical fluctuations, we find that FFR shocks account for 34% and 24% of TOT and output variation, respectively. However, the combined effect of TOT surprises and news implies that the role of shocks to the terms of trade in cyclical fluctuations in Latin American countries is not negligible (i.e. they explain 24% of output variations), confirming the results of Shousha (2016).

3.4.3 Government Spending

In the previous subsection, we have seen that TOT shocks reduce sovereign spread and, as a result, might affect the fiscal policy stance. In turn, a fiscal expansion might induce a larger expansion that would otherwise occur.

The government reaction to TOT shocks might be an important determinant of the role of TOT shocks in shaping business cycle fluctuations. Ilzetzki and Vegh (2008) provide evidence that fiscal policy is procyclical in developing countries. The problem of procyclicality seems to be more acute in commodity rich nations since commodity related revenues can be a large proportion of total government revenues (see Sinnott (2009)). Cespedes and Velasco (2014) study the behavior of fiscal variables across the commodity cycle and show that there is a negative relation between the fiscal balance and the behavior of commodity prices.

In this exercise, we introduce government expenditure as an additional endogenous variables in our benchmark SVAR. The third row of Tables 3 and 4, respectively, presents the share of variance explained by the two identified TOT shocks when we control for movements in government spending in our analysis. The share of output variations explained by TOT news and surprises remains almost
the same. Moreover, we learn from this exercise that government reacts much more to news about changes in the terms of trade relative to unexpected changes in the TOT. News shocks about the TOT explain 25% of government spending variability, while unexpected TOT shocks explain only 9% of the variability of government expenditure on average in our sample. This is an additional reason for why news about TOT affect more severely the economy relative to unexpected shocks.

3.4.4 Commodity-Based Terms of Trade

In their conclusions, Schmitt-Grohe and Uribe (2015) suggest that an improvement in their empirical model could stem from entertaining the hypothesis that commodity prices are a better measure of the terms of trade than aggregate indices of export and import unit values, especially for countries whose exports or imports are concentrated in a small number of commodities. Fernandez, Gonzalez, and Rodriguez (2015) and Shousha (2016) estimate a VAR including commodity prices and find that they explain between 25% and 42% of fluctuations in GDP in emerging economies. In order to investigate whether their and our conclusions are sensitive to the measure of the terms of trade used in the empirical model, we have re-run our benchmark model substituting commodity-based terms of trade with our benchmark TOT index. We define the commodity-based terms of trade as the ratio of weighted average price of the main commodity exports to weighted average price of main commodity imports. The index is available at annual frequency from IMF’s website.\footnote{See https://www.imf.org/external/pubs/cat/longres.aspx?sk=23307.0 for more information on this series. Shousha (2016) computes the country-specific commodity price index following a similar methodology at quarterly frequency. However, his series are not available to use for comparisons.}

Spatafora and Tytell (2009) constructed it from prices of six commodity categories (food, fuels, agricultural raw materials, metals, gold, and beverages) measured against the manufacturing unit value index (MUV) of the World Economic Outlook database. Relative commodity prices of six categories are weighted by the time average (over 1980–2009) of export and import shares of each commodity category in total trade (exports and imports of goods and services). Exports and imports by commodity category are obtained from the United Nations International Trade Statistics Database (COMTRADE) at SITC second digit level. Results from the exercise with annual data...
and the alternative measure of terms of trade appear in the fourth row of Tables 3 and 4. Using commodity-based TOT series in our baseline regressions does not change the fact that unexpected and anticipated movements in the TOT explain a significant part of cyclical fluctuations in emerging countries. TOT shocks explain in total 34% of output fluctuations on average. Yet, the relative importance of unexpected TOT shocks in explaining output fluctuations increases from 12% in the benchmark model to 18% in the model with commodity based TOT series.


We continue by analyzing the empirical specification used in Schmitt-Grohe and Uribe (2015), in order to compare directly our empirical results with theirs and to show that differences are not due to the different sample, different frequency, or different variables included in the VAR. In this exercise we use exactly the same specification and sample as Schmitt-Grohe and Uribe (2015). That is, we estimate country by country VARs using annual data for 38 countries that include log deviations of the TOT, real output, private consumption and gross investment per capita, and the real exchange rate from their respective time trends, as well as series for the ratio of trade balance to trend output. We present impulse responses to a positive one standard deviation shock to the unexpected TOT shock and to TOT news in the online appendix, and in the fifth row of Tables 3 and 4 we present the share of variance explained by the two identified TOT shocks in this exercise. The predictions concerning the importance of unexpected TOT shocks in generating business cycles are very similar with the numbers documented in Schmitt-Grohe and Uribe (2015). In this specification, news TOT shocks are also important, but slightly less relative to the benchmark specification in explaining the variance of output on average. Note that restricting our sample to the seven Latin American countries we consider in our benchmark exercise would make results deviate even further. In the sixth row of Tables 3 and 4 we present the corresponding number of the exercise with annual data and the specification used in Schmitt-Grohe and Uribe (2015) when we use only the sample of countries in our baseline SVAR. What we see is that results are very different when looking at the forecast error variance of unexpected TOT shocks. The SVAR with annual data overstates the
importance of surprises in generating aggregate fluctuations while news, although still important, become less significant in generating cyclical fluctuations in annual data. Hence, we conclude that, although the frequency of the sample might affect overall the relative importance of TOT surprises versus news in explaining cyclical fluctuations, the joint importance of both shocks in generating aggregate variability in emerging countries remains relatively robust to the frequency of the data used.

### 3.4.6 TOT News and TFP Shocks

For our identification procedure to be valid, terms of trade should be exogenous. Clearly, TOT is largely exogenous from a small open economy’s perspective. Yet, in many standard models, an adverse shock to the terms of trade acts like an adverse shock to productivity along many dimensions. We show that this is true also in our framework. Using annual Latin American country-specific VARs and annual data on TFP, we show in the online appendix that both unexpected and anticipated increases in the TOT induce significant increases in the TFP; here we present in the seventh row of Tables 3 and 4 the shares of the two-year variation in the variables accounted for the unanticipated shock and the news shock, respectively. It is noteworthy that TOT unanticipated and news shocks account for 21% and 19% of the variation in TFP, respectively. We have also confirmed that TFP unanticipated and news shocks also explain similar shares of the variation in TOT by using our identification strategy to identify TFP news shocks (15% and 20%, respectively).\(^5\) Hence, we can conclude that while there is some relation between TOT and TFP shocks, this relation seems to be quite limited and does not rule out the interpretation of the TOT shocks identified in this paper as being pure TOT shocks.

### 3.4.7 Exogeneity of TOT Shocks

Another important concern is that, according to our methodology, the true TOT news shock is identified as the linear combination of all other VAR innovations apart from surprise TOT shocks that

---

\(^5\) These results are available upon request from the authors.
maximize the residual forecast error variance of TOT over a finite horizon. In other words, in our setting domestic variables may be relevant to identify news about TOT. Since such an assumption may raise suspicions about the validity of our results, we implement an alternative VAR framework in which the terms of trade and future prices are included in the exogenous block of the VAR. The identification restriction of news shocks implies that only TOT and futures prices movements can affect the evolution of the terms of trade. Results regarding the quantitative contribution of the TOT news shocks to the forecast error variance decompositions of macroeconomic variables are robust to this specification. Moreover, using this specification, contrary to Schmitt-Grohe and Uribe (2015), the quantitative importance of unexpected changes in TOT doubles.

4 The Predictions of a Small Open Economy Model

In this section, we adopt the theoretical model used in Schmitt-Grohe and Uribe (2015) in order to perform country-by-country comparisons of the predictions of the empirical SVAR model with the predictions of a theoretical model concerning the effects of unexpected and anticipated TOT shocks. Following the authors, the comparison is disciplined by the same four principles: 1) The SVAR is based on the identification restriction that the terms of trade in emerging countries are exogenous and driven by an expected and an unexpected component; 2) the empirical SVAR model and the theoretical model share the same terms-of-trade processes for each country in the sample; 3) the parameters of the model are calibrated to minimize the empirical findings country by country. Finally, an additional principle that disciplines our comparisons, for the Monte Carlo exercise, is that the terms of trade shocks are identified exactly the same way in the model and in the data. That is we use the same identification technique to recover the unexpected and news TOT shocks in the theoretical model as we do in the empirical one. In this way, we can investigate the validity of our identification technique in recovering the true surprise and news shocks from the data. All in all, all the principles followed in the analysis should give the theoretical model a larger chance to match the data. In the next subsection, we describe very briefly the characteristics of the model.
Subsection 4.2 describes the Monte Carlo exercise we have performed in order to recover the shocks from our simulated series.

4.1 The Model

The model includes three sectors: exportable, importable and nontradable. Households derive utility from consumption and disutility from working in the different sectors of the economy. They accumulate sectoral capital, which is subject to adjustment costs, and issue international debt. Final goods are produced using tradable and nontradable, while tradable goods are composite of exportable and importable goods. The production function of each sector is assumed to be Cobb-Douglas and domestic nontradables are consumed at home, while net exports are the difference between exportable and importable goods. To ensure stationarity, we assume that the country spread is debt elastic.

Following our empirical specification, we introduce the estimated country-specific TOT exogenous process, including the news and surprise shocks as follows:

\[
tot_t = \sum_{i=1}^{I} \rho_i^{tot} tot_{t-i} + \sum_{j=1}^{J} \rho_j^{news} news_{tot}^{t, t+j} + \sum_{k=1}^{K} \rho_j^{\epsilon} \epsilon_{tot}^{t-k} + \epsilon_t^{tot} \tag{11}
\]

where \(news_{t, t+j}\) and \(\epsilon_t^{tot}\) denote the news about changes in terms of trade that will occur in period \(t + j\) and the surprise shock, respectively. In line with our empirical analysis, we use the estimated process for each country. The detailed description of the model and its calibration are presented in Appendix B.

4.2 Monte Carlo Exercise

In order to evaluate whether there is a disconnect between the theoretical and the empirical predictions, we need to find a way to compare data and theory consistently. The literature on the econometric relationship between DSGE models and VAR models is by now pretty extensive. In particular, if the model shocks cannot be recovered from the SVAR shocks, model estimation and
validation become meaningless. This issue has been very much debated in the literature (see Chari, Kehoe, and McGrattan (2008) vs. Christiano, Eichenbaum, and Vigfusson (2007)).\textsuperscript{6} In order to avoid these critiques, we treat simulated and actual data in the same manner. Given that in our VAR exercise we have only identified TOT news and unexpected shocks, neglecting the identification of other shocks, we use the same identification technique to recover news and unexpected TOT shocks also in the simulated data. This way the comparison between theoretical and empirical predictions is direct.\textsuperscript{7}

To this end, we simulate 1000 sets of data from the standard small open economy DSGE model presented in section 4.1, where the sample sizes correspond to our empirical country specific sample sizes. For each simulation, we estimate the median impulse response from a Bayesian VAR based on 1000 draws from the posterior distribution of the VAR parameters; we include in the Monte Carlo VAR the same variables that we used in the empirical exercise. The only difference in our Monte Carlo exercise relative to the empirical VAR is that we do not include a commodities futures variable because our theoretical model does not contain a natural counterpart to the futures series we have in the empirical VAR.\textsuperscript{8} Also note that, to keep things simple, our model does not include any other structural shock apart from the unanticipated and anticipated TOT shocks.

We draw the unanticipated and anticipated TOT shocks from the normal distribution. To avoid stochastic singularity, we add measurement errors to output, consumption, and investment. We

\textsuperscript{6}It is worthwhile noting that much of the criticism by Chari, Kehoe, and McGrattan (2008) focuses on the unsuitability of using long-run restrictions for the identification of technology shocks. The MFEV identification method has been recently shown by Francis, Owyang, Roush, and DiCecio (2014) to significantly outperform long-run restrictions based identification strategies in terms of estimation precision. Moreover, Barsky and Sims (2011) have shown the effectiveness of a suitably extended MFEV identification strategy, as the one we use in this paper, in identifying news shocks. Hence, there is a good reason to believe, a priori, that our identification method is not susceptible to the criticism put forward in Chari, Kehoe, and McGrattan (2008). The results we present in this section confirm this belief.

\textsuperscript{7}Schmitt-Grohe and Uribe (2015) compare theoretical and empirical predictions by computing the share of variance explained by unexpected TOT shocks as the ratio between the variance conditional on terms-of-trade shocks predicted by the model divided by the unconditional variance implied by the empirical country specific SVAR model, implicitly assuming that SVAR and DSGE model are directly comparable. We perform their exercise for the sake of comparing results, but we insist that the Monte Carlo exercise we perform is the only way to accurately compare theoretical and empirical predictions.

\textsuperscript{8}We have nevertheless confirmed that the simulation results are generally insensitive to adding a variable that is equal to the true news shock series and some reasonably calibrated measurement error that could proxy for future prices.
calibrate the standard deviations of the measurement errors such that estimated contributions to the forecast error variance of output reasonably match their empirical counterparts. The standard deviations of the TOT shocks and measurement errors for our seven countries are presented in Table 5. These measurement errors are also drawn from the normal distribution.

For illustrative reasons, in Figures 4a and 4b we depict the SVAR impulse responses, “true” theoretical model responses, and estimated median impulse responses averaged over the simulations to an unanticipated TOT shock and a TOT news shock in Brazil. The SVAR responses are given by the plus-signed solid lines, “true” theoretical responses are represented by the solid lines, and the average estimated median responses over the simulations are depicted by the dashed lines, with the dotted lines depicting the 2.5th and 97.5th percentiles of the distribution of estimated median impulse responses. The estimated responses are generally very close to the “true” theoretical ones, suggesting that our identification procedure enables us to properly identify the effects of unanticipated and anticipated shocks to TOT. Responses to the unanticipated shock are comparable with the typical responses presented in Section 3.3 (see Figure 2). In responses to TOT news, the model fails to generate the fall in the trade balance observed in the Brazilian data. The responses of the other variables are comparable with the responses presented in Figure 3.

Table 6 and 7 present the estimated contributions of the unanticipated and news shocks to the two-year variation in output along with their empirical counterparts from Section 3.3, respectively. As is Schmitt-Grohe and Uribe (2015), the model attributes a more important role to unexpected TOT shocks in explaining cyclical fluctuations in Emerging Economies. For all the countries in the sample, the model overpredicts the contribution of unexpected TOT shocks in explaining macroeconomic fluctuations. Our results concerning unexpected increases in TOT are in line with the findings in Aguirre (2011), who estimates a similar model and shows that in the theoretical model output displays a larger response to terms-of-trade shocks than in the empirical SVAR model.

\footnote{In the Appendix we depict the theoretical model responses and estimated median impulse responses averaged over the simulations to an unanticipated TOT shock and a TOT news shock for all seven Latin American countries.}

\footnote{Notice that the typical response of Emerging Economies in our sample does not fit the response of the trade balance in Brazil.}
ing to correct for the discrepancy between theoretical and empirical responses to an unexpected TOT shock is beyond the scope of this exercise and we leave this task for future research.

When we focus on the case of TOT news, model and data predictions square well for Brazil and Mexico but the model understates the importance of TOT news in Argentina and Chile and overstates their relevance in Colombia, Ecuador and Peru. This is not surprising given the estimates of Table 2. In our calibration exercise, we have only assumed that those countries differ only in their investment adjustment costs and the interest rate elasticity with respect to external debt. Thus, it is not surprising that we cannot match the data country-by-country and this was not the purpose of our exercise to start with. What we want to highlight is that, on average, the presence of news shocks helps to decrease the disconnect between theory and data in emerging economies.

5 Conclusions

The terms of trade of many commodity-producing small open economies are subject to large shocks that can be an important source of macroeconomic fluctuations. The literature so far based on calibrated business-cycle models has traditionally suggested this to be the case. In their recent article Schmitt-Grohe and Uribe (2015) challenge this view by providing evidence from SVAR that show that unexpected changes in the terms of trade account for a small share of output variations in developing countries.

In this paper we confirm the findings of Schmitt-Grohe and Uribe (2015) and examine the sensitivity of their results when using quarterly instead of annual SVARs and when we complement their analysis with additional information such as country spreads, the world interest rate, fiscal policy and futures commodity prices. We show that their results are robust when alternative commodity based terms of trade are used to identify TOT shocks and when we control for TFP movements and account for the exogeneity of the terms of trade. Yet, we also show that in all these specifications news TOT shocks are equally or even more important as sources of business cycle fluctuations in emerging economies, mainly because they move country spreads and fiscal policy.
triggering larger expansions after they occur.

When we feed a standard small open economy model with unexpected and news TOT shock series we show that the variations of news TOT shocks can account for around 25% of variation in output volatility in emerging countries matching on average the empirical predictions from our SVAR exercises. On the other hand, the model exacerbates the importance of unexpected changes in the TOT in explaining aggregate fluctuation in emerging countries.

We humbly conclude that TOT shocks, when controlling for anticipation effects, matter more than what originally stated by Schmitt-Grohe and Uribe (2015). Future work, following the work of Lubik and Teo (2005), should consider various sources of business cycles fluctuations in small open economies and investigate the importance of both surprise and news shocks in accounting for aggregate fluctuations in emerging economies.
Figure 1: **Estimated Terms of Trade News Shocks for Brazil.**

**Notes:** Solid line denotes the estimated terms of trade news shocks for Brazil using our baseline VAR. Vertical lines denote the dates of these terms of trade events:

- 2001:Q1: Burst of 'Dot-Com' Bubble U.S
- 2007:Q4: Discovery of field of oil and forecast of record agricultural production
- 2008:Q4: World Recession
- 2009:Q2: Draught affected regions of Brazil
- 2012:Q3: Oil reservoir discovery
- 2013:Q3: Oil reservoir discovery
Figure 2: Impulse Responses to a One Standard Deviation Unanticipated TOT Shock from the Benchmark VARs (solid lines).

Notes: Solid line and dashed lines are the average of the country-specific median responses to the unanticipated TOT shock. The bands in the figure are one standard error bands where the standard error is the one corresponding to the standard error of the average estimate computed from the variances of the individual country-specific estimates. The underlying country-specific estimates are based on 1000 draws taken from the posterior distribution of the VAR parameters, where the unanticipated TOT shock is identified as the VAR innovation in TOT. Horizon is in quarters.
Figure 3: Impulse Responses to a One Standard Deviation TOT News Shock from the Benchmark VARs (solid lines).

Notes: Solid line and dashed lines are the average of the country-specific median responses to the TOT news shock. The bands in the figure are one standard error bands where the standard error is the one corresponding to the standard error of the average estimate computed from the variances of the individual country-specific estimates. The underlying country-specific estimates are based on 1000 draws taken from the posterior distribution of the VAR parameters, where the TOT news shock is identified in accordance with the MFEV estimation procedure described in Section . Horizon is in quarters.
Table 1: **Share of Forecast Error Variance Explained by Unanticipated TOT Shocks: Country-Level SVAR Evidence.**

<table>
<thead>
<tr>
<th>Country</th>
<th>TOT</th>
<th>Output</th>
<th>Consumption</th>
<th>Investment</th>
<th>Trade Balance</th>
<th>Real Exchange Rate</th>
<th>Futures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>41</td>
<td>11</td>
<td>8</td>
<td>4</td>
<td>10</td>
<td>13</td>
<td>20</td>
</tr>
<tr>
<td>Brazil</td>
<td>53</td>
<td>13</td>
<td>7</td>
<td>19</td>
<td>4</td>
<td>24</td>
<td>18</td>
</tr>
<tr>
<td>Chile</td>
<td>30</td>
<td>9</td>
<td>16</td>
<td>14</td>
<td>11</td>
<td>16</td>
<td>15</td>
</tr>
<tr>
<td>Colombia</td>
<td>37</td>
<td>14</td>
<td>11</td>
<td>16</td>
<td>13</td>
<td>11</td>
<td>15</td>
</tr>
<tr>
<td>Ecuador</td>
<td>12</td>
<td>4</td>
<td>7</td>
<td>12</td>
<td>11</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td>Mexico</td>
<td>44</td>
<td>12</td>
<td>10</td>
<td>6</td>
<td>18</td>
<td>19</td>
<td>33</td>
</tr>
<tr>
<td>Peru</td>
<td>30</td>
<td>22</td>
<td>11</td>
<td>22</td>
<td>14</td>
<td>11</td>
<td>27</td>
</tr>
<tr>
<td>Average</td>
<td>35</td>
<td>12</td>
<td>10</td>
<td>13</td>
<td>12</td>
<td>15</td>
<td>20</td>
</tr>
</tbody>
</table>

**Notes:** This table presents the estimated contribution of the terms of trade unanticipated shock to the two-year variation in the variables obtained from each of the 7 country-level VARs. Average estimate is simple mean of the country specific estimates. Shares are expressed in percent.
Table 2: Share of Forecast Error Variance Explained by TOT News Shocks: Country-Level SVAR Evidence.

<table>
<thead>
<tr>
<th>Country</th>
<th>TOT</th>
<th>Output</th>
<th>Consumption</th>
<th>Investment</th>
<th>Trade Balance</th>
<th>Real Exchange Rate</th>
<th>Futures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>32</td>
<td>40</td>
<td>33</td>
<td>21</td>
<td>8</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>Brazil</td>
<td>29</td>
<td>19</td>
<td>35</td>
<td>20</td>
<td>26</td>
<td>27</td>
<td>21</td>
</tr>
<tr>
<td>Chile</td>
<td>46</td>
<td>45</td>
<td>32</td>
<td>22</td>
<td>16</td>
<td>35</td>
<td>40</td>
</tr>
<tr>
<td>Colombia</td>
<td>22</td>
<td>8</td>
<td>9</td>
<td>9</td>
<td>15</td>
<td>24</td>
<td>17</td>
</tr>
<tr>
<td>Ecuador</td>
<td>53</td>
<td>14</td>
<td>31</td>
<td>16</td>
<td>37</td>
<td>52</td>
<td>66</td>
</tr>
<tr>
<td>Mexico</td>
<td>32</td>
<td>29</td>
<td>16</td>
<td>19</td>
<td>21</td>
<td>10</td>
<td>27</td>
</tr>
<tr>
<td>Peru</td>
<td>44</td>
<td>18</td>
<td>12</td>
<td>22</td>
<td>34</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>Average</td>
<td>37</td>
<td>25</td>
<td>24</td>
<td>18</td>
<td>23</td>
<td>23</td>
<td>33</td>
</tr>
</tbody>
</table>

Notes: This table presents the estimated contribution of the TOT unanticipated shock to the two-year variation in the variables obtained from each of the 7 country-level VARs. Average estimate is simple mean of the country specific estimates. Shares are expressed in percent.
Table 3: **Robustness Table:** Share of Forecast Error Variance Explained by Unanticipated TOT Shocks for Various Alternative SVAR Specifications.

<table>
<thead>
<tr>
<th>Specification</th>
<th>TOT</th>
<th>Output</th>
<th>Consumption</th>
<th>Investment</th>
<th>Trade Balance</th>
<th>Real Exchange Rate</th>
<th>Futures Spreads</th>
<th>Gov.-Spending</th>
<th>TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country Spreads</td>
<td>32</td>
<td>15</td>
<td>13</td>
<td>13</td>
<td>15</td>
<td>14</td>
<td>13</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Federal Funds Rate</td>
<td>24</td>
<td>9</td>
<td>8</td>
<td>9</td>
<td>6</td>
<td>8</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Spending</td>
<td>38</td>
<td>12</td>
<td>12</td>
<td>14</td>
<td>17</td>
<td>18</td>
<td>23</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Annual Commodity-based TOT</td>
<td>72</td>
<td>18</td>
<td>16</td>
<td>17</td>
<td>13</td>
<td>20</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SGU Specification</td>
<td>72</td>
<td>16</td>
<td>16</td>
<td>15</td>
<td>17</td>
<td>19</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SGU (Our LA Sample)</td>
<td>75</td>
<td>27</td>
<td>22</td>
<td>19</td>
<td>14</td>
<td>24</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOT and Futures in Exogenous Block</td>
<td>82</td>
<td>32</td>
<td>27</td>
<td>29</td>
<td>34</td>
<td>38</td>
<td>46</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Notes:* This table presents the average estimated contribution of the TOT news shock to the two-year variation in the variables. Each row corresponds to an alternative SVAR specification described in Section 3.4. Shares are expressed in percent.
Table 4: Robustness Table: Share of Forecast Error Variance Explained by TOT News Shocks for Various Alternative SVAR Specifications.

<table>
<thead>
<tr>
<th>Specification</th>
<th>TOT Output</th>
<th>Consumption</th>
<th>Investment</th>
<th>Trade Balance</th>
<th>Real Exchange Rate</th>
<th>Futures Spreads</th>
<th>Gov.-Spending</th>
<th>TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country Spreads</td>
<td>39</td>
<td>24</td>
<td>23</td>
<td>22</td>
<td>21</td>
<td>27</td>
<td>23</td>
<td>35</td>
</tr>
<tr>
<td>Federal Funds Rate</td>
<td>21</td>
<td>15</td>
<td>12</td>
<td>15</td>
<td>12</td>
<td>13</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Government Spending</td>
<td>38</td>
<td>26</td>
<td>26</td>
<td>23</td>
<td>20</td>
<td>22</td>
<td>33</td>
<td>25</td>
</tr>
<tr>
<td>Annual Commodity-based TOT</td>
<td>18</td>
<td>16</td>
<td>27</td>
<td>23</td>
<td>33</td>
<td>23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SGU Specification</td>
<td>24</td>
<td>18</td>
<td>21</td>
<td>23</td>
<td>25</td>
<td>21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SGU (Our LA Sample)</td>
<td>22</td>
<td>13</td>
<td>18</td>
<td>25</td>
<td>32</td>
<td>28</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TFP</td>
<td>31</td>
<td>17</td>
<td>15</td>
<td>20</td>
<td>26</td>
<td>23</td>
<td></td>
<td>19</td>
</tr>
<tr>
<td>TOT and Futures in Exogenous Block</td>
<td>18</td>
<td>23</td>
<td>22</td>
<td>24</td>
<td>22</td>
<td>22</td>
<td>54</td>
<td></td>
</tr>
</tbody>
</table>

Notes: This table presents the average estimated contribution of the terms of trade unanticipated shock to the two-year variation in the variables. Each row corresponds to an alternative SVAR specification described in Section 3.4. Shares are expressed in percent.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>0.023</td>
<td>0.012</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.054</td>
<td>0.035</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
<tr>
<td>Chile</td>
<td>0.011</td>
<td>0.009</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
<tr>
<td>Colombia</td>
<td>0.013</td>
<td>0.004</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
<tr>
<td>Ecuador</td>
<td>0.029</td>
<td>0.018</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.017</td>
<td>0.007</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
<tr>
<td>Peru</td>
<td>0.024</td>
<td>0.013</td>
<td>0.02</td>
<td>0.002</td>
<td>0.004</td>
</tr>
</tbody>
</table>

Notes: This table reports the standard deviations of the structural TOT shocks and measurement errors of output, consumption, investment, trade balance, and real exchange rate used to generate the data in the Monte Carlo experiment of Section 4.2. The idiosyncratic measurement errors are simply white noise errors whose purpose is to avoid singularity.
Table 6: SVAR and Monte Carlo Estimated Forecast Error Variance Contributions of Unanticipated TOT Shocks.

<table>
<thead>
<tr>
<th></th>
<th>Argentina</th>
<th>Brazil</th>
<th>Chile</th>
<th>Colombia</th>
<th>Ecuador</th>
<th>Mexico</th>
<th>Peru</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOT</td>
<td>41%</td>
<td>57%</td>
<td>53%</td>
<td>61%</td>
<td>30%</td>
<td>48%</td>
<td>58%</td>
</tr>
<tr>
<td>GDP</td>
<td>11%</td>
<td>40%</td>
<td>13%</td>
<td>32%</td>
<td>4%</td>
<td>27%</td>
<td>12%</td>
</tr>
<tr>
<td>C</td>
<td>8%</td>
<td>31%</td>
<td>7%</td>
<td>29%</td>
<td>11%</td>
<td>6%</td>
<td>19%</td>
</tr>
<tr>
<td>I</td>
<td>4%</td>
<td>56%</td>
<td>7%</td>
<td>46%</td>
<td>12%</td>
<td>19%</td>
<td>6%</td>
</tr>
<tr>
<td>TB</td>
<td>10%</td>
<td>37%</td>
<td>4%</td>
<td>28%</td>
<td>13%</td>
<td>18%</td>
<td>33%</td>
</tr>
<tr>
<td>REER</td>
<td>13%</td>
<td>57%</td>
<td>24%</td>
<td>49%</td>
<td>10%</td>
<td>29%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Notes: C, I, TB and REER denote consumption, investment, trade balance to GDP ratio and real exchange rate, respectively.

Table 7: SVAR and Monte Carlo Estimated Forecast Error Variance Contributions of TOT News Shocks.

<table>
<thead>
<tr>
<th></th>
<th>Argentina</th>
<th>Brazil</th>
<th>Chile</th>
<th>Colombia</th>
<th>Ecuador</th>
<th>Mexico</th>
<th>Peru</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOT</td>
<td>32%</td>
<td>28%</td>
<td>29%</td>
<td>31%</td>
<td>46%</td>
<td>37%</td>
<td>22%</td>
</tr>
<tr>
<td>GDP</td>
<td>40%</td>
<td>23%</td>
<td>19%</td>
<td>24%</td>
<td>45%</td>
<td>25%</td>
<td>8%</td>
</tr>
<tr>
<td>C</td>
<td>33%</td>
<td>21%</td>
<td>35%</td>
<td>23%</td>
<td>32%</td>
<td>24%</td>
<td>9%</td>
</tr>
<tr>
<td>I</td>
<td>21%</td>
<td>26%</td>
<td>20%</td>
<td>27%</td>
<td>16%</td>
<td>28%</td>
<td>9%</td>
</tr>
<tr>
<td>TB</td>
<td>8%</td>
<td>21%</td>
<td>26%</td>
<td>28%</td>
<td>35%</td>
<td>35%</td>
<td>15%</td>
</tr>
<tr>
<td>REER</td>
<td>10%</td>
<td>27%</td>
<td>27%</td>
<td>32%</td>
<td>40%</td>
<td>38%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Notes: C, I, TB and REER denote consumption, investment, trade balance to GDP ratio and real exchange rate, respectively.
Figure 4: Monte Carlo Evidence: (a) Unanticipated Shocks; (b) News Shocks.

(a) The SVAR Impulse Responses, Monte Carlo Estimated Mean and 97.5th and 2.5th percentile Median Impulse Responses, and the True Impulse Responses to the Unanticipated Shock.

(b) The SVAR Impulse Responses, Monte Carlo Estimated Mean and 97.5th and 2.5th percentile Median Impulse Responses and the True Impulse Responses to the News Shock.

Notes: The figures are based on 1000 Monte Carlo simulations of the model of Section B for Brazil, where in each simulation the impulse responses to the unanticipated and news shock were identified as the median values of impulse responses based on 1000 draws from the posterior distribution of the VAR parameters. The SVAR responses are given by the plus-signed solid lines, the solid line represents the true model impulse responses, the dashed line is the average estimated impulse response to the shock across Monte Carlo replications, and the dotted lines are the 97.5th and 2.5th estimated percentiles of the estimated monte carlo impulse responses.
References


Appendix A  Data

We use quarterly data for the following countries and periods: Argentina 1994:Q1-2013:Q3, Brazil 1995:Q1-2014:Q3, Chile 1996:Q1-2014:Q3, Colombia 1994:Q1-2009:Q4, Ecuador 2001:Q1-2013:Q4, Mexico 1994:Q1-2014:Q2, and Peru 1994:Q1-2014:Q2. The sample varies across countries according to data availability. For each case, we use the following series: GDP, Gross Fixed Capital Formation, Private Consumption Expenditure, and Exports and Imports of Goods and Services. All these variables are expressed in current prices and local currency units. We deflate all the variables (except the last 2) using the GDP Deflator. Finally, we compute the trade balance (difference between exports and imports) as a share of current GDP. All these series were downloaded from the International Financial Statistics (IFS) database, which is published by International Monetary Fund. Additionally, we use the Export and Import Price index to compute the terms of trade series for each country. These indexes were downloaded from the national central banks (Brazil, Chile, Ecuador, Mexico, and Peru) and IMF (Argentina and Colombia). Finally, we use the Real Exchange Rate index computed by the Bank of International Settlements. This index is calculated as geometric weighted averages of bilateral exchange rates adjusted by relative consumer prices. We compute the quarterly average and reexpress the series such that an increase (decrease) indicates a depreciation (appreciation). All the series were seasonally adjusted using ARIMA X13.

In order to compute a commodity futures price index, we take the first principal component of the following contracts: Coffee (6th continuous contract), Cooper, Corn (6th continuous contract), Gas (11th continuous contract), Oil (12th continuous contract), Soybean (8th continuous contract), Soybean meal (9th continuous contract), and Wheat (6th continuous contract). We compute a daily principal component (the first component explains 82% of the total variation) and then a quarterly average of this series. These commodities constitute a representative bundle of products exported by Latin American economies. The data for commodity prices was downloaded from Quandl.\footnote{https://www.quandl.com provides continuous series for many commodities based on data from CME.}

For the robustness exercise, we use the Emerging Markets Bond Index (EMBI) Global computed by JP Morgan as a measure of country spread. This index is a composite of different US dollar-
denominated bonds. The Stripped Spread is computed as an arithmetic, market-capitalization-weighted average of bond spreads over US Treasury bonds of comparable duration.

For the annual specification, we use the same sample of poor and emerging countries and periods as Schmitt-Grohe and Uribe (2015). In particular, the panel contains data for the period 1980 to 2011 for the following countries: Algeria, Argentina, Bolivia, Botswana, Brazil, Burundi, Cameroon, Central African Republic, Egypt, Arab Rep., El Salvador, Ghana, Guatemala, Honduras, India, Indonesia, Jordan, Kenya, Korea, Rep. Madagascar, Malaysia, Mauritius, Mexico, Morocco, Pakistan, Paraguay, Peru, Philippines, Senegal, South Africa, Sudan, Thailand, Turkey, and Uruguay. All the data comes from the World Development Indicators (WDI) database, which is published by the World Bank. We add to this database the measure of TFP computed by the Conference Board, which is available for the period 1990-2014. https://www.conference-board.org/data/economydatabase/index.cfm?id=27762 contains detailed information on how this variable is computed.

Appendix B The Theoretical Model

This section describes the model used in Section 4.1. It includes three sectors: exportable \((x)\), importable \((m)\), and nontradable \((n)\). We choose this model because we want to evaluate if it is capable of generating the IRFs we identify in the previous section. We augment the model of Schmitt-Grohe and Uribe (2015) with news and surprise shocks to the terms of trade, following the estimated processes from the empirical section.

B.1 Households

The economy is populated by a continuum of homogenous households with preferences described by the following utility function:

\[
U_t = \mathbb{E}_t \sum_{t=0}^{\infty} \beta^t \left( \frac{c_t - G(h_t^m, h_t^x, h_t^n)}{1 - \sigma} - 1 \right)
\]  

(12)
where $c_t$ denotes consumption and $h^m_t, h^x_t, h^n_t$ denote hours worked in the importable, exportable and nontradable sector, respectively. In particular, $G(h^m_t, h^x_t, h^n_t)$ has the following functional form:

$$G(h^m_t, h^x_t, h^n_t) = \frac{(h^m_t)^{\omega_m}}{\omega_m} + \frac{(h^x_t)^{\omega_x}}{\omega_x} + \frac{(h^n_t)^{\omega_n}}{\omega_n} \quad (13)$$

Households are subject to the following budget constraint:

$$c_t + i_t^x + i_t^m + i_t^n + \frac{\phi_x}{2}(k_{t+1}^x - k_t^x)^2 + \frac{\phi_m}{2}(k_{t+1}^m - k_t^m)^2 + \frac{\phi_n}{2}(k_{t+1}^n - k_t^n)^2 + r_t d_t = \frac{\rho_t d_{t+1}}{1+r_t} + w_t^x h_t^x + w_t^n h_t^n + u_t^x k_t^x + u_t^m k_t^m + u_t^n k_t^n \quad (14)$$

where $i_t^i, k_t^i, \phi_t^i, w_t^i,$ and $u_t^i$ denote investment, capital stock, capital adjustment costs, wages, and rents for each sector $i = \{m,x,n\}$. $\rho_t^i$ denotes the relative price of the tradable composite good in terms of the final good $c_t$ (to be defined below), $d_t$ denotes the stock of debt that matures in period $t$, which is expressed in units of the tradable composite good, and $r_t$ denotes the interest rate on debt. The capital stock dynamics of each sector are described by the following equations:

$$k_{t+1}^i = (1 - \delta)k_t^i + i_t^i \quad (15)$$

for $i = \{x,m,n\}$ and where $\delta$ denotes the depreciation rate of capital.

### B.2 Production of Final Goods

Final goods are produced using tradable and nontradable goods via the following technology:

$$B(a^r_t, a^n_t) = \left(\chi^r (a^r_t)^{1 - \frac{1}{\rho^r}} + (1 - \chi^r) (a^n_t)^{1 - \frac{1}{\rho^n}}\right)^{\frac{1}{1 - \frac{1}{\rho^r}}} \quad (16)$$

where $a^r_t$ denotes the domestic absorption of the tradable composite good, and $a^n_t$ denotes the domestic demand for nontradable goods. Final goods are sold to households and can be either consumed or invested. Firms of this sector behave competitively. Their profits are given by the
following expression:
\[ B(a^t_t, a^n_t) - p^t_t a^t_t - p^n_t a^n_t \]  

(17)

where \( p^n_t \) denotes the relative price of nontradable goods in terms of final goods.

**B.3 Production of the Tradable Composite Good**

The tradable composite good is produced using exportable and importable goods via the following technology:
\[ a^t_t = A(a^m_t, a^x_t) = \left( \chi_m (a^m_t)^{1-\frac{1}{\mu_m}} + (1 - \chi_m) (a^x_t)^{1-\frac{1}{\mu_m}} \right)^{\frac{1}{1-\frac{1}{\mu_m}}} \]  

(18)

where \( a^m_t \) and \( a^x_t \) denote the domestic absorption of importable and exportable goods, respectively.

Firms in this sector also behave competitively. Profits are given by the following expression:
\[ p^t_t A(a^m_t, a^x_t) - p^m_t a^m_t - p^x_t a^x_t \]  

(19)

**B.4 Production of Exportable, Importable, and Nontradable Goods**

Exportable, importable, and nontradable goods are produced with the following technologies:
\[ y^i_t = A^i_t F^i_t (k^i_t, h^i_t) = A^i_t (k^i_t)^{\alpha_i} (h^i_t)^{1-\alpha_i} \]  

(20)

for each \( i = \{x, m, n\} \), where \( A^i_t \) and \( y^i_t \) denote productivity and output of each sector. Firms in each sector are homogenous and behave competitively both in factor and product markets.

**B.5 Market Clearing Conditions and Definitions**

This is the market clearing condition for the final goods:
\[ c_t + i^x_t + i^m_t + i^n_t + \frac{\phi_x}{2} (k^x_{t+1} - k^x_t) + \frac{\phi_m}{2} (k^m_{t+1} - k^m_t) + \frac{\phi_n}{2} (k^n_{t+1} - k^n_t) = B(a^x_t, a^n_t) \]  

(21)
This is the market clearing condition for the nontradable good:

\[ a_t^n = y_t^n \]  \hspace{1cm} (22)

The economy wide resource constraint is:

\[ p_t^\tau \frac{d_{t+1}}{1 + r_t} = p_t^\tau d_t + \overbrace{m_t}^{\text{import}} (a_t^m - y_t^m) - \overbrace{x_t}^{\text{export}} (y_t^x - a_t^x) \]  \hspace{1cm} (23)

where \( m_t \) and \( x_t \) denote aggregate import and export, respectively. Finally, we define two key variables for this economy. First, the terms of trade (\( tot_t \)) are characterized by the following expression:

\[ tot_t = \frac{p_t^x}{p_t^m} \]  \hspace{1cm} (24)

Second, we define the real exchange rate (\( rer_t \)) as:

\[ rer_t = \frac{\epsilon_t P_t^*}{P_t} = \epsilon_t p_t^\tau \]  \hspace{1cm} (25)

where \( \epsilon_t \) denotes the nominal exchange rate. This definition is in line with the index we are using in the VAR (i.e. an increase (decrease) means an depreciation (appreciation)).

### B.6 Exogenous Processes

In order to close the model we need to define the exogenous processes. First, to ensure a stationary equilibrium process for external debt, we assume that the country spread, which is defined as the difference between the domestic interest rate and the international one, is debt elastic:

\[ r_t - r_t^* = \psi \left( e^{\delta_t - \bar{\delta}} - 1 \right) \]  \hspace{1cm} (26)

where \( r_t^* \) denotes the world interest rate and \( \psi \) captures the sensitivity of the country spread with respect to deviations of debt with respect to its steady state. Finally, we define a country-specific
process for the terms of trade as explained in section 4.1.

B.7 Calibration

We calibrate the model following Schmitt-Grohe and Uribe (2015). Since our empirical analysis is in quarterly frequency, we modify some parameters accordingly. Table B.1 displays the values of the parameters common across countries.

<table>
<thead>
<tr>
<th>Table B.1: Calibration—Common Parameters</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\alpha_x$</td>
</tr>
<tr>
<td>$\chi_m$</td>
</tr>
</tbody>
</table>

Following Schmitt-Grohe and Uribe (2015), we adjust the sectoral investment adjustment costs and the interest rate elasticity to external debt to match the dynamics of trade balance and investment in response to both shocks. Table B.2 displays the values of the parameters for each country.

<table>
<thead>
<tr>
<th>Table B.2: Calibration—Country Specific Parameters</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Argentina</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Chile</td>
</tr>
<tr>
<td>Colombia</td>
</tr>
<tr>
<td>Ecuador</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>Peru</td>
</tr>
</tbody>
</table>