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

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Abstract

Schmitt-Grohe and Uribe (2015) find that terms-of-trade (TOT) shocks explain only 10% of movements in aggregate activity, while in standard small open economy models their explanatory power is tripled. This disconnect between the empirical and theoretical models can be due to either problems with the identification of TOT shocks in the data, or the inadequacy of existing models to explain the propagation of TOT shocks. We reconcile evidence and theory by analyzing the effects of TOT news shocks. News shocks are identified as the shocks that best explain future movements in TOT over a horizon of one year and are orthogonal to current TOT. TOT news shocks matter at least as much as unexpected ones for business cycle fluctuations in emerging countries and a standard small open economy model can replicate our empirical findings.

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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.\(^1\) 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. This disconnect between the empirical and theoretical models raises doubts about the validity of the existing models for explaining business cycle dynamics in emerging countries. The authors conclude their analysis by proposing improvements in both the theoretical model and the empirical one for resolving the disconnect between theory and data.

In the current paper we first try to examine whether the empirical findings of Schmitt-Grohe and Uribe (2015) can be challenged by analyzing different SVARs models. We confirm their results for all the specifications analyzed. Next, we try to reconcile evidence and theoretical predictions by introducing anticipated shocks to the terms of trade in their analysis, motivated by the observation that many movements in the terms of trade 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, its reasonable to

\(^1\) Also, Lubik and Teo (2005) estimating a small open economy model using full information Bayesian methods, find that interest rate shocks are a more important source of business cycles than terms of trade shocks, and Aguirre (2011) finds that in a theoretical small open economy model output and other macroeconomic aggregates display a larger response to terms-of-trade shocks than in an empirical SVAR model.
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)). 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. Yet, we believe 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 realised and observed before they materialise. 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-Grohe and Uribe (2012) estimate a DSGE model with flexible prices, which incorporates news about future technology, preference, government spending and markup shocks, and show that anticipated shocks account for around half of aggregate fluctuations in the U.S. 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 using quarterly data for Latin American countries.

In particular, we estimate country-specific VARs for seven Latin American countries and construct typical 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
commodity prices. Individual and mean responses confirm the findings of Schmitt-Grohe and Uribe (2015): Unexpected changes in the TOT explain on average 12% of business cycles fluctuations in EMEs. Yet, our identified TOT news shock explains on average 25% of output fluctuations in EMEs. Unanticipated improvements in the terms of trade cause the country to become more expensive vis-a-vis the rest of the world and lead to contractions in private consumption and investment on impact that quickly bounce above trend in the following periods. Output increases with a lag as a result of the initial fall in domestic absorption and the contemporaneous increase in the trade balance. On the other hand, anticipated increases in the TOT induce significant and persistent increases in output, and the trade balance and investment. Moreover, the TOT news shocks induces a significant impact response of futures prices that we leave unrestricted when identifying the shock. Private consumption falls with a lag once the TOT news occur and the shock does not imply any significant movements in the real exchange rate. We further 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.

Our empirical exercises reveal that 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 the empirical findings. We augment their model with capital utilization to capture more precisely the dynamics of investment and GDP. 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 TOT shocks. 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 Otrok and Kurmann (2011)). Our simulation exercise suggests that there is no need to scrap the standard small open economy model as it can match pretty well most of the empirical predictions.

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 and 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 VAR 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; 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 a 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 it. 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:

\[ TOT_t = \rho TOT_{t-1} + \varepsilon_s^{TOT} + \varepsilon_{TOT\text{news}} \]  

(1)

where \(0 < \rho < 1\), \(\varepsilon_s^{TOT}\) and \(\varepsilon^{TOT\text{news}}\) are the surprise and anticipated innovations in TOT, respectively, and the news shock is realised \(s > 0\) 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

\[ e_t = A\varepsilon_t. \]  

(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 \( (D' = D^{-1} \text{ and } DD' = I, \text{ where } I \text{ is the identity matrix}) \).

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

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

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 TOT over a range of horizons, from 0 to \( H \) (the truncation horizon), subject to the restriction that these shocks have no contemporaneous effect.
TOT. Formally, this identification strategy requires solving the following optimization problem

$$\gamma^* = \arg \max_{\gamma} \sum_{h=0}^{H} \Omega_{1,2}(h) = \arg \max_{\gamma} \sum_{h=0}^{H} \sum_{\tau=0}^{h} B_{1,\tau} \tilde{A} \gamma' \tilde{A}' B_{1,\tau}' \quad (8)$$

subject to

$$\gamma(1,1) = 0 \quad (9)$$

$$\gamma' \gamma = 1. \quad (10)$$

The first constraints impose on the identified news shock to have no contemporaneous effect on 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 $p(F, \Sigma | data),^2$ 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.\(^3\)

### 3 Empirical Evidence

#### 3.1 Data


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\(^2\)Note that $F$ here represents the stacked $(6 \times (p + 1)) \times 6$ reduced form VAR coefficient matrix, i.e., $F = [F_1, ..., F_p, F_c]'$.

\(^3\)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) the relative importance of intra-regional trade in the two regions is significantly different, with higher indicators in Asia, c) 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 d) very importantly for the present argument, there are marked differences between the two regions with regard to the actual composition of intra-regional trade flows, with trade in Asia presenting a higher share of manufactures.

3.2 The Identified News Shock

Following the identification strategy outlined in section 3, 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 with some events in the data. 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 agricultural products (i.e. better TOT for Brazil). This series also peaks in the expected way with the 2 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 news series. Finally, 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. Then, our identified news series captures the most important events that affected the Brazilian TOT during the period. In the next subsection, we analyze the response of Latin American economies to surprise and news TOT 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 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 are small but positive and they increase with a lag to the TOT positive disturbance. 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 to our identified innovation relative to the TOT shock identified in Schmitt-Grohe and Uribe (2015). Turning to the variance decompositions (see Table 3) 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.

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. The response of output and the trade balance is significant and economically important on impact. Consumption increases on impact and investment declines initially while bounces back in later periods, after the increase in TOT. The real exchange rate sluggishly appreciates. Turning to the variance decomposition in Table 4, 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). 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 Chile and Mexico and less important for the variations in output in Brazil and Colombia. One reason for such differences might have to do with the degree of openness of the economies examined, according to the data Chile and Mexico are twice as open to trade as Colombia and Brazil. In particular, the ratio of exports and imports to GDP is above 50% in Mexico and Chile while it is below 35% in Colombia an Brazil. Notice also that futures prices seem to be affected much more by TOT news in Chile and Mexico relative to Colombia and Brazil making possibly the economies of those countries more susceptible to TOT news shocks.

3.4 Alternative SVAR specifications

In this section we consider alternative VAR specifications to examine the robustness of our bench-
mark results. 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 shocks in every exercise on average in Tables 5 and 6, 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's 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. The first row of Tables 5 and 6, respectively, presents the share of variance explained by the two identified TOT shocks in this exercise.

3.4.2 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. 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. 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.

\[^4\]See https://www.imf.org/external/pubs/cat/longres.aspx?sk=23307.0 for more information on this series.
(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 Common Format for Transient Data Exchange (COMTRADE) data at SITC IIInd digit level. Results from this exercise appear in the third row of Tables 5 and 6.

Using commodity-based TOT series in our baseline regressions does not change the fact that unexpected and anticipated movement in the TOT explain a big 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.

3.4.3 The Schmitt-Grohe and Uribe (2015) specification

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).

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 third row of Tables 5 and 6 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 identical with the ones of Schmitt-Grohe and Uribe (2015). In this specification, news TOT shocks also important, but slightly less relative to the benchmark specification in explaining the variance of output on average.
3.4.4 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 fifth row of Tables 5 and 6 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 19% and 21% 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). Hence, we can conclude that, even if 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.

3.5 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 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 and 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

5 These results are available upon request from the authors.
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

4.1 The model

The structure of the model is similar to Schmitt-Grohe and Uribe (2015), who modify the canonical model of Mendoza (1995). In particular, the model includes three sectors: exportable \( (x) \), importable \( (m) \), and non-tradable \( (n) \). We augment the model of Schmitt-Grohe and Uribe (2015) by considering capital utilization in the three sectors, which helps us to match the responses of GDP and investment. We also include news and surprise shocks to the terms of trade, following the estimated processes from the empirical section. We choose this model because we want to evaluate if it is capable of generating the IRF we identify in the previous section.

4.1.1 Households

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

\[
U_t = E_t \sum_{t=0}^{\infty} \beta^t \left( \frac{c_t - G(h^m_t, h^x_t, h^n_t)}{1 - \sigma} \right) (11)
\]

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

\[
G(h^m_t, h^x_t, h^n_t) = \frac{(h^m_t)^{\omega_m}}{\omega_m} + \frac{(h^x_t)^{\omega_x}}{\omega_x} + \frac{(h^n_t)^{\omega_n}}{\omega_n} (12)
\]
Households are subject to the following budget constraint:

\[ c_t + i^x_t + i^m_t + i^n_t + \frac{\phi_i}{2} (k^x_{t+1} - k^x_t)^2 + \frac{\phi_m}{2} (k^m_{t+1} - k^m_t)^2 + \frac{\phi_n}{2} (k^n_{t+1} - k^n_t)^2 + \rho^x_t d_t = \frac{\rho^x_t d_{t+1}}{1 + r_t} + w^x_t h^x_t + w^m_t h^m_t + w^n_t h^n_t + u^x_t k^x_t + u^m_t k^m_t + u^n_t k^n_t \]

where \( i^x_t, k^x_t, \phi^x_t, w^x_t \), and \( u^x_t \) denote investment, capital stock, capital adjustment costs, wages, and rents for each sector \( i = m, x, n \). \( \rho^x_t \) 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:

\[ k^x_{t+1} = (1 - \delta (u^x_t)^{\gamma^x}) k^x_t + i^x_t \]  \hspace{1cm} (14)

\[ k^m_{t+1} = (1 - \delta (u^m_t)^{\gamma^m}) k^m_t + i^m_t \]  \hspace{1cm} (15)

\[ k^n_{t+1} = (1 - \delta (u^n_t)^{\gamma^n}) k^n_t + i^n_t \]  \hspace{1cm} (16)

where \( u^x_t \) denotes the utilization rate and \( \gamma_i \) is the elasticity of marginal depreciation costs, which is negatively related to the responsiveness of utilization to shocks. When \( \gamma_i \) is large, the negative effects of utilization on depreciation dominate the positive effects of utilization on output and firms choose to keep utilization constant.

### 4.1.2 Production of Final Goods

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

\[ B(a^T_t, a^n_t) = \left( \chi_T (a^T_t)^{1 - \frac{1}{\mu_T}} + (1 - \chi_T) (a^n_t)^{1 - \frac{1}{\mu_n}} \right)^{\frac{1}{1 - \mu_T}} \]  \hspace{1cm} (17)

where \( a^T_t \) denotes the domestic absorption of the tradable composite good, and \( a^n_t \) denotes the domestic demand for non-tradable 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:

\[ B(a_t^r, a_t^n) - p_t^r a_t^r - p_t^n a_t^n \]  \hspace{1cm} (18)

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

### 4.1.3 Production of the Tradable Composite Good

The tradable composite good is produced using exportable and importable goods via the following technology:

\[ a_t^r = A(a_t^m, a_t^x) = \left( \chi_m (a_t^m)^{1 - \frac{1}{\mu_m}} + (1 - \chi_m) (a_t^x)^{1 - \frac{1}{\mu_m}} \right)^{\frac{1}{1 - \mu_m}} \]  \hspace{1cm} (19)

where \( a_t^m \) and \( a_t^x \) denote the domestic absorption of importable and exportable goods, respectively. Firms in this sector also behave competitively. Profits are given by the following expression:

\[ p_t^r A(a_t^m, a_t^x) - p_t^m a_t^m - p_t^x a_t^x \]  \hspace{1cm} (20)

### 4.1.4 Production of Exportable, Importable, and Nontradable Goods

Exportable, importable, and Nontradable goods are produced with the following technologies:

\[ y_t^x = A_t^x F^x(u_t^x k_t^x, h_t^x) = A_t^x (u_t^x k_t^x)^{\alpha_x} (h_t^x)^{1 - \alpha_x} \]  \hspace{1cm} (21)

\[ y_t^m = A_t^m F^m(u_t^m k_t^m, h_t^m) = A_t^m (u_t^m k_t^m)^{\alpha_m} (h_t^m)^{1 - \alpha_m} \]  \hspace{1cm} (22)

\[ y_t^n = A_t^n F^n(u_t^n k_t^n, h_t^n) = A_t^n (u_t^n k_t^n)^{\alpha_n} (h_t^n)^{1 - \alpha_n} \]  \hspace{1cm} (23)

where \( A_t^i \) and \( y_t^i \) denote productivity and output of each sector \( i = x, m, n \). Firms in each sector are homogenous and behave competitively both in factor and product markets.
4.1.5 Market Clearing Conditions and Definitions

This is the market clearing condition for the final goods:

\[ c_t + i_t^x + i_t^m + i_t^n + \frac{\phi_x}{2} (k_{t+1}^x - k_t^x) + \frac{\phi_m}{2} (k_{t+1}^m - k_t^m) + \frac{\phi_n}{2} (k_{t+1}^n - k_t^n) = B(a_t^x, a_t^n) \]  (24)

This is the market clearing condition for the nontradable good:

\[ a_t^n = y_t^n \]  (25)

The economy wide resource constraint is:

\[ p_t \frac{d_{t+1}}{1 + r_t} = p_t d_t + m_t - x_t \]  (26)

where \( m_t \) and \( x_t \) denote aggregate import and export, respectively. They can be defined as:

\[ m_t = p_t^m (a_t^m - y_t^m) \]  (27)

\[ x_t = p_t^x (y_t^x - a_t^x) \]  (28)

Finally, we define 2 key variables for this economy. First, the terms of trade \( (tot_t) \) are characterized by the following expression:

\[ tot_t = \frac{p_t^x}{p_t^m} \]  (29)

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

\[ rer_t = \frac{\epsilon_t P_t^s}{P_t} = \epsilon_t p_t^r \]  (30)

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)).
4.1.6 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:

\[ r_t - r_t^* = \psi \left( e^{d_t - \bar{d}} - 1 \right) \]  

(31)

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 process for the terms of trade that is subject to two sources of exogenous variations: surprise and news shocks.

\[ tot_t = \sum_{i=1}^{I} p_i^{tot} tot_{t-i} + \sum_{j=1}^{J} p_j^{news} news_{i,t+j} + \sum_{k=1}^{K} p_k^{\epsilon} \epsilon_{i,t-k} + \epsilon_{t}^{tot} \]  

(32)

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. In line with our empirical analysis, we use the estimated process for each country.

4.1.7 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 1 displays the values of the parameters common across countries.

| Table 1: Calibration—Common Parameters |
|---|---|---|---|---|---|---|---|---|---|---|
| \( \alpha_x \) | 0.35 | \( \alpha_m \) | 0.35 | \( \alpha_n \) | 0.25 | \( \omega_x \) | 1.455 | \( \omega_m \) | 1.455 | \( \omega_n \) | 1.455 | \( \sigma \) | 2 |
| \( \chi_m \) | 0.898 | \( \chi_r \) | 0.813 | \( r^* \) | 0.0277 | \( \bar{d} \) | 0.2189 | \( \delta \) | 0.025 | \( \mu_m \) | 1 | \( \mu_r \) | 0.5 |

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

Table 2: Calibration-Country Specific Parameters

<table>
<thead>
<tr>
<th>Country</th>
<th>$\phi_m$</th>
<th>$\phi_x$</th>
<th>$\phi_n$</th>
<th>$\psi$</th>
<th>$\gamma_m$</th>
<th>$\gamma_x$</th>
<th>$\gamma_n$</th>
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</thead>
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<td>0.6</td>
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<td>2.1</td>
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<td>7.2</td>
<td>2.1</td>
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<td>0.05</td>
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<td>2.108</td>
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</tbody>
</table>

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 hotly debated in the literature, with Chari et al. (2008) arguing that SVAR models are not suitable for model validation and estimation and Christiano et al. (2007) defending SVAR models as a useful tool but cautioning against their incorrect use. In order to avoid these critiques we will try to treat simulated and actual data in the same

\[^6\]It is worthwhile noting that much of the criticism by Chari et al. (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 et al. (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
manner. Given that in our VAR exercise we have only identified TOT news and unexpected shocks, neglecting the identification of other shocks, we will try to 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 would be direct.\footnote{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 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 in the appendix for the sake of comparing results, but we insist that the Monte Carlo exercise we perform is the most suitable way to compare theoretical and empirical predictions.}

To this end, we simulate 1000 sets of data from the standard small open economy DSGE model presented in the previous section 4, 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 use 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.\footnote{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.} Also note that, to keep things simple, our model does not include any other structural shock apart from the unanticipated and anticipated TOT shocks; adding such news shocks would not materially change our results as these shocks do not affect TOT. In general, our identification method would perform well as long as no other shock significantly affects TOT, which is a reasonable assumption since it is sensible to view TOT as an exogenous variable from the standpoint of a small open economy.

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 calibrate the standard deviations of the measurement errors such that estimated contributions to 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 et al. (2008). The results we present in this section confirm this belief.
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 7. These measurement errors are also drawn from the normal distribution.

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. In Figures 5a and 5b we depict the responses of Brazil to save on space; these figures present the SVAR impulse response, theoretical model responses, and estimated median impulse responses averaged over the simulations to an unanticipated TOT shock and a TOT news shock for our seven Latin American countries. The SVAR responses are given by the plus-signed solid lines, 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 ones, suggesting that our identification procedure enables us to properly identify the true effects of unanticipated and anticipated shocks to TOT. Responses to the unanticipated shock are comparable with the responses presented in Schmitt-Grohe and Uribe (2015). The trade balance expands in response to an improvement in the terms of trade and this increases also output. As in Schmitt-Grohe and Uribe (2015), both consumption and investment increase on impact in response to the improvement in the terms of trade, although in the SVAR the expansion of demand is delayed. In response to TOT news, output and consumption expand with a delay as in the empirical model. The model fails to generate the delayed response in investment and predicts an immediate surge in investment after the TOT news and generates a prolonged response of the trade balance.

Table 8 and 9 presents the estimated contributions of the unanticipated and news shocks to the two-year variation in output along with their empirical counterparts from Section , respectively. It is apparent that the Monte Carlo estimated contributions are generally close to their empirical counterparts.
5 Conclusion

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), examine the sensitivity of their results using quarterly instead of annual SVARs and complement their analysis with additional variables such as country spreads 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.

Actually, when we feed their textbook theoretical model with unexpected and news TOT shock series we show that the variations of both disturbances can account for 30% of variation in output volatility in emerging countries matching the empirical predictions from our SVAR exercises. We conclude that the standard small open economy model is still a useful tool for the analysis of the dynamics of small open economies and more attention should be devoted to the anticipation of world shocks and their effects in emerging markets.
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. 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.
References


Kilian, L. and Hicks, B.: 2013, Did unexpectedly strong economic growth cause the oil price shock of 20032008?, *Journal of Forecasting* 32(5), 385–394.

URL: [http://dx.doi.org/10.1002/fut.21615](http://dx.doi.org/10.1002/fut.21615)


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 weighted average of the country-specific median responses to the unanticipated TOT shock, where weighs are the inverses of the variances of the country-specific estimates. The bands in the figure are one standard error bands where the standard error is the one corresponding to the standard error of the weighted average estimate. 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 weighted average of the country-specific median responses to the TOT news shock, where weights are the inverses of the variances of the country-specific estimates. The bands in the figure are one standard error bands where the standard error is the one corresponding to the standard error of the weighted average estimate. 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 3: 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>
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</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 4: Share of Forecast Error Variance Explained by TOT News Shocks: Country-Level SVAR Evidence.

<table>
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<tr>
<th>Country</th>
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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 5: Robustness Table: Share of Forecast Error Variance Explained by Unanticipated TOT Shocks for Various Alternative SVAR Specifications.

<table>
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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 6: Robustness Table: Share of Forecast Error Variance Explained by TOT News Shocks for Various Alternative SVAR Specifications.

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<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 7: Monte Carlo Experiment: TOT shocks and Measurement Error Standard Deviations.

<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 8: 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></td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
</tr>
<tr>
<td>TOT</td>
<td>41% 54%</td>
<td>53% 55%</td>
<td>30% 47%</td>
<td>37% 48%</td>
<td>12% 24%</td>
<td>44% 56%</td>
<td>30% 56%</td>
</tr>
<tr>
<td>Output</td>
<td>11% 35%</td>
<td>13% 28%</td>
<td>9% 29%</td>
<td>14% 24%</td>
<td>4% 20%</td>
<td>12% 24%</td>
<td>22% 38%</td>
</tr>
<tr>
<td>Consumption</td>
<td>8% 24%</td>
<td>7% 20%</td>
<td>16% 21%</td>
<td>11% 20%</td>
<td>7% 18%</td>
<td>10% 16%</td>
<td>11% 21%</td>
</tr>
<tr>
<td>Investment</td>
<td>4% 51%</td>
<td>19% 54%</td>
<td>14% 43%</td>
<td>16% 38%</td>
<td>12% 23%</td>
<td>6% 51%</td>
<td>22% 47%</td>
</tr>
<tr>
<td>Trade Balance</td>
<td>10% 35%</td>
<td>4% 26%</td>
<td>11% 37%</td>
<td>13% 37%</td>
<td>11% 21%</td>
<td>18% 42%</td>
<td>14% 54%</td>
</tr>
<tr>
<td>REER</td>
<td>13% 55%</td>
<td>24% 53%</td>
<td>16% 47%</td>
<td>11% 47%</td>
<td>10% 24%</td>
<td>19% 55%</td>
<td>11% 50%</td>
</tr>
</tbody>
</table>

### Table 9: 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></td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
<td>Data MC</td>
</tr>
<tr>
<td>TOT</td>
<td>32% 26%</td>
<td>29% 31%</td>
<td>46% 33%</td>
<td>22% 27%</td>
<td>53% 47%</td>
<td>32% 28%</td>
<td>44% 28%</td>
</tr>
<tr>
<td>Output</td>
<td>40% 22%</td>
<td>19% 22%</td>
<td>45% 24%</td>
<td>8% 21%</td>
<td>14% 37%</td>
<td>29% 20%</td>
<td>18% 23%</td>
</tr>
<tr>
<td>Consumption</td>
<td>33% 19%</td>
<td>35% 19%</td>
<td>32% 20%</td>
<td>9% 20%</td>
<td>31% 33%</td>
<td>16% 18%</td>
<td>12% 21%</td>
</tr>
<tr>
<td>Investment</td>
<td>21% 25%</td>
<td>20% 30%</td>
<td>16% 31%</td>
<td>9% 26%</td>
<td>16% 45%</td>
<td>19% 27%</td>
<td>22% 32%</td>
</tr>
<tr>
<td>Trade Balance</td>
<td>8% 26%</td>
<td>26% 24%</td>
<td>35% 31%</td>
<td>15% 25%</td>
<td>37% 41%</td>
<td>21% 25%</td>
<td>34% 17%</td>
</tr>
<tr>
<td>REER</td>
<td>10% 15%</td>
<td>27% 15%</td>
<td>40% 34%</td>
<td>24% 28%</td>
<td>52% 48%</td>
<td>10% 30%</td>
<td>5% 32%</td>
</tr>
</tbody>
</table>
Figure 4: Monte Carlo Evidence: (a) Unanticipated Shocks; (b) News Shocks.

Figure 5: (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 4 for each country 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. These estimates were then averaged over the different country estimates to form the aggregated average impulse response estimate. 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.