The Commodity Price Bust: Implications for Latin America

By Bertrand Gruss and Carlos Caceres
June 24, 2015

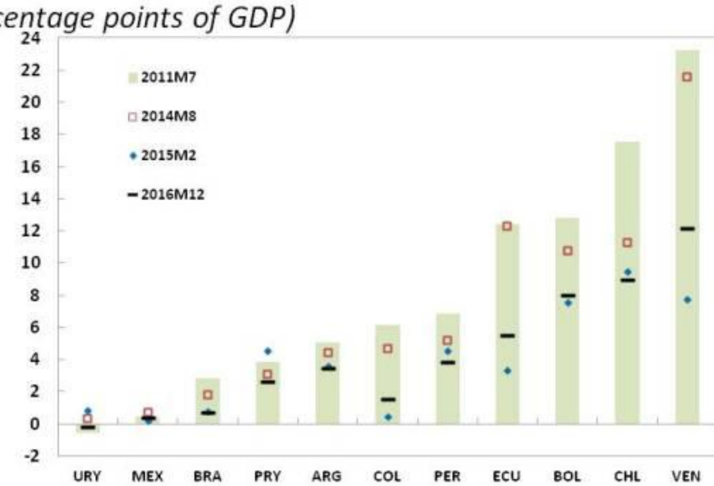
Commodity prices have once again been making the headlines since mid-2014, particularly in Latin America where commodity-related revenue finances a significant share of government budgets and of the region's import bills. With oil prices dropping by 50 percent over six months and other commodity prices accelerating a decline that began even earlier, what impact can we expect on public finances and on the external accounts of the region's commodity-exporting economies?

In our recent *Regional Economic Outlook* we argue that the impact of the steep decline in commodity prices will have important implications, especially for the fiscal position of several economies in the region.

Where are we and where are we going?

First of all, we must put the recent price upheaval in perspective. Not all Latin American countries export (import) the same products, so we must adopt a more granular approach and analyze how each country's commodity terms of trade (the price of commodity exports compared with that of imports) were affected.

Commodity terms of trade, 2003-16
(Cumulative change in CTOT indices from average levels in 2002; percentage points of GDP)



Sources: UN Comtrade, IMF World Economic Outlook; and IMF staff calculations.
Note: CTOT = Commodity Terms of Trade. Projected CTOT are based on the prices of commodity futures prevailing at end-February 2015.

In this regard, our analysis shows that commodity-exporting countries faced different situations across the region. While some countries (such as Brazil, Chile and Peru) had already lost about ¼-⅓ of their terms-of-trade gains from the commodity boom by mid-2014, most were still enjoying terms-of-trade levels that were almost as high as in 2011. But a lot has happened since then, and the effects have differed widely. Bolivia, Colombia, Ecuador, and Venezuela suffered substantial terms-of-trade losses since August 2014 as a result of the drop in oil and natural gas prices. In the case of Colombia, the losses were almost as large as the gains made during 2003-11. For Chile and Peru, the decline in oil prices largely offset the fall in the price of their metal exports, whereas in Mexico the losses from crude oil exports were to a large extent offset by the decline in the prices of imported refined fuels.

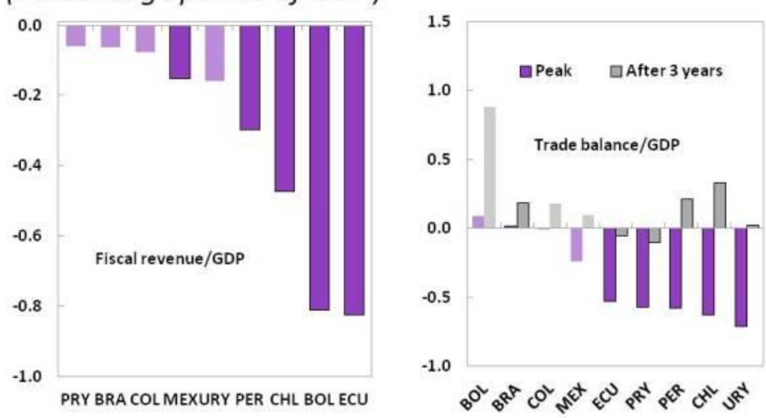
How lasting can the recent adjustment be? It is hard to know with any certainty. But judging by futures prices, the terms of trade of several countries in the region by end-2016 would still be substantially worse than in 2011-14.

The fiscal deterioration may be substantial and lasting…

The effect on fiscal revenue depends not only on the size of the commodity sector, but also on other factors that are difficult to quantify a priori (such as the degree of exchange rate flexibility, the ownership structure of the sector and the specific taxation applied to income from natural resources). With this in mind, we estimated a series of econometric models for each country and found that commodity terms-of-trade shocks do have an important effect on fiscal revenues in the region.

Response of fiscal revenue and trade balance

(Percentage points of GDP)



Source: IMF staff calculations.
Note: Response to a negative one standard deviation shock to commodity terms of trade (departure from long-term trend). Solid bars denote that the response is statistically significant at the 5 percent confidence level.

The effects are significant in Chile, Peru, and Mexico and particularly large in Bolivia and Ecuador. For these two countries, we found that a *standard* shock causes a decline in fiscal revenue of 0.8 percentage points of GDP. And it is worth noting that the *cumulative* drop in commodity terms of trade observed since mid-2014 was unusually strong—in some cases as large as five times the size of a one-period estimated standard shock in our sample.

… whereas the effect on trade balances would be rather short-lived

Our estimates suggest that the deterioration in the trade balance resulting from a standard shock in commodity prices is relatively short-lived. In most cases, three years after the shock the trade balance has converged back to its original level—or even exceeded it.

Why is this so? The quick reversal in the trade balance could reflect "healthy" dynamics: the negative price shock leads to an exchange rate depreciation that fosters noncommodity exports which, after a time, offsets the decline in commodity-export values. However, our estimates suggest that the external adjustment dynamics in Latin America played differently in the past: in most countries, the income drop associated with the price shock results in a strong contraction in import volumes. Although this helps to preserve external sustainability, the implications are less "benign," as they reflect a recessionary context in which consumption and private investment decline (as found in another recent study).

What can the region do?

Our analysis suggests that some countries in the region will experience pronounced and lasting declines in fiscal revenues, typically requiring some fiscal restraint. Certain countries, such as Chile, Colombia, and Peru, have sufficient fiscal space, which will allow them to smooth the necessary adjustment (for example, by preserving investment in infrastructure). Others, however, have no leeway and will have no choice but to rein in deficits over the near term—in an unfortunately procyclical way.

However, our analysis also emphasizes some lessons documented in earlier studies: the adverse effects of terms-of-trade declines are less severe in those economies with more flexible exchange rates (such as Chile and Colombia). But in order to be able to let the exchange rate adjust sufficiently, it is essential to have credible policy frameworks and to mitigate the balance-sheet weaknesses from currency mismatches. In addition, our analysis shows a more benign adjustment to external shocks in those economies with a higher degree of production diversification. This highlights the importance of reforms aimed at creating business environments conducive to investment and innovation in the region.

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