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COMMODITY PRICE VOLATILITY, UNCERTAINTY AND BUSINESS CYCLES IN A SMALL OPEN ECONOMY

Abstract:

Commodities are a major source of income in commodity-producing countries. However, commodity prices suffer from changing volatility over time. How does the volatility of commodity prices affect economic activity in a commodity-exporting country? This paper builds a real business cycle model for a small open economy in which commodity prices are characterized by time-varying volatility. Under such scenario, commodity prices are affected by shocks to their level and shocks to their volatility. Shocks to commodity prices have an expected income effect through which consumption and investment grows. However, shocks leading to higher volatility have an impact on risk-averse agents, with possible reverse consumption and investment decisions.

Keywords:

Commodity prices, Stochastic volatility, Emerging markets.

JEL Classification: E32, F41, O10