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Commodity Shocks and Exchange Rate Regimes: Implications for the Caribbean Commodity Exporters

By Ali Al-Sadiq, Pablo Bejar, and İnci Ötker

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Western Hemisphere Department

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Prepared by Ali Al-Sadiq, Pablo Bejar, and İnci Ötker[1]

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Abstract

Declining commodity prices during mid-2014-2016 posed significant challenges to commodity-exporting economies. The severe terms of trade shock associated with a sharp fall in world commodity prices have raised anew questions about the viability of pegged exchange rate regimes. More recently, the COVID-19 pandemic and the measures needed to contain its spread have been associated with a significant disruption in several economic sectors, in particular, travel, tourism, and hospitality industry, adding to the downward pressure on commodity prices, a sharp fall in foreign exchange earnings, and depressed economic activity in most commodity exporters. This paper reviews country experiences with different exchange rate regimes in coping with commodity price shocks and explores the role of flexible exchange rates as a shock absorber, analyzing the macroeconomic impact of adverse term-of-trade shocks under different regimes using event study and panel vector autoregression techniques. It also analyzes, conceptually and empirically, policy and technical considerations in making exchange rate regime choices and discusses the supporting policies that should accompany a given regime choice to make that choice sustainable. It offers lessons that could be helpful to the Caribbean commodity-exporters.

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