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Does global liquidity drive commodity prices?*

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Abstract

This paper tackles the question of whether a cross-sectional perspective on monetary policy is capable of explaining movements in global commodity prices. In this vein, we contribute to the rich literature on global liquidity in two different ways: on the one hand, to achieve a global series in terms of common monetary policy shocks, we propose a distinction between common and idiosyncratic factors across economies, as proposed by Bai and Ng (2004). Our second innovation stems from the consideration of a Markov-switching vector error correction model when analyzing time-varying short-run dynamics. Having identified the long-run structure which includes a proportional relationship between commodity prices and global liquidity in the first step, our results indeed show that the impact of a global liquidity measure on different commodity prices is significant and varies over time. One regime approximately accounts for times where commodity prices significantly adjust to disequilibria, while the second regime is characterized by either a weak or no commodity price adjustment. The fact that global liquidity also reacts to disequilibria in a specific regime demonstrates the two-way causality between monetary policy and commodity prices.

Keywords: global liquidity, cointegration, commodity prices, common components, Markov-switching error correction

JEL classification: C32, E52, E58

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