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Mariano Kulish, Daniel M. Rees

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Unprecedented Changes in the Terms of Trade*

Mariano Kulish[†] and Daniel M. Rees[‡]

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Abstract

The development of Asia exposed commodity-exporting economies to unprecedented changes in their terms of trade. Using a small open economy model we estimate changes in the long-run level and variance of Australia's terms of trade and study the quantitative implications of these changes. An innovation of our analysis is to account in estimation for structural changes in the terms of trade. We find that long-run commodity prices increased by 35 per cent in mid-2003 and that the volatility of shocks to commodity prices doubled soon after. The increase in the level of commodity prices is much smaller than single-equation estimates suggest. This is because our inferences rely on many observables that in general equilibrium also respond to shifts in the long-run level of the terms of trade.

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[†]School of Economics, UNSW and Centre for Applied Economic Research, m.kulish@unsw.edu.au

[‡]Economic Research, Reserve Bank of Australia reesd@rba.gov.au

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