

Commodity-price booms are usually associated with rising incomes, stronger fiscal positions, appreciating currencies, declining borrowing costs, and capital inflows. During downturns, these trends are reversed. Indeed, since the current slump began four years ago, economic activity for many commodity exporters has slowed markedly; their currencies have slid, after nearly a decade of relative stability; interest-rate spreads have widened; and capital inflows have dried up.

Just how painful the downturn turns out to be depends largely on how governments and individuals behave during the bonanza. If they perceive improvements in their terms of trade as permanent – a view that gains traction as prices climb – increases in consumption and investment tend to outpace income gains, and public and private leverage grows. The risk is that when the roller coaster careens downward, a debt crisis will derail markets.

And, indeed, during commodity-price downturns, banking, currency, and sovereign-debt crises tend to proliferate – and crisis-avoidance becomes a hot topic for policymakers, as highlighted in the International Monetary Fund's most recent World Economic Outlook. It is no accident that the last commodity-price collapse, which ran from the late 1970s until 1992, coincided with more than a decade of sovereign-debt crises in the developing world.

Of course, that was no ordinary downturn. On the contrary, it was the most severe commodity-price collapse to date, resulting in a 40% peak-to-trough decline. More atypical, it involved three waves of price declines, divided by 1-2 year respites. The first wave was connected with the US Federal Reserve's efforts to bring inflation under control in the fall of 1979, which caused international interest rates to spike, triggering a deep recession in the US and elsewhere. The second wave, which began in 1985, reflected a supply glut, as many commodity exporters simultaneously sought to raise hard currency, often in the midst of economic crisis. The third wave, from 1989 to 1992, was fueled by the disintegration of the Soviet Union, which caused output there to collapse.

The question now is whether the current crash will follow a similar trajectory, with the recent break soon giving way to another drop. The answer lies primarily (but not exclusively) with China.

If China's economic slowdown persists – as those following investment booms and fueled by debt overhangs often do – the commodity downturn is likely to continue, as no other economy is capable of picking up the demand slack. The US economic expansion is likely to slow soon, as the Fed raises interest rates. And Europe's relatively recent recovery will probably be moderate and tilted toward domestic services.

Furthermore, at this stage of the commodity cycle, price declines typically retain downward momentum. By the end of the boom, many commodity exporters had already initiated investment projects to expand production. As these investments bear fruit, the increased supply will sustain downward pressure on prices. And many emerging-economy governments' understandable aversion to running substantial and persistent

current-account deficits will lead them to counter weaker export prices by increasing export volume, even if that drives down prices further.

This commodity-price roller-coaster ride is probably not over yet. While we cannot know for sure what will happen, it would be prudent to brace ourselves for another drop – and do what we can to avoid a crash.