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A new taxonomy of Sudden Stops: Which Sudden Stops should countries be most concerned about?

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ABSTRACT

This paper proposes a new taxonomy of Sudden Stops comprised of seven categories with definitions depending on the behavior of gross and net capital flows. The incidence of different types of Sudden Stops is detailed over time and we relate the type of Sudden Stop to economic performance. Sudden Stops in Net Flows associated with reductions in Gross Inflows are associated with larger falls in output than those where Sudden Starts in Gross Outflows dominate. The paper further discusses the mechanisms that might result in Sudden Stops in Gross Flows that are not Sudden Stops in Net Flows such that purchases and sales in financial assets or liabilities do not require a sharp current account adjustment. Still, it is found that Sudden Stops in Gross Inflows that do not provoke a sharp contraction in Net Flows may also be disruptive, particularly Sudden Stops that are driven by “other flows” - which include banking flows. The results suggest new avenues for research and future policy analysis.

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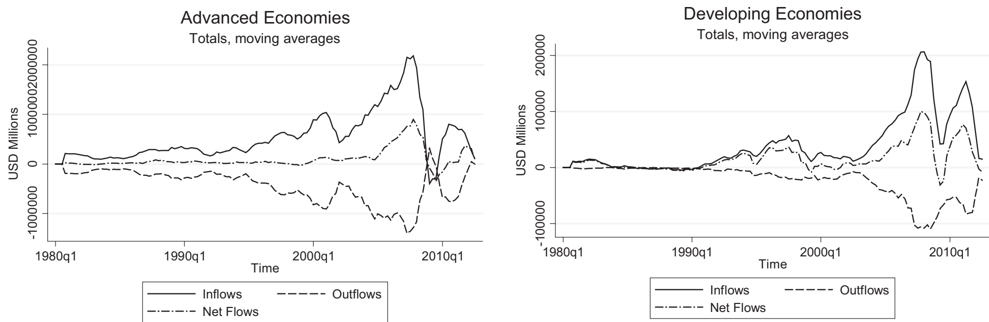

Fig. 1. Gross and net flows: Advanced and Developing Economies.
Source: IMF-IFS database.

1. Introduction

While Net Capital Flows between capital exporting and capital importing countries grew substantially in the 1990s, peaking before the global financial crisis, Gross Capital Inflows and Outflows and have risen quite dramatically (see Fig. 1); particularly in Developing Economies.[1]

This increase might well be related to deeper financial integration but the risks associated with Sudden Stops in capital flows may also have grown.[2] But Gross Inflows and Outflows may move in such a way to dampen the impact on Net Flows. The literature to date has looked at different and somewhat specific aspects of the movement of gross flows. The goal of this paper is to attempt a more systematic analysis. Indeed, we propose a new taxonomy of Sudden Stops encompassing all the logical combinations in the movements of Gross and Net flows. Employing this new taxonomy, we suggest that Sudden Stops of different types may have different impacts on macroeconomic variables.

More generally, the literature regarding cross-border capital flows has tended to focus on certain phenomena regarding Gross and Net Capital Flows with the particular emphasis arguably depending on the epoch. For example, in the 1980s there was considerable interest in “capital flight” from Developing Economies, or what has been termed more recently, Starts in Gross Capital Outflows”; see for example Cuddington (1986) and Dooley (1986). In the 1990s and 2000s, the focus turned to “Sudden Stops”, which were normally defined as an abrupt reversal in Net Flows. It was found that such a Sudden Stop, and the associated current account adjustment and real exchange rate depreciation, resulted frequently in a significant output loss for affected economies (see Calvo, 1998; Calvo et al., 2004, 2008; Guidotti et al., 2004; Cavallo and Frankel, 2008) and that the conditions that led to Sudden Stops being more disruptive were tended to be prevalent in Developing Economies.

More recently, there has been renewed interest in the behavior of Gross Flows and the relationship between Gross and Net flows. Recent papers on the role of Gross capital flows in the determination Sudden Stops include Cowan and De Gregorio (2007), Calderón and Kubota (2013), Rothenberg and Warnock (2011) and Forbes and Warnock (2012) and Alberola et al. (2012). These papers focus on the determinants of such episodes and argue that Sudden Stops may be driven, among other factors, by external and country idiosyncratic factors and by the different behavior of residents and non-residents. In a different vein, Powell et al. (2002) argued that Gross Outflows and Inflows are strongly associated, that each may “Granger-cause” the other, and that there may be vicious and virtuous cycles between Gross capital flows and macroeconomic variables. For example, during periods of increasing financial integration, non-residents may buy domestic assets and residents are likely to use the proceeds to purchase assets abroad. During periods where financial integration has diminished the reverse may

[1] In this paper, Advanced Economies are High Income countries following the World Bank's 2007 classification, prior to the financial crisis. Developing Economies are all Higher or Lower Middle Income Countries according to the same classification. See Table A.1 in the appendix for the list of countries included in each group.

[2] Lane and Milesi-Ferretti (2001, 2007) document the increased stocks of financial assets and liabilities.

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