Sudden Stops: Better Responses & Remaining Challenges

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WHAT IS A SUDDEN STOP?

A "sudden stop" is a period when capital flows into an economy dry up abruptly. Sudden stops are often accompanied by currency depreciation, increases in public debt, and sharp decreases in output.

This paper extends the classic literature on sudden stops, comparing and contrasting the frequency, properties, and causes of sudden stops before and after 2002.

Using data on emerging markets from the IMF's International Financial Statistics, researchers Barry Eichengreen and Poonam Gupta identified 44 sudden stops in 34 emerging markets since 1991.

Characteristics of Sudden Stops

Period	Frequency	Duration (Qtrs)	Capital Inflow Turnaround*	Depreciation	GDP Growth
1991–2002	*1.8%*	*3.6*	*–2.3*	*15.5%*	*0.0%*
2002–present	*2.1%*	*4.5*	*–3.2^*	*11.0%*	*–1.5%*

** (% of GDP)*
^ Statistically significant (1% level)

They found that the frequency, duration, and effects of sudden stops have remained largely unchanged (aside from capital inflow turnaround), but that global factors have become more important relative to country-specific factors.

CAUSES OF SUDDEN STOPS

To investigate the causes of sudden stops, the researchers analyzed the effect of global and domestic factors on the probability of a country experiencing a sudden stop.

Global Factors

- *Volatility Index (VIX) as a proxy for global risk aversion*
- *G4 money supplies as a proxy for global liquidity*
- *Federal Reserve's policy interest rate*

Domestic Factors

- *GDP growth, public debt, and budget deficit*
- *Capital flows in preceding period*
- *Current account balance, bank credit, real exchange rates*
- *Reserves, international investment exposure*

They found that global and domestic factors matter, but the most important factor is the Volatility Index (VIX). A one standard deviation increase in VIX increases the probability of a sudden stop by 60%. Before 2002, US monetary policy was more influential, while the VIX became more important after 2002.

POLICY RESPONSES

The conventional view is that countries respond to sudden stops by tightening both monetary and fiscal policy. Using data from IMF reports, documents, and financial statistics, the researchers found that this only happened in 8 of the 44 cases.

In general, governments eased monetary policy in response to a sudden stop. Although fiscal tightening was a common response before 2002, it happened less after 2002.

Since 2002, countries are less likely to respond to sudden stops with contractionary policies. Despite this, falls in the GDP during sudden stops are similar in both periods, possibly because these expansionary policies are now offset by stronger external shocks.

These findings suggest that the challenge of understanding and coping with capital-flow volatility is far from met.

Policy Response	Before 2002	After 2002
Tighten Monetary Policy	*38%*	*11%*
Tighten Fiscal Policy	*81%*	*37%*
Tighten Capital Transactions	*23%*	*15%*
Macroprudential Measures	*0%*	*15%*
Change Exchange Rate Regime	*63%*	*15%*
New IMF Program	*94%*	*26%*
Structural Reforms	*7%*	*52%*

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