RESEARCH INSIGHTS

IDB

Why Did Some Countries Suffer Sudden Stops in Capital Flows during the Pandemic While Others Did Not?

- **Despite the sharp contraction in portfolio flows in March 2020, only six of 22 Latin American and Caribbean countries analyzed suffered a sudden stop in net capital flows during the COVID crisis.**
- **Outflows were the main driver of these sudden stops, as residents decided to increase their savings abroad. In other cases, external borrowing was crucial to avoid sudden stops. Without sovereign debt issuance or multilateral lending, sudden stops would have been considerably more widespread.**
- **Strong fundamentals are critical to maintaining access to external sovereign debt markets. Countries that suffered sudden stops had weaker pre-crisis macroeconomic indicators.**

CONTEXT

A sudden stop (SS) occurs when cross-border financing unexpectedly dries up, forcing an abrupt current account reversal and often a recession. The early work on sudden stops in emerging economies focused on net capital flows which were driven by inflows—the flows of nonresidents. But at the turn of the century, flows related to residents' investments abroad, outflows, became more important. A full taxonomy of SS events includes sudden stops in net flows (SSN), as well as in gross flows such as an SS in outflows (SSO) and an SS in Inflows (SSI) that are not necessarily concurrent with sudden stops in net flows.

Key Concept

SUDDEN STOP

An event when foreign financing available to borrowing countries unexpectedly dries up, forcing an abrupt current account reversal from deficit to surplus, and often a recession.

PROJECT

We explored how external financial flows behaved during the COVID crisis in the region through the lens of a SS taxonomy and compare the outcomes to previous crises. Specifically, we analyzed whether 22 countries in the region suffered any type of SS. We detailed whether residents' capital flight or the capital retrenchment from nonresidents were offset by other types of flows. In addition, we analyzed whether macroeconomic fundamentals could explain the pattern of capital flows identified.

Key Concept

FINANCIAL ACCOUNT INFLOWS AND OUTFLOWS

Financial account flows from nonresidents, and residents, respectively. Known together as gross flows, their sum is the net financial account flow.

RESULTS

Across the 22 countries, there were six SSNs, six SSOs, and three SSIs. Some countries faced more than one type of event, while others faced none. Compared with previous crises, the number of SSNs is remarkably low (see Figure 1). In some cases, SSIs were offset by an increase in asset repatriation from residents, thus avoiding an SSN.

More frequently, however, there were SSOs (capital flight from residents) offset by inflows from nonresidents due in large part to higher external debt issuance (see Figure 2).

This stands in contrast to the Great Financial Crisis, where typically there was a withdrawal of capital from nonresidents (a decrease in liabilities) that was at times offset by the repatriation of the assets of residents abroad.

Sovereign bond issuance in international markets and loans from multilateral financial institutions were critical to avoiding net flow sudden stops during the pandemic. In a counterfactual analysis, we find that if there had been no bond issuance there would have been double the number of SSNs, and if multilaterals had not lent, the number of SSNs would have increased by about a third.

Countries that did suffer an SSN had already been experiencing weak growth in external financing growth during 2019, indicating weaker initial macroeconomic conditions (see Net SS group in Figure 2 Inflows panel). In fact, those countries were among the most vulnerable when ranked with a model designed to assess the probability of a sudden stop with 2019 data.

Key Concept

GROSS FLOW OFFSETTING

A compensating behavior among financial account inflows and outflows, preventing the appearance of an SS in net flows.

POLICY IMPLICATIONS

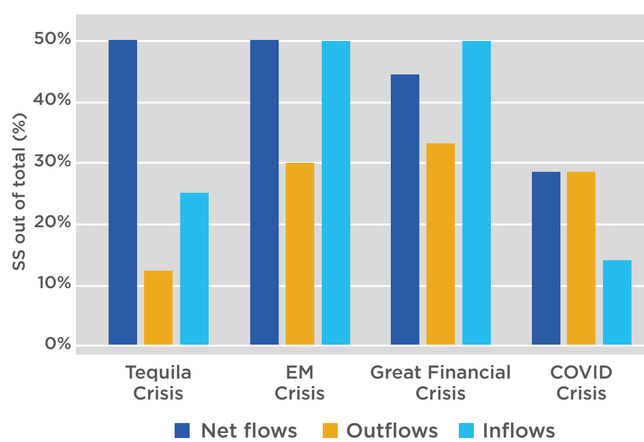
Our results highlight three important policy recommendations:

1. First, as residents' asset flows now play a decisive role in aggregate external financing flows, policymakers should allow those flows to play a countercyclical role. That means i) allowing residents to invest abroad and avoiding controls on capital outflows, ii) avoiding over-valued exchange rates, imposing taxes, or other measures that can discourage capital repatriation.

2. Second, ensuring continued access to international capital markets at reasonable cost is critical for countries to avoid costly sudden stops. External sovereign bonds issuance and multilateral borrowing allowed countries to offset residents' outflows during the COVID crisis.

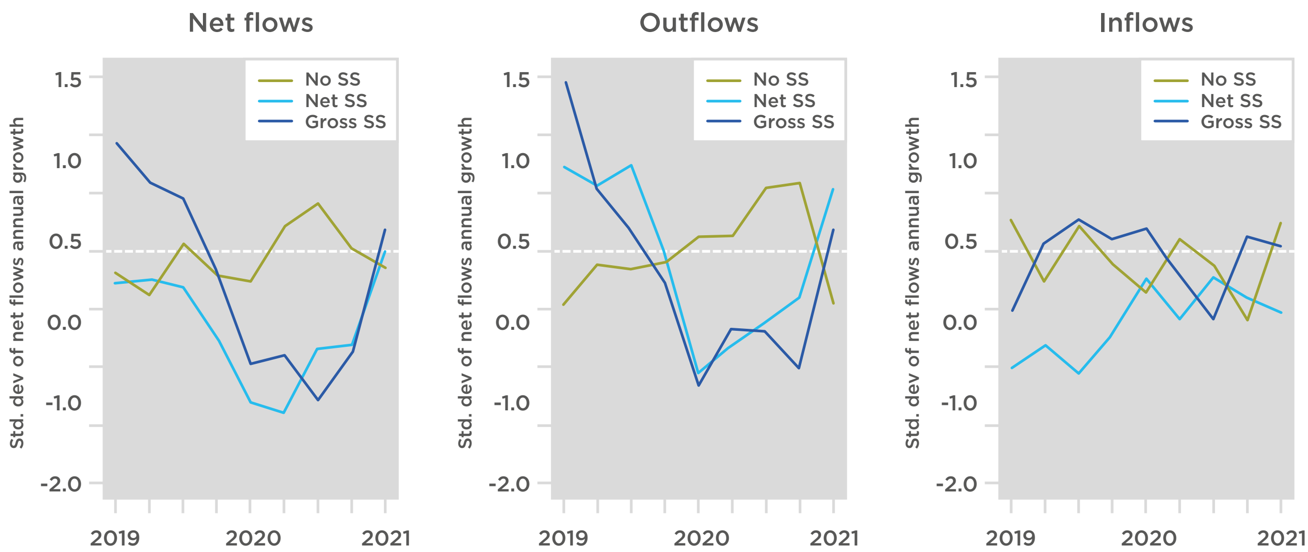
3. Third, sound macroeconomic fundamentals are extremely valuable to maintain access to capital markets. Fiscal and current account deficits should not be excessive, and countries may wish to maintain a healthy level of international reserves, net of domestic liabilities in foreign currency, to act as a buffer.

Figure 1. Sudden Stops in Latin America and the Caribbean across Different Crises



Source: Authors' calculations based on the Financial Account from the IMF's Balance of Payments database.
Note: Figure shows the percentage of countries that suffered an SS out of the total sample. Countries with data are the countries that had information for all the periods of the crisis. Tequila Crisis shows the SSs between 1995 Q1 and 1995 Q4, EM Crisis shows the SSs between 1999 Q1 and 1999 Q4, Great Financial Crisis shows the SSs between 2009 Q1 and 2009 Q4, and COVID Crisis shows the SSs between in 2020 Q2 and 2021 Q1.

Figure 2. Average Flows to Latin American and Caribbean Economies during the COVID Crisis



Note: Figure shows the statistic for each type of flow: the yearly change in the annualized flow in a quarter minus its rolling mean until that quarter, everything divided by the rolling standard deviation of the net flows until that quarter. We divide the sample into three groups: Net SS: countries that experienced a net sudden stop, Gross SS: countries that faced a gross sudden stop but no net SS and, No SS: countries that did not experienced a sudden stop. Net SS Sample: Argentina, Costa Rica, Dominican Republic, Ecuador, Guatemala, and Suriname. Gross SS Sample: Brazil, Chile, Colombia, El Salvador,and Paraguay. No SS Sample: Belize, Bolivia, Honduras, Jamaica, Mexico, Nicaragua, Panama, Peru, Trinidad and Tobago, and Uruguay.

FULL STUDY

Cavallo, Eduardo A., Andrew Powell, Juan Hernández, and María José González Jaramillo. 2022. "Sudden Stops in Latin America and the Caribbean during COVID-19."

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.