Dealing With a Sudden Stop

By Antonio Fatas

Economists disagree about what kept the U.S. from becoming Greece during the financial crisis.

My post on **how the US economy would have performed if it was going through the crisis as a member of the Euro area** was an attempt to explain that the perspective of a small Euro country with limited credibility can be very different from that of the US. **Robert Waldmann** at Angry Bear is surprised by the macroeconomic logic I use so let me clarify what I had in mind -- given that what I am saying is quite standard.

A country with a current account deficit must have a matching capital inflow to finance the excess of spending above its income (this is an accounting identity). During the financial crisis many European countries faced a sudden stop -- which is defined as a situation where international financial markets are not willing anymore to fund the current account deficit of a country. This is something that any textbook discusses although normally in the context of emerging markets [by the way, it is not easy to use the IS-LM model to deal with sudden stops given that the IS-LM model is not the best model to analyse current account imbalances and situations where there is no price at which capital will fund a current account deficit].

If capital inflows stop it means that the country cannot afford to run a current account deficit (unless the rest of the world is willing to hold more of your currency (which is in fact a capital inflow). To close a current account deficit you need to reduce imports. If there was a way to engineer a fall in imports, there would be no consequence to domestic demand and GDP. And if at the same time your currency is depreciating you could see an increase in exports and possibly in increase in activity. But there is no way to engineer a fall in imports to close the current account deficit. Some of these imports are part of the supply chain in the domestic production but, more importantly, when foreign capital stops coming in you simply get an aggregate fall in spending that will affect domestic demand and production. In other words, when individuals of corporations who were borrowing abroad stop getting credit, there will be a fall in demand that will affect both domestic and imported goods. I am not saying anything new here, this is the way we teach about sudden stops and that's why we have mechanisms to provide liquidity during these times (e.g. lending by IMF) to ensure that the adjustment in the current account does not come in a very sudden way. There is no way to get out of this by inflation. Inflation can help dealing with monetizing internal debt (government debt) but cannot help smooth the consequences of sudden stop of capital that was financing a current account deficit. An exchange rate depreciation can help by increasing exports but this effect cannot be fast enough.

Before the crisis the US looked very similar to some of the Euro periphery countries (asset price bubbles, fast credit growth, large current account deficit,...). When the crisis started, the US managed to survive much better than Greece or Spain or Ireland. The point of my blog post was that the main reason for that is that the US maintained access to capital inflows (if any there was an increase in the desire of foreign investors to out their money in the US). The exchange rate itself did not help much, in fact the US dollar appreciated because of the capital inflows. And for Euro countries, the real problem was the large swing in capital flows from excessive inflows to a sudden stop. Competitiveness and the exchange rate played a much smaller role. That is my assessment after looking at the data. I think most economists agree with the existence of both effects but we seem to disagree with the relative importance of each of them.

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About the author(s)

Antonio Fatas is a Professor of Economics at INSEAD. He is also a Research Fellow at the Centre for Economic and Policy Research in London and has worked as an external consultant for the

International Monetary Fund, the OECD and the World Bank.