JOURNAL ARTICLE

Do Some Forms of Financial Flows Help Protect Against "Sudden Stops"?

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Abstract

There is a debate on whether some forms of financial flows offer better protection against crises than others. Using a large panel data set that includes advanced, emerging, and developing economies during 1970–2003, this article analyzes the behavior of several types of flows: foreign direct investment (FDI), portfolio equity investment, portfolio debt investment, other flows to the official sector, other flows to banks, and other flows to the nonbank private sector. Differences across types of flows are limited with respect to volatility, persistence, cross-country comovement, and correlation with growth at home or in the world economy. However, consistent with conventional wisdom, FDI is the least volatile form of financial flow, when the average size of net or gross flows is taken into account. The differences are striking during "sudden stops" in financial flows (defined as drops in total net financial inflows of more than percentage points of GDP compared with the previous year). In such episodes, FDI is remarkably stable, and portfolio equity seems to play a limited role. Portfolio debt experiences a reversal, though it recovers relatively quickly, and other flows (including bank loans and trade credit) experience severe drops and often remain depressed for a few years.

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