Systemic Sudden Stops: The Relevance Of Balance-Sheet Effects And Financial Integration

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Using a sample of 110 developed and developing countries for the period 1990-2004 we analyze the empirical characteristics of systemic sudden stops (3S) in capital flows -- understood as large and largely unexpected capital account contractions that occur in periods of systemic turmoil -- and the relevance of balance sheet effects in the likelihood of their materialization. We conjecture that large real exchange rate (RER) fluctuations come hand in hand with 3S. A small supply of tradable goods relative to their domestic absorption -- a proxy for potential changes in the real exchange rate -- and large foreign-exchange denominated debts towards the domestic banking system, denoted Domestic Liability Dollarization, DLD, are claimed to be key determinants of the probability of 3S, conforming a balance-sheet effect that impacts on the probability of 3S in non-linear fashion. Regarding financial integration, the larger is the latter, the larger is likely to be the probability of Sudden Stop; however, beyond a critical point the relationship gets a sign reversion.

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