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Sudden stops and the Mexican wave: Currency crises, capital flow reversals and output loss in emerging markets

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Abstract

Sudden stops are the simultaneous occurrence of a currency/balance of payments crisis with a reversal in capital flows. We investigate whether sudden-stop crises are a unique phenomenon and whether they entail an especially large and abrupt pattern of output collapse (a "Mexican wave"). Using a panel data set over 1975–1997 and covering 24 emerging-market economies, we distinguish between the output effects of currency crises, capital inflow reversals, and sudden-stop crises. Sudden-stop crises have a large negative, but short-lived, impact on output growth over and above that found with currency crises. A currency crisis typically reduces output by about 2–3%, while a sudden stop reduces output by an additional 6–8% in the year of the crisis. The cumulative output loss of a sudden stop is even larger, around 13–15% over a 3-year period. Our model estimates correspond closely to the output dynamics of the 'Mexican wave' (such as seen in Mexico in 1995, Turkey in 1994 and elsewhere), and out-of-sample predictions of the model explain well the sudden (and seemingly unexpected) collapse in output associated with the 1997–1998 Asian Crisis.
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1. Introduction

Sudden stops in capital flows to emerging market economies are a key characteristic of several recent financial crises. The sudden stop problem, first emphasized by Calvo (1998), features an abrupt cessation in foreign capital inflows and/or a sharp capital outflow concurrently with a currency/balance of payments crisis. Calvo et al. (2002), for example, provide a sudden-stop interpretation for the current crisis in Argentina in which the capital flow reversal together with a dramatic real exchange rate depreciation significantly worsened the government's fiscal position and led to default. In a broad historical examination, Bordo et al. (2001) argue that the sudden stop problem has become more severe since the abandonment of the gold standard in the early 1970s. Kaminsky (2003) argues that sudden stops are a special variety of currency crisis. Finally, Mendoza and Smith (2002) define three key features of Sudden Stops: "sharp reversals in capital inflows and current account deficits, large downward adjustments in domestic production and absorption, and collapses in asset prices and in the relative prices of nontradable goods relative to tradables" (p. 1).

An examination of the data reveals that many currency/balance of payments crises are *not* characterized by sudden stops (Table 1). Capital inflow reversals occur with some regularity in emerging markets (about 22% of the observations in our sample), and currency crises are also fairly common (11% of the observations). But many currency crises do not occur *jointly* with a capital flow reversal—those episodes we term sudden stops. Sudden stops occur in only about 6% of the observations in our sample of emerging market economies and constitute a bit more than half of the number of currency crises we identified. By our metric, there have been 34 episodes of sudden stops among emerging markets since the collapse of the Bretton Woods system of fixed exchange rate parities in the early 1970s till before the 1997 Asian crisis and another 10 between 1998 and 2002. With the higher threshold levels for 'major' crises shown in the lower panel, the frequency of occurrences is lower but the basic pattern is the same as with the standard crisis definitions. Clearly, sudden-stop crises are *not* one and the same as currency crises nor are

Table 1
Sudden stop events

	Currency crisis	No crisis
A. 'Normal' crises and capital flow reversals		
Capital flow reversal	34 (6%)	85 (16%)
No reversal	26 (5%)	389 (73%)
B. Major crises and major capital flow reversals		
Capital flow reversal	26 (5%)	49 (9%)
No reversal	23 (4%)	436 (82%)

The table includes all crises from 1975 to 2002 for the 24 emerging markets in our sample (see endnote 7). The number in parentheses is the percent of country years. The upper-left quadrant stands for Sudden Stops according to our definition of the term (see text). For currency crises, a normal crisis is defined as the deviation in the currency pressure index of more than 2 standard deviations from the country-specific mean (3 standard deviations for major crises). For current account reversals, a standard reversal is defined as a positive change in the current account to GDP ratio of more than 3 percentage points (5% points for a major CA reversal).

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