A Theory of Sudden Stops: An Informational-Frictions Approach

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Abstract

International finance literature has devoted much work to analyze the causes of the recently documented episodes of sudden stops phenomena. These are typically treated as exogenous events with sharp falls in output and employment. In this paper, I show that it is possible to rationalize "sudden stops" as part of an optimal lending strategy in the face of asymmetric information. In a separating equilibrium of the model, a concept of sudden stop arises endogenously resulting in a partial understanding of the classic agency problem of a financial crisis. By committing to terminate funding if borrowing country's performance is poor, international lenders can mitigate incentive problems. Staged financing constraint, however, encourages borrowers to misbehave, makes the financial constraints binding, and induce exit. This seemingly perverse sudden stops form a necessary solution to the moral hazard problem in investment. The model matches most of the qualitative properties of sudden stops that have been documented over the last decade and half. One key policy goal to deal with informational frictions, like those discussed in this paper, is to improve information channels. Recent efforts by the IMF and developing countries to improve data dissemination are in the spirit of this goal.

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