Box 4: Sudden Stops in Capital Flows: The Colombian Case

Box 4: Inflation Report March 2016 Keep in mind
The Monetary Policy Report presents the Bank's technical staff's analysis of the economy and the inflationary situation and its medium and long-term outlook. Based on it, it makes a recommendation to the Board of Directors on the monetary policy stance. This report is published on the second business day following the Board of Directors' meetings in January, April, July, and October.

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In an ever more globalized world, capital flows emerge as a viable alternative for investors who are seeking higher yields and for economies that are short on savings and looking for resources to finance their current expenditure or investments.

Capital flows depend on international financial conditions, such as foreign interest rates and risk perception, as well as the characteristics of the recipient economies. For that reason, although a country's financing needs might not change, inflows of capital from abroad can stop suddenly, with serious consequences for aggregate demand, employment and the financial stability of companies, the government and households. This phenomenon is referred to in the specialized literature as a sudden stop. For the past fourteen years, the Colombian economy has seen its current account deficit increase from around 1.0% of GDP to 6.5% in 2015. This indicates the country is spending more money than it has in terms of disposable national revenue and has resorted to foreign savings to finance this external imbalance.

The boom in capital flows occurred at a time when there was a clear trend toward peso appreciation, both in nominal and real terms, followed by depreciation of the peso4 in a context of lower international prices for raw materials, expectations that the Federal Reserve would raise its policy rate in the United States, and slower economic growth in Latin America and Colombia. All of this shows potential external vulnerability. Thus, if the current account deficit is not corrected and flows of external financing come to a sudden stop, this would imply a sharp reduction in aggregate demand, which would affect economic growth.

This section presents an adaptation of the method proposed by Cavallo et al. (2013) to identify sudden stops in foreign capital flows and the results for the Colombian case in the period from 1996 to 2015.