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Keep in mind

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Sudden stops seem to create the perfect environment for disinflation, especially when central banks defend the exchange rate by increasing interest rates. We propose a variation of the output gap model that incorporates the sudden stop shock. The use of the model in policy analysis shows that fear of floating is pro-cyclical and inflation targeting, counter-cyclical. The model is run for Brazil, Colombia, Korea and Thailand, the inflation targeting countries that have recently had sudden stops. The three policy implications direct attention to the medium and long run. First, the central banks that are targeting inflation should focus on inflation, not during but after the sudden stop. Second, they could complement this medium term view by monitoring a measure of inflation of non traded goods. Third, the monetary authorities could eventually introduce an escape clause to the CPI inflation target under a sharp depreciation.