Sudden Stops with Heterogeneous Agents*

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Abstract

This paper develops a heterogeneous agent model of a small open economy and studies how households differ in their responses to aggregate productivity and interest rate shocks. Poor households display stronger consumption responses to an aggregate productivity shock because they are more likely to be constrained in liquid assets. In contrast, rich households display stronger consumption responses to an interest rate shock because they are more likely to be unconstrained in liquid assets. When the economy experiences a sudden stop, defined as contractionary shocks to productivity and the interest rate, the interest rate effect neutralizes the productivity effect. As a consequence, the sudden stop generates consumption-income elasticities that display little variation along the income or wealth distributions, similar to a permanent shock. My finding captures the observed behavior of households in the Mexican Peso Crisis of 1994. (*JEL* D31, E21, E32, F32, F41)

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