

# Discussion of Eijffinger and Karataş

## Three sisters: the interlinkage between sovereign debt, currency and banking crises

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# The paper focusses on an important issue

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How interlinked are currency crises, banking crises and sovereign defaults?

- European debt crisis renewed interest in understanding interlinkages between banking and sovereign crisis
- Could China be the next triple crisis?

*“Bank of America warns of 'lethal' damage to China's financial system as deflation deepens. 'Deflation, Devaluation, and Default' loom in China this year....”*

*---The Telegraph, 8 Jan 2015*

- Not much literature on triple crises (notable exception: Gourinchas and Obstfeld, 2011)

# Main results

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- Banking crises usually precede sovereign debt defaults
- No strong relationship between currency and debt crises
- Role of worsening fundamentals as expected
- A start to exploring the transmission channels:
  - Banking crisis + high short term foreign indebtedness = more likely future sovereign default
  - Currency crises + overvalued exchange rate = more likely future sovereign default

# What do we really need from an early warning system?

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- Early enough warning, so policy can be used for corrective action
  - Most early warning studies look for 1-3 year ahead warnings
- This paper: methodological focus on predicting timing rather than incidence of crisis
  - Many fundamentals (exchange rate overvaluation, current account) predict sovereign defaults one month in advance
- Suggestion: Redefine dependent variable

# Why focus on triple crisis in same month?

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- Dating may be subject to measurement error:
  - When did the Greece crisis start?
- Crisis often transmits from banks or capital flow reversal to sovereigns with a lag – channels of transmission important from policy perspective
  - Six debt and banking crisis in same month, but an additional 7 debt crisis within a year of banking crises

# From a policy perspective, two interesting questions about triple crises

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- **What makes triple crises different?**
  - Larger credit boom ahead of twin episodes (Baltneau & Erce, 2014)
  - Larger increase in credit spreads at the start of the crisis predicts worse crises (Krishnamurthy and Muir, 2015)
- **What are the transmission channels?**  
(Baltneau & Erce, 2014)
  - Lower liquidity support from central bank ahead of twin event
  - Greater exposure of banks to sovereign

# Other comments

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- Better reflect recent work, which has highlighted importance of:
  - Credit gaps (Borio and Drehmann, several papers)
  - Leveraged bubbles, esp. Housing (Jorda, Schularick, Taylor)
  - Reserves (Gourinchas and Obstfeld, 2011)
- Why only 20 countries in sample?
  - Arteta and Hale (2008) dataset has 39 EMEs with banking crisis start month

# Thank you!

