Dear Ken, Carmen, Sebnem,

Thank you for the invitation to submit a proposal/outline for the project. I have been working with Òscar Jordà and Moritz Schularick to produce an outline of the proposed work we have in mind. Here is a summary below, and we look forward to your response.

Sincerely yours,
Alan

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Paper Proposal

Sovereigns versus Banks: Crises, Causes, and Consequences

Òscar Jordà, Moritz Schularick, and Alan M. Taylor

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As the global crisis of 2008 and its aftermath have made clear, crisis vulnerabilities can lurk in economic systems in a number of places. Notably, fears of current or prospective bad liabilities may be gestating, in principle, within the balance sheet of the private financial system, or else inside the debt structure of the consolidated government, or, perhaps in both places at once. For example, in Euroland, crises in countries as different as Ireland, Greece, Portugal, Spain and Italy, have shown that despite superficial similarities, the underlying causes and possible consequences of such distress my vary profoundly, with potentially varied implications for both prevention and policy responses.

In the last few years the authors have developed and analyzed a private bank credit database for 14 countries since 1870 (see ST, "Credit Booms Gone Bust"), and have used these data to analyze the interconnection between financial sector leverage and financial crisis events, whilst pushing empirical investigation forward with new methods. An important tool for us, now and in what follows, is the local projection

(LP) method used in our recent paper (JST, "When Credit Bites Back") which help us to present cumulative or dynamic conditional paths as we partition or stratify crisis episodes.

More can be done. We aim to advance empirical methods with firmer identification strategies that can complement the LP approach. And our dataset is now poised to be updated (to 2011 or 2012) an expanded (perhaps to 16 or more countries). Multiple publications based on this research are now nearing conclusion but we believe that several more novel and relevant problems warrant investigation.

In this study we propose to build on our analysis of private bank balance sheets, credit booms and busts, and related financial crises, and link all of this up with an analysis of sovereign balance sheets, fiscal stress, and risks of default. It is now well understood that the twin crises (sovereign and financial) may be intertwined, in that the occurrence of one may tend to trigger the other. (See, e.g., R&R...) On the one hand, after a large financial crisis bailing out TBTF banks or pursuing supportive fiscal policies after a financial crisis may tip the sovereign closer to illiquidity if not insolvency. On the other hand, a government in fiscal crisis may endanger its own financial system by degrading the quality of (once-) safe assets, placing banks at risk of collateral shortages, illiquidity, or (especially if a default materializes) insolvency, and, thus, raising the dangers of credit crunches or panics along the way.

Our work will start with a look at event-study windows where we shall see what the typical drivers are pre/post crisis: the government balance sheet versus bank credit. We would then aim to drill down and seek to classify responses by type of crisis, type monetary regime, policy responses, extent of leverage or fiscal strain ex ante, and through other "sorts" on the data. The first goal will be to establish stylized facts about these two balance sheets and their dynamics around crisis episodes. A deeper goal will be to say something about the relationship between stress/crises on these two dimensions and the behavior of the real economy. For example, an important question is whether damage to growth and recovery is connected more to the backwash from credit bubbles or to the blowback from a sovereign debt bubble. Which type of bubble (private/sovereign) is more likely to elevate crisis risk? Which one is more of a drag on government finances? On monetary policy? On economic growth itself?

As policymakers grapple to devise cures, as well as methods of prevention, depend on an historically informed and empirically grounded analysis of such questions.