Avoiding the Fall into the Loop: Isolating the Transmission of Bank-to-Sovereign Distress in the Euro Area and its Drivers

Comments

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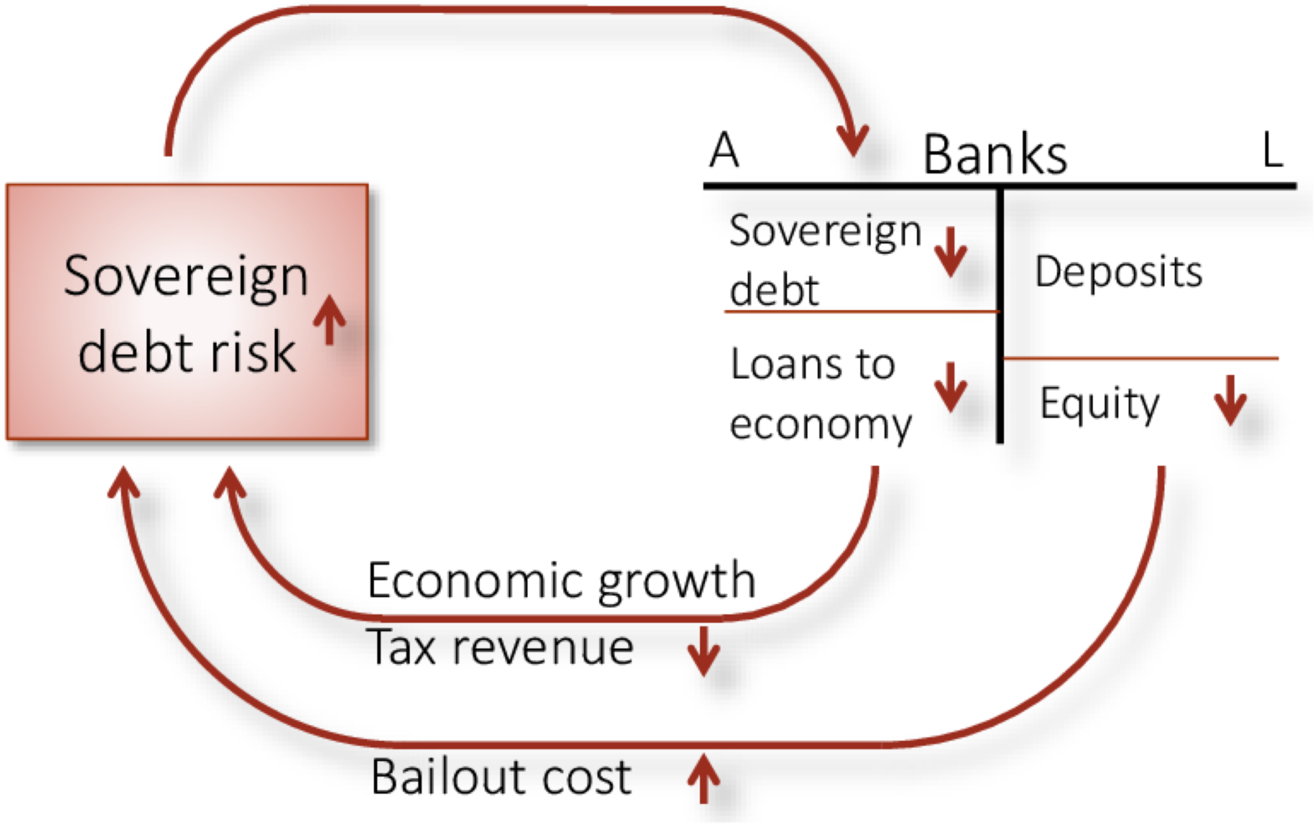
The doomloop



Basic specification

- Government distress depends on banking sector distress.
- But…
  - Second part part of the loop is missing: why not interact banking distress with exposure of domestic banks to domestic government (time varying)
  - Fiscal variables are lacking here (only considered as channel, while they are key element in doomloop model)

How to measure government distress?

- Interest differential vis-à-vis Germany. This implies that:
  - Germany is not included in the analysis;
  - Differential may change because German rates change
  - Why not consider deviation from world interest rate?

How to measure banking distress?

- No perfect measure; I can see the pros of bank stock returns in terms of data availability.
- But…
  - Not obvious to me that stock returns are properly reflecting distress: there is no benchmark (perhaps consider deviation from some world index for banks)
- CDS spreads are considered in robustness analysis
- Z-score (which would be my choice) is not

A final suggestion for interaction effects

- Authors provide marginal effect plots when discussing interaction effects and do not only look at significance of coefficient on interaction term.
- Recent development in this area: Hainmueller et al. (2019) show that scholars often overlook two important problems.
- First, they assume that the conditional effect is constant across the whole range of the corresponding variable.

A final suggestion for interaction effects (2)

- Second, they do not address the lack of common support in the data. The conditional effect may rely on interpolation or extrapolation if not every value of the corresponding variable contains a sufficient number of data points. In that case, the conditional effect will be model dependent.
- Hainmueller et al. (2019) suggest ways to deal with these issues that the authors could implement.

Thank you for your attention