Abstract

There have been various financial crises in emerging market economies EMEs) with often devastating economic, social and political consequences. These financial crises were in many cases not confined to individual economies but spread contagiously to other markets as well due to globalization effect. This has lead to international financial institutions have developed Early Warning System (EWS) models, with the aim of identifying economic weaknesses and vulnerabilities among emerging markets and ultimately anticipating such events. This paper develops a new Early Warning System (EWS) model for predicting financial crises, based on a logit model for the Indian economy. A second aim of this paper is to test for the role of a broad set of economic and financial variables in financial crises. In particular, we test a number of economy's performance indicators to measure real and financial channels of transmission across economies. Finally in this paper we define a loss function which entails the loss of missing a crisis due to chosen time horizon and threshold probability From a policy perspective, developing reliable EWS models can be of substantial value by allowing policy-makers to obtain clear signals as to when and how to take pre-emptive measures in order to mitigate or even prevent financial turmoil. Although EWS models cannot replace the sound judgment of policy-makers in guiding policy, they can play an important complementary role as a neutral and objective measure of vulnerability.