A FINANCIAL STABILITY INDEX
Estimated by the Institute of Financial Studies

Abstract
In each issue of the Financial Studies Review, we update and publish the Financial Stability Index (FSI) of our Institute of Financial Studies, which tracks the correlation between economic growth and macroeconomic and financial factors in Romania. We constructed a composite index using a linear combination of financial variables that are considered to have a significant impact on economic activity. These financial variables are weighted with respect to their cumulated two quarters impulse response on GDP growth, as estimated by a VAR model.

Developing such a composite index of financial stability or financial stress has two main utilities:
- The analysis of the correlation between financial variables and the real economy placed in the context of different historical episodes of financial crisis. Also, this correlation analysis reveals, in each period, the significant positive or negative contribution of each financial variable to real economic growth. Following this analysis, the FSI can measure the impact of economic and financial policy measures aimed at mitigating financial crises.
- The short-term prediction of real economic growth estimated by forecasting the next period evolution of the real economic activity (GDP_{t+1}) using current period GDP_{t} and FSI_{t} and economic and financial variables in the FSI_{t} composition.

Keywords: composite index, financial stress index, economic growth, VAR model, short-term prediction

JEL Classification: E63; G01; G28

* Authors: Ion Stancu (ion.stancu@isfin.ro), Andrei Tudor Stancu (a.stancu@uea.ac.uk) and Iulian Panait (iulian.panait@asfromania.ro).
Introduction

The Institute of Financial Studies has also undertaken to present to the Romanian and International Economic and Financial Community a Financial Stability Index (FSI) as the barometer of the most representative financial indicators on the evolution of the financial market and, correlative, of the real economy. The first versions of FSI were published in the 1st – 3th numbers of the Financial Studies Review (http://revista.isfin.ro/arhiva-rsf/). In the current issue of the review, we return with an updated index for the second quarter of 2018 and we introduce a forecast for the next 4 quarters (Q3 2018 – Q2 2019).

The fifth edition of FSI resulted from the update of the data series with the first and second quarters of 2018, as well as revisions of the data series in accordance with the available statistical reports.

Research methodology and results

We used the time series of financial and economic variables, quarterly, for Q1 2004 – Q2 2018:

- CPI, budget balance, net exports
- ROBOR, EURIBOR, REER, VIX
- BET index, Gross Insurance Premiums (PBS)

The EURIBOR and VIX variables have been included in the FSI composition as a result of economic co-integration at European and international level.

For the FSI calculation we used the VAR model, i.e. the response to the impulse to change the variables analysed on GDP, quarterly real-terms variations. The contribution of each component variable to FSI evolution was studied. Then, correlations and potential causal relationships between FSI and GDP, including gaps, were investigated.

The underlying hypothesis of FSI development is both intuitive and empirically correlated with the causal relationship between systemic phenomena in financial markets and their effects on the real economy. The quality of the financial stability index is validated by the intensity and the stability of this correlation, respectively, between the aggregate index of these financial variables and the real economy reflected by real GDP growth.

The FSI evolution thus estimated is illustrated in the chart below (Figure 1).
Our results reveal, first of all, a steady increase in FSI (-1) with real GDP: $\rho = 0.697$. Secondly, our results are also supported by FSI's correlation with the main episodes of financial crisis in Romania and international markets: the 2008-2009 global crisis; the euro area debt crisis; escalating the political and military conflict in Ukraine, as well as the social-political crisis in Turkey (see in detail these correlations in the numbers 1 and 2 of our review).

As mentioned above, FSI reveals, in each period, the contribution of each economic and financial variable to the evolution of the real economy, implicitly the impact of public policy measures aimed at mitigating financial crises (Figure 2)
The decrease of the FSI in the fourth quarter of 2008 is largely driven by the evolution of the EURIBOR, BET and ROBOR financial variables which, combined with the response to the impulse on GDP, have the largest contributions to the decrease in FSI. The phenomenon was also evident in the first quarter of 2009 through the contribution of EURIBOR, BET and REER. These FSI developments are also confirmed by the decline in GDP in the respective quarters of 2008 and 2009.

In the graphical representation above but also in table no. 1, a close correlation between the real GDP evolution and the EURIBOR evolution ($\rho = 0.575$), respectively VIX ($\rho = 0.195$), SdBug ($\rho = 0.255$) and ROBOR ($\rho = 0.237$) which led to significant weightings of these financial variables in the compositions of FSI in the previous quarters (Q3 2017 – Q2 2018).
1. We can explain the decrease of FSI in Q2 – 2018 by a growth in ROBOR (from 1.58% in Q3 2017 to 3.15% in Q2 2018), and also due to the evolutions of SdBug and VIX from Q2 2018.

2. The budget balance has significant increases in Q1 and Q2 2018. Its correlation with FSI ($\rho = 0.255$) and the impulse-response of GDP to FSI (0.3208) leads to a significant decrease on FSI in Q2 2018 ($-0.4299$).

The GDP forecast for the next 4 quarters was estimated by the economic and financial variables in the FSI, at one lag and two lags. Based on the equation used, the GDP growth rate is 1.72% for the prediction interval with quarterly rates of 0.80%; 0.19%; 0.42%; respectively, 0.31%. This is not in line with other current forecasts of GDP based on different, more comprehensive and more stable models, and suggests that further improvements in our model could be needed in order to make it more accurate.

The quarterly update, when the data becomes available, will allow us to assess the prediction power of the model and make estimates as close as possible to economic reality.

Conclusions and future research

- There is a significant correlation between FSI and GDP, including a relevant response in times of crisis.
- The inclusion of variables related to non-banking entities in the financial sector in the model does not significantly improve the performance of the model.
- It is also necessary to test other methods for building the financial stability index (e.g., PCA, weighted averages).
- At the same time, it is necessary to find and test the inclusion in the model of other variables related to the Romanian non-banking financial system (e.g., investment funds, pension funds, other indicators of the insurance market).

---

**Table no. 1. Identify correlations, impulse / GDP responses and recent developments in FSI**

<table>
<thead>
<tr>
<th>Time</th>
<th>FSI</th>
<th>GDP</th>
<th>ROBOR</th>
<th>REER</th>
<th>IPC</th>
<th>ExpNet</th>
<th>BET</th>
<th>PBS Adj</th>
<th>SdBug</th>
<th>VIX</th>
<th>EURIBOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017Q3</td>
<td>0.3330</td>
<td>0.7819</td>
<td>0.6554</td>
<td>0.2450</td>
<td>0.7673</td>
<td>0.0133</td>
<td>-0.2045</td>
<td>-1.0823</td>
<td>0.7933</td>
<td>-0.2420</td>
<td>0.1193</td>
</tr>
<tr>
<td>2017Q4</td>
<td>0.4485</td>
<td>-0.3422</td>
<td>0.4994</td>
<td>0.3489</td>
<td>1.2257</td>
<td>0.1013</td>
<td>-0.3125</td>
<td>-0.3125</td>
<td>0.7999</td>
<td>0.2336</td>
<td>0.1166</td>
</tr>
<tr>
<td>2018Q1</td>
<td>0.5472</td>
<td>-0.4581</td>
<td>0.2249</td>
<td>-0.4067</td>
<td>1.2839</td>
<td>0.0633</td>
<td>0.5662</td>
<td>0.2357</td>
<td>-0.1493</td>
<td>0.6838</td>
<td>0.1139</td>
</tr>
<tr>
<td>2018Q2</td>
<td>-0.4299</td>
<td>0.2967</td>
<td>0.8738</td>
<td>-0.0162</td>
<td>0.4253</td>
<td>0.2944</td>
<td>-0.6807</td>
<td>0.0558</td>
<td>-0.4501</td>
<td>-0.5698</td>
<td>0.1300</td>
</tr>
</tbody>
</table>

The values in Table 2 are standardised and therefore different from the actual ROBOR growth rates.

The equation is of the form: GDP = $C(1) + C(2) \times GDP(-1) + C(3) \times GDP(-2) + C(4) \times ROBOR(-2) + C(6) \times REER(-1) + C(7) \times IPC(12) + C(13) \times BET(-1) + C(11)(-1) + C(15) \times PBS(-2) + C(16) \times DEFBUG(-1) + C(17)(20) \times EURIBOR(-1) + C(21) \times EURIBOR(-2) + EURIBOR(-2)$

---
Bibliography


