
THE FINANCIAL STABILITY INDEX (3)

Estimated by the Institute of Financial Studies*

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Abstract

There is a vast literature on developing a composite index of relevant macroeconomic indicators that predicts the real economic growth. This is of great importance not only for international financial institutions (e.g. IMF, ECB), central banks, and financial supervisory authorities, but also for the private sector (credit rating agencies).

Our goal is to build a Financial Stability Index (FSI) or financial stress index that tracks economic growth 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 .

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

JEL Classification: E63; G01; G28

* Corresponding authors: Ion Stancu (ion.stancu@isfin.ro), Andrei Tudor Stancu (a.stancu@uea.ac.uk) and Iulian Panait (iulian.panait@gmail.com).
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