Report on Master Thesis

Institute of Economic Studies, Faculty of Social Sciences, Charles University in Prague

Student:	**Dan VAŠKO**
Advisor:	**Roman Horváth**
Title of the thesis:	**Central bank communication on financial stability**

OVERALL ASSESSMENT *(provided in English, Czech, or Slovak):*

The master thesis is an excellent study of how central banks communicate on financial stability. It constructs a „transparency index“ for financial stability communication looking at the published Financial Stability Reports of central banks and other means of external communication (publication of stress test results, financial stability indicators etc.) over the past 10 years for 110 countries. The index is then used in two econometric analysis – one looking at what explains its level (i.e. as depednent variable) and one looking at whether the transparency has an effect on financial stability (i.e. as explanatory variable). Especially the latter analysis is a very useful exercise as central banks often list communication as an important macroprudential policy tool, so let's see whether it is effctive.

The thesis is well written, in very good language, and features all requirements for a master thesis. The econometric work is excellent and has results with high value added. I am aware of only few similar studies on financial stability communication (they are cited in the review of literature), so this study adds to our so far scarce knowledge on the topic. The data work behind the analysis has for sure been demanding as the author had to collect most of the data himself. It is an exceptional study for a master thesis that deserves high appreciation and that ranks among the best master theses of a year.

I have several comments of which some could be discussed during the defence (I leave it to the author to decide which ones to select, but please select say 2-3 topics). They reflect my experience and interest in the topic and should serve to improve the study further should the author want to submit it as a rigorosis thesis or a working paper, or to continue in this type of research also in PhD programme if he decides so (so it is not a „critique“ of the thesis as such which itself is already at very high level).

In general, I fully recommend the thesis for defence and suggest the grade 1. Moreover, I suggest that the thesis be awarded a „dean's award“ (pochvala děkana), submitted to some students' prize competitions and published.

Comments:

1/ In the introduction (p. 1), the author makes a distinction between microprudential factors and macroprudential factors and equals the latter with banking regulation and supervision. This is not how central banks and regulators define microprudential versus macroprudential. On the contrary, banking supervision and regulation is believed to be largely of a microprudential nature, looking at th soundess and stability of individual institutions. Macroprudential dimension has to look at the financial system as a whole, at different interlinkages between the individual institutions and at macrofactors that influence all institutions (such as a positive phase in credit cycle with optimistc expectations, risk accumulation and credit boom).

2/ A slightly better work with financial stability terms could have been done. So, for example, macroprudential policy is not „an instrument“ (p. 4), but it is an economic policy of national authorities (be it govenrment, central bank or regulator, ideally coordinated among them) that may use a number of instruments (see eg. Frait and Komarkova article in Czech National Bank's FSR 2010/2011). At the same time, a clearer distinction between macroprudential policy and financial stability could be done (see the same article). Similarly, a term „financial stability surveillance“ or „oversight“ is used rather than financial stability supervision (p. 6). On p. 12, financial soundess indicators are understood as a sub-part of more general macroprudential indicators, While in general it might be true, a difference arises in interpreting the indicators. For example, a high or increasing NPL ratio indicates financial instability and thus impared financial soundess. Ont he other hand, a prolonged period of „too low“ NPL ratio usually signals accumulation of risks (see the period 2002-2007) and thus it could be understood as a macroprudential indicator flashin red (while at the same time a financial soundess indicator flashing green). But I understand that most of the publically available resources have not yet converged to a single terminology.

3/ In the beginning of part 2.1, I guess regulator/supervisor of financial system is missing should be placed if not first then after the central banks in the order of relevance. True, many central banks are also supervisors, but not all of them. A bit more structural discussion on the topic supervision inside/outside the central bank, possible conflicts between monetary, supervisory and financial stability policies could have been done. I understand that literature is relatively scarce, nevertheless, over time, more and more central banks have published policy articles on this topic which could have been used (including the public policy recommendation by the ESRB on the macroprudential mandate, see http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_3.en.pdf?c0c66ce9315f5d6ac4a021cbadccf54d; other good papers include Bank of England 2009 paper The role of macroprudential policy and the Central Bank of Luxembourg recent special article in the 2012 Financial Stability Review Making macroprudential policy operational).

4/ On p. 13, the footnote 6 belongs probably to one more risk ommited from the list of risks usually tested in stress testing frameworks, namely the interbank contagion risk.

5/ Sometimes, the author makes a recommendation or suggestion that is not sufficently supported by previous discussion. For example, on p. 13, the author states that „we suggest that in the future, more countries should perform and publish a contagion analysis, ideally based on the net uncollateralized interbank exposures as the financial system is globalized and most of shocks are coming from abroad“. But in the text that precedes, the discussion on this type of contagion risk is missing.

6/ While construction of a transparency index is a useful exercise, using the 1-0 approach (or 1-1/2-0 approach) might not be sufficient. For example, if a central bank describes in its FSR the situation of deposit takers it gest ½ points, but no further analysis is done as to *how* it describes the deposit takers. I have seen a number of FSRs with long parts on banks that said nothing useful about the situation in the banking sector, no forward looking indicators, all analysis done in a backward-looking manner. On the other end of the scale, one can find brief but informative FSRs such as the Dutch or Swedish one that go deep into the risks and are not affraid of publishing risk-sensitive information (are more transparent than other ones). Clearly, for a cross-country study one must make a simplification, but it should be stated upfront in the study that it is a simplification and thus the results must be taken with caution. Some caveats (but more on measuring financial stress rather than transparency) are described in part 5.1.2, but is a only a half a page. On the other hand, there is often some correlation between the „risk quality“ of FSRs and the existence of other channels of communication (stress tests, speches), so the approach taken migh in the end be appropriate (but this could be mentioned).

7/ Possible endogeneity of financial stability transparency must be taken into account in part 5.1, as strong position of domestic banking sector allows authorities to run harsh tests and be quite open on the risks (as the domestic banks easily withstand even large shocks). This could explain the high transparency level for countries like the Czech Republic, but also some emerging markets like Armenia, Georgia etc. (and explain also the negative slope in chart 5.1 for NPL/TL).

8/ Why, when explaining the transparency, to consider the importance of financial sector in the economy? Just from looking at the US where financial sector is huge but transparency is questionable (is not that small, in the end, but for sure not at levels seen in the UK or nordic countries). On the other hand, there are countries with huge banking sector and high transparency as those just mentioned, but also countries with small sector and huge transparency (Czech Republic and some emerging markets). A bit of discussion on this determinant would be welcome. In the end, the econometric results confirm that the link is not clear and can actually run both ways (insignificant coefficient).

9/ What is the expected sign for (lagged) financial stress index in the analysis of determinants of FST? I can imagine both signs (stress – central bank supresses transparency in order not to cause more contagion – such as Ireland and Germany not publishing FSRs in 2008-2009 although they have been already written or BoE skipping the part on stress tests in 2008 that has been before an integral part of the FSR; of the other sign – Czech Republic – some signs of stress in 2008-2009 – increase in

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transparency – i. . stress tests done more frequently, FSR more deep as to the risks etc. – used to inform markets about the good situation of banks despite elevated financial stress in the markets – maybe also the effect is not linear – small versus large stress – and it is correlated with the soundess of the financial sector?) , so a discussion on that upfront (i.e. in part 4.1 or even on pp. 23-24) would be useful. Similarly to comment #8, the econometric results confirm that the link is not clear and can actually run both ways (insignificant coefficient in non-lagged regression) or be negative (lagged regression – cases of Germany and Ireland).

10/ In part 4.2.2, the correlation between MPT and FST could be presented also separately for central banks with financial supervision inside and central banks without supervisory powers. Again, it is not clear ex ante in which group the correlation would be higher, I can imagine both possibilities. Clearly, once a central bank is transparent about monetary policy, there are internal pressures in the institution to be tranpsarent also about financial stability, and if supervision is inside, there is a lot of data and resources to be transparent about something. On the other hand, sometimes, supervision does not want to be transparent because they need to operate on a sort-of „confidential“ basis. Once financial stability is to a large extent about soundess of individual (say large) institutions, the level of transparency might actually decrease.

11/ When discussing the lag with wich transparency impact financial stability, I believe that the lag is quite enormous, easily 10 years or so. This is clearly difficult to model still I would prefer to run a cross-country regression on say stress index in 2007-2011 crisis (say its highest level) and the average of FST in the pre-crisis period (i.e. 2001-2006 or even 2007 as some FSRs became more explicit in 2007 on possible aproaching risks and some not...).

12/ In both estimations, the author selects the „best“ model. Given that neither a forecast is done with the estimated equations and elasticities nor decomposition of the changes in dependent variable is performed, I guess it is not necessary to select the „best“ model. The author could just discuss the results of the equations estimated in tables 4.2, 4.3, 4.4, 5.4 etc.

13/ The policy implication on MPT on Sharia-banking system countries might be relavant, but it somehow does not fit into the thesis which is about financial stability transparency. The recommendation could have been put as a footnote in the part on MPT. The policy recommendations should only relate to the results of the analysis on financial stability (of the link between FST and MPT).

SUMMARY OF POINTS AWARDED *(for details, see below):*

CATEGORY		**POINTS**
Literature	*(max. 20 points)*	20
Methods	*(max. 30 points)*	30
Contribution	*(max. 30 points)*	30
Manuscript Form	*(max. 20 points)*	20
TOTAL POINTS	*(max. 100 points)*	**100**
GRADE	**(1 – 2 – 3 – 4)**	**1**

NAME OF THE REFEREE: *Adam Gersl*
DATE OF EVALUATION: *21 June 2012*

Adam Gersl

Referee Signature

EXPLANATION OF CATEGORIES AND SCALE:

LITERATURE REVIEW: *The thesis demonstrates author's full understanding and command of recent literature. The author quotes relevant literature in a proper way.*

Strong	*Average*	*Weak*
20	*10*	*0*

METHODS: *The tools used are relevant to the research question being investigated, and adequate to the author's level of studies. The thesis topic is comprehensively analyzed.*

Strong	*Average*	*Weak*
30	*15*	*0*

CONTRIBUTION: *The author presents original ideas on the topic demonstrating critical thinking and ability to draw conclusions based on the knowledge of relevant theory and empirics. There is a distinct value added of the thesis.*

Strong	*Average*	*Weak*
30	*15*	*0*

MANUSCRIPT FORM: *The thesis is well structured. The student uses appropriate language and style, including academic format for graphs and tables. The text effectively refers to graphs and tables and disposes with a complete bibliography.*

Strong	*Average*	*Weak*
20	*10*	*0*

Overall grading:

TOTAL POINTS	**GRADE**		
81 – 100	**1**	= excellent	= výborně
61 – 80	**2**	= good	= velmi dobře
41 – 60	**3**	= satisfactory	= dobře
0 – 40	**4**	= fail	= nedoporučuji k obhajobě