Measuring and Forecasting Financial Stability

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Comments on „Credit, Asset Prices, and Financial Stress in Canada“

Comments on ‘Credit, Asset Prices and Financial Stress in Canada’, Misina & Tkacz

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Quick summary of the paper

- Analyse whether credit measures and asset prices can be used to predict financial system stress.
- Given the lack of financial crises in Canada, stress is measured by an index (FSI).
- FSI = weighted sum of a range of indicators of financial stress (capturing expected losses, risk and uncertainty).
- Explanatory variables include levels of credit, stock prices, property prices, GDP, inflation, oil prices, US interest rates.

Quick summary of the paper

- Estimate linear and non-linear (threshold) models.
- Benchmark model = lagged FSI. Explanatory variables added to see whether the fit improves.
- Variables with forecasting power: domestic business credit (linear model); business credit and asset prices (threshold model; lags = 4,8 quarters).
- Models pick up the increase in the FSI in 2007 but not the sharpness of the increase.

Comments

- FSI: One of the shortcomings of indicators of financial stress/instability is that they only tell you what you already know, at least in a crisis.

- Having a model that can be used to predict the future FSI is a very useful complement to the index.

Comments

- Why don’t the explanatory variables improve the fit by more?
- Because the asset prices used to construct the FSI are to some extent forward-looking?
- But asset prices may not still reflect tail risk.
- Perhaps focus on predicting high values of the FSI; e.g. by estimating quantile regressions?

Comments

- Financial stress often follows a boom period; this the motivation for including credit and property prices in the regressions.
- But high credit growth and asset prices are flipsides to low spreads and volatility.
- In which case, should the explanatory variables offer much more predictive power than lagged FSIs?

Final comments

- Techniques for forecasting future financial system stress are a useful part of central bankers' and regulators' toolkits.
- But useful to have explanatory variables other than the lagged values of the index.
- Perhaps this could be achieved with a narrower definition/measure of stress; e.g. stress within the banking system.
- Focus on predicting more extreme levels of stress (especially now that there are more extreme observations available).