"Systemic risk diagnostics: coincident indicators and early warning signals" by Schwaab, Koopman and Lucas

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The goal of the paper

"One of the greatest challenges ... at this time is to restore financial and economic stability. ... The academic research community can make a significant contribution in supporting policy-makers to meet these challenges.

It can help to improve analytical frameworks for the early identification and assessment of systematic risk."

Jean-Claude Trichet, December 2009

They build up...

- Four coincident indexes to measure the ‘heat’ at the financial markets.
  - The fraction of financial intermediaries that are expected to fail over the next three months
  - The probability of simultaneous failure of a large number of financial intermediaries
  - Systemic risk indicator
  - Banking stability index
- An early warning indicator to indicate when the risks to financial stability are building up.
  - Based on unexpected differences in the default experiences in particular industry or region compared to what would be expected from macro fundamentals.
    - "It is hard to default if one is drowning in credit."

Contributions

- Global perspective
  - The other papers have typically concentrated only on US markets.
- Methodological
  - A framework to integrate systemic risk signals from different sources.
- The most important contribution remains to be seen.
  - Is the goal going to be fulfilled?

General (academic) assessment

- The paper has all the ingredients for a good academic publication.
    - Well motivated research question
    - New methodology
    - Impressive data set
    - Good execution

Early warning signal

- Data contains only two banking crises periods.
  - Assessing the usefulness of the early warning indicator is challenging.
  - It seems to work well in the latest crisis, but not necessarily in the one before that?
- Figure 8: How should the horizontal lines be interpreted?
  - As thresholds for macro-prudential policy?
  - If not, when should one react to a warning of the early warning indicator?
- Confidence intervals?

Systemic risk - which system?

- International perspective is crucial, but one should not forget the local one.
  - Policy tools are going to be used locally (I believe).
  - How should the global and local warning signals be weighted in the decision making?
  - Is it ok to analyze international and local systemic risk separately or should we try to combine them somehow?

Practical economist viewpoint

- Too complicated?
  - to replicate
  - to interpret
  - to convince the policy makers
- The proposed indicator and the private credit to GDP -ratio are both trying to detect the credit cycle and deviations from the fundamentals.
  - It has to outperform the private credit to GDP-ratio in accuracy, because it looses so much in simplicity.

Systemic risk at the moment

- The heat is certainly on, at least in Europe, right?
- Would your model detect it or are the elements of the systemic risk different this time?