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Central bank transparency and financial stability☆

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ABSTRACT

We develop a comprehensive index of the transparency of central banks regarding their policy framework to safeguard financial stability for 110 countries from 2000 to 2011 and examine the determinants and effects of this transparency. We find that the degree of transparency increased in the 2000s, though it still varied greatly across the countries in our study. Our regression results suggest that the central banks that have a transparent monetary policy are more likely to show increased transparency in their framework for financial stability. More developed countries exhibit greater transparency, past episodes of high financial instability have a negative effect on transparency and the legal origin matters, too. In line with theoretical literature, our results also suggest a non-linear effect of central bank financial stability transparency on financial stability. If transparency is too high, it is not beneficial for financial stability.

1. Introduction

Central banks around the world have increased the transparency of their monetary policies in the last two decades. Central banks nowadays provide very detailed information about various aspects of their policies. Based on the monetary policy transparency index for 110 countries from 1998 to 2010, Dincer and Eichengreen (2014) find that there is almost no occasion that causes central banks to decrease the degree of their monetary policy transparency. Nevertheless, many central banks are nowadays responsible not only for monetary policy but more and more frequently for safeguarding financial stability, too. While the transparency in the area of monetary policy has been extensively examined, we know much less about why central banks change their transparency in financial stability policies and what are the consequences of these changes. This is despite the fact that the communication on financial stability gained the importance dramatically during the crisis (Born et al., 2014).

In this paper, we construct a central banks' transparency index regarding their framework to safeguard financial stability for 110 countries from 2000 to 2011. We find that central banks have been continuously increasing their transparency in their financial stability frameworks. Reversals in the trend towards greater transparency have been extremely rare. The fact that many central banks have been continuously increasing their transparency does not invalidate the theoretical literature emphasizing the limits of transparency (see, among others, Morris and Shin, 2002; Angeletos and Pavan, 2007; Walsh, 2007; Cornand and Heinemann, 2008; Cukierman, 2009; van der Cruijsen et al., 2010; Dale et al., 2011) and the effects of increased transparency on welfare have to be evaluated also empirically (see Gerlach-Kristen, 2004; Meade and Stasavage, 2008; Crowe, 2010; Ehrmann et al., 2012 or Horváth et al., 2012). Unlike in the case of monetary policy transparency, it is important to comprehensively address the fact that the central banks are globally not the only institution responsible to safeguard financial stability and in some countries they are legally not obliged

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to safeguard financial stability at all. Therefore, our empirical analysis controls for these sample selection issues.

To contribute to this transparency literature, we examine what has caused central banks to increase the transparency of their frameworks to promote financial stability (for simplicity, we call this type of transparency financial stability transparency). Next, we address whether greater financial stability transparency is, in fact, beneficial. Although several studies have investigated the determinants and effects of monetary policy transparency (Dincer and Eichengreen, 2014, among others), this evidence is missing for financial stability transparency. Oosterloo et al. (2007) and Cihak et al. (2012) focus on one particular aspect of financial stability transparency, the publication of financial stability reports (FSRs). In addition, Cihak et al. (2012) provide a framework to evaluate the quality of financial stability reports, but the evidence of the effect of quality ratings offers only limited support that financial stability transparency is beneficial. In contrast to these studies, we develop a comprehensive financial stability transparency index that focuses not only on the coverage of financial stability reports but also on other communication channels, decision-making procedures and underlying legal aspects.

In addition, we focus on the effect of central bank transparency in a more complete manner. To our knowledge, previous literature examined only the effects of monetary policy transparency. We explore the interactions between the transparency in monetary policy and financial stability, as there are several plausible reasons why transparency in these two areas is likely to be related. Monetary policy transparency increased substantially during the last two decades, and this trend in monetary policy transparency preceded that of financial stability. The first central banks were assigned the role of safeguarding financial stability in the late 1990s or later. If the central bank makes a decision to communicate more openly about its monetary policy, this may create an impetus to increase transparency in other areas of central bank activities, such as in safeguarding financial stability. The underlying reason is the ambition of central banks to communicate consistently (Blinder et al., 2009).

Our results suggest that most central banks have continuously become more transparent in their communication on issues related to financial stability. In general, more developed countries, especially those with Nordic or German legal origin, tend to exhibit more transparent communications regarding financial stability.

The degree of financial stability transparency depends strongly on the previous experiences with transparent communications regarding the bank's monetary policy. This result survives a series of robustness checks such as addressing sample selection issues, different lag structure or different regression specifications. Our results hold even if we run the regresssions for the components of financial stability transparency index thus reducing substantially the potential concerns that the weighting of index components matter.

We also find that there is a non-linear effect of transparency on the degree of financial stability, which is in line with the theoretical literature emphasizing the optimal level of transparency. According to our results, too much transparency may be harmful. This result is likely to be a consequence of our sample, which includes the period of global financial crisis and more transparency about financial imbalances and accompanying risks in bad times may, in fact, escalate the crisis.

This paper is organized as follows. Section 2 discusses reasons why central banks publish financial stability reports, develops the financial stability transparency indices and presents the resulting indices. Section 3 presents the regression results on the determinants of financial stability transparency. Section 4 gives empirical evidence on whether greater financial stability transparency reduces the risks of financial instability. Section 5 concludes the paper. An appendix with additional regression results follows.

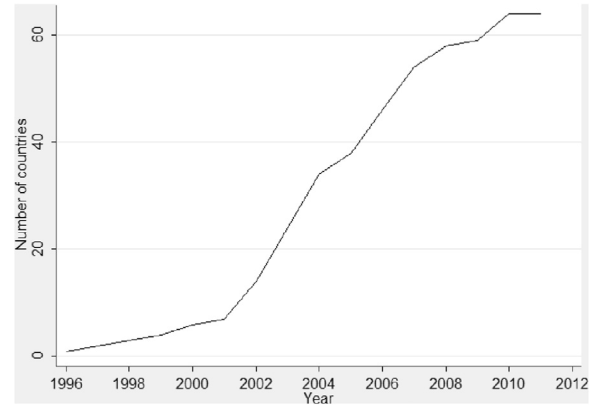

Fig. 1. The number of central banks publishing the financial stability report.

2. Central bank transparency index on financial stability

First, this section focuses on the financial stability reports published by central banks, as they are an integral part of financial stability communications and they strongly influence the degree of central bank transparency on financial stability issues. Second, this section provides the details on the construction of our financial stability transparency index. Third, the resulting indices are presented and discussed.

2.1. Financial stability reports: why publish them?

Many central banks around the world publish financial stability reports (FSRs) and use them as their main communication channel regarding their financial stability. The Bank of England, for example, characterizes the purpose of its FSR as a means to identify the major risks to the UK financial system and to thereby help financial firms, authorities and the wider public manage and prepare for these risks. The Swedish Riksbank states that "... *FSRs present the overall assessment of risks and threats to the financial system and an evaluation of the capacity for coping with them [...] By making the analysis available to financial market participants and other interested parties, we can share our viewpoints and contribute to the debate on this subject.*" Accordingly, Born et al. (2012) suggest that one important reason why FSRs are published is to effectively guide the markets and reduce noise.

The first countries to publish FSRs were the UK and the Scandinavian countries, specifically Sweden and Norway. In 1997, Sweden became the first country to publish a separate document about its financial stability, later called the FSR. Andersson. (2008) contends that the main reason countries began to publish their FSRs was related to the financial crisis of the early 1990s.

Fig. 1 presents the number of countries publishing their FSRs between 1996 and 2011. It further shows that the first FSRs appeared in the late 1990s. The publication of FSRs by central banks became more common in the 2000s, and currently, more than 60 countries publish an FSR, the vast majority of which are published by developed countries. Except Ireland, Greece and the USA, all central banks in OECD countries currently publish their FSRs. The unavailability of the FSRs from the USA is related to the institutional setting of financial sector supervision.[1] With respect to Ireland and

[1] The FED is not responsible for financial stability. This role is delegated to the Financial Stability Oversight Council (FSOC) operating under the Treasury. The FSOC