Financial Linkages and Financial Stability
(Introduction)

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The links between financial markets on the local and global level and the relative impact of the financial sector on the economy continue to pose new challenges to financial stability. The topic has gained a great deal of attention among both practitioners and academicians over the last decade. This dynamic process is certainly worth following, so we have decided to devote the first issue of the Czech Journal of Economics and Finance in 2013 to this issue, paying special attention to the problems of Central and Eastern European (CEE) economies.

There are two distinct areas under consideration. The first one concentrates on the links between financial markets, which may represent the main risk to markets and to correct pricing. We will see how markets are interconnected and how shocks are transmitted on both the local and international levels. The aim is to show to what extent local markets are insulated from external developments, whether there are any non-linearities, and whether asset prices still follow fundamentals. Special attention will be paid to a banking sector with different sources of inherent instability.

Central banks now fully acknowledge the importance of this issue. They have always based their monetary policies primarily on the concept of price stability, but they were well aware of the fact that there are important areas of potential imbalance beyond this narrow monetary policy concept. It was believed, however, that it is hard to kill too many birds with one stone, so central banks used the interest rate instrument to achieve a predetermined level of inflation as their primary objective.

This leads us to the challenging and controversial questions of whether the mandate of central banks should be wider and what kind of instruments central banks should use to comply with such a mandate. In fact, the mandate began to broaden even before the crisis. Central banks started to publish financial stability reports/reviews years ago—in several cases at the beginning of the last decade (for example, the Bundesbank in 2003, the Bank of Canada in 2002, and the Czech National Bank in 2004). To begin with, such reports might have been a secondary product, but they gradually became one of cornerstones of central bank activities. Specialized teams or departments were set up and the financial stability mandate was gradually incorporated into legal statutes in many countries. This happened in the Czech Republic in 2006, when financial stability was approved by lawmakers as one of the key mandates of the Czech National Bank.

This trend has also been reflected in the international financial architecture. The understanding that financial stability is an issue deserving maximum attention by the authorities began to crystallize at the end of the 1990s, when the Financial Stability Forum (FSF) was established. The FSF, which was primarily a consultative group, strengthened its role due to the financial crisis and ten years later became the Financial Stability Board with a much stronger mandate. The crisis also contributed to the decision to create a European institution responsible for financial stability—the European Systemic Risk Board.

This trend contains its own risks and is far from straightforward. Central banks were granted considerable independence, but this was linked to a much narrower mandate—the aforementioned price stability. Some experts are concerned that widening the mandate will jeopardize central banks' independence.[1] Still, the role of financial stability is well established now and the continuously growing literature will improve our understanding of it.

This issue of CJEF contains five articles analyzing several topical issues in the financial stability domain. In the first paper, the authors *Zlatuše Komárková, Jitka Lešanovská, and Luboš Komárek* study the relationship between credit default swaps and sovereign credit risk. This relationship became a controversial issue during the financial crisis, as many people argued that CDSs had ceased to have any link to fundamentals. The volatility of CDSs increased substantially during the crisis and it is important to understand the determinants of the short-term volatility and their distribution between fundamentals and temporary shocks. One of conclusions of the analysis is that it is the CDS market that can explain margins in sovereign debt in the Czech case.

The second article, authored by *Jan Babecký, Luboš Komárek, and Zlatuše Komárková*, looks at the relationship between financial stability and financial integration. Financial integration was driven by, and brought about, financial innovations; the authors conclude that this integration did not cause instability in the Czech financial sector. At the same time, we should always be careful about how much such conclusions are general or country-specific, as the authors rightly point to the fact that Czech financial institutions were robust before the crisis and limited themselves mainly to core banking business.

Further evidence on the impact of cross-border financial linkages on the Czech financial sector is provided by the third article, authored by *Tomáš Adam and Soňa Benecká*. It investigates the transmission of (systemic) financial stress from the euro area to the domestic market. Financial stress incorporates more signs of impaired market functioning, so it offers a broader picture than simple volatility spillover. There is substantial non-linearity in the transmission process and the response of the Czech financial system may differ based on the nature of the shock. The paper also reveals the complex structure of financial market linkages and the different sensitivity of individual markets to external market stress.

The fourth paper, written by *Sinem Derindere Koseoglu and Emrah Ismail Cevik*, examines the dynamic relationship between the stock market and the foreign exchange market in three CEE countries (the Czech Republic, Hungary, and Poland) and Turkey. It initially analyzes the existence of structural breaks in the variance of stock and foreign exchange rate returns series and follows this with causality-in-mean and causality-in-variance tests. The empirical results strongly indicate that the stock market Granger-causes the foreign exchange market in mean and variance in all countries. Based on these findings, the authors conclude that the stock market

[1] See, for example, the speech given by Jens Weidmann, the Bundesbank President:
http://www.bundesbank.de/Redaktion/EN/Reden/2013/2013_01_21_weidmann_boerse.html.

has an important role in the price discovery process for the foreign exchange market. This could lead to improvements in both the financial management of external trade-oriented companies and the portfolio management strategies of financial institutions.

The last paper, authored by *Zuzana Fungáčová and Petr Jakubík*, focuses on the assessment of banking sector resilience through stress testing. The authors argue in favor of such analyses even for emerging market economies, which suffer from limited data availability, short time series, and structural breaks. The application of the proposed stress test framework to the Russian banking sector reveals high sensitivity of the capital adequacy ratio to the business cycle. The analysis backs up the view that the Russian banking sector is under-sized for the size of the economy and that the private sector is likely to face difficulties in obtaining external financing when macroeconomic conditions deteriorate. The Russian banking sector remains dominated by state-controlled banks, which are less vulnerable to global financial problems than foreign-owned banks. In any case, the government has maintained sufficient fiscal space to recapitalize banks in a downturn.