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Evaluation of the Effect of Contagion Risk on the Macroeconomic Performance of Iran and Identifying Too-Connected-To-Fail (TCTF) Banks

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Abstract

The interbank market and the activity of banks in financial markets have led to the interconnectedness of banking system. In the normal situation, the interconnectedness will make the system more stable, but in a turbulent condition, the crisis will quickly spread to the entire banking network. In order to effective policy making in financial stability, continuous measurement and monitoring of the level of contagion in the banking network and studying the mechanism of its impact on macroeconomics is required. This paper evaluates the risk of contagion by using Dynamic causality statistics (DCI), and has identified the banks that have a systemic importance in terms of contagion or so-called too-connected-to-fail (TCTF). The relationship between GDP changes and the value added of the financial sector with changes in the DCI index of Iran's banking sector has been evaluated using Granger causality, which indicates a negative relationship up to 12-month time horizon. In order to take a timely measure for decreasing the adverse effects of systemic risks, Policy-makers should monitor DCI index continuously.

Keywords: Contagion, Dynamic Causality Index (DCI), Granger Causality, Too-connected-to-Fail (TCTF) banks.

JEL Classification: G01, G32, G28, E58.

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