



GLOBAL ECONOMICS UPDATE

Comparing the Fed’s new FCI to our own

- **The Fed’s new FCI does a better job of illustrating the tightness of US financial conditions than various other measures. But our own FCI has had a better record at capturing turning points in real activity in recent decades, is timelier, more versatile, and sits among a suite of comparable FCIs for major DMs.**
- As we pointed out when we published our FCIs earlier this year (see [here](#)), other popular measures have been understating the tightness of financial conditions in advanced economies for a while. Indeed, the oft-cited Bloomberg, Goldman Sachs, and Chicago Fed FCIs indicate that US financial conditions have been broadly in line with their average level since 1998, suggesting that they are not posing a headwind to real activity.
- **Last week, Fed staffers published a new FCI for the US called the ‘FCI-G’** (‘Financial Conditions Impulse on Growth’). Like our FCI, and unlike other measures, this new FCI suggests that financial conditions in the US are around the tightest they have been since the GFC (see Chart 1) and point to a fall in GDP. However, the Fed’s indicator has improved a bit in the past few months – suggesting that the headwind to GDP has receded – whereas ours has not. (The weaker dollar and AI-driven rally in US equity prices have been key in dragging down the Fed’s FCI, whereas these variables receive a smaller weight in our US FCI.)
- **While movements in the Fed’s FCI-G during the past couple of years have been closer to our FCI than most other popular US FCIs, there are a few key points of difference between the Fed’s and our own.**
- **For one thing, its track record as an early warning indicator in recent decades is not as good.** Admittedly, the stated aim of the FCI-G is not to be an early warning indicator of turning points in the business cycle, but to estimate the effect of past and current financial conditions on economic growth. However, given that FCIs are commonly interpreted in terms of what they say about the chances of recession or recovery, we think it is still worth reflecting on how the Fed’s FCI compares to our own in this regard.
- **Whereas our US FCI pre-empted the dotcom and GFC downturns and subsequent recoveries, the Fed’s index was slower to catch the turning points.** (See Chart 2.) In the early 2000s, conditions on the Fed’s measure carried on tightening even as interest rates were falling, and then loosened only once the economic recovery was well underway. As for the GFC, the Fed’s FCI – like Goldman’s – tightened only when the US economy was already halfway through the recession. And, unlike our FCI, the Fed’s index seemed to overstate the headwind to growth – and hence risk of recession – posed by financial conditions in 2015-16.

Chart 1: US Financial Conditions Indices (Z-Scores)

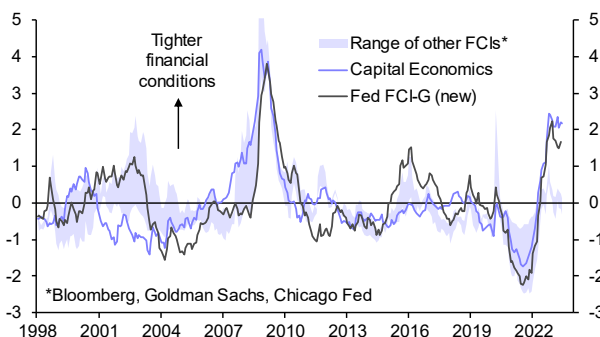
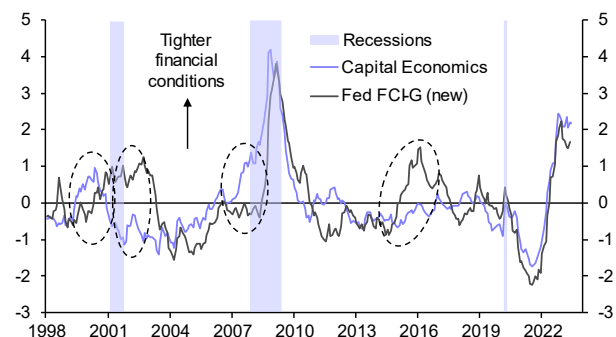


Chart 2: US Financial Conditions Indices (Z-Scores)



Sources: Refinitiv, Bloomberg, Federal Reserve, Capital Economics

- **Another point of difference is that the Fed’s index has a longer back history than ours because it includes far fewer variables.** There is always a trade-off to be made between back history and comprehensiveness. Our FCI has 29 variables but starts in 1998, whereas the Fed’s index includes seven variables but starts in 1979. On balance, we think it is more valuable to have an FCI that is driven by a broad range of factors. In



our eyes, this means favouring an FCI that includes shadow banking indicators, money market rates, and (especially in light of the SVB saga) bank loan officer and credit conditions surveys, rather than a longer back series. The track record of the past couple of decades seems to vindicate our approach.

- **From a practical point of view, the Fed’s index is less timely and versatile than our own.** The Fed staffers committed to updating the index for a given month in the middle of the next month, which means that the latest available observation at the time of writing is still May. In contrast, we produce flash estimates of our monthly FCIs for a given month in the middle of that same month, and update the estimate two weeks later.
- Also, while the Fed index is publicly available only on a monthly basis, we make the ‘narrow’ version of our FCIs available on a daily frequency. This allows us to monitor developments in financial conditions in response to shocks like the collapse of SVB. (See Chart 3.) And the fact that we use the same methodology to make a suite of FCIs for advanced economies means that we can add an international dimension to an analysis of financial conditions. For instance, it is clear that, outside Japan, financial conditions continue to pose a significant risk to growth. (See Chart 4.) Accordingly, we are forecasting recessions in the second half of this year throughout major advanced economies. (See our latest *Global Economic Outlook* for more.)
- **So, the upshot is that while the Fed’s new FCI is a step in the right direction in analysing financial conditions, clients will be better served by visiting our [Financial Conditions dashboard](#) for a holistic overview of financial conditions in advanced economies, where CE Advance clients can download the FCI data.**

Chart 3: CE Narrow US FCIs (Z-Scores)

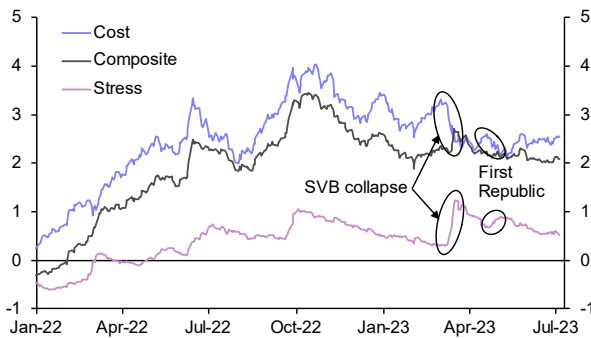
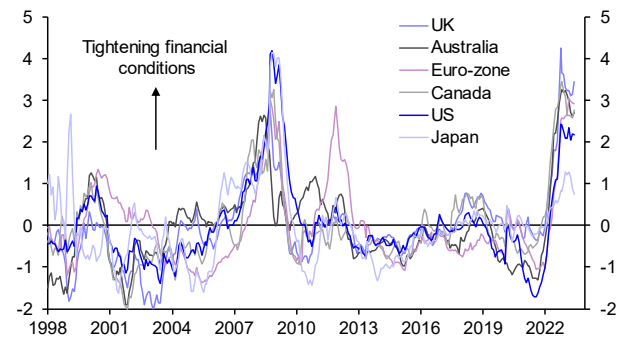


Chart 4: CE Broad Financial Conditions Indices (Z-Scores)



Sources: Refinitiv, Bloomberg, Federal Reserve, Capital Economics



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