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Financial Conditions Indexes: A Fresh Look after the Financial Crisis

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This paper explores the link between financial conditions and economic activity. We first review existing measures, including both single indicators and composite financial conditions indexes (FCIs). We then build a new FCI that features three key innovations. First, besides interest rates and asset prices, it includes a broad range of quantitative and survey-based indicators. Second, our use of unbalanced panel estimation techniques results in a longer time series (back to 1970) than available for other indexes. Third, we control for past GDP growth and inflation and thus focus on the predictive power of financial conditions for future economic activity. During most of the past two decades for which comparisons are possible, including the last five years, our FCI shows a tighter link with future economic activity than existing indexes, although some of this undoubtedly reflects the fact that we selected the variables partly based on our observation of the recent financial crisis. As of the end of 2009, our FCI showed financial conditions at somewhat worse-than-normal levels. The main reason is that various quantitative credit measures (especially issuance of asset backed securities) remained unusually weak for an economy that had resumed expanding. Thus, our analysis is consistent with an ongoing modest drag from financial conditions on economic growth in 2010.

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