St. Louis Fed

What Do Financial Conditions Indexes Tell Us?

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By James Bullard

The Federal Reserve's mission is to promote a healthy economy and financial stability. As such, the Fed closely tracks numerous economic and financial indicators.

Monitoring financial conditions is important for assessing the impact of monetary policy on financial markets and also for keeping an eye out for potential financial instability. But with so many financial market indicators, how can a person know which ones to focus on?

What Are Financial Conditions Indexes?

Measures of equity prices (also commonly referred to as stock prices), the strength of the U.S. dollar, market volatility, credit spreads, long-term interest rates and other variables are sometimes combined into an index to create an overall measure of financial conditions at any given point in time. Movements in such indexes are sometimes cited as reflecting the impact of changes in monetary policy on financial conditions, which, in turn, impact consumer spending decisions (e.g., for housing and durable goods) and firms' investment decisions.

Many different indexes of financial conditions exist. Popular ones include those from Bloomberg and Goldman Sachs. Some Federal Reserve banks—such as the St. Louis Fed, the Kansas City Fed and the Chicago Fed—have their own indexes. The various indexes generally include different components and/or put different weights on those components.[1]

Reflecting Financial Stress

Financial conditions indexes may also have specialized purposes. Some are designed to reflect the level of stress in financial markets, whereby a high value would be an indication of disruptions to financial markets or of financial crisis.

For instance, the St. Louis Fed Financial Stress Index is designed such that zero represents normal financial market conditions.[2] As seen in the FRED graph below, the STLFSI rose above 9 in October 2008 (in the midst of the 2007-09 financial crisis) and above 5 in March 2020 (during the early part of the COVID-19 pandemic). The STLFSI therefore did what it was supposed to do—indicate financial stress. Both of those periods were associated with sharp recessions as well.

Reflecting Tight or Loose Financial Conditions

Other indexes are designed to be more reflective of tight or loose financial conditions, and hence, a tight or loose stance of monetary policy.

Knowing whether financial conditions are tight or loose, which can impact the overall economy, is certainly important. While the broad overview that an index can provide is useful, looking at the individual components one by one instead of putting them together in a single measure could be just as instructive, if not more so. The value of the U.S. dollar and credit market spreads, for instance, are both well studied in the academic literature. It isn't clear that putting them together in an index is any more indicative of the thrust of monetary policy than studying how these individual variables are moving or are impacted by monetary policy.

Furthermore, some variables are better reflections of the stance of monetary policy than others, which may result in a composite measure that doesn't have the ideal mix. In particular, equity prices are known to be quite volatile and, at times, can move financial conditions indexes substantially. And yet, equity markets can reflect an overvaluation or undervaluation at a moment in time. Therefore, I find that channel less useful in trying to assess the impact of monetary policy.

Recent Return of Financial Stress

Over the last year, the Federal Open Market Committee (FOMC) has raised the target range for the federal funds rate by 4.75 percentage points—it now stands at 4.75% to 5%—in an effort to bring inflation back down toward the Fed's 2% target. The FOMC has provided considerable forward guidance about the future path of policy throughout this period. However, not all financial entities have adjusted their businesses appropriately to the changing interest rate environment.

While the STLFSI remained at a low value through early March, financial stress has been on the rise since then in the wake of recent bank failures and turmoil.[3] The macroprudential policy response to these events has been swift and appropriate. Regulatory authorities have used some of the tools that were developed or first utilized in response to the 2007-09 financial crisis in order to limit the damage to the macroeconomy, and they're ready to take additional action if necessary.

In my view, continued appropriate macroprudential policy can contain financial stress in the current environment, while appropriate monetary policy can continue to put downward pressure on inflation.

Notes

1. For more information on various indexes, see the September/October 2012 *Review* article "Disentangling Diverse Measures: A Survey of Financial Stress Indexes" by Kevin Kliesen, Michael Owyang and E. Katarina Vermann.
2. The STLFSI is currently on its fourth version. For details about the revisions, see the FRED Blog posted Nov. 10, 2022, "The St. Louis Fed's Financial Stress Index, Version 4," suggested by Cassandra Marks, Kevin Kliesen and Michael McCracken.
3. For more discussion, see my presentation on March 24, 2023, "Financial Stress and the Current Macroeconomic Outlook."

About the Author

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James Bullard is president and CEO of the Federal Reserve Bank of St. Louis. In this capacity, he oversees the activities of the Eighth Federal Reserve District and is a participant on the Federal Reserve's Federal Open Market Committee, or FOMC, which sets the direction of U.S. monetary policy. See more from President Bullard.