



Financial conditions indexes for the United States and euro area

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ARTICLE INFO

Article history:

Received 21 April 2011

Received in revised form

6 December 2011

Accepted 20 December 2011

Available online 3 January 2012

JEL classification:

E5

E17

E44

Keywords:

Financial conditions

Short-term forecasting

Real-time data

ABSTRACT

Financial conditions indexes are developed for the United States and euro area using a wide range of financial indicators and a dynamic factor model. The financial conditions indexes are shown to be useful for forecasting economic activity and have good revision properties. Variants of the indexes that allow for cross-economy effects reveal very strong financial linkages across the United States and euro area.

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1. Introduction

Financial conditions indexes (FCIs) have long been used to assess the current state of financial conditions. FCIs are typically constructed using either simple weighted averages or the first principal component of a range of financial indicators. This paper develops FCIs for the United States and the euro area using a wide range of financial indicators and a dynamic factor model (DFM).¹ A key advantage of this framework relative to other methodologies is that the FCIs can be estimated when values for some indicators are missing due to publication lags, which allows all available information to be used in a timely fashion. [Hatzius et al. \(2010\)](#) and [Brave and Butters \(2011\)](#) use similar methodologies to construct FCIs for the United States: [Hatzius et al. \(2010\)](#) estimate an FCI at the quarterly frequency, while [Brave and Butters \(2011\)](#) estimate an FCI at the weekly frequency. This paper differs from previous work because it presents results for the euro area, takes account of publication lags at the end of the sample in the forecasting experiments, examines the revision properties of the estimated FCIs, and examines cross-economy financial linkages.

In a real-time forecasting experiment, it is found that simple closed economy VARs augmented with the estimated FCIs produce better forecasting performance than a range of other model specifications. It is also found that the revision properties of the FCIs are generally good over the sample period considered. A

variant of the FCI that incorporates financial linkages reveals large strong financial linkages across the United States and euro area. The results suggest that the FCIs can not only provide useful summary measures of the state of financial conditions, but also useful information about the evolution of economic activity in real time.

2. Methodology

The DFM assumes that each standardized indicator of financial conditions, y_t , can be decomposed into a common component, χ_t , and an idiosyncratic component, ε_t . The common component captures the bulk of the covariation between y_t and the other indicators in the data set, whereas the idiosyncratic component is assumed mainly to affect only y_t :

$$y_t = \chi_t + \varepsilon_t, \quad \varepsilon_t \sim N(0, \psi) \quad (1)$$

where $\chi_t = \Lambda F_t$ and ψ is assumed to be diagonal. The common component is thus simply a scaled common factor, F_t , which is estimated using the entire set of financial indicators. For each economy, the FCI is defined to be this common factor.

The dynamics of the FCI are captured by an autoregressive process:

$$F_t = \sum_{i=1}^p \beta_i F_{t-i} + v_t, \quad v_t \sim N(0, \Sigma) \quad (2)$$

where the β s are coefficients and p is the lag length of the process. In this paper, the lag length, p , is selected using the

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¹ See, for example, [Giannone et al. \(2008\)](#) and [Matheson \(2010\)](#).

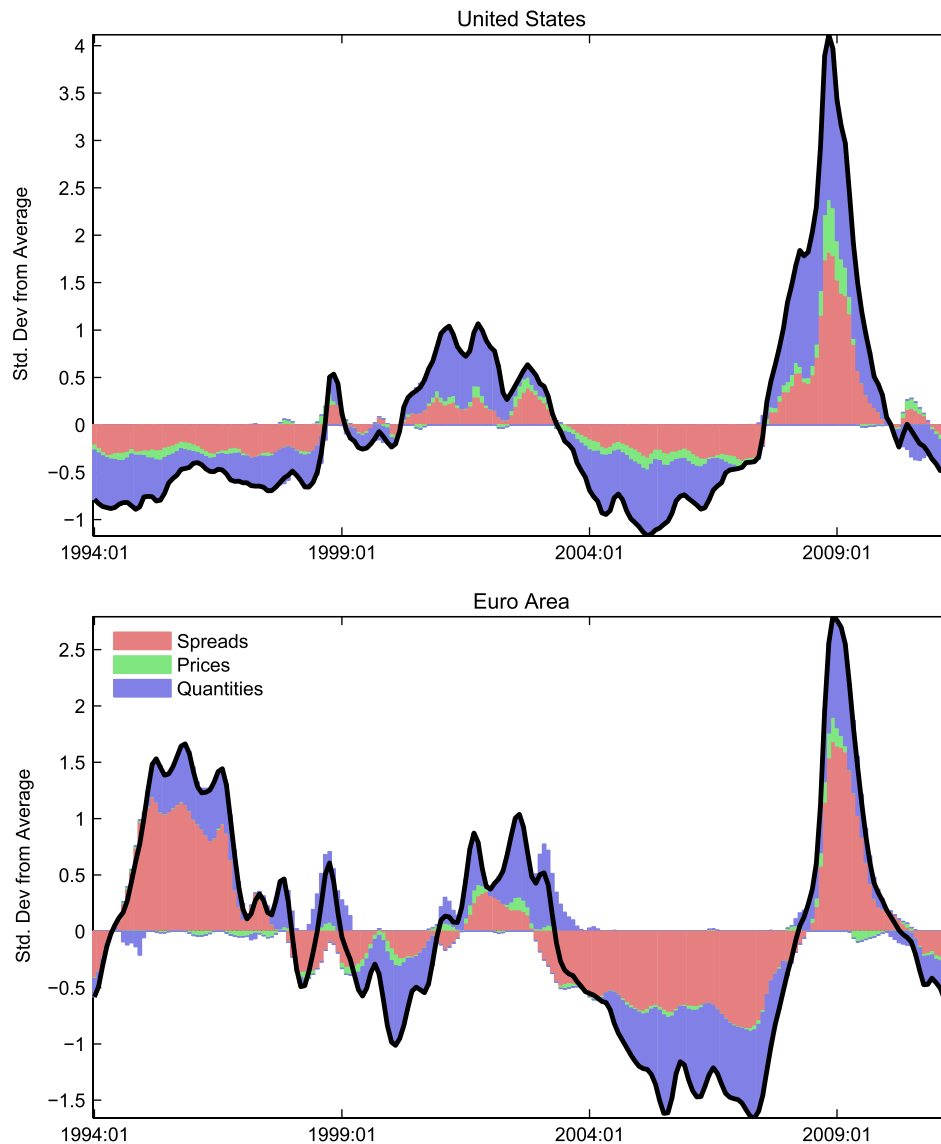


Fig. 1. FCIs and contributions by class of indicator (positive = tightening).

Swartz–Bayesian information criteria (SBC). See Giannone et al. (2008) for a more detailed description of how the procedure deals with missing observations, and Doz et al. (2011) for details on estimation.²

2.1. Allowing for financial linkages across economies

Given the high degree of financial integration across the United States and euro area, we also estimate FCIs that allow for financial linkages across the two economies. These FCIs, denoted FCI*, employ the same measurement equation as the baseline FCIs (1), but the dynamics of each economy's common factor is determined by a VAR in the common factors from *both* economies.

3. Data description and results

For each economy, selecting data from a broad set of financial indicators is a crucial step. Most series are measured at a monthly frequency, with the remainder measured at daily or

quarterly frequencies. Before estimation, all series are converted to monthly frequency, transformed to be free from non-stationarity, if necessary, and standardized.³ The remaining indicators are not transformed. The sample period for the FCIs used here begins in 1994. Indicators that are not available for the entire period, such as survey data for the euro area, are backdated using the DFM prior to estimation over the full sample.⁴

The indicators used in each economy's FCI and information about how the indicators are classified and transformed is listed in Table 1. The table also includes the estimated factor loadings, λ , which reflect the weight of each indicator in the FCI. Each loading can take a positive or negative value, depending on whether a high or low value of the indicator in question implies a tightening or an easing in financial conditions. The Senior Loan Officer Survey (SLOS) data (for which a positive number indicates a tightening of financial conditions) generally have high positive factor loadings.

³ The quarterly series are linearly interpolated, whereas the daily series are converted to monthly averages. Quarterly log differences are taken of the non-stationary indicators. Note, the in-sample results are very similar if the FCIs are estimated using quarterly data, but using monthly data offers more timely estimates of financial conditions at the end of the sample in real time.

⁴ The assumption that ψ is diagonal is relaxed when backdating these indicators.

² We employ a two-step estimation methodology. The results are very similar when quasi-maximum likelihood is used and are available from the author on request.

Table 1

Data description and forecasting performance.

| Indicators/forecasting models | Native freq | First obs. | Category | Transform | λ | RMSEs relative to AR | |
|--|-------------|------------|------------|-----------|-----------|----------------------|--------------|
| | | | | | | 2 Qtrs ahead | 4 Qtrs ahead |
| United States | | | | | | | |
| Baseline VAR | | | | | | 1.23 | 1.05 |
| Baseline VAR augmented with: | | | | | | | |
| FCI | | | | | | 0.84 | 0.79 |
| FCI* | | | | | | 0.89 | 0.88 |
| 10-Year treasury note yield at constant maturity | Daily | 1994M01 | Spreads | Level | −0.51 | 1.26 | 1.28 |
| Fed funds/3 month T-bill spread | Daily | 1994M01 | Spreads | Level | 0.33 | 1.23 | 1.19 |
| 2 Year govt bond/3 month T-bill spread | Daily | 1994M01 | Spreads | Level | −0.09 | 1.23 | 1.06 |
| 10 Year govt bond/3 month T-bill spread | Daily | 1994M01 | Spreads | Level | 0.24 | 1.35 | 1.35 |
| Baa/10yr T-note spread | Daily | 1994M01 | Spreads | Level | 0.90 | 1.26 | 1.33 |
| Auto finance company loan rate, New car/2yr govt bond spread | Monthly | 1994M01 | Spreads | Level | 0.17 | 1.25 | 1.22 |
| 30-yr Conventional mortgage/ 10yr govt bond spread | Monthly | 1994M01 | Spreads | Level | 0.69 | 1.23 | 1.26 |
| High yield corporate / baa spread | Monthly | 1997M01 | Spreads | Level | 0.88 | 1.28 | 1.31 |
| Jumbo mortgage/30yr conventional spread | Monthly | 2005M04 | Spreads | Level | 0.72 | 1.20 | 1.19 |
| 3-Month LIBOR/OIS spread | Daily | 2003M09 | Spreads | Level | 0.83 | 1.14 | 1.30 |
| Bank rate on new car loans, 48 months/2Yr govt bond spread | Monthly | 1994M01 | Spreads | Level | 0.17 | 1.25 | 1.22 |
| Credit spread corporate/financial sector (Citi) | Monthly | 1994M01 | Spreads | Level | 0.61 | 1.09 | 0.98 |
| TED spread | Daily | 1994M01 | Spreads | Level | 0.67 | 1.19 | 1.34 |
| 1 Month commercial paper/fed funds spread | Daily | 1994M01 | Spreads | Level | 0.51 | 1.17 | 1.35 |
| Real broad trade-weighted exchange value of the US\$ | Monthly | 1994M01 | Prices | Growth | 0.18 | 1.27 | 1.17 |
| Wilshire 5000 price index [full cap] | Daily | 1994M01 | Prices | Growth | −0.55 | 1.08 | 1.00 |
| PPI: crude petroleum domestic production | Monthly | 1994M01 | Prices | Growth | −0.32 | 1.24 | 1.15 |
| CoreLogic national house price index | Monthly | 1994M01 | Prices | Growth | −0.62 | 1.14 | 1.06 |
| Bank credit: all commercial banks | Monthly | 1994M01 | Quantities | Growth | −0.22 | 1.32 | 1.29 |
| Commercial paper outstanding: all issuers | Monthly | 1994M01 | Quantities | Growth | −0.60 | 1.31 | 1.22 |
| Value of commercial paper issues | Daily | 2001M01 | Quantities | Growth | −0.37 | 1.21 | 1.12 |
| Value of issuers of commercial paper: >80 days | Monthly | 2001M01 | Quantities | Growth | 0.00 | 1.30 | 1.22 |
| Money stock: MZM zero maturity | Monthly | 1994M01 | Quantities | Growth | 0.45 | 1.24 | 1.22 |
| Domestic nonfinancial sectors: liabs: credit mkt instruments | Quarterly | 1994M01 | Quantities | Growth | −0.28 | 1.24 | 1.23 |
| SLOS: banks tightening loans to large firms | Quarterly | 1994M01 | Quantities | Level | 0.89 | 0.99 | 0.91 |
| SLOS: banks tightening loans to small firms | Quarterly | 1994M01 | Quantities | Level | 0.92 | 0.96 | 0.93 |
| SLOS: banks willingness to lend to consumers | Quarterly | 1994M01 | Quantities | Level | −0.80 | 1.13 | 1.00 |
| SLOS: tightening standards for commercial real estate | Quarterly | 1994M01 | Quantities | Level | 0.91 | 1.06 | 1.02 |
| SLOS: res mortgages: net share, banks tightening | Quarterly | 1994M01 | Quantities | Level | 0.82 | 1.02 | 1.12 |
| CBOE market volatility index, VIX | Daily | 1994M01 | Prices | Level | 0.82 | 1.33 | 1.36 |
| AR (RMSE) | | | | | | 1.09 | 2.01 |
| Euro area | | | | | | | |
| Baseline VAR | | | | | | 1.07 | 1.02 |
| Baseline VAR augmented with: | | | | | | | |
| FCI | | | | | | 0.89 | 0.85 |
| FCI* | | | | | | 0.90 | 0.91 |
| 10-Year government benchmark bond yield | Monthly | 1994M01 | Spreads | Level | 0.46 | 1.20 | 1.08 |
| Overnight/3 month spread | Monthly | 1994M01 | Spreads | Level | −0.50 | 1.34 | 1.24 |
| 2 Year govt bond/overnight spread | Monthly | 1994M01 | Spreads | Level | 0.06 | 1.15 | 1.01 |
| 10 Year govt bond/overnight spread | Monthly | 1994M01 | Spreads | Level | 0.43 | 1.17 | 1.04 |
| Secondary market 10-year govt bond / 10yr govt bond spread | Monthly | 1994M01 | Spreads | Level | −0.31 | 1.62 | 2.53 |
| 3-Month LIBOR/OIS spread | Daily | 1999M01 | Spreads | Level | 0.68 | 1.25 | 1.20 |
| High yield bond/overnight spread | Monthly | 1997M12 | Spreads | Level | 0.91 | 1.05 | 0.90 |
| JP Morgan broad real effective exchange rate index | Monthly | 1994M01 | Prices | Growth | 0.05 | 1.17 | 1.02 |
| EURO STOXX 50 price index: based in euro | Daily | 1994M01 | Prices | Growth | −0.44 | 0.93 | 0.85 |
| European free market price: brent crude oil | Daily | 1994M01 | Prices | Growth | −0.27 | 1.00 | 0.90 |
| Money supply: credit to EA res | Monthly | 1997M09 | Quantities | Growth | −0.62 | 1.11 | 0.94 |
| Nonfinancial corporations: outstanding debt | Quarterly | 1999M01 | Quantities | Growth | −0.34 | 1.21 | 1.09 |
| MFIs ex ES: debt securities issued: euro share | Quarterly | 1997M07 | Quantities | Level | 0.41 | 0.99 | 0.88 |
| Money supply: M3 | Monthly | 1994M01 | Quantities | Growth | −0.42 | 1.07 | 0.91 |
| Euro area: market capitalization | Monthly | 2001M01 | Quantities | Growth | −0.57 | 0.94 | 0.86 |
| SLOS: chg in credit stds for bus lns to med/sm cos, past 3M | Quarterly | 2003M01 | Quantities | Level | 0.79 | 0.92 | 0.84 |
| SLOS: chg in credit stds for bus lns to large cos past 3M | Quarterly | 2003M01 | Quantities | Level | 0.72 | 0.93 | 0.84 |
| AR (RMSE) | | | | | | 1.19 | 2.14 |

Some of the indicators in the “spreads” category also have high factor loadings, such as the BAA/10-year government bond spread in the United States and the high-yield corporate/10-year government bond spread in the euro area. Negative loadings generally predominate in the “prices” categories, reflecting a tendency for prices to rise when financial conditions ease.

Fig. 1 shows the estimated FCIs, along with contributions from each class of indicator.⁵ Both FCIs show an easing in financial

conditions in the years preceding the global financial crisis. Just prior to the crisis, financial conditions began to tighten significantly in both the United States and the euro area, peaking around the beginning of 2009. According to the FCIs, financial conditions only began to ease around the beginning of 2010, despite extremely accommodative monetary policy settings in both the United States and the euro area.

4. Forecasting performance

To assess the usefulness of the FCIs, a baseline quarterly closed economy vector-autoregressive model (VAR), including the output

⁵ Note: the FCIs with cross-economy linkages are qualitatively very similar, and are available from the author on request.

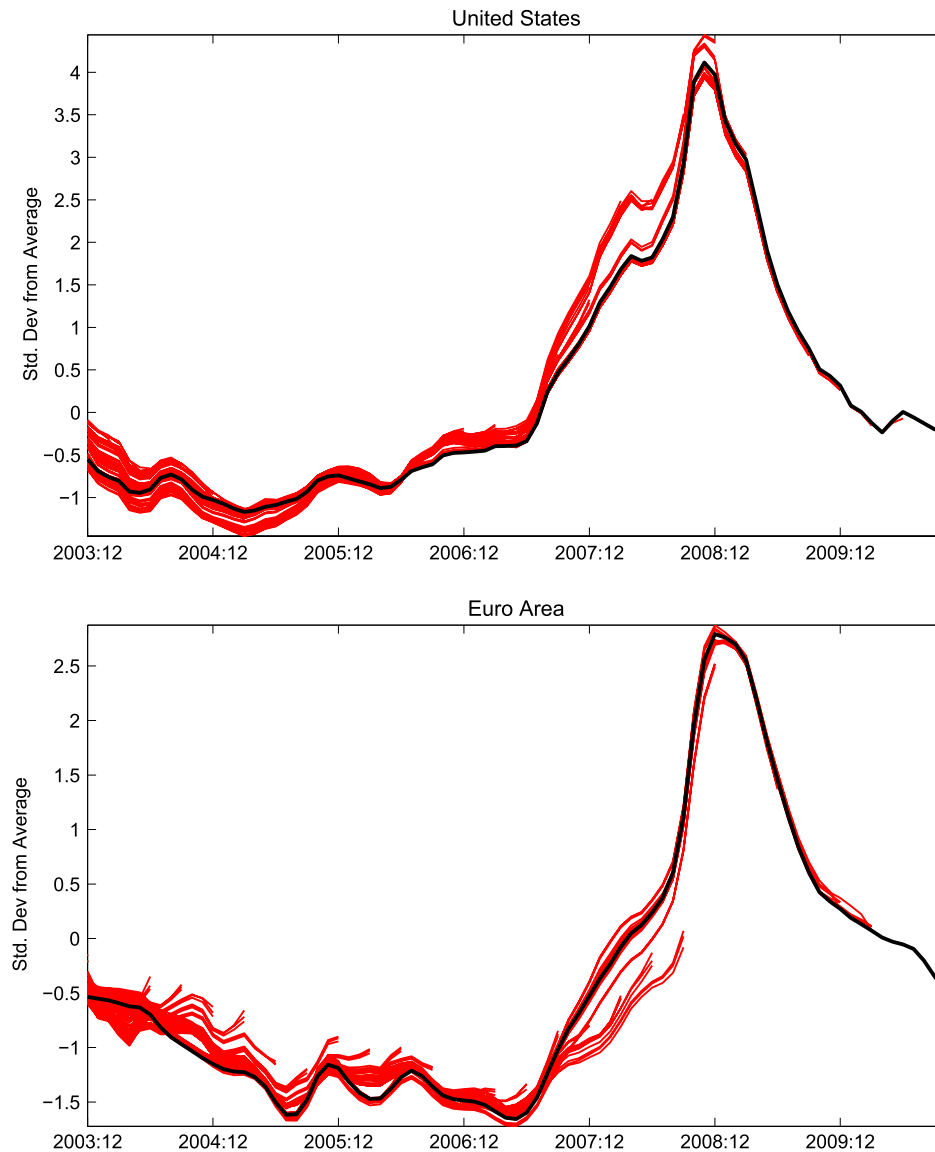


Fig. 2. FCIs in real time.

gap, headline inflation, and a real short-term interest rate is adopted.⁶

An out-of-sample forecast evaluation exercise is then conducted for the period from the first quarter of 2004. The VAR forecasts are constructed in two steps in each quarter of the out-of-sample period. First, the FCI is estimated using all data that would have been available at the beginning of the third month of each quarter.⁷ Second, the FCI is added to the baseline VAR specification and used to forecast all variables beyond the period in which the most recent GDP data would have been available in real time. Using the latest available estimates of the output gap as the target for the forecasts, root mean squared errors (RMSEs) are then computed for forecasts two- and four-quarters ahead.

⁶ The output gap and the real short-term interest rate are taken from a much larger, more sophisticated model—the Global Projection Model (GPM). See Carabenciov et al. (in press).

⁷ Due to a lack of available data, the data vintages that would have existed in real time are not used. Instead, the most recent vintage of data is used to simulate the data available each time a forecast is made. Real-time output gaps and short-term real interest rates are simply truncated from the most recent GPM estimates.

For comparison purposes, RMSEs are also computed for a variety of other forecasts: an autoregressive forecast (AR); a forecast from the baseline VAR, without the FCI; and forecasts from the baseline VAR augmented with each of the underlying indicators that were used to construct the FCI separately. In each quarter of the out-of-sample period, all models are re-estimated and all lag lengths are re-selected using the SBC. The RMSEs for each model relative to those of the AR are displayed in the right columns of the Table 1: a number less than 1 indicates the forecast is more accurate than the AR forecast.

The results are striking. For both the United States and the euro area, the forecasting performance of the VAR augmented with the FCI is good relative to the other models. The FCI forecast outperforms the AR and all other VAR forecasts for the United States. For the euro area, the FCI forecast is at least as accurate as almost all other models, with the VAR augmented with the indicators from the SLOS the only exceptions. Comparing the baseline FCIs with the FCIs that allow for cross-economy linkages (FCI*), we find a slight deterioration in forecasting performance when we allow for financial linkages. This suggests financial linkages might not be relevant for forecasting real activity, perhaps

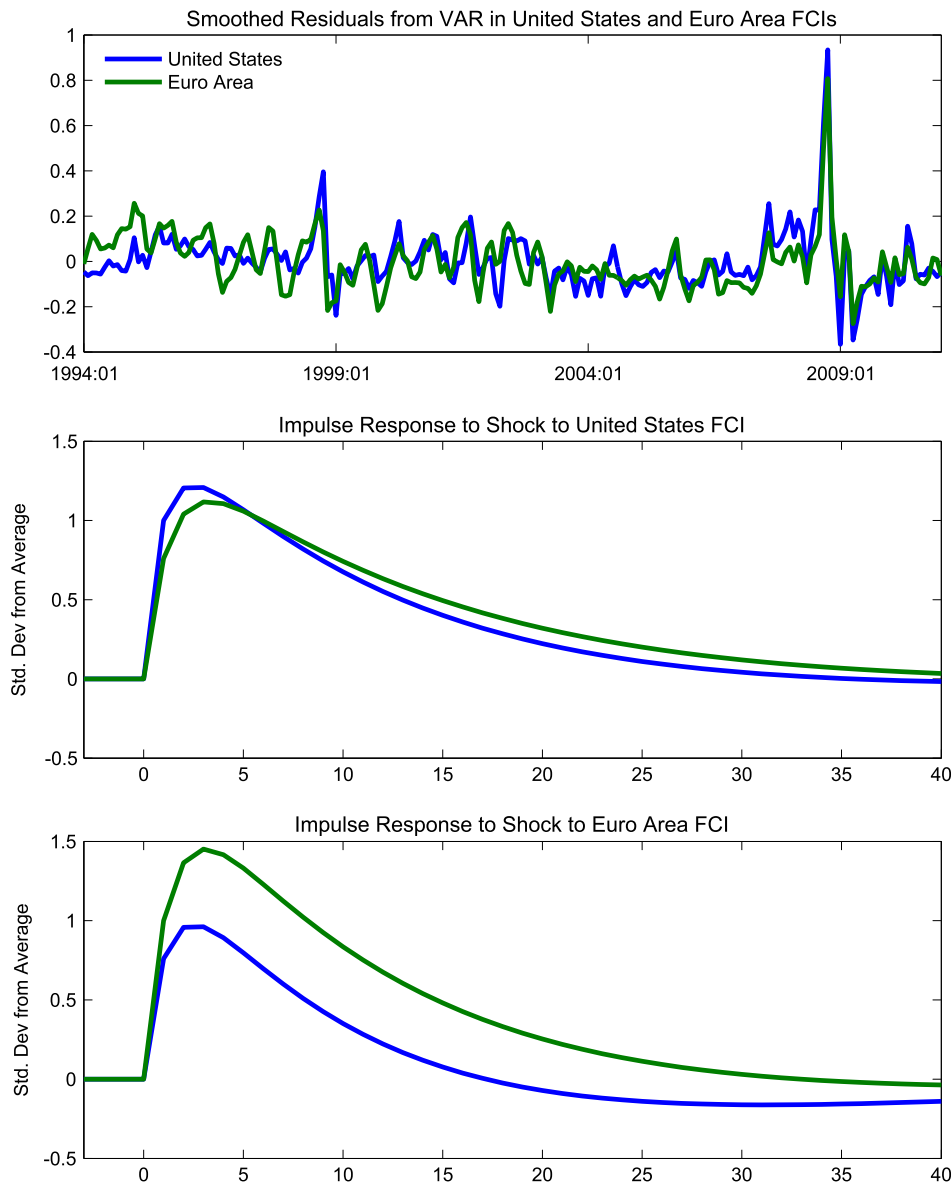


Fig. 3. Financial linkages.

because each economy's financial markets already adequately reflect external developments.

5. Real-time properties

Because the FCIs are estimated and can change with the arrival of more data, it is useful to gauge their revision properties over time. Fig. 2 displays estimates of the FCIs based on data available up to March 2011 (in black), along with the monthly estimates of the FCI made each month of the out-of-sample period (in red).⁸ The figure shows that revisions to the FCIs over time have generally been small relative to their overall variance. Moreover, over this sample, there are very few 'false signals', where an initial estimate of an easing or tightening in financial conditions is later revised away. The period around 2008 in the euro area is an exception, with the real-time estimates indicating an easing in financial conditions, which were later estimated to be a tightening in financial conditions.

⁸ In each month, the end point for the FCI estimate matches that of the GDP data that would have been available at the time.

6. Financial linkages

Fig. 3 shows some analysis of the FCIs that incorporate financial linkages, FCI*. The top panel of the figure shows the smoothed residuals from the VAR in the FCIs for each economy, and reveals a high degree of interconnectedness between the financial shocks hitting the United States and the euro area. This high degree of interconnectedness is further illustrated by impulse responses to these (cross-correlated) financial shocks. Interestingly, shocks to the United States FCI have very similar effects on the FCIs of both economies, while shocks to the euro area FCI have a smaller impact on the FCI of the United States, reflecting the dominance of the United States in global financial markets.

7. Conclusion

This paper developed FCIs for the United States and the euro area, estimated using a wide range of financial indicators and a dynamic factor model. In a real-time forecasting experiment, it was found that simple baseline closed economy VARs augmented with the estimated FCIs produced better forecasting performance

than a range of other model specifications. It was also found that the revision properties of the FCIs have generally been good over the sample period considered. Analysis of FCIs that incorporate financial linkages showed strong financial spillovers across the United States and euro area. The results suggest that FCIs can not only provide useful summary measures of the state of financial conditions, but also useful information about the evolution of economic activity in real time.

Acknowledgments

I thank Jorg Decressin, Vladimir Klyuev, Alasdair Scott, Krishna Srinivasan, Emil Stavrev, and an anonymous referee for useful comments on earlier drafts. All errors and omissions are entirely my own and the views expressed in this paper do not necessarily reflect those of the IMF.

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