US Daily: The Fed's New Financial Conditions Impulse Sends a Similar Message to Our Own (Abecasis)

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- Last week, Fed staff economists introduced a new indicator of financial conditions called the financial conditions impulse on growth (FCI-G). The Fed's FCI-G is constructed using similar inputs to our own financial conditions index (FCI), and both indices use component weights that are meant to capture the importance of each indicator to economic activity.
- The Fed's FCI-G is a measure of the impact of changes in financial conditions on GDP growth, so it is comparable to the GDP growth impulse from our FCI rather than to our FCI itself. On a like-to-like basis, the two indicators show broadly similar growth effects from financial conditions over time, and the growth drag implied by both indices is likely to fade meaningfully in the coming months.
- Nevertheless, there are three notable differences between the two frameworks. First, the Fed's FCI-G suggests that financial conditions affect growth with a longer lag than our FCI impulse by about one to two quarters, leading the Fed's measure to imply a roughly 0.5pp larger drag on GDP growth than our FCI impulse over the next year. Our review of economic studies of the lags with which financial conditions affect growth suggests that most estimates of the lag are closer to the lag implied by our model. Second, the FCI-G includes the Zillow monthly index of house prices and mortgage rates, which our FCI does not include. We choose to consider house prices and housing affordability separately from financial conditions in our consumption and investment forecasts, in part because house price indices are only released monthly and are subject to substantial revisions. Third, while the Fed's FCI-G implicitly assumes that financial conditions affect growth but not the other way around, our approach allows changes in market prices to affect growth and vice-versa.
- Although we estimate that the drag on GDP growth from financial conditions is fading sharply, we expect tighter bank lending standards—which are not included in either our FCI or the Fed's FCI-G—to impose an additional drag on growth in the coming quarters. Taken together, we expect tighter financial and credit conditions to exert a 0.9pp drag on 2023 Q4/Q4 GDP growth.

The Fed's New Financial Conditions Impulse Sends a Similar Message to Our Own

Last week, Fed staff economists introduced a new indicator of financial conditions called the Financial Conditions Impulse on Growth (FCI-G).[1] The Fed's FCI-G is constructed using similar inputs to our own financial conditions index (FCI). In contrast to other financial conditions indices, such as the Chicago Fed's National Financial Conditions Index or the St. Louis Fed Financial Stress Index, which are meant to capture financial market stress, both our FCI and the Fed's FCI-G use component weights that capture the importance of each financial indicator to economic activity (see Exhibit 1).

Exhibit 1: Like Our FCI, The Fed's New Indicator of Financial Conditions Captures the Importance of Financial Variables to Economic Activity

	Indicator		Weight	
	GS FCI	Fed FCI-G	GS FCI	Fed FCI-G*
Variable:				
Short-term interest rate	Federal funds rate	Federal funds rate	4.4%	13.6%
Long-term interest rates	10-year Treasury yield and BBB credit spread	10-year Treasury yield, 30-year mortgage rate, and BBB corporate rate	84.7%	63.7%
Equity prices**	S&P500 Shiller P/E ratio	Dow Jones total stock market index	4.8%	6.2%
Dollar	GS trade-weighted exchange rate index	Fed nominal broad dollar index	6.0%	11.2%
House prices**	--	Zillow home value index	--	5.3%

* Shows the relative importance implied by the sum of weights in the baseline three-year lookback window of the FCI-G.
** An increase in these indicators eases financial conditions in both our FCI and the Fed's FCI-G.

Source: Federal Reserve, Goldman Sachs Global Investment Research

The Fed's FCI-G is a measure of the impact of changes in financial conditions on GDP growth, so it is comparable to the GDP growth impulse from our FCI rather than to our FCI itself. On a like-to-like basis, the two indicators show broadly similar growth effects from financial conditions over time, and the growth drag implied by both indices is likely to fade meaningfully in the coming months (Exhibit 2).

[1] See Ajello, Andrea, Michele Cavallo, Giovanni Favara, William B. Peterman, John Schindler, and Nitish R. Sinha (2023). "A New Index to Measure U.S. Financial Conditions," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, June 30, 2023.

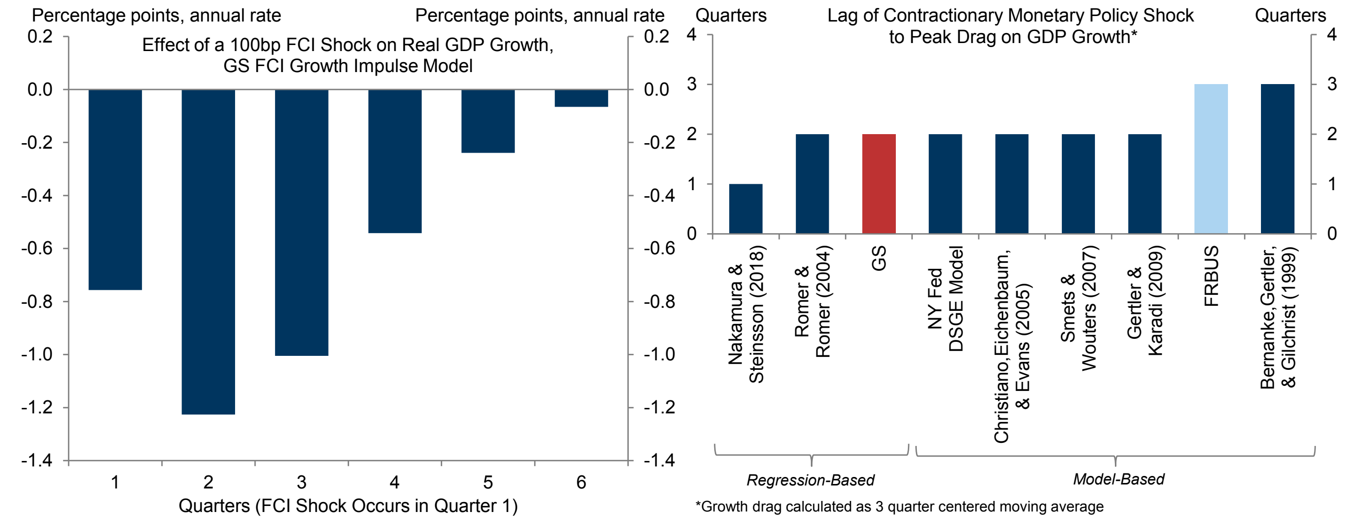
Exhibit 2: The Fed's New Financial Conditions Impulse to Growth Is Similar to Ours, Although It Suggests the Lags Between Financial Conditions and Growth Are One to Two Quarters Longer

Source: Federal Reserve, Goldman Sachs Global Investment Research

Nevertheless, there are three notable differences between our FCI and the Fed's.

First, the Fed's FCI suggests that financial conditions affect growth with a longer lag than our FCI impulse by about one to two quarters (see Exhibit 2 above), leading the Fed's measure to imply a roughly 0.5pp larger drag on GDP growth than our FCI impulse over the next year. Our extensive review of economic studies of the lags with which financial conditions affect growth suggests that they are closer to our own estimates than to the Fed's FRB/US model, which is the basis of the Fed's new FCI. In any case, as we noted last December, our model, the Fed's, and every prominent academic and central bank macro model suggest that the peak impact on GDP growth comes much earlier than the 1-2 year horizon assumed by some market commentators who worried that past rate hikes would cause a recession with a long lag.

Exhibit 3: Our Review of Economic Studies Suggests That Monetary Policy Lags Are Somewhat Closer to Our FCI Impulse Model Than to Those Implied by the Fed's FCI



Source: Federal Reserve, Goldman Sachs Global Investment Research

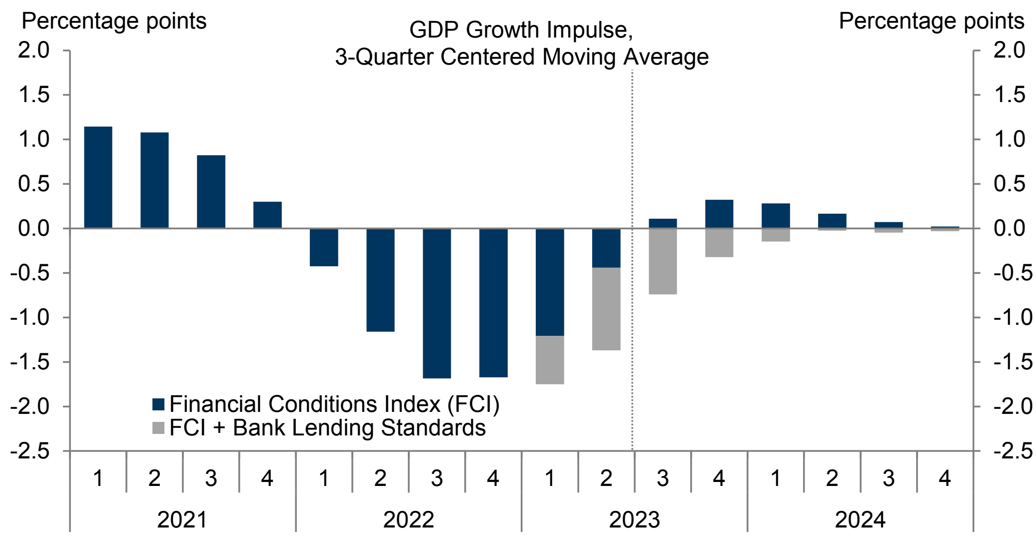
Second, the Fed's FCI includes mortgage rates and the Zillow monthly index of house prices, which our FCI does not include. We choose to consider house prices and housing affordability separately from financial conditions in our investment and consumption forecasts, in part because house price indices are only released monthly and are subject to substantial revisions. Using only daily indicators in our FCI allows us to produce a daily series without needing to make assumptions about house prices and avoids potentially large revisions to our index over time.

Third, while the Fed's FCI implicitly assumes that financial conditions affect growth but not the other way around, we take a more agnostic approach that allows changes in market prices to affect growth and vice-versa. Specifically, after estimating a vector autoregression (VAR) with GDP growth and changes in our FCI, we average the implied effect of financial conditions on GDP growth resulting from the two possible orderings in the VAR (GDP growth first and changes in our FCI first).[2]

Although we estimate that the drag on GDP growth from financial conditions is fading sharply, we expect tighter bank lending standards—which are not included in either our FCI or the Fed's—to impose an additional drag on growth in the coming quarters. Taken together, we expect tighter financial and credit conditions to exert a 0.9pp drag on 2023 Q4/Q4 GDP growth (Exhibit 4).

[2] While this is not a completely neutral approach because it imposes a functional form in averaging the two orderings, we consider it to be somewhat more neutral than assuming that financial conditions affect growth but not vice-versa.

Exhibit 4: We Estimate That Tighter Financial and Credit Conditions Are Likely to Subtract About 0.9pp From 2023 Q4/Q4 GDP Growth



Source: Goldman Sachs Global Investment Research

Manuel Abecasis

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