29/07/2015

NOTE FOR RECORD Copies to MA Div-1

By and

AN UPDATE ON FINANCIAL CONDITIONS INDICES

Main message*:* A financial conditions index based on a wide range of indicators suggests that financial conditions have loosened over the past year, and are now at their most stimulatory level since October 2007. By contrast, other indices that place greater weight on the appreciation in sterling have pointed to a tightening in conditions.

1 Financial conditions indices (FCIs) aim to summarise the state of financial conditions using information from a range of indicators. An FCI developed by MA suggests that UK financial conditions have loosened over the past year, consistent with the MPC's judgement in the July Minutes, and are now at their most stimulatory level since October 2007 (**Chart 1**).

2 This FCI is constructed by estimating the first principal component of a large set of relevant financial indicators since 2004 including interest rate spreads, money and credit growth, survey data and other asset prices. The index does not include the level of short-term interest rates, as it is designed to measure financial conditions once the level of the policy rate have been taken into account.

3 The fall in this index over the past year reflects changes in a broad range of factors, including the fall in gilt yields, the narrowing of secured and unsecured spreads on loans to households and the improvement in credit conditions implied by survey data (**Chart 2**). These falls more than offset other factors, such as the widening in high-yield corporate bond spreads.

Chart 1 - Financial Conditions Index and the Credit Spread Adjustment

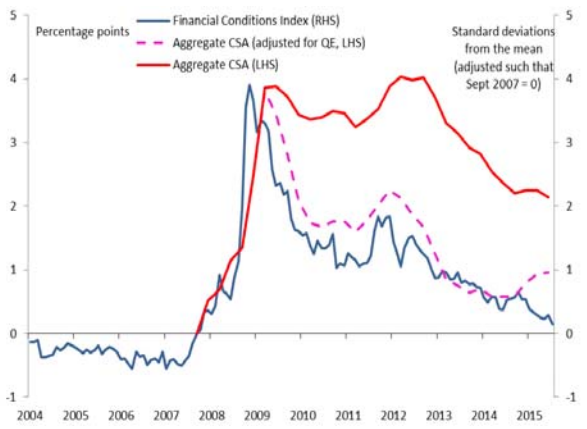
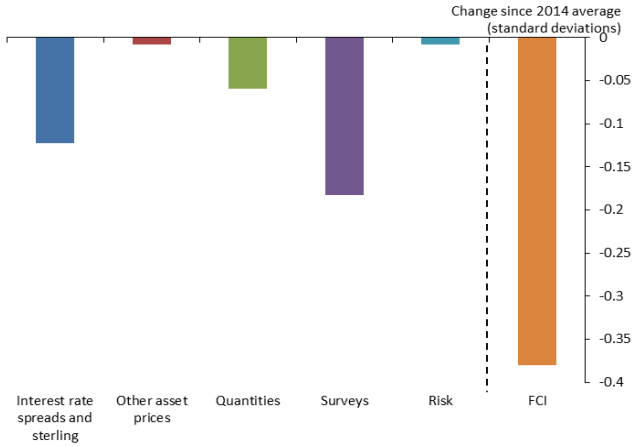


Chart 2 – Contributions to changes in the FCI since 2014 average



4 By contrast, some other FCIs – such as that constructed by Goldman Sachs[1] – have indicated a tightening in UK financial conditions over the past year. This predominantly reflects

[1] The Goldman Sachs FCI is a weighted average of changes in real short-term interest rates, corporate bond spreads, sterling ERI and equities with weights of 0.46, 0.34, 0.17 and 0.03 respectively. The weights are chosen using the coefficients from a regression of these variables on real GDP growth.

the large weight it places on movements in the exchange rate, in contrast to the very small estimated weight in the MA FCI. In addition, the Goldman Sachs measure takes little account of the indicators of wider credit conditions that are included in the MA FCI.[2]

5 The MA FCI can be thought of as a statistical-based estimate of the credit shock to the financial system. The FCI has fallen by more since 2008 than the Credit Spread Adjustment (CSA), MASD's measure of bank credit conditions (**Chart 1**). This suggests that general financial conditions may have loosened by more since the crisis than those in the banking sector.

6 This improvement in wider financial conditions, however, is not necessarily absent from the forecast. Part of this improvement is likely to be driven by the effect of QE. The dotted pink line in **Chart 1** tries to capture this effect on wider financial conditions by adjusting the CSA for the estimated impact of QE in the shadow Bank Rate. This series has been broadly aligned with the FCI, though less so recently, suggesting that the improvements in wider financial conditions picked up by the FCI may in general be captured in the forecast through both the CSA and the impact of QE.

Annex: variables included in the principal component analysis:

Interest rate spreads & FX
10-year gilt yield
3-month T-bill – Bank Rate spread
2-year gilt yield – T-bill spread
3-month Libor – 3-month T-bill spread
3-month Libor-OIS spread
Sterling IG corporate bond spread
Sterling high-yield corporate bond spread
75% LTV variable rate mortgage-Bank Rate spread
£10k personal loan rate-2-year swap rate spread
Sterling ERI

Other asset prices
FTSE 100
Financials market capitalisation
Composite UK house price indices
Sterling gold price
Sterling oil price

Quantities
Stock of bank lending (M4L)
Sterling commercial paper issuance
Sterling bond issuance
M0
M4ex
Government bonds outstanding
PNFC debt

Surveys
CBI survey – factors likely to limit output: credit/finance
CBI survey – factors likely to limit capital expenditure: external finance
CBI survey – factors likely to limit capital expenditure: cost of finance

Risk
VIX index

[2] The MA principal component FCI has also been shown to outperform an AR2 model augmented with the Goldman Sachs FCI in forecasting the monthly GDP series produced by NIESR.