

News Release

THE FEDERAL RESERVE BANK *of* KANSAS CITY

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FINANCIAL STRESS: WHAT IS IT, HOW CAN IT BE MEASURED, AND WHY DOES IT MATTER?

Significant financial stress in the United States has been a large factor in the current economic downturn, resulting in increased credit costs and making households, financial institutions and businesses more cautious. While the Federal Reserve has taken steps to boost liquidity, it will eventually need to unwind its lending and asset purchase programs and decide when to tighten monetary policy to ensure a return to stable growth with low inflation. In past recoveries, the decision on when to tighten policy was based mainly on the strength of private spending and the upward pressure on wages and prices. Another element in the current exit strategy will be determining if the level of financial stress would endanger economic recovery.

Craig Hakkio, special advisor on economic policy, and William Keeton, assistant vice president and economist, both of the Federal Reserve Bank of Kansas City, present a new index of financial stress. The index—called the Kansas City Financial Stress Index (KCFSI)—is detailed in the article, “Financial Stress; What Is It, How Can It Be Measured, and Why Does it Matter?” The article appears in the second quarter edition of the Bank’s *Economic Review*.

In the article, the authors explain the variables used to construct the KCFSI and show how high values of the index have coincided with known periods of financial stress. The authors also find that the KCFSI provides valuable information about future economic growth. These findings suggest that the KCFSI can be a useful tool in the Federal Reserve’s exit strategy for the current crisis and for tracking financial stress in the future.

The article is available on the Bank’s website at www.KansasCityFed.org.

