

Macro Signposts | Monetary Policy Through the Lens of Financial Conditions

PIMCO · Tiffany Wilding, jr scott · 2026-09-30 · English original

In recent months, major central banks have placed a greater emphasis on broader financial conditions when describing the stance of monetary policy.

Chairman Kevin Warsh characterized the Federal Reserve's September rate hike as "removing a dose of accommodation so that financial and credit conditions would be more consistent with [the Fed's] objectives." President Christine Lagarde framed the European Central Bank's decision in September around its "assessment of financial and monetary conditions." At the recent G20 summit, Bank of Japan Governor Kazuo Ueda explicitly linked the policy rate path to financial conditions, noting that the BOJ "hope[s] to continue raising interest rates as financial conditions remain accommodative." Finally, Governor Michele Bullock argued this week that the Reserve Bank of Australia "need[s] to make sure we have financial conditions tight enough to bring inflation down."

For investors, this shift in emphasis raises important questions: How are financial conditions measured? Are they supporting or restricting economic growth? And what does this mean for monetary policy going forward?

To briefly answer the last question first – equity market performance and its impact on wealth and spending has contributed to easier-than-ideal financial conditions. However, higher interest rates since June for U.S. Treasuries, mortgages, and corporate debt should help cool off what would otherwise be a stronger equity impulse to growth. More importantly, the tightening in financial conditions needed to bring inflation more quickly to target appears nowhere near the adjustment required in 2022.

According to these measures, financial conditions were around 50 basis points (bps) too easy at the end of 2Q, arguing that the Fed should shift policy to lean against the earlier easing. In reality, the required adjustment could occur through myriad combinations of asset price changes and over different time frames.

To illustrate the magnitude, the estimated realignment in financial conditions would be equivalent to a 70-bp increase in the 10-year Treasury yield (that passes through one-for-one to mortgage rates and corporate yields), a 9% decline in equities, a 4% increase in the broad trade-weighted U.S. dollar, or some combination of those and changes in the other components of FCI-G. Importantly, these figures are not forecasts, but rather illustrative equivalents.

As of this writing, the 10-year Treasury yield has risen by roughly 80 basis points since June, suggesting that the rates market is doing much of the work needed to cool the economy. Indeed, extending the FCI-G series with the latest market data, and assuming markets follow the paths priced into their respective futures curves, the rates market hypothetically has already more than closed the gap (see Figure 3).

More fundamentally, financial conditions respond to many forces that the Fed does not control. Investor risk tolerance can reset abruptly following a geopolitical shock, growth scare, or fiscal surprise. Currently, financial conditions are supported by optimism around AI and prospective productivity growth,

but that could change in the future. So, the policy rate needed today to recalibrate financial conditions may not be the same policy rate needed tomorrow. The fact that rates have done most of the tightening so far may give way to other asset classes sharing some of the burden in the future.

- Andrea Ajello, Michele Cavallo, Giovanni Favara, William B. Peterman, John W. Schindler IV, and Nitish R. Sinha. "A New Index to Measure U.S. Financial Conditions." FEDS Notes. Washington: Board of Governors of the Federal Reserve System (30 June 2023). The Federal Reserve page notes that the FCI-G materials were updated 21 September 2026. [Return to content](#)
- Ricardo J. Caballero, Tomás E. Caravello, and Alp Simsek. "FCI-star." NBER Working Paper No. 33952 (June 2025, revised January 2026). [Return to content](#)

Related Topics

- Economics
- Inflation
- United States

Source: <https://www.pimco.com/us/en/insights/monetary-policy-through-the-lens-of-financial-conditions>