

Words Matter: How Federal Reserve Communications Impact Financial Markets

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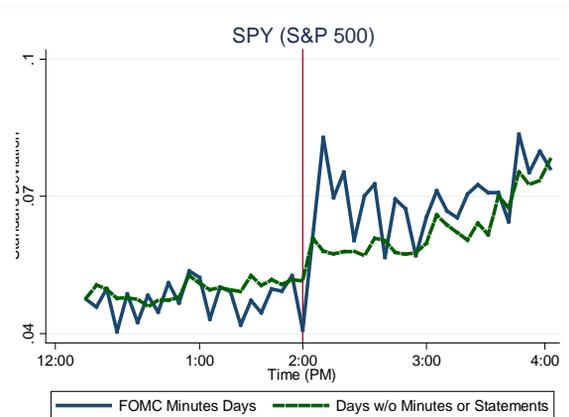
Since 2005, the Federal Open Market Committee (FOMC), the main Federal Reserve committee, has regularly released its minutes three weeks after its meetings. These minutes include the FOMC members' outlook on the economy. Raul assigns an index to the content of FOMC minutes in order to determine if the sentiments obtained from the information therein can be classified as hawkish (analogous to improving economic conditions and stronger inflationary pressures) or dovish (related to deteriorating economic outlook and subdued price changes). He compares sentiments expressed in the minutes to the sentiments in corresponding FOMC statements released immediately after the meetings. He then evaluates how news shocks from the minutes impact broad equity and real estate investment trust indices, as well as the exchange rate valuation of different world currencies against the U.S. Dollar. His findings indicate that financial assets respond to FOMC minutes based on the type of news shock they contain.

Raul's research investigates how sentiments expressed in Federal Reserve meeting documents are related to financial markets in the U.S. and around the world. The information contained in the Federal Reserve's meeting documents includes discussions about the Fed's superior economic information. Raul analyzes the content of meeting minutes to determine the level of economic optimism in those minutes. Analyses show that financial markets are significantly affected when FOMC meeting minutes are more optimistic than expected. In particular, equity markets in the United States, Japan, and a set of emerging economies rise when the content of meeting minutes exhibits high levels of optimism. These results hold when analyzing U.S. real estate investment indices. In addition, there is some evidence of appreciation of the U.S. dollar against other world currencies following surprisingly more optimistic minutes.

Key Findings:

- ◆ Sentiments in monetary policy documents reflect the economic outlook that was prevalent during each meeting
- ◆ When the Federal Reserve fully commits to a policy by specifying exactly when they plan to change it, and when the information is more optimistic than expected, the content of meeting minutes has positive and significant impacts on equity and real estate indices
- ◆ The U.S. dollar appreciates against several world currencies after meeting minutes that are more optimistic than expected are released

Standard Deviation of Asset Price: S&P 500



Implications for Policy

Detailed policy documents are important to financial markets, even if they are previously summarized as smaller documents. These detailed documents are taken as a source of additional information and clarifications regarding important economic information relevant to policy. Given that market participants closely follow and react to these documents, policymakers must be careful about how they tailor such releases. These seemingly supplementary materials have the potential to compliment or nullify enacted policies. Optimizing their construction will be ideal in properly implementing policy as well as in effectively guiding the public's expectations about such policies.

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