The Power of Words

BY CHARLES GERENA

"A Short History of FOMC Communication." Mark A. Wynne, Federal Reserve Bank of Dallas *Economic Letter*, vol. 8, no. 8, September 2013.

"Forward Guidance 101A: A Roadmap of the U.S. Experience." Silvio Contessi and Li Li, Federal Reserve Bank of St. Louis *Economic Synopses* No. 25, September 2013.

Decades ago, business reporters and financial market participants had to play detective to discern changes in monetary policy. They monitored the activities of the open market desk at the New York Fed, which buys or sells securities to reach the goals of the Federal Open Market Committee (FOMC). They even scrutinized the size of the briefcase that former Fed chair Alan Greenspan carried.

Today, Fed watchers can view the chair's quarterly press conferences and pore over increasingly detailed statements released after every meeting. Much has changed about how the Fed communicates the decisions that affect the nation's economic well-being. Two recent reports chronicle these changes, especially the issuance of "forward guidance," an indication of when the FOMC might change the direction of monetary policy.

"Best practices in central banking call for transparency in policy deliberations and communicating the outcome in a timely manner," notes Mark Wynne, associate director of research at the Dallas Fed and author of a September 2013 *Economic Letter*. "Over the past two decades, the FOMC has gone from being quite secretive in its deliberations to very transparent."

The FOMC's first major move towards greater transparency occurred on Feb. 4, 1994. To help explain why it was acting to push up interest rates for the first time in five years, the committee issued a 99-word statement after its meeting. A year later, the FOMC started announcing its intended range for the federal funds rate. It would take another four years, until 1999, before the committee would declare the target level for the funds rate. It also began releasing a statement after every meeting regardless of whether monetary policy had changed.

The year 1999 was significant for another reason — the FOMC started including forward guidance in its post-meeting statements. Since then, the committee had crafted this guidance to lay out a near-term course for monetary policy that was consistent with its past policy regime, but that allowed for course corrections if there was a change in the economic outlook.

Today, the FOMC uses forward guidance a bit differently, making a stronger commitment to a likely course of action. Until its March 2014 post-meeting statement, the committee had agreed to keep the federal funds rate low at least as long as the unemployment rate remained above 6.5 percent, inflation was projected to be no more than a half percentage point above the committee's 2 percent longer-run goal, and long-term inflation expectations continued to be well anchored.

According to Silvio Contessi and Li Li at the St. Louis Fed, such forward guidance may have been a useful tool at a time when interest rates are already close to zero. "A credible promise to continue accommodative monetary policy until a certain date or after the recovery strengthens (and the policy rule calls for higher policy rates) amounts to influencing expectations and long-term yields and providing additional monetary stimulus today," write Contessi and Li in the September 2013 edition of the *Economic Synopses* essay series.

"Are Households Saving Enough for a Secure Retirement?" LaVaughn Henry, Federal Reserve Bank of Cleveland *Economic Commentary* 2013-12, October 2013.

Figuring out whether you have enough retirement savings is a lot harder than checking under your mattress. Many variables affect this critical decision and standard economic models can account for only some of them, notes a recent commentary published by the Federal Reserve Bank of Cleveland.

According to the "life-cycle hypothesis" (LCH) model, all of us make rational choices about how much to spend or save based on what we expect to earn from our jobs and investments during different periods of our lives. The model assumes that we smooth out consumption over time, saving enough during our working years in order to maintain our level of spending many years into the future.

That assumption isn't true for every person, however. "While the LCH model may apply for many households, nearly half of households do not behave the way the model says they will," notes LaVaughn Henry, vice president and senior regional officer at the Cleveland Fed, in his October 2013 report. "Those households end up with inadequate savings for a retirement that maintains their standard of living."

A growing body of research in behavioral economics offers fresh insights into this issue. "Most households do not pay enough attention to financial planning," says Henry. "It may be because the decisions that need to be made are just too complex for the typical household. Many are aware of this and seek the advice of a financial planner [but] others may not be able to afford such advice." That is why automatic enrollment in savings plans or automatic escalation of investments in such plans can help people have a more financially secure future. **EF**