

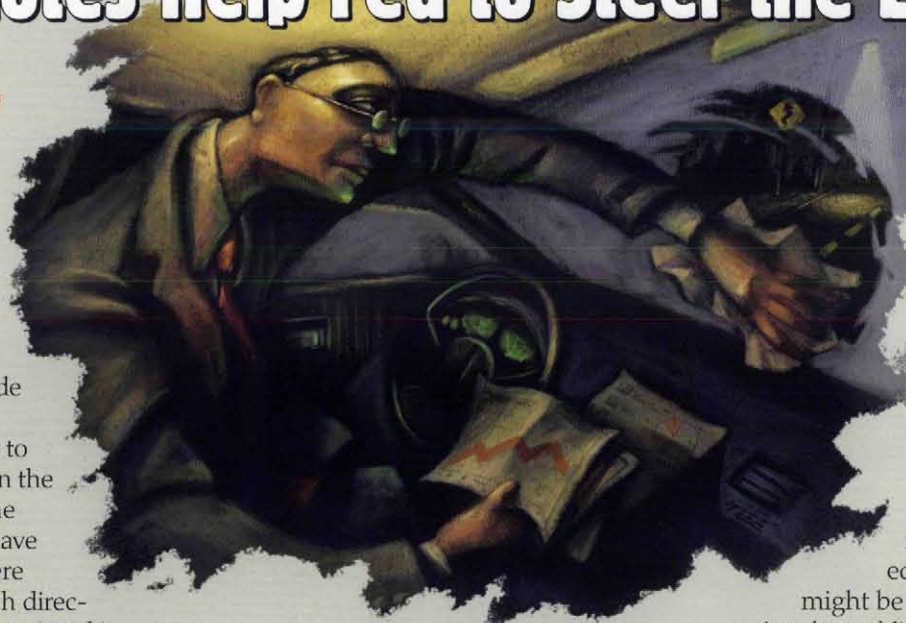
Anecdotes Help Fed to Steer the Economy

by William Poole
and Howard J. Wall

Making monetary policy has often been likened to driving a car with a blacked-out windshield and fogged-up side windows. Before deciding whether to shift gears, step on the gas or slam on the brakes, you first have to figure out where you are and which direction you might be pointed in.

The members of the Federal Reserve's Federal Open Market Committee (FOMC)—our monetary policy-makers—need to know as much as possible about current and future economic conditions before making their decisions. They get their basic picture of the economy from the formal data published by government statistical agencies. Unfortunately, the formal data tell little about business expectations and plans as to where we might be going and, because they trail current economic conditions, aren't even that good at telling us where we are. For example, the Fed has an incomplete picture of the economy's two most important indicators, growth and inflation. The Bureau of Economic Analysis releases formal estimates of gross domestic product (GDP) with lags of a month or more. Moreover, the data are subject to frequent and major revisions. Price indexes also are produced with a lag and are sensitive to factors that may be temporary—such as fluctuating energy prices—and to measurement error.

Of course, official growth and inflation data are not all that the Fed has to go on. Most financial data are very up-to-date, and futures markets allow us to peer into the future—or at least into markets' expectations of the future. However, futures trading covers only a relatively narrow range of goods. In addition, some real economic data, such as initial unemployment claims, auto and steel production, and electricity consumption, are available every week. Because these data are used to construct the official GDP estimates, they can provide partial pictures of current-quarter GDP.



Although the Fed relies heavily on formal data and sophisticated statistical methods for analyzing the data, its economists use anecdotal information that they gather from a network of contacts. This anecdotal information helps the Fed to see what is going on in the economy almost as it is happening. Also, because the information is collected from the people who are actually making day-to-day business decisions, the Fed gets help in understanding what fluctuations in the data may mean.

Collecting and Using Anecdotal Information

The Fed gathers its anecdotal information from a range of sources. Directors of the 12 Federal Reserve banks and their branches provide written economic reports of conditions in their regions. Reserve bank presidents and economists travel around their districts, meeting with business people and bankers to discuss conditions in their industries. Reserve banks maintain a network of industry executives who are contacted on a regular basis in advance of FOMC meetings. In addition, the eyes and ears of the Fed are always open, looking for emerging economic trends.

The vast amount of anecdotal information collected throughout the Federal Reserve System is used for a variety of purposes. Most systematically, it is used to produce the Summary of Commentary on Current Economic Conditions, commonly known as the *Beige Book*. This is published two weeks before every FOMC meeting.¹

The anecdotal information collected also makes its way into FOMC meetings, at which Fed governors and Reserve bank presidents present their views on the economic outlook. In addition to their use in assessing the state of the economy, the anecdotes

might be used to illustrate a point, thus adding impact to the comments. For example, a Reserve bank president could say, "The market for construction material in my District continues to be tight, and prices are rising." Or, he could say the same thing and add, "The situation is so tight that we have had reports of truckloads of drywall being hijacked." The addition of the anecdote (which happens to be an actual one from a Reserve bank president in 1999) adds more to the report than could several charts or tables.

Not all anecdotes have such an obvious impact. In the March 2001 *Beige Book*, for example, the Dallas Fed reported "robust Valentine's Day spending, including healthy sales of singing gorillas." Similarly, it is not clear how the Fed should have responded to the news reported by the St. Louis Fed in the January 2002 *Beige Book* that sales "of dry-cleaning services remain steady." The same goes for the report from the Minneapolis Fed in the July 2002 *Beige Book* that tourists "were recently evacuated from Deadwood, S.D., for two days due to forest fires; however, business recovered quickly."

Nonetheless, in addition to adding occasional oomph to the formal data, anecdotal information can be used to confirm or to help understand ongoing trends that arise from the formal data. For example, during the late 1990s, the unemployment rate fell well below what many people thought was the level at which inflation would start to take off. If the Fed had relied only on the formal data, it might have overlooked what firms and workers were doing to drive down the unemployment rate and how they were responding to tight labor markets. Contacts reported, for example, that

companies were willing to leave positions unfilled rather than bid aggressively for labor. A factory owner in Louisville told how he was able to expand employment and production even though most people in the pool of workers he would normally draw from—prime-aged men—were already employed. This challenge led him to rethink his production process to make it a better match for the workers who were available to him. The result was that, whenever possible, his production methods were changed to reduce the requirement for physical strength.

Contacts told similar stories about companies offering training in basic skills, making work schedules more flexible, providing transportation for their workers, and so forth, to cope with the rapidly changing nature of their workforce. Without this first-hand knowledge of businesses' ability to respond to competitive challenges and new environments, the Fed might not have known that unemployment could keep falling, at least for a time, without inflation being ignited.

The Fed's network of contacts is also useful to identify emerging trends. For example, long before the double-digit increases in health insurance premiums arose last year, the Fed knew they were coming. How? The Fed's contacts reported in mid-2000 about the health insurance contracts they were signing for 2001. Official data didn't pick up on these increases until after they had occurred. Another good example of anecdotal information came from a branch director who noted in the summer of 2000 that loan demand at his bank in Arkansas was falling and that other firms in his area were beginning to experience problems. This information was important because, at the time, current data suggested that the economy was growing rapidly and nearly all forecasts indicated that rapid growth would continue. Nevertheless, reports of this sort continued to surface throughout the rest of 2000 and into 2001, helping the Fed to get ahead of the recession by starting to lower its federal funds rate target early in 2001, even though official GDP data available at the time indicated that the economy was still going strong.

Dangers and Pitfalls

Because a number of dangers and pitfalls are inherent with anecdotal information, a great deal of care should be taken when using it. Despite the effort that the Fed puts into networking, the contacts are small in number from a statistical standpoint, and they are not selected randomly. They tend to be in businesses that are familiar to a director of a Fed bank who

has voluntarily agreed to serve as a contact; they also tend to be in a business whose manager or owner has been asked to serve on a Fed bank's advisory board.

Because of this selection process, numerous unintended biases can arise. For example, perhaps the type of person who would serve as a contact or be a member of an advisory board would also tend to be more successful than the average businessperson. If so, then the information that the Fed receives would tend to under-represent firms that are more likely to be experiencing difficulties.

Also, the responses might reflect the biases of the contacts rather than be accurate representations of conditions. This bias would not arise through any conscious misrepresentation, but perhaps through the tendency for successful business people to be more optimistic than the average person.

The biases of the economist collecting and analyzing the anecdotal information may also mean that it is not representative of general economic conditions. For example, the economist might tend to pay more attention to anecdotes that fit his or her previously held beliefs. As a consequence, the overall impression that is conveyed from the anecdotes in, for example, the *Beige Book*, might tend to reflect the economist's personal views. It might also be that the odd or quirky anecdotes are the ones that have the most influence because they are the most interesting, even though they might not be representative of general trends.

Summary and Conclusions

Because anecdotal information is inherently unscientific, the Fed relies heavily on formal methods when making monetary policy decisions. Nonetheless, because the formal methods provide a far-from-perfect picture of the economy, the Fed will continue to use anecdotal information to help fill the gaps. Anecdotal information helps policy-makers to understand where the economy is and where it might be going, most notably by providing information ahead of formal data. The process of gathering the information puts the Fed in direct contact with people actually making day-to-day economic decisions. The information forces the Fed to question the formal data and provides a view of the economy that formal methods simply miss.

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ENDNOTES

- ¹ The *Beige Book* is available on the web site maintained by the Board of Governors: www.federalreserve.gov.

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