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Using data and anecdotal evidence to understand the regional economy

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The Chicago Fed studies the ever-changing structure of the Midwest economy through long-term academic research, conferences, and gathering anecdotal evidence on regional economic activity for the Federal Reserve's periodic Beige Book publication, which provides a snapshot of all 12 Federal Reserve Districts. Recent changes in the format of the Chicago Fed's Beige Book contribution aim to increase its usefulness to policymakers and the public.

Taken together, economic statistics supplemented with anecdotal information provide policymakers with timely and relevant regional economic information.

The news media provide lots of news on the economy. However, for the most part, these sources focus on the national economy as a whole and seldom acknowledge that changes in the economy do not hit all regions of the country with the same magnitude, and there is significant value in understanding regional economic differences. This *Chicago Fed Letter* examines how researchers at the Chicago Fed track developments in the regional economy, why this information is useful, and how they plan to obtain and report better information in the future.

Why does regional economic information matter?

Tracking the Midwest economy is valuable in several respects, perhaps most importantly to help the Fed meet two of its primary objectives: promoting a healthy economy and maintaining a sound financial system. In addition, timely regional economic information is of value to the Chicago Fed's customers and stakeholders in the Seventh District.[1]

Good monetary policy is key to a healthy economy, and regional economic information is an essential part of the monetary policy process. Prior to every Federal Open Market Committee (FOMC) meeting, the 12 Fed district presidents are thoroughly briefed on the state of their respective regional economy. The bank presidents then report to the FOMC on current economic conditions in the districts, in addition to sharing their views on the national economy.

To be sure, monetary policy is a national policy and, as such, it does not aim to address problems in any particular region. Yet each bank president brings to these policy meetings a perspective of the national economy that is influenced by their own regional experiences. With the understanding of conditions in each region, policymakers can have a more enlightened monetary policy debate.

Tracking the Midwest economy is also critical to the Fed's goal of maintaining a sound financial system. Changes in overall economic activity or in particular industry segments can have profound effects on every aspect of banking, including loan demand, the availability and cost of deposits, fee income, earnings, profitability, and ultimately financial system stability. Current regional economic information is a useful tool that the Chicago Fed's Supervision and Regulation function uses to assess risk to the banking system. Moreover, banks with significant risk exposures can be

identified and Fed examiners can work with those banks to identify, measure, monitor, and control risks, helping them to head off problems before they arise.

Keeping abreast of current conditions and developments in the Seventh District economy is also part of our outreach efforts to provide valuable services to our customers and stakeholders. Business decisions can be significantly affected by regional economic conditions, and vice versa. Businesses, banks, state and local governments, and others who have a stake in the region can use our regional economic analysis in their own decision-making process.

Academic research and the long run

The first step in tracking any region's economy is to understand its long-term dynamics—its mainstay industries and the factors driving change in those industries. This step is crucial in determining what information is going to be relevant to our policymakers' and customers' decision-making.

One only has to drive on I-90, past the steel mills in Gary, IN, or along I-75, past the auto assembly plants in Flint and Detroit, MI, to realize that manufacturing is an important part of the District's economy. This is a double-edged sword: Manufacturing, especially durable goods, is highly cyclical. Generally, when the economy is doing well, income from manufacturing is high; when the economy turns sour, factory output and employees usually suffer more. This was apparent in the early 1980s when the double-dip recession hit the Midwest harder than the nation as a whole.

When the country slipped into recession again in the early 1990s, many feared the worst for the Midwest, but this time the downturn was shallower here than for the nation. Moreover, during the recovery from that recession, the District's unemployment rate fell faster and lower than the national rate.

Many observers correctly noted that this relatively strong performance reflected the fact that our economy had diversified into new industries—notably business services and wholesale trade—which reduced the region's vulnerability to economic cycles. Still, the Midwest economy had not diversified as much as the national economy, so diversification alone cannot explain its vitality relative to the nation.

To fully explore what had changed, the Chicago Fed hosted a series of conferences in the mid-1990s entitled, "Assessing the Midwest Economy: Looking Back for the Future." The research discussed at these conferences revealed that in addition to temporary factors, long-term factors like higher productivity through the implementation of advanced manufacturing techniques and the re-concentration of some of the Midwest's mainstay industries played an important role.[2]

Chicago Fed economists continue to study the ever-changing structure of the Midwest economy, as well as its potential to grow, through long-term academic research, and conferences that look at the region's work force and infrastructure needs.

Statistics and near-term trends

Determining which industries are important to the District's economy helps us evaluate which data may be more useful than others in assessing current conditions. We often begin by analyzing any number of the publicly available economic statistics. Of course, data can help us identify and monitor economic trends, and can be massaged in many ways (absolute values, growth rates, indexes, etc.) to get a different angle or perspective on those numbers. However, there are a plethora of problems with numbers, particularly regional statistics.

First, many official statistics available at the national level do not have corresponding regional estimates. Even when regional information is available, it often isn't strictly comparable across regions because of differences in methodology or regional boundaries. In part, this can be attributed to the difficulty in making regional estimates fairly accurate. Since most estimates are based on surveys, the more disaggregated the geography, the smaller the sample size, the larger the standard deviations, and the less reliable the estimates. The federal government is the primary source for many economic indicators, but in the mid-1990s, due to budget constraints, many statistical agencies lacked the resources to accurately estimate regional statistics and were forced to cut back, or eliminate, many data series.

Timeliness is another shortcoming of statistical information. By the time any number is released, to some extent, it is old news. The lag may be short, as is the case for initial claims for unemployment insurance where the wait is only one week, but it can be considerably longer, as in the case of the economic census where the lag can be as long as five years. In addition to varying lags, economic statistics are released on different dates for different periods.

Numbers are also subject to revision, sometimes to a substantial degree. What is reported initially as an increase may be revised to a decrease or vice versa, as more information becomes available. This was the case in early 2002, when hopes for a rebound in hiring activity were raised when the Bureau of Labor Statistics' national Employment Situation Report initially showed an increase in payroll employment; those hopes were dashed in subsequent months when the gains were revised away for the February to April 2002 data.

Finally, statistics don't tell us everything we need to know. Numbers only represent a snapshot of very specific economic variables at a certain point in time. Taken out of order, out of context, or both, numbers can end up making economic

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activity look like a Quentin Tarantino movie—where the end is at the beginning, the beginning is somewhere in the middle, and nothing really makes sense until well after it is relevant.

Anecdotal information

Due to shortcomings in economic statistics, at the Chicago Fed we seek to round out our regional economic analysis with anecdotal information. This information is gathered through our conversations with business and labor leaders, analysts, consultants, trade associations, state and local governments, and others who can help us get a better sense of the underlying strength or weakness in economic activity. Anecdotal information has both advantages and drawbacks.

It is valuable because it is very timely information. With numbers having at least some lag to them, conversations with our contacts give us a better of what has happened since the numbers were released—whether recent trends have continued or whether they have changed.

Another advantage is that the anecdotal information can be tailored to our District. We select contacts from companies that are headquartered or have a significant economic presence here. The value of talking to contacts that do all or most of their business here, a regional auto dealer for example, is fairly clear. Auto sales in the District give us a sense for the strength of consumer demand and how it may differ from other regions. Auto manufacturers, on the other hand, produce vehicles here, but sell in national and international markets. They can help us get a feel for how demand outside our region will affect auto industry production, employment, and income within it.

Finally, anecdotal information helps fill in the gaps that exist between the numbers. This is especially important when there is a change in trends. When the tides of economic fortunes shift, economists are often left guessing as to the causes. When the numbers don't tell us what we need to know about changes in business activity, our contacts help us avoid guessing the answers to questions about the economy. For example, why has investment slowed? What are businesses' plans for the future? Anecdotes help add texture and depth to our understanding of the dynamics underlying economic information.

The major drawbacks to anecdotal information are that it is highly subjective and can't be quantified. In addition, some observers question its accuracy and reliability. These are valid criticisms. To address these issues, we always cross-reference the information we gather from our contacts with the statistics and with other contact information, which helps us confirm or refute what we learn from the anecdotal evidence.

Some business services, such as temporary help, appear to be good leading indicators of changes in business activity.

Taken together, economic statistics supplemented with anecdotal information provide our policymakers with timely and relevant regional economic information, the breadth of which can be found nowhere else.

The Beige Book

The anecdotal information we collect is not only used to brief our policymakers. Much of it is available to our customers and stakeholders through the Fed's "Summary of Commentary on Current Economic Conditions by Federal Reserve District," more commonly known as the Beige Book.[3] The Beige Book is a compilation of the anecdotal information collected by all 12 District banks, with a national summary.

Each of the Federal Reserve banks is free to choose, within broad guidelines, what kind of anecdotal information to report and how to present it, based on the relevance to its own regional economy. For example, the New York Fed reports separately on its financial services industry, while the Dallas Fed reports on energy and natural resources.

At the Chicago Fed, we periodically review our anecdotal information gathering process to ensure that we are getting the appropriate coverage of industries important to our economy, as well as examining how we can best disseminate this information to the public.

After the latest such review, the Chicago Fed decided to change the way it reports this information in the Beige Book. As of January 2003, we report on seven categories of information, rather than the six categories we had reported on previously. Most of the categories remain the same: consumer spending, construction/real estate, manufacturing, banking/finance, and agriculture. But we have eliminated the labor markets section; and we have added two new breakout sections—business spending and employment costs/prices.

In the consumer spending, housing/construction, and to some extent in the banking/finance categories, we discuss economic activity in the District. For example, our contacts in consumer spending can help us assess the strength of consumer demand for goods (autos, appliances, apparel, etc.) and services (tourism, entertainment, etc.) in the Midwest, and how this compares with the rest of the nation. We can also gain a sense of consumer sentiment and

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retailers' expectations for sales in the District, as well as what factors may be affecting them. In addition, we can discuss information on retail inventories, promotional and discounting activity, and importantly, retail price pressures.

Our manufacturing, agricultural, and to some extent banking/finance industries produce much of their goods and services in the District, but sell them in national and international markets. Contacts in these industries can help us figure out how outside demand for our goods and services is affecting overall production, employment, and income in the region.

Business spending is one of our new categories. We wanted to break out this component because reports from our business contacts can give readers a better feel for business spending, hiring, and capital investment plans. Over the last two years there has been quite a divergence in consumer and business spending patterns. Household spending has widely been credited with keeping the economic recovery afloat, while business spending has been quite a drag. Some business services, such as temporary help services, appear to be good leading indicators of changes in business activity. Before businesses expand, they seek the advice of lawyers, accountants, and consultants to determine the viability of new and/or expanded operations. Often, prior to making the commitment to full-time permanent employees, firms will opt for temporary help to help them meet growing, albeit uncertain, demand. Once demand solidifies, businesses then consider adding to their payrolls on a more permanent basis.

The other new category, "employment costs/prices," should give the reader a better sense of the factors affecting, and the interaction of, prices and costs. We have consolidated the cost information in order to allow our readers to follow price pressures through the pipeline, from raw materials and labor costs all the way through to prices at the retail level. Over the last several years, overall prices at the retail level have been less volatile and lower than they were in the 1970s and 1980s, for example. But beneath the surface, circumstances are more complex. Costs and prices can be affected by any number of factors at every level. This new category takes information that was previously scattered under separate categories and organizes it in a more logical flow, allowing the reader to understand not only what is happening with costs, but also why.

While we eliminated the "labor markets" category, we still report the information previously contained in it. Layoffs or changes to companies' hiring plans in any particular industry will be noted in the respective categories. Conditions in staffing services will now be reported under the business spending banner, while employment costs will be addressed in the "employment costs/prices" section.

Conclusion

Overall, our new Beige Book format will give our customers a more insightful and straightforward way to look at the major sectors of the economy. Coupled with the new research we garner from our infrastructure conferences and supplemented with current economic statistics, our contribution to the Beige Book continues to give our policymakers and stakeholders an up-to-date and relevant understanding of the Midwest economy.

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[1] The Seventh Federal Reserve District comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

[2] For example, the auto and steel industries. For a more complete discussion, see "Assessing the Midwest Economy: Looking back for the future—A summary," by Klier et al. available at www.chicagofed.org/publications/fedletter/index.cfm#1996.

[3] Available on the Internet at www.federalreserve.gov/FOMC/BeigeBook/2002/.