FEDERAL RESERVE

How's Business?

BY RENEE COURTOIS

The role of the Beige Book in Fed policymaking

The Beige Book is a survey of economic conditions published by the Federal Reserve eight times each year. The survey consists of perspectives on economic conditions from business leaders throughout the country who together help build a picture about the health of the overall economy.

The Beige Book is often the most current source of information covering overall economic activity that members of the Federal Open Market Committee (FOMC) have access to when they convene to set monetary policy. Thus, how well this anecdotal survey actually reflects current conditions and near-term trends is potentially important.

At first blush, some are skeptical of the value of a resource that is almost purely anecdotal. Princeton University economist Alan Blinder, who served as vice chairman of the Federal Reserve Board from 1994 to 1996, once famously wrote, "There are two basic ways to obtain quantitative information about the economy: You can study econometric evidence, or you can ask your uncle." He thought there was too much uncle-asking going on in government and central banking, which he said risks letting one's prior beliefs "run rampant."

Despite the doubts of some, the Beige Book has existed as a resource for policymakers for nearly 40 years and has been available to the public for the majority of that. What informational value does it actually provide?

When Data Fall Short

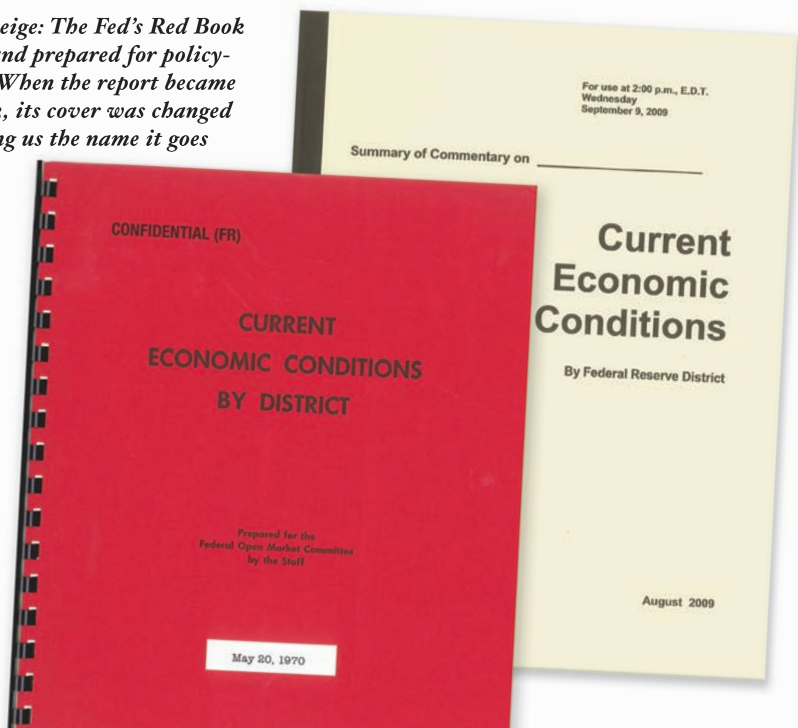
Before each FOMC meeting, the committee members are briefed extensively on aggregate economic conditions, regional developments, financial markets, and international economic conditions. In addition, much of the ongoing economic research conducted within the Federal Reserve System contributes to policymakers' and economists' general understanding of how the economy operates, which is critical for understanding how monetary policy may affect the economy. It is safe to say that policymakers arrive at FOMC meetings having done a lot of homework.

Still, monetary policy is often made under a considerable amount of uncertainty. Economists have an incomplete understanding of how monetary policy decisions work through the economy. And even if models of the economy are robust, the data on which they rely can be incomplete or unavailable at the time policy is made.

For example, data on gross domestic product — the broadest measure of aggregate economic activity and arguably the foremost gauge of the economy's health — are tracked by quarter. It takes a full month for the Bureau of Economic Analysis to gather enough of the thousands of data points that comprise the GDP number to release the first, "advance" estimate. Two revisions follow, with the "final" GDP number being published a full three months after a quarter has ended. And that's just one number — policymakers also care about a wide array of other data series, such as inflation and employment. Fortunately, some of these data arrive with greater frequency than GDP. Still, if an FOMC meeting falls at the end of an estimation cycle, the information policymakers have is somewhat old. That is when anecdotal data can be particularly helpful in filling in some gaps.

Former Richmond Fed President Al Broaddus says that if Fed staffers sample enough opinions, the Beige Book actually might provide a fairly reliable hint at the likely future course of the economy. "You have a huge number of people reporting. Each Beige Book includes comments from directors and all other contacts, well over 100 people per bank, times 12 regional banks — that's a very good sample."

Still, anecdotal reports must be taken with a grain of salt. "You're



From red to beige: The Fed's Red Book was private and prepared for policymakers only. When the report became public in 1983, its cover was changed to beige, giving us the name it goes by today.

talking in a very nonstatistical way with businesspeople, and any individual comment may or may not be representative of the national economy, which the Fed has to focus on," Broaddus says. "I used to read the Beige Book all the way through: every page, every report. But I'd discount some of the individual comments in favor of the overall summary," he says. "The summary has to be done well."

Beige Beginnings

The FOMC has long incorporated anecdotal information in monetary policy discussions. Those meetings include a roundtable of short commentary by each committee member of his views on monetary policy and the economy. Prior to the 1970s, this discussion included an overview of the economic conditions in each Fed region by each Bank president. In 1970, then-Fed Chairman Arthur Burns decided to make the FOMC meetings more efficient by collapsing the bulk of regional comments into a written report — then dubbed the Red Book after the color of its cover — to be distributed to FOMC members the week before the meeting.

At that time, the report of regional conditions was available only to FOMC members, but this changed in the early 1980s. Walter Fauntroy, a nonvoting delegate to Congress from the District of Columbia, made a request under the Freedom of Information Act to publicize the Green Book, the confidential Board staff forecast. Agreeing to publicize the Red Book instead was something of a compromise. Confidential details, such as the names of specific companies, were now excluded from the report, and the color of its cover was changed to beige to indicate its rebirth as a public document. This gave us the Beige Book as we know it today. It consists of 12 summaries of economic conditions — one covering each Federal Reserve district — and one national summary that research staff at each regional Fed author on a rotating basis.

Of course, gathering anecdotes on business conditions is benefited by having 12 regional Federal Reserve banks. The district Feds are each governed by a Board of Directors comprised of business leaders within their districts who share insights on regional economic developments with Fed presidents, including developments in major sectors represented in the region. The regional Feds study their regional economies and make direct contacts with business and industry leaders in their districts, a process made easier by proximity to those businesses. Exploiting that local information advantage was one reason the Fed's creators structured it to include 12 regional districts, and one reason Bank presidents have a seat at the FOMC policymaking table.

There is no set survey format or questions that each bank uses to conduct the survey. Most Feds reach out to contacts by phone and e-mail. The questions are usually qualitative in nature. Fed staff are more likely to ask, "Does business seem to be expanding or contracting?" rather than, "By what percentage have your inventories dropped this month?" This freedom helps each Fed design its questions around what best accommodates the size and industry composition of its district. For instance, you wouldn't likely discuss wage pressures with contacts in agriculture in the Kansas City Fed's district in the same manner as you would tech leaders in San Francisco's.

The appeal of the Beige Book is its breadth, depth, and timeliness. Even though it gathers broad impressions on the economy with almost no reliance on data, it can also provide more information than data alone, such as an explanation of a slowdown in hiring or a buildup of inventories.

This can be instrumental for the Fed staff who brief Bank presidents before policymaking sessions, says Rick Kaglic, a regional economist in the Charlotte branch of the Richmond Fed. "Anecdotal information is kind of a uniting factor between data points." When you're looking at indicators in isolation, it's like trying to figure out what water is by looking at individual hydrogen and oxygen molecules, he says. "Anecdotal information helps you step back and see the whole ocean."

But How Predictive Is It?

Does the Beige Book accurately anticipate economic trends? A 2002 paper by Nathan Balke and D'Ann Petersen, of Southern Methodist University and the Dallas Fed, respectively, is one of the seminal studies on this topic. The authors were interested in how well the Beige Book tracks national economic growth (leaving aside other important data series like inflation or financial market conditions, which the Beige Book also covers).

Balke and Petersen independently read the Beige Books spanning back to 1983, when they were first published, and assigned numeric values to the economic conditions described in the reports. "We tried to quantify these anecdotal reports by scoring them," Petersen explains. Evaluating the qualitative Beige Book in a quantitative manner is one of the major challenges in assessing its accuracy. For example, a statement that the economy was growing "very strongly" would receive a higher rating than one claiming "moderate" growth, while reports of economic contraction received negative scores. Then they created three Beige Book-generated measures of national economic conditions: the average scores of the 12 regional summaries, the average scores of the sectoral summaries included in the District reports, and the scores of the national summary itself.

The authors found that each of these measures tracked aggregate economic performance very well. "Just plotting those scores against GDP, you could see they were following it pretty closely. Then we ran some regressions and found it explained GDP well," Petersen says. The authors also found that the Beige Book was better at predicting next-quarter GDP than other measures available to policymakers at the time, such as the popular Blue Chip consensus forecast.

If the Beige Book is indeed predictive of real-time economic activity, then it has the potential to be especially useful when the data turn out to do something unexpected. "We may report stories that indicate that there's going to be new hiring, for example," says Rubén Hernández-Murillo, a St. Louis Fed economist, who helps create the original Beige Book reports for that district. "That would be an indication of a turn in the labor market, and this is before any of the hiring takes place. It will come out as good news in the Beige Book report, even though that may not be what's reflected in the employment series for that month."

This means anecdotal information can help signal to analysts a turn in the business cycle. Forecasting models have a hard time predicting business cycle turns because those cycles are, by definition, a deviation from trend. As a result, write Balke and Petersen, anecdotal information sources have the potential to do a better job predicting changes in the business cycle because they reflect activity that is happening now and come straight from active market participants, regardless of past trends.

When policymakers receive an indication that the economy may be approaching a turning point in the business cycle, they can begin to envision an appropriate change in policy. The target federal funds rate, the Fed's primary policy tool, may need to change if it appears the business cycle is turning. With that advance knowledge, the Fed can begin to communicate that likely change in the course of policy to the public in speeches and policy statements.

Recently, Fed officials have increasingly discussed the Fed's "exit strategy" for the various lending facilities it has established to address liquidity constraints stemming from the financial market turbulence that began in 2007. Forming better estimates of when the recession is approaching its trough will be critical as the Fed forms this strategy.

At the same time, though, the survey's subjective nature can be a hindrance for predicting business cycle turns. It is possible that the Beige Book could reflect speculation on the economy's health propagated in the news and in business circles rather than on actual recovery in economic fundamentals, Broaddus cautions. "It could give you false signals. The information contained in the Beige Book is early and broad-based, but at the same time there's this bandwagon effect that surrounds economic turning points that means it may not be right."

Also, while the timeliness of the Beige Book is helpful to the Fed in real-time policymaking, it's not clear whether it is the best available alternative to hard data. Even though it is a more timely resource than many data series, a group of Minneapolis Fed researchers found in a 1999 study that the Beige Book provides little information about current economic conditions that is not already captured in private sector forecasts. Private forecasters have a strong economic incentive to make their forecasts extremely accurate, Arthur Rolnick, David Runkle, and David Fettig write, so there's no reason to expect they don't also seek out unconventional information sources as well to improve their forecasts. Since those forecasts often outperform the Beige Book in predicting economic activity, the authors suggest Fed policymakers should look to private forecasts more frequently for real-time information on aggregate economic activity.

Still, the Minneapolis Fed authors write, "There are times when the most sophisticated economic models can't bring insight to a current economic phenomenon. In such an instance, asking your uncle may provide helpful insight." Anecdotes from business contacts, such as those collected in the Beige Book, show up repeatedly in the transcripts of FOMC meetings, revealing that policymakers clearly utilize that information for real-time guidance.

When it comes to understanding the economy, Petersen of the Dallas Fed says, a "more information is better" approach might be useful. "We would never advocate doing everything based on anecdotal data, but it is very helpful, especially in turning points when data can be lagged and are revised," she says. "As long as we view it as just another tool in addition to the other measures that are available, it's wonderful to have as much information as you can. The Beige Book is just another piece of information that policymakers can use, especially in times of uncertainty."

And the fact that the Beige Book provides a mechanism for collecting and reporting anecdotal information in a systematic way is especially important, says Broaddus. It carefully filters information that otherwise could come at policymakers from multiple directions, providing little guidance about which trends are broadly observed and which may be unique to just a few sources. "The Federal Reserve is always going to get anecdotal information from businesspeople, and that's a good thing because the Fed needs to not be isolated from the public," Broaddus says. "But if it influences policy in an unsystematic way, that could be a problem. One of the great benefits of the Beige Book is that it puts all the information in one place, synthesizes it, and churns out which way the wind is really blowing." **RF**

Readings

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