

When Is Sticky Information More Information?

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November 2011

Observations and Motivating Questions

- Data provided by statistical agencies lag current conditions
 - ▶ e.g. manufacturing data are released with a one-month lag ...
 - ▶ are revised up to 3 months after initial release, ...
 - ▶ and further subject to an annual revision

- Even if obtained in real time, monthly manufacturing data is “noisy”
⇒ underlying business cycle conditions are partially masked

- Qualitative surveys also used to track business cycles.
 - ▶ e.g. the ISM monthly diffusion index of manufacturing production,
 - ▶ similar indices produced by several Federal Reserve Banks at a more regional level

Observations and Motivating Questions

- Carrying out timely qualitative surveys is costly...
- Diffusion indices constructed from simple trichotomous classifications
 - ▶ answers are limited to “up,” “down,” “the same,”
 - ▶ number of respondents can vary over time, need not be the same across surveys
 - ▶ individual responses are aggregated into proportions of respondents reporting “increases,” “decreases,” “no change,”
 - ▶ these proportions are aggregated into time series
- Can diffusion indices teach us about informational rigidities?
- Why have qualitative answers, converted in the way suggested by diffusion indices, proven useful in tracking activity in real time

Overview for this paper

- Use output data on 124 manufacturing sectors to construct an empirical framework comprising “hypothetical” survey respondents
- Each Respondent acts as a spokesperson for a firm whose output reflects aggregate and sector-specific considerations
- Methods used to construct diffusion indices are applied to hypothetical respondents to create a synthetic diffusion index - can then be compared with actual production index published by ISM
- 2 key assumptions:
 - ▶ respondents have “sticky” information as in Mankiw and Reis (2002, 2006)
 - ▶ Not all changes in output are reported as “up” or “down” \implies latent indifference thresholds, Pesaran and Weale (2006)

Overview for this paper

- Survey respondents update their expectations on average every 8 months...
- ... compared to **12 months** in Carroll (2003), **12.5 months** in Mankiw, Reis and Wolfers (2003), between **4 and 6 months** in the firms of Mankiw and Reis (2006, 2009), around **6 to 7 months** in Coibion and Gorodnichenko (2009)
- Informational rigidities help explain the widespread use of diffusion indices
 - ▶ survey answers based on expected output rather than actual production
 - ▶ “noisy” fluctuations are filtered out
 - ▶ diffusion indices are degenerate in an RBC environment
- Information on overall manufacturing is sectorally concentrated - surveying 15 sectors may work as well as 124 sectors

Key Steps

- Methods used to construct the ISM and other diffusion indices
- Differences between the ISM index and the underlying sectoral manufacturing production data
- Empirical framework aimed at reconciling these differences
- Review of findings
- Key features of the economic environment that make the ISM “work.”
Can we suggest guidelines for the construction of diffusion indices?

Diffusion Indices: The ISM Manufacturing Production Index

- The Institute for Supply Management (ISM) is a large trade association (40,000 management professionals)
- It compiles a **monthly** Manufacturing Report on Business based on questions asked of executives
- Respondents are asked about output changes this month relative to last month
- Answers are limited to “up,” “down,” and “same”
- ISM index is calculated by adding percentage of positive responses to half of the percentage of “same” responses

Diffusion Indices: The ISM Manufacturing Production Index

- Consider the U.S. Census Bureau classification of Manufacturing into M distinct sectors
- output of a firm i working in sector j at date t (x_t^{ij}), and its growth rate, (Δx_t^{ij})
- N respondents in each of these M manufacturing sectors are asked whether, relative to the previous month, their firm's output...
 - ▶ is “up” (u_t^{ij}),
 - ▶ “the same” (s_t^{ij}), or
 - ▶ “down” (d_t^{ij})

Diffusion Indices: The ISM Manufacturing Production Index

- ISM surveying process may be described as cataloging respondents' perception of changes in their firm's output between $t - 1$ and t as:

if $\Delta x_t^{ij} > \tau$, i reports "up"; $u_t^{ij}(\tau) = 1$, $s_t^{ij}(\tau) = d_t^{ij}(\tau) = 0$,
 if $-\tau \leq \Delta x_t^{ij} \leq \tau$, i reports "same"; $s_t^{ij}(\tau) = 1$, $u_t^{ij}(\tau) = d_t^{ij}(\tau) = 0$,
 if $\Delta x_t^{ij} < -\tau$, i reports "down"; $d_t^{ij}(\tau) = 1$, $u_t^{ij}(\tau) = s_t^{ij}(\tau) = 0$.

- Interval $[-\tau, \tau]$ defines an indifference region that represents respondents' latent perceptions of rises and falls in output.
 - Dependence made explicit: $u_t^{ij}(\tau)$, $s_t^{ij}(\tau)$, and $d_t^{ij}(\tau)$

Diffusion Indices: The ISM Manufacturing Production Index

- Fraction of “optimists”:

$$U_t = M^{-1}N^{-1} \sum_{j=1}^M \sum_{i=1}^N u_t^{ij}(\tau).$$

- Fraction of “pessimists”:

$$D_t = M^{-1}N^{-1} \sum_{j=1}^M \sum_{i=1}^N d_t^{ij}(\tau),$$

- Fraction of “same” respondents:

$$S_t = M^{-1}N^{-1} \sum_{j=1}^M \sum_{i=1}^N s_t^{ij}(\tau)$$

Diffusion Indices: The ISM Manufacturing Production Index

- The ISM diffusion index at t is:

$$\begin{aligned} \mathcal{I}_t &= \left(U_t + \frac{1}{2} S_t \right) \times 100 \\ &= M^{-1} N^{-1} \sum_{j=1}^M \sum_{i=1}^N \left(u_t^{ij}(\tau) + \frac{1}{2} s_t^{ij}(\tau) \right) \times 100. \end{aligned}$$

index values range between 0 to 100, above 50 interpreted as an expansion of economic activity

- The corresponding “balance statistic” is:

$$\begin{aligned} \mathcal{I}_t &= (U_t - D_t) \times 100 \\ &= M^{-1} N^{-1} \sum_{j=1}^M \sum_{i=1}^N \left(u_t^{ij}(\tau) - d_t^{ij}(\tau) \right) \times 100, \end{aligned}$$

balance statistics range between -100 and 100, above 0 interpreted as an expansion of economic activity

Properties of Sectoral Data and the ISM index

- Monthly data on manufacturing production, 1972-2009, 124 NAICS sectors
- Growth rate of aggregate manufacturing output is:

$$\Delta x_t = \sum_{j=1}^M w_t^j \Delta x_t^j,$$

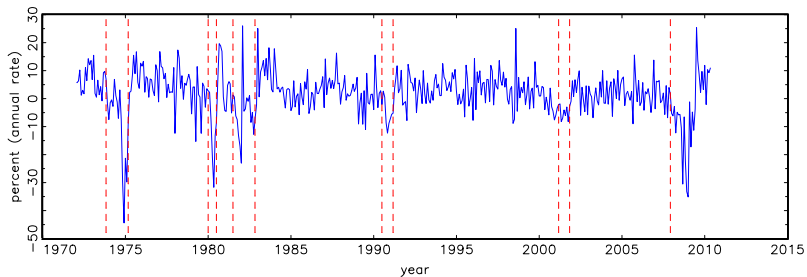
- where

$$\Delta x_t^j = \sum_i w_t^{ij} \Delta x_t^{ij},$$

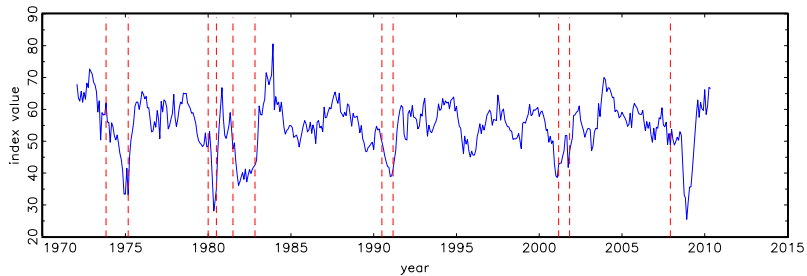
- Sectoral weighting scheme relatively unimportant, Foerster, Sarte, Watson (2010)

$$\Delta x_t \approx M^{-1} \sum_{j=1}^M \Delta x_t^j = M^{-1} \sum_{j=1}^M \sum_i w_t^{ij} \Delta x_t^{ij}$$

A. Aggregate Manufacturing Output Growth



B. ISM Manufacturing Production Index



The Spectral Representation Theorem



$$\Delta x_t = \mu + \int_0^\pi \alpha(\omega) \cos(\omega t) d\omega + \int_0^\pi \delta(\omega) \sin(\omega t) d\omega,$$

where ω denotes a particular frequency and the weights $\alpha(\omega)$ and $\delta(\omega)$ are random variables with zero means.

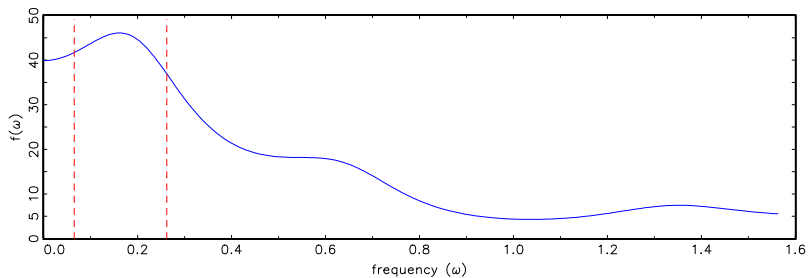


$$\text{var}(\Delta x_t) = 2 \int_0^\pi f(\omega) d\omega,$$

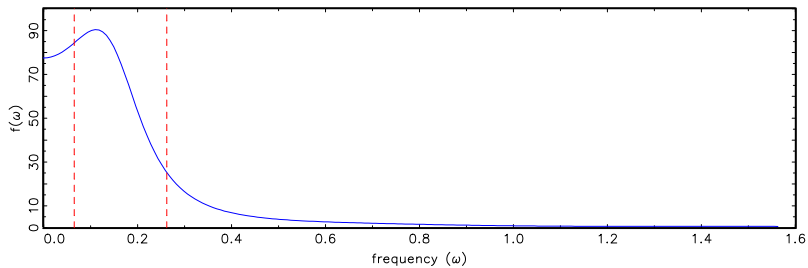
where the power spectrum, $f(\omega)$, gives the extent of frequency ω 's contribution to the total variance of the series. Each frequency, ω , is in turn associated with cycles of period $p = 2\pi/\omega$.

- Business cycle frequencies are defined as those associated with cycles of periods ranging from 24 to 96 months.

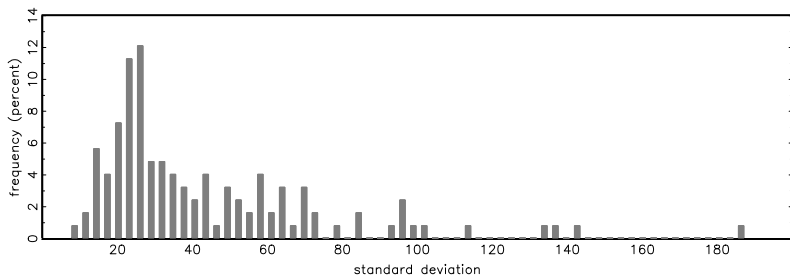
A. Spectrum of Manufacturing Output Growth



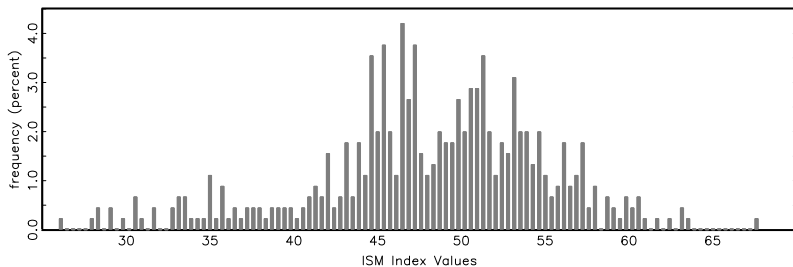
B. Spectrum of ISM Diffusion Index



A. Distribution of Standard Deviations of Sectoral Growth Rates



B. Distribution of ISM Diffusion Index values



Volatility of Output Growth and ISM Index

		<u>1972-2009</u>	
	Std. Dev.	Fraction of Variance in Business Cycles $2 \text{ years} \leq p \leq 8 \text{ years}$	Fraction of Variance at High Frequencies $p < 2 \text{ years}$
Output Growth	8.35	23.90	68.57
Diffusion Index	7.85	54.15	30.03

Autocorrelation and Cross-correlation Structure of Output Growth and the ISM index

		<i>Autocorrelations (1972-2009)</i>						
<i>k</i>		0	1	2	3	4	5	6
$\rho(\Delta x_t, \Delta x_{t-k})$		1.00	0.36	0.33	0.27	0.16	0.10	0.10
$\rho(\mathcal{I}_t, \mathcal{I}_{t-k})$		1.00	0.89	0.78	0.66	0.54	0.44	0.35
		<i>Cross-Correlations (1972-2009)</i>						
<i>k</i>		-3	-2	-1	0	1	2	3
$\rho(\Delta x_t, \mathcal{I}_{t+k})$		0.23	0.34	0.47	0.58	0.62	0.56	0.47

The Empirical Framework

- Output growth of firm i in industry j

$$\Delta x_t^{ij} = \Delta x_t^j + u_t^i,$$

where $E_{t-1}(u_t^i) = 0 \forall i$

- A spokesperson reports on changes in her firm's output, but is only infrequently apprised of the exact state of output growth
- At each date, a fraction $\alpha \in (0, 1)$ of representatives (in each sector) is able to update its information set $\implies \alpha$ of spokespersons have current information, $\alpha(1 - \alpha)$ have one-period old information, $\alpha(1 - \alpha)^2$ have two-period old information ... Mankiw and Reis (2002, 2006)

The Empirical Framework

- Survey designers ask a sample of N representatives in each of M sectors whether their firm's output increased, decreased, or stayed the same
- Informational rigidities \implies answers cannot always reflect firms' current output growth
- For respondents who do not have current information, answers reflect expected output growth conditional on most recent information

$$E_{t-k}(\Delta x_t^{ij}),$$

where $t - k$ is the date at which their information set was last updated.

The Empirical Framework

- Sectoral output changes are modeled as:

$$\begin{aligned}\Delta x_t^j &= \lambda^j F_t + e_t^j, \quad j = 1, \dots, M, \\ F_t &= \Phi(L)F_{t-1} + \eta_t,\end{aligned}$$

F_t set of latent dynamic factors common to all manufacturing sectors, η_t common disturbance such that $E_{t-1}(\eta_t) = 0$, λ^j factor loading specific to sector j , and e_t^j sector-specific shock such that $E_{t-1}(e_t^j) = 0 \quad \forall j$

- DFMs help handle large data sets where both M and T are large - VAR with 124 sectors and 2 lags has 30752 coefficients and 7750 variance parameters
- Neoclassical multisector growth models, Long and Plosser (1983), Horvath (1998,2000), Dupor (1999), Carvalho (2007) etc. produce DFMs as reduced-form solutions for sectoral output growth

The Empirical Framework

- e.g. Suppose $F_t = \phi F_{t-1} + \eta_t$, $\phi < 1$
- In each sector, for αN respondents,

$$E_t(\Delta x_t^{ij}) = \Delta x_t^{ij} = \lambda^j F_t + e_t^j + u_t^i$$

- For $\alpha(1 - \alpha)N$ respondents,

$$E_{t-1}(\Delta x_t^{ij}) = \lambda^j \phi F_{t-1}$$

- More generally, for $\alpha(1 - \alpha)^k N$ respondents,

$$E_{t-k}(\Delta x_t^{ij}) = \lambda^j \phi^k F_{t-k}, \quad j = 1, \dots, M, \quad \text{and} \quad k = 1, 2, \dots$$

The Empirical Framework

- Except for currently updated respondents, only fixed sector-specific characteristics and common shocks influence the construction of the diffusion index
- For majority of firms (if α is small), month-to-month shocks are not reflected in the diffusion index,

$$E_{t-k}(u_t^i) = 0 \quad \text{and} \quad E_{t-k}(e_t^j) = 0 \quad \forall i, j \quad \text{and} \quad k = 1, 2, \dots$$

- Past information will be reflected in the diffusion index through $\lambda^j \phi^k F_{t-k}$, with weights $\alpha(1 - \alpha)^k$
- Δx_t^{ij} is unknown for currently updated firms. Assume

$$\Delta x_t^{ij} = \Delta x_t^j = \lambda^j F_t + e_t^j,$$

\implies currently informed respondents work for firms whose output mimics the sector in which they operate

A Synthetic ISM Diffusion Index

- A synthetic diffusion index can be created by recording, for each sector, differentially informed perceptions of changes in output according to the conditions:

if $E_{t-k}(\Delta x_t^{ij}) > \tau$, $u_t^{kj}(\tau) = 1$, $s_t^{kj}(\tau) = d_t^{kj}(\tau) = 0$, $k = 0, 1, \dots$

if $-\tau \leq E_{t-k}(\Delta x_t^{ij}) \leq \tau$, $s_t^{kj}(\tau) = 1$, $u_t^{kj}(\tau) = d_t^{kj}(\tau) = 0$, $k = 0, 1, \dots$

if $E_{t-k}(\Delta x_t^{ij}) < -\tau$, $d_t^{kj}(\tau) = 1$, $u_t^{kj}(\tau) = s_t^{kj}(\tau) = 0$, $k = 0, 1, \dots$,

- The proportions of “optimists” and “same” respondents are:

$$U_t(\alpha, \tau) = M^{-1} \sum_{j=1}^M \sum_{k=0}^{\infty} \alpha(1-\alpha)^k u_t^{kj}(\tau)$$

$$S_t(\alpha, \tau) = M^{-1} \sum_{j=1}^M \sum_{k=0}^{\infty} \alpha(1-\alpha)^k s_t^{kj}(\tau),$$

A Synthetic ISM Diffusion Index

- The synthetic ISM diffusion index then takes the form:

$$\begin{aligned}\tilde{\mathcal{I}}_t(\alpha, \tau) &= \left(U_t(\alpha, \tau) + \frac{1}{2} S_t(\alpha, \tau) \right) \times 100 \\ &= M^{-1} \sum_{j=1}^M \sum_{k=0}^{\infty} \alpha(1-\alpha)^k \left(u_t^{kj}(\tau) + \frac{1}{2} s_t^{kj}(\tau) \right) \times 100.\end{aligned}$$

- What degree of information stickiness, α , and indifference threshold, τ , best describe the actual ISM?

$$\min_{\alpha, \tau} \mathcal{S}(\alpha, \tau) = T^{-1} \sum_{t=1}^T \left(\mathcal{I}_t - \tilde{\mathcal{I}}_t(\alpha, \tau) \right)^2.$$

Estimation and Findings

- Estimation proceeds in 2 steps: i) Estimate the DFM (i.e. the factors and factor loadings) using PC methods, ii) Use resulting DFM estimates to construct synthetic index and solve second stage minimization problem for α and τ
- Bai and Ng (2002) ICP1 and ICP2 estimators yield 2 factors in the full sample (1972-2009)

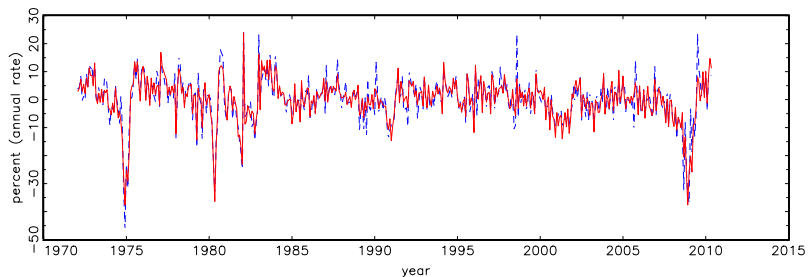
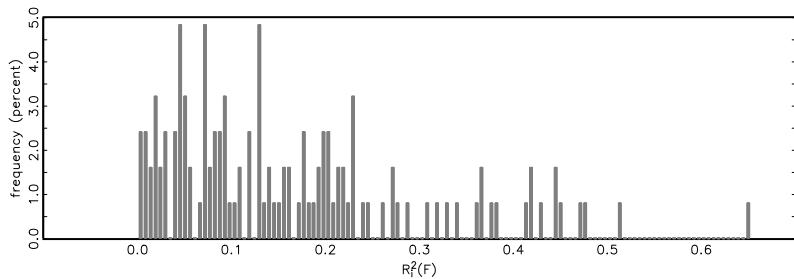
$$\Delta x_t = \mathbf{w}' \Lambda F_t + \mathbf{w}' e_t$$

$$R^2(F) = \mathbf{w}' \Lambda \Sigma_{FF} \Lambda' \mathbf{w} / \sigma_{\Delta x}^2$$

- Distribution of $R_j^2(F)$

$$R_j^2(F) = \lambda^j \Sigma_{FF} \lambda^{j'} / \sigma_{\Delta x_j}^2$$

A. Manufacturing Output Growth (dashed), and Factor Component (solid)

B. Distribution of Sectoral $R_f^2(F)$ 

Estimation and Findings

- The exercise yields $\alpha = 0.13$ and $\tau = 3.06$
- Respondents update their expectations every 8 months on average, and report output changes if they exceed 3 percent \implies somewhat stickier information than in previous work
- **12 months** in Carroll (2003) - Michigan Survey of household's inflation expectations and Survey of Professional Forecasters
- **12.5 months** in Mankiw, Reis and Wolfers (2003), between **4 and 6 months** in Mankiw and Reis (2006, 2009) - Michigan and Livingston Surveys as well as calibrated structural models
- around **6 to 7 months** in Coibion and Gorodnichenko - Same surveys but explore a range of alternative implications implied by Sticky Information frameworks

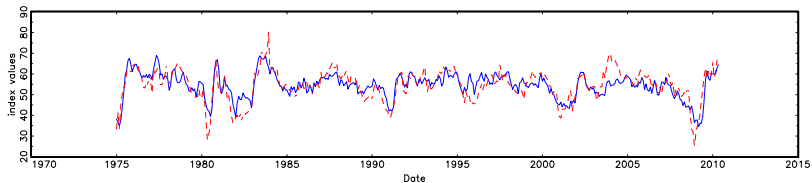
Volatility of the Manufacturing ISM Diffusion and Synthetic Diffusion Indices

		<u>1972-2009</u>	
	Std. Dev.	Fraction of Variance in Business Cycles $2 \text{ years} \leq p \leq 8 \text{ years}$	Fraction of Variance at High Frequencies $p < 2 \text{ years}$
Diffusion Index	7.85	54.15	30.03
Pseudo Index	6.08	50.8	31.74

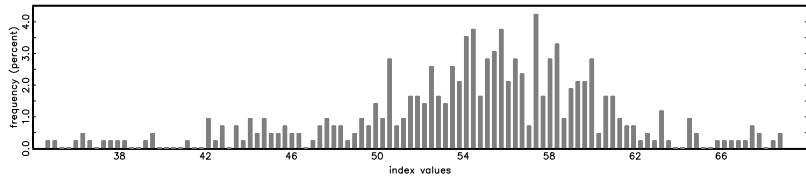
Autocorrelation and Cross-correlation Structure of the ISM Diffusion and Synthetic Diffusion indices

<i>Autocorrelations (1972-2009)</i>							
<i>k</i>	0	1	2	3	4	5	6
$\rho(\mathcal{I}_t, \mathcal{I}_{t-k})$	1.00	0.89	0.78	0.66	0.54	0.44	0.35
$\rho(\tilde{\mathcal{I}}_t, \tilde{\mathcal{I}}_{t-k})$	1.00	0.90	0.76	0.61	0.47	0.36	0.28
<i>Cross-Correlations (1972-2009)</i>							
<i>k</i>	-3	-2	-1	0	1	2	3
$\rho(\Delta x_t, \mathcal{I}_{t+k})$	0.23	0.34	0.47	0.58	0.62	0.56	0.47
$\rho(\Delta x_t, \tilde{\mathcal{I}}_{t+k})$	0.22	0.31	0.40	0.59	0.73	0.67	0.58

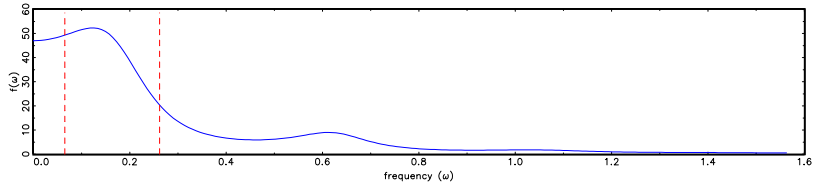
A. Synthetic Diffusion Index (solid) and ISM Diffusion Index (dashed)



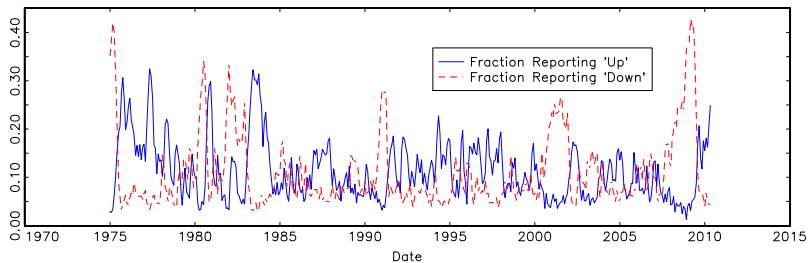
B. Distribution of Synthetic Diffusion Index Values



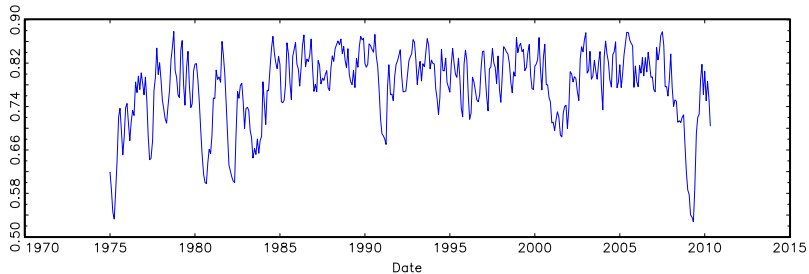
C. Spectrum of Synthetic Diffusion Index



A. Fraction of Respondents Reporting a Change



B. Fraction of Respondents Reporting No Change



Anatomy of the ISM Diffusion Index

- How does the degree of information stickiness affect the behavior of the ISM diffusion index?
- How important is sectoral heterogeneity in helping the diffusion index track business cycles?
- Is it possible to more efficiently construct a diffusion index by steering the underlying survey's efforts towards key sectors?
- What implications does the Great Moderation have for the estimated degree of information stickiness and the types of sectors that are most informative in the index?

Fully Informed Survey Respondents

- What happens when $\tau = 0$?
- What happens when $\alpha = 1$? When all respondents are always fully updated, the diffusion index reflects

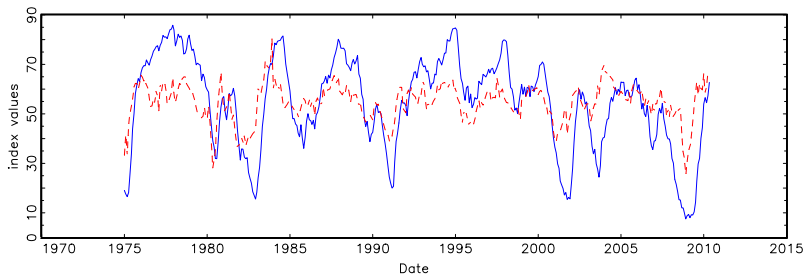
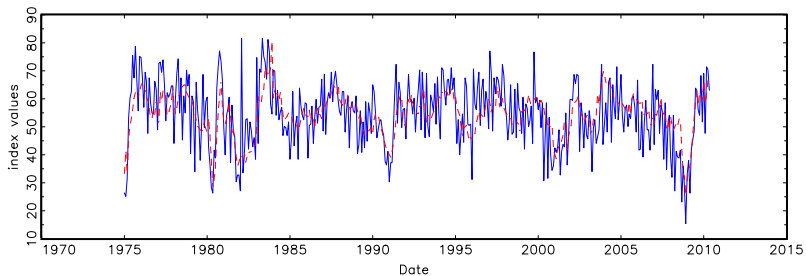
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if $\Delta x_t^j < -\tau$, then $d_t^j(\tau) = 1$, $u_t^j(\tau) = s_t^j(\tau) = 0$,

and

$$\tilde{\mathcal{I}}_t(1, \tau) = M^{-1} \sum_{j=1}^M \left(u_t^j(\tau) + \frac{1}{2} s_t^j(\tau) \right) \times 100,$$

A. Synthetic Diffusion Index (solid) and ISM index (dashed): $\alpha = 0.13$, $\tau = 0.00$ B. Synthetic Diffusion Index (solid) and ISM index (dashed): $\alpha = 1.00$, $\tau = 3.06$ 

Volatility of Manufacturing Output Growth and the Synthetic Diffusion Index with Fully Informed Respondents, $\alpha = 1$

		<u>1972-2009</u>	
	Std. Dev.	Fraction of Variance in Business Cycles $2 \text{ years} \leq p \leq 8 \text{ years}$	Fraction of Variance at High Frequencies $p < 2 \text{ years}$
Output Growth	8.35	23.90	68.57
Pseudo Index	11.74	28.13	61.80

Autocorrelations of Manufacturing Output Growth and the Synthetic Diffusion Index with Fully Informed Respondents, $\alpha = 1$

	<i>Autocorrelations (1972-2009)</i>						
k	0	1	2	3	4	5	6
$\rho(\Delta x_t, \Delta x_{t-k})$	1.00	0.36	0.33	0.27	0.16	0.10	0.10
$\rho(\tilde{\mathcal{I}}_t, \tilde{\mathcal{I}}_{t-k})$	1.00	0.39	0.40	0.42	0.22	0.18	0.20

Sectoral Heterogeneity

- What is the importance of sectoral heterogeneity in the construction of meaningful diffusion indices?
- There are (at least) two dimensions: heterogeneity in production and heterogeneity in information sets

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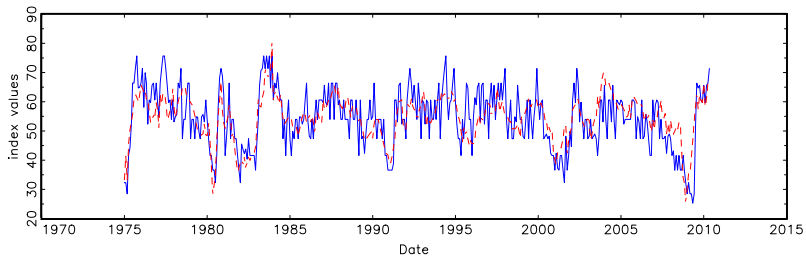
$$E_{t-k}(\Delta x_t^{ij}) = \bar{\lambda} \phi^k F_{t-k} \quad \forall i, j \text{ and } k = 1, 2, \dots$$

where $\bar{\lambda} = M^{-1} \sum_{j=1}^M \lambda^j$

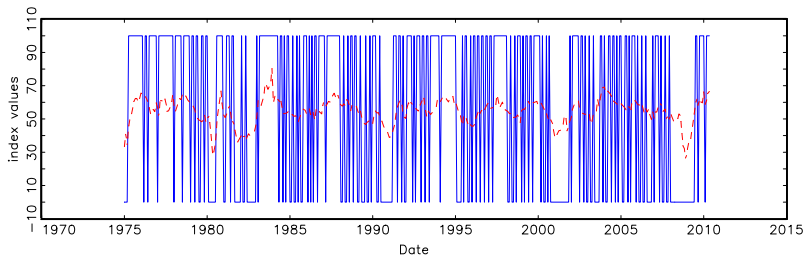
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$$\bar{\lambda} F_t = M^{-1} \sum_{j=1}^M \Delta x_t^j$$

A. Synthetic Diffusion Index with Homogenous Sectors, $\alpha = 0.13$, $\tau = 3.06$ (solid) and ISM index (dashed)



B. Synthetic Diffusion Index with Homogenous Sectors, $\alpha = 1.00$, $\tau = 0.00$ (solid) and ISM index (dashed)



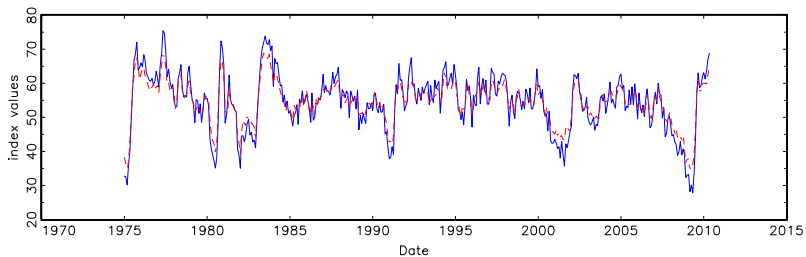
Most Informative Sectors Ranked According to $R_j^2(F)$

Sector	$R_j^2(F)$	Weight
1. Plastic Products	0.65	1.36
2. Household and Institutional Furniture	0.52	1.22
3. Metal Vales Except Balls and Roller Bearings	0.49	0.62
4. Architectural and Structural Metal Products	0.47	0.86
5. Commercial and Service Industry Machinery	0.45	0.17
6. Other Miscellaneous Manufacturing	0.45	0.51
7. Reconstituted Wood Products	0.45	0.23
8. Fabricated Metals: Forging and Stamping	0.45	0.76
9. Foundries	0.43	2.40
10. Fabricated Metals: Spring and Wire	0.43	3.04
11. Sawmills and Wood Preservation	0.42	0.08
12. Metalworking Machinery	0.41	0.05
13. Coating, Engraving, and Allied Activities	0.39	0.08
14. Textile Furnishings Mills	0.37	0.21
15. Other Electrical Equipment	0.37	0.15

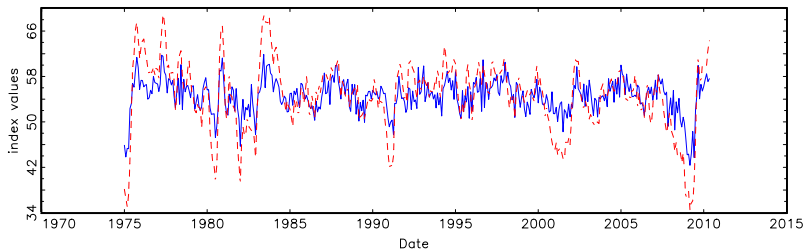
Least Informative Sectors Ranked According to $R_j^2(F)$

Sector	$R_j^2(F)$	Weight
1. Aircraft and Parts	0.00	0.42
2. Guided Missile and Space Vehicles	0.00	0.77
3. Fluid Milk	0.00	0.55
4. Coffee and Tea	0.01	1.03
5. Dry, Condensed, and Evaporated Dairy Products	0.01	0.38
6. Primary Smelting/Refining of Nonferrous Metals	0.01	0.01
7. Farm Machinery and Equipment	0.01	0.17
8. Animal Food	0.01	0.16
9. Seafood Product Preparation and Packaging	0.01	0.11
10. Heavy Duty Trucks	0.01	0.88
11. Wineries and Distilleries	0.01	0.45
12. Soft Drinks and Ice	0.02	0.14
13. Copper and Nonferrous Metal Rolling	0.02	1.23
14. Grain and Oilseed Milling	0.02	0.18
15. Mining and Oil and Gas Field Machinery	0.02	0.98

A. Synthetic Diffusion Index Using the Top 15 Sectors by $R_f^2(f)$ (solid) and Synthetic Diffusion Index Using All Sectors (dashed)



B. Synthetic Diffusion Index Using the Bottom 15 Sectors by $R_f^2(f)$ (solid) and Synthetic Diffusion Index Using All Sectors (dashed)



The Great Moderation

- Carroll (2003) is in part based on inflation expectations from the Michigan Survey, mostly covering the Great Moderation period (1981-2000) - expectations updated on average every 12 months
- Exercise yields $\alpha = 0.09$ over the period 1972-1983 \implies expectations are updated on average every 11 months
- Exercise yields $\alpha = 0.22$ over the period 1984-2010 \implies expectations are updated on average every 5 months
- Intuition: Output growth volatility falls after 1984 while ISM variability is roughly unchanged \implies less smoothing of output growth needed after 1984 \implies lesser need for information stickiness after 1984

Conclusions

- Survey answers underlying the ISM diffusion index reflect informational rigidities
- Informational rigidities paradoxically helps filter out high frequency (or noisy) fluctuations in survey answers \implies resulting index better able to isolate variations at business cycle frequencies
- Diffusion indices would be degenerate in an RBC environment - Heterogeneity in information lags may be more important than heterogeneity in production
- Information regarding the state of aggregate manufacturing is sectorally concentrated \implies suggests steering surveys towards key sectors and ignoring others