

Intelligence MEMOS



From: Paul Jenkins

To: Monetary Policy Watchers

Date: April 22, 2020

Re: **IN PRAISE OF IMPRECISION**

For the first time since 9/11, the Bank of Canada, with the release of its latest [monetary policy report](#) last week, opted not to present a base-case projection for the Canadian economy.

The omission was noteworthy, but appropriate, as to do otherwise would be misleading given that the shape and path of recovery is far from certain. At times like this, it is open and honest communications about the outlook, not a sense of precision, that will reassure citizens of the Bank's stewardship of the economy and its ability to hit its inflation target.

In normal times, base-case projections balance the key upside and downside risks to the global and Canadian economies, and accordingly they represent the Bank's view of the likely path of the economy over the medium-term consistent with achieving its 2 percent inflation control target.

In sharp contrast to the Bank of Canada, last week the International Monetary Fund (IMF) in its spring [World Economic Outlook](#) did present an updated base-case outlook for the global economy and for each of its member countries, including Canada. Why this difference, and importantly what should we make of the difference of approach in helping us to understand the world we are facing?

The answer is twofold: first, the [critical distinction](#) between risk and uncertainty; and second, the fact the Bank of Canada is a monetary policy-making institution whereas the IMF is not.

Because of the COVID-19 pandemic, the world today is an extremely uncertain place, whether viewed from the perspective of the health of the world population or from that of the global economy.

What are some of these uncertainties? On the health side, we have the rate of change of infection cases, the total number of people infected, death rates, and the capacity of our healthcare systems. On the economic side, we have the size and duration of the downturn due to the near shutdown of most major economies, the efficacy of policy actions taken to support recovery, and what workplace protocols will look like as we come out the other end.

Notwithstanding this unprecedented degree of uncertainty, the IMF, consistent with its usual practice, published a base-case projection for the global economy for this year and 2021, incorporating its understanding of the path of the pandemic and policy actions taken to date. Along with this projection, it also provided several alternative scenarios using different assumptions about key variables.

But the IMF is not a policy decision-making organization, whereas the Bank of Canada is. The significance of this is in the distinction made by Frank Knight in 1921 between risk and uncertainty.

Risk applies to situations where the outcome of a given situation is not known, but where we can with some degree of confidence measure the probabilities of an event happening. Uncertainty, in contrast, applies to situations where we cannot know all the information we need in order to estimate the probabilities in the first place.

For a policy-making institution like the Bank of Canada, one needs a single judgment about the economic outlook, where risks are considered balanced, to take informed policy decisions. However, uncertainties may mean that a single judgment is difficult, or near impossible. In today's world with the COVID-19 pandemic, this is the position the Bank of Canada took last week, and correctly so. Put differently, the uncertainties about the path forward, including the economic consequences of the myriad actions that have already been taken, lack sufficient clarity so that quantifying and balancing the risks with any degree of confidence is near impossible.

This is not to say that various scenarios, like those published by the IMF, are unhelpful—far from it. Indeed, the Bank in its report presents a range of possible outcomes, rather than one base-case projection. For the Bank to publish a single, base-case scenario, consistent with achieving its 2 percent inflation target, given the high degree of uncertainty, would simply be misleading.

As the Bank emphasizes, “Many paths for the economic recovery are possible.”

To suggest that the risks are measurable, and to present a base-case projection where risks are balanced, would give economic agents a false sense of precision upon which to base their expectations. And if there is one thing we have learned under the Bank's inflation-targeting framework, it is the importance of well anchored expectations.

Far better for the Bank to be upfront about the extent of uncertainty, share a narrative that acknowledges these uncertainties and in doing so help economic agents to better understand the breadth of what they are confronting.

Rather than unhinging expectations, open and honest communications is what will retain confidence in the Bank's stewardship of the economy and sustain expectations consistent with its 2 percent inflation target.

Paul Jenkins is a former senior deputy governor of the Bank of Canada and a senior fellow at the C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the author. The C.D. Howe Institute does not take corporate positions on policy matters.