In favouring accuracy, central bankers get the message right

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Economists are rarely able to speak for even a few minutes without discussing "trade-offs" – situations in which it's impossible to have more of one thing without giving up at least a little of something else.

They're all around us. For individuals, more spending on restaurant meals means there is less to spend on vacations or entertainment. For governments, spending more on social programs requires either less spending somewhere else or raising more tax revenues – which, of course, forces the taxpayers to give up something more.

In a statement that both illustrates this reality and shows how economists like to communicate with graphs and charts, I frequently remind my students that "life is a downward sloping line." More of X means less of Y, and vice versa.

Not all trade-offs are about spending, however; sometimes they are more subtle. For central bankers, one of the most important trade-offs relates to their style of communication. Their messaging usually strives for both simplicity and accuracy, but a movement too far along one dimension usually forces a sacrifice along the other.

In Ben Bernanke's final years at the helm of the U.S. Federal Reserve, he indicated that policy interest rates would remain at ultra-low levels until the unemployment rate fell to 6.5 per cent. In Mark Carney's first year heading up the Bank of England, he similarly announced that rates would remain unchanged until the British unemployment rate declined to 7.5 per cent.

In both cases, the message was very simple and thus easy to understand. And the underlying logic was quite sensible. Both economies had lots of excess capacity, and the recoveries were so sluggish that the appropriate stance for monetary policy was to remain very expansionary for an extended period. Only when growth picked up (and stayed up), and the unemployment rate fell significantly, would there be a need to begin tightening policy. Both central bank chiefs were using similar versions of what we now call "forward guidance" – efforts to provide a clear indication of the policy path ahead.

The problem was that those simple messages hid lots of real-world complexity – and so they weren't very accurate.

It has long been known that with significant changes in the labour force, movements in the unemployment rate are not a good indicator of changes in the overall performance of the economy. Messrs. Bernanke and Carney understand this very well, but they chose to offer a simple message because they thought it would be more easily understood. They both took a

gamble that the unemployment rate would fall roughly at the same pace that growth improved, and they would then be able to carry through on their commitments, as expected.

Unfortunately for them, they lost this gamble. In both countries, the unemployment rate declined faster than they expected, partly because of continued declines in the labour force.

Mr. Carney and the new Fed chair, Janet Yellen, have now felt it necessary to change their main message by making it more accurate – but less simple.

The new message is that a complex collection of variables must be examined, including the overall level of employment, the amount of excess capacity, the composition of aggregate demand, the durability of various shocks, and much else. And policy rates won't rise until the economy is healthier, where the latter is defined in a way that defies a simple statistic.

For those of us who study monetary policy, these revised messages are unremarkable – but eminently sensible. It is hardly news that the economy is very complicated, often with various indicators pointing in contrary directions. And a good monetary policy has always taken this complexity into account. The problem was not that the policies of Messrs. Bernanke and Carney were inappropriate, just that the earlier messages were too simplistic.

Mr. Carney and Ms. Yellen are now adopting more of the style of messaging favoured by the Bank of Canada's Governor, Stephen Poloz. Since becoming governor last spring, Mr. Poloz has intentionally avoided giving the kind of simple forward guidance that his prominent colleagues are now abandoning. Instead, he has chosen to offer accurate and coherent – but more nuanced and complicated – explanations of the complex set of economic forces at play.

In other words, Mr. Poloz has chosen a better point on that "downward sloping line" between accuracy and simplicity. Good for him.

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