Federal Reserve Bank of San Francisco

What the Moment Demands

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Introduction

In 2004, I read a speech about making monetary policy in a dynamic world.[1] It was written by then Governor of the Federal Reserve, Ben Bernanke.

Bernanke noted, that when central bankers know about where the economy is headed or face imminent risks, they should adjust policy decisively and aggressively—what he called the "cold turkey" approach. He then noted, that in almost every other instance, more caution is warranted. When central banks are unsure about how the economy will evolve; when they are unsure of the impact their policies will have; or when they are uncertain about how the fundamental benchmarks in the economy are changing, the optimal strategy is to look before leaping—to take a "gradualist" approach to policy.

I reference this speech and its lessons to remind us that the economy has always been dynamic. Change is inevitable, and uncertainty is a fact of life.

[1] Bernanke (2004).

But monetary policy can adjust. Going quickly when conditions demand and more slowly when the road is less clear. Our tools, strategies, and actions can always meet the moment. The choice, of course, is ours.

Now before I go much further, I would like to remind you that the views I express today are my own, and do not necessarily reflect those of my colleagues or anyone else within the Federal Reserve System.

A World in Flux

So, what do we face? As many at this conference have noted, we are in a period when the risks seem high and the waters, murky.

After the long fight through COVID, economies around the globe are facing a range of crises and complexities: wars in Eastern Europe and the Middle East, the rethinking of economic relations and global production chains, disruptions and dislocations from a changing climate, and the potential impacts, good and bad, of artificial intelligence and generative AI.[2]

Central banks also face these challenges, as well as a policy landscape that has shifted significantly in the past four years.

Recall that, prior to COVID, central banks around the globe were focused on weaker trend growth, low real interest rates, below-target inflation, and policy tools constrained by the zero lower bound.[3] Policymakers were focused on providing sufficient monetary policy accommodation and keeping inflation expectations from falling.[4]

Post-COVID, the landscape has reversed. Inflation in most countries is now too high, rather than too low. Global interest rates are elevated, and central banks are wondering whether they'll need to pull the policy reins even tighter to control inflation. Policy debates are now centered on what constitutes sufficiently restrictive and how long to maintain that stance.[5]

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[2] Cevik and Jalles (2023), International Monetary Fund (2023a), and Cook (2023).

[3] Discussed in Daly (2023a). Examples include Dudley (2013), Yellen (2016), Evans (2016), Draghi (2016), and Mertens and Williams (2019).

[4] Central banks took a range of approaches, including asset purchases (quantitative easing or QE), negative interest rates, and forward guidance on keeping rates "lower for longer." See Svensson (2015), Bech and Malkhozov (2016), Board of Governors (2023), Diwan, Leduc, and Mertens (2020), and Bernanke (2020).

[5] Powell (2023a, b), Schnabel (2023), Bank of England (2023), International Monetary Fund (2023b), and Daly (2023b).

Policy for the Moment

That is a lot of change in a short period. So it is somewhat surprising that Ben Bernanke's remarks have been so durable.

But remember, his key point was that monetary policy is flexible, and it can adjust as conditions change. And that is an important lesson for today.

When we know where we are going and it's important to get there quickly, moving aggressively makes sense. "Cold turkey" is the appropriate action.[6]

We've seen this many times in history. This was the strategy during the Global Financial Crisis, when central banks quickly lowered policy rates and did multiple rounds of quantitative easing.[7]

Going back further, Federal Reserve Chair Paul Volcker took rapid and aggressive action during the late 1970s and early 1980s, to fight double-digit inflation and a vicious wage-price spiral.[8]

More recently, policymakers across the globe acted decisively in response to the pandemic, bringing all their tools to bear to offset the impending damage to the economy.[9] And then, when inflation followed and proved to be persistent, central banks raised rates rapidly to bring the economy back into balance and restore price stability.[10]

Each of these actions were bold. Central banks were clear on what the moment demanded. They acted forcefully, judging that the risks from aggressive measures were smaller than the costs of any potential policy errors.[11]

But most times we face are not so clear. And a different type of boldness is required: the boldness to wait.

When uncertainty is high and the risks to our objectives more balanced, we need to practice gradualism. To resist the desire to be certain. To react to not knowing with curiosity. And to adhere to the idea that patience, measured adjustments, and continual reassessment make

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[6] Bernanke (2004).

[7] Kohn (2010), Kuttner (2018), and Dell'Ariccia, Rabanal, and Sandri (2018).

[8] Goodfriend and King (2005), Silber (2012).

[9] Clarida, Duygan-Bump, and Scotti (2021), Milstein and Wessel (2021), UN DESA (2022).

[10] OECD (2023), Council on Foreign Relations (2023). Bernanke discussed factors that contributed to the inflation and expressed concerns about the slow response on the part of the FOMC (Bernanke 2022, Cox 2022).

[11] For the European Central Bank's response to the pandemic, see the interview with ECB President Christine Lagarde in Walker (2020).

for better outcomes.[12] Practicing gradualism means having the confidence to say that we don't yet know.

There are many times when gradualism is the best strategy, and there are countless examples of central banks taking this more cautious approach.[13]

The reason it is used so often is because it applies to so many different situations. Uncertainty about the economic forecast.[14] Uncertainty about the monetary policy transmission mechanism.[15] And uncertainty about economic fundamentals, like the natural rate of unemployment or the neutral rate of interest.[16]

In this moment, we are grappling with all of these situations. At the Federal Reserve, we are not certain whether inflation is on track to return to 2 percent. We are unsure about the length of policy lags and whether they are behind us or still to be fully realized. And we are uncertain about whether the dynamics we observe today are cyclical remnants of the post-pandemic recovery or indicators of structural shifts and a new normal for the national and global economy.

The truth is none of these are knowable right now. And the perils of deciding too quickly when we are not sure are real. Declaring certainty without knowing is not just a missed forecast. It's a policy mistake. And it has the potential to leave a lasting imprint on the economy and negatively affect those we serve.

Call to Action

So here is the main message of my remarks.

Uncertainty is a fact of life, but it does not leave us rudderless. We have the tools and the experience to navigate whatever comes our way.

Our challenge will be what it has always been. To respond rapidly when the situation requires, and to resist the pressure to act quickly when patience is needed. To have the will to make these choices, that is the policymakers' job.

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[12] Brainard (1967), Sack and Wieland (2000), Bernanke (2004, 2007), Barlevy (2009),

[13] Blinder (2006), Wilkins (2017), Lagarde (2022), Sack and Wieland (2000), Bernanke (2004), Yellen (2017).

[14] See Reifschneider and Tulip (2019) for a discussion on the elevated uncertainty around economic projections.

[15] Greenspan (2004) and Havranek and Rusnak (2013).

[16] See, for example, Orphanides and Williams (2002, 2006) and Wieland (2006). Uncertainty about the natural rate of unemployment was a key factor coming out of the Great Recession (Kocherlakota 2010, Lacker 2012, and Daly et al. 2012). Currently, uncertainty about the neutral rate of interest has risen; see, for example, Lubik and Matthes (2023) and Mericle (2023).

And we need to be collectively up to the task.

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