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What the Moment Demands

Mary C. Daly

When central banks are unsure about how the economy will evolve, what impact their policies will have, or how fundamental benchmarks in the economy are changing, the optimal strategy is a gradualist approach to policy. The challenge will be to respond rapidly when the situation requires and to resist the pressure to act quickly when patience is needed. The following is adapted from the closing keynote by the president of the Federal Reserve Bank of San Francisco to the 33rd Frankfurt European Banking Congress in Frankfurt, Germany, on November 17.

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

Bernanke (2004) 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.

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.

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-19, 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 (Cevik and Jalles 2023, International Monetary Fund 2023a, and Cook 2023).

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 (see discussion in Daly 2023a and examples in Dudley 2013, Yellen 2016, Evans 2016, Draghi 2016, and Mertens and Williams 2019). Policymakers were focused on providing sufficient monetary policy accommodation and keeping inflation expectations from falling. 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" (Svensson 2015, Bech and Malkhozov 2016, Board of Governors 2023, Bernanke 2020, and Diwan, Leduc, and Mertens 2020).

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 (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 (Bernanke 2004).

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

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 (Goodfriend and King 2005 and Silber 2012).

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 (Clarida, Duygan-Bump, and Scotti 2021; Milstein and Wessel 2021; and UN DESA 2022). 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 (OECD 2023 and Council on Foreign Relations 2023; Bernanke discussed factors that contributed to inflation and expressed concerns about the slow response on the part of the FOMC in Bernanke 2022 and Cox 2022).

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 (for the European Central Bank's response, see the interview with ECB President Christine Lagarde in Walker 2020).

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 for better outcomes (Brainard 1967; Sack and Wieland 2000; Bernanke 2004, 2007; and Barlevy 2009). 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 (Blinder 2006, Wilkins 2017, Lagarde 2022, Sack and Wieland 2000, Bernanke 2004, and Yellen 2017).

The reason it is used so often is because it applies to so many different situations. Uncertainty about the economic forecast (Reifschneider and Tulip 2019). Uncertainty about the monetary policy transmission mechanism (Greenspan 2004 and Havranek and Rusnak 2013). And uncertainty about economic fundamentals, like the natural rate of unemployment or the neutral rate of interest (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; see 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).

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%. 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 policymaker's job.

And we need to be collectively up to the task.

Mary C. Daly
President and Chief Executive Officer, Federal Reserve Bank of San Francisco

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