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Monetary Policymaking in a Context of Extreme Uncertainty

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Good morning,

First of all, I would like to extend my sincere gratitude to the Swiss National Bank and the BIS for inviting me to this highly relevant and timely conference. One of the main challenges we are currently facing as policymakers is finding the right adjective to describe the kind of uncertainty we are dealing with: extreme, unprecedented, unpredictable? We are navigating a very complex policymaking environment characterised by a high degree of uncertainty. To begin with, let me explain why uncertainty is currently so high. The US Economic Policy Uncertainty Index shows that the degree of uncertainty surrounding economic policy in the United States is at extreme levels in general, and also in specific areas: monetary policy, fiscal policy, regulation, and trade policy. We are currently experiencing unprecedented levels of uncertainty in all of these areas. Trade is a clear example, but fiscal policy in the United States is similarly affected. The Congressional Budget Office projects, in the absence of new fiscal policies, persistent deficits of over 5% of GDP for the next decade and a debt-to-GDP ratio rising from 100% to 150%.

No matter which area you look at, we are facing truly unprecedented developments. This is something we must take into account in our decision-making. During the COVID-19 pandemic, we also faced unprecedented uncertainty, but this time the uncertainty is far more of the Knightian kind.¹ At that time, the shock, particularly the potential for adverse scenarios, was huge, but the direction and the nature of the shock were clear-cut. It was a significant negative supply shock. This time around is far more complex. Let me illustrate this using a model-based decomposition of shocks in the recent inflationary episode.² It basically shows that it was possible, even in real time, to identify the nature of the shock as clearly supply-driven.

Today, while the impact on GDP is clearer, the impact on inflation is harder to predict due to potentially opposing dynamics.

I will discuss three key issues arising from this extreme uncertainty and the challenges for policymakers in relation to monetary policy. First, evaluation: we need to improve our tools and methods to better understand and assess this uncertainty. This involves defining the contours of uncertainty and structuring our internal work and decision-making in a way that puts more emphasis on the balance of risks to the central scenario. Second, decision-making: we need to consider how to make decisions in such an uncertain environment. And third, communication: we need to consider how to effectively communicate our decisions and the uncertainty to the public and the markets.

Evaluation

In the current environment, a central scenario is less informative than in past episodes of tension. Instead, we should rely more on well-designed fully-fledged alternative scenarios. The adoption of this approach is challenging, but steps were already being taken in this

¹ Knightian uncertainty refers to a type of uncertainty where the probability of outcomes cannot be calculated or reliably predicted. This concept contrasts with measurable risks, where the outcomes and their probabilities are known or can be estimated.

² See Kataryniuk, Martinez-Martin, Pappa and Rast (2025) "The heterogenous effects of demand and supply shocks", Banco de España Working Paper (forthcoming).

direction even before the recent surge in uncertainty. A relevant example is the 2024 Bernanke review of the Bank of England's forecasting³ which puts emphasis on managing uncertainty and discussing the balance of risks. In my view, the relevance of this issue is going to increase over time, for two main reasons. The first is related to the need to foster robustness in response to a situation of uncertainty. In this respect, Sargent and Hansen⁴ have clearly explained the importance of robustness in modelling and for potential scenarios to deal with uncertainty and model ambiguity. Secondly, we need to improve transparency vis-à-vis the public, so that they know we are prepared for different scenarios. This means focusing less on the central scenario and more on alternatives.

All central banks are currently working on scenarios to assess the potential impact of policy shifts on tariffs. By way of illustration, at the Banco de España, we use different models to analyse past data and predict new economic states if certain events occur. For example, to evaluate the impact of the recent trade policy decisions taken by the new US Administration, we have combined two models: the well-known large-scale multi-country model NiGEM, and an internal Banco de España multi-sectoral, multi-country model. Using these two models, we have simulated different scenarios over a three-year horizon, considering alternative tariffs configurations in the United States vis-à-vis the rest of the world and in the rest of the world vis-à-vis the United States. To better understand the impacts on inflation and on the complexity of the situation, we have also added parallel channels that might be more demand-driven, such as negative confidence shocks and financial uncertainty and volatility. This highlights the importance of combining different shocks and scenarios. As we add more elements, we must choose some to create a simplified view of potential new economic states.

Another key approach when facing an episode of high uncertainty is to monitor short-term developments using high-frequency data. This helps us capture early dynamics that lower frequency data might miss. For example, during the Valencia floods in Spain, we monitored credit card data, ATM withdrawals, employment data, tax data, VAT billing and port data to assess the impact.

Combining numbers with text and other non-structured information is challenging. By using neural models and AI techniques, we can detect non-linear patterns and turning points that traditional methods might miss. In the presence of high uncertainty, it is crucial to combine standard models and forecasting techniques with high-frequency data.

Decision-making

Let me turn now to the issue of how to best take monetary policy decisions in a context of high uncertainty.

Here the terms that we normally use, such as data-driven and full optionality, are more apposite than ever. Given the developments in recent months, our initial reaction in the

³ Bernanke, B. (n.d.). Forecasting for Monetary Policy Making and Communication at the Bank of England: A Review. Bank of England. Retrieved from: <https://www.bankofengland.co.uk/independent-evaluation-office/forecasting-for-monetary-policy-making-and-communication-at-the-bank-of-england-a-review/forecasting-for-monetary-policy-making-and-communication-at-the-bank-of-england-a-review>

⁴ Hansen, L. P., & Sargent, T. J. (2008). Robustness. Princeton University Press.

current situation should be cautious. This is because it is extremely challenging to predict the impact and direction of potential developments and their net economic effects. Therefore, a cautious approach, as suggested by Brainard,⁵ is appropriate in the short term.

At the same time, given the rapid pace at which developments evolve, the most likely scenario can change swiftly, and alternative scenarios can quickly become the new central one. Therefore, we need to act promptly. This requires us to be attentive and prepared to make the appropriate decisions.

In the wording of the recent ECB monetary policy statement, we introduced the concept of "agility", highlighting the need to be flexible and responsive. I view the current situation as one in which we must balance caution with agility. We need more time to fully understand various developments, but we also need to be ready to adapt swiftly. As is often the case in monetary policymaking, achieving this balance is an art.

Communication

Let me finally deal with the issue of how to communicate our decisions in a context of high uncertainty.

Communicating uncertainty is always a challenge for central bankers. There is a fundamental dilemma: if we express too much doubt or present too many alternatives, we risk appearing indecisive. Moreover, it is crucial for central banks to be seen as effective and committed to maintaining price stability with the necessary tools at our disposal.

At the same time, the assessment of certain situations takes time and requires additional information. For the sake of transparency, we need to convey this need, but this must be done in a way that maintains the perception of our commitment and avoids appearing somewhat lost in the current situation. This is especially challenging in a highly uncertain environment.

Tools like the Bank of England's fan charts have been used since the mid-1990s.⁶ However, the use of probability distributions can sometimes suggest that anything is possible. This is somewhat problematic and it may be difficult for certain observers to understand how these charts are constructed and how they should be used. These are factors that limit the usefulness of these tools for communication. Similarly, the Federal Reserve Board's FOMC dot plot charts show a range of future views, but they also involve communication challenges.⁷

If we are moving towards relying more on alternative scenarios rather than a central one, we need to communicate this shift effectively. This involves structuring our internal debates and

⁵ Brainard, W C (1967), "Uncertainty and the Effectiveness of Policy", *American Economic Review* 57(2): 411-425.

⁶ Fan charts were pioneered by the Bank of England back in 1990. They typically show the likelihood that a future inflation outcome falls within a specified range. However, they are silent on the underlying contingencies and policy reaction.

⁷ The Fed dot plots report the median, central tendency and range across (anonymised) individual FOMC members. The uncertainty range is largely a measure of disagreement across individual members, and there is no mapping between the individual FOMC members' views about inflation, the economy and the interest rate. Thus, preventing inference about the implicit reaction function.

discussions on the balance of risks with stylised scenarios that reflect a few impactful alternatives to the central scenario and have a significant likelihood of materialising.

The job of the decision-making body is to reach consensus on these alternative scenarios and then to instruct staff to develop them in detail, presenting them alongside the central scenario. In my opinion, relying more on alternative scenarios is a relatively straightforward approach.

The challenge is how to communicate these alternative scenarios clearly and transparently to the public. While transparency is desirable, it can also lead to misinterpretations or confusion. The simplicity of a central scenario for projections is straightforward, but as we de-emphasise it, we must find effective ways to communicate the shift.

Transparency is also desirable for our reaction function. Not only when we do (not) react to the central scenario, but also to show determination and readiness to react to alternative scenarios or to weigh them in our decision-making process, insofar as they are perceived as relevant and have a significant likelihood of occurrence. Probably at a certain point in time, to manage expectations and provide guidance on understanding the central bank reaction function, it would be desirable to move in this direction.

But at the same time, this is not easy. Imagine how complex it would be to include this in a formal statement. We are already sometimes criticised for being overly complex in how we communicate our actions and assessments, whether these relate to the economy, inflation, or policy decisions. Introducing discussions on alternative scenarios would make things even more complex. It could even lead to misinterpretations. A full appreciation that these are state-contingency commitments, and not exactly a central scenario, is by no means guaranteed.

An additional source of both complexity and confusion has to do with the time-varying nature of the weight we give to alternative scenarios.

The appeal of a central scenario with projections lies in its simplicity and straightforwardness. However, as we begin to de-emphasise these central scenarios, the challenge becomes how to effectively communicate this shift. These are complex questions, and while I do not have all the answers, I firmly believe that more research should be conducted on these critical issues. This is shaping up to be a very important debate for the future.

Let me conclude. High uncertainty may become the new normal. Recent unprecedented developments suggest that this high uncertainty could be long-lasting. Innovations related to AI are accelerating and their impacts are extremely difficult to grasp. In parallel, we may be experiencing significant structural changes in the geopolitical landscape, and in political decision-making at the global level. As Nobel Prize winner Douglass North wrote in *Understanding the Process of Economic Change*, “it is evident that we have been and we are creating societies that are unique in comparison to anything in the past. [...] To know the future, we have to know today what will be known tomorrow.” Let me complement this with another quotation from George Shackle: “What does not yet exist cannot be known.” If we are in a new normal of uncertainty, we need to be prepared. This involves developing

analytical tools, organising internal discussions, and making decisions that account for alternative scenarios. Forward guidance may need to be reconsidered, and we must find effective ways to communicate uncertainty to the public and markets.

Thank you very much.