The economy is a complex system. Moreover, it is constantly changing as a result of technological advances and globalisation. Consequently, monetary policy operates in a very uncertain environment. The unforeseen and radical developments in the international financial markets emanating from the current crisis in the US housing and mortgage market have – once again – brought home the major role of uncertainty in monetary policy.

We are uncertain about the exact way in which the economy functions, the current state of the economy and about future exogenous shocks. This uncertainty can express itself in the form of risk, with a known probability distribution. Alternatively, it may take the form of Knightian uncertainty, in which the probability distribution is unknown. It is the latter form of uncertainty which presents monetary policy with the greater challenges.

Uncertainty is a reason why changes to the monetary policy instrument are generally applied only gradually and in small steps. However, if the economy is thought to be facing major threats, uncertainty may demand rapid and decisive action.

Monetary policy decision-makers must be aware of uncertainty and the limitations of their knowledge. The high degree of uncertainty militates against ambitious fine-tuning of the economy but favours focusing on the main task of monetary policy, which is maintaining price stability. Moreover, uncertainty necessitates broad-based and impartial analysis as well as judgment and flexibility in monetary policy decision-making.