



# Risk Management Approach to Price Stability: The Role of Policy Credibility

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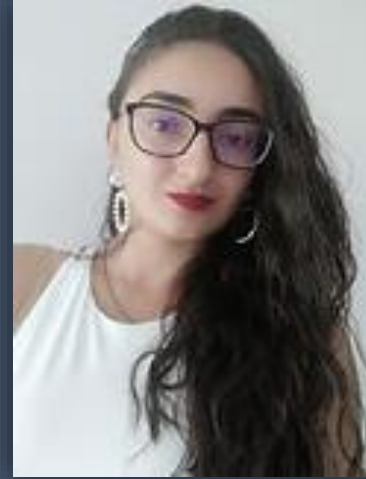
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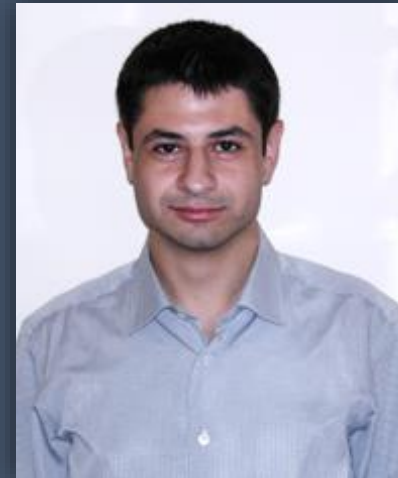
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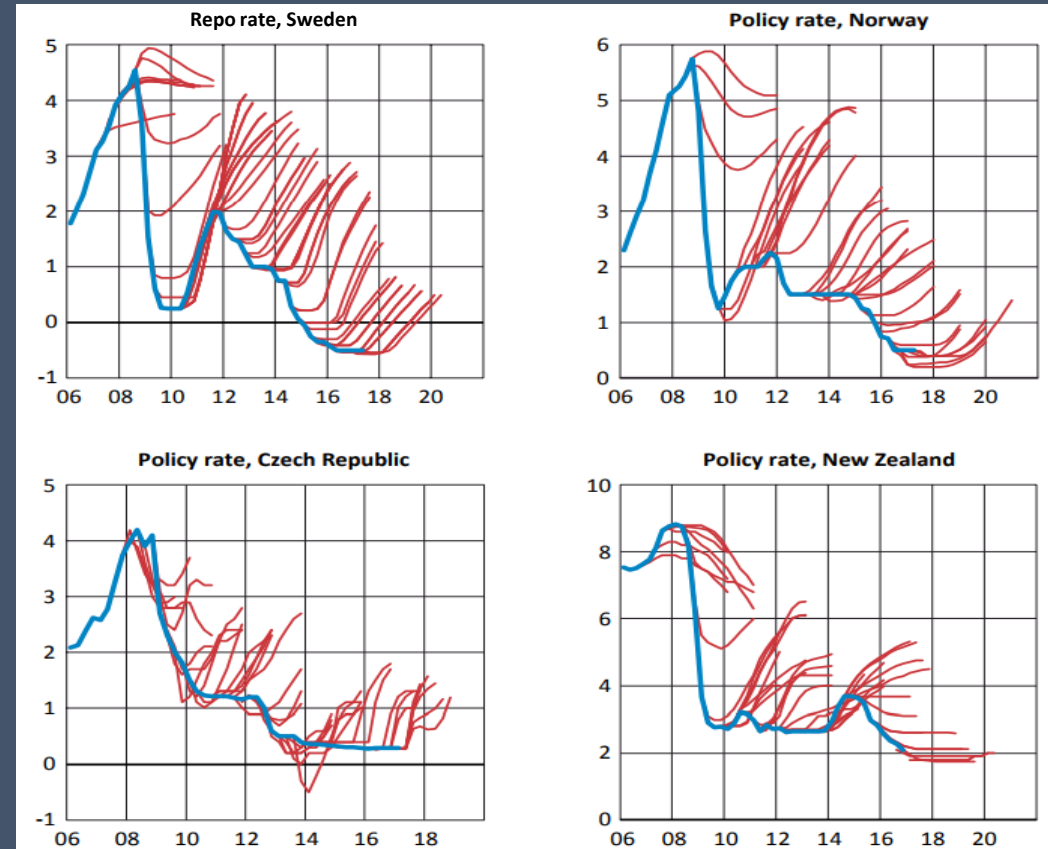
# Current Approaches to Monetary Policy Work Great, Until They Don't



Central bank forecasting is consistently wrong...

We are very bad at predicting the future, particularly in **times of uncertainty.**

Need to think about monetary policy as a risk management exercise.



Source: Alsterlind, Jan (2017) "Common features in short maturity interest rate forecasts", Staff memo, Sveriges Riksbank.



How do we design a framework, which recognizes that:

- Central banks are terrible at forecasting, especially in times of uncertainty;
- Important nonlinearities can kick in and drag the economy towards “dark corners”?





# CBA Working Paper 22/10/06



## FPAS Mark II: Avoiding Dark Corners and Eliminating the Folly in Baselines and Local Approximations

by David Archer, Martin Galstyan, Douglas Laxton

October 10, 2022

[https://youtube.com/channel/UCzRCPV6IE\\_qrqY7GEZgdHg](https://youtube.com/channel/UCzRCPV6IE_qrqY7GEZgdHg)

# Essential Ingredients of FPAS Scenarios



Where is the economy now?



What do we think might be driving it?



What do policy instruments need to do to achieve basic policy objective?  
Elevating importance of avoiding dark corners

FPAS = Forecasting and Policy Analysis System

# Monetary Policy Frameworks: The Big Picture



	No FPAS (BOE)	FPAS Mark I (CNB, RBNZ, NBG etc.)	FPAS Mark II (CBA?)
Three ingredients of FPAS	X	✓	✓
Uncertainty: Scenario Analysis	X	X ✓	✓
Avoiding dark corners or “least regrets” policy	X	X	✓
Accountability and transparency: designing a right reputational equilibrium	X	X	✓

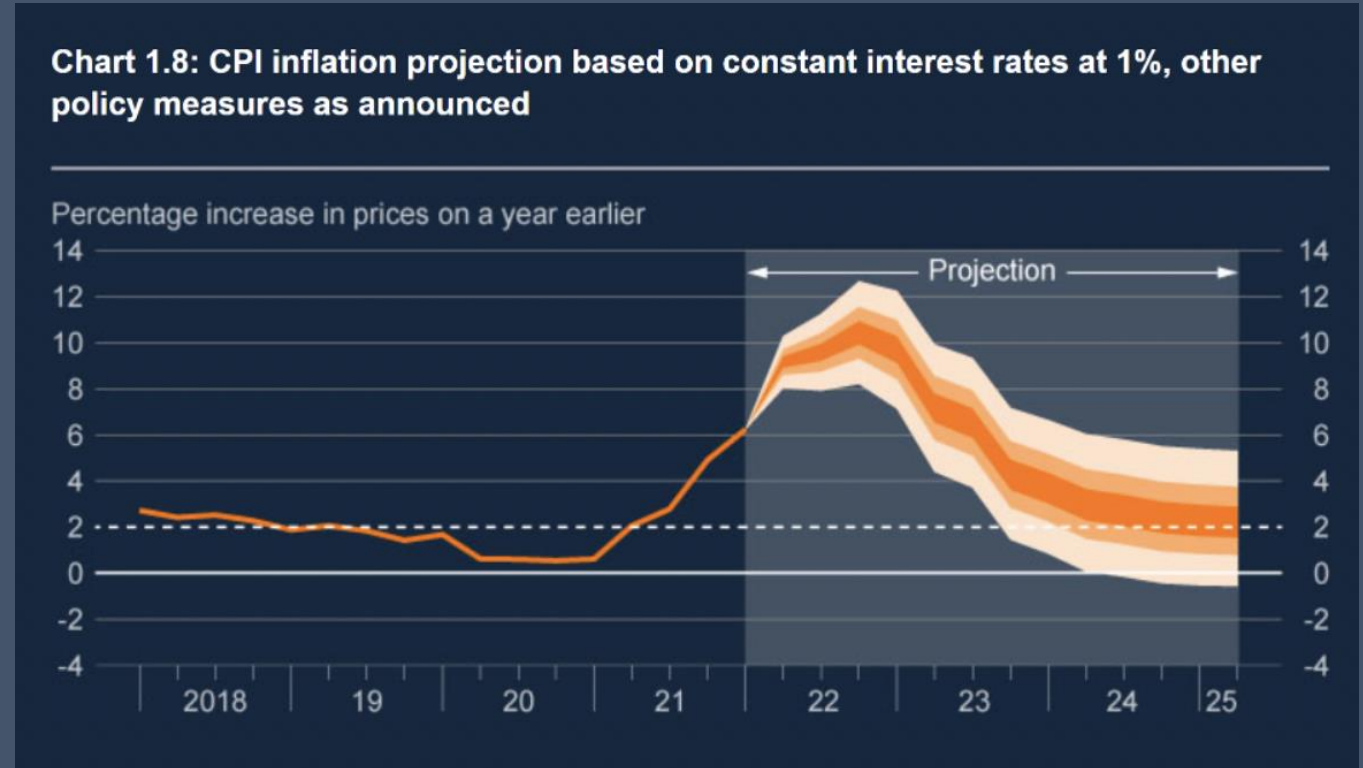


# Qualitative Risk Management is Just Discretion with a Different Name



## Non-FPAS Constant Interest Rate: BoE

- Monetary Policy as Risk Management (MPRM) is a good way of dealing with uncertainty, but without a framework in place, it's just discretion.
- We need a systematic approach to addressing uncertainty that is both **qualitative and quantitative.**



Source: Bank of England Monetary Policy Report.

# FPAS Mark I: A Good System, But Why is it Imperfect?

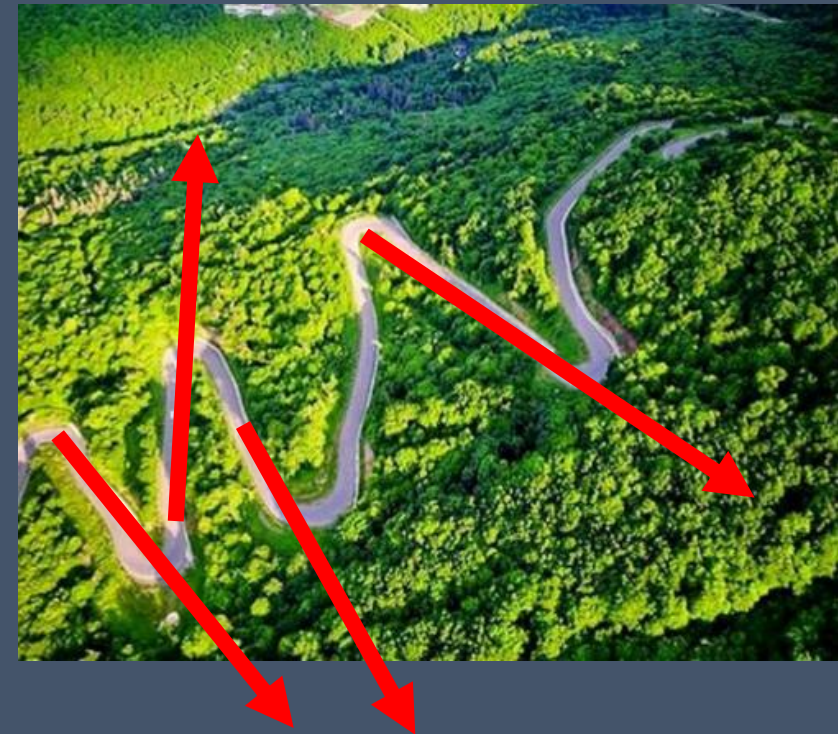


*It can't deal with uncertainties...*

## Folly in Baselines



## Folly in Local Approximations





Introducing a paradigm shift...

# FPAS Mark II

A systematic framework for incorporating MPRM in the policymaking process

# How Do We Eliminate Folly in Baselines?



Case scenarios serve as illustrative examples of policy responses to relevant risks and uncertainties

**Case A:** A plausible hawkish scenario.  
Policy rate path higher than market expectations.

**Case B:** A plausible dovish scenario.  
Policy rate path lower than market expectations.

**Case X(Y):** Avoiding dark corners.  
E.g. high and variable inflation, or a low inflation trap



# Essential Ingredients of FPAS Scenarios



Where is the economy now?



What do we think might be driving it?



What do policy instruments need to do to achieve basic policy objective?  
Elevating importance of avoiding dark corners

*Ingredients  
need to be:*



**Related to the  
current data**



**Realistic**



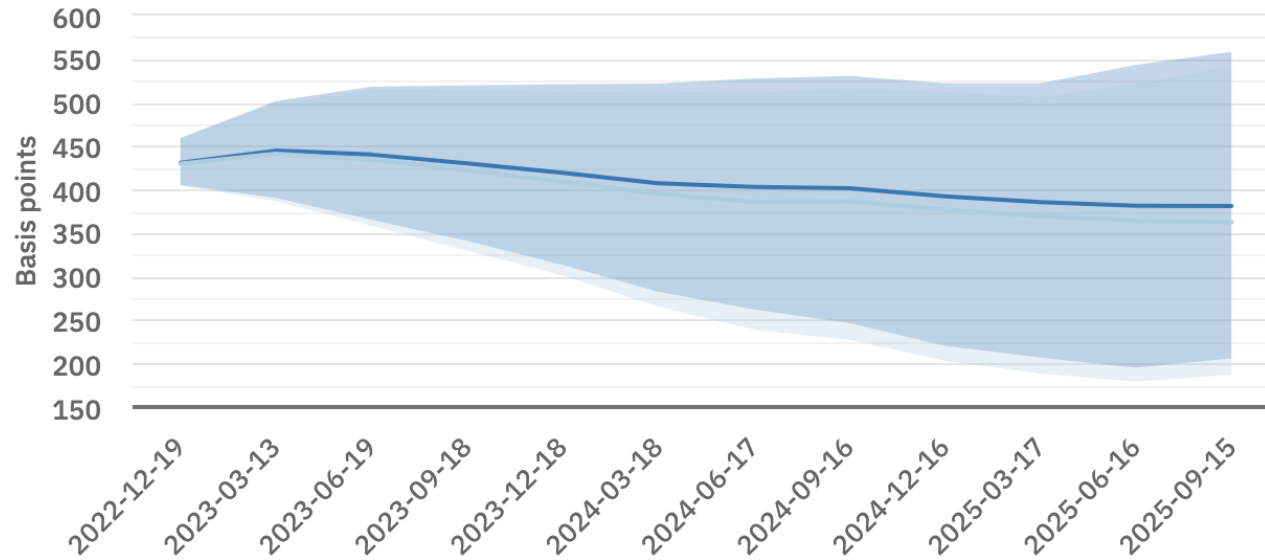
**Relevant for  
policy**

# Market Probability Tracker vs. Case Scenarios



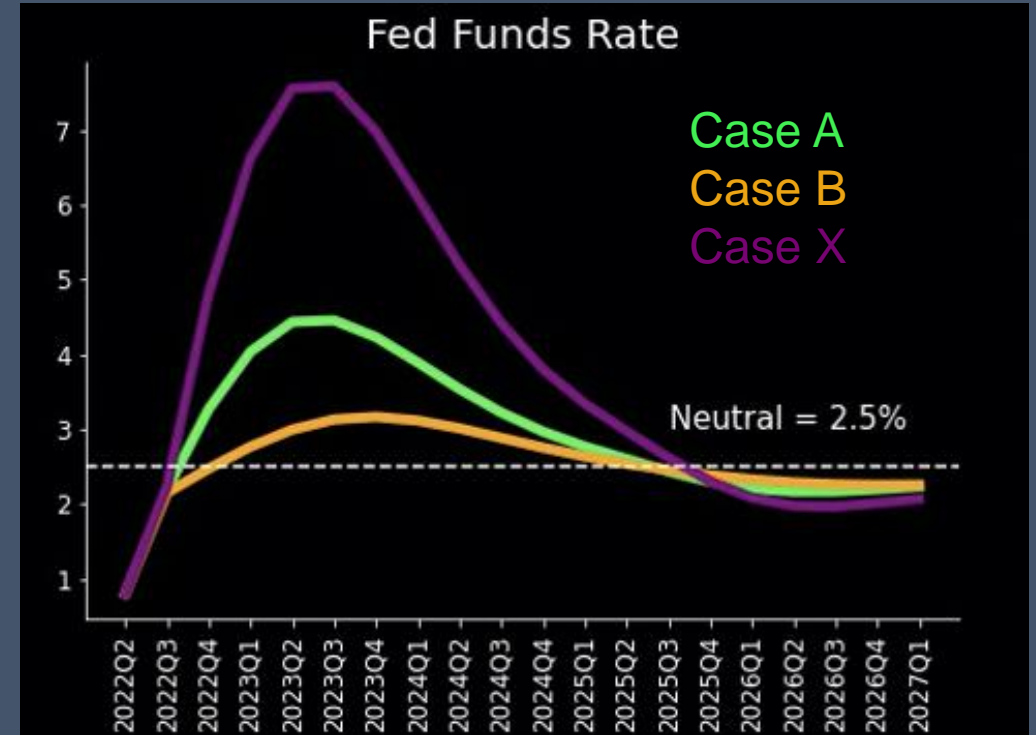
## The Expected Future Path of the Three-Month Average Fed Funds Rate

Current target range: 300 - 325 basis points

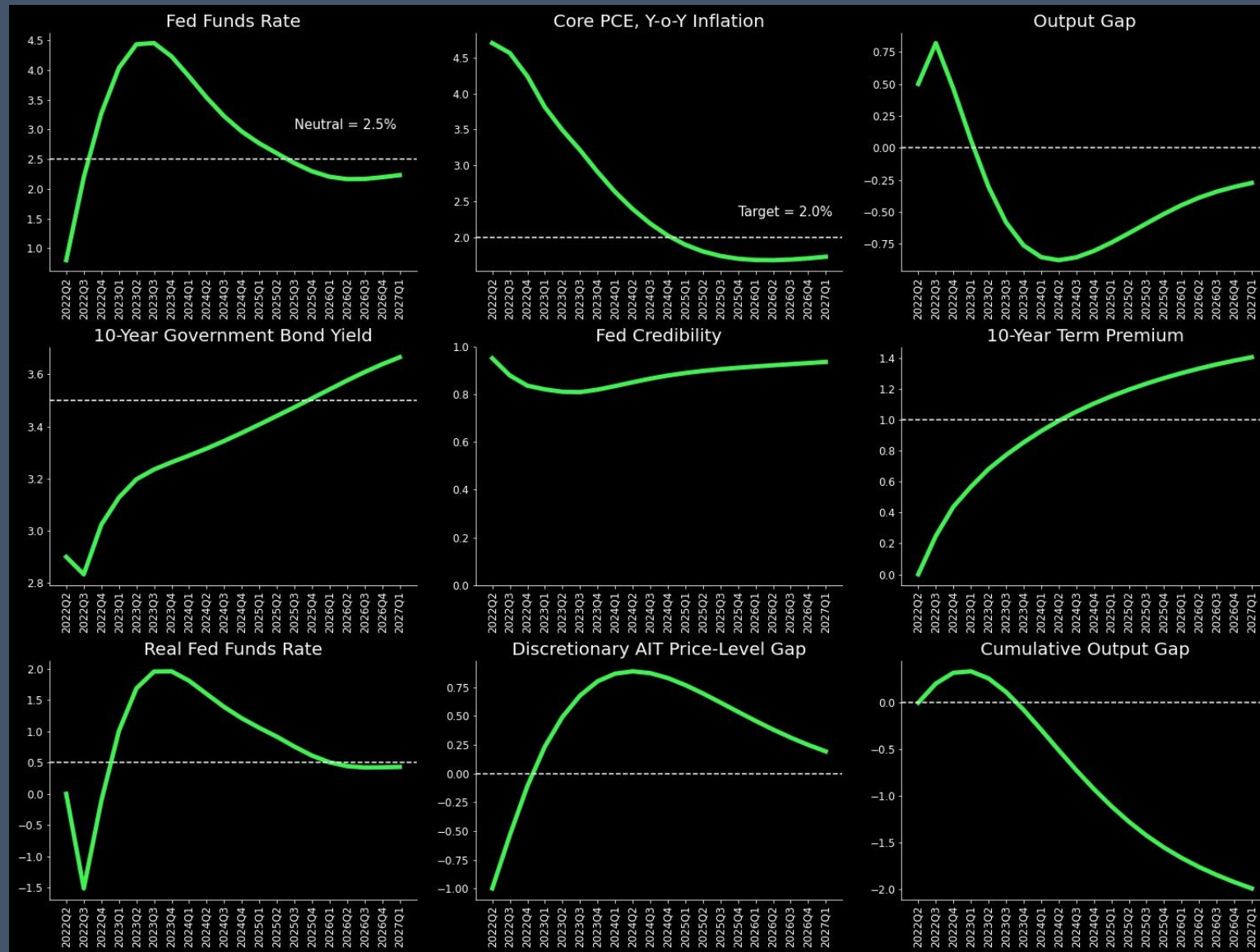


As of September 30, 2022

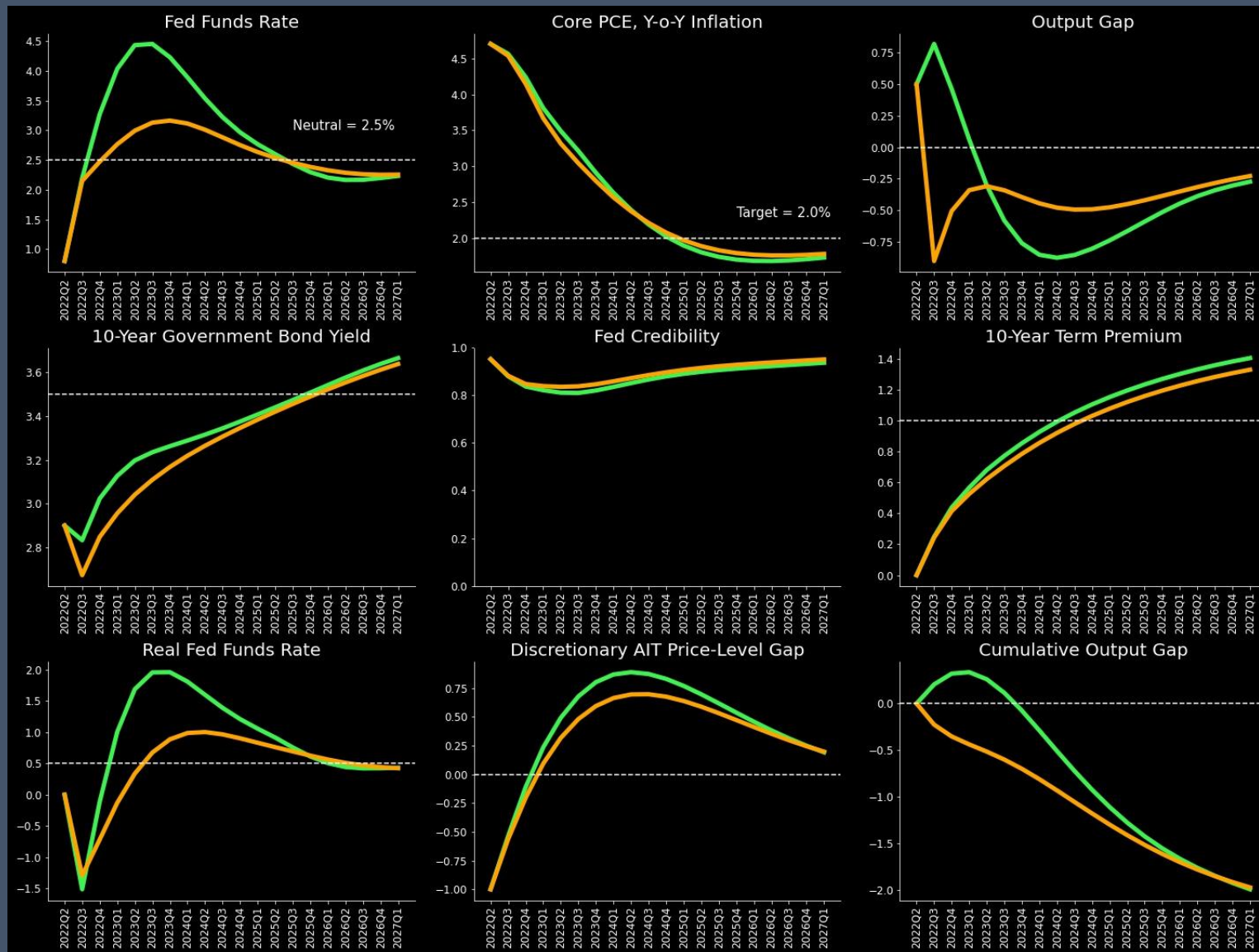
Source: Federal Reserve Bank of Atlanta



# Case A: Persistent Inflationary Pressures

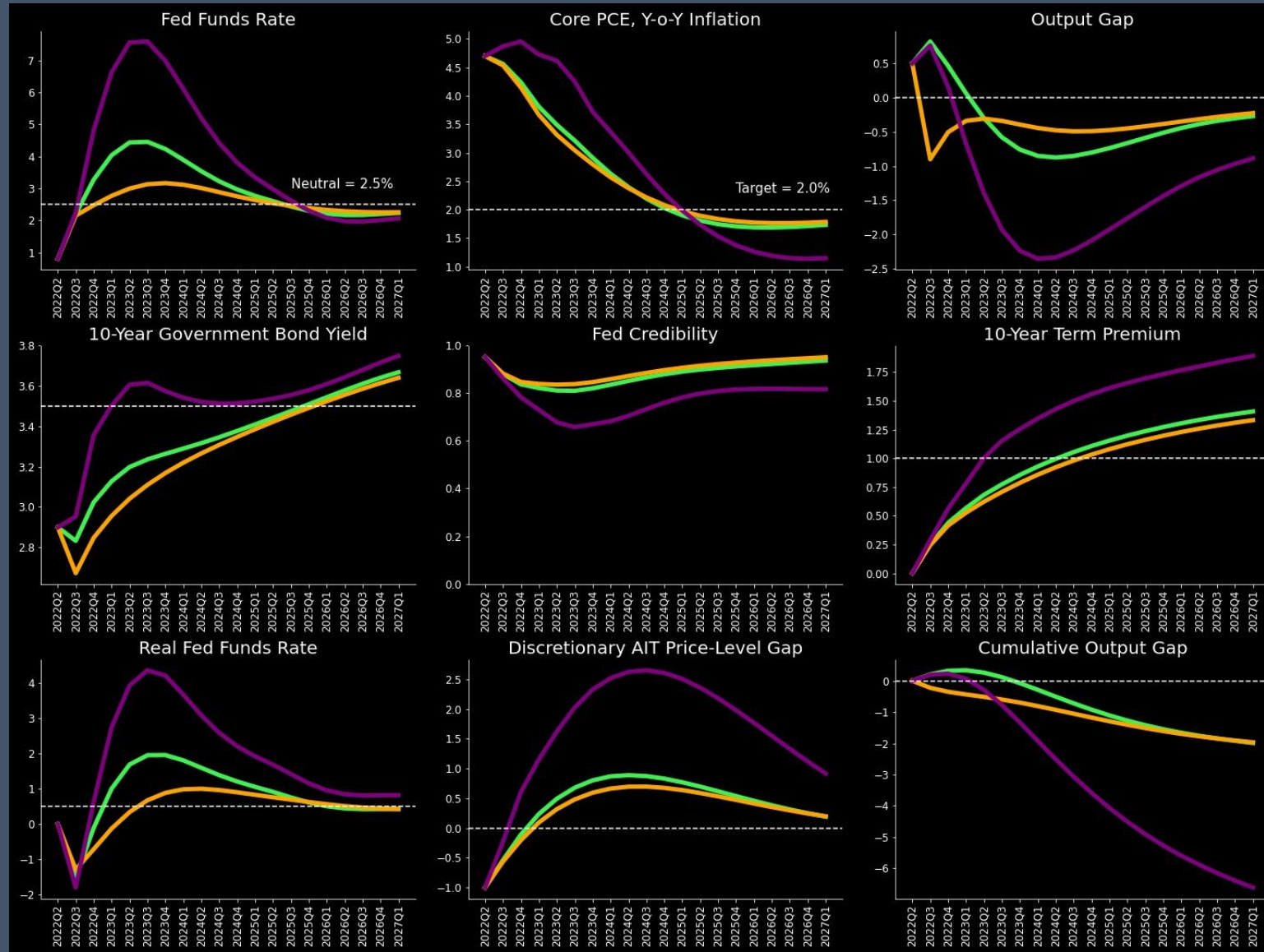


# Case B: Economic Slowdown





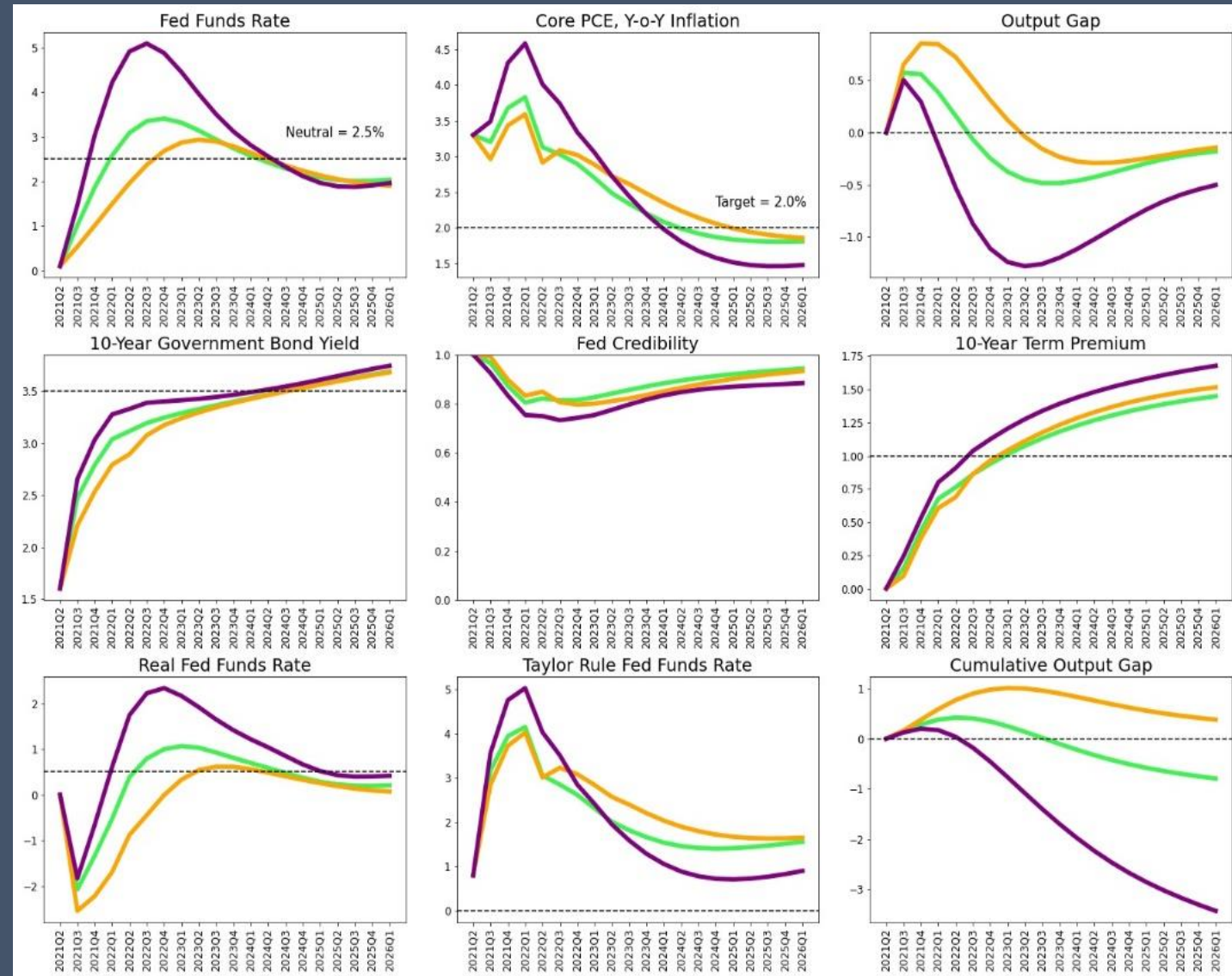
# Case X: Higher Underlying Inflation



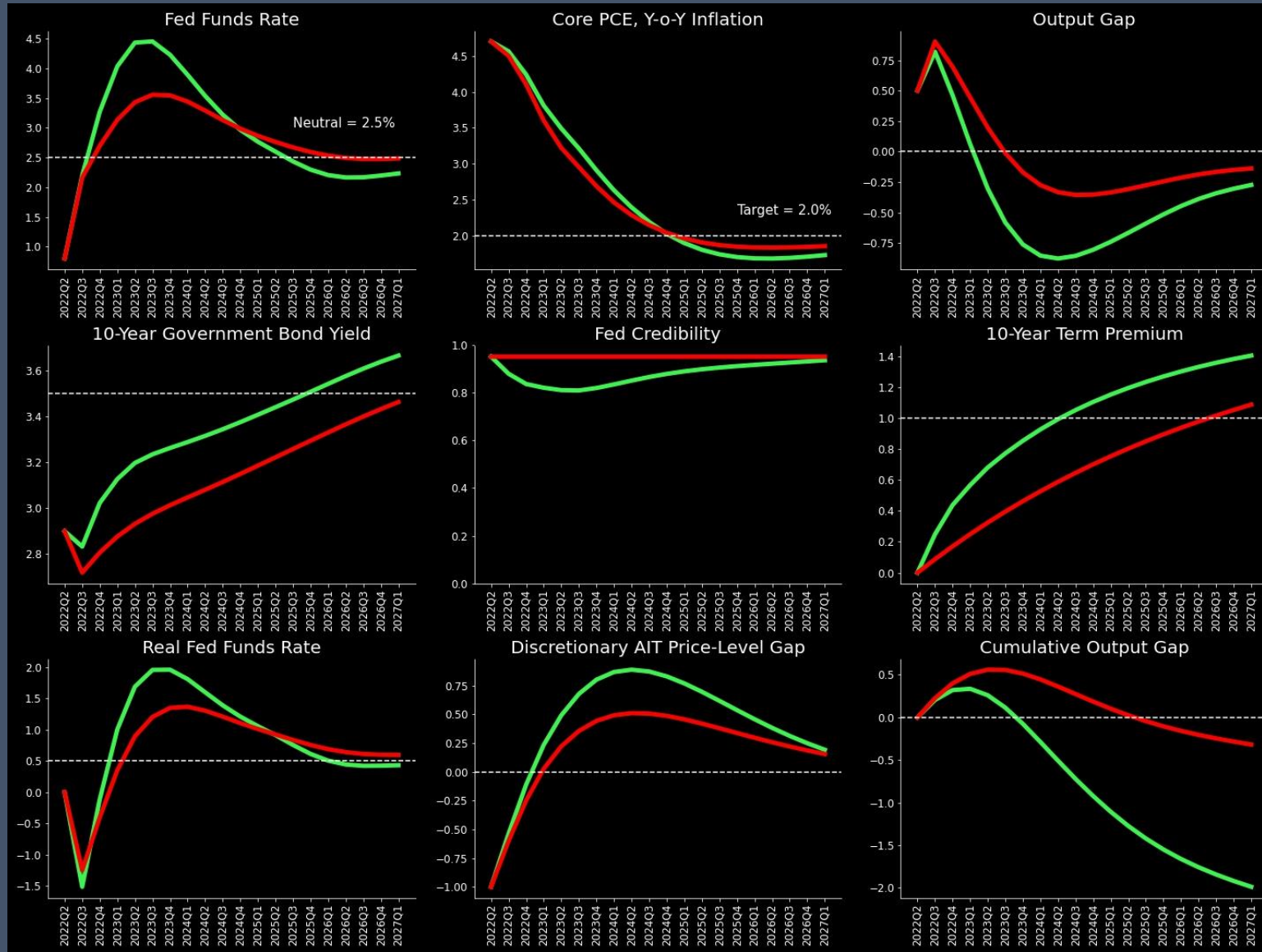
# FPAS Mark II Would Have Made Summer 2021 So Much Easier



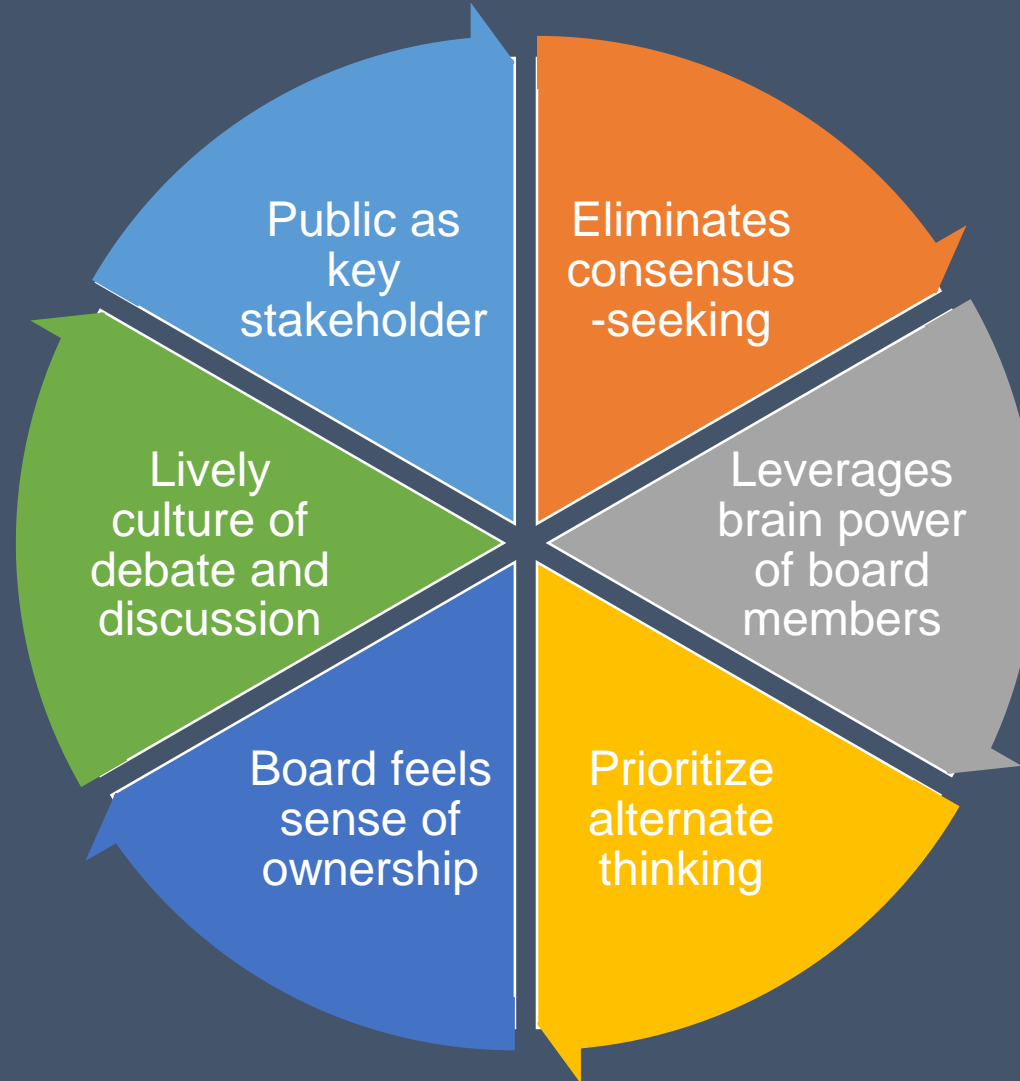
Key metrics for  
 Case A  
 Case B  
 Case X



# Endogenous vs Exogenous Monetary Policy Credibility



# Policymaking Process is Riddled with Organizational Problems—How Do We Solve Them?







Thank you