

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

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Abstract

The major challenge facing central banks today is the inability of existing policymaking frameworks to adequately deal with significant and increasing uncertainty. While the Forecasting and Policy Analysis System (FPAS), used by leading inflation-targeting central banks, has been successful in introducing a systematic strategy and framework for analyzing and describing policy decisions, it is unable to deal with this problem of uncertainty, due to what we term its “folly in baselines and local approximations.” This paper argues that “monetary policy as risk management” (MPRM) is the appropriate method for conceptualizing forward-looking monetary policy in situations of significant uncertainty. Specifically, this paper proposes a new policymaking setup—“FPAS Mark II”—that combines successful parts of the institutional framework of Mark I systems with an MPRM approach to dealing with uncertainty. FPAS Mark II shifts the policymaking focus from optimizing the policy path for the most likely (baseline scenario) future to a multiple-scenario-based approach that is more relevant to economic realities and better able to challenge the prevailing wisdom that results in policy inertia.

Importantly, the shift to a scenario-driven approach allows the central bank to move away from its “expert forecaster” role of trying to predict most likely outcomes, and instead focus its efforts on its “risk manager” role of avoiding what Olivier Blanchard terms “Dark Corners” and dealing successfully with situations of great uncertainty—the essence of

good policy.

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