

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

Discussion

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5 July 2023

Discussion outline

Bank of Russia current FPAS practice

Decision-making vs communication

Regulators as risk managers

Model projections and BoR baseline forecast

- ▶ Quantitative **model projections** by (1) Monetary Policy Department, (2) Research Department and (3) 7 regional HQs (GUs, glavki)
- ▶ **Departments** present their **baseline projections** for Russia alongside with **several alternative trajectories**
- ▶ **Regional HQs** present baseline projections for their respective macro-regions, a “**bottom-up reality check**“ against the Departments’ top-down assessment
- ▶ Published **BoR baseline forecast** is the **collegial opinion of the Board on the central tendency**, which emerges from the evaluation of the presented projections and their respective likelihoods
- ▶ In the frame of FPAS Mark II, published BoR baseline forecast represents the **range between Case A and Case B**

Model projections and Case X

- ▶ **Case X** of FPAS II lies **outside of the central tendency**, and illustrates the **most fat-tailed risk *du jour***
- ▶ It depicts the **skew in the balance of risks** relative to the baseline described by the Case A to Case B range
- ▶ Alternative scenarios presented by the Departments **always** include **one or more Case X-type studies** (large new shocks, different assumptions about steady-state, parameters of policy transmission, etc)
- ▶ The Board's assessment of the balance of risks to the central tendency resulting from evaluation of these cases is **qualitatively** summed up in the press-release with indication of (1) the net direction of the skew wrt inflation forecast and (2) principal sources of risks driving this skew
- ▶ **Quantitatively** BoR details Case X-type scenarios in the **annual Monetary Policy Guidelines** to illustrate what kind of monetary policy path may be required to maintain/restore price stability under these circumstances

In Wim Duisenberg's words...

“Transparency requires that **our [external] communication closely reflects our internal decision-making process**. Adopting “too simple” a form of presentation would not honestly convey the complexity of the analysis we have to conduct.”

Wim Duisenberg, ECB President, 1998-2003, Letter to the Chairperson of the Committee on Economic and Monetary Affairs
European Parliament, 13 Dec 2001

Striking the balance (1)

Reservations

- ▶ General public desires certainty
- ▶ Too many scenarios may excessively shift attention to outliers
- ▶ Differentiation between sources of uncertainty (initial conditions, assumptions about shocks, assumptions about steady-state, model uncertainty)

Striking the balance (2)

Questions for further evaluation

- ▶ Which communication device is more efficient for conveying the nature of uncertainty to markets and public - (1) multiple explicit model-based trajectories or (2) range-based 'central tendency'?
- ▶ How frequently the central bank shall quantitatively communicate its Case(s) X?
- ▶ How the central bank handles the switch from one Case X to a substantively different one?

Regulators as risk managers

- ▶ Economic regulation is first and foremost about risk management, indeed
- ▶ Compensates for (1) limited planning horizon, (2) inherent optimistic bias, (3) ignorance of externalities/systemic risks arising from individual decisions
- ▶ Any regulator exhibits a **higher attention to risk than an average/median economic agent**
- ▶ Misperceived as an unduly elevated risk-aversion, in reality this is a more somber and longer-term evaluation of the risk factors
- ▶ Only if regulator is more aware of risks and assigns higher significance to them than an average/median economic agent, the regulator shall be able to contain these risks arising from individual decisions and action of economic agents
- ▶ Explaining this to general public is an uphill battle though, but it is a very important part of our job)