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CCAMTAC Regional Webinar

"Armenia's New Risk-based Monetary Policy Framework"

November 13, 2024

Introduction and Moderation:

Mr. Norbert Funke, Director, CCAMTAC

Presenter:

Mr. Hayk Avetisyan, Director, Macroeconomic Directorate, Central Bank of Armenia

Interventions:

Mr. Umang Rawat, Resident Representative in Armenia, Middle East and Central Asia Department, International Monetary Fund

Ms. Tamta Sopromadze, Deputy Director, Monetary Policy Department, National Bank of Georgia

Armenia has recently introduced significant changes to its monetary policy framework. In 2024 the Central Bank of Armenia (CBA) adopted a risk management approach to price stability, known as FPAS Mark II. This new framework replaced the traditional baseline scenario with scenario analysis for decision-making and communication. The CBA conducts monetary policy within a risk management framework to analyze and communicate the uncertainty surrounding the economic outlook more effectively. Since the framework was launched recently, a profound assessment of it will require time and observation.

In his presentation, Hayk Avetisyan elaborated on the objectives and building blocks of the CBA's new framework. Following the pandemic and a succession of regional crises, policymakers recognized that this new period of heightened risk and uncertainty would require novel approaches to policymaking and communications. To address them accordingly, the new monetary policy approach was designed to analyze a robust set of scenarios that imply a higher or lower path for interest rates than is currently priced in financial markets. At the same time, to better orient the policy discussion and communication, the CBA would develop two or more illustrative scenarios. These scenarios should not be interpreted as pure risk scenarios but are meant to represent plausible paths for policy rates consistent with managing monetary policy risks and concerns in an individual's economic scenario. Rather than minimizing the uncertainty at hand, the framework is designed to help policymakers better deal with all types of uncertainty—including uncertainty about current and underlying economic conditions and the structure of the economy, as well as uncertainty stemming from statistical limitations during the decision-making process.

The main criticism of the conventional monetary policy framework, which relies on a single baseline scenario, is that it places excessive confidence in a narrow interpretation of underlying economic conditions and the policy outlook which becomes especially problematic in times of great uncertainty. Approaching monetary policy as a risk management exercise implies identifying and quantifying (where possible) the risks and associated costs for the economy to ensure low and stable inflation. By doing so, the central bank can avoid sliding into dark corners and dangerous nonlinearities. Overall, CBA's FPAS II framework includes a comprehensive rethinking of all key aspects of monetary policy design and implementation inside a central bank, including policy design and scenarios, decision-making, communication, board-staff interaction, analytical framework, organizational structure, and public accountability. The framework elevates the role of uncertainty and nonlinearities in analysis and communications and, by doing so, allows policymakers to be agile in responding to changing economic conditions and shocks.

Umang Rawat provided his views on the framework and potential challenges as a part of the IMF surveillance team for Armenia. It was pointed out that for CBA it was critical to launch all the building blocks of the new framework as a comprehensive package to ensure good implementation and effectiveness. Unlike similar frameworks used by other central banks, FPAS II incorporates uncertainties into the decision-making process. However, it also means giving up the central bank's baseline forecast. In addition, the scenario approach relies on market expectations and forecasts, which require a sufficient level of market development and an understanding of economic fundamentals. Market participants should have a good understanding of the monetary policy framework, which requires clear communication and information exchange. The new framework raises individual accountability of board members, which may be considered an advantage, but it also may entail some risks. Over time the experience with a risk-based approach will show how much additional agility can be achieved by the CBA.

In her intervention, Tamta Sopromadze mentioned that uncertainty has been elevated in the region since the pandemic and this resulted in frequent and significant deviations of baseline forecasts from the actual developments, which among other things could be explained by structural changes in the economy. The biggest challenge for the monetary authorities is to avoid 'dark corners', i.e. extremely unfavorable outcomes for inflation and the economy. While the National Bank of Georgia uses FPAS I, it also has some elements of FPAS II, which allows the bank to be more prudent in decision-making. Having several risk-based scenarios can give the central bank more credibility. That said, for the monetary policy framework with a risk-based approach to be successful it requires maintaining good communication with commercial banks that will ensure understanding of all possible reaction functions of the central bank.

During the Q&A section of the webinar, speakers received questions about (i) the CBA's swift reporting on the monetary policy committee decision and challenges associated with it, (ii) the incorporation of behavioral principles in the risk model, (iii) the extent to which unemployment is featured in CBA's new framework.