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THE BETTER POLICY PROJECT
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Principles 3 & 4:

MP and Other Policies — The Inflation–Output Trade-Off

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Hello everyone, I'm **Susanna Grigoryan**, an economist at the **Central Bank of Armenia** and a **Level One student at the Global Forecasting School**. In this video, we'll continue our exploration of the key principles that define credible and effective monetary policy frameworks. Today, we'll focus on **Principles Three and Four** from *Freedman and Laxton (2009)* — principles that deal with **policy coherence** and the **Forecasting and Policy Analysis System**, or FPAS.

While the first two principles emphasized the importance of a clear nominal anchor and internal consistency, these next two principles explain how monetary policy interacts with the broader economy, and how central banks organize themselves to make coherent and credible decisions.

Monetary policy never operates in isolation. Its effectiveness depends on a coherent macroeconomic policy mix — especially the relationship between monetary, fiscal, and structural policies. Just as important, a central bank needs a strong operational framework that links analysis, judgment, and communication. When these elements work together, the central bank speaks with one voice, and its policy signals remain consistent across time and circumstances.

Let's start with Principle Three — policy coherence across government.

Freedman and Laxton emphasize that inflation targeting can only succeed when fiscal and structural policies support the same long-term objectives. If fiscal policy is sound and sustainable, it strengthens the credibility of the central bank's commitment to price stability. But when fiscal or exchange-rate policies move in the opposite direction, credibility erodes and monetary policy becomes less effective.

In practice, coherence is achieved through cooperation, not direct coordination. Monetary and fiscal authorities must share a common understanding of the economic outlook and ensure that their policies complement one another. Each policy area can remain independent, but they should work in harmony toward overall macroeconomic stability.

In exceptional situations — such as during a financial crisis or when interest rates are constrained by the effective lower bound — temporary coordination may be needed to prevent deflation and support recovery. After the global financial crisis, large economies like the United States showed how fiscal and monetary policies could work together to stabilize demand and restore confidence.

Even outside of crises, mutual awareness and communication between authorities are essential. Coherent policies reinforce each other, while conflicting signals can undermine everything.

The experiences of Canada and New Zealand illustrate this principle clearly. In Canada, following the 1991 announcement of the inflation target, credible fiscal consolidation amplified the effectiveness of monetary policy. The government's commitment to sustainable budgets gave the Bank of Canada the space to focus entirely on achieving price stability — free from concerns about fiscal dominance.

In New Zealand, coherence took a slightly different form. The Policy Targets Agreement between the government and the Reserve Bank established shared accountability for achieving the inflation target. This institutional design ensured both sides worked toward the same long-run objective, supported by open communication and transparency.

As Freedman and Laxton point out, coherence does not mean control. It's about alignment of goals, not control of instruments. Monetary policy must remain operationally independent, but independence works best when supported by responsible fiscal and structural policies that point in the same direction.

Now let's move to Principle Four — the Forecasting and Policy Analysis System, or FPAS.

This is where the principles we've discussed so far turn into practice. FPAS is the institutional mechanism that ensures policy decisions are coherent, disciplined, and credible. It brings together models, expert judgment, structured decision-making, and clear communication — creating a unified process through which a central bank forms its view of the economy and decides on policy actions.

According to Freedman and Laxton, FPAS has four essential components.

First, a quantitative model that links policy instruments — such as the policy interest rate — to inflation, output, and other key variables.

Second, a forecast process that integrates model-based projections with expert judgment and alternative scenarios.

Third, a structured decision-making cycle, which includes forecast rounds, internal policy discussions, and publication of reports.

And **fourth**, a communication strategy that ensures consistency between internal analysis and what the central bank tells the public.

Together, these components form the operational backbone of modern inflation-targeting regimes. FPAS allows central banks to manage uncertainty, update expectations in real time, and coordinate effectively across departments — ensuring that everyone works from a shared analytical framework.

The first generation of FPAS systems, developed at the Bank of Canada, showed how disciplined processes could reinforce credibility. The system linked forecasts, models, and communication into one coherent policy cycle. Later, other central banks adapted and refined the approach. New Zealand's Forecasting and Policy System (FPS) and the Czech National Bank's modeling work extended FPAS to small open economies, demonstrating that even in uncertain environments, consistent analysis and transparent decision-making can strengthen credibility.

As Adrian, Obstfeld, and Laxton (2018) later showed, countries that adopted FPAS frameworks achieved smoother policy cycles, clearer communication, and better integration between fiscal and monetary policy.

Over time, these systems evolved into what we now call FPAS Mark II.

FPAS Mark II builds directly on these earlier systems but is designed to handle today's more complex challenges — things like nonlinear dynamics, global spillovers, and constraints from the lower bound on interest rates. The modern approach emphasizes prudent risk management within the FPAS discipline.

That means identifying risks systematically, quantifying uncertainty, and designing policies that minimize regret under a range of possible outcomes. This shift allows policymakers — especially in emerging markets — to operate with greater confidence and transparency, even when the future is uncertain.

In Armenia, this evolution is especially important. The Central Bank of Armenia's FPAS Mark II framework embodies these same principles. It combines model-based discipline

with flexible, forward-looking analysis. It integrates the best international practices while adapting to the realities of a small open economy. And it ensures that every forecast, every discussion, and every policy decision contributes to a single, coherent vision for price and financial stability.

So, to summarize: Principles Three and Four remind us that monetary policy is most effective when it is coherent with broader government policies and when it operates through a disciplined analytical framework like FPAS. Coherence ensures alignment and credibility. FPAS provides the structure and process that transform analysis into action.

Together, they make monetary policy not only credible — but truly effective.

In our next video, we'll turn to Principles Five and Six, where we'll explore flexibility and transparency — the final ingredients of a modern, resilient monetary policy framework.

Thank you for watching, and I look forward to seeing you in the next episode of the CBA Academy.

See you there.

Literature & Further Reading

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