

RESILIENCE AND STRATEGIC ADAPTATION OF MONETARY POLICY IN THE INCIDENCE OF EXTERNAL SHOCKS (LITERATURE REVIEW)

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Abstract: This paper represents a literature review, and examines the strategic adaptation of monetary policy under the influence of external shocks in small open economies, as well as its capacity to support economic and financial resilience, depending on the type of shock and other influencing factors. The article is structured as a theoretical synthesis composed of a review of the literature and policy practices' evidence. The main focus of the study consists of exploring available monetary policy tools' capacity to tackle the external shocks affecting key transmission channels.

Special attention is given to the operational and institutional constraints alongside policy trade-offs associated with the effective conduct of monetary policy in current external conjunctures, marked by high uncertainty, interdependence, and mixed geopolitical trends. While the topic is intensely discussed by academia and policymakers, literature offers a relatively limited comprehensive approach and a conceptual insight into these challenges, in particular with direct relevance for small open economies, characterised by specific structural features such as limited capital mobility, partial exchange rate flexibility, and often opaque transmission mechanisms; this study is an attempt to contribute to that particular (sub) field of study.

The conclusions are multifold; first, there is no universal framework capable of fully absorbing external shocks in such contexts, but there are limits of monetary policy which can be tried to be overcome. Rather, a flexible and adaptive policy mix appears to have positive contribution to achieving its objectives - one grounded in rigorous macroeconomic understanding of the current situation, supported by institutional credibility, and coordinated closely with the general economic growth strategy of the state.

Keywords: *External shocks; Small open economies; Monetary policy transmission; Macroeconomic resilience; Policy coordination; Imported inflation.*

JEL Classification: E52; E58; F41; F44; H12; O23.

Introduction

The topic of adaptation of monetary policy in addressing the external shocks is becoming increasingly relevant in the contemporary context. In recent years there have been witnessed modifications in economic alliances' trends, emerging monetary unions and geopolitical blocks and fragmentation, however, globalisation continues to produce its multiple effects on economic

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and financial relations alongside with transformative advancement of digitalisation and technologisation (Aldasoro *et al.* 2024, Bullok, 2018). Thus, the relevance is supported not only by the increasingly interconnected world, dynamic technological progress, extensions of the central bank's mandates with modern international policy agendas, but also in the context of the recent shocks that economies have recently experienced - the sanitary crisis generated by the Covid-19 pandemic and the geopolitical events, which have reflected in prices of raw materials, directly and indirectly affecting the prices composing the consumer's basket.

Developing small open economies are exposed to external sector events that plausibly aggravate historically existing macroeconomic imbalances and pose additional risks to the financial stability, subsequently producing direct, indirect and, sometimes, costly effects on both the economic and social environment in a country. If not managed effectively, macroeconomic instability, frequently rise social and political problems, affecting other dimensions essential to the quality of life of the population, such as trust, competitiveness, safety, migration, environmental quality, food security and others, which in turn continue to reinforce and deepen existing unstable economic situation.

The vulnerability of small open developing countries is also enhanced by their widespread reliance on international trade and foreign capital inflows that transmit shocks via a number of channels. Given the circumstances of the global economic volatility that has been characterized by extensive fragmentation, volatility in the financial, energy, and trade markets, and recession risk, it is imperative that these nations respond differently so that they become more resilient and sustainably develop.

Even though historically monetary policies operate under presumption of long-run neutral and medium-term demand stabilisation, the recent global events and trends re-bring in their focus supply-side considerations (Babura *et al.* 2024,.) and reopen professional and academic discussions regarding its influence on long-term rates and household consumption decisions (Kovanda, 2025). This approach was a challenge for central banks during the two recent major crises, the global sanitary crisis and the so-called energy crisis, because the instruments of modern central banks are not adapted to the associated shocks, especially given that the last two decades have been marked by relatively modest inflation.

The main purpose of this study is to explore, trace and synthesise the development of the theoretical-conceptual framework that shaped the modern approaches of monetary policy in mitigating the impact of external shocks on price stability and economic growth applicable in contemporary emerging market economies.

The main goal is intended to be achieved by applying the research methodology, consisting of review and analysis of literature. The argumentative body of the article's narrative is expressed predominantly dialectically - synthesis, and progressively - analysis.

The role of the central bank and monetary policy in assuring resilience in face of external shocks

Any discussions about macroeconomic management of shocks, inevitable will resume to its two main pillars: monetary policy and fiscal policy. After the recent so-called sanitary crisis and energy crises macroeconomists question the leadership of one or another. Unquestionable remains the ability of the two in dealing with macroeconomic stabilisation. The trends of recent years call for closer coordination of those policies (Drahi, 2014), which currently meets a range of practical implementational challenges in different types of settings, be it monetary unions, federations, advanced or economies in developing phase.

History shows that forceful monetary policy responses efficiently contributed to restoring stability in advanced economies (BIS, 2024). Brunnermeier (2023, p.6) names central banks as "directors" of modern economies, emphasising monetary dominance, based on the independence of central banks, with which they are invested by law. Moreover, in his analysis, which apparently

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refers to central banks in developed countries, the author supports the idea of central banks setting policies that actually extend their historical role, including setting policies that can stimulate the economy, focus on achieving social objectives, promote financial inclusion and the transition to resilience and sustainability.

Monetary policy theoretical framework alongside the economic thought, as well as its interpretation, progressed through numerous theoretical cycles since their foundation, with each school of thought and current contributing with distinct perspectives on monetary phenomena shaped by their historical and geographical contexts. Contemporary monetary policy frameworks were formed selectively from various theoretical and operational traditions to address the specific challenges of external shocks.

Macroeconomics is a relatively a “young science” (Pişchina, 2012) and given the progress in research, it is natural that there are different and even contradictory opinions, each formed on the basis of assumptions or input data. Monetary theory in the field of economics includes a plurality of ideological perspectives contrary to a single approach. At the same time, the respective competences and subsequently the instruments applied are determined by the regime, strategy and objective of monetary policy. Historically, various schools and currents of thought prioritised different factors and mechanisms defining the price level, respectively, consistently promoting different, individual policy interventions, for each of the distinct challenges that economies faced at certain periods in certain geographical spaces (Scepanti and Zagmani, 2005, p.8).

The prism through which the evolution of economic thought itself should or can be viewed and analysed is a separate research topic, but it is certain that it is in a continuous and multidimensional movement and should be viewed according to the relative importance to the theoretical basis of contemporary central banks.

Keynesian theory, born in an advanced economy, in a specific economic context, applicable to an advanced economy, emphasises the role of active economic policies in managing business cycles and mitigating external shocks. Keynes (1936) argued that in periods of recession, insufficient demand can be stimulated by expansionary monetary policies, by lowering interest rates to encourage investment and consumption.

Irving Fisher, the influential American economist, argued that inflation can be avoided or controlled by monitoring and adjusting the money supply by monetary authorities. Monetarists, starting with Friedman (1968), argue that monetary policy should aim to stabilise the money supply, arguing that inflation is always and everywhere a monetary phenomenon. Both Fisher and Friedman approached the problem of inflation and monetary policy from different perspectives, both made significant contributions in the development of economic thought and in influencing contemporary economic policies. According to Friedman (1968, p.14), first of all, the monetary authority should base its decisions on factors it can control, such as exchange rates, price levels, or monetary aggregates, instead of relying on variables it cannot control.

Additionally, monetarists advocate for steady policy implementation arguing that the monetary authority should avoid abrupt changes in policy direction, and even moderate inflation or deflation is preferable to erratic fluctuations potentially leading to instability (Friedman, 1968). This idea, transposed to external shocks, suggests measured rather than aggressive responses to external shocks. Following this approach, monetary policymakers today would meet the issue of uncertainty related to knowing the duration of the shock and its effects, moreover, macroeconomic shocks typically exhibit two phases of effects (Bloom, 2009, p.624), the severity, direction and length in time of which is typically challenging to predict.

Evolving in distinct directions conceptually and chronologically, Post-Keynesianism and New Keynesianism, represent two different economic schools of thought that stem from the ideas of John Maynard Keynes. Post-Keynesianism, which began to develop in the 1950s and 1960s, focuses on economic uncertainty, financial instability, and supports government intervention,

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sceptically viewing the concept of self-correcting markets. While the New Keynesian Economics, popularised in the 1970s and 1980s, try to combine Keynesianism with aspects of neoclassical economics, such as rational expectations and mathematical modelling, focusing on price and wage rigidities, and the role of monetary policy in stabilising the economy.

The Post-Keynesian school adds the importance of financial institutions. Post-Keynesians comes with idea that the markets are not always self-correcting and to ensure economic stabilisation and employment goals, there is a need of state action, including in form of monetary and fiscal policies (Arestis, 2010). Post-Keynesianism bring doubts in the idea of the neutrality of money, and underline the central bank’s central role of managing the supply of credit and stabilising the financial system.

The first macroeconomic models appeared in 1950s and were based on Keynesian theory, since then central banks employ extensively to analyse, test, model and forecast shocks to the economy. The New Keynesian approach combines Keynesian elements with microeconomics. It involves using the principles and theories of microeconomics to explain and build models of the larger economy, or macroeconomics. These models attempt to integrate individual behavior, market frictions and rigidities, and expectations into the analysis of macroeconomic phenomena, providing a deeper and more nuanced understanding of the economy. Based on Clarida, Gali, and Gertler (1999), it can be argued that monetary policy should respond to shocks by adjusting interest rates according to deviations of inflation from target and the output gap, suggesting that central banks can use interest rate policy to cushion the effects of external shocks on the economy. The authors conclude (Clarida *et al.*, p.78) that a better understanding of the macroeconomics and the determinants of inflation is important and place the persistence of inflation among the important considerations in its relationship with the adaptability of the labour force and economic growth. At the same time, the authors indicate that their research was based on closed economies and in a broader perspective external factor should be taken into account. This study also has another limitation in terms of its relevance for developing small and open economies, because they usually face a higher, persistent level of inflation, and other characteristics that determine that the monetary frameworks in these countries are not primarily focused on the analysis through the prism of business cycles, the real marginal cost, including labour, or even the economic growth/product versus inflation ratio, given that the monetary policy regime will be ignored.

Finding the balance between the rule-based and discretionary approach to monetary policy is one of permanent debates among economic policymakers and scholars. This debate was significantly influenced by the work of Kydland and Prescott (1977), who supported the rules-based, stressing that discretionary policy can lead to suboptimal outcomes due to time inconsistency problems.

New Classical Economics, represented by figures such as Robert Lucas (1976), bring in focus the rational expectations and the idea that monetary policy influences nominal variables, but not the real ones, in the long run. Lucas criticised traditional macroeconomic models for giving way too little weight to the role of rational expectations in economic agents' decisions. This school argues that predictable, rule-based monetary policies are preferable, because discretionary policies can be counterproductive due to their effects on economic agents' expectations.

The evolution of theoretical frameworks supporting modern monetary policy is by far non-exhaustive, that also wasn't the aim of this study. For example, during this same period, the Austrian School of economics advocated for spontaneous market mechanisms while avoiding government economic intervention. Austrian economists contended that central bank manipulation of money supply creates artificial business cycles and distorts markets. However, narrowing the focus to the structural characteristics of emerging market economies that matter for responding to external shocks, it is reasonable to stop here, as New Keynesian models have become widely adopted by mainstream central banks around the globe.

Monetary policy adaptation and associated structural challenges

Prominent contemporary economists, characterise the current situation as one where the main role in the economy belongs to the central bank (Brunnermeier, 2023 p.6)), facing conflicts with fiscal and financial stability policies; the author stresses that the "intellectual framework" of central banks in developed countries adopted after the 2008 financial crisis is still in force, but there are already signs that it will undergo changes, which can potentially lead to the unanchoring of inflation, that can have consequences on both aggregate demand and supply. Developed countries, showing relative stability, in the last three decades have been facing deflationary threats, this has led to the adaptation of monetary policy frameworks, including its instruments, such as, for example, the introduction of unconventional instruments, the data-based approach to avoid tightening monetary policy at the expense of lost economic growth. But major external shocks, which came with disruptions to supply chains, have shown that government policies, including fiscal policy, affect both market developments and central bank independence.

Recent developments in structural monetary policy tools provide additional perspectives on shock management. Guo (2022) examines how the People's Bank of China employs structural monetary policy instruments to address sectoral shocks and support specific economic segments, demonstrating that targeted tools can complement traditional monetary policy in managing heterogeneous external impacts on different sectors of the economy.

Referring to the focus on resilience and sustainability, as the theory and practice of monetary policy continued to develop, political and economic discourses and analyses to describe the objective of central banks or governments to moderate economic growth and prevent inflation, without triggering a recession gained more place. The idea of this, called "soft landing", is closely linked to macroeconomic theories and the practice of business cycle management, which evolved significantly in the 20th century. Thus, contemporary monetary policies, were refined through the work of economists of more than one school, including Monetarist School, as well as through the contributions of the Keynesian School, which emphasised the role of government in moderating business cycles. A "soft landing" is seen as an optimal goal in business cycle management, representing a balanced transition from overheating, while ensuring financial stability and maintaining low unemployment. Monetary policy plays a key role in trying to achieve a "soft landing" by adjusting the money supply and borrowing costs to influence consumer spending and business investment. Global financial crises, pandemics, sudden changes in commodity prices or geopolitical conflicts complicate the central bank's mandate in achieving soft landing objectives, but the risks of this landing remain to be balanced, given the aim to maintain stable growth of demand and labour productivity.

The complementary objectives of maintaining macrofinancial stability, climate agendas, gender balance, digitalisation in a way or another complement today's central bank mandate, with each central bank deciding on its own approach to policy priorities and tools. However, the main objective of price stability remains central, alongside with primary macroeconomic stabilisation.

The Republic of Moldova showcases an example of the structural fragilities typical of small, open countries that conduct inflation-targeting policies. A high dependence on energy causes important exposure to external price shocks, while weather events frequently harm agricultural activity, reflecting in food prices and destabilising growth. Persistent trade imbalances indicate stronger import demands vis-à-vis limited export potential. Although financial sector is enough capitalised to withstand financial frictions, stress of sectoral rapid credit growth and surging immovable property prices amidst supply constraints point towards possible property market overheating. Currency stability demands maintaining enough foreign exchange reserves for cushioning emerging risks. Fiscal sustainability in a large proportion dependent on the externality of foreign assistance that limits revenue generation and create fiscal space constraints. Institutional reforms have gone far, while central bank operational credibility is further required in terms of the

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expectation channel. Although EU accession path adds some clarity, geopolitical and economic uncertainty still makes policy forecasting difficult. These type of structural issues pose policymakers into situation to solve policy trade-offs between inflation restraint and growth goals, amidst the containment of external shocks when policy space face multiple operational and institutional constraints.

Cuhal (2012, p.85) explores details regarding the prioritising of a certain type of objective by the central bank in a small open economy; this would depend on the level of significance that the monetary authority attributes to the factors, with regard to external factors, the central bank chooses in which direction to focus its forces, either on the interest rate, to open the financial market to foreign flows, or on domestic credit to direct domestic demand and the volume of exports. The differences in approaches addressing the most recent crises which generated external shocks to domestic economies, were observed, when during the Covid-19 pandemic, different central banks acted differently and at different points in time to respond to the associated shocks (Cociug and Ialaia, 2023).

Adaptation of policy starts with a clear image on the current situation. Clearly understanding the effects of external shocks on macroeconomic conditions are a complex topic, involving the analysis of how economic, non-economic, or global policy and non-policy changes influence monetary policy decisions at the national level. The complexity is conditioned by many factors, such as the limits of traditional or existing frameworks to analyse the macroeconomic condition, the necessity to apply microeconomic view, where it could become more difficult to disentangle and link a particular event with the outcome in the macroeconomic landscape, this is clearly seen for example in an attempt to define a exchange rate volatility pass-through to inflation.

Monetary policy researchers and monetary policymakers re-brought the issues of limited capacity of current analytical frameworks recently under discussion due to the nature of recent major shocks which monetary policy cannot ignore. Banbura *et al.* (2024) argue that due to the supply-side nature of external shocks on prices, current models should include more of those supply side factors into analysis models by going beyond analysing traditional shocks on oil prices, by including gas prices and supply chain bottlenecks. The complexity in analysis is aggravated for a developing economy due to historical operational and institutional constraints of monetary policy which are different in their nature. Studies (Ghosh *et al.*, 2012, Selvarajan *et al.*, 2020, Antohi *et al.* 2003) directly or indirectly mention that emerging market and developing economies tend to be less financially integrated by having limited capital mobility, financial markets' immaturity (wide current account deficits, lower integration in global financial markets (translated into less access to finance but also less of contagion risks linked to financial crisis), weaker governance, conflict of policy objectives, more opaque monetary policy transmission due to dollarisation and role of exchange rates in expectations, as well as typically higher informal economy rates than more advanced economies.

These country characteristics reinforce a standalone problem associated with data availability and quality. Emerging market economies from the operational point of view lack of granular data, long time series and even the lack of certain type of data that make it challenging to analyse and have a clear event-effect diagnosis.

Those structural aspects, represent challenges of the time and necessitate a detailed approaches that address the problems an all levels.

Conclusions

An efficient monetary system is essential for maximising the use of capital and labour resources, thus generating real economic growth and prosperity (Pișchina, 2012, p.207). In context of this study, an efficient functioning of the monetary system presupposes the ability of the central bank to maintain resilience by acting flexibly, timely and appropriately in times of economic fluctuations, provoked by both by internal and external factors. For the developing small open

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economies, which, due to their deeper economic and financial dependence the international markets, are often more exposed to global economic events, and where the effects of such events are prone to manifest greater negative influence, this ability is vital.

The evolution of economic thought and the theoretical underpinnings supporting the monetary policy framework within macroeconomic policies have predominantly been shaped adapted to the geographical and temporal contexts prevailing at the time the respective methodologies were developed. The recent significant external shocks have underscored that no singular theoretical framework is capable of adequately gauging all complexities, particularly those arising from the non-monetary sector and supply-side shocks. Effective shock management would more appropriately hinge upon flexibility, coupled with a credible framework, rather than dependence on a specific doctrine. The emergence of unconventional tools, the integration of macroprudential policy with monetary policy, as well as structural monetary policy instruments, as evidenced in economies such as China, implies that targeted interventions may serve to augment traditional instruments when shocks disproportionately impact certain sectors. From this analysis, it can be concluded that the theoretical frameworks in economics, ranging from classical monetary theory to Post-Keynesian and Monetarist Schools, provide diverse perspectives and considerations for economic stabilisation. The contemporary and continually evolving new-Keynesian approach, along with its subsequent refinements, has become a prevalent "lens" through which to examine the macroeconomic conditions and to model shocks within a monetary policy framework. This underscores the necessity for timely identification of the nature of uncertainty shocks and the meticulous design and calibration of the appropriate policy mix, contingent upon the formally assigned mandates of the authorities regarding price and financial stability.

Contemporary central banks operate under multiple objectives and goals complementing the main goal of price stability. Therefore, a proactive monetary policy with well-calibrated models is expected to create a good base for counteracting inflationary effects, stabilising the economy and be aligned with the general economic growth strategy of the state. In addition, a stable and predictable economic environment accompanied by effective monetary policy supports economic growth. For the developing small open economies, the aspects are critical to ensuring resilience and capable of adapting and taking advantage of global opportunities, with no or limited negative impact of external events. The study reveals the necessity for a complex action, from the one side continuation of capital market's development, from the other, increasing the quality and quantity of relevant data, that help better understand macroeconomic interlinkages and improve informing timely policy decisions.

It is clear that in real life and modern conditions, achieving the main objective of price stability with optimal costs to the economy by itself a challenging objective. This challenge is additionally compounded by the country's historical specificities as well as by the current world developments in geoeconomics, geopolitics, and technology. The uncertainty around the evolution of those processes serves a source for potential new shocks. Therefore, this task, nowadays requires a comprehensive multi-disciplinary approach, capable of highly calibrated policy responses to anticipate and respond effectively to rapid changes in the global economic conjuncture.

Particular structural features of the economies, as well as limits and constraints of existing monetary policy frameworks in which emerging market economies operate, pose certain constraints that limit its stabilisation capacity. Further research questions and practical challenges would lie not in pursuing optimal policies that assume away these constraints, but in developing resilient strategies that perform adequately across various shock scenarios defined by the uncertain global environment.

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