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MONETARY POLICY TRANSMISSION IN THE REAL SECTOR: CHANNELS, RESPONSES AND MACROECONOMIC IMPLICATIONS

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Abstract: The theoretical paper examines how monetary policy influences the real sector of the economy, focusing on the transmission channels through which policy actions affect the economic processes and decisions. The analysis aims at examining the mechanism of transmission of different channels, observe the empirical evidence and emphasise the limits and conditions for reinforcement and amplification of the effect of the analysed channels. The paper also looks at the economy of the Republic of Moldova, exemplifying a small open developing economy with internal structural and relatively high external vulnerabilities. This analysis completes the overview of the channels' functioning, and allows for tracing the validity and applicability of theoretical regularities and highlight asymmetries in the transmission processes characteristic for countries belonging to different territorial regions and different level of development. The analysis particularly addresses monetary policy implementation in the period marked by occurrence of major external shocks.

Another objective of the study is to explore the capacity of available monetary policy tools in contribution to external shocks management through key transmission channels such as exchange rate fluctuations, imported inflation, shifts in global demand, financial conditions, and foreign monetary stances, in the same time attempting to observe tendencies regarding the policy impact on real output. All of these channels affect the formulation and effectiveness of monetary framework and contribute to its potency for influencing growth, with some being more relevant for modern monetary policy in open economies with inflation targeting regime, which constitute the majority on the global level. In this context this paper observes and outlines the underlying patterns, which enable for better understanding how monetary policy influences economic growth through different channels. Although, since recent times, the topic has been widely discussed in academic and policy circles, the existing literature provides limited comprehensive approaches and conceptual clarity on these challenges, differences and particularly in the context of small open development economies, which are marked by series of particular structural characteristics, and often weak and opaque transmission mechanisms. This study seeks to advance understanding in this specific area. The paper employs a theoretical synthesis approach, systematically reviewing recent empirical evidence on transmission channels and applying this framework to Moldova's institutional context. The analysis underlines the importance of the topic for further research and contributes to a deeper understanding of how monetary policy transmits into real economic outcomes, and reinforces the necessity of building optimal policy frameworks to time- and country-specific conditions.

Keywords: *Monetary policy resilience; real sector dynamics; macroeconomic stability; external shock absorption; transmission mechanisms; economic adjustment; policy responsiveness; resilient growth.*
JEL Classification: E32; E52; E44; E61; O11; F41.

Introduction

Understanding how central bank decisions are transmitted to the real economy is a fundamental prerequisite for any policymaking process and coherent response to external shocks. In a small open developing economy like the Republic of Moldova, where various types of external shocks - trade, financial, energy or geopolitical - exert a decisive influence on macroeconomic dynamics, the simple mechanical adjustment of the interest rate or other monetary policy instruments proves insufficient. The monetary authority must have a deep understanding not only about the appropriate direction of its intervention, restrictive or accommodative, but also which channels would work in the most optimal way, with what intensity and over what period of time the intervention will be transmitted to the entire real and financial economy. Only in this way can monetary policy be adapted in a credible and efficient way to the specific nature of the external shock, avoiding both inaction that prolongs imbalances and overcorrection that amplifies volatility and generates excessive social and economic costs.

The stated goals of monetary policy, such as price stability, macrofinancial stability, and anchoring inflation expectations, are macroeconomic outcome variables that cannot be directly controlled by the central bank. Instead, the monetary authority influences a set of intermediate variables - the monetary policy interest rate, liquidity in the banking system, lending conditions, the exchange rate, the prices of financial and real estate assets, and the expectations of economic agents. This complex set forms what the economic literature calls the monetary policy transmission mechanism. Bernanke and Gertler (1995) demonstrate that the credit channel enhances the effects of monetary policy on the real economy by amplifying interest rate changes through borrower's balance sheets and bank lending. The implication is that models or policy frameworks that neglect this mechanism may underestimate monetary policy's overall impact, potentially compromising the central bank's ability to calibrate appropriate responses.

Analysis of the transmission channels, responses and macroeconomic implications of the monetary policy for the real sector

Recent literature delves deeper into the topic and reinforces the idea that the transmission of monetary policy to the real sector can take place through multiple channels, and is characterised by heterogeneity, sometimes also by twofold effects and non-linearity (for example in case of large shadow banking sector), implying that not all channels operate with the same strength or speed, and the magnitude of the effects depends on the financial structure, the structural characteristics of the economy and the macroeconomic context. Thus, recent research brings to the discussions the four most important channels of monetary policy transmission, viewed through the effort/effect relationship in the use of monetary policy instruments (Table 1). This study will examine some additional channels, sometimes classified as sub-channels of the four traditional ones, and provide more complete perspectives of their functioning, especially comparing developed economies to small open developing economies.

The first classic channel is the *interest rate channel*. Typically, in inflation targeting regimes of the economies with a relatively mature financial sector this channel is considered to be the most responsive and strong channel, as changes in the central bank's policy rate quickly transmit to interest rates on loans and savings, directly influencing the demand for money, through the influence on financing cost of investment and consumption. In a normal tightening scenario, the increase in the policy rate leads to the respective adjustments in consumer and business spending decisions, resulting in a reduction in the volume of loans, and to a decrease in the money creation capacity of banks. Empirical evidence shows that central banks rely on this channel the most, being

accessible, and quite effective in the short term. For instance, an increase in the Bank of England's reference rate in the period of 2023-2024 reduced household consumption and business investment, reflecting intertemporal substitution mechanisms and effects on cash flows (Burr and Willems, 2024).

Another important for the monetary policy channel, is the *credit channel*. Its main mechanism affects the *bank lending (bank-lending sub-channel)*, the importance of which increases when the share of bank financing in the total volume of financing is higher than non-bank financing, for example in bank-based financial systems. Therefore, the effects of this channel are best observed through the responsiveness of the credit supply to the changes in monetary policy. A restrictive policy is expected to materialise in reduced volumes of deposits, bank reserves, constrains in bank lending and decrease in the investment of firms dependent on bank financing. The credit channel can be viewed as an amplifier of the traditional interest rate channel.

Recent evidence comes from the observations for the South African Reserve Bank, where a monetary tightening reduced both bank deposits and the volume of bank loans, and changed the structure of lending towards the non-bank financing system, producing sizeable effects on the real estate market. However, the efficiency of this channel differs depending on the monetary policy stance and the business cycle phase (Choi *et al.*, 2023), as well as on the structure of the economy and the depth of the financial sector. In countries with developed financial sector, besides the effects through bank lending, this channel affects the financial position of the borrowers, affecting the value of balance-sheet assets and producing effects on external finance premium, which further discourages investment and spending. These effects on the economic agent's balance-sheets gave the name to the *balance-sheet channel*, which can be seen as a sub-channel of the credit channel, or a standalone asset-price channel. Thus, in an economy with predominantly small firms, which do not have sufficient collateral assets, these are more sensitive to the credit channel than those with predominantly large bankable firms. In the same time, the effects are stronger in unfavourable economic periods or in countries with low financial market development.

The *asset-price and wealth channel* materialise through the changes to the values of assets and *balance-sheets* of the borrowing firms as a response of the change of monetary policy stance. It works through the effects on the net wealth of households and firms, which influences their access to credit, borrowing capacity or decision about financing (source of financing), once the financing becomes more expensive due to the change in collateral or financial assets price and/or the necessity to borrow external funds (Mermelas and Tagkalakis, 2024).

For the open economies and import-dependent economies, the *exchange rate channel* plays a significant role, because changes in the interest rate influence the exchange rate, affecting the competitiveness of exports, the cost of imports and thus real output (Zahid et al., 2021). This transmission is of increased relevance for developing economies with emerging markets or outward-oriented economies, and often conditions inflation-targeters to employ foreign exchange policy to achieve price stability goals - a largely debated topic in the field of policy-oriented research, because in inflation targeting regimes, foreign exchange interventions aimed at price stabilisation, are considered to blur policy signals leading to policy inconsistency, undermine inflation targeting credibility, and generate excess liquidity or quasi-fiscal costs.

The Table 1 below summarises the evidence about the effects, limits and amplifying factors over the functioning of the four traditional monetary policy transmission channels.

Table 1. Traditional transmission channel functioning

Transmission channel	Effect on the economy	Limits of the channel	Amplifying factors or factors limiting the effects

Interest rate channel	Interest rate changes influence financial conditions, affecting consumption and investment (Lane, 2022)	Incomplete and slow transmission effect- not all rates adjust quickly (and the impact on the economy may be delayed (Byrne and Foster, 2023)	-The interconnection between the banking system and the money market -Sensitivity of consumption or investment to interest rates
Credit channel (Bank lending channel)	Monetary policy affects the supply of credit: when the rate increases, banks restrict lending, investments and consumption being determined by bank loans decrease	If there are alternatives to traditional banks (non-bank credit institutions), the effect can be mitigated- credit can be redirected to non-banks (Cucic and Gorea, 2024)	- The economy is composed of small firms with little collateral (Choi et al., 2023) - Banks are dependent on deposits; - There are no alternative financing markets or financial intermediation is weak (Pirozhkova and Viegi, 2024)
Asset-price, Wealth (Balance-sheet channel)	Changes in interest rates affect asset prices (stocks, bonds, real estate), the wealth of firms and households, available collateral, which influences consumption, investment and lending	The effects are often diffuse, with a lag, and may depend on the level of interconnectedness of financial markets. In addition, asset valuations can be cyclical, with high volatility risk	- The structure of the economy includes a significant share of financial/real estate assets; (Lane, 2022) - When firms and households are exposed to price volatility - The loan is secured by collateral
Exchange rate channel	Monetary policy changes interest rates, which influence the exchange rate by affecting import/export prices, external competitiveness, exports/imports, external demand, having impact on production	If exports/imports are low or balanced, the channel may have a weak effect. External volatility, foreign exchange reserves, capital controls may disrupt the effect (Lane, 2022)	- The degree of openness of the economy with a high share of exports/imports; - The exchange rate reacts to monetary policy shocks; - When there are no severe macroprudential constraints

Source: developed and constructed by the authors based on cited sources

The transmission channels described above, considered classic, can form related channels. Thus, the specialised literature identifies a channel derived from the credit channel, namely *shadow banking / non- bank financial mediation channel*, which manifests itself in the fact that non-bank financial institutions can take over part of the credit demand, cushioning the negative effects of the banking restriction, financing investment and consumption even if banks restrict lending. In this case, the effect of the credit channel is attenuated, and the efficiency of monetary policy is more modest. The Denmark's Nationalbank study "Nonbank Lending and the Transmission of Monetary Policy" (2024) shows how non-banks increase the supply of credit after a monetary contraction, compensating for the decline in bank credit. (Cucic and Gorea, 2024). However, if non-bank financial institutions have a different regulatory regime, do not have easy access to funding, or have liquidity constraints, the channel may be weak or volatile, highlighting structural changes that change the traditional mode of transmission (Cafiso and Rivolta, 2024).

As in case with other transmission channels, its effects depend on its magnitude, in this case, measured by the volume of lending originating outside the banking system. But its effects can be viewed from two sides - from one perspective, in a normal inflation targeting regime, it may hinder proper transmission and blur the right economic diagnostic by the economic policy-seters; from other point of view, it maintains the supply of credit during tightening periods which may be considered excessive. The efficiency of this channel increases if non-bank financing markets are subject to a flexible regulatory/supervisory regime.

Recent research by the ECB (2024) shows that transmission occurs not only through policy instruments, but also through global financial conditions that condition inflation expectations (Lane, 2024). The s.c. *macrofinancial channel* works through expectations of participants to the economic and financial relations which makes them to act based on their anticipation about the future level of rates or value of assets. The channel acts in tandem with the relatively new monetary policy instrument, forward guidance, employed by advanced economies and economies with developed financial markets. If monetary policy influences aggregate financial conditions (interest rates, asset prices, credit, liquidity, exchange rate volatility), the way central banks communicate ("forward guidance", scenarios) affects the expectations of firms and consumers, which alters spending, investment and savings decisions, and can condition a faster or amplified transmission of monetary policy to the real sector. This channel is particularly influential, serving as a key rationale for adopting inflation targeting regimes and occupying a central role in the monetary policy analysis and forecasting frameworks of central banks within those countries.

Its effectiveness, however, depends on several institutional and financial preconditions. The inflation expectations channel operates efficiently when the central bank is credible and transparent, financial markets are well-functioning with a diversity of institutions, and macroprudential constraints are not unduly severe. These conditions are most fully met in advanced economies and those with deep financial markets, where economic agents are responsive to policy signals and adjust their expectations and financial decisions accordingly.

An emerging conclusion from the recent literature analysed above, is that financial development, bank characteristics, economic structure and firm vulnerabilities (debt, dependence on bank credit, liquidity) strongly influence the efficiency of monetary transmission. Countries with underdeveloped banking markets or firms with fragile balance sheets have weaker and more uneven transmission (Oyadeyi, 2024). The analysis and recent studies reaffirm that the effects may vary depending on the macroeconomic regime, the cyclical state of the economy (boom vs. recession), and the mix of instruments (conventional vs. unconventional monetary policy) (Choi et al., 2023).

Monetary policy transmission in the Republic of Moldova

The specialised economic literature pays extensive attention to the analysis of the transmission mechanism in advanced economies (Choi et al., 2023, p.2), yet the specifics of small open economies with underdeveloped financial markets remain insufficiently explored. A developing, young market economy in Eastern Europe, Moldova, exemplifies the complex policy dilemmas that these economies face. The particularities and monetary policy challenges faced by Moldova reflect the complexity of the trade-offs imposed by a range of structural vulnerabilities and exposure to external shocks. Specifically, the National Bank of Moldova (NBM), guided primarily by a forward-looking inflation targeting framework, is continuously adjusting to balance responses to domestic risks and inflationary pressures that cannot be immediately controlled. The energy crisis triggered by Russian gas supply disruptions, coupled with ongoing geopolitical instability, climate-induced challenges clearly exemplify such pressures. Even though an economic recovery is anticipated in the coming years, Moldova's GDP growth stagnated, highlighting the constraints inherent in an economic structure largely based on consumption and investment. At the

same time, net exports remain consistently negative, influenced by agricultural uncertainties and disruptions to established routes, especially with the neighbourhood.

The formal adoption of the euro as the official reference currency in January 2025 signals a deeper structural integration with the EU financial markets, this relationship simultaneously promises a contribution to stability, but also an exposure to various market spillover effects of the European market. However, the currency stability is currently supported by relatively robust foreign exchange reserves and international macrofinancial funding. Moldova's current negative net international investment position (− USD 6 billion) and high gross external debt of USD 10.5 billion, representing 57.4 % of GDP (NBM, 2025), highlight the fundamental fragility of an economic model based on external financing.

While external macrofinancial assistance constantly provides a solid buffer, it cannot provide complete insulation against all external shocks, leaving monetary policy to play the role of primary economic stabiliser in an environment of heightened uncertainty (EU Commission, 2024). After a period of relative stability, price pressures re-emerged in late 2024, with annual inflation accelerating from 3.28% in May 2024 to 9.75% by January 2025 (Figure 1) (NBM, 2025) - well above the NBM's target range. The NBM's medium-term inflation target (as measured by year-over-year CPI growth) is 5%, with a variation corridor of ± 1.5 p.p. The inflation spike was fuelled by overlapping crises, implicitly by stagflation (GDP contraction of -5%) and the increase in natural gas prices. The concomitant spike of real estate lending contributed to the property price inflation, suggesting the need for closer macroprudential surveillance on the stability side. This resurgence highlights the challenges of maintaining price stability in an economy highly sensitive to imported inflation, exchange rate fluctuations, and supply-side shocks.

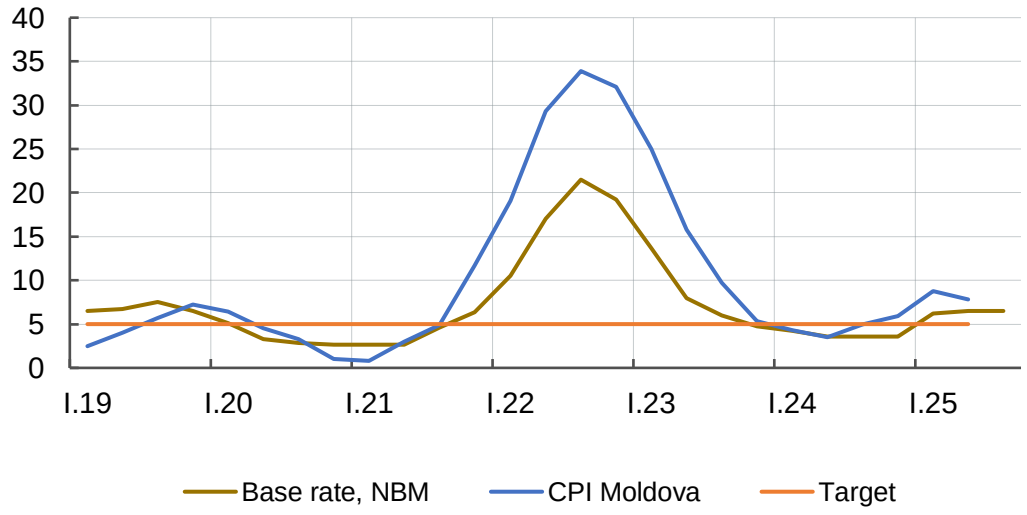

Figure 1. Dynamics of the consumer price index (year-on-year, %), the base rate (%) and the inflation target (%), 2019-2025
Source: constructed by the authors based on NBM data

Monetary transmission is often weakened by elevated currency substitution and excess liquidity in the banking system, both characteristic for Moldova, yet this time external shocks, originating outside of the financial system were at the core of the reasons therefor. Such periods, highlight another particularity of such economies, which is also one of the main dilemmas in macroeconomic management therein - the complex interplay between inflation targeting and exchange rate management. According to its strategy, the NBM intervenes on the foreign exchange

market only if necessary to support the effects of the open market operations to the extent required to achieve the targeted price stability, without influencing the fundamental trends of the Moldovan Leu exchange rate.

For the Republic of Moldova, empirical studies dedicated to assessing the effectiveness of monetary policy transmission are practically absent, at least studies that are extensive and relevant to the nature of contemporary shocks. This fact generates substantial uncertainty on economic policy decisions, but also on the capacity of central bank instruments to optimally stabilise the economy in the face of external disturbances. This lack becomes particularly problematic in a context in which the NBM has been operating under the inflation targeting regime since 2010 (*full transition in 2012),* a regime that requires a precise understanding of the magnitude and persistence of the effects of changes in the monetary policy interest rate.

Transmission analysis therefore becomes the necessary precondition for calibrating the response to an external shock. Consider a negative external supply shock, such as a sudden increase in imported energy prices, a phenomenon experienced by the Republic of Moldova in 2021-2022 when the price of natural gas increased approximately fivefold in a few months. Such a shock, of non-monetary origin, tends to simultaneously affect inflation, pushing it up through increased production costs and second-order effects in supply chains, and economic growth, slowing it down by eroding purchasing power and increasing business uncertainty.

The absence of a rigorous characterisation of the transmission mechanism in the Republic of Moldova generates fundamental uncertainty regarding: (i) the intensity and time horizon of the effects of monetary policy on inflation and output, (ii) the dominant channels through which monetary impulses are propagated, (iii) the existence and extent of transmission bottlenecks caused by the structural peculiarities of the economy, (iv) the complementary role of foreign exchange interventions in the context of a managed floating exchange rate regime. This uncertainty compromises the optimal calibration of the central bank's response to external shocks, increasing the risk of adopting suboptimal economic policy decisions and policy instruments' mix - either through insufficient reactions that prolong imbalances, or through excessive adjustments that amplify macroeconomic volatility and have a counterstimulating effect on growth.

As was seen during the 2021-2022 inflation surge, the NBM acted primarily through the interest rate channel, which is conventionally regarded as the most effective short-term instrument for mitigating sharp inflation driven by sudden increases in imported energy prices. In the absence of a robust understanding of the actual transmission mechanism, particularly regarding how policy rate adjustments propagate through the banking sector to lending rates (as illustrated in Figure 2, which reveals a notably weak and delayed pass-through from the policy rate to commercial bank interest rates), the central bank faces the risk of adopting suboptimal policy responses. Visual inspection of the data indicates that commercial lending rates adjust incompletely and with substantial lags following policy rate changes, suggesting structural impediments in the interest rate transmission channel that warrant further empirical investigation. An excessively aggressive tightening of monetary policy, accentuates the recessionary component of the shock while failing to achieve effective control over the inflationary component, thereby amplifying macroeconomic volatility rather than stabilising the economy.

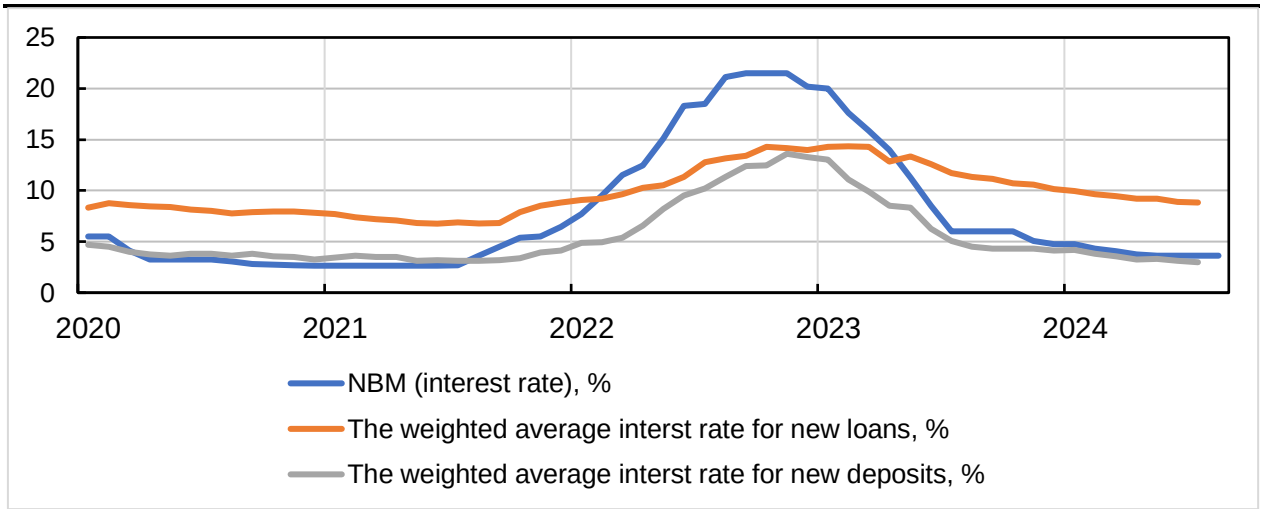

Figure 2. Interest rate channel transmission in the Republic of Moldova, 2020-2024, percentage
Source: constructed by the author based on NBM data

The asymmetry arises because a relevant part of the inflation generated by an energy shock is imported and therefore poorly sensitive to domestic demand, which is the only component that monetary policy can influence in the short term through traditional channels. The analysis of policy transmission provides critical information on the extent to which current inflation is controllable through standard monetary policy channels and to what extent it reflects exogenous factors over which central bank instruments have limited influence.

Conclusions

This theoretical synthesis of the monetary policy transmission mechanism for a particular economy with all its specific characteristics is not a purely theoretical exercise, reserved for abstract macroeconomic modelling or academic debates. It represents a comprehensive indispensable intellectual infrastructure for any responsible monetary policy decision in an open economy, subject to recurrent external shocks. In the absence of detailed knowledge of the transmission channels - how strongly and how quickly the change in the interest rate propagates to the exchange rate, to credit conditions, to consumption and investment; who actually bears the burden of the adjustment; how much of the observed inflation is domestic and controllable, and how much is imported and exogenous; what is the effective resilience of the banking sector to financial shocks - monetary policy risks either becoming excessively pro-cyclical and destabilising, amplifying economic fluctuations instead of mitigating them, or unduly delaying the reaction and losing control over inflationary expectations, allowing them to become unanchored and increasing the future costs of disinflation.

For the Republic of Moldova, this problem is particularly acute. The Moldovan economy is simultaneously exposed to trade shocks through its dependence on relatively geographically concentrated export markets, to financial shocks through its vulnerability to fluctuations in capital flows, to commodity price shocks through its almost total dependence on energy imports, and to geopolitical shocks through the proximity of regional conflicts.

In the absence of a rigorous understanding of the transmission mechanism adapted to these specificities, the central bank operates under conditions of extreme uncertainty, being forced to calibrate monetary policy based on intuitions gained through accumulated experience, contrary to a rigorous substantiation. This situation increases the probability of economic policy errors and diminishes the effectiveness of the instruments available for macroeconomic stabilisation. Therefore, transmission analysis is not just a step towards adapting monetary policy to external

shocks, but the minimum condition for this adaptation to be efficient, legitimate and sustainable in the medium term, protecting both price stability and financial stability and the well-being of the population.

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