WAYS OF INVOLVING CENTRAL BANK IN SUPPORTING ECONOMIC GROWTH

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Abstract

Addressing the relationship between the policy of a central bank and economic growth in the post-crisis stage, the article aims to identify essential tools that the monetary authority has theoretically available to support a sustainable economic growth, in the future. In the context of the global economy developments and the challenges that it is subject to, on the one hand, and considering certain attributes of a central bank, on the other hand, there are highlighted some elements that lead us to clarify the proposed objective.

Keywords: central bank policy, communication tool, postcrisis time, financial stability

JEL Classification: E44, E58, F43

1. Introduction

The financial crisis occurrence and the post-crisis period have brought major challenges, and one of them refers to the role that a central bank can play in supporting economic growth, especially as one of the serious effects of the crisis is the deep and prolonged recession.

The central bank's policy was the main instrument for the economic recovery, after the global financial crisis, compensating for the lack or inadequacy of the structural and fiscal policies. Although the central banks are often accused of overstepping their duties during this period, their actions were still needed to cover the lack or poor action in other areas. After all, the pursuit of achieving a sustainable economic growth implies an adequate macroeconomic policy mix. Moreover, in the following period, the recovery of the economic activity required a greater emphasis on appropriate structural and fiscal policies.

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The concerted efforts of the major central banks and their loosen monetary policy conduit represented an essential support for the recovery of the global economic activity in the post-crisis period, but at the same time their interventions have resulted in very low, even negative, levels of interest rates, as well as significant increases in the balance sheets of central banks of global importance. Thus, the monetary policy has lost its available room for intervention.

In a low inflation environment and given the narrow space of monetary policy actions, it is necessary to identify a trade-off between inflation and financial development, maintaining a balance between reaching inflation goals, on the one hand, and avoiding the risk for further encouraging the development of longer-term financial vulnerabilities, on the other hand. To this end, flexibility is needed both in pursuit of the inflation target and in the reaction to volatility episodes on the financial market, avoiding overly aggressive reactions in the event of short-term volatility episodes.

Theoretically, the central bank's policy should fall within the area of the more general objective, pursued also by other macroeconomic policies, namely, that of reaching the optimal level of the financial frontier (Beck & Feyen, 2013; Barajas et al., 2013). In this regard, the central bank's intervention means applying measures to activate the market to reach its financial potential, while also aiming to direct the market to ensure that the economy is within the limit of its potential financial capacity. In the first case, the central bank has at its disposal the monetary policy, aimed at ensuring price stability, as well as specific measures to regulate the functioning of the banking system. In the second case, the central bank is called upon to ensure, within its limits of responsibility, the financial stability by macro-prudential and supervision policies, and also by financial education measures (as for example: informing the public about the risks of excessive debt, saving methods, etc.).

Starting from describing the responsibility of a central bank and its room of manoeuvre, but also based on the observations from the literature, certain elements that make the connection between the economic growth and the activity of a central bank are highlighted. They are, in fact, important benchmarks for identifying tools that a central bank has available to support future economic growth.

2. Central bank landmarks in supporting economic growth - experiences and explorations in literature

One of the permanent concerns for decision-makers, including the central bank, is to identify risks to financial stability. The latter is an important factor in influencing the sustainability of economic growth, assuming that the long-term economic growth can only be sustained under the conditions of a stable financial system. In this context, the level and dynamics of financial conditions are guidelines elements for identifying the risks regarding the economic growth, the financial indicators included in the financial conditions index providing the authorities with an analysis base in this direction.

Financial conditions are an important factor influencing economic growth, a fact confirmed by the recent episode, after the global financial crisis, when the easing of financial conditions contributed to the economic recovery in many countries. However, the longer-term experience shows that during the times when the financial conditions are favourable, there is a tendency of building up of financial vulnerabilities. This observation, more clearly highlighted with the onset of the global financial crisis, is at the basis of conceiving new methods for measuring the financial stability, based on the *growth-at-risk* indicator, that links financial conditions to the distribution of future GDP growth. Based on this model, it can be evaluated the intertemporal balance between supporting short-term economic growth and increasing the medium-term risk regarding financial stability and economic growth.[1]

Changes in the risk level in the internal market may signal the presence of factors with negative influence on the economic growth, During the post-crisis period, the high levels of the financial leverage may signal the slowdown in medium-term economic activity, although in the short-term such risk is mitigated by favourable indicators of financial markets (low risk margins, low market volatility, positive risk perception). Nevertheless, a rapid decompression of margins in the financial market and an increase in its volatility can add to the risks regarding the financial leverage, amplifying the adverse effects on the economic growth. Therefore, monetary authorities can use this information by integrating it into a broader framework to identify imminent risks and to act quickly to counteract them by adapting their

[1] *The methodology of calculated the growth-at-risk indicator (GaR) is described in Financial Stability Report (IMF, 2017).*

behaviour and using a wide range of measures both for managing crisis and for preventing it. The calibration of the central bank interventions to financial conditions is as important as the calibration of the monetary policy based on the information on inflation and economic activity reflected by the Taylor rule. Moreover, Adrian et al (2019) confirm that financial conditions have become a common element for the monetary policy framework, an idea also emphasized by Peek et al. (2016).

Another important factor of influence of economic growth refers to the characteristics and trends in the housing market imprinted by the process of global financial integration. Thus, the “financialization” of real estate assets and also the greater synchronization of house prices, as effects of the global financial integration, contribute to increasing the degree of connection both between the local real estate markets, and between the prices of these assets, enhancing the risk of contagion in times of crisis. Contagion is a particular feature of the financial markets, but in the real estate sector it has wide and major implications on the real economy, considering the multiple connections with the other sectors of the economy (the private sector balance sheet has a structure that is based on real estate assets and mortgages, and financial institutions are largely exposed to the dynamics of housing prices). Therefore, decision makers should develop a “strategy” for monitoring the housing market aimed at: analysing developments, identifying major factors of influence, and their potential effects, estimating trends, developing scenarios, identifying risks, etc. All these elements require not only access to data, but also a permanent update of these data. In addition, a higher degree of particularization and coverage of information on housing prices can help to obtain more representative control indicators. In this way, one can identify the sphere of influence of both the global financial conditions, and the global investors on the dynamics of the prices in the housing market. More detailed information on the participation of global investors in the housing markets could strengthen surveillance and control efforts. Monitoring the synchronization of prices in these markets can help decision-makers understand the issues related to transactions associated with the broader links on the global housing market.

In order to support the economic activity, from this perspective, the central bank can contribute by carrying out risk analysis and assessments, but also by applying broader measures aimed at financial stability. It is emphasized that the implementation of macro-prudential measures maintains a certain capacity to influence the evolution of housing prices at the local level, even in countries with highly synchronized markets (IMF, 2018a).

The exchange rate flexibility can play an important role as concerns the housing prices, providing a higher capacity for monetary policy to influence domestic conditions. Based on the premise that there is an inverse relationship between exchange rate flexibility and the importance of global financial conditions for the local economy[2], in economies that have flexible currency regime, the central bank can more easily manage liquidity, especially if it has a high and adequate level of foreign exchange reserves. In addition, if lending in local currency prevails in the economy, then central bank can have a greater influence on short-term interest rates and thus on financial conditions.

The involvement of the central bank in supporting economic growth is also achieved through the macro-prudential policy, considering both its relationship with the economic growth, a widely debated topic in the literature, and the fact that the macro-prudential policy is found in the activity of central banks worldwide. Moreover, macro-prudential instruments, aimed at reducing either the tendency of financial crises to occur or their severity, have greater or lesser influence on economic growth. They usually have the role of increasing the resilience of the financial system, thereby reducing the systemic risks arising from financial intermediation.

There is the opinion that macro-prudential measures can contribute to macroeconomic stabilization, but at the cost of affecting economic activity and long-term economic growth, through the influence exerted on lending and investments.

On the other hand, efforts to ensure the financial stability (through macro-prudential measures) are considered to contribute to enhancing its capacity to support and stimulate economic growth. Basically, macro-prudential measures are intended to improve the resilience of the financial system and to alleviate the financial cycle, especially because of establishing and consolidating capital buffers. To the extent that macro-financial volatility reduces economic growth, and macro-prudential policy reduces such volatility, then macro-prudential policy should be positively related to long-term economic growth. Recent studies (e.g. Ueberfeldt and Duprey, 2018) show a higher efficiency of applying the macro-prudential policy compared to the

[2] *The greater the flexibility of the exchange rate, the less the importance of global liquidity for the domestic economy.*

monetary policy regarding reducing the risks of slowing the future economic activity. Although older research has identified a negative relationship between macroeconomic stability and economic growth (Kormendi and Meguire, 1985), it is more recently stated that volatility itself does not affect economic growth, but rather that politically induced (Fatás and Mihov, 2012), based on the idea that a lower volatility in the longer term can induce political decision makers a false safety sentiment, leaving room for financial imbalances accumulation. The Great Moderation confirms such a situation - a period of low volatility for a long time, in which there were built-up imbalances that ultimately led to the outbreak of the global financial crisis.

Analysing the relationship between macro-prudential measures and long-term macroeconomic outcomes, Boar et al. (2017) show that countries that frequently use macro-prudential tools have both higher growth rates for GDP/capita and more stable GDP growth. However, the benefit of applying these measures to economic growth (in terms of level and stability) depends on the degree of openness and financial development of that economy. Thus, economies that either have a greater degree of openness, or are more financially developed, have better results following the application of these macro-prudential measures. In contrast, it is noted that non-systematic macro-prudential interventions affect economic growth.

Anchoring long-term inflation expectations is a common goal of central banks around the world, both in developed and emerging economies, being a support for achieving the monetary policy objective. The experience of the post-crisis period shows that this problem goes beyond the monetary policy spectrum, proving to be useful for sustaining the economic growth. The preconditions for anchoring the long-term inflation expectations refer to the high levels of credibility and independence of the central bank, attributes that allow it to clearly and timely communicate its intentions to the public and to the market.

Inflation in emerging economies is on average higher than in developed economies, but with some differences between countries, rather reflecting the degree of long-term inflation expectations anchored and less external conditions (Criste, 2017). Anchoring for inflation expectations gives the central bank a certain profile of its reporting on economic activity. If these expectations are not well anchored in the long run, they will tend to increase with the spread of price shocks, affecting economic activity. Thus, the central bank is in a dilemma - between correcting expectations by adopting a restrictive monetary policy, which would reduce economic activity and implicitly generate risk of recession, or supporting economic growth through an easing monetary policy., which would have an adverse effect on inflation expectations.

A recent study (IMF, 2018b) shows that the pass-through of exchange rate depreciation was lower in economies with better anchored expectations than in other economies. These observations confirm the results of earlier (Taylor, 2000) or more recent (Carričre-Swallow et al., 2016) studies that underline the influence of inflation expectations on the degree of the exchange rate pass-through in the economy.

For central banks in emerging economies that have large financial and trade openness, reflected by the importance of the foreign exchange factor in the economy, anchoring long-term inflation expectations is a necessary element for sustaining economic growth. An appreciation of the foreign currency dominant in the economy will not constrain central bank to adopt restrictive behaviour as to reduce the risk of inflation. Emerging economies that have better anchored inflationary expectations over the long term will be more protected from the potential tightening of global financial conditions. Under these conditions, central bank have larger room for manoeuvre for a possible monetary policy easing in order to support the economic growth.

Generalizing the observation above, increasing the anchoring of inflation expectations can greatly improve economic resilience to adverse external shocks in emerging economies. A better anchoring reduces inflationary persistence and limits the pass-through of a currency depreciation in the economy, giving monetary policy more room to focus on sustaining more stable economic growth.

The relevance of the central bank's communication increased significantly after the global financial crisis broke out, as a result of the complexity of the political objectives and the operations associated with them. Constrained by the low levels of the monetary policy interest rates, the major central banks have resorted to the implementation of some unconventional measures (Criste and Lupu, 2018). The way these decisions were communicated, the communication “intensity”, as well as the content of the messages were essential to clarify the public about the bank's intentions, as to both eliminate the uncertainty and to create confidence and certain expectations. In this period, we notice, on the one hand, an increase of the central bank’s communication, revealed by the increase in the number of statements released to the public, and on the other, an increase in the interest related to the effects produced by the information communicated by the central banks.

The stage of monetary policy normalization, initiated by the Fed in 2014 and announced by the ECB, is still abandoned, given that the Fed has recently opted for a new easing monetary policy stance, which the market perceives as maintaining at least in the near future, mainly that the other global central banks (ECB, Bank of Japan) have delayed their intention to normalize their monetary policy stance. However, the normalization step remains a landmark in terms of the important role of central bank communication. The financial markets smoothly adjusted to the gradual normalization of the Fed's monetary policy, benefiting from both the clear communication of the central bank and the existence of a “security element” - the large volume of financial assets hold by the Fed.

As major central banks in developed countries will change their behaviour by moving to normalizing monetary policy stance, with rising interest rates and reducing the level of assets on the balance sheet, new challenges are emerging, considering not only the influence on their own economy, but especially on the others, either advanced or emerging economies. Therefore, it is important that the gradual approach of the normalization process be supported by adequate communication. Indicating clear trajectories of political changes helps anchor market expectations and reduce the risk of adverse reactions. On the other hand, the smooth adjustment also reflects a more general problem regarding the functioning of the monetary transmission mechanism. Although central banks have a wide range of intervention tools available, at the same time there is a high degree of uncertainty regarding the functioning of the monetary transmission mechanism. In this context, the difficulty encountered by central banks is the weakening of the link between short-term and long-term interest rates (mainly, after 2000), so that monetary policy actions need to be more strengthen in order to produces the expected effects. In addition, it is noted that long-term interest rates have become more sensitive to monetary policy surprises at higher frequencies (daily) over the same time period (Hanson et al., 2017), indicating a potential risk of sudden change (rising) of long-term interest rates, if the monetary policy tightening would be higher than expected.

3. Central Bank's policy instruments in supporting economic growth

Starting from the analysis of the factors that influenced the economic growth in the post-crisis period and taking into account the relations described above, we consider that the main contributions of the monetary authority in promoting economic growth, besides the anchoring of long-term inflation expectations, refer to applying macro-prudential measures, by extending its role in ensuring financial stability, and also to its involvement in more complex analyses targeting financial markets, based on monitoring the financial conditions and prices of real estate assets measures that will permanently support an adequate communication policy in relation with the market and the public.

3.1. Anchoring of the long-term inflation expectations, the central bank's appanage, is a prerequisite for supporting economic growth, mainly for emerging economies with large trade and financial openness, reflected by the significant role of the foreign currency in the economy.

As a rule, an improvement in anchoring the inflation expectations can increase the resilience of the economy to adverse external shocks, providing the central bank more room to manoeuvre its monetary instruments as to contribute to supporting more stable economic growth.

3.2. Extending the central bank's role on financial stability and applying macro-prudential measures

Increasing the role of the financial factor on the dynamics of economic activity, on the one hand, and understating the one regarding inflation as an indicator that can signal the tendency of an unsustainable economic growth, on the other hand, point to the need to broaden the role of monetary authority by assuming responsibility for the financial stability policy. In this context, the macro-prudential instruments, which are designed to reduce the proclivity of financial crises occurrence or their severity, have greater or lesser influence on economic growth. They usually have the role of increasing the resilience of the financial system, thereby reducing the systemic risks arising from financial intermediation. Experience shows that economies more open or more financially developed have better results in supporting economic activity, following the systematic application of macro-prudential measures.

Macro-prudential policies could be aimed at supporting long-term economic growth through at least two channels:

1) limiting the occurrence of financial crises, which are usually followed by slow returns and long periods of low productivity. Countercyclical capital and liquidity buffers applied in "favourable" period can contribute to increasing the financial sector's ability to mitigate shocks;

2) reducing the macroeconomic and financial fluctuations due to debt accumulation, excessive development of lending activity or due to balance sheet and currency mismatches, in so far as they affect the long-term economic growth. The demand instruments (loan-to-value, debt-to-service-income), as well as loan-targeted measures, applied during expansion, help prevent excessive credit growth and leverage of the private sector.

The use of macro-prudential tools aimed at mitigating the build-up of vulnerabilities in a certain financial sector can also have positive effects on reducing the house prices synchronization, one of the main features of the current international macroeconomic environment that has an impact on economic growth.

3.3. Involvement of the central bank in more complex analysis regarding the financial conditions and broadening the monitoring of the real estate market developments

Given the role of financial conditions regarding both the monetary policy transmission and the informational content related to the future development of the economic activity, a valuable step for the authorities refers to estimate and monitor financial conditions. In this respect, the central bank could play an important role, being the institution able to help determine the risks to the economic growth. There are at least two arguments in this regard: first, having, as a rule, access to specialized financial data, the central bank holds inside information on financial markets, the banking system, etc. Secondly, the monetary authority has at its disposal a complex and specialized mechanism for processing information, analysing and evaluating financial and monetary indicators, which allows it to formulate value judgments regarding the evolution of financial conditions and potential risks on future economic growth.

For a central bank, the major challenges concerning the financial conditions influence refer to two aspects which are the effects of globalization and financial integration:

- The financial conditions are increasingly affected by external shocks, so that the central bank must respond to a growing wider range of phenomena, complicating the matter of their responsibilities. However, the authority has its own instruments, those which give it autonomy and which it can use for the purpose of influencing/directing internal financial conditions;
- The yields on long-term bonds are increasingly set on international markets, weakening their reaction to short-term interest rates, those influenced by the central bank's monetary policy. This situation can also expose the respective economy to shocks that are not related to the economic fundamentals, and one of the important factors is the change of the investors' perception as to increase the level of confidence.

The financialization of the real estate assets and the synchronization of the housing market cycles, with house prices determination at the global level, have implications on economic growth, by increasing the exposure to external shocks. A high level of synchronization can indicate the risk of adversely affect the real economy, especially if the economy is going through a period of excessive lending (credit boom).

In addition to using macro-prudential tools, the central bank can contribute to identifying and assessing the risks arising from these developments by applying a "strategy" for monitoring the housing market, including: analysing developments, identifying influencing factors, causes and potential effects, estimating trends, developing scenarios, identifying risks, etc. A key problem, however, refers to the access to up-to-date and high-level data. Meeting these conditions helps to identify the sphere of influence of global financial conditions and of global investors on the dynamics of prices on the housing market. More detailed information on the participation of global investors in the housing markets could strengthen surveillance and control efforts.

3.4. Improving and intensifying the use of the central bank's communication policy

The relevance of the central bank's communication policy in relation with the public and the market increased significantly after the global financial crisis, as a result of the increased complexity of both the policy objectives and the operations associated with them. The communication, as the central bank’s policy tool, continues to play a major role, including as a way for the central bank to support economic growth during the normalization of the monetary policy in developed economies. The intensification and improvement of the communication policy are all the more important considering the weakening of the link between the short-term and the long-term interest rates, as well as an increase in the sensitivity of the long-term interest rates to the monetary policy surprises.

4. Concluding remarks

While during and after the global financial crisis, the central bank has contributed to the economic recovery through conventional and unconventional policies and by extending their responsibilities, in the recent post-crisis period this institution is still subject to the challenges caused by the financial developments with impact on economic activity.

Based on the above observations it can be concluded that the main contributions of the central bank to support the economic growth would be:

1. anchoring long-term inflation expectations;
2. applying macro-prudential measures and extending the central bank’s role in ensuring the financial stability;
3. involvement in more complex analysis targeting the financial markets, with the monitoring of the indicators regarding the financial conditions and the extension of monitoring the real estate market dynamics;
4. intensifying and improving the use of communication tool in relation with the market and the public.

The paper addresses, as a principle, the instruments available to the central bank in order to support/promote economic growth. In this way, it represents an openness to the deepening of the field based on research at regional level, but also on categories of economies, emerging and developed, which could highlight certain particularities.

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