# Import of international shocks to an open economy

Description for the general public (in English)

We live in a more and more globalized world – almost each year the trade and financial flows increase substantially and thereby remove power from the hands of individual policymakers across the world to an ambiguous entity known as „external/imported shocks" or more generally "global conditions". These conditions have an asymmetric impact on various economies, since financial assets and the capital stocks of the economy are not distributed equally across the world. While the obviousness of these statements makes them sound trivial, the consequences of this asymmetric state are not the least trivial for the small open economies.

Since the beginning of the financial international market, these smaller countries fared worse than others. Mostly because smaller countries were not able to borrow in their own currencies; not because of their inherent problems, but because the larger countries' currencies were more liquid due to larger markets. Initially this asymmetry was attributed to the fact that some of these countries led an inconsistent monetary policy based on fixed exchange rates that made them prone to crises. This resulted in a policy advice suggesting a move to more flexible exchange rate regimes and inflation targeting strategies that should in theory insulate these economies from the global external conditions.

As indicated in numerous theoretical studies – a central bank should not respond to such external events, which have no direct impact on inflation in the form of second-round effects. This claim is based on the observed in the 1970s and 1980s transient nature of supply shocks; therefore, those had not required a significant monetary response. In contrast to these assertions, the recent crisis indicated that the observed phenomena such as financialization of trade, increase in carry trade and dependence on capital inflows are permanent and structural. This is a challenge for central banks, whose role is also maintain the stability of the financial system.

*The main objective of the research project is thus to identify on empirical grounds, the impact of external economic shocks for monetary policy in open economies.*

The proposed research program involves a series of theoretical and empirical monetary policy analysis (including Polish) grouped into three interrelated groups. The Group I investigates a range of responses to capital flows; the Group II analyzes the extent of the reaction to changes in commodity prices (including energy), the Group III connects Group I and Group II with the analysis of an exchange rate corridor, beyond which a non-linear response of monetary policy occurs.

The proposed research attempts to complement the existing state of the art on monetary policy and financial stability. Thus, the investigation of monetary policy response to external shocks has fundamental consequences for the assessment of the effects of the inflation targeting strategy. Possible confirmation of the main hypothesis would challenge the widely accepted view that before the financial crisis the sole aim of the monetary policy was to combat inflation. This would be particularly important when, despite the existing normative consensus assuming no reaction of the monetary authorities - in fact, such a reaction would have taken place. The proposed studies also extend the knowledge on the post-crisis policies of central banks.

On this basis, main challenges facing the monetary policy will be indicated. The conclusions obtained from studies conducted in the proposed project will allow for a better understanding of the relationship between monetary policy and financial markets, and the actual functioning of the inflation targeting strategy.