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## **Role of Central Banks in the Economy**

*Paiman Ramazan Ahmad*

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Paiman Ramazan Ahmad, PhD Student, National University of Public Service-Faculty of Political Sciences and Public Administration (Paiman.ahmad.ramazan@uni-nke.hu).

### *Summary*

In discussing the microeconomics of any country, there is a need to analyze the tools and policies of this specific economy and the role of government in the proper regulation and control of the economy. Within this framework, the role of central banks is highlighted; and specific examples are given from different countries, from both advanced and developing countries. In accordance with the function of central banks, the importance of monetary and fiscal policies is emphasized, as “macro policy in the world economy can be thought of as a game, each country is a player in the game,”<sup>1</sup> and besides, “the macro policy problem is one of choosing policy rules that describe how the instruments of policy should respond to economic conditions in order to improve the performance of target variables.”<sup>2</sup>

### ROLE OF THE CENTRAL BANKS IN THE ECONOMY

Before analyzing the role of central banks, it might be important to note the main criteria for the role of a central bank in the economy as follows:

- Price stability must be the overriding, long-term goal of monetary policy;
- An explicit nominal anchor must be adopted;
- A central bank should focus on goals;
- A central bank should be independent of instruments;
- A central bank should be accountable;
- A central bank should stress transparency and communication;
- A central bank should also set financial stability as its objective.<sup>3</sup>

In essence, central banks can be considered as the engine of the economy, where like the engine the power is controlled and regulated, any malfunction in the engine creates a risk and problem in the system. Therefore; central banks are extremely important tool, Wrightsman stated in defining monetary policy, “the deliberate effort by the central bank to control money supply and credit condition for the purpose of achieving certain broad economic

objectives.”<sup>4</sup>Central banks should have the same role everywhere, but this is not the case. In the introductory part of his book, Curzio Giannini acknowledged that “if the success of an institution can be fairly judged by its diffusion, then the central bank is without doubt a very successful institution.”<sup>5</sup> Currently, the number of central banks is increasing; economists stress the significance of having a country’s central bank, and among the most influential banks can be the following:

1. US Federal Reserve Bank (USD)
2. European central bank (EUR)
3. Bank of England (GBP)
4. Bank of Japan (JPY)
5. Swiss National Bank (CHF)
6. Bank of Canada (CAD)
7. Reserve Bank of Australia (AUD)
8. Reserve Bank of New Zealand (NZD)

In principle, the central banking system is not competitive in the developing countries, regardless of the few “regions and island countries, only North Korea does not have a central bank.”<sup>6</sup> However, in reality central banks do not always function in the way people and economists would like to see. Central banks should be independent, but the government oversees its operations, so they are exposed to politicians’ interference. Apparently, as Charles Goodhart noted, “the central bank as the fruit of an institutionalization of restrictive competitive practices required by the very nature of banking.”<sup>7</sup> Central Banker Report Cards, first published in 1994 in *Global Finance*, rate central bank governors in almost 75 countries on a scale from “A” to “F”. The only governor rated “A” in the 2015 report among the governors of the Middle East was the governor of Israel’s central bank, while the governors of the central banks of “India, Malaysia, Philippines, Taiwan” were all rated “A”.<sup>8</sup> In developing countries, Albania heads the list as the best among the central banks in the world, because “the bank has been able to anchor inflationary expectations well based on its inflation targeting framework, as Albanian economy rejoices over a fluid, well-capitalized and liquid banking sector, making it able to handle the crisis better than most European Countries.”<sup>9</sup> The effectiveness of central banks is not always seen as the main pillar of the economy: in his book “From here to economy: a shortcut to economic literacy” Todd G. Buchholz noted that “central banks cannot do much to make factor management more efficient, or to make workers work hard, or to inspire inventors to invent more.”<sup>10</sup> In other words, the duty of central banks is only facilitation, the provision of efficient supply and figuring out how much the economy needs. The importance of central banks was known in some states in their early years of their economic growth, for instance, “the central bank of the United State was established in 1913 as the Federal Reserve System by the Congress. In this regard, the Congress, the President and Fed all together contribute to macro-economic policy.”<sup>11</sup> The role of central banks in the developing world was extended later than in developed countries, and so, “many central banks in developing countries nowadays proactively, seek to promote sustainable economic development.”<sup>12</sup> Since central banks are the main instruments in improving competitiveness in any economy, they must be independent from the government in decision-making, which means no political interventions in banking affairs at all. However, in advanced economies, the independence of central banks is granted by the government. Understanding the role of central banks is not easy, but crucial, the central bank was described in

a very interesting way in a definition as “the lender of last resort,” which conveys that it is responsible for providing its country’s economy with funds if commercial banks cannot cover a supply shortage. Besides, it also acts “as a regulatory authority of a country’s monetary policy.”<sup>13</sup> Likewise, Thompson and Cowton write that “banks not only need to watch the direct environmental impacts of their own operations, but also the impacts of their lending activities.”<sup>14</sup> A sensitive and serious question that must be highlighted is government control over central banks in the developing world. Have central banks in developing countries ever been independent of governments? Naturally, the cycle model of the banking system in the developing world is fragile, and if the government makes misguiding interventions in certain situations, the economy might collapse. As the Iraqi central bank’s governor put it after a lawmakers’ meeting in Parliament: “The bank is independent, financially and administratively, and therefore all procedures and policies that it adopts are independent.”<sup>15</sup> Likewise, in 2004, the deputy governor of the Iraqi central bank confirmed that “the independence of the central bank.”<sup>16</sup> In such a situation the blame game is worthwhile, but developing countries and governments are always ready to justify financial collapse, in particular, during wars and regional tensions mainly in the Middle East and Africa. Moreover, central banks are also supposed to protect wealth, but the surprising question is whose wealth they protect against whom. If the government takes over monetary policy, does it mean a good agent protects every interest? Central banks in the developing world are not perfect in conducting monetary policy, and the question may arise: what, after all, is the role of a central bank? Is it financial stability at all costs or does it depend on the situation? Central banks have various and significant responsibilities, including overall control over the total amount of money available in an economy, the point where the central bank wants to fight inflation. In fact, inflation “refers to a rise in price levels, which causes a fall in the purchasing power of a currency. It counts for the entire basket of goods and services not only the price of one item”<sup>17</sup> In this respect, tracking and controlling inflation is the level where the bank monitors the system. In a developing region like the Kurdistan Region, not only inflation, but also the lack of money cut the purchasing power. During inflation people need more money to cover their needs, but during the recent economic downturn in the Kurdistan Region in 2014–2015, the government withheld civil servants’ salaries, which are the only source of income for many people. For this reason purchasing power declined, as the prices of services and goods decreased, but incomes declined more rapidly. The reason is not rise in the prices or inflation, but wage management. On the other hand, the 2015 decline in oil prices was an external factor with direct impact on the economy in the Kurdistan Region. “Kurdish oil revenue averaged between \$361 million and \$406 million per month, a shortfall that has caused the KRG to fall behind on salary payments for the past four months.”<sup>18</sup> Interestingly, when oil prices are high in economies dependent on oil, most exported goods are generally more expensive, which affects the populations, while in the periods characterised by low oil prices, the prices of goods do not change. Thus, inflation poses a problem for dependent economic regions, especially those that depend on a single commodity, like energy. In the Middle East and Africa, certain governments seem to have failed to coordinate fiscal and monetary policies. This is only true, however, to countries where central banks are not strong enough, and this leads to the emergence of undemocratic and heavily centralized central banks. The European central bank is a good example, as it efficiently represents the interests of the euro area, although not all euro area countries follow this path. Rangala highlights two important points:

- The ECB has just shown that central banks can act when governments can't, and in doing so, may have increased the role of monetary policy versus fiscal policy.

- Worldwide, fiscal policy has been largely ineffectual, not so much because government efforts have failed, but because most governments have failed to make an effort.<sup>19</sup> One of the key features of the banking system in developing countries is the dependence of central banks, and heavy governmental involvement in banking affairs.

Crowe and Meade discuss central banks' independence as follows:

- Independence is greater when the central bank's management is insulated from political pressure by secure tenure and independent appointment.

- The central bank enjoys greater freedom when the government cannot participate in or overturn its policy decisions.

- Independence is greater when the central bank's legal mandate specifies a clearly defined objective for monetary policy.

- Indeed, guarantying independence of central banks

- Financial independence of the central bank relies upon restrictions that limit lending to the government.<sup>20</sup>

In his lecture on "Central Banks and the Financial System", Corrigan highlights crucial points. In the interest of progress in a number of countries in Eastern Europe, he makes the following recommendations:

- First, the stability of the banking and financial system is an absolute. Prerequisite for the growth and stability of the economy at large.

- Second, of all of the elements of structural reform that are necessary in the transition from a centrally planned and controlled economy to a market economy, none is of greater importance than the reform of the banking and financial system.

- Third, while the development of capital markets especially an efficient market and secondary market for national government securities clearly is important; the highest priority should be 24 E. Gerald Corrigan placed on the reform and adaptation of the commercial banking system.

- Fourth, successful reform of the commercial banking system presupposes parallel reform in the central banking system.

- Eventually, commercial banks and central banks have only one asset that really matters and that asset is public confidence, reforms to aim in enforcing confidence in the context where they applied.<sup>21</sup>

Moreover, two crucial aspects are mentioned in a definition of independence by J.T. Wooley:

- The Federal Reserve System (Fed) is independent if it can propose and put into practice a monetary policy that has not previously been approved by the president of the United States, the Congress and all the other interest groups outside the Fed itself, which may not be to their liking.

- The Fed is independent if it is capable of reaching its objectives without the help of action by other policy-makers.<sup>22</sup>

Jurgen Stark, member of the executive board of the European Central Bank, mentioned three key points of understanding and awareness of price stability:

- protects the real purchasing power of money and incomes so that people can concentrate on productive activities rather than on strategies to protect their

wealth and income against inflation or deflation,

- enhances the ability of markets to allocate resources to their most efficient use by preventing signals from changes in relative prices from becoming blurred by a general trend in prices,

- reduces risk premia in longerterm interest rates, thereby permanently lowering financing costs for consumers and firms,<sup>23</sup>

In developing countries, central banks endeavour to boost economic growth, and thus they can be considered as the driving forces of the economy, so there should be “adjustment between demand and supply of money. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. When the economy develops, the demand for money is likely to go up due to the gradual monetization of the non-monetized sector and the increase in agricultural and industrial production.”<sup>24</sup> With due consideration to this fact, the question of central banks’ control over interest rates in the economy is tantamount to asking if the central bank can maintain the stability of the financial system, especially in developing countries, where financial systems are rather fragile, would this line be the answer for having proper interest rate policy. The reason the central bank changes its policy interest rate is normally to influence economic activity.<sup>25</sup> The management of credit conditions and interest rates must be done by the central bank carefully, in the history of the United States, Paul Volcker with Fed Chairman Arthur Burns aimed at “tight money policies and high interest rates to retard inflation.” This has given clear evidence to the history that monetary policy to allow moderate growth in money and credit. In the price concern, Volcker thought “domestic and international price stability went hand in hand.”<sup>26</sup>

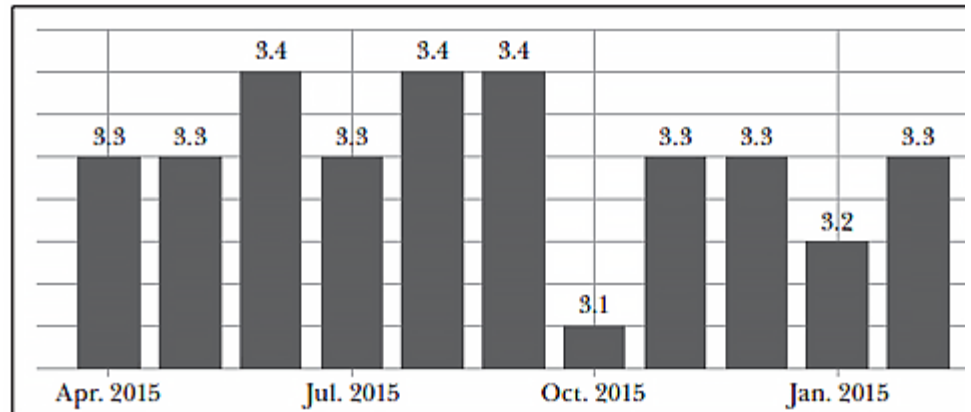
In fact, central banks are not only designed to tackle price and inflation issues, as economic growth and employment are also relevant variables, in most countries the central banks have restrictions, mainly when the monetary policy has limitations, “Monetary policy is not the only force acting on output, employment, and prices. Many other factors affect aggregate demand and aggregate supply and, consequently, the economic position of households and businesses.”<sup>27</sup> The role of the central bank in the employment creation is a concern for governments globally, according to the International Labour Organization (2019), more than 212 million people will be out of work, up from the current 201 million, based on the World Employment and Social Outlook – Trends 2015 (WESO). The rise in unemployment was due to the financial crisis in 2008 in which more than 62 million jobs have been lost.<sup>28</sup> While, ILO report has recorded high unemployment relatively as 186 million jobless people.<sup>29</sup> The main question of unemployment must be addressed as can everyone get a job, if she/he wants? Then that is relatively depending on the economy and the region too. Perhaps full-employment “zero unemployment” is what many countries want, but this scope is not easy to get it, since the population rate, and the duration of the unemployment can be encountered as the variables to find out what to do to absorb full-employment. The complex trade-off between the unemployment and inflation both is related and associated with the central bank and how to manage it, Philips lighted “the more unemployment diminishes, the more rapidly wage rates normally increase, while low wages is correspondingly associated with high percentage of un-employment.”<sup>30</sup> From this point, unemployment and wage relation has direct relation to price concept in the economy, from the perception of Philips, “the policy makers cannot target both unemployment and inflation at the same time, as during the 1960s, the monetarists emphasized price stability (low inflation), while Keynesians more emphasized on job creation.”<sup>31</sup>

What does unemployment mean? And what the natural rate of unemployment is, “the natural rate of unemployment”, we have defined the equilibrium real wage as that at which all those people who would be willing to accept jobs at that wage are in employment.<sup>32</sup> Indeed, the central bank is willing to accept a higher marginal increase in the unemployment rate in order to prevent a further rise in the rate of inflation.<sup>33</sup> Apparently, some countries perform better in the Philips curve than others, it seems that whenever monetary and fiscal policy shove unemployment below 5%, high rates of inflation are likely to occur. It follows from this that if the only way to reduce unemployment to 4% “the old interim target of the Kennedy-Johnson economists, is to accept wage and the price increase of 8 or 9%.”<sup>34</sup> Importantly, people, governments and central banks are concerned about inflation and unemployment at the same time, insofar, the Scandinavian countries have specific model of integrating everyone into a single, skilled labour force, which is not experienced globally, especially the developing countries. While the central bank targets the inflation rate, the Philips curve argues that “rising unemployment ought to be accompanied by slowing inflation.”<sup>35</sup> Considering the situation in developing countries, where labour force, especially the young generations are wasted, Leftwich and Sharp remarks that unemployed resources could have contributed to society’s well-being: the economic value of their lost contribution of goods and services is the economic cost of unemployment. Unemployment does not only affect current but also future production.<sup>36</sup> Unemployment is either frictional (voluntary unemployment, usually for a short term) or structural (long-term) in the nature and usually originate on the demand side of labour. Very importantly, it is noted that structural unemployment is caused due to the demand side of labour in a sector which has a high market value, which means an economic need for a specific type of labour.<sup>37</sup> Additionally, cyclical unemployment is caused by fluctuation in the aggregate demand for goods and services in the overall economy, as a decline reduces total production and causes general unemployment throughout the economic system.<sup>38</sup> Central banks are required by laws to support job creation, but in some economies the central bank does not have any role in employment creation agenda, but the government has a major role in job creation. According to Epstein: “One reason that ‘inflation-focused monetary policy’ has gained so many adherents is the common perception that there is no viable alternative monetary policy that can improve growth and employment prospects.”<sup>39</sup> Moreover, in the debate over inflation targeting or full employment, few cases are considered as best practices. Frenkel and Rapetti describe the case of Argentina, where targeting a stable and competitive real exchange rate has been very successful in helping to maintain more rapid economic growth and in employment generation.<sup>40</sup> In his article entitled “What Comes After Full Employment”, James Robertson stated that “unemployment may be becoming an uneconomic way of getting much important work done, just as slavery became uneconomic in its time.”<sup>41</sup> Notably, Stonier highlights that “education will be a source of creating jobs in the future not only for the industrial countries in which information, knowledge and service sectors expand in the economy, this can be seen as business and industrial drivers to the scope of job creation.”<sup>42</sup> It is crucial to look at the sectors in each and every economy to find out which one contributes more to employment. In countries solely dependent on a natural resource like oil, gas, diamond or copper, these sectors have scope for more employment, but the shortage of technology and capital makes developing countries depend on developed countries. It is estimated that the pursuit of economic growth will increase unemployment rather than alleviate it.<sup>43</sup> The following figures give more explanation on some of the countries and

regions.

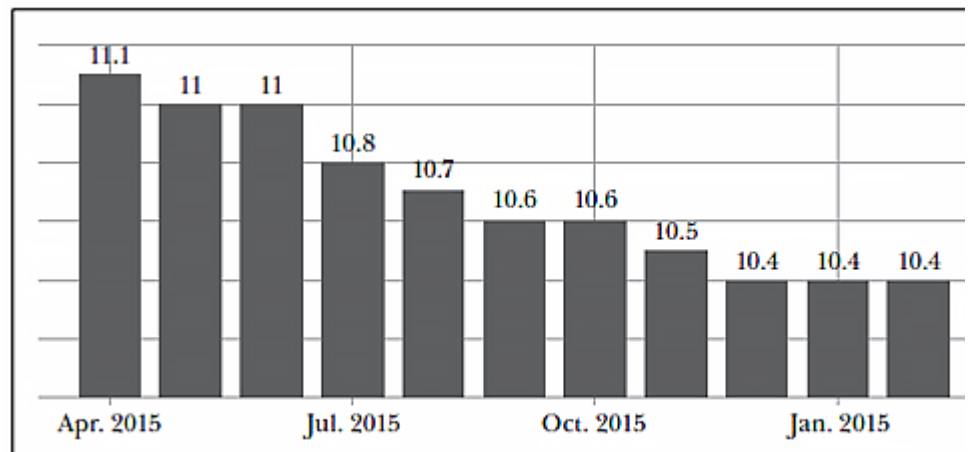
Certain countries, like Japan, have been in recession for years, and yet “the unemployment rate is low, roughly is still 3.6 percent, since in Japan during recession, wages tend to fall when the economy gets rough, which keeps people at work, while in the United States recession tend to lead to high joblessness.”<sup>44</sup> In terms of aggregate supply, unemployment is explained very explicitly, as “jobs are created when the level of goods and services produced expands, and existing jobs are destroyed when production contracts.

*Figure 1: Japan unemployment rate*



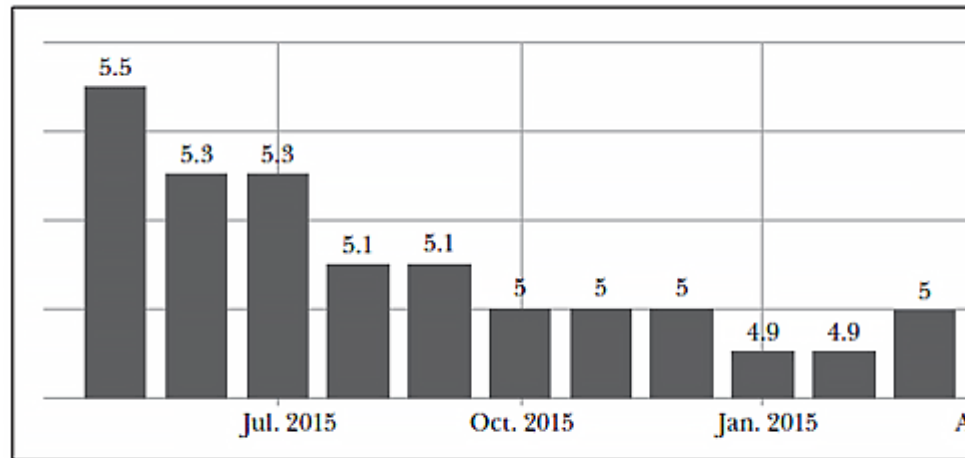
*Source: [www.tradingeconomics.com/Ministry of Internal Affairs & Communications](http://www.tradingeconomics.com/Ministry of Internal Affairs & Communications).*

*Figure 2: EU unemployment rate*



*Source: [www.tradingeconomics.com/Eurostat](http://www.tradingeconomics.com/Eurostat).*

*Figure 3: US unemployment rate*



Source: [www.tradingeconomics.com/U.S. Bureau of Labor Statistics](http://www.tradingeconomics.com/U.S. Bureau of Labor Statistics).

Producers hire more people to produce goods and services, when profits increase, and when profit decrease and losses are incurred, production is cut, and jobs are lost.”<sup>45</sup> The central bank should not be the only institution in the country to be concerned about the unemployment and job creation, the government and the policy makers see this as a real threat to the economy, and this can be justified from the words of Robert Lekachman in his book he claimed that “unemployed people produce nothing. They cost the employed a lot even in an ungenerous period. Put to work, they will produce something and cost less.”<sup>46</sup> More interestingly, the issues is not only about the central bank or the government, but the negative effects of unemployment, which directly influence the human capital in every country, in two directions, the first is the economic effect involves the waste and loss of goods and services when resources are unemployed. The second is social which affects social life, such as family and community relations.<sup>47</sup> This argument on employment is quite close to what Keynes discussed in his work as “the government not to do things which individuals are doing already, but to do those things which are at present not done at all.”<sup>48</sup> To sum up, the full employment goal is a critical point many central banks failed to tackle, because central banks demand independence from the government.

## MONETARY POLICY

In the economic literature many well-known economists have given different definitions for monetary policy, in one way or another all the definitions are circulating into the same notion. In discussing the economic situation of Hungary and economic growth, Lentner remarked “The mechanism supporting fiscal policy is created at the discretion of the central bank on the basis of its responsibility for the national economy, which is implemented without jeopardizing the primary objective of price stability. Similarly, monetary policy is the other important branch of public finance policy”<sup>49</sup> In line with this, Harry G. Johnson defined monetary policy as “A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy.”<sup>50</sup> Similarly, Hart mentioned “a policy which influences the public stock of money substitute of public demand for such assets of both that is policy, which influences public liquidity position, is known as a monetary policy.”<sup>51</sup> Additionally, Paul Einzig highlighted that “monetary policy includes all monetary decisions and measures irrespective of



whether their aims are monetary or non-monetary, all non-monetary decisions and measures that aim of affecting the monetary system.”<sup>52</sup> Briefly, monetary policy aims in employing the central bank’s control over the supply, cost and use of money as an instrument for achieving the certain given objectives of economic policy.<sup>53</sup> The role of monetary policy is crucial, monetary policy aims in “adjustment between the demand for and supply of money, price stability, credit control, create and expansion of financial institutions, suitable interest rate structure, debt management.”<sup>54</sup> Economic growth logically means more money demand, since corresponding to growth will be by injecting more money into the economy. Yet this phenomenon must be regulated by the government and the central bank carefully, since more money creates financial concerns for the economy. In other words, it means “a proper control upon the supply of money will prevent economic fluctuations and pave the ground for rapid development.”<sup>55</sup> In general terms most developing and underdeveloped countries suffer from the economic crisis, or better to state, those are more fragile economics, since monetary policy, which has a vital role is not well formulated, thus for economic growth monetary policy is the tool that facilities growth and stability.

### MAIN INSTRUMENTS OF MONETARY POLICY

The following monetary policy instruments influence the credit-creating capacity of the commercial banks in the economy by operating directly or indirectly on their excess cash reserves.<sup>56</sup>

- Open Market Operation “OMO”
- Changes in the minimum legal cash reserve ratio
- Changes in the bank / discount rate

#### *Objectives of Monetary Policy*

The six main objectives are as follows:

- Exchange rate stability
- Price stability
- Neutrality of money
- Control of cyclical fluctuations
- Full employment
- Economic growth

In analyzing the impacts of monetary policy on the economy, the objective of monetary policy to be taken into consideration very seriously, in a country like Iraq with a large budget deficit, it is necessary to use fiscal policy to reduce the inflationary pressure and thus inflation, and to improve the budget deficit. Broadly speaking, monetary policy is an equally serious concern for advanced, developing and under-developed economies. However, as the economic conditions are different, “monetary policy requires special attention in a country, which seeks to bring about rapid economic growth with controlled inflation.”<sup>57</sup> An appealing point of view is emphasized by Joseph Stiglitz who thinks that there is no guarantee that fiscal policy works, thus the expectation that monetary policy is a response to economic tensions is a mistake: during recessions, monetary policy is ineffective, because people hesitate to purchase goods and services, and thus monetary policy does not work, while fiscal policy can have an impact on the aggregate demand, and provides means of stimulating the economy.<sup>58</sup> Likewise, considering monetary policy as a useful tool to slow

down an overheated economy is not always good, thus Stiglitz concluding the idea of implementing both monetary and fiscal measures as soon as possible. Monetary policy practice in developing countries is different since the factors and environment is quite volatile to inflation, therefore, “low and stable inflation has become the overriding goal of monetary policy,” besides, the trade-off between inflation and employment is another concern, “an expansionary monetary policy could attain a low rate of unemployment at the longterm cost of modest inflation, while tighter monetary policy would suppress inflation but allow unemployment to rise.”<sup>59</sup> In most countries credibility and accountability of the monetary policy is expected, and heavily depends on the central bank’s role in protecting its autonomy and institutional role regardless of the political pressure. In their perception, Walton and Wykoff have pointed out the importance of the first law of economics, “the law of demand,” which states that more of any particular good or service will be purchased as its price falls, less will be purchased as its price rise. In the case of higher prices people purchase less goods and services, contrary to the fall in price condition, in this regard, the population behaviour is changed due to the changes in the price. Besides, high price means low quantities of the goods and services are purchased, while low prices means higher quantities for purchase are expected by the consumers.<sup>60</sup> The other part of this equation, closely related to price stability and inflation must be analyzed as a phenomenon that shows if an economy is healthy or if it is in trouble. Currently, Iraq is in a civil war and is political unstable, there is hyperinflation, and although in the case of the Kurdistan Region, consumer purchasing power has decreased recently, as the purchasing power of individuals is income dependent, at this point the Consumer Price Index (“CPI”) shows the effects of inflation on consumer budgets.<sup>61</sup> Understanding Friedman’s law is a crucial precondition to understanding inflation. Friedman emphasized that inflation follows excessive monetary growth with a long variable lag of “about two years”. In more scientific terms, the rate of price change follows the rate of monetary growth, but after a long and variable lag, inadequate monetary growth would lead to deflation. In fact, monetary policy affects interest rates, “in the short term, increased money keeps interest rates down, however, monetary expansion has different consequences, excessive increases in the money supply produce inflations, thus, an increase in interest rates, thus in the long run monetary policy drives the interest rates up.”<sup>62</sup>

## FISCAL POLICY

Focusing on fiscal and monetary policy, professor Jeffrey Frankel pointed out: “When an economy is in boom, the government should run a surplus; other times, when in a recession, it should run a deficit.” Notably, fiscal policy is changeable and governments must shift it during the economic growth and crisis. Frankel further highlighted on the role of the fiscal policy and compared it to a parked car, which means the role of fiscal policy depends on its environment and time: “But this is no reason to follow a *procyclical* fiscal policy. A procyclical fiscal policy piles on the spending and tax cuts on top of booms, but reduces spending and raises taxes in response to downturns. Budgetary profligacy during expansion; austerity in recessions. Procyclical fiscal policy is destabilising, because it worsens the dangers of overheating, inflation, and asset bubbles during the booms and exacerbates the losses in output and employment during the recessions. In other words, a procyclical fiscal policy magnifies the severity of the business cycle.”<sup>63</sup>

Additionally, “fiscal and monetary policy can be either expansionary or contractionary, policy measures taken to increase GDP and economic growth are

called expansionary, measure taken while inflation is too high are called contractionary measures.”<sup>64</sup> In this view, fiscal policy to be adaptive to the situation during the surplus in the economy, fiscal policy to contractionary, while the revenue is higher than spending, while the spending is higher than revenue, the economy encounters deficit, hence fiscal policy is expansionary in respond to economic growth.<sup>65</sup> Proposed by many economists that fiscal policy positively affects the economic growth, claimed by Agell et al., the neoclassical model documented why economic policy can change the level of the long-term growth path, and that appropriate polices shift the path upwards, whereas inappropriate policies shift this path downwards.<sup>66</sup> In addition to that Zagler and Dürnecker searched the relationship between economic growth and fiscal policy, and presented a unifying framework for the analysis of long run growth implications of government expenditures and revenues.<sup>67</sup> In Iraqi case, government expenditure is very high while recently “the year 2015 started with a budget deficit of \$20 billion on a \$103 billion total budget. The situation is expected to worsen in 2016, as the Finance Ministry is setting the 2016 budget at \$99.65 billion, with a deficit of \$25.81 billion.”<sup>68</sup> In essence, the importance of fiscal policy must be understood by the public and the government. In particular, how fiscal policy can affect economic growth? According to IMF, when policy makers seek to influence the economy, they have two main tools at their disposal “monetary policy and fiscal policy”. Besides, governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty.<sup>69</sup> Furthermore, “Fiscal policy is the use of government spending and taxation to influence the economy.”<sup>70</sup> Moreover, the changes in the government budget affect the economy generally and sometimes specific sector or aspect. In the medium term, fiscal policy is a significant tool for managing the economy since it has the ability to affect the total amount of output produced the gross domestic product. Nevertheless, remembering aggregate demand during fiscal expansion is to raise the demand for goods and services, the greater demand leads to increase in output and prices together. When the economy is in recession, increases in demand lead to more output without price change, by contrast, when the economy is at full employment, fiscal policy affects prices instead of the total output.<sup>71</sup> From this perspective, fiscal policy has an automatic stabilizing nature, which makes the economy to move again. In one very fundamental sense, in the rentier states, the governments, which are dependent on single commodities for their GDP, like Iraq, which is heavily dependent on the energy sector for funding government spending, thus Iraq has several years of experience in deficits in a row. Although Iraq is a rich country, it is economically inefficient, oil revenues and production capacity have boosted in the 21st century, yet security, political tension and war has devastated the infrastructure of the Iraqi economy massively. Budgetary concerns, employment, social welfare and fiscal policy are all related to social and financial stability, a major concern for governments and financial institutions. It is championed by Keynesian that “fiscal policy can be a weapon in the battle against unemployment.”<sup>72</sup> Moreover, Keynesian economics is inflationary, not because it leads to big government, but because it is recognized that unemployment can be created by sticky wages or by a high marginal disutility of labour. To illustrate, the Keynesian revolution was to establish the recognition of the responsibility of the government to maintain a satisfactory level of employment in the economy. In essence, many rentier states, which are abundant with natural resources in particular in developing regions, the government works on, full employment, rather than balanced budget, because governments want to cling to power longer, by holding the public trust in their job security and employment in the public sector.

The deficit and surplus in many countries are expected, while in the case of Switzerland federal budget deficit of 124 million francs (118.5 million euros, \$133.8 million) for 2014. Was not expected, thus government decided to investigate and work on budget by cutting spending and other expenditure.<sup>73</sup> While Germany's budget surplus in a row, helps the government of Germany to spend the money on the current migration crisis.<sup>74</sup>

## CONCLUSION

Central banks and the major components of the economy, in particular, fiscal and monetary policies are closely interrelated. As noted by numerous economists, changes in any of the policies affect financial security in any state. Two techniques may be considered for crisis management: "Central banks and governments are faced with a contradiction of interest, in which if they act against the economic recession, pumping extra state funds into the economy, the possibility of increasing the deficit and accelerating inflation to be expected, whereas, if the preference is to act against inflation, to retain the budgetary balance, they are to expect a recession in the economy."<sup>75</sup>

<sup>1</sup> Robert E. Hall – John B. Taylor: *Macro Economics*. W.W. Norton & Company, New York, USA, 1993.

<sup>2</sup> Ibid. 54.

<sup>3</sup> Frederic S. Mishkin: *What should central banks do?* Federal Reserve Bank of St. Louis, 2000. [www](#)

<sup>4</sup> Wrightsman cited in E. Narayanan Nadar: *Money and Banking*. PHI learning Private Limited, Delhi, 2013, 177.

<sup>5</sup> Curzio Giannini: *The age of central banks*. Edward Elgar Publishing Limited, Cheltenham, 2011.

<sup>6</sup> Michael Snyder: *Guess how many nations in the world do not have a central bank?* The Economic Collapse, June 8, 2015. [www](#)

<sup>7</sup> Giannini, op. cit.

<sup>8</sup> *Global Finance Grades The World's Central Bankers 2015*. March 25, 2016. [www](#)

<sup>9</sup> Indranarain Ramlall: *Central Bank Ratings: A new methodology for global excellence*. Palgrave Macmillan, Hampshire, 2016, 78.

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