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FINANCING BUDGET DEFICIT BY CENTRAL BANK

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Abstract: The paper It is shown that conventional concept of monetary seigniorage does not reflect government gains from money creation in transitional economies. The study also reveals sources of fiscal seigniorage in the period of macroeconomic stabilization accompanied by tight monetary policy. In particular,contrary to the common view, the analysis shows that typically revenues from the money creation has not been extensively used as a tool for financing government expenditures in non of the analyzed transitional economies. Nevertheless, the research shows that in CIS countries the flow of the resources from the central bank to the budget remains significant mainly due to the reduction of the portfolio of non-government debt and quasifiscal operations of central banks.

Key words: Deficit financing, Political and market reforms, fiscal seigniorage revenues, economic imbalances.

Over decades all centrally planned economies were ruled by means of the plan which set output goals for all sectors of the economy. Wages and prices were also set by central planner. Money supply was to adjust to ensure meeting the planned equilibrium. This system, maintained artificially for years, brought all related countries to serious economic crisis. Political and market reforms introduced in these countries in the early 1990s changed the situation drastically, however, they were accompanied by a sharp decline in economic activity, an increase in inflation rates [1] and significant fiscal problems. In the first years of transition in most countries the huge jump of inflation came from a combination of price liberalization on the one hand, and large fiscal deficit on the other (largely due to the collapse of the tax base and the extended social duties of the state).

The absence of other sources of financing led to the monetary financing of budget deficits, and hence rapid inflation. In the middle of nineties, however, inflation had came down significantly in all transition countries. Nevertheless, in subsequent years, due to a variety of factors, including the degree of industrialization, the geographical location and orientation of international trade, the extent of initial economic imbalances and the legacy of state institutions, three distinct clusters of countries emerged: Central and Eastern European (CEE) countries on one end, the western Commonwealth of Independent States (CIS) [2], and Baltic countries in the middle, and the Caucasus and Central Asian states at the other end.

[1] Except Czechoslovakia.
[2] Except Belarus

In more advanced CEE countries rapid liberalization and sustained macroeconomic stabilization have laid the basis for the gradual development of market economy. In the less advanced countries (in Caucasus and Central Asia) progress in liberalization has been slow

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and uneven. Moreover, macroeconomic stabilization in these countries has been jeopardized by the persistence of large budget deficits.

It has to be stressed, however, that all transition countries, have faced and still meet the problem of significant fiscal imbalances. This is closely related both to the output collapse and to process of structural reform in the public sector (on the revenue side) and extended social duties of the state (on the expenditure side). Consequently, in most countries large public sector deficits determine most of macroeconomic indicators (monetary growth, inflation rates, interest rates, etc.). According to a common opinion seigniorage revenue and the inflation tax play an important role in financing large fiscal deficits in all transition countries.

The concept of seigniorage can be defined in a few different ways. In the classical theoretical literature three basic definitions of seigniorage are used. The first defines seigniorage as inflation tax. The second defines seigniorage as opportunity cost of holding money – the private sector's loss of foregone interest revenue from holding non-interest bearing cash balances instead of earning assets. The third – and the most general – defines seigniorage as total revenues associated with money creation. It has been shown that the first two definitions are special cases of the last one.

Furthermore, it has to be stressed (see Figure 10) that in all countries considered the scale of the monetary seigniorage (resulting directly from the extension of the monetary base) was relatively large (up to 4% of GDP). The highest values of monetary seigniorage were observed in the first three years of transformation in the Czech Republic, where inflation was always relatively low. In the fourth year of the period analyzed, when some indicators of economic crisis started to be observed, monetary seigniorage in Czech Republic was negative. On the other hand, in Georgia and Kyrgyzstan, as a result of stabilization programs designed by international organizations (World Bank, and IMF) the amount of central bank revenues resulting directly from the creation of monetary base (monetary seigniorage) was relatively low (it did not exceed 2% of GDP). We have to notice that monetary seigniorage corresponds to the revenues of the central bank from the extension of the monetary base only, and does not reflect the flow of resources transferred from the central bank to the budget (see Figure 9 and 10). The values of the monetary seigniorage and fiscal seigniorage are equal to each other only if net investment and other expenditures (e.g., net credits to private sector) are close to zero. Since such situation is not typical for countries in transition, in transitional economies monetary seigniorage definitely does not reflect the flow of the resources from the central bank to the budget (i.e., fiscal seigniorage).

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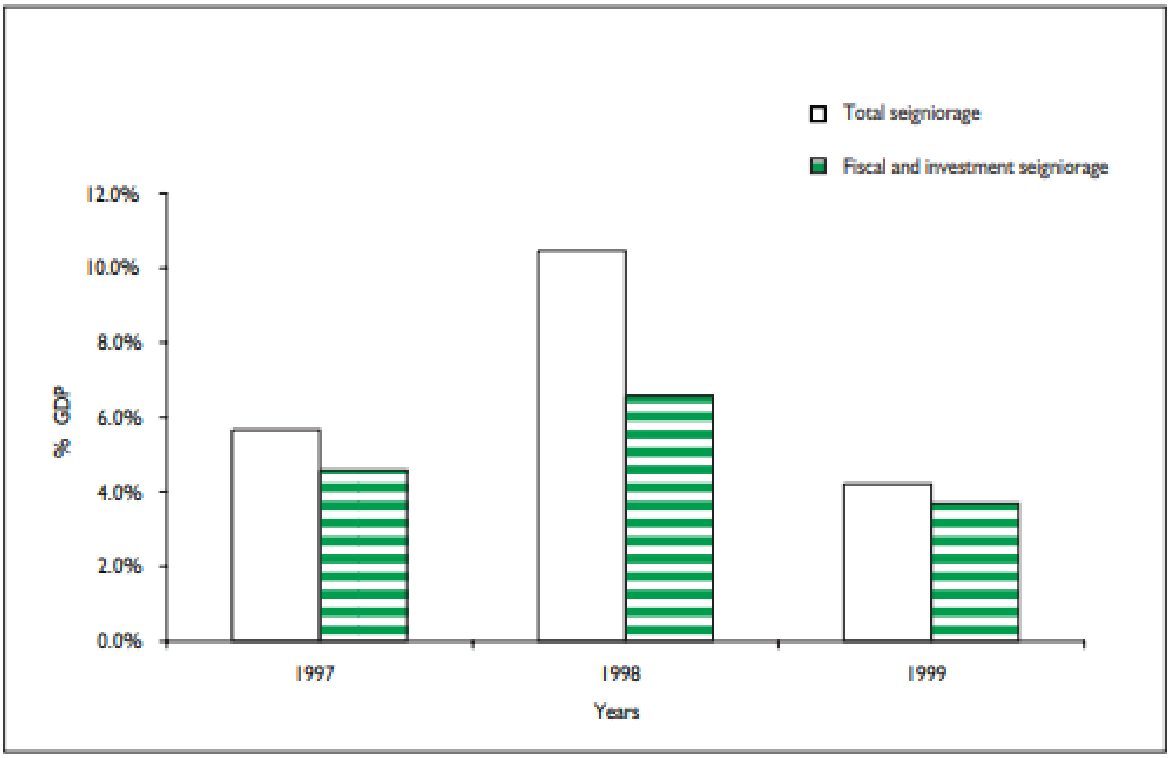
Figure 7. Total seigniorage of the National Bank of Belarus and the scale of public sector financing in the period 1997–1999



Conclusions: The analysis above presents the new view on the formation of the central banks revenues and transfers from the central banks to the budget in the selected transition countries. In particular, in contrary to other empirical studies, in the present analysis we have not relied on the simple concept of monetary seigniorage which measures the flow of the additional monetary base the government can issue, but instead we have used (1) a new concept of total gross seigniorage which measures the total flow to the government sector and (2) fiscal seigniorage which measures the portion of seigniorage received for budget financing.

Finally, it is important to stress that the results presented in this paper imply a weakening of the link between inflation and seigniorage. In particular, much like Klein and Neumann (1990), we would like to emphasize that the increase in a monetary base (and a country's inflation rate) does not automatically imply higher fiscal seigniorage revenues. Nor does the inverse necessarily hold, i.e., a decrease in a monetary base (associated with a decrease in the rate of inflation) does not automatically imply smaller seigniorage revenues for budget deficit financing. An increase in the scope of budget deficit financing can be achieved by increasing the central bank's efficiency instead of by raising the rate of inflation.

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