Can the Central Bank Alleviate Fiscal Burdens?

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Central banks affect the resources available to fiscal authorities through the impact of their policies on the public debt, as well as through their income, their mix of assets, their liabilities, and their own solvency. This paper works through the resource constraint facing the central bank with the goal of understanding whether the central bank can generate fiscal revenues, and in doing so relax (or tighten) the resource constraint facing the fiscal authorities. It discusses five possible channels through which a central bank could feasibly lower this burden by progressively expanding the actions taken by the central bank:

(i) It starts by considering the central bank's ability to take deposits and make loans to banks. This gives it control over nominal interest rates and inflation, and also gives rise to the first channel through which it can lower the fiscal burden: inflating away the debt. While the idea is simple, the paper discusses the difficulties with estimating the size of this channel, with implementing it effectively, and with making it quantitatively relevant.

(ii) It then considers the central bank's provision of liquidity services to the economy, for which it collects a payment commonly known as seignorage. This source of relaxation of fiscal burdens is common during hyperinflations. When inflation is below two digits though, the associated revenues are relatively small, and they are not too sensitive to inflation.

(iii) Next, I introduce voluntary interest-paying reserves that banks can hold at the central bank. The paper starts by describing the unique properties of reserves and by answering one question: should these central bank liabilities be counted as part of the public debt? Taking the other side, this section studies to what extent issuing reserves provides a third channel for the alleviation of fiscal burdens.

(iv) Reserves lead to a definition of the meaning of central bank insolvency, together with its tight link to central bank independence. They point to the fourth channel that this paper studies: the sources of income risk facing the central bank and the possibility that these lead to either sources of revenue to the government or further fiscal burdens in the form of central bank insolvency. I study four sources of income risk, and four associated dangers to solvency. First is the risk from holding foreign currency. This leads to a discussion of the role of central bank income and net worth, and

clarifies why across the world there are special rules involving central bank holdings of foreign reserves. Second are purchases of short-term private bonds by the central bank and their associated default risk. The rules that determine the central bank's dividend to the fiscal authorities and the ability to provision play a key role in determining whether the fiscal authorities must support (or not) the central bank. Third, I discuss sovereign default and the transfers between different economic agents that it entails. Fourth, I discuss quantitative easing: the purchase of long-term government bonds in exchange for bank reserves. I show that QE does not lead on average to fiscal transfers, but it can put to the test the fiscal capacity of the central bank because of duration risk.

(v) Finally, the analysis switches from the resources that the central bank can distribute to the redistributions across fiscal entities that it can trigger. Within a currency union, the central bank can be used to relax the fiscal constraints of some regions, while increasing the fiscal burden of others. This is the fifth and final channel considered in this paper. Using the Eurosystem as an example, I describe the many vehicles that could be used to undertake these redistributions, and how the Eurosystem's institutions prevent them.

The paper concludes by revisiting some commonly heard statements about what central banks can achieve fiscally: "central banks can never go insolvent", "a country that prints its own money can never have a sovereign debt crisis", "the ECB could buy and then forgive the debt of the periphery countries, becoming a vehicle for fiscal transfers within the currency union." I show that, while they are partly correct, they are mostly misleading. The overall conclusion is that the resource flows between the central bank and the fiscal authorities are typically small and do not come for free.