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INFLATIONARY EFFECTS OF BUDGET DEFICIT FINANCING IN CONTEMPORARY ECONOMIES

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Abstract

This paper tries to analyse the relations existing between the different ways of financing budget deficit and inflation, underlining the terms of these relations and the involved social and economic effects. An important source of inflation is considered to be the financing of budget deficits by direct appeal to the central bank's resources, nowadays forbidden by law in most countries for its negative impact. Nevertheless, inflation can also appear as a consequence of debt financing of the budget deficit, considered acceptable in the contemporary society, when it indirectly involves the increase in the amount of money available to the economy above what's absolutely necessary.

Key words: budget deficit, money issuing, debt financing, inflation

1 Introduction

Facing with the need to finance raising public expenses, governments usually resort to increasing current budgetary resources, among which the most important are fiscal revenues. Nevertheless, the effective impossibility or the inappositeness of growing tax revenues (as that supposes measures hard to put into practice, frequently having negative economic and social consequences, unfavourable to the leading Government) often causes a lack of ordinary resources, so that the budget deficit appears, enforcing the use of some other resources, currently called extraordinary as their use is not considered to fall within the normal evolution limits.

In time, two categories of such resources have been frequently employed, the issue of money and the issue of debt, outlining the two major ways of financing budget deficit, namely the monetary financing and the nonmonetary financing.

2 Monetary financing of the budget deficit and its effects

The monetary financing involves the resort of governments to the central bank's resources, in other words the issuing of new money in order to finance the surplus of public expenditures generating budget deficits. Though, we can consider that the monetary financing is employed in order to finance the budget deficit only when governments „force the issuing of money by putting into circulation more money that are normally necessary" [Filip, 2002, 325]. Putting it differently, the government offers on the market a stock of

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money that excels the amount objectively justified to be into circulation, taking into account the proportions and the characteristics of the economy.

Supposing an increase of the money supply, while the quantity of goods and services that are subject to transactions is considered invariable, the issuing of money without real covering in order to finance budget deficit has in the fore-ground as result an increasing level of prices. We can invoke as support for this statement the equation of exchanges formulated by the american economist Irving Fisher in „The purchasing power of money"(1911), which points out the relationship existing between the money stock, the velocity of money and the volume of transactions, as indicated by the fallowing formula:

M*V = P*T, where:

M – the money stock into circulation;

V – the velocity of money;

P – the average price level;

T – the level of output.

On the basis of this equation we can see that, at a given quantity of output, an increasing stock of money into circulation (inclusively as a consequence of new money issuing for financing the budget deficit) is directly reflected in a raising level of prices. It is imperative to specify that, in Fischer's view, the velocity of money is assumed to be constant, as it only depends on the payment habits of the economic entities, which stay unchanged for a certain period of time.

The increase of the level of prices, at a given level of the individuals and organizations' nominal income, will cause the reduction of their real income, in other words a decrease in the purchasing power of these persons. It is enlightened, this way, an important effect of money issuing for financing the budget deficit: it redistributes a part of the purchasing power of the income holders, both individuals and legal entities, at the government's disposal, which makes use of the additional stock of money in order to buy goods and services or to make payments for public consumption. According to Fischer and Dornbusch, „this way, the government can spend more resources and the population less, exactly as if the government would increase taxes in order to finance further spending" [Fischer, 1997, 504].

Regardless of the real conditions of its employment, the monetary financing of budget deficit has as first effect an increase of prices. However, under certain particular conditions of use, this can determine an inflationary, long term increase, depending on the destination of the resources collected by governments in this way.

If the resources resulting from the additional money issuing in order to cover the budget deficit are employed to finance investment projects, which induce a raising output, the original increase in the money stock available to circulation will have as equivalent an raising quantity of goods and services object to tranzactions, in other words of the supply on the real market, and the increase in the level of prices will not become permanent. On the other hand, if the additional resources are employed to finance final consumption expenses, witch do not determine a subsequent grow of GDP, the increse in the price level will be of long standing and the monetary financing of budget deficit will be inflationary.

As governments generally use new money issuing in order to finance unproductive expenses, it is generalized the appreciation that financing budget deficits by money issuing certainly conducts to inflation.

The emergence of inflation, as an effect of financing budget deficit by money issuing, has first of all an impact on the volume of the resources obtained by the government in this way. The real value of usable resources is more reduced following the incidence of inflation, being equal to the purchase power reallocated from the other users of real revenues, lower than the nominal ones as a consequence of the currency depreciation caused by the government.

Moreover, inflation as an effect of monetary financing of the budget deficit has a negative impact, as long as its level is high, all the more so, while the real monetary basis decreases, the inflation rate has to be increased in order to finance a given deficit.

Together with the effects regarding the reduction of government revenues, in conjectural situations and in the short-term, inflation can also have positive effects in this respect. In the case of high indebted countries, inflation can diminish the burden of public debt as a real value, even if this effect only occurs concerning the debt contracted in national currency and is reduced, because often, when inflation appears, the short-term debt weights more. Nevertheless, for the same indebted countries, nominal interest rates increase with the rise of inflation rate, leading to the increase of debt expenditures reflected in the budget, so to the increase of the budget deficit.

The consequences of the rise in prices and the emergence of inflation, including as an effect of excessive money issuing made by the government in order to keep up with its expenditures, can also be emphasized at other levels of economic and social life.

The degradation of value relations among the participants to social and economic life following the inflation, leads to the fact that prices and salaries do not play a role of guiding indices in market economy anymore. When the national supply of goods and services is insufficient and uncompetitive, the depreciated national currency, which should encourage exports, does not succeed in stimulating them; on the contrary, it encourages imports in order to make up for the deficits created by the reduced amount of national output and it leads to the degradation of the balance of payments.

As far as people are concerned, inflation operates an inequitable differentiation of income holders, affecting those having small and fixed incomes (employees, pensioners, unemployed) and encouraging the ones who have a big and variable income, whose purchase power may remain constant or may even increase, under some circumstances. Affecting the corporations management and the investment capacity, inflation can also represent a factor of rise in the unemployment, having severe consequences at the social level. Moreover, inflation spreads uncertainty and anxiety among people, the social climate is deteriorated, the governments and the public authority generally lose their credibility.

High budget deficits that inevitably caused extreme inflation, of up to 50, 100 or even 500 % per year, have been recorded in the mid-eighties in Latin America and Israel. In the 1980's, in Mexico, the monetary basis increased, for instance, with 80-90 % per year, producing an increase of 100-130 % in the inflation rate in that period. According to Nicolae Hoanță, "Mexico's example has to become a warning for any temptation of using money issuing in order to finance the deficit" [Hoanță, 2000, 235].

The awareness of the deep disturbing impact of monetizing budget deficit on the economy and on the society led to its rejection by state authorities, especially in the past decades. Even if money issuing has represented, for a long period of time, a source of financing budget deficit preferred by the governments, as it was easy and quick to employ, in contemporary society it is generally prohibited by law in most of world countries.

This aspect can also be noticed within the European Union, where direct monetary financing of public deficit by central banks was prohibited by the Treaty of Maastrict.

Also, in Romania, within the framework of implementing the acquis communautaire in the banking sector, the new law regarding the status of the National Bank of Romania (Law no. 312/2004) stipulates the prohibition of any direct financing possibility of public institutions by the central bank.

3 Debt financing of the budget deficit and its effects

The second solution for financing the budget deficit implies public loans made by governments in order to make up for supplementary expenditures non-covered by current

revenues. This way, the government facing with the need of raising supplemmentary financial resources transacts with different individuals and corporations disposing of unused financial liquidities and who give them away to states as a loan, this way becoming state's creditors.

There are two essential characteristics definig this form of raising extraordinary revenues. First of all, the resources collected this way are on a temporary basis, the state giving back the respective amount of money to the right owners, after a certain period of time. Those who lend money to governments give up only the right to temporary use the disposable financial resources and the purchasing power they represent, but they keep the property right and the possibility of recovering the resources after some time, in order to satisfy their own needs. Secondly, the public loan, as all other loans, is coslty: it supposes that states pay interest to their creditors as a prices for using the temporary available resources.

As a result of its characteristics, public loan can involve several undesired effects. It mainly leads to the accumulation of public debt and to the increase in interest payments, which determines an increase in the budgetary expenses that states have to cover.

On the other hand, beeing based on attracting free financial resources from the participants in economic relations, the public loan basically expresses "temporary redistribution processes of disposable cash belonging to different physical and legal entities, in order to cover public expenditures". [Filip, 1999, 53]. So, the public loan does not lead to the unjustified increase of the amount of financial signs which are in circulation and it does not generally have an inflationary character. As a consequence, it usually is accepted as a source to finance budget deficits in contemporary society.

Nevertheless, the involvement of money issuing, with all its negative effects, may become possible if the indebtness of the government is accepted as a viable solution, in the context of covering cash deficits of the treasury by loans from the central bank. Thus, if the government meets with financial difficulties, in order to incur expenditures, it may resort to the central bank, requiring it to lend it some money in order to temporarily cover the deficit of public treasury, in exchange of issuing some treasury bills. If the government does not succeed in cashing in current revenues in order to pay back the particular amounts of money anymore, the money stock may unjustifiably increase, that implying the inflationary money issuing.

Under such circumstances, the number of countries forbidding these types of loans has increased. Within the European Union, the Treaty of Maastricht prohibits any type of credit facility granted by national central banks to public entities.

As far as Romania is concerned, it was accepted for a long period of time for the National Bank of Romania to temporary to cover the cash deficits of the public treasury. The central bank was authorized to lend money for no more that 180 days in order to temporary finance the difference between receipts and expenses reflected in the current general account of the Treasury, with market-level interest and without exceding 7% of the state's current budgetary incomes. The unrepayed loans balance had to be, at any moment, less than the double of the bank's capital and reserve fund.

According to the Law no. 312/2004 regarding the status of the National Bank of Romania, the possibility of granting loans by the central bank in order to cover the temporary imbalance between receipts and payments of the current account of state treasury was eliminated.

If the government's indebtness is accepted as a viable solution, the potential engagement of monetary financing, with negative inflationary effects, appears mostly when financing the budget deficit is made via loans from banks, inclusively by acquiring government securities by them.

The participation of banks as government's creditors, without excluding the possibility of redistributing an amount of money already in circulation, often implies the increase of the stock of money for financing the economy. In this respect, the central bank might be involved in the crediting process of commercial banks, by rediscounting operations of commercial papers and, on a similar basis, by granting refinancing credits that can create an increase in the banks' liquidities and the emergence of the so-called "credit-based inflation".

Consequently, money issuing as a financing source of the budget deficit appears only when banks, acquiring government securities and facing a shortage in liquidities, resort to the central bank in order to increase the latter; otherwise, financing the budget deficit remains, in essence, non-monetary.

The size of the newly-created money stock, following government loans in order to cover budget deficit, is rather difficult to assess, depending on one hand on the volume of government securities owned by banks and on the other hand on the ratio of reallocated resources, respectively the newly-created resources, within the total amount of crediting resources.

Banks represent an important buyer of the state's bonds in Romania, this way binding debt financing of budget deficits to inflation. Considering this and since Romania has become part of the European Union and must fulfill nominal convergence criteria in order to be part of the European Monetary Union, the concern of decision-makers to reduce budget deficit should be a crucial one, not only to ensure that the budget deficit is below 3 % of the GDP, which was respected in the last years, but especially to maintain the inflation below 1.5 % of the average of European states performing best in the area.

4 Conclusions

In conclusion, the two main alternatives at governments'disposal in order to cover their budget deficits (namely the monetary financing and the nonmonetary financing) have a different impact on inflation.

As the monetary financing supposes the creation of new money in order to finance budget deficits, it generally involves a greater probability of an inflationary increase of prices to incure, directly depending on the destination of the resources collected by governments in this way. Because of the negative effects inflation has at different levels of economic and social life, it was prohibited by law in most of contemporary economies that state authorities directly resort to the resources of the central bank in order to finance the budget deficit.

This way, at the present time states can only use public loans in order to cover the surplus of public expenditures over current incomes. As it supposes temporary redistribution processes of disposable resources already existent in the economy, this way of financing budget deficits generally does not have an inflationary character.

Nevertheless, in this paper we put into light two indirect ways the involvement of money issuing, with all its negative effects, may become possible if the indebtness of the government is accepted as a viable solution: when the cash deficits of the treasury are covered by loans from the central bank and when banks may acquire government securities and, facing a shortage in liquidities, resort to the central bank in order to refinance. Especially the latter is considerend responsible at the present time for the connection between government's budget deficits and inflation.

Considering this particular connection, we suggest in this paper that the continuous concern of contemporary governments to reduce or to maintain, within acceptable limits, the budget deficits is justified, in order to fight against inflation and its negative effects.

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