

insight on reading the balance sheet of the central bank

Changes in a central bank analytic balance sheet from one year to the other offer an interesting insight about how monetary policy is conducted in practice. The key is to interpret these changes as **sources** or **uses** of financing. Specifically:

- An increase in base money (reserve money) and a decrease in NFA or NDA are **sources of financing**. For example, by increasing currency in circulation the central bank can acquire foreign or domestic assets. Similarly, by decreasing NFA the central bank can acquire domestic assets or reduce its liabilities to the rest of the system.
- A decrease in base money (reserve money) and an increase in NFA or NDA are **uses of financing**. The central bank needs resources to acquire NFA or NDA, which it can obtain, for example, by increasing its liabilities to the rest of the economy. Similarly, the central bank needs resources to decrease base (reserve) money (which is a liability) , which it can obtain, for example, by selling foreign assets.

Changes in base (reserve) money, NFA, and NDA, can illustrate how the central bank is financing its activities and how it is using financing, and in particular they indicate which sectors of the economy the central bank is financing. The table and explanation below illustrate how to use this approach to analyze developments in a central bank's balance sheet.

Analytic Balance Sheet of the Central Bank of Monetaria			
	2011	2012	Difference: 2012 - 2011
ASSETS			
NFA	300	120	-180
NDA	700	1130	430
Net domestic credit	690	1115	425
Net claims on the government	300	650	350
Claims on ODCs	390	465	75
OIN	10	15	5
LIABILITIES			
Reserve money	1000	1250	250
Currency in circulation	450	530	80
Cash in vaults	50	70	20
ODCs deposits	500	650	150

Let us start with the facts:

- During 2012 NFA decreased by 180. This decline cannot be explained by a large exchange rate appreciation (otherwise Other Items, net (OIN) would have increased by about the same amount). The decline in NFA must be reflecting transactions. At the same time, NDA increased by 430, mostly on account of lending to the government sector, and reserve money increased by 250.

Let us now move to the analysis of the changes:

- It appears that during 2012 the central bank more than doubled its financing of the government: the increase was 350. The central bank financed this by increasing reserve money (250) and by selling reserves (180). The financing in excess of what was provided to the government was utilized to provide financing to other depository corporations (75).

At this point, one can reconcile these changes with what happened to the rest of the economy. For example, let us suppose that 2012 was a difficult year for the economy. As growth declined substantially, the government ran a very large deficit to support the economy. This large deficit led to an increase in the current account deficit, which resulted in a negative overall balance of payments which explains the decline in NFA. In addition, the deficit was mostly financed by borrowing from the central bank which resulted in a large expansion of base (reserve) money.