Capital Flows, Real Exchange Rate Dynamics, and the Foreign Debt Position in Sovereign Monetary Systems

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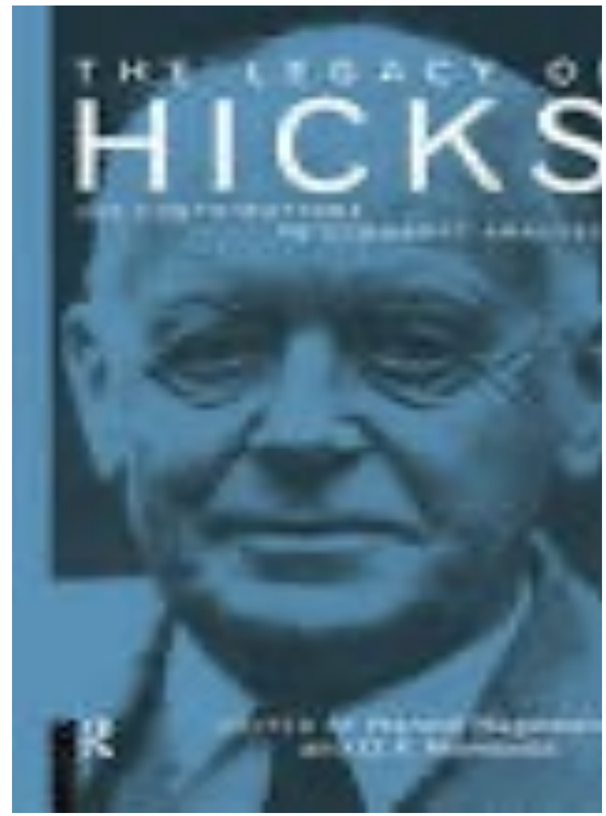
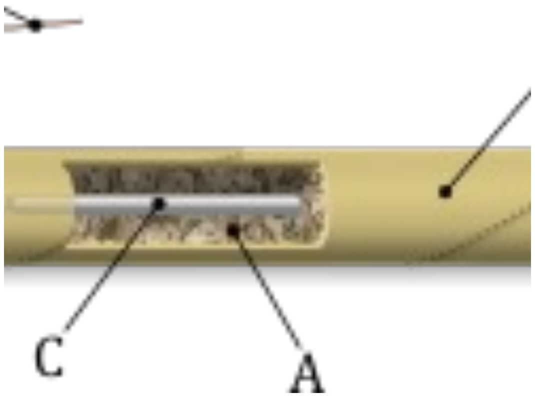
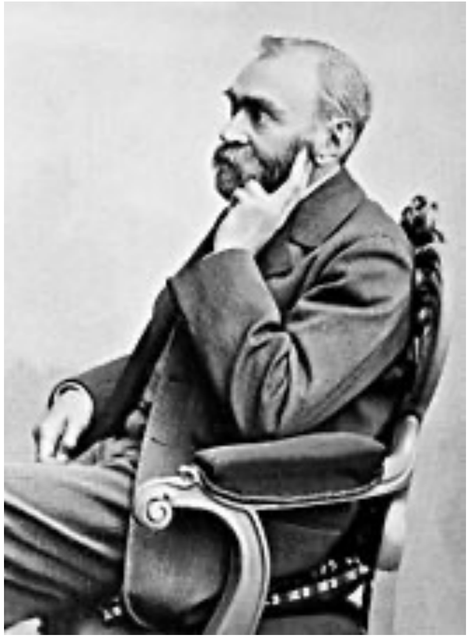
Sir John Hicks (1904-1989): Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, 1972 (joint with Kenneth J. Arrow)



Alfred Nobel (1833-1896)



- The 'real' Nobel prizes are awarded in Physics, Chemistry, Medicine, Literature and (ironically) Peace. Nobel was the inventor of dynamite! The Economics Prize was only started in 1968.
- Apparently, he (Nobel) lived to read his own obituary!
- "The merchant of death is dead"



‘Managing Without Money’ (1986)

- We rely a good deal on Hicks’s work here, in particular his paper ‘Managing Without Money’ (1986).

- What Hicks meant by this was managing without an *international* money (*i.e.*, a reserve currency). He thought that this was impossible.

- The reference was to the great ‘watershed’ in the international monetary system of fifty years ago – the collapse of the Bretton Woods system in the 1971-73 period.

- The ‘system’ that was created then has survived to this. It was a regime of floating exchange rates in the main, *but* with the US dollar continuing in the role of a reserve currency.

- In 2022 we seem once again to be on the threshold of another watershed event in international political economy. To be specific, we refer to the potential displacement of the US dollar as the international reserve currency.

<u>The Bretton Woods System</u>

- A system of fixed-but-adjustable exchange rates, in place 1944-1971.

- Broke down in the 1971-73 period.

- After 1973, there were floating rates for the most part, *but* with the US dollar still as a reserve currency & the USA as the hegemonic power.

- This has lasted to the present day (2022), but now is also breaking down.

- The post-Bretton Woods regime did *not* benefit developing economies, reliance on capital inflows, FDI by multinationals, *etc.*

Keynote Speech Delivered to the Chu-Huang Institution for Economic Research, Tapei, Taiwan, January 03, 1986

❑ Hicks's "Managing without money" paper was delivered as ***Keynote Speech*** in Tapei, Taiwan, in January 1986. This is what he said on that occasion:

"I've done many things in my life, but I don't think I've ever given a keynote speech before before. It puzzled me very much how to give a keynote speech to this distinguished audience. I tried to write out something … but I didn't like it … so I wrote it again. [It] was … better … but … [still] not … a good keynote. However, I got some ideas waking up in the middle of … [the] … night, which … get a little more keynote into it … "

Keynote Lecture (Conferencia Magistral) delivered at UNAM, Cuidad de Mexico, 07/09/2022

- So, as you can see, Hicks's work has been a great help to me (personally) even beyond his contributions to economic theory! I too was not sure how to approach the topic of a **Keynote Lecture** for THIS distinguished audience.

- I had written a neat analytical paper on exchange rate dynamics and capital flows, with some interesting results - but that did not seem to very keynote-like.

- Therefore, what I have done is also to bring in the current crisis in geopolitics and international political economy which - as we speak, on 07 September 2022 - is shaking the foundations of the international financial & monetary itself. (The possible displacement of the US dollar as a reserve currency). It is an obvious move, also, to draw analogies with the earlier crisis of fifty years ago that Hick's himself was discussing.

- I am most grateful to my co-author, and Aurora Philosophy Institute (API) colleague, Andrey Tytchino of Quansimex Inc., for making this happen.

Objectives of the Present Paper (1)

- To present important analytical results for two key indicators of international economic relations for an economy with a sovereign monetary system. (The real exchange rate and the foreign debt position as a % of GDP)

- For the developing economy, the important question is the extent to which the monetary regime can be called a 'sovereign' system. This would involve either a floating exchange rate (or, at a minimum, a 'fixed but-adjustable' exchange rate), an independent fiscal and monetary policy, and the ability to issue foreign debt denominated in the domestic currency.

- *If* so, it might be possible to reverse the dependence on foreign direct investment (FDI), which exists in systems dominated by a hegemonic reserve currency. Instead of uncontrollable capital *inflow*, increasing indebtedness and a negative current account, it may be possible to turn this around. (For the polity to become an international creditor, with a positive equilibrium current account balance as a % of GDP).

Objectives of the Present Paper (2)

❑ Given the geopolitical situation in mid-2022, we also need to comment on a watershed in the development of the international monetary system. Circumstances have arisen that threaten the hegemony of the US dollar. They possibly herald a bi-furcation of the international financial and economic system into two competing blocs.

❑ On the one hand, remnants of the 'Western' system (the G7, the rest of the EU, and Oceania). On the other, much of the rest of world (ROW). The new system may be centred on BRICS (Brazil, Russia, India, China, South Africa), with the addition of new members.

❑ If these changes occur where might the developing economies best throw their lot? Will the new system be more conducive to national economic development and prosperity than before?

Modern Monetary Theory (MMT) and the Notion of Monetary Sovereignty

- Is monetary sovereignty an option for a SOE (particularly a developing economy)?

- The answer to this question is yes, but conditional on the polity having a *sovereign* national currency, in the exact sense in which the term is used in the literature on modern monetary theory (MMT). As explained in such sources as Kelton (2020) and Wray (2012).

<u>According to John Smithin in *Beyond Barter* (2022, vi)</u>

- "The core argument of MMT rests on the logically unassailable proposition that the central government of an economy with … a … sovereign currency and a floating exchange rate (to which I would … add a 'fixed but adjustable' exchange rate), faces no binding financial constraints. Under these circumstances fears about 'unsustainable' budget deficits are nonsense. None of this, however, applies to jurisdictions … [with] … an irrevocably fixed exchange rate, nor … in a currency union. Nor does it apply to the individual Provinces or States in a federal system."

- In short, the structure of the international monetary system *matters*. (It matters a great deal).

The Ontology of Money

- The philosopher Graham Hubbs of the U. of Idaho (another of our API colleagues) has argued that in the debate about MMT the protagonists have all along been arguing about the ontology of money (that is, the nature of money), without perhaps being fully aware of it (Hubbs 2020).

- The main point, discussed in detail in my *Beyond Barter* (2022), is that money is not primarily a 'medium of exchange' evolving from an original state of barter (as assumed by Adam Smith, and in the Mengerian tradition). It is a 'means of payment'. (Specifically a means of payment of debt).

- 'Medium of Exchange' and 'Means of Payment' are not the same thing.

- Hicks himself made this point quite forcefully in his last work, the posthumously published *A Market Theory of Money* (1989)

What 'Counts As' Money? (1)

- The MMT school explains what happens by their mantra that 'taxes drive money'. Consider the two following statements. The first is by Geoff Ingham of Cambridge University (also an API Associate) in *The Nature of Money* (2004):

"All money is debt* in so far as issuers promise to accept their own money for *any* debt payment by *any* bearer of the money"

- The second by Hicks himself in *A Market Theory of Money*:

"Money is paid for a discharge of debt when that debt [itself] has been expressed in terms of money"

* The converse is not true. It is not the case that 'all debt is money' (Smithin 2022).

What ‘Counts As’ Money? (2)

- The state has the power to tax - which means to legally enforce an obligation on everyone in society to become indebted to them. If, therefore, the state is prepared to accept its own liabilities in payment of those obligations (the taxes) it will establish its liabilities as a sovereign money.

- If the state will *not* accept its own liabilities in payment, insisting on payment in things like gold, foreign currency, bitcoin, or whatever, it loses any such power.

- The liabilities of other institutions, such as commercial banks, may also ‘count as’ money when denominated in the national unit of account. Due to:

(a) An explicit or implicit commitment to convertibility.

(b) The fact that those liabilities are also acceptable in payment of taxes.

WHAT 'COUNTS AS' MONEY ? (3)

- Similar mechanisms work not only at the level of the national economy but also at the international level. These considerations will be decisive as to the most acceptable international currency, *i.e.*, a reserve currency (not the power to tax *per se,* but which national currency is acceptable in payment of debt internationally). The reserve currency nation gains hegemonic power (Bell 2001).

- From the point of view of the developing economy two issues are important:

(i) Is the government of a developing economy is able to establish itself as sovereign national level. This is a question of the domestic political settlement, and the appropriate set of institutions.

(ii) What international arrangements allow the developing economy to exercise sovereignty? If all that happens is the replacement of a gold standard with a hegemonic reserve currency, or a common currency, nothing is achieved.

<u>Balance of Payments and Exchange Rate Dynamics for Sovereign Monetary Systems</u> (1)

The analytical results in the paper show that:

- ❑ It is possible to continuously run a budget deficit. The national debt/GDP ratio converges.

- ❑ Similarly for a trade deficit or surplus (preferably the latter!) and the foreign debt position as a % of GDP.

- ❑ The *real* exchange rate is an endogenous (monetary) variable.

Balance of Payments and Exchange Rate Dynamics for Sovereign Monetary Systems (2)

A lower domestic real interest rate:

- Increases the growth rate, reduces unemployment, increases equilibrium inflation, improves the foreign debt position. May either depreciate or appreciate the real exchange rate

An increase in govt. spending as % of GDP:

- Increases the growth rate, reduces unemployment, increases equilibrium inflation, improves the foreign debt position. Effect on the real exchange rate is ambiguous.

An increase in taxes as a % of GDP (the average tax rate):

- Reduces the growth rate, increases unemployment, increases equilibrium inflation, worsens the foreign debt position. Effect on the real exchange rate is ambiguous.

The Preferred International Monetary & Economic System?

- Certainly not globalism!

- Ideally an interaction of different monetarily sovereign nations each with their own currency and central bank, and floating exchange rates or fixed-but-adjustable exchange rates.

- Better not to be dominated by an individual hegemonic power providing the reserve currency.

- A nation possessing a sovereign currency, with a floating exchange rate, has latitude to pursue both monetary and fiscal policies in the national interest. Policy-makers are unconstrained by either budgetary or balance of payments considerations..

- It will be *possible* for that jurisdiction to successfully manage a ‘capitalism in one country’ (even though this is no guarantee that the authorities will pursue the right combination of policies in practice).

Managing Without Money?

- Do the above suggestions imply a need to 'manage without money' - in Hicks's phrase.

- Of course not! There are multiple monies. But there is no *international* money.

- But Hicks, even around the same time he was writing *A Market Theory of Money,* seemed to think that this was impossible

- The context was the earlier watershed event in the international monetary system half-a-century ago - the collapse of the Bretton Woods system when US President Nixon cut the link between gold and the dollar in 1971. Hicks's argument was that the world did then try to get along 'without money' (without an international reserve currency), but failed to do so.

Some More Key Quotes from Hicks

❑ The following (seems) quite like MMT:

"One can lay it down as a general principle that in any country with … a well-established government, and with no trade, anything that that government should like to say was money would be money. There are two ways … that would be so. One is that the government itself would accept it in payments of … taxes … ; the other that contracts … expressed in … money, would be enforced in courts of law"

❑ But Hicks did not accept that these principles also apply to a well-established government *with* trade.
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"When the dollar was floated … in 1971, it was intended … it should be abdicating from the special position … it had occupied … (F)or a while … that … did actually happen. The world had to manage without an international money … it managed very badly … at the next round … international money came back. Governments would not provide an international money … traders had to find one for themselves. There was no alternative … back to dollars. The abdication … was not accepted."

❑ We have already shown that this is not the right way to put it. There *is* a theoretically quite coherent alternative to the existence of some kind of international money. A system of floating exchange rates between the several issuers of separate sovereign monies.

The Current Crisis

❑ Under the pressure of world events, we have arrived at a juncture in geopolitics that may bring great changes in the international monetary and economic system (*e.g.*, the COVID pandemic/panic, debate/agitation around climate change, US military reverses, the Ukraine war & other potential conflicts, increasing political instability in the USA itself).

❑ The governments of the 'Collective West' have increasingly taken decisions to 'weaponize' the economic & financial system against their perceived enemies, domestic and foreign. They have taken to a form of economic warfare, *e.g.*, seizing the property of foreign nationals and domestic citizens by executive order. In the financial sphere the authorities have frozen/confiscated the bank accounts of political enemies, including foreign national governments, effectively shutting them out of the US dollar-based international financial system. In the context of the the war in the Ukraine, we are all familiar with the disruption of the energy and food markets, and the decision of the Russians to accept payment only in roubles.

❑ Whatever the rights and wrongs of the political disputes, decision-makers have failed to appreciate the serious consequences of these actions for the survival of the international financial system itself.

❑ Recall that "all money is debt in so far as issuers promise to accept their own money for *any* debt payment by *any* bearer of the money …" . This is a basic requirement for a money, including an international money, to *be* money. But the USA and others have *not* been honouring their own 'promises-to-pay'. In the long run this can only mean that the claims will no longer count as money, except within a limited national circle, They can hardly continue to serve as international reserves.

A Brief History of the International Financial System

In the paper, we discuss some more of the details of the current geopolitical, economic, and monetary crisis, but a *brief* history of the international monetary system is as follows:

* 1694-1944: Domination by the £ (The ‘international gold standard’ from 1873 onwards was just a façade)

* 1944-1971: Bretton Woods until the ‘abdication’. Effectively domination by the $

* 1971/73 – 2022: ‘Abdication not accepted’ (domination of the $ continued)

* 1999 - ?: The failure of the €

* 2022 - ? : The second abdication of the $

Hegemony of the ₽ or the ¥ or what?

What Does the Future Hold?

- The most important issue is whether any new system would simply devolve back simply into a regime with an alternative reserve system, involving (say) the rouble itself (or perhaps the Chinese yuan), or a system of floating exchange rates as described above. In that case, every jurisdiction trades in terms of its own currency and issues foreign debt denominated in the domestic currency.

- The former alternative would be the logic of Hicks's argument, but the latter would be preferable for the reasons explained above.

- For developing countries, in particular, the preferred alternative is likely to require considerable political will - and enhanced institutional flexibility on their part. Each government, society, and central bank must take active steps to establish its own liabilities as a sovereign money. A difficult task, perhaps, but surely worth the effort?

Conclusion

- A basic question to be asked about ‘money’ is simple. What is it that makes any given promise-to-pay ‘count as’ money? This applies both at the level of the domestic economy, and at that of the international monetary system.

- A nation possessing a sovereign currency, and with a floating exchange, has a great deal of latitude to pursue both monetary and fiscal policies in the national interest. Policy-makers are unconstrained by budgetary or balance of payments considerations.

- This is the opposite position to Sir John Hicks in his discussion of the international monetary system of half a century ago. Hicks thought it impossible to ‘manage without’ an *international* money, even though exchange rates were floating. This was his explanation why the ‘abdication’ (of the US dollar) in 1971 was not accepted.

- Those events were the opening acts in the creation of the unipolar geopolitical system that still exists today - hanging by a thread – and is now itself under immense pressure. Will this latest abdication, 50 years on, now be accepted? If so, what will be the nature of the new system that will emerge to take its place?

Conclusion (continued)

- Contrary to Hicks, this paper has shown that a viable system can exist without there being an international currency *per se*. Each partner must have the ability to issue foreign debt denominated in their domestic currency, and a floating exchange rate.

- The experience of the developing economies has been less than ideal during the revived hegemony of the US dollar during the past half-century. It has been difficult to manage capital flows, and there has been an unhealthy dependence on FDI by multinationals. It has been difficult for developing economies to pursue independent fiscal and monetary policies.

- In the emerging system developing countries will have two difficult strategic policy choices to make. Firstly, which side to take? Secondly, to be willing be consider necessary domestic political and social changes to ensure national monetary sovereignty, escape from globalism, and gain (or regain) the ability to conduct appropriate nationally-based monetary and fiscal policies.