

**The Political Economy of Capital Flows, Real Exchange Rate Dynamics, and
the Foreign Debt Position in Sovereign Monetary Systems**

by

John Smithin

Aurora Philosophy Institute & York University

&

Andrey Tytchino

Aurora Philosophy Institute & Quansimex, Inc.

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1. Introduction

This paper has two main objectives. The first is to present some important analytical results for two of the key indicators of the state of international economic relations for an economy with a ‘sovereign’ monetary system. These are the real exchange rate and the foreign debt position as a percentage of GDP. From the point of view of a developing economy, the key question to ask is the extent to which the monetary system of such an economy 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* (and this may be a very big ‘if’) such a system obtains, then it may be possible to reverse the dependence on foreign direct investment (FDI) - in particular that by large multinational corporations - which has typically existed 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 and to become an international creditor with a positive equilibrium current account balance as a percentage of GDP.

The latter, in turn, is one of three desirable economic circumstances that can lead to a sustainable increase in economic prosperity as measured by real GDP growth. The other two are a primary government *deficit* as a percentage of GDP, and a total of private sector autonomous

spending as a percentage of GDP (including that resulting from Keynes's 'animal spirits') greater than the average propensity to save.¹ In short, the analysis explains the conditions under which it would be possible to pursue a policy of what has variously been called 'economic nationalism', '*monetary* mercantalism', or 'capitalism in one country' (Smithin 2022, 129-34),² as opposed to submission to the vagaries of globalism, the 'New World Order', the 'Great Reset', *etc.*, *etc.*

The second objective is to focus on the extraordinary geopolitical situation which exists at the time of writing (in mid-2022) and what now seems to be a watershed in the development of the international monetary system. A set of circumstances has arisen that at long last threatens the hegemony of the US dollar as an international reserve currency. It possibly also heralds a bifurcation of the international financial and economic system into two competing blocs. On the one hand, there might be the remnants of the 'Western' system (the G7, the rest of the EU, Japan, and Oceania) but, on the other, much of the rest of world (ROW).³ If these sorts of changes do eventually occur (with the obvious caveat that firm predictions at this stage are somewhat hazardous), the urgent question will arise as to where the developing economies might be best be advised to throw their lot. The question also remains as to whether the new system will be more conducive to national economic development and prosperity than it was before.

In what follows, section 2 first elaborates on what is meant by the notion of sovereignty in the present monetary context, while section 3 presents some analytical results. Section 4 discusses the practical implications of the results, and section 5 offers some thoughts on the geopolitical consequences. Section 6 provides a brief summary and conclusion.

¹ See Smithin (2018, 2022). This is not say that it is impossible for growth to occur with any of a higher savings propensity, a budget surplus, or a balance of payments deficit. But it does mean that at least one of the original three conditions must obtain, and also be large enough to outweigh the other two.

² The expression 'capitalism in one country' is a pun on Stalin's (1924) notorious 'socialism in one country'.

³ It is often asserted, for example, that the new system will be centred on the so-called BRICS (Brazil, Russia, India, China, South Africa), with the addition of more and more new members to the bloc as time goes on.

2. Is Monetary Sovereignty an Option for a Small Open Economy (Particularly a Developing Economy)?

Paraskevopoulos *et al.* (1996) posed this very question in an earlier contribution, published at the beginning of the globalist era more than 25 years ago. The answer is *YES*, but this is conditional on the polity under discussion having a *sovereign* national currency, in the sense in which that term has been used in the literature on modern monetary theory (MMT), as explained in such sources as Kelton (2020), Mitchell *et al.* (2019), and Wray (2012).

According to Smithin (2022), the mainstream approach to monetary theory and policy has failed because it is based on the wrong premises. It does not address the real complexities of the social ontology of the macroeconomy and tries to explain all economic activity with reference to the model of barter, thereby treating money as nothing more than a ‘medium of exchange’. According to the conventional approach money may help to facilitate trades that would take place anyhow, but its existence does not change anything fundamental in economic life. However, this ontology was ultimately based on nothing more than false conjectures about money’s historical evolution, and the entire approach turns out to have been misguided in theory and practice. What is truly important about money is that it is a ‘means of payment’, specifically a means of payment of debt. As explained by Ingham (*e.g.*, 1996, 2004) money is actually a ‘social relation’ involving debt and credit.⁴ While it is true that in a modern monetary economy many of the debts are indeed incurred in the process of making trades and fulfilling the associated contracts, the focus on debt marks a fundamental change of emphasis. The analyst is *forced* to recognize the importance of bank credit creation and endogenous money for the generation of profits denominated in monetary

⁴ See also Bell (2001).

terms, and thereby for the entirety of the scale and structure of economic activity. Confusion arising from basic misunderstandings about the nature of money was revealed in dramatic fashion by the policy debates over MMT in the USA in recent years. MMT was championed by some radical politicians and just as strongly resisted by those of a different political persuasion. However, as the philosopher Graham Hubbs (2020) has stated, all along the protagonists have essentially been arguing about the ontology of money without perhaps being fully aware of it. By now, it is clear that there are some ‘empirical problems’ (Smithin 1990) that have arisen in the practical application of MMT-type policies, such as the onset of stagflation. However, the core argument of MMT rests on the ‘logically unassailable proposition’ (Smithin 2022, v-vi) that the central government of an economy with its own sovereign currency and a floating exchange rate faces no binding financial constraints (to which we would add a ‘fixed-but-adjustable’ exchange rate). Under these circumstances fears about unsustainable budget deficits, and so forth, do not make sense. Those empirical problems that have occurred in practice, some of which were predicted by Smithin (2016a, 2016b, 2020, 2021), have had mainly to do with debates about the correct level of interest rates. What seems to be most important is whether we should define and think about interest rates primarily in *real* or *nominal* terms.

Textbook discussions often start with the notion of identifying the ‘functions’ of money. The so-called functions are often given as a triad, namely (1) a unit of account, (2) a medium of exchange, and (3) a store of value. The idea seems to be that money can be defined simply as the asset which best performs the three functions in any given state of society. Keynes (1930), albeit using a slightly different terminology, had actually argued that the unit of account function was fundamentally important, but this view is not shared by modern textbook writers. They don’t seem to think it is important at all. This is a serious mistake. If there were no unit of account it would be

impossible to conduct business on a rational basis by quoting prices, keeping accounts, and obtaining the necessary finance. On the other hand, the notion of a medium of exchange *is* regarded as important, because of the supposed analogy to barter. Another mistake. Finally, in standard theories of the demand for money and portfolio choice, the idea of money as a store of value continues to be emphasized. Also, an error. Experience over long periods shows that money is certainly not the only store of value, and not necessarily the best, often far from it. Yet it continues to be used long after inflation rates have reached very high, and even hyper-inflationary, levels.⁵ In a posthumously published book entitled *A Market Theory of Money*, the late Sir John Hicks (1989) finally broke entirely with the usual three-fold classification. Translated into the terminology we have been using here, Hicks's argument was that the two main functions of money were (1) a *unit of account*, and (2) a *means of payment*. Ultimately - in practice - 'money' will always turn out to be that asset in which the two functions are combined (Smithin 1994). The store of value aspect is downplayed.

How does the notion of a means of payment differ from that of the medium of exchange? Hicks's answer was that, in reality, the typical transaction is not simply a straightforward 'spot' exchange of goods for money or *vice versa*. Particularly for the more important large value transactions, some sort of agreement (an explicit or implicit contract) is required for trade to take place. The timing of delivery and payment is highly variable. Debt are continually being created and extinguished, but it is not possible to be dogmatic about exactly when. In some cases, the buyer must pay 'cash in advance' before delivery of the item. In others, payment is made later, 'in arrears'. Spot payment is only a special case. In all three cases it is implicit that money, the thing

⁵ To make such a case is not to deny that money might be more useful in capitalism if its real value could be kept more stable. But it is not a primary. It is not part of the ontology of money.

offered in payment, is in a different category altogether from the goods and service being offered for sale. Otherwise, when trading apples for oranges why not consider either one of them ‘money’? The concept of a means of payment also extends quite naturally to cover the case of purely financial transactions.

The next question to ask is how all this works out in an actual economy. The MMT school, for example, explains what happens by their mantra that ‘taxes drive money’. Consider the two following statements as quoted by Smithin (2022, 8). The first is by Ingham in the previously cited work *The Nature of Money*:

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.⁶

The second is 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.

So, building on these statements and others like them, the MMT argument is that 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 always prepared to accept its own liabilities in payment of those obligations (the taxes) it will establish its liabilities as a sovereign money. If it does not do that (if the state will not accept its own liabilities, insisting rather on payment in things like gold, foreign currency, or bitcoin!) it loses any such power. In practice, the liabilities of other institutions such as commercial banks may also ‘count as’ money, when denominated in the national unit of account. This is due to:

- (a) An explicit or implicit commitment to convertibility.
- (b) The fact that those liabilities are also acceptable in payment of taxes.

⁶ The converse is not true. It is not the case that ‘all debt is money’ (Smithin 2022).

These mechanisms are thought to work not only at the level of the individual national economy but also at the international, or geopolitical, level. Similar sorts of considerations, if not the power to tax *per se*, will be decisive as to which is to be the most acceptable international currency, *i.e.*, a reserve currency. When a national currency becomes an international reserve currency that nation gains hegemonic power (Bell 2001). And, as already mentioned, from the point of view of the developing economy two issues are important:

- (i) The extent to which the government of a developing economy is able to establish itself as sovereign. This will be largely a question of the domestic political settlement, and the establishment of the appropriate set of domestic institutions.
- (ii) What type of international arrangements need to be in place to allow the developing economy to exercise sovereignty. If all that happens at the international level is the replacement of the hegemony of a gold standard, for example, with that of the nation controlling the reserve currency, or that of a multi-national union currency union, nothing will have been achieved.

3. Balance of Payments and Exchange Rate Dynamics for Sovereign Monetary Systems

In another significant contribution, Hicks, whose views on the ontology of money have just been discussed, also applied similar ideas to the evolution of the international monetary system. Particularly important was a *Lecture* entitled ‘Managing without Money’ delivered many years ago to the Academia Sinica and the Chu-Huang Institution for Economic Research in Taipei, Taiwan. Hicks (1986, 26) stressed that ‘there is ... an intimate relation between money and trade’. In the following passage, he then went on to seemingly anticipate some of the points later made by the MMT school, well before these arguments became popular and were widely discussed:

One can lay it down as a general principle that in any country with a single government, 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 in which it could ensure that that would be so. One is that the government itself would accept it, in payments, such as taxes that were due to it; the other that contracts, expressed in that money, would be enforced in courts of law.

But an important caveat here is that Hicks did not appear to accept that these principles might also apply to a well-established government *with* trade. This was the point of his notion of ‘managing without money’. He was specifically referring to the impossibility of managing without

an *international* money, that is without a reserve currency. He did *not* seem to think that this could be achieved. The context was an earlier watershed event in the international monetary system of half-a-century ago, namely the collapse of the Bretton Woods system in 1971 when then US President Richard M. Nixon cut the link between the US dollar and gold. Hicks's argument was that the world did try to get along 'without money' (without an international reserve currency) in the immediate aftermath of the financial crisis of 1971, but failed to do so. This is how he proceeded to argue the point (Hicks 1986, 28):

When the dollar was floated ... in 1971, it was intended that it should be abdicating from the special position which it had occupied for so long. That is what, for a while, did actually happen. The world had to manage without an international money, and [as I ... have shown] it managed very badly. Then, at the next round, the international money came back. Governments would not provide an international money; so traders had to find one for themselves. There was no alternative; they had to go back to dollars. The abdication, that is to say, was not accepted.

We have already suggested, however, that this is not quite the right way to put it. Of course, capitalism cannot exist without 'money' in the most basic sense. This point is not in dispute. The question is always rather 'what do we mean by money?' in any given context. Regardless of how Hicks and others may have interpreted the experience of the early 1970s, the analytical results we next go on to present will show that there is, in fact, a theoretically quite coherent alternative to the existence of some kind of international money. That is, a system of floating exchange rates between the several issuers of separate sovereign monies.

In such a sovereign economy the effects of most policy and other macroeconomic changes will be qualitatively the same as those in the equivalent closed-economy case (Smithin 2013, 2018, 2022). The domestic authorities will have no difficulty in issuing debt denominated in their own currency, and they are therefore able to conduct exactly the same fiscal and monetary policies as they would do in the closed economy case. All that is then needed for a complete analysis of the open economy, is simply to add the results for changes in the real exchange rate and the foreign debt position to those already worked out. For an economy with a fixed-but-adjustable exchange

rate the results also resemble those of the closed economy. Note that these considerations completely overturn the old idea, derived from the Mundell-Fleming model of the 1960s, that monetary policy can be assigned to a floating exchange rate regime and fiscal policy to fixed exchange rates. To successfully pursue either monetary or fiscal policy requires a sovereign currency, and a floating exchange rate or a fixed-but-adjustable exchange rate.

On the other hand, none of this applies to jurisdictions that have an irrevocably fixed exchange rate, nor to those embedded in a currency union. Nor does it apply to the individual ‘Provinces’ or ‘States’ in a federal system. In spite of the name, a putative ‘hard peg’ for the nominal exchange rate (such as, *e.g.*, a metallic standard, a credible fixed exchange rate regime, or a currency board with no loopholes) is actually an unstable system and will eventually break down.⁷ There is no effective sovereignty in this case. The further idea of a currency union is to do away with exchange rates altogether. That is a total abandonment of sovereignty. And, remarkably, even though the intent is to eliminate exchange rate problems, experience shows that when actually applied the currency union has more-or-less the same instability characteristics as those of a hard peg. For a currency union, unless the domestic polity is willing to give up control over economic policy entirely, there are only two possible long-run outcomes:

- (A) A break-up of the system, which would be the equivalent of an exchange rate crisis in this context.
- (B) Eventual evolution into a true federal state, with a developed system of fiscal federalism. In the latter case, the different countries literally turn into mere ‘Provinces’, and no longer have even the semblance of national sovereignty.

Next, we work out the dynamics of the foreign debt position, and those of the real exchange rate itself, in the sovereign system. Here we can focus here solely on the case of a flexible exchange

⁷ There are numerous historical examples. Incidentally, the use of term ‘credible’ as applied to such a system invariably turns out to be a misnomer. The analysts concerned will typically have been applying the results of financial modeling learned in business school rather than the lessons of historical experience.

rate system because the dynamics for the case of a fixed-but-adjustable exchange rate are similar.⁸ First, recall that in a flexible rate system the capital account (KA) of the balance of payments (BOP) will be the inverse of the current account (that is $KA = -CA$). In turn, CA itself is made up of two components, namely, net exports ($EX - IM$) and foreign investment income (FII). Therefore, we may write:

$$(1) \quad KA = - (EX - IM + FII)$$

Next, let the symbol B stand for the total real value of domestic bonds outstanding in the hands of foreigners (assumed to be denominated in domestic currency), and r for the domestic real rate of interest. This gives:

$$(2) \quad B - B_{-1} = - (EX - IM) + r_{-1}B_{-1}$$

Then divide through by real GDP (Y) to obtain:

$$(3) \quad B/Y - (B_{-1}/Y_{-1})(Y_{-1}/Y) = - [(EX - IM)/Y] + r_{-1}[(B_{-1}/Y_{-1})(Y_{-1}/Y)]$$

Now define the foreign debt to GDP ratio, b , as $b = B/Y$, and also specify the trade balance as a percentage of GDP [that is, $(EX - IM)/Y = ex - im$] as a negative function of the real exchange rate Q ⁹. For example, we may specify that $ex - im = -e_2q$, where $q = \ln Q$ and $e_2 > 0$. We therefore arrive at the following difference equation in the foreign debt position:

$$(4) \quad b - b_{-1} = e_2q + (r_{-1} - y)b_{-1} \quad e_2 > 0$$

Here, lower-case y stands for the growth rate of real GDP, that is $y = [(Y - Y_{-1})/Y_{-1}]$.

Also, as in Smithin (2022, 123), the expression for the real interest differential between the domestic real interest rate (r) and the foreign real interest (rf) is given as follows (where the symbol Z represents the currency risk premium):

⁸ See Smithin (2013, 296-97).

⁹ If E , the nominal exchange rate, is defined as the domestic currency price of one unit of foreign exchange, P is the domestic price index and P_f is the foreign price index, the real exchange rate Q is given by $Q = EP_f/P$.

$$(5) \quad r - rf = [(Q - Q)/Q] + Z$$

The exchange rate dynamics themselves may therefore be inferred by lagging equation (5) by one period and rearranging, as follows:

$$(6) \quad [(Q - Q_{-1})/Q_{-1}] = r_{-1} - rf_{-1} + Z_{-1}.$$

Supposing that the risk premium (or discount) Z may be specified as $Z = -z_0 - z_1 b$, where $z_1 > 0$, this implies that:

$$(7) \quad q - q_{-1} = r_{-1} - rf_{-1} - z_0 - z_1 b_{-1}.$$

For a debtor country Z will be a negative number, and will become the more negative the greater is the foreign debt to GDP ratio. The term z_0 , meanwhile, may be thought of as a measure of ‘international liquidity preference’. It is an index of the extent to which investors feel safer in holding foreign currencies rather than the domestic currency.

Thus, the following is a continuous time approximation to the original system that was set out in equations (4) and (7):

$$(8) \quad db/dt = e_2 q + (r - y)b, \quad e_2 > 0$$

$$(9) \quad dq/dt = rf - r - z_0 - z_1 b, \quad z_1 > 0$$

Temporarily setting $drf = dr = dz_0 = 0$, this reduces to:

$$(10) \quad \begin{vmatrix} db/dt \\ dq/dt \end{vmatrix} = \begin{vmatrix} e_2 & (r - y) \\ 0 & -z_1 \end{vmatrix} \begin{vmatrix} dq \\ db \end{vmatrix}.$$

Global stability for this system (in the mathematical rather than the geopolitical sense!) would require that the trace ($Tr B$) of the right-hand side (RHS) matrix ‘ B ’ is negative and that the determinant ($Det B$) is positive. However:

$$(11) \quad Tr B = -e_2 z_1, \quad (< 0)$$

$$(12) \quad Det B = -e_2 z_1, \quad (< 0)$$

The trace is negative but so also is the determinant. It is *not* positive as a finding of globally stability would require it to be. A negative determinant, in fact, indicates that the equilibrium is a saddle-point. The upshot is that the system is neither globally stable, nor completely unstable.

What are the implications of the above finding? The usual argument is that if some sort of economic mechanism exists to place the economy on the single ‘stable arm’ of the phase plane then eventually the system will be able to reach an equilibrium. In the present case, for example, the stabilizing factor might be expectations of how the exchange rates themselves are going to adjust.¹⁰ If the system does follow the ‘stable arm’, the equilibrium solution is as follows:

$$(13) \quad \begin{vmatrix} -e_2 & -(r-y) \\ 0 & +z_1 \end{vmatrix} \begin{vmatrix} dq \\ db \end{vmatrix} = \begin{vmatrix} 0 & 0 & 0 \\ 1 & -1 & -1 \end{vmatrix} \begin{vmatrix} dr \\ drf \\ dz_0 \end{vmatrix}$$

Next, we can work out the determinant ($Det A$) of the left-hand side (LHS) matrix ‘ A ’. This turns out to be:

$$(14) \quad Det A = -e_2 z_1.$$

With this information, we may then solve by ‘Cramer’s Rule’ (Chiang and Wainwright 2005, 199-205) to obtain the following results;

$$(15) \quad \begin{aligned} dq/dr &= -(r-y)/e_1 z_1 \quad (?), & dq/rf &= (r-y)/e_1 z_1 \quad (?), & dq/dz_0 &= (r-y)/e_1 z_1 \quad (?), \\ db/dr &= 1/z_1 \quad (+), & db/rf &= -1/z_1 \quad (-), & db/dz_0 &= -1/z_1 \quad (-). \end{aligned}$$

In the truncated system in (13) the only policy option available to the authorities of the domestic economy is to influence the domestic real rate of interest *via* monetary policy. But, in context, this remains a valuable policy tool precisely because the domestic authorities need not be influenced or constrained by whatever is happening in the ROW. The results show that a lower

¹⁰ See, for example, Paschakis & Smithin (1998) and Kam & Smithin (2004).

domestic real rate of interest rate improves the foreign debt position by reducing capital inflow and improving the current account. In turn, this will improve the economic growth rate, reduce unemployment, and increase real wages. The effect of a lower domestic real rate of interest on the real exchange rate is ambiguous. It all depends on the starting value of the term $(r - y)$, that is, on the difference between the domestic real rate of interest rate and the rate of real growth. There are thus some circumstances in which a deliberate policy of lower real interest rates may improve the economy so much as to actually cause an eventual *appreciation* of the real exchange rate.

4. Implications of the Analytical Results

Overall economic equilibrium for a sovereign economy does not entail either ‘external balance’ or ‘internal balance’ as these are conventionally defined. It is therefore possible for such an economy to continuously run a budget deficit, for example, and nonetheless the (national) debt-to-GDP ratio will converge to some sustainable steady-state level. The foreign debt position itself will similarly converge. It is also possible for the state of animal spirits or business confidence in the domestic economy to be such that the ratio of private sector autonomous spending as a percentage of GDP is permanently greater than the marginal propensity to save. In short, Keynes’s original idea of ‘abolishing the trade cycle’ by ‘keeping us in a state of semi-boom’ rather than ‘permanently in a state of semi-slump’ (Keynes 1936)¹¹ would be well within reach. Expansionary policy need not be constrained by the usual balance of payments or budgetary considerations. The real exchange rate, meanwhile, is an endogenous variable. It will simply adjust to whatever the state of the economy happens to be. It is not tied down by any notional barter terms of trade, any more than

¹¹ As quoted by Smithin (2022, 101).

the domestic rate of interest itself can be tied down by an (entirely mythical) ‘natural rate’ of interest (Graeber 2011, Smithin 2018, 2022).

Turning now to the specifics of macroeconomic policy in the sovereign open economy, we have already seen that permanently lower real rates of interest on money will tend to permanently increase economic growth - albeit at the cost of a somewhat higher inflation rate. However, an important point to note is that although the inflation rate does increase, it does not continue to ‘accelerate’ after the new equilibrium is reached. It does not get totally out of control. At the same time the foreign debt position will be reduced, or alternatively the foreign credit position will be strengthened. This occurs because lower real interest rates, in addition to their direct effects on growth, cause capital outflow and thereby improve the current account of the balance of payments. The effect on the real exchange rate is ambiguous, depending on initial conditions. As already stated, in an open economy with flexible exchange rates the real exchange rate simply adjusts to whatever the new situation is. It may appreciate or depreciate, but in neither case will the changes in the exchange rate constrain economic expansion.

Details about the effects of other macroeconomic changes, including changes in fiscal policy and in such factors as business confidence and/or liquidity preference, have been provided elsewhere (Smithin 2018, 2022). An expansionary fiscal policy, in the sense of an increase in the ratio of government spending to GDP, will unambiguously increase the growth rate, just as Keynesian advocates of ‘fiscal stimulus’ have always argued. As a result of such a stimulus there will indeed be a somewhat higher inflation rate, but again this will not be an ever-accelerating increase. Moreover, the increase in inflation will lead to precisely the *opposite* results for the effects of fiscal policy on interest rates to those based on either the old IS/LM model, or the Mundell-Fleming model. There is actually a negative relation between real interest rates and

inflation,¹² and therefore the real lending rate of the commercial banks, r , will *fall*. As for international economic relations the foreign credit position and the current account will both improve, whereas the real exchange rate could go either way. (This is a drastic reversal of orthodox thinking about the international economy).

A reduction in the average tax rate (a lower overall tax burden) also constitutes an expansionary fiscal policy and has the effect of increasing the rate of growth of real GDP. In the case of tax cuts, however, this is not just a question of increasing aggregate demand. Tax cuts work *via* a combination of demand-side and incentive, or supply-side, effects. It is *very* important to notice that when an expansionary fiscal policy is effected by reducing the tax burden, rather than increasing spending, the inflation rate does not rise¹³ but actually *falls*, due to the impact of the lower taxes on production costs. This is a major difference between the two alternative types of fiscal expansion (Smithin 2013, 259-60). Given a *lower* rather than a higher rate of inflation, there will also be an increase in the real lending rates of interest charged by the commercial banks. We therefore get a worsening of the current account and an increase in foreign indebtedness. Again, the effect on the real exchange rate will be ambiguous.

It is also interesting to consider the effects of an exogenous or spontaneous increase in productivity that might occur in the domestic economy (say as a result of technological innovation). As might be expected this increases the growth rate and reduces the inflation rate, again *via* lower production costs. The domestic real rate of interest, therefore, is again likely to increase *via* the Mundell-Tobin effect (see fn. 12). Note, however, that this has nothing to do with

¹² This is the so-called ‘Mundell-Tobin effect’ (*aka* in the history of economic thought as the ‘forced saving effect’) as explained by Smithin (2022, 55-60).

¹³ The opposite assumption invariably made in the era of *faux* Keynesianism in the thirty-five years or so after WW2, with the dangerous corollary that one of the ways cure inflation is to *raise* taxes. In some quarters this idea has lasted even down to the present day.

conventional ideas about how productivity changes affect the supposed ‘rate of return to capital’.¹⁴ It is the real rate of interest on *money* that is affected *via* the effects on domestic and international financial markets. If there are no financial effects, there is no impact on interest rates. In effect, we now have a ‘monetary theory of the real rate of interest’ rather than a ‘real theory of the real rate of interest’ (Burstein 1995).¹⁵

5. The International Monetary System at a Crossroads

Returning to the sphere of geopolitics, we have already made reference to Sir John Hicks’s insightful discussion of the events that took place in the international monetary system half-a-century ago, leading to the collapse of the ‘Bretton Woods’ system. In fact, Hicks was describing the very origins of the international regime that has persisted to this day, and is now itself apparently on the point of collapse. Under the pressure of world events in our own times, we have again arrived at a juncture in geopolitics that seems to herald great changes in the international monetary and economic system. To be specific, it is about the potential displacement of the US dollar as a reserve currency. The question naturally arises as to the type of system that might replace it. We earlier spoke, for example, of a possible bifurcation of the system that may be happening as a consequence of the collapse of the pre-existing unipolar geopolitical system. To repeat, from our point of view the vital question is whether, or not, the new emergent system will allow for the type of economic nationalism discussed above (with floating exchange rates, *etc.*) to the mutual benefit of all?

To re-use Hicks’s clever metaphor, the US dollar now seems again to be ‘abdicating’ from its central position in the international monetary system, exactly as happened fifty years ago. Might

¹⁴ Which, in any event, is itself an incorrigibly incoherent and confusing idea (Smithin 2022, 56-58).

¹⁵ See also Smithin (2018, 2022).

it be the case that this time the abdication will be accepted? What has now happened is that under the pressure of the extraordinary series of geopolitical events of recent years, such as the COVID pandemic, concerns around climate change, US military reverses, the Ukraine war and other potential conflicts, and increasing political instability in the USA itself, the governments of what we now call the ‘collective West’ have increasingly taken policy decisions to ‘weaponize’ the economic and the financial system against their perceived enemies, domestic and foreign. The US government and others have taken to a form of economic warfare, simply seizing the property of both foreign nationals and domestic citizens by executive order. In the financial sphere, the authorities have also frozen or confiscated the bank accounts of political enemies, both individuals and foreign national governments, thereby effectively shutting these entities out of the dollar-based international financial system.

Whatever may be the rights and wrongs of the multiple political disputes, the decision-makers concerned have seeming failed to appreciate the very serious consequences of these actions, even for the survival of the international financial system itself. We should immediately recall Ingham’s (2004) concise statement, already quoted above, 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 ...’ (original emphasis). This is a basic requirement for any money, including an international money, *to be* money. It is a fundamental ontological issue. In effect, the USA and others have *not* been honouring their own ‘promises-to-pay’. If this continues, in the long run this can only mean that the claims will no longer be able to count as money, except perhaps within a limited national circle, as Hicks already pointed out. They can hardly continue to serve as international reserves.

As a recent example of this kind of thing, consider the monetary and financial side-effects of the war in the Ukraine in the current year 2022. Economic and financial sanctions against the

Russian side have been applied by the NATO¹⁶ allies, the European Union (EU), and others, preventing either the Russian government or individual citizens from accessing their dollar denominated assets, and thereby from either paying off dollar denominated debts, making interest payments, or purchasing goods and services with dollars.¹⁷ Before the war the Russian Federation had been a major supply of energy such as oil and gas and other commodities to many of those nations in the NATO alliance and the EU who later became their *de facto* adversaries. Typically, payment for these goods had been made in terms of US dollars, the ‘international money’ that Hicks had claimed, back in 1971, that the world could not do without. In 2022, many of the nations that were unfriendly to the Russians, either refused outright to continue to trade (even to their own economic detriment), or if they were willing to continue, expected still to be able to make payments in a currency that was no longer of any use to their trading partners. To the extent to which trade in the ROW had also been conducted in terms of dollars this would be a problem even with those nations/trading blocs that remained on friendly terms with the Russian Federation. For the Russians, therefore, one obvious solution was to require payment for energy supplies in their own currency, the rouble. Regardless of how those participants are able to acquire roubles, it can be seen that this already foreshadows the kind of exchange rate system analysed in Section 3 above. In general, the geopolitical events seem to have persuaded some of those nations *outside* of the collective West that some other form of trading and payments system will have to be set up, one which does not rely on the dollar or Western-orientated banking mechanisms such as SWIFT.¹⁸

¹⁶ That is the North Atlantic Treaty Organization.

¹⁷ Ironically, of course, the main losers from this, in pure economic terms, were the international bondholders or customers/importers themselves!

¹⁸ The acronym stands for the Society for Worldwide Interbank Financial Telecommunication, an international financial messaging system.

The latest blow to the US dollar, at the time of writing, happened at the BRICS meeting in August 2022. At this meeting a discussion about excluding the US dollar from the international trade settlements system was brought to the table. Therefore, if the financial policies of the BRICS and other countries continue to move in the intended direction then, instead of the US dollar, currencies such as the Russian rouble, the Chinese yuan, and the Indian rupee, will take centre stage. The Iranian real may also be another possible currency option. (In that case, because Iran having already been under international economic sanctions for 40 years the Iranian currency has not been exposed to externally destabilizing financial regulations.)

Another recent serious action against the US dollar was the directive of the National Bank of Russia to accept payments for oil and gas in roubles only, prohibiting US dollars and other currencies for use in energy transactions. Also, Russia has refused to settle debts on bonds outstanding in any currency other than roubles, and this has forced Western economies to buy massive amounts of roubles on FOREX markets. Still another factor playing against (much of) the collective West is the need to now replace Russian energy sources with more expensive alternatives. This will greatly exacerbate production costs and supply chain issues generally, and increase inflation. This will put pressure on the exchange value of the Euro and ultimately threatens the very integrity of the economic and financial system of the EU.

No doubt it is too early to say how this is all actually going to work out in the future. On this point, we can conveniently quote from Hicks (1986, 28) once again. Referring to the later historical developments in the international monetary system from the collapse of Bretton Woods up to his time of writing, he writes:

[My final remarks] ... will be confined to what has happened. I have seen too many economists come to grief by making predictions! I shall not follow their example.

We should also be prudent and try to follow Hicks's own example. We will simply say (again) that, in our view, the most important issue to consider is whether or not any new system would devolve back simply into a regime with an alternative reserve currency system involving (say) the rouble itself, or perhaps the Chinese yuan - or a system of floating exchange rates such as that described in Section 3 above. In that case, every jurisdiction trade in terms of its own currency, and has the ability to issue foreign debt denominated in that currency. An alternative reserve currency would be the logic of Hicks's argument, but the latter, we think, would be preferable for the reasons explained above. It is true that for the 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 their own liabilities as a sovereign money. A difficult task, perhaps, but surely worth the effort?

6. Conclusion

A basic question to be asked about 'money' is a very simple one. What exactly is it that makes any given promise-to-pay count as money? This applies both at the level of the domestic economy and *a fortiori* at that of the international monetary system. The analytical part of this paper has shown that a nation possessing a sovereign currency, and with a floating exchange, has a great deal of latitude to pursue both monetary and fiscal policies that are in the national interest. Policy-makers are unconstrained by either budgetary or balance of payments considerations. It will at least be possible for that jurisdiction to successfully manage what we have called a 'capitalism in one country' even though, needless to say, this is by no means a guarantee that the authorities concerned will actually pursue the right combination of policies in practice.

This is the opposite position to that taken by Sir John Hicks in his discussion of the great watershed in the international monetary system of half a century ago, when the Bretton Woods

system collapsed. Hicks thought that it was impossible to ‘manage without’ an *international* money, even though at least some exchange rates were then floating. This was his explanation as to why the ‘abdication’ of 1971, as he put it, was not accepted. As it turned out, those events were the opening acts in the creation of the unipolar financial and geopolitical system that still exists today hanging by a thread, but 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? It is most certainly the case that for there to be ‘capitalism in one country’ there must be a sovereign and well-managed monetary system in that country. Nonetheless, contrary to Hicks, the analytical part of this paper has shown that a viable system can indeed exist without there being an international currency *per se*. What is required is for each of the partners concerned to have the ability to issue foreign debt denominated in their domestic currency, and either a floating exchange rate or a ‘fixed-but-adjustable’ exchange rate.

In any event, we would argue (and imagine that there are few who would disagree) that the experience of the developing economies has been much less than ideal during the revived hegemony of the US dollar as the reserve currency in the *post* Bretton Woods era of the past half-century. It has been extremely difficult to manage capital flows, and there has been an unhealthy dependence on FDI by multinational corporations. It has generally been difficult for developing economies to pursue independent fiscal and monetary policies.

In the changing and emergent system, it seems likely that most such countries will eventually have two difficult strategic policy choices to make. Firstly, the decision as to where best to cast their lot, which side to take, if a new multipolar international system arrives. Secondly, to be willing to consider the necessary domestic political and social changes that need to be in

place to ensure national monetary sovereignty, escape from globalism, and gain (or regain) the ability to conduct the appropriate nationally based monetary and fiscal policies.

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