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## Exchange-rate stability causes deterioration of the productive sphere and destabilizes developing economies

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## **Working Paper No. 1052**

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### **Exchange-Rate Stability Causes Deterioration of the Productive Sphere and Destabilizes Developing Economies**

by

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## **ABSTRACT**

For Matías Vernengo and Esteban Pérez Caldentey (2020), the MMT literature overemphasizes the choice of the exchange rate regime and the relevance of a flexible exchange rate regime, as well as the ultimate effect of that choice upon the policy space. In addition, they argue that the role of capital flows is underexplored, and that the relevance of the balance-of-payments constraint is often underestimated. Vernengo and Pérez’s criticism fails to consider that exchange-rate flexibility makes it possible to use flexible fiscal and monetary policies as well, to boost growth and employment, and to reduce the balance-of-payments constraint.

**KEYWORDS:** Capital Mobility, Currency, Exchange Rate, Financial Sector, Fiscal Policy, Foreign, Exchange Policy, Government Spending, Interest Rates, Monetary Policy, Real Activity

**JEL CODES:** E42, E43, E44, O23, O24

## FIRST PART

This first part of the paper contrasts the arguments of Matías Vernengo and Esteban Pérez's in their piece named "Financialization, Deindustrialization and Instability in Latin America" (2021) with those of Modern Money Theory (MMT), particularly those developed by Randall Wray. Vernengo and Perez article points out that the balance of payments restriction in developing countries is a limitation on the country's ability to make use of their monetary and fiscal policy. They do not consider the benefits behind a flexible exchange rate to address the balance of payment restriction: flexible exchange rates allow the interest rate to be lowered and increase public spending which enhances productive capacity and alleviates balance of payments pressures. They maintain the orthodox position which believes that developing countries need high interest rates to attract capital flows to finance imports of intermediate and capital goods to keep the exchange rate under control. However, for MMT, a country does not have to borrow in foreign currency to buy imported goods: these goods are paid in national currency, which is accepted by those that commercialize the imported goods to pay taxes, to buy goods and services and to invest in the buyer country.

### **The Importance of Working with a Flexible Exchange Rate**

An important point made by Modern Money Theory (MMT)<sup>1</sup> is that a sovereign government that controls its currency and works with a flexible exchange rate has no financial limits on its spending. That combination allows the government to lower interest rates and increase public spending in ways that favor growth. If the government does so, it can spend on anything sold in its own currency, as long as it does so without exceeding the level of spending needed for full employment. Hence, public spending will be limited only by inflation and external restrictions. MMT further recommends that the increased public spending made possible by these policies be targeted to increase demand in productive sectors that have idle capacity, and which can respond rapidly to that spending by increasing their productive capacity. In this way, the increased spending can serve to satisfy domestic demand and avoid inflationary pressures, as well as pressures upon imports. In essence, according to MMT, public spending must increase

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<sup>1</sup> We refer to Randall Wray's *Modern Money Theory, A Primer on Macroeconomics for Sovereign Monetary Systems* and to W. Mitchell, R. Wray, and M. Watts, *Macroeconomics*, Red Globe Press. 2019.

productivity, and potentiate import-substitution while also increasing the value of national exports added. By doing so, the nation can avoid running a foreign-trade deficit that would either limit the expansion of spending or require the economy to incur foreign debt.

### **A Fixed Exchange Rate Acts Against the Economic Growth**

In contrast, a government that elects to maintain a stable exchange rate must work with fiscal balance and a high interest rate to limit demand and pressures on prices, upon the external sector and the exchange rate. In addition, high interest rates and fiscal austerity will be needed to promote the entry of foreign capital, so that the nation may increase its international reserves and stabilize its exchange rate. Therefore, economies that give priority to exchange-rate stability cannot employ flexible monetary and fiscal policies to stimulate growth. The result is an appreciated exchange rate that maintains latent and growing pressures upon the foreign-trade balance, thereby requiring the entry of ever-increasing amounts of foreign capital to finance external debt and maintain exchange rate stability.

Matías Vernengo and Esteban Pérez (2021)—whose work we comment upon here—believe “there is an overemphasis in the MMT literature on the question of the choice of exchange rate regime and the importance of a flexible regime and its effect on policy space that is ultimately misplaced. The role of capital controls is under analyzed, and the importance of the balance of payments constraint is often neglected” (2).

It is appropriate to mention that the importance given by MMT to the exchange rate is not out of place, because that flexibility—in addition to increasing competitiveness—makes possible the flexible fiscal and monetary policies needed for growth. In addition, MMT does not (contrary to the authors’ assertion) overlook controls upon capital, or the restrictions imposed by the balance of payments. To the contrary, MMT recognizes that the balance of payments and the foreign rejection of the national currency are factors that limit the expansion of public spending. Inflation is another such factor. Those factors notwithstanding, flexible exchange rates are important not only for increasing the competitiveness of national productivity and reducing pressures upon the external sector, but for making possible lower interest rates and higher levels of public spending. That higher spending, in turn, increases investment and production to

increase productivity, so that the country can decrease imports and the value added of national exports. In this way, the country can avoid increases in external trade deficit that would put the brakes on economic activity and fiscal expansion.

Vernengo and Pérez (2021) add: “We suggest that MMT needs to be complemented with Structuralist ideas to provide a more coherent understanding of fiscal policy in developing countries” (2). What these authors do not consider is that a flexible exchange rate allows the government to lower the interest rate and to increase public spending—measures necessary for productive structural transformations to reduce pressures upon the external sector. MMT emphasizes that a sovereign fiscal policy in the periphery should direct itself to use its own currency to purchase the goods it produces, and to deal with the productive backwardness that faces its economy in order to promote technological development and import substitution. Those objectives are furthered by expansion of public spending, which in itself promotes conditions of accumulation that incentivize growth of foreign and domestic investment so that the country may avoid restrictions on the balance of payments.

Later, Vernengo and Pérez argue that “what constraints the policy space is not the choice of fixed versus flexible or floating exchange rate, but the necessity to obtain foreign currency, particularly the key international reserve currency, associated to the needs to import foreign intermediary and capital goods, and service debt in foreign currency” (2).

### **Fixed Exchange Rate Increases the Dependence of Capital Inflows**

It is important to clarify the key difference between what is needed to maintain fixed exchange rates versus using floating ones. To maintain fixed rates, a country must work with high interest rates in order to attract capital, build international reserves, and stabilize the exchange rate. That rate is stabilized at the cost of accentuating structural problems (e.g., productive backwardness coupled with low productivity and competitiveness) that increase the foreign trade deficit. That deficit, in turn, prevents the relaxation of fiscal and monetary policies, because these must continue to promote the inflow of capital to finance the deficit. Thus, it is the stability of the exchange rate, along with the restrictive fiscal and monetary policies needed to maintain that

stability, that ends up restricting growth through effects upon the balance of payments. Consequently, the country becomes dependent upon foreign debt and capital inflows.

Regarding this point, we must note that MMT emphasizes that a country should not indebt itself, unless in its own currency. A country that indebts itself in foreign currency (which it does not issue) risks falling into non-payment. In contrast, any debt contracted in the country's own currency can be refinanced permanently. Thus, the importance of having the dynamics of the economy potentiate the productive sphere, in order to avoid external sector pressures that could cause the country to fall into foreign debt. On the other hand, if the country should happen to end up in a foreign trade deficit because the economy is not self-sufficient in capital goods and other inputs, the dynamics of the economy must be able to finance that deficit through exports or by attracting foreign investment.

### **A Country Cannot Pay Debt with a Restrictive Economic Policy**

Vernengo and Pérez's (2021) critique of MMT is grounded in the conventional approach, which uses restrictive fiscal policies to reduce imports and the external commercial deficit. Based upon that approach, Vernengo and Pérez conclude that the need to cover payment of the external debt places limits upon fiscal policy. In contrast, MMT argues that a country which falls into debt will not be able to repay that debt via restrictive fiscal policies, because such policies contract the country's economic activity. The outcome would entail lasting supply-side pressures upon the external sector, because—to satisfy domestic demands—the country would need to import that which it ceases to produce internally. As a result, the country would not generate a surplus with which to pay the debt. Again, MMT's recommendation for avoiding this fate is to operate with a flexible exchange rate, because that policy will allow the country to improve its competitiveness. MMT also recommends that the interest rate be lowered, and public spending increased, in order to increase productivity and productive capacity so that import substitution may reduce the exterior commercial deficit. By helping the country avoid falling into external debt, these measures will obviate the need to ensure a continuing inflow of foreign capital. As a result, the balance of payments will not restrict growth.

### **Developing Countries Should Pay Imports with Their National Currencies**

Further to this point, consider that when an imported product is purchased, it is paid for with the national currency. (For example, pesos.) The foreign companies that sell those products accept the pesos, which they then invest in the selling country's public debt or in sectors of the importing country's economy that might interest them. If those investment opportunities are made sufficiently attractive, the foreign companies will re-invest the pesos within the importing country, rather than demand that the pesos be exchanged for the currency of the companies' home countries. In this way, the importing country can avoid depletion of its international reserves, and, at the same time, avoid falling into external debt to purchase imported products.

Vernengo and Pérez (2021) insist that “it is the balance of payments that constitutes the main limitation upon the policy space of developing countries, and the choice of exchange rate regime would increase or decrease policy space depending on certain circumstances” (3–4). Regarding this assertion, it is necessary to point out that, according to the conventional approach, balance-of-payment problems reduce the space for fiscal policy because public deficit spending is (supposedly) inflationary, and therefore leads to further increases in the foreign commercial deficit. However, that result will be avoided if the increased public spending is channeled into increased productivity and import substitution. The result will be less pressure upon the external sector, and consequently no reduction in the fiscal space. Moreover, the thing that reduces fiscal-policy space is a fixed exchange rate, because the governments fear that by expanding public spending, they will generate inflationary pressures upon the external sector and the exchange rate. By following this reasoning, governments condemn themselves to following fiscal austerity policies, which result in economic stagnation, pressures upon the external sector, and increasing external debt—a condition that has predominated during recent decades among developing economies.

Vernengo and Pérez (2021) do not consider that purchases of imported goods are paid for in the importing nation's currency, accepted by the exporters so that they can make investments, acquire financial assets, and make purchases in that nation. The importing nation must offer investment alternatives so that the importers will not convert the national currency to foreign currencies. There is also the fact (as has been said) that, by working with a flexible exchange



rate, a country may use flexible monetary and fiscal policies as well, in order to promote import-substitution and reduce the country's need for imported goods. In the case of financial obligations denominated in foreign currency, MMT's position is that a nation should not indebt itself in a currency it does not issue.

### **Public Spending Should Act in Favor of the Productive Sector**

A country can employ fiscal expansion with a fixed exchange rate if the economy's productivity, competitiveness, and productive capacity are growing rapidly enough to absorb increasing demand without causing pressures upon prices in the external sector. A country may also employ fiscal expansion with a fixed exchange rate if the expansion is sustained by strong foreign investment which will ease the balance-of-payments restriction.

Vernengo and Pérez (2021) tell us “the CA [current account] is balanced by the flows of capital and variations of reserves. Wray (2012, 130–31) suggests that this implies there are no imbalances, and, hence, exchange rate variations are not necessary to deal with balance-of-payments problems. In his words: “MMT supports floating rates to promote domestic policy space – not to close ‘imbalances’... a current account deficit is not ‘out of balance’ – it is balanced by a capital account surplus. MMT makes no claim that floating rates eliminate current account deficits, indeed, MMT does” (4).

### **A Flexible Exchange Rate Does Not Make Things Worse**

It is necessary to note that Wray's position is based upon the fact that the account deficit occurs because there is an inflow of capital. Therefore, if foreign countries do not accept the debtor nation's currency, and if there is no inflow of capital, then a current account deficit can neither be generated nor maintained. Regarding Wray's position that “floating rates do not eliminate current deficits,” the exchange rate alone cannot adjust the external deficit, but a floating exchange rate allows flexible monetary and fiscal policies that potentiate the productive sector, thus allowing the economy to address the structural problems underlying whatever current account deficit it might have. Therefore, floating rates can indeed pay the external debt—contrary to Vernengo and Pérez's (2021) assertion that “[a] floating regime does not necessarily alleviate the problem, and it might make things worse” (6).

Vernengo and Pérez criticize Wray’s position that “... in the presence of an outflow of capital, and possibly a loss of reserves, there is no need for central bank intervention in a developing country (Wray 2012, 121)” (Vernengo and Pérez 2021, 5). Wray is correct in saying that the government should not take any measures to restrict flotation of the currency. The usual reaction of governments that maintain fixed exchange rates is to raise interest rates and cut budgets, but contrary to the argument made by many economists, these measures contract the economy, rather than the devaluation itself. A case in point is the Mexican economy between 1982 and 1987: budget cuts and high interest rates contracted the economy, but the devaluation increased exports and avoided a fall in manufacturing. More specifically, by offsetting the decline caused by high interest rates and budget cuts in internal market production, exportation avoided a greater collapse of economic activity.

In the relation of the position of Vernengo and Pérez (2021) that fiscal policy “might be constrained by a current account deficit, if it is not possible to finance it, or reserves are not available,” it is necessary emphasized that a fixed exchange rate—which obligates a government to apply fiscal austerity and use high interest rates—makes matters worse. A flexible exchange rate improves competitiveness and promotes economic growth, thereby reducing the current account deficit. Vernengo and Pérez, though—along with neoliberal economists—believe that a flexible exchange makes things worse by causing inflation and raising interest rates.

### **Economic Policies to Avoid Flexible Exchange Rate Act in Favor of Financial Capital**

As support for their rejection of flexible exchange rates, Vernengo and Pérez note the following: “Albert Hirschman, Carlos Díaz-Alejandro, and culminating in a famous paper by Paul Krugman and Lance Taylor, suggest that depreciations are contractionary. This implies that depreciation, actually, resolves the BOP [balance of payments] problem, but by throwing the economy into a recession. This implies that depreciation, actually, resolves the BOP problem, but by throwing the economy into a recession, and reducing imports (M), when capital flows (F) and reserves (R) are not accessible. This is why this proposition by Wray seems misguided” (6).

Going further, Vernengo and Pérez say

According to MMT, the fact that under a floating regime frees the country from converting its currency into another one is sufficient to eliminate the risk associated with running out of reserves (Ibid., 161). However, the reason the government of a developing nation must be always concerned with capital flows and reserves is not related to the convertibility of its currency, but to the need to pay for its short-term obligations in foreign currency, and even if those do not exist, for its need to import essential intermediary and capital goods that would paralyze the economy if they are not imported. That is why the proposition that floating rates provide more space for domestic policy should also be qualified. If the depreciation forces a contraction, there is no extra space for policy, in fact. And that is the reason why very few countries in the developing world have truly free-floating exchange rate regimes. (6)

However, Vernengo and Pérez do not analyze why it is that developing economies have come to depend upon inflows of capital to stabilize their currencies, as well as to pay their debts and finance imports of capital and intermediate goods. The explanation is that the policy of high interest rates and budgetary restrictions followed by these countries to stabilize their exchange rates, has favored the financial sector to the detriment of productive capacity and the external sectors.

The result has been a vicious circle of dependence upon inflows of capital to finance their deficits in order that their currencies remain convertible at the existing exchange rates. Unfortunately, though, the policies needed to promote those inflows are harmful to the productive and external sectors. These countries need to break with the goal maintaining the currency convertible at a stable exchange rate. The countries can then regain sovereign control of their currencies and economic policies to the benefit of productivity and full employment.

It is necessary to point out that most countries do not have truly free-floating exchange rates because they depend upon the inflow of capital. As we have noted previously, this dependence obligates such countries to work with stable exchange rates in order to guarantee the profitability and investor confidence needed to maintain capital inflow. In contrast, devaluation of capital is a potential risk of investing in economies that have free-floating exchange rates. If the national currency is devalued, then (for foreign investors) withdrawing the capital they have invested becomes more expensive. Therefore, the thing that limits space for fiscal and monetary policies,

and leads to economic contraction, is not the use of flexible exchange rates, but the maintenance of a stable exchange rate.

Vernengo and Pérez take a neoliberal stance: “A decline in policy interest rates means, unless outward flow capital controls are in place, greater inflation. Thus, interest rates must be kept high to avoid depreciation. But also, a depreciated currency and lower real wages might reduce consumption, having a contractionary effect. Third, depreciating exchange rates can have significant balance sheet effects, the more so the higher are external debt liabilities, and these also can have contractionary effects” (6–7).

In saying that low interest rates generate inflation, these authors presuppose that low rates increase demand, and that the economy is in full employment. However, Vernengo and Pérez do not consider the fact that low interest rates favor the growth of investment, production, and productivity. These increases would offset the inflationary pressures which might result from the greater demand that could derive from lower interest rates. Vernengo and Pérez also maintain that a low interest rate might provoke capital flight if there are no controls on flow of capital. According to Vernengo and Pérez, the results would be devaluation, a fall in real salaries, and economic contraction. Therefore, Vernengo and Pérez declare themselves in favor of high interest rates. However, low interest rates will not provoke capital flight and devaluation if the economy offers attractive options for investment in the productive sector. Those options are made possible by flexible exchange rates and expanded, appropriately targeted public spending. An additional consideration is that low interest rates make investment in greater productivity less expensive.

High interest rates do favor owners of money, who gain from those rates and from the exchange-rate appreciation that is induced by large capital inflows. The productive sector is the loser because debt becomes more costly, as well as exchange rate appreciation makes this sector less competitive vis-à-vis imports. The ensuing drop in productive investment generates fewer jobs, thus contracting the economy by driving salaries and consumption down.

Vernengo and Pérez (2021) add

Depreciation not only raises debt service costs, but can also increase the value of the stock of liabilities by increasing the local-currency value of outstanding debt. If the collateral for the debt is likewise denominated in a local currency, a currency depreciation will result in a value loss of the collateral. In such a situation, the collateral will no longer support the value of the stock of debt. The end result may be a deleveraging process or a greater demand for foreign exchange to balance asset and liability accounts. In the case of the non-financial corporate debt sector or even the financial sector, depending on its size and importance in the market and the number of firms behaving in this way, this type of behavior can result in an asset sell-off or further devaluation pressures. In both cases the end-result can be an increase in the value of the foreign debt stock. In the specific case of the non-financial corporate sector the available evidence indicates that beyond a given external debt leverage threshold firms tend to contract investment. (7)

### **A Competitiveness Exchange Rate Acts in Favor of the Productive Sector**

It is necessary to note that most companies which have external debt are exporters, who will benefit from flexible exchange rates because such rates improve the exporters' competitiveness and raise their foreign currency incomes. The exporters can use that income to pay the servicing of their debt, and even to reduce the balance. Therefore, the devaluation will not have contractive effects. Companies that produce for the internal market will benefit, too: devaluation makes imports more expensive, and thus makes these companies more competitive. Their sales and income will rise, enabling them to pay off their debts and increase their levels of investment. In addition, devaluation incentivizes import substitution. As a result, private investment will increase rather than decrease. The country will thereby be able to reduce its foreign trade deficit and make its economy more dynamic—a situation that would need to be accompanied by industrial and agricultural policies, together with the low interest rate and a more-flexible fiscal policy.

Vernengo and Pérez note that “the experience of Latin America throws doubts on MMT's notion that a floating rate provides more space for policy. Note that Latin America grew faster in the 1950s and 60s, like most of the world, during the so-called Golden Age of capitalism. That was a period in which exchange rates were relatively rigid. Mexico, for example, maintained its exchange rate fixed from 1954 to 1976 (at \$12.50 pesos per US dollar), when the infamous Peso Problem led a currency crisis, that is, after the collapse of Bretton Woods” (7). We should note

that Mexico's pre-1976 situation was made possible by the large inflow of foreign investment during that period, thanks in part to the growth of Mexico's external debt between the late 1960s and 1976. That inflow enabled Mexico to expand fiscally and finance its foreign trade deficit while maintaining a constant exchange rate. However, Mexico's situation was unsustainable for lack of endogenous conditions that could maintain exchange-rate stability, given the foreign trade deficit that Mexican was running. After the inflow of foreign capital ceased, the country's economy lacked sufficient viability either to maintain stability of the exchange rate, or to expand fiscally. Mexico's economic crisis of 1977 was the result.

Vernengo and Pérez (2021) add that “exchange rates, everything else constant, are inversely related to real wages, and, in part, the higher rate of growth in Latin America during the Import Substitution Industrialization (ISI) or state-led development period could be associated to the combination of appreciated exchange rates, which also allowed for cheap imports of machinery, and higher real wages” (7). The exchange-rate appreciation—made possible by the inflow of capital—did lower the cost of imported capital goods the country needed for industrialization. However, the result was that Mexico did not advance in the production of capital goods internally. Pressures upon the external sector continued, and Mexico's external debt rose as the country's internal multiplier effect for investment decreased. In addition, real salaries did not grow.

### **Economic Policy in Favor of Financial Capital Inflow Increases the Economic Problems**

Vernengo and Pérez affirm that “the interest burden of debt in domestic currency is tied to the external constraint and the need to attract capital, or at least prevent capital flight, even when debt is in domestic currency. In this sense, we think that Mitchell et al. (2019, 555; emphasis added) are not entirely correct when they argue that: ‘[w]ith a floating exchange rate, the interest rate target can be set to be consistent with domestic policy goals,’ by which they mean fundamentally full employment” (Vernengo & Pérez. 2021: 11). Again, Vernengo and Pérez follow the neoliberal logic that high interest rates must be maintained to avoid capital flight. However, as indicated earlier, low interest rates will not cause capital flight when used in a context of flexible exchange rates and the expansion of public spending, because that combination leads to a profitable, growing productive sector. Vernengo and Pérez defend high

interest rates as a means of attracting capital, preventing its flight, and building international reserves to maintain a stable exchange rate, but capital can be attracted without using high interest rates if the exchange rate is allowed to float to boost economic growth and offer investment opportunities in the productive sector.

Vernengo and Pérez (2021) also repeat

The limitations of interest rate policy in developing countries can be seen in the interest rate burden, which is persistently higher, for example, for the small Caribbean countries than for the United States. This certainly does not imply that expansionary fiscal policy is impossible in developing countries. It suggests that the political economy of it is considerably more complex than even MMT authors tend to understand, and having debt in the countries own currency, with a floating currency, might not be sufficient to push back on the enforcement of higher rates of interest, in a world with high mobility of capital, and international organizations pushing for austerity. (11)

For Vernengo and Pérez, free movement of capital condemns a country to high interest rates and fiscal austerity—a situation that arises when the economy’s productive sector does not offer conditions for growth and profitability. To avoid that fate, governments must offer the economy’s financial sector conditions of confidence and stability, usually via stable exchange rates and high interest rates. In contrast, we maintain that flexible exchange rates, low interest rates, and the expansion of public spending configure conditions of confidence and stability to the productive sector.

Vernengo and Pérez insist that “high-interest rates were necessary to attract capital flows and accumulate international reserves. This also was instrumental in keeping the exchange rate under control, and with that checking the inflationary pressures that could ensue from both persistent depreciation and higher wages” (12). Here, the authors maintain the conventional position that a government must employ high interest rates to keep the exchange rate under control—a posture that favors international finance capital, and is deemed necessary by many developing economies that have become dependent upon inflows of capital due the predominance of neoliberal policies. Consequently, the authors reject MMT’s position that a flexible exchange rate obviates the imperative to use high interest rates to attract the capital needed to increase international reserves and to stabilize the exchange rate. The authors also do not recognize that flexible exchange rates allow countries—developed and developing alike—to manage their monetary and fiscal policies

in ways that favor economic growth and reduce both the pressure upon the external sector, and the need for inflow of capital.

### **Functional Finance to Decrease External Constraints**

In their closing observations, Vernengo and Pérez comment upon functional finance as it applies to developing countries: “we do believe that some clarifications regarding the role of the external constraint, exchange rate regimes, the use of capital controls, the relevance of reserves and the political economy of spending and taxation are important when dealing with developing countries. These are seen as necessary refinements of the argument needed to understand functional finance in developing countries” (12). Here, it is appropriate to note that in functional finance, the government of a developing country may spend as much as might prove necessary to close the country’s gap in demand until the country’s growth potential is reached. The government will not need international reserves to deal with external restrictions if it targets public spending to potentiate technological growth, so as to increase productivity and foster import substitution, thereby avoiding pressures upon the external sector.

According to Vernengo and Pérez (2021), certain MMT arguments need to be qualified, for example, “[t]he notion that a government that spends its own floating-currency cannot be forced into default in that currency is correct, but it can still default in foreign currency and might be forced into austerity policies in order to reduce external imbalances. So even without defaulting there is a limit to the expansion of debt in domestic currency” (13). MMT does not claim that floating currencies (i.e., flexible exchange rates) are a magic wand: to avoid defaulting in foreign currencies, the government must combine flexible exchange rates with other monetary and fiscal policies (which are made possible by the flexibility of those rates) to increase productivity, foster import substitution, and alleviate pressures upon the external sector. By doing so, the country can avoid falling into external debt, and continue expanding its internal-currency debt. Public spending will then (according to MMT) be limited only by the real resources available to the economy, rather than by external financial restrictions. Contrary to Vernengo and Pérez’s assertion, the external imbalances that face developing economies will not be resolved via austerity policies because those policies exacerbate the low productivity and productive-sector backwardness that underlie those imbalances.



### **It Is Not Necessary to Have International Reserves to Have Economic Policy Growth**

Vernengo and Pérez worry, too, about an insufficiency of foreign reserves: “[a] government should be concerned that it might run out of foreign currency reserves even if it does not convert its domestic currency to foreign currency (or gold), simply because it must obtain foreign reserves to pay at least for essential intermediary and capital goods. This is compounded by the needs to service debt in foreign currency, and for that reason that should be kept to a minimum whenever it is possible” (13). Our response is that the governments that need to accumulate international reserves are those that have committed themselves to exchanging their national currency at a fixed exchange rate. To understand why a government that flexes its exchange rate need not accumulate international reserves, we begin by recognizing that the government and its citizens will pay in the government’s own coin (e.g., pesos) for imported intermediate and capital goods. The recipients of those pesos will be foreign companies or marketers of foreign goods, who will then have various options. One of those options (which is unfavorable to the importing country) is to convert the pesos into foreign currency, thereby reducing the importing country’s international reserves. Another option (which the importing country will want to encourage) is to sell the pesos in the foreign market to investors that need them to invest in the importing country’s economy. The companies and marketers could, of course, make such investments themselves. A further alternative is to purchase public debt in the importing country, and thus benefit from the country’s interest rate. Several of these options would reduce the importing country’s need to increase its international reserves. The importing country can incline marketers and foreign companies toward those options—and further reduce its need for international reserves—by lowering the country’s foreign trade deficit through the use of a flexible exchange rate in combination with public spending directed toward increasing the nation’s production and reducing its need for imports.

Vernengo and Pérez repeat that, “[i]t is not clear that floating or flexible exchange rate regimes are always preferable to managed or fixed exchange rates complemented by some type of capital controls, even in the more open world of the floating dollar standard in the post-Bretton Woods era. Flexible rates are both inflationary and contractionary, and the exchange rate has distributive effects, that may imply that under certain conditions a stable and appreciated exchange rate could be conducive to higher growth” (22–23). Here, Vernengo and Pérez assert that such exchange

rates are not only inflationary and recessive, but lead to income inequality. These assertions are based upon conventional postulates about maintaining exchange-rate stability—a stability that, according to those same postulates, will discourage speculation and favor growth. (An appreciated rate would, supposedly, be even more favorable.) What Vernengo and Pérez (2021) do not consider is that an appreciated exchange rate is unavoidably accompanied by high interest rates and fiscal austerity, which together reduce competitiveness, demand, productive activity, and salaries, and increase the unemployment rate. Thus, contrary to what Vernengo and Pérez assert, it is exchange rate stability—rather than exchange rate flexibility—that contracts the economy and accentuates income inequality.

Vernengo and Pérez recommend that, “[i]f debt denominated in foreign currency is to be kept under control, to preclude an external crisis that forces austerity at home (to reduce essential imports), then exports must grow faster than the interest on foreign debt. The structure of imports and exports is central for the fiscal space of a developing country” (13). The issue here is that, in order for exports to outpace imports and the interest on external debt, the country must work with a flexible exchange rate in combination with the low interest rate and increased public spending that a flexible exchange rate makes possible. This combination can increase production while potentiating productivity and competitiveness, in order to avoid external restrictions and the fiscal-tightening measures prescribed by neoliberal economists. When a country achieves economic activity and a positive foreign trade balance via flexible economic policies, the country can maintain its fiscal space and a flexible monetary policy—which is not the case when the exchange rate is held stable (given the austerity measures, etc. needed to maintain that stability).

Finally, Vernengo and Pérez say that “[i]n developing economies, the external constraint and the need to avoid capital flight and accumulate hard currency is paramount.” (13) What the authors overlook is that the measures prescribed for accumulating international reserves and avoiding capital flight are the selfsame measures that have proved so detrimental to developing countries’ competitiveness and productive sectors: high interest rates, fiscal austerity, and stable exchange rates. These measures have trapped developing economies in a vicious cycle by causing their imports to outpace their exports, thereby increasing the developing economies’ foreign trade deficits and external restrictions. Consequently, these countries find themselves needing to avoid

capital flight and promote capital inflow to maintain stable exchange rates and service their external debt, even as the prescriptions that the countries are following for that purpose sap the countries' economic vitality.

We might note that every country that raises its exchange rate ends up in economic crisis; the reason being that exchange-rate appreciation aggravates external sector pressures, causes external indebtedness, and enervates productive development. As the incomes of companies and individuals fall, the country becomes unable to meet its external obligations.

It is to avoid that very situation (and the related need to accumulate foreign currency) that MMT warns governments not to commit themselves to converting their currencies at a fixed rate. The public spending of governments that follow MMT's advice will be limited only by the availability and production of endogenous resources, which will be sold in the national currency. In this way, a government can avoid inflationary pressures, as well as the external sector pressures that would otherwise put brakes on growth, provoke capital flight, and make the country dependent upon inflow of capital.

The essential thing for a national economy is the sovereign management of economic policy, so that that policy may be oriented toward growth and full employment. More to the point, sovereign management allows the government to flex exchange rates so that the nation's monetary and fiscal policies will not be constrained by the need to stabilize those rates through high interest rates and fiscal austerity.

## **SECOND PART**

In this second section, another article by Vernengo and Pérez is analyzed. In "Modern Money Theory in the Tropics: A Reply to Agustin Mario" (2022), the authors emphasize that MMT does not apply to countries that do not issue international legal tender and do not have a large amount of international reserves. The present paper claims their approach is wrong: a sovereign country does not need international reserves to have monetary and fiscal policy in favor of economic

growth. A sovereign currency, even if it is not of international legal tender, by definition is not convertible to a fixed exchange rate. Thereafter, international reserves are not necessary: there is nothing to convert.

### **External Restrictions Exist Because the Productive Sector Has Not Been Attended**

In their response to Agustín Mario's article, Vernengo and Pérez (2022) reiterate what was said in their initial article. Therefore, my comments upon their reply will emphasize some of the points I criticized in their original article. Vernengo and Pérez emphasize that, "MMT authors overlook the difficulties in pursuing expansionary fiscal policy in the developing countries. These are constrained by the existence of an external constraint that cannot be solved with a flexible exchange rate policy regime. Foreign reserves and capital controls are needed" (125). In that regard, it is appropriate to say that MMT has pointed out the factors that limit the expansion of public spending are inflation and a foreign trade deficit that cannot be financed. For this reason, fiscal policy must be geared toward boosting import substitution so as to avoid having a foreign deficit. Concerning Vernengo and Pérez's position that external restriction cannot be resolved with a regime of flexible exchange rates, the point is that the said exchange rate allows a flexible monetary and fiscal policy that favors the productive sector, so that that sector can address the production lags that underlie the foreign trade deficit. Indeed, a flexible exchange rate does not, by itself, reduce the foreign trade deficit. An appropriate industrial, agricultural, and credit policy is needed, which is possible with a flexible monetary and fiscal policy that boosts the productive sector to provide substitutes for imports, and to reduce the foreign trade deficit.

By working with a flexible exchange rate, economies do not need to establish high interest rates and apply fiscal austerity to attract capital so that international reserves are maintained large enough to ensure the convertibility of the national currency at a stable exchange rate. When the economy is freed in this way, its policy can act in favor of economic growth geared toward reducing the foreign trade deficit, so that pressures upon the exchange rate can be avoided.

### **A Country with a Sovereign Currency That Is Not Convertible to a Fixed Exchange Rate Spends on Boosting National Production to Reduce External Restriction**

Vernengo and Pérez also point out that “[o]ne of [their] main criticisms is that MMT policy prescriptions have more limited application to countries that do not issue an international reserve currency, and, in particular, in countries that do not hold adequate amounts of dollar reserves” (125). In response, it must be said that, even though a country does not issue a foreign reserve currency, the country’s capacity to spend is not limited. The government can spend, and this will increase deposits and bank reserves. The central bank will act by emitting debt to regulate the bank reserves in order to prevent the target interest rate from declining. Vernengo and Pérez’s worry (that MMT is limited to “countries that do not maintain adequate quantities of reserves in dollars”) stems from their concern that governments must ensure the convertibility of their currency at a stable exchange rate. Because MMT advocates non-convertibility of the currency at a fixed exchange rate, the government does not need to take pains to maintain reserves in dollars.

Vernengo and Pérez comment that “[i]n line with McCombie and Thirlwall (1999, 49) we believe that the balance-of payments constraint means that : ‘... a country’s performance in overseas market, and the response of the world financial markets to this performance constrains the growth of the economy” (126). This is indeed true, which is why MMT advocates sovereign management of the economic policy, which allows a flexible interest rate so the economic policy can deal with the growth-limiting production problems which cause the foreign trade deficit.

### **The Exchange Rate Needs to Adjust to the Price and Productivity Differential Between the Country and its Main Trading Partners**

Vernengo and Pérez stress that, in MMT, “There is no consideration of the negative effects of depreciations. The empirical evidence shows overwhelmingly, in line with Post Keynesian economic theory, that income effects are the main adjustment mechanism to correct for current account imbalances, and not substitution effects working through the impact on domestic and world prices” (126). It should be noted that the reason for MMT’s advocacy of flexible exchange rates is so that the exchange rates may adjust to differences between domestic prices and those of the principal trading partners. By allowing those adjustments, a nation can avoid the relative-price distortions that would affect national production. We also note that MMT does not take a

stance in favor of devaluation per se. Rather, MMT recognizes that in many developing countries, the predominant exchange rate stability (achieved by maintaining high interest rates, in order to promote capital inflow) has led to exchange rate appreciation, which is detrimental to the competitiveness of national production. As a result, the foreign trade deficits of those countries have grown, thus increasing the countries' foreign debts and hindering their economic development. It is precisely the exchange-rate appreciation and the economic policy that it promotes (high interest rates and fiscal austerity) that cause harm to economic activity. To say that "income effects are the main adjustment mechanism to correct for current account imbalances, and not substitution effects working through the impact on domestic and world prices," is to continue favoring the traditional recessive adjustments that restrict economic activity, incomes, investment, and domestic consumption—which could otherwise reduce imports, and thus the foreign trade deficit. What MMT posits is the importance of resuming the management of economic policy to adjust the external sector while in a context of the sort of economic growth that includes increasing exportation and boosting production imports. The fact that exchange rate adjustments have not been used for foreign trade deficits is due to the tendency (on the part of governments in developing countries) to respond promptly to any currency devaluation by raising interest rates and restricting public spending. This response is intended to restabilize exchange rates, but it does not configure relative prices (exchange rates and interest rates) to spark productive activity.

### **For the National Currency to Be Accepted, the Country Must Offer Profitable Investment Options**

Vernengo and Pérez insist that developing countries need foreign currency because "[d]eveloping countries must import intermediary and capital goods, by their nature of being behind in the technological development ladder and being integrated into the complex division of labour of the modern world economy" (126). In contrast, MMT's stance is that payments are made in the national currency. As a result, importers (whether of goods from the US, China, Japan, or Europe) would need to exchange that national currency for the currency of their choice in a foreign exchange market, with investors who want to invest in the country. At the same time, the country must offer attractive investment opportunities so that the national currency will be accepted.

Continuing to emphasize their belief that foreign reserves are needed, Vernengo and Pérez add,

“Moreover, contrary to MMT authors we think that the need for foreign reserves requires, sometimes, higher domestic interest rates, irrespective of domestic conditions and of the exchange rate regime. Mitchell, Wray, and Watts (2019, 555) suggest that “[w]ith a floating exchange rate, the interest rate target can be set to be consistent with domestic policy goals.” The latter presupposes that the interest rate in a peripheral country can be set, in a flexible exchange regime, without concern for the accumulation of foreign reserves. The reason for this is because their only concern seems to be with the management of debt in domestic currency” (127).

Indeed, when the exchange rate is flexible, the economy needn’t take actions that favor capital inflow to have international reserves, because there is no convertibility of the national currency at a stable exchange rate. Instead, the economy acts in favor of full employment and the productive sector. To that end, government spending must be completed in the national currency. If the government falls into debt as a result, that debt will be in the national currency, which the government controls. Therefore, that debt can be refinanced without difficulty.

### **An Expansionist Policy Does Not Necessarily Generate an External Deficit**

The authors caution that “expansionary fiscal policy might lead to external problems if interest rates are not high enough to accumulate reserves” (127). This view is in line with the conventional perspective that has predominated, in which fiscal expansion generates external debt, and must therefore be followed by raising the interest rate in order to finance the increased deficit, as well as to counteract the expansionary effect of the fiscal policy and avoid increasing the foreign debt. However, fiscal expansion will not have this effect if targeted toward domestic products and increasing national productivity and productive capacity, so that exports and import substitutions also increase. Therefore, fiscal expansion should be accompanied by an interest rate decrease that supports the fiscal expansion and favors productive investment. Such a combination of fiscal expansion and interest rate decreases is possible only when working with a flexible exchange rate.

Vernengo and Pérez indicate that “[t]he external constraint is a financial constraint that is binding for developing countries, contrary to budgetary considerations in domestic currency” (127). It is necessary to note that, in MMT, the domestic budget (which is in the national currency) should be spent only on things that are produced in that currency, and that the

economy's real resources are what determines the country's spending capacity. It is precisely in order to avoid foreign constraints that MMT stipulates that domestic spending must not exceed the productive capacity of the country, because excessive spending would generate inflation and a foreign trade deficit.

### **The Job Guarantee Is Not Inflationary**

In criticizing the job guarantee (JG) program, Vernengo and Pérez have “suggested that it is an unreliable tool for inflation control. The notion that a JG program is a price stability instrument derives to some extent from the MMT view of inflation, which seems confined to notions of demand pull versus cost push, and does not pay sufficient attention to the issue of distributive conflict” (127). It is necessary to clarify that MMT proposes creating employment for everyone who desires it, but cannot find it. To avoid conflict and prevent the program from raising costs, these workers would be paid at the minimum wage that does not compete with the salaries provided by the private sector. The creation of minimum wage employment would not generate inflation, because that employment would incorporate labor into the productive process, thereby increasing supply, which would in turn satisfy the demand derived from higher employment. JG would also not cause conflict between capital and labor, for two reasons: the employment would be paid at the existing minimum wage, and businesses would profit from the increased demand derived from higher employment.

Continuing, Vernengo and Pérez reiterate a point made in their original article: that “having debt in the countries' own currency, with a floating currency, might not be sufficient to push back on the enforcement of higher rates of interest, in a world with high mobility of capital, and international organizations pushing for austerity” (128). Here, we must note that international financial capital pushes for high interest rates and fiscal austerity because (a) international financial capital profits from them, and (b) such policies make it possible to achieve stability of exchange rates and currency, which the financial sector controls. In contrast, international financial capital cannot engage in speculation within an economy that grows without pressures upon the external sector, and without incurring problems with foreign debt.



An economy has no reason to maintain high interest rates or practice fiscal austerity under such conditions. MMT reiterates that monetary, fiscal, and exchange-rate policies must be analyzed in terms of their impact upon productive activity and the external sector, rather than in relation to fiscal equilibrium or the stability of the exchange rate. In the context of a flexible exchange rate, these policies will be acting in favor of economic growth.

Vernengo and Pérez finish by saying that, “MMT must learn that the external constraint matters, that foreign reserves are essential and that exchange rates should be managed” (128). The economic policy derived from MMT is geared toward avoiding pressures upon prices, as well as upon the external sector and financial instability. When there are no pressures upon the external sector, there is no reason to have high interest rates to attract capital, to have international reserves and ensure the convertibility of the national currency at a fixed exchange rate.

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