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**Working Paper**

## Fixed and flexible exchange rates and currency sovereignty

Working Paper, No. 489

**Provided in Cooperation with:**

Levy Economics Institute of Bard College

*Suggested Citation:* Sardoni, Claudio; Wray, L. Randall (2007) : Fixed and flexible exchange rates and currency sovereignty, Working Paper, No. 489, Levy Economics Institute of Bard College, Annandale-on-Hudson, NY

This Version is available at:

<https://hdl.handle.net/10419/31583>

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## **Working Paper No. 489**

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### **Fixed and Flexible Exchange Rates and Currency Sovereignty**

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**and**

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**January 2007**

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♦ University of Rome “La Sapienza” and University of Missouri, Kansas City. Previous versions of the paper were presented at the 3<sup>rd</sup> STOREP Conference, Lecce June 1–3 2006 and the 10<sup>th</sup> Workshop del Research Network on “European Integration in Crisis”, Berlin October 27–28 2006. We would like to thank the participants in the two conferences for their comments and suggestions.

## **ABSTRACT**

This paper provides an analysis of Keynes's original "Bancor" proposal as well as more recent proposals for fixed exchange rates. We argue that these schemes fail to pay due attention to the importance of capital movements in today's economy, and that they implicitly adopt an unsatisfactory notion of money as a mere medium of exchange. We develop an alternative approach to money based on the notion of currency sovereignty. As currency sovereignty implies the ability of a country to implement monetary and fiscal policies independently, we argue that it is necessarily contingent on a country's adoption of floating exchange rates. As illustrations of the problems created for domestic policy by the adoption of fixed exchange rates, we briefly look at the recent Argentinean and European experiences. We take these as telling examples of the high costs of giving up sovereignty (Argentina and the European countries of the EMU) and the benefits of regaining it (Argentina). A regime of more flexible exchange rates would have likely produced a more viable and dynamic European economic system, one in which each individual country could have adopted and implemented a mix of fiscal and monetary policies more suitable to its specific economic, social, and political context. Alternatively, the euro area will have to create a fiscal authority on par with that of the U.S. Treasury, which means surrendering national authority to a central government—an unlikely possibility in today's political climate. We conclude by pointing out some of the advantages of floating exchange rates, but also stress that such a regime should not be regarded as a sort of panacea. It is a necessary condition if a country is to retain its sovereignty and the power to implement autonomous economic policies, but it is not a sufficient condition for guaranteeing that such policies actually be aimed at providing higher levels of employment and welfare.

**Keywords:** Foreign Exchange, International Monetary Arrangements, Economic Integration, Stabilization, Keynes

**JEL Classifications:** E12, E63, F31, F33, F36

## 1. INTRODUCTION

The idea that a regime of fixed exchange rates is superior to one of flexible rates is deeply ingrained in the Keynesian and Post Keynesian traditions of economic thought. This is not surprising in light of Keynes's own position in the 1940s and his contribution to the creation of the Bretton Woods system. Although the creation and implementation of the new architecture of the post-war international monetary system differed from what Keynes envisioned, most of his followers do not doubt that Keynes's position was characterized by the idea that a better organization of the international economy had to rely on a regime of fixed but adjustable exchange rates, which could work only if strict controls and constraints on capital movements were introduced, along with international institutions that could lend reserves as necessary to temporarily hold exchange rates as interventions adjusted policy to move toward balanced trade.

Many Keynesian and Post Keynesian economists have never abandoned the idea that fixed exchange rates are superior to flexible rates. They support their viewpoint by pointing out that the current regime of flexible rates, together with the free movement of capital, is far more unstable and prone to crises than was the previous Bretton Woods regime. A return to fixed exchange rates is therefore seen as the way to ensure more stability in the international economic system (Moore 2004). We do not question that in some respects the current regime of floating exchange rates is more unstable than the previous one, but we intend to argue that trying to go back to a regime of fixed exchange rates is neither feasible nor desirable. The global economic conditions that made Bretton Woods a more-or-less successful exchange rate regime are no longer in place and cannot be resuscitated.

A fixed exchange rate regime can work efficiently to eliminate trade imbalances only in the presence of perfect, or quasi-perfect, capital immobility. Currently, however, the world economy is characterized by very high capital mobility, as most of the Bretton Woods constraints and controls have been removed in a large number of countries. In addition, there is no effective mechanism that removes trade imbalances—so long as compensating capital flows attenuate exchange rate pressures. Going back to fixed rates would require, therefore, a thorough reform of the international economic system, which should either reintroduce the old controls or invent new ways to limit capital mobility.

We see two major obstacles to such a reformist project. On the one hand, there are difficulties arising from the current economic, political, and ideological environment, still dominated by a laissez faire stance. On the other hand, there are “technological” and economic difficulties. The evolution of international monetary and financial markets has reached a stage of complexity and sophistication that makes it very hard to imagine and implement effective capital controls (Mussa, et al. 2000). Moreover, it is not only true that today capital can move very rapidly and easily from one corner of the world to another, but also that the size of capital markets and the volume of daily transactions makes it very hard for single countries to effectively counteract and neutralize decisions made in these markets to defend their rate of exchange—unless they are able to accumulate huge “war chests” of international reserves.

Especially in Keynes’s own vision of the post-war world economic order, there was the idea that some form of international governance was necessary. Historically, the idea of a world government has been replaced by the hegemonic role of the United States. In fact, when such hegemony was partly questioned and challenged in the 1970s as a consequence of the U.S. economic and political problems, the Bretton Woods system collapsed. Today we do not see any greater likelihood of proceeding to the creation of some form of international governance of the world economy than the likelihood of doing so in the early post-war era. In the present context, if one wants fixed exchange rates, it is perhaps more realistic to aim at reinstating and reinvigorating the hegemonic role of the United States, which should accept more general responsibilities for being the world’s dominant power. The political implications of such a choice are evident, but we do not enter into that debate, instead limiting ourselves to ask Post Keynesians the question whether a greater role of the United States in the governance of the world economy is something that they would regard as desirable.

That there exist significant difficulties to reintroduce a regime of fixed exchange rates does not say much about the desirability of such regime. In our opinion, however, there are important theoretical considerations that lend support to the conclusion that adopting fixed exchange rates is not advantageous if it is not accompanied by the creation of an institution capable of providing an advanced form of international governance. To adopt a regime of fixed exchange rates without the creation of some sort of “world government” implies that single countries renounce

their sovereignty, i.e., their ability to maintain fiscal and currency independence. We believe this only compounds the problem by creating the sort of global deflationary bias that Keynes feared—a sort of modern mercantilism based on accumulation of international reserves.

The paper is organized as follows. The next section is devoted to a brief description of Keynes's original proposal of a regime of fixed exchange rates and some more recent developments by Post Keynesians. Our criticism of Keynes's and Post Keynesian schemes for the adoption of fixed exchange rates is that they fail to pay due attention to the importance of capital movements in the determination of exchange rates. Instead, these reformist proposals tend to concentrate on current account imbalances. We argue that these schemes implicitly adopt a notion of money essentially seen as a mere medium of exchange. We regard this notion of money as unsatisfactory.

On the grounds of our critique of the notion of money that underpins the predilection for a fixed exchange rates regime, in the following section we expound our alternative approach to money, based on the notion of currency sovereignty. We hold that this approach to money is not only consistent with a Post Keynesian analysis of the international economy, but it also derives from Keynes himself, though from his *Treatise on Money*. As currency sovereignty implies the ability of a country to implement monetary and fiscal policies independently, we argue in section 4 that it is necessarily contingent on the country's adoption of floating exchange rates.

In section 5, we briefly look at the Argentinean and European recent experiences. We take them as telling examples of the high costs of giving up sovereignty (Argentina and the European countries of the EMU) and the benefits of regaining it (Argentina). In both cases, extreme forms of fixed exchange rates were adopted to provide more stability to the economy. Argentina chose a currency board based on the U.S. dollar; some European countries adopted the euro as their single currency.

In the case of Argentina, when the currency board was abandoned after its deep economic crisis, the country regained its sovereignty and could take policy initiatives to promote growth and employment. In the case of Europe, the adoption of the euro by twelve countries gave rise to the creation of a currency area that is comparable in size to the United States. However, unlike in the United States, within the euro area there is no adequate European authority to operate fiscal policy that

could complement or counter the ECB—as the U.S. Treasury is able to do within the United States. The ECB fixes a unique interest rate and influences the euro’s exchange rate with the other international currencies. This form of economic architecture is viable only to the extent that individual European countries subject themselves to strict fiscal constraints (the Maastricht Treaty) while they, of course, have lost any possibility to implement autonomous monetary policies or to control capital movements across borders.

This has produced, in our view, an intrinsically deflationary environment in Europe. A regime of more flexible exchange rates could have likely produced a more viable and dynamic European economic system, in which each individual country could have adopted and implemented a mix of fiscal and monetary policies more suitable to its specific economic, social, and political context. Alternatively, the euro area will have to create a fiscal authority on par with that of the U.S. Treasury—which means surrendering national authority to a central government, an unlikely possibility in today’s political climate.

Section 5 concludes by pointing out some of the advantages of having floating exchange rates, but also by stressing that such a regime should not be regarded as a sort of panacea. It is a necessary, but not sufficient, condition for a country to retain its sovereignty and the power to implement autonomous economic policies, but it is not a sufficient condition to guarantee that such policies be actually aimed at providing higher levels of employment and welfare.

## **2. KEYNES’S BANCOR PLAN AND THE END OF BRETTON WOODS**

Keynes called for the creation of an International Clearing Union (ICU) based on a Bancor unit of account; the Bancor, in turn, would be fixed in value relative to gold and then the currencies of all countries participating in the ICU would be fixed relative to the Bancor. The Bancor would be used only for clearing purposes among countries; countries could buy Bancor balances from the ICU using gold, but Bancors could not be redeemed for gold—ensuring there could be no run on Bancors.

At the outset, the quantity of Bancor reserves would be distributed among countries based on their previous levels of international trade. Countries running trade surpluses would accumulate additional reserves, while deficit countries would

surrender reserves. The ICU would provide overdraft facilities to those countries that exhausted their reserves. Since reserves could not leave the system, the ICU could always expand the supply of Bancor reserves merely by making advances to deficit countries. In addition, surplus countries could use Bancor reserves to make loans to, investments in, or unilateral grants to deficit countries. The ICU would adopt rules regarding actions to be taken against debtors and against countries running persistent surpluses (i.e., accumulating Bancor reserves).

Keynes called for a charge on excessive overdrafts and on excessive reserve balances of one or two percentage points in order to encourage balanced trade. Other possible actions to be taken in the case of deficit countries include currency devaluation, capital controls, seizure of gold reserves, and domestic policy. Actions to be taken against surplus countries included expansion of domestic demand, appreciation of the currency, reduction of tariffs and other trade barriers, and encouragement of international development loans (Keynes 1980). Finally, the ICU could use its power to encourage economic development through the use of overdrafts for relief work, for development of buffer stocks of commodities, for the establishment of an International Investment Corporation, and to help stabilize prices (Keynes 1980).<sup>1</sup>

The Bancor Plan was never adopted. Rather, the U.S. proposal formed the basis for the Bretton Woods system. This was based on a fixed-but-adjustable system of exchange rates, with the dollar pegged to gold and serving as the international reserve currency. The system worked so long as the flow of dollars from the United States to the rest of the world was just sufficient to meet the world's demand for dollar assets. By the late 1960s, the dollar was under pressure. Because the dollar was redeemable for gold, and because any hint of significant devaluation of the dollar would generate a run, the system was abandoned to protect the U.S. gold reserves.

Moving to a flexible exchange rate system was generally supported by neoclassical economists, most notably by Milton Friedman. The claim was that a flexible system would operate much like the fabled “specie-flow” mechanism, purported to have quickly rectified trade imbalances during the gold standard. The orthodox claim was that, in a flexible exchange rates regime, trade imbalances would

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<sup>1</sup> For more details on Keynes's plan and his role in the reconstruction of the international monetary system, see Skidelsky (2000).



cause currencies to adjust, automatically returning trade to equilibrium. After the three and a half decades of experience since the abandonment of Bretton Woods, this claim is thoroughly discredited. To be sure, nations have not adopted freely floating exchange rates, but interventions are not sufficiently large to explain the persistence of trade imbalances. In addition to long-term trade imbalances, the world has experienced a great deal of exchange rate instability (especially among developing nations) that is far larger than would be expected simply because of trade imbalances. Thus, the move to flexible exchange rates has not resulted in balanced trade and appears to have contributed to greater global instability. Nations like the United States run large, and rising, current account deficits for years and nations like Japan run large current account surpluses for decades without setting off equilibrium-seeking exchange rate adjustments.

To provide a solution to this situation, Davidson (1992), inspired by Keynes's plan, has proposed the use of an international clearing money unit (ICMU) as an international reserve used only by central banks in an international clearing system. Each country would continue to use its own money of account for domestic purposes; private agents could choose any of these moneys of account for international purposes. Exchange rates among the international moneys of account would be fixed (with allowance made for adjustments under specified conditions). Clearing among central banks would then take place on the balance sheet of an international central bank, kept in ICMUs. As in Keynes's scheme, sanctions would be placed on countries that continually faced clearing drains, and would also be placed on those countries that continually accumulated reserves of ICMUs. Under the Keynes-Davidson scheme, the creditor nations will lose their ICMU reserves if they don't use them; they would then have an incentive to stimulate their economies so that the ICMU reserves would be used to support greater imports or greater foreign investment; alternatively, excess ICMUs could be given as grants.<sup>2</sup>

In our view, an essential difficulty with Keynes's, or the Keynes-inspired, approach to exchange rates and the international monetary system is that, as in the case of many mainstream analyses, they concentrate on trade imbalances and the current account while capital movements receive too little attention. As a

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<sup>2</sup> Basil Moore has advocated a "go-it-alone" fixed exchange rate system in which individual (smaller) nations would choose to peg against one of the more important currencies, but we believe that such a scheme would be inferior to the Davidson/Keynes multilateral system.

consequence, money tends to be seen as a medium of exchange. In his work on the ICU, Keynes began by noting that his goal was to design an international currency system so that the currency exchange would be made to operate as if countries were “trading goods against goods” (Keynes 1980).<sup>3</sup> The operation of the ICU would be designed to ensure that Bancor reserves would not be lost to idle hoards; rather, the reserves of one country would form the basis of overdrafts of another, thereby encouraging trade. Davidson’s justification for his proposal is similar.

Keynes’s approach to the reform of the international monetary system recalls an older approach to money and its crucial role in the determination of crises in a capitalist economy. This approach was first followed by Marx. The essential rationale of a capitalist economy can be depicted by the money circuit

$M - C - M'$ , with  $M' > M$  : capitalists employ money capital (M) to buy means of production (C) in order to produce commodities that, once they are sold in the market, yield a monetary profit ( $M - M'$ ). The circuit can proceed undisturbed in so far as capitalists expect that their expenditure, M, actually yields a sufficiently large profit. If, instead, capitalists’ expectations are that production will not give rise to sufficient profits, they break the money circuit, i.e., they do not spend money to buy means of production but keep it idle, hoarded. As a consequence of hoarding, the economy experiences a crisis due to an insufficient level of aggregate demand.

All of this is replicated in the early drafts of the *General Theory*, in which Keynes insists that the purpose of production in a monetary economy is based on the expectation of profit. Unlike the barter or cooperative economy—which might use money, but in which money is neutral—in a monetary production economy, money can never be neutral. Just as Veblen’s *Theory of Business Enterprise* had rejected “political economy” that supposes that the purpose of production is consumption (and that the purpose of a sale is to obtain that which one wants to consume), Keynes also rejected the (neo)classical focus on consumption as the end of the production cycle. Marx’s criticism of classical political economy and Say’s Law was based on the idea that money is not simply a medium of exchange, necessarily used to buy commodities (or labor); money can also be demanded as a store of value, kept idle and, hence, can generate a crisis due to insufficient demand. Keynes himself, in those early drafts,

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<sup>3</sup> “The principal object can be explained in a single sentence: to provide that money earned by selling goods to one country can be spent on purchasing the products of any other country” (Keynes 1980).

referred approvingly to Marx's analysis (Sardoni 1997). Thus, both Marx and Keynes rejected the notion of money as a mere medium of exchange and point out that it is not always necessarily and immediately converted into goods or labor (so that there is never a problem of generalized excess supply). Money can be hoarded, making crisis possible. This is a crucial theoretical innovation, which provides the fundamental rationale of the principle of effective demand.

However, when considering the international monetary system, Marx's and Keynes's critique of money needs further developments. In the context of the international economy, in which there are many different currencies, another option is available to those who decide how to use money. Money, in the form of a specific currency, can be used to buy commodities, it can be kept idle, or it can be used to buy assets denominated in other currencies. The latter option is profitable when gains derive from purchases in a currency that is expected to appreciate against the domestic currency. In the modern context, much of the international reserves are hoarded by governments that want to protect their exchange rates. This still breaks Say's Law and depresses global demand. It is this third option that, in Keynes's proposal, as well as in other approaches to exchange rates, receives too little, if any, attention. While the Keynes/Davidson proposal would penalize nations that accumulate international reserves, it still appears to be biased toward the view that money (mostly) circulates goods.

In the real world, currencies are not used solely for current account transactions, but rather are also used in capital account transactions. Therefore, unless capital is completely immobile, there is no reason for exchange rate adjustments to eliminate current account imbalances (note that both the Keynes proposal and the Davidson proposal preserve the option of imposing austerity on nations with persistent trade deficits, recognizing that exchange rate adjustments might not work). Indeed, with the growth of global finance that easily evades national restrictions, the vast majority of international transactions—certainly more than 90% of total volume, and probably more than 99% of total volume—is not directly related to current accounts. If capital controls are neither politically nor technically feasible, then designing an exchange rate system based on the belief that the international monetary system should operate as if goods trade against goods is unlikely to function well. Further, it is hard to imagine countries and groups of countries with interests as diverse as those of the United States, China, and Euroland coming together to create

anything like an international central bank, even one with the limited powers envisioned in the Davidson plan.

The Keynes/Davidson plan hopes to enhance external stability by fixing exchange rates and adopting several procedures to reduce trade imbalances. However, for reasons we discuss below, this comes at a great cost because the ability of a nation on a fixed exchange rate to use domestic policy to achieve internal stability is reduced. If the enhanced external stability does not itself also generate internal stability, there is a trade-off of external stability for internal instability.

### **3. AN ALTERNATIVE (KEYNESIAN) APPROACH TO MONEY**

As we argued in the previous section, reformist projects for the international monetary system that concentrate on trade and current account imbalances are an inadequate response to the present situation, in which speculative capital movements play a central role in the international monetary system. However, in the present paper, we do not intend to propose an alternative reform of the international monetary system. We limit ourselves to outline an alternative approach to money, which is also derived from Keynes. This alternative approach is relevant in the present context as it implies the adoption of a regime of floating exchange rates by countries.

The alternative notion of money, based on its unit of account function, and close to Knapp's approach, can be found in Keynes's positions as expressed in *A Treatise on Money*. This line of argument has been called "state money," or, in recent years, it has usually been called "chartalism." The focus is on the sovereign nature of the unit of account. In the *Treatise*, Keynes argued that the "money of account comes into existence along with debts, which are contracts for deferred payment, and price lists, which are offers of contracts for sale or purchase.... [and] can only be expressed in terms of a money of account" (Keynes 1971). He distinguished between "money and money of account by saying that the money of account is the description or title and the money is the thing which answers to the description" (Keynes 1971). Further, the state "claims the right to determine what thing corresponds to the name, and to vary its declaration from time to time—when, that is to say, it claims the right to re-edit the dictionary. This right is claimed by all modern States and has been so claimed

for some four thousand years at least. It is when this stage in the evolution of money has been reached that Knapp's chartalism—the doctrine that money is peculiarly a creation of the State—is fully realized" (Keynes 1971). Finally, "the age of chartalist or State money was reached when the State claimed the right to declare what thing should answer as money to the current money of account—when it claimed the right not only to enforce the dictionary but also to write the dictionary. Today all civilised money is, beyond possibility of dispute, chartalist" (Keynes 1971).<sup>4</sup>

Keynes explains that moneys are "derived categories" following from the creation of the unit of account. The two types of derivations are "offers of contracts, contracts and acknowledgments of debt, which are in terms of it, and money proper, answering to it, delivery of which will discharge the contract or the debt" (Keynes 1971). Individuals discover "that for many purposes the acknowledgments of debt are themselves a serviceable substitute for money proper in the settlement of transactions" (Keynes 1971). In modern economies, bank money is the most important. Thus, we have, side by side, state money (money proper) and bank money (acknowledgments of debt). Moreover, the acknowledgments need not be of private debts; they can refer to debts of the state, which can "use its chartalist prerogative to declare that the [bank] debt itself is an acceptable discharge of a liability" (Keynes 1971). This bank money becomes money proper, changing "its character" so that it "should no longer be reckoned as a debt, since it is of the essence of a debt to be enforceable in terms of something other than itself" (Keynes 1971).

When a bank makes a loan, it accepts an IOU and issues its own IOU; the bank's debtor clears his IOU by delivering the bank's IOU in payment. All modern banking systems include a clearing house so that a bank's debtor can deliver the liability of any bank. Likewise, as Keynes noted, tax liabilities are mostly cleared by delivering bank liabilities, with the central bank clearing accounts for private banks and the treasury. There is a hierarchy of monies, with bank liabilities used by the

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<sup>4</sup> These views can be traced to Keynes's earlier unpublished work on ancient monies, as well as to his 1914 review of an article by A. Mitchell Innes, whose ideas were similar to Knapp's (Wray 2004). Keynes approvingly noted Innes's rejection of the story of the evolution of money from early commodity moneys to credit and fiat money. The value of coins was never determined by embodied metals; rather, they were "all token coins, their exchange value as money differing in varying degrees from their intrinsic value" (Keynes 1914). Like Knapp, Innes had argued that the way the state "enforces the dictionary" is by imposing a tax (or other involuntary) liability in the money of account. The state ensures that the money it issues—denominated in that unit of account—is generally accepted by agreeing to accept it in tax payments. So long as taxes are enforced, this is a sufficient condition to ensure that the state's money will be accepted.

nongovernment sector and with government liabilities used for net clearing among banks and with the government. Given this arrangement, banks must either hold some reserves for clearing (as in the United States), or must have ready access to them on demand (as in countries like Canada, where banks are allowed to strive for zero net reserve balances).<sup>5</sup>

According to Keynes, state money may take any of three forms: “Commodity Money, Fiat Money, and Managed Money, the last two being sub-species of Representative Money” (1971). Commodity money consists of “actual units of a particular freely-obtainable, nonmonopolised commodity which happens to have been chosen for the familiar purposes of money,” or “warehouse warrants for actually existing units of the commodity” (Keynes 1971). Fiat money is representative money “which is created and issued by the State, but is not convertible by law into anything other than itself, and has no fixed value in terms of an objective standard” (Keynes 1971). This is distinguished from managed money, which “is similar to Fiat Money, except that the State undertakes to manage the conditions of its issue in such a way that, by convertibility or otherwise, it shall have a determinant value in terms of an objective standard” (Keynes 1971). Managed money is the most generalized form of money, which can “degenerate into Commodity Money on the one side when the managing authority holds against it a hundred per cent of the objective standard, so that it is in effect a warehouse warrant, and into Fiat Money on the other side when it loses its objective standard” (Keynes 1971). Both the gold standard and the Bretton Woods system of fixed but adjustable exchange rates were managed money systems. Most developed countries now have fiat money systems—the dollar system in the United States, the yen system in Japan, and so on. While the euro is a fiat money in the sense that it is not “convertible by law into anything other than itself,” the individual members of the EMU are users, not issuers, of the euro. Hence, the euro nations are operating toward the “commodity money” end of the managed money spectrum. Given these views on the nature of money, let us turn to the operation of modern sovereign nations.

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<sup>5</sup> Ultimately, a central bank cannot refuse to provide reserves for clearing if it wishes to maintain an orderly payments system with bank liabilities circulating at par. Further, to hit its interest rate target, the central bank must accommodate the demand for reserves. All of this is well established in the “horizontalist” approach accepted by most Post Keynesians.

#### 4. CURRENCY SOVEREIGNTY AND EXCHANGE RATE REGIMES

A nation like the United States (as well as countries like Japan, Britain, the European nations before they adopted the Euro, and Argentina after it abandoned the currency board) creates a currency for domestic use and ensures its use primarily by demanding payment of taxes in that currency, although some also adopt legal tender laws. The state (including the Treasury and the Central Bank, which acts as an agent of government) issues and spends high powered money (HPM—cash and reserves at the central bank) without any promise to convert its HPM to any other currency, nor to gold or any other commodity, at any fixed exchange rate. The ability of a national state to behave in this way with respect to its currency and to maintain its fiscal independence is what we call sovereignty, although there are other aspects to sovereignty that we do not consider here.

The sovereign state spends (buys goods, services, or assets, or makes transfer payments) by issuing a Treasury check, or, increasingly, by simply crediting a private bank deposit. In either case, reserve balances (HPM) are created when the central bank credits the reserve account of the receiving bank.<sup>6</sup> Analogously, when the government receives tax payments, it reduces the reserve balance of a bank. Simultaneously, the taxpayer's bank deposit is debited. While one commonly thinks of a government needing to first receive tax revenue, and then spending that revenue, this sequence is not necessary for any sovereign government. If a sovereign state spends by crediting a bank account (issuing its own IOU—HPM) and taxes by debiting a bank account (and eliminating its IOU—HPM), then, as a matter of logic, the government is not “spending” tax revenue. In other words, the sovereign government's ability to make payments is neither revenue-constrained nor reserve-constrained.

The final point is that the interest rate paid on sovereign securities is not subject to normal “market forces.” The sovereign government sells securities in order to drain excess reserves to hit its interest rate target. It could always choose to leave excess reserves in the banking system, in which case the overnight rate would fall

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<sup>6</sup> Complex coordination between the central bank and treasury are adopted that obscure the spending process. We will not go through these, but refer interested readers to the work done by Stephanie Kelton (Bell) (2000) and by Wray (1998, 2004).

toward zero. When the overnight rate is zero, the Treasury can always offer to sell securities that pay a few basis points above zero and will find willing buyers because such securities offer a better return than the alternative (zero). There may be economic or political reasons for keeping the overnight rate above zero (in which case the interest rate paid on securities will also be above zero), but it is incorrect to argue that the size of a sovereign government deficit affects the interest rate paid on securities. This is a sometimes neglected conclusion that follows from the horizontalist claim that the overnight interest rate is exogenously set by the central bank. Since short-term government debt is essentially equivalent to interest-paying reserves, and thus a close substitute to lending in the overnight interbank market, the overnight rate set by the central bank will govern the short-term government “borrowing” rate.<sup>7</sup>

This indicates that a sovereign nation can choose interest rates on government debt as low as it wants. By the same token, the sovereign government could have interest rates above 100% if it so desired. All it need do is set the overnight rate target at 100% and then sell securities whenever excess reserves placed downward pressure on that rate. This drives home the point that the interest rate is exogenously set in any sovereign nation, as the horizontalists have long asserted. Whether the base rate will be zero or one hundred is a monetary policy matter, not subject to market determination.

A nonsovereign government is in an entirely different situation. In a “dollarized” nation, the government must obtain dollars before it can spend them. Hence, it uses taxes and issues IOUs to obtain dollars in anticipation of spending; unlike the case of a sovereign nation, this government must have deposits of dollars or euros before it can spend. Further, unlike the sovereign nation, the nonsovereign government promises to deliver third party IOUs to service its own debt (while the United States and other sovereign nations promise only to deliver their own IOUs). Because of this, the interest rate on the nonsovereign government’s dollar liabilities is not independently set (whether it is one of the fifty U.S. states or a dollarized nation).

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<sup>7</sup> The United States accomplished the same feat during WWII, when short-term Treasuries paid 3/8 of one percent, even as the deficit-to-GDP ratio reached 25% of GDP—three times higher than Japan’s current ratio! Rates on longer-term government debt are determined more complexly, but it is important to note that it is the government’s decision to issue longer-term government debt. It can always accomplish the objective of draining excess reserves by issuing short-term bonds and, thus, does not need to issue long-term bonds. Indeed, if it pays interest on reserve balances, it does not need to sell bonds at all.



Since it is borrowing dollars, the rate a dollarized nation pays is determined by three factors. First, there is the base rate on dollars set by the monetary policy of the United States (the issuer of the dollar). Secondly, there is the market's assessment of the nonsovereign government's credit worthiness, which may be determined by a large number of factors. These two considerations determine the lowest interest rate the market will tolerate. Thirdly, the interest rate is also constrained by the nation's need to keep its exchange rate fixed or pegged to another currency. Thus, a nonsovereign government, as user (not issuer) of a currency, cannot independently set the interest rate.

From this it evidently follows that the possibility for a state to set the interest rate in a world of high capital mobility is contingent on its adopting a regime of floating exchange rate. We believe that adopting a regime of floating exchange rates is important for developing countries in particular. They are rightly concerned with the financial and exchange rate crises suffered not long ago by Asian and Latin American nations, triggered by large external debts, declining foreign currency reserves, and market expectations that exchange rate pegs could not be held. In fact, these nations had adopted (formal or informal) pegs to the dollar that they ultimately were not able to hold. By contrast, a nation that adopts its own floating rate currency can always afford to put unemployed domestic resources to work. Its government will issue liabilities denominated in its own currency, and will service its debt in its own currency. Whether its debt is held internally or externally, it faces no insolvency risk. This does not mean that the nation will necessarily ignore its trade balance or movements of its exchange rate, but it does mean that it can put domestic employment and growth at the top of its policy agenda.

A sovereign nation is able to use domestic policy to achieve domestic or internal stability. As discussed above, this comes at the cost of possibly greater external instability. A floating exchange rate will not necessarily move trade toward balance, as discussed above. However, it must be remembered that from the macro perspective, imports are a benefit while exports are a cost. Hence, a trade deficit means net benefits. This is usually neglected in discussions of trade balances because of the presumed impacts on domestic employment. However, so long as the nation's domestic policy is geared toward stability, it can achieve full employment, even in the presence of a trade deficit. This, in turn, requires sovereignty, which necessitates a floating exchange rate. It is possible that a trade deficit can exert downward pressure

on the exchange rate, which can generate some “pass through” impacts on domestic inflation. If desired, domestic policy can turn to inflation-fighting, including the conventional method of using unemployment to attenuate inflation pressures. While we would not advocate such a method, we merely point out that the sovereign nation can implement policy geared toward achieving internal stability.

A nation that adopts a fixed exchange rate must hope that the conditions that generate external stability will also happen to coincide with those that permit internal stability. The nation that floats can enjoy the net benefits of a trade deficit, improved real terms of trade (a trade deficit means that the “real” cost in terms of exports is lower), and domestic full employment somewhat offset by the possible costs of currency depreciation and higher prices. The nation that fixes the exchange rate may not be able to “afford” a trade deficit (because of exchange rate pressures) and will probably have to use domestic unemployment as the means to maintain its peg. For these reasons, a flexible exchange rate preserves “policy space” for independent policy formation.

In the next section, we look at the Argentinean case as a concrete illustration of the negative implications of renouncing sovereignty and the advantages of regaining it by adopting floating exchange rates. We also briefly look at the European experience with monetary integration as an example of countries that have given up their monetary independence.

## **5. THE ARGENTINEAN AND THE EUROPEAN CASES**

Argentina gave up its currency sovereignty when it adopted a currency board based on the dollar and then regained sovereignty by abandoning the currency board during its resulting economic crisis. When Argentina abandoned the currency board, it gained policy independence: its exchange rate was no longer tied to the dollar’s performance, its fiscal policy was no longer held hostage to the quantity of dollars the government could accumulate, and its domestic interest rate came under control of its central bank.

One of the first policy initiatives taken by newly elected President Kirchner was a job creation program that guaranteed employment for poor heads of households. Within four months, the Plan Jefes y Jefas de Hogar had created jobs for

2 million participants—equal to 13% of the labor force. This not only helped to quell social unrest by providing income to Argentina's poorest families, but it also put the economy on the road to recovery. Conservative estimates of the multiplier effect of the increased spending by Jefes workers are that it added a boost of more than 2.5% of GDP. In addition, the program provided needed services and new public infrastructure that encouraged additional private sector spending. Without the flexibility provided by a sovereign, floating currency, the government would not have been able to promise such a job guarantee.

Argentina also benefited from currency flexibility that was made possible by dropping the peg to the dollar, as her exports became competitively priced. The U.S. expansion, as well as the world-wide rise of commodities prices, has helped Argentinean exports. However, there is some precariousness inherent to reliance on export-led growth and Argentina must continue to develop its domestic markets so that it will not be so reliant on U.S. growth. Currency sovereignty allows the nation to use fiscal policy (and monetary policy) to continue to create jobs in the private and public sectors as an alternative to export-led growth.

Although different from Argentina and other cases of explicit or implicit dollarization, the European experience leading to the creation of a common currency area is another important example of the serious effects for national states of giving up their sovereignty through renouncing flexible exchange rates. European countries adopted a common currency area and created a single central bank in their quest for stable exchange rates within Europe. There is nothing inherently wrong with monetary integration that leads to a fixed exchange rate within a union; indeed, the United States can be thought of as a currency union with fixed exchange rates among the fifty states. What is highly questionable is the way in which monetary integration was pursued, as it has been realized with scarce, if any, concern for fiscal integration, so that individual European nations have lost their currency sovereignty while no federal sovereign fiscal institution has been created.<sup>8</sup>

The European strategy of monetary integration is somewhat paradoxical. The European process of integration has always been characterized by the crucial role played by political factors. The creation of a currency area made up of significantly

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<sup>8</sup> For a more detailed criticism of the European monetary integration along the same line, see Sardoni (2006, forthcoming).

heterogeneous countries was an essentially political decision and not the spontaneous outcome of their convergence. There is the idea that monetary integration itself would promote the degree of economic convergence among countries required for an efficient currency area. In this way, Europe could become one of Mundell's optimal currency areas.

However, while recognizing the importance of the political dimension, Europe has at the same time largely overlooked important implications of acknowledging the importance of the role of the state and politics in the process of integration. First of all, Europe has overlooked the role that fiscal policy at the federal level can play in the process toward the creation ex post of an efficient currency area. In a situation in which the countries that adopt a common currency are heterogeneous and characterized by low flexibility of prices and wages, as well as low mobility of the factors of production, the risk of asymmetric shocks can be dealt with by the creation of a fiscal counterpart to the single central bank. A federal fiscal authority can compensate for the effects of asymmetric shocks through its policy, but there is more than the role of fiscal policy to mitigate the effects of asymmetric shocks. Besides the implementation of fiscal policy, a federal government can impose laws and encourage behavior that gives rise to more flexible markets and, hence, bring the monetary union closer to an optimum currency area (Goodhart 1998).

The process of monetary integration in Europe draws its inspiration from a theoretical stance that sees fiscal policy as distorting and ineffective in the long run. More generally, state interventions are seen as something to avoid to the maximum possible extent, in order not to disturb the spontaneous working of the economy. As a result, we believe, Europe has adopted a quite unique process. The strong link between the state (which has fiscal authority) and the creation and administration of money has been weakened to the point of having a central bank that is totally independent of national states, with no fiscal counterpart to it.

In general, the concept of an independent central bank is basically flawed and ambiguous,<sup>9</sup> but in the concrete European experience the concept has come true. The ECB is totally independent, both with respect to the fixing of its objectives and with respect to the policies adopted to realize them. In this framework, individual national states are constrained, as they cannot freely use fiscal instruments to affect output and

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<sup>9</sup> For a critique of the central banks' independence, see Forder (1998) and Bibow (2004).

employment. Europe seems to be entrapped in a vicious circle. The ECB's anti-inflationary stance and the European governments' requirement to be "fiscally responsible" produces substantial stagnation. "Cautious," or restrictive, monetary policies discourage the growth of investment and aggregate demand in general. The endogenous nature of budget deficits means that slow growth impedes tax generation, causing deficits to worsen. This forces a growing effort to stay in line with the fiscal parameters and, hence, a further negative impact on demand. In this context, the European Union relies on foreign demand as an engine of economic growth. But this gives rise to a circularity: each member state tries to increase net exports—both with other EU nations and with the rest of the world—in part by trying to become a low-cost producer. As exchange rates are fixed with the rest of the EU, the only alternative is to maintain or reduce wages and prices within the member state. This adds more pressure for fiscal austerity and slow growth. The euro experience seems to provide a negative lesson for those advocating "go it alone" approaches to pegged exchange rate—even in the case of large trading blocks with substantial international power.

## **6. CONCLUSION**

The world has changed tremendously since the 1940s when the Bretton Woods system was formed. That system performed quite well, with fixed but adjustable exchange rates. However, it was developed for a world in which capital flows were controlled and nearly nonexistent, dominated by official flows. This, after all, can explain why Keynes's plan largely ignored the role and effects of capital movements on exchange rates. Further, even trade in goods and services was quite restrained, in part due to the overwhelming dominance by the United States.

Over time, the United States lost its unique role as Europe recovered and Asia became a major producer. Likewise, private capital flows grew gradually, and then in a torrent—partially due to technological change and partially due to "liberal" policy that sought to free financial markets. Even before much progress was made in that direction, the Bretton Woods system collapsed. While some still nostalgically call for a return to a fixed exchange rate system modeled on Keynes's Bancor Plan, current economic and political trends make this highly improbable. Nor can most nations individually adopt fixed rates because speculative attacks can break virtually all

pegs—except for a few modern mercantilist nations that have accumulated unassailable hoards of dollars.

Pegged exchange rates remove an important degree of freedom, holding domestic fiscal and monetary policy hostage to the exchange rate. Euroland nations adopted Maastricht criteria to constrain policy making as an important condition to integration and adoption of the single currency. Although the criteria are, after all, quite generous, allowing substantial fiscal deficits, they are regularly exceeded, even by nations that have slow growth and high unemployment—that is, by nations that are living far below their means. It is difficult to project how this experiment will play out. Other nations, such as Argentina, have collapsed under the weight of currency board arrangements—and recovered only after returning to a sovereign, floating rate currency.

A floating rate allows for greater domestic policy independence—providing fiscal and monetary policy space. However, it must be stressed that adopting a floating exchange rate is no panacea. A regime of flexible exchange rates cannot, of course, guarantee that effective domestic policies are chosen and implemented. It is only a necessary condition for gaining policy independence. It does not by itself ensure either enlightened use of this policy independence or an easy path to growth and development. In the current world situation, floating exchange rates are a necessary, but not sufficient, condition for the implementation of policies able to promote more growth, employment, and welfare.<sup>10</sup> Ultimately, the adoption of such policies is contingent on the ability and willingness of social, political, and economic actors to do so.

Note that a flexible or floating rate regime is not necessarily a “free float” system. We would leave some room for discretionary intervention. What we advocate is a “managed money” system, but one that is closer to Keynes’s “fiat money” system than to the “commodity money” system at the other extreme. Fiscal and monetary policy, as well as official transactions in exchange markets, can still be used to “manage” exchange rates in some circumstances. In particular, interventions are envisioned in the case of rapid revaluations to ease competitive pressures arising from

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<sup>10</sup> Calvo and Mishkin (2003), referring to developing economies, hold that the adoption of sound policies and institutions is much more important than the exchange rate regime: “we believe that the choice of exchange rate regime is likely to be of second order importance to the development of good fiscal, financial, and monetary institutions in producing macroeconomic success.” What is “good” for Calvo and Mishkin, however, is not necessarily what we intend by using this term.

an overvalued currency. However, achieving domestic, internal stability would be the primary goal of policy, with full employment the most important domestic policy objective.

Floating exchange rates give nations one more degree of freedom but, of course, they also imply some costs. Among such costs there can be a larger degree of uncertainty due to the possible high volatility of exchange rates and terms of trade, as well as the costs of the possible triggering of inflationary processes deriving from a large depreciation of the national currency, which makes the price of imports increase. From this point of view, greater stability and independence could perhaps be achieved by some combination of floating exchange rates, combined with capital controls and trade policy—especially in the case of developing nations. These factors would make it easier to adopt managed exchange rates. However, the question concerning how to introduce effective capital controls in the present world situation remains open.

Keynes's plan relied on the existence of some form of international governance. If it became possible to construct international institutions to promote economic growth by focusing attention on financing development, this could also improve international economic performance by making it possible to give exchange rates and terms of trade more stability. In this perspective, the European experience is a telling example. Monetary integration can be, in principle, the correct response to the need for more stable external conditions in the European countries, but the present European arrangements, although they give stability to exchange rates, do not seem to work effectively to guarantee more growth and higher levels of employment. The basic reason is that there is no supranational institution that plays the role played by the governments of sovereign nations. In other words, the EMU does not seem to work satisfactorily for the same reasons that a world regime of fixed exchange rates cannot function well without a supranational institution with tasks analogous to those envisaged by Keynes and others.

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