



Sovereign

## Currencies, Competition and the Dawning of the Age of Austerity: An Evaluation of Modern Monetary Theory

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### Introduction

Modern monetary theory (MMT), as espoused by Randall Wray *et al*, has further developed the Endogenous Money Paradigm (EMP) to include focus on inter-sectoral balances, national debt management and exchange rate regimes (Wray 2012). The key assertion of the paper is that, for national systems, this post-Keynesian (PK) analysis extends our understanding of the financial realities by demystifying the fallacies associated with the austerity discourse. In addition, internationally, the MMT casts light on the currency competition between nation-states where competing sovereign currencies will define the future monetary order (Cohen 1998). The paper first reviews, in theory and practice, the debt-management process of sovereign currencies. The paper then contrasts sovereign with non-sovereign currencies, in the context of currency competition. It is concluded that sovereign currency status, and reserve currency seigniorage, has distinct advantages for the modern nation-state.

### PK Monetary Theory

The PK conception of money begins with the establishment of the *money of account*, as an accepted convention which liberates the economy from the constraints of barter. In the modern era, following Hawtrey, bank deposit units (created *ex nihilo* by lending) function as money in circulation (Hawtrey 1919). Credits and debits are cleared through the use of the common currency unit, thus affording a key role to financial intermediaries and the general demand for loans. Next, the PK's emphasize the *nominal* nature of the money, that has been

sanctioned by the monetary authorities responsible for the currency jurisdiction. In line with *chartalist* notions of money, following Knapp, the PK's further posit the accepted legitimacy of the monetary unit, is derived from its acceptance by the state for the payment of taxes (Knapp 1924; Wray 2012). This is a key MMT argument that Wray makes (p.9) since he argues that it is the *need* to pay taxes that creates the demand for the nominated currency, and ensures its sustained value (Wray 2012). He further argues that legal tender laws alone are not sufficient explanation (p.46) of why a currency is socially accepted (Wray 2012). The fact that *taxes drive money* means that the political fiscal dimension is an important consideration, and the *sovereign* state maintains control through the legitimization of the money resource.

So, the focus is on the credit system, and bank deposit units, where the monies are created in response to loan-demand (at a given interest rate) and are retired when contracts are settled. This so-called credit-money is endogenous and demand-led, since the central bank simply *accommodates* the reserve requirements of settlement banks, whilst the spectrum of (market) interest rates are exogenously state-determined (Borio 2001).<sup>1</sup> This is achieved through the setting of base rates and open market operations.<sup>2</sup> Differences exist between PK's regarding the shape of the credit supply curve, but there is common agreement that money supply is driven by nominal income, rather than the other way around, since financial innovation (in particular) facilitates a variable velocity of circulation.<sup>3</sup> It is not the demand for money from a given stock that is significant for PK analysis of capitalism, as Rousseas points out (p.56), but the flow of credit-money to the industrial sector (and financial markets) instead, in keeping with the Radcliffe general liquidity thesis put forward in the late 1950's (Rousseas 1998). During the neo-liberal era, as Figure One demonstrates, there has been a substantial increase of UK credit-money as proxied by the M3/M4 measures in relation to the quantity of base money (reserves, notes and coins).

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1The central bank thus operates, as Chick observed, as a *lender of first resort* (Chick 1986).

2Interest-rate targeting by the state is still subject to influence from the market (Wray 2004).

3The central bank, for instance, may only partially accommodate the reserve requirements.

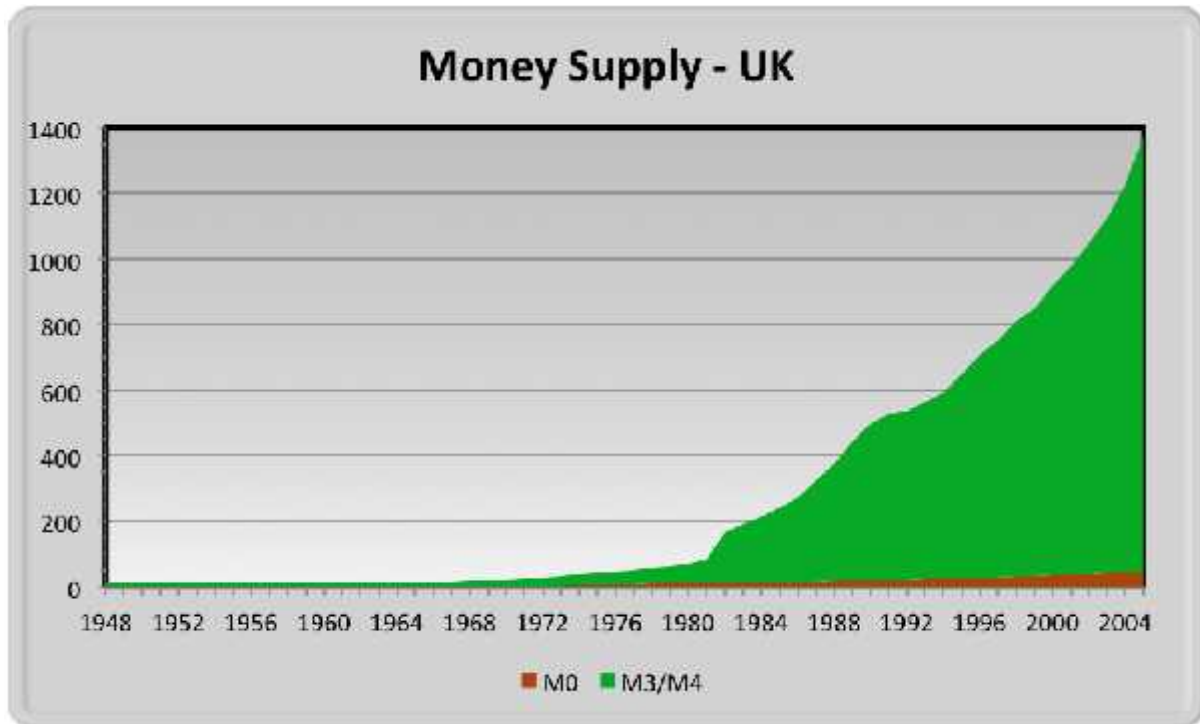


Figure One: UK M3/M4 in relation to Base Money post-WW2.

### MMT Theory

Wray's exposition of MMT (p.4) begins with discussion of inter-sectoral balances, where one sector's deficit is matched by another sector's (or a combination of sectors) surplus, since by definition all balances must net to zero in the aggregate (Wray 2012). In this sense, netting to zero refers to double entry book-keeping on retail bank balance sheets. A bank deposit, for instance, constitutes part of the net wealth of an individual, combined with other (including non-financial) assets, yet it represents a liability for the bank. The MMT approach refers to a *pyramid of liabilities* (p.85) with the government liabilities at the top and layers of credit below founded on base money, which means that if all debt obligations were to be cancelled base money would still remain (Wray 2012). Ignoring base money for simplicity, the private sector balances net to zero but, if this sector has a deficit with the public sector, then the public sector must have a surplus by definition. The public sector will have an asset on their balance sheet (*ceteris paribus*) without a corresponding liability, whilst the private sector has a net liability on its balance sheet.<sup>4</sup>

Yet, money proper can be considered as either a stock or a flow, depending on whether the measurement is taken at a static point in time or over a period of time. MMT adherents argue that it is necessary at all times, when considering inter-sectoral balances, to ensure *stock flow consistency* that takes account of these two measures. Wray explains (p.30) using the analogy of a bath tub, that a certain *stock* of money measured can change according to monies added and subtracted during a specific course of time (Wray 2012). Monies could be added, for instance, as a consequence of credit creation, or subtracted as a result of the settlement of

<sup>4</sup>The external balance is also ignored for purposes of simplicity.

debt obligations. In addition, the analogy can also represent the settlement between sectors. If there is public expenditure, for instance, this creates public sector liabilities in the form of cash, bills, gilts or reserves and a corresponding increase in the net worth of the private sector (measured by the greater stock of water). Taxation, of course, would have the reverse effect. MMT is also extended to include the external sector (balance of payments) between currency jurisdictions. However, it should be recognized that whilst MMT is presented as new, it does bear a striking resemblance to the inside/outside money research of Gurley and Shaw in the 1960's that identified (p.30) inside (private sector) wealth as netting to zero (Harris 1985).



### A Sovereign Currency Jurisdiction

One clear implication of MMT, is the notion that a state which issues its own currency is in a stronger position than decision-makers in a non-sovereign currency jurisdiction. In my 2013 AHE paper, I identified from empirical work that there has been an erosion of state financial sovereignty post-WW2, in terms of credit-creation, in Germany and the UK (Mouatt 2013). In order to account for *financialisation* in the neo-liberal era, which is largely responsible for the erosion of sovereignty, the paper identified falling profit rates and a state that primarily serves the interests of capital (Mouatt 2013).<sup>5</sup> Yet, some states have lost more control than others. MMT presents a sovereign state that retains (at least in theory) the ability to determine financial outcomes, through fiscal policy and debt-management protocols, even if the state is serving the wishes of private capital. In a credit-monetary system, as Wray notes (p.14), a person (or entity) that is credit-worthy can always decide to spend more if they so choose (Wray 2012). Since a sovereign currency (in terms of base money) issuer is able to dictate the terms of supply, and possesses the right to tax at will (note earlier note on tax), there is no theoretical limit to their ability to borrow. As Wray notes, since government deficits create an equivalent amount of non-government savings (p.126), it is impossible for the state to face an insufficient supply of savings (Wray 2012). But, importantly, *self-imposed constraints* exist that limit the behavior of sovereign currencies and, in the current austerity discourse, these tend to be predicated on what Wray calls the *myth of unsustainability* (Wray 2012).

<sup>5</sup>Including banks that lobbied governments for deregulation post-WW2 (Helleiner, 1996).



### **The Myth of Unsustainability**

Wray uses the example (p.66) of an over-weight man that daily consumes more calories than he uses up and will therefore, other things remaining equal, continue to get heavier (Wray 2012). This process is feared to be unsustainable, since the man will eventually explode. Yet, the circumstances *will not remain the same*. The person may become ill, for instance, or his metabolism may adjust, and an equilibrium may be reached where his waistline is stable. The debt to GDP ratio of a nation-state will remain the same if there is a balanced budget, i.e. public expenditure is matched by the taxation receipts, and the interest rate on total debt is matched by economic growth. Yet, if the ratio was set on a path of growth, policy-makers can fear unsustainability. But, other things do change. Inflation, for instance, may lead to taxation receipts growing at a faster rate than government spending thus lowering deficits. In addition, the private sector may adjust its spending upwards, since increasing national debt increases their net wealth, leading to higher tax revenues. Increased state spending will also have the same impact on tax revenues, especially if this is combined with the multiplier/accelerator effect. Finally, there is the introduction of austerity measures, which appears to be the current (and historic) policy of choice for the capitalist nations. The problem is that these actions may lead to stagnation (or worse), and unchanged debt to GDP ratios, as state spending and hence government tax revenues are reduced. Notwithstanding, the policy of austerity remains, and the various self-imposed constraints on debt-management processes also continues. But, what is a plausible explanation for this perennial behavior?

Wray likens the repeated rules and procedures to the Jack Nicholson character in the film *As Good as it Gets* (p.143), where he suffers from OCD and is driven to perform ritualistic daily practices because he fears the consequences if he doesn't. But, in reality, these consequences do not exist (Wray 2012). In a functional sense, the self-imposed constraints for financing the deficit are similar to the responses to an *old-time religion* or Victorian cautionary tale, where it is intended that certain desired behaviors are encouraged even though the rationale bears no resemblance to the underlying reality. In the US (p.204), for instance, for each time a public transaction takes place the FED Treasury Deposit Account is debited, but the deposit is not allowed to fall below a \$5 billion positive balance (Wray 2012).<sup>6</sup> When the Treasury spends

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<sup>6</sup>This may fall below \$5 billion temporarily, but an overdraft would be considered taboo.

money, this leads to a simultaneous credit to the bank deposit of the recipient and, in turn, to an increase of the private bank's reserves at the national bank. Furthermore, as Wray notes (p.119) sovereign currency governments never actually *need* to issue bonds as such, since they can just leave reserves in the banking system instead (Wray 2012).<sup>7</sup> Too much spending leads to excess reserves in the system, however, which then need to be *mopped up* by open market operations in order to target the inter-bank interest rate (and hence market rates).<sup>8</sup> In this sense bond sales are akin to savings for the private banks, whilst their reserves are akin to checking accounts.<sup>9</sup> But, what types of behavior were they trying to prevent when they first introduced the self-imposed constraints? As capitalism developed, were the instigators simply concerned with the latent profligacy of government, the *crowding out* of the private sector or raised interest rates, since these ideas appear to dominate the current political discourse? It may be that inordinate state spending is a danger, with its associated ramifications, but the crowding out thesis is nullified by the existence of endogenous money and, as Wray notes (p.124), new government spending is likely to lower interest rates rather than raise them as a direct consequence of increased net financial assets in the private sector (Wray 2012).

It is likely that as capitalism evolved from the mercantilist to industrial phases, with the pre-eminence of private capital, autonomy of the financial sector was jealously guarded. Banking has been a largely private affair since, as Chick observed, Charles I interfered with the Mint in 1640, and merchants and wealth-holders began to trust the services of private banks instead of the state (Chick 2013). The subsequent Bank of England (BOE) established shortly after the *Glorious Revolution* of 1688, ensured that this *arms-length* relationship between the private BOE and parliament/constitutional monarch was maintained and the BOE model has been replicated (in its basic structure) in all the capitalist nations.<sup>10</sup> The idea that governments need to be restricted in their public expenditure was probably given extra clout following the experience of the Third Reich state in 1930's Germany. Under the auspices of the Reichsbank president Schacht, the state issued its own debt (circumnavigating allied reparation rules), and transformed Germany from the weakest European economy to the strongest in just four years (Overy 1982). This so-called *Wirtschaftswunder*, however, then later enabled Germany to re-arm with devastating consequences. In this sense, the self-imposed constraints offer a form of check on governments, protecting the citizens, should the state choose to pursue expenditure plans to finance undesirable (from the perspective of private capital) objectives of their own making. This perhaps serves to sustain a *de facto* capitalist private plutocracy and weaken the potential capabilities of the state to pursue a more democratic agenda.

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7The view usually presented by politicians is that deficits must be entirely financed by bonds.

8In the US the targeted inter-bank rate is known as the FED funds rate.

9Due to excess reserves, from quantitative easing, governments have recently felt the need to offer interest on reserves in order to ensure that inter-bank rates remain within the limits set.

10The BOE, in turn, was based on the Swedish and Dutch versions that preceded it.



## Currency Competition

In the late 1990's, Benjamin Cohen introduced the concept of *currency competition* to refer to the weakening of the boundaries between currency jurisdictions, and subsequent increased competition between rival states for *seigniorage* (Cohen, 1998). Given that *finance matters* in the (global) economy, the governments with stronger currencies have more sway in political affairs. There are many ways in which financial benefits can accrue to a nation-state whose currency is used on a wider scale, particularly if the currency is used as a reserve.<sup>11</sup> These can include *inter alia* the ability to obtain credit, for international purposes, at lower interest rates and default risk. The ubiquitous use of the US dollar as a reserve since the 1950's has brought substantial benefits to the US economy.<sup>12</sup> This is one of the irritating aspects of Wray's work on the MMT since he refers to the power to tax citizens (and legitimize currency) as a useful monetary policy instrument for a nation-state, but *downplays* the full impact of US dollar *seigniorage*. Yet, if there is a *de facto* universal use of the dollar, including for international debt obligations, and the US authorities have a monopoly on its issue, this is akin to being a *global* currency sovereign.<sup>13</sup> Wray suggests, in contrast, that the impact is minimal. This US-centric view perhaps prefers to attribute US post-WW2 prosperity to entrepreneurialism and the protestant work ethic, no doubt built on the foundations of the late 19<sup>th</sup> C industrialists. Be that as it may, MMT offers us a useful perspective on the financial power of a nation-state, providing they are *able* to issue their own currency. Unfortunately, this is not available for all. Walter Wriston, the CEO of Citibank from 1967-84, had famously announced prior to the onset of the LDC external debt crisis of the early 1980's (p.239), that 'countries don't go bust' (Rukeyser 1983). Wriston had failed to take into account, of course, that the external debts of Mexico *et al* were denominated in *dollars*, and repayments of principal and interest became increasingly difficult to service amidst a depreciating Peso, increased current account

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<sup>11</sup>The US dollar is also used for key commodity markets and international accounting.

<sup>12</sup>The growth in FDI from the US during the 1970's was facilitated by the global dollar use.

<sup>13</sup>The Eurodollar market means there is some credit issued *offshore* i.e. outside of the US jurisdiction, but clearing takes place in US base money, controlled by the US authorities.

deficits and higher interest rates in the West (raising debt service costs).<sup>14</sup> In more recent times, Greece has experienced difficulty with rising national debt to GDP ratios, denominated in a currency that they do *not* issue. Greek bonds are not simply designated as pan-Eurozone bonds but *Greek* state bonds denominated in Euros.<sup>15</sup> This leaves them susceptible to market pressures, as investors fear default, and expensive (politically as well as financially) bail-outs. Yet, if this had been the US there would be no default risk on the dollar, providing the state is prepared to ignore the self-imposed constraints in exceptional circumstances. It is the position of this paper that, given the existence of currency competition, this is something that the capitalist state is normally prepared to do. The recent bail-outs are, perhaps, an example of this bourgeois *sustainer of last resort* role.

There have also been repeated calls for austerity in the US, based on fears of the overall size of the national debt. Yet, as Wray has noted, *it takes two to tango* (Wray 2012). A debtor can only create a claim if there is a counter-party willing to accept the claim and provide the credit. The Chinese, for example, receive dollars from their current account surplus with the US, and then adjust their portfolio position through the purchase of dollar securities. They have amassed a substantial volume of dollar financial assets, and also used their dollars for their FDI operations. Yet, do they fear an appreciation of the yuan against the dollar and the consummate reduction in dollar asset value? Well, perhaps, but their export-led growth, with the US as the key market, shows no sign of abating. In a recent BBC documentary, Robert Peston intimated that the Chinese state was also in danger of domestic credit crises as a direct result of its substantial infrastructure investments (Peston 2014). Yet, as the MMT has helped to stress, a sovereign currency is in no real danger of default since they can always issue any currency required. This would, of course, entail an inflationary threat but, arguably this may lead to a continuation of their export surplus anyhow through their enhanced competitiveness. The rise of the Japanese economy post-WW2, in contrast, had led to an appreciation of the yen that then undermined the competitiveness of their export markets, and was a contributory factor to their relative stagnation in the last two decades. Interestingly, however, their high debt to GDP ratio (214% in 2012) has not been a major cause for alarm. This illustrates that a sovereign currency poses no real threat to investors, in comparison to non-sovereign debtors, especially (as in the case of Japan) if the investors are predominantly domestic.

## Conclusion

It has been argued that MMT develops the EMP further, through a discussion of inter-sectoral balances, that focuses the researcher on the full impact of credit creation, where an increase of indebtedness in one sector is matched by a consummate increase in net financial assets in another. In addition, the MMT adherents also posit that a *stock flow consistency* must be maintained when considering these balances since money can be measured as a stock and a flow depending, of course, on the definition of money used. MMT suggests that the credit theory of money is valid, especially given that the state has sanctioned the use of a credit-money currency (in the form of bank deposit units) for the payment of taxes. The paper then considered the *myth of unsustainability* which is currently part of the political discourse, on which austerity is predicated, and concluded that the concerns are over-egged and (worse) mask the real political agenda which has historically sought to keep the government at arms-

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14So-called *Reagonomics* in the West also reduced imports from the indebted countries.

15The phrase pan-Eurozone is used to distinguish these from so-called *offshore* Eurobonds.



length from the financial resources. Finally, the paper discussed the notion of sovereign currency status which enables a nation-state to obtain *seigniorage* and have greater sway in international political affairs. It is concluded that since non-sovereign currencies tend to lack sovereignty in financial matters, and often depend on decisions made by others, the future monetary order is likely to be determined by the currency competition between sovereign currency jurisdictions.

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