Notes on Monetary Sovereignty from the Economic Point of View

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Monetary sovereignty involves the ability of a nation to use its monetary and financial system to achieve its domestic economic and social policy objectives. It is also possible to extend this definition to the achievement of foreign policy objectives that support domestic objectives or in support of international political objectives.

Monetary sovereignty thus involves the design and structure of the domestic currency, banking and financial system as well as the design and structure of the international financial system. More specifically, it involves the constitutional and legal basis of the provision of coin and currency, the provision of payments mechanisms and the financing of private and government expenditures of both current and capital basis. At the international level it involves the exchange rate regime as well as the legal basis for the transfer of financial assets and financial service providers across national borders. At this level it also involves legislation governing cross-border trade in goods and services other than financial.

Historically the question of monetary sovereignty has been discussed under the title of national policy autonomy in the context of the impact of free movement of capital as a constituent component of the operation of the 19th century gold standard. If capital is free to move across national borders in pursuit of the highest rate of return then interest rates will be equalised throughout the world as investors would borrow in markets with lower interest rates and invest in financial markets with higher interest rates, driving returns to global equality. This represented a loss of national autonomy since it would no longer be possible to use monetary policy to set interest rates at levels to support national policy objectives. Since this is a consequence of adherence to a particular international financial system and free international movement of capital, regaining national

policy autonomy in this context would involve replacing the gold standard as the basis of domestic monetary policy and controlling international capital flows.

More recently this loss of autonomy has been manifested in the volatility of foreign capital flows to developing countries in the form of a balance of payments constraint. Positive net capital inflows will produce a deficit on current account and an accumulation of foreign claims which can only bee repaid via a surplus on current account. When foreign lenders cease providing inflows and request or require repayment countries will have to adopt domestic economic policies that meet the needs of foreign lenders, rather than domestic policy objectives. If policies are not adjusted an exchange rate crisis or a full fledged financial crisis involving default will impose the policy adjustment. Here the remedy is again control of foreign capital flows.

At the national level monetary sovereignty involves the ability of governments to operate expenditure policies compatible with price stability and independently of the decisions of private sector financial institutions. This generally involves the belief that the government budget is constrained by the private sector's saving and portfolio preferences. A recent example is the operation of the so-called "bond market vigilantes". If private financial institutions and investors are unwilling to fund government deficits by refusing to purchase or hold government debt then interest rates will be affected and implicitly determined by the portfolio preferences of the private sector rather than by the objectives of government expenditure policies in pursuit of social and economic objectives.

As these examples indicate, loss of sovereignty is linked to the implementation of deficits, either external deficits or government deficits, in pursuit of specific policy goals and the sovereignty of governments in achieving those goals is thus linked to the financing of those deficits. Thus, of necessity the question of sovereignty is linked to the structure and operation of the financial system that provides the financing. It is thus a question of the private or government provision of financing, and in the case of the former, the combination of private and government financing and the regulation of the private sector

provision of finance. In this respect, governments always ultimately control domestic sovereignty by exercising legal constitutional rights over the provision of coin and currency and the legal status of private enterprise operating in the financial sector.

The legal basis of government control over the financial sector usually derives from the Constitutional authority of the State to issue and regulate coin and currency, which are considered the legal liability of the State. This legal right is inscribed in virtually all Constitutions of democratic and authoritarian States. By exercising this right, the State does not need to issue other types of government debt liabilities, other than government demand notes called currency, in order to finance expenditure policies in support of its economic and social policy objectives.

The fact that the State has the Constitutional authority to fund any of its expenditures through the issue of its own currency liabilities as means of payment insures its ability to implement policy and is the basis of monetary sovereignty. Government can insure the acceptability of these liabilities by taking the additional step of making them legal tender for all debts public and private, but this is not necessary. All that is required is that the State make them the means of extinguishing liabilities of the private sector to the State. This requires the reation of liabilities of the private sector to the State, and these usually take the form of the levy of taxes, excises, duties or other penalties that can only be met by rendering the State's own liabilities. In this way it is never necessary for the State to "borrow" by issuing liabilities to the private sector and need not create interest liabilities to the private sector. However, it is necessary for the State to use it's liabilities to make purchases from the private sector if it is to be able to meet its liabilities to the State.

It is the issue by the private sector of debt liabilities, denominated in the State's own currency or in foreign currency, that limit the sovereignty of the State. Reclaiming Sovereignty requires understanding why States have chosen to allow private sector entities to issue means of payment liabilities other than State

currency and coin and to issue non-means of payment liabilities to foreign and domestic residents.

There are main three areas that undermine Sovereignty:

- Allowing private sector financial institutions to issue substitutes for government liabilities. For simplicity these liabilities may be called private "credit" as opposed to State coin and currency called "money".
- The Creation of a Central Bank to regulate the issue of these private sector liabilities
- The issue of government liabilities in foreign currency.

Historically, weak governments have acquiesced to private sector institutions who offered to substitute for the State's right to issue means of payment to finance exceptional expenditures, such as for war. The major example is the creation of the Bank of England in which the English Sovereign granted a group of English gentlemen the right to issue Bank of England notes in exchange for a promise to provide gold to finance a war with France. This practice gave rise to the ability of this private institution to create unlimited amounts of credit in the form of notes outside the government's control. The same process was followed in virtually every other country until it became normal to consider private bank liabilities in the form of demand notes as the equivalent of State issued notes. Indeed, in some countries the issue of notes by the government ceased or was shared with private sector institutions as is the case in the United States, first with National Bank Notes issued by private banks and then with Federal Reserve Notes, issued by District Federal Reserve Banks owned by private financial institutions..

This led to two major elements in the loss of sovereignty. First, governments came to believe that it was necessary to acquire private sector credits in the form of private bank notes or deposits to finance its operations. To acquire this credit it issued non-currency government bonded debt to private sector credit institutions whose willingness to lend at particular interest rates then provided a limit on the ability of the State to spend. Since the only legally acceptable means of payment was that issued by the State, this was the

equivalent of the State borrowing its own money, which it could have issued itself at no cost. This is a self-imposed loss of Sovereignty. Populist politicians periodically rediscover this fact and seek to restore government funding of government expenditure, or funding by the central bank, as in Canada under the initial charter of the Bank of Canada..

Second, since the ability of private institutions to create means of payment is not directly limited, and since this had led to frequent failure of private institutions, the State created or charged National or Central Banks to impose reserve and equity capital restrictions on the balance sheets of the private institutions to put a constraint on private credit creation. These usually took the form of legally imposed ratios of reserves to credit and capital to credit. But, the reserves were usually in the form of holdings of government liabilities held on the balance sheets of the central bank. This meant that the basic means of limiting credit creation in the private sector took place by what came to be called open market operations, that is changing the composition of the assets on the Central bank's balance sheet via the sale or purchase by the central bank of government non-currency liabilities to the private sector institutions. The control of private sector credit thus required the government to create and issue debt to the private sector on which it pays interest. The operation is meant to use interest rates on government debt as a benchmark to limit credit demand and the share of such debt in private sector balance sheets to limit their credit supply.

Now it is the control function of the issue of private credit that the State could have issued itself, that requires the State to borrow its own currency that it could have issued at zero cost. The Central bank, created to control the credit supply of the private sector, is thus also part of the loss of State Sovereignty.

Finally, it often happens that when the costs of government borrowing private credit from domestic institutions is high, government will seek to borrow from foreign financing institutions in foreign currency if this can be done at lower interest rates. This creates an additional constraint on sovereignty in the form of a currency mismatch and a legal mismatch. The State cannot repay foreign debt with its own currency since its neither its taxation authority nor its legal tender

laws and taxation privileges are not valid in foreign countries. It thus must generate foreign currency to pay service on its debt in foreign currency, and this can be done only by selling government assets to non-residents, by borrowing more from non-residents or by selling more goods and services to non-residents via a current account surplus. The second remedy usually means setting higher interest rates and the third to restricting domestic activity. Both require economic policies that may be incompatible with government policies for the domestic economy.

Thus, in simple terms the loss of sovereign comes from the artificially imposed need to:

Limit private sector credit creation, which it could have achieved itself, via creation of a Central bank, and generates an artificial need to create non-currency government debt.

To repay government debt generated by borrowing private sector credit which it need not have borrowed had it issued its own currency.

To repay foreign debt which it need not have incurred if it had issued its own currency, by taking measures that constrain government expenditures or increase interest rates to limit domestic activity and a current account surplus.

These are the areas that currently limit monetary sovereignty. They could all be eliminated if the government chose to finance its own expenditures by the issue of its own currency liabilities, a right that it has by constitutional authority.