May 20, 2015

Scoping Workshop on Monetary Sovereignty

Moscow, May 25-26, 2015

HSE Skolkovo International Laboratory for Law and Development

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A Note Financial Sovereignty[*]

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Introduction

In this brief paper, I introduce the concept of financial sovereignty and discuss its policy implications. I also highlight some of the basic design flaws in the Eurozone system by introducing a basic accounting identity framework to demonstrate how different Eurozone members are impacted by the financial crisis. Finally, I stress some key points about what Russia and its partners need to consider before establishing a currency union.

1. The Mechanics of Financial Sovereignty

A financially sovereign country is defined as a country that:

a/ prints its own fiat currency;
b/ collects taxes, fines, and duties in its own currency;
c/ only issues bonds denominated in its own currency (not in foreign currencies); and

[*] First draft: comments/feedback are greatly appreciated.

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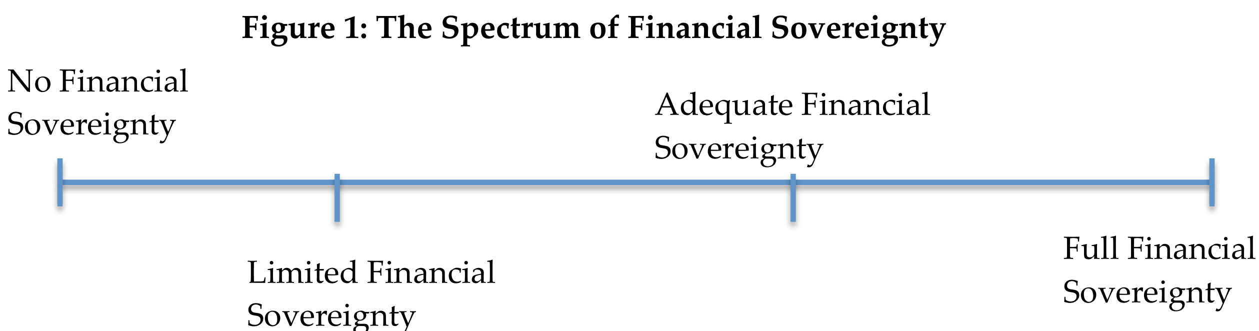
d/ operates under a flexible exchange rate regime.

We can think of a spectrum of financial sovereignty rather than simply considering a country as either financially sovereign or not financially sovereign (Figure 1).

Figure 1: The Spectrum of Financial Sovereignty



For example, countries like the United States, Japan, Canada, and Australia, among others, enjoy full financial sovereignty, which gives them a wider fiscal policy space to finance domestic job creation, public infrastructure, education, public health, and social services. However, countries that have completely given up their financial sovereignty are subject to very severe fiscal policy constraints that can only be relieved by either generating substantial trade surpluses and foreign currency reserves (Germany is a good example), or through adequate access to international capital markets, IMF loans, or other bilateral loans, all of which come with fiscal austerity requirements that often forbid expansionary fiscal expenditures (e.g., Greece, Spain, and Portugal, who now use a foreign currency (the euro), or Ecuador, which uses the US dollar as its national currency). Most developing countries have limited financial sovereignty because of their substantial foreign debt, which limits but does not entirely prevent them from introducing a scaled down version of job creation programs that enhance quality of life and economic prosperity for their citizens.

The design of the Eurozone system fails to recognize the difference between *currency issuers* and *currency users*. It assumes that the principles of sound finance followed by responsible households and firms, must also apply to government budgets. While it is true that the users of the currency (individuals, households, firms, etc.) must earn an income or borrow money (subject to market discipline, credit score, availability of credit lines, etc.) in order to be able to spend; a sovereign government, by virtue of being the monopoly issuer of the currency, spends money into existence. As a matter of logic, a sovereign government cannot collect tax revenues before it had spent money into existence.

Similarly, it cannot "borrow" its own fiat currency from the public before it had spent it. Therefore, taxes and bonds do not and cannot logically be sources of government spending, and as a result the lack of "tax revenues" or the lack of "domestic savings" cannot be used as a justification for fiscal austerity (or even worse, justification for incurring external debt denominated in foreign currencies)[1].

Sovereign currency issuers impose tax liabilities as a mechanism for creating demand for the fiat currency of the state. The demand for the currency is enforced by the coercive authority of the state through the judicial system (tax evasion laws, counterfeit laws, etc.). Tax revenues withdraw some of the excess purchasing power, regulate the quantity of money in the system, and stabilize the value of the currency.

Similarly, when the state issues treasury bonds, it is not "borrowing" from the public, but rather it is giving the private sector an interest-bearing alternative to cash, which also helps the state withdraw excess purchasing power, stabilize the value of the currency, and most importantly stabilize short-term interest rates (since government bonds play the role of risk-free bench mark in financial markets).

As a result, the government's budget deficit and the national debt cannot be viewed as anomalies to be fought at all cost, but rather as normal features of a properly functioning sovereign currency system. What matters at the end of the day is not the *level* of the national debt, but its *function*. As long as government expenditures are directed towards productive national priorities, and as long as physical and technological resources are available, then there should be little to no concern about inflation risks. To put it simply, *anything that is physically and technologically possible is also financially affordable for countries that enjoy full financial sovereignty*.

2. The Eurozone and Financial Sovereignty

A useful way to analyze the fiscal policy space available to the Eurozone members in light of the current sovereign debt crisis is to consider the macroeconomic interrelations between the government sector, the domestic

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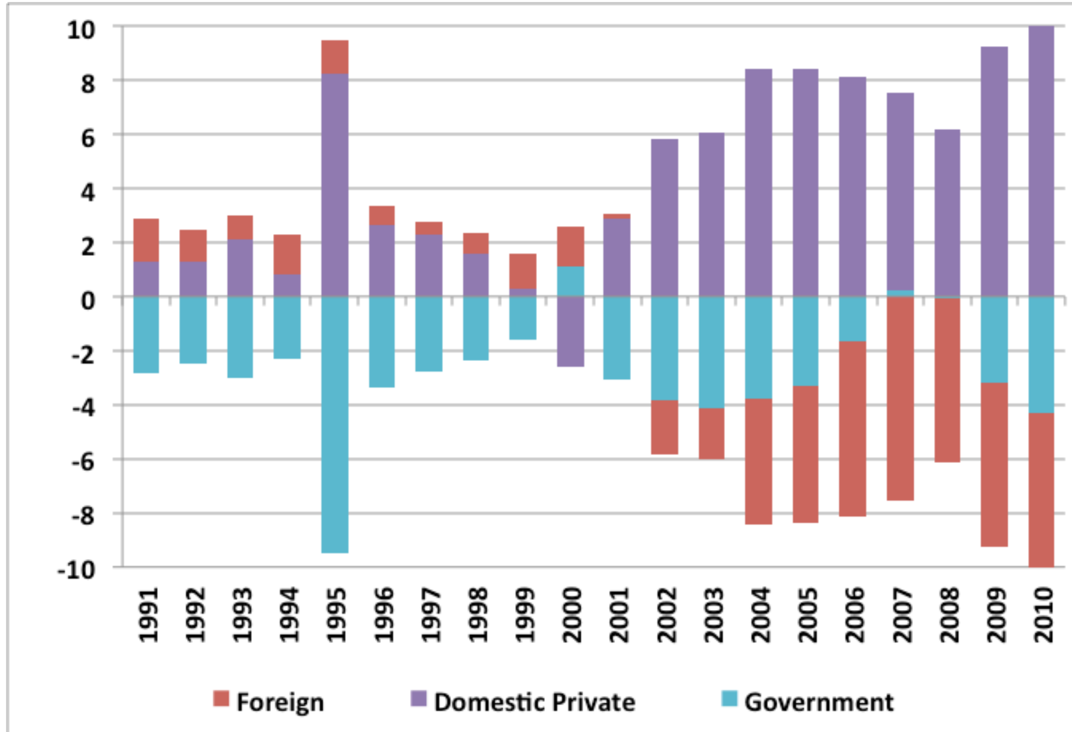
private sector, and the foreign sector. This sectoral balances approach is provided by the macroequilibrium accounting identity, which is defined as follows:

Gov. Sector Balance + Private Sector Balance + Foreign Sector Balance = 0.

This accounting identity holds true for *every* country and in *any* given year. As an example, Figure 2 depicts the sectoral balances of the German economy. All figures are presented as a percentage of GDP. For example, in 2010, Germany's domestic private sector (firms and households) enjoyed a surplus of 10.5% of GDP, which was offset by a government deficit of 4.28% of GDP, and a foreign sector deficit (meaning Germany's trade surplus) of 6.22% of GDP. Notice how the sectoral balances form a perfect mirror image reflecting that fact that all sectoral balances must always add up to zero.

As a hypothetical scenario, if we would reduce Germany's trade surplus (the red bar), then one of the following must also happen: 1/ private sector surplus will decline (the purple bar), 2/ government sector deficit must increase (the blue bar), or 3/ a combination of the two. Clearly, Germany's exports give it an important advantage in the Eurozone by allowing it to forgo the need for larger government deficits during economic downturns. The export sector naturally helps sustain employment levels despite a decline in domestic consumption during the financial crisis.

Figure 2: Germany's Sectoral Balances (percentage of GDP)



As a contrast to Germany's case, Figure 3 and Figure 4 display the sectoral balances of Greece and Spain, respectively. Both countries suffer from chronic trade deficits (foreign sector surplus; the red bars). In 2010, for example, Greece had a trade deficit of 10.8% of GDP, which was offset by nearly the same amount in terms of government deficit, thus leaving no room for a private sector balance. In the case of Spain, it had a government deficit of 9.24% of GDP, which was offset by a private sector surplus of 5.5% of GDP and a trade deficit of 3.75% of GDP.

Figure 3: Greece's Sectoral Balances (percentage of GDP)

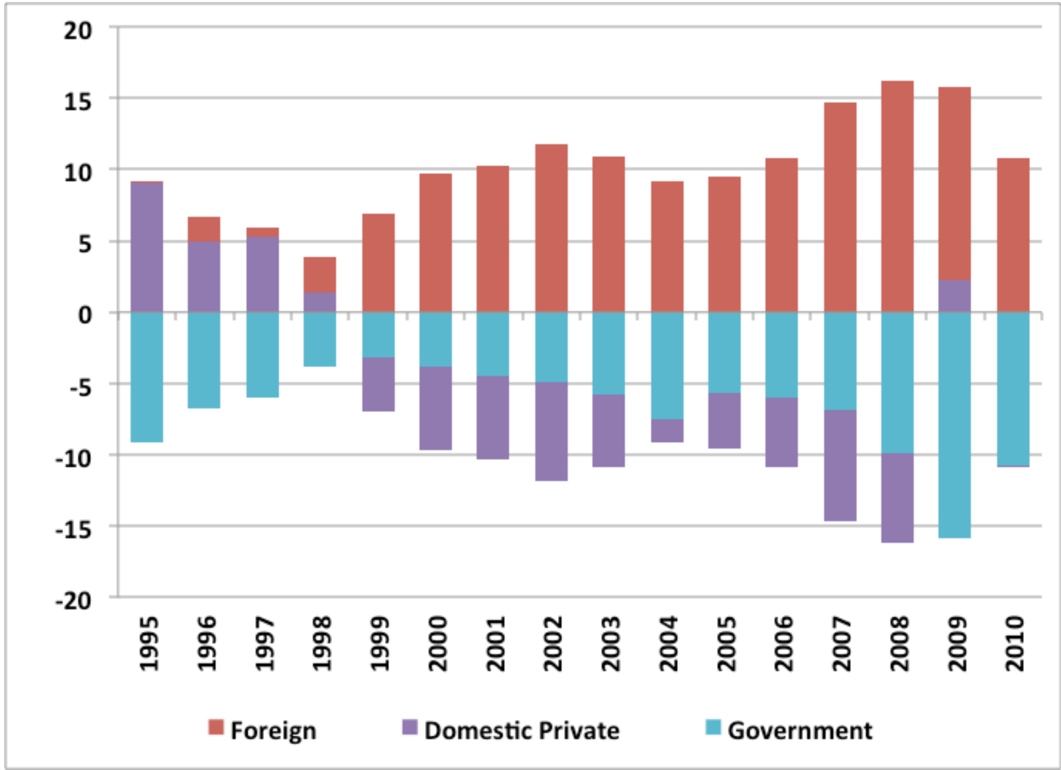
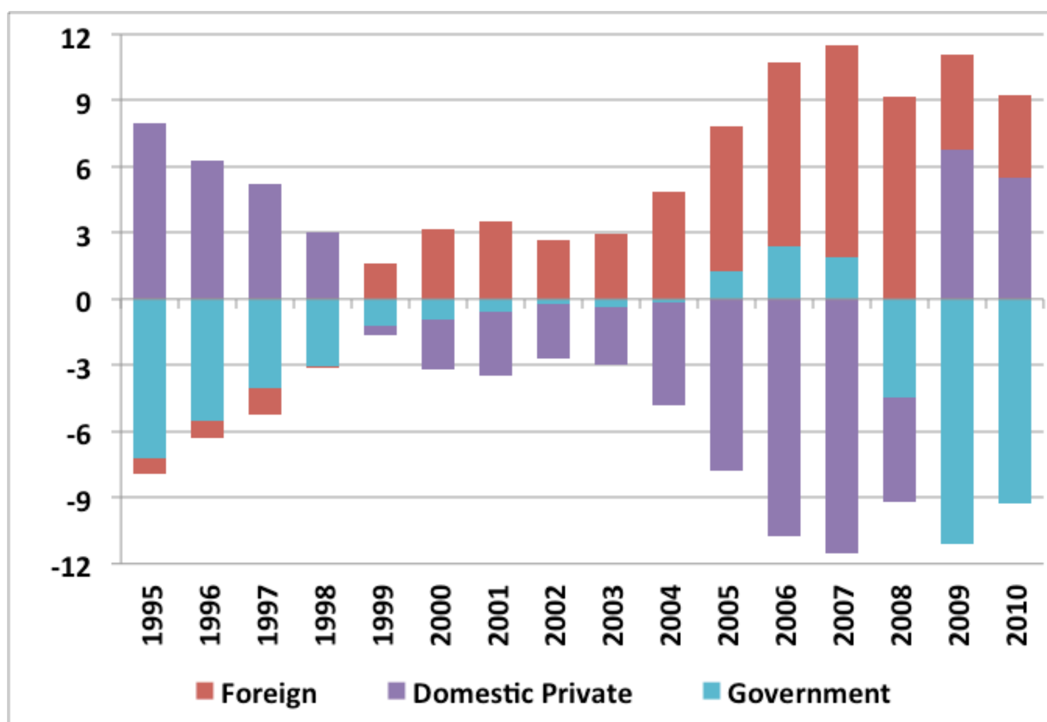


Figure 4: Spain's Sectoral Balances (percentage of GDP)



This unfortunate design flaw in the Eurozone system creates gridlock situation for countries like Greece. As a user of the currency, Greece can only finance its public expenditures through tax revenues or bond sales. During an economic downturn it is natural for tax revenues to decline. Without public expenditures to offset the decline in private sector activity, the economy enters into a downward spiral leading to more unemployment, lower GDP levels, and an even smaller pool of taxable income. Even without increasing its borrowing, Greece's debt-to-GDP ratio was bound to skyrocket simply because of the sharp GDP decline. Indeed the ratio peaked at 175% in 2014, which makes it extremely expensive and difficult to find willing buyers for Greek government bonds.

The Maastricht treaty's "no bail-out, no exit, no default" clauses essentially amount to a collective economic suicide pact for the Eurozone countries; except for countries with large trade surpluses like Germany. Therefore Greece, or any other country with little to no financial sovereignty, is left with the following strategies to

i. More aggressive export strategy (Problems: tough competition abroad, weak industrial base at home)
ii. Trade barriers to reduce imports (inconsistent with EU/WTO rules)
iii. Tourism (limited)
iv. Foreign Direct Investment, FDI (limited; tough competition)

v. Worker remittances (very limited)
vi. Privatization of State-Owned Enterprises (Problems: corruption; limited number of SOEs)
vii. Foreign aid/charity (unlikely)
viii. Voluntary or negotiated debt cancellation (unlikely)
ix. Troika loans (conditionality: austerity measures)

These are temporary fixes that do not address the root cause of the problem: lack of investment in education, training, public infrastructure, R&D, renewable energy, etc. In other words, the loss of financial sovereignty, even if not harmful at first, quickly becomes insurmountably destructive with the dawn of the first major economic downturn.

3. Considerations for Russia and its Partners

Based on Figure 1, Russia has an adequate level of financial sovereignty because of its trade surplus ($190 billion in 2014) and foreign currency reserves ($356 billion as of April 2015). However, Russia also has an external debt ($559.4 billion as of Q1.2015) and suffers from the recent sanctions that continue to burden its fiscal policy space. It is worth noting, though, that the vast majority of Russia's external debt is actually incurred by banks and other private industry firms rather than by the Russian government itself.

Russia has a tremendous opportunity to leverage its significant natural, human, and technological resources to regain full financial sovereignty and to ensure economic prosperity for itself and for its economic partners. Forming regional and transnational partnerships can also enhance financial sovereignty as long as the legal agreements are based on economic complementarity and cooperation rather than competition and dominance.

The proposed formation of a Eurasian single currency system should avoid the Eurozone's mindless obsession with balanced budgets and so-called fiscal discipline. The proposed union must ensure an even distribution of public investment in education, health, transportation, telecommunication, housing, R&D, etc. in order to enhance productivity across the union. Strategic industrial development must also be designed to enhance internal self-sufficiency and horizontal integration within the union. Most importantly, the financial system, under the supervision of a central bank, must operate in tandem with the needs of the real economy, and prevent predatory lending and speculative behavior. Finally, a well-functioning currency union requires a well-functioning

governance system during good and bad economic times. Therefore, the proposed union must have a fiscal union that operates countercyclically to redistribute resources towards member states when the need arises.