WORKING PAPER 2120

Exercising Economic Sovereignty in Today's Global Financial World: The Lessons from John Maynard Keynes

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November 2021

POST-KEYNESIAN ECONOMICS SOCIETY

EXERCISING ECONOMIC SOVEREIGNTY IN TODAY'S GLOBAL FINANCIAL WORLD: THE LESSONS FROM JOHN MAYNARD KEYNES

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Abstract

In this article, I argue that current macroeconomic models (both orthodox and heterodox), centered as they are on local agents or agencies, do not recognize the role that "global investors" play in determining the space for effective macroeconomic policies. I therefore argue that these important players must be placed at the center of macroeconomic analysis if we are to understand how macroeconomic policies really work in the global financial environment. The article describes the key characteristics of global investors, analyzes their power to determine the value at which public sector liabilities (money and debt) are traded on international markets and how this power affects policy effectiveness. Consequently, no country is truly sovereign in a globalized world and the government of every country is subject to an intertemporal budget constraint (IBC), although, of course, not all countries are equal and not all IBCs are equally binding: the IBCs are flexible and endogenous to the decisions of global investors but in any case, unavoidable. I conclude the article by arguing that the policy choices of countries in today's globalized financial environment would benefit from revisiting some of John Maynard Keynes's teachings, considering his in-depth knowledge of global financial markets and how they affect economies. of the countries.

Key words: economic sovereignty; exchange rates; global financial markets; global investors; macroeconomic policies; money; policy credibility; policy space; public debt

JEL codes: E6, F62, F65, G15

EXERCISING ECONOMIC SOVEREIGNTY IN TODAY'S GLOBAL FINANCIAL WORLD: THE LESSONS FROM JOHN MAYNARD KEYNES[1]

Introduction

In a recent commentary on the theme of globalization, Razin (2021) concludes by observing that the situation of the world economy is such that an effective stabilization of national economies can only be ensured using adequate fiscal policies. Sharing the conclusions of Bartsch et al. (2020), I would add in this regard that effective stabilization also requires the exploitation of complementarities between monetary and fiscal instruments, provided that the credibility of the commitments towards desirable long-term objectives (i.e., healthy growth under conditions of price stability and public debt sustainability) is preserved and supported by a resilient institutional framework – a position I myself had previously defended (Bossone, 2015).

However, as I will discuss below, the forces of globalization require each country to consider how truly effective their macro policies can be, considering the characteristics and circumstances that distinguish individual economies. The choice of each country's policies in today's global financial environment suggests revisiting some of the lessons that by John Maynard Keynes (JMK) left to us, particularly in view of his deep understanding of global financial markets and how markets affect countries' economies.

[1] This article expands on my work recently published in the Review of Keynesian Economics (Bossone, 2021a). I thank Thomas Palley for his encouragement to work on this issue, and I thank Massimo Costa for his comments on an earlier version of this article. My intellectual debt is to Charles Wyplosz and the importance he attributes to the issue of credibility for the effectiveness of macroeconomic policies – an issue he and I discussed in private communications, which has inspired my recent research work (referred to in this article). As always, I am grateful to my wife Ornella for her unremitting support. The views expressed in the text are mine alone and do not imply those of the institutions with which I am currently associated.

Financial Globalization and Macroeconomic Modeling

In my works on the Portfolio Theory of Inflation (PTI), I analyze how financial globalization affects the policy space available for national economies,[2] in many cases conditioning this space and making expansive macroeconomic policies ineffective or even destabilizing (Bossone 2019; 2020a, b).[3]

The problem is that the models used today to simulate the effect of macroeconomic policies do not recognize the power that global investors wield in determining the prices at which public sector liabilities (money and debt) are traded on the markets, and do not consider as such power affects the effectiveness of policies. This is true for orthodox (mainstream) modeling, in which the key actors (families, businesses and institutions) are represented by local agents who make optimal allocative choices based on a data base of possible options, as it true for heterodox approaches - take Modern Money Theory (MMT) as an extreme example – where governments have full control of the money supply lever to finance the fiscal budget and steer the economy to full employment.[4]

In reality, these local agents are by no means sovereign when they act in the context of financially globalized economies, and in particular where wealth is highly concentrated and assets are managed by operators who, as will be said, operate with (and from) a global perspective – and that is why I will call "global investors" – who hold significant shares of these liabilities and manage them on their own behalf or / or on behalf of their customers. In this context, the value of public sector liabilities (denominated in domestic and/or foreign currencies) is marginally determined by the expectations

[2] With the expression "policy space" I refer to the margins of use of expansive macroeconomic policies, by a country, within which these policies are effective, in the sense of contributing to the increase in the use of resources and internal production, without compromising the sustainability of the country's public finances and the stability of the value of its currency.

[3] I have integrated the PTI model (and corrected contained in the original version) in a forthcoming work (Bossone, 2021b), which I would make available on request.

[4] As relevant references for MMT, see Wray (2015) and Kelton (2020). For a critical analysis of the theory, see Palley (2020), and for an analysis of the internal inconsistency of MMT's deficit monetization policy prescription, see Bossone (2021c).

and trading of global investors, and the power of global investors to determine the value of public sector liabilities in turn influences non-financial private sector activities. These actors, I argue, must be placed at the center of macroeconomic analysis if we are to understand how the global financial environment constrains macroeconomic policies and conditions the impact of these policies on the real economy. This has become even more evident with the increased importance of the bond market as a source of external financing for many countries and with the recent increase in public debt issues following the protracted level of low interest rates worldwide.

Global Investors: Why Are They Special?

Unlike conventionally considered local representative agents, global investors exercise much greater market power and influence on the price of securities and currency issued by countries, by operating as "marginal" investors.[5] Global investors are not necessarily foreign entities to the country where they operate. They can be country residents, local branches of foreign entities, or foreign entities operating in the country through local correspondents or intermediaries. What matters is that they are influential and make investment decisions based on a global perspective that transcends local interests and preferences. Global investors mobilize far more resources and process far more information than (typically smaller) agents operating locally. They trade and trade at far lower costs and, importantly, are free from "home bias" and, even when they reside in or operate from a country, they are unlikely to use more than a modest fraction of their managed wealth (if at all) to finance consumption. They do not aim at optimizing the level of consumption over time; they aim to maximize the utility of financial wealth by managing financial wealth. Global investors are not interested in the stability of the countries in which they invest, except as it is necessary to protect the value of their investment, and, unlike local agents, they do not participate in the costs of stabilizing the economy, where necessary, whereas they are ready to rush towards the exit from investments in countries at risk of

[5] For a study of the marginal investor and references to the financial literature on the marginal investor, see Bartholdy and Kate (2004) and, more recently, Chen and Lei (2015).

stability, transferring their capital (or managed capital) elsewhere. They constitute the quintessence of the figure of the capitalist as characterized by Karl Marx: while the latter transforms money into commodities to obtain more money through the MCM (Money-Commodity-Money) cycle, global investors transform money into money to obtain even more money through what might be called the MMM (Money-Money-Money) cycle, or, to paraphrase Sraffa, they produce money by means of money - operating on a planetary scale, transcending national borders.

Global investors are not interested in the evolution of domestic price inflation or unemployment in a country, other than to gain insights into the credibility and stability of the country's policy framework and use international price indices or currency baskets as deflators to calculate the real value of relevant financial variables and as a benchmark for estimating exposures to exchange rate risk of local investments. They are much more sensitive to this risk than local entities and require higher premia on the liabilities of a country in the face of issuances that they believe could jeopardize the stability of their external value. Moreover, they can replace these liabilities much more quickly with others (especially foreign ones), at lower transaction costs and on a much larger scale than local investors can do. And whereas local agents operating in closed or captive markets are forced to accept and hold issues of public liabilities on terms that are convenient for the issuing government, global investors operating in open markets can set prices on less favorable terms for the issuing governments, based on their higher risk sensitivity, since they are in a position to exert a much stronger and more effective "exit" threat on the pricing of the government liabilities being issued and traded.

True, local agents always demand domestic currency for internal transactions and to settle tax payments, but their demand may not be sufficient to prevent currency depreciation, as the value of the currency is determined on the margin by global investors and their trading activity on all instruments denominated in that currency (Box 1). It is global investors, and the influence they exercise on large domestic wealth holders, who ultimately determine the price and, hence, the (real) quantity of the money that circulates domestically.

Box 1. Global Finance and the Value of Money

The advocates of monetary sovereignty (see the following section) believe that there is always a demand for the national currency since there will always be, in every country, those who need it to settle domestic transactions and to pay taxes. What we need to ask ourselves, however, is, i) what ensures that this demand is sufficient to guarantee the stability of the external and internal value of the domestic currency and ii) how relevant this demand is for the determination of the internal and external value of the currency of an economy that is strongly integrated in global finance? The answers are, respectively: "nothing" and "little".

To maintain the opposite betrays, first, the disregard of the preponderant importance of financial stocks with respect to real flows in the allocation choices of capital (especially in today's highly financialized economies); second, the lack of understanding of who today holds control of the allocative processes of capital, and of how they exercise it, especially in economies with a very high concentration of wealth; and, lastly, the reluctance to accept that there are no certain economic fundamentals to which the value of a currency is anchored, even in the long term. These three aspects, which are briefly discussed below, are however connected to each other.

Stock vs. flows

The stocks of assets existing in today's economies, especially developed and emerging ones, and traded through modern financial systems constitute a multiple of several orders of magnitude greater than the size of the flows of product, consumption, investment, and trade with the foreign generated by the real national economies. It is the supply and demand of stocks, rather than the flows of savings and investment, that determine the prices of the financial assets denominated in various currencies and of the currencies themselves. The supply and demand of stocks, and the prices they give rise to, are based on risk considerations and preferences for liquidity relating to the different types of stocks, formulated by those who operate on the markets. The resulting allocative dynamics, guided by expectations built on subjective and conventional factors (as JMK's theory of preference for liquidity (LPT) well illustrates)[6], prevail over the effects of the investment and savings flows only, according to the (neo)classical doctrine, from real factors such as the productivity of capital and the thriftiness of individuals.

Finance

Many of the agents who use money in an economy use it for making and receiving payments and to accumulate small savings to be kept in liquid form, but these are typically "small" agents who do not actively manage financial stocks. Once it is spent, and as it circulates in the economy, this money largely end as enterprise profits, rents and high (or very high) salaries; a small share of this money is allocated to internal consumption and a smaller share is retained for other transactional purposes and for precautionary reasons, while the largest share of it is used to purchase alternative assets (liquid and illiquid, domestic and foreign). A smaller share of the accumulated wealth is (re)invested in local productive capital, while the largest share is held in the form of financial instruments and managed with the aim of protecting (and possibly increasing) its value over time. The greater the level of distrust towards the country of residence from these "large" wealth owners and managers, the larger the share of wealth they will invest in foreign assets and countries. It is these wealth owners and managers who act as "marginal" investors and ultimately determine both how much money remains within the country and how much this money is worth vis-à-vis other (benchmark) assets and currencies, in the face of the inelasticity that typically characterizes the demand for money from

[6] For some excellent expositions of the theory, see Bibow (2005) and Tily (2006, 2012).

"small" agents. For "large" agents, the risks of loss on the value of the financial wealth they hold transcend domestic inflation (they will never consume most of it locally) and reflects instead the volatility of financial asset prices (as translated into a currency of reference) and the risk of default of the issuing institutions.

Fundamentals

Wealth owners and managers do not rely on the evaluation of the so-called "fundamentals" of the economy as decisive factors for the choice of investments in domestic vs. foreign assets and currencies (see also Box 2). Moreover, even when they consider the fundamentals to identify long-term trends, the literature does not provide them with useful references on the empirical level. Apart from the large and indefinite number of variables that are considered as "fundamentals" (see, for example, IMF (2019)), the theoretical and empirical approaches are manifold, each based on choices of alternative variables and all of them perfectly justifiable (see, for example, Ca 'Zorzi et al. (2020)). Furthermore, drawing from the most recent estimation exercises (performed by the authors just mentioned), while the traditional approach based on purchasing power parity shows the greater predictive power compared to the other tested approaches, this power is far from being effective in absolute terms. And, if this is true for the most important world currencies (for which ample of data and observations exist), it is *a fortiori* truer for all less important currencies.

As noted, with integrated international financial markets, global investors can move financial capital between markets and countries in real time and at negligible transaction costs. Thus, under conditions of high uncertainty, with capital flowing freely and easily, the price of liabilities that are less secure than others decreases and vice versa. And if global investors (rightly or wrongly) deem a country's credibility to be weak, or if they expect it to be weakened by the growth of its public sector liabilities, this will cause the liabilities to lose value regardless of the currency in which they are denominated.

Sovereign Nominalism and Nominal Sovereignty

Some scholars and practitioners believe that governments should denominate public debt in their national currency, so that they can print as much money as they need to dispel the risk of default, and that they should issue all the debt needed to stabilize the economy at the level of full employment. Others even believe that governments with monetary sovereignty can and should keep the economy at full employment by permanently monetizing their deficits, even if they are chronic, provided exchange rates are flexible.[7]

[7] See the clear explanations in Vernengo e Pérez Caldentey (2019).

Supporters of these forms of 'sovereign nominalism', whereby governments use their autonomy to determine *nominal* variables (i.e., money and/or debt), think of macroeconomic magnitudes as identities and consider that the surpluses of one sector are always balanced by the deficits of the other sectors, thereby concluding that there must always exist a demand that matches the stocks of money or debt that accumulate in the economy as a result of government spending decisions.

Unfortunately, they forget that (notional and actual) supply and demand can only coincide in a market if a price is established that is acceptable for (and accepted by) those who express a demand for a given supply and those who provide supply for a given demand: static identities do always imply inner dynamics that may not be ignored if meaningful economic arguments are to be derived from them.

So, yes: governments can issue as much money or debt as they wish, but only at prices at which other sectors of the economy are willing to hold the stocks of money or debt that accumulate over time – even more so in open and financially integrated market economies. Indefinitely growing stocks require indefinitely falling prices (other things being equal), unless the demand grows correspondingly, and there are instances where equilibrium prices may not form at all. The prices of monetary and financial securities reflect expectations of the future evolution of their respective net supply flows, and a (variable) degree of uncertainty always underlies these expectations.

With high uncertainty, the prices of liabilities considered less secure than others fall and vice versa. And if a country's credibility is considered weak by investors (rightly or wrongly), or weakening, the expansion of the country's public sector liabilities causes them to lose value, regardless of the currency of denomination (Box 2). Below, I examine the case of public debt and that of money separately.

Box 2. Global Investors and the Exchange Rates

It is necessary to clarify which exchange rate theory underpins the macroeconomic modeling focused on the role of global investors, advocated in this article. This is also to overcome the typically post-Keynesian argument according to which, as long as the economy is in a situation of underemployment of resources, expansive macroeconomic policies are always effective in stimulating output (and, therefore, resource employment) and would cause tension on prices, and hence on the currency exchange rate, only as output gets closer and eventually exceeds the level of full employment consistent with stable prices.[8] In the medium term, according to this view, macroeconomic (fiscal, monetary and exchange rate) policies can be effectively used to bring the economy to achieve internal and external balance and the nominal exchange rate can be used to protect the economy from any loss of external competitiveness resulting from higher inflation than in competing economies. The theory supporting this view is that the exchange rate adjusts in anticipation of the expected inflation rate relative to that of competing economies.

On the other hand, according to the Portfolio Theory of Inflation (PTI) developed in the works cited above, the role of global investors generates other transmission mechanisms. In the PTI model, the external value of a country's currency (the exchange rate) does not depend on the forecasts of the country's relative inflation rate. Nor is domestic inflation in a country taken as a reference by investors who consume little or nothing in the countries of the stocks of wealth they own or manage. Instead, investors who have invested in domestic currency denominated assets consider the risks associated with changes in the value of the domestic currencies vis-à-vis a reference currency or basket of currencies, which rarely reflect (actual or expected) inflation differentials – certainly not in the short and medium term. Inflation differentials, therefore, are not useful indicators for global investors to manage exchange rate risk or for measuring the performance of investments denominated in different currencies, with a view to protecting and increasing their value (see Box 1).

The external value of the currency of a highly internationally financially integrated economy is thus determined as the price of a financial asset: Critical for its determination are: i) the overall policy framework of the issuing country, ii) the level of credibility underlying this framework, and iii) the judgment that, on this basis, investors give about the stability of the external value of the currency itself. As the LPT well explains, and as reality confirms, the price of a currency (like the price of any financial asset) reflects *reflective* expectations, fueled by "conventional beliefs" shared by investors, and they to self-realize: if investors expect a currency to be stable, the currency will be stable; and vice versa.[9] As JMK argued about the relationship between the marginal efficiency of capital and the interest rate, it is the real factors that adapt to the conventional factors (the latter being determined by the dominant market actors), not the other way around (Keynes, 1973).

[8] More precisely, while the effectiveness of fiscal policy, all else being equal, is partially weakened by the appreciation of the real exchange rate following the rise in interest rates, the effectiveness of monetary policy is enhanced by the depreciation resulting from the 'lowering of the interest rate. However, the absolute effectiveness of both policies is never in question.

[9] In JMK's own words: «It might be more accurate, perhaps, to say that the rate of interest is a highly conventional, rather than a highly psychological, phenomenon. For its actual value is largely governed by the prevailing view as to what its value is expected to be. Any level of interest which is accepted with sufficient conviction as likely to be durable will be durable …» (Keynes, 1973, p. 203).

Therefore, if the investors' judgment converges on the risk that the stock of liabilities denominated in national currency grows too rapidly and in excess of the possibilities for absorption within the financial portfolios, the exchange rate will depreciate.[10] It is the foreign exchange market that reacts first and it is, therefore, the exchange rate that changes first, followed by the adjustment of internal prices through the pass-through mechanisms of the country under consideration, which they too are influenced by the credibility that investors attribute to the country.[11] Therefore, the credibility of a country as perceived by the markets becomes itself a "fundamental" that contributes to the exchange rate determination.

Depending on the confidence (or lack thereof) with which investors react to announcements or news of new policies, the outcomes of such policies can range from positive to negative (or very negative), thus engendering various possible consequences, from moderate devaluations to divestments or, in most extreme cases, to currency and financial crises, sudden stops and capital account reversals with capital outflows capital and output collapse). Policy authorities must counter-react to these consequences either by accepting currency devaluation (and its consequences) or by counteracting it by raising interest rates and/or taking even more radical actions (e.g., fiscal measures and exchange and capital controls), thus neutralizing in whole or in part the expansionary effect of the policies initially adopted.

The judgment of global investors (whether they are right or wrong) and the credibility criteria they adopt to form their judgment play a decisive (and impossible to ignore) role in terms of both theory and policy for open economies that are highly integrated in global finance. Hence, the need to build models that represent their centrality in the process of allocating resources between countries and that capture their influence on exchange rate determination.

Public debt

Although debt contracts are entered into in nominal terms, they represent rights to real resources and the purchaser is interested in recovering the full real value of the money granted (including any interest). In the case of global investors, contracts denominated in domestic currencies should at least provide returns (net of risk) equal to those obtainable on similar contracts denominated in reserve currencies, which, representing claims on world real resources, act as benchmarks. Redemptions in currencies that depreciate with respect to benchmarks, and whose depreciation is not offset by

[10] In particular, according to the PTI model, the exchange rate depreciates when the net supply of liabilities (money and debt) of the country in question grows more rapidly than the reference country (typically a country that issues reserve currency) and / or if the interest rates of the first are lower than in the second and / or if the credibility of the country considered is lower than that of the reference country (in the perception of the markets). For a simplified model for determining the exchange rate in financially integrated economies, consistent with the PTI, see Bossone (2021d).

[11] See references in the review of the literature in Bossone (2019a).

adequate yield margins, do not generate de jure default, but do so *de facto* and, therefore, they constitute a form of default in economic-financial terms.

If not, a government could always scrounge a "free lunch" by borrowing funds in national currency – which it can (in principle) print in unlimited quantities. Indeed, a government can do this when investors are small and unimportant agents, poorly informed and with limited investment management skills, or operating on segmented or closed capital markets, or under constraints resulting from limited alternative investment opportunities. On the other hand, free lunch is not obtainable where the economy is integrated into global finance and its liabilities are exchanged on the international financial markets; here, global investors evaluate borrowers' ability to repay debt in real value and determine prices for liabilities that reflect that ability.

A government could then contemplate the option of resorting to the issuance of liabilities in national currency and to allocate them exclusively (or at least mainly) to local subjects who, as mentioned, would be less demanding than global investors and would be less active in portfolio management – as was the case before financial globalization. Yet, apart from the fact that internal markets most of the time do not have adequate capacity to match the financing needs of governments, even in the presence of adequate capacity, the recourse to the aforementioned option would require to operate a segmentation of the markets that would be equivalent to questioning the very choice of pursuing financial integration: a perfectly legitimate option, but whose costs and benefits should be carefully assessed and one which the local community might not necessarily well receive.

Nor, on the other hand, would the other option be feasible, that is, resorting to issuing money instead of debt, with the sole precaution that this would not be done if it resulted in higher inflation (which betrays a mechanistic view that the non-inflationary employment threshold is identifiable with certainty and, when it is approached or exceeded, it is always possible to reverse the policy course with immediacy and precision). Indeed, it is shown that, with integrated financial markets and the aforementioned central role of global investors, the dynamics of the money stock imply that the

simple announcement of such a policy would result in currency depreciation and consequent inflation, even in the presence of underemployed resources (Bossone, 2020c).

Money

The fact that governments can in principle print infinite quantities of national currency does not alter – ex ante – the losses (in real terms) that investors expect from contracts that differ only in the currency of denomination: the contractual terms are written so that investors are indifferent between different currencies. That is, the contracts carry terms and conditions that protect the investors from the risk of insolvency, whether this derives from the interruption of the debt service or from the repayment of the debt in a depreciating currency. The debtor is the same subject in both cases, just as his ability to repay the debt (in real value) is the same; therefore, the same is the risk to which the investors are exposed. Furthermore, the lower the credibility of the issuing government, the greater the risk of currency depreciation and, hence, the greater the interest premium required by the investors for them to be induced to buy and hold liabilities denominated in that currency.

The story would not change if the government resorted to permanent monetary financing of budget deficits (as, for example, MMT recommends governments to do): in a globally financially integrated economy, especially if characterized by high concentration of wealth and professional wealth management, the money injected in it through public spending would eventually flow into alternative assets, including foreign assets. While this occurs under normal conditions, it would happen *a fortiori* when wealth owners and managers were to fear disorderly growth of the money stock (as noted in Box 2).

In conclusion, no national economy is fully sovereign in a financially globalized world and every national government is subject to an intertemporal budget constraint (IBC), although, of course, not all national economies are equal and not all IBCs are equally binding. In many countries, "sovereign nominalism" culminates in what I call "nominal sovereignty", that is, a situation where economic sovereignty is more a name (if not even a delusion) than a reality.

The Inescapable IBC

Under the IBC, a government must commit over time to generating sufficient real resources to meet its future financial obligations to the investors who hold its debt. From the investor's point of view, a government that issues debt must be considered capable of repaying the full real value of the debt (and the interest accruing on it) over time. Under no-arbitrage condition, the IBC must apply identically to public liabilities regardless of their currency of denomination, since otherwise investors would move away from public liabilities that underperform (with respect to the benchmarks) and into better performing assets.

Regarding the objection that a government that enjoys monetary sovereignty is never subject to an IBC, since it can always print the currency it needs to honor its future obligations, it should be noted that investors act upon the credibility they attribute to the issuing country: if they predict an undisciplined fiscal and/or monetary conduct by a government, they will act in the markets by depreciating the value of the national currency and will influence the markets to a point where the demand for the national currency (in face and real value) and the assets denominated in that currency will fall, thereby conditioning the government IBC. In globally financially integrated economies that were characterized by weak credibility, the currency issued would not be absorbed by demand at the given exchange rate. And if a moderate currency devaluation could improve the trade balance of the country and support output, a structurally weak national currency would ultimately increase domestic prices, compress internal purchasing power, and depress output.

Each government of a globally financially integrated economy is subject to an IBC whose elasticity is endogenous with respect to the decisions of global investors. A government that is considered capable to satisfy its IBC would be deemed credible by the markets, and vice versa: the stronger its credibility, the higher the elasticity of its IBC and the greater the markets' willingness to absorb larger quantities of its liabilities at a given price. On the other hand, with weaker credibility, the prospects of the government being able to raise sufficient resources to pay off its future obligations would be

perceived as more uncertain, and the resulting tightening of the IBC would drive down the price of its liabilities.

Taking JMK Seriously

While it may seem paradoxical, it is JMK's cautious attitude to policy advice that would be of great usefulness today in helping countries mitigate the risk of losing their economic sovereignty to the global markets. The very knowledge that JMK had of the functioning of the international financial markets of his times directed him to submit a rather conservative fiscal agenda as a basis for economic stabilization policies – quite the contrary of the vulgarization of his thought that has mistakenly led many to believe.

Being «revolutionary in thought and very cautious in policy»,[12] and despite the radical innovativeness of his General Theory, JMK never advocated the creation of chronic public deficits and stated that public spending must generate effective benefits over time (Brown-Collier and Collier, 1995; Dwyer, 2011).

JMK proposed the definition of an "ordinary balance sheet" and a "capital account balance", providing for a separation that reflects the separation between public consumption and investment.[13] The ordinary budget reports current expenses and revenues and records the amortization of public debt, while the capital account balance shows the investment expenses. The distinction between the two budget definitions makes it possible to distinguish, in turn, two types of fiscal policy: deficit

[12] Comment by James Meade as reported in Aspromourgos (2018).

[13] JMK defined the capital account budget as "a regular survey and analysis of the relationship between sources of savings and different types of investment and a balance sheet showing how they have been brought into equality for the past year, and a forecast of the same for the year to come "(see The Collected Writings of John Maynard Keynes, Volume 27: Activities 1940–1946: Shaping the Post-War World: Employment and Commodities, Moggridge, 1980, p. 368). Hence, on the capital account balance, the government predicts the private demand deficit and sets a level of public investment spending that meets the savings-investment requirements for full employment.

fiscal interventions and investment interventions. The former are a means to cure cyclical imbalances; the latter are a way to maintain the balance of full employment.

JMK opposed the use of the ordinary budget to stabilize the cycle, as well as the financing of public works and the use of taxation to affect the level of private consumption. Rather, he argued that, under normal conditions, the ordinary budget must have surpluses which, from time to time, must be transferred to the capital account to expand investments that generate a positive return. He admitted the use of debt, but to support investments that generate positive financial or economic returns that allow the government to repay the initial debt.

JMK viewed with concern the accumulation of public debt issued to finance current spending (what he called "dead-weight debt") and believed that the ordinary budget should not be in deficit, while investment spending must be partly financed by debt and for the rest from taxes. This, again, implied that there should be no debt issuance to meet recurring expenses.

JMK never argued that current or investment spending must be unconditionally deficit-financed,[14] and a careful reading of his contribution shows that he was generally against short-term fiscal activism. For JMK, reliance on debt-financed government spending during a recession was a "second best" remedy, which can only be used temporarily if the capital account proves insufficient to maintain full employment.

Instead, his basic vision was in favor of a permanent enlargement of the public sector, aimed at supporting the level of output and preventing fluctuations. High and stable public spending ensures full employment, while allowing the ordinary budget to remain balanced or in surplus. In this way, the economy prevents output fluctuations or stagnation through a high *socialization of investments*, thus stabilizing output at full employment and preserving fiscal balance. In JMK's own words, strongly doubting that the influence of monetary policy on the rate of interest would be sufficient by

[14] As to why he did not give an unreservedly negative judgment on Abba Lerner's functional finance, despite his own LPT being with in flagrant contradiction with it, I suggest an opinion in Bossone (2020c).

itself to determine an optimum rate of investment, he held that «…a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative» (Keynes 1973, p. 378).[15]

It is to be noted, however, that socializing investment did not necessarily imply an expansion of state ownership of assets, as in fact «…no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community. It is not the ownership of the instruments of production which it is important for the State to assume. If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary. » (Keynes 1973, p. 378).

JMK's recipe would be valid today for the economies that are integrated in the globalized financial world, where not many governments can benefit from the large policy space that is available to economies such as the United States, Japan and (at least potentially) the EU, and governments issuing large liabilities do face the risk of surrendering their economic sovereignty in the hands of global investors acting as agents who would have no interest whatsoever in their fate, other than their ability to honor their debts (at whatever social cost required to do so…).

What is then left for these countries to do when their economies fall in recessions or confront severe crises?

The above considerations recommend being realistic about the policy options actually available. Recalling the work by Bartsch et al. (cit.), coordination between fiscal and monetary policy can expand the policy space, and yet only *if* markets believe that the authorities' commitment to price stability and public debt sustainability is credible. But this is indeed a critical "if", which links the potentially recoverable policy space to the specific conditions of each country, through the improved

[15] For further development of the concept of socialization of investment, see Bellofiore (2014).

coordination of internal policies: for what has been said previously, an economy that suffered from low credibility (in the eyes of the global markets) would be unable to recover significant margins of policy space.

JMK himself, when grounding his LPT on the role of market conventional beliefs, was convinced of the ability of the authorities to influence those beliefs, as they intended to pursue specific policy objectives.[16] Naturally, the authorities JMK spoke of were the very powerful and highly credible British authorities, at a time when they still stood squarely at the helm of the international financial system and had the capacity to coordinate market expectations (and yet he saw the need for limiting international capital mobility as a means to increase the effectiveness of national macroeconomic policies). Moreover, as is clear from his recommendations to the UK Treasury on how to manage the public debt of Great Britain after World War II, JMK reasoned about an economy whose demand for public liabilities (money and debt) was virtually limitless and whose problem was then only to obtain the most advantageous price for the government by satisfying as best as possible the public's liquidity preference through selling the right debt instruments with the right term structure (see Tily, cit.).

Because of this, JMK did not consider the constraints on the policy space that derive from national authorities not being reputed sufficiently credible: unlike the UK government of JMK's times, they would have a hard time making their liabilities attractive to the investors and placing them successfully in the markets.

In a regime of high international financial integration, a superior solution to the problem of constrained policy space would require bringing the coordination of policies to the international level. JMK's teachings in favor of an international financial architecture based on the principle of *symmetrical adjustment* would be relevant in this context: in situations of external imbalances, surplus

[16] See the works by Tily cited earlier.

countries should provide fiscal and monetary stimuli both to soften the adjustment cost of deficit countries and to stabilize world output and avoid spreading deflationary pressures (Piffaretti, 2009).

Unfortunately, the international community has never been willing to take on such a responsible commitment, and the example set over the years by what in principle should be one of the world's most highly cohesive regional associations of states – the EU – has been far from encouraging.

Concluding Remarks

The macroeconomic modeling of today's globalized economies should recognize the centrality of the power of global investors: they determine the elasticity of governments' IBC, which, in turn, affects the effectiveness of the expansionary macroeconomic policies adopted by the governments themselves.

Under a flexible IBC, expansionary policies enjoy more space and can therefore be more effective in terms of output and use of resources, while under a tighter IBC the effects of the same policies dissipate into currency depreciation and higher inflation, according to allocative choices made by global investors. To avoid such consequences, governments must adjust interest rates upward, thereby neutralizing the policies originally implemented.

In conclusion, globalized economies - especially those that are most heavily indebted in foreign currencies and are not sufficiently credible – would not benefit from redenominating their debt in national currency and from adopting a floating exchange rate regime. Their benefits in terms of greater macroeconomic policy effectiveness and protection from external shocks would be negligible.

In the face of severe recessions or crises, some countries can recover policy space by having the central bank and treasury coordinate their interventions. However, this would require the country's commitment to price stability and public debt sustainability, supported by an adequate institutional framework, to be recognized by the markets as credible.

In such circumstances, a more powerful tool would be an international policy coordination strategy based on the JMK principle of symmetrical adjustment. Unfortunately, the prospect of the international community taking such a step does not appear in sight.

Finally, taking as valid for today's globalized economies the prudent policy orientation expressed by JMK, the reflection carried out in these pages can be summarized in the following simple, perhaps trivial, and yet fundamentally wise, advice:

> *The countries that operate in today's global economy should try as much as possible to remain in balance independently of the global financial markets, adopting policies to ensure internal and external stability of their economy without relying on entities – global financial investors – that are eager to take advantage of them and condition their destiny for the sole purpose of extracting wealth from them. Countries should keep their public debt levels low and sustainable, limiting them solely to financing investment programs that can repay themselves over time and/or to supporting the economy in recessions or crises but with the commitment to reducing debt during recovery and the high cycle phases.*[17]

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[17] This conclusion is consistent with the arguments I developed on the choice of exchange rate regimes in Bossone (2019b).

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