



# The Case for Fixed Exchange Rate Regimes: What for and in What Form?

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## 1 INTRODUCTION

The debate about exchange rate regimes is currently an unresolved issue in macroeconomics. The issue has divided all schools of thought: from neoclassical to post-Keynesian economists. For instance, the Mont Pelerin Society members were divided on whether they should support floating or fixed exchange rate regimes, which gave rise to fierce disputes (Schmelzer, 2019, 211). The disagreement has also caused a schism between the different streams of neoliberal economists. For their part, post-Keynesian economists also disagree on the constraints induced by fixed regimes and

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the alleged benefits of floating rates as shock absorbers (Bougrine & Seccareccia, 2004; Lopez & Perrotini, 2006).

During 1930, and until circa 1950, most economists supported fixed (albeit adjustable) regimes (Irwin, 2017). For around two decades after this, the majority opinion, including official and heterodox economists, supported floating or managed floating (Guzman et al., 2018; Ocampo, 2017). Proponents of fixed exchange rate regimes are currently seen as cranks or nostalgic for the gold standard. The literature on exchange rate regimes is abundant and continues to grow. A large part of it is now conducted on an empirical basis, outside any theoretical system, which tends to obscure the fundamental issues at stake.

Two facts will be highlighted in this chapter. The first is that the main discussions regarding the subject are focused on a few issues that have been at the centre of economic debates since the 1930s, although financialisation and globalisation have dramatically accentuated these issues. The second is that a popular contemporary approach to heterodox economics—the Modern Monetary Theory (MMT)—supports floating rates, based on the argument that floating is necessary for currency sovereignty, the latter being key to expansionary Keynesian fiscal policies (Kelton, 2020; Sardoni & Wray, 2007; Tcherneva, 2016). In doing so, MMT allows us to study exchange rates and propose an alternative view.

While recognising the fragility of fixed regimes in the context of the current financial globalisation, this chapter attempts to demonstrate that fixed exchange rate regimes are still appropriate exchange rate arrangements and preferable to floating regimes. The first argument is that businesses and, more generally, all economic agents that trade with non-residents need exchange rate stability, which leads them, in our current system of floating rates, to adopt the US dollar for a wide range of cross-border operations. As examined below, US dollar dominance in trade invoicing and settlement dramatically reduces the benefits of floating and is a significant source of financial problems. Secondly, the alleged advantage of the leading alternative to fixed rates—floating rates—is that the central bank and the government enjoy a policy space that does not exist under fixed exchange rates. Both empirical-based and theoretical arguments have increasingly challenged this assumption. The third argument extends the second one, asserting that floating rates relying on exchange rate adjustments in case of external disequilibrium (currency depreciation) tend to follow uncooperative behaviour, a beggar-thy-neighbour

policy that is harmful for international stability. On the other hand, under specific conditions, fixed rates can pave the way for international stabilisation and multilateral cooperation. The last section (Sect. 4) reviews these conditions and examines two fixed regimes with very different properties: (1) currency boards and dollarisation, and (2) a fixed regime with capital controls. Both allow for exchange rate stability and are, to some extent, preferable to floating rates. However, both have been criticised for causing macroeconomic problems. The paper goes on to examine a third option—which is admittedly “politically naïve” (Moore, 2004)—an International Clearing Union.

## 2 FIXED PARITIES AS A PUBLIC GOOD

The main argument in favour of fixed exchange rates is that it is far more convenient for producers located in a particular currency area to express the price of their exports in terms of local currency, regardless of the currency used for settlement. This argument relates to the fundamental issue of accounting and economic calculation. All economists accept the assumption that exchange between individuals is hardly possible without a standard unit of account. Every trade area—whatever its size—rests on an established standard and stable unit of account. International trade is no exception in this regard; at a minimum, it needs a common accounting standard, and accounting needs stability. From this point of view, fixed exchange rates are preferable to floating ones, as they facilitate traders’ expectations (Lavoie, 2014, 495). Fixed exchange rates not only stimulate foreign trade, but they are also a key mechanism for attracting foreign capital, ensuring security for investment and profits. For peripheral and developing countries, where there are no domestic savings and the fiscal base is weak, external capital is the primary institutional lever for development and catching up to more developed nations (Gerschenkron, 1962).

Until the 1950s, the consensus was that central banks should preserve stable parities (Irwin, 2017). Fluctuating exchange rates were already discussed in academic circles and practised by a handful of countries. Most economists tolerated them only as a temporary adjustment phase to a new set of parities according to macroeconomic fundamentals and the real exchange rate. As a result, fluctuating exchange rates “turned out to be part of the journey to a fixed exchange rate” (De Vries, 1969, 152).

Generalised floating was conceived as disorder and the most uncoordinated response to the failed Bretton Woods agreement. New problems would arise with floating. For instance, Kindleberger believed that transaction costs would threaten the flexible exchange rate system. “Finally, the many academic economists who recommend separating international money and capital markets by a system of flexible exchange rates between national currencies in effect call for a return to Babel, with foreign languages used by none save professional interpreters. This maximises transactions costs and minimises international discourse” (Kindleberger, 1967, 11).<sup>1</sup>

The reality was slightly different. After the gold window closed in 1971, the system did not explode. Foreign exchange markets developed new hedging instruments to adapt to the changing environment of fluctuating rates. Nevertheless, floating introduced new costs associated with the rise of uncertainty (Davidson, 2006, 262). On the one hand, the adoption of flexible exchange rates bolstered speculation and financialisation. On the other hand, it did not prevent private actors from remaining pegged to the US dollar. As Kindleberger (1976, 61) wrote: “When the ‘public good’—international money—is not available, companies have to provide for themselves”.

The argument that commensurability is crucial for international trade may seem trivial. However, it has probably been overlooked by most economists discussing exchange rate regimes. As a result, exchange rate regimes are often considered in the literature merely as alternative options with their specific properties, advantages, and disadvantages (Murau et al., 2020, 771). For example, they are compared as shown in Table 1:

**Table 1** Exchange rate regimes compared: advantages and disadvantages. The authors, adapted from Obstfeld and Rogoff (1995)

|                           | <i>Fixed</i>                                                   | <i>Floating</i>                                                         |
|---------------------------|----------------------------------------------------------------|-------------------------------------------------------------------------|
| Monetary policy           | Constrained                                                    | Unconstrained                                                           |
| International integration | Encouraged with the anchor country and its currency area       | Complicated by fluctuations and risk premium                            |
| Currency crisis           | Not prone to currency crisis when credibly fixed to the anchor | Not prone to currency crisis due to foreign exchange market equilibrium |
| Inflation                 | Low, although this depends on the anchor economy               | Imported inflation caused by depreciation                               |

As Rossi (2007, 101) points out, the fact that exchange rates are constantly fluctuating or expected to move in the future brings the world to a state of disorder in which currencies are bartered. In practice, however, as one can imagine, international trade does not tolerate barter as a *modus operandi*. In a sense, multinational corporations (MNCs) have overcome this problem by adopting the US dollar as their international currency, regardless of their parent countries. Hence, they do have a common monetary standard for trade and accounting by necessity. MNCs have used the same functional currency—the US dollar—for decades, for most international transactions. This private expediency has not gone without raising several significant issues.

The (partial) dollarisation of MNCs is causing a large part of the world to adhere to the dollar standard. Since the US dollar is the global funding currency, MNCs' debt is often denominated in US dollar (Adler et al., 2020). The role of the dollar in invoicing (as a unit of account) and settlement in international trade, has led to the dollarisation of a substantial part of worldwide bank deposits (Gourinchas et al., 2019, 9). The US dollar can only be spent in the US banking system, forcing non-US businesses to hold their export earnings in the US banking system instead of converting them into domestic currencies. These businesses have to use the liabilities of the US banking system, including so-called shadow money (Tokunaga & Epstein, 2018). The US dollar banking system has deployed new banking instruments to meet the global demand for safe US dollar assets. Such a demand has resulted primarily from the accumulation of dollars in institutional cash pools (Pozsar, 2013; Tokunaga, 2019, 34).

The shadow banking system makes US dollar instruments available to non-residents and develops new instruments: “money-like claims” (Pozsar, 2014; see also Murau et al., 2020). Shadow banks create claims that cannot be used for settlement purposes but promise to convert *at par* against bank deposits.<sup>2</sup> Several studies mention that the US dollar shadow banking system has an international dimension (Pozsar, 2013), although this dimension remains understudied. While the global economy is currently characterised by various types of exchange rate regimes—from pure floating to dollarisation—private actors have developed a financial architecture that reconstructs a system with a stable unit of account (i.e. the US dollar). As a result of the development of these financial instruments, coupled with growing international trade, the use of the US dollar increased in the post-Bretton Woods era (Gourinchas et al., 2019).

What is the link between the dominant role of the dollar in invoicing and settlement in international trade, and the discussion of exchange rate regimes? For the country of origin, having a fixed exchange rate against the US dollar does not exempt its MNCs from using and accumulating US dollars. There are still transaction costs that push MNCs to use the US dollar rather than a smaller currency, even if the latter is credibly anchored to the US dollar. One may argue that MNC's preference for stability is of secondary importance to the choice of exchange rate regime. However, depending on their degree of openness and, more generally, the dependence on international factors, monetary authorities, and governments of many countries may prefer to stabilise the exchange rate to avoid the destabilising effects of exchange rate movements on profit margins and/or on domestic prices of imported goods (i.e. the pass-through effect).

It is generally believed that the era inaugurated by Nixon in 1971 after the closing of the gold window is one of the worldwide free-floating exchange regimes. This is not true. Fixed exchange rates are a reality shared by many countries in the world, especially developing countries. Ilzetski et al. (2019) find that 59% of the world's countries are pegged to the US dollar (see IMF 2020 for a classification of countries' *de facto* exchange rate regimes). Free-floating rates are only possible in a few large and advanced currency areas, with a few exceptions. For developing countries, free-floating is considered dangerous for domestic stability. Even one of the most prominent proponents of flexible regimes, Milton Friedman, does not believe that floating rates are appropriate for developing countries (Edwards, 2020). The size of countries also matters: a floating rate regime is unthinkable in small countries.<sup>3</sup> For these reasons, small open economies have a vested interest in joining monetary blocs. The construction of European monetary integration and the continuing enlargement of the area have been undertaken following these principles. Large economies tend to aggregate peripheral economies and form monetary blocs that have a lower degree of openness (taken as a single bloc) and are thereby better prepared for the consequences of floating.

Hence, it would be wrong to argue that all countries can let the foreign exchange markets determine the rate at which the national currency will be exchanged for another currency. The more open the economy is to international trade, the more appropriate a fixed exchange rate regime is. In practice, MNCs and, more generally, all companies involved with activities abroad lobby to peg the domestic currency to socialise this cost

(Broz & Frieden, 2006, 592). If this is so, the central bank would have to bear the cost of maintaining the peg. Note that this argument is not valid for the US economy. As we live in a world where the US dollar is the dominant currency, the US economy does not and cannot have an anchor. McKinnon (2005, 244) defines three rules that the anchor economy should follow: the US capital markets should be open to foreigners; the US should abandon any exchange rate policy, and the Federal Reserve should pursue an independent monetary policy to preserve the purchasing power of the dollar. Therefore, when speaking about fixed exchange rates, we also assume that the dominant currency has no anchor. Only a reform of the international monetary system implementing a currency union or a clearing union (see proposals below) would emancipate the dominant currency issuer from these rules.

### 3 DO FIXED EXCHANGE RATES HINDER CURRENCY SOVEREIGNTY?

Notwithstanding the above arguments, economists may recommend governments adopting flexible regimes because the national currency depreciation against other major currencies serves as a shock absorber to external imbalances. If governments in different countries choose to pursue different policies, it seems easier to let the market “discover” the appropriate exchange rate level. Otherwise, there is a risk of widening disequilibrium. The central bank will find it increasingly difficult to deal with it, and dealing with exchange rates will come at a growing cost.

The other argument in favour of flexible regimes is that floating exchange rates are preferable to fixed exchange rates because of the policy space provided (Kam & Smithin, 2008; Sardoní & Wray, 2007). This argument has been particularly emphasised by post-Keynesian authors highlighting the need to preserve monetary independence and reject hard pegs, currency boards, and currency unions. For instance, Bougrine and Seccareccia (2004, 674) argue that floating regimes “equip policy-makers with a wider capacity to conduct stabilisation policies independently of the rest-of-the-world environment”. A country could decide its economic policies leaving aside the international dimension, thanks to the absorptive properties of floating exchange rates. Following this approach, if a country experiences a current account deficit, its government should let the currency depreciate instead of implementing austerity policies.

The depreciation of the national currency can be compared to a general subsidy from the domestic sector to the export sector, as it reduces relative export prices (in terms of foreign currency) while relative import prices increase (in terms of local currency).<sup>4</sup> On the one hand, it reduces real wages. On the other hand, however, it helps domestic producers gain market shares. Depreciation is considered a less painful way of adjusting to external constraints. In practice, governments try to avoid depreciating national currencies because depreciation can spark a number of macroeconomic problems, including imported inflation. As Moore (2004, 632) notes in a thought-provoking article: “The current floating exchange rate system prevents most countries from aggressively pursuing expansionary domestic policies”.<sup>5</sup>

Several arguments counter the view that the floating regime is stabilising.

First, the free-floating regime relies excessively on speculative self-equilibrating movements. Speculative movements follow boom-bust cycles, which often bring the exchange rate permanently to an unacceptable level (Ocampo, 2017, 105). It is even uncertain that exchange rate movements eventually reach any equilibrium at all. In the meantime, it may have unintended consequences for domestic producers, consumers, and financial stability. Carry trade is a speculative practice that amplifies exchange rate fluctuations and undermines financial stability, reflecting the fact that exchange rate flexibility does not necessarily lead to an equilibrating exchange rate. Flexibility can become a means to profit from speculative activities, as McKinnon (2011, 774) highlights.

Rey (2016) updates an old criticism by arguing that floating rates do not protect against the consequences of US Federal Reserve decisions.<sup>6</sup> The Mundellian trilemma, which concludes that independent monetary policy can be achieved with flexible exchange rates, has lost much of its relevance due to cross-border capital flows (Eichengreen, 2021). According to Rey (2016) the trilemma has become a dilemma: on the one hand, to follow the US Federal Reserve’s monetary policy and, on the other hand, to implement capital controls to obtain monetary policy autonomy. The transmission of US monetary policy to the rest of the world is a fact, so that everyone now recognises that the countries that have opted for flexible rates are nonetheless constrained to follow the US Federal Reserve more or less.

In practice, emerging market economies are most vulnerable to the accommodative US monetary policy (Carstens, 2019). However, even

advanced economies pursue externally constrained monetary policies. For instance, Switzerland is said to be “sovereign”—i.e. it issues its own currency and its debt is denominated in the national currency. Negative interest rates are designed to combat appreciation pressures on the Swiss Franc, although they do put pressure on financial stability in Switzerland (Rossi, 2019). We can also mention China, which is not yet a mature economy, but is engaged in a liberalisation process and is seeking a more market-led exchange rate. McKinnon and Schnabl (2014) highlight that China has been impacted by the quantitative easing policy in the US and, more generally, in Western countries. Therefore, China has chosen to discourage hot money inflows by following the Federal Reserve policy and cutting its central bank rate.

All proponents of fixed rates acknowledge that exchange rate pegging entails a partial abandonment of national self-determination. However, this abandonment is implicit in any open economy. As Davidson (2006, 272) points out:

The loss of complete economic self-determination is the cost of any permanent trading relationship. Economic independence must always ultimately mean either complete economic isolation or complete dominance of others. Autarky and independence can only be purchased at some cost. Once a nation decides to join a community of nations for both political and economic reasons then interdependence and feedback effects among the trading partners are inevitable. The trick is to make these feedbacks provide for economic stimulus as much as possible before global full employment is achieved.

It is true that under a fixed exchange rate regime, monetary policy is ultimately balance of payments constrained (Hanke, 1999, 337). However, monetary policy is balance of payments constrained regardless of the exchange rate regime. “Market” balance of payments (i.e. the balance resulting from supply and demand in the foreign exchange market) should be distinguished from the accounting balance of payments (i.e. the balance of goods, services, and capital recorded within a given period). At freely floating exchange rates, the market balance of payments is necessarily at equilibrium, since the foreign exchange market (supply and demand for the domestic currency) determines the market equilibrium exchange rate. Although market balance is guaranteed, the current account could suffer from exchange rate misalignment even at floating

rates. This could generate persistent disequilibrium. The problem arises from the fact that no country can escape balance of payments (i.e. current account) constraints. As Vernengo and Caldentey (2020, 336) show, developing countries cannot in practice sustain current account deficits for prolonged periods.

In case of recurrent current account disequilibrium, real adjustments must eventually be made. A country that has chosen a floating exchange rate regime and is experiencing currency depreciation is certainly not constrained from defaulting in its own currency. It can, however, be forced to default on foreign obligations—not to mention the fact that currency depreciation usually leads to a reduction in imports whose price has increased. In order to prevent such a default, it may be forced “to adopt contractionary fiscal policies to curtail imports and/or increase interest rates, and deal with the outflows of capital and loss of reserves” (Vernengo & Perez-Caldentey, 2020, 337). In other words, a floating regime does not relieve any country from the balance of payments constraints.

#### 4 THE OBJECTIVE OF INTERNATIONAL MONETARY COORDINATION

Obstfeld and Taylor (2017, 21) recognise that “While floating exchange rates can allow individual countries to stabilise to a degree, they also raise the age-old problem of competitive currency depreciations, in which demand is just being shifted between countries”. This age-old problem is that of beggar-thy-neighbour policies caused by exchange rate depreciation as a balance of payments adjustment tool. Countries may be tempted to rely on currency devaluation or depreciation to boost the domestic economy. As is well-known, currency devaluation can contribute to an increase in exports while reducing imports. This issue was raised after the Great Recession in 2008. Blanchard (2017), for example, reminds us that the monetary policy in advanced economies after 2008 led to currency appreciation in emerging market economies, which shrunk their competitiveness and triggered complaints. The desired currency depreciation leads to a reduction in real wages (in terms of imported goods) and can increase domestic employment. As such, it belongs to beggar-thy-neighbour policies (Davidson, 1992). As Robinson (1969, 87) pointed out in 1937:

For every increase of employment at home there is a corresponding increase of unemployment abroad, where export industries have lost their markets and home industries are exposed to competition from cheap imports. For the rest of the world slump conditions become still more severe. From a purely nationalist point of view this in itself is of no importance – if the unemployed are foreigners they are no concern of ours – but it leads to consequences of which the most hard-bitten nationalist must take account. For other countries, finding them-selves in a more wretched plight than ever, will have still stronger motives for protecting themselves, by tariffs, devaluation or wage cuts.

Depreciation may result in retaliation. For this reason, the International Monetary Fund (IMF), set up at Bretton Woods in 1944, had as its primary task to “exercise firm surveillance over the exchange rate policies of members” (Article IV). Any substantial currency movement required that the IMF be notified. This rule has been violated by several countries. The most significant departure from this rule was by the US in 1971. Trade conflicts and the belief that the US dollar was overvalued led to exchange rate adjustments instead of trade restrictions (James, 2019, 268–269).

Most proponents of fixed exchange rates are not necessarily hostile to changes in parities (Heilperin, 1955, 83), especially when the old parities are inappropriate and even impede domestic adjustment.<sup>7</sup> Nevertheless, any change in parities does not relieve the domestic economy from the real adjustments that must be made. Heilperin (1939, 168) points out that the process of international re-equilibrium must take place regardless of the exchange rate regime. In case of a deficit, the country will have to choose one or more options from the following list: stimulating exports; restricting imports; encouraging inward foreign investment and the entry of foreign short-term deposits; discouraging national investments abroad; and purchasing short-term deposits abroad. In case of a surplus, the country will have to re-equilibrate through the same tools in the opposite direction: stimulating imports; discouraging exports; discouraging foreign investment in the country, or encouraging investment abroad.

A significant difference between fixed and flexible regimes is that the process of re-equilibrium can take place under an organised monetary system compared to a disorganised monetary system. This led the classical faction of the Mont Pelerin Society (including Hayek, Mises, and Heilperin) to reject floating rates on the pretext that they would encourage disorder and monetary nationalism. Fixed exchange rates can facilitate a forum for discussing international monetary coordination. A

fixed regime can be considered the first step towards monetary integration (as opposed to disintegration) and further international cooperation. Outside this logic of cooperation, small countries often decide to fix their exchange rate against a regional or global hegemon because they take into account the peculiarities of the domestic economy, including geo-economic and geopolitical linkages.

Among the above-mentioned external adjustment tools, some are expansionary and others are deflationary. To avoid the deflationary ones, which are very painful (as Krugman 1989 admits), a deficit country should avoid contracting its imports, while a surplus country should increase its imports and encourage investment abroad. In the next section, we examine a proposal aimed at international monetary coordination with stable exchange rates *and* expansionary adjustment mechanisms.

## 5 THREE PROPOSALS TO MAKE FIXED EXCHANGE RATES SUSTAINABLE

Three proposals seem appropriate for maintaining fixed exchange rates over time. The first two (currency boards, on the one hand, and capital controls, on the other) have been often tried, while the third one (the International Clearing Union) has remained at the draft stage.

### *Currency Boards or Dollarisation (or Unilateral Euroisation)*

Proponents of currency boards or dollarisation (or unilateral euroisation) agree with proponents of floating, and recognise that pegged rate regimes are unsustainable. They are incompatible with pursuing an active monetary policy (through sterilisation attempts), because this sooner or later leads to a crisis.

Discretionary monetary authorities such as Central Banks have generally been unsuccessful at maintaining rigid exchange rates because they have done so in an inconsistent way. An analysis of the supply and demand for money shows the contradiction in using sterilized intervention to simultaneously target the exchange rate and the nominal supply of money, as almost all central banks do sometimes and many do most of the time. (Schuler, 1999, 85)

Pegged rates invariably result in conflicts between exchange rate policies and monetary policies. [...] Balance-of-payments crises erupt as a monetary

authority increasingly offsets the reduction in the foreign component of the monetary base with domestically created base money. (Hanke, 2002, 91)

Unlike pegged regimes, currency boards and dollarisation are based on automatic monetary *rules*, and monetary policy is delegated to a credible foreign central bank. This eliminates currency risk; reduces the risk premium; strengthens trade with the anchor area, and attracts foreign capital. Currency boards, in addition to legally pegging the exchange rate to a stable foreign currency, also institute a legal 100% (or sometimes less) coverage of the central bank's monetary base and core liabilities with highly liquid foreign currency assets (Schwartz, 1993).<sup>8</sup> Convertibility is complete. In this case, the central bank's balance sheet eliminates domestic sources of monetary base and abandons active monetary policy. The monetary base is determined endogenously by the demand for money (Hanke, 2002). In this configuration, the central bank cannot influence the system's liquidity, nor can it conduct open market operations or act as a lender of last resort (LOLR). In each particular national case, residual options for influencing liquidity can be found, but these are rather exceptions. The currency board is considered sustainable due to the strong credibility effect (generated by the anchor currency) and as a consequence of the "discipline effect" and the systemic nature of tight budgetary constraints (austerity) (for more details see Desquilbet & Nenovsky, 2004). Friedman, who is often considered the guru of floating exchange rates, actually favours currency boards (or as he calls them, "unified currency") for small and peripheral economies:

[A] unified currency assures a maximum degree of integration of the country in question with the greater world. [...] So I believe there is no conflict between wholehearted advocacy of floating rates for major countries and the existence of currency blocs of smaller countries attached to the major countries. (cited in Edwards, 2020, 14–15)

There have been various institutional departures from the classical principles of currency boards (Camillieri Gilson, 2002). As shown by Nenovsky and Hristov (2002), the new generation of currency boards, unlike the colonial versions of currency boards (often referred to as first generation), allows some flexibility to implement modern monetary policies (reserve requirements, partial LOLR, presence of a government deposit on the central bank balance sheet). It is worth noting that

cross-border capital movements nowadays lead to instability, both in the direction of speculative credit growth and of rapid withdrawal of foreign capital in times of crisis. This instability manifests itself both through the banking system and through other types of external capital inflows, such as EU funds in European countries. This also applies to dollar countries. This is why, especially after 2008, most currency boards and dollarised countries have been pursuing active regulatory policies, especially with respect to foreign banks.

*Dollarisation* is a regime in which a foreign currency is officially adopted as legal tender and the national currency is completely abolished (with some exceptions where small-value national coins are in circulation) (Bogetić, 2000).<sup>9</sup> Unilateral euroisation, which is not agreed upon, is a form of dollarisation involving the European currency instead of the US dollar. Unilaterally euroised countries should be distinguished from euro area members, as they do not participate in the governing institutions of the euro area. Just as the dollarised economies did with the US dollar, the euroised economies have unilaterally adopted the euro as legal tender. In this extremely dependent monetary form, monetary authorities do exist which, however, can only provisionally be called central bank (e.g. the Central Bank of Montenegro, Fabris et al., 2004). Convertibility is complete. There is no monetary policy. It is necessary to put foreign currency banknotes into circulation, which is done by a one-time conversion of foreign reserves into banknotes or their purchase. This regime ultimately links the dynamics of monetary processes to that of the leading centres and is extremely disciplining for public finances.

Dollarisation or currency boards are generally supported by orthodox economists and monetarists, but not only. Basil Moore, a well-known post-Keynesian, argued in 2004, after the Argentina debacle, that dollarisation was the second-best option to stabilising exchange rates since the long-awaited international monetary reform was not taking place. Dollarisation has the great advantage of being a “bottom-up” option, as its implementation does not require a new Bretton Woods-type conference. In comparison, the top-down solution of creating an International Clearing Union (see below) is highly unlikely and politically naïve. According to Moore, dollarisation is superior to fixed rate regimes precisely because it avoids the risk of breaking the fixed rates through devaluation and at the same time integrates the monetary systems of different countries. Eventually, the countries adopting the US dollar

would increasingly be led to share seigniorage incomes and even be represented on the Federal Reserve Open Market Committee (Moore, 2004, 652).

The choice of a currency board and dollarisation is most often the result of geopolitical choice and self-imposed strategic dependence. For example, the choice of a currency board in the Baltic countries in the early 1990s, and later the choice of the German mark as official legal tender in Montenegro and Kosovo, is a visible manifestation of the desire by the national elites to replace the geopolitical anchor: in the first case to replace USSR/Russia with Germany and the EU, and in the second case to replace Yugoslavia/Serbia with Germany. We should also add the consideration that for small countries the political cycle leads to extreme instability of their monetary regimes, which become hostage to the political struggle and most often lead to inflation, devaluation, and financial crisis (often referred to as “financial and inflationary trauma”). This means that in small countries the dependence of the monetary regime on domestic factors is relatively greater and more harmful than their external dependence. Informal monetary practices that are also part of a country’s monetary system, the most common form being “currency substitution”, are also important. It is expressed in the preferences of consumers and producers in the small and peripheral country to pay, measure, and save in a stable foreign currency. Both monetary regimes fit into the model of “dependent capitalism”, which in principle can be quite successful (Magnin & Nenovsky, 2020).

The currency board and dollarisation are also criticised from a technical point of view: the anchor country’s monetary policy is transmitted passively; there are no instruments to react to asymmetric shocks; there is no LOLR, and competitiveness is lost because the exchange rate is overvalued. The proponents of these regimes respond that the goal of these regimes is passive behaviour (following the lead anchor) and that another type of regime would likely be less successful. They also argue that the economy can adjust to any level of the nominal exchange rate. The absence of nominal depreciation of the national money has a stimulative effect, forcing firms to increase their productivity and governments to maintain strict fiscal discipline.

Proponents of currency boards or dollarisation acknowledge that such exchange rate arrangements entail real adjustments that *have to be made* in case of external disequilibrium, meaning deflationary policies in the event of a current account deficit. In practice, this is painful. Deflation can

hardly be avoided in the case of an external deficit, whatever the exchange rate regime adopted. Two alternative policy options do mitigate recourse to deflation.

### *Introduction of Capital Controls on Short-Term Capital Flows*

One of the arguments in favour of flexible rates is that the central bank, by giving up support for official parity, avoids a costly battle with foreign exchange speculators. However, this battle can be better avoided by introducing controls on hot money flows (Vernengo & Rochon, 2003). The grounds for refraining from controlling capital movements are usually that they will lead to misallocation and serious problems arising from this.<sup>10</sup> These arguments rest on the fact that capital market regulations segment domestic markets from international markets (Guzman et al., 2018, 58). However, it can be seen as a policy option, a policy of selective capital controls that permit most capital inflows and outflows while preventing some categories of volatile capital flows with low social utility. This implies screening of capital flows.

Financialisation has reinforced the need to discuss capital controls. Since the 2008 financial crisis, economists from various schools of thought have recommended implementing capital controls, and it is not only heterodox economists who have traditionally supported these instruments (i.e. post-Keynesians, Latin American structuralist schools). For example, McKinnon and Schnabl (2014) recommend introducing capital controls in response to the troublesome inflows resulting from expansionary monetary policies in advanced economies and demand for higher interest rates in emerging economies. Even official economists such as those of the IMF have proposed capital controls as a policy option to stabilise national economies (Ostry et al., 2011). In practice, since WWII, the number of countries applying foreign exchange controls or selective short-term capital controls has declined dramatically, but, as Ilzetsky et al. (2019, 635–637) note, since mid-2014 many developing and emerging country governments have moved towards capital controls.

This solution is probably limited in its time and scope. Capital controls gradually lose their effectiveness once capital flows find other routes to reach their destination. Over the past two decades, investors and speculators in China have used various channels to circumvent existing controls, including trade mis-invoicing and non-repatriation of profits. Despite

capital account regulations, the 2014–2017 period saw massive capital flight from China, which was only, and not completely, stopped by tighter controls. Ideally, to be effective in the long run, capital controls should be applied “at both ends”, with central banks communicating cross-border capital flows to each other (Helleiner, 2015). Such a scheme requires international cooperation and could represent another path towards a more integrated international monetary and financial system.

### *Establishment of a Clearing Union and an International Investment Council*

The very mention of the International Clearing Union immediately evokes Keynes’ post-war plan prepared for the Bretton Woods conference. Working on a post-war international monetary order scheme, Keynes (1980, 33) called its first draft in 1941 “Proposals for an International Currency Union”. Only subsequent drafts were renamed “Proposals for an International Clearing Union”. Keynes wanted a unification of the world monetary system on the model of national monetary systems. Many economists after him followed this route, and have made extensive use of comparing national and international monetary integration (Davidson, 2006; Moore, 2004; Triffin, 1964).

Let us assume a monetary economy similar to ours in which commercial banks issue bank money through decentralised credit policies. Each commercial bank issues its own bank money and is ultimately overseen by the central bank. The role of the central bank, by issuing central bank money, is to unify the monetary system. As a result, a commercial bank issuing bank money does not have to devalue (revalue) its exchange rate when it registers an interbank deficit (surplus). This problem does not exist because the interbank money market, supervised by the central bank, recycles surpluses towards deficit banks. The central bank compensates for interbank money market failure in the event of general distrust and a credit crunch. As a result, thanks to the central bank’s daily operations, commercial bank liabilities (i.e. bank deposits) are means of payment *at par*. Commercial bank liabilities are not bartered among customers as long as the parity is reliably provided by these modern banking system’s mechanisms. Keynes’ Clearing Union sought to replicate the banking system at the international level. It is essentially a blueprint for fixed exchange rates.

As McKinnon (2011, 760) notes, foreign exchange markets should no longer exist within the International Clearing Union, as they will be replaced by central banks' mutual clearing in the International Clearing Union. Consequently, currencies cease to be bartered in the foreign exchange markets. As Keynes (1980, 33) writes, "Central banks will buy and sell their own currencies among themselves only against debits and credits to their accounts at the Clearing Bank...Each national currency will have a fixed value...determined at the creation of the Currency Union in Clearing Bank money". National currencies will remain convertible as long as the par value system is backed by the International Clearing Union, just as in national banking systems a customer of one bank can have his deposits converted into deposits of another bank.

Such a plan implies integration and unification of national banking systems. Fixing parities and creating an international currency unit is only one aspect of this ambitious international integration. Monetary unification should also include the integration of trade and capital markets if it is to be sustainable over time. This means that countries should recycle trade surpluses in deficit regions through financial transfers in an orderly and sustainable way. During the wartime discussions on the post-war monetary order, Oxford economists Kalecki, Balogh, and Schumacher proposed a plan to improve on Keynes' plan in this direction with the creation of an International Investment Council alongside the International Clearing Union (Toporowski, 2018). In fact, Keynes' plan was mainly concerned with the current account and did not adequately address international investment. Kalecki, Balogh, and Schumacher therefore envisioned an International Investment Council under the auspices of the United Nations, which would deal separately with countries in need of investment for post-war reconstruction purposes. This International Investment Council would help developing countries and countries with short-term deficit issues. This would allow cross-border investment flows, especially to underdeveloped countries. This scheme was intended to promote full employment policies, as well as economic development and fixed parities.

Keynes' Plan, combined with the proposals of Kalecki, Balogh and Schumacher, could solve the main problem of the current international monetary (non-)system. Under such conditions, monetary plurality—i.e. the coexistence of many national currencies—would cease to be a problem, as national currencies would be part of a truly international

currency system. The remaining sensitive issues in such an organisation would be arbitrage between rules and discretion (Keynes, 1980, 116). Mutual commitment is necessarily rules-based: it limits discretion to preserve the Clearing Union's cohesiveness.

## 6 CONCLUDING REMARKS

Although most economists acknowledge that fixed exchange rates are a desirable goal for facilitating trade and integration, maintaining exchange rate parity can be a difficult objective. This paper does not demonstrate that a fixed exchange rate regime is a panacea in the current global economy, as many variables can undermine fixed regimes and cause severe constraints on economic policies.

However, the chapter supports the case for fixed rates and the case against floating rates. We begin by showing that any trading area must have stable exchange rates. The unit of account is the heart of any monetary system and is justified by the need for stable exchange rates to enable economic calculations and subsequent trade operations. Therefore, by maintaining fixed exchange rates, monetary authorities would be doing a great service to internationally oriented companies. The rest of the article attempts to debunk the idea that, on the one hand, fixing the exchange rate would mean a complete abandonment of monetary policy, and on the other hand, pure or managed floating exchange rates would give the central bank discretion. Some policy measures may preserve policy space under fixed rates; however, policy space is externally constrained under all exchange rate regimes, especially in the current financial globalisation environment. As a result of all this, the supposed advantages of flexible rates diminish, while fixed rates still have the advantage for facilitating integration.

The paper then discusses three policy options that enhance the sustainability of fixed rate regimes: the adoption of a rules-based currency board (or dollarisation), the introduction of selective capital controls, and the creation of an International Clearing Union. These policy options are very different as they have different impacts and focus on different issues (the instability caused by monetary policy vs. that caused by cross-border capital flows). The first two—currency boards or capital controls – can be implemented unilaterally (although their effectiveness improves with international cooperation). An international clearing union is a much more ambitious plan that preserves both international integration and

macroeconomic stability, but we have to recognise that such a cooperative scheme raises the eternal issue of political feasibility.

## NOTES

1. In this essay, Kindleberger compared international money and international language.
2. “These instruments have one common attribute, which is that they promise to trade *at par* on demand. This makes them money” (Pozsar, 2014, 9).
3. Keynes (1971, 16) also argued that smaller countries should be pegged to a major currency issuer with an international financial center.
4. Here, we assume that once the currency depreciates, the price of imported goods will rise accordingly and will not follow pricing-to-market strategies.
5. Friedman (1966) argues that floating rates aim to stabilise exchange rates.
6. This echoes Hayek (1937, 73), who argues that “the belief that by maintaining an independent national currency we can insulate a country against financial shocks originating abroad is largely illusory”.
7. An eloquent example is the common currency of the CFA area, created in 1948 and devalued in 1994 by 50%, and since then the new parity of the fixed exchange rate has been maintained.
8. The currency boards of recent decades, some of which still exist today, are Hong Kong (since 1983), Estonia (1992–2011), Lithuania (1994–2015), Bulgaria (since 1997), Bosnia and Herzegovina (since 1994/1998), Argentina (1991–2002), and Djibouti (1949).
9. Among the examples of dollarisation, we note Panama (1904), Ecuador (since 2000), El Salvador (2001), and as Euroisations—Kosovo (1999) and Montenegro (1999).
10. The other objection is that capital controls are challenging to implement in practice. “After a while people find loopholes, hidden capital flight occurs, and the central bank again faces a drain of foreign reserves” (Schuler, 1999, 98). This argument is consistent with the experience of many countries in the twentieth century.

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