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Play Money? Contemporary Perspectives on
Monetary Sovereignty

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EUROPEAN UNIVERSITY INSTITUTE, FLORENCE
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Abstract

Money has always been a difficult and complex concept and the views about what money actually is could hardly be more diverse. This is all the more true in the times of completely manipulated irredeemable paper currencies, the functioning of which is based almost completely on the extent to which people believe in its trustworthiness. The final abolition of Gold as a universal standard of currencies in the early 1970s at first glance seems to have strengthened the grip of governments on money. Nevertheless, it is often argued that 'national currencies' are under threat. According to this view, 'monetary sovereignty' is waning, as is sovereignty as a whole. The present paper takes a different view. It argues that 'monetary sovereignty' understood as a legal concept remains intact and is not even significantly limited by obligations under public international law. This leaves governments significant leeway in taking decisions regarding the setup of their monetary regime ('sovereignty games') and empirical evidence shows the large number of different options that are actually chosen.

Keywords

Sovereignty, Monetary Sovereignty, International Monetary Relations, Monetary Policy, Money

Introduction*

The more books one reads on money, the more one gets confused and frustrated about one's incapacity to grasp the very essence, the idea of what constitutes money. Yet one can derive at least some comfort from the fact that even Nobel Prize laureate economists such as *John Maynard Keynes* or famous bankers such as *Baron Rothschild* – almost coquettishly – admitted to know only two or three people who actually understood money, but unfortunately disagreed about its nature.¹ Rephrasing another quote of unknown origin slightly, one could say that there are three roads to madness: love, ambition and the study of money.² I am still undecided whether me being a lawyer by training – and therefore allegedly equipped with a natural confusion about numbers³ – will make me go down that road even faster or rather slower.

The disagreement as to the nature of money is not restricted to the different disciplines that deal with money: Economics, Law, Sociology, Political Science (and even Geography⁴), but also manifests itself within the economic discipline itself.⁵ To some extent, the difference in thinking about money reflects the diverse interests the disciplines have in the subject and is of no relevance to the others: Economists do not necessarily have to take into account in their treatment of monetary theory that money is a symbolic medium and a pre-condition of modern detached life-style from a sociological point of view.⁶ Nor does a lawyer always have to consider what is used in practice as money when he has to answer the question as to the legal tender of a given country.⁷ However, thinking about monetary sovereignty means thinking about the nature of a relationship between the State, the individual and the economy.

According to the still important 'State Theory of Money', formulated in 1905 by *G. F. Knapp*, money is 'a creature of law',⁸ law being identified with the modern state. The key argument of this theory is the existence of debt. The State provides its power of enforcement of contractual debts, but defines what serves as satisfaction of the debt through the definition of legal tender. This definition is always a historic one, based on a recurrent link to the former currency in which old debt may have been denominated.⁹

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1 Quoted by Ingham (ed.), *Concepts of Money* (Cheltenham 2005), p. xi.

2 Quoted in Chown, *A History of Monetary Unions* (London 2003), p. 5 with regard to Bimetallism. See also *Marx's* reference to a statement made by Gladstone in a parliamentary debate on Peel's Bank Act of 1844, who observed that 'not even love has turned more men into fools than has meditation on the nature of money' (*Marx, A Contribution to a Critique of Political Economy* [Moscow 1970], p. 64).

3 According to a common mistranslation of the principle *iudex non calculat*, lawyers are not able to calculate. The original meaning was that arguments, evidence and witnesses are not simply counted, but considered according to their merits.

4 For a geographical approach to the study of money see Cohen, 'The new geography of money' in Gilbert/Helleiner (eds.), *Nation-States and Money* (London 1999), p. 121 with further references.

5 For an account of the different positions see Ingham, *The Nature of Money* (Cambridge 2004) and Ingham (ed.), *Concepts of Money* (Cheltenham 2005); Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), pp. 5 *et seq.*

6 For sociological perspectives on money see Simmel, *Philosophie des Geldes*, 5th Ed. (Munich 1930); Ingham, *The Nature of Money* (Cambridge 2004), pp. 59 *et seq.*; Zelizer, *The Social Meaning of Money* (New York 1994).

7 For a legal definition of money see Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), pp. 5 *et seq.*

8 Knapp, *Staatliche Theorie des Geldes*, 4th Ed. (Munich 1923), p. 1: „Geld ist ein Geschöpf der Rechtsordnung.“

9 *Ibid.*, pp. 9 *et seq.*

However, this legalistic understanding of money is widely rejected in economic circles, who tend to define money in a functional way (*'money is what money does'*) and emphasise the actual acceptance as payment by economic entities as being decisive for something to become money. According to this view, money bears the functions of unit of account, means of exchange, standard of deferred payments and store of value. An item that fulfils all these functions will normally be considered by economists as 'money' with the medium of exchange function given supreme importance by mainstream economists (the so-called commodity theory of money).¹⁰ This view may have been correct in the past, i.e. from early ancient times until the beginning of the 20th Century. In those times the money stuff were predominantly precious metals (or banknotes and state-issued paper currencies convertible into metal), and accordingly the acceptance of money was based on the appreciation the money stuff itself enjoyed as a commodity.

However, things have changed. Change began more or less one and a half centuries ago with the development of true non-redeemable paper currencies and found its ultimate completion with the break-down of the Bretton Woods System in 1971, when the remaining indirect link between all currencies and gold was given up. It is obvious that in our times money cannot simply be –as it had been widely believed over thousands of years– the most fungible commodity available anymore, even though this may have been the historical origin of money. It would contravene the ordinary meaning of the word 'commodity' to use it for money which is made of a substance that has no practical use whatsoever, or at least no real value which comes even close to the exchange value it normally embodies.¹¹ It holds even truer for book money which nowadays may be transferred electronically and has no bodily existence at all or for E-Money¹² or virtual currencies such as the Linden Dollars used in the virtual world of Second Life.

Hence, the nature of money must be something different. As *Georg Simmel* has correctly pointed out in his *Philosophy of Money* (1900), money rests upon the trust of individuals who accept it as payment only because they believe that other individuals will accept it in their turn in the future.¹³ The very core of this societal relationship is that of credit. According to that view, money embodies a negotiable claim upon society to receive goods and services of real value in the future in return for it. It certifies that its owner has made a real contribution to the economy for which he has received only the money stuff and no real goods or services. This view does neither contradict the functions ascribed to money by economic monetary theory –*Schumpeter* developed a very similar position later in his writings on the nature of money¹⁴ and the credit theory of money, on which these thoughts were based, dates back to *John Law's* writings at the beginning of the 18th century¹⁵– nor does it necessarily conflict with the State theory of money. Claims may very well be traded as commodities and trust in social and legal institutions has an extremely close relationship with the State and the law. It is a necessary sociological precondition of all legal institutions and of community as such. The importance of 'credibility' of monetary policy and the need for a 'culture of stability' are nowadays also widely accepted among monetary economists; hence the persistent call for independent central banks.

It has been purported in academic writings that the two defining features of 'national currencies', i.e. their distinctness and exclusivity in a given territory, are under threat by different trends:

10 For an account of this 'mainstream' economic view see Ingham, *The Nature of Money* (Cambridge 2004), pp. 15 et seq.

11 The practical value of paper money is probably exhaustively described by the following usages: sniffing cocaine through it, accelerating a fire with it, using it as wallpaper or toilet paper.

12 For a definition of Electronic Money in European Law see Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, OJ 2000 No. L 271/39.

13 Simmel, *Philosophie des Geldes*, 5th Ed. (Munich 1930), p. 162.

14 Schumpeter, 'Das Sozialprodukt und die Rechenpfennige. Glossen und Beiträge zur Geldtheorie' *Archiv für Sozialwissenschaft* 44 (1917), pp. 627 – 715; Schumpeter, *Das Wesen des Geldes* (Göttingen [1930] 1970)

15 Cf. Schumpeter, *History of Economic Analysis* (London 1954), pp. 321 et seq.

denationalization, regionalization and virtualization of money.¹⁶ In the following we will try to tackle the question what monetary sovereignty is and what use States make of it at the beginning of the 21st century.

Monetary Sovereignty in Public International Law

The power over money has persistently been regarded as one of the core elements of statehood since the development of the notion of ‘sovereignty’ by *Jean Bodin*.¹⁷ The emergence of national currencies as such, i.e. money that is distinct and exclusive to the territory of a State, is seen as closely related to the formation of Nation States in modern times¹⁸ and the use of the respective legal tender has often been coerced by authorities upon citizens.¹⁹ Money is considered a symbol of national independence as well as integration and identity. However, national money is not always appreciated. In the words of John Stuart Mill:

So much of barbarism still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbours, a peculiar currency of their own.²⁰

The presumption that an independent State would normally also have its own currency is also implied in the Statute of the International Monetary Fund. At its conclusion in 1944 it seemed rather unrealistic that an independent country could opt for not having a currency of its own.²¹

Sometimes, the relationship between a Nation and its money can have almost obsessive, even erotic traits, as may e.g. be the case with us Germans and the British. Calls for a ‘Denationalization of Money’²² have therefore –leaving aside the amazing introduction of the Euro– neither been very frequent nor have they gained a great deal of support. Even liberal economists, e.g. the ordo-liberal Freiburger School of *Walter Eucken* and *Franz Böhm*, tend to take the State monopoly over money for granted or at least accept it.

Public International Law reflects this general acceptance of the State power over money. According to an often quoted decision of the Permanent Court of International Justice in 1929,

is [it] indeed a generally accepted principle of public international law that a State is entitled to regulate its own currency.²³

The key legal consequence derived from this *ius cudendae monetae* is that the definition of a State’s currency to which a reference may be made in contracts, is solely described by the law of that State, the *lex monetae*. That means that national courts have to respect measures taken by other States in exercise of their monetary sovereignty.²⁴ It becomes relevant first and foremost in cases of a

16 Cf. Gilbert/Helleiner (eds.), *Nation-states and money : the past, present and future of national currencies* (New York 1999).

17 Bodin, *Les six livres de la République* (1583), Chapter X, p. 211 (223).

18 Helleiner, *The making of national money : territorial currencies in historical perspective* (Ithaca 2003).

19 Simmel, *Philosophie des Geldes*, 5th Ed. (Munich 1930), p. 173.

20 Mill, *Principles of Political Economy* (London 1848 (1909)), p. 615.

21 See Gianviti, ‘Use of a Foreign Currency Under the IMF’s Articles of Agreement’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington 2005), p. 817 et seq.

22 Hayek, *Entnationalisierung des Geldes* (Tuebingen 1977).

23 PCIJ, *Case Concerning the Payment of Various Serbian Loans Issued in France*, Urteil vom 12. Juli 1929, Series A, Nos. 20/1, p. 44.

24 Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), pp. 331 et seq. and pp. 499 et seq.

currency reform or reconstruction such as the introduction of the Euro.²⁵ Furthermore, given the lack of specific treaty obligations, there will normally be no basis for a legal challenge of another State's measures to organise its monetary system or of its conduct of monetary policy as long as this does not interfere with the monetary sovereignty of another State, e.g. by State-controlled counterfeiting of foreign currency.²⁶

Elements of Monetary Sovereignty

Monetary sovereignty encompasses a number of sovereign rights as well as policy tools.²⁷ Internally, the State is free to define its unit of account, to issue banknotes and coins and to declare them legal tender, to impose criminal sanctions on counterfeiting, to prohibit the use of other currencies inside its territory, to regulate the money supply and the banking system and to determine and change the value of its currency.

Given its impact on the effective demand for a currency, one should also consider the definition of the means of payment for taxes and state debts as forming part of the monetary sovereignty of a State.²⁸ With regard to the external dimension of their currency, States may decide to impose exchange restrictions and controls on the flow of capital and payments, opt for a floating or fixed exchange-rate regime and define the exchange-rate vis-à-vis other currencies.

Limitations to Monetary Sovereignty Deriving from the IMF Statute

The sovereign rights of a State are limited by the provisions of international agreements it has entered into. With regard to monetary sovereignty, the main source for such limitations are the Articles of Agreement of the International Monetary Fund (IMF).²⁹ With its 185 member countries, the IMF constitutes the virtually universal legal framework for the exercise of monetary sovereignty.³⁰ However, it must be emphasised that every country is free to join and to leave the IMF,³¹ i.e. membership is not an exogenously imposed restriction on sovereignty, but a deliberate self-restraint, something that is sometimes forgotten in the discourse about the waning of sovereignty in the times of globalization.

For the present contribution, there are two main aspects of the rules of the IMF which deserve mentioning:

- Firstly, since the second amendment to the Articles, which came into force in 1978 and was designed to adapt the legal framework to the practice of freely floating exchange-rates that had emerged with the breakdown of the par value system in the early 1970s, members of the IMF are

25 In such a case, foreign courts must apply the changeover from the national currencies to the Euro when claims denominated in those currencies are brought before them, see Lenihan, *The Legal Implications of the European Monetary Union under U.S. and New York Law* (Brussels 1998).

26 Cf. Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), p. 531 et seq.

27 On these elements see Gianviti, 'Current Legal Aspects of Monetary Sovereignty' in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 4 (Washington 2005), p. 1; Lastra, *Legal Foundations of International Monetary Stability* (Oxford 2006), pp. 22 et seq.; Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), pp. 500 et seq.

28 See van Dun, 'National Sovereignty and International Monetary Regimes' in Dowd/Timberlake (eds.), *Money and the Nation State* (New Brunswick 1998), p. 47 (60).

29 On the law of the IMF in general see Lastra, *Legal Foundations of International Monetary Stability* (Oxford 2006), pp. 371 et seq.; Lowenfeld, *International Economic Law* (Oxford 2002), pp. 529 et seq.; Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), pp. 557 et seq.

30 A list of the members can be consulted at <http://www.imf.org/external/np/sec/memdir/members.htm>.

31 See Art. XXVI Sec. 1 IMF.

free to decide to fix or float the exchange rate of their currency against other currencies (Art. IV Sec. 2 (b) IMF). Even though one of the main purposes of the IMF is ‘to promote exchange stability, to maintain orderly exchange arrangements amongst members and to avoid competitive exchange depreciation’ (see Art. I (iii) IMF), there is ‘no clearly defined and self-standing legal duty to maintain stable currencies’ presently laid down in the IMF Articles.³² Even the most substantive ‘hard obligation’, to ‘avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members’ (Art. IV Sec. 1 (iii) IMF) has turned out to be not very effective and has therefore been subject to changes most recently.³³

- Secondly, the introduction of restrictions on the making of payments and transfers for current international transactions³⁴ without the approval of the Fund is prohibited (Art. VIII Sec. 2 (a) IMF). Whether or not a member is allowed to restrict the transaction itself is a matter not for international monetary law, but for international trade law to decide. Under the WTO regime, which applies to the trade of its 150 member countries, quantitative restrictions on trade in goods are generally prohibited (with some exceptions), but may e.g. be imposed in case of balance-of-payments problems (see Art. XII, XV GATT, Art. XII GATS). Contrary to payments for current transactions, the IMF members are under no obligation to liberalize international capital transfers (Art. VI Sec. 3 IMF). Efforts in the 1990s that were aimed at introducing disciplines in that regard have lost momentum following the Asian crisis of the late 1990s.³⁵

The Waning of Monetary Sovereignty

It is one of the prominent and fashionable tenets of our time that the sovereignty of States is diminishing due to the process of globalisation. The same claim is being made with regard to ‘monetary sovereignty’. According to *Treves*, the statement of the PCIJ nowadays is a mere figure of speech. However, *Treves* writings also reveal the source of much of the misunderstandings in the debates about the waning sovereignty in the post-Westphalian world order. According to him, sovereignty is a factual question, not a question of a right. However, this is exactly where legal understandings of sovereignty and political concepts differ significantly. From a purely legal point of view, sovereignty erodes only where obligations for a State may arise and be enforced without or even against the consent of that State. Sovereign is who is not subject to legally enforceable commands from a third party. From a political science perspective, sovereignty means absolute and factual independence. The problem with the latter view of course is that there is no State that possesses absolute independence in that sense – not even nuclear super powers – and that there was none in the past.

As regards the alleged waning of monetary sovereignty, the usual suspects are the ‘global capital markets’ which have taken control and can bring down currencies, financial centres and governments. Indeed, capital markets have a great influence on domestic economic policies. However, they operate only within a legal framework established and upheld by States. Free movement of capital is nothing

32 Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), p. 564.

33 See Decision of the IMF Executive Board of 15 June 2007 on Bilateral Surveillance of Members’ Exchange Rate Policies, available at <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm> (10 July 2007).

34 The term ‘Payments for current transactions’ is defined in Art. XXX (d) IMF. On this topic see Elizalde, ‘The International Monetary Fund and Current Account Convertibility’ in *Current Developments in Monetary and Financial Law*, Vol. 4 (Washington 2005), pp. 17 et seq.

35 On this topic see Fischer, ‘Capital Account Liberalization’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 1 (Washington 1999), pp. 1 et seq.; Gianviti, ‘The International Monetary Fund and the Liberalization of Capital Movements’ *ibid.* at pp. 7 et seq.; Hagan, ‘The Design of the International Monetary Fund’s Jurisdiction over Capital Movements’ *ibid.* at pp. 68 et seq.; Gianviti, ‘Liberalization of Capital Movements: A Possible Role for the IMF’ in: IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 2 (Washington 2003), pp. 217 et seq.

that markets have imposed, but something that has been made possible by the States because it is seen as economically beneficial. It is for every State to decide whether it wants to benefit from economic globalisation including foreign capital investments or whether it wants to take the ‘Cuban’ or ‘North Korean’ road to the detriment of its people. Sometimes it seems that those who bemoan an alleged inability of political actors rather feel dissatisfaction about the substantive outcome of the political process, since it does not concur with their view of ‘good policies’.

At this point, one factual limitation of all monetary sovereignty choices should not be overlooked: According to what economic theory commonly calls the ‘impossible trinity’, ‘impossible triad’ or the ‘trilemma’, it is –in the long– run impossible to combine free movement of capital, fixed exchange rates and an independent monetary policy.³⁶ One will always have to be sacrificed. The problem described by the trilemma in my view is not a question of sovereignty. It is simply a matter of factual limits to State power as they have always existed. States have at all times been unable to provide certain goods to their people, be it security, economic welfare, health etc. and the more they tried to provide, the less they delivered. It is a mere truth of life that one has to make choices between different opportunities all the time, and it holds true for States – even the most ‘Hobbesian’ ones – as well. As long as they still exercise effective control over their territory and the people living there, they remain free to make such choices as they deem appropriate, but they have to live with the consequences.

Monetary Sovereignty ‘Games’

States can use their power over the currency in many different ways. Money can be and has been used as a coercive means of politics in the past.³⁷ Monetary policy can allegedly also be the trigger of military conflicts. So it has been argued that the 2003 War on Iraq was mainly due to Iraq’s decision to switch from US-Dollar to Euro in its oil trade.³⁸ These matters fall of course into the sphere of International Relations theory and International Political Economy. However, they are not subject of the present contribution, which is focused on ‘sovereignty games’ as referring to a less aggressive, lighter behaviour of States with regard to their sovereignty, including States’ decisions not to make use of what is considered to be their lawful sovereign right.

Every State, in principle, is free not to accede to or withdraw from the IMF. However, given the large number of members and the relatively low level of commitments resulting from membership in the IMF, I will confine the following submissions to strategic options that can be pursued notwithstanding IMF membership, since they do not conflict with its legal rules.

As pointed out above, a member of the IMF is free to choose between a floating and a fixed exchange rate arrangement and is only obliged to ensure the convertibility of its currency for payments for current account transactions. In fact, this leaves quite some leeway for policy choices and the States widely use them. Given the obligation to allow convertibility at least for current account transactions, the key element of every monetary strategy is the exchange rate arrangement a country chooses. According to the degree of flexibility, the possible options embrace a freely or managed floating currency, a (crawling) currency peg (against one other currency or a basket of currencies), a currency board or a fully-fledged ‘dollarisation’ or a monetary union with other countries.³⁹

36 See Bernanke, ‘Monetary Policy in a World of Mobile Capital’ *Cato Journal* Vol. 25 (2005) No. 1, pp. 1 – 12, It may be possible in a case like China’s Yuan, which is under constant pressure to appreciate. In theory, it would be possible for the Bank of China to meet any demand of its currency. At a certain point, however, the increased amount of money in China would lead to increased inflation and the central bank would have to change its policies.

37 See Kirschner, *Currency and Coercion* (Princeton 1995).

38 Clark, *Petrodollar Warfare: Oil, Iraq and the Future of the Dollar* (2005).

39 See Chown, *A History of Monetary Unions* (London 2003), pp. 12 et seq.; Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge, USA, 2002), pp. 21 et seq.; Eichengreen, *International Monetary Arrangements for the 21st Century* (Washington 1994), pp. 9 et seq.; Proctor, *Mann on the Legal Aspect of Money* (Oxford 2005), pp. 793 et

As of July 2006⁴⁰, of the member countries of the IMF:

- 25 countries let their currency float,
- 50 countries had a floating exchange rate without a specific exchange value target,
- five countries had installed a crawling peg system,
- ten countries (mainly EU Member States not (yet) participating in Stage 3 of EMU) were involved in a system of fixed exchange rates with a narrow band of floating (ERM II⁴¹),
- 51 countries had another conventional fixed exchange rate,
- five countries had a currency board in operation,
- 33 countries were member of a currency union and
- nine countries were using another country's currency (to this, countries such as Andorra⁴², Liechtenstein⁴³, Vatican City⁴⁴ or the Principality of Monaco⁴⁵ must be added, which also have no currency of their own, but use either *de jure* or *de facto* the Euro or the Swiss Franc).

The most liberal regime of course is that of floating exchange regimes, where the determination of a currency's exchange value is left to the market and interventions of public authorities are rare. This approach is mainly found in major industrial countries (e.g. the United States, Canada, Japan, Australia, New Zealand, South Korea, Norway, the United Kingdom) and countries already very well integrated in the world economy (e.g. Brasil, Chile, Israel, Mexico and Southern Africa). Of course, the Euro as the common currency of the 13 countries already participating in stage three of EMU is a floating currency as well.⁴⁶ Needless to say that for an exchange rate to be really floating, both currencies must be floating.

A pegged currency is characterized by a fixed exchange rate against either – far more frequently – one specific currency (e.g. the US-Dollar or the Euro) or against a basket consisting of different currencies (only five countries as of July 2006). A variation of a pegged currency is a 'crawling peg', i.e. the currency is pegged against another one, but the exchange rate is adjusted according to a

(Contd.) _____

seq. These categories are also used in practice, see e.g. IMF (ed.), *Exchange Rate Arrangements and Currency Convertibility – Developments and Issues* (Washington 1999), pp. 23 et seq.; Deutsche Bundesbank, *Devisenkursstatistik Februar 2007*, p. 50 et seq. (accessible at <http://www.bundesbank.de/download/volkswirtschaft/devisenkursstatistik/2007/devisenkursstatistik022007.pdf>).

40 See Deutsche Bundesbank, *Devisenkursstatistik Februar 2007*, p. 50 et seq. (accessible at <http://www.bundesbank.de/download/volkswirtschaft/devisenkursstatistik/2007/devisenkursstatistik022007.pdf>). Data for 1997 may be found in IMF (ed.), *Exchange Rate Arrangements and Currency Convertibility – Developments and Issues* (Washington 1999), pp. 23 et seq.

41 Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union, OJ 2006 No. C 73/21.

42 Andorra has no currency of its own. Nowadays, the Euro is used, but on an unofficial basis. Negotiations between the EC and Andorra with a view to entering into an exchange agreement similar to those entered into with the Principality of Monaco, the Vatican City and the Republic of San Marino have not led to any outcome so far.

43 See Monetary Agreement of 19 June 1980 between Liechtenstein and Switzerland, *Liechtensteinisches Landesgesetzblatt* (1981 No. 52), pp. 1 et seq. Liechtenstein had already been using the Swiss Franc for more than 50 years before the agreement was entered into.

44 Monetary Agreement between the Italian Republic, on behalf of the European Community, and the Vatican City State and, on its behalf, the Holy See, OJ 2001 No. C 299/1.

45 Monetary Agreement between the Government of the French Republic, on behalf of the European Community, and the Government of His Serene Highness the Prince of Monaco, OJ 2002 No. L 142/59.

46 The Council could, however, enact guidelines for the conduct of monetary policy which the European Central Bank would have to take into account in the day-to-day operation of the Community's external monetary policy, cf. Art. 111 (2) EC Treaty.

previously announced scheme.⁴⁷ In these cases, the internal money supply is not contingent on the foreign anchor currency nor is the balance-of-payments equilibrium automatic. Moreover, the monetary policy must be pursued according to the principle of exchange rate targeting. It is this aspect in which a currency board deviates significantly from a mere pegged currency. A currency board is a monetary authority that issues a domestic currency which is backed up by a foreign reserve currency, normally with a backing of at least 100 %, and which is legally obliged to exchange the domestic currency against the reserve currency on demand.⁴⁸ Contrary to a central bank, a currency board does not pursue any kind of ‘monetary policy’ since it has no policy choices to make as regards the money supply. The significant impact on monetary policy independence is quite clear in such a case, but it becomes literally much more visible for everybody in case of a complete⁴⁹ ‘dollarisation’, i.e. a substitution of the domestic currency with a foreign currency, which may take place officially as an exercise of monetary sovereignty. The foreign currency would in such case be made either sole legal tender or circulate alongside the persisting domestic currency. The degree of dollarisation will also depend on the policy chosen by the issuing country, which may passively accept, actively encourage or actively resist the use of its currency by another country,⁵⁰ even though there are no legal rules contained in the IMF Articles which prohibit a dollarisation.⁵¹ An active support would e.g. include the conclusion of an international agreement granting the adopting country coinage rights, access to payment systems and central bank credit.

A dollarisation can of course also take place unofficially as a consequence of behaviour of private individuals.⁵² In the latter case the domestic currency – if one ever existed – may be described as a ‘failing currency’, adopting the image of a ‘failing state’, since it remains legal tender but is not used anymore in daily life, even though the respective State may try to suppress the dollarisation.⁵³ The foreign currency does not necessarily need to be the US-Dollar. In fact it may indeed be the Euro, in which case it becomes more and more common to speak of ‘euroisation’.⁵⁴

An equally extensive but still quite different restriction (or surrender) of monetary sovereignty is associated with the establishment of a currency union. Besides the Euro Area, two of them are found in Africa,⁵⁵ another one in the Eastern Caribbean,⁵⁶ and the Golf Cooperation Council plans to establish a customs union.⁵⁷ Also in that case, the institutional design can be quite different.

47 Normally, a regular devaluation occurs to accommodate for differences in the targeted or real inflation rate between the anchor currency and the pegged currency.

48 Chown, *A History of Monetary Unions* (London 2003), p. 16; Ize, ‘Strongly Anchored Currency Arrangements’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 2 (Washington 2003), pp. 641 – 656 at 645 et seq.; Proctor, *Mann on the Legal Aspect of Money*, 6th Ed. (Oxford 2005), p. 801;

49 A currency board is sometimes referred to as ‘quasi-dollarisation’, see Altig/Nosal, ‘Dollarization – What’s in it for the Issuing Country’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington 2005), p. 807.

50 For a discussion of the perspective of the issuing country see Altig/Nosal, ‘Dollarization – What’s in it for the Issuing Country’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington 2005), p. 807.

51 For a discussion of this point see Gianviti, ‘Use of a Foreign Currency Under the IMF’s Articles of Agreement’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington 2005), p. 817. The situation is different with regard to the EU Member States that not yet participate in stage three of EMU. They are under an obligation to stay in the ERM II in order to fulfil the Maastricht Criteria on the basis of which the ultimate decision about their accession to the Euro Area will be taken.

52 The degree of an unofficial dollarisation may vary in different countries, depending on whether the foreign currency is used only as unit of account and store of value or also for (large or even smaller) daily payments, see Baliño, ‘Dollarization: A Primer’ in IMF (ed.), *Current Developments in Monetary and Financial Law*, Vol. 2 (Washington 2003).

53 That is e.g. the case in Cuba, where the use of US-Dollar was legally prohibited in November 2004.

54 Cf. Gruson, ‘Dollarization and Euroization’ in IMF (eds.), *Current Developments in Monetary and Financial Law*, Vol. 2 (Washington 2003), pp. 629 – 640.

55 West African Economic and Monetary Union. (UEMOA from its name in French, Union économique et monétaire ouest-africaine; Member States: Benin, Burkina Faso, Côte d’Ivoire, Mali, Niger, Senegal, Togo and Guinea-Bissau) and the

The Logic of Monetary Sovereignty ‘Games’

For many centuries, the main purpose of the State monopoly over money was to raise revenues for the government through seignorage profits on coinage and through inflation taxes, thereby protecting the financial power of rulers necessary to finance war against foreign enemies. With regard to the exchange regime, the maximisation of gold or silver accumulation corresponds to this role of money.

With the emergence of managed paper currencies without any metal base restricting the money supply, more effective taxation systems and other fundamental changes brought about by the 19th and 20th centuries, however, the goals of monetary policy shifted. *Keynes General Theory*⁵⁸ suggested that governments could use cheap-money monetary policy and deficit-spending to stabilize economic activity and to actively fight unemployment if they accepted some inflation which was seen as a necessary instrument to overcome nominal wage rigidities that prevented a downward real-wage adjustment in economic downswings and therefore caused huge unemployment. It also accepted a consequential decline of the external value of the currency because of its additional price-effect on real wages.

However, the ideology of intervention did not survive for more than 30 years and with the monetarist counter-revolution led by *Milton Friedman*, a policy preference for stable currencies has become almost unanimously supported around the globe.⁵⁹ The benefits ascribed to a stable currency are pretty well-known: they are the pre-conditions for money to fulfil its fundamental functions of unit of account, means of payment and store of value. Inflation leads to intransparent prices, misallocation of resources and disguised property transfers from creditors to debtors. Furthermore, a constantly inflating currency will be under constant pressure to devalue externally and it will become increasingly difficult to attract foreign capital investment. Generally speaking, a stable currency has a major overall economic welfare impact in the long term perspective.⁶⁰ It is against this backdrop only that the different ways in which States exercise their monetary sovereignty can be understood. In order to achieve economic growth and welfare, States will nowadays normally try to integrate into the world economy by encouraging cross-border trade and investment. In order to do so, they have to provide

- a stable economic environment incl. a stable currency, i.e. one which is not inflating at high speed and whose exchange rate is not under constant pressure to devalue;
- (more or less) free convertibility of the currency not only for current account transactions, but also for capital account transactions.

‘Monetary sovereignty games’ can only be understood against this backdrop. As pointed out above, the key decision for the monetary sovereign to take concerns the exchange rate arrangement it wants to follow. All of the options described above have advantages and disadvantages and to choose between

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Economic and Monetary Community of Central Africa (or CEMAC from its name in French, Communauté Économique et Monétaire de l’Afrique Centrale; Member States: Cameroon, the Central African Republic, Chad, the Republic of the Congo, Equatorial Guinea and Gabon).

56 Eastern Caribbean Currency Union, part of the Eastern Caribbean Common Market (Member States: Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines and the two British overseas territories: Anguilla and Montserrat).

57 The following quote has been taken from the official website of the GCC: ‘[The cooperation] is also designed to unify banking and monetary regulations and laws, as well as increase coordination between monetary agencies and central banks, including the initiation of one currency in order to further economic integration.’ (available at <http://www.gcc-sg.org/cooperation.html#coop5>).

58 Keynes, *The General Theory of Employment, Interest and Money* (New York 1935).

59 See Helleiner, *The Making of National Money: Territorial Currencies in Historical Perspective* (Ithaca 2003), pp. 230 et seq.

60 Cf. Ferguson, ‘Monetary Credibility, Inflation, And Economic Growth’ *Cato Journal* Vol. 26 (2006) No. 2, pp. 223 – 230; Levy, ‘Sound Monetary Policy, Credibility, And Economic Performance’ *Cato Journal* Vol. 26 (2006) No. 2, pp. 231 – 242.

them will depend upon a great deal of different economic and social circumstances prevailing in the country making the choice.⁶¹

The main advantage of floating exchange rates is seen in the relative gain in internal monetary policy independence, which enables the competent authority (i.e. normally the respective central bank), to focus on the control of inflation and economic growth inside the country.⁶² At the same time, a floating exchange rate will always ensure an equalized balance-of-payments, however at the cost of private businesses that have to live with changes in their international competitiveness and transaction cost caused by the need to hedge the inherent exchange rate risks. Furthermore, floating exchange rates do not attract speculation against the currency as may happen in case of a currency that is pegged against another one at an exchange rate above or below market rates and the central bank is consequentially under no pressure to intervene. This policy choice, as pointed out above, is prevalent in industrial countries and there is no obvious reason to abandon it within the foreseeable future, especially for the 'Big Three' USA, Japan and the Euro Area.⁶³ They have established credible commitments to low inflation, large open economies and only little to gain from more exchange rate stability, since the existing exchange risks are hedged by functioning financial markets.⁶⁴

For the rest of the world, matters are by far not as straightforward. For most of these countries, a stable currency is still a rather difficult goal to achieve. The reasons for inflation are still very poorly known, even though some key factors have been identified: an independent central bank, low level of conflict between capital and labour and decentralized forms of governments in federal systems.⁶⁵ For the last decades, the increasing integration of low-cost producer countries such as China and India into global markets and the general competitive pressures deriving from the opening-up of national markets are also deemed to have contributed to the lower inflation over the last 25 to 30 years.⁶⁶

Whatever the reasons of inflation are, once an economy has been infected, it becomes very difficult and economically very costly to get rid of the disease. The weaker the State and its government in general are the less likely a successful reconstruction of a sound monetary system with a stable currency is. In such a situation, it may be the most promising way to 'import monetary stability' by surrendering political monetary sovereignty, which in itself is an exercise of legal monetary sovereignty. The key options then are a pegged currency, a currency board or a complete dollarisation. However, these options have quite different impacts and the conditions that must be fulfilled to maintain them vary. Generally speaking, a simple currency peg, i.e. a fixed but adjustable exchange rate will be difficult to operate without capital controls and its likely breakdown creates huge political and social costs as demonstrated by Britain's exit from the ERM I and the Asian crisis of the late 1990s. This is why this kind of exchange rate regime is frequently ruled out as a policy option in economic literature. The remaining choice between a more flexible exchange rate and a more credible commitment to exchange rate stability (i.e. non-adjustable) will take into account the following

61 Of the abundant literature on different exchange rate policies and their pros and cons see Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge, USA, 2002); Eichengreen, *International Monetary Arrangements for the 21st Century* (Washington 1994), IMF (ed.), *Exchange Rate Arrangements and Currency Convertibility – Developments and Issues* (Washington 1999); Sweeney/Wihlborg/Willett (eds.), *Exchange-Rate Policies for Emerging Market Economies*, 1999.

62 If, however, monetary has only very limited effects on real economies, monetary sovereignty (understood as policy sovereignty) is indeed 'useless', cf. Schwartz, 'The Uselessness of Monetary Sovereignty' *Cato Journal* Vol. 24 (2004) Nos. 1-2, pp. 107 – 121.

63 See Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge, USA, 2002), p. 255.

64 See Eichengreen, *International Monetary Arrangements for the 21st Century* (Washington 1994), p. 134.

65 Busch, 'Die politische Ökonomie der Inflation' in Obinger/Wagschal/Kittel (eds.), *Politische Ökonomie* (Opladen 2003), pp. 175 – 197.

66 Levy, 'Sound Monetary Policy, Credibility, and Economic Performance' *Cato Journal* Vol. 26 (2006) No. 2, pp. 231 – 242 at 234.

arguments which are put forward in favour of and against flexible exchange rates or currency board or dollarisation solutions.⁶⁷

- Proponents of flexible exchange rates usually put forward the greater domestic macroeconomic policy flexibility that remains under a flexible exchange regime as well as the shock-absorber function of flexible exchange rates which allow for easier and less burdensome adjustments than a deflationary domestic policy in case of economic shocks.
- Proponents of currency boards and dollarisation emphasise the credibility-import that is associated with currency boards and dollarisation and the desired consequential loss in domestic policy discretion, but point also to the reduction of transaction costs and the likely stimulation of trade and investment.

Which of these arguments are more convincing in a given situation will depend on circumstances such as the size of the economy, the credibility of the political institutions involved in monetary and fiscal policies, the development and regulation of the financial sector, the degree openness of the economy and so on. Furthermore, the loss of seignorage profits in case of a fully-fledged dollarisation may play a role as may the need to have a national currency for symbolic integrative purposes, e.g. for newly independent states. States having gone through a conflict of a military kind may need a complete reconstruction of the monetary and financial system in which a currency board may be a quick solution to establish credibility.⁶⁸ What decision is being taken will of course also depend on policy preferences of domestic politicians, possible alliances between major political groups and long-term strategic monetary goals such as accession to the Euro Area.

The creation of a monetary union such as the Euro Area seems to have rather different reasons. Of course, the whole scale of arguments against and in favour of fixed exchange rates also applies to a monetary union, but in order to reap its benefits, it suffices to fix the exchange rates of the participating countries irrevocably. A common currency is not a necessary element of a monetary union, as was made clear by the Delors Report that outlined the way to EMU and it also imposes costs on private individuals, e.g. in connection with the change of the unit of account. However, it is equally clear that a common currency further reduces transaction costs, bolsters the credibility of the commitment to 'exchange rate' stability and has a significant symbolic meaning for the creation of a common identity among the citizens of the participating countries.⁶⁹ In the case of EMU, it is also commonly asserted that the other European countries intended to benefit from the credibility of the Deutsche Bundesbank and import the stability of the Deutsche Mark. Additionally, as it has been pointed out, the introduction of the Euro has the potential to challenge the role of the US dollar as the predominant international currency (for payments as well as reserve purposes), a role that is accompanied by significant economic benefits such as seignorage profits from the currency circulating abroad or the benefit of borrowing in domestic currency.⁷⁰

67 Cf. Baliño, 'Dollarization: A Primer' in IMF (eds.), *Current Developments in Monetary and Financial Law*, Vol. 2 (Washington 2003), pp. 613 – 628; Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge, USA, 2002); Eichengreen, *International Monetary Arrangements for the 21st Century* (Washington 1994); IMF (ed.), *Exchange Rate Arrangements and Currency Convertibility – Developments and Issues* (Washington 1999); Schuler, 'Some Theory and History of Dollarization' *Cato Journal* Vol. 25 (2005) No. 1, pp. 115 – 125.

68 On this particular problem see Lönnberg, 'Restoring and Transforming Payment and Banking Systems in Postconflict Economies', in IMF (eds.), *Current Developments in Monetary and Financial Law*, Vol. 3 (Washington 2005), pp. 725 – 753.

69 On the costs and benefits of currency unions see Tavlas, 'Costs and Benefits of Entering the Eurozone' *Cato Journal* Vol. 24 (2004) Nos. 1-2, pp. 89 – 106; Yeager, 'The Euro facing Other Moneys' *Cato Journal* Vol. 24 (2004) Nos. 1-2, pp. 27 et seq. See also Jonung, 'The Political Economy of Monetary Unification: The Swedish Euro Referendum of 2003' *Cato Journal* Vol. 24 (2004) Nos. 1-2, pp. 123 – 149.

70 See Wegner, 'EMU and the World Economy' *European Foreign Affairs Review* 1998 (3), pp. 451 – 457.

Conclusions

What is left then of ‘monetary sovereignty’ at the beginning of the 21st century and how do States use it strategically in their ‘sovereignty games’? The present paper has tried to demonstrate that monetary sovereignty is a generally accepted element of State sovereignty and that it consists of a number of different sovereign rights including the definition of a unit of account, the issuing of banknotes and coins and the establishment of an exchange rate arrangement. The most important international monetary agreement, the IMF Articles of Agreement do hardly confine the rights of its members to opt for the monetary regime they deem appropriate, except for the obligation to guarantee the convertibility of their currency for current account transactions. In fact, there are numerous options from which States can ‘choose’.

However, in making their sovereign choice, States are confronted with a practical ‘trilemma’ according to which exchange rate stability, domestic macroeconomic policy discretion and free movement of capital cannot coexist for a long time. Whereas in the past monetary sovereignty was mainly used for raising revenue (seignorage and inflation tax), the emergence of irredeemable paper currencies brought about new perspectives. During the reign of Keynesian macroeconomic policies, efforts were made to use loose monetary policies and public deficit spending to fight unemployment and economic stagnation. When the outcome after first successes was inflation plus stagnation and unemployment (‘stagflation’), the monetarist counter-revolution struck back. As a result, stable non-inflationary currencies are nowadays universally considered the primary goal of monetary policy. However, stable money has a lot to do with credibility of policy and with trust into institutions and society, something not all governments are able to generate and to build upon. In such situations, a deliberate restriction of domestic macroeconomic policy discretion by means of a credible exchange arrangement or a complete dollarisation may be the most effective and efficient way to restore a sound monetary system and may generate further benefits such as the stimulation of trade and foreign investment. Further reaching restrictions of monetary sovereignty such as they are conjoint with the creation of a monetary union will normally have a rationale that goes beyond pure economic reasons, but will also rest upon political goals, in particular the creation of an identity beyond the Nation State.

Whatever decision a State may take, the implications for its economy, society and political system will be significant and failure may be extremely costly in economic as well as in political terms. Thus, there is no such thing as a ‘monetary sovereignty game’, since the consequences are normally too serious, the stakes too high.

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