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External debt matters: What are the limits to monetary sovereignty?

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ABSTRACT

Proponents of Modern Monetary Theory frequently use the slogan that a nation State that issues its own currency possesses monetary sovereignty. The problem with this definition is that most countries issue their own currency. There are a few such as Ecuador and El Salvador that use the US dollar, or the members of the Eurozone that use a currency, the Euro, that is not issued by a member State, but these are exceptions. For the rest, sovereignty appears to be limited. To assess constraints on sovereignty initially assume a closed economy and abstract from private activity, or assume a socialist economy. Relaxing these initial assumptions will produce the conclusion that private sector activity reduces clarity, but does not impinge on sovereignty. However, the external constraint faced by most open economies does limit monetary sovereignty, irrespective of the exchange rate regime adopted.

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Introduction

Proponents of Modern Monetary Theory frequently use the slogan that a nation State that issues its own currency possesses monetary sovereignty. The problem with this definition is that most countries issue their own currency. There are a few such as Ecuador and El Salvador that use the US dollar, or the members of the Eurozone that use a currency, the Euro, that is not issued by a member State, but these are exceptions. For the rest, sovereignty appears to be limited.

To assess constraints on sovereignty initially assume a closed economy and abstract from private activity, or assume a socialist economy. Relaxing these initial assumptions will produce the conclusion that private sector activity reduces clarity, but does not impinge on sovereignty. However, the external constraint faced by most open economies does limit monetary sovereignty, irrespective of the exchange rate regime adopted.

Defining monetary sovereignty

Monetary sovereignty in the MMT tradition is most clearly represented as the condition in which expenditures by government issuing its own currency are not limited by a budget constraint. A budget constraint for a government may be defined as income, usually tax receipts or other imposts, or the ability to borrow to offset any discrepancy between income and expenditure. As a result of the stipulation that governments need not tax or borrow to finance expenditures, this definition leads to the fiscal policy conclusion that government need not operate with balanced budgets, nor impose austerity policies that sacrifice full employment to do so.

Nonetheless, we observe governments that do impose taxes and issue debt; sovereignty thus requires a further explanation of the absence of the budget constraint. While taxation is not required to finance government expenditure, it is argued that levying tax creates the willingness of the citizens to accept the sovereign's currency in exchange for provision of goods and services to government. Instead of quantitative targets for production appropriated by the government in a command economy, goods and services are willingly provided to the State in exchange for sovereign money.

This willingness is explained by reference to Knapp's theory of "State money" (Knapp 1924) which argues that if the State imposes a liability on its citizens in the form of a levy or tax that can only be discharged by rendering the State's sovereign currency liability then the only way to escape tax prison is to acquire that currency by providing goods and services to the State, or to provide goods and services to someone else who has done so. Here the budget constraint on government expenditure is the physical output of the economy, rather than the means to pay for it. The State can only acquire as much as can be produced, but there is no financial constraint forcing it to spend less and leave unemployed resources.

This means that taxes are considered an incentive, rather than an impediment, to economic activity. It also means that the State must impose taxes to create the ability to use its sovereign currency to finance expenditure. This is an alternate constraint on government expenditure: it must be at least equal to the tax obligation levied on the population, for if it were not the population in aggregate would default on its tax liabilities. This implies that the normal government budget should never be in surplus.

If citizens for whatever reason choose to hold currency in excess of their tax liability, then government must spend more than it collects in taxes to provide this additional currency held by the public. Fiscal stability, and avoiding penal servitude of the population, thus requires that the government accounts should always show a negative balance in these conditions.

While this explanation is sufficient to show why government need not borrow to finance its expenditures, some governments do so. If some

households hold currency in excess of their tax liabilities, while there are others with a shortfall of currency relative to tax obligations borrowing and lending might take place, generating interest rates determined by idiosyncratic personal credit risks.

To engage in economic policy measures and manage market interest rates governments could issue interest paying debt to absorb part of the expenditure deficit in order to provide a minimum benchmark interest rate for various tenors of debt. Issuing this debt provides a minimum rate because the debt is risk free compared to private debt; it can always be redeemed by the issue of the sovereign currency. This leads to the conclusion that the government need not pay interest or borrow its own sovereign currency, but it may do so to influence interest rates for monetary policy purposes.

This possibility means that the issue of debt must be coordinated with the imposition of taxes because it will generate future interest payments to holders of the debt. This adds to the conclusion that the government budget balance must be negative the corollary that there is no reason for there to be any economic relation between government deficits and interest rates. Interest rates created by debt issue represent a policy decision, not a law imposed by financial markets—or what have been called the “Bond market vigilantes.” But it does suggest the need for coordination between fiscal and monetary policies.

While Knapp is used to explain the demand for sovereign currency, and government expenditures explain the issue of currency, this leaves open the question of the mechanism employed to create the sovereign currency and the possible issue of term debt. That is, what is the procedure for issuing the sovereign currency, for writing the government IOU's that citizens are required to acquire in order to discharge the imposed tax liability? Is there a government employee with a pen and blocknotes that writes up these notes?

One possible institutional structure would be a Budget and Planning Ministry¹ charged with the coordination of a Finance Ministry responsible for tax collection, and a Treasury Ministry responsible for government acquisition and distribution of goods and services. In this configuration the Treasury would create a liability when it issues the sovereign currency used in its acquisition of goods and services (and would recover part of that currency if it issues term government debt), while the Finance Ministry creates credits by imposing taxes to absorb the sovereign currency liabilities paid to households for goods and services. The Treasury Minister issues sovereign currency IOUs to finance government expenditure while the Finance Ministry ensures that the currency will be accepted by applying the appropriate level of taxation and collecting the currency: It is the role of the Budget Ministry to coordinate these two activities.

Note that in this arrangement there is no need for a central bank to create liabilities (high powered money) against the acquisition of government debt. Indeed, we note that government debt is issued to households in order to influence the rate of interest on private sector financial intermediation, so there is no need for a central bank to hold government debt as assets to back the issue of its liabilities. Indeed, a corollary of the independence of interest rates from the government's fiscal balance is the redundancy of a central bank to manage interest rates or provide prudential regulation in a sovereign currency system. The issue of sovereign liabilities and term bonds by the Treasury is all that is required. In this sense it appears that MMT is in essence a theory of fiscal policy sovereignty or what Minsky would call "fiscal autonomy" (see Minsky 1989 and below).

Indeed, there appears to be no reason why a sovereign government Treasury Minister needs to issue a sovereign currency in the form of physical IOU's, or operate a mint or printing press to create them. Since every citizen has a notional debit account for taxes due with the Finance Ministry on the income that is recorded in a credit account with the Treasury for provision to the government, the Budget Ministry could keep a consolidated balance sheet for the two ministries representing the fiscal position of the government. The Treasury balance sheet would have an account for credits given to the public for the acquisition of goods and services and debits for the value of public credits granted. The Finance Ministry would have debits for the taxes due on the public receipt of Treasury credits, and credits for the tax receipts. The Budget ministry would thus be recording the liabilities of the government denominated in notional units of the sovereign currency against the tax liabilities. The books kept by the Budget Ministry would always balance since every Treasury debit to the public has a counterpart in the Finance ministry credit to the public for taxes paid. As Schumpeter (2014, Chapter IV) has noted this looks very much like a Socialist economy in which a "central office" distributes a pro rata share of the goods and services acquired determined by labor hours worked (or any other system of allocating purchasing power that might be imposed). No banking system is necessary, but a set of rules governing distribution (e.g. according to hours worked) is required.

Complications arise when the Treasury issues interest bearing debt to create benchmark interest rates, which reduces the Treasury's current sovereign currency debit to the public for goods and services and increases them in future when interest is paid. On the Finance Ministry account the public has a reduced credit to taxes which is balanced by the increase when interest is paid. But this does not disturb the balance of the accounts. It is thus still possible for the system to function without the existence of a government sovereign currency in the form of banknotes or coin.

Bank money and state money

Outside of a Schumpeterian socialist economy the government may not absorb all output and there will be private sector activity in addition to the personal borrowing and lending mentioned above. Again, this creates a complication that does not vitiate sovereignty. The complication occurs because citizens will now have incomes that exceed those generated by sale of goods and services to the government and registered in the Treasury accounts. The Finance Ministry will thus have to monitor private sector incomes in order to assess taxation on income from sales to government and sales to other private sector units, and it will be the responsibility of the Budget Ministry to ensure that it does not violate the principle that the budget balance be negative. Second, the operation of private market purchase and sales may be intermediated by use of the sovereign currency, which would have an impact on the size of the government deficit required to finance private transactions and depend on the velocity of circulation.

While it is possible for the private sector to engage in production and exchange activity using the sovereign State money, most analysts have noted that historically the private sector developed an independent financial system prior to and independent from that of State money; indeed that in most economies the share of State money is extremely small, being limited by the size of government.

For example in a “Foreword by a Banker” to Fisher (1935, xxii) “If all bank loans were paid, no one would have a bank deposit, and there would not be a dollar of currency or coin in circulation.” Which simply indicates that in modern financial systems the public often does not even have direct access to State money and can only acquire it via the private financial system. As the unbanked can testify, it is extremely difficult to access State money in the form of notes or coin without a private banking relationship—you must beg, borrow or steal! This would seem to make it impossible to engage in private activity without participating in the private financial system.

Thus Colwell’s principle explaining the dominance of private bank money that “No currency can be more suited to pay a man with than that which he has issued himself.” (Colwell 1859, 8) is used by Mitchell Innes (1913, 37) to explain “how such acknowledgements [of indebtedness] acquire value in the case of private persons. We are all engaged in buying and selling. We manufacture commodities for sale ... and the only way in which we can be paid for the services we thus render is by receiving back from our purchasers the tallies which we ourselves have given in payment of like services which we have received from others.” ... may be extended to government “But a government produces nothing for sale, and owns little or no property; of what value then, are these tallies to the creditors of

the government? They acquire their value in this way. The government by law obliges certain selected persons to become its debtors. ... This procedure is called levying a tax, and the persons thus forced into the position of debtors to the government must in theory seek out the holders of the tallies or other instrument acknowledging a debt due to the government, and acquire from them the tallies by selling to them some commodity or in doing them some service, in exchange for which they may be induced to part with their tallies.”²

Mitchell Innes further notes that “of all the false ideas current on the subject of money none is more harmful than that which attributes to the government the special function of monopolizing the issues of money. A government dollar is a promise to ‘pay,’ a promise to ‘satisfy,’ a promise to ‘redeem,’ just as all other money is. All forms of money are identical in their nature.” Keynes took a similar position, “Historically a good many examples of representative State money are descended from some kind of bank money, which by being adopted by the State has subsequently passed over from one category to the other.” (Keynes 1930a, 6) And “Nevertheless, whilst representative money is a relatively modern device, it was, as we have seen, adapted and taken over by the State from a far more ancient contrivance of private finance – namely bank money.” (Keynes 1930a, 13) “We thus have side by side State money or money proper and bank money or acknowledgements of debt.” (Keynes 1930a, 2, 5). Thus it is most likely that the private sector would have already developed its own system of payments via creation of a system of private debts and credits operated by private sector financial institutions creating what Keynes called “bank money” which was subsequently joined by State sovereign money.

This raises the question of whether the existence of private “bank money” impinges on the sovereignty of State money. First note that this private money is what Schumpeter (1912) refers to when he states that the banker can create purchasing power out of nothing. Second, while the principle behind both is the same, and the liabilities issued by the State and the private financial institutions both serve as means of acquiring the output of the economy the assets held on the balance sheet of each are different.

The liabilities that the government issues in the form of currency and the liabilities it imposes on the population in the form of taxes due are both subject to government decision and coordination in the Budget ministry. On the other hand, in the private system the liabilities issued in the form of means of payment created out of nothing to finance production can only be recovered by the success of the enterprise in the market. For the private financial system the assets banks hold as loans are the liabilities of private sector producers who have to undertake successful production and sale in the market to acquire the bank liabilities to extinguish their

liabilities. While the government can always adjust the tax liabilities to accommodate imbalances, private individuals and financial institutions are at the mercy of the market and in the case of imbalance must take capital losses which will impinge on private sector credit creation. For State money the Budget ministry ensures sovereignty while for bank money it is the market which often fails to ensure stability.

As a result it is possible to have a run from the private liabilities and the creation of financial instability. Such conditions have historically produced the introduction of prudential regulations in which the issue of private liabilities is limited by a linkage to the sovereign currency in the forms of reserves or capital ratios via the creation of a regulatory authority or a central bank. Further, the Finance and Treasury Ministry may choose to hold accounts with the Central Bank or private banks. These measures to ensure stability of the private sector financial liabilities creates a direct linkage between State money and private bank money, as well as between the Treasury and the Central Bank which clouds the simple sovereignty managed by the Budget ministry. This is one reason Schumpeter argued that the Socialist model was more perspicacious in identifying the essence of monetary analysis than private property. It also explains why many economists analyzing monetary sovereignty choose to treat the Treasury and the Central Bank as a single entity. To the extent that this creates a hierarchy of State money over bank money, this is solely due to the institutional-regulatory arrangements and the difference in the ability to control State and private liability—the market result for bank money and tax or expenditure decisions for State money.

The external constraint

Further complications are introduced when foreign trade and payments are taken into account. It is quite easy to see that this will create complications in recording income and tax obligations similar to the case with private sector activity. First, the income of the foreign suppliers of imports will not be recorded by the Treasury or the Finance Ministry, and most importantly this means that neither the individual nor the income is subject to domestic taxation. There is then no incentive to accept either the importer's private liability or the sovereign currency of the government of the importer's residence in payment. Similarly, there is a debit in the Treasury account, but it will be denominated in foreign currency. The tax credit representing the levy on the exporters income and the importers purchase credits lie in different national jurisdictions.³ However, these cross-border imbalances could be resolved if exports of an equivalent amount create domestic

income in the form of a claim on the foreign government's sovereign currency.

The Budget ministry would thus be required to introduce an additional set of accounts for purchases and sales to foreign entities in which debits and credits would be kept in foreign sovereign currency. For the Finance Ministry loss of taxes on imports would just offset the taxes imposed on export earnings. As long as debits and credits balance there would be no impact on the sovereignty conditions set out above. In an open economy Sovereignty is maintained in conditions of balanced external accounts. Note that in these conditions there will be no compensatory cross-border borrowing and lending since debits and credits match in the domestic sovereign currency of each country, so the capital account can be ignored.

Thus while sovereignty is associated with a neutral or negative government budget balance, this depends on the existence of external balance. The question then becomes how that balance is to be maintained aside from direct government controls to maintain balance as were applied in Socialist systems.

Traditional economics argues that the gold standard is the prerequisite for sound money of stable domestic and international purchasing power, while fixed exchange rate systems such as the gold standard are considered to be incompatible with monetary sovereignty. If the gold standard is defined as a 100% gold coin or 100% gold backed paper currency system It is clear that such a system cannot be considered as Sovereign: the demand for the currency is determined by the value of the gold it represents, while supply is determined by gold production. Both are outside government Sovereign decision and thus may impose a budget constraint on government spending.

However, rather than providing both monetary and exchange rate stability the gold standard was a mechanism to ensure external balance (or as Keynes was told during the Macmillan Committee hearings, to prevent the Bank of England losing gold, which is the same thing). In this view, the gold standard is a mechanism to ensure price instability and unsound money (price flexibility) in order to move relative import and export prices to values that generate external balance. Here the gold standard is incompatible with domestic price stability, but is compatible with sovereignty since it would insure external balance! Which then suggests that external balance is a necessary but not sufficient condition for sovereignty.

The alternative to the gold standard would be to allow exchange rate flexibility to substitute for domestic price flexibility in insuring external balance. This requires the substitution of the gold standard with a system Keynes and others called "managed" representative money. Unlike gold, representative money does not physically or formally enter the process of

external adjustment; its domestic value remains stable with appropriate monetary policy, although its foreign purchasing power is variable. If exchange rate adjustment of managed money can produce external equilibrium this should give the necessary and sufficient conditions for sovereignty in an open economy.

However, this result has one additional condition—that the Marshall–Lerner conditions are met for all countries.⁴ This is equivalent to the assumption that all countries are in external balance and thus all have monetary sovereignty. Or equivalent to the existence of a common global government and currency, in which case the problems of exchange stability and external balance are thought to disappear. But so does the sovereignty of the individual state.

But these elasticity conditions will never be met, unless all countries in the trading system have similar domestic policy objectives, productive conditions and financial systems. As noted above, these problems are similar to those Keynes raised in his criticism of asymmetric adjustment between debtor and creditor countries. As we know from the specification of the Keynes–Kaldor–Godley financial balances approach, if budget ministry coordination produces a government budget balance that just offsets a private sector financial surplus, the external balance would be in equilibrium and preserve sovereignty. Here it is not the operation of relative international prices or the exchange rate that ensures the result it is the use of monetary sovereignty to influence aggregate economic activity. Thus the use of government budget measures to just offset a private sector surplus, would preserve external balance and sovereignty.

But, there are conditions in which countries may choose other budget configurations. The most obvious example pertains to development strategies. Some countries have chosen to finance development on the basis of foreign capital inflows (debt-led development), producing sustained external deficits and others have sought to use export-led strategies and sustained external surpluses. Similar conditions were present in the period of dollar scarcity after the Second world war as well as during the postwar recovery in Europe when Germany chose a combination of private sector and government surplus that produced an external surplus. Sovereignty would then depend on the financial balance of the private sector.

Such conditions led Angus (1935, 184) to comment “It is obvious that no country can go on forever covering by new lending a chronic surplus on current account without eventually forcing a default from the other parties.” While Keynes concurred “It is impossible for any one country, or for countries as a whole, ever to have a permanent excess of exports (or imports), visible and invisible, unless international defaults occur.” (Keynes 1946, 32)

It was Domar (1950) who provided the analytics behind these cryptic statements which are simply based on the idea that foreign debt is the equivalent of imposing a foreign currency tax liability on domestic residents: since only an export surplus can generate the means to meet debt service, it constrains the sovereignty created by the Finance ministry taxation on domestic currency incomes. Thus any country that wants to receive debt service on its foreign lending has to lend its currency abroad in sufficient amounts to allow those payments to be made.⁵ Which contradicts the definition of sovereignty for both the debtor and creditor country.

Domar put it more succinctly, to be able to sustain foreign borrowing at a stable share of income it is necessary for the interest rate on the borrowing to be equal or less than the rate of increase of the stock of debt. As we now understand, this is the equivalent of what Minsky called a Ponzi scheme and the cause of frequent financial crisis which represents a major loss of sovereignty.

Fiscal autonomy and international sovereignty

This raises the question of whether it is possible for a national sovereign currency to have international sovereignty? Why was sterling the international money in the 19th century and the dollar in the 20th century. We might say that England made sterling sovereign by imposing taxation on the members of the British Empire—the home charges on India as example. But most economists argue that the real reason was the structure of the British balance of payments: a deficit on trade more that offset by factor service payments (interest on foreign lending and things like the home charges) which produced a current account surplus. It was the foreign lending that imposed sterling debt service payments and substituted for taxation in determining international sterling sovereignty.

Minsky follows the same logic when he notes “The United States had a great deal of what we can call fiscal autonomy over almost all of the post war period: there was no need for American policy makers to be much concerned about adverse foreign reactions to the steps that were taken to contain and reverse episodes of embryonic financial instability and the deficits that sustained domestic profits.” (Minsky 1989, 10) Thus “countries with large positions in offshore assets possess fiscal autonomy.” However, he also notes that if domestic sovereignty frees the country from a government budget constraint and allows fiscal deficits to respond to domestic financial instability this may conflict with international monetary sovereignty and reduce fiscal autonomy. “If global profits are to be sustained such countries need to maintain domestic profits even as they run an international trade deficit.” (Minsky 1989, 11).

Thus Minsky argued that the “accumulated deficit have led to a large foreign holdings of United States financial assets. The large United States government deficit in relatively prosperous times means that the deficit that is needed to sustain profits in the aftermath of even an aborted financial crisis may well be enormous. In the environment that now exists the interventions needed to sustain the economy the next time may well be beyond what the combined efforts of the Federal Reserve and the Treasury can sustain: financial market may reject even the liabilities of these institutions.” (Minsky 1989, 11).

Minsky suggests that “The containment of some future economic and financial crises may depend more on what Japan and Europe do than upon the Federal Reserve and the United States Treasury” (Minsky 1989, 11) because their external surplus provides them with fiscal autonomy which the US no longer maintains.

Alternatively he suggests that the government has to restructure its fiscal policy to restore “fiscal autonomy” in the form of an external surplus: “The government cannot be in a structural ‘Ponzi’ financing posture: the in place tax and spending programs need to show a surplus, not necessarily now but when things are going well. . . . There is nothing in principle nor in the facts of an economy with public and private debts that says that the United States cannot become an Argentina: a country whose debts, whether denominated in its own or in foreign currency, are not marketable.” (Minsky 1989, 14).

As international financial markets became global and integrated Minsky (1979, 1983) raised an additional complication: the ability of international banks to change the denomination of international held debt which may diverge from actual capital flows determined by the external accounts. He notes that exchange rate instability produced by a change in the denomination of international debt issued or held by nonresidents may make it necessary for the Central Bank of the country of major currency denomination to generate an external account balance that ensures the ability of debtors to meet debt service payments. It thus appears highly unlikely for a country with a sovereign currency but an external imbalance to have fiscal autonomy and to have a sovereign international currency unless it takes measures to constrain its fiscal position.

To resolve this problem Keynes’s initial proposal (Keynes 1930b, Chapter 36) was direct measures to introduce capital controls. However, he subsequently suggested the impossibility of international sovereignty for a national currency and proposed a common unit of settlement for international transactions in the form of a Clearing Union (Keynes 1980). Even this proposal required a partial loss of sovereignty since an excess of a members’ external position above given limits would trigger a penalty and

if not remedied subject to recommendations of adjustment in domestic policy on decision of the other members of the Union and would represent an imposed international budget constraint. Kregel (2015, 2019) surveys the various proposals made in this regard in addition to Keynes's Clearing Union.

Notes

1. Rendered in Italian as Ministero del bilancio e della programmazione economica which indicates that it is the bookkeeper managing the government balance sheet accounts on income and expenditure.
2. Minsky (1970, note 8) adopts a similar position: "For fiat money to be generally acceptable and valuable there must be a set of payments units must make for which this money will do. ... money as a liability ... acquires value in the market because there exist units, the debtors ..., which have payments to make for which this credit money will be acceptable. The acceptability and value of money depend on the existence of payments denominated in that money: thus fiat money ... without debtors under constraint to meet payments commitments are quite meaningless concepts."
3. It is interesting that Smith in the *Wealth of Nations* already notes in his analysis of the impact of paper money that "any superfluous issue due to 'overtrading' would result in reflux to the banks because it could not find domestic employment and, unlike gold" "they could not send it abroad" (Smith 1937, 284).
4. It is often forgot that these conditions only hold if both countries are initially in external balance making the conditions even more restrictive than they might first appear. The difficulty is that if there is an initial imbalance it has to have been financed on capital account, which will generate debt service flows on factor service account, so that adjustment in the goods and services balance may not be sufficient restore balance.
5. "Whether or not an ... excess of inflow of funds over the outflow will at all appear depends on the relative magnitudes of the rate of growth [of the stock of debt] and of the interest rate. If the rate of growth exceeds the interest rate, this ratio will be less than one, and an import balance will never arise. If, on the other hand, the rate of growth falls below the rate of interest, an import balance will become inevitable, its timing depending on the magnitudes of [the annual amortization rate, the annual interest rate, and annual rate of growth of debt stocks] In any case, the ratio between the inflow and the outflow will be gradually stabilized unless of course the variables themselves change". (Domar 1950, 808)

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