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CAPITALISM IN ONE COUNTRY?: A RE-EXAMINATION OF MERCANTILIST SYSTEMS FROM THE FINANCIAL POINT OF VIEW

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INTRODUCTION

Kam and Smithin (2008) use the term "monetary mercantilism" not to refer to protectionism as such, but rather a general policy of stimulating aggregate demand, and hence full employment, economic growth, general prosperity, *etc*., by various financial and monetary techniques. These might include, for example, a monetary policy that delivers low and stable real interest rates (Smithin 2003, 2007, 2009), or Keynesian-type expansionary fiscal policy. We note that Humphrey (1998) also uses the expression mercantilism (without the qualifier) in a somewhat similar way, casting the entire history of economic thought as a contest between "mercantilism" and "classical economics", with figures like Law, Steuart, Tooke, Keynes and Kaldor on the one side, and Hume, Smith, Thornton, Ricardo and Friedman, on the other. According to Humphrey (1998):

> This policy prescription [protectionism] was, of course, the mercantilist's main claim to fame. But the hallmark that secures them a permanent niche in the history of monetary doctrines was their contra- or anti-quantity theory of money.

As far as the international situation is concerned, the expectations of those pursuing such "mercantilist" strategies (as now defined) might well have been that along with higher growth, they would also lead to a strong current account, and (perhaps most obviously under a system of floating exchange rates) the building up of a foreign *credit* position, rather than becoming indebted either to other nations or to international financial institutions. Kam and Smithin (2008) have also suggested that historically, whether under flexible exchange rates or not (and whether or not the issues were fully understood/articulated by the relevant decision-makers at the time), strategies that might be characterized this way were indeed employed by many nations that *did* succeed in achieving stronger economic growth, and hence a prominent global economic and political position in the "capitalisms" of their day. In present paper, moreover, it is shown that similar policy options continue to exist, even in modern conditions created by globalization, increasing economic integration, and increased capital mobility (Palley 2004),[1] given certain preconditions. These are, first, the domestic political situation, specifically a certain type of domestic political "settlement" or bargain (Ingham 2004, Kim 2009), leading to the development of the necessary domestic financial and business infrastructure; second, an independent currency; and third; either floating exchange rates, or, with fixed nominal rates, the existence of sufficient residual frictions or (perceived) remaining currency risk such that the conditions of a "virtual" floating exchange rate system are replicated. This is the meaning of the expression "capitalism in one country" (a pun on Stalin's "socialism in one country"). However, it would not be correct to describe such an approach as a "beggar-thy-neighbour" policy, as some writers might be inclined to do. As shown below, if one country alone does pursue the type of policy suggested here and others do *not*, there may be circumstances in which it will be to the first mover's sole advantage. They may eventually gain a hegemonic position, as has been seen historically. However, we would also argue that the world economy is not in principle a zero sum game. Even in such cases, if each nation (given the necessary socio-political preconditions) were to pursue similar policies simultaneously then (in that ideal set of circumstances) the result would simply be higher overall world growth with balance across both the current and capital accounts (Kam and Smithin 2008). There also exist other situations in which expansionary policies seem to simply to improve domestic conditions, and have little or no effect on the real exchange rate or on the foreign credit position. There seems to be nothing, therefore, to preclude offering similar policy advice to each jurisdiction separately. It should be still be emphasized, nonetheless, that the formal analyses undertaken below do relate only to one jurisdiction acting alone with others taking no action.

The underlying premise of the paper is a heterodox rather than a mainstream approach to monetary and financial issues, including, specifically, the concepts of endogenous money and the importance of credit/debt creation for the enterprise economy (Smithin 2009, 2010). Also prominent is the key idea that *both* the real interest rate and the real exchange rate are *monetary* variables, rather than being determined by such things as time preference in the one case, or the barter terms of trade in the other (Kam 2005, Kam and Smithin 2004, 2008, Smithin 2003, 2006). This paper illustrates that policy views on international economics relations, quite as much as those on the domestic economy, will differ essentially depending on the underlying social ontology and the theory of money and finance adopted (Bougrine and Seccareccia 2008, Seccareccia 2003/04). In what follows, a formal macroeconomic model of the open economy is presented, examining such topics as the role of flexible versus fixed exchange rate regimes, changes in the general level of aggregate demand, changes in domestic monetary and fiscal policy, and innovations in productivity.

A SIMPLE MACROECONOMIC MODEL OF A SMALL OPEN ECONOMY WITH FLEXIBLE EXCHANGE RATES

Consider the following linear model of a small open economy with a separate currency and floating exchange rates, and which, as a result of domestic political conditions, is able to issue foreign debt denominated in the domestic currency:

(1) $y = [1/(1+\varepsilon\eta+\gamma)]d - [(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]t - [(\alpha-\varepsilon\theta)/(1+\varepsilon\eta+\gamma)]q + [\varepsilon/(1+\varepsilon\eta+\gamma)][a - w_0 - r]$

(2) $p = p_0 + t + w_0 - a - \theta q + \eta y$

(3) $\delta b/\delta\tau = \alpha q + \gamma y + rb$

(4) $\delta q/\delta\tau = r^* - r + \zeta b$

The endogenous variables are:

y = the growth rate of real domestic product (GDP),

p = the domestic inflation rate,

q = the logarithm of the real exchange rate (where the nominal exchange rate is defined as the foreign currency price of one unit of domestic currency).

b = the real foreign debt position as a percentage of base-year real GDP, denominated in domestic currency.

The exogenous variables, including policy-determined variables, are;

d = autonomous demand as a percentage of GDP, equal to government spending as a percentage of GDP *plus* an intercept term from an investment function as a percentage of GDP - Keynes's (1964) "animal spirits" - *minus* the average propensity to save,

t = the average tax rate,

r = the domestic real interest as influenced (in particular) by the financial policies of the domestic central bank,

a = the log of labor productivity,

w_0 = the intercept in an after-tax target real wage equation (in logs); representing socio-political influences on the real wage bargain (the strength of labor unions, the state of labor law, *etc*.),

r^* = the foreign real interest rate,

p_0 = the intercept in the inflation equation; this will depend on fixed parameters of the money demand and (endogenous) money supply equations.

From among the exogenous variables r^*, p_0 and w_0 will be treated as constants for present purposes. Therefore, the paper investigates changes in each of d, t, r, and a, respectively. The parameters of the system are:

ε = the sensitivity of aggregate investment as a percentage of GDP to changes in the average mark-up or "rate of surplus value" ($\varepsilon > 0$),

α = the sensitivity of the trade balance as a percentage of GDP to changes in the real exchange rate ($\alpha > 0$),

η = the sensitivity of the after-tax target real wage target (in logs) to an increase in real GDP growth ($\eta > 0$),

θ = the weight assigned to the price of imports (in terms of domestic currency) in calculating the price index used in determining the after-tax real wage target, ($0 < \theta < 1$),

γ = the analog to the textbook Keynesian "propensity to import" ($0 < \gamma < 1$),

ζ = the sensitivity of the currency risk premium to changes in the foreign debt position as a percentage of base-year real GDP, ($\zeta > 0$).

The terms $\delta b/\delta\tau$ and $\delta q/\delta\tau$ are the time derivatives of the foreign debt position, and the (log of) the expected future real exchange rate, respectively. Note also that $(\alpha - \varepsilon\theta) > 0$. This term is taken to be positive by analogy to the "Marshall-Lerner conditions" from non-monetary international trade theory. For mathematical convenience, the foreign price level is normalized at $P^* = 1$, and the foreign inflation rate therefore, at $p^* = 0$.

STABILITY IN THE FLEXIBLE EXCHANGE RATE CASE

Setting all exogenous variables equal to zero the dynamic system reduces to:

(5) $\delta b/\delta\tau = \alpha q + \gamma y$

(6) $\delta q/\delta\tau = \zeta b$

also, note that from (1) we have:

(7) $y = -[(\alpha - \varepsilon\theta)/(1+\varepsilon\eta+\gamma)]q$

therefore, the system can be written in matrix form as:

(8) $$\begin{vmatrix} \delta b/\delta\tau \\ \delta q/\delta\tau \end{vmatrix} = \begin{vmatrix} 0 & [\alpha(1+\varepsilon\eta)+\varepsilon\gamma\theta]/(1+\varepsilon\eta+\gamma) \\ \zeta & 0 \end{vmatrix} \begin{vmatrix} b \\ q \end{vmatrix}$$

Let Δ = the coefficient matrix. Stability requires that $tr\ \Delta < 0$ and $det\ \Delta > 0$. However, we have:

(9) $tr\ \Delta = 0$

(10) $det\ \Delta = -\zeta\{[\alpha(1+\varepsilon\eta)+\varepsilon\gamma\theta]/(1+\varepsilon\eta+\gamma)\}, \qquad (< 0)$

Therefore, the system has a saddle-point, meaning that there is just one stable path to equilibrium (the “stable arm”) and all other trajectories are unstable. As previously explained by Kam and Smithin (2004), however, in the modern mainstream economics literature this finding in itself is usually regarded as sufficient justification to proceed to comparative static analysis around the equilibrium. This is on the grounds that it is always possible to invoke the existence of a “jump variable” within the system, based on the likely behavior of the various players in the economy, and able to shift the system on to the single stable arm Although this is by now standard practice in mainstream economic theory, as a general proposition it is not, in fact, as convincing an argument as the graduate level textbooks make it seem. In the mathematical jargon, it requires specifying a plausible “transversality condition”, grounded in the actual behavior of the actors in the system, to achieve the desired goal. In reality (as opposed to working through a purely mathematical exercise), there may exist several types of economic scenario in which it is not possible to do this. We make this observation as a general caveat. In the present case, however, as it specifically involves asset markets in foreign exchange, it nonetheless does seem plausible to appeal to the likely behavior of the participants in these markets to provide the solution. These players will be constantly involved in valuing, revaluing and rearranging their portfolios, and hence it becomes possible to suggest that the asset values can be either inflated or deflated sufficiently, as the case may be, such that the system eventually arrives on the stable arm.[2] Therefore, in the next section we proceed to a comparative static analysis.

COMPARATIVE STATICS IN THE FLEXIBLE EXCHANGE RATE CASE

The equilibrium solution in the flexible exchange rate case is:

(11) $y = 1/(1+\varepsilon\eta+\gamma)d - [(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]t - [(\alpha-\varepsilon\theta)/(1+\varepsilon\eta+\gamma)]q + [\varepsilon/(1+\varepsilon\eta+\gamma)][a - w_0 - r]$

(12) $p = p_0 + t + w_0 - a - \theta q + \eta y$

(13) $0 = \alpha q + \gamma y + rb$

(14) $0 = r^* - r + \zeta b$:

Next, work out the comparative static derivatives. These are:

(15):

$\delta y/\delta d = [1/(1+\varepsilon\eta+\gamma)]$, $\delta y/\delta r = -[\varepsilon/(1+\eta+\gamma)]$,

$\delta y/\delta t = -[(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]$, $\delta y/\delta a = [\varepsilon/(1+\eta+\gamma)]$

$\delta p/\delta d = [\eta/(1+\varepsilon\eta+\gamma)]$, $\delta p/\delta r = -\eta[\varepsilon(1-\theta)+\alpha]/(1+\varepsilon\eta+\gamma)$,

$\delta p/\delta t = [\eta(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]$, $\delta p/\delta a = -[(1+\gamma)/(1+\varepsilon\eta+\gamma)]$,

$\delta q/\delta d = 0$, $\delta q/\delta r = -[\zeta b+r)/\alpha\zeta]$,

$\delta q/\delta t = 0$, $\delta q/\delta a = 0$,

$\delta b/\delta d = 0$, $\delta b/\delta r = 1/\zeta$,

$\delta b/\delta t = 0$, $\delta b/\delta a = 0$.

The signs of the comparative static derivatives may then be conveniently summarized as in Table 1 below.

Table 1: Signs of the Comparative Static Derivatives in the Floating Exchange Rate Case

	δd	δt	δr	δa
δy	+	-	-	+
δp	+	+	-	-

δq |	*0*	*0*	+	*0*
δb |	*0*	*0*	+	*0*

Therefore, the results show that low real interest rates on money (that is, an expansionary monetary policy, or "cheap money" - in the true sense of the term) will tend to increase the growth rate, just as old-time mercantilists would have suggested. It will also increase the inflation rate, but notice that inflation will not "accelerate" (that is, get out of control) after the initial increase. We are back in a realm in which there is a "trade-off' between inflation and growth, at least as far monetary policy is concerned. Meanwhile the real exchange rate will depreciate, and the foreign debt position will be reduced (or the credit position increased), in what seems like the classic monetary mercantilist scenario alluded to above.

An expansionary fiscal policy by means of an increase in government spending as a percentage of GDP (illustrated here by an increase in the demand variable *d*), will also increase the growth rate, much as a Keynesian advocate of "stimulus" would argue. Again there will be a somewhat higher inflation rate, but not an "ever-accelerating" rate. Interestingly enough, a change in the demand variable ultimately has no effect on either the real exchange rate or the foreign debt position. This occurs because by construction the (*e.g.*) expansionary fiscal policy is carried out against the background of a stable monetary policy, that is, stable real interest rates (Smithin 2007). This reinforces the point that the real exchange rate, like the real interest rate, is above all a monetary variable.

A fiscal stimulus brought about by a reduction in the average tax rate rather than an increase in spending - either way entailing an increase in the budget deficit – is another means of increasing the growth rate, *via* a combination of demand side and incentive (supply side) effects. In this case, however, it is important to note that the inflation rate *falls* rather than rises, because of the impact of lower taxes on production costs. As with increases in spending, tax cuts ultimately seem to have little or no effect on the real exchange rate or the foreign debt position.

The final change to be considered is the impact of an increase in productivity, as might occur, for example, in the Schumpeterian model of growth due to technological innovation. In the present model this may be represented by an increase in the exogenous variable, *a*. In a similar manner to the effect of tax cuts this will lead to an increase in the growth rate, together with a fall in the inflation rate. This recalls, for example, the discussion of the so-called "new economy" scenario of the 1990s (Atesoglu and Smithin 2007; Smithin 2009). Once again, however, we should point out that this situation is "allowed" to occur because of the backdrop of a stable monetary policy, with no interruption in the provision of financing. The opposite case, a fall in the productivity variable, *a*, would alternatively lead to 1970s-style "stagflation", with growth falling and the inflation rate rising.

A MACROECONOMIC MODEL OF A SMALL OPEN ECONOMY WITH A "HARD PEG" (AN IRREVOCABLE FIXED EXCHANGE RATE REGIME)

If, instead of floating the exchange rate, we institute a fixed exchange rate system which is confidently expected to be a "hard peg", an "irrevocable" fixed exchange rate, or a "credible" fixed exchange rate regime (which are some of the expressions commonly used), the macroeconomic model set out in equations (1) to (4) above must be changed to:

(16) $y = [1/(1+\varepsilon\eta+\gamma)]d - [(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]t - [(\alpha-\varepsilon\theta)/(1+\varepsilon\eta+\gamma)]q + [\varepsilon/(1+\varepsilon\eta+\gamma)](a - w_0 - r)$

(17) $p = p_0 + t + w_0 - a - \theta q + \eta y$

(18) $\delta f/\delta\tau = \alpha q + \gamma y + r(1+\upsilon)f$

(19) $\delta q/\delta\tau = p$

In the case of a hard peg, evidently the nominal exchange rate will not be expected to change, nor will there be any risk premium charged in forward foreign exchange market, so that □ = *0*. The implication is that nominal interest rates must always be equal system wide, $i = i^*$, where i is the domestic nominal rate of interest, and i is the foreign nominal rate. However, with endogenous money (and therefore the potential for various "cost-push" sources of inflation), this does not guarantee that *real* interest rates would be the same everywhere. For real interest parity (RIP) to hold there would have to be a combination of covered interest parity (CIP) and uncovered interest parity (UIP), both of which do hold in the dynamic system of equations (14) through (18), *plus* purchasing power parity (PPP), which does not necessarily hold outside of the equilibrium state.[3] As exchange rates are now fixed, changes in foreign exchange reserves will be occurring, and therefore a new variable must be introduced, namely:

f = real foreign debt net of real foreign exchange reserves (both denominated in domestic currency) as a percentage of base-year GDP,

and also, a new parameter (treated as such mainly for mathematical convenience):

υ = the ratio of net real foreign debt to real foreign exchange reserves.

In the next section, we discuss the stability properties of the irrevocable fixed rate case.

STABILITY IN THE IRREVOCABLE FIXED EXCHANGE RATE CASE

Once again setting all exogenous variables equal to zero, the dynamic system will reduce to:

(20) $\delta f/\delta\tau = r(1+\upsilon)f + \alpha q + \gamma y$

(21) $\delta q/\delta\tau = - \theta q + \eta y$

Totally differentiating, and noting also that the real interest rate r is now no longer in principle an exogenous variable, we obtain:

(22) $[\delta(\delta f/\delta\tau)] = r(1+\upsilon)]\delta f + \alpha\delta q + \gamma\delta y + [(1+\upsilon)f]\delta r$

(23) $[\delta(\delta q/\delta\tau)] = -\theta\delta q + \eta\delta y$

From the definition of the real interest rate and using equation (16), we also have:

(24) $\delta r = \{[\theta(1+\gamma) + \alpha\eta]/(1+\gamma)\}\delta q$

(25) $\delta y = -[\alpha/(1+\gamma)]\delta q$

and, therefore, the dynamic system can be re-written in matrix form as:

(26) $$\begin{vmatrix} [\delta(\delta f/\delta\tau)] \\ \\ [\delta(\delta q/\delta\tau)] \end{vmatrix} = \begin{vmatrix} r(1+\upsilon) & \{1+f(1+\upsilon)[\theta(1+\gamma)+\alpha\eta]\}/(1+\gamma) \\ \\ 0 & -[\theta(1+\gamma)+\alpha\eta]/(1+\gamma) \end{vmatrix} \begin{vmatrix} \delta f \\ \\ \delta q \end{vmatrix}$$

coefficient matrix. Stability requires that $tr\,\Delta < 0$ and $det\,\Delta > 0$. However, we have:

(27) $tr\,\Delta = r(1+\upsilon) - [\theta(1+\gamma)+\alpha\eta]/(1+\gamma),$ (?)

(28) $det\,\Delta = -[r(1+\upsilon)][\theta(1+\gamma)+\alpha\eta]/(1+\gamma),$ (< 0)

Therefore, this system also has a saddle-point, but now the equilibrium solution has certain essential features that make the argument about how equilibrium might be achieved much more precarious than in the floating exchange rate case. The equilibrium solution is, in fact:

(29) $y = (1/\eta)(a - p_0 - t - w_0)$

(30) $d = [(1+\gamma)/\eta](a - p_0 - w_0) - (1/\eta)(1+\gamma-\eta)t + \varepsilon r^*$

(31) $p = 0$

(32) $q = 0$

(33) $f = -[\gamma/\eta(1+\upsilon](a - p_0 - t - w_0)(1/r^*)$

Therefore, if there is to be equilibrium the system *must* involve zero inflation, that is, the same inflation rate as in the rest of the world, and also purchasing power parity (PPP) here exemplified by $q = 0$). Something similar to a neoclassical "natural rate" of growth emerges in equation (29) though the term is a clear misnomer in this case. There is nothing natural about the equilibrium growth rate, as it is basically imposed by the nature of the exchange rate regime. The only *policy* variable that can now affect the GDP growth rate is a change in the average tax rate *t*. A cut in taxes will increase the GDP growth rate, essentially because of incentives, as in the usual "supply-side" argument. There is a problem with this artificially imposed version of supply-side economics, however, because equation (30) is over-determined and as it stands is inconsistent. There are only exogenous variables on both sides of the expression. To make it work it seems that the demand variable, *d*, must become endogenous rather than exogenous, if the unique saddle-point equilibrium is ever to be reached. In short, it would have to be deliberately by the management of government spending. For example, any tax cut would have to be balanced by some change in government spending, and moreover (against the usual instincts of policy-makers), this may have to be *either* a cut or an increase, depending on the value of the parameters. Similarly, an exogenous increase in the real wage, for example (say through an increase in the w_0 term, without any concomitant increase in productivity), would have to be offset by government spending cuts; whereas an increase in foreign real interest rates would need to be countered by spending increases. These may seem like familiar propositions about the need to carefully manage the public finances, but notice that there are some anomalies here that differ from the conventional wisdom about what the concept of "fiscal responsibility" means. Also these rules are not imposed by market forces or anything of the kind, in fact, just the opposite. There are necessary only because of the commitment by the governmental authorities to the exchange rate regime. In effect, the willingness to adjust/manage the government budget in this way becomes the necessary transversality condition if the single stable arm of the system is ever to be reached. It is evident therefore, that there is a difficult balancing act to perform, both politically and financially, if equilibrium is ever to be attained. Failing this, the practical analogy to the mathematical problem may be that the system is likely to break down in a foreign exchange crisis as (it can surely be argued) frequently does occur in reality. It may be objected to this that "rational agents" will not initially believe in the system if it can ultimately end in crisis. The point is, though, that "rational expectations" in themselves are not enough. The policy-makers and market participants would also have to be working with the *correct* model of the economy. It seems evident that many in the real world are not doing so, simply by noting that there are, and have been, many expert advocates over the years of such things as currency unions, currency boards, "dollarization", the gold standard, other commodity standards, a single world currency, and so forth.

A MACROECONOMIC MODEL OF A SMALL OPEN ECONOMY WITH FIXED EXCHANGE RATES, BUT RESIDUAL FRICTION AND REMAINING PERCEIVED CURRENCY RISK

Perhaps ironically, a fixed exchange rate regime that is initially perceived as less secure than a hard peg may in reality have a greater chance of longevity and, precisely because a currency risk premium will re-emerge in such circumstances, also allows the domestic monetary authorities a greater degree of control over both interest rate and fiscal policy. A related argument to be made in this context is that the introduction of various frictional elements into the system (some form of capital controls being the obvious example) will also allow more room to maneuver on the part of the domestic policy-makers. The old "Bretton Woods" system of 1944-71, for example, was called a "fixed but adjustable" regime, and also had various capital control provisions, so there clearly would have been a substantial element of currency risk in that case.

The following set of equations may be used to represent this type of situation:

(34) $y = [1/(1+\varepsilon\eta+\gamma)]\, d - [(1+\varepsilon)(1+\varepsilon\eta+\gamma)]t - (\alpha - \varepsilon\theta)(1+\varepsilon\eta+\gamma)q + [\varepsilon/(1+\varepsilon\eta+\gamma)](a - w_0 - r)$

(35) $p = p_0 + t + w_0 - a - \theta q + \eta y$

(36) $\delta f/\delta\tau = \alpha q + \gamma y + r(1+\upsilon)f$

(37) $\delta q/\delta\tau = r - r^* + \zeta f$

This system is almost the same as that outlined in (16) through (19) above, but with one main difference. The nominal exchange remains fixed and is not *expected* to change. However, there is now nonetheless a currency risk premium on debt obligations denominated in domestic currency, as there is some perceived risk that these expectations will not be fulfilled. Therefore, the parameter ζ is re-introduced, and now stands for the sensitivity of the currency risk premium to real foreign debt net of real foreign exchange reserves, as a percentage of base-year GDP ($\zeta > 0$). The implication is also that nominal interest rates need not now be equal system-wide, that is, $i \neq i^*$.

STABILITY IN THE CASE OF FIXED EXCHANGE RATES WITH RESIDUAL FRICTIONS AND REMAINING PERCEIVED CURRENCY RISK

Once more setting all exogenous variables equal to zero, the dynamic system becomes:

(38) $\delta f/\delta\tau = \alpha q + \gamma y$

(39) $\delta q/\delta\tau = \zeta f$

where the domestic real interest is once again under the control of the domestic monetary authorities, and for the purposes of the stability exercise can be set at zero. In matrix form, the system becomes:

$$(40)\quad \begin{vmatrix} \delta f/\delta\tau \\ \\ \delta q/\delta\tau \end{vmatrix} = \begin{vmatrix} 0 & [\alpha(1+\varepsilon\eta)+\varepsilon\gamma\theta]/(1+\varepsilon\eta+\gamma) \\ \\ \zeta & 0 \end{vmatrix} \begin{vmatrix} f \\ \\ q \end{vmatrix}$$

Let Δ = the coefficient matrix. Stability requires that $tr\Delta < 0$ and $det\Delta > 0$. However, we have:

(41) $tr\,\Delta \;=\; 0$,

(42) $det\,\Delta \;=\; -\zeta\{[\alpha(1+\varepsilon\eta)+\varepsilon\gamma\theta]/(1+\varepsilon\eta+\gamma)\}$, $\qquad (< 0)$

Therefore, this system again has a saddle-point, as in the original case of floating exchange rates.

COMPARATIVE STATICS IN THE CASE OF FIXED EXCHANGE RATES WITH RESIDUAL FRICTION AND REMAINING PERCEIVED CURRENCY RISK

In this case of "fixed" exchange rates, but with remaining perceived currency risk, the equilibrium solution will be:

(39) $y = [1/(1+\varepsilon\eta+\gamma)]d - [(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]t - [(\alpha-\varepsilon\theta)/(1+\varepsilon\eta+\mathrm{g})]q + [\varepsilon/(1+\varepsilon\eta+\gamma)][a - w_0 - r]$ (41) $p = p_0 + t + w_0 - a - \theta q + \eta y$

(42) $0 = \alpha q + \gamma y + r(1+\upsilon)f$

(43) $0 = r^* - r - \zeta f$

Next, again work out the comparative static derivatives. These are:

(44):

$\delta y/\delta d = [1/(1+\varepsilon\eta+\gamma)]$, $\qquad \delta y/\delta r = -[\varepsilon/(1+\eta+\gamma)]$,

$\delta y/\delta t = -[(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]$, $\qquad \delta y/\delta a = [\varepsilon/(1+\eta+\gamma)]$

$\delta p/\delta d = [\eta/(1+\varepsilon\eta+\gamma)]$, $\qquad \delta p/\delta r = -\eta[\varepsilon(1-\theta)+\alpha]/(1+\varepsilon\eta+\gamma)$,

$\delta p/\delta t = [\eta(1+\varepsilon)/(1+\varepsilon\eta+\gamma)]$, $\qquad \delta p/\delta a = -[(1+\gamma)/(1+\varepsilon\eta+\gamma)]$,

$\delta q/\delta d = 0$, $\qquad \delta q/\delta r = -[\zeta f+r)/\alpha\zeta]$,

$\delta q/\delta t = 0$, $\qquad \delta q/\delta a = 0$,

$\delta f/\delta d = 0$, $\qquad \delta f/\delta r = 1/\zeta$,

$\delta f/\delta t = 0$, $\qquad \delta f/\delta a = 0$.

The signs of the comparative static derivatives are then summarized as in Table 2:

Table 2: Signs of the Comparative Static Derivatives in the "Virtual" Floating Exchange Rate Case

	δd	δt	δr	δa
δy	+	-	-	+
δp	+	+	-	-
δq	*0*	*0*	+	*0*
δb	*0*	*0*	+	*0*

The most obvious point about the results in Table 2 is that they simply replicate those of the flexible exchange rate case discussed earlier. This shows that the reintroduction of the currency risk premium, the possibility of exchange rate adjustments, and/or the introduction of other frictional elements can recreate the conditions of a "virtual" floating exchange rate regime (as stated in the caption to Table 2), and thus may still provide the necessary degrees of freedom for domestic policy-makers.

CONCLUSION

In effect, the framework set out in this paper has been able to illustrate several of the "growth scenarios" that have been suggested by a number of different schools of economic thought, including the original mercantilists, as well as to predict the impact of these on the real exchange rate and the foreign debt position. The main conclusion the key to "capitalism in one country" (to return to our original expression, is the existence of a separate monetary and financial system, with either a floating exchange rate regime, or at least one in which adjustments can be made as frequently as required, without excessive political or other difficulties. By the same token, it may explain the problems that have often been experienced by jurisdictions that are not in a comparable situation.

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