# CONTENTS

Latin America and the Caribbean and the world economy  
*Gert Rosenthal*  
7

Foreign capital inflows and macroeconomic policies  
*Andras Uthoff and Daniel Titelman*  
13

Financial repression and the Latin American finance pattern  
*Marcos Antonio Macedo Cintra*  
31

Policies for competitiveness  
*Wilson Peres*  
49

Industrial policy and promotion of competitiveness  
*Osvaldo Rosales*  
59

Open regionalism and economic integration  
*Juan A. Fuentes K.*  
81

Changes in the urban female labour market  
*Irma Arriagada*  
91

Water management and river basins in Latin America  
*Axel Dowrojeanni*  
111

Public policies and the competitiveness of agricultural exports  
*Milton von Hesse*  
129

Agroindustry and changing production patterns in small-scale agriculture  
*Alejandro Schejman*  
147

National private groups in Mexico, 1987-1993  
*Celso Garrido*  
159

China's economic reform and opening to the world: a retrospective and prospective view  
*Li Cong*  
177

Guidelines for contributors to *CEPAL Review*  
185

Recent ECLAC publications  
186

_August 1994_
Financial repression
and the Latin American
finance pattern

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This article presents a critique of the theory of financial repression, in place of which it offers an alternative approach to development financing, based mainly on the Keynesian tradition. The concept of financial repression refers to the situation of a market suffering from institutional obstacles, both in terms of economic policy and administrative aspects, which prevent it from attaining an equilibrium position and thus jeopardize the rationality of the resource allocation process. The policy consequences that follow from a study of this theory mainly involve the liberalization of the financial sector as a contribution to the development process. The author seeks to identify the limitations of policy options based on the theory of financial repression and proposes other alternatives which fit in better with the structural conditions of Latin American financial markets and the place they occupy within the international credit markets. He concludes that it is necessary to develop new forms of credit creation and financial intermediation, and not just redirect the existing resources and institutions. The financial sector cannot be burdened with the exclusive responsibility for correcting the intrinsic features of a given development pattern, reallocating resources in given directions, or increasing the rate of investment. Consequently, in various situations the State has been obliged to use financial policy mechanisms that facilitate the industrialization process.
I

Introduction

In the foreword to his *General Theory*, Keynes said that the preparation of that work had represented a long struggle to set himself free, and that reading it should mean the same thing to most of his readers: a struggle to break away from the usual forms of thinking and expression. The ideas so laboriously expressed in it, he said, were extremely simple and should be obvious. The difficulty did not lie in the new ideas, but in getting away from the old ones, which extended their ramifications to all corners of the human mind (Keynes, 1983, p. 4).

In a way, I am returning to Keynes's debate with the liberals of his time concerning the role of financial institutions and financial markets in the process of capital accumulation and, hence, economic growth. The old ideas surfaced again in 1973 with the studies by McKinnon (1974) and Shaw (1973) which sought to identify the links between monetary processes and capital accumulation in the developing world and represent a “financial approach to economic development” which became the new orthodoxy in United States academic circles and in the main international agencies that lay down basic policy lines for the developing countries (the IMF and the World Bank), and which was fully applied in the liberalizing experiences of the Southern Cone countries between 1973 and 1984.

McKinnon and Shaw worked out the concept of financial repression on the basis of a pre-Keynesian view of the relationship between saving and investment, heightened by institutional rigidity of the financial market due to State intervention. Here, repression is taken to mean the situation of a market suffering from institutional obstacles (of an economic policy and administrative nature) that hinder it from attaining an equilibrium position and therefore jeopardize the rationality of the resource allocation process.

For these theorists, the constraints on expansion of investment in the developing countries are due to the lack of liquidity of credit markets caused by repression in the banking sector and the capital markets. In other words, the main problem in under-developed countries is financial repression: i.e., the maintenance of interest rates below the equilibrium rate and the application of selective credit policies, which have harmful effects on the allocation of savings.  

Liberalization (increasing interest rates and deregulating banking activities) is seen as the way to stimulate saving, financial intermediation and investment. The core of the argument is the assumption that all investments not financed directly from the prior savings of the investor himself must be financed from savings deposited in the banks. The role of the latter is limited to centralizing savings and transferring them to investors, at an interest rate which matches the supply and demand of loan resources (i.e., savings and investment in equilibrium). This means that the financial institutions are merely intermediaries of savings, since the volume of funds available for loans is determined outside the system.

In this sense, increasing interest rates is the fundamental element of the policy of financial liberalization: interest rates should be allowed to fluctuate until they reach the right levels for the elimination of the domestic savings deficit caused by artificially

2 It should be stressed that the financial repression theory has the merit of being one of the few examples among orthodox currents of development theory —perhaps the only example— that deals with the role played by the financial system in economic growth or, more exactly, in development finance.

3 In the 1930s, in a debate with Keynes, Ohlin (1987, p. 160) put forward similar arguments: “If an authoritarian government sets an interest rate much lower than the rate that would prevail on a free market, at all times savings and new ex post investment will nevertheless remain equal, even if it is observed that the amount of credit offered is less than that demanded, thus representing a kind of “rationing”. It should be remembered that the credit market reacts in the same way as the market for goods when maximum prices are fixed”. In reality, Shaw, McKinnon and Ohlin are associated with the tradition of the Stockhol theory of saving and investment, also known as Wickell’s theory of the natural rate of interest or theory of loan funds (Wicksell, 1978).
low interest rates. Increasing interest rates would lead to an increase in bank deposits—which would permit an increase in credit and investment funds—and savings would be freed from inferior uses, thus making possible improved efficiency of allocation. Moreover, higher interest rates would discourage over-investment in activities and speculation with real or risk assets.

The analysis of the initial theories and of the thorough-going criticisms and self-criticisms leveled at the “theory of financial repression” is designed to evaluate economic liberalization, carried to an extreme, as a suitable policy for the restructuring of production in a developing country faced with severe restrictions in terms of sources of finance for productive investment. For methodological and objective reasons, in this article we will accept the validity of the theoretical hypotheses and the inner logic of the diagnoses and proposals.

II

Economic development financing and financial repression

It is important to analyse the relations which exist between financial accumulation and the accumulation of productive capital, since they form the basis of the arguments in favour of the “financial repression” theory. We shall therefore make a critical appraisal of the functions and institutional nature of loan capital and savings in the formation of productive capital, the real and financial dimensions of saving, and the processes that determine the levels of interest, saving and investment.

Keynes’s view of the role played by credit in financing investment excludes the hypothesis that investment demands an act of prior saving, seen as a function of the interest rate. In Keynes’s view, interest rates are not determined by *ex ante* equality between saving and investment. There would always be sufficient *ex post* saving to cover the investments made. Institutionally, interest rates are determined in the money market by Central Bank policy and the demand for money, especially by businessmen, and they reflect the particular stage of preference of the community for liquid assets. Consequently, the two relevant variables for determining interest rates are: the amount of money in circulation (the money supply) and the form in which the agents decide to keep their monetary reserves (i.e., in the form of cash or in the form of securities), which Keynes called the “liquidity preference interest rate theory”.

Through the principle of effective demand, which posits a unilateral causal relationship between expenditure and income, Keynes demonstrates that investment is the dynamic variable of the economy, whose execution depends on capitalists’ expectations of future yields rather than on a fund of prior saving. “Saving, in fact, is a mere residual” (Keynes, 1948, p. 64), since businessmen only

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5 According to Keynes (1987a, p. 151), “(...) interest rates are a monetary phenomenon, (...) in the sense that they balance the advantages of current possession of money against future right to possess it”. In other words, the interest rate on an investment of a given quality and a given term is set at a level which, in the view of those possessing wealth, makes it more advantageous to exchange immediate liquidity for the prospect of increased wealth in the future.

6 “(...) the *ex ante* interest rate applicable to an investment is that determined by the current supply of money and the current state of liquidity preference at the date stipulated for the finance demanded by the decisions” (Keynes, 1987b, p. 167).

7 “(...) it is not the rate of interest but the level of income that ensures the balance between saving and investment” (Keynes, 1987a, p. 154).

8 It consists of an income flow, registered in the national accounts, which corresponds to expenditure on goods and services for investment.
decide what they are going to spend, and not what they are going to save. Thus, credit and not saving is the financial motive force behind the capitalist process of accumulation of wealth, and hence the decisive role played by the financial system in supplying resources for the execution of investment expenditure is completely different, since it does not stem from the accumulation of savings but rather from its capacity to expand or reduce liquidity and credit in an autonomous manner.

To sum up, while it is true that fully developed financial systems play a fundamental role in the expansion of a capitalist economy, as is acknowledged by both schools of thought, the way these interrelations are conceived in theory has very varied consequences. From the Keynesian viewpoint, it would be an error to equate “saving” with deposits and with “financial assets” and to claim that the interest rate regulates the “supply and demand” of loan resources, because not only are those liquid balances not automatically converted into investments, but, on the contrary, their recurrent rise in value in the financial circuit is seen as an investment alternative for enterprises, since if a growing positive interest rate is maintained, the tendency would be towards a drastic reduction in productive investment. Ultimately, the determinants of financial saving are different from those that apply to investments, and may even be in contradiction to them and display a form of feedback, generating more and more financial resources and less and less productive investment.

In other words, there is no a priori relation, as advocates of the theory of financial repression claim, between financial saving—corresponding to total financial assets which swell the liquid monetary balances of the agents registering a surplus, sometimes even as protection against erosion by inflation—and “real saving”, corresponding to an income flow associated with an investment action. In the words of Keynes: “(...) while we may be tempted to see money as the beverage which stimulates the activity of the system, we should not forget that there may be many a slip twixt the cup and the lip” (Keynes, 1985, p. 125).

Decisions on the accumulation of capital goods depend on the expectations of future gain and are the sole responsibility of capitalists and the State. The latter takes such decisions either directly, through the execution of the public budget or through State enterprises, or indirectly, through the multiplier effect of public spending and the manipulation of the general conditions of prices, interest rates, exchange rates, wages, credit, etc., which condition the private sector’s initiatives.

In capitalist dynamics, however, it is not enough for businessmen merely to foresee their gains in order to take investment decisions. They also need to have a suitable amount of capital (money) at hand, at compatible costs. Thus, if there is a marginal capital efficiency curve (a measure of the gains expected from a capital asset) and the banks maintain a suitably accommodating policy, finance will be equal to the liquidity needs of investors. As investment gives rise to a savings flow strictly equivalent to its a posteriori amount, it does not need any prior amount of saving for its execution, but it does need credit, and the expansion of the latter is prior to and indispensable for the generation of savings.

In short, according to the Keynesian view the expansion of investments and, hence, of income in a capitalist economy depends on: i) the expectations of the agents regarding markets, technologies, profits, projected idle capacity, etc.; ii) the existence of suitable domestic financing mechanisms; and iii) the availability of the foreign exchange needed to import raw materials and equipment and to cover the financial servicing of foreign capital. At this point, we need to go more deeply into the questions of domestic and external finance.

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It should be noted that the traditional theory of loan resources was severely criticized by Keynes (1948, p. 243): “I am now (in the General Theory) no longer of the opinion that the concept of a “natural” interest rate, which previously seemed to me to be a most promising idea, has anything very useful or significant to contribute to our analysis”. According to Belluzzo and Almeida (1990, p. 64): “Keynes’s objection to the “natural rate” is that businessmen’s expectations are in a constant state of flux and cause sudden alterations in the hypothetical natural rate, that is to say, in the appraisal of the future, so that the system of asset prices would appear to change continuously, independently of banking and monetary policies. The extreme case is that of the “liquidity trap”, in which the price system becomes insensitive to monetary stimuli. Thus, Keynes’s contribution was that he demonstrated that monetary systems are not intrinsically secure and that the only way of operating in a stable manner is that the past should continue to reproduce itself in the present and determine future expectations”. 
1. The active role of credit in financing investment

Let us begin by looking at the importance of banks for bringing about growth and investment. In addition to their financial intermediation function, banks generate money to cover loan advances. Money or credit is generated when a bank acquires assets and issues liabilities in the form of credit money in their place. In the next stage the banks are concerned for their liquidity positions (formation of passive reserves). The latter can be acquired in the Central Banks (which discount private paper in the hands of the banks), in the inter-bank system (taking advantage of the inactive balances of other banks), or through their own bank deposits, depending on the interest rate paid. The value of this money depends largely on the future value of the money as foreseen by the agents and is therefore subject to the conditions of the financial market: i.e., it represents the prevailing liquidity premium. It also depends on the competition existing in that market for additional resources to cover loan positions already assumed by the banks.

Credit money is thus endogenous, since it is created by the banking system in response to the state of business and as a function of its forecasts and expectations regarding the performance of the economy. Monetary policy is not necessarily passive, however. The Central Banks —provided they have control over the monetary reserves through compulsory reserve requirements in respect of bank reserves, the rediscounting rate and open market policies— are in a position to regulate the expansion of primary liquidity: i.e., they can determine the monetary base.

Monetary policy consists of manipulation of interest rates and of the level of bank reserves in order to influence through them the volume and price of bank credit in the short term. In the long term, the amount of money is reproduced through the liability/asset ratios between the financial and non-financial agents. Variation in the amount of money is therefore a function of the requests for credit met by the banks, which subsequently have to look for funds to back them up. In aggregate and long-run terms, bank finance is self-financed. The banks make loans which return to the system in the form of deposits, and financing of reserves to cover new loans is the only current need of the banks.

In short, notwithstanding the degree of freedom of action of monetary policy, the fundamental cause of the variation in the amount of money does not lie in the possible short-term manipulation of these funds and their prices by the monetary authorities, but in the bank financing of the expenditure decisions of capitalists.

In these circumstances, it is basically the dynamics of profit, through the ongoing expansion of aggregate expenditure, which guarantees the solvency of the economic agents: in other words, purchasing power is generated to pay off past debts. In the words of Belluzzo and Almeida (1989, pp. 121 and 122): "It is with these profits that they (the enterprises) service their debts, pay taxes and accumulate financial funds, thus enabling the banks to renew their financial stocks. It is therefore the continuation of the process of investment and indebtedness which makes it possible to service past debt. (...) the economy generates debt now so that past debt can be serviced". Consequently, "(...) from the macroeconomic standpoint a decline in investment necessarily means an increase in indebtedness, because it deprives enterprises of the capacity to service past debts. Furthermore, as contraction of investment depresses the internal accumulation of enterprises, it reduces their own capital and frustrates any attempt to reduce the

10 These loans may be destined not only for financing the formation of fixed capital but also for current production, consumption, or the acquisition of existing real or financial assets for speculative or accumulation purposes.

11 When it discounts private paper in the hands of the banks, the Central Bank fixes the price of its liquidity loans to the banking system (Keynes, 1971, pp. 43-69).
level of indebtedness. This means that if each unit tries to reduce its current deficit, the result for enterprises as a whole will be an aggravation of their wealth position and current commitments, because of the rigidity of the financial costs of the debt assumed in the past”.

If we look at the system in dynamic terms, with investment and savings continually being replenished, the contribution made by credit to the process of capital formation is seen to be determined by the generation of surplus value: i.e., by profits. If the flow of profits is not maintained, because of interruption of the productive investment feeding the active portion of capital, the dynamics of profit will begin to flag and the weight of the passive portion will begin to make itself felt. Consequently, if there is an unforeseen reduction in the growth rate, firms will have difficulties in meeting their commitments with the banking system. The alternative would be to renegotiate their debts by assuming further indebtedness, that is to say, by accepting a reduction in the ratio of their own capital to the total capital, sometimes on inferior terms as regards interest rates, deadlines and margins, thus increasing the financial fragility of the firm, or by seeking to restructure the pattern of ownership through the issue of new shares, the entry of new partners, etc. There is thus a problem of financial intermediation, of reconciling deadlines as a function of the aversion to risk of all the economic agents, in order to procure resources to consolidate investors’ debts.

It is not necessary to think in terms of a situation of falling investments, however, to show that financial intermediation based on the procurement of medium- and long-term investments capable of ensuring the stability and operational solidity of firms is of vital importance. It has already been noted above that banks make temporary advances of purchasing power to cover the time-lags between investment decisions and their actual execution. At the macroeconomic level, loans taken out to cover investment needs in general are based on the spreading over time of the income associated with business projects, which is only produced once the new production capacity has been installed and is in operation. If for some reason it is necessary to pay off the credits owed before the investment project generates the expected income, however, or if the rate of yield of the investment proves to be lower than expected, investors will have to have recourse to the financial market in one way or another in order to find fresh finance.

The most important conclusion to be drawn from this debate is that it is necessary to have financial mechanisms capable of lengthening the debt profile. If financial intermediation does not function properly, this may lead to default by debtors/investors, an increase in the financial fragility of the system, or transfers of ownership. On the one hand, the possibility of this “insufficiency”, perceived ex ante by investors, may act as a constraint on investment activities. In contrast, a guarantee that the banking system will adopt an accommodating position and that the Central Bank will influence it in this direction will be a powerful incentive to invest.

Thus, mechanisms which make possible the conversion of short-term debt into long-term debt give greater stability to the investment process, since they reduce the risk of a change in ownership of assets when a profit-generating process comes to an end or when new production capacity has not yet generated sufficient income to pay off the debts assumed. In other words, the lack of linkages between the short and long term in the capital market makes the system more unstable and harder to regulate.

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13 With regard to the limits of the contribution made by credit to capital formation, see Zolinsein (1989).

14 Tavares (1983, p. 110) emphasizes that it is perfectly possible to finance investments by increasing and continually renewing short-term debts, the soundness of which is guaranteed in periods of expansion by the rapid growth of production and the growing retention of profits. This conclusion is only valid, however, for increasing the capacity of sectors where there are no significant technical indivisibilities and the lead times are relatively short.

15 It must be emphasized, however, that “instability is of the very nature of monetary economies” and that the endogenous creation of money by private agents (banks and businesses) is a way of stimulating and prolonging the expansionary phase of a cycle when the prospects of growing profits bolster the confidence of those agents, but it cannot avoid illiquidity when circumstances are unfavourable.

16 “In an uncertain world, and in the absence of financial consolidation, banks would be obliged to lower their safety margins (liquid assets/non-liquid assets) or investors would be forced to refinance their long-term liabilities until the investments matured and came on stream. In both cases—in view of the nature of the banks' liabilities—the possibility of future changes in interest rates or credit terms would represent too much of a risk for both agents” (Studart, 1993, p. 110).
2. The finance - investment - funding circuit

The existence of a system of commercial banks issuing fiat money and acting as intermediaries of finance flows frees investors from any need for prior saving, as already noted. The banks finance investment through a revolving fund—the finance fund—or, if this is not enough, by expanding their demand deposits. Investment is thus financed in the money market. The banking system increases credit independently of the anticipated procurement of money capital, as asserted in the financial repression theory, without compromising the self-sustainability of the accumulation process. 18

Thus, finances consist of lines of credit or bank advances which make it possible to anticipate future resources (future income) in order to finance investment. They therefore precede investment and have nothing to do with saving. The banks create money, not savings, and can thus adjust the supply of funds to the demand for them, that is to say, they adjust saving to investment.

Belluzzo and Almeida (1989, p. 121) describe the demand for money to be provided by the banking system in the following terms: “(...) the increase in investment can only be effected at the macroeconomic level through indebtedness of the units making the expenditure. When this investment generates profits it restores the liquidity conditions of the loans: i.e., the generation of profits maintains the conditions for the renewal of the financial fund administered by the banks and originally generated through the issue of bank credit against their own resources in the light of the demand of those who are going to make the expenditure. The principle of effective demand (the level of income and employment of the community is determined by the capitalists’ decisions regarding expenditure) only requires that a given expenditure decision should be endorsed by the banking system as the administrator of the money and financial funds of society. The banks sanction the capitalists’ wager on the acquisition of new capital assets, and the profits derived from that investment sanction the wager made by the banks”.

17 The following reservation must be added, however: “But the markets for new short-term loans and new long-term issues are substantially the same as for previous transactions, and the small anomalies which may exist are not important at the present level of debate (...).” Keynes seems to be suggesting that the structures of assets and liabilities with different terms, risks and guarantees can be reconciled within the financing system itself. In other words, the financial system would take care of the diversification of assets in terms of their divisibility, liquidity, profitability and safety. However, this does not do away with the need for a surplus of income which is temporarily available and can be freely managed.

18 According to Keynes (1987b, p. 168): “(...) finance consists basically of a revolving fund. It does not use saving. For the community as a whole, it is merely an accounting transaction. After being “used”, in the sense of spent, the lack of liquidity is compensated automatically and the temporary illiquidity mechanism is ready to be used once again (...). For the most part, the flow of new resources required by ex ante current investment is supplied by the finance freed by ex post current investment.”
However, nothing guarantees that businessmen will automatically be able to convert their short-term commitments into long-term debts. There is a risk in this process, and businessmen take their decisions on the basis of their expected profits: i.e., finance has a speculative component. In other words, in the question of compatibility between terms and rates there is always a risk that forms part of the speculative calculations inherent in any capitalist investment decision.

In order to reduce this risk, however, at the same time that they procure the short-term sources of credit businessmen begin negotiations with investment banks and other institutions of the capital market in order to mobilize the long-term funds needed for the financial consolidation of the investment: the process of funding.

The consolidation of the investment consists, then, of issues of long-term debt paper or shares on the financial and capital market. The debts can be served by the units making the expenditures, through the internal accumulation of profits or through the portfolios of financial intermediaries. In the latter case, part of the long-term financial assets maintained by the “saving” units take the indirect form of time deposits, pension fund contributions, insurance policies, share funds in banks, mutual funds, bonds without any specific guarantee, shares in the hands of banks, etc.

Thus, the component parts of the capital used in the process of consolidation of investments come from the channelling of real savings, i.e., accumulated income whose purchasing power was delayed in time. The mere existence of a given volume of savings is not enough, however. It is also necessary that these financial savings should be effectively channelled in order to meet the needs for funding. 19

Notwithstanding the role played by the financial system in the ongoing functioning of the long-term securities markets, Baer notes that “(...) the actions of the financial agents (...) are of a residual nature, since savers must assume most of the burden of financial assets. In other words, there must be capacity for funding, and the role of the banks is to be ready to cover possible financial circulation needs in the capital markets” (Baer, 1983, p. 37).

In late-industrializing economies, government intervention designed to further the consolidation of investments takes place predominantly through State development banks, the establishment of compulsory financial saving funds, and discretionary mechanisms for the allocation of credit. 20

To sum up, for our purposes it is important to remember from this debate that a necessary but not sufficient condition for maintaining the stability of capitalist economic growth is the development of financial instruments that will make possible the conversion of the wealth inherited from the past into various forms of assets, including long-term securities.

Clearly, the theory of financial repression does not take account of the distinction between the mechanisms of short-term finance and of the consolidation of investment. Thus, not only do long-term assets and ownership rights disappear, but also the capital and financial savings markets themselves. In reality, the financial market plays the role of the universal panacea of the market as a means of equalizing the rates of profitability of the economy.

3. The role played by external finance

Finally, it should be added that in the countries of the periphery, investment (or autonomous expenditure) must also be in keeping with the availability of foreign exchange, insofar as the national currencies do not circulate internationally either as reserve currencies or as convertible currencies, contrary to McKinnon’s assumption. There is therefore a need for inflows of external resources to finance development, in the form of either short-term bank credits,

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19 See Baer (1993, p. 29): “(...) although investment and saving decisions are completely independent of each other at the level of the individual agents, there must be a certain minimum degree of compatibility between the total volume of investments to expand production capacity and the corresponding needs for long-term finance, on the one hand, and the volume of savings and the way they are invested as the basis for the process of provision of funds, on the other”. It may be emphasized that the aggregate level of saving is related with the level and distribution of income as well as with the growth and consumption models of the economy, deriving from the structural characteristics of industrialization.

20 Later on in this article we will see the inherent difficulties in promoting mechanisms for the consolidation and intermediation of financial saving and for ensuring complementarity between bank credit activities and participation in the equity of production enterprises in most of these economies.
long-term official and private finance, or even venture capital. The inflow of direct investment is particularly important in view of the fact that the generation and possession of new technologies is concentrated in the big transnational firms.  

In theory, the growing mobility of international capital flows and the greater integration of financial markets expand the facilities for gaining access to external resources, depending on each economy’s potential for attracting international capital. This linkage with international financial flows has serious consequences, however. Just as resources are brought in more easily from abroad, in contrast there are new mechanisms for external portfolio investments and it is thus possible to channel resources abroad. In other words, even though the arbitrage process is conditioned by exchange risks, it may become globalized and limit the intervention capacity of the monetary authorities of a country which lacks the power (reserves) to intervene in the international market. Furthermore, the mobility of capital and the generalized spread of floating interest rates make the balance of payments of countries with a high degree of financial openness more vulnerable, since such countries are passively exposed to the repercussions of the monetary policies applied by the central countries (Baer, 1993, p. 32 and Baer, 1992, pp. 173-186).

III

Specific features of the Latin American system of finance: financial contracts under inflationary conditions

The foregoing theoretical considerations make possible an analysis of the axioms of McKinnon and Shaw regarding the theory of financial repression in the Latin American context: defence of liberalization—both internal and external—as the only way of attaining the so-called deeper development of financial activities, without taking account of the specific structural features of the late-industrialized (or only semi-industrialized) economies of the periphery, and the chronic nature of inflation, which makes it difficult to sign contracts, which are a basic institution in a world dominated by uncertainty. We shall try to show that the matter is more complex than the mere identification of repression of the capital markets: in other words, it is not a question of public policies which restrict the financial markets, but the supervision of money and credit in conditions of very great uncertainty.

Keynes defined capitalist economies as “monetary economies engaged in production”, since the basic condition for their functioning is the existence of a system of contracts fixed in monetary terms: “(...) money stands, in a broad field, between a real asset and the owner of wealth. The effective owner of the real asset obtained finance through a loan granted by the real owner of wealth. Moreover, this was largely arranged through the intermediation of the banking system. In other words, for a consideration the banks gave their guarantee and ended up as both the real grantor

21 Calling on external capital may cease to be an indispensable and essential resource for economic development on the periphery when there are aggressive production strategies aimed at the international market, based on national entrepreneurial resources, which make it possible to satisfy the need for imported goods and services or other forms of association with foreign capital, such as the formation of joint ventures. See Canuto, 1991.

22 “My conclusion is that the question of financial regulation or deregulation implicit in McKinnon’s concept of repression is over-simplified. It is not possible to posit the existence only of money and capital markets which are either repressed or liberalized. Financial history, the national character, the evolution of institutions, and relations between businesses and financial institutions affect both the way financial markets react to changes—financial or real government regulation or deregulation—and the way capital markets effectively allocate resources among competing investments” (Kindleberger, 1987, p. 350).
and the real grantee of the loan. They gave their guarantee to the actual lender, and their guarantee is only good if the monetary value of the asset belonging to the real grantee of the loan is worth the money given by him” (Keynes, 1978, p. 47).

Any transaction in the capitalist market is represented by a contract corresponding to a future responsibility between the parties involved, more exactly, because capitalism assumes the existence of a pattern for measuring values and fixing contracts with a certain degree of stability: “(...) money is simply what the State periodically declares to be a good legal instrument for settling contracts in money” (Keynes, 1978, p. 7, and Aglietta, 1990). Such stability is subject to temporary, reversible interruptions, however, since it is based exclusively on confidence, generated through conventions and beliefs, which is capable of guiding the rational and calculating behaviour of the agents in the market.

In this sense, the institutional arrangements which make possible the issue of long-term securities (resources available for the process of consolidation of productive investment-funding), which depend on the expectations of positive interest rates generated within the financial system, play a fundamental role inasmuch as they offset the uncertainty regarding the financing of long-term positions and reduce the risk of financial instability which could ruin the growth process. In conditions of relative price stability or “illusion of stable currency”, there is a reduction in the premium demanded by investors to cover the market risks (risk of devaluation of assets) inherent in such securities. According to Davidson, “the institution of term contracts allows the agents to take action and control the effects of an uncertain future through repurchases and payments at a future date. The long-term contract is the way in which a free-market economy, in an uncertain world, establishes institutional controls of prices and wages over time. In such a world, contractual security regarding future events is a necessary condition for stimulating businessmen to carry out economic activities in a market economy” (Davidson, 1989, p. 17).

In economies with stubborn inflationary tensions, the effect of expectations of price variations is to make contracts impossible or to reduce their scope and time-length, since the uncertainty about the purchasing power of money is greatly increased. The markets only operate in the short term, where costs and yields are more predictable by the agents, and moreover they can renegotiate the conditions laid down in the contracts in a shorter space of time. In reality, in such circumstances we are in the presence of a “fallacy of composition”: each unit considers that it will run fewer risks by operating in the short term, but these individual forms of behaviour themselves cause increased fragility of the whole system in so far as they increase the number of firms that need to constantly refinance their liabilities and assets.

From our perspective, this is the fundamental question with regard to the atrophy of the financial system in developing countries; with the persistence of high rates of inflation and “(...) in the absence of formal indexing mechanisms, the national financial markets fail to develop. At the most, the government takes on the function of offering credits (...). The market is limited to very short-term money market operations and the capital market is practically non-existent” (Mendonça de Barros, 1993).

What is needed, then, is a way of finding mechanisms to defend the real value of contracts through a clause which varies their nominal value as a function of some external referent. Indexation of the value of securities issued by the financial system and of finance contracts, on the basis of the variation in a price index, is a means of regularizing debt and credit contracts and imparting viability to the functioning of financial intermediation and even of the public debt itself.  

23 In the final analysis, “(...) considered in terms of its most significant attributes, money is above all a subtle process of linking the present with the future, and without it we could not even begin to study the effects of changeable expectations on current activities” (Keynes, 1985, p. 204).

24 In the words of Carvalho (1992, p. 209): “(...) through erosion of the purchasing power of the currency, inflation makes its value as a unit of account unpredictable and gives rise to unforeseen gains or losses”.

25 Even a generalized system of indexing, which makes possible term contracts in an inflationary economy, does not do away with all the risks. If the currency loses value there is still the risk: i) that the indexes fixed by the government do not follow the index of inflation, which means that there will be reduction in the time-lengths of contracts as a means of protection, and ii) that the prices or yields of assets do not follow the arbitraged index; the higher the inflation, the more serious this is, as high inflation increases the possibility of disparities between prices and yields (see Belluzzo, 1992, pp. 25-31).
To sum up, in situations where there are persistent inflationary pressures the owners of wealth will tend to shorten the terms of their financial investments because of uncertainty about the way prices will evolve. This gives rise to a central problem of some developing economies which the advocates of the theory of financial repression do not take into account: as there is a high demand for liquid assets, the financial system’s capacity to supply short-term credit and oversee the continued functioning of the markets for long-term securities is limited.

The insufficient development of Latin American financial systems in terms of the volume, terms and conditions of medium- and long-term credit is not due strictly to “repression” but to the extremely high levels of instability and uncertainty and the lack of confidence on the part of savers and investors. Negative interest rates are due to macroeconomic instability—specifically the speeding-up of inflation—and not to public policies aimed at promoting growth. In reality, what is involved is a structural restriction on the full generation of financial intermediation. 26

In the words of Keynes: “When inflation advances and the real value of the currency fluctuates wildly from one month to the next, all the permanent relations between debtors and creditors, which form the ultimate foundations of capitalism, become so completely disordered that they almost have no point, and the process of the acquisition of wealth degenerates into a gamble or lottery” (Keynes, 1978, p. 3).

This is one of the fundamental errors of the theory of “financial repression”: the mechanisms of financial capitalization and indebtedness are not based on the existence of “prior savings” but of a set of financial and monetary institutions capable of multiplying all kinds of securities, with different degrees of profitability, risk and liquidity. In other words, the Keynesian conception of financial dynamics enables us to assert that the problems of underdevelopment are not due to mere public restrictions, but to the lack of financing mechanisms and the impossibility of deferring over time the spending of income accumulated in the past and channelling these resources to investment projects. Because of this restriction, the private financial markets of Latin America have never generated a flow of capital sufficiently great to support a significant rate of investment in production activities. How, then, can we create instruments and institutions capable of financing investment, production and consumption? How are we to channel capital funds (undistributed profits, resources accumulated by families, etc.) to these institutions? How are we to induce the private financial sector, which traditionally operates in the short term, to participate in lines of finance for the productive system, as well as liquidity credits? And finally, how are we to set up the apparatus for financing the economy?

Thus, it is not a question of reorienting existing resources and institutions, as desired by the advocates of the theory of “financial repression”, but of working out new ways of creating credit and furthering financial intermediation. In the words of Baer: “(...) it is not the financial system which is responsible for proper resource allocation in an economy. This allocation is determined, a priori, by investment decisions, on the basis of which the demand is established for resources from the financial market, either in the form of finance or funding. The financial system’s responsibility concerns its capacity to adequately satisfy the demands for finance: i.e., to provide short-term credits and create suitable conditions to persuade the holders of wealth to defer its purchasing power in time and place their resources at the disposal of economic units which have a temporary deficit in their cash flows”. And he goes on to say: “Although the financial agents are not those who are responsible for resource allocation, (...) they can frustrate decisions if they do not co-operate in covering firms’ financing needs. It is this unilateral capacity for denying credit which accounts for the power of the banks and the profound impact they can have on the accumulation process” (Baer, 1993, p. 37). In short, it is not reasonable to expect the financial sector to bear the responsibility for promoting the correction of the intrinsic characteristics of a particular development model, for reallocating resources in a given direction, or for increasing the rate of investment.

In these conditions, control of the system of finance by the State is of decisive importance, as this would make resources available for productive investment. Strict and effective public guidance, suitably coordinated and centralized, is necessary both

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26 Obviously, institutional rigidity, and particularly the application of upper limits on interest rates in a context of increasing inflation, prevents the creation and diversification of instruments for mobilizing finance and debt paper. What we want to stress, however, is that this is not due exclusively to State intervention. Generally speaking, this happens because those limits are not working, and the direction of causality must therefore be reversed.
for increased participation by public financial institutions in the procurement, supply and channelling of financial resources to priority sectors and firms and for the integration of private financial intermediaries in the explicit development strategy. In other words, "(...) experience seems to show that except when expressly "developmentalist" financial institutions are established under the control of the public sector, it will be very difficult for a country to solve the problems of the intersectoral (or spatial) transfer of resources to the most backward sectors or to new sectors or regions through the spontaneous development of its financial intermediaries" (ECLAC, 1976, p. 109).

This problem was encountered in the initial period of the import substitution industrialization process. The difficulties in mobilizing resources for public and private finance were not accompanied by significant changes in the domestic financial structure. There was not enough political capacity to institutionalize the procurement and transfer of private resources in the amounts and forms needed for financing the industrialization process or to establish new forms of fiscal and para-fiscal collection of resources to take the place of the traditional ones and those connected with the surpluses of the export sector. In short, neither the private nor the public sector had the financial and fiscal instruments needed to carry out the programmes of expansion of productive capital.

The pragmatic solution proposed by ECLAC and reflected in the economic policies of most of the Latin American countries was the inflow of foreign capital in the form of risk investments, or else indebtedness with official or private agencies and the establishment of State development banks to finance investment projects in new and strategic sectors, leaving aside financial intermediation. In addition, the public sector was obliged to mobilize resources through exchange policies, exchange subsidies for imports of intermediate and capital goods, tariff protection to ensure high levels of self-financing for private import substitution firms, and forced saving mechanisms represented by inflation, compulsory deposits, etc. The expansion of capitalism in Latin America thus took the line of least resistance, consolidating a development model which never succeeded in solving the problem of long-term finance on a permanent basis.

Some further comments are warranted by the fact that, within certain limits, governments were able to manipulate inflation rates as another means of finance, in so far as they encouraged intersectoral resource transfers through abrupt changes in the relative prices of the main goods and services. "In this way, most of the countries began to use inflationary expansion as a way of balancing the simultaneous pressure of the public and private sectors on the financial system. In some cases, for more or less short periods of time depending on the particular features of each country, this became an effective means of forced saving which gave a post-hoc sanction to the investment decisions of the sectors with the greatest possibilities but which, with the passage of time, lost all its effectiveness" (ECLAC, 1976, p. 128). Inflation loses its effectiveness as a mechanism for intersectoral resource transfers because the persistence of the inflationary process gives rise to quicker defensive reactions by the various economic agents and leads to a price system which is extremely rapid and flexible in terms of its expansion mechanisms.

In short, the lack of an active capital market and a private banking system that backs up the industrialization process, together with limitations in the field of taxation, obliged the State to have resort to exchange and credit policy, inflationary transfers, efforts to attract foreign investment, and external indebtedness. Through State funds, programmes and financial bodies, in some cases it managed to assemble and provide the amounts of financial resources needed for large-scale projects with long lead time.

\footnote{In a 1956 study, Kaldor (1971, p. 541) very rightly says that "(...) the general impression is that the obstacles to proper development are not natural, technical or economic, but essentially political". In other words, the mobilization of resources to boost Latin America’s economic development depends on social and political changes capable of altering the structures of ownership, income and consumption. According to Furtado (1992): "In order to escape from this style of development it would be necessary to (...) freeze substantial segments of demand for final consumer goods and greatly intensify accumulation in the production system: that is to say, set about a political process which, because of the magnitude of the interests it would confront, can only take place within a context of social upheaval. The easy way out would be to continue to rely on modernization, thereby simply reproducing underdevelopment".}

\footnote{With regard to the active function of the financial system or the passive function of the State as leaders of the capital monopolization process, see Tavares, 1983, pp. 109-111).}
times, especially in the areas of construction of economic and social infrastructure and promotion of heavy industry (Fiori, 1991; and 1992, pp. 76-89).

1. Control over finance and funding in conditions of chronic inflation

The specific dynamics of the Latin American money and financial markets, which display a high degree of demonetization, are basically associated, as already noted, with the level of inflation and lack of confidence in the monetary standard. The extremely marked reduction in the percentage of M-1 represents, in reality, a breakdown of the monetary functions, and the increase in quasi-money corresponds to the introduction of "indexed currencies", i.e., when "financial money" is corrected by a general price index or expressed in terms of a foreign currency. In the words of Mendonça de Barros: The defence sought for by permitting clauses varying the nominal value of a contract as a function of some external referent is in direct relation to the real value. In conditions of chronic inflation, the important point is the purchasing power of the currency associated with financial contracts during their validity (Mendonça de Barros, 1993, p. 2).

In chronic inflationary processes, the currency—the general instrument for contracts, trade and evaluation of private wealth—ceases to play the role of a suitable reference standard for prices and a store of value. "Demonetization is the counterpart of capital flight, for the private agents no longer see the currency as an asset capable of representing value through its mere possession. In extreme cases, the demand for idle money (the grounds for caution and speculation in the Keynesian triad) drops to zero, meaning the elimination of money from the list of assets and total impossibility of money management and regulation of interest rates by the State" (Belluzzo and Almeida, 1990, p. 65). These extreme conditions were to be observed in the second half of the 1980s in all the Southern Cone countries: the ratio of M-1 to GDP stood at around 7% in Argentina, 6% in Chile and 8% in Uruguay, while the ratio of demand deposits in commercial banks to the GDP was around 2% in Argentina and 3% in Chile and Uruguay. The replacement of the currency by another indexed asset (Chile) or by a foreign currency (Uruguay) represents a search for protection and a reference for wealth. When the economic agents cannot make forecasts with a certain minimum degree of security, this causes decisions on financial accumulation to converge towards "indexed money". The various kinds of quasi-money gradually concentrate all the monetary balances, savings and financial wealth and extend to most of the agents, both individuals and producers, institutional investors, renters and speculators. Thus, quasi-money tends to increasingly absorb financial wealth, even that of agents whose resource structure includes venture or longer-term investments. All this greatly hinders the restoration of other dimensions of financial markets and the recovery of evaluation and risk patterns regarding the holding of the various types of assets.29

As the risk of loss of wealth as a result of unforeseen changes in prices, interest rates and exchange rates makes medium- and long-term investments inadvisable, indexed financial assets consequently tend to be favored by most decisions regarding the holding of wealth and thus lead to diversion of resources from investment and production.

Ultimately, there is an almost complete shift of demand for money—for transactions, saving or speculation—towards very short-term indexed money, as a medium of protection and liquidity. Maintaining liquidity in order to be prepared for possible changes in the financial situation is the basic strategy of the agents, since the formation of positions with long-term yields may cause irreversible losses in view of the instability of the economy. In these circumstances, the various forms of quasi-money, especially in the form of "indexed money", become the only form of protection of the value of financial wealth and make the free movement of finance and funding by banks and other financial institutions practically impossible. Moreover, the latter do not expand either.

In principle, finance could be obtained from the financial liquidity accumulated in indexed investments. This does not take place, however, because in

29 We hope that we clearly showed earlier that the financial system conditions the appreciation of wealth and the evaluation of net worth in two ways: on the one hand, it gives important signals for predicting the future yields of the various assets, and on the other, since the formation of active positions naturally presupposes their financing, the conditions as regards costs, repayment periods and access to resources defined in the banking system and the capital market are of decisive importance.
view of the high level of uncertainty the preference for liquidity is almost complete.\textsuperscript{30} And there is no funding, because it is difficult to predict the yield to be expected over longer periods. Consequently, no institutional mechanisms are established which are capable of promoting the displacement of these monetary balances—financial liquidity—towards industrial or productive circulation through the market forces, and much less through the mere deregulation of financial markets. The idle (financial) money is not transformed into a means of finance and an instrument for the circulation of income. In this context, selective credit policies represent institutional arrangements devised precisely in order to make up for the lack of private sources of medium- and long-term finance.

To sum up, the volatility of the financial systems of developing economies shows once again that the problem is not so much the lack of savings as the lack of reliable selective mechanisms for channelling financial resources. Thus, unlike the rule initially formulated by the financial repression theory, we believe that “(...) when inflation is high, it is necessary to increase real interest rates, not so much by increasing nominal rates as by reducing inflation” (Akyüz and Kotte, 1991, p. 6).\textsuperscript{31}

IV
Final considerations

After the failure of the financial liberalization experiments in the Southern Cone, McKinnon carried out an exercise of self-criticism.\textsuperscript{32} In this, he leaned once again towards the experiences of South-East Asia (Japan, Taiwan and South Korea), which are marked by strict State supervision of the financial system, with limits on interest rates on loans and deposits, subsidies, and State guidance of credit and of special institutions.\textsuperscript{33} In spite of this strong State intervention, however, the Asian financial system could not be described as repressed, since the interest rates applied were positive in real terms and were quite high compared with those of other developed countries. Financial repression, then, would appear to be associated only with the application of low real interest rates (especially negative rates), rather than with policies restricting the free functioning of credit markets.

The deregulation of the Japanese banking market, which was begun only in 1981, and the liberalization of interest rates (only since the late 1980s) provide an important lesson: “(...) only after substantial financial development of the non-banking institutions of the capital market—an increase in trading in primary stocks and in intermediation by finance and insurance companies, pension funds, etc.—did the Japanese authorities substantially relax (or consider relaxing) their control of what the commercial banks could do” (McKinnon, 1988, p. 19).

\textsuperscript{30} Obviously, the banks can offer lines of short-term credit when there is a demand for this (generally associated with the maintenance of production flows), even if their liabilities are concentrated in the very short term. What we want to stress, however, is that pessimistic future expectations lead to a reduction in the marginal efficiency of capital and, hence, of investment. In other words, in conditions of high inflation and high uncertainty, wealth remains concentrated in liquid or venture financial assets. In this case, a forced issue of finance (through an economic policy decision) may not be channelled towards productive investment or, more exactly, will be shifted towards the financial appreciation circuit (of indexed money). In these circumstances, there are no mechanisms—financial or real—which will allow financial liquidity to expand investment and hence employment.

\textsuperscript{31} This is the same as saying that the convention of stable prices, which is necessary in order to maintain the system of monetary contracts, depends on the struggle against inflation, not through monetary policy (raising interest rates) but in terms of the fixing of prices by producers.

\textsuperscript{32} "In view of the serious distortions which had taken place in the Chilean economy up to 1973, these new policies of liberalizing international trade and eliminating domestic financial repression seemed very well-arranged, in a textbook sense. They were widely applauded by almost all the economists who were direct observers at that time. Thus, the many bank failures and the serious recession in the economy from late 1981 up to 1984, which left the economy with excessive indebtedness compared with a limited GDP, are a source of anguish not only for Chileans but for economists too" (McKinnon, 1988, p. 31).

\textsuperscript{33} For a study of the Japanese financial system, see Torres Filho, 1992.)
Diversification of financial instruments and intermediaries should be independent of liberalization policy. Indeed, it is desirable that liberalization should be carried out gradually, preferably after there has been considerable financial development: i.e., when the non-bank segments of the financial system are already fully established. 34

Thus, the last pillar of the financial repression paradigm was removed by one of its founders, with the abandonment of the prescription of higher interest rates as a financial development strategy. What is even more important is that a liberalization policy would only be viable on the basis of a situation of relative diversification of financial markets. Indeed, avoiding high real interest rates becomes of fundamental importance for the viability of the financial system and economic development itself. In the words of McKinnon: “Sadder but wiser, we now realize that the incredibly high interest rates on loans in pesos largely meant the collapse of the (...) Chilean banking system” (McKinnon, 1988, p. 25).

In short, we are now a long way from the evaluations and policies recommended in 1973, when McKinnon and Shaw presented financial liberalization as the epicentre of a new theory of development. In reality, all that remains of the original formulation is the proposal that real interest rates must be positive. Thus, the defence of financial liberalization has lost its objective sense and is now based solely in the ideological field, since it continues to be recommended as the best and only strategic development option: “Financial liberalization (...), with deposit-taking and investment at high real interest rates, made possible by stable price levels, is not easy and is full of pitfalls. However, it continues to be the only game in town as far as economic development is concerned. This, of course, was the main message of my 1973 book, Money and Capital in Economic Development” (McKinnon, 1988, p. 45).

If financial liberalization should only take place in a stable economy with diversified financial markets (including capital markets and institutional investors), then we can infer that the financial repression theory has nothing to say either regarding economic development financing or regarding institutional policies for increasing financial intermediaries. In other words, economic development requires the definition of financial and credit policies to stimulate productive ventures in conjunction with industrial and social development policies. Past experience indicates that what is needed could be a policy capable of generating “financial development”, and not just a policy of relaxing controls on financial markets. 35

From this standpoint, a selective credit policy with differential interest rates, designed to stimulate priority sectors (new technologies, exports, agriculture, small and medium-sized enterprises, etc.), linked with medium- and long-term planning, represents an approach that, on the basis of its own maturity, will give rise to pressures for liberalization as the masses of capital increasingly begin to demand access to all possible forms of production and financial enhancement. 36

34 “Only after nearly two decades of extraordinary financial development, with price stability, has Formosa finally relaxed its rigid controls on banking activities” (McKinnon, 1988, p. 22).

35 “Trade and financial liberalization is essential when, as in the case of Brazil, the aim is to continue to form part of the global market, but it must be accompanied, and if possible preceded, by adjustment policies and restructuring of the State to permit it to embark once again on industrial and technological policies for restructuring industry, accompanied by new and more efficient social policies” (Taveras, 1993, p. 20).
36 “With the crisis (of 1973), the big firms acted to break the absolute domination that the banks imposed on the rest of the conglomerates (keiretsu). As well as having greater liquidity as a result of the reduction of their investments, the firms began to obtain resources on the international market. In order to do this, they simply bypassed the institutional limitations imposed by the law and the government authorities and began to make use of the opportunities offered by an international financial system which was rapidly expanding at that time. When they saw their market power reduced, the Japanese banks were also forced to innovate and began to compete for clients with other institutions operating in the Euromarket, including the “Big Four” (Japanese) securities firms” (Torres Flibo, 1992, pp. 293-294). Basically, this change in the financing model of non-financial firms is one of the decisive factors in the changes -deregulation and internationalization- that have taken place in the Japanese financial market in the last two decades.
Premature liberalization of the financial system tends to exacerbate the speculative and short-term component and heightens the role of quasi-money and arbitrage in risk markets. Successful processes of market liberalization are related with complex decisions that order, condition, select and organize such liberalization, not as a function of abstract criteria on the supremacy of regulation by the "market" over State regulation, but in the light of the needs and limits of the entrepreneurial base starting from which these policies are defined.  

Thus, we reject the idea of applying a liberalization policy for its own sake without the prior achievement by the economic groups of suitable levels of financial integration and internationalization. In other words, the success or failure of financial liberalization policies depends firstly on the forms of linkages of the business groups—the linkages between financial institutions and the production and trade sectors—and ultimately on the role played by the State as the shaper of these linkages.  

(Original: Portuguese)

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For an analysis of the successful Korean liberalization process, see Akyüz and Kotte (1991, p. 15): "(...) Korea followed a gradual, cautious model in which financial liberalization only took place after the achievement of stability and a considerable degree of economic and institutional development. Structural trade deficits and shortages of foreign exchange had been eliminated through an industrialization process that was successful both in substituting imports and increasing exports; the rate of saving had increased considerably, especially because of a rapid and sustained increase in income; fiscal and monetary discipline and price stability had been achieved on a solid basis; and structural areas of fragility in the entrepreneurial and financial sectors had been reduced."

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