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# CAMPINAS SCHOOL OF POLITICAL ECONOMY

Selected Works on Economic Theory  
and International Political Economy

Campinas School of Political Economy Book Series  
Volume 1





Alex Wilhans Antonio Palludeto | Mariano Francisco Laplane  
(Editors)

André Martins Biancarelli | Célio Hiratuka | Roberto Alexandre Zanchetta Borghi  
(Series editors)

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ECONOMY:  
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and International Political Economy

Campinas School of Political Economy Book Series  
Volume 1

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# FOREWORD

The Institute of Economics at the University of Campinas (Unicamp) is pleased to present to the international community the two volumes of “Campinas School of Political Economy”, a careful selection of key translated manuscripts that contributed to the formation of our intellectual history over time.

The Institute was born in the late 1960s as the Department of Economic and Social Planning of the Institute of Philosophy and Human Sciences of the recently established University of Campinas at that time. Since its beginning, the Institute of Economics has represented an intellectual project rather than only an academic body. The departing point was the original perspective of the Latin American Structuralist School, which emerged in the late 1940s with the seminal work of Raúl Prebisch and represented an authentic and autonomous way of thinking about development in this region of the globe – an early preview of the current “decolonizing economics” trends. Two decades later, a group of young economists brought together in an infant university during the worst phase of the civil-military dictatorship in Brazil followed the same path, but adding novelties and criticisms to the ECLAC’s approach.

Trying to understand the specificities of the origins and the development of capitalism in Brazil, those collective discussions were able to mobilize different theoretical inputs and tools, always with creativity, accuracy and independence. The result was an original interpretation, which throughout the following five decades was updated, renewed and transformed not only by the changes and challenges of the Brazilian economy but also by the evolution of both the international economy and the economic thinking in Brazil and worldwide.

For a long time, most of these contributions were written and published only in Portuguese, which is frequently a problem both for international students attending courses in Campinas and for the outward circulation of these ideas. Long awaited, these two volumes have tried to capture, organize and translate some of the most important chapters of what sometimes is referred to as “Campinas School”. Each of the two volumes – whose division is thematic and follows a chronological sequence – has its own presentation and contextualization of choices. The list of manuscripts is neither exhaustive nor consensual, but the effort is, at least, a first step in spreading such key ideas.

Institutionally, we would like to thank all people involved in this project of translating original texts. Professors Alex Wilhans Antonio Palludeto and Mariano Francisco Laplane are the editors of the first volume, dedicated to contributions to theoretical and international topics. The second volume, whose texts focus on the formation and contemporary Brazilian economy,

is organized by professors Pedro Paulo Zahluth Bastos and Denis Maracci Gimenez. Professor Roberto Alexandre Zanchetta Borghi assumed a fundamental organizing task at a later stage of the project, and professor Rosângela Ballini was also essential all the time. Professors Célio Hiratuka and Carolina Troncoso Baltar also made important contributions to this project. Our assistants Geisa Aguiari, Francisco Orlandini and Greisiane da Silva also played a fundamental role in different steps of the process. Finally, we thank all the authors of the texts for their collaboration.

More than an important step on the unavoidable path of academic internationalization, these books are an institutional invitation to the dialogue, collaboration, and “cross-fertilization” of ideas with other theoretical and empirical perspectives as well as researchers around the world.

Enjoy the books!

*André Biancarelli*  
Director of the Institute of Economics – Unicamp  
Campinas, Brazil, September 2022.

# GENERAL INTRODUCTION

*Alex Wilhans Antonio Palludeto*  
*Mariano Francisco Laplane*

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The formation and institutionalization of teaching and research centers in economics in Brazilian universities throughout the 20th century present peculiar traits when compared to other historical experiences. Contrary to what is commonly observed in other countries – especially in the United States and Europe – the Brazilian economics developed and consolidated itself in a plural academic environment (Ekerman, 1989; Versiani, 2007; Fernandez & Suprinyak, 2019). In fact, Brazil is one of the rare cases in which professors and researchers who predominantly present heterodox theoretical and methodological perspectives are a significant share of economics teaching and research institutions in the country, including the most prestigious ones (Dequech, 2018). Indeed, Brazil is one of the few countries in which heterodox economists are well-established, numerous and influential (Hodgson, 2021).

Among the main institutions in Brazil that have been sources of critical contributions to conventional economics, especially to its neoclassical core, the Institute of Economics at the University of Campinas (Unicamp) stands out as one of the most relevant (Dequech, 2018; Fernandez & Suprinyak, 2019). Unicamp's Institute of Economics was founded in 1985 and was born as an expansion of activities related to teaching and research in economics developed since the late 1960s in the Institute of Philosophy and Human Sciences (IFCH) at the same university. Since its beginnings, still as a department of the IFCH, in the context of the civil-military dictatorship in Brazil, Unicamp's teaching and research in economics have been marked by interdisciplinarity and a permanent concern with the country's social and economic problems (Belluzzo, 1996; Castilho, 2008). Indeed, based on the critical framework derived from ECLAC's Latin American structuralism,

Gradually, a specific approach to the capitalist development of Brazil was forged, with a view to understanding its peripheral, underdeveloped condition, and the ways to overcome this condition. At the same time, as an indispensable part of these contributions, an equally unique understanding of the structure and dynamics of global capitalism and its transformations was crystallized in a wide range of works, which was constituted from the critical engagement with certain interpretations about the capitalist system

based on Marx, Keynes, Kalecki, Schumpeter and Minsky, among others (Ferreira *et al.*, 2021: 338).

In this context, the expressions “Campinas School of Economics” and “Campinas School of Political Economy” became common as references to the contributions about capitalist development in Brazil and the evolution of contemporary capitalism by authors linked to Unicamp over time (Santos, 2013; Bastos, 2019).

However, access to a significant part of the contributions developed at the Institute was limited to Portuguese-speaking readers. In this sense, the present book seeks to make available in English a share of the works of professors and researchers of the Institute of Economics since its beginnings.

Although the selection of contributions presented in this book is not able to accurately reflect the thematic and intellectual scope that have marked the academic production of professors and researchers of the Institute of Economics, it is a small sample of the critical reflection developed in this institution in the past five decades on topics related to economic theory and international political economy<sup>1</sup>. The contributions basically comprise chapters of doctoral theses or books, articles and working papers published in the period from 1975 to 2013 and, with few exceptions, unavailable in English until now.

This book is divided into three Parts, in which the chapters are presented in the chronological order in which they were originally published. Part I consists of 10 chapters, whose contributions were published in the 1970s and 1980s. In this part, themes related to more general topics in the fields of political economy, macroeconomics and international economics prevail. Part II, in turn, is formed by 7 chapters of works originally published in the 1990s. Instigated by the economic transformations taking place in that period, the contributions of this Part are directed at the critique of globalization, the analysis of the productive dimension and industrial policy, and financialization. Finally, Part III presents 5 chapters and includes works published in the 2000s and 2010s dedicated to the analysis of competition as well as the monetary and financial dimension of contemporary capitalism, especially in the context of the 2008 financial crisis. The reduced number of works presented in Part III reflects the growing internationalization of contributions made by the Institute of Economics. In fact, since the 2000s, a significant share of the works

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1 For a selection of works on Brazilian economy and economic history, see Bastos & Gimenez (2023).

in the fields of economic theory and international political economy has been published in journals and books in English.

As editors of this book, we thank Carolina Troncoso Baltar, Hugo Leonardo de Jesus, Maria Priscila Ribeiro Lima, Pedro Quintiliano Paiva, and Roberto Alexandre Zanchetta Borghi for their reading and invaluable assistance in the review process of some of the chapters. Special thanks are also extended to Professors Frederico Mazzucchelli, José Carlos Braga and Luiz Gonzaga de Mello Belluzzo, for encouraging the publication of this book and for kindly accepting the task of preparing brief introductions to each Part of it. We are also grateful for the effort and dedication of Unicamp's Institute of Economics staff and for all the professors, employees and students of our institution who made this publication possible.

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# PART I



# INTRODUCTION

*Frederico Mazzucchelli*

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The world that emerged after the Second World War saw important transformations. The memory of the hardships of the depression, the still fresh memory of the horrors of war, the need to rebuild nations torn apart by the world conflict, the emergence of the Soviet colossus and the outbreak of the Chinese revolution called the highest attention of the leaders of Western countries. It was necessary to stop the advance of socialism at all costs, which meant not only military deterrence and international coordination under US imperial leadership, but also to avoid – by all means – the recurrence of the economic disaster of the 1930s.

In fact, even before the end of hostilities, the perception was already clear that it was no longer possible to leave men at the mercy of the markets. The New Deal, the economic policy of Nazism, the innovative Swedish experience, the reflections of Keynes and the Beveridge Plan, among other examples, all started from the same premise: the inability of deregulated markets to promote public welfare and the related need for compensatory State intervention.

The outbreak of the Cold War only reaffirmed this conviction. In the midst of the imperative of material rebuilding of Europe and Japan, not only was it necessary to provide resources from the Marshall Plan and the opening of the gigantic American market to post-war allies, but the explicit action of the State in the promotion of economic recovery and the implementation of social protection systems. The celebrated economic miracles of Japan, Germany, Italy and France, for example, would be unthinkable without the operation of the visible hand of the State. Historian Tony Judt is right when he says that “the success story of post-war European capitalism was everywhere accompanied by an enhanced role for the public sector.”

In retrospect, there is no doubt that the post-war “political construction” at the heart of advanced capitalism was fully successful: output growth rates were exceptional, unemployment and inflation rates were extremely low, real wages grew, the social protection network expanded, economic instability was visibly attenuated and the advance of industrialization reached the periphery of the capitalist system. In face of the uncomfortable presence of the Soviet giant, regulated and disciplined capitalism managed to show its progressive face.

It is important to note, however, that the Golden Age also had its dark side. US hegemony was exercised truculently in its “areas of influence” through the promotion of military coups and support for dictatorships aligned

with its strategic interests. Crude anti-communism became the hallmark of post-war US politics, with considerable implications for the cultural and academic world. New Deal intellectuals and Keynesian-trained economists – as well as countless public servants and Hollywood actors – became targets of the McCarthyism rage. In the assessment of brilliant journalist Zachary Carter, “academia became a Core battleground, as McCarthyist crusaders sought to discredit New Deal intellectuals. The purge did more than damage careers; **it profoundly shaped the development of Keynesian economics, as Keynesians were either forced out of work or pressured to disguise their ideas in conservative clothing to avoid drawing the fury of the new right-wing zeitgeist**” (emphasis added).

In the post-war period, Keynes’ theory was reduced to a “special case” of classical theory. Full employment equilibrium would be the notional state of the economy; only the occurrence of “Keynesian warnings” regarding the inflexibility of nominal wages and prices, the liquidity trap or interest rate inelasticity of investment could move it away from the optimal path. However, the proper management of fiscal policy – public spending and/or tax cuts – could correct such “market failures” and bring the economy back to full employment. The neoclassical synthesis – hegemonic in the 1950s and 1960s – was the marriage between the Walrasian paradigm of equilibrium and the topical and circumstantial use of fiscal policy. This policy would be so much more precise the more accurate the data and the more sophisticated the statistics. Economics became an accessory branch of mathematics, and econometrics became its main instrument. The stability of growth in the capitalist world in the nearly three decades that followed the Second World War may explain the “theoretical success” of the neoclassical synthesis.

The fact is that the Core point of Keynes’ contribution – uncertainty about the future – was summarily abandoned, as were his more radical proposals (socialization of investments, euthanasia of rentiers, permanent redistribution of income, redefinition of relations between debtor and creditor countries) and, of course, his utopia about the “good life”. His repulsion to “love of money” was never even mentioned. Emptied of its richest content, its contribution was simplified and diminished, surviving only within the narrow confines of the IS-LM model. The post-war world owed much to Keynes; paradoxically, it was then that he became an “outlawed” author.

If post-war conventional economic thinking was dominated by the neoclassical synthesis produced in the laboratories of U.S. universities, Marxist-inspired economic reflection, on its part, made little progress in this period. To speak of the collapse of capitalism or of a declining tendency of the rate of profit in a context of stable and accelerated expansion in the West and in Japan



was, of course, nonsense. To speak of underconsumption when real wages were rising and unemployment exhibited minimal rates was, in the same way, nonsense. To speak of class struggle and super-exploitation when workers benefited from productivity gains and the protection of the Welfare State was equally unreasonable. The exceptional performance of capitalist economies in the post-war period and the tribulations of the Cold War practically silenced Marxist economic thought in the 1950s and 1960s. The few exceptions only confirmed that a great effort of rereading and reinterpreting Marx's writings was necessary, in order to reach a new understanding of capitalism from his formulations. It was in the context of neoclassical hegemony and Marxist "silence" that the Economics and Economic Planning Department (future Institute of Economics) at the University of Campinas was born in the late 1960s. Two Core questions guided its formation: the understanding of capitalism and the understanding of the specificities of capitalist development in Brazil. The intellectual effort and the challenges to be faced were enormous. It was about revisiting the trajectory of economic thinking, identifying the origins, forms and stages of evolution of capitalism in the world and, at the same time, pointing out the particularities of Brazilian capitalism. The basic premise was that theory and history should always go hand in hand: there was the conviction that theory without history – the arena where life and the contradictions of the real world are processed – was in danger of being reduced to a collection of causations and general determinations empty of content. Historical analysis, on its part, when unsupported by a structuring theoretical vision, tended to be limited to a merely limited description of the phenomena. The effort was to unite theory with history.

This ambitious and practically inexhaustible program of study involved – and still involves – generations of professors and researchers. The set of works selected here is just a sample of some of the great contributions presented between the mid-1970s and the end of the 1980s. Regarding their theoretical scope, we highlight the effort to revisit and reinterpret authors considered fundamental in the understanding of the deepest connections and essential elements of the structure and functioning of capitalism (such as Marx, Keynes and Kalecki). The chapters "The Critical Transfiguration" (Belluzzo), "Income Distribution: An Outline of the Controversy" (Belluzzo), "A Counterpoint to the Vision of Self-regulation of Capitalist Production" (Tavares), "A Note on the Principle of Effective Demand" (Possas & Baltar), "Wealth and Production: Keynes and the Double Nature of Capitalism" (Belluzzo & Gomes de Almeida) and "The Contradiction in Process" (Mazzucchelli) deal with this topic. The works "Finance Capital and Multinational Corporation" (Tavares & Belluzzo), "A Reflection on the Nature of Contemporary Inflation" (Tavares

& Belluzzo), “The Revival of North American Hegemony” (Tavares) and “Wages and Prices: Final Remarks” (Baltar) perfectly exhibit the permanent concern to establish theoretical mediations and embrace historical analysis in order to advance, at all times, in the understanding of reality.

Perhaps, the main merit of these contributions is that their reading always raises new questions.

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# CHAPTER 1

## THE CRITICAL TRANSFIGURATION

*Luiz Gonzaga de Mello Belluzzo*

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### **1. Value, money and capital**

The mere mention of the word “value” is disconcerting to a modern economist. The vast majority are only surprised by the persistence of such useless issues. Others are embarrassed by the mere memory of what they probably consider the most serious sin of youth of the science they have embraced.

Professor Joan Robinson does not hide her discomfort when dealing with the issue: “none of the important ideas expressed in terms of the concept of value cease to be better without it.” Or even more bluntly:

“One of the great metaphysical ideas in economics is expressed by the word “value.” What is value and where does it come from? It does not mean usefulness – the good that goods do us... It does not mean market prices, which vary from time to time under the influence of casual accidents; nor is it just an historical average of actual prices. Indeed, it is not simply a price; it is something which will explain how prices come to be what they are. What is it? Where shall we find it? Like all metaphysical concepts, when you try to pin it down it turns out to be just a word” (Robinson, 1962: 29).

In short, Professor Joan Robinson means that no science worthy of the name can allow this metaphysical intrusion to survive among its concepts, as a mockery of its positivity.

This exposition seeks to try to show that Mrs. Robinson’s “aggressive common sense” is hardly justifiable and that the labor “theory” of value is fundamental for the formulation of a coherent hypothesis about the working conditions of the capitalist economy, as Marx conceived of them.

Not infrequently, commentators and critics of the labor theory of value embrace a continuity, a linear development of its problematics, from the classical political economists to Marx. The idea of continuity is postulated from

the authors who consider themselves Marxists to those who, as Professor Samuelson, treat it as “a minor post-Ricardian.”<sup>2</sup>

Characterizations aside, both positions, as we will seek to demonstrate, are not aware of the radical transformation operated by Marx in the structure of classical theory. And this transformation breaks out, immediately, in how the theory of value is treated in the body of Marxist economics.

In fact, the classical political economy approach pursues value as an “essence” of the contingent phenomenon of exchange. The “natural order” of the physiocrats reappears in the analysis of Smith and Ricardo metamorphosed into “value,” as **essence** of the naturalness of society. Value becomes an entelechy, “as anything absolutely indifferent and external to the commodity itself,” and work appears as the concrete determination of this abstraction, being reduced to its more immediate empirical dimension of physical units of work. Apropos, Ricardo, at the end of his life, sought in every way an absolute standard for measuring value: “a perfect unit of measurement.” With this we do not mean that the problem of “absolute value” did not follow **logically** from the Ricardian argument, as its necessary crowning (or impasse?), but, rather, that the difficulty is not there, but in the fact that Ricardo started with value as an abstract concept.

Conversely, Marxist research is founded on a very different question, and it is surprising that most authors have not grasped its specificity. While – we reiterate the argument – classical political economy approach is founded on the abstract concept of value, Marx simply asks under what conditions the products of human labor assume the value-form. It is founded, therefore, on an undeniable fact, observable in any society and at any time, that man produces his own subsistence. And that the only way to do it is through labor. I believe that even the most unrepentant supporter of the utility theory of value would agree with this.

The object of his investigation is not, therefore, “value” as imagined by the minds that adhere to metaphysics, but the **commodity**, the elementary form that the products of human labor assume in commodity societies.

Marx explicitly refers to this in one of his controversial works *Marginal Notes on Adolph Wagner’s Lehrbuch der politischen Oekonomie*. There, rebutting his opponent’s challenges, he clarifies the many reservations – real and imagined – denounced by critics of the labor theory of value and suggests many clues for the unveiling of the relationships between his theory and previous theoretical attempts. Right at the beginning, he points out to the treatise

2 Among those who postulate a continuity of problematics between the classics and Marx, see, for example, Dobb (1966: 9-29) and also, accordingly, the chapter on Marx (Dobb, 1973: 146-50). See Samuelson, *Marxian economics as economics* (1967: 616-23), whose mistakes start with the title of the work.

proponent “that for me neither ‘value’ nor ‘exchange-value’ are subjects, but the **commodity**.” And, further on, addressing the opponent’s arguments:

“When Mr. Wagner says that it is not a ‘general theory of value’, he is quite right in his own sense, since he means by a general theory of value the hair-splitting over the word ‘value’, which enables him to adhere to the traditional German professorial confusion between ‘use-value’ and ‘value’, since both have the word ‘value’ in common” (Marx, 1966b: 714).

Although these clarifications were provided more than a century ago, they certainly had little effect on the minds of economists, who preferred to continue addressing the problem of value according to the tradition of German professors. And, hopeless as to their own metaphysics, they ended up taking refuge in the word “price.”

It is, therefore, based on the commodity that Marx seeks to unravel the mechanisms of the functioning of the capitalist society as a developed form of the commodity society. This is also why the simple commodity society constitutes the first step in his analysis of capitalist society. The method has the advantage of not only enabling the study of exchange in “pure state,” since in a society of independent producers the relations of production are entirely resolved in the social division of labor, but also of enabling the capitalist categories to appear as historically modified forms of prior economic societies. The path of analysis is not only logical, but eminently genetic, as Marx points out in the *Introduction to the Critique of Political Economy*:

“[...] it may be said that the simpler category can express the dominant relations of a less developed whole, or else those subordinate relations of a more developed whole which already had a historic existence before this whole developed in the direction expressed by a more concrete category” (Marx, 1957: 164).

It is necessary to warn here, for the sake of rigor and fidelity to the Marx’s thought, that the expressions “developed form” or “developed totality” do not suppose that Marx conceived commodity society as a **concrete society**, whose “development” led to the emergence of capitalist society. Conversely, his starting point is capitalist society, as it is offered at the moment he begins the analysis.

“[...] In general, all historical and social science, when observing the development of economic categories, must always take into account that the subject (of research – LGMB) – in this case, modern bourgeois society – is something given, both in reality as in the mind and that the categories

express, therefore, **forms of being**, determinations of existence, often simple aspects of this determined society, of this subject, and that, therefore, **from a scientific point of view**, its existence in no way begins in the moment when one begins to speak of it **as such**" (Marx, 1971, v. 1: 27).

It would be wrong, from Marx's perspective, not only to start the analysis by the most general categories, for example labor, land, the instruments of production, etc. – but also to start from the more complex (more developed) categories, such as capital, wage labor, profit, ground-rent, interest, etc. In the first case, the sin would be of excessive abstraction; in the second, of insufficient abstraction.

From this perspective, the commodity will be moved to the dimension of a society of independent producers – owners of the means of production and of the products themselves. In this society, goods are produced exclusively for exchange, insofar as they have no "utility" for their producers, except to the extent that they represent the possibility of acquiring other goods. For each producer, his product appears only and solely as a result of his labor and as a "utility" for others, in the same way that his needs will be met by the product of the labor of "others." Rodolfo Banfi argues that "in this aspect, the division of labor moves to the background, while, in the foreground, society itself appears as a consumer of labor." And, from this point of view, the "important thing is that the total 'quantum' of labor consumed is distributed among the different sectors of production in such proportions that allow the annual reproduction of society as a producer" (Banfi, 1970: 145).

The proportions in which the commodities are exchanged for one another are not predetermined by the amount of labor spent by a producer or productive sector in isolation, but, on the contrary, the amount of labor that each producer spends is manifested as a fraction of the total labor consumed by society. The exchange value of each commodity is not pre-established in advance by the efforts of each producer, but is determined after the fluctuations, marches and counter-marches of the exchange process. This means that production for exchange transforms each producer into an organ of social labor, and only under these conditions can the commodity be conceived as the crystallization of human labor – "as a simple coagulation of labor."

Then, the useful labor of each producer is dissolves in social labor, becoming **abstract labor**, and in this sense it is led to the position of substance of value.

Thus, in the society of independent producers, concrete labor, which creates use values, is shifted to a subordinate position. Natural and eternal activity, interchange between man and nature, it becomes a mere instrument



of social labor, whose sociability is not given beforehand, but results from the exchange and, therefore, its product, the commodity, is expressed as **value**.

“When the labor of individuals is not immediately social, that is, when they are private and independent labors, where the weight of the constitution of society is entirely related to the thing, to the product, it is necessary that, in addition to its material determination as object of use, the product must be value, that is, general purchasing power, money; labor that is not immediately social, but private, becomes social as a producer of money. It becomes social because its product assumes the form of value; but since, because of this metamorphosis, all products are equal, that is, general wealth, so all labors, as producers of money, are equalized, parts of a general labor; therefore, individual, concrete, useful, determined labor becomes collective as it transforms into its opposite, into abstract labor” (Napoleoni, 1974: 105).

In the history of economic thought, perhaps few concepts have had such an ambiguous trajectory as that of “abstract labor” formulated by Marx in the first volume of *Capital*. In relation to it, orthodox economics has assumed a double position: for the less sophisticated, it is the complete proof of the metaphysical character of the labor theory of value; for others, an obscure way of reducing different types of labor to the *genus* of labor in general. This latter interpretation, apparently correct, is, however, too timid to reveal the importance of the concept in the theoretical structure of Marxist economics. More than that, the restricted understanding of the idea of abstract labor, as a mere deputation of the particular characteristics of the different qualities of labor, can lead us to questions full of perplexity, as Joan Robinson does in her book *Economic Philosophy*:

“How can we find out how much abstract labor is contained in an hour’s work of a skilled engineer?” (Robinson, 1962: 44).

Professor Robinson’s question is the most conspicuous example of theoretical confusion. It would be fine if addressed to Ricardo or Adam Smith; never to Marx. The confusion stems from the inability to understand under what conditions labor is led to the position of substance of value, as “abstract labor.” Under very special conditions, in fact. Although Marx did not explain them when he addressed the problem in the first volume of *Capital*, he did so very clearly in the *Introduction to the Critique of Political Economy*:

“Indifference in relation to a particular type of labor presupposes the existence of a very developed totality of kinds of real labors in which none is

absolutely predominant... On the other hand, this abstraction of labor in general is not the result of a mental process of reducing the set of concrete labors. Indifference in relation to a particular kind of labor corresponds to a form of society in which individuals move easily from one labor to another and in which a particular form of labor is fortuitous to them and, therefore, indifferent. Labor, in this society, has become, not only at the level of categories, **but in reality itself**, a means of creating wealth in general, separating itself, as a determination, from particular individuals” (Marx, 1957: 168).

Accordingly, in the society of independent producers, it is society itself that appears as a consumer of labor, so the productive activity of individuals seems to be, and in fact is, governed by forces that are foreign to them. Adam Smith, when considering this type of society, “the rough and primitive state,” attributed to it a character of naturalness that, in fact, it does not have. And, in doing so – we repeat an argument already presented – he was not able to understand the consequences caused by the separation of direct producers from the means of production. That is, he was not able to understand that this separation, on the one hand, already exists “in potential” in the simple commodity society and, on the other hand, which implies the generalization of commodity production, an exacerbation of the phenomenon of exchange that culminates in the transformation of labor-power into commodity and of the means of production into capital. Marx is very clear on this point:

“In the one hand, it is often forgotten that the presupposition of exchange value, as the objective basis of the productive system as a whole, already includes coercion to the individual; that its immediate product is not a product for him, as it only comes to be so through the social process and it has to adopt this general and external form; that the individual exists only as a producer of exchange value, which implies the absolute negation of his natural existence; the individual is therefore completely determined by society. Finally, it is not seen that already in the simple determination of exchange value and money the antithesis between wage labor and capital is latent. The desire that exchange value does not become capital or that the labor that produces exchange value does not become wage labor is as pious as it is stupid” (Marx, 1971, v. 1: 186).

In the simple commodity society, the concrete labor of each producer is only social labor *qua* abstract labor. The particular activity of each one as a producer only acquires meaning when referred to the general activity and, therefore, to society as a consumer of labor.

The reference of all particular and concrete labor to the productive activity of society supposes, however, that each commodity represents, before the others, exchange value in general. Now, this becomes evident in the relations of exchange between commodities in which each of them must express its existence as value in another concrete commodity. This is because, although the possibility of exchange is given by the reduction of all labors to a common condition of existence as abstract labor, producers do not exchange their labors directly except through the movement of commodities. These are considered in relation to one another in the exchange relation, and not the quantities of labor directly. Therefore, the problem arises that the measurement of value can only be achieved by denying the abstract character of labor, that is, a commodity can only express its value in another concrete, particular commodity. The antithesis that was already present in the nature of the commodity between exchange value and use value begins to be expressed in the simplest exchange relation.

The reiteration and expansion of exchange, understood as an expression of the differentiation of the social division of labor, demand that the exchange value preside and regulate the acts of production, and for that it is necessary that a particular commodity can embody the abstract labor time from which it is a result.

Marx points out, therefore, that the appearance of money does not simply accomplish the “technical” purpose of facilitating exchange, but is an expression of the nature of a society in which private producers produce for exchange, and only through it they can make their labor social. However, the sociability that is expressed in money and at the same time is imposed by it as a power of command over the labor time of private producers is no longer a natural phenomenon, as Adam Smith wanted. The appearance of money implies, therefore, the substantiation of exchange value, in the sense that money presents itself as something “autonomized” in relation to individual producers. In the capitalist society, the separation between direct producers and conditions of production not only turns the labor-power into a commodity, but, in doing so, it also turns that commodity into an element of capital. The “social” is no longer opposed to the worker as something strange, “but hostile and antagonistic, when it appears before him objectified and personified in capital” (Marx, 1972: 60). Now society is only a consumer of labor through the operation of the set of individual capitals, that is, as social capital. For this very reason, capital as the embodiment of abstract wealth – the historical form of social wealth – can only be opposed to labor-power as the embodiment of abstract labor.

The existence of capital, as a historical form of social wealth, demands, in a radical and overwhelming manner, that the useful character of each labor becomes indifferent, so only labor as use value for capital remains as an essential determination. The substantiation of exchange value in money, which enables the reiteration and expansion of exchange in the commodity society, already contains, potentially, the most general determinations of capital in the sense that it “completes” the autonomization of money before the set of producers. It is no longer the case that independent producers are dominated by exchange value, but that the generalization of exchange value converts some direct producers into owners of means of production and subsistence, on the one hand, and wage earners, on the other. At this time, exchange value is no longer opposed to the worker as something strange, “but hostile and antagonistic, when it appears before him objectified and personified in capital.” Money, once a simple expression of a sociability proper to a society of independent producers, now becomes the **subject** of a process that enables the owners of money (as capital) to command the means of production and wage laborers. This is how living labor, real element of all production, appears only as a means of valorizing existing values and, therefore, as a means of capitalization. It is accumulated labor, materialized in the means of production, which, acting as capital, is preserved and increased by sucking living labor, becoming a value that is valorized. Accordingly, under the capitalist regime of production, it is not labor that uses the means of production, but it is the means of production that use labor.

The reduction of all labor to abstract labor, therefore the mere ability to work, is what allows capital to quantitatively extend labor time beyond what is socially necessary for the reproduction of the labor-power. It is the fact of sucking living labor as mere labor time that gives capital the possibility of obtaining surplus-value during the production process, which, for this very reason, ceases to be a simple relation between **input** and **output** in physical terms to present as a valorization process. Thus, Marx makes explicit the crucial phenomenon of capitalism as an economic society in which the production of value is mandatorily the production of surplus-value. And, more than that: a form of society in which the objective of production continues to be exchange, “but, while in the case of the simple mercantile society exchange is, ultimately, the mandatory path that leads to the consumption (individual and productive) of the producer, in the capitalist society selling is the mandatory way to accumulation” (Banfi, 1970: 155). In this sense, commodity exchange reappears as a subordinate and intermediate sphere, where goods are exchanged no longer as products of labor, but as products of capital. This last observation is particularly important for a correct interpretation of the

famous transformation problem of “values” into production prices, which has raised so much controversy in recent years, between Marxist and non-Marxist authors. Before that, however, it would be convenient to better define the scope of what was said above about the labor theory of value as theory of surplus-value, in Marxist analysis. It has been said before that the theory of value postulated by Marx in the first volume of *Capital* does not exhaust its pretensions, contrary to what is usually believed, in the formulation of a first approach to the theory of prices, but rather to explain the appearance of a surplus, even if the commodities are exchanged for their respective values. Well, this is not accurate.

It is the permanent tension between the indirectly social and directly private character of production in the simple commodity society that gives value-form to the products of labor. That is, in these societies the product of labor can only subsist as value (the capability to acquire other products), and the **value**, therefore, can only manifest itself as exchange value. In these terms, the theory of value is **only** a theory of relative “values,” in the sense that exchange is the fundamental nexus that interrelates independent producers and defines the nature of their production relations.

In capitalist society – we already know – the separation of direct producers from the means of production and the means of subsistence implies the generalization of commodity production, the crucial fact that these commodities – labor and capital – will be placed in opposite poles in the process of exchange according to the law of value. But the transformation of the means of production into capital and of the mass of direct producers into labor-power, if it is the result of a process of generalization of commodity production, it is also the starting point for reordering the fundamental relations of society, to the extent that capital is only opposed to labor-power as **value** whose sole purpose is to valorizing itself, and it can only do so by sucking living labor. The law of value, from that moment on, is the law that regulates the “value creation” process only as an immanent law of the capital valorization process. This crucial moment in Marx’s analysis shows that the emergence of capital through the more general determinations of exchange value and money subverts the relations of society. The labor process is transformed from its core to meet **the appearance of value as something that is intended to be absolute**, in the sense that its quantitative expansion becomes the only objective of social production; and that, at the same time, it is the movement of capital in the pursuit of maximum valorization that regulates the distribution of social labor. It is in this sense that must be understood Marx’s statement that “as the unity of the labor process and the process of creating value, is the process of production of commodities; considered as the unity of the labor process and

the process of valorization, it is the capitalist process of production, or the capitalist form of the production of commodities” (Marx, 1966a, v. 1: 147).

## 2. The law of value as a law of motion of capital

The entire trajectory of *Capital* is committed to this fundamental transformation. The divergences in the various interpretations of the importance and significance of the law of value all stem from a radical misunderstanding of its theoretical status in Marxist thought. Drunk by the “positive” conviction that “a black slave is a black man,” it does not even come to the imagination of critics and commentators how the generalization of commodity production may imply the transfiguration of the very law of value into the law of the valorization process. And this transfiguration is not the result of a skillful conceptual game, but results from the very metamorphosis of the relations between independent producers of commodities, relations that are expressed through value, which, therefore, determines a transformation in the very way that the **value** expresses these relations. From this perspective,

“Even if the capitalist regime of appropriation seems to openly break with the laws originated from the production of commodities, it does not arise, in any sense, from the violation of these laws, but, on the contrary, from their application [...]. This result becomes inevitable as soon as the labor-power is freely sold by the worker himself as a commodity. But this is also the moment from which the production of commodities is generalized and converted into a typical form of production; it is from then on that all articles are produced for the market and that all the wealth produced follows the paths of circulation. Only there, where it is based on wage labor, does the production of commodities impose itself on the whole of society and only there does it develop its hidden potential. To say that the interposition of wage labor distorts the production of commodities is equivalent to saying that the production of commodities must not develop if it does not want to be distorted. As this production develops, obeying its immanent laws to become capitalist production, the laws inherent in the production of commodities are **exchanged** for the laws of appropriation of capitalism” (Marx, 1966a, v. 1: 492, 495 – emphasis added).

The discovery that the law of value imposes itself, under the regime of capitalist production, as the law of the production of surplus-value means that it continues to express, in a transfigured form, the capitalist relations of production, as developed forms of commodity relations. And just like the law of value, in the simple commodity society, guaranteed that the total “quantum” of labor consumed was distributed among the different branches of production,

in such proportions that would allow the annual reproduction of the society as a producer, in the same way the law of surplus-value, the capitalist form of the law of value, is the law that governs the reproduction of capitalist relations and determines their possibilities and limitations. Therefore, in a much deeper sense than what economists usually attribute to the expression, it is the fundamental law of motion of the capitalist mode of production, as a law that defines the specificity of its dynamics, in opposition to the previous modes of production. It is the internal law of a production regime “that is not linked to predetermined and predetermining limitations of needs,” but only to the needs for self-valorization of capital. Extracting surplus-value from the mass of direct producers it subjugates, capital not only increases but also restores its own conditions of existence:

“Labor not only produces, in antithesis with itself, on an ever-wider scale, its own working conditions as capital, but that capital produces the productive wage earners it requires on an ever-increasing scale” (Marx, 1972: 73, 103).

The accumulation process is born from the core of the capitalist system, it emerges from the antagonism of its production relations, while reconstructing them continuously.

Accumulation and reproduction are, in reality, two immanent moments of the same dynamics regulated by the law of value, as law of the valorization process. The distinction between these two immanent moments of the same movement is of decisive theoretical importance, since it is what allows the form of this **movement** to be defined as **tendency**. Balibar was able to express this with extreme precision:

“[...] the analysis of the tendency of the capitalist mode of production produces the concept of the dependence of the **progress of productive forces in relation to the accumulation of capital**; therefore, the concept of the temporality that is proper to the development of productive forces in the capitalist mode of production. Only this movement can be called, as had already been proposed, **a dynamics**, that is, a movement of development **interior** to the structure and sufficiently determined by it (the accumulation movement), which occurs according to a specific rhythm and speed determined by the structure, having an irreversible necessary **orientation**, and conserving (reproducing) indefinitely, on another scale, the properties of the structure.”<sup>3</sup>

3 See Balibar (1966: 311-12). It is surprising that after this correct formulation Balibar sought to establish a distinction between “dynamics” and “diachrony.”

It is only from this point of view, that is, within the concept of dependence of the progress of the productive forces in relation to the accumulation of capital, as an expanded reproduction of capitalist relations, that we can strictly circumscribe the scope of the concept of “technical progress” in Marxist thought. This is because Marx, in establishing the necessary dependence between the progress of the productive forces and the reproduction of the relations of production, makes the indispensable connections between labor productivity and the law of value, in its capitalist form.

“**Labor productivity**, in short – the maximum of products with minimum of work; hence, the greatest possible cheapening of commodities. Regardless of the will of these capitalists, this becomes a law of the capitalist mode of production. And this law is only realized by implying another law, that is, that it is not the existing needs that determine the scale of production, but, on the contrary, it is the scale of production – always increasing – that determines the mass of the product. The goal is that each product contains as much unpaid work as possible, and this is only achieved thanks to the production for the sake of production. This presents itself, on the one hand, as a law, since the capitalist who produces on a small scale would incorporate into the product a ‘quantum’ of work greater than that socially necessary. It presents itself, therefore, as an adequate application of the law of value that is not fully developed except under the capitalist mode of production. However, it appears, on the other hand, as an impulse of the individual capitalist who, in order to violate this law or to use it astutely to his benefit, seeks to lower the individual value of the commodity, in relation to the socially determined value” (Marx, 1972: 76 – emphasis added).

### **3. Accumulation and development of productive forces**

Accumulation is not, therefore, a matter of individual choice. It is a necessity engendered by competition itself: a struggle in which capitalists seek to exclude each other from the market. Technical progress is the weapon used by these gentlemen to crush each other. Through the introduction of innovations, they seek to lower their costs and increase their profit margins, being fought by others.

“Technical progress, the fruit and weapon of intercapitalist competition, appears in its effects, as a differential income for the individual capitalist, an income that reinforces the competition between capital and labor, for the benefit of capital” (Salama, 1972).



The finding that technical progress reflects the dependency between the development of productive forces and the expanded reproduction of production relations, therefrom stemming its tendential form, its orientation – increasing of the organic composition of capital – has not been understood by some authors who addressed the matter. Blaug even affirms that “ultimately, Marx was also a victim of the myth of the labor-saving tendency in technical progress,” and that, in reality, everyone (!) agrees that:

“Technological progress works to counterbalance decreasing incomes in the faster development factor... Seen in this light, the Marxist idea of capital accumulation even seems deliberately paradoxical. Marx does not establish any distinction between functions of production and changes in them: capital cannot be invested without changing the state of the art. Hence, the issue of insufficient compensating influences from diminishing returns is not posited in the Marxist system. At the same time, Marx assumed that innovations would lean heavily toward the labor economy. Despite this, he concluded that the accumulation of capital lowers the profit rate without necessarily raising real wages per worker” (Blaug, 1972: 227-28).

And he finishes by arguing that, in the perfect competition regime, innovations cannot, in the long run, simultaneously reduce profits and wages. Any tendency to increase the remuneration of one of the factors would cause the stabilizing interference of technical progress.

Let us leave aside the evident neoclassical bias of the criticism that only increases the conceptual embarrassment and perplexity of our author and try to understand it in its *pièce de résistance*: the issue of diminishing returns from “factors” and the stabilizing role of technical progress. For this purpose, and in order not to confuse the spurious version with the authentic article, it is convenient to return to Ricardo, the source of all the confusion.<sup>4</sup>

In Ricardo, the increasing in capital intensity results from the introduction of “machines,” to save labor, as a way to temporarily escape the law of diminishing returns from land. It is a necessity of capitalists pressured by decreasing profit margins, not due to the action of workers, but by the determination of natural laws. The important thing, in the Ricardian view, is that the accumulation of capital with the introduction of machines, instead of leading to an increased organic composition of capital and the consequent tendency of the rate of profit to fall, leads exactly to the opposite operation.

The introduction of machines, which, in the short term, saves labor, that is, variable capital measured in terms of wheat (wage fund), and therefore

4 See Ricardo (1951, Ch. 31: 386).

increases the proportion of constant capital, subsequently, in the expansion dynamics – given the assumption of rigid wages (subsistence level), but of flexible prices – leads to the resorption of the displaced labor.

Thus, the effects of technical progress are “neutralized,” both in terms of the organic composition of capital and of the distribution of income. It is not by chance that the neo-Ricardian models are of the type of constant income of scale, with “neutrality” of technical progress and constant distribution of income.

However, Marx’s view is quite different. According to him, it is not in the short term and by the labor-saving or reproduction cost-reducing characteristics that technical progress tends to continuously raise the organic composition of capital.

Steindl’s interpretation that Marx struggles between two contradictory versions – one short-term and another long-term version – of the relations between technical progress and capital accumulation stems from a reading that is, at least, flawed, if not completely wrong, of chapter 25, “The General Law of Capitalist Accumulation” (Steindl, 1952, cap. 14: 228 et seq.). The distinction between the short-term and long-term versions, introduced *ex nihilo* by the author, denotes, in reality, his inability to perceive the nature of the connections that, throughout that chapter, Marx seeks to establish between **cycle** and **tendency**. There is no indication that Marx confused “short-term” problems with “long-term” issues, even because these concepts (?) are foreign to the theoretical trajectory of the text, as we will seek to demonstrate.

First of all, Steindl’s divergence and the unfortunate theoretical gibberish that Professor Blaug offers us have a common origin. Both lost sight of the connections and the distinction that Marx establishes between the process of constitution of capitalist productive forces (that is, of the technical bases of capital) and the process of accumulation of capital supported on these already constituted bases. In short, they interpret the chapter on the general law of capitalist accumulation as if the fourth section of *Capital* had never been written. It is not by chance that this Section, called *The Production of relative surplus-value*, includes the chapters on *Co-operation*, *The Division of Labor and Manufacture* and *Machinery and Large-Scale Industry*, which deal with the process of emergence of the technical bases of capitalism, based on the nature of the capitalist relations of production.

The first two chapters analyze the conditions for the reproduction of capitalist relations supported on a technical basis that is not their own, but inherited from previous modes of production. In this case, labor is submitted only **formally** to capital in the sense that there was no essential change in the real form and way of the labor process, of the real production process, and the

production of surplus value can only be achieved predominantly through the extension of the working day, in the form of absolute surplus value.

It is in **manufacturing** that this form of capitalist organization of labor finds its most favorable conditions for development and it is there, at the same time, that capital prepares, through the division of tasks and the differentiation of tools, consequent collectivization of the labor process, the emergence of its own technical “nature,” crystallized in the machinery system and externalized in the Large Industry.

“In manufacture, workers, in isolation or in groups, have to perform each specific partial process with their tools. And if the worker is assimilated by the production process, this process had to adapt, previously, to the worker. In the production supported by machinery, this subjective principle of division of labor disappears. Here, the total process becomes **objective**, it can be analyzed in itself, in the phases that constitute it, and the issue of executing each partial process and coordinating these diverse partial processes as a whole is solved by means of the technical application of mechanics, chemistry, etc.” (Marx, 1966a, v. 1: 310 – emphasis added).

The fact that the production process assumed an **absolutely objective** form with the introduction of the machinery system has three significances. Firstly, although it is a characteristic common to all capitalist production that the worker be subjected to their own working conditions as capital, this **inversion only** acquires a technically tangible expression with the advent of machinery. “Upon becoming an automaton, the very work instrument begins to face the worker as capital” (Marx, 1966a, v. 1: 350). The work instrument ceases to be an expression of the worker’s subjective activity to become the personified expression of capital that uses the worker as its instrument. Second, the objectification of the production process, although it can only be explained as the crowning of the capital’s designs of extracting an increasing volume of unpaid work, means the **autonomization** of the technical structure, in the sense that the “application of science becomes a criterion that determines and stimulates the development of immediate production” (Marx, 1966a, v. 2: 227). For this very reason, all methods that are born from this technical basis, which can only confirm its internal reason, are methods of producing relative surplus value on an increasing scale, whose **continued** application makes immediate labor increasingly redundant.

The autonomization of the technical structure does not just mean that capital has absorbed the subjective potentialities of the worker and crystallized them in specific material forms (machinery system). Moreover, the appearance of these material forms is revealed at the level of the social division of labor

by the emergence of a sector specialized in the production of the material elements that constitute constant capital, which is now autonomized before the sector destined to the production of means of consumption.

Material production now corresponds to the social relations that originated it and, thus, the dynamics of capitalist accumulation and reproduction is definitively transformed into an objective process, free from any limits, other than those fixed by the very nature of capital. In other words, capital removes the external limits to its expansion. The production instruments, taken from the skill of the individual worker, who handled and produced them, are now produced according to the dictates of the capitalist production regime. Accordingly, insofar as they are subjected to capitalist production, they come to be regulated by the laws that compel this production regime to the continued expansion of capital-value. That is, the recurrent enhancement of the productive force of social labor, at the same time that it is driven by the introduction of new methods, it in turn drives the creation of new use-values suitable for the expansion of capital-value.

Production for the sake of production now finds its appropriate material vehicle, embodied in a social division of labor in which the social labor time is autonomously linked to the production of means of production. This means that all social labor time is regulated by the dynamics of transformation of the sector of means of production. And this dynamic is expressed by the relative decrease in living labor or, in another perspective, by the continued increase in the organic composition of capital, which is to say, by the exacerbation of the pursuit of production for the sake of production.

The use of Marx's reproduction schemes is only possible once established the theoretical connection between the new nature of use values (created by capital) and the tendency toward unlimited expansion of exchange value implicit in them.

Reproduction schemes are introduced shortly after capitalist accumulation has been dealt with, where all the assumptions regarding the variation in the organic composition and in the rate of surplus value play a Core role in explaining the movement of capital. Concurrently, the reproduction schemes prepare the discussion of the competition and of the crisis, developed in the third volume of *Capital*.

Thus, when Marx discusses the possibilities of expanded reproduction in the second volume of *Capital*, he does not intend to propose a scheme of intersectoral equilibrium in the sense commonly assumed by the epigones, but rather seeks to demonstrate the **possibility and only the possibility of the functioning of an economy that due to its nature is driven by the contradiction between the tendency towards unlimited enhancement of**

**productive forces and the narrow base (the appropriation of labor time) on which it is supported.** And this demonstration is just an indispensable logical step to make the antagonistic, and therefore historical, character of this production regime more evident.

Therefore, the point is not demonstrating that capitalism can somehow expand and reproduce itself in “equilibrium” or, through equilibrium, examine the possibilities of disequilibrium. Such idea is entirely out of Marx’s perspective and the concepts of equilibrium and disequilibrium are not compatible with materialist dialectics, but are part of another theoretical horizon: functionalist positivism. On the contrary, the adoption of reproduction schemes works as a counter-proof of the “harmonic” nature of capitalism, in the sense that proportional and non-turbulent expansion would be possible only if the growth of the means of production sector were entirely adjusted to the expansion of the means of consumption sector. In other words, such a thing would be possible if needs commanded production, not the other way around. It would be as if capitalism ceased to respond to its nature. Or would there be another way of explaining the adoption of hypotheses so absurd that they violate the very mode of existence of capitalism, such as constant rates of surplus value, unchanged organic composition, etc.?

But let us return to chapter 25, which is the subject of debate. Based on what was schematically exposed in the previous paragraphs, it becomes easy to understand that the **analytical démarche** of this chapter is supported on the assumption of an adequate technical basis for capital that is already constituted.

Marx, therefore, is dealing here with the tendency laws of the **capitalist mode of production**, which strictly appears only at the moment when capitalist relations revolutionize the nature of the labor process to enable the expanded reproduction of capital *qua* capital, admitted at its maximum limit the rate of surplus value for each time segment of the technical structure, that is, for each new generation of producer goods.

“All methods for raising the social productivity of labor that grow up on this basis are at the same time methods for the increased production of surplus-value or surplus product, which is in its turn the formative element of accumulation. They are, therefore, also methods for the production of capital by capital, or methods for its accelerated accumulation. The continual re-conversion of surplus-value into capital now appears in the shape of the increasing magnitude of the capital that enters into the production process. This is in turn the basis of an extended scale of production, of the methods for raising the productivity of labor that accompany it, and of an accelerated production of surplus-value. [...] With the accumulation of capital, therefore, the specifically capitalist mode of production develops,

and, with the capitalist in ode of production, the accumulation of capital. These two economic factors bring about, in the compound ratio of the impulses they give to each other, that change in the technical composition of capital by which the variable component becomes **smaller** and **smaller** as compared with the constant component” (Marx, 1966a, v. 1: 528 – emphasis added).

It is unequivocal that Marx does not intend to discuss the conditions of the social distribution of income (basically the profit/wages ratio), but the fact that intercapitalist competition gradually changes the technical structure of capital and shifts the limits of expanded reproduction beyond its own possibilities for realization. It is in this sense that the law of value remains as an inexorable internal law of dynamics of the capitalist mode of production. A permanence that is expressed in the fact that the “virtues” of the development of the productive forces of capital lead it to clash with its social possibilities of reproduction. It is not because of supposed “decreasing returns,” but because of progressive increase in production scales, the growth of its technical capacity for accumulation and its increasing **concentration** and strength, that capital tends to surpass its possibilities of realization and expanded reproduction.

In very general terms, this conflict consists in that,

“on the one hand, the capitalist regime of production tends towards the absolute development of productive forces, regardless of the value and surplus-value implied therein and also regardless of the social conditions within which there is the development of capitalist production, while, on the other hand, it aims at the conservation of the existing capital-value, as well as its maximum valorization (that is, ever accelerated increase in this value; its specific character lies in the existing capital-value as a means for the highest possible valorization of this value). The methods through which this is achieved include the decline in the rate of profit, the devaluation of existing capital and the development of productive forces of labor at the expense of the productive forces already produced” (Marx, 1966a, v. 3: 247).

The permanence of the law of value presents itself, therefore, for capital as a whole – as realization of its concept (self-valorizing value, sucking living labor) – as an inviolable norm of existence, at the same time that the violation of this norm appears for each individual capitalist, in the competition process, as a condition of survival. Thus, capital is the very contradiction in process, insofar as the same law that compels it to a progressive valorization ends up determining a narrowing of the base on which this valorization process rests.

## 4. The law of tendency

That is why, in the perspective envisioned by Marx, the contradictory nature of the capitalist accumulation process manifests itself fundamentally in the tendency of the rate of profit to fall, **as a characteristic expression of this production regime**, not because capital shows any inclination to incur diminishing returns as it accumulates, but, on the contrary, because its accumulation necessarily involves the continued enhancement of the social productive power of labor. And the progressive development of the social productive power of labor

“is revealed precisely in the fact that, thanks to the increasing use of machinery and fixed capital in all forms, the same number of workers can convert into product, at the same time, that is, with less labor, a greater amount of raw and auxiliary materials. This increase in the volume of value of constant capital – even if only remotely expresses the increase that occurs in the real mass of use values that materially form constant capital – is accompanied by progressive cheapening of products. Each individual product now contains a smaller amount of labor than in previous stages of production, in which capital invested in labor represented an incomparably greater proportion in relation to capital invested in means of production... Therefore, as the total mass of living labor added to the means of production decreases as production of their value, so does unpaid labor and its share in the value, as a proportion of the value of total capital employed. Or rather, it is an increasingly smaller share of the total invested capital that is converted into living labor and, therefore, this total capital absorbs less and less surplus labor in proportion to its magnitude, **even though the ratio between the unpaid portion and paid portion of labor employed can grow at the same time**. The relative decrease in variable capital and the relative increase in constant capital, even though both grow in absolute terms, present themselves, as already mentioned, as a different way of designating greater labor productivity” (Marx, 1966a, v. 3: 217 – emphasis added).

Accordingly, the tendency of the rate of profit to fall, as the accumulation process progresses, does not exclude, but, on the contrary, implies not only the (obvious) increase in the mass of profits, but also in the rate of surplus value (having as hypothetical maximum limit the *maximum* duration of the working day – 24 hours – “if the workers could live on air”). But, on the other hand, both phenomena imply acceleration in the accumulation process and, as a consequence, a continuous increase in the organic composition of capital, which tends, dynamically, to counter those two effects. Thus, capitalist

accumulation evolves, driven by the tension of two **parallel movements** that act in the opposite direction on the rate of profit. Thus, the tendency of the rate of profit to fall is nothing but the appropriate way for the capitalist mode of production to express the progress of the social productive force of labor and, for this very reason, it is the manifestation, *par excellence*, of the contradictory nature of the process of capital accumulation.

This interpretation has not been accepted peacefully by some authors who deal with the issue. Sweezy (1962) is one of his most radical and persistent opponents. In a controversy with Mario Cogoy, he reaffirms these points of view, already outlined in his book *The Theory of Capitalist Development*. The core of his argument is as follows: Marx considered as a “significant and striking contradiction” of capitalism the fact that the progress of the social productive power of labor is expressed in a way that tends to oppose the unlimited development of the system. However, he did not formulate any explicit theory of crises in capitalism, and it was not even his intention to foresee an “immediate” fall in the rate of profit which he treated only as a **tendency**, like all others subject to the operation of opposing forces. Therefore,

“For Marx, the falling tendency of the rate of profit was a manifestation of only one of capitalism’s many contradictions, and I see no reason to believe that he would have considered the system to be any more viable had he foreseen that the future direction of technological change would mitigate or even eliminate this particular contradiction in the form that it assumed in the period of transition from manufacture to modern industry” (Sweezy, 1974: 1224).

Among the numerous contradictions of capitalism, Sweezy favors one in particular, which seems to him to be characteristic of the current stage of capitalism: the growing disproportion between production capacity and consumption capacity. This would, in fact, be the contradiction already implied in the concept of capital as a self-valorizing value.

The first part of the argument that highlights the tendential character of the fall of the rate of profit gives the impression that Sweezy really understood the meaning that Marx wanted to impart to the expression “contradictory nature of capitalist accumulation.” However, that impression soon vanishes when, subsequently, he begins to speak of “capitalism’s many contradictions” and of a supposed “future direction of technological change would mitigate or even eliminate this particular contradiction in the form that it assumed in the period of transition from manufacture to modern industry.”

Right from the start, one wonders what Sweezy means by “future direction of technological change,” a possibility he indicates but does not explain.



It is hard for us to believe that he is simply referring to the growing economy of constant capital, dictated by the very intercapitalist competition, and that Marx explicitly considers a peculiar characteristic of the capitalist regime of production:

“[...] when large-scale production begins to develop under the capitalist form and the fury of profit becomes widespread... competition forces the maximum cheapening of commodities, maximum economy in the use of constant capital, which now appears as a peculiar characteristic of the capitalist regime of production and, therefore, as a function of the capitalist” (Marx, 1966a, v. 3: 99).

When Marx begins to develop his hypothesis about the tendency of the rate of profit to fall, he already assumes not only that each individual capitalist is obliged to reduce investments in constant capital to the minimum possible, but also that the growth in labor productivity itself, throughout the accumulation process, promotes a progressive cheapening of all commodities, which includes, as is wise, the elements that constitute constant capital. And, consistently, Marx points to constant capital economy as one of the counterbalancing causes of the Core tendency of the rate of profit to fall.

Thus, when Sweezy refers to a change in the orientation of technological progress, he must be proposing the occurrence of much more profound changes that can reduce or even eliminate this particular contradiction, that is, the tendency of the rate of profit to fall. However, in all of his work, we will struggle in vain in the search for enlightenment. Even because, from a theoretical point of view, it is simply a mirage. For this change in the orientation of technological progress to take place, that is, for the Sweezy hypothesis to have any theoretical consistency, it would be imperative to demonstrate that, from a certain point in the accumulation process, capitalists start to progressively and systematically reduce the value of constant capital, while maintaining or decreasing to a lesser extent the socially necessary labor time in the economy as a whole. In reality, a strange way of conceiving capitalist dynamics. Or rather, a surprising way of conceiving capital as self-valorizing value and, therefore, of understanding the operation of the law of value in capitalism. The reason for this procedure is the way in which Sweezy intends to explain the cheapening of constant capital, and situates it within the scope of relations with variable capital and surplus value. In fact, he assumes constant capital as an independent magnitude in relation to variable capital and surplus value. Thus, he takes not only constant capital but also variable capital and surplus value as autonomous magnitudes, without considering the specific quality that they present as moments of the capital valorization process, as a

self-contradictory movement. If he had been aware of this crucial point, he would have realized that the same process that engenders the cheapening of the elements of constant capital promotes, at the same time, the increasing “mass and variety of use values in which it is materialized the same exchange value and that constitute the material substrate, the objective elements of capital, the objects that directly form constant capital” (Marx, 1966a, v. 3: 246-7). And that this translates, simultaneously, into the growth of mass of capital, as well as in further acceleration of the process of development of the productive capacity of labor, and, consequently, in the reduction, even greater, of the socially necessary working time in all sectors of the capitalist economy. For this reason, the law of the fall of the rate of profit only manifests itself as a tendency of a contradictory process, that is, as an expression of the contradiction in process. Because,

“at the same time that the rate of profit falls, the mass of capital increases and, in parallel, there is a devaluation of the existing capital that suffers this decrease, giving an accelerated impulse to the accumulation of capital-value. At the same time that productive capacity is developed, the composition of capital also increases, variable capital decreases relatively to constant capital. These diverse influences occur simultaneously within space, or rather, successively in time; the conflict between these conflicting factors periodically manifests itself in the form of a crisis. Crises are always violent, purely momentary solutions to existing contradictions, violent eruptions that temporarily restore the broken equilibrium” (Marx, 1966a, v. 3: 247).

It is again surprising that Sweezy, like so many others, missed the clear interrelation that Marx sought to establish between the tendency of the rate of profit to fall and the periodic crises of capitalism. Certainly, his strong “under-consumptionist” bias contributed decisively to this. However, in reality, Marx formulated the theory of the tendential fall of the rate of profit in close correlation with the cyclical movements of capitalism, as Mario Cogoy rightly states in his article *The Falling Rate of Profit and the Theory of Accumulation: A Reply to Paul Sweezy* (Cogoy, 1974: 1231-55). That is because the accumulation process itself, by expanding the mass of new capital, whose material elements are more efficient and cheaper, simultaneously determines the periodic depreciation of existing capital. The same law that compels capital to a progressive valorization ends up imposing the need for its periodic devaluation, a phenomenon that is expressed through sudden paralyzations and crises in the production process.

It is clear that these crises and paralyzations in the production process invariably take the form of overproduction, but overproduction of capital and not of commodities. Therefore, “the overproduction of capital, not of individual commodities – although the overproduction of capital always implies the overproduction of commodities – is nothing more than over-accumulation of capital” (Marx, 1966a, v. 3: 249). It is not because low wages or “labor-saving” technical progress promote an increasing relative narrowing in the consumption of the working population that crises are triggered. Moreover, it would be unproductive to write three volumes to demonstrate that capitalism is based on the separation between production and consumption, a characteristic, apropos, common to other modes of production. It is necessary to explain how this separation is expressed in the capitalist dynamics.

“As the purpose of capital is not to satisfy needs, but to produce profit, and **as this purpose can only be achieved through methods that adjust the mass of what is produced to the scale of production** – and not the opposite – there must arise, constantly and necessarily, dissonances between the limited proportions of consumption on this capitalist basis, and a production that constantly tends to exceed this immanent limit. Furthermore, capital is formed by commodities, which is why the overproduction of capital also involves the overproduction of commodities” (Marx, 1966a, v. 3: 254 – emphasis added).

In fact, the separation between production and consumption under the capitalist regime is manifested in the form of over-accumulation of capital, which, in turn, implies a fall in the rate of profit and hence the intensification of intercapitalist competition, so that “losses are divided in a very unequal and very different way, causing some capitals to be paralyzed, others to be destroyed, others still to experience a simply relative loss or a purely transitory devaluation” (Marx, 1966a, v. 3: 251). All this happens so that, through new ‘waves’ of concentration of capital, new increases in the scale of production and use of the labor available in large quantities, the conditions for a new cycle of accelerated valorization of capital are reestablished.

Here, there is the question, often debated, of the forces that drive capitalist accumulation into crisis. In fact, several authors present the periodic decline in accumulation as a result of pressure from wages on profits. In order to prove this thesis, they use the first paragraph from chapter 25 of Marx’ *Capital*, in which Marx seems to corroborate this hypothesis. The mistake lies in not realizing that Marx works in this case, as he himself says, with the assumption of a constant organic composition of capital, so that the acceleration of the rate of accumulation, by boosting demand for labor, causes wages

to rise and, consequently, a decrease in profits and a decline in capitalist expansion. However, according to Marx, the increase in wages leads to the neutralization of the very dynamics that generated it, and the paralyzation of the accumulation process recomposes the labor reserve, lowering wages. This would be the most favorable hypothesis for workers, a hypothesis, however, that Marx discards when introducing changes in the organic composition of capital. Now, this hypothesis is by no means something that can be introduced or removed according to the conveniences, as it is part of the very core of the analysis of the dynamics of the capitalist mode of production.

Changes in the organic composition of capital, contrary to what is supposed, are only ultimately related to the need to continually lower wages. Now, it has already been said that the process of constitution of capitalist productive forces and the consequent subordination of the subjective elements of the labor process by the objective elements embodied in the machinery system imply an autonomy of the technical structure of capital, whose development confirm the reason that gave rise to it: the reduction of socially necessary labor time and the continued production of relative surplus value. Technical progress becomes part of the virtues of the capital as subject and, as such, can only be expressed as a weapon of individual capitals. Accordingly, it is irrelevant for the capitalist to introduce an innovation that directly lowers wage costs or reduces the **input** of raw materials or even replaces a less efficient machine with a more efficient one. It is important that the introduction of innovation gives individual capital the capability to reduce the value of his product below its social value.

It is unequivocal that the generalization of innovations tends to reduce the abstract labor time and that it only does so by increasingly replacing living labor with labor that is objectified in the means of production. Nevertheless, even though this is an inevitable consequence of the process and at the same time its deepest reason, its immediate reason is given by the confrontation between the parts into which the social capital is divided.

This means, speaking at a higher level of abstraction, that subsumption of labor, autonomization of the technical structure and, therefore, reversion of the potential of labor to capital establish the **dominance** of competition between capitals over the relations between capital and labor in the movement of the capitalist mode of production. The tendency of the rate of profit to fall as a manifestation of the contradictory nature of the capital accumulation process expresses exactly the fact that, in its expansion movement, capital tends to detach itself from the bases that ensure its own valorization process. It is in this sense that capital becomes the only limit to its own expansion.

## 5. Marx, Sraffa and the “transformation” problem: a brief interpretive note

Nowadays, some confusion has been established in the neo-Marxist literature about the meaning of the Sraffian *démarche*, taken as a return not only to the classical political economy (specifically to Ricardo) but also to Marx. This claim has been expressed by the most illustrious representatives of this stream of thought, including, for example, Maurice Dobb and Ronald Meek.

The greatest discussion revolves around the “so-called” problem of transforming values into production prices. In general, the question concerns the assimilation of the concept of standard commodity to that of industries with average organic composition. It is unquestionable that Sraffa’s standard commodity solves the famous problem of “deviations,” in the sense that the price of that commodity **would be** equal to the value, independently of the rate of profit, and that, on the other hand, a correspondence could be established between net output, measured in terms of the standard commodity, and the labor time socially necessary to produce it, determined by the industries with average organic composition. In this sense, the formal problem of transformation would be satisfactorily solved in a static system of equilibrium or steady-state reproduction (just as it would be possible to convert any formal system into another system of equilibrium prices).

Apparently, however, Samuelson would be right to state that, if the problem of transforming values into prices is conceived thusly, surplus value would not be necessary to determine the rate of profit: given wages, at the subsistence level, and the coefficients of the technological matrix, the rate of profit would be determined by the system. In fact, to consider that Sraffa’s reproduction scheme is convertible into that of Marx, since, given wages, the Ricardian surplus in labor time is converted into Marxist surplus value, is to disregard Marx’s fundamental criticism of Ricardo and accept Mr. Samuelson’s qualification that Marx is a minor Ricardian.

Apropos, the confusion between the Ricardian surplus and the Marxist surplus-value is recurrent in the contemporary economic literature, and we could say that it worsened considerably after the publication of Sraffa’s work. The misconceptions begin with the identification between value of the labor-power and fixed “basket” of wage-goods. John Eatwell writes:

“In classical and Marxian theory surplus is defined simply as social product less that share of product which must be paid to the laborers. The size of the social product and the share of it which goes to the laborers are independent variables in the sense that they may be taken as data in their size and variation- the social surplus is then the only unknown. The essential

idea on which this procedure rests is the possibility of taking the real wage per unit of labor as **given**, even if the produce obtained with labor varies” (Eatwell 1974: 286).

Let us see, on the other hand, how Marx, in criticizing Ricardo’s insufficient approach to the origin and nature of surplus-value in capitalism, formulates the problem:

“Ricardo, naturally, assumes that the labor time incorporated into the means of subsistence is equal to the labor time that the worker must provide to reproduce the value of these means of subsistence. However, he thusly introduces a difficulty and prevents a clear understanding of the relation, as it does not directly represent a share of the working day as the reproduction of his own labor-power. Whence a double confusion arises. The genesis of surplus value is not clear and, therefore, Ricardo is censured by his successors for not having developed the nature of surplus-value... Nevertheless, because the origin and nature of surplus-value are not clearly conceived, surplus-value, in addition to labor, that is, the total working day, is considered as a fixed quantity; differences in the magnitude of surplus-value are neglected, and the productivity of capital, the compulsion for surplus labor, for absolute surplus labor, on the one hand, and, on the other hand, its immanent tendency to shorten the necessary labor time, is unknown, and thusly the historical legitimation of capital is not clarified... Ricardo starts from a factual aspect of capitalist production. The value of the labor is less than the value of the product it creates. The value of the product is, therefore, greater than the value of the labor that produces it, or than the value of the wage. The ‘excess’ of the value of the product over the value of the wage is equal to the surplus-value... Why is that? He does not demonstrate it” (Marx, 1955, v. 2: 117-8).

It must be made absolutely clear that Marxist surplus-value is an *open* relation, in the sense that it expresses the variable strength of capital in sucking living labor, and that, thus, it is **illegitimate** to fix any of the magnitudes that compose it. Neo-Marxists seem to ignore this, seeking to find an ideal solution to “close the model” and make it determined, that is, to find an equilibrium solution, using the wage/profit ratio as the rate of exploitation. In doing so, they judge they “save the honor” of the Marxist tradition, “politically” determining the rate of exploitation through class struggle and reintroducing it into the model to obtain the equilibrium prices. They throw out the crucial role of surplus-value as a capitalist form (expression) of the law of value and, therefore, fundamental law of movement of this historical mode of production. Furthermore, what is more serious, by restricting the determination of the rate

of surplus-value to the relative bargaining power of capitalists and workers, they confine the exploitation to the orbit of the exchange of commodities, and disregard the entire Marxist theoretical construction that is founded precisely on the dominance of capital over the labor process, as a process of valorization. In this *démarche of high theory* regarding the problem of transforming values into production prices, the Marxist theory of value is reduced to a “general” theory of exploitation, completely losing the meaning of the theory of value as a theory of valorization and dynamics of capital. The task that is imposed on the heirs of the Marxist tradition is to demonstrate how the permanence of the law of value in its capitalist form implies a permanent change in the phenomenal expression of value, that is, in the exchange value. In this perspective, the insistence on reducing the problem to the formal demonstration that the exchange value of commodities, measured in labor time, can be converted into production prices is a way to elude the issue and not to solve it.

In fact, transforming exchange values – as they manifest themselves in the simple commodity society – directly and mechanically into production prices, *qua* exchange values proper to capitalist society, is to ignore the real nature of the “transformation problem.” In the “simple commodity” society, variations in a product’s labor value destroy the “equilibrium” of social labor and cause its transfer from one sphere of production to another, effecting a redistribution of productive forces in the social economy.

“Changes in the productive power of labor cause increases or decreases in the amount of labor needed for the production of given goods, bringing about corresponding increases or decreases in the values of commodities. Changes of value in turn bring about a new distribution of labor between the given productive branch and other branches. The productivity of labor influences the distribution of social labor through the labor-value. [...] The distribution of labor is completely different in a capitalist economy. Since the organizers of production are in this case industrial capitalist, the expansion or contraction of production, i.e., the distribution of productive forces, depends them. Capitalists invest their capitals in the sphere of production which is most profitable. [...] This distribution of capitals in turn leads to a corresponding distribution of living labor, or labor-power. [...] In the capitalist society, **the distribution of labor is regulated by the distribution of capital**. Thus, if our goal (as before) is to analyze the laws of distribution of social labor in the social economy, we must resort to a round-about path and proceed to a preliminary analysis of the **laws of distribution of capital**” (Rubin, 1974: 279-80).

Production prices express a relation of equivalence between capitals, or rather, between commodities as products of capital, which translates into the

proposition that equal capitals must obtain the same rate of profit. On the other hand, the “market equalization of commodities produced with **equal** capitals means an equalization of commodities produced with **unequal** quantities of labor” (Rubin, 1974: 285) due to the diverse organic composition of capitals. Therefore, production prices, as a proper expression of exchange value under capitalism, will systematically diverge from values. Baumol, in seeking to rebut Samuelson’s interpretation of the nature of the transformation problem, clearly understood that

“Marx did not intend his transformation analysis to show how prices can be **deduced** from values. Marx was well aware that market prices do not have to be deduced from values (nor, for that matter, values from prices). Rather, the two sets of magnitudes which are derived more or less<sup>4</sup> independently were recognized by Marx to differ in a substantial and a systematic manner. A subsidiary purpose of the transformation calculation was to determine the nature of these deviations. But this objective and, indeed, any explanation of pricing as an end in itself, was of very little consequence to Marx, for the primary transformation was not from values into prices but, as Marx and Engels repeatedly emphasize, from **surplus-values** into the non-labor income categories that are recognized by ‘vulgar economists,’ i.e., profits, interest, and rent” (Baumol, 1974: 52).

There, the transformation problem is exposed in a nuclear way. The surplus-value remains as a Core relation, from which the concept of profit is built, and from which the possibility of formation of an average rate of profit starts.

Profit, as an economic category, actually expresses the relations of interdependence between capitalist producers and the laws that regulate exchange between them. But these relations are, in turn, supported by the basic relations of production between capitalists and workers, so that profit can only appear as the “transformed” form of surplus-value. Hence, it follows that a change in the set of production prices must always be explained as a consequence of a variation in the real value of the commodities, that is, in a variation in the total labor time necessary for their production. Consequently,

“the general rate of profit can change if the sum of labor applied changes in relation to the constant capital, as a result of technical changes in the labor process. But technical changes of this kind must always show themselves in, and thus be accompanied by, a change in value of the commodities whose production now requires either more or less labor than it did before, therefore being accompanied by a variation in value” (Marx, 1966a, v. 3: 172).



And this change in value can only be explained by the attempt by capitalists to repeatedly violate the law of value for their own benefit, increasing the productivity of labor in his sphere of production.

The dynamics of intercapitalist competition, which translates into a constant change in the technical status of economic society, will be, at the same time, changing the conditions of the “industries of average organic composition” and causing variations in the average rate of profit.

“From this it follows that changes in costs of production and changes in average profit rates are caused by changes in the productivity of labor. And since the production price consists of production costs plus average profit, changes in production prices are in the last analysis caused by changes in the productivity of labor” (Rubin, 1974: 305).

Accordingly, the elaboration of a standard system to solve the problem of technical reproduction and resource allocation, in an equilibrium model, cannot be further from the Marxist *démarche*. It is the constant transfer of capitals from one sphere of production to another that creates a **tendency** toward the equalization of rates of profit and, consequently, enables an average rate of profit, corresponding to the “industries of average organic composition,” to be theoretically determinable. It is clear that this movement of capitals toward the equalization of rates of profit is only manifested as a tendency, “as an average of perpetual fluctuations which can never be firmly fixed,” (Marx, 1966a, v. 3: 167). On the other hand, it is precisely this lack of equilibrium, expressed in different rates of profit, that causes the transfer of capital. Marx called this process “constant equalization of ever-renewed inequalities” (Marx, 1966a, v. 3: 198).

Thus, the transition to analysis in production prices does not propose a theory of the allocation of resources for a capitalist economy, whose contradictory nature of the dynamics of accumulation and reproduction prevents it from reaching equilibrium – unless in situation of crisis, by the destruction of the sectors with the lowest power of resistance, that is, exactly those whose organic composition is below average. This does not mean that capital does not redistribute itself between its different spheres, tending, in consequence, to equalize the rate of profit. Thus, the concept of average rate of profit, in Marx, cannot be determined only “technically,” nor much less through a system of simultaneous equations of prices. In the terms of the Marxist approach, a “general” theory of prices and resource allocation is a meaningless proposition, as is the reduction of the wage/profit contradiction to an equilibrium “frontier.”

Definitely, in Marx’s view, the historical ways through which the capitalist system resolves both the equalization of rate of profit and the problems

of distribution of income between wages and profits do not depend on an **abstract** “class struggle” that occurs at the political level, but on the very changes in the technical structure of capital and on its form of **social** organization as “power of command over labor.” Therefore, they cannot be the object of a theoretical study equivalent to that of an abstract structure, of any static or dynamic nature. Accordingly, it is not the transition from competitive capitalism to monopoly capitalism that would invalidate a theory of relative prices, in the style of those proposed by any of the authors who attempted to solve the problem. In fact, in Marx’s perspective, the transition from competitive capitalism to monopoly only changes the way the system “rebalances” itself in crises, that is, the way through which it gets rid of the “excess” of capital – existing, as a **barrier** to the potential for expansion of capital as a whole. It should be noted, there is change only in the way through which a new cycle of capital valorization is reestablished.

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# CHAPTER 2

## INCOME DISTRIBUTION: an outline of the controversy

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### 1.

The issue of income distribution has been the subject of wide controversy in its theoretical dimensions as well as in the analysis of its historical and concrete expressions. In other words, both the effort to reduce and logically articulate the categories and the relations between development patterns and distribution profiles have provided contradictory explanations.

In this chapter we present an overview of the most acute points of the theoretical controversy, aiming to determine the “turning points” ultimately represented by the outlook of economic society underlying each one of the theories. For a theory of distribution, the way in which this society is segmented is essential. Each basic dichotomy (capitalists versus workers, or companies versus families) relates to different ways of proposing the operating rules or presenting the laws of motion of the economic system.

The Theory of Distribution proposed by classical economists, and revived by Marx **from the perspective of a new problematic**, was based on the situation of social classes at the moment of production. The position of workers and capitalists at the “moment” of production provided the limits and possibilities of each social class within the sphere of distribution.

As long as the means of production are monopolized by a social class, they are transformed into “capital” with the sole purpose of expanding it through the submission and **exploitation** of the mass of direct producers. The “free” worker will be entitled to his wages, i.e., to the means required for his subsistence, provided he surrenders to the owner of the means of production, free of charge, a fraction of his working time in the form of goods. Profit thus emerges as surplus-value appropriated by the capitalist and created by the direct worker at the “moment” of production. “Wages presuppose wage labor, profit, capital. These concrete forms of distribution therefore presuppose certain social characteristics of the agents of production. Hence, the concrete relations of distribution are simply the expression of production, historically

determined” (Marx, 1966, v. 3: 814). The antagonistic relations of production between labor and capital translate into equally antagonistic relations of distribution: the desire of workers to improve their living conditions is opposed to the impulse of capitalists to expand the value of their capital.

In this perspective, relations of distribution are “forwardly” interconnected with the possibilities of reproduction and accumulation of the capitalist system. While it increases in value (is accumulated) by extracting surplus-value from direct labor, capital restores its own conditions of existence. It is only when surplus-value provides the private profit of capitalists that new means of production emerge as additional capital, requiring a new “creation” of workers. Therefore, not only does labor produce on an ever-increasing scale, in antithesis with itself, its own working conditions “as capital,” but capital also produces on an ever-increasing scale the productive wage earners it requires (Marx, 1972: 103). The process of accumulation is born from the bowels of the capitalist system and thrives on the antagonism of its relations of production and distribution, even as it continually reconstructs them. The system’s motion is nourished by the class conflict that defines its structure, and, as it proceeds, it reproduces the antagonistic framework.

In the last decades of the 19th century the “Marginalist Revolution” shakes the foundations of classical political economy, replacing the idea of **contradiction** with the paradigm of **harmony**. It is no longer a matter of unveiling the laws of motion stemming from the class antagonism in the sphere of production, but of postulating the conditions of equilibrium in the process of exchange. The marginalist assault immediately targets the theory of surplus-value, which privileged the conditions of production, to focus on the concept of utility, which emphasizes the exchange of use values.<sup>5</sup> It is not difficult to understand the consequences of this radical change for the Theory of Distribution. The idea of exchange immediately presupposes equal conditions between the agents involved. The problem that arises is how to achieve this reduction to equality so that capitalists and workers enjoy equal conditions at the time of the exchange. The key concept of this delicate reduction operation is that of **factors of production**. Both capitalists and workers come to the market as **owners** of factors of production whose services they are willing to sell in exchange for remuneration. From the point of view of classical economists, this kind of theoretical reduction banishes social classes as relevant categories of political economy while falsifying the concept of capital, now transfigured in its purely physical aspects.

The Theory of Distribution can thus be addressed as a special case of the theory of price. The remuneration paid to the owner of a factor of production

5 In this sense, see B. Seligman (1967: 83-84).

depends on the price he can get for the sale of his “services.”<sup>6</sup> And, if the remuneration of each factor is conceived as a price, it will be determined by the supply and demand of its “services” in the market. But the services of the factors of production are desired not in themselves but for the value of the final goods they are capable of producing. The price of the factor is, therefore, derived from the price of the final goods. Assuming that companies seek to maximize their profits under conditions of perfect competition, they will employ factors of production to the extent that the price obtained from the sale of an additional unit of the final good equals the cost of the additional unit of the employed factor. Thus, the price (remuneration) of each factor of production will tend to match its marginal productivity. In other words, each factor will be paid according to its “contribution” to the production process. And this contribution is strictly limited by the technical conditions of production: according to the law of diminishing returns, the marginal productivity of each factor, *ceteris paribus*, varies inversely to the amount employed. This framework that we have outlined in a schematic manner was a response to the labor theory of value: labor no longer creates value alone, as capital is also capable of producing it. The worker is entitled to his wages, just as the capitalist deserves his profit.

The process of theoretical reduction, elegantly operated by the marginalist school, was not, however, free of logical obstacles, which were difficult to be grasped by those who were educated in its tradition. The greatest obstacle consists of confusing two concepts of capital: the financial fund controlled by capitalists is identified with the physical facilities and machinery that allow the worker to produce. As a sum of money, controlled by capitalists, capital does not play any role in the production process. It only does so when it becomes a set of facilities and machinery that allows labor to produce. But turning this undifferentiated fund into an instrument of production requires knowing in advance the price of each of these heterogeneous goods, which presupposes, naturally, prior knowledge of the average rate of profit of the economy. In short: the conversion of the homogeneous financial fund into specific and heterogeneous instruments of production cannot be done without prior knowledge of the set of prices for those goods, and, of obviously, of the rate of profit. Therefore, there is no sense in establishing a univocal relationship between “capital amount,” marginal productivity and profit rate: the value of capital depends on the rate of profit and this cannot, in any sense, be determined by the “mass of capital,” unless circular reasoning aims at scientific status.

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6 The distinction between price of services and price of goods was originally formulated by Walras. See Stigler (1941).

Most neoclassical economists accepted the criticism for its “purely technical” features, as if it were a simple matter of conceiving a unit of measurement for capital that was independent of the rate of profit and other prices.<sup>7</sup> Unfortunately, as it later turned out, the ambiguity and weakness of the neoclassical postulates did not stem only from the lack of an adequate measurement unit for “capital,” but involved the very concept of capital as a factor of production. What the critics point out, in inverting the relations of **determination** between rate of profit and value of capital, is the impossibility of abstracting the “capitalist” dimension of capital that Adam Smith identifies as “power of command over labor.” Moreover, suggesting that the concept of capital only makes sense as an expression of a social relationship between owners of the means of production and direct workers, they support another explanation for the nature of profit and distribution mechanisms in a capitalist society.

This ambiguity of the concept of capital that remained disguised for so long was denounced by Joan Robinson (1953) and more rigorously by Sraffa in his book *Production of Commodities by Means of Commodities* (1960). Sraffa’s work sparked a controversial debate among the neoclassicals, still entrenched in their production functions, and a host of critics logically well-equipped to reinstate the classical tradition.

According to Sraffa, neoclassical theory taught us to conceive the economic system as “a one-way avenue that leads from ‘Factors of production’ to ‘Consumption goods’” (Sraffa, 1960: 93) Given the quantities of each factor, combined in a macro function of production, we immediately obtain the corresponding “product.” Among the factors designated as primary are land, capital and labor, each receiving payment proportional to their contribution to the production process. At the other end of the avenue are the consumers with their preference scales which, filtered through the price system, will determine what should be produced.

Sraffa, in contrast, describes the production and consumption system as a circular process commanded by a set of interdependent activities, insofar as each one uses the goods produced by the others as inputs. Industry *A* absorbs, in order to produce good *a*, inputs produced by industries *B*, *C* and *D*, just as they incorporate goods produced by activity *A*. It is important to note that the author includes in inputs the livelihoods required for the workers’ subsistence. He initially proposes an extremely simple society model in which the total product is just enough to provide for the workers and replenish the means of production at the end of each period. In such an economy (which does not generate surplus) “there is a unique set of exchange values which restores the

7 That was the interpretation of T. Swan (1956), who introduced the concept of *meccano sets* and Solow (1963).



original distribution of products among industries, thus assuring the possibility of the continuation of the cycle of production, period after period” (Bharadwaj, 1963: 1450). This set of relative prices is firmly anchored to the technological matrix of the economic society and corresponds to what could be called the system’s prices of **reproduction**. That is, a set of exchange values that allows society to produce in the following period exactly the same as in the previous period. In this sense, prices are set exclusively “on the supply side.”

$$\begin{array}{r}
 A_{apa} + B_{apb} + \dots + K_{apk} = A_{pa} \\
 A_{bpa} + B_{bpb} + \dots + K_{bpk} = B_{pb} \\
 \dots \\
 A_{kpa} + B_{kpb} + \dots + K_{kpk} = K_{kp}
 \end{array}$$

where:

1.  $A$ ,  $B$  and  $K$  are the quantities of the goods  $a$ ,  $b$  and  $k$  produced in the period
2.  $pa$ ,  $pb$  and  $pk$  are the prices of each one of the goods
3. each one of the equations represents an “activity” or “industry” or, more strictly speaking, a production technique.

If the economic system starts to produce more than is strictly necessary for its “simple” reproduction and there is a surplus to be distributed, it becomes self-contradictory (Sraffa, 1960). Introducing the notion of average rate of profit, Sraffa argues that the surplus cannot be allocated among the various industries “prior to the determination of prices,” since it must be distributed in proportion to the means of production of each industry, while prices cannot be determined before the rate of profit is known. “As the surplus has to be distributed proportionately. to the means of production advanced in each industry – and this cannot be done unless the heterogenous means of production are aggregated with the help of prices – and as prices cannot be determined before knowing the uniform rate of surplus, both prices and the rate of surplus will have to be determined simultaneously” (Bharadwaj, 1963: 1450).

Sraffa then abandons the assumption that wages consist only of the goods necessary for workers’ subsistence, admitting their participation in producing surplus. That means that wages start to compete with profits for the net product (in the Ricardian sense) of the economy and, on the other hand, that the amount of labor in each industry must be explicitly represented, “taking the place of the corresponding quantities of subsistence” (Sraffa, 1960: 10).

$$\begin{aligned}
 A_{apa} + B_{apb} + \dots + K_{apk} (1+r) + L_{aw} &= A_{pa} \\
 A_{bpa} + B_{bpk} + \dots + K_{bpk} (1+r) + L_{bw} &= B_{pb} \\
 \dots & \\
 A_{kpa} + B_{kpb} + \dots + K_{kpk} (1+r) + L_{kw} &= K_{pk} \\
 A - (A_a + A_b + \dots + A_k)_{pa} + B - (B_a + B_b + B_k)_{pb} + \\
 + (K - (K_a + K_b + \dots + K_k))_{pk} &= 1
 \end{aligned}$$

where:

1.  $L_a, L_b$  and  $L_c$  are fractions of the workforce employed in each activity
2.  $r$  and  $w$  are the profit rate and wage rate, respectively
3. The last equation gives us the national income. "The value of this set of commodities, or 'composite commodity' [...], we make equal to unity. It thus becomes the standard in terms of which the wage and the  $k$  prices are expressed" (Sraffa, 1960: 11).

Thus, if wages absorb the entire net product ( $w = L$ ), commodity prices are proportional to their direct and indirect labor requirements. Insofar as the rate of profit starts taking on positive values ( $r > 0$ ), prices start to vary according to the different relations between labor and means of production in different industries. In this case (the only one permissible in a real economic system), relations of distribution directly affect the set of relative prices. If wages fall, industries with a higher labor/means of production ratio will have a **surplus** (if prices remained unchanged) compared to those in which the ratio is lower. Reestablishing the balance between both groups of industries requires a variation in relative prices in favor of loss-making industries. Changes in distribution would be indifferent to the price structure if and only if labor and means of production were combined in the same **proportions** in all industries.

$$L_a w + L_{a_1} w (1+r) + \dots + \dots + L_{an} w (1+r)^n = A_{pa}$$

However, Sraffa warns us that variation in relative prices may not necessarily comply with this pattern. "The reason for this seeming contradiction is that the means of production of an industry are themselves the product of one or more industries which may in their turn employ a still lower proportion of labor to means of production (and the same way be the case with these latter means of production; and so on)" (Sraffa, 1960: 14-15). The indeterminacy

in the movement of relative prices, as described by Sraffa, is at the root of the phenomenon known as “reswitching of techniques.” What has now come under criticism is the neoclassical proposition that lower interest (profit) rates are associated with more “intensive” capital production processes. In fact, if the possibility of reswitching exists, the same technique, profitable at a higher interest rate, might be so again at lower rates, simply due to different combinations of labor and means of production in the various stages of the production process. This problem can be correctly grasped if we reduce the entire “chain” of production of a commodity to “dated” amounts of labor multiplied by the factor  $(1 + r)$ . Thus, each equation in the original system can be reduced to the following expression:

Imagine two production techniques ( $A$  and  $B$ ) for the same commodity. Technique  $A$  requires a greater amount of labor (evenly) distributed over a shorter period of time. Technique  $B$  uses a smaller amount of labor, but (evenly) distributed over a longer period of time. With low wages and high interest rates, the first technique will be more profitable, despite a greater payroll. If wages go up (the interest rate falls), at any time technique  $B$  becomes more profitable due to its reduced payroll, compared to technique  $A$ . This change corresponds to the neoclassical hypothesis of Böhm-Bawerkian inspiration which foresees the adoption of more roundabout methods of production as interest rates fall. This type of reasoning is associated with the concept of “average period of production” as a quantitative “essence” of capital, regardless of prices and distribution. Labor productivity grows as methods of production become more roundabout, but at decreasing rates as the average period is extended, reflecting a diminishing marginal productivity of capital. We are deep in neoclassical territory, where the functions of production and their cohort of worshipers walk freely.

But let us admit another pair of techniques,  $A_i$  and  $B_i$ , both employing different amounts of labor unevenly distributed over their respective periods of production. Technique  $A_i$  presents a shorter period of production and labor inputs at an intermediate stage. Technique  $B_i$  offers us a longer period of production and a small amount of labor located at the beginning of the process, concentrating a larger fraction in the final stages. It is reasonable to assume that technique  $A_i$  is more profitable at higher interest rates (with lower wages) and also at lower interest rates. Technique  $B_i$  would be more profitable at intermediate levels of interest rate and wages.<sup>8</sup> It is not the goal of this paper to discuss of the problem of reswitching of techniques, but the (theoretical) possibility of its occurrence creates a problem for the neoclassical attempt to identify a unit of capital measurement in the period of production, regardless

8 M. Dobb (1973) gives a similar example of reswitching of techniques.

of prices and distribution. The biggest obstacle lies in the fact that the various periods are only comparable if the labor inputs are evenly distributed over time (Dobb, 1973).

It is clear that Sraffa is not interested in the problem of income distribution per se, but rather in explaining how a change in the relative share of wages and profits affects the relative prices of commodities. Therefore, he is interested in criticizing the inconsistency of neoclassical reasoning in its vain attempt to develop a theory of distribution based on the idea of an aggregate production function without explaining what it means by “amount of capital,” which leaves the concept of marginal factor productivity unresolved.

No alternative theory is offered in the book other than the very general idea that the laws governing the distribution of output between labor and capital cannot be deduced from a technical function of production, but are determined in the context of the relations between owners of the means of production and direct workers. What each one receives is not related to their contribution to production but to the bargaining power of each social class.

Capitalist institutions return to economics. For many participants in the debate, Marx’s ghost has returned to haunt the aseptic sanctuaries of economic science with the specter of class conflict. However, the mere reference to sociological data introduced from outside the “model” to explain the distribution of income between wages and profits is a far cry from being a “return to Marx.” Therefore, the initial scare being over, we must try to identify the ghost.

First of all, the very concept of surplus addressed by Sraffa derives directly from the idea of “*produit net*” formulated by the physiocrats. “Among them, this concept takes on a purely material and physical expression, which is otherwise compatible with their general conception of economic society” (Belluzzo, n. d.: 6). Surplus is **technically** defined as the fraction of the product that society is able to generate above its reproduction costs. The Marxist notion of “surplus-value” involves the explicit acknowledgement of relations of production as a defining element of capitalist conditions of production and distribution, and not as an external condition that can be introduced “from the outside” to “close” the model. Contrary to what is usually believed, the labor theory of value proposed by Marx in the first volume of *Capital* is not merely intended to formulate an initial connection with the theory of price. Above all, it is proposed to answer this question: how to explain the presence of a “surplus” if the goods are exchanged for their respective “values” (measured by the socially required labor time)? Indeed, if the goods are exchanged for their values, the “surplus” cannot appear in the exchange other than in the process of “productive” consumption of those goods, including labor-power.

In this sense, the initial assumption that commodities are exchanged according to their values “merely means that capital accumulation is possible *even* in cases in which the prices correspond to the values” (Marx, 1966, v. 1).

In view of the above, in the Marxist model, distribution cannot be viewed as an outside fact, institutionally determined, even if such institutional constraint is specified and sought to be identified with the bargaining power of each social class. Relations of distribution feature as a mediating element between production on one side and exchange and accumulation on the other. “The rate of profit (and the corresponding production prices) is no mystery as long as we are able to reveal the laws that govern the presence of surplus-value. If we invert the path we cannot understand “*ni l’un, ni l’autre*” (Marx, 1966, v. 1).

Interestingly, this is what Sraffa does. He starts out by determining the prices of production in an economy in a state of simple reproduction and later introduces surplus as a “technical” fact. Relations of distribution are therefore restricted to the competition for the surplus and submitted to the relative power of the classes. It is true that this power is based on the conditions of ownership and non-ownership of the means of production of each social class. However, in determining the relative shares, such conditions are practically ignored and profits and wages vary freely.

In fact, there is no “explicit explanation of the forces that determine the division of the social product between profit (or property income) and wages” (Dobb, 1973). And although Marx was accused of proposing a theory of distribution founded on the relative bargaining power of social classes, the truth is that wage variation is clearly restricted, at its lower limit, by the cost of reproduction of labor, and, at its upper limit, by the requirements of capitalist accumulation.

## **2. Two hypotheses on the forces that determine the evolution of relative share: Marx and the Neoclassics**

### **2.1.**

In the Marxist perspective, “the law of capitalist accumulation excludes any decrease in the rate of exploitation or any increase in the price of labor that puts at risk the continual accumulation of capital and its reproduction on an ever-larger scale” (Marx, 1966, v. 1). That means that, given a rate of accumulation, wages must be adjusted to it to allow capitalists to carry out their expansion plans. In the versions that we could qualify as “static” of the Marxist model, the ratio between rate of exploitation and rate of accumulation

would appear reversed: given the surplus/wages ratio, we would obtain, discounting the capitalists' consumption, the corresponding rate of accumulation. Accumulation, therefore, appears as a residual phenomenon dependent on a greater or lesser "propensity to accumulate" by capitalists. For Marx, however, accumulation is not a matter of individual choice. It is a necessity engendered by competition itself: a struggle in which capitalists try to exclude each other from the market. Technical progress is the weapon used by these belligerent gentlemen to crush one another. Through the introduction of innovations, some seek to lower their costs and increase their profit margins, and are opposed by others. "Technical progress, the fruit and weapon of intercapitalist competition, appears, in its effects, as an (differential) income for individual capitalists, an income that reinforces the competition between capital and labor for the benefit of capital" (Salama, 1972).

In other words, in order to reproduce on an enlarged scale, the process of accumulation is forced to continuously increase the rate of exploitation. If the advance of accumulation tends to absorb the existing relative unemployment, favoring an increase in wages, capitalists react by intensifying the degree of mechanization of the labor process, therefore recreating the industrial reserve army at a sufficient ratio to curb wage growth and allow accumulation to continue.

Technical progress works in two directions: preventing wage growth by maintaining the relative unemployment rate required by the process of accumulation and increasing productivity per employed worker. The increase in productivity enables an **absolute** growth in real wages, insofar as it reduces the labor time socially necessary for the production of the goods that are part of the cost of labor reproduction. This does not prevent, however, the decline in the share of wages in the global income. Although Marx's position on the diminishing share of wages in income in the long run is clear, the interpretation that real wages tend to fall in absolute terms is not authorized.

Kaldor noted that the "[Marxist] theory can only allow for a rise of wages in terms of commodities as a result of the collective organisation of the working classes which forces the capitalists to reduce the degree of exploitation and to surrender to the workers some of the 'surplus-value' (Kaldor, 1955: 88). The assessment is incorrect because the theory involves – due to the internal dynamics of the Marxist distribution model and regardless of the introduction of "bargaining power" as an additional assumption – a rise of real wages in absolute terms. Moreover, it contains an elementary error of logic, insofar as the share of income that is absorbed by wages cannot, by definition, be surplus-value.

Marx does not, in fact, have a strict theory of wage determination. He merely establishes the lower limit by the historical cost of reproduction of labor and the upper limit by the requirements for the continuity of accumulation. Once these limits are set, the share of wages in the rising income will depend on the power of capital, on the one hand, and the resilience of workers, on the other. With these restrictions, it is legitimate to introduce bargaining power as an additional hypothesis to explain the evolution of relative share.

Kalecki formulated a special theory on how such “bargaining power” is manifested in modern economics, founded on the idea of “degree of monopoly.” In this point of view, the determining factor in the distribution of income is the ratio that is established, in a monopolistic economy, between the sale price of final goods and the price of inputs (wages + raw materials). Assuming that the average variable cost curve of companies is horizontal to the point of full capacity utilization, the degree of monopoly is defined as the power of companies to set a markup on costs, which varies inversely to the actual intensity of competition. When setting their prices, businesspersons must take into account the rate of profit they hope to obtain, the prices of their competitors and their average unit costs. For the sake of simplification, let us assume that all industries are vertically integrated, so that wages represent total variable costs. The markup cannot be set at a very high level, in the first place, for in the short term that could mean a reduction in sales and, consequently, in the rate of profit (depending on the elasticity of the demand curve). If sales do not fall (and the rate of profit remains high in the short term), new companies may be attracted to the sector, reducing the rate of profit in the long run.

This capacity of companies to set a markup on their costs undermines the power of trade unions, insofar as wage increases can be absorbed by increasing prices. Therefore, the relative share of wages in the aggregate value tends to decline as the “degree of monopoly” grows. Dobb suggests that the “degree of monopoly” comes in as an additional element in Marxist theory to explain the distribution of income between wages and profits – “reminiscent of forms of exploitation typical of pre-capitalist stages” (Dobb, 1973).

If this description corresponds to the mechanism of price formation in modern economies and the idea of degree of monopoly is used as a supposed modifier of the Marxist theory of distribution, this immediately minimizes the role played by the industrial reserve army as an element of adjustment between the rate of accumulation and the share of wages. This also implies a redefinition of the role ascribed to technical progress in the process of accumulation. Indeed, if the industrial reserve army loses its function of stabilizing the ratio between rate of accumulation and distribution of income, technical progress tends to become independent of the conditions of scarcity or abundance of

labor. As an explanation, Steindl suggests that under these conditions, the process of innovation acquires an impetus of its own, “freeing even more workers than necessary for the smooth continuity of accumulation” (Steindl, 1972). This would be a spurious and unnecessary solution to the problem, inasmuch as within the scope of Marxist theory, technical progress is viewed above all as a weapon of intercapitalist conflict. It is fair to admit that this weapon continues being used more intensively by companies in the monopoly phase of capitalism. And since the nature of the forces driving it have been changed, it would also be legitimate to accept a change in the character of technical progress (from saver of labor to saver of capital).

## 2.2.

The neoclassical hypotheses about the evolution of relative share revolve around the “Law of Variable Proportions.” More precisely, they are based on the concept of elasticity of substitution that Hicks defined as “the measure of the ease with which a variable factor can be replaced by the others.” This coefficient actually measures the sensitivity of technology to variations in the relative prices of production factors.

The share of one of the factors in the result varies as long as its relative intensity, measured by the capital-labor ratio, changes. If the supply of capital grows faster than the supply of labor (technology being constant), the marginal productivity of labor increases and the change in the distribution of income will depend on the elasticity of substitution. In simpler terms, with a small drop in the price of capital, the greater the elasticity, the greater the replacement of labor by capital.

The Cobb-Douglas production function, often used for econometric purposes, presupposes a unitary elasticity of substitution. That means that a fall in the relative price of capital will lead to an exactly proportional increase in the ratio between capital and labor, so that the relative shares remain constant. This assumption, which is quite restrictive from a theoretical point of view yet quite convenient from an econometric point of view, was relaxed with the appearance of production functions that admit different values for the elasticity of substitution unit. This is the case of the CES function, which allows the coefficient to assume values different from one, but constant for each production function (Arrow *et al.*, 1961: 225). The theoretical implications of this change are not relevant, even though the econometric implications are. Relations of distribution remain limited to the determinations of technology. In other words, they continue being an eminently technological phenomenon.

In neoclassical production functions, technical progress appears as a means to increase the efficiency of the factors (alas!) but its introduction is



not endogenously linked to the process of accumulation. It depends on what has been called “state of the art” and its capacity to be neutral, saving either capital or labor. The Cobb-Douglas function presupposes neutral technical progress. If the elasticity of substitution guarantees the stability of shares in the short term, the neutrality of technical progress ensures such stability during the growth process, increasing in the same proportion the productivity of capital and labor. That is, keeping the long-term capital/labor ratio constant.

In this well-behaved “vaudeville,” perfect competition prevents any blunder that may compromise the show. Unlike the Marxist model, in which a fierce struggle between workers and capitalists and among capitalists themselves drives the whole system towards concentration of property and unequal distribution, in the neoclassical world competition is hypostatized as a magical entity that always leads the economy to balance and steady growth.

### **3. Relations between functional and personal distribution of income**

The controversy becomes more heated when it comes to establishing the links between functional and personal distribution of income. In general, personal distribution has been basically addressed in terms of statistical and descriptive aspects. These analyses are often accompanied by broad explanatory hypotheses that do not exactly constitute coherent theories. The theory required must be able to explain how wage earners are stratified and how property income is differentiated.

In the framework of Marxist analysis, not all wage earners enjoy the same theoretical status, as not all fulfill the same duties in the process of reproduction of social capital. All workers are equally subjected to the capitalist work process, some engaged in the generation of surplus-value (productive workers), the others engaged in the sphere of circulation (unproductive workers). The adjectives “productive” and “unproductive” have no ethical meaning, as Marx himself often warned, but simply refer to the position occupied by workers in the process of capital reproduction.

Modern capitalism, for reasons that cannot be discussed here, supposedly reinforced the role of activities involved in the “realization” of surplus-value and, therefore, expanded the fraction of its labor. Marx himself recognized the growing importance of these activities for the process of capital reproduction: “To the extent that merchants’ capital contributes to shortening the circulation period, it can favor an increase in industrial surplus-value; insofar as it contributes to the growth of the market and produces the division of social labor among capitalists, its function favors the productivity of industrial capital

and its accumulation; to the extent that the period of circulation shortens (merchants' capital), the ratio between surplus value and capital 'advanced' increases and, therefore, the rate of profit" (Marx, 1966, v. 3).

The tasks of workers subjected to merchants' capital, even though they constitute a necessary step of reproduction, are unproductive, in the sense that they only bring about a transfer of surplus-value from the sphere of production to the sphere of circulation. In this line of argument, the development of commercial capital causes the rapid growth of the number of unproductive workers and, consequently, a wider range of remuneration.

The difference between productive and unproductive labor suggests immediately the distinct nature of remuneration as perceived by both groups of workers. The remuneration of unproductive labor is "seen" by individual workers as wages, but in fact it is a fraction of surplus-value transferred from the sphere of production. That is not enough, however, to explain the different structures of personal remuneration, unless it is shown that the laws that regulate the wages of productive workers do not apply to unproductive workers. The most correct hypothesis, since both groups of workers are subjected to the process of reproduction of capital (whether commercial or industrial), is that the wages of productive and unproductive workers are regulated by the same forces. Just as capitals of equal amount and composition, whether of circulation or production, should yield equal profit rates, equally qualified workers should receive equal wages. This conclusion apparently situates the Marxist theory of personal distribution at a "dead end" and on the brink of incorporating an awkward version of the theory of human capital.<sup>9</sup>

The distinction between productive and unproductive labor is of little use, at the level of abstraction in which it is usually formulated, to explain the differences in personal remuneration. But one can use it in a more rigorous manner, changing the Marxist perspective and incorporating the diversification of the bureaucratic apparatuses of companies and the state in the oligopolistic stage of capitalism. Oligopolistic competition reinforces the growth of a particular type of unproductive worker insofar as it brings about change in the structure of companies in favor of management levels linked to the decision-making process. Above all, this has led to deep segmentation in personal distribution of income. Bureaucratic staff linked to the decision-making levels of large companies waste no time in setting their own remuneration as a function of profits. What they earn has very little to do with how qualified they are and a lot to do with their proximity to power centers. Nell, commenting on two recent books on distribution, does not conceal his bewilderment when exposed to the argument of productivity differentials to justify the stratification

9 I thank my friend Jorge L. Miglioli for this insight.

of labor incomes: “Given the power structure of corporations, executives at the top largely set their own pay; from these levels down the pay structure reflects relative position in the hierarchy” (Ferguson; Nell, 1972: 445). A higher or lower pay, therefore, reflects a greater or lesser identification with the power of capital (with its ability to exploit labor) and perhaps in this sense we might admit the semantic perplexity contained in the concept of “human capital.”

In this case, return on education depends much more on the nature of the occupation than on the improved level of qualification of the workforce. That is, if such individuals can be logically included in the workforce. In other words, there is no point in mentioning a modest cognitive capacity, there is no measurable product (decisions per hour?) as long as the productivity of this type of labor is measured by its actual pay.

On the other hand, changes in the corporate structure, causing a decline in the relative weight of the direct workforce, undermine the bargaining power of trade unions while the increase of the “degree of monopoly” expands the ability of large companies to control their profit margins. On the other hand, that makes it possible for direct wages to grow at a slower pace than productivity and for pay differentiation to expand in the bureaucratic hierarchy.

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# CHAPTER 3

## A COUNTERPOINT TO THE VISION OF SELF-REGULATION OF CAPITALIST PRODUCTION

*Maria da Conceição Tavares*

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### 1. Two “mistaken” concepts of profit

The two most frequent ideas in the contemporary “neo-Marxist” debate about the theory of value present the concept of profit either as a “previous appropriation of surplus labor” or as a “surplus” of real production over the workers’ necessary consumption. In my opinion, these interpretations represent one of the biggest mistakes in progressive thinking and lock it in a “theoretical trap” with no way out. Profit, defined in any of these ways, acquires a static “deduction” or “residue” character which, in my view, is away from the Marxist view of the theory of value in its fundamental purpose, which is that of a **theory of capital valorization**.

In the current discussion, the interpretations of the first-type neo-Marxists convert the **labor theory of value** into a simple naive theory of “exploitation.” The second-type interpretations tend to be more academic and end up transforming the Marxist theory of value into a minor “neo-Ricardian” version.<sup>10</sup>

The use of the concept of “surplus” to replace that of profit has also given rise to contemporary non-Marxist variants, with Ricardian or even neoclassical roots, which discuss the “social appropriation of the surplus” as a result of a relationship of domination or power, found in all societies.<sup>11</sup> It is, therefore,

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10 Regarding the vast contemporary neo-Marxist literature, I consider Emmanuel's Theory of Unequal Exchange the touchstone of both mistaken versions. Among the best-known Marxists, the version of “surplus” of Professors Sweezy and Baran is at the root of many later theoretical developments. As for the academic efforts of neo-Marxist-Ricardians, especially those arising from an “illegitimate addition” of Sraffa to the Marxist theory, they gave way to an endless controversy which ended up with the participation of Prof. Samuelson who, with his irony, coined the expression “minor post-Ricardian” to reduce the size of Marx’s thought. Again, “the two schools of Cambridge,” in their confrontation, contribute more to the “reigning theoretical crisis” than to its clarification and end up “erasing” the fundamental differences of their original conceptions. Later, Prof. Samuelson made a mea-culpa and publicly acknowledged that Marx was a respectable author of great intellectual strength.

11 This view is shared, albeit with different nuances and languages, by a large number of economists, with divergent past and theoretical backgrounds. Professor Celso Furtado is, along with Baran, one of the first

a vision of a classless society antagonistic to history – except for the general designation of “dominant” and “dominated” sectors. The “class struggle” becomes, in any historical circumstances, regimes and societies, a struggle for the **distribution of consumption**. The problem, as assumed by the relations of production that give rise, in capitalism, to the emergence of **capitalist profit**, with its historicity and contradictory development, is thus reduced to a struggle for the distribution of the surplus that ends up in a struggle for the distribution of consumption. Capital, as an object, expression and “subject” of these social relations of domination, disappears as if by magic. The struggle for social justice would have as a **general** and **universal** paradigm the distribution of the surplus and the fight against conspicuous consumption by the dominant classes and their associates, the middle classes.

The fight against the “consumerism” of the latter becomes the main target so that the “surplus” can be “reversed” in order to maximize the flow of consumption by the masses. Without wishing to disregard the ethical appeal that the fight against poverty has and must have among all of us, and in which I include myself following the progressive authors, my view of “surplus” and the nature of profit is completely different. Nevertheless, before delving into my reflections on the subject, I would like to explain the objectives of this essay.

## 2. Purposes and limits of this essay

Unlike the previous theoretical section, this one has no didactic purposes and does not claim to be a “reading guide” for my students. It represents an attempt to openly discuss my own view on some issues in the Theory of Value and Capital, which I have discussed in seminars with some disciples and colleagues.

In this essay, I do not intend to follow the path of Marx’s problem with the “patience of the concept,” as my colleague Luiz Gonzaga Belluzzo does with brilliance and rigor in his doctoral thesis.<sup>12</sup> Nevertheless, I owe him the apprehension of several Core analytical points, through the fraternal debate and the care with which he prepares his seminars. Despite sharing with him his vision of the **Theory of Value**, as “**Theory of Capital Valorization**,” evidently, he is not responsible for the nature of this essay or for its possible mistakes.

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contemporary economists to analytically introduce the concept of surplus. He did it, however, to study underdevelopment and give it theoretical status. However, in his book *Prefácio a nova economia política* [Preface to new political economy] (1976), he transforms the concept of “surplus” into a paradigm.

12 See Belluzzo (1975).



My “pedagogical” purposes could easily be qualified as “obstacle pedagogy,” since I only intend to take some “obstacles” out of a path that is traversed in the midst of endless controversies, some “issues” of a theoretical discourse, whose challenging reading, done in an obsessive or dogmatic way, has misguided many young economics professors.

The meaning of this “misdirection” is twofold. The first refers to what I consider to be the main task of a socially conscious economist, and concerns the struggle to understand the issues of contemporary capitalism and the critical effort in relation to the specific issues of Brazilian society. The second refers to the learning and theoretical training process, to which the “critical” reading of great thinkers should be an aid and not an obscurity.

I believe this last “misdirection” is due to the real complex reading of the main texts of Marx, especially *Capital*, but also (leaving aside those who make this reading only because of a fad) to the fear of finding “contradictions” or “errors” by the careful reading of the main texts, considered “sacred.” Some university-educated economists even prefer a “Marxian” reading, to give academic respectability to a thought that, due to its rebellious strength, “theoretical tradition” and “modernity,” is very little sympathetic to this type of reading.

My working hypothesis is that the “errors” are not there by chance, they are really “dark questions,” “gaps” in the text, difficult to fill with simplifications, difficult “obstacles” to overcome with “deviations.” And as such they must be seen as signs of rupture **not only of the text** but of the category – capital – that the author is trying to totalize and is not easily dominated, even by his method of analysis. As for the “contradictions,” it would always be advisable, at first, to research if they should not be understood as the dialectical movement that Marx himself gave to his “concept” of capital, like that of “contradiction in process.” However, in no case it is justified as a theoretical procedure, on the pretext of doing a “scientific reading” of *Capital*, codifying it in a language that is the opposite of his, on the pretext of “decoding” the dialectical language and removing it from the swamp of “metaphysics” or “Hegelianism.” In this case, a “naive” and “intuitive” reading of the text would be preferable, which runs the risk of apprehending only its most general movement. This last type of reading has at least the real excuse that at this point in the century, and in the face of a “theoretical crisis” that is only a pale “reflection” of a new fundamental crisis of capitalism, it may be impossible to “redo” a theoretical construction of the essence of any of the great thinkers from the past.

In fact, the “political economy” has been plunged for more than 40 years, with rare exceptions, into a terrifying vulgarity. Therefore, young university students who are targets of alienating teaching practice and of a low theoretical

level may make their mistakes and exercise their freedom in a reading of the “Critique of Political Economy.”

In my case, due to my long “theoretical practice,” there are some poor excuses when I dare to pose certain substantive theoretical issues desordely with some contemporary issues. Except for that about the issues affecting us all dramatically, and the “opening of the debate,” even “apparently disordered,” will be easily forgiven by those who have the honesty and rigor of a more “patient” reading.

### 3. “Obstacles” in the path of the movement of *Capital*

The best path in the movement of *Capital* cannot be followed through an apparently didactic reading of the three volumes, thinking that one is moving from a higher level of abstraction (in the 1<sup>st</sup> volume) to progress, by successive approximations to the concrete, until ending (in the 3<sup>rd</sup> volume) in the “capitalist competition” and in the “credit” that could be interpreted as manifestations at the “epiphenomenal” level of the “essential” movement of capital.

I do not intend to make questions about the “Marxist method,” for which, incidentally, I do not have “technical competence,” but I reject, and not *a priori*, any of the versions of “Guide” on how to read *Capital*. A more philosophical reading of the “genetic” or “logical-historical” character of the method in Marx is totally out of my reach, but any of the good philosophers I have read recognizes that the transition from “abstract” to “concrete” is made by Marx in many ways and in all chapters, and it is one of the biggest headaches for any “warned” reader of his texts.

I have already read *Capital*, sometimes with specialists, sometimes with “unwarned” students. The Core theoretical issues of my current path have been suggested to me by the difficulties that all readers, experts or not, encounter in understanding what can be considered “essential” and “problematic” in its reading. At this point, my greatest interest – for the sake of my profession, which is to teach – is to understand by myself the fundamental theoretical issues that can be formulated and debated in order to understand the concrete issues of contemporary capitalism. In other words, I am only interested in a path that “illuminates” the “obstacles” that the very development of capitalism has shown to be necessary to “remove,” without intending to make an explanation of a complex theoretical discourse. In this sense, the order of the “movements” that I am going to undertake has a “logic” despite appearing disordered in its “course.”

## 1<sup>st</sup> movement

### Constitution of profit and capital as a contradictory unit

“Surplus labor” or “surplus-value” can be understood in a simple scheme of the process of production of commodities that has nothing “metaphysical.”<sup>13</sup> The basis of the theory of value explains what is fundamental in the relations of capitalist production, namely: capital commands the social labor process and subjects workers in a peculiar way, which does not require physical violence, and “forces” them to work “voluntarily” as “free workers,” not only for their subsistence (that is, to reproduce themselves), but to reproduce capital with “profit.”

The terrible force of “necessity” and “freedom” is combined in the historical emergence of this new mode of production, generating a power of subordination to labor much greater than that of servitude, since it is the legal power of “free contract.” Unemployment is worse than exploitation, since all the means of production and Nature are appropriated by capitalism.

The exploitation of labor does not mean “theft” since the “good” labor power receives “its exchange value” “as an average,” that is, the value of the workers’ means of subsistence, in exchange for which they had to cede the use value of their labor. And this private appropriation of the use value of labor “socialized” by capital is subordinated to it, which allows the “conversion” of surplus labor into “surplus-value,” that is, at the “base,” at the “possibility” of profit.

The conversion of “surplus-value” into profit, which in Marx is a logical transition to understand the nature of profit, has given rise to a number of controversies that obscure, through quotations out of context, the general movement of “law of value” as law of capital valorization.

Let us look at one of the statements that has given rise to confusion: “surplus-value” can only be generated in the “orbit of production,” and can only be “realized” in the “orbit of circulation.” What does it mean? Does it mean, by any chance, that in capitalist production, surplus-value is generated **first** and **then** it becomes profit, as some naive or sophisticated exercises for transforming “value” into “prices” imply? No, it does not. It just means that although it can be decomposed **abstractly**, that is, analytically, capitalist production into several “orbits” (to separate it from the phenomenon of “commodity production” and to oppose it to pre-existing modes of production), in

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13 The reference to the metaphysical character of the theory of value is due to, among others, Professor Joan Robinson, who probably struggles with the attachment of Marx’s disciples to orthodoxy, but ends up misguide Marx’s problem in her *Collected Economic Papers* (1951, Vol. 1 and 1973, Vol. 4).

reality it is the first historical mode of production in which production and circulation of commodities and the circulation of money are associated (concretely inseparable). The “separation” between the orbit of production – where “surplus-value” is generated –, the orbit of circulation of commodities – the “market” where “surplus-value” takes place –, and the orbit of circulation of money capital – where capital becomes its most “apparent” form – is very dangerous, and it can only be done with clear analytical purposes. In other words, with clarity about the Marxist “separation” method. Orbits are only “separated” to be “redone,” to understand that profit and capital are global phenomena that do not remain without any of them.

In a deeper sense, the “orbit” of capital circulation contains each one in the global movement of capital and therefore destroys all of them when it destroys itself in the crisis.

The “separation” of the orbits is therefore equivalent to the abstraction movement that later allows (as a logical movement) appropriating the concrete articulation, without which profit would be unintelligible. Profit is inherent in the complete capitalist production process, and as such it cannot be “deducted” from “surplus-value” or “surplus,” nor **measured** by the number of hours of “surplus labor.” Both surplus (in commodities) and surplus labor, that is, the number of hours worked in excess over those required for the workers’ necessary consumption, exist in any non-“primitive” society. The “conversion” of “surplus labor” into surplus-value results, however, from a social relationship of production, “capital,” which converts labor into wage labor, which allows it to privately **appropriate** the fruits of the social productivity of labor. Nevertheless, this appropriation of surplus-value in the **form of profit** does not occur in an “abstract production” scheme separate from the accumulation of capital, from capitalist competition, and from the monetary valorization of the “elements that constitute capital.”

Without expanded reproduction of capital, there is no profit in the **capitalist sense**, in the sense of the process of continuous capital valorization. The construction of simple reproduction schemes is just a logical exercise, to demonstrate the “value” distribution of production and capital. The transition of values to prices is another logical exercise to demonstrate how capital is distributed in the various orbits and how to arrive at the **concept** of average rate of profit.<sup>14</sup>

In the Marxist perspective of the law of value as a “law of valorization,” the process of capitalist production presupposes the submission of the labor

14 There are several other ways of making this logical transition, and certainly more correct than Marx’s exercise. Bortkiewicz would be right to say that if this was **that which** the Theory of Value was reduced to, it would not be worthwhile to make this “deviation.” The problem is that it is not **reduced** to this, as we will try to show.

power, but its starting point is the capital already constituted and, therefore, labor as its “appropriation.”<sup>15</sup> Profit presupposes the valorization (in money) of all elements of the capital that has been advanced. Variable capital presupposes the “valorization” of the labor power (wages paid to the good “labor power”), and constant capital, the valorization of the means of production (the value of raw materials and equipment produced in the period of production).

The possibility of **equivalence** between profit and surplus-value requires highly restrictive conditions. Profit (measured in production prices) would only amount to surplus-value (measured in socially necessary labor time) if all the capital produced in the period was consumed, productively, in the same period of production. That is why Marxist reproduction schemes use the concept of constant capital –  $c$  – and not that of capital “stock.”<sup>16</sup> The valorization of total capital –  $C$  – cannot be made based on production prices, since **fixed** capital cannot be valorized, **strictly**, in a period of production different from the periods in which it was produced. It cannot be valorized at the same average rate of profit determined under the restrictive conditions represented by the transition to production prices. Capital can only be valorized in money, that is, through its **metamorphosis** into a special commodity, which leads to a rate that is the **premise and basis** for calculating the global capital “valorization” – the interest rate on financial capital.<sup>17</sup>

Thus, two distinct possibilities of non-equivalence are presented. The first stems from the addition of new productive capacity with different technical and organic compositions, which unequivocally disturbs the equivalence between the value extracted from living labor and the production prices. The second arises from the “general” money valorization of “fixed” capital through reserves for “depreciation” – such as a “financial fund” –, which inexorably breaks the possibility of **equivalence** between the rate of surplus-value and the **capitalist profit** rate.<sup>18</sup>

15 See Marx (1972b, item III: *As mercadorias como produto do capital* [Commodities as the product of capital], especially page 128 and the following.

16 It is to this “reduction” that Professor Robinson refers in her essay on Marx, accusing him of confusing stock with flow. See Robinson (1951).

17 See Marx (1966, Vol. 3, Ch. 2: 353-4).

18 This “rupture” introduced by money already appeared as a possibility, through hoarding, in the circulation of commodities (C-M-C), when M appeared as a “general equivalent” and as a means of payment (see Marx, 1966, Vol. 1, Ch. 3: 73, 95). It is confirmed in the metamorphosis of capital (Marx, 1966, Vol. 2, Ch. 2: 70, 76). Money was never thought of by any deep thinker of the capitalism movement as a “monetary veil,” nor just as a general instrument of exchange. The “active” function of money, as Hicks (1967) recalls in his “The Two Triads,” when commenting on Keynes’s liquidity preference and contrasting it with Friedman’s view, is fundamental to understanding the movement of capital accumulation. For Hicks, however, the “active” demand for money is precisely that of “liquidity preference” that is intended to form funds for investment or for speculation and not the portion of the money that enters the circulation of commodities, which is simply the money required (necessary) for exchanges.

Therefore, profit as a category that expresses the global capital valorization can only be understood as a problematic totality, which requires the apprehension of three **logical** movements of the valorization process. The first occurs in the appropriation of **abstract** labor by **capital** (determination of the rate of surplus-value); the second, in its “transformation” into production prices (determination of the average rate of profit); the third, by the metamorphosis of capital in the form of a special commodity – money (determination of the effective rate of profit).

Capitalist production, therefore, presupposes capital already constituted in its “apparent” and therefore more general form – **money** – that buys goods, including the labor power, which increasingly “exploits,” forcing it to work more hours than what is necessary for its subsistence. But it does not necessarily manage to “transform” the whole mass of surplus-value into profit. It depends on what happens in the competition between the various capitals and how they are distributed in the various productive and unproductive orbits. It also depends on what happens in the **circulation of money capital**. It depends, in short, on how capital valorizes itself. If this valorization is arbitrary, as it usually is, the parallelism between interest rate and average rate of profit is broken, the equivalence between the latter and the rate of surplus-value is broken.

## 2<sup>nd</sup> movement Contradiction in process

The first reading of the Theory of Value, in Marx, is intended to analyze the logical movement of “internal connections” of the capital, of its contradictory unity. Capital, however, is “a contradiction in process,” which tends “logically” and historically towards its “concept,” towards its “more general and apparent form” that increasingly moves away from its “origin,” the labor-value. Let us see, in general lines, how this contradictory dynamic occurs.

In its historical evolution, capital buys less and less **living** wage labor, the basis for surplus-value is more and more produced means of production, more **dead** labor. Note the use of the word “dead” and not “incorporated,” which means that capital does not have to **pay** for incorporated labor since the beginning of capitalism,<sup>19</sup> but for the **current production prices of fixed capital**, that is, for valorizing the new capital incorporated into the expanded reproduction movement. However, the issue of “fictitious valorization” of all fixed capital, of transforming it from “past” to “present,” remains.<sup>20</sup> This

19 See the attack on Ricardo and his concept of dated labor in the Theories of Surplus-Value.

20 The endless discussion about “historical cost,” present value (updated) and “market price” of fixed capital incorporated into capitalist production is one of the clearest manifestations of the impossibility of the “measure

“update” is made through the calculation rate – the interest rate – and is entirely arbitrary, giving rise to accelerated or delayed depreciation processes, according to the conjuncture interests of the capitalists.

The concrete evolution of capital in the long term is entirely dedicated to reducing the need for living labor (the source of value) and to cheapening “dead labor,” the produced means of production, that is to say, “counterbalancing” in “production prices” the secular tendency to increase the technical composition of capital and the concomitant increase in its organic composition. The development of the capitalist productive forces (mainly from the “monopolistic stage,” through successive scientific and technological revolutions) continuously increases the social productivity of the labor power, that is, it reduces the number of hours of labor necessary for the current production of any commodity, through the continuous reduction of industrial costs. This reduction occurs, however, in two “departments”: that of wage-goods and that of means of production, in such a way that the valorization in “production prices” of “constant capital” and “variable capital” does not necessarily follow the movement of the “law of tendency to a falling rate of profit.” Thus, both the rate of surplus-value and the organic composition of capital, measured in labor-value, become progressively unintelligible when applied to the analysis of the “concrete movement of capital.” The law of tendency appears more and more as what it theoretically is: a “limit”-law of the movement of capital, in the sense of overcoming itself as a historical and social category, as Marx himself indicates in his “Supplementary Remarks” to the “Development of the Law’s Internal Contradictions”.<sup>21</sup>

Marx gives some examples in the chapter on the “The Law of the Tendency to a Falling Rate of Profit” of how the movement of organic composition can be “counterbalanced in value,” which makes intelligible its “provisional departure” from the movement of technical composition towards the “intensification of the use of dead labor.” Nevertheless, technological development, by gaining progressive “autonomy,” which is only comparable with the “autonomy” that capital itself gained in its general and financial form, makes this “departure” become definitive. The law of capital valorization inexorably produces, through the development of Technique and Financial Capital, the internal destruction of the very connection mechanisms between

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of capital.” The theoretical discussion of the “measure of capital” issue has taken “Economic Theory” to the greatest deviations. See the endless controversy of the two Cambridge schools and the neo-Austrian version of time as a measure of capital in J. R. Hicks. *Capital and time: a neo-Austrian theory* (1973). Not even Sraffa solved this issue with the artifice of using a calculation rate, the interest rate, as a substitute for the rate of profit. This only solves the issue of the current distribution of production with different technical compositions, and not the issue of valuing “dated labor.”

21 See Marx (1966, Vol. 3, Ch. 15: 259, 262-3).

capital valorization **in production** and its **global valorization movement**. Production prices tend to deviate from labor-value.

The concrete movement of capital is no longer tied to the “laws of its logical movement,” and it tends to stop having the “surplus-value” as a “limit” of valorization. In Marx’s own words (1972a, v. 2: 228):

“The theft of alien labor time, on which the present wealth is based, appears a miserable foundation in face of this new one, created by large-scale industry itself. As soon as labor as directed form has ceased to be the great well-spring of wealth. Labor time ceases and must cease to be its measure, and hence exchange value [must cease to be the measure] of use value.”

Historically, the “market surplus” in terms of material commodities produced over the “necessary consumption” of workers has increased dramatically, as the number of hours socially necessary to keep workers directly productive decreases, in relative terms, in a continuous manner. The industrial workday has decreased, in less than 100 years, from 14 to 8 hours in the capitalist world. The economically active population in industry and agriculture decreases in relative terms and, in some cases, in absolute terms. However, the share of wages in the money value of the final product does not drop or fall very slowly. In other words, the rate of surplus-value determined, in the first instance, by the increase in the technical composition of capital, ceases to be the element that allows the “organic composition of capital” to regulate the rate of profit.

What happens, then, with the “surplus-value” to “convert” into profit? In particular, how is the problem of “realization” resolved once technical progress is on track to increasingly convert “living labor” into “dead labor”? It was not enough to continuously develop the means of production department, through a growing differentiation “of its material production,” in fixed capital goods and inputs of all kinds. That is, it is not enough that  $D_1$  production is increasingly intradepartmental and serves as a market for itself. From the point of view of the “realization” of surplus-value, a growing mass of commodities appears that tends to “devalue” continuously. It is therefore necessary to expand markets wildly and to control them “monopolistically” to prevent “devaluation” from causing commodities to “get rid of exchange value” and become mere “use values.” It was also necessary to create an overproduction of the “unproductive workers” in the service sector of the great metropolitan urbanization – the so-called “employees” – and to increase the “disguised unemployment” with a new kind of personal service lumpen – which increasingly appear in the large final consumer market. Agriculture and consumer goods industries are no longer the basic market for themselves; the final production of wage-goods goes to large urban consumption; and



the consumption of the workers who produce it is an increasingly smaller proportion of the total consumption.

At this point in the century, wanting to make the transition between the “value” of the labor power, measured in man-hours required for its reproduction, and the “price” of the labor power, or between “surplus labor” and profit, is a mistaken “task.”<sup>22</sup> The countless discussions and unsuccessful attempts around the concepts of “productive and unproductive labor” fail to restore the concept of “reproduction cost of labor power” in its clarity, as when it was discussed to explain the nature of the “factory labor” in contrast to “manufacturing labor.” The introduction of the “moral and historical elements” in determining the “reproduction cost” had already shifted the discussion from the “abstract concept” to the concrete-historical concept of the social and political practice of the working class.<sup>23</sup>

The degree of objective development of the productive forces makes the concept of “necessary consumption of workers” increasingly removed from the notion of “time and labor socially necessary for the subsistence of the labor power.”

What about “valorization of capital”? It remains strong. Capital moves inexorably towards its “appearance” and its “reality”, valorizing itself,  $M - M'$ . The fetish of money and **commodity** increases its magical and real powers.

Commodities are “devalued” according to the law of value: “The labor-values of commodities are in direct proportion to the labor-time expended in their production and in the inverse proportion of the productive forces of the labor employed,” says Marx in the first volume of *Capital* (Marx, 1966, v. 1). But the prices of goods do not move in line with this devaluation.<sup>24</sup> The productive forces are developing terribly. Commodities lose value; they should tend to be “free” – free from labor, free from value. It is profit to deny its origin, the labor-value; capital to deny one of its starting points, the wage labor.

But commodities are not “free” from a special form of commodity, their most general and “abstract” form – money – which gives them its mark. Not

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22 As wrong as wanting to bridge the gap between “utility” and price, although less mystifying, because it points to the root of price, to the social root of “value.” Not as the value produced by labor, but by the capital that appropriates social labor and the commodities socially produced in order to increasingly distance its use value (its utility) from its exchange value (its price in money).

23 This “displacement” from the abstract to the concrete is very common in Marx and has been a source of inexhaustible quarrels and headaches between “economists.”

24 In fact, Marx warned that prices move through “intercapitalist competition” in such a way that only the **general movement of capital** makes the concept of the average rate of profit intelligible and not through the **direct** fixing of the price by the labor value contained in the commodities (Marx, 1966, Vol. 3: 352-3 and Marx, 1972b).

as **money** for circulation, but as “price,” whose equivalence with the labor-value is getting increasingly remote.

**Relative prices** do not move according to any “natural law”; land or natural resources diminishing returns do not work; neither do they move by the “law of value” (understood as the law of relative prices); they move by the law of “capital valorization” in their general movement of competition in the “international market.” The “price of tradable goods worldwide” tends to be unified by the power of internationalized capital. The movement of capital on an international scale tends to unify the financial profit rate of the capital blocks, at the same time that it sharpens the uneven character of the social conditions of production and, by implication, makes the conditions of “average profitability of productive capital unequal” in the different regions. Working conditions and the wage rate, for this reason, are increasingly dissimilar and do not tend to match. Thus, exchange of commodities does not just become “unequal,” but without the possibility of “equivalence” in terms of “labor-value.”<sup>25</sup> Absolute misery becomes increasingly “relative” in different countries, with increasing disparities in the social organization of labor and in the “politicized” distribution of labor incomes.

Absolute prices, as a long-term trend, are rising steadily. The “monetary expression of value” rises as a secular trend in brief inflationary periods. Periodic devaluations of the monetary standard do not change this trend; each rupture of the monetary standard to put the circulation of capital in “order” only replaces the issue more strongly.

Capital that has historically walked on two “legs,” two “special commodities” – wage labor and money – tends to progressively deny the value of one of them – living labor – and to assert itself in the other – money – only to verify that it is also devalued. Money capital always “stretches too long in its inexorable and worldwide expansion,” but it always proves to be “insufficient” and ends up “breaking down” in crises. Just to be replaced more strongly in the next stage of the expansion.

### **3<sup>rd</sup> movement** **The explosion of the “Sun”**

Technical progress advances with the growing socialization of the productive forces promoted by the large monopolized industry, tending to make labor free. But it remains a prisoner of money, of remuneration, which only by tradition continues to be called wage, but which is in fact literally “ordered”

<sup>25</sup> I would say more; the word “unequal” to indicate the conditions for the exchange of commodities between “Center” and “Periphery” is confusing: it obscures more than it clarifies the **fact** of the irreducibility of price formation on an international scale to labor-value.

capital. Capital tends to deny labor; not to “oppose it” but to deny it, trying to get “free” from it.<sup>26</sup> Only to find itself a prisoner of itself. Periodically, it has to destroy itself and then again to reinvent itself. The two extremes, M - M’, tend to come together inexorably at the end of each cycle of expansion of productive capital, destroying each other in a major financial crisis. And they destroy themselves just to start again, increasingly fetishized.

The development of credit relationships and the periodic invention of new financial “institutions,” which allow for “capitalization,” that is, the accounting valuation of money for money, only finds parallel with the inexorable development of the technique in the direction of making productive labor “useless.” The “active” part of the money, which enters the circulation of goods required by the production process, decreases, and the fictitious financial capital becomes more and more “actively” **passive**. The share of living labor required by technological development is decreasing in the face of gigantic scales of production, and capital can become **productive**, sucking less and less direct labor.

Both stop together in crises. Technical progress slowed in its advance and financial capital leading to precariousness and disruption of financial institutions. Both of them will be able to recover later in the race of the next cycle. But financial institutions have to be tidied up and “reinvented” before, and then the flow of technological innovation will begin, following the enlarged capital reproduction as a “magnified shadow.”

Marx, in studying the development of interest-bearing capital in his unfinished manuscripts, had underlined the growing fetishization of social relations in the capitalist mode of production. It was to unveil the “fetish” that he made his “critique of political economy,” that he returned to the Ricardian theory of value to criticize and restore it as a theory of capital valorization, that he explored in its most intimate details the capitalist production process to understand the problem of the movement of capital and not that of surplus-value. This is only the “origin” of profit, its “base.” Its point of departure and arrival is capital as abstract value, money. Not just the production of commodities, but the production of capital for capital. The basis of capitalism is the commodity, but its permanent valorization requires an “altered, fetishized commodity,” money, and its dominance over the other commodity, “alienated” wage labor. At the base of capitalism there are social labor and money; the latter “appears” valorizing itself, but it actually follows the path of production. However, it is

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26 As Colleti (1974) acknowledged in his self-critical reflection, the opposition between capital and labor is not reduced to a mere ‘Kantian opposition,’ but it is effectively a dialectical **negation**. This concept, which unfortunately became “cursed” due to its misuse, does not translate an “irreducible opposition” between its poles, but involves “the need” for its not logical but historical overcoming. The history of this overcoming is a long history and can only be “theorized” a posteriori, it can only be lived reflexively, dramatically, or politically.

an increasingly smaller part of the money that travels the path of production, as capitalism advances in the internal destruction of its “mechanisms” of regulation and “equivalence.”

“Interest-bearing capital is the consummate automatic fetish, the self-expanding value, the money-making money, and in this form it no longer bears any trace of its origin. [...] The social relation is consummated as a relation of things (money, commodities) to themselves” (Marx, 1974, v. 35: 268).

This is (in Marx’s own words) the initial and final “limit” of capital.

Wage labor is also its “special limit”; but in the valorization process, capital tends to systematically “negate” it, to dispense it as a source of value and to convert workers, from producers into consumers, into “mouths,” hungry or not, depending on their political power and not on their “productivity.” In advanced societies the State pays for them to produce nothing. Structural unemployed people, expelled from land and labor instruments, are no longer desired as a “labor power” to be subjected to capital in production, but to proliferate in the metropolises and become unproductive consumers or outcasts. The “socially progressive” beginning character of capitalism is thus converted, by the logic of profit and capital, into a machine of devaluation of the very use value of social labor. This is what has to be explained, understood and combated, and not the pseudo law of “relative prices,” or “unequal exchange.”

It is not, therefore, a matter of demonstrating that “prices” have historically tended to “values”; but on the contrary, that they “inexorably” depart from them, that the “equivalence” between surplus labor and profit – not equality (=) since they are not commensurable, but the equivalence (~) – which gave capitalist production its “rational basis” increasingly moves away with the evolution of capital. That in its movement of self-expansion and permanent valorization it ends up finding itself a prisoner of itself: money trying to valorize money. Thus, the law of value is not only the law that allows determining the “average rate of profit” that would keep technical and social production revolving around the Sun – Capital – as in a Copernican System approaching and moving away from it, in its self-regulating movement. It is a more profound and dialectical law, like the “modern laws” of physics and energy, of the expansion of the universe, which transform the “Sun” from the inside, which explode the suns, which make the “universe” a system in expansion full of “holes.”

Modern physicists did not need to see suns exploding to formulate their laws; they did not have to disintegrate the atom to produce their theory. They did not want to plug “holes” with “old equations”; they invented

“new” equations. Economists have seen the “Sun” exploding in their lives and have not yet understood its nature. Instead of taking seriously the “holes” and “errors” of one of the few modern social thinkers – Marx –, they want to reduce their dialectic to “metaphysics” or, on the contrary, to “Newtonian physics.”

Economists saw the progressively more serious character of capitalist crises, saw the separation of the “orbits” of production, of the circulation of commodities and of money, in increasingly destructive ways. They saw the “use value” of labor deteriorate and become useless for capital. In spite of everything, some insist that the present value of living labor is the “substance of value” or want to convert “the law of value” into a paradigm of the “law of relative prices.” They want to force equality (if not identity) between values and prices, when the real movement of capital affirms its “rupture” and Marx himself only discussed the “possibility” of equivalence.<sup>27</sup>

Even today, after 100 years of monopoly capitalism and 40 years of a producing and intervening State, they understand the double movement of the process of capital valorization (of the production and circulation of capital) as a **self-regulating** movement through periodic crises. They continue to see the “need” of the periodic crisis to try to restore the equivalence between labor value and price. They do not understand the meaning of the “definitive crisis” nor do they see how it actually presents itself: the growing “politicization” of prices, the periodic and **arbitrary** devaluation of commodities and capital so that the latter can resume its contradictory movement of overcoming itself.

Here, the “definitive crisis” is also seen as a “catastrophic prophecy,” not as what it actually is: the “impossibility” of self-regulation by capital competition, since the system moves away from its “origin” and becomes increasingly “arbitrary,” less self-regulating by the destructive force of its expansion. Its regulation, therefore, becomes increasingly political. That is, capitalism is increasingly “regulable” by the relations of “power” – which is exactly what gives it both a dimension of uncertainty and instability, as well as of **regeneration** (even if traumatic).

Capital requires less and less direct production of surplus labor, because it has already socialized the labor process in such a way that it requires, above all, the arbitrary valorization of itself, through new forms of inter-capitalist competition that increase the **power** of big capitals, through the discretion of the State.

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27 He discussed the possibility of “non-equivalence” and “rupture” in a thousand ways, but economists only cling to their ill-fated exercise of “transformation of values into prices of production,” which was only intended to make the theoretical sense of an average rate of profit.

*Finale***The fetish giving way to the discretion of the State**

If one wants to fetishize the technical production measured in man-hours worked, one must seek a system of social relations other than capitalism. Perhaps the “technocratic” system, if it could exist.

If one wants to look for an “invariable standard” of the value of commodities, one should use Sraffa and not Marx, who never sought such a thing, since he knew that the tendency was devaluation and not “maintenance of value.”

For this very reason, we do not accept the attempts of those who try to hypostasize either the labor value converted into a standard of measurement, or the technique treated as an explanatory basis for the dynamics of the system. If there is a fetish, one should look for it in the money that is its theoretical form and “realized” history.

Money represents the unifying form of capital, both the “theoretical” form, through its metamorphoses, and the real form of a dominant monetary standard on a world scale. It is also the only way in which it is possible to “measure” it. That is why it is a “measure of itself,” that is, with no real possibility of measure.

Commodities also have their production prices fixed with reference to the international market. It is only possible to change prices “in the national markets” of internationalized capitalist production, with tariff protection, subsidies and exchange rate management. All of this requires the intervention of the State, the “politicization of prices.” Only international (even devalued) money reigns apparently “sovereign.” The search for a “New International Order” with an “ideal standard of commodities” to replace the “hegemony of the international monetary standard” – an expression of the power of capital, which hides under its shadows – is the demonstration of this “measure difficulty” in all the senses of the word.

The “labor market,” on the contrary, tends to segment even on a national scale. The “formal” and “informal” labor markets are as many as are sought, depending on the analytical purposes.<sup>28</sup> The conditions of the labor process are so different between one region and another in a country (such as Brazil), that perplexity leads some social scientists to try to invent any number of “modes of production.” In a country steeped in capitalism and subjected to the forced unification of big capital (agrarian-mercantile-industrial-financial), one still talks of “pre-capitalist modes” of production to explain the perverse way in which capitalism itself produces contemporary formations, apparently reproducing “past” relations of production.

28 On the subject, see the work of Paulo Renato Costa Souza presented to the ANPEC Congress (1978).

In the most advanced countries of capitalism, under the same technical conditions of production, remunerations of the labor power are different. Wages do not tend to match. “Equal” jobs (?) do not correspond to equal wages, since the technique, when socializing labor in large units, does not tend to homogenize labor except for the (increasingly smaller) portion of non-“qualified” manual labor. On the contrary, it tends to differentiate it by “hierarchy.”<sup>29</sup>

In view of the growing fragmentation of the “labor market” and the impossibility of homogenizing the social conditions of production, the concept of “reproduction cost” of the labor power is still being sought for a contemporary analysis of wages. In view of the internationalization and monopolization of capital, the tendency to equalize the average rate of profit occurs only in the form of **general financial capital**, but there are still those who seek the “formal” equivalence between “surplus-value” and profit.

The interest rate, being the arbitrary basis of capitalist calculation, varies very little in the long run and, even in the crisis, it tends to suffer minimal variations compared to those suffered by the masses and the profit rates of “industrial capital.” One then starts to confuse the interest rate with the “natural” rate of profit of the system, declaring that it is in “balance” when it is in crisis.

In the search for “rationalizing” the intolerable reality of capitalism and its “order” in disaggregation, one discusses the “personal remunerations” of “free labor,” converted into “bureaucratic subjection” in the organized services of the State, is discussed in terms “productivity.” The work of doctors and teachers employed by the State is discussed as if it were “productive labor.” As it is subject to the same “general” regime of exploitation of “wage labor,” all “special” types of labor are considered as if they were subject to the objective regulation of the working hours of a machined labor process. Instead, it would be better to discuss its “social utility” – **its use value** – and try to negotiate its “exchange value” not “arbitrarily,” but in accordance with the real conditions of “power” and **legitimation**, by society.

The “politicization” of prices is denied, including that which is noticeably more politicized, which is the price of labor in services, which are not reducible to categories such as “productivity” or “scarcity.” It is not noticed that the fundamental difference between the “lumpen corporation” and the “university labor corporation” lies in the distinct “political power” and “social

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29 Reread carefully the nature of the “Socialization of Labor” process in *Capital*, chapter on “Cooperation” (1966, Vol. 1, Ch. 11: 268), where the nature of the hierarchy required by the collective labor process is already indicated. The increasingly “bureaucratic” nature of large capitalist organizations has only increased and disproportionately differentiated this “hierarchy,” in such a way that the “pyramid” of functions appears with an increasingly narrow “base” of direct labor.

status.” That the valorization system is different, that the hierarchical system of the labor process no longer corresponds to the technical and productive differentiation of capital. That in modern social organizations, the “superstructure” of the capitalist system contains in itself rules of valorization in which “political power” and “legitimation” are more important than the movement of capital in disorderly expansion.

**Outside the “law of necessity” there is no “law” for valorizing labor.** If capital dismisses labor, it, in its “freedom,” is temporarily condemned to the situation of “foreigner” or to create its survival organizations. It is obliged to wage a political struggle, periodically lost, in a society in disintegration, until the transition to a new society.

The theory of value was a powerful critical tool in the hands of its founder and very few of his disciples. To continue as it goes, it is becoming a fad that only serves to demoralize it and help those who have always seen it as “metaphysics.” The return, however, to the pseudo-vigor of formal models, on the other hand, ends up making the Marxist, Ricardian and Neoclassical “models” of production equivalent, and converting the “relative prices” into a self-regulated machine of production and the interest rate in the **Deus ex Machina** of the capitalist production movement.<sup>30</sup>

A “smaller god” designed to regulate a “deregulated machine” and that is powerless in the face of the destructive force of a schizophrenic expanding system. The profit from the surplus-value that requires “unity of the orbits” becomes a fiction because the real movement of capital separates them. Interest as the price of capital and the manifestation of the “fetish” that cannot be measured or regulated by itself. The real (of contemporary capitalism) is not rational; it is only intelligible, denying its theoretical and historical “reason.” The irrational emerges and makes use of another power. The State power. Not Hegel’s Rational State, but its opposite: the Reason of State.

30 In terms of formal models, I prefer those that take the “interest rate” as **Deus ex Machina**, since at least they are possible with an **ironic** interpretation like the one Ricardo Tolipan does in his essay *Capital e taxa de juros em Sraffa* [Capital and interest rate in Sraffa] (1979). Naturally, when it comes to “political economy,” I prefer Schumpeter, Keynes and Kalecki, who never took interest rates as the **Core** of analysis, but, on the contrary, submitted them to the determination of capital movement in intercapitalist competition.



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# CHAPTER 4

## FINANCE CAPITAL AND MULTINATIONAL CORPORATION

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### 1. The emergence of finance capital

Part V of the third volume of *Capital* addresses the problem of the **autonomization** of money-capital in the form of interest-bearing capital. Marx refers to this form of capital as “the most meaningless, in which the perversion and objectification of production relations are taken to the highest degree [...] the simple form of capital is placed in front of its own process of reproduction” (Marx, 1966, v. 3: 374).

The process of reproduction of capital as a whole, which presupposes the actual subordination of the workforce and, therefore, the constitution of suitable technical foundations for the continued extraction of surplus-value, is, at the same time, a movement of transfiguration of individual capitals into their necessary forms of money-capital, commodity-capital and productive-capital. It is, in fact, a movement of eternal return to “the simple form” (of money-capital) that allows the realization of the internal reason of the process: the valorization of capital-value. However, in order to achieve its goal, capital is obliged to submit to the harsh pilgrimage of the money-capital, commodity-capital and productive-capital circuit. Not only does it have to go through these three stages in succession, but it must also exist permanently under each of these forms.<sup>31</sup> The unity of these three stages is the most general and also the most elementary expression of the capitalist circuit. More general because the unity of three forms that compose the capital circulation process clearly reveals the nature of the mode of production, in the sense that it follows the evolution of the capitalist system in **any of its stages**. It is the

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31 “Every functional form, although a distinct part of capital is constantly expressed in it, thus goes through its own circuit, simultaneously with the others. One part of capital, continually changing, continually reproduced, exists as commodity-capital which is converted into money; another part as capital-money that is converted into productive capital; another as productive capital that is converted into commodity-capital. The continuous existence of all three forms is conditioned precisely by the circuit of aggregate capital, passing through these three phases” (Marx, 1966, v. 2: 93).

most elementary because such unity, merely constitutive of the concept of capital, is insufficient to account for the anatomical structure of the **capitalist system in its evolution**.<sup>32</sup>

In this perspective, Marx does not interrupt his investigation when he has finished breaking down the elements that make up the capitalist mode of production, but analytically unfolds the possibilities of these forms having a historical evolution in a **specific** direction. Thus, in the general law of capitalist accumulation are structurally implied the needs for capital concentration and centralization, mainly through the increasing expansion and externalization of interest-bearing capital, with the increasing predominance of the credit system over the merchant and productive spheres. Interest-bearing capital therefore emerges from the need for perpetual expansion and valuation of capital beyond the limits of its most general and elementary process of circulation and reproduction. In order to periodically revolutionize the technical foundation, subject growing masses of labor to its control and create new markets capital needs to exist permanently in a “free”, liquid and, at the same time, increasingly centralized form. Only thus can it flow unimpeded to reap new opportunities for profit while reinforcing the power of industrial capital immobilized in the previous circuits of accumulation. That is why analyses of competition, credit and, therefore, the process of concentration and centralization of capital make up the richest and most substantial part of Marxist research on the evolution of the capitalist system and its metamorphoses.

The autonomization of money-capital in the form of interest-bearing capital and the corresponding expansion of the credit system are the elements that make it possible to understand the centralization of capital and the merging interests of banking and industry. The form of capitalist organization that historically materializes this merger of interests is the joint-stock company, whose “collectivist” nature overrides the dispersed capitals and, at the same time, reinforces their rivalry. It represents, in Marx’s words, the “abolition of capitalist private ownership within the capitalist mode of production regime itself” (Marx, 1966, v. 3: 417).

Starting out from this analysis by Marx, Hilferding (1963) develops the concept of finance capital following two strands. On the one hand, he proposes a general formulation intended to characterize a more advanced stage of capital concentration. This stage is more advanced because the development of the capacity to mobilize capital, through new forms of association (cartels and trusts), also becomes a force for the suppression of technological and market

32 “It is the unity of the three circuits. . . that achieves the continuity of the aggregate process. The aggregate social capital always has this continuity and its process always exhibits the unity of the three circuits” (Marx, 1966, v. 2: 94).

barriers, which arise from the actual concentration process – especially those derived from the increase of production scales with progressive immobilization of large masses of fixed capital.

The large banks that take part in the constitution and management of the capital of large companies are interested in eliminating competition among them and, therefore, in reinforcing their monopolistic character. However, in doing so they stimulate the search for new markets, stirring rivalry among capital groups and even causing an increasing internationalization of inter-capitalist competition. This analysis is evidently of a general nature and not limited to the morphological description of German monopoly capitalism. There is no doubt that another part of his investigation concerns the specific form of association between banks and large companies, from which stemmed the large German cartels. It is especially specific given the role played by German banks as commanders of monopoly machinery. The presence of this two-pronged analysis in Hilferding's work led some authors, Sweezy among them, to confuse the particular morphological character of the German cartel with regard to the merger of interests between banking capital and industrial capital, under the hegemony of the former, with the more general and **Core** issue of the role of finance capital in the monopolization process.

The American case has often been invoked to disqualify both the historical inexorability of the monopoly stage and the predominance of finance capital as an ordering element in the dynamics of the system.

In this regard, Hobson's analysis of the "American case" is particularly enlightening, considered a paradigm of what he himself described as "modern capitalism." Hobson (1965), in his classic book, whose first edition dates from the end of the last century, outlines the theoretical contours of so-called trustified capitalism. This "modern" form assumed by capitalism was developed from the changes occurring in the US economy at the turn of the century. The results of the observed changes certainly deserve the designation of "modern capitalism," especially in the sense that the emergence and development of the large US corporation are the **national** embryo of the subsequent transnational unfolding of big business.

Not infrequently, the current predominance of the US economy has been explained by the technological advantages of its manufacturing system vis-à-vis European industry. With the same purpose some authors emphasize the continental nature of the American economic space. More recently (see Chandler and Hymer) the emphasis has shifted to the multidivisional morphology of the US corporation. We believe, however, that Hobson, like Hilferding, correctly underscored the role of finance capital to explain the rise of the large American company and the character of its future hegemony.

In Chapter X, “The Financier,” Hobson masterfully highlights the basic elements that, even today, can be considered essential in the economic structuring of big monopoly capital.

The radical changes in the industrial organization of large companies are accompanied by the emergence of a “financial class,” which tends to concentrate in the hands of those who operate the monetary machine of developed industrial societies, that is, the big banks, increasing power in the strategic management of interstitial relations (intersectoral and international) of the system. Thus, says Hobson, “the reform of the corporate structure based on cooperative capital, tapped from numerous private sources and amalgamated in large masses, is used in favor of the profitable industry by competent directors of large corporations” (Hobson, 1965: 236-237). As can be seen, Hobson emphasizes the “financial class” as strategic rhetoric of large corporations rather than the fact that the banks are committed to the direct management of industrial companies. In his view, the solidarity between banks and companies was merely effected through the “business community,” since, due to its peculiar form of structuring, the modern American company had become virtually the owner of the entire spectrum of strategic activities of the capitalism: mines, transport, banking and manufacturing.

In fact, what distinguishes this form of finance capital from those that preceded it historically is the universal and permanent nature of the processes of speculation and creation of fictitious capital, which were occasional and “abnormal” practices in the previous stage of “dispersed capitalism.”<sup>33</sup> The intrinsically speculative nature of business management in this form of “modern capitalism” is reflected by the growing importance of practices aimed at “fictionalizing” the value of existing capital, requiring the building of a huge and complex financial apparatus. According to Hobson, an honest company

33 We would like to draw the attention to how Keynes, in *General Theory*, addresses the issue of the profound changes that have occurred in modern capitalism, particularly in the elements that influence the decision to invest. Thus, in chapter 12 of his major work, Keynes argues that “decisions to invest in private business of the old-fashioned type were, however, decisions largely irrevocable, not only for the community as a whole, but also for the individual. With the separation between ownership and management which prevails to-day and with the development of organized investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system. In the absence of security markets, there is no object in frequently attempting to revalue an investment to which we are committed. But the Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to review his commitments. But the daily revaluations of the Stock Exchange, although they are primarily made to facilitate transfers of *old investments* between one individual and another, inevitably exert a decisive influence on the rate of current investment. For there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased. Thus, certain classes of investment are governed by the average expectation of those who deal on the Stock Exchange as revealed in the price of shares, rather than by the genuine expectations of the professional entrepreneur” (Keynes, 1971).

usually assigns separate values to tangible assets – land, buildings, machinery, inventories, etc. – and intangible assets, such as patents, brands, market positions, etc. However, the **real** estimate of the assets' value is effectively calculated based on their earning capacity. If tangible assets can be estimated by their cost of production or replacement, intangible ones can only be estimated by their net earning capacity. This, in turn, can only be estimated as the capitalized value of total expected future income minus the replacement cost of tangible assets. It is here, in this last element (intangible assets), that lies the elasticity of capital, commonly used by the “financial class” to expand capitalization beyond the limits of “real” valorization capacity. In this way, the expected earning capacity of a large company, regardless of how it is financed, lies fundamentally in market control, in the strength of its competitive weapons, and is highly speculative in its present value, even if supported by advanced methods of production.

In highlighting the speculative element of modern finance, Hobson nevertheless warns that the “financial class” only speculates in the security or money markets with the surplus income earned from its monopolistic practices in well-run businesses (industrial or commercial), or with income accumulated in successful past speculations. These include both those practiced in security markets and those related to the manipulation of commodity prices, especially raw materials under its control. The expansion and consolidation of such practices, from the viewpoint of the monopoly economy as a whole, can only enjoy free rein with the expansion of credit. “When we realize the dual role played by banks in financing large companies, first as promoters and underwriters (and often as holders of large quantities of stock not absorbed by the market) and, second, as money traders – discounting bills and advancing money – it becomes evident that the “business” of the modern banker is general financial management (general financier) and that the financial domination of the capitalist industry is mainly exercised by the banks” (Hobson, 1965: 254). And as credit becomes the lifeblood of modern business, the class that controls credit becomes increasingly powerful, taking for itself – as profit – an increasing share of the industry's product.

The prevalence of finance in the organization of monopoly capitalism merely shows that the autonomization of interest-bearing capital, referred to by Marx, ends up leading to domination over productive capital, regardless of the particular form such domination may take or the morphological form the large company may adopt in its expansion strategies. The “corrupting” function of interest-bearing capital, envisioned by Marx in his image of Moloch and materialized in the process of making money out of money, dispensing with any mediation by productive capital, is also emphasized by Hobson. The

“financial class,” as a class distinct from capitalists and “amateur” investors, uses its legitimate and fruitful function of directing the most important part of capital flows to develop methods of private revenue, all of them “an abuse and corruption of its true function” (Hobson, 1965: 251).

## 2. The large American company and the recent process of internationalization

The large American company builds its monopoly power on the intrinsically financial nature of the capitalist association from which it emerged. It is from this aspect, rather than the technical framework, that derives the capacity for growth and gigantism of the “trustified” capitalist organization. Conquest of new markets, monopoly control of raw material sources, “fictitious” capital valuation, overwhelming tendency to conglomeration, all these traits are embedded in the original matrix of the large American corporation, whose development is based on two pillars: finance and protectionism and privileges granted by its “liberal” state.

Any form of “trustified” capital necessarily leads to a concentration of finance capital that cannot be reinvested in the actual trustified industry. It must expand outward. The new profits must be transformed into general finance capital and directed towards creating and financing other large companies. Thus, the process of monopoly concentration and consolidation advances generally over all industrial branches where capitalist production methods prevail. Regardless of the extent of national space monopolized and protected by the state, as was the case in the United States, the continuous expansion of surplus profit drives the search for foreign markets, for both goods and direct investments and “financial” exports of capital. The internal conglomeration of capital can neither revert the tendency of the falling rate of profit nor absorb the growing mass of finance capital that accompanies the overcapitalization of the large company. In this sense, the internationalization of capital, at this stage, requires the reproduction of **global capital**, which in our opinion goes far beyond simple “imitative behavior” (Knickerbocker) or Professor Vernon’s product life cycle theory.

In other words, the internationalization of capital is based on the structure of the large company, mentioned above, and concentrates all the previous mechanisms of expansion: commercial, industrial and financial. It also concentrates in its “foreign policies” the practices of previous imperial states, from the liberal facet of foreign trade to the internal protectionist and overtly interventionist facet in the defense of strategic reserves of raw materials. Consequently, it also implies the imposition of a hegemonic monetary standard.



That is why the hypothesis advocated in the contemporary debate ascribing the international preeminence of the large American company mainly to productive and technological aspects seems to us to be mistaken. The much-vaunted spread of American consumption patterns or the generalization of its technological “matrix” are both shadows of the hegemony of US **big business**, which ended up imposing simultaneously its “manufacturing system” and its “financial system” worldwide. The latter plays the dual role of unifying the global capital structure while allowing its differentiation through the specialization and differentiation of financial institutions.

The transnational unification of the schemes to value big business does not imply, as many authors seemed to suppose, a trend for the state to disappear as a coordinating agent, in each market, between local capital and multinational companies. Quite the contrary, the permanent need to manage such coordination imposes the advance of so-called “state monopoly capitalism.” Although this “management” is limited to an economic space that only affects a fraction of internationalized global capital – generally dominant in host markets – the state must operate this coordination not only in the interest and “defense” of local capital (which apparently ensures its political support), but also to guarantee the expanded reproduction of the fraction of international capital based there. It is in this sense that interests are convergent and local, national and international private capital become “solidary.” The regretted submission of the “dependent” national bourgeoisie is thus transformed into an association of interests, guaranteed by the state’s capacity for mediation.

Prominent among the state’s tasks of economic “administration” is the power to issue and control the national monetary standard, however strong its currency may be internationally. This currency – whether its relative value fluctuates or not – is the only accounting and internal debt settlement standard and, therefore, the only active instrument of capital circulation and, consequently, the only suitable means of expanded reproduction. Evidently, such constraint does not exclude the possibility of speculative activities in the local money market due to pressures exerted by the movement of international capital, which tends to periodically destabilize the purchasing power of the national currency or its parity with other currencies. The frequently advocated impossibility of operating a stabilizing monetary policy internally stems mainly from this phenomenon and not from a supposed lack of state authority. In the current situation of crisis, in fact, the other state economic policies are also incapable of regulating the general movement of capital.

### 3. The circuit of contemporary finance capital

The post-war internationalization movement was supported by the expansion of US direct investment in Europe, mainly through the creation of an affiliated manufacturing subsystem that started to occupy open spaces in the European market following reconstruction. The subject is well known. However, the internationalization process can be broken down into three interconnected movements: 1) the replacement of goods and capital export flows with the operation of the affiliated system in the European internal market; 2) the increasingly reduced competition in the goods and capital open market is offset by the establishment of a headquarters-subsidiary; parent company-subsidiary closed circuit, which increases the growth capacity of the affiliated subsystem in relation to the headquarters; 3) from the mid-1960s, the establishment of US bank branches regenerates the entire finance capital circuit, outside the control of US monetary authorities, whose expansion or contraction starts placing pressure on local monetary authorities. Once a volume of finance capital has been reached that cannot be reinvested in local circuits of capital reproduction, conditions are in place for the establishment of a global financial market, supported in its speculative movements by the main financial markets of the developed world and playing strong currencies against weaker ones as an **instrument of speculation**.

As operators and converters of the mass of surplus finance capital, banks set up a special circuit that overcomes the restrictions imposed by the respective Core banks on the cancellation of debit and credit transactions between companies, the state and the actual private sector. In this sense, the emergence of this special transnational circuit provides greater elasticity to financial valuation and overcapitalization of international companies, while causing increasing national monetary instabilities and triggering the ruin of several national monetary standards in a chain reaction, ultimately leading to the breakdown of the international monetary system itself, based on the US dollar.

The transitional monetary standard that was introduced in stages from the 1971 crisis and more rapidly following the 1974/75 crisis no longer corresponds to the consolidation, **in any centralized agent**, of the surplus and deficit positions of the main creditors and debtors (transnational corporations and states). In contrast to the debate in the late 1960s, in which the issue focused on the origin of the primary deficit, attributed to both a lenient management by the US Treasury and the recurring balance of payments deficit (see the Triffin, Kindleberger controversy), the problem has now shifted to the operation of the international interbank circuit.

The capacity for self-expansion of this circuit, supported by excessive secondary deficit (strictly financial), is manifested in the fact that 70% of the portfolios of so-called Eurobanks comprise debit-credit securities of the banks themselves and a number of significant but select assets and bonds issued by large transnational corporations. Evidently, all of this occurs without any supporting growth of international production, income or trade that has been clearly in crisis since the mid-decade.

The autonomization of finance capital, in the form of interest-bearing capital, takes on here proportions that would be hardly imaginable by Marx in his worst nightmares. Worse than that, because such autonomization occurs through the operation of an intrabank circuit, which no longer respects any stable monetary standard, the speculation game immobilizes the controls commanded by Core banks, including those of hard currency countries, which are obliged to periodically bail out the weakest currencies. In the particular case of the US dollar, whatever the position of the balance of payments or the position of the Treasury, the solidarity of the finance capital circuits, inextricably linked to their headquarters, requires both a periodic bailout of the dollar and the submission of the other currencies to the deliberate movements of its devaluation.

The turbulence in the main prices of strategic raw materials is also fueled in a speculative and compensatory manner by parallel movements in the financial market, which increase the inflationary pressures unleashed with the crisis and affect interest rates in the international market in an excessive way. Thus, the breakdown of the dollar standard, quickly replaced by a basket of the main currencies traded worldwide, enabled the formation of truly transnational banks, both in the sense of being beyond the control of any monetary authority, and in the deeper sense of their private issuing power being placed above the issuing power of states. Their investments are widely distributed across all countries – even those with weak currencies – where the presence of large companies requires the financial recycling of surplus cash capital.

In this way, domestic interest rates become a kind of shadow price of international market rates, set by the main Eurobanks, failing to reflect domestic credit conditions. The private circuits of domestic credit, in turn, start to reflect, in a perverse way, the conditions of international liquidity, operating under the twofold pressure of the antagonistic movements of the private intrabank circuit and the attempts at stabilization of the monetary authorities. For countries that are heavily in debt, as is the case with the United States and most Latin American countries, it is not possible to avoid the preeminence of the merely speculative function of the movement of finance capital, which aggravates the context of crisis and decline of the real rate of accumulation.

Ironically, the paroxysm of transnationalization in the form of banking, instead of achieving the much-desired transnational order, where the nationalist dispute for hegemony would finally end, is leading the capitalist system to the resurgence of defensive national policies of all shades, despite the manifest understanding among the managers of the machinery of big international financial business.

The hegemonic state of the capitalist system no longer has the power to establish the economic limits of its sovereignty, without which the hierarchical ordering of the capitalist system has never been possible. Finance capital, in becoming transnational, does not realize the golden dream of those who saw the formation of a supranational **order** in world cartelization. This transnational capitalism, in fact, brings about the ruin of the old order, above all of its monetary framework, the greatest symbol of hegemonic power. It proposes the unfettered competition of “free capital,” in a kind of laissez-faire without the support or visible address of an old imperial power which benefits from it. In this way, the dominance of the most general form of capital reinstates the **predominance** of the particularism of interests against the capitalist **order**.

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# CHAPTER 5

## A NOTE ON THE PRINCIPLE OF EFFECTIVE DEMAND

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### 1. The principle of effective demand in a general formulation

“The production of commodities creates, and is the one and universal cause which creates a market for the commodities produced... But if a nation’s power of purchasing is exactly measured by its annual produce, as it undoubtedly is; the more you increase the annual produce, the more by that very act you extend the national market... The demand of a nation is exactly its power of purchasing” (Mill, 1808: 81-83).

This quote by James Mill, considered a precursor to Say’s Law, not only is compatible with said law, but also with the principle of effective demand, paradoxical as it may seem. It is nothing more than a truism, which expresses the accounting identity (that is, ex-post) between product, income and expenditure.

Say’s Law itself only appears in the 2nd edition of his book,<sup>34</sup> in the famous passage in which he states that “the mere circumstance of the creation of one product immediately opens a vent for other products.” This proposition is no longer reduced to a simple tautology, but involves a relationship of causal determination: namely, production creates an equivalent demand.

There are two missing links in the previous reasoning, given that this apparently simple relationship actually covers up a chain of reasoning. The first overlooked link consists of the relationship between income and expenditure, which are shown as two sides of the same phenomenon. In this respect, refuting Say’s Law consists in demonstrating that these are two phenomena of a different nature. The second gap to be filled is the distinction between production and realization, falsely identified in that reasoning. Production is only capable of generating an equivalent income if fully realized, that is, it is

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34 J.-B. Say, *Traité d’Economie Politique* (2<sup>nd</sup> ed., Paris, 1814), cited from the English translation *A Treatise of Political Economy* (1821: 167). A considerably comprehensive survey of the historical origins and theoretical and practical implications of Say’s Law can be found in Miglioli (1979).

ultimately the realization and not the production as such that is responsible for the creation of purchasing power.

With regard to the distinction between income and expenditure, it should be initially noted that what is questioned is not their *a posteriori* equality, but the causal order of determination pointed out by Say and rarely made explicit by his followers. In general, the latter limit themselves to accepting said identity as evident, but in fact use it as a unilateral relationship in the sense of Say. This bad habit is generally due to a “common sense” view whereby capitalism (or a market economy) can be studied in the light of the daily behavior of individuals – in general, consumers – or their families. Only in this case is it justified to consider income as a given magnitude, and expenditure as a result of it, in a necessarily identical amount.

The experience of capitalist companies and even of higher-income consumers, on the contrary, through expenditure above current income, provide indications that are systematically opposed to the aforementioned ones. The latter, to be sure, are nothing more than “common sense of the poor” – or perhaps of economists of the early 19th century, when the lack of a fully developed credit system, alongside the possibility of self-financing a significant part of companies’ activities of the time, perhaps justified on a purely empirical level the idea of the magnitude of income as a restriction on spending. Conversely, the possibility that expenditure may fall short of the immediately previous income for most economic units, especially capitalist companies, is ensured by the presence of money with all the functions it assumes in the capitalist economy, and not only as a passive instrument that facilitates exchange, which reduces the capitalist economy to a simple exchange system, where production is consumption-oriented.<sup>35</sup>

Since the capitalist economy provides the possibility of the expenditure of an economic unit being different (higher or lower) from its level of income, it remains to be seen to what extent this possibility can be expected to actually take place. At the level of the economic unit, such a possibility arises from the fact that spending decisions – regarding consumption or investment, for example – are logically independent of income. However, the compensation between the different individual balances could occur by means of some kind of automatic adjustment mechanism, so that the aggregate expenditure would correspond to the level of income previously established. It turns out that such an adjustment can in no way be taken for granted; on the contrary, all attempts

35 As Ricardo (1951 [1821]: 290-292) assumes: “No man produces, but with a view to consume or sell, and he never sells, but with an intention to purchase some other commodity, which may be immediately useful to him, or which may contribute to future production... Productions are always bought by productions, or by services; money is only the medium by which the exchange is affected.”



made in this sense by the neoclassical authors do not hold, insofar as they start out from the answer, namely that global expenditure must somehow adjust to the previous level of global income. In this sense, for example, only by “chance” would any investment function, however simplistic and arbitrary, result in the aggregate investment coinciding with the difference between the previous income level and total consumption.

The core of the preceding argument can then be expressed as follows: the aggregate level of any type of expenditure – for example, investment – results from a number of independent decisions made by economic units which do not necessarily relate to the level of income. As a result, the amount of this expenditure will also, in principle, be independent of the previous level of income. Therefore, since the identity between aggregate income and expenditure must necessarily be maintained over any period, it is concluded that, at the aggregate level, expenditure determines income, and not the other way round. It is in this context that Kalecki (1954: 46) observes that “it is clear that capitalists may decide to consume and to invest more in a given period than in the preceding one, but they cannot decide to earn more. It is, therefore, their investment and consumption decisions which determine profits, and not vice versa.”

Let us now address the second distinction noted above, the one between production and realization. Although both are inseparable sides of the same process,<sup>36</sup> from the point of view of income generation or purchasing power, realization is ultimately the determining element.

The previous argument aimed to emphasize the unidirectional nature of the sense of determining the aggregate variables. Thus, rather than the identity between production and demand of Say (1821) and Ricardo (1951 [1821]), which implies that the former always creates the latter in equal magnitude, we now have a chain of relationships of determination. This last part of expenditure items as “independent variables,” which explain the aggregate effective

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36 As Tavares (1978) correctly observed: “one of the statements that has given rise to confusion [is that] ‘surplus-value’ can only be generated in the ‘orbit of production’ and can only be ‘realized’ in the ‘orbit of circulation.’ What does that mean? Does it mean, by any chance, that in capitalist production, surplus-value is generated **first** and **then** it becomes profit ...?” (p. 45); “The ‘conversion’ of ‘surplus labor’ into surplus-value results, however, from a social relationship of production, ‘capital,’ which converts labor into wage labor, which allows it to privately **appropriate** the fruits of the social productivity of labor. Nevertheless, this appropriation of surplus-value in the **form of profit** does not occur in an ‘abstract production’ scheme separate from the accumulation of capital, from capitalist competition, and from the monetary valorization of the ‘elements that constitute capital.’” (p. 46). According to the very conception of value and surplus-value as social categories, there is no point in isolating the process of their production from the corresponding realization, since they must necessarily be sanctioned by the economy as a whole; otherwise, strictly speaking, they will not even have been produced. In this circumstance, laborers subjected to the capitalist production process would not be distinguished from the domestic worker who provides personal services to the boss.

demand, is what will realize a certain volume of production; this in turn generates, in the form of gross profits and wages, the amount of income that, together, will be equivalent to the expenditure made in the period in question. Prominent among the numerous theoretical implications of the change in perspective associated with the previous formulation of the principle of effective demand, in contrast to Say's Law, are the consequences that can be deduced for the analysis of capitalist dynamics. While within the scope of Say's Law the conditioning factors that move the economy would tend to be exogenous to the economic process as such, since production, in guaranteeing its own realization, encounters no obstacles other than the eventual shortage of production resources, in the perspective of effective demand the investigation of the mechanisms of such movement now has elements that are endogenous to the actual process of capital accumulation, given the crucial role that investment is forced to play in this case.

So far we have considered the more general formulation of the principle of effective demand, without resorting to any specific analytical tools that incorporate it. We will broadly examine below how Kalecki (1954) introduces this issue, contrasting it, when necessary, with the corresponding analytical instrument used by Keynes.

However, first we will try to address, still in a broader fashion, the operating assumptions of the principle of effective demand, in view of the recurrent attempts of "Keynesian" authors – entirely unfounded, by the way – to challenge it based on Keynes's version. This requires a survey of the main mechanisms of balance and "spontaneous adjustment" that the advocates (aware or not) of Say's Law have tried to develop over many decades.

## **2. A few controversies about the functioning conditions of effective demand**

The basic precondition to validate the principle of effective demand applied to determining the level of the real product is associated with the elasticity of production in relation to demand. This means that, if there is idle capacity, a change in effective demand may lead to a similar change – although not necessarily exclusive – in real production, through variation in the level of use of the production capacity. Thus, the decisive factor for its operation is not absolute price rigidity, but the fact that a shift in demand will not be fully transferred to prices.<sup>37</sup> Even in the case of a competitive situation, with price

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37 Price flexibility is not strictly an obstacle to the functioning of effective demand in its most general sense. The discussion on this point, which was introduced by the "Keynesians," indicates a distortion of Keynes (1936)'s own ideas, exposed in Chapter 20, where he merely raises the possibility that when effective demand

competition, the inertia inherent in the functioning of a market in terms of changing established prices – which implies uncoordinated individual decisions – would suffice to ensure a reaction of supply in real terms. However, a higher average level of idle capacity, for being generally associated with less flexible prices and greater elasticity of production, should make this mechanism more effective.

Nevertheless, from a dynamic point of view, the aforementioned conditions are not sufficient to establish limits to the application of the principle of effective demand. The elasticity of production and the existence of idle capacity are essential requirements for the level of real production to adjust to the level of effective demand in the short term. In this short period, in which production capacity is assumed, the operation of this process – basically, the Keynesian multiplier effect – has the virtue of highlighting the way in which real income is determined by spending. While this is the most frequent way of presenting the principle of effective demand, it should be noted that it restricts it to a static framework, by assuming the production capacity to be constant. Therefore, the meaning of this concept may and must be expanded to incorporate increases in production capacity following an initial increase in demand, either through a higher level of capacity utilization or greater profitability associated with higher prices. In the latter case, the dynamic effect of a change in effective demand would be felt even in a competitive market operating at full capacity.

The issue of output elasticity and price inflexibility is not the only one usually viewed as a prerequisite for the operation of the principle of effective demand within the scope of determining the level of real production, in the context of Keynesian analysis. On the contrary, two other types of inflexibility are often highlighted: that of nominal wages and that of interest rates. It is important to note, however, that both are usually addressed by neoclassical critics of Keynesian theory in the context of discussing possible mechanisms for the **automatic adaptation** of the level of effective demand to a previously established level of income. That is why they cannot be considered (“passive”) preconditions for the operation of the principle of effective demand – such as the existence of idle capacity – but rather (“active”) instruments imposed ad hoc to nullify the possibility of that same principle.<sup>38</sup> In this sense, we

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is directed to low output elasticity sectors, the latter's increase is accompanied by higher prices. To refute this supposed need for price inflexibility for the operation of effective demand, it would be “sufficient only to give up the... strong assumption of instantaneous price adjustments. Systems with finite price velocities will show Keynesian multiplier responses to initial changes in the rate of money expenditures” (Leijonhufvud, 1967: 403).

38 This distinction can be better explained with the following illustration: saying that “a car can only take a given route because the road exists” is very different from saying that “it will only take this route if no landslide blocks the road.” Eloquent examples of these tireless attempts to create obstacles to the logic of the operation of

do not consider it necessary to dwell on a more detailed and comprehensive examination of the various neoclassical mechanisms for adjusting demand to income, but only to note this is an attempt to unduly transform the unilateral relationship proposed by Keynes into an apparent process of “simultaneous determination” of demand and income. Behind this lies the reintroduction of the familiar hypothesis of full employment, which requires, moreover, not the “simultaneous” setting of income and demand levels, but rather, as is typical of Say’s Law, a unilateral causal direction from the former variable to the latter.

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effective demand are given by Pigou (1949), Hicks (1937) and Haberler (1964), just to mention the most well-known. The Keynesian formulation of the principle of effective demand is thus reduced to “inflexibilities” – of prices, wages and interest rates – as noted by Leijonhufvud (1967: 403): “The strong assumption of ‘rigid’ wages is not necessary to the explanation of such system behavior [multiplier effect]... It is not necessary, moreover, to rely on ‘monopolies,’ labor unions, minimum wage laws, or other institutional constraints... in order to explain finite price velocities. Keynes, in contrast to many New Economists, was adamantly opposed to theories which ‘blamed’ depressions on such obstacles to price adjustments. The implied proposition that, if ‘competition’ could only be restored, ‘automatic forces’ would take care of the employment problem was one of his pet hates.”

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# CHAPTER 6

## THE CONTRADICTION IN PROCESS

*Frederico Mazzucchelli*

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### 1. Capital and its constitutive conceptual determinations

#### Capital as progressive value

Analyzing the nature of the value form, demonstrating its social and historical characteristics, Marx states:

“The value-form of the product of labor is the most abstract, but also the most universal form of the bourgeois mode of production; by that fact it stamps the bourgeois mode of production as a particular kind of social production of a historical and transitory character. If then we make the mistake of treating it as the eternal natural form of social production, we necessarily overlook the specificity of the value- form, and consequently of the commodity-form together with its further developments, the money form, the capital form, etc.” (Marx, 1966, v. I: 45, footnote 35).

This statement condenses one of the Core issues underlying Marx’s construction: the development of forms. If the commodity and the value form, which is characteristic of it, constitute the “most general and abstract form,” the “elementary form” of the capitalist system of production, it becomes possible to understand the internal structure, the very nature of capital, from the logical development of these forms.<sup>39</sup> Indeed, Marx studies the nature of

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39 “In our exposition, we saw how value, which appeared as an abstraction, is only possible as abstraction. Once money is in place, this monetary circulation, on the other hand, leads to capital, and therefore can only develop fully on the basis of capital, just as, in short, circulation only on this basis can cover all the moments of production. Thus, in the development, not only is revealed the historical character of forms which, like capital, belong to a specific historical period, but determinations such as value, which are presented as purely abstract, expose the historical basis from which they were abstracted and only on which, therefore, they can appear in this abstraction. Then, determinations such as money, which more or less belong to all periods, show the historical modification to which they have been subjected. **The concept of value is entirely proper to the most recent economy, since it constitutes the most abstract expression of capital itself and of production based on it. In the concept of value its secret is revealed**” (Marx, 1973, v. II: 314-315, emphasis added).

money as a form of social existence of the products of labor by genetically starting from the value form. In addition, Marx demonstrates from the study of money and its functions in the process of commodity circulation how this “social common substance” to the products of labor becomes autonomous before circulation, subordinates it and thus constitutes itself in a “progressive social substance,” in the “subject of a process” whose finality is the process itself.<sup>40</sup>

The conversion of money into capital is, therefore, the logical moment of conversion of mercantile determinations into capitalist determinations, which, of course, does not mean the suppression of the first ones, but their adaptation to the new content of social production. This is exactly the logical transformation moment of the law of value into the law of valorization. This means not only that the valorization of value is the law that will regulate the movement of social production, but also that the determinations of simple mercantile production are projected in a transformed way, adequate to the new capitalist nature of the process of mercantile production. Moreover, it is only under its capitalist form that these determinations are fully realized.<sup>41</sup>

After explaining the nature of capital as value that is valorized via the appropriation of unpaid labor, Marx indicates how the commodity production process assumes, in its capitalist dimension, the form of a unity of the processes of use-value production (labor process) and surplus-value production (valorization process).

The use-value/value unity underlying the commodity thus projects itself appropriately into the process of capitalist production. Moreover, since the aim of this process is the quantitative expansion of value, it is the determinations of valorization that will regulate, subordinate the material transformations of the productive process. Thus, the self-centered movement of valorization of value

40 “Money, once a simple expression of a sociability proper to a society of independent producers, now becomes the subject of a process that enables the owners of money (as capital) to command the means of production and wage laborers” (Belluzzo, 1980: 85).

41 “Although the capitalist system of appropriation seems to openly break with the original laws of commodity production, it does not arise from the violation of these laws, but rather from their application” (Marx, 1966, v. I: 49). “Only there, where wage labor is the basis, the production of commodities imposes itself on the whole of society, and only there it develops all its hidden powers. To say that the interposition of wage labor distorts commodity production is equivalent to saying that commodity production should not be developed if it does not want to be distorted. As this production develops, obeying its own immanent laws to become capitalist production, the laws of property inherent in commodity production are exchanged into capitalism’s laws of appropriation” (Marx, 1966, v. I: 495). Belluzzo states, in this regard, that the “discovery that the law of value imposes itself, under the regime of capitalist production, as the law of the production of surplus-value means that it continues to express, in a transfigured form, the capitalist relations of production, as developed forms of commodity relations” (Belluzzo, 1980: 89). Indeed, the identification of this “transfiguration of the law of value into the law of the valorization process” constitutes one of the fundamental pillars on which his interpretation of Marx is based. See also Rosdolsky (1978: 203-210).



rebounds on the development of the productive forces, adapting the technical base to the capitalist content of production. Hence, with the great industry built on the basis of machinery capitalist production finds its appropriate material vehicle, overcoming the intrinsic limitations to a technical organization of production, where “the manual craft remains the basis of everything.”<sup>42</sup> This process culminates with the production of machines by means of machines – the constitution of the production department of means of production (DI) – a phenomenon that configures “the last step of the industrial revolution or the constitution of the productive forces adequate to capital.”<sup>43</sup>

The implementation of specific capitalist productive forces determines, therefore, the real subordination of labor to capital and ensures at the same time the conditions necessary for the **self-determination of capital accumulation**.<sup>44</sup> In other words, the accumulation of capital will no longer encounter “external” obstacles to its expansion, and its limits will be given only by the relationship of capital with itself.

This is demonstrated by Marx in “The General Law of Capitalist Accumulation.” The author evidences that the movement of capital accumulation – by implying the continuous elevation of labor productivity and of the technical and organic composition of capital; by merging into a technical base in which the “productive art” is concentrated in the capital and embodied in the machines<sup>45</sup>, determining the disqualification and numbing of living labor; by progressively advancing, destroying previous forms of production and making direct products “free” – by its own internal dynamics creates demand and supply of labor, regulating wages without using extra-economic forms of coercion.<sup>46</sup>

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42 Marx (1966, v. I: 274). See Barbosa de Oliveira (1977) and Belluzzo (1980) on this subject. The idea of adequacy of the technical base is exposed by Marx in section IV of book I of *Capital*; see also Marx (1973, v. II: 216-225).

43 Barbosa de Oliveira (1977: 37). According to Marx, “large-scale industry had no choice but to take possession of its characteristic means of production and produce machines by means of machines. In this way it created the proper technical basis and stood on its own feet” (Marx, 1966, v. I: 314).

44 “Thus, although the capitalist system of production presupposes a degree of capital accumulation, this system, once established, contributes to accelerating accumulation. Therefore, with capital accumulation the specifically capitalist system of production is developed, and the specifically capitalist system of production drives capital accumulation” (Marx, 1966, v. I: 528). On the formal and real subordination (subsumption) of labor to capital, see Marx (1972, book I: 54-77). On the self-determination of capital accumulation, see Cardoso de Mello (1982); see also, in this regard, Barbosa de Oliveira (1977) and Belluzzo (1980).

45 “Rather, it is the machine which possesses skill and strength in place of the worker, is itself the virtuoso, with a soul of its own in the mechanical laws acting through it; and it consumes coal, oil etc. (*matières instrumentales*), just as the worker consumes food, to keep up its perpetual motion.” (Marx, 1973, v. II: 219).

46 See Barbosa de Oliveira (1977). “With free labour, wage labour is not yet completely posited. The labourers still have support in the feudal relations; their supply is still too small; capital hence still unable to reduce them to the minimum. Hence statutory determination of wages. So long as wages are still regulated by statute, it cannot yet be said either that capital has subsumed production under itself as capital, or that wage labour

On the other hand, the constitution of adequate technical bases assures to the capital the possibility of recreating its conditions of existence. The expanded reproduction of capital is thus not only the reproduction of the worker as a wage worker, but also the recreation and expansion of markets through the expansive mechanism of accumulation itself.

Capital therefore reveals at first a double character: an antagonistic and a progressive. Its antagonistic character derives from the social relationship that underlies it: capital is based on the appropriation of labor time; it opposes itself in a “hostile and antagonistic” way to the worker and repeatedly reproduces him as a wage worker. Capital is, on the other hand, progressive, because its goal, the maximum valorization, supposes the maximum appropriation of unpaid labor, which implies the maximum development of the productive forces and, therefore, the maximum accumulation. The “production for production’s sake,” the tendency to the “absolute development of the productive forces” and “progressive accumulation” constitute an immanent law of the capitalist system of production, in the sense that they are deduced from and conform to the concept of capital as value that is valorized by means of the appropriation of unpaid labor.<sup>47</sup>

According to Marx (1972: 76),

“The productivity of labour in general = the maximum of product with the minimum of labour, hence the greatest possible cheapening of the commodities. This becomes a law in the capitalist mode of production, independently of the will of the individual capitalist. And this law is only realised because it implies another one, namely that the scale of production is not determined according to given needs but rather the reverse: the number of products is determined by the constantly increasing scale of production, which is prescribed by the mode of production itself. Its purpose is that the individual product, etc., should contain as much unpaid

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has attained the mode of existence adequate to it” (Marx, 1973, v. II: 265). According to Maria da Conceição Tavares (1978: 44): “The basis of the theory of value explains what is fundamental in the relations of capitalist production, namely: capital commands the social labor process and subjects workers in a peculiar way, which does not require physical violence, and ‘forces’ them to work ‘voluntarily’ as ‘free workers,’ not only for their subsistence (that is, to reproduce themselves), but to reproduce capital with ‘profit.’”

47 “The ownership of past unpaid labour is thenceforth the sole condition for the appropriation of living unpaid labour on a constantly increasing scale. The more the capitalist has accumulated, the more is he able to accumulate” (Marx, 1966, v. I: 491). “Fanatically bent on making value expand itself, he [capitalist] ruthlessly forces the human race to produce for production’s sake [...]. Moreover, the development of capitalist production makes it constantly necessary to keep increasing the amount of the capital laid out in a given industrial undertaking, and competition makes the immanent laws of capitalist production to be felt by each individual capitalist, as external coercive laws. It compels him to keep constantly extending his capital, in order to preserve it, but extend it he cannot, except by means of progressive accumulation” (Marx, 1966, v. I: 499). See also pages 407 and 408, and Marx (1973, v. II: 362).

labour as possible, and this is only attained by engaging in production for production's sake."

## The immanent contradictions of capitalist production

To the same extent that "the **true barrier** of capitalist production is **capital itself**" (Marx, 1966, v. III: 248), the accumulation is not an unlimited process. It is important to point out that, at the same time that capital must move within the limits imposed by the conservation and valorization of capital-value, it tends toward the absolute development of the productive forces and, therefore, to recurrently exceed its specific limits. According to Marx,

"The barriers within which the preservation and self-valorization of the capital-value resting on the dispossession and impoverishment of the great mass of producers can alone move – these limits come continually into contradiction with the methods of production employed by capital for its purposes, which drive towards unlimited extension of production, towards production as an end in itself, towards unconditional development of the social productivity of labour. The means – unconditional development of the productive forces of society – comes continually into conflict with the limited purpose, the self-valorization of the existing capital."<sup>48</sup>

Capital is "a living contradiction," since "according to its nature, therefore, it posits a barrier to labor and the value-creation, which contradicts its tendency to expand them boundlessly" (Marx, 1973, v. I: 375).

In other words: capital, as progressive value, generalizes and transforms commodity production and consequently the production of values constituting the developed form of mercantile production. This means, at the same time, that the contradictions implicit in this production (notably the use-value/value contradiction) are equally generalized and transformed by capital. Moreover, the capitalist form of these contradictions can be expressed in the following terms: the presupposed valorization of value, by resulting in the autonomization of the production for production's sake, implies, contradictorily, the recurrent tendency of capital to abstract itself from the determinations of value production.

As we shall see, in this regard capital contains the tendency toward overproduction and the negation of immediate labor. Before detailing this aspect,

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48 See Marx (1966, v. III: 248). "The contradiction of the capitalist mode of production, however, lies precisely in its tendency towards an absolute development of the productive forces, which continually come into conflict with the specific conditions of production in which capital moves, and alone can move" (p. 255).

it is fundamental to understand that the immanent contradictions of capitalist production are always exteriorized and “solved” in crises, to be reestablished later on, since they are constitutive of this production system.

Thus, if capital contains a recurrent tendency to abstract itself from the determinations of its valorization, these determinations are violently imposed on capital by means of crises. The crises, in the same way that they explain how capital exceeds “the limits within which the conservation and valorization of capital-value must move,” restore, via general devaluation, the conditions for production to take place again within those same limits.<sup>49</sup>

This is to say that the production/valorization unity “is not direct,” but rather constitutes a process subject to external conditions.<sup>50</sup> Indeed, the various moments of the valorization process

“determine each other internally and search for each other externally; but that they may or may not find each other, balance each other, correspond to each other. The inner necessity of moments which belong together, and their indifferent, independent existence towards one another, are already a foundation of contradictions” (Marx, 1973, v. I: 367).

Such contradictions are externalized in crises that, at the same time they explicit the autonomy of the “diverse moments of the valorization process,” they ensure the internal need for their correspondence. The crisis is thus the moment of explicitness of independence and of violent recomposition of the unity of elements that, united internally, assume an independent dynamic in their external movement:

“To say that these two independent and antithetical acts have an intrinsic unity, are essentially one, is the same as to say that this intrinsic oneness expresses itself in an external antithesis. If the interval in time between the two complementary phases of the complete metamorphosis of a commodity become too great, if the split between the sale and the purchase become too pronounced, the intimate connexion between them, their oneness, asserts itself by producing – a crisis” (Marx, 1966, v. I: 73).

Crises, therefore, externalize and solve momentarily the immanent contradictions of capitalist production; but they do not suppress them. Such contradictions indicate the limited nature of this production system precisely

49 The crisis represents “the sudden *recall* of all these necessary moments of production founded on capital; hence general devaluation in consequence of forgetting them.” (Marx, 1973, v. I: 368).

50 “The main point here – where we are concerned with the general concept of capital – is that it is this unity of production and realization, not immediately but only as a process, which is linked to certain conditions, and, as it appeared, external conditions.” (Marx, 1973, v. II: 359).

because they are not suppressible. It is limited, because capitalism contains inherent limits, which it cannot avoid, despite its uncontrolled impulse to do it. For this reason, this production system is not absolute, but historically determined, which at the same time creates the conditions for its own overcoming.<sup>51</sup>

According to Marx,

“there is a limit, not inherent to production generally, but to production founded on capital [...] It is enough here to demonstrate that capital contains a particular restriction of production – which contradicts its general tendency to drive beyond every barrier to production in order to have uncovered, more generally, the fact that capital is not, as the economists believe, the absolute form for the development of the forces of production – not the absolute form for that, nor the form of wealth which absolutely coincides with the development of the forces of production” (Marx, 1973, v. I: 367).

Capital is consequently “the contradiction in process” (Belluzzo, 1980: 100): “its production moves in contradictions which are constantly overcome but just as constantly posited” (Marx, 1973, v. I: 362).

It is now convenient to detail the immanent contradictions of capitalist production. Immanent, we repeat, because they are deduced from and are appropriate to the concept of capital, as value that is valorized through the appropriation of unpaid labor. Immanent, because they adapt to the concept of capital, because they correspond to its “constitutive conceptual determinations.”<sup>52</sup>

As Rosdolsky points out,

“what matters at this stage of the investigation ‘is firstly to prove the existence of the contradictions’ and to demonstrate that both these contradictions and the tendencies that temporarily overcome them are already contained in the ‘simple concept of capital,’ so that their further development must be considered as an evolution from this kernel” (Rosdolsky, 1978: 357).

## The tendency to overproduction

The capital containing the natural tendency to overproduction is the first aspect to be considered. It is not yet a matter “to develop overproduction

51 “Although by its nature (capital) is limited, it tends toward a universal development of the productive forces and becomes the premise of a new mode of production [...]” (Marx, 1973, v. II: 31).

52 “The immanent limits (to capitalist production) have to coincide with the nature of capital, with its constitutive conceptual determinations” (Marx, 1973, v. I: 368).

specifically, but only the predisposition to it, such as it is posited in primitive form in the capital relation itself” (Marx, 1973, v. I: 372).

The tendency to overproduction can be put in the following terms:<sup>53</sup> insofar as sociality in a market economy does not take place in the immediate process of production, but is given by exchange, the product of labor assumes a natural, useful, material determination (use-value), referred to its “fitness to satisfy human needs”; and a social determination (value) referred to its connection with exchange. Since, however, value exists only in a relative way, as exchange value, “the opposition or contrast existing internally in each commodity between use value and value, is, therefore, made evident externally by two commodities [...]” (Marx, 1966, v. I: 27).

This externalization is completed with the substantiation of the value of money, by which “an unfolding of the commodity into commodity and money is produced, a mechanical antithesis in which commodities reveal their antithesis of use-value and value” (Marx, 1966, v. I: 65). The interposition of money and the constitution of a process of commodity circulation determine the fracturing of exchange into acts of purchase and sale, whereby the unity existing in direct exchange unfolds into the antithesis of the acts C-M and M-C. Thus, “the internal unity externally takes the form of an antithesis” (Marx, 1966, v. I: 66).

This means that mercantile circulation contains “a framework for crises” insofar as buying and selling, production and circulation, production and consumption, constitute complementary but not identical pairs, there is the possibility of a non-coincidence between these distinct moments, and crises arise. Mercantile economy, opposed to exchange based on direct exchange, is necessarily a monetary economy, production being necessarily referred to money, and only socially realized when converted into money. There is no guarantee that this conversion will happen, since buying and selling, production and circulation, production and consumption, although linked inwardly, maintain in their movement a reciprocal independence (Marx, 1978).

That is why

“the general nature of the metamorphosis of commodities – which includes the separation of purchase and sale just as it does their unity – instead of excluding the **possibility** of a general glut, on the contrary, contains the possibility of a general glut” (Marx, 1978: 113).

Consequently,

<sup>53</sup> The demonstration is based on what is presented in the *Theories of Surplus-Value* and, to a lesser extent, in *The Capital*. In the *Grundrisse*, it is another logical path: see Marx (1973, v. I: 353-389) and Rosdolsky (1978: 353-370).

“The most abstract form of crisis (and therefore the formal possibility of crisis) is thus the metamorphosis of the commodity itself” (Marx, 1978: 118),

since

“The difficulty of converting the commodity into money, of selling it, only arises from the fact that the commodity must be turned into money but the money need not be immediately turned into commodity.”

Therefore

“sale and purchase can be separated” (Marx, 1978: 117).

The crisis appears, therefore, as the forced establishment of the unity between buying and selling, production and circulation, production and consumption:

“The independence which these two linked and complimentary phases assume in relation to each other is forcibly destroyed. Thus, the crisis manifests the unity of the two phases that have become independent of each other. There would be no crisis without this inner unity of factors that are apparently indifferent to each other. But no, says the apologetic economist. Because there is this unity, there can be **no** crises. Which in turn means nothing but that the unity of contradictory factors excludes contradiction” (Marx, 1978: 109).

The contraposition to Say and Ricardo is evident. If mercantile circulation to the direct exchange is reduced, if it is admitted that “productions are always bought by productions or services, and money is only a vehicle for the exchange,”<sup>54</sup> the use/value contradiction underlying the commodity, whereby the commodity becomes directly confused with “the product,” is suppressed. Thus, the commodity becomes directly associated with “the product,” and money becomes a mere intermediary in the exchange of products. The simplest determinations of capitalist production, as mercantile production, are thus denied: “Since the transformation of the commodity into mere use-value (product) obliterates the essence of exchange-value, it is just as easy to deny, or rather it is necessary to deny, that **money** is an essential aspect of the commodity” (Marx, 1978: 110). As a result, buying becomes identical to selling,

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54 See Ricardo (1959: 217-218) (Quoted in Marx, 1978: 108).

production identical to circulation and consumption, and the possibility of crises disappears.<sup>55</sup>

However, it should not be assumed that the tendency of capital to overproduction is explained. In fact, this tendency can only be fully understood when considering the specifically capitalist, and not merely mercantile, determinations of production. This is why “crisis arises out of the special aspects of capital which are peculiar to it as capital, and not merely comprised in its existence as commodity and money” (Marx, 1978: 120). The “formal possibility,” the “most abstract form” of crises in capitalism, is already contained in the commodity, in particular by its counterposition to money. Although the “more abstract forms repeat themselves and are contained in the more concrete forms” (Marx, 1978: 118), they are not sufficient – and they cannot be! – to clarify the capitalist determinations of crises. The more abstract forms only indicate “that the framework for a crisis exists.”<sup>56</sup>

The arise question is to see how the possibility of crises, already present in simple mercantile circulation, is projected and realized in capitalism because the “developed circulation of commodities and money only occurs on the basis of capital” (Marx, 1978: 120). The first aspect to be considered is that only under the system of capital “commodity production is generalized and becomes the typical form of production; it is only from then onwards that, from the first, every product is produced for sale and all wealth produced goes through the sphere of circulation.” (Marx, 1966, v. I: 495).

55 Thus, “commodity, in which the contradiction between exchange-value and use-value exists, becomes mere product (use-value) and therefore the exchange of commodities is transformed into mere barter of products, of simple use-values.” Thus, “the first condition of capitalist production, namely, that the product must be a commodity and therefore express itself as money and undergo the process of metamorphosis” is denied. At the same time, “instead of speaking of wage-labour, the term “services” is used [...] when ‘service’ is labour seen only as *use-value* (which is a side issue in capitalist production) just as the term “productions” fails to express the essence of *commodity* and its inherent contradiction. It is quite consistent that *money* is then regarded merely as an intermediary in the exchange of products, and not as an essential and necessary form of existence of the commodity which must manifest itself as exchange-value, as general social labour.” Thus, “crises are thus reasoned out of existence here by forgetting or denying the first elements of capitalist production: the existence of the product as a commodity, the duplication of the commodity in commodity and money, the consequent separation which takes place in the exchange of commodities and finally the relation of money or commodities to wage-labour” (Marx, 1978: 110). See, also, pages 109, 112 to 115, 135 and 136; (Marx, 1966, v. I: 72-73); Marx (1973, v. I: 363-367, 377-378) and Rosdolsky (1978: 164 e 533, note 108, 537-538). The reaction of such conceptions of Ricardo on his theory of value is precisely seized by Marx: “With Ricardo, however, this false conception of money is due to the fact that he concentrates exclusively on the quantitative determination of exchange-value, namely, that it is equal to a definite quantity of labour-time, forgetting on the other hand the qualitative characteristic, that individual labour must present itself as abstract, general social labour only through its alienation” (Marx, 1978: 112). Belluzzo (1980) and Bianchi (1975) systematically study the contraposition of Marx to Ricardo’s theory of value.

56 See Marx (1978: 110); see also pages 118 and 120.



Capitalism, by generalizing mercantile production, generalizes the buying/selling separation and, consequently, the possibility of crises. This is not just the generalization of abstract determinations: capital gives a specific content to this possibility insofar as it leads to production for production's sake. The "absolute development of the productive forces" and "production for production's sake" tend to become so autonomous that capital, in its expansive movement, recurrently exceeds its possibilities of realization as capital-*value*. It is therefore in the nature of capitalist production to "produce without considering the limits of the market" (Marx, 1978: 129).

"The contradiction, to put it in a very general way, consists in that the capitalist mode of production involves a tendency towards absolute development of the productive forces, regardless of the value and surplus-value it contains, and regardless of the social conditions under which capitalist production takes place; while, on the other hand, its aim is to preserve the value of the existing capital and promote its self-expansion to the highest limit" (Marx, 1966, v. III: 247).

Accumulation and the fanatical pursuit of profit repeatedly clash with the conditions of realization of products as values, so that capital reveals a recurrent tendency "tends to surpass its possibilities of realization and expanded reproduction" (Belluzzo, 1980: 100). Overproduction becomes an intrinsic characteristic of this production system, since "is specifically conditioned by the general law of the production of capital: to produce to the limit set by the productive forces [...] without any consideration for the actual limits of the market or the needs backed by the ability to pay" (Marx, 1978: 141).

It is not only about the overproduction of commodities: insofar as these are now products of capital, it is fundamentally about the overproduction or "overaccumulation of capital," synonymous for "reproduction on an excessively expanded scale."<sup>57</sup> In this regard, "the separation between production and consumption under the capitalist regime is manifested in the form of over-accumulation of capital" (Belluzzo, 1980: 107). This means that the overaccumulation of capital is the specific and strictly capitalist form of the crisis of overproduction. It means that capital contains a tendency to unbridled accumulation that makes it periodically "excessive" at a given rate of profit. It means that the conditions of realization tend to be overcome in a recurrent way by the vigor assumed by accumulation. It means that the "proportions" and the "balance" are continuously broken and only restored in crises. It means that the production process, in the course of the expansive movement,

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57 Capital overaccumulation is discussed in Mazzucchelli (1983, Ch. 1, item 3).

becomes independent of the circulation process, and the crisis, as a crisis of overaccumulation or dynamic realization, is the “forced establishment of the unity” that is intrinsic to these processes.

Thus,

“circulation process as a whole or the reproduction process of capital as a whole is the unity of its production phase and its circulation phase, so that it comprises both these processes or phases [...]. The economists who deny crises consequently assert only the unity of these two phases. If they were only separate, without being a unity, then their unity could not be established by force and there could be no crisis. If they were only a unity without being separate, then no violent separation would be possible implying a crisis. Crisis is the forcible establishment of unity between elements that have become independent and the enforced separation from one another of elements which are essentially one” (Marx, 1978: 121).

Therefore, it is possible to state that the contradiction use-value/value immanent to the commodity, which in the simple circulation process is “externalized” under the commodity/money form, is not only projected but also fully realized only in the movement of capitalist accumulation. There is a conflict between “production for production’s sake,” which is unlimited in use-values characterized as material supports of surplus-value, and the realizable conditions of these products as values. This conflict, when it takes the form of crisis, of the blockage of the extended reproduction of capital, means at the same time the existence of a mass of commodities that has not achieved their conversion into money, and of a mass of use-values that has not been realized as value. Therefore, the “formal possibility” of crises, which emerges from the fracture of exchange in the acts of purchase and sale and the substantiation of value in money, becomes real and assumes a general character only when the circulation of commodities is a process subordinated to the circulation of capital.

### **The redundancy of living labor**

The contradictory nature of capital is not only revealed in the tendency to overproduction that characterizes it. “Production for production’s sake,” unbridled accumulation, concentration and centralization, by implying the continuous expansion of scales, the increasing automation of the productive process and the recurrent elevation of technical composition determine the progressive redundancy of living labor. Capital, by realizing its progressive character, tends to deny its simplest determinations by means of the denial

of labor. This means that “the adequacy of capital to its concept leads it to deny its own foundation.”<sup>58</sup> This aspect is detailed by Marx in the *Grundrisse*, in particular in his analysis of the development of fixed capital in capitalist production (Marx, 1973, v. II: 216-237).

The contradiction, at first, is placed in the sphere of the simple surplus-labor/necessary labor relationship:

“Capital itself is the contradiction [, in] that, while it constantly tries to suspend necessary labour time, [...] surplus labour time exists only in antithesis with necessary labour time, so that capital posits necessary labour time as a necessary condition of its reproduction and realization.”<sup>59</sup>

The unbridled desire to appropriate relative surplus-value clashes with the tendency to “suppress” necessary labor<sup>60</sup>, insofar as the unity that prevails in the relationship between surplus and necessary labor tends to be broken by the autonomization of the first and the elimination of the second.

Nevertheless, it is not only necessary labor that tends to be suppressed: insofar as the purpose of capital is to “give production a scientific character,” reducing labor “to a mere moment of this process,”<sup>61</sup> the labor becomes progressively redundant for the purposes of capitalist production. It involves an abrupt contradiction, since capital tends to negate the basis on which value production and the valorization rests.

Thus, “to the degree that labour time – the mere quantity of labour – is posited by capital as the sole determinant element, to that degree does direct labour and its quantity disappear as the determinant principle of production” (Marx, 1973, v. II: 222). Inasmuch as the assumption of value-based production “is – and remains – the mass of direct labour time, the quantity of labour employed, as the determinant factor in the production of wealth” (Marx, 1973, v. II: 227). As the appropriation of unpaid labor constitutes the foundation of capital valorization, “the theft of other people’s labor time ... appears as a miserable basis” (p. 228) in big industry built on the basis of machinery. As capital “tends to reduce labor time to a minimum [...] it places labor time as the only measure and source of wealth” (p. 229). Inasmuch as in a mercantile

58 Marcos Müller, debate on the Law of the Tendency at Unicamp’s Institute of Philosophy and Human Sciences (IFCH) with Belluzzo and Giannotti (1979).

59 See Marx (1973, v. II: 35). “But if either surplus labour time or necessary labour time = 0, i.e., if necessary labour time absorbed all time, or if production could proceed altogether *without* labour, then neither value, nor capital, nor value-creation would exist.” (p. 30).

60 “The increase of the productive force of labour and the greatest possible negation of necessary labour is the necessary tendency of capital” (Marx, 1973, v. II: 219-220).

61 “To give production a scientific character; direct labour [is] reduced to a mere moment of this process” (Marx, 1973, v. II: 221).

economy labor is only mediately social, “in production process of big industry [...], individual’s labor, in its immediate existence, is posited as individual labor overcome, as social labor” (p. 233).

“Capital is the contradiction in process” (p. 229). The impulses that lead capital to suppress necessary labor; to dissociate itself from labor time as the determining, presupposed element of production, as measure and source of wealth; to “free” itself from the theft of other people’s labor and to convert labor directly and immediately into social labor indicate a capital tendency to deny essential and determinations impossible to deny.<sup>62</sup>

This is why, in Marx’s perspective, capitalism constitutes a limited, historically determined system of production that creates – by the movement of its own contradictions – the conditions for its overcoming:

“As soon as labour in the direct form has ceased to be the great well-spring of wealth, labour time ceases and must cease to be its measure, and hence exchange value [must cease to be the measure] of use value [...]. With that, production based on exchange value breaks down and the direct, material production process is stripped of the form of penury and antithesis” (Marx, 1973, v. II: 228-229).

This is how “Capital thus works towards its own dissolution as the form dominating production” (Marx, 1973, v. II: 222).

The tendency toward the negation of labor fits the concept of capital and refers to the law of the tendency of the rate of profit to fall. In fact, the progressive redundancy of living labor is in the wording of the law of tendency, which, as we shall see, condenses the immanent contradictions of capitalist production. While the law is exteriorized in crises, the conditions of valorization of capital are recomposed also in crises, which means that it is through crises that capital reaffirms its original unity with labor. This is how the impossibility of capital separating itself from its initial determinations is revealed, despite its permanent impetus to do it.

<sup>62</sup> See Tavares’ reflections (1978, Ch. 2). In counterpoint to the Neo-Ricardian and Neo-Marxist arguments, the author demonstrates that the tendency to deny labor, characteristic of capitalism, reinforces the logical impossibility of the immediate reduction of the real movement of capital to its conceptual determinations. The result may be that determinations by labor time tend to become concretely more and more remote in capitalism, representing an additional difficulty – added to the theoretical impossibility – in the attempt to reduce prices, profits, wages, etc. to labor hours. Contrary to what many people assume, this does not mean the “abandonment” of the theory of value, but its realization. See below item 2 of this chapter.

## **The law of the tendency: condensation of the immanent contradictions of capitalist production**

The contradictory nature of capitalist production finds its ultimate theoretical expression in Marx's formulation of the law of the tendency of the rate of profit to fall. Thus, "the progressive tendency of the general rate of profit to fall is, therefore, just an expression peculiar to the capitalist mode of production of the progressive development of the social productivity of labour" (Marx, 1966, v. III: 215). This is because the development of the productive forces, by including the elevation of the organic composition of capital, determines a narrowing of the base on which the valorization process rests. Each aliquot part of capital sets in motion a smaller mass of living labor, which results, even with the progressive increase of the rate of surplus-value, in a contraction of the rate of profit. Rising rate of surplus-value and falling rate of profit are two results of the same process. Thus, "in the same proportion that in the production process capital as capital occupies a larger space with respect to immediate labor, the more the relative plus-value – the value-creating force of capital – increases, the more the rate of profit will fall" (Marx, 1973, v. II: 279).

The law of the tendency confirms all the results concerning the progressive tendency of capitalist accumulation: the increase in labor productivity; the increase in the total capital moved, both as a mass of capital-value and, in an even greater proportion, as a mass of use-values in which capital materializes; the expansion of scales; the tendency to the concentration and centralization of capital; the growth of the total mass of profits; the quantitative expansion of total constant capital and total variable capital; the increase of the rate of surplus-value; the increase of accumulation; the increase in the employed labor population and the concomitant expansion of the "surplus" labor population are results combined by means of the growth of the technical and organic composition of capital with the fall in the rate of profit for capital as a whole; the fall of the rate and mass of profits relative to each part of the aliquot of capital; the cheapening of commodities (reduction of the total amount of labor contained in each commodity); the reduction of the live labor implicit in the production of each commodity relative to the labor already materialized; the reduction of paid labor in relation to unpaid labor; and the reduction of the mass of unpaid labor contained in each commodity.

These results are produced concomitantly, making explicit the contradictory nature of capitalist accumulation. The same process that induces its continuous acceleration (cheapening of constant capital; increase in the rate of surplus-value, etc.) determines a change in the internal structure of capital,

which results in a tendency to rate of profit to fall.<sup>63</sup> Thus, as Belluzzo states, “capital is the very contradiction in process, insofar as the same law that compels it to a progressive valorization ends up determining a narrowing of the base on which this valorization process rests” (Belluzzo, 1980: 100).

As an expression of the contradictory nature of accumulation, the law of tendency reveals the progressive and at the same time limited characteristic of capital. Limited because capital contains limits that are inherent to it and that tend to be denied by its own movement. Limited, because capital tends to deny the conditions of its own valorization. Limited because capital, when guided by maximum valorization, is led to production for production’s sake, abstracting itself from the specific framework in which it should move: that of conservation and valorization of the presupposed value.

That is why the law of tendency exposes, for Marx, the relativity of capitalism,

“from the standpoint of capitalist production itself – that it has its barrier, that it is relative, that it is not an absolute, but only a historical mode of production corresponding to a definite limited epoch in the development of the material requirements of production”,

That

“unconsciously creates the material requirements of a higher mode of production” (Marx, 1966, v. III: 256).

Nevertheless, if capital tends to deny the conditions of its valorization, it cannot separate itself from them. In addition, the form by which these conditions are affirmed are crises. In this respect, it is presented “the violent annihilation of capital, not because of circumstances external to it, but as a condition of its self-preservation” (Marx, 1973, v. II: 282). This means that the contradictions which the law of tendency expresses “result in bursts, crises, in which the momentary cancellation of all labor and the destruction of a large part of capital bring it violently back to the point at which **is enable fully employing its productive powers without committing suicide.**”<sup>64</sup> It

63 “The same causes that bring about a tendency for the general rate of profit to fall necessitate an accelerated accumulation of capital [...]” (Marx, 1966, v. III: 225). “Accumulation, in turn, hastens the fall of the rate of profit, inasmuch as it implies concentration of labour on a large scale, and thus a higher composition of capital. On the other hand, a fall in the rate of profit again hastens the concentration of capital and its centralisation [...]. This accelerates accumulation with regard to mass [...]” (p. 240). See also page 247 and Belluzzo (1980: 104-105).

64 See Marx (1973, v. II: 283). “In severe contradictions, crises, convulsions, the growing inadequacy of the productive development of society to its relations of production is expressed [...]” (p. 282). Similarly, in

is clear that capital contains devaluation and valorization, because “these two aspects are placed in the essence of capital: both the devaluation of capital through the production process and its abolition and the re-establishment of the conditions for the valorization of capital” (Marx, 1973, v. I: 407).

Belluzzo precisely highlighted this aspect:

“The same law that compels capital to a progressive valorization ends up imposing the need for its periodic devaluation, a phenomenon that is expressed through sudden paralyzations and crises in the production process.”

Given that

“these crises and paralyzations in the production process invariably take the form of overproduction, but overproduction of capital and not of commodities.”<sup>65</sup>

The law of tendency condenses the immanent contradictions exposed above. On the one hand, the tendency towards the denial of labor, which is inscribed in the wording of the law, through the progressive elevation of the organic composition (and above all technical) of capital. On the other hand, the tendency to overproduction, which appears as the unfolding, the manifestation, the exteriorization of the law. When we state that crises recompose the conditions of valorization of capital, we are, at the same time, stating that the production/circulation unity is recomposed and, on an even more abstract level, that the adequacy of capital to its simplest determinations is recomposed through the very adequacy of and to the continuity of accumulation. This is how “**exchange does not modify the internal conditions of valorization, but projects them to the outside**; it gives them their reciprocal autonomous form and allows the internal unity to exist only as an internal necessity, which manifests itself externally and violently in the crises.”<sup>66</sup>

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*Capital*, Marx notes that the various contradictory influences on accumulation and the rate of profit “assert themselves simultaneously within space or successively in time. The conflict between these contending factors is periodically solved in the form of crises” (Marx, 1966, v. III: 247). See also page 255.

65 See Belluzzo (1980: 106). According to Belluzzo, it is also surprising that Marxist authors, in general, have “missed the clear interrelation that Marx sought to establish between the tendency of the rate of profit to fall and the periodic crises of capitalism.” In his judgment, “Marx formulated the theory of the tendential fall of the rate of profit in close correlation with the cyclical movements of capitalism [...]. That is because the accumulation process itself, by expanding the mass of new capital, whose material elements are more efficient and cheaper, simultaneously determines the periodic depreciation of existing capital” (p. 106).

66 Marx (1973, v. I: 407, emphasis added). This means that the tendency toward overproduction and the tendency toward the denial of labor (exposed separately previously) do not exist independently as two distinct tendencies that are juxtaposed throughout the movement of capital. In fact, these are just different **dimensions** of the

Nevertheless, one must not assume that we are here faced with crises in their determined or “complexly determined” character.<sup>67</sup> It is only a matter of understanding – in terms of “capital in general” or “capital as such” – the way in which the immanent contradictions of capitalist production are exteriorized and “solved” during crises. This is an abstract consideration of crises, opposed to any attempt to establish an immediate and direct relationship between variations in the rate of surplus-value and organic composition and “real crises.”<sup>68</sup> These, as we shall see, obey determinations that presuppose the necessary inclusion of competition. For the moment, it is not considered “The other way in which this same law [of tendency] also expresses itself, in the relation among many capitals, i.e. in competition” (Marx, 1973, v. II: 284).

Although the law of tendency is exteriorized in crises, these, in their determined character, as “real crises,” cannot be deduced directly from the law. They cannot be reduced to the law.

There is, moreover, another aspect to be considered: the law of tendency is not only enunciated in connection with the crises of capitalism. There is also a “classical inspiration” underlying Marx’s formulation, insofar as it is intended to provide an explanation for the evolution of the rate of profit along the development of capitalism.<sup>69</sup>

Thus, “Simple as this law appears from the foregoing statements, all of political economy has so far had little success in discovering it [...]. The economists perceived the phenomenon and cudgelled their brains in tortuous attempts to interpret it” (Marx, 1966, v. III: 215). In this sense, Marx rejects

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same process: it is the desire for maximum valorization that determines the maximum denial of necessary labor, and this “is only achieved through production, by production itself” (see Marx, 1972: 16). Hence the irrepressible tendency towards the denial of necessary labor (and therefore of labor) is constitutively linked to the development of “production for production’s sake” and thus to the generalization and concretization of the very “formal possibility of crises.” Overproduction, in the limit, appears as an inevitable result of the continuous objectification of the production process.

67 This brings us back to the contraposition between immanent laws and the real movement of capital. It is worth noting Marx’s observation that “the movement in the course of which this (crisis) really takes place can only be analyzed when the same is done with real capital, the competition, etc., the real conditions. It is not yet appropriate to analyze them here” (Marx, 1973, v. I: 407).

68 “Abstract determinations cannot apply directly to more developed concrete relations; they must first be mediated” (Rosdolsky, 1978: 209). In the case of crises and of the “real movement of capital,” mediation is given, in our judgment, by competition and its underlying determinations. The question that arises, then, is to understand *in what sense* the execution of immanent laws and of “abstract determinations” by the movement of competition. See below part 1.2 of this chapter.

69 See Marx (1966, v. III: 214-216, 224, 232, 238 and 256), where references to the tendency of the rate of profit to fall are explained, **insofar as capitalist production develops and progresses**, and to the conversion of the law only into a tendency (given the “play of influences that counteract and neutralize its effects”). See also Marx (1973, v. II: 285-293), where the critique is delimited to the **demonstration** that Smith, Ricardo, Wakefield, Carey and Bastiat give for the assumed phenomenon of the tendency of the rate of profit to fall with the development of capitalism.



the interpretations of Smith and Wakefield for “the phenomenon,” since they are based on intercapitalist competition. The main disagreement relates to the fact that the immanent laws of capitalism cannot be deduced from competition: “competition executes the internal laws of capital, imposes them as binding laws on each capital, but does not create them. It puts them into operation. Therefore, to explain them simply by competition means to admit that they have not been understood” (Marx, 1973, v. II: 285).

For Ricardo, the tendency of the rate of profit to fall, “as capitalist production develops” (Marx, 1966, v. III: 215) is associated with decreasing incomes from land, with which “one flees from economics to organic chemistry.”<sup>70</sup> It is clear, for Marx, that this cannot be the case: the contradictions of capitalist production can only arise from the relationship of capital to itself, and not from supposed physical limitations of nature. Its construction is perfectly coherent: the law of tendency is enunciated from the simplest determinations of capital, without introducing competition and “without any reference to ground rent” (Marx, 1973, v. II: 288) or “division of profit into different independent categories” (Marx, 1966, v. III: 215).

However, even in a “classical” perspective, the law of tendency is not presented by Marx as the demonstration of the tendency inviability of capitalist accumulation or the tendency to “collapse” (as Rosdolsky intends).<sup>71</sup> The determination is precisely inverse: it is not the law of tendency that expresses itself in a tendency to block accumulation; it is the progressive accumulation that expresses itself in a tendency of the rate of profit to fall. The only possible conclusion is that “the self-valorization of capital becomes more difficult insofar as capital is already valorized” (Marx, 1973, v. I: 284) or that “the capital relation becomes a barrier to the development of the productive forces of labor.”<sup>72</sup> Hence, the law of tendency would capture a change in the

70 See Marx (1973, v. II: 288). “Those economists, therefore, who, like Ricardo, regard the capitalist mode of production as absolute, feel at this point that it creates a barrier itself, and for this reason attribute the barrier to Nature (in the theory of rent), not to production” (Marx, 1966, v. III: 240). “There is nothing more foolish than to attempt to explain the fall in the rate of profit by an increase in the rate of wages, even though such cases may exceptionally occur [...]. The rate of profit does not fall because labor becomes more unproductive, but because it becomes more productive” (p. 239). See also Marx (1973, v. II: 40-50).

71 “The contradictions of the capitalist mode of production, which manifest themselves precisely in these disturbances (understood by Rosdolsky as “disturbances of the equilibrium of extended reproduction brought about by technical progress,” which would lead capitalism into renewed crises) and in the tendency of the rate of profit to fall that stimulate them, reproduce themselves on an ever higher plane, until finally the “spiral” of capitalist development reaches its end” (Rosdolsky, 1978: 554). A rare quote from Marx that could support this view: these regularly recurring catastrophes (crises – F.M.) lead to their repetition on a higher scale, and finally to its violent overthrow (Marx, 1973, v. II: 284).

72 See Marx (1973, v. II: 282). “This is another manifestation of the specific barrier of capitalist production, showing also that capitalist production is by no means an absolute form for the development of the productive forces and for the creation of wealth, but rather that at a certain point it comes into collision with this

quality of capitalism. Capitalism, according to its own development, would tend to make the possibilities of expanded reproduction progressively more problematic, so that its characteristic movement expansion/barriers/expansion would be transmuted into the sequence barriers/expansion/barriers,<sup>73</sup> which means nothing more than the growing inadequacy of the relations of production to the development of the productive forces.<sup>74</sup>

However, this is not the interpreters' point of view, in a literal interpretation; the discussion is about the "empirical validity of the law." An attempt is made to demonstrate the impropriety of Marx's reasoning through statistical verification of the variations in the rate of surplus-value (assimilated to the profit/wage ratio) and the organic composition of capital (assimilated to the capital/output ratio), to conclude that the rate of profit "has not evolved according to Marx's predictions."

On the other hand, it seeks to "save the honor" of the law by "demonstrating" the concrete mechanisms that capital would use to reverse the "inexorable" tendency to decline in the rate of profit. The law of tendency appears as an authentic spectrum of capital, and every analytical effort is focused on identifying new and, generally, singular "causes" that would counteract the tendency to the falling rate of profit. Regardless of the insistence on directly deducing the concrete functioning of the capitalist economy from its simplest conceptual determinations – which in itself is already a serious offense –<sup>75</sup> an improper inversion is made: instead of the law of tendency being conceived as the expression of a contradictory movement, it is now understood as the determining element of this movement, as the "key" to its understanding.

Finally, in its apocalyptic version, the law of the tendency is understood as the demonstration of the tendential impossibility of capitalism. This operation generates an invalid argument, since, by characterizing capitalism as a limited and historically determined system of production, it does not follow – except by a great and confused effort – the evidence of its self-annulation. It is absolutely clear the counterpoint of Marx in relation to the classics: while Say and Ricardo, for example, denied the existence of intrinsic barriers to

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development" (Marx, 1966, v. III: 260). "The law of tendency appears more and more as what it theoretically is: a 'limit'-law of the movement of capital, in the sense of overcoming itself as a historical and social category [...]" (Tavares, 1978: 51).

73 See Elliot (1978-79: 148-169) and Lebowitz (1976: 232-254).

74 Perhaps the observation can be understood in this way: "As soon as capital formation was exclusively in the hands of a few large capitals already structured, in which the mass of profits exceeds their rate, the active forum of production would be extinguished. It would fall into inertia" (Marx, 1966, v. III: 256).

75 "Thus, both the rate of surplus-value and the organic composition of capital, measured in labor-value, become progressively unintelligible when applied to the analysis of the 'concrete movement of capital'" (Tavares, 1978: 51).

capitalist production, Malthus and Sismondi tried hard to demonstrate the economic impossibility of capitalism.

First, according to Marx, the problem is different: accumulation is a progressive and contradictory process that is, therefore, neither unviable in tendency, nor free from sudden interruptions. This is not a regular, continuous process. Since, during cycles of crisis and valorization, there are quality changes in the organization of the internal structure of capital, resulting in the “formation of the conditions of production necessary to reach other collective and social conditions of production” (Marx, 1966, v. III: 261), which cannot be mistaken for “collapse.” Hence “economists who, like Ricardo, conceptualized production as identified directly with the capital self-valorization [...] understood the positive essence of capital” more adequately than others, like Sismondi, who “grasped more profoundly the narrowness of production founded on capital, its negative unilateralism. The first one, more a universal tendency; the second, a particular limitation” (Marx, 1973, v. I: 363).

In summary: as an expression of the contradictory nature of capitalist production, the law of tendency indicates, on the one hand, the recurrent tendency of capital to deny – by its own expansive movement – its conditions of valorization, “a phenomenon that externalizes itself in crises.” It condenses the immanent contradictions of this system of production. On the other hand, the same law seems to indicate the progressive difficulty of valorizing capital once it is valorized, or once the productive forces are developed, a phenomenon that reveals the growing inadequacy of capitalist relations to the “development of the social productive force.”

## 2. The passage of competition

Rosdolsky, in discussing the relationship between “capital in general” and the “plurality of capitals” present in the *Grundrisse*, notes: “in order to be able to investigate in a pure state the immanent laws of capital, it is necessary to make an abstraction from competition and its accompanying phenomena, starting from ‘capital as such’ or ‘capital in general’” (Rosdolsky, 1978: 72). In fact, the investigation of the immanent laws of capitalist production is the major goal of Marx’s construction. In this respect, the explicitness of the simplest determinations of this production is needed, and, through their development, to reach an understanding of its essential relations and the general laws that regulate its movement. For this reason, “the introduction of many capitals here should not disturb our analysis. The relationship between the many capitals will become clear as soon as we have considered what they all have in common: being capital” (Marx, 1973, v. II: 4).

This means that

“if it is necessary to understand the fundamental premise of the capital relation – the relation between capital and labor and the role of surplus- value as the engine of capitalist production – it is important to start not from ‘many capitals’ but from capital [...], that is ‘capital in general.’ Only then is it possible to truly develop the concept of capital” (Rosdolsky, 1978: 74).

It is not only a matter of understanding the “fundamental premise of the capital relation,” but also, and above all, its general laws of motion, which must necessarily be referred to “surplus- value as the engine of capitalist production.” There is, on this point, an extremely enlightening comment by Marx:

“It is easy to develop the introduction of machinery out of competition and out of the law of the reduction of production costs which is triggered by competition. We are concerned here with developing it out of the relation of capital to living labour, without reference to other capitals” (Marx, 1973, v. II: 315).

The analysis must at first focus on the introduction of machinery from “the relation of capital to living labor,” **and only from it**. However, concretely, the introduction of machinery is determined by intercapitalist competition, in particular by the “law of reduction of production costs” aimed at obtaining extraordinary profit, and not – directly – by the relation of capital to living labor. These two distinct theoretical planes must maintain a single relationship.

Before we discuss this point, two points should be retained. At first, a conclusion implicit in what has been seen up to now: the concept of capital contains, in its primary form, its later developments. Thus, “in the simple concept of capital, must be contained its civilizing tendencies etc. [...]. In the same way, in it are latent proofs of the contradictions that will manifest themselves later” (Marx, 1973, v. I: 167). This means that the laws and contradictions immanent to capitalist production are not mere abstract artifices, but that they already anticipate and make intelligible – in a general dimension – the results that will be verified “later.” In this sense, “the latter is already comprehended in the general concept of capital.”<sup>76</sup>

76 See Marx (1973, v. I: 354). “The exact development of the concept of capital [is] necessary, since it [is] the fundamental concept of modern economics, just as capital itself, whose abstract, reflected image [is] its concept [*dessen abstraktes Gegenbild sein Begriff*], [is] the foundation of bourgeois society. The sharp formulation of the basic presuppositions of the relation must bring out all the contradictions of bourgeois production, as well as the boundary where it drives beyond itself” (Marx, 1973, v. I: 273). See also Rosdolsky (1978: 78).

Thus, the characterization of the progressive, antagonistic, and contradictory nature of capitalist production – tangible by all titles – emerges already from the simple consideration of the concept of capital as value that is valorized through the appropriation of unpaid labor. Which is not to say, of course, that the movements of this production are limited – or directly reduced – to its abstract consideration.

The “posterior,” as a “complexly determined totality,” cannot be reduced to its first determinations.<sup>77</sup> Thus, “all the moments of capital that appear implicit in it, if one considers it according to its universal concept, acquire an autonomous reality, they only manifest themselves when it presents itself as many capitals” (Marx, 1973, v. II: 8).

On the other hand, the contrast between “capital in general” and the “plurality of capitals,” as Rosdolsky reminds us, is characteristic only of the *Grundrisse*, since Marx’s entire analysis is limited to the first aspect. This is noted by Marx in several passages, as, for example, when he states that “here we are talking about capital as such, say the capital of the whole society. The diversity etc. of capitals is not yet our subject.”<sup>78</sup>

In *Capital*, this contraposition is abandoned, **but only in a formal sense.**<sup>79</sup> **In substantive terms, it is preserved.** Thus, although some general dimensions of competition are included in the analysis (conversion of profit into average profit; breakdown of profit into interest and entrepreneur’s profit, etc.), it is unmistakably limited to the sphere of the “general nature of capital.” This means that competition includes – as any object of investigation – different levels of analysis: to say that “with duality there is already plurality in general” (Marx, 1973, v. I: 409) is different than analyze competition from its own determinations. All unfolding of surplus – value, which supposes competition on an abstract plane, is still confined to the “general analysis of capital.” The point of this unfolding is to explain the nature of the average rate of profit,<sup>80</sup> the nature of interest, and the nature of land rent in capitalism. Thus, in *Capital*, “the

77 The following comment by Maria da Conceição Tavares on capitalist profit fits into this context: “profit as a category that expresses the global capital valorization can only be understood as a problematic totality, which requires the apprehension of three logical movements of the valorization process. The first occurs in the appropriation of abstract labor by capital (determination of the rate of surplus-value); the second, in its ‘transformation’ into production prices (determination of the average rate of profit); the third, by the metamorphosis of capital in the form of a special commodity – money (determination of the effective rate of profit)” (Tavares, 1978: 49).

78 See Marx, 1973 (v. I: 290). “We do not yet have to consider here the exchange between a plurality of capitals, a subject that belongs to the theory of competition or the circulation of capitals (of credit)” (Marx, 1973, v. II: 259). See also pages 253 and 257.

79 Regarding the relationship between the *Grundrisse* and *Capital*, see Rosdolsky (1978: 27-91).

80 “The conversion of ‘surplus-value’ into profit [...] in Marx is a logical transition to understand the nature of profit [...]” (Tavares, 1978: 44-45).

previous separation of principles between the analysis of ‘capital in general’ and of competition is abandoned: **which of course does not exclude those specific problems must continue to be referred to a special investigation about the competition**” (Rosdolsky, 1978: 47, emphasis added).

For avoid doubt: the contraposition established in *Capital* is between “immanent laws of capitalist production” and “coercive laws of competition”; “intrinsic nature of capital” and “scientific analysis of competition”; “general nature of capital” and “concrete forms of capitalist production”; “concept” and “real conditions” and “real relations”; “internal organization of the capitalist mode of production” and “real movement of competition.”<sup>81</sup>

Marx’s reflection is almost entirely centered on the plane of the “immanent laws,” “intrinsic nature,” “general nature” of capital: the “real movement of competition remains outside our plan, and we have only to present the internal organization of the capitalist mode of production in its ‘ideal medium term.’”<sup>82</sup>

Having made these considerations, we can return to the previous question: what is the relationship between the plane of immanent laws and the plane of competition? For Marx, “competition is none other than the internal nature of capital, its essential determination, which presents itself and realizes itself as the reciprocal action of the various capitals among themselves; the internal tendency as an external necessity” (Marx, 1973, v. I: 366). Competition, therefore, executes the internal laws of capital: “Competition, in short, this essential engine of the bourgeois economy, does not establish its laws, but is their executor. Unlimited competition is not the presupposition of the truth of economic laws, but the form of manifestation in which their necessity is realized. [...]. Competition does not explain these laws, but lets them be seen; it does not produce them” (Marx, 1973, v. II: 45). “What is inherent in the nature of capital is put from the outside, as an external necessity, by

81 “It is not our intention to consider, here, the way in which the laws, immanent in capitalist production, manifest themselves in the movements of individual masses of capital, where they assert themselves as coercive laws of competition, and are brought home to the mind and consciousness of the individual capitalist as the directing motives of his operations. But this much is clear; a scientific analysis of competition is not possible, before we have a conception of the inner nature of capital” (Marx, 1966, v. I: 253-254). “These more definite forms of capitalist production can only be comprehensively presented, however, after the general nature of capital is understood” (Marx, 1966, v. III). “In this type of general investigations (such as that of *Capital*) it is always assumed that the actual conditions correspond to its concept or, what is the same, the actual relations are only presented insofar as they express their own general type” (Marx, 1966, v. III – Quotes mentioned by Rosdolsky, 1978: 81. See also page 70 – note 118 – and page 98).

82 Marx (1966, v. III). Quoted by Rosdolsky (1978: 81, footnote 173). Similarly, Marx observes, with respect to the reduction of wages below the value of labor power, in the chapter dedicated to the causes which counteract the law (book III, chapter XIV), that “here we only mention this empirically, since in reality, like so many other things that could be added to this, **it has nothing to do with the general analysis of capital, but is related to the problem of competition, not studied in this work**” (Marx, 1966, v. III: 235, emphasis added).

competition, which is nothing other than that the many capitals impose among themselves and on themselves, the immanent determinations of capital.”<sup>83</sup>

If competition externally imposes its essential determinations on the different capitals, it is essential to draw the relevant conclusions from this. First, it is clear that the analysis of competition constitutes an indispensable theoretical mediation for the understanding of “real situations” or the “real movement of capital.” It is only by considering competition and its determinations (which are distinct from the immanent determinations of capital)<sup>84</sup> that an understanding of the “concrete forms of capitalist production” becomes possible. It must be clear, moreover, that Marx did not develop this mediation, which, although fundamental – and far from being a mere discourse about “appearances” or on “fetishized forms,” as vulgar Marxism supposes –, remained consigned “to the eventual continuation of the work,” even if not due to the scope of it.

Second, if the laws of competition “develop differently from the laws based on value and surplus-value,” and if the determinations of competition are distinct from the conceptual determinations of capital,<sup>85</sup> it is impractical to penetrate the complexity of “real situations” by making omission of the “forms of measurement.”<sup>86</sup> In other words, it is impossible to deduce *directly* the “real movement of capital” from the “laws based on value and surplus-value,” and this is perhaps the most recurrent fault of most of the Marxist economic literature.<sup>87</sup>

83 Marx (1973, v. II: 168). “Free competition is the real development of capital. By its means, what corresponds to the nature of capital is posited as external necessity for the individual capital; what corresponds to the concept of capital, is posited as external necessity for the mode of production founded on capital.” (p. 168). See also page 285. Later, Marx notes: “So as to impose the inherent laws of capital upon it as external necessity, competition seemingly turns all of them over. Inverts them” (Marx, 1973, v. II: 297). In addition, in *Capital*, Marx refers to the “inversion that the immanent laws of capitalist production experience within the world of competition” (Marx, 1966, v. III: 226), see also Marx (1966, v. I: 253-254 and 499) and Rosdolsky (1978: 71-72).

84 “The fundamental law in competition [...] distinct from that advanced about value and surplus value” (Marx, 1973, v. II: 175). The consideration “of capital as such differs from the study of one capital in relation to another capital, or the study of capital in its reality” (p. 208).

85 In competition, “all determinants appear in a position which is the inverse of their position in capital in general” (Marx, 1973, v. II: 175).

86 The original reference is to Ricardo who, according to Marx, “do not investigates the form of mediation” (Marx, 1973, v. I: 268).

87 The same criticism by Marx about Ricardo applies here. Thus, “Ricardo makes deliberate abstraction from the form of competition, from the appearance of competition in order to grasp the **laws as such**”. Nevertheless, it must be “reproached, on the one hand, for not going far enough, for not making a sufficiently complete abstraction; [...] on the other hand, for conceiving the form of manifestation [...] **in an immediate, direct form, as a proof or representation of general laws, but in no way developing them**. With reference to the first, its abstraction is too incomplete; with reference to the second, it is a formal abstraction, erroneous in itself [...]” (Quoted by Rosdolsky, 1978: 615). “Ricardo, still according to Marx, does not delve into the necessary intermediate links and tries to demonstrate, in an **immediate** way, the reciprocal congruence of

Finally, if intercapitalist competition “puts into practice” (Marx, 1973, v. II: 285) the internal laws of capital, one must recognize “the dominance of competition between capitals over the relations between capital and labor in the movement of the capitalist mode of production” (Belluzzo, 1980: 109). Thus, if the internal laws of capital are only realized through the permanent confrontation between different capitals, the analysis of this realization – which forms the “real movement” of the mode of production – must be referred in the **first instance** to intercapitalist competition, and not to the relations between capital and labor.<sup>88</sup> Consequently, for example, the introduction of machinery is initially deduced from “the relation of capital to living labor” (Marx, 1973, v. II: 315), in particular from the need to cheapen the value of labor power with a view to obtaining relative surplus-value. However, if the same question is seen from the angle of competition – and, therefore, of the “real movement of capital” – there are other determinations that explain, in the *first instance*, the phenomenon. Thus, the capitalists’ permanent quest to lower the individual value of their commodities in relation to their competitors determines the systematic introduction of technical progress. Then

“it is irrelevant for the capitalist to introduce an innovation that directly lowers wage costs or reduces the input of raw materials or even replaces a less efficient machine with a more efficient one. What is important is that the introduction of innovation gives individual capital the capability to reduce the value of its product below its social value” (Belluzzo, 1980: 108).

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the economic categories” (Quoted by, 1978: 619). In the same way, for Marx, “Ricardo is not interested in developing genetically the forms, but in reconstructing them, their unity, through an analysis, because he starts from them as from given premises. However, analysis is the necessary premise of genetic formulation, of understanding the actual process of conformation in its various phases” (Quoted by Rosdolsky, 1978: 620). In the same line, Rosdolsky warns that not considering the “contradiction between the general law and the more developed concrete situations” (Marx) induces to the “illusion that the abstract image simply reflects the concrete conditions, without mediations of any kind” (Rosdolsky, 1978: 499). Regarding the classics, and Ricardo in particular, his observation is that “since the specifically bourgeois forms of production appeared to them as unalterable natural forms, since they were based on them as given premises, **there was no need in their circle of interests to develop these forms genetically, but only ‘to bring them back, through analysis, to their internal unity’ (Marx), that is, the law of value**” (Rosdolsky, 1978: 617). Ricardo and the classics thus focused on “the methodical elusion of the categories of mediation” (Lukács) and “**the desire to ‘derive directly’ the phenomena occurring on the surface of economic life ‘by means of simple formal abstraction from the general law, or to adapt them to it by means of reasoning’ (Marx)**” (Rosdolsky, 1978: 617-618, emphasis added). Such criticisms, originally directed at Ricardo, can be extended, without much effort, to much of the Marxist-inspired economic thinking.

88 Reversely, insofar as the **result** of competition consists in the affirmation of the determinations of capital in general for each capital **in particular**, the relations between capital and labor are then revealed as the **ultimate** determinant of the mode of production.



What happens is that this process acts in the same direction of the cheapening and relative liberation of labor power. This means that it is the condition implicit in the process of obtaining extraordinary profit that ensure, at the same time, the realization of capital's "deeper reason" – that is, the appropriation of surplus-labor. Thus,

“the generalization of innovations tends to reduce the abstract labor time and that it only does so by increasingly replacing living labor with labor that is objectified in the means of production. Nevertheless, even though this is an inevitable consequence of the process and at the same time its deepest reason, its **immediate reason** is given by the confrontation between the parts into which the social capital is divided” (Belluzzo, 1980: 108-109, emphasis added).

This occurs in the same way with the tendency of capital to progressive accumulation, which is deduced from the concept of capital. Since its purpose is the maximum appropriation of unpaid labor, the continuous reversion of surplus-value into capital becomes imperative, as “the only condition on which the appropriation [...] of unpaid living labor rests, in ever increasing proportions, is the ownership of unpaid past labor” (Marx, 1966, v. I: 491).

In the field of competition, however, there are other determinations regulating the process. Only those capitalists who “leap ahead” remain in the market, who operate aggressively through the expansion of scales, the multiplication of plants, the introduction of innovations, the diversification of production, and the differentiation of products. The conservation of capital-value through its own expansion is thus something that imposes itself as a norm for every capitalist:

“the development of capitalist production makes it constantly necessary to keep increasing the amount of the capital laid out in a given industrial undertaking, and competition makes the immanent laws of capitalist production to be felt by each individual capitalist, as external coercive laws. It compels him to keep constantly extending his capital, in order to preserve it, but extend it he cannot, except by means of progressive accumulation” (Marx, 1966, v. I: 499).

This is how competition implements the tendency to the “absolute development of the productive forces” and to “production for production’s sake.” By doing this – through the “autonomization of the technical structure,” the progressive differentiation of the productive base, the systematic enlargement of scales, the increasing concentration and continuous centralization

– it creates, at the same time, the conditions for “the appropriation of living labor” to take place “in increasing proportions.”

The same happens with over-accumulation crises. Their immediate reason, as we will see, is that the growth of productive capacity – driven by inter-capitalist competition – determines the excess of capital in face of the current rate of profit. The fact that the concrete part of capital remains inoperative “is what has to decide the struggle of competition,”<sup>89</sup> just as it is competition that establishes the conditions for recovery through “immobilization and even the destruction of capital to a greater or lesser degree” (Marx, 1966, v. III: 251). However, this recomposes the rate of exploitation to the conditions of capital valorization. This is how “the crisis is solved in a real fall of production, of living labor, in order to restore the correct relation between necessary labor and surplus-labor, on which **ultimately everything is based.**”<sup>90</sup>

We should therefore keep the following conclusions in mind:

- the analysis of competition constitutes an indispensable theoretical mediation for the understanding of the “real situations” or the “real movement of capital”;
- Marx did not systematically develop this mediation, but left it “to the eventual continuation of the work”;
- the determinations of competition are distinct from the conceptual determinations of capital;
- it is impossible to **directly** deduce the “real movement of capital” from the “laws based on value and surplus-value”;
- in the “real movement of capital” the relations between capital and labor are subordinated to intercapitalist relations;
- the “real movement of capital” can **only ultimately** be traced back to the immanent determinations of capitalist production.

89 See Marx (1966, v. III: 251).

90 See Marx (1973, v. I: 407 – emphasis added). From the point of view of capital, adds Marx, “the basis remains the proportion between necessary and surplus-labor, or, if you please, between the various elements of objectified labor and living labor” (p. 405).

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## CHAPTER 7

# A REFLECTION ON THE NATURE OF CONTEMPORARY INFLATION

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### 1. The Keynesian pricing model

For Keynes, the aggregate supply price was an expected price that made it possible to cover variable and facilities costs, plus a normal profit margin, according to the Marshallian formulation. However, Keynes goes a step beyond Marshall in defining the production period and the user cost. Thus, Keynes's long-term supply price (or normal price) was that which should realize, during the production period, the expected valuation of the company's assets – a capitalist dimension that involves updating values related to raw material stocks, finished products and the depreciation of fixed capital. As for past debt, the implicit assumption was that credit and indebtedness agreements could not be breached during the production period, that is, they had fixed terms and interest rates.

The aggregate supply price could therefore **be planned** – like an actual production price – depending on the expected level of capacity utilization of the company or industry, which, in turn, depended only on short-term expectations about the behavior of the various components of aggregate demand. The past could not be reviewed and short-term expectations, when frustrated, only affected capitalist decisions – in the production period – in terms of quantities (not prices). That means that the instantaneous adjustment variable is variation of stocks, or of the level of capacity utilization, because price variation in spot markets for raw materials and finished products was expected to fluctuate around normal supply prices without affecting so-called “supply contracts.” Short-term fluctuations in interest rates did not affect production decisions either, as debt contracts were fixed. In these conditions, the expected valorization of net capital, as well as the user cost of fixed capital and strategic raw material stocks, had to take into account only expectations

regarding the long-term interest rate and the opportunity cost of retaining raw material stocks.<sup>91-92</sup>

Regarding industrial prices, the Hicksian hypothesis of fix-prices assumed: *i*) national markets that respected the assumptions of a closed economy, in which the monetary standard was stable and the money supply regulated by the Core bank; and *ii*) in the case of an open economy, it admitted a fixed exchange rate and ascribed a stabilizing role to international reserves.<sup>93</sup> Assuming these hypotheses, a model of “normal prices” could be established, in which industrial companies were mere operators of production prices calculated from relatively stable primary costs, with a normal profit margin (or a fixed markup). In these models, the starting point for price formation was the nominal wage rate, fixed by collective bargaining rules and kept constant during the production period, whatever the structure of the labor market. The nominal wage rate related to the product per person employed (measured in monetary wage units) would express the price of aggregate supply flows during the production period.

The stability of contractual conditions, especially in the labor and credit markets, or, in Davidson’s language, the synchrony in the production period between “supply contracts” and “debt contracts,” allowed the calculation of normal production prices.

Thus, commodity and money markets – which were international markets par excellence – could float freely and alter the rentier nature of wealth, but did not determine the production price of goods. There was a clear divide between fix- and flex-prices. Flex-prices could fluctuate instantaneously with a changing demand. Fix-prices could only rise, in the next production period, with an increase in demand, if there was a rigidity of supply. In an industrial system, rigidity of supply could only occur close to full capacity utilization or full employment. Normally, the assumption made was that there were margins of idle capacity in the industry or an adaptive response to increased demand. Thus, the effects in terms of prices and interdependence of markets only appeared at the height of the cycle. At this moment, there is a cost-push inflation originating both in the commodities (spot) market and the actual raw material offer prices. Income inflation also appears, due both to possible bottlenecks in the labor market, which raise the cost of wages to industry, and to abnormal profits in sectors with full capacity utilization. True inflation in the Keynesian model, therefore, only occurred at the height, when the

91 See Davidson (1978: 340).

92 See Keynes (1973, Ch. 6, Appendix on user cost).

93 See Hicks (1974).

distinction between capital inflation and income inflation was irrelevant.<sup>94</sup> The redistributive conflict also appeared only at the height, i.e., in a situation of rigid aggregate supply.

Capitalist production decisions, as originally envisioned by Keynes, assumed two different macroeconomic situations, in terms of both price formation and the behavior of agents. One relates to the valuation of capital in the production process, the other to the nature of valuation and possession of wealth in its various forms, especially the more liquid ones. Under normal functioning conditions of a capitalist economy, it is the production process that commands the process of valorization of capitalist wealth. In this perspective, “preference for liquidity” is governed by the reasons of transaction and precaution and admits a “normal” speculative component in financial markets. Short-term interest rates are expected to fluctuate around the long-term rate, which tends not to change as long as there is no reason for an increase in the liquidity premium. The latter rises not because there is an imbalance between the goods and money markets or between decisions to invest and to save, but because there is uncertainty about the long-term prospects for the profitability of fixed assets.

The finance motive is not enough to determine a lasting increase in interest rates. This revolving investment financing fund tends to increase alongside the implementation of investment decisions, unless there are banking policy restrictions that result in a sharp decrease in liquidity and net domestic credit. That obviously affects the general financing conditions of the economy.<sup>95</sup> A sharp increase in preference for liquidity and the speculative-rentier character of capitalist wealth could only occur after the downfall of the marginal efficiency of capital in the reversion of an expansion cycle.<sup>96</sup>

Although Keynes assumes an independent money supply controllable by Core bank policy through classic open market instruments, the impotence of monetary policy becomes manifest in a recessive situation. An increase in primary liquidity and a decrease in interest rates might be effective at the beginning of a situation of expansion to facilitate the funding of new investments and undo bottlenecks.<sup>97</sup> An expansive monetary policy would, however, be totally ineffective to avoid a cyclical reversal.

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94 Actually, pure demand inflation (inflationary gap) or pure cost inflation (wages) belongs to a view that is entirely foreign to and incompatible with Keynes's theory. In addition, the redistributive conflict, as presented in the “Neo-Keynesian” models, with given rigid mark-up, product and real income, is entirely incompatible with Keynes's view.

95 Such restrictions, in an open model and with government, may result from a change in public debt policy or a sudden change in international reserves.

96 See Keynes (1973, Ch. XXII).

97 In this case, actually, it would be a policy that is at once anti-inflationary and anti-monetary.

## 2. Breakdown of the international monetary standard and the Keynesian pricing model

A Keynesian supply price equation does not hold as an explanatory model in the current conditions of breakdown of the international monetary standard and anarchic price movement. The spot commodity and money markets are not “independent.” The Hicksian hypothesis of fix-prices assumed fixed exchange rates or, if they were fluctuating, the possibility of establishing a balanced parity of purchasing power among currencies. The money and commodities markets should, therefore, be considered independent and, guided by cyclical demand, move in a compensatory manner, keeping long-term supply prices stable.

The existence of a stable international monetary standard would guarantee long-term balance for interest and exchange rates, which would allow a system of fixed industrial prices to work in any national economy.

With the breakdown of the international standard, the hypothesis of fix-prices does not hold for any market. The closed economy model is no longer valid and domestic markets in open economies – operating with fluctuating exchange rates – no longer respect the stability hypotheses of the Keynesian model. The dynamics of international reserves ceases to play a stabilizing role in the nominal flows of national income, in the monetary adjustment of the balance of payments. The stock market – especially the financial markets – can no longer be considered exogenous to the production system and, therefore, the hypothesis of the stability of supply and debt agreements during the production period does not hold.

It is not possible to admit the stability of debt contracts due of their periodic renegotiation, linked to sudden fluctuations in interest rates in the international money market. It is not possible to admit the stability of contracts for the supply of strategic raw materials (imported and exported) because the parity of the purchasing power of currencies is not maintained and both the terms of trade and the production prices of raw materials suffer violent discontinuities. Thus, both the price of inventories and the value of assets and liabilities start to fluctuate uncontrollably during the production period, making the horizon of capitalist calculation uncertain. Despite the impact of “external” prices on the purchasing power of wages, this is the only relatively stable variable in nominal terms in supply contracts during the production period, although it reacts in the following period, after the fall in purchasing power and expected inflation. Supply prices, in turn, planned by producers, tend to be greatly overestimated in an attempt to offset a possible devaluation of net capital. Hence, the aggregate supply price ceases to meet the “normal”



conditions of production prices in a capitalist company. In other words, the profit margin is no longer a stable markup on primary costs, since a fixed margin is no longer a guarantee of a normal rate of gross profitability on the capital invested in production.

Thus, the desired profit margin, rather than representing a stable markup on primary costs, becomes an uncertain calculation margin. With the successive devaluations of the international currency, this margin tends to increase, since it incorporates the successive revaluations of inventories and the readjustable debt load (floating interest).

Uncertainty about the user cost of raw material stocks and the updated value of past debt are the two decisive elements in converting the fix-price model into a flex-price model. Unfortunately, such price flexibility is always upward, not because of nominal or low-wage rigidity, or due to wage indexation, which only occurs in the new production period. The problem of the “upward” flexibility of desired profit margins and nominal prices is due to the fact that production price adjustments are not instantaneous. Prices continue to be forward, set by expectations regarding supply conditions in each new production period. The values of supply and debt contracts continue guiding expected prices, but must be permanently reassessed.

The instability of short-term expectations contaminates long-term expectations that are no longer solely linked to the user cost of existing equipment, as in a situation in which the monetary standard and the raw materials market are stable. The monetary unit of wages is no longer stable, not because of the workers’ negotiating conditions, but of the lack of purchasing power parity for wages. The operating cost of equipment is no longer a reasonable element of calculation, not due to a change in equipment production conditions, but because the values of capital and long-term interest rates cannot be calculated.

In fact, the nature of short-term expectations in question differs from that discussed by Keynes: fluctuations in effective demand, allowing quick quantity adjustments due to inventory changes or production elasticity. Nor is it about adaptive or rational expectations, as has been claimed in the “Walrasian disequilibrium” models, or of a struggle between wages and productivity, as suggested by the Keynesian distributive models. It relates to an unexpected adjustment in the calculation price of aggregate supply due to unpredictable changes in the conditions of “absolute” price formation.<sup>98</sup>

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98 The discussion about adjusting relative prices is a false issue, as they are the ex-post result of absolute corporate or government price calculation (cost and profit margin) and not elements of ex-ante calculation as in the neoclassical model. See successive passages from Keynes against the hypothesis of relative prices as “calculation” prices.

Prices are no longer “normal” because the calculation of long-term production prices now involves use costs (opportunity) of money and strategic raw materials (especially ore) that are entirely “abnormal.” They are abnormal not only because interest and oil prices are high, but because they fluctuate unexpectedly and sharply in the short term and their long-term cost of use tends to be abruptly and arbitrarily revised. Therefore, it is not uncertainty on the demand side that can be corrected in price calculation with a portion of supplementary cost. It is an actual “supply shock” that cannot be corrected, since the behavior of long-term prices is impossible to predict. The bridge to the future, represented by money, is a suspension bridge over an “abyss” of uncertainty. “Long-term balance” is a vain utopia and short-term imbalances are not resolved by adjusting quantities only, but also prices upwards.

The components of the price equation, which correspond to the strictly speculative valuation of capitalist wealth, are now “autonomized” in relation to the conditions of production valuation and express the particular phenomenon of this crisis. The forms of capital valuation are, therefore, predominantly speculative, but given the disorganization of the monetary and exchange rate patterns, they find no rest in any particular asset. The rentier nature of capitalist wealth prevails over its productive nature, which means that a substantial part of “production costs” must be estimated with a huge safety margin. Consequently, both past and expected inflation are embedded in the prospective calculation, less on the side of the traditional notion of “supply flows” and much more on the side of inventory and capital value. Thus, real primary costs may be falling (oil, raw materials, wages) and inflation may be being fed by instability in the elements of capitalist valuation, which is expressed through sudden fluctuations in interest rates, exchange rates and desired profit margins.

It should be explained that inflation is not caused by the interest rate levels reached, but by expectations of their sharp fluctuation. Likewise, it is not the level of currency overvaluation or devaluation that causes price instability, but the constant fluctuations and the prospects of real devaluation of the international currency itself. Therefore, it is the instantaneous adjustment markets that destabilize capitalist decisions, whether by imposing the “rehiring” of past commitments (floating interest rates) or by requiring speculative reviews of expected prices, which are no longer rigid and become flexible upwards.

If the price-setting agents took into account, in price formation, only the past component of inflation, the latter would become inertial. After each “supply shock,” inflation would be only of costs and the desired markups would be conventional and stable. But the leading price-setting companies tend to protect themselves against any hitch in future inflation by raising the desired markup. In such a situation, measured inflation tends to accelerate and

may cause true profit margins to decline (ex-post), despite increasing desired margins over several production periods. Ironically, labor contracts are the only stable ones, despite the strong opposition to indexation. Wage indexation is only applied after a year or six months and allows at most the restoration of purchasing power of the previous period. It also enables nominal stability of the main primary cost in each new production period. Only when wage negotiations incorporate an expectation of future prices higher than the past is it legitimate to speak of inflationary feedback caused by wages.

At the core of this unstable process of “forward flight,” which the valuation of capitalist wealth has become, is the money market, which no longer works according to the assumptions formulated by Keynes. First, the money supply can no longer be considered rigid and exogenously controllable by the Core bank. The movement of reserves caused by speculation in the international currency market leads to endogenous fluctuations in public debt and money that deprive monetary policy of its autonomous regulating nature.

Second, Keynes’s idea of liquidity preference loses its original simplicity. It is true that the active component of the demand for money continues having, as Hicks has already noted, a speculative motivation.<sup>99</sup> The breakdown of the international monetary standard, however, makes international money a fleeting category, inasmuch as the purchasing power parity of any national currency in relation to the others or a hypothetical basket of basic goods cannot be fixed. Hence, the idea of the existence of an asset that, due to its characteristics of low elasticity of production and substitution, provides a liquidity premium (ability to acquire goods or to release contracts without transaction and maintenance costs) is no longer meaningful.

The interest rate calculated in the money market now incorporates a risk spread that expresses the growing uncertainty in relation to future exchange contracts and the settlement of past contracts. The successive devaluation of the various national currencies and the absence of a stable monetary standard make money lose its function as a store of value and eliminate the very notion of long-term capital market and an equilibrium or normal interest rate. The reintroduction of the concept of natural interest rate is, in these circumstances, a total aberration, comparable only to the notion of natural unemployment rate.

The “international financial system” starts to function as a “pure credit” system in its relations with companies and governments, endogenously creating liquidity and high-risk premiums. Indebted agents accept any interest rate. It is in this circumstance that the increase in interest rates no longer corresponds to an increase in the liquidity waiver premium, but to a risk premium on the probable devaluation of past wealth. The permanent revaluation of this

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99 See Hicks (1967).

past wealth, through frequent debt renewal, with renegotiation of rates, prevents inflation from fulfilling its historical role of devaluing financial money while reducing the real value of past wealth. Thus, there is no opportunity for the creation of future wealth (new investment), with increasing amounts of liquidity trapped in financial circulation and the necessary liquidity restricted to industrial circulation. This liquidity constraint, plus interest rate instability, is what makes productive investment unfeasible, not absolute rate levels. A capitalist company can always balance its financial assets and liabilities if the interest rate is high, but stable. That would simply increase the rentier nature of capitalist wealth. Proper distribution of the portfolio would resolve that issue. The problem is risk added to the uncertainty caused by strong fluctuation in interest rates during the production and investment period, both involving different times of valuation of real assets and liabilities, with different periods of maturity.

The shortened horizon for calculating the value of capitalist wealth, expressed in interest rate fluctuations, not only raises the cost of use of all assets produced, but, in particular, makes it impossible to calculate the supply price of new capital goods, i.e., makes it impossible to calculate the marginal efficiency of capital. As uncertainty regarding the future becomes absolute, the speculative and “financial” character of wealth is aggravated. Under these conditions, Keynes’s euthanasia of the rentier would be tantamount to the collective suicide of capitalists.

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# CHAPTER 8

## THE REVIVAL OF U.S. HEGEMONY

*Maria da Conceição Tavares*

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Until 1980-81, it was unjustified to suppose that the United States (US) would be able to reassert its hegemony over Western competitors, let alone move towards a new international economic order and a new division of labor under its command. It is quite likely that this will happen nowadays.

Until the end of the 1970s, it was not foreseeable that the US would be able to bring into line two countries that had strategic importance in the capitalist order: Japan and Germany. If the US had not been able to control the Japanese private economy to its interests, and if English and German politics were not so conservative, the US would have faced a bloc with European and Asian pretensions of economic independence. It should be noted that, at that time, the interests at stake were so conspicuously contradictory that world trends were polycentric, and it seemed impossible for the United States to be able to reaffirm its hegemony, even though it continued to be the dominant power.

Other general circumstances that became apparent in the 1970s seemed to contribute to this argument. The private banking system operated entirely outside the control of Core banks, in particular the Fed. The subsystem of transnational subsidiaries operated regional intra-firm labor divisions, in spite of American national interests, and led to an intensification of inter-capitalist competition that was unfavorable to the US. In summary, the existence of a world economy without a hegemonic pole was leading to the disruption of the post-war order and the decentralization of private and regional interests.

The developments in US domestic and foreign economic policy, from 1979 until now, were aimed at reversing these trends and resuming international financial control through the so-called strong dollar diplomacy.

As it is well known, at the last IMF meeting in 1979, Mr. Volcker, chairman of the Fed, withdrew from the meeting, went to the US and from there declared to the world that he was against the IMF and other member countries' proposals, which tended to keep the dollar devalued and to implement a new international monetary standard. Volcker argued that the IMF could propose what it wanted, but the United States would not allow the dollar to continue to devalue as it had been doing since 1970, particularly after 1973 with the Smithsonian Agreement collapse. Following on this abrupt change of position,

the United States declared that the dollar would remain as an international standard and that its currency's hegemony would be restored. The restoration of the Fed's financial power has cost the United States to plunge itself and the world economy into a continuous recession for three years. It even broke down several large companies and some American banks, in addition to subjecting the American economy to violent structural tension. The onset of the recession and the sharp rise in rates of interest weighed heavily on Carter's popular defeat.

Looking back on events, it can be said that the Reagan government's economic policy (which followed these events) was not absurd for American **national** interests – as almost all economists proclaimed when it was formulated – although it did cause real “imperial” pressure over the rest of the world. In fact, it is an extremely contradictory policy that did not result from any “international conspiracy,” nor even from a solid internal agreement. In fact, there could be no agreement, when the US Treasury has a policy, the Fed has another, the people in California have some ideas, the people in the mid-west and the east coast have totally different ones. In short, as a result of an intense confrontation of interests and internal conflicts, the United States has carried out and continues to carry out a multi-faceted policy that implied starting a process of economic recovery whose peculiar nature was almost unimaginable in the early 1980s.

Indeed, in addition to the movement to restore political and ideological prestige, Reagan decided to do something never seen before, namely a bastard, upside down, Keynesian policy combined with a tough monetary policy. Redistributing income in favor of the wealthier, increasing the fiscal deficit and raising rates of interest is a combination of an explosive economic policy, both domestically and internationally. However, this contradictory policy resulted in the American economic recovery, as the United States managed to guide its partners to militarily and economically challenge its opponents.

On the other hand, by maintaining a tough monetary policy and forcing an overvaluation of the dollar, in practice the Fed resumed its control of the international private banking system and articulated the interests of the dispersed herd to its advantage. In fact, as a result of Volcker's policy, followed by the collapse of Poland, this system was forced in the first place to contract credit almost instantly, halting the pace of operations in the interbank market and, above all, the expansion of credit to the peripheral countries. The reduction in loans was even more violent after the crisis in Mexico, as on that occasion the private banking system reacted in a panic and took refuge in the large financial markets. From then on, the movement of interbank credit was decisively oriented towards the US and the banking system came to be



under the Fed control. And not only under the control of monetary policy, which dictates the rules of the game, fluctuations in interest and exchange rates, but also in the service of American fiscal policy. From the beginning of the 1980s, all major international banks are in New York, not only under the umbrella of the Fed, but also obligatorily financing – because there is no other alternative – the American fiscal deficit.

All this can seem strange. But the truth is that today we are witnessing the following situation: the US have a fiscal deficit of a structural nature whose rigidity stems from its own financial and military policies, both aggressive and “imperial”. The financial component of the deficit is growing thanks to the mere rollover of the public debt that caused it to double in only three years. In 1984, public debt reached around US\$ 1.3 trillion, a figure close to the global monetary circulation in the international interbank market. This debt is the only instrument the United States has to carry out a forced borrowing of international liquidity and to channel the movement of Japanese and European banking capital into the American money market.

Until 1981, only England’s economic policy reportedly supported the American currency. The Japanese maintained real possibilities of making an autonomous monetary policy and resisted the adoption of neoconservative policies supported by the monetarist prescription. Several other countries such as France, Austria, those in northern Europe and even Brazil tried to resist the automatic alignment of orthodox economic policy. Every country had it clear, from 1979 to 1981, that they should not line up, but despite that they were all submitted. All developed countries in the world, whatever their governments – socialists, social democrats, conservatives, etc. – are practically aligned in terms of exchange rate policy, policy of rate of interest, monetary policy and fiscal policy. The result of this movement is that the spectrum of growth, exchange and rates of interest has become concentric to the performance of these variables within the scope of the American economy.

All countries were obliged, in these circumstances, to practice restrictive monetary and fiscal policies and increasing trade surpluses, which sterilize their endogenous growth potential and convert their public deficits into structural financial deficits, useless for an economic reactivation policy.

An impressive and even dramatic experience of aligning economic policy happened in Japan. This country was, during the post-war period, the most heterodox in terms of economic policy. It invested with short-term credit and a loose monetary policy, conglomerated its business system with an apparently impossible risk structure, made little use of the stock market and public debt, in short, produced its own national model of development. In 1975 Japan tried an internal adjustment plan in line with its potential but was gradually forced

to give up all efforts and today is entirely subject to the dynamics of the American economy. Japan is not pursuing an autonomous development policy of any kind, except for its society minimum internal security. Japan has most of its banking and multinational capital tied to American recovery projects, with gigantic exportable surpluses, with no possibility of resuming its investment and historical growth rate. This means that the Japanese financial market is irremediably tied to the American, except for a setback that may occur between 1985 and 1987, as long as the American banking system goes into turbulence and the dollar depreciates sharply – the only point that may still be subject to a possibility of rupture capable of destabilizing American hegemony.

Some time ago, it seemed that the United States had lost its ability to lead the world in a beneficial way. This remains true. But on the other hand, the Americans undoubtedly gave, from 1979 to 1983, a demonstration of its evil capacity to exercise its hegemony and to adjust all countries, through the recession, to its *desideratum*. And it did so, of course, with unprecedented arrogance and violence.

Since 1984, according to the words of its financial elite, it is demanding a new division of labor from the world and boasting of being the “trade locomotive” of the global recovery (Morgan Guaranty Trust Company of New York, 1984).

A fundamental aspect of this process of restoring the hegemonic position of the US is evident when we analyze its international economic relations. Between 1982 and 1984, the United States managed to double its trade deficit each year, which together with the receipt of interest allowed it to absorb real savings transfers from the rest of the world, which in 1983 alone corresponded to one hundred billion dollars, and in 1984 must have exceeded 150 billion. On the other hand, its terms of trade have improved, and its domestic costs have fallen, as the imports that the US is making are the best and cheapest in the world. Thus, without making any intensive effort to save and invest, without touching its energy infrastructure, without touching agriculture, without touching the old heavy industry, the US is modernizing its cutting-edge industry with cheap, **latest** equipment and venture capital from Japan, Germany, the rest of Europe and of the world.

The American trade structure was always symmetrical and closed. The US exported and imported raw materials, food, industrial inputs and capital goods, in short, all the important items of international trade. The US economic relations with the rest of the world could not be framed within the traditional center-periphery scheme. The United States did not need an international division of labor that would favor it in absolute or relative terms. The surprising fact is that it is now looking to establish an international division of labor for

its exclusive benefit. After exporting to the world, for more than two decades, the technological pattern of the American industrial system uses its hegemonic power to remake its position as the dominant technological Core through its multinationals. Thus, it uses its banks, commerce, finance and foreign direct investment to achieve redeployment, despite having lost commercial competition to other advanced economies and even some semi-industrialized ones.

The United States is now investing heavily in the tertiary sector and new high-tech industries. It is enough to look at the investment structure in 1983 and 1984 to see the extreme concentration of investment spending in the areas of information technology, biotechnology and sophisticated services. The United States is not interested in supporting its old structure. It also knows that it does not have the capacity to achieve a huge boom from reforms in the industrial sectors that led the post-war world economic growth. On the contrary, the United States is concentrating efforts on the development of cutting-edge sectors and subjecting the old industry to international competition from its partners.

With its huge trade deficits and the resumption of growth, it guarantees the solidarity of its exporting partners, especially Japan and Germany. With its high real rates of interest, it guarantees the solidarity of bankers. And, with joint ventures within the US, it guarantees its position of advancement for the future; besides helping to recover its national economy.

A fact that must be stressed is that the recovery of the American economy is being carried out with short-term credit and increasing indebtedness. In practice, the Americans are applying the same technique that Brazil and Mexico recently applied, and that Japan used in the 1950s. Finally, the United States discovered the Latin American and Japanese development technique: investment financing based on short-term credit, foreign indebtedness and fiscal deficit. And since its currency is hegemonic and overvalued, the American economy does not even have inflation. Actually, this fact astonishes some economists because if what the monetarists or Keynesians say – or any traditional textbook says – was valid the US would already be experiencing rampant inflation due to the fantastic demand-pull promoted by a heterodox economic policy technique.

An example of this heterodoxy concerns fiscal policy. The United States practically stopped spending on public goods and services, increased spending in the military sector, and offset welfare spending. In short, it exchanged social welfare expenditures for weapons and redistributed incomes in favor of the wealthy. In addition, it reduced the tax burden on the middle class and virtually eliminated the incidence of taxes on interest paid to banks for purchases of durable consumption. It also led to accelerated depreciation of

assets and refinancing of liabilities of certain firms. In these circumstances, household indebtedness becomes an excellent business because part of the financial burden of the debt is deducted from income tax. Thus, large-scale short-term credit was taken to support the purchase of houses and consumer durables. In addition, it financed investments in the tertiary sector and in the high-end industry, which do not require a very long maturation period and whose expected rate of return is much higher than the declining nominal rate of interest. This decline in rates of interest is apparently due to three interconnected reasons: the absorption of international liquidity, the less orthodox position of the Fed and the fall in inflation. The latter is in turn due to the drop in domestic costs caused by the overvaluation of the dollar and competition from imports, leading to an improvement in terms of trade favorable to the purchasing power of wages.

Many hoped that from 1983 onwards the United States would reverse the overall surplus position in the balance of payments because since 1982 US capital income abroad has not been covering the American current account deficit. But this did not happen because foreign capital inflows are responsible for making this coverage widely. Investment in venture capital has also increased. Japan alone, for example, invested US\$ 10 billion in the recovery period and has already projected to invest US\$ 40 billion by the end of the decade. Germany, for its part, must have invested something around 8 to 9 billion dollars, although we do not have the precise data on its amount. In short, all of Europe and Japan are investing in the US; while the latter have taken over part of the capital of the subsidiaries of American multinationals that do not have the capacity to expand further in the rest of the world. After all, while the periphery is stagnant and the rest of the world is growing by 1% or 2%, the US has been growing at a rate of 7% to 8% in the past year and a half.

Supported by this huge inflow of capital, the US was able to maintain and widen a trade gap whose limits are not yet visible. From US\$ 30 billion in 1982 to US\$ 60 billion in 1983 and jumped to more than US\$ 120 billion in 1984. Next year, it could reach US\$ 200 billion and continue to increase, if it were not for the deliberate slowdown in the American economy, simply because there is capital left over in the world. And this excess of capital and “foreign savings” is due to the fact that the rest of the world followed conservative policy, regardless of the type of government. In fact, the synchronization of orthodox policies has forced all countries to keep their investment and growth rates low and to force exports. As a reflection of the forced adjustment, all countries in the world are experiencing surpluses in the trade balance. All but one: the US.

It opens up its economy and in doing so it cause a massive transfer of income and capital from the rest of the world to the United States. A very important aspect is that it enables to close the structural financial deficit of the public sector. Everything happens as if every time the Fed throws government bonds on the market, it is sure that the bonds will be placed in all banking structures and with all rentiers in the world. The essential fact is that **the whole world** is financing not only the American Treasury, especially its financial component, but also American consumers and investors. This time, and unlike the 1970s, there was a transfer of “real savings” and not just credit, liquidity or speculative capital.

Another issue that needs to be clarified concerns the influence of the rate of interest on investment. Many people say that the high level of real rates of interest will end, sooner or later, curbing investment spending. I want to warn that Americans are not financing investment through the capital market. There is no new capital market; the relevant market today is the money market. Americans, it is worth reaffirming, are replacing traditional long-term debt (through the issuance of debentures, stocks, etc.) with short-term credit or using their own resources and risky capital. On the other hand, it is clear that this situation puts many old companies and the value of their shares and debentures at risk. If a large company wants to launch, as several have tried to do recently, some billions of bonds in the debentures market, in a week this same company will be obliged to repurchase them, because otherwise, the value of the shares will certainly fall. That is to say, the only real risk that the United States is taking is that of suffering a brutal devaluation of the old companies whose shares are listed at a different price than the effective one. By the way, all the big banks that got involved with investments in the “old” productive branches, or in energy and agriculture, went through and are still going through serious problems. Continental Illinois’ technical breakdown is a clear example of this. On the other hand, all those who invested in California, in the Silicon Valley, in services, are in an extremely favorable situation.

Returning to the main argument, there is no longer a *stricto sensu* capital market in the US. The relevant market has been that of money. Their open and overnight market is no less crazy than ours, although it is Fed-controlled madness and not the Brazilian “inverted” madness. Their public debt is no less crazy than ours, but it is “profitable” since it is being financed through the rush of all banking capital in the world to the US, which obviously does not happen with our public debt anymore. Thus, while we are obliged to solve the domestic problem of public financing at the expense of inflation and the dramatic rise in domestic rates of interest, the United States is no longer under any pressure in this regard. Its rates of interest may fall as long as it maintains

a slight differential from European countries. It can thus be said, in the light of events earlier this year, that “confidence” in the dollar from Reagan’s victory and “forced solidarity from international bankers” is hard to shake. Thus, the devaluation of the dollar did not occur, even with a looser monetary policy of the Fed and with the increase of the American deficit. On the contrary, the European Core banks have dedicated themselves since the end of 1984 trying to avoid the devaluation of their own currencies. England has just paid for its services to the US, suffering the biggest devaluation of the pound in a week.

The US does not need to solve its domestic financing problem as long as the growth rate of European countries is lower than the rate of American growth, as there is no chance that the capitals of the rest of the world will decide to invest preferentially in their countries of origin while they do not resume sustained growth rates. So far they are investing preferentially in the US, while national policies are aimed exclusively at insuring industrial production structures and, in the case of the European Common Market, also food production structures. The countries of Europe have not formulated, since the recessive adjustment, any plan to solidly restore their global economic growth. They just played individually and tried to protect themselves so that Japan would no longer invade their markets. But at the same time that inter-capitalist competition is intensifying in the rest of the world, there is a fantastic increase in the efficiency of modern industries in Japan and in some countries in Europe. And, as we have already seen, the United States is taking advantage of this situation to modernize its productive structure at the expense of the rest of the world, including the Latin American periphery, which in the past few years has transferred almost 100 billion dollars between interest and terms of trade loss.

The European and Japanese response has necessarily been an “alliance” with the United States; but its long-term destiny as the “periphery” of the “center” is yet to be seen.

The arrogance with which the Morgan Report considers it a privileged area of American interest and its “expanded base in the Pacific”, which includes Canada, Mexico, Japan and the Asian NICs (Newly Industrialized Countries), is seriously worrying Europe. The continent remains paralyzed, for security reasons, by strategic automatic alignment relations with the United States and by economic reasons due to its own inability to make a common economic policy, starting with monetary policy. England and Germany, each in their own way, played a decisive role in defeating the projects of European social democracy and socialist France melancholically succumbed to their national projects.

We hope it is not too late when they react politically and they are not condemned to the role of the second periphery of the US.

If the US is able to maintain the current policy with the same vigor until 1988, without causing an internal or international financial crash (a possibility that becomes increasingly remote), then it will have completed a decade – from 1978 to 1988 – of liquidity absorption, capital and credit from the rest of the world. It will also have achieved five years of growth at the expense of the relative stagnation of its most important capitalist competitors. It will have financed the modernization of the tertiary sector and the remodeling of its industrial structure taking advantage of the “external economies” of the rest of the world. Thus, the revival of hegemony ended up finally converting the American economy into a **Core** and not just dominant economy. Any similarity to 19th century England is a mere baseless analogy, given the continental weight of the US and the existence of the Soviet Union.

The structural problems that the United States has yet to solve concern the readjustment of its basic infrastructure, which cannot be done with debt and short-term capital. This requires a prior process of bank consolidation and restructuring of the American domestic debt. Compared to the volume of the American debt and its fiscal deficit, the Third World debts are a drop in the bucket.<sup>100</sup> We lost the initiative and the ability to “blackmail” American banks in 1982. Should the recycling of the financial structure occur, and only then, the US will be able to let the dollar slide again. If the dollar depreciates before that happens, there will obviously be a massive capital flight and, as a result, the American financial system could break down. That is why, unless it cannot avoid it, the US should not allow the dollar to devalue substantially until at least 1988.

If these assumptions are confirmed, and the United States does not change the relationship between the Fed and the Treasury with the banks, Brazil and the other Latin American countries will be condemned to renegotiate the foreign debt year after year, if they do not take individual and collective measures of cooperation to face this state of affairs. In any event, Brazil will be forced to pay at least part of the interest due to international bankers and to try to capitalize the remaining part. The export effort that has been going on in recent years is nothing new, but it is following an entirely different pattern from the one that prevailed until 1978.

In fact, in the 1970s, especially in the period of chaotic indebtedness, which began in 1977, Brazil made a huge export effort, having diversified

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<sup>100</sup> Incidentally, one of the possible explanations for Solomon's and Volcker's change in relation to the capitalization of interest on the peripheral debtor countries (with which they seemed to be in agreement until July last year) may be due to the fear of a change in the rules of the game that ends up hitting hard at home.

its foreign trade structure. In this period, the Brazilian trade balance was in surplus in relation to Latin America, Africa and the socialist area, and in deficit only with the countries of the Middle East. With regard to the US and Europe, the Brazilian commercial position was relatively balanced until 1978. Since this year, we have started to face a violent destabilization in the international markets of non-convertible currencies that forced us, especially after 1982, to change the trade structure entirely. We have moved into the condition of increasing surpluses with the US and Europe, and we have a more or less balanced trade balance with the rest of the areas to which we export, in addition to making a violent effort to replace oil.

If the US wants us to pay the interest bill, it must let Brazil accumulate a trade surplus equivalent to the amount of due interest. In fact, this is not happening, as we are maintaining a surplus with the US higher than the remittance of interest to American bankers, although lower than those paid to the international banking system as a whole. This is evidently an untenable situation, both for us and for European bankers. When our surplus with the US stops growing due to the slowdown in the American economy and the growth of the surplus with Europe and Japan does not keep up compensatively (given its low growth rates, protectionism and the continued appreciation of the dollar), Brazil will only have the alternative of negotiating hard. Even a conservative and recessive policy will be useless given the low level and coefficient of imports already achieved.

Of course, the problem of protectionism remains an important source of conflict, but the United States will be willing to give up to the limit of what we need to pay in interest due to its bankers. Even so, we will hardly be able to maintain a surplus with the US above the global amount of interest. If we renegotiate the debt and the amount of interest to be paid is lower, then, automatically, the surplus should also be smaller. That is to say, the growth prospects for exports depend on a tenacious trend: the conditions for debt renegotiation and American and European protectionism. In short, we have been entirely subject to American economic policy in terms of export policy, exchange rate policy and debt policy specifically.

For this reason, the exchange rate policy has been carried out in the last two years, disregarding entirely the structure of export prices and its effect on inflation and terms of trade. Brazil has been making currency devaluations beyond what it needs, in terms of its domestic price structures, exclusively to compete. Contrary to what has been said, we are, in terms of the internal cost structure of exports, depreciating excessively and, therefore, losing in terms of trade. In other words, we are once again being forced to do the opposite of the United States.



The United States will not (and cannot) give up its special relationship with Japan, Germany, Canada and Mexico, as these are economic and political spaces that it needs to control in some way. In my opinion, the countries of the Southern Cone are not important for the American growth and trade strategy. In the case of Brazil, in some markets we are suppliers of second line of agricultural products, in the spaces opened by the cyclical fluctuations of the American supply. This is where competition will be fiercer and give rise to conflicts, if we intend to maintain our position in the international market in the long term. Textiles, footwear, metallurgy and machinery are sectors in which we will have to face the competition from other countries for the American market. From the point of view of American direct investment, the “coveted” sectors have already been publicly and repeatedly announced. It has *a priority* interest in the sectors of information technology, banks and arms, the ones over which it wants to maintain an undisputed hegemony and those that present the greatest possibilities of expansion in the long term for American capitals already based in the country.

Apart from these “contentious” areas, which may continue to be carried out competently by Itamaraty, what remains is to know whether Brazil is able to behave as a “sovereign debtor” and renegotiate its external debt without giving in to its interests and without creating false psychological “black-mails,” which cannot be practiced, and which would make our population even more frustrated. What is intolerable, however, is not recognizing our right to survival and our capacity for self-determination, under the pretext of “automatic alignments,” false assumptions about the importance of Brazil and its preferential relationship with the US.

The so-called “naive arrogance of caboclo nationalism” is disappearing, despite the conservatives’ efforts to revive it as a scarecrow. A sovereign country is one that recognizes the world reality, but is not intimidated by it, making correct choices and negotiating with seriousness and responsibility, trying to overcome the limits of the Present to make room for the Future.

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## CHAPTER 9

# WAGES AND PRICES: final remarks

*Paulo Eduardo de Andrade Baltar*

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It is impossible to summarize a Doctoral Thesis in brief conclusions, given the breadth of the themes discussed in it (Baltar, 2003). Rather than making a failed *a priori* attempt, we have chosen to highlight two Core issues for the contemporary debate on the labor market and wages.

The first one is a tight synthesis in which we seek to rescue the essential and specific nature of underdevelopment that has led to an endless and, in our opinion, mistaken controversy, about the functioning of the labor market in countries of late and peripheral capitalism.

The second issue concerns the way in which wages are considered in the specific inflationary context of the current global economic crisis, focusing on the situation in developed countries. Both the crisis and the theories about inflation originated in these countries animate and confuse the contemporary debate.

### **1. Wages and underdevelopment**

To structure the argument, let us focus the discussion on wages considering the marked contrast in the behavior of the level and distribution between developed and underdeveloped countries in the post-war period, when the American industrial and consumption pattern became widespread in the capitalist world. These productive transformations implied great increases in productivity. However, while in developed countries wages increased with productivity, enabling the diversification of the consumption of wage earners by incorporating the population into the mass consumption of durable consumer goods, in underdeveloped countries the majority of the population, even the wage earners, although not entirely excluded from the consumption of these products, did not constitute the basis of its market, reflecting the fact that wages did not keep up with the increasing productivity.

We associate, in the first place, this difference in wage behavior with the fact that developed countries resumed growth in the post-war period with a reasonably consolidated urban-industrial society, having an economy with a much less heterogeneous structure than that of underdeveloped countries, and not having suffered, during the period, such intense sectoral and geographical

population displacements. The problem, however, is how to concatenate causal relations so that this association, which has an intuitive appeal, becomes more analytically clear. Our starting point was a discussion of views deeply rooted in the tradition of Latin American thought on economic underdevelopment. These views linked low wages to surplus labor and the latter to the limitations of the industrialization process in underdeveloped countries. They thus suggested that it was a problem that could be overcome by the intervention of the State through a deliberate policy of economic development.

However, the intensification of industrialization did not overcome the exclusionary character of peripheral economic development, nor did it provide the necessary structural conditions to raise wages alongside productivity in order to increase the consumption of the majority of wage earners, making it the basis of the market of durable consumer goods, notably those with higher prices. On the contrary, there was a deepening of social and income inequality that took on new nuances.

This verifiable fact alone suggests the need to seek a specific explanation of poverty and social and income inequality, in the sense that they are not simply considered as a mere reflection of the economic-productive backwardness. In our opinion, reflection on this issue should be conducted based on the discussion of what was assumed as hypothesis, that is, the relationship between surplus labor and wage formation.

Following the proposal of Paulo Renato Souza and Maria da Conceição Tavares, we place the question in opposition to Arthur Lewis' classic thesis, who emphasized without further mediation the effects of surplus labor on the formation of wages, in order to provide an elastic supply of labor, at a given real wage, equivalent to the standard of living obtained in small subsistence agricultural production. In this perspective of facing the relationship between surplus labor and wages, a precondition for economic progress to finally allow for raising wages and diversifying by expanding the wage earners' consumption – as the case in developed countries – would be that the capitalist development surpassed the traditional agricultural production, and its duality, through the unification of the labor market.

We believe that progress is being made in the study of the relationship between surplus labor and wage formation by not taking that surplus as a simple result of the economic backwardness, which would influence wages by allowing an elastic supply of labor at a real wage equivalent to the standard of living subsistence in the countryside or in the urban informal sector. Thus, it is possible to highlight more clearly the need to study how the heterogeneity of the labor market is reproduced with the development of capitalism.

However, distinguishing two different problems is necessary. First, we highlight the issue of functionality of existence of the informal sector. If it were

true that it contributes to raising the pace of capitalist progress, for example, by helping to lower the cost of reproducing the labor force, the informal sector should not be considered a haven for surplus labor. Another issue is the very characterization of the informal sector as a haven for leftovers, considering it as a remnant of the past associated with the condition of economic backwardness in underdeveloped countries or, on the contrary, emphasizing its structural character in the reproduction of the informal sector with capitalist progress. For the study of the relationship between surplus labor and wages, the second issue is more important than the first. Regardless of whether it contributes or not to increase the pace of capital accumulation, it is key to highlight the informal sector as a structural element of a heterogeneous system that is reproduced with capitalist progress, thus highlighting its mercantile relations directly with capitalist companies or indirectly through the circulation of income generated predominantly in the capitalist core of economic activity. With this it is possible to emphasize that the capitalist progress not only does not incorporate in the paid employment all the active population, but also by reproducing its mercantile relations it allows the survival of those who constitute the surplus labor.

In this perspective of facing the surplus labor, the informal sector is defined, privileging its mercantile character and emphasizing the absence of capital and therefore of its valuation as an objective. The essential nature of the informal sector would lie in the mercantile, but not capitalist, nature of its production. From this last aspect of informal production, the technical-economic characteristics that describe informal productive units would be derived as limited in terms of scale, division of labor and mechanization, as well as the peculiar way and the meaning of the expansion of their activities as vegetative growth by proliferation of producers in search of survival.

Note, however, that informal producers and small companies are being conceptually distinguished. The distinction may seem subtle, because, after all, informal productive units present aspects similar to those considered typical of small companies in certain capitalist market structures such as small scale and growth due to the proliferation of productive units instead of expanding the existing production scales, which is more typical of the big capitalist company. In fact, these are common aspects associated with the small size of the productive unit, regardless of its informal or entrepreneurial character. However, strictly defining the notion of the informal sector as an aspect of the structural heterogeneity of the underdeveloped economy, which is reproduced through capitalist progress, it actually results in a differentiation of markets and not simply differences between types of productive units.

However, the establishment of this distinction and the relevance of its implications for the analysis of the informal sector and its influence on wages

require a wider than usual notion of market and competition, restricted to the study of prices (as if it were possible to isolate this variable), which privileges the most evident aspects of the methods used in the disputes of producers in the market through prices, product quality and various forms of sales promotion.

In the distinction between capitalist and informal markets, it is important to highlight the differences in the nature and implications of the competitive process in terms of the potential for transforming the economy structure. The latter would be typical of competition between capitals in valuation in production, although it assumes specificities and differentiations in terms of the different structures of the capitalist market, with their peculiarities in terms of competition patterns.

Due to its transformative potential, it is possible to consider capitalist competition in production and markets as the engine of the economic system dynamics, which generates its spaces even when they are not fully occupied by capitalist companies. On the contrary, informal activities would be limited to filling the economic spaces not occupied by the capitalist company, not being able to create the spaces it occupies, with which its behavioral dynamics can be considered a reflection of the capitalist dynamics.

Even when small, the capitalist company is inserted in a capitalist market and participates in a competition between capitals. Its profitability reflects the conditions under which this competitive process takes place in terms of the actual and potential advantages of the different companies, including regarding their respective financial situations. Although small businesses are often just accommodating to the expansion strategies of market leaders, their existence presupposes minimal profitability, since they are primarily the result of a capital investment.

This is not the case in the informal sector, and for this reason the level of per capita income of its different segments can be considered as an immediate result of an adjustment between its economic and populational dimensions. These two dimensions of the informal market are explained or determined independently of each other and in relation to the prevailing level of per capita income, based on the behavior of the capitalist core of economic activity, its pace and peculiarities of development.

Then, there is a distinction between informal income and capitalist profit, even though in certain special circumstances informal activity allows for a relatively high level of subsistence compared to that prevailing among wage earners. On the other hand, the peculiar fact of informal production - that both the number of producers and the economic space available for their activities derive from the pace and peculiarities of the development of the capitalist core - also allows to distinguish the determination of the average level of income in the informal sector wage formation. In contrast to the informal sector, in the

wage labor market the number of employees is an immediate consequence of the existence of a demand for work derived from the companies' production decisions, given the technique and organization of the productive units.

Therefore, wages, unlike the average income of the informal sector, should not be seen simply as an immediate result of an adjustment between a given economic space and the available labor because, contrary to informal occupation, paid employment do not arise for the simple fact that there is a labor force available.

The previous statement does not deny that the level of wages can exert some influence, complex and of indefinite *a priori* meaning, on wage employment. It just highlights the differences in the process of generating employment and informal occupation, and from them the different nature of determining wages and of informal average income is affirmed. This, however, is sufficient to problematize any attempt to establish a direct causal relationship between the levels of wages and of informal average income, even in purely nominal terms. However, in principle, the possibility of a more general relationship between surplus labor and wage formation is not denied, particularly in the so-called base of the wage labor market.

Thus, the great pressure of the surplus labor, which is the main responsible for the behavior of the level of informal average income, does not necessarily have the same direct and immediate influence on the level of wages. Its influence depends on the peculiarities in the organization of the wage labor market, which not only reflects the presence of a surplus labor, but also the characteristics of the industrialization process of underdeveloped countries.

In fact, the assumption that the average informal income, to the extent that it influences the supply of paid employment, would determine the level of wages, has driven a large part of the debate about the influence of the surplus labor around a false question and covered up the implications of how the economic structure of underdeveloped countries was transformed, with the industrialization, on the shape of the wage labor market.

However, it seems to us that it would be a mistake to try to generalize about the forms of organization of the wage labor market based on the consideration of the industrial structure characteristics. In fact, we can observe that basically similar productive structures gave rise to different forms of organization of the wage labor market. These forms not only differ in the configuration of the various specific market segments, but even present jobs that, if in one situation are part of specific segments, in the other belong to the base of the wage labor market.

However, we believe it is possible to affirm that, in general, the stability of a certain productive structure facilitates the consolidation of a determined organization of the wage labor market. In other words, the simple expanded

reproduction of the same productive structure over time helps to consolidate certain patterns of labor specialization, making it preferable to certain jobs and specific industries, thus contributing to stabilize the existing employment relationships. The opposite could be said when radical transformations occur in the productive structure, in the competition patterns of capitalist markets and in the spatial distribution of economic activity which, to the extent that they cause intense sectoral and geographical shifts of labor, can contribute to destabilize the organization in the wage labor market.

Extrapolating these general considerations, we affirm that a labor market tends to be more fluid or, on the contrary, more rigidly structured, due to the speed or slowness, continuity or discontinuity, with which the productive apparatus of the capitalist economy is set up and transformed. Our hypothesis is that the situations of a country that builds its productive structure in a period that extends for decades and of another that sees the emergence of several industries simultaneously in a short period of time would be very different. In the latter situation, a wage labor market with a very broad base would tend to prevail, which includes a high proportion of the jobs in the various industries and a few small and rigidly structured segments.

In the first case, the emerging industries recruit labor predominantly in the pre-existing industries and give rise to broad segments of the wage labor market, thereby establishing the structural conditions for workers to bargain for global wage increases that accompany the increase in productivity, allowing the vast majority of wage earners to incorporate, in their consumption structure, the new goods and services that are being introduced by industrialization. In the second case, the new industries recruit labor from an undifferentiated urban mass and little adapted to the discipline of industrial work and which finds economic spaces to survive outside wage employment, including in the interstices of the productive apparatus under construction. Despite this, the growing dominance of this by industrial capital ends up causing the reproduction of informal markets to take place mainly outside the productive system, in the service provision, with the exception of industries that for technical reasons do not provide advantages of scale and where mechanization is difficult and therefore tend to maintain a close interface between the formal and informal sectors.

The recurrence of sudden and intense outbreaks of deepening industrialization, which can even provoke intense industrial booms, increasing wage employment at a rate higher than that of the urban working population and momentarily reducing the proportional magnitude of the surplus labor, permanently replaces the conditions for a high turnover in employment and a lack of specialization for a significant fraction of the paid labor force. This, in



principle, contributes to keep the wages of most workers low, while increasing wage dispersion during these industrialization surges. The experience of developed countries shows that the mere existence of a surplus labor is not enough to imply low wages. Even in countries that underwent profound changes in the structure of their economy during the post-war period, the existence of a previously built urban-industrial base helped to reconcile a relatively large surplus labor with a rigidly structured wage labor market and with a relatively narrow base, which facilitated the increase in wages with productivity and allowed to expand and diversify the consumption of the majority of wage earners.

However, the concrete form of organization of the wage labor market is not subject to generalization. It depends fundamentally on the way in which the workers' and trade union movements accommodate themselves to the structural transformations of the economy, and this accommodation depends essentially on factors of a historical and socio-political nature. We just underline that, for most workers' wages to keep pace with productivity, a precondition is that the labor market does not have a very broad base. This last fact tends to occur in underdeveloped countries that are more advanced in industrialization, not so much because of the characteristics of their industrial structure – similar to that of developed countries – but because of the speed and discontinuity with which it was set up and the peculiarities of the urban environment it faced. This, much more than the simple existence of a large surplus labor, has to do with the low wages and great dispersion that prevailed in those underdeveloped countries.

However, the peculiarities of the organization of the labor market are not sufficient to explain the low wages and their great dispersion in the underdeveloped countries that have made the most progress in industrialization. By themselves they do not account for why wages did not keep up with productivity, preventing the expansion of the consumption of the majority of wage earners, who for this reason were not the basis for the expansion of the markets for new products introduced by industrialization. It would not be enough to highlight the effects of industrial capital on the organization of the labor market, in the sense of not generating the necessary structural conditions for the wages of the vast majority of workers to keep up with the productivity and labor intensity, characteristic of the industrial structure set, which denotes the presence of overexploitation. It is necessary to explicitly consider another aspect of the issue, which concerns the purchasing power of wages and the consumption structure of the population.

A characteristic associated with the condition of economic underdevelopment, displaying more closely concrete aspects of certain societies, particularly

concerning the State organization, in many underdeveloped countries that have advanced towards industrialization, we highlight the fact that a substantial portion of the goods and services consumed by wage earners is produced outside the industrial system and shows increasing relative prices. In part, this phenomenon is a consequence of the economic backwardness manifested in a peculiar agrarian structure that involves the organization of production, the distribution of land ownership, the land tenure regime and the commercialization patterns of products, in the State's inability or unwillingness to provide adequate urban infrastructure and in the consequences of structural problems of balance of payments. However, it also reflects problems associated with the type of modernization or "development style," rather than the economic backwardness. Perhaps the most illustrative case of this is the development of modern agriculture focused on agro-industry and/or exports, which instead of guaranteeing a minimum food standard for the population ended up sticking the prices of its products to those prevailing in the international market, suffering the influence of the contingencies of this market as well as those of the exchange rate evolution.

In the previous argument, the behavior of wages was analyzed as an aspect of the unfolding of a pattern of industrialization that characterized the post-war period. We noted the differences between developed and underdeveloped countries and related them to the peculiarities of these two types of economy in terms of the organization of the wage labor market and the evolution of prices external to the industrial system. They would account for the fact that wages followed productivity in developed countries without at the same time deepening wage dispersion and differentiating consumption structures among wage earners, exactly the opposite of what happened in the underdeveloped countries with more intense industrialization in the post-war.

## **2. Wages and inflation**

The confrontation of the current global economic crisis with that of the 1930s shows the peculiarity of the acceleration of inflation simultaneously with the increase in unemployment, drawing economists' attention once again to the issue of determining employment, wages and prices. The current inflation with unemployment also contrasts markedly with the prolonged and intense growth of the world economy in the post-war period when in the developed capitalist countries, the real wage seemed to increase in line with the productivity. Empirical evidence in this regard has been interpreted by some as a symptom of a change in the very nature of wage determination processes, which would have been functional for the performance of the economy while

prosperity lasted, but which would have become an obstacle to the rebuilding of the economic activity, contributing to accelerating inflation.<sup>101</sup>

The essence of the change in the nature of wage determination processes would lie in the gradual transformation of wage negotiation into a progressively collective contractual process, which would have gradually reduced the influence of the labor market. Indeed, post-war wage behavior meant, first in the United States and then in Europe, a substantial change in the standard of living of the working class and contrasted in many ways with what happened in earlier times. Since the consolidation of capitalist production, it has always been possible to observe a close influence of the pace of economic activity on the nominal level of wages, noting however very different movements by occupation, industry and geographic locations due to changes in the behavior of employment and available labor force. While monetary wages seemed to respond in some way to the pace of economic activity, real wages better reflected price movements, which often also varied in the same direction of production and to a greater extent than that of monetary wages.

To a large extent, the disproportionality of changes in prices and monetary wages in the cycle of economic activity can be attributed to the behavior of exchange relations between primary and industrial products. While in the expansion of economic activity the increase in the relative prices of primary products restricts the rise in real wages despite the possible increase in monetary wages, in the downturn the fall in the relative prices of primary products facilitates the accommodation of industrial costs to a slight decline in monetary wages with a possible increase in the real wages of those who still manage to remain employed.

In the post-war period, however, there was a widespread increase in real wages during a prolonged period of intense economic growth. Many associated this real wage behavior to the absence of significant, rather than cyclical, disturbances in the exchange relations between primary and industrial products and to a relative stability of profit margins in industrial production.<sup>102</sup> As a slow and dragging price increase was observed at the same time, it was basically attributed to an increase in nominal wages above productivity gains, if not in all, at least in some industries.

Initially, two different approaches prevailed in an attempt to explain this increase in nominal wages above productivity. On the one hand, that of cost inflation, which highlighted the wage demands in the collective bargain, and on the other, that of demand inflation, which emphasized the expansion of employment with the growth of effective demand. This controversy

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101 See, for example, Boyer (1979).

102 See among others Kaldor (1976); Cripps (1977) and Robinson & Wilkinson (1977).

surrounding the origin of the monetary wage increases was somewhat interrupted by Phillips' statistical finding on the existence of a stable relationship between the pace of growth in monetary wages and the unemployment rate, which helped to consolidate the explanation of inflation centered on existing labor market pressures.

Note that the discussion around the Phillips curve concerns the behavior of the general level of wages and not only specific sectoral variations that could mean simple changes in the profile of wage differences. Even among authors who, despite the different behavior of employment by industries, consider the relative permanence in time of interindustry wage differences as contradicting the interpretation that takes them as a result of simple random disturbances in relation to the competitive norm of the labor market functioning, some still highlight the influence of the unemployment rate on the level of wages, including that of industries that do not show significant fluctuations in employment.<sup>103</sup>

In fact, in developed capitalist countries, during the post-war period, wages do not appear to have increased to a greater extent in the industries and geographic locations that showed the greatest growth in employment. There is evidence not only of a certain stability in the ordering and differences in wages between industries, but also of an association between them and the concentration of production in large productive units and the profitability of the industries.<sup>104</sup>

Many authors have interpreted those statistical results as a symptom that high-wage and rapidly growing job industries are more able to pay wages higher than strictly necessary to attract and maintain adequate labor, and that they do so as a result of the combined influence of the peculiarities of the market structures of their products and the labor they use, reflected even in a greater degree of unionization and a greater bargaining power of the union.

Nevertheless, the previous proposal does not rule out the possible influence of the global situation of the labor market on the behavior of wages, as it would be necessary to explain why wages increase at a similar pace in low-wage industries, including those with slow employment growth. One possibility that cannot be ruled out *a priori* is that in a time of rapid and prolonged expansion of employment led by many of the high-wage industries, low-wage industries may find themselves facing difficulties in retaining the necessary labor force, being forced to increase their wages, despite a slow growth in employment.<sup>105</sup> This proposition assumes not only a faster global

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103 See for example Wachter (1970).

104 See OECD (1975).

105 See Wachter (1970).

growth of employment than the availability of labor, but also that, when this situation occurs and the unemployment rate is already low, there are greater possibilities for workers normally employed in low-wage industries to move to industries with high-wages and fast-growing employment.

Other authors despise the influence of the global labor market situation and directly emphasize workers' wage claims in collective bargaining with their employers.<sup>106</sup> They are also obliged not only to show the reasons for a general increase in monetary wages, but also to present an alternative mechanism for determining wages that overlaps the market competitive forces, leading to an increase in wages regardless of the situation of scarcity or abundance of labor.

As Joan Robinson suggests, while there is a logical possibility of a pure wage-centered cost inflation scheme, it is more plausible that economic growth will generate extraordinary increases in profits with or without increases in prices and profit margins.<sup>107</sup> This high profitability in some industries could lead to localized increases in monetary wages from the attempt of their employees to take advantage of the situation to improve the standard of living, with or without the presence of labor shortages. If these monetary wage increases were to spread to other groups of workers through their respective efforts in an attempt to maintain the relative position of their wages, there would be a general increase in wages and prices, the latter being mainly in the industries with slower productivity growth.

However, the idea that there is a rigid and well-defined structure of relative wages that encompasses the economy as a whole does not seem plausible.<sup>108</sup> In fact, when considering groups of workers strictly defined according to the wage comparisons established between themselves, significant changes are observed, either in their ordering, or in the magnitude of the differences between their respective average wages. It seems, therefore, more plausible that the relative similarity of wage increases in the economy should be attributed not to the existence of a rigid set of wage relativities, but to the presence of common causes that affect the different independent wage fixations. If this is the case, then it would be necessary to explain the nature of these common causes that end up causing a general increase in wages.

One of the main common causes of the widespread increase in wages is the very rise in the cost of living, which enters as an argument in the negotiation of wages between employees and employers, through the attempt of the former to replace losses in the purchasing power of wages. However, the

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106 See Cripps (1977) on this.

107 See Robinson & Wilkinson (1977).

108 See Cripps (1977) on this.

effectiveness in protecting the real wages already achieved varies between groups of workers depending on how quickly they react to the rising cost of living. It is possible that some may only do so with a lag.<sup>109</sup>

However, if the rise in the cost of living is expressive and persistent, it may motivate the emergence of militancy and workers' organization, so, as Joan Robinson said, it seems more correct to assume that it is inflation that generates the union, than to attribute to the union the source of inflation. Indeed, as noted in the late 1960s and early 1970s, unionism spread widely not only among previously disorganized manual workers, but also among office workers and civil servants, and even among independent professionals who, in the face of rising prices, had to struggle in the same way as less "skilled" workers to prevent the fall in their respective standards of living only in part due to the success of other better organized workers (Robinson & Wilkinson, 1977).

It is symptomatic the widespread inclusion of wage indexation clauses to the cost of living in collective labor contracts. Some authors interpret it as a symptom of semi-explicit recognition of the existence of a minimum level of consumption by employees.<sup>110</sup> In fact, as long as there is no sudden acceleration in the increase in the cost of living, the indexation of wages guarantees the maintenance of the average wage between successive periods of validity of wage contracts, although there is a permanent decline in wages during each of these contracts.

The indexation of monetary wages to the cost of living seems to suggest that it is easier for workers to seek compensation after they have actually raised prices than to try to anticipate these increases.<sup>111</sup> It is true that, in the face of chronic inflation, workers perceive the insufficiency of simply restoring past losses in the purchasing power of their wages. However, the effectiveness of wage negotiations between employees and bosses in terms of preserving adequate working relationships requires a reference that can give it a minimum of "objectivity." The increase in the cost of living in the past contributes more to this "objectivity" than the prediction of future price behavior, particularly in stable industrial markets with prices shaped from costs. And if inflation is not constantly accelerated, the indexation of wages to the cost of living at least guarantees the preservation of the real average wage for the duration of the wage contracts. However, the generalization of the indexation of wages to the cost of living is more evident in conditions of continued acceleration of inflation and, in this situation, the non-anticipation of price increases by

109 See Robinson & Wilkinson (1977) on this.

110 See, for example, Boyer (1979).

111 For a contrary opinion see Rowthorn (1977).

workers in the wage bargain means a recurring loss of purchasing power. However, everything indicates that, in view of these circumstances, it seems more plausible that workers, instead of trying to include in the wage adjustments a margin for anticipation of the inflationary acceleration, try to shorten the period of validity of the wage contract or even try to establish some type of sliding scale of wages, in which the very duration of the contract depends on the pace of inflation.

The experience of developed countries in the post-war period showed how the sustained growth of economic activity and the increase in real wages can be compatible with stable inflation at a slow pace. While it lasted, the long prosperity was accompanied by the diversification in the consumption of wage earners, which, especially in European countries, was contemporary to the sharp changes in the industrial structure. Although the expansion of consumer credit and possible changes in the relative prices of products were very important in this process, the role of the behavior of monetary wages cannot be overlooked.

It was only with the exhaustion of this long prosperity from the end of the 1960s that the problem of inflation worsened, triggering an escalation in prices and wages at the same time as the decline in the pace of economic activity. Despite the increasingly recurrent symptoms of the global crisis, money wages continued to rise. The reasons why this occurred, in the face of growing unemployment and the marked precariousness of the economic and financial situation of many companies, should be sought basically in the explanation of the acceleration of price increases.

As Conceição and Belluzzo show, the impossibility of establishing a stable parity in the purchasing power of the main currencies – as a result of the rupture of the international monetary standard – ended up triggering upward movements in interest and exchange rates, destabilizing supply and debt contracts that are essential for the formation of industrial production and prices. It is in this destabilization of contracts and in the attempt to anticipate changes in interest and exchange rates by industrialists, in order to avoid the devaluation of capital, that lies the explanation of the recurrent inflationary acceleration. In the face of it, monetary wages respond late, trying to recover the purchasing power lost with the rise in prices.

It is not, then, the contractual rigidity of monetary wages and their indexation to the cost of living that are at the root of the decline in production and the increase in prices. As long as the duration of wage contracts is longer than the interval for setting industrial prices, usually (but not necessarily) marked by the industrial production planning period, wages will remain a stable cost item, despite increasing with each renewal of wage contracts. Only in the

extreme case in which inflationary acceleration motivates the reduction of the periods of validity of wage contracts, making them shorter than the periods of price formation and production planning or, what would be less plausible, which incorporated expectations about inflation in the future, it is that monetary wages would become an element that feeds inflation, contributing to raise the desired profit margins on current costs in industrial production.

Thus, it does not appear that the collective contractual nature of wage negotiations in contemporary capitalism has much to do with the origin of the simultaneous acceleration of inflation with the increase in unemployment, peculiar to the current world economic crisis. In fact, as the recurring failure of income policy experiences in some developed countries illustrates, particularly those with balance of payments deficits and high inflation, the willingness of union leadership to collaborate with the government to alleviate the situation does not appreciably reduce inflation, only exacerbating trends in the decline in the purchasing power of wages.

And it is not only, as Hicks wants to believe, that income policies are not able to offer reliable prospects of stability, indispensable to any lasting recovery, because they only freeze the structure of relations between the wages of the various existing jobs, in circumstances such that a recovery requires the creation of new jobs and not just the replacement of people in the old ones, lost during the crisis (Hicks, 1983).

It is true that the world economy seems ready to undergo profound structural changes with the prospect of the emergence of new industries and sharp changes in the productive structure of existing ones, a process that is already underway. Possibly these transformations will drastically change the profile of the composition of employment. This can be accompanied by the need for higher wages for the formation of new segments of the labor market, despite the presence of high global unemployment. However, it is not convincing to attribute to these possible events the current difficulties in triggering a lasting recovery. It seems more plausible to consider that what is disturbing the capitalist calculation in production and making recovery difficult is not the instability of wages, but the very uncertainty involved in those structural transformations that are likely to mean a profound change in the international division of labor and in the economic structure of the various nations.



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# CHAPTER 10

## WEALTH AND PRODUCTION: Keynes and the double nature of capitalism

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*In honor of Maria da Conceição Tavares*

### 1. Effective demand, capitalist production and instability

The principle of effective demand states that the level of income and employment in the community is determined by capitalist spending decisions. These decisions (given the stock of existing equipment) are taken from evaluations carried out in **isolation** by each capitalist on the quantities they imagine to sell at a certain (supply) price. The set of capitalist spending decisions (and not their sum) determines **at each moment in time** what the community's income level will be. Therefore, what the capitalists are spending **now** on the production of consumer goods and investment goods (payments of wages in both sectors) is the community income. It is important to emphasize the simultaneity of production decisions in both sectors to avoid misinterpretations regarding the Keynesian multiplier or Kaleckian multipliers. In both authors, the idea of a multiplier seeks to establish a hierarchy of spending decisions in which decisions to produce investment goods today **determine** the volume that must be produced in the consumer goods sector (Keynes). More importantly, this hierarchy seeks to establish the type of capitalist decision that is fundamental for determining profit.

The *ex-post* multiplier, however, defines a relationship between investment and consumption which, theoretically, within the scope of the principle of effective demand can only be defined *ex-ante*, that is, at the moment when the capitalists make the decision to spend and produce. In this case, the multiplier is always equal to 1 (one). *Ex-post, post factum*, the multiplier may be greater than 1, but this is a national accounting problem and not a theoretical one. Once the theoretical nature of the multiplier has been established, we can say that the famous Kaleckian proverb – “workers spend what they earn and capitalists earn what they spend” – has several implications:

- a) macroeconomic profit is the result of the spending decision of the capitalist class as a whole in the production of investment goods.
- b) the growth of profits depends on what the capitalists (or someone for them) decide to spend above their current income (current profits).
- c) the acceleration of the investment rate that induces the growth of profits and income is a phenomenon of imbalance between the present spending decision and the ability to finance it through profits derived from previous spending decisions.
- d) the condition for the growth of the capitalist economy is that the capitalists are, together, permanently in “current deficit” to generate future profits.
- e) thus, indebtedness is a phenomenon inherent in capitalist accumulation.

Let us look at an economy where the players are businesses, households and banks. Companies determine the volume of expenditure, employment and income at each moment and the expenditure is made on the production of consumer and investment goods; households can use their income for the purchase of consumer goods and for the accumulation of financial assets issued by companies and banks (in the role of financial intermediaries). Banks, in addition to their financial intermediation function, create money to supply the demand for credit.

In this economy, income growth depends on the increase in investment and this can only be achieved macroeconomically by the indebtedness of the spending units. This investment, when generating profits, restores the liquidity conditions of the loans, that is, the generation of profits maintains the conditions for renewal of the financial fund administered by the banks and originally generated by the issuance of the banks’ **credit** against themselves and under the demand of those that will carry out the expense. The principle of effective demand only requires that a given spending decision be validated by the banking system as a manager of the money and financial funds of the society. Banks sanction the capitalist bet on the acquisition of new capital assets and the profits derived from this investment sanction the banks’ bet.

To examine the equity effects of this process of increasing investment, income, profits and maintaining liquidity conditions, we must work at the level of the agents’ behavior. At a given moment there is a group of companies that are making the investment expenditure and have already exercised the demand for **finance** on the banking system. This group of companies is running a deficit financed by banks. At the same time, another group of companies is reaping the results of their previous investment decisions, that

is, they are making a **surplus** – the gross profit. It is from this profit that they serve their debts, pay taxes and accumulate financial funds, allowing banks to renew their stock of **finance**.

Therefore, it is the continuous investment and indebtedness process that makes it possible to serve past debt. In other words, the economy is generating debt now so that past debt can be served. In this sense, the investment generates a trail of debts or entails the transfer of property if it is financed by shares. In fact, the possibility of redeeming debt when an investment boom ends raises very interesting questions as it involves changing ownership of assets and thus introduces permanent “instability” in ownership relationships. It is not by chance that the managers of the large masses of capital maintain a prudent relationship between the actions that define ownership and those that do not: the transformation of capital into fictitious capital allows expanded control over capital and this was the basis for diversification and monopolization. On the other hand, what is allowed is a greater participation of rentiers in the return on capital as function<sup>112</sup>.

The reduction in investment may mean for some companies the reduction of their own indebtedness, but from a macroeconomic point of view the fall in investment necessarily implies an increase in indebtedness because it removes from companies the ability to service past debt. In addition, the contraction in investment by depressing the internal funds of companies reduces equity and frustrates the attempt to reduce the degree of indebtedness. This means that if each unit wants to reduce its current deficit, the result for the group will be a worsening of the equity situation, as well as current commitments, due to the rigidity of the financial costs of the debt contracted in the past. The above conclusion would not only be verified in the hypothesis of a certain price dynamics: inflation following the fall in the rate of accumulation. The valorization of assets and the nominal rigidity of debts and non-indexed financial commitments would help to increase shareholders' equity and reduce financial costs. Evidently, in Fisher's hypothesis (1933), deflation would raise the level of indebtedness and increase financial costs. Steindl (1976, Ch. 9), however, showed that it is not necessary to suppose the “Fisher effect” for macroeconomic forced indebtedness to occur, in conditions of falling accumulation rate, even in the implicit hypothesis of passivity in the price movement. The indexing of debt values and financial commitments, on the other hand, has the theoretical meaning of reinforcing and expanding the effects of the Steindl hypothesis.

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112 There is a little-remembered passage from Kalecki (in chapter 8 of *Theory of Dynamics*) in which he clearly poses the problem. Funding the debt presents the risk of devaluation of the entire stock of fictitious capital and not penalties for “new” capital, derived from the investment.

If so, we must add rentiers as agents to the economy and inquire about their behavior (and that of households) in the face of falling investment. This was proposed by Steindl and Kalecki in their misunderstood approaches to the rentiers' behavior.

These agents, preserved from the process that leads to the fall in the internal accumulation of profits and the simultaneous increase in the indebtedness degree of the companies, could counterbalance these results, were it not for the "inelasticity of the rentiers' savings": the desire to accumulate rights over wealth subordinates the effects on spending that could have a drop in current income. That is, rentiers would resist a reduction in their stock of wealth rather than a downward adjustment in consumer spending.

The behavior of typical waged households is opposite. However, here, the formation of "deficits" is contradictory to the fall in income due to the decline in investment. Except in times of income growth or financial innovations that allow anticipated consumption, households do not have the autonomy to decide their expenditure and compensate for the fall in investment. The expenditure derived from wages depends on the willingness of the capitalists to increase the volume of employment. What we want to emphasize is, in this case, the eminently passive character of the workers' expenditure. These cannot compensate, with their deficits, for the reduction of capitalist deficits, although they can accentuate, with their deficits, an expansion driven by capitalist spending. This is the profound meaning of the Kaleckian supposition that workers do not save and the hierarchically determined character of income distribution.

Thus, the process of falling indebtedness, in an environment of reduced investment, can only occur with the intervention of an external agent willing to incur deficit and new debt. In the first case, to allow the decline in productive accumulation to not translate into a reduction in the internal accumulation of companies; in the second, to accommodate the unilateral reaction of rentiers, so that it does not materialize in the growing indebtedness of companies, although the trend towards forced indebtedness at the macroeconomic level remains intact until a new stimulus to investment reintroduces the dynamic conditions of growth profit and debt as a whole. As Kalecki noted, the State's decision to incur a deficit and a corresponding debt against itself has the same effect as net exports.

Let us now look at the issue of risk, related to rates of interest fixed in debt contexts.

At each moment in the operation of the effective demand circuit, we can find a structure of assets resulting from past decisions to which the fruits of present decisions are being added, regarding the ownership of capital assets

and the way to finance them. These assets are generally entitled to the capture of future income. The fulfillment of this promise will depend on the behavior of the investment and nothing is guaranteed *a priori*. However, the ownership of these assets was obtained through contracts of various types (terms, conditions and risk), which not only require certain and fixed payments but may include variable payments, according to the results of the current operation of assets. Debt contracts have always deserved special treatment because they finance assets of uncertain yield, forcing certain and regular payments. In this sense, the stability of the contractual conditions means a rigidity of the current financial commitments, that is, a doubling of the business risk when deciding the investment<sup>113</sup>. At the same time, in this case, a change in the rate of interest affects only the price of the assets and the financial commitments related to the new indebtedness. The debt already contracted, therefore, depreciates, but the flow of payments resulting from it does not change. The change in the rate of interest fundamentally affects the demand price for capital assets, the stock of assets that must now have their expected returns discounted at a higher rate of interest. The nature of fixed capital and the nominal character of financial contracts prevent the precipitation of generalized liquidation movements and require an adjustment in the margin of wealth portfolios and this will mean a shift towards more liquid assets. The increase in the rate of interest may, however, be such that it simply paralyzes the production of new capital assets. Assets already financed, whose trading value deteriorates, have the expected profitability also depressed by the dynamic effects of the fall in investment, despite the non-change in financial commitments.

The increase in risk for creditors and debtors will cause the economy as a whole to move towards the search for greater liquidity, both in terms of flows and portfolios. In other words, left to its own strength, the economy would tend to a relative paralysis of production and an even higher rate of interest, expressing the rise in the margin of the cost of disengaging from liquidity.

In this situation, the risks increase on both sides – creditors and final debtors. The debtors' risk increases because the conditions for covering the assumed financial commitments deteriorate. Creditors' risk arises from the deterioration of asset quality and – in the case of banks as financial intermediaries – due to their position as both creditor and debtor and the difference between investment and borrowing rates. What indexing does in this case is to accentuate the risk of the first type, without reducing that of the second.

We want to point out that both the current problems – mainly related to the generation of profit, income and employment – as well as equity – such as the degree of indebtedness and the risk of the active and passive

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113 See Keynes (1964, Ch. 11).

positions – originate in the variations of the flows, particularly in the investment. Although these fluctuations can trigger portfolio adjustment movements, accentuating the decline in productive accumulation and giving the process a cumulative character, they still theoretically admit the operation of endogenous recovery mechanisms or sensitivity to the performance of conventional Keynesian policies. These, as it has been seen, are intended to defend production flows, asset prices and debt validity, supporting liquidity, profit and employment. In other words, they aim to preserve equity and risk conditions, including making portfolio movements possible, in the direction of greater liquidity, so that a rebuilding of the marginal efficiency of capital will restore the conditions for the growth of profits, for the appreciation of assets and the formation of new indebtedness<sup>114</sup>. If this occurs, the State could reverse its action, rebalancing its current account and reducing its indebtedness. So far, we are in the world of fluctuations or, at most, of the instability of production, income and employment in capitalist economies.

## 2. Wealth valuation and crisis

Keynes (1963: 169) defined wealth in a capitalist entrepreneurial economy in a particularly precise way:

“There is a multitude of real assets in the world which constitute our capital wealth – buildings, stocks of commodities, goods in course of manufacture and of transport, and so forth. The nominal owners of these assets, however, have not infrequently borrowed **money** in order to become possessed of them. To a corresponding extent the actual owners of wealth have claims, not on real assets, but on money. A considerable part of this ‘financing’ takes place through the banking system, which interposes its guarantee between its depositors who lend it money, and its borrowing customers to whom it loans money wherewith to finance the purchase of real assets. The interposition of this veil of money between the real asset and the wealth owner is a specially marked characteristic of the modern world.”

There are several important questions raised by the author. The first concerns wealth in its productive dimension, the only one that exists for society as a whole because it is able to guarantee its reproduction and survival.

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114 These would be the antidotes to a Fisher's debt deflation crisis, where the collapse of asset prices and debt settlement translates into a drastic reduction in liquidity, despite the movement of portfolios towards greater liquidity, and in an unbearable increase in the overall risk of the system despite attempts to minimize individual risk on the part of banks and the public.



This wealth has yet another dimension, in addition to the productive one, in a capitalist entrepreneurial economy. It is necessarily someone's ownership. Productive wealth must have an "efficiency" as a function of itself: this efficiency is the ability to reproduce its own value and still generate a surplus. The ability of an asset to reproduce itself and still leave a surplus is called by Keynes the marginal efficiency of capital. Wealth, as ownership, can only be measured as **purchasing power**, power over others who have wealth, as general wealth. In this sense, its measurement can only be made in monetary terms and its **effectiveness** is the rate of interest, that is, the "price" of letting go of the "general power" now to recover it later.

Keynes is referring to the criteria for assessing the stock of wealth, in its two inseparable dimensions, the productive and the capitalist. In this sense, it is possible to imagine, in a Keynesian perspective, changes in the rate of interest and in the marginal efficiency of capital, without this having originated in the fluctuations previously discussed. Efficiency – a measure of expected profitability – belongs to capital, that is, to instrumental assets as wealth. The rate of interest is the rate of conversion of wealth, in its various forms, into net wealth, not the rate fixed in debt contracts<sup>115</sup>.

The capitalist evaluation of wealth is therefore subject to three simultaneous measures:

1. the expected return on a capital asset, defined based on its ability to reproduce and still generate a surplus.
2. this valuation of a capital asset as a function of itself must be recognized **socially** and, therefore, the probable yields must be discounted at the monetary rate of interest that converts the "value" of this asset to the common measure.
3. the expected variation in the purchasing power of the assets, allowing for fluctuations in the value of money.

These three types of valuation conform to what Keynes defined as the demand price of assets. He was particularly interested in the conditions under which this complex evaluation of capitalist wealth would favor:

1. carrying out the operation of a given stock of productive wealth, which will depend on the evaluation of the cost of use and the evaluation of the offer price.

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115 It is symptomatic that the neoclassical theory only admits changes in the rate of interest on the basis of savings and investment **flows**.

2. the decision to put a specific capital stock into operation must already include long-term assessments that will determine what the current production of new capital assets will be. And this has as a specific condition that the demand price of the asset is higher than the offer price, that is, the replacement cost of capital assets of the same class. That is, Keynes is interested in determining the asset price system, the valuation of the various classes of wealth and the conditions in which they can provide variations in production and employment flows. We must emphasize this point because, in doing this, Keynes is subordinating the goods and labor market to the asset valuation system.

The idea that Keynes supposed a low degree of substitution between real assets or long-term bonds and money must be qualified. Within the scope of conventional expectations, this substitution occurs naturally within the agents' wealth stock, according to the movement of portfolios already described, corresponding to the expectation of relative stability in their prices. In this case, the expected return on ownership of the various types of wealth can be matched at the margin. Keynes argues, however, that this state is far from guaranteed and that the private accumulation of wealth, the uncoordinated and anarchic of decisions tend to make the future fearsome, and fear can focus wealth holders' preference on an asset they **imagine** endowed with the property of absolute value, in the sense that it would have an invariable purchasing and liberating capacity now and in the future. Keynes's observation that this asset cannot be produced privately is very important, even though under conditions of steady growth in the economy private producers have the impression of "producing money" by selling their private goods. This illusion is undone when the "market" refuses to transform "private money" into "social money." In this case, holders of directly social money, which is beyond the control of each private producer, reveal their preference for liquidity, increasing the rate of conversion of private wealth into social wealth. There is no doubt that Keynes supported the idea that money or assets that perform the functions of means of payment, unit of account and value reserve have zero production and substitution elasticities.

Thus, a rupture in the state of confidence leads to the hope of safeguarding the value of wealth converging on this asset. This means that wealth holders **have to imagine** the existence of a measure and form of enrichment that is not subject to the contestation of others, that is, **socially** recognized. In any society where private enrichment is the criterion of production, the existence of this general form of wealth, income and product is unavoidable.

The rupture in the state of confidence, the abandonment of the conventions that had been governing a certain state of the economy means that private producers can no longer continue to make their decisions without considering the radical uncertainty in which they are plunged<sup>116</sup>. In this regard, the question that Keynes raised was that of the contradiction between private enrichment and the creation of new wealth for society (employment and income growth). He sought to demonstrate at the same time that the form taken by the crisis tends to push the impetus towards private enrichment to the limit, to the point of making it antisocial.

It is not that the current movements of productive accumulation depress internal accumulation in companies and aggravate the problems of indebtedness and risk. Rather, the evaluation of wealth (long-term expectations) and radical uncertainty (not risk) paralyze and deny new investment flows, current production and employment, even though the wealth-effects could be present. Keynes did not deny validity to the Pigou effect. He did not consider it relevant, since the devaluation of assets other than money would have to be very drastic and rapid and, furthermore, there would be no guarantee that this would reverse panic and the search for “security.” Quite the contrary. The factors that “reward liquidity” depress the marginal efficiency of capital.

Keynes did not trust monetary policy for the same reasons that made him suspicious of the wealth-effect, in a situation of rupture of expectations (liquidity trap). In this case, however, the State’s policies for generating deficits and managing public debt – as ways of sustaining current profits and safeguarding private portfolios, respectively – will find a state of long-term expectations insensitive to conventional stimuli.

In this crisis economy, the imbalance in the government’s current account and the growth of public debt in the composition of private assets tend to become a permanent phenomenon. With this, the indebtedness and the risks of the private sector decrease, the current production will oscillate in spasmodic movements and the capital assets will maintain their book values. The private crisis is transformed into a State financial crisis, whose limit may be the agents’ perception that the fiscal policy and public debt are unsustainable. Private mistrust reaches the heart of state sovereignty, compromising the legitimacy of the State as a currency manager. In view of the inflationary tensions triggered by the “stabilizing” action of policies, the State may be led to attempt to preserve the values of assets and private financial wealth through indexation. Thus, it will sanction the shortening of the time horizon that presides over the setting of private sector commitments, raising the

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116 In the state of conventional expectations, agents behave as if uncertainty does not exist and as if the present is the best assessment of the future. See Keynes (1964, Ch. 12).

liquidity premium and making practically nonexistent the markets for longer term contracts, which will end up reaching its own capacity to issue new debt and manage the existing debt stock. This further reduces the possibilities for monetary policy action, subjecting it to the constraint of high real rates of interest, with negative effects on the current deficit, in order to prevent the abrupt collapse of the monetary standard.

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## PART II





# INTRODUCTION

*José Carlos Braga*

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Below is a summary of ideas that the authors of the chapters of this Part of the book developed in their research originally published in the 1990s.

Capitalist globalization, as it really is, already revealed remarkable characteristics in the 1990s, which contrasted with the process of virtuous homogenization worldwide at the socioeconomic level disseminated by mainstream economists and neoliberal ideologues.

Investment flows were advancing in Core countries. Investments supported by the expansion of credit and in a broad Schumpeterian “cluster of innovations” are the real determinants of economic growth, not prior savings – as Fernando Nogueira da Costa warns us in his chapter on “The Controversy about the Relationship Between Investment, Savings and Credit”. The diffusion of microelectronics in a constellation of products and services dynamized a substantial set of industries and sectors. As Luciano Coutinho presents in the chapter “The Third Industrial and Technological Revolution: The Major Changing Trends”, in the early 1990s, information and communication technologies spread widely in economies and boosted, in a long-term dynamism, a new technological paradigm, an industrial and technological revolution.

The understanding of this movement also includes studies on the logic of firms and capitalist calculation in the dynamics of capital accumulation, represented by the works “Notes on decision-making and expansion of capitalist firm”, by Maria Silvia Possas, and “General Laws of Motion, Competition and Capitalist Calculation: The Complex Economic Dynamics”, by myself.

Capitalist globalization has been a historical construction by the State and the private sector, the latter grouped together under the enigmatic and significant denomination of “the Market”. As Luiz Gonzaga de Mello Belluzzo argues in “The Decline of Bretton Woods and the Emergence of ‘Globalized’ Markets”, it is essential to analyze this construction in the context of the dissolution of the capitalist order forged under the Bretton Woods Agreements. It corresponded to the constitution of an internationally negotiated regulation system under the leadership of the winners of the Second World War whose end only occurred after the dropping of two atomic bombs on the Japanese territory. Rules and institutions were established to ensure global economic and financial stability. Two of the fundamental aspects of this stability – the regulation of exchange and interest rates – collapsed in the early 1970s, when exchange and interest rate flexibility was imposed and when the United States

decreed the end of the dollar's convertibility into gold. In this way, globalization spread in conditions of free fluctuation of those two crucial rates and in a world of "Fiat Money", with the Dollar occupying the dominant role in the transactions of goods and services and playing the role of store of value in the globalized capitalism.

As I seek to demonstrate in the chapter "The Financialization of Wealth: The Financial Macrostructure and the New Dynamics of Central Capitalisms", the impetus of these transformations gave rise to a new *modus operandi* of capitalism from the 1970s onwards, with the destruction of the regulation of the Bretton Woods order. Its crucial character is the financial dominance that determines the decisions of the agents in production (investment), finance, consumption, balance of payments, as well as by public institutions, such as the National Treasury and the Core Bank. Thus, new relationships are structured and established in the macroeconomic dimension, as highlighted in "Financialization' of Wealth, Asset Inflation, and Spending Decisions in Open Economies", by Luciano Coutinho and Luiz Gonzaga de Mello Belluzzo.

In other words, Financialization is a systemic pattern of wealth that launches all "actors" in a movement guided by the general financial logic. As the totality of capitalism operating under that dominance is considered, there is no room for dualisms such as "bank" versus "industry", "bad capital" versus "good capital", "State" versus "Market", "productivism" versus "rentism", or "stagnation" versus "expansion" of globalized capitalism.

The word Financialization expresses such characteristics in the texts published here. In this way, its use contrasts with the widespread use presented in this growing literature, in which Financialization is often a phenomenon whose explanation is reduced to a tautology, similar to the statement that "salt is salt because it is salty".

The concept of dominance is used by Gregor Mendel (1822-1884), known as the founder of modern genetics, who used it to unveil the basic laws of heredity, as a biological phenomenon. This way of thinking is compatible with the genetic method as a historical and dialectical logic, very useful for the production of knowledge in the social sciences and in particular in a critical political economy approach such as that of Karl Marx. In the latter, it is about understanding the subject of the process – capital, conceived as self-valorizing value – through the development of its forms that begins with the commodity, passes through money, through productive capital that, finally, unfolds into interest-bearing capital and fictitious capital.

In this way, the financial dominance performed by capital, which encompasses its multiple forms, is nothing more than capital realizing its own concept

according to the laws of its “heredity”, perceptible by the genetic method, in a logical-historical and dialectical thinking.

Contrary to the sterile circular reasoning mentioned above, the Financialization of wealth involves the intensified tension between expansion and crisis in the context of a global economy whose spending decisions are conditioned by variations in the prices and returns of financial assets.

The works presented here, therefore, will make possible to understand the capitalist dynamics under financial dominance, in which the concentration of income and wealth is humanely destructive and in which Core Banks and National Treasuries are compelled to act to prevent the deepening of the destruction of financial wealth and the devastating contagion on the macroeconomics of income and employment.



# CHAPTER 11

## THE CONTROVERSY ABOUT THE RELATIONSHIP BETWEEN INVESTMENT, SAVINGS AND CREDIT

*Fernando Nogueira da Costa*

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### **Introduction**

In the Keynesian view, the rate of interest is a first determinant of investment. It differs from the neoclassical view, where, according to the Loanable Funds Theory (LFT), the rate of interest is determined jointly by savings – the supply of loanable funds – and by investment – the demand for these funds. In this theory, savings, necessary for investment, have a causal priority. Keynes reversed this causality by pointing out that investment can rise regardless of the previous existence of savings (abstaining from consumption), causing an increase in effective demand and, consequently, in aggregate income, which will exceed global consumption in the residual amount of savings. However, there are antagonistic streams within Keynesian thought in relation to the interpretation of the investment financing theory that is extracted from Keynes' work.

The two Keynesian approaches discussed by Amadeo and Dutt (1987), according to a conciliatory view,

“[...] explore different dimensions of the General Theory. In short, post-Keynesians emphasize the role of money and uncertainty, while neo-Ricardian Keynesians emphasize the multiplier mechanism, the role of the output as an equilibrium variable between savings and investment. In doing so, they are, in fact, searching their identities: they are focusing their analysis on what they consider to be the truly revolutionary and innovative elements of Keynes' ideas. An important reason for the existence of two groups of Keynesians not belonging to the “mainstream” is the fact that Keynes himself emphasized the notions of equilibrium with unemployment (for which the role of the multiplier is central) and the system instability (in which the role of money and uncertainty is fundamental)” (p. 596).

Post-Keynesians call attention to the role of uncertainty that involves any decision-making act.

“In a world of uncertainty, money plays a major role in protecting agents from the effects of the irreversibility of time. When uncertainty increases, agents prefer to have liquid assets at hand (money being a “par excellence” liquid asset). If the agents retain money, instead of using their income to buy goods, there will be an interruption of the income-expenditure circuit (sic) and, thus, unemployment” (p. 361).

The argument of the neo-Ricardian Keynesians is that,

“[...] in a model with several commodities, the rate of interest may not play the role of a equilibrium variable between savings and investment. This is the reason why the neoclassical theory of employment is flawed. The Keynes multiplier mechanism provides a consistent theory of adjustment between savings and investment and the level of output. According to this mechanism, savings are adjusted to investment through changes in production and employment levels. Only by chance will the level of employment thus determined correspond to full employment” (p. 562).

In fact, post-Keynesian economists deny the analytical property of the use of equilibrium, being, in relation to this issue, in an opposite pole to the neo-Ricardian Keynesians. Neo-Ricardians insist that the economy can only be adequately studied through a long-term equilibrium position. On the other hand, post-Keynesians are restricted to the behavior of capitalist economies in the short term and, by pointing to their inherent instability, deny the applicability of the equilibrium method. The rejection of equilibrium analyses of any kind implies the rejection of formal models. Neo-Ricardian Keynesians fear that this attitude will lead to less communication between economists of different approaches, because the neoclassical “mainstream” has opted for technical formalism as part of its methodological core. They think that “[...] there is a risk that the post-Keynesian economy will remain ignored by the profession” (p. 581).

Conventional economic thought (neoclassical “mainstream”) assumes the existence of constants, parameters, structural relationships, etc. in the economy. It supposes the permanent existence of a stable structure, because according to this stream of thought, if there is no equilibrium, anything can happen. Keynes assumes that, at any time, there is a structural relationship, but there is no way of knowing whether (and how long) these relations will last. The structures, determined by institutional arrangements, are as solid as the institutions. He therefore admits that they can change. The role of economic

policy is precisely to create institutions that limit the way in which the structure can change. Among defensive institutions in the face of uncertainty and disappointments are money and financial institutions in general.

Neoclassical theory ignores institutions, particularly financial ones. It emphasizes equilibrium and/or the tendency to equilibrium – i.e., how decentralized markets acquire coherence and coordination in production and distribution. Keynes's theory thinks that questions about the evolution of income, output and prices should be answered in the current context of financial institutions and practices – in which bankers and businessmen “play the cards on Wall Street” – not in terms of an abstract economy, as if it were a “medieval village fair.”

Minsky, for example, develops a theory to explain why the economy fluctuates, showing that instability and inconsistency – the process of generating inconsistency is the result of incompatible plans, by decentralized decisions –, shown periodically, are related to the development of fragility of financial structures. They usually occur in capitalist economies, in the course of financing the acquisition of capital and investment assets. They result, therefore, from internal processes of the capitalist economy, due to the flaws in the capitalist ways of organizing accumulation, which reflect, in the behavior of the financial markets, asset prices and profit flows.

In Brazil, Ekerman (1989) distinguishes the institutional style, a characteristic of the economists at UNICAMP, from the formal monetarist style, of the economists at FGV-RJ and USP, and the formal structuralist, from those who were trained at PUC-RJ. The first style is characterized

“[...] due to not making use, at least constantly, of mathematical formalism, and for turning to the meticulous understanding of the institutional framework (labor relations, industrial organization, financial and banking organization, international political-economic relations)” (p. 133).

It starts from the observation that, in the process of capital valorization, institutional conflicts occur.

“To detect them, knowledge of history, remote and present, and contact with the way of thinking and proceeding of businessmen, bankers, monetary and political authorities – national and foreign is necessary” (p. 134).

We will review, in this work, in this institutional style, the recent contributions to the theoretical controversy regarding the relationship between investment, savings and credit. In the first part, we will deal with the question of savings, or better, if the “savings shortage” is a limitation for the expansion

of investment. In the second step, we will see how post-Keynesian economists reinterpret Keynes's theory of investment, emphasizing financial aspects, in an alternative view to the conventional one of neoclassical synthesis.

## 1. The issue of savings

The issue of savings was Core to the official argument in favor of the adoption of recessive measures by economic policy, for the adjustment of the Brazilian economy in the face of the currency crisis; balance of payments crisis; crisis of balance of payments caused by the external debt. Five functions were assigned to "domestic savings":

- compensating for the drop in the share of "foreign savings" in the financing of economic activities;
- reducing inflationary pressures on the demand side for final goods or services, given the greater attraction of financial investments;
- rebuilding a rate of investment in the economy, as a proportion of GDP;
- contributing to the balance of external accounts, by releasing, with the drop in domestic consumption, a greater quantity of goods for export and, at the same time, constituting a non-inflationary source of resources for the financing of these exports;
- canceling inflationary pressures arising from the "deficits" of the monetary budget, by presenting itself as a non-inflationary source of financing of the domestic public debt.

Tavares *et al.* (1982) criticized, in such arguments, the conceptual confusion regarding "aggregate savings," "abstinence of families," "global internal financial savings" (function of monetary correction and dissociated from fluctuations in real investment), "effective or real savings" (profits retained in the case of companies and fiscal "surplus" in the case of the Government), "external savings" ("deficit" in current balance of payments transactions), "ex ante" macroeconomic savings," etc. They reaffirmed that "[...] the investment decision is the link between real savings and financial savings, or the form of materialization of the latter" (p. 41), represented by the amount of financial asset balances. Given the countercyclical role of economic policy and the economic weight of state intervention, in a situation of pessimistic expectations, they argued that "[...] increasing savings/investment or changing its profile is a decision that is eminently of the State, in Brazil" (p. 42).

Finally, they showed that, if the financial profitability grows in real terms, accompanied by a guarantee of prompt liquidity, it reduces, relatively, the



space for profitable productive investment. However, the “awkward monetarism” that guided the economic policy drew out pre-Keynesian arguments to resolve this contradiction:

“[...] the rate of interest would be an expression of the scarcity of resources and, therefore, we would be having too many investments, and not too little. The rate would only fall with the reduction of investment or, alternatively, with the increase of financial savings” (p. 43).

In her Full Professor’s thesis, Tavares (1978) had already discussed the theoretical relationship between savings, investment and indebtedness, that is, “the false savings problem” (p. 23). Based on Kalecki’s analytical approach, she recalled that “capitalists earn what they spend” and that, if profits are a function of investments made in previous periods, an increase in investments “in the present” will imply greater profits “in the future” and, therefore, more “savings”. Thus, in dynamic Kaleckian terms, the more capitalists spend (today), as a class, the more they save (afterwards) and the more they save (today) the less they profit, that is, the less they actually save (afterwards). Capitalists cannot decide what they profit, that is, they cannot decide “ex ante” what they can save, they can only decide what they invest with their own capital (retained profits) and how much they intend to borrow (equity capital from third parties). This investment decision considers the expected profit in view of the indebtedness risk. This is subject to the restrictions of the credit market and it is paid with the realization of profits, under conditions of the market of products that capitalists also do not control.

The only way for “potential savings” to become “effective savings” is by making investments, in the period, in their own amount. “Potential savings” is the amount of global income not consumed, which can be invested financially by economic agents, that is, it can constitute a “fund” available to finance investment through financial intermediation. However, if this “potential savings” is “treasured” by investing in securities for mere financial valorization, it is “diverted” from its macroeconomic potential, which, therefore, is not effectively realized by the drop in effective demand and thus not-expansion of real income.

The effective demand is given by expectations in face of the value of the production that the entrepreneurs would want to produce and sell. It therefore involves a concept of expected income “ex ante” in relation to sales. Demand is “effective” if a certain use of existing resources in production is employed or effective, regardless of whether it takes place in whole or only in part. There is no “supply” before the production is carried out, or rather, before the realization of the added value in production. Income as a whole ( $Y = W$

+ I + R + P) is a result realized “ex post,” with part realized “ex ante” (salary, interest and rent paid at microeconomic, business level) and the residual component (profits) carried out “ex post.” Therefore, “ex ante” savings is a dubious concept, as it refers to “decisions that are not made.” In fact, “savings” is not the object of decisions, it is simply an accounting residue evidenced by the “ex post” difference between aggregate income and consumption. It is a passive variable, a simple residue that is “a posteriori” equal to the total investment through income variation. It has no relevant role in the theory of effective demand (Possas, 1983: 93).

However, this concept always reappears in the formulations of economists, including the “heterodox” ones. For example, “the savings problem” is examined in the final part of the Government’s Goals Plan, released in July 1986 by the Office of Planning and Economic Affairs (Secretaria de Planejamento e Assuntos Econômicos – SEPLAN), where the macroeconomic aspects of the Brazilian economy related to the financing of the necessary investments are analyzed. It states that

“The sustaining of Brazilian economic growth, over the next few years, depends on an additional saving effort to obtain the resources indispensable for the expansion of the national productive capital. [...] To this end, it is inevitable that there will be an additional saving effort on the part of the private sector. Brazilian society needs to choose between consuming and stagnating or saving and growing. Deferring a significant portion of consumption for the near future is the only realistic way to guarantee the sustainability of economic and social development” (SEPLAN, 1986: 150).

The failure of the heterodox experience in the so-called Cruzado Plan (1986) represented an implicit stimulus for the rescue of ideas of neo-classical theoretical foundation, as opposed to the “bastard” versions of Keynesian thought.

“Take as an indication of this trend the fact that many of these Keynesians, also reveal a certain predisposition to make a revision of old theses, based on the idea that what is good in the short term is not advisable when you think in terms of long-term sustained growth. In particular, policies aimed at stimulating consumption would be recommended for shorter periods, but sustaining growth would imply containing this consumption in order to increase the country’s savings ratio” (Giambiagi & Amadeo, 1990: 75).

These authors, of course, are unaware of what is known as the paradox of thrift, that is, the idea that the (neoclassical) recommendation to save more individually, with a view to investing more and growing more in the future,

would be just a typical fallacy of composition, as the aggregation of these individual acts would lower the expected return on investments, thus reducing their level and, consequently, the aggregate savings of the economy.

They also suggest that the most appropriate recommendation for the saving coefficient depends on the “regime” the economy is in every moment of time: Keynes’ idea, according to which, in order to grow, it would be necessary to consume more, is conditioned to availability of resources; the neoclassical thesis, on the contrary, by which consumption should be contained, only becomes valid when the installed capacity is effectively used to its fullest. In fact, even in conditions of full employment, although Keynesians and neoclassicals agree on the possible excess of consumption, the latter propose to increase savings, while the former suggest that more investments are needed.

Giambiagi and Amadeo (1990) state that

“[...] the causal relationship pointed out by Keynes, from investment to savings – contrary to the neoclassical view –, remains valid under any hypothesis about the current circumstances” (p. 78).

But when analyzing the limitations faced by investment to overcome the restriction of productive capacity, the first one is precisely that of savings (the others are the supply of labor, credit and financing, foreign exchange and demand for credit). Modeling to discuss “the limitation of savings” is nothing more than a presentation of accounting equations. They recognize that “[...] these tell us nothing, however, about the causal relationships involved in the analysis. For this reason, it is essential to go beyond identities and have a brief theoretical discussion” (p. 82).

The controversy over the relationship between investment, savings and credit arises around two theories: that of loanable funds – with interest determined by flows – and that of liquidity preference – with interest in terms of asset stocks.

Amadeo and Franco (1987) note that

“[...] the differences between these theories in their various alternative versions are due, in large measure, to the way they conceive the financial system, since each of them can be related to a particular historical context and, therefore, to a specific stage of development of the banking system” (p. 380).

The “classic” version of LFT is identified with a primitive banking system. In the 19th century, savings were a precondition for investment, as investment largely depended on direct loans from the creditor to the borrower. Even

indirect loans through banks required this precondition, that is, they needed to obtain deposits to lend. Deposits at this stage represented savings, not yet universal means of payment. Only when checks became widely used as means of payment did the banking system gain better institutional conditions (clearing house, rediscount portfolio, etc.) to expand the money supply through the bank currency multiplier. Loans began to create deposits that never left the banking system and represented money to finance both consumption and investment. The Keynesian theory reflected this change.

Another explanation for the interest had to be found as the determination of the rate of interest by savings and investment was historically invalidated. The alternative theory, that of liquidity preference, shows the rate of interest as the benefit that is obtained to give up liquidity. It is determined by the combination of convention — a stable basis for decision-making — and speculation, as Dennis Robertson's satire reveals (Chick, 1989: 41): "The interest rate is what it is because of the expectation that it will be different. If there is no expectation that it will be different, there is nothing to tell us why it is what it is."

The rate of interest is a function of decisions by economic agents, including the Core Bank and commercial banks, on the allocation of wealth between existing assets (stock of "old") and new ones and on how to finance their spending decisions. Therefore, the portfolio decisions of these economic agents determine the rate of interest according to the liquidity preference theory. Taking this rate of interest as a reference and depending on the expectations of investors regarding the profitability of their projects, investment expenditures are determined. According to the principle of effective demand and the multiplier mechanism, compatible levels of income and savings are determined. The "ex post" equality between investment and savings is a function of the variation in the income level and not in the rate of interest; in this sense, there is the difference between Keynes's theory and LFT.

Criticism of the "ex ante" character of LFT implies criticism of the theory of "ex ante" savings, based on the idea that there is no point in expressing it from the point of view of society as a whole. "The logic of individual choice" is not the same logic, or rather, it is "the lack of logic in the behavior of aggregates." The paradox of thrift expresses the non-existence of a similar aggregate to individual savings. In fact, even this must be qualified and considered a concept of expendable explanatory power.

Spending decisions, including the decision to consume, taken under conditions of uncertainty, therefore, based on expectations, among which, with respect to future income flows, are conditioned by the purchasing power that the agents command, which comes from their own stock of wealth and credit.

So, consumer decisions can be made even before income flows are received, for example, via credit cards.

“It is, therefore, something much more complex than the mere definition of using a certain portion of income in the purchase of consumer goods and ‘saving’ the rest. [...] Now, by definition, individual savings are the residuals of income, after consumption has been subtracted. But, if one does not decide to consume from income, neither does one decide not to consume from it. Purchasing power not intended for consumption is, by definition, invested. How – and why – to separate investments into a portion supposedly financed by the income flow, and into another portion acquired based on the previously existing purchasing power?” (Macedo & Silva, 1990: 38).

Thus, individual savings should also be considered a mere accounting residue, defined “*ex post*” (and not as a result of an “*ex ante*” decision to “save”), verified by the difference, at the end of the accounting period, between the flow of individual income and the flow of spending on consumer goods.

The conventional wisdom of economists’ orthodoxy is based on the “commonplace” of the lay individual’s justification for their decisions to consume and apply from their current income flows.

“In fact, this tends to be all the more likely the poorer the individual, that is, the greater the importance of their income flow in the face of their wealth stock. At one extreme, there are individuals totally deprived of a stock of wealth (as well as access to credit) other than that periodically redone by income. For them, the discussion about the stock of wealth (and not income) as a condition for spending decisions is, in fact, merely academic” (Macedo & Silva, 1990: 39).

The capitalist calculation implies a continuous rethinking of the portfolio structure, that is, the economic decisions of the capitalists have as fundamental objective the preservation and expansion of their wealth stock according to the logic of capital valorization. The economic structure of an economic agent is composed according to the participation of each type of asset – the various forms of allocation of wealth – and of liabilities – the various ways of financing the portfolio. Many wage earners, due to a lack of culture, time and money to acquire new information, tend to adopt a routine procedure in the management of the wealth stock, dealing with the income flow as a basic variable for their investment and consumption strategy. It is also considered a portfolio decision – or investment – that the agent retains, in their asset

portfolio, in monetary form, their income flow or the products from the sale of any asset.

As Andrade (1989) states,

“[...] denying the role of ‘ex ante’ savings is essential for the **principle of effective demand** to prevail, typical of monetary economies with a credit system without ‘backing.’ In fact, in economies where the banking system functioned only as a depository and intermediaries of values, loans – advances of purchasing power for some – represented savings, or deferred purchasing power for others. In these economies, there was a link between credit and savings, as perhaps classical economists thought. Therefore, the savings desired by the community represented a limit higher than the investment made. However, Keynes was thinking of monetary economies with developed bank money – as they have existed since the middle of the last century – and where there is a complete separation between savings and credit, and it is precisely the privileged access of business-investors to credit that guarantees the priority (separation, advance) of investment over savings” (p. 138, emphasis added).

Since what investors need “*a priori*” is purchasing power, that is, money,

“[...] the question of funds necessary for investment is understood not in the real sphere, but in the financial sphere, that is, in the liquidity conditions of the economy, which determine the pace of the accumulation process in the economy and not the availability of savings” (p. 138).

Therefore, in considering the rate of interest as a determining element of the investment, given the long-term expectations, Keynes was assuming access to credit. The “finance motive” argument for demand for money must be studied along with the investment financing process.

## 2. The issue of financing

Keynes focuses on investment as a fundamental determinant of aggregate demand and short-term fluctuations in economic activities. It rejects the microeconomic fundamentals of investment that are based exclusively on technological conditions for capital productivity, highlighting uncertainty, finances and monetary factors as essential explanatory concepts. Monetary and financial conditions affect firms’ capital expenditure decisions.

Fazzari (1989) analyzes the formulations developed by three interpretive strands of Keynes’ theory of investment, specifically with regard to the interrelationships between real and monetary-financial variables.

“[...] in the 1960s and 1970s, views about links between finance and investments bifurcated into distinct schools of thought. The ‘post-Keynesians’ maintained that the original insights of Keynes remained valid: instability in financial relations could cause volatility in investment and macroeconomy. The more formal ‘neo-Keynesian’ approach rested on optimization models derived from the neoclassical ‘first principles’ that did not allow important links between finance and investment. During this period, there was little common ground between the two schools of thought” (p. 102).

However, Fazzari points out that, in the 1980s, a new and distinct macroeconomic research program emerged. The roots of the economics of the new Keynesians, in part, are due to both the success and the bankruptcy of the 1970s new classical macroeconomics. The new Keynesian work retained the characteristic of the new classical approach, which places special emphasis on the constructions of its models, on the optimization of neoclassical origin. However, as the implications of the new classical theories have not been empirically successful, some economists have resumed some Keynesian ideas that had been abandoned at the height of the “revolution of rational expectations.” The new Keynesian changes the approach around the optimization of microeconomic agents, examining more closely the problems of market economies, especially of decentralized commercial activity. Several problems arise around asymmetric information about the market between buyers and sellers.

One of the most fruitful applications of these ideas is in the study of the credit market. For example, a company’s ability to implement an investment project may depend not on the technological foundations of the project under consideration, but on the financial conditions of how to have internal funds and not to rely on external funds. Risk aversion characterizes the behavior of part of the suppliers of these funds. In the neoclassical perspective, the problem can be overcome by the diversification of funding sources. The hypothesis is that both lenders and borrowers have full information regarding the project quality and the borrower character. However, with the opposite assumption, that the information is asymmetrical and that the quality of projects and debtors is variable, loans will be granted not with reference to the same “general equilibrium rate of interest” that orders the external funds market with full information, but rather with a higher rate of interest for borrowers.

“These circumstances explain a link between a firm’s financial structure and its investments. Firms with good investment projects face a higher cost of external capital than their opportunity cost of using internal funds because the cost of external funds includes a premium to compensate lenders for the risk of inadvertently funding bad projects. This creates a preference for internal funds [...].

This result is fundamentally different from predictions of the neoclassical theory predicated on the essential independence between real and financial decisions. One cannot understand real investment as ultimately determined by exogenous tastes and technology alone” (Fazzari, 1989: 105).

As to whether this result is within the post-Keynesian tradition, the aforementioned author believes that the problem of asymmetric information in the capital markets is an essential element – distinct from the problem of the arbitrary “imperfection” of information, artificially placed in the “standard” new neoclassic – and represents a fundamental feature of the decentralization of market economies. The inherent characteristic of decentralized markets includes the separation of agents and the need for institutional structures that consciously coordinate the diversified activity of isolated individuals.

Fazzari considers the implications of this type of specialization and isolated information on the financial market functioning.

“Entrepreneurs have informational advantages in developing new technologies and marketing new goods and services. Bankers and financiers specialize in financial intermediation. If an entrepreneur seeks funds for an intermediary to finance an investment project, the natural starting assumption to make is that the entrepreneur has more information about the project’s prospects than the banker. The banker may be able to obtain some information from independent sources, but this activity is costly. To become fully informed would require that the banker *become* an entrepreneur, a condition that would undo the specialization that is fundamental to the productivity of the system” (p. 106-7).

The consequence of these ideas is that financiers are only able to hold full information about projects for financing if the investor voluntarily discloses them. But this is impossible because debtors have an incentive to present their situation as best as possible. This stimulus is well understood by creditors, and with rational skepticism they put their safeguards on loan interest. In this case, the Keynesian “debtor’s risk” is evident, as a result of asymmetric information. This asymmetry is not exogenous to the system functioning, but represents an inherent characteristic of decentralized market production.

The “debtor’s risk” is a limitation on the expansion of investment. This obstacle is not technological, but inherently financial. It can be overcome by increases in liquidity, regardless of changes in the project technological characteristics.

The author concludes that



“The view of investment that emerges from these new models is unmistakably Keynesian in its empirical implications. Information asymmetries lead to a preference for internal funds over external finance. The most important determinant of fluctuations in internal cash flow and liquidity is undoubtedly the aggregate business cycle. Therefore, these models immediately suggest a link between investment and the cycle unlike anything that comes out of the tastes and technology microfoundations of the neo-Keynesian synthesis” (p. 109).

In this sense, in an attempt at micro-macro synthesis, Fazzari assesses that the formulations of the new Keynesians represent a convergence between the neo and post views.

The Core distinction between orthodox and Keynesian theories lies in the axiom of the real or its equivalent to the neutrality of money, which is accepted by orthodox theory and rejected by Keynesian theory. Minsky (1985) underlines the crucial importance of the impact of financial relations and, therefore, of the structure that organizes them over the whole economic activity. A theoretical construction on indebtedness in general, in which the monetary rate of interest plays an essential role cannot be supported by a “neutral” money – a mere artifice to facilitate the exchange of real goods, that does not affect the essential nature of transactions, that is, motivations and decisions. Money is not neutral: it affects the absolute and relative prices of assets and, consequently, the investment rate.

The companies’ indebtedness aims at anticipating purchasing power, allowing the creation of a new demand for raw materials and labor to sustain the dynamics of accumulation. It is essential to consider the indebtedness structure and the need to pay debts by selling production at a profit. In this sense, on the one hand, the prices of capital assets and, on the other, the wages and money prices of current production must be considered analytically, in a dynamic context, in which rate of interest and of inflation play a decisive role in relations between creditors and debtors. To the extent that the profits extracted from current transactions are insufficient to cover the financial charges, that is, when the real sphere no longer validates the charges created in the financial sphere, an over-indebtedness constitutes due to the emergence, on the debtor side, of the obligation to refinance themselves to settle their commitments with their lender.

The Keynesian theory, reinterpreted by the post-Keynesians, maintains that the behavior of the system, both in its aspects of detail (relative prices, private productions), and in its global dimensions (employment, national product, price level), depends on the financial structure. There is no division between what orthodox theorists call “real” and “nominal.” Keynes’ theory

deals with asset prices, the level of prices and the solvency of banks and companies; the theory of interest in terms of liquidity preference is really a theory of determining asset prices in a capitalist economy. This economic theory by Keynes, open to the incorporation of details concerning the institutional dispositions of finance, provides a theoretical view and a set of propositions that explain how financial fragility develops.

Financial relationships can be assessed in terms of the “cash flow” established by the contracts and the objectives of those contracts.

“The money now for money later contract between banks (generally speaking all financial institutions) and business is entered upon so that business can acquire assets or spend. The spending that is traditionally financed is investment spending. The typical investment process involves credit and financial markets at two phases - one the ‘construction’ phase, the second the ‘take out’ phase. The **construction phase** is often called ‘temporary’ and the **investment phase** is often called ‘permanent’ financing. All financing contracts involve the eventual payment of more money to the financing organisation than the amount paid out. The money to meet these commitments will arise either from refinancing, such as take out financing, or from the flow of gross profits [...]. However take out financing will be available only as the expected profits over the life of the take out financing contract exceeds the face value of the contract by a goodly sum” (Minsky, 1985: 318, emphasis added).

Therefore, there is a need for **permanent debt validation** through a flow of profits from current production to the financial structure, so as not to break the capitalist mode of resource creation. The latter cannot finance the effective demand unless it grows cumulatively, therefore, the investment that generates the profits. The crisis arises when flows from the sphere of current transactions no longer support the profit needed for companies to pay interest to banks. In this situation, the real economy no longer validates the accumulated debt structure.

The currency is not neutral because it constitutes the bank’s liabilities because they hold the assets released in currency, and because these assets will be validated by the liquidity flows from the companies. So, for Minsky,

“Money holdings are not sterile in a world of uncertainty and outstanding financial contracts, where uncertainty applies to a particular extend to the ability to realise profit expectations and to fulfil financing and refinancing plans” (p. 319).

It appears that “J. M. Keynes devoted less space in his work to the classification of financial systems than to the various motives for holding money balances” (Boissieu, 1985: 337). The cleavage between the debt economy and the economy of the financial markets (or, more precisely, of the capital market) does not arise in his work. This cleavage, however, make it possible to understand, in Boissieu’s opinion,

“[...] some significant aspects of Keynes’s analysis and its post-Keynesian interpretation, in particular concerning the formation and the role of interest rates, and the policies designed to influence them.”

As for the direction of causality between savings and investment, in an indebtedness economy, thanks to banks, investment financing can operate without calling for previously constituted savings. In such a financial system, the causality of the Keynesian income multiplier prevails: indebtedness allows the investment that, thanks to the variation in income, generates the savings supplement, which finally ensures the completion of the circuit.

Boissieu (1985) notes that

“[...] Keynes’s theory of employment, production and income refers to an overdraft economy [debt economy], the theory of liquidity preference takes on its full significance only in an auto-economy [financial market economy framework]” (p. 339).

The finance motive, proposed by Keynes in 1937, is, by nature, linked to the notion of debt economy. It is based on a distinction between the demand for money and the demand for credit, between the money demanded to be retained and the money demanded to be spent. Boissieu (1985) argues that,

“In the General Theory, it was not necessary to distinguish between the demand for money and credit because Keynes assumed that the nominal supply of money was exogenous [sic], which excluded the conditions of adjustment in credit markets from the analysis. This is not the case once finance is introduced” (p. 340-1).

The finance motive corresponds to a revolving fund that, in principle, has nothing to do with savings (since it is based on bank credits multiplied in the debt economy) and which serves, in Keynes’ (1937: 246) words, “[...] to bridge this gap between the time when the decision to invest is taken and the time when the correlative investment and saving actually occur. This reason takes on meaning when the investment grows from one period to another:

the financing of the additional investment is made through the companies' supplementary indebtedness.

In describing the **investment financing process**,

“Keynes reduces the financial supply procedure, to meet the investment needs, as part of the determinants of the money market, having on the one hand, the money supply and, on the other, the state of liquidity preferences” (Andrade, 1989: 139).

According to this author,

“Keynes considered the demand for liquidity necessary for the realization of the investment as a finance motive, that is, the demand that arises between the decision to invest and its execution. The moment investment expenditures are made, the liquidity of the community as a whole is restored and the finance motive disappears. It is in this sense that Keynes uses the idea that funds in order to meet the finance motive constitute a revolving fund that collects itself as investment expenditures are made. This is where he employs the notion that ‘ex post’ investments provide finance for ‘ex ante’ investments” (p. 139-40).

In Keynes is the notion of a revolving liquidity fund, which is recovered by spending.

“The finances, or the money, that are tied during the interval between planning and execution, are released in due time after they have been paid in the form of income, whether the recipients save it or spend it” (Keynes *apud* Andrade, 1989: 140).

In the debate of the 1930s, the distinction in relation to Robertson became clear, since his emphasis is on **loan repayment**, a notion that is not part of the Keynesian concern. Keynes is concerned only with the gap between planned and realized investments, and not with the stage that extends to the amortization of investment financing loans (Andrade, 1989: 141).

For Keynes, **savings do not matter, money does matter in decisions**. The community's lack of availability to buy bonds – due to a preference for liquidity that leads to retaining money rather than acquiring other assets – and freeing up money, can interrupt the circulation of liquidity in the economy, causing a crisis in spending.

According to Andrade (1989), the question that arose in the controversy of the 1930s between the Swedish economists and Keynes was basically the same that today is established between Asimakopulos (1983 and 1986), on the

one hand, and Kregel (1984 and 1986), Davidson (1986) and Snippe (1985), on the other, around Keynes' finance motive.

“The central element is in the confusion between savings as the release of real resources that allows the balance between aggregate supply and demand and savings as funds to finance investment, characteristic of the loanable funds theory. Keynes rejects this scheme by separating the savings decision from the wealth allocation decision between the various assets. In short, the principle of effective demand and the principle of preference for liquidity are clearly different spheres in Keynes. Once this hypothesis is understood, it is possible to understand the controversy of the 1930s and its current ramifications” (p. 150).

Amadeo and Franco (1987) consider that investment spending decisions cover three distinct **monetary flows** or three different **decision horizons**: first, the net resources held by the investing firm are released in the period preceding the expenditure, that is, there is a redistribution of ownership of liquid assets at the time the investment is made. Then the demand for money ceases for the “finance motive” and the previous level of preference for liquidity is restored. At that moment, with the effective spending, the multiplier process begins, during which income and savings flows are generated. This second period is longer than the first, in which changes are made to the agents' portfolios due to the “finance motive.” However, the third period is much longer, since it goes from when the new productive capacity actually begins to operate, generating income until the end of its useful life. The multiplier effect of income, caused by the investment, has been previously exhausted.

These authors state that

“[...] there are two types of liquidity problems encountered in the investment process that should not be confused: one with **financing**, the other with **economic viability**. The first concerns the fact that the financing obtained by the investing firm for investment expenditures often does not have a duration equal to the relevant horizon for the investment decision, that is, the estimated useful life of the new equipment. Thus, at some point in the process, it will be necessary to refinance debts, and at that time financial intermediation will have an important role to play. The second type of problem is observed due to difficulties in generating sales revenues compatible with the expectations of the time of the decision to invest, the firm will experience problems that will, in Minsky's terminology, raise the degree of financial fragility of the system. The problem is associated with the quality or economic viability of the specific investment project.

In fact, this is a **solvency problem**, while the first is genuinely a **problem and liquidity**” (p. 384, emphasis added).

The conclusion is that the difficulty in relating these three decision horizons and differentiating the role of the flows associated with them – “finance,” savings and income – is at the root of the controversies about the relationship between credit, savings and investment.

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# CHAPTER 12

## THE THIRD INDUSTRIAL AND TECHNOLOGICAL REVOLUTION: the major changing trends

*Luciano Coutinho*

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### **1. The “Virtuous” Growth of 1983-90: Political Coordination and Economic Innovation**

After ten years of crisis, characterized by stagflation; by oil price shocks; by the shock of the interest rate and the consequent financial instability; by the relative paralysis of the flows of productive capital accumulation; by the significant reduction in the rates of productivity growth – between 1973 and 1983 –, the main industrial economies have found the path of economic growth. Indeed, eight consecutive years of sustained expansion, with price stability, marked the evolution of the world capitalist economy between 1983 and 1990.

Although the average growth rates in this recent phase were not as spectacularly high as those obtained in the post-war “Golden Age,” it is relevant to highlight: (1) the victory of growth stability and sustainability over the recurring outbreaks of strong currency speculation (caused by the huge and continuing US trade imbalance against Japan and Germany) and over two real speculative earthquakes that occurred in the world capital markets in October 1987 and January 1989 (respectively, from the violent “crashes” seen on the New York and Tokyo stock exchanges); and (2) the steady resumption of private capital accumulation flows (with a globally synchronized peak in 1989), accompanied by a significant recovery in the increase in productivity and, more importantly, by an increasing acceleration in the diffusion of economic innovations (technical, organizational and financial) in the main capitalist industrial economies.

It is intuitive to understand that the two aspects highlighted above are strongly interdependent: on the one hand, the political capacity to coordinate, with credibility, macroeconomic stability and, on the other hand, the acceleration of productive capital accumulation with innovations are mutually reinforcing – feeding a virtuous circle of expansion with price stability, a

significant increase in productivity and a moderate but continuous increase in real wages.

The political capacity to coordinate the conjuncture, extinguishing potentially devastating fires promptly, was evidenced mainly by the orchestrated performance of the economic authorities and, in particular, by the “sensitivity” shown by the American economic policymakers, namely: (a) the rapid and cohesive reaction to the surprise of the Mexican default in 1982; (b) the smooth accommodation of financial, real estate, agricultural and speculative bankruptcies in the USA between 1983 and 1989; (c) the remarkably successful orchestration of the planned devaluation of the dollar between 1985 (Plaza Agreement) and 1987 (Louvre Agreement), with the establishment of cooperative mechanisms to contain exchange speculation between Core Banks; (d) the competent and rapid compensatory action of the Fed and the Bank of Japan in 1987 and 1989, respectively, aiming to neutralize the spread of the financial impacts of the “crashes” of their stock exchanges; (e) the coordinated, hard and objective treatment of debtor countries, avoiding the occurrence of simultaneous defaults and the formation of an effective alliance of debtor countries; and (f) the administration, at the same time agile, sensitive and cold, calculated in relation to the financing of the deficit of the balance of payments of the USA, avoiding the accumulation of critical tensions, with a prompt and effective reaction in face of the instability of capital flows (since the historic removal of withholding tax on foreign investors, in 1984), and with signaling and coordination of exchange and interest fluctuations in order to tame destabilizing expectations. To a large extent, the fragility of the US balance of payments and the delicacy necessary for signaling interventions on voluntary international foreign exchange markets, capital and financial investments must be credited for the undeniable sensitivity shown by the US economic policy authorities regarding the reactions of its relevant partners, in the financial and foreign exchange fields (while practicing the old *big stick* policy in the commercial field). Indeed, the successful succession of summit meetings between OECD leaders, featuring a phase of intense political coordination and exchange and financial policy among capitalist states, seems to have finally vindicated Kautsky’s thesis of “super-imperialism,” that is, a tendency to the deliberate coalition of capitalist states in the face of economic and political crises.

However, as impressive as the cooperation between capitalist powers in recent years may seem, it would not be sufficient to ensure the continued support of private flows (decisions) of productive investment – in a climate of global instability – without articulation and diffusion, simultaneously, of a powerful cluster of innovations based on new technologies of comprehensive impact on the set of industrial structures of the main capitalist economies.

The application (or creation through it) of the microelectronics of a technological base common to a constellation of products and services grouped a set of industries, sectors and segments in the form of an “electronic complex,” densely integrated by the intrinsic convergence of information technology. The formation of this powerful cluster of innovations capable of penetrating widely (widespread use), directly or indirectly, all sectors of the economy shape the formation of a new technological paradigm in the purest neo-Schumpeterian sense.

The fundamental conditions for this seem to be met, namely: (1) broad spectrum of application in goods and services; (2) growing and sufficient supply to meet demand in the accelerated diffusion phase; (3) a rapid fall in the relative prices of products with innovations, continually reducing the costs of adopting these by users; (4) strong related impacts on organizational, financial structures and labor processes; (5) widespread reducing effects on capital costs and amplifying effects on labor productivity.

The technical conditions for the constitution of the “electronic complex” had been configured since the mid-1970s, in advanced industrial economies, with the approximation of the technological base of the computer and peripheral industries, telecommunications, an important part of consumer of electronics and a segment of the industrial automation area. It was throughout the 1980s and especially in the phase of continuous worldwide growth after 1983 that the rapid diffusion of goods and services in the electronic complex met the Schumpeterian economic conditions (1 to 5, listed above) unequivocally, producing what Christopher Freeman and Carlota Perez called a true “storm of creative destruction.”

The strength of this process of technical, social and managerial innovations will be shown below, but, at first, it must be stressed that this strength was largely due to the impressive speed of reduction in relative prices, made possible by the spectacular fall in the real cost of computational processing (bit/US \$) from the large-scale production of increasingly powerful chips (exponentially) at falling prices. The report of this project by Paulo Tigre (1990) describes it this way: “Microelectronics and its applications have completely satisfied these requirements. Taking computers as an example, some studies estimate that the real average reduction in equipment prices, internationally, adjusted in terms of quality and performance, has been above 20% per year for the past twenty years. Such a price reduction is unparalleled in the world’s economic history.”

## **2. The Seven Innovation Trends in the Main Capitalist Economies**

In a nutshell, it is possible to highlight seven main new trends that have emerged on the world stage in recent years and which are expected to take shape throughout the 1990s as a result of the vigorous expansion of the electronic complex. They are: (1) the increasing weight of the electronic complex; (2) a new industrial production paradigm – flexible integrated automation; (3) revolution in labor processes; (4) transformation of corporate structures and strategies; (5) the new bases of competitiveness; (6) “globalization” as a deepening of internationalization; and (7) “technological alliances” as a new form of competition.

### **2.1 The growing weight of the electronic complex**

Firstly, the growing and stimulating weight of the electronic complex in the main capitalist economies stands out. Indeed, the set of industries in the electronic complex has gained a notable quantitative expression (surpassing in many cases the automotive complex, former “flagship” of the previous technological standard). The rapid growth of the electronic complex tends to increase even more its share in the value added, employment and formation of income in the advanced capitalist economies. Two aspects deserve attention: (a) the greater the diversification and the degree of integration of the electronic complex within the industrial structure, the greater the tendency to be the internalization of interactive relations of input-output with a high endogenous dynamic impact; (b) the growing approximation of the technical base of the capital goods system – especially of the industrial machinery and equipment industries – to the same microelectronic base of the electronic complex tends to merge these two relevant industrial complexes in a large electronic-mechatronic complex, on which we will discuss in the next section. There are solid reasons to believe that the potential of productive capital accumulation, in terms of profitability and dynamism of advanced industrial systems, will be directly proportional to the degree of progress achieved in the dimensions a and b described here.

### **2.2 A new industrial production paradigm: flexible integrated automation**

Secondly, it is necessary to highlight the significant impacts already imposed by the new microelectronic-based technological wave on industrial production processes. The industrial processes typical of the dominant technological paradigm in the 20th century, based on electromechanics, through

dedicated, repetitive and non-programmable automation, have undergone an intense transformation (since the second half of the 1970s and notably in the 1980s) through accelerated diffusion digitalized (or computer-driven) mechanisms capable of programming the automation process. Electronics replaced electromechanics as the basis for automation, in such a way that dedicated microprocessors or dedicated computers started to guide the machine system or parts of it. In fact:

- a) the continuous production processes, which were already rigidly integrated, absorbed intensively programmable logic controllers (PLCs), sensors, digital meters, which, through computerized control systems (distributed or centralized) proved to be able to optimize on much more efficient bases its production flows, allowing partial or global optimization of systems with real-time control and automation of the industrial process;
- b) the discrete-interruptible automation processes, which had also launched an extensive range of dedicated mechanical automation, advanced significantly with the massive introduction of PLC and other equipment that, under the command of computers, allowed the optimized programming of the production, partial or total (in the case of CAM, that is, Computer Aided Manufacturing);
- c) the fragmented automation processes, dominated by assembly lines (*stricto sensu* characteristic of Fordism), managed to replace certain repetitive segments corresponding to direct manual operations by dedicated robots, approaching the discrete-interruptible processes, incorporating the new digital equipment and computerized controls for the segments that were already integrated by electromechanical automation, obtaining greater income in their economies of scale;
- d) finally, the manufacturing-artisanal production processes for the production of “customized” (or made-to-order) goods, notably of a certain type of capital goods, were the object of significant progress with the introduction of numerical commands (NC) and computer numerical commands (CNC) in their machine tools and machining centers, allowing critical segments of the previous production process (mechanical-artisanal) to jump to an advanced stage of programmable automation (and, therefore, susceptible to new advances towards flexible forms of automation).

The rapid diffusion of these forms of automation in the 1980s set the stage for a new, more comprehensive and complex leap, which should gain momentum in the 1990s: the emergence of integrated flexible automation systems.

Flexible automation fully integrated by hierarchical control computers (or Computer-Integrated Manufacturing – CIM) will tend to take shape throughout the 1990s, towards a dominant pattern whose characteristics are still difficult to predict. More powerful and cheaper computers (due to the diffusion of parallel processing techniques), endowed with some degree of “artificial intelligence,” advanced software systems capable of acting at various levels (from the factory floor to marketing) and enabling advanced integration techniques, new generations of robotics, etc. will be part of future CIM systems. The realization of this new stage, however, depends on important progress in integration software and other technical advances to be achieved in many fields: materials science, microprocessors capable of embedding artificial intelligence, laser and photonics, optics, instrumentation, micromechanics, etc.

The evolution towards this advanced stage of flexible automation tends to articulate intensely with computer aided design (CAD) and engineering (CAE) techniques. This new paradigm in formation, which will mark the industry of the first decades of the 21st century, means, in the limit, the radical fusion of mechanics and digital electronics, leading to a profound restructuring of the sector or of the “industries” of capital goods and services. The emergence of this new industrial complex supplying the future generation of processes, scheduled for the end of the 1990s (see the Arcangeli Report, 1990), should attract companies from the electronic complex, especially computers, since the massive use of these in industrial processes is yet to come.

### **2.3 Revolution in labor processes**

The third fundamental aspect, in contrast to the changes described above, is the ongoing revolution in the organization of labor processes. Today’s dominant forms of programmed automation are increasingly incorporating flexible, versatile characteristics that, designed for a future limit (with the structuring of a CIM paradigm), will transform the factory into a complex, “intelligent” organism, capable of learning and adjust itself. This transition points to an approximation of discrete production processes to the form of continuous processes, and will allow increasing flexibility in production, enabling a “customized” variety of products without losing economies of scale and with full capture of scope economies.

This tendency to flexibility, already present in leading economies, responds to the oligopolistic needs of competing in quality and in product differentiation, refining and adapting their lines to the characteristics and demands of developed economies’ markets. The interactive connection between users and producers has assumed an increasing importance and, undoubtedly, represents a key factor in shaping possible technological trajectories. In other

words, unilateral causal determination, which based on the technical possibilities of production rigidly defined the final characteristics of products, tends to be overcome in this technological transition, giving rise to new causal interactions in the opposite direction. For example, the conception and design of products takes on several challenges: it is about meeting users' demands and preferences, creatively incorporating the available technological advances and, still, finding the most appropriate way to save costs and production efficiency.

What do these trends to flexible automation and "mass customization" mean (or have already meant) for labor processes? The impacts are multiple:

- a) the introduction of flexible programming (as opposed to rigid programming) requires the direct participation of the manufacturing workforce in conducting the process to operate and reprogram the necessary adjustments to the equipment;
- b) the above tasks require a global understanding of the production process, which requires a broad and versatile level of qualification from the workers;
- c) production decision-making interventions at the industrial plant level reduce the hierarchical distance between management and the factory floor, thereby changing the pattern of relationship between management, engineering and production;
- d) the level of tacit, non-codable and specific knowledge of each factory unit is deepened and the need to invest in **intangibles** (applied software, training and qualification, organization and coordination of the production process and its relations with marketing, design, etc.) expands;
- e) all of the above impacts mean that labor processes move away from the Taylorist-Fordist paradigm in which the trivialized, fragmentary and repetitive division of tasks is pushed to the physical limit, towards a process (still transitory) in which the workforce interacts creatively with a flexible automation system.

The trends detected above lead us to the conclusion that the impacts on the composition and profile of the workforce imply much higher average levels of qualification, with an emphasis on the ability to interact and deal proficiently with digitalized equipment, controls and, mainly, computers. This requires a minimum of training in abstract reasoning, mathematics, instruction interpretation, programming, the ability to interpret visual information, codes, etc. and to react to them promptly. At the management level, it is essential to shorten the hierarchical distance with the manufacturing workforce, interact and be able to visualize, stimulate and take advantage of all the cross interactions

between engineering, design, marketing, production, development, in a manner consistent with the strategies outlined – enabling them to influence their conception. Engineering (both in development and, mainly, in production) will need to adapt and interact with the manufacturing workforce, preparing to face new and unexpected problems that will inevitably result from the deepening of flexible automation techniques.

Flexible automation systems make increasingly relevant the ability to **coordinate** the flow of the manufacturing process, marketing, commercialization, finance, design and development and, moreover, they will tend to make interaction processes even more complex, on the one hand, with suppliers for *kanban* and just-in-time systems and, on the other hand, with distribution networks.

In summary, in addition to coordination, the ability to absorb and sediment – cumulatively – practical technological knowledge about the operation of new flexible automation technologies seems essential.<sup>117</sup> It will do no good (and this is demonstrated by several empirical studies) to introduce new processes and equipment if the workforce, in production, management and engineering, is not prepared to perform these new roles effectively.

## 2.4 Transformation of business structures and strategies

Fourthly, the rapid transformation of business strategies, organization and culture is highlighted in the context of the changes described in 2 and 3. The evolution of new flexible forms of production; the need to guarantee and expand market shares by offering differentiated or “customized” goods, at falling prices accessible to the wealthy middle classes of developed societies; the possibility of setting up internal computerized networks to centralize management, sales, purchases, stocks, finance, production, if necessary in real-time; the possibility of establishing new profitable relationships with suppliers, customers, service providers, research institutes, universities, or even with traditional competitors, in certain areas – all of this has led to relevant changes in corporate structures and strategies.

The remarkable advancement of telecommunication intertwined (and interlaced) with information technology, enabling the formation of internal networks capable of informing and controlling functions and activities at different levels, has dramatically reduced diseconomies of organizational size and intra-hierarchical transaction costs, allowing large corporate structures to efficiently manage and coordinate their operations.

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117 Conjugation of learning-by-doing, learning-by-using, learning-by-experimenting.



The internal computerized networks enable the extensive practice of sourcing all intra-group resources, especially the technological knowledge in R&D activities. Important changes in the organization of multinationals, from telematics, have been leading to the abandonment of classic multidivisional structures in search of new **global arrangements**, combining forms of regional decentralization or product groups with global service centers for finance, “trading,” R&D, data processing, transport.

The organizational changes experienced by large multinational companies raise another issue – parallel – about the structure of large business groups, namely: which form of capitalist organization is more agile and capable of maximizing the process of economic innovation and, therefore, of capturing the “quasi-rents” resulting from the innovative leadership?

Several studies have indicated the “virtues” of large Japanese groups in the form of *keiretsu*, in view of the following connotations:

- a) its connection with the practice of long-lasting cooperation systems, including with subcontracted units outside the group, in the form of *kanban*, just-in-time, total-quality, which allows for a production standard that minimizes stock retention, reduces costs and obtains high levels of factory yield, with high quality and zero defects;
- b) the tendency to invest more in training and the formation of the workforce at all levels, facilitated by the stable employment relationship, by long-term salary contracts associated with a system of promotion and rotation of positions and functions that stimulates versatility and rewards *esprit-de-corps*, competence and productivity. This environment provides a more advanced degree of decentralization of production decisions, with online management and co-responsibility of workers, which is crucial for the use of flexible manufacturing techniques;
- c) greater integration and interaction between R&D, design, marketing and engineering both with the needs of production, with maximum efficiency, and with the preferences of users and consumers, and the intense use of technological resources available in the group to obtain the desired sophistication of products.

The combination of the abovementioned characteristics (cooperation, coordination, quality, valorization of human resources, decentralization of responsibilities with the participation of workers, high level of qualification, interaction in R&D, production, marketing, differentiation of products in attention to user preferences, use of flexible automation techniques – enabling “mass customization” of product offerings) has been described by

many authors as a new form of organization of capitalist production, called “Toyotism” as opposed to “Fordism,” symbol of the American technological paradigm previously dominant and whose characteristics are distinct and mostly opposed to those listed here.

*Keiretsu*’s superiority in promoting cooperative, agile and innovative strategies is not simply due to cultural-subjective factors but, rather, it was shaped and conditioned by the peculiar form of Japanese capitalist centralization in **dynamic multisectoral groups**, marked by the strong presence of leading industries of technological irradiation. Furthermore, in addition to the sectorial profile, *keiretsu* are founded on a harmonious form of bank-industry relationship. These are the characteristics that enhance the strong propensity to innovate and face risks, since: (a) they enable a high degree of **internal synergy**, deliberately pursued. For example, all large Japanese business groups contain within themselves an electronic complex, covering the production of high-precision capital goods, microelectronics, consumer electronics, data processing computing, telecommunications, service automation, industrial automation, software. In addition, these groups have other mature technology industries that maintain dynamic market prospects (for example, automotive, petrochemical) and that benefit from interaction with the electronic-based complex; (b) the banking organization functions as the financial lung of the multisectoral bloc of capital, whose profit rate (and accumulation) is maximized for the group as a whole and not strictly in the financial sphere<sup>118</sup>). The bank’s framing of the group’s objectives explains the ability to finance long-term projects without immediate pressures to maximize profits/interest that impose perverse business and technological decisions. Fundamental to this behavior is the stable and inexpensive saving base, built directly on the salary mass (especially of the group itself) through retirement, pension and insurance systems. High savings rates (of the order of 30% of GDP), based on these systems, allow the sustaining of long-term operations, with low interest rates, providing the necessary breath to wait for the maturation of long-term projects, to withstand painful stages of restructuring and to finance the risks of innovation. The ease of setting up new ventures/subsidiaries, through the “cross-ownership” participation of several group companies in the new project and through a high level of long-term credit leverage, allows quick responses to follow the strategies of the leaders, and bold initiatives to take the risks of pioneering.

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118 The abundant dollar liquidity of the large Japanese groups, resulting from their solid competitive position, has boosted the internationalization of their large banks and brokerage firms in recent years, which has been modifying at the international level – but not at the domestic level – the accumulation strategies of the Japanese financial capital.

These genetic characteristics (since the *zaibatsu*) of Japanese capitalist centralization explain the strong capacity for intra-group cooperation, with organized networks of suppliers, small and medium-sized companies, risk sharing, technical collaboration and financial solidarity. On the other hand, in contrast to intra-group cooperation, inter-group competition is intense and is expressed primarily in the search for quality and innovative leadership.

In summary, the organizational superiority of the large Japanese company – today imitated by American and European multinationals – resides in a multi-industrial, cooperative structure based on a dynamic technological profile. The financial power that emerges from the large size of capitalist groups is not sufficient in itself – it is essential that the bank-industry relationship works in a joint and supportive way, and not in an individualized and antagonistic way. That is, the ability to coordinate internal cooperation (at various levels, from the factory floor to relations with suppliers and distributors); to face the risks; and to reap benefits from innovation, appear as key points of competitive capacity at the business level.

The comparison with the big Korean *chaebols* is pertinent. These, despite being multisectoral diversified, do not have a profile as concentrated and advanced in the microelectronic-based industries as the Japanese *keiretsu*. On the other hand, Italian companies highly successful in coordinating, in a network, a large number of suppliers and distributors demonstrate (as is the case with Benetton) that size itself is not essential for competitive success, but, rather, the managerial capacity to control – with pronounced coordination capacity – strategic assets and activities, together with the ability to accelerate economic innovation within these structures.

## 2.5 The new bases of competitiveness

The fifth trend, clearly perceived from the 1980s, refers to the new bases of competitiveness. There are two findings from several studies carried out in OECD countries. **First**, that competitiveness has a **systemic dimension**, that is, it does not rely exclusively on the dynamism and the managerial and innovative agility of the private company, although this has not ceased to be the key vehicle for the realization of technological innovation, that is, of the commercial application, on an economic scale, of scientific advances translated into new processes and products. It happens that private innovation flows with greater dynamism in economies where the presence of benign “externalities” is combined with the strong interaction between the private company and public institutions of applied science and research (universities, institutes, research centers).

The interaction between private R&D centers and the scientific base concentrated in universities and institutes enables the solution (or, at least, the indication of viable options) for basic technological problems that cannot be solved through incremental experiments, which means saving resources and risk reduction. It is from this type of interaction between scientists and R&D engineers and researchers from university institutes and departments that new paths and ideas emerge that often lead to radical innovations. This statement is particularly true for cutting-edge technological sectors, classified as “science-based,” that is, sectors that are closely associated with the application of scientific advancement and directly depend on this application to launch and/or improve products and conquer markets. The virtuous interaction is not limited, however, to the relationship between universities, institutes and companies. Relevant, too, is the interaction **between** private R&D centers or between engineers from different companies. It is evident that this interaction tends to be much more intense between companies of the same group or between producers and suppliers that maintain long-lasting partnership relationships (which explains yet another characteristic “favorable” to *keiretsu*).

In summary, the capacity for business innovation tends to be enhanced by the existence of favorable and stimulating environments, in which systematic and spontaneous cooperation prevails between public and private centers of pure and applied research, which, certainly, requires a high density of qualified personnel and the presence of an adequate infrastructure of equipment and communications network. That is to say, the endogenous capacity to innovate – centered on the private company, as a vehicle – has a systemic or social dimension and, not by chance, has been the object of governmental promotion policies.

The **second** finding, partly based on the first, is the recognition that competitiveness largely depends on the endowment of “factors” and natural resources and tends to be increasingly a deliberate result of private and/or public investment strategies with innovation. In other words, comparative advantages, in addition to being essentially dynamic, tend to be advantages **built**, exercised and dependent on a continuous effort to be maintained. This means recognizing that the bases of competitiveness are directly and umbilically linked to the capacity to innovate, which is understood in its broad sense and not just as the ability to invent and introduce new products and/or processes. One of the main components of the ability to innovate lies in the **ability to produce** with maximum efficiency, given a specific production process, which depends on a set of factors, such as organization of the work process, inventory management, supplies, applied engineering capacity, qualification and commitment of the workforce, techniques and methods of quality control,

etc., which ultimately result from a high capacity for managerial coordination. The economic importance and complexity of the set of knowledge and techniques necessary to maximize the productive (physical) yield of a given process has led to the conceptual separation between “innovation technology” (that is, the ability to create new processes and/or products) and “production technology” (that is, the ability to efficiently produce a product line, given a certain process). By extension, the concept now applies to “marketing technology,” “organization,” “design” etc.

It is relevant to note that **technological production capacity** is more important for current competitiveness (which means relative efficiency) than innovation capacity understood *stricto sensu*. This statement is all the more true the longer the “process cycle.”

The systemic interaction between production engineering and the activities of design, R&D, quality control (including inputs, parts, pieces and components), management and, last but not least, the manufacturing workforce thus appears as a relevant condition, but not the only one. It is essential to have interactions in the opposite direction, for example, between design and production, that is, the concern to draw with characteristics adjusted to efficient production. Furthermore, it is not only important the intra-factory interaction, but certainly the interaction between companies or between companies and research centers can often be fundamental for the optimization of production processes.

One cannot fail to point out, at this point, that the qualification and commitment of the manufacturing workforce becomes a *sine qua non* condition for efficient production, notably in industrial processes with an increasing incidence of flexibly programmable equipment and with frequent modification in the specification of products.

In short, competitiveness does not come simply from “endowment of factors and resources” and their relative prices, although it can (and should) make use of these conditions, but results from deliberate business investment strategies, based on endogenous and systemic technological training, to produce with maximum efficiency and to introduce new processes and products. These, in turn, when move from the product launching phase to the mass production phase, need to go through the stage of accumulation of knowledge, adjustments, advances and incremental improvements, at various levels, as quickly as possible, until reaching a regime of production in high physical yield.

## 2.6 “Globalization” as a deepening of internationalization

The sixth trend, perceived and repeated with the effervescence of fads, is the so-called “globalization” of economic relations. Leaving aside any imprecise and vague sense – which, under the pretext of the “growing interdependence” and the “generalized fall of economic barriers,” advocates for the unrestricted opening of national economies to the flows of investment, trade and technology –, one can understand the “globalization” as a step towards deepening internationalization, throughout the 1980s, in the following lines.

1. In the intense and vigorous interconnection of the foreign exchange, financial and portfolio-type markets, promoted by massive and continuous flows of capital (and interest) between the main financial markets of the globe, whether offshore or onshore. The main source of massive dollar capital movements is the huge and uninterrupted deficits in the US balance of payments, which **roughly** correspond to strong surpluses in Japan, Germany and the “Asian Tigers.” The comprehensive and accessible online interconnection, anywhere in the world, is due to the remarkable progress of satellite telecommunications and the overwhelming capacity for processing, storing and transmitting information made possible by the fast diffusion of computing equipment, which allows any small agent to operate, directly or indirectly, in the different world markets.

The truly global interconnection of the markets (foreign exchange, financial and securities) was, moreover, facilitated by the “deregulation” of financial systems, with the aim of stimulating the compensatory capital flows necessary to finance the chronically countries with deficit, especially the USA.

The cumulative result of this process can be portrayed as an intense process of **patrimonial interpenetration** between the great industrial and financial bourgeoisies of the main capitalist economies. The great American (bourgeois) company had already invaded all world markets in its shining post-war heyday. In the 1970s, international financial markets for funding and credit (offshore) were developed in Europe and in other markets. In the 1980s, the American trade imbalance caused, ultimately, massive counter-flows of “investment” or, better, capital movements for multiple investments that inflate papers that represent capitalist wealth (stock exchanges), properties and permanently pressure for higher real rates of interest for investment in government securities (especially those in the USA, which, also domestically, have sustained a high fiscal deficit). The two major crises on the New York and Tokyo stock exchanges (in 1987 and 1989) substantially “corrected” the

speculative valorization, but the advent of a deeper recession in the main capitalist economies in the 1991-1992 may cause acute turbulence in the risky capital markets.

The equity interpenetration between capitalist economies can be seen by the net “debtor” position of large American capital *vis-à-vis* its competitors: that is, the total of American-owned assets in the rest of the world has been, since 1986, lower than total assets under foreign control in the USA. This is mainly due to the heavy inflows of Japanese and European investments in the American economy. At the same time, significant Japanese investments were made in Europe. This large-scale capitalist interpenetration has largely functioned as an international agglutination factor for the interests of national “super-bourgeoisies” – for example, a “collapse” of the US capital market or financial market not only affects the bourgeoisie of the USA but also imposes significant losses on the large Japanese and European capitalists who hold a not insignificant part of the ownership of these assets in that country. A hypothesis to be investigated, regarding the forces at work behind the greater cooperation and coordination of economic policies in recent years among the main capitalist economies, may have its origin in the advance of the patrimonial interpretation described above.

The strong interconnection of the financial and capital markets has effectively extended the “global” interdependence, especially with regard to foreign exchange markets (and parities), stock exchanges and interest rates. However, it is important to point out that surplus countries still maintain (because they can) the power to regulate their rates of interest and their **internal** credit conditions, with relative comfort. This stems not only from the fact that they can have high foreign exchange reserves to intervene in foreign exchange markets, but mainly from the fact that they have managed to prevent the “bank deregulation” advocated by the USA from reaching their institutional bases of stable and cheap savings.

2. In the productive dimension, in the realization of international, **world**, or if you wish, “**global**” **oligopolies** in several important industries, in which the competitive internationalization of the great American, European and, later, Japanese companies already pointed out – since the end of the 1970s – for the concentration of world competition in a few companies. The most conspicuous case of world oligopoly is that of the automobile industry, in which no more than ten internationalized producers dominate and compete for market shares on a global scale. Other examples can be mentioned, such as the pharmaceutical industry, of some sectors of heavy electrical material, information technology, consumer electronics, “cosmetics,” chemistry, non-ferrous metals. In some cases (such as aluminum and petrochemicals)

global competition in recent years has contributed to “decommissioning” industries that previously constituted world oligopolies since the 1960s. Other, less stable, forms of cartelization or global oligopolization are configured in highly specialized industries, in which the cumulative economies of scale are very high, or in industries in which the degree of specialization is very high and the world market is relatively small: examples of these two cases are the aeronautical industry and some segments of capital goods and sophisticated equipment (instrumentation, supercomputers).

The formation of these global oligopolies does not represent, however, a historical novelty, although the significant acceleration of direct risk investments in recent years, in the context of the strong equity interpenetration, described in the previous topic, has contributed to increase and configure an expressive number of “new” global or world oligopolies in the 1980s. This finding does not imply that these oligopolies cannot be challenged by emerging actors, especially from Asian NICs, as it is the case with Korean *chaebols* in some segments of consumer electronics (TVs and VCRs) and the automobile industry.

3. In structuring sophisticated computerized global management networks online within multinational or high-tech companies in the process of internationalization, which allow the practice of various forms of global sourcing. Among these are: (a) sourcing for the supply of standardized parts and components or raw materials, especially in stages of general scarcity (this type of sourcing is old and is not new for multinational companies); (b) the sourcing of preferences and characteristics of consumer markets to determine production plans anticipating the trends detected and guaranteeing market shares with the strengthening of commercial brands; (c) finally, the sourcing of technological knowledge, including qualified human resources. Technological sourcing has been identified as the main cause of the restricted decentralization of the R&D activities of large companies, which establish research centers in countries where the scientific and technological base is advanced so that they function as “windows” of access to innovations or emerging advances. These windows can, in certain opportunities, function as “surveillance posts” to detect the technological trajectories of rival companies and to trigger imitative efforts to prevent a competitor from reaching a significant distance in a given field. Technological sourcing is also relevant for the accumulation of knowledge of production technology: the exchange of methods, techniques and ways of organizing production with superior



performance, including through the international rotation of the qualified workforce, carrier of this knowledge.

The three points described above (equity interpenetration, with the online connection of the financial and capital markets, the formation of a significant number of global oligopolies and the structuring of global telematic networks by large companies) characterize genuine advances in the internationalization process towards “global” forms of interaction, largely made possible by the remarkable advance of telematics. On the other hand, the imprecise and vague use of the “concept” of globalization as an **ideology**, a trend that has recently gained considerable strength, should be noted here, although it is methodologically irrelevant for this work.

## 2.7. The “technological alliances” as a new form of competition

The seventh relevant trend that has emerged in recent years is the intense formation of “technological alliances” between two or more competing companies, through cooperation agreements, joint projects, research consortia, *joint ventures*, etc. These initiatives must be seen as a new form of “organization” or configuration of oligopolistic competition in view of the following points:

1. the rising costs of R&D in various industries, whose high magnitude induces the sharing of these costs through joint projects among a small number of oligopoly participants;
2. the high risks of certain R&D projects, which, although promising, do not develop on a predictable path in terms of costs and results, which also leads to the formation of cooperation agreements and shared projects;
3. the struggle to impose technological standards dominant in certain areas, assuring the controllers of the solution that it will become a world standard with great advantages in capturing large market shares. The advantage of building and disseminating standardized solutions (*vis-à-vis* the alternative of seeking individualized “proprietary” solutions) increases as the product cycle is fast and as the specific product has wide diffusion, with large-scale production, advising the search for substantial market shares. In the area of the electronic complex, the advantage of introducing and controlling “standards” is, moreover, reinforced by the strong preference of the markets for equipment **connectivity**, which requires the consolidation of dominant solutions or normative standards. The association or alliance of groups of oligopolistic firms around consortia, agreements or projects to define

and establish a standard solution is due to the need to form a critical mass of market participants to achieve success in the endeavor.

The strong trend observed in recent years towards the formation of alliances between oligopolistic companies has been described by some authors as yet another demonstration that “globalization” is advancing in a comprehensive manner. The research work carried out by Hagedoorn and Shakenraad at MERIT, at the University of Maastrich (1990), using 2700 agreements made by companies belonging to their database, indicates, however, the dominant importance of oligopolistic alliances of **national** or **regional** character. The increasing intensity of technological cooperation relations can be assessed by the index that divides the number of inter-company links actually observed and the total number of possible combinations  $n(n-1)$ , where  $n$  is the number of firms in the sample. This index jumped from 23% to 40% from the first to the second half of the 1980s. The predominance of the national or regional character of these associations is evidenced by the formation of clusters (or dense groupings) of interactions between companies of the same national/regional origin. The identification of these through the cluster analysis technique applied to companies in the electronic complex indicates three distinct groupings: (a) a concentration of Japanese inter-company partnerships, which, once again, ratifies the associative facility intrinsic to *keiretsu*; (b) a second cluster is clearly formed by leading American companies; (c) the alliances between large European companies, under the leadership of Siemens, have been forming with greater relative speed in recent years, indicating that the “Europa 92” project apparently contributed to accelerate intra-European cooperation.

The predominantly concentrated character, from a geographical point of view (at the national or regional level), reveals that inter-oligopolistic alliances represent a new way of reinforcing the competitive power of “groups” of partners, especially from the same national origin, to face the intense competition for world markets, due to the three reasons mentioned above (increasing R&D costs, increasing R&D risks with increasingly shorter life cycles for products and processes, striving to impose market standards).

However, there is the occurrence (clearly minority, but significant) of alliances between protagonists from different origins (or, as some authors prefer, trilateral alliances), involving Japanese, European and American companies. These alliances tend to occur as a result of two characteristics: (a) they involve companies that operate and compete in world markets, that is, they are part of global oligopolies; (b) they involve, in general, strong companies in different market segments and that present a high degree of complementarity in their technological profiles, in such a way that the benefits of cooperation tend to overcome the risks of erosion of the market bases of each protagonist. The

most frequent supranational partnerships in the area of the electronic complex involve the following leading companies: AT&T, IBM, GTE, Motorola, Siemens, Toshiba, Fujitsu, NTT.

To conclude, it is necessary to warn that the expressive propensity to form technological alliances, between companies of the same national/regional origin or even between companies of different national origins, far from signifying a genuine indiscriminate tendency towards the expansion of technological cooperation on non-competitive “social” bases, represents rather a way of sharpening inter-oligopolistic competition. The formation of technological consortia or coalitions has a pragmatic, temporary character and as a rule aims to obtain (offensively) competitive advantages derived from innovative leadership or the imposition of standard solutions, for the benefit of the group. The formation of these alliances obliges, on the other hand, the other rivals to reactively organize themselves from other similar coalitions. Even within the respective groups or bilateral alliances, several authors point out the frequent intention of one of the participants to condition, constrain or exhaust the technological capacity of the partner.

### **3. Growth Driven by Innovation and Sustained by Political Cooperation**

The significant trends of change and technological, business and financial reorganization of the main capitalist economies in the last decade and the projection of the deepening of these trends in the 90s (increasing weight of the electronic complex, advancement of factory automation flexibly integrated by computers, reorganization of the labor processes, changes in the structures and strategies of large companies, an increasingly “built” character of competitiveness, the advancement of “global” forms of internationalization, technological sourcing, and in particular the patrimonial interpenetration between the great national bourgeoisies, intensification of inter-oligopolistic technological alliances) configure a scenario of evident acceleration of **economic innovation**, understood as an endogenously articulated Schumpeterian wave. It is clear to any observer that this wave of innovation has been an essential factor in driving the dynamism of the capitalist economies along the virtuous stage of growth of the main capitalist economies in the last eight years. The remarkable demonstrated ability to coordinate financial and exchange rate policies among the economic authorities of the main economies can now be put into perspective: it was instrumental in prolonging this powerful innovation cycle, preventing the instabilities resulting from large trade, speculative and excessive indebtedness imbalances having shortened the expansion.

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# CHAPTER 13

## THE FINANCIALIZATION OF WEALTH: the financial macrostructure and the new dynamics of the Core capitalisms<sup>119</sup>

*José Carlos Braga*

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### **Introduction**

This study examines the financial transformations and economic dynamics of developed capitalism, addressing, for this purpose, three strategic questions of the (re)definition, management, and realization of capitalist wealth, which mark the last four decades of the 20th century.

The first issue is that of the instability and contemporary transformations of American capitalism. This analysis must start from the 1966 event, called “Credit Crunch,” recognized by several authors as a turning point in the post-war economy of the United States. It corresponded to a critical credit situation and to the primary expression of instability linked to financial dynamics. This process was linked to the emergence of the public deficit and inflation – and, therefore, to the contradictory management of monetary and fiscal policies – as well as to the internationalization of banks in the emergence of the Euromarket.

The relevant changes in world finance in this period were driven since the crisis of the dominant power, the United States, from the 1960’s, and, recently have reached Europe, Japan and, to a lesser extent, the developing countries in Asia.

The aforementioned crisis of American capitalism refers to the structural transformations of the last three decades, a temporality that unfolds over a long term and in which critical cyclical moments are manifested. In these circumstances, the following elements have emerged, combined differently in the chronological timeline: public deficit, weak currency, inflation, balance of payments deficit, bankruptcies of corporations and even financial subsystems.

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119 This study is one of the results of my postdoctoral research at the Department of Economics at the University of California, Berkeley, United States (1988-9). For this version, I counted on the valuable contribution of the professor and friend Maria da Conceição Tavares, which resulted in greater precision and elaboration of fundamental aspects of the argument. Discussions with colleagues at Unicamp’s Institute of Economics and Fundap’s Institute for Public Sector Economics (IESP) were of great value. All are exempt from possible imperfections still present in the text. I would also like to thank João Manuel Cardoso de Mello for encouraging this publication.

It is important to understand that, more than ever, in contemporary capitalism “finance sets the pace of the economy” (Minsky, 1975), and, in this sense, there is a financial dominance in the economic dynamics.

Thus, in this context, changes in finance have been an internationalized dynamic, based on a true financial macrostructure, with a transnational scope, originating in the United States and also transposed, in national terms, to some important countries in Europe and Asia. Financial dominance is the most apparent and problematic form of the economic dynamics of contemporary capitalism. It does not rule out that the dynamics remain, to a large extent, conditioned, as a last resort, by the capitalist calculation about technical progress and fueled by international inter-company competition, supported or not by the adjustment and restructuring policies of the dominant countries<sup>120</sup>.

Financial dominance – **financialization** – is a general expression for **defining, managing and realizing wealth in capitalism**. Financial dominance also includes conceptually the fact that all corporations – even the ones that are typically industrial, such as those in the metal-mechanic and electro-electronic complex – have in their financial investments, of retained earnings or cash profit, a Core element of the investment process of global wealth accumulation. Thus, their financial departments have been acquiring greater strategic importance than those of research and development (R&D), to the point of assuming the profile of nonbank banks, internal to companies<sup>121</sup>.

The second issue addressed in this study concerns the nature of competition and the corporate structure of modern capitalism, in which this financial dominance is very important. This is not considered here as dominance of the financial sector, particularly because this cut, financial sector *versus* productive sector, or financial capital *versus* industrial capital, is today, at least, quite questionable. Questionable by the existence of the financial macrostructure – above all at international level – and, in some national cases, given the conglomeration prevailing in some leading countries, such as Japan and Germany, although that cut remains valid in the other countries of the Organization for Cooperation and Economic Development (OECD), including in the United States, which are subjected to tensions arising from this general trend<sup>122</sup>.

120 See Coutinho (1991) on the dynamics of technical progress, and Tavares (1992) on macroeconomic adjustment and restructuring policies.

121 To illustrate, consider the financial behavior of large Japanese corporations since the 1960s. A structural increase in financial capitalization is revealed even in companies in Japan, a country notably geared towards productivism. Thus, the relation between non-operating and operating profits has the following minimum and maximum values in the last three decades: 1960-70 – 22.9% and 37.5%; 1970-80 – 34.9% and 62.5%; 1980-8 – 41.1% and 60.4% (See Table 1 of the Statistical Annex).

122 The banking reform underway in the United States will be an important decision moment on the legality of industrial firms to have banks and on the end of the separation between commercial banks and investment

Also, the second issue points out that the structure of contemporary capitalist corporations seems to be changing rapidly, considering the United States, Japan and Germany, highlighting the speed of changes in the second half of the 1980s. Therefore, these are changes that are taking place and upon which there are still no convincing reflections of an analytical and theoretical nature, even in universities in Europe, in the United States and in Japan.

The third issue refers to the emergence of a financial macrostructure – of public and private, national and international dimensions –, and to what is considered as the “financialization paradox” of this contemporary dynamic and which corresponds to changes in the system’s forms of movement. That is, crises and restructuring follow different processes in relation to other historical moments. This study analyzes why existing theories on economic dynamics succumb before the innovation that prevails in this new logical-historical time of world capitalism, which has been designated with a certain impropriety of “globalization”<sup>123</sup>.

## **1. End of Prosperity of the American Economy and Financial Capitalization**

### **1.1. Financial-monetary fundamentals and recent transformations**

The determinants of structural instability that have hit national and international economies in the last few decades were born in the United States, in the 1960s. At the time, the American economy was the most powerful in terms of the scale of capital accumulation, the complexity of financial mechanisms, the power of its industry, the role of the State and its international power. Considering that part of these powers remains in force, its trajectory has conditioned world transformations both in the Core and on the periphery of capitalism.

Before this analysis, we will see what are the financial and monetary characteristics of successful capitalisms in the 20th century, which are at the heart of the ongoing restructuring.

These countries combined growth and monetary stability by having their finances founded either on a credit-based system or on a capital market-based system.

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banks. These are the Core issues of said reform, in addition to the existing regional division between the institutions.

123 The “Global Reach” of the great transnational oligopolies has been examined in its various strategic dimensions — commercial, technological, financial — but this, in my opinion, is a permanent dimension of the capitalism of large companies. This study examined a macrostructure with a new dimension, which goes beyond the logic of the large company and which has, at its origin, the so-called “macroeconomic imbalances” of the dominant power and the rupture of the stability of the international monetary standard. See Barnett and Müller (1974).

In the credit-based system, there is, in general, a close articulation between industrial capital and banking capital, in interaction with the monetary authorities, as well as with other government institutions. Such a process implies the management of technical-productive (industrial) and financial-monetary policies, in order to provide long-term growth trajectories with stability. Despite differences, it is the standard common to Japan, Germany, France and some developing countries in Asia.

In the other system, the capital market is the Core of the financing pattern. It is based on institutional investors (mutual and pension funds, insurance and others) and traditional banking operations (credit and financing with different terms). This is the Anglo-Saxon standard adopted by the countries that exercised hegemony in the international monetary system: England, until the first decades of the 20th century, and the United States, until the beginning of the 1970s.

Recently, however, there has been a tendency to reduce the borders between these systems, although in each country this is happening with different forms and rhythms. This movement stems from the evolution of the globalization process of the economy, particularly the financial system, through a globally integrated capital market and an upward trend in the homogenization of inter-country financial systems.

### ***Finance structure and institutional framework***

In both systems there is a structure formed by the interaction between productive investment and financial capitalization, which was constituted by the articulation between financial and non-financial companies, and between the banking systems and Core banks, respecting the organizational differences of each country.

On the other hand, there is an institutional framework that facilitates and induces the relationship between the two fundamental dimensions of modern capitalism: the financial-monetary one, expressed in property wealth (diversified and liquid assets), and the productive one, expressed in the innovative and industrializing accumulation of technical-productive bases. This institutional framework creates in the economy, through (financial and industrial) business practices and relations between the State and the market, bases for economic growth and, at the same time, inhibitors of structural instability problems, such as inflationary episodes. It is in these conditions that industrializing finances become reality, whose meaning was discussed in the Introduction.



### *Property wealth and innovative investment*

Capitalism moves around money, credit and equity, as have been already shown. Articulated, these elements allow the combination of liquidity and capital immobility, which, despite registering detachments due to instabilities, constitute a decisive factor in development.

However, in the 1960s, after the American economy began to live with financial uncertainties that culminated in the end of the convertibility of the dollar into gold and triggered interest and exchange instabilities around the world, the currency was no longer fully stable, even in developed countries. Also, the combination of liquidity and capital immobility has become more difficult to achieve and has caused important financial innovations.

In these conditions, the growth with controlled inflation, which has recently occurred in OECD countries, is due to a virtuous articulation between financial innovations (supported by diversified financial assets) and technical-productive innovations, which have enabled high levels of net worth and industrial investments, despite the increase in the speculative nature of financial investments.

The ongoing financial innovations are characterized by the principle of securitization, which implies the predominance of negotiable financial securities, meeting the requirements for mobility, liquidity and risk coverage, demanded by capital owners and investors in general. Such requirements have become essential in the macroeconomic context recently, marked especially by interest and exchange instability.

The new financial instruments partially replace bank loans as credit and valuation mechanisms specific to the new micro and macroeconomic context. Securities can be equities, bonds or any other financial papers that, in addition to being marketable, represent a right to charge income from a final issuer or a financial intermediary, as a last resort. Securitization is sometimes mistakenly understood as a process of banking disintermediation – exclusion from the banking system –, given that, with financial innovations, borrowers and investors would bypass banks. This is a fallacy, since in these changes the banks themselves are transformed, redefining their connections with the industry, and are important underwriters – in underwriting operations – and distributors of securitized bonds.

The deregulation of financial systems, related to those innovations, has been carried out by all governments in the developed capitalist world, even though the rhythms and immensities are different. These practices obey less the doctrinal preaching of neoliberalism than the reality of the tension between official regulations and the pragmatism of large transnational business groups in the pursuit of profitability and investment opportunities, both financial and

productive. Thus, over the course of these two decades, the daily routine of “investment markets” has supplanted Core bank controls and standards, as well as the exercise of certain public policies by monetary authorities. In many cases, the so-called deregulation is nothing more than a response to the economic reality, while governments are given time to know what they should and can do as “new regulation.” Namely, it is about defining a new type of relationship between governments and financial systems at national and world scales.

## 1.2. The turning point in 1966

In the 1960s, after the events of 1966, the origins of these elements of instability and transformation were revealed, which can be used as a starting point for thinking about the international restructuring that is underway. In any case, it is an unstable restructuring, not only in the United States but also in Japan and Germany – especially from the second half of the 1980s. From 1990 onwards, even the “organized model” of Japanese capitalism shows signs of instability through the Tokyo Stock Exchange, with a devaluation of 25%.

From a theoretical point of view, since the mid-1960s, the contemporary way in which finance sets the pace of the capitalist economy has already been made explicit, as analyzed by Minsky (1975; 1986). These important changes in financial relations that have occurred in the United States have meant a transition to financial turmoil and fragility, which are taking over the economy. As a dominant power, the United States has, since then, experienced balance of payments difficulties, inherent in the fight against the loss of hegemony of the dollar as an international currency. This is a trap, a determination, constantly present in instability and that impacts the Core Bank through loss of reserves, pressure on interest and exchange rates, conditionalities to monetary policy.

First, the expansion of fixed investment that occurs between 1962 and 1970, in the American economy, occurs through an increasing the ratio between fixed investment and gross internal funds; that is, the participation of external funds in the financing of investment by non-financial corporations increases. U.S banks internationalize themselves as important members of the “eurobonds” market. The ratio between total debt and demand deposits also increases significantly, which results from the emergence of new financial assets of great importance. At that time, there was already a large investment in interest-earning assets in the United States, replacing the possession of the money itself, as a defense against inflation. In other words, there is already the context of a financial and monetary market, accompanied by inflationary tensions, which is beginning to change in relation to the one that prevailed in the postwar prosperity. The tactics and valuation calculations of American corporations change.

There is a leap, on the part of corporations, towards what Minsky calls exotic finance. There is also an increase in the ratio between “open market” papers, added to the financing obtained from financial companies (other than commercial banks) and the total debt. That is, American non-financial corporations begin a multifunctional leverage of resources through operations with papers and financial companies, operations that no longer had to do with the traditional form of leverage for investment, which was in force until the mid-1960s<sup>124</sup> and was at the Core of prosperity. This leverage now involves both funding and investments, with different deadlines and objectives. It is funded in the long term, applied in the short term and then productive and financial profits are made up.

And more than that, the American Central Bank – the Federal Reserve – is beginning to support these types of liabilities. The inflection of American monetary policy, in the late 1970s, towards high interest rates – the Volcker Rule – undoubtedly plays an important role; which must be considered, however, within this “heavier” set of dynamic and structural determinants, which were already present in the 1960s, in addition to the balance of payments crisis itself.

American commercial banks experience a process in which the so-called “Equity Protection” deteriorates. That is, the representative values of the banks’ equity are increasingly smaller in view of their liabilities. Between 1961 and 1973, “Equity Protection” declined, for American commercial banks, from 0.85 to 0.59 (that is, from 85% to 59%).

At commercial banks, at the same time, there is an increase in the multiplicity of new bank liabilities. The ratio between demand deposits and banks’ total liabilities dropped from 50% in 1962 to 35% in 1972. The fundamental financing instruments in the 1960s were the so-called negotiable Certificates of Deposit. Later on, at the end of the 1960’s, the “Commercial Papers” appear, which will have an extremely important “performance” in the 1970’s and even throughout the 1980’s.

Let us now see how the development of these main instruments of financialization, which occurred in the United States, ends up contaminating the market in general, the monetary management of the Federal Reserve and public finances.

In the 1970s, the main instrument of expansion of the American economy, from a financial point of view, was the “commercial paper.” When, as a measure of economic policy, a race against the papers happened with both the “commercial paper” and the certificate of deposit in the 1960s, the Federal

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124 Until now, financial intermediation was supported, in the long term, by insurance companies and pension funds, while short-term operations were typically credit and non-financial. Therefore, the Gurley and Shaw model was valid. In this new context, corporations try to ensure their own founder gains, resulting from the valuations of their shares, previously obtained by the subscribing banks and distributors.

Reserve enters, opening the so-called “Discount Window,” to refinance the banks and stop this race against the “commercial paper.”

This financing of the banks is done so that banks can refinance the companies that issued the “commercial papers,” which, as we know, are a security issued by a non-financial company or corporation, which will be purchased on the market by a direct investor. At the time of the race against the “commercial paper,” which would affect the industrial corporations issuing the bonds, the Federal Reserve asks its banks to refinance these positions, given that companies could not have statutory access to the “Discount Window” to refinance their positions. Thus, they inject additional funds into the banking system, via an “open market” operation. What does this mean? The Central Bank institutionalizes a support for corporations that issue commercial papers, via a credit line in the banking system; Minsky, in the 1986 book, finds that the “commercial paper” becomes a secret liability of commercial banks, because these are actually being used to ultimately fund corporations, which had to be financed, in a boom, via the aforementioned security. It turns out that these additional liabilities that banks hold, in fulfilling that function, jointly with the Federal Reserve, do not appear on the balance sheets. This procedure, which is part of the financial innovations, much analyzed over the 1970s and 1980s, originates from the inflection of the American economy. This way, the Federal Reserve, along with the great American banks, supports and prevents the verification of major financial traumas, allowing the system to continue operating, although, evidently, with all the instabilities that were present.

Relations between the State and the market are accentuated as the public deficit begins to play an extremely important role regarding increases in the gross profit of American corporations, net of taxes. So much so that this corporate profit was around \$60 billion between 1968 and 1970, jumping to \$69 billion in 1971, and reaching \$77 billion in 1972. Minsky (1986: 93) comments that “[p]aradoxically, recessions are good for corporate gross profits after taxes in an economy with Big Government.”

However, it is necessary to qualify this big government. The public deficit, throughout the American crisis, will have an important financial component and thus should not be seen solely as an autonomous increase in expenditure/income, as in the simplified “Keynesian model.” On the contrary, that deficit, to a large extent, is linked to asset valorization, to the increase in financial-private wealth, and further strengthens private securitization in the financial macrostructure. In fact, through official operations with government bonds, the portfolios are fed financial assets guaranteed by the Core Bank, financializing the general market to a greater degree.

In summary, the **financialization** movement of the American economy, since the 1960s, on the one hand, increases the vulnerability of corporations regarding the form of financing and, on the other hand, both the way of managing the banking system and the multiplicity of the system start to register a greater degree of fragility. At the same time, within this framework, the Core Bank becomes an adjunct to the ways in which financial institutions take their positions<sup>125</sup> by financing them; these forms are decreasingly related to cash and reserves, and increasingly linked to a complex set of new financial assets. Thus, there is an increase in the volume of certificates of deposit, repurchase agreements, positions in the Euro-dollar and funding from the Core Bank.

Therefore, it became evident that this financial movement, occurring in the most important economy in the capitalist world, led to a process of reducing the possibility of control, by the Core Bank, of financial and monetary policy. The exercise of monetary policy became increasingly complex and difficult because these new financial instruments, by which organizations made their positions, gained a short-term characteristic and were moving towards an increasing instability. From the point of view of the banks, this meant giving **priority to the management of their liabilities**, via the federal funds market<sup>126</sup>, which can also be used not only to regulate liquidity, but also to finance the public sector, the interest rate of this market being the fundamental rate for the American economy. This financing is made via possible transfers to the Treasury of profits made in this market by the Core Bank and other governmental financial agencies.

This practice had already started in the second half of the 1960s. Throughout the post-war prosperity, on the contrary, banks basically managed their assets, loans and investments along with the formation of financial positions based on the American “Treasury Bills”<sup>127</sup>.

In other words, the Core Bank establishes a connection between the market and the State, parts of the financial macrostructure, which produces increasing instability. The movement of the American economy has since led to endogenous disturbances in the conventional functions and operations of the Core Bank, both due to pressures from the public deficit and the balance of payments deficit. Thus, for example, the management of monetary (and interest) policy is

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125 Corresponds to the acquisition of resources (cash) to finance assets that are essential to the company's business. Therefore, making position involves active or passive transactions in securities that can be traded on a liquid market and with reasonably constant prices under normal conditions.

126 “Federal Funds” are deposits with the Federal Reserve banks, which continue as the main “position-making instrument,” and the federal market rate (funds) is the interbank loan rate based on these deposits. Stock-brokers and official institutions – savings and loans – also participate in this short-term loan market, whose interest rate signals the banking system's reserve position and is therefore closely monitored by the Federal Reserve Bank of New York.

127 When Treasury Bills are used to fund positions, banks replace one asset – corporate loans – with another – Treasury bills – or vice versa.

conditioned by the financing needs linked to those two problems and not only by the control of liquidity and inflation. That is, if the interest rate was (or will be) so high, in some moments, it is not so much because of the control of inflation, but, to a large extent, because of the need to finance the public deficit – partly financialized – and attract foreign capital to balance payments.

In the private banking dynamic, there was an increase in loans above the reserve base when, finally, the “Credit Crunch” came on the scene in 1966. That year, the Core Bank aimed to control the growth rate of the monetary base, at the same time that there was a flight from that bond that had been one of the main drivers of the expansion – the certificates of deposits. In this movement, the interest rates of “commercial papers” and treasury debts are increased, implanting, therefore, what Minsky calls a “controlled panic.”

This is the first moment, since the post-war period, when a developed capitalist economy is approaching a financial collapse of the magnitude of that which occurred at the turn of the 1930s<sup>128</sup>.

It so happens that, this time, the Core Bank enters substantially as a lender of last resort, facing the possibility of imminent financial crash. But not only does the Federal Reserve act as a lender of last resort; several important banks that operated in the money market also fulfil this role, by offering credit lines to a group of institutions that had grown in that speculative financial process<sup>129</sup>.

So, in fact, there is a saving catch on the part of the big banks, with the Core Bank behind them, guaranteeing them there is already an embryo of what can be called a financial macrostructure, with an international dimension, which has extremely important dynamic implications for all capitalist economies. The embryo of that type of macrostructure is already there through the activity that the Federal Reserve and the big American banks do, in order to prevent a new financial collapse. Minsky points to an accelerated increase in the speculative character of capitalism in the United States, which would provoke financial fragility.

As one can see, Minsky got it right in some aspects of the crisis, in others he made very pessimistic predictions. Also, in 1975, the process of financial instability reached proportions that he was unable to predict, even between 1984 and 1985, when he was writing the book published in 1986<sup>130</sup>, which will be commented on below.

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128 However, they are different situations. In the 1930s, the situation of American international reserves was comfortable, in surplus, and the system collapses because the “Treasury view” wins against the interests of banking policy. In the 1960s, American banks and transnational companies, with operations abroad, put pressure on the Treasury, which starts to lose reserves and the first crisis of the “dollar standard” follows.

129 It is worth mentioning that, in this episode, in contrast to the 1930s, previously commented on a note, the “Banking view” prevailed and not the “Treasury view.”

130 See Minsky (1986).

At this point in the argument, it is noteworthy that throughout this movement, in the capitalist country with the largest dimension and complexity of the accumulation process, extremely unstable factors, which would lead to a financial collapse and, probably, to a great depression, have not emerged thanks to the intervention of the Core Bank and the other large banks.

Meanwhile, Japan and Germany, in the 1960s, were consolidating their post-war expansion, an issue that will be resumed later.

In this crisis of the American economy, some important aspects are already present: first, the expansion of the financial and “fictitious” nature of wealth in Core capitalism; second, the search for accelerated profitability, and third, what applies both to corporations and to the construction of positions by the financial system, the trajectory towards the preponderance of liquid and profitable assets.

It is also present, at the same time, an extremely accelerated mobility, beyond national borders, of money operating as capital, through which U.S banks operate in Europe, already escaping internal regulation. At the same time, the question that will be at the Core of this discussion of regulation appears, which is the relation between the market and the State in the financialization process. The American State will finance its capitalism, not only its financial system, but also its corporations. But in doing so, it jeopardizes not only the stability of its currency but also that of the international monetary standard, and introduces a new element of risk and instability in the system.

It is a dynamic that prevents collapse and deceleration of investment from recurring, analogous to those seen in past periods of capitalism, but that exposes a perverse sense at the same time. This happens because the Core Bank sanctions and funds financial innovations, which imply instability, given they are characterized, in contemporary capitalism, by the search for immediate liquidity, especially at this stage experienced by the American economy. When sanctioning them, crises are aborted, but when crises are aborted, there is an increase in indebtedness and/or speculation further ahead, via new instruments. Again, innovations are regulated, crises are aborted; the market responds, it creates again; therefore, the economy is between the market and the State, in an extremely problematic dynamic, without, however, having a great depression and a general financial collapse, “classic” manifestations of the crisis.

Therein lies the roots of the instability that has permeated these last decades and whose structural forces were briefly synthesized. Such roots mark the crisis and the restructuring of this late 20th century, in which elements such as inflation, unemployment, and relative economic stagnation occurred in the 1970s; and a reorganization full of uncertainties, from the 1980s to today. These factors originate in this movement, through which the dominant American economy surpassed in the 1960s.

Again, according to Minsky (1986: 95): “Instead of a financial crisis and a deep depression being separated by decades, threats of crisis and deep depression occur every few years; instead of a realized deep depression, we now have chronic inflation.”

This formulation is important because, in fact, the evolution of the 1980s, even in the United States, was not as negative as Minsky predicted<sup>131</sup>. However, in the second half of the 1980s, both in the United States and in Germany and Japan, financial instability of another kind is heightened. It is no longer a question of financial instability resulting from corporations that become indebted to the banking system or issue “commercial papers,” but it is an instability that results from an articulation in the financial macrostructure, increasingly undertaken by both financial and industrial corporations, as presented synthetically in the section below.

## 2. Competition and Business Organization: Financialization

This section deals with competitive dynamics, the general features of changes in corporations, comparisons between countries and some macroeconomic and structural impacts.

As to commercial banks and other financial and non-financial corporations, the following should be noted: in these various institutions there is a kind of generalization and homogenization in the forms of operation, restructuring, in view of what could be called “financial competition,” which is superimposed on the intensification of industrial and commercial competition, not meaning disarticulation with the productive, as will be seen later.

Evidently, it is necessary to qualify the ways in which this happens. There are differences not only in timing but in characteristics, from country to country. For several reasons, even because it is not possible to think about these structural changes only through logical time; logical time has to be qualified by historical time, differentiated among countries. Thus, the logical-historical time of the United States is that of a structural crisis, since the 1960s, while those of Japan and Germany have been restructuring their spaces of accumulation and expansion, since the post-war, entering structural instability only in recent years.

Specifically, regarding the various forms of competition (industrial, commercial and financial), the possibility of convergent or divergent temporalities opens up, conditioned by historically distinct trajectories. That is why, while the United States made innovations in financial competition, based on past industrial

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131 In the 1980s, the following factors compensated for American instability: the “dollar diplomacy”, the warlike Keynesianism of “Reaganomics,” the macroeconomic adjustment at the expense of Japan and Germany surpluses. See Tavares (1985; 1992).



and commercial domination, Japan and Germany were engaged in industrial and commercial competition, passing only recently to typical incursions of **financialization**, which have been imposed as a general modality of the inter-capitalist struggle. These different national processes have, recently, implied greater power for Japan and Germany, precisely because the temporalities of the various forms of competition have been converging on them<sup>132, 133</sup>. While for the United States, involved in another logical-historical time, there was a loss of commercial and industrial competitiveness, especially in technologies that produce mass consumer goods. The United States maintain their global power through weapons and the strength of their financial gravitation<sup>134</sup>. The power to “coordinate,” in “tour de force,” the “capitalist system,” increasingly interdependent, through **financialization**, happens because of the fear of a complete collapse of the “dollar standard,” what in symbolic language was called “hard landing.”

Trying to capture the general features, it is noteworthy that there is a context of increased competition in general, which is expanding in relation to the financial space and financial time, which will affect not only financial corporations but non-financial corporations<sup>135</sup>.

There is a loss of the credit monopoly and payment system by the banking system: monetary authorities and commercial banks. The supply of credit and the payment system are no longer controlled by national Core and commercial banks, and there is a strong trend towards **financialization** with **private currencies**<sup>136</sup>. Commercial banks in the United States – and partly in England and Japan – start to operate in the securities business in general, such as bonds and shares, acting as if they were investment banks and starting a strong pressure against impeding regulations, so that commercial banks can open up and act

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132 An indication of this financial autonomy relative is the higher speed of growth of financial operations vis-à-vis international transactions in goods and services (See Tables 4 and 5).

133 The stable organicity, between banks and industries, of the praised “Japanese model” has been questioned since the mid-1980s, when its corporations became internationalized and carried, within Japan itself, the characteristics of financialization. As a result, the credit system’s own “national defense” is hampered.

134 The United States are still, by far, the largest economic and financial space available in the world for capital valorization.

135 The securitization process – issuance of direct debt by companies through different financial instruments – is part of this more general movement (See Tables 2, 3 and 11).

136 The ability of the financial macrostructure to create credit and operate payment mechanisms at the margin, even if partially, under the control of the monetary authorities means, in practice, the power to generate private currency. Financial securities, under permanent innovation, are recognized as quasi-money, given their liquidity, and are, pragmatically, in the day-to-day operations of the market, private currency. Hence the innocuousness of Tobin’s (n.d.) indignation at what it already is: “The idea that ‘private money’ could supersede government money is a ridiculous one.”

in this competitive dynamic, which expands in space and in the management of financial time<sup>137</sup>.

Investment banks and securities houses, institutions that deal with shares, securities, bonds, etc., start offering credit to financial and non-financial organizations, that is, they reinforce the tendency for commercial banks to no longer hold the credit monopoly.

These transformations imply, as never before in the history of capitalism, a phenomenal concentration of financial power. They also imply the drop of barriers between markets, sectors, companies and nations. Without this multifunctionality, any business group is weakened in the competition. Consequently, there is a significant advance in the concentration, centralization and international expansion of capital.

After the “crash” of 1929 in the United States, the legislation implemented the compartmentalization of the financial system and the banking system, obsolete in an internationalized financialization field. A comparison about the degree of banking concentration is illuminating: in the United States, according to 1988 data from FMCG Capital Strategies (financial advisers in New York), 35 banks control 50% of banking system assets; in Japan, 13 banks control 50% of bank assets; and in Germany, 8 banks control 50% of assets. In other words, there is a higher degree of concentration in the banking systems of Japan and Germany, which certainly corresponds to the use of concentrated power to, along with industrial companies, accumulate strength in international competitiveness.

The losses experienced by U.S groups have caused changes in the situation of low banking concentration in force since the 1930s. Thus, in the mid-1960s, there were 13,400 banks that were really independent, while in 1988 this number dropped to 9,800. From that date until today, the movement of mergers and acquisitions has accelerated and banking reform has a prominent position on the agenda for changes.

In parallel, there has been a crucial transformation in the United States recently, which is the fact that commercial and manufacturing organizations start to own insurance companies, companies that issue various types of securities, savings institutions and “nonbank banks.” This set of financial companies, owned by commercial and manufacturing organizations, is beginning to increase its offer of financial services in general. These are automobile companies, consumer finance companies, such as American Express and Sears, among others, which start to offer commercial and consumer loans directly, which is related to the fact that part of the payment system start to get out of the control of commercial banks.

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137 In Japan, deregulation is slower, while conflicts between main banks and independent security houses have been intense and have not yet been resolved.

Therefore, the exercise of monetary policy itself, if it is already problematic in a capitalist economy – where the determination of money is both exogenous and endogenous, dependent on coordination between Core banks and commercial banks –, much more so becomes as the banking system begins to lose control over currency and credit management. Commercial and manufacturing organizations have entered the financial services system to such an extent that the so-called “nonbank banks” have a 45.6% market share, while the banks themselves have a 54.4% market share, both in the supply of commercial loans, that is, loans for companies, and in loans for the consumer. In addition, there is an important presence of these companies in the financial market in general, which involves private securities split operations and, through associated financial organizations, the acceptance of public securities.

In Europe, Universal Bank, similar to the multiple bank, operates in all markets (monetary, credit and financial). Given the historical presence of the universal bank in industrial investment and management, the concern of European regulators is the fact that industries may have banks. We must remember that in Germany the articulation between bank and industry has a long historical tradition that was maintained in the post-war period, in contrast to what happened in the United States, where this tradition was lost with the appearance of new industrial oligopolies (electromechanical), with the segmentation of the financial market and the internationalization of banks.

In Japan, “cross-shareholdings” and interdependent market and investment strategies have been built since the post-war, a very strong articulation between industrial corporations and the various arms of the financial system; articulation that has already far exceeded the existing legislation and regulation frameworks. The articulation for common objectives was much stronger in the “keiretsu” and in the consolidation period of the Japanese competitiveness goals – from the 1960s to the mid-1980s –, and it has become more flexible due to the global internationalization, in which companies look for opportunities of financial capitalization. Recently, **financialization** has been driven mainly by corporations that were, at first, purely industrial, such as Toyota and Sony<sup>138</sup>.

Therefore, what appears as a common denominator in the history of the 20th century – pointed out, embryonically, by the great authors of the beginning of the century (such as Hobson and Hilferding) –, is a broad development of the fusion of the various forms of wealth. Capitalism’s ability to concentrate and merge the various forms of wealth is now reproduced on an international scale, through “global” financial and industrial corporations.

Contemporary capitalist corporations are, therefore, multifunctional (finance, production and trade), multisectoral (various industrial segments),

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138 Toyota, for example, has stakes in seven major Japanese groups.

in addition to multinationals, and obey a general financial logic in the definition, management and realization of wealth. However, for the dynamism of expanded reproduction of economies and for the success in inter-capitalist competition, the role of industrial restructuring and technological innovation is decisive even for basing, founding and determining financial dominance and the evolution of **financialization**<sup>139</sup>.

Thus, the leading business groups, which are constituent and integral parts of the financial macrostructure, have the following characteristics in their organization and valuation and growth strategy:

1. The financial services and calculations conglomerate becomes the Core of new corporations, of these “new firms.”
2. In these corporations, access to capital, information, technological networks and global markets is privileged, through the gathering of companies with different functions within large groups.
3. There is a trend, as already mentioned, to be called “cross-shareholdings.”
4. There is a flexibilization of the time to return on investments and also of the debit/credit ratios, as well as of the asset/liability ratios.
5. There is a simultaneous combination of mobility, liquidity, profitability and speculation – including arbitrage gains – in the circulation of capital.

### 3. The Financial Macrostructure

The financial macrostructure is formed by business groups with the profile defined above and by public organizations linked to the financial-monetary issue, mainly Core banks. Financial transactions with papers, currencies and commodities constitute the corresponding stocks and flows of wealth. This macrostructure exists at the national level but is complete at the international level, especially through the financial dynamics materialized in centers such as New York, Tokyo and London, and through the interactions of Core banks.

Its constitution took place with the financial development of the last decades, which generally corresponds to what we call transformations in the definition, management and realization of capitalist wealth, towards financialization.

To elucidate this process of the financial macrostructure, a brief comparison of the cases of Japan, Germany, and the United States from the 1980s onwards will be made. When examining the issue of debt and the stock market,

<sup>139</sup> Japan is exemplary in this regard, since the ongoing financialization process, albeit unstable, overlaps with an extremely dynamic technical-economic base, with the superiority of its economy and its business groups being sustained in the international competition.

we see that, between 1980 and 1988, the average ratio between the total liability of corporations and the sum of their share capital and reserves was 2.7 in Japan, 1.5 in Germany and 0.3 in the United States. In other words, there was an extremely higher and comprehensible level of indebtedness in Japan and Germany, given the well-known articulation between banks and companies in both countries<sup>140</sup>. In Germany, through the participation of banks in the management of their own companies. In Japan, through collateral guarantees provided by “cross-shareholdings,” which are situations in which company “A” holds 10% of company “B” shares while “B” holds 10% of “A” shares, making a long-term ownership agreement, without actually exchanging shares. Only a quarter of the shares listed on the Tokyo Stock Exchange are available for purchase, the remainder being unavailable, as they form part of these agreements, through which Japanese industrial groups articulate. In Germany, in the early 1980s, there were only four hundred companies listed on the stock exchange, while only ten were responsible for 50% of the turnover. The post-war Japanese and German expansions were therefore not based on the stock market, but on the captive credit market of large groups.

But recently, the stock market emerges, explicitly in the case of Germany and increasingly in the case of Japan. However, there is still a low share of institutional investment in the stock exchange in both countries. Institutional investment means investing in pension funds, insurance companies and so on. The dividends of Japanese and German companies were fundamentally used to increase the capital of companies and not for a kind of immediate “monetization of wealth, in the financial circuit,” as had been happening in the American market. This has been the object of review by the U.S corporations, since the stock market has become a vehicle for that “monetization of wealth” – in addition to providing a high risk of “take-over” by “riders” – and, as a result, it has been weakening the corporations. Today, there is a process of modifying the performance of the American market that reflects a regeneration in view of the already known perverse consequences of financialization. For this “self-criticism,” pension funds, insurance companies etc. are working together with investment fund managers, which apply to corporations and participate in the board of these corporations.

As for the changes that have occurred since the mid-1980s, the fact is that those factors of stability, mentioned in the case of the Japanese and German economies and which gave them the known “performance,” begin to change and generate worrying instabilities.

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140 This indebtedness has been reduced due to the instability that has started to affect companies and banks and the internationalization of subsidiaries that start to take resources in Eurobonds as national rates become more unfavorable. This aspect has been examined by Ernani Torres Filho, from the Federal University of Rio de Janeiro.

There was, of course, a strong expansion of the trade surpluses of these countries due to the very technological-industrial potential of the Japanese and German economies and the movement of the dollar appreciation. This has led to an important increase in their liquidity, which has led companies, mainly Japanese companies, to liquidate their debts. There is information from the OECD that the hundred largest Japanese companies, or about one third of them, have a cash balance greater than the debit balance, that is, an important financial power, with which they are creating, within themselves, a kind of internal banks. This occurs in companies such as Toyota and Nissan (automakers), Matsushita and Toshiba (consumer electronics). This trend towards the creation of a “bank” within the industrial corporation itself has led to forty companies already having financial subsidiaries in Europe and the United States, including to take care of their exposure in exchange and interest rates. These companies’ internal financial units finance the expansion of their various business segments at lower costs than the banks themselves are able to. So, in the Japanese economy of the last few years, there are elements of financial instability that are growing, which should (re)qualify the previous stability of the “Japanese model.”

To the extent that, in contemporary capitalism, economies reach volume, scale of accumulation and complexity of the process of valuation and accumulation typical of Core capitalisms, they inevitably constitute a financialization of wealth that causes general financial instability, albeit with differentiation from country to country, given their institutional frameworks.

This instability is of a different kind, not the kind that Minsky accused. Corporations reduce the rate of indebtedness to banks and increase self-financing with financial profits, in addition to streamlining, as an end in itself, paper transactions. Financial instability, at the micro level, depends on speculative equity situations, resulting from operations in interlocking markets such as those in Tokyo, New York, London. For example, Japanese banks have been affected, since October 1990, by speculative operations in the stock and land markets, while, at first, industrial companies, with increasing financial autonomy, have improved their financial situation. However, in the coming years it is expected that the wave of uncertainty on the stock exchange will eventually affect them, including through the warrants market<sup>141</sup>.

141 Banks hold company shares as collateral, guarantees for credit operations. With the devaluation of the Tokyo Stock Exchange having affected the profitability of banks, it turns out that they end up weakening the companies whose shares they hold as collateral. Consider, further, that banks do not have as much freedom to change their assets (equity) in the “portfolio,” since this would cause a significant contaminating devaluation of the system. “Warrant” is a negotiable instrument that gives the holder the right to buy (from) or sell (to) the “warrant” issuer a fixed income security or shares, under certain conditions and terms. As for the conversion into shares, one of the conditions is the “exercise price” which, falling below a limit, gives the holder of the “warrant” the right to refuse said conversion. With the stock market crash in 1990, that limit was reached for more than half of the US\$ 120.2 billion stock that companies had issued in warrants. These companies, having maintained this situation,

At the macro level, in different countries and on an international scale, instability is manifested by the opposition between productive wealth and financial wealth, by the financial component of the public deficit, by imbalances in international reserves, by exchange speculation, by intermittences between recession and growth and, finally, due to considerable difficulties in coordinating economic policies.

By the way, it is worth remembering passages by James Tobin (n.d.) in the article cited above: “A disquieting implication of the large premiums in takeover values is to confirm failure of ordinary market prices to reflect long-run fundamental values. [The ability to seek short-term profit and ‘feverish capital operations’ is privileged, with the resulting social product of the] proliferation of financial instruments, markets, arbitrage opportunities, and paper transactions [being far from clear].”

In the early 1990s, in the Japanese economy, total financial assets plus real estate were equivalent to US\$35 trillion, and the Gross National Product was equal to US\$3 trillion. In other words, there were a total of assets 9.5 times higher than the gross national product. It was estimated that property prices in Japan in 1990 would be overvalued by 40% (data from various editions of *The Economist*).

Of that total of assets, about US\$14 trillion corresponded to real estate assets, while bonds and shares corresponded to US\$21 trillion. In the early 1990s, the Tokyo Stock Exchange, after a process of intense capitalization, moved ahead, including in England, regarding capitalization as a percentage of the product. The Japanese economy had a ratio between capitalization – the price of the shares times the number of shares on the market – and the product equivalent to 1; which culminated in the devaluation that occurred on the Tokyo Stock Exchange<sup>142</sup>.

Hiroshi Takeushi (Long-Term Credit Bank of Japan) says of this situation: “this is highly unstable, it could come crashing down, in the face of even the slightest bump or surprise.” Sijuro Ogata (Bank of Japan) says that “the development of technology for innovations in financial techniques, such as swaps, has broken the borders between nations, which can no longer protect internal players from outside competitors.”

In other words, the issue that refers to the national *versus* the international should not be perceived only as the physical presence of financial companies within the country, but also through a growing trend of interaction between

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will have to borrow money at the interest rate, which is now higher, in order to redeem the warrants. The basic cost of borrowing jumped from 4-6% (1987-9) to 8% in 1991, being already in real terms 4-5%, which exceeds the US rate of 2-3%. The maturities of warrants are concentrated in 1992-3, with the stock index (Nikkei) rising between 20% and 50% to convince warrants to convert them into shares. See *The Economist* (1991).

142 It should be noted that these numbers are not absolutely comparable due to differences in equity calculations in Japanese companies and those in other countries.

the national and international levels, provided by operations in the macro-structure financial.

Some common elements seem to trace the entrepreneurial profile of this contemporary capitalism, in which this financial dominance is imposed, this entrepreneurial profile of financialization that tends to reduce the difference, in terms of wealth management, between banking capital and industrial capital, between the productive and the financial, although the different importance of these spheres in terms of development of the productive forces remains. On the side of banks as well as large financial companies and large corporations, that is, in all leading organizations and in most Core capitalisms, there is a movement so their organizational and financial calculation structure is directed towards a paradoxical articulation: a financial capitalization, taken even to certain extreme limits, *pari-passu* to the capacity for technological-productive innovation and to finance balance of payments deficit.

Therefore, it is the very core of capitalist corporations and their strategies in the financial macrostructure that lead us to identify a new dynamic, to analyze the enormous **flexibility** of the time for the return on investments, of the debit/credit ratios and also of the asset/liability ratios. The mobility between the various **forms of crystallization of capitalist wealth**<sup>TM</sup> has never been greater in the search for greater and faster profitability, given by the possibility of converting the diverse temporalities of the assets into a time structure of valuation always updated with the successive impulses of revisions of the past decisions. This ability to quickly review the time structure of asset valuation, apparently at an ever-lower cost, coupled with the extension of the financial market on a global scale, allows the maximum use of capitalist valorization time<sup>143-144</sup>.

Thus, there is an introjection, on the part of these organizations, of the more general financialization paradox, at the same time that their practices engender, at macroeconomic and macrofinancial level, that paradoxical dynamic that is the hallmark of the contemporary crisis and restructuring in the Core capitalisms, synthesized in the conclusion of this study.

## Conclusion: The Financialization Paradox

The new structures – in the micro and macro sphere – and the new general movements that are emerging – with greater or lesser speed, in the different

143 See Tables 2 and 3 for the expansion of financial assets representing property wealth expanded by financial capitalization in the bond market and the stock market.

144 I am grateful to José Geraldo Portugal Júnior for contributing to a better explanation of this part of the argument.



capitalisms, and with some differences, given the political-institutional frameworks – set up what can be called financialization.

There is an internationalized capitalist economy<sup>145</sup>, in which the three big economies have decisive powers in the global economic process. The imbalance between the speed of expansion of the financial markets and that of the goods and services markets is increasing<sup>146</sup>.

The International Monetary Fund, in its reports of 1988, 1989 and 1990, emphasizes its concern about the volatility of interest rates and exchange rates due to the fact that the financial markets continue to expand at a faster rate than the other markets. There are important currency movements that derive both from the American instability and from the opening of several monetary areas, still under the weight of the instability of the dollar.

In the process of **financialization** of capitalist wealth, there is a complex interweaving between currency, credit and equity; this is what we have seen for the past few decades. There is a changing international monetary system, which generates structural uncertainty and, therefore, instability. The dollar standard is being questioned, but there is no new standard to replace it – the yen does not fulfil this role; that is to say, the foundation of a new international currency has not been resolved, it is left with a mixed currency system. Therefore, uncertain currency parity and interest rate volatility hinder monetary stability. The defense of wealth and equity is made in the operations of the financial macrostructure, which also changes the forms of credit, reducing the clear separation between the credit and capital markets<sup>147</sup>. All capitalist leaders – corporations and countries – operate in that macrostructure, although there are morphological differences between them, on the organizational level. In that macrostructure, forced and ephemeral monetary coordination is carried out under the aegis of the hegemonic system, still the American one. Forced and ephemeral because the possibility of a more “balanced” intercountry picture, as far as international reserves are concerned, is dominated by Japan, without whose participation there is no agreement between Core banks; while the founding power and the public and hegemonic currency belong to the United States, the dominant power in crisis<sup>148</sup>.

The realization of such intense financial capitalization and fictitious wealth, as well as the possibility of monetizing (even if partially) that wealth, provided by the interactions existing in the financial macrostructure – not only

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145 Observe in Tables 7, 8, 9 and 10 the growth of foreign bonds, foreign government bonds, and of institutional investors in foreign bonds and the positions, abroad, of Japanese and German banks.

146 See Tables 4 and 5.

147 The dominant system, American capitalism, has been capital market-based as, incidentally, tend to be the dominant systems. The national systems are credit-based and tend to be harassed, by internal and external agents, in view of the internationalized *financialization* in progress.

148 Note that the dollar remains the main reference currency for issuing securities (see Table 6).

between private markets, but also between these and Core banks –, could lead the unsuspecting to believe there would be, at the very least, a framework of stagnation of innovative investment.

And yet, in the contemporary crisis and restructuring, two critical international situations were overcome, in the mid-1970s and early 1980s. This process did not cause a financial crash or a great depression; on the contrary, it made possible an eight-year period of growth (1983-1990) accompanied by a kind of institutionalized rentism. However, after this period, we see instabilities, especially in the United States and Japan, as if the crisis was back, in the early 1990s. This permanent tension between expansion and crisis is an expression of structural instability.

Inflationary tensions, exchange rate instabilities, important unemployment – in some areas of European capitalism –, the limits of public finances, as well as the recent emergence of financial speculation even in the “organized” Japanese capitalism; everything composing a paradoxical dynamic.

Institutionalized rentism is reminiscent, ironically, of the rentier’s euthanasia that Keynes dreamed of, and which has not taken place. On the contrary, there is the institutionalization of rentism in the practice of business groups in the analyzed financial macrostructure; which, at the same time, combines with innovative investment. It is another way of manifesting the financialization paradox, because it is a contemporary way in which the different developed capitalisms are simultaneously managing to develop the productive system and amplify financial capitalization, even if full of instability.

It is also worth thinking that this financialization paradox may illuminate the fact that, in a certain sense, we are not yet facing a “Third Industrial Revolution,” by which technical progress would be engendering a long-term capitalist expansion. There is evidence that the speed of technological-productive innovations is enormous. However, it is good to consider that it has not undergone infrastructure or heavy investments of the type of the “Second Industrial Revolution” (electricity, transport, chemicals, steel). It has been characterized, however, as a technological cycle, with short and rapid developments, on important segments of the electro-electronic complex and the metal-mechanic complex. Consequently, the hypothesis is raised that this financialization, if it does not hinder technical progress, limits its fully revolutionary propagation of the technical bases of expanded reproduction; understandable, given what has been analyzed about its impacts on the public and private sectors.

The contemporary movement of these economies does not correspond to the harmonious regulation of financial capital, expected by Hilferding, among others. Nor does it fully correspond to Schumpeter’s cyclic theory, associated

with the automatism of technical progress in “trusted capitalism<sup>149</sup>,” by which there would be, today, a long wave of growth based on the “third technological revolution.” Nor is it equivalent to the euthanasia of the rentier expected by Keynes, since the State has not been able to promote an increase in the mass of productive capital to bring the marginal efficiency of capital down to near zero, and thus lead to euthanasia<sup>150</sup>.

This impediment that affects the State is forged both by the nature of its deficits and by the deregulation of national banking systems, which, moreover, have their operations highly conditioned by financial internationalization. With this, public financing and spending, as well as national credit systems, have not been able to fulfill Keynes’ utopia and have imposed restrictions on the deepening of technological transformations in the perspective of expanded reproduction<sup>151</sup>.

The capitalist dynamics in question is of a new nature, that is, the forms of movement of this crisis and its restructuring are new, so that most of the existing theoretical texts on the economic dynamics of capitalism are not relevant. Not the formal dynamics that derive from the thought of neoclassical synthesis, nor some Neo-kaleckian dynamics, nor other neo-Schumpeterian ones, all based on the repetitions of the cycle phases – short, medium, long.

In fact, there is a structural instability marked by this logic of **financialization**, which is paradoxical in the various directions mentioned.

Returning to the previous logical axis, it is important to highlight the existence of a **financial macrostructure**, in which there is an articulation between the market and the State, between corporations, with the profile described, and Core banks; it is important to identify the occurrence of a simultaneity in the processes of realizing income and financial and fictitious<sup>152</sup> capitalization.

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149 Reference is made here to Schumpeter’s analysis that the automatism of technical progress, typical of the “trusted” phase of capitalism, would attenuate the cyclical instability that previously existed in competitive capitalism. Obviously, his brilliant overview of capitalist evolution is not being questioned, including the idea of creative destruction that stimulates important current analyses of technical innovations. I want to draw attention to the fact that the global economic dynamics and the movement of wealth, in contemporary capitalism, cannot be understood even by the Schumpeterian cyclical theory.

150 For Keynes, the reason for an asset such as capital equipment to have net income is scarcity. And capital is scarce because there is competition for interest rates on money. If the state action provoked an abundance of “capital goods,” its marginal efficiency would drop to zero and there would be a gradual disappearance of a rate of return on accumulated wealth. The owner of the capital earns interest only while the capital is scarce. Keynes is incisive: “I see, therefore, the rentier aspect of capitalism as a transition phase which will disappear when it has done its work. And with the disappearance of its rentier aspect, much else in it besides will suffer a sea-change. It will be, moreover, a great advantage of the order of events which I am advocating, that the euthanasia of the rentier, of the functionless investor, will be nothing sudden, merely a gradual but prolonged continuance of what we have seen recently in Great Britain, and will need no revolution.” See Keynes (1964: 376).

151 Consider the problems of urban infrastructure identified even in countries such as the United States and Japan.

152 Insofar as this fictitious financial capitalization has become a permanent means of realizing wealth, identifying it as fictitious is even debatable. However, as this does not fail to pose contradictions between wealth and

This, of course, gives this restructuring characteristics different from those typical of cycle models or a long wave of growth. On the contrary, it is a restructuring that, in the different capitalisms, with their political-institutional nuances, recurrently gives the impression that, once again, there is a crisis<sup>153</sup>.

And the structural instability with financial dominance, as has already been said, is the hallmark of this contemporary capitalism. In this theoretical conception, the movement is formed by cyclical fluctuations of changeable profiles and by a structural tension between expansion and crisis, resulting from the interaction between capital accumulation in general and effective demand, typical of financialization and wealth management in the financial macrostructure. That is, the dynamics no longer derive primarily from the capitalist calculation on the adjustment of investment to the productive capital stock as in the cycle models. It is not pertinent, therefore, to think about the movement through the repetitive cycle phases – peak, recession, depression, recovery, peak.

There are neither the collapses that were imagined, on the one hand, nor the harmonious regulations that were designed, ideally, on the other; although there have been contradictory and conflicting regulations at the macroeconomic level and at the structure itself.

Finally, it should be understood that in the face of **financialization** and the corresponding internationalized macrostructure, which permeates countries, Core capitalism is no longer “industrial capitalism” in which, in the absence of a crisis, the innovative entrepreneur captures credit, advances productive expenses, buys labor power, sells production, makes profits and everything starts again aiming at production, resulting in increased income realization and at the global reproduction of the system. On the contrary, in modern capitalism, particularly since the end of the 1960s, keeping in mind the different national temporalities, business groups – true capitalist corporations – they act, simultaneously, for the financialized wealth and for the production, intermittently engendering the instabilities arising from the contradiction between realization of income (product) and financial capitalization. And, moreover, leaving the system, in this process, as if permanently in crisis, or rather, on the verge of crisis<sup>154</sup>.

Wealth, in that past capitalism, seems to be in a less complex stage of its contradiction with global reproduction, even though the destructive character of its crises was great, both for capital and, especially, for labor. This

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reproduction, it should be registered as such.

153 This early 1990's is illustrative, in that it seems to be the moment when the three great capitalist powers are converging, at the same time, to an explicit situation of structural instability: American recession, fragility of Japanese banks and companies, monetary disturbances in Germany – although in this case, there is a strong geopolitical determination.

154 I believe this is the way to reconsider what, controversially, has been called “Systemic Risk,” associated, in the literature, to the recent financial transformations.

capitalism corresponded to a less complex articulation between currency, credit (investment) and equity.

The industrial-reproductive process obviously remains and is crucial for expanded reproduction, but what is new in modern capitalism is that “industrial capitalism” is **subsumed** in the more general movement of wealth management and realization (*lato sensu*) under financial dominance; movement in which capital and technology not only make the “old work,” and the worker himself, redundant, but they fill the world not only with goods, as before, but, predominantly, with financial assets, abstract and full materialization of Equity; movement in which the dominant age and space, intrinsically, for the purposes of wealth, are engendered by the internationalized financial-monetary dimension. It thus constitutes a specific dynamic interaction between currency, credit and equity, distinct from that of past capitalism.

Factories, labor, productive capital are, of course, the substrate and also the opposite of financial-monetary wealth, which is truly one of the objects of desire, so dear to capitalist sociability. Privileged wealth, in contemporary sociability, is in shares, in securitized financial assets, in currencies, in money, in short, as full, liquid and general wealth; money and bonds as financialized wealth and contradictorily autonomous in relation to other commodities.

Some will say that this has always been the nature of the search for capitalist wealth. Once again, the innovation is that what was limited, partial, national, a transitory moment, became broad, restructuring of the micro and macro spheres, dominant, institutionalized, internationalized and a mark of sociability, even though access to this type of wealth management and realization is highly differentiated, between nations, social classes and capitals, because of the inequalities and heterogeneities of all types, present in the world capitalist process.

This process – the financialization of wealth – is, in short, a true paroxysm in Core capitalisms, in which the speculative management of wealth is taken to extremes and, even so, paradoxically articulated with expanded reproduction, redefining the dynamics of crises and restructuring, as demonstrated. And, as a paradox, it calls into question systems and assumptions, from different schools, in the interpretation of capitalism, which until today are presented as current, consistent and indisputable.

The financial and fictitious capitalization, a strategic component of this process, imposes on the social processes and on the present times both its frenetic, innovative rhythm, and its harmful consequences. I am tempted by an allegory to conclude with “Citizen Kane,” by Orson Welles, who, ironically, said of the drama imposed, even on the dominant ones, by the fulfillment of the prevailing desire in 20th century societies: “if I hadn’t been very rich, I might have been a really great man.”

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## STATISTICAL ANNEX

**Table 1 – Non-operating revenue from large corporations in Japan as a percentage of operating profits (fiscal year)**

1960	22.9	1975	62.5
1961	27.9	1976	51.4
1962	34.2	1977	61.8
1963	30.3	1978	55.6
1964	32.1	1979	34.9
1965	37.5	1980	43.0
1966	32.4	1981	41.5
1967	29.1	1982	44.7
1968	29.9	1983	45.6
1969	29.3	1984	41.1
1970	33.0	1985	50.4
1971	44.3	1986	60.4
1972	43.2	1987	50.5
1973	35.5	1988	42.0
1974	42.9		

Note: Corporations are those industries with paid-in capital above one billion yen. Non-operating income includes interest and dividend income, discount rate for invoices and capital gains on securities.

Source: Hojinkigo Tokei Nenpo, quoted by Teranishi. *Finance and economic development in postwar Japan*. Tokyo: The Institute of Economic Research/Hitotsubachi University, January 1991.

**Table 2 – Portfolio transactions — USA (US\$ billion)**

	1975	1980	1985	1986	1987	1988	1989
Total International Transactions	66.3	251.2	1,497.3	3,060.2	3,911.4	4,177.3	5,473.3
Bonds	37.0	158.1	1,292.6	2,682.6	3,239.6	3,661.2	4,826.6
Shares	29.3	90.1	204.7	377.6	671.8	517.1	646.7
American transactions with foreign securities							
Bonds							
Purchases	8.7	18.1	85.2	170.7	207.0	226.0	240.0
Sales	2.4	17.1	81.2	167.0	199.1	218.5	234.1
Shares							
Purchases	1.7	10.1	24.8	51.0	94.4	77.3	121.4
Sales	1.6	7.9	20.9	49.0	95.5	75.4	108.9
External transactions with American securities							
Bonds							
Purchases	14.3	66.6	585.2	1,207.5	1,443.3	1,646.8	2,220.7
Sales	11.5	56.3	541.0	1,137.4	1,390.2	1,569.9	2,131.8
Shares							
Purchases	15.4	40.3	82.0	148.1	249.1	181.2	213.0
Sales	10.7	34.9	77.1	129.4	232.8	183.2	203.4

Notes: (i) The data cover transactions between a resident and a non-resident; transactions in American securities carried out between two residents abroad and transactions in foreign securities carried out between two residents in the USA were excluded. (ii) In the item American transactions, purchases refer to those made by residents in the USA (which in the Treasury Bulletin appear as "foreign sales").

Sources: *US Treasury Bulletin* and US Securities and Exchange Commission (1987). Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).



**Table 3 – Portfolio investment indicators in developing and developed countries (US\$ billion)**

A. International bond issues <sup>1</sup>							
	1984	1985	1986	1987	1988	1989	1990
Developed countries <sup>2</sup>	96.8	147.2	212.3	166.6	213.4	240.4	207.1
Developing countries	3.8	6.9	4.3	3.1	4.2	2.6	3.6
of which:							
Seven dynamic Asian economies <sup>3</sup>	2.7	4.9	1.8	0.8	1.1	1.5	2.4
Eastern Europe	—	0.4	0.3	0.5	1.4	2.2	1.6
International Development Institutions <sup>4</sup>	7.9	10.7	9.2	10.3	8.0	10.3	14.6

Sources: BIS, *International banking and financial market development*, several editions; and OECD, *Financial Statistics Monthly*, several editions.

B. Stock market capitalization					
	1980	1984	1988	1989	1990e
Developed countries <sup>5</sup>	2,592.1	3,293.9	9,402.8	11,005.4	8,985
Developing countries	146.0	129.6	466.9	724.6	544
of which:					
Seven dynamic Asian economies	87.0	73.2	345.1	559.2	410
Latin America <sup>6</sup>	39.9	37.0	57.8	83.0	74

e = estimated data.

Source: International Finance Corporation. *Emergency Stock Markets Factbook*, updated in 1990. Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).

C. Global stocks of bonds and equities				
	1983	1985	1988	1989
Global Portfolios				
Equity Participation	3,284	4,667	9,297	10,926
Bonds	4,318	6,049	10,067	10,622
Non-resident stocks				
Equity Participation	233	341	619	728
Bonds	345	589	1,148	1,357
Non-resident stocks as a percentage of global portfolios				
Equity Participation	7.1	7.3	6.7	6.7
Bonds	8.0	9.7	11.4	12.8

- (1) International bonds and traditional foreign bond issues.
- (2) European Common Market institutions and OECD member countries.
- (3) Hong Kong, Singapore, South Korea. Taiwan, Indonesia, Malaysia and Thailand.
- (4) AFDB, ASDB, IBRD, 1DB and IFC.
- (5) All OECD member countries, Israel and South Africa.
- (6) Argentina, Brazil, Chile, Colombia, Mexico, Uruguay and Venezuela.

Source: JP Morgan, *World Financial Markets* (1989, n. 5, updated). Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).

**Table 4 – Economic activity, international trade and international financing**

Item	Compound Annual Growth Rate			
	1964-72	1972-80	1980-85	1964-85
Gross Domestic Product <sup>a</sup>	9.6	15.0	4.7	10.4
International Trade of Goods and Services <sup>b</sup>	12.0	21.2	0.4	12.4
International Financing <sup>c</sup>	33.6	26.7	12.9	25.8

(a) World data excluding Soviet bloc.

(b) World data excluding Soviet bloc.

(c) Bank for International Settlements (BIS) data. They correspond to net international bank credits. It covers the developed countries of the Group of Ten (8is), other Europeans and branches of U.S banks in centers such as Bahamas, Panama, Singapore, etc.

Source: IMF. *International Financial Statistics* (1984 Supplement and 1986 Yearbook).

**Table 5 – New means of financing in the international market (US\$ billion)**

Instruments	1981	1982	1983	1984	1985
A. Issuance of International Securities <sup>a</sup>	44.0	71.7	72.1	108.1	163.6
B. Issuance of loan notes <sup>b</sup>	1.0	2.3	3.3	18.9	49.5
C. Banks: syndicated loans <sup>c</sup>	131.5	100.5	51.8	36.6	21.2
D. Total new instruments (A+B+C)	176.5	174.5	127.2	163.6	234.3
E. Share of securitized instruments ((A+B)/D)	25.5%	42.4%	59.3%	77.6%	91.0%

(a) They are International Bond Issues: includes Floating Rate Notes —transferred on average, every 6 months; excludes securities that include shares as collateral.

(b) Includes instruments that are underwritten or not, such as NIFS, RUFs, and Eurocommercial papers.

(c) It does not include existing loans in which only spreads are changed: it includes packages promoted by the IMF, government entities and commercial banks, in cooperation, with “new money.”

Source: BIS. *Report*, 1986.

**Table 6 – Global bond markets (installments in percentage at the end of the period)**

	1980	1985	1988	1989
<b>Total issued nominal:</b>				
(as % of GNP)	46	66	74	75
Currency in which the values are expressed:				
US Dollar	44	52	46	48
Japanese Yen	17	18	22	19
Deutsche Mark	10	7	8	8
Others	29	23	24	25
Markets:				
International	4	7	10	10
Domestic	96	93	90	90

Sources: Rosário Benavides. *How big is the world bond market?* New York: Salomon Brothers, 1990; and Richard BENZIE. *The development of the international bond market*, unpublished. Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).

**Table 7 – External bond issues, by type (US\$ billion)**

	1985	1986	1987	1988	1989	1990
Total external bond issues	167.8	227.1	180.8	227.1	255.7	228.8
Fixed rate	94.8	141.5	121.3	160.2	154.6	160.2
Floating rate	58.7	51.2	13.0	22.3	17.8	36.8
Convertible	7.0	7.8	18.2	11.3	14.1	9.5
Equity warrants	4.3	19.1	24.8	29.7	66.2	21.1
Memorandum:						
Equity warrants in US\$	n.a.	n.a.	20.3	27.0	61.5	17.4
Common shares issued in international markets	2.7	11.6	20.3	9.1	16.7	14.9

Sources: OECD, *Financial Market Trends*, Michael Howell and Angela Cozzini. "Are international equities ex-growth?" In: Salomon Brothers. *International equity flows*. London: Salomon Brothers, August 1989; idem. "New investors, new risks and new products." In: SALOMON BROTHERS. *International equity flows*. London: Salomon Brothers, August 1990. Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).

**Table 8 – Foreign penetration in the bond markets of national governments<sup>1</sup>**

	1983	1985	1988	1989
Australia <sup>2</sup>	20	33	55	54
Belgium	4	10	13	14
Canada	16	21	31	37
France	4	2	6	15
Germany <sup>2</sup>	9	17	31	34
Italy	3	4	4	6
Japan	6	6	4	4
(The Netherlands)	33	28	35	37
Spain <sup>3</sup>	0	0	2	5
United Kingdom	9	11	15	15
United States	13	14	17	19
Mean	10	13	13	15

(1) Inventories held by non-residents as a percentage of the Core government's domestic bonds and Eurobonds — unless otherwise indicated.

(2) Core and local government.

(3) Excluding Eurobonds.

Source: J.P. Morgan, *World Financial Markets* (1989, No. 5, updated). Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).

**Table 9 – Stocks of foreign securities held by institutional investors, as percentage of their total stocks of securities**

	1980	1985	1986	1987	1988	1989	1990 <sup>1</sup>
<b>USA</b>							
Private pension funds <sup>2</sup>	1.0	3.0	4.0	4.0	4.0	4.1	
<b>Japan</b>							
<b>Life Insurance Companies</b>	9.0	26.4	28.9	31.4	31.1	33.9	32.2
<b>Other companies (other than life insurance)</b>	7.4	19.4	21.5	21.5	22.3	26.1	28.2
<b>Trust accounts/banks</b>	2.2	14.0	17.1	16.7	15.3	17.0	18.6
<b>Postal life insurance</b>	0.0	6.7	9.2	11.2	11.3	11.2	11.2
<i>Memorandum:</i>							
<i>Total assets of insurance companies<sup>3</sup> (in billions of 1000 Yen)</i>	48.2	94.1	111.7	132.4	157.7	172.9	192.2
<b>Canada</b>							
Life Insurance Companies	2.1	2.2	2.8	3.4	3.5	3.6	3.6
Pension funds	6.1	6.6	7.0	6.6	6.7		
<b>Germany</b>							
Investment Companies	10.8	40.4	34.9	39.3	57.8	59.9	58.9
<b>Italy</b>							
Insurance Companies	11.7	10.1	8.1	8.4	10.4		
<b>United Kingdom<sup>4</sup></b>							
<b>Insurance Companies</b>	6.9	17.3	19.7	15.7	17.7	22.3	
<b>Pension funds</b>	10.3	17.8	20.1	16.3	17.8	22.2	
<i>Memorandum:</i>							
<i>Total net assets of companies, insurance and pension funds (in billions of £)</i>	109.5	287.8	350.7	371.7	408.4	465.1	
<b>Belgium</b>							
Insurance companies and pension funds	1.7	3.3	3.8	3.3	2.8		
<b>The Netherlands</b>							
Insurance Companies	5.2 <sup>5</sup>	10.3	11.0	11.0	11.4	10.1	9.8
Private pension funds	10.6 <sup>5</sup>	13.8	17.6	18.0	20.2	21.3	20.8
Public pension funds	1.7 <sup>5</sup>	2.8	3.0	3.3	3.5	4.2	4.6
Insurance Companies	1.5	1.6	4.0	10.1			

(1) Position in the middle of the year, except Sweden (end of September).

(2) Schemes based on tax exemptions (excluding IRAS).

(3) Sum of life insurance, insurance of a different type (other than life) and postal life insurance.

(4) Pension funds exclude the Core government sector but include the rest of the public sector. Trust investment allocated as follows: 50% foreign and 50% domestic at the end of 1989 (according to results obtained in partial research), and other years calculated as a proportion of the changes in the measured portion of foreign assets.

(5) 1983.

Sources: Bank of Italy; Bank of Japan (Economic Statistics Annual and Economic Statistics Monthly); Sveriges Riksbank (Quarterly Review); De Nederlandsche Bank (Annual Report and Quarterly Bulletins); Deutsche Bundesbank (Statistical Supplement to the Monthly Report, series 2); Intersec Research Corporation; National Bank of Belgium; Statistics Canada; UK Core Statistical Office (Annual Abstract of Statistics and Financial Statistics). Quoted by Turner, *Capital flows in the 1980s: a survey of major trends*. Basel: BIS, April 1991 (BIS Economic Papers n. 30).

**Table 10 – Bank's domestic and external assets (end of year)**

	1980	1985	1986	1987	1988	1989	1990 <sup>1</sup>
Japan							
Stocks of foreign securities held by banks as a percentage of their total stock of securities (bank accounts)	2.7	12.7	14.2	14.0	12.6	13.5	14.7
Germany							
Foreign bank loans as % of total loan to:							
Banks	13.0	17.0	20.9	20.5	21.9	25.4	26.1
Non-banking institutions	5.2	5.2	5.0	5.0	5.1	5.3	5.7
Stocks of foreign securities held by banks as % of their total stock of securities <sup>2</sup>	4.7	3.4	4.3	3.9	4.5	5.4	6.4

(1) Position in the middle of the year.

(2) Including bank securities.

Sources: Bank of Japan, Economic Statistics Monthly; Deutsche Bundesbank, Monthly Report.

**Table 11 – Changes in bank loans in foreign currency to non-bank residents (US\$ billion)**

	1984	1985	1986	1987	1988	1989	1990 <sup>2</sup>
<b>Japan<sup>3</sup></b>	9.7	4.6	47.6	56.7	31.6	11.4	10.6
<b>European countries<sup>4</sup></b>	7.6	1.5	4.7	19.3	23.4	26.6	13.4
<b>of which:</b>							
<b>UK</b>	3.0	5.4	1.0	3.4	7.2	16.9	-16.9
<b>Italy</b>	3.8	—	4.6	2.9	6.9	5.6	5.8
<b>Sweden</b>	1.0	1.6	0.6	4.4	6.1	16.1	18.7

(1) Assets minus charges: positive values indicate an increase in loans to non-bank institutions. Data adjusted according to changes in exchange rates. No data is available on American banks.

(2) The first three quarters at a real rate.

(3) Assets only, as charges are not published: in general, year-over-year movements in net positions are dominated by changes in assets.

(4) Austria, Belgium-Luxembourg, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Spain, Switzerland and the United Kingdom. The actual figures show a large fluctuation between 1987 and 1988, reflecting an increase in French loans to residents of US\$ 6.6 billion (net) in the fourth quarter of 1987, followed by net repayments of US\$ 8.4 billion in the first quarter of 1988: the figures above exclude these transactions.

Sources: BIS, *International banking and financial market developments* and historical data.

# CHAPTER 14

## NOTES ON DECISION-MAKING AND EXPANSION OF CAPITALIST FIRM

*Maria Silvia Possas*

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The concept of firm adopted here is that of an organization focused on capital valorization, a unit of capital accumulation. Production is only a means of fulfilling this purpose, as are attempts to cut costs, including transaction ones. In other words, in a capitalist economy, all the logic of economic decision and action must be understood from the predominance of the search for valorization. The capitalist industrial firm produces, it is the “basic unit for the organization of production,” (Penrose, 1959: 9) and there is a logic in the productive processes it uses. It carries out contracts and has an internal structure for coordinating the various activities necessary for the continuity of the production and sale of its products, which is why it also functions as a **governance structure**<sup>155</sup>. However, neither the analysis of one nor that of the other function allows to apprehend its Core characteristic, which subordinates both, that is, to be a structure of appropriation of purchasing power from the use of its resources, also conceived as values. So, it is also “a collection of productive resources the disposal of which between different uses and over time is determined by administrative decision,” as defined by Penrose?

The firm has resources and needs to valorize them. What resources are these and how can they be used? They are of all types: physical, such as land, buildings, equipment and raw materials; human; financial; and also immaterial resources, such as image, public relations, experience, capabilities<sup>156,157</sup>. The degree of flexibility of these resources varies. Financial resources are highly flexible and can be easily transferred from one sector to another, from one form of valorization to another. Physical resources can be turned into cash, which usually leads to some loss. Human resources can also be transferred, possibly with some additional training, or some waste of specific qualifications.

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155 See Williamson (1986, Part 1).

156 And the author's definition is virtually equivalent to the idea of a firm as a capital valorization unit, as it emphasizes the administrative decision on the allocation of pre-existing resources, which are “the source of uniqueness for each individual firm” (Penrose, 1959: 25) for the purpose of profit.

157 The latter are extremely important. Teece (1992: 101) goes so far as to suggest that firms should be represented “by the capabilities they possess, and their capacity to employ and augment them,” emphasizing that differences in capacities are not balanced in the market.

The tacit knowledge of employees will often fail to be used in the event of a change in their tasks<sup>158</sup>. Intangible assets have very little flexibility, they can only be used in close activities.

The different degree of flexibility of resources is a crucial point to be considered in the firm's decisions, as it is a way to defend itself against uncertainty. The fact that some assets are not very flexible helps to explain why economic agents tend to maintain their line of activity or production for long periods. Their accumulated experience, their equipment, among others, are in principle better able to be used and to generate income where they always had.

If flexibility is an objective for firms, why would they acquire non-flexible assets? For several reasons. First, because no type of production is possible without any non-flexible asset. But another more relevant reason is that the non-flexibility is often a feature of those assets that are the source of the most significant competitive advantages, which further increase the degree of appropriateness of innovations, that is, which allow the firm to obtain a greater amount of purchasing power for longer periods: specific and (or) non-transferable assets. It is precisely these latter attributes that make them difficult to reproduce and obtain and that is why they give their holders a high degree of power over the production process and, with it, the ability to appropriate value. Let us take a closer look at this issue.

All economic theories seem to converge on two points. The first one is the establishment of a basic wage rate for unskilled work. The second one is a basic remuneration for capital (which can be zero, as in Schumpeter). Below these basic levels, production does not take place, due to the mobility of capital and labor, which would go to other branches.

What matters here is not to discuss these levels, their determination, their limits, whether they are desirable, or any other aspect of them. All the analysis of this study so far has aimed precisely to affirm that competition is the struggle for the appropriation of purchasing power, preferably above these basic levels<sup>159</sup>. On what could such an appropriation be founded? According to the hypothesis of this work, it is located in a higher productivity than that of unskilled labor and average capital, so that it cannot be easily reproduced

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158 Regarding the importance of the tacit aspect of knowledge, see Polanyi (1966).

159 Producers who only achieve such levels of remuneration are marginal producers, in Steindl's sense (1952. Ch. IV), easily eliminable. In a market that fulfills the requirements of perfect competition, which leads to the absence of the possibility of significant competitive advantages, there would only be this type of producer. The theoretical stance adopted here, unlike the mainstream economics, which in general, takes them as paradigmatic, sees such markets as irrelevant, if they really exist. Not only because its assumptions are very restrictive and cause the model to be unreal; more serious than that, the assumption of the absence of competitive advantages fundamentally distorts the dynamics of the capitalist economy, in such a way that, if such markets exist, even for a brief period of time, they will be theoretically irrelevant, due to their low dynamism and the difficulty of strategies to be devised in them.



– i.e., that other economic agents cannot offer the same commodity at the same price<sup>160</sup>. Now, this means the existence of particularities in the process used by the firm, which can be located in the capacity of its employees, in the form of work organization, in the quality of the inputs, or even in the image projected by the firm. What matters here is to draw attention to the fact that these “assets”, which allow the firm to obtain extraordinary gains, usually take the form of special assets, not easily reproducible by existing and potential competitors, therefore not found in the market.

The above proposition is placed on a very general perspective. Let us try to detail it a little more. There are several dimensions of competition, that is, points on which advantages can be established. In many cases, such as design, specification or performance, this will depend on specific technical knowledge; in others, a particular capacity for organization and administration; there are also situations in which the firm’s image is relevant, or others where what matters are well-established relationships. In all the aforementioned cases, we have the presence of intangible assets, based on experience, knowledge, established relationships.<sup>161 162</sup> All of these assets have several characteristics in common: 1) they are created over time and a certain amount must be spent on their construction; 2) they are ephemeral, not just because they can be overcome, but also because if they are not constantly used and reinforced, they disappear. Their use and reaffirmation usually mean their expansion; 3) on the one hand, their “sale” does not mean a transfer, as it continues to exist under the control of the “seller”; on the other hand, the “buyer” must be prepared to receive it. To learn a licensed technology, for example, some prior knowledge of elements related to it is needed. Likewise, to acquire the franchise of a prestigious brand, it is necessary to be able to produce within certain quality specifications. This preparation, in itself, already means a certain degree of presence of intangible assets. Therefore, it is necessary to use them to recover the expenses with their acquisition, to expand them and to obtain income, whose potential only ceases to exist due to their wasting or overcoming, the only ways in which their buyer loses them.

Not all competitive advantages are based on intangible assets. The economies of scale and scope, for example, results from precedence in occupying the market and there are other types of advantages that result from the financial

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160 This hypothesis is not obtainable by simple deduction. There could be alternatives, for example inspired by Knight’s theory that profit must be explained by uncertainty.

161 I allow myself to expand the usual notion of intangible assets, which here assumes the meaning of anything non-material owned by the firm and which provides it with advantages. Therefore, it is not restricted only to assets to a certain extent negotiable, such as trademarks and patents.

162 As you can see, these properties are inspired by those attributed by Dasgupta and Stoneman (1987) to knowledge.

strength of the firm and the group to which it belongs. These advantages tend to lose part of their importance, if not accompanied by others, based on intangible assets. After all, the financial power that matters in a particular market is likely to be available to many large groups when we think about the world. As for economies of scale, their deterrent power of barrier to entry can always be challenged, if other producers have access to them. However, when these advantages are combined with others, associated with intangible and therefore less reproducible assets, there is a reinforcement of their ability to appropriate purchasing power, as the challenge of other competitors becomes less likely.

Hence, it is concluded that intangible assets are extremely important for appropriability, both for their intrinsic ability to differentiate their owner, and for reinforcing the monopoly gains generated by other sources. For this reason, making the best use of their intangible assets becomes a key part of the firms' competitive strategy. This phenomenon has been analyzed by several authors, using different concepts, with different theoretical approaches, but basically all dealing with the importance of the resources already owned and the special assets in the understanding of the nature and dynamics of firms.

Williamson (1975; 1985) went a long way towards examining how the specificity of the use of certain assets makes it hardly plausible that producers depend on the market for their supply or for their continued sale. Two points are fundamental in this explanation: the existence of uncertainty and the opportunism present in many human beings<sup>163</sup>. The first point influences because specific assets are less flexible, so whoever sells or needs them is more at the mercy of unforeseen variations in demand and supply. In addition, the internal organization promotes the convergence of expectations and the emergence of more efficient codes to be used between the parties (producers and users of specific assets, internalized by the firm). Opportunistic behavior, on the other hand, is characterized by promises and threats made without the intention of being fully fulfilled, with a view to obtaining personal advantages. Even though not everyone is an opportunist, the mere fact that there is a possibility of being so makes it problematic to maintain such a relationship under the aegis of the market<sup>164</sup>. The fact that an asset is too specific and not very flexible with regard to its possible uses means that it must achieve high transaction costs and encourages vertical integration between its producer and supplier.

Langlois (1992) makes an important criticism to this approach: Williamson's model is too static, insofar as learning, or, more generally, the

163 Uncertainty as thought by Simon (1959) to which Williamson adds an additional dimension, represented by language issues.

164 See Williamson (1985).

evolution of the firm's own capabilities, based largely on tacit knowledge, is not dynamically incorporated into the assessment of transaction costs. The production and use of assets allows advances in experience and capacity, especially in the case of a technology that is still relatively new. Such advances mean the possibility of additional gains for its holders, who know this and bring it to mind when their expectations are formed. The decision to internalize a stage of the production process cannot therefore be based solely on the consideration of its specificity, but must consider the agents' perception regarding the relevance of controlling the subsequent learning process, due to the opportunities envisaged there.

The foregoing consideration leads one to think that the specificity of assets should be thought of a little differently from the economics of transaction costs. Undoubtedly, the specificity of the uses of the asset makes its transaction difficult, but this is not the only source of this type of difficulties. In particular, the non-entirely transferable dimensions of the firm's resources, based, among other factors, on its experience, knowledge or reputation, are not entirely amenable to commercial transactions. This makes them specific in another sense, that of being particular attributes associated with the resources of a given firm. These attributes are probably one of the most important sources of competitive advantages, precisely because they are specific to the firm and difficult to reproduce, therefore scarce.

At this point, it is worth resuming the contribution of the pioneer to emphasize the particularity of the resources owned by the firm and the "services" they could provide: Edith Penrose. For this author, these resources are sources of "economies of expansion," that is, they mean special advantages in the expansion process of the firm following certain directions. Particularly they originate "economies of diversification," arising from the fact that the experience acquired in a market allows a certain advantage in penetrating markets with similar characteristics, as in the case of knowledge of a technology, which generates savings in the production of other goods that use it. Thus, the "diversification horizon" of the firm is formed by products that are located in the same market area or technological base of the goods already manufactured<sup>165-166</sup>. That is to say, the skills acquired by the firm, whether in marketing or in technological knowledge, represent "assets" to facilitate and stimulate their diversification in order to make good use of them. Translating into the language we have been using, it can be said that intangible assets that represent competitive advantages in a given market may also be in very

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165 See Penrose (1959. Ch. VI).

166 See Penrose (1959. Ch. VI).

close markets, and penetrating the latter is a way of extracting a greater part of their potential earnings capacity.

There are limits to this process. Penrose pointed out that the new markets must be known and this takes time and requires a certain effort from the firm's leaders. This means a limit to the pace at which the diversification process takes place, but not to how much a firm can diversify in the future. To these must be added the financial limits concerning the expansion of the firm itself.

If Penrose's contribution to the existence of a privileged path for expansion and diversification can be revised in light of the notion of intangible assets, specific to the firm, the non-negotiability of the fruits of learning is at the basis of what Dosi, Teece and Winter describe as coherence of the large company, the core of its analysis of diversification<sup>167</sup>. According to these authors, learning and "path restrictions," constituted by technological opportunities, the selection and the existence of complementary assets are key points to think about the company's limits.

According to these authors, the theory of transaction costs fails to give any relevance to the companies' organizational capabilities. On the other hand, the more conventional neoclassical theory supposes them, when such capacities should be an object of explanation. Its vision is that the creation of these capacities through learning is fundamental for the understanding of the firm and its expansion process. The aforementioned cumulative nature of learning and the need to constantly use the knowledge acquired so that it is not forgotten or lost is one of the reasons for this. Another important aspect is raised: the fact that "the learning processes are intrinsically social and collective phenomena," as they are frequently produced "due to joint contributions to the understanding of complex problems." That is why they require common communication codes and coordinated procedures for finding solutions. Within a company, this means that in the learning process certain complex organizational routines must be created, which are not fully codable, that is, tacit and therefore specific. It means not only the knowledge generated by learning is tacit, but also the routine created to obtain it<sup>168</sup>.

As for the idea of "path restrictions," it aims to emphasize irreversibility, the fact that "history matters." Three irreversible elements are remembered in this context: a) the selection process, that is, the elimination of the weakest firms or techniques, which can occur in a more or less vigorous way and which requires a certain commitment of resources from the firm<sup>169</sup>; b) the

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167 See Dosi, Teece and Winter (1990).

168 See Dosi, Teece and Winter (1990: 242-3).

169 Penrose argues in a similar sense that competition requires a firm commitment of resources, both financial and human, organizational, etc., so that it is not eliminated. The expansion of the firm cannot take place at the expense of the resources necessary to maintain a competitive position where it has already been

breadth of technological (and, it may be added, innovative) opportunities that arise at a given moment; c) the complementary assets necessary to carry out the desired innovations or, more generally, to penetrate new markets. These elements confer or not consistency to the limits of the firm's performance. The firm's expansion and also its decision to leave an economic sector will be consistent if it is able to consider the core competence that its experience, the result of learning, provides it, as well as the complementarity of its assets in its different areas of activity, the specific opportunities at its disposal and the needs for resources and liquidity to face the selection process it faces in the different markets where it is present.

The role of the need to preserve and use intangible assets as a key explanatory variable in the expansion process of the firm is not restricted only to the field of growth in the same market, leading to concentration, or to diversification. The conquest of foreign markets must also be focused on this idea. Caves (1971) was the first to work in this precise direction, followed by many others, such as Buckley and Casson (1991), Rugman (1981) and Dunning (1981), with slightly different approaches<sup>170</sup>.

In conclusion, the firm's strategy in its quest for valorizing the resources it has must place particular importance on the efficient use of its intangible assets, those that are specific to it, that are not entirely reproducible by rivals and even whose imitation does not occur without an important expenditure of time and money. These assets are not only important "assets" in obtaining purchasing power, but have special properties, which give them relevance in decisions regarding the expansion or reformulation of the firm's activities. Such properties are mainly its tacit dimension and its particular form of ephemerality. The first prevents their commercialization, therefore they never leave the hands of those who own them and are only obtainable after a great effort and according to the achievement of certain prerequisites, not always widely attainable. The second causes them to be extinguished if they are not used because they are lost and because they are supplanted.

In order to get the most out of its intangible assets, the firm's decision-making body must seek to maintain a certain coherence, that is, to carry out activities that widely use the same intangible assets. As its use generally means its reinforcement, when they are shared by several company segments, everyone wins. It can be said that a synergy is created, which will be greater the more intense the improvement of these assets through use. Nevertheless, the company must prevent the expansion into new areas from weakening its

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operating. Otherwise, it may be in danger of losing its position in its home markets, without reaching an important position in the new ones (Penrose, 1959, Ch. VI).

170 This point was addressed in Possas (1993, Ch. IV).

favorable competitive position in the various markets in which it operates, assessing and reinforcing its competitive advantages in an integrated manner, considering their complementarity, constituting a core of competence specific to it. The cost of competitive process may lead it to eventually abandon some sectors, where it becomes difficult to maintain a coherent set of relevant tangible and intangible assets, so that it can reinforce its position where its specific competence is most prominent. Evidently, this type of diversification, based on the company's core competence, differs from conglomeration through the purchase of a company or shares, in which only the financial aspect is considered<sup>171</sup>.

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171 Langlois (1992) suggests that even in these cases an attempt may be made to more effectively use an intangible asset, namely, the ability to properly assess the possibilities of financial gains.

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# CHAPTER 15

## THE DECLINE OF BRETTON WOODS AND THE EMERGENCE OF “GLOBALIZED” MARKETS

*Luiz Gonzaga de Mello Belluzzo*

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At the end of World War II, the democratic society project discussed among the political forces opposed to Nazi-Fascism was created in the light of terrible memories. The 1920s and 1930s revealed an increasingly powerful capitalism in its capacity to create and destroy, to transform competition into monopoly, to practice protectionism, to wipe out national currencies, to cause unemployment and to stop the machines. These crazy and tragic years have also revealed that societies can react to the blind and disruptive violence of economic laws with the weapons of brutality, political voluntarism, and the ruthless centralization of decisions.

Fascism had many masks, but it is undeniable that, in essence, it represented the drama of the politician's revenge against the pretensions of economic autonomy. It was necessary to subtract the production and exchange of goods of the empire from norms emanating from the *diktat* of monetary gain and submit them to the will of the Führer and the needs of the people. The fascist economic regime was a monstrous “populist” movement, a rebellion against “the objectivity” of economic laws and their dire consequences on the living conditions of individuals.

Important political forces that fought fascism knew quite well that the survival of democracy did not depend only on the restoration of institutions and mechanisms of popular representation, the balance of powers, and the public control of the authorities' actions. The negative experience of the 1920s and 1930s taught us a lesson: the capitalism of the large business and the financial capital would inexorably bring society to the threshold of other totalitarian adventures, in case a public jurisdiction with decision-making power, capable of coordinating and disciplining private mega-powers, was not created. The threat to freedom, as Karl Mannhein has stated, does not come from a government that is “ours,” which we have elected and that can be overthrown, but rather from oligarchies without public liability. Coalitions of interests and business combinations typical of contemporary capitalism have the power to

adopt arbitrary measures such as production rationing, strike of investments, increases in abusive prices, and the control of patents, resources and markets.

Social forces and men of power tasked with rebuilding postwar capitalist institutions were pregnant with this conviction. In order to avoid repeating the disaster, it was necessary, first and foremost, to establish an international economic order capable of encouraging the development, without obstacles, of trade between nations, following monetary policies that would guarantee confidence in the reserve currency, the non-deflationary adjustment of the balance of payments, and the supply of liquidity required by expanding transactions. Therefore, it was about building an international economic environment designed to provide a wide range of maneuvers for national policies on development, industrialization, and social progress.

The creation and management of this favorable international environment found an adequate response in the reforms promoted in the institutions and policies of the Nation States. The new institutions and economic policies of the Welfare State were committed to maintaining full employment, with the mitigation, in the name of equality, of the damage caused to individuals by the unshakable operation of the "economic mechanism." Alliez (1988) rightly states that, for over two decades, the creation of a world based on the right to work took place, aimed at full employment and the growth of real wages. "Promoting this dynamic, in which wage growth takes place for the benefit of the profits generated by them, implies a change in the role of the State. The State must not only ratify and guarantee productivity agreements, but also maintain, when not developing [it], the dynamics covered by them: on the one hand, stimulating the consumption of wage earners by increasing social transfers and, on the other, by sustaining productive investments – the control of interest rates and policy on public investments."

The conception of national development, within the framework of a stable and regulated international order, was not an idiosyncratic fantasy, but stemmed from the "spirit of the time," forged in the reminiscence of the terrible experience of the first four decades of this century. Nor was the role attributed to the State action in stimulating growth, preventing economic instabilities, and correcting social imbalances fortuitous.

The events that have been manifesting in the last quarter of the century seem to indicate that the Keynesian Era – the golden years of capitalist growth – was succeeded, as of the beginning of the 1970s, by turbulences and instabilities that history may demonstrate as formidable as those that emerged in the 1920s and 1930s. The fact is that the set of commercial, productive, technological, and financial relations that arose from the Bretton Woods agreement and prospered under the U.S leadership has not resisted its

own success. The United States of America and its economy fulfilled, during the first twenty years of the postwar period, the hegemonic function that stemmed from their industrial, financial, and military supremacy. Under the cloak of this hegemony, the economies of Europe and Japan were rebuilt and conditions were created for the advancement of industrialization experiences on the periphery of capitalism.

However, before evaluating the performance of the Bretton Woods systems and discussing the reasons for their crisis, some considerations about the role of the International Monetary Fund (IMF) and the World Bank must be pinpointed.

The multilateral institutions of Bretton Woods – the World Bank and the IMF – were born with regulatory powers inferior to those initially desired by Keynes and Dexter White, representatives of England and the United States of America, respectively, in the negotiations of the agreement, which were **basically** conducted between 1942 and 1944. Harry Dexter White belonged to the so-called left wing of the New Dealers; therefore, after the war, he was heavily investigated by the House Un-American Activities Committee. Its initial plan foresaw the constitution of a true International Bank and a Stabilization Fund. Together, the Bank and the Fund would have an increased capacity to provide liquidity to trade between member countries and would be more flexible in determining the conditions for adjusting deficits of the balance of payments. This scared the American establishment. Some because they understood that these powers seriously limited the maneuver scope of the American national economic policy. Others because they feared the “inflationary” tendency of these liquidity and adjustment mechanisms.

Keynes proposed the Clearing Union, a kind of Core Bank for Core banks. The Clearing Union would issue a bank currency, the “bancor,” to which national currencies would be referred. Deficits and surpluses of the countries would correspond to reductions and increases in the accounts of Core banks (in bancor) with the Clearing Union. A peculiarity of the Keynes Plan was the more equitable distribution of the burden of adjusting imbalances of the balance of payments between borrowers and lenders. This actually meant, within the established conditions, facilitating credit to borrower countries and penalizing lender countries. Keynes’ purpose was to avoid deflationary adjustments and to keep national economies on the path to full employment. The proposal was also subjected to severe restrictions from the United States of America, a country that emerged from the second war as a creditor to the rest of the world and a lender in its trade relations with the remaining countries.

The weakening of the Fund, in relation to the original ideas, meant handing over the functions of liquidity regulation and lender of last resort to the

Federal Reserve. The monetary and payment system that emerged from the Bretton Woods Agreement was less "internationalist" than those who dreamed of a true "world economic order" would wish. The IMF problem is not its excessive power, but its deplorable submission to the power and interests of the United States of America.

Much has been written about the role of the USA in postwar prosperity. Some authors sought to define more precisely the conditions of stability of the Bretton Woods system: the benefit of *seignorage*, enjoyed by the country issuing the reserve currency (the USA) was a condition for member countries to implement, under the rules, internal "Keynesian policies" and neomercantilist strategies.

Padoan (1986) suggests that, for the United States of America, the *seignorage* benefits were developed as follows:

- a) strategic objectives: the Americans borne most of the costs of the military alliance formalized in the North Atlantic treaty and were able to do so, to a large extent, thanks to the condition of issuers of the international reserve currency;
- b) economic objectives: *seignorage* allowed the expansion of American industry and its technological style (Fordism), mainly through direct investment;
- c) financial objectives: the position of "international banker" on the part of the USA has paved the way for the growth of American banks.

In pursuing these objectives, the American economy worked – as Minsky correctly pointed out – as a "regulator" of the capitalist system. This means that the United States of America fulfilled the role of an autonomous source of effective demand and of a lender of last resort. For member countries of the hegemonic system, this regulatory function was an *ex-ante* guarantee of continued expansionist national policies and neomercantilist growth strategies.

Therefore, the USA and their economy began to feel the effects of the rise of partners/competitors. Japan and Germany, for instance, have rebuilt newer industrial and business systems that are more permeable to technological and organizational changes, and the new industrialized systems in the periphery have gained more space in the growing volume of global trade. Not by chance, from the beginning of the 1970s, the negative balance of the American balance of payments showed an increasingly important share of the trade deficit. During the 1950s and 1960s, the American trade balance was consistently a lender one despite the borrower position in the global balance.

The inevitable pressures on the dollar intensified and, in 1971, Nixon suspended the convertibility of the dollar into gold at a fixed rate. In 1973,

Bretton Woods' fixed, though adjustable, parity system was replaced with a system of dirty floats.

The United States of America were unable to sustain the dollar position as the standard currency, as an "excess" supply of dollars grew out of the growing imbalance in the balance of payments, now under the pressure of a trade deficit. Minsky and other authors defend that the "standard dollar," similar to national systems, was actually a monetary credit system. In this system, the global deficit in the balance of payments determined the **amount** of credit and the positive situation of the trade balance guaranteed the **quality** of the dollar flows made available to other countries, companies, and individuals.

In fact, it was under the influence of financial and monetary disorganization that the formidable expansion of the "internationalized" financial circuit took place in the 1970s. The Bretton Woods regulatory system crisis allowed and stimulated the emergence of loan/deposit operations that were beyond the control of Core banks. The initial source of these "internationalized" operations was certainly the amount of dollars that exceeded the demand of economic agents and foreign monetary authorities. The first oil shock and the famous private recycling of petrodollars have broadened the foundations of the international credit supply and pushed the system into the area of increasing risks. In any case, the frenzy of foreign indebtedness that gave impetus to many projects of industrialization and industrial growth (both in the periphery of capitalism and in the socialist area) was already the result of the fatigue and the contradictions reaching the basic mechanisms that guaranteed, simultaneously, the stability and growth of the Core economies.

The internationalized financial circuit, operated by large commercial banks, apart from any regulation or supervision on the part of Core banks, has accentuated the tendency to overexpand loans and the progressive reduction in the quality of the granted credits. As previously stated (Tavares & Belluzzo, 1986), the international financial circuit started functioning as a "pure credit" system in its relations with governments and companies, with the endogenous creation of liquidity and high-risk premiums. Indebted agents, in turn, accepted any interest rate for the rollover and expansion of their debts.

The financial internationalization that emerged in the late 1960s took place through the increasing supremacy of the function of financing and payment medium of the dollar in relation to its function as a universal standard. The conflict between both functions, which must peacefully coexist within a stable monetary system, ended up provoking, at the end of the 1970s, tests for substituting the dollar for Special Drawing Rights (created in 1967) issued by the IMF and backed by a "currency basket."

Nevertheless, threats to the dollar were contained by the unilateral gesture of the USA that, in late 1979, steeply raised interest rates in order to preserve

the reserve function of their national currency. If someone wanted to set a date for the final downfall of the Bretton Woods architecture, they would have a chance to get it right by choosing October 1979. It is not just a matter of verifying that the USA have ceased to play the role of a "residual country," that is, a country capable of easing the tensions – both inflationary and recessive – of the system functioning as an autonomous source of effective demand and lender of last resort. By imposing the regeneration of the role of the dollar as a universal reserve through an unprecedented rise in interest rates, the USA dealt a death blow to the state of convention that had sustained the relative stability of the Keynesian Era. During the 1980s, the world economy was affected by wide fluctuations in the exchange rates of the currencies that control the three currency zones (dollar, yen, and mark). These fluctuations in exchange rates were followed by extreme volatility in interest rates. In fact, exchange rate fluctuations, supposedly aimed at correcting imbalances in the balance of payments and granting greater autonomy to domestic policies, have been destabilizing. This is because the increasing mobility of short-term capital has imposed many monetary policy interventions, determining fluctuations between interest rates in the several currencies and creating severe restrictions on the action of fiscal policy.

It is in this environment of financial instability and "decentralization" of the international monetary system that financial transformations, known by the generic designations as **globalization**, **deregulation**, and **securitization**, take place.

These transformations have matured over a period of growth interrupted by relatively mild recessions and "countercyclical" government interventions. Hence, two important consequences can be mentioned:

- a) severe debt deflation processes have been avoided; and
- b) as of 1975, the weight and importance of the American public debt in the composition of private portfolios proportionately grew.

In the 1980s, the widening of the two budget and trade deficits in the USA was an important factor in giving a second impetus and a new direction to the process of financial globalization. In practice, the development of the securitization process was based on the expansion of public debt markets. This is not only because the share of American bonds has grown in the formation of the financial wealth demanded by private agents from the USA and other countries, but also because the securities of the US government are the noblest and safest products in integrated markets. The expansion of the US net debt position allowed the adjustment of the banks' portfolios, without major trauma,

as the undervalued credits of developing countries were being replaced with debt issued by the National Treasury to the United States of America.

We are attempting to state that the evolution of the internationalized credit system crisis and the US responses to the weakening of the role of the dollar created the conditions for the emergence of new forms of financial intermediation and for the development of a second phase of **globalization**. This process of transformations in the financial sphere can be understood as the generalization and supremacy of the capital markets to replace the previous dominance of the credit system commanded by the banks.

Overall, financial markets tend to **individualize** losses, that is, to put the risk of nonpayment or illiquidity on private agents. This means that these financial forms are inherently deflationary. In other words: the tensions of illiquidity or nonpayment that arise at some point in the system are “resolved” through the fall in the prices of financial instruments. These characteristics contrast with the “inflationary” trends implicit in the credit system in which situations of illiquidity and the possibility of “bankruptcy” are faced by the Core bank through discount lending or last resort actions.

For this reason, in the new financial markets, **information** prepared by credit rating agencies has become a fundamental element in the decision of investors. This reinforces, in the case of developing countries, the tendency to make credit more selective, favoring international companies or those capable of generating revenue in foreign currency.

These “new” markets would have the virtue of combining the advantages of better information circulation, reduced transaction costs, and a more rational distribution of risk. The “efficient market” hypothesis aims, finally, at teaching that all relevant information about the fundamentals of economy is available at anytime for market participants. And that, in the absence of government intervention, the rational action of agents would be able to guide the best distribution of resources, among the different assets, denominated in different currencies.

In practice, what has happened, once again, in the case of Mexico and other emerging markets, was the spectacle of the “persistent error” expressed in the evaluations formulated by the markets and by specialized agencies in the classification of debtors. Investors’ behaviors corresponded much more – both at the inflow and at the outflow – to what Keynes called “herd behavior.” History repeats itself. But the voices calling for the reconstruction of a true international economic order are still weak. Free-market fanatics refuse to understand that the market order is seriously threatened when there are no centralized rules and monetary institutions capable of guaranteeing a minimum of predictability to private decisions.

Reexamined after a period of over fifty years, Keynes and Dexter White's views on the institutions and rules that should preside over a true international economic order seem inspired by a pessimistic view on the virtues of the self-regulating market, and particularly negative in relation to free movement of short-term capital. Although the Bretton Woods system of rules and institutions has indeed turned out to be only a shadow of the reality imagined by the two public men, nowadays no one discusses the unique character of the postwar capitalist boom until the mid-1970s. Recent studies show that no other phase of capitalist development has presented, nor has been presenting, such favorable results with regard to product growth rates, real wages, inflation behavior, and interest and exchange rate stability.

Nevertheless, technological changes, in the forms of competition, in the organization and strategy of the large business and, finally, in the operation of the financial markets, which occurred in the last two decades, seem to justify the opposite view, which celebrates the supremacy of economic mechanisms – the logic of the market – as for the vain attempts to discipline the forces that are simultaneously creative and destructive of capitalism.

After some time condensed by society and the State, the fundamental trends of this production regime are present, and they are getting their revenge: a vigorous economy of time and devaluation of work; and the intensification of competition on a global scale. In this process of globalization of competition, a new wave of capital centralization has been triggered, which takes the form of an increasing spatial dispersion of productive functions and outsourcing of ancillary functions of the production process, followed by a violent concentration of decisions and the circulation of information in the "brain" of the large business. The dominance and the ability of the large business to control the markets find a favorable environment in the development of the new finance. Capital markets are more sensitive to risk assessment, which determines greater selectivity in the choice of roles offered for the consideration of portfolio managers. At the same time, the global character of the markets allows companies broad access to hedge and protection mechanisms against fluctuations in exchange rates and variations in credit conditions in different countries.

The centralization of capitalist control, the relentless pursuit, imposed by competition, of reducing the socially-necessary working time, and the increasingly "patrimonialist" and volatile character of the markets that trade property rights and credit bonds are processes that reinforce each other to produce results very different from those observed in the so-called Keynesian Era. The cycles of prosperity and depression are shorter, investment rates are noticeably more modest, structural unemployment is increasing, and the



gap between disturbances in the financial and foreign exchange markets is increasingly narrower.

As for the National State, unarguably its economic action has been severely restricted: it helplessly watches the development of strategies of localization and internal division of labor of the large business, and it has been increasingly at the mercy of tensions generated in the financial markets, which submit the monetary, fiscal, and foreign exchange policies to their own whims. Rather than its global character, the new finance and its logic became decisive due to its ability to impose vetoes on macroeconomic policies. This veto power in the financial markets is imposed on all economies, albeit differently. The United States of America, for example, issuers and managers of reserve currency, have more scope to implement expansionary fiscal and monetary policies, provided that they accept the permanent risk of speculative attacks against the dollar and adequately manage the tensions that manifest through the immediate rise in long-term interest rates, when growth is deemed “excessive” by the markets.

Conversely, “weak currency” countries are unable to escape from situations of instability but by pegging their currencies to a foreign currency, while renouncing any claim to determine the direction of fiscal and monetary policies. The discipline imposed by the financial markets, whose anticipatory movements can destroy precarious stability, ends up inhibiting any and every attempt to implement active policies aimed at promoting growth.

The most important effects of these transformations have been, everywhere, the economic decline of many regions, the growth of structural unemployment, the proliferation of forms of precarious employment, and the increase of inequality.

To these negative forces, the State and society cannot respond with compensatory actions from other times, as in the globalized markets there is growing resistance to the use of fiscal and social security transfers, while increasing restrictions on the taxable and debt capacities of the public sector. This is because globalization, by making the space for the circulation of wealth and income of integrated groups freer, dismantled the old tax base of Keynesian policies and subjected the State’s debt capacity to the veto power of financial markets.

In addition, the action of the State, particularly its fiscal prerogative, has been challenged by the intense process of ideological homogenization of celebrating individualism, which is opposed to any interference in the process of differentiation of wealth, income, and consumption carried out through the capitalist market. The ethics of solidarity is replaced with the ethics of efficiency and, thus, programs for redistributing income, repairing regional

imbalances, and assisting marginalized groups have encountered strong resistance within societies. Undoubtedly, this new individualism has its social base originating in the great middle class produced by the long prosperity and the more egalitarian processes that prevailed in the Keynesian Era. Today, the new individualism finds reinforcement and support in the emergence of millions of outsourced and self-employed entrepreneurs, creatures of the changes in the working methods and in the organization of the large business.

The State action is seen as counterproductive by successful and integrated people, and as insufficient by the demobilized and unprotected ones. These two perceptions converge in the direction of "delegitimization" of administrative power and in the devaluation of politics. Apparently, we are in a historical situation in which the "great transformation" occurs in the opposite direction to what was predicted by Polanyi (1980): the economy tries to free itself from the fetters of society. It remains to be seen what responses society will give to the exploits of the disentangled economy only limited by its own laws of motion.

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# CHAPTER 16

## GENERAL LAWS OF MOTION, COMPETITION AND CAPITALIST CALCULATION: the complex economic dynamics

*José Carlos Braga*

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### 1. The Problem of Mediation of Competition and Capitalist Calculation under Uncertainty

The category of capital in general formulated by Marx does not dispense with the determinations of competition and, precisely for this reason, the general laws of motion already constitute a theoretical framework of capitalist dynamics. This is where the misunderstanding of several interpreters begins, who do not recognize these determinations and end up inverting them, as it will be seen.<sup>172</sup>

The fundamental law of competition is that individual capitals are made general: “The reciprocal action of capitals as individual entities is converted precisely into the general position and the suppression of apparent independence and the no less apparent autonomous existence of the individuals” (Marx, 1971: 175-176). What is highlighted is precisely how the influx of individual capitals over others is based on the fact that everyone has to behave as capital (in general). The suppression of independence and autonomy can be seen, according to Marx, clearly in credit and in an extreme way in share capital. It must not be overlooked that in this excerpt there is an important logical moment of the opposition between free competition and monopolization, which is precisely accelerated by the centralization that credit and joint-stock company promote.

That is why the proper mediation for the investigation of competition must refer to a theoretical-analytical framework – the **mesostructure** – that comprises capitals operating as capital in general, and not as capital of this or that sector, branch or product, immobilized in this or in that market structure. This framework corresponds to that which consists of the concentration and centralization of capital, credit (ability to dispose of social capital) and share capital. The capital

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172 Rosdolsky (1968, Ch. 2) is the interpreter on which those who do not recognize in Marx an analysis of competition rely, which in itself is already an moment of economic dynamics.

generated in this process is what we call, in more abstract terms, centralized capital, capable of mobilizing to operate in various industries, in different product lines; qualified to operate in production, marketing and finance. It is in this way that **they are posited as capital in general and, as such, controllers of various markets, main determinants of investment/aggregate demand and the accumulation of *lato sensu* capital**. I insist that it is this nature, this logical imposition, that manifests in the different modalities of organization – the U.S multidivisional company, the German conglomerate, the Japanese *keiretsu*. The framework to which they correspond is a **mesostructure** in the sense that it is logically and effectively between the microeconomic (of particular industries and markets) and the macroeconomic dimension (where investment decisions interact globally). It should be noted that the decisions related to the performance in the markets and industries are subsumed in the organizations (centralized capitals) that make up the **mesostructure** and that perform, in this **meso** dimension, their expectation calculations from their objective function. At the same time, it must be recognized that markets and industries are subsumed in the **mesostructure**, which is the space for confrontation of those organizations as centralized capital. Namely, the calculations coming from the markets/industries in which an organization operates are subordinate to the organization's overall logic, which can redefine those original calculations dictated from the microeconomic dimension of markets/industries. (Obviously, this applies to all relevant organizations, according to the centralized capital criterion).

To understand the analysis proposal at the meso-structural level, one must consider the determination derived from the meaning of capital in general. The understanding **must start from the fact that capital in general is a concrete universal**,<sup>173</sup> that as such a category brings with it the plurality of capitals<sup>174</sup>

173 Concrete universal is understood "as an object that contains both universality and singularity." (Fausto, 1983: 98) There is a kind of tension between capital in general and individual capital (which forges the so-called "plurality of capital"). This tension is analogous to that between value/use value, abstract labor/concrete labor, money/commodity. Let us take the latter into account for clarification, as Ruy Fausto does. Money and commodity are not simply different things. Different are just any commodities, one in relation to the other. On the contrary, money is the general or universal commodity, but money is also a commodity: "dual condition of genre and of individual, of individual-genre, which makes the social thing money the opposite of each commodity." There is "a coincidence between the universal and the individual [...]" as if the universal invaded the particular, from where the tension, which would be absent if it were only the genre or only the individual." Capital in general is, thus, the universal (concrete), an abstraction engendered by credit, by share capital, by money (and financial assets) functioning as capital, which finds in the centralized capitals (the particular term) the mediation for the singular (the individual capital), being thus (the capital in general), at the same time, an individual capital or several, subsumed in it. Capital in general as a genre exists alongside the species and individuals that compose it (the same that occurs between money and commodities), which is why the forms of competition are inevitably inserted and understood within the scope of this tension. Capital in general and the plurality of capital are no different. There is no competition in general (capital in general), on the one hand, and concrete competition, on the other (plurality of capital).

174 At that point, Marx (1971: 409-410) is incisive, and the quote is indispensable: "Capital in general, unlike capital in particular, presents itself, in fact, only with an abstraction [...] that captures the *differentia specifica* of capital in

and that is why, conversely, the fundamental law of competition is that singular (individual) capitals are placed as capital in general. In this way, competition becomes unthinkable, in Marx's terms, without capital in general. Logically, it is also impossible to separate laws of motion (established for capital in general and which have a level of determination over the plurality of capitals) and dynamics, since it is precisely from the capitals, placing themselves as general, and, as such, enthroned in centralized capitals, that the mediations of competition must be sought to understand the dynamics.

It is important to include the understanding of the law of value as a law of capital valorization and its relationship with monetary prices in order to advance in terms of competition and capitalist calculation in the mesostructure. Authors who are entangled with the contradiction of value tend to seek some way of transforming values into prices, escaping the fact that the category value is precisely a category under negation by the actual reality of capitalist dynamics. In other words, the logic of contradiction makes labor value an evanescent category. Nevertheless, the law of valorization of value remains in force under capitalism, in the sense of imprinting the internal nature of capital in general and the rivalry of competing capitals.

Thus, the dynamic motions are consistent with the logic of capital as an autonomous value, for which it is monetarily elastic and, at the "limit," it fulfills its full purpose when it is configured as fictitious capital. However, labor values as quantity do not make up price formation, neither in the sense of relative values/prices, nor in the sense of the simultaneous realization of the reproduction price of a commodity and the labor value contained therein. As stated by Belluzzo (1980), capital, by stimulating capitalist methods of production, annihilates its base of valorization, "devalues" its own measure, advancing towards self-negation. Therefore, the Marxist theory of value is a theory of absolute value or a phenomenology of the absolutization of value. In what way? Precisely because working time becomes a "miserable basis" for the valorization of the immense mass of value that should function as capital. Thus, for Marx, value is not the essence of society's naturalness, but only the

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opposition to all other forms of wealth or ways in which (social) production develops. These are determinations that are common to each capital as such [...] but capital in general, as distinct from the particular real capitals, is itself a real existence. The ordinary economics recognizes this fact, does not understand [...] capital in this universal form, even though it belongs to several capitalists, in its elementary form [...] it constitutes the capital that accumulates in banks or is distributed through these [...] it is the law of capital in general, as an example that in order to be valorized it has to be placed in a double way, and it has to be valorized under this double form [...] the capital of a nation in particular which in contrast to another represents capital *par excellence* will have to be lent to a third nation so that its valorization is possible [...]. While the universal is on the one hand only an ideal specific difference, it is simultaneously a real particular form alongside the form of the particular and the singular [...]. As in algebra [...]  $a, b, c$ , are numbers in general; but in addition, they are whole numbers in front of  $a/b, b/c, c/a, b/a$ , etc. which presuppose them as universal elements."

form of capitalist sociability. The problem of the content of value, in terms of the quantitative aspect of labor and the exchange value, consists of a problem of classical political economy, more precisely of Ricardo. Therefore, it is a theory of absolute value, for Marx, in which the “activity of each producer only acquires meaning when sanctioned by the general form of exchange value [...] for money [...] the commodity is only confirmed as value the moment it becomes a general commodity, money.”<sup>175</sup> That is why, under capitalism, the theory of absolute monetary prices is what matters, as it will be seen below, a theory that Marx did not pursue, but Keynes did.

The very existence of the law of value implies, in the strongest sense of the word, a contradiction originated by the antagonism between capital as a subject and abstract labor, in such a way that the amount of labor is no longer the measure of valorization. If working time has become a “miserable basis,” any theoretical operation to validate labor value as a quantitative essence loses its meaning. However high the rate of surplus value, given the “miserable base,” only far away can the quantities of socially homogeneous labor be thought of as the basis for the immense masses of profit, all the more if we consider the financialization of wealth (Braga, 1991). That is, the process by which wealth is increasingly expressed in financial assets – in “paper wealth” – whose valorization have little relation to the economic “fundamentals” (productivity, amounts of physical capital, working times, etc.). There is no mass of surplus value that explains the dimensions achieved by the expansion of capitalist wealth, via capitalization on the stock exchanges and the capital market, in general, via foreign exchange operations that far outweigh – for monetary-financial reasons – the volume of operations that would be necessary if only trade in goods and services were considered.

Ultimately, it is the very dynamics of self-valorizing value which leads to the negation of the relevance of quantities of labor in the effective generation of profits in the monetary world of the prices of production and financial assets. These are not analytically deductible from the quantities of labor value, nor are they formed by capitalist decisions referring to quantities of labor, but by evaluations of monetary magnitudes. It is precisely in this issue that competition is a sovereign determinant: capitalist pricing as a monetary phenomenon, an understanding compatible with the phenomenology of the absolutization of value proposed by Marx. Therefore, the proposition of the transformation problem (commensurability/invariance) reflects, in fact, a “Ricardian bias,” which is self-defeating, and can be simply disqualified in the light of the absolute value theory itself. Nor did Marx investigate production prices because they were the main problem of competition theme. His “exercise” was only

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175 See Belluzzo's Introduction to Rubin (1980: 11).



intended “to make the theoretical sense of an average rate of profit” (Tavares, 1978: 61). In short, Marx did not formulate a theory of monetary prices of production. This formulation is necessary as a mediation for the investigation of competition, capitalist calculations and dynamics, and for that it can be done without the study of the relationship between prices and value-quantity of labor, maintaining the logic of capital as self-valorizing value in the monetary world. This logic develops, given the technical-economic factors, **under conditions** of intercapitalist competition and state monetary management, which is of an interdependent nature with the management of private wealth, resulting in terms of valorization/devalorization not always consistent with the aforementioned “economic fundamentals.”

In the investigation of prices, inspiration must come from Keynes (Tavares & Belluzzo, 1986), whose way of thinking about the monetary economy of production allowed him to theorize them from the nominal wage, from the contracts (of debts, of production, of orders, among others) and the cost of replacing capital (supply price), all expressed in money. This is the reference base in the formation of absolute money prices, which are presented in the effective reality of capitalism. On this basis, capitalists calculate their expected operating and non-operating profit margins, finding a strategic reference in the short-and long-term rates of interest (Tavares, 1978: 48). The general rate of profit is not limited by the amount of surplus labor, but by intercapitalist disputes, on the one hand, and, on the other, the possibility of extending monetary sanction over time, without deflation or inflation. To the extent that both culminate in the negation of the functions of money, the maximum contradiction of the capital regime is thus made explicit by destroying, in this process, that which is the form of wealth *par excellence*: money as capital. Hence the strategic role of rates of interest in the formation of prices: “Capital can only be valorized in money, that is, through its **metamorphosis** into a special commodity, which leads to a rate that is the **premise and basis** for calculating the global capital ‘valorization’ – the interest rate on financial” (Tavares, 1978: 48, emphasis in original).<sup>176</sup>

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176 The discussion about interest, profit and surplus value would deserve special treatment, which does not fit within the limits of this work. Let it be pointed out, however, that in Book III, Section V of *Capital*, Marx points out important elements of the contradictory and exacerbated valorization by interest-bearing capital. Although interest is considered as a part of the surplus value and the rate of interest has as its upper limit – and only determinable – the average rate of profit, the same logic revealed in the text points to a rupture between the interest-bearing capital valorization and its quantitative basis on surplus value. That logic, I think, would even lead to consider only the qualitative dimension of the relationship between interest and surplus value, while, quantitatively, the rate of interest would not only be determined independently, as “detached” from a possible limit or regulation given by the profit rate (calculated from the rate of surplus value/quantities of labor value). It is evident that this contradiction with the real bases of valorization has critical consequences

Keynes's conception of prices, properly reinterpreted in the light of current conditions, is compatible with the general motion of capital and competition, understood by Marx from the law of value as a law of valorization. This is, certainly, for Political Economy, an analytical problem in which Keynes must be taken as complementary to Marxist economic theory. Both knew that "the attitude of business" is M-C-M' (and also M-M', money-surplus money in the pure financial circuit), and it is this calculation that guides the production and realization of wealth (Keynes, 1933).

For this reason, the consistency of the laws of motion and an investigation of competition that is appropriate to it does not require repeated incursions into the theme of transforming values into prices of (re)production. Thus, one can formulate the following theoretical and historical "fantasy": the axis of Marx's thought allows us to imagine that, if he could manifest himself today, he would certainly dispense with all types of "transformisms" and would most likely have in Keynes the interlocutor to advance in the understanding of this monetary production economy or money-wage economy or, even, a financialized economy based on the "paper wealth" of its financial assets. In this economy, "prices carry profits" that are operational and non-operational (Minsky, 1986, Ch. 7), and they valorize, even fictitiously, the capital value.

## 2. Capital in General and Laws of Motion: Autonomization of Value and Centralized Capitals

The theoretical issue of the relationship between the general laws of motion and competition leads to the clarification of capital as a subject and to the reconsideration of the category of capital in general in its determinations about capitalist dynamics.

Capital placing itself as a subject has a real double meaning that is poorly understood. First, it expresses that free competition is placed by capital and not supposed by it.<sup>177</sup> This is explained in the logical movement in which capital, by centralizing itself, drives monopolization and thus restricts free competition, even if it does not eliminate capitalist rivalry. For this reason,

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for the system, but this should not evade the fact that the interest-bearing capital makes the labor value even more radical as a "miserable basis" for the process of valorization of value.

177 For Marx (1971: 168): "The domination of capital is the assumption of free competition, exactly as the despotism of the Roman emperors was the assumption of free "private law" [...]. While capital is weak, it relies on the crutches of past modes of production [...]. As soon as it feels robust [...] it moves according to its own laws [...]. As soon as it begins to feel itself as a barrier to development (it moderates) free competition and (announces) the dissolution of the mode of production in which it (capital) was founded." Here, too, the understanding of Possas (1989: 59) is, "consistently," wrong and inverse: "for Marx [...] capitalist production and surplus value [...] demand competition as a previous element, a fundamental logical assumption of its existence."

monopolization does not imply less competition. In the face of this process, ideology and economic theory of liberal inspiration continue to maintain the assumption of the existence of free competition and democracy of capital.

In the second sense, capital as a subject expresses that the actors of this economic system do not coordinate their decisions, as a collective subject, to choose what to invest in, how to use technical progress, how to accumulate and how to distribute income. Therefore, the actors of this economy are not the subjects of the process. Capital is the subject of the process, which determines the anarchic character of this production system, as it is subjected to decentralized and competitive decisions, as well as subjected to a result of the whole, not socially coordinable, in which the possibilities of order, coherence and stability, although existing and verifiable, are repeatedly negated by the capitalist dynamics. In this state of affairs, it is understandable that decisions are made under radical uncertainty, the unknowability of the future and that they end up producing instabilities and crises in the aggregate, since the decision-makers are not effectively the controllers and coordinators of the system as a whole, but only from rival subsets.<sup>178</sup> In other words, operating theoretically with capital as a subject has nothing of “philosophical speculation” but that it means to conceptually apprehend an effective reality of capitalism.<sup>179</sup> And recognize that “capital is subject [...] because it is an autonomous motion, an object motion” (Fausto, 1983: 30) – whose predicates are money and commodity.

This theme is theoretically strategic, because the understanding of capital as the autonomization of value implies learning that, in the real motion, money

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178 At the very least, it is worth noting that for Marx this logical process leads to the notion of “anarchy” in capitalist production, which has a theoretical parallel with the idea of uncertainty in Keynes. For the latter, a business economy implies assessments of wealth, permanently referred to money, under conditions of unknowable future earnings, so that expectations produce structural instability in effective demand and, therefore, in the pace of the economy. In this sense, capitalist instability is insoluble within the framework of the system, and any theorization that intends to standardize capitalist calculations, via the “endogenization” of expectations, is inappropriate, even when attributing to the “conventions” a regulatory function in which Keynes did not theoretically trust. The convention would restrict uncertainty because it corresponds to a state of expectations according to which the current direction of state of affairs would continue indefinitely. However, Keynes himself (1964: 152), without hesitation, warned: **“This does not mean that we really believe that the existing State of affairs will continue indefinitely. We know from extensive experience that this is most unlikely. The actual results of an investment over a long term of years seldom agree with the initial expectation.”**

179 Rubin (1980: 16) refers to Marx in the *Introduction to the Critique of Political Economy*: **“it is necessary to take into account, regarding the course of economic categories, that the subject – in this case, modern bourgeois society – is given so much in effective reality as in the brain; that the categories express, therefore, forms of being, determinations of existence, often isolated aspects of this determined society, of this subject [...] in the theoretical method (of Political Economy), the subject – society – must always appear in the representation as premise.”**

as capital is the social substance – (abstract labor) – taken as subject.<sup>180</sup> It is precisely this realization of capital fully in the money it brings to the world of prices, and very concretely for the calculation in a monetary economy of production, the negation of the labor value, the fact that value as an average and social labor time is an evanescent category. On the one hand, the productive capital, developing its specifically capitalist methods of production, I insist, annihilates its basis for valorization, “devalorizes” its own measure, in the sense of self-negation. As a result, working time becomes a “miserable basis” for valorizing the immense mass of value that should function as capital (Rubin, 1980: 12). On this basis and on the another hand, monetary-financial, “monetary capital” or, more precisely, finance capital, as a synthesis of forms of wealth, founds the relative autonomy of capitalist wealth, in a contradictory relationship with its “rational basis” that would be based on labor value. Hence the “irrationality” that presides over productive and financial prices – which carry profits and wealth – whose intelligibility, as I have already considered, introduces us to the monetary theory of (absolute) prices, to rates of interest, to the valorization indexes of financial assets.

Capital in general, as self-valorizing value, arises from those determinations as a real social abstraction and as a concrete universal. And as such, it is asserted as a theoretical element that interconnects the laws of motion with competition and dynamics. Consequently, I affirm that the mediation of competition that is imposed is that concerning the (logical-historical) unfolding of capital in general in the plurality of capitals (individual/singular) which in itself is already placed insofar as it is a concrete universal. Hence, centralized capital (in competition) is the appropriate medium term for mediation between the laws of motion and dynamics, between singular (individual) and general capital, between concrete and universal.<sup>181</sup> Therefore, **centralized capital consists of a medium term whose logic is that of capital in general and which operates the mediation between it and individual capitals.** Thus, centralized capital, unlike individual capital, does not belong to this or that market structure, this or that product, this or that technology, or even this or

180 I return here to capital in general to reaffirm it as a real social substance (and subject) that opposes abstract labor, and this (as much as abstract capital/in general) “is not even a construction of the spirit, although the spirit reproduces it, nor a physiological generality (muscles, blood, brain activity, sweat): it is the motion of abstraction that operates in the real itself. The production of commodities operates, itself, the abstraction: it and not us, who limit ourselves to reproduce it, operates the reduction [...] of the concrete to the abstract” (Fausto, 1983: 123).

181 The relationship between the universal and the concrete is not one of formal inclusion or exclusion. It is a relationship in which they dialectically refer to each other, through mediation. Between the universal and the concrete, it is impossible to suppress the mediation of the particular, in this case, centralized capital (Lefebvre, 1979: 236).

that national space. Consequently, centralized capital subsumes individual capital and market structures.

### 3. Competition between centralized capitals and the logic of finance capital

The analysis of capital in general, as we have seen, already points to a level of determination of both competition and dynamics. Therefore, the problem is which type of mediation, **for both**, is consistent with the laws of motion of capital and which is the compatible proposed theoretical organization. To do the opposite, starting from the competition, is to invert the determinations and to leave those laws in a “theoretical limbo,” it is to render them useless.

I will demonstrate that this inversion leads to the conclusion that the real capitalist dynamics is constituted solely from competition in market structures and under barriers to entry. This is a proposition exactly contrary to that of Marx, for whom “competition is nothing but the internal nature of capital, its essential character,” being “a simple executor of laws that it does not even originate nor affect, it only brings to the surface and gives its form.” Consider this passage, however, with the awareness that, if competition cannot affect the laws of motion, in the sense of eliminating or modifying them at the level of real abstraction of capital in general, however, **it (competition) determines the complexly determined dynamics, which is not a mere expression, on the surface, of the general laws of motion.** If so, what are the mediations for?

Once again, the investigation of competition cannot do without “capital in general” in the Marxist method. Thus, if the competition dimension complements the laws of motion to forge dynamics, this cannot mean an inversion of determination. However, agreeing with Marx on this point, as I do, does not mean giving up on elaborating, theoretically and analytically, the mediations of competition, nor pretending to think the dynamics via logical-deductive operation, from capital in general.

What is required is an understanding of how competition aggregates content and shapes immanent laws (internal nature of capital and its motion), without eliminating them, but altering their manifestations in actual reality, which makes mediation necessary. For example: it is an immanent law that the capitalist production regime generates crises of over-accumulation of capital and devalorization of productive and financial wealth. However, the forms of competition, at national and international levels, together with other factors, determine different **types of crisis**. The “Great Depression” of 1873-1896 and the “Great Depression” between 1929-1939 are crises of capitalism that express that **crisis law**, but they are not theoretically the “same thing.” It is not

enough to say that both are the result of innovations and fluctuations typical of competition and dynamics, or that both are the depression of a long business cycle. In order to understand them in their differences and specificities, while theoretically maintaining their general determinants,<sup>182</sup> it is necessary to examine the forms of competition – in national and world capitalisms – and other elements, among which the institutional dimension, which is perceptible both by the modality of private capitalist organization (industry, finance, etc.) and in the relationship between the State and the Market.

It is possible to find quotes from Marx stating that he studied competition, as the opposite. But this is of less importance. The key is to know which is the appropriate method of investigating the determinations of competition for the dynamics, following Marx's propositions about competition itself, although admitting that he did not "exhaust the topic," a fact that could not be different, given that the mediations are logical-historical and, as such, find their place only in an "open theory," which admits transitory abstractions.

I maintain that Marx announces in Book III of *Capital* an analysis, a methodological path, and elements of the competition that are much more important than the problem of prices. After clarifying that in Books I and II he dealt with the unity of the production and circulation process, he clearly formulates the following: "Here in Book III, it is not a matter of formulating general reflections on this unity [...] it is to discover and to expose the concrete forms that emerge from **the capital's movement considered as a whole**. In their actual movement, capitals face each other in these concrete forms [...] The manifestations of capital developed in this book are close [...] to the way in which they appear on the very surface of society, through competition, and as reflected in the habitual consciousness of the agents of production themselves" (Marx, 1968: 45, emphasis added).<sup>183</sup>

In this process, surplus value and its rate are converted into profit and profit rate, giving rise to the emergence of profit as a complex totality, indicating that, in the concrete forms of the real movement, the negation of labor value and of surplus value as the sovereign substance of valorization. I point, above all, to what is crucial in terms of concrete forms: a) commercial capital; b) the unfolding of profit into interest, profit of enterprise and ground-rent; c) credit, interest-bearing capital, share capital and fictitious capital; d) the origins of the income, where the considerations about the appearance of the competition stand out.<sup>184</sup>

182 A general crisis theory or a general business cycle theory is not pertinent. There is a need for transient abstractions, which is appropriate to the notion of a theory of dynamics that is complexly determined where the categories and determinations involve the logical-historical perspective.

183 Again, another theoretical point of contact with Keynes.

184 I suggest examining the index of Book III of *Capital* of Marx, which explains the aforementioned theme.

In this perspective, it is a fallacious interpretation, a true misguidance, to claim that in Book III competition was only introduced as a mechanism for leveling prices and rate of profit. What matters is that there we find a proposal for a theoretical and analytical organization of competition and dynamics, based on the concrete forms of the real movement of capital. It is in this way that the so-called logical-historical mediations of competition must be developed to understand the capitalist dynamics. So much so that Marxist works, and even others inspired by political economy, followed this same proposal, at the end of the 19th century and the beginning of the 20th century.

Take Hilferding's *Finance Capital* as an example. In my opinion, this work is a very good illustration of what I just said. In this work we find an investigation of commercial capital, banking capital, industrial capital, its forms of articulation and competition, its investment processes, price formation, mobilization of monetary and financial resources, operationalization of the stock market, the industrial intersectoral dynamics, distribution, and so on. All of this is focused on the angle of logical and historical research, with German capitalism in perspective. It was in this way that Hilferding managed, despite problems here and there, to elaborate a historicized dynamic theory, considering the general laws of motion and competition.<sup>185</sup>

In summary, it should be noted that the interaction between general laws of motion and competition imposes the logic of finance capital on the calculation and motion of centralized capital.

The analysis of competition approached in this way is not a mere external expression of laws of motion, even though it is subordinated to them and fulfills a mediation function. "Deductivism" based on general laws is a procedure that finds its place only in vulgar or naive Marxism, which is invoked only as a rhetorical device for convincing, by Marx's opponents, who carry out a slight criticism.

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185 The modern capitalism of Hobson (1983), without being exactly a Marxist work, engages, as a vision and analysis, in this same theoretical conception of dynamics and competition, when dealing with mechanized industry, the modern corporation, the structure of business and markets, cartels and trusts, the financier, labor and wages, the relationship between industrial development and civilization. In other words, it sought to reveal the extent of the competitive mobility of capital, without being trapped in a narrow conception of the market or firm, which allowed it to see that the triangle of forces of American capitalism was in the informal merger between the railways, the industrial trusts and banking corporations, which exercised general financial control over "business," displaying the form of purely financial power. For him, this was the dynamics of modern capitalism, which implies perceiving differences with the past and, explicitly or implicitly, adopting a historical periodization. It is not by chance that Tavares (Hobson's Presentation, 1983) considers him, given the nature of his method, "an industrial economist, in the modern sense of the word, and a political economist, in the classical sense."

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## CHAPTER 17

# “FINANCIALIZATION” OF WEALTH, ASSET INFLATION, AND SPENDING DECISIONS IN OPEN ECONOMIES

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### **Introduction**

In the 1990s, awareness of the weight and influence of financial assets in modern economies became widespread. This is not surprising. In just over a decade, since the early 1980s, the composition of social wealth has undergone an important change. The share of financial assets in the composition of private wealth has rapidly grown. In developed countries, the middle classes now hold – directly or through investment funds or pension and insurance funds – important portfolios of bonds and/or stocks. Thus, in addition to real estate and durable goods the typical net worth of a middle-income family started including financial assets in an increasing proportion.

Companies in general have also significantly increased the ownership of financial assets and not only as a reserve to make future fixed-capital investments. The “accumulation” of financial assets has, in most cases, gained permanent status in the management of capitalist wealth.

For this reason, interest rates – as a general criterion for estimating the value wealth – insofar as it express expectations of price variations and, therefore, the “liquidity” of the different financial assets, now play a key role in the financial management of corporations and banks, as our colleague José Carlos Braga had first pointed on in his doctoral thesis (1985).

This process was not confined to national borders. Although the largest share of financial assets in each country is owned by its residents, the cross ownership of such assets by foreign investors has considerably grown, *pari passu* with the liberalization of foreign exchange markets and the deregulation of controls over capital flows. According to BIS estimates the value of the amount of tradable financial assets in the capital markets worldwide jumped from about US\$ 5 trillion in the early 1980s to US\$ 35 trillion in 1995.

This impressive increase in the volume of financial wealth (at a pace of at least 15% per year) has far outpaced the growth in production and the accumulation of fixed assets. As financial assets ultimately represent property rights over capital in function or rights over future income generated by it, it must be concluded that there has been a notable inflation of financial assets in recent years. In other words, the prices of these assets have risen well beyond the speed of accumulation of the instrumental capital assets, creating for its holders a perception of accelerated enrichment.

Thus, companies, banks, and also wealthy families – through institutional investors – started subordinating their spending, investment, and savings decisions to expectations regarding the pace of their respective financial “enrichment”. From an individual point of view this “enrichment” does not seem fictitious as the bonds can be perfectly validated by liquid and deep markets. The certainty of “commercialization,” that is, that the securities could always be converted to the monetary and general form of wealth, feeds the appreciation circuit, inducing an increasing share of agents to leverage their financial asset portfolios based on debts incurred with the banking system. The authors<sup>186</sup> already highlighted, in a previous text, the characteristics of the current financial market:

- depth, ensured by recurrent secondary transactions on a large scale and frequency, conferring a high degree of negotiability to the securities;
- liquidity and mobility, allowing investors easy entry and exit between different assets and market segments;
- asset price volatility resulting from the frequent changes in the estimate of agents regarding the evolution of prices of securities (denominated in different currencies, with floating exchange rates).

The rapid development of financial innovations in recent years (hedge techniques through derivatives, leverage techniques, models and mathematical algorithms for “risk management”) associated with the intense computerization of the market has enabled to greatly accelerate the volume of transactions with increasingly short deadlines. These characteristics, combined with bank credit-based leverage, explain the enormous potential for feedback from bullish processes (bubble formation) as well as the risks of collapse in the case of unrestrained bearish movements.

The purpose of this brief essay is to examine changes that the “financialization” process has been imposing on the main macroeconomic relations

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186 See Coutinho & Belluzzo (1996).

(determination of investment and consumption decisions) in open economies, subject to free or managed floating exchange rates, in a world in which financial capital flows (between national markets, currencies and assets of different categories) are intense, fast, and highly sensitive to changing expectations. The intention is to contribute to the formulation of a new open macroeconomics, under the dominance of financial assets.

## **1. Cycles of asset appreciation and spending decisions in an open economy**

The change in the composition of wealth has had two important effects on spending decisions: 1) it expanded the scope of agents who, having an important share of their wealth in financial form, must take into account the variation in asset prices; 2) this expansion of the wealth effect implies the possibility of more violent floats in consumption and investment. Consumption ceases to have the relatively stable behavior predicted by the Keynesian consumption function and starts presenting a typical component of capitalist spending decisions.

This does not only mean that a fraction of consumption is no longer proportional to current income, a phenomenon established since the post war Fordist cycle by the widespread consumer credit. Indeed, it means that asset inflation significantly increases the possibility of additional indebtedness by important groups of consumers. This greater “leverage” of household consumption expenditures is allowed by the perception of consumers (and banks) that their wealth has increased due to the accelerated appreciation of financial assets. It is necessary to explain that this “wealth effect” is not accomplished by selling financial assets to convert the monetary result into consumption, but by an increase in the demand for credit from these “enriched” consumers. Needless to point out that this additional credit demand has been swiftly met by the banks.

Confident in an upward trajectory of appreciation of their share of wealth, consumers tend to increase their propensity to consume on current income and at the same time to bear extraordinary expenses, supported by the increase in indebtedness. The prospect of accelerated enrichment begins to drive consumer spending decisions: the level of indebtedness is no longer calculated on current income, but rather on the expectation of growth in the prices of the assets that compose its portfolio. Thus, it is possible to observe increases in debt service ratios on current income, although the relationship between this service and the value of wealth stock may remain stable or may even decline.

It is the “differential” consumption of high-value goods and services, especially leisure, that benefits from this special form of the wealth effect.

As an expressive segment of the middle classes is captured by this expanded wealth effect, a cycle of asset appreciation has the ability to excite the demand far beyond the normal expectations of entrepreneurs who produce consumer goods. In a world in which economies are increasingly open and subject to increased competition within tradable sectors, this shift in the propensity to consume has an effect on the balance of payments and on investment decisions, with little pressure on consumer goods prices. Price increases caused by the boost in demand are limited to services and other non-tradable goods.

Investment decisions, in turn, is susceptible to a threefold influence from asset inflation: 1) the overheating of consumption raises the marginal efficiency of the capital of the sector producing consumer goods; 2) the increase in the value of stockholders’ equity – via rising market value of companies in the consumption goods sector – and the consequent expansion of these companies’ debt capacity. Thus, although companies involved in investment efforts usually incur debt, the debt/equity ratio may remain stable or even decline if respective share price increases significantly; 3) in this context, the capital costs of the companies best evaluated by rating agencies tend to fall, reducing the risk perception for investors and borrowers.

Under the influence of the aforementioned factors, as the investment rate of the private sector accelerates, some well-known macroeconomic effects manifest: reduction of the public deficit given extra tax revenues, expansion of the external deficit, followed by the growth of employment, current income, and the reduction of idle capacity margins.

There are several mechanisms that encourage investment. The first is the increase in consumers’ confidence, due to the reduction in the unemployment rate and the continued appreciation of assets. The second is the reinforcement of the virtuous circle (Kalecki, 1971), whereby the increase in investments results in an expansion of profits. This increase in profits induces a greater appreciation of the companies’ equity, which is caused by further increases in stock prices. This reinforces the pro-cyclical behavior of the credit system, which, managing to maintain high levels of current liquidity for its assets, tends to reduce its perception of risk, meeting the demand for new loans in an elastic way.

As in the entire expansion cycle, the demand price of real assets and that of financial assets tend to grow together. The specificity of the current cycle, driven by asset inflation, is that there is a tendency for faster growth in the market prices of nonreproducible assets than in the expected returns on

instrumental capital assets. One of the problems with the current capitalization of the U.S. stock exchange is the massive rise in price/profit ratios. Sustaining the price levels already achieved will progressively depend on increasingly optimistic assessments by investors regarding the future flow of profits.

## 2. Causes and ways of reversing the cycle

The classic way of reversing the cyclical peak, in an economy with national credit regulation and dominance of banks in financial intermediation, presupposes a drop in the marginal efficiency of capital, based on an “autonomous” change in the state of expectations on the part of businessmen. The drop in marginal efficiency of capital promotes an immediate reduction in demand prices for capital assets, both financial and instrumental. There follows a decline in stock prices and investment spending, with subsequent contraction in profits and wages. The banking system would inevitably be affected by the crisis and would seek to recover, as quickly as possible, the credit extended to companies, refusing to fully roll over liabilities and its service. If not countered by effective action of the Core Bank to supply the economy (and the banks) with adequate liquidity, the banking system, in its defensive action, will determine a brutal aggravation of the crisis, leading to deflation. In the classic sequence of the Keynesian cycle, a credit crunch tends to be a direct consequence of an autonomous fall in the rate of accumulation of companies.

Even in this economy in which financial intermediation is dominated by bank loan and not by direct finance, the cyclical reversal can also start with a “loss of confidence” by banks regarding the full realization of the value of their loan portfolios. In this case, there would be an increase in interest rates and greater selectivity in the credit supply. This factor would be sufficient to lead to a drop in the marginal efficiency of capital. If the investors’ animal spirits falter in the face of bank action, a recessionary movement will be triggered giving rise to a rapid fall in investment decisions.

In an economy in which banks indirectly participate in the financing of spending through lines of credit designed to support positions in the capital market, Keynes has not ruled out the possibility of a cyclical reversal caused by decreases in asset prices, which are quickly transmitted to the credit system (*Treatise on money*). It was this possibility that led the reformers of the U.S banking system, in 1933, to enact a law (Glass Steagal Act) on the strict segmentation of the financial markets, with an explicit prohibition on the participation, directly or indirectly, of money Core banks in the asset markets. The idea was to avoid the risk of excessive leverage on the part of brokerage

firms and investment banks, causing “inflationary” pressures on the securities, always followed by financial fragility.

The peculiarity of contemporary economies – in which direct and securitized finance is prevalent – seems to be the high sensitivity of spending decisions to fluctuations in asset prices. The transmission mechanisms are fast, varied, and powerful. First, deregulation and liberalization facilitated the involvement of banks in financing capital market positions. This allowed for the current levels of “leverage” of brokerage firms, funds, and investment banks. When these agents are surprised by adverse price movements and the estimated losses force the liquidation of positions to margin coverage, both the market risk and the liquidity risk rapidly become exponential. The very abrupt and substantial fall in prices drives away the eventual buyers of these assets, making their markets unfeasible. In the absence of a timely bailout from the lender of last resort, the spread of panic can lead to a disruption of the payment system and to bank runs.

Even if the lender of last resort refrains crises in the payment chains, their intervention will not be able to reverse the rising cost of capital for companies and countries considered to be at higher risk. Trauma in any of the big markets (e.g. public bonds, stock exchanges, foreign currencies, real estate, derivatives, futures) has enormous potential for contamination, causing, in general, capital flights to strong convertible currencies and liquid public securities deemed to have better reputation and quality. These liquidity crises have a major adverse impact on solvency and on the spending capacity of issuers of higher-risk assets, whether countries, companies, or banks.

The financial agents holding these depreciable assets, in turn, will have to digest the losses and try to restore their own capitalization levels, through the forced sale of high-quality assets and by restricting the supply of credit to other agents, including to those with better reputation. For instance, we could mention the significant increase of 400 to 1,000 base points, in the spreads charged to small and medium-sized U.S enterprises, after the episodes of the Russian currency crisis (1998), the attack on Brazil (1998-1999) and, in the wake of these events, the bankruptcy of the Long-Term Capital Management (LTCM).

Monetary authorities cannot allow the contagion and deflation of assets to prosper and deepen. Core Banks must be willing, in these circumstances, to provide abundant liquidity for markets in crisis, promoting a rapid reduction in interest rates.

In addition to these risks of reversing the financial cycles driven by asset inflation, other factors, typical of an open economy, can be added.



In the advanced stage of any expansionary cycle, inflationary tensions usually arise, resulting from the heating of the demand for labor, the rise in the prices of raw materials, and non-tradable services and inputs. In a financially open economy, however, the increase in the demand price for capital assets and the prospect of significant gains with the appreciation of financial assets tend to intensify inflows of foreign capital. Strong capital inflow determines currency appreciation, thus worsening the trade deficit. The currency appreciation can temporarily contribute to quell the aforementioned inflationary tensions. Nevertheless, as the trade and current account deficits widens, the likelihood of private portfolios, on the margin, start to reject absorbing new assets denominated in the deficit country's currency increases exponentially. Hence, there is a tendency towards a currency depreciation, which involves a double risk: the outbreak of inflationary tensions and the sharp reversal of capital inflows, in view of the possibility of future losses for foreign investors.

At this stage of the cycle, the market is particularly sensitive to the possibility of an increase in interest rates on the part of monetary authorities, fearful of both a future rise in inflation and an abrupt depreciation of the exchange rate. Furthermore, the flow of profits may lose strength not only because of a slowdown in spending on productive accumulation, but also due to the growth of the trade deficit. Both factors accentuate the profit erosion, making the "irrational exuberance" of stock price assessments even more evident given the perspective of rising interest rates.

Monetary authorities, in these circumstances, are faced with a difficult choice. Fear of accelerating inflation and capital outflow would recommend raising short-term interest rates. However, this measure could trigger a dangerous collapse of the bubble formed by the excessive expansion of asset prices.

Therefore, there are great risks in an economy that is reaching the peak of an expansion cycle exacerbated by asset inflation. An abrupt collapse of these prices will inevitably lead the economy to depression, given the inherent cumulative and self-fueled nature of asset deflations. Considering the high prevailing levels of leverage, both families and companies will be faced with unexpected jumps in their debt ratios, both in terms of income and in relation to the value of their respective wealth. In the case of companies, there will be involuntary increases in the debt/equity ratios, worsening rating assessments and making structuring of new loans very unfavorable. This deterioration in the market value of companies and their indebtedness situation will certainly cause spirals of depreciations of their stock.

Consumers, in their turn, feeling "impoverished" by deflation of assets, will seek to recompose the desired wealth/income ratio and to reduce the debt/asset ratio and, to achieve this, they need to increase their current savings

levels. This means that consumer retrenchment is likely to be very pronounced, particularly affecting sectors that fed on asset inflation and credit expansion, like conspicuous consumer goods of high-value and differentiated services. It is exactly these sectors that have experienced the greatest relative growth in the recent expansion.

The spontaneous reaction of the banking system, in the face of the generalized expansion of the debt margins of families and companies and the depreciation of respective collaterals, is to violently contract credit, causing a credit crunch and accelerating the path of economy towards depression.

In these cycles driven by asset inflation, monetary authorities are always faced with the risk of a crash of huge proportions, which forces them to try to smooth out the landing. The first reaction is to lower interest rates and prevent the banking system from triggering the credit crunch. However, in an open economy in which direct finance has become important, lowering interest rate can prove to be relatively ineffective. This is so because the depreciated prices of private assets will not recover immediately as a result of a sharp shift in the liquidity preference curve and the possibility of capital flight that exacerbates the pressure on the currency depreciation.

Under these circumstances, monetary policy may become impotent in the face of credit crunch, if asset deflation and capital flight continue to degrade the value of guarantees offered by the private sector and the banks' own capital base. Incidentally, this is what has been happening with the Japanese economy. The U.S. economy, in turn, seems to be close to the start of an asset price disinflation.

The current situation shows, on the one hand, that the dominance of asset revaluation over spending decisions implies an unpleasant symmetry between expansion and peak phases of the cycles and the subsequent stages of slow-down and crisis. On the other hand, in a context of increasing interpenetration and interdependence of the wealth markets, especially in conjunctions of cyclical divergence between economic blocs and national economies, severe restrictions may affect the freedom to maneuver national economic policies to regulate and stabilize the respective economies.

### **3. Asset price cycle, economic policy dilemmas, and global disagreements**

What was exposed in the previous section describes a cyclical behavior of an economy under the dominance of the capital market that corresponds to an exacerbated form of the Minskyan cycle. Following the Keynesian and Marxist tradition, Minsky (1975) had already underlined the relevance of asset

inflation in the mature stage of the cycle. Working with two price systems, one for instrumental and reproducible assets (supply prices) and one for financial assets, Minsky showed how – as the prosperity cycle progresses – a growing divergence develops between these two set of prices in favor of financial assets. This “informational” peculiarity of the capitalist economy (namely, a tendency to herd behavior) inevitably encourages the entry of debtors and lenders in the region of increasing risks. The first ones are eager to accumulate new assets in the midst of a fast process of revaluation; and the second ones, confident in the profitable realization of their loan portfolios give course to new credits backed by increasing asset valuation. Thus, the self-powered revaluation of assets, by inflating the value of capitalist wealth, causes a generalized reduction in the perception of risks for both lenders and debtors.

We do not intend to invoke any originality for our approach, which was already advanced by Michel Aglietta in his book *Macroéconomie financière* (1995). However, in light of the events taking place in global markets, we would like to stress the following points:

- This cycle presents, as already mentioned in the Introduction section, a dominance of rentier behavior, on the part of families and companies, perhaps unparalleled in other stages of capitalist development.
- The feedback mechanisms between spending decisions and asset inflation appeared earlier in the current cycle and proved to be more “robust” over a long period.
- The willingness of Core Banks to circumvent and circumscribe localized crises in markets or regions has been sanctioning the perception that risks can always be absorbed, without major consequences for wealth holders.
- The increasing volume and speed of capital movements has resulted in a multiplication of episodes of fundamental inconsistencies between asset inflation, currency appreciation and the balance of payments situation.

The first two characteristics of this cycle are strongly correlated, as the generalized possession of wealth in financial form makes the effects of asset appreciation on spending decisions comprehensive. As the market and the credit system sanction the optimistic expectations of wealth holders, the demand for financial assets expands and encourages an increase in more leveraged operations. This, in turn, tends to stimulate higher prices, reflecting on the expansion of credit and on aggregate expenditure, generalizing the feeling that society is richer.

This sentiment is supported by the effective (albeit transitory) liquidity conferred to assets by the depth of the capital market. Thus, the organization of the markets by market makers and the strong presence of institutional investors add other important element of exacerbating the financial cycle. When seeking to beat competitors, to gain the upper hand, pension and mutual fund managers are required to present high-performance financial products to their customers. This induces them to increase the degree of leverage and to seek alternatives in other areas of higher risk and lower degree of information. The attractiveness of these funds depends on achieving “success rates”, that is, additional percentages of return above a certain reference interest rate.

This seems to be the reason for the involvement of large international banks in financing Russia even under conditions of increasing risks.

It is hardly underlined by the conventional analyses the fact that large blocks of financial institutions that dedicated themselves to managing large amounts of wealth have become hostages to the continued rise in asset prices. Excessive leverage makes them extremely vulnerable to abrupt reversals. In this context, financial fragility is progressively worsening, a phenomenon that is masked by the upsurge in accelerated asset appreciation.

The intense involvement of big banks and large internationalized companies in this game of wealth appreciation inhibits the discretionary power of the Core Banks. Monetary authorities have often given signs that they consider the expectations of those agents to be overly optimistic. But, at the same time, they are forced to compromise, in the face of the fear that any restrictive action could lead to bearish inclinations in the markets and consequently to asset deflation. The strong interaction between asset inflation and aggregate expenditure – characteristic of the Japanese economy in the 1980s and the U.S economy, since the early 1990s – illustrates the strength of these feedback mechanisms.

The succession of critical episodes in different markets throughout the 1980s and 1990s was, overall, neutralized with liquidity support interventions aimed at preventing the generalization of the fall in prices for other assets. This attitude on the part of Core Banks has undoubtedly strengthened the belief that markets will always be safe from pronounced and definitive losses. The eventual crises would be momentary, only opportunities in which inviting “points of purchase” would emerge for the beginning of a new season of generalized asset price upward move.

In cyclical peaks, however, some relevant agents become suspicious of the possibility of sustaining the price level reached by the assets. The weakening of trust begins to take place. Henceforth these agents start to form bearish positions, targeting the weakest links of these globalized markets, which are

still predominantly bullish. They bet against currency appreciation, stock exchanges in the periphery deemed as lacking strength for further capitalization and real estate markets that they consider overvalued due to signs of excess supply. Usually, these hedge funds operate short in foreign-exchange future markets, with large positions sold in the currencies that are subject to a speculative attack.

Financial markets have shown an increasing propensity for sudden changes of opinion, polarization of expectations, and self-fulfilling prophecies. In the *Treatise on money*, Keynes stressed the importance of a fairly equitable “division of opinions,” between bearish and bullish agents, for the maintenance of stability in the markets in which capitalist wealth is assessed. Nevertheless, these markets are subject to asymmetry of power and information between “opinion-forming” agents and those who have no alternative but to follow the dominant trend. Thus, the conditions for the eruption of mimetic processes are created, which tilt expectations in a certain direction, giving rise to “speculative bubbles,” invariably followed by price collapses, contagion of other assets and currencies, and intense “risk aversion.”

Both the weight of the positions taken by bullish speculators and the growing presence of bearish agents in emerging markets reinforce the defensive strategies of Core Banks, making their monetary policies prisoners of the need to prevent capital flight and abrupt depreciations.

In peripheral countries, these defensive measures are almost always restricted to raising interest rates in order to defend parities or crawling pegs. This provision is, overall, counterproductive. First, because it depresses the capitalization of bonds and real estate, affects public debt service and also the financial health of mid-sized national banks. Second, and lastly, because the rise in interest rates increases the mistrust in relation to the sustainability of the exchange rate anchor, infusing the fear of wild and uncontrolled depreciations.

These characteristics of the asset cycle accentuate the asymmetric character of adjustments in the balance of payments between countries with strong currencies and those with weak currencies. In the case of the latter, the inadequacy of the adjustment programs adopted to repair the effects of an inevitable collapse of an overvalued currency cannot be more striking. It is worth noting that the recent cycles of “appreciation” of local currencies invariably favored the financing of predatory imports and, consequently, promoted the productive destructuring of manufacturing, mass unemployment and, finally, the accumulation of large external and internal liabilities. It is in this environment that programs require debtor countries to raise interest rates, promote drastic short-term fiscal adjustment, and to impose losses, in real terms, on wages and income.

At the top of the currency hierarchy, the United States of America, due to their ability to attract capital to its markets – a phenomenon that is accentuated in the face of a crisis of confidence in the “emerging” economies –, can afford to maintain moderate interest rates, despite the widening of the of current account balance and the fiscal deficit. Moreover, as aforementioned, in times of crisis in peripheral countries, the demand for higher quality US bonds allows its long-term yields to fall. This means that the current asset cycle, from an international point of view, reinforces the supremacy of the dollar and induces capital accounts to immeasurably expand the U.S. *seigniorage* power. This is one of the reasons why it was possible to prolong the U.S. growth, without the feared inflationary pressures being manifested.

On the other hand, the recovery of the Japanese economy has become more difficult. The lax monetary policy was not able to significantly reinvigorate domestic asset prices, configuring, as Krugman (1998) correctly observed, a scenario of “liquidity trap.” In an economy with “financial openness,” the maintenance of very low domestic interest rates, followed by credit crunch, means that the liquidity available in yen currency is transformed into demand for U.S and European bonds.

The divergence between asset cycles accentuates and exacerbates the divergences between product and income growth. In this sense, exchange rates are determined by the expected appreciation of assets denominated in different currencies. Currencies are appreciated or depreciated according to the upward or downward move of asset prices, in such a way that the current account balance becomes secondary. The dominant-currency country, for example, even with increasing current account deficits at the margin, can benefit from strong currency appreciation if the price of its assets is also rising.

Moreover, in a scenario of floating rates, this adjustment asymmetries implies the possibility of exacerbated fluctuations between the exchange rates of the countries that form the hard core of the world monetary system. These floats tend to cause serious difficulties in adjusting the national-regional balances of payments, as they affect the estimate of asset prices – denominated in different currencies –, imposing the adoption of measures that may not be compatible with the stabilization and growth of the global economy.

It is not safe to imagine that, in the event of a prolonged and profound downward “price correction” on the New York Stock Exchange combined with a strong depreciation of the dollar, would it be possible for the United States to react with a reduction in interest rates to contain the world recession. Undoubtedly, a depreciation of the dollar, in the current market conditions, may lead to a flight of assets denominated in such currency, aggravating the problem that is intended to be solved. This possibility becomes even greater,

considering the prospect of the formation of an alternative monetary standard, with the entry of the European single currency in force in 2000-2001.

As it is known, in a system with floating rates, with wide and rapid capital mobility and provision of liquidity through deep money markets – supported by the action of specialized private agents –, interest and exchange rates become increasingly “endogenous” and dependent on sudden changes in expectations. It is not surprising that in this loosely regulated system liquidity crises become much more frequent, being resolved through violent fluctuations in asset prices accompanied by short cycles of corresponding currency appreciation or depreciation. In this case, interventions are *ex-post* and their inevitable recurrence frequently ends up posing moral hazards.

The “causality” relationships are not the same for the different monetary-financial systems. In a “regulated” international system, with fixed but adjustable exchange rates, limited capital mobility, and predominance of “centralized” provision of liquidity for debtors and borrowers, we could say that, to a large extent, foreign exchange and interests are anchors for the formation of more stable expectations on the part of wealth holders.

In fact, the recent evolution of the financial markets towards broad deregulation of capital flows has exacerbated the predominance of private spending decisions and allocation of capital under the logic of valuation, via capital markets, of the stocks of private wealth (existing and non-reproducible), relegating to the background the decisions related to production and trade flows. This means that unforeseen changes in expectations regarding interest rate differentials, asset prices or exchange rates can become destabilizing and cause major disturbances, forcing the adoption of perverse fiscal and monetary policies which are detrimental for the growth prospects of the economies.

Contrary to what supporters of financial liberalization and deregulation have been advocating – especially the radicals of the Free Banking School –, more than ever, the dimension of money as a desirable asset in itself overrides its other functions. In a world of global finance and with a multi-currency system, in which the Core currency is under suspicion, the preference for liquidity, nowadays carried out through the dollar, can suddenly shift to an alternative currency. This is also why crises are mainly manifested as liquidity crises that private markets are unable to resolve.

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## PART III



# INTRODUCTION

*Luiz Gonzaga de Mello Belluzzo*

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My fellows at the Institute of Economics granted me the honor – I would say the responsibility – of writing the Introduction to the third Part of this book, which presents the contributions of Ana Lúcia Gonçalves da Silva, Frederico Mazzuchelli, Daniela Magalhães Prates, Maryse Farhi and Marcos Antonio Macedo Cintra, and myself.

The Core topic of this Part is money, or as some prefer, world money. The selected works deal with the dissolution of the Gold Exchange Standard in the Great Depression of the 1930s and examine the perverse asymmetries of the Dollar Standard erected in the post-war period. The authors seek, above all, to identify the problems that marked the history of the international monetary system built in the shadow of the revival of U.S. hegemony.

I ask permission to the reader of this Introduction to open my digressions by presenting a short essay recently published in *Carta Capital* magazine (Belluzzo, 2022). In this article, I started with the words of the Secretary of the Treasury of the United States, Janet Yellen, pronounced on April 13, 2022 at an event held by the Atlantic Council:

“We, the sanctioning countries, are saying to Russia that, having flaunted the rules, norms, and values that underpin the international economy, we will no longer extend to you the privilege of trading or investing with us. **By joining together, we demonstrate that these sanctions are not motivated by any one country’s foreign policy objectives.** Rather, we are acting in support of our principles: our opposition to aggression, widespread violence against civilians, and in alignment with our commitment to a rules-based global order that protects peace and prosperity (emphasis added)”.

Then Yellen gets straight to the point:

“We cannot allow countries to use their market position in key raw materials, technologies, or products to have the power to disrupt our economy or exercise unwanted geopolitical leverage”.

Yellen develops a geopolitical parable pregnant with globalist and imperial Americanism, a cognitive system that invariably follows the cosmopolitanism of Uncle Sam’s servants. Janet Yellen is against the market power of

the producers of “raw materials and other important products”, but she has hidden the power of the dollar, the main strength of American power. She also does not mention the “democratic” interventions carried out by Americanism from the Korean War in 1950 to Iraq in 2003. Nor did she remember the military coups in Latin America guided by “moral and democratic” principles.

Yellen’s Americanist parable stimulated my concerns. They stirred to instigate fables about the relationship between the power of the dollar, the dynamics of capital and the instabilities in the so-called emerging economies.

In times of free and light-hearted global finance, the recipe recommended in the laboratories of global wisdom began to include financial openness to everyone. Those who advocated such measure started from a dubious assumption: in the assembly of national currencies, all cats are grey.

The idea does not take into account the “imperfections” that disturb the real world: 1) the global monetary system is constituted by a hierarchy of currencies, some more “liquid” than others; 2) in all known monetary systems, including the Gold Standard, the currency that denominates and settles international contracts and transactions is the currency of the hegemonic country; 3) the Keynesian idea of a truly international currency was defeated at Bretton Woods (1944).

To simulate the relationship between the volatility of non-convertible currencies and capital flows, I imagined a family whose father is an alcoholic and a regular at underground casinos. Every day, the two vices led this citizen to gambling. In the permanent lose-win game, the family’s finances were in shambles. During dinner, the drunk accuses his son of wasting money on buying clothes and books to go to school.

I do not need to explain to the reader that the father plays the role of international, unstable and volatile financial markets and the son plays the role of emerging countries, always accused of fiscally irresponsible management.

In “reputable” and “illiquid” currency economies, financial openness tends to produce boom and bust cycles. Unwanted appreciations of the national currency are followed by abrupt devaluations and crises in domestic financial markets.

In moments of contraction of international liquidity, even if the adoption of a floating exchange rate regime is capable of absorbing, in part, the external shocks, the authorities of the “weak currency” country – with an unpredictable “buying signal” – will be forced to use its international reserves or raise its interest rates to prevent an exchange rate overshoot. If its international reserves are scarce, the price to pay is a recessive adjustment.

Let’s go now to the history and theories that deal with the international monetary system. In the papers prepared for the meetings that preceded the

Bretton Woods reforms in July 1944, John Maynard Keynes formulated the most advanced and internationalist proposal for the management of an international currency. Based on bank currency management rules, the Keynes Plan called for the constitution of a public and supranational organization in charge of managing the international payment system and providing liquidity to deficit countries. It was not just a matter of avoiding the subjection of world money to the economic policies of its issuing country, as we have now observed, but also of preventing the international currency from assuming the role of a dangerous agent of “flight to liquidity”.

Commercial and financial transactions would be denominated in *banco* and settled on the records of the international monetary institution, the Clearing Union. Deficits and surpluses would be recorded in a current account that countries would maintain at the Clearing Union. In the new institutional arrangement, both surplus and deficit countries would be obliged, through conditionalities, to rebalance their positions, which would distribute the burden of adjustment more equitably among the participants in international trade. In Keynes Plan, there would be no room for the free flow of capital in search of arbitrage or speculative gains.

In 1944, in the rooms of the Mount Washington hotel, in the little Bretton Woods, Keynes’ monetary utopia was defeated by the American hegemonic position that imposed the dollar, anchored in gold, as the world money.

These characteristics of the monetary arrangement actually adopted at Bretton Woods survived the gesture of 1971 (the suspension of the dollar’s convertibility into gold) and the subsequent free exchange rate fluctuation in 1973. In the wake of the devaluation of the dollar in the 1970s, the sharp rise in the interest rate in 1979 collapsed Third World debtors, launched Europeans into “competitive disinflation” and culminated in the Japanese crisis of the 1990s. In the following critical episodes, the dollar became stronger, in obedience to the role played by the United States as “demandants and debtors of last resort”.

The crisis in mortgage loans and their derivatives, which still afflicts us today, was born and developed in the financial markets of the United States. Contrary to common sense, global investors have made a desperate flight into US government bonds.

The intended and never implemented reform of the international monetary system, or something similar, will not face the disturbances generated by the decadence of the USA. It will settle accounts with the challenges engendered by the adjustment asymmetries caused by the breakdown of the Sino-American economy, anchored in the strength of the dollar and the power of the US financial markets.

Driven by the “relocation” of large US companies and anchored in the generosity of the country’s private finance, the process of productive and financial integration of the last two decades has left as a legacy the unprecedented indebtedness of American “consumer” households, the migration of the manufacturing industry for “productivist” Asia and the deregulation of private indebtedness in developed countries.

Sino-American interdependence does not exhaust its effects on the trade imbalance between the two countries, but advances its consequences for manufacturing Asia and extends its influence to Africa and Latin America, not only as sources of raw materials, but as a space for expansion of Chinese companies that started a strong capital internationalization. It is clear that the Chinese are cautiously but firmly rehearsing the internationalization of the yuan by expanding its financial convertibility and its currency exchange agreements (swaps) with their most important trading partners.

It will not be easy for Americans to share monetary leadership with China. Many argue that the policy of flooding liquidity aimed at buying, above all, long-term debt securities (quantitative easing) in no way affected its use as the money of account for commercial and financial transactions, despite the advance of the yuan in business between Asian countries and, probably, now in transactions between the BRICS.

In any case, the crisis has shown that the desired correction of the so-called global imbalances will require adjustment rules that are not compatible with the international monetary system in its current form, including the role of the dollar as a reserve currency. This does not mean predicting the replacement of the American currency by another currency, either the euro or the yuan, but realizing that the future promises more instability in trade and financial relations between nations.

In their latest book, *Course à la suprématie monétaire mondiale*, Michel Aglietta, Guo Bai and Camille Macaire address issues regarding American hegemony and the power of the dollar.

Such an international monetary organization [...] is only stable if the hegemony is “benevolent”, that is, if it is recognized by other countries in international trade as offering more advantages through trade and financial integration than disadvantages for subordinate countries.

When this is no longer the case, either because of the unilateral policies of the country that issues the key currency, or because of the assertion of powers that challenge this hegemony, the problem of a renewal of the principles of the international monetary system (IMS) arises. Among the many reasons for the deterioration of dollar hegemony, the assertion of Chinese power is a matter of political and economic rivalries.

Because the rise of China is shaking the global economic and financial order. The second largest economy by GDP size after the United States, it has also become the world's largest international creditor. The rapid expansion of its financial system has led to the emergence of megabanks that occupy the top places in the world in terms of asset size. This meteoric rise raises questions about China's role in the international financial system and the place of its currency (Aglietta, Bai & Macaire, 2022: 19-20).

Recently, out of the arcana of its neoliberal ignorance, the Brazilian Core Bank sent a bill to the National Congress with the objective of simplifying and making foreign exchange markets "competitive". This simplification involves allowing the opening of accounts in foreign currency. Permission will be granted to individuals and companies. The managers of our highest and independent monetary authority understand that a progressive and cautious regulatory change could culminate in the full convertibility of the Brazilian real.

It is important to remember: the dollar is the reserve currency. It denominates more than 70% of commercial and financial transactions in the world. The Brazilian real is a non-convertible currency. The national monetary policy is subordinated to Brazil's position in the hierarchy between nations and their currencies. The media and their vassals, those who produce the news and those who read it, spread a falsified version of the world of international finance: they assert that all cats are grey.

The Argentine tragedy of 2001 still haunts the world of the living (or survivors) with the specter of Doctor Domingo Cavallo's unfortunate "convertibilidad". Distilled in the retorts of the alchemists of international finance, the Cavallo Plan forged a regime of full convertibility with a fixed exchange rate. The peso was as strong as the dollar, proclaimed the then celebrated Argentine Minister of Economy. The strong peso alchemists threw the country into the tragic exchange rate and currency crisis of 2001-2002.

At the end of 2001, affected by the Brazilian devaluation of 1999, the adventure of currency convertibility with a fixed exchange rate – spiced up with the permission of foreign currency deposits – ended in the tragicomedy of the "corralito". The holders of the currency deposits in foreign currency ran to the banks looking for dollars that were recorded in their accounts, but there was little cash in their safes. The Core Bank of Argentina, as is well known, could only issue devalued pesos.

The Argentinians still pay the price for the convertibility regime that, among other things, spurred a devastating process of currency substitution: the peso is just the shadow of the dollar.

China, on the other hand, seems to be rehearsing the internationalization of the Renminbi. First, it took care to defend its currency from the instabilities promoted by speculative capitals. With capital controls and a devalued currency, it triggered a formidable expansion of its trade relations. Today, built on large international reserves, the Middle Kingdom expands its companies' investments abroad. To this end, it supports its pretensions in the formidable expansion of its trade relations and in the investment rally of its companies abroad.

This process began with the articulation of the Eurasian bloc, including Russia and India, and extended its influence to Africa and Latin America, not only as sources of raw materials, but as a space for expanding investment by Chinese companies. It is clear that the Chinese are cautiously and firmly rehearsing the internationalization of their national currency, supported by a web of trade and financial relations increasingly denominated in Renminbi.



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# CHAPTER 18

## NOTES FOR THE STUDY OF ANALYSES FOCUSED ON THE DYNAMICS OF COMPETITION IN OLIGOPOLISTIC MARKETS

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### **1. Preliminary considerations**

This chapter tries to present, although in a very succinct way, the analyses centered on the dynamics of competition in oligopolistic markets, gathering contributions of the neo-Schumpeterian approach to competition based on the dynamic effects of the (incessant) search for competitive advantages. First, however, we seek to present a brief assessment of the point we have reached throughout my Doctoral Thesis (Silva, 2010).

According to several authors, in addition to the possible privileged access to inputs, raw materials or even information, the sources of competitive advantages are mainly associated with:

- product differentiation (accessible even to small businesses), as discussed in (Silva, 2010, Ch. 1) (in particular from Kaldor's contributions);
- economies of scale, according to (Silva, 2010, Ch. 2) (main focus of the contributions of Bain and Sylos-Labini).

Although important, these contributions fall short of the static approach. It is true that the structure has a strong component of the past, in this given sense. The relevance of this aspect gives the contributions of Bain and Sylos-Labini the deserved importance and is captured in the concept of barriers to entry, Core to industrial economy studies. But better observed (in historical perspective), it is seen that the industrial structure also presents mutations, in an endogenous transformation process. In this sense, Steindl (Silva, 2010, Ch. 3) allowed us to go further by analyzing the dynamic effects of cost differentials and profit margins on industrial structures, contributing

to the understanding of the mechanism that engenders the tendency to concentrate markets.

The typology of competition patterns proposed by Possas (1985, Ch. 4) allows to gather all these contributions, articulating market structure versus competitive strategy (forms of competition). Possas has advanced in formulating a typology of market structures based on the study of prevailing competition patterns, which seeks to capture the relationship between the type of barrier to entry and the type of competition strategy most suitable in each case. Without failing to recognize the valuable contributions of authors who privilege the firm as part of the analysis, he is aligned with the focus of market structures, emphasizing the structural constraints of competition, which puts the company under the situation of having to adopt strategies consistent with structural conditions.

After reconstructing the concepts of oligopoly<sup>187</sup> and barriers to entry,<sup>188</sup> Possas (1985: 183-194) proposed a typology that encompasses the following market structures: concentrated oligopoly, differentiated oligopoly, differentiated-concentrated or mixed oligopoly, competitive oligopoly and properly competitive markets (in the non-oligopolistic sense), describing the competition pattern<sup>189</sup> characteristic of each case.

So far, therefore, a good idea has been reached about the structural determinants of competitive patterns that characterize the behavior of companies in the face of strategic decisions in oligopolistic markets, with emphasis on

187 **Oligopoly** is no longer necessarily characterized by the small number of competitors, but by the presence of barriers to entry, if not for all company sizes, at least for the largest or best located ones. (Possas, 1985: 172). Strictly speaking, remembering the situation described by Kaldor of an atomized market with the existence of closer rivals, in which the barrier to entry is installed by the simple fact that, in the situation described, the **presence of interdependence of shares** can be detected there, where we locate the first defining element of oligopoly.

188 **Barriers to entry** are no longer just one of the components of the market structure, among others, and come to be seen as the synthesis of the nature and determinants of competition in a given oligopolistic market, encompassing both potential and internal competition. As the magnitude of barriers to entry is primarily responsible for determining profit margins (long-term), the Core object of the theory turns to **profit margins** as a more general variable, as a synthetic expression of the conditions of competition and their potential for transforming the market structure (Possas, 1985: 172).

189 **Competition pattern** defined based on the following elements (Possas, 1985: 175-177): (1) the **insertion** of companies or their production units in the **productive structure** or elements of the technical-productive structure, covering from the technological requirements of production (type of inputs and capital goods required, with emphasis on the importance of economies of scale and the structure of production costs) to the use of products (type of product, characteristics of demand - with emphasis on the possibility of product differentiation); (2) **competition strategies**, encompassing the expansion policies of leading companies, at all levels – technological, financial and policies for adapting to and recreating markets. Given the restrictions imposed by structural constraints, the competitive strategy is undoubtedly the place where the company's decision-making autonomy is most present. Finally, Possas highlighted the dual condition of technology. In fact, the technological standard, in addition to being a structural requirement, also forms part – as a technical progress -- in terms of business strategies.

the role of cumulativeness resulting from the advantages associated with economies of scale and differentiation economies.<sup>190</sup>

But the advantages are not perennial. Even companies supported by solid cumulative advantages resulting from economies of scale cannot rest on their laurels, which raises the need for the permanent search undertaken by companies to maintain and, if possible, expand their competitive advantages, or in other words, the incessant search new asymmetries in their favor, which refers to the absolutely Core role of innovation, the object of this chapter.

It is now a more dynamic approach, centered on the contributions of Schumpeter and his followers.<sup>191</sup> A more complete and complex theoretical framework in which the company plays an active role and in which structure and strategies are endogenous, simultaneously determined.

The purpose of this chapter is to introduce the Core elements for a better understanding of the role of asymmetries (in general – not just of costs and margins) and, mainly, how they form and change (with effects, simultaneously, on companies and markets).

It is a succinct presentation aimed basically at providing the reader with a guide for further studies of the neo-Schumpeterian approach, which is absolutely Core in the construction of an alternative paradigm to the neo-classical one.

## **2. Schumpeter's lessons: the search for innovations and their dynamic effects**

Schumpeter is recognized as a Core author in the study of competition under oligopolistic conditions.<sup>192</sup>

Starting from the Marxist view of capitalism fundamentally as a system in motion (expressed in the continuous development of the productive forces) and which has the competition process as the engine, Schumpeter advanced in the understanding of the functioning of competition and its dynamic implications.

In Marx, competition is at the basis of the process of accumulation and, more specifically, of concentration and centralization of capital. Thus, the tendency towards concentration/centralization stems from the internal logic

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190 It is worth remembering Sylos-Labini's argument about product differentiation as a source of a mechanism capable of also originating economies of scale, contributing powerfully to the process of concentration of capitalist economies.

191 With emphasis on the contributions of Nelson & Winter (1977, 1982) and Dosi (1984, 1988), authors whose Core focus and concepts, supported by Schumpeter, inaugurated what is today a vast research program around the microeconomic foundations of the Schumpeterian economic evolution.

192 In Schumpeter, one finds "the best and richest economic theory of competition, although incomplete" (Possas *et al.*, 1995: 277).

of competition between capitals as a process of formation and dissolution/consolidation of comparative advantages and monopolistic positions.

In general, Schumpeter (1942) sought to highlight the progressive (non-stationary) character of the capitalist system. Thus, regardless of exogenous factors, capitalism is described as an evolutionary system in permanent transformation, where productivity is increasing. A system that, by its very nature, can never be stationary.

Based on this observation, Schumpeter argued that the Core issue of economic theory should focus on understanding the forces that make it move (and not identifying equilibrium situations).

The basis of this transformative dynamic is in competition between companies as a driving force and, in particular, in the form of competition that is imposed in the struggle for survival in a hostile and changing environment, that is, one based on innovations (of any kind, as the author highlights).

Schumpeter saw competition as a process of rupture and transformation at the heart of capitalist dynamism. He had as clear the Core role that the pursuit of extraordinary profit or (temporary) monopoly plays in the introduction of innovations, as well as the relevance of the implications of the innovation process for the analysis of capitalism dynamics.

This theoretical stance allowed him to rethink the traditional opposition between “competition” and “monopoly,” with the latter being seen not as the “opposite,” but as the very **fundamental reason** for competition.

Competition, raised to the Core of the analysis, reveals itself as the engine of the incessant and endogenous process of mutation, which Schumpeter called **creative destruction**.

The purpose of this item is to present Schumpeter’s main conceptions about the functioning of capitalist competition.

## **2.1. Dynamic effects of competition: permanent change in industrial structures and the way companies are organized**

In his analysis of the dynamic effects of cost differentials and profit margins, one of Steindl’s (1952) main contributions was, as we have seen, to have revealed the importance of innovation in the sense of “destabilizing” existing market structures. In this analysis, Steindl had specifically taken into account innovations in the production process that reduced costs and, therefore, amplified the differentials in costs and margins. In Schumpeter (1942), it became clear that this destabilizing role can be extended to other forms of innovation (which also affect profit differentials).

This perception allowed Schumpeter to advance in the understanding of capitalism as a system that changes independently of exogenous factors, as a result of the innovation process engendered endogenously by the forces of competition, since it appears (as already suggested by Steindl) as a search for deepening asymmetries and innovation is a powerful source for generating asymmetries.

The image that best portrays these ideas is Schumpeter's famous definition of the "**creative destruction**" process:

Capitalism [...] is, by its very nature, a form or method of economic change, and not only is it never, but can never be, stationary. [...] The fundamental impulse that initiates and maintains the movement of the capitalist machine stems from the new consumer goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that the capitalist company creates (p. 112).

These innovations represent a "process of industrial change – if I may use the biological term – that incessantly revolutionizes the economic structure **from within**, incessantly destroying the old, incessantly creating a new one" (p. 113, emphasis added). "Usually, one sees the problem of how capitalism manages existing structures, while the relevant thing is to know how it creates and destroys them" (p. 114).

This author was interested in emphasizing that the introduction of "new modes" (in general) more efficient than the old ones (making these obsolete) leads to important implications. He proposed to concentrate efforts, then, on the study of the dynamic effects of competition, in particular on industrial structures (the market) and on the organization of companies.

The **permanent mutation of industrial structures** results in "the internal process of internal transformation of the system," which is incessantly processed (although in outbreaks) and endogenous. As the main weapon of competition, innovations (of any nature) lead to a permanent tendency to modify the production base, products and the market structure itself. In parallel, there is a **permanent change in organizations/institutions (companies)**.<sup>193</sup>

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193 Schumpeter (1942: 112): "organizational development, from the artisanal workshop to the conglomerates."

## **2.2. The general logic of the intercapitalist competition process: the pursuit of capital appreciation<sup>194</sup>**

An inseparable part of the general movement of capital accumulation, capitalist competition is above all a permanent dispute between companies for survival in the market (more than for the highest possible profit!), constituting the main engine of capitalist dynamics.

In fact, competition between capitals, as opposed to leveling and homogenizing capitals (as idealized in the perfect competition model), promotes the continuous differentiation of producers, in a recurring process of formation and dissolution/consolidation of comparative advantages and monopolistic positions. Pushed by the logic of capital accumulation and reproduction, the search for extraordinary profit is permanent.

It is, therefore, a process of “confronting” the various capitals in the search for accumulation (according to Possas, 1985: 174). Companies move in this environment guided by the logic of seeking extraordinary profit or (temporary) monopoly. In this sense, the monopoly is revealed not as the “opposite,” but as the objective of competition. It is not surprising, therefore, that competition is at the basis of the very tendency towards concentration/centralization of capital.

## **2.3. The process of relentless pursuit of competitive advantages and the Core role of innovations**

In the pursuit of capital appreciation, companies seek to enjoy competitive advantages over competitors. In this coping process, they try to maintain (or expand) their market spaces, using all possible weapons.

The advantages supported by economies of scale and the advantages of differentiation are important, as highlighted by Bain (1956), but the most forceful form of competition is, as Schumpeter (1942) emphasized, innovation.

In fact, in the capitalist reality, whose striking feature is the permanent mutation, the type of competition that counts is the active and offensive competition that, as Schumpeter warned, occurs through new goods, new production techniques, new sources of supply, new means of transport, new sources of energy, new markets, new forms of organization, etc. In other words, new modes are more efficient than the old ones (which, in turn, become obsolete).

Schumpeter (1942: 114) highlighted that the traditional form of competition supported by prices and even competition in quality and sales effort, but

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194 For a more detailed discussion of the general characteristics of the capitalist competitive process, see M. Silvia Possas (1999).



still “within a rigid pattern of invariant conditions, in particular, production methods and forms of industrial organization,” only punctually affect the profits and production of companies, while competition by innovations (a powerful lever that in the long run gives rise to a decisive advantage in cost or quality, increases production and productivity and reduces prices, destabilizing the structures of existing markets) interferes with the foundations and the very existence of companies.<sup>195</sup>

It is important to highlight that this type of competition “acts not only when it actually exists, but also when it is merely an omnipresent threat” (Schumpeter, 1942: 115) on the competitors that threaten, whether effective or potential, exercising strong dissuasive power.

In summary, in the fight without relent against competitors, the most important form of competition is innovation in general, of any nature, as it allows the creation of new spaces for capital appreciation.

In this sense, innovation is an economic phenomenon, which is at the base of the search for extraordinary profits. It is, therefore, an endogenous process, inherent to the capitalist system.

It is true that companies do not engage in this type of more aggressive competition all the time. In fact, the competition can have different intensities, different moments (active/offensive x passive/defensive), but it must be clear that innovation (of any nature) is the main and most powerful weapon that a company can use against its rivals.

#### **2.4. The role of restrictive practices in the competition process<sup>196</sup>**

The impact of “new things” on the existing structure of an industry, in addition to reducing the scope and importance of competition in prices and quality/sales effort, considerably reduces the long-term relevance of monopolistic defensive maneuvers aimed at conserving positions already gained and increasing the profits from these positions at the expense of buyers.

Adopting a long-term perspective, Schumpeter (1942) showed that so-called “monopolistic practices” or restrictive practices are necessary (and not inefficient), in the context of broader competitive strategies with objectives and horizons. They must be seen as part of more aggressive competition

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195 “The efficiency of this type of competition, close to each other, is like a bombardment compared to forcing a door” (Schumpeter, 1942: 114).

196 In addressing this issue, Schumpeter (1942, Ch. VIII) established a critical “dialogue” with the conventional view of monopolistic practices, characterized by a static approach that takes the highest concentration of the market as a synonym for less intense competition and a supposed tendency to reduce the pace of expansion and even innovations of contemporary capitalist economies (*vis-à-vis* the competitive paradise lost).

strategies supported by innovations, and not simply as restrictive and predatory measures that exhaust their purpose in themselves.

Schumpeter's Core argument is that, under conditions of capitalist economic uncertainty, restrictive practices take on new meaning.<sup>197</sup> They can do much in the sense of:

- “stabilizing the ship and alleviating temporary difficulties” (p. 118) (for example, by defending the profit margin and administered prices in recessive periods); in this way, these measures can provide profits capable of more than compensating for unfavorable situations;
- counteracting the risks and uncertainties of capitalist decisions (for example: patents and temporary process secrets, long-term advance contracts, massive sales campaign, planned overcapacity, restrictive laws on access to innovations, etc.); in this way, the aim is to discourage competitors (at least, to save time).

Uncertainty is inherent in the capitalist decision-making process. Thus, any investment requires certain safeguard actions (such as insurance), in particular “long-term investment in conditions of rapid change, especially under conditions that change or may change at any time” (p. 118), especially under the impact of innovations.<sup>198</sup>

Thus, this type of investment requires “protective devices” (such as patents and temporary process secrets, long-term advance contracts, etc.). Such preventive actions may prove to be *a posteriori* unnecessary and result in excess profits, but *a priori* are indispensable.

Thus, in the relentless pursuit of maintaining and expanding their market spaces, companies, in particular leading companies, adopt **active/offensive** competition strategies (supported by innovations in general) whose results are visible in the long term (price reduction and vigorous increase in production, quality and productivity). These strategies, however, present high risks and uncertainties, which implies the need to adopt, in parallel, **passive/defensive** competition strategies aiming at more immediate results, in other words, the adoption of restrictive practices in the short term (price rigidity, restriction to production, cartel-type trade restrictions, tacit price agreements).

In fact, “under the perennial wind of creative destruction” (p. 117), restrictive policies are “incidents, often unavoidable, of a long-term expansion

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197 In the interpretation of the reasons that lead to the adoption of restrictive practices and their positive role, Schumpeter (1942: 114) recalled that the objective of companies is, in the last instance, “to remain standing in a terrain that moves underneath them.”

198 Using an image evoked by Schumpeter (1942: 118), “it is like shooting at a target that is not only indistinct [barely visible], but that moves – and jolts.”

process that they protect, rather than prevent” (p. 119). In the end, they can produce a more stable and greater expansion of total production.<sup>199</sup>

~ The functionality of monopolistic practices is well exemplified by Schumpeter when discussing the devastating and instability-generating effect of price flexibility vis-à-vis the stability provided by price rigidity: “A perfect and universal price flexibility can, in depression, further making the system instable, instead of stabilizing it” (Schumpeter, 1942: 127). Viewed, in a short-term perspective, as a harmful practice, price rigidity acquires a new interpretation within the context of changes in the capitalist system. Its functionality for long-term development stems from its dual role: sustainability of profits (and, by extension, investments) and stability (by providing greater security in making investment decisions).

In short, what are called monopolistic practices are, in fact, restrictive short-term strategies aimed at sustaining competitive advantages created by the innovation process. Restrictive practices, in turn, suppose the existence of barriers to entry that are created during the process of creative destruction.

The oligopoly with its restrictive conditions is a precondition for long-term development. Regardless of whether the basic engine of innovation is profit, the result is the expansion of markets and the improvement of productivity conditions. Long-term development in capitalism depends on restrictive practices in the short term.<sup>200</sup>

Thus, the oligopolistic company is the main agent of the creative destruction process, as it is the only one capable of applying restrictive policies and defending itself against instabilities in the system. As a result, in the oligopoly, the search for innovation is conscious and systematic, being part of the company’s routine activities.

Obviously, it may happen that, in certain cases, regulatory or restrictive strategies have harmful effects on the long-term development of production, but for Schumpeter these are exceptions. “Our argument is not a proposition against state regulation. It shows that there is no general reason for a ‘trust hunt’” (p. 122).

The above analysis allowed Schumpeter to counter the traditional view of the competitive strategies of capitalist companies, whose biggest problem is the poverty of their conception of competition.

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199 “It is no more paradoxical to say that than to say that automobiles move faster **because** they have brakes” (Schumpeter, 1942: p. 119).

200 It is not possible to think that the succession of optimization in the short term leads to optimization in the long term. “A system – any system, economical or not – that at *all* points in time makes full use of its possibilities in the best possible way, can, even so, in the long run, be inferior to a system that does not do it at **any** point in time, because this can be a condition for the level or speed of long-term performance” (Schumpeter, 1942: 113).

It can be said that one of Schumpeter's great theoretical contributions is to show that there is a false opposition between monopoly and competition, because in fact the competitive process in which the large company is inserted has two necessary and inseparable faces. Competition is endowed with two complementary and inseparable movements<sup>201</sup>:

- **defensive/passive:** defensive maneuvers of the big monopoly company through the adoption of “restrictive practices” basically aiming at the preservation/support of established positions (short-term strategies);
- **offensive/active:** long-term strategies and high offensive power supported by innovations aimed at building competitive advantages (in concrete terms, this power is often exercised through productive diversification).

In this way, and as always subordinated to the general logic of valuing its capital, the capitalist company seeks, in addition to obtaining extraordinary profits, to sustain the acquired advantages (combining short- and long-term practices). And, precisely because it does so, it is constituted, especially as it grows in its dimensions, as the most powerful machine of economic progress and, in particular, of the long-term expansion of total production (Schumpeter, 1942: 141). This is not in spite of, but in large part due precisely to the adoption of monopoly defensive maneuvers, in perfect agreement with innovative offensive strategies. For Schumpeter, it is necessary to recognize that the growing concentration does not inexorably lead to the “accommodation” of the market and companies.

Schumpeter thus intended to highlight that:

- his concept of competition is inseparable from the innovation process, which seeks to search for new market spaces through the creation of differential advantages between companies; in other words, the exploration and expansion of asymmetries between companies;
- the progressive aspect of capitalism (expressed in the continuous growth of productivity) is fundamentally linked to innovation, which is repeatedly introduced due to inter-capitalist competition;
- in this context, the capitalist company behaves like a “growth machine.”

201 For a more detailed discussion of the active and passive dimensions of competition, see Possas (1989a).

### 3. Competition as a process of searching for and selecting innovations from an evolutionary perspective

Under Schumpeter's inspiration – in particular the Schumpeterian notion of competition and the Core role attributed to innovation, as the main driver of capitalist economic activity – Nelson & Winter (1977) propose an evolutionary approach to competitive dynamics, supported by explicit biological analogy, but within a dynamic framework: evolution of species process (Darwinian theory).

#### 3.1. Biological analogy with the evolution of species process

The Core idea is that the economic and institutional transformation process that keeps the capitalist economy in constant motion, under the main impact of innovations (of any nature, but especially technological ones<sup>202</sup>), can be compared, in a first approximation, to the process of genetic mutations of the species, inexorably subjected to the selection of the environment.

In other words, the authors argue that economic and institutional changes result from interaction:

- of the process of incessant **search** for innovations (corresponding to the genetic mutation process), undertaken by companies in their desire to maintain/expand their market spaces; and
- of the **selection** process (corresponding to the selection of species process) to which these innovations are submitted by the competitive and market environment.

As Possas (1989b: 161) points out, the biological analogy is striking in the second case, but it is no less explicit in the first case: Nelson & Winter (1982) relate the search for innovations with genetic mutations, also noting the possibility of success or not in the attempt to innovate. They still observe that not only can the acquired characters be “inherited,” by learning or imitation, but also adverse situations can sporadically cause variation and mutation.

As, in fact, nothing ensures that the result of the **search** and decision process of the company will be sanctioned by the **selection** mechanisms inherent to the competition and the market, there is room for movements or trajectories

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202 This type of innovation is particularly important because they are more difficult to imitate. In fact, as Schumpeter (1942: 129) points out: “The first thing that a modern company does, as soon as it feels able to support it, is to establish a research department.”

that are far from being determined *a priori*. And they certainly cannot be reduced to the fiction of an adjustment process to some equilibrium position.

The dynamic interaction between the **search** (supported by business strategies) and **selection** processes (carried out by the market – validating an innovation or not – but also by the companies themselves, for their decisions) “sanctions, redirects or rejects certain strategies, as well as the **trajectories**” (Possas, 1989b: 161) that companies and the industry as a whole will follow.

Thus, according to the evolutionary approach, it is a dynamic process by which the company’s behavior patterns and market results are determined jointly over time (Nelson & Winter, 1982).

The endogenous interaction between **strategy** (of the firm) and **structure** (of the market) over time is proposed as the alternative theoretical framework for addressing the processes of generation and diffusion of innovations, seen respectively, in an evolutionary perspective, through the search processes and selection of innovations (Possas, 1989b: 162).

In other words, the resulting trajectory emerges from an interactive process over time, which articulates strategy/structure, search/selection and generation/diffusion.

Therefore, it is an “important contribution to the construction of an alternative microeconomic theory, no longer centered either on the firm in isolation or on markets classified and analyzed by static morphological criteria, but on the dynamics of transformation of the market structures themselves from of their productive base. Thus, intending to dynamically overcome the firm *versus* market position, the strategy-structure interaction is focused, without privileging any of the poles as an exclusive determining element, when trying to capture the movement resulting from this interaction over time. [...] trajectories not of balance, but of change and structural transformation” (Possas, 1989b: 158).

One of the great merits of this approach is to show the close interaction between strategy and structure, exemplified by Dosi (1988: 107) when observing that “the success of some companies in the introduction or imitation of new products and production processes alters their costs of production, their market competitiveness and, finally, it is part of the evolution of the industries affected by the innovations.”

### **3.2. General characterization of the innovation search process under uncertainty: the role of routines**

Constantly subjected to competitive pressure and compelled to constant struggle to maintain and, if possible, expand their competitive advantages,

companies face the great challenge of making decisions related to a necessarily uncertain future, in the sense that it is impossible to apply probabilistic calculations to it.

Decision making, which is necessarily complicated due to the uncertain environment, is based on expectations regarding technological development,<sup>203</sup> action and reaction of competitors and the reaction of consumers, in addition to the assessment of the macroeconomic context.

The presence of uncertainty is a constant in the capitalist decision-making process and ranges from the decision on production and price (even when it comes to atomized markets, according to Silva, 2010, Ch. 1) to those related to new investments, particularly when they involve innovations of product and/or process, since technological innovations are particularly uncertain, with greatly limited predictability: a) to begin with, there is no direct correlation between the processes of generation and diffusion of innovations; b) there tends to be mismatch and divergence in assessments by individual agents.<sup>204</sup>

Expectations regarding the preservation/expansion of competitive advantages are linked, in many cases, to expectations regarding the evolution of a technology. In this context of technological progress, the uncertainty regarding the future is particularly clear, since the introduction of a new production method or a new product requires the agent to consider a greater number of unknown elements.

In the presence of **uncertainty** in the horizon of capitalist calculation, the economic rationality of individual agents is far from being based on orthodox maximization criteria. In this context, there is no way to adopt rationality based on maximization criteria (neither profit, nor any more complex objective function), as it is not realistic to assume the optimization of a well-defined objective under given conditions.

The agents, in spite of their efforts, do not have sufficient cognitive capacity to assess the conditions of the present (in view of the complexity of

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203 For a discussion of the role of technological expectations in business decisions and in defining the future trajectory of technological innovation, see Rosenberg (1982, Ch. 5). In the decision to adopt innovations, the entrepreneur takes into account (inevitably differentiated) expectations regarding: improvements in technology X, introduction/improvements in a new technology Y (substitute for X), improvements in technologies complementary to X and improvements in "old" technology. For this, the entrepreneur considers the expectations regarding the rate of obsolescence *versus* the improvement of technologies, which, in turn, are confronted with the costs of disruption. Furthermore, the different levels of risk aversion have an influence. All of this contributes to the establishment of differentiated business behaviors.

204 The two points were mentioned by Rosenberg (1982, Ch. 5). See also Nelson and Winter (1977, 1982) and Dosi (1984).

the results of the interaction between agents) and neither have conditions to predict future events.<sup>205</sup>

Under the influence of the context of technological innovation, when the capitalist company is faced with the need to decide without any certainty as to the results, how then do companies behave? In this context, given the recognition of the existence of uncertainty in the capitalist calculation, companies resort to the adoption of a cautious and defensive behavior, of trying to follow the average opinion, best expressed in the use of conventional procedures. Thus, the agents' adherence to the **routine** in decision-making and in the innovative effort prevails.

In fact, routine decision rules are adopted (supported by some kind of usual or conventional norm) that, based on the agents' history, conform to defined behavioral patterns. According to Nelson & Winter (1977), simple practical rules turn out to be less risky lines and the set of practical rules of conduct will configure what the authors call a **strategy**.

They apply both to decisions related to operational activities with a short-term horizon (production, prices, etc.) and to activities with a long-term horizon (investment in general and investment in research and development) and translate concretely into the definition of objectives (goals) and sets of procedures and routines.

In the particular case of technical progress, these rules are expressed in certain routines of search for innovations, involving, for example, the expenditure of a certain fraction of the revenue in R&D, ordering of potentially profitable projects (according to criteria that consider the potential of technical feasibility and potential demand for the product<sup>206</sup>), technological prospecting strategies, ways of importing and updating technologies and reverse engineering activities.<sup>207</sup> These are routines often applied by companies in the process of choosing what to do (how to invest, in which direction to innovate, etc.).

The rationale for adopting this type of procedure rests essentially on the fact that "the results from decisions under uncertainty are neither predictable nor guaranteed, on the one hand, nor correctable, but with high costs, on the

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205 "The search for profit maximization can be attempted, but there is a lack of cognitive elements that allow an *ex-ante* evaluation of the maximizing strategy" (Gadelha, 1998: 16).

206 "Decision-making as to the direction and magnitude of investments in R&D can thus be defined as a 'search strategy,' non-deterministic, heuristic, conditioned at the same time by economic factors – the expected return on innovations – and technical – the opportunities offered by a given line of technological development, alongside training and specific areas of competence of the company" (Possas, 1989b: 163). Regarding the technical potential, Nelson and Winter highlight the role of the direction (or directions) most likely for technological advancement and potentially more promising, which they call **natural trajectory**, capturing the cumulative character of the technical dimension. This point will be presented below (item 4.4).

207 The emphasis on realism in the decision-making process had Simon, Cyert and March as predecessors, grouped under the name of firm's behavioral theories.



other hand, since the decisions to invest, particularly in innovations (new products and processes), are basically irrevocable” (Possas, 1989b: 160).

In short, the evolutionary approach highlights two fundamental characteristics of the **innovation search process**: its **irreversibility** and the **uncertainty** that surrounds it.

However, if the decision-making process is characterized by the adoption of routine and convention, the same does not apply to the results. Routine procedures do not necessarily produce equally routine results. In other words, a good result cannot be guaranteed even if heuristic and routine procedures have been identified in the behavior of companies in the decision-making process.

Finally, it should be noted that, although routine, the procedures adopted by companies in decision-making are also subject to change. In fact, as Possas (1989b: 160-161) points out, “the specifically innovative effort to change existing routines based on them, characterizes what the authors [Nelson & Winter] call the search process, by companies, of new opportunities focused on the spectrum of innovations that the present technological context, or future already manifest, offers.”

### 3.3. General characterization of the innovation selection process: *ex ante* (company decisions) and *ex post* (market)

In the evolutionary approach, the innovation selection process corresponds to the selection of species process, but the biological analogy (natural, in the sense of non-deliberate or **blind**) is partial. The selection process has its Core mechanism in the market, but it is not exclusive. This is because selection is *ex post*, through diffusion through the market and/or between competing companies, but it is also *ex ante*, via **deliberate** adoption of strategies by companies.<sup>208</sup>

The process of sanctioning/redirecting/rejecting certain business strategies (decision-making process) and trajectories (companies and market structure) highlights the simultaneity in determining the conditions of the company and the market.

But *ex ante* or *ex post*, the selection process (as well as the search process) interferes with factors related to market demand and factors related to the internal logic of technological progress – respectively, in specialized jargon, **demand pull** and **technology push**.

According to the evolutionary approach, the processes of generation and diffusion of innovations are “influenced both by demand and by the internal

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208 One should also consider the influence of other institutional selection environments, such as public agencies and regulatory mechanisms.

logic of technology's 'natural trajectory,' [...]. Thus, the influence of demand occurs, in a more evident way, in the selection of the technological trajectory by the market, but not less important through the expectations of companies in their R&D strategies and in the launching/absorption of new technologies and/or products, regarding the future behavior of sales and profitability in order to be able to finance the necessary investments. On the other hand, the internal logic of technology manifests itself in the search for new opportunities within the referential framework offered by the current 'natural trajectory,' as well as in the progressive fixation of the latter through the selection process carried out *ex post*, in which the technical characteristics can play a decisive economic role" (Possas, 1989b: 162).

The close relationship between the search and selection of innovation processes is evident, both encompassing behavioral, institutional and structural factors, albeit in a non-deterministic way. Although analytically distinguishable, search and selection are, therefore, simultaneous and interactive in the evolutionary process, theoretically inseparable.

The search and selection of innovation processes (which are, as we have seen, inherent in the competition process itself) generate a movement of transformations (companies; markets) and this movement is not random; it presents regularities (theorizable, therefore).

In order to address these regularities, the next item focuses on the effects of the search and selection of innovation processes in the specific case of technological innovations (of product and of process), seeking to present:

1. the characterization of innovative processes, in general; and
2. the factors that explain the differences observed in the ways of searching for innovation and in the rates of innovation between different sectors and over time.

It should be noted that, in addition to the differences above, they also differ in their propensity to innovate companies within the same sector, which refers to the study of inter-company differences in the processes of generation and diffusion of technological innovations, that is, for the specificities of each company, outside the scope of this thesis.

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# CHAPTER 19

## THE ASYMMETRIES OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

*Daniela Magalhães Prates*

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### Introduction

The incidence of financial crises<sup>209</sup> increased significantly in the 1980s and 1990s compared to previous decades, in both developed and emerging countries.<sup>210</sup> However, in the latter the currency crises were more recurrent and the banking crises were more severe. Moreover, the latter tended to become currency crises, threatening the stability of domestic financial systems. In other words, the crises generally had a twin nature (Eichengreen & Bordo, 2002).

The successive financial crises of emerging countries in the second half of the 1990s called the attention of mainstream economists.<sup>211</sup> These economists acknowledged that the currency crisis models developed in the 1980s, known as first-generation models,<sup>212</sup> proved to be inadequate to understand these events, whose characteristics such as unpredictability and disconnection

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209 A financial crisis is any crisis that affects one or more segments of financial markets, thus involving foreign exchange, banking, and internal and twin financial crises.

210 In this chapter, the term “emerging countries” refers to capitalist peripheral countries that received most of the capital flows from core countries in the 1990s.

211 In this chapter, the terms mainstream and conventional literature are used as synonyms and the definition of mainstream economics by Colander, Holt and Rosser (2003) is adopted. According to these authors, this term refers to the ideas that the profession’s elite – the leading economists of the main higher schools of economics – consider acceptable, thus constituting a broader term than orthodoxy – which is the dominant school of thought in a given historical period (in the current context, neoclassical economics). In the mainstream context, new ideas and approaches – which do not fall under orthodoxy – can be accepted as long as they are subject to modeling. The term heterodoxy, in turn, is defined more by what it is not (by the rejection of orthodoxy) than by what it is, given the diversity of heterodox schools. And even if the heterodox share similar views with mainstream economists on the limitations of orthodoxy, they would not fit into the mainstream due to the modeling used and/or the assumptions assumed in the models.

212 The first-generation canonical model developed by Krugman (1979) argues that currency crises are the predictable result of inevitable speculative attacks, which stem from the rational response of private agents to an economic policy inconsistency resulting from the combination of a fixed exchange rate regime with an expansionary fiscal policy financed by money issuance.

with the fiscal and monetary fundamentals of countries had so far been practically ignored by the conventional literature.

In this context, the mainstream theorists started introducing in their models external factors typical of the current international financial system, including self-fulfilling speculative attacks and the herding behavior of foreign investors.<sup>213</sup> However, in these new models (known as second- and third-generation models), the ultimate determinants of crises continue being domestic imbalances, caused by either government distortions (i.e., “external” factors) or financial market failures (national and/or international).

Meanwhile, a few heterodox authors also sought to explain the financial crises of emerging countries in the second half of the 1990s. Kregel (1999), following the tradition of Keynes and Minsky, argues that such crises are systemic rather than resulting from external factors or so-called “market failures,” as in conventional models, and generated endogenously from the absorption of intense capital flows, which led to the emergence of situations of domestic macroeconomic and financial fragility. This debilitating process was not caused by inconsistent policies, but by the introduction of policies aimed at achieving or maintaining macroeconomic stability and integrating the economy into the global financial environment.<sup>214</sup> Besides Kregel (1999), Taylor (1998) and Eatwell & Taylor (2000) also stress the endogenous process of the deteriorating macroeconomic and financial situation of these countries due to capital inflow. However, such analyses focus on the internal dynamics of crises and fail to explore the causes of the greater vulnerability of emerging countries to financial crises in this environment.

This chapter aims to develop a heterodox interpretation of this vulnerability based on work by Keynes, who highlighted the monetary nature and intrinsic instability of modern capitalist economies, and by Prebisch, who emphasized the asymmetries between core and periphery in the global capitalist system. Thus, the goal of the chapter is not the crises themselves but the underlying conditions of their emergence.

Like the heterodox analyses mentioned above, it is assumed that the crises in emerging countries were yet another manifestation of the systemic instability typical of the international monetary and financial system since the collapse of Bretton Woods.<sup>215</sup> The general features of this system are presented

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213 Some heterodox-oriented economists had already emphasized the potentially destabilizing role of these factors before the crises broke out. See, for example, Akyüz (1992) and Felix (1994).

214 Financial globalization relates to the elimination of internal barriers between the different segments of financial markets, added to the interpenetration of national monetary and financial markets and their integration into globalized markets (Chesnais, 1996).

215 This view is also supported by Unctad (see Unctad, 1998). Miranda (1998) comes to a similar conclusion in his analysis of the Asian crisis, but emphasizes one of the dimensions of this instability: the lack of a stable

in section 1. Section 2 develops the main hypothesis of this chapter, namely that the greater vulnerability of emerging countries to financial crises in the 1990s was linked to the monetary and financial asymmetries of that system; furthermore, such asymmetries also help explain its predominantly twin nature highlighted at the beginning of this introduction.

## **1. The Current International Monetary and Financial System**

The main features of the international monetary system (IMS) in each period of history are: the nature of the international currency; the exchange rate regime; and the degree of capital mobility. A fourth main feature, not always mentioned in the literature, is the hierarchical dimension of this system. As Miranda (1995: 187) argues, “within an international monetary system (or non-system) [...] there is a currency hierarchy that determines different conditions, potentialities and degrees of freedom for domestic economies.” These features, in turn, shape the profile of the international financial system in each period, as stressed by Keynes during the debates leading to the Bretton Woods conference (Keynes, 1980).

The international currency should perform the functions of national currency – medium of exchange, unit of account and store of value – at international level. However, there is a qualitative difference between these two forms of currency, as so far no real international currency has ever existed (Guttman, 1993). Despite the different traits of the successive international monetary systems since the 19th century, the practical solution to this dilemma was similar. Based on a hierarchical agreement among core countries that reflects the power relations between them, a key currency – usually the currency of the hegemonic country – and the prevailing exchange rate regime are established. However, this commitment is contradictory, since the key currency is also a financial asset in competition with other currencies (Brunhoff, 1996).

The IMS that emerged after the collapse of the Bretton Woods agreement was also based on that commitment and thus on a key currency, the US dollar. The other features of this system are floating exchange rate regime and free capital mobility. This section will focus on the three aspects of the IMS addressed in the literature – the role of the US dollar as the key currency, the flexible or floating exchange rate regime and free capital mobility – and on the profile of the current international financial system. Its hierarchical aspect will only be addressed in section 3, as it is one of the principal elements of the main hypothesis of this chapter, which will be developed in that section.

Following the collapse of Bretton Woods, the position of the US dollar as the key currency was founded on the financial power of the United States, associated with the importance of US financial institutions and the size of its domestic financial market (Strange, 1986; Helleiner, 1994). This financial hegemony was boosted by the 1979 interest rate shock, which inaugurated the “strong dollar” policy, and also by the financial deregulation and/or liberalization<sup>216</sup> introduced in the late 1970s, measures that marked what Tavares (1997) called “resumption of US hegemony.” Resumption because in the 1970s the position of the US dollar as the system’s key currency was increasingly challenged, reflecting the weakening of US technological and commercial leadership underlying that position in the Bretton Woods system.

It is important to clarify the role played by the US dollar in this environment. As Tavares and Melin (1997) argue, in this system the US dollar no longer fulfills the function of a store of value like a classic monetary standard, but mainly plays the role of financial currency in a deregulated system without fixed exchange parities.

The US dollar denomination of multi-currency transactions (securitization,<sup>217</sup> arbitrage, etc.) carried out in the international financial market fulfills three main functions for global investors: it provides instant liquidity in any market; it ensures security in risk operations; and it serves as a unit of account for present and future virtual financial wealth. In other words, the US dollar took on the role of financial currency of public origin, capable of serving as a common denominator of global financial wealth (Tavares and Melin, 1997). And US government bonds consolidated their position as a safe haven at times when global investor confidence was shaken (Belluzzo, 1997).

Besides its transformation into financial currency, Teixeira (2000) and Serrano (2002) highlight a second fundamental change of the US dollar as a key currency of the international monetary and financial system, underlying the concentration of power by the United States and the typical imbalance of present-day international relations. According to those authors, the specificity of the current situation compared to that established in Bretton Woods is due exclusively to fiduciary nature of the US dollar, which is no longer linked to any actual commodity (that is, to gold). This grants the country issuing the key currency an even greater degree of policy autonomy. In this context,

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216 Monetary and financial deregulation and/or liberalization relates to the reduction of government controls over the monetary and financial markets. These terms are usually used interchangeably in the literature.

217 Securitization relates to the transformation of non-negotiable assets (bank loans) into negotiable assets (securities) and the proliferation of different types of bearer securities issued by companies, financial institutions and governments. As Medeiros and Serrano (1999) point out, geopolitical conditions (i.e., the end of the Cold War and the collapse of the Soviet Union) also contributed to the greater degree of political autonomy of the country issuing the key currency.



the management of US monetary policy and, therefore, the fluctuations of the system's base interest rate, which decisively influence the direction of international capital flows, are closely dependent on the US domestic economic cycle.<sup>218</sup>

At the same time, by freeing itself from the "shackles" of ultimate convertibility to gold, the United States was able to run recurring trade deficits, which resulted in another specificity of the international monetary system after Bretton Woods: the condition of net debtor of the country issuing the key currency. This condition introduces new sources of instability in the system, as US monetary policy is also dependent (albeit to a lesser extent) on the need to roll over the domestic public debt and maintain the value of the US dollar. The possible inconsistencies between the internal and external goals of this policy result in uncertainty regarding US interest and exchange rates, which, given its core position in the system, is transmitted to other core and peripheral countries (Belluzzo, 1997).

In addition to the traits of the contemporary key currency – its fiduciary nature and the United States' condition as net debtor – this uncertainty also stems from the other characteristics of this system mentioned above: the environment of free capital mobility and the floating exchange rate regime.

While the consolidation of this environment was linked to US policy decision-making aimed at ensuring the hegemony of the US dollar in the international monetary and financial system,<sup>219</sup> its emergence, in turn, ultimately determined the collapse of Bretton Woods's fixed parity system, replaced by a floating exchange rate regime. As Eichengreen (1996) points out, these two aspects are inextricably linked: the post-war trend of exchange rate flexibility is an inevitable consequence of increased capital mobility.<sup>220</sup>

The floating exchange rate regime in a context of free capital mobility did not result in greater exchange rate stability and the elimination of balance of payment imbalances, as announced by the monetarists in the late 1960s, but in extreme exchange and interest rate volatility (Belluzzo, 1995). The unpredictability of exchange rates stimulated speculation in foreign exchange

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218 Strange (1986) stresses that two types of policy decisions were key for the emergence and consolidation of this environment: the positive and negative decisions that relate, respectively, to interventions through rules or financial resources to influence or restrict markets and the non-interference of governments in markets.

219 Eichengreen (1996) argues that this mobility is only compatible with an exchange rate regime other than the floating one (fixed or managed exchange rate) if the autonomy of the domestic economic policy is used as an adjustment variable, a situation that prevailed during the gold standard.

220 This environment of structural uncertainty in relation to the evolution of key prices is at the origin of the financial derivatives market. These financial instruments (futures and forward contracts, options, swaps, etc.), referenced to an underlying asset – exchange rates, interest rates, etc. – emerged with the goal of hedging against changes in these assets, but also expanded the scope for speculation in financial markets, given their leverage power. For an analysis of these instruments, see Farhi (1998).

markets and short-term capital flows, which further increased the volatility of foreign exchange markets.<sup>221</sup>

One of the consequences of this context of structural uncertainty regarding the behavior of key prices is the greater preference of agents operating in the international monetary and financial market for liquidity. But this is not only due to the characteristics of the “flexible, financial and fiduciary” US dollar standard summarized above, but also to the dynamic of the current international financial system, dictated by financial globalization and the predominance of so-called market finance. This dynamic is detailed below.

Financial globalization, which was consolidated in the 1980s, is a development of the trends present in the international financial system since the emergence of the European market and the adoption of the floating exchange rate system. The set of financial changes underlying this process – financial liberalization and/or deregulation, debt securitization, institutionalization of savings and proliferation of financial innovations – emerged in the United States and started to contaminate other core countries, in different rhythms and intensity, and, above all, the international financial system, precisely because of the position of the US dollar as the key currency and the financial deregulation and opening policies championed by that country.

Despite national specificities (in terms of timing and speed), financial liberalization and deregulation processes resulted in an important development in most core countries, highlighted by Aglietta (1995): the increased importance of capital markets vis-à-vis the credit market and, consequently, the enhancement of market finance, which profoundly changed the behavior of the agents – families, companies and financial institutions – whose investment logic became increasingly speculative.

As stressed by Keynes (1936), in an environment in which organized, liquid financial markets prevail, corporate logic becomes subordinate while speculative logic proves to be dominant. In such a context, investments are no longer made for their ability to produce a flow of income that, capitalized at the current interest rate, exceeds the initial amount disbursed, but for the capital gain they are able to generate based on the expectation of short-term changes in the asset’s market value. In other words, asset allocation decisions are guided by speculative logic, insofar as agents seek to “predict the psychology of the market”, that is, the “market’s average opinion,” which determines the prices of financial assets.<sup>222</sup>

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221 In the Keynesian approach, the prices of financial assets do not reflect the fundamentals, but the prevailing conventions in financial markets, that is, the “average market opinion” (Orléan, 1999).

222 This new pattern of wealth management did not “contaminate” all countries in the same way. Its degree of diffusion is directly associated with the degree of deepening of market finances, which depends, in turn, on the intensity of the financial liberalization and deregulation processes in each country.

The dominance of financial over productive valuation in contemporary capitalism has been emphasized by several heterodox authors, such as Chesnais (1997), Orléan (1999) and Braga (1997). According to the last author, such dominance reflects the emergence of a new pattern of wealth management called “financialization.” In this pattern, which emerged in the United States and spread progressively through other core countries and the international financial system, speculation has become systemic rather than a phase of economic cycles and has characterized the action of all relevant economic agents.<sup>223</sup>

At national level, the predominance of financial accumulation over production resulted in a new macroeconomic dynamic in core countries, whose main expression is the so-called asset lifecycle.<sup>224</sup> However, this new form of wealth management was not restricted to national borders. Decisions to allocate the financial wealth of agents – institutional investors, who manage the savings of families, large banks and transnational companies – also dictate the direction and characteristics of the different types of capital flows, which have become detached from world trade and production flows. In other words, speculative logic became deeply embedded in the behavior of economic agents as a whole and started to condition decisions of consumption, savings, investment, financial investment, indebtedness and credit granting, both domestically and internationally.

Speculative logic imparts a volatile profile to capital flows in general, which does not imply that there is no difference in terms of volatility between the various types of flows. Statistical tests carried out by Turner (1991) suggest the following ranking: foreign direct investment (FDI), portfolio investment and short-term loans.

The extreme volatility of key prices (exchange and interest rates) that has characterized the international monetary system since the collapse of Bretton Woods has also contributed to the generalization of speculative logic. In this context, creating expectations about the evolution of those prices has become “an almost imperative need for agents in the normal course of their activities” (Farhi, 1999: 103). In other words, prediction of “market psychology” started guiding the action of all relevant economic agents operating globally, contaminating the various types of capital flows.

The new operating mode of transnational companies, dictated by “financialization,” resulted in the increased importance of FDI flows associated with company mergers and acquisitions, which are asset appreciation transactions,

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223 For a detailed analysis of the new macroeconomic dynamics in the core countries, see Aglietta (1995) and Coutinho and Belluzzo (1998).

224 Pension funds also started to show an increasingly speculative behavior as the payment of managers came to depend on performance criteria. In this regard, see Freitas (1997).

inherently more volatile than so-called greenfield investment (building of new facilities). Furthermore, in the context of financial globalization, even greenfield investment can put pressure on the foreign exchange market of recipient countries (Kregel, 1996). That is because recent financial innovations – especially derivatives – besides contributing to blur the boundaries between short- and long-term investments, make it possible to carry out hedge operations against foreign exchange risks associated with FDI, which also imply short-term financial flows.

In turn, credit flows, whose importance should not be overlooked, increasingly acquired a short-term profile. In the environment of financial globalization, these flows prove to be essential in structuring not only the hedge operations mentioned above, but also risk positions in different currencies (or assets denominated in different currencies), involving derivatives. Despite the different degrees of freedom of action in these systems (depending on the exposure limits in foreign currency and the permission or not of loans in that currency), banks have the ability to hedge against the exchange rate risk of any type of transaction (commercial, financial, with derivatives), but they can also opt for a decoupled position in view of the expected behavior of interest and exchange rates, which reflects a speculative attitude (Carneiro, 1999).

On the other hand, portfolio investments – buying and selling of shares and fixed income securities, beyond borders – which are the typical capital flows of the globalized international financial system, are by nature inherently speculative, as they are motivated by short-term gains rather than long-term considerations, which in turn result in intense fluctuations in asset and exchange rate prices. The increased importance of this type of flow from the 1980s was directly linked to the performance of institutional investors, predominantly American and British, who “seek to globally optimize their net financial income through operations aimed at anticipating changes in asset prices in the different markets” (Cintra, 1997).

However, the speculative logic of portfolio flows does not stem solely from the performance of investment and pension funds, whose managers are dominated by an equity logic, focused on portfolio performance.<sup>225</sup> Alongside these institutional investors, banks and large companies are equally important players in the international capital market.

Banks played a leading role in expanding this market: besides securitizing a significant part of their loans in the context of the 1980s foreign debt crisis, these institutions are mainly responsible for transferring resources between deficit and surplus agents. As Freitas (1997) explains, the growing importance

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225 The term “asymmetries” was borrowed from Prebisch (1949), who emphasized three types of core-periphery asymmetries within the global capitalist system: technological/productive, macroeconomic and financial.

of capital markets and the expansion of securitization did not mean financial disintermediation, but a new form of financial intermediation characterized by the predominance of financial assets tradable in both the liabilities and assets of banks.

In the international capital market, banks operate directly – buying and selling securities, managing the portfolios of large investors, structuring operations with financial derivatives – and indirectly by granting loans to investors and financial intermediaries operating in this market (Guttman, 1996). This indirect activity is essential to ensure the liquidity of the asset markets, since commercial or universal banks function as market makers and they alone have access to the ultimate medium of payment, the currency issued by the Core bank (Aglietta, 1995).

Transnational companies have also become important players in the international capital market (Serfati, 1996), holding significant stock of convertible currencies, derivatives and foreign securities. As Braga (1997) argues, the liquidity they manage has become strategic, with the permanent possession of stocks of currencies, quasi-currencies and domestic and foreign financial assets rather than the preference for short-term liquidity, which proves to be essential not only to enable hedge operations in a context of unstable key prices, but also for capital appreciation in the financial sphere.

In short, given the context of asymmetric information and power, divergent opinions, uncertainty and high preference for liquidity typical of contemporary financial markets, the main agents in these markets (mutual and pension funds, large banks and treasury of large companies) are obliged to formulate strategies based on an agreed assessment of price behavior and are convention makers. Their strategies are mimicked by other investors, smaller and with less information, leading to the formation of speculative bubbles and subsequent price collapses (Coutinho & Belluzzo, 1996). According to Orléan (1999), the agents' actions are guided by “self-referential” reasoning, which results in the predominance of imitative or herd behavior and extreme volatility of recent capital flows, especially affecting emerging countries, as will be highlighted in the next section.

## **2. The asymmetries of the international monetary and financial system and the financial crises of emerging countries**

This section introduces and develops the following hypothesis: the greater vulnerability of emerging countries to financial crises in the 1990s was associated with the monetary and financial asymmetries of the current international

monetary and financial system,<sup>226</sup> which would explain their greater susceptibility to the volatile profile of recent capital flows. Such asymmetries also contribute to explain the greater incidence of the so-called twin crises in those countries, as they underlie the trend to indebtedness in foreign currency and to dollarization, which result in mutual feedback between exchange and banking crises.

Monetary asymmetry relates to currency hierarchy at international level. As mentioned in the previous section, the hierarchical side of the international monetary system is not exclusive to the present-day system. Since the gold standard there has been a hierarchy of currencies at international level.<sup>227</sup> However, the intention herein is to show how such a hierarchy can prove to be even more perverse in the current environment, given the traits of the current international monetary and financial system summarized in section 1.

In the current system, the US dollar is at the Core of the hierarchical system – i.e., it is the key currency – in relation to which the other currencies are hierarchically positioned: first, convertible currencies, issued by other core countries, and, second, more distant from the center, non-convertible currencies, issued by emerging countries (Carneiro, 1999).

The concept of convertibility relates to the acceptance of national currencies as a medium of payment, unit of account and denomination of contracts, and store of value in the international monetary system. In other words, a national currency is fully convertible if it is able to perform the three functions of currency at international level. However, there are different degrees of convertibility.

In the currency hierarchy, only the US dollar, as the key currency, fully performs these three functions and thus has the highest degree of convertibility. The US dollar is the main currency used in monetary (medium of exchange) and financial (denomination of contracts) transactions, besides being the most liquid and safest asset and, hence, the most desired by agents as a store of value and “receptacle” of uncertainty, structurally higher and more volatile

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226 As Belluzzo and Almeida (2002) point out, in *Treatise on Money* Keynes had already mentioned the existence of a currency hierarchy when analyzing the different degrees of monetary policy autonomy of debtor and creditor economies in the interwar period.

227 Bordo and Flandreau (2001) show that only 25 countries – among them four emerging countries – have the capacity to issue debt denominated in their own currency in the international financial market. This specificity of “emerging” countries has also been highlighted by other authors (see Haussmann et al., 1999), according to which these countries suffered from an “original sin” that explained their inability to borrow externally in their own currency. It is worth mentioning that in 2004 a few emerging countries, Brazil included, issued bonds denominated in their own currencies (settled in US dollars at the exchange rate on the day of maturity) in the international financial market. However, these issuances are marginal and were mainly absorbed by investors of a more speculative profile who bet on the continuation of the dollar devaluation trend and the consequent appreciation of some currencies.

in the current context due to both the instability of the international monetary system after the collapse of Bretton Woods and the speculative logic of globalized finance.

The currencies of the other core countries are also used as denomination of contracts at international level and are desired, less intensely, as store of value in the portfolios of foreign investors. The currencies of peripheral countries participating in the system – i.e., emerging countries – are not convertible. Unlike core countries, these countries are generally unable to issue foreign debt in their own currency.<sup>228</sup>

Regarding the function of store of value, their respective currencies do not fulfill the role of “receptacle” of uncertainty at global level. Concerning specifically the store of value function, such non-convertibility is mainly expressed in the different risk premiums attributed to currencies, which result from the rule for determining interest rates in the international monetary and financial system, unfavorable to countries that do not issue the key currency and, above all, to emerging ones.

As Carneiro (1999) explains, the US dollar interest rate, which is the system’s base rate, tends to be the lowest of all, since its return is on the key currency, considered the safest and most liquid by capital holders. Non-core interest rates always correspond to the US dollar interest rate plus country risk. Countries that are farthest from the core – i.e., emerging countries – have the highest interest rates, as their currencies are considered to be the least secure and, therefore, investors demand a higher premium to hold them. Considered from a different angle, capital holders in the periphery accept lower rates of return to invest in convertible currencies.

Given the environment of free capital mobility, if emerging countries set domestic interest rates below the rate fixed by the market, they not only fail to attract capital, but also cause local capital flight. Countries that issue convertible currencies, in turn, have the possibility to escape this rule, given the permanent flow of productive and financial capital. In those countries, fixing the domestic interest rate below the market rate results in capital outflow and currency devaluation. However, after a certain level, return on capital becomes attractive due to the low prices of productive and financial assets caused by the

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228 Following the return of voluntary capital flows to peripheral countries in the early 1990s, empirical studies on the determinants of these flows abounded, distinguishing two sets of factors: external and internal/regional factors. While the studies done in the first half of the decade concluded that circumstantial external factors, mainly the US base interest rate and the economic cycle phase in core countries, played a key role in the direction and volume of those flows, more recent studies relativize the importance of these factors and stress the role of external structural factors – financial globalization – and the complementarity between external factors – which determined the timing and volume of flows – and internal ones – which conditioned their regional distribution (Jeanneau and Micu, 2002).

devalued currency. In the case of emerging countries, that alternative does not exist, as there is no floor for the currency devaluation due to the inexistence of such flow (Carneiro, 1999). This lack of flow, in turn, results from financial asymmetry, as will be highlighted below.

Thus, this rule for determining interest rates results in different degrees of political autonomy of the countries in the system. In other words, monetary asymmetry implies macroeconomic asymmetry.

As in the previous international monetary systems (gold standard and Bretton Woods), also based on a national currency as a key currency (pound sterling and US dollar, respectively), the country issuing the key currency has a higher degree of political autonomy. However, in the present-day system, such autonomy is even greater thanks to the fiduciary nature of that currency, which allows the United States to closely link the management of its monetary policy to the domestic economic cycle (Teixeira, 2000). On the opposite end of spectrum are emerging countries that, for issuing non-convertible currencies, have a lower degree of political autonomy.

Besides being unable to escape the interest rate determination rule of the system in periods of normality, given the environment of free capital mobility, in periods of abundant or scarce resources these countries in general do not have enough freedom to adopt countercyclical policies to mitigate the impacts of capital flows on domestic economic performance. Core countries, on the other hand, have a greater degree of economic policy autonomy (obviously lower than the country issuing the key currency) precisely because of the convertible nature of their currencies, which makes it possible to use monetary policy to manage the domestic economic cycle. To use Ocampo's (2001) terms, the core has greater policy autonomy, thus being **policy making**, while the periphery is essentially **policy taking**.

However, a caveat is in order here: despite the trend towards financial globalization, emerging countries differed from each other in their degree of financial openness. Basically, countries that maintained control over capital flows had greater policy autonomy and vice versa. However, this chapter will not address the relationship between autonomy of macroeconomic policy and degree of financial openness, for that contributes to explain differences in the external vulnerability of emerging countries, while the intention herein is to highlight the specificities of the group of emerging countries" vis-à-vis core countries, which made them more susceptible to financial crises in the 1990s.

Added to the asymmetry of the international monetary system is the asymmetry of the international financial system, which concerns two factors: first, the determinants of capital flows directed to emerging countries; second, the relative size of those flows.



The volume and direction of these flows are mainly determined by factors outside those countries, both circumstantial – the economic cycle phase and level of interest rates of the country issuing the key currency and, to a lesser extent, of the other core countries, which determine the liquidity status of international financial markets – and structural – the new international financial dynamics.<sup>229</sup> As Ocampo (2001) points out, while core countries produce global shocks (in terms of capital flows, of exchange etc.), being business-cycle makers, developing countries (the periphery) are business-cycle takers.

It is important to highlight that this trait is not exclusive to recent capital flows. Historically, international financial market dynamics have determined the nature of capital flows to the periphery, while economic dynamics – growth versus recession – in core countries have conditioned their volume (Baer, 1995). However, this asymmetry has become even more perverse in the current context due to the volatile and speculative nature of those flows, which depend on the assessments and investment decisions of agents living in those countries, who are guided by financial and speculative criteria and extremely partial to liquidity.

The second dimension of financial asymmetry concerns the particular way in which emerging countries are inserted in international financial flows. On the one hand, despite the absolute growth of flows directed to those countries in the 1990s, only a marginal proportion of resources held by global investors is allocated to “emerging markets.”<sup>230</sup> On the other hand, securities issued by emerging countries, mainly those with higher risk premiums, rated “non-investment grade” by credit risk rating agencies, are part of a broader submarket of high-yielding securities, whose dynamic is even more volatile.<sup>231</sup>

Even within emerging countries there was no dispersion of investments in the 1990s. As the securities and stock markets of those countries are less liquid, there is a trend to concentrate investments in larger markets and in issuances involving greater fundraising. In other words, the financial flows directed to the “periphery” are selective in several aspects, not only in terms of countries, but also of agents. As stressed by Chesnais (1997), besides being exclusionary – strongly penalizing peripheral countries not included in the globalization process, as in the case of African countries – financial globalization is hierarchical, integrating national financial systems in an uneven, imperfect and incomplete way.

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229 Data released by BIS (2004) illustrate this marginal insertion: in December 2003, the core countries absorbed about 90% of the stock of international bank loans; and, in March 2004, 94% of the total stock of securities traded on the international capital market had been issued by residents of those countries.

230 Calculations carried out by the IMF (2003) identified a “synchronized” behavior between the spread of these securities and those of bonds issued by “emerging markets.”

231 Evidence in this regard is also presented in the study by Dowers, Gomez-Acebo; Masci (2000).

Following this general characterization of the asymmetries of the globalized monetary and financial system, it is essential to explain the relationships between those asymmetries, whose dimensions (monetary and financial) are self-reinforcing, and the greater vulnerability of emerging countries to contemporary financial crises.

The volatility inherent in recent capital flows affects above all emerging countries, since these flows are ultimately determined by external dynamics, more specifically the economic cycle and monetary policy of core countries and the investment and redemption decisions of global investors (one of the dimensions of financial asymmetry). At times of business cycle changes, changes in monetary policy at the core or increase in preference for liquidity, “emerging” currencies and financial assets, which are not held as a store of value at international level – reflecting monetary asymmetry – are the first to be sold by those investors in the recurring flight-to-quality trends (that is, to the US dollar and/or US government bonds).

The recurrence of these trends is also associated with the monetary policy management of the country issuing the key currency, the United States, whose policy autonomy is even greater due to the fiduciary nature of the US dollar in the current international monetary system. This country’s current stance perversely affects emerging countries mainly. On the one hand, financial shocks associated with changes in this management initially and mainly affect their currencies and non-convertible assets. On the other hand, these countries have little scope for adopting countercyclical policies (which will depend on their degree of financial openness), which would mitigate variations in the domestic economic cycle associated with capital flows and, thus, their vulnerability to flow reversals and recent financial crises.

The dimension of monetary asymmetry, related to the function of denomination of contracts, also increases the vulnerability of emerging countries to contemporary financial crises. The main consequence of this dimension is the inability of these countries to issue significant volumes of debt in international markets in their own currency, as highlighted above. As these countries have been historically dependent on external funding sources, the financial situation of domestic borrowers – and thus their ability to honor external commitments – becomes intimately linked to changes in the respective exchange rates, potentially greater in the current context due to the volatility of recent capital flows. Furthermore, since most of these agents’ external debt is denominated in the key currency (i.e., US dollars), changes in exchange and interest rates of that currency, associated with US monetary management, have an immediate impact on the value of debt, for, as Shulmeister (2000) stresses, the US dollar plays the role of unit of account of international assets.

The second dimension of financial asymmetry – the fact that a marginal proportion of flows is allocated to “emerging markets” – also contributes to the greater occurrence of financial shocks, intrinsic to the current international monetary and financial system, in emerging countries. The reason is that if the level of investment instability is generally higher in the case of foreign assets compared to national assets (Plihon, 1996), in the case of “emerging” assets – especially those with a “non-investment grade” rating – such instability is even greater, given the equally marginal impacts of the sale of these assets on the profitability of global portfolios, due to their residual nature.

However, despite the residual nature of capital flows directed to emerging countries, the potentially destabilizing effects of these flows on domestic foreign exchange and capital markets are significant, since, in relation to their size, the volume allocated to these markets by global investors is not marginal (Akyüz and Cornford, 1999). On the contrary, “international financial integration is integration between unequal partners” (Studart, 2003).

In fact, while it increased the structural volatility of secondary markets in emerging countries – associated with their small size, strong concentration and scarcity of quality liquid bonds – external opening did not result in greater development and dynamism of primary markets, which remain a marginal source of resources for most domestic companies. As Freitas and Prates (2003) emphasize, in terms of the development of these markets, both Asian and Latin American countries suffer from the same problem: narrow and highly speculative markets.<sup>24</sup>

In the case of fixed income securities markets, their volatility is potentially more intense compared to stock exchanges, since they are even smaller, generally dominated by the public securities segment. Thus, sales by foreign investors significantly reduce securities prices, with potential repercussions for other segments of the financial market (Studart, 2003). Furthermore, since in several emerging countries these markets are totally or partially dollarized (the securities have an exchange rate correction clause), the potential feedback between the fixed income and foreign exchange securities markets is accentuated, since an exchange devaluation caused by the reversal of flows contaminates the price of securities, affecting the financial situation of domestic borrowers (Griffith-Jones, 1995).

This trend to dollarization, which affects several sectors of emerging financial markets besides the fixed income securities market, is an additional feature of those markets that increases the vulnerability of emerging countries to the twin crises, as it intensifies feedback between exchange and banking fragility, also associated with foreign indebtedness in foreign currency.

This trend stems not only from the inflationary past of these countries, but also from the non-convertibility of peripheral currencies, which “contaminates” the operation of domestic financial systems. In most cases, besides foreign investors, the actual locals refuse to hold assets in domestic currency, which are not convertible, or demand high risk premiums to hold them. Likewise, local banks, which obtain funds in the international financial market in foreign currency, generally pass them on internally in the same funding currency or with foreign exchange indexation, to avoid currency mismatch.

## Conclusions

The purpose of this chapter was to develop a heterodox interpretation of the greater vulnerability of emerging countries to the financial crises of the 1990s. It argued that the asymmetries of the international monetary and financial system, with its core-periphery structure, help explain this greater vulnerability.

Four important developments of monetary asymmetry that contributed to this greater vulnerability were highlighted. First, “peripheral” currencies, for not fulfilling the function of store of value, are unable to play the role of “receptacle” of uncertainty at global level, which is structurally higher due to the characteristics of this system. On the contrary, these currencies are the first targets of flight-to-quality movements of global investors in times of increasing preference for liquidity. An additional expression of this incapacity is the higher risk premiums attributed to these currencies, which contaminate domestic interest rates.

Second, these countries, historically dependent on external funding sources, are generally unable to issue foreign debt denominated in their own currency. Consequently, the ability of domestic borrowers to honor external commitments becomes entirely linked to changes in the respective exchange rates, which are potentially higher in the current context due to the volatility of recent capital flows. Furthermore, since most of these agents’ external debt is denominated in the key currency (that is, in US dollars), changes in the exchange and interest rates of that currency associated with US monetary policy management – whose degree of autonomy is almost complete, given the fiduciary nature of the US dollar after the Bretton Woods collapse – have an immediate impact on the value of that debt.

The third consequence of the non-convertibility of their currencies is the lower degree of political autonomy of emerging countries. Finally, non-convertibility also “contaminates” the operation of domestic financial systems. More specifically, it is one of the causes of the trend to dollarization of these

systems, since, in many countries, in addition to foreign investors, local investors themselves refuse to hold assets denominated in non-convertible domestic currency or require high risk premiums to do so. Additionally, local banks, which raise funds in the international financial market, transfer them internally in the same funding currency or with exchange rate indexation to avoid currency mismatch in their balance sheets.

Financial asymmetry, on the other hand, has two aspects. The first concerns the determinants of capital flows directed to emerging countries. These flows ultimately depend on outside dynamics, making the countries permanently vulnerable to their reversal. The second aspect of financial asymmetry concerns the marginal insertion of emerging countries in global capital flows, which also contributes to their greater vulnerability to financial shocks, intrinsic to the present-day international monetary and financial system, since the sale of currencies and financial assets issued by those countries by global investors have equally marginal effects on the profitability of their portfolios. On the other hand, the potentially destabilizing effects of capital flows on emerging foreign exchange and capital markets are significant, as such flows are not marginal in relation to the size of these markets.

In short, monetary and financial asymmetries, which are closely inter-related, contribute to explain the greater vulnerability of emerging countries to the intrinsic volatility of recent capital flows, as well as the trend towards foreign currency indebtedness and dollarization, which result in the currency mismatch and reciprocal feedback between exchange and banking crises underlying the predominantly twin character of financial crises in those countries.

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# CHAPTER 20

## THE ARCHITECTURE OF THE CONTEMPORARY INTERNATIONAL FINANCIAL SYSTEM<sup>232</sup>

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### **Introduction**

The financial crisis originated in the United States in mid-2007 due to the sharp rise in default rates and the devaluation of assets linked to sub-prime mortgages has rekindled the discussion about the current architecture of the US and international financial system, its potential systemic risks and its mechanisms of supervision and regulation. This specific architecture has turned a classic credit crisis into a major financial and banking crisis. In a classic credit crisis, the sum of potential losses (corresponding to loans granted against poor collateral) would already be known. In the current configuration of financial systems, credit derivatives and structured products backed by real estate credit have multiplied such losses by an unknown factor and redistributed the ensuing risks globally to a wide variety of agents. The very traits of the risk transfer mechanisms have introduced new uncertainties. It is not known whether the risks have been diluted among a large number of small speculators or concentrated in a few portfolios. Therefore, a year and a half after the outbreak of the crisis, the losses remain immeasurable and their distribution is still largely unknown, contributing to a credit crunch, keeping interest rates on loans high, and increasing uncertainty and, at times, panic among investors, in addition to causing liquidity pooling in interbank markets.

The goal of this paper is to discuss some of the traits of the institutions and financial instruments that generated this crisis. It is divided into three sections following this introduction. The first features a short chronology of the main events of the crisis. The second characterizes the main elements of the global shadow banking system. The third section outlines the actions

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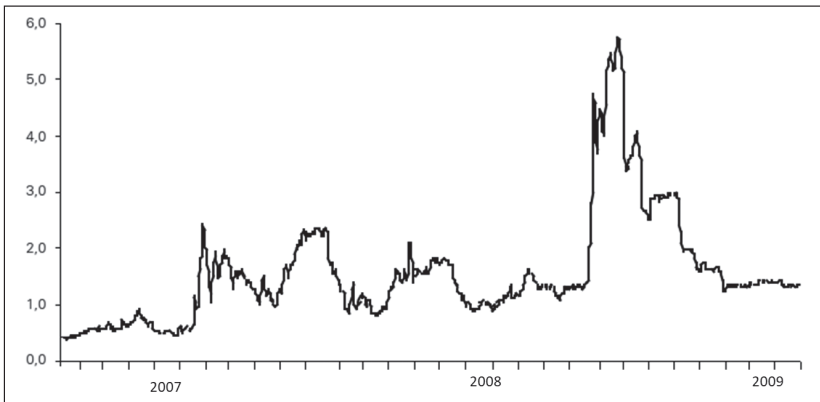
implemented by government authorities and large banks to provide possible solutions to the global financial crisis.

## 1. The development of the financial crisis

As of June 2007, there were several more acute moments of the crisis, with marked repercussions in global interbank markets.<sup>233</sup> Such moments became evident in the behavior of the TED spread – the difference between the interest rate on three-month US Treasury bills (in the secondary market) and the Libor (London Interbank Offered Rate) rate for three-month deposits in Eurodollar – an international benchmark for interbank loans (see Chart 1). Despite the sharp drop in the US base interest rate, the spread between short-term Treasury bills and Libor remained higher than that observed before the crisis broke out, showing a marked uncertainty in the interbank market.

In mid-June 2007, rumors surfaced that two hedge funds managed by Bear Stearns, with assets backed by subprime mortgages, had suffered losses and that the bank had sold \$ 3.8 billion in bonds to cover collateral replenishment. Credit rating agencies started to downgrade the rating of residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO). In early August 2007, BNP Paribas Investment Partners suspended redemptions and subscriptions in three investment funds, following the downgrading of numerous US mortgage-related assets by credit agencies.

**Graph 1 – TED Spread – Risk premium between US short-term bonds and Libor (percentage points)**



Source: Federal Reserve. Available at <http://www.federalreserve.gov/releases/h15/data.htm>.

Note: TED spread is the difference between the interest rate on three-month US Treasury bills (secondary market) and Libor for deposits in three-month Eurodollar.

233 For a more detailed chronology of the main events of the crisis, see BIS (2008: 109-110), Borio (2008) and Fundap (2008).

The Federal Reserve (Fed) and the European Core Bank (ECB) carried out extensive operations to increase market liquidity. There was also the intervention of the Bundesbank in the German bank IKB and the failure of the American Home Mortgage Investment Corporation. In late November and early December 2007, several US and European banks announced plans to incorporate assets allocated to SIV (Special Investments Vehicles) into their balance sheets. In view of the anticipation of high losses to be revealed by bank balance sheets, the Core banks of the USA, England, Europe, Switzerland, Canada, Japan and Sweden were forced to jointly intervene. This deterioration in expectations continued through January 2008, with the disclosure of new losses and the downgrading of the ratings of monoline insurers (such as Ambac, MBIA, Assured Guaranty, FSA), which specialize in providing coverage for bonds issued by US states and cities.

In March 2008, the failure of the fifth largest US investment bank, Bear Stearns, was prevented by intervention and \$ 29-billion guarantees offered by the Fed for its highly depreciated purchase by JP Morgan Chase (\$ 10 per share; a year earlier shares had hit \$ 170). As an investment bank, Bear Stearns was neither supervised by the Fed nor had access to rediscount operations.<sup>234</sup>

In spite of several statements that the worst of the crisis was over, high tension occurrences persisted. July 2008 saw the failure of IndyMac Bank, part of the Federal Savings Bank (FSB) group of financial institutions specialized in mortgage credit. IndyMac was the largest savings and loan institution in the Los Angeles area and the seventh largest mortgage loans originator in the United States. The institution was seized by the Federal Deposit Insurance Corporation (FDIC), a fund that guarantees deposits up to \$ 100 thousand. The failure of IndyMac Bank had two other immediate effects: a) depositors in the US banking system with deposits above the limit guaranteed by the FDIC sought to redistribute them among several banks; b) the fears of investors and depositors spread to the other FSB institutions, causing several new failures.<sup>235</sup>

Almost concomitantly with the IndyMac bankruptcy there was a sharp loss of confidence in the two large quasi-public agencies created for the purpose of providing liquidity to the US real estate market, the Federal National Mortgage Association (nicknamed Fannie Mae) and the Federal Home Loan Mortgage Association (known as Freddie Mac).<sup>236</sup> These privately owned

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234 According to Section 13 (3) of the Federal Reserve Act (1932), the Core bank has the power to underwrite any institution against any collateral, provided that it declares that this is necessary, as "specific circumstances so require."

235 With the spread of the confidence crisis, Ireland increased its deposit guarantee by granting, on September 30, 2008, full deposit guarantee for a two-year. In reaction to the Irish decision, the British government increased the bank deposit guarantee limit to £ 50,000. The granting of full guarantee by the governments of Germany and Denmark led the European Union to increase the minimum guarantee limit for bank deposits from € 20 thousand to € 50 thousand for all 27 member countries. Following the European governments, the FDIC raised the limit on guaranteed deposits to \$ 250,000 and started to guarantee for three years the new debts of banks and savings institutions and holding companies - including promissory notes, commercial paper, interbank loans (Fundap, 2008).

236 For more information on the US real estate financial system, see Cagnin (2007).

companies listed on stock exchange but considered Government Sponsored Enterprises (GSE) were able to finance themselves at a cost very close to that of the US Treasury while operating in a more leveraged manner than other financial institutions, supporting their activities with a combined net worth of just \$ 71 billion. That is, such equity could be consumed by a relatively low loss as a proportion of the portfolio. While house prices rose, that risk seemed limited. With the fall in the price of real estate, put up for collateral and now worth less than the mortgage, and double default level, the companies were faced with the possibility of insolvency (equity imbalance) or at least lack of capital to continue operating (Torres Filho & Borça Jr., 2008).

President George W. Bush's administration asked Congress to approve an aid package for these two institutions, through loans and stock purchases. In turn, the Fed announced in a separate statement that it would grant them short-term loans. The unprecedented initiative was linked to the size of the liabilities of those companies. Fannie Mae had a total debt of around \$ 800 billion, while Freddie Mac's reached \$ 740 billion. In addition, the two companies carried or had guaranteed mortgage bonds worth \$ 4.6 trillion, which accounted for 38% of mortgage loans in the USA and 32% of its Gross Domestic Product (GDP), estimated at \$ 14.3 trillion in June 2008. To further complicate things, a significant part of these securities had been purchased by foreign Core banks. In June 2008, the total debt of US federal agencies held by foreigners amounted to \$ 1.66 trillion, \$ 1.1 trillion of which in portfolios of official creditors and \$ 557 billion of private creditors.<sup>237</sup> In other words, the bonds issued by Fannie Mae and Freddie Mac were considered for the investment of international reserves to be as "risk free" as US Treasury bonds, with the advantage of offering slightly higher returns.

The failure of Lehman Brothers on September 15, 2008 was the most acute point of the crisis, which started to take on a systemic look.<sup>238</sup> It led to a halt in interbank operations and spread distrust among investors in financial systems, resulting in global panic in stock, foreign exchange, derivatives and credit markets. The refusal of US authorities to prevent the failure of Lehman Brothers was followed by the purchase of Merrill Lynch by Bank of America, while Goldman Sachs and Morgan Stanley obtained permission to become financial holding companies, subject to Basel standards and Fed supervision and having access to rediscount operations. It was the end of Wall Street's big independent investment banks.

However, not only investment banks and GSEs suffered the impacts of the crisis. During this period, other non-bank financial institutions such as hedge funds, investment funds and insurance companies faced a veritable "bank run" against the global shadow banking system, according to McCulley

237 According to the Treasury, the largest holders of US agencies debt were China and Japan.

238 According to Barros (2008): "When it broke, the Lehman Brothers investment bank had assets of \$ 650 billion supported by only \$ 20 billion." See also, Lehman's demise triggered cash crunch around globe, *The Wall Street Journal*, October 29, 2008.

(2007), or a “bank run against non-banks,” according to Kedroski (2007). In moves that revealed the importance acquired by non-banks, the Fed and the US Treasury had to extend access to rediscount operations to several of these institutions – with the acceptance of mortgage-backed securities – and create credit lines for money market mutual funds.<sup>239</sup> The Bank of England also adopted similar measures through swap operations.

Universal banks also recorded increasing losses. Estimates of losses remained incomplete and conflicting.<sup>240</sup> Defaults starting spreading to other forms of consumer credit and affecting mortgage borrowers considered less risky than subprime borrowers. Moreover, one must consider that most subprime mortgages were granted with low initial installments, but which rose sharply after a year or two. As they recognized new losses, the big banks were repeatedly forced to seek increasingly expensive capital contributions, especially with sovereign wealth funds, in order to comply with Basel standards for liquidity.<sup>241</sup> However, the failure of Lehman Brothers made it difficult for banks to raise new capital. Large injections of public funds into banks were necessary, besides guarantees for the issuance of new debt. In the euro area, for example, public resources made available to try to restore confidence in the financial system amounted to € 2 trillion, equivalent to 22.5% of regional GDP (see Table 1). Other countries such as Canada, South Korea, Denmark, United Arab Emirates, Norway, Sweden and the United Kingdom implemented programs estimated at € 898.2 billion (see Table 2).

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239 So far, hedge and pension funds have not had access to relief operations. American International Group Inc. (AIG), an insurance company, received \$ 182.5 billion from the Fed in exchange for voting shares. Subsequently, it was discovered that it had sold \$ 2.7 trillion notional credit protection (CDS) in early 2008, a position reduced to \$ 1.5 trillion in March 2009 (Sterngold, 2009). Life insurance companies were included in the Troubled Asset Relief Program (TARP) in early April 2009 (Patterson *et al.*, 2009).

240 One of the difficulties lay in the actual way of calculating losses. Some believed the banks were falsifying balance sheets, hiding losses behind mathematical formulas for valuing more complex and illiquid assets at market prices. For others, the banks should not even mark all losses at market prices, as they would not be able to absorb them with the available capital. In addition, the rule would be pro-cyclical, imposing the repricing of balance sheets in times of risk aversion. On April 2, 2009, the Financial Accounting Standards Board (Fasb) relaxed the rules for pricing assets and liabilities at market values for financial institutions (known as FASB 157). By “fair value” accounting, financial statements should be made at market prices, unless institutions prove that some markets were inactive or experiencing unordered sales. With the deepening of the crisis, negotiations with many securities were interrupted or carried out at prices that did not reflect their values. Flexibility allowed institutions to offer valuations for these securities through internal pricing models, as long as the amounts, models and parameters used were explained in the explanatory notes to the balance sheets.

241 In addition to the losses in their credit portfolios, new problems arose as a result of successive falls in bond prices, bringing to light alleged hoaxes that had been overlooked. One case involved securities called auction rate security (ARS). Banks were accused of deceiving their customers by selling them assets considered safe, even when their markets had ceased to exist. Between August 7 and 8, 2008, after investigations by the Securities and Exchange Commission (SEC), Citigroup and UBS agreed to redeem all of these bonds at par, at a cost of \$ 7.5 billion to Citigroup and \$ 19 billion to UBS. Merrill Lynch announced a \$ 10 billion disbursement for the same purpose, prior to an agreement with the SEC. As of August 14, banks had pledged to repurchase \$ 48 billion in ARS. Other financial institutions are expected to follow the same procedures, placing additional pressure on their reserves (Chang, 2008).

**Table 1 – Measures to stimulate financial systems – euro area**

	Capital injection	Guarantee for issuance of new debts	Other (a)	€ billion	% of GDP	Notes
Germany	80	400	-	480	20.0	
Austria	15	85	-	100	37.0	
Belgium	17.4	-	-	17.4	5.2	Includes Dexia, Ethias, Fortis and KBC
Cyprus	2	-	-	2	12.8	
Slovenia	-	12	1	13	39.0	
Spain	-	200	50	250	23.8	
Finland	4	50	-	54	30.1	
France	24	320	-	344	18.0	Includes Dexia
Greece	5	15	8	28	12.3	
Netherlands	36.8	200	-	236.8	41.6	Includes Fortis
Ireland	10	400	-	410	215.1	
Italy	12	-	40	52	3.4	
Luxembourg	2.9	-	-	2.9	8.0	
Portugal	4	20	-	24	14.7	
Euro zone	213	1,702	99	2,014	22.5	

Source: BNP Paribas, Market Economics/Credit Strategy/Interest Rate Strategy, 19 January 2009. Note: a) Includes purchase of assets. Excludes guarantee for bank deposits.

**Table 2 – Measures to stimulate financial systems – other countries**

	Capital injection	Guarantee for issuance of new debt	Others (a)	Local currency (billion)	€ billion	% of GDP	Notes
Saudi Arabia	\$ 3	-	-	\$ 3	2.4	0.8	
Australia	-	-	8	8	4	0.7	
Canada	-	218	75	293	187.9	19.1	
Qatar	\$ 6	-	-	\$ 6	4.7	8.8	
South Korea	-	\$ 100	\$ 8.1	\$ 108,1	85.8	11.1	
Denmark	100	-	-	100	13.4	5.9	Plus losses above DKK 35 billion in banking liabilities
United Arab Emirates	\$ 19	-	-	\$ 19	14.7	9.6	
Hungary	\$ 1.5	\$ 1.5	-	\$ 3.1	2.3	2.2	



	Capital injection	Guarantee for issuance of new debt	Others (a)	Local currency (billion)	€ billion	% of GDP	Notes
Norway	-	-	350	350	41	15.4	
United Kingdom	50	250	50	350	385	25.0	Excludes Special Liquidity Scheme (£ 200 billion)
Sweden	15	1,500	-	1,515	153	49.3	
Switzerland	6	-	-	6	4	1.0	Excludes capitalization of UBS
<b>Total</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>898.2</b>	<b>-</b>	

Source: BNP Paribas, Market Economics/Credit Strategy/Interest Rate Strategy, 19 January 2009. Note: a) Includes purchase of assets. Excludes guarantee for bank deposits.

Obs.: \$ – values in US dollar.

US bailout plans reached \$ 7.4 trillion, including the Troubled Asset Relief Program (\$ 700 billion, managed by the Treasury), according to an estimate by Bloomberg (see Table 3). Moreover, to address distrust in its banking system, the Treasury announced a Financial Stability Plan in March 2009. The plan provides four basic components: a) the banks' balance sheets will undergo severe stress tests and institutions that need capital will have access to a new program sponsored by the Treasury (Financial Stability Trust); b) the Treasury, the Fed, the FDIC and the private sector will set up a Public Private Investment Fund, starting with \$ 500 billion, which may reach \$ 1 trillion. This fund will be used to purchase toxic assets; c) the Fed will provide \$ 1 trillion to stimulate consumer credit recovery; d) \$ 50 billion in federal funds will be earmarked to try to mitigate the foreclosure of residential mortgages and buffer the impact of the housing crisis.

**Table 3 – US relief plans (US\$) – November 2008**

	Earmarked	Invested
Federal Reserve	4.5 trillion	1.8 trillion
Federal Deposit Insurance Corp. (FDIC)	1.5 trillion	139 billion
Treasury Department	1.1 trillion	597 billion
Federal Housing Administration (FHA)	300 billion	300 billion
<b>Total</b>	<b>7.4 trillion</b>	<b>2.83 trillion</b>

Source: <http://www.bloomberg.com/apps/data?pid=avimage&iid=f0YrUuvkygWv>.

## 2. The main features of the global shadow banking system

It is noteworthy that the most acute cases of financial fragility recorded in this crisis involved financial institutions that, by previous regulation, had no access to deposit insurance and/or rediscount operations of the monetary authorities. This trait is typical of what has been called the global shadow banking system. This term was first used by Paul McCulley (2007), CEO of Pimco, the leading global investment management company. It should be noted that the measures adopted by the Fed and other Core banks include granting access to rediscount operations – with the acceptance of mortgage-backed securities and others – to these various institutions that could not use them like investment banks and GSEs. However, these measures proved to be insufficient to contain the “dismantling” of the global shadow banking system, since, in order to survive, they avidly sold the assets for which there was still a market, causing a sharp devaluation of their prices.

This system has developed over the past few decades against the backdrop of the complex relationships established between financial institutions in opaque over-the-counter (OTC) markets. Since the late 1980s, these markets have been widely used to trade financial derivatives, whereby financial institutions could both seek to hedge their foreign exchange, interest and market price risks of other assets and speculate on the trend of these prices or carry out arbitrage transactions. While they were restricted to the trading of these assets, the relationships between the actual banking system and the institutions that made up the global shadow banking system were reduced to the credits granted by the former to the latter and to the fact that transactions were frequently carried out between them.

However, when these OTC markets started trading credit derivatives and securities from the securitization of credits granted by commercial banks, combined with some type of derivative with the generic name of “structured products,” the banking system and the global shadow banking system interpenetrated in an almost inextricable way. Banks sought different ways to remove risks from their balance sheets in order to leverage their operations without having to meet the minimum capital requirements of the Basel Accords (Cintra & Prates, 2008, & Freitas, 2008). They did this in several ways: by acquiring protection against credit risks in the derivatives markets, by securitizing credits whose return was linked to amortization paid by borrowers and by creating several special investment vehicles (SIV), conduits or SIV-lites.<sup>242</sup> However,

242 According to the IMF (2007: 18), these special vehicles tend to differ in their size and composition of assets and liabilities. In general, conduits tend to be larger and less risky, with assets of up to \$ 1.4 trillion; SIVs are intermediates with assets of around \$ 400 billion; and SIV-lites have smaller assets, around \$ 12 billion, but

they were only able to transfer these risks because other agents were willing to take on the counterparty of these operations, that is, to take risks against a return that, at the time, seemed high.

The other financial institutions, which were not subject to the prudential rules of the Basel Accords, gained highly profitable access to credit operations. All they had to do was raise funds in the short-term securities market and purchase long-term securities backed by credits issued by banks and/or sell to the latter protection against credit risks to “synthetically” reproduce a credit operation. As a result, OTC markets became a site for trading both the assets and liabilities of financial institutions. As such, they turned into a source of funding and investments for the financial institutions taking part in them.

### **Borrowing short and lending long**

Banks loan money with the resources they receive from their depositors and with their own capital. But banks create deposits – scriptural currency – when granting credit (Keynes, 1930). They also issue debt securities in order to raise funds and grant new loans (Chick, 1994). In general, loans have longer terms than deposits or debts. Due to the creation of deposits and to term mismatches, systems tend to be highly unstable, subject to processes of euphoria or pessimism and bank runs. That is why institutions were created to guarantee deposits, serve as “last resort lenders” and regulate and supervise the banking system.

In the last decade there have been two simultaneous and complementary trends. First, banks subject to regulation sought to remove risks from their balance sheets to avoid holding large amounts of capital reserve, as required by the Basel Accords,<sup>243</sup> and increased their leverage extraordinarily. Second, a wide range of institutions started playing a similar role to traditional banks without being included in the existing regulatory framework and, therefore, without having the required capital reserves.

As suggested, banks subject to regulation have resorted to several instruments to remove credit risks from their balance sheets, as a means to face competition. They were at the origin of the emergence and strong expansion of credit derivatives, through which they can purchase protection against the credit risks of their loan portfolios. They also used the so-called “structured products” – ABS, RMBS, CMBS, CDO etc. – instruments resulting from the combination of a credit securities – debentures, bonds, negotiable securities,

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with high risk. The asset portfolio of SVI-lites, which operate with high leverage (40 to 70 times depending on collateral), tends to be 96% residential mortgage-backed securities (RMBS) and 4% CDO. All have some mechanism of total or partial liquidity guaranteed by the sponsoring institutions.

243 For a discussion of the impacts of the Basel Accords, see Guttman (2006) and Freitas (2008).

mortgage, credit card debt, etc. – and the set of financial derivatives (futures, forwards, swaps, options and credit derivatives), whatever their underlying asset. Thus, these banks packaged the credits they granted, submitted them to the credit rating agencies and issued bonds attached to them whose returns are proportional to the cash flow generated by the amortization of loan installments. The structured securities were divided into several tranches with different risks and returns. The structure of interest distribution became known as “interest waterfall” because the water must fill up the first reservoir or most senior tranche to later start filling the others (mezzanine and equity). The riskiest portion of them (equity) – the one that assumes the initial default risks and which was named toxic waste – often ended up among the SIV assets.

The banks subject to regulation created legal entities – Special Investment Vehicles (SIV), conduits or SIV-lites – that purchased these structured bonds with funds from the issuance of asset-backed commercial papers. According to the *Wall Street Journal*, SIVs had issued \$ 1.5 trillion in commercial papers by mid-2007 (Reilly and Mollenkamp, 2007). These legal entities were not technically owned by banks nor did their results appear on the balance sheets, constituting a relevant part of the global shadow banking system along with several other new financial intermediaries. Thus, universal banks were able to raise more funds besides income (fees, commissions), which allowed them to grant new credits and increase their profits, in a process of increasing leverage.

Unable to raise funds from depositors, SIVs, as well as the other new financial intermediaries, sought them in the capital market, especially by issuing commercial papers. They used these short-term funds to take over the counterparty of the banks’ operations, either in the derivatives market, selling protection against credit risks, or in structured products, purchasing securities issued by banks with return linked to the amortization of loans. Thus they became participants in the credit market, raising short-term funds with which they funded long-term operations (30-year mortgages, for example), operating as quasi-banks (Kregel, 2008; Guttmann & Plihon, 2008; Freitas & Cintra, 2008).

There is a wide range of participants in the global shadow banking system. The main actors are investment banks, followed by hedge funds, investment funds, insurance companies, pension funds and GSEs. Investment banks have multiplied the hedge funds under their management, making room in their portfolios for products and assets with higher risk and setting up highly leveraged structures. Universal banks also started to sponsor hedge funds, providing them with credit for their operations (including the purchase of “structured products”) and emulating their business strategies. As Blackburn (2008: 90) argues: “The Wall Street banks not only sponsor hedge funds but

increasingly come to resemble them as they use their position as prime brokers to leverage up their bets and pursue arbitrage.”<sup>244</sup> The GSEs, guaranteed by the public sector, represented the mirror of the “off-the-balance-sheet” vehicles of the highly leveraged private financial sector. As Belluzzo (2008) states: “In a context of stability and falling returns, the search for higher gains has led to an exacerbation of relationships between the value of assets carried in portfolios and the equity of institutions. Greek equations and letters are mere pseudoscientific rhetoric to justify financial cock-ups. [...] When these agents are surprised by sudden and unanticipated price movements, the estimated losses force the liquidation of positions to cover margin, greatly increasing market and liquidity risk.” With no capital reserves, with assets whose liquidity vanished following the outbreak of the June 2007 crisis – so that they no longer had a market price – and faced with the significant shrinkage of their funding source, many of these institutions ended up in terrible financial situation, if not on the verge of bankruptcy.

### **An opaque network of international financial interrelationship**

The losses incurred by the institutions in the global shadow banking system ended up partly finding their way into the banks’ balance sheets. Some banks (such as Citigroup) had included put options (which give their holder the possibility to resell the asset at a predetermined price) in the credit securities. These options were exercised, forcing banks to repurchase the assets when their liquidity disappeared and their prices tended to zero. The various SIVs were guaranteed by the banks that created them. In other cases, these new intermediaries had pre-approved credit lines with universal banks that, widely used, started to show very low possibilities of being repaid.

There is another important link between the banks’ balance sheets and the institutions of the global shadow banking system. They have interacted in the over-the-counter derivatives markets and, in particular, in the credit derivatives markets, becoming counterparties to each other. However, the specific traits of these instruments make these markets a zero-sum game, in which the losses of some correspond to the gains of others, transaction costs excluded. In the aggregate of the derivatives markets one can only gain what is lost by other participants.

Products traded on the OTC market are not officially listed. Prices are freely agreed between the parties. In addition, unlike assets and derivatives traded in organized markets, the prices of OTC assets are not transparent, as they are not made public. This lack of transparency in OTC markets prices,

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244 On the emulation of hedge fund strategies by universal banks, see Cintra and Cagnin (2007).

especially those with little liquidity or in complex and sophisticated packages, may prevent or hinder their evaluation during the time the position is held.

The accounting practice of mark-to-market (adjusting to market prices), adopted in accordance with the recommendations of international supervisory and regulatory bodies to enable an evaluation of the value of positions, may not have a clear reference and may only be an estimate regarding OTC derivatives, involving consultations with other intermediaries or calculations according to complex mathematical models. In the late 1990s some cases of high losses in OTC markets were only detected on their maturity dates rather than during the course of the transaction and were at the origin of several lawsuits against the financial institutions that intermediated the operations. In the current crisis, the problem has resurfaced more acutely. In late 2006 the Financial Accounting Standards Board, which regulates the accounting information of US financial institutions, introduced a new classification of financial assets to calculate their prices. Tier one comprised assets whose prices were determined on liquid markets; tier two included assets whose prices depended on models with inputs based on the prices of assets traded on markets; tier three involved assets whose markets were less liquid and whose prices could only be determined using mathematical models. A large part of OTC derivatives was in tier two, while mortgage-backed assets or other types of credit and investments in private equity were in tier three.

These accounting standards, which should guarantee the system's stability and transparency, contributed to increase its volatility and lack of transparency, thereby triggering a liquidity crisis coupled with a confidence crisis. "Structured products" and credit derivatives, which had allowed record profits to be made, became, once again in Warren Buffett's expression, "weapons of mass destruction" (English, 2003). The systemic risk of a collapse of the banking system as a whole was outlined. Indeed, tier one assets accounted for only around 9% of the assets of US financial institutions, while tiers two and three made up the remaining three quarters. Thus, it is difficult to deny that these financial institutions held an excess of illiquid assets, which the financial crisis repriced at levels close to zero. The same investor Warren Buffett told *Fortune* magazine that these institutions "are marking to model instead of marking to market. The recent collapse of debt markets has turned this process into one of marking to myth."

In his testimony to the US Senate on April 3, 2008, Fed chairman Ben Bernanke acknowledged that the decision to intervene in Bear Stearns was due to the fact that "the financial system is extremely complex and Bear Stearns participated extensively in a range of critical markets. Its sudden failure likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses" (Bernanke, 2008a). That

statement indicated that the problems that prompted the Fed's intervention in a financial institution that was not under its supervision went beyond the classic excuse of "too big to fail." It would be best described as "too interconnected to fail," i.e., serious difficulties in banks that participate in "critical markets" start triggering "last resort" intervention even when it is not part of the institutional "rules of the game," because their bankruptcy would cause a domino effect in these markets, with high systemic risk. Bernanke's words also indicated that Bear Stearns' problems exceeded mortgage credit and covered the entire range of its positions in these "critical markets."<sup>245</sup> To a large extent, such markets were the OTC asset and derivatives markets, the only ones with risk to "thousands" of counterparties. By late December 2007, Bear Stearns' declared position in these derivatives markets amounted to a notional value, i.e., the value of the assets at maturity, of \$ 13 trillion. The decision by the US monetary authorities to allow Lehman Brothers to fail became even more incomprehensible, since that bank also held important positions in those same markets.

On stock exchanges, the transfer of gains and losses is organized and guaranteed by the clearinghouses. In OTC markets, the absence of such clearinghouses reveals a high risk of default of the losing counterparty. Thus, the potential risks of OTC derivatives increase compared to those traded on organized markets. The introduction at the turn of the millennium of credit derivatives and their marked expansion greatly increased the aggregate risks on OTC markets. These derivatives were born from the growing gap between sophisticated interest, exchange and market risk management techniques and the more traditional means available of credit risk management (securitization, portfolio diversification, collaterals, operational limits, etc.). By using existing swap mechanisms, credit derivatives allowed banks to remove risks from their balance sheets while the financial institutions of the global shadow banking system found new means of risk exposure and profit on the credit market. The most commonly used are credit default swaps (CDS), which transfer credit risk between the agent that purchases protection and the counterparty that sells it.<sup>246</sup> In this mechanism, the holder of a credit portfolio buys protection (pays a premium) from the protection seller. In return, the latter assumes, for a predetermined period of time, the commitment to pay the agreed sums in the cases specified in the contract, ranging from default or bankruptcy to credit rating downgrade or other events that may cause a drop in the portfolio's value. Counterparty risk increases in credit derivatives, since the transaction risks affect the main position, unlike the other derivatives in which the risks of operations are situated at the margin.

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245 Cf. Blackburn (2008: 96): "The Bear Stearns rescue was hard on shareholders but not on bondholders or counterparties."

246 On credit derivatives and their pricing models, see Magalhães (2008) and Yokoyama (2007).

Not being credit “originators,” the institutions of the global shadow banking system assumed, above all, the short position in these derivatives, “synthetically” reproducing exposure to credit and their gains. Data gathered by the Bank for International Settlements (BIS) in June 2008 indicated: a) the generalized growth of OTC derivatives, which reached \$ 683.7 trillion in notional values (practically 11 times the world GDP) and \$ 20.3 trillion in gross replacement values at market price,<sup>247</sup> i.e., a 28.7% increase over the previous semester (see Table 4); b) an extremely rapid increase in notional values and gross market values of credit derivatives (CDS) between June 2007 and June 2008, at a time when deals with structured products linked to credit were practically nonexistent. The notional values of credit derivatives reached \$ 57.3 billion, and the gross replacement values at market price, \$ 3.2 trillion.

The crisis arising from increased default rates on US mortgages and their consequences caused a strong increase in CDS premiums that is clearly shown in the following data: for a 34.6% increase in the notional value of CDS between June 2007 and June 2008 there was an increase of 339.9% in their gross replacement value at market price (see Table 4). The institutions that had assumed short positions in CDS suffered extremely high losses due to this increase in premiums.

Furthermore, the rise in notional values of credit derivatives in such a troubled period indicates, on the one hand, that higher premiums attracted new speculators willing to take on credit risks for which many sought coverage. On the other hand, recognition of the crucial role of these leveraged instruments led to a rare convergence between regulators and representatives of financial institutions for the creation of a clearinghouse that would cover the participants’ guarantee margins, to minimize counterparty risks, and bring some transparency to open positions and risk distribution. Some private companies are “applying” to this clearinghouse function. In the competition among them, in November 2008, new data began to emerge, shedding some light on the opaque OTC markets. Albeit partial, these data showed that, after the positions had been cleared, there was a sharp reduction in net commitments and, therefore, in the volume of risk. They made it clear that in the absence of a clearinghouse, any settlement before the maturity of operations is counted twice, once related to the original position and once to its early settlement, until maturity.

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247 There are two methods of aggregating derivatives. The first is by the notional value, which is equivalent to the value of the underlying asset. The second is called “gross market values,” which corresponds to the cost of replacing all contracts at current market prices. Just to exemplify, notional volumes on organized derivative markets are much lower than those on OTC markets: \$ 20.1 trillion in futures markets and \$ 39.7 trillion on options markets, adding up to US \$ 59.8 trillion in December 2008.



**Table 4 – Stocks of derivatives traded on OTC markets – \$ billion**

Instrument	Notional value				Gross market value			
	Dec. 2006	Jun. 2007	Dec. 2007	Jun. 2008	Dec. 2006	Jun. 2007	Dec. 2007	Jun. 2008
Total	414,845	516,407	595,341	683,725	9,691	11,140	15,813	20,353
Exchange market	40,271	48,645	56,238	62,983	1,266	1,345	1,807	2,262
Reporting Dealers (a)	15,532	19,173	21,334	24,845	438	455	594	782
Other financial inst.	16,023	19,144	24,357	26,775	521	557	806	995
Non-financial institutions	8,716	10,329	10,548	11,362	307	333	407	484
Interest rate market	291,582	347,312	393,138	458,304	4,826	6,063	7,177	9,263
Reporting Dealers (a)	127,432	148,555	157,245	188,982	1,973	2,375	2,774	3,554
Other financial inst.	125,708	153,370	193,107	223,023	2,223	2,946	3,786	4,965
Non-financial institutions	38,441	45,387	42,786	46,299	630	742	617	745
Stock market	7,488	8,590	8,469	10,177	853	1,116	1,142	1,146
Reporting Dealers (a)	2,537	3,118	3,011	3,479	290	405	398	376
Other financial inst.	4,295	4,473	4,598	5,496	452	549	578	616
Non-financial institutions	656	999	861	1,203	111	161	166	154
Commodity market	7,115	7,567	8,455	13,229	667	636	1,899	2,209
Gold	640	426	595	649	56	47	70	68
Other	6,475	7,141	7,861	12,580	611	589	1,829	2,142
Credit derivatives	28,650	42,580	57,894	57,325	470	721	2,002	3,172
Simple	17,879	24,239	32,246	33,334	278	406	1,143	1,889
Multiple	10,771	18,341	25,648	23,991	192	315	859	1,283
Other	39,740	61,713	71,146	81,708	1,609	1,259	1,788	2,301
Gross credit exposure	-	-	-	-	2,036	2,672	3,256	3,859

Source: BIS, Semiannual OTC derivatives statistics at end-June 2007.

Note: a) In BIS' statistics, reporting dealers are the major international banks and agents called broker-dealers in the US. No other non-bank financial institution is included in this item.

Taken as a whole, OTC derivative markets are extremely opaque, in terms of both the price level of operations and the volume and risks of positions assumed by participants. As a virtual instrument that mirrors, through different mechanisms, the risks and returns of a financial asset they enable those risks and returns to be replicated countless times through speculation and arbitrage activities. Regarding their use as a hedge instrument, they are efficient at the microeconomic level. However, with regard to the economy as a whole, one must consider that the amount of risk present in the system is not reduced with the use of financial derivatives for the purpose of hedging against risks. They only change their distribution. For the potential macroeconomic benefits of hedge operations to be felt in a crisis situation, it is necessary that, on being transferred, the risks have been diluted among a large number of small speculators or concentrated in strong portfolios capable of offsetting the resulting losses. Otherwise, in a further demonstration of the complicated interconnection between micro- and macro-economic aspects, the derivatives markets will have contributed to the worsening of the original instability, triggering cascading defaults that may give rise to systemic risk (Farhi, 2002). As the trading of these derivatives ends up forming an intricate web of credits and debits among financial institutions, episodes of high volatility in prices result in a sudden increase in the perception of supplementary credit risks, whose consolidated amount and distribution are unknown. Such episodes tend to interrupt interbank credit lines more sharply and abruptly than in the period when derivatives were largely traded on organized markets. The current crisis has confirmed previous analyses of the macroeconomic impacts of financial innovations in periods of financial fragility. But it does so on an expanded scale due to the sharp increase in the volume of traded derivatives and structured products, the increase in the numbers and types of participants, and the emergence and expansion of credit derivatives.

### **3. Responses to the deepening crisis**

The first response to this complex and bitter situation that led to a systemic risk, in which financial and banking risks affected the real economy and reinforced recessionary trends, was lax monetary policy (reduced interest rates in the USA, United Kingdom, euro area, Japan, Canada, China, India and numerous emerging countries) and liquidity loans (exchange of government bonds for liquid assets and exchange of illiquid mortgages for government bonds) by the Fed and other Core banks. The second response was the expansion of currency exchange agreements by the Fed and 14 other Core banks to facilitate the global deleveraging process. The third response

was expansionary fiscal policy, either through an increase in public spending or through US Treasury contributions to GSEs, taxpayers and low-income families with mortgage debts (and other fiscal budgets in the eurozone, Japan, the United Kingdom, China and numerous emerging countries).

The fourth response points to reforms in existing supervision norms and regulations. This alternative was suggested by Bernanke (2008b) at the Fed's seminar in Jackson Hole. For the chairman of the US Core bank, regulators generally "focus on the financial conditions of isolated institutions," while it would be necessary to analyze their interconnections and consider "potential systemic risks and weaknesses." But this is no easy task. Given the international interpenetration of assets and liabilities of banks and institutions in the global shadow banking system, regulators would have to unify, even above national borders, the bodies responsible for their implementation and execution in order to apply the same rules to all financial institutions and be able to evaluate the set of risks present in the system. This was one of the points on which no consensus was reached in the March 2009 G20 meeting. Moreover, operating rules should be established for OTC markets, which are not used to complying with any kind of regulation. This may prove to be a long and thorny debate, especially if it occurs within the sphere of the Basel Committee (Basel Committee for Banking Supervision, BCBS). Indeed, in order to be productive, the discussion should abandon one of the basic principles that have guided international supervision and regulation agreements in recent decades, namely that corporate governance and risk management by banks have evolved to the point that their decisions are the most efficient to avoid the occurrence of episodes leading to systemic risk. The crisis revealed how mistaken that principle was.

That is the reason for the attention given to the report released by the Counterparty Risk Management Policy Group III (CRMPG III, 2008), made up of the US President's Working Group on Financial Markets, comprising the main banks operating in the USA. Its goal was to provide a response of the private sector to the 2007-2008 credit crisis, providing input and complementing other initiatives by public bodies and private sector organizations such as the Institute for International Finance (IIF, 2008).<sup>248</sup> Among the suggestions put forward the following stand out: a) creation of a clearinghouse for OTC derivatives; b) requirements that counterparties in certain operations on the OTC market be "sophisticated enough to understand the operations and their risks"; c) changes in the accounting of credit-backed assets – including existing ones – that would no longer be considered "off-balance sheet" items and would be included in balance sheets. This last recommendation caused a

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248 For other proposals see Group of Thirty (2009) and Carvalho and Kregel (2009).

stir in international high finance for leading to an increase in the regulatory capital of institutions. Yet the report stated: “Costly as these reforms will be, these costs will be minuscule compared to the hundreds of billions of dollars of write downs experienced by financial institutions in recent months to say nothing of the economic dislocations and distortions triggered by the crisis.”

Both the CRMPG III (2008) and IIF (2008) reports are typical examples of the so-called “self-regulatory” mechanisms of financial institutions. These mechanisms involve taking voluntary measures. In this sense, their implementation and effectiveness would depend on the persistence of large institutions. Only they could turn these voluntary measures into regulations to be followed by all wishing to trade with them.

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# CHAPTER 21

## THE NEOLIBERAL TRANSFIGURATION AND THE FORMATION OF THE 2008 CRISIS

*Luiz Gonzaga de Mello Belluzzo*

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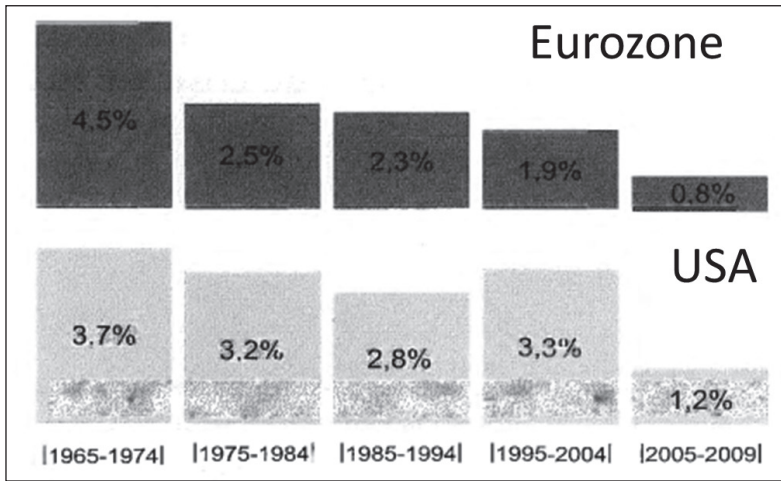
*The same rule of self-destructive financial calculation governs every walk of life. We destroy the beauty of the countryside because the unappropriated splendours of nature have no economic value. We are capable of shutting off the sun and the stars because they do not pay a dividend.*

John Maynard Keynes, 1933

### **1. Notes on the post-war capitalist internationalization**

In the second half of the 20th century, the worldwide expansion of capitalism under American hegemony changed the international division of labor and the core-periphery scheme proposed by the British hegemony. The international economic space, after World War II, was built from the integration project between national economies proposed by the U.S. State and economy. The hegemony of Uncle Sam was exercised through the expansion of the large American corporation and banks. After the economic reconstruction of Europe and the competitive response of the large European company, the rivalry between business systems would promote productive investments between the United States and Europe and the first round of Fordist industrialization in the periphery.

Chart 1 – GDP growth rates in the US and Europe



Source: Eurostat, OCDE, FMI, M. Aglietta (*Le Monde*, 18/5/2010).

During the so-called “golden age” (1947-1973), the expansion of trade involved, above all, the exchange of final consumer and capital goods between North Atlantic partners. After the Chinese Revolution and the Korean War, Japan and, later, Korea and Taiwan, would participate with their respective business systems. “Developmental” Latin America was integrated into this expansion outbreak. Brazil used national industrialization policies that, in the domestic sphere, promoted the “internationalization” of the economy, that is, the distribution of tasks between multinational corporations, state enterprises, and national private companies—the latter two in charge of producing intermediate goods and semi-processed raw materials. This stage ended in the dollar crisis in 1971 and in the unilateral decree of the inconvertibility of the U.S. currency.

Since the mid-1940s, the history of the world economy cannot be told without understanding the perils of the dollar in its role as billing currency in international transactions and as universal reserve asset. In the immediate post-war, under the aegis of Bretton Woods, the power of the convertible dollar sustained three simultaneous processes: 1) the deficit in the capital account, a product of the expansion of the large U.S. company, ensured the liquidity supply required for the growth of the world trade; 2) the reconstruction of industrial systems in Europe and Japan; and 3) the industrialization of many countries in the periphery, driven by foreign direct investment in conjunction with national development policies.

The growing imbalances in the U.S. balance of payments led to the fall of the Bretton Woods’ convertibility and fixed rates system, by imposing the

unpegging of the dollar in relation to gold in 1971 and the introduction of floating exchange rates in 1973. The continued devaluation of the dollar in the 1970s threatened the world economy.

The stagflation and low “productivity” crisis of the 1970s was faced with the rise in the monetary policy rate by Paul Volcker in 1979. The increase in the interest rate was presented then as a measure to achieve the domestic goal of controlling inflation, but the most relevant effect for the international economy was the recovery of the dollar as a reserve currency and its role in commercial and financial transactions. This promoted profound changes in the structure and dynamics of the world economy. Since the early 1980s, there was an increasing migration movement of the manufacturing industry to regions where a more competitive ratio between exchange rate and wages prevailed, as well as growing imbalances in the balance of payments between the United States, Asia, and Europe.

Over the next three decades, in the shadow of the strengthening of the dollar, the United States promoted trade opening policies and imposed financial liberalization *urbi et orbi*. Thus, their companies found the fastest and clearest path to productive migration, while their banks fully played the role of universal finance and currency managers. This means that U.S. banks were empowered to: 1) manage, on a global scale, the network transformation of debt-to-credit relations, advancing the securitization process; 2) command the movement of capital between financial markets and, therefore, affect the exchange rates; 3) promote changes in the property structure, that is, to organize the game of patrimonial and productive concentration; and 4) provide liquidity to the payment system on a global scale.

Over the past forty years, the deregulation of markets and the increasing liberalization of capital movements have profoundly altered the **game of rules**. Since 1973, the exchange rate regimes have followed towards floating exchange rate systems. It was said that they would escape from the difficulties of the “impossible trinity,” that is, the coexistence between fixed exchange rates, capital mobility, and autonomy of domestic monetary policy. The words of the new consensus proclaimed the virtues of trade opening, liberalization of capital accounts, deregulation and “decompression” of domestic financial systems.

One after the other, non-convertible currency countries promoted financial openness. In core countries, financial deregulation broke through the security dams erected after the 1930s crisis. As already mentioned, the restrictions on finance sought to prevent commercial banks from becoming involved in the financing of “speculative” positions in the wealth markets (stocks and real estate) with undesirable consequences for the soundness of banking systems.

In a leading position, major U.S. financial institutions created and diffused financial innovations that led to the crisis. Indeed, the subordination

of the dynamics of capitalist economies to the whims of wealth markets in the recent cycle of asset valorization and credit expansion was driven by an intense and creative development of financial innovations. The use of derivatives and the intense computerization of financial markets were associated with the methods of “originate and distribute” to excessively increase the volume of transactions. The combination of low interest rates – ensured by the capital movement to the United States – and loose supervisory and regulatory practices spurred fierce competition among financial institutions in the search for higher returns. To this end, it was essential to increase the volumes of “securitized” credit and to increase the leverage coefficients of the institutions carrying these assets. These characteristics, combined with the expansion of debt-to-credit relations between financial institutions, explain the enormous potential for feeding bullish processes (bubble formation), as well as the succession of financial crises that have plagued the global economy since the 1980s.

The typical care of the Keynesian era, that of “financial repression,” was aimed mainly at mitigating the instability of trading in the bond markets that represented rights over wealth and income. This means that monetary and credit policies were concerned with mitigating the effects of the fictitious valorization of wealth on the current spending and investment decisions of the capitalist class. It was about avoiding cycles of excessive appreciation and catastrophic devaluations **of already existing wealth stocks**. Ironically, the counter-cyclical policies of the Keynesian era fulfilled what they promised by suppressing the recurrence of “asset devaluation” crisis; however, by guaranteeing the value of existing wealth stocks, they increased their weight in the composition of total wealth and expanded the “coordination” power of banks and other financial institutions.

**Table 1 – Assets of the financial system in the USA -  
1970-2007 (in %, by type of institution)**

	1970	1990	2000	2005	2007
Commercial banks	33.7	24.1	17.8	18.3	18.0
Pension funds	12.0	17.0	18.6	15.7	15.1
Investment Funds	3.4	8.3	17.6	16.3	18.0
Insurance Companies	16.4	13.6	11.0	11.0	10.2
Federal agencies	3.4	10.8	12.3	12.4	12.3
ABS	0.0	1.9	4.1	6.6	7.3
Selected Institutions	68.9	75.8	81.4	80.3	80.9
Total assets (US\$ billion)	1,534	13,862	36,333	51,007	62,110

Source: Fed-Flow of Funds Accounts of the United States.

Between the 1980s and 1990s, the United States not only pressured partners to promote the liberalization of capital accounts, but also implemented policies that favored the appreciation of the dollar, which reinforced the migration movement of large enterprises to more “competitive” economic spaces. From there on, the world experienced a movement of profound transformation in the international division of labor. Asia became a producer and processing region of cheap manufactures – parts, components, and both capital and final consumer goods. Around China, a “manufacturing stain” emerged, a major importer of raw materials. With the new international division of labor, the U.S. national economy expanded its degree of trade opening, generated a growing trade deficit to accommodate the “mercantilist” expansion of Asian countries, and advanced in the transformation of its financial and capital markets.

For nearly three decades, China has been implementing national industrialization policies tailored to the expansion movement of the “global” economy. Chinese leaders realized that the constitution of the “new” world economy was the movement of the large transnational company in search of competitive advantages, with implications on route changes of trade flows. The Chinese have adjusted their national strategy of accelerated industrialization to the new realities of global competition.

The Chinese experience combines maximum competition – the use of the market as a development tool – and maximum control. They understood perfectly that the liberal policies recommended by the Washington Consensus should not be “copied” by emerging countries. They also understood that the U.S. “proposal” for the global economy had opportunities for their national development project. Thus, they controlled the Core institutions of the modern competitive economy: the credit system and the foreign trade policy, including the administration of the exchange rate. Public banks were used to direct and facilitate productive and infrastructure investments.

The rapid industrialization of China and Southeast Asian countries has shifted an important share of global demand to producers of raw materials and food. China still maintains a very high positive balance with the United States. But its deficit is growing with the rest of Asia and other trading partners. Asia’s industrialized block, articulated around China, has functioned – and still functions – as a transmission gear between the demand generated in core countries and the supply of “natural resource exporting” economies.

The well-informed reader knows that the so-called “Asian model” has a symbiotic relationship with the financial and organizational transformations that originated the new forms of competition between the dominant companies of the developed triad – the United States, Europe, and Japan.

The wanderings of the new competition did responded to the liberalization policies of the 1980s. And, in this response, the movement of the large company reconfigured the international environment. The metastasis of the developed triad business system – particularly in the United States and Japan–determined an impressive change in trade flows. It is not only a question of reaffirming the growing importance of intra-firm trade, but of emphasizing the decisive role of global sourcing, a phenomenon that is present mainly in the relocation and investment strategies that have benefited Asian economies, in particular, China, since the 1990s.

The new competition has simultaneously created: 1) the centralization of control through the waves of mergers and acquisitions observed since the 1980s; 2) the new spatial distribution of production, that is, the internationalization of value chains. Centralization of control and decentralization of production: this double-sided movement affected the nature and direction of foreign direct investment in new productive capacity, reconfigured the division of labor between producers of parts and components and “assemblers” of final goods, and, as mentioned earlier, changed the participation of countries in trade flows. The purpose of competition between large capital blocks is to ensure both adequate spatial diversification of the production base of large companies and “free” access to markets.

But the advantages of China and its Asian partners are not assured. There is no rest in capitalism. After the 2008 crisis and its consequences, countries that lost their position in the competitive manufacturing dispute – especially the United States – signal to a new round of innovations, those that would be classified as “labor savers” by the wise men who still apply production functions.

General Electric’s chief economist, Marco Annunziata, and Keneth Rogoff advocate the imminence of an intense automation movement based on the use of “smart machine” networks. Nanotechnology, neuroscience, biotechnology, new forms of energy, and new materials form the innovation block with enormous potential to revolutionize again the technical bases of capitalism.

As Marx foresaw in the *Grundrisse*:

“The development of fixed capital indicates to what degree general social knowledge has become a direct force of production, and to what degree, hence, the conditions of the process of social life itself have come under the control of the general intellect and have been transformed in accordance with it” (Marx, 1971, v. II: 230).

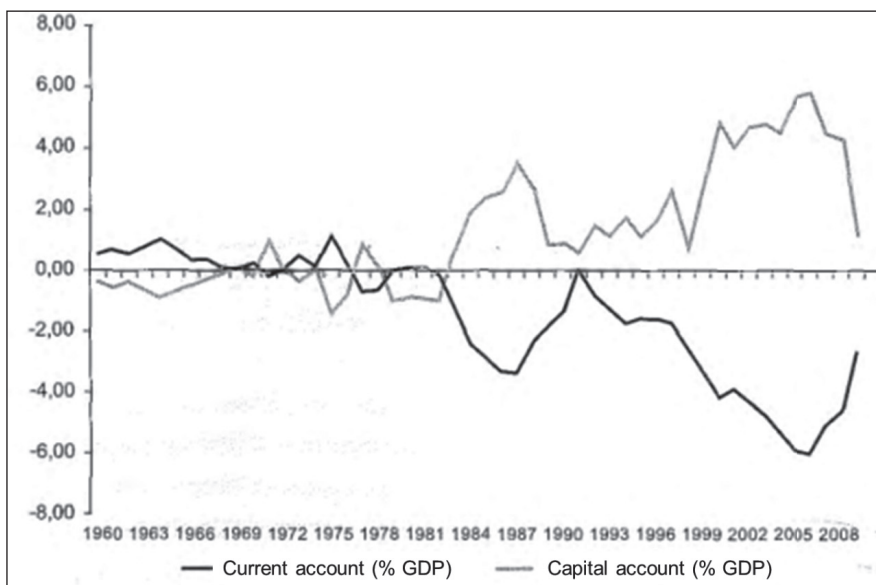
The methods that have emerged from this technical basis can only confirm their internal reason: they are production methods designed to expand the social

productivity of labor on an increasing scale. Its **continued** application makes immediate work increasingly redundant. The **automation** of the technical structure means that the application of science becomes the dominant criterion in the development of production and in the conformation of social life.

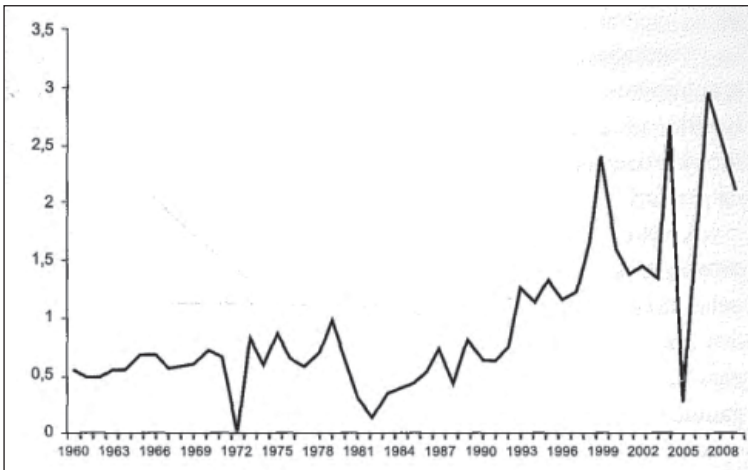
The game of the large companies is played on a board in which capital mobility jointly imposes the liberalization of trade, the control of technical progress dissemination (patent laws etc.), and the weakening of workers' bargaining power. Thus, the "new" forms of competition hide, under the daily veil of freedom, the brutal increase in the centralization of capital, the concentration of power over markets, the enormous capacity to occupy and abandon territories and to change people's living conditions.

The depth, liquidity of the markets, and innovation capacity of large U.S. financial institutions were fundamental to configure a macroeconomic dynamic that involves four correlated movements: 1) **the independent variable of the model** is the massive influx of capital to the United States; 2) hence, the inflation of assets in the U.S. economy, source of consumer and real estate credit, which contaminated other core economies; 3) this caused the expansion of current-account deficits in the United States and, in return, the accumulation of foreign reserves, especially in Asian countries; 4) the drop in prices of manufactured goods produced in emerging Asian countries had a major impact on the "moderation" of inflation rates.

**Graph 1 – Current account and capital account (% of U.S. GDP)**



Source: Facamp.

**Graph 2 – Foreign direct investment (% of U.S. GDP)**

Source: Facamp.

It is worth repeating: the combination of low wage costs, devalued currency, and the abundant inflow of foreign direct investments boosted the competitiveness of producers located in the Asian manufacturing cluster. Trade relations in the international market are no longer in favor of manufactures and against primary goods.

Theories about adjustments (and misadjustments) of the balance of payments (monetarists, Keynesians, and new classicals) are not in line with the new organization of the international economy – as the conventional assumptions about the capital movements are under negative assessment. Given the structural asymmetries of the global economy, the desired correction of imbalances through the “realignment” of currencies is problematic and dramatically reposes the issue of a world money.<sup>249</sup>

249 In his preparatory writings of the Bretton Woods meetings, Keynes had predicted that national policy coordination would hardly occur towards an international payment system capable of reducing the instabilities of global capitalism. Troubled by the memory of the monetary and currency disorders of the 1920s and 1930s, Keynes – Britain’s delegate at Bretton Woods – proposed the Clearing Union, a sort of Core Bank of Core banks. The Clearing Union would issue a bank currency, the *bancor*, intended exclusively to settle positions between Core banks. Private business would be carried out in national currencies, which in turn would be referred to *bancor* by a system of fixed, yet adjustable, exchange rates. The deficits and surpluses of the countries would correspond to reductions or increases in the accounts of national Core banks (in *bancor*) with the Clearing Union.

Keynes’ plan sought a more equitable distribution of the adjustment of imbalances between deficit and surplus countries in their balance of payments. This meant, in fact – within the established conditions – to facilitate credit to deficit countries and penalize surplus countries. Keynes’ purpose was to avoid deflationary adjustments and keep economies on the path of full employment. He also imagined that capital control should be “a permanent feature of the new world economic order.” But the utopia of the “supranational currency”

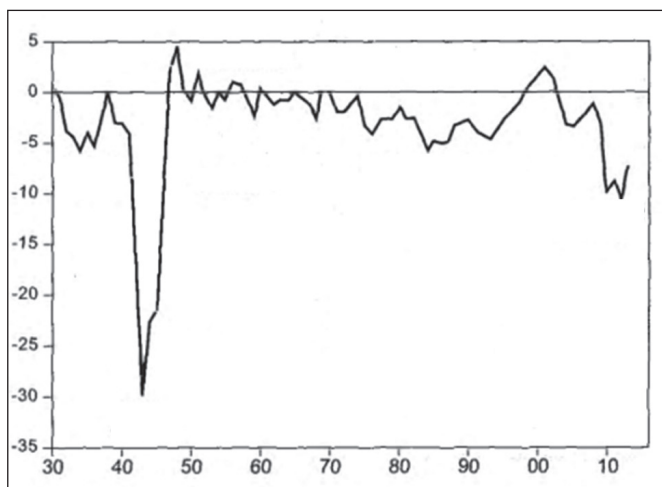


## 2. Financial openness, credit cycles, and asset inflation

The association between capital account liberalization and financial deregulation led to the excitement of credit cycles, the formation of bubbles in asset markets, and the succession of banking, foreign exchange and sovereign debt crises in the periphery.

Reagan’s economic policy, in his initial move between 1981 and 1982, caused a strong recession sponsored by high real interest rates. Since 1983, the drop in real interest rates has joined the fiscal deficit and the overvalued dollar to result in the negative balance in the balance of payments, for the joy of the export-led growth group: Germans, Japanese, Koreans, and other Asians. Under the pretext of reducing the state’s role in the economy, “neo-liberal” policies fueled the deficits and the debts. In the United States, the “supply economics” and its favorite daughter, the Laffer curve, came into vogue, advocating the reduction of taxes for the rich – “savers” – and companies. This was the argument of the supporters of supply-side economics: the systems of progressive taxation of income demotivate production and savings that generate new investment. Reagan’s macroeconomics defended the trickle-down thesis: working-class and government would receive the benefits of freely accumulated wealth by the rich entrepreneurs in the form of rising real wages and increased tax revenues.

**Graph 3 – U.S. public deficit (1930-2012)**



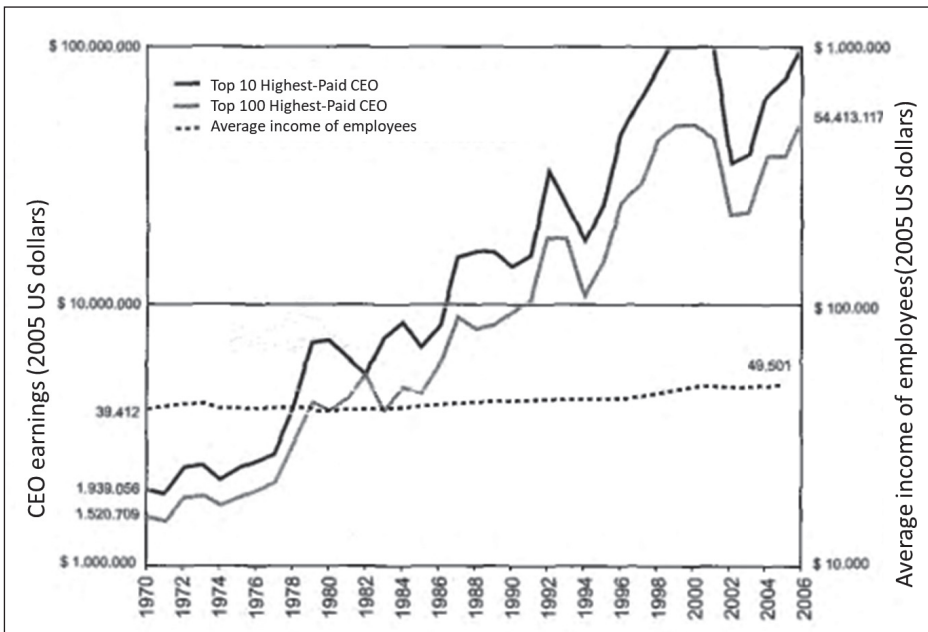
Source: Economic Report of President, 2011.

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was defeated by the international arrangement proposed by the US State, then registering a surplus and holding more than 60% of gold reserves. It was, of course, about preserving the privilege of *seigniorage*,

With the exception of the 1990s, the period of the “internet bubble” development, the trickle down hypothesis did not deliver what it promised. The migration of large companies to low-wage regions, financial deregulation, and the huge amount of tax exemptions and favors for businesses and wealthy people did not promote the expected increase in the investment rate in the U.S. territory and, at the same time, produced the income stagnation for middle- and low-income classes, the persistence of budget deficits, and the growth of public and private debts. The chain of deceptions was accompanied by the expansion of current account deficits and by the transition of the United States from a creditor to a debtor country.

**Graph 4 – Unequal earnings – Average executive income vs. average income of employees in the USA (1970-2006)**



Source: Emmanuel Saez, UC-Berkeley.

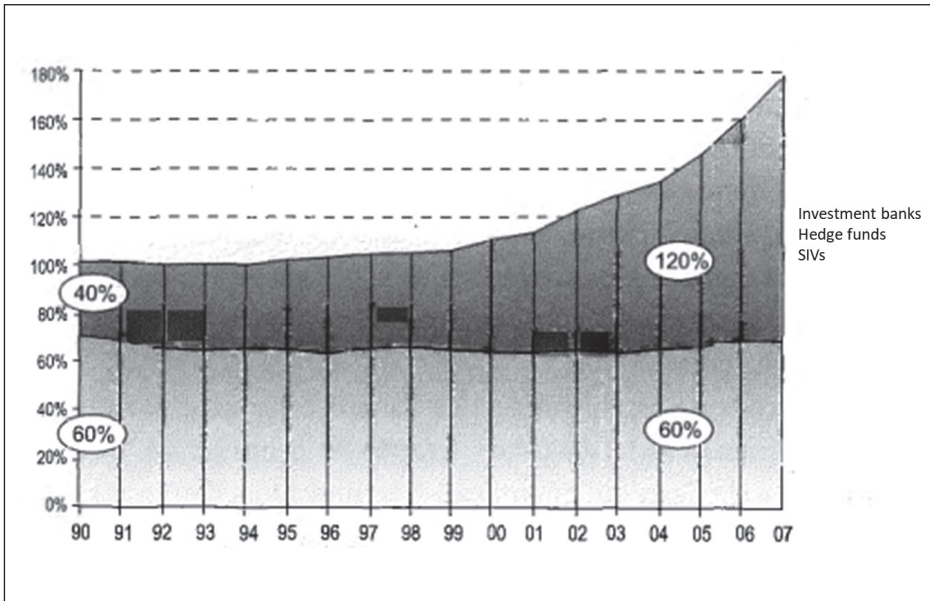
However, the deceptions led to the expansion of the U.S. public debt, a crucial phenomenon to keep the big banks afloat in the outbreak of the foreign debt crisis of the early 1980s. Loaded with rotten assets in Latin America and other peripheral countries, banks replaced peripheral debt in their portfolios with bonds from the world’s most powerful government. The issuance of new debt by the U.S. government was important to boost the development of capital markets, i.e. of securitization and derivatives. The

U.S. securities, for their liquidity and security, stimulated the expansion of “securitized” credit operations.

Since the 1980s, participation in loans provided to companies and households by deposit banks was rapidly lost. These institutions carried the loans in their portfolios until maturity. The importance of institutions dedicated to issuing, negotiating, and evaluating the quality of public and private bonds increased. This is the growing moment of large institutional investors, investment funds, and hedge funds. It is not by chance that the advance of securitization coincides with the “swelling” of private pension funds and the pressure in all countries to reduce the role of pension systems, based on the simple allocation system and their replacement by the capitalization “model.”

The countercyclical monetary and fiscal policies that were associated with the “financial repression” of domesticated capitalism of the 1950s and 1960s continued to be implemented in the deregulation stage and, thus, continued to suppress the recurrence of crises of deflation of assets and “capital devaluation.” A new agenda of antithetical conventions arises, different from the one that prevailed between the end of the 19th century and the Great Depression. In fact, a situation of permanent “moral hazard” was created: whatever the intensity of optimism, Core banks would interfere to cure the hangover. The markets cultivated the perception that losses would be limited.

The stabilization actions of Core banks and Treasuries built the basis for the advancement of the “securitization” and market deregulation processes. As stated earlier, U.S. government bonds, without risk and with prompt liquidity, allowed the formation of a pyramid of securitized assets, ranked by rating agencies according to the risk/liquidity ratio. The support of the financial wealth value stimulated the use of leverage techniques for the purpose of raising portfolio yields, favoring the concentration of most securities assets in a small number of financial institutions that were **too big to fail**. The administrators of these institutions gained power in defining strategies for the use of household “savings” and the accumulated profits of companies, as well as in the direction of credit. In the international sphere, the opening of capital accounts led to the spread of floating exchange rate regimes that expanded the role of “financial assets” of national currencies, often to the detriment of their relative price dimension between imports and exports. Currency fluctuations led to arbitrage opportunities and speculation to internationalized financial capital and made domestic monetary and fiscal policies hostage to the volatility of interest and exchange rates.

**Graph 5 – Financial system vs. banking system**

Source: Apex / Brender & Pisari, Fed, FMI, Hedge Fund Research.

In the wake of deregulation and liberalization of capital accounts, large institutions built a web of “internationalized” debt-to-credit relations between deposit banks, investment banks, and institutional investors. The expansion of global interbank markets and the improvements of the payment systems contributed to the advancement of these interrelations. Investment banks and the other *shadow banks* moved closer to the monetary functions of commercial banks, fueling their liabilities in the “wholesale money markets,” based on short-term investments of companies and households. Notwithstanding, in the 2000s, intra-financial debt grew faster than household and business indebtedness, as a proportion of U.S. GDP. The “endogeneity” of money creation through the expansion of credit came to perfection in its relations with the growth of the stock of near-currencies sheltered in money markets funds. These phenomena correspond to what Marx called “private control of social wealth,” a phenomenon that happens in the expansion movement of the capitalist system.

After the separation of functions between commercial banks, investment banks, insurance companies, and associations in charge of mortgage loans, large financial conglomerates sought to escape prudential rules, promoting the process of originating and distributing, boosting credit securitization and the leverage of positions financed by money markets. It was such North

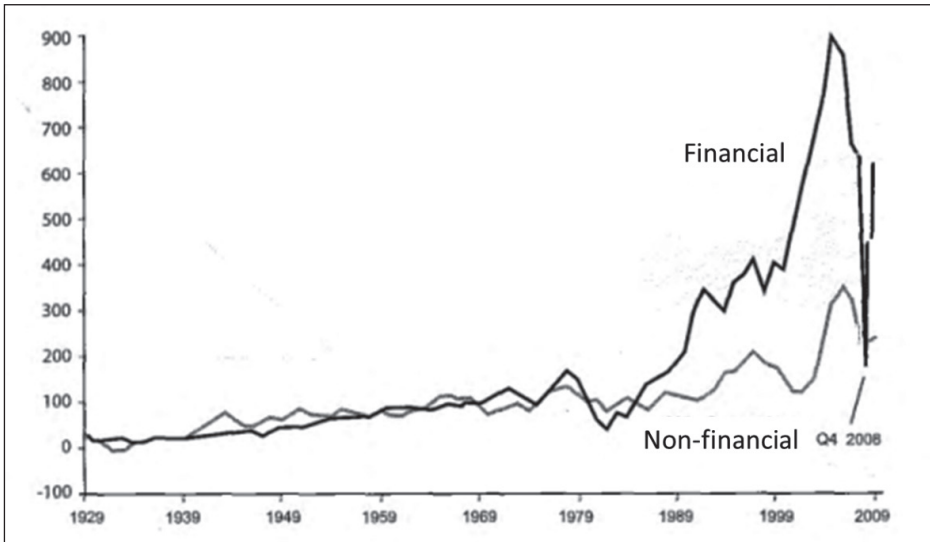
Americanized financial system that promoted the expansion of consumer credit and the consequent “release” of this spending component from the restrictions imposed on families by the evolution of current income. This phenomenon brought the consumption dynamics closer to the spending financing form that sustains the expansion of investment, adding fuel to financial instability.

The crisis triggered in 2008 demonstrates clearly how the transformations that have occurred in the last thirty years in the size of institutions and in the instruments of credit mobilization increased the participation of consumption in the formation of effective demand and, at the same time, accentuated the instability of capitalist economies. The adventure of unruly credit is not unknown to those dedicated to the study of the matter, but it has been reproduced sharply in the recent cycle.

The transformations in the financial orbit and the concentration of monetary policies in the models of inflation targets caused a strong speculative movement, first with technology companies and, then, with residential real estate. The mortgage credit adventure spread the “wealth effect” to the mass of consumers. This new moment of “asset inflation” was based on three determining factors: 1) the degradation of credit risk assessment criteria and the “improvement” of the methods of capturing primary debtors—middle- and low-income households, whose ability to pay was weakened due to the income stagnation of the past thirty years; 2) the extension of the securitization space of mortgages and other receivables, through the creation and multiplication of assets backed by household debts; and 3) the possibility of “extracting” new loans—supported by the valorization of real estate—intended for the acquisition of durable goods, air tickets, and even tax payment.

In Europe, the introduction of the single currency was simultaneous with the “American transition,” which shifted the stock bubble of technology companies to the real estate market between the late 1990s and the following decade. Monetary policies to digest the excesses of the previous bubble paved the way for the formation of a new operation stage that Ben Bernanke called a “financial accelerator.”

**Graph 6 – Profitability: financial vs. non-financial companies - 1929-2009 (USA)**



Source: Bureau of Economics Analysis.

The excess liquidity injected by the Federal Reserve’s interventions and the reduction in the U.S. monetary policy rate spilled its effects on the global market. At the dawn of the euro, the elimination of foreign exchange risk by the adoption of the same currency by “Greeks and Trojan” caused the drop in spreads between German bonds and the costs in placing public and private papers in the countries of the so-called periphery. The drop in interest rates and the extension of deadlines triggered private indebtedness in Spain, Ireland, Portugal and others. This spurred an intense competition between German, French, Swedish, Austrian, and English banks. The competition between them promoted a large “movement of capitals” that flowed from the Core to the periphery of Europe.

**Table 2 – Europe – Gross private and public debt (% of GDP)**

	France		Germany		Italy		Spain	
	Priv.	Pub.	Priv.	Pub.	Priv.	Pub.	Priv.	Pub.
2007	196	65	200	60	214	105	317	40
2009	203	78	207	73	214	115	334	64

**Table 3 - Exposure of European banks to public and private debt (Dec. 2010 in US\$ billion)**

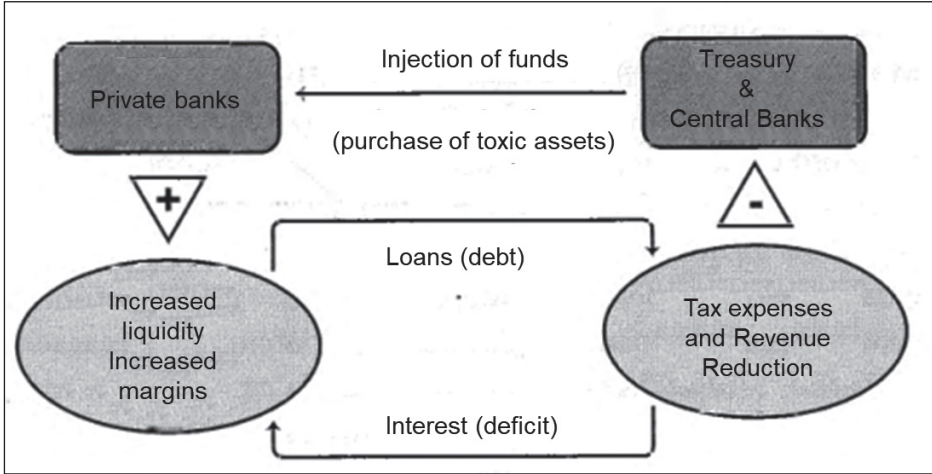
	Greece	Portugal	Ireland	Spain	Italy	Total
France	53.00	27.00	36.8	141.5	389.1	647.4
Germany	34.0	36.4	118.2	181.9	162.3	532.8
United Kingdom	13.1	24.4	152.4	112.1	66.7	368.7
Holland	4.5	5.3	19.1	77.0	45.4	151.3
Spain	1.1	86.00	11.1		30.7	128.9
Belgium	1.8	1.6	45.6	20.3	23.7	93.0
Portugal	10.2	-	22.2	25.9	2.9	61.2
Italy	4.2	4.1	14.2	29.9	-	52.4
Switzerland	2.7	3.1	14.7	14.6	14.2	49.3
Austria	3.1	1.6	3.0	6.8	22.2	36.7
Ireland	0.7	2.5	-	13.9	13.3	30.4
Denmark	0.1	0.3	16.8	2.0	0.4	19.6
Sweden	0.1	0.4	4.8	3.7	1.3	10.3
Total	128.6	192.7	458.9	629.6	772.2	2,182.0

Source: *Financial Times/BIS*.

Spain can be used as a paradigmatic case: it lived the euphoria of the housing bubble and the delights of the consumption of “enriched” families with the appreciation of real estate. Before the euro, it was impossible to obtain loans of twenty years with fixed rate in Spain. After the introduction of the single currency, the Spanish people were offered rapidly expanding credit with inviting rates and deadlines. These conditions boosted the housing market and expanded the bubble that generated the “Golden Decade” euphoria. The fiscal fundamentals were excellent: Spain’s fiscal surpluses and low debt-to-GDP ratio dropped the Germans’ jaws and filled their pockets. Imports from Iberia – as well as other peripherals – boosted Germany’s trade surpluses and produced sour deficits in the Spanish current account.

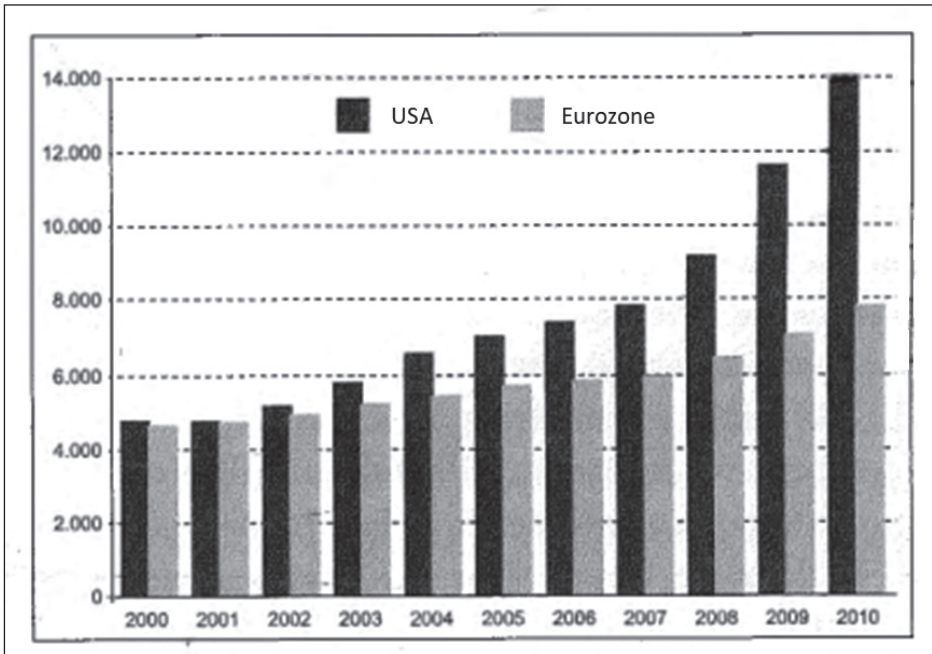
The European crisis is a lesson on the privatization of gains and socialization of losses. In face of the collapse of asset prices, Core banks were compelled to take liquidity and capitalization measures for banks drowning under unrecoverable credits. To cure the “hangover” of real estate “drinking excess”, governments swallowed up the stock of private debt and expelled a mountain of government bonds.

**Chart 2 – Global mechanism for the transformation of private debt into public debt (socialization of losses)**



Source: Apex / FMI, *Perspectivas da economia mundial* (jun. 2011).

**Graph 7 – Transfer of private debt to the State: the explosion is a good deal for banks – Total government debt (in US\$ billion and € billion)**



Source: Apex / FMI, *Perspectivas da economia mundial* (jun. 2011).



### 3. Between incentives and madness

Fertilized in the insides of deregulation and legitimized by the academic bosses of efficient markets, the organization of contemporary finance generated a parade of perverse incentives. On the list of its accomplishments are abusive leverage, obsession with volume, limitless competition, and generous remuneration for executives.

In the first quarter of 2007, the total debt stock of the non-financial sector in the United States reached more than \$35 trillion (for a GDP of \$15 trillion), more than the double of the GDP. This amount includes, in addition to private debt (especially of households), the total public debt and financial liabilities of the public agencies in charge of financing home acquisition. More impressive was the growth of intra-financial debt: on the eve of the crisis, indebtedness among financial institutions reached 120% of GDP.

Total debt grew six times more than GDP, with increasing participation of federal, state, and municipal governments. Large corporations sought to reduce their rate of indebtedness by seeking rapid “deleveraging” to stabilize the debt-to-equity ratio. Families, however, were not afraid, making new commitments or rolling the old ones still at high speed. Thus, household debt jumped to 130% of disposable income.

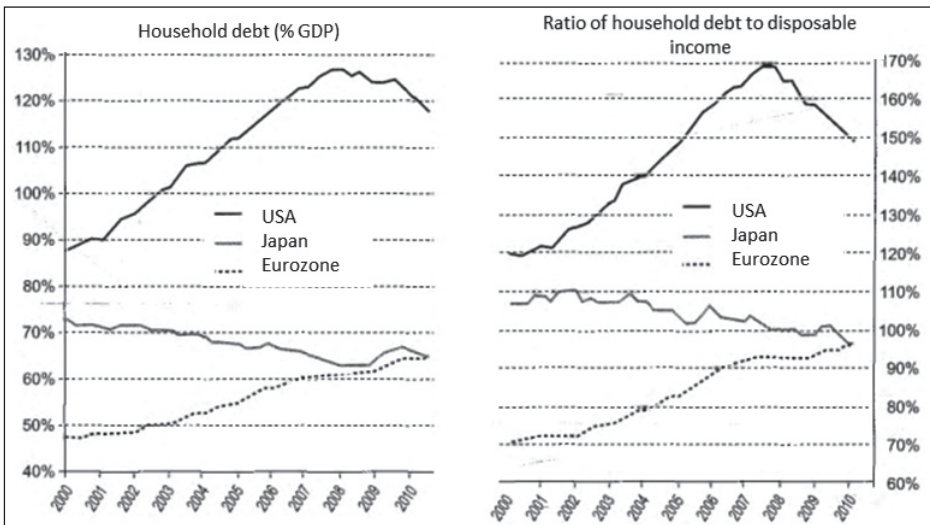
In the period of euphoria leading up to the crisis, commercial banks, investment banks, pension fund managers, mutual funds, private equity funds—not to mention sophisticated hedge funds – succumbed to the impersonal forces of competitive mimicry, referred to in the vulgar market language of as “herd behavior.” All consolidated the conviction that they were shielded against market, liquidity, and payment risks. The climate of confidence, as usual, disseminated the systemic risk that the operators of large financial institutions imagined to have driven away with the use of derivatives.

The banks tried to “pack” the credits – the good, the bad, the horrible—and remove the “commodity” from the balance sheets, through the creation of Special Investment Vehicles (SIVs), bank “creatures” used to distribute risk. Not only did they fulfill the function of releasing equity from institutions to secure new loans, but they served to maintain the “originating” portfolios neat. Such tricks went around the Basel Accords that impose the cost of equity requirements for risk coverage. SIVs issued commercial papers to finance positions in securitized assets – the assets backed commercial papers. Short-term instruments issued to “load” positions in longer papers, the commercial papers are especially sensitive to changes in the liquidity conditions of financial markets. Thus, banks were obliged, in times of stress, to provide liquidity to keep their “creatures” afloat. The collapse in subprime credit prices has

set off commercial papers markets and left banks in a bad position. This is how wealth markets work: poor risk assessment becomes endemic, especially during periods in which low volatility and well-behaved inflation predominate.

During the so-called Great Moderation of the 2000s, the reduction in volatility of asset prices and currencies, the expansion of liquidity, and very low interest rates led to the exasperation of “leverage.” The securitization techniques of bank credits, the use of derivatives, and the intense computerization of markets increased the transaction volume. In recent years, the transformations in intermediation practices, methods, and models of “pricing” assets and associated risks—as well as in the hierarchy and role of institutions—have been rapid and intense. Such innovations allowed greater fluidity in transactions, stimulated greedy securitization, and reckless “leverage.”

**Graph 8 – Indebtedness replaces income growth**



Source: Apex / Banque de France, BCE.

Core banks and other regulatory authorities were caught up in the network of interests that commands credit and asset valorization in wealth markets. The alleged advances in risk management techniques and the stricter rigor imposed by the Basel Accords hid the incessant violation of all standards and the old and fatal combination of euphoria, bad evaluation of credits, and position concentration in assets of the same nature.

Paul Samuelson noted that competitive financial markets are micro-economically efficient, because price divergences between assets of the same class can be eliminated by arbitrage. However, they are “inefficient” from a macroeconomic point of view, because credit bubbles affect “all” assets and

arbitrage is not possible. My interpretation of old Samuelson seems to be correct: microeconomic “fundamentals” contradict with the idiosyncrasies of the collective behavior of investors.

Extreme price movements – those in Gaussian stochastic models would be at the tail of probability distribution – cannot be considered enlarged versions of small fluctuations. Euphoria episodes deform the probability distribution itself. They are called “tail events.”

Keynes, in his *Treatise on Money*, considered that the stable functioning of markets that evaluate wealth bond stocks depended on the division between “bullish” and “bearish” opinions. This means that markets function smoothly and no changes can disrupt the trajectory of the economy when market opinion is evenly divided between those who bet on rising bond prices and those who believe in their drop. If, however, opinions are focused in one direction, financial markets enter a cumulative process of rising or generally dropping asset prices. In the euphoric phase of the credit cycle, opinions focus on the “optimistic” wing—the bulls command the herd. Once the “reversal of expectations” is exposed, market opinions tend to focus around a “bearish” position. Organized or over-the-counter financial markets trade promises and are, therefore, subject to fluctuations and changes in the investors’ expectations and to the risk of endogenous liquidity contractions, that is, the misfortune of trading an asset with “capital loss.”

Analysts of all hues and trends invoked the economic studies of the American Hyman Minsky on the financial cycle. Considered a heterodox, the Keynesian Minsky formulated hypotheses about the formation of asset prices in monetary economies in which competitive dynamics generates liquidity. Liquidity is not an intrinsic property of any particular asset, but it stems from private decisions, taken in uncertain conditions. Such decisions cannot escape the compulsion to win the lead and beat the competitor, much less are they able to control the conditions in which liquidity is restricted. It is, therefore, a systemic phenomenon, in the sense that it is the result of an environment in which the strategic decisions of protagonists are mimetic and precariously supported by expectations of other expectations.

In abundant and cheap credit conditions, the expectations of asset valuation cause, in fact, an “explosion” of prices whose continuity is sustained by credit concentration in the search for assets of higher expected valorization. The confirmation of anticipated capital gains reinforces speculative fever and encourages households, companies, banks, and other intermediaries to increase their degree of “leverage” in the asset markets – financial, instrumental, and real estate – favoring the progression of the “inflationary” outburst.

The magazine *The Economist* reports a meeting of risk managers held in January, 2007. One of them asked from where could a liquidity crisis arise.

No one risked a pessimistic prediction in the face of four years of spread compression, “buddy” interest rates, no relevant default, and historically low volatility. “The most benign environment of the last twenty years,” the participants concluded.

The agents were surprised by an unanticipated drop in real estate prices and financial assets created by the originating and distributing operations. At this point, the prospect of losses forces the race for the liquidation of leveraged positions for margin coverage, greatly expanding the contraction of market liquidity and untying the prices collapse. The trauma in these markets has enormous potential for contamination, causing, in general, leaks to assets with supposed better reputation and quality, such as the U.S. Treasury bonds, whose yields dropped to extraordinarily low levels.

Banks involved in the financing of positions in the “securities” markets are obliged to take credit. This defensive movement aggravates the liquidity crisis, affecting the economy as a whole, including companies and sectors that have healthy balance sheets. The payment crisis is triggered. The payment network formed by the banking system is crucial for the proper functioning of financial markets. It is the infrastructure that facilitates the clearing and settlement operations among the protagonists of the monetary economy. Difficulties in these institutions, which are at the basis of the system of liquidity and payment provision, inevitably become difficulties for the whole economy.

In the absence of timely relief offered by a last resort provider, the spread of panic inexorably leads to the contraction of credit, the disruption of the payment system, and a bank run.

The outcome of Core bank maneuvers is conditioned to changes in the “state of expectations” of wealth-possessors. Experience of the 2007 crisis shows that liquidity injections designed to prevent price collapse and inter-bank markets paralysis indeed contained the collapse of prices, but failed to revive the economy. If the degree of mistrust and pessimism is high, the wealth-possessors will react negatively, keeping their wealth in liquid form.

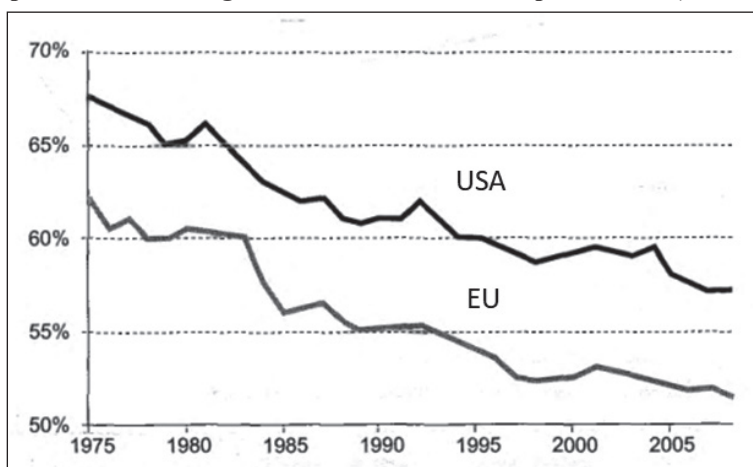
Banks, “final” funders of positions in these depreciated assets, will have to digest losses and, to do so, they will try to re-compose their capitalization and liquidity levels by restricting the supply of credit to other agents, including those best placed in the risk assessment ranking. The Federal Reserve overturned the rules and provided bailouts to investment banks. It decided to open the floodgates of liquidity to keep the bizarre creatures of “infectious greed” alive. Markets applaud and proclaim that monetary authorities, representing the collective interest, cannot let contagion, asset deflation, and credit contraction prosper nor deepen. Core banks must be willing, in these circumstances, to provide relief for markets in crisis.

This is the crucial paradox of contemporary finance: the “private centralization” of currency and credit in “too big to fail” institutions spreads – in the globally integrated financial markets – the competitive process of generating and distributing assets with enigmatic pricing in different currencies, subject to the floating exchange rate regime. When the wheel of fortune breaks, with price collapse and wide fluctuation of currencies, the remedy is to resort to state centralization to prevent the destruction of credit and its currency, that is, to prevent the disorganization of market infrastructure.

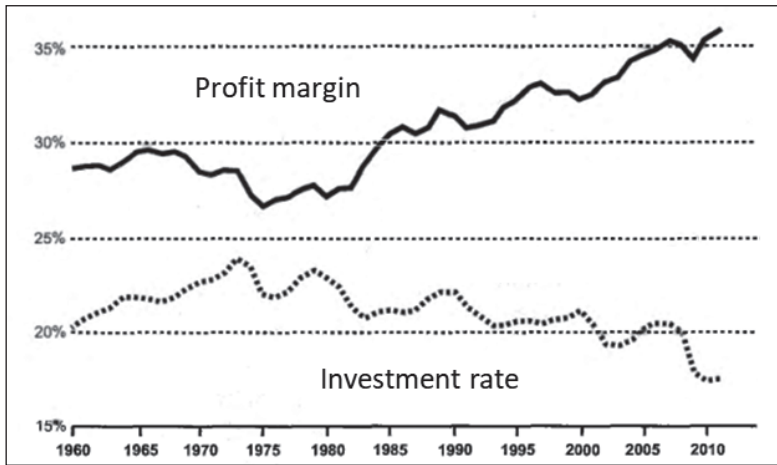
The Core banks of the capitalist world are the managers of the universal monetary system and, therefore, in charge of “opening their balance sheets” to ensure the survival of the property right, even if some owners have to be sacrificed. Core banks are doomed to carry out their mission to prevent the financial crash and to contain the huge mismatch in the balance sheets of the private sector caused, simultaneously, by the disorderly devaluation of assets and the rigid nominal debt. The negative impacts on the real economy – that of employment and income – need to be remedied. The action of governments prevents that the deterioration of balance sheets promotes the spending collapse of businesses and families.

These are the real rules of the game: when the crisis becomes acute and widespread, there are no limits to save capitalism from itself. It is about appropriating the values created by the effort of workers and placing the survival of property relations above the regular “market” conventions that, in “normal” times, supposedly regulate the assessment of private wealth.

**Graph 9 – Share of wages in GDP - USA and European Union (1975-2008)**



Source: Apex / Dew-Beker & Gordon, Ameco Données Base (Com. Européenne).

**Graph 10 – Profits x investment - USA and European Union (1975-2008)**

Source: Apex / Ameco.

With damaged credibility due to their own exploits until recently, “markets” were reinvigorated by formidable injections of money, a spectacular “inflation” of monetary liabilities of the Core Bank. The money was generously distributed in an “atypical” form of cooperation between the previously independent Core banks and austere national treasuries. The former housed the financial scum of the subprime and adjacencies in their balance sheets and set up programs to exchange rotten papers for liabilities of their issuance – that is, money. While treasuries emit government bonds to protect private balance sheets in an unstable situation, Core banks promoted the purchase of these securities through Quantitative Easing operations, with the purpose of maintaining long-term interest rates low.

In addition to their classical functions of last-resort lenders and regulators of liquidity and credit conditions, Core banks promoted implicit transfers of ownership in debit-credit relationships, without violating the principles of private wealth appropriation, even though, as already mentioned, some individual owners had been sacrificed.

#### **4. The “open” macroeconomics of the balance sheets in the neoliberal era**

Started in the second half of 2007 and accelerated in the unfortunate episode of the Lehman Brothers crash in September 2008, the crisis offered the opportunity to understand the transformations that occurred in the relations between financial innovations, financing of household consumption

expenses, business investment, and income and employment generation in the globalized economy.

The economist of the Bank for International Settlements (BIS), Claudio Borio, revealed the origin and nature of imbalances that most banking analysts strive to hide under the rich tapestry of their invaluable knowledge.

In the genesis of the development and configuration of the expansion cycle that culminated in the crisis is the rearrangement of portfolios, a financial phenomenon: the gross flows of private capital from Europe and the periphery to the United States. Financial interpenetration led to the diversification of assets on a global scale, thus imposing the “internationalization” of the portfolios of wealth managers. The United States absorbed a volume of external capital greater than current account deficits, benefited by the attraction capacity of its broad and deep financial market. In a world where capital mobility prevails, determination does not go from current account deficit to “external savings.” It is the high liquidity and high “elasticity” of global financial markets that sponsor the exuberant expansion of credit, asset inflation, and indebtedness of families addicted to hyper-consumption.

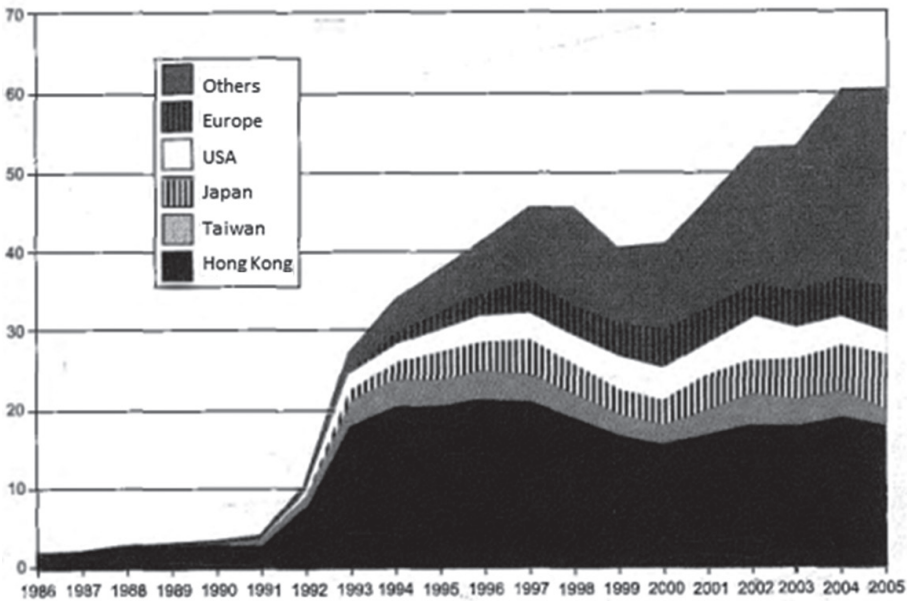
Borio demonstrated that, in the success of inflation control policies, “global factors have become more important than domestic factors.” He refers to the important changes that affected the conditions of supply and demand in the globalized economy before the financial crisis. These changes, already analyzed, are:

1. The large manufacturing company moved to regions where the unit cost of labor is significantly lower. In these markets of unlimited supply of labor, wages are prevented from keeping pace with productivity growth.
2. The high “exploitation rate” in emerging Asians prompted the rapid creation of new production capacity in the manufacturing industry, with productivity gains, intensifying global competition among manufacturing producers.
3. The foreign trade policies of emerging countries in process of industrial “upgrading” combine sour trade balances, reserve accumulation, and real exchange defensive policies.

The combination of these phenomena—low inflation and excessive elasticity of the financial system – accentuated the pro-cyclical nature of credit supply and stimulated the creation of cumulative problems in the balance sheets of households, companies, and countries – with serious consequences for the effectiveness of national monetary policies. In Borio’s opinion, the Core issue lies in the exceptional growth of gross capital flows between core

economies, particularly between Wall Street and the City of London. This means that changes in debt and credit relations and assets of banks, companies, governments, and households were much more intense than those reflected by net results revealed by the observation of current account deficits. The “financing” of the national debt of the U.S. by the reserves of emerging countries, especially China, is an accounting illusion that hides macroeconomic relations: the movement goes from gross capital flows to the expansion of credit to U.S. consumers, and from there, to current account deficit. Chinese reserves close the credit-spending-production-savings circuit with the “final financing” of the U.S. current account deficit. So, even if the United States had not presented external deficits throughout the 1990s (and the first decade of the 21st century), capital inflows would have been robust.

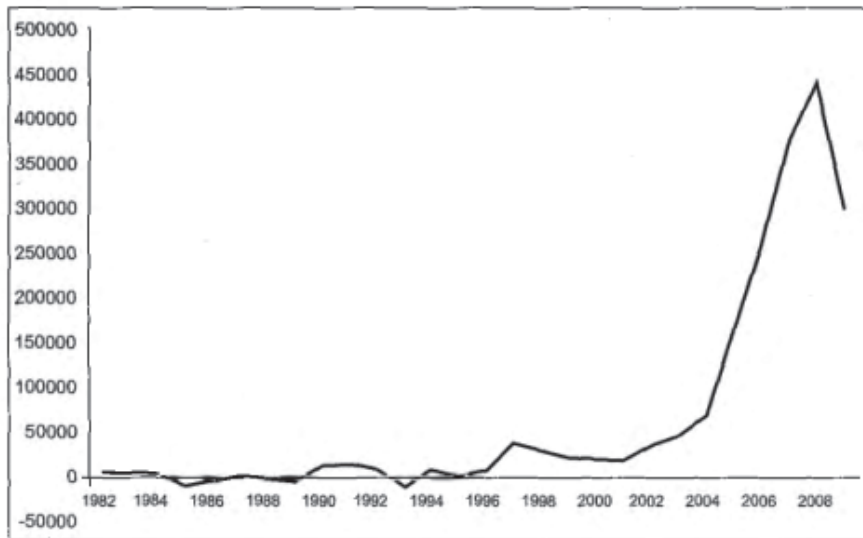
**Graph 11 – China: direct investment by country of origin (US\$ billion)**



Source: Chinese Statistical Yearbook.



**Graph 12 – Current Account (China - in US\$ million)**



Source: Chinese Statistical Yearbook.

The self-development of the financial system, invested in its global format and incited by its “innovative vocation,” reversed the macroeconomic relations that are in the manuals and courses of the most famous universities on the planet. Financial innovations and market integration promote credit exuberance, reckless leverage of consumer households and, of course, the deterioration of the balance sheet quality of creditors and debtors. And it is this “arrangement” that generates the current account deficit – not the other way around.

## **5. The origins and nature of the current crisis**

As shown in the charts and tables gathered in this chapter, the articulation between the following factors have driven the recent cycle of internationalized financial expansion: 1) capital flows to the U.S. market; 2) innovative methods of financial “leverage”; 3) the appreciation of real estate assets and excessive indebtedness of households; 4) migration of manufacturing production to low-cost labor countries; 5) the expansion of inequalities; 6) the insignificant evolution of income of the employed population; 7) the degradation of progressive taxation systems; and 8) the recurrence of fiscal deficits and the expansion of public debt.

The slow evolution of incomes led to the vertiginous expansion of credit to boost household consumption. Based on the “extraction of value” caused by the escalation of property prices, consumer spending reached high share in the formation of final demand in almost all countries in the developed regions. Meanwhile, companies in the “consumerist” countries were trying to intensify the strategy of separating in different territories the new capacity formation, the expansion of consumption, and the capture of results. The companies significantly expanded the ownership of financial assets as a way to change the management strategy of accumulated profits and indebtedness. The goal of maximizing cash generation determined the shortening of the business horizon. The expectation of change in the prices of financial assets began to play a very relevant role in companies’ decisions. Financial profits easily surpassed the operational ones. Business management was thus subjected to the dictates of short-term equity gains, and financial accumulation imposed its reasons on investment decisions – those that generate employment and income for people.

Large companies moved their manufacturing production to regions where low wages, devalued currency, and high productivity prevailed. Americans and Europeans rushed to Asia and the Germans, even if frugal, jumped to their Eastern neighbors. From these places, they exported cheap manufactures to their countries and regions of origin or under their influence. Lulled by the expansion of household spending, they made profits and accumulated cash (usually in tax havens). The displacement of U.S. companies fueled current account deficits in the territorial economy of the motherland. Despite the move to Eastern Europe, the Germans financed, through their banks, the expenses that produced the huge current account deficits of its European neighbors.

The world did not converge on the floating exchange rate regime. Quite the opposite: the coexistence between floating exchange rate regimes and managed or fixed rates became the trademark of the world economy. The number of countries that adopted currency “anchoring” in the dollar or in a basket of currencies increased considerably. After the Asian crisis, the economies in that region, particularly China, resumed *export* strategies with strong accumulation of reserves and very pragmatic capital control measures. In face of the flood of capital engaged in arbitrage with interest rates and unashamed speculation with their currencies, developed and emerging countries struggle to avoid credit bubbles and try to obviate the unwanted and harmful effects of currency appreciation.

The entry of China and other emerging markets as important players in international manufacturing trade fostered a strong deflationary movement, contributing to price stability within the global economy. Commodity prices

remained subdued until the late 1990s. After that, the situation changed and, on the eve of Lehman Brothers' collapse, commodity price indexes reached their highest level since the second oil shock of 1979. After the crisis, commodity prices began to respond elastically to the impulses of Chinese demand and, above all, to the excess liquidity engendered by the actions of the Core banks of developed economies.<sup>250</sup>

The drop in investment in the formation of aggregate demand from core countries was more than offset by the acceleration of this spending component in the emerging Asians. Therefore, the global balance sheet registers the widespread creation of surplus productive capacity, particularly in the high- and medium-tech sectors affected by international competition.

When the engines reversed, driven by the drop in real estate prices and the devaluation of financial assets associated with consumption, a stock of "excessive" household indebtedness was released, calculated in relation to the expected income flows and the collapse of residence values. Drowned in idle capacity on a global scale, companies cut capital spending even further. Relieved of the burden of bad assets – thanks to the action of Core banks – financial institutions accumulated surplus reserves, but hesitate to lend, even to their congeners. Between the drop in revenues, the automatic expansion of expenses, and the bailout of dying banks, fiscal deficits increased, fattening the banks' portfolios with government debt. On the other hand, current account imbalances of the balance of payments did not improve nor worsen.

Over the past three years, households with negative debt/equity ratios and companies with excessive idle capacity raced to the comforts of liquidity and equity rebalancing. Countries and regions are clenching: some to reverse external deficits, others to maintain their surpluses. Governments are rehearsing fiscal austerity policies. Such decisions are "rational" from a microeconomic point of view and virtuous from the perspective of domestic finance management, but perverse to the economy as a whole. If everyone wants to cut spending, make surpluses, and become liquid at the same time, the result can only be the drop in income, employment, and the growth of the "weight" of debts whose "value" is fixed in nominal terms. It is the paradox of deleveraging, also known as the "hell of good intentions", whose flames crackle in the well-known – but always careless – territory of the fallacies of composition. If interpreted correctly, the fallacies could advise us to discern the macroeconomic foundations from the microeconomic ones.

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250 At first, the continued drop in manufacturing prices pushes global inflation down. In a second round, the demand pressure of emerging countries on natural resources raises the commodity prices.

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## CHAPTER 22

# THE GREAT DEPRESSION OF THE 1930s AND THE CURRENT CRISIS: counterpoints and reflections

*Frederico Mazzucchelli*

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The unfolding of the international crisis that began in 2007 allows establishing clear contrasts with the shock that affected the world between 1929 and 1933. First of all, the **origin** of the disturbances, in both cases, was the proliferation of financial operations of doubtful ballast, promoted by the disproportionate expansion of credit, in the absence of effective rules of regulation and discipline for the financial system. Both on that occasion and in the recent crisis, the root of the storm was the unimpeded action of private agents, provided by the existing loose regulation of the world of finance. Not by chance, in both cases the mishaps of the financial system were the Core factors in triggering and spreading the crisis. There is no doubt that the unbridled speculation of the 1920s and the “derivatives festival” of the current crisis were endogenous constructions of the U.S. and European financial system – typical creatures of a credit cycle, which involved banks, financial intermediaries, companies, families and nations, and resulted in the assembly of a complex and intricate web of indebtedness. Asset inflation – in both cases – was encouraged by abundant credit, in the optimistic expectation of future gains. With the reversal of expectations, the betting castle collapsed, leaving only the trail of debts. Once the crisis was initiated, the charge of commitments assumed and the contraction of credit were responsible for promoting the deceleration of consumption and investment spending, with negative impacts on production and employment. This is a common feature of both crises, indeed a script that is embedded in the mode of being of capitalist reality.

The difference between the two processes lies in the response of governments to the crisis: while in the early 1930s government intervention was late, insufficient, and repeatedly mistaken, in the current crisis intervention was prompt and forceful, aimed – above all – at rescuing large institutions in trouble. This point needs to be emphasized: it was because of the massive injection of public resources – directed to the rescue of financial institutions on the edge of insolvency – that the current crisis did not turn into a tragedy

of incalculable proportions. The result, predictable, was the significant rise in public debt in the USA and Europe.

The different nature of the responses resulted in different trajectories on the course of events: while the Great Depression of the 1930s hit the advanced core of world capitalism (USA, Germany and England), from where it spread to the rest of the world; the current crisis affected, with greater intensity, the European periphery (Greece, Spain, Ireland and Portugal). It is obvious that the atrophy of the spending circuit, household debt, and uncertainty are still affecting the advanced economies, particularly affecting immigrants, the dispossessed, and the young people, whether in the USA, Germany, England, France, or Italy. Nowadays, there is no doubt that the populations on the fringes of the European continent feel the dramatic nature of the crisis most acutely.

This has distinct political implications: in 1929-1933, the intensity of the crisis in the core of capitalism gave rise to the search for ruptures, more or less intense, in relation to the practices and teachings of **conventional knowledge**. After all, entire populations within the Core capitalist countries were subjected to the misfortunes of the economic crisis. The economic policies of Nazism, the New Deal, the Swedish experience, and the initiatives of the *Front Populaire*, were innovative actions designed to rescue countries from the depths of the Depression. The rupture, however, would only materialize – consistently – after the end of World War II, by the formation of **reformist political** coalitions in Western Europe and even in the USA. Its main objective was to regulate and guide the operation of market mechanisms by rational state action, especially in an international environment conditioned by the existence of the Cold War.

Already in the current crisis, because of the worst hardships are felt by the marginalized in the Core and the periphery of Europe – and in the absence of a “common enemy” to be stopped – favors the introduction of accommodative policies, aimed at avoiding the implosion of the financial system. As a result, the adherence of social and political actors in the capitalist Core to proposals for reform and discipline of the economic regime is weak. Occupy Wall Street and its many variants do not have the enthusiasm and popular support of the transformative projects of the New Deal, the Beveridge Plan, or Bretton Woods, for example.

These are the topics to be discussed. In order to organize the discussion, no further considerations will be made on the origins and morphology of the two crises. We will consider the **nature of the responses**, the **course of events**, and the **consequent political implications**, seeking to establish a counterpoint between the Great Depression and the current crisis.

## 1. Peculiarities of the fiscal issue

We begin with the fiscal issue. We noted in another occasion<sup>251</sup> that a vigorous intervention – such as the one recently undertaken in the rescue of the financial system – would have been unthinkable in 1929. It should not be forgotten that conventional knowledge in the 1920s was determined by the rules of the gold standard. In its guidelines, expansionary actions (especially fiscal ones) were seen with suspicion for supposedly fueling inflation and thus precipitating currency devaluation. Fixed exchange rates and balanced budgets formed an inseparable unit. The defense of the exchange rate was the supreme objective, which conditioned monetary policy and, in practice, annulled fiscal policy. The truth is that hearts and minds – both on the right and on the left<sup>252</sup> – professed, at that historical juncture, their mythical belief in the virtues of healthy finance.

The deepening crisis in the 1930s, however, victimized millions of workers around the world, particularly in the core capitalist economies: the unemployment rate in 1932 reached the dramatic numbers of 30.1% in Germany, 23.6% in the USA, and 15.6% in England. In the same year, the fall in industrial production – relative to 1928 levels – was close to 40% in Germany and the USA. It was impossible for countries to continue passively to watch events unfold, in the empty hope that the “automatic correction” of market mechanisms would put the economies back on the path to growth. The depth of the crisis gave rise to the formation of new political coalitions, each in its own way, willing to break free from the chains of conventional knowledge. After all, the spontaneous operation of market forces had driven the world to disaster, and there was nothing to suggest that the situation could be reversed without vigorous State intervention.

It was only in Hitler’s Germany – and to a lesser extent in Sweden – that fiscal policy (in this case, the expansion of public spending) was used as an intentional and explicit mechanism to stimulate economic activity. In Germany’s case, the results were spectacular: between 1932 and 1936, real output growth was about 40%. The contingent of unemployed, about 5.6 million in 1932, fell to 1.6 million in 1936, and to 430 thousand in 1938. In Bleaney’s (1985: 72) assessment, the German experience under Nazism was “the most successful example of a Keynesian response to depression.” Of course, the Nazis’ success in the astonishing recovery of the German economy was closely

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251 See Mazzucchelli (2008).

252 Before the rise of Nazism in 1933, Rudolf Hilferding – the renowned Marxist economist of German Social Democrat – in vehemently repudiating a plan to expand public spending drawn up by the unions (Plan WTB), dogmatically asserted that “if [the formulators of the Plan] think they can alleviate a depression through public works, they are simply demonstrating that they are not Marxists [...]”. See Berman (2006: 112-114).

linked to their despotic control over the economy and society, but there is no denying the crucial role played by controlled State spending. In Sweden, under the theoretical inspiration of Gunnar Myrdal's works, the social democrats (in coalition with the agrarians) intentionally made use of government spending and the public deficit as (circumstantial) weapons to combat the depression. The results were auspicious: industrial production grew by about 50% between 1932 and 1936, and the unemployment rate was reduced by about 40%. Even if public spending – unlike in Germany – was not the main responsible for the recovery (led, in this case, by private investment and exports), its importance – especially in the 1934-35 biennium – cannot be ignored. Moreover, because they resulted from an innovative theoretical perception – as opposed to the deflationary believing of conventional knowledge –, they indicated ways of acting that would be used in the future. The innovative character of the Swedish experiment is all the greater when one realizes that in 1936 Roosevelt was still a supporter of balanced budgets, England worshipped monotonous reverences for fiscal prudence, and France (until September) remained fervently tied to the strict rules of the gold standard.

The necessities of war, of course, buried the discomfort toward fiscal orthodoxy. The financing of military spending resulted in the brutal rise of public debt (in the USA, for example, the debt stock grew by about 400% between 1940 and 1945) and in monetary expansion. Inflationary pressures, inevitable in an atypical context of supply imbalances, increased liquidity, and aggregate increase in purchasing power, were circumvented – with greater or lesser success – through rationing, price controls, credit constraints, and selective taxation. The product growth was extraordinary, especially in the countries that did not have their territories invaded: between 1939 and 1943, the real GDP variation in England was over 25%. In the USA, the expansion was even greater, reaching the exceptional number of 72% in the period 1939-1944. Unemployment, as a result, fell in a way unthinkable in peacetime: in 1939, there were 1.5 million unemployed in England. In 1943, they were only 82 thousand. In the USA, this number fell from 9.5 million in 1939 to 670 thousand in 1944.

If the Second World War was certainly the most shameful experience humanity has ever seen (leaving in its trail 50 million dead), one of its few positive legacies was the clear demonstration that the conscientious targeting of public spending is the most effective instrument to raise nations from the rubble of an economic depression. Hitler's dementia forced Roosevelt and Churchill to adhere to warlike **Keynesianism**, replicating the *Führer's* experience in the 1930s. With peace, a consensus was forged that the appropriate management of fiscal policy was an essential factor of stability, fundamental for the



attenuation of cyclical fluctuations: the rough fiscalism of “(always) balanced budgets” gave way to the perception of Myrdal and Keynes that “healthy” finances should be in deficit in bad years and in surplus in good times.

The virtuous structuring that was implanted in the post-war capitalist economies had public spending – not to mention State-controlled credit, essential to explain the economic boost in Japan, Germany, Italy, and France – as one of its fundamental pillars. The automatic stabilizers (unemployment insurance, transfers to individuals, minimum price support) in the USA, public investments in France and Italy, the implementation of the National Insurance System and the ambitious National Health Service in England, the consolidation of the Welfare State in the USA and in Europe as a whole, and the range of subsidies granted to agriculture and the economically weaker sectors, indicated a modality of intervention absolutely different from the one prevailing until then. Public budgets have expanded, with a consequent increase in public spending in the creation and composition of output. Between 1950 and 1973, for example, government spending grew from 28% to 39% of GDP in France, from 30% to 42% in West Germany, and from 34% to 42% in the United Kingdom. As Judt (2005: 418-419) reminds us, “the success story of postwar European capitalism was everywhere accompanied by a growing role for the public sector.”

It is important to point out that this did not result in any fundamental imbalance, since at the same time the tax and contribution burden on the private sector (companies and households) was increased from pre-war levels. In addition, continued output growth has systematically expanded the public sector’s revenue base. As Belluzzo (2009: 101) points out, during the post-war period “there was no ‘structural’ public deficit, except in periods of small fluctuation activity level, and such imbalances were soon absorbed by the resumption of growth. This was due to the continuous increase in income and employment that made government revenues grow.”

There is a peculiarity in the recent rescue rounds of the financial system making State intervention essentially distinct from the Great Depression and postwar times. At the peak of the Depression, the actions of Hitler, the Swedes, and even Roosevelt, aimed at restoring production and employment. Public spending on infrastructure and basic industry in Germany, worker protection in Sweden, or the numerous New Deal programs, all of these initiatives were based on the assumption that public spending had the primary task of reviving the economy. In this sense, their success was undeniable: by being part of a process of restoration and recovery of the expenditure-production-employment-income circuit, the state sponsored expenditures contributed (with greater or lesser success) to mitigate the devastating effects of the Depression. The same can be said about postwar government spending, whether on

investment or the Welfare State: they represented important components in sustaining and stabilizing aggregate demand.

Meanwhile, the current injections into the U.S. and European financial systems have not contributed – or are not contributing – to the recovery of the economies. The resources accumulated in the cash of banks and financial institutions that – contrary to risks after the problems that culminated in the crisis of 2007 – became extremely parsimonious in granting new credits (especially in a still nebulous picture regarding the solvency of potential debtors). The result is that public spending has not materialized into new spending. Public spending thus became a prisoner of the liquidity trap: resources left the Treasury, migrated to private banks, and did not convert into new loans. It is exactly for this reason that countries that have public financing systems (the case of China is exemplary) are better able to counteract the crisis.

There is no doubt that public disbursements were essential to avoid the deepening of the crisis, which would inevitably occur with the implosion of the financial system. Thus, while the function of public spending in the initiatives to combat the depression and in the post-war structuring was to regenerate and **expand** the spending circuit, its function in the present crisis – notably with regard to the countries of the capitalist Core – was to, as far as possible, avoid its atrophy. That is why the recent increase in public debt did not be converted into an expansion of the product and a significant reduction in unemployment. The USA, for example, had an unemployment rate of 4.6% in 2007. With the outbreak of the crisis, this rose to levels close to 10%. The bailout of the banks caused the net public debt as a proportion of GDP to jump from 43% in 2007 to 78% in 2012. The growth rate, which was negative in the 2008-2009 biennium, had a rather modest performance between 2010 and 2012 (average of 2.1%), which resulted in only a discrete reduction in unemployment (9.0% in 2012). The same phenomenon was repeated in England: net public debt doubled between 2007 and 2012 (from 38.2% to 77.0% of GDP), while the average change in output was 1.4% between 2010 and 2012, with unemployment remaining around 8.0% (5.4% in 2007).

In the periphery of Europe, the situation is different. Anchored in the euro, the countries on the European “fringe” were caught up in the intra-European credit boom of the 2000s, which led to the formation of real estate bubbles and the explosion of consumption. There was no fiscal imbalance at first: abundant credit irrigated the economies, which translated into higher private indebtedness and increased imports. As Belluzzo (2011) reminds us, “in the euphoric times, the ‘spenders’ had checking accounts largely in deficit and fiscal surplus results.” Spain, for example, showed fiscal surpluses between 1% and 2% of GDP between 2005 and 2007, with current account deficits between 7% and 10%. With the outbreak of the crisis, the government bailout

of the banks resulted – as in Core countries – in deteriorating public accounts. In the case of Spain, the surpluses turned into fiscal deficits of 10% of GDP in the 2009-2010 biennium, which caused public debt to jump from 26.5% in 2007 to levels above 55% in 2011- 2012. The bailout of the banks was accompanied by a concomitant contraction of credit: as a result, output plummeted and the unemployment rate rose to alarming levels of more than 20% (50% in the case of young people). It is estimated that the virtual paralysis of credit, since the beginning of the crisis, has victimized some 450 thousand small and medium-sized Spanish companies (Buck, 2013).

It is worth considering here that Spain's relative levels of public debt (debt/GDP) are equivalent to those of Germany, and lower than those of England, USA, France, or Japan. The biggest problem, however, is not the stock but the flow of the debt. What is in question is the capacity of the country to honor the solvency of its sovereign bonds (denominated in the European currency), which refers to the possibilities – in this case, limited – of obtaining the resources destined to the payment of the debts. This is why the counterpart required by the international authorities (European Central Bank, European Union and IMF) in the contribution of emergency resources – in order to prevent default – was the imposition of a strict fiscal adjustment. This is also the case in other countries of the European periphery: the guarantee of survival of local banks and the solvency of sovereign bonds (in many cases held by core borrowers) was conditioned to the deliberate application of severe deflationary policies.

The sequence of events almost followed a common pattern: the smaller economies of the European continent that joined the euro were captured – in the expansion of the 2000s – by the delights of cheap credit (provided by German, Austrian, French and British banks). Local banks were the transmission belt of credit. Households got into debt, expanded consumption, and the price of real estate increased a lot. Of course, the continuity of the process became dependent on maintaining the regular flow of loans. With the reversal, credit dwindled, real estate prices plummeted, and local banks found themselves dealing with borrowers. The governments then went out to bailout the banks: they raised funds by issuing sovereign bonds and transferred them to the financial institutions. Suspicions about the capacity of governments to honor their commitments then began. Default was only avoided (not in Greece, where the borrowers were forced to bear losses) thanks to emergency contributions from international authorities. In return, countries were forced to seek fiscal surpluses at any cost, in order to obtain the resources to pay off their debts. The generation of surpluses in the midst of a recessive context is an inglorious task, but this is a script that, in the final analysis, was already present in the

innumerable tribulations of the 1920s and 1930s<sup>253</sup> and, more recently, in the successive conditionalities imposed by the IMF on countries victimized by the external debt crisis. The results, as we know, were melancholic.

This leads to the unique result that in the European periphery, the increase in public spending (the bailout of the banks) was not associated with the regeneration, expansion, or sustaining of aggregate demand, but rather with its **contraction**. The expansion of the deficit and public debt, in this case, became the gateway for the **forced imposition of deflationary policies**, which resulted in the maintenance of extremely high levels of unemployment.

The following Tables illustrate the three situations:

### DEBT AND GROWTH

Germany	1932	1933	1934	1935	1936	1937	1938
Debt/GDP*	30.0	32.7	32.4	36.3	41.5	44.6	53.3
Variation GDP	-7.3	5.9	9.3	7.6	8.7	10.9	10.5
Unemployment	30.1	26.3	14.9	11.6	8.3	4.6	2.1
USA	1932	1933	1934	1935	1936	1937	1938
Debt/GDP	29.1	39.6	44.9	41.8	43.6	42.0	42.3
Variation GDP	-13.3	-1.7	7.8	8.1	14.2	4.6	-4.4
Unemployment	23.6	24.9	21.7	20.1	16.9	14.3	19.0

\* Data for German debt is undervalued due to the non-inclusion of MEFO bills. *Sources:* GDP: Maddison (1991); Unemployment: Mitchell (1992; 1993); Overy (1996); Barkai (1990); Stein (1994).

Note the extraordinary reduction in unemployment in Germany since 1934. The rise in unemployment and the contraction of GDP in the USA in 1938 was due to Roosevelt's (unsuccessful) attempt to balance the public accounts. In both cases, the positive GDP variations were associated – largely in Germany – with increased public spending (expressed in the increase of the debt/GDP ratio).

253 It is worth making a brief reference to Germany, today the main advocate of austerity policies for the European periphery. With the Dawes Plan of 1924, Germany – in exchange for an emergency loan – was forced to abandon the sovereign management of its economic policy: public and external accounts began to be monitored by the General Agent for Reparations sent to Berlin, and the Reichsbank was subject to shared management. The objective of the Plan was to achieve a fiscal surplus and external trade balance intended to meet the payment of reparations established in Versailles by cutting public spending and curbing aggregate demand. The Plan, however, was formulated in an international environment of abundant liquidity, and German bonds soon began to arouse the appetite of international investors (especially North Americans), eager for generous yields. Germany was inundated with foreign loans, and between 1924 and 1928 it sailed in apparently calm waters. When – at the end of 1928 – there was a reversal in the flow of loans, international commitments became unbearable. Brüning sought to generate the long-awaited surplus in public and external accounts through a succession of deflationary decrees (wages cut, layoffs, tax increases). The result was the deepening of depression, especially after the bank failures of mid-1931. In 1932 unemployment reached a third of the workforce, without achieving the desired fiscal and external surpluses. See Mazzucchelli (2009: 157-177). As you can see, bad lessons are always useful, especially when it comes to recommending them to poorer neighbours!

### DEBT AND STAGNATION

<b>USA</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Debt/GDP	42.0	42.9	48.7	60.6	68.3	72.6	78.4
Variation GDP	2.7	1.9	-0.3	-3.5	3.0	1.5	1.8
Unemployment	4.6	4.6	5.8	9.3	9.6	9.1	9.0
<b>England</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Debt/GDP	38	38.2	46.6	60.9	67.7	72.9	77.0
Variation GDP	2.8	2.7	-0.1	-4.9	1.4	1.1	1.6
Unemployment	5.4	5.4	5.6	7.5	7.9	7.7	7.8

Source: IMF

The bailout of the banks was, in both the USA and England, the main responsible for the increase in the debt/GDP ratio from 2008-2009. Thus, a generalized collapse was avoided. GDP started to have modest changes, but unemployment remained at still high levels. The victims are immigrants, those lower down on the social scale (*déclassé*), and the young people. The social safety net still guarantees minimum benefits, but the precariousness of labor relations tends to advance.

### DEBT AND CONTRACTING

<b>Spain</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Debt/GDP	30.5	26.5	30.5	41.9	48.7	56.0	58.7
Variation GDP	4.0	3.6	0.9	-3.7	-0.1	0.8	1.1
Unemployment	8.5	8.3	11.3	18.0	20.1	20.7	19.7
<b>Ireland</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Debt/GDP	15.8	11.2	24.6	42.3	78.0	99.0	104.6
Variation GDP	5.3	5.2	-3.0	-7.0	-0.4	0.4	1.5
Unemployment	4.4	4.6	6.3	11.8	13.6	14.3	13.9

Source: IMF

As in the most advanced countries, the increase in the debt/GDP ratio in Spain and Ireland was the result of governments bailing out of banks. The contraction of credit resulted in the virtual paralysis of the economic system and the explosion of unemployment. The recommendations of international authorities point to the permanence of the state of economic prostration of the European periphery.

## 2. The reactions to the Great Depression of the 1930s

Crises always bring about responses. They can be bold and inventive, partial and palliative, or simply innocuous. The political correlation ultimately establishes the limits and possibilities of the different alternatives. When looking at the reactions to the current crisis and contrasting them with the initiatives undertaken in the 1930s and post-war period, it is possible to perceive essentially disparate behavior patterns. Thinking about the Great Depression, the responses were clearly differentiated, ranging from the boldness of the Nazi experiment, through the innovation of the New Deal and the Saltsjöbaden Agreement, the restrained reformism of the British, or the immobility of France. In the post-war period, a broad consensus was established, which resulted in uniform actions – despite national challenges and specificities – aimed at sustaining maximum levels of employment and consolidating the welfare state. In the current crisis, what we observe is a **negative uniformity**, marked by resignation in relation to the domination of finance and weakness in facing crucial issues. The main responses to the depression of the 1930s are presented below.

### Sweden

In January 1933, the same month that Hitler came to power, the Social Democrats became the head of the Swedish government. Armed with innovative theoretical thinking in economic matters and with a multi-class political platform, the Social Democrats were especially skillful in dealing with the crisis. By pegging the *krona* to the pound (pegging policy), not without first promoting a discrete devaluation, the Swedes ensured the competitiveness of their exports to England (their main consumer market). Thus, unlike in France, the appreciation of the local currency was avoided. Moreover, in contrast to what happened in Brüning's Germany, the Swedes advocated – even in the midst of escalating unemployment, which reached its peak in early 1933 – the maintenance of nominal wages for the economy as a whole. In a carefully articulated political agreement – which resulted in the formal alliance with the representatives of agriculture (cow trade) – the social democrats, using price regulation and stock purchasing, sought to preserve the farmers' purchasing power. The economic and political importance of this initiative is understood when one realizes that in 1930 more than 35% of the economically active population was employed in agriculture. However, the conscious use of fiscal policy – through a spending program that favored public investment – was the Swedes' great innovation. According to Arndt (1972: 209-219), “the main

innovation of the Labor [social democratic] government [...] was the adoption of a policy of deliberately using the state budget as a recovery instrument. [...] The compensatory fiscal policy was extremely successful in Sweden.” Myrdal, as already mentioned, understood that budgets should be in deficit during economic downturns and in surplus during business cycle contexts.

The results were largely satisfactory: The GDP grew at an average annual rate of 6.0% between 1934 and 1937. The expansion of industrial production was 66.0% between 1933 and 1937. The volume of exports increased by 60% between 1932 and 1937. Finally, the unemployment rate – even though it remained at levels close to 10% at the end of the decade – was significantly reduced. The Swedish experience, due to its unprecedented nature, gave rise to ponderings and criticisms. Criticism related to the fact that the impact of fiscal policy has been negligible in explaining the recovery; likewise, the resumption of growth in England between 1933 and 1937 – and not necessarily the exchange rate policy – is what would have allowed the expansion of Swedish exports. The cow trade would have resulted in higher goods/wage prices, thus compromising workers’ real purchasing power and private investment, and it is exports – not public spending – would have revived the Swedish economy from 1933 onwards. Furthermore, it was the Second World War, and not social democracy, which would have eliminated unemployment, the criticism also pointed out that the Swedish experience was overrated by the publicity and notoriety of its economists, etc. etc.

Some qualifications may even be true, but it is necessary – as always – to retain the fundamental: through a comprehensive social agreement, and freed from the obtuse chains of conventional knowledge, the social democrats were able not only to counter the crisis, but to build a secure and lasting path for the nation. The Social Democratic hegemony in Sweden lasted for 44 uninterrupted years. Wigforss, familiar with the writings of Keynes, remained at the Ministry of Finance from 1932 to 1948. Tage Erlander held the office of prime minister from 1946 until 1969. Not only representatives of agriculture were involved in the negotiations with the Social Democrats. With the Saltsjöbaden Agreement of 1938, the industrialists – at first fearful – adhered to an economic and political platform that included the protection of workers, use of compensatory fiscal policies, investment incentives, and the implementation of the world’s most advanced welfare state. It is not without reason that the Swedish experience – conceived and implemented during the 1930s – became a remarkable and pioneering example in the post-war period.

## Germany

In Germany, the initial attempt to combat recession with deflation (Brüning) resulted in the wild depression. The anguish of the Germans began to call for solutions radically different from those advocated by the orthodox concept. The latter had led to the deepening of the crisis. In this context, it is important to point out strategic mistakes: the insistence of the German Communist Party (KPD) in revere directives emanating from Moscow, qualifying social democracy (SPD) as the political representation of “social fascism.” This, of course, was the time when the democratic forces – including the Catholic Core – should have united in defense of the Republic and in promoting an emergency program to combat the depression. The systematic advance in the vote achieved by the communists between 1924 and 1932 (jumping from 9.0% to 17.0%) may have given rise to the false perception that they would become the main pole of unification in the resistance to National Socialism (NSDAP). This was a big mistake, since in the two elections of 1932; the sum of the votes obtained by the social democracy and the forces of the Core (36.3% in July and 35.2% in November) was equivalent to that achieved by the Nazis (37% and 33,1%). The Communists’ pretension to lead the opposition to Nazism facilitated Hitler’s plans. On the other hand, as already mentioned, the refusal of the social democrats to subscribe to the plan of expansion of public spending (WTB) elaborated by the unions, destroyed an effective possibility of mitigating the devastating effects of the depression. The illusion that the “business cycle” should follow its normal course, added to the paranoia that the expansion of the public deficit could resurrect the ghost of hyperinflation, generated – in German social democracy – a political and propositional immobility, unacceptable under the terrible conditions the country was going through. Facing the crisis required forceful solutions, but the Social Democrats apparently remained hopeful that eventually, at some point in time, conditions would be good for the establishment of socialism in Germany.

When Hitler was chosen by Hindenburg to head the German government in January 1933, he soon realized that it was essential to change the course of events. Parallel to crushing the trade unions and cruelly persecuting communists and social democrats, he launched a crusade to rehabilitate the German economy. The “Battle of Jobs” was fought by mobilizing the resources of the Reichsbank, by framing the weakened German private banking system, by creating private currency with official guarantees (MEFO bills), and by using Treasury revenues to promote the expansion of public spending. Only after 1936, once the recovery was consolidated, military spending started to occupy a decisive position in the composition of public spending. The success of this program was achieved. In addition, by dramatically reducing unemployment,



Hitler obtained – despite the closure of the unions – the sympathy of millions of workers. He obtained a broad social base of support for his policies, such as: The dispossessed of the market became Soldiers of the New Order. By ensuring the preservation of farmers' purchasing power (29% of the economically active population in 1933), the base of support in the countryside was consolidated. There was enthusiasm from relevant business sectors for securing orders for industry and reviving aggregate demand. Banks was submitted to the priorities of National Socialism by saving them from the nationalization intended by Gottfried Feder (the Nazi theorist who denounced the “slavery of interest”). The gaining of Army obedience by assassinating – on the Night of the Long Knives – the leadership of the SAs (Ernst Rohm).

It is true that the economy, in the national socialist State, has been converted into a line of politics, and the latter into the expression of the *Führer*'s will. Unlike the New Deal, the Swedish experience, the British or French initiatives – which took place in an atmosphere of preservation of democratic rituals –, the Nazi response to the crisis benefited immensely from the implementation of a regime of terror. Only by means of the violence of the State, it was possible to establish an iron system of controls over wages, prices, foreign trade, the raising of resources, and the orientation of spending. The point to be noted, however, is that – armed with dictatorial powers – Hitler undertook a successful break with the canons of conventional economic policy management, reviving the German economy from the dramas of the depression. With the end of the war, the Western leaderships realized that some of their initiatives – provided they were decoupled from their oppressive form of execution – could be useful, and even necessary, in the recovery and expansion of national economies. This was the case, for example, with price controls in Germany, with foreign trade within the European Payments Union (evoking Schacht's “compensatory contracts”), and with the setting up of vigorous public financing systems in Europe and Japan.

## USA

The response of the New Deal was different. The USA was not the scene of such a broad social agreement as was seen in Sweden, nor was the American economy enslaved by politics, as in Nazi Germany. In fact, Roosevelt had to move in unknown territory, facing many Republican guerrillas, business resistance, political obstacles, and (not always wise) Supreme Court decisions. More than an economic experiment, the New Deal was, above all, a political construction in the heart of a markedly conservative nation. The violence of the depression in the USA found in Roosevelt a fearless leadership, ready to face problems and ready to take risks with bold initiatives.

His first mission was to stop the meltdown of the financial system. The country had seen three waves of bank failures (it is estimated that 11 thousand banks closed their doors during the depression), and any action to combat the crisis should have as a principle the strengthening of the financial system. His initiatives in this regard were not only successful, but lasting. The Banking Act of 1933 – in the scope of the Glass-Steagall Act – established strict regulatory norms for the banking system, with emphasis on the separation (containment wall) between commercial banks and investment banks, insurance for bank deposits (FDIC) and the prohibition of interest payments on deposits in cash, in order to avoid predatory competition among banks (Regulation Q). The creation of the Securities Exchange Commission (SEC) in 1934 tightened the criteria for issuance of shares. The creation, in the same year, of the Federal and Saving Loan Insurance Corporation (FSLIC) provided security for savings deposits and regulated the operation of insurance companies. With the Banking Act of 1935, the Fed's power was strengthened, resulting in the centralization of the command over monetary policy. The New Deal legislation, if it was crucial to contain the spread of depression, redefined, at the same time, the institutional design of the American financial system and forged a new regulatory framework for the sector. In this regard, its contribution was permanent.

The initiatives in the field of agriculture were equally successful. By policies of support and elevation of agricultural prices (acreage allotments), debt refinancing, official financing with minimum price guarantees, introduction of modern land use techniques (combating erosion), and the diffusion of rural electrification – American agriculture was rebuilt from the violent depression years. Between 1933 and 1937, the income of farmers grew by 60%, an extremely important fact in a country where almost a quarter of the population was still engaged in agricultural activities.

For its part, the social legislation implemented in the New Deal, in 1935, was remarkably important: The Wagner Act ensured workers the broad right to unionize and the Social Security Act established the retirement system for workers who reached 65 years old, as well as unemployment insurance. The beginning of Roosevelt's Welfare State was born of the conviction that citizens could not remain forever exposed to the winds of the market, and helpless in old age. The relevance of this commitment is greater when referred not only to the cruel context of the depression, but also to the individualistic and dissolving tendencies that have always been present in American society. It is not hard to imagine the furious reaction of conservative sectors to the president's social initiatives.

The fiscal policy of the New Deal was essentially contradictory. Unlike what happened in Germany and Sweden – where public spending was

explicitly and intentionally used as an essential weapon to struggle against depression – the expansion of public spending in Roosevelt’s USA was an inevitable consequence of the emergency actions that were necessary to mitigate the effects of the crisis. The numerous New Deal programs demanded public resources, increased spending, and led to deficits in Core government accounts, but the intention of the New Dealers (with the exception of Marriner Eccles, of the Fed) and Roosevelt was always – at some point in time – to return to balanced budgets. In short, Roosevelt was conservative on fiscal matters. After the 1936 election, convinced by his advisors that the recovery was consolidated and that inflation was just around the corner, the president consented to a reversal of monetary policy and fiscal tightening. The result was disastrous: industrial production plummeted and 2.7 million workers became unemployed. The recession in the Depression of 1938 demonstrated it was impossible for the New Deal to remain a prisoner of the dogma of balanced budgets. From then on, and with the clouds of war looming ever closer, Roosevelt abandoned his fiscal convictions completely.

The result of the New Deal programs cannot be underestimated. It is projected that on average about three million workers per year (5.7% of the labor force) were lifted out of unemployment because of the actions of, among others, the Public Works Administration (PWA), the Civilian Corps Corporation (CCC), and the Works Progress Administration (WPA) – not to mention the extraordinary impact of the Tennessee Valley Authority (TVA) works. Millions of workers ravaged by the depression could only find some relief in their lives thanks to the emergency programs of the New Deal. However, only with the outbreak of the Second World War the uncontrolled unemployment would disappear. The conclusion that follows (contrary to what some critics assume) is that fiscal policy was indeed expansive during the New Deal. It could have been more expansive, in truth, if not for the ideological, political, and intellectual constraints that inhibited bolder interventions in the scope of state action.

The New Deal initiatives proved to be fundamental in removing the USA economy of depression. The regulation of the banking system, the defense of agriculture, the spending of government agencies, and the establishment of the social protection system allowed an almost systematic recovery of personal consumption (46% growth between 1933 and 1939), in the middle of the introduction of mechanisms and institutional achievements that would reshape the face of the nation. In addition, of course, there were mistakes in the implementation, and even in the conception of the New Deal, but criticism can only make comments about what was done, never about what was not done.

If Germany, the USA and Sweden have promoted innovative responses, the same cannot be said about England and especially France. With the

devaluation of the pound in September 1931, England was able to enjoy cheap money, as it was not constricted by the exercise of monetary policy anymore. Parallel to the reduction in the discount rate, a successful public bond exchange operation was promoted, which resulted in a reduction of the internal debt service. On the external front, England raised its import tariffs and strengthened commercial relations with the Empire. Devaluation, cheap money and protectionism formed the tripod on which the country's recovery in the 1930s rested. A modest recovery when compared to Germany and the USA, but still superior to the lethargic march of the countries that formed the gold block (France, Belgium and Holland, among others). Although the impact of the depression was less dramatic in England (where the banks were not ruined), and the recovery occurred earlier than in other countries (centered on residential construction and the new industries – chemicals, electricity, consumer durables), unemployment reached high proportions – especially between 1931 and 1935, but also by the end of the decade.

This is explained by the refusal of the British to practice an expansionary fiscal policy. During the 1930s, budgets remained strictly balanced. The strength of the City and Treasury View was too evident in England, and inhibited any bolder initiatives in terms of fiscal policy. The British Labor leaders (Ramsay Mac Donald and Philip Snowden), in power since June 1929, became advocates and implementers of the sound finances recommended by Conservative circles. Keynes' speaking in 1929, 1931 and 1933, or the pressure from labor unions and other prominent labor leaders (Ernst Bevin) to expand public spending, did no help. Some people, dissatisfied with the weakness of the policies to control unemployment, broke away from the Labor Party – like Oswald Mosley, who in 1932 founded the Fascist Party of England. The strength of the establishment prevented the forging of the Lib-Lab (Liberals and Labor) alliance, the only one that would be able to carry out a consistent program to reduce unemployment. With the labor leadership emasculated, the British reaction to the crisis was limited, with caution overlapping innovation.

The case of France was more melancholic. Since the implementation of the Franc Poincaré in December 1926, the nation remained fervently tied to gold. In June 1928, the franc was formally devalued against the dollar and the pound, which suggested that economic conditions would become more promising. This was not the case: the growth of 1928-29 was promptly aborted by the world depression and the country would enter a desolate course of stagnation. One fact is enough to illustrate the French decadence in the 1930s: In the six years between 1930 and 1935, GDP growth was negative in five of them (the exception was 1933). Behind this result lies the French devotion to gold. Defending parity became synonymous with defending the nation. Nothing that could threaten sacred parity could even be contemplated. Budgetary

balance, as a result, became the *pièce de résistance* of the country's economic management. The public deficit would be the antechamber to the much-feared inflation, which would destroy the parity consecrated in 1928. Reversely, devaluation – in the French understanding – would result in inflation, the demon to be exorcised. This simplistic conception – especially in a context of depression and deflation – was not only shared by conservative circles. In addition, the left (in the manner of Hilferding's German social democracy) adhered to the dogma of balanced budgets and the defense of exchange rate parity. In Kemp's observation (1972: 103), "a solid block, from the directors of the Bank of France to the Central Committee of the Communist Party, was calling for the preservation of the 1928 parity."

In September 1931, England devalued the pound, and already in March 1933 the devaluation of the dollar began. The franc, consequently, appreciated in value. With the appreciation of the franc, French exports, which had already been on a modest downward trajectory since 1927, simply collapsed: between 1929 and 1936, their fall – systematically over the years – was of 70%. Part of this decline is of course explained by the contraction of international trade, but there is no doubt that the currency appreciation has been disastrous for French exports. What's more, by undertaking deflationary policies designed to "save the franc," successive actions (Flandin and Lavai, in particular) buried the country in recession. The recession contracted public revenues, which increased the deficit in government accounts. The alternative was to cut public spending, which only deepened the recession.

When the French, tired of the innocuousness of deflationary policies, brought Léon Blum's *Front Populaire* to power (in June 1936), political divisions prevented the adoption of any coherent alternative response to the crisis. The *Front Populaire* did not result from a structured social agreement like what would be seen in Saltsöbaden, and Blum did not have the political and popular backing of Roosevelt. Besieged by the *mur d'argent*, which promoted the flight of capital – repeating what was done during the *Cartel des Gauches* between May 1924 and July 1926 – Blum became the impotent arbiter in the face of the burning disputes between workers and owners. The Matignon Agreement (which resulted in higher wages and the introduction of the 40-hour workweek in exchange for the vacating of factories that had been taken over by the workers) did nothing to ensure the recovery of the economy. The devaluation of the franc in September 1936 was not helpful either. France, unlike Sweden, became a society in upheaval: the only flags that united the country were the defense of the Republic and the fear of Germany. The "restoration of confidence" with the fall of the *Front Populaire* in April 1938 was not enough to give the country a more optimistic outlook either. Victimized by the foolishness of deflationary policies in the midst of

the depression, by internal political radicalization, and by the disgrace of the Nazi occupation, France – for twenty years – was the stage for an astonishing economic regression: in 1948, the level of its GDP was lower than in 1929.

### 3. The postwar reformist coalitions

Political circumstances were primarily responsible for the differentiated nature of national responses to crisis in the 1930s. Political conditions in Sweden, for example, were distinct from those prevailing in France. As a result, the Matignon Agreement could never have had the scope and transcendence of the Saltsjöbaden Agreement. Likewise, the prevalence of the City in the political spectrum in England would never have permitted the tutelage of the banking sector, as observed in Germany. Hitler created political conditions that favored the continuous expansion of public spending, which did not occur in England, France or even in the USA. There were powerful interest groups in these countries that strongly advocated balanced budgets. The New Deal programs, for their part, introduced in the midst of heated disputes in the USA, would have been unthinkable in the backward context of France, where small businesses and small farms were the norm of social life. It was a set of independent and uncoordinated actions, within varying local political restrictions, in an international environment increasingly fraught with the threat of war.

The unfolding of the Second War created the conditions for a radical reversal of the political framework, both at the global level and at the level of nations. The war has, in fact, created new consensus and buried several myths. After the many years of depression and the tragic experience of world conflict, it was no longer acceptable that men remain defenseless against the market winds, subjugated by ruthless dictatorships, or that international relations be resolved by the brute force of arms. This common mood ran through the West. The struggle against Nazism and Japanese militarism kindled the hope that political democracy, protection of citizens, and orderly functioning economies should guide the organization of nations. Lord Beveridge's proposal (Full Employment in a Free Society) or the implementation of the Welfare State in England, or Keynes' suggestions for the constitution of a new international monetary order were even before the end of the war. They expressed a latent and widespread state of mind. The heroic struggle of the resistance in France and Italy, likewise, was not only aimed at the military defeat of Nazism and Fascism, but also at creating the conditions for the formation of more fair societies. In all Western countries the conviction that the end of the war would open a new chapter of prosperity and social justice within nations was formed.

The immediate tasks of reconstruction were of course dramatic and imperative, and there was still a long, hard road ahead. The challenges were

enormous: if the end of the long conflict was a relief, the harsh reality of food shortages, coal rationing, destruction of housing, collapse of transport, persecution, the tragedy of the refugees, and the misfortunes experienced – this harsh reality still inhibited the arising of hope. According to Lowe (2012: xvii), “the history of Europe in the immediate post-war period [...] is not one of reconstruction and rehabilitation – it is, first of all, the history of entry into anarchy.” Moreover, there was no clarity and political clarity regarding the steps to be taken: Germany was shared by the occupying forces (USA, USSR, England and France), which were in internal disagreement regarding the actions to be implemented. The Soviets demanded reparations, the French wanted to weaken their historic rival, the Americans wanted to destabilize the German banking system, while the British sought to normalize relations with Germany. Japan, for its part, occupied by General MacArthur’s forces, found itself cornered, subjected to a punitive project that inhibited any prospect of recovery. In France and Italy, the intense participation of communists in resistance movements gave them credibility as legitimate and relevant political actors, and governments were barely able to sustain themselves (De Gaulle, for example, felt compelled to renounce in January 1946). The nationalizations in France, Italy, and England expressed a new perception regarding the role of the state in the economy, but the difficulties were still notorious. In England, where Attlee’s Labor dethroned Churchill in July 1945, the balance of payments situation was critical, and the harsh winter of 1946-47 made living conditions even more difficult. The dream of building the Welfare State seemed doomed by the misery of the economy. According to Laqueur (1972: 42), “the great problem facing the Labor Party in 1945 was to build a welfare state in a country that was practically bankrupt.” In the USA, similar to what happened after the First World War; the Republicans regained control of both legislative houses in the 1946 elections and started an obscurantist crusade aimed at persecuting the left and trying to undo the achievements of the New Deal.

What we want to emphasize is the complexity of the picture that emerged in the immediate post-war period. There was not a settled consensus regarding the ways in which the economy and politics should be conducted. There was a diffuse hope about the future, but material difficulties and political disagreements inhibited more promising prospects for the countries. Two interlinked facts contributed to the change in the course of events: the massive economic superiority of the USA and the outbreak of the Cold War. American contributions via United Nations Relief and Rehabilitation Administration (UNRRA, created in 1943, under Roosevelt’s inspiration, and especially active between 1945 and 1947) were decisive in keeping Europe from entry in a complete unknowing situation. Only UNRRA’s donations allowed the most

urgent needs to be overcome. On the other hand, the announcement of the Truman Doctrine and the Marshall Plan, in March and July 1947, respectively, defined the new political framework for international relations and assured Western countries a regular flow of resources that would continue until 1952. The nations aligned to the United States would enjoy privileged treatment. In exchange, they had to obey Washington's geopolitical designs: not by chance, in May 1947, the Communists were excluded from the coalitions of power in Italy and France. The succession of events in 1948-49 gave final shape to the Cold War and established the political basis on which the economic recovery of Europe and Japan would be built: In February 1948, the Communists took power in Czechoslovakia. In June 1948, the Berlin blockade began (extending until May 1949). In 1948, disbursements of the Marshall Plan began and the countries started to show reasonable rates of growth in industrial production. In March 1949, the creation of the North Atlantic Treaty Organization (NATO) was formalized. In August of the same year, the USSR announced possession of the atomic bomb. In September 1949, the Federal Republic of Germany was formally established. In October, Mao Tse-tung's forces seized power in China. Finally, the outbreak of the Korean War in June 1950 definitively changed the terms of USA-Japan relationship: Japan was no longer seen as a defeated enemy but as the principal strategic ally of the USA interests in the Pacific (Mazzucchelli, 2013: 60).

The implications of the new international political configuration were decisive. **The environment became favorable for the formation of reformist political coalitions within the different countries.** A broad camp was forged in which Christian Democrats (Germany and Italy), Social Democrats (Germany and Sweden), Socialists (Italy), Gaullists and non-Gaullists (France), Labor and Conservatives (England), Liberal Democrats (Japan), Democrats and Republicans (United States), and even Communists (France and Italy). Perhaps the Core point of these coalitions was the **conviction, shared by all, that it was necessary to domesticate the functioning of capitalism.** Freed from regulation and public control, capitalism had produced the disaster of the 1930s, and it was essential to retain the positive lessons of successful defense strategies. Not coincidentally, the experiences of Sweden, the New Deal, and Nazism became object of attention.

Regarding the economic orientation of the countries, three aspects should be highlighted: **firstly**, the international order that emerged from Bretton Woods (of a markedly reformist inspiration) facilitated the exercise of national economic policies. The existence of restrictions on the free movement of capital, in particular, allowed national credit systems to be directed toward their primary purposes, namely the financing of investment, production, and consumption (Belluzzo, 2009: 75-6; 155-6; 283). The absence of more intense



exchange rate fluctuations (especially since the realignment of the exchange rates in 1949) and the possibility of practicing low interest rates greatly favored productive accumulation. **Second**, as has already been highlighted, the State's participation in the economy came to be understood as essential. A new consensus was built based on which the presence of the State – in industrial and macroeconomic planning, in the management of part of the productive sector, in the provision of infrastructure, in direct financing of investment, and in the structuring of social welfare systems – would become vital to direct private investment and to sustain aggregate demand. **Third**, it is important to point out that – in the face of the fifteen consecutive years of tribulations that had elapsed from the beginning of the depression to the end of the war – the opportunities for investment had broadened considerably in Western Europe and Japan. In particular, the possibility of imitating the U.S. manufacturing pattern, based on local efforts, had become a plausible reality.

No less important was the conviction, shared by most political currents of opinion, that the fate of individuals could no longer be defined – as in earlier times – only by the vicissitudes of the market. These, on the one hand, should be mitigated by the permanent search for full employment, through the appropriate management of fiscal policy. On the other hand, the State would be responsible for the lives of its citizens. After the hardships of the depression and the war, the understanding that the fate of men, women, the elderly, and children should be dissociated from the vicissitudes of competition became firmly established. The result would be the web of benefits incorporated into universal education, health, and welfare programs; public protection for childhood, motherhood, and old age; the regulation of working hours and working conditions; the defense of minimum standards of pay, and the protection of unemployment insurance, which would benefit millions of workers throughout the West. The dissolving tendencies of the capitalist production regime would be subjected to the tutelage of the hand of the state: Lord Beveridge's sword would now be turned against the "five giants" that for so long have afflicted advanced societies – discouragement, ignorance, disease, misery and indolence<sup>254</sup>.

Nations had specific challenges. In the USA, for example, the Core issue in the postwar period was not exactly reconstruction or recovery, but the exercise of world hegemony. Endowed with unchallenged economic and military supremacy, the USA, in the midst of Cold War disputes, set about stimulating capitalist expansion in their sphere of influence. The Marshall Plan, the opening of its big markets, the support for European integration, and the acceptance

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254 In a cartoon, Lord Beveridge appears brandishing his sword against the aforementioned "giants", which he considered the greatest evils in England. See Lynch (2008: 9).

of Japanese protectionism were all part of this perspective. At the same time, Western military leadership generated obligations and interventions in order to contain the worldwide expansion of communism. Domestically, the liberal **consensus** of incremental reforms (which lasted until Nixon's election) was based on the **odd** association between **reformism** and **anti-communism**. Its most conspicuous example was Johnson, who launched the ambitious domestic Great Society programs in parallel with the escalating Vietnam War.

For England, which was stripped of its once glorious empire, the postwar tasks were concentrated on defending the pound and defending its citizens. The search for full employment and the consolidation of the Welfare State became the consensual objectives of both labor and conservatives. The British faced the recurrent balance of payments constraint in the post-war period, responsible for the systematic application of the stop and go [*Butskellism*<sup>255</sup>]. Isolated from European integration, England surrendered to the City's supremacy and implemented an advanced and comprehensive welfare state. Its worldwide political pretensions were damaged by the disastrous occupation of the Suez Canal in 1956, when it was ordered by Eisenhower to withdraw from Egypt.

In the case of Germany, once the political and institutional setbacks were overcome in 1949, the mission of Adenauer and Erhard's Christian democracy was to get rid of the arsenal of restrictions imposed by the Nazis, and to free the enormous German production machine. Endowed with a more robust and differentiated industrial structure than their European partners, the Germans have given priority and explicit incentives to exports. The German export devil began to exhibit consistent trade balances from 1952 onward. The millions of refugees were progressively absorbed into the labor market, and the principle of codetermination ensured peace in labor relations. The social **market economy**, far from being a reinvention of *laissez-faire*, represented a successful experiment in stimulating and controlling the driving forces of local capitalism.

The challenges faced by Japan, France and Italy in the post-war period were different. In these countries, it was a matter of undertaking a genuine **leap in modernization**. To this end, it was essential to have decisive participation of the State. The outbreak of the Korean War buried the deflationary precepts of the Dodge Mission sent to Japan the previous year, and stimulated exports to the USA. Through the discretionary actions of the Ministry of Industry and Trade International (MITI), the entry of foreign capital was strictly disciplined, and selective criteria were established for imports. The Japan Bank was in

255 Acronym resulting from the merger of the names of R. A. Butler (Conservative, Minister of Finance between 1951 and 1955) and H. Gaitskell (Labor, Minister of Finance between 1950 and 1951), intended to illustrate the essential similarity of the economic policy conducted by the two parties in the post-war.

charge of providing resources to private banks, strengthening the position of the large capital blocks (*keiretzu*). The investments were directed to the sectors considered priority, and in 1966 Japan asserted itself as the second capitalist economy in the world. In France, a country where small establishments were the norm, modernization came with the introduction of the Monnet Plan between 1947 and 1952. Through public control over credit, it was possible to stimulate the branches of industry elected by Core planning as strategic in terms of national development. The normalization of economic relations with the powerful German neighbor came with the creation of the European Coal and Steel Community in 1952, a European cartel that established production targets and common access to the two essential raw materials for industry. The legion of small and medium-sized enterprises were not abandoned to their fate, as the adaptive policy of “support for the big and protection of the small” was a characteristic mark of the country’s economic management. In Italy, where 42% of the working population was still in agriculture in 1954, capitalist expansion was concentrated in the north (Turin and Milan, basically). The discovery of the natural gas deposits in the Po Valley, the construction of hydroelectric plants, public investments by IRI (*Istituto per la Ricostruzione Industriale*) and ENI (*Enti Nazionale Idrocarburi*), the advances of the local automobile industry (Fiat), the innovative performance of large companies (Pirelli and Olivetti), foreign investments, tourism, and European integration have breathed new life into local capitalism and redefined the fades that, until then, had been fearful in Italian society.

The great postwar social agreement met with exuberant economic expansion. Growth was accompanied by rising productivity and real wages, perceptible improvements in people’s living conditions, the spread of social protection programs, it sustained low levels of unemployment, and the absence of pronounced fluctuations in economic activity. Even amidst the differences in national trajectories there was a greater political consensus, in which **all** currents of opinion in **all** countries participated, that it was indeed possible – and necessary – to discipline the functioning of capitalism in order to achieve the strategic goal of full employment and social welfare. International economic tribulations, and the changing course of the Cold War, caused the great postwar agreement to be progressively undone in the 1970s. When confronted with the current picture of passive submission to the designs of finance, the postwar experience is not only surprising, but also something almost impossible.

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