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Custodial Regulation

Money, interest rate and financial markets

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Abstract

This paper brings into focus some general – and indeed basic – aspects of financial markets and processes, the understanding of which is indispensable for the investigation of many penetrating questions that, notwithstanding their importance, are likely to be set aside by more specialist and sophisticated treatments of financial flows.

We shall start with the most typical and important of financial phenomena, money, thereby illuminating various crucial traits and characteristics relating to the subject matter of this conference. It will be shown that the changeable role and meaning of money over time has had a strong impact upon the overall financial landscape, primarily by way of the weakening of the working and interactions of various financial activities. This analysis makes evident both the difficulty but also the urgency of restoring the exogenous character of the money supply. We further focus upon the interest rate, underlining the nonessential role of this variable that, nevertheless, stands at the root of so many exasperating and destabilizing speculations. Finally, we face the problem of how to bring into being a financial market that does not strive for mastery over production but is rather content to work in the service of production; we face the problem, that is to say, of how we can foster simpler and more transparent financial markets that are able to reconcile efficiency with social justice.

**1. A brief review on the role and operation of money from the beginning of last century
to the present time**

Both the role and the meaning of money have changed substantially over time, in parallel with some important transformations within the economic and social systems. The period between the second and third industrial revolutions witnessed the diffusion of oligopolies together with a related large increase in productivity, low wages and variable entrepreneurial expectations and investment, and hence a recurrent deficiency of effective demand and increase in liquid money. The emergent situation persuaded Keynes to emphasize the idea of liquidity preference and to base the explanation of the rate of interest on the supply and demand for money, as opposed to the earlier appeal to the quantity theory of money and related account of the interest rate in terms of the relationship of savings and investment.¹ But as is not infrequent in the history of social thought, the Keynesian view triumphed only at the moment when its own foundations began to be shaken by further social and economic development.

From the seventh decade of the last century, a long and bitter controversy grew up between the Keynesian theory that (by way of liquidity preference) the quantity of money determines the interest

¹ Hobson's (1902) study on imperialism preceded Keynes in underlining the explanatory role of the deficiency of effective demand, but his analysis disregarded the question of money and interest.

rate, and the orthodox theory revived by Milton Friedman that the quantity of money determines the general price level. Actually, late twentieth-century socio-economic conditions fitted neither monetarist nor Keynesian theories. For the second half of the last century witnessed a fundamental and unprecedented change: a transition from monopoly capitalism to what may be called conflictual-consumeristic capitalism. The new state of affairs was characterized by competition based largely on new products, the stimulation of consumption through advertisement, high wages in the most dynamic sectors not only due to the bargaining power of trade unions but also aimed at stimulating the consumption of new goods and maintaining an unvaried mark-up margin, and the imitational growth of wages and consumption in the less dynamic sectors of the economy. One consequence of this transformation has been a qualitative change in the role of money, which may primarily be expressed as the increasing importance of what may be called the ‘nominal demand for money’, *i.e. variations in the quantity of money have been endogenously stimulated, and this by both price changes and in consequence of the conflict for income distribution*. This demand for money is just the opposite of the Keynesian preference for liquidity associated with the deficiency (or excess) of effective demand. In fact, while the notion of demand for real money (liquidity preference) refers to the role of money as a fund of value, the demand for nominal money concerns the role of money as means of payment. More in general, this new situation, characterized as it is by the *endogenous* supply of money, differed substantially, both from the situation diagnosed by Keynes,² in which exogenous variations of the money supply determine the interest rate, and from the situation described by the quantity theory of money, according to which exogenous variations of the money supply determine prices. Let us examine more closely the substance and the effects of this new state of affairs.

Inconvertible paper money constitutes an efficacious instrument for taking the sting out of some of the contradictions that may afflict the economy. In particular, it has the potential to diffuse the impact of the conflict over income distribution upon weak and/or ingenuous social groups. Employing a literary parallel, we may say that inconvertible money resembles don Circostanza (don Circumstance), an intriguer and opportunist lawyer, who in defense of the people of Fontamara³ against the plan of the mayor to deprive them of the water of the brook, proposes that each of the two conflicting parties be awarded $\frac{3}{4}$ of the water. With this trick, he succeeds in placating a protest of the people intended to preserve more than one half of the available water.

In conflictual-consumeristic capitalism, the money supply is stimulated, as just seen, by endogenous factors, primarily the conflict over income distribution. In some sense it reproduces don Circostanza’s expedient to placate Fontamara’s conflict by promising to the opposing parties more than the available water. In the presence of money illusion, a modest inflation is sufficient to make don Circostanza’s strategy bear fruit. But what happens if people begin to detect the illusory quality of money wages and the object of the bargain becomes real wages? The expansion of public expenditure and public debt may become an alternative path to the apparent elimination of the difficulties and inconsistencies that arise out of the struggle for income distribution. But, in the end, the financing of the public deficit stimulates the ‘nominal demand for money’ and hence inflation.

It is precisely this ‘cheeky’ use of money that has opened the door to some of the main difficulties afflicting financial markets today.

² Some neo-Keynesians, e.g. N. Kaldor and J. Robinson, underlined the endogenous character of money variations. But they did not consider that this endogenous character destroys the relation between the money supply and production based on the interest rate; in fact, they ignored its reductive impact on the preference for liquidity and hence on the validity of the theory of interest rate based on the demand and supply of money. These students did indeed express doubts on the incisiveness of the relation between money supply and production, but for different reasons from those we underline and they sometimes improperly assimilate interest rate to profit rate.

³ See Ignazio Silone (1990 [1930]).

2. The implications on financial activities of endogenous money variations

The palliative of monetary expansion in masking the inconsistencies considered above cannot work in the long run. In the absence of monetary illusion, the cumulative rise in inflation will oblige the introduction of restrictive monetary policies that discourage growth. So in conflictual-consumeristic capitalism, inflation does not stimulate production and accumulation; rather it primes depression, thereby generating so-called stagflation.

In the 1970s, J. Hicks provided an explanation of stagflation in terms of an extension to the long run Keynesian goods supply curve in which, in compliance with the so-called Phillips curve, a trade-off between unemployment and inflation is postulated.⁴ But in that period unemployment did not affect prices in the way predicted by this curve. Hicks pointed to the availability of primary resources as the cause of this anomaly. But, as a matter of fact, a primary cause of the stagnation in this period was restrictive policies directed to reduce the inflation caused by the intensified conflict over income distribution. The related oil price hike of those days was likewise the product of a distributional conflict, this one between oil-consuming and oil-producing countries. But the economic situation at that time was beset by more than just stagflation.

High inflation has perverse effects on the operation of financial activities. In particular, endemic inflation causes a fall in the preference for liquidity, thus demolishing the Keynesian barrier against the decline of the interest rate. Such demolition is accentuated by the fact that people with savings find it difficult, for the most part, to directly invest saved money; this induces them to accept nominal interest rates that, even if inferior to the inflation rate (i.e. negative real interest rates), nevertheless allow them to reduce the damage deriving from hoarding money in the presence of inflation. In other words, in the presence of endemic inflation the Keynesian liquidity trap does not operate in defense of the interest rate. In these conditions the rate of interest ceases to depend on the demand and supply of money, not only because of the disappearance of the liquidity trap but also because, as previously seen, the money supply is not an exogenous entity but is endogenously stimulated by the factors determining the 'nominal demand of money'. In such situations, therefore, the rate of interest on savings is decided by the banking system, which is obviously inclined to dampen this rate – a decision that the monetary authority may well be inclined to allow as it provides a way for the costs of the conflict over income distribution to be passed on to defenseless savers. In effect, from the 1970s and for many years, real interest rates have frequently been negative.

The implications of all this on financial markets can be shown by a brief framing of the so-called portfolio analysis: a general equilibrium model consisting of a number of reciprocally interacting sectors and financial activities. The operation of such a model requires a satisfactory degree of communication between financial activities, in particular between the money market and the remaining financial markets. If this condition is fulfilled, portfolio analysis allows us to see the ways in which variations in the money supply directly and indirectly affect the capital market, investment and, more generally, aggregate demand. But in order for such an analysis to be meaningful, two further conditions are also required: a flexible and stable monetary system, and that financial operators act with professional skill. Well, if the money supply is endogenously driven, being forced to follow the demand for nominal money, and if the demand for real money (the preference for liquidity) is practically insensible (as previously seen) to variations in interest rates, then the result is that the interrelationships between the money market and other financial markets are obstructed. Moreover, that a large number of savers do not have professional skills hinders the interaction among the various types of financial activities (even in the presence of savers' frenzies

⁴ See J. Hicks (1977).

and ingenuous speculations on shares and various bonds). So, the system of financial flows is almost deprived of some fundamental interactions. In sum, an increasing role of the demand for nominal money, by destroying the exogenous character of the money supply and causing a substantial atrophy of the demand for real money or the preference for liquidity, tends to restrict the financial structure to three poles: the banking system, the firm and the organs of the state charged with financing the public deficit. This may cause difficulties for the accumulation process and imply an unsatisfactory functioning of the economic and financial system.

However, the inflationary tendencies inherent to the endogenous character of money supply (i.e. the use of this endogenous character as a remedy in the conflict over income distribution by way of deficit spending, wages, etc.) cannot operate freely. From time to time, money restrictions to reduce inflation or, as an alternative, money depreciation will be requested.

3. What about the present?

The behaviors referred to above, drive (and force) the progressive restoration of the exogenous role of money; a restoration, however, that may be undermined by a heavy inheritance of public debt and inflationary potential. The situation is aggravated by the operation and strength of international financial markets in the modern global world, where speculation shifts enormous masses of capital instantaneously. There is no supranational authority able to discipline these activities and prevent the crises provoked by massive transfers of hot money.⁵ The evolution of financial instruments and markets easily renders obsolete older guidelines and codes of conduct. Worldwide speculation may force monetary depreciation upon monetary authorities, resulting in inflation and a perverse impact on financial markets. In this state of affairs, the restoration of an exogenous money supply becomes a difficult, not to say impossible task, while the control of the financial market is no longer within the hands of the individual sovereign state.

At the present moment, the situation of the European Community appears to be particularly acute and confused in this regard: the restoration of the exogenous character of the money supply is obstructed by the absence of a sovereign monetary authority concerned with the new currency, the Euro. The result is an almost free terrain for international speculation that is primarily the consequence of the large economic and financial disequilibria existing between the various European economies, which condemns those countries afflicted by high public debt and some risk of insolvency both to high interest rates and to the enactment of significant reductions of public expenditure, wages and hence demand, with a consequent and endemic stagnation and substantial inability to reduce public debt.

We have previously seen that some of the main problems that have entangled the role of money with the behavior of financial markets derives from the conflict over income distribution, the mediating role of public expenditure and the consequent variation of money supply following what we have called the 'demand for nominal money'. We have further seen that the attempt to control the consequent inflation has often initiated restrictive money policies, thus generating recession or, as an alternative, money devaluation, along with the inevitable implications for financial markets. One way to avoid these drawbacks is the separation of income distribution from production, with the exception of material incentives required by particularly undesirable or risky activities, thereby reducing the market to a mere mechanism for the imputation of costs and efficiency and, in this way, preventing the conflict over the distribution of income from affecting the production side.

⁵ Significantly, J. E. Stiglitz (2002) has harshly criticized IMF policies.

This separation seems necessary in order to meet the disorder of financial markets previously outlined, and has been discussed briefly in a paper for the online conference on ‘Economics in Society: the Ethical Dimension’. A more complete and rigorous treatment of the matter may be found in an article by A. Fusari and A. Reati published this year (2012) in *SCED (Structural Change and Economic Dynamics)*. The article presents and formalizes a model with all variables indispensable for the representation of a dynamic economy (in particular: endogenous innovation, radical uncertainty and entrepreneurship, non-competitive markets, production, prices, and the accumulation process). We therefore call our approach a ‘necessary’ model. It also includes the costs of factors as determined by their availability, but just in the mere quality of production costs, that is, excluding any implications (except material incentives, as previously noted) on income distribution, this latter being the object of choices and policies. For its part, the profit rate (intended separately from interest on capital) mainly plays an accountability role or, more explicitly, is primarily a measure of the degree of success of entrepreneurial actions and decisions, both in private and public firms. These features of our ‘necessary’ model and, in particular, the implied exogenous nature of income distribution, warrant the inference that the operation of the production side is only affected by the availability of resources (and, of course, by demand) and would allow the restoration of a genuinely exogenous role of money. Here we limit ourselves to only one variable of income distribution, the interest rate, in compliance with the object of the present online conference.

4. The rate of interest

What we say in this section and the next may appear to have – and in a certain sense does have – a provocative content and, furthermore, is in the main a reproduction of some part of another work by the present author.⁶ However, in the long run the suggested remedies may reveal an obligatory way of overcoming some untenable behaviors of financial markets and may lead to the building of some form of social capitalism, or even something better in terms of both equity and efficiency.

We have seen real interest rates moving from negative to high positive values and causing serious difficulties on such fronts as public finance, investment, production and entrepreneurship. S. Homer has given us an impressive and weighty study of the history of interest rates.⁷ The first developments in banking, which occurred in Medieval Italy, acted as a brake on what were then surging rates of interest, which indeed fell in that country to levels between 10 and 20 percent, while in the British Isles and Germany they rose to levels as high as 100 percent. In the late fourteenth century, Italian interest rates on commercial loans hovered around 8 percent, with a minimum of 5 percent, and in the fifteenth century an average of 5 percent prevailed in Germany. A century later, interest rates between 4 and 12 percent were frequent in Italy, Antwerp and Lyons. According to the historian C. Cipolla, Genoa’s financial powerhouse, the Banco of San Giorgio, charged interest and discount rates of 5 percent in the fifteenth century and little above 1 percent a century later.⁸ The wars of the sixteenth and seventeenth centuries caused a rise in the rates, but the seventeenth century subsequently witnessed a new fall: in the Netherlands interest rates dropped to 4 percent and, by the end of the century, 3 percent. The continued development of the banking system was the main cause of these decreases. With the advent of the financial leadership of England in the eighteenth century, long term government bond yields declined in that country towards 3 percent while the usury laws reduced the maximum rate of interest to 5 percent. In the nineteenth century, Britain’s long-term interest rates stabilized at around 3 percent, while

⁶ See Chapter VIII, written by A. Fusari, in H. Ekstedt and A. Fusari, *Economic Theory and Social Change*, Routledge 2010.

⁷See S. Homer (1996).

⁸See C. M. Cipolla (1980).

government bond yields reached 2 percent by the end of the century. The wars that followed caused the rates to rise again. These various fluctuations point to an inverse correlation between prosperity and interest rates; contrary to Homer's opinion, these movements do not establish a causal direction between the two phenomena; but their association is certainly meaningful. True, low levels of interest stimulate growth, and a low level thereby often stands as an expression of prosperity. What is more important, however, is that since interest rates decrease with the development of banking, their level – and indeed their very existence – come to depend on the characteristics of the credit system itself.

It is worthwhile emphasizing that interest basically represents a deduction from profit; a deduction that may be partially discharged at the expense of wages – which is a sure way of exacerbating social conflict. In any case, interest stifles entrepreneurial initiative. Can such an impediment to entrepreneurship be eliminated? Can the ensuing deduction from labour-income be eliminated? These are complex issues marred by a host of misconceptions.

To begin with, we have the deeply problematic challenge to the very idea of interest mounted, on the basis of the labour theory of value, by political economists and moralists from Aquinas to Marx.⁹ Actually, such a challenge is senseless. But as a consequence of this challenge the alternative justification for the rate of interest, which posits interest as just fruit (reward) of capital productivity – indispensable for the achievement of equilibrium between the supply and demand for capital – could easily gain ground (as in Neoclassical and Austrian theories). But this second justification is contradicted by a simple remark: capital productivity requires technical progress; in fact, in the absence of technical progress the process of accumulation would drive the productivity of capital toward zero; while, for its part, technical progress has almost nothing to do with financial capital. The Sraffian discovery of the phenomenon of the 're-switching of techniques' (that is the possibility that a rise in the rate of interest may imply an increase in the intensity of capital, instead of a decrease) and the connected controversy on capital by J. Robinson, P. Garegnani and others, undermined the thesis of Böhm-Bawerk's average period of production, finishing off once and for all the fashionable models of capital productivity built upon Robinson Crusoe's utopia.

Let us ask: is interest strictly necessary for productive and organizational efficiency? If it is not, the existence (and exaction) of interest is unnecessary, and we may thus safely conclude that interest represents an arbitrary and artificial form of income revenue. Is this the case?

Interest has little to do with the equilibrium between supply and demand of capital. As a matter of fact, far more than it does on interest, saving depends on the amount of income gained and therefore on the level of production; while entrepreneurs' demand for capital depends on levels of entrepreneurship in relation to the state of business, which is mainly expressed by profit expectations.

The argument that the rate of interest is necessary in order to prevent 'over-investment' and the concomitant waste of capital is belied by the fact that *such a role is as a rule fulfilled not by the interest rate but by the profit rate*; that is by: (a) the entrepreneurial search for profit, i.e., the tendency to extract the highest rate of profit from investment, and (b) by role of the rate of profit as a gauge of accountability.

All of the foregoing suggests that the role of interest is simply to throttle entrepreneurship and to subtract income from distribution. In principle, the share of income to be invested may be

⁹ In the *Tabula Exemplorum*, a manuscript of the thirteenth century, it is written: "All men abstain from working on Sunday days, but usurers work incessantly"; see J. Le Goff, *La borsa e la vita*, Laterza, Bari 1987, p. 24.

determined by the community abstracting from the rate of interest, being the profit rate sufficient to impose a judicious use of capital, thereby demonstrating that it is perfectly possible and efficient to share financing among the entrepreneurs at zero interest. *In sum, there are no technical impediments to the abolition of the interest rate through legal prohibition, i.e. by defining as usurious a positive real interest rate.* Of course, within a free international financial market there would need to be a concerted agreement to abolish real interest everywhere across the world.

It may be objected that zero percent real interest rates might encourage the tendency to hoard money; but this tendency could be opposed through a low rate of inflation or some sort of demurrage scheme on cash money. At any rate, nowadays the tendency to hoard seems to be almost irrelevant, due to the variety of modern banking services.

It is indeed remarkable that, on the shoulders of a variable as unnecessary, if not wholly pernicious as the interest rate has grown an enormous, complicated and rather obscure financial body primarily devoted to speculation and responsible for the serious shocks and malfunctions of the global network.

5. What about financial markets?

It remains, at this point, to attempt to delineate a blueprint for a financial system of production shorn of the negative and pervasive presence of interest – a blueprint that illustrates a potential, among other things, for clipping the wings of financial capital, stimulating entrepreneurship, overcoming the deficiency of global demand, and achieving a far greater openness than exists at present toward social justice. The financial system at present is a very complicated and slippery beast; we have seen that it is also heavily subject to malfunctioning and the tricks of speculation. It seems to us that the financing of production does not need such a complicated and insidious system, and could largely be replaced by the operation of the banking system, albeit not in its habitual features.

A discussion of the procedures required to modify the banking system in accordance with what follows is not relevant in this context; a detailed analysis of the matter may form the theme of another paper. The important point that needs to be emphasized at this juncture is the need to radically modify the central function of the banking system with regard to the funding of production. Financial capital is not at present at the service of production but, for the most, it enslaves production and exploits the toiling community into the bargain. This distortion needs to be redressed in the sense that *financial institutions become the servant, not the master of production.* Our proposal, aimed at heavily simplifying the complicated set of financial markets and activities, is presented here in as simple and transparent a fashion as possible.

Every year the community should define the share of value added to assign to consumption and investment, and to investment in selected strategic sectors. After that, care must be taken to ensure, through stimulus and instructions to the banking system, that these prescriptions are executed, as each investment is at the discretion of individual businesses. The capital required by the firms will come, in the first place, from profits. The uninvested portion of a firm's profits may be set aside for future investment. But the financing of capital must generally exceed the reinvested profits, so as to allow the formation of new firms and the financing of firms' investment plans in excess of gross profit. Such extra accumulation may be covered in part by private saving, which should yield a real interest rate of zero percent.¹⁰ However, savers should not be allowed to buy shares directly, since

¹⁰ A real interest rate of 0 percent on saving would actually be a bargain for savers who, over the course of time, have generally suffered a continuous devaluation of their savings owing to inflation, fraud and robbery, which in turn are

the stock exchange is much worse than a gambling house. The rest of the funds required to achieve the planned rate of accumulation will be provided by a fund of common wealth,¹¹ allowed for by the exogenous character of income distribution. This fund should channel the necessary quota to the banking system, to be distributed among firms.

Each bank's application to the fund for resources should be judged on the basis of its profit rate. In fact, bankers must be obliged to operate as entrepreneurs, and their commercial tenure must depend on business results. The more successful they are, as expressed by the profit rate, the more capital will be granted by the fund of common wealth via their commercial bank. Banks' profits should derive from the prices of the services that they offer to their customers; competition should keep these prices low.

A substantial feature of such a reform would be the creation of a mechanism directed to the achievement, through firms' investment, of the yearly rate of accumulation projected by the community, so that the possibility of a deficiency of global demand would be avoided or at least reduced substantially. Such a mechanism would also act as a stimulus to entrepreneurship. A major condition for the effectiveness of the projected mechanism is that *bankers provide sufficient credit to firms to allow them to achieve the community's projected accumulation rate*. Therefore, if the banks' requests for capital do not exhaust the fund set aside for accumulation, the difference should be assigned compulsorily to banks (say in proportion to the amount each has requested), for distribution among investing firms. This implies that, if the propensity to invest is low, banks will be forced to lower the prices for their services so that all the funds allotted to them for investment may be placed with the applicant firms. Vice versa, if the amount of capital provided by the fund of common wealth is lower than the total applications of banks based on the firms' borrowing, the negative difference will be deducted from those requests, in inverse proportion to their profit rates. This guideline of equality between the allocations for saving and investment is of crucial importance for the control of aggregate demand; in particular, it moderates the cyclical effects of entrepreneurial euphoria or pessimism. Moreover, it stimulates entrepreneurship since, when demand for credit is slack, firms may obtain inexpensive loans, as banks are required to loan funds up to the accumulation target. So banks are induced to make golden bridges to entrepreneurship.

If the propensity to invest is low, the duty of attaining the established aggregate rate of accumulation may cause heavy losses to the banking system. But this does not represent a problem for public banks, for which the profit rate is *only* an indicator of success (accountability role); in fact, the relative degree of success may also be expressed by the inverse of the rate of loss.

Such a financial system should eliminate the complications, tricks and unconstrained speculations of current financial systems, with their worldwide power over production.

Conclusion

The processes of globalization generate an increasing, and increasingly complicated role for the financial system in the contemporary world economy. By contrast, production, even if projected on a world scale, is subjected to largely national and local constraints. Moreover, production suffers from the clear – and yet often undecipherable – hegemony of the financial side. The opposition between the urgency and the increasing difficulty of restoring the exogenous and instrumental role of the money supply represents an outstanding contradiction within the world economy; a

mainly caused by speculation in financial markets.

¹¹ See, on this matter, A. Fusari, Chapter VIII in H. Ekstedt and A. Fusari (2010).

contradiction that is aggravated by the ever-increasing aggressiveness and power of international financial markets. The present confusions and complications, as well as the fleeting adjustments and obscure maneuvers associated with international financial flows, require drastic simplification and the restructuring of what represents, so to speak, the most effective world wide institution, i.e. the financial order. This paper has attempted to provide some ideas aimed at meeting this situation, ideas directed toward the construction of a national and international financial order that does not enslave but rather works in the service of production, promotes rather than brushes aside the claims of social justice, and improves rather than damages efficiency.

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