DEPARTAMENTO DE ECONOMIA

PUC-RJ

TEXTO PARA DISCUSSÃO

No. 272

CAUSES FOR PERSISTENT UNEMPLOYMENT AND FLUCTUATIONS IN MONETARY ECONOMICS

EDWARD J. AMADEO

JANEIRO 1992.

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Edward J. Amadeo

Department of Economics
Pontifícia Universidade Católica
Rio de Janeiro, BRAZIL

January 1992

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1. Introduction

Capitalist economies follow different patterns of fluctuation. If we think of the rate of unemployment as a measure of the movements of the economy, we note that the patterns of fluctuation vary across time and across countries. After the Second World War, unemployment remained very low in all advanced capitalist economies up until the late 1960's, then started fluctuating around a much higher rate over the 1970's and 1980's. In certain European countries, the average rate of unemployment over the 80's has been significantly higher than the OECD average, and much higher than what it was in the 1950's and 60's.

What accounts for the differences in patterns of fluctuations and in averages around which economies fluctuate? There is no complete answer to this question, and the answer to it cannot be the object of this paper. However, the paper does try to discuss issues associated with this general question. In particular, based on Keynes's views on the properties of monetary economies, the paper endeavors to highlight the factors accounting for economic fluctuations.

The paper opens in section 2 with a discussion of the operation of barter economies to show that, in principle, the existence of time and money are not required to impede the possibility of isolated bargains and decisions determining real

variables. Section 3 explores the properties of money which led Keynes to emphasize the differences between barter and monetary economies. Section 4 examines Keynes's criticism of the 'Classical theory'. In section 5 the notion of involuntary unemployment is presented based on the General Theory's static equilibrium position. The factors accounting for fluctuations in monetary economies are discussed in section 6. Section 7 looks at Keynes's view on the causes of persistent unemployment. Section 8 concludes the paper by arguing that current orthodox macroeconomics thought dismisses Keynes's view on the ineffective workings of market economies based on dogmatic grounds.

2. Nominal Decisions and Real Outcomes

In a barter economy, people exchange goods for goods, or promises to receive goods in the future. In particular, workers exchange human effort for goods. Let us take this wonderland one step further, and assume that only one good exists. In such case, workers would work only enough to receive the amount of the good they want to consume and save. In this very special world, workers and firms would negotiate over the real wage (units of the good per hour of work) and firms would be certain about the amount to produce. As noted by Chick (1983, p. 294):

> If workers are paid in kind, it is conceivable that they receive directly, as payment, the goods they wish to consume. In that circumstance, not only do employers know the demand implications of the labour they hire, but labour also knows the consumption potential of an hour's work, i.e. labour is demanded and supplied for a real wage which is known to both parties.

The situation if different if there is more than one good. For then, if workers were paid in kind, they would have to trade the goods in which they are paid for the goods they want to consume. In this situation, a vector of market prices would arise from the interaction of supply and demand for the goods at each period. Assume that firms only produce to pay their respective workers. Firms would still be sure of selling their output but workers would not be sure about the purchasing power of their wage -- the relative value of the basket of goods they receive at the end of the period. However, if the firm pays its workers in kind and sells the surplus in the market, it will not be sure of the price for which the goods will be sold. Hence, in this circumstances, firms would also face uncertainty.

The multi-goods system invites the appearance of monies: indeed, money first appeared to facilitate trade. A monetary economy is primarily one in which goods are traded for money. Labor is traded for money, and like all other prices, the money wage is denominated in money terms. Firms pay workers in money and sell goods for money. Firms buy machines for money, and sell the goods produced with the machine for money. Because relative prices and the price of money in terms of goods change over time, in monetary multi-goods economies agents exchange goods for money, and do not know exactly the purchasing power of their receipts.

However, as long as money only performs the role of means of exchange, its existence is immaterial for the phenomenon discussed here. Indeed, for the possibility of windfall gains or losses of workers, producers and investors, it does not really matter which good or goods are used as means of payment. In barter

economies with many goods, contracts are denominated in terms of a numeraire which has a variable value in terms of the other goods. The real price (in terms of any numeraire) of a good depends on the movement of relative prices. The later depend on the interaction of decisions of decentralized agents, and the individual agent cannot know for certain what the outcome of this interaction will be.

We usually think of time as an essential element in generating discrepancies between nominal and real prices, or expected and actual prices. Indeed, time is important to the extent that most contracts and decisions refer to future payments, and current prices do not provide a good signal of prospective prices. However, what is really crucial is the uncertainty associated with the decentralization of decisions, that is, the fact that agents negotiate and make decisions without really knowing what other parties are deciding. The compilation of a set of spot trades in an economy with many agents and many goods would certainly lead to windfall gains to some and losses to other agents. In principle, time does not have to elapse to create unexpected outcomes. Time surely adds uncertainty. Things which are taken for given in timeless cases may change as time elapses.

In sum, in an economy with many goods, in which atomized and uncoordinated decisions and transactions based on expectations are the rule, agents can not be thought to trade over real variables. All transactions are denominated in 'money' terms, and the 'real' outcomes will depend on the interaction of a multitude of decisions and bargains in the economy. It is interesting to note that this result does not depend on the existence of money or time.

3. The Essential Role of Money

Again, the possibility of windfall gains or losses of agents in a market economy does not depend in any essential way on the existence of money as a means of exchange or time. The importance of money in Keynes's thought is associated with fact that money as a store of value is a 'good' in itself in a system in which time elapses. As a means of exchange, money facilitates life, but no one would hoard money beyond a certain amount only because it minimizes transaction costs. The decision to hold money for transaction motives is rather mechanical, and the ratio of transaction demand to income is very stable.

However, agents do hold money and quasi-monies beyond the point determined by the transaction requirements. They do so because the possession of money provides them with a reward, namely, liquidity or marketability. Agents keep assets for their prospective return (interests on bonds or equities or profits resulting from the use of capital goods), and they keep money for its liquidity.

The benefits of possessing money --a barren but liquid asset-- varies over time. The preference for liquidity increases when, in face of a changing or unstable environment, agents find it difficult to form expectations over the prospective yield of assets, and therefore do not want to commit themselves with assets of doubtful marketability. The result of an increase in liquidity preference is a rise in the rate of interest which Keynes thought as a premium for giving up liquidity. An increase in the rate of

interest have a host of effects on the decisions taken by economic agents. In particular, it tends to reduce the propensity to consume and the incentives to invest. In a recession it would be desirable to have a decline in the rate of interest in order to activate aggregate demand.

It is the role of money as a store of value and the liquidity premium attached to it which Keynes probably had in mind when in 1933 he wrote that "the theory which I desiderate would deal ... with an economy in which money plays a part of its own and affects motives and decisions." [JMK, XIII, p. 408] Keynes referred to this theory as the **monetary theory of production.**

4. Keynes's Criticism of the Classical Theory

Keynes criticized the orthodoxy of his time on many grounds.[1] It is very difficult to provide a cohesive view of the critiques, but an attempt can be made. To concentrate on essentials and to maintain the objectivity of the argument, two objections to the 'classical theory' seem crucial:

I) Keynes criticized the orthodox economists for maintaining that "the wage bargains between the entrepreneurs and the workers determine the real wage... so that [the workers] can, if they wish, bring their real wages into conformity with the marginal disutility of the amount of employment offered by the employers at that wage". (JMK, VII, p. 11] The bargain over real

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1 It is interesting to note that, judging from the point of view of the General Theory, Keynes's Treatise on Money, published in 1930, was itself a piece of orthodox theory.

wages presupposes that the levels of employment and output are determined in the labor market, and correspond to the level of full employment of labor.

Keynes argued that workers negotiate money (not real) wages with entrepreneurs based on their expectations of the price level. Given the wage, firms fix the amount of employment based on the expected price of their product. The actual real wage of workers and product wage of the firm will depend on the evolution of the consumer price index and the market price of the good produced, respectively. Both depend on the interactions between the decisions made in other spheres of the economy. The first objection is thus related to the notion discussed in section 2 that in market economies, agents can not negotiate over real variables, only money variables.

An important contribution of the **General Theory** was the systematic analysis of the determinants of aggregate demand. Keynes's point was that the level of aggregate demand could be insufficient to absorb the output produced, in which case producers would revise their expectations and reduce the level of employment at the going wage.

II) Keynes also criticizes the orthodoxy for "rest[ing] the supposedly self-adjusting character of the economic system on an assumed fluidity of money-wages; and, when there is rigidity, to lay on this rigidity the blame of maladjustment." [JMK, VII, p. 257] In the **Treatise on Money** Keynes saw in money wage rigidity the main cause of prolonged unemployment. A reduction in money wages and prices would increase the level of real balances and

reduce the real wage thus closing the gap between investment and the level of full-employment saving. The **Treatise** was thus part of the orthodoxy which Keynes criticized in the **General Theory**. In the latter book, as we shall note in the following section, Keynes did not see the flexibility of money wages as a remedy to unemployment.

The treatment of changes in money wages is pivotal in Keynes's criticism of orthodox thinking in macroeconomics for it dismisses any logically unambiguous movement of the economy towards full-employment.

5. Equilibrium and Involuntary Unemployment

By noting that agents cannot negotiate over real variables --not even in barter economies-- we eliminate the possibility of real wages and employment being determined in the labor market. This is the essential message of Keynes's first criticism to orthodoxy as mentioned in section 4. Workers negotiate over money wages based on their expectation of the aggregate price level. Based on their expectation of the demand for their products, firms determine the level of employment. Workers and firms have to wait and see if their expectations are realized or falsified.

The actual price level will result from the interaction of supply and demand. Firms will offer what they produce --assuming for simplicity that they do not carry inventories between production periods. Aggregate demand will depend on the levels of consumption and investment. There is nothing that guarantees that the level (and composition) of output demanded will coincide with

the level (and composition) of supply. Windfall gains and losses ensues from the confrontation of supply and demand. In face of persistent windfall losses producers may reduce the level of employment or negotiate a reduction in money wages.

Keynes did not emphasize the role of windfall events in explaining the possibility of unemployment or economic fluctuations. Indeed, he assumed that short-period expectations were continuously fulfilled. If producers correctly foresee a reduction in the desired level of demand, they could either reduce the level of employment or negotiate a reduction in money wages.

Keynes's static equilibrium in the **General Theory** was given by the level of employment associated with the level of aggregate demand as determined by long-period expectations of entrepreneurs, the supply of money, the propensity to consume out of income, the state of preference for liquidity and the money wage rate. The level of employment thus determined could well be such that workers would not find jobs at the prevailing wage thus characterizing a situation of involuntary unemployment.

6. Sources of Fluctuations in Monetary Economies

In Keynes's scheme, the levels of employment and price and the rates of interest and real wage (the endogenous variables) fluctuate according to the effect of changes in the independent variables, namely, long-period expectations of entrepreneurs, the supply of money, the propensity to consume out of income, the state of preference for liquidity and the money wage rate.

The more volatile of the independent variables are the state of liquidity preference and the long-term expectations of investors. Both affect the rate of investment which is seen as the more unstable component of aggregate demand. Keynes ascribed great importance to the uncertainty associated to decisions involving long intervals of time. Expectations about the future always have an imponderable element which, to a certain extent, makes the decision slightly (or, depending on the circumstances, fairly) irrational.

In stable environments, a set of beliefs develop, and decision-makers become more confident about their choices. The imponderable is still there, but they do not ascribe a lot of weight to it. This does not mean that they might not turn pessimistic about the economy, in which case their long-period expectations will lead them to reduce the level of investments with obvious effects on employment. There might be objective reasons for the pessimism (the international market for a certain product is becoming sluggish) or simply the spread of some pessimistic subjective view.

Unstable environments increase the weight attributed to the imponderable. It is time to be careful, and avoid committing resources with iliquid assets. That is when the demand for liquidity increases creating pressures on the rate of interest, and thus negative influence on investment and consumption.

Some prominent Keynesians like G.L.S. Shackle and Paul Davidson ascribe great importance to the volatility of investment as a result of changes in expectations and the instability of the environment. Indeed, they tend to see Keynes's main contribution

to economics associated with the instability of expectations and investment. The volatility of the level of employment would then be the central concern of this strand of Keynesian thought.

7. The Persistence of Unemployment

If the instability of employment is undesirable, the persistence of it is even worse. Keynes had a very pessimistic view on the prospects of self-adjustment of market economies. He thought that the key adjusting variables (the interest rate and the money wage rate) were slow to change, and when they changed, the economy did not respond in the right direction. In this respect Keynes was not an apologist of market economies, quite the contrary.

Keynes thought that money wages were slow to fall in face of unemployment. His argument for the rigidity of wages was the following:

> Since there is imperfect mobility of labour, and wages do not tend to an exact equality of net advantage in different occupations, any individual or group of individuals, who consent to a reduction of money-wages relatively to others, will suffer a **relative** reduction in real wages, which is a sufficient justification to resist it... The effect of combination on the part of a group of workers is to protect their **relative** real wage. [JMK, VII, p. 14]

However, if in face of acute unemployment, money wages start falling, the question still persists about the response of aggregate demand. Keynes saw a number of 'pathological' responses, that is, responses which would lead to greater unemployment. The effects of changes in money wages on aggregate demand are well

known, and we shall not endevour to list them all. Suffices to quote a few of Keynes's most important remarks:

If ... we restrict our argument to the case of a closed system, and assume that there is nothing to be hoped, but if anything the contrary, form the repercussions of the new distribution of real incomes on the community's propensity to spend, it follows that we must base any hopes of favorable results to employment from a reduction in money-wages mainly on an improvement in investment due either to an increased marginal efficiency of capital ... or a decreased rate of interest. [JMK, VII, pp. 264-5]

The contingency, which is favourable to an increase in the marginal efficiency of capital, is that in which money-wages are believed to have touched bottom, so that further changes are expected to be in the upward direction. The most unfavourable contingency is that in which money-wages are slowly sagging downwards... When we enter on a period of weakening effective demand, a sudden large reduction of money-wages to a level so low that no one believes in its indefinite continuance would be the event most favourable to a strengthening of effective demand. But this could only be accomplished by an administrative decree and is scarcely practical politics under a system of free wage-bargaining. [JMK, VII, pp. 264-5]

It is, therefore, on the effect of a falling wage- and price-level on the demand for money that those who believe in the serf-adjusting quality of the economic system must rest the weight of their argument. [JMK, VII, pp. 266]

Keynes was doubtful about the efficacy of reducing money wages, and if the only effect which could really attenuate the persistence of unemployment was a reduction in the rate of interest, he favored an increase in money supply. However, even the reduction in the rate of interest was not sure because if the recession was associated with uncertain prospects about the future, agents would tend to absorb whatever amount of money the Monetary Authority decided to throw in the market.

Keynes's pessimism on the self-adjusting properties of market economies resulted from the rigidity of the money wage and

interest rates, on the one hand, and on the ambiguity of effects associated with the fluidity of money wages.

8. Orthodox vs. Heterodox Views on Self-adjustment

In macroeconomics textbooks, Keynesian theory is identified with the case of rigid money wages. This is of course an incorrect interpretation which results either from an incomplete reading of the **General Theory**, or a partial interpretation of Keynes's ideas which, for some reason, elects one of the two alternative (but not excludent) possibilities mentioned by Keynes. Another intriguing aspect of the current orthodox literature is the selection of effects of changes in money wages which unambiguously lead the economy to full employment. What is even more curious is the fact that in the literature itself one finds 'pathological' effects (different from those mentioned in the **General Theory**) which the authors chose to ignore.

The bias towards a view which only privileges either wage rigidity or 'well-behaved' effects, completely abandoning the pathological cases, can only result from a dogma --the dogma according to which market forces, in a competitive setting, work. Even if, from an empirical point of view, the perverse effects were irrelevant, the fact that they are theoretically sound should be sufficient to deserve notice.

In order to illustrate the dogmatic attitude of the orthodoxy, we introduce a semi-formal presentation of the determinants of aggregate demand taking into account not only some

of the effects discussed by Keynes but also others found in the literature. Consumption is usually seen as a function of disposable income (D), wealth (W) and the real rate of interest (i - p where i is the nominal interest rate and p is the expected rate of inflation):

$$C = C\ (D, W, i - p)$$

where $D = Y - T - p[(M + B)]/P$

$W = (M + B)/P + K$

Y = total income; T = taxes; P = price level; M = stock of money; B = stock of governemt bonds; and K = stock of physical capital.

The definition of disposable income is a simplified version of the definition given by Sargent (1979): total income minus taxes minus "the perceived rate of capital loss on the real value of the public's net claims on the government" (p. 16). The idea of the latter deduction from total income is that inflation imposes a tax on assets held by the public. The definition of wealth follows the conventional specification: the sum of the stocks of real outstanding financial and physical assets.

Investment demand is usually seen as a function of the ratio of prospective returns measured in terms of the marginal efficiency of capital (Q) to the real interest rate:

$$I = I\ (q)$$

where $q = Q/(i-r)$. Aggregate demand can thus be written as follows:

$$(*) \qquad A = A\,\{Y - T - p[(M+B)/P],\ (M+B)/P,\ q,\ i-p\}$$

In general, an asset market equilibrium equation of the following type is appended:

$$L\,(i,\ Y) = M/P$$

Assuming a typical production function and perfect competition, it can be shown (see Sargent, p. 50) that

$$(**) \qquad dP/P = dW/W - (F''/F'^2)\ dY$$

where F' and F'' are the first and second derivatives of the production function which respect to labor.

In the typical Keynesian model, the aggregate demand function has all the arguments listed in equation (*), and it can be shown that, given the money wage, the level of

aggregate demand may not be sufficient to employ all workers willing to work at the prevailing real wage. This is the conventional Keynesian static equilibrium result. If money wages fall, and thus through equation (**) the price level falls, given the anticipated rate of inflation (p), there will be an increase in real balances creating pressures for the interest rate to fall (Keynes effect). The reduction in the rate of interest tends to activate both investment and consumption. The increase in the

price level also increases the value of wealth (Pigou effect) thus inducing greater consumption. These are the favorable effect for employment.

But there are adverse effects as well. The reduction in the price level increases the loss on the real value of the public's net claims on the government thus reducing disposable income and consumption.\[3] Deflationary expectations ($p < 0$) increases the expected real interest rate thus inhibiting investment and consumption. \[4]

Orthodox economists are optimistic (and apologetic of market economies): they only believe that the favorable effects prevail. That is why they privilege money wage flexibility, and blame rigidity for the persistence of unemployment. Heterodox economists on the other hand, are pessimistic about the prospects of self-adjustment through wage deflation and favor institutions which reduce the degree of wage flexibility.

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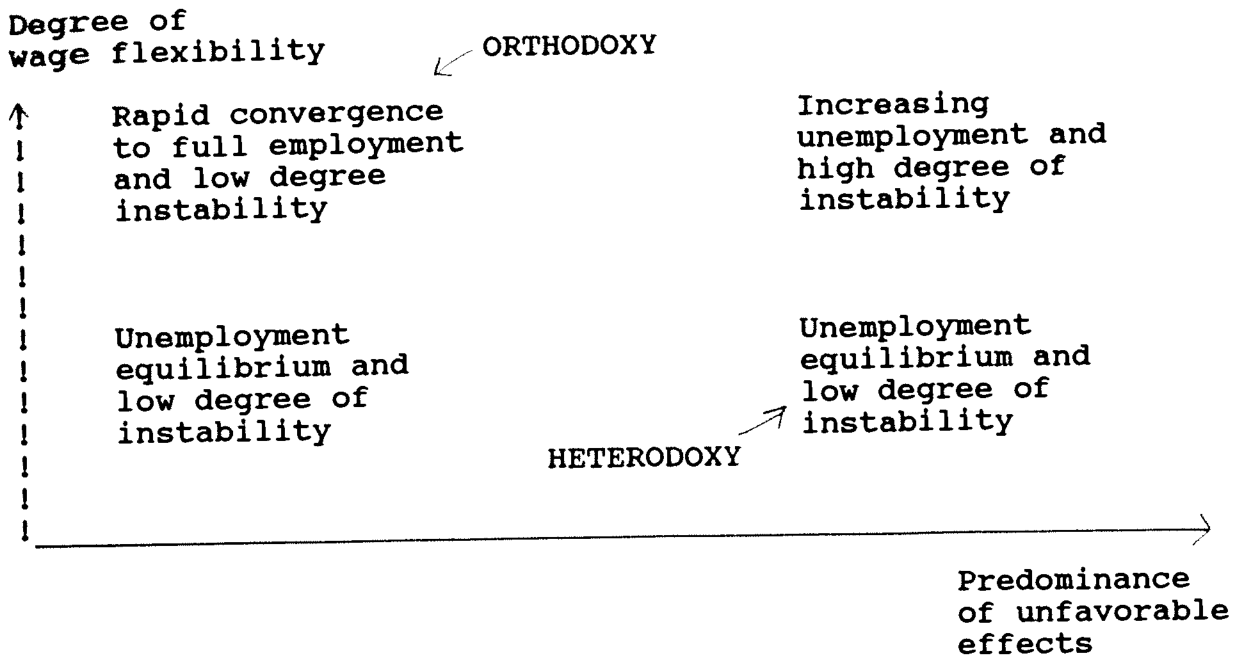
3 This effect is found in Sargent (1979, p. 61).

4 This effect is found in Tobin (1975), Delong & Summers (1984) and Amadeo & Dutt (1991).



As shown in the Figure, the greater the predominance of favorable effects, the more desirable wage flexibility becomes. On the other hand, if there are reasons to believe that unfavorable effects might prevail, the best situation is one in which wages are rigid downwards. Keynes himself was a heterodox:

> It follows, therefore, that if labour were to respond to conditions of gradually diminishing employment by offering its services at a gradually diminishing money-wage, this would not, as a rule, have the effect of reducing teal wages and might even have the effect of increasing them, through its adverse influence on the volume of output. The chief result of this policy would be to cause a great instability of prices, so violent perhaps as to make business calculations futile in an economic society functioning after the manner of that in which we live. [JMK, VII, p. 269]

It is an intriguing matter the reasons which led the profession to ascribe to the General Theory and Keynes the notion that unemployment resulted from rigid money wages. Keynes did

believe that wages were slow to fall, but his message was clearly that flexibility would not solve the problem. Keynesians are right in discussing explanatory hypothesis for the existence of wage rigidity,\[5] but they do no good in disregarding the ambiguous results coming from flexibility. The preference for unambiguously favorable effects, and thus the self-adjusting property of market economies, can only result from a 'vision' or an ideology about the functioning of capitalist economies. Logics alone will not do it.

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5 See Solow (1990) for a review of the alternative explanations.

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