The impact of financial liberalisation on income inequality
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In the 1970s, the tight regulation of financial systems came under attack from neoclassical economic writers who argued that liberalisation would ensure a greater provision of finance for investment. In the US, financial liberalisation in the 1980s and 90s led to a major expansion of financial institutions paying very high top salaries while the pressure on non-financial corporations to cut costs and raise returns led to a significant increase in inequality. In Brazil the financial system was liberalised in the 1990s, but determined efforts by the government from 2003 to raise lower incomes and pensions and to make financial services more widely available resulted in a noticeable decline in inequality. In Germany, government attempts to promote a greater role for financial markets in the 1990s had only a limited impact and, while inequality increased in the 2000s, this was primarily due to highly regressive labour market reforms. In India, liberalisation of the highly the highly regulated financial system in the 1990s led to a relaxation of priority programmes directed at rural areas and, as private and foreign banks shifted to providing finance to the business sector, there was a striking increase in inequality.

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In the first three decades after the Second World War, the financial sector was tightly regulated in most capitalist countries. In both developed and developing countries the main aim of economic policy was to promote economic growth and high levels of employment. Under the influence of Keynesian ideas, there was a belief that low interest rates were desirable to promote investment. As a result of the experience of the 1929 crash and the subsequent depression there was widespread scepticism about the stability of an unregulated financial system. Famously, in the US the Glass-Steagall Act of 1933 had imposed a complete separation between commercial banks (which accept deposits and give loans) and investment banks (which are involved in securities markets). More widely, countries established strict controls on the financial sector, often involving limits on interest rates and the creation of government programmes to direct the allocation of credit. In many countries, state owned development banks were established to ensure that credit would be made available to priority sectors. These ranged from the Kreditanstalt für Wiederaufbau in a developed country like Germany, to the Banco Nacional de Desenvolvimento Econômico e Social in developing Brazil.

In the 1970s, when the post-war economic boom came to an end and the high rates of economic growth could not be sustained, the government regulation of finance began to be challenged, both by academic writers and by large financial institutions, in particular the big banks in the developed countries, which

¹ Berlin School of Economics and Law. I should like to thank Hansjörg Herr and Alexander Gallas for their helpful comments on an earlier draft of this article.
were keen to escape the constraints on their profit-making activities. This article will first outline the arguments that were put forward in favour of policies of financial liberalisation; it will then turn to examine the impact of such policies, first in the United States of America, which was the archetypal example of financial liberalisation, and then in Brazil, Germany and India, three countries where the impact of financial liberalisation has had rather diverse outcomes.

**Financial liberalisation**

In the early 1970s, the predominant view that the financial sector should be subjected to tight regulation by the state was challenged in influential books by two US economists, Ronald McKinnon (1973) and Edward Shaw (1973). The books appeared as the post-war economic models were running into difficulties in both developed and developing countries, and as a more general critique of interventionist policies by neoclassical economists such as Milton Friedman was gaining influence in policy making circles.

Much post-war economic analysis had paid relatively little attention to the monetary and financial dimensions of the economy – this despite the fact that Keynes himself had, above all, been a specialist in monetary economics. The analysis of McKinnon and Shaw, which was primarily concerned with developing countries, represented a shift away from the post-war focus on the so-called ‘real’ economy. They argued that greater monetisation and the development of financial intermediation were conducive to economic growth. McKinnon and Shaw referred to the expansion of the financial sector, approvingly, as ‘financial deepening’, and used the ratio of monetary assets to gross domestic product as a key indicator of how far it had advanced.

McKinnon and Shaw were very critical of policies which they considered restricted the process of financial deepening. They argued that government ceilings on interest rates, or programmes to direct credit to priority sectors, had had a negative impact on economic development. They categorised these policies as ‘financial repression’ – a term which sought to appropriate the language of freedom and liberty to support their proposals for financial liberalisation.

A key argument in favour of financial liberalisation was that, by eliminating legal limits on interest rates, it would be possible for interest rates to rise above the government imposed ceilings. Higher interest rates, it was argued, would lead to higher savings, as the higher return would make it more attractive to postpone consumption. Higher savings, in turn, would increase the funds that were available to finance investment in production and growth.

A further argument advanced in favour of financial liberalisation and higher interest rates was that it would lead to better quality investment. With higher interest rates only those projects that could generate a high rate of return would obtain financing, in contrast to the situation with programmes of directed credit which often resulted in the financing of projects with low (or even negative) rates of return.

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2 This draws on Evans (1998).
Criticisms of financial liberalisation

The analysis of McKinnon and Shaw proved to be very influential, both in academic circles and amongst policy makers. However, it has also been subject to considerable criticism. One line of criticism has been based on analysing the impact of early financial liberalisation programmes. A widely cited example of this was the analysis by Carlos Días-Alejandro (1985) of developments in Chile after the military coup in 1973. Under the influence of neo-liberal economists from the University of Chicago, the military dictatorship privatised the banking system, eliminated interest rate controls, and removed all restrictions on international capital transactions. Chilean banks responded by borrowing large amounts of capital abroad, and lending this at much higher interest rates to domestic private firms. This initially proved extremely profitable, but following a flight of capital from the country in 1981, the banks were hit by a major crisis. Faced with a widespread collapse of the banking system, the government was obliged to intervene and takeover large parts of the financial system.

A second line of criticism of the policy of financial liberalisation has been based on questioning the neoclassical argument that higher interest rates will lead to higher savings. From a Keynesian or Marxian perspective, an increase in interest rates is likely to lead to a decline in investment. This will have a negative effect on the growth of national income which, in turn, will tend to depress the amount of savings (Burkett & Dutt, 1991).

A third criticism of financial liberalisation has been based on the results of econometric studies. Such studies are always faced with problems of obtaining appropriate data, and this is especially true in developing countries. There have, however, been many such studies and while some of these do appear to lend support to the arguments in favour of financial liberalisation, there are many which do not. An influential survey co-authored by Rudiger Dornbusch (1989) concluded that the strong claims for financial liberalisation were not supported by the evidence.

In the face of the criticisms and doubts about the claims made for financial liberalisation, the response of some mainstream economists was to side-step the terms of the debate. An important example of this was an article by Robert King and Ross Levine (1993) which surveyed a large quantity of cross-sectional data for indicators of financial development in 80 countries over a period of some 30 years. They concluded that an argument by Joseph Schumpeter, that finance is important for development, was right – albeit without entering directly into the controversy over financial liberalisation. A later survey article by Levine (2005) reached a similar conclusion, adding that the development of the financial system is a precondition for economic development, rather than a result.

Ronald McKinnon also responded to the criticisms of financial liberalisation with a collection of essays (McKinnon, 1993) in which he distanced himself from some of the positions he had taken in his earlier book. In response to developments in Chile and various other countries he argued that financial liberalisation should be carefully phased, and that the order in which different measures were implemented should depend on the specific conditions in a country. He also accepted that the empirical evidence showed that savings did not respond to higher interest rates, as he had argued in his earlier work. Perhaps most strikingly, he agreed that, due to what he referred to as ‘information deficiencies’, governments should probably introduce ceilings on interest rates.
The impact on official institutions

Despite the more critical approach of some academic economists, the arguments for financial liberalisation have had considerable influence on official international institutions. Following the onset of the debt crisis in many developing countries in 1982, the countries that were affected had to turn to the International Monetary Fund (IMF) and the World Bank for financial support. The IMF had since its inception held deeply conservative positions on financial policies, calling for sharp cuts in public spending as a condition of financial support.

The World Bank, by contrast, had previously provided long-term finance for funding development projects, such as road building or rural electrification. In the early-1980s, however, it shifted its approach with the adoption of so-called Structural Adjustment Programmes. In place of funding for specific projects, government received loans to support their general spending, but it was a condition of such loans that the government introduced major policy changes. Subsequently, in 1987, the IMF introduced what it called Enhanced Structural Adjustment Programmes, which also involved advancing loans on the condition that governments introduced major policy changes.

One of the conditions that countries were usually required to meet in return for a structural adjustment loan was the introduction of financial liberalisation programmes. These programmes typically involved the liberalisation of interest rates, the abolishment of directed credit programmes, and the closing of state-owned development banks, many of which had made losses.

In 1989, the World Bank dedicated its prestigious annual development report to the subject of finance and development (World Bank, 1989). This presented a radical critique of state intervention in the financial system, and argued strongly for the adoption of policies of privatisation and deregulation. In subsequent reports, the World Bank stepped back from its more extreme calls for liberalisation, and adopted a somewhat more nuanced position. But while the analytical positions adopted in World Bank publications might have stepped back from some of the more wide-sweeping claims for the benefits of free-market economics, the policies which it and other international financial institutions promote have continued to stress the benefits of financial liberalisation.

Financial liberalisation in the United States

The United States – along with Britain – was one of the first developed capitalist countries to embark on a widespread deregulation of its financial system. In 1980, as official interest rates were raised to combat rising inflation, the Carter government abolished the legal ceiling on deposit interest rates that had been introduced in 1933. The process of financial liberalisation then accelerated after the Reagan government took office in 1981. In 1982, a new banking law lifted many of the restrictions on the activities of savings & loans associations (S&Ls), financial institutions which allowed households to save and subsequently obtain financing to purchase a home. This allowed the S&Ls to expand rapidly and many embarked on financing more speculative activities until huge losses led to a serious crisis in the sector in the late 1980s and early 1990s, requiring government support of some $150 billion. In 1987, the Reagan government appointed Alan Greenspan as head of the Federal Reserve and in the following years

\[3\] For a fuller account see Evans (2009).
the Fed adopted an increasingly flexible interpretation of the 1933 Banking Act, allowing commercial banks to slowly expand into activities that previously had been prohibited. Finally, in 1999 under the Clinton government, the legal separation between commercial and investment banks introduced in 1933 was entirely lifted, allowing the reemergence of giant financial conglomerates.

The financial sector had grown roughly in line with the rest of the US economy between the 1950s and 1970s, but from the 1980s its growth registered a significant acceleration. Firstly, there was a major expansion of financial institutions, including banks, institutional investors (in particular mutual funds where better-off middle class households could invest their savings) and, somewhat later, smaller but highly speculative hedge funds and private equity funds, which operated to large extent with borrowed money. Secondly, there was a rapid growth of financial markets, including the foreign exchange market, and the markets in bonds, shares and other securities. Finally, there was a rapid process of innovation which gave rise to the creation of a whole range of new financial instruments, including exotic forms of derivatives and highly complex instruments, such as collateral debt obligations which were designed so as to obscure the risks which they involved.

Developments in the financial sector had a significant impact on non-financial corporations. Institutional investors, which had previously played a relatively passive role, began to exert pressure on non-financial companies to give priority to raising their short-term profitability, so as push up dividends and share prices. Companies that failed to meet profit projections were threatened with the prospect that investors would sell their shares, and a fall in share prices would leave the top management vulnerable to a hostile takeover. Indeed, non-financial firms began to buy back their own shares in order to strengthen their price. In order to meet the profit targets, firms were under constant pressure to rationalize and cut costs, by closing the least profitable units and by outsourcing tasks, either within the US or abroad. Because of the constant pressure to obtain high returns, non-financial firms also began to invest in financial markets themselves when this appeared to offer a higher return than investing in production or commerce.

The constant pressure to rationalise production and cut costs, together with non-financial firms’ investments in financial assets rather than in productive or commercial projects that might create jobs significantly weakened the bargaining position of workers. The downward pressure on wages and on jobs, once described by two mainstream economists as ‘the frightened worker effect’ (Blinder & Yellon, 2001) has led to a very marked increase in inequality in the distribution of income. According to estimates by the Economic Policy Institute, between 1979 and 2007, real wages for the lowest paid 20 per cent increased by 10 per cent and for the middle 20 per cent by 20%, with most of the increase occurring in both cases during a short period of strong growth in the late 1990s. By contrast, there has been a strong growth of income during this period for the top 20 per cent, with the very top 1 per cent benefiting from an increase of 240 per cent. (Mishel et al, 2012). According to estimates published in Alvaredo et al (2013), the share of the top 1 per cent in US national income increased from 9 per cent in the late 1970s to around 20 per cent in 2007, although it then declined slightly as a result of the financial crisis.

In the US, the growth of the financial sector from the 1980s was therefore strongly associated with a major increase in inequality. Top incomes increased dramatically, both in the financial sector and in non-
financial corporations, while the income of middle and working-class sectors remained stagnant or increased only very slowly. However, as became obvious, these developments were unsustainable. The income generated by big banks and other financial institutions was dependent on the creation of ever more dubious financial instruments. Non-financial corporations increased their holdings of financial assets, which proved more profitable than fixed investment in expanding productive capacity. Domestic demand was consequently strongly dependent on consumer spending, but with wages for most working and middle-class households effectively stagnant, spending was financed by borrowing against rising house prices (Rajan, 2010). This constellation collapsed in the financial crisis which broke in the US in August 2007 and, after a dramatic deepening in September 2008, led to the most severe recession in the US since the 1930s.

**Financial inclusion in Brazil**

The financial system in Brazil is predominantly bank based, and is characterized by conglomerates organized around large public and private banks. In 1994 the government launched the Real Plan which was intended to stabilize the economy and which brought a lengthy period of very high inflation to an end. The financial system was subsequently subjected to a policy of deregulation and partial privatization, and foreign banks were allowed to enter the country as part of a policy of promoting greater competition. This led to a wave of mergers and takeovers among private national banks in the late 1990s and early 2000s, as they sought to consolidate their position. Despite the liberalisation programme, public banks continue to play a major role in the economy, and include two universal banks, the national development bank (BNDES) and two regional banks. The public banks are largely responsible for managing an extensive programme of ‘earmarked’ credits for priority lending to households and businesses at reduced interest rates. In 2011, public and national private banks each accounted for about 41 per cent of bank assets, and foreign banks for 18 per cent.

Despite the important changes in the structure of the Brazilian banking system after 1995, banks initially continued to favour investments in short-term treasury bills, which were indexed to the central bank’s policy rate, and which offered a high rate of return. Although nominal interest rates declined after the end of hyperinflation in 1994, real rates remained high and between 1994 and 2002 the volume of bank lending actually declined as a share of GDP.

A major change occurred from 2003 following the election of President Lula da Silva, and the beginning of a strong period of economic growth. The new government raised the level of minimum wages and pensions, and introduced the *Bolsa Familiar*, a programme of cash grants for poor families. Growth benefited strongly from the demand for the country’s primary commodity exports – in particular from China – while at the same time an inflow of foreign capital contributed to lower interest rates and a stronger exchange rate. In the following years bank lending increased significantly, rising from 25.7 per cent of GDP in 2003 to 49.0 per cent in 2011. This involved a large expansion of lending to the business sector, but it involved an even larger expansion of lending to private households. This was encouraged by the new government’s policy of promoting financial inclusion, which involved the introduction of payroll deducted credit schemes for workers and pensioners. The aim was to enable lower-income

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4 This section is based on Magalhães Prates and Nunes Ferreira (2013).
households to purchase consumer durables and homes, and contributed to a strong growth of domestic demand.

The onset of the international financial crisis resulted in a considerable modification in the pattern of credit expansion. Between 2003 and 2008 the expansion of credit was led by national private banks and foreign banks, which are primarily involved in the provision of non-earmarked credits, including the strong growth of credit to households. But from 2008, the growth of private and foreign bank lending declined sharply in response to the deepening international crisis, and the public banks embarked on a strong increase in their lending, including for earmarked programmes, as part of an anti-cyclical credit policy. The national development bank (BNDES) in particular played a key role in implementing a programme of investment support in 2009, which provided substantial financing for private companies, with around half of its resources intended for micro, small and medium enterprises. From 2011, as the danger of contagion declined, the private and foreign banks increased their rate of credit expansion, while the public banks began to scale their lending programmes back.

The restructuring of the banking sector in the 1990s led to a significant loss of jobs in the sector, although this was partially recuperated after 2003, when the policy of expanding access to credit led to the establishment of new bank branches with new posts. Wages in the banking sector also increased in real terms by some 14 per cent between 2004 and 2012, although this was accompanied by a shift to the employment of less qualified staff and more precarious contracts, so that the cost for banks increased somewhat less.

Brazil introduced measures to promote the liberalisation and restructuring of its financial system in the 1990s. This initially led to a loss of jobs in the sector, but since 2003 there has been a major expansion of bank lending and, in a context of strong economic growth and high prices for export commodities, there was a strong growth of employment and real incomes, especially for lower income groups (Azevedo et al, 2013). Despite the shift towards a more liberalized financial model in the 1990s, the period since 2003 has been characterized by a reduction in income inequality. In 2012, as the demand for Brazil’s commodity exports began to weaken, economic growth slowed. But a major expansion in the availability of credit to households since 2003 has contributed to making consumer durables and homes available to much wider sectors of the population than before.

Limited changes in Germany’s bank-based system

Germany has a predominantly bank-based financial system in which, in principle, universal banks combine commercial and investment banking activities. Unusually for a developed capitalist country, private profit-oriented banks account for a minority of banking assets (38 per cent in 2012), and the sector is dominated by four big banks, of which one – Deutsche Bank – is much larger than the others. There is also an important publicly-owned sector (29 per cent), which consists of local savings banks owned by city and county governments and regional Landesbanken. In third place, a cooperative sector (12 per cent) includes local cooperative banks and two regional organizations. Historically, the profit-oriented banks lent predominantly to large corporations in which they also had significant shareholdings,

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5 This section is based on Daniel Detzer (2013).
6 Remaining assets are mainly accounted for by specialised mortgage banks.
whereas the savings and cooperative banks provided finance for Germany’s very successful small and medium enterprise sector.

In the 1990s, the German government launched a series of legislative initiatives designed to promote a more active role for financial markets in the economy (Financial Market Promotion Acts of 1990, 1995 and 1998). This was strongly encouraged by the big private banks which were keen to develop their investment banking activities as industrial companies had become largely self-financing and cut back their borrowing from the banks. Financial market activity also received an impetus from the elimination of a tax on capital gains in 2001, which made it much more attractive for banks to sell off their large shareholdings in non-financial corporations, and the introduction of a law in 2002 which reduced the ability of firms to defend themselves against hostile takeovers. The growth of financial markets was also strengthened in the 1990s by a privatization programme, most notably of the national telecommunications company, and for a time it looked as if a more share-holder oriented culture might be taking hold in the country, but the collapse of the stock market in 2000 quickly brought this to an end.

In Germany, unlike the US, the size of financial markets has not increased in relation to the rest of the economy. Financial corporations’ share of value added has fluctuated somewhat since the turn of the new century but, if anything, slightly declined. Since the early 1990s, earnings in the financial sector have increased roughly in line with economic growth, and although top incomes in the financial sector rose strongly, the increase was in general similar to that in other sectors of the German economy.

The regulatory changes in the financial sector have however been accompanied by a change in the pattern of share ownership. In the 1990s, there was a significant increase in the proportion of shares held by German institutional investors, such as insurance companies and pension funds; and in both the 1990s and in the first decade of the new century, there was an even stronger increase in the proportion of shares held by foreign shareholders, in particular institutional investors from the US and Britain. Surveys indicate that this has led managers of German firms to give greater attention to meeting demands from shareholders for higher returns. There has also been a rise in the activities of hedge funds and private equity funds, both of which invest in companies and then pressure them to raise their returns, something that invariably involves pressure to lay off workers and cut costs.

The German financial system remains predominantly bank based despite attempts to promote a more active role for financial markets. Such measures have had a rather limited impact on the source of company financing, but have nevertheless put greater pressure on German companies to raise returns. These changes coincided with a marked deterioration in the distribution of income in Germany, especially in the first decade of the 2000s. This was a period when real wages did not rise for the great majority of employees and the share of wages in national income declined. However, these wage developments affected all sectors of the economy, and not just those that were most affected by the increased shareholdings of institutional investors or the more active interventions of hedge funds and private equity funds.

The deterioration in the distribution of income in Germany appears to be due primarily to the radical labour-market reforms introduced by the Social Democratic – Green coalition government in the early 2000s, rather than to developments in the financial system. As a result of these reforms, Germany’s
relatively generous system of unemployment insurance benefits was curtailed and the possibility of unemployment therefore became much more threatening for many workers. In this situation, the unions responded by shifting the main focus of their bargaining away from demands for higher wages and instead gave priority to obtaining guarantees of job security for their members.

The decline of priority lending in India

The financial system in India consists of an organized sector, which is predominantly based on public and private banks together with various development financial institutions, and a large ‘unorganized’ or informal sector which provides loans for those who do not have access to the organized sector, but at much higher interest rates.7

The organized sector was subjected to a major policy initiative in 1969, when 14 banks were nationalized on the grounds that the private banks had primarily served big industrialists and ignored rural areas, leaving much of the population without access to banking services. Two development banks were set up shortly after, the Regional Rural Bank in 1975 and the National Bank for Agricultural and Rural Development in 1982. Following nationalization, a lead bank scheme allotted districts throughout the country to one public bank or another and the banks were required to focus on priority lending to agriculture and small industry. The priority lending was later broadened to include retail trade and professional and self-employed people, together with housing and consumption loans. Banks were also required to expand their network of rural branches, and a central bank directive in 1980 required public banks to allocate 40 per cent of their loans to priority lending. During this period the Finance Ministry also introduced the concept of ‘social banking’, by which public banks were to promote various poverty alleviation programmes, and which are reported to have contributed to a substantial reduction in rural poverty (Burgess and Pande, 2005).

In 1991, the Indian government initiated a major shift in policy, and as part of this the financial system was subjected to a policy of liberalisation, with the stated aim of creating an efficient and competitive financial system that could stimulate growth. This followed concerns about the low returns obtained by the public banks, and revelations that loans intended for poverty alleviation had partly benefited public functionaries. Liberalisation resulted in an easing in priority sector lending, and a reduction in targeted lending to small farmers and entrepreneurs. The mandate to open rural branches was relaxed and the number of rural bank branches declined. The policy of liberalisation resulted in the establishment of new private banks, and also permitted the entrance of foreign banks. However, these concentrated their business primarily on entrepreneurs and corporations, rather than rural lending which was seen as unprofitable and unreliable.

Despite the shift in policy, the State Bank of India, the key public sector bank, is by far the largest bank in the country, with more than 14,000 branches and some quarter of a million employees. Overall public sector banks accounted for 76 per cent of loans in 2012, compared with 19 per cent by private banks and 5 per cent by foreign banks. The private banks and the foreign banks pay much higher salaries than the

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7 This section is based on Anjeli Bedekar (2013).
public sector banks, but jobs in the public sector banks are highly prized as a source of stable employment, with applicants for jobs massively exceeding vacancies.

The period after 1991, when the Indian government adopted policies of liberalisation, was characterized by higher economic growth. However, it was also marked by a very marked increase in inequality (Aug, 2008). Real wages for the great majority of the urban and rural poor have not risen, and the benefits of economic growth accrued to the middle and above all the upper-income groups. Developments in the financial sector appear to have contributed to this process by shifting the availability of credit towards business and the better off, while the ending of interest rate ceilings put the cost of credit beyond the capacity of many rural and small-scale producers.

Conclusion

Closely regulated financial systems in both developed and developing capitalist economies began to come under pressure from the 1970s in response to the challenge from neoliberal thinkers, who advocated a process of liberalisation, and private bankers, eager to expand the sphere for profit-making activities. Although financial liberalisation programmes of one form or another were widely introduced, they have had a rather diverse impact. In the US, extensive liberalisation in the 1980s and 1990s was closely associated a major increase in inequality, due to both the very high incomes paid in the financial sector, and the pressure from financial institutions on non-financial corporations to reduce wage costs and employment. In Brazil, although a liberalisation programme was launched in the 1990s, government policies from 2003 led to a rise in the minimum wage and pensions, and new credit programmes have provided lower income groups with greater access to housing and consumer durables. Although incomes in Brazil remain highly unequal, inequality has declined. In Germany, government initiatives in the 1990s to promote a more active role for financial markets in the country’s traditionally bank-based system had only a limited success. There was however a notable increase in inequality from the early 2000s, but this was primarily due to labour market policies, in particular revisions to the country’s unemployment insurance system, rather than to any changes in the financial system. Finally, in India financial liberalisation in the early 1990s has led to a marked retreat from earlier credit programmes designed to counter inequality, most notably in rural areas. Economic growth accelerated but the benefits have accrued almost exclusively to middle- and upper-income sectors and the country has seen a marked rise in inequality. While financial liberalisation generally results in greater inequality, Brazil shows that committed government policies can, at least to some extent, counter this; in Germany, by contrast, although attempts to reshape the financial system met with only limited success, inequality increased.

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