Jnl Publ. Pol., **23**, 2, 171–199
DOI: 10.1017/S0143814X03003088

Financial Interventionism and Liberalization in Southern Europe: State, Bankers, and the Politics of Disinflation

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ABSTRACT

The article provides a structural and political account of financial intervention in Spain, Portugal and Greece and examines competing explanations for financial liberalization. It focuses on the economic and political objectives underlying financial reform, and the costs and benefits for government, central bank, and the banking sector. It argues that financial liberalization was, to a significant extent a necessary prerequisite for the central banks' programmatic effort to achieve effective disinflation. This challenges the dominant arguments viewing financial liberalization exclusively within the framework of the European financial integration program or as a result of interest group pressure. At a subsequent stage, a stabilization strategy based on monetary austerity entailed the significant political advantage of allowing governments to avoid a more radical pace of fiscal adjustment. Both financial interventionism and liberalization displayed a state-driven policy pattern.

Society-centered approaches tend to treat economic and structural reforms by mostly focusing on interest coalitions and rent-seeking beneficiaries of the status quo (Haggard and Kaufman 1992; Williamson 1994). On the other hand, much of the European integration literature centers attention to the economic dynamics and the political workings of integration at the European level (be it intergovernmental or Commission-centered). Such treatment often leaves the impression of a nearly 'automatic' convergence or adjustment of the periphery towards the EU institutional and policy program (cf. Bennett 1991; Tsoukalis 1997).

This article presents evidence to qualify the EU-centric view of financial and monetary policy adjustment, thus taking a more *decentralized* cross-national standpoint. Contrary to the familiar tendency of almost singularly attributing financial liberalization to the European financial integration program, we shift attention to the important additional role of the domestic reprioritization of monetary policy objectives. On the other hand, the article takes a *centralized* view in drawing primary attention to the state-level objectives, both economic and political, that underlie financial reform. We thus take exception to the view that seeks to explain financial reform in terms of interest group pressure; instead we advance a more state-centric approach that stresses the central bank (CB) and government interest in financial adjustment. The main argument to be developed is that the CBs' effort to disinflate drove liberalization in all three countries, financial reform being a precondition for the effective implementation of monetary austerity. Moreover, under European, external, or purely domestic economic pressure, the governments of Spain, Greece and Portugal tolerated or embraced monetrary reform for its advantage in offsetting their own more reluctant pace in fiscal tightening.

The origins of financial interventionism in Southern Europe

The Southern European (SE) postwar record of developmental state activism in finance was typical of financial and industrial interventionism in late industrializing centres (Haggard 1990; Wade 1990; Haggard and Lee 1995; Woo-Cumings 1999). To expedite industrialization and to offset market failures (lack of capital markets, undercapitalized private sector, an investment preference for speculative activities rather than manufacturing, inability of future profits to compensate for short-term losses, general information deficiencies) governments intervened in finance (Amsden 1992: 59). A first step, predicated on achieving some degree of monetary stability, was to draw public savings into the banking system. The next step was to encourage banks to lend long-term, and for that governments intervened in two ways. First, by creating specialized institutions like industrial development banks. Second, by requiring commercial banks (through lower fixed interest rates) to devote funds to private industrial investment or to long-term development loans or to state bonds for financing public infrastructure.

To facilitate growth, SE authorities decreased financial costs by suppressing lending rates. Through various interventionist instruments governments directed cheap credit to favoured sectors (industry, exports, small enterprises, agriculture) deemed 'productive', and discouraged the financing of 'unproductive' sectors (consumption, domestic and import trade, partly housing). As cheap credit was expansionary the authorities controlled its inflationary effects through direct instruments like credit ceilings, special reserve requirements and the occasional adjusting of interest rates.

Extending cheap credit to recipient groups over time conferred them considerable economic and political advantage. However, the establishment of financial interventionism to benefit industry, exports or agriculture did not come as an expression of these groups' power, in the sense that it would have existed even if such demanders were powerless, given the almost undisputed developmental doctrine of the time.[1] The interventionist financial institutions, universal as they were in their role of subsidizing manufacture, had more to do with the aforementioned state-directed strategy of development via industrialization, framed under the conventional developmentalist wisdom of the time, than with the bargaining power of national industrial sectors.[2] Industrial demand for subsidized finance increased as a result of the higher emphasis on capital intensive undertakings and the extensive reliance on external sources of finance, all standard features of the state-sponsored model of import substitution industrialization (Haggard 1990; Haggard and Maxfield 1993: 299; César das Neves 1996: 341). These remarks are germane in allowing us to conceptualize financial interventionism as primarily state-led or supply-driven rather than society-led or demand-driven. This is not to say that the (particularistic) pressure of business firms and groups did not carry some weight when it came to the specific arrangements and policies of financial interventionism. Favoring large established oligopolistic industries over newcomers aimed to protect their oligopoly privileges also in exchange for their political support (cf. Ellis 1964: 191ff; Lukauskas 1997: 68). Similarly, subsidized credit was extended to farmers also in regard of their electoral scope.

Financial interventionism in Greece and Portugal until the early 1970s, being part of a developmentalist policy mix, was premised on monetary stability.[3] On the other hand, Spain's 'cheap credit' policies, especially over the 1960s, had resulted in persistent inflation (Prados de la Escosura and Sanz 1996: 368, 372; Pérez 1997). Overall, especially in the 1960s and up to 1973, SE economies grew at significantly higher rates than other European economies (Diagram 1). Apart from its promise in delivering industrialization and growth, financial interventionism entailed the formidable political advantage of granting state policymakers (via state corporatism or plain patronage) the ability to indirectly control the country's socioeconomic life. At the same time it allowed government-favored economic groups to translate their political links into privileged access to financial resources. Thus, overall, financial interventionism in SE served a function of political as much as economic stabilization and, quite notably, a particularistic mode of economic development.

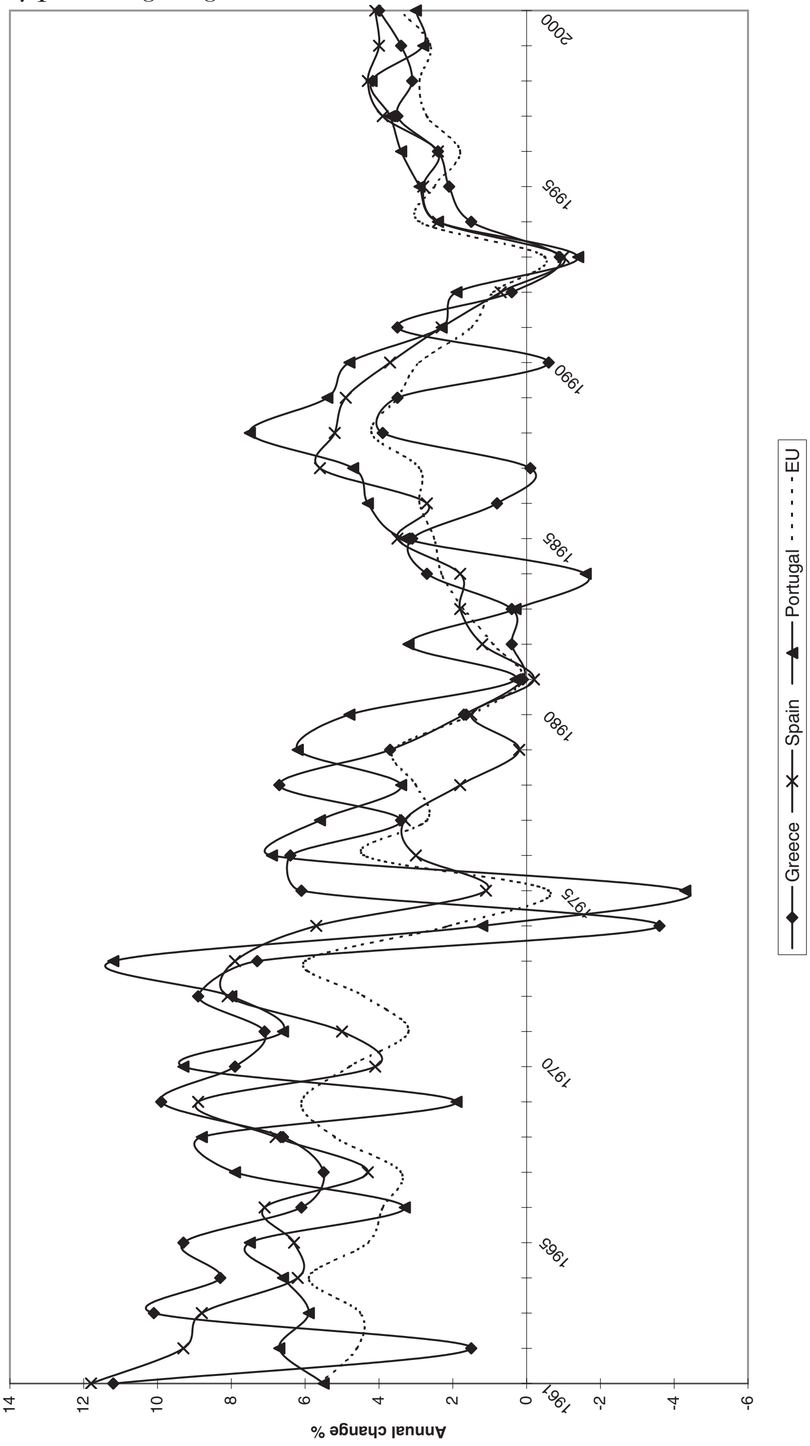


DIAGRAM 1. Real GDP growth.

Finally, postwar financial interventionism, operating in protected credit-based systems, benefited the banking sector. All three countries had cartelized banking sectors reigning over heavily underdeveloped financial markets; financial interventionism helped consolidate the sectors' oligopolistic structure. Despite suppressed lending rates to favored categories and relatively high reserve requirements, banks retained considerable profit margins resulting from the lack of competition. These were expressed in the form of suppressed deposit rates or high commissions and other administrative expenses charged by commercial banks. A study of the Greek banking system in the mid-1960s estimated such charges at the levels of 40% of the overall weighted average of lending rates (Ellis 1964: 55). Thus, under financial interventionism postwar banking sectors prospered. In Portugal, total banking sector assets between 1947 and 1973 expanded at an average annual rate of 9% in real terms (Reis 1994: 824), and parallel were the growth rates in Spain and Greece.

Democratization and the crisis of interventionism

The first steps away from financial interventionism were initiated under grave concern over its inflationary effects during the 1970s. The combination of recession and democratic transition in Spain, Greece and Portugal post-1974 exacerbated the adverse effects of financial interventionism. Democratization brought an upsurge of socioeconomic demands for extensive redistribution. This coincided with the need to cushion the effects of recession amidst generalized industrial crisis. A common strategy prevailed of consolidating democracy through expanding public sector and catching up with the levels of social spending of advanced European countries (Maravall 1993; Gunther et al. 1995). Thus SE economies responded to the stagflation shock of 1973–74 with significant fiscal expansion. Since budget revenues remained more or less inelastic, government borrowing, financed by the banking system, covered public sector expansion. The monetization of public deficits, combined with the extension of credit at negative real interest rates, further fuelled the escalating inflation. Though SE monetary policymakers tried to strengthen monetary policy and gradually shift to positive rates, the combination of a stagflationary environment with democratization made government authorities very reluctant to allow interest rates to rise in parallel with inflation. Still within the realm of the interventionist paradigm, monetary authorities attempted to confront the inflationary crisis through adjusting the available direct monetary policy instruments such as quantitative controls, special reserve ratios and compulsory investment requirements. By the late

1970s monetary policy remained tied to a countercyclical logic; any upward move of interest rates was aimed at curtailing demand, while at the same time fiscal expansion sought to stimulate the economy out of recession (eg, OECD, Spain 1981: 19–20).

Indicative of a standard pattern of learning and paradigm shift (Hall 1993), liberalization in SE was a gradual process. It began with the monetary authorities recognizing the undesired effects of the interventionist system, attempting to respond by utilizing the available instruments, then gradually replacing those instruments until finally abandoning the entire interventionist system and paradigm.

From a political standpoint, and contrary to financial interventionism (which both from a demand and a political supply side is far easier to understand), financial liberalization in general poses something of a puzzle. As summarized by Haggard and Maxfield (1993: 314): 'why would politicians and the recipients of subsidized credit opt for a market-based system of credit allocation that typically entails higher interest rates and over which they have less control?' The rest of the article reviews proposed expanations of domestic financial liberalization, providing evidence that will help evaluate their explanatory relevance for Southern Europe.

Accounting for domestic financial liberalization: the 'external constraint'

The mainstream argument views the European financial liberalization and integration program as a principal driving force for domestic financial liberalization in SE.[4] This can be called the 'external constraint' argument, broken down into two distinct propositions. One refers to the 'objective' constraints derived from the transformation of the international economic regime and from the dynamic of financial liberalization, integration and globalization. Indeed, the economic backdrop to liberalization can be traced in the momentous changes in the international political economy after the 1960s and especially during the 1970s. The changing international context entailed a new set of external economic constraints to which small open European economies were pressured to adjust. Changes included the exponential increase of capital mobility, the collapse of the Bretton Woods system of fixed exchange rates that had underwritten monetary stability in Europe, followed by the oil crises and stagflation of the 1970s.

Over the 1970s and 1980s international capital movements were gradually liberalized. The new financial environment engendered a logic of competitive deregulation, pressing smaller economies which had not yet liberalized their capital account to do so (Frieden 1989; Helleiner 1994; Eichengreen 1996; Forsyth and Notermans 1997; Simmons 1999). To crudely summarize the rationale of domestic financial liberalization: if real interest rates remained negative or at lower than market levels, and the national financial system was not competitive and efficient enough, then (when capital controls were lifted according to the EU program) savings would flow out and the payments balance would collapse. Thus, the capital liberalization prospect necessitated the completion of domestic financial liberalization as a necessary prerequisite. The other compoent of the 'external constraint' refers to the particular 'positive'' institutional obligations imposed by the European single financial market program. As a subsequent wave of institutional reform came the Economic and Monetary Union (EMU) program, the entry into which was contingent on the SE currencies' participation in the European Monetary System (EMS). The combination of liberalized capital movements and stable exchange rates necessitated the full alignment of national monetary policies behind EMS even for those EC/EU member states that had not yet entered EMS (Branson 1990; Eichengreen and Frieden 1994).[5]

There is certainly great power in the external constraint argument for Greece and Portugal, which began to deregulate credit in the second half of the 1980s under the unambiguous prospect of the single financial market. However, Spain had already initiated liberalization from the first half of the 1970s, long before preparing to open its capital account.[6] At that time any current account shortfall could still be confronted by tightening capital controls and (at least theoretically) by raising interest rates (Gros 1993: 149ff). In that sense the Spanish experience constitutes something of a paradox, for three main reasons, relating to the international, the domestic and the sectoral level respectively. First, reforms were initiated before the external constraint associated with capital liberalization had begun to take effect. Second, they unfolded in the context of Spain's transition to democracy, which was politically unpropitious for structural reforms (cf. Bermeo 1994). And third, they were implemented despite the opposite interest of powerful sectoral players such as private banks (Lukauskas 1997: 2). So the external constraint argument appears convincing in the cases of Portugal and Greece, but less so in the case of Spain.

Two distinct approaches (Lukauskas 1997; Pérez 1997) have been proposed to explain Spain's adoption of financial liberalization given its divergence from the external constraint rule. Both approaches refute the so-called 'public interest' argument, which would attribute reforms to their merits of higher economic efficiency, as recognized by policymakers (cf. Toma 1991). Following a public choice approach, Lukauskas argues that it was the exact conditions of transition to democracy, with the large, broad-based national parties they involved, which created a 'new reward structure' for government policymakers against particularism. This made 'the supply of public goods, like strong economic performance, more attractive and a narrow defense of special interests less tenable as a political strategy because leaders had to compete against opposition parties for the support of a heterogeneous array of voters to stay in power' (Lukauskas 1997: 3).

This line of argument raises at least two substantial objections. First, government policymakers cannot be treated as a single unitary category. Depending on ideological predispositions (more or less pro-European or free-market oriented, and so on), the exact office held (a 'spending ministry' as opposed to a 'financial ministry' [Haggard and Maxfield 1993: 296]), and individual political strategies (clientelistic versus reformist), policymakers' interests may substantially diverge (cf. Peters 1995; Weller et al. 1997).

Second, the political advantage conferred by economic efficiency-maximizing strategies is highly dubious given the significant time lag with which the effects of a more efficient allocation of resources can be manifested. Whether diminished inflationary expectations or an increased allocative efficiency of the financial system, such public goods can become visible after a period of time that most probably outlasts the electoral cycle of a government term.[7] Thus, if the beneficial effects of financial liberalization were what policymakers were targeting, then one should see this as substantiating a 'public interest' rather than a 'public choice' argument.

The Greek and the Portuguese cases of belated and reluctant reform undermine the counterintuitive argument that financial liberalization could be instigated by political reward-maximizing concerns of policymakers of the type described above. Both countries went through parallel transition paths, and yet were late in liberalizing. Though inflation in these countries was not yet as entrenched as in the Spanish case, the pursuit of economic efficiency – if rooted in 'universal' utility calculi as public choice accounts tend to assume – should have characterized the intentions and acts of Greek and Portuguese postauthoritarian government policymakers as well. In fact, the state ownership of the majority of the respective national banking sectors would have allowed Greek and Portuguese government actors to reap the expected economic benefits of early liberalization while at the same time retaining a considerable degree of indirect control over credit policies. However, despite what were certainly reformist pressures from their CBs, neither the Greeks nor the Portuguese deregulated until well into the second half of the 1980s and then mostly under 'external constraint' pressure, as already remarked. If Lukauskas' explanation can claim broader validity one should expect to see the Greek and Portuguese governments resorting to financial liberalization with far less reluctance than they did, and one would not expect such bold divergence between Spain on the one side and Portugal/Greece on the other.

'Public interest' and 'banking collusion'

Pérez's powerful refutation of the 'public interest' argument appears more convincing. While agreeing with Lukauskas that liberalization was viewed negatively by the cartelized and privately controlled Spanish banking sector, she rightly focuses attention on the main promulgator of reform, the Bank of Spain. She thus regards the shift of monetary and financial policy in the early 1970s as the aftermath of the ascendance, during the 1960s, of a group of CB neoliberal reformers who gained power over the regime's technocratic planners (Pérez 1997: 88–9). The CB's ambition to weaken the government's financial interventionism and expand its own control over monetary policy led it to take advantage of the democratic transition period in advancing its reform agenda. To that aim, the Bank of Spain established a 'working alliance' with the banking sector, which resulted in serious concessions in the implementation of financial reform. These concessions allowed banks, after liberalization, to reap very high profit margins at the expense of industrial borrowers (Pérez 1997; cf. Lukauskas 1997: 164).

The possible counter-argument to this thesis suggesting a CB-banking sector collusion (for simplicity: the 'banking collusion' argument) is that it is premised on overstating and understating two sets of factors respectively. Overstated is the importance of the CB-banking elite accommodation, as it disregards the 'objective' reasons why the Bank of Spain should 'normally' treat the banking sector favorably, that is a CB's stake in the strength of the banking system. And understated are the macroeconomic circumstances in Spain that necessitated a monetary strategy of effective disinflation predicated upon financial liberalization.

One way of understating the 'objective' surrounding circumstances is by toning down the pragmatic (as opposed to ideological) component of monetary reform.[8] Parallel liberalizing concerns were preoccupying other SE CBs too. For example, the Bank of Greece's motives could hardly be characterized as ideological, especially given the role of its administration under governor Zolotas in devising the country's system of financial interventionism over the 1950s and 1960s (see Zolotas 1965; Halikias 1978). The entrenched inflationary effects of interventionism, visible even before the 1970s stagflation crisis, were the principal underpinning of the Spanish shift. Any effort to curtail these effects and allocative distortions through liberalization would be not only fully compatible with a CB's role as guardian of price stability, but also proportionate to the severity of the inflationary effects of 'cheap credit'.[9]

Indeed, as Diagram 2 indicates, the inflationary effects had become evident alredy since the 1960s. Inability to control inflation – especially at a time when Greece and Portugal were delivering a more auspicious combination of price stability and economic growth – amounted to a CB failure in obtaining its chief institutional objective. The growing signs of economic unsustainability of the interventionist model (including an abrupt recession in the late 1960s and an alarming balance of payments shortfall) followed by a salient banking scandal (the Matesa affair) offered adequate economic justification for the Bank of Spain policy shift. The Matesa affair only served to demonstrate the sustained misuse of administered credit and to discredit its government defenders (Pellicer 1993: 24; Tortella 1994: 872–3). Thus the Bank of Spain's effort to generate the operational preconditions for satisfying its objective of monetary stability should be characterized as fundamentally pragmatic, even if conceptually framed by the ascending (monetarist) technocratic discourse of the time.

The corollary of understating the economic factors that necessitated monetary and financial reform is to overstate the political intentions, interest coalitions, and collusive strategies followed by the protagonist of reform, *in casu* the Bank of Spain. Thus Pérez greatly emphasizes the gains Spanish banks reaped as result of the particular pattern of credit liberalization: the reluctance to allow in foreign banks, and the lifting of interest rate ceilings and liberalization of commissions that allowed banks to enhance their profit margins, passing on the costs of their cartelized behavior to their industrial borrowers. Though these are valid points, one should view them in the mitigating context of the previous Franquist corporatist tradition of instrumentalizing banks for financing industry. Indeed, state-driven industrial activism had resulted into the banks' extensive industrial portfolios and preferential, non-diversified lines of credit to specific industries, which eventually helped translate the 1970s economic and industrial crisis into a banking crisis. Other West European industrialized countries too, including Greece and Portugal, underwent similar industrial crisis in the second half of the 1970s, their industries suffering a financial shock from which they were rescued by the state undertaking their debts. However, the Spanish banking system, whose banking model of industrial activism was more pronounced, was harder hit.[10] This, in the eyes of the Bank of Spain, justified a pattern of financial reform that would also allow banks to accumulate the necessary profits so as to recover from the crisis.

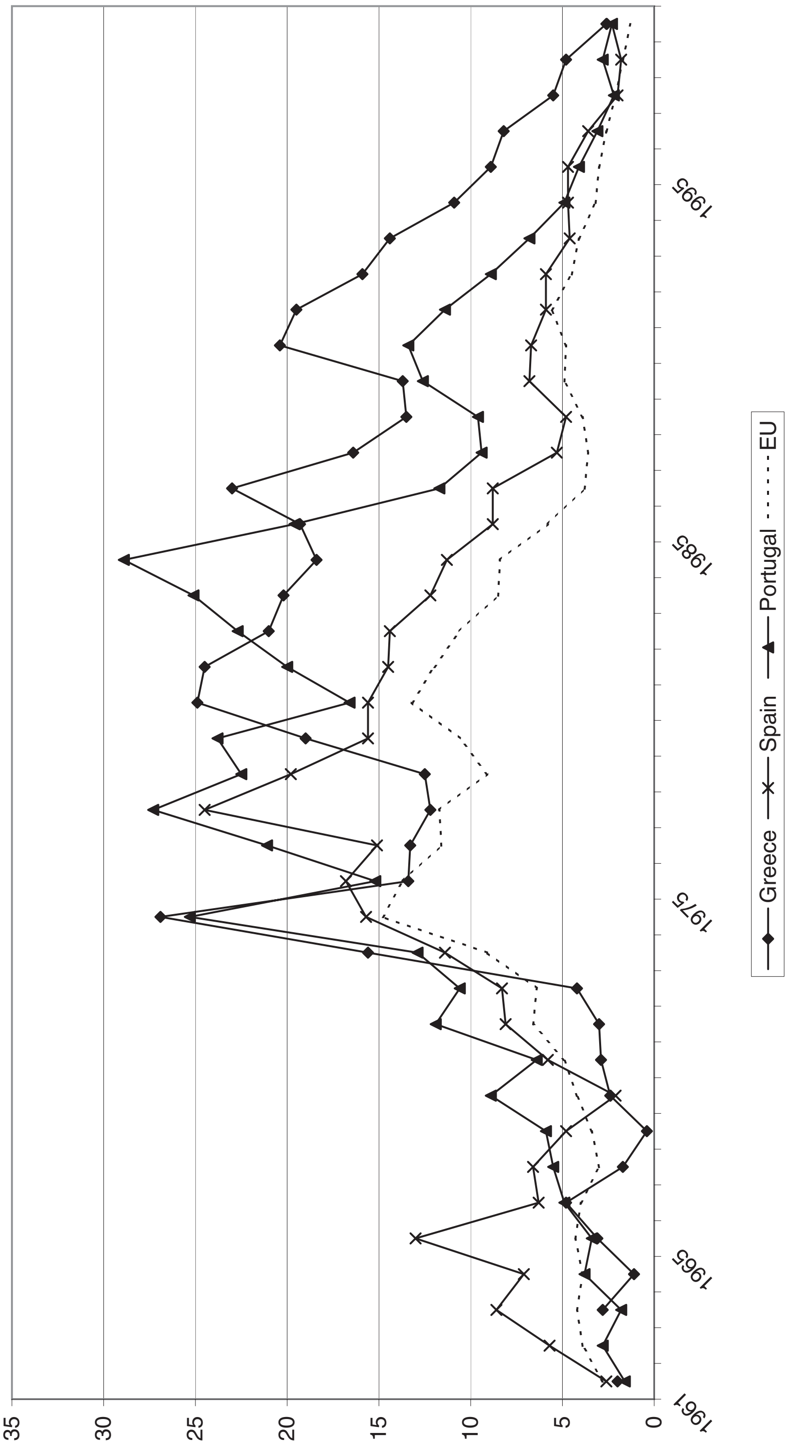
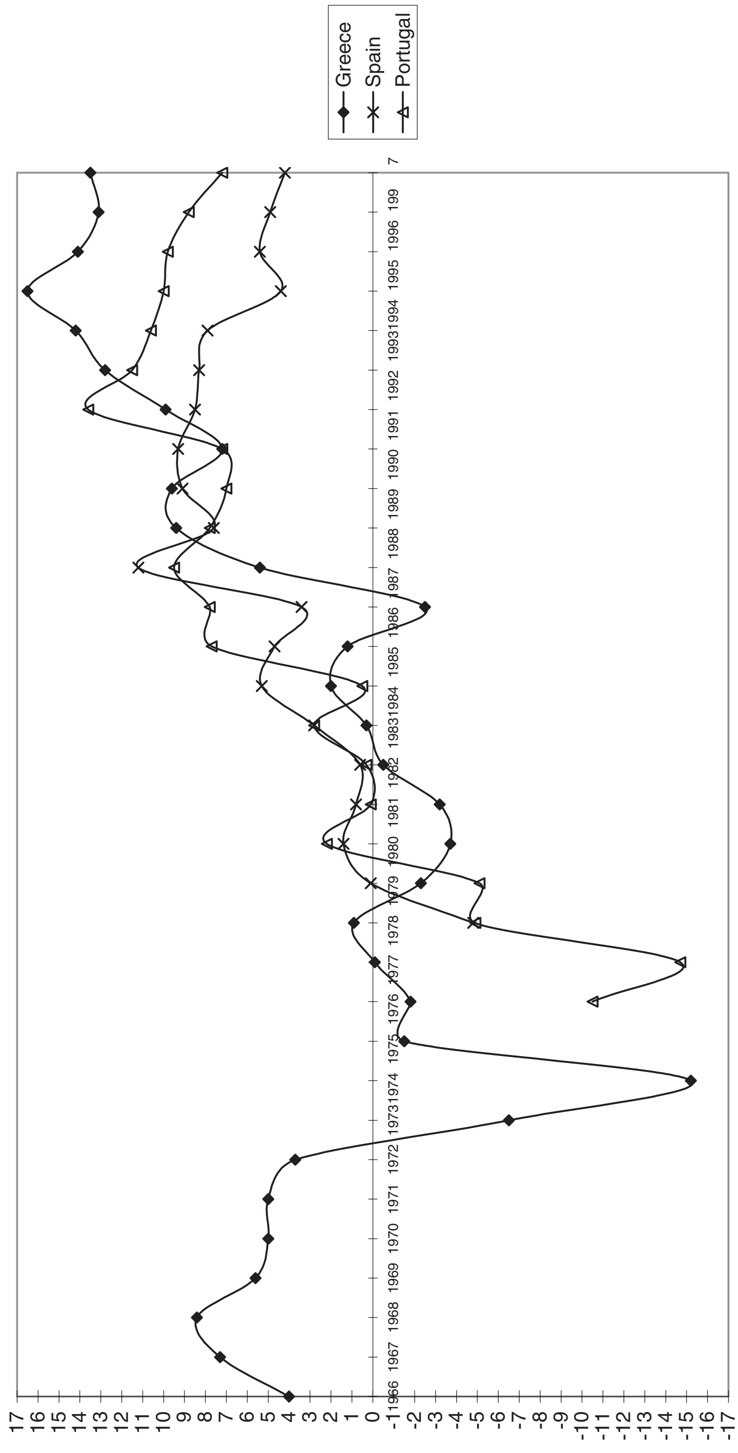


DIAGRAM 2. Inflation (CPI).

Several authors in general have affirmed the elective affinity of CBs with their banking sector constituency (Woolley 1984; Moran 1984; Goodman 1992). Indeed, by their institutional role, CBs are chiefly responsible for the 'well-being' of their national financial and banking sectors (Goodhart 1995: 210). This task became even more demanding especially over the 1980s under the imminent prospect of competition by other more robust and efficient EU banking systems. In other words, the project of strengthening the banking sector via credit deregulation need not presuppose banking sectoral pressure on any collusion with the CB, but only the latter's ability to pursue its institutional objectives of banking systemic strength and stability. This argument substantially weakens the banking collusion thesis for the case of Spain, and even more so for Greece and Portugal. It would indeed be even less convincing to claim that the politically weaker, government-subservient, state-controlled banking sectors of Greece and Portugal could have the bargaining clout to effectively push through their demands.[11]

That the 'banking collusion' argument is substantially overstated at the expense of the objective constraints surrounding the Spanish financial system and economy can be inferred if one looks at the development of Spanish credit policies compared to the rest of the EU. It was only after 1985–86 that real credit rates or financial costs for industrial firms notably began to diverge upward from the EU standard. Only toward the end of the 1980s Spanish banks began to exhibit overall higher rates of profitability – though more in return on assets than in terms of return on equity, indicating the higher provisions following the banking crisis (OECD 1992). So the emergence of Spanish banks as beneficiaries of liberalization only became a salient feature towards the later stage of reform. In any case, the increase of financial costs for business has been noted as a typical direct aftermath of credit liberalization (Caprio et al. 1994: 426). Like in Spain, credit costs rose both in Greece and Portugal from the late 1980s through much of the 1990s, before intensifying banking competition, the development of financial markets, and the reduction of inflation as part of EMU nominal convergence allowed real interest rates to decline (Diagram 3). By mislabeling a transitional cost as a long-standing redistributive one, one can easily underestimate the reform's longer-term efficiency objectives, as vindicated by the visible improvement of SE macroeconomic indicators over the 1980s and 1990s in terms of growing convergence with the EU.

Looking at rising bank profitability post-liberalization one could easily elicit the conclusion that liberalization from the second half of the 1980s and into the 1990s benefited SE credit institutions. However, this only occurred to the extent to which it also served the CBs' own policy objective of allowing their national banking sectors to recover



Sources: IMF, OECD

DIAGRAM 3. Real lending rates.

from accumulated bad debts, overhaul their balance sheets, offset structural weaknesses, meet the EC capital adequacy requirements, and successfully compete with the more advanced banking sectors in the single market. In that sense, of allowing banks increased profitability and strength, SE CBs tolerated high interest rate spreads (the difference between lending rates and deposit rates), especially since they were highly compatible with their own monetary austerity strategy, as will be seen further below.

Sectoral interests and state-driven reform

Generally speaking, and referring mostly to capital liberalization, the beneficial effects of liberalization on financial sectors have given rise to the argument that reform often occurs under pressure on the part of the financial and banking sector. Powerful and internationally competitive financial sectors in countries with established financial markets (US, Britain, Germany, the Netherlands) were indeed a principal source of liberalization pressure, as financial interests were eager to enlarge the circuit of capital and volume of transactions and to capture wider profit margins (Kurzer 1993: 22–3).

However, financial markets in Southern Europe were credit-based (Zysman 1983) and heavily underdeveloped, and the national banking sectors were relatively weak, overprotected and domestically oriented (Gibson and Tsakalotos 1992). Thus they were anxious over the potential effects of capital liberalization, which would be inconceivable anyway before domestic liberalization had been sucessfully completed. While SE banking sectors favored the abolition of restrictions on their portfolios and policies (such as obligatory investment requirements, credit controls and interest rate ceilings) they feared that liberalization could erode their comfortable oligopolistic margins, forcing them to compete with each other and with far more efficient European banks. Hence, initially they were reluctant if not negative towards reform, especially state-controlled banks of Greece and Portugal.[12] Thus it was not banking pressure that brought about financial liberalization.

All that said, liberalization did eventually serve the interests of domestic financial and banking sectors, vesting them with considerable strength. On the aftermath of liberalization, and despite the competition by non-bank financial institutions, banks throughout Southern Europe reaped remarkable profits by colonizing the new financial markets and institutions (Edey and Hviding 1995: 15ff; OECD 1997). Liberalization (especially after capital movements were freed in the first half of the 1990s) overall advanced banking interests by lifting imposed restrictions and multiplying profit opportunities. The recourse of governments to public debt markets enhanced the banks' bargaining power, given their role as principal buyers of government paper. They were able to place their assets on risk-free government securities, and negotiate not only market rates but also other significant concessions (underwriting privatization schemes, providing counterpart finance to large-scale infrastructure projects, etc).

Given these prospective benefits, CBs often relied on their national banking sectors as strategic allies for certain liberalization measures also favored by the banks, especially given the retentionist pressures on the part of socioeconomic beneficiaries of financial interventionism. That, clearly, is different from saying that the CBs' deregulation program was overall molded so as to serve banking interests. Under this framework, the accommodation of banking interests by CBs should not be viewed as indicating CB susceptibility and thus weakness vis-à-vis banking pressures, but quite the contrary, as expressing CB strength in advancing its own policy objectives.

The banks' role was more important when it came to supporting the monetary austerity that followed in all three SE economies from the late 1980s into the 1990s. As will be explained in the next section, the CBs' main objective from domestic liberalization was to increase the effectiveness of their monetary policy. It can thus be argued that the strengthening of national financial sectors through policies of liberalization and, later, privatization entailed the additional 'political' advantage of providing SE CBs a reliable and increasingly powerful (given the momentous sectoral growth) strategic ally for disinflation. Banks are generally averse to cheap credit and inflation because it erodes their real interest earnings (Maxfield 1990: 24ff), whereas monetary stability enhances financial growth and bank profitability. Though monetary austerity implied burdensome restrictions on their liquidity (Borges 1990: 320), SE banks were able to benefit in the high-interest-rate period that followed liberalization by retaining (as already said) wide interest rate spreads, indicative of the sectors' persisting oligopolistic structure.[13]

In that sense, the specific pattern of liberalization-cum-disinflation from a CB standpoint also resolved the fundamental conflict of allegiance of a 'Janus-faced' CB, turned towards public/government objectives on the one side, and the financial sector on the other (Moran 1984: 46–7). The program of disinflating through releasing interest rates upwards served both the 'public' objective of disinflation and eventually the commercial banks' preference for market-determined interest rates.

The predominance of economic, especially macroeconomic, objectives in domestic financial liberalization has two main theoretical implications. First, it demonstrates the vital link between financial liberalization and monetary stabilization (as will be further elaborated). And second, it points out the state-driven character of reform, financial liberalization being promulgated by state authorities, the CB in particular.

The state-driven character of the reform contradicts the standard view that sees socioeconomic interests as the crucial push factors for liberalization. For example, echoing rent-seeking approaches, Haggard (1990: 260–1) sees economic reforms including financial liberalization as responsive to particularistic collective interests and thus potentially modeled in terms of group conflict or collective action problems. Such interests (with the part exception of banks, as already discussed) had very limited if any role to play. First, the main direct gainers of credit liberalization were confined to the public as depositors (who under the high-inflation interventionist regime had to put up with negative real deposit rates, subsidizing the cheap lending rates for favored production categories) and trade (which – considered unproductive – was penalized with higher lending rates). Depositors, being dispersed, suffered an obvious collective action problem, which made it impossible for them to organize. The trade sector's power, on the other hand, was hugely offset by the accumulated influence of the status quo interests and socioeconomic losers from credit liberalization. These included manufacturing industry and the handicraft sector, exporters, and farmers, all of which were especially vocal groups, well entrenched after several decades of preferential financial treatment under the interventionist regime (Pagoulatos 2000). Second, socioeconomic group pressures in any case confronted the notoriously esoteric, close, unilateral and exclusive patterns of monetary policymaking exercised by CBs over issues falling within their own jurisdiction, rarely open to public debate and safeguarded as the CBs' own exclusive preogative (Moran 1984). Indeed the program of financial liberalization was framed and phrased in terms of the CBs' exclusive sphere of monetary policy responsibility, as the annual CB reports demonstrated.

We have so far examined SE reform in light of the main theses normally proposed to explain financial liberalization. We have rejected or seriously discounted the theses that liberalization resulted either from interest group or banking sector pressure, also by pointing out the CBs' institutional interest in the well being of their banking sector. We have thus established liberalization as a state- rather than society-driven reform. We have futher qualified the 'external constraint' thesis by arguing that it cannot be claimed to apply for Spain's early liberalization. This brings us to the principal driving force of liberalization in all three countries, namely the CBs' programmatic effort for disinflation. Financial liberalization as precondition for effective disinflation predates the implementation of the EMU program (especially in the case of Spain) though the two programs overlap significantly.

CBs, governments, and the political economy of monetary austerity

CBs favoured financial liberalization because it increased their policy autonomy towards government, improving their ability to conduct monetary policy unhindered by government interventions – though the completion of capital liberalization would surrender that autonomy to the international markets.[14] The emergence of persistent deficits and inflation after the 1970s had dramatically altered the conditions for the effective exercise of monetary policy. For one thing, direct credit controls, the postwar state's leading stabilization instrument, were becoming increasingly incapable of stabilizing the economy: as public deficits were pushing money supply growth upwards, it was hard to control credit supply without changing the levels of the interest rate. Government-administered interest rates, however, prevented CBs from applying their own interest rate policy. Special rediscount lines (as in Spain until 1971) or special compulsory investment ratios (as in all three SE economies until liberalization) and the borrowers' recourse to the informal credit markets precluded the CB exercise of effective monetary control. Government securities forced upon the banking system at a government-determined interest rate forestalled the CB exercise of open market policy (that is, buying and selling government paper). In that framework, only a developed money market, the underlying CB view held, would allow effective control of monetary aggregates by enabling the CBs' regular unobstructed response to short-term liquidity changes. Liberalization removed the constraints of interventionism, allowing CBs to employ their indirect monetary policy instruments more effectively towards disinflation and to respond more flexibly to the restrictive conditions of the international markets (IMF 1995; Padoa-Schioppa 1994).[15]

Of course, at least theoretically, interest rates could still be raised administratively within the interventionist framework of direct credit policy instruments, at levels high enough to satisfy the need for monetary harshness or corresponding to their estimated equilibrium prices. However, none of the three major actors involved (CB, government, later the European Commission) favoured this adjustment strategy, which hence never really entered the agenda in any of the three countries. The Commission, in view of the single market program, encouraged complete (albeit gradual) financial liberalization. The CBs had internalized the orthodox view that only liberalized interest rates and market-determined allocation of finance (with the exception of some *ad hoc* quantitative ceilings whenever credit expansion threatened overheating) would allow the necessary monetary policy leeway and flexibility to rip the inflation out of the system. Administered interest rates, even if fixed at disinflationary levels, would keep monetary policy subject to constant political bargain and government-imposed objectives, as they had done throughout the interventionist period. Thus credit liberalization also served the long-held CB pursuit for more political and policy autonomy from government. From its own standpoint, and given the pressing need to proceed with stabilization, the government also had some interest in doing so by setting interest rates free (thus shifting the responsibility and blame for monetary stringency to the CB) rather than raising them administratively (which would have burdened government with the political cost of disinflation).

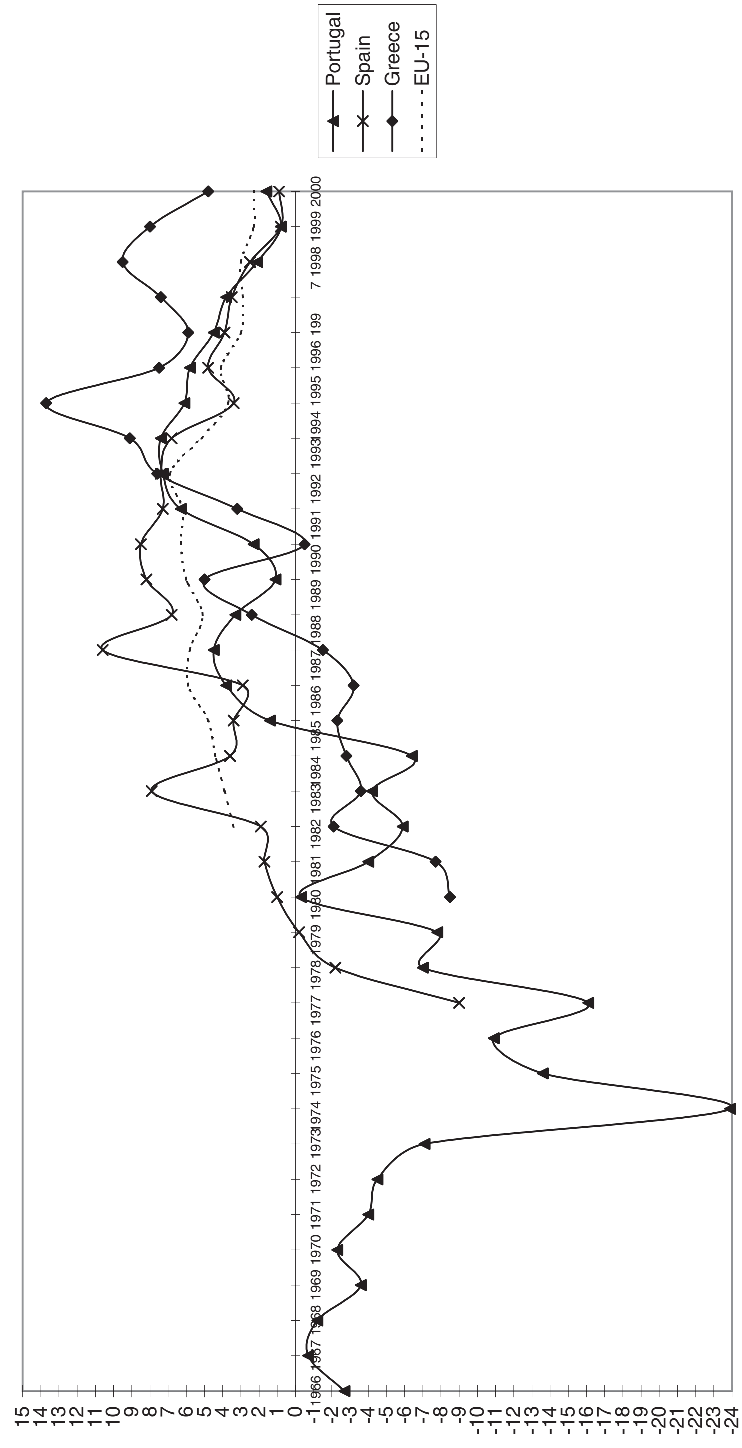
There is considerable evidence of the programmatic intention of SE CBs to liberalize in order to acquire better use of monetary instruments against inflation. Probably the first such evidence is contained in the Bank of Spain report for 1974, which forcefully stated the (monetarism-inspired) targeting of monetary aggregates as its main intermediate objective:[16]

> The monetary policy objectives pursued by the Spanish monetary authorities are centrered in obtaining a fixed rate of growth of the available liquidity . . . Given the tight dependence between liquidity of the monetary system, private sector financing, and interest rates, it is practically impossible to define independent objectives for every one of these variables. The first implication of this is that, whatever the importance assigned to every one of these variables, the control of all of them must pass from the direct manipulation by the authorities of one only and the indirect determination of the other two. In that respect, the Spanish solution, which coincides with that of several other countries, consists in exercising control over the liquidity of the monetary system. All recent reforms in the implementation of monetary policy have been directed towards allowing and improving the control of that variable (Banco de España 1974: 115).

As a Bank of Spain paper explained several years later, ‘the non-existence of freely formed interest rates precluded selecting either the money stock or interest rates as the intermediate target of monetary policy’ (Pellicer 1993: 33). From the second half of the 1980s, the endorsement of monetary adjustment via liberalization became regular in all SE CB reports. For example, the Bank of Greece annual report, after describing the deregulation policies abolishing direct administrative credit controls and fixed interest rates, stated: 'These [liberalization] measures have expanded the Bank of Greece's ability to exercise effective monetary control . . . in pursuit of replacing direct with indirect monetary controls' (Bank of Greece 1987: 37).[17] On the money market it said: 'The reduction of the public sector's borrowing requirement . . . combined with the government's recourse to the non-bank money and capital market . . . enable better control of money supply and of the liquidity of the credit system and the economy' (Bank of Greece 1987: 42). The next year's report left no doubt as to the use of liberalized interest rates for disinflation: 'More than the growth rate in money supply, high real interest rates offer safer evidence of the restrictive direction of monetary policy . . . [which] played the principal role in the successful outcome of the stabilization effort' (Bank of Greece 1988: 34). Two expert committee reports for Greek financial reform also contained such arguments (Harissopoulos Committee 1981; Karatzas Committee 1987). Similar pronouncements can be found in the reports of the CB of Portugal in the 1980s and early 1990s. Diagram 4's display of real short-term interest rates gives an indication of the severity of monetary stabilization.

Thus CBs pursued financial liberalization in order to strengthen their ability to conduct monetary policy, and eventually – by removing government actors from finance – their political autonomy. For that, CBs exploited their power of suasion toward government, as well as any windows of opportunity created by European pressure, domestic economic and financial conditions, government indecisiveness or internal divisions, and any backing that could be drawn on the part of the banking sector. For example, the Bank of Greece took advantage of an urgent balance of payments crisis in the aftermath of the 1985 elections, as well as a favorable conjuncture at both government and EC level, to decisively put liberalization on the agenda. At the same time, however, governments too had a positive stake in pursuing stabilization through extensive if not nearly exclusive reliance on monetary austerity. This strategy allowed them to retain a relative laxity in fiscal and structural reforms, two fields where the political cost of adjustment is particularly high.[18] All three SE economies in the second half of the 1970s and into the 1980s carried an extensive and highly corporatistic public enterprise sector, high public deficits, and labor market rigidity. Thus fiscal and structural adjustment involved far-ranging and politically costly reforms, especially if one considers the time lag with which fiscal tightening and especially structural reforms produce their efficiency results, as opposed to the short-term emergence of their sociopolitical cost.

Contrary to fiscal and structural adjustment, stabilization via mon-



Sources: European Commission, OECD

DIAGRAM 4. Real short-term interest rates.

etary austerity (that is, a real appreciation of the currency and high interest rate differentials relative to the EMS basket of currencies) is politically attractive also because it allows the stabilization cost to be distributed in an apparently indiscriminate manner, saving government from hard redistributive choices (Pérez 1997: 39–40). That is of course far from saying that disinflation is costless. High interest rates squeeze demand for credit and raise the cost of private sector debt servicing, suppressing business expansion. A 'hard' currency is detrimental for the tradeables sector of the economy. However, compared to fiscal and structural adjustment, monetary austerity in a regime of liberalized interest rates is the stabilization strategy that politically implicates government to the relatively lowest extent, as interest rates are supposedly determined by the market as a result of the CB's monetary policy. Notably, this strategy allows a government to shift part of the political cost of adjustment to its CB through an implicit tactic of scapegoating (cf. Woolley 1984: 191ff). The higher the perceived CB strength, the more the chances the CB would be regarded as responsible for the policies of monetary austerity.

Phrased differently, SE governments undertook monetary austerity (and financial liberalization as its necessary precondition) under the pressure or 'moral suasion' of their CBs as a 'self-binding' strategy for compensating for the expansionary effects of fiscal policy (cf. OECD, Spain 1989: 34) or for implementing stabilization while eschewing a bolder curtailment of public spending.[19] This interpretation is especially strong for the cases of Portugal, whose fiscal convergence towards EU levels began in the late 1980s, and Greece where (despite the 1985–87 stabilization) fiscal laxity persisted well into the 1990s (Diagram 5). Admittedly, as Pérez contends, the argument appears less convincing for Spain whose public deficits and debt remained close to EU levels through the 1980s and 1990s. Given the moderate aggravation of the fiscal front then, the intensity of monetary austerity in Spain from the late 1980s through the 1990s could be regarded as particularly harsh, especially considering the entrenchment of unemployment at 20% levels. However, the disinflationary commitment remained unflinching as Spanish authorities, in view of the economy's heavily corporatistic structures, interpreted unemployment as structural not cyclical, advocating labor market liberalization instead of monetary relaxation (cf. OECD, Spain, 1992: 55ff; Boix 1998: 130ff). The relatively high overall growth rates of the second half of the 1980s also permitted a harsher disinflationary trade-off between growth and monetary stabilization.

While SE governments acceded to the necessity of monetary austerity to a degree that was proportionate to their own fiscal laxity, they

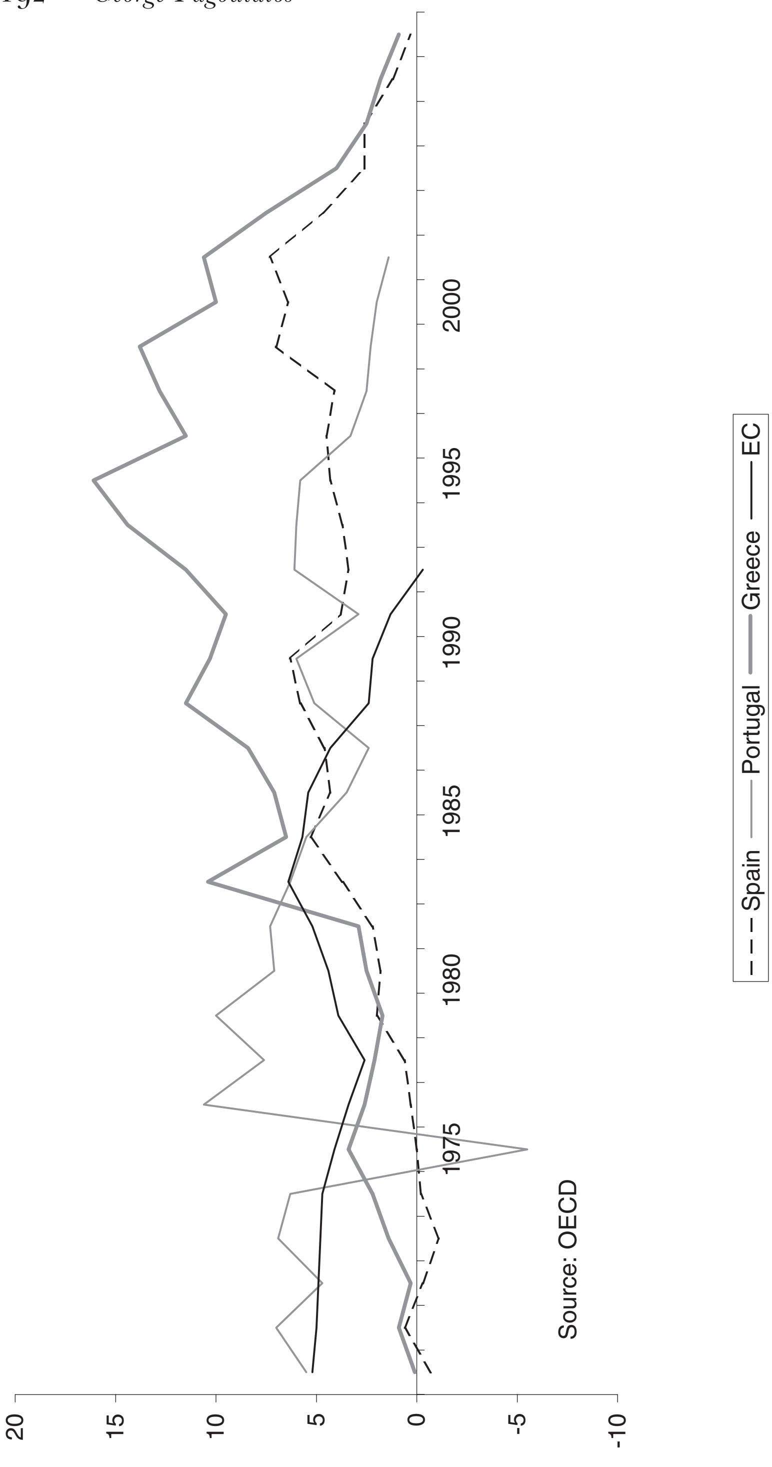


DIAGRAM 5. General Government Deficit (%GDP).

patently tried to delay as much as possible their own financial detriment from monetary reform. The need to retain low debt-servicing costs operated as a serious brake to the expansion of financial liberalization (OECD, Spain, 1988: 43). Thus can be explained the survival of compulsory investment ratios on government securities until well into the first half of the 1990s (exhausting the Maastricht deadlines against privileged government recourse to finance) and the procrastination in the creation of a money market.[20]

Spain's monetary policy shift took place after the previous 'cheap credit' paradigm (cf. Hall 1993) had become part of the status quo to such an extent as to be blamed for the conspicuous policy failures. By the mid-1970s, when the Bank of Spain launched financial reform, the inflationary policies of monetary expansionism had been applied for several decades under Franco. As domestic macroeconomic conditions were aggravated in the 1970s, the aggravation was perceived as a crisis of the entire financial/monetary policy model rather than simply one of a conjunctural nature. Even more pronounced was the paradigm shift in Greece and Portugal.

An additional factor weighed heavily in the Bank of Spain's ability to initiate its reforms earlier and to pursue what could be characterized as perhaps excessive monetary austerity. This factor concerns the greater strength of the Spanish CB, compared to the CBs of postauthoritarian Greece and Portugal. The Bank of Spain was the only SE CB whose leading group of reformers under the Franco regime not only survived democratic transition but proceeded reinvigorated into the second half of the 1970s and through the 1980s and 1990s (see Pèrez 1997: 118–9). The consolidation in the Bank of Spain of that strong monetarist-leaning technocratic elite representing 'change through continuity' afforded it a leading role in monetary and financial reform. Given its internal cohesiveness and crystallized agenda, the CB reformist elite commanded the influence that allowed it to win government approval for its policies. Moreover, the consensual character of the Spanish transition to democracy necessitated a symbolic breach with the Franquist past, which was served by the cross-party adoption of a Europeanizing agenda that identified liberalization with modernization (cf. Maravall 1993; Pérez-Diaz 1993: 20ff; Bermeo 1994; Alvarez-Miranda 1996). This afforded the Spanish CB vital leeway with government, exemplified in the adoption of financial liberalization as one of the major structural policies included in the 1977 Moncloa Pacts (OECD, Spain, 1980: 32). On the contrary, less strength and continuity characterized the CBs of Portugal and Greece during the 1970s and 1980s. In both countries political exigencies increased government control, imposing monetary expansion. The Bank of Portugal was nationalized in 1974, its functions redefined. The Bank of Greece, whose administration was replaced after the dictatorship, supported the reflation of the 1974–77 period, objected to that of the 1979–80 but was unable to contain it, while during 1981–84 it officially came under the Economy minister. In both countries, intensified electoral competition rendered the surrender of financial interventionism politically undesirable.

The above help to account for the power of suasion enjoyed by CBs vis-à-vis government in their effort to apply monetary reform. Though they lacked the especially conducive circumstances enjoyed by the Bank of Spain, CBs in Greece and Portugal also emerged stronger in the environment of the second half of the 1980s. Their significant macroeconomic divergence from the EU, combined with their governments' declared objective of adjustment (Greece's 1988–89 expansionist diversion notwithstanding), and framed by a European context of ascending monetarist ideas and policies and growing CB authority, bestowed CBs with increasing bargaining power towards their governments (cf. Dyson et al. 1995; Dyson and Featherstone 1996). Under these conditions, CBs were given the green light even by otherwise expansive governments to steer financial liberalization, economic stabilization and monetary adjustment. Thus, while CB strength is conventionally presented by the economic literature as being positively correlated with low inflation,[21] from a political viewpoint SE also points to the reverse causation: CBs in an inflationary environment, under their governments' auspices or mere tolerance, are in effect strengthened not weakened. The persistence of high inflation itself strengthens the role of CBs, forcing governments to allow them to acquire more effective monetary instruments in pursuit of disinflation.

Conclusion

Contrary to standard accounts, we have argued that both financial interventionism and financial liberalization in Southern Europe did not result from interest group or sectoral pressure but corresponded to a state-driven pattern of reform in which CBs played a prominent role. However, both financial interventionism and liberalization, while principally serving broader economic stabilization and efficiency objectives, remained marked by a pursuit of political expediency and beneficial for banking interests. Political expediency can be attributed to the ultimate government control over both interventionism and liberalization – given the lack of CB independence prior to the EMU program leading to a system of independent CBs. The accommodation of banking was heavily associated with the pivotal policy role of the CBs and their institutional commitment to the 'well being' of their financial sectors.

The CB accommodation of banking interests should not be exaggerated. If CBs implemented liberalization in a way as to alleviate the cost of adjustment for their banking sectors and even to increase their profit opportunities, this was to the extent to which it principally served their own dual purpose of controlling inflation and boosting their national banking sectors' strength. In their institutional capacity as banking supervisory authorities and guarantors of systemic stability, CBs encouraged bank profitability as a condition for enabling national banking sectors to survive in the single market by affording competitive interest rates. Even more so given the SE banking sectors' standing as the weakest and least competitive in the EU, and their aggravation by the industrial and financial crises of the late 1970s and early 1980s.

Though acknowledging that the shift to liberalization was rooted in the transformations of the international and European political economy over the 1970s and 1980s, we have offered evidence to considerably qualify the mainstream argument that views domestic financial liberalization simply in terms of adjustment to the external constraint. Such evidence is provided by Spain's early liberalization and by the employment of domestic liberalization by CBs as a vital precondition for the effectiveness of their disinflationary effort.

NOTES

1. Nearly every mainstream economic development book of the early postwar decades communicated the conventional wisdom of state-directed or state-assisted economic development via industrialization. See, for example, Meier (1989).
2. For Greece, the argument is developed in Pagoulatos (2003).
3. This was not only because of a tendency towards balanced budgets – excluding investment – but also due to the extensive use of credit controls for monetary stabilization, and to a limited reliance on rediscounting facilities.
4. We distinguish *domestic* financial liberalization (the abolition of the institutions and instruments of national financial interventionism) from *external* financial liberalization (the liberalization of the capital account through the abolition of inward and outward capital and foreign exchange controls).
5. Spain joined the Exchange Rate Mechanism of the EMS for the first time in 1989, Portugal in 1992, and Greece in 1998. The deadline for the elimination of all remaining capital controls extended to the end of 1992 for Spain and July 1994 for Portugal and Greece; all made it in time.
6. Indeed, between 1971 and 1974 in Spain special rediscount lines were eliminated, and bank commissions and branch banking were liberalized. In 1974 deposit and lending rates of more than a two-year term were liberalized. Much bolder were the 1977 liberalization reforms, that included deregulation of certain longer-term interest rates, abolition of specific institutions of targeted credit, and steps towards developing a money market – which however remained limited until the second half of the 1980s (OECD, Spain, 1988: 53).
7. The characterization 'public goods' is not meant to discount the significant redistributive

implications that even 'universal' economic desiderata such as low inflation and economic growth are bound to carry.

8. Pérez invokes the adoption of monetary targeting by the Bank of Spain from as early as 1973 as argument for the Bank's ideological orientation. However, this is less impressive if one considers that Portugal began setting monetary targets in 1977, and Greece followed in 1979, and both continued to pursue expansionary or accommodative monetary policies until well into the 1980s.
9. The Bank of Spain itself until the late 1970s continued to justify its policy as pragmatic and middle of the road, as 'a middle course which could not lead to a deceleration of the inflationary process – nor to its uncontrollable acceleration – and which was hoped would not contribute to exacerbating the falling rate of economic activity and rising unemployment' (Banco de España 1979: 203).
10. Credit liberalization, combined with the banks' cartelized behavior, may have exacerbated the effects of the Spanish crisis: by raising industry's financial costs, it aggravated the effects of the energy shocks, leading many industrial firms to failure, which confronted the banks with a surging number of bad loans. The banking crisis that began in 1978 peaked between 1982–84, by which time half of the banks operating in 1977 had failed and had to be rescued (Caminal et al. 1993: 277). This crisis led the CB to temporarily defer its liberalizing intentions, but it also provided a justification for a more favorable treatment of Spanish banks in the second phase of liberalization.
11. In portugal, the nationalization of the entire banking system by the revolutionary regime of 1974 was devastating for the country's old banking oligarchy; the sector remained in state hands until the 1990s. Similarly in Greece, where most of the banking sector had been already under state control, the Karamanlis government in 1976 nationalized the second largest banking group, Commercial Bank. Only the Spanish privately owned banking sector remained practically intact after transition to democracy.
12. Overall, banks stand to lose from financial liberalization if under the restricted regime they were able to set interest rates by cartel collusion; they stand to gain if credit rates were determined by government. They can offset the competitive effects of liberalization if they continue to set interest rates through cartelization. The least efficient ones are bound to be disaffected if real competition erupts (usually through the entry of new market players) forcing them to narrow profit margins in order to withstand competition.
13. Only towards the mid-1990s did banking competition begin to take effect.
14. The weakening of CB autonomy by capital liberalization was the reason why SE CBs were not as favourable to external as they were to domestic liberalization – though they did appreciate the benefit of subjecting the government's fiscal and other policies to the constant disciplinary mechanism derived from a liberalized capital account. However, contrary to domestic liberalization which began earlier and in which CBs carried a central role, capital liberalization was exogenously imposed by the single financial market and EMU program, and thus CB skepticism was of lesser importance.
15. I am using this argument in the positive rather than the normative sense, as it is far from incontrovertible that liberalization is better for monetary control. The exact opposite may be argued: by allowing banks to begin to market credit aggressively liberalization is usually accompanied by rapid growth of monetary aggregates, which in the interventionist regime were strictly controlled. At the same time the demand for money tends to become unstable, which makes it rather difficult to use monetary aggregates as indicators of the monetary stance. For an excellent discussion see Gibson and Tsakalotos (1994).
16. The exact same extract was emphatically repeated the year after (Banco de España 1975: 141).
17. In personal interviews, an ex-governor and a former deputy governor of the Bank of Greece confirmed that the most important objective of domestic financial liberalization was to enable the CB to effectively implement monetary stabilization.
18. In the narrow sense, the high interest rates of monetary adjustment undermine fiscal stabilization by raising the cost of public debt – hence what is regarded as liberalization's 'disciplining' effect on public spending.
19. For example, the Bank of Greece report stated: 'the [restrictive] monetary policy of high real interest rates and relative exchange rate stability was and continued to be necessary for the stabilization of the economy until the necessary adjustments in fiscal policy and the reduction of pressures on the part of the public sector upon money and foreign currency markets' (Bank of Greece: 1988: 35).

20. In that Spain was the leader, Greece and Portugal following with a time lag of several years. Initially, the money market was exclusively an interbank market; a secondary market for the sale of government securities to the public (mostly under repurchase agreements) did not begin to develop until after the mid-1980s. Even more delayed was the decision of government authorities to issue their securities at market rates, as well as the activation of a secondary market in medium and longer-term debt – which only began after inflation de-escalated.
21. See, for example, Grilli et al. (1991); Cukierman (1992); Alesina and Summers (1993).

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