Paper for the European Community Studies Association (ECSA)
Sixth Biennial International Conference
Pittsburgh PA, June 2-5, 1999

Financial Repression and Liberalization in Europe's Southern Periphery: From "Growth State" to "Stabilization State"

George Pagoulatos

Postdoctoral Fellow
Department of Politics, Princeton University
Email: gpag@princcton.cdu

ABSTRACT

Postwar economic growth in Spain, Portugal and Greece was premised, more or less, on a system of state-directed finance. After the 1970s and especially after the mid-1980s, all three Southern European economies (SEEs) led by Spain entered a process of gradual financial liberalization. To account for liberalization, four explanations are examined: (a) the external constraint posed by the prospect of European financial and capital liberalization/ integration (which is held valid for the cases of Portugal and Greece but not for Spain); (b) financial liberalization as a strategy for Europeanization (which applies mostly to the case of Spain, and secondarily to Portugal and Greece); (c) financial sectoral pressure (an explanation rejected); (d) financial liberalization as a prerequisite for effective disinflation and macroeconomic stabilization (which is singled out as the most important explanation). Further, the paper argues that the transformation of the state's role in finance over the 1980s and 1990s denotes a shift from a "growth state" to a "stabilization state".

Working Paper (last revision: May 1999)

COMMENTS WELCOME

Financial Repression and Liberalization in Europe's Southern Periphery: From Growth State to Stabilization State

George Pagoulatos
(Princeton University)

Whence financial restriction or "repression", and why financial liberalization? What does each stage imply for the state's economic role? This paper is driven by these two questions, both of which will be examined with reference to the least advanced Southern periphery of the European Union, comprising Spain, Portugal and Greece.[1]

The role of state over finance remains predominantly subject to normative economic policy debate (World Bank, 1989; Caprio, Atiyas, and Hanson, 1994; Haggard and Lee, 1995) ranging within the broader spectrum between the seminal assault to financial "repression" originating from the Stanford neoliberal school (Shaw, 1973; McKinnon, 1973; Fry, 1988) and the equally seminal defense of credit rationing on the grounds of the information asymmetry argument (Stiglitz and Weiss, 1981; Caprio and Summers, 1993; Stiglitz, 1996: 222-4) leading to a reinvigorated endorsement of banking (re)regulation (Goodhart, 1995a; Lastra, 1996).

On the positive analytical level, explanations of both financial restriction/ repression[2] and (secondarily) financial liberalization (Appendices 1 and 2) have been often sought in various versions of public-choice type accounts, often drawing on what is broadly known as "economic theory of regulation" (Stigler, 1971; Peltzman, 1989) (Calder, 1993; Lukauskas, 1997). In general, the political science literature has predominantly sought to explain both financial restriction and financial liberalization by looking at the configuration of interests on the demand side (financial and banking sector, business and other socioeconomic groups) as well as on the supply side (political, government, or central bank elites) (Haggard, Lee and Maxfield, 1993). Within this broader interest-based analytical framework, various approaches have placed their emphasis on different factors: structural/ institutional factors (Zysman, 1983;

[1] Though most of the arguments developed in this paper apply in the case of Italy as well, Italy (which is far more integrated in the EU core) is not considered here, as the historical section of the argument draws on the three countries' parallel trajectories under authoritarianism and, since 1974, democracy.
[2] According to the literature, "[f]inancial restriction becomes financial repression when regulations that limit competition in the financial sector are combined with high and growing inflation" (Cottani and Cavallo, 1993: 41).

Loriaux, 1991; Story and Walter 1997), elite interests (Pérez, 1997), or a hegemony or regime international political economy dynamic (Loriaux, 1991; Helleiner, 1994; Woo-Cumings, 1997).

While not fundamentally departing from the interest-based political science orthodoxy in treating financial restriction and liberalization, this paper follows an historically informed structuralist-institutionalist approach in emphasizing a less salient and rather overlooked aspect: the implications of the two stages of financial regulation (repression and liberalization) for the state's economic role. Fundamental premise underlying this paper's thesis: actors have choices, but their choices are crucially circumscribed and constrained by the structural framework within which they operate.

The paper deals with the questions:

- Why were the financial systems of Southern Europe (Spain, Portugal and Greece) organized the way they were, and why were they liberalized after the 1980s? Why and to what extent were the financial systems of S. Europe different from the rest of Europe?

- What does the experience of financial restriction and liberalization in Southern Europe tell us about the state's role in the allocation of finance?

- What does the change of the state's role over finance signify? What is the content of the shift from a growth state to a stabilization state?

A case for South European specificity: industrialization and finance in the periphery

What is specific about Southern European economies (SEEs) and the role of state and finance in their economic development process? As these economies were placed in the periphery and were late or late-late developers, there was a crucial role to be played by the state in their industrialization.[3] The argument, drawing on Gerschenkron's (1966) seminal contribution, is well known. In order for the private or public sector to pursue industrial investment, a massive flow of capital was needed. States in late or late-late industrializing countries could not rely on capital accumulation to occur simply through the market, as had historically been the case with early industrializer Britain (Kindleberger, 1993: 77 ff). Capital markets in latecomer countries

[3] This classic argument on "late industrialization", though old, has proven remarkably resistant in the face of later dissent. Prominent (though far from uncritical) recent exponents of the thesis with reference to various national case studies include Amsden, 1989 and 1992; Wade, 1990. Other

were practically nonexistent, so capital could only be provided by the banking system (by turning deposits into loans). In order to expedite industrialization and to offset a range of market failures (an undercapitalized private sector, or a tendency to invest in speculative activities rather than manufacturing, or the inability of future profits to compensate for short-term losses, or general information deficiencies regarding investment opportunities) governments intervened in banking (Amsden, 1992: 59).

A first step was to encourage people to deposit their money in the banks, instead of hiding it under their mattresses. That was obtained as soon as the inflationary aftermath of the War had been overcome (eg, in Greece by 1955). The next step was to encourage banks to lend long-term. That was not easy. Banks are notoriously keen in lending short, making a quick profit, rather than undertaking the uncertainty and risks involved in long-term lending. So governments in late or late-late industrializing countries intervened in the banking system mainly in two ways. The first was to create special long-term finance institutions, such as industrial development banks (or mortgage banks, or agricultural banks). The second was to oblige commercial banks to devote a percentage of their deposits to industrial investment or to long-term development loans, or to government bonds through which government could raise the money to build up infrastructure.

In addition, to allow for economic growth, governments attempted to keep down the cost of borrowing by imposing interest rate ceilings. Through such instruments as favorably fixed interest rates and credit quotas, governments directed cheap credit to favored economic sectors (industry, exports, small enterprises, agriculture, etc) deemed as "productive" or discouraged and penalized the financing of sectors deemed as "unproductive" (consumer credit, trade, imports, dwellings, etc). At the same time governments attempted to control the growth of credit through quantitative restrictions (such as credit ceilings, special reserve requirements, etc).

That gives a rough idea of the rationale and the content of financial restriction or "repression" as it developed during the postwar decades.[4] Though important specific sociopolitical objectives were also undoubtedly served through the establishment of financial restriction (see

---

approaches have revisited the Gerschenkronian thesis not by rejecting it but by including further criteria of cross-national divergence (Zysman, 1983: 289 ff).

[4] Postwar economic development literature overwhelmingly identified economic development with industrialization, and converged in suggesting a considerable degree of state activism in bringing it about. Thus financial repression emerged as a virtually undisputed "universal" strategy of growth for developing countries, such as those of Latin America, South East Asia, or Southern Europe. From the vast literature, indicative of the developmentalist consensus are the official publications of the World Bank, OECD, and similar organizations in the 1950s and 1960s, as well as mainstream development economics textbooks of the time.

further), postwar SEEs converged in fitting the typical outline of an activist state role in financing development.

In all these aforementioned functions, South European financial systems (including those of Italy and France) were similar to each other, and different from others in Europe.[5] They were different from the Anglo-Saxon type financial systems. In these systems no continental-type development banking institutions existed, very modest selective credit policies were implemented aimed more towards demand management rather than growth, quantitative credit controls were only a limited instrument of monetary stabilization (until they were completely abolished in the early 1970s), and the financing of industry was implemented mainly through the capital market, based upon market criteria (Shonfield, 1965: 222 ff; Zysman, 1983; Moran, 1984a and 1984b).

South European financial systems were also different from the German-type financial systems. Like Southern Europe, these systems were bank-based instead of capital-market based, and manufacture was broadly financed through specialized long-term credit institutions (though the degree of industrial involvement of German banks was far more substantial than in Southern Europe). Contrary to Southern Europe, however, no detailed system of administered credit developed in Germany, and the allocation of bank finance was realized in accordance with market criteria instead of state control (Shonfield, 1965; Dyson, 1986; Deeg and Pérez, 1998).[6]

The entire growth model of postwar SEEs was premised on a state-controlled financial system and a government-controlled central bank. State control took either the form of ownership and management control over banks (as in postwar Greece and postauthoritarian Portugal), or at least the form of directed credit and administrative control over the rules, prices and generally operational framework under which financial resources were allocated.

Main economic policy features of the postwar era (1950s to early 1970s) and the role of finance

A significant degree of state activism for promoting industrialization was a principal common feature of Spain, Portugal and Greece in the postwar period. For Portugal and Spain that

[5] On the financial systems of France and Italy, see Zysman, 1983; Loriaux, 1991; Pérez, 1997b; Cassese, 1984; Furlong, 1986. On the organization of European financial systems from the postwar decades to date, see Institut d'Etudes Bancaires et Financières, 1969 and 1970; Wilson, 1986; Fair and de Boissieu, 1990; Dermine, 1993.

[6] A number of other West European countries such as Belgium, Austria, or Scandinavian countries presented considerable features of financial restriction but for various historical reasons should be treated as distinct from the South European model of administered credit.

postwar period could be claimed to have begun in the 1930s and late 1930s respectively –given the continuity of their authoritarian regimes. State role in Spain and Portugal was part and parcel of state corporatism amounting to a highly cartelized economy, and in that exceeded the scope of state *dirigisme* in the postwar market economy of Greece.

The Spanish and Portuguese growth trajectories until the 1960s were based on a model of autarchy, aimed towards a policy of import substitution industrialization and the development of agriculture. Franco's Spain until 1959 and Portugal under Salazar pursued industrialization through relying on protectionism and trade controls. Spain shifted to internationalization and liberalization after 1959 under the influence of the Opus Dei group; a similar though less pronounced shift to economic liberalization took place in Portugal after the succession of Salazar by Caetano in 1968 (Baklanoff, 1978).

Spain under Franco relied heavily on protectionism through extensive financial restriction that included quantitative controls and exchange controls. The regime sought to foster long-term financing and to institutionalize active bank involvement in industrial affairs (the *Instituto Nacional de Industria* sought to replicate the Italian IRI) through specific financial regulation (Pérez, 1997). Overall, the autarkic period in Spain was characterized by failure either to control inflation or to post economic growth rates that could match those achieved in other European countries. In 1959 the autarkic strategy was abandoned and the Franco regime subscribed to a strategy of open trade and liberalization launched with an orthodox stabilization plan that, among others, prohibited the financing of government deficits through debt monetization and imposed restrictions on the cheap credit provided to private sector (Prados de la Escosura and Sanz, 1996: 369; Lukauskas, 1997: 69-70). What followed from the early 1960s through the mid-1970s was an industrialization model very much inspired by French indicative planning, reoriented through successive four-year development programs. Private sector was designated as the engine of economic development, and government intervened through policies such as subsidies, tax alleviations, tariff advantages and preferential lines of credit (Prados de la Escosura and Sanz, 1996: 370; Lukauskas, 1997: 70-71). Similarly, development in Portugal was steered and financed by the state and a cartel of privately-owned big banks acting in concertation with government; thus the Portuguese postwar growth model was also premised on the provision of cheap, administered finance, which generated capital intensive industries (César das Neves, 1996: 341).

Greece from the 1950s took on a distinct course which carried stronger features of an export-led growth model, premised as it were on price stability and relatively free trade, though there was always a tendency for import substitution.[7] The period of economic growth was launched with a once-for all major devaluation in 1953, whereby drachma was fixed with the dollar at an undervalued rate in order to maintain economic competitiveness (Germany had done very much the same in 1948; Italy too) (Boltho, 1996). The economic policy mix acquired increasingly stronger features of an active import substitution industrialization model in the 1960s, bolstered as in the case of Spain and Portugal by French-style indicative planning institutions –which lasted through the 1970s and even early 1980s. Even though Greek state *dirigisme* was comparatively less entrenched than in Spain and Portugal, postwar growth was steered in terms of finance allocation by the Currency Committee (1946-82), a governmental body comprising the central bank governor, with extensive authority over the direction of credit and the formulation and enactment of financial regulation up to a highly detailed level (Halikias, 1978; Pagoulatos, 1999a).

In all three SEEs, typical features of financial restriction were predominant since the 1930s and early postwar decades (specialized credit institutions, state-controlled banks, exchange controls and a wide range of qualitative and quantitative credit controls and regulations, administrative restrictions, oligopoly structure and lack of banking competition, rigidly fixed interest rates, nonexistent capital and money markets). A policy of artificially low interest rates was enforced thanks to government direction of the banking system and to the existing controls on international capital movements.

All SEEs could be claimed to have subscribed to a mostly neoclassical doctrine, placing strong emphasis on fiscal discipline and the pursuit of running a budget surplus (in the early postwar years Greece and Portugal were helped to that effect by their participation in the Marshall Plan aid). Pre-1974 policies in SEEs were averse to Keynesianism as either an economic philosophy or a set of economic policies. Certain phases possibly formed a partial exception (such as in the Greek case the immediate postwar reconstruction period of widespread public investment – which was still rather protoKeynesian— or the 1964-65 Center Union phase of considerable fiscal expansion). While there was government spending on public works, that was not aimed to raise effective demand, but to build development infrastructure. Thus South European postwar policies could be grossly characterized as subscribing to a neoclassical-developmentalist mix. However, by the second half of the 1970s all SEEs were reacting to economic crisis through countercyclical policy means (by increasing the levels of public spending to stimulate the economy, and by easing or tightening monetary policy); more on that later.

[7] For a discussion of import-substitution industrialization and export-led growth strategies see Haggard, 1990.

All three postwar economies (Greece after 1955 and Spain and Portugal from the 1960s) delivered overall high rates of growth, which especially in the case of Greece was also combined with remarkably low inflation. However, these economic achievements were underwritten by the authoritarian-prone or plainly authoritarian repression of labor demands; foreign outward migration (especially in Portugal and Greece) took care of unemployment; cheap flowing credit (for industry, SMEs, farmers, and to a lesser extent housing) kept the regime's political clienteles satisfied. Targeted credits in postwar Southern Europe were the means by which authoritarian or imperfectly democratic governments could "buy" social acquiescence and substitute for the lack of a European-type welfare state. Apart from their perceived promise in delivering industrialization and growth, the postwar institutions of administered finance entailed the formidable political advantage of granting state policy-makers the ability to indirectly control the country's socioeconomic and business life, while at the same time allowing government-favored economic groups to translate their political links into privileged access to financial resources. Thus, overall, administered finance in Spain, Portugal and Greece served a function of political as much as economic stabilization and, quite notably, a particularistic model of economic growth.

Crisis and transition: the post-1974 period

The 1973-74 phase marked not only the SEEs' passage to democracy but also the beginning of a slow transition to a new system of financial and eventually economic and monetary policy. To summarize these well-known developments: in 1973 the Bretton Woods system of fixed exchange rates –which had underwritten monetary stability in Europe for the entire postwar period— collapsed. Europe was hit by stagflation. Over the 1970s and 1980s international capital movements were gradually liberalized. The new globalized, liberalized financial environment engendered a logic of competitive deregulation. Europe was pressured to deregulate its financial systems and capital movements in order to compete with the US, Japan, and Southeast Asia in attracting mobile, globalized capital (see Goodman and Pauly, 1993). Capital liberalization necessitated the deregulation of national financial systems and the abolition of financial restriction.

The need to abandon the particular model of state role in finance rose stronger in S. Europe because it was there that growth had been pursued through principal reliance on specialized banking institutions and administered credit.

The crisis of financial restriction was exacerbated in Spain, Portugal and Greece under the state expansion that took place after 1974. A common strategy prevailed of stabilizing democracy through expanding and consolidating public sector and catching up with the levels of social spending of the advanced European countries. As budget revenues remained more or less inelastic, public sector expansion was covered through government borrowing financed mainly by the banking system. The monetization of growing public deficits, combined with the extension of cheap credit at negative real interest rates, generated sustained inflationary pressures, turning financial restriction into financial repression.[8]

Consequently, financial restriction suffered a twin crisis. It suffered an economic crisis: apart from its inflationary effects, administered finance had also been responsible for distorting the price mechanism and misallocating resources (Halikias, 1978); under the new post-Bretton Woods environment these perverse effects were exacerbated (cf. Forsyth, 1997: 115). And it also suffered a political crisis: a prolonged subjection of financial instruments to distributive purposes had encouraged rent-seeking demands and the systematic use of credit for winning over crucial electoral groups.

To sum up the argument so far:

Late-late industrialization in the South European periphery necessitated an active state role in banking. State control over finance in Spain, Portugal and Greece was consolidated through the postwar period, and exacerbated during the period of transition to democracy. Due also to the exigencies of democratic transition, SEEs responded to the stagflation shock of 1973-74 with significant fiscal expansion. Under the new international economic regime of the post-Bretton Woods era combined with the expanding program of European integration, administered finance became economically unsustainable.

Four explanatory accounts for financial liberalization

These contextual changes underlie the emergence of financial liberalization in Southern Europe (Appendix 2). It was implemented mainly over the 1980s (and especially in the second half of the 1980s), though the deregulation of interest rates in Spain began from as early as the mid-1970s.

From a political viewpoint, financial liberalization (as opposed to the establishment of financial restriction, which from both a demand and a political supply side is far easier to understand) in general poses something of a puzzle. As summarized by Haggard and Maxfield (1993: 314):

---

[8] See footnote 2.

"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?"

Four principal arguments can be laid forth to resolve the puzzle of financial liberalization:

a) The external constraint argument

As already implied, the process of financial liberalization in the EC/EU was a principal driving force for the abolition of financial restriction in Southern Europe. This can be called "the external constraint" argument, which can be broken down into two particular propositions. One refers to the "objective" constraints deriving from financial market globalization, integration and liberalization in general (Pauly, 1997: 29 ff). The other proposition refers to the particular "positive" institutional obligations imposed by the European single market and financial integration program.

With regard to the first version of the argument: financial and capital liberalization posed an external constraint and had to be preceded by the abolition of administered credit and interest rate controls at the national level. To crudely summarize the rationale: if real interest rates remain negative or at lower than market levels, and the national financial system is not competitive and efficient enough, then (when capital controls are lifted) savings will flow out of the country and the payments balance will collapse. As capitals are internationally attracted by less regulated markets, the process of financial internationalization in Europe rendered the domestic allocation of resources through *direct* monetary instruments (credit controls and regulations, interest rate ceilings and directed credits) undesirable and ineffective.

The aim of complete liberalization of capital movements was a crucial constituent of the EC financial integration program before and after the Single European Act. The capacity of member states to confront the constraints generated by capital liberalization was considered by the Commission to be dependent directly on the structure of their balance of payments, the international status of their currency, and the level of development of their domestic banking and financial systems (European Commission, 1988: 15 ff). Thus the prospect of capital liberalization entailed in the European single market and financial integration project necessitated the move of financial systems towards market-determined credit prices not only for reasons of financial system competitiveness but for heavily interrelated purposes of macroeconomic stability. As a subsequent wave of institutional reform came the Economic and Monetary Union (EMU) program, the entry in which was contingent on the SEE currencies' participation in the European Monetary System (EMS). The combination of liberalized capital movements and exchange rate stability necessitated the full alignment of national monetary policies behind the EMS even for those EC/EU member states who had not yet entered the EMS (Branson, 1990; Eichengreen and Frieden, 1994).[9]

There is certainly great power in the external constraint argument, especially for the cases of Greece and Portugal, which began to deregulate credit in the second half of the 1980s under the clear spectrum of the single financial market. However, Spain initiated banking liberalization already from the first half of the 1970s, long before the liberalization of its capital account. 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: reforms were initiated long before the external constraint associated with capital liberalization had begun to take effect; they unfolded in the politically unpropitious for structural reforms context of Spain's transition to democracy (cf. Bermeo, 1994); and they were implemented despite the opposite interest of powerful sectoral players such as private banks [more on which later under (c)] (Lukauskas, 1997: 2). So the external constraint argument appears convincing in the cases of Portugal and Greece, but less convincing in the case of Spain.

This points to an alternative or rather complementary line of explanation.

b) Financial liberalization in SEEs and especially in Spain served a broader "Europeanization" strategy on the part of economic and central bank elites to promote their countries' accession to the EC.

Two distinct approaches (Lukauskas, 1997; Pérez, 1997) have been proposed to explain Spain's final adoption of financial liberalization given its divergence from the external constraint canon. Both approaches challenge the so-called "public interest" argument, which would attribute reforms to their recognized (by policy-makers) merits of higher economic efficiency. Following a public choice approach, Lukauskas argues that it was those exact conditions of transition to democracy, with the large, broad-based national parties that they involved, which created a "new reward structure" for government policy makers against particularism, "making 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

[9] 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 well in time.

against opposition parties for the support of a heterogeneous array of voters to stay in power" (Lukauskas, 1997: 3).

However, this line of argument raises at least two serious objections. First, government policy makers cannot be treated as a single unitary category. Depending on ideological predispositions (more or less pro-European or free-market oriented), the exact office held (a "productive" ministry as opposed to the Economy Ministry or the Treasury), and individual political strategies (clientelistic versus reformist), state policy-makers' interests may diverge. Especially crucial is the distinction between political government and central bank policy makers, derived mainly from the latter's lack of (or reduced) concern for reelection. Thus though methodologically individualist, the above approach does not engage in the necessary disaggregation involved whenever one addresses such abstract entities as "state" or "government", especially since internal divergence of interests may be critical.

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 a build up of industrial and financial sector productivity, these are public goods whose real outcomes can become visible after a period of time that most probably outlasts the electoral cycle of a government term. Thus, if the beneficial effects of financial liberalization were what policy makers were targeting, then one would see this substantiating a "public interest" rather than a "public choice" argument.

[On the contrary, Pérez (1997) demonstrates that financial liberalization deteriorated instead of improving economic performance by excessively increasing the financial costs of Spanish businesses, contributing to the dramatic rise of unemployment rates. If the public choice argument held true, and given the heavy political cost economic recession and the loss of jobs involves for government, the Spanish authorities should have reversed the deregulation process].

The Greek and the Portuguese cases of belated and reluctant reform undermine the (already counterintuitive) argument that financial liberalization could be instigated by political reward-maximizing concerns of policy makers of the type described above. Both countries went through parallel transition paths and despite the far weaker political standing of their banking sectors (given the overwhelming scope of state ownership and control) they were late in initiating and implementing liberalization. In the case of Greece –with the exception of a few neoliberal-minded reformers— the entire government machine under both main parties was opposed to the prospect of government surrendering its discretionary command over the banking system. And that despite the fact that the great majority of the banking sector was already state-controlled (as opposed to privately owned in Spain), which meant that government involvement could continue even after credit had been liberalized (as in fact it did). So if Lukauskas' argument can claim broader explanatory validity one should expect to see Greek and Portuguese government policy makers 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.

Pérez's refutation of the public interest argument appears more convincing. While agreeing with Lukauskas that financial liberalization was viewed negatively by the highly cartelized and privately controlled Spanish banking sector, she rightly focuses attention to the main promulgator of reform, the central bank. The central bank's ambition to weaken the government's financial interventionism and expand its own control over monetary policy led it to take advantage of the transitional period in advancing its reform agenda. To that aim, the Bank of Spain established a "working alliance" with the banking sector, which resulted into serious concessions in the implementation of financial reform; these concessions allowed banks, even after liberalization, to reap very high profit margins at the expense of industrial borrowers (Pérez, 1997). This argument accords with well-known findings affirming the "elective affinity" of central banks with their banking sector constituency (Woolley, 1984; Moran, 1984a; Goodman, 1992).

However, both Lukauskas and Pérez underplay not the external constraint factor (which indeed at the initiation stage of Spanish financial reform was only distant and indirect) but the EC factor in specific. Several authors (Maravall, 1993; Bermeo, 1994; Alvarez-Miranda, 1996; Marks, 1997) have remarked the Europeanizing zeal with which Spanish postauthoritarian elites from both main parties viewed the prospect of Spain's accession to the EC, identifying it with national modernization. The political consensus over Europe (the PSOE's early rhetorical anti-market attacks notwithstanding), in fact the consensus base of the Spanish transition in general (as exemplified in the October 1977 Moncloa Pacts) formed one of Spain's principal differences from Greece's politically conflictive transition to democracy. The Europeanizing consensus of Spain's main political forces embraced the monetary reforms that had already been initiated by the country's strong central bank [for ample evidence of the Bank of Spain's significant political influence from the 1970s onwards, see Pérez (1997)]. Indeed financial liberalization was one of the major structural measures included in the Moncloa Pacts (OECD, Spain, April 1980: 32). It is only reasonable then that the country's central bank (an institutional champion of European integration and pro-market policies in general, and a high-quality technocratic elite institution) would find the moment ripe to claim its own role to the country's economic Europeanization-via-market liberalization, even more since that also happened to support its own strengthening of position vis-à-vis government.

Central banks in Southern Europe formed probably the most ardent champions of their countries' accession to the EC, viewing the latter's external pressure as a valuable ally in their own disinflation efforts. For instance, the Bank of Greece in the late 1970s openly campaigned through publications and public pronouncements in support of Greece's entry to the EC. Portuguese central bank and government authorities in the beginning of the 1980s were declaring their intentions to improve market mechanisms and set up a full-scale financial and capital market as necessary condition for Portugal's accession to the EC (OECD, Portugal, 1981: 29). Both these central banks, however, were notably weaker than the Bank of Spain. The Bank of Portugal, only freshly nationalized during the transition to democracy period along with the country's entire banking system, throughout the 1970s lacked the institutional continuity and self-confidence of the Bank of Spain's elite apparatus. And the Bank of Greece on the other hand, trapped amidst a heavily polarized political climate during the post-transition years, could only accede, albeit reluctantly, to the government's political dictates. In the cases of Portugal and Greece the central banks were able to exercise only limited influence towards financial liberalization and monetary policy reform, hence the relative delay in the initiation of financial reforms.

Thus the early liberalizing zeal of Spanish government and central bank policy makers can be explained as the combined effect of two factors: (i) these elites' pursuit of "Europeanizing" the economy in order to spearhead Spain's admission to the EC; and (ii) the Bank of Spain's increased institutional and political influence, which allowed it to effectively promote its agenda of financial reform and a more active use of monetary policy instruments in pursuit of disinflation [on which more under (d)]. From then on, the scope and exact content of financial liberalization reforms would be shaped under the impact of the "incestuous" relation of the Bank of Spain with the Spanish banking sector, managed in such a way as to also accommodate the latter's interests –as the dominant literature would indeed tend to expect.

c) Which brings us to another familiar contention. The beneficial effects of financial liberalization on the financial sectors and markets, and the well-grounded observation of a central bank disposition of accommodation towards banking sector interests, have given rise to the argument that **liberalization took place under the pressure of national banking and financial sectors.**

True, national financial sectors were vested with remarkable strength as a result of liberalization. On the aftermath of liberalization national banking sectors throughout Southern Europe reaped remarkable profits by colonizing the new financial markets and institutions. Financial liberalization overall objectively advanced the banking sector's interests by lifting imposed obligations and releasing and multiplying profit opportunities. The recourse of governments to public debt markets meant that banks were left with high bargaining power (given their role as principal buyers of government paper) vis-à-vis heavily indebted governments. They were able to place their assets on risk-free government paper, and negotiate not only market rates but also other significant concessions as part of the deal (eg, underwriting privatization schemes, providing counterpart finance to large-scale infrastructure projects, etc).

Given these prospective benefits, central banks often relied on their national banking sector as principal strategic ally for at least certain liberalization measures that mainly had to do with the removal of obligations and restrictions on the banks' credit policies. That, however, is qualitatively different from saying that the central banks' deregulation program was molded so as to serve the banks' interests. The overall argument that financial liberalization served to accommodate the banking sector's interests should be watered down. Though a central bank operates as custodian of the long-term interests of the banking and financial sector (Goodhart, 1995b: 210), the impact to be carried by the latter upon the central bank's policies is contingent on the financial sector's size and strength.

In countries with established financial markets and powerful financial sectors (US, Britain, Germany, the Netherlands), liberalization came about largely as a result of pressures on the part of these strong, internationalized, financial sectors eager to enlarge the circuit of capital and volume of transactions and to capture wider profit margins through deregulation (Kurzer, 1993: 22-3).

However, as already mentioned, financial markets in SE were virtually nonexistent, and the national banking sectors were weak, overprotected and domestically oriented (especially the state-controlled ones of Portugal and Greece) (Gibson and Tsakalotos, 1992). Financial liberalization, though also serving the interests of banking sectors, did not originate as result of their pressure.

Thus financial liberalization in Southern Europe was not demanded by potential winners (banking sectors), which in fact usually had mixed feelings about liberalization. On the one hand they relished the prospect of getting rid of government-imposed restrictions on their portfolios and policies. On the other hand, protected and less efficient as they were, they feared the opening of the market to external competition. [10] Principal components of the banking liberalization program (the opening of the market to foreign banking competition, the liberalization of deposit rates, and a wide range of prudential reregulation measures) were strongly disfavored by protected national banking sectors in all three SEEs.

Therefore financial liberalization in Southern Europe clearly represented a statist model of policy reform. It constituted a reform program placed on the agenda, initiated, formulated and finally implemented under the nearly exclusive control of state policy makers (be they central bank or government officials) for purposes serving their own rationale and policy objectives, and not as result of societal pressures toward that particular reform direction.

d) Which brings us to our fourth and most important argument: **financial liberalization for the purpose of disinflation.**

As already mentioned, the transition of SEEs to democracy was followed by a rise of public deficits which did not relieve but perhaps even further aggravated the stagflation of the 1970s (see Tables CPI and GDP).

Table DEF demonstrates the considerable difficulty to stabilize public deficits in Southern Europe. This was due to a combination of factors: the public sector expansion under democracy (especially the increase of transfer payments through the end of the 1970s –and through the first half of the 1980s in Greece—to catch up with the relative underdevelopment of social expenditure as well as for the provision of unemployment benefits); the difficulties in raising government revenues; the rent-seeking demands of various interest groups encouraged by the particularistic structure of resource distribution; the self-feeding function of public debt.

The argument to be developed here is that monetary austerity (and financial liberalization as its necessary precondition) was undertaken by governments under the pressure or "moral suasion" of their central banks as a "self-binding" strategy for counteracting the governments' lack of fiscal discipline or for the purpose of expediting stabilization while eschewing a more radical cut-down of public spending.

---

[10] Overall it can be argued that 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 results of liberalization if they continue to set interest rates through cartelization. The are bound to be disaffected (the least efficient ones) if real competition erupts (usually through the entry of new market players) forcing them to narrow their profit margins in order to withstand competition.

The argument can be broken down into two propositions:

1) governments and central banks in Southern Europe had an interest in pursuing stabilization through a principal reliance on monetary policy means

2) their ability to implement stabilization by employing these monetary policy means was predicated upon financial liberalization

To begin with the second proposition: financial liberalization is a precondition for the central bank's ability to effectively employ its monetary policy instruments towards disinflation.

What does a central bank (CB) do, how does it handle monetary policy? In conducting monetary policy and managing how much money will flow in the economy, a CB has three "traditional", "indirect" policy instruments:

- The interest rate with which it lends banks for their everyday liquidity needs.
- The trading of government securities in the open market (open market policy).
- And the reserve requirements through which the central bank can oblige banks to deposit a portion of their liquidity with the CB.

The effective exercise of monetary policy in the pre-liberalization era was severely constrained by financial restriction and administered credit: if interest rates are fixed by the government, the CB cannot apply its own interest rate policy. If government securities are forced upon the banking system, at an interest rate determined by the government, then the CB cannot apply open market policy. Thus, particularly for smaller and open economies, the logic of financial integration necessitated the phasing out of the impact of domestic political factors upon monetary policy, in order to enable central banks to effectively adjust to the constraining conditions of the European monetary system and financial markets.[11]

Repeatedly over the 1970s and 1980s, South European central banks were confronted with the problem of being unable to effectively control liquidity due to the narrowness of the money market and the prevailing low interest rates. A way of getting round this predicament would be for CBs to seek to neutralize liquidity through compulsory non-interest bearing reserve requirements, and indeed they occasionally resorted to that solution. However, that was

[11] This practically engendered the gradual shift of SEEs from the second half of the 1980s through the 1990s to a non-accommodating monetary and exchange rate policy, aimed at reversing the entrenched inflationary expectations through a commitment to high real interest rates and a real appreciation of the currency.

undesirable and unsustainable on the long run as it posed a considerable additional burden on the banks already "repressed" by low lending rates and a broad range of special investment coefficients (OECD, Portugal, 1980: 19).

Thus SE central banks consistently since the 1970s and especially the 1980s pursued the development of a money market, to which their governments resisted for the implications that would have in increasing the cost of public borrowing. The delay in the development of a money market in all three SEEs can be unambiguously attributed to their governments' reluctance. Efforts to make the banking system more sensitive to monetary policy influence were first initiated by the Bank of Spain from the first half of the 1970s. In 1973-74 the Bank of Spain sought to control the excessive rise of liquidity by reducing the ceiling for rediscounting at the central bank and by pursuing, for the first time in its history, an active policy of open market operations, which was made possible by the issue of 3-month Treasury bills. The interest rate on these government securities was left free, and the central bank intervened daily in the money market in pursuit of its policy aims (OECD, Spain, 1974: 24). Portugal and Greece, whose central banks were considerably weaker, slowly followed suit with similar policies in the course of the 1980s.

Central banks therefore spearheaded financial liberalization, focusing on two vital policy issues: the abolition of direct credit controls and all government interventions in the pricing and allocation of credit; and the full development of a money market. Both objectives were deemed necessary so that CBs could make effective use of the policy instruments allowing them to routinely respond to short-term changes in the money market by effectively adding or detracting liquidity (IMF, 1995; Padoa-Schioppa, 1994).

Thus central banks pursued financial liberalization in order to strengthen their ability to conduct monetary policy, and eventually their political autonomy vis-à-vis their governments. To that aim, they exploited their power of suasion toward their governments, as well as any windows of opportunity created by European pressures, domestic economic and financial conditions, government indecisiveness or internal divisions, and any backing that could be drawn on the part of the banking sector (cf. Dyson, Featherstone and Michalopoulos, 1995).

At the same time, however, governments also 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 public spending and structural reforms, two fields where the political cost of adjustment is particularly high. Both Spain and Portugal had inherited a widespread and highly corporatistic public enterprise sector coupled with considerable labor market rigidity (see Pagoulatos and Wright, forthcoming). In the case of Spain that was combined with a legacy of highly entrenched inflationary expectations, sustained by the cheap credit policies pursued over a course of several decades. Greece, on the other hand (with the exception of the 1985-87 macroeconomic stabilization phase) for electoral reasons eschewed serious fiscal adjustment until well into the 1990s. Thus in all three SEEs, fiscal adjustment and structural reforms involved either far-ranging reforms with significant sociopolitical cost, or were deferred anyway by electorally-minded governments (Greece through the 1980s), or both.[12] This, however, intensified the role to be played by monetary policy, given the inexorable European pressure.

Contrary to fiscal and structural adjustment, stabilization via monetary austerity (practically translated into a real appreciation of the currency and high interest rate differentials relative to the EMS basket of currencies) at least allows the stabilization cost to be distributed indiscriminately, saving the government from hard redistributive choices (argument developed by Pérez, 1997b: 209; cf. Loriaux, 1991). Most importantly, this particular strategy allows governments to shift part of the political cost of adjustment to their central bank through an implicit tactic of scapegoating (cf. Woolley, 1984: 191 ff). The higher the perceived CB strength, the more the chances of the CB being viewed as responsible for the policies of monetary austerity.

This government - central bank collusion fundamentally underlies the choice of monetary austerity as stabilization strategy. The observation is accordant with the insight that whenever macroeconomic instability tends to prove a political liability, governments will be more willing to delegate authority to their central bank (Haggard and Maxfield, 1993: 308). The monetary austerity strategy resulting from this authority delegation was logically premised upon a liberalized financial system.

Summing up the argument: the rise of central banks

In conditions of macroeconomic instability and rising inflation monetary policy assumed greater importance, as it was called in to offset the governments' limited capacity of fiscal discipline in fighting inflation. That enhanced the bargaining power of central banks, allowing them to impose their stabilization agenda and any institutional changes that facilitated

[12] To that should be added the considerable 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.

monetary stabilization.[13] Most central among these institutional changes were financial liberalization and the creation of a money and capital market, the recourse to traditional "indirect" monetary policy instruments, and finally the rise of central bank autonomy against government.[14]

A clear correlation is derived from our comparative case (and one that indeed corroborates conventional wisdom): the stronger the central bank and financial sector, the stronger the disinflationary commitment.[15] For example, Portugal and Greece in the 1980s and until the early 1990s were more tolerant of inflation, exhibiting a stronger pro-employment stance on t Philips curve. On the contrary, Spain (where an influential CB was further emboldened by a strong, privately owned, cartelized banking sector) persistently pursued disinflation in a far more committed way and at an extremely high unemployment cost.

However (rather counterintuitively this time) the South European case also testifies to a rever process: central banks are given the green light even by otherwise expansive governments to steer financial liberalization, economic stabilization and monetary adjustment. Thus, while central bank strength is conventionally presented by economic literature as being highly correlated with low inflation, from a political viewpoint Southern Europe also points to the reverse: central banks in an inflationary environment, under their governments' auspices or mere tolerance, are in effect strengthened not weakened. It is the persistence of high inflation that strengthens the role of central banks, leading governments to entrust them with more effective monetary policy instruments in pursuit of disinflation (Pagoulatos, 1999c).

Conclusion: from growth state to stabilization state

A substantive transformation at the state-level underlies both the establishment of financial restriction in the postwar period and its gradual dismantling over the 1980s and early 1990s. This transformation follows the changes in the external economic environment surrounding state actions and the different opportunity set deriving from that transformed environment: abandonment of Bretton Woods, oil crises and stagflation of the 1970s, monetary and

---

[13] As was earlier mentioned, financial liberalization, at least in the short run, undermined fiscal stabilization by raising significantly the cost of public debt financing. Thus several Finance ministers (to be distinguished from their Economy Ministry colleagues) were seriously opposed to a stepping up of financial liberalization initiative.

[14] Of crucial importance of course was also the pegging of monetary policy to an external anchor with high anti-inflationary credibility (the Deutsche-Mark or a basket of EMS currencies).

[15] The majority of the economic literature finds central bank autonomy/ strength and price stability to be positively correlated (Grilli et al, 1991; Cukierman, 1992; Alesina and Summers, 1993; Bleaney, 1996).

exchange rate instability along with spreading financial globalization. All these developments have been marked as underlying a shift from a growth regime to a disinflationary regime (Forsyth and Notermans, 1997; cf. McNamara, 1998). On top of all that came the process of financial integration and the Economic and Monetary Union (EMU) program of the European Union.

The change of international and European economic regime over the 1970s and early 1980s and its attendant institutional and ideological transformations denote a change in the quality and configuration of the factors circumscribing state actions. Consequently these constraining factors point to state capacities in the sense of the economic and political feasibility of the state's policy options, and in that sense they also denote a change in the state's policy preferences and priorities.

What is argued here is that the state has been transformed from a "growth" state into a "stabilization" state. Each stage implies and necessitates a different instrumentalization of the financial system, given its paramount role in serving, at different historical moments, each of the two objectives, growth as well as economic stabilization.

The need to abandon the particular model of state role in finance rose stronger in Southern Europe because it was there that growth had been pursued through principal reliance on specialized state banking institutions, financial restriction and administered credit. Thus, the transformation of a growth state into a stabilization state is not a mere reflection of the shift from a growth regime to a disinflationary regime (Forsyth and Notermans, 1997). While developed West European economies in the postwar era were subject to a growth regime (enabling monetary stability but prioritizing employment), the mechanisms of growth did not pertain to the state's role over the financial system but involved mainly the exercise of other macro- and microeconomic instruments of a usually Keynesian hue. It was mainly in Southern Europe that the state pursued growth through a far-reaching regime of institutional interventions and policies that instrumentalized the financial sector, thus warranting its classification as a growth state. And it was therefore again in Southern Europe that economic adjustment was principally pursued through a shift from the growth state to a stabilization state.

What defines a growth state and what distinguishes it from a stabilization state? A growth state seeks to enlist the mechanism of allocating financial resources to the primacy of economic growth. An institutional framework is thus devised so as to substitute for the market's perceived failure to promote long-run development. Through various institutional instruments (political subordination of the central bank, bank nationalizations, credit and capital controls, financial regulations, selective credit policies and indicative planning, specialized banking institutions), domestic production is protected, and finance is directed to economic activities considered as pivotal for economic development. The principal attachment of the state to the growth objective does not mean that macroeconomic stability is ignored. The mostly neoclassical economic rhetoric and policy record of postwar governments in Southern Europe until 1973 unambiguously testifies to the fact that price stability and payments equilibrium were consistently at the forefront of government objectives (though to a lesser extent in Spain than in Portugal and Greece). But these were not viewed as objectives in themselves, but as the necessary preconditions for allowing sustainable economic growth. Growth was the paramount objective, and macroeconomic stability was the necessary precondition for achieving it. The growth objective over the postwar decades was even more explicit in the countries of Europe's Southern periphery (Spain, Portugal and Greece): the keyword there was not just growth but development, signifying a more far-reaching process than growth, not just more output but a different composition of output than previously produced, derived from technical and institutional transformations (Herrick and Kindleberger, 1983: 21; Bangs, 1968: 3; Zolotas, 1962 and 1965; Little, 1982: 3 ff).

The transition from the growth state to a stabilization state with regard to the state-finance connection, is anteceded by two major events or processes. One is the acquisition of a satisfactory state of development, which has placed the three SEEs amidst the broader group of developed countries, even if at the rear of that group. That is obtained by their membership in the EU, through which SEEs partake in the collective dividend of European advancement be it in the form of institutional modernization, international political upgrade, structural adjustments in various fields, or plainly increased financial inflows. This also implies that the pace of SEEs' economic policies in the 1980s and especially in the 1990s is being set by the developed economies of the EU. The latter's principal objective, at least until this writing, has been stabilization. The second major event is, of course, the ideological decline of the postwar development model that had underpinned the strategies and policies of the growth state. The descent of *dirigisme* is the most definitive trait of that event.

It is far from accidental then that the transformation from a "growth" to a "stabilization" state is temporally identified with the process of economic Europeanization in the SEEs. It can be traced in the early 1980s or even mid-to-late 1970s in Spain and Portugal, where governments and central banks initiated a process of economic convergence towards the EC ahead of their formal entry beginning in 1986; and it can be traced in the late 1970s and most clearly in the aftermath of the 1985 election in Greece, when stabilization and economic adjustment were initiated in earnest under the institutionalized surveillance mechanism and conditionality that accompanied the EC balance of payments support loan to Greece. In all three cases the gradual shift to a stabilization state included the watering down of the state expansionism that characterized the early postauthoritarian period. Both processes were sanctioned by the launching of the single market program that would eventually lead to the objective of the Economic and Monetary Union.

A stabilization state is not a Keynesian state pursuing stabilization through countercyclical or interventionist policy means (such as incomes policies, price and credit controls), which under the new liberalized environment have been rendered obsolete or ineffective.[16] Macroeconomic stability is not just a temporary policy objective but the long-run government aim and a constitutive pillar of government policy. Consequently, while the growth state pursues economic stabilization through its available interventionist institutions and policy instruments, the stabilization state devises the appropriate institutions and instruments for long-run stabilization: a liberalized and "deep" capital and money market acting as a deterrent to expansionist policies; most importantly, an independent central bank, institutionally prohibited from participating in the primary market for public debt, and officially endowed with a statutory commitment to price stability. Or a stabilization state enters a self-binding process of subscribing to international institutions such as the EMU nominal convergence criteria or surveillance mechanisms. A stabilization state will seek to rely on market allocation and to abolish state intervention in the market process under the premise that interventions would create longer-run disequilibria by distorting market signals and resource allocation.

A growth state would seek to stimulate the economy through relaxing fiscal and monetary policy. It would implement selective interventions aimed at supporting economic sectors deemed as "productive". On the contrary, a stabilization state would allow for growth through enhancing private profit opportunities, enlarging the scope of the private economy, and seeking to maximize the expected efficiency advantages of market allocation.

For the stabilization state, growth is no more the principal objective. The stabilization state treats macroeconomic stabilization as the principal objective for the sake of which economic growth and employment can be deferred. No doubt, this is predicated upon the re-ascendancy of neoclassical economic ideas in Europe in the second half of the 1970s, in the same way that the growth state was ideologically premised upon the pro-industrialization, developmentalist bias of the postwar decades combined with the contextual influence of Keynesian ideas placing employment and growth at the forefront of government objectives. The influence of

---

[16] The liberalization of collective bargaining in Southern Europe over the late 1980s and early 1990s has eroded the governments' ability to exercise incomes policies, limiting their impact to public sector salaries. As for price and credit controls, they were deemed incompatible with the European single market program and were gradually abolished throughout the EU.

Keynesianism in the postwar development process of SEEs was thus indirect and residual: it reinforced belief in the objective of growth, and it asserted a strong state role in bringing it about. However, these two successive stages of state commitment do not completely coincide with the hegemony of the respective ideological paradigms in Europe since they emerge as an interactive result of those paradigms and their domestic economic and sociopolitical environment. Besides, the economic policies in the 1950s and 1960s in Southern Europe were underpinned by neoclassical-leaning economics that repeatedly served to mitigate or counterbalance the developmentalist orientation of the postwar growth state.

The characterization of the SE states of the late 1980s and 1990s as "stabilization states" does not imply that state policies remain unflinchingly committed to stabilization throughout that period, nor –even more— that other principal objectives (redistribution or electorally-minded expansionism) leave the picture. What this distinction signifies is that the constitutive factors of the environment within which state role is defined have fundamentally changed. The broader state strategy and policies that under the postwar conventional wisdom used to appear as necessary, desirable or feasible, are now (under the post-1973 configuration) treated as politically precarious, economically hazardous or fundamentally flawed.

The state enrollment from a "growth" to a "stabilization" mission is not simply a mirror image of its external environment. External pressures and constraints do not amount to one-way options; they simply increase, often unbearably so, the cost of noncompliance. The decision whether to conform or not continues to rest in the hands of national policy makers, as several examples of non-conformist government policies have demonstrated (eg, the severe electoral expansionism of the 1988-90 period in Greece which gravely deteriorated all macroeconomic indicators). More importantly, what is of interest here is not just the extent to which external pressures are internalized by the domestic policy system. What is mostly of interest is the set of deeper transformations these pressures help to bring about in state ideology, preferences, strategy, and ultimate policy behavior. The state's role in the economic process is defined under the conceptual framework of a new paradigm which determines the meaning state actors impart to their policies as well as the direction these policies take. It is in that sense opportune to refer to a substantive transformation of the state's role in the economy.

The transformation into a stabilization state is not just a simple transition stage to the EMU, a transitory occurrence bound to fade away as soon as national currencies enter the Euro and monetary policy is ceded to the European Central Bank. For one thing, the integration of SEEs in the European economy does not release but even further binds them to the objective of sustained macroeconomic stability. This time, fiscal discipline is vested with the powerful institutional guarantees of the Stability Pact (prescribing a maximum budget deficit of 3% of

GDP). Even if Euro member states were to defy the rules of the Stability Pact (a fading possibility after the resignation of Oscar Lafontaine from Germany's Finance Ministry), the Pact's disciplinary role would be taken over by public debt markets (demanding prohibitive interest rates on new debt), the Maastricht Treaty no-bail-out clause (prohibiting EU governments from helping each other). and potentially financial regulators as well (prohibiting large exposures of banks to government bond holdings) (Lemmen, 1999). Thus, under the EMU disinflationary economic regime, economic growth can only be pursued to the extent to which it does not compromise macroeconomic stability in a rather austere definition of the term, and then always within the framework of the European Union's growth objectives. True, the EMU's ultimate promise is not just stability but, quite importantly, growth (through the conducive circumstances of long-run monetary stability, liberalized markets, and low interest rates) (Tsoukalis, 1997; European Commission, 1998). However, the Maastricht legacy and the superb power of the European Central Bank have suggested that if, in the proverbial trade-off between stability and growth, push comes to shove, then it is growth that will be deferred and not the other way round.[17]

In the post-EMU landscape the state in the broader sense acts as custodian of macroeconomic stability, and growth is expected to result:
a) from expanding privatized and liberalized banking and financial systems operating upon market efficiency standards that enable them to afford low interest rates;
b) from increasingly liberalized product and labor markets (which of course are not devoid of social and redistributive implications);
c) from any remaining EU structural funds (at least for the European periphery);
d) in the transitional period of high interest rate differentials and liberalized capital account, growth has been promoted by the inflowing foreign capitals (much of which, however, have been of a short-term speculative as well as inflationary nature).

A combination of some or all of these four factors have produced remarkable growth in all three SEEs, especially from the second half of the 1990s. This, however, does not refute but rather substantiates the argument, demonstrating perhaps a tentative success of the stabilization strategy.

Now compare the above with the growth instruments available in the hands of the state in the growth state era: monetary and fiscal policies to stimulate demand, industrial and sectoral

[17] Eichengreen and Wyplosz (1998), estimate that if the Stability Pact had been in force over the period 1974-95, the cumulated output losses for France, Italy and the UK would range between 5-9% of GDP –an estimate disputed by Bean who holds that the output losses are at least half as much as Eichengreen and Wyplosz suggest (Eichengreen and Wyplosz, 1998: 106).

policies, protectionist measures, and a large array of government-controlled financial instruments, all have been severely diminished or rendered obsolete. Thus the growth functions under the stabilization state emerge as residual and minimalistic: they are what remains after the state's macroeconomic stabilization objective has been served. Most importantly, the growth functions are not to be carried out by the state but by the market.

The above notwithstanding, a stabilization state is not exactly tantamount to a neoliberal state. The latter, if true to its ideological proclamations, would enhance that exact type of institutional arrangements that would promote market competition in the allocation of financial resources. On the contrary, competition was not a directly pursued effect, and financial liberalization across Southern Europe (at least in the short-run) gave way to strong instances of banking cartelization. Wherever competition followed, it was mostly limited to banking services rather than interest rates, the spread between lending and deposit rates remained high, all this meaning that the competitive effects of liberalization in the financing of business borrowers were not as pronounced as the neoliberal project would anticipate.

On the other hand, the stabilization state that replaced the growth state was not in the full sense tantamount to a "monetarist" state either. True, Spain and Portugal began setting monetary targets from as early as 1977, and Greece followed after 1979. While the influences of monetarism were clearly discernible in a number of factors (the primacy of disinflation, the extensive reliance on protracted monetary austerity) the differences were equally significant. To begin with, the endorsement of fixed exchange rates (the EMS project) is a departure from the monetarist doctrine (McNamara, 1998: 173). Moreover, monetarism in the strict sense (of a practical lack of monetary activism for the sake of a stable and predictable monetary growth) was rarely applied. Monetary targets were set but usually grossly overshot until eventually – toward the mid-1990s— abandoned for the sake of inflation targeting. And in some cases, as in Greece, the transformation into a stabilization state was not launched with monetarist or neoliberal policies but with a typical neo-Keynesian stabilization program in 1985-87, that was designed, formulated and implemented by government policy makers whose anti-monetarist views were never disguised.

It does appear then that the most consistent, definitive feature of that transformed economic role of the state was not the attachment to ideological doctrine of a neoliberal or monetarist character, but a more or less pragmatic (depending on the particular government in power) pursuit of stabilization, framed however under the conceptual impact of the neoclassical economic re-ascendance in Europe.

To recap, three principal arguments have been advanced in this paper:

a) Europeanization, catch-up –in the nominal-macroeconomic more than in the structural sense— has been the most pronounced economic objective of Southern European governments in the 1980s and 1990s (though pursued at a different timing and with varying degrees of commitment).

b) In state-driven economic policy and financial systems, Europeanization has been mainly pursued through extensive reliance on monetary austerity predicated upon financial liberalization, and through the transformation of the growth state into a stabilization state.

c) The main strategy employed for the transformation of a growth state into a stabilization state has been a strategy of surrendering government control over finance to the regulatory authorities of an increasingly autonomous central bank and to the allocative functions of a rapidly internationalizing market (cf. Pagoulatos, 1999b).

References

- Alesina A. and L.H. Summers (1993) "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence", *Journal of Money, Credit and Banking*, 25 (2): 151-62.
- Alvarez-Miranda B. (1996) "On the Edge of the Community: Southern European Political Debates on Membership", *South European Society & Politics*, 1 (2): 206-28.
- Amsden A. (1989) Asia's Next Giant: South Korea and Late Industrialization, New York: Oxford University Press.
- Amsden A. (1992) "A Theory of Government Intervention in Late Industrialization", in L. Putterman and D. Rueschemeyer (eds) *State and Market in Development. Synergy or Rivalry?,* Boulder: Lynne Rienner.
- Baklanoff E.N. (1978) *The Economic Transformation of Spain and Portugal*, New York: Praeger.
- Bangs R.B. (1968) *Financing Economic Development. Fiscal Policy for Emerging Countries*, Chicago: University of Chicago Press.
- Bermeo N. (1994) "Sacrifice, sequence and strength in successful dual transitions: lessons from Spain", *Journal of Politics*, 56 (3): 601-27.
- Bleaney M. (1996) "Central Bank Independence, Wage-Bargaining Structure, and Macroeconomic Performance in OECD Countries", *Oxford Economic Papers*, 48: 20-38.
- Boltho A. (1996) "Convergence, competitiveness and the exchange rate", in N. Crafts and G. Toniolo (eds) *Economic Growth in Europe Since 1945*, Cambridge: Cambridge UP.
- Branson W.H. (1990) "Financial market integration, macroeconomic policy and the EMS", in C. Bliss and J.Braga de Macedo (eds) *Unity with Diversity in the European Economy: The Community's Southern Frontier*, Cambridge: Cambridge University Press.
- Calder K. (1993) *Strategic Capitalism: Private Business and Public Purpose in Japanese Industrial Finance*, Princeton: Princeton University Press.
- Caprio G. and L. Summers (1993) "Finance and its Reform: Beyond Laissez-Faire", Washington DC: The World Bank, Policy Research Working Paper, WPS 1171.
- Caprio G., I. Atiyas, and J.A. Hanson (eds) (1994) *Financial Reform. Theory and Experience*, Cambridge: Cambridge University Press.
- Cassese S. (1984) "The Long Life of the Financial Institutions Set Up in the Thirties", *Journal of European Economic History*, 13 (2).
- César das Neves J.L. (1996) "Portuguese postwar growth: a global approach", in N. Crafts and G. Toniolo (eds) *Economic Growth in Europe Since 1945*, Cambridge: Cambridge UP.

- Cottani J. and D. Cavallo (1993) "Financial Reform and Liberalization", in R. Dornbusch (ed.) *Policymaking in the Open Economy*, New York: Oxford University Press and IBRD/ World Bank.
- Cukierman A. (1992) *Central Bank Strategy, Credibility, and Independence: Theory and Evidence*, Cambridge MA: MIT Press.
- Deeg R. and S. Pérez (1998) "International Capital Mobility and Domestic Institutions", paper at the Annual Meeting of the American Political Science Association (APSA), Boston MA, September 3-6.
- Dermine J. (ed.) (1993) *European Banking in the 1990s*, Oxford: Blackwell.
- Dyson K (1986) "The State, Banks and Industry: The West German Case", in A.Cox (ed.) *State, Finance and Industry*, Sussex: Harvester Wheatsheaf.
- Dyson K., K. Featherstone and G. Michalopoulos (1995) "Strapped to the mast: EC central bankers between global financial markets and regional integration", *Journal of European Public Policy*, 2 (3): 465-87.
- Eichengreen B. and J.A. Frieden (1994) "The Political Economy of European Monetary Unification: An Analytical Introduction", in Eichengreen and Frieden (eds) *The Political Economy of European Monetary Unification*, Boulder: Westview.
- Eichengreen B. and C. Wyplosz (1998) "Stability Pact: More than a minor nuisance?" *Economic Policy*, April: 65-113.
- European Commission (1988) "Programme for the liberalisation of capital movements in the Community: Communication from the Commission to the Council - May 1986", *European Economy*, 36, May.
- European Commission (1998) "Growth and employment in the stability-oriented framework of EMU", Commission communication to the Council, *European Economy*, 65: 163-210.
- Fair D.E. and C. de Boissieu (eds) (1990) *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer.
- Forsyth D.J. (1997) "A Sea Change in Economic Governance Across Europe, 1931-1948", in Forsyth and Notermans (eds) *Regime Changes*, Providence: Berghahn Books.
- Forsyth D.J. and T. Notermans (1997) "Macroeconomic Policy Regimes and Financial Regulation in Europe, 1931-1994", in Forsyth and Notermans (eds) *Regime Changes*, Providence: Berghahn Books.
- Fry M.J. (1988) *Money, Interest and Banking in Economic Development*, Baltimore: Johns Hopkins University Press.
- Furlong P. (1986) "State, Finance and Industry in Italy", in A. Cox (ed.) *State, Finance and Industry*, Brighton: Wheatsheaf.
- Gerschenkron A. (1966) *Economic Backwardness in Historical Perspective*, Cambridge Mass: Harvard University Press.
- Gibson H. and E. Tsakalotos (eds) (1992) *Economic Integration and Financial Liberalization: Prospects for Southern Europe*, London: St Antony's/ Macmillan.
- Goodhart C.A.E. (1995a) "Some Regulatory Concerns", LSE Financial Markets Group, Special Paper No. 79, December.
- Goodhart C. (1995b) *The Central Bank and the Financial System*, London: Macmillan.
- Goodman J.B. (1992) *Monetary Sovereignty: The Politics of Central Banking in Western Europe*, Ithaca NY: Cornell University Press.
- Goodman J.B. and L.W. Pauly (1993) "The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets", *World Politics*, 46(1): 50-82.
- Grilli V., D. Masciandaro and G. Tabellini (1991) "Political and monetary institutions and public financial policies in the industrial countries", *Economic Policy*, 6 (13): 342-92.
- Haggard S. (1990) *Pathways from the Periphery. The Politics of Growth in the Newly Industrializing Countries*, Ithaca: Cornell University Press.
- Haggard S. and C.H. Lee (eds) (1995) *Financial Systems and Economic Policy in Developing Countries*, Ithaca: Cornell University Press.
- Haggard S. and S. Maxfield (1993) "Political Explanations of Financial Policy in Developing Countries", in S. Haggard, C.H. Lee, and S. Maxfield (eds) *The Politics of Finance in Developing Countries*, Ithaca: Cornell University Press.
- Haggard S., C.H. Lee, and S. Maxfield (eds) (1993) *The Politics of Finance in Developing Countries*, Ithaca: Cornell University Press.
- Halikias D.J. (1978) *Money and Credit in a Developing Economy. The Greek Case*, New York: New York University Press.
- Helleiner E. (1994) *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s*, Ithaca: Cornell University Press.

- Herrick B. and C.P. Kindleberger (1983) *Economic Development*, New York: McGraw-Hill.
- IMF (International Monetary Fund) (1995) *The Adoption of Indirect Instruments of Monetary Policy*, IMF Occasional Paper 126, June.
- Institut d'Etudes Bancaires et Financières (1969) *Institutions et Méchanismes Bancaires dans les Pays de la Communauté Economique Européenne*, Paris: Dunod.
- Institut d'Etudes Bancaires et Financières (1970) *Systèmes Bancaires d'Europe Occidentale (hors C.E.E.)*, Paris: Dunod.
- Kindleberger C.P. (1993) *A Financial History of Western Europe*, New York: Oxford University Press.
- Kurzer P. (1993) *Business and Banking*, Ithaca: Cornell University Press.
- Lastra R.M. (1996), *Central Banking and Banking Regulation*, London: Financial Markets Group, LSE.
- Lemmen J. (1999) "Life Without the Stability Pact", Special Paper No. 109, LSE Financial Markets Group, January.
- Little I.M.D. (1982) *Economic Development. Theory, Policy and International Relations*, New York: Basic Books.
- Loriaux M. (1991) *France After Hegemony: International Change and Financial Reform*, Ithaca: Cornell University Press.
- Lukauskas A.J. (1997) *Regulating Finance. The Political Economy of Spanish Financial Policy from Franco to Democracy*, Ann Arbor: University of Michigan Press.
- Maravall J-M. (1993) "Politics and policy: economic reforms in Southern Europe", in L-C. Bresser Pereira, J-M. Maravall and A. Przeworski, *Economic Reforms in New Democracies*, Cambridge: Cambridge University Press.
- Marks M. (1997) *The Formation of European Policy in Post-Franco Spain*, Aldershot: Avebury.
- McKinnon R.I. (1973) *Money and Capital in Economic Development*, Washington DC: Brookings Institution.
- McNamara K.R. (1998) *The Currency of Ideas. Monetary Politics in the European Union*, Ithaca: Cornell University Press.
- Moran M. (1984a) *The Politics of Banking. The Strange Case of Competition and Credit Control*, London: Macmillan.
- Moran M. (1984b) "Politics, Banks and Markets: An Anglo-American Comparison", *Political Studies*, 32.
- OECD (1974) *OECD Economic Surveys: Spain*, Paris: OECD.
- OECD (1980) *OECD Economic Surveys: Portugal*, Paris: OECD.
- OECD (1981) *OECD Economic Surveys: Portugal*, Paris: OECD.
- Padoa-Schioppa T. (1994) "Adapting Central Banking to a Changing Environment", in T.J.T. Balino and C. Cottarelli (eds) *Frameworks for Monetary Stability: Policy Issues and Country Experiences*, Washington DC: IMF.
- Pagoulatos G. (1999a) "The Greek Banking System and its Deregulation: History, Structure and Organization in a European Context", in K.P. Kostis (ed.) *Modern Banking in the Balkans and West-European Capital in the Nineteenth and Twentieth Centuries*, Aldershot: Ashgate.
- Pagoulatos G. (1999b) "European Banking: Five Modes of Governance", *West European Politics*, 22/1, January: 68-94.
- Pagoulatos G. (forthcoming 1999c) "The Liberalization of Southern European Financial Systems", in K.Lavdas (ed.) *Junctures of Stateness: Political Boundaries and Policy Change in Southern Europe*, Aldershot: Ashgate.
- Pagoulatos G. and V. Wright (forthcoming 1999) "The Politics of Industrial Privatization: Spain, Portugal and Greece in a European Perspective", *Rivista Trimestrale di Diritto Pubblico*.
- Pauly L.W. (1997) *Who Elected the Bankers?* Ithaca: Cornell University Press.
- Peltzman S. (1989) "The Economic Theory of Regulation after a Decade of Deregulation", *Brookings Papers on Economic Activity*: 1-41.
- Pérez S.A. (1997) *Banking on Privilege. The Politics of Spanish Financial Reform*, Ithaca: Cornell University Press.
- Pérez S.A. (1997b) "'Strong States and 'Cheap' Credit: Economic Policy Strategy and Financial Regulation in France and Spain", in D.J. Forsyth and T. Notermans (eds) *Regime Changes*, Providence: Berghahn Books.
- Prados de la Escosura L. and J.C. Sanz (1996) "Growth and macroeconomic performance in Spain, 1939-93", in N. Crafts and G. Toniolo (eds) *Economic Growth in Europe Since 1945*, Cambridge: Cambridge University Press.
- Shaw E.S. (1973) *Financial Deepening in Economic Development*, New York: Oxford UP.

- Shonfield A. (1965) *Modern Capitalism. The Changing Balance of Public and Private Power*, London: Oxford UP.
- Stigler G. (1971) "The Theory of Economic Regulation", *Bell Journal of Economics and Management Science*, 2 (1): 3-21.
- Stiglitz J. (1996) *Whither Socialism?* Cambridge MA: MIT Press.
- Stiglitz J.E. and A. Weiss (1981) "Credit Rationing in Markets with Imperfect Information", *American Economic Review*, 71: 393-410.
- Story J. and I. Walter (1997) *Political Economy of Financial Integration in Europe*, Manchester: Manchester UP.
- Tsoukalis L. (1997) *The New European Economy Revisited*, Oxford: Oxford University Press.
- Wilson J.S.G. (1986) *Banking Policy and Structure*, New York: New York University Press.
- Woo-Cumings (1997) "Slouching toward the Market: The Politics of Financial Liberalization in South Korea", in M. Loriaux et al. *Capital Ungoverned. Liberalizing Finance in Interventionist States*, Ithaca: Cornell University Press.
- Woolley J.T. (1984) *Monetary Politics: The Federal Reserve and the Politics of Monetary Policy*, Cambridge: Cambridge University Press.
- World Bank (1989) *World Development Report 1989: Financial Systems and Development*, New York: Oxford University Press.
- Zolotas X. (1962) *The Role of the Banks in a Developing Country*, Athens: Bank of Greece.
- Zolotas X. (1965) *Monetary Equilibrium and Economic Development*, Princeton: Princeton UP.
- Zysman J. (1983) *Governments, Markets and Growth*, New York: Cornell University Press.

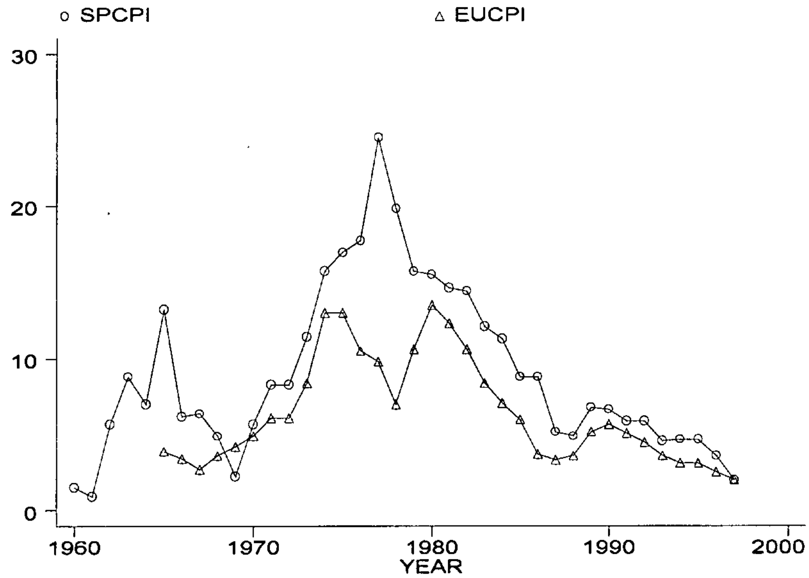
Appendix 1: Financial restriction or repression or financial *dirigisme*

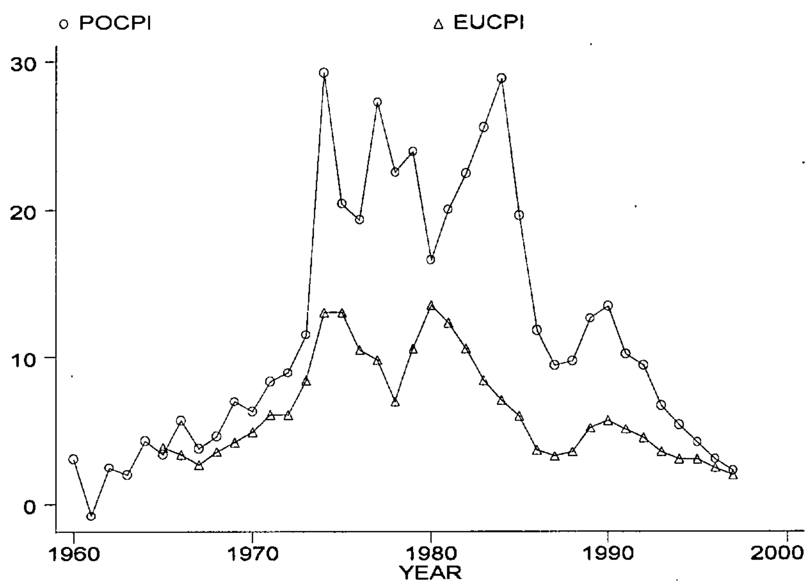
- State control over ownership or management of commercial banks
- State-imposed institutional specialization of banking institutions
- Administered interest rates (ie, specifically fixed per economic category or sector) and interest rate ceilings
- Quantitative credit controls and credit quotas
- Investment ratios and special reserve requirements for public debt financing
- International capital and foreign exchange controls
- Bank-based financial system and weakness of capital market

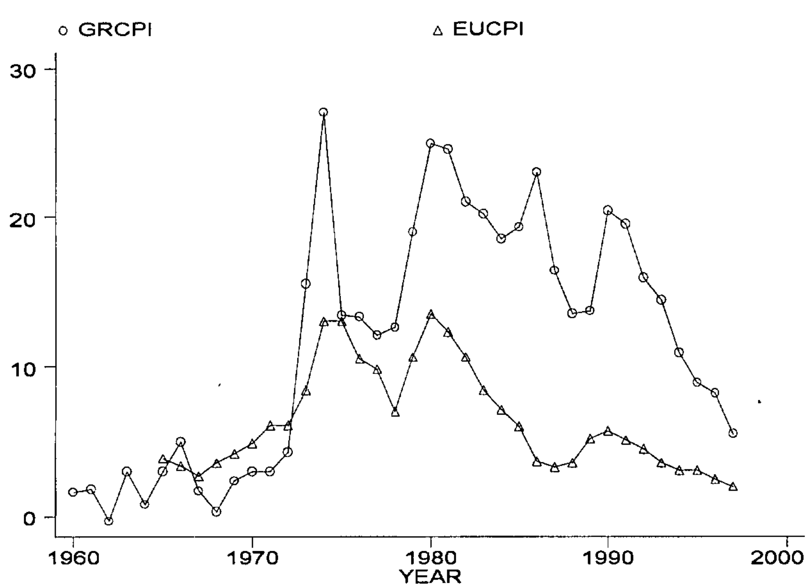
Appendix 2: Financial Deregulation or Liberalization

- Deregulation of interest rates, lifting of credit ceilings, abolition of credit controls and regulatory restrictions
- Despecialization, ie allowance of specialized credit institutions (such as agricultural banks or development banks) to operate as «universal» commercial banks
- Opening of the national financial market to foreign competition
- Abolition of capital and foreign exchange controls
- Disintermediation through the growth of public debt markets, development of capital and money market, erosion of banks' position as intermediaries in the financial market
- Creation of new instruments and markets for corporate and public finance

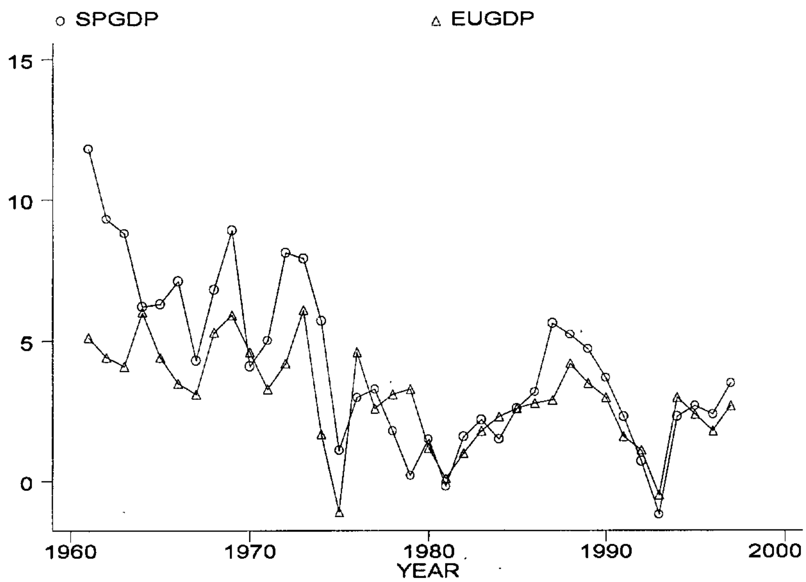
Inflation CPI: SP-PO-GR and EU

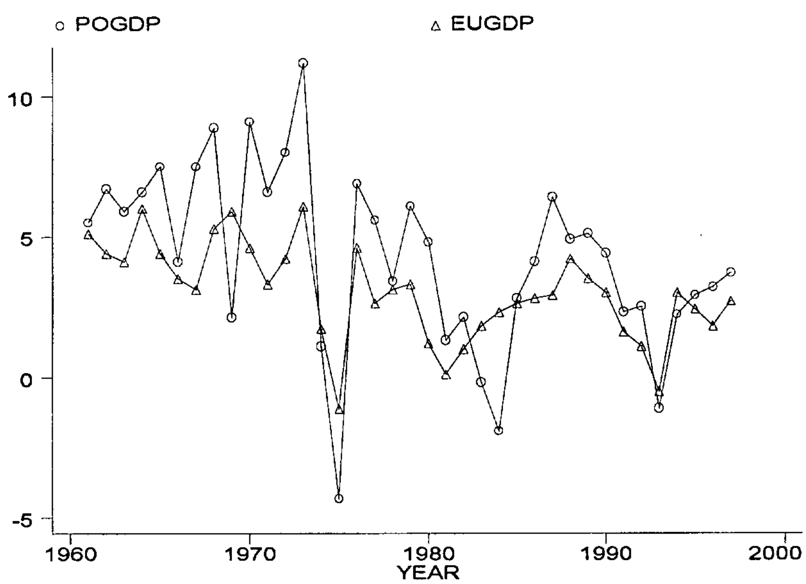


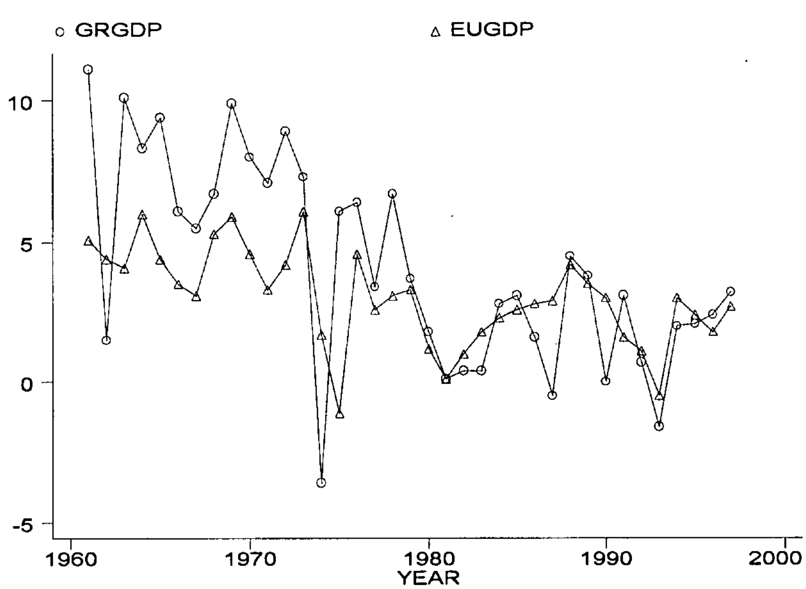




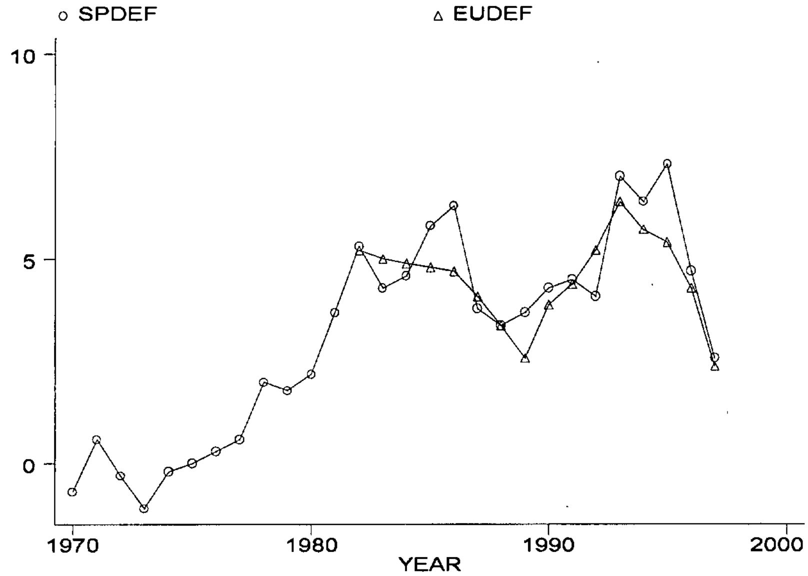
Real GDP Growth: SP-PO-GR and EU

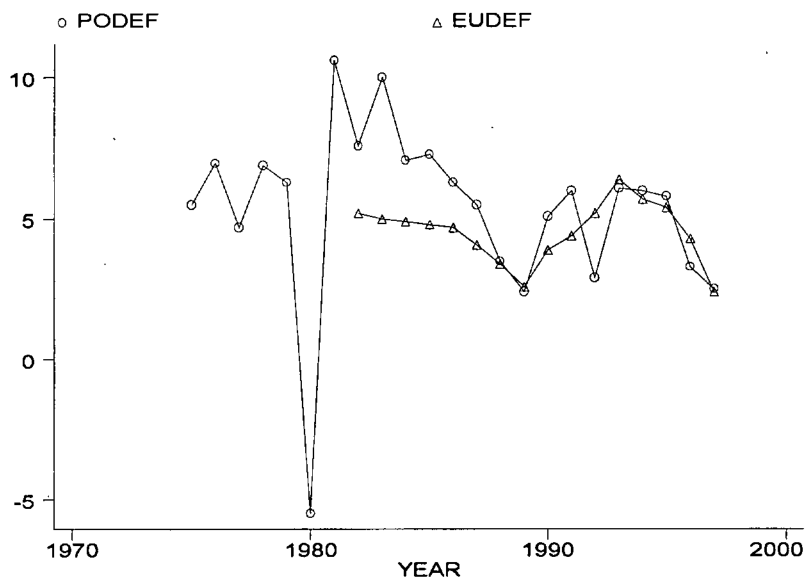


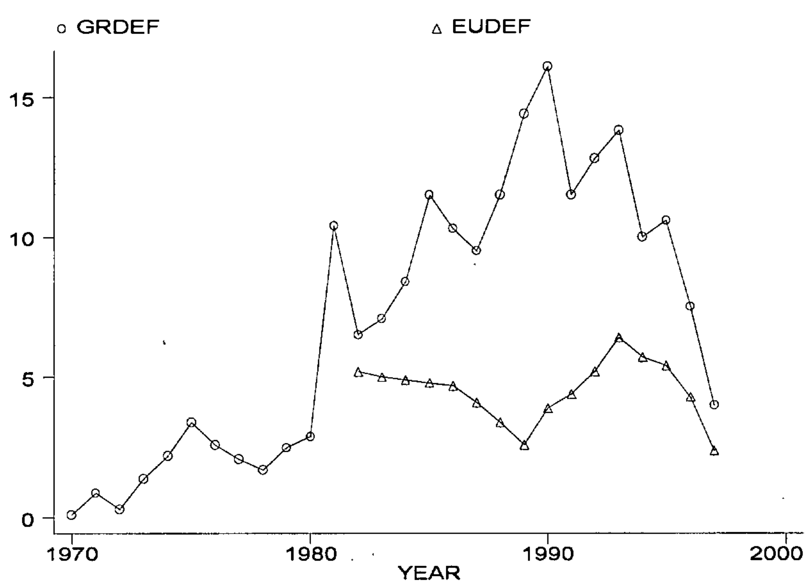




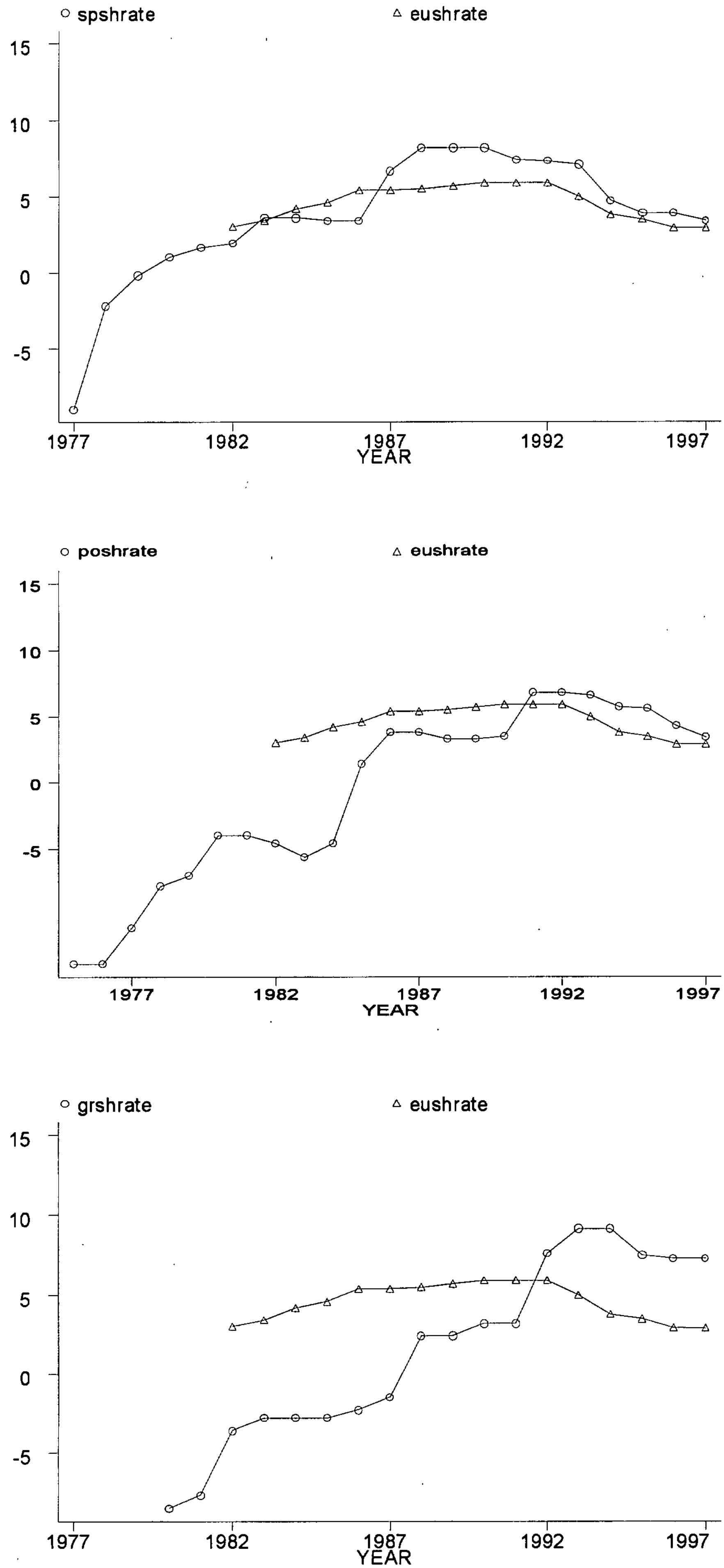
Government Deficit (%GDP): SP-PO-GR and EU



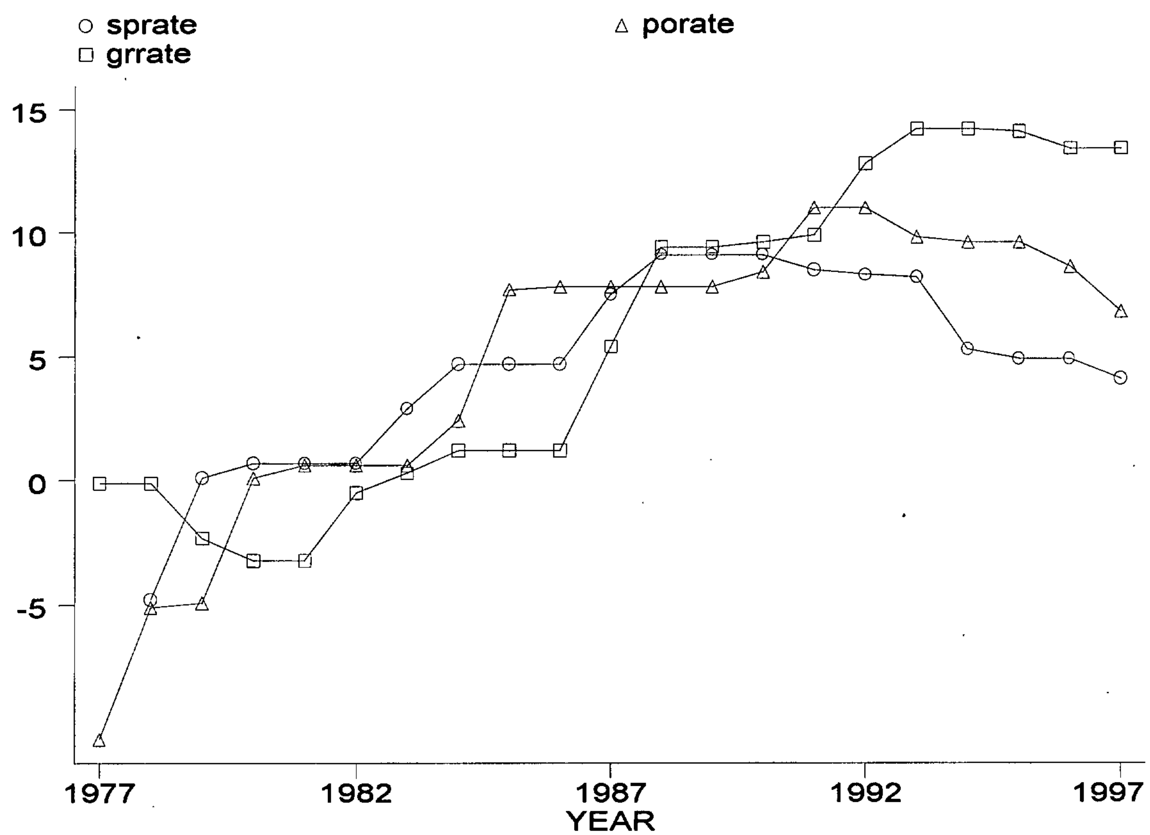




Real Short-term Interest Rate (SP-PO-GR-EU)



Spain, Portugal, Greece: Real Lending Rate



Source: IMF *International Financial Statistics*