State based financial liberalization

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Entitled
State Based Financial Liberalization

For the degree of Doctor of Philosophy

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Head of the Departmental Graduate Program Date
STATE BASED FINANCIAL LIBERALIZATION

A Dissertation
Submitted to the Faculty
of
Purdue University
by
Robert J. Kulzick

In Partial Fulfillment of the
Requirements for the Degree
of
Doctor of Philosophy

August 2016
Purdue University
West Lafayette, Indiana
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ABSTRACT


In the last 40 years, states around the globe have increased the role of markets in their financial systems. Using newly collected information on the educational backgrounds of Central Bankers, I demonstrate that the beliefs of state officials about the proper role of markets in the financial system influence the extent to which state’s liberalize their financial systems. By tracing the liberalization experiences in both France and China through secondary sources, I show that bureaucrats within the state suggest reforms that conform to their neoliberal training when political leaders turn to them for solutions to what are perceived as technical problems.
1. INTRODUCTION

The developed world has seen significant debate in the last decade over the proper role of finance in their economies. Prominent political figures in the United States and elsewhere have demanded the reduction of the financial and political power of major banks. Unchecked financial innovation has been placed at the central of catastrophic economic collapses in countries around the world. Despite all of this debate and discussion, what has remained unchallenged is the role of markets in the operation of the world’s financial systems. The debate has centered around how to regulate these markets, not in how to abolish them and replace them with state controls. Even as market actors have been bailed out by the state and briefly nationalized, the fundamental belief that markets should determine the price of capital has remained unchallenged. The dominance of the market approach to finance in the developed world and increasingly in the developing world is a significant change from how finance operated in the immediate aftermath of the Second World War. The Bretton Woods system prioritized state control over economic outcomes more than capital mobility and viewed financial markets as potentially unstable creatures who must be strictly controlled. That attitudes have shifted so dramatically and remained dominant even in the face of such dramatic upheaval is only the beginning of the larger puzzle that the process of financial liberalization represents.

Unlike other areas of economic policymaking financial policy has had an attenuated relationship with politics. Trade politics is a frequent target of political mobilization with both political and economic forces forming alliances and taking sides around how open to trade the country will be. Most states have histories of contentious trade politics stretching back to their founding. Fiscal policy is another area of economic policymaking which has attracted political forces and contestation. Austerity, taxation, and debt are all issues that political forces mobilize around. Finance, however,
tends to only receive attention in isolated spurts in comparison to these other areas. There are famous instances of mobilization around financial politics (Williams Jennings Bryan’s “Cross of Gold” speech or calls for the nationalization of banks during the global financial crisis), however the politics of finance tends to focus on issues of regulation rather than the larger structure of financial systems. William Jennings Bryan’s presidential campaign was directed at fundamentally changing the nature of the United States’ monetary policy from the fixed exchange rate of the Gold Standard to the shifting exchange rate that adopting the Silver standard would have caused. In comparison, suggestions for a tax on financial transactions or the enforcement of insider trading restrictions represent minor shifts in regulation rather than wholesale reforms. Even when financial considerations enter the political stage, they tend not to have a prominent place. Given the magnitude of the effects that the way in which finance is organized have on the operation of key functions of the state and the economic outcomes that affect the daily lives of citizens this distance raises interesting questions. What has caused the worldwide shift in the way finance operates? Are the same forces responsible for financial politics in different countries?

One of the most commonly applied paradigms in the study of economic policymaking is what Lake (2009) calls Open Economy Politics. This paradigm emphasizes the role of interest groups in determining economic policy. While not always as directly stated as in Grossman and Helpman (1994), the basic conception of political-economy as the result of market competition in which economic strength plays an important role in determining outcomes is implicit in research that adopts this paradigm. This approach also adopts the economic/game theoretic concept of equilibrium to the political sphere. While policymaking may be somewhat variable in the short-term, ultimately an approach which emphasizes the role of underlying interests finds major policy outcomes to be a stable reflection of these interests. As long as the fundamental conditions are unchanged, interests with the strength to determine economic policy are able to maintain their preferred outcomes. From this point of view, therefore, changes in economic policies must be the result of a shock from outside the system,
since interests would otherwise maintain the policy status quo that they previously selected (Krueger 1993; Williamson 1994).

The interest based paradigm or what I shall refer to as the interest based approach to financial liberalization argues that changes in financial policy are the result of demands from newly powerful economic interests, either directly or through their elevation of political actors that represent these interests (Frieden 1991, 2014; Drazen and Easterly 2001; Haggard and Maxfield 1996; Abiad and Mody 2005; Drazen and Grilli 1993; Bartolini and Drazen 1997). My alternative approach which I refer to as state-based financial liberalization stems from my observation that the reform process is nowhere near as conflictual as an interest based approach would suggest. It also emphasize the importance of ideas rather than interests in structuring economic reforms. Theoretically, I am led to constructivism by what Abdelal et al. (2015) refers to as the “path of uncertainty”. The idea that actors “have a hard job living in such a random world, and thus construct stability through the development and deployment of governing ideas, institutions, norms, and conventions” (Abdelal et al. 2015, 12).

Beyond the question of uncertainty, I also think that interest based approaches are too quick to assign interests preferences to particular policy arrangements. One of the pillars of game theory is that actors have preferences over outcomes and not strategies and I argue that scholars who are concerned with policy outcomes have shifted their concerns on economic actors who are more concerned with profits, wages, employment security, market share, etc. Finally, economists tend to view the operation of market economies as a smoothly purring engine which only needs to be taken into the shop when external conditions like technological developments change. I argue that in actuality market economies are far more finicky and develop their own internal contradictions that require more frequent tune-ups and adjustment.

While this theoretical framework is less directly stated in studies that emphasize the role of interest groups in determining the historical development of economic policy, the tracking of shifts in policy to shifts in economic conditions makes the same implicit argument. Alt et al. (1996) is a good example of research which assumes a political-economic equilibrium without making it a central feature.
Briefly stated, the state based approach to financial liberalization argues that politicians are primarily concerned with staying in power, economic interests are interested in profits and that this leaves the bureaucrats responsible for running the financial system as the actors primarily concerned with the form that financial policymaking takes. While bureaucrats may be the only actors with preferences about how the financial system operates, in normal times they lack the power to make these changes. The preferences of bureaucrats over the operation of the financial system are only expressed when political actors view them as furthering their interests. I argue that this will occur during periods of economic adjustment and that therefore financial reform will occur in partial halting steps as a response to specific economic problems and disequilibriums. Because the development of academic economics over the last forty years has privileged neoliberal pro-market solutions, the preferences of economic bureaucrats in this period has been for greater liberalization. While I argue that bureaucrats are motivated by what they view as the appropriate way to manage the economy, this does not discount self-interest as a motivator. As the masters of the economic theories motivating these reforms, bureaucrats elevate themselves when they are able to convince political actors to adopt them.

In my theory of financial reform, economic interests are primarily present as impediments. The economic implications of financial reforms are complex and difficult to predict which makes them unlikely targets for committed interest group lobbying. I view economic interests as maximizing their benefits within existing institutional frameworks and only opposing reforms under conditions where they are organized and informed enough to mobilize and reforms are inextricably linked to a reduction in their benefits. The flexibility of financial arrangements means that these conditions should rarely be met. Because politicians are not committed to reforms in and of themselves they will be willing to make adjustments and accommodations to these reforms to compensate potential losers who are able to anticipate the danger they face. Other interests will take time to discover the negative implications of financial reforms and will focus more on attempts to acquire accommodations of their own
than on the uncertain prospect of reversing reforms. In comparison to the conflictual model of policymaking envisaged by interest based approaches to financial liberalization, I argue that financial reforms will be surrounded by side payments and quiescent interests.

In this chapter I will discuss two families of existing theories of financial liberalization: the interest group theory and the policy diffusion theory. As part of this discussion I will identify what I see as some theoretical limitations of these approaches and then suggest how these limitations can be remedied by adopting the theoretical framework that I develop: a state based theory of financial liberalization. State based financial liberalization argues that uncertainty and information processing difficulties make financial reforms unattractive as targets for interest group lobbying. Additionally, for those interests sophisticated enough to mobilize around issues of financial reform the ability to provide compensation while maintaining reforms reduces the strength of their opposition. I view neoliberal ideas contained within bureaucratic agencies as the more likely source of liberalization. These reforms are motivated by demands from political leaders interested in maintaining the smooth functioning of the financial system. The final section of this paper puts both interest group and state based financial liberalization to the empirical test using a dataset that I have collected that identifies the presence of neoliberal ideas within a state’s economic bureaucracy.

One of the most commonly identified sources for economic policy change in both the political science and economics literature are organized interests external to the state. This applies not only to financial policy, but also to trade, labor, and other economic policy areas (Hall and Soskice 2001). Interest based explanations of economic policy change view economic policy as changing only when conditions have altered the relative power of domestic interest groups. As various interests grow or decline in strength, their ability to pressure the state to enact policies that favor them shifts in a

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2 Lake (2009, 224–226) describes how what he calls Open Economy Politics was developed in the context of trade policy, applied to a wide variety of economic policy areas, and then became the dominant paradigm in the study of International Political Economy.
corresponding fashion. Therefore an econometric examination of economic indicators and policy outcomes will detect a relationship between changes in the economy and changes in policy.

In the study of International Political Economy, this research paradigm has been most successful in the study of trade policy. The successful application of interest based explanations to trade policy has inspired scholars to adapt similar approaches to finance.\(^3\) In both trade and finance, addendums to basic approaches have focused on attempting include more economic sophistication in the identification of economic indicators.\(^4\) The reason for the inclusion of these factors is that they more closely align economic interests to specific policies.

Economic interests have preferences over outcomes, such as employment for union members or profits for individual firms or sectors, rather than specific policy positions.\(^5\) However, most interest group based approaches to economic policy change consider trade policy, for example, in isolation from exchange rate policy even though as Frieden (2014) points out they are substitutes for each other. The isolation of particular policy dimensions is a common feature of attempts to identify determinants of financial policy change. Exchange rate regimes are typically considered in isolation from capital account openness, or any of the other dimensions of financial policymaking.\(^6\) This is particularly problematic because the different dimensions of financial policy alter the outcome of reforms in individual dimensions.\(^7\)

\(^3\)Frieden (1991) is a classic example of this adaptation, which divides its predictions between developed and developing nations. Frieden (1991) identifies managers of financial assets and multinational corporations based in developed countries as supporting liberalization and being opposed by stakeholders in home nation focused industries. In developing nations, Frieden (1991) argues that national industries will support liberalization, while financial asset holders will oppose it.

\(^4\)For example, the inclusion of factor specificity in trade models (Hiscox 2002) or considering how the ability of businesses to pass on exchange rate changes to their customers influences exchange rate regime preferences (Frieden 2014).

\(^5\)Brooks and Kurtz (2007, 704) point out that concerns over the distributive outcomes of policymaking are only relevant to the extent that they are predictable and identify the regulation of international capital as being an area of policy whose consequences are difficult to anticipate.

\(^6\)Bernhard et al. (2002), in an important exception to this tendency towards the isolation of policy dimensions, examine exchange-rate regime and Central Bank Independence jointly.

\(^7\)The most basic example of this is the standard Mundell-Fleming trilemma, which dictates how monetary policy autonomy, capital account openness, and exchange rate regimes interact (Mundell
The decision to limit most considerations of economic policy change to individual policies or policy dimensions reflects more than a necessary scientific simplification to render a complex world amenable to analysis. Limiting analysis to individual policies and dimensions is a tacit acknowledgment of the difficulty facing economic interests attempting to purchase within what Grossman and Helpman (1994) memorably discussed as a market for protection. This is a market singularly lacking in the most important source of information for any market; prices. How are economic interests to evaluate the relative benefit to themselves of any particular alteration of economic policymaking?

Frieden (2014) paints a vivid account of mass mobilization around monetary policy issues in the United States of the 19th century. The unique features of this mobilization help to demonstrate the limitations of the interest group approach to economic policy change. Frieden identifies the financial sector as the major supporter of the 19th century gold standard in the United States. According to Frieden this support was the result of the belief that the gold standard kept the cost of foreign capital low for American financial intermediaries. The primary opponents of the gold standard were farmers whose produce was being undercut by foreign producers whose lower exchange rates made their goods cheaper. The alternatives to the gold standard status quo were either the floating exchange rates of paper money that the country had experienced during the Civil War suspension of the gold standard or the use of silver backed money which matched the monetary policy of major developing world competitors (India, Australia, etc.). The debate over monetary policy was given special relevance by the Great Deflation period (1870-1900) when economic growth and productivity increases raised the demand for money far faster than gold discoveries could satisfy. This decline in prices created the ‘cross of gold’ to which William Jennings Bryan referred. Frieden (2014) notes the ability of farmers to identify their economic interest in lower exchange rates which would increase demand for agricultural exports. What he fails to consider are the unique set of conditions that helped to make this possible.

1963). Research has shown that the presence of particular policies in one dimension of financial policy influences what policy will be chosen in other dimensions (Leblang 1997; Garrett 2000).
The sharpness of the economic downturn caused by adherence to the gold standard, the direct experience with lower exchange rates under the civil war greenback regime and the contrasting example of foreign silver-backed currencies, and the similarity of economic activities and regionally unified nature of the farmers during this period all served to push monetary policy from the corridors of elite discourse into the center of mass political mobilization. Even though this was the case, farming interests remained indifferent to the specific mechanism through which the exchange rate was reduced and ultimately only latched onto silver as a means to ally with powerful western mining interests. As these conditions receded in the Twentieth Century, monetary policy lost its place of prominence and President Roosevelt’s eventual suspension of the gold standard took place as part of a technical solution to issues of bank liquidity and not as the result of mass mobilization (Eichengreen 2014). In general, economic interests have beliefs about the effects of the outcomes of economic policies (inflation, exchange rate level, exchange rate volatility, etc.) on their businesses. However, only in extreme cases will specific policy arrangements come to be tied closely to these outcomes and therefore become targets for lobbying by these interests.

As mentioned earlier, an important contribution of Frieden (2014) is the identification of tariffs as a substitute for a reduced exchange rate. The availability of multiple dimensions of economic policymaking also allows for accommodations to be made in cases where economic interests are mobilized around particular areas of economic policymaking. One group of economic interests which are particularly attuned to changes in financial policymaking are financial intermediaries. These entities are crucial for the functioning of the financial system and their expertise and position as central clearinghouses for financial transactions makes them likely to identify potential harmful consequences of policy changes. This does not necessarily mean that intermediaries will be implacable enemies of financial reforms. Perez (1997) demonstrates this in her discussion of the process by which Spain liberalized foreign competition in their banking sector as part of their accession to the European Community.
As Perez describes, Spain negotiated a 7 year delay in the implementation of liberalizing reforms during which they helped to foster mergers among the major Spanish banks that helped to make competing with them unprofitable for foreign entrants into Spain’s domestic credit markets. Ultimately it was losing market share and profits to foreign banks that Spanish banks opposed and this was avoided despite the imposition of a liberalizing reform that an interest based approach would expect to have been anathema. Another potential interest based approach to this process of policy change would have been to attempt to identify a decline in the political clout of the Spanish banking sector as an explanation for why this plainly detrimental reform was adopted. However, as Perez points out despite these reforms, “Spanish banks as a group continued to lead European banks in profitability in 1991, 1992, and 1993” (Perez 1997, 166). It is profits, rather than any particular policy arrangement over which economic interests have preferences and this makes attempts to derive preferences about policies highly challenging. In finance in particular, there are numerous ways in which reforms can be adjusted to accommodate those few interests who can make strong predictions about how reforms will affect them.

The fundamental insight of interest based theories of economic policy change is essentially tautological. Interest groups by definition act in their interest and powerful interest groups get their way or they are not really powerful. Finance, however, creates such a complex set of linkages between actors, political institutions, and policies that attempting to identify all of the factors that might influence how a financial reform will affect the economic fortunes of various interests within society is no less a challenge for researchers than it is for those interests themselves. Because interest group based approaches to economic policy change assume a conflictual model of policymaking, any policy changes that occur reflect losses to existing interests. While this may be the case in instances in some areas of economic policymaking, this assumption ignores the possibility that the losers of policy change have failed to identify how policy change will effect them or that apparent losers have been compensated. As discussed earlier,
the complexity of financial policymaking makes these other two possibilities much more likely.

The traditional association between economic policy change and loss of political power has made economic crises a prime target for explanations of economic policy change. The expectation is that economic crises upend the political status quo of the various economic interests within the state and therefore allow for policy changes which would have previously been blocked. When it comes to financial reform this research program has had a very mixed track record and despite some intermediate findings that suggested a link between crises and financial reform (particularly capital account opening)\textsuperscript{8} the ultimate conclusion in the literature is that those results reflect measurement errors and the inversion of causality (Pepinsky 2012). Given the centrality of crises to the theoretical arguments behind interest based approaches to economic policy change this absence is puzzling and suggests that financial policy is not locked in by the political system or that crises are so disequiliberating that they cause retrenchment or maintenance of the status quo rather than reform.

Economic crises are significant because without this disequiliberating force powerful economic interests might be able to maintain the policies that benefit them regardless of who is in power. However, there is a branch within the interest based reform literature that sees transfers in political power as reflecting shifts in the strength of underlying economic interests. These authors typically identify parties as either left or right parties and argue that right parties represent the interests of capital and left parties represent the interests of labor (Abiad and Mody 2005; Bartolini and Drazen 1997). Therefore, this literature suggests that right parties will support liberalizing reforms and left parties will oppose them. Bartolini and Drazen (1997) complicate this dichotomy by considering the possibility that left governments may be motivated to signal reliability by adopting reforms in return for access to foreign capital. Findings on the role of changes in the party in power have been as conflicted as findings on economic crises, the types of financial reforms that are considered influence the

\textsuperscript{8}Haggard (2000); Haggard and Maxfield (1996); Drazen and Easterly (2001); Drazen and Grilli (1993); Rodrik (1996); Abiad and Mody (2005)
outcome as the mechanism identified by Bartolini and Drazen (1997) does not apply to all reforms equally. However, the relationship between financial reform and transitions in political power where it has been found has been limited and in several cases conflicting results have been found (Quinn 1997; Eichengreen 2001; Oatley 1999; Franzese Jr 2002; Clark 2009).

Direct indicators of interest group strength are frequently used in interest group based approaches to financial policy reform. Just as interest group based approaches to trade policy use measures of industry size and capital or labor abundance depending on their economic model (Hecksher-Ohlin or Ricardo-Viner) as a proxy for interest group strength, interest based approaches to financial reform use measures of the internationalization of the economy and the US interest rate to measure the strength of pro-liberalization interests (Abiad and Mody 2005). The degree to which a states’ economy is involved in international trade influences the desirability of financial liberalization because states that are more integrated into the global economy will have the large firms with global supply chains that will benefit from access to international capital and more efficient allocation of capital (Brune and Guisinger 2003; Hodler 2007; Rajan and Zingales 2003). The central place of the United States in the global financial system makes the its interest rate an indicator of the global availability of capital (Krueger 1993). When the United State’s interest rate is higher it attracts more capital which reduces the availability of capital to other countries. When capital is more available, the benefits to states of liberalizing their financial systems are increased. These two indicators (trade openness and the U.S. interest rate) are the major way in which cross-national variation in the strength of pro and anti-reform interest groups are identified. Interest group based approaches to financial reform argue that reforms should occur when these factors indicate that pro-reform interests are strong.

The final type of interest based approach to financial reform turns away from domestic interests and identifies international interests as the source of financial reform.

\[\text{Büthe and Milner (2008) find that membership in free trade agreements increases the ability of developing states to attract foreign direct investment beyond the direct effect of increased trade.}\]
The specific sets of international interests identified as pushing for financial reform vary, however international governmental organizations which are focused on economic issues particularly the International Monetary Fund and the World Bank are often singled out as advocating economic reforms including financial reform (Chwieroth 2009; Stiglitz 2000). International interests are able to directly influence the reform process when states find themselves in need of international aid, whether in the form of grants or concessionary loans (Joyce and Noy 2008; Henisz et al. 2005; Wade 2000). Whether acting through international governmental organizations or through direct government to government loans, the international interest group approach to financial reform argues that reform is conditioned explicitly or implicitly on the enactment of reforms. A less sinister version of this theoretical approach is adopted by Mukherjee and Singer (2010) who suggest that aid is related to the enactment of reforms because IMF loans allow governments to compensate losers from liberalizing reforms and crises that necessitate loans weaken domestic forces that would be able to successfully oppose reforms under normal conditions. Whether seen as a source of weakness to be exploited by external interests or a source of opportunity that allows otherwise impossible reforms to be adopted, international aid is often seen as a trigger for financial reforms. Policy matching theories of policy diffusion argue that the appeal of liberalizing reforms depend on the number of other states and neighboring states in particular that have adopted reforms. The increasing liberalization of neighboring states increases the pool of capital that becomes available when any individual state liberalizes their reforms. The increasing efficiency and effectiveness of neighboring financial systems also has the potential to diminish the relative competitiveness of the economies of states that fail to liberalize. Between the sticks and carrots that the reforms of their neighbors generate, states are driven to match their policies to those of their neighbors and this results in the observed pattern of diffusion. A related structural argument identifies technological changes which have increased the desirability of international credit flows as the motivating factor for financial liberalization. Improvements in the information processing capacity of international capital markets
has increased the benefits that liberalization can make available to more peripheral economies and is therefore responsible for the increasing liberalization that has been observed over the last several decades. In this view of policy diffusion the same technological factors that have led to the massive increases in trade and communication associated with the second wave of globalization are the root cause of the spread of financial liberalization.

An entirely separate approach to explaining financial reforms begins from the empirical observation that reforms have become increasingly prevalent internationally over the last forty years. This literature examines whether reforms have been adopted as part of a policy diffusion process (Simmons and Elkins 2004). The diffusion approach identifies several separate potential causal mechanisms through which diffusion could operate. One potential source for diffusion are the neoliberal economic theories that have been developed by academic and professional economists since the 1970s (Harvey 2005). As these ideas have spread from state to state they were adopted over time and this explains how the policy diffusion pattern developed. The policy learning theory of diffusion argues that diffusion depends on the examples of neighboring states. As states adopt policy reforms and are successful, they demonstrate to their neighbors that reforms are practically applicable to their particular set of pre-existing conditions.

In contrast to the interest based approaches to liberalization the policy diffusion literature deemphasizes the politics of financial liberalization. Independent of the diffusion mechanism the changes they motivate reflect fundamental factors that subsume political considerations. Either because of changes in perceptions or changes in economic conditions the advantages available through liberalization overwhelm the potential for distributional conflicts over policymaking. Therefore the puzzle of how reforms come to supplant the political forces that created the current policies is absent from policy diffusion approaches.

An advantage of the policy diffusion approach is that it argues that across the globe policymaking environments have fundamentally shifted to support liberaliza-
tion, which fits the empirical trend of greater financial liberalization more convincingly than the interest based approach which has no explanation for why reforms over the last forty years have consistently favored liberalization. If interest groups are contesting policymaking then absent some fundamental change in the worldwide balance of power between pro and anti-liberalization interests, policy retrenchment should be present to the same extent as liberalization. The less contested view of policymaking developed by policy diffusion theorists may fit the recent record of liberalization more closely than the interest group approach. However, it fails to give more than a cursory explanation for the quiescence of interest groups that are harmed by financial liberalization.
2. THEORY

At its heart finance is the selling of promises outside of the constraints of hierarchy; in the market. What is promised determines what name is given to a particular financial instrument. If money is promised, then it is called a bond. If a product is promised, then it is called a futures contract. If ownership is promised, then it is called stock. Money of course is a promise from the state that they will accept pieces of colored paper in payment for taxes (Desan 2014). There is even an entire class of financial instruments which are promises about promises, these are called derivatives. So if you purchase a stock option, then you have purchased the promise that you may in the future purchase stock (a promise of ownership and fiduciary responsibility) at a given price. The special features of finance all derive from the role non-hierarchically constrained promises.

By far the most important feature of finance is its ability to create something from nothing. A promise after all requires nothing more than to be uttered to be created. If you want to sell a car, a house, or any other real good, then you need to go to all of the trouble of creating them first. With financial instruments this difficulty is dramatically reduced. Though there is the necessity of drafting documents and perhaps hiring some lawyers, this process is far less materially constrained. The fact that in 2011 the total dollar value of stocks, bonds, and bank assets was 366% of the dollar value of global GDP demonstrates how this difference between the real economy and finance plays out in the actual economy (Taylor 2013).

To further illustrate how finance differs from the real economy, consider the difference between selling a futures contract on a gallon of gasoline and selling an actual gallon of gasoline. When selling a futures contract you are paid immediately and then must secure a gallon of gasoline in whatever manner is most convenient. Only when the contract you have sold matures are you required to have a gallon of gasoline
available. When selling an actual gallon of gasoline, you must first pay to acquire the gasoline and then pay to store it and you are only paid after you find a buyer.

There are important physical limitations on the sale of actual gasoline that are not present for the seller of the futures contract. Additionally, you must have all of the necessary funds in advance to participate in the real economy. Because you pay immediately for the contract and only receive the gasoline in the future, you have essentially transferred funds from that future date into the past by using a financial rather than a real economy transaction. The ability of finance to transfer funds from the future into the past is yet another useful feature. One final advantage of the futures contract over a sale in the real economy is that it can be flexible to the requirements of the buyer. If that gallon of gasoline is really only needed in two weeks, then that date can be specified for the maturity of the contract. This saves the buyer the cost of storing gasoline that they do not yet need. Selling gasoline in the real economy means that the transaction must occur at that moment without the flexibility to alter the transaction even if it might be a change that would benefit both buyer and seller.

The two transactions under discussion are identical, money traded for a gallon of gasoline. Simply reversing the order of the transaction has enormous benefits. There is one important limitation introduced by this inversion, sale of a promise requires that a buyer be found who will trust that promise. For all the advantages of the financial transaction over the transaction in the real economy, a transaction in the real economy has the significant benefit that the buyer in the real economy actually has a gallon of gasoline at the moment that the transaction is complete. The purchaser of the futures contract will only know on the date of its maturity if their purchase has been successful. Because of this additional complication finance is even more dependent on the enforcement power of the state than the real economy.

The importance of law to the development of finance has recently returned to center stage in the study of financial development (Pistor 2013). There have been many attempts to argue that non-state based enforcement mechanisms could be sufficient
reassure the purchasers of financial instruments, however the reputational and other mechanisms that have been suggested can only operate in an environment where governments are providing the necessary backstops (Milgrom et al. 1990). New types of financial instruments become popular and accepted once the legal system has been altered so as to provide buyers with an ultimate enforcement mechanism. Stripped of these legal protections, finance cannot operate. A fact that the state makes use of when they seek to eliminate certain types of financial transactions.\footnote{Governments have periodically banned short selling of various types. Since short selling could still be accomplished by private arrangements, with one party lending a stock to the other for a nominal fee with the agreement to return it, the state’s ability to eliminate this common form of financial transaction by withdrawing its imprimatur is emblematic of its central role in enabling financial instruments and transactions (Beber and Pagano 2013).}

Another important protection for the purchasers and sellers of financial instruments is the existence of a robust secondary market. Returning to the example of a gasoline futures contract, the primary market in gasoline futures includes those who create the futures contracts and those who purchase them with the intent of receiving gasoline at the agreed upon date. The secondary market for gasoline futures includes all those who might buy and sell such contracts without originating them or intending to use gasoline. The existence of a secondary market ensures that originators and end-users are not stuck with their purchases. Originators who have difficulty fulfilling their contracts can simply purchase a contract from a different originator and thereby fulfill the contract that they created. End-users who decide that they do not actually need gasoline or that they need it sooner than they thought can sell their existing contract and purchase a new one if necessary. For those who are not end-users or originators, the driving interest is in arbitrage. By identifying contracts that are priced too high or too low, these participants can hope to make profits without ever seeing a gallon of gasoline.

In order for there to be effective legal protections and a robust secondary market, the standardization of financial instruments is essential. Standardization is not strictly necessary for the existence of legal protections for the purchasers of financial instruments. Basic contract enforcement laws might be sufficient, however, such
litigation can be costly and difficult and if definitions within a financial instrument are idiosyncratic to that particular instrument then the enforcement costs will be dramatically increased. Standardization ensures that there can be quick resolution of disputes following established precedents.

Standardization is absolutely essential to the creation of a secondary market because it creates financial instruments that can appeal to a wide array of purchasers. A gasoline futures contract which ensures the delivery of a three and a half liters of leaded gasoline to a particular street corner in Amarillo Texas may be of use to a classic car enthusiast in Amarillo, but can hardly appeal to a wider audience. The financial instruments that are most common (stocks, bonds, etc.) are all standardized to a significant degree, and differ only along agreed upon dimensions (the maturity of bonds for example). Because these products are standardized and can appeal to a wide variety of sellers they are sold in deep secondary markets with a wide variety of buyers and sellers.

The existence of deep financial markets allows price discovery to occur, which helps to ensure that financial instruments are priced according to their underlying value. As new information is revealed that changes the beliefs of buyers and sellers about the value of financial instruments this information is reflected in their price. Without a deep financial market in which these products might be sold, there may be no buyer or seller available to make the trades necessary to alter the price of the financial instrument to reflect new information. This process of price discovery ensures that resources are allocated efficiently, so for example trustworthy companies can borrow cheaply because they will be able to find buyers for their bonds at low rates of interest. If that company’s investments or products perform poorly suggesting that their ability to pay their bondholders has been harmed, then the original bondholders will sell at least some of their bonds at a lower price and raise the future cost of borrowing for that company. In this manner a well functioning financial system provides information about and allocates resources efficiently to the real economy.
No discussion of the uses and usefulness of finance would be complete without a discussion of risk and risk management. The unique flexibility of finance allows for the careful calibration of various types of economic risks. Returning to the earlier discussion of gasoline futures, by purchasing a gasoline futures contract rather than actual gasoline the end-user has shifted risk on to the originator of the futures contract. The primary risk that has been shifted is the possibility that the price of gasoline will go up before the contract comes due. If this occurs then the difference between the price of the futures contract and the price of the real good at the time of maturity is profit to the end-user. Even if the price of gasoline stays the same, the end-user has avoided risk by being certain of what price they would pay for their gallon of gas. This shifting of risks is one of the primary reasons for the creation of more complex financial instruments such as derivatives. Because financial instruments are only limited by the imagination of their writers and the regulatory enforcement powers of the state, risks can, in theory at least, be managed to minute levels of specificity. While the value of these activities is often hotly debated, risk management motivated financial engineering takes up a significant portion of resources in many of the largest corporations in the world.

As financial systems have developed in various societies one of the recurring niches in these systems has been that of financial intermediary. Organizations that profit from facilitating financial transactions. They provide originators and end-users with advice in how to structure financial instruments, the types of products that end-users should purchase, and help originators to find purchasers often purchasing financial instruments themselves for at least a time. By the very nature of their businesses financial intermediaries have formidable amounts of specialized knowledge about finances as well as access to private information from both originators and end-users of financial products. This gives financial intermediaries both the incentive and the ability to attempt to influence how financial systems operate. The degree to which this influence will be viewed as benign or malignant varies, however it is always relevant.
In addition to being powerful, financial intermediaries like finance itself are highly useful to the operation of the real economy. When functioning properly financial intermediaries create powerful positive externalities and when mismanaged they create catastrophic negative externalities. This makes the proper functioning of financial intermediaries through financial regulation a compelling state interest in every financial system of any size. The creation of positive and negative externalities by private businesses is not unique to finance; it is unnecessary to agree fully with the statement that “what is good for general motors is good for the United States” to grasp that the two interests are not wholly unrelated. What makes finance and financial intermediaries different is that the failure of General Motors reduces but does not entirely destroy the knowledge of their workers, the value of their real estate holdings, or the parts and cars that they have created. When financial intermediaries fail their promises pop out of existence and the trust necessary for the continued operation of other intermediaries and the financial markets are damaged, sometimes fatally. The central importance of financial intermediaries to the functioning of the financial system makes them the target of both state oversight and support.

The state has a direct and indirect interest in its financial system. As a financial actor in its own right, the state has an interest in managing and promoting the financial instruments that it creates; money and bonds in most cases. The states’ indirect interest in its financial system derives from its reliance on the health of the economy within its borders for tax revenue. As has already been discussed, a functioning financial system has strong benefits for the operation of the real economy and therefore the state has a compelling interest in safeguarding its financial system.

The interest of the state in the financial system can be divided into four issue areas that the state must manage. Inflation damages the value of the money that the state issues and therefore control of inflation is an important concern for the state. The level of the exchange rate is one of the central prices within the economy and impacts any businesses that engage in trade. The state, therefore, has an interest in limiting changes in the exchange rate that might harm businesses and therefore the
overall economy and the states’ tax revenue. The ability of the state to fund itself depends on its ability to borrow inexpensively and therefore it is in the interest of the state that the government bonds be purchased and held. If it is necessary to intervene into the financial system to make this happen, then the state will do so. Finally, the overall efficiency of the financial system influences the efficiency of the economy (Abiad et al. 2008). For this reason states’ regulate and generally act to support the effective functioning of the financial system.

Both the features of the financial system (the need for an enforcement mechanism, the benefits of standardization, etc.) and the interests of the state dictate that the state will be heavily involved in the functioning of any financial system. Despite this fact, financial systems are frequently described as being more or less liberalized. If the state is central to the functioning of the financial system then how can a financial system be liberal? Liberalization refers to a particular feature of the financial system, specifically how prices are arrived at. Financial liberalization is the removal of elements of government coercion to allow prices to be set by the market through supply and demand. This does not mean that the state will not be involved in the financial system, which would be impossible. What it means is that the state chooses to act indirectly, rather than directly mandating outcomes within the financial system. Liberalization can take on a partisan political meaning when supporters of deregulation attempt to paint any removal of government intervention as liberalizing. The scale developed by Abiad et al. (2010) shows the importance of this distinction.

Abiad et al. (2010) identify seven distinct dimensions of financial liberalization and I will touch on them here to illustrate how there is more to liberalization than the removal of government intervention. In the first dimension of their index of liberalization, credit controls and excessively high reserve requirements, Abiad et al. (2010) highlight this distinction. Reserve requirements are restrictions on financial intermediaries (usually banks) that force them to hold onto a certain amount of capital rather than investing it. When these requirements are low they provide intermediaries with a safety net that can be relied upon when investments fail or there is a sudden
need for cash for another reason. When the reserve requirement is set at a very high level it becomes a mechanism that the government can use to dictate the uses of capital rather than a support for the functioning of the financial system. The specific form of the government intervention and its effect on the functioning of the financial system rather than the fact of intervention alone is what determines whether its removal is a liberalizing reform.

The remaining dimensions of financial liberalization that Abiad et al. (2010) identify can be divided into those that involve direct state control over financial decisions (interest rate controls and State ownership in the banking sector), those that limit competition in the financial sector (Entry barriers and Financial account restrictions), and those that promote the functioning of the financial system (Prudential regulations and supervision of the banking sector and Securities Market Policy). These three groupings show the range of ways that state interventions can impact the market pricing mechanism. The most extreme type of state intervention involves the replacement of the market with state commands. Less severe is the use of state intervention to limit the scope of the market while maintaining the operation of supply and demand within these reduced boundaries. Finally there are state interventions that serve to support the operation of the market.

Up to this point the state has been discussed as though it were a cohesive unit capable of acting independently and having its own interests. States are in fact corporate entities which consist of multiple competing groups and interests. However in order to use the state to further their own ends groups frequently act to strengthen the state and the illusion of its separate existence (Mitchell 1991). As was discussed earlier, the maintenance of a functional financial system requires the enforcement and regulatory capacity that state formation brings with it. If these state actions ultimately benefit some set of actors within the public or private sectors, they nonetheless require the institutional capacity of the state and the development and support of that capacity. As long as it is acknowledged that state interests ultimately benefit

\footnote{Abiad et al. (2010, p.283-284) identify Argentina’s 1973 deposit nationalization law as a particularly extreme example of excessive reserve requirements.}
those who are currently in control of the state apparatus, then the danger of reifying the wholly ideational construct of the state is more than compensated for by the conceptual clarity of discussing the state directly.

The conceptual framework that will be developed later in this chapter does not depend on any specific understanding of how state leadership operates. It is consistent with approaches ranging from Olson (1993) to Bueno de Mesquita et al. (2003). The sole requirement is that there be some coherent actor who can benefit from state actions. As long as the potential for benefit exists, leaders of various stripes and motivations will feel its pull. Strengthening the financial system and therefore the real economy of your state provides additional resources that can be directed at whatever other goals those in control of might have. The only two conditions under which this process is likely to break down are when leaders make a conscious decision to limit state capacity as a regime survival strategy or when ideological commitments forbid financial liberalization as a strategy. However, as can be seen in the subsequent discussion of liberalization in France and China, ideologies can prove to be surprisingly flexible.

On September 18th, 2008 at the height of the global financial crisis, President George W. Bush met with his most senior financial advisers and as described by Sorkin (2010, 278), reacted with puzzlement as to how the financial system had turned into an engine of economic destruction. When pushed for an explanation Treasury Secretary Hank Paulson debated going through the complex set of events that had led to this point and then rejected this course and simply laid out his solution; a $500 billion fund to buy troubled assets. To this suggestion the President could only turn and ask, “Is that enough?” While this is a rather extreme example of how political leaders might interact with their economic advisers, the structural advantages of experts over their political masters is a long understood feature of economic policymaking (Heclo 1978; Hall 1993).

The role of specialization and informational asymmetries in generating autonomy for experts is widely understood, but at the root of these differences are divergent
interests. Political leaders are concerned with the smooth operation of the financial system and the economy, but are concerned with the particulars of their operation only to the extent that they become politically salient. Economic experts are therefore tasked to operate the various levers of the economy so that it produces positive political outcomes for leaders and perhaps more significantly to address any malfunctioning of the system. Political leaders typically lack the expertise necessary to evaluate economic processes and in any case do not owe allegiance to specific policy arrangements. This leaves policy experts as the only potential source of policy entrepreneurship within the state. Ultimately it is the interests of the political leadership that will dominate decision making, however these interests leave plenty of slack within which specific policies can be formed.

The most commonly identified source for economic policy change in both the Political Science and Economics literature are organized interests external to the state. This applies not only to financial policy, but also to trade, labor, and other economic policy areas. Interest based explanations of economic policy change view economic policy as changing only when conditions have altered the relative power of domestic interest groups. As various interests grow or decline in the strength, their ability to pressure the state to enact policies that favor them shifts in a corresponding fashion. Therefore an econometric examination of economic indicators and policy outcomes will detect a relationship between changes in the economy and changes in policy.

In the study of International Political Economy, this research paradigm has been most successful in the study of trade policy. The successful application of interest based explanations to trade policy has inspired scholars to adapt similar approaches to finance. In both trade and finance, addendums to basic approaches have focused on attempting include more economic sophistication in the identification of economic indicators. The reason for the inclusion of these factors is that the identification of

\[ \text{Hall and Soskice (2001)} \]

\[ \text{For example, the inclusion of factor specificity in trade models or the considering the ability of businesses to pass on exchange rate changes to their customers in determining exchange rate regime preferences (Frieden 2014)} \]
economic interests that align directly with specific policies is often more complicated than it seems. Interest based approaches are best suited to situations here economic interests are relatively homogeneous. The more diverse these interest groups are the more scattered the effect of any particular economic policy change will be.

Economic interests do have some important advantages in that they have specialized knowledge of their particular economic fields. Anticipating the effects government regulation or the impacts of proposed legislation are skills that economic interests are likely to develop. Knowledge of government processes can be purchased through the acquisition of lobbying operations at the firm or interest group level. However, there is a distinct difference between identifying the effects of particular policies that are tightly tied to your central economic activity and evaluating the relative merits of a wide variety of disparate economic reforms. In particular, it is difficult to imagine that economic interests are likely to be proactive in suggesting reforms when the evaluation of the merits of the status quo presents much less of a challenge. The further an area of economic reform moves from the central economic activity of an interest group and the less interest group has previous experience with a particular type of reform, the less likely that area of economic reform is to be the subject of interest group mobilization. Comparing trade policy and financial policy illustrates how differences in the characteristics of a policy area can influence the applicability of interest group explanations for economic policy change.

The experience of import competing interests with trade policy has been long term and direct. Tariffs have been a well understood aspect of economic policy making for as long as trade has existed. The effect of tariffs on import competing interests are simple and direct. By making imports more expensive tariffs make domestically produced goods more competitive. The extent to which they are more competitive is a direct function of the size of the tariff applied. Therefore the mobilization of import competing interests to support tariffs has not surprisingly been a common feature of trade policy. In comparison, the economic effects of deregulating interest rates is far less certain. If interest rates increase following deregulation, that could raise the costs
of capital for existing businesses and could therefore be harmful. However, higher interest rates might limit the ability of less established competitors to raise capital and therefore protect incumbents from competition. Higher interest rates could also attract increased foreign investment and therefore stimulate economic growth the effect of which for any individual business may not be entirely clear. This uncertainty makes interest rate regulation a far more difficult issue for economic interests to mobilize around. This is generally true of dimensions of financial policymaking.

The solution to the deficiencies that I have identified in both the interest group and policy diffusion approaches to financial liberalization lies in 'bringing the state back in'. As discussed above, the role of the state in explanations of political phenomenon has long been highly contested. Turning to the state as a causal factor in this instance is the result of the peculiar nature of the financial system and financial policymaking. It is also an important contrast to the main causal factors identified by the interest based and policy diffusion approaches to financial liberalization. Identifying the causal forces behind financial liberalization as emanating from within the state does not, as indicated earlier, require that the state be seen as a unitary actor independent of its component parts. Just as interest groups and other corporate actors have component parts with distinct and potentially diverse interests, so do actors within the state. What binds actors within the state together and distinguishes them from interest groups outside of the state is their shared concern in strengthening state capacities and their responsiveness to state structures. Just as political parties and the military can play a role within the state, or alternatively can attempt to supplant the state in one-party autocracies or military dictatorships. State actors only remain state actors if they continue to act within the state. Despite some notable exceptions this is the typical behavior of state bureaucracies and therefore the main focus of the theoretical framework that will be developed below.

The ephemeral nature of finance demands the involvement of the state to generate the trust necessary to allow financial transactions to flourish. The many benefits to the real economy of finance creates a dependency on finance that also forces the state
to be involved in protecting and nurturing the financial system. The technical nature of the tasks involved generates specialization within the state that creates bureaucracies wholly devoted to finance. The level of sophistication of financial systems and the bureaucracies that manage them varies, however even if only in a very primordial state these exist in all but the most abjectly failed states. This is particularly clear once currency is properly understood as a financial instrument issued by the state. The process of minting money as Desan (2014) demonstrates is a central state activity and has an ancient vintage. The utility of currency and other more advanced financial instruments to the functioning of a states’ economy and therefore to the state itself are manifest. Just as clearly, the creation and maintenance of the financial system are the province of experts. The close relationship between finance and the state is crucially different from other types of economic activities. States have certainly acted to support numerous types of economic activities and without the presence of state enforcement capacities the possibilities for exchange and production are likely to be limited. However, state involvement in other types of economic activities is supplemental whereas for finance it is essential.

The specialized bureaucracies that develop to support financial systems generate a strong degree of compartmentalization when it comes to finance. The Wile E. Coyote component to financial instruments, that they have value as long as nobody looks down, encourages those involved to take their existence and stability for granted. The bureaucrats charged with ensuring that the system functions smoothly also tend to be taken for granted by most political actors until something fails to function correctly. Rather than considering the financial system directly, therefore, actors in society outside of the financial bureaucracy and perhaps private financial intermediaries focus on four specific outputs of the financial system. Inflation and deflation have society wide effects on the economy altering the investment and production decisions of every economic actor. Therefore in periods of inflation or deflation both groups outside the state and political leaders who answer to them will turn to the financial bureaucracy to solve these issues. The exchange rate is the single most important price level
within an open economy and therefore changes to the exchange rate will also cause demands for bureaucrats to return to the status quo position. It is certainly true that the specific distributional consequences of exchange rate shifts will vary depending on the nature of the shift and the economy in which it is occurring. However, since the current exchange rate levels and regime are in the interest of those groups that control policymaking in this area it is only in extraordinary situations where political power has shifted that the desired exchange rate policy will be re-litigated based on the relative benefits and political strengths of the groups impacted. The amount of economic growth experienced by the state is another important aggregate outcome that can direct political pressure on the financial bureaucracy. Sluggish growth, recessions, or in extreme cases depressions are signs of an economy that is not functioning well and will drive demands that financial bureaucrats act to remedy the situation. Finally, the state itself is an important financial actor particularly through the use of bonds to raise money to finance government spending. When the state finds itself unable to borrow inexpensively this sharply constrains its ability to function. Without the ability to borrow, the remaining options are reductions in government spending or increases in taxation both of which will be strongly felt by groups within society. Therefore changes in the interest rate on sovereign debt will bring attention and demands for solutions to financial bureaucrats.

As opposed to the interest group based approach which seeks to link interest group to individual policy decisions, the state based approach argues that interest groups and the political actors that they influence are interested in the highly visible and broadly impactful aggregate outcomes listed above. Additionally, the state based approach sees the dominant concern for societal groups in financial policymaking as the maintenance of the status quo. Rather than attempting to maximize their interests by altering how financial policy is made, the state based approach argues for interest groups who satisﬁce and for whom the uncertainty surrounding the potential results of financial reforms overwhelms any potential benefits. The advantage of the state based approach is that it demands signiﬁcantly less information processing capacity
from economic interests. Consider the difference in the information processing capacity required of a computer manufacturer to determine the effect on their business of a reduction in banking reserve requirements versus a decrease in the level of the exchange rate. The exchange rate decline directly increases the cost of the foreign sourced parts that the computer manufacturer relies on and therefore cuts into their profit margin. The change in reserve requirements may increase the availability of capital for the business to expand or it might result in greater competition over newly available capital and therefore increase the businesses’ funding costs. A wide variety of factors would need to be taken into account to even begin to properly assess the effects of such a change.

The state based approach rather than eliminating the role of interest groups merely restricts it to limits generated by the complexity of assessing the effects of financial changes and the fungible nature of economic interests who are concerned with their bottom line rather than the specific policy arrangement that produces it. Financial intermediaries suffer less from informational restrictions because of their specialized skills and their privileged position within the financial system, however these advantages give them the ability to defend their economic interests no matter what policy arrangements are enacted. Financial intermediaries are at worst temporary impediments to the enactment of financial reforms only needing a means for the necessary compensation to be discovered for their objections to vanish. In addition to taking a different approach to the role of interest groups the state based approach also has a different view of the operation of the financial system than the interest based approach.

Implicit in the interest based approach is the assumption that the financial system is self-regulating and only falls into crisis when shocks from outside of the financial system upset its equilibrium. Because in the interest based approach the financial system self-regulates reforms can only be motivated by attempts to alter the balance of benefits produced by that system. In the state based approach, the financial system is viewed as less stable with periods of instability caused not only by external forces
but also by internal contradictions. This is partly a consequence of the wider view of the financial system taken in the state based approach. Because interest based approaches attempt create direct links between economic interests and specific policy positions they typically consider only a single financial policy dimension. This limits the ability of these approaches to consider how various policy dimensions interact with each other. Trade-offs among intermediate financial policy goals, such as controlling inflation and maintaining exchange rate stability are common and attempts to balance these concerns are a technical motivation for reform that is absent from interest based approaches. Because technically motivated reforms do not attempt to alter the benefits that interest groups derive from the financial system any alteration that they do cause is a side effect rather than the main goal of the reform. These technical reforms are consistent with the view of interest groups from the state based approach to financial reform because the more limited ability of interests in this approach to assess the results of financial reforms allows potential side effects to go unremarked upon.

It might be tempting to consider temporary disequilibriums caused by the incompatibility of different intermediate financial goals as a lesser version of the reform inducing crises that are central to many of the interest group based approaches discussed earlier, but these are distinct phenomena. The role of crises in interest group approaches are to upset from outside the political-economic equilibria that sustain the policies adopted by states at any given time. The technical problems that develop within financial systems are completely internal to the political and economic system of the state. They do not disrupt the balance of political power among interest groups and they develop slowly giving interest groups the time to adjust to these changes if they have the capacity. In the state based approach, reforms taken in response to problems with financial aggregates are an attempt to maintain the status quo rather than to capitalize on shifts in the balance of power. Because in the state based approach it is financial aggregates that are the targets for contention rather than policies themselves changes in policy do not necessarily reflect gains or losses.
The greater flexibility in policymaking that is opened up by the state based approach to financial reform gives room for discretion to policymakers. Because of the technical and specialized nature of financial policymaking this discretion is ceded to the financial bureaucracy by political power holders. For politicians as for the economic interests that seek to influence them, the specifics details of financial policymaking are not of central importance. Instead maintaining the smooth operation of the financial system and financial aggregates at their status quo levels is the central concern. The motivations of the financial bureaucracy derive from their positions. The prestige and power of financial bureaucrats comes from their mastery of their area of specialization and their ability to solve problems for their political leaders. While concerns over regulatory capture might suggest that the interests of bureaucrats is dominated by the interest groups they are intended to regulate, particularly large financial intermediaries, the state based approach to financial liberalization views policymaking as sufficiently flexible to reconcile the interests of these actors. Financial bureaucrats are responsible for maintaining the smooth functioning of the financial system and to the extent that defending the interests of outside actors comes directly at the expense of the stability of the financial system it can hardly benefit them. Even those bureaucrats captured by outside interests would prefer to provide them benefits while also maintaining the functioning of the financial system and the flexibility of financial arrangements and regulations makes this eminently possible.

If the maintenance of the financial system is the primary focus of the bureaucracy, then what motivates them to adopt liberalizing reforms? The academic literature on financial liberalization is contested and stability in particular is often cited as a casualty of financial liberalization. Reforms of any type have the potential to be destabilizing and a bureaucracy that is attempting to maintain the status quo hardly seems a likely source for change. However, as discussed earlier financial systems attempt to maintain multiple contradictory goals and frequently develop internal contradictions that upset the maintenance of the status quo. It is in these instances that reforms can become attractive, not because they will upset the existing system
but because they will contribute to its smooth operation. Reforms will not be the
first impulse of the bureaucracy, but will only be sought when existing management
techniques have been discredited by persistent problems. Within the bureaucracy
reforms will tend to be developed by younger members of the bureaucracy influenced
by the latest academic research and specialized policy research elements that many
financial bureaucracies develop. Just as politicians turn to bureaucrats to resolve
problems within the financial system, the heads of bureaucracies turn to lower level
members of the bureaucracy for new ideas when the old ideas have failed to resolve
the problem. Policy reforms in the state based approach are therefore fundamentally
less conflictive and less radical than in the interest based approach to financial reform.

The development of the state based approach to financial liberalization to this
point has not addressed the puzzle at the center of the policy diffusion literature on
financial liberalization; why have the reforms that policymakers have developed over
the last forty years tended to move uniformly in the direction of liberalization? The
policy diffusion literature offers two distinct sets of explanations for this shift; ideas or
structural changes. Of the two, the ideational explanation is more convincing. Over
the last forty years there have been a wide variety of structural changes in the world
economy that could be identified as creating an environment that is more hospitable to
financial liberalization, however these changes have not had the consistency necessary
to explain the uniform direction of reforms. Why have periods of financial crisis and
scarce global capital within the last forty years not caused the reversal of policy
reforms? What accounts for the locked in nature of reforms despite wild swings of
structural conditions? In contrast to shifts in structural conditions the ideational
landscape is serenely stable and uniform.

While the specific details of individual reform initiatives are often hotly debated
in the academic community, the general trend toward supporting greater liberaliza-
tion is uncontested. This is particularly clear when deregulation and liberalization are
properly distinguished from each other. Scholars differ in their beliefs about the speed
with which liberalization should be attempted and the necessary background condi-
tions that must be achieved before specific liberalizing elements can be attempted, however there is uniformity in the direction of reform that is desirable. In addition to emphasizing the benefits of greater market pricing, there has been significant focus on the way in which attempts to use control mechanisms to regulate the financial system create unintended consequences and disruptions. Within academic economics the prestige and success of the neoliberal program has proceeded unimpeded for the last forty years. The fierce scholarly battles over how the economy functions all take place within the boundaries of the neoliberal program. Anyone trained in academic economics will therefore have a thorough experience with neoliberal ideas and arguments. When solutions to problems are sought by political leaders and the heads of the financial bureaucracy, they therefore move in the liberalizing direction reflecting the underlying inclination in the academic research.

Financial liberalization is the result of a series of disconnected reforms based on the ideational substrate generated by academic economists rather than an organized program of intentionally directed reforms. This means that the extent of liberalization is contingent on the conditions within specific states. The amount of liberalization will vary depending on these conditions, however in the time period under consideration (1970 through the present) financial reforms will be almost entirely in the direction of greater liberalization. Partial rather than systematic these reforms are motivated by attempts to resolve individual problems or inconsistencies and to maintain the smooth functioning of the financial system rather than to upset the arrangement of benefits generated by the financial system to reflect new political and economic realities.

The state based approach to financial liberalization is complementary to the ideational branch of the policy diffusion literature. It gives political detail to the flow of ideas and locates the sources of reform within the financial bureaucracy and the attempts of these bureaucrats to manage their individual financial systems. By turning to the state and state interests as central to the reform process, the state based approach resolves the inconsistencies of the interest based approaches to financial reform. In so doing it emphasizes what makes financial systems and financial
policymaking unique, the flexibility of finance and the centrality of active state management to the financial system. The failure to acknowledge these unique elements of finance also explains why previous attempts to adopt models from other branches of international political economy to financial reform have been unsuccessful. A final and important implication of the state based approach to financial reform is the limitations it identifies in the reform process.

Interest based approaches to financial reform assume that reforms are the result of titanic contestations and monumental changes in the political economies of states. If these approaches are correct then financial reforms should be expected to have massive effects on the economic performance of the states who adopt them. In the state based approach reforms are marginal and contingent and can be compensated for in a myriad of side payments and alternative arrangements. This suggests that the effects of reforms will be limited by ancillary changes and largely leave status quo actors unmolested. This more limited view of reforms may help to explain why in many cases financial liberalization has not had the magnitude of benefits that are promised by proponents of these reforms. It also indicates why reforms frequently stall at a more limited level rather than driving forward inexorably towards a universally high level of liberalization. It also suggests that unless the academic study of finance begins to champion the benefits of using direct control mechanisms over market mechanisms to manage the financial system the direction of financial reforms are unlikely to change. As long as neoliberal ideas about finance remain dominant when opportunities for reform occur those reforms will increase the usage of market mechanisms to control the financial system.
3. QUANTITATIVE

On April 3rd 2012, Chinese Premier Wen Jiabao said on state run radio, “Frankly, our banks make profits far too easily. Why? Because a small number of major banks occupy a monopoly position, meaning one can only go to them for loans and capital” (Barboza 2012). This statement made headlines all over the world, but was more than a bit anti-climactic coming near the end of the Premier’s term after nine years during which little progress had been made in reforming the major banks that dominate China’s financial system. Accomplishing banking reform has been a central goal of the Chinese Communist Party leadership for nearly twenty years (Zhu et al. 1996; Allen et al. 2008). The deficiencies in China’s financial system are well understood as is the rough outline of the necessary reforms.

Wen Jiabao’s statement made headlines not because what he said was not already common knowledge, but because he said it publicly. China’s combination of a widespread recognition of the deficiencies in their financial system as well as their knowledge of the kinds of reforms necessary to remedy these deficiencies is not uncommon. While there is significant academic debate over the timing of financial reforms and the suitability of particular reforms to individual country contexts, the ultimate desirability of acquiring a deep and mature financial system is largely uncontroversial.

\footnote{For generalized reviews see Levine (2005); Ang (2008). A number of studies find that financial liberalization can lead to crises (Stiglitz 2000; Kaminsky and Schmukler 2008; Bonfiglioli 2008). Complimentary research emphasizes the importance of the sequence through which liberalization is accomplished (Ito 2006) and finds that capital controls enhance the resilience of financial systems to crises (Ostry et al. 2012; Wong and Eng 2015). The relationship between an efficient financial system and the efficient functioning of a states’ economy can be seen in Diamond (1984); Boyd and Prescott (1986); Williamson (1986); King and Levine (1993b). A number of studies tie financial development to economic growth (Merton and Bodie 2005; King and Levine 1993a; Atje and Jovanovic 1993; Demirgüç-Kunt and Maksimovic 1998; Levine and Zervos 1998; Bekaert et al. 2005; Chinn and Ito 2006; Bekaert et al. 2011).}
By reforms, I mean changes to the financial system that increase the operation of the market in the allocation of financial resources. Liberalization and neoliberal reform programs can encompass a wide variety of policy areas and policy recommendations. The term liberalization itself has acquired a propagandistic quality used both to champion and defame reforms. In this paper the financial system refers to the actors and institutions that determine the availability and price of capital. Liberalization of the financial system refers to any reform which replaces state control over the availability and price of capital with the action of supply and demand determined by private actors. While some extreme proponents of a “free market” would see any removal of government involvement as having this effect, the state has a recognized role in financial regulation and oversight in even the most liberalized financial systems. Markets are embedded institutions which depend on recognized rules, enforcement mechanisms, and information systems that governments have a role in facilitating. Therefore the removal of government involvement in and of itself need not be considered liberalization.

One way that I simplify the identification of liberalized financial systems in this paper is to use the coding developed by Abiad et al. (2010). As this dataset considers financial systems in broad terms rather than focusing at the level of individual financial regulations, it will not detect minor changes in for example the amount of capital banks are required to hold. Additionally, it includes a category for prudential regulation that counts certain types of government intervention as increasing the liberalization of the financial system. Therefore the United States in the 21st century is scored as a highly liberal financial system with limited state involvement in the banking sector, interest rates that are set by market participants and not the government, and robust securities markets. Despite being scored as highly liberalized, the United States has a central bank that plays an active role in managing monetary policy and banking regulation remains an important government function. Therefore as financial liberalization is discussed in this paper, what is meant is only large policy
changes that limit in a significant fashion the government’s role in determining the availability and price of capital.

Returning to Wen Jiabao’s complaint about China’s financial system, the state’s involvement in China’s financial system has long restricted competition in the banking system. This has the effect of making capital expensive and limiting the growth of businesses within the Chinese economy. As discussed previously, there are two main potential sets of explanations for the decision to reform the financial system. Either the state-based or interest-based explanations could be consistent with Wen’s statement about China’s financial system. It is possible that his statement is motivated by the concern of business interests that their costs of raising capital is being driven up by the dominant position of the Chinese state in their financial system. Alternatively, Wen’s statement might be motivated by the arguments of technocrats within the Chinese Central Bank that flagging economic growth could be improved by reducing the outsized profits of the Chinese banking sector. Distinguishing which of these two sets of explanations provides the primary motivation for financial reform is the purpose of this paper.

The measurement of a state’s financial policy I use was developed in Abiad et al. (2010). In creating their measurement, the authors broke financial policy into seven different dimensions (credit controls, interest rate controls, entry barriers, state ownership of banking, capital account restrictions, securities market policy, and prudential regulation) and coded each dimension on a scale from 0 (most repressive) to 3 (most liberal). For the first five of these dimensions greater degrees of government involvement results in lower scores. In the securities market policy area, government policies encouraging the development of securities markets result in higher scores, while restrictions result in lower scores. The prudential regulation dimension is the only dimension in which, “a greater degree of government intervention is coded as reform” (Abiad et al. 2010, 285). From these seven dimensions, Abiad et al. develop a 0 to 21 point scale with 0 representing full financial repression and 21 representing full financial liberalization. Abiad et al. generated their measure for 91 countries over
the period from 1973 to 2005. These 91 countries include countries from a variety of different geographic regions as well as at different levels of economic development.

In order to examine the fates of particular reform initiatives, I adopted the coding for financial policy score used by Abiad et al. (2010) into a measure of financial reform. An increase in a country’s overall financial policy score (a move in the direction of liberalization) in a given year is measured as an instance of reform. Each instance of reform is considered as continuing until the country suffers a reversal in their financial policy score that drops that score below that achieved by the original reform. Particularly severe policy reversals can result in multiple reforms being terminated if they drop the financial policy score low enough. There are several interesting patterns that can be observed by simply examining the raw data on the instances of financial reform.

Fig. 3.1.: Size of Financial Reforms
A histogram of the size of financial reforms clearly shows that small reforms are by far the most common types of reform. Of the 772 instances of financial reform found in the dataset, 406 (over 50%) of these reforms are of size 1. Since a one unit increase in the coding created by Abiad et al. (2010) represents an improvement in one category of only a third of the distance between repression and liberalization, this indicates that most financial reforms are highly incremental. This contradicts the theoretical view of financial system as highly integrated political-economic equilibriums that only change after receiving significant shocks. The two largest reforms, increases in financial policy scores of 8, were experienced by Columbia in 1991 and Argentina in 1977. The average reform is an increase in financial policy score of 1.64.

Fig. 3.2.: Financial Reforms by Year
Examining the distribution of reforms over time shows an increase in the number of reforms from the 1970s through the 1990s. The maximum number of reforms in any given year occurs in 1995 with 42 countries out of the 91 countries included in the dataset experiencing financial reforms. Financial reforms enacted by states transitioning away from state-controlled communist economic systems as well as the emphasis on “Washington Consensus” type policies by development scholars and international institutions during this period may explain this increase. While reforms continued following the peak, there is a marked decrease in the number of reforms following 1995.

Another pattern that is clear in a simple examination of the record of financial reform is the scarcity of reform reversals. While there are 772 years in which countries liberalize their financial systems to a greater or lesser degree, there are only 127 year in which countries reverse existing reforms. The most common occurrence is the maintenance of the status quo (1,681 country-years), which is consistent with a view of reforms as being costly and therefore the exception rather than the rule. This bias towards reform and away from reversal presents a puzzle that both an interest-based and a state-based theory of liberalization must explain. For state-based liberalization, the growth of neoliberal ideas and the adoption of liberalization as an orthodoxy within academic economics provides this explanation. The challenge for interest-based theories of liberalization is to identify some global factor that has privileged groups benefiting from additional liberalization across a diverse group of countries at different levels of development and with very different political systems. One potential solution is the growth in importance of international capital flows and the role of international governmental organizations in promoting liberalization.

Having gotten a sense of the general structure of financial reforms in the period from 1973 through 2005 and a few of the potential implications for the earlier theoretical discussion of financial liberalization, I will now turn to the quantitative measures I have collected to attempt to resolve the conflict between my theory of state-based financial liberalization and the dominant interest-based theories. The major causal
factor identified in my theory are neoliberal ideas about how to manage a country’s financial system. Measuring the flow of ideas across a wide variety of countries over time presents a significant challenge. The most common approach within the existing international political economy literature has been to measure the flow of ideas as the result of policy diffusion between neighboring states (Simmons and Elkins 2004). The actual factor measured is the policy positions of neighboring states, which then are shown to influence the degree of liberalization within other states. The extent to which ideas are performing the transformation as opposed to the adoption of congruent policies cannot be directly ascertained. In this paper I use a more direct measure of the flow of ideas; the educational background of the head of a states’ Central Bank.

The Central Bank is an attractive target for measuring the ideas within the bureaucracy about how financial systems should operate. One peculiarity of the Central Bank is that it is an institutional form that has been adopted by almost every state included in the dataset for the entire period under consideration. This isomorphism is not shared by other aspects of the state’s economic bureaucracy. There is a dizzying array of arrangements and levels of relative importance among other potential targets that makes them unsuited for cross-country comparison. While almost every state has a Central Bank, there are differences in the roles and independence of these institutions. For example, the European countries within the dataset come under the aegis of the European Central Bank during the time period considered in this paper, which puts them in a very different position than the United States’ Federal Reserve. Because my interest in Central Banks is due to their role as repositories for ideas rather than in their explicit policy making strength or portfolio of responsibilities, I believe these differences are less significant than would otherwise be the case.

Educational backgrounds have been used in the past in the attempt to predict the future behavior of political leaders.\textsuperscript{2} Education has also been used to ascertain

\textsuperscript{2}This is common in the study of the leadership of the Chinese Communist Party because its inner workings are largely opaque to outside observers (Cheng and White 2003).
the spread of neoliberal ideas within the ranks of economic bureaucracies. Adopting Chwieroth’s methodology, while expanding my focus to a wider range of states, I have identified whether the heads of the Central Banks of the 91 states in my dataset received a Ph.D. in Economics or Finance from a U.S. or U.K. University. The dominant mode of thought in these universities during the period when these Central Bank heads were trained was overwhelmingly neoliberal. However, there is no guarantee that after being trained in this manner any particular individual will continue to espouse neoliberal ideas. However, given the difficulties associated with identifying the flow of these ideas this measure represents a reasonable way of identifying at least the greater likelihood of these ideas being held.

One important limitation of this measure is that Central Bank heads are not at the center of the theoretical argument I made earlier. New ideas are unlikely to flow from such senior figures. Because of the great seniority that is typical of the individuals appointed to these positions, it is likely that they may have had their major impact on financial reform while holding lower level positions within the bureaucracy. A better measure of the flow of neoliberal ideas would track the training of the numerous lower level bureaucrats that I think are likely to play a more crucial role in pushing forward neoliberal solutions to problems in the financial system. Such detailed information about the membership of economic bureaucracies is, however, exceedingly difficult to retrieve for such a large number of states. Despite being an imperfect measure of the flow of neoliberal ideas, I envision the educational background of the Central Bank head to reflect the relative orthodoxy of neoliberal ideas within the Central Bank. By the time a University of Chicago trained Ph.D. economist is appointed to head the Central Bank, it is likely that the ideas reflected in their training are deeply embedded in the institution.

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3Chwieroth (2007) examines 29 countries from 1977–1999 and considers only their impact on capital account liberalization.
4Where Central Bank heads did not provide C.V.’s or bios listing their educational backgrounds, I used a ProQuest dissertation search to determine whether they have completed a Ph.D. in the proper fields.
Fig. 3.3.: Neoliberal Central Bank Heads by Year

An examination of the distribution of U.S. and U.K. trained Central Bank heads shows an increase in the influence of neoliberal ideas over time. The absolute number of these individuals is never very large and as a measure of the strength of neoliberal ideas it presents a hard test. In numerous countries the presence of a commitment to neoliberal ideas will not be detected, since the lower levels of the bureaucracy can have adopted a neoliberal ideology even though the head of the bank did not receive the training I use as a proxy measure.

The next set of important concepts for my state-based theory of financial liberalization are the measures of “problems” within the financial system that I discussed earlier. I have collected both subjective and objective measures of these problems. The use of subjective measures allows me to separate the perception of problems from
their actual existence. There are frequently significant differences between the actual status of economic indicators and public beliefs about these factors. The rational expectations model of influencing the rate of inflation is based on the idea that these beliefs can have their own independent influence on the economy. In order to develop my subjective measures I used keyword searches of the New York Times. Searching for mentions of inflation, exchange rate, and debt, for each country-year in the data set. I simply counted the number of articles mentioning each of these terms. In order to control for differences in the levels of coverage of different states, I have demeaned each of these data series. Therefore the level above or below the average mentions of these factors in each year is used to measure the level of public concern about inflation, the exchange rate, and the amount of debt.

Turning to objective measures of problems within the financial system, I used changes in existing trends to measure the existence of problems in the financial system. Therefore, I calculated changes in the GDP growth rate and the exchange rate using base GDP and exchange rate data from the Pen World Tables. When these two indicators deviate from their pre-existing trends, as I laid out earlier, political leaders demand solutions from technocrats who provide them in the form of neoliberal reforms. I use changes in relative trends rather than absolute values because different states operate comfortably in very different economic conditions. Theoretically, it is changes in the economic status quo that I predict will lead to calls for reform.

In order to test my theory of state-based financial liberalization against the idea that interest group demands are the primary factor leading to financial liberalization, it is necessary to identify the key factors that an interest group account predicts will lead these groups to demand liberalization. One of the important sets of interest group accounts of financial liberalization sees political parties as acting as proxies for interest groups. These accounts are frequently more nuanced on an individual country level, but in order to examine a wide array of countries simultaneously they typically use the right party/left party division to measure which set of interests controls the

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5The number of articles varied dramatically by the state being considered. The U.S. and Canada for example received far more coverage than states like Kazakhstan or Albania.
government. Therefore I have adopted the left government/right government data series collected in the Database of Political Institutions (Beck et al. 2001). The interest group theory of financial liberalization identifies right parties with capital and therefore sees reforms as more likely to occur when right governments are in power. Additionally the presence of a Presidential system of government has been argued to increase the power of forces on the right and therefore to increase the likelihood of financial reforms. To test this possibility I have included a dummy variable indicating the presence of a Presidential rather than a Parliamentary system of government.

An important mediating force for the interest group account of financial liberalization are the institutions through which interest groups influence the political process. I have therefore included the standard Polity IV measure of democracy/autocracy in order to control for the impact that the level of popular control over the state has on the likelihood of financial liberalization. This is particularly important because my dataset includes both highly democratic and highly authoritarian regimes. Even though I expect these regimes to behave in a similar fashion when it comes to financial liberalization, it may be the case that regime type has an important effect.

The benefit that interest groups are likely to receive from financial reform influences the level of financial liberalization that domestic interest groups desire. Measuring the potential economic benefit for groups across different states is problematic, however one frequently used proxy measure is the degree of openness in the economy in general. This is measured as the sum of imports and exports as a percentage of GDP. States that engage in more trade are likely to be more integrated into the global economy and therefore are in a position to benefit from increased access to capital that will allow them to expand their businesses further into foreign markets. For states that import a large amount of goods, greater liberalization has the potential to provide financing for these purchases. Additionally, states that are exposed to greater amounts of trade are likely to have businesses that are more prepared to compete on the international stage and therefore benefit from financial liberalization. If the

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6Some research has found the presence of democracy and democratization in particular to influence the degree of financial liberalization (Brune et al. 2001).
interest group account of financial liberalization is correct, more open states will be more likely to reform their financial systems.

The availability of international capital also influences the attractiveness of financial liberalization for domestic interest groups. In conditions where foreign capital is widely available, domestic interest groups will benefit more from greater financial liberalization. A common measure of international capital conditions is the interest rate in the United States. When U.S. interest rates are high, then capital will be attracted to safe high-yield investments in the United States. Conversely, low interest rates in the United States indicate that capital will be available to interests in states that allow it to enter. If the interest group account of liberalization is correct, then under the favorable conditions of low U.S. interest rates liberalization will be more likely to occur.

A final potential source of interest group demand for greater financial liberalization comes from international business interests, particularly acting through key economic international governmental organizations. This account of an interest group based liberalization depends on states becoming vulnerable to external pressure when they rely on support from the World Bank or the International Monetary Fund. The greater the support provided by these organizations, the more likely it is that states will reform their financial systems in ways that benefit businesses in the developed states that control these organizations. In order to test this possibility, I have collected from the World Bank Development Indicators measures of the dollar value of non-technical cooperation grants and the amount of IMF credits borrowed. If this internationalized version of the interest group account is correct, then increased grants and borrowing will lead to the adoption of financial reforms.

The table above lists the various independent variables discussed above and groups them according to which account of financial liberalization they are expected to provide support for. Finally, the expected direction of the coefficients in each case are included. Findings that are consistent with the state-based or alternatively the inter-
Table 3.1.: Expected Effect of Independent Variables on Financial Liberalization

<table>
<thead>
<tr>
<th>State-Based</th>
<th>Prediction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neoliberal Education</td>
<td>+</td>
</tr>
<tr>
<td>Inflation Count</td>
<td>+</td>
</tr>
<tr>
<td>Exchange Rate Count</td>
<td>+</td>
</tr>
<tr>
<td>Debt Count</td>
<td>+</td>
</tr>
<tr>
<td>% Change in GDP Growth</td>
<td>+</td>
</tr>
<tr>
<td>% Change in Exchange Rate</td>
<td>+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest Group</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Right Government</td>
<td>+</td>
</tr>
<tr>
<td>Presidential System</td>
<td>+</td>
</tr>
<tr>
<td>Economic Openness</td>
<td>+</td>
</tr>
<tr>
<td>U.S. Interest Rate</td>
<td>-</td>
</tr>
<tr>
<td>IMF Credits</td>
<td>+</td>
</tr>
<tr>
<td>Grants (Non-Technical Assistance)</td>
<td>+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Controls</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Polity</td>
<td></td>
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<tr>
<td>GDP</td>
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</table>

est group account of liberalization will provide supporting evidence for their respective theoretical argument.

The major statistical model that I use in this chapter is a simple time-series logit with fixed effects. The dependent variable is the presence of reform in a given year. In years where there is no reform, this is coded as a 0 and any year in which a reform has occurred is coded as a 1. Given the numerous differences between the countries in my dataset that are not controlled for, it is essential that fixed effects be used.

Because of missing variables on some of my covariates I lose 4 countries in my dataset from the final analysis. However, the remaining number of observations is more than sufficient for the use of maximum likelihood estimation. The ultimate result of this analysis is ambiguous; there is some support for both the state-based and interest group explanations of financial liberalization. Both the presence of a neoliberally trained Central Bank head and the presence of a Right government increase the likelihood that financial reform will be adopted in a given year. None of
Table 3.2.: Financial Reform Regression

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Observations</td>
<td>2355</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Groups</td>
<td>87</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Log Likelihood</td>
<td>-1113.175</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-Based</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Neoliberal Education</td>
<td>0.357</td>
<td>(.180)</td>
<td>*</td>
</tr>
<tr>
<td>Inflation Count</td>
<td>-0.0002</td>
<td>(.008)</td>
<td></td>
</tr>
<tr>
<td>Exchange Rate Count</td>
<td>-0.002</td>
<td>(.025)</td>
<td></td>
</tr>
<tr>
<td>Debt Count</td>
<td>0.001</td>
<td>(.007)</td>
<td></td>
</tr>
<tr>
<td>% Change in GDP Growth</td>
<td>-1.322</td>
<td>(1.046)</td>
<td></td>
</tr>
<tr>
<td>% Change in Exchange Rate</td>
<td>-0.019</td>
<td>(.024)</td>
<td></td>
</tr>
<tr>
<td>Interest Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right Government</td>
<td>0.309</td>
<td>(.137)</td>
<td>*</td>
</tr>
<tr>
<td>Presidential System</td>
<td>-0.153</td>
<td>(.248)</td>
<td></td>
</tr>
<tr>
<td>Economic Openness</td>
<td>0.227</td>
<td>(.571)</td>
<td></td>
</tr>
<tr>
<td>U.S. Interest Rate</td>
<td>0.022</td>
<td>(.015)</td>
<td></td>
</tr>
<tr>
<td>IMF Credits</td>
<td>2.35 × 10^{-6}</td>
<td>(3.33 × 10^{-5})</td>
<td></td>
</tr>
<tr>
<td>Grants (Non-Technical Assistance)</td>
<td>3.80 × 10^{-4}</td>
<td>(2.07 × 10^{-4})</td>
<td></td>
</tr>
<tr>
<td>Controls</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polity</td>
<td>0.0037</td>
<td>(.005)</td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>0.05</td>
<td>(.179)</td>
<td></td>
</tr>
</tbody>
</table>

*p<0.05; **p<0.01; ***p<0.001

the remaining covariates reaches the .05 level of statistical significance. Moving from having a Central Bank head without a Ph.D. in economics or finance from a U.K. or U.S. university to having a Central Bank head with such training leads to a 10% increase in the probability of a financial reform occurring. Similarly, changing from having a non-right party in control of the government to having a right party in control of the government increases the probability a state will have a financial reform by 8%.

While the magnitude of these two effects are similar, the neoliberal training variable is far more central to my proposed state-based financial liberalization theory than the right government variable is to the interest based account of liberalization. The
failure of any of the financial problem variables to research significance is puzzling. It may be that my attempt to look for “problems” rather than shocks requires more nuance than can be captured by the available data. Because these problem variables are important to my theory, this result provides only a limited amount of support for this theory. The finding of a significant result in the expected direction despite the limitations of Central Bank head education as a measure which were discussed above, does provide support for the role of ideas in driving financial liberalization.

The interest group approach to financial liberalization receives support from the importance of right governments in promoting financial reform. This suggests that a closer look at the government’s ideological leanings will be an important component of the subsequent case studies. The remaining interest group variables do not reach the .05 level of significance. These various factors, which if the interest group approach is correct should lead to increased demands for financial liberalization, fail to lead to the increased incidence of financial reform. Since these are primarily economic factors, this is an important contradiction with the underlying theory of the interest group approach. If economic interest lies at the heart of demands for liberalization, then conditions which make liberalization more lucrative should be associated with a higher likelihood of reform. One potential way to reconcile these findings with the findings on the presence of right government is to question the assumption that right governments represent liberalization demanding interest groups. It is possible that ideological commitments by right governments are influencing reform independently from interest group demands. If right governments are elected for other reasons and then undertake reforms on their own, it would explain why the other measures of interest group demand do not have a significant effect on reform. This could be most clearly addressed by case study examinations of the demands placed on right governments.

The main focus of this paper is the prediction of instances of reform that was the focus of the previous analysis. However, a brief examination of how these same covariates influence the absolute level of financial liberalization provides additional
Table 3.3.: Financial Policy Regression

<p>| | | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Number of Observations</td>
<td>2355</td>
<td></td>
</tr>
<tr>
<td>Number of Groups</td>
<td>87</td>
<td></td>
</tr>
<tr>
<td>r²</td>
<td>0.257</td>
<td></td>
</tr>
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</table>

State-Based

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Neoliberal Education</td>
<td>2.226</td>
<td>(.280) ***</td>
</tr>
<tr>
<td>Inflation Count</td>
<td>-0.026</td>
<td>(.011) *</td>
</tr>
<tr>
<td>Exchange Rate Count</td>
<td>-0.031</td>
<td>(.035)</td>
</tr>
<tr>
<td>Debt Count</td>
<td>0.013</td>
<td>(.009)</td>
</tr>
<tr>
<td>% Change in GDP Growth</td>
<td>-2.560</td>
<td>(1.577)</td>
</tr>
<tr>
<td>% Change in Exchange Rate</td>
<td>-0.042</td>
<td>(.011) ***</td>
</tr>
</tbody>
</table>

Interest Group

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<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Right Government</td>
<td>0.626</td>
<td>(.208) **</td>
</tr>
<tr>
<td>Presidential System</td>
<td>0.474</td>
<td>(.381)</td>
</tr>
<tr>
<td>Economic Openness</td>
<td>-2.567</td>
<td>(.865) **</td>
</tr>
<tr>
<td>U.S. Interest Rate</td>
<td>-0.769</td>
<td>(.023) ***</td>
</tr>
<tr>
<td>IMF Credits</td>
<td>1.88 × 10⁻⁴ (5.07 × 10⁻⁵) ***</td>
<td></td>
</tr>
<tr>
<td>Grants (Non-Technical Assistance)</td>
<td>1.84 × 10⁻³ (3.28 × 10⁻⁴) ***</td>
<td></td>
</tr>
</tbody>
</table>

Controls

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<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Polity</td>
<td>0.053</td>
<td>(.00) ***</td>
</tr>
<tr>
<td>GDP</td>
<td>0.985</td>
<td>(.273) ***XS</td>
</tr>
</tbody>
</table>

*p<0.05; **p<0.01; ***p<0.001

insight into the process of financial liberalization. This analysis uses the same fixed effects approach to deal with unit heterogeneity as above, however since the dependent variable is the level of financial liberalization (0–21) I used simple OLS regression.

As in the prediction of reform, the presence of a neoliberally trained Central Bank head has a significant effect on the overall level of financial liberalization. The absolute magnitude of that effect is not overly strong, since it only leads to a 0 category increase in liberalization. While some of the “problem” variables are significant when it comes to influencing the level of financial reform, they are both negative and very small. this suggests that perhaps economic problems do not provide the impetus to
technocrats that my theory predicts, or perhaps these problems are in other areas that these measures are not identifying.

The interest group variables reveal some interesting differences with the earlier analysis of instances of reform. The right government variable has the expected sign, but has a reduced impact relative to the influence of neoliberal ideas in determining the overall level of financial liberalization. Interestingly economic openness has the opposite effect on financial liberalization from what the literature would suggest. In economies that are more involved in international trade, the overall level of financial liberalization is lower. This suggests continued problems with accounts of liberalization that privilege the growth of internationally focused domestic businesses as explanatory factors. Despite not impacting the likelihood of reform, the U.S. interest rate has the expected effect on the overall level of reform. In addition, both measures of International Governmental Organization influence are significant and increase the level of liberalization as the interest group theory of liberalization predicts. This provides some support for the international variant of the interest group approach to liberalization. Finally there is a small effect of regime type on the level of financial liberalization and even though more wealthy countries are not more likely to have financial reforms they do have higher levels of liberalization.

The factors that drive reform, rather than the absolute level of financial liberalization are the focus of this project; however considering how these same factors influence the level of financial liberalization provides some additional insight into the reform process. In particular, the influence of both neoliberal training and right parties are important for both the likelihood of reform as well as the overall level of liberalization. The failure of any of the economic problem variables to have a significant impact presents an additional challenge to my theory of state-based financial liberalization.

The most significant conclusion to be drawn from this analysis is that both the presence of right party governments and a neoliberally trained Central Bank head have an important impact on the likelihood of financial reform occurring. While an
increased probability of 8% and 10% respectively does not sound very significant, these events are relatively rare and have a major impact in the places in which they occur.
4. CHINA

The simplest way to make sense of China’s financial and economic institutions is to begin with an understanding of these systems as they were designed prior to the institution of reforms in 1978. As was traditional in the planned economies of the Soviet Bloc, the central motivating principle behind the pervasive intervention of the Chinese Communist Party in the Chinese economy was to use planning and political mobilization to spur explosive growth in the economy (Naughton 2007, 56).

There are many lengthy treatises on the operation of Soviet style economies and of the pre-reform Chinese economy,¹ so I will provide only the briefest overview necessary to make sense of the operation of the modern Chinese economy. In order to foster the growth of heavy industry, the leaders of China’s Communist Party needed to acquire capital intensive machinery and the skilled labor capable of operating this machinery. The basic resources that they had on hand to acquire these were those produced by an impoverished and largely agrarian society. Therefore, the fundamental structure of the pre-reform Chinese economy consisted of a transfer from the agrarian sector to the industrial. This transfer not only allowed for the purchasing of equipment, but also provided for a subsidized lifestyle for industrial workers. Food prices were kept low and numerous social services were provided to industrial workers that were not made available to agricultural workers.

Essentially, pre-reform China operated as two linked but separate economies. The agrarian economy was forced to operate on as few resources as possible and prevented from competing with or otherwise impacting the industrial economy. The industrial economy was coddled and protected, receiving numerous subsidies and supports. By forcing down the prices of raw material inputs and subsidizing the cost of capital, industries that would not otherwise have been profitable could be sustained. This

¹Naughton (2007); Rawski (1999); Tsai (2007)
structure was naturally inimical to pricing driven by considerations of supply and demand, since the economy was expressly designed to prevent specialization in the labor-intensive mix of agriculture, light industry, and natural resource extraction to which China’s endowments would naturally have lent themselves. Therefore, like other planned economies China depended on a series of different quota based structures to determine the flow of goods and services (Naughton 2007, 56–62).

The financial system that made this economic structure possible ceded all control over decision making and existed as only a shadow of more traditional mixed public/private financial systems. The overall economic plan dictated the levels of prices and the flow of money between the state treasury, state owned enterprises, and other economic entities. Therefore the financial system primarily served to monitor the transmission of monetary flows, rather than as a center for decision making or intermediation. In comparison to the list of functions discussed earlier, it is clear that in pre-reform China the financial system existed in name only. Financial repression or restriction is the policy of limiting interest rates in order to subsidize capital and has been an important strategy associated with developmental states (Amsden 1992; Woo-Cummings 1999). The low cost of capital creates a huge demand for capital and the state selects among these the recipients which it feels are most likely to contribute to development. Opponents of this policy term it repression since it represents an indirect tax on savers, which is given to recipients of bank loans. Proponents highlight it as a solution to the traditional development difficulty of organizing capital and directing it at its most productive uses (Gerschenkron 1962; Pempel 1999).

There are a number of institutional requirements for states to use financial repression as part of a development strategy. States must have a revenue stream of sufficient size to support the subsidization of capital required to maintain a policy of financial repression. This can be financed either internationally or domestically, but requires that the capital allocations that the state makes are successful enough to stimulate the amount of government revenue needed to pay for the entire system. Interest on foreign loans can be an important limitation to the ability of states to maintain a
system of financial repression. Similarly, the state may be unable to attract domestic capital without paying higher interest rates which will threaten the viability of financial repression. Therefore extractive capacity of the state is important in determining whether financial repression will be stable. The success with which the state 'picks winners' will help to determine the strength of the economy from which the state will be extracting. The question of how effective the state is at 'picking winners' is at the center of the debate over financial repression.

In the face of clear empirical evidence that states can be both successful and unsuccessful in making these choices, a new trend in the literature is to focus on the success of states in identifying and cutting ties with losers. Kornai’s concept of the ‘Soft Budget Constraint’ faced by businesses in command economies, which can depend on the state to cover their defaults and the inefficiency that this breeds makes an important contribution to this literature (Kornai 1998). Opponents of financial repression have tended to view these kinds of moral hazards as the inevitable result of state involvement with financing, while others have pointed to the domestic politics and institutions of particular states as better explanations for differences in the ability of states to cut their losses (Pempel 1999, 173). The conclusion that moral hazard cannot be mediated tends to support arguments for the inherent desirability of liberalization, whereas if other institutional arrangements can limit these costs then liberalization is one choice in competition with other potential policy regimes.

Over time the existence of a soft budget constraint for certain businesses can have a highly perverse impact on the structure of certain sectors and the economy in general. The direct costs of propping up failing businesses can be less significant than these other indirect costs. Without the possibility of firm exit and bankruptcy, firms are encouraged to over-invest in production without considering whether a market exists for their goods.² Inexpensive capital combined with the implicit protection from bankruptcy encourages these firms to build large capital intensive factories (Huang 1999; Kornai et al. 2003). This is because of the potential for significant profits based

²Kornai et al. (2003, 1111–1112) discuss why high demand for inputs by firms with soft budget constraints may explain the use of rationing in formerly communist countries.
on economies of scale, which is not matched by a risk of default on loans. This is a classic example of moral hazard, where the reward is captured by the firm but the risk is felt by the state which will have to cover its losses if the gamble fails.

For firms that do not have the implicit backing of the state, competing with those that do is very difficult. While their competitors can operate at a loss for significant periods, firms with hard budget constraints must be far more cautious in their expansion strategies. This makes it difficult for them to capture market share and therefore firms with hard budget constraints are likely to seek out those areas of the economy which offer the most level playing field. This pushes them towards less capital intensive industries and gives those with soft budget constraints virtual monopolies over the capital intensive aspects of the market, which further reduces their incentives for efficiency.³

The softness of the budget constraint depends on the ability of the state to credibly refuse further support to a previous recipient of state aid. Aid can come in a variety of forms, but the ultimate impact on firm behavior is similar (Kornai et al. 2003, 1101-1104). Since the behavior of the firm operating under a soft budget constraint is the crucial factor, it is the beliefs of these firms about their likelihood of receiving aid which must be altered. States which can intervene in the economy, while still maintaining the credibility of their willingness to limit aid will face lower costs to efficiency from state intervention than those which cannot.

From this initial state, China definitively made the transition towards “reform”, meaning the increasing adoption of market forms as opposed to centralized state planning. However, unlike other transitional regimes this occurred without a change of political system and was accomplished gradually rather than in a dramatic ‘big bang’ style (Rawski 1999). This makes reform easy to identify broadly and in retrospect,

³Yasheng Huang describes the process through which State Owned Enterprises in the Chinese small appliance sector overinvested in production and where eventually driven out of the market by semi-private competitors who were able to secure financing from foreign sources. These private businesses had earlier been relegated to sectors with low capital requirements and unable to compete with the same SOEs they drove into bankruptcy once their budget constraints hardened (Huang 2003, 180–204).
but in real time it is difficult to determine if individual policy changes will be carried forward into a general program of reform. Reform is best thought of as a critical juncture in which a set of political and economic policies that were previously outside of the realm of possibility were made available. It also represents a shift in the conditions which were considered to be politically viable in China, i.e. the expectation that the state will provide significant and ongoing economic growth. To borrow a popular description of Chinese economic policy making, China after reform began to ‘cross the river by feeling the stones’. If those stones led in a market oriented direction, then that was acceptable as long as they led to the growth would get China across the river. Allowing growth to falter or turning back to pre-reform economic stagnation was no longer acceptable.

The crushing of pro-democracy demonstrators in Tienanmen Square in 1991 is another critical juncture in modern Chinese history. This set the bounds of political change that would be acceptable and also represented an important change in the types of economic policies that would be advocated going forward (Huang 2008). The pro-market policy changes began in 1978 created a boundary on policy, that henceforth policies promoting ongoing economic growth would be the new norm. The decision to suppress the protesters in 1991 created another boundary; that challenges to political stability would be suppressed and that economic changes which threatened this stability would not be accepted.

These three features, a starting point in a command economy, a commitment to pragmatic growth, and an insistence on political stability, provide the basis for understanding the unique challenges and conditions facing financial liberalization in China. As discussed earlier, the primary school of thought on financial liberalization is that it is driven by interest group demands. That groups, either domestic or international, who would benefit from changes in financial rules push for these changes. In order to consider this possibility, it is necessary to identify what these groups would look like in the Chinese context.
Initially, it is difficult to suggest that interest groups, distinct from the Chinese party-state existed. However, rejecting the interest group approach on this ground would be overly hasty. New interest groups were definitely unleashed by the beginning of the reform process (Tsai 2007). A process which by some of the loose standards by which ‘exogenous shocks’ are identified might be labeled as such. As I mentioned in my very brief discussion of the pre-reform organization of the Chinese economy, those most negatively impacted by the operation of China’s command economy were those stuck in the stagnant Chinese agricultural sector. Prevented from operating non-agricultural businesses, limited by quotas in the amount of agricultural production that they could undertake, and discouraged from even this level of production by low prices, rural China certainly benefited from the reform process (Rawski 2002). The explosion of productivity in agriculture and the quick development of the rural Town and Village Enterprises once reforms were adopted is a testament to the suppressed potential of this sector. Once economic activities for these groups were legalized, then certainly the demand for capital became a pressing concern. These concerns were not only a sectoral matter, but given the distribution of heavy industry geographically within China also created regional interests.

In addition to newly empowered groups within the Chinese countryside, the process of economic reforms created a new class of entrepreneurs devoted to exactly the types of light industry which had been banned by the pre-reform emphasis on heavy industry. Additionally, these new businesses tended to be increasingly linked into global supply chains and outward looking. This created a distinct business sector that lacked the favored status of the State Owned Enterprises which predated reform. Without state support and disciplined by participation in global markets, these businesses are far more nimble and competitive than their larger state supported brethren. The larger the role of the market as opposed to political connections in the allocation of capital, the more it will favor this class of businesses (Naughton 2007, 271–292).

A final interest group that has the potential to provide demand for financial liberalization, are the multinational corporations which have become increasingly involved
in the Chinese economy since the beginning of the reform era. The motivations for supporting financial liberalization by MNCs are multifaceted and depend on the specific nature of the MNC involved. Most heavily invested are the international financial institutions, who with greater financial liberalization will be able to compete with China’s weak domestic financial institutions. Greater state involvement directly benefits existing Chinese banks and other financial institutions which have existing relationships with crucial state actors (Naughton 2007, 454–460). In comparison, companies whose primary involvement in the Chinese economy is production for the export market have far less at stake. While restrictions on capital can limit their ability to raise funds within China, this is hardly crucial due to their access to global capital markets. One final group of foreign MNCs are those that are producing for China’s domestic market. For these businesses, the difficulty in raising capital is less significant of a concern than restrictions on the exchange rate harming domestic purchasing power. Additionally, to the extent that these businesses are competing with domestic firms that are receiving favored access to capital they share the burden of rigged competition with foreign financial firms.

While these interest groups might support the increasing liberalization of the financial system, there exist some important domestic actors that benefit from a less-liberalized financial system. The most prominent set of interests who might oppose liberalization are those State Owned Enterprises that benefit from preferred access to capital. While the amount of subsidization of the state owned sector has declined since the reform process began, there remains significant sectors of the economy whose existence depends on the ability to borrow at subsidized rates and to have their loans periodically forgiven by state owned banks. For these businesses increasing levels of liberalization represent a fundamental threat to their existence. Not only does liberalization increase their cost of capital and cut into their profits, but it would also enable their domestic and multinational competitors who are currently unable to compete in part because of the scale of operation their access to state capital provides. It is worth noting that SOEs as interest groups include workers as well as managers.
For many workers their jobs, pensions, health care, and other benefits are all tied up in the continuing survival of their companies.

The other set of interests that could potentially oppose greater liberalization are party officials and bankers who profit from their control over access to capital. Financial liberalization limits the discretion of these actors in allocating capital by forcing them to consider loan repayment and the profitability of the loan in making their decisions. Market discipline also makes the operation of financial institutions more transparent by creating measures of effectiveness that can be compared between officials and institutions. Depending on the specific structures of financial institutions at different points in the reform process, discretion over capital can be held by different types of officials. However, the essential factor is that the greater the level of discretion the greater the opportunity for these officials to extract personal rents and exchange favors.

The alternative to an interest-based theory financial liberalization, which I developed earlier, is that it is driven by concerns within the state. I have identified four primary areas of concern which tend to attract the attention of government officials; the exchange rate, funding of government debt, inflation, and the maintenance of growth within the economy. Concerns in each of these areas will look different within specific country contexts and I will therefore discuss how problems in each of these areas impact China.

The management of China’s exchange rate has caused a number of problems for the Chinese government as well as for the global economic system. In many ways, this issue demonstrates the extent to which domestic economic policy makers find themselves managing competing concerns whose implications generate the next set of problems with which they will then have to contend. During the pre-reform era China maintained an elevated exchange rate (Naughton 2007, 62–76). This is typical of command economies and those operating under an Import Substitution Industrialization regime. Since China had no interest in selling exports and wanted to purchase capital goods abroad, an overvalued currency fit the bill. However, with
the beginning of the reform era this logic shifted and maintaining a low relative exchange rate became a crucial component of Chinese economic policy. Post-reform China was an exporting powerhouse and therefore needed a low exchange rate to make its goods competitive internationally. Initially, the weak state of the Chinese economy made this an easy goal to achieve.

However, as China has grown to become the world’s second largest economy, international demand for Chinese currency has increased. China has responded by maintaining a closed capital account and limiting the ability of speculators to purchase renminbi. As with any currency peg that is suspected of being undervalued, speculators have continually attempted to find ways to hold assets valued in Chinese currency as a way to speculate that the exchange rate will increase and therefore increase the value of their assets. This creates pressure on the Chinese economy and complicates the operation of standard foreign direct investment processes.

In addition to limiting purchases of Chinese currency, China has responded by intervening in international markets to stimulate demand for competing currencies. These interventions have led China to hold massive amounts of assets denominated in Dollars and other foreign currencies. While this has helped to maintain China’s exchange rate at a reduced rate, it has the negative side effect of making China vulnerable to economic conditions in these other countries. Most famously, China has become increasingly sensitive to the risk that their Dollar denominated assets could drop in value precipitously if a major economic or political crisis were to strike the United States. The collapse of the US housing market in 2007–2008 for example had significant costs for the holders of US housing debt, including the Chinese government (Bell 2013, 216).

A final problem associated with the maintenance of an undervalued exchange rate for China is the political pressure placed upon them by their trade partners. Countries competing with Chinese exports bristle at a policy, which they see as negatively impacting their domestic economies. The political will to organize a significant response to Chinese currency policy has to this point been limited, but it has proved
to be a source of constant strain in Chinese economic foreign policy (Naughton 2007, 392–396).

In addition to the measures I have just discussed by which China maintains an undervalued exchange rate, China has also experimented sporadically with allowing greater exchange rate flexibility. The significance of these experiments have been debated by outside observers of Chinese economic policy, however their effect has been a real appreciation in the Chinese exchange rate over the last decade (Bell 2013, 210). This appreciation has been joined by frequent high level discussions of the benefits of moving towards an increasingly liberalized exchange rate as a means to harmonize the contradictions caused by the ongoing maintenance of an undervalued exchange rate (Bell 2013, 209–223).

For China, the funding of government debt represents a rather unique problem because unlike most other countries China operates with a capital surplus. This surplus is primarily related to the exchange rate manipulations discussed above. While it does not face difficulties raising funds for the government, China does face difficulties with the debt of many of the State Owned Enterprises that occupy key positions within the Chinese economy; utilities, oil and gas companies, heavy industries, crucial employers in particular regions. These companies comprise the vast majority of the Non-Performing Loan or NPL problem that routinely plagues the Chinese banking system.

By far the most widely discussed weakness of the Chinese financial system and particularly of the major commercial banks is the amount of non-performing loans or NPLs that they carry. NPLs are loans on which the principal or the interest is not being repaid. Different banks have different standards on the length of delinquency required to qualify as an NPL and there has been some concern that Chinese banks in particular are reluctant to identify NPLs (Allen et al. 2008, 522). There are two underlying causes of the high rate of NPLs in Chinese banks, which scholars have identified.
NPLs are frequently the result of lending decisions not made on the basis of the ability of the lendee to repay the loan, but are influenced by the policy preferences of the Chinese state. China’s banks were an important means through which Chinese leaders managed economic policy during the dual price transition away from a command economy (Naughton 2007, 453–454). By extending credit to state owned enterprises, the government could maintain employment and the social services which had traditionally been provided by these entities. Managers in these industries traditionally viewed these payments as fiscal transfers and were not motivated to repay these loans, which accordingly became NPLs. It is somewhat disingenuous to classify these transfers as NPLs, since the extent to which they were loans in the first place is questionable. While attempts have been made to limit this type of behavior, these kinds of transfers continue to occur particularly as local governments struggle to make up the differences between their expenditure requirements and the tax revenue that they are allotted by the central government (Wong and Bird 2008, 448).

The other source of NPLs are from loans that are given out with poor oversight on the capacity of the lendee to repay them. These loans are not necessarily related to particular policy goals or given to SOEs, however the professionalization of China’s banking sector has been a slow process. Given the low cost of credit, there is a high demand for capital which makes it difficult for a proper assessment to be made of the quality of the loans being given out. Additionally, there is much concern about the role of corruption in helping politically connected individuals to secure large loans with limited collateral and without clear plans of repayment (Sun 2004; Pei 2009).

Because the state is ultimately responsible for the resolution of the periodic NPL crises that develop, the management of these debt issues are a form of government funding problem that must be repeatedly addressed. There have been repeated calls for more professionalization of the lending process to limit the creation of NPLs and necessarily greater liberalization of the allocation of capital. If market forces underlie the granting of loans, then the rate of NPLs should be reduced to a manageable level. In the meantime, the usage of Asset Management Companies to resolve NPLs
without damaging the underlying banking system, has been adapted by the Chinese government from the United States’ Savings and Loan bailout experience (Naughton 2007, 460–468). This permits market forces to resolve these loans with minimal disruption to the economy.

As opposed to the relatively minor debt issues facing the Chinese state, inflation has been a consistent and dangerously destabilizing force in China for the last 40 years. Building on the discussion of inflation from earlier, China faces unique pressures because of its high growth rate. Booming economic growth leads to scarcity of both goods and labor as existing supplies of both are used up as factors of production. Rather than waiting for shortfalls to be overcome as production further down the supply chain ramps up, individual firms will tend to offer higher prices (wages) to compete over what are at the moment scarce resources. This drives up the overall price level as price increases are passed on to consumers. The phenomena is generally referred to as ‘overheating’ the economy. For China, with its decades of extremely high growth, this has been a consistent issue.

The traditional mechanism to prevent the economy from ‘overheating’ and particularly to keep inflation expectations from becoming entrenched is to restrict access to capital. If individual economic actors cannot borrow additional money, then they cannot bid up prices. Of course, restricting capital has a chilling effect on economic growth because goods that would otherwise have been produced cannot be. The reduction in capital access has to be managed carefully to avoid bankrupting over-leveraged firms and creating a destructive spiral within the economy. This means that fast growing economies face a delicate balancing act to maintain growth, while avoiding the resulting inflation.

As was discussed earlier, the typical management mechanism for access to capital in liberalized financial systems is the central bank’s interest rate. Higher interest rates raise the cost of capital and therefore reduce the amount of capital available to the economy. This one centralized decision ripples through the economy and allows financial intermediaries to make judgments about which individual companies
are most deserving or in need of additional capital. The reason that Central Bank Independence is such a key factor in the economic literature on controlling inflation is that in all states the chilling of economic growth to fight inflation is a politically unpopular action. Therefore, in states without an independent central bank the claim that they will fight inflation will not be credible.

The question of how China has been able to maintain its high rate of growth, while avoiding major problems with inflation is the subject of a major recent work by Shih (2009). Shih demonstrates that divisions within the party provide a mechanism similar to central bank independence in developed economies (Shih 2009, 47–63). Shih divides the factions within the party into two categories generalist and technocratic factions. Technocratic factions are made up of specialists in particular policy areas, “In the economic arena, the most important narrow faction is the central technocratic faction, typically led by cadres who have extensive experience in the central economic bureaucracy” (Shih 2009, 55). Generalist factions, in contrast, are made up of party members who take local leadership positions within specific provinces.

Because technocratic factions draw from some such a narrow base, they cannot challenge a generalist faction for the control of the party. This means that technocratic factions are not a direct threat to generalist factions, and therefore can be trusted to have control over the economy delegated to them. Control is delegated to the technocratic faction is delegated when generalist spending on political influence has sparked fears of inflation. Because the technocratic faction gains its authority from its role in limiting inflation, it can credibly commit in the same fashion as an independent central bank to maintaining low inflation (Shih 2009, 56–60). What neither type of faction is interested in, is reducing state control over the financial sector, “Although the Chinese leadership willingly liberalized other sectors of the economy, the enormous pool of savings in the banking sector made it an indispensable policy and political instrument” (Shih 2009, 191).

An additional complication for the use of macroeconomic controls is that because of financial repression interest rates are not an available mechanism to control inflation
and stimulate demand. This forces the government to rely on banks as a mechanism to increase or decrease the amount of money in the economy. This raises the risk that inefficient or non-performing loans will be made by banks focused on macroeconomic policy rather than the profitability of the loans under consideration. As a recent example, the use of bank lending to stimulate domestic growth in response to the 2007 global economic crisis has led to the announcement by the Chinese Banking Regulatory Commission that banks will be required to have greater reserves in order to cover potential losses from reckless lending.\footnote{Chinese banks’ capital adequacy ratios look high by comparison with the ratios at Western banks, many of which are struggling to meet an international standard of 8 percent. But the Chinese banks’ ratios are not necessarily directly comparable, bank analysts caution, because Chinese banks are sometimes slow to acknowledge that delinquent loans may not be collectible. A big worry among Chinese policy makers lies in whether Chinese banks have already lent too much to real estate developers for residential projects and to municipal and provincial government agencies for infrastructure projects” (Bradsher 2009).}

We will return to Shih’s distinction between technocratic and generalist factions later, however in a manner similar to the management of the exchange rate. China has tentatively and haltingly adopted more liberalized mechanisms to control the availability of capital. Returning to more crude and centrally controlled quota restrictions in moments of extremis, but continually experimenting with reserve requirements, inter-bank lending restrictions, and other more nuanced ways to limit access to capital as inflation rates became troubling. As discussed at the beginning of this chapter, explosive growth is one of the central tenants of postreform China and the other is the maintenance of political stability. Inflation control is therefore the central concern for the Chinese state in the operation of the Chinese financial system.

The final area of state concern for the financial system is the least direct, but in the Chinese context perhaps ultimately the most important. Since the adoption of economic reforms has removed Maoist ideology as a central unifying principle for governance, what remains is the commitment of the Chinese state to provide economic growth (Naughton 2007). As discussed earlier, the primary contribution of the financial system to economic growth is in the allocative efficiency of the financial system. If capital is routinely allocated to its best purpose, then the economy will
grow at a faster rate. This of course raises the question of how economic growth could be problematic for China, whose growth rate success is renowned. However, China’s growth must be considered in the context of the depressed state of its economy at the beginning of the reform era. Starting from a low level makes it much easier to demonstrate significant gains.

Assessing the record of China’s financial system in providing economic growth requires the consideration of both the low levels of initial development, as well as the level of inputs (both capital and labor) which have been marshaled by the Chinese economy. The ultimate question is what is the relative efficiency of capital allocation provided by the Chinese financial system? Buoyed by an abnormally high private savings rate and a less significant but still substantial amount of foreign investment, China has benefited from access to enormous amounts of capital. This capital has helped the Chinese economy to grow at historically high rates, but considering the amount of capital involved the return on investment has been relatively low (Young 2003).

Rather than following a developmental state strategy and picking winners, China has proven to be far more successful at picking losers. Capital is most available to those sectors of the economy which are the worst rather than the best performing (Shih 2009; Huang 2003; Pei 2009). The most productive sectors and particularly private enterprises are largely dependent on informal methods of finance, self-financing, or foreign direct investment. One conclusion to draw from comparing this fact with the historic growth of the Chinese economy is that efficiency is unimportant. This argument acknowledges that while it may have been inefficient, China’s growth validates the institutional structures which produced it.\(^5\) An alternative approach is

\(^5\)“With one of the largest and fastest growing economies in the world, China differs from most of the countries studied in the law, institutions, finance, and growth literature, and is an important counterexample to the existing findings: Its legal and financial systems as well as institutions are all underdeveloped, but its economy has been growing at a very fast rate. More importantly, the growth in the Private Sector, where applicable legal and financial mechanisms are arguably poorer than those in the State and Listed sectors, is much faster than that of the other sectors. The system of alternative mechanisms and institutions plays an important role in supporting the growth in the Private Sector, and they are good substitutes for standard corporate governance mechanisms and financing channels” (Allen et al. 2005, 99).
to consider that the conditions which made that institutional structure viable are not permanent and this seems to be the approach adopted, at least publicly, by the leadership of the Chinese Communist Party (Bergsten 2008).

Turning to the liberalization record of the Chinese financial system, Abiad et al. (2010) documents the transition of China’s financial system from an entirely repressed state (a score of 1 out of 21 in 1981) to a fairly liberalized one (a score of 10.25 out of 21 in 2005). China has shown significant improvements in almost every category tracked, though in no category are they fully liberalized. Looking beyond the quantitative measures developed by Abiad and Mody, dramatic changes in the financial system were required by the economic transformation undergone by the Chinese economy over this time period. Before a more in depth discussion of the liberalization process can be undertaken, I will describe China’s financial system.

China’s financial system is dominated by its banking sector. Banks are by far the most important financial intermediaries, while there exists a limited curb market and a growing number of non-bank financial institutions, they are far smaller than the banks and in particular the large commercial banks. The largest banks in China are the four major state owned banks that were formed during the process of economic reform. The banks were originally divided into functional specializations, but those distinctions have largely been removed. The Bank of China, the People’s Construction bank of China, the Agriculture Bank of China, and the Industrial and Commercial Bank of China are the major lenders in China. As of 2004 the total assets of all of the bank and non-bank financial intermediaries outside of these four was worth only 60% of the assets held by the big four (Allen et al. 2008, 532). There are a variety of other banks including rural and urban credit cooperatives as well as a growing number of foreign banks and joint ventures.

The equity and bond markets play a far less significant role in China’s financial system. China has two major domestic stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange. In comparison to the size and growth of the Chinese economy the growth of these markets has been relatively anemic (Allen et al.
2008, 535). Additionally there have been widespread allegations of insider trading and speculative behavior, which are supported by academic findings that suggest that the high correlations in the trading behavior of investors is the result of market inefficiencies (Morck et al. 2000). Additionally, corporate governance rules and a lack of minority shareholder protection have retarded the growth of these markets.

Listing on the stock market is largely seen by firms as a mechanism to raise capital, without the attendant market discipline and ownership rights that are traditionally associated with equity markets. The bond markets are similarly underdeveloped with a lack of bond rating and other regulations an important factor. Additionally, the overall low cost of capital from bank lending makes corporate bonds a relatively unattractive means of raising capital for private corporations. Those unable to attract bank loans, tend to raise money through self-financing and from the curb market (Allen et al. 2008, 540).

In many ways the current features of China’s financial system are the result of the course of its development during the reform era. Prior to the reform era, banks were the main way in which the central economic plan was administered. Banks coordinated capital flows between different sectors of the economy which allowed the plan to operate. In many ways, banks operated as adjuncts to the plan rather than as financial intermediaries. During the early parts of the reform process, between 1978 and 1993, banks began to operate as financial intermediaries and to have more concern about the return on their investments. They continued, however, to have important motivations for lending besides profit.⁶

During the reform era attempts were made to increase the number and types of financial intermediaries by allowing private and local institutions to develop. Local credit cooperatives were a popular mechanism to provide credit to local businesses (Naughton 2007, 237–238). These institutions remained fairly small and were hampered by their lack of capital reserves. When many of the township and village

⁶“During the period of 'reform without losers' (1978–1993), the banking system played the key role in buffering workers in inefficient firms from the consequences of increased competition” (Naughton 2007, 460).
enterprises that these cooperatives lent to failed in the late nineties, local lenders had difficulty absorbing these losses. Neither local collective nor private financial intermediaries developed sufficiently to alter the basic structure of the financial system.

The Chinese financial system therefore is dominated by its banking sector and that sector is dominated by the four main commercial banks. The importance of other financial intermediaries should not be discounted, especially since they are increasing in size and number, but for the foreseeable future these institutions will not be major players. Therefore a closer examination of the nature of state intervention in the main commercial banks will give a clearer indication of the impact of that intervention on China’s financial system.

There are a number of different mechanisms through which the Chinese state influences the major commercial banks. Many of these mechanisms are used by most states of significant size; reserve requirements, implied bankruptcy protection, regulatory oversight, etc. What is less common is the role of the Chinese state in directing capital towards businesses that are deemed to have important social value. Additionally, access to capital can be made conditional on unrelated business decisions made by firms. For example, a loan might be made available if a successful firm was willing to merge with a failing one and keep its employees from being released (Huang 2008). As mentioned earlier, the interest rate mechanism of monetary policy control is underdeveloped and therefore lending quotas are frequently used instead. During the economic downturn that struck globally as a result of the financial crisis of 2007, the Chinese state turned to the major commercial banks to provide economic stimulus. Unlike more typical fiscal stimulus that would have entailed increased government spending, the major Chinese Commercial Banks acted as agents of the state and enabled private spending by increased lending (Bell 2013, 178–208).

The ultimate structure of the Chinese financial system that results from this relationship is an overly concentrated banking sector that remains at the center of the operation of the Chinese economy despite attempts to reduce its importance. Experiments with local credit cooperatives, increased international cooperation, raising
capital through stock and bond issues, and the creation of private commercial banks have all been attempted or are ongoing. These have certainly increased the diversity of the Chinese financial system and brought more market forces to bear on financial decision making. However, when weighted by their relative size and importance within the economy, these liberalizing moves are relatively insignificant. Within the Big Four Banks there have been moves to increase lending standards and to adopt more market-oriented procedures for monitoring risk and pricing loans, which is reflected in the improvements in several of the components of Abiad and Mody’s financial liberalization score.

China’s status of partial financial liberalization leaves outside observers to debate the significance of the changes and what impact they have on the likelihood of future reforms. For the purposes of this study what is more important is what China’s reform process can illuminate about how states’ liberalize their financial systems. I will begin by considering the interest groups discussed earlier and what their experiences within the Chinese economy suggest about the likelihood that they had a decisive role in liberalizing the financial system.

The business climate across China for entrepreneurs varies strongly depending on the time period considered and the type of businesses involved. Two signs of this reality are the use of what Tsai (2007, 53) calls ‘wearing the red-hat’ and ‘round-trip capital’. ‘Wearing the red-hat’ involves private entrepreneurs registering their businesses as collective or state-owned industries. This was a particularly popular strategy in the early stages of development, when the party’s acceptance of market reforms was uncertain. Equivalently, ‘round-trip capital’ involved disguising private businesses as FDI-invested businesses by partnering with foreigners particularly in Hong Kong and Taiwan. In different ways money would be transferred by a Chinese entrepreneur to a foreign business; for example by undercharging for a foreign customer product. The extra profit would subsequently be lent back to the original company thereby making that company a recipient of foreign direct investment (Tsai 2007, 184–186). By disguising the fact that they are privately held businesses, these
business gained greater property rights and more favorable access to capital. The antipathy to entrepreneurs in particular localities depends strongly on the extent to which they are in competition with state owned industries for resources (Tsai 2007, 188–199). This reinforces the willingness of the party to sacrifice growth for political purposes. This hardly bodes well for the long term effect of state intervention on growth.

Yasheng Huang argues that the rise of anti-entrepreneurial polices are the result of a change in Chinese economic policy which followed the Tienanmen Massacre (Huang 2008, 169). Rather than the common interpretation that Chinese economic reform has gradually but consistently moved China towards privatization, Huang argues that in fact the Chinese economy was partially recentralized in the 1990s (Huang 2008, 171–172). Because of the party’s concern over the potential unrest of unleashing entrepreneurs following Tienanmen and its desire to direct investment at massive infrastructure projects and large scale SOEs, the regional and entrepreneurial businesses started in the 1980s were systematically starved of access to capital in the 1990s (Huang 2008, 213–215). The emphasis on growth primarily through state-directed investment in productive capacity has resulted in the declines in productivity discussed earlier, as well as drops in real household income, increasing health care costs and rising illiteracy.  

Property rights are a key example of an institution whose heterodox form was previously successful in supporting reform, but has become increasingly problematic in supporting reform. Rodrik specifically cites the effectiveness of the mixed property rights regime represented by China’s use of Township and Village Enterprises or TVEs to spur entrepreneurship (Rodrik 2008, 156). The separation of control and profit rights has become less successful over time. This is particularly evident with respect to the performance of China’s stock markets. Because the companies, especially those owned by the state, do not make a majority of their shares available for trade the stock

7“The investment/GDP ration in China increased substantially in the 1990s, from the 35 percent range in the 1980s to the 40 to 45 percent range in the 2000. China seems to have acquired a permanent addiction to new investments” (Huang 2008, 279).
markets cannot serve any function in corporate governance. Without shareholders to answer to, management is less concerned with maximizing profits and can fall prey to a host of principal-agent problems.

Property rights are also problematic in the banking sector, due to the heavy influence of state officials on lending patterns. Banks, especially the major commercial banks, operate under a soft budget constraint implicitly backed by the state’s promise of support in the case of shortfalls. They have been successful in attracting foreign investment through listing on foreign stock exchanges, but it is questionable whether this has resulted in institutional reforms since the holdings of foreign investors are limited. Control of the banking sector is ultimately exercised by the state in support of state initiatives. Bank managers and investors are entitled to profits from bank operations, but do not have any long term control over the institution. This limits their interest and ability to improve the return on the bank’s investments and retards the efficiency of the entire sector (Rawski 2002).

The success of the SOE sector at maintaining its access to capital at the expense of the new businesses that have developed since the reform era began suggests that the relative power between the two major domestic private interests impacted by financial liberalization is the reverse of what an interest group based liberalization would suggest. If new businesses are pushing the Chinese state to adopt more market-oriented financial structures, then they are managing to do so in a way that is benefiting the same businesses privileged under the previous system. This is particularly clear in the post-Tienanmen era when a number of non-financial policies that had been more supportive of entrepreneurs were reversed. Despite the problems caused for the government by the creation of NPLs directed at the SOE sector, this sector has maintained a privileged position even as liberalization has opened up more avenues for financing their operations.

The situation for financial institutions themselves is very similar to the position of non-financial firms. While newly formed private banks and even large international financial institutions are more nimble and effective than the major state owned banks,
the sheer size of these banks makes them very difficult to compete with. For domestic competitors the important size component is the amount of assets that these banks have available to them. Private Banks don’t have deep enough pockets to compete with their public brethren. An obvious solution for these Banks has been to seek partnerships with larger international financial institutions. These types of mergers are potentially very sensitive for the Chinese state, however, a number of mergers have been approved and enacted. For international banks, however, a different component of size has managed to limit their capacity to compete with the Big Four despite optimistic initial projections. Chinese state owned banks have a very dense network of branches spread throughout China, which makes it very difficult for international banks to compete with them either on their own or in partnership with private Chinese banks. Remedying this deficiency has been an ongoing process, but for now has prevented foreign financial institutions from cutting into the overwhelming position of the Big Four Banks.

From a policy-making perspective, access by foreign financial services firms to the Chinese market was an important issue in China’s WTO accession and clearly something that these firms pressured the Chinese government about both directly and through their home governments. This provides some evidence for the interest group theory of financial liberalization, however, I think the strength of this evidence is limited at best. The opening of China to these businesses has ultimately proven to be of limited value to them for reasons discussed above. Moreover, the Chinese state was able to set its own schedule for the adoption of the necessary reforms. If the opening to foreign competition was a sign of the strength of international interests over the liberalization process, then that strength has remained strangely limited to this particular issue. Further reforms that would have made it easier for foreign banks to expand and aided their ability to compete with the major commercial banks have not been forthcoming. Both the timing of the opening and the absence of follow-on reforms, suggests that foreign businesses lack the necessary clout to provide the impetus for financial liberalization.
Turning to the state owned financial sector and the financial bureaucracy, these seem to have been the ultimate victors of the financial liberalization process. While competition has been fostered, to some extent, with new financial entities. That competition has been limited and the overall power of the state over finance maintained. The essential impact of reforms has been to shift the exercise of state power into more market oriented forms. As discussed earlier, Victor Shih has explained the capacity of the Chinese State to control inflation without an independent Central Bank by developing his theory of the technocratic faction within Chinese politics (Shih 2009). Shih’s vision builds off of the long-running use of factional politics to explain outcomes within the Chinese State. However, Bell and Feng question the extent to which Shih’s signature distinction of the technocratic from the political can hold up (Bell 2013).

As Bell and Feng discuss, it is difficult to imagine a bureaucrat anywhere in the world who is entirely without political ambition, even if it is only for a larger budget for his agency. Moreover, even in states’ with strong central bank independence, the statements of the head of the central bank sends ripples through the political system. I join Bell and Feng in thinking that the role of bureaucratic actors in state owned banks and the financial bureaucracy is best envisaged simultaneously political and technocratic. The crucial factor is under what conditions do political or technocratic concerns prove to be dominant. Bell and Feng are suggest an answer through their quotation of an unnamed insider at the Chinese Central Bank as saying, “Western media usually analyze our policy making from the perspective of factions, and I noticed that some domestic media has media had started mimicking this in our country. To be frank, I don’t know how they make up the stories, but I do know that if inflation is out of control, no one can save our Governor Zhou [Xiaochuan], no matter who is his political support (kaoshan). No one can save him [laughs]. He will definitely have a hard time when briefing to Zhongnanhai” (Bell 2013, 129).

When issues of central state concern, such as inflation, are pressing is when the technocratic component of the bureaucracy comes to the fore. This matches with
the state-based financial liberalization theory outlined earlier. The major institution responsible for the management of the Chinese financial system is the People’s Bank of China. This institution has grown in importance and sophistication since the beginning of the reform period. It has consciously attempted to adopt practices from the Central Banks of other major economic powers, while remaining cognizant of the unique demands of China’s transitional economy and institutions (Bell 2013, 145–151). An important component of the growth of the PBC has been the development of its own educational institution. What originally began as the PBC’s graduate school in 1980 was merged with Tsinghua University and became the PBC School of Finance in 2012 (Bell 2013, 121). Since its inception, this school has attracted top talent from across China and provided the bank with employees with modern financial training. Students graduating from this program have also taken up key position in both private and state owned banks and many of the other components of the Chinese financial system. This provides the PBC with significant intellectual influence over the thinking of actors within the financial system.

In addition to training their own talent, the PBC has recruited U.S. trained economists. The current chief of the State Administration of Foreign Exchange, Deputy Director of the PBC’s Second Head Office in Shanghai, Director of the PBC’s Monetary Policy Department II, and the Director of the PBC’s International Department all received Ph.D.’s in the United States (Bell 2013, 122). While there has yet to be a U.S. trained economist as the head of the PBC, this brief listing is suggestive of the desire of the bank to attract American trained workers and their influence within the Bank. Given the type of training favored both in recruitment to the PBC and in the development of their own curriculum, the types of technocratic solutions favored by the PBC have been typically been in the direction of greater liberalization. Before discussing specific types of liberalizing reforms in more depth, it is important to note that while the reforms suggested have tended to move in a liberalizing direction they have been gradual. The PBC has not shown any interest in dramatic or sudden shifts
and their move from the bottom of Abiad and Mody’s financial liberalization scale to the middle has been accomplished in slow fits and starts.

A prime example of adopting liberalizing technocratic solutions is in the area of exchange rate management. China has had a thirty percent appreciation of its currency since 2005, which has not entirely assuaged the complaints of its economic competitors, but given the importance of exchange rate management for China represents a significant change. The willingness to allow China’s exchange rate to appreciate to reflect the relative fundamental strength of the Chinese economy required a consensus that took time to develop. The PBC was essential in convincing the Party Leadership that this change could be accomplished successfully and their primary weapon was a set of economic models that showed that appreciation was the only way out of the trap of increasing foreign reserves and incessant speculative currency pressure. In the face of these arguments, opponents were left to negotiate the speed with which these policies would change rather than whether they would change at all.

Developments in inflation control have followed a similar trend, with the PBC presenting liberalizing solutions to controlling inflation while maintaining growth and their opponents within the CCP limited to arguing about the pace at which these reforms will be adopted. Reformers within the PBC have been particularly effective at avoiding an ideological commitment to a particular pace of reform as well as being willing to accept short term compromises. This has allowed them to avoid having newly developing problems tied to their reform agenda and kept all possible policy options available to them in order to combat pressing concerns. In the area of inflation, this has meant that while the general trend has been to move away from the cruder mechanisms of state control, quotas on lending and direct party discipline, the PBC has been willing to return to these mechanisms in the face of worrying episodes of high inflation. Since the management of the problem rather than the mechanism through which the problem is managed is the primary concern for the state, the successful control of inflation has allowed the PBC to have significant latitude on the direction of reforms. Therefore despite temporary backsliding, the overall trend has
been to greater usage of reserve requirements, intra-bank lending rate manipulation, and interest rate targeting (Bell 2013, 267–298).

China’s experience of financial liberalization is intimately tied to their experience in economic reform more generally. Both of these processes have moved China from a centralized command economy to an imperfectly market oriented capitalist economy. The growth of the Chinese economy and the status of financial liberalization are both reflective of the backward state from which the Chinese economy began the reform process. However, financial liberalization was not inevitable and has not been uncontroversial. The pace and direction of financial liberalization has been determined by the concerns of actors within the Chinese state, particularly the People’s Bank of China. Liberalization has been motivated by the technocratic sense that the increasing use of market forces to determine the allocation of capital represented the best practice for the Chinese economy and that it would resolve many of the tensions and inconsistencies faced by the Chinese economy and those tasked with managing it. Uncoincidentally, the adoption of more liberalizing reforms has placed a premium on the types of training and knowledge that technocrats within the PBC and the government more generally already possess. As was discussed earlier although the state based financial liberalization model sees technocratic motivations as being central, it does not reject the rational self-interest of bureaucratic actors within the state. In this case, however the training and background of those within the PBC who are pushing for greater liberalization tells them that adopting these reforms is in their best interest.

While there is some partial evidence for the interest group model of financial liberalization, the realities of China’s political-economy makes it highly implausible. China certainly has experienced significant political and economic shocks during its period of economic reform. These types of shocks have also generated new interests of exactly the type that the interest group theory of liberalization paints as its main protagonists. However, with the partial exception of international financial firms, these new interests have been largely unsuccessful in pressuring the state to provide
them with accommodative policies. Rather, it has been the existing interests—those that the interest group theory of liberalization would see as opposing reforms—which have been most successful in gaining aid from the state. As I discussed earlier, the interest group approach to liberalization has tended to see the preferences of interest groups as too closely linked to particular policy options and underestimated the ability of accommodations for powerful interests to be made under a variety of policy regimes.

This can clearly be seen in the case of China, where the increasing use of market forces to allocate capital, has not impeded the state’s ability to tilt the playing field in support of State Owned Enterprises and other key economic interests. For both state actors outside of the key economic bureaucracies and stakeholders in incumbent firms, the specific structures through which economic policies are made are of less significance than the outcomes of those policies. For the PBC, however, the mechanisms by which economic policy is made are most definitely a key concern. For those responsible for operating this machinery, it is highly desirable that it work in the best possible fashion. Their jobs and advancement are dependent on the resolution of problems on whose outcomes the state and other interest groups have specific concerns. This creates a situation where bureaucratic actors have the motivation and the unique position to drive the adoption of policies of their choosing as long as they can fulfill the needs of their clients. Even more powerfully, these bureaucrats can explain how the outcomes that they provide are the best possible for their clients.

This can be seen in the management of inflation and the exchange rate within China. The PBC has managed to effect a significant appreciation of the renminbi, despite the unpopularity of this change with some sectors of the Chinese economy. The move to release control over the exchange rate to market forces was possible because it fulfilled the desires of other state actors to limit the problem of foreign reserve holdings. Because of their specialized knowledge bureaucrats within the PBC had the unique opportunity to determine for these different groups the ranges of possibilities and therefore influence their willingness to accept the reforms that were ultimately adopted.
Despite its limited initial lack of financial sophistication and the economic backwardness caused by the imposition of a big push command economy, an examination of China’s financial system shows strong support for the state based theory of financial liberalization. Examining the alternative interest group based theory demonstrates its unsuitability to explain the process by which China has reformed its financial structures. The state based theory of financial liberalization suggests a far more optimistic view of the future potential for financial reform in China and therefore for the continued growth of the Chinese economy. In fact an important future test for these two theories is whether China continues on the path to financial liberalization. As discussed in this chapter, the interest groups that would most strongly support further financial liberalization have had limited success in influencing economic policy making and therefore if it is interest groups that drive liberalization, then it is unlikely that financial liberalization will continue. On the other hand, if state actors are driving financial liberalization, then it is reasonable to expect that this process will continue into the future as new problems develop and market based solutions are proposed to resolve them.
5. FRANCE

In 1973, the earliest year where Abiad et al. (2010) quantify the degree to which financial systems are liberalized, France scores in the lower third of the possible amount of financial liberalization. By 1997 France had the highest possible degree of financial liberalization, matching countries like the United Kingdom and the United States. This dramatic transition occurred despite what Gualmini and Schmidt (2013) describe as a concerted ideological and political opposition to neoliberalism in French public discourse. During this time period there were Presidents and Prime Ministers representing parties of both the left and the right and no triumphant political movement or set of newly empowered interest groups with a strong enough commitment to market reforms to explain such a dramatic shift.

The French economy prior to the Second World War was characterized by the prevalence of small and mid-sized firms in its industries and agriculture’s relatively large share of the economy. The French state had consistently acted to shield its industries and financial intermediaries from foreign competition and therefore the need to develop the size and economies of scale necessary to compete with larger foreign firms. Following the war, the French economy and state was in ruins after the twin traumas of occupation and reconquest. This legacy motivated the institutional response of the French state as it reconstituted itself following the war and the structure of these post-war institutions have cast long shadows on the overall development of the French state and economy.

On the political side, the immediate response to the perceived failures of the French state was the creation, after significant debate and political struggle, the new constitution that instantiated the Fourth Republic. While the specific form of the new institutional structure was much debated, the failings of the Third Republic (weak executive, fragmented party system, and unstable political leadership) were
generally accepted (Gildea 2002, 37). Disagreement among the political parties, particularly resistance from the French Communist Party, limited the degree to which the executive was strengthened in the Fourth Republic (Gildea 2002, 39–41). Amid the crisis brought on by the Algerian War and at the urging of Charles de Gaulle, the constitution approved by the referendum on the 28th of September 1958 created the Fifth Republic which completed the strengthening of the executive begun with the creation of the Fourth Republic. The feature of this constitution which is of central importance for the manner in which financial liberalization occurred in France is the strengthening of the powers of the presidency, which served to split power between the office of the Prime Minister and the President. Because the President served terms of seven years, amended to a five year term (Gildea 2002, 240), this created the possibility of what came to be called “cohabitation” where a parliamentary election swept into power a Prime Minister from a different party than a sitting President.¹ The creation of a politically powerful Presidency created an ultimate prize over which French politicians could vie and therefore shaped the nature of French political contestation, particularly following the constitutional amendment that led to the direct election of the President in 1962 (Gildea 2002, 56).

Besides the evolving institutional structure of the French state, the other major feature of French politics that influenced the manner in which financial liberalization occurred is the historical development of party competition in France. The prominent position of the French Communist Party following the Second World War, buoyed by the role of Communists in the French Resistance, exacerbated the deep Left / Right divide in French Politics. The strength of the Communist Party made them challenging coalition partners for more moderate parties of the left. This split on the left kept the government in the hands of parties associated with the right and center for almost the entire period from the end of the war until the election of François

¹This occurred in 1986 with Socialist President François Mitterand and RPR Prime Minister Jacques Chirac, in 1993 again under President Mitterand with RPR Prime Minister Édouard Balladur and again in 1997 with President Chirac and Socialist Prime Minister Lionel Jospin (Gildea 2002, 218–221, 230, 232).
Mitterand in 1981. From this point forward the French Communist Party entered a slow but continual decline and control of the government alternated between the Socialists and center-right parties (Rassemblement pour la République and Union pour un Mouvement Populaire). Financial liberalization in France takes place during the heightened period of left/right confrontation surrounding the elevation of the Mitterand government and therefore provides an excellent opportunity to examine the role of party ideology in shaping financial reform. For France, however, it is important to note that Mitterand’s election to the presidency in 1981 represented not merely the regularized alternation of democratic politics, but an unprecedented shift whose meaning was very unclear to participants at the time. The long control of the right and center over the government also influenced the composition of the state bureaucracy.

The immediate challenge facing France following the Second World War was the reconstruction of its economy. A number of factors helped to ensure that this reconstruction would be state led. France’s long history as a strong state left the reconstituted state naturally inclined towards taking a leading role. In addition France’s failure in the face of the German threat made the reconstruction of the economy a question of national security. In the uncertain security environment following the war, French politicians needed to reconstitute the industries that would enable the French military to rearm themselves and help to ensure that France’s failure to defend herself would not be repeated. Finally, the United State’s provision of Marshall Plan aid gave the French state a ready mechanism by which to direct economic development. By determining which industries would receive financing and the amount of money that would be made available state bureaucrats were able to maintain tight control over how the economy developed. The threat of restricting finance also gave bureaucrats a convenient lever which could be used to force economic actors to comply with state directives. Interestingly the labor movement in France never gained the same strength as in other post-war European economies. The extent of corporatist
bargaining was always less in France with the state able to act more independently rather than depending on the cooperation of industrial and labor organizations.

The twin goals of post-war bureaucrats were the creation of large vibrant businesses that could compete internationally and a high degree of industrial growth that would give France an economic base for its long term national defense. In particular there was concern that France not lag behind Germany and repeat what was seen as the failures of the inter-war period. The institutional structures that were tasked with enacting these goals were the Planning Commission and the Ministry of Finance. Within the Ministry of Finance the Treasury acted as a state bank directing capital in accordance with governmental priorities (Quennouëlle-Corre 2005, 67). The Planning Commission itself lacked the institutional capacity to force either public firms, private firms, labor unions or other components of the bureaucracy to comply with the plan. The financial mechanism therefore became the primary way that compliance was enforced. Interestingly, France expanded the issuance of government bonds in the post-war period even as the United States and the United Kingdom demobilized state borrowing from its wartime prominence. Rather than being concerned about crowding out private investment, France created l’encadrement du credit which forced banks to hold reserves in government bonds. This limited the costs of state borrowing and essentially transferred control over private funds to the state.²

The dominant role of the state in providing subsidized capital to selected winners was central to the creation of what is still referred to as “Les Trente Glorieuses”: the thirty years of growth and prosperity between 1945 and 1975 during which France had the highest annual GDP growth rate among industrialized nations at 5.8% on average (Corbett 1994, 301). Ambitious programs were undertaken in the development of computer and nuclear power industries, as well as more prosaic success in the development of heavy industry and manufacturing. In addition to providing subsidized capital, French foreign policy was also focused on the negotiation of contracts

²Because banks were required to hold government bonds (lend to the state) this money was directed at what the state viewed as its most productive use rather than leaving this decision in the hands of private actors like bankers.
with developing nations for the products of French industry (aviation, construction, military technology). Following the 1973 oil crisis, the factors which had contributed to make this period so glorious began to unravel. Increasing energy costs drove up prices to a degree that subsidized capital could not offset and the increased cost of living provoked demands for higher wages which also drove up the cost of French products. To offset the flow of capital into oil producing nations the French state increasingly turned to subsidized exports to less developed nations: “infrastructural projects, turnkey plants, and weapons” (Smith 1998, 33). This dependency would come to haunt the French state once the oil boom in their client countries declined.

This post-war pattern created the French tradition of dirigisme or direction which characterized the French economy through the 1980s and continues to cast a shadow on the French political-economy to this day (Knapp and Wright 2006, 18–22). The system of dirigisme had important side effects on other aspects of the French economy particularly on the prevalence of inflation. Because the French state could direct capital to firms and industrial sectors they were an attractive source of solutions for firms that ran into difficulty. The nature of this difficulty could range from demands for higher wages to failed investments or greater foreign competition. Regardless of the specific cause, firms knew that inexpensive capital from the state was always a potential solution. This created what is known as a soft budget constraint, which creates an ever expanding demand for capital (Kornai et al. 2003). When the state increases the monetary base without a corresponding increase in the creation of real goods within the economy it generates a textbook scenario for the creation of inflation as more money chases the same amount of goods and therefore increases prices. The states’ reaction was to attempt to control the expansion of credit more strictly using quotas and more advanced planning, however the ability of firms to evade these restrictions created periodic bouts of inflation from the 1950s through the 1980s (Cohen 1995). While controlling the amount state largess created inflationary difficulties, those sectors of the economy that were not priorities for the state tended to languish.
The counterpart to the focus of the French state on heavy industry and manufacturing was the lack of attention paid to industries focused on creating consumer goods. The lack of easy access to capital, despite the fact that many of these industries were less capital intensive, meant that they were difficult to develop or expand under the dirigiste system. Under the plan this was an intended consequence, but it helped to ensure that firms of this type were entirely unable to compete with foreign firms. Competitiveness was also sapped by the planning process, since competing with businesses receiving state subsidized capital was a distinctly losing prospect. When the state seized the reigns through the planned allocation of capital it encouraged passivity from business. This passivity made it difficult for French firms to compete internationally when qualities besides the large scale made possible by state support were necessary. The influence of state planning on the structure of French industry helped to set up the conditions that ultimately caused major economic dislocation during the 1970s and 1980s (Smith 1998, 30–33). The limited competitiveness of French firms in many sectors of the economy and the inflationary pressure caused by the state’s provision of capital combined to create significant international problem’s for the French state.

Rising prices caused by inflation undercut the competitiveness of French firms, both in the export market and domestically. In order to compensate for the change in relative prices between France and its trading partners caused by the inflationary trends of the dirigiste state, French bureaucrats were forced to turn to devaluation as a solution (Knapp and Wright 2006, 459–467). However these devaluations created problems for France’s trading partners: transferring their inflationary troubles by increasing the relative price levels of Germany most importantly. Devaluations also made the France uncompetitive in attracting international finance, because of fear that any investment would ultimately have its value slashed as the value of the franc was unexpectedly reduced. The lack of international investment removed a potential alternative source of financing for firms that were not prioritized by the state. Capital controls were also necessary, though at the time these were fairly common, to
prevent speculative capital flows out of the country as pressure for devaluations built up. Finally, the periodic convulsions of inflation and devaluation made French companies potentially unreliable trade partners and a complicated theater of operation for multinational corporations.

At the same time that France’s dirigiste political-economy created difficulties for its neighbors and trade partners it also threatened a central French strategic priority: European integration. Just as the structure of the French state and economy were indicted by the defeat of 1940, the diplomacy of the inter-war period was another area of perceived failure. Integration with Europe generally and Germany in particular therefore became a central priority for the French state moving forward. This process started with economic integration beginning with the creation of the European Coal and Steel Community in 1951. Integration, however, demanded increased stability of exchange rates and greater trade and capital flows. The instability and lack of competitiveness caused by dirigisme created real headaches for integration which periodic negotiated currency adjustments could help to assuage but not resolve. This problem became even more acute following the United States’ abrogation of the Bretton Woods system in 1971. Without the United States’ willingness to absorb excess international demand the costs of adjustment became increasingly zero-sum between France and the very European countries with which it was trying to integrate.

The pattern of policymaking under dirigisme demonstrates the flexibility inherent to the use of finance as a policymaking tool. In particular the room for compensating economic interests that is opened up when state interests are less pressing. As Schmidt (1996, 107) points out, “Much depends upon the centrality of the policy to the government, the policy’s potential impact on the most affected interests, and these interests’ level of access, upset, and organization”. This environment made direct opposition to state initiatives less profitable than accommodations that shifted demands away from areas that conflicted with state priorities. If the state wanted capital directed at certain industrial sectors then rather than oppose those transfers business interests were better served by identifying how they might profit or how they
could make themselves attractive targets for governmental largess. The consequences for the development of those sectors of the economy not emphasized by the plan and for business competition more generally of policy made by directing financial resources has already been discussed.

Like many countries France’s financial system has always been dominated by its major banks and long term bank loans are the predominant form of business finance. This is a commonly observed result of limited protections for the property rights of minority shareholders (Gourevitch and Shinn 2005). The nationalization of major banks following the Second World War had limited effects on the structure of the nationalized banks, which were allowed to maintain their original internal structures and operating procedures. Over the years a variety of reforms shifted a number of large banks from state control to private-public partnerships and ultimately to totally private control. However, these distinctions are less significant than the extent of political control that the bureaucracy chooses to exercise, since even private banks can be brought to heel by the power of state regulation and control over funding. The dominance of the banking sector has not precluded the complementary operation of capital markets, however they play a purely secondary role.

The internal and external contradictions of France’s dirigiste economy became increasingly evident over the course of the 1970s. The death in office of President Georges Pompidou in 1974 disrupted the control of the government by conservative Gaullist parties and following the strategic decision of Chirac to support him in the first round of the election Valéry Giscard d’Estaing was able to unify the parties of the Right and narrowly defeat François Mitterand for the Presidency. Giscard d’Estaing’s election gives interesting evidence on the role of ideology in financial liberalization because unlike other Presidents of the period Giscard d’Estaing was openly committed to liberalization as a general principle(Prasad 2005, 369). This ideological commitment ultimately failed to bring about significant liberalization in finance or other sectors of the economy.
President Giscard d’Estaing and his Prime Minister Raymond Barre faced an econ-
omy still shaken by the 1973 Oil Crisis and with the weakness of many of many French
firms their avowed goals of forcing greater competition, reducing subsidies to unprof-
itable industries, and encouraging initiative by private business led to bankruptcies
and higher unemployment. These negative economic consequences limited the extent
to which such reforms were politically viable (Prasad 2005, 392–393). The unpopu-
larity of the cuts taking place in the private sector led the government to offset them
with the “politically generated continuation of subsidies plus symbolically important
investment in certain industries” (Prasad 2005, 393) all of which led to a quarter of
French workers being employed by the state. The total absence of institutional re-
forms in finance is also striking, since directed finance was the major source of state
control over the economy. Ultimately the neoliberal ideology of the government was
subsumed by the need to manage the declining economic conditions for the populace.3
The fact that Mitterand and the Socialists came within 425,000 votes of defeating
Giscard d’Estaing no doubt also limited the government’s appetite for risk.

The challenges facing the French system of dirigisme came to a head with the
election of a socialist government in 1981. The elevation of the Socialists to control
over the parliament unified control over the state under socialist President Fran¸cois
Mitterrand. Mitterrand’s initial policy solution was to move in the direction of greater
state control (Guyomarch 1999). The conversion of the socialists to support for
financial liberalization demonstrates how state based liberalization operates despite
the potential for ideological opposition. While the period from 1981–1983 would
see attempts to maintain ideologically consistent economic solutions to the country’s
problems, Mitterrand’s “tournant de la rigueur” of 1983 touched off a process of state-
based financial liberalization that continued with subsequent governments until the

3 “In practice, Giscard’s approach succumbed to the realities of domestic political pressure and the
second oil shock in 1979. Its consistent discourse notwithstanding, the government’s policies shifted
continuously and diverged increasingly from the philosophy itself. . . . Giscard’s strategy eventually
employed three incompatible elements: at the outset he tried market competition, then added rescue
operations for failing firms, and finally added to the first two a policy of betting on the strong. By
1981 the president’s industrial strategy was contradictory mélange” (Smith 1998, 34).
transformation of the French financial system described in the scores coded by Abiad et al. (2010). Unlike the earlier period under Giscard d’Estaing, in 1983 the key factors for the operation of state based liberalization were present: the perception by the political leadership of technical financial problems and the presence of neoliberal ideas within the bureaucracy.

The initial response of the socialist government would seem to validate the interest based approach to economic policy making. In 1981 the socialists rewarded their constituents raising the minimum wage, extending health benefits, and shortening the work week. This spurt of spending drove budget deficits to increase by more than 2% of GDP (Loriaux 1991, 216). When attempts to finance these deficits through additional borrowing failed the shortfall was made up by drawing down business finance which in addition to a stubborn bout of inflation dragged down French businesses. The end result of socialist largess was an expansion in imports as rising domestic prices and the failure of domestic businesses to expand to meet demand drove spending into foreign products. Changing course the government reduced taxes on business and offset this with an increase in consumption taxes. When this failed to provide sufficient stimulus to the economy and high inflation continued to erode consumer purchasing, the government turned to the standard solution and devalued the franc three times between 1981 and 1983. These devaluations ultimately failed to provide sufficient relief to reverse the trade imbalances sparked by the socialists initial spending spree.

The relationship between the political leadership and the financial system revealed in the opening phase of socialist leadership in France is also consistent with the predictions of the state based approach to financial liberalization. Mitterrand’s government considered the financial system only as an after thought and acted to assuage imbalances in the financial system caused by their actions only after their negative effects were readily apparent. The ability of business leaders to maintain their access to capital was the root source of the persistent inflation that plagued France during this time period, but despite the power wielded by these influential
business interests they were unable to direct the government’s policies. Political leaders were content to maintain pre-existing patterns of financial management rather than being ideologically committed to enacting financial reforms. The failure of these financial management techniques ultimately drove the political leadership to look for alternatives and it is in this search that the beliefs of the bureaucracy about the proper ways to manage the financial system would show the extent of their influence.

The sources of new ideas within the bureaucracy are four distinct clusters within the bureaucracy; the national statistical agencies, the research departments of state ministries, research departments within the prime minister’s office, and ministerial conseils (Campbell and Pedersen 2014). The National Institutes for Statistics and Economic Studies was originally created to assist the Planning Commission and came to dominate the creation of economic data and remains an important source of economic analysis in its own right. Ministerial research departments particularly the General Directorate of the Treasury and Economic Policy within the Ministry of Finance are another important source of economic ideas. Less tied to the traditional bureaucracy are the Council of Economic Analysis who are appointed by the Prime Minister and are brought in as experts from across the political spectrum to provide the executive with multiple perspectives. Finally ministerial conseils do independent policy analysis for individual ministries and exist outside of the bureaucracy and the political control of the party leadership. These research organs represent the unions and business interests impacted by their particular ministries policy initiatives in addition to the ministerial bureaucracy and this is reflected in their membership and policy orientation. These policy research organizations were tasked with resolving the policy contradictions at the heart of the French financial system in the 1980s.\footnote{Clift (2003) describes how neoliberalism as a “deconstructive project” impacted the influence of the Trésor and Banque de France.} Despite the importance of the French Grandes Écoles in the training of French bureaucrats, the neoliberal ideas dominant within academic economics in the United States infiltrated the training of the members of these research organs (Fourcade-
Gourinchas and Babb 2002, 565-567). It was from these neoliberal ideas that the set of policy reforms next attempted by Mitterrand and the socialists would come.\footnote{As Eric Helleiner points out in his description of the choices facing the socialist government, “The French choice also reflected the growing influence of neoliberal thinking. Delors and others in the French financial bureaucracy had become increasingly convinced of the need to make a policy shift, replacing Keynesian theories with a neoliberal focus on monetary discipline and market liberalization” Helleiner (1996, 143)}

Neoliberalism’s infiltration of ideational landscape of France began with growing influence of neoliberal economics in the French academy of the 1970s. Though neoliberal economics was not the only school of thought within the École Nationale d’Administration Kesler (1985) describes it as the dominant paradigm in that important source for future French bureaucrats by the 1970s. Prasad (2005, 375) describes a similar process occurring in the Sciences Po (Institut d’Études Politiques) singling out a quote by the influential economics Professor Jacques Rueff from Hatzfeld (1971) “If you aid the unemployed, you make durable a condition which would have been only temporary had you not intervened” (Prasad 2005, 375). Prasad (2005) coded doctoral theses in economics at the Sorbonne from 1976–1985 (the Sorbonne was selected for its anti-neoliberal reputation in order to provide a hard test) and found that 35.5% of these dissertations mentioned the extent to which the state should intervene in the economy in either their introduction, conclusion, or table of contents (Prasad 2005, 376–377). As Prasad (2005) demonstrates this shows the growing relevance of neoliberal ideas within the academy and importantly the institutions most strongly seen as feeding into the state bureaucracy had the reputation of being much more strongly influenced by neoliberal ideas. It is important to note, that Prasad (2005) is interested in neoliberalism in all areas of the economy rather than finance in particular, however the ultimate linkage between neoliberal ideas and financial liberalization can be seen in the statements of the political forces that convinced the first socialist President of the Fifth Republic to dismantle the financial infrastructure through which the French state had directed its economy since the Second World War.

The timing of President Mitterand’s conversion to financial liberalization combined economic and political considerations. The continuation of standard dirigiste
policymaking under President Giscard were masked by the liberalizing rhetoric adopted by his government. This led the Socialist government that came to power in 1981 to see the solution to France’s economic challenges as a re-commitment to and strengthening of dirigisme (Levy 1999, 43–46). The Socialist’s need to maintain peace with their coalition partners in the French Communist Party was another motivating factor. This re-commitment to investment in and modernization of existing industries as well as the direction of state finance into new and hopefully more productive sectors set the stage for the crisis that grew during 1982 and came to a head in 1983. The other political consideration facing President Mitterand was the electoral schedule: parliamentary elections in 1986 and presidential elections in 1988. The failure of their economic program, which had been the central electoral issue that brought about the historic transfer of power to the Socialists, became increasingly apparent. The fiscal limitations of the state ultimately forced President Mitterand into a trap that made a previously unthinkable turn towards neoliberal financial reforms not only necessary but desirable.

The limitations of the dirigiste system discussed earlier (inflation, limited competitiveness, international policy contradictions) only became worse as the Socialists ramped up the level of state involvement in the economy: both directed funding and outright nationalization of firms. The decision by many of France’s most important trade partners to turn to austerity in the early 1980s left France as the sole country adopting an expansionary policy. This left France with few potential customers for their expanded production. Jonah Levy describes how dire this problem became, “By 1983 a number of firms were so heavily subsidized that it would have been far cheaper for the government to pay workers not to produce. In shipbuilding, for example, it was estimated that each job paying 100,000 francs in annual wages cost the government 150,000 to 450,000 francs in subsidies” (Levy 1999, 48). The failure of French business to prosper had dire fiscal consequences for the French state as they were its primary investor. France’s current account position also suffered as subsidized wages were used to purchase foreign goods and the lack of offsetting exports
required significant and increasingly expensive external borrowing by the state (Story and Walter 1997, 194–195). The worsening external position of the French economy with inflation harming the competitiveness of French exports led to a showdown between politicians who argued for continuing the original Socialist program even if it required devaluation of the franc (leaving the European Monetary System’s fixed exchange rates), trade barriers to limit imports, and wage controls to stem inflation and politicians who advocated the abandonment of state controlled finance and the adoption of neoliberal reforms.

The most important supporters of neoliberal reforms were Finance Minister Jacques Delors, Prime Minister Pierre Mauroy, and Planning Minister Michel Rocard. These politicians argued that the government must fundamentally break out of the dirigiste pattern of inflation and devaluation (Smith 1998, 76–77). Neoliberal reforms offered a new policy that diagnosed the continuing problems of the French economy, but also promised that these problems could be overcome without the cost of harming France’s relationship with its trading partners and its long term project of European integration. Proponents of adopting autarkic policies to maintain state intervention or what came to be called “l’autre politique” included Research and Industry Minister Pierre Chevenèment Social Affairs Minister Bérégovoy, Budget Minister Laurent Fabius and the National Assembly President Louis Mermaz. Intensive lobbying by both sides was ultimately resolved with the conversion of Fabius to the neoliberal policy of “rigueur”. This convinced President Mitterand to send Delors to negotiate a devaluation of the Franc with the Deutsche mark of 8% that kept France within the European Monetary Stabilization agreement (Smith 1998, 78). This concession was predicated on the commitment of the French government to the adoption of policies that would reduce the budget deficit and inflation while maintaining their commitment to the free flow of trade.

This policy shift from ramped up dirigisme to neoliberal reforms and austerity from the first Socialist government of post-war France represented a massive and

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6 This period also saw the tightening of monetary policy in the United States forcing rates on France’s sovereign debt up in order to attract capital away from US Treasury Bonds.
jarring change of direction. The political calculation for President Mitterand was influenced by the timing of the parliamentary and presidential elections and the extremity of the alternatives that the two paths open to him offered. The proliferation of neoliberal ideas had an important effect in shifting how these alternatives were perceived. As will be discussed below, beliefs about the effectiveness and appropriateness of capital controls had already begun to shift. Additionally, the idea that inflation is a symptom of macroeconomic policy malpractice rather than being an inevitable side effect of policy that could be lived with and managed with periodic adjustments made a radical break with past policymaking more attractive. The political downside to “rigueur” was the same for Mitterand as it had been for Giscard (unemployment), however in the face of an already precarious economic environment and with a three year window between the beginning of reforms and the parliamentary elections Mitterand was willing to gamble that the worst consequences would have begun to dissipate and that the benefits of the new policies would allow him to be successful in the presidential elections. Essentially, a period of cohabitation with the right taking control of parliament in 1986 seemed inevitable by 1983 and therefore made the harsh medicine of “rigueur” more palatable (Levy 1999, 50–51).

The linkage between the system of directed finance and the persistent inflation that bedeviled the socialist government was pointed out in a report produced by the Credit Information and Study Center in 1983, “With the arrival of hard times, welfare credit ... grew in favor because it provided solutions to the problem of financing the welfare state by allocating short-term financial aid to this or that economic sector as needed. That very facility gave rise to the risk of excessive use. ... Welfare credit is a financial tranquilizer that becomes addictive if used too much. The symptoms of crisis are the same as in the case of the welfare state: each sector that benefits becomes a lobby that opposes any withdrawal of financial aid. Aid increases and uses up a growing proportion of resources ..., reducing the maneuvering room of the state and economic actors.” (Loriaux 1991, 236). This report clearly identified the source of the problem in the states’ control of capital and the difficulty that it faced
in restricting capital once aid had been extended. The first attempt to resolve this difficulty was to create alternative sources of finance by revamping the capacity of French capital markets.

In order to replace state influenced banks as a source of capital a renewed emphasis on capital markets began in 1983 with the creation of new savings instruments that allowed citizens to place their money outside of the system of state owned or manipulated banking. These new instruments were joined by the simplification of regulations for the creation of financial instruments by firms, particularly the issuance of stock. There was also the creation of a secondary market in unlisted securities to facilitate greater financial depth in these instruments. The creation of a new government under Laurent Fabius in 1984 brought in Pierre Béragovoy as the new Minister of Finance and further accelerated the reforms of capital markets. A brief list of the financial innovations promoted in the following years includes instruments for interest rate and currency hedging, a futures market, a fund for mortgage refinancing, and a fully reformed money market (Loriaux 1991, 224). The changes to the money market, particularly opening it directly to firms created competition for bank lending and broke the monopoly of the banking sector on short term financing. In addition to these reforms the specialization of individual banks in dealing with particular sectors and the restrictions which blocked banks from competing with each other across sectors came under attack. Finally, banks were encouraged to take on a more entrepreneurial role and seek out lending opportunities rather than waiting for the state to suggest targets for their capital. Many of these reforms had been suggested in government white papers stretching back to 1968, but were only finally enacted when the contradictions of the French financial system became severe.

Turning to the alternative explanations for this series of reforms, it is difficult to argue that the socialist government turned to financial liberalization as the result of pressure from the economic interests that formed their core constituency. The initial response to the elevation of the socialists in 1981 was a spending spree that closely matched these traditional constituencies. The change to a program of finan-
cial liberalization was not the result of a realignment within French political economy. The weakness rather than the strength of French business was the impetus for reform, which directly contradicts the interest based approach to financial liberalization. While these reforms placed competitive pressure on important and potentially influential financial intermediaries they also provided opportunities for expansion. Nothing in the political-economy of France in the early 1980s suggests a societal force sufficiently strong to generate the widespread set of reforms that were enacted. Policy diffusion arguments are potentially more convincing, since the 1980s was also a time when deregulation was adopted in the United States. The 1980s also saw the increasing importance international capital flows providing a potential structural impetus for policy diffusion. However, the disjointed manner in which reforms were adopted does not fit with the pattern suggested by the policy diffusion literature. Liberalization was adopted grudgingly as a last resort by the socialist government and the immediate payoffs from liberalization were limited. France also retained important idiosyncratic policies that contrasted with their neighbors and important trade partners (U.S., U.K., and Germany). If policy diffused it was a highly limited and heavily mutated diffusion.

Financial liberalization was intended to give the French state the room to solve the inflationary dilemma without fundamentally altering the operation of the French economy. This intention can be seen in the report of the financial commission of the Ninth Plan, “By progressively improving the structure of credit establishments, the institutional environment, and banking techniques, it will become possible to reduce the tensions and the perverse effects produced by conjunctural regulatory measures” (Loriaux 1991, 238). This desire to free up the regulatory power of the state resolves the contradiction of a socialist government reducing state control over the financial sector. The reforms initially adopted by the socialists in 1981 were their true goals and if financial liberalization would allow them to return to these goals rather than having to devote themselves to attempting to restraining inflation then it was a sacrifice worth making.
The contradictions within the French financial system had developed and worsened over time and simultaneously the devaluation coping mechanism had become less and less effective at resolving these contradictions. This situation placed French bureaucrats in the unenviable position of having no solution to worsening financial conditions. For the political leadership the means by which French business was financed was less significant than that they be free to enact their preferred policies. These policies far more directly benefited their economic constituencies than the manipulation of financial policy. It is important to note that right wing coalitions had been in power and controlled the presidency immediately preceding the elevation of the socialists. As was discussed earlier, even though right parties might be presumed to support financial liberalization for either ideological reasons or in support of business interests, they consistently failed to enact financial liberalization. As predicted by the state based theory of financial liberalization, the form of financial policymaking was not a central policy goal for parties of either persuasion. Other priorities, whether in foreign policy, controlling unemployment through the protection of domestic industries took precedence over the enactment of financial reforms.

The process of financial liberalization proceeded after the change in government in 1986 when Jacques Chirac became Prime Minister. Chirac moved quickly to use the newly liberalized financial markets to privatize nationally held banks and companies (Schmidt 1997, 231–233). Chirac’s political goal for his privatization policy was to demonstrate his effectiveness prior to the presidential elections in 1988 and to reverse the nationalizations undertaken by Mitterand in 1981 (Tuppen 1991, 176–200). The corporate reaction to the privatization process gives another example of the capacity for economic interests to adapt to changes in the regulation of the financial system. The privatization of firms prioritized employees both by discounting the share price offered to employees and by reserving to them as much as ten percent of shares. There were also limits on the number of shares that any individual could purchase, which was intended to ensure that share ownership did not become concentrated. The reaction of business interests to privatization was not to attempt to block the policy
change, but instead to use the restrictions on share ownership to create a system of cross-shareholding that retained control in the hands of management (Hall and Soskice 2001, 320-323). Unable to concentrate share ownership in their own hands, management within different firms purchased shares in each other's companies, which created a situation of cross-ownership where no individual or group could control enough shares to compete with management for control.

The ultimate result of privatization was to nominally increase the liberalization of the French economy while simultaneously maintaining the status quo for powerful economic interests. The primary interest of the political actors who pushed through the policy of privatization was the removal of these companies and banks from the states' balance sheet which was accomplished. As Jonah Levy describes, “The Privatizations were Gaullist in a partisan as well as an ideological sense. Party loyalists dominated the ranks of the noyaux durs assembled by Chirac and Balladur, and Gaullists were also placed at the helm of key companies just prior to privatization. Furthermore, thanks to the protections afforded by the system of interlocking directorates, the heads of the privatized companies were intended to be responsible, not so much to anonymous market forces, as to each other” (Levy 1999, 67). Despite the presumably greater ideological complimentarity between liberalization and the newly elected right wing government, liberalization ultimately shaped the way in which long standing political goals were achieved rather than disciplining political actors to forgo their own interests or reflecting a fundamental change in the structure of the economic interests in France. The ultimate result was exactly the type of non-conflictual compromised reform that state based financial liberalization envisions.

The privatization of important French firms under right governments such as TF1 the national television station and the major bank Société Générale in addition to the continued reduction in preferential state finance would seem to create a puzzle. Why were bureaucrats willing to cede control over important industries and why were influential firms unable to defend their financial benefits? As discussed earlier, the change in control over nationalized firms is vastly overstated if the manner in which
privatization was accomplished is ignored and the reduction in the states’ provision of capital was matched by compensating changes in fiscal policy. Socialist governments under Rocard, Cresson and Bérégovoy moved to a policy of fiscal austerity that was matched with compensating reductions in corporate taxation. Additionally, the restrictions on state largess could be targeted to shelter those firms most harshly impacted by changes in state policy. Therefore despite liberalizing policies that might seem to harm powerful economic interests, there remained significant opportunities for accommodation (Schmidt 1996). While it might seem contradictory for bureaucrats to want to reduce their sphere of influence, responsibility for supporting business was perceived as more burden than benefit.

The “tournant de la rigueur” adopted by Mitterrand had the ability to avoid reversing course of European integration as one of its central benefits, however integration continued to place pressure on the French state through the early 1990s. The increasing magnitudes of international capital flows and the progressive elimination of capital controls placed strong limitations on the independence of French monetary policy. One possible solution, floating exchange rates with European partners was rejected due to the harm it caused to inter-European trade and the overall project of European integration. Attempting to maintain exchange rates that were fixed in the medium term resulted in a series of speculative attacks by investors on the French franc. The European Monetary Stabilization agreement precluded devaluation of the franc, but as speculative attacks moved from peripheral economies such as Portugal and Spain to France the pressure to devalue became significant. While French political leaders tried to convince Germany to help support the franc by reducing interest rates to disincentivize capital outflows. The German leadership refused to accept the potential inflationary effects of this adjustment and ultimately European leaders were forced to widen the currency bands within which their currencies were allowed to fluctuate (Eichengreen 2008, 364–365). This episode demonstrated that the intermediate step of managing exchange rates was not sustainable and drove leaders to move further toward the adoption of a single currency.
In the face of another problem in their financial system, the same financial bureaucrats that had seen getting the state out of the business of directing capital as the solution to recurrent bouts of inflation, argued for further liberalization rather than the adoption of capital controls or other potential regulatory responses. Rawi Abdelal captures how attitudes within the policy establishment towards capital controls had shifted when he quotes Henri Chavranski a treasury official during Mitterand’s socialist government, “Our capital controls failed not in the sense that everyone was able to elude their grasp; they failed in the sense that those who were less well connected bore their burden most. We recognized, at last, that in an age of interdependence capital would find a way to free itself, and we were obliged to liberate the rest.” (Abdelal 2007, 58–59). The perception that capital controls were no longer appropriate in this case stems not from a change in the values of the Socialist Party, but rather a shift in technical beliefs about capital controls. Specifically, that they are ineffective and that they ultimately harmed the very groups that the Socialist Party had committed to protect. This shows the power of ideas to shift policy positions without affecting the fundamental interests that politicians are seeking to serve. To explain the Socialists abandonment of support for capital controls through a purely interest based paradigm would require there to be a dramatic shift in their political coalition. A shift in the ideational framework through which these issues were seen provides a far more parsimonious explanation for the shift. Therefore, when facing difficulties caused by capital flows further liberalization, as a stop-gap solution rather than as part of a greater program, was the only viable solution.

The problem of maintaining currency coordination in the face of speculative attacks created significant problems for French bureaucrats in the 1990s. The embarrassing series of exchange rate commitments and subsequent admissions of failure and devaluation harmed the reputation of the same bureaucrats who had managed the deconstruction of the dirigiste state apparatus. Capital controls were one possible solution, however adopting these controls would have directly contradicted the liber-

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7 Since none of the European states were willing to sacrifice their ability to manage their economies with monetary policy and help to cushion speculative attacks on their neighbors, one potential
alization of the capital markets which depended on the ability of international capital to compete within French markets. Additionally, as was discussed above, attitudes towards capital controls within the French economic bureaucracy had already irrevocably changed. Therefore the adoption of the single currency, though potentially difficult, provided a solution that allowed for the maintenance of financial liberalization without the economic dislocations caused by exchange rate fluctuations. This came despite the widespread unpopularity of the single currency and greater integration within member states including France. Currency unification progressed in the same manner as the financial liberalization of the 1980s, with an economic management problem empowering the bureaucracy to suggest reforms with which economic interests would have to accommodate themselves.

The next step in the progression of French financial liberalization was the granting of independence to the Bank of France in 1993. This transition from a dirigiste system of state controlled finance to an independent central bank took place within a decade of the beginning of financial liberalization under the socialist government in 1983. The adoption of central bank independence was motivated by the desire to prepare for greater economic and monetary integration under the European Union (Fourcade-Gourinchas and Babb 2002). Removing monetary policy from political control limited the ability of the state to expand the money supply at the expense of greater levels of inflation. It also gave the central bank the capacity to use contractionary monetary policy to offset fiscal policy in the event that it caused inflation. These restrictions placed significant limitations on the economic policymaking capacity of state bureaucrats. The economic interests that had the potential to be harmed by the inability of the state to provide discretionary finance were compensated by the resulting influx of foreign capital. The cross-holding arrangements of French firms ensured that they were protected from foreign mergers, which limited the downsides of foreign capital Culpepper (2010, 38–39). In addition, greater integration into the European economy opened new potential markets to these firms as well. Integration solution that the basic Mundell-Flemming trilemma would have suggested was the adoption of comprehensive capital controls.
also offered the promise that it would solve the problem of inflation transmission between European countries and the instability caused by currency fluctuations among France’s trade partners.

Another important source of accommodation between domestic business interests and state bureaucrats has been the shift of regulatory authority to Brussels under the European Union. While important industrial interests under the dirigiste state had privileged access to capital and state support, they also had to suffer under significant amounts of state interference with the operation of their businesses. The underlying goal of the post-war dirigiste state was to force economic actors to adopt practices that would not have been economically viable. The states’ desire for French firms to be large and internationally competitive led them to push firms to expand and to rationalize the organization of their sectors with their competitors. Therefore as the dirigiste state was dismantled both support and interference was retracted. Internationalization has helped to align the interests of state bureaucrats with those of the businesses they had previously regulated. As French businesses became increasingly independent and focused on lobbying Brussels they found themselves on the same side as French state bureaucrats for whom successful lobbying by French businesses now represented a win for the French state rather than meddling in their domain (Schmidt 1996). The large relative weight of France and French businesses within the European Union was also favorable to the interests of both bureaucrats and businesses. The primary sources of opposition to French membership in the European Union would ultimately come from labor unions and the general public rather than business. These groups were focused on labor market regulations, increased labor competition and the loss of sovereignty, with concerns over financial liberalization largely absent.

The influential French banking sector was another important potential source of opposition to the adoption of the Euro and greater economic integration. While many of the largest French banks were nominally nationalized during the post-war period and some as recently as the early 1990s, the ability of these financial intermediaries to limit state influence stemmed from their control over information and
their specialized skills rather than their ownership structure. Because the state relies on large commercial banks to perform the important tasks of financial intermediation, the banks have consistently been able to maintain their autonomy within the parameters defined by state priorities and regulations. Therefore the opening of the financial sector to foreign capital and competition might be expected to have drawn strong opposition from these influential actors. However, French banks have instead taken advantage of state assistance prior to the introduction of foreign competition to merge into some of the largest financial institutions in the world. This size has made French banks such as Société Général and Crédit Agricole dominant financial actors within Europe. Size increases have also given French banks, in contrast to the pre-1945 French financial sector, the scale necessary to compete at the international level. The extent of this involvement became unfortunately clear during the Global Financial Crisis in 2007 and 2008, when the exposure of French banks to troubled securities based on American mortgages was revealed. French banks have also been heavily implicated in the sovereign debt crises that have plagued peripheral European countries. For the French financial sector, financial liberalization and the admittance of foreign competition ultimately failed to generate the competition and pressure on profits that academic proponents of liberalization envisioned. Rather French financial firms were able to adjust their operations to take advantage of the changes in the institutional structure and were aided in doing so by state bureaucrats. This helps to explain the relatively tranquil acceptance of such sweeping economic reforms.

France has seen massive changes in the organization of its financial system over the last forty years. It has moved from being a persistent champion for state intervention in the financial sector to the total liberalization of its financial system.

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8Story and Walter include a lengthy discussion of how the career of Jean-Yves Haberer as Chairman of the state owned French bank Crédit Lyonnais from 1988–1996 showed the alignment between business and the state in anticipation of the opportunities represented by European integration (Story and Walter 1997, 198–210). With the support of the French state Haberer went on a wild buying spree across Europe intended to give Crédit Lyonnais the size necessary to make it a dominant player in a unified Europe. In this instance the entire scheme ended in criminal investigations and recriminations about massive incompetence. However, the perception of the possibilities for collaboration between economic interests and the state at the expense of foreign competitors created by integration was a general phenomenon that helped to limit backlash over financial reforms.
During this same time period there has been significant political contestation with country-wide riots and strikes in 1968, the transition from the Fourth to the Fifth Republic, and multiple transitions between left and right party governmental control. Despite this history of partisan conflict, the transition to financial liberalism has been fairly smooth. There have been periodic pauses in liberalization, but no reversals. A process that was begun in desperation by a socialist government has been continued through multiple changes in governments and has ultimately seen significant delegations of economic and financial decision-making authority to a supranational body. In addition to political forces, France has had throughout this time period strongly organized interest groups, whose ability to lobby and influence state decisions was implicated in the inflation difficulties created by state direction of finance. The large banks that dominate the French financial sector, rather than losing authority in the face of periodic nationalizations have maintained their control, but nevertheless external financing mechanisms and capital markets have grown and flourished.

France contains all of the causal factors that lie at the heart of the interest based approach to financial liberalization. At the beginning of the liberalization process in 1983 there were numerous economic interests who benefited from the maintenance of the status quo policy arrangement. These were organized and sophisticated economic actors which should be as capable as any set of economic interests of identifying and defending their interests. The extent of their influence can be seen in inflationary results of the inability of the French state to effectively limit their access to capital. The French state has a reputation for being strong, for limiting the influence of interests, however France is a democracy and with political power shifting consistently between parties over this time frame the potential for interests to influence policymaking was certainly there. This potential can be clearly seen in the fiscal policymaking of parties of both the left and right. Socialist governments consistently directed state benefits towards their constituents, while right party governments cut corporate taxes and limited social spending. The responsiveness of political leaders to their constituencies did not translate into the area of financial policymaking. While there were a number
of political and economic crises before and after the process of liberalization began, it is difficult to link these crises to shifts in policy or to changes in influence among economic interests.

What was tightly linked to changes in policymaking, at least in the minds of the policymakers were the problems of inflation and devaluation. As the spending spree undertaken by Mitterrand’s socialist government in 1981 and its unforeseen consequences demonstrates, political leaders are only indirectly tied into the intricacies of the financial system. The main goals of the political leadership dominate their focus and unless the financial system manages to interfere with these goals it does not gain political salience. The privatization drive undertaken by Chirac’s government in 1986 is another example of a partisan policy priority that though it implemented a degree of financial liberalization (by privatizing a number of major banks) was ultimately directed towards other goals. For political leaders like Mitterrand, Chirac, and Rocard the financial system was a source of constraint and opportunity for their policy goals in other areas. Presented by bureaucrats as a way for political leaders to free themselves from constraints caused by the dirigiste system of directed finance, liberalization was a means rather than an end. For economic interests and political leaders financial liberalization was a source of disruption, but one to which they could accommodate themselves. This is particularly clear in the case of Mitterrand since liberalization violated his ideological commitments and was only adopted because the neoliberal ideas advanced by members of his cabinet offered a more promising set of outcomes than traditional dirigiste responses.

French financial liberalization’s roots can be traced back to ideas developed by neoclassical economics and adopted into a general neoliberal critique of state intervention. As these ideas filtered from the academy into the bureaucracy they awaited their moment to be brought forward. This approach to finance can be traced back to neoliberal economists who championed the effectiveness of bond and equity backed corporate finance and financial markets on which these could be traded (Fourcade-Gourinchas and Babb 2002). The subsequent deepening of these reforms served to
resolve the imbalances within the French financial system that bureaucrats would otherwise have had to try and resolve using other mechanisms. For politicians in particular, the turn to a new set of policy tools that offered the hope of a break from the stubborn pattern of inflation and devaluation was a source of relief.\textsuperscript{9} The ability to compensate influential economic interests directly harmed by liberalization while maintaining the structure of these reforms matches the predictions of the state based approach to financial liberalization I developed earlier, as does the central role of state bureaucrats and more importantly their technical concerns over the management of the financial system.

Ideas about the desirability of European integration have deeper roots within the French bureaucracy than neoliberal economics, however economic integration and the adoption of the Euro ultimately served to strengthen financial liberalization. The desirability of monetary union in particular stemmed from its ability to eliminate persistent exchange rate difficulties that had come to bedevil financial bureaucrats. Just as economic interests were compensated during the initial phases of financial liberalization, French banks and industries that faced new sources of competition as France integrated itself into the European Union were prepared for and protected from these challenges. The process of integration proceeded in a top down fashion with the concerns of government leaders and bureaucrats dominating. Despite concerns from academic economists about the long term viability of the Euro project (concerns whose validity have been demonstrated in the string of sovereign debt crises that have racked the euro-zone from 2007 to 2014) the ability of the Euro to resolve the immediate problems of financial bureaucrats without overturning the general trend toward liberalization helped to drive forward this process of reform.

\textsuperscript{9}Abdelal (2007) quotes Jonah Levy describing the motivation of prominent Socialist politicians for adopting a neoliberal agenda, “Fabius, Bérégovoy, and others like them had multiple motivations in adopting a liberal agenda. At one level, they underwent a genuine conversion. The shift in their positions derived from more than learning, however. For Fabius and Bérégovoy, the embrace of the market offered an appealing political identity, a “modern,” “competent,” profile, in contrast to the “archaic” and excessively “ideological” image of a Chevenèment or a Georges Marchais” (Levy 1999, 51)
France’s experience with financial liberalization matches the predictions made by the state based approach to financial liberalization. The centrality of the bureaucracy as opposed to interest groups outside the state in the reform process as well as the halting forward progress of the reforms themselves far more closely match the predictions of the state based approach to financial liberalization than the interest group based approach. While the role of neoliberal ideas in motivating reforms does suggest a role for policy diffusion, it is diffusion through the state bureaucracy conditioned on the needs of the political leadership. If the ideas themselves or even the conditions to promote them were the dominant factor, then the reforms adopted would have encouraged the disruptive competition that is intended give liberalization its societal benefits. Instead France has experienced a limited and compromised financial liberalization that has been manipulated to limit societal disruptions while maintaining its essential structural form. This process is at the heart of state based financial liberalization which rather than depending on ideological purity has the practical concerns of the political leadership as its primary motivating principle.
6. CONCLUSION

At its heart state based financial liberalization is a call for a re-examination of a set of longstanding standard assumptions in the study of political economy. Because political economy and in particular international political economy has tended to focus on areas of economic policymaking that are highly contentious and politically salient this has mad it hard to identify the supporting conditions that made the types of political behavior that are common to these areas of economic policymaking possible. It has instead been common to generalize from these areas of economic policymaking into all forms of political economy. The key unspoken assumption is not that common target of constructivist scholars that preferences are exogenous, but a related but ultimately more problematic assumption: that preferences are over policy. The assumption that individual policies are so tightly bound to economic outcomes over which political actors have preferences, that the actual preferences themselves can be ignored has generated an overstated status quo bias among both political and economic actors. This status quo bias, one based in firmly held self-interest rather than in norm adherence or limits to cognition, has driven scholars to emphasize the role of crises and upheaval in the process of economic reforms in a manner that does not remotely fit the empirical record.

Finance by its very nature exists at the opposite extreme from an issue area such as trade. Financial reforms are frequently leaps into the ether about which there is very little certainty rather than well trod distributional conflicts. The floating exchange rate, for example, which was seen as a disastrous and inherently unstable experiment until it was adopted by the United States and the majority of the developed economies during the 1970s has become in retrospect unremarkable and perfectly respectable. The adoption of the Euro was a lengthy process requiring negotiation among numerous sovereign governments and provoking significant study and analysis. Despite
this lengthy period of preparation the effects and long term prospects of European monetary union continue to be debated and remain uncertain. Even a much humbler financial innovation like the collateralized debt obligation for U.S. home mortgages has had a massive impact on the global economy that its creators could not have hoped to predict. While previous research has attempted to wrangle finance into a limited scope designed to make it more amenable to standard political economy analysis, the analyses of capital account opening or exchange rate regimes produced by this approach give an inherently stilted view of the process of financial policymaking. Importantly, these analyses frequently generate cross-national quantitative research that cannot be matched up with any individual country’s experience.

Just as my theory of state based financial liberalization argues for a recentralization of economic motivations (profits, employment, contracts, market share, wages, etc.) as more central motivators of economic actors than specific policies, it also argues for political motivations (electoral victory, advancement in the party hierarchy, prevention of civil unrest, maintaining a stable economy) to be at the heart of politicians’ motivations. Recognizing that economic actors have preferences over outcomes rather than policies removes an important tie binding politicians and parties to link their preferences to policies because they can be flexible in how they satisfy important economic interests. The final possible source of linkage is political ideology and though this might seem to be insurmountable, the case studies in this dissertation of the adoption of market forces and rhetoric by the French Socialist Party and the Chinese Communist Party put the lie to this idea. While it has long been recognized that measuring party ideology with crude left/right divisions has limited the power of quantitative studies to find links between ideology and reform, I think the assumption that ideology is not flexible enough to adopt itself to policies that have been considered anathema in the past is the larger reason that these studies given more conclusive results. Politicians are motivated by political success and though this banal generality does not give much substance around which to understand political behavior, it is a better guide (when filled in with the particular features of
a specific time and place) to predict the behavior of political actors than the idea that on average politicians will sacrifice themselves for their principles. Accommodation and negotiation between both political and economic forces are far more likely than a standard clashing-of-interests approach to political economy would suggest. This type of behavior is harder to observe than crushing swings in political and economic fortunes, but necessarily constitutes a far greater percentage of people’s lived experience.

The flexibility of politicians and interests in the face of policy alternatives is not unlimited and in those areas of economic policymaking where flexibility is limited policymaking is more likely to follow a conflictual model. Even in these areas of policymaking opportunities for flexibility, compensation, and negotiation will arise that help to weaken how strongly committed to particular policy positions at least some members of economic and political interest groups will be. Diversity among economic interests has only been introduced in the past through increasing the complexity of the economic model used to assign preferences. Greater complexity in a trade model, for example, allowed for labor interests to be divided by economic sector. This greater complexity is not true flexibility as envisioned by the state-based model that I have developed in this dissertation. Flexibility would involve targeted subsidies to mollify a section of labor interests harmed by the adoption of a new policy. There are an almost unlimited set of mechanisms through which this kind of compensatory policymaking could be accomplished. Policymakers therefore have significant leeway in negotiating the specific nature of the policies that they will suggest, rather than being forced into narrow channels with well defined losers and winners.

Taken to an extreme the approach described in this dissertation would suggest that policymakers create no losers when they adopt new policies. Certainly this is not the case, but unlike other approaches to political economy I argue that the makeup of the losers is not determined externally to the policymakers themselves. This fundamentally alters some of the normative attitudes taken towards policy changes. As has been seen in both the Chinese and French cases of financial liberalization, reforms
undertaken in this mediated and compensated fashion are far less sweeping than the champions of liberalization might assume. State influence over the economy has not been eradicated and the ability of powerful economic interests to acquire benefits has not been reduced by the adoption of market based mechanisms of finance. Instead, influence operates through a different set of mechanisms. The flexibility of policymaking and the diverse set of compensatory options available to the state means that the discipline and rigor which cheerleaders for reform expect it to bring are unlikely to occur. Ultimately, political actors will adopt reforms when they seem likely to help them to survive and only accept economic consequences that harm their chances of survival under a very specific set of circumstances.

The decision faced by the French President François Mitterand in 1983 is an archetypal example of the unique set of conditions under which a political leader will knowingly allow economically costly and politically risky reforms. Mitterand faced a deteriorating economy which was already placing him in a precarious political situation. He also knew that his term of office gave him a limited window wherein he could weather negative economic conditions as long as he could demonstrate positive results after this downturn. From a certain perspective it might be possible to see this decision as a political actor forced by economic conditions to sacrifice their agenda and Mitterand found himself in 1983 making policies far from what he would have preferred, however Mitterand’s ultimate agenda was to maintain himself and his party in power and with the brief hiccup of cohabitation he was successful. Even from an ideological perspective Mitterand’s goals for the working class or strengthening France need not be sacrificed and by remaining in power Mitterand has the opportunity to pursue these goals within a new context. These types of extreme conditions are not the norm and typically politicians will not undertake reforms that are as costly or dramatic as those Mitterand undertook. Much more typical are the privatizations undertaken by Prime Minister Chirac in 1986: ideologically consistent, limited in their scope, and designed to prevent harm to powerful interests. While standard approaches to political economy might be able to account for Mitterand’s reforms
if they can isolate an economic condition which shifts quickly enough to represent an exogenous shock, they cannot account for Chirac’s reforms. They also cannot account for the absence of policy reversals that should occur when economic fortunes turn against the coalition that benefits from financial liberalization.

My approach to political economy places ideas in their typical role as determining what actors believe the outcomes of their actions will be. The ideational consensus within the academy about how finance works during the last forty years is what explains the dominance of liberalization during this period. The empirical record of states who undertake liberalizing reforms, as was discussed earlier, is highly mixed, however the belief in the desirability of the liberalized end state is unchallenged within the academy. Debate over the proper sequence of reforms or the necessary complementary conditions under which liberalization should be undertaken does not shift the consensus that it is desirable and importantly the consensus on the negative consequences associated with state intervention in finance. Within the state the holder of these ideas is the financial bureaucracy and typically the central bank an institution whose very ubiquity is a testament to the power of ideas in this area of economic policymaking.¹ The role of ideas is another area where the focus of this dissertation on finance allowed for a simplified view of what I believe to be a more general phenomenon: the independent (non-instrumental) power of ideas.

Financial expertise as opposed to other areas of policymaking tends to be isolated from public debate. By focusing on finance, I am able to avoid having to develop a theory of how specialized knowledge gets converted into more generally held sets of beliefs. Much has been made for example about what is known as the “household analogy” in fiscal policymaking and how the public’s understanding of public budgeting as analogous to their own household budget influences the types of fiscal policymaking that are possible. Economic ideas developed within the academy

¹Nearly every state examined had an institution identified as the “central bank” despite the great diversity of parliaments, executives, and judiciaries. The specific responsibilities and formal structure of these banks varies dramatically, however they represent a center of specialized expertise and influence even in states with only limited control over their own monetary policy.
have played an important part in influencing ideas about the relationship between taxation and growth or the minimum wage and labor supply, however these ideas are processed through a public and partisan debate process from which finance is typically sheltered. Since public debate over these types of ideas is often motivated by economic and political interests and developing an ex ante basis for which ideas will be accepted or rejected is difficult, avoiding this component of economic policymaking makes it much simpler to view the independent role of ideas divorced from most motivated reasoning. Bureaucrats within the financial bureaucracy do have an interest in elevating the importance of their own expertise, however this motivation is agnostic as to the particular set of ideas held by the bureaucracy.

The reforms suggested to the Chinese government by bureaucrats within the People’s Bank of China have had the effect of both empowering that institution as well as moving China towards a more liberalized exchange rate regime. By linking together the problem of inflation and exchange rate management, the People’s Bank forced the government to chose between these goals and tilted their choice towards the liberalization of the exchange rate even though its appreciation harmed the export goals of the government. If bureaucrats have the autonomy to impress their ideas on political actors, what keeps them from simply twisting this power to benefit themselves instrumentally? The ultimate responsibility that these bureaucrats have to the successful operation of the financial system and the economy holds them to ideas that they believe to be effective. Because political power is not held directly by the bureaucracy they can only control policy to the extent that they are able to successfully serve politicians. As has already been discussed and can be seen in any recent assessment of economic policymaking made by a neoliberal economist, politicians fall short in their reforms from the doctrinaire suggestions of neoliberal economics. They do so because they are unwilling to sacrifice their political survival on the altar of ideological purity. The usage of economic ideas by political forces is limited to situations in which they feel that the ideas serve their interests.
The quantitative analysis in this dissertation shows that, even measured in a mediated manner, neoliberal economic ideas play a central role in motivating financial liberalization. Even though measuring ideas is challenging because these ideas have been so consistently directed towards greater degrees of liberalization they are a more consistent force than the economic and political forces that are also involved in economic policymaking. The two political-economies considered in depth in this dissertation show some of the problems in attempting to identified these forces cross-nationally. While in both France and China inflation concerns played a role in motivating political leaders to turn to bureaucrats for answers, the other features of their political-economy are so different that they make generalizations between these two cases difficult. France’s post-war evolution towards European integration, the position of the socialist party within France, and the manner in which French business evolved during post-war reconstruction are all features that uniquely shape the timing and manner in which liberalization occurred in France. China has its own trajectory determined by its particular historical experience and the reform project of the Chinese Communist Party. These outside conditions shape the timing and specific manner in which liberalization occurred in each country. Despite all of the differences between these countries in region, history, economy, and development, the similarities in their evolution reinforces the findings of the quantitative analysis.

Though neither of these countries had Central Bank Presidents that received a doctorate in economics or finance from an English or American university, the neoliberal ideas that such an education would have provided infiltrated both countries at lower levels of their economic bureaucracy. Though reform occurred later in China this is simply a reflection of their later opening to outside ideas and economic reform. Neither country could be considered a natural incubator for such ideas and certainly other ideologies were represented with Communist Parties influential in both countries, though clearly more important in China. For both countries managing the problems of macroeconomic management while maintaining openness with the outside world created problems that required solutions that neoliberal economics offered.
Beyond simply providing solutions, neoliberal economics also defined for both countries the nature of the problems that they were facing. Both countries created stock markets and elevated their importance during the time period considered in this dissertation as well as opening themselves to foreign capital flows. For both countries business competition was a problematic goal with governments attempting to strengthen the competitiveness of domestic firms without risking their potential failure. Exchange rates proved problematic for both France and China because of their impact on foreign economic relations and the potential for exports. France took a far more radical step than China when it adopted the Euro and gave up its monetary autonomy, however this reflects the difference in the conditions facing the two countries. The underlying concerns and motivations facing the politicians in each country are similar despite the same outcomes.

Another important similarity between France and China is the hollowed out nature of the financial liberalization that occurred in both countries. This is less surprising for China, since they ultimately liberalized to a far lesser degree than France. Even in France liberalization has not ended the role of the French state in the economy. The competitiveness of French business has not seen the kind of transformation that proponents of liberalization might have argued for. Liberalization in finance has not resulted in liberalization in other areas of the economy. Labor market liberalization has been harshly contested and stymied by political resistance. Political power in France has shifted between the Left and Right after liberalization in much the same way as it had begun to as liberalization began, so the effect on the political economy has not been to enshrine a new winning coalition in France’s political economy. In China, as well, liberalization has not fundamentally altered the ability of the state to be involved in the economy. The Chinese government continues to subsidize export industries and though GDP growth has declined it continues to be a central concern for the political stability of the state. Liberalization in both countries has had important effects on the form through which policy is made and managed but in a
manner consistent with the predictions of state based financial liberalization has not represented a revolutionary change in the pre-existing political economy.

Continuity in the wake of financial liberalization would be a perplexing result if the interest based approach to financial liberalization were correct. If a fundamental shift in the interests that control the state was what caused reforms to happen in the first place, then it would be expected that reforms would create a discontinuity within the political-economy of the state. The discontinuity that does occur in both France and China is in the manner with which financial policymaking operates. In both countries, after liberalization, there is no retrenchment or reversal of that liberalization. If political contestation causes reform, then the absence of reversals would suggest that there has been political continuity since liberalization. While the same party has been in power in China, the same factions within the party have not been in control and there has been significant political competition and upheaval with important figures being removed from power and new leadership consolidated. The presence of political conflict and change is even more apparent in France where there have been numerous changes in the party in power since the adoption of liberalization. Once the interest based approach is put aside, then the source of the continuity of liberalization as well its limitations can be seen in the neoliberal consensus towards the operation of financial systems.

This consensus cannot force the adoption of reforms that might harm political actors, but it does prevent the introduction of alternative types of policies that might unravel existing reforms. If financial liberalization were restrictive enough that politicians or economic interests viewed it as limiting their ability to pursue their preferences, then it might come under attack from some outside source. However, the flexibility of liberalized finance as well as the unpredictability of the results of reforms, particularly for those untrained in finance and economics and therefore unindoctrinated, make it an unlikely target for political mobilization moving forward. Future innovations in finance, such as Nominal GDP Targeting or expansions of Quantitative Easing-like programs by Central Banks will most likely continue to take a liberalized
form with the emphasis being on decentralizing control into financial markets even as the state plays a central role. Without a fundamental shift in the ideational landscape of the type created by Keynes and his followers and then the neoliberal thinkers who reacted against them the general trend towards greater liberalization may not be fast, but will continue.

Moving forward with this research agenda will require a narrowing of the focus from financial liberalization generally to particular tracing particular policy reforms and the interaction between bureaucratic problem solving and political opportunities. This is more likely to be successful in studies of individual countries and perhaps would be best served by bureaucratic biographies focused on individual bureaucratic careers. How is that bureaucrats advance and bring their ideas to prominence? What is the interaction between how politicians and bureaucrats view economic problems? As was mentioned earlier in this chapter, I have avoided the entire issue of the public debate over and perception of economic problems. This process is an important component of generalizing state based financial liberalization into a more general model of political economy. While I have observed some of the boundary conditions which shift between conflictual and negotiated political economies, these have not been addressed in a systematic fashion in this study and should receive more attention in the future. An important component of these boundary conditions are the factors which tie particular political movements, parties, or leaders to particular policy positions. Why do actors come to identify themselves with policy proposals and what makes such an identification inflexible? What are the consequences of such an approach? I’ve identified finance as an unlikely target for political conflict, but what makes some areas of economic policymaking much more likely to receive such attention?
REFERENCES


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**Abstract**  In the last 40 years, states around the globe have increased the role of markets in their financial systems. Using newly collected information on the educational backgrounds of Central Bankers, I demonstrate that the beliefs of state officials about the proper role of markets in the financial system influence the extent to which state’s liberalize their financial systems. By tracing the liberalization experiences in both France and China through secondary sources, I show that bureaucrats within the state suggest reforms that conform to their neoliberal training when political leaders turn to them for solutions to what are perceived as technical problems.
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