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**Understanding Financial Globalisation**

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## **ABSTRACT**

Understanding the nature, origins and consequences of global finance is a central task for contemporary political economy. This paper makes three arguments. First, contemporary levels of financial integration are high by historical standards, even if they are not absolutely as high as some believe. Second, it is now reasonably well-established that financial globalisation is not yet the great 'levelling force' implied in some IPE literature, where it is seen as an increasingly powerful structural constraint upon national policy autonomy in all countries. The extent to which financial globalisation constrains state policy varies considerably both across countries and by policy area, depending upon various national characteristics and institutional structures. Third, most of the costs and risks entailed by financial globalization fall upon developing countries.

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## **UNDERSTANDING FINANCIAL GLOBALISATION**

### **Introduction**

Understanding the nature, origins and consequences of global finance is a central task for contemporary political economy.<sup>1</sup> This paper makes three main arguments. First, it is implausible to claim that contemporary levels of financial integration remain low by historical standards (e.g.: Waltz 2000), even if they are not absolutely as high as some believe. Although it is open to dispute as to whether certain countries are more financially integrated today than a century ago, it is indisputable that there has been a dramatic increase in the level of international financial integration since the breakdown of the Bretton Woods system in the early 1970s.

Second, I argue that it is now reasonably well-established that financial globalisation is not (or at least not yet) the great ‘levelling force’ implied in some of the earlier literature, where it was seen as an increasingly powerful structural constraint upon national policy autonomy in all countries (e.g.: Andrews 1994; Cerny 1995). In fact, the extent to which financial globalisation constrains state policy varies considerably both across countries and by policy area, depending upon various national characteristics and institutional structures, as shown in some of the more recent empirical literature (e.g.: Garrett 1998; Quinn 1997; Kitschelt 1999).

Third, I argue that it would be wrong to conclude from this somewhat Euro-centric literature that financial globalisation has had little effect at all. The emergent international financial structure constrains governments, but very unequally: most of the costs and risks it entails falls largely upon developing countries. Thus, financial liberalization continues to be supported by the major industrialized countries, while there are growing concerns in much of the developing world.

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<sup>1</sup> Among the various relevant discussions are Eichengreen 1996; Frieden 1991; Quinn 1997; Simmons 1999; Garrett 1998; Scharpf 1991; Cohen 1993, 1996, 1998; Kurzer 1993, Cerny 1995; Strange 1998.

The rest of this paper is divided into three sections. The first briefly discusses definitional and empirical issues surrounding the nature and measurement of financial globalisation. The second section turns to an assessment of three main contending approaches to understanding financial globalisation: technological determinism, hegemonic power, and rationalist interest group explanations. A concluding section discusses the relative merits of the existing dominant approaches in this area and suggests avenues for future research.

### **How Extensive is Financial Globalisation?**

Many studies refer to the dramatic increase in foreign exchange and portfolio capital flows in recent years. The triennial Bank for International Settlements (BIS) survey showed that in April 2001, average daily turnover in spot foreign exchange markets was \$1.2 trillion, and average turnover in derivative markets was \$1.4 trillion.<sup>2</sup> In terms of international financial stocks, by the end of September 2001, outstanding international bank loans with maturities of one year or less were estimated to be \$4.5 trillion (of which \$398 billion was to developing country entities). By the same date, international bond issues (of all maturities) reached \$6.7 trillion; notional foreign exchange derivatives contracts exceeded \$17 trillion.<sup>3</sup> These measures of financial flows and stocks are sizeable compared to world GDP of about \$31 trillion in 2001.<sup>4</sup>

However, international financial flows and stocks are a problematic measure of financial integration, in part because there is much double counting involved, in part because such flows may indicate poorly integrated national financial markets rather than the reverse. For most economists, the 'law of one price' is the preferred measure of market integration. In practice, although there appears to have been some asset price convergence among the advanced industrial countries in recent years, much was accounted for by Euro-area asset price convergence; financial asset prices in similar classes continue to differ across borders – not least due to exchange rate volatility and political risk (IMF

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<sup>2</sup> BIS, 'Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity 2001 - Final Results,' <http://www.bis.org/publ/rpfx02.htm>, accessed March 18, 2002.

<sup>3</sup> BIS, *Quarterly Review: International Banking and Financial Market Developments*, March 2002.

<sup>4</sup> According to the IMF's World Economic Outlook database, <http://www.imf.org/external/pubs/ft/weo/2001/03/data/index.htm#1>, accessed March 18, 2002.

1997: ch.3). This has led researchers to focus upon different measures of financial integration.

One of the most influential approaches has been to measure the correlation between national savings and investment. In a world of perfectly integrated financial markets, national investment need not depend upon the flow of national savings, since countries can borrow from abroad. Feldstein and Horioka (1980) found that despite the widespread removal of capital controls by developed countries since the early 1970s, the correlation between national savings and investment remained surprisingly high. More recent empirical work suggested only a partial breakdown of this relationship for some countries since the 1970s. Nevertheless, it is suggestive of a trend towards greater financial integration since the early 1970s among the advanced industrial countries (see Simmons 1999: 56-61).

Others have measured financial integration by focusing upon the use of capital controls at the national level. In empirical work, this is probably the preferred measure, because of its ready availability via the IMF's *Annual Report on Exchange Rate and Monetary Arrangements* (e.g.: Quinn 1997; Johnson and Tamirisa 1998; Garrett 1998, 2000; Brune et al. 2001). This kind of measure also shows a clear trend towards greater financial openness in many countries. However, it too suffers from various problems. The IMF data is crude and does not distinguish more important from less important forms of exchange control. Nor does it take into account other kinds of barrier to market integration, such as national tax regimes. Furthermore, portfolio capital flows also seem to have led, rather than preceded, the removal of various forms of capital control (Garrett 2000: 9). Finally, this measure describes national policies rather than the degree of global integration: the removal of capital controls by the US, Japan and EU countries has been much more decisive for the latter than are policy choices elsewhere.

Despite problems with all of the above measures, there is no doubt that global financial integration has increased considerably since the 1970s, though the major industrial economies and a few offshore financial centres and developing countries account for most of this 'global' phenomenon. Almost all developed economies followed, if with substantial delays in many cases, the lead of the US in 1973 to remove capital

controls. Some important developing countries in Latin America and East Asia also removed many capital controls in the late 1980s and the 1990s (see Brune et al. 2001).

Despite this, globalisation skeptics have argued that contemporary financial integration falls considerably short of that which existed just before 1914, when the most important country, Britain, was exporting annually net savings worth up to 9% of its GDP (Hirst and Thompson 1996). Although this is correct, there are other reasons to believe that the degree of global financial integration is both different and deeper than pre-1914. First, the ratio of short-term capital flows to long-term flows is much greater today than pre-1914, which was dominated by the latter (Bordo et al. 1999: 31-4).<sup>5</sup> Before 1914, long-term bond issues mostly financed railways and raw materials extraction, from the rich European core to developing countries. Second, there was nothing to compare with the way in which, today, deep markets in many different kinds of financial product and many different currencies, including spot and derivative contracts, have flourished and become disassociated from their national origin (and often from fixed investment and trade). The actuality or potential of financial markets to operate ‘offshore’ has become a defining characteristic of contemporary global finance.

The growth of financial integration over the past few decades has led some to call global finance a ‘structure’ (Andrews 1994), or a ‘cage’ (Lindblom 1977). The strong implication is that the scope for national policy agency or autonomy has been considerably narrowed by financial integration. However, here the globalisation skeptics have been more right so far. The reason is simple: although contemporary financial integration is unprecedented, national savings and investment flows continue to dominate cross-border flows. Some careful recent empirical studies have demonstrated that, as a result, there is so far no evidence of a clear trend towards less activist fiscal and monetary policy or any shrinkage of the welfare state and capital taxation (Garrett 1998, 2000; Kitschelt et al. 1999). Despite the increase in the degree of financial integration, it is by no means sufficiently progressed that national policy autonomy has been erased. Indeed, for the major countries, the shift to floating exchange rates since the early 1970s has probably increased macroeconomic policy autonomy.

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<sup>5</sup> As Bordo et al. explain, investors’ preference for bond rather than equity investments, and the dominant intermediary roles of family-owned investment banks, was probably due in part to the much poorer information about foreign investment risk that prevailed before 1914.

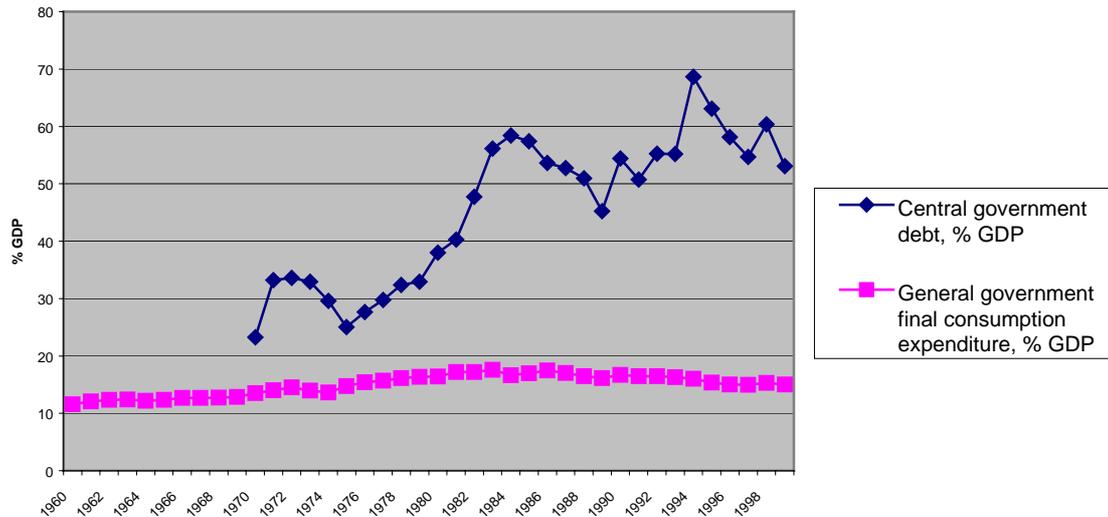
It should be emphasized, however, that the great bulk of this evidence is heavily focused upon the OECD countries and upon developed Europe in particular. This is primarily because of the better available time-series economic and political data for OECD countries, the dominance of European countries within this grouping,<sup>6</sup> and the concern of particular researchers for the fate of the social-democratic model. Some might be tempted to argue, looking at the fate of Argentina in early 2002, that financial globalisation represents nothing but a cage for developing countries. But it remains possible that Argentina's problems were more home-grown than structurally imposed from the outside, not least the government's long persistence with the currency board arrangement and the fiscal weaknesses produced by Argentina's federal structure.

For developing countries in general, the data shows that for low and middle income countries, the average ratio of general government final consumption expenditure to GDP rose fairly steadily from 12% in the early 1960s to 15% in the late 1990s, with a small decline from a peak of about 17% in the mid-1980s. Might this suggest that financial integration has imposed greater constraints on public expenditure since the early 1980s? However, there has also been a continuous increase in government indebtedness in developing countries, which is at odds with the view that financial openness should increasingly constrain deficit spending. This picture is broadly similar to that in the OECD, but lacking good data and serious cross-country studies, we simply do not know enough about trends in developing countries to be able to say what impact financial integration is having outside of the OECD.

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<sup>6</sup> Of 30 current OECD members, 23 are territorially European. Other members such as Australia and Canada arguably have European-style political economies.

Figure 1: Low and Middle Income Developing Countries, Fiscal Indicators



Source: World Bank, *World Development Indicators 2001*, CD-Rom.

Without doubt, however, the main costs posed by financial openness for emerging market countries relate to the increased potential for financial crises it entails. Recent crises in various developing countries over the 1994-2002 period, from Mexico to East Asia, Russia, Brazil, and Argentina, are powerful testimony to the extent to which the costs of financial globalisation have fallen disproportionately upon the bigger so-called emerging market countries. The association with the post-Bretton Woods world of financial globalisation seems difficult to ignore; Eichengreen and Bordo (2001) estimate that the probability of a random country suffering a financial crisis approximately doubled after 1973. Developed country banks in particular were more than willing to lend to the emerging market countries before mid-1997, but they tended to do so in dollars or yen (often at short maturities). When banks withdrew credits and helped to precipitate the crises, IMF-led international rescue efforts also largely ensured that international banks were repaid, with the exception of some Russian debt.

By contrast, financial openness for the developed countries has allowed them to borrow from international investors by selling domestic currency-denominated financial assets, which does not entail the currency risk incurred by emerging market borrowers. Consistent with this, Edwards (2001) finds evidence that capital account liberalization boosts growth in high income countries, but slows it in low income countries. Those who, relying upon textbook economics, claim that the free flow of international savings is

Pareto welfare-improving ignore this basic asymmetry. For the developed countries, perhaps the most obvious cost (as Britain, Italy and Sweden discovered in 1992) is the greater difficulty of using pegged exchange rates as an anchor for monetary policy. For the emerging market countries, the cost-benefit calculation is much more complex and of much greater import. For most of the least developed countries, which tend not to be seen as creditworthy by international banks and investors, the degree of integration with global financial markets remains very limited. This includes most of China, India, and almost all of South Asia and Sub-Saharan Africa; in other words, most of the world's population.

### **Explaining the Origins and Consequences of Global Finance**

The last section argued that the costs of financial integration have been substantial. I suggest below that these costs have also been much greater than initially expected, particularly for the emerging market countries. This poses the question of why the level of financial openness has nevertheless been steadily growing for many developed and developing countries. The puzzle is particularly clear for the emerging market countries that have suffered financial crises in recent years, since with the temporary exception of Malaysia in 1998, most crisis-hit countries have not reverted to capital controls. On the contrary, these countries have committed themselves to a set of domestic institutional reforms that some argue amount to 'making the world safe for global finance capitalism' (Rodrik 2000). Even Malaysia has been taking steps to improve its standards of corporate governance, accounting, financial regulation and macroeconomic transparency, albeit more quietly than the other crisis-hit countries in the region, and has relaxed its capital control regime (Meesook et al. 2001).

Three main approaches in the existing political economy literature to explaining financial globalisation may be identified: technological determinism (Strange 1998; Garrett 2000), hegemonic power approaches (Gilpin 2001; Gill 1995), and rationalist interest group approaches (Frieden 1991; Frieden and Rogowski 1996). Technological determinism explains financial globalisation as the product of technological changes that are gradually sweeping aside the barriers to the integration of national financial markets. Political factors may help explain the details of the timing of liberalization in particular cases, but essentially this perspective sees financial globalisation as driven by factors exogenous to the political system. Not surprisingly, most economists adopt this approach.

The other two perspectives place more emphasis upon political choice and agency. Hegemonic approaches argue that financial globalisation is a product of dominant political forces. These may be in the shape of a hegemonic country that promotes financial liberalization abroad (the US), and/or in the shape of a set of hegemonic ideas ('market neoliberalism') that shape the assumptions and choices of policymakers. Rationalist interest group approaches, in contrast, focus not on structural forces and state policymakers but upon the preferences of key societal interest groups. Financial liberalization from this perspective occurs when groups that favour liberalization organize and lobby more effectively than groups that oppose it. Each perspective helps in understanding why financial liberalization has kept growing since the 1970s. I devote more space to the analysis of this last perspective, since in contrast to the previous two, it provides more insight into the particular pattern that international financial liberalization has taken.

### *Technological Determinism*

Many authors have argued that the rise of global finance is fundamentally a product of technological change that has undermined the viability of barriers separating domestic financial markets from one another. More specifically, the communications and information technology revolution is seen as the driving factor: 'new technologies make it increasingly difficult for governments to control either inward or outward international capital flows when they wish to do so.' (Eichengreen and Mussa 1998a). The dramatic fall in communications and computing costs over the past three decades, continued technological innovation in the form of various derivatives products, and the emergence of the borderless Internet, have all undermined the efficacy of capital controls (Eichengreen and Mussa 1998b; Strange 1998; Edwards 1999; Garrett 2000). In turn, this has eroded the foundations of post-1930s Keynesian national economic management.

Attempts to maintain barriers between national and global financial markets only serves to push such markets offshore. Garrett (2000: 17) cites the example of the Japanese Ministry of Finance's attempt in the 1990s to outlaw trading in Nikkei index derivatives. In response, market agents (both Japanese and foreign) simply traded these contracts in

Singapore, with the same effects upon the underlying stock market index as if they had been traded in Tokyo. In this view, once governments discover capital controls do not work, they have an incentive to remove them. Indeed, a process of competitive financial deregulation has unfolded since the early 1970s, since unilateral liberalisers reap the benefits in terms of attracting international financial business. Re-regulation at the global level is a theoretical possibility, but it suffers from the standard free rider problem, since there will always be at least one jurisdiction willing to offer a home to offshore financial markets.

This perspective also implies that contemporary financial globalisation is different to that of the pre-1914 world. Then, the comparatively high costs of and delays in the communication of information, the underdevelopment of financial markets and supporting services in many countries, and the underdevelopment of derivatives markets in even the most advanced centres meant that unsophisticated capital controls could work. As Broz (1997) has shown, countries like France and Germany, who were less ideologically attached to the ‘rules of the game’ than was Britain, were able to make unsophisticated capital controls work at various times before 1914.

However, not all governments are convinced that the world is so different today and that capital controls can achieve no macroeconomic benefit. Many developing country governments hold firmly to the view that their own experience suggests capital controls can work (IMF 2000). The Chilean government and central bank clearly thought so until recently (Edwards 1999: 74), and the Chinese and Indian governments continue to do so. Furthermore, some prominent economists have gone against the orthodoxy in arguing that Chilean or Malaysian-style capital controls have been especially useful in periods of international financial distress (e.g.: Krugman 1999; Stiglitz 2000; Kaplan and Rodrik 2001). Even so, most of these accept that such controls work well only if they are temporary.

There are other reasons why governments might nevertheless maintain capital controls after they have lost most of their macroeconomic efficacy. One answer is that capital controls enable policymakers to achieve other objectives, such as rent-seeking.<sup>7</sup>

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<sup>7</sup> For an explanation of recent Malaysian capital controls along these lines, see Johnson and Mitton 2001.

Another is that offered by Garrett (2000: 41), who suggests that governments may retain capital controls simply to signal to important domestic constituencies that their interests are taken into account. So, for example, one might explain the late removal of capital controls in Scandinavian countries (compared to other OECD countries) by the political importance of service sector unions who favoured monetary policy activism. However, this argument can only explain relatively short delays in liberalization, since these groups should soon learn that such signalling is ‘cheap’ if the controls have no macroeconomic value.

In summary, technological determinism may help to explain the broad trend towards financial liberalization since the 1970s. However, in using exogenous technological factors to explain policy change, this perspective is less able to explain the differential timing of financial liberalization across countries. In addition, it fails to explain why so many countries continue to maintain capital controls of various forms. Explanations must either rely upon cognitive failures by governments to understand the implications of the technological revolution, or upon political economy explanations that shift the focus away from technological factors.

### ***Hegemonic Power Approaches***

Gilpin (1987, 2001) is perhaps most associated with the argument that an open international financial system depends upon the existence and leadership of a liberal hegemonic power. In this view, financial globalisation today and a century ago is fundamentally similar, and due to the promotion of international financial openness by the US and Britain respectively. In contrast to technological determinism, Gilpin’s explanation is political in nature, and focuses upon the self-interest and international political power of the hegemon.

Helleiner (1994) builds on this explanation in focusing upon the role of the US and UK governments in initiating a process of competitive deregulation in the 1970s.<sup>8</sup> This began with the decision of the UK authorities to allow a lightly regulated ‘Eurodollar’

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<sup>8</sup> As I elaborate below, Helleiner’s explanation overlaps with that outlined in section 2.3, since he argues that there was an alliance of state and domestic financial sector interests that favoured unilateral financial liberalization in the US and UK.

wholesale financial market to emerge in London from the late 1950s, promoting the interests of the City of London without jeopardizing domestic monetary control. From Nixon on, succeeding American administrations rapidly removed the Bretton Woods era restrictions after the collapse of the fixed exchange rate system in 1973.

The key argument of this perspective is that there is a strong hegemonic state interest in promoting the development of this increasingly important service industry, made more acute by the declining importance of manufacturing in the American and British economies. The mechanism by which initial hegemonic liberalization promotes financial liberalization in other countries varies according to different versions of the theory. One line of argument emphasizes unilateral decisions by other countries since, it is suggested, international financial liberalization, unlike trade liberalization, can flourish with international competition rather than cooperation (Helleiner 1994; Cerny 1995). Another, more coercive, version of the theory holds that the US in particular has used various multilateral and bilateral means to promote financial liberalization abroad, above all its dominance within the IMF and World Bank (Wade 1998-9).

Others argue that hegemonic dominance is derived as much from ideological supremacy as from material power factors. The rise of neoliberal economic ideas since the early 1980s has often been associated with American influence over international financial institutions and especially the liberalizing zeal displayed by the IMF and World Bank since that time (Wade 1996). Economic ideas in this view become another power resource for the hegemonic state, in part because of their 'technocratic' character. The mechanisms by which ideas influence outcomes may vary, including via the policy conditions attached to international financial institutions' (IFI) lending, or via the circulation of individuals between national central banks and finance ministries and the IFIs. More indirectly, America's higher education system, particularly in economics, is said to serve as a means by which liberal market ideas are transmitted abroad (especially to Latin America), to the possible long-term benefit of US economic interests.

Other ideational accounts emphasize a greater separation between the interests of the hegemonic state and those of the private financial sector. At the extreme, the hegemonic project becomes less that of the hegemonic (US) government and more that of '*haute finance*' itself (Gill 1995; Polanyi 1944). Here, the dominant hegemonic interests

are more class than state-based, even though the dominant state may be seen as having been captured by private financial interests (as in the ‘Wall Street-Treasury complex’).

The variety of hegemonic power explanations of financial globalisation makes a general assessment difficult. One general problem is that they seem to be insufficient by themselves. Explaining why the US or UK governments would pursue such policies requires an analysis of domestic political factors within these advanced countries, as Helleiner (1994) recognizes. Furthermore, explaining why other countries might choose unilaterally to follow them requires a similar domestic politics analysis for each country. Even the coercive version of hegemonic power theory cannot avoid this, as when powerful countries put pressure on weaker ones to liberalize the results are in practice varied. In the absence of such analysis, the details of the financial globalisation process are left unexplained. Why, for example, in response to US capital account liberalization in 1974, did only Canada and the Netherlands follow with similar liberalization in the same year? Systemic explanations may help explain the accelerating trend towards liberalization after 1973, but they cannot explain the nuances of the pattern.

This lacuna also tends to apply to those approaches that stress the role of hegemonic ideas in explaining financial liberalization. Given the persistence of financial controls in most developing countries, ideational explanations must account for why neoliberal market ideology was less influential in such countries. This in turn requires detailed analyses of the way in which official, educational and training linkages between the US, Europe and the IFIs on the one hand and particular countries on the other have varied. It may also be that particular cultures or political systems and institutions are more receptive to liberal economic ideas than others. So far, however, such questions of comparative economic sociology have been left largely unexplored.<sup>9</sup>

A further problem with ideational accounts is that they sometimes exaggerate the grip that ideas can have upon political collectives, as opposed to individuals. One prominent example suffices to demonstrate the difficulties here. Chile after the right wing coup of 1973, for example, was often seen as a kind of laboratory for economic neoliberalism in the developing world, introduced by the ‘Chicago boys’ brought in by the

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<sup>9</sup> Hall (1989) is an exception, but it explores the influence of Keynesian ideas in different national contexts.

Pinochet government. However, even if it could be said that this government was wedded to the doctrines of Monetarism and open trade, the same could not be said of policy choices relating to the capital account. Indeed, until very recently, Chile stood out prominently as one of the developing countries resisting the removal of capital controls in South America (Edwards 1999; IMF 2000: Appendix 1).

If the Chilean regime could buy some parts of what became termed the ‘Washington Consensus’ but reject a key element of it, this suggests that governments do not treat economic ideologies as complete packages. This example is inconsistent with the ‘brainwashing’ view of ideologies promoted by some Gramscian analyses (Gill 1985; Lukes 1973). It is more consistent with the view that politicians merely profess to believe in ideas that suit them and the interests they wish to promote.<sup>10</sup> When governments such as that of Mexico under President Salinas voiced adherence to market economics, we need to ask whether such apparent conversions are more instrumental than deep, and whether it is not other factors other than economic ideology that are in fact driving policy choices.

In summary, hegemony explanations of financial globalisation usefully emphasize the role of dominant powers and dominant analytical frameworks. However, this perspective raises more problems than it resolves. The relative importance of hegemonic coercion vs. unilateral liberalization in explaining financial liberalization remains unclear. As regards the role of dominant economic ideas, we are still left largely in the dark as to the circumstances in which particular neoliberal economic ideas became influential outside of the major countries. Finally, on close inspection hegemonic power arguments tend to lose their analytical clarity, since they typically need to be allied with interest group explanations to explain why hegemonic powers pursue financial liberalization and why others follow. I turn to these accounts next.

### ***Rationalist Interest Group Approaches***

As noted above, both technological determinist and hegemonic accounts of financial liberalization tend to rely upon domestic interest group analysis to fill in the analytical

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<sup>10</sup> It is true that the Chilean government undertook financial liberalization along with trade liberalization after 1973, and subsequently re-imposed capital controls after the financial crisis of the early 1980s.

detail. However, more formal political economy theories of interest groups have been a relatively recent development in the area of finance.

Such theories typically do not challenge the basis of the neoclassical economic view that financial liberalization is welfare enhancing at the national and global levels. Rather, they employ the tools of neoclassical economics to discern how such liberalization differentially affects identifiable interest groups within society (Frieden 1991; Frieden and Rogowski 1996). This allows these authors to derive the *a priori* preferences of key interest groups relating to financial liberalization. Depending upon the strength of their preferences, such groups will have incentives to lobby politicians. Self-interested politicians, in turn, weigh the electoral costs and benefits of various policies and make decisions on this basis.

How, then, does this approach explain the trend towards financial globalisation since the 1970s? Frieden and Rogowski (1996) accept that technological change is a key driver of financial liberalization, but focus upon its distributional consequences. They argue that technological change, along the lines addressed in section 2.1, raised the 'opportunity costs of closure' for countries and key interest groups, such as the financial sector itself, multinational corporations, and domestic firms seeking cheaper sources of finance. This increased the incentives for these sectoral groups to lobby governments to undertake liberalization policies in recent decades. In addition, as the median voter becomes richer in the process of economic development and acquires more wealth, he/she favours policies that ensure low inflation and also maximize the investment options available to them. This should lead to a shift in median voter preferences towards greater capital account openness over time.<sup>11</sup> If the costs of financial openness fall on individuals, firms and sectors whose political influence is weak (perhaps in part due to relative immobility), there may be little reason for politicians to oppose it.

In contrast with technological determinism, this account accepts that governments may choose to accept increased costs of closure if the electoral gains from liberalization are insufficient. Financial closure remains a viable option, at least in the political short

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However, this suggests that the Chilean government learnt from experience and did not blindly pursue market-oriented policies in the 1980s and 1990s when these were so much in vogue.

run. This is necessary to the theory, since if barriers to integration between national and international financial markets were essentially unworkable, as many economists suggest, then political coalitions opposed to the liberalization of capital controls could play only a residual role.

To what extent does this theory help explain the pattern of financial liberalization since the 1970s? It is broadly consistent with the fact that financial openness is highly correlated with the level of development (Brune et al. 2001). Export-oriented firms and related labour forces usually favour exchange rate stability rather than financial openness, since the latter can increase exchange rate volatility. This helps us to understand why, for example, financial liberalization was pursued first in the US and UK, where the manufacturing sector was politically less influential than in other countries (Frieden 1991). As Henning (1994) explains, in countries with close bank-industry linkages, as in continental Europe and Japan, a strong political coalition can emerge that favours exchange rate stability. This also helps explain why financial liberalization came later in most of continental Europe and Japan than in the US and UK. It is also worth noting, as an extension to this literature, that bank-industry linkages also tend to be strong in developing countries, where capital controls have been more often used and where there has been a strong revealed policy preference for exchange rate fixity (Calvo and Reinhart 2000; Demirguc-Kunt and Levine 1999).

Nevertheless, as noted elsewhere, big steps towards financial openness were taken in a number of developing countries in the 1980s and 1990s, particularly in Latin America and East Asia. In countries that wished to attract large inflows of foreign direct investment, MNC preferences for financial openness may have been an important factor in government decisions to liberalize. As surveys of MNCs have shown, a major concern of investors, even those oriented to domestic markets, has been their freedom to transfer funds and profits.

Another important consideration for developing and transition countries, which typically have shallow domestic capital markets, is that financial liberalization can reduce

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<sup>11</sup> Capital account openness should provide the government with an incentive to pursue low inflation because of the threat of capital exit.

the cost of funds for creditworthy firms and banks. This factor seems to have been especially important in decisions to liberalize in East Asian countries in the early 1990s (Haggard 2000: ch.1). This motivation may also apply to governments themselves, as the state is typically the largest debtor within countries, and taxation systems may be underdeveloped. Italy was among the first to tap the Eurobond market in the 1960s to finance its large infrastructure projects. In the early 1970s, especially in the wake of the oil crisis, many Latin American governments borrowed heavily from international banks. At the time, borrowing through private international capital markets also had the benefit of avoiding the policy conditionality of official sources of finance such as the IMF or World Bank. Although developing country governments may be cut off from international borrowing in a crisis, this consideration is unlikely to have much weight with incumbent governments who perceive a short-term financial opportunity.

Although interest group approaches have major strengths, and build on the overly general frameworks of the previous two approaches, they also suffer from weaknesses. The first is that although the Frieden-Rogowski approach helps explain the strong association between the level of development and financial openness, it seems less able to explain the suddenness of the trend towards openness in a number of key developing countries since the late 1980s. Notwithstanding general arguments about technological change, it is unlikely that the opportunity costs of closure for influential firms and sectors increased suddenly anywhere, not least because of the ineffectiveness of most capital controls. This suggests we have to look elsewhere to explain the broader trend.

Second, interest group approaches tend to pay little attention to political and regulatory institutions, which may affect policy outcomes in important ways. One important institution, the central bank, may prefer capital mobility not just because it is usually proximate to the financial sector, but also because it believes openness may constrain deficit spending by governments (see Maxfield 1997 and 1998 on Latin America). Governments facing highly independent central banks may feel they have little influence over monetary policy with or without capital controls, undermining any rationale for retaining them. However, if central banks are required to defend a currency peg or band, as in many developing countries, central bankers may be more supportive of capital controls. Openness may also be favoured by bureaucrats in finance ministries, who may

see it as a means of resisting populist politicians who wish to engage in deficit spending.<sup>12</sup> However, in Japan and Korea, powerful finance ministries supported capital controls for many years to facilitate their influence over domestic credit allocation.

These considerations suggest that once domestic institutions are introduced to supplement interest group analysis, the complexities expand exponentially. As is obvious, policies relating to financial liberalization are interdependent in complex ways with other policy choices, such as those relating to exchange rate and industrial policy. Further complexity can be introduced via consideration of the political regime type. Implicitly, Frieden and Rogowski assume a democratic pluralist system in which interest groups compete for the attention of elected politicians. Clearly, this may misrepresent the situation typical in most countries, particularly in the developing world. In some countries, we may need to pay more attention to the preferences of connected family interests (Indonesia, the Philippines) or to those of the army (Thailand, Nigeria, China). Democratisation may produce greater political populism and demands for macroeconomic activism, which might push against financial liberalization.<sup>13</sup> However, it can also be argued that democratisation favours financial liberalization by increasing the influence of the median voter and the middle classes in general over governments as compared to powerful connected interests (Brune et al. 2001 find evidence of this).

Another complexity problem in rationalist interest group approaches is that interest cleavages between groups may be ambiguous or multiple. It is commonly accepted that interests may cleave along class lines and sectoral lines. According to the standard Heckscher-Ohlin-Samuelson model, in capital rich economies, capital as the abundant factor gains and labour loses from financial opening. In capital poor economies, by contrast, labour as the abundant factor gains from capital importation and domestic capital loses. From this perspective, democratisation in major developing countries since the 1980s might have encouraged financial openness by strengthening the voice of labour over

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<sup>12</sup> In a further complication, Quinn and Inclán (1997: 785-6) argue that in non-majoritarian political systems, coalition governments have less incentive to impose capital controls because they receive less credit or blame for macroeconomic activism.

<sup>13</sup> For an historical argument along latter lines, but one focused on Europe, see Eichengreen 1992: 391, and Simmons 1994: 61. However, Brune et al. (2001) find financial openness is systematically greater in democracies.

capital in the political process.<sup>14</sup> Others argue that preferences divide primarily along sectoral lines, with both labour and capital in internationally competitive sectors favouring financial openness.<sup>15</sup> Within sectors, internationally competitive firms are often strong supporters of financial openness, as they will benefit from lower global costs of capital. Domestic banks may oppose foreign bank entry, but they may support financial opening if this allows them to act as intermediaries between firms and lower cost foreign funding. This motivated the Thai government to allow Bangkok International Banking Facilities in the early 1990s. Even domestic firms suffering growing competition from MNCs may also support the removal of controls on offshore borrowing to lower their own costs, as did Korea's chaebols and Indonesian conglomerates.

Moreover, in emphasizing domestic interest cleavages the Frieden-Rogowski approach ignores international distributional cleavages. This is because, as noted above, their approach depends on standard neoclassical economics, which holds that at the international level, financial opening is welfare-improving. Despite the slew of costly financial crises in many emerging market countries in the 1990s, the leading liberalisers such as the US and UK have gained most and lost least from financial globalisation. The size and competitiveness of their financial sectors and MNCs, the comparative strength of their financial regulatory institutions, and the discretionary capabilities of their central banks have limited the costs of financial instability at home.<sup>16</sup> In addition, the US and UK have been able to foster international regulatory cooperation, particularly via the Basle Committee at the BIS, to reduce the regulatory risks of financial globalisation (Kapstein 1994; Oatley and Nabors 1998).

A deeper problem with the Frieden-Rogowski approach is that it side-steps the problem of information and actor cognition. Their approach assumes that economic agents and, by extension, interest groups, unproblematically discern their policy preferences and undertake political action based upon them. However, the 'politicisation'

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<sup>14</sup> Quinn and Inclán extend this to argue that in capital-abundant economies, rightwing parties will favour financial opening while leftwing parties will oppose it. The opposite result would hold in labour-abundant economies. However, labour preferences may differ according to the level of labour skill, which can in turn affect party policies in complex ways (Quinn and Inclán 1997: 776). Whether the left in practice has led financial liberalization in developing countries is unclear.

<sup>15</sup> This relates to the 'specific factors' model of international trade in economics texts.

<sup>16</sup> As noted below, the UK government did suffer ejection from the European Monetary System in 1992, but has since floated the pound.

of public policy not only depends upon there being different distributional consequences of alternative policies for identifiable interest groups. There must also be a perception by these groups of a clear link between policy and its distributional effects, and such groups must be able to convey their policy preferences to political representatives. Need economic and political agents understand the Mundell-Fleming and Heckscher-Ohlin models Frieden and Rogowski use to determine distributional conflicts, or is it sufficient that such groups acquire such knowledge inductively? And what should we do when, as is usually the case, alternative underlying economic models are available?

A simple illustration of the problem is the so-called ‘unholy trinity’, derived from the Mundell-Fleming monetary framework. This is the argument that individual countries can only choose two of the following three policy options: open capital accounts, independent monetary policies, and fixed exchange rates (Cooper 1968; Cohen 1993). Although this may hold as a long run approximation, in the short run governments have often assumed they are not in fact constrained by this trade off. Governments in a number of East Asian countries in the early 1990s liberalized capital flows while retaining pegged exchange rates and persisting in the belief that this entailed few risks for monetary and even more, for banking regulatory policy. As Haggard (2000: 5) found, ‘there is evidence in several countries [in East Asia] of a basic failure to understand the policy constraints associated with an open capital account.’

A rationalist rejoinder might be that incumbent politicians understood the risks involved but discounted them because they were not relevant to the political short run. However, such calculations would be more likely to pertain to democracies than to countries like Mexico or Indonesia, where entrenched governments nevertheless undertook financial liberalization, to their later cost. The evidence is more supportive of the view that such risks were simply misunderstood by most governments and the IFIs, who were actively promoting capital account liberalization in the developing world in the early 1990s. The domestic bankers and firms who pushed for financial liberalization in Thailand and Korea in the early 1990s certainly believed they would gain. But it is now evident, given that many of these firms subsequently became bankrupt, that they did not fully understand the great risks such liberalization entailed.

Lest it be thought that such cognitive failures only occur in developing countries, the same failure was also evident in the pro-market Conservative UK government from 1990, when Britain joined the European Monetary System and thereby pegged the pound to the Deutschmark, until September 1992. Almost right up until the very moment that the Bank of England was instructed to give up the battle for the pound, the government continued to believe that it could retain some monetary policy autonomy whilst maintaining the Deutschmark peg and a completely open capital account. Of course, it is true that in this case (as in Asian countries) there were domestic political reasons for resisting interest rate increases (in the UK case, the costs further increases would entail for mortgage holders). However, this does not refute the fact that governments believed such policies to be sustainable for much longer than they proved to be.

This suggests that the implications of the knowledge problem have not been fully addressed in the rationalist political economy literature, casting some doubt upon its predictions. As Odell (forthcoming) has argued, in the real world, there are likely to be slippages and deep complexities once informational problems and cognitive failures are taken into account. In other words, research in this area needs to take the implications of bounded rationality more seriously.

## **Conclusion**

I have argued that structural theories, including technological determinism and hegemonic power theories, are better at explaining the broad trend towards financial opening since the 1970s. However, they largely fail to explain the large differences in patterns across countries. Rationalist interest group approaches, supplemented by institutional analysis, provides considerably greater insight into the cross-country pattern of financial liberalization, but perhaps inevitably does so at the cost of much greater analytical complexity.

Nevertheless, greater attention to domestic political institutions and structures is required if we are to understand the large variations that occur between countries. Earlier structural approaches in political economy, in searching for grand theories, were generally uninterested in such variations. They also tended to suggest that circumstances in the

poor, underdeveloped countries were analytically unimportant. Interest group and institutionalist theories, by contrast, raise many interesting questions about less powerful countries, and thereby point towards a more 'universal' IPE. However, they suffer from both theoretical and empirical shortcomings in this respect.

Rationalist political economy models typically assume that polities are similar to the pluralist democratic system prevailing in the US and elsewhere. To be sure, the great strength of formal rationalist models is that they make such assumptions admirably clear. Milner (1997) confronts the question of whether we should expect autocracies to respond differently to democracies in such models; she argues they should not, since autocrats must still manage distributional conflicts in order to retain power. Nevertheless, we have seen that the kinds of interest groups identified by standard models may differ from those important in authoritarian systems (connected interests, the military, etc). This in turn necessitates greater attention to the political realities of individual countries.

Haggard and Maxfield (1996), for example, find that currency crises play a crucial role in inducing developing countries to open their financial account. They argue that countries dependent upon capital inflows to ameliorate the consequences of crises need to signal to international investors that future capital controls will be avoided; in an uncertain environment, investors may view current openness as a credible commitment to such a future policy. They also argue that crises strengthened both domestic and international interests pushing for liberalization. Similarly, the crisis of 1997-8 accelerated financial deregulation in Korea, partly because it increased the influence of the IMF and US Treasury over Korean policy, but more because it allowed domestic liberal reformers to use the crisis as a means to pursue policies they had long desired. By contrast, Mahathir's decision to impose capital controls in Malaysia in 1998 was in part a product of internal struggles for political supremacy in that country.

This is not to suggest that detailed country case studies are the only way forward (as in Maxfield 1990, 1991; Haggard et al. 1993; Haggard and Maxfield 1996; Loriaux 1996). On the contrary, work such as that provided in Brune et al. (2001) may begin to fill the large gaps that exist in our empirical knowledge of policy change in the developing world. Until now, most of the evidence that has been brought to bear on questions of the

causes and consequences of financial globalisation pertains only to the developed countries. This is largely driven by the much greater availability of comparable cross-country data for the OECD countries than for developing countries, but also by a particular concern amongst western scholars to investigate the fate of social democracy in Europe.

Finally, IPE in general needs to confront directly the even more difficult issue of how to treat the problem of knowledge and cognition. Political economists have given little attention to the way in which knowledge affects individual decisions in particular contexts, and how economic knowledge in particular may be systematically biased in different national and cultural contexts. Continental European economists tend to be more sceptical than their American counterparts about the virtues of laissez faire policy solutions, particularly in the area of financial markets. The growing influence of American ideas in South America since the debt crisis of the 1980s, combined with the growth of material US power in the region, may help explain why financial liberalization came more quickly there than elsewhere in the developing world. Nevertheless, the consequences of financial liberalization were usually poorly understood, by international and national policymakers, and by organized interest groups.

When knowledge and cognition is imperfect, as it always is, the role of ideology and of individual biases may be more important than rationalists assume. The failure of the import substitution model in Latin America, the collapse of Communism in Europe, and the ideological vacuum this created for the influence of market liberalism may have been more important for financial liberalization in the developing world than any of the factors identified in rationalist models. Although such cognitive factors are impossible to capture in statistical analysis, researchers should not ignore them. The IMF and World Bank have helped to build local technical expertise in central banks and finance ministries of developing countries, favouring financial liberalization. Chronic indebtedness and balance of payments problems may have favoured individuals within governments with financial expertise and foreign academic training. 'Graduation' to developed country status, as demonstrated by entry to the OECD, may have played a role in bringing countries like Mexico and South Korea to undertake liberalization, even apart from the leverage that this provided to existing members like the US.

This is not a plea for a return to an anti-rationalism in which ideology and perception rule. What is required is a combination of quantitative approaches with more qualitative case study approaches that are sensitive to the role of ideas in particular contexts, but also sensitive to the possibility that ideas may be used instrumentally by politicians. What remains most unclear is why certain economic ideas are more influential in some places and times than in others.

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