

MAKING GLOBALIZATION ENDOGENOUS
The Domestic Determinants of International Capital Mobility

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ABSTRACT

Globalization is usually depicted as an exogenous force of recent times that alters the fundamentals of our societies, economies, and political systems. In sharp contrast, this paper is a first step to show how the process of economic internationalization can be seen as the result of political decisions taken at the national level. By looking at governmental regulation of international capital flows, I develop a very simple political-economy model to account for the different incentives of governments to liberalize. The derived hypotheses are tested –and confirmed- using a worldwide dataset. In democratic regimes, liberalization of international capital flows is more easily embraced by wealthier countries –because capital-owners have much more to benefit from such a policy- and by countries with lower levels of government intervention in the economy –because compensating losers is very costly in these economies. This conclusion implies a fundamental difference between trade and financial liberalization. Whereas compensating the negatively affected groups of openness is easy in the former case, international capital mobility makes the task of compensation more difficult, because it involves high transaction costs. Autocracies, in contrast with democracies, do not appear to be bounded by these politico-economic constraints, and their movements towards more integration in global markets appear somewhat more unpredictable.

1. Introduction*

How have national economies become so internationalized? Have governments' decisions affected the way in which this process has taken place? Have domestic situations influenced the extent to which governments have fostered the internationalization of their economies? In spite of the growing concern about the internationalization of economies and its consequences, relatively little attention has been paid to these questions¹. Studies about the internationalization process have tended to focus on the impact of growing links and exchanges with the world on such political economies. In other words, the tendency has been to take the so-called globalization phenomenon as an "exogenous" variable (Frieden and Rogowski 1996). Governments, from this perspective, have had to respond to new societal demands, deal with new problems, and face new scenarios in which their capabilities may have been limited. In contrast, my aim in this paper is to *make globalization endogenous*. I will stress the fact that governments have been central actors in the process of growing economic internationalization. The reasons that have driven them towards this outcome, as well as the ways in which they have done so will be the central interests of the paper.

"Globalization" and "economic internationalization" are rather fuzzy terms that refer to the easing of international exchanges among countries. In practical terms, however, a distinction should be made between the two big dimensions of the concept: the lowering of restrictions to trade of goods and services between national economies, and the liberalization of financial flows across countries. While most research in political economy has dealt with the former case, the literature dealing with the latter is more limited (Garrett 1996, Quinn 1997, Cohen 1996). In this paper I will try to *explain* this second dimension from a domestic perspective. There is a practical reason that makes capital liberalization easier to *endogenize*

* I wish to thank for their comments and criticisms José María Maravall, Carles Boix, Madeleine Hosli and the participants in the panel "International Capital Markets", held at the 59th Annual Meeting of the Midwest Political Science Association, April 2001, Chicago, where a previous version of this paper was presented.

¹ In fact, this needs to be qualified. There are plenty of case studies of liberalization and its domestic determinants, especially for the U.S., as the development of the endogenous tariff literature shows. Haggard and Maxfield's (1996) studies are also example of this focus on in-depth case studies. The problem is the lack of comparative analysis. Apart from Rogowski's (1989) work on factor endowments and trade policy coalitions, few attempts to assess comparatively the propensity of countries to open up have been made.

than trade policy. Measuring the degree of “openness” of a trade policy is an extraordinary difficult task. Not only because all countries practice different trade regimes by setting differential tariffs, but especially because in recent years, the more widespread device of trade policy is non-tariff barriers. Measuring this can be an extremely complex and problematic task. On the contrary, isolating the impact of government on capital internationalization is much easier².

Focusing on governmental impact on level of financial internationalization faces an additional problem. It is increasingly commonplace among public commentators and some economists to argue that new information technologies have made governmental intervention in this issue almost completely futile. The argument is that improvements in the technology available for investors have presumably constrained the ability of governments to affect the outcomes produced by markets. Hence, I need first to be able to reject the null hypothesis of “technologic determinism” before I study the influential factors driving different government’s propensities to liberalize international capital flows. Otherwise, it can be argued that this variation in regulations is flatly irrelevant. I shall argue that governments, and choices they have actually made, have had a great impact on the result of a more internationalized economy.

The paper only refers to one dimension of the globalization phenomenon –namely, growing of international capital mobility. However, the overall conclusion of it –that particular domestic characteristics can help to explain why economic internationalization takes place-, should also apply for the other dimension of globalization: easing of trade restrictions, since it is much easier for national governments to control flows of goods and services than movements of capital.

² This is a consequence of my different way of looking at this phenomenon. As long as the causal mechanism reverses, new problems arise. If internationalization of trade is used to explain government responses (as in Katzenstein’s compensation argument), then it is not central to identify where does this variable –usually operationalized as “exports plus imports as a share of the GDP”- come from (as long it is considered exogenous). Here, however, if I want to explain “internationalization” looking at government behavior, then I have to take into account other variables that are also affecting the growth or decrease in exports, imports, and GDP. In other words, for interpreting an increase in the trade openness index as a more pro-free trade governmental trade policy would require controlling for all the variables that affect that index independently of trade policy. These controls may prove very difficult to implement: asymmetric economic shocks, idiosyncratic national changes, etc. On the contrary, the liberalization of capital mobility by governments can be more easily assessed.

The paper is structured as follows. The next section is devoted to a discussion on the ability of government decisions to affect financial flows. As long as this is becoming a controversial debate, I will try to demonstrate that in spite of technological changes, national regulations on international capital flows are not irrelevant. Section 2 is focused on the political economy of capital internationalization. I develop a very simple model that depicts who are the beneficiaries and losers of capital internationalization, and extract consequences for the incentives and capabilities of governments to vary the degree of financial openness. Departing from this theoretical construction, I will develop some hypotheses that will be tested in section 3, in which I present some data and the result of several regressions using capital account liberalization measured in 1988 as a dependent variable. It follows a discussion in which I refine the arguments in the light of the evidence. I will pay special attention to the comparison between my findings for financial liberalization and previous arguments used to explain different governmental propensities to remove barriers to international trade. A final section summarizes the main findings and suggests some further questions.

2. Do government decisions really matter?

Since the end of the Bretton-Woods era in the mid-70s, international capital markets have experienced a dramatic growth compared to the internationalization of other areas of the economy. Most scholars cite two main factors as the causes of this development: innovations in communication and information technologies and new national policies eliminating or reducing capital controls. However, a growing tendency in the public debate has been to emphasize the limited capability of governments to influence capital flows due to the extreme mobility of money and the difficulties this poses for its control. Technological improvements in the area of communications could have done nothing but exacerbate those characteristics that would eventually make national regulations largely irrelevant.

At a first sight, some evidence would seem to support this interpretation. Whereas the easing of capital controls has been quite limited, the growth of capital flows has been much

more dramatic. One first problem with this view is that some evidence shows how governments have been central actors in the building of a freer environment for capital flows, and these stimuli would not be captured by capital controls indexes. For instance, Helleiner (1994:81-100) shows how the U.S. and British governments provided fundamental support for the initial development of the Euromarket for bonds in London during the 1960s. Even though these governmental incentives have provoked a disproportionate reaction by capital markets, this lack of proportionality in the response does not mean the lack of causal relationship.

But even if it is the case that governments' capital controls have not changed³ and capital flows have increased, it is a fallacy to deduce straightforward that the former have no effects on the latter, provided there has been a third variable –technological innovations in this case- affecting the relationship. Simply put, to prove the lack of effects of capital regulation on the evolution of capital flows it is necessary to hold constant technological change. Assume a level x of capital controls, and a level C_x of capital flows associated with x . If technology makes possible that the level of capital flows for x increases to $C_x' > C_x$, this says nothing about the capability of x to alter C_x and C_x' . At least in theory, it is perfectly possible that by altering x , the final outcome after the technological improvement would remain at the C_x level. Hence the lack of an empirical finding pointing at changes in capital controls does not mean necessarily that these changes were potentially ineffective. In fact, if governments have not altered capital controls in the face of easing international transactions due to technological reasons, that has to be considered a choice made by governments to allow for greater capital flows. It can be interpreted as a *de facto* deregulation, since governments could have passed stringent legislation on international capital transactions to keep flows at former levels⁴. Why they did not do so is a question I tackle in the rest of the paper.

So far, it is clear that in the light of preliminary evidence, governments could theoretically affect the level of capital internationalization of their economies. But, could they

³ Simmons' average measure of capital controls shows that this is not the case (Simmons 1999:42).

⁴ It can also be argued that technological improvements have made governmental control easier, since governments are not excluded from their use.

really do it in practice? Given the growing mobility and frugality of capital (see above), how effective would be their intervention? In a recent paper, Garrett (2000: 953) has shown the existence of a significant correlation between open capital accounts and more international capital flows, which indicates that government regulations affect the level of movements of capital. Other scholars are more skeptical. Edwards holds an empirically-grounded argument on the issue that runs against this view. He divides regulation on control on outflows and in inflows. The former, Edwards argues, has proved largely ineffective, given that capital owners have always found ways of circumventing the controls. The more convincing piece of evidence on this is that “in 70 percent of the cases where controls in outflows were used as a preventive measure, there was a significant increase in “capital flight” after the controls had been put in place” (1999: 69)⁵. But he is mainly concerned with controls on inflows. His aim here, however, is not only to show the lack of consequences of this kind of policy but also to demonstrate how negative this can be. The criticism to the argument becomes almost self-evident: how placebo can produce side effects? By looking at the Chilean example⁶, he concedes that capital controls had some –although limited- effects. For instance, he acknowledge that “controls on inflows allowed Chile’s Central Bank to undertake a more independent monetary policy” (1999: 77). If even the more skeptical scholar accepts this, one may wonder if the position of considering capital controls as completely irrelevant is a serious picture of reality.

It may be the case, however, that the removal of capital controls increases capital flows, but once these flows are in place, to control them is much more difficult. The Chilean story runs against this wisdom. But more pieces of evidence show greater importance of capital controls even after their liberalization: one referred to a systematic cross-sectional and time-series analysis, and one case study. Eichengreen et al. (1995: 289) found that under circumstances of exchange market crises, controls allow governments to avoid “not only realignments... but also regime transitions. Capital controls may be a potent weapon for

⁵ Note, however, that what has been said before applies here. That is, it is at least possible that in those 70 percent of the cases, the increase in capital flight would be even greater without capital controls.

⁶ Chile implemented controls on capital inflows from 1991 through 1998. The main instrument of this policy was the requirement for foreigner investors to make non-interest deposits at the Chilean Central Bank. The controls, it has been argued, have helped to discourage short-term (destabilizing) capital inflows while allowing for longer-term capital flows. (Stiglitz, 1999)

governments willing to avoid regime switches". In Spain, under the crisis of the European Monetary System in 1992, García Solanes and Sancho (1999) show the success of the Spanish Central Bank's decision to restrict capital transactions in the last quarter of 1992. Those capital restrictions in place reduced the short-term financial flows and, along with them, the speculative attacks on the Spanish peseta.

Summarizing, it has been shown that the idea that capital controls established by governments are irrelevant for capital flows has several shortcomings both on theoretical and empirical grounds. Governments have had the ability to alter capital flows in the past, and they still have it in these days. What may explain the apparent embracement of more 'liberal' capital flows policies is not the abilities of governments but the change in the costs of pursuing a strategy of stringent controls. For instance, Goodman and Pauly (1993: 79) argue that the imposition of controls were becoming exceedingly costly compared to the benefits. But to argue that the costs of one option have increased is not the same as saying no other option were possible. Also, when the discussion is in terms of increasing costs, one has to develop an argument to explain how this increase happened, and under what mechanisms these increasing costs were eventually translated into decisions in the national arena. The development of such a model is the aim of the next section.

3. The political economy of capital liberalization

Explaining why countries decide to reduce or eliminate controls on capital flows requires looking at the politico-economic dynamics of those countries. Is financial liberalization good for all in the country? That is, is it Pareto-improving? Or are there winners and losers? Who are they? Can winners compensate losers, that is, can the former pay-off the acquiescence of the latter? By looking at the literature on the consequences of increased capital mobility, it is rather easy to identify who is going to be better-off and worse-off after an easing of the regulation of international capital movements. Quite surprisingly, the dialogue between the literatures on causes and on consequences of capital liberalization has

been limited⁷. Common sense, however, indicates that one will support or oppose a decision depending on the expected impact the decision will have on his or her wellbeing. Thus my intention is to develop a model that, by considering the expected consequences, may explain what are the forces within the political system that foster or obstruct the decision of governments to liberalize international capital exchanges.

I assume a democratic government that, in order to retain office, tries to satisfy the median voter. I also assume a society divided in two parts according to their role in the economy: capital-holders and labor force. As long as labor force is significantly higher in number, the median voter is always within this sector of the population. Hence, the government prefers to satisfy capitalists' demands, but it will do so as long as it does not harm labor. In order to define how the easing of international capital transactions affects each group I rely mainly on Rodrik (1997a, 1998a)⁸. The basic argument is that the more mobile is capital, the larger is the elasticity of demand for labor. This larger elasticity translates into i) larger share for the costs of improvements in work conditions for workers, ii) greater instability of earnings, and iii) lower bargaining power for wage-earners (Rodrik, 1998a: 3). Hence capital enjoys a premium from the fact that it can, in Rodrik's words, "pack up and leave", whereas workers cannot. In brief, then, liberalization of capital flows benefits capital-owners and harms the labor force.

Is capital mobility Pareto-improving? Does it enhance overall welfare? The argument could be roughly similar to the one used against protectionism. Capital mobility allows for more efficient allocation of resources. Many economists, however, are not satisfied with this parallelism. The intuitive counter-argument is that because of the importance of imperfect information in capital markets, capital flows are extremely volatile and may carry greater

⁷ See for instance Cohen 1996.

⁸ Frieden, departing from the different endowments of factors among countries, reaches different but not contradictory conclusions. Departing from the Heckscher-Ohlin model, designed originally for international trade, increased capital mobility will benefit capital owners in capital-abundant countries, whereas it will harm the same group in capital-scarce economies. The rationale is quite simple: without borders, rates of return for capital tend to converge, and this means a reduction in capital-poor countries and an increase in capital-rich ones. Labor faces the opposite scenario: as capital flows towards capital-poor countries, labor is harmed where capital was abundant and benefits when capital was scarce. Frieden himself, however, questions the fact that capital can be treated homogeneously. Different forms of capital will be affected differently by capital internationalization. See Frieden 1991.

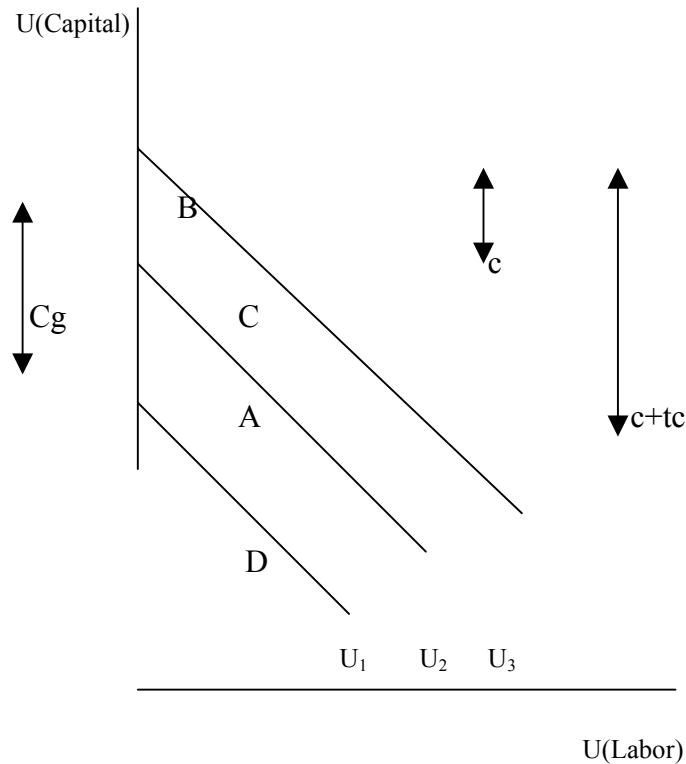
problems than the hypothetical benefits that would be eventually obtained (Bhagwati, 1998). Obstfeld (1994) argues, on the contrary, that the welfare gains from capital mobility arise because of the possibility to diversify and invest more into riskier but also high-yield capital. Whatever the case, this is an open question for economists in which I would not like to enter into. To build the model, I will only assume that there *may* be welfare gains from capital mobility.

From the fact that capital mobility enhances overall welfare it does not necessarily follow that everyone in the society will be better-off after an increase in capital-mobility. As it has been shown above, there are also distributive consequences. But if there are overall welfare gains, there is the possibility of transferring some of these gains from winners to losers making both groups better-off with respect to the original situation⁹. Following this reasoning, in a democracy with zero transaction costs, every decision that improves overall welfare would be adopted. However, we know that transaction costs in real life are usually positive. Depending on how large these costs are, it will become more or less feasible the adoption of a decision that improves overall welfare but has distributive consequences. I will show this graphically.

The problem is depicted in Figure 1. Utilities of the two social groups are represented in each axis. U-curves represent distributions of welfare among groups with equal overall results for the society as a whole. For the sake of simplicity, the graph assumes that the distribution of welfare among groups is a zero-sum game, that is, overall welfare is not affected by how it is distributed. That is why I have represented all U-curves as straight lines. U-curves situated at the right mean more overall welfare for the society. Note however that a society can be in a “superior” U-curve, but one of the groups to find itself worse-off relative to the previous “inferior” U-curve (a movement from A to B, for instance, harms labor even if society as a whole is in a “superior” U-curve).

⁹ This is one perspective of analyzing the compensation argument that explains the correlation between open economies and higher government spending. Countries, in this view, increased their welfare states in order to “compensate” some groups for the risk of the opening of their economies. See for instance Katzenstein (1985), Garrett (1998). The strategy is successful if after the transfers, the beneficiaries of the opening are still better-off. And that is only possible if free trade, as international economists argue, is Pareto-efficient.

Figure 1. Overall benefits, compensation, and transaction costs



Capital liberalization, as explained above, is a decision that harms labor and benefits capital¹⁰. But as long as labor is more numerous among the population and the policy-making process is democratic, movements from A to B would not be adopted. With no transaction costs, however, this need not be a problem, since capital can *always* pay-off the acquiescence of labor, by transferring the quantity c (for compensation). Formally, let Cg be the capital gains of the liberalization move, and c the cost of making labor indifferent between the situation without liberalization and with liberalization and transfers. If overall welfare is greater with capital mobility, then irrespectively on how much the move benefits capital and harms labor, always $Cg-c > 0$. Hence government adopts capital mobility and compensates labor in an amount that depends on how this group has been affected by the liberalization policy. In Figure 1, this is represented as a movement from B to C.

¹⁰ In the Heckscher-Ohlin scheme, this is conditional on the relative abundance of capital.

But suppose that there are also costs of transferring c from capital to labor, and call them t_c . Now it is not assured that $C_g - c - t_c > 0$. Now the adoption of the decision will depend not only on the transaction costs themselves, but also, and perhaps more critically, on the quantity c . The reason why the quantity of the “transfer” becomes relevant is because it is reasonable to assume that t_c increases in c . Graphically, the presence of transaction costs means that transfers from capital to labor imply movements of the U-curve to the origin. Hence it is possible that after the necessary transfer to obtain acquiescence, society is in a U-curve inferior to the one prior to the decision to liberalize. In the figure, for instance, it could be the case that in order to reach a utility for labor similar to A, society has to pay more than what capital gains, moving from B to D. If actors anticipate this, capital controls will not be eased, given that no group prefers D to A.

From this very abstract model it is possible to derive testable hypotheses about the tendency of governments to relax controls on capital flows. First, one should expect a more “liberal” policy when the demand for them is greater. The existence and the size of a capital sector demanding this policy is a necessary factor to press government to move in that direction. In other words, *ceteris paribus*, the greater the C_g , the larger will be the incentives for governments to liberalize capital movements.

But as the discussion has shown, in democratic systems the demand for liberalization on the side of capital may not suffice provided the policy produces a loss for labor. The “compensation” argument becomes critical here. As compensation becomes costly –because of the net transfer and the transaction costs originated by it-, the greater the need for compensation, the more difficult it will become to achieve the acquiescence of labor, and hence the less likely that government will ease international capital flows.

These are the two main hypotheses that will be tested in the next section, in which I discuss the indicators and the data.

4. The data

Before entering into the analysis of the results, I will briefly discuss the data that will be used in the regressions. Measuring the liberalization of international capital flows by governments is not an easy task. The IMF publishes on a yearly basis a report on the exchange restrictions adopted by governments. Based on these annual reports, Quinn (1997) has constructed two indexes of current and capital account liberalization for a set of sixty-four countries. Unfortunately, the data set available has information only for three moments of time (1958, 1973 and 1988), limiting the possibilities of a time-sensitive analysis¹¹. Hence I have relied on cross-sectional regressions. The proxy I use for the dependent variable in the regressions is Quinn's index of liberalization of the capital account¹², that ranks from 0 (total closure) to 4 (maximum openness), adopting eight possible values.

The first independent variable will be GDP per capita as a proxy for the demand for liberalization. To see why, I simply assume that overall wellbeing –that is what this variable indicates- captures the existence of a potential capital that can obtain gains from the existence of exit options, that is, of investing abroad. In poor countries the pressure for easing the restrictions to invest abroad should be minimal given the lack of an excess of domestic capital. The underlying assumption here –which I believe is not very controversial- is that the higher the per capita income, the higher the C_g –the expected gains from financial openness- because of the existence of decreasing returns to capital, so the more pressures governments will have to reduce capital controls. This idea also fits under a Heckscher-Ohlin perspective. Capital is expected to benefit more from international capital mobility the more relative-abundant is in a country¹³.

¹¹ A more time-sensitive dataset is available only for developed countries. The sample of countries I use here, however, covers countries from the five continents and different levels of economic development.

¹² I have neglected the measure on current account liberalization, because my main focus, as set at the beginning is on capital mobility, rather than on trade.

¹³ See footnote 8. Note however that I assume that capital mobility can never benefit per se labor. The Heckscher-Ohlin model of international economics, on the contrary, indicates that freedom of movements of factors of production moves returns towards the same factor in different countries towards convergence. If that is the case, labor would benefit from capital mobility in countries relatively poorly endowed with capital. In other words, labor is expected to benefit from globalization in the less developed countries. This leads to a puzzling question: why developing countries with democratic governments do not liberalize more, if that is what

The magnitude of the transaction costs involved -that is a crucial element of the model- is much more difficult to grasp. Recall however that the difference transaction costs make is that the size of the compensation needed to achieve labor support now matters. So my strategy will be to forgo to measure transaction costs in themselves, and to use the size of the compensation package as a proxy for this package multiplied by the transaction costs¹⁴. Looking at government intervention in the economy can capture the extent of the compensation mechanism. More intervention means less reliance on market mechanisms of allocation of resources, and therefore more alteration of the market-generated outcome¹⁵. Using the terms used before, measures of government intervention would capture the quantity c ¹⁶.

I will also use other variables with the aim of controlling for other potentially influential factors, and to test the plausibility of other alternative explanations. Among them, I include real GDP, to test whether big economies have more propensity to liberalize given that their eventual resistance to external shocks is bigger¹⁷. I also include as explanatory variables the growth of the economy in the previous period, the level of trade openness (exports plus imports as a percentage of GDP), and an index of liberal-democracy. I have also used Gini coefficients to test whether the level of inequality in a society could affect how expensive it could be to pay-off the acquiescence of labor. Finally, as a proxy for government

is expected to benefit the majority of the population, that is, the labor force? I owe this reflection to a comment made by Madeleine Hosli.

¹⁴ But as long as the existence of transaction costs is central to my argument, I have to justify their presence in this area. I do this in the next section by discussing the difference between financial and trade openness.

¹⁵ I assume that government intervention is focused exclusively in redistributing welfare from capital to labor. Although I acknowledge this is not a very realistic picture, it is also true that it is not completely misleading.

¹⁶ I have used the indicator of “real government share of GDP as %”, as presented in Penn World Tables. This variable does not include public investment and –unfortunately- income transfers. Although government consumption is a larger share of the government intervention in the economy in developing countries, Rodrik (1997a: 58), however, shows how this variable may serve as a redistribution device.

¹⁷ Rodrik (1997a: ch.4) has been the main proponent of this argument. If risk avoidance is so central in the explanation of economic openness, one should expect that the smaller the economy, the higher potential impact from internationalization, and thus the less likely will be to liberalize capital flows.

intervention, I have included the level of government share of the GDP¹⁸. In all the regressions I have also included the value of the variable with one lag –fifteen years before- because my real interest lies in the evolution of the variable during the period.

Table 1 shows the results of several OLS regressions taking as dependent variable the level of capital account liberalization in 1988. First, I will look at the first two models -the difference between the two being the inclusion of the liberal-democracy indicator in the first and of the Gini coefficient in the second. Abstracting from the influence of the lagged dependent variable –an influence that appears in all regressions suggesting some kind of “path-dependency”- the only explanatory variable seems to be the per capita income. According to the first hypothesis, this would imply that the demand for financial liberalization would play a central role in governmental responses. Neither the government consumption measure nor the rest of the variables turn out to be significant¹⁹.

However, if the political-economy model depicted in the previous section were to be taken seriously, their predictions would apply only in democracies. In non-democratic regimes, neither the incentives to respond to capital pressures nor, and more importantly, the need to compensate losers from liberalization would be present. That is why I have split up the sample according to the political regime in place²⁰. Models 3 and 4 in Table 1 show the results. The two hypotheses derived from the model now work quite well in democracies, whereas in dictatorships none of the variables except the past level of financial openness is statistically significant. I believe this is one of the more important findings of the paper. It has been argued in many studies that the measure of political regime -a simple distinction between democracies and autocracies- is too rough an indicator of how institutions shape the

¹⁸ All variables have been obtained from Penn World Tables, version 5.6, except the following: Gini coefficients are from Deininger and Square (1996), indicators of liberal democracy from Bollen (1998) and the dummy for the regime type from Alvarez, Cheibub, Limongi and Przeworski (1996).

¹⁹ Both Bollen’s index and Gini coefficient were insignificant if introduced in all subsequent models. That is why I do not show the results with these variables.

²⁰ I could have done this in one regression, but I would have to make explicit in the model all the differences in mechanisms between democracies and non-democracies. As long as these differences were several, I preferred simply to break the sample in two.

Table 1. OLS Regressions for the Capital Account Liberalization index, 1988

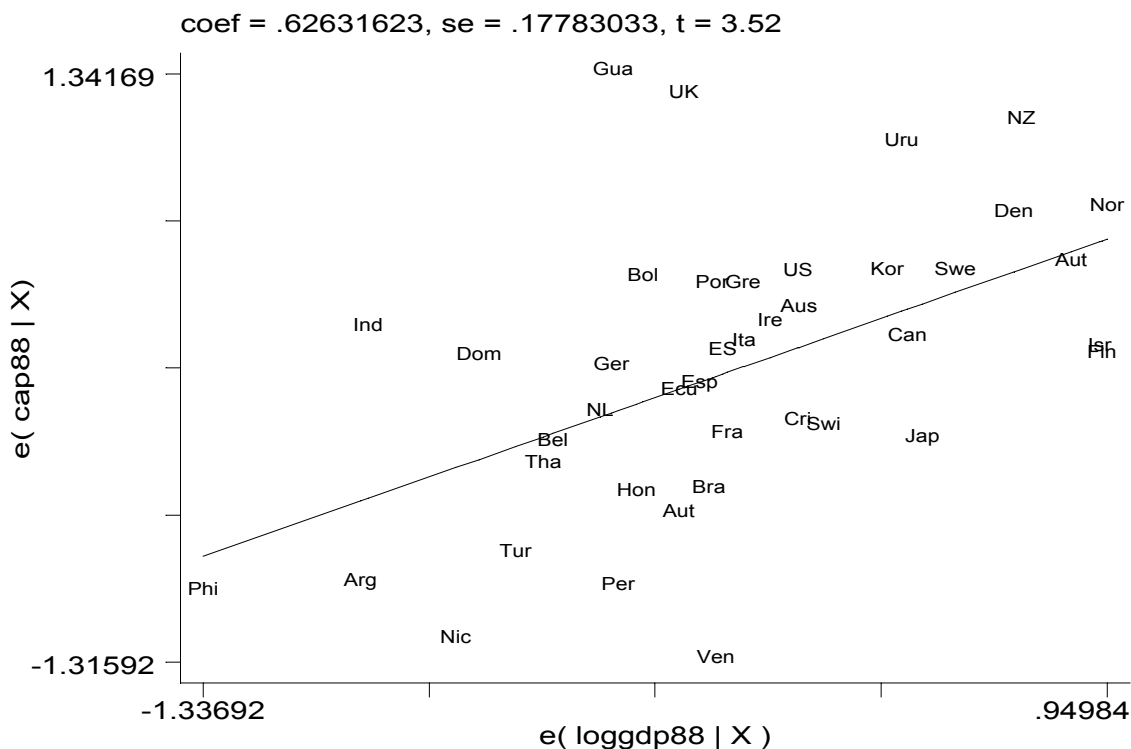
Independent variables	Model 1 Capital account liberalization Index, 1988	Model 2 C.A.L. index, 1988	Model 3 C.A.L. index, 1988 (democracies)	Model 4 C.A.L. index, 1988 (dictatorships)
Intercept	-2.8375 (1.5896)	-.2275 (2.7249)	-.8662 (2.0526)	-3.7977 (2.1938)
Capital Openness 1973	.5064** (.0901)	.5749** (.0995)	.4991** (.1147)	.6786** (.1358)
Log GDP per capita 1988	.4095** (.1628)	.3571* (.1768)	.6263** (.1778)	-.0980 (.2863)
Gov. Share %GDP 1988	-.0224 (.0142)	-.0292 (.0167)	-.0525** (.0186)	.0126 (.0198)
Log trade openness 1988	.2109 (.1977)	.1365 (.2549)	-.0741 (.2635)	.5787 (.2758)
Log real GDP 1988	.0119 (.0814)	-.0438 (.1028)	-.1079 (.1013)	.1642 (.1186)
Log growth 1973-88	-.0228 (.0277)	-.0088 (.0305)	-.0096 (.0414)	-.0437 (.0375)
Bollen liberal-democracy index, 1988	.0015 (.0032)			
Gini coefficient, 1988 circa		-.0188 (.0133)		
F	16.85	14.01	12.28	8.80
Prob>F	<.0001	<.0001	<.0001	0.0006
Adjusted R²	.6686	.6456	.6284	.7113
N	62	51	41	20

Standard errors in parentheses

*: 95% sig, **: 99% sig.

way decisions are taken²¹. In this matter, however, the statistical findings seem to suggest that the scenarios policy-makers face are completely different depending on the type of regime, even abstracting from the big existing differences within democratic political systems. Hence one first conclusion is that political regimes have played an important role in the way governments have decided to open up their economies. Not because democracies are more or less prone to open up their capital account (Bollen's index in model 1 was largely insignificant²²), but because the incentives to follow one course of action or another are different from those of dictatorships. Figures 2 through 5 show with partial correlations the different impact of the two more relevant variables –GDP per capita and government share of the economy- in the level of capital openness of democracies and dictatorships, after controlling for all the other variables included in the regressions.

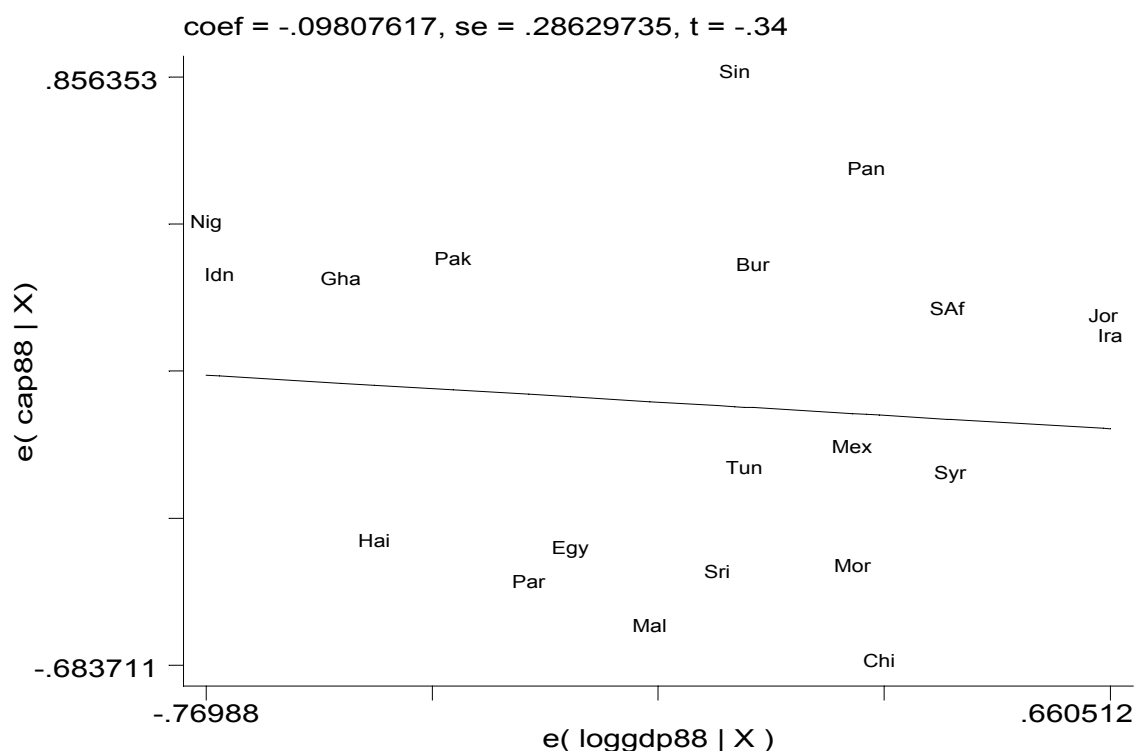
Figure 2. Partial correlation between per capita income (log) and CAL for democracies, 1988.



²¹ See for instance Przeworski and Limongi (1993) in their analysis of economic performance of regimes.

²² Including Alvarez et al.'s dummy variable yielded similar results (not shown).

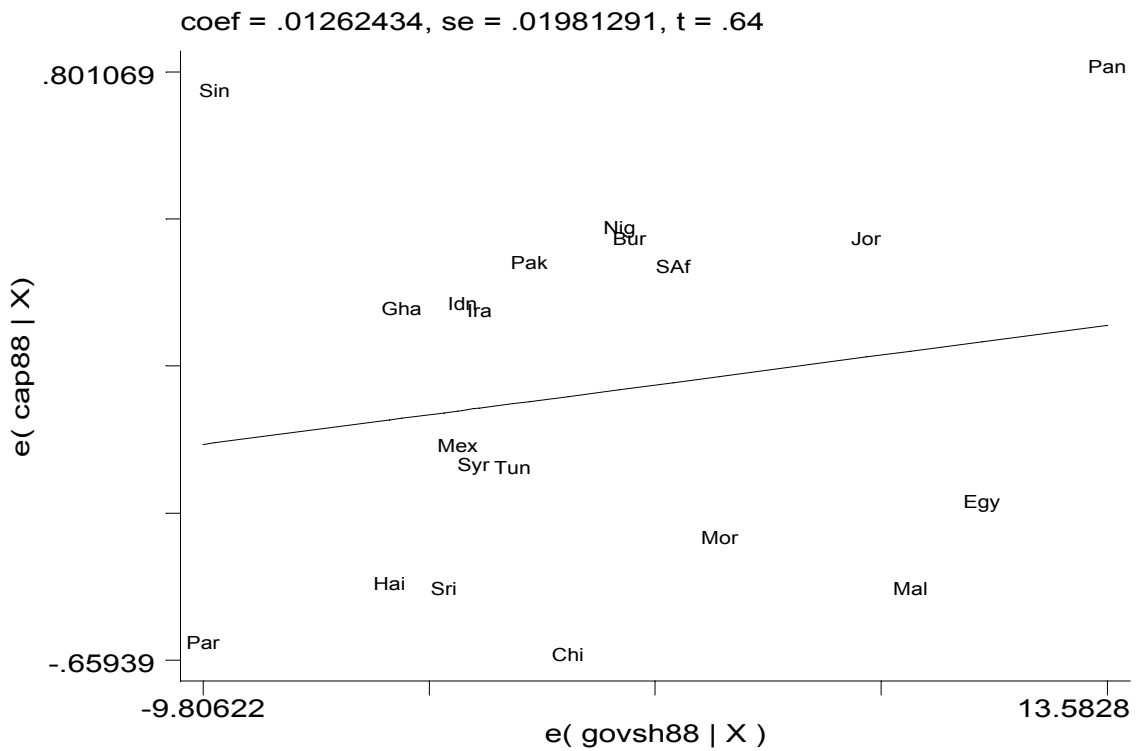
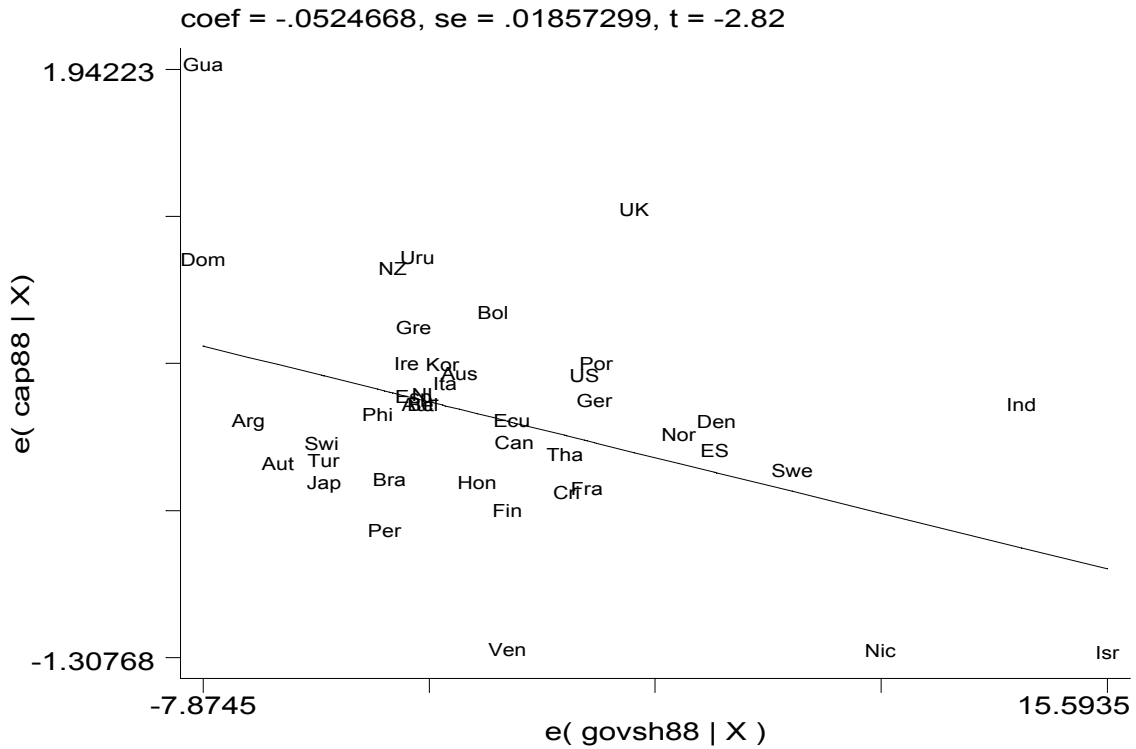
Figure 3. Partial correlation between per capita income (log) and CAL for dictatorships, 1988



What were these different mechanisms between democracies and autocracies? In democracies the two hypotheses of the model perform well. The variables of the log of GDP per capita and government share of the economy are highly significant, and their signs are in the “right” direction. Higher levels of per capita income are associated with higher levels of capital openness. In fact, this would support the hypothesis derived from the previous section. Financial openness produces higher gains for capital the more developed is a country. This would imply higher pressures from the financial community towards capital liberalization. From a Hecksher-Ohlin view²³, capital-abundant countries would be the more willing to liberalize –because with financial openness returns will increase- whereas capital-scarce ones tend to have stringent capital controls –because returns would decrease. On the other hand, the size of the compensation package –government consumption of the GDP- correlates negatively with the openness index. Note that having a government share indicator of ten percentage points higher predicts a reduction of half a point in the index of capital account liberalization, after controlling for the influence of all the remaining variables.

²³ See footnote 8.

Figures 4 and 5. Partial correlation between government share (%GDP) and CAL for democracies (above) and dictatorships (below), 1988.



Dictatorships show different tendencies to opt for financial liberalization²⁴. Two features can characterize their behavior. On the one hand, the influence of the past seems to be even stronger than for democracies. This is quite reasonable. Given that many of these autocratic regimes have not changed in the last fifteen years, and that the governments tend to be isolated from societal demands, there are fewer reasons to alter policies in these contexts than in democracies. On the other hand, to account for changes in the capital account policies of these regimes seems to be more difficult. It is not possible to reject the null hypothesis of zero influence of all of the variables included in the model²⁵. Their behavior in terms of change appears then less predictable than the one of democratic systems. This has also a straightforward interpretation. Whereas for democracies it is feasible to figure out the mechanisms that lie behind decisions because majority rule allow for modeling how and when decisions would be adopted, as shown in section 2, in dictatorships there is no such “rule of thumb”. Democracies are much more predictable because they share the necessity – or at least they have some identifiable incentives- to respond to societal demands. On the contrary, each autocracy is different from each other. The incentives of one need not coincide with the incentives of another.

Are these findings a peculiar phenomenon of the post-73 period, or were they already present before? I have run similar regressions for the period between 1958 and 1973, trying to account for the level of financial openness (measured in the same scale) in 1973. The results are shown in Table 2. And there are striking differences with recent times. Now both democracies and dictatorships show the typical behavior of non-democratic regimes in the 80s, namely strong dependence of the past and unpredictability of changes. So the model depicted in section 2 is a time-contingent one. It works only for the 1973-1988 period. These results, contrary to common wisdom, seem to suggest that the impact of domestic variables in the process of economic internationalization is bigger in recent decades than in previous ones. How can this difference be explained? Some speculation about the differences between the two periods will be offered in the next section.

²⁴ The results for dictatorship are more problematic given the low number of cases (20).

²⁵ This is true for the 95% standard level of confidence. Other variables not included in model 4 produced similar negative results.

Table 2. *Regressions for the Capital Account Liberalization index, 1973*

Independent variables	Capital account liberalization Index, 1973	C.A.L., 1973 (democracies)	C.A.L., 1973 (dictatorships)
Intercept	-3.9109* (1.7596)	-6.8498** (2.1202)	.1548 (4.0545)
Capital Openness 1958	.5027** (.0729)	.5528** (.0883)	.4247** (.1335)
Log GDP per capita 1973	.3382* (.1533)	.1627 (.1894)	.5936 (.2952)
Gov. Share %GDP	-.0018 (.1333)	.0251 (.0162)	-.0288 (.0229)
Log trade openness 1973	.2102 (.2429)	.3875 (.2857)	.0058 (.4688)
Log real GDP 1973	.0492 (.0988)	.2256 (.1158)	-.2341 (.2254)
Log growth 1958-73	.0413 (.0248)	.0425 (.0266)	.0659 (.0625)
F	13.55	10.79	5.87
Prob>F	<0.0001	<0.0001	.0010
Adjusted R²	.5734	.6773	0.5197
N	57	29	28

Standard errors in parentheses
*: 95% sig, **: 99% sig.

5. Discussion

Previous results can be the object of many criticisms. Perhaps the more fundamental problem is the lack of dynamic data that would make the results much more reliable. My intention here, however, is to respond to some possible points that the model and the results may have left unclear, and hence contributing to a better refining of the paper's arguments.

5.1. *Are capital controls causes or consequences?*

I acknowledge that there are potential problems of bidirectionality here. As stated in the introduction, the mainstream of the political-economy literature dealing with economic internationalization takes it as an exogenous variable. My aim has been to point out the second line of causality: from domestic variables to internationalization outcomes. Regarding the results, those emphasizing the conventional approach could make two claims. First, it could be the case that instead of economic wellbeing producing capital account liberalization, it is financial openness that promotes growth, as many economists argue. The problem is that evidence is not very supportive of this claim. Using my data, the correlations between capital account openness and subsequent growth points in the opposite direction, although the association is extremely poor: Pearson's $r=-0.09$ for the 1973-1988 period, and $r=-0.16$ for 1958-1973. There are other pieces of evidence suggesting the same lack of association²⁶.

The second reverse-causality criticism would be that government consumption would be reduced *because* of the problems created by capital mobility. Three points are in order here. First, a rather crude –and hence not conclusive- analysis with the data suggests that the level of capital account liberalization index does not affect the evolution of the government share indicator in the fifteen subsequent years (Person's r is 0.002 taking 1973 as the year of reference). Second, as Garrett (1996) has shown, the level of capital mobility does not necessarily lead to less government intervention, because this effect is mediated by the party in office and the kind of political economy²⁷. And third, it is artificial to treat the level of financial openness as an exogenous variable, given that the government almost directly determines it –even more that the level of government share in the economy.

²⁶ Rodrik (1998b:8) concludes bluntly: “There is no evidence in the data that countries without capital controls have grown faster, invested more, or experienced lower inflation”. Stiglitz (1999) also points out that two of the more expanding economies in recent times –China and India- are growing dramatically while using extensive capital controls. Edwards (2001) argues that the effect of international capital mobility on economic performance is contingent on the level of economic development, due to the fact that it is necessary to have a developed financial system to enjoy the advantages of liberalization.

²⁷ His evidence –he uses panel data- shows that capital mobility leads to less government intervention, but if the increased capital mobility is associated with his “left-labor” index (that indicates the presence of both left parties in power and strong unions) then this promotes higher government intervention. See Garrett, 1996:94.

5.2. *Why are transaction costs so important in the liberalization of capital flows? Comparing capital mobility and trade openness*

To use the measure of government size as a proxy for the importance of transaction costs may appear controversial. As discussed before, the size of the compensation –that is what the measure of government share captures- is irrelevant for the easing of controls if there are no transaction costs, or if they are negligible. Following the model, the indicator is valid only if there are substantial transaction costs, and that has not been demonstrated so far. I will try to show the existence of this kind of cost in this specific realm by comparing it with a similar area: trade policy. Since Cameron (1978), political-economists have been pointing out the persisting relationship between trade openness and higher levels of government spending²⁸. Economic openness, it is argued, foster societal demands for compensation, and government responses by increasing their spending. The argument could also be reversed: more “protected” societies by bigger governments would oppose less intensively the internationalization of the economy²⁹. Note that this evidence points in opposite direction compared to the financial openness phenomenon studied here. My explanation of this *paradox* lies on the transaction costs argument. Compensating losers of the opening of trade is just as expensive as the size of the transfer. Transferring *per se* is cheap. By contrast, in the financial openness issue, the costs of transferring may be substantial. Let us see why.

There is one fundamental difference between the costs of transferring from “winners” to “losers” under trade openness and under financial openness. The reason is that easing capital flows makes more difficult the task of compensating in itself, because of the exit option that this policy offers to capital. As shown formally by Rodrik and van Ypersele (1999), increased levels of capital mobility harms the possibility of transferring income from capital to labor because they enable domestic capitalists to evade national taxes on capital. This hinders the levy of taxes necessary to compensate. That is why the higher the costs of compensating (in terms of size), the more problematic would be to reduce capital controls,

²⁸ Rodrik (1997b) shows the robustness of the association.

²⁹ Katzenstein (1985), in this vein, explains how the generous welfare states cause the low resistance to economic internationalization in Scandinavian countries

because these large demands for compensation would be more difficult to implement due precisely to the greater financial openness.

5.3. Do real democracies function as the model predicts?

Every model is an abstraction of reality, and thereby it leaves many “real” dimensions outside the analysis. The model gives a central role to the need for compensating the labor sector, even more than to the “demand” for a policy of financial openness. The results, however, shows that the existence of a strong capital sector that could potentially benefit from such a policy is perhaps the more important factor. In fact, that is the main argument of some of the descriptive accounts of the phenomena of capital flows liberalization. The pressures from a “financial community” within the state, in this literature, seem to be a determinant element in the governmental shift towards the easing of capital controls (Underhill 1991, and especially Goodman and Pauly 1993). So it is perhaps true that democracies have ways to shortcut the impositions of the majority rule. Some groups may have more access than others to the policy-making process. A more accurate description of how decisions are taken in democracies would have to take into account these differences, although this would surely harm the parsimony of the argument.

I also believe that a closer-to-reality model would have to relax the assumption of the median voter determining in an absolute manner the results and take into account partisan differences. Constituencies of left and right parties tend to be situated close to one of the two factors depicted in the model: labor and capital. Hence the nature of the party in office would have a special interest in promoting the interest of its constituency. The reason why I have not included this in the analysis is the lack of reliable data for the worldwide sample of sixty-four nations. A study made by Quinn and Inclán (1997) for a sample of OECD countries show that parties really make a difference in this issue, with left governments having systematically higher levels of capital closure than right-wing ones.

5.4. *Why did it happen in the 80s?*

Why does the model not perform well in previous period, whereas it does so quite well in the later one? My answer would be that the gains from capital openness become especially important in more recent years. Recall that the two hypotheses of the model are actually the two sides of the same coin. Without the incentives to liberalize –that is, if financial openness provides no substantial gains for capital- the argument about compensation and transaction costs become irrelevant. In the 80s, important changes took place altering the potential benefits to the actors. The gains that could be obtained by capital openness became much more substantive, putting enough pressures in governments to liberalize, provided this decision would not jeopardize the need of compensating labor. But, what was it in the 80s that changed the picture so dramatically?

My intuition here is that the key point lies in the dynamics of financial openness. Think of a government deciding whether to liberalize the capital account or not. Or, to be more accurate to the model, think of the financial community that would eventually lobby for capital openness. What would it do? It seems quite reasonable that it would look at what other countries are doing. If every neighbor country is financially closed, then the gains from the easing of capital controls are rather undetermined, and the more risk-averse is capital and the government, the less incentive they would have to liberalize. Once a certain number of countries have liberalized, however, the structure of potential gains and losses changes radically. In this second case, the pressure from liberalizing would dramatically rise because of the perceived cost of “being left behind”³⁰. In a situation of growing capital openness, because other countries’ capital is benefiting from the gains of openness, the distance between what capital is obtaining with closure and what could be obtained with openness widens. In that context, governments would become more willing to embrace the easing of capital controls, although this would depend, again, on the extent of the pressures of the

³⁰ In these kinds of bandwagon processes, actors that can alter the game by their “go-it-alone” capabilities enjoy special gains. Other actors (countries), on the contrary, driven by the change in the context produced by the “go-it-alone” leaders, can end up in a worse scenario compared with the original status quo. For instance, Lloyd Gruber argues that Italian and British governments had to embrace the European Monetary System once it was set up by Germany and France –who enjoyed this “go-it-alone” power. The fact that Britain and Italy embraced the EMS should not lead us to conclude that they preferred the pre-EMS status quo in which, in Gruber’s view, both were better off. See Gruber 1999.

financial community (that would be given by C_g , the potential gains) and the obstacles created by the need of compensation.

Note that the period for which the model performs better is also the era of growing internationalization of capital markets. By indicating the explanatory variables of the governmental shift towards financial openness, a first step contribution to the explanation of the globalization phenomenon has been made. Economic internationalization, in this sense, can be studied also as an endogenous variable, whose origins lie in the functioning of some mechanisms of domestic political systems. The study of these domestic mechanisms that have prompted this growing internationalization appears as a promising avenue for further research.

6. Concluding remarks

Insufficient attention has been paid so far in the literature to the mechanisms through which governments have pursued recent strategies of internationalization of their economies, assuming implicitly that the so-called globalization phenomenon was a force behind their control and could be considered thereby a purely exogenous variable. Questioning this assumption, and focusing on the liberalization of capital flows, I have attempted in this paper i) to demonstrate that governments decisions have permitted or even facilitated the growth of financial flows, and ii) to analyze what internal constraints may serve to explain the variation in the proclivity of governments to implement financial openness. Two factors have turned out to be central elements in the explanations offered here. First, pressures from the financial community are the driving-force in these changes. And second, governmental capacities to compensate losers of the distributive consequences of openness –because of the existence of transaction costs- have played a central role in explaining varying degrees of capital controls easing. The higher the costs of compensating labor from capital, the more difficult it is for governments to reduce capital controls. By illuminating these phenomena, I hope to have stressed the importance of looking at the domestic political economies in which decisions affecting the economic openness are taken. Obviously, international factors have domestic

impacts. But scholars have to been also aware that, to some extent, that very international context has been a creation of governmental decisions.

The empirical evidence presented here should be taken, however, with some caution. Lacking panel data that would make the results much more reliable given the dynamic dimension of the processes studied here, cross-sectional regressions have been useful in suggesting that the hypotheses derived from the model may not be too misguided. Interestingly enough, the political regime turned out to be a decisive factor in the sense that the mechanisms grasped by the model appeared as relevant only in democracies. The conclusion here is that in spite of the huge heterogeneity in the way democracies aggregate preferences and make decisions, there is some common denominator among them that makes their governments somewhat responsive to citizens' demands. The need of the support of a majority in the electorate places all these regimes under relatively similar scenarios, and thus predicting their behavior becomes somewhat more feasible. Evidence also shows that this explanation of governmental liberalization corresponds only to the 80s. Perhaps the explanation lies in the snowball effects prompted by the financial openness embraced by a set of countries during this period³¹.

Many questions are still open, but I would like to conclude by pointing out two issues that may deserve further attention. Does capital liberalization enhances overall welfare? As it has been said, there are studies denying this. The more problematic issue is that whereas the gains from financial openness are uncertain, allowing for large capital flows produce enormous damage as the recent Asian crisis has shown³². The perceived existence of these risks would make the potential gains (Cg) smaller and the need for compensation (c) higher. As a consequence, the propensity to open capital markets would decrease. But, and here comes the second point, is the liberalization trend reversible? Contrary to the technological determinist argument, the explanation given here suggests that it is theoretically possible to

³¹ Helleiner (1994: ch.9), for instance, argues that the game being played when countries liberalize finance is of a different nature than when countries liberalize trade. Whereas in the latter case the "temptation" option is to close and rise tariffs, in the former is to open. That is how he explains the rapid capital liberalization in contrast with the slower and more difficult liberalization of trade.

³² In fact, the more recent debate is on the regulation of short-term capital flows, that play a determinant role in such crises.

reverse the trend if compensation grows more and more costly³³. However, it is also expectable to find strong difficulties to reverse the trend. One is Gilligan's (1997) account of the strengthening of exporting interests for the case of trade policy in the United States. As long as the strength of the lobbying groups is endogenous to the policy in place, once a policy that favors a group has been put forward, the strength of the group not only consolidates, but it can also increase. In the case of financial openness, capital interests can have become so enhanced by the liberalization policy that an extraordinary change of situation may be necessary to reverse the trend towards liberalization. An additional problem would be the dynamics of financial liberalization (see footnote 30). Implementing control mechanisms requires international cooperation, and the temptation for a country to free-ride can make this cooperation difficult. Acknowledging these difficulties, the study has also shown that democratic mechanisms do matter, and as long as citizens' preferences are relevant, nothing can be prevented of change if these citizens are not satisfied.

³³ Rodrik (2000) also envisages this problem. His "solution", however, is the appearance of "global federalism", that is, democracy on a global scale.

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