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The Political Economy of Economic Openness

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1 Introduction

It is commonplace both in the academia and in the public discourse to emphasize a radical novelty of our times: the growing influence of international factors on domestic economic outcomes. This in short what many understand as the “globalization” phenomenon¹. A huge and growing bulk of literature in sociology, political science and economics has become to deal with the consequences of this process for domestic societies, political systems and economies². My aim is not to investigate further what are these domestic consequences of the acceleration of the internationalization process. Rather, my intention is to focus in the opposite direction of causality, namely, how domestic considerations have affected the way in which national economies have become more internationalized. In other words, I do not take internationalization as an exogenous variable (Frieden and Rogowski, 1996). On the contrary, my basic aim is to explain it as a result of governmental decisions subject to different domestic constraints. Thus my research question is, simply put, why have governments opted for more open economies in recent times and what variables explain the variation in that process.

¹ Hereafter, I will avoid to refer to this term given the different connotations –civilizational change, cultural convergence,... - that may lead to confusion. Instead, I will use “economic internationalization” defined simply as an easing of barriers to transnational movements of the factors of production.

2 Theory

If, as usually assumed, national political economies have undertaken a radical mutation as a consequence of the easing of barriers to the entrance and exit of factors of production, one may wonder what have been the position of governments on this process. More precisely, I am interested in the governmental decisions that have made capital more mobile across countries. Focusing on capital controls rather than on decisions to relax trade barriers –the other “big dimension” of globalization”- have two advantages from a research perspective. First, gathering data on change in levels of trade protection can be an extraordinary difficult task, since governments use not only tariffs, but also very different instruments –as production regulations- which are almost impossible to measure, to fulfill the same protection objective. Secondly, very few studies using a political-economy approach have studied domestic factors influencing levels of financial liberalization.

So the question is why and how governments have accepted this change and in many ways actually prompted it. Two things may justify the relevance of the project. First, we should be able to understand why liberalization³ has triumphed in recent times, in contrast with previous periods of pervasive closeness. This is a puzzle that the political economy literature has not solved in a convincing and comprehensive way yet⁴. And two, by the knowledge of the political underpinnings of the internationalization process, we would also be better equipped to foresee the future tendencies of this process. This would not be the first investigation focused on the governmental policies towards the level of openness of the economy. However, I do believe that my proposal is original and can fill an existing gap on the literature. The relations between the internationalization of capital movements and domestic politics have been studied, (Garrett 1996, 1998a, 1998b are the clearer examples) although the former has been systematically treated as an independent

² See for instance Cerny (1999), Kitschelt et al. (1999), Garrett (1998a, 1998b), Huber and Stephens (1998).

³ By this term I refer exclusively to the easing of international barriers. Its opposite is economic protectionism.

⁴ Milner (1999) reviews the different arguments, although she focuses on international trade.

variable –precisely the opposite direction of causality in which I am interested⁵. Much more work has been done on trade liberalization, which can be helpful for my research⁶.

In summary, I believe there is a gap to be filled. A comparative analysis of the domestic dynamics prompting or hindering economic openness has not been done. My proposal would be original because financial openness has not been studied as a dependent variable from a political-science perspective.

Seeking explanations

As I advanced, I am interested in giving a politico-economic account of the process of financial liberalization. There are three type of explanations that I am interested in. A first way of thinking about the reasons prompting governments to liberalize international capital flows is to turn upside down the classical argument in the political economy literature (Cameron 1978, Katzenstein 1985, Rodrik 1997a) that links more economic openness with a large role for the public sector in the economy through the “compensation mechanism”. My argument here is that domestic characteristics that make compensation to those who are likely too be “worse-off” because of the increased financial liberalization more (or less) feasible affects the governments’ propensities to adopt such liberalizing policies.

⁵ There is no convincing comparative and comprehensive study of how domestic variables may help to explain outcomes in terms of variation in capital controls. The little work that has been done (Quinn 1997 and Quinn and Inclán 1997) is too inductive and lacks a strong theoretical background. There are other contributions, but again they are focused in just some set of cases and end up being a little more that a detailed description of national phenomena of liberalization (Haggard and Maxfield 1996, Helleiner 1994, Underhill 1991).

⁶ For instance, a great bulk of research has been devoted to the study of internal factors influencing US trade policy. Two main arguments come out of this research. First, the protectionist bias of the commercial policy is explained in terms of collective action problems. In short, the costs of import-competing groups are concentrated whereas the benefits of liberalization are dispersed along the consumer population. Departing from this idea, a considerable amount of work has developed the “endogenous tariff” literature. And secondly, the research agenda focused on the American trade policy has also found some answers in the role of institutions and the different way in which they aggregate interests. The main point here (Lohmann and O’Halloran 1994) is that by allocating the decision-making authority in the presidency, overall welfare considerations gained leverage, and state-based protectionist interest found much more difficult to impose their preferred policy. In fact, the massive liberalization of US commercial policy took place after the delegation towards the presidency. The problem with this literature is that is too focused in just one case, and it is only comparative across time.

A second causal mechanism does not really lie in national specificities. I would like to test empirically the impact of “diffusion effects”, that is, how decisions made by other governments affect the costs and benefits of international closure and openness for a national government. Although this is a variable “external” to domestic dynamics, an interesting question is how this exogenous forces are filtered by different national politico-economic configurations.

A third element that has to be taken into account when referring to the political incentives and constraints that governments face when liberalizing movements of capital with other economies is the “macroeconomic constraint”. As the well-known Mundell and Fleming’s trilemma shows, it is impossible at the same time to have international capital mobility, autonomous monetary policy and a fixed exchange rate. Following this argument, the costs and benefits of relaxing capital controls may vary a lot depending on the existence of a fixed rate regime. As Goodman and Pauly (1993) suggest, the decisions that governments make under this circumstances are likely to depend on political reasons⁷.

3 Methodology

How to operationalize the dependent variable? This is a task that I have not done yet, and I guess this is where I have to work in the following. Nonetheless, let me make some points on what are my intentions. First, as long as my interest lie in governmental decisions to open or close I need indicators of what these decisions actually are. Regarding capital controls, the IMF publishes every year an annual report on exchange restrictions implemented by governments. Fortunately, Quinn (1997) has already done the work of indexing the IMF evaluation on two scales. However, his time-sensitive database do not cover all countries in which I am potentially interested. Provided it is feasible in terms of time, I would like to expand this database to non-OECD countries –which are basically those uncovered by Quinn’ data. This would be interesting since my intention is to build a

⁷ The idea here is that the problem the exchange rate regime has to be taken into account when analyzing the expected consequences of financial liberalization. However, it should be emphasized that the decisions to adopt a fixed or a floating exchange regime are not of my specific interest.

“high N” database that allows me to do statistical analyses in order to test the hypotheses I will develop.

Regarding this statistical analyses, two non-excludable strategies are available. The first one deals with the substantive problem of endogeneity already envisaged: countries are affected by levels of economic internationalization (this is the traditional literature on the consequences of globalization), but at the same time the levels of internationalization depend on domestic circumstances (this is my contribution). As long as the first line of causality cannot be overlooked, it is suggested the use of simultaneous equations models, in which the dependent variable in one equation can enter in the right-hand side in the second one. This allow for the estimation of the effect of domestic variables in the decisions to liberalize *taking into account the consequences that growing levels of economic internationalization have in national political economies.*

The second proposed strategy is to define in categorical terms the dependent variable. The substantive reason for that is that my interest is not on marginal changes in a country’s regulations on international capital movements, but rather on qualitative changes that government undertake regarding financial openness. Defined as such, the decision to liberalize international capital flows can be studied as an “event” that can be modeled using traditional duration or event-history models. This technique allows for estimation of the influence of time-constant and time-varying variables in the “hazards” of experiencing an event –in my case, the removal of capital controls.

Finally, a macro-statistical analysis may not suffice. Looking in detail to specific phenomena of international financial deregulation may not only contribute to confirm my hypotheses, but can also provide with some clues for the understanding of the domestic variables that can foster or hinder the process of domestic adoption of free movements of capital. In this direction, it has been suggested the analysis of the process of financial deregulation implemented in Sweden in the 90s, in contrast with the one undertook in Britain one decade before.

4 References

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