Liberalizing Capital Controls:
Economic Pluralism or Political Institutions?

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Financial globalization has been proposed as the single most important characteristic of the contemporary international political economy. Conventionally, this means the financial markets of different nation states are more integrated than ever before. Movement of portfolio and direct investments encounter increasingly fewer barriers and ever lower transaction costs. Although it is widely believed financial globalization has reached such an extent that capital moves frictionlessly across borders, empirical evidence has yielded a somewhat different conclusion. International financial markets have not yet reached the degree of integration found in domestic financial markets, and even the industrialized countries vary greatly in the degree to which they have reduced barriers to financial flows.

In this article, we take on the issue of financial globalization by arguing that financial market integration and the high levels of international capital mobility we observe are but the outcome of domestic policy processes. What we must first understand is why nation states consciously choose to remove various restrictions on capital movement across their borders.\footnote{Any complete understanding of the financial globalization must include the complex and dynamic relationship between government liberalization, the resulting increase in capital mobility and the pressures for greater liberalization that follow. Both Goodman and Pauly (1993) and Cohen (1996) have recognized the importance of this dynamic interaction between national choices and systemic processes. However, as a first cut, we believe it is important to focus on the determinants of governmental decisions to reduce barriers to capital flows, without ignoring the effect of earlier liberalization on the government’s current decision.}

As Cohen (1996) notes in a recent review article, capital liberalization has been explained from a number of different approaches.\footnote{After reviewing a number of recent books on capital liberalization and the approaches both employed and rejected by the various authors, Cohen admits that, “the organization of inquiry seems to be treated very much as a matter of personal taste” (1996:274). The taxonomy we employ -- systemic, societal and}
financial power or the spread of technology to explain globalization. Since this approach ignores domestic influences, a policy of liberalization is assumed to be the rational choice of a unitary national actor. Alternatively, domestic explanations can be divided into two groups. A societal approach argues that changes in the economic fortunes of powerful societal and economic interest groups lead to competition for control of government policy. Termed by some as economic pluralism, this approach sees government policy as a reflection of the balance of power among these socioeconomic groups. While acknowledging the importance of societal influences, a statist approach contends that a state’s governmental and institutional structures play an independent role in determining policy choice. These approaches have often been presented as competitors in explanations of financial liberalization, but they are obviously complementary. Systemic changes alter the economic and political interests of societal groups. However, that new constellation of power and interest is not seamlessly translated into changes in government policy, as economic pluralism would have us believe. Rather, changes in the power and interests of these groups is mediated by existing governmental institutions.\(^3\) Thus, the different models are essentially complementary rather than competing.

Drawing explanations from each of these approaches, but focusing particularly on the pluralist and statist approaches, we seek to explain both cross-sectional and cross-time differences in governmental decisions to remove controls on capital transactions. We expect that capital control liberalization reflects domestic societal interests and their share of power, but that societal support is not sufficient. The policy is also affected by the incumbent government’s ideological composition and political institutions. Using a sample of 18 OECD countries over 24

\(^3\) This is essentially the argument found in Garrett and Lange (1996).
years (1967-1990) we statistically test the hypotheses drawn from each of these approaches and evaluate their complementarity in explaining states’ capital decontrol decisions.

The rest of the paper is organized as follows. In the next section, we review different measures of capital control liberalization and market integration and make a case for the measure of this important variable we choose. A discussion of the different theoretical explanations of capital liberalization policies is followed by a presentation of our methodology and specification of hypotheses. We then present the results of our statistical analysis, and conclude the paper with a discussion of the theoretical implications of our findings.

**Capital Control Liberalization**

Financial globalization has been empirically assessed using several different measures. Frankel (1993) reviews different measures of capital mobility based upon some economic relationships, including capital flows, onshore-offshore interest differentials, deviations from covered interest rate parity, and the Feldstein-Horioka saving-investment approach. He shows that international financial integration has advanced much less than the integration of domestic financial markets. More recent analyses using time series techniques have shown some evidence of international financial market integration, but again only to a certain extent (Cavaglia, 1992; Goodwin and Grennes, 1994). However, this type of research focuses on the increased flows of capital, and the liberalization policy is assumed but not directly measured.

Attempts to measure the capital control or liberalization policy usually rely in some form on the IMF's Annual Report of Exchange Arrangements and Exchange Restrictions. In summary tables, this publication reports the presence (or absence) of twelve different types of restrictions on exchange rates and capital and current transactions.⁴ These data have been used widely by economists and are beginning to appear in the political science literature.

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⁴ See Appendix 1 for a listing of the types of restrictions.
Authors have often summed across these categories to produce a simple aggregate index of restrictions. While such an aggregated index has the advantage of providing an interval level measure, and thus facilitating statistical analysis, it might distort the extent of capital control for at least two reasons. First, it treats very different restrictions with equal weight, and second, some of the restrictions are functionally complementary and are usually lifted (or imposed) concurrently.

A different approach to measurement of policy change is to focus upon the most essential types of capital control restrictions. One of the most important capital flow restrictions deals with restrictions on payments for capital transactions. The imposition of these restrictions are carefully studied in Mathieson and Rojas-Suarez (1994), Alesina, Grilli and Milesi-Ferretti (1994), and Grilli and Milesi-Ferretti (1995). Such a restriction curtails capital flows across borders and thus, produces stabilizing effects upon national economies with respect to the balance of payments situation and the real sector of the economy. The restraining impact is most acutely felt by domestic financial institutions in terms of their foreign asset and liability positions and by nonbank residents such as the multinational corporations in terms of foreign direct investment. Corporations and domestic financial intermediaries are suggested to be the prime political actors who might have strong interests in seeing the removal of such capital restrictions (Goodman and Pauly, 1993; Frieden, 1991; Sobel, 1994). Given that our major theoretical interest is to specify the conditions under which state leaders make decisions to

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5 Restrictions are defined as “official actions directly affecting the availability or cost of exchange, or involving undue delay…other than restrictions imposed for security reasons” (IMF, AREAER).

6 We follow Alesina, Grilli and Milesi-Ferretti (1994) in using this measure as our focus of study, but our design is different from theirs in terms of the fundamental research question, operationalization of some of the political variables, and the inclusion of other independent variables.
liberalize capital controls, we focus on examining the removal of this essential restriction limiting capital transactions.

**Theoretical Explanations:**

*The Pluralist Model*

The pluralist view of democracy argues that policy is a result of competitions among societal interests and that elected politicians have to meet the demands of their own constituencies in the process of pursuing reelection. When capital liberalization is explained in terms of economic pluralism, it is suggested that the liberalization policy simply reflects the wishes of the dominant interest groups (Goodman and Pauly, 1993; Sobel, 1994). The expected distributional consequences of a liberalization policy will generate an incentive for different domestic interest groups to compete for influence over the policy outcomes.

Frieden (1991) identifies several key societal actors who are affected by financial globalization: owners of capital, owners and workers in specific sectors, producers of traded goods, international investors and producers of nontraded goods. The distributional effects of capital mobility lead to political realignments among these different groups. Thus he suggests that support for greater financial integration can be expected from owners and managers of financial assets and from multinational corporations with internationally diversified investments. In a comparative analysis of the capital decontrol experiences of Japan, Germany, France and Italy, Goodman and Pauly (1993) also conclude that multinational firms and domestic financial intermediaries in these countries have more and more interest in investing abroad and diversifying their portfolios internationally. Consequently, as these societal interests have become increasingly powerful in domestic politics, their interests in liberalizing capital flows usually coincide with the adoption of such policies. In this article, we specifically examine
whether domestic deposit money banks and multinational firms are the primary supporters of the liberalization policy and whether policy adoption is correlated with their interests in removing restrictions on capital transactions. We expect that as domestic deposit money banks are more and more interested in owning foreign assets, they are more likely to support policies liberalizing capital controls. We also hypothesize that as multinational firms increase foreign direct investment abroad, they will increasingly support removing restrictions on capital flows across borders.

**The Statist Model**

According to this model, state leaders are rational political actors who act to realize their policy preferences within various institutional and environmental/contextual constraints. The question at issue is whether state leaders enjoy some degree of policy autonomy with respect to capital decontrol in the face of systemic changes and societal pressures. More specifically, if they do play some autonomous role, state leaders should be able to take advantage of domestic political institutions and pursue their own policy preferences, regardless of systemic and societal pressures.

State leaders make decisions based on their policy preferences, and their policy preferences derive from their value assumptions and how they think the economic world works. Helleiner (1994) argues that shifts in the beliefs of state leaders provide an important explanation to why capital decontrol is adopted. Two kinds of beliefs may be important to the adoption of liberal financial policies. The first is a state leader's belief about how the economy works. The belief that Keynesian type economic interventionism and demand side management do not work is the driving force behind the policy of financial de-regulation (Cerny 1994). Only when state leaders believe that capital control liberalization is desirable will they act in favor of removing capital movement restrictions. Thus, policy preferences are related to the decision
makers' cognitive belief. Second, state leaders may be ideologically pro-labor or pro-capital. Pro-labor state leaders are more likely to impose a higher tax rate on capital and, therefore, are less likely to liberalize capital controls in order to avoid capital flight (Alesina, Grilli and Milesi-Ferretti 1994; Grilli and Milesi-Ferretti 1995). On the other hand, pro-capital leaders tend to adopt policies in line with the interests of their own constituencies such as multinational corporations and domestic financial institutions. They are more likely to liberalize capital controls. Thus, ideology is related to the decisionmakers' policy preferences.

Both the cognitive beliefs of state leaders and their attitude toward capital and labor are reflected in the ideological composition of the government and correlated with the partisanship of the government. Extensive evidence has been garnered about the effects of political partisanship in the choice of macroeconomic policies of the industrialized countries (Quinn and Shapiro 1991, Hicks and Swank 1992; Alesina 1995; Garrett 1995). The leftist or liberal party is more prone to adopt a Keynesian type of economic interventionism whereas the rightist or conservative party is more inclined toward laissez faire, neoclassical economic policy packages.

State leaders may be successful in seeking their most preferred policies, but only within existing institutional constraints. In the making of foreign economic policies, state leaders are bound by state political institutional features (Ikenberry 1988; Gourevitch 1986). Two institutional features are relevant to the adoption of capital decontrol policies: the degree of government cohesion, and the degree of central bank independence. One feature of modern democracy is the dispersion of power among disparate political institutions. In a parliamentary system, governments can be formed based upon coalitions of different parties or a single party. Coalitional government is undoubtedly characterized by more compromises than single party government. Government cohesion in policy adoption and implementation can be reasonably expected to be lower in the former than in the latter. Similar situations also exist in presidential systems. Laver and Shepsle (1996) and Fiorina (1996) draw an analogy between coalitional government under a parliamentary system and divided government under a presidential system.
In terms of policy adoption and implementation, both lead to the expectation of more compromises and lower government cohesion, compared to single party government and unified government respectively.

The level of government cohesion is especially relevant to capital liberalization. Frieden (1991), Goodman and Pauly (1993) and Sobel (1994) argue that capital liberalization has important distributive effects upon different groups in the domestic economy. Accepting their argument, we may reasonably expect that the adoption of a liberalization policy will be quite controversial. The issue itself can have a very divisive impact upon a coalitional or divided government. Ceteris paribus, it is less likely for a coalition or divided government to remove capital restrictions, but more likely for a single party or unified government to do so.

One other institutional feature state leaders have to take into account in liberalizing capital controls is the degree of central bank independence. Greater central bank independence implies greater monetary discipline. Thus, not surprisingly, it is found to be significantly correlated with lower inflation and smaller variability of inflation and real interest rates (Cukierman, Webb, and Neyapti, 1992; Alesina and Summers, 1993). Lower inflation does not produce the need for contractionary monetary policy, and less variability in inflation and real interest rates eliminates another reason for drastic capital flows across borders in search of higher returns. Thus, greater central bank independence serves as a facilitating factor when state leaders consider the removal of capital and exchange restrictions. In a sense, financial liberalization is expected to be easier to achieve when the central bank is independent enough to instill monetary discipline.

In the next section, we discuss the methodology used to evaluate these hypotheses and the operationalization of the relevant theoretical concepts so that they are amenable to empirical assessment.
Methodology

We are interested in explaining the conditions under which states liberalize controls over capital flows across national borders. As we discussed earlier, there are different approaches to the measurement of global financial liberalization, and each approach has its strengths and weaknesses. Given that our theoretical focus is state policy choice, we follow Mathieson and Rojas-Suarez (1994) and Alesina, Grilli and Milesi-Ferretti (1994) and focus on “restrictions on payments for capital transactions.” The IMF’s Annual Report on Exchange Arrangements and Exchange Restrictions has reported (since 1967) whether member states imposed or lifted this restriction for a given year. We use this measure to represent state capital liberalization policy. It is coded zero if an IMF member state restricts payments for capital transactions for a given year, and one if it does not impose restrictions for that year. While this measure does not reflect the intensity or degree of capital liberalization for a given state, it does capture whether a state allows domestic financial institutions and multinational firms to invest freely abroad. Therefore, it aptly fits our theoretical interest in assessing the explanatory power of pluralist and statist explanations.

Since our dependent variable, the adoption of capital liberalization policy, is dichotomous, regular regression analysis is not appropriate. Thus, assuming that our sample is drawn from a normal distribution, we use a probit model. Our sample includes 18 OECD countries from 1967 to 1990.\(^7\) This gives us a pooled time series cross-sectional design. One assumption we make in using the pooled time series cross-sectional design is that the parameters for the independent variables are stable across time and over space. Since we

\(^7\) Although we began this project expecting to test our model with 24 OECD countries, six (Greece, Luxembourg, Portugal, Spain, Switzerland, and Turkey) had to be dropped due to missing data on some of the variables. Due to the creation of the lagged variables, the year 1967 had to be dropped from the estimation. The final sample includes 414 observations with 18 countries for 23 years.
believe that our theoretical model is generalizable to the liberalization processes in all industrial countries, the pooled time-series cross-sectional design is most appropriate here.\(^8\)

Economic pluralism argues that state capital liberalization policy is simply an outcome of domestic interest group competition. According to Frieden (1991), Goodman and Pauly (1993), and Sobel (1994), multinational firms and domestic financial institutions are the most important domestic groups that may have interests in liberalizing capital controls. To test whether the pluralist model explains capital decontrol, we use two different measures to gauge the relative interest of these two important domestic actors in capital decontrol. The first measure is a state’s foreign direct investment as a percentage of its gross domestic investment. It reflects the extent to which home country based multinational firms are interested in liberalizing state restrictions over capital flows across borders. The greater the ratio, the more interested multinational firms based in a state will be in having the state’s capital controls liberalized, and the more active they will be in pushing for such a policy change.

The second measure is the domestic money deposit banks’ foreign assets as a percentage of their assets in the (domestic) private sector. This measure is meant to capture the relative interest of domestic financial intermediaries in diversifying their portfolios at home and abroad. The higher the ratio, the more we anticipate domestic financial institutions want to see capital controls liberalized.

Since loosened capital controls may lead to the purchase of more foreign assets by domestic financial institutions and more foreign direct investment flows by multinational firms, the direction of causality between these two independent variables and our dependent variable may run in both directions. Using contemporaneous observations of the independent and

\(^8\) In order to test the robustness of our results, we also carry out analysis on the measure of capital restrictions/mobility in Garrett (1995). Since the variable has multiple rank-ordered categories, we use a
dependent variables could result in spurious findings. To correct for the possibility that capital
decontrol policy may lead to greater capital outflows, we use one-period lagged values for these
two variables. Data on these variables are taken from the IMF’s International Financial Statistics
Yearbook.

We argue that even in the face of systemic and societal pressures, state leaders enjoy
some policy autonomy to make politically rational policy choices. They may act on their beliefs
and policy preferences, or they may be constrained by political institutions in pursuing their
policy choices. To test this statist model, we use one measure to capture the state leaders’
cognitive and ideological beliefs that inform their policy preferences, and two measures to
examine the influence of domestic political institutions. As discussed earlier, state leaders’
beliefs and policy preferences are correlated with their partisanship. Alesina, Grilli and Milesi-
Ferretti (1994), and Grilli and Milesi-Ferretti (1995) use a dummy variable for government
partisanship. We believe that in modern democracies where power is dispersed among different
political actors and institutions, a dummy variable is too crude a measure to truly reflect
government partisanship. Instead, we use an interval level measure of government ideological
complexion developed by Woldendorp, Keman and Budge (1993). The measure is a five point
scale with 1 representing most conservative and 5 representing most liberal. The higher the
scale, the more liberal the government, and the less likely it is to liberalize capital controls.

Government cohesion can affect the adoption of a capital decontrol policy which can
have important distributional consequences. Government cohesion is to a large extent
determined by the structure of domestic political institutions. We measure government cohesion

pooled ordered probit. All the major statistical findings in terms of hypothesis testing are the same as
those presented in the text. Results are available from the authors upon request.

9 See Appendix 1 for an explanation of this measure.
using the “type of government” measure created by Woldendorp, Keman and Budge (1993).\textsuperscript{10} The measure is again a five point (1-5) scale. The higher this measure, the less cohesive the government is, and the less likely it is to liberalize capital controls.

The degree of central bank independence also affects the adoption of a capital decontrol policy. We obtained the aggregate legal index of central bank independence from Cukierman, Webb and Neyapti (1992). It is expected that greater central bank independence facilitates the adoption of capital liberalization policies.\textsuperscript{11}

In considering the liberalization of capital controls, state leaders may also be influenced by several other important factors: systemic level pressures, the exchange rate regime, a country’s trade openness, and its current account status. Valid evaluations of the pluralist and statist models require that we control for these other relevant variables. Systemic level pressures constitute the impact of the market and global financial developments. We measure them by the lagged number of countries in our 18 nation sample which have liberalized capital controls for any given year. As more countries lift restrictions on capital flows, pressures for liberalization are exerted on other countries in the international system.

The type of exchange rate regime also affects a country’s likelihood of capital liberalization. Since 1967, different states have experienced different types of exchange rate regimes: fixed rates under Bretton Woods, managed floating, target zones, and freely floating

\textsuperscript{10} See Appendix 1 for details on the coding used to create this variable.

\textsuperscript{11} Cukierman et al compose two measures for central bank independence: central bank turnover rate and the legal independence measure. They find that the aggregate legal independence index is a better measure for the industrialized countries, whereas the central banker turnover rate is a better measure for the developing countries. In this paper, since our sample includes only the industrialized countries, we use the legal independence index. One drawback of the measure is that it lacks variation over time for many countries. Thus, it does not inform us much about over time changes, but it does show cross-national differences.
exchange rate regimes. The general trend is a movement in exchange rate regimes from more fixed to more flexible. The more flexible the exchange rate, the more difficulty states will have in maintaining stringent capital control policies. We use two dummy variables to control for the effects of different exchange rate regimes. One dummy variable is coded one if a country is under the Bretton Woods fixed rate system, and zero otherwise. The other dummy variable is coded one if a country is under some pegged system and zero otherwise. Both variables are expected to be negatively related to capital liberalization.

There is no definitive expectation on how a country’s trade openness might affect a state leader’s decision on capital liberalization. On the one hand, trade openness is often used as a measure of economic interdependence among countries. When a state is more open to trade, it is more dependent upon other countries, and it has a greater interest in capital decontrol. On the other hand, greater exposure to the world economy implies more exposure to international market risks. As a result, state leaders might be reluctant to liberalize capital controls, since free capital flows could lead to greater volatility and loss of policy autonomy. The lagged value of exports plus imports divided by GDP allows us to estimate the effect of trade openness on capital liberalization. These data are from the Penn World Tables (Mark 5.6a).

As suggested in Goodman and Pauly (1993) and Grilli and Milesi-Ferretti (1995), current account surpluses provide favorable conditions for capital liberalization whereas countries in deficit are less likely to liberalize capital controls. We use the lagged current account balance as a percentage of GDP to account for the effect of macroeconomic conditions upon capital liberalization.

To summarize, our dependent variable, restrictions on payments for capital transactions, is dichotomous with one representing no restrictions on payments (i.e., liberalization) and zero representing the existence of restrictions. The independent variables (along with their expected signs) are as follows:
Control/Contextual Variables:

- number of states in the sample with liberalized capital controls, lagged
  (expected sign: +)
- fixed exchange rate regime (-)
- managed floating/pegged exchange rate regime (-)
- trade openness, lagged (+,-)
- current account balance as a percentage of GDP, lagged (+)

Pluralist Variables:

- domestic banks’ foreign assets as a percentage of their assets in the private
  sector, lagged (+)
- foreign direct investment abroad as a percentage of gross domestic
  investment, lagged (+)

Statist Variables:

- ideological complexion of the government (-)
- type of government (-)
- index of central bank independence (+)

Findings and Implications

The first step in our analysis was to estimate the pluralist model with all the control
variables. However, we began this paper by arguing that these two models are really
complementary, and so the next step was to add the statist model to our pluralist estimation.
We attempt to show that the pluralist model provides an important explanation for state adoption
of capital decontrol policies, but that the inclusion of the statist model can significantly improve
our understanding of state policymaking. We use probit to analyze the pooled time series
cross-sectional data on 18 OECD countries from 1967 to 1990. The statistical estimation results are presented in Table 1.

****Table 1 about here****

The overall model fit measures show that both the pluralist and the statist models provide significant variables for explaining a state’s capital liberalization policy. The likelihood ratio (LR) test, essentially a chi-square test, allows us to reject the null hypothesis that all coefficients are jointly zero at the .01 level for both the pluralist and the full model. The percentage reduction of error for the pluralist model and the full model, as compared against the null model of a constant only, is 44% and 59%, respectively. The percentage of correctly predicted observations is 74.6% and 81.4% respectively, which can be computed from the data in Appendix 2. The pseudo R-square, computed as the likelihood ratio index according to Greene (1993, 651), is reasonably high for both models. Thus, both the pluralist model and the full model have significantly improved our predictions of state capital liberalization policy.

The findings also reveal the complementary nature of the pluralist and the statist models. The LR test comparing the pluralist model and the full model rejects the null hypothesis that all three independent variables from the statist model are jointly equal to zero. Compared to the pluralist model, the full model improves the reduction of error by 27%. These statistical results imply that a model without the statist variables is underspecified in explaining capital liberalization.

Table 1 also shows that all the major theoretical hypotheses have received statistical support for both the pluralist and the full model. Drawn from the pluralist model, the percentage of domestic banks’ foreign assets and the percentage of a state’s foreign direct investment abroad turn out to be statistically significant and in the expected direction. The more domestic financial institutions increase their portfolios in foreign assets and the more multinational firms invest abroad, the more likely a state is to liberalize its capital controls. The policy coincides with the interests of powerful societal actors and supports the tenets of economic pluralism.
Under the full model, both of the pluralist variables continue to be significant and exhibit their robustness to different model specifications. Their effects are not washed out by the inclusion of the statist variables. All three statist variables, government cohesion (type of government), the ideological complexion of the government, and central bank independence, are statistically significant and in the expected directions. The lower government cohesion (represented by higher values on our “type of government” scale), and the further left the state leaders are (represented by higher values on the “government ideological complexion” scale), the less likely a state is to liberalize capital transactions. And the more independent a state’s central bank is, the more likely the state is to adopt a policy of liberalization. These results appear to support the notion that capital decontrol policies are the result of rational and conscious decision making on the part of state leaders and that they have some policy autonomy in making such decisions. They are able to follow their beliefs within the constraints of political institutions. It seems a reasonable inference that although state leaders are constrained by the political institutions in their policy making capacity, they can also design political institutions in ways which may increase their own policy autonomy, even in the face of strong societal interests. Therefore, political institutions may be a double-edged sword for state leaders.

There are also interesting findings for our control/contextual variables in these two models. The lagged number of states with liberalized capital controls is statistically significant and has the expected sign. As more states within the system liberalize over time, pressures for the remaining states to liberalize increase. In addition, relative to a flexible exchange rate regime, the fixed exchange rate regime under Bretton Woods and pegged systems such as the EMS exert less pressure upon nation states to liberalize capital transactions. These results suggest that systemic factors may indeed set broad parameters, within which more complex political interactions between societal and statist forces take place. Consistent with previous research (e.g. Goodman and Pauly, 1993), the current account balance is found to serve as
either a facilitating factor or a hindrance to capital liberalization, depending on whether the
current account is in surplus or deficit. Lagged trade openness is statistically significant and
takes on a negative sign. If our theoretical conjectures about its effects are correct, then the
inference here is that fear of exposures to international financial market risks supersedes the
positive influence of economic interdependence upon capital liberalization.

Our major theoretical expectation is that the statist model complements the pluralist
model in the sense that state leaders are able to exercise some degree of policy autonomy even
under the influence of systemic and societal forces. If the empirical results shown in Table 1
support this notion, then it is reasonable to expect that a capital liberalization policy is most
likely to be adopted when state political factors, societal interests, and the systemic level
influences all point in a favorable direction. A single (majority) party, right-wing government,
accompanied by a highly independent central bank, is most likely to liberalize capital controls
when domestic financial institutions and multinational firms have large percentages of foreign
assets and transactions, and when a relatively large number of countries have already
liberalized capital controls. Unfortunately, the extent to which such an expectation is
substantiated is not explicit in Table 1, because in probit analysis we cannot directly interpret
the coefficient estimates as the marginal effect of the respective independent variable upon the
dependent variable as we do in regular regression analysis. Thus, in order to translate the
statistical results into evidence supporting our major theoretical argument, we need to calculate
the marginal effects of the major statist variables upon the probability a state will adopt a capital
liberalization policy. We compute some probability estimates using the parameter estimates
from the full model and present these results in Tables 2.1 and 2.2.

****Tables 2.1 and 2.2 about here****

The tables illustrate the effects of the major statist variables on the probability of the
adoption of a capital liberalization policy under a pegged exchange rate system and a freely
floating exchange rate system. In both cases, we are interested in the extent to which
government cohesion and government ideological complexion affect the probability of the policy choice, even in the presence of high societal and systemic pressures. Thus, we set both the pluralist model variables (banks' foreign assets and foreign direct investment abroad) and the number of states having liberalized capital controls at values equivalent to the 80th percentile of their respective distributions. We hold all other variables at their mean levels.

Table 2.1 shows that under a pegged exchange rate system, ceteris paribus, a single-party, right-wing government will liberalize capital controls with a probability of 0.72. Alternatively, a multiparty, minority government with a centrist/balanced ideological orientation has a probability of only 0.42 of adopting capital decontrols. Holding everything else constant, but now shifting to a flexible exchange rate system, Table 2.2 shows the probability for a single-party, right-wing government to liberalize capital controls is 0.93. This is very similar to the ideal scenario we identified above. A single-party, right-wing government, facing high societal demands from banks and multinational corporations, a highly liberalized international environment, and a freely floating exchange rate is almost certain to liberalize. However, the probability of liberalization for a multiparty minority government with a left-wing orientation is only 0.69. High societal demands, a highly liberalized international environment, and freely floating exchange rates all remain unchanged in our example. We have only altered the structure and ideological orientation of the government, and yet the probability of liberalization has dropped significantly.

Clearly, the probability estimates, computed using estimated parameters from our statistical model, help drive home the point that the ideological orientations of state leaders and the characteristics of political institutions make a real difference in terms of policy choice, with respect to capital liberalization. It is reasonable to infer that state leaders can manipulate the chances of policy adoption by altering the design of relevant political institutions. Providing the central bank with greater legal independence would increase the probability of adopting more liberal capital controls. State leaders may also use the characteristics of their political
institutions to deflect societal pressures. For example, a leftist government, ideologically reluctant to liberalize capital controls, can always blame the sluggishness of policy adoption on the lack of government cohesion, even in the face of paramount societal and systemic pressures. Our results illustrate the central role that politics play in the choice of capital liberalization policies and have rendered statist explanations more relevant.

Conclusion

Whether referred to as globalization or internationalization, it is widely accepted that barriers to a whole range of international transactions have been falling throughout the post-war period. These systemic changes alter the power and interests of powerful socioeconomic groups within states. In turn, these groups press their governments for changes in policy. However, changes in government policy do not directly and truly reflect the changes in the power and interests of those societal groups. There is another set of actors involved. Government structures and institutions have an independent role to play in translating societal demands into government policy.

Within a sample of industrialized states, we have examined governmental decisions to liberalize on an essential dimension of capital controls -- restrictions on capital transactions. We explained policy choice in terms of a relatively parsimonious statistical model that draws from systemic, pluralist and statist explanations. Our results provide powerful evidence for the links described in the previous paragraph. Explanations drawn from the pluralist model are strongly supported, but the addition of statist explanations significantly improves the explanatory power of our model. Economic pluralism is important, but only tells part of the story. Politics matter.
References


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<th>Parameter</th>
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<th>Full Model</th>
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<td>Banks' Foreign Assets as a percentage of Assets in the Private Sector, lagged (+)</td>
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<td>Foreign Direct Investment Abroad as a percentage of Gross Domestic Investment, lagged (+)</td>
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<td>0.0479**</td>
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<td>Government Ideological Complexion (-)</td>
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<td>0.1908***</td>
</tr>
<tr>
<td>Fixed Exchange Rate under Bretton Woods (-)</td>
<td>-0.9135***</td>
<td>-1.155***</td>
</tr>
<tr>
<td>Pegged or Managed Floating Exchange Rate Regime (-)</td>
<td>-0.8423***</td>
<td>-0.9196***</td>
</tr>
<tr>
<td>Current Account Balance as a percentage of GDP, lagged (+)</td>
<td>0.1417***</td>
<td>0.125***</td>
</tr>
<tr>
<td>Trade Openness, lagged (+,-)</td>
<td>-0.0136***</td>
<td>-0.0143***</td>
</tr>
<tr>
<td>Sample Size</td>
<td>295</td>
<td>295</td>
</tr>
<tr>
<td>Log-Likelihood</td>
<td>-146.59</td>
<td>-133.18</td>
</tr>
<tr>
<td>LR-test (Chi-Square)</td>
<td>113.31***</td>
<td>140.11***</td>
</tr>
<tr>
<td>% Reduction of Error</td>
<td>44%</td>
<td>59%</td>
</tr>
<tr>
<td>Pseudo R-square</td>
<td>0.28</td>
<td>0.35</td>
</tr>
<tr>
<td>LR-test comparing the two models</td>
<td>26.8036***</td>
<td></td>
</tr>
<tr>
<td>% Reduction of Error comparing the two models</td>
<td>27%</td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. *** (**, *) statistically significant at 0.01 (0.05, 0.1) level (two tail).
2. Reduction of error is computed using the following formula:
   \[
   \text{% Reduction of Error} = \frac{(\text{% correctly classified - modal category})}{(100 - \text{modal category})}. \]
3. Psuedo R-square is computed as the likelihood ratio index (LRI) as in Greene (1993, 651).
**Table 2.1:**
Effects of the Major Statist Variables on the Probability of Capital Liberalization Policy Adoption under a Pegged Exchange Rate System as in the Full Model

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Right Wing Dominance</td>
<td>0.72</td>
<td>0.62</td>
<td>0.51</td>
</tr>
<tr>
<td>Balanced Situation</td>
<td>0.64</td>
<td>0.53</td>
<td>0.42</td>
</tr>
<tr>
<td>Left Wing Dominance</td>
<td>0.55</td>
<td>0.45</td>
<td>0.34</td>
</tr>
</tbody>
</table>

Notes:
1. The row variable is government cohesion (type of government); the column variable is government ideological complexion. Each variable is a 5-point scale, we show the effects of these two variables only at their minimum (1), median (3) and the maximum (5) values.
2. The two pluralist model variables and the number of states liberalized in the system are set at their 80th percentile values; all other variables are set at their mean values.

**Table 2.2:**
Effects of the Major Statist Variables on the Probability of Capital Liberalization Policy Adoption under a Flexible Exchange Rate System as in the Full Model

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Right Wing Dominance</td>
<td>0.93</td>
<td>0.89</td>
<td>0.83</td>
</tr>
<tr>
<td>Balanced Situation</td>
<td>0.90</td>
<td>0.84</td>
<td>0.77</td>
</tr>
<tr>
<td>Left Wing Dominance</td>
<td>0.85</td>
<td>0.78</td>
<td>0.69</td>
</tr>
</tbody>
</table>

See notes to Table 2.1.
Appendix 1

Types of Exchange and Capital Restrictions:  
Source: IMF, AREAER.

Exchange Arrangements:  
- separate exchange rates for some or all capital transactions
- import rate(s) differ from export rate(s)
- more than one rate for imports
- more than one rate for exports

Prescription of Currency

Bilateral Payments Arrangements:  
- with members
- with non-members

Payments Restrictions:  
- restrictions on payments for current transactions

Cost-Related Import Restrictions:  
- import surcharges
- advance import deposits

Surrender Requirement for Export Proceeds

Government Cohesion:  
Source: Woldendorp, Keman and Budge (1993)

Data for states under parliamentary systems came from Woldendorp, et al. Data for the United States were coded by the authors. For parliamentary systems, the variable is based on the number and status of parliamentary parties. We created analogous scenarios for our coding of the U.S. presidential system. The government cohesion variable uses the following five point scale:

1 = single party majority government. Parliamentary: the party in government possesses a majority in parliament. Presidential: one party controls the executive branch and both Houses of Congress.

2 = minimal winning coalition. Parliamentary: all participating parties are necessary to obtain a majority in parliament. Presidential: no such correspondence for the U.S.

3 = surplus coalition. Parliamentary: coalition government exceeds the minimal winning criterion. Presidential: one party controls the executive branch, but only one House of Congress.

4 = single party minority government. Parliamentary: the party in government does not possess a majority in parliament. Presidential: no such correspondence for the U.S.

5 = multiparty minority government. Parliamentary: the parties in government do not possess a majority in parliament. Presidential: one party controls the executive branch, but the other party controls both Houses of Congress.

Ideological Complexion of the Government:  
Source: Woldendorp, Keman and Budge (1993)

Data for states under parliamentary systems came from Woldendorp, et al. Data for the United States were coded by the authors based on the rules below. The variable reflects the relative strength of parties in government with reference to the ideological or partisan Left-Right dimension. It uses the following five point scale exhibiting the degree of party control of the government:

1 = right-wing government: share of seats of the right-wing party in government and their supporting parties in the parliament is larger than 66.6%; or the Republicans control both the presidency and the Congress.

2 = right-center complexion: share of seats of the right and center parties in government and their supporting parties is between 33.3% and 66.6% each; or the Republicans control the presidency and one House of Congress.

3 = balanced situation: share of the center party is larger than 50% in government and in the parliament, or the left and right parties form a government together not dominated by either side; or one party controls the presidency and the other party controls both Houses of Congress.

4 = left-center complexion: share of seats of the left and center parties in government and their supporting parties is between 33.3% and 66.6% each, or the Democrats control the presidency and one House of Congress.

5 = left-wing government: share of seats of the left party in government and their supporting parties is larger than 66.6%; or the Democrats control both the presidency and the Congress.
Appendix 2:
Frequencies of Actual and Predicted Outcomes for the Pluralist Model and the Full Model

### The Pluralist Model

<table>
<thead>
<tr>
<th></th>
<th>Predicted (y = 0)</th>
<th>Predicted (y = 1)</th>
<th>Total for Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual (y = 0)</td>
<td>128</td>
<td>33</td>
<td>161</td>
</tr>
<tr>
<td>Actual (y = 1)</td>
<td>42</td>
<td>92</td>
<td>134</td>
</tr>
<tr>
<td>Total for Predicted</td>
<td>170</td>
<td>125</td>
<td>295</td>
</tr>
</tbody>
</table>

### The Full Model

<table>
<thead>
<tr>
<th></th>
<th>Predicted (y = 0)</th>
<th>Predicted (y = 1)</th>
<th>Total for Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual (y = 0)</td>
<td>137</td>
<td>24</td>
<td>161</td>
</tr>
<tr>
<td>Actual (y = 1)</td>
<td>31</td>
<td>103</td>
<td>134</td>
</tr>
<tr>
<td>Total for Predicted</td>
<td>168</td>
<td>127</td>
<td>295</td>
</tr>
</tbody>
</table>