"Change & Continuity in Contemporary Capitalism" John Stephens et al. (eds)

2

THE INTERNATIONALIZATION OF CAPITAL

Beth A. Simmons

The internationalization and integration of capital markets has been the most significant change in the political economy of the industrialized countries over the past three decades. From the Great Depression to the Bretton Woods period, capital markets developed largely within national boundaries. Yet the past three decades have witnessed historically unprecedented growth in cross-border capital movements that have surpassed those of the late nineteenth century, often thought of as a golden age of international finance. Moreover, since World War II, the integration of capital markets has been far more rapid and complete among the industrialized countries than has the integration of markets for goods and services. No other area of the economy has been so thoroughly internationalized as swiftly as have capital markets since the 1970s.

The consequences of such rapid and fundamental change have begun to unfold in a number of countries. More highly integrated capital markets may erode governments' ability to use monetary and even fiscal policies to stimulate the economy. At the same time, newly liberalized capital markets and the growth in foreign investment opportunities may alter the balance of power between relatively immobile labor and capital with a credible "exit option," potentially with significant consequences for domestic institutions and policy outcomes.

The purpose of this essay is to describe the recent internationalization of capital, and to explore the implications for the industrialized countries of the Organization for Economic Cooperation and Development (OECD).

The first section describes capital controls under the Bretton Woods regime and their subsequent liberalization. Bretton Woods endorsed capital controls, but these were relaxed in the 1970s and virtually eliminated in the 1980s and 1990s in most OECD countries. The second section describes the increase in transnational capital movements, and the third reviews the evidence of capital market integration since the 1960s. The fourth section explores the consequences of more integrated capital markets on national politics and policy making, and the final section offers conclusions.

THE POST–BRETTON WOODS LIBERALIZATION OF CAPITAL CONTROLS

Ever since international capital markets collapsed in the early 1930s, governments of the advanced industrialized countries have used capital controls as a key tool of economic policy. In the face of collapsing financial markets and downward spiraling trade, capital controls were employed primarily to try to stabilize currencies and prevent capital flight. Harsh controls were put into place in a number of countries, notably Germany and Japan, for which intervention in capital markets soon became connected to the goal of allocating capital according to national objectives. In other countries, such as Czechoslovakia, controls initially designed to prevent capital flight and balance-of-payments crises were gradually lifted over the course of the decade. The Gold Bloc countries (France, Netherlands, Switzerland, and Belgium) placed few restrictions on capital flows during this period (League of Nations 1938). In the United States, capital controls were favored by the Treasury Department as a way to control the inflationary effects of vast inflows from Europe, but this proposal was ultimately defeated by more liberal thinkers touting sterilization of these inflows rather than their prohibition (Helleiner 1994). In Britain, foreign loans were scrutinized in the 1930s for their effects on domestic British industry (Cairncross and Eichengreen 1983).

After World War II, however, a clear and distinctive justification for maintaining capital controls was articulated in both Britain and the United States: they could be used by governments to manage the domestic economy. Capital controls were defended by White, the primary American negotiator at Bretton Woods, as giving governments much greater control over monetary and tax policy (Horsefield 1969). According to Keynes, capital controls were essential to autonomous management of the economy: "the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates pre-

vailing elsewhere in the world. Capital control is a corollary to this" (quoted by Heillener 1994: 34). And in describing the Bretton Woods agreement before the British Parliament, John Maynard Keynes defended capital controls as an accepted norm of the new international monetary system:

> Not merely as a feature of the transition but as a permanent arrangement the plan accords to every government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox. . . . It follows that our right to control the domestic capital market is secured on firmer foundations than ever before, and is formally accepted as a proper part of agreed international agreements. (as quoted by Goodman and Pauly 1993: n. 5)

Thus, after World War II, a tight matrix of capital controls was continued in many countries of the OECD, and these were viewed not only as an instrument of exchange rate stabilization, but as a means to secure full employment and other national economic priorities. To be sure, Americans, flush with funds to invest, were not and had never been as enamored of controls as were deficit-plagued Europeans at this time (Epstein and Schor 1992). Nonetheless, capital controls were legitimized by Article VI of the Bretton Woods agreement, which allowed members to regulate international capital movements, as long as these did not restrict payments for current external transactions. Even the OECD's 1961 Code of Liberalization of Capital Movements endorsed freer markets subject to the right of the cooperating states themselves to determine when conditions were sufficiently "severe" to warrant a departure from this principle (Lamfalussy 1981). Far from ensconcing principles of capital market liberalization parallel to those in the postwar institution for trade, the Bretton Woods agreement condoned capital controls not only for short-term management of balance-of-payments crises, but also for purposes of domestic economic management.

Virtually every government – surplus and deficit – took action at one time or another to shield its economy from undesired capital movements, though some had constructed much tighter and more enduring barriers than others. Recent research suggests that from the 1950s to the 1970s, governments of the left tended to restrict international financial flows more frequently than those of the right. Right-wing governments did not hesitate to do so, however, in economies with less competitive business firms (Quinn and Inclan 1995). Decision makers in countries plagued by high inflation rates, high government deficits, and high current-account deficits also tended to implement a more intense system of controls (Lemmen and Eijffinger 1995). Overall, controls were typically used as a tool to shield

the domestic economy and prevent the kind of capital flight that might be expected under inflationary conditions.

The most common restrictions limited capital-account convertibility by placing limits on the possession and availability of foreign exchange. Quantitative restrictions were another measure, typically involving limitations on the external asset and liability positions of domestic financial institutions (the evidence on the internationalization of these assets is discussed later). Quantitative restrictions were also at times placed on the domestic operations of foreign banks, as well as on resident firms' and individuals' foreign portfolio assets, real estate holdings, and direct investments (Mathieson and Rojas-Suarez 1994).

Another form of control on the movement of capital was the use of dual or multiple exchange rate systems involving distinct rates for commercial and financial transactions. Typically, the commercial exchange rate was controlled by the authorities, while the financial rate was allowed to float (as will be discussed, floating rates have tended to contribute to capital market segmentation by injecting uncertainty regarding future exchange rate fluctuations into the decision to invest). Dual exchange rates required a detailed set of rules to distinguish capital from current transactions. They also necessitated establishing oversight over residents' foreign exchange transactions and nonresidents' domestic currency transactions, making this approach to controlling international capital movements one of the most burdensome to administer and enforce (Mathieson and Rojas-Suarez 1994). To varying degrees, separate exchange rates for some kinds of capital transactions or invisibles were maintained in Italy between 1972 and 1982, France between 1970 and 1974, the Netherlands from 1971 to 1973, Ireland until 1978, the United Kingdom until 1979, and Belgium as late as 1990 (IMF, various years).

Among the OECD countries, Japan has perhaps made the greatest use of capital controls, largely for purposes of managing the exchange rate and international payments. Through the Foreign Exchange and Trade Control Law of 1949, the Japanese government prohibited capital transactions and restricted licenses for financial institutions engaged in international business. There were also informal controls, such as administrative guidance of the foreign-exchange positions of Japanese banks (Henning 1994). German authorities, opposed to controls in principle, tried to control the inflow of capital, which threatened inflation by increasing the liquidity in the banking system and expanding the money supply. They tried to do this largely through ceilings on overall net flows through the banking system, prohibitions of or negative interest rates on nonresidents' deposits, and bans on further deposits. So did Switzerland, Netherlands, and Belgium in the

waning years of Bretton Woods. In 1966, France passed a law that gave the government the right to control foreign-exchange transactions, and oversee the liquidation of foreign funds in France and French funds overseas. Italy tightened controls in 1973 when expansionary policies led to fiscal imbalances and current-account deficits.

The United States also resorted to capital controls in the 1960s and early 1970s, though these were somewhat halfhearted and often porous in comparison to those in Japan and Europe (Henning 1994). For example, under balance-of-payments pressure, in 1963 the United States imposed the Interest Equalization Tax (IET) on U.S. residents' purchases of foreign stocks and bonds, and two years later the tax was extended to long-term bank loans. In 1965, the United States instituted a "voluntary" program aimed at protecting the balance of payments by limiting the acquisition of foreign assets by U.S. banks and nonbanks. Three years later, the United States began to regulate the outflow of foreign direct investment.

But for a number of reasons, capital controls were significantly reduced over the course of the 1970s. For one thing, despite (or perhaps because of) national regulation, offshore markets grew significantly free from government intervention. Increasingly over the course of the 1960s, national regulations and controls coexisted alongside a growing pool of largely unregulated international capital. Though the Eurodollar market began as a short-term money market, the influx of U.S. banks and multinational corporations seeking relief from national restrictions transformed it into a full-fledged international capital market serving the needs that had previously been met in New York. Despite the widespread desire in western Europe to control speculative capital movements, multilateral cooperation to do so failed in the early 1970s, due to opposition from the United States and a growing realization that effective controls would indeed have to be draconian.[1]

Meanwhile, the growth in private international financial activity jeopardized the system of fixed exchange rates. Their collapse between 1971 and 1973 changed the calculus on which capital controls were premised. Willing to float their currencies, countries could, in theory, enjoy the benefits of efficient international capital allocation while retaining a high degree of monetary policy autonomy (Haberler 1945, 1954; Friedman 1953; Johnson 1974) – a rationale that had the most appeal for the relatively insulated United States. In the American view, a more liberal international financial system would preserve U.S. policy autonomy in the long run: the dollar would still be the world's reserve currency, American

[1] Report of the Committee of 20 established by the board of governors of the IMF in 1972.

financial markets – the most competitive in the world – would remain preeminent, and U.S. current-account deficits could be financed by foreign investors.

In 1974, the United States dismantled the web of controls that had built up since 1963. Once the United States unilaterally lifted controls, other countries felt competitive pressures to do the same. Canada and the Netherlands, for example, lifted controls in the same year. Germany and Switzerland reduced capital controls but up to 1979 continued to regulate transactions to head off currency appreciation. Britain significantly liberalized exchange controls on capital movements beginning in 1977, and removed existing exchange controls of all kinds in October 1979. Japan relaxed controls over the course of the 1970s, and by 1980, these were formalized in the Foreign Exchange and Control Law that made all external transactions free unless otherwise specified (Eken 1984; Rosenbluth 1989: 57). France removed capital controls as a prelude to entering the European Community's single market in financial services in 1986 and had fairly completed the task by 1990; Italy did not begin to eliminate capital controls until 1987 and did not complete the task until 1992.

Figure 2.1 graphs the repeal of nine institutional indicators of capital controls for fifteen OECD countries between 1967 and 1993. The vertical axis is a count of the average number of nine different types of controls (listed in Figure 2.1) in place in each country by year.

Clearly, there have been steep reductions in these types of capital market interference. It should be noted, however, that this composite measure does not reflect various tax and taxlike incentives that even the most liberal states have devised to channel international capital flows. By this composite measure, the United States and Germany had no capital controls between 1967 and 1990, despite the pervasiveness of tax incentives in the 1960s and early 1970s that had tremendous effects on investment decisions. Nonetheless, the repeal of policies that interfere with cross-border capital movements has been substantial, taking only a slight upturn with the final breakdown in fixed exchange rates in 1973, and during the steep hike in world interest rates in 1981. Notably, there was no return to capital controls with the European Monetary System (EMS) crisis in 1992–1993. Most of the major markets were completely unfettered by capital controls by the early 1990s.

The dynamics that led to such drastic relaxation in capital controls over the past two decades are increasingly under study. Early popular accounts stressed the role of technological innovation. The financial services industry has been revolutionized by technological innovations that affect communications, the speed of computations, and the ability to conclude

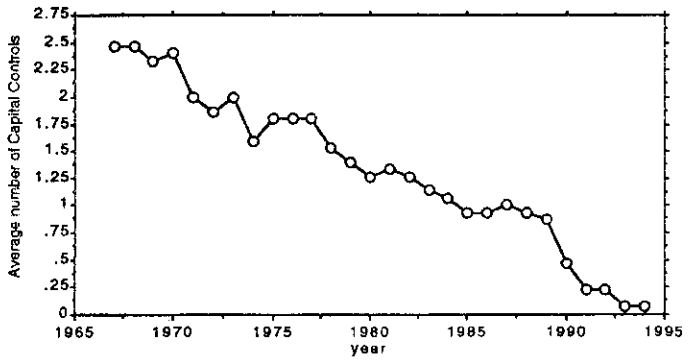


Figure 2.1. Average number of capital controls (of a total of nine measures for fifteen OECD countries, 1967–1993. Included controls: (1) *restrictions on capital account* (refers exclusively to resident-owned funds); (2) *bilateral payments with members* of the International Monetary Fund (considered a highly illiberal way to settle payments and in effect posed a barrier to the movement of capital); (3) *bilateral payments with nonmembers*; (4) *deposit restrictions* (typically a quantitative restriction on the external liability and asset positions of domestic financial institutions); and (5) *dual exchange rate regime* (separate exchange rates for some or all capital transactions and/or some or all invisibles). The following constituted limitations on current-account transactions, and are included because current-account transactions can be used to partially evade restrictions on capital transactions by overinvoicing imports and underinvoicing exports (allowing capital to exit): (6) *advance import deposits*; (7) *import surcharge*; (8) *restrictions on current transactions*; and (9) *surrender of export proceeds*. (SOURCES: All data are from the International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Restrictions*, Washington, D.C., various years. Computer readable copies of 1–4 were originally supplied to me by Geoffrey Garrett; computer readable copies of 6–9 were coded and supplied by Gian Marie Milesi-Ferretti; and 5 was hand-entered by the author from *Annual Report on Exchange Arrangements and Exchange Restrictions*, various years.)

international transactions instantaneously. Technological advances that make international transactions instantaneous and inexpensive in effect raise the cost of trying to seal off the national economy from global capital markets (Bryant 1987; Wriston 1988; McKenzie and Lee 1991; O'Brien 1992). More economically and politically nuanced renditions have stressed the element of competitive liberalization, by which lifting

controls in one country creates pressures to liberalize elsewhere (Frankel 1992; Frieden 1989; Kenen 1985; Porter 1990; Moses 1994). For example, controls may disadvantage domestically based multinational firms whose foreign competitors are able to invest and borrow globally at will. Goodman and Pauly (1993) argue that by 1984, when capital markets were rapidly developing elsewhere, the competitiveness of both French industry and finance was seen to be seriously undermined by capital controls. Political pressure from internationally oriented firms provides the mechanism linking liberalizing moves in other countries with similar policies elsewhere.

To be sure, there are also a number of reasons states may have begun to favor deregulation and the lifting of capital controls on domestic policy grounds. In the cases of the United States, France, and Japan in the 1980s, for instance, liberalization of financial markets and capital controls may at least partially be related to the needs of governments to tap internal or external sources of funds to finance growing public debts (Eken 1984; Feldman 1986; Cerny 1989). Others have stressed that the policy of maintaining or lifting capital controls is a highly political – even partisan – policy choice. Some political economists have argued that the propensity to use or to eliminate capital controls is the outcome of class conflict in which market discipline is marshaled to constrain the inflationary demands of labor and the profligacy of leftist governments (Notermans 1993). Gerald Epstein and Juliet Schor (1992) have argued that the propensity to employ capital controls reflects the relative balance of power between labor and capital. Where the former has greater political influence, controls are more likely. Thus, they argue, controls have been dismantled not because they are ineffective, but because of the relative shift in political power among groups. Domestic ideology is also cited as a factor. The spread of neoclassical ideas most clearly embodied in the policies of Reagan and Thatcher provided a clear framework for eliminating controls. As one scholar has written, "Liberalization and deregulation were, after all, the catchwords of the decade" (Moses 1984; see also Plender 1988; Pauly 1988). This view attributes the decision to lift controls to convergence around the tenets of neoclassical economics.

Obviously, technological, competitive, political, and ideological explanations are not competitive, but rather are highly complementary explanations for the decision to facilitate capital-market integration. The next section examines the extent of actual capital movements over the past three decades and the evidence of increased integration across markets.

TRANSNATIONAL CAPITAL MOVEMENTS: THE EVIDENCE

Transnational capital movements have reflected the broad contours of government policy toward capital controls this century. From a historical high before World War I, international capital markets recovered somewhat during the 1920s and then virtually shut down during the Great Depression through World War II (Stallings 1987). The past three decades can be thought of as a *reemergence* of international capital, since by a number of measures, capital markets were as integrated and money flowed as readily across borders during the height of the nineteenth-century gold standard as it has in recent years. By the last quarter of the nineteenth century, for example, Italy, India, and Denmark owed more than 30 percent of their gross national product (GNP) to foreigners – a ratio that approximates that of the largest developing country debtors in the 1980s (Zevin 1992: 47). On the creditor's side, during the height of the gold standard Britain had invested some 153 percent and France 97 percent of their respective GNPs overseas. No creditor today comes anywhere near these figures. The stock of world gross foreign direct investment was approximately 49 percent of the total GNP of the five largest nations in 1914, and it was about 50 percent of the five largest nations in 1989 (Pollins 1993). Before World War I, government bond yields, and business cycle correlations among the major markets between 1876 and 1914 were apparently as correlated as they have been in the 1980s – another indicator that these markets were comparatively integrated (Zevin 1992).

A few preliminary points should be made about the reintegration of capital markets in recent years. First, the most important burst of transnational flows among the OECD countries took place in the early to mid-1980s and largely reflected the tremendous financing needs of the U.S. current-account deficit. Figure 2.2 shows that transactions in international capital movements within the OECD (measured here as the total absolute value of net changes in assets and liabilities of foreign direct and portfolio investment) bear a strong mirror-image resemblance to the U.S. current-account deficit (all figures are standardized by GNP).

Apparently, as was the case with the OPEC surplus of the 1970s, one of the major stimulants of the increased volume of capital across borders was the presence of tremendous current-account imbalances in the system. Yet despite the reduction of the U.S. deficit, international capital flows have continued, evidence that once internationalized, firms and investors do not readily retreat from their global vantage.

Second, and relatedly, the "internationalization" of capital in the

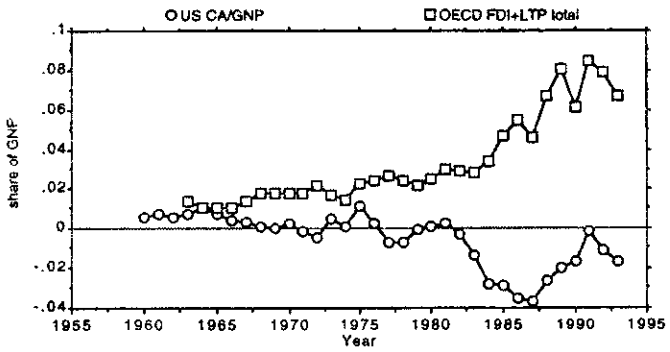


Figure 2.2. Relationship between the United States current-account deficit and the absolute value of total net flows of foreign direct and portfolio investment of OECD countries. (SOURCES: Foreign direct investment is calculated from *Balances of Payments of OECD Countries*. Portfolio investment is calculated from *Balances of Payments of OECD Countries*, supplemented by IMF, *Balance of Payments Statistics Yearbook*, detailed transactions tables: portfolio outflows are calculated from lines 53 (government bonds); 56 (corporate bonds); and 59 (corporate equities); and portfolio inflows are calculated from lines 55 (government bonds), 58 (corporate bonds), and 61 (corporate equities). Total net flows are calculated as the absolute value of the sum of these inward and outward flows. U.S. current-account deficit is from IMF, *Balance of Payments Statistics Yearbook*.)

1980s was largely an investment orgy among the wealthy, and only recently and fitfully has extended to developing countries. While the absolute value of investment in developing countries doubled over the course of the 1980s, their *share* of global foreign direct investment fell from 25 to 19 percent, largely as the result of very favorable investment opportunities in the United States (OECD 1992c: 11)[2] Even more than has been the case with foreign direct investment, the explosion of portfolio investment largely reflects transactions among advanced capitalist countries; portfolio

[2] In addition, ten developing countries outside Europe accounted for three-quarters of total FDI over the course of the decade: Singapore (12 percent), Brazil (12 percent), Mexico (11 percent), China (10 percent), Hong Kong (7 percent), Malaysia (6 percent), Egypt (6 percent), Argentina (4 percent), Thailand (3 percent), and Colombia (3 percent) (United Nations 1991). The increasingly "north-north" nature of much FDI is an important distinguishing feature of the current period compared with circumstances in the first golden age of the nineteenth century, when FDI tended to flow from the creditor countries of western Europe (United Kingdom, France, and, somewhat later, Germany) to Latin America, Russia, the United States, and "regions of new settlement" (Australia, New Zealand, and Canada) (Pollins 1993).

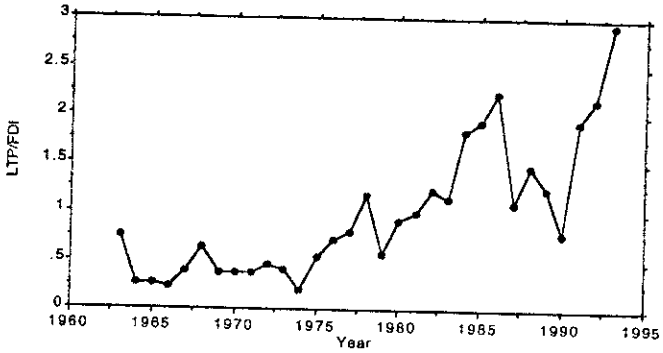


Figure 2.3. Ratio of long-term portfolio investment to foreign direct investment for the OECD, 1963–1993. (SOURCES: See Figure 2.2.)

investment in all but a few developing countries has remained rather limited. The capitalization of developing countries' stock markets stagnated at 6 percent of those of the advanced industrialized economies throughout the 1980s (Sobel 1995; Turner 1991: 52). International bond issues of developed countries were valued at $96.8 billion in 1984 and $207 billion in 1990. Developing countries' bond issues totaled $3.8 billion in 1984, but they did surge to $59.4 billion in 1993 before the Mexican crisis (IMF 1995). These investments are heavily concentrated in a few emerging markets: approximately 70 percent of non-OECD bond issues were those of Hong Kong, Singapore, South Korea, Taiwan, Indonesia, Malaysia, and Thailand (Turner 1991).

Third, within the advanced industrialized countries, there has been an important shift in the relative importance of portfolio and foreign direct investment. The former has grown far faster than the latter recently (Figure 2.3). In the 1970s, net portfolio inflows and outflows were perhaps half again as large as foreign direct investment; by the 1990s they were 2.5 times as large for the OECD as a whole – a development that has enhanced the perception if not the reality that governments are facing increasingly volatile economic forces that need not make for the most efficient allocation of resources and over which they have little control.

Finally, country-by-country evidence suggests that there are still noticeable differences among countries with respect to their reliance on foreign capital relative to their total economy. There are also some differences in the extent to which national interest rates have become correlated with those prevailing internationally, though these have narrowed significantly over time and are heavily influenced by exchange rate volatility. This leaves room to argue that it is possible, though undoubtedly, increasingly costly,

to resist the waves of capital-market liberalization that have been sweeping most markets of the OECD.

FOREIGN DIRECT INVESTMENT

During the Bretton Woods period, foreign direct investment (FDI) was the most common form of international capital movement for most OECD countries. In fact, during the decade of the 1960s, every OECD country save three – Belgium, Canada, and the Netherlands – had larger total FDI transactions than any other category of international capital transaction. During the 1960s and early 1970s, American multinational firms invested heavily in Europe, but this trend was moderated in the 1970s and then reversed drastically as U.S. current-account deficits grew in the early 1980s. As a result, foreign shares of U.S. assets, employment, and production held by U.S. affiliates of foreign firms nearly trebled between 1977 and the late 1980s (Graham and Krugman 1989). All of the most highly industrialized European countries became net exporters of FDI in the 1980s.[3] Sweden had the most precipitous shift toward net export status in the late 1980s, with *net* overseas direct investment in 1990 totaling more than 5 percent of GNP.

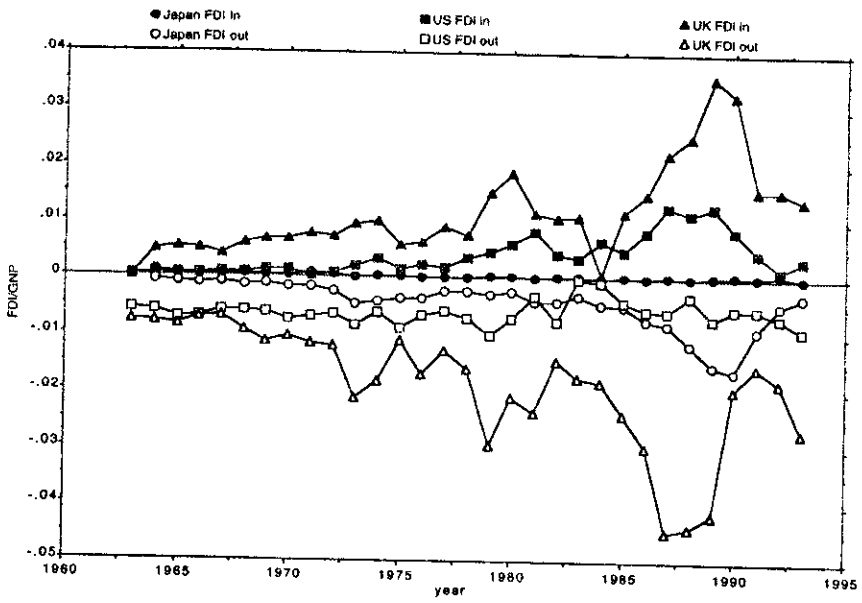
Figure 2.4 gives some impression of the openness to FDI of several OECD countries from the early 1960s to the present. This figure charts total FDI transactions – net inflows (liabilities) and net outflows (assets) – relative to GNP each year.

In most cases these flows began to grow significantly around 1985. Thus, many advanced industrialized countries became increasingly subject to FDI inflows and outflows relative to their total productive capacity (as well as a share of their domestic capital formation)[4] in the mid-1980s. There are some exceptions, to be sure. Japan, for example, has come to rival the United States and United Kingdom as one of the leading sources of FDI, yet net inflows have not grown appreciably (Figure 2.4a). For obvious reasons the developing regions of Europe (Spain, Portugal, Ireland, Iceland, and Greece) have imported far more direct investment capital than they export (Figure 2.4b). The ratio of FDI to GNP has been highly variable for a number of countries (Australia, Canada, Norway, Switzerland; not pictured here), though the reasons for this pattern certainly vary across cases. France, Belgium, and to a lesser extent the Netherlands most

[3] Spain and Portugal increasingly imported foreign direct capital investment during the 1980s, though net imports decreased in Ireland.

[4] OECD 1992c: 11.

a. United States, United Kingdom and Japan:



b. Spain, Portugal, Ireland:

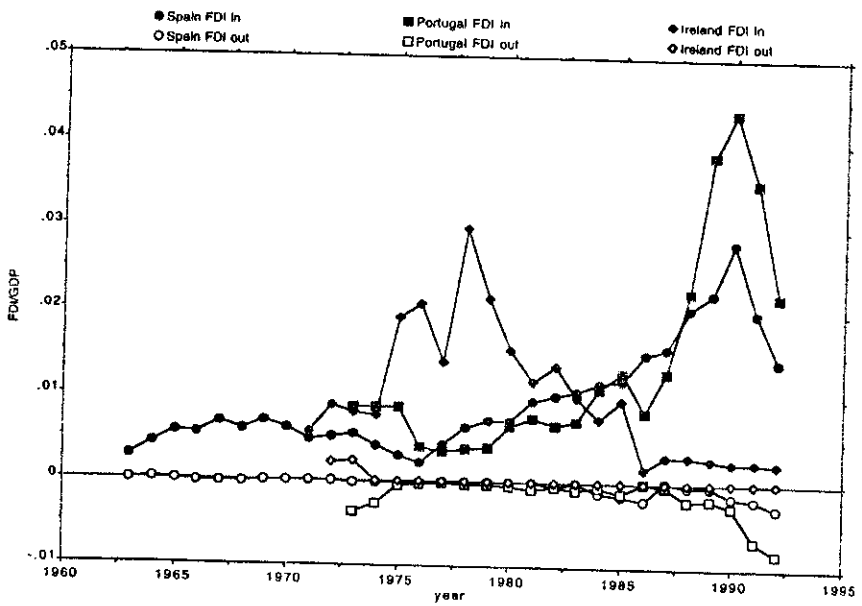
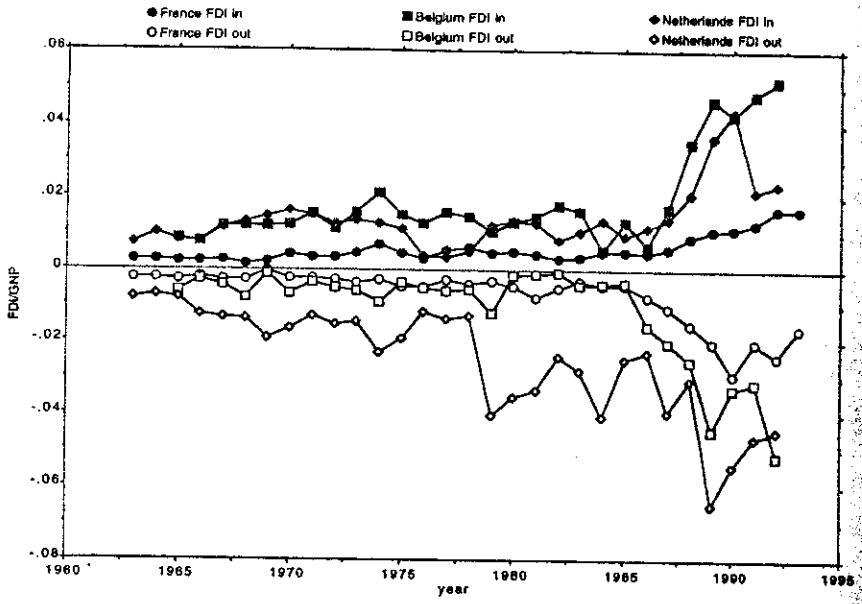


Figure 2.4. Foreign direct investment inflows (liabilities) and outflows (assets), as a percentage of GNP, 1963–1993.

c: France, Belgium, Netherlands:



closely typify the OECD pattern over the course of the past three decades (Figure 2.4c): while Belgium and the Netherlands are overall far more open to FDI, these countries all show a marked increase in both net imports and net exports between 1985 and 1990. In each case, although there was some evidence that these movements were beginning to moderate by the beginning of the 1990s, they have since recovered. Virtually all restrictions on the outward movement of FDI have been removed in OECD countries, and inward investments face only sectoral restrictions (rail and road transport, and public utilities, for example; OECD 1992c: 11).

The kinds of direct investments made over the course of the past decade have evolved as well. Traditional investments in raw materials and manufacturing are an ever smaller portion of the share of FDI in the OECD. Foreign investors are increasingly looking to service and high-technology sectors for investment opportunities. One of the most distinguishing features of the 1980s was the fact that most members of the OECD for the first time came to authorize foreign banks to establish branches on their soil (OECD 1992c: 37). And relatively fewer foreign investors are willing to start from scratch: mergers, acquisitions, and strategic alliances account for a growing share of total investment, as firms seek to penetrate markets and tap new sources of technology cheaply and

quickly (OECD 1992c: 11, 36).[5] This last trend may provide one explanation for the recent burst of FDI in many OECD countries: having liberalized their trade over the course of the past two decades, the international competition stimulates a constant search for new technology and know-how so essential to the ability to compete in global markets (Cowhey and Aronson 1993).

THE INTERNATIONALIZATION OF THE BANKING SECTOR

The internationalization of the accounts of national deposit banks provides further evidence of the internationalization of finance. Figure 2.5 shows that there has been a tremendous and, until recently, unrelenting increase in foreign assets and liabilities of national deposit banks relative to total GNP.

The decision of the United States to lift regulations on international capital flows led to a huge increase in the external claims of U.S. banks from $26.8 billion to $203 billion from 1973 to 1980. Yet the United States lags far behind the OECD average when standardized by GNP. Belgium, the Netherlands, the United Kingdom, and most especially Switzerland are best known for their highly internationalized banking sectors. These countries are the only four that are obviously above the OECD average (Figure 2.5a), but even in France and Austria, countries known for government intervention in finance for purposes of industrial and macroeconomic policy making (Zysman 1983; Kurzer 1993), deposit banks have increased their international business in real terms and have kept up with the regional average. The Scandinavian deposit banks have made the most dramatic changes over time. From rather insulated beginnings these banks are increasingly accepting foreign deposits and lending to foreign borrowers (Figure 2.5b). Once again, the deposit banks of Greece and Portugal reflect the developing status of these regions: though international activity of all kinds is up, they increasingly accept more deposits (liabilities) than they make loans (assets) (not pictured here). Banks in OECD countries with the least international business relative to the size of their national economy tend to lie outside of Europe – in North America or Down Under (Figure 2.5c).

The comparative statistical evidence is fairly clear that production and banking are increasingly aimed at and depend on international markets.

[5] This is despite the fact that some governments (e.g., Sweden, Canada, and Belgium) are more likely to require authorization for foreign acquisitions than greenfield investments.

The fact that these trends are *real* – these measures of internationalization and openness persist when standardized by GNP – suggests that the economic and hence the political visibility of these more highly internationalized firms has truly increased over time. These firms are likely to continue to demand open markets, further entrenching liberal policy choices to date (Goodman and Pauly 1993; Scharpf 1991: 248).

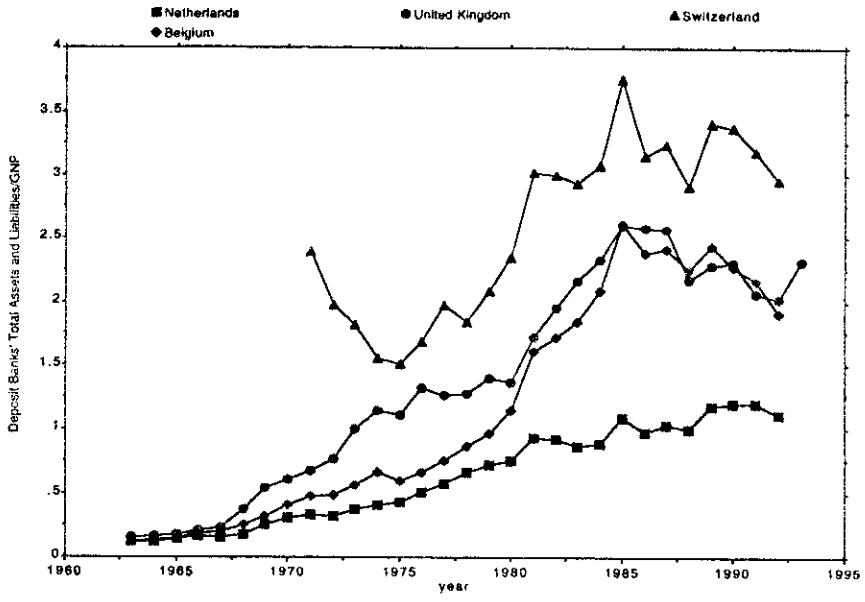
PORTFOLIO INVESTMENT

Portfolio investment (stocks, bonds, and bank loans) have grown much more rapidly than has direct foreign investment, and tends to be much more liquid and, as a result, more volatile. Beginning around 1974, but accelerating again in the mid-1980s, net changes in portfolio inflows totaled about 3 percent of GNP per year in the OECD, but for some countries were much more.

Figure 2.6 plots total inward and outward flows standardized once again by GNP. Since portfolio investment is highly volatile, we might expect it to be highly responsive to the institutional environment, and this does seem to be the case, especially for the Scandinavian countries (Figure 2.6a). Norway's 1974 capital control liberalization coincided closely in time with that of the United States, and led to a tremendous increase in inward flows. Sweden is another case in point. Until mid-1989, Sweden imposed tight restrictions on foreign investment by domestic institutional investors. The large acquisition of foreign assets that year indicates they lost little time in starting to diversify: their holdings of foreign securities as a percent of total security holdings jumped from 4 to 10 percent between 1989 and 1990 (Lindenius 1990). The phaseout of Britain's capital controls in 1979 opened the way for massive increases in these flows in the 1980s (Figure 2.6b). For France, flows seem to have been stimulated slightly by liberalization in the United Kingdom, and even more so by France's own program of liberalization prior to the unification of the European market in 1992. Italy's 1987 reforms were followed almost immediately by unprecedented two-way flows of portfolio investment. With the exception of Greece, long-term portfolio flows increased drastically in the European periphery from the mid-1980s (Figure 2.6c). The removal of capital controls in the United Kingdom (1979) seems to have preceded large jumps in international portfolio flows even in countries such as Ireland that made no major changes in their own controls over the period.

What these graphs do not reveal is that the *composition* of portfolio investment has undergone some change over the course of the past decade and a half with a strong dip in bank lending between 1981 and 1986.

a: Belgium, Netherlands, United Kingdom, Switzerland:



b: Sweden Norway, Denmark, Finland:

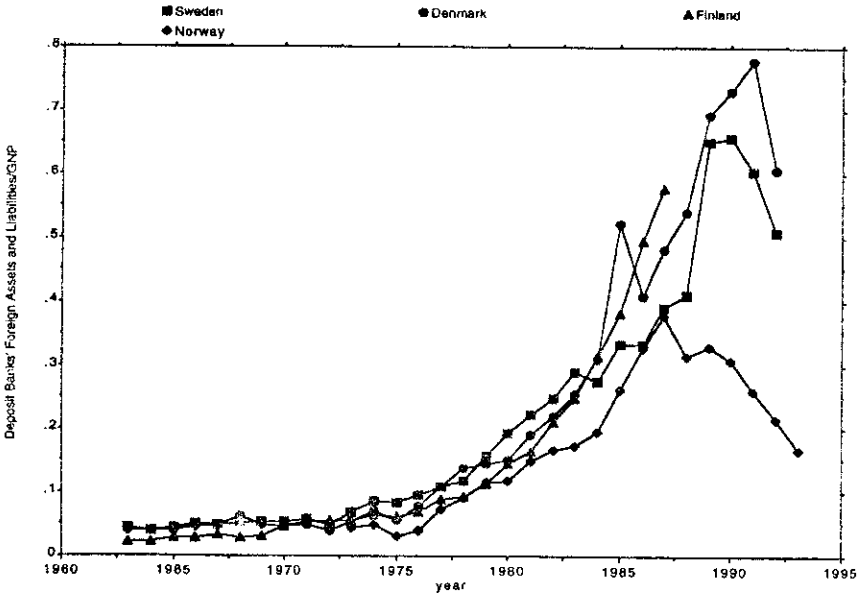
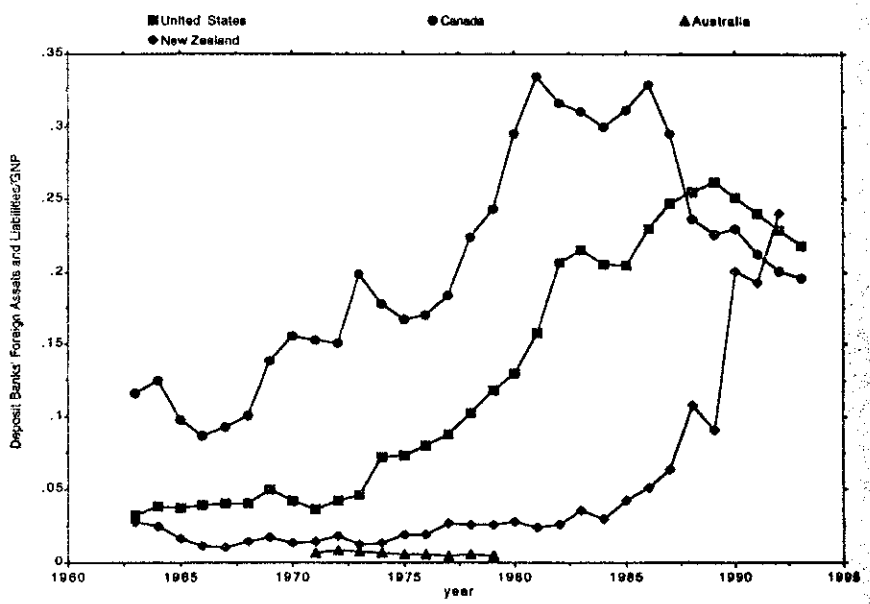


Figure 2.5. Assets and liabilities of deposit banks relative to GNP, 1963–1993. (SOURCES: Deposit Banks' Foreign Assets and Liabilities: IMF, *International Financial Statistics Year Book* [World Tables], various years.)

c: The United States, Canada, Australia, and NewZealand:



During the debt crisis international lending fell so steeply that it was very nearly overtaken by bond financing. "Securitization" and "disintermediation" were largely the result of negative interest rates in the late 1970s and the fallout of the debt crisis, and have spawned a number of new financial instruments and innovations that have greatly increased the flexibility of borrowers and lenders and deepened secondary markets that in turn render securities markets more liquid (Cerny 1993). Bank lending has since recovered, however, and now accounts for about three-quarters of international finance reported by the Bank for International Settlements (BIS) (Turner 1991).

A host of institutional innovations has contributed to the dramatic increase in portfolio investment, especially in securities. Variable-rate bonds, convertibles, futures, options, and swaps have allowed securities to be tailored to the needs of borrowers and investors, contributing to the volume of portfolio borrowing, especially for sovereign governments and large multinational corporations (Cerny 1993: 63–64; Cosh, Hughes, and Singh 1992). These instruments have been designed primarily to cope with the risks of flexible exchange rates and volatile interest rates. They are designed to increase the marketability and reduce the risk of foreign investment, and their volume attests to their perceived usefulness in this

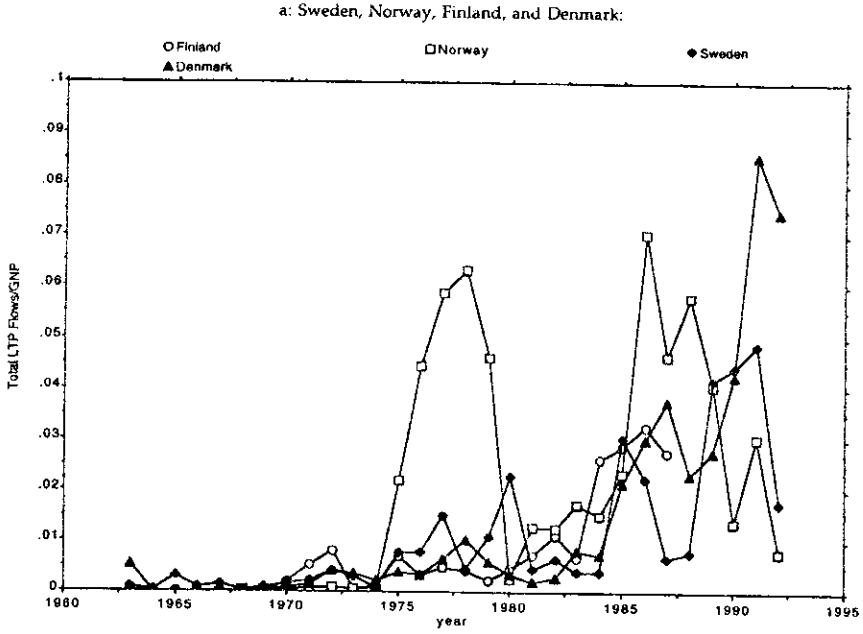
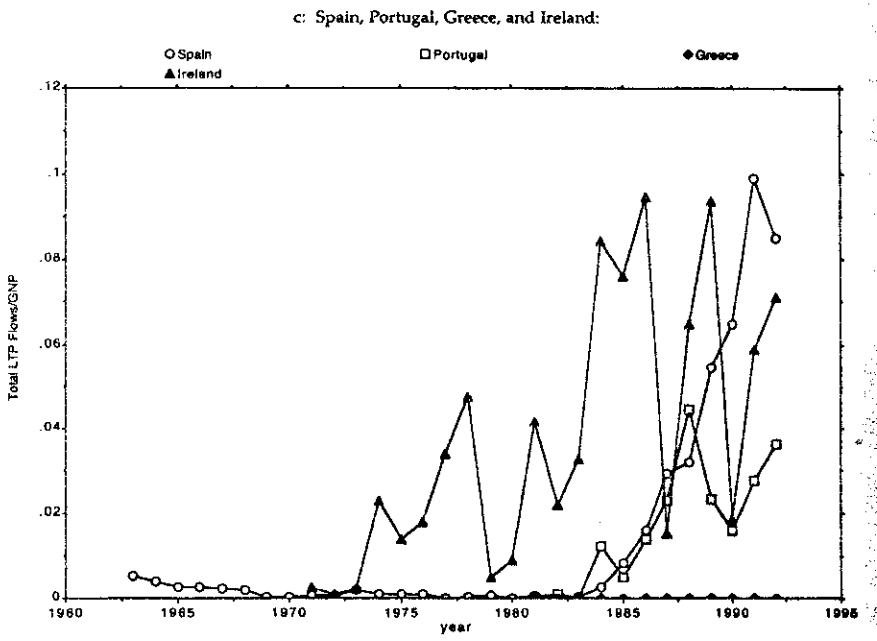


Figure 2.6. Total long-term portfolio investment flows (government bonds, corporate bonds, and equities) as a percentage of GNP, 1963–1993. (SOURCES: See Figure 2.2.)



regard: futures contracts of various descriptions have increased from about $200 million in 1975 to about $440 billion in 1986, at the height of volatility in exchange rates and the dark days of the debt crisis. Various options contracts grew from virtually nothing to about $239 billion over the same period (Levich 1987). The BIS now estimates the annual turnover in all derivatives contracts – defined as financial agreements that derive their value from the performance of other assets, interest or currency exchange rates, or indexes – to have tripled in value from $3.4 trillion in 1990 to over $10.6 trillion in 1995.

The liberalization of securities markets has meant that major corporations can now gain access to New York, London, and other international financial centers nearly as readily as to their home markets.[6] The end of fixed commissions, the spread of foreign membership on national stock exchanges, the advent of automated computer quotation, and the Intermarket Trading System are recent examples of institutional innovations that have internationalized and liberalized the world's major securities markets over the past decade or so (Sobel 1994; French and Pterba 1990). As barriers to overseas participation in securities markets have been lifted,

[6] However, differing accounting standards, for example, continue to contribute to the fragmentation of equity markets (Simmons 1997).

there has been a perceptible rise in foreign participation relative to domestic participation on the major exchanges. In New York, the share of foreign listings nearly doubled between 1980 and 1990 (from about 2.4 to 5.4 percent); the corresponding figures for the London stock exchange were 12.5 and 21.6 percent. By this measure, internationalization of the Tokyo stock exchange was most dramatic: foreign listings went from about 1 percent to about 7 percent of all listings over the decade, though *volume* of trade in foreign securities on the Tokyo exchange remained fairly small (Sobel 1994).

CAPITAL MARKET INTEGRATION: EVIDENCE OF CONVERGENCE

Despite the dramatic increase in international movements of capital, it is risky to consider the integration of capital markets in terms of volumes alone. It should be possible to point to other measures of market integration that have followed the period of liberalization. Were capital perfectly mobile internationally, a shortfall in national savings should be easily made up by borrowing on international capital markets at the going world interest rate. If so, then investment should no longer depend on national savings rates, since international capital pools are easily tapped to finance current investment needs. Martin Feldstein and Charles Horioka were the first to investigate the relationship between national savings and investment rates over time, and found, much to the surprise of the integrationists, that changes in countries' rates of national savings had very large effects on their rate of investment (Feldstein and Horioka 1980). Further studies in the 1980s found little evidence of heightened integration by this measure before and after 1973, when the most important controls were lifted (Feldstein 1983; Penati and Dooley 1984; Dooley, Frankel, and Mathieson 1987; Feldstein and Bachetta 1989).[7] Indeed, some findings seem to suggest that savings and investment rates were much less related during the nineteenth-century gold standard than they have been in recent years – potentially providing further evidence that capital markets had been at least as highly integrated in the past as they are at present (Bayoumi 1990). Nonetheless, smaller countries have been found to have a lower correlation between savings and investment ratios than do large countries, perhaps reflective of their greater openness to international capital movements (Murphy 1984). But even in the case of the United States, recent research

[7] For a good review of the literature, see Tesar (1991).

suggests that the stable relationship between savings and investment had begun to break down in the second half of the 1980s (Frankel 1991). The deficits documented graphically above drew in capital in unprecedented quantities, freeing the country as never before from the constraint of domestic savings.

A second test of capital market integration is convergence of interest rates across markets. If capital is highly mobile internationally, then interest rates should be determined in world markets; there should be very little room for divergence across countries. Moreover, markets could theoretically be highly integrated by this measure, even if international capital movements are small, since among integrated markets, asset prices often adjust in *anticipation* of capital flows that *otherwise* would occur (Machlup, Salant, and Tarshis 1972). Markets can in theory adjust to new equilibrium levels without flows of arbitrage funds. So an additional measure of the integration of capital markets is to ask, To what extent do we see price convergence across these markets?

Some studies of the major economies do reveal evidence suggestive of increasingly highly correlated returns to capital across markets. By the early 1980s, U.S. and Eurobond yields were substantially the same. However, by the end of the decade it became increasingly clear that one could not speak of interest rate convergence without serious qualifications. Money market returns for five large industrialized countries (the United States, United Kingdom, Germany, Japan, and Canada) appeared to have been tighter in the late 1960s than for most of the 1980s, despite the reduction in legal barriers and the increased flow in capital across borders. Furthermore, the response of foreign interest rates to those of the United States seemed to be smaller in the 1980s than in the 1960s and 1970s, which some took as evidence that interest rate movements could not easily be characterized by convergence (Kasman and Pigott 1988). Research has turned up further anomalies: while the most open of the advanced industrialized economies certainly seem to have interest rates that are more highly correlated than those of closed developing countries, it is difficult to explain, on the basis of capital-market liberalization, why it was in the 1980s that France's interest rates – at a time when France still had stringent capital controls – seemed more highly correlated with world rates than those of Switzerland, Japan, and the Netherlands, major countries that, by that time, were known to be virtually free of capital controls (Frankel 1991).

A first cut at resolving the inconsistency between theory and evidence must single out exchange rate volatility as a prime explanation for variations in the pattern of interest rate convergence. Floating exchange rates

among the G-5 subjected interest rates in those countries to crosscutting pressures: converging pressures due to market integration, but diverging pressures as a result of exchange rate fluctuations. In studies where efforts were made to separate the *exchange* premia (expectations of variability in exchange rates) from the *country* premia (including transactions costs, discriminatory tax policies, and capital controls), the results seem to suggest that the former continue to pull rates apart, while the latter influences have been virtually eliminated as a cause of interest rate divergence (Frankel 1991; Bayoumi and Rose 1993). Institutional barriers to the free movement of capital are no longer the main reason for market segmentation. Yet full integration continues to be hampered by currency volatility.

This is graphically illustrated by a plot of the yearly standard deviations of three different interest rates across countries between 1964 and 1993 (Figure 2.7). Government bills and bonds, and even money market rates were characterized by lower standard deviations before the breakdown of Bretton Wood's stable exchange rate regime than they have been since. The big jump in variance in all three markets is precisely between 1973 and 1974, when it became clear that flexible rates would prevail. Bond rates, for which evidence is available for a large number of OECD countries from the 1960s, show significant convergence with the establishment of the European Monetary System of relatively stable exchange rates in the early 1980s. Money markets also appeared to be on their way to convergence before the disruptions in the European Monetary System (EMS) in 1992. T-bill yields appear to continue to diverge, although this could be explained by the composition of the countries in the sample, two of which are non-European. Overall, price convergence is highly sensitive to expectations of exchange rate fluctuations, which have diminished within Europe but not across regions. The continuing divergence might also be explained by the fact that the purpose of much of this investment is to balance and diversify investment portfolios, the consequences of which need not be price convergence at all (Osler 1991).[8]

Another way to examine integration across capital markets is to look at correlations in interest rate *change*. Once again, these correlations can be affected by exchange rate expectations, and are ideally modeled as relationships of covered interest rate parity among national currencies.[9] Rather

[8] This argument rests on the intuition that if investors are primarily motivated to diversify their portfolios, there is no reason to expect investment to go strictly to jurisdictions with the highest risk-adjusted returns, and thus no reason to observe convergence of these returns.

[9] This is defined as the domestic interest rate (i$) minus the foreign interest rate (i*) plus any forward premium or discount (fp). The forward premium or discount is defined as the difference between, for example, the dollar price of a unit of foreign currency on the forward market less the dollar price of a unit of foreign currency on the spot market, scaled by the spot price of foreign currency:

$$i\$ - (fp + i^*) = 0$$

where

$$fp = \frac{[\text{forward \$/foreign currency} - \text{spot \$/foreign currency}]}{\text{spot \$/foreign currency}}$$

The data demands for making this calculation are very large. Forward exchange rates are difficult to find for many of the currencies represented in this sample for the 1960s. Furthermore, it is crucial to find interest rates that are quoted for exactly the same trading day as the exchange rate quotation, rather than period averages. However, end of period interest rates are not available in the IMF's *International Financial Statistics* for most market rates; rather they are averaged for the period as a whole, which would render the calculation of covered interest parity highly suspect.

than perform these detailed calculations, Table 2.1 provides evidence on correlations in uncovered interest rate changes across markets comparing two relatively stable exchange rate regimes within Europe, before the breakdown of Bretton Woods (1965–1973) and the contemporary EMS (1983–1993). While this is not a definitive test of capital market integration, this approach controls for the worst exchange rate volatility by excluding the 1970s and limiting the observations to Europe. Table 2.1 provides correlations of eleven European countries' bond yields with those of the United Kingdom and Germany. The results overwhelmingly indicate heightened price change correlations with the major markets under the EMS compared with the earlier fixed exchange rate period. In the case of correlations with bond rates in Britain, only one European country for which data were available, Ireland, failed to demonstrate stronger price change correlations in the more recent period. Correlations with German bond yields were stronger under the EMS for eight countries; only the Scandinavian markets – already fairly highly correlated with interest rate changes in Germany during the 1960s – show no signs of price sensitivity. Sweden and Norway did maintain significant capital controls into the 1980s, which might explain their patterns. Overall, while this is not a perfect test of capital market integration, comparing two periods of relatively stable exchange rates in Europe roughly controls for exchange rate volatility, and lends support to the argument that changes in interest rates in Europe increasingly move together.

A review of the extent to which international capital markets are linked would not be complete without an examination of equities markets, since equities make up a significant and growing portion of international portfolio flows. If equity markets are highly internationalized, one would

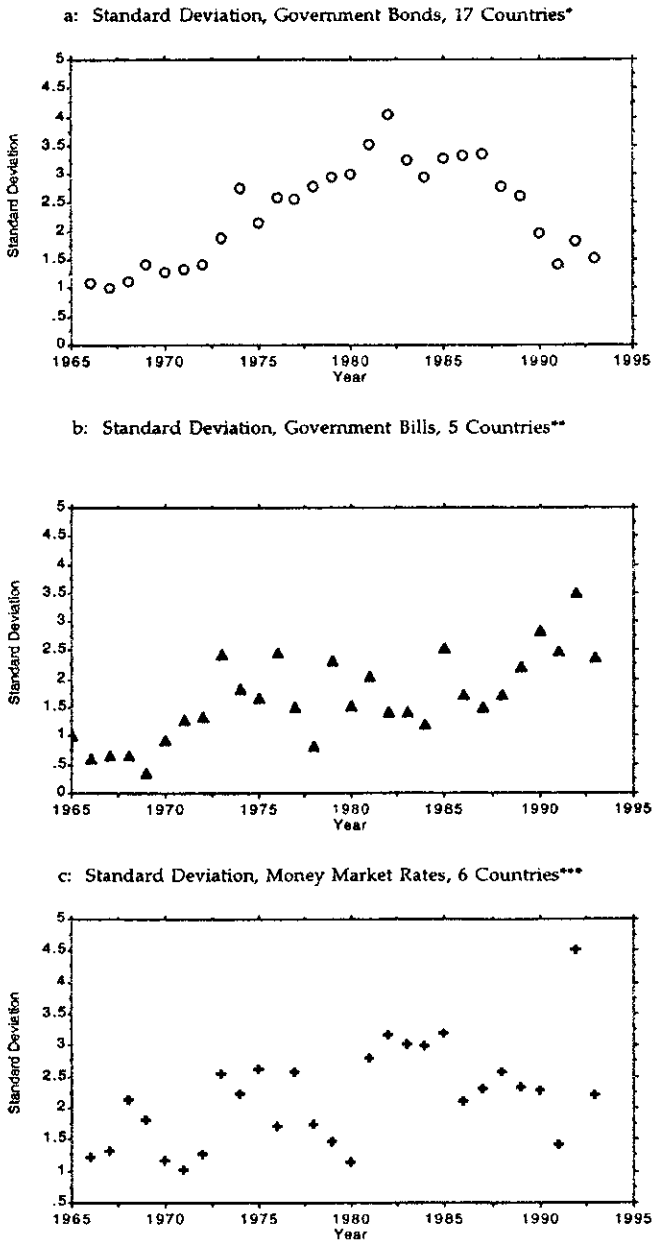


Figure 2.7. Yearly standard deviations of three different measures of interest rates, 1964–1993, various countries. * = Australia, Austria, Belgium, Canada, Denmark, Japan, France, Germany, Ireland, Italy, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom, United States; ** = Belgium, Canada, Sweden, United Kingdom, United States; *** = Belgium, France, Japan, Germany, Netherlands, Sweden. (SOURCE: IMF, *International Financial Statistics*, various years.)

Table 2.1. *Correlations between yearly changes in government bond rates for twelve European countries with comparable rate changes in the United Kingdom and Germany, Bretton Woods versus the EMS*

	Correlations with changes in the United Kingdom		Correlations with changes in Germany	
	1965–1973	1983–1993	1965–1973	1983–1993
Austria	.202	.810	.290	.896
Belgium	.090	.765	.593	.791
Denmark	−.049	.444	.684	.606
France	.397	.596	.289	.801
Germany	.136	.859	—	—
Ireland	.775	.474	.417	.622
Italy	−.361	.470	.535	.680
Netherlands	.369	.812	.745	.985
Norway	−.672	.161	.460	.073
Sweden	.160	.675	.639	.566
Switzerland	−.011	.913	.525	.909
United Kingdom	—	—	.136	.859

Source: IMF, *International Financial Statistics Yearbook* (various issues).

expect strong correlations in price movements and in expected rates of return across stock markets. The stock market crash of October 1987, with its repercussions in major markets around the globe, epitomized the notion that these markets are in fact strongly linked (von Furstenberg and Jeon 1989; Hamao, Masulis, and Ng 1990; King and Wadhwani 1990). There has been some increased sensitivity in price movements between London, New York, and Tokyo in recent years, though the evidence seems to be strongest for increased common movement in expected returns between London and New York, with little evidence of such movements on the German and Tokyo markets (Bekaert and Hodrick 1992; Jeon and von Furstenberg 1990; Goodhart 1988; Fischer and Palasvirta 1990). Moreover, it is difficult to tell whether these are markets of truly interchangeable assets, or if they are in fact still highly segmented markets responding to common external shocks. If one judges by continued differences in transaction costs across markets (Japanese commissions begin at 1.2 percent while those in London are about .2 percent; a seat on the Tokyo stock exchange costs between $8 and $16 million, while a seat on the New York Stock Exchange goes for perhaps a bit over a half a million; Sobel 1994: 331), an interpretation of continued segmentation may at this point still be warranted.

POLITICS AND POLICY IN A WORLD OF INTERNATIONAL CAPITAL MOBILITY

By virtually every measure considered – the removal of institutional barriers, the flow of capital itself, the growing correlation of interest rate changes across national markets – financial markets are more integrated now than they have been at any point since the nineteenth century. Capital controls have been disassembled across the OECD, beginning with the United States in 1974, Britain in 1979, and most of Europe by 1992. As quantitative restrictions on external deposits have been lifted, the assets of domestic banks across Europe have become more highly internationalized. The U.S. deficit and the announcement of the Single European Act in 1985 sparked foreign direct investment across continents and within Europe, stimulating further internationalization of production. Even more striking has been the relative rise in portfolio investment, which is typically much more liquid and therefore potentially more volatile than direct investment. The integration of capital markets is evidenced by the increased positive correlation in national interest rate movements compared with that during the Bretton Woods period, although country-specific risks continue to explain divergent interest rate levels.

The consequences of capital-market integration for politics within Europe and the rest of the OECD countries are potentially profound. Consider first their impact on the strategies available to multinational firms (Hall, this volume). As barriers have been removed to the transnational movement of direct investment, these firms' options have broadened, and some scholars have argued that this has been at the expense of both labor and governmental authority. The existence of an ever more credible exit option has arguably increased direct investors' ability to influence tax policy (Frenkel, Razin, and Sadka 1991; Gordon and Mackie-Mason 1995), regulatory policy (McKenzie and Lee 1991; Kane 1987), and employment policy (Kurzer 1993) as jurisdictions vie for productive investments and workers increasingly compete with foreign labor. However, little empirical evidence has to date been adduced to support such claims. Quantitative as well as case studies cast doubt on the proposition that capital market integration greatly reduces governments' ability to tax capital (Quinn 1997; Hallerberg 1996). Similarly, case studies of regulatory reform frequently fail to turn up evidence that capital mobility has unleashed a regulatory "race to the bottom" (Vogel 1996). Moreover, not all firms can be expected to be affected in the same way by the removal of barriers to exit. Asset specificity may be important in firms' strategies (Frieden 1991; Maxfield 1997). Those with investments specific to a given domestic market are likely to lobby harder to influence the national regulatory environment or rules of the labor market, while firms with low asset specificity may relocate to less restrictive foreign arenas (Murphy and Oye 1994).

Some observers have also argued that the availability of an ever broader array of highly liquid investment options has undercut long-term investment. Multinational firms, it is argued, increasingly find it tempting to invest in liquid assets that are more flexible and potentially more profitable, at least in the short term, than productive investment (Crotty 1989). Kurzer argues that this has led to further disintegration of business-labor pacts and has undermined working-class solidarity and class voting, due to social democratic governments' inability credibly to oversee the negotiation of centralized wage bargains (Kurzer 1993). As long as financial investments are potentially liquid, convertible, and mobile, tripartism can be expected to be difficult to sustain, constituting a fundamental impact on institutions of economic management and social concertation that were developed in a radically different international environment (Moses 1994).

Even more significant is the potential macroeconomic impact of the recent integration of capital markets, and most especially markets for portfolio capital. Highly liquid capital gives rise to trade-offs among three broad policy aims: governments are generally not able to achieve capital mobility, monetary autonomy, and a fixed exchange rate simultaneously (Mundell 1960, 1962, 1963, 1968). Expansionary monetary policy may be able to stimulate real economic demand where capital mobility was *low* (it could reduce domestic real interest rates without real exchange rate changes or reserve losses), but where capital was able to move abroad, domestic interest rates would be forced to match those prevailing in the region or the rest of the world. Attempts at stimulation would merely lead to capital flight. Nor could monetary policy effectively be used to damp down economic activity and keep inflation under control where capital was highly mobile internationally: attempts to raise interest rates attract capital, thus stimulating demand and expanding the monetary base. In effect, interest rates are determined in world markets, and are no longer available for policy (or political) manipulation. As a result, capital mobility poses an unavoidable trade-off between fixed exchange rates and monetary policy autonomy, as a number of scholars have argued (Goodman 1992; Andrews 1994; Cohen 1993; Webb 1991). National autonomy can be had only at the price of currency instability; an exchange rate target can only be maintained, over time, at the cost of loss of control over interest rates. Smaller countries highly dependent on access to international capital markets have increasingly opted to resolve the trade-off in favor of open capital markets and exchange rate stability. In larger more insular economies, such as the

United States, capital mobility has given rise to opposed coalitions: those who placed more value on exchange rate stability (those oriented toward the international economy) and those who place more value on low interest rates (nontraded goods sector) (Frieden 1991).

For the smaller open economies, integrated capital markets can also impact the ability to use fiscal policy to stimulate economic growth. Capital mobility forces governments to pay the going world rate to finance their borrowing. If global interest rates are very high, as they were for the first half of the 1980s, fiscal policy is effectively stymied as a policy instrument, since the staggering costs of financing such debt poses a serious budget constraint. Under conditions of very high world interest rates, therefore, Keynesian coordination of the economy may be "blocked" as Fritz Scharpf and others have argued, though this critique is somewhat less telling as interest rates have fallen in the 1990s.

But even under relatively low interest rates, capital mobility may make it more difficult for governments easily to manipulate the fiscal policy lever. International capital mobility makes accessible a much bigger pool from which to borrow, but holders of this capital may demand more stringent standards of macroeconomic performance than did captive domestic lenders. The liberation of once captive national capital suggests that increasingly, democratic governments have to sell their policies not only to electorates, but to international investors, who are usually presumed to be leery of public sector growth (Moses 1994). Even successful externally financed fiscal expansions can cause problems in small open economies. Foreign borrowing can lead to a real appreciation of the currency, causing overvaluation and pressure on the traded goods sector (for the case of Sweden, see Moses 1994).

Empirical work is beginning to confirm the expectation that highly mobile capital may place limits on the ability of governments to choose not only an autonomous monetary policy but an expansionary fiscal policy as well. There is some evidence that, controlling for other effects such as the business cycle, capital mobility (measured institutionally as the removal of capital controls) is associated with lower levels of government spending, and smaller budget deficits. Garrett (1995a) argues, however, that partisan differences continue to remain with respect to the uses of fiscal policy at the highest levels of "internationalization" (combined capital mobility and trade openness): left-labor power is associated with higher spending and deficits under conditions of high internationalization. Overall, while it is not *impossible* to use fiscal policy to manage economic growth (notably through supply-side policies; Garrett and Lange 1991), the strategies appear to have become more limited and the price of expansionary fiscal policy to have become higher (Garrett 1995a).

Table 2.2 presents some suggestive evidence of a fiscal constraint. Using the budget balance as a proportion of GNP as the dependent variable, it reports the result of a time-series panel analysis of the effects of portfolio flows of capital on fifteen countries' budget position, controlling for the business cycle (unemployment), party complexion of the government, and degree of trade dependence (imports plus exports as a proportion of GNP). Country dummies were also included but not reported. The results show that, as portfolio investment has increased, there has been a substantial tendency for the budget balance to improve, controlling for these other factors. Strikingly, the opposite is true with respect to trade integration: the strong negative coefficient indicates that high levels of openness are quite consistent with budgets in deficit. This provides some evidence that the movement of highly liquid capital across borders is associated with a degree of fiscal restraint when party, business cycle, and country-specific factors are taken into account. Trade integration has apparently been more consistent with the use of budgetary deficits across the OECD (Katzenstein 1985) and with public-sector growth generally (Rodrick, 1997) than may prove to be the case with highly mobile portfolio capital.

This constraint on fiscal policy has implications for policy within the advanced industrialized countries, and a number of these are explored in this volume. If budgets are to be cut, expenditures associated with the welfare state offer the potential for savings. The finding of Stephens, Huber, and Ray (this volume) that there have been not only important reductions in various aspects of welfare benefits, but also a striking decline in partisan effects, is consonant with – though not shown to be linked to – the convergence in fiscal policies one might expect from the integration of international capital markets. The changes they have revealed in cuts in the welfare state exhibit some parallels, at least at the extremes, with changes in policy with respect to capital-market integration: Britain has most thoroughly liberalized its financial integration and disassembled the welfare state; Norway has most strenuously resisted both.

The loss of fiscal policy autonomy is also the starting point for Kitschelt's analysis (this volume) of the dilemmas facing social democratic parties: if they advocate expansionary policies, they fail to win elections; if they adopt moderate macroeconomic policies and produce macroeconomic outcomes favored by international bondholders (low inflation), they are punished by their core constituency. Though much more work needs to be done to link capital-market integration with the electoral difficulties of

Table 2.2 *The influence of portfolio investment flows on budget balance for fifteen OECD countries, 1965–1993, coefficients (standard errors)*

	Dependent variable: Government budget balance
Total long-term portfolio flows	.251[a] (.101)
Trade/GNP	−.146[a] (.025)
Cabinet partisanship	−.005 (.004)
Unemployment	−.003[a] (.001)
d.f.	354
Adj. R^2	.485
S.E.R	.03

[a]Country dummies are included but not reported here.
Sources: Long-term portfolio flows: See Figure 2.2. Trade (Imports + Exports)/GNP: OECD. Unemployment rate: OECD. Cabinet Partisanship: Garrett (1995a).

social democratic parties, these results suggest a link is not entirely farfetched.

Tightening fiscal constraints also has implications for the future of unions and the institutions of corporatism themselves. Streeck and Schmitter (1991) have argued that without the ability to manage demand, governments have little need for union cooperation and unions have little incentive to organize collectively. As a result, fiscal austerity makes it more difficult to get the wage-restraint-for-policy-concessions bargain. The data contained in Golden, Wallerstein, and Lange (this volume) might provide an opportunity to more systematically assess the impact of fiscal constraints implied by highly mobile capital on the fortunes of European unions.

CONCLUSION

The liberalization of capital markets has changed the context of economic policy making in significant ways for a number of countries over the past several years. Two facts are certain: there has been a strong move away from capital controls, especially since the collapse of the Bretton Woods system, and there has subsequently been a burst in the movement of capital across borders in the form of foreign direct and portfolio investment among the countries of the OECD. The politics of liberalization has differed by

country, but once the process was set in train in the early to mid-1970s, external competitive pressures have encouraged one country after another to reduce barriers to international capital movements. By most accounts, the prime demanders of change have been multinational corporations concerned that they would be at a disadvantage vis-à-vis competitors who could freely borrow and lend in global markets. Governments interested in accessing international capital markets themselves have been willing to oblige. Recently, the pressures (or prospects) of European Union membership have added an important external institutional dimension to the decision to lift controls on capital.

The liberalization of capital controls has facilitated a large real increase in the volume of capital movements among the OECD countries. Much of this reflects the financing needs of the U.S. balance-of-payments deficit in the mid-1980s, but these movements continue despite reduction of imbalances in the 1990s. The reasons are myriad. Foreign direct investment continues to be driven by the need to access technology, marketing networks, and newly liberalizing service industries in foreign markets. Portfolio investment surges whenever there are new opportunities to diversify portfolios internationally, as the case of Sweden in the 1990s suggests.

Yet it is possible to exaggerate the extent of the "revolution" in international market integration over the past twenty years. For one thing, the extent of monetary independence enjoyed in the 1960s should not be overdrawn. For several countries, for example, Denmark, the Netherlands, and Ireland, interest rate movements were highly correlated to those in foreign markets in the 1960s. And the variance in interest rates across markets has not tightened unambiguously over the past thirty years, which is what we should expect if capital mobility had robbed countries of all monetary independence. Part of this can be explained by persisting exchange risks and specific country risks. But some of the persistent difference in interest rates across markets is due to the fact that governments are still interfering "successfully" with the free movement of capital internationally (Epstein and Schor 1992: 146). Despite widespread evasion, capital controls (e.g., those in Finland, Norway, and, to a lesser extent, Italy in the past decade) have been effective enough to permit interest rates in some countries to diverge from those prevailing elsewhere. Where the increasingly costly choice is made to preserve monetary autonomy through the use of such controls, interest rates tend to display a somewhat more independent course.

Capital-market liberalization is likely to be more difficult for the institutions of social democracy to digest than was trade liberalization of earlier decades. International capital markets react much more quickly than

do international trade markets to changes in macroeconomic policies, making it difficult to plan and implement compensatory strategies that have been the hallmark of trade adjustment in many of the smaller social democracies (Katzenstein 1985). The size of capital flows makes them far more difficult to manage than trade flows. The daily volume of trading on foreign exchange markets typically exceeds the combined foreign reserve of leading central banks, and swamps by far the value of global trade. Only in rare instances do trade adjustments have economy-wide consequences. Typically, they involve sectorally limited adjustments, to which it is relatively easy to design a compensatory policy response. Capital-market openness can permit external shocks to ripple throughout the national economy in the form of interest rate fluctuations. In short, while institutions within many OECD countries have coped well with trade openness by responding flexibly as protectionist barriers were peeled away in succeeding GATT rounds, integrated capital markets pose a new set of policy dilemmas, some of which appear to strike at the very core of the social bargain that in many countries produced unprecedented growth in the 1960s and adapted to the external shocks of the 1970s.

International capital mobility has been a significant concern to analysts of politics and policy, largely because of the fact that an unprecedented period of economic growth and stability took place under conditions of relatively *closed* national capital markets. The unprecedented period of growth, high employment, and low inflation from the 1950s through the 1960s rested on a number of conditions, but among the most important of these were a system of fixed exchange rates and the adoption of a new array of government policies that generated a belief that cyclical fluctuations could be controlled by demand management. Along with conditions in the labor markets that encouraged wage restraint, and often under the leadership of highly stable social democratic governments, the 1950s and 1960s delivered rapid growth in living standards, a prolonged period of full employment, and a very sharp decrease in the incidence of individual economic risk (Boltho 1982).

The internationalization of capital markets potentially challenges each of these conditions, but research that might more fully inform an understanding of these relationships is in its infancy. Specifically, more attention needs to be given to issues of causation. Is capital-market integration the cause or a consequence of a shift in the relative political clout of capital and labor? Does capital market integration explain the apparent convergence on particular policy instruments, or is this the result of some underlying common shift toward neoclassical economic ideas that have had a parallel impact on liberalization? What are the mechanisms through which

the internationalization of capital can be expected to have its hypothesized political effects? The evidence presented here suggests that there is a good degree of variation both across countries and over time that might be exploited to untangle some of these issues. The answers to these questions will address not only scholarly debates in international and comparative politics, but also some of the most significant policy issues of the decade.