

The Power of Money: Global Capital and Policy Choices in Developing Countries

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Extant studies of the impact that international phenomena have on policy choices, and those focused on the political economy of exchange-rate regimes in particular, are incomplete because they do not consider the effect that reliance on global capital has on the policy preferences of domestic groups. Consequently, they cannot explain why some newly emerging market countries pursue fixed exchange regimes under political and economic conditions—such as recently completed elections, uncompetitive export sectors, and poor national economic performance—in which others have altered their policies. I argue that reliance on different types of foreign capital generates distinct capital-specific policy preferences. Furthermore, rather than simply mimicking the preferences of foreign investors, domestic groups are likely to promote policies that reduce their capital-specific risks and vulnerabilities. Panel logit models of exchange-rate regimes in emerging market countries from 1973 through 2000 demonstrate that higher levels of democracy bolster these effects.

The Politics of Pursuing Self-Destructive Policies

The choice of exchange-rate regimes can make or break a country. In Argentina, the 1991 policy of linking the peso to the dollar at a rate of 1:1 is widely credited with defeating hyperinflation and attracting foreign investment.¹ As early as 1995, however, the antiinflationary political coalition had begun to breakdown and some of the negative consequences of this policy became apparent: persistently high unemployment, increasingly uncompetitive exports, and diminishing access to capital for small- and medium-sized companies. Combined, these effects devastated the economy and transformed Argentina from a model of development in 1991–1994 into a developmental basket case by 2002 (Pastor and Wise 2001).

Why did Argentina continue to staunchly defend its exchange rate policy long after its initial goals had been achieved and signs of the current economic collapse had become evident? Many observers have looked to the unique aspects of Argentina's history and political contexts for an explanation, yet Argentina is not alone. Over

the past thirty years, several prominent emerging market countries, including South Korea and Hong Kong, have clung to their fixed exchange-rate regimes at certain times despite high costs to their tradable sectors, labor, and other domestic groups. Thus, it is important to ask why governments pursue policies after they become counterproductive and impose substantial political and economic costs on their countries.

These outcomes are attributable in part to the effects of international factors—particularly reliance on foreign capital—on the policy preferences of domestic groups and the impact that these groups have in their national economic and political arenas (Stallings 1992). One set of arguments about the impact of international factors on policy preferences emphasizes the distributional effects that economic policies—and the choice of exchange-rate regimes in particular—have on groups in the tradable and nontradable sectors of the economy (Bernhard, Broz, and Clark 2002; Blomberg, Frieden, and Stein 2001; Frieden 2002; Frieden and Stein 2001; Wise and Roett 2000). These arguments suggest that the Korean and Argentine governments should have responded to pressure from their

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¹See Frieden and Stein (2001, 1–19) for a review of important political and economic events involving exchange-rate regimes over the past thirty years.

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exporting sectors to increase competitiveness and devalue their currencies. One would expect this pressure to have begun in Korea in the 1970s and to have peaked as its currency appreciated relative to the Japanese yen in the late 1980s; similarly, one would expect this pressure to have peaked in Argentina after Brazil devalued in 1997 and 1999. Yet, neither country changed its policies. Another set of arguments emphasizes the level of democracy, the political leaning of the executive, and the effects that elections have on the exchange rate preferences of policymakers (Alesina 1989; Alesina and Rosenthal 1995; Bernhard, Broz, and Clark 2002; Bernhard and Leblang 1999, 2002; Garrett 1995). It suggests that having won the elections, Argentine leaders in 1995 and 1999, and Korean leaders after 1988, should have devalued their currencies in order to address the negative consequences of having maintained fixed and overvalued exchange rates for prolonged periods of time. Yet, again, neither country changed its policies.

I argue that, while fruitful, these studies are incomplete because they do not consider the impact that reliance on foreign capital has on policy decisions. While there is a growing literature on the impact that exchange-rate regime choice has on investment and trade flows (Rose 2000), this article examines the reverse causal arrow and contributes to the extant literatures on the nature of societal preferences (Hiscox 2001) and the economic and political motivations for selecting particular exchange-rate regimes (Bernhard, Broz, and Clark 2002; Frieden 2002; Mussa et al. 2000). It does so by developing a capital-specific argument about policy preferences that explains how reliance on different types of capital affects policy decisions. Building on Stallings' (1992) premise that policy decisions cannot be fully understood without considering the relationships between external and internal structures and actors, I argue that reliance by domestic constituents and their governments on different types of foreign capital (such as commercial bank loans, foreign direct investment, and portfolio investment) can generate distinct policy preferences. Both globalization and dependency perspectives posit that local groups that rely on particular forms of investment are likely to modify their preferences and create coalitions to promote policies favorable to those investors (Cohen 1996, 288; Stallings 1992, 52–55). I posit, in contrast, that these local groups are likely to balance their motivations to promote investor-favored policies with a preference for government policies that minimize the risks and vulnerabilities associated with the particular type of capital they rely upon. In some circumstances, domestic groups that are motivated by vulnerability-reducing preferences are likely to promote policy choices that reflect the prefer-

ences of certain foreign investors (including those involved in commercial bank lending), but not others (including those involved in portfolio investment).

I test these arguments using panel logit models to estimate the probability that emerging market countries will pursue fixed or flexible exchange-rate regimes.² The statistical results lend support to the proposed capital-specific approach to policy preferences by demonstrating that states whose constituents have large foreign denominated liabilities are more likely to adopt fixed exchange rates than those that do not, while states whose governments or constituents rely on portfolio investment are more likely to pursue flexible exchange rates. Based on this argument, the Korean and Argentine puzzles make sense. In both cases, high reliance on dollar-denominated lending relative to other forms of foreign capital motivated key domestic constituents and policymakers to favor maintaining their exchange-rate regimes despite competing motivations (such as trade or labor concerns) to adopt more flexible rates.

This article will be divided into two sections. The next section will develop a set of capital-specific arguments about the impact of global trade and financial flows on the policy preferences of domestic constituents. The subsequent section will be devoted to testing the competing hypotheses using panel logit analyses to examine the likelihood that states will pursue fixed exchange-rate regimes. By way of sensitivity analysis, the models are estimated controlling for variations in the level of democratization and electoral politics and the other political and economic factors that may affect the choice of exchange-rate regimes.

Domestic Preferences, International Trade, and Finance

While there is general agreement that reliance on foreign trade and capital are likely to affect the policy preferences of domestic constituents, propositions about the nature of these relationships vary depending on how domestic preferences are specified and the presumed ability of groups with those preferences to affect the policy making. One prominent approach specifies the preferences of domestic constituents in terms of their sector-specific characteristics. A sector-specific approach to trade policy

²Survival models measuring the duration of fixed exchange-rate regimes also indicate the significance of capital-specific preferences. I chose to use logit analyses for this study because countries over this time period tended to switch from flexible to fixed and fixed to flexible exchange-rate regimes with roughly the same frequency. I thank an anonymous reviewer for AJPS for highlighting this point.

would submit that when factor mobility is low, the internationalization of trade will affect people in different industrial sectors differently (Alt and Gilligan 1994; Hiscox 2001; Shambaugh 1996, 1999). Consequently, policy preferences are likely to converge based on industrial sector-specific commonalities rather than traditional class-based or factor-based identities and are expected to reflect the interests of the dominant sectors in society. This approach has been fruitful in explaining the exchange-rate regime preferences of trading and nontrading sectors (Eichengreen and Frieden 1994; Frieden 1991, 1998, 2002), but it remains limited in its ability to account exchange-rate preferences associated with reliance on different types of foreign capital. To compensate, I build on two of the principal insights from this literature—that it is fruitful to relax the assumption of factor mobility across sectors (Haggard, Maxfield, and Schneider 1997, 43) and that the tendency for real exchange rates to appreciate under nominally fixed exchange-rate regimes has real and significant distributional consequences in society (Blomberg, Frieden, and Stein 2001)—and develop a set of capital-specific arguments about the nature of societal preferences.

Capital-Specific Preferences and the Choice of Exchange-Rate Regimes

Many scholars have emphasized the pressures that market forces can exert on states that rely on foreign capital (Andrews 1994; Cohen 1996, 2000; Frieden and Rogowski 1996; Haggard and Kaufman 1992; Maxfield 1997; Peterson 1995; Stallings 1992). This pressure is particularly strong in newly emerging market countries that rely on an influx of foreign money (or the repatriation of domestic flight capital) to finance persistent government and balance of payments deficits, to make payments on existing external debts, or to pursue economic development generally (Lukauskas and Minushkin 2000). The policy pressures resulting from a reliance on foreign sources of capital are compounded by the availability of multiple comparable destinations for investment,³ the increasing abilities of foreign and domestic capital to relocate quickly (Sassen 1996), and the increasing privatization of capital flows (which are less politically motivated and more market driven than public flows). The combination of these factors creates a powerful incentive for governments, and members of their constituencies who benefit from or are

³Recent research suggests that shifts in the interest rates or other financial conditions in advanced industrialized countries play a large part in promoting capital movements toward or away from newly emerging market economies (Calvo, Lieberman, and Reinhart 1996, 108–51).

vulnerable to foreign capital, to promote policies that foreign investors find favorable (Garrett and Lange 1991; Stallings 1992).⁴ The implications of this “policy convergence hypothesis” are consistent with those of dependency theory (Stallings 1992) and are summarized succinctly by Cohen’s proposition that, “the globalization of finance has obviously increased pressures for general policy convergence toward an agenda set by investors” (1996, 288).

While appealing, this proposition is based on a simplifying and potentially misleading assumption that all foreign investors, and by association all those affected by them, are likely to exhibit a unified set of policy preferences. Despite intense international pressures, policy responses in emerging market countries have not been uniform. While scholars have emphasized the importance of institutional incentives and constraints in explaining this variation (Haggard and Kaufman 1992, 3–4), I argue that some of this variation can be explained by the variation in policy preferences generated by reliance on particular types of capital.

Just as it was fruitful for sector-specific theorists to analyze preference variations within particular factors of production, it may be fruitful to specify—at least in ideal terms—the policy preferences associated with particular types of capital. Maxfield (1997) has, for example, demonstrated that policies which increase central bank independence attract particular types of capital. Similar expectations are plausible regarding exchange-rate policy (Bernhard, Broz, and Clark 2002, 709). If investor preferences are variable, then it is equally plausible that domestic constituents who rely on particular types of investment will favor specific exchange-rate policies. Thus, rather than anticipating a general policy convergence in response to increased reliance upon global sources of capital, a capital-specific approach suggests that the degree of policy convergence will vary across countries and over time depending on the degree to which they rely on the same type of capital.⁵

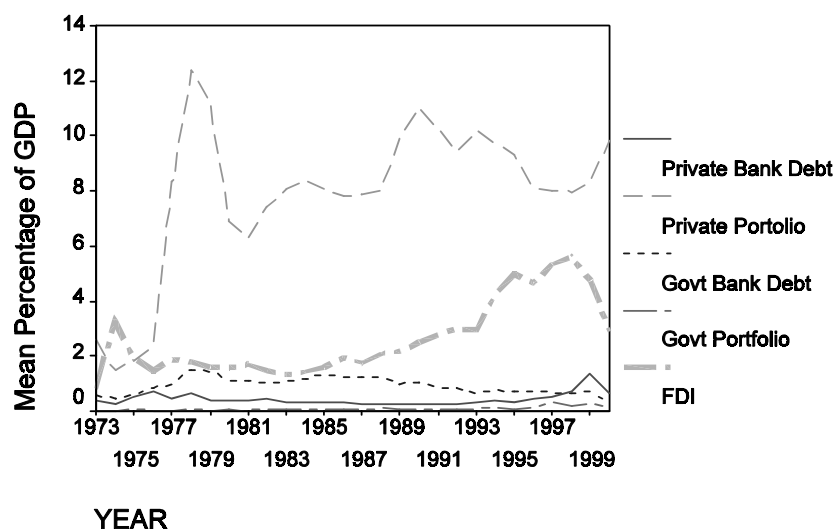
As a first step in developing an argument based on capital specificity, it is useful to divide capital into ideal types including commercial bank lending, foreign direct investment, and portfolio investment.⁶ As a second step,

⁴For an apposing viewpoint, see Garrett and Lange (1994) and Oatley (1999).

⁵Critics argue to the contrary that the policies selected by newly emerging market countries in response to the demands of foreign capital vary substantially as a function of their bargaining power vis-à-vis one another (Lukauskas and Minushkin 2000).

⁶This varies slightly from Maxfield (1997) who includes a separate category for foreign bonds. Foreign direct investment represented 44.9% of private capital flows into developing countries or \$109.5 billion in 1996, commercial bank lending accounted for 36.3% or

FIGURE 1 Reliance on Private Capital by Type in Emerging Market Countries



it is important to specify the capital-specific preferences of investors and those who rely on them. From either a dependency or “policy convergence” viewpoint, the policy preferences of domestic recipients should converge with those of the investors. From a risk- or vulnerability-reducing viewpoint, they may vary.

The levels of public and private sector reliance on commercial bank lending, portfolio investment, and foreign direct investment, respectively, on countries around the world are summarized in Figure 1. While the boundaries between these types of private capital may blur under certain conditions, each ideal type generally has a set of distinct preferences regarding exchange rate policy. As Frieden (1991) and others have argued, these preferences can be approximated in terms of a trade-off between stability and price level. On one hand, fixed exchange rates offer highly visible signals of stability against exchange-rate risk and inflation, while lack of a fixed-rate regime offers greater flexibility to governments attempting to respond to external shocks or distribute benefits to various groups within society (Eichengreen and Frieden 1994; Frieden 1991, 1998, 2002). On the other hand, in terms of value, there is a tendency of real exchange rates to appreciate under nominally fixed exchange-rate regimes with distributional consequences for societal groups (Blomberg, Frieden, and Stein 2001). While there is no necessary link between fixed exchange rates and overvalued real exchange rates, the mean real exchange rate between 1974

and 2000 for countries in this study pursuing nominally fixed rates was 13% higher than those pursuing flexible exchange-rate regimes.⁷

Commercial Bank Lending. Both commercial bank lenders and borrowers are likely to prefer the economic stability and credibility enhancing characteristics of fixed exchange rates to the risks (and potential benefits) of policy flexibility associated with flexible exchange-rate policy. Commercial lenders are likely to be seeking yield, value, and diversification and, thus, also have relatively long time horizons (Maxfield 1998). Increased stability related to a fixed exchange-rate regime (combined with the maintenance of a high level of international reserves to ward off currency speculators), decreases risk and therefore increases the risk-adjusted rate of return as long as the commitment to the fixed rate is credible. Fixed exchange-rate regimes represent highly visible “anchors” to government policies enhancing the credibility of their commitments to fight inflation (Calvo 1986; Calvo and Vegh 1994; Edwards 1996; Tavlas 1993; Tornell and Velasco 1995). Maintaining an exchange-rate anchor is particularly appealing if the country in question lacks the political will and financial sophistication to provide stability by other means.

Furthermore, in newly emerging market economies it may be difficult to disentangle the impacts of actions by the central bank or monetary authorities from those of external shocks. This may make it difficult for investors

\$88.6 billion, and portfolio or “institutional” investment 18.7% or \$45.7 billion. While all three forms of private capital increased in the 1990s, portfolio investment grew faster than any other sector—increasing 14-fold between 1990 and 1996 (World Bank 1997, 3).

⁷This is consistent with the findings of Frieden, Ghezzi, and Stein (2001) who find that the average Latin American country with a fixed exchange rate has a real exchange rate 8% higher than the average country with a floating rate.

and borrowers to determine the intent and credibility of the central bankers or monetary authorities in the absence of a visible commitment like that associated with currency board or other hard peg arrangement (Calvo 2000). As a consequence, the absence of a hard peg increases the incentive for banks and companies with foreign liabilities to hedge. Borrowers are likely to place an even higher premium on the credibility of their fixed exchange-rate regime because they have less of an ability to hedge and diversify their risk in the event of a devaluation.

Liability dollarization also increases the risks associated with the failure of exchange-rate anchors to borrowers. To minimize their risks, local banks may issue dollar-denominated and dollar-backed loans. As long as consumers expect that an exchange rate will remain fixed, there is little perceived risk in accumulating dollar-denominated debt. Furthermore, the incentive to borrow in the foreign currency will grow if the domestic currency interest rates rise above foreign currency rates making foreign loans cheaper (this could happen due to efforts to tighten monetary policy to counter real exchange-rate appreciation). This is particularly true when moral hazard becomes a problem and international banks attempt to lend more than may be justified by local market conditions (Maxfield 1997, 41–42). The more liability dollarization is passed on to domestic groups, the stronger their vested interest in making sure that the pegged rate is maintained (Eichengreen 2001, 25–32). This means that those domestic constituents who have liabilities denominated in foreign currencies and/or conduct business in foreign currencies are likely to support fixed exchange-rate regimes to avoid the negative consequences of a devaluation or depreciation on their debt obligations.⁸ Furthermore, a real appreciation under a nominally fixed exchange rate will decrease the cost of dollar-denominated liabilities.

Since the exchange-rate preferences of commercial bank lenders and borrowers are similar, there is no difference between what dependency, policy convergence, and vulnerability-reducing arguments predict regarding the nature of linkage between the preference of international lenders and domestic borrowers. Private sector reliance on lending from commercial banks is operationalized as the private nonguaranteed bank debt burden to the private sector as a proportion of gross domestic product (World Bank 2002a). Government reliance on lending from commercial banks is operationalized as the public guaranteed bank debt burden plus other public guaranteed debt as a proportion of GDP (World Bank 2002a). The greater the reliance on commercial lending, the greater the probab-

ity that a country will pursue a fixed exchange rate. Thus, higher values on these indicators at time $t - 1$ are likely to increase the probability that a country will pursue a fixed exchange rate at time t .

Capital-Specific Hypothesis 1: The greater a country's reliance on commercial lending at time $t - 1$, the greater the probability that a country will pursue a fixed exchange-rate regime at time t .

Based on this argument, the tenacity with which Argentina supported the maintenance of peso-dollar parity in the late 1990s under conditions (including high unemployment, a balance of payments deficit, and uncompetitive export sector) that compelled Brazil and others to change their policies can be explained, in part, by the increased reliance by growing segments of its population on capital from foreign banks—especially the increased access to dollar-denominated loans by federal and provincial governments, businesses, and citizens—and the preference of the banking sector to maintain a fixed exchange-rate system. Similarly, the maintenance of a fixed exchange rate in Korea in the 1970s despite costs to its exporting sector can be explained by the heavy reliance of chaebols on dollar-denominated borrowing for which the national government was liable. Note that the effect of reliance on foreign lending on exchange rate choice is the same, even though the reason these countries relied heavily on foreign lending differs. In Argentina, commercial banks were attracted by the stability and antiinflationary success of their currency board in the 1990s.⁹ In contrast, commercial lending was attracted to Korea by government policies that guaranteed loans while restricting other forms of foreign investment until the 1990s.

Foreign Direct Investment. In contrast to the exchange-rate preferences of domestic borrowers and their foreign lenders, the exchange-rate preferences of foreign direct investors are likely to vary depending on their investment motivations. Consequently, it is plausible to argue that they should vary in conjunction with those of the sector or business that they invest in. Therefore, if they are seeking export platforms, then their preferences are likely to reflect those of the tradable or export dependent sectors. Given the tendency of nominally fixed exchange-rate regimes to appreciate, one can posit that export-oriented firms and, thus, countries with large export-dependent sectors

⁸For a review of strategies other than devaluing the currency, see Mussa et al. (2000, 22).

⁹A credible fixed exchange-rate regime may have been chosen in part to attract foreign capital that, in turn, generates societal preferences in favor of maintaining the fixed-rate regime. While this is a mutually reinforcing effect, the dependent variable under review remains the choice of exchange-rate regime.

would prefer flexible to fixed rates.¹⁰ One exception to this general pattern involves exporters of specialized goods with limited “pass through.” This refers to goods whose final prices are not affected by exchange-rate fluctuations (Frieden 2002, 839–40). Such industries are likely to prefer the stability of fixed exchange-rate regimes to the relatively lower value of flexible exchange-rate regimes because the export producers benefit less from depreciations, and they absorb the risk of exchange-rate fluctuations.¹¹

Reliance on foreign direct investment is operationalized as gross foreign direct investment as a proportion of GDP, with no differentiation made between public and private sector reliance (World Bank 2002b). The importance of the exporting sector in the economy is operationalized as exports of goods and services as a proportion of GDP (World Bank 2002b). The importance of producers of specialized manufacturing goods whose final prices are unaffected by the exchange rate is approximated by using manufacturing exports as a percentage of merchandise exports (World Bank 2002b). Since the exchange-rate preferences of foreign direct investors are expected to converge with those in the sector that they invest in, there is no difference between what dependency, policy convergence, and vulnerability-reducing arguments predict regarding the nature of linkage between the preference of international actors and domestic groups.

Capital-Specific Hypothesis 2: The exchange-rate regime preferences of countries whose constituents rely heavily on foreign direct investment will vary depending on the sectors targeted by the investments.

Hypothesis 2a: Given the tendency of nominally fixed exchange rates to appreciate, foreign direct investors seeking export platforms will prefer flexible to fixed rates. Highly export-dependent countries will likely attract export-oriented foreign direct investors and will, therefore, generally be less likely to pursue fixed exchange rates.

Hypothesis 2b: Investors seeking export platforms for specialized manufactured goods

¹⁰In addition, as Blomberg, Frieden, and Stein (2001) argue, if a fixed exchange-rate regime succeeds in slowing inflation, firms in tradable sectors lose the advantage they would gain from an inflation-induced real depreciation which would raise the price of their outputs relative to the price of their nontradable inputs.

¹¹Export oriented firms who conduct trade among countries whose relations approximate an optimal currency area may also prefer the price stability associated with a fixed exchange rate (Mundell 1961; Tavlas 1993). The relations between the emerging market countries in this study and those with whom they have fixed their currencies do not, however, closely approximate optimal currency areas.

whose consumer prices are not susceptible exchange-rate variations will prefer fixed to flexible exchange rates. The higher the proportion of exports accounted for by these pass-through goods, the more likely it is that they will pursue fixed exchange-rate regimes.

Portfolio Investment. Portfolio investments, largely composed of stocks, bonds, and other liquid assets, have short-time horizons and are the most prone to exit of the three types. Portfolio investors are also most likely to invest in newly emerging market economies as a result of external “push factors” including low interest rates or low returns in OECD countries (Maxfield 1998, 70–73). Consequently, portfolio investors are likely to be less concerned with shifts in economic fundamentals in any particular location than with indicators of uncertainty in local economy and political conditions. This suggests that portfolio inflows may be attracted by the medium-term price stability, risk reduction, and credit worthiness associated with a commitment to maintain a fixed exchange-rate regime (Maxfield 1997, 42–45). Therefore, if, as dependency theory and the policy convergence thesis suggest, domestic constituents are likely to promote policies consistent with those international actors they rely upon, then a high reliance on portfolio investment will be associated with a preference for fixed exchange rates.

Capital-Specific Hypothesis 3a: Countries whose constituents rely heavily on portfolio investment are likely to pursue fixed exchange-rate regimes.

At the same time, the tendency of portfolio investment to exit quickly creates a large amount of risk and vulnerability for governments and domestic groups that rely on this form of capital. It follows that those who rely on portfolio investment have a strong incentive to enhance their government’s ability to reduce these risks and vulnerabilities. They are likely support policies (like capital controls) that reduce the risk of capital flight, but are likely to resist policies (like fixed exchange rates) that limit their governments’ ability to respond to external shocks. Thus, counter to dependency and policy convergence arguments about international-domestic linkage, vulnerability-reducing arguments predict that exchange-rate preferences between portfolio investors and those who rely on portfolio investment will diverge.

Capital-Specific Hypothesis 3b: Countries whose constituents rely heavily on portfolio investment are likely to pursue flexible exchange-rate regimes.

Private sector reliance on portfolio investment is operationalized as the sum of private nonguaranteed bonds, short-term debt, and portfolio equity as a proportion of GDP (World Bank 2002b). Government reliance on portfolio investment is operationalized as public guaranteed bonds as a proportion of GDP (World Bank 2002b).

Sensitivity Analysis: Politics and Local Economic Conditions

The effect that reliance on foreign capital has on domestic policy is likely to be mediated by several factors. These include the nature and permeability of the political process in each country and local economic conditions (including a recent history of hyperinflation and the level of foreign reserves).

First, the nature and permeability of the political process mediate the relationship between policy preferences and policy outcomes. Echoing Ruggie's (1989, 195–323) explanation of “embedded liberalism” in the post-World War II era, Rodrik, Eichengreen, and others posit that governments need to compensate those who suffer due to increased exposure to international trade and capital flows in order to forestall a political backlash (Eichengreen 1992; Rodrik 1997, 49–67; Rodrik 1998, 997–1032).¹² The sensitivity of the government to this pressure is likely to be stronger in more democratic countries because democratization increases the availability of information and transparency of the political process, decreases the transaction costs of organizing into political units, and generally increases the capacity of those vulnerable to international capital or trade flows to become politically active (Alesina 1989; Alesina and Rosenthal 1995; Bernhard and Leblang 1999; Garrett 1995; Leblang 1999). The compensation thesis suggests that democracies will be less likely than authoritarian regimes to pursue fixed exchange rates because doing so will decrease their ability to respond to popular demands in the context of increased vulnerability to international trade and capital. The level of democratization is operationalized using the POLITY index from the POLITY IV data set.¹³

High levels of democracy should also enhance the impact of groups with capital-specific and trade-specific policy preferences by facilitating the influence that these groups have on national policy choices. The impact of foreign capital on the policy preferences of domestic groups within states is likely to have grown with the privatiza-

tion of the sources and recipients of capital over the last three decades. Prior to 1970, public sources of foreign capital (primarily in the form of aid) were substantially larger than private sources. Throughout the 1970s and 1980s the proportion from private sources grew as public sources of capital stagnated. In the 1990s the private sources of foreign capital grew substantially and now account for more than three times the amount of public flows. Similarly, until the mid-1980s, the primary recipients of foreign flows were governments. This shifted in the late 1980s and by the early 1990s the majority of foreign capital in emerging market countries went to private rather than public recipients. The privatization of sources of capital suggests that investors are increasingly motivated by economic policies rather than political agendas, while the privatization of recipients means that the impact of global capital on national policy decisions is increasingly mediated through the private actors beneficiaries of those investments (Armijo 1999, 25–27).

This article does not address differences in the ability of groups with competing preferences to mobilize or exert political influence. This simplifying omission is intentional, but it is not intended to suggest that the political context does not affect policy preferences and the relationship between capital flows and decisions to maintain fixed exchange-rate regimes. Recent works by Leblang, Lobo and Tufte, and Frieden and others suggest, for example, that exchange rate policy may be volatile around elections (Frieden 1998; Frieden, Ghezzi, and Stein 2001; Leblang 2000; Lobo and Tufte 1998). This research shows that governments will prefer the stability of fixed exchange rates in advance of elections. They will also seek to avoid the political stigma associated with the failure to maintain a peg prior to an election. Even if maintaining the fixed-rate regime imposes costs on some domestic constituents, the political risks associated with a forced devaluation are often high. As Jeffery Sachs has argued, “governments that commit to a peg and then renege on the promise typically face costs—loss of pride, voter disapproval, maybe even removal from office—that need not be proportional to the devaluation” (Leblang 2000, 9–10).

This has two implications. First, policy makers in democracies will likely wait to abandon fixed exchange-rate regimes until after elections have taken place. Therefore, one would expect the probability of exchange-rate regimes ending to be highest following elections. Second, policy makers could avoid the political risk of forced devaluations by forsaking fixed exchange-rate regimes in general. Adopting a flexible exchange-rate policy not only reduces political risk, it also increases policy flexibility and reduces the visibility of negative exchange-rate movements since under a flexible exchange-rate regime it is more difficult for the public to differentiate between

¹²For a critique of Rodrik's analyses, see Garrett (1999a, 1999b) and Etchemendy (2001).

¹³See the Polity IV web site at <http://www.cidcm.umd.edu/inscr/poly/> for a full description of the variables (Polity IV Project 2000).

market-determined fluctuations and specific government actions (Collins 1996, 119). Therefore, one would expect that countries with high levels of democracy and those that just completed an election to be more likely to abandon their fixed exchange-rate regimes than others. To control for these effects, dummy variables are included which indicate the presence of an election in the previous year and in the subsequent year.¹⁴

In addition to electoral politics, local economic conditions, especially the presence of inflation and history of hyperinflation, may increase pressure for governments to pursue particular exchange-rate regimes. Problems of inflation generate a trade-off between investor-related concerns for stability and credibility in monetary and fiscal policy which could be enhanced by adopting a fixed exchange-rate regime versus societal pressures to counter the real distributional effects that inflation has within the economy (Frieden 2002). The societal pressures for fixed versus flexible rates are, however, likely to be mixed. While workers are likely to be hurt (in terms of lower wages or higher unemployment) by the real appreciation of the exchange rate that takes place under nominally fixed regimes and would therefore prefer flexible to fixed rates, societal groups with commercial bank liabilities are likely to fight for policies that enhance monetary-policy credibility in order to continue to attract commercial lending and minimize their personal vulnerability to a devaluation.¹⁵ Their desire for fixed exchange-rate anchors is particularly likely in the event of economic conditions—like inflation or a recent history of hyperinflation—that threaten monetary policy credibility. This pressure is likely to be high even in countries with left-leaning governments whose constituents have large commercial bank liabilities. Despite their tendency to support worker concerns, Leblang (2002, 11) argues, for example, that because left parties have less inflation-fighting and monetary-policy credibility and face greater risk to capital flight, they have more to gain than the right by defending a peg.

¹⁴Elections data are estimated using data from the Database of Political Institutions published by the World Bank Economic Review (Beck et al. 2001).

¹⁵The consequences of this strategy are reflected vividly in Argentina which has suffered from persistently high levels of unemployment since its currency board was implemented. Pastor and Wise argue, for example, that “the failure to offset rigid management of fiscal and exchange rate policy under the Convertibility Plan with programs designed to help economic agents adjust to additional simultaneous challenges of trade liberalization and privatization” has led to high unemployment and “worrisome” distributional consequences in Argentina (Pastor and Wise 1999, 478; Wise and Roett 2000, 114).

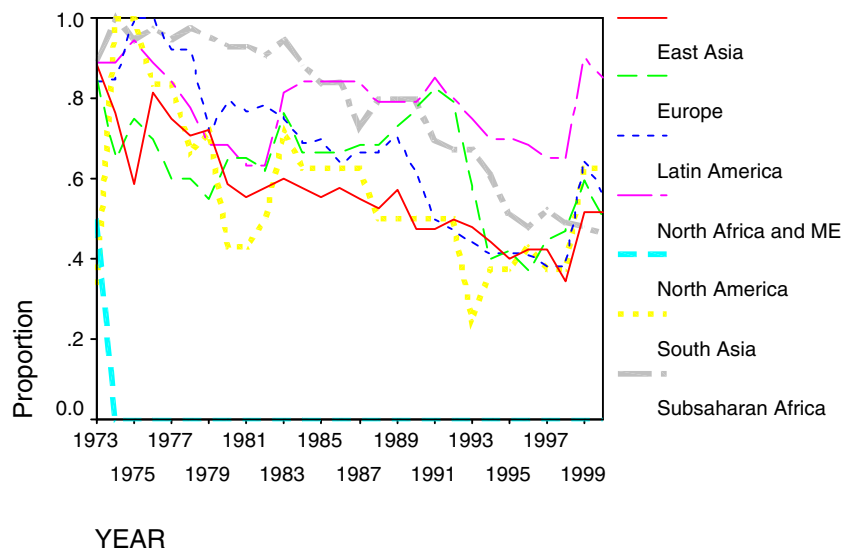
In countries whose constituents rely heavily on portfolio investment, if domestic groups are assumed to mimic the preferences of foreign investors, political pressure for fixed exchange rates should also be high during inflationary periods. If, however, domestic groups seek policies that reduce their capital-specific vulnerabilities, then societal concerns are likely to trump credibility concerns. This suggests increased societal pressure for capital controls that reduce the ability of portfolio investors to exit. Furthermore, since these efforts plus the enhanced policy credibility associated with a fixed exchange rate regime cannot guarantee protection from speculative attacks or capital flight, constituents who rely heavily on portfolio investment will demand exchange rates policies that do not constrain the government’s ability to compensate the losers from such crises. Thus, left-leaning governments in countries whose constituents rely heavily on portfolio investment are likely to pursue flexible exchange-rate regimes during inflationary periods.

Inflation is measured in terms of the appreciation of the real exchange rate which is calculated as the log of the difference between the real exchange rate at time t and the real exchange rate at time $t - 1$ using the World Bank estimate of the real exchange rate with a base year of 1995 (1995 = 100; World Bank 2002b). To test for the effect of high inflation, a dummy variable is used to indicate whether the country experienced inflation of 25% or more in the consumer price index within the previous five years (World Bank 2002b). The effect of ideology in the Executive branch is coded as an increasing ordinal variable from left to center to right.¹⁶

Additional economic control variables include the level of gross international reserves as a proportion of money plus quasi money (World Bank 2002b) and the presence of controls on the capital and current accounts as specified by the International Monetary Fund (IMF 1972–2000). High levels of reserves and controls on the capital and current accounts are expected to increase the probability that countries will pursue fixed exchange rates. In addition, decade dummies are used to differentiate the era of import substitution, oil shocks, and petro-dollar recycling between 1973 and 1981; from the debt crisis from 1982 through the renegotiation of Mexican debt in 1989; and the dramatic economic liberalizations and rise of private capital in the 1990s. With the decline of import substitution and rise of economic and political liberalization, expectations are that the salience of exchange-rate regime choice should be larger in the 1980s and 1990s

¹⁶Ideology data are estimated using the Database of Political Institutions published by the World Bank Economic Review (Beck et al. 2001).

FIGURE 2 Proportion of Countries with Fixed Exchange Rates by Region



than in the 1970s. Fixed exchange rates are likely to be prevalent in the 1980s in countries that grew in reliance on commercial lending in the 1970s, while the exchange-rate choices in the 1990s are expected to be more varied as reliance on foreign direct investment and portfolio investment increases.

Empirical Analysis

The following section specifies the sample, variables, and methods of analysis and will ascertain whether capital-inspired preferences affect the likelihood that countries will pursue fixed exchange-rate regimes when controlling for trade-inspired preferences, the level of democracy, and a variety of economic and political control variables. Data are gathered for all developing countries from 1973 through 2000 for which they were available from World Bank and IMF sources.¹⁷

The Dependent Variable

The dependent variable is the probability that a country will pursue or maintain a fixed exchange-rate regime at time t . Based on the IMF rating of the country's exchange rate, the exchange-rate regime is considered fixed if it is

¹⁷The analysis begins in 1973 because by then most efforts to revive the Breton Woods dollar to gold standard were abandoned and policy makers were forced to choose an alternative to the par value arrangements they had previously made with the IMF.

designated by the IMF as a pegged rate, fixed rate, crawling peg, or exchange rate that is maintained in relatively narrow margins to a particular currency, group of currencies, or an average of exchange rates of main trading partners.¹⁸ The exchange-rate regime is considered not to be fixed if it is designated as an exchange rate maintained within a relatively narrow margin in terms of a set of indicators, a band, or is not maintained within a relatively narrow margin, follows a more flexible arrangement or is considered to have a flexible rate. While there are variations across regions, the proportion of countries pursuing fixed exchange the regimes generally declined after 1973, reaching approximately 50% in 2000.

Expectations and Results

The arguments specified above are tested using conditional logit models with country-specific fixed effects to estimate the probability that a country will pursue a fixed exchange rate at time t .¹⁹ There are three sets of results presented in Table 1. Estimate 1 presents the base model.

¹⁸The data on exchange rates and capital controls are collected from the IMF, 1974–2000, *Annual Report on Exchange Restrictions* (retitled as the *Annual Report on Exchange Arrangements and Restrictions*). Difficulties with this measure are well known, but they still provide the most consistent indicators of official exchange-rate policy across the countries and time periods analyzed in this study. The data are cross checked with Ghosh et al. (1997), which refines the IMF data on exchange-rate regimes from 1973 to 1996.

¹⁹The analyses were conducted using STATA 7.

TABLE 1 Capital-Specific Preferences and the Choice of Fixed Exchange

Dependent Variable: Probability of Pursuing a Fixed Exchange-Rate Regime			
	1	2	3
Existing Fixed Exchange-Rate Regime	2.69	2.98	3.60
Presence of a Fixed Exchange-Rate Regime at $t - 1$	(7.89)**	(4.33)**	(3.81)**
Capital-Specific Variables			
Private Sector Reliance on Foreign Lending at $t - 1$ (Bank Debt PNG/GDP * 100)	0.122 (.69)	0.988 (1.90)'	1.02 (1.67)'
Government Reliance on Foreign Lending at $t - 1$ (Bank Debt PPG plus other public guaranteed debt/GDP * 100)	-0.0164 (-.11)	0.127 (.38)	-0.0881 (-.21)
Private Reliance on Portfolio Investment at $t - 1$ ((Bonds PNG + SR Debt + Portfolio Equity)/GDP * 100)	-0.0289 (-2.59)**	-0.0535 (-2.34)*	-.0580 (-2.23)*
Government Reliance on Portfolio Investment at $t - 1$ (Bonds PPG/GDP * 100)	-0.920 (-2.70)**	-2.31 (-2.30)*	-3.09 (-2.30)*
Reliance on Foreign Direct Investment at $t - 1$ (Gross FDI/GDP * 100)	-0.0301 (-.42)	0.00408 (.04)	-0.0379 (-.28)
Trade-Specific Variables			
Importance of Export Dependent Sector at $t - 1$ (X/GDP * 100)	-0.0264 (-.80)	-0.124 (-1.85)'	-.180 (-2.23)*
Importance of Import Dependent Sector at $t - 1$ (M/GDP * 100)	-.0290 (-.86)	-0.0317 (-.42)	0.0242 (.29)
Proportion of Specialized Pass Through Goods at $t - 1$ (Manufacturing Exports/Merchandized Exports * 100)	0.00451 0.26	0.0599 (1.56)	0.121 (2.06)*
Change in the Real Exchange Rate			
Real Exchange Rate Change (Log) (REER estimated with 1990 = 100 World Bank, WDI)	-1.75 (-2.18)*	-3.49 (-1.81)'	-4.28 (-1.95)*
Democracy Variables			
Level of Democracy (Polity)		-0.532 (-2.15)*	-0.774 (-2.53)**
Elections this next year ($t + 1$) (Dummy = 1 if yes)		0.266 (.39)	.0580 (.08)
Elections Last Year ($t - 1$) (Dummy = 1 if yes)		0.698 (1.09)	1.15 (1.54)
Conservatism of Executive (Left = 1, Center = 2, Right = 3)		-0.214 (-.55)	-0.425 (.87)
Economic Control Variables			
Controls on the Capital Account (Dummy = 1 if yes, IMF)			1.86 (1.75)'
Controls on the Current Account (Dummy = 1 if yes, IMF)			-0.00644 (-.01)
High Inflation in Past 5 Years Dummy (Dummy = 1 if CPI > 25% for any year in the past five)			-2.22 (-2.24)*
Foreign Reserves (Foreign Reserves/M2)			0.661 (.36)
Debt Crisis (Dummy = 1 if year \geq 1982 and year \leq 1989)			0.239 (.23)
1990s (Dummy = 1 if year \geq 1990 and year \leq 2000)			-1.41 (-1.05)
Number of Observations	431	197	196
Prob > χ^2	.000	.000	.000
Pseudo R squared	0.386	0.502	0.584

'alpha = .10, *alpha = .05, **alpha = .01

It examines the relationship between capital-specific preferences and exchange-rate regime choice when controlling for trade-related preferences. Estimate 2 evaluates and controls for the impact that the level of democracy, electoral politics, and ideology of the executive have on these relationships. Estimate 3 provides an additional robustness check by including other economic and era-specific controls. To evaluate the impact that reliance on particular types of capital at time $t - 1$ has on the choice of exchange-rate regimes at time t and address the potential problem of endogeneity associated with the impact that exchange rate choice has on investment, all explanatory variables are lagged one year.²⁰

The first capital-specific hypothesis posits that countries which rely on commercial bank lending are likely to pursue fixed exchange-rate regimes. The results lend qualified support to this proposition. On one hand, the base model (Estimate 1) suggests that reliance on foreign lending does not have a significant effect on the choice of exchange-rate regimes. On the other hand, when political factors are considered (Estimate 2), higher levels of reliance on foreign lending by the private sector increase the probability that countries will pursue fixed exchange rates (sig. $t = .06$). This effect remains significant (sig. $t = .09$) when controlling for the presence of high inflation in the past five years, the level of foreign reserves, controls on the capital and current account, and broad changes between the 1970s, 1980s, and 1990s.

Interestingly, while higher levels of private sector reliance on commercial bank lending at time $t - 1$ increase the probability that a country will adopt a fixed exchange rate, government reliance on bank lending does not have a significant impact on exchange-rate regime choice. Furthermore, while higher levels of democracy are associated with flexible rates as predicted by the compensation thesis (sig. $t < .05$), controlling for the level of democracy enhances the opposing effect associated with high levels of private sector reliance on bank lending. The combination these two results lend support to the proposition that the impact of foreign lending on policy choices is mediated through its effects on the private sector.

²⁰To evaluate the problem of reverse causality, country-specific fixed-effect regression models were used to estimate the impact of a fixed exchange-rate regime at time $t - 1$ on the level of a country's reliance on different types of foreign capital at time t . These analyses indicate that the presence of a fixed exchange rate a time $t - 1$ does not have a significant effect on the level of private or public reliance on commercial lending, or the level of private reliance on portfolio investment. A fixed exchange rate at time $t - 1$ does, however, have a significant positive effect on the level government reliance on portfolio investment and significant negative effect on the level of FDI as a proportion of GDP at time t . Using the same data, the signs and significance of the coefficients in these estimates differ from those presented below in which the choice of exchange-rate regime is the dependent variable.

In contrast to the variation in the policy impacts of private and public sector reliance on commercial bank lending, private and public reliance on portfolio investment had similar effects on the choice of exchange-rate regimes. Counter to expectations based on the dependency theory and policy convergence proposition that preferences of international and domestic actors are likely to align, reliance on portfolio investment at $t - 1$ decreased the likelihood that countries would pursue fixed exchange-rate regimes at time t ($\alpha < .05$). This effect remains significant when controlling for the presence of high inflation in the past five years, the level of foreign reserves, controls on the capital and current account, and broad changes between the 1970s, 1980s, and 1990s ($\alpha < .05$).

This result supports the proposition that domestic groups promote policies that reduce their capital-specific vulnerabilities rather than mimic investor preferences.²¹ Given the risks and vulnerabilities of capital flight and the relative inability of governments to stop it, those who rely on portfolio investment may prefer to enhance their government's ability to respond to the potential shock of capital flight rather than tying its hands by instituting a fixed exchange-rate regime. This result is consistent with expectations based on Rodrik and Eichengreen's compensation thesis. It also suggests that the link between international phenomena and domestic policy preferences is more complex than the dependency or policy convergence arguments suggest (Stallings 1992).

The preferences of commercial bank lenders and borrowers converge because both benefit from the credibility and stability enhancing effects of fixed exchange-rate regimes. At a minimum, domestic groups with dollar-denominated liabilities can reduce their vulnerabilities to price shocks while reducing their debt servicing costs (due to real appreciation) by promoting nominally fixed rates. In the case of portfolio investment, however, investor and recipient preferences diverge. Fixed exchange rates and the benefits of stability they offer portfolio investors do not necessarily reduce the risks of capital flight for domestic groups who rely on portfolio investment. Consequently, these groups are likely to demand policies—like controls on the capital account (sig. $t < .10$)—that reduce their risk. They are also likely to resist policies—like fixed exchange-rate regimes—that limit their government's ability reduce their vulnerability in the event of capital flight or other external shocks. Also consistent with the compensation thesis, but counter to the proposition that domestic groups will consistently promote fixed exchange-rate regimes following periods of high inflation, inflation (as reflected in the appreciation of the real exchange rate) and the

²¹See previous footnote regarding investor preferences.

experience of high inflation in the past five years (inflation in the CPI > 25%) decrease the probability that countries will pursue fixed exchange-rate regimes. This further suggests that recipients of foreign capital prefer not to constrain their government's ability to respond to external shocks and internal demands by adopting fixed exchange-rate regimes.

The results in Estimates 2 and 3 confirm the general finding that higher levels of democracy decrease the probability that national governments will pursue fixed exchange-rate regimes. At the same time, counter to expectations, elections in the coming year did not significantly increase the probability that a country would pursue a fixed exchange rate. Similarly, elections in the previous year did not increase the probability that a country would pursue a flexible exchange-rate regime. Finally, political leaning of the executive did not have a significant impact on exchange-rate regime choice. Thus, while high levels of democracy in emerging market countries have the anticipated effects of increasing demands government activity (Garrett 1995) and they increase the impact of private sector groups with capital-specific and trade-specific preferences on policy choices, other factors traditionally associated with democratic politics in advanced industrialized countries—particularly, electoral politics and political leaning of the executive—do not. This suggests that the institutionalization of democracy has a greater impact on policy than who gets elected or when elections take place.

Counter to expectations, reliance on foreign direct investment does not have a significant impact on exchange-rate regime choice in any of the estimates. This may be due to the competing incentives that drive foreign direct investment and is a fruitful avenue for future research. As expected, countries with large export sectors in their economy are more likely to pursue flexible rates (Estimates 2 and 3), while those which export a high degree of specialized manufactured goods are more likely to pursue fixed exchange rates (Estimate 3). These results support Frieden's (2002) finding among European countries that industries that trade in pass through goods prefer fixed to flexible exchange rates.

Finally, the signs of the remaining control variables are consistent with expectations. Higher levels of reserves increase the probability that a county will pursue fixed exchange rates, and countries were more likely to pursue fixed exchange rates during the debt crisis era and less likely to do so in the 1990s as alternative sources of private capital became more readily available. None of these effects are, however, statistically significant.

Conclusion

I began with the proposition that extant studies of the impact that international phenomena have on policy choices, and those focused on the political economy of exchange-rate regimes in particular, are incomplete because they do not consider the effect that reliance on global capital has on the policy preferences of domestic constituents. As a consequence, they cannot explain why certain newly emerging market countries pursue fixed exchange regimes even when doing so imposes high costs on their export sectors and other domestic constituents. To answer this puzzle and expand our understanding of these policy choices in the context of increased reliance on global capital, I developed a capital-specific argument of policy preferences. I argued that domestic groups are likely to promote economic policies that reduce their capital-specific risks and vulnerabilities.

Panel logit models of fixed exchange-rate regimes in emerging market countries from 1973 through 2000 demonstrate that reliance on different types of foreign capital generates distinct policy preferences. The findings offer three primary lessons for international political economy:

- Global trade and finance influence policy choices in emerging market countries, but their effects vary depending on the type of capital on which a country relies. Levels of private and public sector reliance on different types of capital—particularly among foreign direct investment, commercial bank lending, and portfolio investment—are associated with particular policy decisions. Specifically, high levels of private reliance on commercial bank lending increase the probability that countries will pursue fixed exchange-rate regimes, while high levels of private or public reliance on portfolio investment increase the probability that countries will pursue flexible rates.
- Globalization affects policy outcomes by altering the policy preferences of domestic actors who rely on international capital and trade. These actors are likely to balance their motivations to promote investor-favored policies with a preference for government policies that minimize the risks and vulnerabilities associated with the particular type of capital they rely upon. In some circumstances, they are likely to promote policy choices that reflect the preferences of certain foreign investors (including those involved in commercial bank lending), but not others (including those involved in portfolio investment).
- Democracies generally prefer policy flexibility to constraint and are responsive to their citizens. Higher

levels of democracy generally increase the likelihood that countries will pursue flexible exchange rates, regardless of recent experiences of high inflation. At the same time, high levels of democracy also increase the impact of domestic groups with varying capital-specific and trade-specific preferences on policy choices. Finally, the level of democracy matters more than who gets elected or when the elections take place. Neither the political leaning of the executive nor the timing of elections has a significant effect on exchange-rate regime choice in emerging market countries.

Only by understanding the sources of actor preferences can we understand why particular policy decisions are made. This project shows that international phenomena—in the form of foreign investors and their capital—do indeed have an impact on the preferences of domestic actors. By examining these relationships, this study sheds some light on the general issue of how international and domestic phenomena interact and affect policy decisions. In particular, the finding that reliance on particular types of private capital is associated with particular policy choices is significant because it suggests that, like their trade related counterparts, actors in financial markets have to some extent their own issue-specific autonomy. In addition, the finding that those who rely on foreign capital act to minimize their risks and vulnerabilities rather than simply mimic the preferences of investors suggests that domestic actors respond strategically to the constraints and opportunities created by increasing levels of globalization and democracy.

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