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How Constraining Is Capital Mobility? The Partisan Hypothesis in an Open Economy

Thomas Oatley, *University of North Carolina at Chapel Hill*

A growing literature argues that international financial integration has eliminated the possibility for distinct partisan macroeconomic strategies. I test this hypothesis by reformulating the partisan hypothesis in an open-economy context and conducting pooled time-series analysis of budget balances, real interest rates, and capital controls for fourteen OECD countries between 1970 and 1994. The analysis provides little evidence that financial integration has eliminated distinct partisan macroeconomic policies. Under fixed exchange rates leftist governments run larger deficits than rightist governments and use capital controls to reduce interest rate premia. Under floating exchange rates leftist governments pursue looser monetary policies than rightist governments. While partisan distinctions do weaken in the 1990s in countries with fixed exchange rates, this is attributed to the recession of the early 1990s and to important institutional changes in the European Union. International financial integration, therefore, does not prevent governments from pursuing distinct partisan macroeconomic policies.

1. Introduction

The partisan hypothesis has become a standard of the political economy literature. Pioneering work by Hibbs (1977, 1987) generated a research program that posited a systematic relationship between the partisan composition of government and macroeconomic policies (See Alesina 1988, 1989; Alesina et al. 1993; Alt 1985; Hibbs 1977, 1987, 1992, 1994; Quinn and Shapiro 1991; and the useful survey in Keech 1995). This hypothesis asserts that different political parties have different ideal macroeconomic outcomes and once in office use monetary and fiscal policy to try to move the economy toward their most preferred point. Governments led by leftist parties with strong organizational and electoral ties to labor use expansionary macroeconomic policies, budget deficits, and low interest rates to try to produce low unemployment even if this implies rising inflation. Governments led by rightist parties with strong organizational and electoral ties to capital and the professional managerial class use restrictive macroeconomic policies,

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balanced budgets, and high interest rates to try to produce low inflation even if this implies rising unemployment.

A growing body of literature, which I will call the "capital mobility hypothesis," suggests that international financial integration has eliminated the latitude leftist governments require to pursue fiscal and monetary expansions and, therefore, has eliminated distinct partisan macroeconomic policies (see, e.g., Andrews 1994a, 1994b; Garrett and Lange 1991; Goodman and Pauly 1993; Keohane and Milner 1996; Kurzer 1993; Moses 1994; Scharpf 1991; Simmons 1998; Walsh 1994; Webb 1995). According to the capital mobility hypothesis, financial market integration forces all political parties to respond in the same way to large financial institutions that can easily and quickly shift their funds across national borders. The hypothesis assumes that these financial institutions prefer low inflation and balanced budgets and rapidly shift their funds in response to macroeconomic policies that threaten to generate inflation or otherwise reduce the return on investment relative to other national markets. As a consequence, rather than being able to pursue expansionary fiscal and monetary policies, leftist governments must adopt policies identical to those preferred by the right: tight money and balanced budgets. The implication of international financial integration for the partisan hypothesis, therefore, is quite clear: "governments no longer possess the autonomy to pursue independent macroeconomic strategies successfully. In anything but the short run, the fiscal and monetary policies of governments of the left and the right should converge"(Garrett and Lange 1991, 543).[1]

This paper evaluates the extent to which international financial integration does constrain macroeconomic policy by first reformulating the partisan hypothesis in an open-economy framework and then testing the resulting expectations against annual data from fourteen OECD countries in the period 1970–1994. Placing the partisan hypothesis in an open-economy context forces us to recognize that the macroeconomic policy instrument a government will use to pursue its macroeconomic objectives depends upon how the domestic economy relates to the international economy. Specifically, whether we observe partisan distinctions on monetary or fiscal policy depends upon whether a government fixes or floats the exchange rate and upon whether the government does or does not use capital controls. Once we control for this context, open-economy macroeconomics suggests that international financial integration does not eliminate the autonomy necessary to pursue distinct partisan macroeconomic policies.

[1]Garrett and Lange have subsequently backed away from this conclusion. (See Garrett 1995, 1998; Garrett and Lange 1995; Kitschelt et al. 1998.)

The empirical findings provide strong support for these conclusions. Once we control for choice of the exchange rate regime and the use of capital controls, governments do have the autonomy necessary to pursue distinct strategies. Throughout the period analyzed, leftist governments offered lower real interest rates and ran larger deficits than rightist governments. While left and right governments did pursue distinct macroeconomic strategies, the policy instrument they relied upon to do so was context dependent. Under fixed exchange rates partisan distinctions are evident on fiscal policy but not on monetary policy, while under floating exchange rates partisan distinctions are evident on monetary policy but not on fiscal policy. Finally, the analysis indicates that the context within which policy is made is not exogenous. Leftist governments with fixed exchange rates relied on capital controls much more heavily than did all other governments and as a result were able to offer lower real interest rates and run larger budget deficits than they could otherwise. Thus, governments manage the relationship between the domestic economy and the international economy in order to gain the autonomy they require to pursue their desired objective.

My paper proceeds as follows. Section two defines financial integration, presents a simple open-economy model to demonstrate why the effect of capital mobility on fiscal and monetary depends upon the exchange rate and capital controls, and then restates the partisan hypothesis in this open-economy context. Section three presents the data and estimation technique. Section four discusses the results. Section five summarizes and offers some concluding comments.

2. Capital Mobility and the Partisan Hypothesis in an Open Economy

The last twenty-five years have brought the internationalization of finance. While the increase in daily turnover on foreign exchange markets to over $1 trillion per day is the single most apparent symbol of the growth of international finance, what is distinctive about global financial integration is that parties to financial transactions increasingly live in different countries. The extent to which finance has become globalized can be glimpsed from the dramatic increase in portfolio capital flows. According to the Bank for International Settlements, gross portfolio flows (inflows plus outflows) for the United States rose from $10.5 billion in the late seventies to about $230 billion in 1993. The American increase was not atypical. Gross flows for western Europe increased from $29 billion in the late seventies to $660 billion by 1993. On a transactions basis, the growth of international finance appears even more dramatic. Cross-border transactions of bonds and equities in the United States increased from 4 percent of GDP in 1975 to more than

150 percent in the first half of the 1990s. Europe displayed identical trends, with cross-border transactions rising from less than 4 percent of GDP in 1975 to close to 200 percent of GDP in the early 1990s (Bank for International Settlements 1998).

How tightly integrated are financial markets? One way to measure financial integration is to evaluate the extent to which the interest parity condition is met.[2] The interest parity condition states that in a world of tightly integrated financial markets, a condition economists call "perfect capital mobility," the risk-adjusted domestic interest rate must equal the world interest rate. Economists examine two measures to assess whether financial integration has forced risk-adjusted returns on equivalent short-term instruments to equalize. The simplest indicator is the difference between onshore and offshore returns on identical instruments denominated in the same currency. For example, if financial markets are fully integrated, then a French franc deposit in Paris should yield the same return as a French franc deposit in Luxembourg. A second measure, covered interest parity, compares the rates of return on equivalent financial instruments denominated in different currencies, such as the return on a one year U.S. Treasury bill and a one year bond issued by the British Government. In a perfectly integrated market the returns on these two instruments should be identical once one adjusts for the cost of purchasing forward cover to insure against exchange rate depreciation. Empirical tests of these two measures of international financial integration indicate that short-term markets exhibit a very high degree of integration: during the 1980s onshore-offshore rates largely converged and covered interest parity was largely established (International Monetary Fund 1991; Marston 1995).

To what extent has the integration of international financial markets forced the convergence of macroeconomic policies? This section develops a theoretical structure that produces a set of hypotheses concerning the extent to which international financial integration has eliminated the latitude leftist governments require to pursue expansionary policies. This structure is developed in two steps. First, I use the standard model of open-economy macroeconomics to elaborate how capital mobility affects fiscal and monetary policies. Second, I use this open-economy framework to reformulate the partisan hypothesis. This reformulated partisan hypothesis then serves as a null hypothesis against which to evaluate the capital mobility hypothesis.

[2]An alternative to the approach adopted here is to examine the correlation between national savings and investment rates. The expectation is that as international financial integration increases the correlation between domestic savings and domestic investment will fall. See Feldstein and Horioka (1980) and Frankel (1991). For a useful comparison of alternative measures of financial openness, see Clark et al. (1998).

2.1 Macroeconomic Policies in an Open Economy

The standard model of open-economy macroeconomics suggests that the effect international financial integration has on monetary and fiscal policies depends upon how governments use the exchange rate and capital controls to manage the linkages between domestic and international markets (Mundell 1968; Krugman and Obstfeld 1991; Sachs and Larrain 1993). While this model was developed in the early 1960s, it remains the "workhorse" for analyzing open-economy macroeconomics (Krugman 1991, 1995). The model's basic conclusion is that even with perfect capital mobility, governments' abilities to use macroeconomic policy instruments depend upon the exchange rate choice they make. Under a fixed exchange rate, capital mobility increases the effectiveness of fiscal policy but eliminates monetary policy autonomy. Under a floating exchange rate, capital mobility renders fiscal policy ineffective, but monetary policy can be set independently.

In monetary policy, the basic insight of open-economy macroeconomics is that given three possible objectives, capital mobility, monetary autonomy, and exchange rate stability, governments can achieve only two simultaneously. With perfect capital mobility the open-economy framework tells us that governments can gain monetary autonomy if they are willing to allow the exchange rate to float. The economic logic can be elaborated briefly. From an initial equilibrium, a domestic monetary expansion will cause a reduction in domestic interest rates. Free to leave the national market, capital will move abroad in search of a higher return. Capital outflows will reduce the demand for the domestic currency, and one of two things must happen in response. If the government is maintaining a fixed exchange rate, then it must enter the foreign exchange market to purchase domestic currency at the given exchange rate. These foreign exchange market operations will contract the domestic money supply and as the money supply shrinks the domestic interest rate rises back to the world interest rate. Thus, with perfect capital mobility and a fixed exchange rate, governments cannot move the domestic interest rate below (or above) the world interest rate. If the government allows the exchange rate to float, however, the shift into foreign assets prompted by the domestic interest rate reduction causes the exchange rate to depreciate. The domestic interest rate reduction can be sustained as exchange rate movements equilibrate the foreign exchange market. Thus, with perfect capital mobility the extent to which governments lose monetary autonomy depends upon whether the exchange rate is fixed or floating.

Governments need not passively accept the interest parity condition, however. Cohen (1996) notes that much of the literature suggests that international financial integration has been exogenously imposed, in effect

forcing governments to choose between monetary autonomy and exchange rate flexibility. Goodman and Pauly (1993), for example, argue that the micro-computer revolution, the dramatic growth of domestic financial markets during the 1970s and 1980s, and the increased prominence of multinational corporations with a greater need to move funds across national borders have made it much easier for wealth holders to evade capital controls.[3] As capital controls became less effective, governments largely stopped trying to prevent cross-border capital movements. It is not clear, however, that capital account liberalization has been exogenously imposed. Existing analyses suggest that variation in the use of capital controls corresponds quite well with the basic expectations of the partisan hypothesis: leftist governments, who are more likely to pursue expansionary monetary policies, are more likely to rely on capital controls than rightist governments (see Quinn and Inclan 1997; Quinn 1997; Alesina et al. 1993; Grilli and Milesi-Ferretti 1995). And while little of the extant literature investigates systematically whether those governments that have used capital controls have continued to enjoy monetary autonomy, we do know that capital controls allowed the French and Italian governments to combine considerable monetary policy autonomy and membership in the European monetary system during much of the 1980s (Giavazzi and Giovannini 1989; Oatley 1997). Thus, the claim that capital account liberalization has resulted from the declining effectiveness of capital controls rests on thin empirical foundations. If capital controls do remain effective, then governments have an additional degree of freedom; they may be able to combine fixed exchange rates with monetary policy autonomy.

Whether fiscal expansion is an effective instrument for stimulating domestic demand in an open economy also depends upon whether the exchange rate is floating or fixed. With a floating exchange rate capital mobility renders fiscal policy ineffective as a tool for demand management. The economic logic can be briefly elaborated. A government-financed fiscal expansion will cause an increase in output, and this increase in output will cause an increase in the transactions demand for money. With the money supply initially fixed, this increase in money demand will place upward pressure on domestic interest rates. As domestic interest rates rise above the world rate, foreign asset holders will exchange foreign assets for domestic assets. This shift in asset demand increases the demand for the domestic currency and the domestic currency appreciates. Currency appreciation

[3]Keohane and Milner (1996) share this conclusion. For arguments that financial liberalization was a domestic or state-driven process, see Sobel (1994), Helleiner (1994), and Notermans (1993).

causes foreign goods to become relatively less expensive than domestic goods, and this relative price change causes a shift in consumption from domestic to foreign goods. The shift in consumption from domestic to foreign goods in turn offsets the expansionary effect of government spending on the domestic economy. Thus, if a government allows its exchange rate to float, fiscal policy is rendered ineffective as capital inflows cause the currency to appreciate.

If the exchange rate is fixed, however, fiscal policy is highly effective under perfect capital mobility. Fiscal policy is effective under a fixed exchange rate because the interest parity condition forces monetary policy to accommodate the fiscal expansion. As elaborated above, the fiscal expansion will cause an increase in output, and this increase in output will cause an increase in the transactions demand for money. As the domestic interest rate rises above the world interest rate, foreign asset holders will demand domestic assets, and this shift in asset demand will increase the demand for the domestic currency. Unlike the floating exchange rate case, however, the central bank is now obligated to intervene in the foreign exchange market to defend the fixed exchange rate. By purchasing foreign currencies through these foreign exchange market interventions, the monetary authorities expand the domestic money supply, and the monetary expansion restores the asset and foreign exchange markets to equilibrium. Thus, because the monetary authorities are forced by the fixed exchange rate to accommodate the fiscal expansion, the increase in domestic interest rates that would have occurred in the absence of capital mobility and the appreciation of the domestic currency that would have occurred with a floating exchange rate are both prevented. Given a fixed exchange rate and capital mobility, therefore, fiscal policy has a powerful impact on domestic demand.

It is important to recognize that fiscal policy's effectiveness results from what are assumed to be automatic changes in the money supply induced by foreign exchange market intervention. Central banks may try to prevent these foreign exchange market interventions from affecting the domestic money supply by sterilizing these operations. Sterilization occurs when central banks buy domestic assets through open market operations at the same rate at which they sell foreign assets through foreign exchange market transactions. As a result, the expansion of the money supply engendered by foreign exchange market transactions is offset by the sale of domestic assets in open market operations. Through sterilization, therefore, central banks try to support a fixed exchange rate without altering the domestic money supply. While central banks do sterilize their foreign exchange market interventions, empirical studies of sterilized intervention in the industrialized world have indicated that this practice has, at best, only a "temporary influence" on the

exchange rate (Edison 1993; Dominguez and Frankel 1993).[4] Thus, if a government is in fact committed to maintaining a fixed exchange rate, they cannot sterilize foreign exchange market intervention and fiscal expansion will therefore generate a monetary expansion.

To summarize, according to the standard open-economy model, international financial integration does not strip governments of the ability to use monetary and fiscal policies to achieve domestic economic objectives. Instead, the open-economy model tells us that while capital mobility does impose a constraint on macroeconomic policy instruments, even with perfect capital mobility one of the two policy instruments is always effective. Which policy instrument is effective depends upon governments' preferences on the exchange rate. If governments want to maintain a fixed exchange rate, then fiscal policy is effective but monetary policy autonomy is lost. If governments want a floating exchange rate, then monetary policy autonomy is maintained but fiscal policy is ineffective.

2.2 The Partisan Hypothesis in an Open Economy

The discussion of macroeconomic policies in an open economy suggests that to test the hypothesis that international financial integration has eliminated the latitude leftist governments require to pursue expansionary macroeconomic policies we must recognize that choices about exchange rates and capital controls shape governments' abilities to manipulate monetary and fiscal policies. Thus, rather than testing the hypothesis that leftist governments pursue expansionary policies and rightist governments pursue restrictive policies, we need to test a hypothesis in which parties' macroeconomic policy objectives are pursued through either monetary or fiscal policy given their prior choices on the exchange rate and capital controls.

Table 1, which depicts the effectiveness of macroeconomic policy instruments as a function of exchange rate and capital controls, presents this reformulated version of the partisan hypothesis. As the table indicates, in an open economy, governments face a choice between an independent monetary policy or an effective fiscal policy and the effectiveness of each policy

[4]There are two models of exchange rate determination: the monetary approach and the portfolio balance model. According to the monetary approach, a bilateral exchange rate is fully determined by the relative supply and demand of the two currencies. Because sterilized intervention causes no change in relative money supplies, the monetary approach suggests that sterilized intervention can never be effective. According to the portfolio balance model, sterilized intervention can affect the exchange rate *directly* by altering the relative supply of foreign and domestic bonds and *indirectly* by signaling monetary authorities' future policy intentions. No empirical support for the direct effect has yet been found, and only very limited empirical evidence consistent with the signaling effect has been reported. Both models, and the empirical evidence on the portfolio balance model, are surveyed in Edison (1993).

Table 1. The Partisan Hypothesis in an Open Economy

	Capital Controls	No Capital Controls
Fixed Exchange Rate	• *Fiscal Policy Is Effective* • *Monetary Policy Autonomy* **Partisan Hypothesis:** *Distinct Partisan Fiscal Policies* *Distinct Partisan Monetary Policies*	• *Fiscal Policy Is Effective* • *No Monetary Policy Autonomy* **Partisan Hypothesis:** *Distinct Partisan Fiscal Policies* *No Distinct Partisan Monetary Policies*
Floating Exchange Rate	• *Fiscal Policy Is Effective* • *Monetary Policy Autonomy* **Partisan Hypothesis:** *Distinct Partisan Monetary Policies* *Distinct Partisan Fiscal Policies*	• *Fiscal Policy Is Ineffective* • *Monetary Policy Autonomy* **Partisan Hypothesis:** *Distinct Partisan Monetary Policies* *No Distinct Partisan Fiscal Policies*

instrument is dictated by the choice of exchange rate and capital controls. If a government floats its exchange rate there is latitude for independent monetary policies, irrespective of whether or not capital controls are used, and latitude for an effective fiscal policy if capital controls are in place. The implications for the partisan hypothesis are clear: under floating exchange rates we are likely to observe systematic partisan differences on monetary policy, with leftist governments more inclined to pursue monetary expansion. When the floating exchange rate is accompanied by capital controls, we are likely to observe systematic partisan differences on fiscal policy, with leftist governments more inclined to pursue deficit spending. Thus, the expectations generated by the lower left hand cell of Table 1 correspond with those formulated by traditional partisan theory: we are likely to observe partisan distinctions on fiscal and monetary policies. With a fixed exchange rate, fiscal policy is effective but the latitude for an independent monetary policy depends upon whether capital controls are in place. Again, the implications for the partisan hypothesis are clear: under a fixed exchange rate we are most likely to observe systematic partisan differences on fiscal policy, with leftist governments more likely to pursue deficit-financed fiscal expansions and unlikely to observe partisan distinctions on monetary policy. If a government with a fixed exchange rate relies upon capital controls, the open-economy framework leads us to expect an effective fiscal policy and monetary policy

independence. The expectations for this cell thus also correspond to those formulated by the traditional partisan hypothesis: we are likely to observe partisan distinctions on fiscal and monetary policies.

This reformulated partisan hypothesis provides a null hypothesis against which to test the capital mobility hypothesis. The capital mobility hypothesis suggests that international financial integration has eroded distinct partisan macroeconomic policies by forcing all governments to adopt capital-friendly policies. Thus, support for the capital mobility hypothesis requires a consistent lack of systematic partisan distinctions where the reformulated partisan hypothesis suggests they should exist. Thus, under fixed exchange rates, a failure to find distinct partisan fiscal policies is consistent with the capital mobility hypothesis. Under floating exchange rates, a failure to find distinct partisan monetary policies is consistent with the capital mobility hypothesis. Conversely, systematic evidence of partisan distinctions on fiscal policy under fixed exchange rates and on monetary policy under floating exchange rates is inconsistent with the capital mobility hypothesis.

3. Data and Analysis

I test the capital mobility hypothesis with pooled time-series analysis on two measures of macroeconomic policy, interest rates and budget balances, and one measure of capital controls for fourteen OECD countries in the period 1968–1994.[5] The interest rate I analyze is the real money market rate, which I select because money markets are liquid, closely linked to foreign exchange markets, and therefore the interest rate series that are most likely to be affected by international financial integration. Budget balances are measured as a positive or negative percentage of GDP. I focus on policy instruments rather than macroeconomic outcomes such as the rate of economic growth, the unemployment rate, or the rate of inflation because a focus on macroeconomic outcomes tests joint hypotheses: (a) governments retain the ability to target fiscal and monetary policy at their most preferred domestic economic objectives and (b) fiscal and monetary policies generate the desired macroeconomic outcomes. A test of joint hypotheses makes it difficult to evaluate theoretical hypotheses against negative findings. For example, if no systematic relationship is found between partisanship and, say, rates of unemployment, it could be because expansionary fiscal and mon-

[5]The countries included in the sample are: Australia, Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Norway, Sweden, and the United Kingdom. The United States was excluded to maintain a focus on small and relatively open economies. The combination of large financial markets and a currency that serves as the primary international reserve currency makes the United States as much a price maker in international financial markets as a price taker. Thus, its macroeconomic policies are unlikely to be subject to the same constraints as the other OECD economies.

etary policies are ineffective at reducing and raising unemployment, or it could be because mobile capital prevents governments from adopting policies that, in the absence of capital mobility, would otherwise be effective. Using policy instruments as the dependent variables eliminates this joint hypothesis by testing only whether partisanship is systematically related to different macroeconomic policy stances.

The form of the models estimated is

$$Y_{i,t} = a + B_1 Y_{i,t-1} + (B_2\ PARTY_{i,t}) + (B_3 PARTY*INTERNATIONAL\ ECONOMY_{i,t}) + (B_4 PARTY*INTERNATIONAL\ ECONOMY*1990_{i,t}) + (B_5 CONTROL_{i,t}) + (B_6 DUMMY_{i,t}) + e.$$

$Y_{i,t}$ is one of two dependent variables, real money market interest rates and government budget balance (deficit or surplus as percentage of GDP), for country *i* at time *t*. $Y_{i,t-1}$ is the one period lag of the dependent variable. $PARTY_{i,t}$ is the measure of partisanship. This is a continuous variable that ranges from 1, which is a cabinet with only rightist party members, to 5, which is a cabinet with only leftist party members. PARTY*INTERNATIONAL $ECONOMY_{i,t}$ is a vector of interactive terms between $PARTY_{i,t}$ and the exchange rate regime and capital controls. The precise specification is model-specific and is discussed for each model. PARTY*INTERNATIONAL $ECONOMY*1990_{i,t}$ is a set of interactive terms between a dummy variable for observations in the 1990s and PARTY*INTERNATIONAL $ECONOMY_{i,t}$. These interactive terms are included to test for the stability of the estimated relationships over time. $DUMMY_{i,t}$ is a set of dummy variables that includes the three exchange rate/capital control terms, 1990, and country dummies. I also include a set of political and economic variables as controls. These include labor strength, inflation, economic growth in the fiscal policy model, and government budget balance in the monetary policy model.

Pooled time-series designs of this type often violate three of the standard OLS assumptions about the error process (Beck and Katz 1995). First, errors might be contemporaneously correlated, such that errors in country *i* at time *t* are correlated with errors in country *j* at time *t*. Second, the error process may display panel heteroskedasticity, "where the variances of the error process differ from unit to unit" (Beck and Katz 1995, 636). Third, there may be serial correlation such that errors in country *i* at time *t* are correlated with errors in country *i* at time $t+1$. Each of these violations tends to reduce the size of the estimated standard errors, thereby raising estimated levels of significance for the individual coefficients. To reduce the severity of these problems, I reduced serial correlation by including a lagged dependent variable. To minimize the effect of heteroskedasticity I report robust

standard errors calculated based on White's heteroskedastic-consistent covariance matrix. The reported models are robust to alternative specifications and estimation techniques.[6]

4. Results

4.1 Fiscal Policy

I estimated two models of fiscal policy that differ in how the relationship between the domestic economy and the international economy is modeled. The results are reported in Table 2. Model one controls only for the exchange rate regime while model two controls for both the exchange rate regime and the presence or absence of capital controls. In model one the excluded category is floating exchange rate, and therefore, the lack of a significant coefficient on *Party* indicates that with a floating exchange rate there is no systematic relationship between partisanship and fiscal balance. The large negative coefficient on the *Party*Fixed Exchange Rate* interaction term, however, indicates that with a fixed exchange rate leftist governments are associated with larger deficits and smaller surpluses while rightist governments are associated with smaller deficits and larger surpluses. The large positive and significant coefficient on *Party*Fixed Exchange Rate*1990* indicates that the strong relationship that holds throughout the earlier period weakened during the 1990s. Thus, this model suggests that with a fixed exchange rate, parties pursued distinct fiscal policies, but that these distinctions disappeared in the 1990s.

Model two presents a three-way interaction between partisanship, exchange rate regime, and financial openness using a dummy variable to measure the presence or absence of capital controls. The excluded category is fixed exchange rate with capital controls, and therefore the independent effect of *Party* in this model captures the relationship between partisanship and budget balances in this category. The large, negative, and statistically significant coefficient on *Party* is fully consistent with the open-economy partisan hypothesis: given a fixed exchange rate and capital controls, leftist governments were associated with systematically larger deficits or smaller surpluses than rightist governments. When we shift from a fixed exchange rate with capital controls to a fixed exchange rate without capital controls (*Party*Fixed Exchange Rate and No Capital Controls*) the size of the partisan effect is reduced, though it remains negative. This indicates that leftist governments run larger deficits behind capital controls, suggesting that leftist governments use capital controls to reduce the extent to which capital

[6]For example, a model based on first differences rather than lagged dependent variable generates substantially identical results as do models estimated with generalized least squares rather than OLS. Nor are the reported results sensitive to the elimination of nonsignificant variables or to the inclusion of other nonsignificant variables.

Table 2. The Partisan Hypothesis and Fiscal Policy in an Open Economy

	Model 1	Model 2
Lagged Dependent Variable	.79 (.04)***	.79 (.04)***
Party	.10 (.10)	−.62 (.19)***
Party*Fixed Exchange Rate	−.45 (.16)***	
Party*1990	.03 (.15)	
Party*Fixed Exchange Rate*1990	.43 (.14)***	
Party*Fixed Exchange Rate and No Capital Controls		.42 (.21)**
Party*Floating Exchange Rate and Capital Controls		.76 (.22)***
Party*Floating Exchange Rate and No Capital Controls		.28 (.25)
Party*1990		.86 (.23)***
Party*Fixed Exchange Rate and No Capital Controls*1990		−.48 (.21)**
Party*Floating Exchange Rate and Capital Controls*1990		−.84 (.21)**
Party*Floating Exchange Rate and No Capital Controls*1990		−.72 (.21)***
Labor Strength	−.003 (.004)	−.003 (.004)
Inflation	.08 (.03)**	.11 (.03)***
GDP Growth (percent change)	.26 (.05)***	.28 (.04)***
1990s	−1.15 (.54)**	−1.15 (.50)**
Fixed Exchange Rate and Capital Controls		−.79 (.68)
Floating Exchange Rate and Capital Controls		−2.44 (.70)***
Floating Exchange Rate and No Capital Controls		−.02 (.79)
Fixed Exchange Rate	1.28 (.48)***	
R-Squared	.88	.89
F	103.29 (P > F .000)	87.77 (P > F .000)
N	323	323

Dependent variable is government budget balance. Method of estimation is OLS fixed effects with robust standard errors.

* significant at .1 ** significant at .05 *** significant at .01

flight constrains their ability to engage in deficit spending. I explore this question in greater detail below.

The floating exchange rate cases yield mixed results. On the one hand, when governments float their exchange rate and use capital controls, there

is no evidence of a partisan distinction. The large positive coefficient on *Party*Floating Exchange Rate and Capital Controls* more than offsets the negative coefficient on *Party*. On the other hand, when governments float and do not use capital controls, there is evidence that leftist governments run larger deficits than rightist governments. The absence of a significant coefficient on *Party*Floating Exchange Rate and Capital Controls* interactive term indicates that the relationship between *Party* and *Budget Balances* in this category is no different from the relationship in the excluded category. These results are not fully consistent with the open-economy framework which suggested that fiscal policy should be effective under floating exchange rates and capital controls and should not be effective under floating exchange rates and capital mobility.

Finally, the relationship between partisanship and budget balances is not stable across time. The large positive and statistically significant coefficient on *Party*1990* suggests that during the 1990s the budget balances produced by leftist governments were no different than those produced by rightist governments in countries with fixed exchange rates and capital controls. The negative coefficient on *Party*Fixed Exchange Rate and No Capital Controls*1990* offsets the main effect of fixed exchange rates and capital mobility, indicating that partisan distinctions in this category also disappeared during the 1990s. These findings mirror those reported for model one. The interactive terms for the floating exchange rates cases, both with and without capital controls, are statistically significant and negative. For the floating exchange rate and capital controls case, this negative coefficient offsets the positive *Party*1990* coefficient to yield a combined effect of no partisan distinction. For the floating exchange rate and no capital controls, the negative sign indicates the continued persistence of partisan differences in this category. The elimination of systematic partisan differences on fiscal policy, therefore, appears to be restricted only to countries with fixed exchange rates.

Both models provide support for the open-economy partisan hypothesis for the period 1970–1989, and both provide evidence that the relationship between partisanship and fiscal policy has eroded during the 1990s in those countries with a fixed exchange rate. While this erosion could be evidence of a capital mobility effect, two variables in both models, the *1990s* dummy variable and *GDP Growth*, suggest an alternative interpretation. The capital mobility hypothesis expects financial integration to drive partisan convergence toward balanced budgets. Thus, if the capital mobility hypothesis is correct, leftist governments should be forced to run smaller deficits in the 1990s than they did in the earlier periods. Yet, the 1990s dummy variable is large, negative, and highly significant, indicating that in the 1990s budget balances deteriorated across the board rather than improved. This deterioration is evident in the raw budget figures, which indicate that the average bud-

get balance fell from –1.87 percent of GDP for the 1968–1989 period to –4.14 percent of GDP in the period 1990–1994. Thus, while the 1990s did see a partisan convergence of budget balances, rather than leftist governments moving toward balanced budgets as the capital mobility hypothesis suggests, it appears that rightist governments moved into deficit. This suggestion is further supported by the relationship between economic growth and budget balances. The *GDP Growth* coefficient indicates that budget balances are positively correlated with economic conditions. As economic growth increases, the budget deficit shrinks. The early 1990s brought a severe economic recession to most of western Europe, and GDP growth was negative in most European countries in 1993. Thus, as growth slowed, one would expect budget balances to deteriorate. Thus, while one might suggest that partisan convergence on budget balances reflects the impact of capital mobility, it is plausible to suggest that this erosion of partisan distinctions was driven by the recession that hit European economies in the early 1990s.

Our ability to differentiate between the recession and the capital mobility hypotheses based on an extension of the data to the post-recession years is complicated by the Maastricht Treaty's convergence criteria. These criteria required governments to have a deficit to GDP ratio of no greater than 3 percent in order to qualify for monetary union. Thus, between 1994 and 1998, those years following the recession and preceding the implementation of monetary union, governments hoping to qualify for monetary union were working to reduce their deficits and we would not expect systematic partisan difference for these years. Our ability to untangle the recession from the capital mobility hypotheses, therefore, as the cause of the elimination of partisan distinctions in the 1990s will require data points for the years following the implementation of monetary union.

4.2 Monetary Policy

I estimated two models of real money market interest rates, one that controls only for the effect of exchange rate regime and one that controls for the full interaction between party, exchange rates, and capital controls. The results are presented in Table 3. Model one controls only for the effect of exchange rate regime, fixed or floating. The excluded category is floating exchange rate. The large negative and highly significant coefficient on *Party* in this model is consistent with the open-economy partisan hypothesis: under floating exchange rates, leftist governments offered significantly lower real interest rates than did rightist governments. Note that the model controls for inflation, and thus this partisan effect is not driven by higher realized inflation under leftist governments. Under fixed exchange rates, the interactive term *Party*Fixed Exchange Rate* indicates the absence of distinct partisan monetary policies. Thus, through most of the sample

Table 3. The Partisan Hypothesis and Monetary Policy in an Open Economy

	Model 1	Model 2
Lagged Dependent Variable	.31 (.07)***	.29 (.06)***
Party	–.37 (.14)***	–.48 (.19)***
Party*Fixed Exchange Rate	.49 (.12)***	
Party*1990	.48 (.25)**	
Party*Fixed Exchange Rate*1990	.56 (.13)***	
Party*Floating Exchange Rate and No Capital Controls		.52 (.38)
Party*Fixed Exchange Rate and No Capital Controls		1.04 (.30)***
Party*Fixed Exchange Rate and Capital Controls		.55 (.32)*
Party*1990		.39 (.26)***
Party*Floating Exchange Rate and No Capital Controls*1990		–.80 (.38)**
Party*Fixed Exchange Rate and No Capital Controls*1990		–.83 (.30)***
Party*Fixed Exchange Rate and Capital Controls*1990		–.30 (.27)
Inflation	–.61 (.10)***	–.56 (.06)***
Budget Balance	.06 (.06)	.02 (.05)
1990s	–.51 (.80)	–.52 (.82)
Fixed Exchange Rate and Capital Controls		–.91 (.90)
Fixed Exchange Rate and No Capital Controls		2.45 (.92)***
Floating Exchange Rate and No Capital Controls		1.68 (1.09)
Fixed Exchange Rate	1.51 (.50)***	
R-Squared	.75	.76
F	34.14 (P > F .000)	34.49 (P > F .000)
N	323	323

Dependent variable is the real money market interest rate. Method of estimation is OLS fixed effects with robust standard errors.

* significant at .1 ** significant at .05 *** significant at .01

distinct partisan monetary policies were pursued in countries where governments floated their exchange rates and were not pursued in countries where governments fixed their exchange rates. The large positive coefficient on *Party*1990* indicates that partisan distinctions under floating exchange rates disappeared after 1989. Moreover, the *Party*Fixed Exchange*

*Rate*1990* suggests that leftist governments with fixed exchange rates were charged fairly steep interest premiums in this decade.

Model two controls for capital controls and the exchange rate regime. The excluded category in this model is floating exchange rate with capital controls. The large negative coefficient on the independent variable *Party,* therefore, is consistent with the open-economy partisan hypothesis: under floating exchange rates and behind capital controls, leftist governments offered lower real interest rates than did rightist governments. Though not statistically significant, the positive coefficient on the *Party*Floating Exchange Rate and No Capital Controls* suggests that as governments abandon capital controls their ability to pursue distinct partisan monetary policies disappears, even with a floating exchange rate. The large positive coefficient on *Party*Fixed Exchange Rate and No Capital Controls* is also consistent with the partisan hypothesis: under a fixed exchange rate, capital mobility not only prevents leftist governments from offering lower interest rates, but imposes a fairly steep interest rate premium. The positive coefficient on *Party*Fixed Exchange Rate and Capital Controls* indicates that capital controls do not provide monetary autonomy with a fixed exchange rate, as this coefficient almost exactly offsets the negative relationship between party and interest rates in the excluded category. Interestingly, however, the differential between the coefficients on *Fixed Exchange Rate and No Capital Controls* on the one hand and *Fixed Exchange Rate and Capital Controls* on the other suggests that capital controls do influence the size of the leftist exchange rate risk premium. This effect is particularly interesting given that the tendency of leftist governments to run larger deficits is likely to induce financial markets to charge large risk premia. I will return to this point.

As in the previous models, some of these relationships are not stable across time. The partisan distinction observed under floating exchange rates and capital controls disappears after 1989, as indicated by the large positive coefficient on *Party*1990.* Partisan distinctions persist, however, under floating exchange rates and no capital controls in this period, as indicated by the large negative term on *Party*Floating Exchange Rate and No Capital Controls*1990.* The interactive terms for the fixed exchange rate cases, both with and without capital controls for the 1990s, suggest that leftist governments continued to suffer under higher interest rates than rightist governments in this decade, but that the size of this differential fell dramatically when compared to the earlier period. This may reflect a reduction in leftist governments' risk premia or it may reflect an increase in rightist governments' risk premia as a result of the larger deficits they were required to run in the 1990s.

In sum, the two models of money market interest rates suggest two conclusions. First, the ability to pursue distinct partisan monetary policies was

largely a function of the choice of exchange rate regime. Under floating exchange rates leftist governments offered lower real interest rates than rightist governments, whereas under fixed exchange rates leftist governments were charged higher risk premia by financial markets than rightist governments. Second, capital controls appear to be effective. During much of the period they contributed to monetary autonomy for countries with floating exchange rates, and they reduced the risk premiums leftist governments paid under fixed exchange rates.

4.3 Capital Controls

The models of fiscal and monetary policy suggested that leftist governments with fixed exchange rates have an incentive to rely upon capital controls. While the models did not suggest that capital controls can fully insulate the domestic economy from international financial markets, capital controls did appear to provide important breathing space. In particular, capital controls allowed leftist governments to reduce the risk premiums associated with fixed exchange rates, and by reducing risk premiums, capital controls allow leftist governments to run larger budget deficits. It is possible, therefore, that given a commitment to a fixed exchange rate leftist governments rely more heavily on capital controls than rightist governments. This section tests that hypothesis.

The dependent variable, capital controls, is measured with the Quinn and Inclan (1997) index. This index is constructed from restrictions on current and capital account transactions reported to the International Monetary Fund. The index ranges from zero, indicating a financially closed economy, to fourteen, indicating an economy with no restrictions on either current or capital account transactions. *Party* and the *Party* interaction terms are measured exactly as in the previous models, and therefore we expect our measure of partisanship to be negatively associated with the measure of financial openness. The model also includes a set of four economic control variables: current account balance, government budget balance, interest rate, and inflation. Each of these economic variables can be a possible trigger for capital flight and are included to control for the possibility that an underlying deterioration of these macroeconomic aggregates rather than partisan preferences drives governments' choices about the degree to which they rely upon capital controls. As in the previous models the estimation technique is fixed effects OLS with a lagged dependent variable and robust standard errors.

The results are presented in Table 4. The excluded category is floating exchange rates, and thus the absence of a significant coefficient on *Party* indicates that under floating exchange rates leftist governments are no more or less likely to rely on capital controls than rightist governments. This is generally consistent with the previous findings, where a floating exchange rate

Table 4. Determinants of Financial Openness

Lagged Dependent Variable	.87 (.04)***
Party	.02 (.02)
Party * Fixed Exchange Rate	–.11 (.04)***
Party*Fixed Exchange Rate*1990	.11 (.05)**
Inflation	-.02 (.009)**
Fixed Exchange Rate	.27 (.13)**
1990s	.26 (.13)**
Labor Strength	.002 (.001)**
Current Account Balance	.21 (.44)
Budget Balance	–.003 (.01)
Government Bond Interest Rate	–.01 (.012)
R-Squared	.94
F	431.21 (P > F .000)
N	323

Dependent variable is the Quinn and Inclan index of financial openness. Method of estimation is OLS fixed effects with robust standard errors (in parentheses).
* significant at .1 ** significant at .05 *** significant at .01

was sufficient to provide the desired monetary policy autonomy. However, the *Party*Fixed Exchange Rate* interaction coefficient is statistically significant and positive. Thus, the hypothesis that emerged from the models of fiscal and monetary policy is supported by the analysis: given a fixed exchange rate leftist governments are more inclined to control cross-border financial flows than are rightist governments. The control variables largely fail to yield statistically significant coefficients. *Inflation* returned a negative and statistically significant coefficient, indicating that financial openness decreases as inflation rises. The absence of significant coefficients on these control variables is important, as it suggests that the relationship between partisanship and capital controls is direct rather than mediated by the consequences of budget deficits and monetary expansion on financial flows. In other words, leftist governments appear to rely on capital controls because they facilitate the use of fiscal policy, rather than being driven to them as a consequence of the policies they adopt. Finally, as was the case in the models of fiscal and monetary policies, the relationship between partisanship and financial openness given a fixed exchange rate disappears in the 1990s, as indicated by the positive coefficient on *Party*Fixed Exchange Rate*1990.*

Is the elimination of partisan distinctions on the use of capital controls evidence of a capital mobility effect? While this finding is consistent with such an effect there is a plausible alternative hypothesis. As part of the

European Union's completion of the internal market, EU governments agreed to eliminate barriers to the free movement of capital. This initiative called for the elimination of controls on long-term commercial credits and securities transactions by the end of 1987. All restrictions on short-term capital movements were to be eliminated by June 1990 (Story and Walter 1997, 254–255). Thus, the beginning of the 1990s marks the final implementation of EU efforts to create a single market for financial services, and the disappearance of distinct partisan strategies regarding the use of capital controls is likely to reflect this institutional change rather than a dramatic decrease in the extent to which capital controls were effective in helping governments achieve domestic macroeconomic objectives.

5. Discussion

Throughout the post-Bretton Woods era governments have pursued distinct partisan macroeconomic strategies. In particular, leftist governments have pursued consistently more expansionary macroeconomic policies than rightist governments. Whether they rely upon fiscal policy or monetary policy to pursue these distinct macroeconomic strategies depends upon the prior choices they have made about the exchange rate regime under which they operate. Under fixed exchange rates leftist governments have relied on fiscal policy; under floating exchange rates leftist governments have relied on monetary policy. Rather than finding that international financial integration has eliminated the room for distinct partisan macroeconomic policies, the analysis suggests fairly stable relationships between partisanship and macroeconomic policy across space and time. The analysis, therefore, does not lend strong support to the capital mobility hypothesis.

The distinct partisan macroeconomic policies that we observe throughout the post-Bretton Woods era did disappear for countries with fixed exchange rates in the early 1990s. While the disappearance of partisan distinctions is consistent with the capital mobility hypothesis, it is important to place these changes in the context of economic and institutional change in the European Union. The recession of the early 1990s promoted fiscal convergence around larger deficits. Institutional changes, the creation of the internal market and the Maastricht Treaty's convergence criteria in particular, also contributed to the elimination of partisan distinctions. Thus, the weakening of partisan distinctions in the 1990s are as likely to be driven by recession and institutional change as by increases in capital mobility. It will be difficult to distinguish between institutional change and capital mobility as the cause of the elimination of partisan distinctions in Europe until after the single currency is introduced in 1999.

Finally, capital controls proved to be less effective in providing monetary autonomy than the open-economy model led us to expect. Given a fixed exchange rate, leftist governments did rely upon capital controls to promote their broader macroeconomic objectives, and these controls were effective tools for doing so. But capital controls did not provide full monetary autonomy under a fixed exchange as the open-economy model suggested they might. Instead, capital controls relaxed rather than eliminated the international financial constraint. By raising the costs of exiting the national market, capital controls reduced the interest rate costs to leftist governments of expansionary fiscal policies under fixed exchange rates. And while capital controls did not provide full monetary autonomy, they did reduce the costs of fiscal expansion under fixed exchange rates. Thus, while capital controls were not perfect, the analysis does not support the suggestion that capital controls have been rendered ineffective by technological change.

Global markets, therefore, need not be incompatible with national politics. This paper suggests two reasons why this is the case. First, globalization has been only partially a market-driven process. In contrast to those who argue that technological change has made it impossible for governments to restrict capital flows, the evidence presented here suggests that the instruments governments can use to manage the domestic-international nexus remain effective. While governments have elected to abandon these instruments, the same political process that has led governments to allow financial markets to extend beyond national borders can, in the future, produce decisions to restrict the scope of these markets to national borders. The re-evaluation of the utility of capital controls in the academic and policy arenas that has been sparked by the 1992–93 EMS crisis and the Asian financial crisis is but one indicator that governments retain the authoritative capacity to restrict the global market. What is lacking, at present, is a desire on their part to use it to control cross-border financial flows.

Second, even without capital controls, macroeconomic policy is much less constrained than the globalization literature asserts. As we saw here, even when taking the world interest rate as given, governments can run expansionary fiscal policies or they can pursue expansionary monetary policies. Thus, even under the most constraining set of conditions governments are not driven to adopt balanced budgets and restrictive monetary policies. Thus, the latitude necessary to pursue distinct partisan macroeconomic strategies does exist, even in an open economy.

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DATA APPENDIX

BUDGET DEFICITS: Measured as balance of government spending as a percentage of GDP. Deficits are negative percentages, and surpluses are positive percentages. Taken from IMF International Financial Statistics.
CAPITAL CONTROLS: In the models of macroeconomic policy, country years in which any controls were imposed on capital account transactions were coded 1, all other country years were coded 0. Taken from the International Monetary Fund's Exchange Restrictions Annual report. In the capital controls model I relied upon the Quinn and Inclan (1997) index; for further details see their appendix. In this index, the severity of a nation's financial restrictions is evaluated with a 0, .5, 1, 1.5, 2 scale for each dimension of exchange restriction, with 0 meaning that, e.g., import payments were forbidden, and 2 meaning that, e.g., import payments were unrestricted. This index ranges from a possible low of zero, indicating a tightly closed financial system to a possible high of fourteen indicating a fully open financial system.
CURRENT ACCOUNT BALANCE: Current Account as a percentage of GDP. Data from the International Monetary Fund's International Financial Statistics.
EMS: Country-years in which national currency was in the exchange rate mechanism are coded 1. All other country-years coded 0.
GOVERNMENT SPENDING: Government spending as a percentage of GDP. Data from the International Monetary Fund's International Financial Statistics.
GOVERNMENT BOND RATE: Interest Rate on government debt for maturities of one year or less. Data from the International Monetary Fund's International Financial Statistics.
INFLATION: GDP deflator. Data from the International Monetary Fund's International Financial Statistics.
LABOR: A multiplicative score that combines Cameron's 1984 measure of union centralization with a measure of union density. Higher scores indicate stronger labor. Data are from Cameron 1984; Visser 1989, 1990, 1991; and Huber, Ragin, and Stephens, 1997.
MONEY MARKET INTEREST RATE: Data from the International Monetary Fund's International Financial Statistics.
OPENNESS: Absolute Value of imports plus exports as a percentage of GDP. Data from the International Monetary Fund's International Financial Statistics.
PARTY: Ideological complexion of government that accounts for relative strength of parties in government with reference to a five-point left-right scale in which the proportional shares of the left, center, and right are transformed into scores (1 to 5) representing the degree of dominance of either party both in parliament and government. Taken from Woldendorp, Keman, and Budge (1993). Right-wing dominance is coded as 1, and left-wing dominance is coded as 5.

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