

**The Domestic Politics of Financial Internationalization in the Developing World\***

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**Forthcoming at the *Review of International Political Economy***

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\* Thanks to Andy Baker, David Brown, Jerry Cohen, Gustavo Flores-Macías, Jeff Frieden, Jonathan Kirshner, David Leblang, Sonal Pandya, Grigore Pop-Eleches, David Waldner, participants at the 2009 IPES meeting in College Station, TX and the 2010 Annual Meeting of the American Political Science Association in Washington, DC, and the editors of *RIPE* for valuable comments. All errors are my own.

## *Abstract*

This paper examines the domestic politics of financial internationalization. Financial internationalization has two components—the liberalization of *cross-border capital flows* and the liberalization of *foreign ownership restrictions*—yet most research to date has concentrated exclusively the former. Building on existing theoretical work, this paper argues that in the developing world, domestic finance favors the joint abolition of restrictions on the inflow of foreign capital alongside continued restrictions of the ability of foreigners to own and operate domestic financial institutions. I test the argument on a unique dataset of foreign entry restrictions in developing economies, and by examining interest group pressures for financial internationalization in Indonesia and Mexico. The findings complement and extend recent work on financial internationalization in the developing world, and suggest further areas for research in the role of domestic interest group preferences for global economic integration.

# The Domestic Politics of Financial Internationalization in the Developing World

## INTRODUCTION

This article studies the domestic financial interests that shape financial internationalization in the developing world. Financial internationalization has two components—the liberalization of *cross-border capital flows* and the liberalization of *foreign ownership restrictions*—yet most research to date has concentrated exclusively the former. Doing so obscures important differences in interest group preferences over the movement of international capital versus the entry of foreign banks. Building on existing theoretical treatments by Frieden (1991), Haggard and Maxfield (1996), and others, I argue that in the developing world, domestic finance favors the abolition of restrictions on the inflow of foreign capital, but also the restriction of the ability of foreigners to own and operate domestic financial institutions. Consistent with this argument, I show that cross-country patterns in financial liberalization follow two simple predictions: powerful financial sectors are associated with both limitations on foreign entry into the banking sector and capital account openness.

This argument complements and refines existing work that has shown that domestic financial interests play an important role in international financial liberalization. Financial sectors in developing and emerging countries, which are relatively capital poor by global standards and where domestic banks cannot hope to compete with established foreign banks, should be swamped by foreign capital under complete financial liberalization.<sup>1</sup> Indeed, foreign banks in developing economies offer lower interest rates, mobilize more funds from depositors, and earn greater profits than domestic banks (see e.g. Claessens et al., 2001; Claessens and Lee,

2003; Demirgüç-Kunt et al., 2004; Hübler et al., 2008; Micco et al., 2007). This raises questions about why domestic lenders in developing countries lobby for capital account liberalization.

The simple insight that explains why domestic finance in the developing world favors open capital accounts is that its comparative advantage is in intermediating between foreign creditors and domestic borrowers. As intermediaries, financial institutions prefer to access relatively inexpensive foreign capital, which capital account openness provides. But to protect their market position as lenders, they wish to avoid subjecting themselves to competition from the same foreign financial institutions from which they borrow. Lenders in developing countries therefore push for capital account openness, which gives them access to foreign capital, with ownership restrictions, which ensures that they can protect their role as intermediaries between foreign banks and domestic borrowers.

I support this argument using both qualitative and quantitative evidence, beginning with case studies of Indonesia and Mexico, two countries long noted for both the political influence of their financial sectors and for their openness to cross-border movement in capital. In contrast to existing work, this argument turns the analytical lens away from the capital account, and towards the regulation of foreign entry. In the twentieth century, high levels of openness to capital flows were accompanied by substantial restrictions on foreign financial ownership, and that these policies conformed to the preferences of the banking sector. These policies were only abolished following the financial crises that hit Mexico in 1994-95 and Indonesia in 1997-98, which both weakened the market power of the financial sector and undermined its political influence in each country. I then test the argument on cross-national data, showing that banking sector size is positively associated with both limitations on foreign entry into the banking sector and capital account openness.

By distinguishing between firm ownership and capital flows, this article provides a more nuanced treatment of the domestic politics of financial internationalization than can be obtained from studying capital account policy alone. Both qualitative (e.g. Haggard and Maxfield, 1996) and quantitative (e.g. Brooks, 2004; Chwioroth, 2007) studies have uncovered domestic political pressures for financial internationalization, but their empirical focus has been almost entirely on capital account policy. Yet ownership restrictions are essential to any theory linking domestic finance to capital account liberalization in the developing world. Likewise, the most sophisticated political economy studies of financial policy in developing economies focus on liberalization of domestic finance (e.g. Haggard et al., 1993; Loriaux et al., 1997; Woo, 1991). By focusing on domestic financial institutions as intermediaries of foreign funds, I provide a more complete characterization of the policy preferences of domestic finance in a global economy, and highlight key differences in its preferences for capital openness versus the lifting of foreign ownership restrictions. Finally, while the beliefs of state elites (central bankers, finance ministers, and other technocrats, as well as politicians) are frequently invoked as driving the liberalization of finance (Chwioroth, 2007; Loriaux et al., 1997; McNamara, 1998) it is useful to examine policy areas such as the liberalization of foreign ownership restrictions in which, I show, reformist efforts from state elites frequently stall. This article identifies obstacles to cross-border financial liberalization as originating in the specific interests of the private financial sector, which can run counter to those of state elites.

While this article focuses exclusively on financial internationalization, distinguishing between asset movement and firm ownership as two separate components of economic globalization has implications for other literatures on the domestic politics of economic integration as well. Most notably, this argument predicts intrasectoral cleavages in domestic

preferences over trade liberalization, with producers in import-competing sectors resisting trade openness but distributors in import-competing sectors preferring trade openness in combination with a restrictive distribution licensing regime. These and other implications of this argument are discussed in the conclusion.

## **TRADE IN CAPITAL**

Standard trade theory predicts that pressure for protectionism comes from the sectors suffering from free trade (Alt and Gilligan, 1994). In the developing world, foreign banks outcompete domestic banks, much as standard approaches predict. This raises the question of why financial institutions in developing countries would pressure their governments for capital account openness.

### **Financial Intermediation and Ownership Restrictions**

Among financial sector actors we can identify three groups: corporate borrowers, direct lenders and brokers, and institutional investors. Corporate borrowers seek access to capital to fund their enterprises. Institutional investors remain a relatively small segment of the financial market in most developing countries. Unless otherwise noted, in the remainder of the article I focus on the preferences of lenders and brokers.

Lenders and brokers have a singular commonality: they operate as businesses by borrowing from some agents and lending to others. “Borrowing” in this sense has many related attributes: it may mean literal borrowing, or it may mean broader liabilities such as accepting individual deposits. “Lending” can be to individuals, firms, and financial institutions, both through loans and through equity investments. Whatever the structure of the transactions between external agents and the financial institution, direct lenders are both creditors and

debtors, and they make profits through this enterprise. Theories of financial intermediation show that the transactions costs associated with direct agreements between buyers and sellers make financial intermediation necessary (Benston and Smith, 1976; Diamond, 1984). In most models, these transactions costs are natural: a time-consuming matching process, discontinuities between credit and liability streams, costly monitoring of borrowers by creditors, and inefficient decentralized markets for liquid assets. But intermediaries may purposively create transactions costs through regulation or other means. In the financial sector, direct lenders may lobby for regulations that ensure that they are the sole borrowers and creditors for financial transactions. It is common, especially in low income countries, for a small group of lenders to dominate a country's financial sector, to their great profit (Beck and Demirgüç-Kunt, 2009).

While most financial institutions in the developing world lend almost exclusively to the domestic market, as borrowers they (in principle) can access funds from anywhere in the world. When policies restrict international capital inflows, the supply of credit depends solely on its availability within that country. Limits on capital inflows in developing countries raise the cost of capital, making loans more expensive for borrowers. Capital account liberalization therefore lowers the cost of borrowing for developing economies. Critically, capital account liberalization lowers the cost of borrowing for all actors, *including domestic financial intermediaries*. But if foreign capital can flow directly to firms or equity markets, foreign lenders will outcompete domestic lenders, for the reasons identified above.

Developing country lenders accordingly seek policies that allow them to benefit from the lower costs of capital that capital openness provides, but shield them from competition. These policies will welcome capital inflows but restrict how they flow into an economy. It is helpful to contrast this argument with a closely related recent study by Rajan and Zingales (2003), who

argue that both industrial firms and lenders that enjoy relation-based contracting may oppose financial liberalization. Importantly, Rajan and Zingales also argue that when international financial integration is high, then capital inflows will push the domestic financial sector to lobby for a better regulatory environment: if there are no restrictions on foreign bank entry, capital account liberalization will make borrowers more likely to borrow from foreign lenders, forcing domestic lenders to seek business from a riskier class of domestic borrowers. Note that they make no prediction about lenders' preferences over restrictions on foreign bank entry under conditions of high capital mobility, for they assume that capital mobility implies no restrictions on foreign bank entry. By contrast, I show that it is precisely when the financial sector is able to secure access to foreign capital that it should restrict foreign bank entry through foreign ownership restrictions. This argument is therefore a different—though complementary—domestic interest group approach to financial regulation. Moreover, this article addresses on cross-national variation in *policies* (foreign ownership restrictions and capital account policy) rather than subsequent economic *outcomes* (international financial integration and domestic financial development) that are the object of Rajan and Zingales' inquiry.

Disaggregating “financial internationalization” into two distinct components—liberalization of capital movements and liberalization of financial ownership—therefore completes the logic that links powerful domestic financial sectors to capital account liberalization in the developing world. Lenders lobby for capital account openness as part of a broader strategy that also favors restrictions on the ability of foreign financial firms to enter the domestic financial market.



## **Ownership Restrictions: Alternative Views**

This argument predicts that developing countries with larger and more politically powerful domestic banking sectors will enact more restrictions on foreign ownership of financial assets but will welcome capital inflows. Why else might a country restrict foreign entry into its financial sector? One alternative explanation for ownership restrictions is a state-centric logic of infant industry protectionism. Because financial sectors in the developing world are too small to compete with foreign financial institutions, they require protection in order to compete in the global financial marketplace. If the infant industry argument explains cross-national patterns of financial liberalization, then the smallest and weakest sectors should receive protection, not the strongest ones as hypothesized above. My empirical analysis therefore tests the two hypotheses against one another in examining the link between banking sector size and foreign ownership restrictions.

A second alternative explanation is political. There are two ways in which political institutions may affect financial liberalization. Haggard et al. (1993) find that many authoritarian regimes resist financial liberalization because of political utility of a repressed financial sector. Absent competitive pressures from foreign banks, authoritarian regimes can use their countries' controlled financial sectors to allocate credit to themselves or to connected firms. The impetus for retaining ownership restrictions here is neither sectoral pressures nor national interests, but rather the political exigencies of authoritarian rulers. Authoritarian regimes, moreover, likely respond to the interests of a narrower fraction of their citizens than democratic regimes (Bueno de Mesquita et al., 2003), and hence will be more beholden to special interest pressures than a regime whose constituents include laborers and farmers along with industrial and manufacturing enterprises eager to access cheap foreign credit. Such arguments imply that more democratic

regimes should be more likely to liberalize their financial sectors. A different view, though, holds that such use of the financial sector is valuable to democratic regimes in the same way as it is to authoritarian regimes, as cases such as the Philippines suggest (Hutchcroft, 1998).

The second way that political institutions may affect financial liberalization in this context is by giving political voice to borrowers. Borrowers *who are not in the financial sector* may strictly prefer the complete liberalization of their economy to foreign bank entry in order to obtain cheaper credit. If so, because borrowers comprise a large and diffuse interest group, their interests are more likely to affect policy under democratic than authoritarian rule. Likewise, Frieden (1991: 437) notes that industrial capital, unlike financial capital, will benefit from the liberalization of foreign bank entry because it lowers the cost of capital to them. However, Rajan and Zingales argue that large industrial borrowers may not favor financial liberalization if it runs the risk of empowering their domestic competitors (Rajan and Zingales, 2003). If they are correct, then democracy may not empower interest groups with competing preferences to domestic lenders. This proposition, along with the many experiences of financially repressed democracies, suggests that the link between political regimes and financial liberalization is at best tentative.

A third explanation for restrictions on foreign entry focuses on the role of the state, or of state elites, in crafting financial policy. Pérez (1997), for example, argues that financial reform in the Spain in the 1970s began as part of a distinct strategy by a relatively small number of economic elites to shift economic policymaking in a liberal direction. Recent contributions in constructivist IPE make an analogous point by illustrating how U.S.-trained technocrats helped to craft liberal capital account policies in Indonesia (Chwieroth, 2010). The argument in this article does not require that states or state elites play no role in shaping financial reform, and

indeed, the case studies below illustrate how technocrats in finance ministries and central banks can push for reform as a measure for revolving financial crises. More generally, independent central banks (and other financial authorities) have long been understood to be political creations that arise out of “the financial interests of those in a position to delegate authority to central banks: government politicians and private banks. Central banks both reflect and reinforce financial interests and structures” (Maxfield, 1994: 557). This observation reinforces the conclusion that it is often impossible to separate the interests of private banks from the interests of state elites. However, the case studies below will nevertheless demonstrate that where state elites are pressing for broad financial liberalization, sectoral pressures play a decisive role in shaping the contours of financial reform as it is implemented.

Finally, recent research has highlighted international influences on capital account liberalization. This may be through international lending institutions such as the IMF (see e.g. Mukherjee and Singer, 2010) or through processes of diffusion or contagion (see e.g. Simmons and Elkins, 2004). Similar processes likely affect the liberalization of foreign ownership restrictions, although neither logic can explain why capital account liberalization and ownership *restrictions* would covary with domestic financial sector power, as the following analysis will demonstrate.

### **FINANCIAL INTERNATIONALIZATION: CASE STUDY PERSPECTIVES**

The cases of Indonesia and Mexico illustrate how foreign entry restrictions coevolve with capital account liberalization in countries with powerful domestic financial sectors. In contrast to existing work which has captured the domestic politics of capital account liberalization (e.g. Haggard and Maxfield, 1996), the case studies here concentrate on how restrictions on foreign

financial entry facilitated these policies. The logic of case selection here is akin to “on-the-line” model testing advocated by Lieberman (2005), investigating cases that fit the argument well (large and politically powerful financial sectors along with foreign ownership restrictions and very open capital accounts) to ensure that my argument explains why. Rather than investigate one case very closely, moreover, I choose two case studies in order to demonstrate that my argument is broadly applicable beyond particular cases. Indonesia under the New Order and Mexico under the PRI differ in a number of important ways that could plausibly affect financial policymaking: exposure to liberalizing pressure from the United States (higher in Mexico than Indonesia), authoritarian regime type, ethnic political structure, export structure, initial level of development. What Indonesia and Mexico shared for most of their recent history is a political influential domestic banking sector.

Indonesia and Mexico are also useful because a large body of research has chronicled their experiences with capital account liberalization. As such, the case studies do not introduce new data on financial politics, but rather exploit existing studies to put their arguments in a new light. Moreover, the Mexican case clearly deviates from expectations in the early 1980s, when the regime retreated from capital account openness as a response to the Latin American debt crises. The financial sector must have lost political favor during this period, and would have opposed these policies, which is indeed the case. Finally, if the argument above is correct, then when the market power and political influence of the financial sector declines, this should increase the likelihood that governments will lift foreign entry restrictions. Mexico’s financial crisis in 1994-1995 and Indonesia’s financial crisis of 1997-98 illustrate how the liberalization of foreign entry restrictions follows such shocks to the political and economic influence of the financial sector. In my subsequent cross-national empirical tests, I control for crises in order to

distinguish my claim about interest group preferences from competing claims about whether crises themselves cause financial liberalization (Haggard and Maxfield, 1996).

### **Indonesia**

Indonesia has a long history of capital account openness, beginning in the mid-1960s.<sup>2</sup> Under Sukarno, both Indonesia's financial sector and the broader economy at large faced extensive controls and regulations. Upon replacing Sukarno in 1966, one of Soeharto's first tasks was to appoint a team of neoliberal economists to oversee Indonesia's integration into the world economy. Early in their tenure, these economic advisors prompted Indonesia to liberalize its capital account to a level nearly unprecedented in the developing world at the time (Chwieroth, 2010).

The initial move was feasible in no small part because of simultaneous pressures from the country's ethnic Chinese financiers, whose comparatively wealthy status within the country made them an attractive ally for Soeharto (Pepinsky, 2009; Winters, 1996). Their mobile financial assets gave them important bargaining leverage over the regime, and this leverage was especially valuable because of their vulnerable political status as non-"indigenous" Indonesians. Haggard and Maxfield (1996), among others, interpret capital openness as a tool for assuaging the worries of ethnic Chinese financiers, who might have otherwise refused to invest without a way to cut their losses through exit. At the same time, capital account openness provided these same ethnic Chinese financiers with access to abundant and cheap foreign capital. The New Order regime's own state-run banks, whose role in development financing remained large throughout Soeharto's rule, also profited from capital account openness, allowing them to fund a

vast array of (often politically driven) development projects (Pepinsky, 2009; Sharma, 2001; Soesastro, 1989).

At the same time that the New Order regime opened Indonesia to cross-border capital flows, though, its leaders constructed one of the developing world's most impressive edifices of patronage and clientelism (MacIntyre, 1993). Tight linkages between domestic finance and the regime were instrumental for this task. Public investment banks funneled cash to the regime's cronies in the military and among the ethnic Chinese business community, rewarding loyal supporters with easy access to credit. Other private banks, which developed in the 1980s and early 1990s as central organs in ethnic Chinese financiers' business empires, allowed business moguls to amass substantial funds with which to invest in local business ventures as shadow partners of indigenous entrepreneurs and the military (MacIntyre, 1993; Pepinsky, 2009; Winters, 1996). Even indigenous Indonesian business empires grew to include powerful banking subsidiaries. The regime's ability to deploy credit facilities to its allies allowed it to use finance as a tool for regime maintenance. Indonesia's financial markets accordingly supported not only the regime's developmentalist projects and the private interests of ethnic Chinese financiers, but also the political foundations of the New Order state. Capital account openness gave it the access to abundant foreign capital necessary to accomplish these goals.

The regime was careful, though, to retain a tight hold over the domestic financial sector. A flood of foreign financial lenders might have threatened the politically valuable banking subsidiaries of both ethnic Chinese cronies and the state—foreign lenders could not provide political protection, but could have offered more favorable terms than domestic lenders ever could have. To forestall this, Soeharto's regime retained tight barriers over entry into the financial sector (Pepinsky, 2009; Soesastro, 1989). These included a number of preferential

credit provisions for domestic bankers, ownership and presence limitations on foreign banking subsidiaries, and high barriers on foreign equity ownership on the Jakarta Stock Exchange which persisted into the 1980s. Each of these fulfilled key political interests among the country's lenders, who were free to intermediate abundant foreign capital at their own discretion.

At the close of the 1980s, facing a serious balance-of-payments crisis, the New Order regime directed a round of deregulation (known as Pakto 88, or the "October 1988 Package") that eliminated a number of the ownership restrictions that it had previously kept in place (Soesastro, 1989). Indonesia's technocrats and other state elites played a critical role in identifying financial liberalization as a tool for responding to the late 1980s crisis. These reforms gave foreign financial institutions new access to the Indonesian market, yet the specifics of this second round of financial liberalization are instructive (Sharma, 2001; Soesastro, 1989; Winters, 1996). Despite rhetorical commitments to open stock markets to foreign investors, the regime retained substantial restrictions on foreign equity ownership. Furthermore, as late as 1997 *no* new foreign banks were permitted to enter the country—only banks whose presence had predated deregulation were permitted to open new branches (Sharma, 2001).

In fact, the main target of Pakto 88 was the Indonesian financial sector. The deregulation package streamlined Indonesian banks' ability to raise funds overseas by abolishing Bank Indonesia's role in approving and overseeing foreign loans. It also removed ceilings on the amount of funds they could raise overseas. Sharma (2001: 86) notes that as a result of the strong entry controls, by 1996 there were just ten foreign banks in Indonesia, as compared to thirty-four joint ventures and 160 fully private domestic Indonesian banks. All of these measures "liberalized" Indonesia's financial sector, but in a way that protected Indonesian banks' roles as

intermediaries between foreign capital and domestic borrowers. Liberalization, in other words, took place precisely as predicted by my theory, and for precisely the same reasons.

Indonesian financial institutions' practice of intermediating between foreign capital and the domestic market accordingly fulfilled the demands of both Indonesian lenders and the New Order regime. In fact, the lucrative nature of this transaction eventually would lead to the excesses that spawned Indonesia's financial crisis in 1997, as domestic borrowers increasingly neglected to hedge their foreign currency debts against exchange rate movements. By the eve of the Asian Financial Crisis, capital inflows were massive, yet still dwarfed by domestic bank lending. By 1996, claims on private sector held by deposit money banks were 55% of GDP, while new capital inflows totaled just 4.8% of GDP (Jomo and Hamilton-Hart, 2001).

Indonesia removed restrictions on foreign bank entry only following the Asian Financial Crisis (Gopalan and Rajan, 2009). In terms of the causal story that I outline here, the crisis had two important consequences. First, it crushed the domestic financial sector, leaving the largest and most politically connected firms insolvent and undermining the New Order's ability to mobilize funds for political gain (Pepinsky, 2009; Sharma, 2001). Second, the crisis upended the New Order political economy, forcing Soeharto's resignation and driving the heads of many of the country's largest firms overseas. Absent either the market power or the political influence necessary to direct policymaking, lenders were unable to withstand the post-crisis restructuring of Indonesia's financial regulations (Sharma, 2001). The IMF and Indonesian elites in institutions such as the Indonesian Bank Restructuring Agency were decisive in reforming the country's financial sector (Sato, 2003), including lifting foreign ownership restrictions. But timing is critical: reforms only began to bear fruit after the resignation of Soeharto in late May 1998, which marks the end of the bankers' privileged access to political power (many bankers



had literally fled the country; see Pepinsky, 2009) and the beginning of a far messier period of competing interest group politics. In contrast to the mid-1980s crises, which affected neither the market power nor the political influence of Indonesia's domestic banking sector, the Asian Financial Crisis was decisive in overcoming domestic opposition to foreign bank ownership.

### **Mexico**

Mexico is unique among Latin American countries in its long-standing adherence to capital account openness.<sup>3</sup> Capital account openness in Mexico began in the 1920s amidst a situation rather similar to that facing Indonesia in 1965. In a move to placate domestic and international financiers and keep capital from fleeing the country, and facing stifling foreign debt, the regime adopted an open capital account policy in order to project credibility for sound economic management (Maxfield, 1997: 97-101). This policy was ultimately successful. Mexico's capital account would remain largely open for nearly six decades, until Mexico 1982 debt crisis.

As it developed throughout the middle half of the twentieth century, the financial sector progressively gained influence over policymaking, coming to form what Maxfield (1990) terms the "bankers' alliance" (see also White, 1992). This explains why liberal capital account policies were not matched by liberal foreign ownership and presence laws, which were progressively made more restrictive towards foreign entry throughout this period. Governments forbade foreign banks from entering the Mexican market without meeting increasingly stringent requirements from Banco de México. Those that had already established a commercial presence faced heavy restrictions on their activities, and were "essentially prohibited from engaging in any form of financial intermediation" (Maxfield, 1997: 101). This was a direct product of Mexican

lenders' pressure on the regime for favorable ownership policies amidst an open capital account: "the [bankers'] alliance consistently pressured policy makers to preserve both the unregulated development of domestic financial markets and unrestricted international capital mobility" (Maxfield, 1990: 71). A strong domestic financial sector was also politically useful for the Mexican government. By mobilizing reserve funds held at Banco de México, governments were able to finance industrialization, which produced economic growth and benefited constituents from organized labor to industrial capital (Maxfield, 1990; Santín Quiroz, 2001: 80-9).

So far, the Mexican case confirms the relationship between a large and politically influential banking sector and both capital account openness and restrictions on foreign financial ownership. But the PRI, unlike Indonesia's New Order, was a populist regime that at least until the mid-1980s openly embraced organized labor and used it as one of its bases of political support. When the Latin American debt crisis hit Mexico in late 1981, the regime turned against the Mexican financial sector in order to protect the fortunes of labor and industrial capital. President José López Portillo's famous September 1, 1982 speech that announced the nationalization of Mexican banks and the imposition of tight exchange controls also likened domestic bankers to "rats" carrying a "financial plague," and blamed them for the country's industrial hardship and growing unemployment (López Portillo, 1982). The decision to close Mexico's capital account to inflows and outflows, and to nationalize the entire domestic financial sector, was widely popular among industrialists and laborers, but heavily resisted by domestic lenders, as the theory here predicts (Maxfield, 1990: 142-62, 1992; Santín Quiroz, 2001; White, 1992). These decisions show that financial sector size does not correspond exactly to political influence in the developing world, but it is reassuring that interest group pressures continued to operate as expected by the theory.

With the end of López Portillo's term in office and the onset of the term of his successor Miguel de la Madrid Hurtado, financial policymaking veered back towards Mexico's traditional accommodation of the "bankers' alliance." Undoubtedly some of the impetus for financial re-opening came from new technocratic elites associated with the new de la Madrid administration, who viewed financial liberalization alongside privatization and other structural reforms as necessary measures for reintegrating Mexico into global markets and for fostering private sector-led development (Cook et al., 1994; Santín Quiroz, 2001; Teichman, 1995). But even as banks began to be reprivatized and the capital account reopened, pressure from lenders ensured that liberalization would not extend to foreign ownership of domestic banks; writes Santín Quiroz (2001: 155), "the banks' privatization further activated the alliance between the economic elite and the financial coalition." Under the 1990 banking law, instrumental in the ongoing privatization process, foreign banks were expressly prohibited from intermediating in the country's domestic financial sector (Haber, 2005; Maxfield, 1997: 108-10). In addition to foreign entry restrictions, the privatization exercise restricted the amount of newly privatized Mexican financial institutions that foreigners could own (Adams, 1997). These policies reflect the strong pressure that Mexican lenders brought to bear (see Santín Quiroz, 2001: 159-63).

The policy shifts that took place in the second half of de la Madrid's term and later under Salinas emphasized privatization (Teichman, 1995; Valdés Ugalde, 1994: 227-38), and returned political power to the Mexican banking sector that had been so assaulted in 1982. Under Salinas the regime embraced the financial sector as a key coalition partner. This period saw bank reprivatization completed, but the financial industry remained highly concentrated and subject to a wealth of anticompetitive regulations that "virtually prevented foreign competition" (López de Silanes and Zamarripa, 1995: 114). In fact, the foreign investment law of December 1993—

widely seen as emblematic of Salinas' move towards financial liberalization—mandated ownership maxima of 30% foreign equity and insurance market participants and 49% for other financial institutions (Adams, 1997: 183-4).

In the early 1990s negotiations with the United States over the North American Free Trade Agreement gave new external impetus to Mexican financial sector liberalization. While the IMF had been supportive of privatization across various sectors of the Mexican throughout the 1980s, privatization (at least in the case of the Mexican banking sector) did not mean the liberalization of restrictions on foreign ownership. As part of the NAFTA negotiations, then, the United States pressured Salinas to allow U.S. banks to enter the Mexican market. Nevertheless, pressure from the newly re-ascendant Mexican bankers (Maxfield, 1997: 116-9) meant that amidst almost total trade and capital account opening, foreign financial institutions *still* faced substantial restrictions in entry, market share, and equity ownership. Under the final NAFTA agreement, foreign banks could still not open new branches in Mexico, were restricted to 30% capital ownership in commercial banks, and their commercial activities were restricted to no more than fifteen percent of the market as late as 1999 (NAFTA, 1994). Such measures reflected the political influence of Mexico's financial sector and protected Mexican banks from foreign competition while welcoming capital inflows: Maxfield (1997: 118) argues that “we see evidence that the interests of those regulated, Mexico's commercial bankers, *directly shaped* the liberalization process” (emphasis added). In sum, even when ownership restrictions began to be liberalized in the early 1990s—despite external pressure from the United States and the long support of the IMF for privatization and neoliberal reform—ownership restrictions remained significant, and followed the interests of domestic lenders.

Much as in Indonesia following the Asian Financial Crisis, Mexico's foreign ownership restrictions were fully lifted only after the 1994 Tequila crisis (Haber, 2005). In 1982, a financial crisis that had struck at the market power and political influence of the financial sector produced capital controls and bank nationalization; under an ideologically different administration, the 1995 crisis produced a different policy response. Mexican policymakers attempted initially to bail out the fragile banking sector. Not only did this fail to resolve the banks' problems (Mackey, 1999), the public backlash at its exorbitant cost was so dramatic as to foster some of the social movements that ultimately hastened the demise of the PRI (see e.g. Williams, 2001). Policymakers accordingly reversed course. With domestic banks' political power declining rapidly, their market power nearly destroyed, and technocratic elites no longer willing to accede to the protectionist demands of domestic bankers (Horowitz, 2005: 127-9), regulators finally allowed for the full liberalization of all restrictions on foreign entry in the domestic banking market. This policy was distasteful to domestic bankers, with the Mexican Bankers Association lobbying unsuccessfully for a gradual or delayed removal of ownership restrictions (Riner, 1998), although even some Mexican bank managers acknowledged that foreign ownership would increase access to foreign funds for the most undercapitalized banks (Larson, 1998). By 2002, foreign banks "controlled more than 80 percent of Mexican banking assets" (Schulz, 2006: 3). Despite foreign pressure dating from at least the mid-1980s, and an increasingly neoliberal technocratic elite, Mexican authorities only eliminated foreign ownership restrictions and cooperated with their U.S. and international counterparts (Hernández-Murillo, 2007) after the 1995 crisis destroyed the political and economic power of Mexico's domestic banking sector.

## Summary of Case Study Findings

The preceding discussion of Indonesia and Mexico reveals the correspondence between the preferences of domestic lenders for protection from foreign entry and capital account openness in two very different developing country contexts—a party-based, highly durable competitive authoritarian PRI regime in Mexico, and Soeharto’s military-backed New Order regime in Indonesia. What unites these two cases is the central political role played by large and influential domestic banking sectors, the “cronies” in Indonesia and the “bankers’ alliance” in Mexico.

The case studies, however, also paint a complex picture of financial policymaking in which state actors, technocratic elites, financial crises, and foreign pressures all shape the course of financial internationalization. As such, the case studies do not advance a mono-causal explanation for financial internationalization, but rather highlight how bankers’ interests shape policy choices *within* the broader political context (especially after the 1980s in both countries) of economic reform and financial liberalization. Elites have played an instrumental role in financial internationalization over the past four decades, and nothing in these accounts denies that. Yet central bankers in particular, who are among the most influential financial elites in these economies, face a dilemma in that they are entrusted with protecting national financial stability (which should make them receptive to the competition that foreign banks can provide), but they are most influential precisely when the private domestic financial sector is *itself* large and influential.<sup>4</sup> These case studies indicate that within the broader context of liberalization in which elites’ interests have been shown to be so influential, the interests of the domestic financial sector are instrumental for explaining the particular coupling of foreign ownership restrictions and capital account openness.

## CROSS NATIONAL EVIDENCE

The case studies of Indonesia and Mexico illustrate the causal pathways between domestic financial interests and policy outcomes. But without considering a broader sample of cases, three problems may arise. The first is selection bias: are countries where the financial sector is *less* powerful *less* likely to place restrictions on foreign bank entry, as my theory predicts? The second is omitted variable bias: can we find evidence consistent with my claims when accounting for other factors that might plausibly shape financial policy? The third is indeterminacy: the case studies of Indonesia show that state elites, financial crises, and foreign pressure can all push towards the lifting of foreign ownership restrictions at the same time that the domestic banking sector loses political power, making it difficult to distinguish the explanatory weight of these factors. In this section I show that in a wide sample of countries and controlling for other potential determinants of foreign entry regulations, where the banking sector is politically powerful, we observe capital account openness along with restrictions on foreign bank entry.

The major difficulty in capturing interest group pressure from the financial sector is measurement, for interest group pressures are seldom directly recorded. This task is more difficult in the developing world and in non-democratic settings. In proxying for the political importance or influence of the financial sector, then, I follow existing work by measuring sectoral size and assuming a direct link between size and political influence.<sup>5</sup> I use a standard set of financial indicators compiled by Beck and Demirgüç-Kunt (Beck and Demirgüç-Kunt, 2009; Beck et al., 2000). Consistent with earlier work, I measure the size of the financial sector as the sum of deposit money bank assets, central bank assets, and the assets of other financial institutions, as a fraction of GDP (*FINANCIAL ASSETS / GDP*).<sup>6</sup> As a control, I also include a

variable measuring banking sector industrial concentration, *CONCENTRATION*, which measures the ratio of the assets of the country's three largest banks to total banking assets. An obvious weakness of this proxy measure is that as the Mexican case study shows, it cannot capture sudden changes in the political status of the banking sector that may accompany financial crises or changes in political regime. Nevertheless, it easily captures the economic power of the financial sector—an important property for any comparative study of the political power of economic actors—and is the best proxy for the relative political influence of the financial sector which is available across countries.

### **Measuring Financial Internationalization**

Because my theory emphasizes that capital account liberalization is distinct from the liberalization of foreign entry restrictions, I measure these dependent variables using two indicators that focus tightly on these different policy choices.

To measure legal restrictions on foreign bank entry, I employ a cross-sectional measure of restrictions on foreign banking activities compiled by Barth, Caprio, & Levine (2008). The data include four variables that capture legal restrictions on foreign banks' ability to enter a country's financial market through (1) acquisition of domestic banks or establishing (2) joint ventures, (3) subsidiaries, or (4) branches. The data cover the years 2005-2006. From these I create two dependent variables: *BANK LIBERALIZATION*, an ordinal variable that ranges from 0 (indicating restrictions on all four types of foreign bank entry) to 4 (indicating no restrictions on any type of foreign bank entry); and *BANK LIBERALIZATION (BINARY)*, a dummy variable that is 0 when *BANK LIBERALIZATION* is less than 4 and 1 otherwise. This indicator separates



countries that have at least one kind of restriction on foreign bank entry from those that allow foreign banks complete legal freedom to enter the domestic financial market.

To measure capital account openness I follow Karcher and Steinberg's (2009) modification of the index of capital account openness developed by Chinn and Ito (2008), a variable that they call *CKAOPEN*. I also extract the binary measure of capital account openness (*K3*) from Chinn and Ito's raw data. While *CKAOPEN* is an extensive measure of capital account openness, *K3* is purposefully very narrow, capturing capital account policy and nothing else. I measure both as averages from 2005-2007 (the most recent year available) to ensure that they are contemporaneous with *BANK LIBERALIZATION*.

### **Control Variables**

The paucity of research on ownership restrictions means that existing research provides few clues as to potential alternative explanations for their presence or absence. Given the incomplete state of knowledge about the determinants of ownership liberalization, I borrow from the literature on capital account liberalization.

The first two variables are economic: a country's level of development as measured by the log of per capital real gross domestic product (*GDP PER CAPITA*), and yearly economic growth (*GDP GROWTH*). All countries under consideration are developing countries or emerging market economies, so all are relatively capital-poor, making foreign bank entry likely absent restrictions. But wealthier countries may find it easier to resist pressures for financial protectionism due to more diversified economic bases. Alternatively, they may have less of a need to protect their financial sectors from international competition. A similar logic holds for economic growth. Findings that financial crises spur financial opening, however, suggest that

countries experiencing economic booms will face *less* pressure to liberalize their financial sectors. Given these opposing hypotheses, the expected impact of economic growth on financial liberalization is ambiguous. Drawing on the literature on crises and capital account liberalization (Haggard and Maxfield, 1996), I also include a variable that captures speculative attacks (*CRISIS*) to test the hypothesis that currency crises spur liberalization. This is particularly important as the cases of Indonesia and Mexico showed the removal of ownership restrictions followed crises. By controlling for crises, therefore, I am able to distinguish my own argument from the broader claim that crises themselves, for whatever reason, best explain why some countries remove foreign ownership restrictions.

I also control for regime type using the Polity IV dataset (*POLITY2*) (Marshall and Jaggers, 2007). As argued above, authoritarian regimes profit from controlled financial sectors. The case studies of Indonesia and Mexico, in fact, were both authoritarian regimes during the periods when they restricted foreign bank entry, and transitioned to democracy at the same time that they abolished entry restrictions. For my purposes, though, the question is whether the political utility of a controlled financial sector is unique to dictators, and whether regime type rather than financial sector preferences in particular explains restrictions on foreign bank entry. By controlling for regime type, I therefore test, first, whether authoritarian regimes are actually more likely to restrict the entry of foreign banks, and second, whether or not financial sector interests matter when accounting for the possible influence of regime type.

The next set of control variables includes several standard economic correlates of financial liberalization: the log of international reserves as a fraction of imports (*RESERVES / IMPORTS*), a fixed exchange rate (*FIXED XR*), the volatility in the exchange rate (*XR VOLATILITY*), broad money as a fraction of GDP (logged) (*M2 / GDP*), debt service as a

fraction of GNI (logged), (*DEBT SERVICE / GNI*), and inflation (logged) (*INFLATION*). Each of these is commonly held to influence the costs of financial openness. Two measures of a country's international trade and investment position (*TRADE / GDP* and *CA BALANCE*) capture the country's baseline openness to the global economy.

Finally, to capture international pressure for financial liberalization, I control for IMF participation using a variable (*IMF*) that captures whether a country is under an IMF standby arrangement for at least five months in any given year (Dreher, 2006). It is likely that over time, a process of diffusion or contagion affects cross-national patterns in financial liberalization (as Simmons and Elkins, 2004 argue). However, because the foreign entry data employed here are purely cross-sectional, such temporal relationships cannot be studied using the same methodological tools, even though they offer an exciting avenue for future research.

## **Methods**

To test the theory, I model financial internationalization as a system of two equations, one whose dependent variable is the removal of restrictions on foreign entry and the other whose dependent variable is capital account openness. Ownership restrictions and capital account openness are driven by similar factors, so I assume that the two equations share the same independent variables but that their errors are correlated across equations, as in a seemingly unrelated regression. To estimate these models, I employ Roodman's (2009) maximum likelihood framework, which generalizes seemingly unrelated regression models to systems of equations (including both probit and ordered probit) whose errors share a multivariate normal distribution. For each two-equation model, then, the first equation is estimated as an ordered probit or a probit (depending on how the dependent variable is operationalized) and the second is

estimated via OLS. I report robust standard errors for all models. Qualitatively identical results can be obtained from estimating the equations separately (these are available in the supplemental materials).

There is no inherent causal ordering between capital account liberalization and lifting restrictions on foreign bank entry, making it possible to estimate the two models separately. Many developing economies in fact have both restricted capital accounts and no restrictions on foreign bank entry—this is common in sub-Saharan Africa, where domestic financial sectors tend to be small and politically weak, as my argument would predict. Due to the purely cross-sectional nature of the available quantitative data it is not possible to investigate the temporal ordering of capital account liberalization and the restriction of foreign bank entry. The case studies of Indonesia and Mexico both indicate that historically, restrictions of foreign bank entry predated capital account liberalization, but the argument in this article does not require this to be true across all cases.

Is banking sector size a consequence of financial liberalization rather than a cause of it? Research cited previously confirms that countries whose financial sectors have been liberalized to foreign ownership have larger financial sectors. But this bias should work in my favor. If openness causes financial sectors to grow, this should increase the probability that I find no evidence that large financial sectors inhibit liberalization. Nevertheless, to mitigate the possibility that simultaneity will mask the effect of sectoral size on liberalization, I measure independent variables as averages from the five years prior to the release of Barth et al.'s survey, 2001-2005. Averaging across these years has the additional benefit of smoothing out any year-specific shocks. Simultaneity bias may still contaminate estimates of the relationship between financial sector size and capital account liberalization, but as the central contribution is to show

how powerful financial sectors *produce ownership restrictions alongside* open capital accounts, I rely on existing cross-national studies that have more convincingly addressed the relationship between financial sector size and capital account liberalization using time-series cross-sectional data (Brooks, 2004; Chwioroth, 2007).

As my theory applies to emerging markets only, the sample of cases includes all countries for which Barth et al. have data but which are not classified by the International Monetary Fund as industrial economies.<sup>7</sup> A table of summary statistics along with data definitions and sources is available in the supplementary materials.

## Results

The results appear in Tables 1 and 2. In every model, the coefficient on the key independent variable of interest (*FINANCIAL ASSETS / GDP*) is statistically significant in the expected direction at the  $p < .01$  level. To begin, the results of Table 1 (with *BANK LIBERALIZATION* as the dependent variable) show consistent evidence that countries with larger domestic financial sectors are more likely to restrict the ability of foreign banks to enter the domestic financial market (the negative coefficients on *FINANCIAL ASSETS / GDP* in columns 1 and 3) but more likely to have open capital accounts (the positive coefficients on *FINANCIAL ASSETS / GDP* in columns 2 and 4).

--- Table 1 about here ---

*CONCENTRATION* is positively correlated with a liberalized banking sector in Model 2, but this result is not consistent across models. Table 2 shows results using the alternative dependent variable, *BANK LIBERALIZATION (BINARY)*.

--- Table 2 about here ---

The results for *FINANCIAL ASSETS / GDP* are consistent with the results in Models 1 and 2: countries with larger domestic financial sectors are more likely to place restrictions on the ability of foreign banks to enter the domestic financial market but they are also more likely to have open capital accounts. These findings comprise powerful evidence that is consistent with my argument that large financial sectors in emerging economies should push for capital account openness alongside restrictions on foreign bank entry.

To facilitate interpretation of the substantive effects of financial sector size, I plot two quantities of interest (using methods discussed in King et al., 2000; Tomz et al., 2003). The first is the predicted probability that a country has a fully liberalized banking sector (that is,  $\Pr(\text{BANK LIBERALIZATION}) = 4$ ) across the range of the key independent variable *FINANCIAL ASSETS / GDP*, with all other variables held at their means. The second quantity of interest is the expected value of the capital account liberalization index, again across the range of the key independent variable *FAGDP* and with all other variables held at their means. These appear as Figure 1 and Figure 2.

--- Figure 1 about here ---

--- Figure 2 about here ---

The two figures are instructive. Figure 1 shows that a country at the tenth percentile for financial sector size in the sample has more than a 95% chance of being fully liberalized; this drops to just 15% at the ninetieth percentile of financial sector size. For *CKAOPEN* in Figure 2, the expected value at the tenth percentile of *FINANCIAL ASSETS / GDP* is approximately -.30, and at the ninetieth percentile of *FINANCIAL ASSETS / GDP* is 1.65. These corresponding to roughly two-thirds of a standard deviation above and below the sample mean of .49. Together, these are substantively large effects: countries with large domestic financial sectors indeed have

substantially more open capital accounts, and are far less likely to have liberalized their banking sectors to foreign entry.

The results for several control variables are also of interest. There is no evidence that democracy explains the liberalization of foreign financial entry restrictions in this sample of developing economies. There is some evidence that past crises predict the removal of entry restrictions—in three out of the four models the coefficient on *CRISIS* is positive and significant at conventional levels, and it just misses conventional levels in the fourth. As expected, more open economies (as measured by *TRADE / GDP*) are more likely to have eliminated restrictions on foreign financial entry. Similarly, countries with a recent history of IMF participation (as measured through the variable *IMF*) are more likely to have eliminated restrictions on foreign financial entry, which is consistent with the argument that international pressures matter for financial internationalization. Despite the fact that none of these variables are correlated with capital account liberalization, one should not conclude that IMF participation, trade openness, and currency crises are unimportant for capital account liberalization, as these non-findings are likely a consequence of the purely cross-sectional data used here.<sup>8</sup> Finally, the parameter  $\rho$  confirms that the errors in each two-equation model are highly correlated; the significance of the estimated parameter  $\operatorname{atanh}(\rho)$  rejects the null hypothesis that the errors are uncorrelated at conventional levels. Net of the systematic determinants of financial internationalization captured in the independent variables, countries with open capital accounts also tend to have eliminated foreign ownership restrictions. This reinforces the importance of carefully specifying how domestic financial sector interests shape financial internationalization, which explains the cases in which capital account openness is accompanied by ownership restrictions.

The quantitative results presented here confirm that the findings from Indonesia and Mexico case studies are not driven exclusively by other factors that shape financial internationalization: state-led protectionism, political regime, economic openness, financial crises, international pressures, and others. Some of these factors do matter: in a global sample, countries that have received IMF loans and which are more open to trade are more likely to have liberalized financial sectors. Nevertheless, they support the key argument in this article that independent of these, domestic interest group pressures affect the course of financial internationalization in developing countries.

## **CONCLUSION**

This article has uncovered a broad range of empirical evidence that domestic financial sector interests play in shaping the course of financial internationalization: where domestic finance are large and powerful, developing economies are more likely to liberalize their capital accounts but also to restrict the entry of foreign firms. Only by distinguishing between capital movement and firm entry as two distinct components of financial internationalization is it possible to capture the precise contours of this relationship. Lenders in these economies demand access to foreign capital—which lowers their costs of borrowing—without having to compete with it. These findings complement and refine existing research on the domestic politics of financial internationalization, showing how domestic lenders' role as intermediaries gives them distinct preferences for capital openness without foreign bank entry. Case studies illustrate the causal pathways at work in two important national contexts, while quantitative evidence allows me to control systematically for alternative explanations.



Beyond the literature on financial internationalization, this argument has broader implications for open economy politics. Neither a mobile-factors approach (Rogowski, 1989) nor a sector-specific factors approach (Gourevitch, 1986) can explain the pattern of financial sector lobbying for free movement but restricted entry of international capital identified here. My argument suggests that preferences over globalization strategies follow at least in part the positions that firms take in global production and distribution chains. It implies that within other sectors, firm-level preferences over movement and entry of foreign goods will differ between producers and distributors. From the 1960s to the 1990s in Indonesia, for example, the positions of a small number of trade intermediaries hamstrung the transition from openness to imports to true trade liberalization. Large intermediaries such as PT Astra International constructed elaborate distribution networks dependent on their status as sole legal importers of automobiles and industrial equipment (Sato, 1996). Far from rare, trade intermediaries handle a substantial portion of trade in many emerging economies (Schröder et al., 2003). Like financiers, trade intermediaries benefit from their status as importers but sole distributors of foreign goods. Like in finance, such intermediation can arise naturally from transactions costs, or more perniciously as the result of political lobbying. Describing the origins of Astra's central firm, PT Toyota-Astra Motor, Sato notes that the company's being awarded the sole right to distribute Toyotas

was undeniably facilitated by the facts that AI [Astra International] was in a business partnership with the government and that the then Minister of Trade in charge of supervising sole agency allocation was Sumitro Djojohadikusumo, with whom William [Soeryadjaya, the company's founder] had since the mid-1950s maintained a "personal relationship"....The reasons why Indonesia insisted on majority ownership are...because the business was of a distribution industry in which the government wanted to exclude foreign capital (Sato, 1996: 253).

Finance only differs in that by their nature all lenders are distributors. In the developing world, intrasectoral cleavages within import-competing industries should arise between producers and

distributors, the former resisting all forms of trade liberalization and the latter favoring licensing regimes that would make them sole importers of particular goods.

There is clearly more work to be done on this topic. As noted previously, additional sources of financial liberalization in the developing world remain underspecified, for—as in the case of liberalization of movement versus entry—other aspects of financial internationalization surely have very different cross-national determinants. This should push scholars of international finance more closely to examine the domestic politics of financial liberalization.

Perhaps more importantly, though, I have shown how lenders pressure governments for both capital account openness and entry restrictions. Unmeasured is the pressure brought to bear by borrowers, whose preferences may operate at cross-purposes from lenders. Indeed, the traditional “sector-specific factors” approach to the distributional implications of capital mobility holds that industrial capital will favor any policy that lowers the costs of capital (Frieden, 1991: 437). Borrowers may demand liberalization of cross-border capital inflows *as well as* greater direct foreign participation in the financial sector, both of which will decrease their cost of capital. Using democracy as a proxy for the ability of borrowers to affect policy is a rough first cut at this; future research can explore the extent to which such demands countermand those of lenders. The same country studies that document the political influence of financial sectors, though, suggest that in many developing countries, tight corporate links between lenders and domestic borrowers lead the latter to mitigate demands for foreign financial entry. In the limit, vertically integrated firms that finance themselves internally will have the same preferences as domestic lenders (Acemoglu et al., 2009). Additionally, even in non-vertically integrated firms, many corporate borrowers may resist the due diligence of foreign lenders. Large corporate borrowers may favor restrictions on foreign bank entry for fear that foreign lenders will provide

funds to their competitors (Rajan and Zingales, 2003). These are areas of research that will benefit from closer attention to the domestic politics of financial internationalization in the developing world.

Finally, empirical research on economic interests and policy choice always faces the difficult challenges associated with data availability. It is almost impossible to measure directly the ways in which any pressure group shapes policy formation, because such pressures are rarely recorded. Comparative studies are made all the more difficult by the necessity of obtaining data on interest group pressures in multiple countries. Often, interest group pressures are most critical when they are least likely to be easily observable: in closed polities or other information-poor political environments. Moreover, interest group pressures can be difficult to separate from the influence of political elites or central bankers, who may happen to share their preferences or beliefs about the proper strategies for financial internationalization. For this reason, the present argument depends critically on the extensive empirical research by scholars of financial politics in Mexico and Indonesia. Future research on the domestic politics of financial internationalization will similarly require such careful study of the networks of political influence that link financial sector interests to policy outcomes elsewhere in the world.

## NOTES

<sup>1</sup> By “relatively capital poor,” I mean both that the marginal product of capital in the developing world is higher than that in the advanced industrial economies, and that domestic banks are at a competitive disadvantage relative to foreign banks. I thank an anonymous reviewer for clarifying this point.

<sup>2</sup> I base the narrative in this section primarily on Cole and Slade (1999), MacIntyre (1993), Pepinsky (2009), Sharma (2001), Soesastro (1989), and Winters (1996).

<sup>3</sup> I base the narrative in this section on Adams (1997), Haber (2005), Hernández Trillo and Villagómez (2000), Maxfield (1990, 1992, 1997), Santín Quiroz (2001), and Valdés Ugalde (1994).

<sup>4</sup> I thank an anonymous reviewer for suggesting this point.

<sup>5</sup> This practice is also standard in the subnational and cross-national literatures on tariff policy. For other uses of national sector size as a proxy for sectoral political influence in the realm of international finance, see Blomberg et al. (2005), Brooks (2004), Chwioroth (2007), Frieden et al. (2001), Shambaugh (2004).

<sup>6</sup> Data on deposit money bank assets and central bank are widely available in the dataset, but data on the assets of other financial institutions are very sparse. Where these data are missing for a country or country-year, I calculate *TOTAL FINANCIAL ASSETS / GDP* as the sum of deposit money bank assets and central bank assets only. Including central bank assets is useful for three reasons. First, central bank assets help to capture the relative market power of the financial sector because as indicators of the depth of the domestic financial market, these assets are understood as comprising some of the fund to which private sector actors might have access in the event of a financial downturn. Second, they are also useful in countries where the accounts of state-owned financial and quasi-financial enterprises have unclear legal standing. Third, in liberalizing economies, central bankers may in fact operate as representatives or agents of private financial sector actors, meaning that central bank assets are another measure of the (indirect) political influence of the banking sector. I thank an anonymous review for suggesting this possibility.

<sup>7</sup> These are countries whose IFS country code > 200.

<sup>8</sup> See e.g. the findings in Mukherjee & Singer (2010) and AUTHOR.

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**Table 1: Financial Assets, Bank Liberalization, and Capital Account Openness**

	Model 1		Model 2	
	BANK LIBERALIZATION	CKAOPEN	BANK LIBERALIZATION	K3
FINANCIAL ASSETS / GDP	-0.035** (0.011)	0.029** (0.011)	-0.037** (0.011)	0.011** (0.004)
CONCENTRATION	0.029* (0.014)	0.018* (0.009)	0.035* (0.014)	0.002 (0.004)
GDP PER CAPITA	-0.036 (0.273)	0.832*** (0.195)	0.047 (0.292)	0.233** (0.076)
GDP GROWTH	-0.056 (0.087)	-0.041 (0.061)	-0.061 (0.095)	-0.014 (0.019)
POLITY2	-0.001 (0.035)	0.052 (0.028)	-0.023 (0.039)	0.012 (0.009)
TRADE / GDP	-1.439** (0.495)	0.036 (0.352)	-1.573** (0.533)	0.083 (0.142)
CRISIS	5.369* (2.262)	1.095 (1.277)	4.428* (2.185)	0.506 (0.453)
FIXED XR	-0.326 (0.532)	-0.697* (0.324)	-0.510 (0.526)	-0.139 (0.117)
RESERVES / IMPORTS	-1.056** (0.387)	0.002 (0.271)	-1.009* (0.412)	0.100 (0.088)
M2 / GDP	2.681*** (0.663)	-1.140 (0.621)	2.778*** (0.696)	-0.527** (0.192)
DEBT SERVICE / GNI	0.649* (0.315)	-0.438 (0.245)	0.686* (0.340)	-0.182** (0.070)
XR VOLATILITY	-27.414* (12.716)	-25.012*** (6.407)	-25.591* (13.021)	-6.603** (2.200)
CA BALANCE	-0.000 (0.000)	-0.000** (0.000)	0.000 (0.000)	-0.000** (0.000)
INFLATION	0.872 (3.521)	3.613* (1.641)	-0.180 (3.484)	1.454* (0.598)
IMF	1.728* (0.871)	1.065 (0.569)	1.732* (0.800)	0.339 (0.240)
Constant		-20.140** (7.695)		-7.059** (2.735)
Cut 1	3.509 (16.652)		-0.858 (16.427)	
Cut 2	5.653 (16.469)		1.400 (16.249)	
$\operatorname{atanh}(\rho)$	0.628*** (0.173)		0.436** (0.164)	
$\rho$	.557		.410	
Observations	80		81	

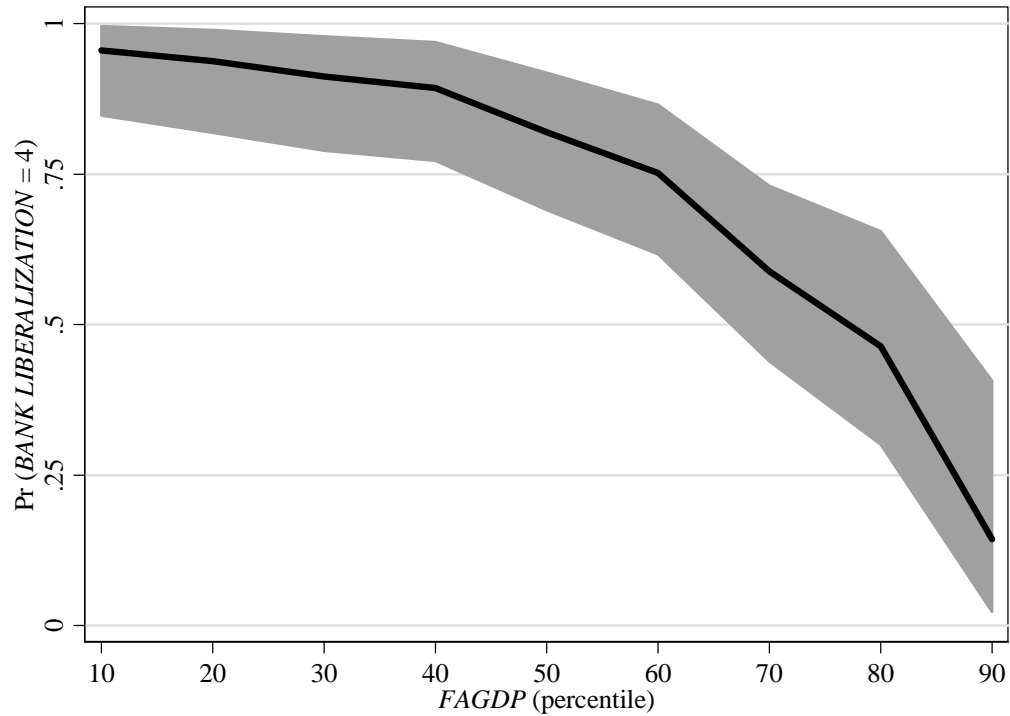
Robust standard errors in parentheses.  $\operatorname{atanh}(\rho)$  is the inverse hyperbolic tangent of  $\rho$ , the estimated correlation between the error terms in each pair of equations. The ML SUR model estimates  $\operatorname{atanh}(\rho)$ , from which  $\rho$  is calculated. \*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ .

**Table 2: Financial Assets, Bank Liberalization, and Capital Account Openness**

	Model 3		Model 4	
	BANK LIBERALIZATION (BINARY)	CKAOPEN	BANK LIBERALIZATION (BINARY)	K3
FINANCIAL ASSETS / GDP	-0.045** (0.015)	0.029** (0.011)	-0.047** (0.017)	0.011** (0.004)
CONCENTRATION	0.027 (0.017)	0.018* (0.009)	0.035 (0.018)	0.002 (0.004)
GDP PER CAPITA	-0.176 (0.322)	0.832*** (0.195)	-0.152 (0.340)	0.233** (0.076)
GDP GROWTH	-0.018 (0.093)	-0.041 (0.061)	-0.039 (0.103)	-0.014 (0.019)
POLITY2	-0.034 (0.043)	0.052 (0.028)	-0.058 (0.047)	0.012 (0.009)
TRADE / GDP	-1.316* (0.623)	0.036 (0.352)	-1.570* (0.685)	0.083 (0.142)
CRISIS	5.452* (2.567)	1.095 (1.277)	4.248 (2.657)	0.506 (0.453)
FIXED XR	-0.489 (0.583)	-0.697* (0.324)	-0.736 (0.620)	-0.139 (0.117)
RESERVES / IMPORTS	-1.236** (0.451)	0.002 (0.271)	-1.232* (0.514)	0.100 (0.088)
M2 / GDP	3.820*** (0.977)	-1.140 (0.621)	3.997*** (1.100)	-0.527** (0.192)
DEBT SERVICE / GNI	0.840* (0.388)	-0.438 (0.245)	0.965* (0.450)	-0.182** (0.070)
XR VOLATILITY	-19.970 (11.976)	-25.012*** (6.387)	-19.206 (12.884)	-6.603** (2.199)
CA BALANCE	0.000 (0.000)	-0.000** (0.000)	0.000 (0.000)	-0.000** (0.000)
INFLATION	1.873 (2.811)	3.613* (1.624)	0.981 (2.942)	1.454* (0.597)
IMF	2.204* (1.102)	1.065 (0.569)	2.271* (0.955)	0.339 (0.240)
Constant	-13.405 (13.606)	-20.140** (7.614)	-9.278 (14.296)	-7.059** (2.729)
$\operatorname{atanh}(\rho)$	0.704*** (0.182)		0.477* (0.196)	
$\rho$	0.607		0.444	
Observations	80		81	

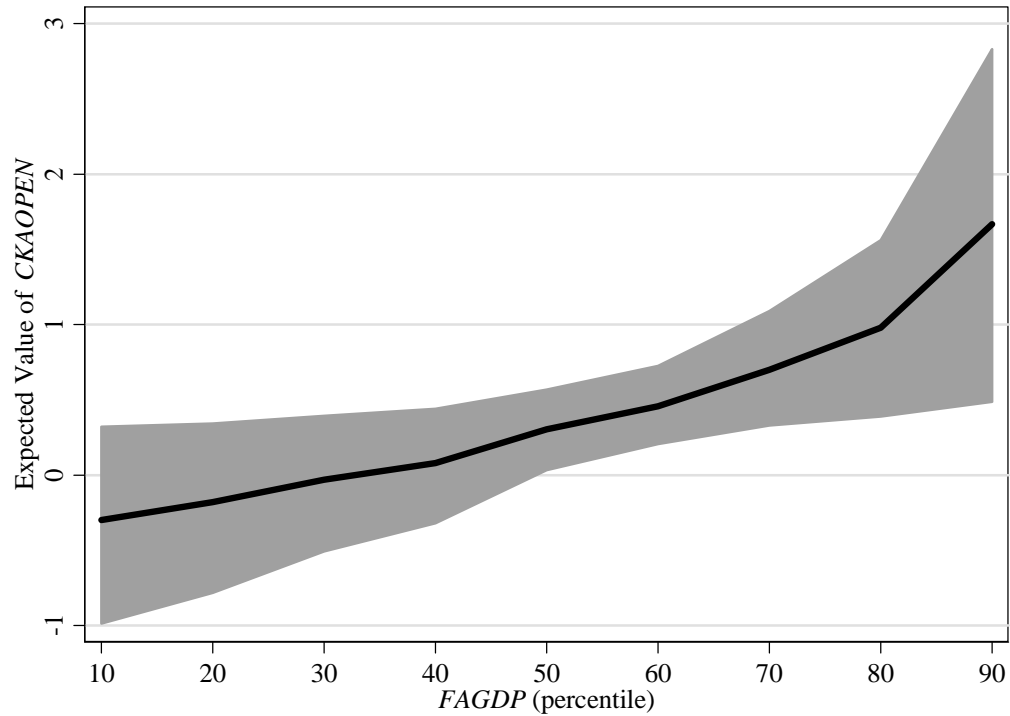
Robust standard errors in parentheses.  $\operatorname{atanh}(\rho)$  is the inverse hyperbolic tangent of  $\rho$ , the estimated correlation between the error terms in each pair of equations. The ML SUR model estimates  $\operatorname{atanh}(\rho)$ , from which  $\rho$  is calculated. \*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ .

**Figure 1: Probability of Full Banking Liberalization**



This figure estimates the probability that a country's banking sector is fully liberalized (*BANK LIBERALIZATION* = 4) at various levels of *FINANCIAL ASSETS / GDP*. The black line is the predicted probability, and the shaded region corresponds to the 95% confidence interval. (Estimates were calculated using CLARIFY; see Tomz et al. 2003.)

**Figure 2: Expected Value of *CKAOPEN***



This figure plots the expected value of *CKAOPEN* (the capital account liberalization index) at various levels of *FINANCIAL ASSETS / GDP*. The black line is the expected value, and the shaded region corresponds to the 95% confidence interval. (Estimates were calculated using CLARIFY; see Tomz et al. 2003.)