Internationalization and Domestic Politics

Edited by

ROBERT O. KEOHANE
Harvard University

HELEN V. MILNER
Columbia University

CAMBRIDGE
UNIVERSITY PRESS

PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE
The Pitt Building, Trumpington Street, Cambridge, United Kingdom

CAMBRIDGE UNIVERSITY PRESS
The Edinburgh Building, Cambridge CB2 2RU, UK www.cup.cam.ac.uk
40 West 20th Street, New York, NY 10011-4211, USA www.cup.org
10 Stamford Road, Oakleigh, Melbourne 3166, Australia
Ruiz de Alarcón 13, 28014 Madrid, Spain

First published 1996
Reprinted 1996, 1997, 1999

Typeset in Times

A catalog record for this book is available from the British Library

Library of Congress Cataloging in Publication Data is available

ISBN 0 521 56264 3 hardback
ISBN 0 521 56587 1 paperback

Transferred to digital printing 2002

Contents

1

Internationalization and Domestic Politics: An Introduction

HELEN V. MILNER AND ROBERT O. KEOHANE

Rapid increases in international economic exchanges during the past four decades have made national economies very open, by historical standards, to the world economy. Much recent economic analysis has been devoted to exploring the effects of such internationalization on macroeconomic policy options, national competitiveness, and rewards to various factors of production. Since economics and politics are so closely linked, there is reason to expect profound political effects as well: in particular, domestic politics in countries around the world should show signs of the impact of the world economy. The central proposition of this volume is that we can no longer understand politics within countries – what we still conventionally call "domestic" politics – without comprehending the nature of the linkages between national economies and the world economy, and changes in such linkages.

"Internationalization" is a broad concept used by a variety of writers in a variety of ways. In Chapter 2, Jeffry Frieden and Ronald Rogowski attempt to introduce some precision into its analysis by distinguishing between observable flows of goods, services, and capital, on the one hand, and the "exogenous easing of international exchange that such flows reflect," on the other. Measurable flows, such as the vast increases in international capital movements over the past few decades, reflect more basic shifts in the costs of international relative to domestic transactions. Indeed, shifting opportunity costs are more fundamental than the flows themselves: the *potential* for international movements of capital, in response to shifts in interest rates or changing expectations about exchange rates, can exert profound effects on national economic conditions and policies even if no capital movement actually takes place. Hence, as Frieden and Rogowski recognize, an adequate analysis of internationalization cannot begin with international flows, but must probe the sources of these transactions.

However, "the exogenous easing of international exchange" is less directly observable, whereas flows of goods, services and capital can be measured, however imperfectly. In this volume, therefore, internationalization is measured by such indicators as changes in trade as a proportion of gross domestic product (GDP) or the ratio of a country's net foreign investment to its total domestic assets. *Internationalization, as used in this volume, refers to the processes generated by underlying shifts in transaction costs that produce observable flows of goods, services, and capital.* As documented below, international trade, investment, and currency trading have grown dramatically during the last two decades, especially relative to the size of national economies; hence, internationalization, as we define it, has grown.[1]

Frieden and Rogowski devote some attention in their chapter to the sources of internationalization. This volume as a whole, however, focuses not on the causes of internationalization but on its effects. Internationalization affects the opportunities and constraints facing social and economic actors, and therefore their policy preferences – not necessarily the basic values that actors seek (power, money, or virtue as they define it) but their choices about which policies will best achieve their fundamental goals. Internationalization also affects the aggregate welfare of countries, their sensitivity and vulnerability to external changes, and therefore the constraints and opportunities faced by governments. As incentives change through internationalization, we expect to observe changes in economic policies and in political institutions. Possible changes include the liberalization of foreign trade and investment policies, the deregulation of domestic markets, shifts in fiscal and monetary policy, and changes in the institutions designed to affect these policies.

Political institutions reflect domestic actors' policy preferences, since they are intentionally created to guarantee the pursuit of particular policies. But they also have independent effects: they create rules for decision making, help to structure agendas, and offer advantages to certain groups while disadvantaging others. Over time, strong institutions may even shape actors' policy preferences. Since institutions have effects, people have preferences about institutions as well as about policies; and these preferences will be linked. If an independent agency seems less likely to provide tariff protection than the legislature, free traders should favor appointment of the agency while protectionists should oppose it.

The central explanatory variable throughout this volume is internationalization, which involves an exogenous reduction in the costs of international transactions that can be empirically measured by the growth in the proportion of international economic flows relative to domestic ones. We recognize throughout, however, that the effects of internationalization are mediated through domestic political institutions. The dependent variables are twofold:

1 The policy preferences of relevant socioeconomic and political agents within countries toward national policies and national policy-making institutions, as reflected in their political behavior; and
2 National policies and national policy institutions themselves.

This volume is built around two core sets of propositions, which are elaborated in Chapter 2 by Frieden and Rogowski and Chapter 3 by Geoffrey Garrett and Peter Lange. Frieden and Rogowski focus on the policy preferences of socioeconomic actors, Garrett and Lange on the institutional side of the story. The empirical chapters examine both sets of arguments in light of evidence from countries around the world.

Frieden and Rogowski argue that internationalization affects the policy preferences of actors within countries in broadly predictable ways, based on the economic interests of the actors. Most obviously, it expands the tradables sector within an economy, thus reducing the amount of economic activity sheltered from world market forces. *Ceteris paribus,* internationalization should therefore increase the sensitivity of national economies to world market trends and shocks.[2] More significantly, internationalization affects the relative prices of domestically produced goods or domestically owned factors, compared to each other and to foreign goods and factors. Since changes in relative prices have implications both for growth and for income distribution, socioeconomic actors advantaged by these price changes will press for increased openness, while disadvantaged groups will seek restrictions, subsidies, or protection. Each of the empirical chapters evaluates this first proposition: that changes in policy preferences will reflect changes in relative prices.

Yet internationalization affects policies and institutions differently from country to country: the existing institutional context conditions the incentives facing interest groups and politicians. Thus the second fundamental proposition of this volume is that political institutions can block and refract the effects of internationalization. Political outcomes cannot be predicted simply on the basis of economic interests. Coalition formation depends on strategic judgments and maneuvering, and often cannot be predicted from policy preferences alone.[3] Moreover, decisions on whether to work through existing institutions or to press for radical institutional change depend not merely on economic policy preferences and strategic judgments, but also on exogenous factors.[4]

In Chapter 3, Garrett and Lange discuss how preferences, policies, and institutions relate to one another. Given a set of domestic political institutions, an increase in the size and productivity of the exposed sector of the economy (the tradables sector) will not, in general, be accompanied by a comparable increase in its political influence. Garrett and Lange suggest, through a set of stylized models, that nondemocratic regimes should react more sporadically than democratic ones to changes in internationalization; and that variations in the responsiveness of democratic regimes will be related to the strength of labor unions, the electoral rules, the number of veto players, and the extent of political independence of key bureaucracies such as central banks. They conclude with a discussion of the conditions under which democratic governments, seeking reelection, will pursue strategies of institutional change. Although no single, well-specified deductive theory exists to guide us through the institutional thickets, a number of interesting hypotheses can be formulated about the connections among preferences, policies, and institutions.

The empirical chapters assess how different forms of internationalization have affected the policy preferences of actors and have produced changes in domestic coalitions, policies, and institutions. These chapters also discuss many instances in which that impact was mediated and in some respects fundamentally altered by national political institutions. Chapters 4–6, by Geoffrey Garrett, Jeffry Frieden, and Frances Rosenbluth, discuss Europe, the United States and Japan, followed by Chapters 7–8, by Matthew Evangelista and Susan Shirk, on the Soviet Union and China. Chapter 9, written jointly by Stephan Haggard and Sylvia Maxfield, analyzes the effects of financial internationalization in selected developing countries. Our own arguments are presented in Sections III and IV of this introduction and elaborated in the concluding essay of this volume.

This volume is firmly within the "second image reversed" tradition (Gourevitch 1978). Its distinctiveness derives from the juxtaposition of theories of policy preferences based on microeconomics, on the one hand, and arguments that emphasize how existing institutions shape the effects of internationalization, on the other. In a broad sense this volume presents a dialogue between international political economy, heavily influenced now by economic models, and comparative politics, driven these days by the "new institutionalism." Our work therefore reflects attempts in political economy to integrate these two distinct types of theories.

In this volume, both the political economists and the institutionalists assume that political actors are, broadly speaking, rational. Politicians respond to incentives, which are provided both by institutions and by the opportunities and constraints of the world economy. Thus, the debate in this volume is *not* between rationalistic and nonrationalistic approaches. It *is* about the relative importance of the constraints and incentives imposed by the world economy, on the one hand, and the constraints and incentives inherent in preexisting national institutions, on the other. It is also about how these international and domestic constraints interact.

The next section of this introductory chapter reviews earlier work on international and domestic political economy, explaining how this volume relates to it. Section II provides some evidence on the various dimensions of internationalization during the past twenty years. In Section III we put forward some hypotheses about the impact of internationalization on domestic politics, which are then juxtaposed, in Section IV, to hypotheses about institutional sources of resistance to the linear effects of internationalization. We conclude by emphasizing the essential point of this volume: that internationalization is having profound effects on domestic politics, although the forms that these effects take vary cross-nationally due to different institutional as well as political-economic conditions.

I. EARLIER STUDIES OF THE EFFECT OF THE INTERNATIONAL ECONOMY

Two substantial literatures have addressed the broad issues we raise in this volume. During the late 1960s and early 1970s, studies of international "interdependence" focused on the ways in which greater economic linkage among countries could affect them (Cooper 1968, 1972; Deutsch and Eckstein 1961; Keohane and Nye 1972; Rosecrance and Stein 1975; and Waltz 1970). As this literature developed, it became more precise about the meaning of interdependence and its relationship to the concept of power, adapting concepts that Albert Hirschman (1945/1980) had developed a generation earlier (Baldwin 1980; Keohane and Nye 1977). Interdependence, this literature argued, altered the nature of world politics by changing the context and alternatives facing countries. In that respect, the essential point of this work was similar to the argument made here. Missing from this literature, however, was a systematic analysis of how interdependence affected domestic politics.[5] Keohane and Nye, for instance, limited their analysis in *Power and Interdependence* to the international level and thus "had to view interests [of states] as formed largely exogenously, in a way unexplained by our theory . . . [yet] changes in definitions of self-interest . . . kept appearing in our case studies" (Keohane and Nye 1987: 739). Our study of "internationalization" in this volume attempts to build on the interdependence literature by exploring the impact of interdependence on politics within countries.

Responding to this neglect of domestic politics in the work on interdependence, a new literature, beginning in the late 1970s, argued that international forces had decisively affected the internal politics, and hence the foreign policies, of major countries. By affecting interests and power, international developments could affect the coalitions that form in domestic politics (Gourevitch 1978; Katzenstein 1978). However, since the early, innovative literature on these issues was not firmly grounded in economic theory, the causal linkages between international-level changes and domestic politics were rarely made explicit.

More recent work has attempted to address these problems and to extend this "second image reversed" tradition. Four arguments about the diverse effects of international economic forces on domestic politics are prominent in recent work. In *Commerce and Coalitions,* Ronald Rogowski has used the Stolper–Samuelson theorem to argue that changes in international trade flows affect national political coalitions and cleavages by changing the returns to factors of production (Rogowski 1989).[6] Grounding his analysis in the Heckscher–Ohlin approach to international trade, he has argued that the factors that gain and lose from the external changes form distinct political coalitions that mark the major political cleavages within states. Hence showing what shifts in the level of trade occur and which factors gain and lose from these trade flows generates hypotheses about the national political cleavages within countries.

Factors of production, however, may be tied to the economic sectors in which they are used: that is, factors may be "specific" to sectors, or industries. Insofar as such specific factor models are applicable, coalitions will be based on sectors rather than on factors of production. Politics will not pit labor versus capital along class lines, or city versus countryside, but will be oriented toward cleavages such as those between producers of tradables and nontradables, exporting and import-competing sectors, or multinational and purely national firms. Following the argument of Alexander Gerschenkron, Peter Gourevitch showed that during the last quarter of the nineteenth century, countries' "production profiles," defined by "the preferences of societal actors as shaped by the actors' situation in the international and domestic economy," help to explain their trade policies (Gourevitch 1986, especially chapter 3).[7] Changes in trade flows and the competitiveness of sectors will therefore reshape national preferences and thus alter domestic politics. International openness, as Jeffry Frieden (1991b) has argued, may shift political disputes from interest rates toward exchange rates, and pit international traders and investors, who favor stable exchange rates, against import-competing manufacturers of tradeable goods for the domestic market, who favor depreciated currency values.

In a complex modern economy, however, the gains from trade may be even more specific, accruing to particular firms rather than to either broad sectors or factors of production. Coalitions will then rest on the convergence of firms' interests. For instance, in *Resisting Protectionism,* Helen Milner (1988) has argued that different degrees of export dependence or multinationalization of production by firms affect their preferences toward the regulation of international transactions and hence national policies.

Finally, different levels of integration into world markets may influence the character of national political institutions. David Cameron (1978) showed that exposure to the international economy during the 1960s and 1970s was associated with large public sectors; and Peter Katzenstein interpreted the corporatist structures of small European states as designed to provide "an institutional mechanism for mobilizing the consensus necessary to live with the costs of rapid economic change" (Katzenstein 1985: 200), although the exact form taken by these institutions varies with those states' historical experiences.

Other observers have also noted variations in national responses. First, a number of authors have claimed that countries' responses will depend heavily on the partisan composition of the government in office: left-wing governments will react differently to economic pressures than will their right-wing counterparts. The partisanship of governments matters since each party has a different program that appeals to a different electorate. To win or keep office requires keeping one's core constituents happy. This argument is based in part on the literature on macroeconomic policymaking, which shows that a rational partisan model of the economy is a powerful predictor of policymakers' behavior. In this model, governments controlled by left-wing parties expand the economy when they come to office, while right-wing governments contract the economy after winning office. However, in a highly internationalized economy, these simple relationships do not hold. Alesina and Roubini find that small, highly trade-dependent countries do not show evidence of rational partisan macroeconomic cycles, suggesting that very high levels of internationalization constrain the use of macroeconomic policy (Alesina and Roubini 1992; Alt 1985).

Second, the organization of labor and financial markets seems to matter. Garrett and Lange argue that successful policies of left-wing or right-wing governments depend on compatible social constellations. Left-wing governments succeed best where labor is strong and centrally organized, while right-wing policies work best where labor is weaker and more fragmented (Alvarez, Garrett, and Lange 1991; Garrett and Lange 1986). Paulette Kurzer (1993) focuses on financial linkages between economies of small European states and world markets, seeking to show, in a study of Belgium, The Netherlands, Austria, and Sweden, that these financial linkages are important determinants of the success of social democratic corporatism.

Third, political institutions make a difference. For the developed countries, a score of studies focused on economic policy make this point (Hall 1986; Katzenstein 1978; Shonfield 1965; Zysman 1983). Katzenstein, for instance, argues that how nations respond to external economic pressures depends on whether their political institutions are "strong" and able to insulate policymakers from immediate political pressures or "weak" and more permeable to societal influences. Countries with long traditions of professional bureaucracies, like France and Japan, will react differently than will countries lacking such well-developed, distinct state institutions, such as the U.S. and United Kingdom. Of particular importance for this volume is the argument that some countries, because of their political institutions, can insulate themselves from societal pressures. This implies that even though internationalization may be growing and the policy preferences of domestic actors changing, central policymakers will not respond to such changes, or will respond in their own fashion.

Virtually all of the work on this topic, whether stressing partisanship, labor or financial markets, or state institutions, casts doubt on the argument that countries will respond to internationalization simply as a function of its effect on their relative prices. No matter how seriously one takes the propositions in Chapter 2 about the impact of internationalization on actors' preferences, it is clear that this impact is mediated by domestic political factors, which reflect diverse historical experiences.

II. INTERNATIONALIZATION: THE EVIDENCE

Economic transactions across national boundaries have expanded dramatically over the last two decades. Hence internationalization, as we empirically identify it, has increased. Such internationalization can be expected to increase integration between domestic and international markets, where integration is defined in terms of the convergence of prices of goods, services, and capital in those markets. Although internationalization and integration do not perfectly covary, and measures of price convergence are hard to construct, the correlations between short-term interest rates have become quite high recently, returning to levels only seen in the Gold Standard period. (Frankel 1991; Zevin 1992: 46–55). Since our concern is with the political effects of flows across borders, rather than with their effects on integration, we sidestep the issue of the relationship between internationalization and economic integration.

International trade flows

Data on world trade document a major dimension of internationalization.[8] During the first fifteen or twenty years after World War II, measures of trade openness (such as ratios of import volumes to real income) recovered to levels above those of the 1930s and 1940s, but did not reach levels as high as those of the period before 1914 (McKeown 1991). Since the early 1970s, however, world trade has increased dramatically relative to previous levels, and relative to domestic product. Import volumes as a percentage of real GNP in industrial capitalist countries, which remained between 10 and 16 percent throughout the ninety years between 1880 and 1972, increased to almost 22 percent during the 1973–87 period (McKeown 1991: 158). Between 1972 and 1991 the average rate of import growth into the Organization for Economic Development and Co-operation (OECD) area was slightly over five percent, compared to an average increase in real total domestic demand (both expressed in 1987 dollars on the basis of 1987 GDP weights) of only three percent (OECD 1992: tables R10 and R8, pp. 210, 208). That is, imports grew over these two decades at a rate about 65 percent higher than growth in domestic demand. Much of this trade occurred through multinational enterprises: roughly 40 percent of United States imports, 25 to 30 percent of Japanese imports, and thirty percent of British imports occurred as intrafirm transactions during the early 1980s (McKeown 1991: 168).

The long-term patterns are documented in Tables 1 and 2, which show changes in the ratio of merchandise exports to GDP for sixteen developed countries between 1913 and 1987, at current and 1985 prices, respectively. With few exceptions this ratio fell between 1913 and 1950, and rose both between 1950 and 1973 and between 1973 and 1987. However, there is also a great deal of country-by-country variation. In 1973, half of the countries listed in the table still had ratios below those of 1913, on the basis of current prices; even in 1987, five countries had lower ratios than in 1913. However, the period after 1950 is marked by sustained increases in the export/GDP ratio for all countries, with the exception of Australia, when measured in current prices.

The more recent export records of the Newly Industrializing Countries (NICs) are equally relevant for documenting the internationalization of national economies. Six countries are often regarded as the first NICs: Brazil, Mexico, Hong Kong, South Korea, Singapore, and Taiwan. Although trade preferences extended by rich countries did not favor these economies over other developing countries, their gross domestic products and exports grew dramatically in the 1970s, unlike those of many of their counterparts. These six countries accounted for 3.5 percent of world gross domestic product and 1.9 percent of world exports of manufactures in 1964–5, but accounted for 6.2 percent of world GDP and 8.7 percent of world exports of manufactures by 1983 (OECD 1988: tables 1.1 and 1.4, pp. 11 and 14). Their exports to OECD countries, which had been less than half their imports from those countries in 1964, exceeded their imports by 1983 (OECD 1988: figure 1, p. 17). Between 1964 and 1985, imports to the OECD countries from the NICs grew at an average annual rate of 23.6 percent, compared to 13.6 percent for all imports (OECD 1988: 18) As a result both of this export boom and falling oil prices, the proportion of South to North merchandise exports comprising manufactured goods rose from 15.2 percent in 1980 to 53.3 percent in 1989; in that same period, the percentage of Southern nonfuel exports consisting of manufactured goods rose from 45.1 to 70.9 (Wood 1994: table 1.1, p. 2). The record of the NICs demonstrates that during the 1970s and 1980s, the world economy was sufficiently open that even in the absence of any special treatment some poor countries could achieve rapid rates of export and income growth.

The expansion of international capital markets

In the past twenty years, capital markets have grown increasingly internationalized. Global capital flows of all types have expanded dramatically, far

Table 1. *Ratio of merchandise exports to GDP at current market prices*

	1913	1950	1973	1987
Australia	18.3	22.0	13.7	13.5
Austria	8.2	12.6	19.0	23.2
Belgium	50.9	20.3	49.9	59.8
Canada	15.1	17.5	20.9	23.9
Denmark	26.9	21.3	21.9	25.4
Finland	25.2	16.6	20.5	22.5
France	13.9	10.6	14.4	16.8
Germany	17.5	8.5	19.7	26.4
Italy	12.0	7.0	13.4	15.4
Japan	12.3	4.7	8.9	9.7
Netherlands	38.2	26.9	37.3	43.6
Norway	22.7	18.2	24.4	25.7
Sweden	20.8	17.8	23.5	27.6
Switzerland	31.4	20.0	23.2	26.6
UK	20.9	14.4	16.4	19.3
USA	6.1	3.6	8.0	5.7
Arithmetic average	21.2	15.1	20.9	24.1

Source: Maddison 1991: 326.

faster than domestically. As one economic text claims, "If a financier named Rip Van Winkle had gone to sleep in the early 1960s and awakened two decades later, he would have been shocked by changes in both the nature and the scale of international financial activity. In the early 1960s, for example, most banking was purely domestic . . . Two decades later, however, many banks derived a large share of their profits from international activities" (Krugman and Obstfeld 1988: 622).

Three factors created this revolution in the world's capital markets: deregulation of capital markets and finance by governments; the rapid growth of world trade and investment, which has generated huge financial flows; and technological innovation, making the movement of capital faster and cheaper (Turner 1991: 11–12). These changes are mutually reinforcing: the growth of international investment has prompted governments to deregulate capital movements, which in turn has facilitated investment and technological change (Goodman and Pauly 1993).

All aspects of finance have been internationalized in the past twenty years. By the end of the 1980s, gross international capital flows rose to $600 billion annually (Turner 1991: 9). International capital inflows to the industrialized countries (mostly from other industrialized countries) rose from an annual average of $99 billion in 1975–7 to $463 billion in 1985–9, nearly a five-fold increase. For developing countries, international flows doubled from $52 billion in 1975–7 to $110 billion in 1985–9 (Turner 1991: 23).[9] Net

Table 2. *Ratio of merchandise exports to GDP at 1985 prices*

	1913	1950	1973	1987
Australia	10.9	7.7	9.5	12.4
Austria	5.2	4.0	12.6	20.0
Belgium	17.5	13.4	40.3	52.5c
Canada	12.9	13.0	19.9	23.8
Denmark	10.1	9.3	18.2	25.8
Finland	17.0	12.7	20.5	23.0
France	6.0	5.6	11.2	14.3
Germany	12.2	4.4	17.2	23.7
Italy	3.3	2.4	8.7	11.2
Japan	2.1	2.0	6.8	10.6
Netherlands	14.5	10.2	34.1	40.9
Norway	14.6	13.5	27.4	34.0
Sweden	12.0	12.2	23.1	27.0
Switzerland	22.3	9.8	21.3	28.9
UK	14.7	9.5	11.5	15.3
USA	4.1	3.3	5.8	6.3
Arithmetic average	11.2	8.3	18.0	23.1

Source: Maddison 1991: 327.

capital inflows to the developing countries reached $151.3 billion in 1993 (BIS 1995: 146). Net short-term international bank flows also quintupled in the last two decades, growing from $11.5 billion annually in 1975–9 to almost $62 billion by 1989 (Turner 1991: 75). Total net lending in world markets exploded; it averaged $100 billion per year in the late 1970s and $342 billion yearly by 1990. By 1992 the stock of international bank lending had reached $3.6 trillion, seven times the level of 1978.[10] Foreign exchange trading more than doubled between 1986 and 1989, when it amounted to $650 billion daily, which was about 40 times the average daily volume of world trade. By 1992 the volume of such transactions had increased to almost $1 trillion per day (Turner 1991: 34, 9–10; Eichengreen 1993). Thus while increases in international trade of goods and services have far outstripped the growth of domestic production, the movement of capital around the globe has grown even faster than that of trade.[11] "The growth of international capital movements has dwarfed the growth in trade. The stock of international bank loans, for example, has grown from 5 percent of GDP of countries in the OECD in 1973 to about 20 percent of OECD GDP in 1991" (*Economic Report of the President,* 1993, p. 281.)

International portfolio and direct investment have also grown. In 1979, annual international transactions in equities averaged about $73 billion; by 1990, this had grown twentyfold to $1500 billion (Turner 1991: 53). By 1989, furthermore, the total worldwide stock of foreign direct investment (FDI) was $1.5 trillion in a $20 trillion world economy (United Nations *World Investment Report 1991:* 3). Global inflows of FDI surged to $185 billion that same year, compared with annual averages of $53 billion in 1980–4 and $28 billion in 1975–9 (Turner 1991: 39). Aggregate foreign direct investment outflows in 1994 reached a new record of $230 billion as well (BIS 1995: 66). In the 1980s, direct investment outflows grew at an "unprecedented rate" of 30% annually, three times faster than the growth of trade and four times faster than the growth of world output (United Nations *World Investment Report 1991:* table 1, pp. 3–4). In the aggregate, FDI accounted for one percent of all the OECD GNP by the end of the 1980s; it was only 1/2 percent in 1980 (Turner 1991: 30–2). FDI grew more rapidly than domestic output and more than domestic investment. The ratio of FDI to gross domestic capital formation rose from 2.9 percent in 1980–2 and 3.4 percent in 1985–7 for the developed countries. As with the other aspects of finance, foreign direct investment has become a more important component of almost all economies.

Of course, the fact of huge capital flows is neither a necessary nor a sufficient condition for the true integration of capital markets, in which real covered interest rates should equalize. Where no barriers to transactions exist, interest rates could converge as a result of information flows and expectations, without much actual capital movement; conversely, one can at least imagine a situation in which barriers to capital mobility, preventing true economic integration, persisted alongside substantial flows.[12] Nevertheless, one would normally expect an association between capital mobility and actual flows of financial assets. Other studies, such as those by Frankel and Zevin cited earlier, do show that at least for short-term instruments, covered interest rates have become very highly correlated. The level of internationalization existing now is close to the very high levels experienced during the Gold Standard years of the late nineteenth century.

In any event, these data show that internationalization, as we have empirically defined it, is well under way: international transactions are of increasing importance in the world economy. No country can escape the effects of this dramatic change. But the degree of openness of a given economy depends also on national policy. It is still possible, at least temporarily, to insulate a country from the world economy, although the opportunity costs of doing so may be high. Cuba and North Korea illustrate this point. Moreover, the impact of the world economy on countries that are open to its influence does not appear to be uniform. Differences in factor endowments, group organization, national institutions, and the political strategies of leaders have all helped produce diverse national responses to common international trends. Understanding the effects of internationalization thus requires analysis of its impact both on policy preferences and incentives more generally, and also on political reactions of socioeconomic groups to its effects and the way that political struggles over openness are mediated by domestic institutions.