Paths of Policy Diffusion:
Institutional Legacies and the Diffusion of Capital Account Liberalization

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The 1990s brought a dramatic resurgence of capital flows to Latin America as governments reopened capital accounts following nearly a decade of isolation from global financial markets (Larraín 2000). Although international financial liberalization allowed such capital-scarce nations to overcome the limits of low domestic savings, stimulating consumption and growth, it also presented considerable challenges to their governments, including diminished monetary policy autonomy, currency appreciation, and monetary expansion and widening current account deficits. In addition to these potential dislocations, the long-term benefits of capital account liberalization remain highly contested as academic research has yielded contradictory findings in regard to the policy's overall effects, particularly on growth (e.g., Quinn 1997; Rodrik 1998). Indeed, this measure remains subject to controversy among scholars and practitioners alike (for the debate, see Eichengreen 2001; Eichengreen and Leblang 2003). Accordingly, a guiding question for research on capital account liberalization in developing countries has been to explain why such governments would choose enact this policy innovation?

An important stream of research on this question has emphasized external pressures on capital-scarce nations to attract investment or to conform to dictates of international financial institutions such as the International Monetary Fund (IMF) (e.g., Bartolini and Drazen 1997; Henisz et al. 2004). While such findings are consistent with the longer tradition of dependency research that views domestic policy choices as being constrained by external holders of capital, more recent research shows that the influence of international financial institutions is conditioned systematically by domestic politics (Chwieroth 2007a, 2007b; Mukherjee and Singer 2008). Other research focusing on international sources of domestic economic policy has emphasized the horizontal diffusion mechanisms of emulation, learning, and competition among peer nations that stimulate capital account liberalization (Brune and Guisinger 2003; Simmons and Elkin 2004) as well as other free-market reforms in developing nations (Brooks 2005; Meseguer 2005; Weyland 2005a, 2005b). Both streams of research, however, depart sharply from earlier studies of financial liberalization, which highlight the domestic coalitions supportive of financial integration (e.g., Frieden 1991; Helleiner 1994; Goodman and Pauly 1993). More recent studies have

also found a critical role for domestic political and economic sources of capital account liberalization in the developing world (Leblang 1999; Brooks 2004).

In this paper we attempt to close some of the distance between these divergent streams of research on capital account liberalization by examining how a crucial set of domestic political and economic conditions – specifically, the legacy of advanced import substituting industrialization (ISI) – may condition the diffusion of capital account liberalization in Latin America. We argue that it is difficult to understand the international diffusion of this economic policy choice without linking it to a domestic political economy of reform, for it is the latter that conditions the former. In doing so, we look for path dependencies both in the domestic political economy of reform, and as a factor conditioning cross-national diffusion processes. Our principal claim is that path-dependent forces shape the adoption of capital account liberalization through two distinct mechanisms. The first is the formation of domestic political coalitions of competitive (and potentially-competitive) export sectors and strong financial interests that press governments for partial liberalization of capital flows. The second involves the creation of *sub-regional* groups of nations sharing a common economic development 'path.' Nations with common ISI legacies should provide a more relevant source of policy cues and possibilities for learning from earlier experiences with capital account opening, for they share similar economic and interest group profiles.

We test our hypotheses against rival sources of diffusion in data on capital account liberalization in Latin America between 1985 and 2005. We find support for the expectation that channels of policy diffusion are themselves path-dependent, wherein countries are more likely to follow the lead of nations that are on a similar economic development path, namely, advanced import substituting industrialization. We also find that this is a learning process, as the most successful nations of the same trajectory are the sources of the greatest influence on subsequent adoptions. The domestic politics of capital account liberalization are also conditioned by the legacy of advanced ISI. In this realm, we find that governments on the right tend to adopt more liberal capital account policies, as do nations with more efficient domestic financial sectors.

Explaining Capital Account Liberalization

Early research on capital account liberalization brought important attention to the significant technological changes promoting the integration of global capital markets. Such innovations were found to make capital controls increasingly costly, if not impossible to maintain as offshore capital markets burgeoned (Andrews 1994; Goodman and Pauly 1993). Convergence on open capital accounts in the advanced industrial nations in the late 1980s seemed to confirm the inevitability of international financial integration, as domestic political and economic variables that once predicted movements toward liberalization receded in significance after the mid-1980s (Kastner and Rector 2003).

Yet, developing countries have defied this trend toward convergence on liberal capital account regimes, despite their movement toward greater openness to capital flows. Even though these countries had much to gain by importing foreign savings, developing nations throughout the 1990s generally maintained broader capital controls than the advanced industrial nations did (Brooks 2004; Leblang 1999). Such diffidence toward open capital markets has brought increasing attention to the array of vulnerabilities and costs associated with exposure to global financial markets for small and less diversified economies. Indeed, capital account liberalization forces governments into what is often a difficult tradeoff between monetary policy autonomy and exchange rate volatility, as surrender of the latter threatens to dampen both exports and private real investment in capital-scarce nations (Labán and Larraín 2000; Larraín and Vergara 1993; Caballero and Corbo 1989). Nevertheless, capital account liberalization has been upheld as a crucial policy means through which governments can attract foreign savings by signaling their commitment to market discipline (Bartolini and Drazen 1997; Haggard and Maxfield 1996).

As the imperative of attracting ever-more-footloose capital has risen in importance, less attention has been paid to the domestic political and economic interests affected by financial openness. In part, this approach may owe to the relative lack of salience of capital account policies for ordinary citizens who are hardly likely to engage in collective political action if they are uncertain about its implications (Chwieroth 2007b) particularly compared to more prominent and better-understood issues such as free trade (Brooks

and Kurtz 2007). Yet, even if, for example, shifts in nonremunerated reserve requirements may lack salience to the median voter, we should not expect decision to liberalize the capital account to remain altogether uncontentious or apolitical. For these policies impose direct and concentrated costs on what are often powerful, well-organized, and knowledgeable groups of interests. Accordingly, capital account policy should be subject to lobbying by elite actors with concentrated interests in financial openness.

Who is likely to lobby in support of capital account liberalization? In developing our expectations on this dimension, we take a path dependent approach by examining the coalitions of economic interests that have been generated by earlier economic development policies. The premise of this view is that the legacy of earlier policy choices will shape the costs and benefits of adopting an innovation in systematic ways that may prevent cross-national convergence in response to putatively similar incentives. Such a perspective has been central to the varieties of capitalism literature (Hall and Soskice 2001; Hays 2003) and to the post-communist transition research (Kitschelt 1999). Even research on diffusion has begun to incorporate path dependencies into this perspective by showing how patterns of innovation may be conditioned by the legacies of earlier policy decisions (Kopstein and Reilly 2000; Mazzoleni 1997). The next section develops our argument and expectations on these dimensions.

Institutional Legacies and the Diffusion of Liberalization

The key to sorting out the patterns of societal interests that should emerge around capital account liberalization, we expect, is to examine the sectoral interests arising from earlier patterns of state intervention. Import-substituting industrialization (ISI) was among the most far-reaching economic transformations to emerge in Latin America over the 20th century. In various forms, this development model left few if any Latin American countries untouched by conscious efforts by the state to stimulate the production at home of industrial products that had previously been imported. As early as World War I, the interruption of traditional patterns of raw material export and shifts in relative prices of imported consumer goods altered the profitability of domestic investments in manufacturing in some of the larger Latin American economies (Baer 1972). Although typically treated as a coherent development model, ISI

in fact issued from very different origins and took a variety of forms throughout the region (Hirschman 1968). And ISI programs were carried out to starkly-varying degrees across Latin America. In most cases, however, ISI involved state interventions aimed at protecting infant industries such as through the establishment of import tariffs and barriers. It also entailed an array of financial measures to channel investment and credit to domestic industries, including selective foreign exchange rates and bank credits, as well as controls over interest rates (Buttari 1992: 181).

Significant variations in the nature of ISI efforts across Latin America were apparent by the 1970s and 1980s, however, as industrialization processes moved variously to the 'deepening' stage. While some industrialization efforts stalled, other countries made the difficult shift toward the development of capital-intensive manufacturing, including capital goods and consumer durables; some even shifted toward the export of higher value-added products. The importance of competitive exporters and more developed financial systems in Latin America is typically overlooked in the hoary dichotomy that is often drawn between ISI and export-oriented development in the region (e.g., Bair and Gereffi 2001). Indeed, Latin America's experience was prominently depicted as having been almost-universally characterized by an anti-export bias and extensive inefficiencies in domestic industries (Baer 1972; Edwards 1995). Yet, many Southern Cone countries began to move toward export strategies as early as the mid-1970s. Indeed, Rodrik (1999:71) has shown that inefficiencies were not economy-wide, and in some cases globally-competitive exporters were cultivated precisely because of ISI policies; this was, after all, their original goal (Prebisch 1959).

Just as there were significant continuities in the political basis of early ISI and the shift toward export-led growth in Asia (Haggard et al. 1991: 851), ISI and export-oriented manufacturing initiatives also were not strictly antinomical in Latin America. Indeed, exchange rate management was as important as protectionism *per se* in this regard. This is because Latin American governments retained a significant role in the allocation of resources to promote certain national industries even as trade liberalization advanced (Kurtz and Brooks 2008). Political alliances with business that were cultivated in the advanced stage of ISI to produce competitive exporters thus were not necessarily disrupted following the debt crisis

and liberalization processes in the 1980s; instead, they were reconstituted around the promotion of export and the selective liberalization of trade and capital flows.

The expectation that beneficiaries of state-led industrial promotion would become proponents of financial liberalization may be contentious, however, since the beneficiaries of protection are typically considered to be opponents of economic liberalization (Krueger 1974). Indeed, economic research has emphasized the opposition from entrenched firms to economic liberalization (Morck et al. 2000; Rajan and Zingales 2003). Nevertheless, there is good reason to expect some recipients of state protections to lobby for capital account liberalization. Frieden (1991), for instance, found that certain beneficiaries of ISI were not strictly opposed to international financial integration, even though they were owners of a scarce domestic factor. Likewise, we expect sectoral interests to emerge around capital account policies, with the effect of driving a wedge between, on the one hand, workers and owners in competitive exporter sectors, and those in uncompetitive or untraded sectors.

Important research on capital account liberalization has taken a different approach by embracing the relative factor abundance to predict the formation of domestic coalitions around integration into the global economy (e.g., Quinn and Inclán 1997). Drawing upon the Heckscher-Ohlin-Samuelson model, this view holds that interests in liberalization are predicted by the relative factor proportions in the domestic economy: owners of a relatively scarce factor should benefit from closure to the global economy, while owners of the relatively abundant domestic factor should benefit from liberalization. In capital-scarce nations, owners of capital thus should be opponents of liberalization. Indeed, there is a rich literature on Latin American political economy that points to the opposition to liberalization by protected financial sectors. But this model rests on the crucial assumption that workers and capital are homogenous and move costlessly between industries (and that these interests are both clearly understood and acted upon). If these conditions do not hold, then the Ricardo-Viner model of sectorally-defined interests may be more relevant (Alt and Gilligan 1994; Hiscox 2002; Shambaugh 2004).

There are several reasons to anticipate that sectoral, rather than factor-based, interests will emerge around capital account policies in countries that pursued advanced ISI. For one thing, such countries often

cultivated competitive export industries in higher value-added product markets that required very specific capital investments. Although factor mobility is typically high at early stages of industrialization when technology is quite basic and labor is low-skill, at later stages of industrial development, interindustry mobility tends to decline as the use of higher technologies demands more specific human and physical capital investments (Hiscox 2002:10). As Frieden observed, "A firm producing turbines for a Venezuelan hydroelectric power plant is likely to have a larger proportion of its assets tied up in things specific to this use than a firm producing men's clothing or bricks." (1991:22). Indeed, high interindustry wage differentials – a key indicator of low factor mobility – are characteristic of advanced ISI countries such as Brazil, which cultivated a competitive export sector through state-led industrialization efforts (Arabache 1999). Accordingly, the emergence of distinctive sectoral interests should generate a sharp divergence among the capital account policy preferences of competitive export sectors and domestic traded and non-traded interests, with the former actively promoting some degree of international financial liberalization.

The internationally-competitive export sectors in advanced ISI countries should consist of cross-class coalitions of workers and owners of capital that stand to gain concentrated benefits from liberalization (e.g., Armijo 2001; Schamis 1999: 242). And because these groups were cultivated through government-directed sectoral policies, they should similarly expect to promote their interests in the open economy through pressure for government privileges. Indeed, governments in Latin America remained very much involved in industrial promotion during the shift toward export orientation in the 1980s and beyond (Schamis 1999). Many of these interventions, however, simply took a different form as tariff barriers were dismantled than they had under the closed economy. With liberalization, export promotion came to revolve around supply-side policies such as the allocation of credit and subsidies rather than traditional tariffs (Schrank and Kurtz 2005; Kurtz and Brooks 2008). In Mexico, for instance, the government-supported export sector claimed an array of targeted benefits even as imports were liberalized. These included concessions on imports, protections and preferential credit, which resulted in a sharp rise in exports of auto, glass, steel and cement. As Schamis (1999) has shown, moreover, by the late 1980s these industries began to lobby for partial opening of the capital account. In turn, powerful

manufacturing interests may have provided critical political support for governments embracing liberalization, countervailing the protectionist impulses of import-competing firms (Armijo 2001:10).

Competitive export industries seeking capital account liberalization may also include multinational corporations (MNCs) based in developing countries that emerged from government-supported ISI efforts. Yeung found, for instance, that participation of developing-country MNCs in the global economy increased significantly in the 1980s, when their "organizational capabilities were much more consolidated and their home governments were serious about growing 'national champions'" (1999:4). Liberalization of the capital account may be attractive for such firms not only as a way to promote diversification, but also because capital controls raise the cost of borrowing in the local market (Desai et al. 2006:1434). For domestic industries that rely on joint ventures with foreign MNCs, moreover, capital controls may be particularly costly as such restrictions may have a dampening effect on the attraction of foreign direct investment (Desai et al. 2006). And for some industrializing countries, the attraction of FDI played a central role in the development of a competitive export sector, especially in the capital-intensive energy sectors (Birch and Halton 2001:18). Local manufacturers for whom the combination of currency appreciation and high borrowing costs undermined competitiveness also face strong incentives to lobby for capital account liberalization.

It is important to note that capital account liberalization, while often treated as a coherent policy, entails diverse measures that may differentially affect the inflow or the outflow of capital. In response to fears of real exchange rate appreciation, for instance, countries such as Brazil, Chile and Colombia imposed controls on capital *inflows* in the early 1990s (Edwards 1998:25). But the same concerns also pointed in the contrary direction – toward the liberalization of capital outflows, which some observers in the early 1990s hoped would dampen the appreciation of domestic currencies (Larraín 2000). For this reason Colombia liberalized outflows in 1992 following a surge of inflows in 1991 (Labán and Larraín 2000: 22-23). They did so by extending the liberalization of export surrender requirements to all exporters, by allowing local agents to hold offshore stocks (up to a limit), and by easing restrictions on the provision of foreign loans. Even in the context of restricted inflows, therefore export sectors may

advocate a shift toward liberalization of outflows, allowing domestic firms to diversify assets and protect capital from inflation or taxation (Frieden 1988, 1991; Schamis 1999: 243). This may simply entail allowing local agents to diversify assets abroad, or it may involve removing restrictions on the repatriation of profit on capital for foreign investors – therein providing incentives to attract FDI to high-end manufacturing export sectors. Or, capital account liberalization may entail allowing exporter to keep a larger fraction of export earnings, phasing out strict surrender requirements with the central bank (Labán and Larraín 2000:22).

Overall, we expect export-oriented manufacturing sectors that are cultivated through advanced ISI efforts to support at least partial capital account liberalization, though not wholesale liberalization. For rapid inflows associated with full removal of barriers to capital movements should threaten export competitiveness if such liberalization results in a rapid appreciation of the currency. Instead, modest capital account liberalization, and in particular of outflows or of certain long-term capital inflows, such as to promote foreign direct investment, should be the target of lobbying by labor and capital in competitive export sectors.

Diffusion Mechanisms in Capital Account Liberalization

In addition to the emergence of sectoral interests that may promote capital account liberalization, interdependent decision-making forces should play an important role in reform decisions. We expect diffusion to be important here for several reasons. For one thing, capital account opening a potentially costly measure and its effect on the domestic economy is likely to be uncertain. Uncertainty, in turn, should raise the importance of information drawn from previous innovation decisions (Brooks 2007) while also encouraging decision-makers to look for models to emulate in order to legitimate this policy choice (DiMaggio and Powell 1983). Scholarship on the diffusion of capital account liberalization, moreover, has yielded strong evidence of each of the principal diffusion mechanisms – coercion, competition, emulation and learning – in capital account liberalization across nations (Brune and Guisinger 2003; Chwieroth 2007a; Henisz et al. 2004; Simmons and Elkins 2004; Simmons, et al. 2006).

While embracing the importance of this research, we seek to re-examine these diffusion mechanisms through the lens of path dependence. In particular, we ask whether the legacies of prior economic development models may systematically condition the channels through which policy innovations such as capital account liberalization diffuse across nations. In this sense, path dependence should help explain both the continuities in institutional designs within each country, and to the extent that economic development 'paths' are shared by some nations, we expect to observe continuities across nations as well in the decision to adopt an innovation.

This may happen first through emulation processes. Emulation involves the social construction of appropriate behavior on the basis of relevant 'peer' nations, including the following of prominent states (Lee and Strang 2006; Swank 2006; Weyland 2005a, 2005b, 2008). The process of emulation does not seek to resolve specific problems, such as identifying the most appropriate or successful policy; instead, it has other goals such as the achievement of higher status and international acceptance (Meseguer 2005). Common economic policy legacies may establish a set of specific 'peers' whose shared domestic economic configurations provides a more relevant model to emulate. Such "mimetic isomorphism" has been shown to be strongest where social contact is strongest, and among countries that share common cultural ties (Brune and Guisinger 2003; Simmons and Elkins 2004). This makes Latin America a very likely region within which to find such closely-tied diffusion processes.

Yet, there is reason to expect more than a process of simple mimicry to be involved in capital account liberalization. Where the stakes in adoption of a policy innovation are very high and the potential costs of the innovation's failure are great, as in this case, governments may be expected to weigh the experiences of relevant peers with the goal of discerning whether a given policy is likely to be appropriate and successful in their country. Policy makers thus should take into consideration the chance that reform will be successful when evaluating the merits of costly policy changes (Braun and Gilardi 2006). Thus for high-stakes policies such as opening a nation's economy to cross-border capital flows, the mechanism of policy learning is likely to be relevant. Learning involves the incorporation of information about a policy into the formation of beliefs about its application at home. This information may be positive or negative:

it may involve learning from the successes as well as the failures of relevant peers. In the case of positive learning, we should expect that governments are likely to enact a policy in which previous adopters have achieved success following its implementation (Meseguer 2004, 2005; Braun and Gilardi 2006; Volden 2006). It is also possible that policy failures provide crucial information for policy makers about what measures they should avoid. In such cases, we should expect government actors to be not only attracted to success, but also systematically less likely to enact a policy that is associated with failure. Whether policy makers respond to success or failure, evidence of learning from the experiences of relevant earlier adopters should be distinguishable from more generalized emulation insofar as adoption decision are tied directly to the broader economic performance – positive or negative – that follow from the adoption of an innovation among earlier peer adopters. Notably, this type of learning differs from the bounded learning that Weyland (2005a, 2005b, 2008) proposes, in which certain sources of information about the success of a policy would be weighed more heavily than others. Weyland (2008) found that, consistent with prospect theory, social sector reform in Latin America was governed by certain cognitive biases, such as the tendency among policy makers to accord greater weight to the experience of Chile than rational learning theories would predict. We do not expect there to be a specific country that should be more 'representative' of lessons about capital account liberalization in Latin America. And where there is a bias in the types of lessons from which policy makers learn – such as from success only, rather than success and failure –these differ from the "logically arbitrary factors" associated with cognitive heuristics such as availability, representativeness, and anchoring (Weyland 2005a: 282-3).

The basic contention of this study is that the importance of these 'horizontal' diffusion mechanisms is mediated by a crucial domestic variable, namely, the existence of common development 'paths' within Latin America. Accordingly, in defining the group of countries from which Latin American governments should learn, we expect to see a divergence in the pathways of policy diffusion according to the legacies of distinctive ISI development legacies. In this sense, we argue that the mechanisms through which this policy innovation diffuses should be path dependent (as in Mazzoleni 1997; Kopstein and Reilly 2000). Indeed, common legacies of advanced import substitution delimit a set of peer nations that

share similar domestic economic and political landscapes. We expect these common development paths to be more relevant than common linguistic or cultural contexts in resolving uncertainty about the likely success of capital account liberalization. Of course, competitive concerns may also be relevant, as the more developed countries in the region may view other advanced-ISI nations as competitors for direct investment or in specific export markets. Where one advanced industrializer liberalizes capital outflows, therefore, the opportunity costs of maintaining capital controls in a similarly-situated nation thus should increase. The common policy legacy in both instances defines both a set of 'relevant' nations from which to draw lessons about the value of a policy, and should define a set of direct competitors for cross-border capital flows.

In the next section we test the expectation that countries that followed advanced ISI are more likely to borrow from other nations that followed the same development path, all else being equal. We also examine whether such legacies condition the operation of coercive, emulation and both positive and negative learning diffusion mechanisms while controlling for key domestic political and economic correlates of capital account liberalization.

Empirical Strategy and Data

We propose an empirical evaluation of three theoretically very distinct phenomena as they affect the liberalization of capital controls. First, we examine whether – and more importantly *when* and *through what mechanism* – processes of international diffusion are important in determining this economic policy change. Second, we examine whether historical legacies from an earlier era of inward-looking industrialization have long-term consequences for choices about openness to capital flows, and finally how the latter are reflected through contemporary interest groups *and* through their effect on the international diffusion process.

Dependent Variable. Our measure of capital account liberalization is taken from Chinn and Ito (2007). In this measure, the extensity of capital controls based on the information from the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER) where the reported value is the first standardized principal component for four indicators of capital account regulation: the use of

multiple exchange rates, restrictions on current and capital account, and the compulsory turnover of export receipts. A higher value on this index indicates a more open capital account. We use data for Latin America from 1985-2005.

Diffusion Variables. In keeping with recent approaches to the study of international diffusion, we treat the diffusion process as a subspecies of spatial autocorrelation. Rather than considering the contemporaneous correlation among countries with respect to a policy outcome as an econometric nuisance that must be managed, we opt to model it in alternative theoretically-relevant ways. This method explicitly models diffusion forces as the weighted average of the outcome variable – here, capital account liberalization – in each government's 'neighborhood' (Simmons and Elkins 2004: 178), where neighbors are defined not simply in geographic terms, but rather on the basis of other sources of conceptual proximity (Beck et al. 2006). Central to this, of course, is the construction of a matrix of weights that specifies the influence that diffusion effects from each sending country will have on the recipient. These weights will be quite different depending on the diffusion mechanism being studied, affording the ability to answer the question *how* does peer behavior affect policy choices, rather than simply testing whether or not it does.[1]

As a general strategy, our empirical approach is thus to estimate a series of models of the general form:

$$\mathbf{Y} = \rho\mathbf{WY} + \mathbf{X\beta} + \boldsymbol{\varepsilon}$$

In this case $\mathbf{Y}$ is an NT × 1 vector of the dependent variable, $\mathbf{W}$ is a matrix specifying the spatial weights (which is in some cases N × N if the weights are time-invariant, and in others NT × N, if they are time-varying).[2] The diagonal of this matrix is set to zero, such that it reflects only diffusion effects from

[1] And since it is entirely possible that multiple channels of diffusion can operate at the same time, it will be important to make allowances for this in model estimation. For each of our analyses, panel corrected standard errors are employed to minimize the effect of contemporaneous correlation in the errors not captured by the specific diffusion pathway under examination.

[2] The difference hinges on the nature of the diffusion process that is being studied. Were geographic proximity the dimension in question, then naturally the weight matrix would be time-invariant (barring changes in the physical boundaries of states). By contrast, if the theory of interest posits, for example, mimicry of the current best-performers, then the weights would change with each period. Examples of both are found in this paper.

other countries. This is then multiplied by the vector of the dependent variable, **Y**, to produce a vector that contains the weighted sum of peer-effects for each observation – that is, the diffusion variable (or spatial lag), whose strength is summarized by the parameter ρ. The **X** matrix is an NT × K matrix of K independent variables, and **β** is its associated K × 1 vector of coefficients. In some cases a further analysis will proceed by examining the possibility of a *conditional* spatial lag (i.e., conditional diffusion) – in which case **WY** would be further multiplied by a variable specifying the subset of observations for which diffusion is hypothesized to be operating.

Crucial in this exercise is the specification of the spatial lag, and thus the content of the **W** matrix (Franzese and Hays 2007). Our strategy is to create a series of matrices that operationalize the principal alternative mechanisms by which diffusion of economic policy choices is thought to occur across countries: coercion, emulation and learning. In the simplest specification, where all countries in the regions equally form the peer group from which policy is thought to diffuse, this matrix would be constant, and all off-diagonal entries would be identically one, with the diagonal being zero. This variable [*Region*] tests the baseline expectation that decisions made anywhere within the region in the prior period should influence subsequent capital account liberalization decisions in Latin America.

A second specification posits diffusion as a function of likeness (i.e., emulation) – in this case in terms of level of development [*PeerGDP*]. For this, the weight assigned to diffusion from $country_j$ on $country_i$ is calculated as:

$$\frac{1}{n-1}\left[1-|wealth_i - wealth_j|\right], for\ all\ i \neq j; 0\ for\ all\ i = j$$

Wealth here is measured as gross domestic product per capita, normalized for all countries to the [0,1] interval based on the lowest and highest values found in the data.

A third approach considers the possibility of diffusion-through-coercion from international financial institutions. In this case, the weight matrix is time-varying, and indicates diffusion pressures emanating from the set of peers defined by those who at any point in time have agreements in force with

the International Monetary Fund [*IMF*]. We use updated data from Vreeland (2003), which now runs through 2004, to code countries 1 for years in which they have entered into an agreement with the IMF, and 0 for other years. With this variable we test two hypotheses: The first is the simple coercion argument that capital account liberalization is imposed on many countries from a common source, *viz.*, the terms imposed by IMF agreements (Chwieroth 2007a). We also test a second hypothesis, however, that governments are subject to peer influence on capital account only from other countries that have signed agreements with the IMF, as opposed to those who are noncompliant or uninterested in agreement with the fund, whose governments should be less inclined to move in this direction. This allows an empirical effort to parse out the direct effects of participation in IMF programs from the diffusion effects as well as the domestic political and economic correlates of this reform (Mukherjee and Singer 2008).

Our fourth model evaluates the hypothesis that diffusion processes are based on learning from successful and unsuccessful adopters of the innovation (Braun and Gilardi 2006; Meseguer 2005, 2004). In this set-up, a time-varying matrix weights the effects of peer countries based on relative antecedent economic performance (the difference in growth rates). Our first learning variable [*Success*], assumes that no learning effects emanate from countries whose economic performance is less than that of the country in question, and weights the effect of other peers based on the degree to which their performance exceeds that of the case at issue. A second variable probes a more complex form of learning, where information from success and failure alike are used to arrive at policy decisions. This variable [*Learning*] assumes that where the economic performance of previous adopters is worse than the country in question, the likelihood of policy adoption diminishes systematically, while at the same time the likelihood of adoption increases in countries where growth rates are higher than the reference country.

Finally, we consider the effect of historical legacies as they interact with diffusion processes. The hypothesis here is that if there are path dependencies in economic reforms in the region, then countries will tend to borrow policy initiatives only from those neighbors who are on the same developmental trajectory. For us, the critical factor here is the legacy of advanced import-substituting industrialization [*ISI*]. To this end, a weight matrix was constructed that selected as peers all those countries that had

proceeded to the deepening of ISI by 1980.[3] Further, in estimating the effect of diffusion from this set of countries, interaction terms were utilized to examine its effects only on other countries proceeding from the legacy of advanced ISI. In this way the potential effects of the legacy of advanced ISI could be examined, in conjunction with the possibility that this would render a domestic political system amendable to the diffusion of policy ideas from similarly-situated countries out of a process of mimicry or cooperation.

Domestic Political and Economic Variables. We include in our analysis measures to capture the legacy of advanced import substituting industrialization, and the principal domestic correlates of capital account opening. In the first instance, we include a variable that is based on the manufacturing value added as a percent of GDP in 1980. Where manufacturing accounted for a higher share of national income in 1980, ISI is likely to be most advanced. Our legacy variable [*ISI*] thus codes countries with higher than the median valued added in manufacturing as a share of GDP 1, and 0 otherwise.

Changes in capital account policy have been shown to vary systematically with the partisan stripe of the government (Quinn and Inclán 1997; Li and Smith 2002; Kastner and Rector 2005; Brooks 2004; Leblang 1999). We thus control for partisanship using a three point measure that codes left-wing government leaders as 0, centrist governments as 1, and conservatives as 2 [*Partisanship*]. This variable is taken from the *Database of Political Institutions* (DPI), 2004 update). [4]

The distributional cost of capital account liberalization in the domestic economy also has been found to matter (Mukherjee and Singer 2008). And thus the domestic politics of capital account liberalization have been found to be influenced by concerns for ex post blame avoidance for the distributional costs imposed by this reform (Brooks and Kurtz 2007). In this view, capital account liberalization should be more politically palatable where legislative authority is more broadly dispersed.

[3] Specifically, a country is coded as having an advanced ISI legacy if the ratio of manufacturing output to GDP in 1980 exceeded the group median.

[4] An alternative analysis, relying on a dichotomous coding of left vs. non-left executives produced very similar results. We incorporate the updates to the dataset indicated by Keefer (2005), and also corrected an error in the coding of the Chilean case, so that it now properly considers the two post-transition Christian Democratic governments centrist, while the two Socialist executives are recoded as left-wing. Inexplicably, all post-transition Chilean governments had been coded as right wing in the database. The dataset is described in Beck et al. (2001).

We measure legislative fragmentation through the Herfindahl index [*Fragmentation*] as reported in the *Database of Political Institutions* (Keefer 2005). This index, which runs from zero to one, takes on lower values for maximum fragmentation and takes on higher values for complete unity.

We also include controls for domestic economic variables that are likely to be associated with capital account liberalization. The first is the interest rate charged by banks on loans to prime customers minus the interest paid by commercial or similar banks for demand, time or savings deposits. This variable [*Spread*] is a standard measure of the efficiency of the domestic financial sector as it indicates the margin between the cost of mobilizing liabilities and the earnings on assets (Daniels 2004). As the difference between the cost of mobilizing liabilities and the earnings on assets spread declines, the domestic financial sector is said to be more efficient, lowering the transaction cost of investment and making it more likely that the domestic financial sector can cope with international financial liberalization. Indeed, the structure of the domestic financial sector has been found to be an important predictor of capital account liberalization (Leblang 1999). Data for this variable are from the 2008 *World Development Indicators*.

We also control for macroeconomic growth [*Growth*] and the size of the economy, which is taken as the natural log of gross domestic product [*lnGDP*]. We control for national wealth, which is measured as the natural log of GDP per capita [*lnGDP/capita*], and for the level of indebtedness of the government [*Debt Ratio*], which may act as a constraint on liberalization (Brooks 2004). International incentives to liberalize capital controls also have been closely associated with international interest rates as changes in global liquidity have been shown to account to a substantial share of the surge in capital flows to Latin America in the 1990s (Calvo et al. 1993). Accordingly, we control for the U.S. Federal Funds rate [*USRate*], a key benchmark of international liquidity, in our specifications of the empirical model. Finally, we include a measure of the size of the current account deficit [*Current Account*], which may account for the incentives to liberalize the capital account in order to finance a growing trade deficit.

Empirical Model. Our estimation strategy implies a pooled cross-sectional time-series analysis. We employ panel corrected standard errors to account for any remaining spatial autocorrelation not

captured by the specific diffusion process that is being examined, and we correct for first order serial correlation in the error terms. Our models also contain controls of a linear time trend as well as unit fixed effects, with exception of analyses that include time-invariant factors (most notably, historical legacies), which would naturally be incompatible with a fixed effects specification. In these instances a random effects model is employed.

Our empirical approach utilizes data on the Latin American region from 1985 through 2005. While in principle the analysis could be conducted on a global sample, we have elected to retain the regional and temporal emphasis for several reasons. First, diffusion research has found considerable evidence of systematic peer effects that operate through at the regional level, as well as among nations that share cultural legacies (Brune and Guisinger 2003; Quinn 2003; Simmons and Elkins 2004; Brooks 2005; Gleditch and Ward 2006). Indeed, the Latin American region suffered a shared shock – the debt crisis of 1982–83 – which brought the issue of capital account liberalization to the political agenda in all the Latin American countries at roughly the same time. The same would not be true, however, in a global sample, introducing the possibility of causal heterogeneity in such data. Similarly, it is widely acknowledged that the debt crisis induced a sea change in economic policy-making throughout the Latin American region, and that as a consequence the causal factors that underpinned changes in capital account regulation in the pre-debt crisis era were almost certainly different from those that obtain thereafter. By controlling for the common heritage and regional effects, moreover, we hope to capture more precise sub-regional diffusion patterns theorized above.

Restricting our data to Latin America, while on balance useful, does come at a cost. Naturally the external validity of our results cannot be established, nor can certain particular mechanisms of diffusion (e.g., cultural similarity) be examined meaningfully; and others, such as wealth, will have a somewhat attenuated variation. But it does simplify matters in terms of the commonly cited sources of external pressure: the relevant international financial institutions (IMF, IDB, etc.) and the regional hegemon are basically the same across countries in the region. On balance, we think the regional focus is thus

appropriate for a direct examination of both shared historical legacies and specific mechanisms of international policy diffusion.

Results

Diffusion in the simplest sense is the communication of an innovation through certain channels among members of a social system (Rogers 1995). It is the determination of those channels, and the conditions under which they matter, however, which is the critical aim of our research. For there is little doubt that international and interdependent forces were at work as capital account liberalization spread throughout Latin America after the debt crisis. Were a straightforward process of emulation to explain this outcome, such an approach would suggest that the *collective* wisdom of other countries in the region (as summarized by their average score on this policy choice) would systematically influence national policy making for liberalizing nations. In other words, the trend itself would be the source of subsequent decisions to liberalize international capital flows rather than any specific piece of information about those reforms that would help decision makers discern the merits of the policy.

As a starting point for our analysis, we examine this possibility in Table 1. The idea here is to assess whether – net of domestic political considerations, trends and fixed national differences – diffusion from (all) the other countries of the region is a likely cause of capital account policy choices. We do not claim that this is in any sense a "complete" model; rather, we seek only to see whether this very simple, and common, approach is empirically appropriate to capture basic interdependent forces in capital account diffusion. As the results in Table 1 show, however, the region-wide trend is not the likely mechanism by which capital account reforms diffused in Latin America. While capital account openness responds predictably to executive partisanship (more conservative governments are more open), economy size, and wealth, there is no measureable impact of emulation, or the average of one's regional 'neighbors' decisions on one's own economic policy choice. There is evidence, however, of a *vertical* diffusion mechanism whereby governments that in the previous year were under IMF agreements are systematically more likely to enact capital account liberalization. Thus we do find evidence supportive of

a coercion hypothesis whereby a common external source – here, the IMF – rather than country-to-country diffusion, explains the regional pattern of adoption of a similar policy model.

Naturally, such a result is far removed from an ultimate contention that peer diffusion is of little importance to choices about capital account regulation. But it *does* suggest that attention needs to be squarely be placed on the questions of what *type* of peer diffusion process(es) might operate, under what *circumstances*, and in *conjunction* with what characteristics? In other words, more precise measures of the channels of horizontal diffusion are needed, as is closer analysis of the conditions under which those forces matter. It is here that we next proceed, testing first whether peers that are emulated are defined more specifically as nations of a similar level of wealth. We also test whether or not learning is mediated only by prior 'successful' adoptions of this innovation (i.e., where the diffusion of policy choices is based on information only from more rapidly-growing countries) or whether learning is governed both by lessons from successful and unsuccessful liberalizers (i.e., more and less-rapidly growing economies). Then we examine whether the horizontal diffusion effect of IMF accords remains significant in the presence of distinct horizontal diffusion measures. Finally, we shift gears in Table 3 and consider the prospects for policy diffusion as they are shaped by the historical legacy of advanced import-substitution development in the pre-debt crisis era. There we test a joint hypothesis: that on the one hand the historical path matters a great deal, and on the other, that diffusion processes will operate *only* among countries following the same basic developmental trajectory.

In Table 2 we examine several alternative, more specific channels through which horizontal policy diffusion may occur. In column A we examine whether or not peer emulation is at work, weighting the effect of peer countries based on their similarity in the level of development. Here we find results that broadly confirm earlier work focusing on domestic politics and economic conditions, such that higher levels of capital account openness are associated with conservative executives, and with lower levels of external indebtedness (relative to GDP). But there is no evidence that policy-makers are markedly influenced in their choices by similarly-developed peers in the region. So far, at least, the story continues to be one essentially confined to the realm of domestic politics and political economy.

In column B, we turn to the consideration of the role of the IMF. Typically, this is achieved by considering only the generic relevance of coercive pressure from the IMF as in Table 1; that is, whether or not having an agreement in place produces higher levels, on average, of capital account openness (see however, Chwieroth 2007a; Mukherjee and Singer 2008 for conditional effects of IMF programs). Here we add to this focus the question of whether the IMF might – in addition – facilitate international diffusion. In other words, it is arguable that pressure from the IMF might induce host governments to engage in foreign learning, in addition to encouraging changes through direct pressure in the course of negotiating loan conditionality. The empirical evidence suggests that while the presence of an IMF agreement in the antecedent year is associated with higher levels of capital account liberalization (though it is a comparatively small substantive effect), it is not a factor that opens up countries to peer diffusion. When the presence or absence of such an agreement is interacted with the spatial lag (the average level of openness of peers in the antecedent period), there is no evidence of either a direct diffusion effect or a change in effect for those countries subject to an IMF agreement in the year in question. While, thus, international pressures here clearly matter, they don't seem to be operating through a peer network. Nor does international liquidity appear to be a relevant factor in capital account diffusion processes, as our control for US interest rates continues to be insignificant across model specifications.

A third general form of diffusion involves neither broad-based emulation, nor IMF-induced coercive adoption of peer economics strategies. Instead, one might expect that if political leaders are inclined to borrow costly and potentially quite risky innovations such as capital account liberalization from abroad, this might involve a learning process. In particular, decisions about the likely success of the policy in their home country may be informed by the use of information drawn from prior successes with this innovation. In this view, one learns from those who are successful, rather than simply from those who are similar (Meseguer 2004, 2005; Braun and Gilardi 2006). In column C we examine whether the empirical evidence is consistent with such a learning-from-success process, as we weight the effects of peers' policy choices by the degree to which their growth performance exceeds that of the country in question (and setting the diffusion effect emanating from countries that perform less well to zero). Once

again, however, the evidence is against diffusion processes. While the domestic political variables perform as expected – and in a fashion consistent with the earlier models – there is no evidence that there is a 'follow the leaders' dynamic in policy toward the capital account, at least in this specification. Nor does our more complex learning variable provide insight into diffusion patterns in Latin America. Column D includes the learning measure where governments can draw lessons from positive *and* negative performance following capital account liberalization. This learning variable likewise is insignificant, suggesting that the diffusion of capital account liberalization defies a strict performance-based pattern of adoption in Latin America.

At the outset, of course, we argued that studies of economic policy diffusion – at least in the Latin American region – should take account of the historical legacies that simultaneously shape domestic politics as well as channel diffusion's effects. In Table 3 we proceed to do this. There are several changes in this set of models that are of importance. First, we continue the examination of whether or not policy diffuses from best-performers in the region, but we now condition this as well, to ascertain whether or not such a process occurs only among the set of countries on the same economic development trajectory.[5] The theoretical justification for this is twofold. On the one hand, countries on the same developmental trajectory (as a historical legacy) face substantially similar challenges and opportunities from the liberalization of capital flows, and as such the cost-benefit dynamics may be quite distinct from countries that lack such a legacy. Policy-makers thus may consider same-trajectory states as fundamentally more 'similar' models from a policy-borrowing perspective. Put simply, leaders in Brazil are far more likely to see Mexico as a peer in economic strategy terms as they are to see El Salvador in that light. And within this set, of course, learning would favor high-performers. Secondly, as we posited earlier, deep ISI transforms the domestic political economy in ways that are endogenously favorable to capital account liberalization. This policy legacy, critically, should operate as a separate matter from the mechanism of learning from foreign experiences.

[5] As discussed above, we distinguish between those countries that achieved fairly advanced (and deepened) levels of import-substituting industrialization from those who only pursued the initial, easier phases of this economic strategy.

The results are quite striking. In Table 3, we see that that the direct effects of peer-policies (weighted by relative growth performance) are indistinguishable from zero. By contrast, conditional on sharing a similar developmental trajectory – that of deep ISI – the evidence suggests a substantial role for international diffusion among advanced-ISI nations. The coefficient on the interaction is positive and significant, both in the statistical and substantive senses. Importantly, there is a strong direct effect of the ISI legacy itself – and it is very likely that domestic and international politics of diffusion are here deeply entwined.[6] The control for the presence of an agreement with the IMF – which we found above to be a relevant, if not very substantial, predictor of capital account openness – remains associated, as expected, with a liberal policy outcome. The complex learning variable, by contrast, where lessons from positive and negative growth experiences are recorded, remains insignificant in its interaction with domestic policy legacies and thus we do not report this result in Table 3. Learning about capital account liberalization in this case thus is driven more powerfully by the positive lessons from nations following a similar development path of advanced import substituting industrialization, rather than by an effort to avoid the failures of peer nations.

As we begin to unpack the 'black box' that is, so far, the ISI pathway, we hypothesized that a fairly well developed, even if previously protected, financial sector will tend to favor capital account liberalization. We thus introduce a measure of the efficiency of the domestic financial sector: the spread between borrowing and lending rates in the domestic economy. Where this spread is high, the financial sector is inefficient, uncompetitive, and performing relatively little intermediation. Where the spread is low, which in many cases occurs even in quite protected markets, the financial sector is considered to be more efficient, and in our account likely to favor liberalization.[7] The results are very consistent with this

[6] A simple example serves to make this point. When domestic interests lobby for capital account liberalization because, for example, it lowers their cost of capital and thus enhances their profitability, then this is a domestic political economy explanation. But when they engage in the same lobbying because, having observed the cost-structures facing their international competitors, they note that others have more open capital accounts and thus lower cost structures, then they contribute – even as domestic actors – to a diffusion process.

[7] One might be tempted to suggest that a high spread implies a closed capital account and a repressed finance sector, while a low spread implies external openness. This does not follow at all. While openness may well reduce interest rate to international levels, it says little about the spreads – especially since oligopolization is as possible through

expectation, implying that domestic financial interests play a role in addition to that of the large manufacturing sectors captured by the ISI variable, although both are likely consequences of advanced ISI.

Conclusion

Even if governments act strategically when faced with the decision to adopt a policy innovation, the legacies of earlier development choices may systematically alter the payoffs of this choice in ways that systematically alter patterns of diffusion across nations. We have argued that the experience of advanced import substituting industrialization provided a crucial domestic institutional legacy that conditioned patterns of capital account liberalization in Latin America both through the domestic political economy, and by shaping patterns of cross-national diffusion. In the first instance, we have argued that the formation of political coalitions of competitive export sectors that support capital account liberalization in advanced ISI countries should generate pressures for partial liberalization, such as of capital outflows, while in the international realm the shared legacy of advanced ISI delimits specific channels of learning and emulation through which sub-regional peer groups have formed, altering pathways of capital account liberalization in Latin America.

The results of our analysis are preliminary, but encouraging. We find a significant effect of domestic institutional legacies shaping both the channels through which innovations diffuse through a social system, and directly through which earlier policy choices constrain subsequent economic reform options. In this sense, the analysis suggests that even as the established mechanisms of diffusion continue to be important, they operate within a set of bounds defined by the legacies of earlier government policy choices. Governments still respond strategically to contemporaneous opportunities to learn from abroad, but they do so in ways that reveal the heavy weight of the past. In the diffusion of capital account liberalization, we thus observe a strong influence of past development models, conditioning the costs and

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extensive foreign investment as it is in protected settings! The spreads, by contrast, reflect the level of competition and the efficiency with which credit is provided (at any overall level of interest rates).

benefits of liberalization in the domestic economy, and shaping the channels of nations through which this innovation diffuses in a path-dependent fashion. While we have posited that a crucial mechanism through which these legacies operate is the formation of domestic coalitions of industrial sector interests supportive of liberalization, further in-depth case research is needed in order to confirm this expectation and provide evidence of the causal process through which domestic legacies operate. These tasks, along with further inquiry into the conditions under which diffusion processes are path dependent, form an ample agenda for future research.

Table 1.
Emulation, Domestic Politics, International Pressures and Capital Account Liberalization

Dependent Variable: Capital Account Openness

Diffusion Process	
Peer Effects	0.092
	(0.172)
International Pressure	
IMF Agreement$_{t-1}$	0.188**
	(0.078)
Political Economy Controls	
Executive Partisanship	0.141**
	(0.06)
Legislative Fragmentation	0.212
	(0.628)
Current Account Balance	0.003
	(0.009)
Debt/GDP	-0.09
	(0.063)
Growth Rate$_{t-1}$	-0.006
	(0.008)
ln(GDP/capita)	-2.451
	(1.769)
ln(GDP)	3.668**
	(1.826)
US Rates	0.006
	(0.021)
Other Controls	
Time	0.065
	(0.045)
Country Fixed Effects	suppressed]
Constant	-90.191**
	(43.633)
N	336

Notes: Prais-Winsten regression with panel corrected standard errors and correction for panel-specific AR-1 autocorrelation.

Table 2. Pathways of Diffusion: Emulation, Coercion, and Competition

	Model A	Model B	Model C	Model D
Diffusion Process				
Emulation(wealth)$_{t-1}$	0.417			
	(0.31)			
Coercion (IMF)$_{t-1}$ × Peers		-0.004		
		(0.005)		
Peers		0.007		
		(0.01)		
Success$_{t-1}$			-0.011	
			(0.024)	
Learning				-0.0002
				(0.0003)
International Pressure				
IMF Agreement$_{t-1}$	0.186**	0.195**	0.182**	0.186**
	(0.077)	(0.078)	(0.077)	(0.077)
Politics and Political Economy				
Executive Partisanship	0.14**	0.144**	0.138**	0.136**
	(0.061)	(0.06)	(0.06)	(0.06)
Legislative Fragmentatic	0.104	0.212	0.197	0.333
	(0.627)	(0.63)	(0.628)	(0.624)
Current Account Balance	0.003	0.003	0.003	0.003
	(0.009)	(0.009)	(0.009)	(0.009)
Debt/GDP	-0.086	-0.092	-0.093	-0.092
	(0.061)	(0.063)	(0.062)	(0.063)
Growth Rate$_{t-1}$	-0.005	-0.005	-0.006	-0.006
	(0.008)	(0.008)	(0.008)	(0.008)
ln(GDP/capita)	-2.186	-1.991	-2.615	-2.614
	(1.891)	(1.77)	(1.758)	(1.79)
ln(GDP)	3.216	3.206*	3.882**	3.875**
	(1.96)	(1.847)	(1.813)	(1.855)
US Rates	0.007	0.009	0.008	0.007
	(0.021)	(0.021)	(0.022)	(0.021)
Other Controls				
Time	0.05	0.073	0.076**	0.076**
	(0.047)	(0.046)	(0.037)	(0.038)
Country Fixed Effects	suppressed]	[suppressed]	[suppressed]	[suppressed]
Constant	-78.958*	-79.327*	-95.396**	-95.361**
	(46.835)	(44.16)	(43.296)	(44.306)
N	336	336	336	336

Notes: Prais-Winsten regression with panel corrected standard errors, and correction of panel-specific AR-1 autocorrelation.

Table 3.
Historical Legacies and Diffusion Processes in Capital Account Liberalization

Diffusion Process and Historical Legacy	
ISI	0.5943***
	(0.2235)
$Success_{t-1}$	-0.0003
	(0.0011)
ISI × $Success_{t-1}$	0.003*
	(0.0016)
Spread	-0.0001**
	(0.00004)
International Pressure	
IMF $Agreement_{t-1}$	0.2874***
	(0.1049)
Politics and Political Economy	
Executive Partisanship	0.1752**
	(0.07)
Legislative Fragmentation	0.0586
	(0.5936)
Current Account Balance	-0.0034
	(0.0089)
Debt/GDP	-0.1857***
	(0.0654)
Growth $Rate_{t-1}$	-0.0031
	(0.0092)
ln(GDP/capita)	0.5452***
	(0.147)
ln(GDP)	-0.4214***
	(0.087)
US Rates	0.0345
	(0.0229)
Other Controls	
Time	0.1457***
	(0.0115)
Constant	7.639***
	(2.1001)
N	295

Notes: Prais-Winsten regression with panel corrected standard errors, and correction of panel-specific AR-1 autocorrelation.

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