

## Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations

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This article argues that the degree of capital market integration between states meets even the restrictive criteria established by structural realists for consideration as a structural feature of international politics; that is to say, the degree of international capital mobility systematically constrains state behavior by rewarding some actions and punishing others. Key terms are defined, and a heuristic model of the "capital mobility hypothesis" is introduced. Evidence from both U.S.-Japanese and intra-European monetary relations appears to corroborate the model. However, since the distribution of costs generated by monetary independence under conditions of relatively mobile capital can be asymmetrical, caution is warranted when generalizing about the effects of heightened capital mobility on individual states' monetary autonomy.

A number of political and economic theorists in recent years have focused attention on capital market integration as a partial explanation of important political phenomena, particularly changes in states' macroeconomic behavior. One particularly interesting argument about the effects of increasingly mobile capital has been advanced by a class of political economists employing what might best be described as system-level or structural analysis. Political economists such as Padoa-Schioppa (1985, 1987), Cohen (1993), Goodman and Pauly (1993), and most explicitly Webb (1991) identify the degree of international capital mobility as an important attribute of the international system. In essence, the central claim of these theorists is that when capital is highly mobile across international borders, the sustainable macroeconomic policy options available to states are systematically circumscribed. International financial integration, so the argument goes, has raised the costs associated with pursuing monetary policies that diverge from regional or international trends. While differences in national preferences, the causal beliefs of policymakers, and institutional affili-

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ations may help shape particular patterns of adaptation, proponents of what may be termed the "capital mobility hypothesis" maintain that changes in the external constraint confronting all states constitute a structural cause of observed shifts in the patterns of states' monetary policy behavior over time.<sup>1</sup>

Is the capital mobility hypothesis a sustainable proposition? If so, what are the analytical benefits of conceptualizing international monetary relations in structural terms? Following an overview of the literature on international financial integration, the conceptual case for regarding the relative degree of capital mobility as a structural feature of the international system is considered. Key terms are defined, and a heuristic model of the capital mobility hypothesis is introduced. Highlights from the monetary adjustment experiences of Japan and within Western Europe are then presented, both as a corroboration of the capital mobility hypothesis and in order to highlight some of the controversies raised by the structural approach. Both insights and limitations of this analytical approach are considered, and an agenda for future research is suggested.

### Monetary Policy Independence, Exchange Rate Stability, and Capital Mobility

A small but growing cohort of academics has recently examined the effects of capital mobility on politics and policy. While united in their attention to changes in the international financial environment, theorists from a variety of intellectual and methodological traditions have advanced numerous and often conflicting claims about the nature of these changes, the nature of the constraints they place on economic policymakers, and resultant alterations in the economic relations between states. Many of their arguments have been framed so as to have important implications not only for narrowly conceived models of international finance but for theories of international political and economic relations more generally.

For example, Garrett and Lange (1991) show that, despite the constraining effects of international financial integration on macroeconomic policies, national economic policies have nonetheless remained partisan. At the sectoral level, Frieden (1991) analyzes the differential impact of capital mobility on various socioeconomic groups and then generalizes about the effects of these differences on important national economic policy debates. Cerny (1993) maintains that the "competitive re-regulation" of financial markets has resulted in the development of the "competition state," vying for access to international capital and the right to regulate it. Strange (1986) argues that increased financial volatility brought on by capital mobility threatens to undermine social, economic, and political norms. Focusing on ideology, Gill and Law (1989) maintain that the emerging international financial structure may legitimize a new global regime of transnational accumulation.<sup>2</sup> Goodman and Pauly (1993) emphasize the market forces behind the decisions of the advanced industrial states to abandon capital controls.

Much of this recent work owes a great intellectual debt, directly or indirectly, to the pioneering studies of Robert Mundell (1962, 1963, 1964, 1968) and Richard Cooper (1968). Mundell recognized that three key desiderata of governments—exchange rate stability, private capital mobility, and domestic monetary independence—could not be achieved simultaneously except on an

<sup>1</sup>Arguably, rises in capital mobility constituted the structural background to the demise of the global system of pegged exchange rates in 1973; see Solomon (1982), Williamson (1977), and Willett (1977).

<sup>2</sup>In this regard, see also Gill (1990).

episodic basis.<sup>3</sup> Recognition of the mutual incompatibility of these three policy objectives has since been variously referred to as the Mundell-Fleming approach,<sup>4</sup> the Unholy Trinity,<sup>5</sup> and the Inconsistent Quartet.<sup>6</sup> Cooper explored the broader policy implications of Mundell's analysis in *The Economics of Interdependence* (1968), a seminal work which influenced the thinking of a generation of economists and political scientists alike.

Capital mobility, in this context, refers to the capacity of capital to cross borders rather than to actual flows of money. Put differently, capital mobility refers to the relative absence of friction on financial flows across borders. It is essential to recognize that this *capacity* of capital to cross international boundaries may not manifest itself at any given moment, due to the (relative) absence of profit incentives deriving from differential rates of expected return in different states.<sup>7</sup>

On the other hand, the independent pursuit of monetary policies by states with sometimes divergent objectives generally produces such incentives. To the degree that assets are mobile, then, differential rates of expected return can generate capital flows.<sup>8</sup> These flows of financial assets can in turn generate foreign exchange market disequilibria (i.e., excess supply or demand in the foreign exchange market). Conceptually at least, the foreign exchange market pressures resulting from these disequilibria can be reflected entirely in changes in reserves with a constant exchange rate, or entirely in changes in the exchange rate with constant reserves. In practice, however, since governments are generally not indifferent about either their currencies' external value or their stocks of foreign exchange, foreign exchange market disequilibria are likely to result in some combination of changes in *both* the exchange rate and reserves.<sup>9</sup>

As authorities recognize that their pursuit of monetary policies diverging from international trends has or may result in undesired foreign exchange market pressures, they will have incentives to correct that divergence. Thus, to the degree that capital is freely able to traverse international boundaries, a direct trade-off exists between exchange rate stability between states and their pursuit of independently chosen monetary policies. As discussed later in this article, exactly how this trade-off will be resolved depends crucially upon policymakers' beliefs (i.e., the economic models that inform their decisions) and the structure of their preferences (the extent to which they value stability).<sup>10</sup>

A number of political scientists have integrated key insights of Mundell and

<sup>3</sup>That is to say, except when states' interests happen to harmonize and therefore individual policy optimization does not require mutual accommodation (Keohane, 1984:51-55). These fortuitous circumstances are likely to occur only sporadically.

<sup>4</sup>The reference is to J. Marcus Fleming, another important international monetary theorist; see Fleming (1962).

<sup>5</sup>Cohen (1993).

<sup>6</sup>Padoa-Schioppa (1985, 1987) explicitly includes the pursuit of free trade as an element in his treatment of the problem.

<sup>7</sup>Fritz Machlup explicitly distinguished between capital mobility and capital movements as early as twenty years ago (cf. Machlup, Salant, and Tarshis, 1972).

<sup>8</sup>Short-term assets (financial instruments with maturities under one year) are especially sensitive to differences (and expected differences) in real interest rates, adjusted for exchange rate risk.

<sup>9</sup>The discussion of foreign exchange market equilibria here and elsewhere in this article refers to a pure exchange-market definition of balance or imbalance in states' payments positions. In other words, it refers to the supply of and demand for foreign exchange at various "prices" or exchange rates, rather than to any particular accounting measure (e.g., the current account, the basic balance, etc.).

<sup>10</sup>Strictly speaking, states do not have "preferences." It has become customary, however, to refer to the reaction functions of decisionmakers as constituting national preferences. As a result, national preferences are malleable not only because of changes in individuals' beliefs but also because of changes in the relative influence of different groups and individuals.

Cooper into their studies of economic decisionmaking.<sup>11</sup> One particularly interesting argument, advanced by Michael Webb (1991), is noteworthy for its efforts to locate the effects of increasingly mobile capital within a Waltzian framework for the study of international relations. Beginning with the publication of *System and Process in International Politics* (Kaplan, 1957) and *Man, the State and War* (Waltz, 1959), American students of international relations theory have been captivated by the notion of system-level or "third-image" explanations of international political phenomena.<sup>12</sup> The 1979 publication of Waltz's *Theory of International Politics* reinvigorated this fascination.<sup>13</sup> While criticisms of Waltz (1979) have ranged from the constructive to the excoriating,<sup>14</sup> the structural realist approach<sup>15</sup> to theorizing that he pioneered continues to hold wide sway within the discipline. This is reason enough for Webb's effort to merit close attention, inasmuch as it challenges the traditionally narrow scope of structural realist theory—and does so on the latter's own terms.<sup>16</sup>

Webb suggests that the third-image tradition in international relations theory can be linked with the policy interdependence arguments pioneered by Mundell and Cooper by identifying the degree of international capital mobility as an important third-image attribute of the international system. He maintains that since a high degree of capital mobility systematically circumscribes the sustainable economic policy options available to states, it should be identified as part of the international structure. Conventional neorealist models of international relations, he continues, are unable to explain important domains of state behavior because they lack reference to this important conditioning element of international economic relations.

The distribution of power alone cannot explain patterns of macroeconomic policy coordination, an area central to the concerns of governments; we also need to look at the characteristics of the international economy that persist over time and systematically influence how governments relate to each other . . .

All . . . the advanced capitalist countries . . . responded in a similar, though not identical, fashion to changes in international capital mobility. According to Kenneth Waltz [1979], if different states act similarly in response to similar

<sup>11</sup>Keohane and Nye (1977) is perhaps the most famous; see pages 11–19, as well as the monetary case studies. Odell's (1982) analysis of U.S. international monetary policy decisions in the 1960s broke new ground; his framework was in turn adopted by Story (1988) to examine the origins of the European Monetary System.

<sup>12</sup>For example, after examining several alternative explanations of the passage of the Single European Act, Sandholtz and Zysman (1989:100) conclude that "an argument based on domestic politics cannot answer the question, why now? Such an argument would have to account for the simultaneity of domestic developments that would induce states to act jointly. Attention to changes in the international context solves that problem. International changes posed challenges and choices to all the EC states at the same time."

<sup>13</sup>For good or for ill; Milner (1992:488–495) laments the primacy that has characteristically been afforded systemic theory over domestic or "second-image" explanations of international conflict and collaboration.

<sup>14</sup>See, for example, the articles by Keohane (1983), Ruggie (1983), Cox (1981), and Ashley (1984) that were later incorporated into Keohane's (1986) text.

<sup>15</sup>The term is Keohane's (1983).

<sup>16</sup>Wendt (1987) argues persuasively that structural realist theory is intellectually impoverished by its insistence on the logical priority of agents (states) over structures (the properties of the international system), with the latter generated by the interaction of the former. Wendt proposes an alternative approach to theorizing wherein the key properties of both states and the international system are recognized as "co-determined" or "mutually constituted"; see especially his discussion on pages 339–340. While the present article is by no means hostile to this "strukturalist" approach, it takes a different tack. Whereas Wendt argues that the neorealists have adopted an inappropriate ontological framework for the analysis of international affairs, the present article accepts, for the purposes of argument, structural theory as traditionally conceived by neorealists. It then argues that capital mobility meets even the restrictive terms established by leading proponents of structural realism for consideration as an essential property of the international system. This, in turn, suggests that insistence on the primacy of the distribution of military capabilities in the theoretical analysis of international affairs is more a reflection of researchers' preferences than the inevitable consequence of a rigorous intellectual scheme.

phenomena, we are justified in thinking that there may be some kind of structural effect at work. (Webb, 1991:312)

In similar fashion, Cohen (1993) argues that the influence of the Unholy Trinity on international monetary relations between G-7 countries is "systematic," thereby accounting for the episodic nature of cooperation efforts.<sup>17</sup> While not explicitly adopting a Waltzian framework (or vocabulary<sup>18</sup>), this analysis once again points to environmental constraints on the successful realization of governments' macroeconomic policy objectives. Likewise, Padoa-Schioppa's (1987) advocacy of European monetary union is grounded in his analysis of the Inconsistent Quartet, wherein he maintains that governments' exchange rate and policy independence objectives are severely and predictably constrained by the relative degree of international financial integration between them. And Goodman and Pauly (1993) maintain that the liberalization of capital controls undertaken by different states during the 1970s and 1980s was brought about, in part, by market pressures deriving from preexisting levels of financial integration.<sup>19</sup>

#### Capital Mobility as a Structural Variable

The proposed synthesis between third-image, system-level analysis of international relations and the literature on economic policy interdependence outlined above hinges on the premise that the constraints imposed on states by capital mobility are structural in nature, or at a minimum can usefully be construed as structural by analysts. That is to say, the degree of international capital mobility systematically constrains state behavior by rewarding some actions and punishing others.<sup>20</sup>

An alternative view is that the degree of capital mobility between states is simply a consequence of national policy decisions to liberalize national financial markets—and that the consequences associated with these decisions are (at least potentially) fully reversible. If so, to regard capital mobility as a structural constraint (in the Waltzian sense of the term) is to obscure the political decisions that have made and continue to make international financial integration possible.<sup>21</sup>

The practical difficulties confronting individual governments attempting to limit or reduce capital mobility (or its policy effects) provide the most substantive rationale for treating this phenomenon as a structural feature of the interna-

<sup>17</sup>Consideration of the underlying political economy of the issue suggests that the dilemma is, in fact, systematic—endogenous to the policy process—and not easily avoided in relations between sovereign governments" (Cohen, 1993:146).

<sup>18</sup>Purists will note that "systematic" problems are not necessarily "systemically" derived.

<sup>19</sup>In other words, Goodman and Pauly (1993) treat capital mobility as both an independent and dependent variable.

<sup>20</sup>Even in the unlikely event that the degree of international capital mobility were significantly reduced, the effects of whatever new degree of capital mobility obtained could still be considered structural in the sense discussed in this article. Lower levels of mobility would simply result in different (i.e., less constraining) structural effects.

<sup>21</sup>For example, Helleiner (1994) argues that a variety of political factors encouraged the process of post-war financial liberalization, including widespread ideological shifts, the emergence of new domestic coalitions supportive of liberalization, and the particular interests of Britain and the United States in the liberalization process. As the following discussion makes clear, however, none of these factors precludes a structural interpretation of the consequences of financial liberalization once undertaken.

tional system.<sup>22</sup> The following analysis of impediments to the purely political control of financial markets distinguishes between two related matters: the degree to which increases in capital mobility have taken place independently of changes in national regulatory frameworks, and the degree to which the widespread liberalization of national financial markets has itself taken place in response to system-level pressures. The ensuing discussion of the competitive pressures between states is then supplemented by consideration of the cognitive impediments to the successful regulation of international capital.

#### *Technological and Private Sources of Capital Mobility*

With regard to the first of these issues, at least three distinct types of underlying causes of the increase in the degree of capital mobility since the establishment of the Bretton Woods system in 1944 can be identified. First, advances in communications and information technologies have facilitated private international capital transactions.<sup>23</sup> Notably, both Cooper (1968) and especially Bryant (1987) emphasize the role of technology in altering the environment in which both private and public financial actors operate. Second, innovation by financial firms—at least partly in response to technological advances—has produced new instruments capable of facilitating the flow of capital across borders.<sup>24</sup> This includes, but is not limited to, the development of international or so-called “Euro” money markets, established to operate beyond the normal purview of national authorities.<sup>25</sup> Finally, the liberalization of domestic capital markets (the removal of legal and technical barriers to international capital mobility) by the political authorities of many of the world’s countries has dramatically reduced the friction of international capital movements.<sup>26</sup>

These changes have taken place in technological capacity, the private sector, and the public sector, respectively. Put differently, the increasing integration of the world’s capital markets is a consequence of a variety of developments, only some of which are subject to straightforward manipulation by political authorities. Empirical assessment of the relative weight of each of these factors in accounting for the shift toward greater capital mobility is difficult, especially inasmuch as each factor was interactive with its counterparts. In the absence of an appropriate methodology for quantitative analysis, Bryant offers the following counterfactual observations:

The technological nonpolicy factors were so powerful, I believe, that they would have caused a progressive internationalization of financial activity even without changes in government separation fences and the inducement of differing regulatory, tax, and supervisory systems. But I also conjecture that government-policy changes were important enough to have promoted a significant integration of national financial systems even if there had been no shrinkage in the

<sup>22</sup>This is not to say that the current degree of capital mobility cannot be reduced, but instead that reduction is likely to be both difficult and costly. See the discussion in Webb (1991:313). For alternative perspectives on the reversibility of the trend toward greater capital mobility see Strange (1986), Loriaux (1991:304–307), and Helleiner (1993). Each of these authors rightly emphasizes the role of politics in bringing about financial market liberalization efforts. The following discussion, however, emphasizes the importance of distinguishing between the trend toward liberalization and the trend toward greater capital mobility, since the former is only one of several contributors to the latter.

<sup>23</sup>Accessible accounts of recent developments in this regard include Strange (1986), McKenzie and Lee (1991), and Kurtzman (1993).

<sup>24</sup>See, for example, Cobham (1989:248), who provides a summary of financial innovations in the United Kingdom since 1970 classified in terms of their impact on policy.

<sup>25</sup>“Eurocurrency banking is not a phenomenon *sui generis*, but merely one part of a general nexus of financial interrelations linking open national economies” (Bryant, 1987:24).

<sup>26</sup>Cf. Solomon (1982).

economic distances between reservoirs [of market funds] due to nonpolicy innovations such as the fall in relative costs of the international communication of information. (Bryant, 1987:69).<sup>27</sup>

To summarize, one reason why capital mobility is difficult to resist as a general matter has to do with the diffuse nature of its sources. As a general matter, the normal purview of the state includes attention to only one source of capital mobility (namely, the regulation of national financial markets, including access to and from these markets). Changes in the market itself, however, as well as in the technological capabilities of market actors, have jointly reduced the impediments to capital movements between states quite independently of the regulatory decisions of governments.

#### *Competitive Pressures on States' Regulatory Policies*

Turning to the second issue, the financial regulatory decisions of governments have themselves been subject to enormous systemic pressures. Recall that a system consists of a structure and interacting units (Waltz, 1979:79). As the structure itself has changed (due in part to technologically induced changes in market practice, increasing the capacity of capital to cross borders), the nature of the interactions between the units has been altered as well. New competitive pressures between states have been unleashed, resulting in new patterns of adjustment and adaptation.

As discussed above, the features of the emerging international structure include improved communications and information technologies as well as new financial mechanisms. Together, these features have enhanced the capacity of capital asset-holders to evade the jurisdiction of unfriendly regulators. States must therefore be increasingly sensitive to changes in the regulatory policies of their neighbors, since they are now effectively competing for the right to regulate capital. The general thrust of this new competitive dynamic has been for states to accommodate the preferences of market actors by liberalizing (or in other words, lowering) their regulatory standards.<sup>28</sup> States that had previously resisted financial liberalization began instead to court international investors, resulting in what Cerny (1993) calls the “competitive re-regulation” of national financial markets.

The decision of the Socialist government in Paris to adopt substantial liberalization of its internal financial markets is illustrative.<sup>29</sup> French liberalization efforts were announced less than two years after adopting remarkably draconian measures to restrict capital movements;<sup>30</sup> furthermore, they served as a necessary antecedent to (rather than consequence of) negotiations leading to the Single European Act.<sup>31</sup> In light of the Socialists' stated preferences both prior to and immediately after assuming office, this suggests that the perceived costs of resisting liberalization were sufficient to overcome even strong ideological

<sup>27</sup>Bryant (1987:69) concludes by observing that “it is likely that the interaction between nonpolicy innovations and changes in government policies was itself an important part of the history. Each set of evolutionary changes reinforced the effects of the other.”

<sup>28</sup>Cf. Gowland (1990).

<sup>29</sup>Loriaux's (1991:214–240) account of the Mitterrand reforms downplays the competitive dynamic while emphasizing the French government's efforts to regain control over domestic monetary policy. This interpretation accurately reflects an understanding that prevailed in some official quarters in Paris about the nature of financial markets, exchange rates, and monetary independence. This understanding was sorely tried when increases in German interest rates (following national unification) squeezed French monetary policy options and contributed to the foreign exchange crises of 1992–1993.

<sup>30</sup>Cf. Petit (1989:256–260); Goodman and Pauly (1993:70–75).

<sup>31</sup>Note the discussions of this problem in Sandholtz and Zysman (1989:99–100) and Moravcsik (1991:21, 29–31).

resistance.<sup>32</sup> And once adopted, the liberalization of financial regulations joined with the market and technological forces that had helped to produce this policy change, further reinforcing the new competitive dynamic.

Despite similarities between them, it is analytically useful to distinguish between regulation of national financial markets and regulation of capital movements between them. In the case of France, for example, substantial market liberalization took place beginning as early as 1984, but capital controls were not abandoned until 1990. Goodman and Pauly (1993) argue that both these developments were "fundamental changes in the structures of international production and financial intermediation." They note that the abolition of capital controls, together with the liberalization of internal markets, has tended to proceed regardless of whether the state experienced chronic balance-of-payments deficits or surpluses (although states' different payments positions may help explain differences in the timing of their reform efforts).<sup>33</sup> The existence of genuinely international or "offshore" financial markets, in conjunction with changes in the production strategies of firms,

made it easier for private firms—specifically, corporations and financial institutions whose aspirations had become increasingly global—effectively to pursue strategies of evasion [of controls] and exit [from heavily regulated national markets]. For governments, the utility of controls declined as their perceived costs thereby increased. (1993:51)

In short, they argue that both the widespread abandonment of capital controls by the advanced industrial states since the late 1970s and the movement toward competitive reform of domestic market regulations were rational responses to similar competitive difficulties. This may not necessarily be the case.<sup>34</sup> It is not clear that the exchange rate implications of capital control abolition were entirely understood by all the governments that undertook these reforms. Indeed, the decision of European governments to abandon controls remains particularly problematic, given these states' pronounced preference for mutual exchange rate stability.<sup>35</sup>

The widespread decision to abandon capital controls is perhaps better understood in the first instance as a consequence of widely shared ideological commitments (and especially the priorities of central bankers), rather than in terms of objective competitive pressures.<sup>36</sup> However, as the discussion of these matters

<sup>32</sup>In effect, as international financial integration outside France accelerated, French policymakers came to the conclusion that their preference for national monetary autonomy was unrealistic" (Goodman and Pauly, 1993:75). Their use of the term *monetary autonomy* differs from my own later in this article.

<sup>33</sup>They come to this conclusion following a comparison of the French, Italian, German, and Japanese cases. The British experience (which they do not examine) suggests that sectoral interests and ideology can influence timing as well. London liberalized its markets relatively early and later chose to abandon capital controls altogether upon the election of Margaret Thatcher, despite persistent deficits in the balance-of-payments.

<sup>34</sup>The chief distinction in this regard is between the overall movement toward the liberalization of financial markets and the remaining utility (for states protective of their mutual exchange rates) of policy instruments allowing governments to resist flows of speculative capital not generated by balance-of-payments fundamentals. Cf. Portes (1993:3): "The key [to the foreign exchange crises of 1992–1993] was the dismantling of capital controls. The minority view that they were ineffective, unnecessary or even potentially destabilising . . . was wrong. By limiting the rate of short-term speculative capital flows, controls had permitted orderly realignments [within the European Monetary System] . . ."

<sup>35</sup>The economists (cf. Gros, 1987, 1992) who argued that capital controls were ineffective, or perhaps even destabilizing, were widely criticized by their colleagues both before and after the European foreign exchange crises of 1992–1993; see footnote 34. There is, after all, some considerable difference between observing that capital mobility is difficult to resist and abandoning efforts to do so. What is especially interesting in the European case is that advocates of monetary union were persuaded to do the latter.

<sup>36</sup>Recall in the European case that the Committee for the Study of Economic and Monetary Union, chaired by Jacques Delors, was composed almost entirely of central bankers. The Committee's *Report on Economic and Monetary Union in the European Community*, including its recommendation for the abolition of capital controls, formed the basis for the eventual negotiations at Maastricht; see in this regard Sandholtz (1993:15–18).

in the next section suggests, such cognitive constraints are also consistent with a structural explanation of international monetary relations. Furthermore, once removed, it became evident that the reintroduction of capital controls by individual states on an isolated basis might prove costly, not least because it might be taken as a signal (even if wrongly) that regulators intended to backtrack on liberalizing reforms of national markets as well.

Finally, the competitive pressures on states to attract foreign capital have not only resulted in great potential costs for states seeking to resist financial liberalization on an isolated basis. In addition, the competitive dynamic has generated important impediments to the possible multilateral regulation of international capital markets.<sup>37</sup> The high economic and political stakes associated with the attraction of international capital provide powerful incentives to "cheat," exacerbating the general impediments to international cooperation.<sup>38</sup> In short, the costs of resisting capital mobility either in isolation or in combination have dramatically escalated, with the result that states have by and large chosen to accommodate the phenomenon. This decision, taken both individually and collectively, serves to reinforce the market trends that originally induced it. The circular nature of this process further justifies consideration of the phenomenon as systemic in nature.<sup>39</sup>

#### *Competition, Socialization, and the Emergence of Structure*

The preceding discussion suggested that the competitive interaction of states serves as an important impediment to the successful national and international regulation of capital. It also suggested that certain widespread cognitive phenomena further restrict states' collective ability to regulate international capital movements. Ideology, to use Gill and Law's (1989:489–490) term, or mindsets, as employed below, are instances of such phenomena. National monetary authorities are increasingly likely to imagine that the process of international financial integration has become largely inevitable and irreversible. As authorities become convinced (again, even if wrongly) that it is costly or even futile to resist the strong tendency of market and technological forces to produce further financial integration, they become less inclined to undertake such actions.<sup>40</sup> Such mindsets augment the objective difficulties associated with joint action between states to control capital movements, further undermining the likelihood of successful collaboration.<sup>41</sup>

This observation is entirely consistent with describing capital mobility as a structural feature of the international system. "Structure affects behavior within the system, but does so indirectly. The effects are produced in two ways: through socialization of the actors and through competition among them" (Waltz, 1979:74). Socialization and competition, acting in concert, condition unit behavior in ways that are both comprehensible and predictable. Consequently,

<sup>37</sup>Keynes, among others, had envisioned a system of widespread, reciprocal controls for the postwar world; see Helleiner (1994).

<sup>38</sup>Most prominently information and other transaction costs, and uncertainty; see Keohane (1984:90–96).

<sup>39</sup>This functionalist explanation of the competitiveness dynamic is discussed further below. See again Wendt (1987) on the mutually constitutive relationship of agents and structures in international relations.

<sup>40</sup>Note that while the recent foreign exchange crises have caused some European states to reintroduce capital controls, none have described this as anything more than a temporary measure.

<sup>41</sup>On the other hand, the recent foreign exchange crises have caused efforts to constrain short-term capital movements to regain at least a modicum of intellectual responsibility. When Tobin (1982) suggested the merits of "putting some sand in the wheels" of capital mobility through unconventional means ten years ago, his suggestion was roundly criticized as costly and impractical (cf. Dornbusch, 1988:220–222). More recently, however, Eichengreen and Wyplosz (1993) and others have advocated similar proposals, whether via taxation of short-term financial assets crossing borders or through some sort of compulsory deposit requirement.

they are both "example[s] of the familiar structural-functionalist logic by which consequences become causes."<sup>42</sup> For example, the emergence of the so-called competition state in international financial affairs, initially a consequence of policy decisions, subsequently has become an important cause of them. Goodman and Pauly conclude as much: "The diminishing utility of capital controls can be considered the unintended consequence of other and earlier policy decisions. . . . But the fundamental convergence in the direction of [capital market liberalization] noted in all of our cases suggests that systemic forces are now dominant in the financial area . . ." (1993:79, 81). Likewise, the belief or mindset of monetary authorities that international collaboration to limit capital mobility is unlikely to succeed becomes one element in a self-fulfilling prophecy.

It is noteworthy that in *Theory of International Politics*, Waltz utilized a "strictly positional" definition of structure, permitting attention exclusively to "the principle according to which [the units] are organized or ordered . . . the differentiation of the units and the specification of their functions, and . . . the distribution of capabilities across units" (1979:88).<sup>43</sup> As an illustration of this logic, he argued that "in shaping the behavior of nations, the perennial forces of politics are more important than the new military technology" (1979:173). In later years, though, Waltz reconsidered this view and argued that changes in military technology (and specifically the development of nuclear weapons) produced structural effects, inasmuch as calculations about the nature and utility of warfare (and hence the behavior of the units in these regards) were systematically altered.<sup>44</sup> Just two years after the publication of *Theory*, Waltz wrote:

The prevalence of peace, together with the fighting of circumscribed wars, indicates a high ability of the post-war international system to absorb changes and to contain conflicts and hostilities. Presumably features found in the post-war system that were not present earlier account for the world's recent good fortune. The biggest changes in the post-war world are the shift from multipolarity to bipolarity and the introduction of nuclear weapons. (1981:2)<sup>45</sup>

Regard for the advent of nuclear technology as a structural feature of international affairs informs the writings of theorists as diverse as John Mearsheimer and Stephen Van Evera; what unites them is common attention to the structural realist tradition.<sup>46</sup> In a similar sense, capital mobility constitutes a structural feature of international affairs inasmuch as the degree of mobility systematically alters state calculations and behavior. Capital mobility is fully consistent with Waltz's underlying conception of a structural feature of international politics: a constraining condition which rewards certain behaviors and punishes others.<sup>47</sup> It follows that the rapid increase in the degree of international capital mobility over the past thirty years constitutes a structural change. In Waltz's own terms:

A structural change is a revolution, whether or not violently produced, and it is so because it gives rise to new expectations about the outcomes that will be produced by the acts and interactions of units . . .<sup>48</sup> Across systems, a theory

<sup>42</sup>Waltz (1979:74), citing Stinchcombe (1968:80-101). These are distinct from other, deviant (even if recurrent) cognitive phenomena such as misperception (Jervis, 1976).

<sup>43</sup>In practice, Waltz's analysis included attention only to the first and third of these elements, with problematic consequences: these are discussed best by Ruggie (1983).

<sup>44</sup>See Gaddis's remarks (1992:32-33).

<sup>45</sup>This continues to be Waltz's view; see Waltz (1990:3).

<sup>46</sup>See, for example, Mearsheimer (1990:19-21) and Van Evera (1984, chap. 13).

<sup>47</sup>Cf. Waltz (1979:73-74).

<sup>48</sup>The excised passage reads, "whose placement in the system varies with changes in structure." Here structure is defined in the restrictive, purely positional sense which Waltz later modified in order to include attention to nuclearization; see again the discussion in the preceding paragraph.

explains change. A theory of international politics can only succeed if political structures are defined in ways that identify their causal effects and show how these effects vary as structures change. (Waltz, 1979:70)

The political and economic stakes associated with interstate competition for capital are very high indeed. Thus, if Waltz is correct—if a theory of international politics can only succeed if *political* structures are defined in ways that identify the connection between changes in structure and changes in causal outcomes—then theories attempting to account for the consequences of this competition must define political structures broadly, including attention to changes in the international mobility of capital. According to the terms of discourse established by Waltz himself, capital mobility is a structural feature of international politics.

### The Capital Mobility Hypothesis

The central claim associated with the capital mobility hypothesis is that financial integration has increased the costs of pursuing divergent monetary objectives, resulting in structural incentives for monetary adjustment.<sup>49</sup> To assist in the evaluation of this claim, a simple model of the capital mobility hypothesis will be introduced. First, though, greater attention to definitions is required, especially regarding the elusive concept of monetary autonomy. In the literature, monetary autonomy sometimes refers to a formal right, sometimes a policy practice, sometimes policy objectives, sometimes outcomes, and sometimes capacity. This multiplicity of meanings contributes to imprecise theorizing and unnecessary confusion.

### The Meanings of Monetary Autonomy

In the broadest sense, monetary policy refers to the state's attempts to control its domestic money supply. Monetary policy is therefore at least conceptually distinct from the domestic monetary conditions (usually described in terms of interest rates, or the "price" of money) prevailing at any given time, since policy may fail to achieve its desired ends. As a matter of convenience, however, monetary policy is typically described as "tight" or "loose" based on the monetary conditions it produces relative to other countries (or to past experience), rather than interpretation of policymakers' intentions or identification of the policy instrument(s) employed. Following this practice, characterizations of monetary policy in this article refer to observable conditions in domestic markets, and especially on the price of money (i.e., the interest rate, in both real and nominal terms).

*Formal monetary sovereignty* refers to the legal or jurisdictional authority of domestic monetary policymakers to pursue independent policies as they see fit. The monetary union portion of the Treaty on European Union, for example, includes restrictions on the legal autonomy of the monetary authorities of those states eventually adopting a single European currency; hence, the treaty's implementation necessitates (among other things) a partial abdication of formal monetary sovereignty. The legal controversies posed by the Maastricht treaty, however, are not the subject of the present article.

Differences in the monetary conditions between states are referred to as *monetary divergence*, again regardless of the similarity or difference in policy

<sup>49</sup>That is to say, changes in domestic monetary policy designed to accommodate monetary conditions and policies in other states. See the discussion of monetary independence and interdependence below.

instruments employed by different monetary authorities. *Monetary convergence* consists, logically, of the absence of divergence; but convergence and divergence should not be conceived of in terms of a dichotomous variable. Rather, there are degrees of divergence which can, again, be measured according to various objective criteria (including interest rates).

*Monetary independence*, at least in this article, refers to those policies believed to maximize desired domestic outcomes *independent of external constraints*.<sup>50</sup> The concept therefore hinges on policymakers' preferences and causal beliefs about how to achieve desired ends, but not (by definition) on monetary conditions in other states. Monetary independence contrasts with policymaking under conditions of *monetary interdependence*; the latter necessitates revising policy actions in light of beliefs about how international interactions, including capital flows, are likely to affect outcomes.

Changes in national monetary independence will be difficult to identify except by inference. Conceptually, reductions in national monetary independence consist of an imbalance between a government's actual policy and its (externally unrestricted) preferences. However, this definition involves estimating ambitions based on "revealed" preferences, an imprecise science at best, and especially suspect in a situation where preferences are subject to modification as beliefs change.<sup>51</sup> Some of these difficulties can be avoided, however, by distinguishing between monetary independence and monetary autonomy.

*Monetary autonomy*, as defined here, refers to a choice set rather than the realization of a specific policy objective. This choice set can be thought of in terms of the foreign exchange market pressures generated by different degrees of monetary divergence. According to the capital mobility hypothesis, as national capital markets become more integrated, the foreign exchange pressures associated with the pursuit of independently chosen monetary objectives increase. Consequently, the nature of the choice set available to states (between the pursuit of their externally unrestricted preferences and stabilizing their exchange rates) becomes more constricted.<sup>52</sup> States are less autonomous in the sense that monetary independence has become more costly.<sup>53</sup>

#### A Heuristic Model of the Capital Mobility Hypothesis

The relationship between monetary independence and monetary autonomy described above is represented in Figures 1-3, which represent a static, bilateral simplification of international monetary relations. Figure 1 depicts the foreign exchange pressures associated with various levels of monetary divergence between a given state (State A) and an imagined partner (State B). Foreign exchange market pressures are represented by the x-axis, with the (at least relative) absence of pressure indicated at its origin. State B's policies are initially taken as autonomously chosen;<sup>54</sup> the degree of divergence is indicated by the y-axis. Monetary convergence is represented at the origin, with loose policy (relative to

<sup>50</sup>This appears to be the meaning of monetary autonomy as used by Goodman and Pauly in the reference cited in footnote 32.

<sup>51</sup>See the discussion of state preferences in footnote 10.

<sup>52</sup>This discussion presumes that the externally unrestricted preferences of different states vary at least somewhat; see footnote 3.

<sup>53</sup>As discussed earlier, these foreign exchange "costs" consist of changes—in either states' exchange rates or their foreign exchange reserves, or both—that authorities prefer would not occur. No judgment is intended on whether or not these preferences reflect sound economic thinking.

<sup>54</sup>It should be noted that this simplifying assumption is rightly subject to the criticism that (like other static applications of Mundell's analysis) it pays insufficient attention to the dynamic character of international monetary relations. Some of the implications of this simplification are discussed later in this article.

State B) ascending from the origin and tight policy (again relative to B) descending from the origin.

In each of Figures 1-3, the monetary autonomy of State A corresponds to the feasibility curve. The intersection of the feasibility curve with the y-axis is defined as the degree of divergence necessary to compensate for the state's underlying payments position.<sup>55</sup> For example, in order to minimize foreign exchange pressures, a deficit state would require somewhat tighter monetary policies than State B in order to induce private financing of this deficit. Figure 1 has been organized to represent this situation (i.e., State A is a deficit state and State B is a surplus state). If the situations were reversed, the y-axis would need to be inverted. In such an instance, State A would need to pursue relatively looser policies than State B in order to minimize foreign exchange market pressures by inducing compensatory outflows on its capital account.<sup>56</sup>

In Figure 1, point (1) represents the degree of monetary divergence resulting from State A's pursuit of its own preferred, fully independent domestic monetary policy. Point (2) represents the degree of foreign exchange market pressure

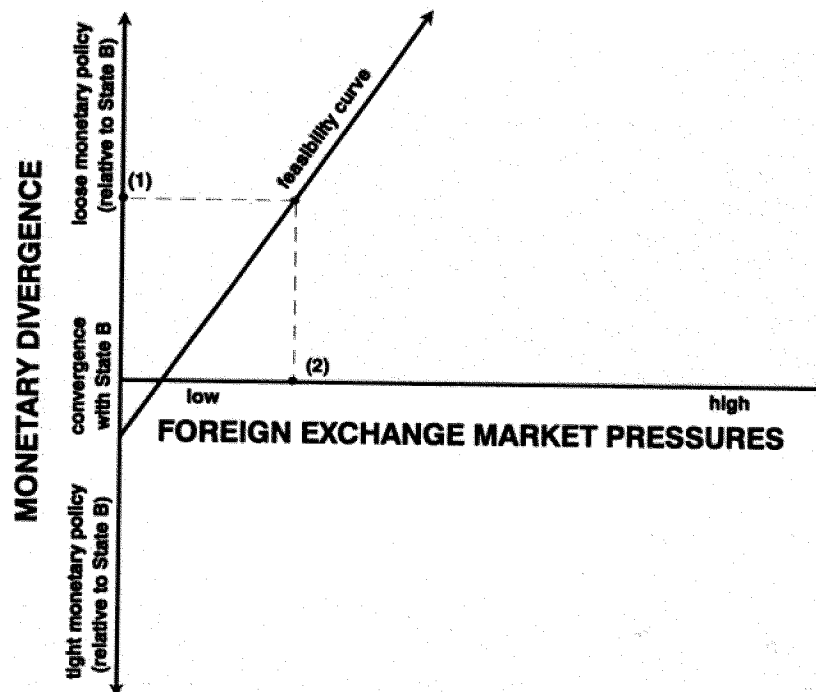


FIG. 1. Foreign exchange market pressures and monetary divergence.

(1) State A's unconstrained preference regarding the degree of monetary divergence from State B.  
(2) Degree of foreign exchange market pressure associated with point (1), given the shape of the feasibility curve.

<sup>55</sup>See footnote 9.

<sup>56</sup>Looking ahead, this is exactly the situation faced by Switzerland vis-à-vis Germany in the 1970s and 1980s. It was also the situation faced by Germany vis-à-vis the United States under the Bretton Woods system.

associated with this degree of monetary divergence, given the slope of the feasibility curve.<sup>57</sup> The feasibility curve's slope is in turn a function of the degree of integration of these two states' markets for goods, services, and especially financial assets; it is therefore at least a partial function of the degree of capital mobility between the two states.<sup>58</sup> For example, if the two states had no market relations between them, nor between intermediaries (in other words, if the two economies were hermetically sealed from one another), then no foreign exchange market pressures would be generated by their pursuit of independent policies. In such a case, the feasibility curve would be vertical, running along the x-axis. However, to the extent that these two states' economies are integrated, some degree of foreign exchange market pressure is generated by monetary independence.<sup>59</sup>

As discussed earlier, manifestation of these foreign exchange market pressures (hereafter referred to as market pressures) can vary. The exchange rate between the two states may change, or their foreign reserves positions may vary (as one or both states intervene in defense of the exchange rate), or both. As a general matter, since states' capacity to intervene in foreign exchange markets is not unlimited, high degrees of market pressure are likely to produce at least some movement in the exchange rate. Deficit states may be limited in their capacity to intervene in defense of overvalued exchange rates by the scarcity of their foreign exchange reserves and their access to external balance-of-payments financing. Surplus states are limited as well, albeit in different ways. The capacity of surplus states to sterilize the inflationary effects of capital inflows, while substantial, is not unlimited; hence, unless the exchange rate is allowed to appreciate, states pursuing relatively tight monetary policies may eventually suffer from "imported" inflation.<sup>60</sup>

Since states differ in their willingness to tolerate movements in their exchange rates, different states will be inclined to resolve the trade-off between pursuing independent policies and incurring market pressures in different manners. This is represented by Figure 2, wherein there are two alternative representations of State A's preferences regarding the trade-off between monetary policy independence and exchange rate stability.<sup>61</sup> Indifference curve A typifies a government that is rather tolerant of changes in its exchange rate with State B. The optimal degree of monetary divergence (point 2), given this structure of preferences, differs only slightly from its preferred policy in the absence of any external constraint (point 1), despite the fact that this results in considerable foreign exchange market pressures (point 5) and almost certainly some movement in the exchange rate.<sup>62</sup>

Indifference curve A', on the other hand, depicts a government that is rela-

<sup>57</sup>The feasibility curve has been represented as a straight line by assumption. No effort has been made to estimate its shape precisely; it might be concave or convex. The discussion in the text is not dependent on the particular shape of the curve, except upon the reasonable assumption that it is not highly irregular.

<sup>58</sup>This is simply a restatement of Mundell's analysis.

<sup>59</sup>States that are economic partners, or that participate in markets common to one another, are therefore not autonomous in the sense of being able to choose monetary policies diverging from their economic partners without experiencing any foreign exchange costs. Again, this is the difference between (formal) monetary sovereignty and (practical) monetary autonomy. All states that have not compromised their formal monetary sovereignty are (by definition) legally capable of pursuing whatever policies they choose. In practical terms, however, there are at least potential foreign exchange costs associated with choosing to pursue policies that differ from those of one's trading partners.

<sup>60</sup>Cf. Goldstein (1980:36-38).

<sup>61</sup>Should the preferences of the two states happen to coincide, State A's indifference curve would be centered on the origin and bisected by the x-axis. This unlikely situation is discussed in footnote 3.

<sup>62</sup>The term *optimal* refers here strictly to the interaction between the state's preferences and the available choice set (defined by the feasibility curve). No reference is intended to the concept of economic welfare identified with maximizing economic output.

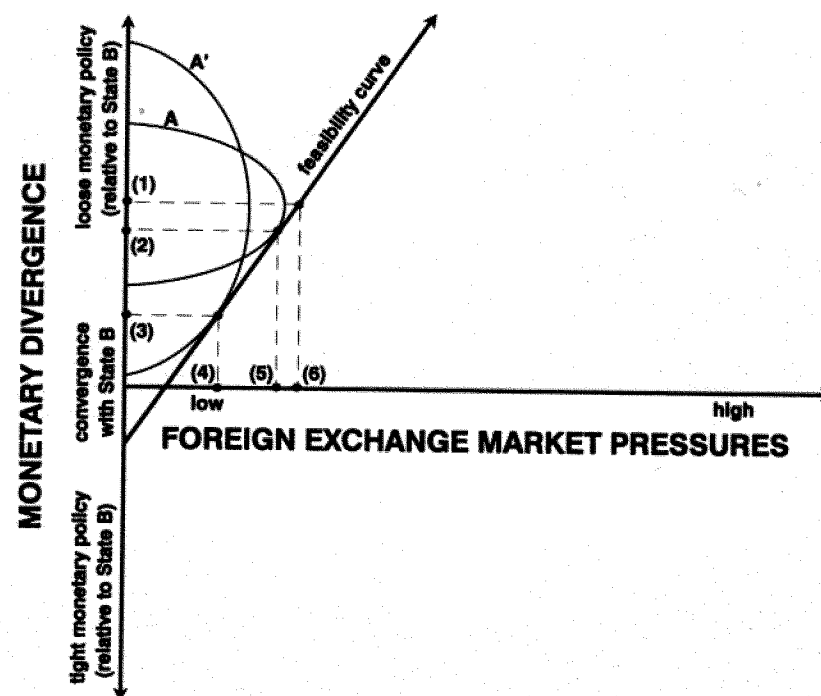


FIG. 2. Optimal choices given different preferences.

- (1) State A's unconstrained preference regarding the degree of monetary divergence from State B.
- (2) Optimal degree of divergence given the shape of the feasibility curve and indifference curve A.
- (3) Optimal degree of divergence given the shape of the feasibility curve and indifference curve A'.
- (4) Degree of foreign exchange market pressure associated with point (3).
- (5) Degree of foreign exchange market pressure associated with point (2).
- (6) Degree of foreign exchange market pressure associated with point (1).

tively intolerant of changes in its exchange rate with State B.<sup>63</sup> Under this scenario, the optimal degree of monetary divergence differs considerably from its unconstrained preference: indeed, it represents rather considerable accommodation of State B's policies (point 3). This degree of accommodation, however, results in minimal foreign exchange market pressure (point 4)—pressures that might be redressed by intervention or a small movement in the exchange rate, or perhaps some combination of both.

As these two states' economies become more integrated, and especially as the degree of capital mobility between them increases, the feasible curve collapses toward the x-axis. This is simply a restatement of the capital mobility hypothesis: as capital mobility increases, the foreign exchange costs of monetary indepen-

<sup>63</sup>This may be due to differences in national characteristics. The literature on optimum currency areas suggests that smaller, more open economies face greater economic costs from exchange rate fluctuations than do larger, more closed states. For a review of this literature see Tower and Willett (1976).



dence increase.<sup>64</sup> As a consequence, even states with stable, widely divergent preferences will be expected to reduce the degree of monetary divergence between them as the degree of capital mobility between them increases, as pictured in Figure 3. Here, the optimal degree of monetary divergence from State B (given State A's preferences about monetary independence and exchange rate stability with State B) is considerably reduced, from point (1) to point (2). The heightened costs of independence, all other things being equal, induce new levels of accommodation.<sup>65</sup>

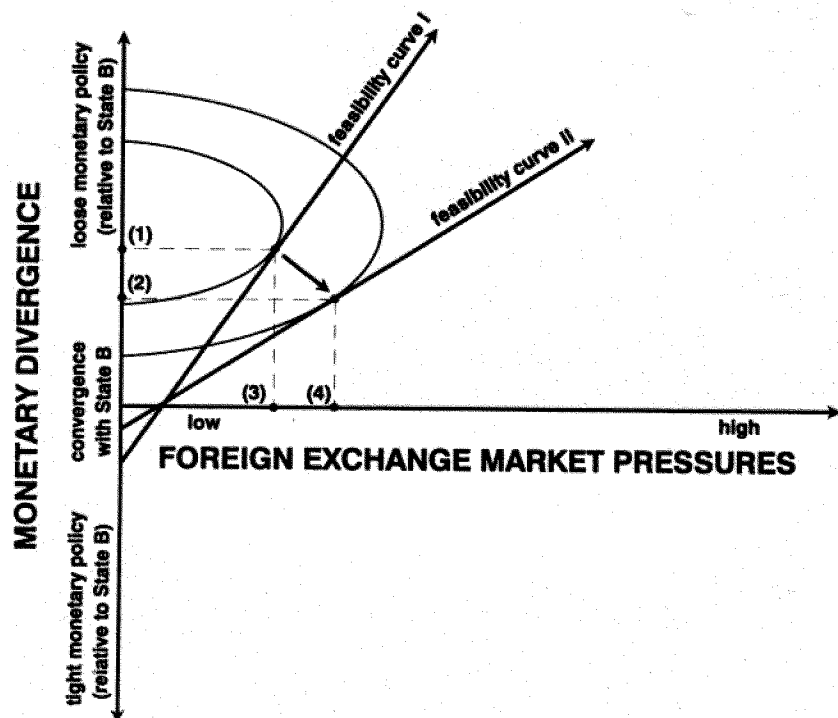


FIG. 3. Optimal changes in behavior associated with increases in capital mobility.

- (1) Optimal degree of divergence given the shape of the indifference curve and feasibility curve I.
- (2) Optimal degree of divergence given the shape of the indifference curve and feasibility curve II.
- (3) Degree of foreign exchange market pressure associated with point (2).
- (4) Degree of foreign exchange market pressure associated with point (1).

<sup>64</sup>In theory, if capital were perfectly mobile then monetary divergence would be impossible; the feasible set would be restricted to a horizontal line and national monetary autonomy would be nonexistent. However, given the presence of exchange risk and risk aversion, capital is never perfectly mobile even if exchange risk can be eliminated through forward contracts. "In such a case a country may [exercise] considerable monetary independence even though international arbitrage enforces covered interest parity at all times" (Willett and Wihlborg, 1990:176). Note that Willett and Wihlborg's use of "independence" differs somewhat from that in this article.

<sup>65</sup>The placement of the intersections of the two feasibility curves in Figure 3 with the x- and y-axes is intended to be suggestive; the implications thereof are not explored in this text. The empirical effects of changes in capital mobility on the degree of compensatory divergence needed to minimize foreign exchange market pressures will be explored in a future article.

Note that this representation of the capital mobility hypothesis is not deterministic about the degree of monetary divergence from its neighbors that a given state will pursue. To the degree that states value exchange rate stability with their partners, they will be inclined to sacrifice some degree of monetary independence in order to realize this objective; as capital mobility increases, the nature of this trade-off becomes more severe. In such an environment, the precise strategy a state employs in pursuit of its mutually inconsistent objectives of monetary independence and exchange rate stability depends on many things, including the causal beliefs of policymakers, the structure of its domestically determined preferences, and the nature of its interactions with its partners.<sup>66</sup> But this has always been the case with economically interdependent states enjoying formally monetary sovereignty. Increases in capital mobility have simply altered the parameters of these relationships, not their fundamental character.

### Monetary Adjustment in Japan and Western Europe

One of the strengths of the capital mobility hypothesis is that it provides a system-level explanation for a variety of behaviors observed around the world. For example, the capital mobility hypothesis provides an initial account of Japanese monetary policy immediately following the collapse of the Bretton Woods system of pegged exchange rates. As the degree of capital mobility rose in the 1950s and especially the 1960s, Japanese monetary authorities found themselves increasingly obliged to pursue domestic monetary policies accommodating U.S. behavior in order to defend the yen's dollar parity.

Following the demise of the Bretton Woods system in March 1973, however, monetary authorities in Tokyo adopted substantially looser policies than those in the United States for the remainder of 1973 and 1974. The exchange rate effects of pursuing such an independent course, however, soon proved intolerable for a state as heavily reliant on trade as Japan. As a consequence, and in spite of the absence of any formal exchange rate regime, by 1976 Tokyo had returned to its previous practice of only minimal variation from U.S. monetary policy. This pattern of interest rate experimentation followed by retrenchment is manifest in Figure 4.<sup>67</sup>

Similarly, Western European governments have for many years regarded mutual exchange rate stability as a very high priority, owing not only to their trading patterns but also to the sensitivity of the institutions of the European Community (especially the Common Agricultural Policy) to exchange rate movements.<sup>68</sup> Consequently, according to the capital mobility hypothesis, the rising costs of pursuing independently chosen monetary policies should have induced a substantial degree of mutual monetary adjustment between these states.

In fact, Western European states in widely different circumstances did adopt strikingly similar sets of policies during the late 1970s and 1980s. These differences in the economic and institutional circumstances of Europe's industrial states were not trivial. They varied as to size, membership in the European Community,<sup>69</sup> participation in the exchange rate mechanism of the European

<sup>66</sup>Importantly, causal beliefs and preferences are both subject to change; see footnote 10.

<sup>67</sup>Figure 4 depicts the differential (in absolute terms) between U.S. and Japanese short-term real interest rates between 1965 and 1985. These are derived from lines 60b and 99bi x (nominal money market rates and the annual GDP deflator, respectively) of *International Financial Statistics*.

<sup>68</sup>There is also the widespread mental association in Europe—whether or not well founded—between the competitive devaluations of the 1930s with the depression, the rise of fascism in Germany and Italy, and the coming of the Second World War; cf. Giavazzi and Giovannini (1989:2-19).

<sup>69</sup>With the ratification of the Maastricht Treaty, the former European Community is now the European Union.

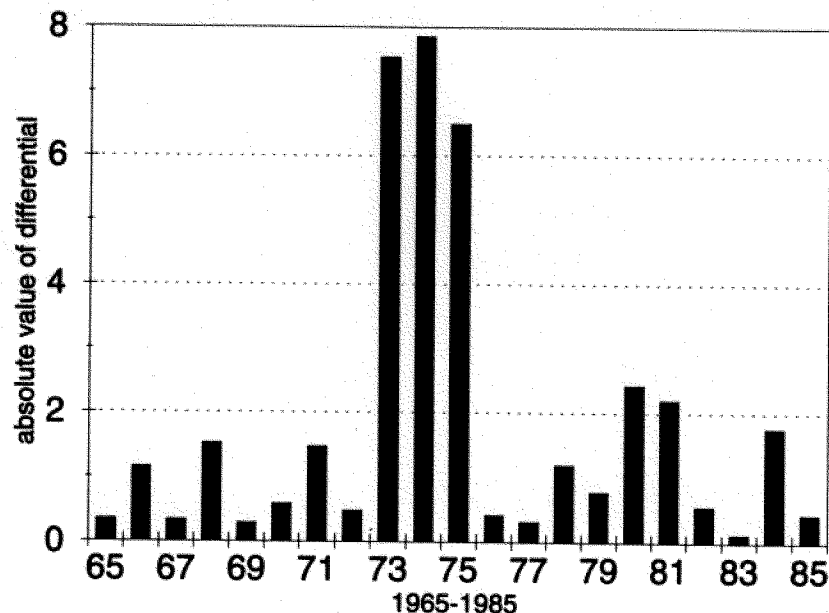


FIG. 4. Differentials in U.S.-Japanese short-term real interest rates. (Source: Derived from *International Financial Statistics*; see footnote 67.)

Monetary System (EMS), and revealed policy preferences. Yet despite these underlying differences, all the advanced industrial states of Western Europe eventually accommodated German policy (as I demonstrate elsewhere<sup>70</sup>).

Membership in the EMS was not decisive in accounting for this accommodating behavior;<sup>71</sup> despite initial differences in monetary strategy (for states both inside and outside of the system's exchange rate mechanism), all the advanced industrial states within the German *deutschemark's* orbit ended up coordinating their policies more closely with the Bundesbank and experiencing greater exchange rate stability with the *deutschemark*. Indeed, establishment of the pattern of evolutionary adjustment to German policy *preceded* formation of the EMS in each case, including France and Italy.

Nor did state size alter the general pattern, except perhaps in terms of timing. Indeed, the adaptive behavior of the large states (France, Italy, and Britain) increasingly paralleled the patterns of monetary accommodation previously associated with their relatively small and economically open neighbors. Evidently the effects of capital mobility have overwhelmed the formerly differential effects

<sup>70</sup>For an account of the experiences of Austria, Belgium, Denmark, France, Italy, the Netherlands, Norway, Sweden, and Switzerland in accommodating German policy see Andrews (1994).

<sup>71</sup>Although participation in the exchange rate mechanism has been effective in reducing stochastic variations in exchange rates; cf. Giovazzi and Giovannini (1989:45-50).

of economic openness in this regard.<sup>72</sup> Finally, differences in the *direction* of revealed policy preferences relative to Germany did not alter the general pattern of adaptation either.<sup>73</sup> Increased capital mobility constrained the monetary autonomy not only of states with relatively expansive preferences but of those with relatively restrictive preferences as well.<sup>74</sup> Switzerland, the only Western European state with demonstrably more restrictive preferences than Germany, was obliged to lower real interest rates considerably in order to stem undesired appreciation of the Swiss franc.<sup>75</sup> The relatively tiny Swiss economy simply could not insulate itself from the effects of massive capital inflows, and authorities eventually reconciled themselves to living with (from the Swiss perspective, undesirably high) German inflation rates.

The outcomes from both Europe and Japan described above can be understood, on a first-cut basis, in terms of a minimum number of postulates. To reiterate, the underlying assumptions of the capital mobility hypothesis are that monetary policy independence, exchange rate stability, and capital mobility trade off against one another; that the degree of international capital mobility is increasing; and that states' feasibility curves are regularly shaped.<sup>76</sup>

In addition to these general assumptions, however, the preceding analysis characterized U.S.-Japanese monetary relations in terms of American dominance. Likewise, European monetary relations were depicted as a series of bilateral relations with the German Bundesbank. While empirically defensible, the latter assertions are theoretically problematic—that is to say, our discussion of the capital mobility hypothesis thus far does not account for them. This is the subject of the next section.

#### Capital Mobility and Strategic Interdependence: An Agenda for Research

The capital mobility hypothesis maintains that the costs of monetary independence have increased as financial markets have become more integrated, prompting adaptation by national monetary authorities. It is important to note, however, that the *distribution* of these increased costs is not necessarily symmetrical. The simple bilateral representation of the effects of increasingly mobile capital in preceding sections was based on the assumption that the partner state (State B) chose its policies autonomously. Since international monetary policy decisionmaking is in fact strategic in nature, however, the partner state's mon-

<sup>72</sup>While all European economies were becoming somewhat more open during the 1980s, the ratio of total trade (exports plus imports) to GDP still varies significantly between the large and small states. This ratio ranged from below fifty percent in France and Italy to well above one hundred percent in Belgium and Holland (average for the years 1984-1986, *International Financial Statistics*, lines 90c, 98c, and 99b).

<sup>73</sup>This statement requires some qualification. Certainly the magnitude of difference from German policy standards altered the external pressure generated by pursuit of independent policies. For example, the Austrian schilling was never subject to the same foreign exchange market pressures as the Italian lira. Furthermore, had there been another major hard currency in the region (with a stature in international markets similar to the *deutschemark*), Europe might not have developed into a *deutschemark* zone. But this is to get ahead of the story.

<sup>74</sup>France, Italy, and Britain have had expansive monetary policy preferences relative to Germany. Goodman (1992, chap. 5) argues that the preferences of Italian authorities for loose monetary policies may have moderated following institutional reforms in 1981. Be that as it may, Italy's underlying preferences are still regarded as more expansive than Germany's. The adoption of a monetarist economic philosophy by the British government during the Thatcher years certainly resulted in a relative tightening of British monetary policy, but underlying tendencies toward expansion remained evident. The revealed policy preferences of Belgium, the Netherlands, Denmark, Sweden, and Norway during the 1970s were somewhat more expansionary than Germany's. Austrian monetary policy preferences (at least prior to 1982) were slightly more expansive than Germany's, while Swiss preferences were somewhat more restrictive. See Andrews (1994).

<sup>75</sup>Notermans (1991:6-7).

<sup>76</sup>On the latter point, see footnote 57.

etary policies are neither fixed nor autonomously chosen. Moreover, exchange rate relations are multilateral, not bilateral; a state may have a relatively stable exchange rate with some partners and relatively unstable exchange rates with others. Monetary policy decisionmaking is, in other words, an interdependent phenomenon. The choice made by one government regarding its divergence from another's policies, under conditions of capital mobility, necessarily affects the options available to third parties (presumably by influencing the shape or position of their feasibility curves). The model presented earlier must therefore be qualified in order to underline its identification of states' *initial choices* rather than Nash equilibrium outcomes.<sup>77</sup>

Consider in this regard the European case. Within the economics profession, it has become commonplace to characterize Western Europe since the collapse of the Bretton Woods par value system in 1973 as a *deutschemark zone*.<sup>78</sup> One indicator of this phenomenon is the more or less passive role played by Germany in the multilateral stabilization of European exchange rates.<sup>79</sup> Giavazzi and Giovannini (1989:63–83), among others, employ several measures in support of this observation. Their analysis of foreign exchange intervention data within the European Monetary System leads them to conclude that "most of the intramarginal intervention was carried out by countries other than Germany," evidence that "Germany has on average kept no positions in other EMS currencies for the purpose of intervention. . . . Germany intervened only when bilateral fluctuation margins were reached."<sup>80</sup> The data on dollar intervention, while not as conclusive, is nonetheless consistent with the hypothesis that "dollar intervention by the Bundesbank was motivated . . . by the desire to avoid big fluctuations in relative prices with a large trading partner—the United States—along with the assumption that other European authorities would accommodate" the resultant dollar-DM rates (1989:66–67).<sup>81</sup>

To the degree that the non-German states of Europe have felt increasingly compelled to accommodate German policy, the terms of the trade-off Germany has experienced between pursuing its internally determined monetary objectives on the one hand and stabilizing the *deutschemark vis-à-vis* the currencies of its European trading partners may have actually improved.<sup>82</sup> As a general matter, this suggests that increases in capital mobility do not necessarily reduce the

<sup>77</sup>For game-theoretical analysis of the strategic nature of international monetary policy coordination problems see Artis and Ostry (1986), Cooper (1985), and Hamada (1974, 1976), cited here in ascending order of difficulty.

<sup>78</sup>Cf. Giavazzi and Giovannini (1987). This view is not universally held; for example, Fratianni and von Hagen (1990:309) find that "many observers have mistaken German long-run [policy] independence and French [policy] under representation in the EMS for German dominance." Their analysis is based on the observation that states have varied in the degree to which they have accommodated German interest rate changes, suggesting that German dominance is overstated. Such differences in accommodative strategies, however, are fully compatible with the heuristic model of the capital mobility hypothesis presented above.

<sup>79</sup>The 1987 Basle-Nyborg reforms of the European Monetary System were intended to redress this asymmetry, but with uncertain results.

<sup>80</sup>The active element of the EMS is a bilateral parity grid, referred to as the exchange rate mechanism (ERM). Marginal intervention within the grid system refers to compulsory intervention by both central banks when the prices of their two currencies have reached their bilateral limits or margins; intramarginal intervention refers to the buying and selling of foreign exchange before the outer limits of the bilateral band have been breached, and is not mandatory. The bulk of intervention activity consists of intramarginal rather than marginal intervention; see chapter 4 of Giavazzi and Giovannini (1989).

<sup>81</sup>In other words, German monetary authorities were in much the same position *vis-à-vis* the dollar as was the Bank of Tokyo, as described earlier.

<sup>82</sup>This asymmetry has been most spectacularly evident in the aftermath of German unification, when the Bundesbank was able to pursue a tight money policy that was entirely at odds with the expressed wishes of its EC partners. Prior to September 1992, Germany experienced practically no foreign exchange costs within the European context for this display of monetary independence. Since then, the magnitude of exchange rate movements against the *deutschemark* have been actually quite limited in comparison with the intra-European experience of the mid-1970s.

monetary autonomy of all states equally at all times. While financial integration raises the *total* foreign exchange costs of pursuing independently chosen monetary policies, the asymmetrical *distribution* of these costs can produce widely differential effects on individual states' monetary autonomy.

Recall in this regard that the heuristic model presented in this article does not represent a deterministic view with regard to outcomes of international monetary relations. Rather, the capital mobility hypothesis argues that international financial integration alters the *choice set* available to different national monetary authorities; optimal strategies were noted to vary according to differences in the preferences as well as the causal beliefs of national monetary authorities. In addition, however, strategies will vary according to the nature of a state's interactions (and expectations about future interactions) with its partners.<sup>83</sup>

This suggests that the degree of capital mobility can alter power relations between states—the relative ability of different states to achieve conflicting policy objectives. Willett and Wihlborg (1990:53) argue that "depending on the exchange rate regime in operation and the policy blend in use, international capital flows can enhance rather than undercut a national government's ability to achieve its domestic macroeconomic objectives." In addition, the potential for exchange rate destabilization latent under conditions of advanced international financial integration may induce a state's trading partners to accommodate its monetary policy preferences.<sup>84</sup> In such cases, highly mobile capital may serve to enhance some national governments' ability to achieve their internal and external policy objectives simultaneously.<sup>85</sup>

If so, then what are the parameters of these phenomena? How do interstate differences in exchange rate, trade, and macroeconomic strategies influence these bargaining outcomes—and by extension, the relative power of different states? Certainly changes in relative power have been manifest. Germany has not always enjoyed the degree of monetary primacy within Europe that it exercised in the late 1980s, and America's once unchallenged leadership of the post-war international monetary system has become increasingly problematic. Changes in the degree of international capital mobility frame the context within which these developments have taken place; but merely noting that the costs of monetary independence rose does not explain the particular distribution of these costs, nor the exact forms that national monetary policies and international monetary relations have assumed in response to them.

Given this degree of indeterminacy, future research on international monetary relations might profitably examine the relationship between changes in capital mobility and exchange rate regime choice. On the latter subject, the economics profession has developed a voluminous literature on optimum currency area theory. The optimum currency area approach focuses on differences in the economic effects of flexible versus fixed exchange rates on states varying in size, economic openness, and trading patterns.<sup>86</sup> A more general treatment of regime choice might treat exchange rate arrangements as interstate bargains

<sup>83</sup>As a consequence, exactly how power relations will vary under conditions of rising capital mobility is indeterminate. In game-theoretic terms, this suggests an *n*-player game with constantly changing payoffs. The problems involved with even contemplating such a game are mitigated, however, by the observation that the payoffs are shifting in an orderly fashion (as the capital mobility hypothesis suggests).

<sup>84</sup>See in this regard the discussion of sensitivity versus vulnerability interdependence in Keohane and Nye (1977:11–19). For an alternative analytical treatment from a different context, see the discussion of modes of control in Mintz and Schwartz (1985:1–15).

<sup>85</sup>Willett and Wihlborg cite U.S. macroeconomic policy in the early 1980s as an example of the former phenomenon; it may well be an instance of the latter as well.

<sup>86</sup>See footnote 63.

influenced not only by these (relatively static) efficiency-oriented concerns but also by changes in the choice sets available to states as capital markets become increasingly integrated.

Such an integrated framework would provide the analytical basis for a useful comparison of the wide variety of exchange rate arrangements extant in the world today—ranging from largely *ad hoc* collaboration, as between the G-7 states, through the widespread practice of unilaterally pegging national currencies to external targets, to the ongoing European experiment in more formal and multilateral exchange rate management. The resulting analysis could yield insights into not only the efficiency but the distributional effects of different exchange rate arrangements (including the sensitive matter of the distribution of adjustment costs), allowing for a genuine fusion of the central concerns of both economic and political theorists—efficiency and power.

### Toward a Structural Theory of International Monetary Relations

The preceding discussion has been intended to suggest that the mutual incompatibility over time of monetary policy independence, exchange rate stability, and capital mobility can serve as the conceptual foundation of a structural analysis of interstate macroeconomic (and especially monetary) relations. To summarize key elements of the argument, the global integration of financial markets has been the consequence of changes in technology, market practice, and national policies. The difficulties in reversing the trend toward financial integration derive in part from this diversity of sources and in part from their collective interaction. The costs of reversing the technological advances that underlie capital mobility are difficult to contemplate in any straightforward counterfactual sense. While governments need not have allowed Eurocurrency markets to have developed in quite the unrestricted fashion that actually took place, the forces unleashed by the introduction of these and other new market practices have proven extremely difficult and costly to contain (much less to reverse or even eliminate). Finally, the widespread reduction in regulatory barriers to the movement of capital (both within and between states) was in the first instance the consequence of national policies. However, interstate competition for capital and socialization of monetary authorities serve as powerful impediments to either unilateral or collaborative reversal of these trends. The collective impact of these developments has been to punish certain approaches to macroeconomic (and in particular monetary) policy while rewarding others, justifying treatment of capital mobility as a structural feature of the international system.

It is important, however, not to demand too much of a purely structural theory of international monetary relations. As the discussion in the previous section underlined, the choice of exchange rate strategy (as well as the outcomes of strategic interactions between states) is influenced but not determined by structural constraints. At a more general level, a purely structural theory of international monetary relations is subject to the central criticism leveled at structural theories of politics in other contexts: it helps account for some things but not others.<sup>87</sup>

But in similar fashion, attention to capital mobility as a structural variable helps account for some important phenomena, and the connections between them, in ways that other approaches cannot. Consider in this regard Milner's

<sup>87</sup>Waltz seemed more sensitive to this concern in his early writing than in *Theory of International Politics*; see Waltz (1959).

(1992) review of the strengths and weaknesses of the last ten years of theorizing about the nature of international cooperation. She observes that international relations theorists have made two general contributions to our understanding of the phenomena: the establishment of some degree of consensus on the definition of the cooperation and the "develop[ment of] propositions about the conditions under which cooperation is likely to emerge, by using game theory to model relations at the systemic level" (1992:467).<sup>88</sup> On the other hand, she maintains that these two insights are counterbalanced by two important defects: reliance on problematic assumptions used to generate relatively parsimonious hypotheses, and the widespread neglect of the influence of domestic politics on international relations. Both these problems, Milner concludes, "derive from [the literature's] reliance on systemic theories and game theory" (1992:481).

Milner's documentation of these drawbacks is impressive and persuasive. However, the literature that she reviews lacks attention to an important element of systemic theory, namely, structural change in the Waltzian sense. Rational choice analysis of the strategic interactions of functionally similar states may well constitute third-level analysis (in the sense of Waltz, 1959), but it does not constitute structural analysis (in the sense of Waltz, 1979). In other words, the formal literature on international cooperation has generally failed to associate changes in outcomes with changes in structure.<sup>89</sup> Thus, while attention to structural change has been a major concern of analysts of international security affairs, application of a similar Waltzian framework has generally been neglected in the literature on international political economy.<sup>90</sup>

Certainly recognition of the constraining effects of heightened international capital mobility represents the beginning rather than the end of theoretically informed explanation of contemporary international monetary relations and macroeconomic policy coordination efforts. Description of capital mobility as a structural phenomenon is in this sense intended to invite discussion, not preclude it. But accounts of states' internal or external monetary policy decisions that fail to acknowledge capital mobility's effects do so at their own peril.

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<sup>88</sup>In other words, about the nature of cooperation between units in a system characterized by formal anarchy. See, for example, Axelrod (1984), Keohane (1984), and Oye (1986).

<sup>89</sup>The structural feature that has most concerned formal theorists of international relations is anarchy, which is widely presumed to have been a constant (and perhaps even the defining) feature of international politics in the modern era. If it is a constant feature, then by definition it cannot account for systematic changes in the behavior of states over time.

<sup>90</sup>For a similar argument in a different context, see Zakaria's (1992) critique of Snyder (1991).

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## The Problem of Peaceful Territorial Change

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This article deals with the process of change in the international status quo of territories, and how such changes may be brought about "peacefully," by means other than war. The main question I address is: Under what conditions and circumstances will alterations in the status quo of territories take place without warfare or other unilateral coercive means?

In order to answer the above question, this study identifies three background conditions that facilitate peaceful territorial change: an asymmetrical distribution of power between the parties involved in the process; a similar type of political regime of the members of the dyad; and a convergence of norms and rules of international law and morality sustained by the parties with reference to the disputed territory. In addition, it is important to understand the variables that make the process of peaceful territorial change likely to occur. This process will be affected by the different interests of the parties in a given territory, their degree of cooperation and reciprocity, and their strategies of bargaining and negotiation.

This article deals with the process of change in the international status quo of territories, and how such changes may be brought about "peacefully," by means other than war. The main question addressed is: Under what conditions and circumstances will alterations in the status quo of territories take place without warfare or other unilateral coercive means?<sup>1</sup>

In order to answer the above question, I identify three background conditions that facilitate the process of peaceful territorial change: an asymmetrical distribution of power between the parties, preferably to the advantage of the status quo power; a similar type of political regime of the members of the dyad; and a convergence of norms and rules of international law and morality sustained by the parties in relation to a disputed territory.<sup>2</sup> These conditions are not very

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<sup>1</sup>This question is based on Keohane (1986a:198). See also Bloomfield (1987).

<sup>2</sup>These are not the only possible background conditions for the occurrence of peaceful territorial change. In a larger study, I examine three additional background conditions: diplomatic intervention by third parties in the