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FEAR FACTOR: HOW POLITICAL INSECURITY SHAPES THE DIFFUSION OF FINANCIAL MARKET DEREGULATION

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Abstract[1]

Nearly 30 years after "financial repression" was flagged as a major problem in developing countries, nearly all nations have at least partially liberalized their financial systems. Explanations for this spread of financial market deregulation have emphasized either "top down" mechanisms (globalization, pressure from IOs and the U.S.) or "bottom up" mechanisms focusing on domestic coalitions (derived from configurations of economic interests). In contrast to these broadly structural approaches that de-emphasize the choices of agents, this paper focuses on the micro-foundations of diffusion by emphasizing the incentives facing office-seeking leaders. I argue that politically insecure leaders are potent agents of diffusion because they are particularly likely to "learn" the lessons of financial market reform and emulate the liberalizing practices of others for two reasons. First, the hefty economic boom often associated with financial liberalization provides a tempting way to attempt to buttress their near- to medium-term grip on power. As they observe other nations in their region experiencing a boom, leaders fearful of losing office will be quick to learn the lesson and particularly eager to jump on the liberalization bandwagon, accelerating regional deregulation cascades. Second, insecure governments may be particularly susceptible to pressure from international organizations: they have motivated biases both to believe the efficiency claims of liberalizers and strong reasons to seek the "seal of approval" for their policies. Either way, politically insecure leaders will be quick learners about the benefits of liberalization. To assess these arguments, I estimate hazard models of political survival to generate a proxy for political insecurity. With this proxy for insecurity in hand, time-series cross-sectional logit models of the timing of reforms are estimated. The argument implies that while politically insecure leaders may speed diffusion, their depth of commitment will be shallow, and that reforms motivated partly by fear of losing office will be more likely to unravel than those taken out of deeper conviction.

INTRODUCTION

Domestic financial market liberalization – the process of allowing the market to determine who gets and grants credit and at what prices – has swept the world over the past three decades. Although by 1970 a handful of OECD countries had liberalized their financial markets, they were in general few and far between (Williamson and Mahar 1998).[2] Thirty years later the picture differed dramatically: any remaining restrictions in OECD countries were mere relics of the past, and broad swaths of the developing world have liberalized at least some parts of their financial systems. Thus nearly thirty years after "financial repression" was diagnosed as a major

problem of developing countries, the arguments of early advocates of financial liberalization (McKinnon 1973; Shaw 1973) seemed to have carried the day.

Explanations for this spread of financial market deregulation have emphasized either "top down" mechanisms (globalization, pressure from international financial institutions and the U.S.) or "bottom up" mechanisms focusing on domestic coalitions (derived from configurations of economic interests). In contrast to these broadly structural approaches that de-emphasize the choices of agents, this chapter focuses on the micro-foundations of diffusion by emphasizing the incentives facing office-seeking leaders. Acting as pivots between the pressures emanating from the international realm and domestic political imperatives, office-seeking politicians ultimately must decide whether, when, and how to liberalize domestic financial markets. Placing the incentives facing leaders center-stage and focusing on the horizontal diffusion of liberalization, I argue that politically insecure leaders are potent agents of diffusion because they are particularly likely to "learn" the lessons of financial market reform and emulate the liberalizing practices of others for two broad reasons, one having to do with the particular psychological dynamics of decision making when facing prospective losses and the other with the specific dynamics of financial market reform.

First, to argue that insecure leaders may be particularly receptive learners of the lessons of financial market reform, I combine insights from two areas of cognitive psychology: prospect theory and motivated biases. The central insight of prospect theory is that when faced with losses, individuals often become bold risk takers, whereas when faced with prospective gains they become more cautious (Tversky and Kahneman 1981), whereas the literature on motivated biases highlights the prevalence of wishful thinking, a dynamic by which our desires shape our beliefs. I suggest that marrying prospect theory with the literature on motivated biases implies that decision makers facing prospective losses will be disposed towards the fallacy of "wishful thinking" when assessing the likely consequences of domestic financial market reforms. According to prospect theory, decision makers facing losses are driven by a desire to regain the status quo ex ante. This desire is likely to shape their beliefs, via a process of wishful thinking, about the likelihood of successfully avoiding losses, leading them to accept eagerly plans and policies suggesting a way out of their dilemma. Thus the unmotivated biases of prospect theory

can combine with the motivated biases of wishful thinking to create distinctive patterns of information processing and action among politically insecure leaders. In particular, in the context of financial market reform, insecure leaders are likely to find the arguments of reform advocates very tempting and to discount the risks entailed by the reform process.

These psychological dynamics of decision making in the face of prospective losses interact with specific features of domestic financial market reforms in a way that renders such policies particularly attractive to politically insecure leaders. The immediate aftermath of liberalization is often characterized by an economic boom, an effect that is particularly strong in developing countries (Wyplosz 2001). Loosened borrowing restrictions, new credit instruments, and capital inflows fuel a credit-driven consumption and investment boom, boosting GDP growth to well above trend for several years. I argue that this economic boom associated with financial market liberalization can provide an important source of political strength for insecure governments, meaning that insecure governments can have a surprisingly strong attraction to liberalization efforts. The hefty economic boom often associated with financial liberalization provides a tempting way to attempt to buttress their near- to medium-term grip on power. Combining the distinctive psychological dynamics of insecure leaders with the specific dynamics of domestic financial market reform suggests that politically insecure leaders will prove surprisingly likely to initiate reforms and can be potent agents of diffusion in the right circumstances.

What are the right circumstances to facilitate "learning" by politically insecure leaders? I suggest two. First, as they observe other nations in their region experimenting with reform, and ideally experiencing a boom, leaders fearful of losing office will be quick to learn the lesson and particularly eager to jump on the liberalization bandwagon, accelerating regional deregulation cascades. The example of other countries in the region undertaking financial market reform will assure that the possibility appears on an insecure leader's radar screen, and the psychological dynamics of loss avoidance will make them particularly eager to follow suit. Second, insecure governments may be particularly receptive to policy advice from international organizations: they have motivated biases both to believe the efficiency claims of liberalizers and strong reasons to seek the "seal of approval" for their policies. Leaders who are otherwise resistant to the advice of international financial institutions (IFIs) may see things differently when operating

in the psychological domain of loss. In this context, they have additional reasons to want to believe in the promises held by reform policies. I thus expect regional trends towards liberalization and the prevalence of IFIs in policy debates to provide two circumstances in which politically insecure leaders are likely to be drawn disproportionately to domestic financial market reforms: these two circumstances interact with political insecurity to speed the spread of financial deregulation.

To assess these arguments, I estimate hazard models of political survival to generate a proxy for political insecurity, using a newly available dataset on political leadership. Treating the predicted hazards from these models as a proxy for political insecurity, time-series cross-sectional logit models of the timing of reforms are estimated. Results indicate that the combination of political insecurity, regional trends towards reform, and prominence of IFI policy advice in policy discourse together make a powerful combination encouraging the diffusion of domestic financial market reform.

The rest of this chapter proceeds as follows. The next section fleshes out the logic of my argument, appealing to a combination of the specific macro-economic dynamics of domestic financial market reforms and the psychological dynamics of decision making in the shadow of potential losses to argue that politically insecure leaders are likely to be particularly potent agents of diffusion. I then turn to the question of political insecurity, estimating a discrete time hazard model of political survival: the predicted probabilities that a leader will fall form power in a given time period serve as proxies for political insecurity. In the following section I use these predicted hazards to assess whether political insecure governments are more likely to "learn" the lessons of reform: are politically insecure leaders particularly prone to emulate the actions of their neighbors, and particularly responsive to the cajoling of international financial institutions? By way of a conclusion, the final section discusses the implications of my findings for the broader literature on the spread of financial liberalization**.**

LEARNING IN THE DOMAIN OF LOSS

Why might politically insecure leaders make surprisingly quick learners when it comes to the lessons of domestic financial market reform? While at first blush it may appear counter-intuitive

to suggest that politically insecure leaders would be attracted to major reforms programs, delving deeper into the specific nature of financial market reforms and the psychology of decision making in the shadow of potential losses resolves the apparent paradox. I discuss the two in turn.

The Macroeconomic Dynamics of Domestic Financial Market Reform

While many reform packages promise short term pain in return for long term gains, domestic financial market reforms frequently reverse this formula, promising short term benefits while posing long term risks. Indeed, the macro-economic dynamics of financial liberalizations create temptations for governments with short time horizons to initiate reforms in an attempt to reap short-term benefits from liberalization, despite the long-term risks posed by hasty and poorly executed reform. This is because the immediate aftermath of liberalization is usually characterized by an economic boom, an effect that is particularly strong in developing countries (Wyplosz 2001). Loosened borrowing restrictions, new credit instruments, and capital inflows fuel a credit-driven consumption and investment boom, boosting GDP growth to well above trend for several years. I argue that this economic boom associated with financial market liberalization can provide an important source of political strength for insecure governments, meaning that insecure governments can have a surprisingly strong attraction to liberalization efforts.

Let us trace the channels of the boom phase more closely, with an eye to likely political consequences. First, the immediate consequences of financial market liberalization often lead to favorable trends in macroeconomic aggregates (robust GDP growth, expanding employment) that are likely to improve assessments of government performance. Moreover, the boost can be large and long-lasting: using simulations based on empirical models, Charles Wyplosz estimates that the cumulative boost arising from growth above trend often amounts to nearly 15% of GDP and that the boom typically lasts up to five or six years (Wyplosz 2001).

More narrowly, the two chief engines of growth powering these expansions – consumption and investment booms – disperse benefits widely across broad constituencies. Increased availability of credit upon liberalization often fuels a consumption boom, as borrowing opportunities never before available induce a rapid expansion in consumer credit and spending. Particularly well-documented in expansions following deregulation in the United Kingdom and Sweden in the

1980s, consumption booms seem of even greater potential importance in developing countries, where new avenues of credit bring consumer durables within reach of many for whom such luxuries had previously been unattainable. Mexican banks, for example, rapidly extended credit-card issues and loans after financial liberalization, fueling a boom in automobile and consumer durable sales. Consumer lending also accelerated rapidly upon liberalization in Thailand, in particular leading to a rapid expansion sales of automobiles and other consumer durables. Similar credit-led consumption booms following financial market liberalization have been documented in the Philippines, Argentina, New Zealand, and Chile, among others.

Turning to investment, financial market liberalization commonly has two positive effects: a general increase in lending that fuels an investment boom, and a more efficient allocation of investment. Both effects should boost economic performance, although the latter may create an important group of "losers" and take longer to filter through into higher growth.[3] In general, systematic studies of the effects of liberalization conclude that financial constraints for most firms are loosened – or at least not affected adversely – by liberalization (Laeven 2000). Smaller firms, in particular, are often the beneficiaries of an increased ability to borrow: in Korea, small firms gained improved access to funds following liberalization (Caprio, Atiyas et al. 1994), as they also did in Mexico and Chile. The most comprehensive evaluation – a panel study of 40 countries – concludes that financial liberalization reduces the effect of financing constraints on investment for most firms in most countries (Love 2001).

This is not to say these policies are without risk, by any means. However, the risks tend to lie relatively far in the future. In the medium term, financial liberalization is often followed by banking sector problems, which sometimes erupt into full-scale economic crisis. Systematic studies documenting the link between financial liberalization indicate that liberalization raises the risk of banking crises, even when controlling for other factors increasing their likelihood (Demirguc-Kunt and Detragiache 1998; Demirguc-Kunt and Detragiache 1998; Kaminsky and Reinhart 1999; Wyplosz 2001). More than 50 percent of liberalizations are followed by a crisis sometime in the ensuing 10 years. Although the origins of these crises are hotly debated, most tend to be preceded by a credit boom resulting from an overly rapid expansion of the financial system, which leaves the banking sector extremely vulnerable to macroeconomic turbulence (Gavin and Hausman 1996) or creates an overhang of bad loans, whose accumulation is

facilitated by a lack of well-functioning financial system infrastructure. Still, for governments concerned with their near-term political survival, the danger posed by a potential bust five or ten years down the line is likely to be heavily discounted.

Summing up, the macroeconomic effects of the boom phase should strongly affect the "headline" national economic performance that most strongly shapes evaluations of government performance, and the benefits from growth arising through consumption and/or investment booms should be fairly widely dispersed: all in all, this adds up to a winning formula for governments looking for a near- to medium-term boost to their political security. The bust, if it occurs at all, is likely to come five to ten years later, sufficiently far in the future that it is unlikely to loom large in the political calculations of governments with short time horizons.

Learning in the Zone of Loss: Prospect Theory, Motivated Biases, and Reform

How might a high level of political insecurity affect the likelihood that leaders will "learn" the lessons of reform?[4] While at first blush it would appear likely that insecure leaders would refrain from major policy initiatives, lessons from cognitive psychology suggest that leaders striving to hold onto power may in fact be bold risk takers in certain situations. To argue that insecure leaders may be receptive listeners to those peddling the merits of financial market reform, I combine insights from two areas of cognitive psychology: prospect theory and motivated biases.

The central insight of prospect theory is that when faced with losses, people often become bold risk takers, whereas when faced with prospective gains they become more cautious (Tversky and Kahneman 1981). People tend to use the status quo ex ante as the point of reference when assessing the attractiveness of risky choices (Kahneman, Knetsch et al. 1990). When contemplating gains relative to the point of reference,[5] people tend to prefer small gains that are "sure things" to lotteries that promise higher payoffs, even when the expected value of the latter is greater than the former. However, when facing losses relative to the reference point,[6] decision makers become willing to take greater risks, preferring lotteries that contain the promise of avoiding losses even when these yield lower expected values than other options. In other words, when in the domain of loss, decision makers will tolerate great risks to avoid losses, whereas when in the domain of gains they will avoid great risks in order to lock in modest gains. In making decisions under risk, people exhibit relative loss aversion: losing hurts more than a

comparable gain pleases, and people are willing to take on risky prospects in attempts to avoid the pain of loss.

Prospect theory's relevance to the behavior of politically insecure leaders is fairly straightforward.[7] Leaders at a relatively high risk of losing office can safely be assumed to be in the zone of loss; with office holding as the frame of reference, they are faced with the unpleasant prospect of losing power, along with all its attendant prerogatives (both material and psychological). Thus they are likely to perceive office holding as the status quo ex ante, and actions will be oriented towards avoiding losing office, situating their psychological frame of reference firmly in the zone of loss. From this frame of reference, the risky prospect of financial market reform may hold new attractions. Although holding great promise, financial market reform also poses considerable peril. Even if the short-term boom often associated with domestic financial market reforms materializes, in the long run the considerable peril posed by a potential bust phase could easily outweigh the benefits. However, governments interested in avoiding losses may find this risk tolerable. The promise of gain is likely to outweigh the peril of loss in their calculations.

While prospect theory provides an account of decision making under risk grounded in solid empirical research, it does not contain a theory of updating and learning. This is important because financial market reform is not like the simple choices among straightforward options typical in prospect theory experiments. Rather, it entails acceptance of a broad economic framework of analysis, and indeed, acceptance of portions of neo-liberal ideology. Such choices are not snap decisions, but entail a substantial amount of information processing and fairly sophisticated cognition; in short, learning. To supplement the prospect theory analysis, I appeal to the literature in cognitive psychology on how affect influences cognition; in particular, I draw on studies of motivated biases and learning (Dember 1960; Epstein 1967; Zajonc 1984). Motivated biases refer to situations in which our desires shape our beliefs: our views about how we would like the world to be color our views about how the world is. One type of motivated bias is "wishful thinking," in which the desirable is deemed feasible. For example, systematic studies have repeatedly shown that individuals over-estimate the likelihood of highly desired events or the ease of attaining highly desired goals. To take two illustrations, scientists, most of

whose career work falls exclusively under the heading of normal science, tend to overestimate the likelihood of making a major contribution to the stock of knowledge. In a similar fashion, employees tend to overestimate the rate of promotion in their workplaces, believing advancement is more likely and common than it is in fact. One problem confronting the literature on motivated biases, however, is that psychologists have cataloged a large number of common errors and fallacies that fall under this heading, but have difficulty specifying when one bias will emerge instead of another.[8]

I suggest that marrying prospect theory with the literature on motivated biases implies that decision makers in the zone of loss will be disposed towards the fallacy of "wishful thinking" when assessing the likely consequences of domestic financial market reforms. According to prospect theory, decision makers in the zone of loss are driven by a desire to regain the status quo ex ante. This desire is likely to shape their beliefs, via a process of wishful thinking, about the likelihood of successfully avoiding losses, leading them to accept eagerly plans and policies suggesting a way out of their dilemma. Thus the unmotivated biases of prospect theory can combine with the motivated biases of wishful thinking to create distinctive patterns of information processing and action among politically insecure leaders.[9][8] In particular, in the context of financial market reform, insecure leaders are likely to find the arguments of reform advocates very tempting and to discount the risks entailed by the reform process. Turning back to the specifics of financial market reforms, these policies promise great efficiency gains in the long run: widely accepted economic theories suggest that financial market liberalization should improve economic performance by encouraging the efficient allocation of savings to productive use, increasing the savings pool available for investment, and leading to financial deepening (McKinnon 1973; Shaw 1973). In the short run, of course, the potential of a boom phase driven by expanded consumer credit and investment would be particularly appealing to leaders needing to boost their domestic standing. On the downside, in both developing and developed countries, the process of financial liberalization sharply increases the likelihood of banking crises, which in turn can cause a sharp and potentially lengthy economic downturn (Demirguc-Kunt and Detragiache 1998; Mehrez and Kaufman 1999; Wyplosz 2001). However, insecure leaders who are operating psychologically in the zone of loss are likely to downplay these risks because they have a motivated bias to emphasis the potential benefits of these policies. Both the short term

boom and the long term efficiency gains promise to deliver results that would help them stay in office, whereas they are likely to both underestimate and discount the potential risks. The non-motivated biases identified by prospect theory interact with the motivated biases of wishful thinking to render politically insecure leaders eager learners of the lessons of financial market reforms.

Policies of financial market reform, in other words, provide a lesson that insecure policy makers have strong incentives to learn. Combining the distinctive psychological dynamics of insecure leaders (who are likely to perceive themselves in the "zone of loss" and to be particularly prone to the motivated bias of wishful thinking) with the specific dynamics of domestic financial market reform (which offers a plausible "all good things go together" promise over the short to medium term) suggests that politically insecure leaders are likely to be surprisingly likely to initiate reforms. They can prove to be potent agents of diffusion in the right circumstances.

In particular, two circumstances are likely to heighten the chance that insecure leaders learn the lessons of reform and attempt policy changes by making sure that the issue of financial market reform is on their radar screen. First, when they observe other countries in their region experimenting with reform and, ideally, experiencing the boom phase associated with the macroeconomic dynamics of reform, they will be particularly likely to emulate the (apparently successful) policies. In the context of crisis, leaders will be searching for alternative policies that can deliver the goods necessary to bolster their chances of staying in power. Trends in nearby countries will surely be noticed, and countries apparently benefiting from reform will provide powerful and persuasive examples for others to emulate. While struggling to hold onto power, leaders will be highly motivated to pay attention to the apparent successes of others. Thus the example of other countries in the region undertaking reform will assure that the possibility appears on an insecure leader's radar screen, and the psychological dynamics of loss avoidance will make them particularly eager to jump on the reform bandwagon.

A second way in which insecure leaders can learn the lesson of reform is from international organizations such as the IMF. Just as regional examples of reform make sure such policies are on the menu, so can the pressure emanating from international financial institutions (IFIs).

Leaders who are otherwise resistant to their advice may see things differently when operating in the psychological domain of loss. In this context, they have additional reasons to want to believe the promises held by reform policies. Moreover, in addition to the psychological dynamics, gaining the seal of approval for reforms from technocratic policy elites may appear particularly appealing to politically insecure leaders. Following expert advice on "best practice" may provide a welcome safety net for leaders whose own poor policy choices may have gotten them into trouble in the first place. For these reasons, politically insecure leaders are likely to prove surprisingly receptive to advice from IFIs urging them to end "financial repression" and reform their domestic financial systems. I thus expect regional trends towards liberalization and the prevalence of IFIs in policy debates to provide two circumstances in which politically insecure leaders are likely to be drawn disproportionately to domestic financial market reforms: these two circumstances interact with insecurity to speed the spread of financial deregulation.

ESTIMATING POLITICAL INSECURITY

When we turn to testing these arguments, an immediate problem appears: my central explanatory variable – political insecurity – is not directly or easily observable. One approach, taken in many studies of political business cycles, is to focus on electoral cycles and election dates. This has the unfortunate consequence of limiting the domain of cases to democracies. Although democracy (almost by definition) surely increases political insecurity through regular competitive elections, this does not mean that rulers of non-democracies are spared concerns about their hold on power. To overcome this limitation, I use a newly available dataset on leadership tenure to estimate models of political survival, and then use the predicted risk of losing office as a proxy variable for the (unobservable) concept of political insecurity.

Event History Models

I draw on the growing literature on government survival to create an indicator of political insecurity. Although office-seeking motivations have played a central role in the work of political scientists at least since Downs (Downs 1957), very little empirical work had been done on the determinants of leadership tenure prior to the past decade. In a path-breaking study, Bienen and van de Walle (Bienen and Van de Walle 1991) constructed a data-set covering all leaders of 167 countries from 1901 until 1987. Focusing on individual and country specific

factors, they estimated a series of event-history models of leadership duration. Recently, these models have been extended to consider international political variables (such as war or dispute involvement) and domestic institutional variables such as regime type (Bueno de Mesquita and Siverson 1995; Bueno de Mesquita, Morrow et al. 1999; Chiozza and Goemans 2002), while another strand of research has focused on government survival in the specific context of parliamentary democracies (Warwick 1995).

Building on these studies, I estimate duration models of leadership tenure in 165 countries from 1950 to 1998.[10] The sample covers 1227 leadership tenures,[11] lasting an average of 5.4 years. Since most of the explanatory variables are measured annually, each leader's time in office is divided into yearly observations. Each leader has one record for each calendar year in office.[12] Leaders who exit office because they died of natural causes are treated as right-censored observations.

Since I am interested in estimating the likelihood of a loss of power in a given year, the methods known collectively as event history analysis provide the appropriate tool-kit. Event history models provide estimates of the probability of an event occurring – in our case, exit from office – at a particular time, given that it has not yet happened (Allison 1984; Box-Steffensmeier and Jones 1997). In the language of event history analysis, this probability is given by the hazard rate, which tells us the "risk" that a leader will fall from power in a given time period. One class of event history models – continuous time survival models – estimates durations with time-invariant explanatory variables; in the case at hand, this would mean attempting to explain leadership duration with variables measured at the time of entry into office. While these models have been popular in studies of cabinet duration (King, Alt et al. 1990; Warwick 1995), we can do better by using models incorporating both time-invariant covariates (such as region or country dummies or a leader's age upon assuming office) and time-varying covariates (such as GDP growth or involvement in an international conflict or electoral cycles). To this end, I estimate parametric discrete-time hazard models using a Weibull distribution to characterize the baseline hazard function.[13] The hazard rate is then given by:

$$h(t|x_j) = pt_{p-1}\exp(\beta_0 + x_j B_x)$$

where h(t) is the hazard rate, *t* is time, and $\beta_0 + x_j B_x$ are the estimated coefficients and variables. *P* is a shape parameter estimated from the data: when *p* equals one, the baseline hazard is constant over time; if *p* is less than one, it is decreases monotonically; and if *p* is greater than one, hazard increases with time in office. In this model, a positive coefficient indicates that a variable increases the hazard rate, or "risk" of the event occurring, with associated standard errors providing standards of statistical significance as in a conventional regression model. A negative coefficient indicates that the variable decreases the hazard rate, or in our particular case, reduces the predicted likelihood of a leader losing power in a given year.

Explanatory Variables

Drawing on the findings of previous studies, I employ five groups of explanatory variables in the hazard models of leadership duration.[14] First, rather banal variables tapping characteristics of individual leaders have proven (unsurprisingly) to possess great explanatory power: the leader's age, length of time in office, and prior experience in office.

A second battery of variables measures economic performance, which has proven to be a major determinant of a leader's ability to stay in office (Lewis-Beck 1988; Lewis-Beck and Stegmaier 2000; Przeworski, Alvarez et al. 2000). I include variables tapping a ride range of indicators of both level and change in economic activity, including GDP, energy consumption, trade, and inflation. While the influence of economic performance on government survival is well documented, a smaller but growing literature focuses on foreign policy performance. Building on this growing literature in international relations, I include variables for interstate war involvement, the outcome of wars, militarized dispute involvement, and participation in an enduring rivalry. A fourth set of variable taps domestic political factors. Variables for institutions, such as democracy, regimes in transition, electoral clocks (time until next election is due) were included, as well as variables tapping domestic political processes: general strikes, political demonstrations, political violence, etc. Finally, a series of dummy variables are included to capture the possibility that leadership turnover varies across regions and time periods.

Results

Although our primary goal with these models is to generate a reasonable proxy for political insecurity by using the predicted hazard rate, let us briefly consider the results. Table 1 reports the results of three models: the first includes all of the variables of principle interest, the second adds regional dummy variables, and the third adds time period dummies. Positive coefficients indicate that a variable increases the hazard rate, or "risk" of loss of power, whereas a negative coefficient indicates that higher scores on a variable reduce the risk of losing office. The duration parameter *p* (not reported in the table) is less than one, indicating that the risks of losing office decline the longer one remains in power.

Table 1. Hazard Model of Government Survival

	(1)	(2)	(3)
Leader's Age	0.0161***	0.0169***	0.0170***
	(0.0037)	(0.0037)	(0.0037)
Time in Power	-0.0009***	-0.0009***	-0.0009***
	(0.0001)	(0.0001)	(0.0001)
Civil War	-0.0348	-0.0121	0.0505
	(0.1290)	(0.1293)	(0.1316)
Interstate War	-0.3012	-0.2141	-0.2613
	(0.2007)	(0.2020)	(0.2039)
Won Interstate War	-0.5000	-0.5614	-0.5689
	(0.3841)	(0.3845)	(0.3850)
Lost Interstate War	0.3476	0.3636	0.3172
	(0.2987)	(0.3028)	(0.3042)
Log of GDP	0.0408	0.0484*	0.0613**
	(0.0255)	(0.0285)	(0.0289)
GDP Growth	-0.0314***	-0.0292***	-0.0339***
	(0.0076)	(0.0077)	(0.0080)
GDP Growth Squared	-0.0021***	-0.0020***	-0.0021***
	(0.0004)	(0.0004)	(0.0004)
Log of Energy Consumption	-0.0821**	-0.1987***	-0.1913***
	(0.0353)	(0.0445)	(0.0450)
Energy Consumption Squared	-0.0132	-0.0137	-0.0136
	(0.0111)	(0.0120)	(0.0120)
Change in Energy Consumption	-0.2120	-0.1720	-0.1981
	(0.1859)	(0.1949)	(0.2006)
Change in Level of Trade	0.0204	0.0124	-0.0064
	(0.1208)	(0.1303)	(0.1386)
Democracy	0.0285***	0.0270***	0.0271***
	(0.0060)	(0.0060)	(0.0061)
Regime in Transition	0.4285***	0.3914**	0.3926**
	(0.1605)	(0.1601)	(0.1605)
Election, Fixed Dates	1.4234***	1.4450***	1.4496***
	(0.1358)	(0.1495)	(0.1510)
Political Protests Events/Year	0.036**	0.034**	0.033**
	(0.012)	(0.014)	(0.013)
Europe (West)		0.8730***	0.8257***
	(0.1420)		(0.1447)
Sub-Saharan Africa		0.4214***	0.3966***
	(0.1488)		(0.1502)

Asia (S, SE, NE)		-0.2966*	-0.2978*
	(0.1548)		(0.1549)
Latin America		0.4245***	0.4039***
	(0.1274)		(0.1288)
1950s			0.1237
			(0.1514)
1960s			0.1516
			(0.1465)
1970s			0.1031
			(0.1442)
1980s			-0.1566
			(0.1431)
Constant	-4.1605***	-4.7980***	-4.9504***
	(0.3295)	(0.3820)	(0.4110)
Observations	5168	5168	5168
Log Likelihood	-1017.81	-995.43	-990.32
LR χ_2 (prob > χ_2)	615 (< .00001)	650 (< .00001)	671 (< .00001)

Note: Coefficients with their standard errors in parentheses. Models estimated with an accelerated failure time parameterization using a Weibull distribution.
* significant at 10%
** significant at 5%
*** significant at 1%

The results indicate that several variables in each of the five categories are both statistically and substantively significant. The leadership characteristics variables have major effects, with cumulative time in power and prior office-holding experience reducing risk, and advancing age increasing it. Unsurprisingly, good economic performance reduces the risk of losing power, and the significance of squared terms on economic variables indicates that the relationship is non-linear: very high growth rates have a disproportionately greater effect than moderately high ones (and correspondingly, very sharp down turns are disproportionately more dangerous than moderate ones). All of the domestic institutional variables are both highly significant in a statistical sense and substantively important as well. More democratic political institutions, transitions, high levels of political protests, and an electoral clock ticking down all affect risk by a substantial amount. Taking these three results together, we can say that the worst situation a leader could face would be an election year early in a transition period during which a country has recently become fully democratic. The effects of conflict involvement are a bit more ambiguous: while neither civil nor interstate war involvement appears to have a clear effect in and of themselves, the outcomes of wars do: losing a war increases the risk of losing power whereas winning one strengthens a leader's grip on power. Finally, the regional dummies show significant differences across regions, although the time period dummies show that, once we

have accounted for other factors influencing risk, there are no great changes across decades in the baseline vulnerability of leaders.

The predicted probabilities of losing power generated by these models can proxy for political insecurity: when the predicted hazard is very low, we can reasonably assume that leaders feel quite secure in office, whereas when the predicted hazard is high or increasing, leaders should feel more insecure.[15] To be sure, political leaders surely have much more detailed information and more sophisticated beliefs about their grip on power than these relatively crude indicators can reveal, but still the predicted probabilities should serve as a rough and ready proxy for their beliefs. To that end, I use the predicted hazard rates as an independent variable, "Political Insecurity," in the models of financial liberalization to which we now turn.[16]

FEAR FACTOR AND THE DIFFUSION OF FINANCIAL LIBERALIZATION

Measures of Financial Liberalization

With a proxy for political insecurity in hand, we can explore the relationship between it and liberalization. Choosing an indicator of financial liberalization, however, is far from straightforward. Although quantitative studies of the consequences of financial liberalization abound in economics, indicators vary fairly widely in terms of countries included, definitions and operational criteria, and years covered. Lacking a single database recording all observed policy changes, researchers draw on case studies, IMF country reports, and other sources of information to create indicators of liberalization. While most follow the lead of Williamson and Mahar's characterization of six dimensions of liberalization (Williamson and Mahar 1998), some choose to create an index summing up several of these dimensions, while others choose to focus on one or two key dimensions thought to be central to the reform process (usually deregulation of interest rates).

Given this lack of an "industry standard" indicator of domestic financial market liberalization, I follow a conservative strategy of employing several different indicators, which facilitates the assessment of the sensitivity of results to the coding decisions of any particular authors. Two of these indicators focus on interest rate deregulation. Arguing that the removal of interest rate

controls is the centerpiece of financial liberalization, Demirguc-Kunt and Detragiache record the beginning date of liberalization in a panel of 53 developing and developed countries from the late 1970s through 1995 (Demirguc-Kunt and Detragiache 1998). Collecting data on capital controls and financial sector liberalization in addition to interest rates, Mehrez and Kaufman nonetheless focus primarily on interest rates in building their panel dataset covering 56 developing and developed countries spanning 1973 to 1998 (Mehrez and Kaufman 1999). Taking a broader approach, Laeven combines six reform measures – interest rates, entry barriers, reserve requirements, credit controls, privatization, and prudential regulation – to create a summary index of domestic financial system liberalization covering 13 developing countries up to 1998 (Laeven 2000). Finally, Wyplosz emphasizes interest rate deregulation, directed credit, and competition in the financial sector to create an alternative five-point index of domestic financial restrictions for 27 developing and developed countries from 1973 to 1999 (Wyplosz 2001).[17]

Although aiming to measure similar concepts, these four indices exhibit considerable variation. The interest rate indices, for example, usually flag the same general policy reforms, but sometimes locate the crucial turning point in different years. In Zambia, for example, (Demirguc-Kunt and Detragiache 1998) place interest rate liberalization in 1992 whereas (Mehrez and Kaufman 1999) record it as 1993; in Venezuela, the former key in on 1989 whereas the latter place it in 1991. Given these discrepancies, it is not surprising that the correlation between the two data sets is only 0.68, indicating a respectable overlap but non-trivial disagreements. The two liberalization indices correlate more highly (0.81), although they differ significantly on some countries: Wyplosz (Wyplosz 2001) has Thailand, for example, beginning the liberalization process much earlier than does Laeven (Laeven 2000). Overall, this variation among measures underlines the desirability of checking results against a battery of indicators.

Insecurity, Regional Examples, and International Pressure

To assess my hypotheses about political insecurity and financial market reform, I also need indicators of the prevalence of regional examples of reform and the availability of templates from IFIs. For regional trends, I code two types of variables. One taps the proportion of countries in the region that have liberalized their financial system.[18] The other focuses exclusively on

recent trends towards liberalization: I code one variable counting the proportion of countries in the region that have taken liberalizing steps sometime in the previous five years, and another extending the range to ten years. These variables proxy for the availability of concrete examples of the abstract policy prescriptions of those advocating financial market liberalization, as well as the prominence and acceptability of those ideas (Collins 1996; Broz 2002).

Turning to policy prescriptions of IFIs, we need a variable tapping the likely prominence of advice from IFIs, but I am not interested in a measure of actual coercion or imposition by conditionality. Instead, I want an indicator of the likely general prominence and availability of advice from IFIs in policy discussions. To that end, I include various combinations of variables that have been shown to influence the likelihood that a country enters into an agreement with the IMF (Przeworski and Vreeland 2000). In particular, I focus on two variables: 1) the quantity of annual foreign exchange reserves in terms of monthly imports, and, 2) the annual government budget deficit as a percentage of gross domestic product. Countries have been shown to be more likely to turn to the IMF the lower are reserves and the higher are deficits (Przeworski and Vreeland 2000). Thus, we should expect that the prominence of IFI advice and dialogue in policy debates should be positively correlated with these variables, suggesting they can serve as rough and ready proxies of the availability of IFI advice about liberalization on a policymaker's menu of choices.

With these variables in hand, I estimate a series of time-series cross-sectional logistic regression models covering up to 53 countries from 1970 to 1999. To assess my argument that political insecure leaders are surprisingly potent agents of diffusion, I estimate interaction models (Jaccard 2001; Jaccard and Turrisi 2003). My argument implies that effects of political insecurity and regional examples/IFI advice are mutually contingent: political insecurity is more likely to lead to liberalization when regional examples abound and IFI advice is prominent in policy debate, and the lessons provided by regional trends and IFI advice are expected to have greater effects on political insecure leaders. To accommodate the possibility of these mutually contingent effects, I include multiplicative interaction terms between political insecurity and the other two explanatory variables. If political insecure leaders are surprisingly potent agents of diffusion, the interaction term should be positive.

Estimating logistic regression models allows us to estimate the marginal effects of variables on the probability that a country liberalizes in a given year. However, since the observations vary across both time and space in this panel-data setup, several potential problems arise for standard logit models. To account for country-specific effects, I estimate fixed effects logit models, and to obtain consistent estimates in the presence of heteroskedasticty, I report Huber/White robust standard errors adjusted for clustering by country.[19]

Table 2. Political Insecurity and the Spread of Financial Liberalization: Logistic Regression Models

	(1)	(2)	(3)	(4)
	Dependent Variable: Interest Rate Liberalization			
	(Demirguc-Kunt and Detragiache 1998)		(Mehrez and Kaufman 1999)	
Political Insecurity	0.378**	0.332**	0.435**	0.412**
	(0.16)	(0.16)	(0.21)	(0.20)
Regional Trend	0.32**		0.35**	
	(0.14)		(0.16)	
Region*Insecurity	0.59**		0.66**	
	(0.23)		(0.25)	
Reserves		0.12		0.03
		(0.10)		(0.14)
Reserves*Insecurity		0.35*		0.27*
		(0.21)		(0.17)
OECD	0.523	0.524	-0.234	-0.245
	(0.793)	(0.823)	(0.84)	(0.88)
Log Total Population	0.273*	0.282*	0.231	0.202
	(0.157)	(0.166)	(0.158)	(0.156)
Inflation Rate	0.0005***	0.0005***	0.0003**	0.0003**
	(0.0002)	(0.0002)	(0.0001)	(0.0001)
Trade / GDP Ratio	1.834*	1.838*	0.963	0.821
	(1.018)	(1.019)	(0.843)	(0.814)
M2 / GDP Ratio	-0.613	-0.604	1.96	2.12

	(1.012)	(1.031)	(1.51)	(1.66)
Constant	-6.123***	-6.173***	-5.788***	-5.873***
	(2.20)	(2.16)	(2.25)	(2.03)
Observations	423	280	818	489

Note: Coefficients with robust standard errors in parentheses.
* significant at 10%
** significant at 5%
*** significant at 1%

Table 2 records the results of logistic regression models estimating the relationship between the dichotomous, interest rate-based measures of financial liberalization and the variables of interest. The most important thing to note about Table 2 is the consistently positive and statistically significant (at better than the 5% level) coefficient on the regional trend[20] and interaction variables. This pattern of results implies that each variable individually is associated with a greater likelihood of liberalization: a country is more likely to liberalize as the number of other countries in the region liberalizing grows, and politically insecure leaders are more likely to liberalize. However, the two also have significant interactive effects: the pro-liberalizing effect of insecurity is greater when regional examples of reform abound, and reform spreads more quickly across regions when leaders are politically insecure. While the variables measuring receptivity to IFI pressure do not perform as well, the interaction term between them and political insecurity is positive and always around standard thresholds of statistical significance. Consistent with the findings of others regarding IFI pressure and liberalization (Meseguer 2003; Simmons and Elkins 2003), vulnerability to IMF pressure, whether measured by adequacy of foreign reserves or budget deficit,[21] has no discernible effect on the likelihood of financial market reform. However, it does have a marginally significant interactive effect with political insecurity – the positive coefficient on the interaction term indicates that politically insecure governments are more likely to liberalize when they are low on reserves or running large deficits. Finally, several of the controls are positively linked to the likelihood of liberalization and frequently significant: population size, inflation rate, trade ratio, and depth of the financial system (proxied by M2 as a ratio of GDP).[22]

Table 3 reports the results of similar models using changes in the two liberalization indices as alternative dependent variables. The only other difference with the models in Table 2 is the

inclusion of the level of the index, which I add because the likelihood of further liberalization is greater for countries that have already started down the liberalization path. The results are similar to those in the previous models, albeit with generally lower levels of statistical significance. Both regional trends and political insecurity are again positively related to financial liberalization, and the interaction between them is positive and significant, although barely so in the models using the Mehrez and Kaufman index. The measures tapping likely exposure to IMF advice again fail to attain significance, although the interaction term between reserves and insecurity is positive as anticipated. However, in contrast to the models reported in Table 2, none of the control variables reach significance using the alternate dependent variables, a somewhat puzzling result.

Table 3. Political Insecurity and the Spread of Financial Liberalization: Logistic Regression Models

	(1)	(2)	(3)	(4)
	Dependent Variable: Interest Rate Liberalization			
	(Demirguc-Kunt and Detragiache 1998)		(Mehrez and Kaufman 1999)	
Political Insecurity	0.463**	0.499**	0.27*	0.23
	(0.22)	(0.246)	(0.14)	(0.16)
Regional Trend	0.36**		0.31*	
	(0.16)		(0.19)	
Region*Insecurity	0.64**		0.52*	
	(0.23)		(0.30)	
Reserves		0.04		0.06
		(0.08)		(0.14)
Reserves*Insecurity		0.32*		0.26
		(0.19)		(0.21)
Level of Index	0.723***	0.749***	0.756***	0.769***
	(0.142)	(0.122)	(0.127)	(0.113)
Log Total Population	0.121	0.132	0.423	0.468*
	(0.142)	(0.166)	(0.278)	(0.265)
Inflation Rate	0.0002	0.0002	0.0001	0.0001
	(0.003)	(0.0003)	(0.0001)	(0.0001)
Trade / GDP Ratio	0.596	0.635	1.12	1.16

	(0.869)	(0.842)	(0.965)	(0.864)
M2 / GDP Ratio	-0.58	-0.63	-1.21	-1.42
	(1.32)	(1.22)	(1.49)	(1.41)
Constant	-6.278***	-5.82***	-6.59***	-5.27***
	(2.92)	(2.1606)	(2.2541)	(2.0391)
Observations	423	280	818	489

Note: Coefficients with robust standard errors in parentheses.
* significant at 10%
** significant at 5%
*** significant at 1%

Although the measures of financial liberalization are somewhat crude and easily questioned, the consistency of the results across four different indicators of financial liberalization is quite impressive, suggesting that the relationships are relatively robust and not dependent on the use of any particular measure of financial liberalization. In particular, eight of eight interaction terms have the anticipated positive sign, and seven of those variables are significant at better than the 10 percent level.[23] Politically insecure leaders seem to be particularly potent agents of diffusion: when provided with regional examples or exposed to the policy advice of IFIs, they are disproportionately drawn to policies of domestic financial market reform.

CONCLUSION

Eschewing broadly structural approaches to the spread of financial market deregulation that focus on either "top down" mechanisms (globalization, pressure from international financial institutions and the U.S.) or "bottom up" mechanisms focusing on domestic coalitions (derived from configurations of economic interests), this chapter focused on the micro-foundations of diffusion by emphasizing the incentives facing office-seeking leaders. Placing the incentives facing leaders center-stage and focusing on the horizontal diffusion of liberalization, I argue that politically insecure leaders are potent agents of diffusion because they are particularly likely to "learn" the lessons of financial market reform and emulate the liberalizing practices of others. Combining the distinctive psychological dynamics of insecure leaders (who are likely to perceive themselves in the "zone of loss" and to be particularly prone to the motivated bias of wishful thinking) with the specific dynamics of domestic financial market reform (which offers a plausible "all good things go together" promise over the short to medium term) suggests that

politically insecure leaders will prove surprisingly likely to initiate reforms. In particular, politically insecure leaders are likely to speed diffusion when the experiences of other countries in the region provides examples of success or when IFIs place the reform option clearly on the policy menu.

To assess this argument, I estimated hazard models of political survival in order to generate a measure of insecurity. With that measure in hand, interactive logistic regression models showed that the likelihood of financial liberalization increases when political insecurity is combined with a recent regional trends towards liberalization and vulnerability to IFI pressure. When regional examples and IFI advice bring the option to the attention of politically insecure leaders, they become disproportionately likely to "learn" the lessons of domestic financial market liberalization and launch reforms.

This argument has important implications both for the literatures on financial market liberalization and diffusion of regulatory practices. Starting with the former, there are good reasons to think that politically insecure leaders may not be the most effective reformers, even if – at least in the case of domestic financial market liberalization – they may be eager ones. To see this, consider some of the conclusions of the literature seeking to explain the success and failure of domestic financial market reforms. In general, studies have tended to support the advocates of a careful, patient sequencing strategy of reform (Edwards 1984; McKinnon 1991). A gradualist strategy of reform is more likely to lead to reforms that are successful in the long run and avoid the dangers of banking crises (Caprio and Klingebiel; Mehrez and Kaufman 1999; Wyplosz 2001). Thus the ideal reforming government would have long time horizons and exhibit great patience in executing reforms. Unfortunately, the arguments developed in this chapter suggest that precisely the wrong type of government is likely to jump on the reform bandwagon. Relatively unconcerned about any bust that may occur five to ten years in the future following poorly executed reforms, insecure governments impatient to reap the rewards of liberalization are likely to do a poor job of it, making an ensuing crisis all the more likely. By jumping the gun and freeing credit markets too quickly in their eagerness to reap the rewards, they are unlikely to lay the careful foundations necessary for long term success and stability. My argument thus has implications not just about *when* countries liberalize, but *how* they liberalize.

A closely related implication is that reformers who "learn" the lessons of reform partly in response to psychological dynamics associated with fear of losing office will have a relatively shallow depth of commitment to reforms. Reforms motivated partly by fear of losing office will be more likely to unravel than those taken out of deeper conviction. One of the puzzles of the trend towards neo-liberal reforms in general is that so many reforming leaders evidence little previous attraction to liberal policies. While there is good reason to doubt explanations focusing on coercion by IFIs,[24] the argument of this chapter provides an explanation for why insecure office-seeking leaders may suddenly see the attractions of liberal financial market policies. However, it also implies that their commitment may be less than rock solid if it motivated largely by the dynamics of loss-aversion and the motivated bias of wishful thinking.[25] Leaders who adopted reform policies under such circumstances are unlikely to defend them when they fail to yield the desired results or encounter serious political opposition. Politically insecure leaders may be potent agents of diffusion, but they may also be likely backsliders; exploring this possibility provides an avenue for future research.

Finally, turning to the dynamics of diffusion, in models of contagion, the distribution of thresholds across agents plays a central role in determining the likelihood of rapid contagion (Granovetter 1979). The distribution of types of agents across categories of instigators, followers, and laggards shapes the likelihood that countries will "herd" towards a new convention (Levi-Faur 2003). The argument presented in this paper suggests that agents are not necessarily fixed types, but that their propensities towards reform are partly situationally determined. It is not just their preferences, but their political situation – in my argument, their degree of political (in-)security – that shapes their type and propensity to jump on the reforming bandwagon. Thus suggests that for a given configuration of agents, the possibilities of cascades and herding behavior can vary over time as situational factors change. In this interpretation, the wave of liberalization following democratic transitions in Latin America may be linked to the increased political insecurity associated with democratic political institutions and political transitions; the political circumstances may have rendered Latin America particularly fertile ground for the rapid spread of domestic financial market reforms.

Notes

[1] Paper prepared for the workshop on "The Internationalisation of Regulatory Reforms," Berkeley, April 25-26, 2003. Thanks to Maria Fanis for helpful discussions on ideas developed in this paper. Hein Goemans and Alastair Smith both generously shared their leadership data. Catherine Maher and Ryan Micklus provided superb research assistance in collecting and organizing some of the data.

[2] Following Williamson, J. and M. Mahar (1998). A Survey of Financial Liberalization. Princeton, NJ, Department of Economics, Princeton University.

I have in mind five aspects of domestic financial systems: 1) regulation of interest rates; 2) credit controls; 3) entry barriers to financial services industry; 4) bank autonomy; and, 5) private ownership of banks.

[3] Obviously, if a government's core support base is in sectors that will be "losers" from such reforms, their political attractiveness will be sharply curtailed.

[4] I am using the term "learning" loosely here. In this section, I am describing something between rational learning, by which I mean updating of beliefs in light of experience according to some inferentially sound guidelines such as Bayes' Rule, and emulation, which I take to mean adoption of policies without reasoned understanding of likely consequences. In my argument, policy-makers are updating beliefs with a view to policy consequences, but the updating is skewed by special characteristics associated with prospect theory and motivated biases.

[5] Prospect theorists refer to this as the "zone of gain."

[6] Prospect theorists call this the "zone of loss."

[7] Prospect theory has been applied to the study of politics with increasing frequency since the early 1990s. Two particularly notable applications to politics are Weyland, K. (1996). "Risk Taking in Latin American Economic Restructuring: Lessons from Prospect Theory." International Studies Quarterly **40**(2): 185-208.

[8] For this reason, many psychologists think in terms of "causal mechanisms" instead of covering laws.

[9] For an overview of work in psychology seeking to combine "cold" and "hot" sources of decision making errors, see Izard, C. E., J. Kagan, et al. (1984). Emotions, cognition, and behavior. Cambridge Cambridgeshire ; New York, Cambridge University Press.

[10] The data is a revised version, updated and expanded by Hein Goemans and Alastair Smith, of the dataset compiled by Bueno de Mesquita and Siverson Bueno de Mesquita, B. and R. M. Siverson (1995). "War and the Survival of Political Leaders: A Comparative Study of Regime Types and Political Accountability." American Political Science Review **89**(4): 841-855 which was itself based on Bienen & Van de Walle's data.

[11] There are fewer leaders than leadership tenures since many individual leaders have governed multiple times.

[12] For years in which the leadership changes once during the calendar year, a country would have two observations (one for each leader, each for a portion of the year). In democracies, election years are also divided into two observations: a pre-election (high insecurity) period, and a post-election (presumably low insecurity) portion.

[13] Since parametric models derived from contending distributions are non-nested, I used the Akaike information criteria to assess the relative appropriateness of models using exponential, Weibull, Gompertz, log-logistic, and log-normal distributions.

[14] For details on the precise variables and sources, see Way, C. (2002). Political Insecurity and Domestic Financial Market Reform. Paper presented at the annual meetings of the Americna Political Science Association.

[15] Clearly the incentives created by the risk of losing office are a function of two things: the chance of exiting office, and the consequences of losing offices. These two factors combined comprise what I call a leader's "fear factor." As a first cut, the initial version of this paper deals only with the first; future drafts will strive to incorporate the likely costs of losing office as well.

[16] The same strategy has been used to generate a measure of political uncertainty in the study of currency crises in industrial democracies Leblang, D. and W. Bernhard (2000). "The Politics of Speculative Attacks in Industrial Democracies." International Organization **54**(2): 291-324.

[17] These indices cover all geographic regions (to varying degrees) with the exception of Eastern Europe and the Soviet successor states. Thus the highly volatile transition polities and economies of the former Eastern bloc are excluded from my analysis.

[18] Regions are treated very crudely here with

[19] In addition, observations over time within a particular country are clearly not independent, and time-period specific influences may affect all countries at the same time. Failure to account for temporal dependence across observations within each cross section can result in underestimates of standard errors, leading to unduly optimistic inferences. To avoid this pitfall, I will account for temporal dependence by including a natural cubic

spline of the number of years without change in future revisions Beck, N., J. N. Katz, et al. (1998). "Taking Time Seriously: Time-Series-Cross-Section Analysis With a Binary Dependent Variable." American Journal of Political Science **42**(4): 1260-1288.

[20] The regional trend variable reported in the table taps number of liberalizing changes over the past 10 years. The other specifications of regional trends produced similar results.

[21] Only the reserves variable is presented in the table. The two have broadly similar effects.

[22] Unsurprisingly, decade dummies (not recorded in the tables yet) indicate that liberalization was much more likely in the 1990s than in the preceding two decades.

[23] Of course, in interaction models, the significance levels on the conditional coefficients are really of fundamental interest. However, across some range of values, the conditional coefficients are sure to be more significant than the underlying variables, so the fact that the component terms are significant assures us that the conditional coefficients are highly significant for at least some values (Jaccard, J. and R. Turrisi (2003). Interaction Effects in Multiple Regression. Thousand Oaks, CA, Sage.

[24] Some of the reasons for skepticism are summarized in Covadonga Meseguer's chapter in this volume (Meseguer, C. (2003). The Diffusion of Privatization in Industrial and Latin America Countries: What Role for Learning? The Internationalization of Regulatory Reforms. J. Jordana, D. Levi-Faur and D. Vogel.

[25] Considerable evidence, for example, suggests that Latin American reforms such as Carlos Menem and Alberto Fujimori never developed deeply held beliefs in many of the neo-liberal policies they pursued.

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