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## **Globalization and economic sovereignty**

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## **Introduction**

The concept of globalization has been central to many of the political and intellectual discourses of the 1990s. Used in very different ways by neoliberals, postmodernists and radical environmentalists among others, globalization has been interpreted in cultural, technological and geopolitical terms.

In this paper, attention will focus primarily on economic and financial aspects of the globalization debate, and on their implications for public policy. Globalization will therefore be defined as an increase in the international integration of markets for goods, services, capital and labour. However, these economic developments cannot be separated from their historical and political context. The current discussion of globalization can only be understood in relation to the development of economic and political institutions over the past century.

Globalization is frequently discussed as a counterpoint to national sovereignty. It is commonly asserted that globalization has eroded national sovereignty or that it has rendered borders obsolete. In particular, it is asserted that, in a globalized world economy, governments have no alternative but to adopt neoliberal economic policies of privatization, deregulation and reductions in public expenditure.

In assessing claims about globalization and sovereignty, it is useful to begin by observing that sovereignty is itself a complex term. Krasner (1999) usefully distinguishes four different concepts of sovereignty. International legal sovereignty is the acceptance of a given state as a member of the international community, and is, in most cases, relatively uncontroversial. Westphalian sovereignty is based on the principle that one sovereign state should not interfere in the domestic arrangements of another. Interdependence sovereignty is the capacity and willingness to control flows of people, goods and capital into and out of a country. Domestic sovereignty is the capacity of a

state to choose and implement policies within its territory.

During the 1980s and early 1990s, the emerging literature on globalization focused primarily on the apparent erosion of interdependence sovereignty and Westphalian sovereignty. Much of this literature was primarily concerned to criticize 'realist' models of international politics in which the Westphalian notion of the state as a unitary actor are taken as axiomatic (Camilleri and Falk 1992).

During the 1990s, a neoliberal account of globalization came to the fore. The starting point of the neoliberal account of globalization is the observation that states have abandoned or lost much of the interdependence sovereignty they possessed for most of the 20th century. It is then argued that this loss of interdependence sovereignty entails a loss of domestic economic sovereignty, so that states are constrained by the pressures of international capital markets to follow the neoliberal policy agenda of deregulation, privatization and small government, regardless of the wishes of their domestic electorates (Ohmae 1990, Friedman 1999). A similar view is implicit, though not always clearly argued, in postmodernist and 'Third Way' accounts of globalization (Giddens 1999). In addition, left-wing writers such as Panitch (1994) and Strange (1996), while deploring convergence on a neoliberal policy agenda, broadly accept the claim that such convergence is the result of technologically-driven developments in the world economy.

This paper is a critical analysis of the neoliberal account of globalization, written from a social-democratic viewpoint. Its main object is to present the globalization debate in its historical context and to consider the analytical implications of the observation that globalization is not fundamentally new, but is, in large measure, a reversion to the economic institutions of the 19th century. The experience of the late 19th century casts doubt on claims that the loss of interdependence sovereignty implies the erosion of Westphalian sovereignty. The claim that the loss of interdependence sovereignty entails the adoption of neoliberal domestic policies is similarly problematic. The paper concludes with a consideration of options for social-democratic responses to neoliberal globalization.

## **The fall and rise of the global economy**

Much of the popular discussion of globalization is based on the assumption that we are dealing with a wholly new phenomenon, driven by technological change. This assumption also dominated the early literature on globalization, which focussed on the steady increase in economic integration since 1945 (for example, Camilleri and Falk 1992).

More recent writers have pointed out that this assumption is incorrect and that, in important respects, the world economy was just as globalized in the late 19th century as it is today (Baker, Epstein and Pollitt 1998, Williamson 1998). This does not mean, however, that the processes described as globalization are unimportant. The fact that the world economy is now returning to an institutional framework very similar to that of last century is highly significant, as is the fact that, until a few decades ago, this institutional framework was almost universally regarded as an outmoded failure.

### *The global economy before 1914*

The world economy in the period before 1914 was one of untrammelled global capitalism. As early as the mid-19th century, Marx and Engels (1976, first published 1848) observed the rise of a global economy dominated by the European bourgeoisie.

By 1900, the main rail networks in use today had been put in place, and the combination of steel hulls and steam had produced cargo ships capable of equalling or exceeding the speeds at which sea freight usually travels today. As far as the transport of goods is concerned, subsequent advances have been incremental. Moreover, with the laying of the trans-Atlantic telegraph line in 1866, communications between the major international financial centres became instantaneous. As a result of these linkages, the reliance on overseas investment of European colonies countries and of the newly independent nations of Latin America was greater in 1914 than that of developing countries today (Waltz 2000). Moreover, because of restrictions on migration, labour mobility is

much lower today than in the 19th century (Baker, Epstein and Pollitt 1988).

The ratio of merchandise exports to world GDP has risen modestly, from 8.7 per cent in 1913 to 13.5 per cent in 1990. However, it is important to note that intra-European trade has made a large contribution to the growth in the ratio of trade to world GDP. As will be discussed below, the implications of intra-European trade for globalization are ambiguous. On the other hand, it has been argued that growth in intra-industry trade and trade within global corporations is indicative of a deeper level of integration than the 19th century model in which raw materials from the colonial and developing world were traded for manufactured goods from the developed world (Reich 1991, Feenstra 1998, Held et al. 1999).

The central institution of the global financial system in the 19th century was the gold standard. Under the gold standard, the exchange rate between any two currencies was the ratio of their values in gold. Currencies were freely convertible into gold at fixed rates. The combination of the fixed exchange rates implied by adherence to the gold standard and free movement of capital left individual countries with little or no freedom of movement in monetary policy.

The operation of the gold standard is an example of the 'impossible trinity'. It is possible to maintain any two of fixed exchange rates, free movement of capital and independent domestic monetary policy, but not all three (Mundell 1963). In this sense, then, the loss or abandonment of interdependence sovereignty entails a corresponding loss of domestic sovereignty. As Mundell (1963) observes, however, the implication is not that governments are powerless but that, under fixed exchange rates, they must rely more on fiscal policy, while, under floating exchange rates an independent monetary policy is possible.

The economic integration of the 19th century global economy contrasted sharply with the absence of political integration. In political terms, the second half of the 19th century was the high point of the nation-state. The Peace of Westphalia in 1648 had

ended attempts at the imposition of any supranational authority on European states.<sup>1</sup> The ‘Westphalian’ doctrine of states as independent actors was powerfully bolstered by the 19th century theory of nationalism, under which legitimate states were assumed to correspond to nations, that is, groups of people united by language and culture. Giddens (1985) aptly refers to these putative nations as ‘imagined communities’.

In the Westphalian system, the interests and goals of nation-states were widely assumed to transcend those of any individual citizen or even any ruler. Although practical considerations still led powerful states to seek to influence the affairs of others, forcible intervention by one country in the domestic affairs of another was less frequent in the period between 1850 and 1900 than in most previous and subsequent periods (Leurdijk 1986).

The starting point of international law in the 19th century was the presumption that states were legal persons acting in a Hobbesian state of nature. That is, unless they had bound themselves by treaty, states were free to act as they chose in pursuit of their own self-interest. Moreover, it was generally assumed that, in the absence of countervailing force, states could advance their self-interest through the use or threat of military force to gain territorial and economic benefits.

A few dissenters, most notably Angell (1911), argued that, in a globalized free-market economic system, no economic benefit could be generated even by successful wars of conquest. Writing for a British audience, Angell’s basic point was that, even if Germany succeeded in establishing political mastery in Europe, workers in the newly subjected countries would still have to be paid, goods would have to be purchased at market prices and so on. Hence, individual Germans would gain nothing from being part of a larger country.

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<sup>1</sup> However, as Kratochwil (1995) points out, the treaties of Osnabruck and Munster required a number of the signatory states to adopt measures of religious tolerance, contrary to the principle of non-interference in internal affairs. The ‘Westphalian’ doctrine of ‘*cuius regio, eius religio*’ (the religion of the prince determines the religion of the state) had been enunciated in the Peace of Augsburg in 1555, but proved incapable of maintaining peace.

Angell's argument anticipated much of the critique of international political realism put forward in the globalization debate. However, seeking to counteract the rising pressure for war, he argued that Germans would correctly perceive their own self-interest and would therefore not support an aggressive war. He was rapidly proved false on this point by the outbreak of the Great War in 1914.<sup>2</sup> Nevertheless, the War confirmed Angell's view that attempts to gain economic advantage through military power had become obsolete. Both sides suffered catastrophic losses. The attempt by the victors to recoup some of their losses through the reparations imposed in the Treaty of Versailles proved both fruitless and economically disastrous (Keynes 1920).

In addition to the conflict between the global economy and the Westphalian system of nation-states, the capitalist system was facing increasing pressure from socialist and social-democratic critics, who condemned both the poverty and inequality generated by the system and the cycle of boom and bust, which was seen by many (particularly Marxists) as certain to intensify over time. The first steps towards the creation of social welfare systems were a response to these pressures, but necessitated greater government intervention and higher taxes (though taxes were still very low by the standards of the second half of the century).

In summary, the global system of the late 19th century was one of almost complete Westphalian sovereignty, combined with very limited interdependence sovereignty. The fact that this system remained stable for more than fifty years casts doubt on the view that erosion of interdependence sovereignty necessarily entails a loss of Westphalian sovereignty. On the other hand, the catastrophic collapse of the system in 1914 may be seen as an inevitable, or at least probable, outcome of the contradictions inherent in the system. In the vast literature on the origins of the Great War, many other views have been put forward, of which the most important are that the War was an unlucky accident

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<sup>2</sup> I use the term by which the War was known at the time, rather than the more common 'World War I', in part to stress the continuity between the 1914–18 and 1939–45 wars.

and that the War was the result of German militarism. Some combination of these views is naturally attractive to Westphalian realists such as Taylor (1969).

Domestically, the system involved an apparently unstable balance between newly enfranchized democratic electorates, which expected government action to redress the inequities of capitalism, and highly mobile international capital, which demanded adherence to the doctrines of sound finance. Williamson (1998) argues that the contradiction between open borders and domestic sovereignty had already generated significant movement towards tariff protection and restrictions on immigration by the early 20th century. The collapse of the system in 1914 left unresolved the conflict between globalization and domestic sovereignty, which re-emerged as a vital issue in the 1990s.

#### *The failure of the global economy 1914–39*

The process of globalization went into reverse for most of the 20th century. To understand this process, it is necessary to examine the way in which the global economic institutions of the 19th century broke down. As was noted above, by 1914, the global economy of liberal capitalism faced external and internal stresses which seemed likely to result in major structural changes.

The question of whether the global economic system could have survived these stresses was rendered academic by the failure of the political system to prevent the outbreak of the Great War in Europe. By the time Germany and its allies surrendered in 1918, Britain's position as the leading world economy had been lost forever, and trade among the European economies had fallen almost to zero. Wartime inflation had forced the major powers to abandon gold convertibility.

Nevertheless, the prime objective of policy after 1918 was to return to prewar normality as rapidly as possible. In political terms, the breakup of the Austro-Hungarian and Russian empires allowed the completion of the 19th century movement to redraw European boundaries on the lines of nationalist theory, inevitably creating a new set of

national grievances and drawing the battle lines for future wars. Apart from the attempt to demilitarize Germany, the only move away from the Hobbesian theory of international politics was the creation of the ineffectual League of Nations.

In economic terms, this meant not merely a return to the gold standard, but a return to prewar price levels. The need to force price levels down required a long deflationary slump and high unemployment throughout the 1920s (Keynes 1925). By the late 1920s, however, it appeared to most observers that prewar normality had returned. Although the return to the gold standard had been made unduly difficult by insistence on a return to prewar parities, it had been achieved. Trade was expanding rapidly. Most importantly, the United States, now unquestionably the world's leading economy, was booming. Moreover, it was widely believed that the newly developed tools of monetary policy allowed central banks to stabilize the economy, eliminating the century-old cycle of boom and slump.

The Great Depression, which followed the stockmarket crash of 1929, ended hopes of a return to the 19th century economic system. The gold standard was finally abandoned and tariff barriers were greatly increased. Trade was increasingly confined to blocs by devices such as Imperial preferences. More than this, the Depression discredited liberal capitalism, seemingly forever. Even the supporters of capitalism were disillusioned, or at least recognized the inevitability of some move away from *laissez-faire*. The 'economic policy for a free society' put forward by leading Chicago economist Henry Simons (1948), allowed for far more government intervention than the free-market orthodoxy of the 19th century.

The most effective theoretical challenge to the free-market system was Keynes' (1936) analysis showing how unemployment could remain high indefinitely because of inadequate demand. The most effective practical challenge was Roosevelt's New Deal, which showed that government intervention could yield substantial benefits. Support for Keynesianism and for more extensive systems of economic planning was greatly enhanced

by the experience of the wartime planning between 1939 and 1945. The contrast between the chaos of the Depression and the success of wartime planning convinced most observers that *laissez-faire* capitalism was fundamentally flawed. The point was made very effectively by the White Paper on *Full Employment in Australia* (Commonwealth of Australia 1945)

Despite the need for more houses, food, equipment and every other type of product, before the war not all those available for work were able to find employment or to feel a sense of security in their future. On the average during the twenty years between 1919 and 1939 more than one-tenth of the men and women desiring work were unemployed. In the worst period of the depression well over 25 per cent were left in unproductive idleness. By contrast, during the war no financial or other obstacles have been allowed to prevent the need for extra production being satisfied to the limit of our resources.

The failure of free-market economic policies after 1914 guaranteed the failure of the Versailles political settlement. The Great Depression led to the rise of Hitler and then to the renewal of world war in 1939. The global economy of the 19th century and the associated political system were gone, seemingly forever.

### *The Bretton Woods system*

After 1945, the victorious allies sought to establish a set of national and international institutions that would secure peace, ensure that the Depression did not return, and protect people from the chaos and insecurity associated with unregulated free markets. Whereas in 1919, the aim of postwar reconstruction had been to return to prewar 'normality', the economic and political institutions of the 1945 settlement were based on the view that the institutions of the past had failed.

At a political level, the theory underlying the postwar settlement was one of co-

operative internationalism. The assumption that nation-states were free to pursue their own interests was replaced by a belief in a system of international law which bound all states, whether or not they accepted it. This assumption was reflected in the replacement of the failed League of Nations by the United Nations, which had the power to intervene militarily in cases of war and civil conflict, and by the creation of international crimes including 'waging aggressive war' and 'genocide' under which the Nazi leaders and lesser war criminals were tried.

In practice, the international political structure was rendered ineffectual by the Cold War. Except for the anomaly of the Korean War, when a boycott by Russia and China permitted the United States and its allies to claim the authority of the United Nations, the superpowers used their veto rights to block any intervention by the United Nations in their affairs and those of subject and allied nations. Hence, the United Nations was confined to peacekeeping operations in peripheral conflicts where neither of the competing blocs was directly involved.

The economic component of the postwar settlement was more effective, though its operation was confined to the non-Communist countries. The object of the system of international economic co-operation was to control capital flows in a way which allowed for both fixed exchange rates and sufficient domestic freedom in economic policy to permit the maintenance of full employment.

The crucial institutional decisions were made at Bretton Woods (New Hampshire, United States) in 1944, and led to the establishment of two international institutions, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (the World Bank). The IMF was to provide short-term assistance to countries experiencing balance-of-payments problems. The World Bank was to provide long-term finance for development projects. These institutions, it was hoped, would provide a framework for international capital flows which captured the benefits available from international borrowing and lending without the instability associated with uncontrolled

international markets.

In the Bretton Woods system, the United States took over the role played by Britain in the gold standard system. The US dollar was convertible into gold at a fixed rate of \$35 per ounce. Hence, as long as other countries maintained fixed exchange rates with the US dollar, their currencies were effectively pegged to gold. As a result, the stability of the system depended, in the long term, on the maintenance of price stability. However, the restrictions on capital flows, the availability of short-term assistance from the IMF and the fact that occasional devaluations and revaluations were considered acceptable meant that, over fairly long periods, moderate inflation was consistent with the maintenance of the system.

The achievement of full employment was the basis of a much broader consensus. All parties agreed on the need for extensive systems of social welfare, and on the need for extensive government intervention, including, in most countries, public ownership of basic infrastructure (roads, electricity, telecommunications and so on) and public provision of human services (health, education and other community services). Although socialist parties formally advocated complete nationalization of industry, in practice they accepted private ownership of primary industry, manufacturing and wholesale and retail trade.

The result was referred to as the ‘mixed economy’, and was put forward as a ‘third way’ transcending the opposition between the polar alternatives of *laissez-faire* capitalism and a Soviet-style command economy (Shonfield 1984). The combination of Keynesian stabilization policies, the welfare state and a strong public role in infrastructure produced a distinctively new economic system rather than a mere compromise between the command economy and the free market.<sup>3</sup>

The reconstruction of the international financial system was intended to complement

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<sup>3</sup> In the 1990s, advocates of a ‘Third Way’ such as Giddens (1999) similarly aspired to transcend the opposition between the mixed economy (the Third Way of the post war boom) and neoliberal globalism (a revival of the orthodoxy of the 19th century). So far, however, little more than a messy compromise has been achieved.

the domestic mixed economy by preventing or ameliorating international financial crises. Trade played a subsidiary role in the mixed economy. The General Agreement on Tariffs and Trade (GATT) was an attempt to reduce barriers to trade, which had proliferated during the Great Depression. However, the maintenance of full employment retained priority. Many countries used import quotas and dual exchange rates to maintain external balance when domestic demand was strong.

#### *Decline of the Bretton Woods system and fiscal crisis of the state*

From 1945 to the late 1960s, the Bretton Woods system, in association with the use of Keynesian macroeconomic policies, functioned effectively in most developed countries. The period from 1945 to 1970 was unparalleled in the history of capitalism as one of full employment and rapid economic growth in the developed countries.

Despite the exceptional nature of this 'golden age', only limited research has been undertaken into the factors that made the 'golden age' possible and the reasons for its breakdown. Still less is there any consensus on either of these issues. The assumption that prevailed at the time, that prosperity was a direct result of the adoption of Keynesian macroeconomic policies, is untenable in the light of subsequent experience of the limitations of those policies. The suggestion that the boom was simply the result of postwar reconstruction does not stand up to scrutiny (Marglin and Schor 1990), but there is no simple alternative.

Some consequences of the success of the mixed economy are evident however. In particular, the perceived ability of governments to manage the economy strengthened support for government intervention more generally, and weakened the capacity of business to oppose such intervention.

The role of government expanded rapidly in the immediate postwar period as industries were nationalized, social security systems were put in place or expanded and public responsibility for education and health care was generally accepted. In most countries,

the boundaries between the public and private sectors that characterized the mixed economy were in place by the early 1950s.

Although the role of government did not change much in qualitative terms between the 1950s and the 1970s, quantitative measures of the size of the public sector, such as the ratio of public expenditure to GDP increased steadily. A number of factors contributed to the growth of the public sector.

The most important was the growth in the human services sector, encompassing such 'social infrastructure' services such as health, education, police and welfare services. The demand for human services tends to rise with income, and to increase as a proportion of total demand as income rises. At low levels of income a large share of expenditure must be devoted to necessary goods such as food, shelter and basic clothing, and services may be regarded as luxuries. In communities with the income levels of developed countries, the satisfaction of these basic needs requires only a small proportion of total income.

On the other hand, productivity growth in the services sector has been limited. The growth of the services sector was first analyzed in these terms by Baumol (1967), who argued that if labour productivity grew more slowly in the services sector than in other sectors such as manufacturing, and it was desired to maintain output in the services sector at least as a constant proportion of total output, it was necessary that resources should be progressively transferred towards the services sector.

The growth in demand for human services generated what O'Connor (1973) described as 'the fiscal crisis of the state'. From the late 1960s onward, governments faced intractable problems in reconciling growing demands for services with increasing resistance to higher rates of taxation. In the United States, the growth in domestic expenditure was accompanied by a large increase in military expenditure associated with the Vietnam war. This expenditure was largely financed through budget deficits. The expansionary effects of these deficits reinforced the inflationary pressure for increases in wages and other incomes associated with a prolonged period of full employment.

The use of budget deficits to finance the Vietnam war and the Great Society social programs was justified in part by an over-optimistic view of the capacity of Keynesian macroeconomic policies to combine very low levels of unemployment with acceptable, and stable, inflation rates. However, the growth of budget deficits also reflected the onset of the fiscal crisis of the state, as governments found increasing difficulty in raising sufficient revenue to fund their expenditure programs.

Rising rates of inflation put the Bretton Woods system under increasing strain. Sustained inflation undermined both the international role of the US dollar as a reserve currency pegged to gold and the Keynesian system of domestic economic management. The pressures arising from inflation were exacerbated by the relaxation of the tight restrictions on international capital movements that prevailed at the end of World War II. Exchange controls were relaxed in many countries. The inflationary surge associated with the financing of the Vietnam war would eventually have forced the abandonment of \$US convertibility into gold. However, the process was accelerated by the increased capacity of participants in international financial markets to speculate against currencies seen as overvalued. In the early 1970s, convertibility was abandoned and the Bretton Woods system collapsed.

## **Globalization since 1970**

### *Financial liberalization and macroeconomic policy*

The collapse of the Bretton Woods system and the upsurge of inflation rendered a system of fixed exchange rates untenable. Most countries moved to some form of floating or adjustable rate and simultaneously relaxed restrictions on international capital flows. The process of international financial deregulation, which took place over the 1970s in most countries, enhanced pressure for deregulation of domestic capital markets. Domestic deregulation took place gradually during the 1970s and more rapidly during the 1980s. It

was this process of policy change, rather than technical developments in telecommunications and computing, that was responsible for the growth of international financial markets. The primary contribution of technical change was to facilitate growth in very short-term transactions, both domestic and international.

The collapse of the system of fixed exchange rates was accompanied by the abandonment of Keynesian macroeconomic policies, which had proved largely ineffectual in the context of 'stagflation' (simultaneous inflation and unemployment) and the associated 'supply-side' shocks to international commodity prices, most notably the OPEC oil price shock of October 1973. Because monetarist critics such as Friedman (1968) had accurately observed the vulnerability of the Keynesian policies of the 1960s to accelerating inflation, it was widely assumed that their main policy proposal, namely that central banks should target the rate of growth of the money supply, would provide a relatively painless method of restoring price stability.

In reality, monetarism proved no more successful than Keynesianism as a response to stagflation, and policies of monetary targeting were abandoned by the early 1980s. Although emphasis remained on monetary policy rather than fiscal policy, the strict monetarist approach was replaced by a somewhat eclectic mixture of monetarist and Keynesian ideas.

### *Neoliberalism*

Just as the successes of Keynesian macroeconomic management increased the credibility of the case for government intervention in the economy, the decline of Keynesianism was accompanied by more general disillusionment with the role of government. From the viewpoint of neoliberal globalists, the entire 20th century was a long detour from the natural path of development of the global economy. In most cases, neoliberal globalists see the global political and economic system of the 21st century as

being broadly similar to that of the 19th. In the global system advocated by neoliberals, interdependence sovereignty is largely eliminated, except with respect to migration. Domestic economic sovereignty is tightly constrained, with all participants in international capital markets being forced to adopt a model similar to that of the United States. The key elements of the neoliberal domestic program include privatization of government business enterprises and social security schemes, economic deregulation, and private provision of services such as health and education.

In neoliberal accounts of globalization, the growth in flows of goods, services and capital frequently presented as an exogenous force necessitating free-market domestic reforms. It would be more accurate to see the removal of barriers as the international component of the neoliberal policy program. Admittedly, the removal of restrictions on trade and capital flows tends to undermine interventionist domestic policies. Equally, however, the adoption of the domestic component of the neoliberal policy packages enhances pressure for liberalization of trade and capital flows.

Neoliberals claim that their domestic and international policy package is a proven success. During the 1980s and early 1990s, they contrasted the supposed success of radical free-market reforms in English-speaking countries including New Zealand, the United Kingdom and Australia with the supposedly sclerotic performance of the European social democracies.

In fact, the example of New Zealand provides no support for the *laissez faire* model. Following disappointing economic performance for most of the period since World War II, successive New Zealand governments imposed radical economic reforms after 1984. Although the reforms won the admiration of neoliberals around the world, New Zealand's economic performance deteriorated. Growth in New Zealand since 1984 has been well below the OECD average, and also slower than in Australia, which faced broadly similar conditions but which adopted less radical reforms (Quiggin 1998).

The results of neoliberal reform in the United Kingdom and Australia have been

mixed at best. Both countries experienced promising improvements in the mid-1980s (the period of the ‘Thatcher miracle’ in the United Kingdom), severe recessions commencing in the late 1980s, and moderately strong recoveries in the 1990s. For the period since 1980 as a whole, economic performance in Australia and the United Kingdom has been broadly comparable to the OECD average. In terms of GDP per capita, the gap between the two countries and the leading group of European countries has remained almost unchanged.

The current appeal of the neoliberal story relies largely on a US-centric view of the world, in which the major political and economic questions are seen through the lens of the Cold War with the Soviet Union. The collapse of the Soviet Union is seen as demonstrating the superiority of American economic and political institutions. On the political front, American triumphalism after the Cold War was relatively short-lived. The ‘New World Order’ did not live up to expectations, and many Americans are clearly disillusioned with their political system. But economically, the performance of the United States since the end of the Cold War has been seen as confirmation of the superiority of the free market.

This claim depends critically on the assumption that the current US boom will continue or, at least, that it will be followed by a ‘soft landing’ and steady growth. However, there are a number of features of the current boom that make it appear unsustainable. First, the boom is largely driven by a speculative bubble in stock prices. Almost no-one now claims that the market values being accorded to Internet stocks are sustainable.

Second, because consumption has been fuelled by capital gains, US household savings are now negative. The counterpart to disappearing private savings has been the growth in the current account deficit, now approaching 5 per cent of US GDP. The need to borrow on this scale makes the US economy very vulnerable to a change in the sentiments of capital markets

A third characteristic of an unsustainable boom is a breakdown in financial and accounting standards. This is clearly evident in the United States, as firms increasingly use devices such as payment in stock options to boost their reported profits. In this and other respects, the economy appears to be pulling itself up by its own bootstraps: the stock market can keep rising only if profits keep rising; profits keep rising because of increasing use of stock options and the like; and stock options are a viable method of payment only if the stock market keeps rising.

It is impossible to predict the future with any certainty, but we can look at the past twenty years and observe that, for the period as a whole, the economic performance of the United States has not been nearly as strong as is often supposed. According to the International Labour Organization, productivity growth since 1980 in the United States (measured in output per hour worked) has been weaker than in any of the major Asian or European economies. Output growth in the United States has been driven largely by a steady increase in annual hours of work (yet another reversion to the labour market characteristics of the 19th century).

### **Is there any alternative ?**

#### *Capital markets and neoliberal globalization*

Friedman (1999) refers to the neoliberal program outlined above as the ‘Golden Straitjacket’, implying that nations that accept this program will prosper, at the cost of sacrificing freedom to respond to the preferences of their electorates for more interventionist policies. As in other accounts of globalization, Friedman does not make it clear whether adoption of neoliberal policies is necessary for prosperity because these policies are inherently desirable or because they are demanded by participants in international capital markets.

Friedman’s claim, which Bell (1997) describes as the ‘neoliberal convergence’ hypothesis, has been criticized on a number of empirical grounds. A notable example is

the observation that more open economies, which are presumably more subject to the pressures of globalization tend to have higher ratios of government expenditure to gross domestic product (Cameron 1978). There are also significant theoretical problems in the argument underlying the neoliberal convergence hypothesis.

The claim that capital markets will generally reward sound economic policies is based on the 'strong efficient capital markets hypothesis' which states that the prices of financial assets reflect the best estimate of future returns based on all available information. It follows from the strong efficient capital markets hypothesis that the adoption of desirable (undesirable) economic policies by the government of a given country will lead to an increase (decrease) in the price of financial assets. However, there is little evidence to support the strong efficient capital markets hypothesis, and a good deal to suggest that markets can produce irrational bubbles, excess volatility and an excessive focus on short-term outcomes (Shiller 1989, Quiggin 1995).

Moreover, policies which increase the returns to financial assets may not improve the performance of the economy as a whole. For example, policies that shift the burden of tax from capital to labour will raise the price of financial assets, whether or not they are economically beneficial.

More importantly, the majority of internationally traded financial assets are fixed-interest securities, such as bonds. The returns to fixed-interest securities depend only on the rate of inflation for the currency in which the security is denominated and on the risk that the issuer will default. Hence, financial markets naturally favour policies that place a high weight on price stability. However, as the example of New Zealand shows, policies that place an excessive weight on price stability tend to increase the severity of fluctuations in output and employment and to lower the long-term rate of economic growth.

The question of whether the policies favoured by capital markets are socially desirable is academic if, as is commonly asserted, governments have no choice but to adopt those policies. However, assertions of this kind have little basis in reality. To put the power of

international financial markets in perspective, consider the implications of a decision by the international rating agencies to upgrade or downgrade public debt. A decision to reject policies of privatization might lead to a single downgrade, say from AAA to AA, which implies a reduction of about half a percentage point in the interest rate payable on debt. On a gross public debt equal to 50 per cent of GDP, the resulting increase in annual interest payments is equal to 0.25 per cent of GDP. Even if such an upgrade were maintained for 20 years, the aggregate cost would be around 5 per cent of GDP, less than the cost of a minor recession.

The objective danger posed by international financial markets is not that they can effectively impose their political preferences on governments. Rather it is the risk of a panic flight of capital in response to a sudden change of sentiment. Unfortunately, there is no easy way of preventing such changes in sentiment. While capital flight has sometimes taken place from countries where governments have tried to fight capital markets (for example, the expansionist program of the Mitterand government), most recent capital flights have occurred because financial markets have suddenly turned sour on governments that had been regarded as paragons of financial reform only a few months previously (Chile in 1980 and Mexico in 1996).

#### *National sovereignty and international competitiveness*

The metaphor of the 'Golden Straitjacket' implies that, in a world of freely mobile capital, governments have very little freedom in their choice of economic policies. In a globalized economy, it is often argued, governments are constrained by the need for international competitiveness.

However, the notion of 'competitiveness' used in this argument is based on a false analogy between a national economy and a private firm (Krugman 1996). If a private firm is less efficient than its competitors, it will be unable to pay market wages to its employees and return a market rate of return to its investors. If the inefficiency is great

enough, the firm will go bankrupt and the resources it employs will either be hired by other firms or will become unemployed.

If labour is not internationally mobile, no such process of bankruptcy is applicable to national economies. If a country adopts inefficient economic policies, the result will be a reduction in labour productivity and therefore, ultimately, in the equilibrium level of real wages. The process is similar whether the inefficiencies are generated in the traded or the non-traded goods sectors of the economy. Inefficiencies in the traded goods sector produce persistent deficits in the balance of trade in goods and services which must be resolved by a real devaluation, that is one which raises the cost of tradeable goods and services and is not offset by compensating increases in real wages. The only technically valid use of the term 'competitiveness' is as a shorthand for an index of the real exchange rate.

The most important implication of this discussion is that, in a world of mobile capital, government policy can affect only labour income. Hence, attention should be focussed on policies that affect either the productivity of labour or the distribution of labour income. The most important examples are education, health, tax and social welfare systems. Thus a critical issue in the analysis of globalization is whether, as is claimed by neoliberals such as Friedman (1999), institutional frameworks for the provision of education, health care and retirement income are converging, or should converge, to some free-market norm.

The claim that international financial markets will produce optimal policy outcomes is weak, particularly, in relation to policies that affect the long-term productivity of labour. Clearly, investment in countries with high labour productivity is attractive. Hence, rational investors will favour public expenditure that enhances labour productivity. On the other hand, the short-term focus of financial markets entails an excessive emphasis on demands for tax reductions. Thus, while financial markets are unlikely to endorse drastic cuts in public expenditure on health and education services, they will tend to encourage

lower levels of provision than are socially optimal.

Empirically, a comparison of the education, health and tax-welfare policies of different OECD countries shows that there is a wide variation in both the content of policies and the associated institutional frameworks (Mitchell 1991). Moreover, the main constraints on governments appear to arise from the difficulty of changing existing institutional frameworks rather than from the pressures generated by the need for international competitiveness. For example, the reliance of the United States on employer-funded health care is deeply entrenched, despite its obvious drawbacks.

In responding to the fiscal crisis of the state, governments have relied at least as much on increasingly centralized control as on increasing competition. For example, reform of education policy and local government in the United Kingdom enhanced the power of the national government at the expense of local authorities,

Moreover, a number of attempts at increased reliance on market forces for the provision of human services have failed, or been abandoned in the face of public opposition. Most notably, the reform of the New Zealand health system, based on systematic application of the 'purchaser-provider split', proved entirely unsuccessful with most of the managers of the newly created Crown Health Enterprises resigning within a few years (Easton 1997).

The case for the optimality of private-sector, market-driven provision rests on assumptions of perfect information and costless access to capital markets that are not satisfied, even approximately. There is not even a single optimal model of intervention, since the desirable policy outcome will depend on such factors as the homogeneity or diversity of the population the risk-aversion of individuals and the willingness or unwillingness of society to accept inequality in opportunities and outcomes. The optimal policy mixture is likely to be different for different countries.

Even where there is evidence to suggest that one policy approach is superior to another, the costs of maintaining a suboptimal policy are usually small relative to national

income, and there is no evidence to suggest that international competition will enforce the adoption of superior policies. Suboptimal economic policies, whether they apply to industries engaged in international trade, or to purely domestic activities, will reduce national income. If money incomes do not decline, the exchange rate must depreciate, but the idea that a country can 'lose international competitiveness' in such a way as to be driven out of all the export markets in which it operates is nonsensical.

This point is particularly important in assessing developments in labour markets, where the divergence between the United States and the European social democracies is marked, particularly in relation to working hours. Annual hours worked per employee in the United States have risen steadily, from around 1800 hours per year in 1980 to more than 2000 hours per year in 1998. The result is like turning the clock back several decades. Average hours of work for US manufacturing workers were higher in 1998 than in 1950 (Bureau of Labour Statistics 2000). Working hours in the United States are similar to those in much poorer countries, like Mexico and Hungary. Dutch and Norwegian workers average around 1400 hours per year, about two-thirds of the US level. Workers in other European countries average around 1600 hours (International Labour Organization 1999).

The French have led the way in resisting pressure for American-style working conditions. In 1997, the 'loi Aubry' set a maximum working week of 39 hours, applicable to all workers including managers. The maximum was lowered to 35 hours per week with effect from February 1 2000. There have been some offsets, such as systems of annualization, allowing a maximum of 48 hours per week. However, the majority of agreements concluded so far call for annual hours of less than 1600 hours for full-time workers, equivalent to about 45 weeks per year at 35 hours per week. Despite Anglo-Saxon predictions of disaster, the new law has been accompanied by strong economic growth and falling unemployment.

*State capacity*

The idea of 'state capacity' (Mann 1988) is useful in understanding the debate about globalization and neoliberalism. Despite claims to the contrary, the state retains a substantial capacity to intervene effectively in the economy (Weiss 1998). However, that capacity has not grown in line with the demands implied by the range of responsibilities taken on by governments in the postwar period, giving rise to the notion of a 'capacity gap' (Evans 1997).

When the inadequate capacity of the state to meet all its obligations becomes undeniable, a period of crisis occurs, which, in most cases, has been followed by reforms aimed at increasing the role of the market and winding back that of the state. Because the growth in public provision of human services represents a response to real social and economic needs, however, neoliberal attempts to reduce the level of provision and the role of government have not, in general, been successful. As a result, the fiscal crisis of the state has been followed, not by fundamental change, but by a prolonged period of 'muddling through'.

The crisis of the 1970s, then, may be seen as a result of states overreaching their capacity, producing a corresponding overreaction in the 1980s and 1990s. As Rodrik (1996, p2) observes, "excessive optimism about what the state would be able to accomplish was replaced by excessive pessimism." The deregulation of financial markets and the resulting globalization of finance were part of this process, as was the rise of neoliberalism in domestic economic policy. Neoliberals proposed a radical rolling-back of state capacity with comprehensive deregulation and substantial cuts in taxes and public expenditure. However, even where regulatory structures were swept away, there has been reregulation in response to the unsatisfactory performance of unconstrained markets. Recent discussion of the need for a new global financial 'architecture' is part of this process. After two decades of neoliberalism, state capacity has not been substantially reduced.

In some respects, market-oriented reforms have enhanced state capacity. While claims of a reinvention of government (Osborne and Gaebler 1992) are overstated, the

attempt to make governments more market-oriented has, in many cases, increased the capacity of the public sector to provide services efficiently and with lower budgetary costs. Dogmatic presumptions such as the view that government business enterprises should not earn a return on capital, or that public sector employees must work under conditions radically different to those prevailing in the private sector have been discarded. In some cases, they have been replaced by different, but equally dogmatic, presumptions, such as the belief in the universal applicability of purchaser–provider splits or ‘user pays’. Nevertheless, the net effect of reform has been to increase the range of organizational and financial structures available to states seeking to provide human and other services.

### **Policy directions**

For neoliberals, the main policy problem arising from globalization is that of winding back government intervention in response to the limits on state capacity. By contrast, social democrats must consider how to order social priorities in the light of undeniable limits on state capacity, but also how to maintain and increase state capacity. In this section, some responses to the latter problem are considered.

#### *Constraints on international financial flows*

The financial crises of the late 1990s led to a general reassessment of the desirability of unregulated international financial flows. Central banks, which had previously advocated minimal regulation, expressed support for a ‘new global financial architecture’. Although most advocates of a new financial architecture envisaged only modest improvements in prudential regulation, there was increasing support for *ad hoc* interventions such as capital controls and a reappraisal of proposals for more systematic intervention.

The most popular proposal of this kind calls for a small tax on all international financial transactions. The proposal was first put forward by Tobin (1988, 1991) and is commonly referred to as the ‘Tobin tax’. Related ideas have been put forward by Stiglitz

(1989). The arguments for and against a Tobin tax have been discussed in Quiggin (2000), from which much of the discussion below is drawn.

Most proposals for a Tobin tax have been based on the assumption that an international agreement could be reached to levy a tax on financial transactions wherever they took place, and that the resulting revenue could be divided among national governments or paid to the United Nations. Although the prospect of an agreement like this may appear remote, many of the issues that are raised by considering an idealized Tobin tax are relevant in evaluating more limited and practical policy options for controlling financial flows. There are a number of different motives for considering a Tobin tax. They may broadly be classed as macroeconomic, microeconomic and revenue motives.

The main macroeconomic motive is the belief that the operations of financial markets unduly constrain macroeconomic policy and represent a source of macroeconomic instability. By reducing the volume of international financial flows, it is hoped that a Tobin tax will reduce the influence of financial markets on macroeconomic policy. One concern is that markets place excessive weight on inflation as a policy objective. With the major exception of stocks, and instruments based on stock prices, the profitability of the majority of financial instruments depends either on the actual rate of inflation, or on the rate of inflation relative to other countries. To the extent that financial markets are able to direct government policy, therefore, they are likely to impose a deflationary bias. A second concern is that the short-term power of financial markets may result in financial crises, even in countries where economic policies are sustainable in the long term.

The microeconomic reasons for considering a Tobin tax include, firstly, the concern that financial markets appear to increase the risks faced by firms and individuals engaged in economic activity by, for example, increasing the volatility of exchange rates. Secondly, it is widely perceived that the resources consumed in financial markets represent a loss to the economy, and the rewards earned by market participants are excessive compared to the economic benefits they generate. Thirdly, there is a concern that prudential regulation

may be undermined by the availability of risky, large-scale and hard-to-monitor financial instruments. This concern has been heightened by a number of financial collapses involving derivatives. A more general concern is that the control exercised by markets over macroeconomic policy may be extended to microeconomic and social policy, 'punishing' governments that pursue, for example, redistributive taxation and welfare policies. In all of these cases, it is hoped that, by reducing the volume of financial transactions, and confining the financial sector to a supporting role in facilitating trade and long-term investment, a Tobin tax would reduce the damage associated with excessive financial speculation.

Finally, a Tobin tax is attractive when considered simply as a potential source of revenue for governments and, possibly, international institutions such as the United Nations. Various estimates suggest that the volume of financial transactions is between 10 and 100 times that of real transactions. As a first approximation, this implies that a Tobin tax could raise between 0.4 and 4 per cent of GDP. The latter estimate is certainly too high, since 4 per cent is implausible in the context of a financial sector with total resources equal to about 12 per cent of GDP, much of which is in the retail sector (banking, insurance and real estate services for households and small business). Moreover, the volume of financial transactions would shrink if the tax were imposed. (This is, of course, a desired outcome.) It is reasonable to anticipate a revenue yield of between 0.2 and 1 per cent of GDP from the imposition of Tobin tax. A Tobin tax could, therefore, raise significant revenue. Note that this would not represent a solution to the problems associated with the difficulty of taxing mobile capital. The revenue a Tobin tax might yield is much less than the revenue currently raised by taxing capital income, and the existence of a small Tobin tax would not deter owners of capital from moving their capital to countries with low tax rates.

The most obvious objection to a transactions tax is that the tax could be avoided or evaded either by substituting exempt for taxable transactions, or by shifting transactions

to a financial centre that does not levy the tax. Unless a tax is imposed universally, it is argued, a shift in transactions to financial centres where the tax is not applied would nullify it. This claim appears premature, to say the least. After all, it is already possible in principle to completely avoid income tax by making all income-generating contracts in jurisdictions that levy no income tax (tax havens). Although in practice considerable tax is already avoided in this fashion, countries nevertheless do succeed in levying income taxes (at widely divergent rates) on their residents.

Moreover, prudential problems, such as those associated with the near-collapse of the US hedge fund, Long-Term Capital Management, in 1997 can only be fixed by imposing a rigid separation between financial institutions that are regulated and protected by central banks, and those that are not. Given that the standard objection to a Tobin tax is that it will simply drive speculators offshore, this would be an advantage in the context of an internationally supported system of prudential regulation. Countries could choose to operate outside the Tobin tax net and the system of prudential regulation in the knowledge that they would not have access to the IMF if things went wrong. Financial institutions could choose to base themselves in countries operating outside the Tobin tax regime, but they would be unable to borrow from central banks or the institutions operating within their prudential control. On the other hand, arguments concerning the possibility of substituting exempt for taxable transactions appear well-founded. It would appear that the only feasible approach is to tax all financial transactions, domestic and international, at a common rate. Many countries, already tax a range of 'retail' financial transactions, such as bank debits and credits, often at rates higher than those envisaged for a tax on international transactions.

No matter how compelling the arguments in its favour, there seems little likelihood that a Tobin tax will be adopted in the near future. There is a need, therefore, to focus on other instruments that can be implemented unilaterally, like deposit requirements. Although details vary, deposit requirements are generally applied to capital inflows, with the intention

of deterring speculative inflows and outflows In 1974, the Australian government adopted a deposit requirement, under which a proportion of capital inflows had to be lodged with the Reserve Bank for several months. A similar scheme has been in operation in Chile since speculative flows brought about the collapse of its financial system in 1979.

Deposit requirements impose a relatively high effective tax on a relatively narrow range of transactions and bite most severely in periods when exchange rate alignments are under pressure, resulting in large flows of short-term capital. They therefore appear to be a more appropriate response to the instability associated with large-scale capital flows than Tobin taxes. On the other hand, Tobin taxes may be a more appropriate response to the microeconomic distortions associated with an over-expanded financial sector.

#### *Continental social democracy*

A natural response to the limits on national macroeconomic independence associated with globalized capital markets is the development of a co-operative international approach to macroeconomic policy. In this context, it is noteworthy that, while welcoming the erosion of domestic economic sovereignty, neoliberals typically favour a high degree of Westphalian sovereignty. Conversely, they are generally hostile to international co-operation, except in the negative form of agreements not to interfere with the flow of goods and services. In particular, US neoliberals generally reject the idea of linking trade issues, such as China's proposed membership of the World Trade Organization, with human rights, environmental or labour issues.

The ambiguities of the relationship between globalization and neoliberalism are particularly evident in relation to the European Union. British neoliberals are generally sceptical about, or openly hostile to, the idea of European unification. On the other hand, the idea that, because most European trade is internal, a unified European economy would be independent enough to permit the adoption of Keynesian and social-democratic policies without regard to the dictates of financial markets has been advocated most

prominently by Hirst and Thompson (1996).

Progress towards European economic unification remains limited. The European Monetary Union is already in place, although important European countries including the United Kingdom have so far not joined. Moves are now being made to harmonize the rates of tax on income from capital to prevent the competitive bidding down of rates. Some income redistribution across national boundaries has taken place, though primarily as the result of sectoral initiatives.

By contrast, the European Parliament and associated institutions such as the European Commission remain ineffectual, so that the European economic policy (other than monetary policy) is still effectively determined by national governments acting either alone or in consultation through bodies such as the Council of Europe. Nevertheless, given the steady progress towards integration that has taken place so far, it is reasonable to predict that federal European economic policy will continue to grow in importance relative to national policy.

If nation–states are taken as the unit of analysis, the integration of Europe represents a substantial loss of Westphalian and interdependence sovereignty. However, in the contest between social democracy and neoliberal globalization, the nation–state *per se* is only marginally relevant. The crucial issue is whether policy is to be determined by the wishes of a democratic electorate, or to be tightly constrained by the ‘Golden Straightjacket’ of international financial markets.

The first steps towards European monetary union tended to support the latter view. The struggle to meet the limits on budget deficits and public debts imposed by the Maastricht criteria for participation in European Monetary Union gave a deflationary bias to European macroeconomic policy for much of the 1990s. However, since monetary union has commenced, the general stance of monetary policy has been modestly expansionary. Moreover, there has been some growth in European state capacity, reflected in initiatives such as the European social charter.

The direction of future developments in Europe will turn, in large measure, on the performance of the major continental European economies relative to that of the United States and United Kingdom. If European unemployment remains high and the boom in the United States continues, governments will face increasing pressure to introduce neoliberal 'reforms'. On the other hand, if the current boom in the United States is followed by a serious slump, or even a sustained slowdown, the inherent dangers in an economy characterized by a weak government and minimal welfare provision will again become evident.

All of this is as it should be. If neoliberal policies produce better-than-expected economic and social outcomes, social democrats must revise their views and consider less interventionist policies. Conversely, given the poor to mediocre performance of neoliberal policies in New Zealand and the United Kingdom, a failure to sustain the present strong performance of the United States economy would greatly weaken the case for neoliberalism. In either case, choice should be driven by judgements about what kinds of policies would produce desirable outcomes, rather than by obedience to the supposed demands of global capital markets.

### **Concluding comments**

Claims of inevitability are commonplace in policy debates. It is frequently argued that the success of some policy program or other is historically inevitable and therefore should be supported. For much of the 20th century, historicist claims of this kind were most commonly made by Marxist and Fabian socialists, but during the 1990s, the same line of argument was taken over by supporters of neoliberal globalization.

The analysis presented in this paper gives little support to the view of globalization as an exogenous force that has undermined domestic economic sovereignty. On the contrary, financial globalization is best interpreted as the international counterpart of domestic neoliberalism. Both in domestic and international policy, the swing to

neoliberalism was a response to the actual and perceived failures of the post-1945 policy framework in which domestic Keynesianism and the welfare state were complemented internationally by the Bretton Woods system.

The advocates of neoliberal reform have had only limited success in implementing their policy agenda, even in the English-speaking countries. The choice between continued neoliberal reform and a remodelled social democracy remains open. The direction chosen by democratic governments will ultimately depend on the relative success of competing economic and social models, rather than on an exogenous process of globalization.

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