

**Regionalism and global
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6 The social democratic predicament and global economic integration

A capital dilemma*

Jonathon W. Moses

Whereas there is much agreement among economists and political scientists about the efficiency-gains associated with a unified market in tangible goods, the internationalization of capital markets has received fewer words of praise. Recent tensions within the European Monetary System (EMS) might even suggest that capital market integration has brought with it a new international economic regime which governs by an iron law of policy. This chapter addresses the constraints placed by this particular aspect of global and regional economic integration (financial capital mobility) on a particular regional form of capitalist development (northern European social democracies). This problem of the Nordic countries carries with it considerable implications for welfare state arrangements in a number of European countries (see Chapter 5 by Rhodes in this volume).

The social democracies of northern Europe, until recently, were able and willing to pursue relative policy autonomy, maintaining full employment as a primary objective of economic policy. For these countries, at this time, the distinction between national and international concerns was clear-cut. Today, Nordic unemployment rates and policy objectives are approaching those on the rest of the continent. Efforts to maintain national policy objectives are being challenged by forces at two overlapping levels: one global, the other regional. As a result, solutions to once national dilemmas are now being sought at both of these levels.

The most important global factor, financial capital mobility (henceforth, just capital mobility), is challenging national policy autonomy in all of its variants. To the extent that Nordic social democracies had a distinct policy line that varied from other developed nations, their conformity under global pressure is an interesting subject of study. This chapter argues that social democratic governments want to maintain full employment, but are handicapped by changes in the international economy. Its intent is to ask whether the traditional policy mixes of these countries can be maintained in the new international economic environment, and if so – how? In this way, the story told here is similar to those told in other areas (e.g., Japan): global capital mobility challenges heretofore unique regional modes of development (cf. Chapter 3 by Stubbs in this volume).

In addition to these global forces, however, there are pressures for change (and potential solutions) circulating at the regional level. European attempts at solving the dilemmas that arise from global capital mobility present themselves as alternative regime options for the Nordic social democracies. Joining the European single market and the prospect of a single currency represent potential solutions to the problems arising from international capital mobility. At the same time, however, European regime decisions represent yet another challenge to (neighbouring) national policy autonomy. Finland and Sweden's decision to join, and Norway's taxing decision to opt out of, the European Union should be read in this light.¹ This chapter aims to understand the relationship between regional and global factors – between the pressures from European integration and an increasingly global financial market – by looking at the effect that they both have had on social democratic policies. The Nordic social democracies, as neighbouring states to the European Union, were under unique pressure from both regional and global factors.

The argument which follows offers a parsimonious explanation of the way in which increased capital mobility affects the traditional policy matrix of social democratic regimes. While many authors have alluded to the nature of the problem, there has been no explicit detailing of the mechanisms by which small state autonomy is being undermined by international (and regional) economic (and political) integration. It is my hope that the formalization in the first part of the chapter, in a closed-capital economy context, will shine light on the nature of the problems that accompanied the increased international mobility of capital.

Generally, my intent is to provide a framework for understanding the social democratic predicament (in all of its variants) in terms of a policy dilemma brought about by regional integration and the development of global capital markets. Although my focus is on the Nordic countries, the lessons are intended to be generalizable. Small, porous, social democracies have represented one of the most autonomous economic policy regimes in the post-war era. In that role, they represent a good test on the bounds of autonomy in relation to increased capital mobility. As the Nordic social democracies are smaller and more porous than most, they should feel the impact of this integration earlier and hardest. In this respect, Nordic adjustment might be seen as a bell-wether for the larger economies.

The chapter is divided into three parts. The first part looks at traditional models of social democracy in terms of an internal (full employment) balance encouraged by active government intervention. The social democratic compromise is modelled in terms similar to a simple iterative prisoners' dilemma, where organized capital and labour are encouraged to achieve co-operative, Pareto efficient, outcomes through government transfers, information and guarantees. The specific nature of government intervention is assumed to be primarily fiscal or monetary in nature.

The advent of unprecedented levels of capital mobility has made this

domestic level game obsolete. The second part of the chapter shows how governments face policy dilemmas when capital is fully mobile. Because governments, under conditions where there are policy dilemmas, are unable to provide the incentives required to overcome the prisoners' dilemma in section one, the social democratic compromise might break down.

The third section offers an explanation for the lag between the advent of increased international capital mobility and the increased rates of unemployment in the Nordic social democracies. Using the model from the second section, I suggest that exchange rate adjustments could be (and were) used to overcome the policy dilemma. Devaluations were used as a means to defend the external balance so that traditional policy instruments could remain focused on the full employment objective.

The conclusion sums up this deductive argument and suggests some avenues for future empirical research with which to test the hypotheses presented.

A SOCIAL DEMOCRATIC MODEL

Quite possibly there are more definitions of social democracy than there are social democracies to be defined. Whereas it may be more common for political scientists to point to the electoral hegemony of a Social Democratic Party, I intend to use a broader definition which emphasizes the economic and social aspects of the political movement. In particular, social democracy can be understood as a corporatist-based² institutional- and policy-mix aimed at full employment. Full employment growth policies can be seen as the result of a bargained outcome between peak, hierarchical, organizations representing capital and labour, combined with government policies aimed at complementing those national bargaining outcomes.

The disadvantages of such a general definition are clear and many, such that little reflection on them is required. To its advantage, the model presented below can be used as a surrogate for political autonomy in the international economy. The lessons learnt from the theoretical section are those for social democracies with centralized peak bargaining organizations in a world with managed capital flows. Along with others, I assume that these institutions make the full employment outcome more likely than in less centralized systems (e.g. Lange and Garrett 1985; Garrett and Lange 1986, 1989; Alvarez *et al.* 1991; Moene and Wallerstein 1993).

It is accepted academic wisdom that the benefits of social democracy in the post-war era can be explained in terms of these small countries' dependence on, and access to, international markets (e.g. Katzenstein 1985). It is my contention that it is this very dependence and access which is the primary impetus for the fall of social democracy. The difference between the traditional explanation and the one that follows is the difference between free trade in tangible goods and free trade in capital.

Earlier definitions of social democracy have emphasized the openness of

markets for tangible goods, but failed to note explicitly the necessity of having closed capital markets. This is quite peculiar as the socialist objective, if often only in rhetoric, was social ownership of the means of production (i.e. capital). By assuming that the international context was fixed, and by concentrating on the internal determinants of policy, these authors are unable to explain adequately (or anticipate) the crisis in social democracy. Without belittling explanations based on the contradictions of the welfare state (Offe 1984), the deradicalization effects of industrialization (Kerr *et al.*, 1964) and a growing middle class (Parkin 1972), class divisions (Abrahamson 1971; Esping-Andersen 1985; Swenson 1989), the demographic retreat of the working class, or the shifting priorities of policy-makers (Notermans 1993), I wish to argue that the roots of the current dilemma grow beyond the domestic realm and are part of a wider process of global economic integration which is increasingly interdependent with domestic/regional arrangements.

The defining characteristic of social democratic governance is not solely the relative strength (weakness) of labour (capital); it must also be defined by the relative immobility of capital. Social democracy was a prisoner of its period; as an autonomous economic regime, its traditional policy mixes worked well as long as the free trade rhetoric did not extend beyond tangible goods. Thus, references to social democracy – as is the case below – should assume a condition of managed capital flows.

THE CLOSED-CAPITAL ECONOMY MODEL: A PRISONERS' DILEMMA

Traditionally, social democracy has been characterized mostly in class-theoretical terms. Full employment and solidaristic wage policies are explained in terms of the institutions and norms that sprouted from the relative strength of domestic labour (e.g., Korpi 1983; Esping-Andersen 1985) or the relative weakness of domestic capital (e.g., Castles 1978; Baldwin 1990). This balance of class power crystallized in highly organized class-based institutions (and parties) which minimized conflict between capital and labour. In Scandinavia, Norway's (1935) Basic Agreement and Sweden's (1938) Saltsjöbaden Agreement constituted 'historic compromises', establishing the foundations of effective social democratic rule (Korpi 1983).

It can be argued that corporatist style agreements were able to minimize political confrontation, offer a stable business and bargaining atmosphere, and avoid the pitfalls of both unemployment and inflation.³ This is a common explanation for the fact that the social democracies have been so successful at maintaining economic growth at full employment levels. Some have even suggested that concerted bargaining and centralization promote 'virtuous circles' that benefit capital, labour and governments together (Castles 1978; Przeworski and Wallerstein 1982).

The logic of these arguments is best captured in simple game terms. With highly centralized collective bargaining arrangements, successful policy

outcomes can be understood as solutions to something akin to a prisoners' dilemma problem (Marial and Benjamin 1980; Crouch 1985; Lange 1984; Scharpf 1987; Hedström 1986). This is the framework which I intend to use for understanding the current policy dilemmas facing social democracies.

We begin by assuming that a capital-closed economy is organized along class lines in two encompassing (and equally powerful)⁴ peak organizations (one representing labour, the other capital). The assumption of power symmetry shared by labour and capital is important for the game's outcome.⁵ Wages and prices are determined at regular intervals as a result of bargaining between the two groups.⁶

Government, in the model below, plays a guarantor's role in the capital-closed economy game.⁷ Thus, it matters little whether a government is 'left' or 'right' in orientation: its preference is for low inflation, full employment outcomes. Indeed, any government mindful of re-election can be assumed to have these preferences (a formal ranking of the government's preferences is found below). This assumption is all the more reasonable in the Scandinavian context where (a) one can speak of a post-war Social Democratic Party electoral hegemony and (b) where government change has meant little in terms of actual policy outcome.

Following Hedström (1986), this game begins by assuming that a Peak Centralized Labour Organization begins each bargaining round with the following preference ranking: $\beta > \alpha > \delta > \gamma$ (see Figure 6.1). In other words, organized labour would prefer real-wage increases (β); over a low inflationary outcome with no real-wage change (α); over a high inflationary outcome with no real-wage change (δ); over real-wage losses (γ). It is assumed that there is a direct trade-off between wages and profits such that real-wage loss implies increased profits for employers. This helps to explain why the Central Employer Organization prefers the following ranking: $\gamma > \alpha > \delta > \beta$.

In the non-interactive outcome, both organizations find it 'individually' rational to choose δ : increased prices/wages, no real-wage change, outcome (i.e., both a unique Nash and a dominant strategy equilibrium). This equilibrium is not only Pareto Sub-optimal for both negotiating actors, it is also undesirable for a sitting government considering re-election: it is inflationary. This provides an incentive for the government to intervene in the negotiations and attempt to bring about a solution which is consistent with its own preference ranking: $\alpha > \beta > \gamma > \delta$.⁸

In theory, then, governments can be expected to intervene to bring about Pareto efficient outcomes: shifting the corporatist bargaining outcome between labour and capital from δ to α (i.e., to a less inflationary, full employment outcome). The government can, and has the incentive to, encourage co-operative solutions along several lines: by providing information,⁹ guarantees,¹⁰ transfers and contemporaneous economic policies (i.e., monetary and fiscal policy mixes).

Government interventions, in particular the latter type (transfers and economic policies), assume an important role in the second part of my argument.

		Central Labour Organization	
		Moderate wage increases	Maximum wage increases
Central employer organization	Moderate price increases	α	β
	Maximum price increases	γ	δ

<i>Rankings</i>	<i>Outcomes</i>
Trade Unions $\beta, \alpha, \delta, \gamma$	Non-Co-operative. Likely outcome δ : maximum price, maximum wage increase. Not Pareto efficient (α , for example, is preferred by both)
Employers $\gamma, \alpha, \delta, \beta$	
Government $\alpha, \beta, \gamma, \delta$	Induced Co-operative Equilibrium. Government provides guarantees, information and transfers to reach Pareto efficient α solution.

Figure 6.1 The corporatist game

Therefore, before moving on, it may be worth while to explain their relationship to bargaining outcomes in more detail. The general idea is to integrate traditional economic policies (i.e., monetary and fiscal policies) as part of a government strategy of providing incentives for negotiating partners to obtain co-operative outcomes. Oftentimes this linkage is made explicit, especially in connection with incomes policy and/or price freeze agreements. (For example, a price and/or wage freeze is accompanied by an explicit promise by the government to pursue a restrictive economic policy during the agreement's lifetime.)

Indeed, examples of this type are numerous in Scandinavia. A Norwegian Labour Party government in 1973, and again in the period 1975–80, offered tax cuts for wage moderation; and from 1978–9 the central wage agreement was complemented by a mandatory wage freeze. In Sweden, explicit linkage is less frequent, but in the Haga Agreements (1974–6) the wage-earner organizations promised to moderate their wage claims in return for increased payroll taxes. In the period 1983–4 there was also some adjustment of the Swedish tax schedules in connection with the upcoming bargaining round. Thus, it was not uncommon for governments to intervene and induce a co-operative equilibrium.

But traditional policy mixes can be important influences even when they are only implicitly part of the negotiations. Consider two cases. First, the likelihood of encouraging both organizations to move from δ (a high inflationary outcome with no real-wage change) to α (a low inflationary outcome with no real-wage change) surely increases during periods when the government pursues a restrictive policy mix (or when both actors anticipate such a move in the near future). Alternatively, in the aftermath of a devaluation (or under expectations of a government's future devaluation), it may prove very difficult to get labour market partners to agree to make the move from δ to α . The importance of such government 'background' policy was seen in the wake of the recent (1993) Swedish devaluation. Leif Blomberg, the Swedish Metal Industry Workers' Union (Metall) spokesman, publicly demanded (for his industry) wage increases that would shadow competitiveness improvements in the immediate aftermath of the devaluation.¹¹ Thus, it was the government's prior policy which set the context for subsequent corporatist bargaining rounds.

In these closed-capital models, monetary and fiscal policies can be applied in traditional fashion, according to simple IS/LM¹² logic. During the pre-stagflationary period, counter-cyclical demand management could be efficiently directed at the full employment internal balance. Supply-side measures were more easily funded, facilitating the co-operative solutions outlined above. Under conditions of stagflation, fiscal and monetary policies became less effective at addressing so-called cost-push inflation and demand-gap unemployment, but these policies could be (and were) fortified with effective wage policies (Scharpf 1987: 222; Weintraub 1978), and exchange rate changes (see below, section three).

If this is an accurate, albeit amorphous, depiction of the social democratic compromise, the nature of its recent collapse might be said to have come from one of three directions. First, a relative shift in the power of one organization would make the compromise unlikely and problematic. Should the power of capital (*labour*) grow relative to labour (*capital*) it would be less inclined to enter into such a co-operative arrangement, and might try to secure its preference, γ (β), in the open market. The relative bargaining strength between the two organizations would approach levels found in the rest of the developed world, and less co-operative solutions might be expected. In a similar vein, changing perceptions of relative strength might also encourage one of the organizations to jettison corporatist solutions in the hopes of achieving better outcomes in the open market.

The co-operative solution might also be problematic if fragmentation undermines the encompassing nature of the two organizations. Fragmentation might occur, as Høegnes and Hanisch (1988) have shown, when peak bargaining organizations pursue solidaristic wage policies and/or allow wage drift. The game theoretic framework is useful only in so far as the peak bargaining institutions remain highly centralized and encompassing. The recent breakdown of collective bargaining in Sweden, along sectoral lines, is

indicative of the problem. The causes of fragmentation may be manifold, but increased international capital mobility might be responsible for significant sectoral divisions (Frieden 1991).

Another, non-exclusionary, explanation for the collapse of the model might be found in the weakening of the government's position to offer feasible transfers, information and/or guarantees to cement Pareto efficient outcomes. Without devaluing the importance of the other two government instruments (information and guarantees), or suggesting that the other variables do not offer significant explanations for the breakdown of collective bargaining, it is the remainder of my argument that the government's ability to wield the third instrument (domestic economic policy and transfers) has been undermined by changes in the international economy.

While there are many explanations of the collapse of social democracy that emphasize the internal dynamic of class and organization strength, the fact that the model has been undermined in several countries simultaneously suggests an additional reason to search for an explanation beyond the domestic realm. Thus, a comparative analysis would suggest that an external variable may be responsible for effecting changes in one of the three ways mentioned above.¹³

INTERNAL AND EXTERNAL BALANCES: THE POLICY DILEMMA

This second section adds another layer to the bargaining model outlined above. The first section assumed a closed economy with effective fiscal and monetary tools at the disposal of government officials. These tools, along with other government incentives, helped move collective bargaining rounds to co-operative solutions. In this depiction, policy effectiveness may be understood in simple IS/LM terms.

Governments in this model wielded monetary and fiscal policy in textbook style, providing both counter-cyclical impulses to smooth economic expansions (retractions) and supply-side measures to encourage even growth and distribution (Stephens 1994). Regular collective bargaining rounds are both affected by, and made within the context of, government economic policy in 'virtuous circle' fashion. In this way, social democracies were able to maintain some of the world's lowest unemployment rates combined with egalitarian income distributions.

Recently, the social democratic model (as well as much of its collective bargaining core) has collapsed. The hardest evidence of this can be found in Figure 6.2, where Swedish and Norwegian unemployment levels are shown to have skyrocketed in recent years. I propose that the reason for this breakdown can be found in the fact that increased capital mobility has undermined the effectiveness of traditional monetary and fiscal policies, making the induced co-operative solutions more difficult to attain. In a world with increased capital mobility and fixed exchange rates, it is quite difficult to pursue an independent policy mix.

Traditionally, social democratic models have focused only on the internal

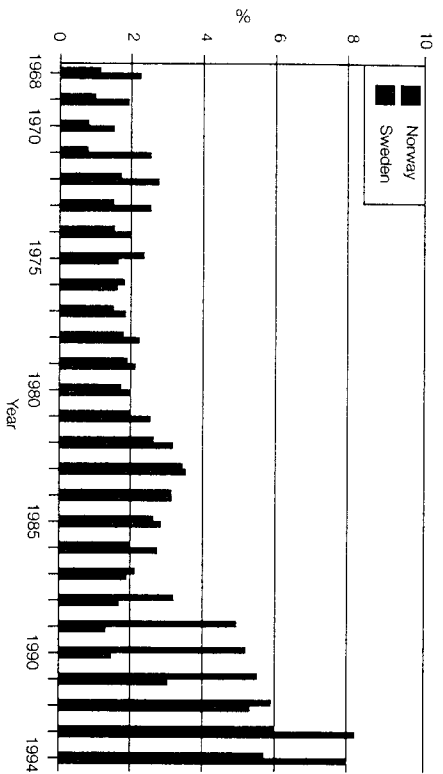


Figure 6.2 Unemployment (percentage of total labour force)
Sources: OECD (1983, 1993); *Nordic Economic Outlook*, 14 February 1994

balance (full employment); the external balance (of trade and payments) is assumed to be of marginal interest.¹⁴ This is largely an artefact of an international regime characterized by Ruggie as 'embedded liberalism': external balances never become threatening as payment flows were largely restrained by exchange controls (Ruggie 1982). Erik Lundberg has juxtaposed the Swedish post-war experience with that of the United Kingdom. His prominence as a leading Swedish economist, and the relevance of his juxtaposition for our current purposes, justifies the following, lengthy citation:

The most important difference from the United Kingdom developments is the absence of disturbing balance of payments difficulties. Since 1947 and up to 1965 foreign exchange conditions have not – or at most only to a negligible extent as a potential factor – worked as a restriction on demand and costs, and have therefore not necessitated restraining policies. It is in fact quite remarkable both in the shorter and longer run how parallel export and import volume as well as value indices have been moving... After the liberalization of imports in 1950 (more or less completely effectuated by 1954), there have been no controls of any relevance on imports, and Swedish tariffs have been kept on a relatively low level... The regular long-term capital import and export movements are controlled by the government and are of small importance... It should be emphasized that Sweden has during the whole period kept a certain amount of exchange regulation, mainly implying control of long-term capital movements, thereby also giving more free space for independent monetary policy than is possible in countries with internationally highly integrated money markets.

(Lundberg 1968: 206–8)

The removal of these capital controls has led to an erosion of the independent monetary policy to which Lundberg refers.¹⁵ In order to understand the impact of increased capital mobility on the social democratic policy mix, it is necessary to extend the game framework of the first section to another level.

The problem can be captured visually by using a two by two box matrix drawn for internal and external balances. Whereas the closed economy model might be presented in two by one terms (where the government responds to a recession with expansionary policies, and to a boom with restrictive policies), increased capital mobility requires that another dimension be added to the model. Both the closed- and open-capital economy models, for the time being, assume fixed exchange rates. That assumption is briefly relaxed in section three. Both dimensions (internal and external) are captured in Figure 6.3.

Generally, small open economies trading in the world market are faced with two policy objectives (internal and external balances), leading to four possible outcomes. These economies face the following four quadrants:

- 1 a domestic boom with an external surplus;
- 2 a domestic recession and an external surplus;
- 3 a domestic boom with an external deficit; or
- 4 a domestic recession and an external deficit.

In this characterization, both internal and external balances are at equilibrium at the intersection of the four quadrants. The unshaded quadrants (two and three), though complicated by the addition of an external imbalance, can be resolved using traditional economic policy tools. In quadrant two, for example, an expansionary economic policy will correct both internal and external imbalances. In the closed-capital economy, counter-cyclical spending is straightforward. Thus, by lowering interest rates, the domestic recession *and* the external surplus are solved concomitantly. On the fiscal side, an external surplus can be corrected by borrowing abroad. The money borrowed can be spent at home to spark output, bettering the internal balance. The same, though reversed, is true for quadrant three. Foreshadowing

	EXTERNAL	
	(+)	(-)
INTERNAL	(+)	(2) recession surplus
	(-)	(3) boom deficit

Figure 6.3 The policy dilemmas

the next stage of the argument, contrast the situation in the open-capital economy: an expansionary domestic policy might spur growth internally by lowering the interest rates. However, lower domestic interest rates will provoke capital flight in search of higher returns abroad, nullifying the effects of the policy.

Returning to the assumption of a closed-capital economy, the shaded quadrants (one and four), however, represent policy dilemmas in that pursuing a solution to one balance worsens the other (given traditional policy instruments). Consider the following examples. In the fourth quadrant, expansionary policies to achieve full employment work against the restrictive policies required of a foreign deficit. The same conflict is evident in the first quadrant: restrictive domestic policies would exacerbate the external surplus by restricting import demand. The dilemma is not hopeless, as we shall see below, but its solution requires an additional policy instrument.

However, a switch to free capital mobility severely exacerbates this dilemma. Increased capital mobility undermines the effectiveness of government policy when it is reliant on traditional policy mixes of either the monetary or fiscal type. This, in turn, undermines the induced co-operative outcomes to the model outlined in section one. Under these new conditions, fiscal and monetary policies must be redirected to defend the external balance; no longer can they be reserved for effecting an internal, full employment, balance. Domestic interest rates are severely constrained by the rates on foreign currencies to which the home currency is fixed. Budget deficits and fiscal policies are also constrained by creditworthiness constraints, real appreciations (fed by debt-financed fiscal expansions), and the loss of seigniorage and surprise-inflation revenues (Moses 1994, 1995).

Thus, in order to return to the full employment equilibrium of social democratic bargaining outcomes, and in order to restore confidence in the possibility of achieving Pareto efficient outcomes in the corporatist game modelled in section one, monetary and fiscal policies need to be effectively redirected to the internal balance. This can only be achieved by once again securing the external balance. The lifting of capital controls in these countries has meant that the external balance demands more attention, at the expense of the internal balance. Monetary and fiscal policy in these countries must now be diverted *away* from securing the internal balance to defending the external balance. In effect these countries are suffering from a classical policy dilemma: too many policy targets and not enough instruments.

In the post-war era, the external balance has traditionally been maintained by the widespread resort to exchange controls. This is not the only possible instrument; earlier periods of capital mobility (and the instability associated with it) were met and managed by government implementation of both exchange and trade constraints. In the inter-war period, for example, tariffs were used within the framework of bilateral trade agreements.¹⁶ Under Bretton Woods, foreign exchange controls dominated. During both of these periods, an internal balance – one more favourable to labour – could

be obtained with traditional monetary and fiscal policies *because* the external balance was secured with another, independent, instrument.

Indeed, during the formative inter-war period of social democracy in Sweden, the autonomy issue became dominant in the policy debate:

The regimes of fixed versus free exchange rates were compared. The economists used the conception of 'international space' as a reminder, rather than a measure, of the limited latitude the country might have for independent expansionary policies. They paid attention to import leakages when discussing multiplier processes; they considered international capital flows when studying what scope there was for expansive monetary policies, not least as to their effects on interest rates.

(Lundberg 1985: 9)

In 1931 that 'international space' was provided for by large devaluations which significantly undervalued the krona throughout most of the following decade (Lundberg 1983: chs 2–4). It is the same sort of space that was utilized by the social democracies in the 1970s as a means of extending autonomy and policy effectiveness in a world economy more and more characterized by international capital flows.

With the advent of increased capital mobility from the 1970s onwards, the social democratic model, as depicted in the first section, was severely undermined. Policy-makers had to redirect their policy instruments to manage problems with the external balance, at the expense of the internal balance. In short, price stability came to replace full employment as the major objective of policy.

THE DEVALUATION DECADE

What remains to be explained is the decade-long lag between the rise of capital mobility and the rise of unemployment. After all, social democracies were able to maintain high employment levels throughout the 1970s and early 1980s – when most of the other industrialized economies were suffering from serious adjustment difficulties. One simple explanation for this difference may be that capital mobility develops over time. While the process itself may have begun in the late 1960s and early 1970s, the policy constraints were only beginning to be felt in the 1980s. A second explanation may be the judicious use of exchange rate adjustments.

During much of the 1970s social democracies used re/devaluations as a means of dividing the two balances, before conquering them both (Lybeck 1985). Exchange rate adjustments allowed the social democracies to maintain their full employment equilibrium while other economies fell prey to external disequilibria. The model in the second section suggests how exchange rate adjustments might have supplemented the traditional economic policy mix as a means of defending the external balance, leaving the monetary and fiscal policies free to promote employment.

If we return to the shaded policy dilemmas in quadrants one and four of Figure 6.3, we can see how flexible exchange rates might liberate policymakers from their external constraint. By adjusting the exchange rate, policymakers can manipulate the internal/external price mix to isolate the internal and external effects of a given policy.¹⁷ An example may prove illustrative. If we assume fixed exchange rates and free capital mobility with the domestic economy in quadrant four (i.e., a domestic recession and an external deficit), the government is one tool short of recovery. This is the point of the previous section. Now, assume that the government devalues its currency. A devaluation will immediately shift domestic demand away from imports, and increase the export of its products by lowering their production costs relative to competing countries.¹⁸ Thus, a devaluation will address the problem of the trade deficit in quadrant four. The domestic recession could then be alleviated by the new demand in both exposed and sheltered sectors.

Similarly, the dilemma in quadrant one can be solved by a revaluation. In this case there was a boom in the domestic economy, and a trade surplus with the rest of the world. Revaluing the currency will shift demand from domestically produced goods to those imported from abroad. It will also undermine international demand for its exported goods, as their production costs will become relatively expensive. This will lighten the trade surplus burden. At the same time, the reduced demand for goods in both sectors will dampen the overheated domestic economy.

Thus, the devaluations of the 1970s seem to support the hypotheses purporting by the analytical framework above: devaluations can be used as a means to free up traditional policy tools in the face of increasingly burdensome external imbalances. Obviously, exchange rate adjustments are not the only tool available for defending the external balance, but they do help to shine some light on the nature of the current dilemma.

CONCLUDING REMARKS

I have tried to provide a parsimonious analytical model which explains and contextualizes social democratic full-employment policy outcomes. Full employment outcomes were explained in terms of a simple model in the context of embedded liberalism dominated by relatively fixed exchange rates. Government intervention is non-partisan and is directed at securing Pareto efficient outcomes for the negotiating parties, and society in general. The main government tools for assisting and securing those outcomes are assumed to be autonomous monetary and fiscal policies.

In effect, the capital dilemma facing social democracies is twofold. As others have shown, global capital mobility increases the relative strength of capital in corporatist bargaining environments, offering it an effective 'exit option' (Gill and Law 1989; Martin 1994). Capital, now liberated, can circumvent traditional fiscal and monetary policies, exacerbating the external balance problem. In addition, however, I have argued that increased capital

mobility also places constraints on traditional government policy instruments. With fixed exchange rates, traditional monetary and fiscal tools must be redirected away from full employment to defending the balance of payments. This leaves the government without adequate tools for maintaining the domestic balance. Unless a new tool is devoted to securing the external balance, traditional policy tools will not be able to eke out the political and economic autonomy traditionally associated with small social democratic regimes.

Nordic desires for EU membership are a reflection of these problems. For Sweden and Finland, the hope is that the European Union will be able to implement traditionally national policy instruments at the regional level. This may be optimistic in that it will require the development of new capital controls, as well as fiscal and monetary policies, at the regional level. Furthermore, the EU appears to be moving in the opposite direction as its capital markets have become increasingly integrated with global markets. Norway will need to decide whether to pursue the exchange rate adjustment option as outlined in section three, or follow in the shadow of European regime decisions. At any rate, Norway's options for autonomous policy – as a non-EU member – are more numerous.

The investigatory nature of this argument has required that it be balanced on two related fulcrums. Future work might be aimed at more explicitly grounding the assumptions that underlie these pivotal points. The first assumption regards the nature of the connection between collective bargaining institutions, outcomes, and government policy. Were social democratic policies really utilized as incentives to secure co-operative outcomes in the centralized bargaining rounds?

The second pivotal assumption of this chapter is the linkage of increased capital mobility with an effective external constraint on domestic economic policy. Mainstream macroeconomic theory would recognize the argument in terms of the constraint placed on monetary policy, but would suggest that fiscal policy should only increase in effectiveness with free capital mobility. Why, and if, fiscal policy is no longer an effective instrument for encouraging collective agreements needs to be examined more closely.

Casual observation suggests that both of these assumptions are consistent with the empirical record, but further empirical investigation can and should be followed up to provide firmer grounding for the central hypothesis posited herein. After all, the models provided are not meant as definitive explanations for the fall of social democracy. Obviously, the nature of the problem is much more complex than could be provided for by this simple framework. My intent is to try and formalize the relationship between internal and external balances as a means for generating both counter-intuitive and future empirical findings in the field and to suggest why this regional variant of economic development is under threat from global economic integration. The models do, however, clearly show the nature of the problems facing economies that wish to pursue full-employment policies in an increasingly integrated regional

and global context. As exchange controls have become increasingly difficult to maintain, and traditional policy weapons have become increasingly unwieldy and ineffective, regional and global integration has effectively imposed upon states an iron law of policy.

NOTES

- * An earlier version of this chapter was presented to the 22nd Annual European Consortium for Political Research (ECPR) Joint Sessions of Workshops, Madrid, Spain, April 17–22 1994. I would like to thank Jeffrey Frieden, Scott Gates, Tørbjørn Knutsen, Geoffrey Underhill, and the Madrid workshop participants for their useful comments and suggestions. No responsibility on their part is implied.
- 1 For a more detailed analysis of the Nordic EU referendums, see Moses and Jønsen (1996).
- 2 Obviously, social democracy can be defined as being more than highly centralized, encompassing bargaining institutions. European history also teaches us that the existence of these institutions does not in itself guarantee social democratic outcomes. In other words, these institutions represent a necessary but not sufficient part of the social democratic definition. Still, they are an essential part of the policy mix, and concentration on them for purposes of analytical parsimony is justified.
- 3 This view is not universal. Several observers have held that either capital (Hibbs 1977; Korpi 1983; Korpi and Shalev 1980; Stephens 1980) or labour (Offe 1981; Pantich 1977, 1980) loses from centralized bargaining arrangements.
- 4 The assumption of symmetry is important. If organized capital thinks itself stronger than organized labour (or vice versa) it will be inclined to try and achieve its objectives in a more suitable forum (e.g. the open marketplace).
- 5 Obviously, this depends heavily on how the game is structured.
- 6 In the model, wages and prices are determined contemporaneously. Generally, however, prices are determined after wages are set (Matal and Benjamins 1980: 465). Although the decisions involved are more complex than a prisoners' dilemma game, because wage and price decisions are more complex than a simple moderate/maximum dichotomy, the situation is 'strategically in a class with' prisoners' dilemma games (Kreps 1990: 38).
- 7 The iterated nature of a wage bargaining game might suggest that the role of a government guarantor is not all that large. Iteration, in itself, is said to encourage co-operative outcomes, as players pursue strategies over time which signal preferences (Oye 1986). Iteration alone, however, is not enough to bring about collectively optimal solutions as countless examples from international relations show us. Indeed, iteration is a highly fragile means of effecting co-operation (Conybear 1986: 150).
- Iteration alone may not affect co-operation as the perceived payoffs of the game may change over time and obscure the interactiveness of the game. In addition, punishing defection with direct and proper retaliation is often crucial for the success of contingent strategies in iterated games. State intervention in both these realms, as well as providing the over-arching context (favourable or not) of the negotiations is important for inducing co-operative outcomes. Essentially, it is the government's role in this context which ensures that perceived payoffs remain unchanged over time, and that penalties are swift, so that iteration is an effective incentive for co-operative solutions.
- 8 We can assume that this is the preference ranking of a traditional Social Democratic Party. Conservative parties may prefer $\alpha > \gamma > \beta > \delta$. The difference is

unimportant, however, in that both governments prefer the low inflation/Pareto optimal outcome.

- 9 Technically, in terms of game theory, the actors are moving simultaneously and therefore play with imperfect information. Informally, however, the centralized bargaining institutions outlined in so-called Basic Agreements can be understood in informational terms, as information is shared by all three actors (labour, capital and government) at each bargaining round. In Scandinavia, for example, it is commonplace that bargaining organizations share economic data and projections from which their individual strategies are planned.
- 10 Guarantees in this context might be understood as legislated income policy solutions, price and/or wage freezes, or even government sponsorship of dispute settlement commissions/courts.
- 11 For a description and interview, see 'Ett genomtrutt lönesystem' in *Dagens Nyheter*, 28 April 1993.
- 12 The IS/LM model represents the core of modern macroeconomics. The IS schedule represents a goods market equilibrium, while the LM schedule represents the money market equilibrium. See Dornbusch and Fischer (1994) for a description.
- 13 It might also be the case that integration itself raises uncertainty in that information-gathering costs rise along with the likelihood of cheating by partners (i.e. increased difficulty of detection).
- 14 That full employment is desirable is fairly obvious, but the desirability of an external balance may be less clear. The simplest answer is that (with fixed exchange rates) a current account deficit requires borrowing. See Moses (1994).
- 15 For an explanation of the impetus for their removal, see Goodman and Pauly (1993), Tranyu (1993), Helleiner (1994), and Moses (1994).
- 16 Generally, tariff levels in these small open economies have always been lower than those in the larger economies. Still, they have varied over time. In the inter-war period, tariffs not only increased, but they were fortified with other constraints in the form of foreign ownership restrictions and domestic cartels.
- 17 I do not mean to suggest that devaluations are a cost-free economic tool for small economies. Frequent exchange rate adjustments in the same direction can feed speculative ebbs and floods of capital, leading to fiscal instability. Instability and lack of faith in a currency lead to a higher interest rate which discourages domestic investment and growth. In addition, exchange rate changes sometimes affect long-term price developments.
- 18 This assumes that imports are either luxuries, have domestically produced substitutes and/or they do not play a significant role as inputs in domestically produced goods. To the extent that the Nordic economies are heavily reliant on raw material production and export, and have adequate substitution possibilities, this assumption is largely unproblematic.

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