VARIETIES OF LIBERALISM:
ANGLO-SAXON CAPITALISM IN CRISIS?

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Abstract

'Global financial crisis' is an inaccurate description of the current upheaval in the world's financial markets. The initial banking crisis did not affect all countries to the same degree. Notably, while the US and UK banking systems were badly hit, those of the other two major Anglo-Saxon economies, Canada and Australia, remain largely unscathed and have even gained in terms of global market share. The national business systems and comparative corporate governance literatures underscore the similarities among these four 'liberal market economies' (LMEs) and would predict similar trajectories. This paper investigates the reasons behind the differing performance of the Anglo-Saxon banking systems, which defy a verdict of failure of the LME variety of capitalism as such.

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'The largest banks know … that they are literally too big to fail and can count on a helping hand from government if the worst comes to the worst. … Thus, in yet another intriguing but ominous irony of history, 10 years of ultra-liberalism have resulted in a US financial system whose future may only be assured with the help of federal government handouts.' (Albert 1993, p. 61).

1. Introduction

The OECD's (2009) conclusion that the current financial crisis is the result of a failure of corporate governance at the level of the individual firms involved does not account for the 'national blocs' of banks in the list of the 50 largest banks globally (by market capitalisation) (*Financial Times*, March 2009). Compared with a decade earlier, American and British banks had lost significant ground, whilst those of other countries, including Canada and Australia, clearly gained. This strongly suggests that national factors also played a significant role.

The national business systems and comparative corporate governance literatures underscore the similarities among the 'liberal market economies' (LMEs) and would have predicted similar trajectories for the US, UK, Canada and Australia. Indeed, prior to the 2007 crisis, this was (on the surface at least) apparently borne out in reality. Only when the crisis deepened, did it become clear that there were fundamental differences in the four banking systems and in the underlying economic and political ideology upon which they were based.

This paper investigates the reasons behind the divergent performance of the Anglo-Saxon banking systems, focusing on their structural and regulatory differences, but perhaps more crucially, on what gave rise to them. We examine the influences behind financial de-regulation, corporate governance, economic and political ideology, in conjunction with more subjective factors, including cultural legacy and attitude towards risk. Individually and collectively, these factors not only played a part in the genesis of the crisis, they also helped to define the relative resilience of the systems in this study when confronted with its effects. Our analysis reveals significant variation in the interpretation of liberal economic theory and the way it was applied in the Anglo-Saxon countries in our study. Rather than representing a failure of the LME variety of capitalism as such, we argue that the financial crisis was a result of the failure of the neo-classical variety of liberal capitalism.

Section two examines the four major Anglo-Saxon countries in terms of macro-economic indicators of their vulnerability to financial market instability. Section three explores varieties in the form that economic liberalism might take, the context in which it was introduced in the countries in our study and the resulting nature of the system produced. In Section 4, we focus the analysis on financial market liberalisation in the UK, the UK, Canada and Australia; we then explore the ways in which this shaped each country's response to prior crises in their financial markets and the influence this had on their experience of the most recent crisis. Section five examines the genesis of the current crisis, with a focus on the evolving relationship between the *regulator* and the *regulated* in the countries in our study and on the system of home financing that gave rise to the real estate – and in particular, the American sub-prime – bubble credited with igniting the most recent crisis. Section six draws conclusions from the analysis and explores possibilities for policy and regulatory reform.

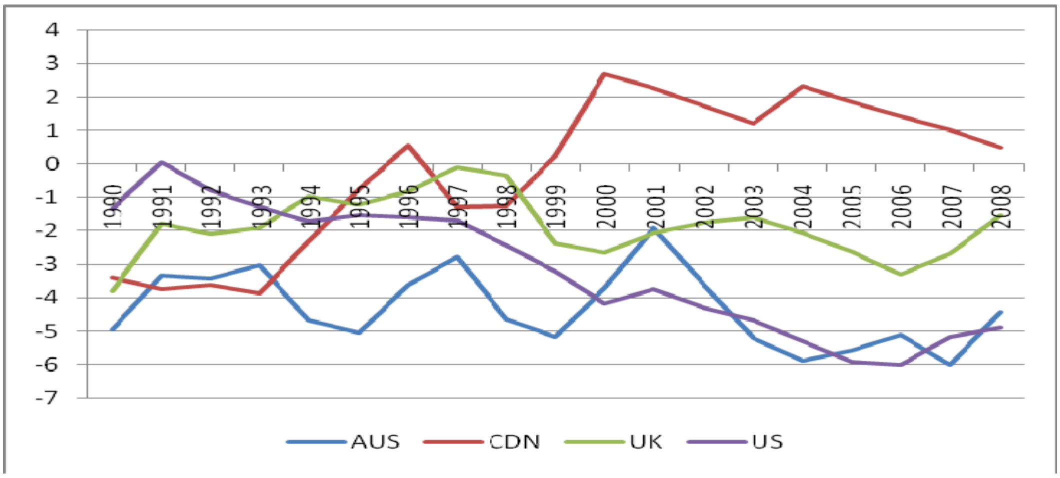
2. Peas in a pod – The Anglo-Saxon economies before the crisis

The US, the UK, Canada and Australia are widely recognized for their institutional and economic similarities. Along with Ireland and New Zealand, they constitute the 'Anglo-Saxon' countries or the 'Anglosphere'. They are also all classified within the 'liberal market economy' (LME) variety of capitalism by Hall and Soskice (2001)[2] These countries share a variety of macro-economic features stemming from their common institutional and cultural heritage that distinguish them from other advanced economies, notably continental Europe and Japan. Yet although many have interpreted the recent financial crisis as a crisis of Anglo-Saxon capitalism, the divergent experiences of the countries in this study suggest otherwise.

The underlying cause of the recent crisis has been widely attributed to macro-economic imbalances (FSA 2009). Based on extensive historical analysis, Reinhart and Rogoff (2009) identify a series of macro-economic factors that tend to increase the likelihood of financial crisis. Of these, the four main predictors include: i) increasing current account deficits; ii) increasing accumulation of debt; iii) significant increases in asset prices (house prices in particular, but also equity prices);[3] and iv) slowing down of GDP growth after a prolonged period of sustained growth (Reinhart and Rogoff 2008: 342). These factors are also features of an asset bubble, with the end result being overvalued assets, excessive leverage and questionable lending practices, all of which are recurring themes in our analysis.

A current account deficit indicates capital inflow, putting downward pressure on interest rates and on the returns from traditional financial instruments while at the same time fuelling asset and equity price inflation. During the past two decades, the large current account surpluses of emerging economies were absorbed by the US and to a lesser degree by the UK and Australia. As evident in Figure 1, although trends in the balance of payments have fluctuated, since 1999, only Canada's account was in surplus. By contrast, the US's balance of payments has steadily deteriorated; and by 2007, it was nearly matched by that of Australia.

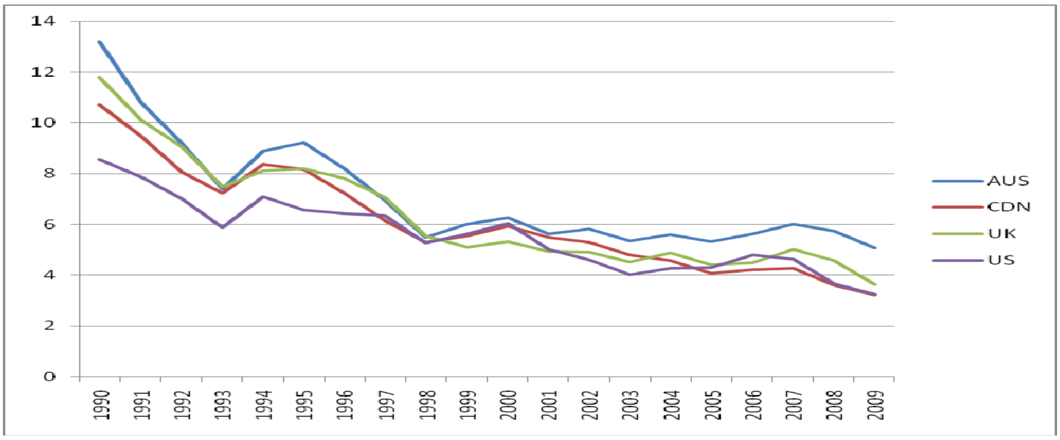
Figure 1: Current account balance as a percentage of GDP



Source: OECD 2009

In the run-up to the crisis, the four countries experienced very similar trends in interest rates. The steady decline in long term interest rates, evident in Figure 2, made traditional financial instruments relatively unattractive and provided the impetus for financial innovation carrying more risk, and hence, a greater return.

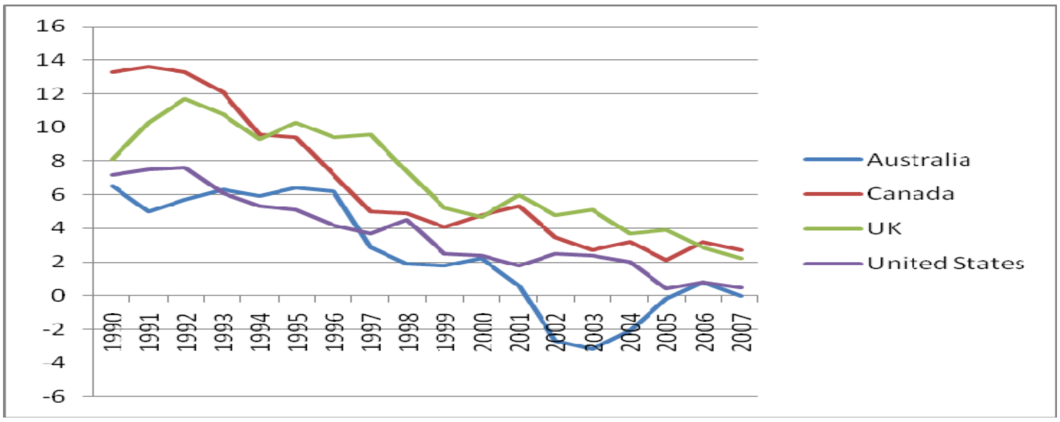
Figure 2: Long-term interest rates



Source: OECD MEI 2010

Massive capital inflows and low interest rates also made it relatively easy for households, as well as financial institutions, to finance their expenses through debt. As evident in Figure 3, there has been a steady decline in household savings rates since the early 1990s in the countries in our study. This suggests that households increased their borrowing to finance spending, which in turn increased the financial sector's exposure to household debt. A second effect was to reduce the ability of banks to finance themselves through deposits, increasing their reliance on the money markets.

Figure 3: Household Net Savings Rates

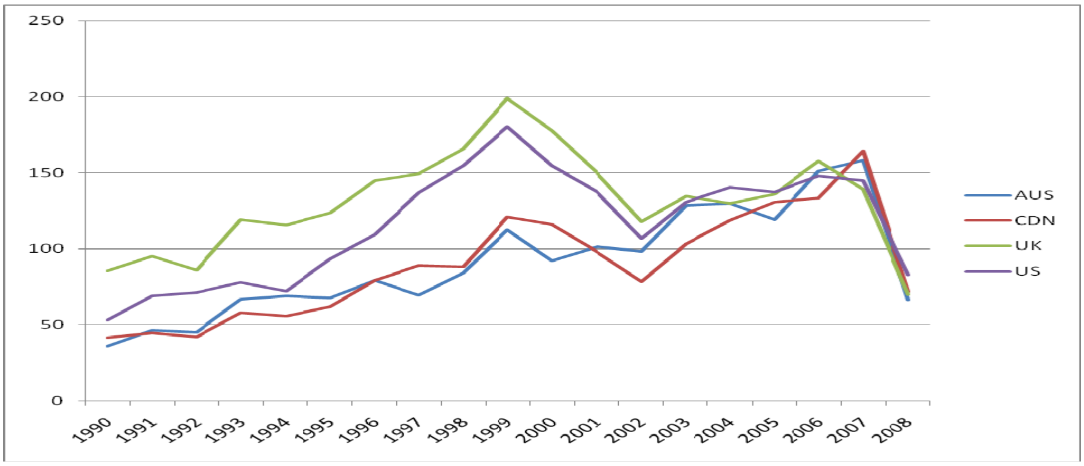


Source: OECD Factbook 2009; UK data: Office for National Statistics

A major component of household debt is mortgage debt, used to finance home ownership and in some cases, additional consumption. In the four countries in our study, patterns of home ownership are comparable and relatively high. In 2000, 65 percent of American households were owner-occupied, compared with 67 percent in Canada and 69 percent in the UK and Australia (The *Economist* 2002). By 2007, ownership rates in the US, UK and Canada were 71 percent, 70 percent and 68 percent, respectively, but this may have become a source of vulnerability. In the US and the UK, the mortgage debt to GDP ratio was also very high (71 percent and 86.3 percent, respectively) (Vorms 2009: 5); in Australia, it was 85 percent in 2008 (Keen 2009: 347). This is in contrast with Canada, where the mortgage debt to GDP ratio was considerably lower (45.6 percent) (Vorms 2009: 5). The reduction in household savings and high mortgage debt to GDP ratios suggest heightened vulnerability to financial instability.

Asset price inflation is another indicator of financial volatility. As evident in Figure 4, throughout the 1990s, equity prices increased, especially in the US and the UK; and after a brief decline, the upward trend continued from 2002, following a very similar pattern in all four countries, until the 2006 credit crunch.

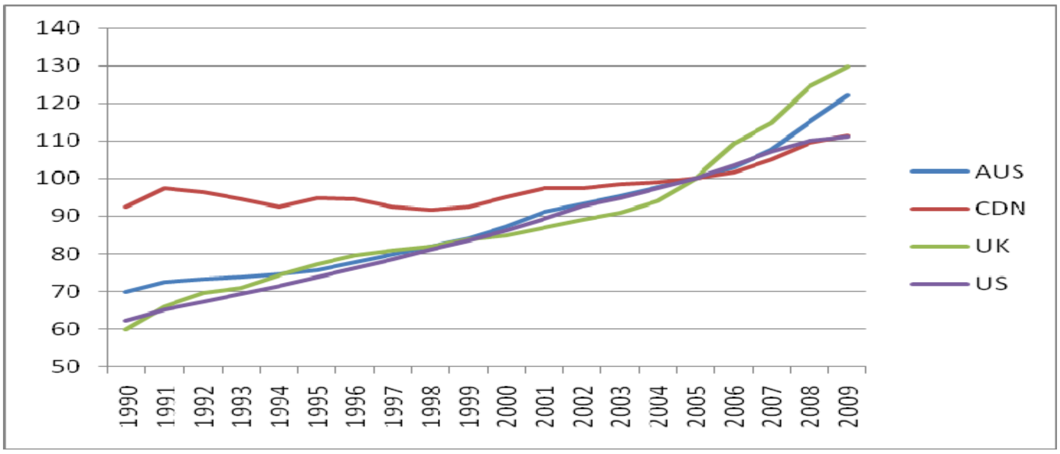
Figure 4: Equity Prices (Total Market Capitalisation as percent of GDP)



Source: World Development Indicators

The cost of housing also increased during the past two decades (see Figure 5); and immediately preceding the crisis, house price inflation rose even more quickly, especially in the UK and Australia, as the real estate bubble inflated further.

Figure 5: Consumer Price Index Housing 1990-2009

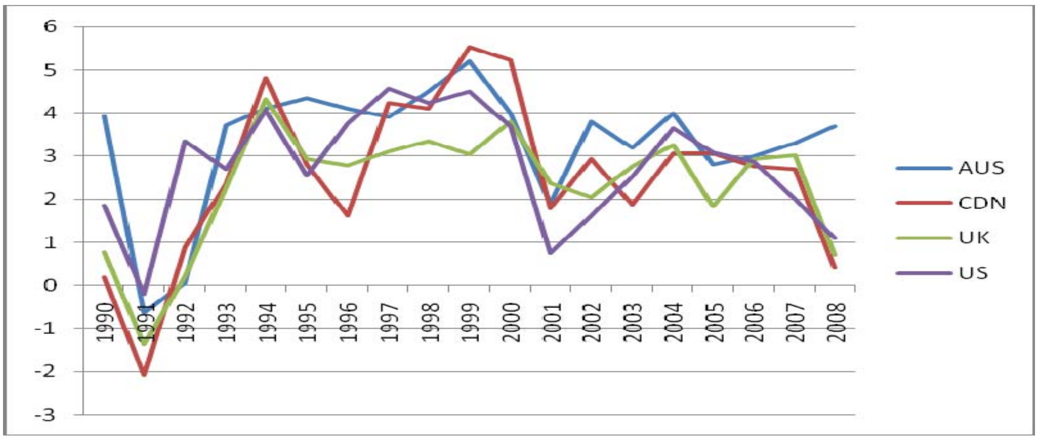


Source: OECD MEI 2010

Asset price bubbles are a strong predictor of financial crises (Reinhart & Rogoff 2009), particularly when the inflated price of a given asset is used as collateral to raise further debt. This was the case, especially in the US and the UK, where many mortgage holders used their home as a 'piggy bank'. However, the use of equity in this way increases vulnerability to an interruption in the flow of cheap money. Even more worryingly, some mortgage lenders had effectively done the same, in an effort to maintain the supply of mortgages with which to build increasingly risky derivative products. But the house of cards began to crumble when defaults on sub-prime mortgages soared above the model's predictions in 2006, triggering a collapse of house prices and undermining the system of payments.

A fourth key predictor of vulnerability to financial crisis is a slowdown in economic growth after a prolonged period of expansion (Reinhart & Rogoff 2009). As evident in Figure 6, after the recession of the early 1990s, average annual growth in real GDP from 1990 to 2007 was relatively strong, ranging from 2.95 percent (UK) to 3.76 percent (Australia), with the US (3.06 percent) and Canada (3.22 percent) in between (OECD 2009). The early 2000s saw a more volatile environment: the Dot-com bubble was the first blow to confidence in the 'New Economy,' followed by the corporate scandals at Enron, WorldCom and others, and the aftermath of the terrorist attacks of 9/11. These events contributed to a softening of economic growth after 2004, especially in the US, where the slowdown was a major contributor to the increase in non-performing loans in the American sub-prime sector that sparked off the crisis.

Figure 6: Real GDP Growth 1990 – 2007



Source: World Development Indicators.

In short, during the two decades prior to the crisis, the Anglo-Saxon economies evolved in similar ways. Whilst Canada appeared somewhat less vulnerable (in terms of its current account balance and mortgage debt to GDP ratio), most of the major indicators of financial market instability were present. Yet there are compelling differences in the relative performance of the four countries' financial systems. Table 1 shows that the largest Canadian and Australian banks gained in terms of market capitalization whilst the American and British banks lost.[4]

Table 1: Change in bank market capitalisation

	Change 1999-2009 ($bn)
Canada	97.5
Australia	85.6
UK	-211.4
USA	-633

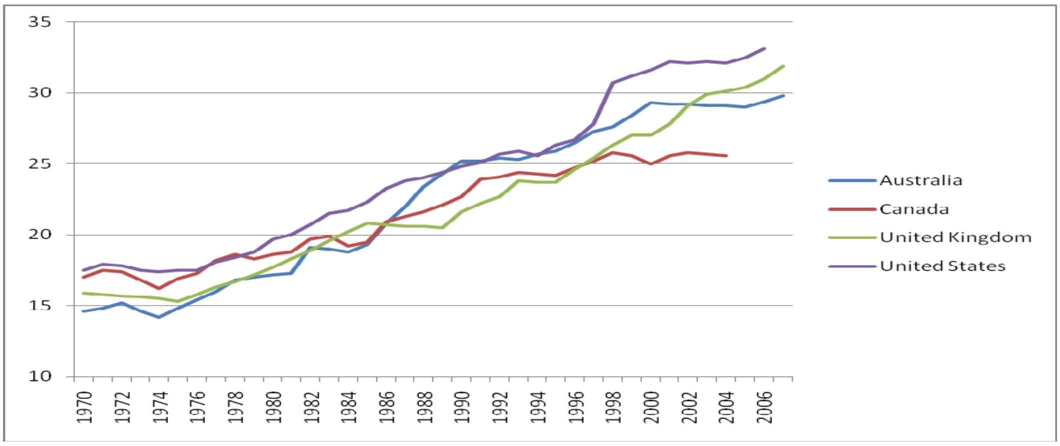
Source: *Financial Times*, 23 March 2009, p.9. 1999 values are as of 31 May 1999; 2009 values are as of 17 March 2009.

These divergent experiences are further illustrated by the magnitude of the bank bailouts in the four countries. By March 2009, the US government's bailout packages amounted to 6.8 percent of GDP, while the UK's accounted for a staggering 19.8 percent of GDP (Stewart 2009). By contrast, Australia used only 0.1 percent of GDP to help struggling banks and Canada, none at all.[5]

Another important trend in the world's advanced economics, which was particularly pronounced in the countries in this study, is the transition from a manufacturing to a service-based economy. In the Anglo-Saxon world, during the latter part of the twentieth century, financial and related services replaced manufacturing as the key driver of employment and economic growth. This followed the breakdown of the post-war mass production-based model during the 1970s; and in many countries – especially the US and the UK – financial services became the engine of growth (Gamble 2009).[6] This was made possible by a process of economic liberalisation, in which the financial services sector was transformed from a pure financial intermediary into an industry in its own right; and competition among financial services companies intensified, with product innovation and price serving as the basis of competition (Toporowski 2000).

The extent of the shift is illustrated in figure 7, which tracks the relative contribution of financial and related services to total value added.

Figure 7: Value Added By Financial Services (percent of total VA)



Source: OECD Factbook 2009

Although the general increase in the relative contribution to value added made by the financial services sector in the major Anglo-Saxon countries follows a similar trend, it masks their differing approaches to the process of economic liberalisation. As we argue below, it is the nature of this process and the form that economic liberalisation assumed that explains differences in the performance of these countries' banking systems during the most recent crisis. Whilst Reinhart and Rogoff (2009) identify financial market liberalisation as another indicator of financial crises, the resilience of the Canadian and Australian banking systems suggests that liberalisation can indeed be achieved without creating major instabilities.

The following section examines the process of economic liberalisation in the US, the UK, Canada and Australia, focusing on its interpretation and implementation. The way that economic liberalism was understood, introduced and developed would have a crucial effect on the nature and extent of regulation, on the relative position of the financial sector in the broader economy and on its relationship with government.

3. Some are more liberal than others – doctrinal differences

In his book *The Affluent Society*, Galbraith argued that the 'conventional wisdom' in economics is inherently conservative and gives way not so much to new ideas as to 'the massive onslaught of circumstances with which [it] cannot contend' (Galbraith, 1999, p.17). This creates the environment in which different ideas find favour and reconstitute the conventional wisdom. Friedman (1962) articulated the process by which the conventional wisdom becomes embedded in policy. In his view,

> 'Only a crisis – actual or perceived – produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around. That, I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes politically inevitable.'

Once a crisis had struck, Friedman believed that it was crucial to act swiftly, before the moment was over-taken by the 'tyranny of the status quo.' (Friedman and Friedman, 1984, p. 3) [7]

One example of this process was the replacement of classical 'laissez faire' economic liberalism by Keynesian conventional wisdom, triggered by the mass unemployment and poverty of the inter-war years, which eventually led to the state's management of the economy. The growing inflationary crisis of the 1970s may also be regarded as a massive onslaught of circumstance. But this time, the 'ideas lying around' were those of Friedman and the Chicago School economists; and the conventional wisdom reverted to pre-Keynesian, liberal economic ideas that success in combating inflation depends on controlling the money supply whilst efficiency in the use of resources is most effectively secured by unrestricted markets. Analogous developments can be observed in theory and policy relating to corporate governance, with the efficient market hypothesis emerging to provide the orthodox explanation for – and justification of – the role of the stock market in reorganising industry and its ownership.[8]

We are currently in the midst of another crisis which has given rise to doubts about the conventional wisdom of economic liberalism and debate about the appropriate direction of theory and policy. The fact that Canada and Australia have apparently achieved sustainable economic liberalization argues against a wholesale abandonment of the current system per se and suggests a closer examination of how this has been accomplished and to what end.

3.1 Varieties of economic liberalism

It is perhaps ironic that the perspectives of Galbraith and Friedman with regard to the process by which theory and policy evolve are so congruous because their economic doctrines could not be more opposed. Nevertheless, the *varieties of liberalism* flowing from the work of these two influential economists – Galbraith a Keynesian and Friedman a Neo-classical – might well form the basis for an understanding of the differing experiences of the Canadian / Australian and the Anglo-American systems in the current crisis.

In the US, UK, Canada and Australia, the return to economic liberalism during the period preceding the crisis was strongly influenced by the political and economic climate of the 1970s and early 1980s. In the US and the UK, it is associated with the rise to power of the politically conservative governments of Ronald Reagan and Margaret Thatcher. However, its origins can be traced to the early 1970s and the liberal responses of the Nixon and Heath governments to the economic challenges of that decade. In 1971, in response to its first balance of trade deficit since before the first World War, US President Nixon announced that the US would no longer provide gold backing for the American dollar. This effectively lifted the capital controls that had been introduced in 1944 under the Bretton Woods Agreement. With the collapse of Bretton Woods, international capital movement restrictions and fixed currency relationships were eliminated.

In the UK, the Heath government introduced a policy of 'Competition and Credit Control' in 1971, as part of an effort to liberalize the money markets and stimulate competition among banks. Quantitative limits on bank lending were removed, banks' liquidity requirements were reduced, and interest rates were allowed to play a more central role in the allocation of credit. At the same time, in response to rising unemployment, the Heath government made a 'dash for growth.'[9] In this, fiscal and monetary expansion and macroeconomic growth were accelerated by an increase in bank lending. However, against a backdrop of international inflationary conditions during the 1970s, property market speculation inflated a property bubble which resulted in the Secondary Banking Crisis of 1973-5. The Bank of England responded quickly, launching a 'lifeboat' to provide emergency liquidity for the secondary banks and thereby averted a widening collapse.

Heath's varying policy responses to the economic turmoil of the 1970s, however, did not save his conservative government. The election of a labour government in 1974 eventually resulted in James Callahan becoming Prime Minister in 1976. Callahan was in fact strongly convinced of the value of many of Friedman's ideas and gave what is arguably the purest expression of monetarism to the 1976 Labour Party Conference. According to Smith (2006), Callahan warned that 'You could not spend your way out of recession. It only fuelled problems by injecting inflation into the economy. The result was: Higher inflation, followed by higher unemployment. That is the history of the last 20 years.' But Callahan was not to get the chance put these ideas into practice. In 1979, Margaret Thatcher, more usually associated with monetarism, was elected Prime Minister, by a large majority.

In Canada, the process of economic liberalization is often identified with Brian Mulroney's Progressive Conservative Party government. However, its origins can be traced to the implementation of controversial wage and price controls by Pierre Trudeau's Liberal government as a response to the inflationary crisis of the 1970s (Klassen 2005). In Australia, economic liberalism began in the 1970s, under the banner of 'economic rationalism,' which was incorporated into policy by the labour governments of Bob Hawke (1983-1991) and Paul Keating (1991-1996) The economic rationalists adhered to a mainstream post-war view, incorporating Keynesian macroeconomic models with neo-classical microeconomics, based on a simple model of perfect competition that allowed for market failure, market imperfection and externalities. From this perspective, government intervention was justified in order to correct market failures and stabilize the level of employment and output.

The Reagan and Thatcher governments are noted for their commitment to market freedom and to reducing the role of the state in the management of the economy. This took the form of privatization in the UK and de-regulation in the US. In Canada, the introduction of economic liberalization under Trudeau was strongly influenced by Galbraith's pragmatic economic ideas. Trudeau once said that 'there is no doubt that he [Galbriath] has permeated my thoughts and those of a lot of other people' and that he had a powerful impact on the process and extent of economic liberalization in Canada (Hicks, 1977: 88). In Australia, the Hawke and Keating Labour governments followed the blueprint laid down by Thatcher and Reagan in America. But rather than seeking to crush the unions (as had been the case in the US and the UK), the Hawke and Keating governments negotiated compromises with business leaders. Thus, in Canada and Australia, economic liberalism assumed a more moderate form than it did in the US and the UK.

3.2 Economic liberalism and the 'philosophy' of the state

The underlying assumption of *neo-classical economic liberalism*, the form that liberalization assumed in the US and in the UK, is that self-regulating markets transform the inherent selfishness of individuals into general economic well-being. The market is seen as providing opportunities and incentives for individuals to fully exploit their property (labour in the case of workers), whilst preventing them from exploiting any advantages that ownership might afford by throwing them into competition with others similarly endowed. By these means, markets are assumed to provide a forum in which the values of individual contributions are collectively determined by the choices of buyers and sellers. These judgements are delivered as market prices, which serve to guide labour and other resources to their most efficient use. Competitive markets should therefore function as equilibrating mechanisms, delivering both optimal economic welfare and distributional justice. Consequently, neo-classical economic liberals assert that man-made laws and institutions need to conform to the laws of the market if they are not to be in restraint of trade and therefore economically damaging. From this logic follows a radical anti-government rhetoric, best expressed in Reagan's assertion that 'Government is not the solution to our problem. Government *is* the Problem'. From this perspective, the effective functioning of markets was best assured by 'rolling back the state.'

In addition to the claim of minimal state intervention, neo-classical liberalism also has a perspective on *how* the state should intervene in the economy when such intervention is required. One of the central aims of the US and UK variety of economic liberalism – which was strongly influenced by Friedrich Hayek's ideas – is that the state should regulate economic activity; but it should not intervene as an economic actor (see Gamble 1996). It should 'steer,' but not 'row.' In other words, the state should not concern itself with the outcome of the economic game; it should instead make sure that there is room for the 'game' to be played.

By contrast, economic liberalism in Canada and Australia resembles that of *'ordoliberalism,'*[10] originally conceptualized by the economists of the German Freiburg School during the interwar period (Boas and Gans-Morse 2009). Drawing on the concept of 'ordo,' the Latin word for 'order,' ordoliberalism refers to an ideal economic system that would be more orderly than the laissez faire economy advocated by classical liberals (Oliver 1960: 133-34). Following the 1929 Stock Market Crash and Great Depression, while Franklin Roosevelt was pledging a 'New Deal' for Americans and John Maynard Keynes was writing *The General Theory*, intellectuals of the German Freiburg School were proposing a pragmatic revision of liberal economic policy. They argued that for the free market to function effectively, the state should assume an active role, supported by a strong legal system and appropriate regulatory framework. Without a strong government, they argued, private interests, in a system characterized by differences in relative power would serve to undermine competition (Oliver 1960: 118; Boarman 1964: 25; Gerber 1994: 33). The German ordoliberals were concerned that the rules of the game not favour the powerful and wealthy (Gerber 1994: 38). However, they opposed full-scale Keynesian employment policies and an extensive welfare state. Instead, the ordoliberals believed that liberalism – the freedom of individuals to compete in markets – should be separated from *laissez faire* – the freedom of markets from government intervention.

Walter Eucken, one of the founding fathers and most influential representatives of the Freiburg School, criticised classical *laissez faire* liberalism for its 'naturalistic naivety,' which finds expression in the US and UK varieties of liberalism. These systems hold onto the belief that the market is a 'natural given', a natural order which occurs spontaneously if the state does not hamper its emergence (Foucault 2004). On the contrary, Eucken's understanding of the market and of competition is very much at odds with the classical (and neo-classical) liberal notion that markets constitute some sort of natural order, which requires protection from excessive state interference. In Eucken's view, the market and competition can only exist if a strong state establishes an economic order. The state's role must be clearly delimited; but in the area where the state has a role to play, it needs to be powerful and active. It is this theory of order that distinguishes German ordoliberalism most clearly from its American neo-classical cousin. For ordoliberals, government is the solution to the problem, so long as it is the right kind of government. Only specific conditions – created by the state – can establish competitive markets. It is not about rolling back the state to free the underlying natural market order. Rather, it is about a strong state creating a functioning and humane economic order (Goldschmidt & Rauchenschwandtner 2007: 8; cf. Eucken 1932: 307; Rüstow 1932).

This humane economic order has the principle of competition at its heart; and it is through this principle that the state constitutes its *raison d'etre*. This perspective was expressed by Alexander Rüstow, a prominent German ordo-liberal, in a 1932 essay entitled 'Free Economy – Strong State.' In the words of OM Hartwich (2009):

> 'Rüstow blamed excessive interventionism for the economic crisis. He also warned of burdening the state with the task of correcting all sorts of economic problems. His speech was the clear rejection of a state that gets involved with economic processes. In its place, Rüstow wanted to see a state that set the rules for economic behaviour and enforced compliance with them. It was a limited role for the state but it required a strong state nonetheless. Apart from this task, however, the state should refrain from getting too engaged in markets. This meant a clear 'no' to protectionism, subsidies, cartels – or what today we would call 'crony capitalism,' 'regulatory capture,' or 'corporate welfare.' However, Rüstow also saw a role for a limited interventionism as long as it went 'in the direction of the market's laws.'' (p. 14)

Conversely, as the state had to be powerful, but limited, markets were similarly not seen as an absolute principle, but as one that had to be confined within a given economic order. According to Wilhelm Röpke, another major figure in ordoliberlism,

> '[W]e must stress most emphatically that we have no intention to demand more from competition than it can give. It is a means of establishing order and exercising control in the narrow sphere of a market economy based on the division of labor, but no principle on which a whole society can be built. From the sociological and moral point of view it is even dangerous because it tends more to dissolve than to unite. If competition is not to have the effect of a social explosive and is at the same time not to degenerate, its premise will be a correspondingly sound political and moral framework. There should be

a strong state, aloof from the hungry hordes of vested interests, a high standard of business ethics, and undegenerated community of people ready to co-operate with each other, who have a natural attachment to, and a firm place in society' (Röpke 1950[1942]: 181).

In other words, for ordoliberals it was not the state but private monopolies that were the main enemy of a free society. Accordinly, Röpke argued that

> '[I]t is naturally understood that … a considerable section of the economic sphere is reserved for the economic activities of the public authorities. Planning also has very definite and positive tasks particularly in the realm of regional development. But we shall have to remain quite firm and make no compromises as far as monopolies and 'monopoloids' are concerned. Wherever they are unavoidable as, for example, in the important sphere of the so-called utilities …, we should adopt the attitude that if a monopoly must be permitted, it should only be in the hands of public authorities and is quite insupportable as a private monopoly' (Röpke 1950[1942]: 181)

In order to preserve a free society, the state had to be strong and impose a rigorous competition policy. Another central claim of the ordoliberal school was the importance of creating an economy where production is decentralised and takes place in relatively small units (see Röpke 1950: 59; Röpke 1981[1944], Rüstow 1953 and 1957). Achieving this implied a role for the state in preventing powerful actors from concentrating their economic power. Hayek, who was early-on in his career a connector between the German ordo-liberals and the US neo-liberals (Foucault 2004), defended similar views regarding decentralisation (Gamble 1996). But, in the more libertarian views of Milton Friedman, the free play of markets overwhelmed concerns about concentration of economic power in certain industries.

Whilst it is difficult to empirically establish a direct influence of this 'history of thought' on liberalisation policy in contemporary Australia or Canada, in many respects, economic liberalism in Canada and Australia resembles that of German ordoliberalism rmuch more than it does the anti-state neo-classical liberalism that characterizes the US and UK. The philosophical roots of ordoliberalism, absent in the US and UK varieties of liberalism, provide an interpretative framework for understanding the varieties of Anglo-Saxon liberalism. They hint at alternative justifications and perceptions of state intervention in the economy and allow us to understand the regulation and de-regulation of the financial sectors in these countries.

As evident in the analysis below, traces of this ideological difference in the various strands of economic liberalism appear to have influenced the evolution of financial market regulation in the four countries in our study.

3.3 Contemporary economic liberalization in the Anglo-Saxon World

Contemporary economic liberalism, particularly in the US and the UK but also in Canada, Australia and elsewhere, was strongly influenced by the work of Milton Friedman and the Chicago School economists. From the mid 1960s, as prices and unemployment rose together, despite counter-inflationary measures, Friedman (1977) revived pre-Keynesian monetary theory. He argued that inflation is purely a monetary phenomenon, caused by an increase in the money supply in excess of real growth at the natural level of unemployment. From this perspective, there was a level of unemployment at which prices are stable, a natural level determined by inflexibilities and imperfections in the labour market. Thus, excesses in monetary expansion generate inflation; and unemployment stems not from an insufficiency of effective demand but from labour market imperfections resulting from state and trade union intervention, overly generous welfare benefits that discourage work, and the poor quality and low motivation of those without work which makes them unemployable at the prevailing wage. As such factors were considered to be determinants of the natural rate of unemployment, attempts by government to increase employment beyond this level were believed to either increase inflation or squeeze out employment elsewhere in the economy (Friedman, 1977).

Alternatively, New Keynesians attributed stagflation[11] to the degree of trade union monopoly which raises wages above their market clearing rate and in so doing adds to the level of unemployment. From this perspective, attempts to increase employment beyond this level, labelled the non-accelerating inflation rate of unemployment (NAIRU), merely add to inflation (Meade, 1982). Thus, for both the Liberal and New Keynesian economists, there was a simple choice between higher real wages or more jobs.

During the 1970s, as inflation appeared out of control, these alternative theories of inflation and unemployment supplanted Keynesianism as the conventional wisdom in macro-economics and were progressively incorporated into government thinking and policy. Attempts to control inflation by monetary means, however, triggered deep recessions during the early 1980s and 1990s. This severely undermined confidence in Monetarism. With the retreat from Monetarism, the target for controlling inflation switched from the money supply (which had proven uncontrollable) to exchange rates. But this also ended when Britain was forced out of the European Exchange Mechanism in 1992 by speculation against Sterling. At this point, the target for price control switched to inflation itself and interest rate adjustments became the primary instrument of policy. Monetarism was ultimately replaced by 'rational expectations' theory.[12]

Meanwhile, the role of increasing employment and competitiveness was delegated to market reforms. Markets and business were de-regulated, large sections of the public sector privatised, and taxes on the rich cut to encourage enterprise. Trade unions were weakened, legal control of labour standards relaxed, out-of-work benefits reduced and subject to more onerous conditions; and wage subsidisation was introduced with the express purpose of lowering NAIRU and generating higher levels of employment. In the interest of freeing up global financial markets, exchange rate controls were removed, encouraging banks and other financial institutions to move off-shore. As a consequence, attempts to regulate the banking and financial sector became increasingly futile and any control over the money supply was lost.

Thus, in contemporary economic liberalism, the focus of theory and policy centred on the monetary causes of inflation and the efficiency and welfare benefits associated with free markets. The Central Bank was assigned responsibility for controlling inflation by means of interest rate policy while the Central Government assumed responsibility for maintaining market freedom. This effectively severed the theoretical and policy link between the dynamics of financial markets and those of other markets.

3.4 Corporate governance and the 'market for corporate control'

A parallel shift in the conventional wisdom in corporate governance occurred with the rise of the hostile takeover movement in the UK and the US and the stock market boom that accompanied it (Konzelmann et al 2010).

Anglo-Saxon corporate governance is characterized by widely dispersed equity ownership among individuals and institutions; the prioritization of shareholder interests in company law and the protection of minority shareholder interests by securities law and regulation. Hall and Soskice (2001) argue that rather than being based on bank-finance, financial systems in LMEs are centred on the financial markets. This is a result of the relaxation or even lack of capital flow regulation that tends to be a feature of these economies. In LMEs, stock markets are well developed and seen to play a central role. A similar argument, based on different fundamental assumptions, can be found in the Law and Finance literature. La Porta et al. (1997), for example, posit that common law countries in the Anglo-Saxon world have more developed financial markets than do civil law countries.

The wave of hostile takeovers in the UK during the 1960s and 1970s served to reorganize British industry while at the same time fuelling a stock market boom.

It also increased awareness of what could be done with leveraged finance and in so doing, marked the beginning of the rise to heightened economic and political power of the financial sector. Perhaps equally significantly, it encouraged 'short-termism' as huge profits could be made in months or a year – rather than decades. As a result, both bankers and share holders became increasingly impatient for a quick return on their investments and equities became their gambling chips. During the 1980s in the United States, a very similar movement took place with the loosening of regulation with respect to takeovers and with the development of a very active market in 'high yield' or 'junk' bonds (Konzelmann et al 2010).

The response of liberal economic theorists was to declare the stock exchange to be an 'efficient market' for managerial control in which the value of a company's shares reflected the value of the underlying productive enterprise (Fama 1970).[13] From this perspective, the stock market boom was taken as evidence of overall industrial strength while the short-term increase in share prices resulting from cost cutting and massive layoffs in companies that had been taken-over, served to reinforce the theory's assumptions. However, this ignored the reality that a significant proportion of the 'profits' generated by hostile takeovers were derived from asset stripping. They were consequently a one off 'blip,' as opposed to being a result of restructuring that had enhanced sustainable output and productivity in the organizations involved (Lazonick and O'Sullivan 2000).

In the US and UK, the leveraged buyouts of the 1960s through the 1980s effectively dismantled large segments of the heavy manufacturing sectors in the two countries. Trade unions were weakened and opportunities for longer term investment in manufacturing were curtailed. During the 1990s, this process was carried on in America by the institutional investors, who were reacting to the enormous loss of (long-term) shareholder value that had resulted from the ultimate performance difficulties and in many cases the competitive failure of the productive organizations involved in the leveraged buyouts of the 1980s. Investor activism took a variety of forms in the US and UK. But in the end, it strengthened the relative power of the shareholder in corporate governance. This period also resulted in an enormous increase in the political and economic power of the financial sector in both countries, with far reaching consequences. In the US, this was evidenced by the successive repeal of the second Glass Steagall Act in 2000, relaxation of Housing and Urban Development (HUD) regulatory policy in 2004 and avoidance of regulation of the derivatives market. All of these were to contribute to both the genesis and severity of the current money market crisis.

Whilst the preponderance of widely dispersed shareholder owned companies in the US and UK made industrial restructuring by means of the financial markets possible, the structure of governance in much of corporate Canada and Australia prevented a similar movement from taking place. Like the US and the UK, both Canada and Australia have well developed stock markets and a large number of listed companies with dispersed shareholder ownership. However this form of ownership structure is not the norm. In Canada, only a minority (just under 16 percent) of the 550 largest companies had a widely dispersed shareholder base in 1989 (Morck, Strangeland and Yeung 1998); and in more than 75 percent of Canadian companies, a single shareholder – often a wealthy family – controlled at least 20 percent of the voting shares (Rao and Lee-Sing 1995). In Australia, too, share ownership tends to be concentrated; and there is a much higher incidence of founding family and inter-company control than in the US and UK. According to Clarke (2007: 145), 'all the evidence suggests that Australian business has maintained an unusually high degree of block-holder control.' In 1999, only 11 of the 20 largest public quoted companies did *not* have a shareholder that held 10 percent or more of the equity, with a similar pattern among smaller companies (Clarke 2007; Stapledon 1998).

It is thus unsurprising that in both Canada and Australia, the takeover market is not particularly active. Dignam and Galanis (2004: 20) conclude that the discipline mechanism of the American and British market for corporate control 'is absent from the Australian listed market' and that 'block-holders exercise control over key decisions as to the sale of the company.' Similarly, a 2008 study of Canadian companies found that 'a significant share of Canadian firms is largely immune to hostile takeover attempts' (Secor 2008, p. 6).

4. Doctrine and deregulation

Economic liberalization began with capital flow de-regulation. The Anglo-Saxon countries opened their economies to foreign capital, with its attendant challenge to control over the money supply. However, the process of financial market liberalization varied, particularly with regard to the stock markets. In the US and UK, the process was sudden and decisive ('May Day' 1975 in New York and 1986 'Big Bang' in London) whilst in Canada and Australia, liberalization was much more incremental and prudential.

De-regulation in New York – and perhaps even more so in London – swept aside the old order. The role of the stock jobber was removed, dis-intermediating the selling and buying process, and effectively giving rise to the modern trader. The result was a faster, more competitive system through the abolition of fixed broking commissions and the introduction of computer technology on the trading floor. However, it also gave rise to a governance question of a similar nature to that addressed by the Second Glass Steagall Act in 1933: Are Chinese

Walls between differing sets of interests in the same organisation a sufficient guarantee of probity?

Changes in the City of London had other effects. The new-found ability of overseas organisations to buy British financial firms resulted in consolidation and ultimately the emergence of financial behemoths with a global footprint. It also gave rise to the 'Wimbledon Effect,' where a successful British institution, the London Financial Market, was increasingly populated by foreign players. Computer technology made it possible for subsidiaries of overseas banks not only to operate globally and more rapidly, but also to effectively engage in regulatory arbitrage. In contrast to financial liberalization in Canada and Australia, this new order was subject only to 'light touch' regulation, with the assumption that free markets would convert universal greed into appropriate and economically efficient outcomes.

The structure of financial market regulation in the four countries also varies significantly. In America and Britain, unlike Canada and Australia, the structure of regulation is fragmented. The US Federal Reserve regulates the banking sector while the Securities and Exchange Commission (SEC) regulates the American stock markets. The British system of regulation is tripartite: the Financial Services Authority (FSA) is an independent body with responsibility for regulating financial services markets, exchanges and firms; the Bank of England handles systemic crises and is lender of last resort; whilst the Treasury provides public funds when necessary to keep sound financial institutions in business. In the current crisis, the American and British systems have both been criticized for their lack of transparency with respect to which of the regulatory bodies was to take the lead, thereby impeding the system's ability to exercise macro-prudential regulation of banks within the market as a whole.

By contrast, regulation in Australia and Canada is much simpler, with a single regulatory body overseeing the system as a whole. In Canada, following the Mulroney government's deregulation bill, most of the large investment houses were acquired by the big five banks. But since regulatory power was consolidated in the Office of the Superintendent of Financial Institutions (OSFI), Coyne (2009) noted that 'far from destabilizing the banks, the brokers absorption into the banks served to stabilize the brokers.'

In both Australia and Canada, the financial sector is predominantly composed of domestic and largely immobile banks and financial institutions. This is in sharp contrast to New York and London, where regulators are charged with responsibility for regulating a dynamic and innovative market *place*, populated by highly internationalized financial institutions and dependent on global capital for the financial sector's economic performance. In these cases, there is a potential conflict of interest: while light touch regulation is attractive to global capital, it also increases the risk of instability and fraud. It also means that whilst in Australia and Canada, the single regulator is overseeing a relatively small number of home domiciled institutions, their counterparts in America and Britain are faced with a bewildering array of largely overseas organisations, and are fragmented themselves. This inevitably affects the relationship between the regulator and the regulated, making it much harder to be assertive.

Across the Anglo-Saxon world, the short-term result of liberalization was not the predicted economic nirvana. During the 1980s, both Australia and America were tested by crises. However their responses were diametrically opposed - largely as a result of the nature of economic liberalisation, tempered by their respective cultures. Whereas the Australian response to the excesses of the 1980s was prudential regulation, the American response to the Savings and Loans Crisis (in line with Milton Friedman's thinking) was further de-regulation. In Canada and the UK, the test came during the 1980s and 1990s, with the collapse of a number of banks, insurance trusts and investment houses. Again, the responses differed. The Canadian response was to strengthen prudential regulation and in so doing to address the possibility of systemic risk. Conversely, in Britain, the collapse of Johnson Matthey, BCCI and Barings Bank were largely viewed as the consequence of problems confined to the individual firms involved. As a result, there were no direct systemic reforms, aside from the cessation of self-regulation and the replacement of the Securities and Investment Board by the Financial Services Authority.

Thus, whilst all four systems had looked into the abyss, Australia and Canada fenced it off while the British and American response was to contemplate its potential for risk sports instead.

4.1 Crisis Management in Australia and America

4.1.2.The Australian Crisis – Causes and Response

During the 1980s, as a result of initial de-regulation, Australia was rocked by instability and scandals in both the corporate and financial sectors of the economy. According to Sykes (1996),

> 'The corporate booms and busts of the 1980s were the greatest ever seen in Australian history. The boom saw a bunch of corporate cowboys financed to dizzying heights by greedy and reckless bankers. Large sectors of Australian industry changed hands.' (p. 1)

In 1990, Australia entered a severe recession, dominated by financial failure (MacFarlane 2006). But the long-term impact was to change Australian banking culture. When the dust had settled, and after what was described as a 'titanic struggle between the investment bankers and the credit risk managers' (Harper in Colebatch 2009), the conservative banking sector rose to power and prudential regulation was enacted.

This was underpinned by the political approach to the banking sector taken by both the Labour and Conservative governments during the 1990s. The Australian 'six pillar' policy was initiated by Australian Labor Party (ALP) treasurer Paul Keating in 1990, when he not only blocked the merger between the ANZ Bank and the National Mutual insurance company but also applied the ban to any merger between the four largest banks (Commonwealth Bank (CBA), Westpac, NAB, ANZ) and the two largest insurance companies (AMP and NatMut) (Maiden 2008). The six-pillar policy was upheld until the Wallis investigation into financial system reform recommended abandoning it in order to expose the largest banks and insurance companies to the same level of take-over pressure faced by other publicly listed companies. In 1997, Conservative treasurer Peter Costello lifted the 'merger ban' for the two insurance companies; but it was maintained for the four largest banks under what came to be known as the 'four pillar' policy, that exists to the present.

The endurance of the four-pillar policy and prudential financial regulation seems to lie in popular resentment of banks in Australia, as evident in Malcolm Maiden's observation that 'banks are bastards, bigger banks are bigger bastards' (Maiden 2008).[14] In any event, prohibition of mergers between the largest Australian banks prevented the emergence of a 'global player'. This may partly explain the robustness of the Australian financial system, as risk was spread across four large banks and, even they were too small to expand extensively into the US market, as for instance the Swiss UBS or the Dutch ABN Amro, both prominent victims of the sub-prime crisis, had done.

In 1998, the Australian Prudential Regulatory Authority (APRA) was established as the national financial market regulator. It imposed higher capital adequacy requirements than any other country: the requirement for tier 1 (common equity-like securities) capital was above 7 percent, plus approximately 4 percent for tier 2 (subordinated debt and preferred shares) (Laker 2004). The next strictest country was Canada, with tier 1 requirements of 7 percent of assets, plus 3 percent for tier 2. Financial market supervision was further strengthened by the establishment of the Securities and Investment Commission (ASIC) following the 1998 Financial Sector Reform Act. ASIC was assigned responsibility for consumer protection and market integrity in financial services. Its responsibilities were increased in 2001 by the Financial Services Reform Act. In March 2001, the failure of Australia's second largest insurance company, HIH Insurance, prompted further prudential regulation; and in 2003 – five years earlier than the US Federal Reserve – APRA tested the solidity of the Australian banks by means of ‘stress tests’ using a scenario of a 30 percent decline in house prices.

Thus, the end result of the excesses of the 1980s was Australian corporate governance reform, the creation of a national regulator and increased supervision and prudential regulation.

4.1.3 America - a dress rehearsal for the Credit Crunch

In many ways, the American Savings and Loans Crisis of the 1980s and 1990s was a dress rehearsal for the current crisis. All the usual ingredients were there: rapid de-regulation, a property bubble driven by low interest rates and derivative products (including CDOs) plus excessive leverage and risk-taking. The whole edifice was built on a flawed formulaic valuation of the risks involved; and the trigger for the crisis was a combination of problems associated with the supply of cheap debt funding and poor lending decisions.

Savings and Loan Associations (S&Ls) or ‘thrifts’ had appeared in the 1800s as community-based institutions for savings and mortgages. The sector was tightly regulated, with restrictions on the range of loans that could be made and ceilings on the returns that could be offered to depositors. During the 1970s, however, when both inflation and interest rates soared, interest caps on deposits made S&Ls increasingly uncompetitive and funds flowed out in search of higher yields.

Because of the risk that this might cause large numbers of S&L failures, the industry was quickly de-regulated. The Depository Institutions De-regulation and Monetary Control Act of 1980 eliminated many of the distinctions between S&Ls and banks and removed the interest rate cap on deposit accounts. The Garn–St.Germain Depository Institutions Act of 1982 allowed federal S&Ls to own projects funded by their loans, resulting in a massive conversion from state to federal status, the acceptance of significant additional risk and a clear conflict of interest. The combined effect was not only a much wider range of savings and lending options, but also more relaxed accounting rules and less stringent oversight.

The Tax Reform Act of 1981, providing powerful tax incentives for real estate investment, and the lower interest rates of the early 1980s set off a property boom. Badly advised (if not fraudulent) real estate lending combined with excessive leverage to form the foundations of the S&L crisis. This leverage was partly facilitated by Drexel Burnham Lambert, an investment bank which wrote the first Collateralized Debt Obligation (CDO) for the Imperial Savings

Association in 1987. In this, Imperial loans were bundled together and sold on the securities market as investment products, permitting Imperial to remove the assets from its balance sheet and generate cash to fund additional loans. Leverage increased as the process continued. These assets were valued by mathematical formulae, with the same scope for inaccuracy that undermined the credibility of the high yield bonds during the 1980s. The fatal weakness was that like most bubbles, it depended on a continually rising, or at the very least, stable, property market and the availability of cheap debt to sustain itself. In a downturn, or with an increase in interest rates, the system would be threatened, with potentially fatal effect on the underlying investments. In addition, the appetite for profit had led to lax lending criteria and significant numbers of non-performing loans in S&L portfolios.

The crisis itself was precipitated by two factors. First, competition for deposits caused a steep increase in the rate of return paid for them, which in turn, necessitated involvement in ever-riskier projects to generate those returns. This was exacerbated by brokers, who, in return for placing deposits with a particular organisation, required the S&Ls to fund specific projects – so called 'linked financing' – which opened the door to many of the fraudulent projects. The other nail in the coffin was inadvertently hammered in by Paul Volcker, who, in an effort to reduce inflation, raised interest rates. This made the short-term funding that many S&Ls were now reliant upon unsustainably expensive. The end result was the failure of 747 thrift institutions in what has been identified as 'the greatest collapse of US financial institutions since the Great Depression' (Curry and Shibut 2000: 33). As the total cost of these failures exceeded the Federal Savings and Loan Insurance Corporation's (FSLIC) ability to pay insured depositors, US taxpayers and the industry were required to contribute to the insurance coverage at a total cost of approximately $153 billion (Curry and Shibut 2000: 33).

Whilst many of the factors and processes at work in the S&L crisis bear comparison to the current crisis, there is a crucial difference. The limitation of the main effects to a single sector of the American banking industry, whose survival was not critical to confidence in, or the health of, the national or global financial system meant that it could be allowed to fail. When the crisis was finally resolved, the number of federally insured S&Ls had been reduced from 3,234 in 1986 to 1,645 and Drexel Burnham Lambert had disappeared. But like the high yield bond, extreme leverage, and the formula-based assessment of risk, the CDO survived the crisis.

Unlike Australia's response to the events of the 1980s, the S&L Crisis did not shock America into reforming its financial regulatory system. In fact, the response was ultimately further de-regulation due to the conclusion that the crisis has been a result of too much rather than insufficient regulation and supervision. This is in spite of the fact that some of those close to the crisis did make the case for reform. In a 1996 address, delivered in Tokyo, Japan, L. William Seidman, former Chairman of the FDIC and the Resolution Trust Corporation (RTC), [15] said that during the 1980s and 1990s, the US had experienced

> ‘a banking, S&L and credit union problem of major proportions – clearly the worst difficulties since the Great Depression.’ He went on to say that ‘given the extent of the problems, we in the US are ‘long’ on experience and if we don’t learn a lot from these experiences, we will surely repeat our problems.’ (Seidman 1997, Volume II, pp. 55-56)

In the wake of the current financial market crisis, it would appear that the important lessons were not learned.

4.2 Canada and Britain: Financial Failures – Individual or Systemic?

4.2.1 Canada – strengthening a culture of compliance and prudential regulation

The Canadian approach was far more conservative than that taken by the other three countries, with a focus on ensuring the system’s resilience; and during the 1980s and 1990s, prudential regulation was strengthened in response to the failure of two small banks in the western provinces and a crisis in the Canadian insurance trust sector.

Established in 1975, the activities of the Northland Bank of Canada (NBS) and the Canadian Commercial Bank (CCB) were concentrated in the western provinces where they invested heavily in financing oil, gas and real estate ventures. The economic recession of the early 1980s, however, hit these sectors particularly badly, putting pressure on investors in energy-related real estate and on banks specialized in financing such activities. Adding to these challenges, early in 1985, downward pressure on the Canadian dollar was met with increasing interest rates which served to augment the difficulty of carrying real estate positions. As a result, the loan portfolios of NBC and CCB deteriorated and deposit outflows continued to worsen, even as they received liquidity support from the central bank. By the end of August, 1985, outstanding loans from the Bank of Canada accounted for more than half of the total assets of CCB and over a third of assets at NBC. On 1 September 1985, the Inspector General of Banks informed the Ministry of Finance that the CCB and NBC were no longer viable; and the Bank of Canada ceased providing liquidity support.

Following the collapse of CCB and of NBC, a number of insurance trust failures led to the establishment of the Office of the Superintendent of Financial Institutions (OSFI) in 1987, under the OSFI Act. OSFI is not only responsible for the supervision of all federally regulated financial institutions; it also monitors federally regulated pension plans and provides actuarial advice to the Canadian government.

The failure of the Confederation Life Insurance Company in 1994, resulted in further strengthening of internal controls, regulatory compliance and 'a culture of prudence.' On his first day as finance minister in 1993, Paul Martin, who later served as prime minister, received notice of the impending collapse of Confederation Life, the fourth largest Canadian insurance company and one of the largest insurance company failures on record. Owned by its policy holders, Confederation Life had operations in Canada, the US and Britain.[16]

During the early 1980s, when Canadian insurance companies faced increasing competition, not only from each other but also from mutual funds, banks and trust companies, Confederation Life's CEO, Patrick Burns, decided to pursue a strategy that involved investing as much as possible in the booming real estate market, which was yielding impressive returns at the time. From 1982, Confederation Life's real estate holdings were increased from $119,000 to $1.1 billion in 1994 while its mortgage portfolio grew from $1.2 billion to $8.5 billion in 1993. By 1994, 71 percent of Confederation Life's assets were invested in real estate, either through direct ownership or through mortgages held on residential and commercial properties. During the late 1980s, the strategy appeared to have been successful; and in 1989 and 1990, the company reported profits in excess of $100 million. But when the property bubble burst, profits plummeted; and in the fall of 1993, Confederation Life announced that it needed help. The company opened its books to competitors who might be interested in a merger, take-over, business alliance, asset purchase or another form of financial assistance. Although the other major Canadian life insurance companies attempted a joint rescue, it never materialized; and on 11 August 1994, Canadian regulators, fearing that public panic would lead to a surge in withdrawals and cancellations, seized the 123 year old company and took it into liquidation.

Marc Duquette specialist in corporate and securities law at the Montreal Law firm Ogilvy Renault explained:

> 'We learned from those lessons … We learned to adopt a culture of prudence, and that is something shared by the institutions themselves. In other places, you try to find loopholes that the regulator won't find. Here, the culture is to comply and be transparent with the regulator.' (Millan 2009)

According to Don Drummond, a senior official at the finance ministry during the Canadian insurance trust crisis, ‘The perspective of government on the financial sector is clear: ‘We are the regulator – our job is to tell you what to do, not to help it grow.’’ (Freeland 2010) Because of this, Martin and the Canadian financial authorities held a shared conviction that ‘we could never afford to go through with our banks what we went through with our trust system.’ According to Martin, ‘I knew there was going to be a banking crisis and so did everyone else who has read any history. I just wanted to be damn sure that when a crisis occurred it wouldn’t occur in Canada.’ (Freeland 2010)

Thus, during the 1990s and 2000s, Canada was not interested in participating in what amounted to a contest to create the most attractive haven for global capital. Whilst the US and UK were implementing a system of ‘light touch’ regulation, Martin recalled ‘talking to [the regulator] … we agreed that we were not prepared to take that approach. Light-touch regulation in an industry that was totally dependent on solvency didn’t make any sense.’ (Freeland 2010). Instead, while capital requirements were being lowered in other parts of the world, Canada raised its capital requirements; those required by OSFI were more stringent than in the Basel Accord of 1989, where 7 percent Tier 1 capital and 3 percent Tier 2 is required. Canadian banks voluntarily exceeded these standards (Booth 2008: 39); so compared to US and UK competitors, they operated with more regulatory capital.

Thus, in contrast to the American response to the S&L crisis, whose origins were much the same as that of Confederation Life, Canada embarked on a decade of prudential legislative reforms.

4.2.2 The UK – warning tremors go unheeded

Like Canada, Britain experienced a number of apparently unrelated bank failures during the 1980s and 1990s. The nature of some of these failures should have set off more warning bells than they evidently did. The Secondary Banking Crisis that had taken place in the 1970s, was dealt with swiftly and effectively. Precipitated by a property bubble, cheap debt and excessive leverage, the crisis was met with a financial ‘lifeboat’ providing emergency liquidity, launched by the then bank regulator, the Bank of England. The collapse of Johnson Matthey Bankers (JMB) in 1984, however, revealed fault lines in the regulatory system itself. In response to the potential loss of confidence in the City of London’s gold bullion market, where JMB was a key player, the Bank of England acted once again. But this time, there were tensions between the governor of the Bank of England and the then Conservative Chancellor, Nigel Lawson, who felt that the Bank had acted without keeping him informed. A public rift erupted between the two; and ever since, the relationship between the government and the central bank has been strained, with obvious implications for the effectiveness of the current tripartite system.

The JMB debacle, and the resulting political tension, appears to have contributed to pressures for a change in the regulatory structure. Prior to 'Big Bang', regulation was largely entrusted to the industry itself, through the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA). Supervision by the Bank of England was relatively informal. Over time, however, its regulatory capabilities were believed to be compromised by its close proximity to the City, creating a 'situation whereby the Bank would have been 'captured' by the industry it was supposed to regulate.' (Ojo 2005: 3-5) In 1985, the Securities and Investments Board (SIB) was set up to oversee the various self-regulatory organisations, such as FIMBRA. Since its members were directly appointed by the Treasury, the regulatory authority of the Bank was eroded even further.

JMB had been toppled by lending large amounts (relative to their capital) to a few, highly suspect borrowers. In a response that demonstrates the tendency for regulation to lag events. The Banking Act of 1987 required bankers to disclose loans exceeding 10 percent of bank capital and they were prohibited from lending more than 25 percent of their capital to any one borrower. The regulatory response was thus more limited and less aggressive than that of the Canadians to not dissimilar circumstances.

By the mid 1980s, London found itself falling behind New York as an international financial centre. Attributing this to excessive regulation and the 'old boys' network,' the Thatcher government set out to remove both. In 1986, 'Big Bang' liberalization ushered in radical cultural changes and a period of rapid internationalisation, with profound effects on the UK financial sector, and by extension, the wider economy. Prior to 1986, the City had been largely composed of small, specialist companies which were largely immune from takeover. The roles of buying and selling were separated by the intermediaries, or 'stock jobbers,' through whose books every transaction went, on a fixed-fee basis.

This earlier regime was swept away; the buy and sell sides of brokerage were united and the modern trader was born. At the same time, the hitherto well-protected City firms found themselves vulnerable to heightened international competition and the risk of hostile take-over. The adoption of computerised trading combined with a time zone ideally placed between New York and Tokyo, put London at the centre of the global financial network. This and the easing of regulation attracted overseas banks, resulting in a wave of acquisitions, many by non-British institutions. The process was not restricted to specialist City firms.

In 1987, the Hong Kong Shanghai Bank (HSBC) acquired almost fifteen percent of the Midland – then the UK's biggest high street bank by market capitalisation. By 1992, HSBC had completed a full acquisition and moved its headquarters to London to take advantage of 'light touch' regulation.

British banks also pursued growth through acquisition. In 1986, Lloyds acquired the Continental Bank of Canada, adding the Trustee Savings Bank and the Cheltenham and Gloucester Bank in 1995. RBS acquired the Citizens Financial Group, which itself had made acquisitions, becoming the eighth largest bank in America and giving RBS significant representation in the US market. RBS also aquired NatWest in the 1990's, and not long before the crisis, the Dutch bank, ABN Amro. By this process, the 'Big Four' UK domiciled banks were created.

Whilst this might on the surface appear similar to the Australian 'Four Pillar' policy, the reality could not be more different. Not only were these banks highly internationalised in their business and consequently much less 'British' than Australian banks were 'Australian' or Canadian banks 'Canadian;' they were also much more diversified in terms of share ownership and much more complex in terms of management systems.

Indeed, in 1981, when Standard Chartered attempted to acquire the Royal Bank of Scotland (RBS), against RBS's expressed wishes, HSBC put in a counter-bid for RBS. Both bids were referred to the Monopolies and Mergers Commission and blocked. The failure of the HSBC bid was based on a persuasive argument by RBS that a large overseas-owned UK bank might be less willing to be 'leant on' in the national interest than a 'Native' bank, or might feel a conflict between public demands (i.e., to help out in a troubled situation) and its owner's interests. 'We find,' the Commission reported 'that the transfer of ultimate control of a significant part of the clearing system outside the United Kingdom would have the adverse effect of opening up possibilities of divergence of interest which would not otherwise arise.' (Reid 1988)

An international footprint also brings the ability to span jurisdictions, arbitrage regulatory systems and relocate in a short timescale if necessary. Thus, as in America, instead of regulating a relatively small number of locally domiciled banks, the game in London shifted to regulating a place, populated by potentially very mobile players. This set up the conditions for another bank failure that should have resulted in more serious regulatory consideration than it apparently did. The collapse of the Bank of Credit and Commerce International (BCCI) in 1991 took place seven years after that of JMB. Not only did it reveal the challenges associated with regulating a complex international bank without a clear national jurisdiction; it also highlighted the numerous possibilities for fraud arising from the globalisation of markets.

In circumstances eerily prescient of the current crisis, the BCCI failure caused the 1992 collapse of National Mortgage Bank (NMB), a subsidiary of National Home Loans. As had been the case during the S&L Crisis and the current crisis, the NMB had been providing mortgages during a boom (including many that would now be termed ‘sub-prime’), funding the loans from the short-term money markets, and then securitising them as investment vehicles. A government bailout was again launched to deal with the immediate crisis; but long-term regulatory responses were limited. In 1994, the SIB revoked recognition of FIMBRA, bringing a final end to self-regulation in the City. In 1997, the SIB changed its name to the Financial Services Authority (FSA) and as a result of changes made by Gordon Brown, Chancellor of the in-coming Labour government at the time, the FSA became the lead regulator in a tripartite system, along with the Bank of England and the Treasury. The lack of clear roles for each component of the regulatory structure, as well as poor communication between them, was to result in the missing of clear opportunities for the system to act, prior to the crisis.

Mervyn Kings arrival at the Bank of England brought with it an apparent distancing of the relationship between Threadneedle St and the City; however, not everyone at the Bank had lost interest in the goings on in the square mile. Paul Tucker, Head of Markets at the Bank had carried out an analysis of the changes, and in particular the rapid growth in the shadow banking system. In 2007, the Financial Stability Report showed that the balance sheets of large financial institutions had more than doubled since the start of the decade, whilst shareholder equity had only risen from $500Bn to $1Trn; This called into question the avowed object of the ‘originate to distribute’ model of banking – to shed assets and spread risk.

The Bank, however, could not react, as the task of regulating had been ceded to the FSA, which for its part, was not inclined to act either. Aside from its focus on individual banks rather than the potential for systemic risk, the financial sector appeared to be performing extremely well; and whilst the potential for mayhem inherent in the new breed of derivatives had been raised by a number of people – not least the outgoing first Chairman of the FSA, Howard Davies, regulators did not feel confident to act (Tett, 2009 pp182-4).

Even the handover period to the FSA had not gone without incident. Technological developments meant that modern traders could change risk positions very quickly and in the process break the management chain between setting and monitoring the appetite for risk. This was evident in the collapse of Barings Bank in 1995; and apparently the lesson had still not been learned by the time of the current crisis, when the Chairman of Deutsche Bank’s London branch, Lord Aldington, confessed to knowing little about how complex structured products actually worked – in spite of a significant exposure to them (Treasury Committee, 2008, p. 16).

The Barings failure also demonstrated the effect of inadequate standards of corporate governance, resulting from two, theoretically counter-balancing roles being held by the same person, Nick Leeson, who simultaneously was Trading Floor Manager and Head of Settlement on the Singapore International Monetary Exchange. As Head of Settlement's role was to ensure transparent and accurate accounting, Leeson was reporting to himself, removing him from the bank's internal auditing system. Leeson did not hedge his positions, and took a view on the future direction of the Japanese markets in which the result could only be large gains – or catastrophic losses. In the end, in less than two months and without the knowledge of senior management, Leeson's losses amounted to £827 million, over twice Barings capital. (Reserve Bank of Australia 1995)

An inquiry by the UK Board of Banking Supervision concluded that responsibility for the bank's failure rested with senior management and the board of directors (Board of Banking Supervisors 1995). There was hence no need for macro-prudential reform and the City remained the attractive haven for global capital it had been since Big Bang.

5. 'I'll huff and I'll puff and I'll blow your house in' … : the genesis of the current crisis

As section 2 demonstrates, the pre-conditions for a financial crisis were all in place in the countries in our study, to some extent. Capital flow de-regulation combined with imbalances in household savings rates between Asia and the West, contributing to the availability – and uptake – of cheap and plentiful debt. However, in the largely post-industrial Anglo-Saxon economies, this funding found its way into the consumer, rather than the industrial sector. From the mid 1990s, it funded a property boom, fuelled asset price inflation and increased the ratio of mortgage debt to GDP. Consumer leverage also rose, as mortgages were made at increasingly high initial loan-to-value ratios, with both borrowers and lenders assuming that debt burdens would ultimately fall as a result of continued house price inflation.

The conditions that produced this consumer boom were less comfortable for the internationalised banks in New York and London. Low interest rates and the large volume of Asian savings in the market had not only depressed returns; it also generated increasing pressure from investors for higher yields, which could be generated in essentially two ways: higher risk and higher leverage. Many opted for both, using the booming property markets as fuel.

5.1 Financial alchemy

For investors, the desired returns were initially provided by Collateralised Debt Obligations (CDOs), derivative vehicles which cherry-pick higher risk (and hence, higher yield) loans from conventional asset backed securities (ABSs). Until the market crash of 2008, Structured Investment Vehicles (SIVs) were a popular mechanism for investing in these products. An SIV is a ‘virtual bank.’ Essentially a shell company, it had a line of credit from its parent bank which it was assumed would never be required because the SIV was designed to fund itself via the short term money markets, taking advantage of low interest rates. SIVs would borrow money (by issuing short-term securities at low rates of interest) and lend it (by buying long-term securities at a higher rate of interest), making a profit for investors from the difference. By buying new assets as the old ones matured, SIVs were envisaged to have an indefinite lifespan.

With advances in information technologies, ever-more complex CDOs could be constructed by individuals using desktop machines and trading them privately, without the use of an exchange as an intermediary. When demand from investors for these ‘over the counter’ products proved insatiable, erosion of initial profit margins through competition and the increased cost of the underlying loans produced further creativity. The resulting ‘synthetic’ CDOs were constructed from the riskier parts of traditional CDOs, adding another layer of complexity and risk to achieve the desired returns.

In these markets, competition created a ‘herd’ mentality and a squeezing of margins after each innovation. It also gave rise to a governance challenge in organizations with widely dispersed shareholder ownership, hungry for returns. The perceived risk of hostile action by shareholders or the markets impedes the board’s ability to take decisions relating to risk independently of the sector, which is a major contributing factor in the building-up of systemic risk. A good example is JP Morgan, one of the more cautious players on Wall Street, who paid the price for its individual view on derivative risk through a hostile takeover by Chase Manhattan in December 2000; (Tett, 2009 pp92-3) it was subsequently forced to *again* defend its continued conservative stance on derivatives to shareholders.

An important component of the CDOs that played a central role in the most recent financial crisis were mortgage backed securities (MBSs), most of which were created in the US. However, despite its recent *bete noir* status, mortgage securitisation is far from new.[17]

In the US, the structured financing of mortgage pools has its origins in the 1970s, when MBSs were used to help the American banking sector keep up with growing demand for housing credit. Prior to this, banks held loans to maturity. The first MBS was created by the US Department of Housing and Urban Development (HUD) in 1970; and the Government National Mortgage Association (Ginnie Mae) was set up to sell these securities with a guarantee of timely repayment on principal and interest.

In the UK, which pioneered mortgage securitization in Europe, the first MBS was issued in 1985 and its market grew rapidly during the 1980s housing boom (ODPM 2003). However, it declined equally rapidly with the housing market recession of the late 1980s and remains relatively small. More recently, despite some growth in the sub-prime market, consumer leverage was fuelled by other forms of questionable lending, notably the extraction of equity from homes to fund additional investment in property or the purchase of consumer goods and the issuance of improbable mortgages with loan to value ratios of up to 125 percent. During the credit and property boom, the conventional wisdom again assumed that inflationary conditions would continue indefinitely, thereby eroding debt levels – until the bubble burst.

Compared with America, mortgage securitization in Britain plays a relatively minor role. It is even less significant in the Canadian and Australian financial markets, where concern about maintaining a high quality of assets means that banks tend to operate to an ‘originate to hold’ strategy – holding loans to maturity, rather than selling them on. Between 2003 and 2006, MBSs as a proportion of outstanding residential loans averaged 20.1 percent in the US, significantly higher than in the other three countries, where MBSs accounted for 7.9 percent of residential loans in Australia, 6.4 percent in the UK and 3.6 percent in Canada (IMF 2008, p. 107).

5.2 Home financing in the Anglo-Saxon world

The securitization of risky American sub-prime mortgages was a key contributor to the high returns of the CDOs they populated; it was also pivotal in precipitating the most recent financial crisis. However, whilst sub-prime mortgages provided the raw material for risky derivative products created in the US, the system of home financing in the UK, Australia and Canada prevented the proliferation of such risky loans originated in these countries. Thus, while Anglo-Saxon home ownership patterns are comparable, their systems of home financing gave rise to very different outcomes with respect to mortgage lending; and this played a role in their experience of the crisis. Nevertheless, the high returns on these derivative products encouraged many to invest in them, exposing investors around the world to the American sub-prime bubble. It is thus useful to examine more closely the systems of home financing in the main Anglo-Saxon countries and the role they played in the crisis.

The Great Depression created both mass unemployment and industrial unrest amongst those still working.[18] One of the responses to the crisis was to create incentives encouraging more American households to own their homes were also introduced; and in 1938, the Federal National Mortgage Association (Fannie Mae) was set up to purchase mortgages from their originators, thereby freeing up their capital so that they could make additional loans. American home ownership is also encouraged by US tax policy: interest payments on mortgage loans are tax deductible and up to $500,000 in capital gains from the sale of a house is tax exempt. At the same time, ease of obtaining a mortgage and limited liability in the case of default provide incentives for households to purchase houses using debt. When mortgage affordability is assessed, other debts are typically not taken into account; car loans, for example, are specifically excluded. Mortgage loans are 'non-recourse,' meaning that a home-owner's liability is limited to the amount of money invested in the mortgage. If the mortgage debt exceeds the value of the house, it is possible to turn in the keys and walk away from the loan. Mortgage insurance is optional; and high loan to value ratios are normal, especially during a boom.

The effect of these policies on the American housing market was spectacular; between 1940 and 1960, home ownership in the US rose from 43.6 to 61.9 percent (US Census Bureau 2004). By 2000, 66.2 percent of American households owned their homes. This figure peaked in 2004 at 69.0 percent before declining slightly to 67.4 percent in 2009 (US Census Bureau 2010). However, whilst the 'easy in' policies encouraged rapid growth in home ownership, their counterpart, 'easy out' options also built in a much higher degree of volatility than in the other systems in our study.

In the UK, whereas the vast majority of households had lived in rented accommodations, from 1980, under the Thatcher government's 'right to buy' legislation, there was a rapid expansion in British home ownership. As with America during the inter-war period, a political agenda lay behind this policy. Increasing the rate of home ownership by offering more and cheaper mortgages and privatizing government-owned housing formed part of a wider strategy aimed at raising the number of conservative supporters; accompanying this was another policy, encouraging people to buy shares in newly privatized businesses.

Under the 1980 Housing Act, UK public sector tenants were encouraged to purchase the properties they occupied, at heavily discounted prices. The response was direct: by 1981, 56 percent of British households lived in owner-occupied accommodations; by 2003, the figure had risen to 68 percent and by 2007, it was 70 percent (Office of National Statistics, 2010). In contrast to the American system, however, the Conservative government soon began to cut back on income support for mortgage interest and to withdraw mortgage interest tax relief, which by 2000, under New Labour, was completely abolished. Thus, from the mid 1990s, there was a steady reduction in government support for home ownership, as measured by income support for mortgage interest, mortgage income tax relief, stamp duty and inheritance tax (Williams and Pannell 2007). In more recent years, as increasing house prices outpaced growth in earnings and affordability, and with growing interest in strengthening public services, attention has been re-focused on housing policy in favour of home ownership (Williams and Parnell, 2007, p. 5). The 2001 Starter Home Initiative and the 2004 Key Worker Living Scheme were introduced to help key public sector workers, particularly nurses, teachers and police, to buy or rent homes in the communities in which they serve. Mortgage support schemes have also been set up to provide assistance to first-time home buyers and to those experiencing difficulty paying their mortgage due to unemployment or a short-term decline in income.

British – and especially American – home ownership and financing systems stand in sharp contrast with those of Australia and Canada. In these countries, mortgage insurance is mandatory and lending criteria more stringent. The regulator's emphasis on the quality of assets means that instead of securitizing mortgages, banks hold onto them until they are paid-off. Adjustable rate and interest-only mortgages are virtually unheard of. There are no non-recourse loans and mortgage interest is not tax deductible. The sub-prime market is thus relatively insignificant in both countries.

Whilst, ironically, the American system is a product of heavy and on-going government intervention, the Australian mortgage system is a product of minimal intervention, the last of which was phased-out during the early 1990s with the collapse of the New South Wales government-owned equivalent to Fannie Mae (Stapledon 2009). In Australia, mortgages have traditionally been limited to a level where debt servicing accounts for less than 30 percent of a borrower's gross income. More recently, this was adjusted such that income above the 'costs of living' serves as the basis for assessing mortgage affordability (Laker 2004: 6). As the costs of living can be considered independent of income level, wealthier individuals can expand debt further than others. As a result, only those who can afford to take on the debt can secure mortgage loans. Mortgage debt is insured by Lenders' Mortgage Insurance (LMI), which covers 100 percent of mortgage debt, transferring the risk of credit exposure to the insurer. Although there was some securitization of mortgages during the 1990s and 2000s, a strong ownership culture combined with non-deductibility of interest and no capital gains tax on owner-occupied property provide strong incentives for Australians to build equity in their homes. At the same time, high property market transparency and the predominance of Listed Property Trusts (LPTs) as issuers of mortgage backed securities contributes to the relative stability of the MBS market in Australia (Australian Securitization

Forum 2008). LPTs are legally required to report their activities and underlying collateral performance to the regulators (ASX and ASIC).

In Canada, too, the mortgage market is highly restrictive. The vast majority of mortgages are originated by banks to hold, thereby providing a strong incentive to *not* lend where there is a high risk of default. All mortgages with less than a 20 percent down payment must be insured by the Canadian Mortgage and Housing Corporation (CHMC), backed by government guarantee. As a result, Canadian mortgages are much less leveraged, translating to lower risk for the lender. Established in 1945, the CMHC insures the principal and interest on Canadian mortgage loans, backed by its borrowing power under federal government legislation, the National Housing Act (NHA). High credit standards on eligibility for mortgage insurance, imposed by government regulators, were recently tightened to guard against a US style housing bubble (CBC News, 2010). As a result, only those who can demonstrate an ability to repay the loan are able to secure mortgages in Canada. In 1985, the CMHC introduced the National Housing Act Mortgage Backed Securities (NHA MBS) programme in response to rising mortgage costs. In 1987, following investors' complaints about the lengthy payment period on defaulted loans during the 1980s, the NHA MBS programme added a 'guarantee of timely payment.' This effectively removed risk from the equation. With a defaulted mortgage, the payments would be kept up until the principal amount was repaid by the guarantor, the CMHC. The stability of the Canadian MBS market was further strengthened and liquidity increased in 2001, when the CMHS introduced the 3 and 5 year Canada Mortgage Bond (CMB), guaranteed by the CMHC.

In short, and as discussed above, although MBSs are present in the British, Australian and Canadian financial systems, they do not account for a significant proportion of the market. Further, given the nature of house financing in these countries – especially Australia and Canada – there has been little or no growth in the volatile sub-prime sector, which remains very small outside of the US.

5.3 The American Sub-prime Bubble

By the mid 2000s, the housing boom in America was cooling, so the search for yield by the internationalised banks intensified and an apparent solution was found in the more extreme parts of the American sub-prime sector. Here, the higher the risk, the higher the returns for investors in the securitised products built from these mortgages. However, exploiting the more risky segments of the sub-prime mortgage market would require nearly complete relaxation of lending criteria, given how relaxed they already were; and this in turn created pressure to securitize sub-prime loans more quickly. Closer examination of the criteria for sub-prime lending reveals the reason why: all that was required was a willingness to sign up for an Adjustable Rate Mortgage (ARM). No proof of income, no documentation and no insurance was required. However, a very low initial rate – and many could barely afford even that – quickly increased to an unaffordable level. Even when the initial rate was being paid, under Generally Accepted Accounting Practices (GAAP), lenders could show the full amount in their books, so by the time the mortgage defaulted, it was likely to be someone else's problem. So popular were these products that between 2000 and 2005 sub-prime mortgage backed bonds exploded from $80 billion, or less than a tenth of the market in 2000, to $800 billion or almost half, by 2005 (Tett 2009).

For the ARM loan holders, though, things were worse; the sub-prime bubble had lengthened the property boom, so they had bought at the very top of the market. Not only could they not afford their loans, there was no incentive to even try. With non-recourse loans, they could easily walk away; so they did exactly that – in their droves. But when default rates outpaced expectations, investor confidence collapsed, as did liquidity in the money markets and the ability of many SIVs to fund themselves.

The relaxation of sub-prime lending criteria, however, raises questions of other regulators, in particular HUD. Whilst the Clinton administration had set targets to help more low income and minority families own their own homes, it had also charged HUD with curbing predatory lending. By not allowing Fannie Mae and Freddie Mac to get involved with the riskiest sub-prime loans, it was expected that the worst excesses of the lenders would be limited. However, in spite of the warnings by HUD researchers in 2001 that sub-prime default rates were rising, little action was taken. By the time HUD targets were next revised, in 2004 under the Bush administration, the affordable housing goal was raised from 50 to 56 percent, Freddie and Fannie's purchases of sub-prime securities had risen by a factor of ten; and between 2004 and 2006, they purchased an additional $434 billion of sub-prime loans. This both exposed the borrowers to exploitation and the securities market to extreme volatility.

HUD has since been severely criticised for poor policy implementation and weak regulation. According to Senator Jack Reed,

> 'We need to focus on putting families in homes they can truly afford, not just getting a sale, packaging the loan into a sophisticated financial security and walking away to the next closing. Today people are wondering, 'why weren't the regulators and the industry probing these loans more deeply?'' (Leonnig 2008)

By contrast, in response to continuing house price inflation in Australia, the Australian Prudential Regulatory Authority (APRA), well aware that house prices could not increase forever, warned that competition for a share of a slowing house lending market should not lead to an easing of credit standards. Instead, banks were advised to consider alternative investment opportunities, in particular a return to corporate lending (Laker 2004: 9). This more cautious approach may have prevented a further increase in investment – at lower lending standards – in the housing sector, ultimately contributing to gentle deflation of the Australian housing bubble and avoiding the destruction of a burst.

With hindsight, the American sub-prime bubble appears to be the inevitable result of the combination of mortgage lending practices and housing policy. The securitization of sub prime mortgages encourages risk-taking in lending; the predominance of non-recourse loans encourages risk-taking in borrowing; and housing policy designed to promote sub-prime lending in a system where there is little regulation or supervision of the market for derivative products both legislates and legitimates risk-taking on the part of all involved. The failure of policy-makers to address the obvious problem of risk that is inherent in the American house financing system however suggests that political influences and vested interests may be at play. We thus turn attention to the issue of regulation and within it, to the relationship between the *regulator* and the *regulated* in the countries in our study.

5.4 Regulation: conform or configure?

Getting around regulation, getting it changed, or simply fending it off, became something of an art form for international investment banks in New York and London, as indeed it had for the British 'fringe' banks during the Secondary Banking Crisis of the 1970s and for the American S&Ls during the 1980s.

Following the 1929 stock market crash, the Glass-Steagall Act of 1933 had separated private deposits from investment banking, resolving the conflict of interest between those wanting a safe place for their money and those prepared to speculate. Since the 1980s, however, the American banking sector had been lobbying for the Act's repeal; and a report assessing its advantages and disadvantages was prepared by the Congressional Research Service in 1987. The previous year, however, had seen the 'big bang' de-regulation in the City of London and US institutions were not slow to realise the potential to circumvent Glass-Steagall by means of such things as overseas subsidiaries beyond its jurisdiction. This encouraged the growth of multi-national financial conglomerates, with widely dispersed shareholder ownership and a keen focus on profits and share price by both investors and management. It also made risk management more difficult, an effect magnified by the individualisation of computer technology. Thus, the final repeal of Glass-Steagall in 1999 under President Clinton's administration seemed a relatively insignificant event. In reality though, it helped to inflate the sub-prime bubble by speeding up the process of securitising increasingly risky mortgages, as well as allowing mergers such as that of Citi Bank and Traveler's Group, continuing the growth of the financial behemoths.

Canadian and Australian banks however, did not join the international party. Far from internationalising, they were less dependent on the money markets than their American and British counterparts. In the case of Canada, Canadian banks are funded mainly through deposits, thereby reducing exposure to capital markets (Booth 2008: 43), and consequently, any changes in interest rates or availability of funds. As evident in Table 2, in December 2008, domestic and foreign deposits accounted for 77 percent of total funding in the Canadian Banking Sector. This contrasts sharply with America, where deposits account for only 56 percent of total funding.[19] In this case, low savings rates resulting from increased consumer leverage, necessitated funding through the financial markets. In Australia and the UK, the use of foreign and domestic deposits as a source of funding is somewhere between the US and Canada, accounting for 60 and 61 percent, respectively. This was one of the reasons for dis-intermediation and the creation of special investment vehicles (SIVs), especially by US banks (Booth 2008: 43). The SIV offered one means by which regulatory capital requirements could be reduced, and the money invested for profit instead.

Table 2: Share of Domestic and Foreign Deposits in Total Funding* December 2008

	Percent
Canada	77
Australia	61
United Kingdom	60
United States	56

* Deposits include CDs. Total funding includes total liabilities, excluding derivative liabilities.

Source: Battellino (2009) based on data from the Royal Bank of Australia and banks' financial statements.

In response to the increasing ease with which financial institutions could practice regulatory arbitrage, the US, UK, Canada and Australia were all signatories to the Basel II Accord. Basel II represented an attempt to extend consistent, international regulatory criteria to banks, especially those that had outgrown national jurisdictions. Among its recommendations was specification of the amount of capital to be held against assets on banks' balance sheets which included a risk weighting criteria on differing asset classes.

Although the US and UK were signatories to Basel II, the large internationalised banks in New York and London looked for ways around it. The carnage of the

S&L crisis had not lived long in America's corporate memory; excessive leverage, poor lending decisions, flawed risk models and off-balance sheet accounting gymnastics would all be back. L.Wiliam Seidman, Chairman of the FDIC at the time of the S&L Crisis, in an address to Nikkin in Tokyo, had noted the potentially devastating effect of derivatives and off-balance sheet transactions a decade earlier, in September 1996.

> 'Technology can create soundness or hinder it. Many have identified the globalization created by new technology as a threat to the world financial system. Its speed does create the potential for panic. Another danger is that technology also gives institutions the ability to create infinitely complex financial instruments. These new contracts are a two edged sword, giving the banks and regulators the ability to hedge risk and also misjudge it. The Challenge is to use technology to develop systems that will aid safety and soundness knowing all the while that it also has the potential to destroy.' (Seidman 1997)

The Basel II Accord was also circumvented in other ways. Firstly, it applied to banks only; and as SIVs that were trading securitized products were not technically banks, their relationship to regulation was unclear. Secondly, because risk models could apparently demonstrate a very high level of safety for super-senior debt, only 20 percent of the full regulatory capital against these assets was required. In America, regulation of the derivatives market had also been avoided through successful lobbying on the part of the banks (Tett, 2009). Instead of operating in the open via an exchange, transactions were private, 'over the counter' deals; and there was a clear conflict of interest resulting from the issuer (rather than the investor) paying the fees associated with the rating of derivative products.

In quite the opposite approach, Australian and Canadian banks chose to match, or preferably exceed, the capital reserve requirement recommendations of Basel II. Both countries voluntarily opted for a higher ratio of capital against assets, which although not adding to returns or growth, contributed positively to financial stability.

The relationship between the regulator and the regulated in the main Anglo-Saxon countries, which is itself a product of the process of financial market liberalisation, thus played a central role in the differing experiences of their banking systems. In the US and the UK, the progressive manipulation of both bank regulation and lending criteria was a consequence of the political and economic influence of the large and highly mobile financial institutions in these countries, in a system where the regulation was fragmented and the regulator was responsible for regulating a marketplace while at the same time making it attractive to global capital. This stands in sharp contrast to the Australian and

Canadian financial systems, where the ability of the single regulator to exercise regulatory and supervisory power over the banks – and its willingness to do so – ultimately contributed to their resilience.

6. Conclusions and Implications for Policy and Regulatory Reform

In the wake of the global financial crisis, doubts have been raised about the conventional wisdom of economic liberalism as policy-makers search for an appropriate response. In this context, the divergent experiences of the British and American banking systems, on the one hand, and the Canadian and Australian, on the other, suggest that it may not so much be economic liberalism that is in question as it is the form that liberalism assumed in the four main Anglo-Saxon economies, the way this shaped their response to previous crises and the nature of the regulatory system that evolved during successive stages of liberalisation. Closer examination of the process of economic liberalisation reveals that the structuring role of economic and corporate governance theory and policy is strongly tempered by context.

The logic of economic liberalism is based on confidence in the benefits associated with competitive markets. In its classical form, markets are viewed as equilibrating mechanisms. They are theorized to be self-regulating and if unimpeded, to deliver optimal economic welfare (individual and collective) and distributional justice and to neutralize differences in relative power. In this model, the role of government is to assure market freedom. If, however, private interests and relative power are taken into account, there is a potential role for the state in setting and enforcing the 'rules of the game' so as to allow markets to operate effectively. Our analysis suggests that the classical conceptualization of economic liberalism describes the form it takes in the American and British systems while the Canadian and Australian variety of economic liberalism allows a role for the state in preventing exploitation of the power associated with economic concentration. This latter interpretation is closer to the ordoliberal understanding of the state's role in the economy.

Much has been said concerning regulation in the wake of the most recent crisis. However, the relationship between the regulator and those it regulates has received much less coverage than the nature of the rules themselves. Thus, whilst our findings underscore the merits of a prudent regulatory framework, demanding high levels of own-capital as well as other requirements of a sound financial system (ranging from lending criteria and risk management to corporate structure, ownership and strategy), the fundamental regulatory issue is that of the relationship between regulator and the regulated.

Our analysis reveals significant financial market liberalization in the four main Anglo-Saxon economies; it also highlights clear divisions in the overall philosophy behind the process, which profoundly influenced the way in which financial institutions interact with regulators. The divide in the relationship between banks and regulators appears to be largely based on the nature of the financial institutions themselves and the environment within which they operate. The British and American regulators find themselves with a conflict of interest in that they need to both assure stability and probity but at the same time provide an attractive haven for international capital. Being a successful global financial centre necessarily means more, and more complex, banks to regulate; and this stretches resources. Australian and Canadian regulators, on the other hand, have a more clearly defined, domestic, and transparent banking sector to deal with; and unlike their more global counterparts, they have the simplicity of a single regulatory body.

It is possible to attribute the difference between the Australian and Canadian experiences on the one hand, and those of the US and Britain on the other, as being a result of the State regulator or the financial sector, respectively, holding the whip hand. For example, the comments by the Australian regulator ‘Banks are bastards…’ and by their Canadian equivalent, ‘We are the regulator; our job is to tell you what to do…,’ might be interpreted as suggesting a rather macho approach on the part of the regulator, resulting perhaps in missed economic opportunities. At the same time, the ability of the American and British financial sectors to find or create loopholes, and to strongly influence the regulatory structure, suggests that the balance of power may have shifted too far towards the other extreme. Nevertheless, both situations could be characterised as essentially adversarial in nature, which does not easily allow for the degree of cooperation necessary for the achievement of considered, sustainable growth.

It would also be tempting to draw the conclusion that the Australian and Canadian regulators got it completely right during the lead up to the financial crisis, whilst the British and especially the Americans got it spectacularly wrong. However, this is demonstrably true only of the period around the sub prime bubble and not of the period of economic liberalization as a whole. The sub-prime bubble marked the end of a long period of sustained economic growth in the US; and had the housing market been simply allowed to cool off, as it was in Australia, the outcome – and the verdict with respect to economic liberalism – might well have been very different. As it is, whilst the economic liberalization that fuelled this growth was clearly helpful, the liberalization that allowed the sub prime bubble to inflate, and subsequently burst, most definitely was not. The question thus becomes: ‘How do you decide what constitutes effective regulation at a particular point in time and what does not?’ Further, since circumstances change, what was once appropriate may become genuinely disruptive – and *vice versa.* The question of how best to develop and implement effective regulatory reform thus arises, arguing strongly in favour of a more even, but also, crucially, a more dynamic relationship between the regulator and the regulated, of the type suggested by Rustow and the Freiburg School economists.

In this context, dynamism can be understood as a combination of transparency, openness and discussion, taking place in real time or preferably ahead of time, to avoid regulators in particular having to play catch-up, with too little information.[20] This would allow developments to be considered by both parties as they occur and an appropriate response – and if necessary, a set of rules – to be developed and implemented. This is not to suggest that regulators and the regulated do not already communicate; of course they do. However, transparency of purpose, intent and information is often a different story. Lacking this, a strong regulator might well be tempted to say 'No' to almost everything. On the other hand, with trust and transparency, the potential gains are significant, both in terms of economic growth and perhaps also the avoidance of future crises.

It is doubtful that a regulatory framework could ever be entirely independent of political influence, as it is shaped by legislation giving it not only authority but also many of its rules. However, whilst it might be assumed that the regulator (and by extension, the state) and the financial sector would have opposing viewpoints, it is not necessary that the relationship be adversarial. The State regulators assumed objective – that of stability and probity – can be overridden by short-term political *force majeure.* This is evident in the Heath government's 'Dash for Growth' in the 1970's or the Thatcher government's Building Societies Act of 1986, both of which were aimed at economic growth to satisfy their electorates. On the other hand, the current crisis clearly demonstrates that the longer-term interests of financial institutions – in growth, share price and profits – can also be vulnerable to the whims of short-term expediency. Making explicit this variability in purpose might serve to support the process of building a more cooperative and functional relationship between the regulator and the regulated.

Marc Duquette's observation, quoted earlier – 'We learned to adopt a culture of prudence, and that is something shared by the institutions themselves … Here, the culture is to comply and be transparent with the regulator' (Millan 2009) – suggests that such a cooperative approach might be not only be possible but may actually be in the process of developing in Canada. However, this does not necessarily mean that the same solution would work in the same way in another national context. There are other factors, too, that may result in the balance of power in the regulatory relationship shifting one way or the other. The current focus of regulation, for example, is almost entirely the result of recent and on-going upheaval. But this will not last indefinitely. Real-politik suggests that politicians are more likely to respond to short-term concerns instead of playing a long term hand, highlighting the potential benefits associated with a strong, independent regulator that is not subject to short-term political pressures.

The adoption of an approach friendly to global capital in New York or London would in all likelihood prove hardest to change. However, the shape of regulation and the all important relationship between the regulator and the regulated might still be altered in apparently small, but nonetheless significant ways. The 'comply or explain' approach, for example, can easily work in favour of the regulated, especially as it has a tendency to be retrospective, focusing attention on events that have already occurred. Changing this to a forward looking view, more along the lines of 'comply or propose,' might facilitate a more informed discussion in advance of events instead of presenting the regulator with a fait accompli.

There is, however, no such thing as a 'perfect' regulatory system and belief in such a thing would be very likely to produce a rigid system based on the philosophy of its time, unable to evolve and develop to accommodate future challenges. Whilst financial crises do have similar contributing factors, they also have unique characteristics of their own. As a result, although some systems have proven more vulnerable than others during the current crisis, this might well *not* be the case in a future crisis. It is therefore essential to legislate, not for the last crisis, but for future ones. Nevertheless, it does seem clear that a more dynamic balance between the state and the market has a better chance of curbing the worst excesses of either.

In the final analysis, it is time to engage in a debate about the true nature of liberalism. Only then will we be able to understand the type of liberalism that has failed and to identify ways out of the current crisis of contemporary capitalism.

Notes

[2]According to Hall and Soskice (2001), LMEs rely on market mechanisms to solve the problem of coordination, both among firms and between firms and their various stakeholder groups, including employees, customers, suppliers and capital providers. LMEs have open and competitive markets that are protected by strict anti-trust and competition legislation. Levels of regulation, taxation and government intervention in the macro-economy are low. Labour markets are flexible; and in comparison with the coordinated market economies (CMEs), employment protection and welfare spending are relatively low.

[3] The combination of house price bubbles and increasing levels of private and public debt are particularly important factors increasing the probability of crises (Bordo & Jeanne 2002, Disyatat 2005)

[4] Table 1 reports the change in cumulated market value of each country's largest banks, i.e. those among the world's fifty largest banks.

[5] It should be noted, however, that the Harper government in Canada decided in the autumn of 2008 to make available a bailout/stimulus package of C$ 75bn, corresponding with 4.3 percent of GDP. Yet, this package can by no means be compared to the US or UK rescue packages. The Canadian 'bailout plan' consisted of the government's commitment to buy 'good' – as opposed to 'toxic' – assets from the banks so as to inject liquidity into the banking system and, ultimately, the real economy. These funds were thus made available to prevent a slowdown in economic growth rather than to support failing banks. Nevertheless, a proportion of these funds was used to acquire parts of foreign banks that were in trouble and to make strategic acquisitions in attractive markets such as Brazil (Chossudovsky 2009; Heinrich 2009).

[6] One important qualification of this general trend concerns the fact that both Australia and Canada have a much larger part of their GDP stemming from extractive industries and mining. This arguably made them less dependent on the finance-driven growth model that was so prominent in the US and the UK.

[7] Research on the role of ideas in economic change in the field of political science largely supports this view: External shocks and economic crises challenge and destabilise the existing orthodoxy which did not manage to prevent or was even the very cause of the crisis. As the dominant view is weakened, 'policy entrepreneurs' use existing ideas or reactivate old ones in order to propose alternatives to the failed existing orthodoxy (Blyth 2002, Hall 1993).

[8] For a further discussion, see Konzelmann et. al., 2010.

[9] Pressures contributing to unemployment during this period were in part a result of the (not yet evident) hollowing-out of the British manufacturing sector through leveraged buyouts which continued into the 1970s. This is discussed below in Section 3.3. See also Konzelmann et al 2010.

[10] For further discussion of the historical development of 'ordo-liberalism,' see Hartwich (2009) and Boas and Gans-Morse (2009), who trace the origin of the term – originally used synonymously with 'neo-liberalism' – to inter-war Germany and the intellectual writing of the Freiburg School. In this context, 'neo-liberalism' means quite the opposite of its contemporary usage. Hence, in the discussion here, we use the term 'ordo-liberalism' to avoid confusion with the more classical economic liberalism associated with contemporary 'neo-liberalism.'

[11] Stagflation is the co-incidence of economic stagnation and price inflation.

[12] Rational expectations theory posits that outcomes do not differ systematically from what people rationally expect.

[13] The efficient markets theory of financial securities prices, which is rooted in rational expectations theory, asserts that the price of an asset reflects all relevant available information about its value.

[14] Malcolm Maiden is business editor for The Age.

[15] The RTC was established and assigned responsibility for winding-up the failed S&Ls.

[16] At the end of 1993, $8 billion of the company's assets were in Canada, $9.4 billion in the US and $2 billion in Britain.

[17] Prior to the first CDO created for Imperial Savings & Loans, MBSs had a successful track record. Corporate debt also has a history of securitisation, but is much easier for investors to assess than mortgage debt. Aside from broad indications of the source of the mortgages in the securitized product, the system's stability is reliant on solid lending criteria for a low rate of default. America however, evolved the least stringent lending criteria of the four countries in our study – and carried out the vast majority of securitisations of the resulting loans.

[18] In the US, a strike at Ford's Detroit plant in 1938 resulted in the strikers being summarily fired. This triggered the events leading up to the 'Ford Massacre' and the deaths of four workers. The ensuing public outrage resonated with then current events in China and Germany and with the revolution in Russia fifteen years earlier. As a result, one of the aims of the Roosevelt Administration's New Deal was to foster co-operation among workers, industry and government and in so doing to avoid the likelihood of more radical social change (Ferguson 2002).

[19] One explanation for this pattern is the existence of caps on deposit rates in the US. Since banks could only promise a limited return on bank accounts, savings were channelled away from them, leading to lower levels of deposits, further increasing incentives for banks to rely on money markets (Booth 2008: 43).

[20] It is generally the regulator on the wrong side of the information divide, as by their very nature, rules have to be made clear – whilst bending them is inevitably a rather more covert operation.

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