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**ANGLO-SAXON CAPITALISM IN CRISIS?
MODELS OF LIBERAL CAPITALISM AND THE PRECONDITIONS
FOR FINANCIAL STABILITY**

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by

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Abstract:

The return to economic liberalism in the Anglo-Saxon world was motivated by the apparent failure of Keynesian economic management to control the stagflation of the 1970s and early 1980s. In this context, the theories of economic liberalism, championed by Friederich von Hayek, Milton Friedman and the Chicago School economists, provided an alternative. However, the divergent experience of the US, UK, Canada and Australia reveals two distinct 'varieties' of economic liberalism: the 'neo-classical' incarnation, which describes American and British liberal capitalism, and the more 'balanced' economic liberalism that evolved in Canada and Australia. In large part, these were a product of the way that liberal economic theory was understood and translated into policy, which in turn shaped the evolving relationship between the state and the private sector and the relative position of the financial sector within the broader economic system. Together, these determined the nature and extent of financial market regulation and the system's relative stability during the 2008 crisis.

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E44, G38, N10, N20, P16, P17, P52

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Corporate governance, Regulation, Financial market instability, liberal capitalism, Varieties of capitalism

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1. Introduction

The comparative capitalism literature sees national business systems as ‘configurations of institutions’, where different socio-economic institutions are interconnected in coherent, non-random ways (Jackson & Deeg 2008). From a comparative perspective it is argued that different countries cluster into a limited number of ‘models’ (Albert 1993, Whitley 2000, Hall & Soskice 2001, Amable 2003). Whilst different classifications exist, virtually all of them group the six Anglo-Saxon countries into the same category of market-based, shareholder-oriented or ‘liberal market economies’ (LMEs).

The similarities in the institutional configuration of the Anglo-Saxon economies would lead us to predict similar conditions for doing business and comparable economic trajectories. However the 2008 financial crisis has demonstrated that the broad categorizations of models of capitalism may conceal important differences among these LMEs. Indeed, the Anglo-Saxon variety of capitalism groups some of the worst hit countries with countries whose financial systems were remarkably stable during the crisis. As evident in the *Financial Times*’ ranking of the 50 largest banks by market capitalization (*Financial Times*, March 2009), between 1999 and 2009, American and British banks had lost considerable ground whilst those of the two other main Anglo-Saxon countries, Canada and Australia, clearly gained. This casts doubt on the conclusion that the 2008 crisis represents a crisis of Anglo-Saxon capitalism as such.

This paper examines the question of why the four main Anglo-Saxon countries experienced the 2008 financial crisis in such divergent ways, despite their similar cultural attributes (Redding 2005), legal origins (La Porta et al. 1997) and institutional configuration (Hall & Soskice 2001). Of particular interest are the reasons behind the rise to dominance of the British and American financial sectors – and the resulting shift in the balance of the economy in their favour. This is in sharp contrast to the Canadian and Australian systems, where greater restraint prevented a similar outcome.

We explore how political, ideational and historical factors led to different approaches to the regulation of the financial industry, focusing on the influences shaping the process of economic liberalization in each country and their effect on the evolution of corporate governance. Our analysis reveals a clear division in the interpretation of liberal economic theory and the way it was applied. This gave rise to more than just the ‘fundamentalist’ neoclassical incarnation, characteristic of both British and American capitalism: by contrast, the Canadian and Australian systems evolved in a more balanced

way, producing an apparently more stable result. From this, it is hard to escape the conclusion that there is in fact no such a thing as ‘Anglo-Saxon Capitalism,’ and consequently, no general failure of liberal capitalism per se. Instead, the 2008 crisis suggests the failing of a particular variety of economic liberalism, where the balance between the state and the private sector had become unsustainable.

We begin by examining the similarities among the four main Anglo-Saxon economies, and why, at first glance, they might have been expected to respond to a general crisis in comparable ways. We then consider the influences that caused the interpretation of liberal economic theory and its translation into policy to diverge – ultimately producing the two varieties discerned in our analysis. Finally we examine the role of regulation – de-regulation and re-regulation – in the 2008 crisis before turning to our conclusions.

1.1 One crisis, two outcomes

The US, UK, Canada and Australia, along with Ireland and New Zealand, constitute the ‘Anglosphere’ and are all within the LME variety of capitalism (Hall & Soskice 2001).¹ The four share a variety of features, stemming from their common historical 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 one of Anglo-Saxon capitalism, there are compelling differences in the relative resilience of the four countries’ financial systems during the crisis. As evident in Table 1, compared with a decade earlier, the largest Canadian and Australian banks gained ground in terms of market capitalization whilst American and British banks lost heavily.² The contrast is even starker when the magnitude of bank bailouts is considered. By March 2009, American rescue packages amounted to 6.8 per cent of GDP and the UK’s a staggering 19.8 per cent (Stewart 2009). By contrast, Australia used only 0.1 per cent of GDP to help struggling banks and Canada, nothing at all.³

Table 1: Change in bank market capitalization

	Change 1999-2009 (\$bn)
Australia	+85.6
Canada	+97.5
UK	-211.4
USA	-633.0

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

From a comparative capitalism point of view, these differences are surprising. If the global financial crisis was a crisis of neo-liberal, market-based capitalism, then Australia and Canada should have been equally vulnerable. Moreover, the macro-economic imbalances, to which the recent crisis has been widely attributed (FSA 2009), were present in all four countries, to varying degrees.⁴ Capital account liberalization combined with imbalances in household savings rates between Asia and the West, contributing to the availability – and uptake – of cheap and plentiful debt. In the largely post-industrial Anglo-Saxon economies, this money found its way into the consumer sector, inflating a property bubble and significantly increasing the ratio of mortgage debt to GDP.⁵ Consumer leverage also rose; and mortgages were made at ever-higher initial loan-to-value ratios, as borrowers and lenders assumed that debt burdens would ultimately fall as a result of continued house price appreciation. Asset bubbles are significantly associated with financial crises (Reinhart & Rogoff 2009), particularly when inflated prices are used as collateral to raise further debt.

Economic liberalization and deregulation since the early 1970s have also been identified as contributing factors in the crisis (FSA, 2009; Reinhart & Rogoff, 2009). But recent studies suggest that the four countries' trajectories were comparable and that they have all become considerably more 'liberal,'⁶ especially since the early 1980s. They were the four most liberalized of the OECD countries in 1980, a position they maintained in 2000, although the UK had overtaken Australia as the second most liberal after the US (Höpner, Petring, Seikel & Werner 2009). The effect of economic liberalization was particularly apparent in the four countries' financial sectors, which rapidly replaced manufacturing as the driver of employment and growth (Boyer 2000, Peters 2011). In 1970, the value added by banks, real estate and other business services accounted for 14.6 per cent of total value added in Australia, 17 per cent in Canada, 15.9 per cent in the UK and 17.5 per cent in the US. By the

early 2000s, it had risen to 29.1 per cent in Australia, 25.6 per cent in Canada, 30.1 per cent in the UK and 32.1 per cent in the US, whilst services as a proportion employment represented 74.9 per cent in Australia, 74.7 per cent in Canada, 73.6 per cent in the UK and 77.5 per cent in the US (OECD, 2009).

However, whilst Reinhart and Rogoff (2009) identify financial market liberalization as an important determinant of financial crises, the resilience of the Canadian and Australian banking systems suggests that this is not always the case, and that liberalization can be achieved without necessarily creating major instabilities.

2. Changing the Conventional Wisdom

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, 17). This creates the environment in which different ideas find favour and reconstitute the conventional wisdom. Friedman (1962) articulated the process by which new 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 crisis had struck, Friedman believed that it was crucial to act swiftly, before the moment was overtaken by the ‘tyranny of the status quo.’ (Friedman & Friedman 1984, 3)⁷

One example of this was the replacement of ‘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 also constituted 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, in which combating inflation depends on controlling the money supply whilst efficiency in the use of resources is most effectively secured by markets. Similar developments can be observed in the evolution of 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 now potentially in the midst of another ‘Galbraithian Episode;’ giving rise to doubts about the conventional wisdom of economic liberalism, and debate about the future direction of theory and policy. However, the apparently sustainable economic liberalism evolved in Canada and Australia suggests that some incarnations of liberal theory may in fact be able to contend with that ‘massive onslaught’ after all.

In the following sections, we examine the underlying theories behind economic liberalism, the reasons for its ascendancy during the decades leading up to the 2008 financial crisis, and most crucially the varying processes of economic liberalization in the US, UK, Canada and Australia. We focus on the way that economic liberalism was understood and translated into policy; and we argue that this would define the relationship between the private sector and the state, the nature and extent of regulation, the relative position of the financial sector in the broader economy and ultimately, the relative resilience of the system as a whole.

2.1 Keynesianism displaced by the promises of economic liberalism

Contemporary economic liberalism, particularly in Britain and America, was strongly influenced by the work of Friedrich von Hayek, Milton Friedman and the Chicago School economists. John Ranelagh tells an anecdote of a Tory party meeting during the 1970s when Margaret Thatcher took a copy of Hayek’s *Constitution of Liberty* from her purse. She brandished it at a speaker who had argued for a pragmatic middle way between right and left, declaring ‘*This is what we believe!*’ (quoted in Gamble 1996).

Milton Friedman, too, was an influential figure in the emergence of the British and American ‘new right.’ As prices and unemployment rose together despite counter-inflationary measures, he revived pre-Keynesian monetary theory and 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 (NAIRU). From this perspective, there is 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 theorized to either increase inflation or squeeze-out employment elsewhere in the economy (Friedman 1977).⁹

During the 1970s, as inflation appeared out of control, these alternative theories displaced Keynesianism as the conventional wisdom in economics and were progressively incorporated into government policy. But deep recessions during the early 1980s and 1990s undermined confidence in Monetarism, which was ultimately replaced by ‘rational expectations’ theory.¹⁰ Meanwhile, the task of dealing with employment and competitiveness was delegated to market reforms. Markets and business were de-regulated; large sections of the public sector were privatised; and taxes on the rich were cut to encourage enterprise. Trade unions were weakened; legal control of labour standards was relaxed; out-of-work benefits were reduced and made 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 remaining 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.

2.2 Economic liberalism in theory

The underlying assumption of the neo-classical model of economic liberalism 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. Judgements are delivered as

market prices, which 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. Neo-classical economic liberals therefore 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 by extension economically damaging. From this logic follows a radical anti-government rhetoric, best expressed in Ronald 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 economic liberalism also has a perspective on *how* the state should intervene in the economy when required. One of the central aims is that the state should regulate economic activity; but it should not intervene as an economic actor (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.

Whilst this describes the interpretation and implementation of economic liberalism in the US and UK, the process of economic liberalization in Canada and Australia does not appear to have stemmed from such a narrow doctrinal root. There is no policy agenda in either country that could be branded with the name of its champion in the same way that 'Reaganomics' or 'Thatcherism' have been. This is largely a result of the political and economic power of the provinces, states and territories relative to central government as well as the range of participants in the economic policy-making process. The result is a more even balance of power between the state and the private sector, which seems to have curbed the excesses of both and produced a more stable political and economic system. It is worth noting, however, that this more balanced outcome is a result of the inter-play of responses to events during the process of economic liberalization rather than of a deliberate approach to liberal economic policy.

2.3 Economic liberalization in the US and the UK

The return to economic liberalism was strongly influenced by the political and economic climate of the 1970s and early 1980s. Whilst 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, 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.

During the 1960s, especially in America, the emphasis in economic policy had shifted – from maintaining full employment and a high level of aggregate demand to a ‘new economics’ focused on economic growth (Perry & Tobin 2000). In 1961, confronted with recession, the newly elected Kennedy-Johnson administration’s expansionary policy response reflected the view that rising unemployment was caused by cyclical as opposed to structural factors. The resulting strong growth seemed to justify this perspective and boosted confidence in the direction of economic policy at the time. Real interest rates remained low and investment strong, largely due to confidence about future profits. Yet Johnson’s chief economic strategist, Gardner Ackley, was quoted in a 1965 article in *Time Magazine* as saying ‘We’re learning to live with prosperity and frankly, we don’t know as much about managing prosperity as getting there.’

As it turned out, he was right. The prosperity of the 1960s masked growing imbalances (Marglin and Schor 2007). With production scraping up against the economy’s capacity limits, productivity growth began to slow and by 1965, the economy was beginning to show signs of strain. Labor costs rose faster than productivity; consumer and wholesale price inflation accelerated sharply and the federal budget was increasingly strained by the war in Viet Nam (Clark 1979). As the newly re-built Japanese and European production systems began to come on-line, manufacturing imports surged and the US balance of trade deteriorated. In 1971, in response to its first trade deficit since before World War One, and under pressure to devalue the currency, President Nixon took Milton Friedman’s advice and announced that the US would no longer provide gold backing for the American dollar (Helleiner 1994, 115-21).¹¹ This effectively lifted the capital controls that had been introduced in 1944 under the Bretton Woods Agreement. Although Japanese and Western European governments lobbied for voluntary capital controls in an effort to maintain a degree of policy autonomy, the US refused, urging other countries to follow its lead (Helleiner 1994). With the collapse of Bretton Woods, international capital movement restrictions and fixed currency relationships were eliminated.

It is important to note that during the Nixon and Ford administrations, advocates of neo-liberal economic thought held influential positions on the Council of Economic Advisors and in the Treasury (Helleiner 1994, 115). After Nixon’s resignation, there was a brief return to the use of Keynesian tools by the Democratic Carter administration, in an effort to mitigate the effects of the first oil shock. But the Iranian revolution in 1979 set off another oil shock; and with inflation and unemployment rising sharply and American hostages being taken by Islamist militants in Tehran, in 1980 Ronald Reagan was elected President, by a landslide.

In the UK, the over-riding problem during the 1960s had been the plight of Sterling, causing the International Monetary Fund (IMF) to put pressure on the government to address the problem through monetary policy (Marglin & Schor 2007, 139). In 1971, the Heath government introduced a policy of 'Competition and Credit Control,' in an effort to liberalize the money markets and stimulate competition among banks. Quantitative limits on bank lending were removed, liquidity requirements reduced, and interest rates were allowed to play a more central role in credit allocation. In response to rising unemployment, the Heath government also made a 'dash for growth.'¹² Fiscal and monetary expansion and macroeconomic growth were accelerated by increased bank lending. However, against a backdrop of international inflationary conditions during the 1970s, speculation inflated a property bubble resulting in the Secondary Banking Crisis of 1973-5. The Bank of England quickly provided emergency liquidity, averting a wider collapse. But these policies did not have the desired longer-term effect.

The elections in 1974 eventually resulted in the Labour Party's James Callaghan becoming Prime Minister. Confronted with a Sterling crisis and fiscal deficit, he was persuaded by the promises of Monetarism; and in a speech at the 1976 Labour Party Conference, he 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' (Smith 2006). But Callaghan would not get the chance put this policy into practice. In 1979, Britain returned to a Conservative government, led by Margaret Thatcher.

In Britain and America, the 1980s ushered in a strengthening commitment to the neo-liberal political and economic agenda. What came to be known as 'Reaganomics' and 'Thatcherism' are associated with laissez-faire, supply side economics, shifting the policy focus from aggregate demand to the economy's productive capacity. 'Business friendly' policies included tax cuts, weakening of trade unions and reduction of the government's role in the economy, whilst monetary policy – manipulating the money supply – was used to combat inflation. In the UK, public industries were privatized and people were encouraged to buy property (Skidelsky 1990, Johnson 1991). In the US, the economy was de-regulated and the defence industry modernized (Boskin 1989). Throughout the 1980s, despite strong pressure from organized labour and their Democratic and Labour party allies to protect domestic industry and employment, both Reagan and Thatcher believed that protectionism would only create inefficiency and competitive weakness; unions were seen to have caused wage inflation and industrial disruption. Both leaders thus remained

committed to allowing free market ideology to determine the winners and losers in industry and they challenged the legitimacy of organized labour. In the US, Reagan's success in shaping policy was aided by the fact that for the first time in twenty eight years, Republicans gained control of the Senate; and although the Democrats retained a narrow majority in the House, Republicans and Conservative Democrats accounted for an effective majority.

The apparent return to economic prosperity during the 1980s boosted confidence in neo-liberal economic theory and policy. However, by the end of the decade, both the US and UK had high levels of fiscal debt; and responsibility for social welfare had been largely individualized. A less obvious effect was that in both countries a significant shift in relative power had also taken place, with the private sector – finance in particular – increasing their influence, at the expense of the state. Both Reagan and Thatcher had begun their administrations with enough political clout to push through a narrow political and economic vision; but that vision would ultimately result in less clout for future governments.

2.4 Economic liberalization in Canada and Australia

The challenges of the 1970s also encouraged a return to economic liberalism in Canada and Australia. However, the process assumed a more balanced form than it did in the US and UK, due in large part to the existence and relative strength of countervailing political and economic forces that mitigated against the imposition of a narrow policy agenda by a dominant central government. There was to be no Thatcher or Reagan in either country and no central government with the power to do as it wished. The process was also overseen by mostly liberal or labour – rather than conservative – governments.

In Canada, confidence in Keynesianism remained strong during the 1970s, despite the turbulence of that era and a concerted effort by political and business coalitions to mobilize support for neo-liberal economic policies (Enoch 2007). Distrust of big business and the free market system was reinforced by the 1973 oil crisis, when Canadian oil companies seemed to profit at the expense of consumers; and in 1974, in an attempt to stabilize inflation, Trudeau was forced to introduce controversial wage and price controls. In his view, this 'amounted to a massive intervention in the decision-making power of economic groups, and it's telling Canadians that we haven't been able to make it work, the free market system' (Clarke 1997, 11).

Nevertheless, the difficulties of the 1970s and early 1980s put pressure on the fiscal budget and challenged faith in economic management. In 1984, after

twelve years of Trudeau's liberal government, the progressive conservative government of Brian Mulroney came to power. But the constitutionally-based economic powers of the Canadian provinces and the relative strength of organized labour meant that economic liberalism had to reflect the interests of a broad range of constituencies. According to Norrie and Owsam (1991, 620), taken as a package, Canada's liberal reforms 'constitute a consistent policy agenda, with the twin themes of increasing reliance on market signals to guide the allocation of resources and a desire to accommodate the diverse regional nature of the Canadian economy and society more formally in the formulation of economic and social policy.'

In Australia, economic liberalism was incorporated into policy by the labour governments of Bob Hawke (1983-1991) and Paul Keating (1991-1996), under the banner of 'economic rationalism.' Economic rationalists had a mainstream post-war view, blending Keynesian macroeconomic theory with neo-classical microeconomics, based on a simple model of perfect competition that allowed for market failure, market imperfection and externalities (Quiggin 1997). From this perspective, government intervention was justified in order to correct market failures and stabilize the level of employment and output (Patience and Head 1979).

Rather than being imposed by the government and economic rationalists, however, the process of economic liberalization in Australia was a negotiated one that sought a balance between the concerns of business, markets and the broader community (Argy 2001). Following its election, the Hawke government held a politically successful national economic summit, creating a tripartite system that extended the accord between government and organized labour to include business interests (Quiggin 1998). It also continued the social democratic policy of earlier liberal governments. The expansionary fiscal policy inherited from the Fraser government was maintained and extended; social welfare benefits were raised and a national health insurance system was introduced.

Thus, as in Canada, economic liberalization in Australia did not result in a dismantling of the welfare state; and it was not accompanied by de-regulation. Instead, it involved a range of relevant stakeholders and was accompanied by regulation designed to ensure that markets operated effectively and that the private sector profit motive did not impede the provision of public services or the public good (Argy 2001). According to Berg (2008), 'the most striking attribute of the last few decades is how Australian governments have matched privatisations and liberalizations with regulatory expansion, rather than retreat.'

Governments have shifted away from the direct provision of services, to the regulation of those services.’

3. Countervailing Power in the Anglo-Saxon World

The above narratives tracing the evolution of different interpretations of liberal capitalism demonstrate that the frameworks of national financial systems are determined in complex, on-going processes, where different events and actors influence the outcome. An important element, which seems to explain in part why the British and American financial systems were particularly vulnerable, is the lack of willingness on the part of governments and regulators to oppose the industry’s desire for ever more far-reaching liberalization. Both Australia and Canada had much more determined governments that reined in the industry’s options and created a more stable structure. This state capacity can in turn be related to certain features of the state in the two countries. Here, the presence and relative strength of countervailing powers in the policy-making process is important. The more ‘veto players’ or ‘veto points’ there are – i.e., those who can block or modify a given policy – the more difficult it becomes for any single actor to get what they want (Tsebelis 2000). Such players in the countries in our study include electoral, corporate governance and industrial relations systems, which served to shape relations within and between actors in the political system, industry and organized labour. It is to these that we now turn.

3.1 Electoral systems

The US, UK, Canada and Australia are all liberal / constitutional democracies in which the decision-making power of elected representatives is moderated by a constitution that emphasizes protection of individual liberties and minority rights within society. The US is a constitutional republic with a presidential system of government in which executive, legislative and judicial powers are separated in order that no individual or group has absolute power. Thus, whilst the president’s ability to implement policy is ultimately dependent on the support of Congress, the system is set up to limit the power of the executive, whose party may or may not control the Senate and the House of Representatives. During the first six years of the Reagan government, the Conservatives’ control over the House and Senate effectively lifted the electoral constraint on the President’s ability to implement radical changes in policy, with very significant knock-on effects. These early changes would effect a shift in power away from central government and towards the private sector, paving the way for an increasingly powerful lobbying base which would, in time, help put in place the preconditions for a major financial crisis

The UK, Canada and Australia are constitutional monarchies with a parliamentary system of government in which the British monarch is head of state and an elected prime minister is head of government. The executive and legislative branches of government are not separate, but the prime minister is dependent on the support of Parliament.¹³ As a result, a Prime Minister is on the face of it, less likely than an American President to face strong opposition to the policy agenda of central government. This was the case under Thatcher; and the apparent success of the neo-liberal policy agenda meant that New Labour did little to reverse the current of policy when it came to power in the late 1990s. In Canada and Australia, however, the political and economic strength of the provinces, states and territories and the more collective approach to the formulation of policy served as a moderating force within the system, highlighting the importance of the nature and structure of the relationship between central and regional government.

Whilst the UK is a unitary state, with a centralized national government, it has devolved some powers to Northern Ireland, Scotland and Wales; but the Prime Minister still has considerable influence over the direction of policy. By contrast, the US, Canada and Australia are federal states, with partially self-governing regions and states, united by a central government. In the US, the diffuse nature of political power and reliance on the support of Congress, with representation from each of the fifty states, serves to limit the President's influence over the direction of policy; and this acts as an impediment to major shifts in the direction of policy from one administration to the next. However, with fifty states, as opposed to the much smaller number of provinces and territories in Canada and Australia, strong opposition to central government policy is harder to crystallize. Yet as we saw during the 1980s, the nature and structure of the electoral system had a clear influence on the ability of the executive to push forward an economic and policy agenda. In both Britain and America, a single vision was implemented, by and large, as intended. Ronald Reagan had, perhaps unusually, the benefit of Republican and conservative Democratic control of Congress to help pass a raft of liberalising legislation during his first term in office. This helped to shift the balance of power, as the state gave ground to the private sector, which only made it easier to pass further legislation in the future. In the same way, opposition to the Thatcher programme was also weak and relatively ineffective. The British system tends to allow a prime minister with a large majority in the House of Commons and a relatively united party to implement their policy agenda with very little moderating influence.

In Canada and Australia, on the other hand, the political and economic strength of the provinces, states and territories not only limits the extent to which central government can unilaterally impose a policy agenda; it also means that policy is determined through a process of negotiation and compromise involving a range of stakeholder groups from various competing geographical constituencies and both sides of industry. This also contributes to a cultural divide with regard to perceptions about the balance between the state and the private sector. In Britain and America, where the state has withdrawn in favour of the private sector over the last thirty years, there is frequently a presumption of the primacy of the private sector. In both Canada and Australia, government has played a much stronger part and if anything, the presumption is in favour of the state. This difference was a significant contributor to moderating the process of liberalization.

3.2 Corporate governance and ‘the market for corporate control’

The effect of the presence or otherwise of countervailing power was especially clear in the evolution of corporate governance and the financial sector. From the 1960s onwards, finance assumed a progressively larger role in both the British and American economies.

In Britain, corporate raiders, such as Tiny Rowland, James Goldsmith and Jim Slater of Slater Walker showed what could be done with leveraged finance (BBC 1999). They then passed the baton to the Americans, like Michael Milken and Ivan Bosky, and to the mutual fund managers, who by and large continued the process in the US and UK. The motivation for the bankers, shareholders and investors was the realisation of large, short-term profits and the creation of funds with which to carry on the process, targeting ever larger businesses and selling off acquired assets to finance the debt (Bluestone and Harrison 1982, Reich 2008). The benefits for the businesses involved, however, were transitory at best, often amounting to little more than a brief spike in the share price. Many were left without the resources to sustain their productive activities; and the large numbers of job losses involved – both from announcements of layoffs (that served to excite the markets) and from the industrial restructuring that typically followed hostile acquisitions – did little to improve the relationship between unions and the governments of the day (Deakin and Singh 2008, Bluestone and Harrison 1982, Reich 2008). This was particularly the case in the US and UK, where many of the corporate raiders were political insiders. Nevertheless, the short-term increase in share price convinced some that the combination of leveraged finance and asset stripping was delivering results while others saw it as economic cannibalism.

Whilst the tactics of corporate raiding were exported wholesale from Britain to America, with similar effect, takeovers in Australia had only a brief heyday during the 1980s and in Canada they were never really a factor. The reasons for this are both cultural and structural, and are a significant part of the story of finance in the Anglo-Saxon economies.

Anglo-Saxon corporate governance is typically characterized by widely dispersed equity ownership among individuals and institutions, 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 also tends to be a feature of these economies. In LMEs, stock markets are well developed and play a central role. A similar argument, based on different 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. Nevertheless, the role played by the stock market in the US and UK differs sharply from that in Canada and Australia, particularly with respect to the re-structuring of industry and the economy during economic liberalization.

In the US and UK, the leveraged buyouts 1980s effectively dismantled the heavy industrial sectors in both countries. Unions were weakened and opportunities for longer term investment in manufacturing curtailed. During the 1990s, this process was carried on in America by institutional investors, reacting to the enormous loss of (long-term) shareholder value that had resulted from the poor performance, or in many cases failure, of the productive organizations previously targeted by the corporate raiders. Investor activism took a variety of forms in the US and UK, but it demonstrated the increasing power of the shareholder – and the will to use it.

Liberal economic theorists lauded the stock exchange as 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).¹⁴ The stock market boom was taken as evidence of overall industrial strength while the short-term increase in share prices resulting from cost cutting in companies that had been taken-over, served to reinforce these assumptions. However, the reality was that the ‘profits’ generated by hostile takeovers were derived from asset stripping (Lazonick & O’Sullivan 2000, Bluestone & Harrison 1982), and consequently a one off ‘blip,’ as opposed to enhanced sustainable output and productivity in the organizations involved.

The structure in much of corporate Canada and Australia however, for the most part mitigated against a similarly extended frenzy of leveraged buyouts. Both Canada and Australia have well developed stock markets and many listed companies with dispersed shareholder ownership. But this form of ownership 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 & 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 & 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 unsurprising then, 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, 6).

3.3. Labour relations

In most industrialized countries, organized labour and trade union movements were broadly accepted by the 1970s, and their relative power seemed secure, especially in countries with social democratic governments (Fairbrother & Griffin 2002b). During the 1980s and 1990s, however, there was a sharp reversal. The widespread acceptance of neo-liberalism undermined the pluralist political ideology upon which the justification of union involvement in economic, social and political activity was based; and the legitimacy of unions and existing labour market structures was seriously challenged.

Corporate governance played a part by allowing investor interests to trump those of industry and labour, particularly in the US and UK. Electoral systems in the four countries also played a role through their influence on relations between the state and organised labour, and, indeed, attitudes towards labour generally. Canada and Australia have a much stronger tradition of Liberal or

Labour governments, and with the exception of the period in power of the Progressive Conservatives in Canada, the process of liberalization was carried out by these centre-left parties. The result was thus a far less confrontational process, involving labour; and there were relatively few scenes of industrial strife in the media. The situation in America, and especially Britain, could hardly have been more different.

Already severely weakened by the industrial restructuring and deindustrialization triggered by the corporate raiders, trade unions in the US and UK resisted further concessions. Bitter and violent disputes between organized labour, big business and the state were widely publicized; and throughout the 1980s and 1990s, a series of laws and legal rulings further eroded union power, marginalizing them in political and economic policy (Fairbrother 2002a, Jarley 2002). As evident in Table 2, whereas trade union density in the UK peaked in 1980, at 52.8 percent, by 1995, it had declined to 32.2 percent. In the US, organized labour was much weaker, with trade union density falling steadily from 1960, to 14.2 percent in 1995.

Table 2: Trade Union Density (percent of employed wage and salary earners)

	1960	1970	1980	1990	1995
Canada	28.3	29.8	36.0	36.0	37.0
Australia	49.1	44.4	48.0	41.0	35.2
UK	44.3	48.6	52.8	40.1	32.2
US	28.9	25.9	22.0	16.0	14.2

Source: Visser (1993); ILO (1997) and OECD (1997)

In Australia, too, the ability of organized labour to effectively participate in political and economic policy debates was seriously eroded during the 1980s and 1990s (See Table 2), although not as a result of a concerted effort on the part of government. Despite the election of a labour government in the early 1980s and a return to centralized wage determination in which unions assumed a major role, from 1987 onwards, this accord was gradually eroded; and in the early 1990s, a system of enterprise bargaining was introduced and extended (Griffin & Fairbrother 2002, 246). According to Griffin and Svensen (2002), the centralized nature of Australian trade union governance was unable to effectively cope with the decentralization of collective bargaining, undermining the relative strength of the union movement.

In sharp contrast, the Canadian trade union movement retained much of its membership and density during the 1980s and 1990s. Table 2 shows density increasing steadily throughout the period of economic liberalism. This is in large part due to the central role that provincial-level political action and law play in union-state relations and the traditional strength of the relationship between the local and national levels within Canadian unions (Murray 2002). Thus, even in an environment of employer opposition and periodic hostility on the part of state governments and policy, Canadian trade union strength was not eroded during the 1980s and 1990s, providing a voice for labor in economic, social and political policy debates that continues to the present.

In short, whilst Canadian labour maintained its voice in the political and economic policy arena, the process of economic liberalization in the other three countries seriously undermined organized labour's relative position, skewing the balance between the two sides of industry and removing or weakening an important countervailing force within the system.

4. Financial Market Liberalization and Regulation in the Anglo-Saxon World

Although the more obvious beginnings of financial market liberalization can be located in the 1970s, when international capital flow restrictions were removed, its roots can be traced much earlier, to the 1950s and the emergence of Euromarkets, regulation-free markets where banks deal in currencies other than their own.

Following World War Two, the enormous increase in the quantity of US dollars held by foreign banks, companies and countries, including the Soviet Union, gave rise to the need for a market in which to exchange them; and during the cold war, this made London (rather than New York) an attractive centre for Eurodollar activities, which expanded rapidly during the 1960s, with the strong support of both the US and UK (Helleiner 1994, 81-100). This huge increase in available funds not only increased the importance of the city of London as a centre for international finance; it also gave rise to the first cross border hostile takeover (by Siegmund Warburg) and marked the beginning of the return to dominance of the American and British financial sectors (Fergusson 2010)

4.1 The UK and US: lightly regulated financial markets and institutions

Following the 1929 stock market crash, both sentiment and policy in the US and UK had taken a more cautious turn and the Treasury assumed greater

influence over monetary affairs. Since the financial community was held responsible for the chaos, reform focused on stricter control of domestic financial markets and monetary policy and on limiting the power of the central bank and financiers (Helleiner 1994, 32).

4.1.1 American Financial Markets: regulatory fragmentation

The American financial system has historically been a fragmented one. The Constitution gives the federal government control over the money supply but is silent about control of banks, so bank regulation was left to the states (Gordon 2004). After the Civil War, the 1863 National Bank Act offered federal charters to banks with sufficient capital that were willing to submit to strict regulation by the newly created Office of the Comptroller of the Currency. But they were prohibited from branching across state lines or from branching within states that did not allow it. Despite the establishment of national banks, state banks proliferated. In states that did not permit branching, they were small and vulnerable to the economic performance of the local community in which they were located. In 1913, the Federal Reserve System (Fed) was established to regulate state banks, secondary national banks and bank holding companies. But instead of one, twelve Reserve banks were created, located in major financial centres across the country.

During the Great Depression, one third of all American banks failed (Richardson 2007). In response, Congress made sweeping reforms: The Federal Reserve System was re-organized and the Federal Deposit Insurance Corporation (FDIC) was set up. The Glass-Steagall Act separated commercial and retail banking from investment banking. By preventing institutions that were ‘principally engaged’ in banking from underwriting or dealing in securities and vice versa, Glass Steagall resolved the conflict of interest between those wanting a safe place for their money and those prepared to speculate. This was reinforced by the 1956 Bank Holding Act that applied the same separation to bank holding companies. Glass Steagall’s Regulation Q prohibited the payment of interest on demand deposits and put a ceiling on interest rates on deposit accounts in order to encourage local banks to lend instead of holding balances with larger banks that used these funds for speculative purposes. (Gilbert 1986).

But there remained thousands of banks, along with thrifts, bank holding companies and credit unions, regulated by different authorities at both the state and federal levels. According to Pan (2011, 837) ‘the United States has the dubious distinction of having the world’s least coordinated regulatory structures in the world.’¹⁵ Nevertheless, the system was stable during the

prosperous postwar period, when the memory of the financial crisis and Great Depression was fresh. But it began to break down during the 1960s and 1970s as inflation accelerated and the economy confronted increasing structural challenges. As regulation was progressively loosened, it began to show serious failings – with drastic consequences.

4.1.2 The American savings & loans crisis: A warning goes unheeded

A clear example of the potential consequences of insufficient prudential oversight was the American Savings & Loans (S&L) crisis. During the 1970s, when inflation caused interest rates to rise above those set by Regulation Q, investors sought alternatives to traditional deposit accounts and funds flowed out of depository institutions in search of higher yields. This caused particular distress for the tightly regulated S&L industry, which specialized in taking short-term deposits and making long-term mortgage loans. Because of the risk of 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. But further inflation and competitive pressures pushed up the interest rates that S&Ls had to pay, causing large losses and some failures. No large-scale action was taken, however, as the Federal S&L Insurance Corporation (FSLIC) had insufficient funds to bail out insolvent S&Ls and the Federal Home Loan Bank Board (FHLBB) provided lax supervision (Sherman 2009).

The Garn–St.Germain Depository Institutions Act of 1982 allowed federal S&Ls to own projects funded by their loans. This resulted in a mass conversion of S&Ls from state to federal status and fuelled a commercial real estate boom. However, poor lending decisions and excessive leverage laid the foundations for 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, loans were bundled together and sold on the securities market, permitting Imperial to remove assets from its balance sheet and generate cash for additional loans, with leverage increasing as the process continued. The fatal weakness was dependency on continually rising, or at least, stable, property prices and cheap debt. A downturn, or an increase in interest rates, would burst the bubble.

During the early 1980s, rising interest rates cut off the cheap funding upon which many S&Ls relied; and with the disappearance of real estate tax shelters, funds dried up, causing the failure of 747 S&Ls in ‘the greatest collapse of US financial institutions since the Great Depression’ (Curry & Shibut 2000, 33).

As the total cost 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 \$210 billion. (Curry & Shibut 2000). In 1989, the newly elected Bush administration signed into law a bailout plan for the S&L industry. The Financial Institutions Recovery and Enforcement Act (FIRREA) abolished the FSLIC and transferred assets to the FDIC. The FHLBB was abolished and the Office of Thrift Supervision was created to regulate the S&Ls; and the Resolution Trust Corporation was created to dissolve and merge troubled institutions.

Whilst many contributors to the S&L crisis bear comparison to that of 2008, a crucial difference was its limitation to one sector of the American banking industry, whose survival was not considered critical to confidence in the national or global financial system. As a result, the S&L crisis did not shock America into reforming its system of financial regulation. Ultimately, the response was further de-regulation, in spite of the voices calling for reform. In a 1996 address, delivered in Tokyo, Japan, L. William Seidman, former Chairman of the FDIC and the Resolution Trust Corporation (RTC),¹⁶ 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, 55-56)

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

4.1.3 British financial markets: a tradition of regulatory informality

After the Second World War, HM Treasury assumed responsibility for monetary policy and regulating building societies, friendly societies and trustee savings banks; and the Department of Trade and Industry (DTI) had responsibility for securities and insurance regulation; and the Bank of England was nationalized and given responsibility for regulating banks.

The Bank of England's approach to financial supervision has historically been informal (Goodhart 2004), with regulation largely entrusted to the industry itself, through the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA). Until the 1970s, the system seemed to work well.

During the early 1970s, however, a number of fringe banks found themselves in trouble, triggering the 'Secondary Banking Crisis.' Precipitated by a property bubble, cheap debt and excessive leverage, the crisis was met with a financial 'lifeboat,' swiftly launched by the Bank to provide emergency liquidity. Following the crisis, the Treasury put banking regulation on a statutory footing. The 1979 Banking Act gave the Bank legal powers to underpin its supervisory authority; it also created a 2-tier system of 'recognized banks' and 'licensed institutions' and introduced a scheme to protect small depositors in the event of bank failure. But the Treasury retained on-going responsibility for the legal framework of banking supervision and the performance of its regulator.

The 1984 collapse of Johnson Matthey Bankers (JMB) revealed flaws in the 1979 Act and fault lines in the regulatory system itself. To prevent a loss of confidence in the City of London's gold bullion market, where JMB was a key player, the Bank acted once again. The Banking Act of 1987 significantly increased the Bank's supervisory capacity. But this time, the Conservative Chancellor, Nigel Lawson felt that the Bank had acted without keeping him informed. A public rift ensued; straining relations between the government and the Bank, with obvious implications for the effectiveness of the tripartite system. This political tension appears to have contributed to pressures that were already mounting for a change in the structure of regulation, in particular, regulation of securities, financial markets and insurance. In 1981, a review of the role and functioning of financial institutions and investor protection for securities and other property produced the 1986 Financial Services Act, the first UK legislation to comprehensively regulate the securities industry and markets. The Securities and Investments Board (SIB) was set up to oversee the various self-regulatory organisations (SROs); and City firms conducting business in the UK were required to seek membership in an SRO or direct supervision by the SIB. Since the SIB's members were appointed by the Treasury, the changes served to further erode the regulatory authority of the Bank.

Throughout the 1980s, the supervision of securities and insurance remained the responsibility of the DTI. But as the lines between financial institutions became blurred, the Treasury assumed responsibility for regulating financial services in 1993 and insurance in 1998. In 1998, the Bank of England was granted operational independence and assigned responsibility for the implementation of monetary policy. The 2000 Financial Services and Markets Act created the Financial Services Authority (FSA), as a single, unified regulator for financial services. The Treasury has no operational or financial control over the FSA, which was established as a private company, limited by

guarantee, to emphasise its independence. There was no formal legislation setting out the respective responsibilities of the three financial authorities; but a memorandum of understanding was established, fitting the tradition at the Bank of England, of flexibility in the banking system and avoiding the red tape and restrictions found in other systems. The Memorandum delineated the responsibility of the Treasury as being responsible for the legal framework; the Bank for the stability of the financial system as a whole and the FSA for the supervision of individual firms.

4.2 Stock market liberalization in the US and UK and 'light touch' regulation

During the late 1920s and early 1930s, both London and New York were considered the epicentres of the global financial crisis. As US Treasury Department Secretary, Henry Morgenthau, told the conference at Bretton Woods, the objective was 'to drive the usurious money-lenders from the temple of international finance ... [and] move the financial centre of the world from London and Wall Street to the US [and HM] Treasury' (quoted in Gardner 1980, 76).

However, as memories of the stock market crash and Great Depression faded, so did the atmosphere of caution; and increasing concern about restoring the attractiveness of London and New York to global capital gradually overwhelmed concerns about domestic financial market regulation. During the 1970s and 1980s, 'competitive deregulation' accelerated the process of liberalization (Helleiner 1994, 12). In 1974, the US removed the capital controls it had introduced during the 1960s. Britain followed by abolishing its forty year old capital controls in 1979; and others were forced to follow suit or lose business and capital to New York and London.

On 1 May, 1975, 'Mayday,' the New York Stock Exchange deregulated its commission structure, allowing competition, opening stock trading to market forces of supply and demand and driving down commissions. The result was reduced profitability of trades, and the incentive to make up the loss by increasing volume and economizing on market research, shifting the focus from 'research and analysis' to 'sales.' Britain followed in 1986, with 'Big Bang.' However, these developments also gave rise to a governance question of a similar nature to that addressed by the Glass Steagall Act in 1933: Are Chinese Walls between differing sets of interests in the same organisation a sufficient guarantee of probity?

4.2.1 USA: progressive loosening of regulation

In the US, bankers had been lobbying Congress as early as the 1960s to loosen the restrictions of Glass-Steagall. With money market mutual funds and other complex financial instruments that blurred the lines between deposits and securities, the banking industry complained that the Glass-Steagall restrictions were becoming obsolete. Regulators were sympathetic on some accounts. There was always a fear that financial de-regulation in other countries would entice firms to take their capital abroad; and many in government shared the free market ideology of de-regulation.

In 1986-7, the Fed loosened the Glass-Steagall restrictions and allowed banks to derive up to 5 percent of gross revenues from investment banking business and to handle among other things, commercial paper, municipal bonds and mortgage-backed securities. In 1987, Greenspan was appointed Chairman of the Federal Reserve Board; and early in his tenure, Glass Steagall was re-interpreted to allow banks to deal in certain debt and equity securities, up to 10 percent of gross revenues. In 1996, this was raised to 25 percent, which effectively rendered Glass-Steagall obsolete. In 1994, the Reagle-Neal Interstate Banking and Branching Efficiency Act eliminated restrictions on interstate banking and branching and in 1999 Gram-Leach-Bliley Act repealed all restrictions on the combination of banking, securities and insurance operations for financial institutions.

After the ‘big bang’ de-regulation in the City of London, US financial institutions had seen the potential to circumvent Glass-Steagall by means of overseas subsidiaries beyond its jurisdiction. This encouraged the growth of multi-national financial conglomerates, with 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.

4.2.2 The emergence of financial behemoths in London

By the mid 1980s, London had fallen behind New York as a 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 composed of small, specialist companies, largely immune from takeover. The roles of buying and selling were separated by intermediaries, or ‘stock jobbers,’ through whose books every transaction went, on a fixed-fee basis.

On 27 October 1986, this regime was swept away; the buy and sell sides of brokerage were united and the modern trader was born. At the same time, City firms found themselves vulnerable to international competition and hostile take-over. Computerised trading and 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. This was not restricted to specialist City firms. By 1992 the Hong Kong Shanghai Bank (HSBC) had acquired the Midland Bank – then the UK’s biggest high street bank by market capitalisation – 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 acquired 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 superficially this might appear similar to the Australian ‘Four Pillar’ policy or Canada’s system dominated by six large banks, the reality could not be more different. Not only were the large London-based 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 vastly 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. Both 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 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)

4.2.3 Summing things up

In both Britain and America, the return to dominance of the London and New York financial centres was aided by 'light touch' regulation. However, The British and American systems are at opposite ends of the spectrum. The UK takes an 'integrated' approach, where a single universal regulator ensures consumer and investor protection, as well as the health and stability of financial institutions in all sectors of the financial services industry. By contrast, the US system is diffuse, with a plethora of institutions regulated by an equally complex system of federal and state regulatory agencies. Both systems have been criticized for their inability to provide supervisory oversight of financial institutions offering an ever expanding range of services. But whilst 'modernization' of the financial services industry has been welcomed, regulatory reform has met with opposition from powerful industry insiders, lobbyists and political activists (Gordon 2004).

In short, in New York and London, 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. An international footprint brings the ability to span jurisdictions, arbitrage regulatory systems and quickly relocate if necessary. There is thus a potential conflict of interest for the financial market regulators: while light touch regulation is attractive to global capital, it also increases the risk of instability.

4.3. Canada and Australia: Financial market liberalization – but with regulatory reform

In both Canada and Australia, prior to adoption of the current 'twin peaks' model of regulation, the approach to financial market regulation was institutional, with the firm's legal status determining the regulator responsible for overseeing its activities. As the boundaries between financial institutions became increasingly blurred by the diversification of services provided, in stages, financial market regulation evolved into a 'twin peaks' system in which the Central Bank is responsible for monetary policy and market stability, and a separate regulator is responsible for safety and stability and for conduct of

business. Both Canada and Australia also take a ‘principles-based’ approach to regulation in which financial institutions are required to ensure that they meet both the intent and the prescription of legislation; this approach (in contrast to a ‘rules-based’ approach) is believed to encourage competition and innovation as well as to make the financial market more attractive to international financial institutions (Pan 2011).

In both Canada and Australia, financial markets are seen as integral to the performance of the economy as a whole, rather than being an end in themselves (Nieuwenhuysen, Lloyd & Mead 2001, Courchene & Purvis 1992). The core of the financial services industry is a branch banking system in which a few large banks provide retail, commercial and investment banking services nationwide. Branching and diversification of financial services are seen as contributing to reduced vulnerability to regional and market shocks, significant economies of scale for the banks involved, and hence, market stability. At the same time, competition among the banks is considered to be in the public interest (Department of Industry 1997).

In Canada, the government’s commitment to maintaining a balance between the public interest and the commercial interests of Canadian business is enforced by the Competition Bureau Canada (CBC), whose mandate is to ‘ensure that Canada has a competitive marketplace and that all Canadians enjoy the benefits of low prices, product choice and quality service’ (Competition Bureau Canada 1998). Consequently, all proposed mergers are subject to review. In 1998, with the objective of improving their competitiveness in the global financial market, the Royal Bank and the Bank of Montreal proposed merging as did the Canadian Imperial Bank of Commerce (CIBC) and the Toronto Dominion Bank. However, the mergers were blocked on the grounds that they would work against the best interests of Canadians by concentrating economic power, reducing competition and restricting the government’s ability to address future prudential concerns (Lott 2005).

A similar balance was achieved in Australia by the government’s ‘six pillar’ policy, initiated by Paul Keating in 1990 when he blocked the merger between the ANZ Bank and the National Mutual insurance company and extended 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). The six-pillar policy was maintained until the 1996 Wallis investigation into financial system reform, which exposed the largest banks and insurance companies to the same level of take-over pressure as other publicly listed companies. Thus, in 1997, the

merger ban was lifted for the two insurance companies, but not the four largest banks, resulting in the present ‘four pillar’ policy.

4.3.1 Canada’s banking ‘pillars’ – a change of architecture

Traditionally, the ‘four pillars’ of Canadian banking – chartered banks, trust and loan companies, insurance companies and securities dealers – were distinct in terms of ownership, market function and legislative control, with regulations that enforced an institutional separation of activities and prohibited cross-ownership. During the 1950s, however, financial innovation by ‘near banks,’ beyond the jurisdiction of regulation, caused a gradual blurring of the institutional lines differentiating financial institutions. This, in a context of growing concern about capital market liberalization with the decline of the Bretton Woods Arrangement, uncertainty about the Eurodollar market and competition from newly re-built Europe and Japan, led to the establishment of the Royal Commission on Banking and Finance in 1961. The resulting 1964 Porter Commission Report produced the Bank Act of 1967, which loosened controls on interest rate ceilings and reserve requirements, to allow financial institutions in Canada greater flexibility in responding to market opportunities. It also introduced rules maintaining a clear separation between banks and their customers and established the Canada Deposit Insurance Corporation (CDIC) to guarantee deposits of up to \$60,000 Canadian (now \$100,000 Canadian).

During the 1970s, in response to the financial uncertainty created by soaring inflation, the 1980 Bank Act relaxed restrictions on ownership and entry. In response to this and the Mulroney government’s 1987 Deregulation bill, by the end of the 1980s, all of the major Canadian banks entered into the brokerage and investment banking business by acquiring existing firms or building their own (Krysanowski and Ursel 1993). This emergence of universal banking was met with the 1987 establishment of the Office of the Superintendent of Financial Institutions (OSFI) – the first of the ‘twin peaks’ – as a centralized regulator of banks, insurance companies and pension funds.

In 1988, concerns about the globalization of finance, markets and production, cross-border competition in corporate and government finance and global financial consolidation led to the formation of the MacKay Task Force. One of its key findings was an information and power imbalance between financial institutions and their consumers and investors. In response, the Financial Consumer Agency of Canada (FCAC) – the second of the ‘twin peaks’ – was founded in 2001 to consolidate and strengthen consumer protection regulation.

Another concern of the Task Force was the tension between federal and provincial government in the regulation of the financial services industry. The Canadian constitution assigns national government the authority to regulate ‘the business of banking’ but it does not define what that means (Brean et. al. 2011). This ambiguity has impeded the establishment of a pan-Canadian regulatory framework, particularly with respect to securities regulation. At present, securities regulation is entirely in the hands of the provinces, with cross border regulation coordinated by the Canadian Securities Administration (CAS), whose membership includes the chairs of the 13 provincial commissions. Despite efforts to centralize securities regulation, it continues to be met with strong opposition from provincial government.

4.3.2 Australia’s ‘corporate cowboys’ bite the dust

In Australia, as in Canada, the institutional lines between financial firms began to blur during the 1950s. While major banks were tightly regulated by the Reserve Bank of Australia, by the 1960, every big bank had acquired an equity stake in a major finance company, operating in the profitable fringe banking sector, beyond the jurisdiction of central bank controls. The finance companies began in hire-purchase; but became increasingly entrepreneurial and by the 1960s and 1970s were heavily engaged in property speculation with the ‘corporate cowboys’ of the day (Sykes 1994). Although the banks extended very little finance to the speculators, their finance companies were less cautious. This fuelled a property bubble that burst in 1974, causing a devastating string of corporate and financial failures.

In 1979, amid growing concern about the effectiveness of existing regulations, the government commissioned a review of the financial system, the Campbell Inquiry. Although the 1981 Campbell Report noted that Australian banks had become significantly involved in non-banking business activities through their ownership of equity stakes in finance companies, money market companies, superannuation funds and insurance brokers (Bain & Harper 2000), its recommendations resulted in the introduction of an institutional system of regulation, composed of four main regulators: the Reserve Bank of Australia (RBA) was responsible for banks; the Insurance and Superannuation Commission (ISC) for insurers and superannuation funds; the Australian Securities Commission (ASC) for securities market conduct and disclosure; and the state and territory based State Supervisory Authorities for the building societies, friendly societies and credit unions. It also paved the way for liberalization of the financial system.

In 1983, Australia's New Labour government was welcomed into office by a major currency crisis, brought about by speculators fearful of the change in government. The government's leaders 'immediately realized that long-term stability depended on reassuring a wary business community' (Helleiner 1994, 165) and in 1984, the Australian Financial System Review recommended further deregulation. However, the result was instability and scandals in both the corporate and financial sectors of the economy; and in 1990, Australia entered a severe recession, dominated by financial failure (MacFarlane 2006). According to Sykes (1994),

'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 1991, the Martin Inquiry into the effects of deregulation and the extent of bank competition was followed by the 1996 Wallis Inquiry, whose objective was to reduce the potential for regulatory arbitrage and increase neutrality within the Australian financial system. In particular, it explored the idea of a 'twin peaks' regulatory model, favoured by the Treasury Department and ultimately recommended it to the Howard government (Bakir 2003). The result was the 1998 creation of a new single prudential regulator, the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investment Commission (ASIC). APRA took over prudential regulatory powers from the RBA, ISC and AFIC; and ASIC took over responsibility for consumer protection and market integrity from the ASC, ISC and Australian Consumer and Competition Committee (ACCC). To coordinate financial regulation among the different branches of government, the Council of Financial Regulators was set up, composed of representatives from the RBA, APRA, ASIC and the Treasury. In March 2001, the failure of Australia's second largest insurance company, HIH Insurance, prompted further prudential regulation, bringing most insurance companies, previously only lightly regulated, under the jurisdiction of APRA.

4.3.3 Summing things up

In both Canada and Australia, the financial sector is predominantly composed of a relatively small number of domestic and largely immobile banks and financial institutions, subject to 'twin peaks' regulation, in which separate regulators have responsibility for soundness and for conduct of business oversight. In both Australia and Canada, financial market liberalization was matched by flexible regulation designed to ensure that markets were stable and

operated effectively. The continuous development of prudential regulation in response to the challenges of liberalization and shifting market conditions reflects the strong tradition of respect for government and for the public interest, which is well summarized in the credo of both countries' Constitutions: 'peace, order and good government.'¹⁷

The relative strength of Canadian and Australian regulation – and its regulators – may also reflect popular opinion about banks and financial interests. According to Harris (2004, 167) 'Bank bashing ... is a favourite pastime in Canada, participated in by both politicians and bureaucrats'; and in Australia, Malcolm Maiden famously commented that 'banks are bastards; bigger banks are bigger bastards' (Maiden 2008).¹⁸ Perhaps this helps to keep the banks – and the bankers – in their proper place within the political and economic system.

5. Reactions to Regulation in the Anglo-Saxon World: Conform or Configure?

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

Canadian and Australian banks however, did not join the international party. They were less dependent on the money markets than their American and British counterparts. Canadian banks are funded mainly through deposits, reducing exposure to capital markets (Booth 2008, 43), and changes in interest rates or availability of funds. As evident in Table 3, 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 Low savings rates resulting from increased consumer leverage, necessitated funding through the financial markets.

**Table 3: 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 Australia and the UK, the use of foreign and domestic deposits as a source of funding is somewhere between the two, accounting for 60 and 61 percent, respectively. This was one reason for dis-intermediation and the creation of special investment vehicles (SIVs), especially by US banks (Booth 2008: 43). SIVs are 'virtual banks' - Essentially shell companies, with a line of credit from the parent bank which it was assumed would never be required; the SIV would fund itself via the short term money markets at 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, offering a means by which regulatory capital requirements could be reduced, and the money invested for profit instead.

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. William 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.

6. The Anglo-Saxon Varieties of Liberalism are Put to the Test

The conditions that produced the long consumer boom preceding the 2008 financial crisis confronted the internationalised banks in New York and London with problems. Low interest rates and the large volume of Asian savings in the market had not only depressed returns; it also increased 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.

The desired returns were initially provided by Collateralised Debt Obligations (CDOs), derivative vehicles cherry-picking higher risk (and hence, higher yield) loans from conventional asset backed securities (ABS). Advances in computing meant that ever-more complex CDOs could be constructed by individuals on desktop machines and traded privately - without an exchange as an intermediary. When demand from investors for these 'over the counter' products (SIVs were a popular mechanism for investing in them) proved insatiable, erosion of initial profit margins through 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.

A governance challenge also arose in organizations with widely dispersed shareholder ownership, hungry for returns. The perceived risk of hostile action by shareholders or the markets impeded the board's ability to take decisions relating to risk independently of the sector - a major contributor to a build up of systemic risk. JP Morgan, one of the more cautious players on Wall Street, paid the price for its individual view on derivative risk through a hostile takeover by Chase Manhattan in December 2000; (Tett 2009, 92-3) and was subsequently forced to *again* defend its continued conservative stance on derivatives to shareholders.

A fundamental building block of CDOs were mortgage backed securities (MBS), mostly created in the US. However, despite recent *bete noir* status, mortgage securitisation is far from new.²⁰ In the US, the structured financing of mortgage pools has its origins in the 1970s, when MBS 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, where mortgage securitization in Europe was pioneered, the first MBS was issued in 1985 and the market grew rapidly during the housing boom (ODPM 2003). However, it declined equally rapidly with the 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 consumer goods and the issuance of

mortgages with improbable loan to value ratios of up to 125 percent. During the boom, the conventional wisdom again assumed that these conditions would continue, eroding debt levels – until the bubble burst.

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

6.1. Fuelling the bubble: residential financing in the Anglo-Saxon world

The securitization of risky American sub-prime mortgages was key to the high returns of the CDOs they populated; it also precipitated the crisis. 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 in these countries. Thus, while home ownership patterns are comparable, the systems of home financing gave rise to very different outcomes with respect to mortgage lending, playing 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 the systems of home financing in the main Anglo-Saxon countries.

The Great Depression created both mass unemployment and industrial unrest amongst those still working.²¹ One response was to create incentives encouraging more American households to own their homes and in 1938, the Federal National Mortgage Association (Fannie Mae) was set up to purchase mortgages from their originators, freeing up their capital to make additional loans. American home ownership is also encouraged by 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 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 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 normal, especially during a boom.

The effect 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 three systems.

In the UK, many homes were rented, but from 1980, under the Thatcher government’s ‘right to buy’ legislation, there was a rapid expansion in home ownership. As with America during the inter-war period, a political agenda lay behind this; increasing the rate of home ownership by offering more and cheaper mortgages and privatizing government-owned housing was part of a wider strategy, which included encouraging people to buy shares in newly privatized businesses and expand conservative party support.

Under the 1980 Housing Act, UK public sector tenants were encouraged to purchase the properties they occupied, at heavily discounted prices. In 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 (ONS 2010). In contrast to the American system, however, the Conservative government soon began to cut back on income support for mortgage interest and 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 & Pannell 2007). As increasing house prices outpaced earnings growth and affordability, and with growing interest in strengthening public services, attention has been re-focused on housing policy in favour of home ownership (Williams & Parnell 2007, 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 – given the retreat of the state in most other areas - 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 CMHC introduced the 3 and 5 year Canada Mortgage Bond (CMB), guaranteed by the CMHC.

Thus, although MBS 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.

6.2. Neoclassical liberalization finally goes too far

By the mid 2000s, the housing boom in America was cooling, so the search for yield by the internationalised banks intensified. An apparent solution was found in ever more extreme parts of the American sub-prime sector. Here, heightened risk meant higher returns in the securitised products built from these mortgages. However, exploiting these highly risky segments would require nearly complete relaxation of lending criteria, which in turn created pressure to securitize sub-prime loans more quickly, before they went bad. 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 unaffordable levels. 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 would 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 even 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 lending criteria, however, also required relaxation by other regulators - in particular the Federal Department of Housing and Urban Development (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 warnings by HUD researchers in 2001 that 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; between 2004 and 2006, they purchased an additional \$434 billion of sub-prime loans, exposing 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 successful lobbying for successive and specific loosening of

regulation in order to allow predatory mortgage lending practices and toothless housing policy. The securitization of sub prime mortgages encouraged risk-taking in lending; the predominance of non-recourse loans encouraged 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 legislated and legitimated 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, hinting at undue private sector influence over the state. This, in many ways, is the underlying principle defining the Varieties of Liberalism approach – the relative balance of power between the state and the private sector, and the character of that relationship.

7. Conclusions

The return to economic liberalism in the Anglo-Saxon world was motivated by the apparent failure of Keynesian economic management to control the stagflation of the 1970s and early 1980s. In this context, the theories of economic liberalism, championed by Friederich von Hayek, Milton Friedman and the Chicago School economists, provided an alternative. However, the divergent experience of the US, UK, Canada and Australia reveals two distinct ‘varieties’ of economic liberalism: the ‘neo-classical’ incarnation, which describes American and British liberal capitalism, and the more ‘balanced’ economic liberalism that evolved in Canada and Australia. In large part, these were a product of the way that liberal economic theory was understood and translated into policy, which in turn shaped the evolving relationship between the state and the private sector and the relative position of the financial sector within the broader economic system. Together, these determined the nature and extent of financial market regulation and the system’s relative stability during the 2008 crisis.

7.1 The ‘neo-classical’ and more ‘balanced’ varieties of economic liberalism

In the US and the UK, ‘Reaganomics’ and ‘Thatcherism’ represented a conscious rejection of Keynesian theory and a re-orientation of policy, away from reducing unemployment and boosting growth, towards improving the productivity of individual sectors within the economy. In both countries, a strong central government, led by a charismatic leader, was able to effect a radical change in policy, emphasizing the merits of free markets, private sector provision, withdrawal of the state and individualisation of social welfare.

In Canada and Australia however, whilst the challenges of the 1970s undermined confidence in the state's ability to manage the economy, it did not weaken support for the social welfare state. Canadian and Australian economic liberalism thus emphasized the merits of competition in markets (rather than focusing purely on market freedom); it sought to limit the role of the state in the provision of services, but without compromising access to basic health, education and income security. Economic liberalization was therefore accompanied by regulation designed to permit the market to function effectively; and to the degree that public services were privatized, the state assumed a strong role in regulation in the public interest.

In both Canada and Australia, economic liberalism was interpreted and implemented by successive Liberal and/or Labour governments, in an incremental process that involved the co-operation of economic liberals and modernizing social democrats; and those policies that were seen to best serve the interests of society were evolved through a process that encouraged learning to take place when challenges were encountered. The existence of countervailing forces, including strong regional governments and effective mechanisms for the participation of a range of stakeholders, including citizens and representatives from both sides of industry, resulted in a more 'balanced' approach to economic liberalism that in some respects, served to enhance the capacity of the Canadian and Australian states.

Despite the logical coherence of economic liberalism in Australia and Canada, however, the process of incorporating it into policy was evolutionary, rather than consciously planned. It is thus possible to argue the existence of a third – more deliberate – variety of liberalism: 'ordoliberalism.' Whilst ordoliberalism contains many of the features that distinguish the Australian and Canadian varieties of economic liberalism from their American and British counter-parts, the crucial difference is that far from being accidental, ordoliberalism represents an overall vision of economic liberalization. The theory was championed by Walter Eucken and Alexander Rüstow and arises from Germany, a nation with very strong regional governments as well as institutions for joint consultation and collective participation in debates about social and economic policy – all powerful veto players.

7.2. The theoretical and historical roots of 'ordoliberalism'

'*Ordoliberalism*'²² was originally conceptualized by the economists of the German Freiburg School during the interwar period (Boas & 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, Boarman 1964, Gerber 1994). 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, Eucken 1932, Rüstow 1953 and 1957).

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'être*. 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, 14):

‘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.’

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 ordoliberalism,

‘[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, 181).

In other words, for ordoliberals, it was not the state but private monopolies that were the main enemy of a free society. 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 (Röpke 1950, Röpke 1981,

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.

To what extent it would be possible to have deliberately imposed such a wide ranging system on another economy is a moot point; and much would depend upon the scale of Galbraith's 'massive onslaught of circumstance' and the nature of Friedman's 'ideas lying around at the time.' In the final analysis, it is time to engage in a debate about the true nature of the varieties that exist within economic liberalism. Only then will we be able to understand the type that has failed and in so doing to identify ways out of the current crisis of contemporary capitalism.

Notes

¹ 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 comparatively low. Labour markets are flexible; and in comparison with the coordinated market economies (CMEs), employment protection and welfare spending are relatively low.

² 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.

³ 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 per cent 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).

⁴ Canada appeared somewhat less vulnerable (in terms of its current account balance and mortgage debt to GDP ratio). See Konzelmann, Fovargue-Davies and Schnyder (2010), especially section 2, for a further discussion.

⁵ In 2008, the mortgage debt to GDP ratio was 71 per cent in the US, 86.3 per cent in the UK and 85 per cent in Australia (Vorms 2009, Keen 2009). This is in contrast to the much lower ratio of 45.6 per cent in Canada (Keen 2009).

⁶ Höpner et al. (2009, 5-6) single out three defining principles of a liberal economic order: individual responsibility, decentralized decision-making and competition.

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, Wilkinson, Fovargue-Davies and Sankey 2010.

⁹ By contrast, New Keynesians attributed stagflation to the presence of union monopoly that served to increase wages above their market clearing rate, thereby causing unemployment to rise. From this perspective, attempts to increase employment beyond the 'non-accelerating inflation rate of unemployment' (NAIRU), would merely fuel inflation (Meade 1982). Thus, for both Liberal and New Keynesian economists, there was a simple choice between higher real wages and more jobs.

¹⁰ Rational expectations theory posits that outcomes do not differ systematically from what people rationally expect.

¹¹ Under the Bretton Woods system, most countries sought to maintain an overall balance of trade, settling international trade balances in US dollars, with the US's agreement to redeem other central banks' dollar holdings for gold at a fixed rate of thirty-five dollars per ounce. The US, however, had not been overly concerned about maintaining a balance in trade since it could pay its export deficits in dollars. Nor had it taken action to prevent the steady loss of American gold. By 1971, under pressure to devalue its currency, due to the decline in US gold reserves, instead of devaluing the dollar, President Nixon removed gold backing from the dollar.

¹² 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. See also Konzelmann, Wilkinson, Fovargue-Davies and Sankey 2010.

¹³ The American, British and Canadian voting systems are plurality systems in which seats are awarded to the person with the most votes, even if it is not a majority. This is in contrast with the Australian system, which seeks to resolve the concern about balancing plurality with proportional representation. In Australia, seats are awarded in the upper house on the basis of proportional representation by states and territories and in the lower house on the basis of preferential voting. This system is argued to produce a more stable government while having better diversity of parties to review its actions (Calvo 2009, Morelli 2004).

¹⁴ 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.

¹⁵ Five different US federal agencies share responsibility for regulating depository institutions: the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS). Depending on its legal structure, a depository institution may be subject to regulation by up to three of these federal agencies as well as a state regulator. State authorities are also responsible for regulating the insurance industry. The national securities markets being regulated by the Securities Exchange Commission (SEC) and the futures markets are regulated by the Commodities Futures Trading Commission (CFTC), individual derivatives and commodities exchanges and the National Futures Association (a self-regulating organization (SRO)).

¹⁶ The RTC was established and assigned responsibility for winding-up the failed S&Ls.

¹⁷ It is interesting to note the contrast with the American credo: 'life liberty and the pursuit of happiness.'

¹⁸ Malcolm Maiden is business editor for *The Age*.

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 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.

²¹ 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).

²² 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.’

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