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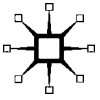
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Financial Structures and Regulation: A Comparison of Crises in the UK, USA and Italy

Alessandro Roselli

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To my wife

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Preface

This book is a study in political economy issues. But what is “political economy”, as distinct from “economics”? Looking at the *New Palgrave Dictionary of Economics*,¹ no less than ten definitions can be found. According to the first, it is none other than a discipline gradually replaced by economics from the end of the nineteenth century, after coexisting for a while as synonyms. John Stuart Mill, however, affirmed its moral and social nature, and Marx defined it as the anatomy of civil society. More recently, “broad policy issues” and “normative economics” have been stressed as features of political economy. I should like to use this sort of approach in my research, which deals with public policy issues and the historical developments of financial systems and their crises. These systems, in fact, do not exist in a *vacuum*, and their institutional and historical aspects cannot be neglected.

According to one theory on financial crises, instability is inherent in financial systems. This theory relates financial instability to the turning points of the business cycle, regarding crises and contractions in economic activity as an unavoidable consequence of the “excesses” of previous booms. Such excesses – shown as bubbles in financial or real assets – are generally accompanied by high and growing levels of debt in one or more sectors of the economy (households, business, government), up to the point where the level of debt becomes unsustainable in relation to the income produced. Banking and financial intermediaries – particularly banks, largely characterized by demand or very short-term liabilities – suffer from the decline, or collapse, of the value of their assets, prompting sudden withdrawals of funds (“runs”): illiquidity and insolvency follow, often spreading to other, solvent, institutions, in a contagion process (“domino effect”).

Given this theoretical perspective, and therefore assuming the inevitability of a crisis in a capitalistic market economy, we may ask whether the probability and depth of a crisis are affected by the structure of the banking and financial system, and by its laws, regulations, institutions and supervisory styles. In such an institutional approach, even if monetary policy is prudent and so timely as to promptly spot symptoms of instability, an inadequate institutional framework could not prevent the occurrence of the crisis.

This research aims at highlighting the interactions between the institutional and regulatory arrangements of the financial system, on the one hand, and the structure of the system, on the other, as well as looking at these interactions as a key to a better understanding of the origins and developments of some financial crises. It should be immediately added that this research will not try to find an “optimal” institutional and regulatory scheme: not only

because it would be a very difficult and ambitious task, but also because I doubt that such a scheme exists at all. It has been observed that each crisis is unique in its main object of speculation and overtrading; in the incident which saps confidence, reverses expectations and precipitates distress-selling of commodities and assets; in the sequence and timing of the fall of the latter's prices; in the international ramifications of the bust-up. The institutional and regulatory framework is evolving, and a "superior" model has yet to be found. However, in any historical context, in any geographical/political environment, we may have an adequate, appropriate answer to the containment of a crisis and its consequences, in terms of loss of output and generally of economic welfare. This is what this research is about.

Institutionalism, as a connection between law and economics, has been long neglected or repressed as an irrelevant instrument in the analysis of financial crises. There is a polarization between the quantitative approach, built around massive (where possible) databases and aimed at finding analytically causal connections between sets of data, and an essentially narrative approach, based on personalities (the *dramatis personae*), politics and their interactions. The institutional view looks rather at the rules that define a certain financial system, and at the institutions that these rules create or are subject to. In order not to become a purely legalistic approach, however, this view has to be supported by a historical perspective, and verified on the basis of the available statistical evidence. The regulatory system as an issue of political economy reflects broad approaches to the role of government in the economy.

The contexts here considered are those of the USA and the UK, while taking Italy, with a rather different financial structure and regulatory framework, as a reference point (the final result of this research will be an attempt at answering the question about whether, and to what extent, it's entirely appropriate to speak today of an "Anglo-Saxon financial crisis").

These are the time frames here considered:

Part I: The interwar period (Great Depression), which is meaningful because of the great financial instability prevailing in several countries. The connections between categories of intermediaries and asset classes, on one side, and the regulatory frameworks, on the other, are thus of particular interest. Not only this: not a few people think that today's problems find their roots in the same attitude of "free banking" that prevailed in the USA (and, partly, in Italy) before the bank reforms of the 1930s. The UK kept its system of short-term deposit banks: no relevant financial crisis occurred, but perhaps the banks failed British industry. Everywhere, the fragile financial situation was superimposed on the more fundamental problem of the collapse of industrial production. Many countries came out of the 1930s with legislation very different from what existed at the start of the decade. This was the case of America and Italy (not

the UK). That legislation remained substantially unchanged in the postwar years.

Part II: The postwar decades can be seen as a phase of institutional – and corresponding financial – stability. At the beginning of the 1970s, however, the UK started to emerge from the “institutional inertia” that had characterized the interwar years, as compared to the interventions enacted in the other two countries. In a context very different from the interwar years, however, this strategy went, broadly speaking, in the direction of increasing competition in the system and the growing internationalization of London as a financial centre. Pressure grew in America to get rid of the 1930s legislation.

Part III: The 1980s and the following decades represent the third phase, covered by the too generic term “deregulation”. Here, we try to assess whether the innovations in the financial structure and products have influenced institutional and regulatory changes, with perhaps an inverse link of causality, in the end making the regulators – according to one view – “captives” of the very institutions they have to regulate. With the institutional approach, one has to ask whether a more cautious monetary policy would have totally prevented the financial crisis, or whether current structures and regulations would have anyway led to the crisis (a “counter-factual” question that a historian would consider irrelevant, but not so a policy-maker).

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They should in no way be held responsible for my mistakes.

I have received continuous and much needed assistance from Michael Horn, who manages figures much better than I do. Ken Hurry polished my somewhat uncertain English.

Acronyms

ABS	Asset-Backed Security
AGCM	Autorità Garante per la Concorrenza e il Mercato (Italy)
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (USA)
BCCI	Bank of Credit and Commerce International (UK)
BHC Act	Bank Holding Company Act (USA)
BIF	Bank Insurance Fund (USA)
BOT	Buoni Ordinari del Tesoro (Italy)
CCC	Competition and Credit Control (UK)
CDO	Collateralized Debt Obligation
CDs	Certificates of Deposit
CDS	Credit Default Swap
CEBA	Competitive Equality Banking Act (USA)
CFTC	Commodity Futures Trading Commission (USA)
CICR	Comitato interministeriale per il credito e il risparmio (Italy)
CIS	Credito Industriale Sardo (Italy)
Comit	Banca Commerciale Italiana (Italy)
CONSOB	Commissione Nazionale per le Società e la Borsa (Italy)
CPFF	Commercial Paper Funding Facility (USA)
CRA	Community Reinvestment Act (USA)
Credit	Credito Italiano (Italy)
CSVI	Consorzio sovvenzioni valori industriali (Italy)
CWA	Civil Works Administration (USA)
DIDMCA	Depository Institutions Deregulation and Monetary Control Act (USA)
EAB	European American Bank (USA)
EC	European Community
EEA	European Economic Area
EMH	Efficient Markets Hypothesis
EMS	European Monetary System
ENEL	Ente Nazionale per l'Energia Elettrica (Italy)
ENI	Ente Nazionale Idrocarburi (Italy)
FannieMae	Federal National Mortgage Association (USA)
FASB	Financial Accounting Standard Board (USA)
FDIA	Federal Deposit Insurance Act (USA)
FDIC	Federal Deposit Insurance Corporation (USA)

FDICIA	Federal Deposit Insurance Corporation Improvement Act (USA)
FED	Federal Reserve (USA)
FHC	Financial Holding Company (USA)
FHLBB	Federal Home Loan Bank Board (USA)
FICO	Financing Corporation (USA)
FIN	Financial Intermediation Ratio: ratio of financial institutions' assets to total financial assets
FIR	Financial Interrelation Ratio: ratio of total financial assets to real wealth
FIRREA	Financial Institutions Reform, Recovery and Enforcement Act (USA)
FreddieMac	Federal Home Loan Mortgage Corporation (USA)
FSA	Financial Services Authority (UK)
FSLIC	Federal Savings and Loan Insurance Corporation (USA)
FSMA	Financial Services and Markets Act (UK)
FSOC	Financial Stability Oversight Council (USA)
GDP	Gross Domestic Product
GinnieMae	Government National Mortgage Association (USA)
GLB Act	Gramm–Leach–Bliley Act, or Financial Modernization Act (USA)
GSE	Government-Sponsored Enterprise (USA)
H.C.	House of Commons (UK)
HSUS	Historical Statistics of the United States
IFRS	International Financial Reporting Standards
IMRO	Investment Management Regulatory Organization (UK)
IRFIS	Istituto Regionale per il Finanziamento alle Industrie in Sicilia (Italy)
IRI	Istituto per la Ricostruzione Industriale (Italy)
ISVEIMER	Istituto per lo Sviluppo Economico dell'Italia Meridionale (Italy)
JMB	Johnson Matthey Bankers (UK)
LCFI	Large and Complex Financial Institutions
LIFFE	London International Financial Futures Exchange (UK)
LSE	London Stock Exchange
MBS	Mortgage-Backed Security
NCC	National Credit Corporation (USA)
NRA	National Recovery Administration (USA)
OCC	Office of the Comptroller of the Currency (USA)
OFHEO	Office of Federal Housing and Enterprise Oversight (USA)
OFIs	Other Financial Institutions
OLA	Orderly Liquidation Authority (USA)
OTC	Over-the-Counter, outside official exchanges

OTS	Office of Thrifts Supervision (USA)
PDCF	Primary Dealer Credit Facility
PIA	Personal Investment Authority (UK)
RBS	Royal Bank of Scotland (UK)
REIT	Real Estate Investment Trust
RFC	Reconstruction Finance Corporation (USA)
ROE	Return on Equity
RTC	Resolution Trust Corporation (USA)
S&Ls	Savings and Loan associations: American thrifts
SAIF	Savings Association Insurance Fund (USA)
SallieMae	Student Loan Marketing Association (USA)
SCI	Special Credit Institution (Italy)
Sconto	Banca Italiana di Sconto (Italy)
SEC	Securities and Exchange Commission (USA)
SFA	Securities and Futures Authority (UK)
SIB	Securities and Investment Board (UK)
SIPA	Securities Investor Protection Act (USA)
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle
SROs	Self-Regulatory Organizations
SRR	Special Resolution Regime
TAF	Term Auction Facility (USA)
TALF	Term Asset-Backed securities Loan Facility (USA)
TARP	Troubled Assets Relief Program (USA)
TSLF	Term Securities Lending Facility (USA)
VFCR	Voluntary Foreign Credit Restraint program (USA)
WFC	War Finance Corporation (USA)
WPA	Works Progress Administration (USA)