Original Article

Different varieties of capitalism? British and Italian recapitalization policies in response to the sub-prime crisis

Manuela Moschella
School of International Studies, University of Trento, Italy, Via Verdi 8/10, Trento 38100, Italy.
E-mail: m.moschella@email.unitn.it

Abstract The article explores the variation between British and Italian policies adopted in response to the sub-prime crisis. Specifically, the article focuses on the variation within the recapitalization policies adopted in the late 2008. In contrast to partisan politics and regulatory competition expectations, the article finds that the difference between the British and the Italian recapitalization policy was shaped by distinctive national models of financial capitalism. Those models shaped both governments' understanding of their role in the economy and domestic financial firms' support to government policies. Thus, the British government sought policies that relied on market mechanisms to adjust the domestic financial system to the shock caused by the global crisis. The Italian government, in contrast, sought policies conducive to the bank-based model of financial capitalism where government intervenes to help domestic economic actors to adjust their activities to an economic shock. In line with the literature on comparative capitalisms, the article thereby emphasizes the long-standing importance of distinct national models to explain the practical aspects of policy outputs. However, in light of the variegated responses to the crisis, the article also raises the question about the persistence of distinct models of capitalism.
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Introduction

The global financial crisis, which started in summer 2007 in the US sub-prime market, propelled a variety of international and national responses. Around the world, national authorities adopted policies primarily aimed at restoring financial market stability and at avoiding spill-over effects to the real economy. Despite the similarities, however, national responses followed different paths

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even within the European Union (EU) where significant efforts have been made to create a single financial market.[1]

This article explores such an institutional variation by focusing on the microeconomic side of governments' response to the crisis. Specifically, the article investigates the variation within the recapitalization policy that several governments adopted in the fall of 2008 as the crisis intensified following the collapse of a major US investment bank, that is, Lehman Brothers. Indeed, recapitalization took different forms based on the extent to which governments intervened in the battered domestic banking system. That is to say, some governments pursued the path of formal recapitalization by acquiring shares of domestic banks and imposing transparency and compensation requirements. Other governments preferred the path of an informal recapitalization by acquiring banks' debt and avoiding to interfere into the management of domestic banks. Whereas recapitalization via equity purchase represents one of the most intrusive forms of government intervention in the economy because it entails governments' direct control over the bank's activities, recapitalization via debt acquisition tends to preserve the banks' autonomy because the government does not gain a say in the internal business of banks.

Interestingly, however, the most intrusive forms of intervention were adopted by countries with a long-standing tradition of light-touch regulation for financial markets and actors. The United Kingdom, for instance, decidedly opted for entering into the capital of domestic banks, setting some guidelines for their conduct. In contrast, countries with a long-standing tradition of government intervention in the economy, such as Italy, elaborated a recapitalization policy that was based on the acquisition of bonds and on the guarantee of independence for the domestic banks. The variation between the British and the Italian policy output also seems at odds with much of the findings of the comparative political economy of the advanced industrial economies. Indeed, the United Kingdom represents the ideal type of liberal market economy (LME), that is, a capitalist economy wherein the process of economic adjustment is driven by the financial markets and firms with very little input from the state. Italy, in contrast, well represents a type of coordinated market economy (CME) where adjustment is often state-driven.[2]

The difference between the British and the Italian recapitalization policies, and the seeming incongruence with the findings of the literature on the varieties of capitalism raise important questions. What are the factors that shaped the content of the British and the Italian policy? How do we account for the fact that an LME opted for deep interventionist policies and vice versa?

Two alternative explanations can be of help to answer these questions. On the one hand, we could explain the difference between the recapitalization policies that took place in Britain and in Italy using a partisan politics argument (Hibbs, 1977; Tufte, 1978). From this perspective, policy outputs

reflect the ideological preferences of the incumbent government coalitions. Hence, we can expect a centre-right government, such as the Italian one, not to enter into domestic banks by equity acquisition in line with its presumed free market proclivities whereas a Labour government, such as the British one, is better placed for such an intervention. On the other hand, we could explain the difference in the recapitalization policies in light of the regulatory competition argument (Scharpf, 1997; Radaelli, 2004). According to this argument, government policies are driven by economic integration as vividly embodied by the global spread of the crisis. Specifically, the argument is that the crisis induced national authorities to upgrade regulation by recapitalizing domestic banks in order to preserve the competitiveness of the domestic financial industry. Hence, the difference between the UK and Italian policy output can only be explained assuming that external pressures impacted the countries with different degrees of intensity.

The hypotheses drawn from the partisan politics and the regulatory competition explanations disclose important factors to account for the policies pursued by the British and the Italian government to recapitalize domestic banks. Nevertheless, each of them cannot fully account for the variation within the recapitalization policy. Indeed, the partisan argument, which is usually well placed to explain variation among national policies, has difficulty explaining the fact that both British and Italian governments *de facto* recapitalized domestic banks in spite of different party composition of national governments. The regulatory competition problem, in turn, seems unable to account for the differences in the modalities through which the British and the Italian recapitalization policy was carried out. That is to say, by referring to the different impact of the crisis in the two countries, such an explanation may well identify the motivations for governments' intervention – be that of avoiding banks' failures (in the United Kingdom) or that of avoiding a spill-over effect to the real economy (in Italy). Nevertheless, the regulatory competition explanation has troubles explaining the preference for equity or debt acquisition in carrying out the recapitalization process. In other words, this explanation is indeterminate about the mechanisms through which an external shock is translated into a practical policy output.

This article thereby builds on the regulatory competition argument to explain British and Italian governments' choice to recapitalize domestic banks but moves from it to explain the practical aspects of the recapitalization policy in the two countries. In doing that, the article draws attention to the institutional characteristics of distinct national forms of financial capitalism. Indeed, the article argues that the practical aspects of British and Italian recapitalization policies can be found in the organization of the domestic financial system that characterizes the political economy of each country. The configuration of the domestic financial system, indeed, shaped each

government's understanding about its role in the economy and financial firms' support for the mechanisms of economic adjustment proposed by national governments. In this connection, the British government adopted policies staked on the assumption that the government's role in the economy is that of a guarantor of market rules. Indeed, the British government adopted a recapitalization policy that relied on mechanisms such as the maximization of shareholder value, the restoration of transparency and the punishment of incompetent managers that are typical of market-based models of financial capitalism. The adoption of those mechanisms was, in turn, instrumental in forging domestic firms' support to the government plans. In Italy, in contrast, the government acted on the understanding of its role as that of a negotiator among economic actors. Hence, the government ultimately adopted a recapitalization policy that was not aimed at maximizing the returns on the government investment and that was not punitive for domestic bankers. These characteristics were crucial in assuring domestic banks' support to the government.

Bringing into relief the differences in national policy responses to external challenges, this article feeds into the scholarly debate on the process of convergence in economic policies under conditions of globalization (Cerny, 1995; Berger and Dore, 1996; Schmidt, 2002; Soederberg *et al*, 2005). In line with the comparative capitalisms (CC) approach to political economy (Deeg and Jackson, 2008), the article draws attention to the persistence of distinct national institutions and policy variations in spite of common challenges and pressures, such as the one represented by a financial crisis. Nevertheless, as discussed in the conclusions, the differences between the British and the Italian policies should not be overdrawn. Indeed, if we put those policies within the framework of the wide range of policy responses that followed the crisis, it is possible to identify the signs of mixed convergence among different models of capitalism rather than the continuities of contrasting varieties.

Before proceeding, three clarifications are in order. First, although this research builds on the insights of the literature on the varieties of capitalism, the focus is clearly shifted from firms' to governments' behaviour (Schmidt, 2007; Deeg and Jackson, 2008). Indeed, the goal of the article is to identify the influence of institutional financial configurations on the policies pursued by domestic governments rather than on the strategies that firms pursue because of the institutional configuration within which they operate (Hall and Soskice, 2001).

Second, the scope of this research is confined to one among the wide range of policies adopted during the crisis management efforts: the policy aimed at recapitalizing domestic banks. In doing that, the article focuses on the microeconomic policies adopted in response to the crisis, leaving aside the analysis of both monetary and fiscal policies that add to the armoury that national authorities used to stem the effects of the crisis.[3] Hence, the conclusions

reached in this article about the importance of the features of domestic financial systems in shaping the content of the policy response only apply to the realm of the recapitalization policies. I do not exclude that a similar logic was at play in the elaboration of other policies but such a claim requires further empirical investigation.

Finally, it could be argued that the conclusions drawn in the article are flawed by the comparison between the two case-studies. That is to say, it could be argued that the UK financial system was the most affected by the crisis because of its exposure to the sub-prime assets – in contrast to Italy where the financial system is far more conservative in its investment decisions. Nevertheless, although it is undeniable that the crisis hit the United Kingdom and Italy with different intensity, the validity of the comparison to the purposes of this study should not be underestimated. To start with, it certainly true that the crisis hit the United Kingdom the most and the most quickly – primarily because of the sub-prime linkages. But the crisis was a 'sub-prime' crisis only at the beginning. Indeed, the characteristic of the crisis was its spread from market to market and from country to country. When problems emerged in the specific category of US sub-prime assets, this triggered a process that ultimately led to a repricing of risk of several asset classes. Deleveraging took place across the board from the mortgage-related structured credit markets to the money markets and to emerging market assets. Hence, although the Italian financial system was less exposed to the toxic assets than its British counterpart, the need to recapitalize nonetheless emerged because of contagion effects, losses on assets other than the sub-prime, and the deterioration of the position of loan-holders in the real economy (Banca d'Italia, 2008, Ch. 15, 16). In sum, although we cannot refer to the subprime crisis as a 'single' crisis, the two countries faced challenges that forced them to adopt crisis management measures in order to maintain domestic financial stability.

Furthermore, even recognizing the different impact of the crisis in the two countries, such a difference cannot fully explain the variation in the policy outputs in the two case-studies. Indeed, positing the different impact of the crisis in the United Kingdom and Italy can help explain the motivations behind the decision to recapitalize but it cannot tell us about the 'settings' of the policy output (Hall, 1993). That is to say, the different impact of the crisis can tell us that the United Kingdom reacted to the crisis to avoid bankruptcies whereas Italy acted in prevention of bankruptcies and risks to the real economy (Quaglia, 2009). But how the policy was carried out, its technicalities, cannot be explained. Indeed, as Daugbjerg (1997) has noted, policy outputs differ not only in terms of goals or means but also in terms of practical aspects (see also Howlett and Ramesh, 2002).

The article is organized as follows. The second section shows how different theoretical frameworks fare in explaining British and Italian recapitalization

policies and develop the argument advanced in this study. The subsequent empirical sections show how the organization of domestic financial markets shaped the type of recapitalization that each government pursued. The last section concludes.

What Recapitalization? Governments and Crisis Management

Starting in August 2007, the world has experienced one of the most severe financial crises in decades mainly because of risky lending decisions undertaken by the private sector in the industrialized world. Indeed, in the run-up to the crisis, low nominal interest rates and ample liquidity encouraged many investors, especially major banks, to take on significant risky assets such as securities backed by sub-prime mortgages. The growing prices of real estate and the increasing recourse to loan securitization, then, induced private investors to lull into the complacent belief that booming profits will last indefinitely.[4]

By the end of 2007, however, an increasing number of loan delinquencies abruptly interrupted the earlier positive financial outlook. Banks found themselves with their balance sheet severely deteriorated and scrambled for liquidity to face outstanding obligations. In this atmosphere, financial confidence deteriorated leading the inter-bank market to a halt. In other words, banks became unwilling to lend to each other without knowing the true state of the counterparty's credit portfolio. As a result, bank funding became scarce and expensive, raising the probability of large-scale defaults. In a vicious circle, the growing price of funding and falling house prices made it difficult for loan holders to repay their debt thereby augmenting the rate of delinquencies. Companies also suffered from the credit crunch as banks withdrew or rescheduled outstanding loans. Still, many companies that borrow directly on wholesale markets by selling bonds and other securities found it much harder and more expensive to raise money.

In this atmosphere, banks' stocks around the globe tumbled to historic lows and mounting losses on both financial assets and loan portfolios threatened the normal operations of many financial institutions. Nowhere is the crisis so emblematic as in the reshape of Wall Street. Indeed, at the end of 2008, some icons of investment banking, such as Bear Stearns and Lehman Brothers, did no longer exist; Merrill Lynch was sold to Bank of America; and the two remaining investment banks, Morgan Stanley and Goldman Sachs, were transformed into deposit-taking institutions eliminating the traditional difference between commercial and investment banks. Although triggered in the US sub-prime market, by September 2008, after the bankruptcy of Lehman Brothers, the crisis turned into a global crisis. In particular, financial institutions across Europe experienced severe difficulty.

In response to the quick deterioration in the financial markets, virtually all governments of advanced economies adopted policies that aimed at boosting confidence and restarting interbank lending. In this connection, bank recapitalization, along with the provision of liquidity and bank deposit guarantees, became a critical measure.[5] Indeed, by injecting public funds into banks that were no longer able to raise sufficient private capital or that were forced to cut-back their operations to serve outstanding obligations, governments attempted to halt panic and avoid the adverse feedback loop with the real economy.

Two explanations may be of help to explain governments' recapitalization policies: the partisan politics and the regulatory competition explanation. According to the partisan explanation, public policy in democratic states can largely be explained by party composition of government (Tufte, 1978; Schmidt, 1996). Several empirical studies have thereby shown how differences between right and left party governments affect policy outcomes in different issue areas.[6] In general, studies that draw on the partisan theory tradition have found that centre-right and conservative governments tend to adopt less interventionist policies in the economy than left and social democratic governments do. Furthermore, scholars that draw on the partisan politics tradition argue that the pattern of public policy associated with party composition of government persists under conditions of globalization. Geoffrey Garrett (1998), for instance, has argued that global economic integration has not weakened support for leftist governments, thereby explaining enduring cross-national differences in domestic economic management.

When applied to the case under investigation, the partisan politics explanation seems to have significant explanatory value. Indeed, the Italian centre-right government adopted a recapitalization policy that was more market-friendly than the policy adopted by the UK labour government since it did not entail direct government participation into the banks' ownership structure. A closer inspection, however, reveals how the partisan politics explanation cannot fully account for the policy variation between the British and the Italian recapitalization policy.

To start with, partisan influence on public policy may be limited by state structures. That is to say, party influence is stronger in majoritarian democracies whereas partisan effects are less influential in consensus democracy – as several scholars working within the partisan theory tradition have themselves conceded (Schmidt, 1996). Therefore, the partisan effects can be relevant for the British democracy but they may be negligible when applied to a democracy such as the one represented by Italy (see, for instance, Della Sala, 2004). Furthermore, it has been found that partisan influence on public policy is lesser than it is conventionally assumed even in majoritarian democracy, including the United Kingdom (Rose, 1984). Moving to the empirical findings presented in this article, partisan theory also sits uncomfortably with the fact that both

the British and the Italian governments decided to recapitalize domestic banks in spite of the difference in the party composition of governments. In other words, the same fact that the two governments pursued the same policy, although with different modalities, represent an anomaly for partisan theory whereas it expects that left and centre-right parties have different proclivities and constituencies and thereby adopt different types of policies.

If the partisan politics explanation has difficulty explaining the similarities across the two countries, the regulatory competition explanation presents a mirror image problem because it sits uncomfortably with explaining differences accurately. According to the regulatory competition argument, the driver behind public policies lies in the external constraints within which the government operates. Specifically, under conditions of capital mobility, governments follow policies favourable to markets. Given these assumptions, a regulatory competition explanation predicts a world in which governments converge on a limited number of policies – be they policies that upgrade (Vogel, 1995) or relax (Streeck, 1996, 1997) existing legislation in a given area of the political economy. Applying this hypothesis here, we can explain British and Italian recapitalization policies as the result of market pressures. To preserve the competitive position of the domestic financial industry, both governments adopted measures to increase banks' capital ratios thereby maintaining banks' appeal to international investors.

However, this explanation overlooks the fact that recapitalization can take place through different paths such as the use of equity or debt acquisition, as attested by the different recapitalization plans adopted in Britain and in Italy. The fact that different countries pursued different recapitalization policies under the same economic pressures is therefore a puzzle for the regulatory competition explanation to solve. Even assuming that market pressures were different in the United Kingdom and Italy, thereby leading to different policy responses, the regulatory competition explanation cannot accurately explain how the external shock translated into actual policy outputs (Hay, 1999; Blyth, 2002; Widmaier *et al*, 2007). Hence, this explanation needs to rely on some other factors to account for the apparent anomaly of the difference among national policies. In other words, the regulatory competition explanation is well placed to identify the general policy direction that governments have to take under conditions of globalization but is indeterminate about what specific policy output governments will choose within the parameters set by the external constraints.

Building on these observations, this article expands on the regulatory competition explanation suggesting that factors other than market pressures must be brought into the picture for a complete analysis. In particular, building on the insights of a strand of scholarship that emphasizes the importance of different political-economic institutions in comparative public policy analysis

(Hall, 1986; Steinmo *et al*, 1992; Thelen, 1999; Steinmo, 2003), the argument advanced in this article is that, within the constraints of external market pressures, the organization of domestic financial markets is of great importance in explaining the type of recapitalization policy adopted in Britain and Italy.

Borrowing from the comparative political economy literature (Zysman, 1983; Deeg, 1999; Vitols, 2004), I identify two types of financial system organizations: the capital-market-based and the bank-based system. It is commonplace to distinguish between the two systems based on the terms on which financing is made available to firms. In the market-based system, often associated with the LME among which the United Kingdom is the emblematic case, markets play the primary role in allocating capital among firms based on publicly available information. Market mechanisms, such as the maximization of shareholders' value, guide the process of capital allocation over time. In the bank-based system, often associated with CMEs among which Italy can be included, the terms on which financing is made available to business are primarily governed by banks and are not entirely dependent on public financial information. Information problems are overcome by building long-standing relationships with domestic firms.[7]

The market-based and the bank-based financial systems also differ in another important respect: the role of governments in the process of economic adjustment.[8] In the market-based system, adjustment to economic changes is generally viewed as company-led. 'Firms mergers and take-overs are common adjustment mechanisms facilitated by equity markets' (Deeg, 1999, p. 12). Hence, the primary function of government is that of ensuring the smooth functioning of markets by presiding over transparency of information and competition. In other words, governments tend to augment the function of market mechanisms. In the bank-based model, in contrast, the role of the government in the economy is that of a negotiator. Governments tend to intervene into the markets to protect domestic actors from economic disturbances and to coordinate the process of adjustment. Adjustment thereby takes place by political bargaining rather than by recourse to market mechanisms.

This essay suggests that the type of financial system helped forge distinct types of recapitalization policies in the United Kingdom and in Italy by shaping governments' understanding of their role in the economy and firms' support to governments' policies. As the empirical analysis is going to show, although it was the British government and not British firms that led the process of adjustment in the country, the government did so by adopting measures that relied on market mechanisms. For instance, the government adopted recapitalization policies that followed the path of equity acquisition and aimed at restoring transparency and at punishing incompetent bankers. At

the same time, the government acted as a shareholder that wants to maximize its equity investment thereby stimulating competition among financial firms. In Italy, in contrast, the government adopted a recapitalization plan based on debt acquisition that relied on non-market mechanisms to adjust the economy to the financial shock. For instance, the Italian government recapitalized banks by providing credit independently from its return and did not set the mechanisms to punish managers responsible for risky lending decisions.

Domestic banks, in turn, supported or opposed government policies based on whether those policies incorporated the adjustment mechanisms that are typical of the domestic financial system within which banks operate.[9] In this connection, British banks did not oppose the content of government's recapitalization plan because it followed market mechanisms of economic adjustment, such as the restoration of transparency and competition. In Italy, banks initially opposed the government plan when it seemed that it was moulded upon the UK plan and thereby on market mechanisms. Banks became supportive when the government decidedly opted for a recapitalization plan based on debt acquisition and coordination as the following sections are going to show.

A Market-based Output: the British Recapitalization Policy

The United Kingdom well represents the type of market-oriented model of financial capitalism, wherein markets drive the process of capital allocation and economic adjustment. The role of government, in turn, is that of ensuring competition and transparency. Over time, these characteristics have certainly contributed in making the United Kingdom the leading financial centre in the world.[10] In particular, the financial services industry is primarily centred in the City of London's 'Square Mile' where more than 550 international banks and 170 global securities houses have set up their offices.[11] By the early 1990s, London was already a major centre for cross-border bank lending, international fund management, foreign equity trading and customized and over-the-counter derivatives. Today, its foreign exchange market is the largest in the world, with an average daily turnover of $504 billion, more than the New York and Tokyo combined.

Since the early 1980s, the UK economy has been transformed by increased specialization in international financial functions. On the one hand, the British banking system underwent a process of consolidations and mergers in retail banking. On the other, confronted with the opportunities offered by the integration of financial markets, British banks have decidedly diversified their activities on a global scale and have specialized in investment banking and asset management. In particular, after the 1986 deregulation of securities market

or the ‘Big Bang’, the biggest British banks, such as Barclays, National Westminster, Midland and Lloyds, have restructured their activities from deposit-taking to what was the most profitable activity of asset management and investment banking services. At the end of the 1990s, there were already 300 000 jobs in financial services accounting for 8.4 per cent of total jobs in London and for almost 30 per cent of all financial services employment in the United Kingdom.[12]

The United Kingdom was one of the first countries to suffer from the US contagion and one of the most severely affected, mainly because of the exposure of its domestic financial system to the US market and to the toxic sub-prime assets. The high level of indebtedness of British households as compared to other EU countries was a further factor that contributed to the magnitude of the crisis in Britain. By the late 2007, the rate of growth of the Halifax index, which traces house prices in the country, turned negative for the first time after many years of steady growth.[13] At the same time, domestic banks came under significant market pressures. The situation was aggravated by the run on Northern Rock in February following rumours that the bank was about to collapse. After several attempts, the government eventually decided to nationalize the bank in order to restore both markets and depositors’ confidence.

In fall, however, market conditions severely deteriorated in the United States and across Europe following the bankruptcy of Lehman Brothers; and the United Kingdom was drawn into the storm. In an attempt to calm markets, on 18 September, HBOS, a main mortgage lender for residential loans, whose crisis has been determined by its excessive exposure to the real estate market, announced its merger with Lloyds TSB with a financial operation of £12.2 billion. At the end of September 2008, Bradford & Bingley (B&B) was nationalized and its retail deposits were sold to Spain’s Banco Santander. In the meanwhile, macroeconomic data signalled a worse-than-expected economy contraction pushing the pound down to alarming levels. The other listed British banks all suffered severe sell-off. In particular, the shares of Royal Bank of Scotland that used to be Britain’s second-largest bank, and HBOS, a big mortgage lender, tumbled by around 40 per cent.

As this brief overview of the crisis has already revealed, national authorities heavily intervened in the domestic financial system to stem the effects of the crisis. The decision to nationalize Northern Rock and Bradford & Bingley via equity transfer marked the first time since 1984 that the government had taken control of a bank. What this story also tells us is that market pressures in the United Kingdom forced the government to devise measures in reaction to the crisis, that is, to avoid bankruptcies. Nevertheless, in order to understand how the government opted for a specific course of recapitalization, the government’s reaction must be analysed within the organization of the domestic financial system.

The core of the government response was the legislation issued in early October: the Credit Guarantee Scheme. As several of the crisis management policies adopted in the fall of 2008, the UK Scheme had a threefold objective: to protect depositors, to inject liquidity and to raise banks' capital ratios. In this connection, the legislation lifted from £35 000 to £50 000 the limit of retail deposits protected by the government at any one banking group. Still, the Treasury further committed to guarantee new short- and medium-term debt issued by banks for periods of up to three years. Finally, and most important to the purposes of this study, the Credit Guarantee Scheme addressed the issue of recapitalization of domestic banks. Indeed, the Treasury set up a fund of £50 billion that would have been used to raise British banks' capital ratios. Government injection would have taken place in exchange for common and non-voting preference shares or for permanent interest bearing shares.

Although the British prime minister was quick in announcing that nationalization was meant to be temporary only,[14] government direct intervention in the economy, coupled with similar measures in the United States, sparked a significant debate about the end of the Anglo-Saxon model of capitalism (Buiter, 2008; *The Economist*, 2008). Although it is still too soon to know in what direction capitalism will evolve as a result of the latest crisis, the recapitalization policy adopted in the United Kingdom speaks to the current debate because it shows some important continuities rather than discontinuities with the model of market-based financial capitalism. In particular, the recapitalization plan imposed by the government on to the domestic financial system reveals how the British government relied on market mechanisms to restore stability. Several aspects of the adopted legislation as well as the pronouncements of government officials help illustrate government attempts to use market mechanisms to recapitalize domestic firms.

To start with, although the British recapitalization policy offered public money to private financial firms, it did so on a commercial basis. In other words, the government acted as a true shareholder that seeks to maximize the shareholder value of its investment. In return for government support, for instance, banks were required to issue shares with a return for the government of 12 per cent per year. Still, a new government agency, the UK Financial Investments (UKFI), was set up to manage the government shareholdings. Maximization of shareholder value and competition provided the justification for the creation of the UKFI which, according to the Treasury, will have the primary task of 'creat[ing] value for the taxpayer as shareholder', and 'acting in a way that promotes competition'.[15] That the government preferred to use market mechanisms for clearing up the financial mess had already been clear in February, in the event of the nationalization of Northern Rock. In that occasion, the government refused two bids from private companies because they did not ensure that taxpayer loans extended to the struggling bank would

be repaid quickly and sufficiently enough. As Alistair Darling, Chancellor of the Exchequer, commented, 'in the current market conditions, we do not believe that the two proposals deliver sufficient value-for-money for the taxpayer'.[16]

Maximization of shareholder value and transparency, two key features of the market-based model of financial capitalism, thereby inspired government policies. As the Treasury Ministry (2008) explains, 'transparent arrangements will be put in place to ensure that any role for the government in relation to investment decision-making is clearly defined'. Similarly, emphasizing government intention to act respecting market rules despite the partial state ownership, Alistair Darling noted that the banks 'will be run on an arms' length basis away from government', further stressing that 'Ministers will not be taking day to day decisions'.[17]

As a further reflection of British government's attempt to impose a market-led adjustment, the Credit Guarantee Scheme entailed precise conditions for the recipient bank that, as markets would have asked, were punitive for their managers. In particular, the plan provided that banks should limit bonuses and executives pay and should keep the loans flowing to homeowners and small businesses. Furthermore, tough conditions were imposed upon the banks that accepted government help. Royal Bank of Scotland, Lloyds TSB and HBOS, for instance, were prevented from paying dividends on ordinary shares until they have repaid in full a total of £9 billion in preference shares they were issued to the government. Still, in return for government support, RBS, Lloyds and HBOS were submitted to new controls. Specifically, the Treasury were to appoint three new RBS directors and two directors to the board of the combined Lloyds-HBOS. The government also specified that in selecting the new directors it would look for people with a commercial, rather than a civil service, background, thereby signalling its intention to use market actors along with market mechanisms to manage the crisis. As the Chancellor observed 'my clear intention is to put people on the board who understand the business'.[18]

Although the conditions imposed on banks were tough, the fact that government acted on a market basis to manage the crisis proved essential in making the deal politically acceptable to domestic banks. Indeed, there was virtually no opposition to the plan while all major UK banks confirmed their participation to the government-supported recapitalization scheme. Sir Tom McKillop, RBS's chairman, for instance, admitted to 'regret having to raise capital but believe that decisive action is necessary in this unprecedented market environment'.[19] RBS, Lloyds TSB and HBOS also agreed to scrap their dividend payments on ordinary shares as part of the government plan and accepted the departure of the chief executives and top officials.[20] Furthermore, even the British banks that refused to accept the government's financial support did so not because they contested the details of the recapitalization plan but because they thought they could still raise the funds in the markets.

For instance, Barclays declined to participate in the government-sponsored recapitalization plan because 'the bank … could get a higher return on investment without government assistance', as Chairman Marcus Angius remarked.[21] In other words, the appropriateness of the government plan was not at stake. Rather, in the words of Barclays Chief Executive John Varley, 'the package addresses the most significant issues in the market'.[22]

In sum, as a result of the recapitalization policy adopted to confront the 2007-2008 financial crisis, the British government now controls outright two banks, Northern Rock, Bradford & Bingley and it owns around 68 per cent stake in Royal Bank of Scotland. The government also owns 43 per cent of the combined Lloyds TSB/HBOS. Although this policy seems to run counter the traditional model of the Anglo-Saxon capitalism, the scope of the British recapitalization policy can nonetheless be explained by reference to the features of the country's market-based financial capitalism. In particular, the organization of the UK financial system influenced government understanding about its role in the economy. As a result, the government confronted the crisis adjusting the financial system by using market mechanisms, in contrast to what happened in Italy.

A Bank-based Output: the Italian Recapitalization Policy

If the United Kingdom embodies the ideal type of the market-oriented model of financial capitalism, Italy is a good example of the bank-based model of capitalism wherein bank intermediation and government's intervention play a central role in the functioning of the economy. In Italy, the presence of government in the economy has been historically exerted in both the industrial and the financial sector through the creation of government-controlled companies (Padoa Schioppa Kostoris, 1996). As far as concerns the financial sector, until the beginning of the 1990s, the Italian banking system was characterized by the presence of four bank categories: government agencies and Banche del Monte, savings banks, credit societies and cooperatives, and commercial banks. Among the latter, there were the so-called banks-of-national-interest (BIN): Banca Commerciale, Credito Italiano e Banco di Roma. These banks were almost totally owned by the government via the Institute for Industrial Reconstruction (IRI), which was a sort of government's financial holding (Caparvi, 2006, p. 22).[23]

Starting in 1992, following a period of political and economic turmoil, successive Italian governments launched a massive economy plan that, together with budgetary cuts aimed at curbing public debt, contemplated a profound privatization programme. In particular, steps were taken towards privatizing government holdings in sector as diverse as energy, food and insurance. The

same measures were adopted to reduce government's presence in the banking system. As a result, Banco di Roma was merged into the Banca di Roma in 1992, and Banca Commerciale and Credito Italiano were privatized in 1994 and 1993, respectively.

Despite the opposition of powerful economic groups,[24] several changes took place in the domestic financial system during the 1990s. In particular, following the conversion of the banking industry to the model of corporate entities listed on the stock exchange, a process of consolidation and concentration contributed to the emergence of few banking groups (Drummond *et al*, 2007). The two biggest groups are Unicredit and Intesa-San Paolo. Unicredit, which was born by the combination of nine Italian banks, is the first Italian bank in terms of market capitalization and international scope because of its acquisitions in Germany, Austria, and Central and Eastern Europe (CEE).[25] Intesa-San Paolo is the leading deposit-taking institution in the country, although it also has an important investment-banking branch. The other main banking groups include Mediobanca, Monte dei Paschi, UBI and Banco Popolare.

The major changes in the banking landscape notwithstanding, some of the core features of the Italian financial capitalism have remained firmly in place. For instance, there are still close ties between bank managers and political elites and, as it happens in most CMEs, the terms on which financing is made available to business are based on information that are not always publicly available.[26] Considering that Italy is also a country where bank lending is the main and often the only form of financing for all except the very biggest companies, the role of banks in the production regime of the country appears as the most important.

The characteristics of Italian banks – their conservative lending strategies and their limited exposure to international assets as compared to British banks – have in certain sense helped the country not to be devastated by the toxic mortgage-backed securities that triggered the crisis. Nevertheless, the crisis hard hit Italy too. In particular, after the collapse of Lehman Brothers, publicly listed banks severely suffered from the deterioration of confidence that was spreading from markets to markets. At beginning of October 2008, for instance, UniCredit's share price was battered by massive selling leading its share price to collapse 60 per cent of its value since January and forcing the bank to sell its real estate assets to bolster its capital base. Not only did the crisis hit the most internationalized among the Italian banks. The other big domestic groups also suffered from similar massive sell-off. In an effort to calm the markets, Intesa-San Paolo even announced to stop paying dividends to its shareholders to retain capital. The situation was then aggravated by the deterioration of the loans that the Italian banks had extended to the economies in CEE, where the crisis put at risk the solvency of debtors.[27] As a result,

during the first three quarters of 2008, 'Italian banks, in particular the biggest banks, faced difficulties in raising funding in international markets' (Banca d'Italia, 2009, p. 201).

As parliaments across the EU approved measures to rescue weakened banking institutions so Italy did by developing its recapitalization policy. While this policy was probably elaborated more in prevention than in reaction to potential bankruptcies and to prevent spill-over effects to the real economy, the form that the recapitalization policy took in Italy requires an understanding of the organization of the domestic financial system within which the government operates.

In early October, the government, which had been elected just five months before, adopted two decrees that, according to the Treasury Minister Giulio Tremonti (2008), had 'three fundamental objectives': restoring trust among savers, providing liquidity for the economy and ensuring stability of the banking system. Accordingly, the legislation identified three areas of intervention. First, the government pledged to guarantee deposits up to €103 000, giving government backing to what was previously a private guarantee by banks. Second, the Treasury committed to provide liquidity to domestic banks in coordination with the Bank of Italy by swapping government bonds with other banks' owned assets. Finally, and particularly important to the purposes of this study, the government adopted emergency measures to recapitalize domestic banks. In particular, the proposed legislation would have allowed the government to take a stake in domestic banks, via the purchase of preference shares. In other words, similarly to the content of the British recapitalization policy, the Italian government was set to become a shareholder in domestic banks.

Although it was partly modelled on the measures adopted in the United Kingdom and on proposals agreed by EU finance ministers, the Italian recapitalization policy is nonetheless distinctive in some crucial respects that reflect the characteristics of the country's model of financial capitalism. Specifically, the proposed recapitalization policy relied on non-market mechanisms to respond to the crisis.

To start with, the October legislation did not set up a predetermined amount for the banks' bail-out. In other words, the rescue plan did not set up a UK-style fund mainly because the government repeatedly and publicly stressed that there was no real intention of a direct intervention in the ownership of domestic banks. As Tremonti coincisely put it in front of the Senate finance commission, 'governments are governments whereas banks are banks'.[28] That is to say, 'capital injected into the banks won't be the type of capital active in the management of the bank. Rather, it will be a capital that will exhaust its role in the form of preference shares, that is to say, shares that do not contemplate the possibility for the government to directly act within the bank'

(Tremonti, 2008). As the Prime Minister Silvio Berlusconi further explained the logic that underlined the proposed recapitalization plan, 'if the banks will ask it, government is ready to support them' (*Il Sole 24 ore*, 2008a). In other words, the government did not mean to impose adjustment on domestic banks but to coordinate with them the way towards the restoration of functioning capital and credit markets.

Furthermore, in contrast to the British recapitalization plan, the Italian legislation did not contemplate punitive measures for the CEOs of domestic banks in need of recapitalization – in contrast to the stance held by the Bank of Italy that issued recommendations to limit bankers' bonuses later in June 2009 (Livini, 2009, also, Banca d'Italia, 2008). Rather, in an attempt to reassure domestic banks, the Prime Minister Silvio Berlusconi explained that government intervention would have taken place 'without the imposition of punitive conditions for managers and shareholders' (*Il Sole 24 ore*, 2008a).

Although the government made clear to have no intention of participating to the ownership of domestic banks, the provision that recapitalization should take place via government purchase of preference shares triggered the opposition of domestic banks. That is to say, the fact that the Italian government had suggested the use of a market-based mechanism was not in line with domestic banks' expectations. On 22 October, for instance, after a meeting of the Italian Association of Bankers, several banks' representatives publicly refused the government support. 'We think we have an adequate capital base', so commented Corrado Passera, CEO of Intesa San Paolo, the second biggest Italian bank. Along similar lines, Emilio Zanetti, President of UBI Banca, emphasized that its bank was in no need of public money.[29] Interestingly, however, this stance was about to be reversed by some changes in the government policy.

Indeed, in an attempt to acquiesce to banks' concerns and thereby to coordinate with them the process of adjustment, the government started discussing the revision of the proposed recapitalization policy. According to the rumours leaked to the press, by the end of October, government was considering the option 'to underwrite perpetual subordinated banks' bonds and other hybrid instruments in order to attain 'soft' recapitalization, that is, without recourse to intervention by acquiring shares that are 'intrusive and dilutive' of capital' (Bufacchi, 2008).

By the end of November, the government approved a new set of measures to recapitalize the domestic financial system. Specifically, the government decided to underwrite financial instruments different from equity that nonetheless contribute to raise capital adequacy ratios. In other words, even the minor proposal of recapitalization through a quasi-market mechanism, such as shares acquisition contained in the October legislation, was not included in the ultimate version of the law.

As had been the case with the October plan, the new recapitalization policy reflected the features of the Italian financial system and, in particular, the role of the government in the process of adjustment. For instance, the new policy did not specify the returns that the Italian government expected to obtain from the recapitalization of banks via bonds acquisition as much as in the same manner of the October decree. In contrast to the British plan, the government did not set the yields that banks were requested to pay in exchange for government support and left to banks the decision on how and when redeem the investment. Furthermore, the new policy did not contain any strict conditions for domestic managers except for the adoption of an ethics code. Conceived in these terms, the revised recapitalization plan found the support of the domestic financial industry. As the President of the Italian Association of Bankers Corrado Faissola summarized the shift from opposition to support, 'it is doubtless that the government plan … is useful', adding that 'Italian banks are going to take advantage of government's help' (*Il Sole 24 ore*, 2008b).

Conclusions

At the end of 2008, in response to the deterioration of the sub-prime crisis, both the British and the Italian governments adopted measures to strengthen the capital base of domestic banks. Despite the similarities, however, important differences exist between the recapitalization policies adopted in the two countries. One of the main differences concerns the modality through which government support was provided. For instance, the British government opted for a direct intervention by using equity capital and setting transparency and compensation requirements for the failing banks. The Italian government, in contrast, opted for indirect intervention by acquiring banks' debt and by avoiding to interfere in the internal management of domestic banks. The aim of this article has been to investigate such a variation in the policy output of governments' recapitalization policies.

Specifically, the article found that the form that recapitalization took in the two countries was shaped by distinctive national models of financial capitalism. Those models shaped both governments' understanding of their role in the economy and the support of domestic firms to government policies. Thus, the British government shaped a recapitalization policy that relied on market mechanisms to adjust the domestic financial system to the shock caused by the global crisis. The Italian government, in contrast, developed a policy conducive to the bank-based model of financial capitalism where government intervenes to help domestic economic actors to adjust to an economic shock without necessarily relying on market mechanisms.

Although the difference between the British and the Italian case is significant, it should not be exaggerated. Indeed, such a difference helps shed light on an understudied aspect of the policy process, that is, the policy designs that are actually implemented, and represents an argument in favour of the continuing importance of the role of national institutions in spite conditions of globalization. In particular, the findings of this article provide evidence that runs counter to the argument positing a progressive erosion of the government's economic management capacities (Strange, 1996; Falk, 1997). As the empirical analysis has shown, the process of adjustment to the financial shock was driven by the government and not by the markets even in an LME such as the United Kingdom.

Nevertheless, the difference revealed in this article must be read within the wide range of responses that followed the sub-prime crisis. In the two countries, and in virtually all the most advanced economies, the response to the crisis has fallen within a range of mixed crisis responses that include both market-strengthening and market-weakening dimensions that can be found in liberal and coordinated market economies respectively. For instance, the British recapitalization plan was more based on market-strengthening mechanisms than the Italian was. If we move beyond the limited comparative perspective, however, the market-strengthening mechanisms evidenced in the UK recapitalization plan give way to other mechanisms in the overall response to the crisis. Indeed, the United Kingdom, as several other countries, adopted a number of policies where market and non-market mechanisms coexist. The fact that the head of the Financial Services Authority has recently called for cutting down the financial sector to size using non-market mechanisms such as a tax on financial transactions is just one of the latest examples of the blending of policy mechanisms that have been adopted in a LME. This is even more evident if we expand the focus of the analysis so to include the other advanced economies. The United States offers a good illustration here. Indeed, US policymakers have been experimenting with both marketizing regulations and more clientelist or CME-type bailouts for the private sector. At the same time, they have opted for friendly workout alongside new regulatory powers to control and take over systemically important banks.[30]

Bringing to the surface the differences but also the similarities between the British and the Italian response to the crisis, the article has thereby tapped into the scholarly debate on policy convergence under conditions of financial integration, as exemplified by the spread of the sub-prime crisis. That is to say, the article raises the question of whether national diversities are likely to endure or to disappear as a result of common economic and financial challenges. In this connection, what this article has argued and illustrated is that important continuities persist at a lower level of analysis – that is, the analysis of the factors that shape the form that specific policies take.

Nevertheless, at the macro-level, there are important signs of a process of mixed convergence in national practices and institutions that require our attention and further empirical investigation.

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About the author

Manuela Moschella teaches Comparative Politics at the University of Bolzen, Italy. She holds a Doctorate in International Studies from Trento University and an MA in Banking and Finance from the Institute on Banking Studies in Lucca. Her research work has focused on the regulation of international finance through the activities of international organizations and on the relationship between economic ideas and policy-making. Further research has concentrated on financial regulation in cross-countries comparison.

Notes

1 For instance, presenting the EU regional economic outlook, the director of the IMF's European department commented that EU crisis measures 'have been unhelpfully diverse'. As reported in Daneshkhu *et al* (2009).

2 The Italian model of capitalism has been classified under different types. See, for instance, Thelen (2001); Schmidt (2002); Molina and Rhodes (2007); Rhodes and van Apeldoorn. (1998).

3 For an overview of the wide range of policies adopted to confront the crisis in the European Union, see Quaglia *et al* (2009).

4 For a more detailed and accurate account on the causes of the crisis and its development see, for instance, Kodres (2008) and Blundell-Wignall *et al* (2008).

5 In this list of crisis management responses, I do not include interest rates moves because rate cuts fall within the responsibility of independent central banks and not within government responsibility. Anyway, it is worth noting that both the Bank of England and the European Central Bank cut rates aggressively as the crisis deepened in the fall of 2008.

6 In macroeconomic management, for instance, scholars have shown that left parties governments tend to implement a low unemployment-high inflation set of policies whereas a high unemployment-low inflation set is frequent in political systems dominated by centre and rightist parties (Hibbs, 1977).

7 It remains an open issue whether the establishment of long-term relationships between financial intermediaries and their clients represents an advantage of bank-based systems over market-based systems in promoting long-term economic growth (Allen and Gale, 2000).

8 Vivien Schmidt (2002), for instance, identifies three ideal-typical patterns of state economy policy in Europe: the 'liberal state' giving large autonomy to economic actors (in the United

Kingdom), the 'enabling state' encouraging associational governance among private actors (in Germany), and the 'interventionist state' directly intervening to coordinate private activity (in France).

9 The organization of domestic financial system is thereby here conceived as an institution 'that shape[s] how political actors define their interests and … structure[s] their relationships of power to other groups' (Steinmo *et al*, 1992, p. 2).

10 According to the Global Financial Centres Index (GFCI) produced by the Z/Yen Group for the City of London, in September 2008 London was still ranked at the top among 59 financial centres. City of London Corporation, 'The Global Financial Centres Index (GFCI) September 2008.

11 By contrast Frankfurt has around 280, Paris 270 and New York 250. Data are drawn from the official website of the Mayor of London. Available at http://www.london.gov.uk/london-life/business-and-jobs/financial-centre.jsp.

12 City of London Corporation 'Report London New York Study: the economies of two great cities at the millennium', June 2000.

13 At the end of December, the UK average house price has returned to the level in August 2004.

14 As reported in Larsen (2008).

15 UK Treasury webpage, UK Financial Investments Limited (UKFI), available at http://www.hm-treasury.gov.uk/uk_financial_investments_limited.htm, accessed 7 January 2009.

16 As reported by Laurent (2008). See also Vina and Morris (2008).

17 As reported in Eaglesham and Pickard (2008). On the 'arms'-length' relationship between governments and the markets as one of the distinctive features of the Anglo-American model of capitalism, see Zysman (1983).

18 As reported in Eaglesham and Pickard (2008).

19 As reported by Larsen (2008).

20 For instance, RBS confirmed the departure of Sir Fred Goodwin as chief executive. Sir Tom McKillop, RBS's chairman also stepped down.

21 As reported in Landon (2008).

22 As reported in Laurent (2008).

23 IRI was created in 1933 in response to the 1929 financial crisis in order to support the domestic battered industrial sector. In 1939, IRI became the repository of all government's industrial and financial equity investments.

24 For an account of how Mediobanca, the biggest investment bank in the country, and other corporate groups opposed a British-style privatization plan in Italy, see Friedman (1996).

25 The data on market capitalization refer to the end of 2007.

26 For instance, in the recent debacle about Alitalia's rescue, Intesa-San Paolo worked in close collaboration with the government to strike a take-over deal of the national airline by a consortium of Italian industrialists.

27 For an assessment of the potential losses that Italian banks faced in the CEE countries, see Danske Bank projections as reported in Lemer *et al* (2009).

28 As reported in Bozzo (2008).

29 As reported in *Corriere della Sera* (2008) and *Repubblica* (2008).

30 I am indebted to one of the anonymous referees for having drawn my attention to this case.

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