In defence of Anglo-Saxon capitalism

by Charles Grant, 29 September 2008

Those who never liked 'Anglo-Saxon' capitalism are feeling smug. Marxists, fans of 'Rhineland' capitalism and those who simply cannot stand American power are crowing. "The US will lose its status as the superpower of the world financial system," says Peer Steinbruck, Germany's finance minister. "Self-regulation is finished, laisser faire is finished, the idea of an all powerful market which is always right is finished," says France's president, Nicolas Sarkozy. The British academic (and sometime fan of Margaret Thatcher) John Gray proclaims that "in a change as far-reaching in its implications as the fall of the Soviet Union, an entire model of the government and the economy has collapsed."

All this hyperbolic froth and windy rhetoric conceals a real danger for the European economy. The perceived failure of one model of capitalism, combined with growing protectionist pressure from all continents, could push EU governments to ban or discourage a whole range of 'Anglo-Saxon' practices and institutions. Cross-border takeovers and equity issues, the private equity and hedge fund industries, and even privatisations - all of which can help to make economies more efficient - may come under threat. Furthermore, some governments may think that because the EU's 'Lisbon agenda' of economic reform is British-inspired, they can relax their efforts to carry out its painful but essential prescriptions.

Of course, the credit crisis has exposed huge weaknesses in the American and British financial systems. The so-called phantom banking industry of institutions and instruments that focused on fiendishly complex off-balance sheet financing was poorly regulated. Those in charge of many leading banks appear to have had no idea about the risks they were taking on. Their pay packages were ridiculous and unjustified, especially when those who had failed received tens of millions of dollars of 'compensation' for being fired. The property and credit booms in the US, the UK, Spain and Ireland were excessive. And the British decision to allow the building societies (mutuals) to turn themselves into banks - and their subsequent move into risky financial instruments and models of funding - may have been an error.

But politicians such as Steinbruck should not indulge in too much Schadenfreude. For the next few years, some of the core euroland economies may be lucky enough to escape some of the pain that will afflict the Anglo-Saxons. But the continental banks are certainly not immune from the crisis, as the rescue of the Dutch-Belgian Fortis shows. The capital ratios of some of the top continental banks are inferior to those of their American peers. And if a European bank involved in several members-states did head for the rocks, could the EU's ramshackle regulatory system - with national authorities holding many of the key powers - move as quickly as Treasury Secretary Hank Paulson, Federal Reserve Governor Ben Bernanke and the Congress have done?

Many of today's Cassandras mistakenly assume that financial crises are a uniquely Anglo-Saxon phenomenon. Very different sorts of financial system - such as those of Japan and Sweden in the early 1990s - have ended up being bailed out by governments. Financial crises are inherent in the nature of capitalism, rather than one particular brand of it.

However the current crisis turns out, many continental European governments will have to tackle serious structural flaws in their economies. They are held back by a lack of competition and restrictive practices in a host of sectors, especially services. Their universities cannot compete with the world's best. In many of these countries, old-fashioned trade unions block reform and modernisation (look at the pitiful saga of Alitalia). Excessive state aid distorts the allocation of capital and may deter new entrants. Over the past 20 years, France, Germany and Italy have performed poorly on economic growth and job creation. Europe as a whole has a poor record on innovation and the adoption of new technologies.

Among the EU-27, the UK has not been the star of the class. In recent years the Nordic economies and the Netherlands have had the best record of combining on the one hand high employment and active labour market policies, and on the other generous welfare and high-quality public services. But the UK has many strengths (as well as notable weaknesses like infrastructure). Its liberal labour markets have helped to push the employment rate above 70 per cent of the workforce - the only other EU countries above 70 per cent are Denmark, Sweden and the Netherlands. And of the EU's large economies Britain is the most open to foreign investment, which is one reason why it has a good record of adopting new technologies.

Moreover, the City of London remains a big British strength - despite everything that has happened. Much of what the City does is valuable not only to the UK, but also to Europe and indeed the world economy. If properly regulated, mergers and acquisitions, corporate advice, City law firms, hedge funds, private equity, the euromarkets, the fund managers, the Lloyds insurance market, the currency markets, the international equity markets, and much else, add value. The City is in for a lean few years, but it will come back - after some consolidation and regulatory reform - because the world needs a centre of expertise for international finance.

Nobody should write off the American economy. Compared to its European peers, its history of recovering rapidly from recession is impressive. Its track record on innovation and start-ups is the envy of the world. Where are the European Googles, Microsofts, Ciscos and Intels? The US has most of the world's best universities. It consistently out-performs the EU on productivity. Despite the rise of the BRIC economies, at market exchange rates the US will remain the world's leading economy for many decades. China's leaders know this very well and have not resorted to the kind of hubris that we have heard from certain continental politicians.

Some European leaders may view the Lisbon agenda of economic reform as 'Anglo-Saxon', but they should not abandon it. Parts of the agenda are rather Anglo-Saxon, such as the emphasis on creating employment, liberalising utilities and enhancing competition. But much of the agenda has a broader scope: boosting innovation, improving R&D, reforming pensions and helping start-ups. All the European economies need the Lisbon agenda, whether they are Anglo-Saxon, Rhineland, Nordic, East European or Mediterranean. At some point the financial turmoil will settle down. Then EU leaders will need to return to two key questions: why is the trend growth rate of the EU economy about one percentage point less than that of the US, and what can Europe do to catch up?

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