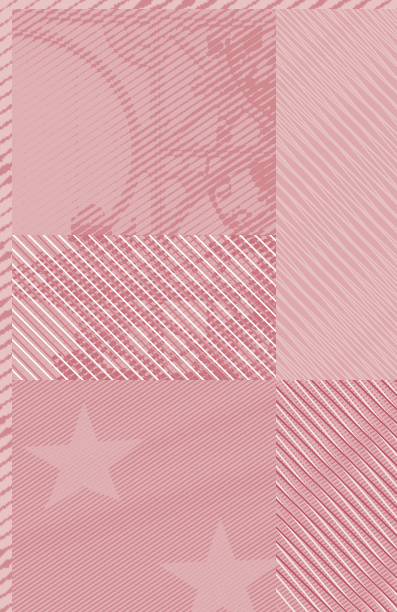


**BANCO DE ESPAÑA 4TH COMPETITION
FOR SCHOOLS** **2010**

**FINANCIAL STABILITY:
A CONCERN FOR ALL**

“Team II” from Secondary School
CAMILO JOSÉ CELA
POZUELO DE ALARCÓN, MADRID

BANCO DE **ESPAÑA**
Eurosistema



FINANCIAL STABILITY: A CONCERN FOR ALL

“Financial stability is essential for the correct functioning of the economy. It is one of the missions of the Banco de España, but one that should also involve other participants in the financial system: institutions and their managers, market players (individuals and firms) and consumers of financial products and services, among others.”

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WINNING ENTRY IN THE BANCO DE ESPAÑA VIRTUAL CLASSROOM 4TH
COMPETITION FOR SCHOOLS

FINANCIAL STABILITY: A CONCERN FOR ALL

"TEAM II" FROM CAMILO JOSÉ CELA SECONDARY SCHOOL
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[All the events and characters in this story are completely fictitious. Any resemblance to real events or persons is purely coincidental. Or is it?]

A long time off in the future, in a galaxy very, very close to home...

The economy of the universe was enjoying one of its longest growth periods ever. Unemployment was virtually non-existent, inflation appeared to be fully under control, interest rates were at their lowest level in living memory and everyone enjoyed easy access to credit to buy their first, second or third home. Many experts believed economic cycles were finally a thing of the past. This was, indeed, a brave new world.

But in the financial underworld something was stirring. Unnoticed, the scheming *Fiths* had designed and were implementing a devious plan that would financially destabilise the galaxy. Their aim was to achieve astronomical profits, but what they failed to realise was that the plan could place the economy of the entire universe, including themselves, in danger. And they would be no pushover, as in their ranks were warlords from the dark side of finance, such as *Darth Silverman* or *Fith Brehman*, who still held the trust of the governments of the Republic and the Confederation, on either side of the Nebulous Atlantic, unaware of their dark intentions.

However, one bright morning in September 3008...

The Supreme Financial Commander of the Confederation's Euron System, *Monsieur Chitret*, was in his office at Headquarters in the Euron Tower, happily reviewing the latest local inflation figures, when he suddenly received an intergalactic message. *Monsieur Chitret's* smile vanished instantly, for this was the dreaded Red Intercom, used only to guarantee safe, direct and immediate contact, in the event of a severe financial crisis, with the Financial Commander-in-Chief of the Republic's Dolario System. Concerned, *Monsieur Chitret* pressed the switch and a 3D holographic image of *Mr Branke*, the Financial Commander-in-Chief, materialised on his desk. With a sombre expression, the dolarian explained what was happening.

The *Fiths* had it all prepared down to the last detail, *Mr Branke* informed him with a heavy heart. For years they had been stealthily building up and distributing their primary level financial time bombs known as *subprimes*, flooding the dolarian mortgage market. They had then ingeniously combined them to build secondary level financial time bombs, the dreaded *CDOs (Collateralised Debt Obligations)*, and had secured maximum triple-A credit ratings for them from the Sidereal Financial Valuation Agencies, meaning they could be distributed easily throughout the universe. Lastly, to round off a brilliant exercise in deviousness, they had placed bets on the financial markets that the very securities they had created would depreciate in value, via the definitive financial time bomb, the dreaded *CDSs (Credit Default Swaps)*. So far, all this had provided them with astronomical profits. However, as they had ignored the most elementary principles of prudence and financial ethics, they had placed themselves in a highly vulnerable position in light of the oncoming financial tsunami. In fact the situation was so serious, went on *Mr Branke*, that *Fith Brehman* had collapsed and it was impossible to predict how the dark side of finance would react.

Monsieur Chitret and *Mr Branke* were both fully aware of the extreme gravity of the situation. The intergalactic financial system, including the *Fiths* themselves, was on the verge of col-

lapse! Disaster looked imminent! Without wasting a second, the two financial leaders outlined an emergency plan. A domino effect in the financial system, with institutions collapsing, dragging others down with them, was to be avoided at all cost. The extent of the crisis was enormous, though difficult to gauge accurately because the primary level time bombs – the *sub-primes* – were spread across such a wide area and could explode at any time, and because it was unclear exactly how they had been combined to create the lethal CDOs. As for the CDSs, the uncertainty was even greater, and they had already resulted in one illustrious victim, the giant *Fith* GlA. In short, the rescue operation would require a huge volume of funds, which, unfortunately, would have to be diverted from other more productive uses. But the survival of the economy of the universe was at stake, there was no alternative. And the response had to be immediate.

Surprisingly, and even though some of their members had already been hit by the crisis, the *Fiths* continued to believe the system was under control. In fact, under *their* control. Despite their mutual distrust, characteristic of the dark side of finance, they still seemed to think that theirs was the right strategy and that it would continue to bring them huge profits. They would not surrender easily.

Monsieur Chitret decided to call the Special Financial Forces Corps, comprising all the *Fedi* Knights of the Galaxy, representing the bright side of finance, to an urgent meeting at the Euron Tower. Unfortunately, very few members turned up, as many were busy addressing serious financial problems in their respective solar systems. But among those who did attend were two highly respected members, *Señor* Yodóñez and *Herr* Axeler.

Monsieur Chitret solemnly addressed the meeting with these words:

—Gentlemen, I must inform you that we face a dire financial situation. The *Fiths* have planted powerful *subprime* bombs throughout the Dolario System, aiming to obtain huge profits. The shock wave has spread to all other financial systems, including our own, via secondary financial time bombs known as CDOs and CDSs. This irresponsible behaviour has destabilised our financial system; in fact it has already brought about the collapse of *Fith* Brehman and *Fith* GlA. In light of this emergency, we must act prudently, but we must also act quickly. What is to be done, gentlemen? Have you any ideas?

There was a brief silence and worried looks were exchanged. But then *Herr* Axeler recovered his composure and addressed the meeting:

—We cannot, in any circumstances, allow the populace to lose their faith in the intergalactic financial system, which must function correctly in order to permit the efficient allocation of resources in our transtechnological economies. But as we well know, this faith can only be upheld if the financial system is generally believed to be robust, i.e. if it is designed and operates in such a way as to guarantee that the immense majority of transactions are completed successfully. Naturally, there is always a risk in financial transactions, and there will always be some cases of default, but these must be the exception to the rule. Evidently, as is demonstrated by this *Fith* attack, our present system is not robust, but is in need of reform.

All the *Fedi* Knights agreed with *Herr* Axeler. *Señor* Yodóñez then spoke:

—I share the idea that financial reform is necessary, Axeler. But we must bear in mind that we all have our share of responsibility in this matter. Clearly, the *Fiths* have distorted the financial possibilities offered by our system, using it to their own devices and advantage, to turn a

profit. But households have acted imprudently when taking on debts, no doubt due to a lack of financial culture, and firms and governments have also assumed excessive debts, unfortunately in no small number of cases. In turn, the Sidereal Financial Valuation Agencies have used erroneous models to assign their credit ratings, leading others to make mistakes. And let it be clear, gentlemen, we the financial supervisors, the *Fedi* Knights ourselves, have been effectively unable to prevent the deterioration of the system. Financial reform is, therefore, essential, and it must be deep-rooted and comprehensive.

He was followed by *Monsieur* Chitret:

—You speak wisely, as always, Yodóñez. In effect, we must take this opportunity to radically redesign our financial system, along the lines you mention, to prevent disasters such as that we are currently facing from being repeated in the future. We must learn our lesson, as we did after the Great Cosmic Depression of the last century. But in the short term, even though the ultimate aim is to reform the financial system, we must first rescue it from imminent collapse. We need immediate support measures. It will be costly, very costly. But I see no alternative.

The *Fedi* Knights agreed. In the subsequent discussion they resolved to recommend to the Confederation direct intervention in the institutions most seriously affected, providing the public funds necessary to ensure they would not fail. They also decided in favour of a sharp increase in liquidity in the financial markets, and an expansive economic policy, similar to that proposed by *Master* Keynobi after the Great Cosmic Depression. Measures were needed to reactivate an economy that was inexorably heading into deflation. The measures should be temporary, but in the present situation they were unavoidable. Finally, the Knights established an Intergalactic Financial System Reform Committee, chaired by *Monsieur* Chitret himself, to promptly draw up a detailed proposal that would enable the financial system to recover its robustness, leading, in turn, to a recovery of confidence and economic health.

Similar discussions were held in the Dolario System, under the leadership of the President of the Republic, *Mr* Bamack, and similar conclusions were reached. Agreement at last between the Republic and the Confederation. Hope at last. Yes, we can!

Dark times followed. As everyone had imagined, the crisis soon spread from the financial to the productive system. As the *subprime* time bombs exploded, many people lost their homes. House prices started to fall. Construction companies fell like a pack of cards. Financial institutions, and most particularly the *Fiths*, experienced great difficulties due to the increase in delinquencies, especially when the CDOs and CDSs began to explode, and many of them went under. Credit was rationed, meaning that firms and governments had great problems funding their activities. Some solar systems, such as the *Hellas* System, which had built up enormous debts, were obliged to introduce severe adjustment plans. Economic activity contracted sharply. Unemployment soared. Many people had to rely on the social services, on charity and on help from their families to make ends meet. People began to lose their faith in the system, finding it very difficult to understand why the *Fiths*, those responsible for the crisis, were receiving so much public funding.

But the *Fedi* Knights had learned their lesson. The Intergalactic Financial System Reform Committee promptly presented its proposal, acknowledging that the deregulation and self-regulation of the past decades had been a mistake, as it had allowed many highly sophisticated financial instruments (such as CDOs and CDSs) to come into being and be traded without supervision. Such instruments entailed risks that were very difficult to assess and were often not traded on organised markets, making them more difficult to control. Financial rules and

regulations were redesigned and supervision was strengthened. Solvency at the financial institutions was also strengthened. The problem of the *Fiths* that were too big to fail was addressed. The role and responsibilities of the Sidereal Financial Valuation Agencies were redefined. Funds were earmarked for financial education, making subjects such as economy and finance compulsory in school curricula. For the first time, the Republic and the Confederation acted in perfect harmony, thus intensifying the effect of the measures.

Little by little at first, and then more quickly, the system began to recover. Financial turmoil diminished, calm was restored among investors and confidence was re-established. Credit normalised, economic activity speeded up and unemployment fell. The New Great Depression was over.

A few years later, the *Fith* attack was no more than just a bitter memory. In his annual address, *Monsieur* Chitret concluded:

—Citizens of the world, thanks to your efforts and your sacrifices, we were able to overcome the serious difficulties caused by the *Fith* attack. And what is most important, we learnt our lesson. Instead of patching up what had proved to be a defective financial system, we had the courage and the resolve to make radical reforms. It was not easy. We had to overcome much resistance. But it was well worth it. It is now impossible that what happened then will ever happen again. It only remains for me to urge you all to learn more about the financial system. There are many ways of doing so, but possibly one of the most enjoyable is to take part in competitions that we, the *Fedi* Knights, organise. As a case in point, this humble futuristic financial fable. Thank you for your attention.

