**"THE REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM: A Proposal with the Lessons from the Crisis"**

**Speech by José María Aznar**
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**November 10, 2009**

Sir Howard Davies, professor Garicano, ladies and gentlemen, dear friends

Thank you all for being so kind to share your time with me. I am here today to present to you the latest strategic report conducted by the FAES Foundation titled "The Reform of the International Financial System; A Proposal with the Lessons from the Crisis".

This is an extensive analysis on the current economic crisis in which a diagnosis on what has happened is provided. It also contains what we consider are the appropriate measures to heal the international financial system.

For those of you who may not know it, I have been chairing FAES Foundation since its creation 20 years ago. At FAES we believe in free markets as the most powerful tool for human development; we hold respect for individual rights and liberties as essential; and we are strong advocates of the Atlantic alliance, this is, the partnership between Europe and America as the best way to preserve democracy, freedom, our security and prosperity.

I am very proud that through our constant work we are contributing to strengthen these values. Our purpose is to create, promote and disseminate ideas based on political, intellectual and economic freedom; ideas that can offer policy alternatives to socialism and interventionism; and ideas based on reality, that can be applied on practical terms.

These ideas are those that have inspired this report because we know that ideas, good ideas, can shape a better world. Free and open markets have proved to be the best economic system. Free markets make free people.

Since the Spanish edition of this report was firstly launched in July it has provided valuable inputs to relevant policy discussions on the reform of the international financial system.

As such, this report has made its contribution to make FAES become, in its 20th anniversary, the most prominent and influential Spanish think-tank and one of the 50 more

influential worldwide, excluding the American institutions, according to a leading research conducted by the University of Pennsylvania.

Ladies and gentlemen, dear friends

The current financial and economic crisis has provided some with the perfect excuse to criticize free market economy and present it as the sum of all evils.

There are those who have not missed the opportunity to try to certify the death of capitalism; to blame all failures on free markets; to state that this crisis proves the inefficiency of the market system.

I do not share these alarmist opinions that try to blame free markets for the current crisis. Nor did I share the comparison this very same people made portraying the current situation as a new Great Depression. Now we know they were wrong.

I am an optimist because I am confident on the strength of free people and on the resilience of free societies. I believe in free markets, because they have brought about prosperity, wealth and have reduced poverty, more than at any other time in history. Precisely because there still remains a lot to be done to eliminate poverty we should stand firmly by these principles.

Those voices that try to blame the crisis on market failures are the same voices that have blamed capitalism for pretty much everything since 1989. The Berlin Wall fell hard on those who were incapable of accepting the failure of their old creed; on those nostalgic of the times of central planning and social engineering; and on those who have been looking for a way to tear down, not only markets, but freedom itself.

The curious thing about these trends is that they lack the necessary analysis of facts; they pay little attention to the truth, and with just a quick look at what has happened, they fall under their own sectarian misjudgment.

Once again time is certifying how wrong they were on their analysis of this crisis. It makes no sense at all to state that this crisis is a new edition of 1929. The world is now 6 times richer, bank deposits are now guaranteed, the monetary system is not based on the gold standard, and the rate of return outside the banking sector is now about 10%, while in 1929 it was roughly 0.5%.

The differences are big; to a great extent precisely because we learnt and implemented some of the lessons provided by the Great Depression.

This is, or has been should I say, a serious crisis, of course. Especially for those suffering unemployment. But it is not a new Great Depression. It took the US economy nearly 10 years to recover after the 1929 crisis, but today the debate is about the strength and the timing of recovery.

There is only one possibility that this crisis will become a new Great Depression, and that is to make the same mistakes that we made 80 years ago. Protectionism, interventionism, and huge amounts of public debt are a direct path for this to happen.

In the aftermath of the crisis we have witnessed some doses of protectionist and interventionist policies. Of course they will delay and weaken the recovery, but up to now these doses have been unable to derail the world economy as they did during the Great Depression.

However, the risk of unsustainable public finances should be today a major concern for responsible leaders. I do not think the solution to a crisis that could be labeled as a "private debt crisis" is the accumulation of a huge amount of new public debt. This policy reaction does not make sense. It does not promote a sound basis for the recovery needed by our economies. We need a strong and sound recovery to heal the damages the crisis has inflicted upon our communities and societies.

And it makes no sense either to say that free markets are responsible for the crisis.

I may be wrong, but I think Central Banks are the ones in charge of monetary policy. And Central Banks worldwide, and not markets, were the ones that during the times of prosperity flooded world economy with money too cheap for too long. Cheap money that allowed many bubbles to appear. Cheap money that fuelled indebtedness in many western economies. Cheap money that inflated financial and real estate asset bubbles. Cheap money that fostered huge imbalances in the world economy.

I also believe Governments were the ones that did not succeed in properly regulating and supervising financial markets.

And, I ask you all, who was it that promoted, through its housing policy, the extension of credit to hundreds of thousands of people who were not able to repay their loans?

Let's be clear, subprime mortgages and related financial products were only able to appear and survive in the financial markets thanks to public policies and support that distorted the incentives under which the financial sector operated.

And who bet in Europe on huge public expenditure and did not undertake economic reforms? I think you all know the answers to these questions.

And yes, of course, many executives in financial firms around the world were negligent in their risk management responsibilities and acted with complacency. Some even assumed and acted as if no crisis could ever happen again. It is fair, therefore, that the market punishes with severe losses those wrong behaviors and decisions. That is not a market failure but the expression of a good operating market.

And of course, there has been a lack of transparency and control in financial markets. But whose job is it to ensure the adequacy of oversight mechanisms?

This does not exclude, in any case, the total lack of ethics that some have shown, leading in some cases to multi-million dollar swindles.

So, as I was saying, after a quick review of the facts, we see how this crisis is far from representing the death of free markets, as some too quickly declared.

We see how this crisis had little to do with free markets, but much to do with flawed public policies and governments' interventions. The public sector has very important tasks assigned to it in a free market economy, as the ones we have just reviewed. And it is essential that it fulfils them appropriately.

Certainly many mistakes have been made on the part of all agents in the market; and I do not believe the market is perfect. Of course not. But it has proved to be the best mechanism for achieving global prosperity. And I am confident on its capability of reforming itself. That is why I said I am an optimist.

As Winston Churchill once said: "A pessimist sees the difficulty in every opportunity: The optimist sees the opportunity in every difficulty." We are undergoing difficult times, yes; but let us see the opportunity hidden within.

We have the opportunity to learn from this crisis. We have the opportunity to learn from experience, and react with better regulation, better public policies and an efficient undertaking of the roles entrusted to the Government. Better regulation and not bigger Government is what's needed.

We should avoid a re-regulating process that risks killing the much necessary innovation and incentives the economy needs to recover. Also, we should avoid losing momentum for implementing the necessary reforms under the mirage that the worst part of the

crisis is behind us. Those would be fatal mistakes that risk undermining the strong recovery that our societies demand.

We should have learnt from this crisis how powerful incentives are. And how destructive it can be to distort the incentives under which the financial sector operates for the sake of shortsighted political objectives.

Ladies and gentlemen, dear friends

When I commissioned two prominent Spanish economists, Fernando Fernández and Fernando Navarrete, the task of undertaking this report I simply asked them two simple questions: What has gone wrong? And, how can we fix it?

Getting the right answers to these two basic questions is essential to provide greater stability to world economy and restore public confidence.

Not only does the cyclical recovery of economy depend on it. More importantly, the long term potential of our economies lies on the adequate response to the challenges this crisis has posed in front of us.

Efficiency and fairness are the basic two pillars upon which economic freedom can defend itself from its enemies. The solution to this crisis is also an opportunity for responsible leaders to reinforce these pillars vis á vis society.

The analysis underlying the proposals contained in this FAES report is based on reality, and not on ideology. In my opinion, the report answers with accuracy the two essential questions I have mentioned before. Therefore, the main conclusions of this report are of help to anyone really trying to solve the things that have gone wrong.

Trying to find who to blame is too often not the best way to solve real problems. Some people are constantly looking what to blame in order to get rid of it (especially if it is freedom). On the contrary, this report looks at the root causes of the crisis. It proposes amendments to those policies and institutions that have not delivered appropriate outcomes.

The main driver of the analysis is to extract the lessons from the experience and propose solutions that are both workable and, above all, that respect freedom and promote stability and prosperity.

For those leaders that only take decisions based on prejudice and flawed ideology this report may be useless. For those that do try to provide the most appropriate framework for prosperity to flourish, this report will be of help.

Ladies and gentlemen,

We have to learn from this crisis that at the onset of the crisis the policy instruments in the hands of governments were inadequately prepared for a world of greater economic and financial interdependence, complexity and openness.

Contrary to those that see in globalization the cause of all harms I see its potential for delivering wealth and prosperity to those that for too long were kept away of opportunities.

But as economists say “there is no such thing as a free lunch” and to take full advantage of these new opportunities, Governments’ tools and policies have to adapt to the new requirements of a global economy.

The failures in detecting, preventing and preemptively solving the causes of a crisis that has impoverished the world, have impelled us to look for new solutions in the areas of central banking, financial regulation and supervision and a reinforced financial architecture.

The political reactions to the financial crisis have broken all traditional prescriptions. The challenges we face highlight the need for a new rules-based setting to which all participants in the financial markets can abide by. New contingent rules, specially designed to be applied also in times of systemic crisis, are needed.

This new way of thinking should lead to predictable, anticipated and efficient government reactions. Rules that known beforehand could increase public confidence in the resilience of the system, prevent future crisis and alleviate the impact of those that inevitably will continue to occur.

Public policies should promote and reward sound risk taking and management. Regulations should take into account systemic risk and the increased interdependence in the global financial sector.

As you all know better than I do, bubbles are created when monetary and credit conditions are too loose for too long. And we had witnessed too much of this prior to the crisis.

In this report you may find in detail some proposals to increase the effectiveness of Central Banks to attain two objectives not always easy compatible as price stability and financial stability.

Transparent and clear rules that restore the importance of money and credit growth should help insulate Central Banks from political pressures and enhance their transparency, independence and accountability.

In the area of financial regulation current re-regulating trends pose the risk ending up with a new regulation which is too interventionist, that would create new regulatory arbitrage opportunities and reduce innovation.

In this area it is essential to encourage financial institutions to adopt business strategies that promote greater financial stability.

The proposals in this report aim to encourage innovation to lead to a more robust financial system. In this vein, bank strategies which are considered to increase systemic risk should be charged extra capital requirements according to a proposed new macroprudential pillar to be included under renovated international Capital Adequacy Standards.

The implementation of this approach will serve to reduce excessive risk taking and also reduce the pro-cyclical effect of current solvency rules.

Challenging conventional wisdom, wholesale financing has proven in this crisis to be less stable than retail deposits. In fact, it is fair to say that in the end of 2008 we all witnessed a global post modern version of a bank run. This shows the need for a stabilising mechanism for money markets that will prevent this to happen again in the event of a systemic crisis.

In any case, no matter how good financial regulation will be, we must recognize that ex post supervisory intervention will still be required in the future. And you all know that the cost of a banking crisis is lower the sooner it is detected and the sooner the intervention takes place.

Therefore, supervisors should have the capacity to intervene pre-emptively, gradually and with legal certainty when the solvency of financial institutions or the stability of the system is threatened. Also, international crisis management should be reinforced by pre agreed and binding commitments by the  Governments in which an international bank operates.

Public interventions will only serve a sustainable purpose if they meet the principle of rewarding prudent behaviors or, at least, they do not damage the competitive position of those institutions that do not need public support. Unfortunately this has not always been the case during this crisis.

The final recapitalization of the banking system is a must in order to avoid the recurrence of financial instability episodes that will delay and weaken economic recovery.

The poor implementation of different rescue packages in the past has lead to social distrust and the creation of negative effects to other countries. In the end, this has given rise to the emergence of a new “financial protectionism” that is even more pervasive than traditional protectionist measures.

A more fruitful approach would be a coordinated recapitalization strategy of viable, although undercapitalized, credit institutions along the following principles: full transparency; maximum efficiency and taxpayer protection in the use of public funds; minimum public sector involvement in banking management; use of prices generated by competitive procedures among private parties; and a clear public sector exit strategy.

And let's be clear when talking about recapitalization packages. This is not about rescuing imprudent banking managers, shareholders or bondholders with taxpayers' money. This is all about protecting the legitimate interests of depositors and taxpayers.

Those non viable institutions in which no private investor is willing to risk her money, should be left to fail in an orderly manner once we have in place mechanisms that will avoid massive contagion. All in all, this is all about providing the right incentives for prudent behaviors.

Ladies and gentlemen,

In Europe we face all the above mentioned global challenges. But in addition, we are amidst the process of increasing financial markets' integration.

One of the lessons from the crisis is that -at least for those countries in the euro area- real financial sector integration with no regulatory hurdles across borders is necessary to fully enjoy the benefits of the single currency.

This integration process could be spurred and speed up if countries could agree on a single European voice in certain international institutions like the IMF.

Certainly the task ahead is not easy. We are now facing a reform process that will shape the international financial system for the decades to come. We need to get it right to grasp all the potential of an open, prosperous, innovative and stable global economy. I do hope we will do so and the ideas in this report will contribute to it.

Thank you very much for your attention.