Jaime Caruana: Presentation of the Bank of Spain’s annual report

Speech by Mr Jaime Caruana, Governor of the Bank of Spain, to the Governing Council of the Bank of Spain on the presentation of the annual report, Madrid, 14 June 2002.

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A year ago I addressed you in my first presentation of an Annual Report, that for the year 2000. At the time I highlighted the importance of an impending event: the introduction of euro notes and coins. This event clearly symbolised the culmination of monetary union in Europe, a process set in train ten years earlier and coming to fruition against a background of enormous expectation not free from uncertainty.

It is only fair today to start by stressing the success of the cash changeover, which was notably smooth despite the complexity inherent in such a singular, large-scale and radically novel operation. Underpinning this success was the collaboration of all the sectors concerned: households and firms and, in particular, the banking system and the distribution sector, without whose contribution the changeover of notes and coins would have simply been unviable. The fact that such a far-reaching change should have found such widespread support in society ultimately reflects European citizens' acceptance of their new currency and their confidence as to the benefits they may reap from it.

With the culmination of this process, the euro area is consolidated as an extensive and stable monetary zone. This is an effective instrument for increasing the prosperity of European citizens and one suited to playing a leading role in the international monetary system. It is also a magnet for other European countries whose integration into the area will give it greater worldwide influence. A dynamic process is now under way in the area in which those economies that are most flexible and best equipped with physical, technological and human capital will be those that most benefit from participation in the common European venture.

To date, the Spanish economy has been able to draw on its progressive economic and monetary integration in Europe to move towards correcting some of its structural imbalances, to further real convergence with the core European countries and to pursue increasing external openness. In parallel, Spain has re-geared its economic policies towards stability and has pushed through the liberalisation of its financial, factor and product markets. This modernisation and openness drive has led to a substantial change in Spain's position in the world economy, which includes strategic ownership interests in certain regions in which it has invested strongly.

Undoubtedly, the main challenge now facing the Spanish economy is to consolidate this position against a background of heightened competition, rapid technological change and future European Union enlargement.

The Annual Report presented today illustrates the benefits that the Spanish economy has obtained from participation in Economic and Monetary Union, even under the particular circumstances of a generalised slowdown in the world economy, as was the case in 2001. The advantages stemming from price stability, budgetary discipline and the reforms undertaken are enabling the phase of lacklustre growth to be overcome without halting progress in real convergence. The pattern has differed from previous cycles, where the imbalances incubated in expansionary phases would inescapably result in periods of recession and job destruction.

In this first part of my address, I shall give an overview of world economic developments last year and discuss the response of the euro area economy to the new international setting, paying particular attention to the performance of the Spanish economy. In the second part, I shall refer to matters relating to financial stability, banking supervision and the role of the Banco de España in these areas.

The world economy

The slowdown in the world economy in 2001 was more short-lived and milder than expected, despite the emergence of several adverse shocks which it was thought, at the time, would have a strongly negative impact. First, there was the correction of the speculative bubble in the industries most closely related to new technologies and telecommunications. This prompted a substantial decline in these companies' earnings and their share prices on the stock market, and a rapid adjustment to the over-investment that had built up. Next were the repercussions of dearer oil prices in 2000, which were partly corrected in 2001 but which have rebounded again this year. Further, the crises in Turkey and

Argentina once more highlighted the vulnerability of some emerging economies and certain shortcomings in the architecture of the international financial system. And finally, there were the attacks of 11th September, which had a specific and strongly depressive effect on confidence.

Despite this build-up of adverse effects, the world economy proved notably resilient. This was all the more striking considering that on this occasion the downturn coincided in the three main areas (the United States, the European Union and Japan), which a priori heightened the risk of a deep and prolonged decline in world output. With the exception of Japan, the industrialised countries avoided going into recession, while the emerging economies, although seeing a decline in their growth rates, have on the whole remained more buoyant than the developed countries.

The opening months of 2002 have gradually confirmed the greater buoyancy of the world economy. This is clearer in the United States, but is also perceptible in other countries. Activity, confidence and employment indicators have all firmed, and GDP growth forecasts have been revised upwards. Nonetheless, elements of uncertainty remain in place over the strength and timing of the ongoing recovery. These relate essentially to the persistence of certain imbalances in the US economy (linked mainly to the shortfall in private saving and the high foreign deficit), the weakness of the Japanese economy and the crises besetting certain emerging countries.

It is worth inquiring into the causes of the world economy's resilience in the face of these shocks. Firstly, it is probably indicative of the greater microeconomic flexibility of both the developed and the emerging economies. It appears the structural reforms of recent years, aimed at increasing the adaptability and responsiveness of economies to adverse effects, are beginning to bear fruit. Consequently, it is crucial to further such reforms, especially in times of plenty, when their cost is lower, so that when lean times arrive the economy has the spontaneous adjustment mechanisms in place to reduce the cost and duration of the crisis.

Secondly, from the macroeconomic policy standpoint, the recent economic slowdown shows the importance of having sufficient fiscal and monetary policy leeway to be able to react to adverse disturbances, meaning in turn that prices and public finances should have performed favourably during economic upturns. Fortunately, on this occasion, the slowdown found the main economies in a relatively balanced inflationary and budgetary situation. This was conducive to a monetary policy response (which was more intense in the United States, in step with the sharper reduction in the pace of activity in this country) and to the operation of the automatic stabilisers, without jeopardising the long-term fundamentals.

The notable exception is Japan. Here there is no further room for additional stimuli on the demand side owing to the economic and financial problems inherited from previous years. And this has led to the economy going into recession for the third time in ten years. In the other industrialised countries, the prompt economic policy response largely accounts for the mildness of the slowdown.

Thirdly, part of the explanation for the swift recovery in the main economies in the face of the aforementioned shocks lies in the fact that efficient, sound financial systems are in place, which have been propitious to the smooth working of the monetary policy transmission mechanism. I will return to this idea later on discussing financial stability.

In most of the main countries, then, the cuts in intervention rates have fed through appropriately to banks' lending and deposit rates, and the liquidity provided by central banks has passed through the credit channel to households and firms, where expenditure decisions are taken. The exception once more here is Japan, where the financial sector's problems have prevented the pass-through of monetary policy stimuli.

Fourthly, the limited knock-on effect of the Turkish and Argentine crises to other emerging countries, in contrast to similar previous situations, also contributes to explaining why the slowdown in the world economy has been relatively mild. This phenomenon is all the more notable given that two relatively large countries of potentially systemic significance are involved. And particularly so Argentina, which was the biggest sovereign issuer among the emerging countries.

The more orthodox and disciplined policies of the main emerging countries have been rewarded on this occasion by the international financial markets. As the dispersion of spreads testifies, markets appear to have increased their ability to discriminate between countries with better and worse fundamentals. This greater ability has been partly due to increased transparency in the emerging countries themselves, as a result of reforms in recent years including the application of statistical codes and standards of good practice. It is also partly attributable to improved risk management by investors on international financial markets.

In sum, behind the greater resilience of the world economy in facing adversities, it appears there are positive factors which have tended to increase economies' capacity for spontaneous adjustment, the responsiveness of macroeconomic policies and the discipline exerted by international financial markets. Hence the importance of persevering in the coming years along these lines, especially bearing in mind the growing economic and financial interdependence of different countries and regions and their exposure to global shocks.

Euro area and monetary policy

The euro area fell prone to the slowdown affecting the world economy in 2001, although the impact on the euro zone differed from that on other areas.

The initial idea that the euro area could sustain growth on its own has not held up in reality. Indeed, some particular features of the area (such as the notable falling off of residential investment in Germany) exacerbated the slowdown in activity in 2001. Nonetheless, the euro area does appear to be emerging from this slump relatively satisfactorily, helped by the absence of significant imbalances and by an economic policy response which have contributed to shortening the recessionary bout and tempering its impact on employment.

At the onset of 2001 inflation was on a rising path, influenced by various essentially temporary factors such as dearer oil prices, crises in the meat industry and the depreciation of the euro. Its trajectory changed mid-year, partly following that of oil prices, and it fell to 2% in December. Although inflation stood above the 2% level throughout the year, medium-term inflation expectations broadly converged towards levels consistent with price stability. This contributed to wage moderation, preventing the temporary rebound in prices from having a durable effect on inflation.

Thus, against a backdrop marked by the progressive slowdown in activity, by moderate cost pressures and by price expectations on the part of agents that coincided with the monetary authority’s targets, the inflation outlook improved as the year unfolded.

The monetary policy stance, marked by the tightening carried out in 2000 in a very different macroeconomic setting, gradually became accommodative of the new circumstances and several interest rate cuts were applied, proving conducive to the economic recovery.

I would like to underscore two different factors that were pivotal to the assessment of the inflation outlook and the intensity of the monetary policy response in 2001. The first was wage moderation, and the second the reaction by the economic authorities to the attacks on 11th September, particularly in the light of the sizable rise in economic uncertainty and the immediate deterioration of confidence levels. The firm, concerted response by the monetary authorities in the main economic areas softened the initial impact on financial markets and meant that the effects on the world economy were relatively short-lived, though sharp, and confined to specific sectors.

Broadly, the design of the euro area members' fiscal policies in 2001 prevented expansionary discretionary measures being adopted. Such measures would have jeopardised the sustainability of recent fiscal consolidation achievements and, given the lag with which such measures operate, they could have had a counter-productive effect on the cyclical stability of the economies in the area. However, the available estimates of the structural budget balance show that, at the aggregate level, there was a slight deterioration last year as a result of the tax cuts applied in certain countries before the cyclical weakening had become apparent.

Further, fiscal results have shown that, in certain countries, not enough room for manoeuvre was available to absorb the budgetary effects of the slowdown without drawing too close to the limits set in the Stability and Growth Pact. Clearly, in such cases the consolidation drive made has not been sufficient to attain a balanced budgetary position. In this respect, it is of paramount importance that EMU members maintain the commitments entered into under the Pact and do so symmetrically, as reflected in the conclusions of the Barcelona Summit.

The appropriate response by economic policies to the slowdown in 2001 has therefore contributed to the recovery of the European economy apparently under way since the beginning of the current year. The intensity and duration of this new phase of recovery will be influenced by conditioning factors that are largely external to the area, such as oil prices, or the sustainability of the US recovery, given the persistence of its financial imbalances. But, above all, a sound recovery will depend on the ability of European economies to underpin their growth with domestic factors supportive of robust investment that increases productive capital.

The monetary policy stance should be tailored to the prospects of maintaining price stability. Particularly important in this respect (besides oil prices, which have already hampered any reduction in inflation in the first half of the year) is continuing wage moderation which, in some countries, is beginning to be questioned.

The single market and monetary union provide the European economy with a particularly suitable framework for developing its growth potential and for consolidating it as one of the central pivots of the world economy. Notwithstanding, the area still lacks sufficient flexibility and innovative capacity to compete satisfactorily with other more dynamic areas, mainly in the more technologically advanced industries. The Barcelona Summit has clearly shown the ability of the European authorities to pinpoint key issues and to design a blueprint for reforms (of differing ambition but of equal importance) that will make Europe a more dynamic economy. While greater ambition would conceivably have been desirable, meeting the targets laid down in Barcelona on schedule would entail a qualitative change of enormous importance.

The Spanish economy

The weakening of the international economy and the loss of buoyancy in the European economy contributed in 2001 to prolonging the gradual slowdown in activity in Spain in train since the previous year, when the first symptoms of the previous lengthy expansionary phase having run its course were discerned. Consumption and investment in construction were the main underpinnings of growth in our economy, while productive investment and exports were the chief components dampening it. That said, GDP increased by 2.8% in 2001, clearly above the figure of 1.5% posted in the euro area.

The maintenance of high job creation rates during 2001, set against the slowing trend marked by general developments in the economy, and the favourable financial conditions in place contributed to sustaining household income and helped underpin consumer spending and residential investment. However, the declining course of investment in capital goods steepened in the face of heightening uncertainty, worsening expectations and slowing final demand, which the generous financial conditions were unable to offset. The effects on activity were reinforced by the fall in the growth rate of exports as from the early months of 2001.

In any event, the trends apparent at the beginning of the year 2002 (namely greater growth in the economy in quarter-on-quarter terms but with something of a loss of steam in job creation and in consumption, accompanied by a check on the rate of decline of investment and continuing sluggishness in exports) are consistent with a scenario of gradual recovery, but fail to dispel the uncertainty over its intensity and scale.

The profile of the Spanish inflation rate during 2001 was similar to that in the euro area as a whole, albeit maintaining a positive gap. After rising in the opening months, in the wake of dearer food and energy product prices, inflation dipped appreciably in the second half of the year, largely due to the course of oil prices on international markets. At the end of 2001 it stood at 2.7% in year-on-year terms. However, the initial data for 2002 have shown a more marked rebound in the 12-month growth rate of consumer prices than that recorded in the euro area as a whole, due partly to temporary factors that should be reabsorbed in the coming months.

Of concern to us is the persistence in the Spanish economy of inflationary biases reflected in the inflation gap with the euro area, especially when they are manifest in the behaviour of unit labour costs. I shall refer to the risks this entails later.

The change in the cyclical pattern of the Spanish economy

As I said at the outset, these features of the recent slowdown in the Spanish economy have shown up a different pattern of behaviour than that followed in previous cycles. The factors accounting for this change are related both to the conditions of greater macroeconomic stability attained by the Spanish economy in its convergence towards and integration into the euro area, and to the progress made in terms of structural reforms. These factors have had a bearing both on the balanced nature of the upturn in the second half of the nineties and on the mildness of the recent deceleration.

The greater macroeconomic stability has been underpinned, as is known, by a notable fiscal consolidation drive and by wage moderation. In the upturn, these conditions provided the economy with a most significant expansionary boost, prompting rapid convergence towards the real income levels of the core European countries, without this translating into the emergence of significant macroeconomic imbalances. During the more recent phase of lower economic growth, the absence of imbalances left over from the expansionary phase continuing favourable monetary conditions have tempered the intensity of the adjustment, allowing real convergence to continue.

The presence of a credible environment of price stability and fiscal equilibrium is a necessary condition for further headway in real convergence by the Spanish economy, as it moves into a phase of recovery. Consequently, particular attention must be paid to the fiscal policy stance and to monetary and financial conditions.

The year 2001 saw the attainment of a balanced budget, without the slowdown in the Spanish economy preventing strict compliance with the commitments made under the Stability Programme, consistent with the requirements of the Stability and Growth Pact. Last year, moreover, new fiscal discipline measures were adopted which will contribute to maintaining sound public finances in the medium term. I refer here to the budgetary stability legislation and to the new regional government financing arrangements, which increase the degree of fiscal co-responsibility of the regional governments under the transparency requirements demanded of general government.

I have already mentioned that monetary and financial conditions in the Spanish economy were more generous than in the rest of the euro area, although the significance of this difference lessened as demand lost momentum. The credit aggregates grew at high rates for the third year running. That said, they did slow during the year, in step with cyclical developments, although this remains insufficient.

The growth of financing to Spanish households and corporations translated last year into a fresh increase in this sector’s debt as a percentage of GDP, with the rise in lending to households for house purchases proving particularly notable. The greater ease with which the private sector has been able to finance its spending decisions has contributed to limiting the depth of the ongoing cyclical slowdown, but at the expense of incurring high debt levels. The increase in private debt is a logical response to the new setting of lower interest rates in the Spanish economy, but it has also increased the exposure of this sector to potential adversities.

As the expansionary effects of this process of adaptation by our economy to the new environment ease off, progress towards real convergence at similar rates to those at present will require that growth be underpinned by more stable factors.

Main challenges facing the Spanish economy

This overall positive assessment of the Spanish economy, even during the recent slowdown, should nonetheless not conceal the presence of certain rather unsatisfactory aspects. These include the positive gap with the euro area in terms of price and cost growth, the flatness of investment in capital goods and low productivity gains. To further real convergence, these problems must be overcome.

In this connection, economic policy action should be geared primarily to promoting competitiveness, in the broadest sense of the term, where aspects linked to the behaviour of prices and costs combine with others related to growth potential.

Regarding the behaviour of prices, and despite the substantial progress made towards nominal stability since the mid-nineties, the persistence of an inflation differential with the euro area poses risks in respect of future competitiveness. The wage restraint characterising the most recent phase of the Spanish economy has passed through unevenly to the sectors exposed to competition and those sheltered from it. In the exposed sectors, price increases cannot be far removed from those made abroad, whereas in the sheltered sectors there has been a continuous tendency to widen margins, irrespective of where the economy is in the cycle. Hence, the combination of a rather inflexible wage structure and still-insufficient competition in certain services sectors has led to the phenomenon of dual inflation, which feeds the inflation gap with the euro area.

Another fundamental variable for the economy's competitiveness is productivity, although it is difficult to measure and interpret. Clearly, what lies behind the low labour productivity gains in recent years is the beneficial effect of employment-promoting policies, which have raised the economy's employment-generating capacity. However, research indicates that such low gains may also be reflecting a low increase in certain components of the stock of capital and an insufficient incorporation of technological progress.

The most significant means of expanding the economy's growth potential has therefore been the incorporation of workers into the labour force. This is a suitable way to improve the Spanish economy’s endowment and utilisation of productive factors, and should be maintained. But it cannot be the sole avenue. In parallel, investment must be bolstered, especially in those forms of capital most conducive to the incorporation of technical progress and innovation. Policies supportive of a more flexible and efficient corporate environment and aimed at the better functioning of the economy must also be persevered with.

The investment in new technologies in recent years has already had a positive influence on Spanish productivity, although its overall effects have been blurred by the less dynamic behaviour of other types of investment. Looking ahead, a step-up in investment in technological capital will require the complementary promotion of investment in human capital and in capital goods to help spread innovation across the economy as a whole.

As regards policies aimed at promoting market flexibility and efficiency, the liberalising momentum of the reforms undertaken must be carried further. The Annual Report underscores the advisability of land market reform, given its consequences for the formation of real estate prices and costs and its influence on labour mobility. It further stresses the need to pursue liberalisation and competition policies in the network industries (telecommunications, electricity, transport and distribution, etc.), as the benefits of better workings here will spread to all productive activities.

In the labour market, the persistently high ratio of temporary to permanent employees alongside a high unemployment level (especially among certain groups), with labour shortages in certain industries and regions, highlights the need to press ahead with reform. In particular, the incentives for effective participation in the labour market must be further improved, as must the decentralisation of collective bargaining, so that it is better suited to the conditions firms face and to workers' characteristics.

To conclude this part of my address, let me stress the importance of building on the balanced budget obtained in 2001 by introducing improvements into the structural aspects of general government conduct. Public spending must be increasingly efficient, so that it contributes to increasing the economy's stock of capital and productivity. Moreover, the necessary adjustments should be made so that due attention to the growing demands that will be made of the public sector as a result of the ageing of the population (to cover pensions, health, care for the aged, etc.) will not lead in the long run to situations jeopardising public finances.

Financial stability

I shall devote the second part of my address to financial stability. From this perspective, I shall discuss the main consequences of some of the earlier-mentioned shocks the international financial system underwent last year.

I should like to begin with some reflections drawn from the crises experienced by certain emerging countries. First, let me mention the importance of compatibility between the exchange rate regime chosen by a country and its overall economic policies and institutional structure. No exchange rate regime can, on its own, protect an economy from financial crises if it is not accompanied by appropriate and coherent policies.

A second reflection is that the presence of and adherence to a legally sound, open and stable institutional framework that is respectful of creditors' and debtors' rights is the only way to generate the confidence and support of international financial markets in such a way that domestic saving shortfalls may be financed.

My third reflection considers the need for clear, credible criteria beforehand as to how to distribute the costs of crises. Such criteria should strike a balance between both domestic and foreign private creditors.

Coverage of the shocks experienced by the international financial system last year would be incomplete without some reference to the set of shortcomings highlighted in the so-called ENRON case, which goes beyond the particular scope of this company and reveals weaknesses of a more institutional and systemic nature. These events were significant since they showed that, even in economies with more sophisticated institutional arrangements, some types of conduct with great destabilising potential may occur. The ENRON case was important not only in quantitative terms but also, and especially, in qualitative terms, witnessing a series of legally dubious practices which go beyond the strictly financial field: conflicts of interest, serious corporate governance shortcomings, excessively ad-hoc accounting practices deviating from prudential principles and from what is a fair view of the real economic situation, manipulation of information, etc. And all this set against the inoperativeness of the internal and external control mechanisms of the company.

We have thus been faced with a broad litany of serious problems affecting many of the institutional requirements and elements that are so vital for maintaining confidence, for the efficient allocation of resources, for the orderly working of any financial system and for the effective supervision thereof.

I shall return to these matters later. But let me first say that, faced with the above-mentioned multifarious shocks, the international financial system showed a capacity for resilience that should be viewed as highly satisfactory. It is not easy to assess which factors have contributed to increasing, and to what extent, such resilience.

Among them, however, mention should be made of the following: the priority given to stability by many monetary and fiscal authorities during the preceding long expansionary phase; the improved workings of more integrated and better informed international financial markets with increasingly flexible trading systems; the high levels of solvency, via own funds and provisions, attained by banks during the previous upturn, which has made it easier to soak up the losses now arising; and, finally, the advances made by many banks in risk management, providing for better risk identification and monitoring, risk diversification and the reallocation of risk towards final investors, on increasingly efficient derivatives markets.

Despite the resilience of the international financial system, both the independent developments within the system and the aforementioned events which perturbed the markets have repercussions for banking supervision. These are worthy of mention. Before doing so, however, I shall offer a brief overview of the financial situation last year in Spain.

Spanish banking system

Inevitably, the Spanish financial system was affected during 2001, albeit unevenly, by the aforementioned shocks. The economic slowdown throughout the year translated into a lesser rate of banking activity than in previous years, resulting in growth in total assets of 7.3% in consolidated terms. Though below this, the growth rate of credit remained high, especially in respect of mortgage lending, which made for an increase in the level of debt and, in turn, saw credit markets gain weight relative to securities markets.

The Spanish banking system was scarcely affected by the shocks discussed earlier, with the exception of the Argentine crisis, whose repercussions were more telling.

Notwithstanding, our banks are weathering the storm caused by the Argentine crisis thanks to an appropriate and prudent provisioning policy. Although this has meant reduced earnings, these have still continued to outgrow those of most of the major international banks.

The cyclical turnaround has also led to an increase in bad loans. Yet owing to the relatively strong growth of credit, this has not been reflected in default ratios, which have held at historical lows. The solvency of Spanish banking institutions was bolstered last year, breaking with the trend seen since 1997, although this improvement is mainly attributable to secondary capital. As a result, credit institutions' capital adequacy ratio stands three percentage points above the regulatory minimum, calculated in accordance with Spanish rules, and almost five percentage points higher according to the criteria of the Basel Banking Supervision Committee.

As a result of the lower rate of banking activity, combined with the impact of the crisis in Argentina, with the consequences of the full implementation of the statistical provision and with the unfavourable performance of stock markets, the growth of net attributable earnings after tax declined to 6.9% in 2001. Although this growth is but one-third of that posted the previous year, compared with our peer countries it may be viewed as satisfactory. This result has been possible thanks to the favourable contribution of the traditional business segment in Spain. Reversing the trend of prior years, the net interest margin picked up slightly while operating expenses fell. As a consequence of the foregoing, the fall in the return on equity was cushioned.

Spanish banks have thus successfully negotiated a relatively difficult year. Contributing to this, undoubtedly, have been the improvements during the lengthy expansion in general and risk management, in the containment of costs and in the reinforcement of solvency. These improvements should be built on. Regarding this latter issue, I wish to highlight the significant stabilising role that the so-called statistical provision has begun to play. The provision is designed to promote the provisioning of the foreseeable losses generated by credit risk at the time this risk is assumed, and not when, years later, such losses begin to emerge, frequently on the downward track of the cycle when activity is lower and the profit and loss account is weakened.

I shall conclude this section with a reference to the position in 2001 of Spanish securities markets. Apart from the decline in equity indices and trading in favour of fixed income, I might mention the significant headway made in market integration, which crystallised in the creation of a holding company grouping all existing secondary and derivatives markets, together with all the securities clearing and settlement systems. This process of vertical integration will enable the unquestionable economies of scale and scope offered by the securities industry in Spain to be harnessed, thereby enhancing their efficiency and strengthening their competitive position on the international stage.

Banking supervision

I shall commence the final part of my address, dedicated to banking supervision, with a summary of events last year in both the international and the Spanish financial system.

Given the speed of change in the financial environment, supervision requires an ongoing effort to improve and adapt itself to changing circumstances. This means proving equal to market innovations, developments and trends, but also involves being more attentive and sensitive to the changes that arise in the demands society makes of the financial system and its supervisors.

Accordingly, as supervisors we should test principles, theories and procedures against the reality of events in financial systems. Both within and outside Spain, last year provided us with representative cases of weaknesses that leave no room for complacency and which require fresh thought and responses. The rest of my speech will deal with these aspects.

Let me begin by noting that no new initiative it is sought to take in this field may be considered in isolation. It must be part of a two-dimensional framework. First is the matter of international co-ordination, since in markets as interrelated as is currently the case, the stability and behaviour of the system has an international facet. And second is the multi-disciplinary dimension, since, as revealed by the welter of problems I discussed in connection with the ENRON case, it is becoming increasingly evident that no banking supervision model may be expected to be efficient if the rest of the institutional apparatus underpinning the rationale of the market economy does not function properly.

Among these institutional underpinnings, there are two which, although they affect all companies, I consider to be of particular importance for the workings of credit institutions and for their proper supervision.

The first is the need to reinforce market discipline. On the basis of adequate, reliable and updated information compiled by companies, duly verified by independent auditors and impartially evaluated by analysts and rating agencies, such discipline should simultaneously act as a deterrent to and penalise imprudent, inappropriate or simply mistaken behaviour.

The second concerns strengthening corporate governance. Banking supervision cannot and should not replace company directors and senior managers in the performance of their functions or the discharging of their responsibilities. Naturally, then, the contribution of bank directors and senior managers is essential if sounder, more stable and more efficient systems are to be attained.

Achieving appropriate corporate governance standards contributes to corporate health, increases market confidence and promotes efficiency in the economy in general. Legislators, supervisors and, above all, entities themselves should promote the sound functioning of companies through the following key aspects: management transparency; the reliability and integrity of accounting information; the protection of shareholders; and the appropriate treatment of conflicts of interest. Also vital are the accountability of boards of directors and the suitability of their composition and procedural rules; guarantees that key decisions are adopted by the appropriate collegiate bodies and then duly recorded and conveyed to the market with sufficient transparency; and the setting up of audit, remuneration or appointment committees with clear objectives so as to ensure their effectiveness.

To be effective, the adoption of any code in this area should be supported by appropriate structures and procedures. It will also require substantial participation and commitment by the company's directors and managers. Specifically, I should like to stress the importance for good corporate governance of an audit committee that is suitably composed and committed and on which non-executive directors form the majority.

As a complement to a good corporate governance structure, credit institutions should be equipped with a sound risk culture. Such a culture should infuse the design and workings of the organisation and its management criteria, systems and methods; it should be founded on control procedures whose reliability has been duly tested; and its application should be overseen by departments possessing sufficient power and independence. All this should be substantiated by internal and external auditors and be highly visible to the market.

Finally, I would like to stress the need for all types of financial institutions to apply due diligence. They should know their clients and systematically monitor their operations so they might prevent, and where necessary curb, not only money laundering and the funding of terrorism but also any other attempt to use the financial system for illegal or unethical purposes. Beyond the obligation all individuals and corporations have to observe and comply with the law, good practices in this area have an important supervisory dimension, as they play a decisive role when preventing or curbing such serious risks as those pertaining to reputation, legal risk, and so on.

Despite the unquestionable importance of market discipline and good corporate governance, these are complements to banking supervision and, therefore, cannot replace it in respect of its essential task, namely "to promote the sound functioning and stability of the financial system", as stipulated in article 7 of our Law of Autonomy. Without exceeding the terms of this legal mandate, proper compliance requires, as I stated earlier, that banking supervision should be able to adapt to changes in its environment.

One group of these changes covers aspects such as financial innovation, concentration and internationalisation, i.e. all developments present in the system and the attendant trends. Banking supervision must know how to capture and interpret the latter, as part of a threefold aim: to encourage their positive aspects; to eliminate, or at least minimise, processes which may prove harmful; and to adapt its own procedures to new circumstances. Only in this way will banking supervision, observing to the full the system's underlying rationale and the initiative of its agents, be able to avoid or correct, at the lowest possible cost, the imperfections of the markets, especially the externalities that may harm third parties.

The second no less important group of changes to which banking supervision must adapt is in relation to the demands posed by society. I consider two such demands to be particularly significant. The first is the growing social demand that supervision should promote not only sound, stable and efficient financial systems but systems, moreover, which are governed by increasingly stricter codes of conduct giving rise to practices and conduct subject to ever-higher standards. Among the practical consequences of this demand are, among others, improvements in transparency, in corporate governance and in banks' knowledge of their clients, as I mentioned earlier.

On the basis of these tenets, and within the framework of international co-ordination I have referred to, banking systems as internationalised, interdependent, liberalised, dynamic and complex as those at present require an increasingly less intrusive and more incentives-based form of regulation, along with more preventive supervision. To achieve such regulation and supervision we are, at the national and international levels, setting aside ever more resources.

The relevance of all these matters has been duly reflected in the work of different groups at the international level, addressing the associated accounting, financial regulation and corporate governance facets. In the EU, we may mention the action envisaged under the Financial Services Action Plan, or the work of groups such as the High Level Group of Company Law Experts. And in the international domain we have the work of the International Accounting Standards Board. In Spain the Financial Law, currently under passage through Parliament, heralds many improvements, one of which is particularly significant for banking supervision. This is, namely, the possibility of considering as a breach of disciplinary rules the situation whereby a credit institution's solvency and viability is jeopardised by administrative or accounting shortcomings or deficiencies in internal control procedures, including those relating to risk management.

The methodology known as Supervision of Banking Activity under the Risk Approach, on which the Banco de España has been working, provides a framework suited to meeting the challenges posed to Spanish banking supervision by the aforementioned aspects. The Banco de España will assign more resources to complementing traditional supervision with the evaluation of the foregoing qualitative aspects, including corporate governance codes of practice, procedures and structures. The results of this evaluation will bear on our determination of each institution's risk profile.

Let me conclude this section with a reference to the greater demands made of supervisors by society for information and transparency. The obligation of professional secrecy imposed on supervises by national and international standards and the necessary discretion with which constructive banking supervision must be pursued are compatible with greater supervisory transparency. Indeed, that will allow for better knowledge, and thus control, of what are, at each moment in time, the priority goals of supervision, the problems it faces, the procedures to which it resorts, the means it assigns and the resulting measures drawing the foregoing elements together. In order to meet this - in my view - fully legitimate demand, and to foment knowledge and discussion on these matters, a Banking Supervision Report, which is at an advanced age of preparation, is shortly to be released. This will complement the new publication "Estabilidad Financiera" ("Financial Stability") launched in September last year.

In our capacity as a Eurosystem central bank to which additional functions of great importance are entrusted, we continued to make progress in 2001 along the lines marked out for the future last year. Major changes have been initiated in the areas of human resources management and technology, and the directorates banking supervision, internal audit, administration and works, note issuance and circulation, and control and accounting have been reorganised.

In all these changes, the collaboration of the Bank's staff has been excellent. I should thus first thank the Deputy-Governor and the Directors-General for their support and co-operation and, on their behalf, express our profound gratitude to all the Bank's staff for their positive attitude and hard work. Particular acknowledgment is due to all those who, directly or indirectly, participated in the physical introduction of the euro. Without their dedication and effort, the success of the changeover would not have been possible.

Finally, let me convey my gratitude to all the members of this Council for their invaluable support and co-operation. Their contributions have been fundamental in ensuring collegiate decision-making, adding depth and quality to the process.