Jaime Caruana: Overview of the Spanish economy in 2004

Address by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, to the Governing Council of the Bank of Spain on the occasion of the presentation of the Annual Report 2004, Madrid, 10 June 2005.

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Ladies and gentlemen,

The performance of the world economy in 2004 was exceptional: growth exceeded 5%, the highest rate for the last quarter of a century; inflation remained under control, with the exception of slight rises in some emerging countries; and the climate on international financial markets was relatively relaxed, allowing generous financing conditions in most countries. No headway was made, however, in correcting the world economy's main disequilibria, which tended to worsen. Adding to these imbalances was the shock of higher oil prices, which look more permanent than in previous episodes. There are thus persistent risks and vulnerabilities which, if not corrected, might endanger the continuity of growth.

Underpinning the buoyancy of the world economy was, above all, the contribution of US and, to a greater extent, Chinese demand, along with that from other emerging Asian economies. There was also a marked rise in activity in other emerging regions, such as Latin America and the central and eastern European countries. Conversely, the economic performance in the euro area and Japan was disappointing, with rates of expansion running below initial forecasts. That would appear to confirm the scant flexibility of these economies and their limited responsiveness to changing conditions on world markets.

Recent growth patterns have also led to widening divergence between the growth rates of the three main developed areas, as the high rate of expansion of the US economy increased and that of Europe and Japan declined or rose less than expected. This bore unfavourably on the global disequilibria, as manifest in the widening US current-account deficit, the counterpoint to which was the rising surplus in Japan, China and other Asian economies, as well as in the oil-exporting countries, while the slight surplus in the euro area increased very moderately.

The prolonged deterioration of the US external balance - linked to a very expansionary fiscal policy that has compounded the effects of scant private-sector saving in recent years - engendered expectations of a depreciation of the dollar on international foreign exchange markets, which materialised only partially and asymmetrically. Consequently, while the dollar depreciated significantly against the euro until late 2004, it held very stable against the Asian currencies with which most of the US external imbalance has been built up. The effective depreciation of the dollar was thus only 5% in 2004.

The dollar's fall in the period 2002-04 has not prompted a turnaround in the progressive widening of the US external deficit, either because, as is well known, depreciations tend only to correct current-account deficits with a lag, or because of the aforementioned asymmetry in the behaviour of the dollar against the main currencies and the fact that it has scarcely depreciated against the currencies of the countries that are running the counterpart surpluses. In turn, in a situation of large current-account surpluses and strong capital inflows, the Asian countries with de jure or de facto fixed exchange rates against the dollar continued to build up sizable international reserves.

The need of the Asian central banks to place these reserves also partly explains another salient feature of economic developments in 2004: the maintenance of long-term interest rates at abnormally low levels. This is also largely attributable to the persistence of low inflation expectations, set against highly credible counter-inflationary monetary policies, and to the conditions of ample liquidity in which international financial markets operated. For much of the year, European bond yields were markedly synchronous with their US counterparts, despite the different position of the fundamentals of the two economies. From November, however, European rates declined, moving progressively away from US rates so that the yield spread between these areas widened considerably. This more recent development is consistent with the uncertainty over economic recovery in the euro area and the brighter outlook for the US economy.

But perhaps the most salient international economic development in 2004 was the persistent rise in oil prices. At the root of this, above all, is the force of demand from the United States and China, in a situation marked by production and refining capacity bottlenecks, arising from limited investment in the past. Compared with other recent periods of oil price rises, such as the peaks in 1990 and 2000 linked to geopolitical tensions, the increase in prices on this occasion fed through to a much greater extent to long-term futures contracts, suggesting the markets are expecting oil prices to hold at high levels. Despite this, and on the indicators available, dearer energy scarcely affected inflation expectations, meaning the so-called second-round effects - linked to the reaction by wages - were avoided. On past experience, it is these latter affects which are most damaging.

So far, the effects of higher oil prices have been surprisingly mild. But economic policies should remain vigilant in the face of a potential pass-through to inflation expectations, all the more so when there are other risks and vulnerabilities in the world economy which, in some respects, have not only not diminished but have tended to increase. Of note, here, is the necessary re-establishment of a more normal macroeconomic stance (the main countries' policies have been adding abnormally expansionary momentum in the world economy in recent years), and the potential impact on financial markets.

As regards monetary policies, the countries most ahead in the business cycle have already begun to adjust their interest rates to a level more consistent with a neutral stance, and foreseeably those further behind in the cycle will progressively pursue this trend as their economies gather steam.

Turning to fiscal policies, it is telling that these should have deteriorated both in areas with more moderate growth rates, such as Japan and certain euro area countries, where it has been sought to use fiscal policy for counter-cyclical purposes, and in other particularly dynamic economies, such as the United States, where buoyant demand should have allowed more ambitious fiscal consolidation goals. The exceptions to this pattern of deteriorating budget positions are in certain emerging economies, where public debt is relatively high. This is the case of the Latin-American countries, which have harnessed the favourable economic situation to improve their primary surpluses. The importance of furthering fiscal consolidation in the medium term in the more developed economies becomes even clearer if the long-term problems linked to population ageing are taken into account, while the emerging economies, with high debt levels, need to persevere with budgetary discipline.

Restoring a more normal monetary and fiscal policy stance requires care, to ensure that the world economy is not dislodged from a low-inflation path of recovery. It is particularly important to limit the potential shock to international financial markets, which have been operating in very favourable conditions marked by high liquidity, low risk premiums and an interest-rate term structure that has been propitious to long-term borrowing.

In this respect, monetary measures to safeguard price stability must be accompanied by an appropriate communication policy and consistency in the application of fiscal rules and commitments, if the authorities are to avoid a sharp change in conditions on financial markets, which might induce exaggerated reactions. In particular, although long-term interest rates should no doubt resume a level more in keeping with past experience and with the current cyclical phase, this process should be orderly and without excessive propagation towards credit risk premiums on the corporate-debt and emerging sovereign-debt markets, or on foreign-exchange markets.

Another source of vulnerability of the international economy lies, as discussed, in the global disequilibria. Broad international consensus has it that the correction of these imbalances requires an increase in public and private saving in the United States, structural reforms to invigorate the euro area economies and Japan, and greater flexibility in Asian exchange rates, especially in China. These policies would gradually correct the present current-account mismatches and would have to be accompanied by exchange-rate movements tending to bring positions closer to long-term equilibrium levels.

The correction of these current-account imbalances would also ideally re-establish a more natural direction of capital flows between developed and emerging countries. Compared with the anomalous situation at present, in which these flows are from the latter countries to the former ones, owing to the combined impact of the absorption exerted by the US economy and the exchange-rate policies in Asia, a smoother working of the world economy should channel surplus saving from the more mature economies to those where the return on capital is higher, as they are at a more incipient phase of development.

It should be recalled that many of the achievements of the world economy in recent years, such as moving on to a high, inflation-free growth path and infusing the emerging areas with greater dynamism so as to allow them to achieve standards of living closer to those of the richer countries, are a direct or indirect consequence of growing worldwide integration. Globalisation has thus given most countries more fluid access to foreign markets while offering them incentives to concentrate on those industries in which their comparative advantage lies, and it has provided consumers with a wider range of products at more favourable prices. But it should not be forgotten that the rigidity of certain countries' exchange-rate policies has ultimately triggered protectionist threats in others that see themselves as adversely affected. It is thus vital not to succumb to these protectionist temptations and to persevere with the liberalisation of international trade so that the trends which have allowed the world economy to achieve its recent favourable results may become entrenched.

The euro area

The prolonged sluggishness of the euro area economy continues, with output growth of below 2% for the fourth year running. In the first half of 2004 a more dynamic trajectory was discernible, in line with the greater robustness of the world economy, presaging the onset of a firmer expansionary phase. Activity has since weakened notably, however, and the first half of the current year has seen no improvement. Nonetheless, the conditions remain in place to allow the rate of expansion of GDP to increase gradually in the coming quarters, spurred by the continuation of relatively expansionary financial conditions and by the momentum of the international situation.

Dearer oil and the appreciation of the euro have been holding back growth in the euro area for some time, and these factors intensified in 2004. However, it would be wrong to attribute the protracted period of low growth seen in the euro area to these factors. The euro area has in fact benefited in recent years from a relatively sharp expansion of its export markets, allowing it largely to offset the negative effects of the euro's appreciation. Moreover, the rise in the euro, along with progress in reducing oil dependency, has softened the adverse consequences of higher oil prices.

At the root of the European economy's persistent weakness are, instead, the factors that hamper the sustained buoyancy of domestic spending and which heighten its sensitivity to external developments. The lacklustre consumption and investment of recent years are telling in this connection, and denote the presence of structural shortcomings which dampen household confidence and dent corporate profit expectations. Accordingly, questions such as the uncertainty over the viability of the public pension system currently in place or the constraints preventing higher productivity growth not only have long-term repercussions but also exert a contractionary effect on the present economic situation.

These overall characteristics of the area do not apply to all the member economies. Growth rates vary considerably, largely due to the different degrees of vigour shown by internal demand. Amid these divergences, Spain is one of the countries that has consistently posted substantially higher-than-average rates of expansion.

The Eurosystem monetary policy has retained an accommodative stance, with the intervention rate set in June 2003 unchanged at 2%. Although the forceful oil shock has hampered the reduction of inflation, medium-term inflation expectations have held at a rate compatible with the Eurosystem's definition of price stability, partly as a result of sustained wage moderation. The favourable trend of labour costs is a natural corollary of the prevailing sluggishness of activity and of employment creation, but it also reflects the credibility of the anti-inflationary goal of monetary policy. The European Central Bank has been able to sustain monetary conditions propitious to the strengthening of activity although, as indicated earlier, these have so far proven insufficient to achieve a satisfactory degree of dynamism. It thus appears that the euro area has yet to harness fully the benefits arising from economic integration and the introduction of the single currency.

The emergence of difficulties in furthering European economic integration has recently been discerned. Cases in point are the problems affecting the fiscal discipline framework, the delays in meeting the targets of the Lisbon Agenda and the obstacles still blocking, in certain industries, the development of the single European market.

At the March 2005 European Council, the authorities attempted to correct the lack of ambition behind the structural reforms and the scant consistency of budgetary policies with the disciplinary rules set by adjusting some of the policy co-ordination mechanisms. However, only clear resolve on the part of the authorities to fulfil their commitments would dispel the scepticism some of these proposals evoke.

In the fiscal policy realm, the European Council approved a reform of the Stability and Growth Pact. Among other changes, provisions were made to pay greater attention to the particular situation of each country when evaluating its budgetary position and to make the application of the corrective measures envisaged in the Treaty more flexible. As a result of these changes, the economic rationality of certain components of the Pact has perhaps been enhanced, though its complexity and the margin available for discretion in its application have also undoubtedly increased. There are some favourable aspects to the new rules, but they raise doubts as to the Pact's capacity to deliver the budgetary discipline that proper functioning of the Monetary Union requires. Regardless of the fact that a full assessment of the agreement reached can only be made once the related legal texts are known, it is imperative, to dispel the uncertainty the reform process has aroused, that the European authorities should now apply the revised rules unequivocally and strictly.

The European Council also revised the so-called Lisbon Agenda, with which it was hoped to reinvigorate the European economy in the first decade of the new millennium. Assessment of the results achieved at the half-way stage makes disappointing reading. The introduction of reforms has been insufficient and the European co-ordination mechanisms have proven too weak to encourage the adoption of the appropriate measures at the national level. The Council has sought to re-launch this strategy, focusing on growth and employment, and altering the co-ordination arrangements between the Council, the Member States and the Commission, so as to ease the way for the adoption and monitoring of reforms at the national level. This new direction is appropriate, although more specific measures giving a more determined political impulse to the process would have been desirable.

Such determination will be needed, in particular, to overcome the obstacles hindering completion of the single market. Indeed, these were manifest in the European Council's request that the Commission revise its draft directive on liberalising the provision of services in the Union.

The challenges facing the European economy are considerable and set in an institutional context that has been disrupted by the "no" votes in the recently held French and Dutch referendums on the ratification of the Constitutional Treaty. The difficulties of entrenching growth that is sufficient and consistent with the European model and with the general public's expectations may have influenced the disappointing results returned by these referendums. But this is something which is closely related to the difficulties at the national level in pushing through the necessary reforms and explaining them convincingly.

The significance and implications of these results should not be underestimated. But they need not check European integration. Rather, they should act as a spur to further integration by means of European and national policies that respond to the demands of the public. In any event, European integration has not been a linear process in the past and I am fully confident that the European Union will be capable of overcoming these difficulties just as it always has when obstacles have stood in its way. On the plus side in the current circumstances is the fact that it has a currency shared by a large number of countries and a federally organised central bank which are a focal point of stability and exemplify Europeans' ability to embark on and co-ordinate ambitious undertakings that contribute effectively to the collective well-being.

The Spanish economy

Spain, as I said earlier, has been one of the euro area economies that has continued to post high growth rates, compared with the relative slackness of the area as a whole. The new base-year 2000 National Accounts estimates for Spain, released a few weeks ago, indicate that its GDP grew in 2004 at a significantly higher rate than the previous estimate (3.1% against 2.7%), albeit with a more unbalanced composition. Moreover, the growth rate has remained on a mildly accelerating path, which has continued into 2005 Q1, when output stood at 3.3% compared with the same period in 2004.

As indicated in the *Annual Report*, it has not yet been possible to analyse in depth the new National Accounts series, although the first comparisons with previous estimates indicate that both datasets offer a fundamentally similar diagnosis of the economy's performance. In particular, the higher growth the new figures - available so far from 2000 - show has confirmed the continuity of the long expansionary phase in train since the mid-nineties. The expansion has been the result of the notable momentum of domestic demand combined with high employment-generating capacity and the extension of the supply side of the economy, two mutually reinforcing phenomena over these years which have provided a sound base for growth.

Spanish euro area membership lay at the root of the significant expansionary impulses experienced by household and corporate expenditure. The effects of the anchoring of inflation expectations and the adjustment of interest-rate levels have recently been reinforced by the looseness of monetary and financial conditions in the euro area. Progress towards fiscal consolidation and the maintenance of balanced public finances have contributed decisively to shaping an environment of stability, which has eased the financing of private expenditure and growth.

On the supply side, robust population and employment figures have made for favourable conditions in which the expansionary demand impulses have translated into higher growth in activity and not into greater pressure on productive capacity leading to disequilibria. That said, and as I will remark later, this has not prevented the structural shortcomings of the economy from being manifest in upward pressures on prices and costs and in a wider current-account deficit.

Job creation is being fuelled by an expanding labour force, to which the increasing inflow of immigrants and the rising labour-market participation of women are both contributing. Regarding immigration, population projections drawn from the 2001 census and the continuously updated municipal population census show an impact that could hardly have been envisaged only a few years back. In any event, strong employment generation has been accompanied by very modest productivity gains, a trend which continued in 2004 when employment increased by 2.7%, compared with 2.5% in 2003, and apparent labour productivity growth was only 0.4%.

Domestic demand quickened in 2004 by almost 1 pp, growing by 4.6%. The growth rate intensified as the year unfolded, rising to a rate of 5.8% at the start of 2005. This acceleration has been driven by a higher increase in private consumption and the renewed buoyancy of construction coupled with a pick-up in investment in equipment. Households' expenditure has been underpinned by the recovery in their disposable income, which has benefited from higher employment growth and from a comparatively favourable contribution by general government, through the net effect of benefits and taxes. But above all it is the increase in household wealth in recent years - largely linked to the rise in real-estate asset values - and favourable financing conditions which are most underpinning household consumption and residential investment decisions.

The behaviour of productive investment has, in recent years, reflected the opportunities and uncertainties of this expansionary phase, many of them related to the external environment. However, business investment progressively took a lead from the robustness of demand during 2004 and it started the current year on a clearly more expansionary path. Lax financial conditions, the healthy position achieved by those corporations with most investment potential and favourable expectations about economic developments are behind this rise.

Set against the increase in domestic demand, external demand has exerted an increasingly contractionary influence. Although world trade picked up in 2004, goods exports grew less than external markets, while imports climbed at very high rates, increasing their penetration in the Spanish market. Tourism is feeling the effects of competition from nearby destinations offering packages similar to those of Spain at very competitive prices. The negative contribution of external demand to GDP growth thus continued to expand over the course of 2004, without any signs of a turnaround in 2005. On the contrary, according to National Accounts data for Q1, the contractionary effect of net external demand has stepped up significantly, against a backdrop of stronger domestic demand pressures driven by high consumption and vigorous construction spending combined with a clearer take-off in investment in capital goods.

Among the factors influencing this negative behaviour of net external demand, the causes and repercussions of which I shall return to later, are the persistence of inflation differentials. Indeed, the inflation differential with the euro area widened during 2004, reflecting a relatively sharper impact of dearer oil on Spanish prices. Moreover, although the growth rate of labour costs eased, it remained relatively high. As a result, the 12-month increase in consumer prices rose from 3.2% in December to 3.5% in April. It is expected to moderate in the coming months, however. Indeed, the initial estimate of the HICP for May (3.1%) suggests it already has done.

At the onset of 2005 the Spanish economy was highly buoyant. This robustness continues to be based on the momentum of domestic expenditure and on high job creation. While the impact of some of the factors underpinning household spending may moderate in the coming quarters, most of the factors operating in the recent past will continue to boost domestic demand and, in particular, productive investment. Likewise, insofar as European markets recover and the effects of the euro appreciation in 2004 ease and are absorbed, the contractionary influence of external demand might be checked. Under this scenario, the outlook for the economy in the short run points to a prolongation of the expansionary phase, with sustained GDP growth rates similar to those observed in 2004.

These forecasts are subject, however, to some risk. This poses significant challenges for economic policy, especially when it comes to promoting the sustainability of economic dynamism over a longer term, under the constraints stemming from euro area membership. There are certain external risks whose potential influence on Spain is significant, but which economic policy action can do little to counter. This is the case with the dangers arising from the weakness of the euro area, from higher oil prices and from the appreciation of the euro. What economic policy can do here is in line with what policymakers can do to counter domestic risks, these undoubtedly being the most relevant ones for policy design. Accordingly, I shall focus on analysing the nature of the latter and their possible repercussions.

The domestic risk factors stem largely from the very prolongation of a long, domestic demand-led expansionary phase, and can be grouped in two major areas. First, the losses in competitiveness that have built up in the earlier described setting of inflation differentials and very low productivity gains, which might ultimately check the generation of value added and job creation. And second, the increase in household debt that has accompanied the expansion of consumption and residential investment, which might constrain households' spending capacity, particularly if developments in the housing markets were to prompt any uncertainty about the value of this sector's wealth, which is strongly concentrated in real-estate assets. Although both areas of risk are inter-related, I shall deal with each separately.

In respect of competitiveness, there are signs that the risks signalled by the Banco de España in the past have already begun to materialise. The significant restraint on growth exerted by external demand in the past year and the considerable widening of the Spanish economy's external deficit point in this direction. Admittedly, these results partly reflect the influence of certain external factors, such as dearer oil and the appreciation of the euro, which have dampened the positive impact of the international recovery. Moreover, the deficit is also partly influenced by the cyclical divergences between Spain and the euro area. But these factors do not suffice to explain either the scale of the deficit or the speed at which it has widened, and they should not therefore conceal the existence of a genuine deterioration relating to the losses in competitiveness built up in recent years, as I shall now seek to illustrate.

But let me first address the significance and scope of an external deficit when the country concerned belongs to a monetary union, so as to qualify interpretations whereby such a deficit would have ceased to be a cause for concern. It is true that under the new circumstances there is no danger of a burgeoning external deficit generating financial or foreign-exchange pressures that then trigger a sharp adjustment in the economy, since fundamental variables such as the interest rate and the exchange rate are determined at the area-wide level. But that does not mean that the economy is immune to competitiveness problems. On the contrary, when a large external deficit emerges in a monetary union as a result of an economy's difficulties in competing, a very costly dilemma may arise: nominal costs are either adjusted head-on, or the loss of competitiveness will check the generation of value added and job creation.

A first sign of competitiveness problems is to be found in the growing difficulties Spanish products face in maintaining their market shares. Spanish export shares on foreign markets, which had held stable since the start of Monetary Union, tended to decline in 2004, even on the European market. And the fall-off in the tourist market is a similar development. Although there are specific factors that might explain some aspects of this behaviour, the strength of growing import penetration in the domestic market tends to confirm the diagnosis of diminished competitiveness of Spanish products on domestic and foreign markets alike.

The concurrence of the incipient slide in export shares and the ongoing increase in import penetration primarily reflects the higher relative prices of Spanish products as a result of persistent inflation differentials and of the more recent appreciation of the euro. Testifying to this is the negative trend of the traditional price competitiveness indicators, even when these are calculated with export deflators that capture how the sector more exposed to foreign trade has narrowed margins to face growing competitive pressure.

Behind the ongoing deterioration in price competitiveness lie a relative increase in unit labour costs, reflecting continuing higher wage increases in Spain despite the moderation compared with previous periods, and very low labour productivity gains. The existence of wage-setting and indexing mechanisms that set a higher floor for nominal wage growth than in other countries hinders the rapid absorption of external price shocks. And it also tends to hamper full convergence with the arrangements required in an area of macroeconomic stability.

The problems posed by wage inertia are exacerbated by the lacklustre behaviour of productivity. As noted on previous occasions, this partly reflects intensive growth in employment generation, which has been most beneficial for entrenching the expansionary cycle of the economy and making more efficient use of the labour supply available. But weak total factor productivity growth - the relative position of which vis-à-vis the EU has continued to worsen - denotes the presence of other more worrying factors which appear to be checking the incorporation of innovations and technical progress into productive processes.

The lack of innovation in the productive system tends to stifle the economy's overall efficiency and its long-term growth capacity. The indicators available for the stock of technological capital suggest a considerable lag remains in place. Undoubtedly, specific features of the Spanish economy's pattern of productive specialisation - which is very biased in manufacturing towards the production of intermediate- and low-technology goods, and in services towards tourism activities - may partly explain this phenomenon. But there are also shortcomings that are restricting the business sector's capacity to incorporate advances in knowledge and to adapt productive processes, human resources management and corporate strategies to an environment of heightened competition.

Of particular importance are the persistent mismatches between the skills and training levels of labour and companies' requirements, and, above all, the rigidities in the workings of factor and product markets, which discourage the adoption of more innovative strategies. I draw attention to these limitations of the Spanish economy at a particular juncture in which foreign direct investment is slowing considerably (FDI having been one of the main channels for the diffusion of technological advances), and in which the weight of high-technology imports remains very limited, despite the surge in import penetration.

The prolongation of the current trends might mean that the industries most exposed to foreign competition have to adjust their staffing levels in order to maintain their business margins. Hence the importance of creating an environment conducive to technological innovation and to higher productivity, which I shall refer to later.

The second area where risks have arisen from the extended expansionary phase of the economy is related, as earlier indicated, to the ongoing buoyancy of household spending on consumption and residential investment. This variable has been favoured by the notable generosity of financing conditions, and this has given rise to certain pressures on the financial position of Spanish households. As is known, household debt last year held on the upward course it has been following since the mid-nineties, clearly exceeding 100% of the sector's gross disposable income. This new peak marks a departure from the average levels of the euro area and is beginning to draw closer to that of countries such as the United States.

Although the low interest rates and the long average maturities of liabilities keep the financial burden within moderate limits, at end-2004 the cushion of saving available after interest and capital payments had fallen to practically zero for Spanish households as a whole. However, the effects of higher indebtedness and of this lower saving on household wealth were again more than offset by the notable surge in their real-estate wealth, which was strongly linked to the rise in house prices. As a result, the overall financial position of Spanish households remains sound.

The strength of the sector's balance sheet as a whole is likewise reflected in the microeconomic information drawn from the Spanish Survey of Household Finances recently compiled by the Banco de España. Although this survey identifies a household segment that is in a more vulnerable situation than is apparent from the overall indicators, the size of this segment is small.

While the notable changes in the household balance sheet have not led to a weakening of their wealth position, there has been an increase (by various mechanisms) in this sector's exposure to a relatively broad range of possible shocks, thereby raising the sensitivity of consumption and of residential investment to them. These shocks notably include those that may affect employment, a variable which, as mentioned above, largely determines the behaviour of household spending. Obviously, the behaviour of interest rates is also very important. However, the greatest uncertainties lie in the possible implications of developments in the real-estate market.

This market is in the midst of an expansionary phase which still shows no clear signs of faltering, despite its extraordinary duration and intensity. 2004 ended with significant growth in supply which, however, was insufficient to push down a price growth rate that again topped 17% in nominal terms. The statistical changes underlying the official information for 2005 make it harder to interpret the most recent data, although they still seem to show no signs of a significant slowdown. Such high growth rates are difficult to explain entirely on the basis of recent changes in income or in interest rates, or as a response to the demographic changes under way in Spain. Consequently, the overvaluation that has been detectable in this market for some years continued to expand in 2004, although the size of this gap is difficult to gauge accurately.

Subject to the natural caution required in view of this lack of precision, analyses by the Banco de España indicate that the current level of overvaluation is not incompatible with a gradual correction of that overvaluation, as seen in the past in both Spain and abroad. However, a central bank should consider not only the most likely scenarios but also the consequences of those which, though unlikely, might significantly affect the behaviour of the economy. Importantly in this connection, the Spanish economy has sufficient depth of stability to enable it to weather the impact on household spending of an appreciable house price correction, in the unlikely event that it should occur.

The soundness of Spanish credit institutions, underpinned by high solvency levels and comfortable bad debt coverage ratios (a matter to which I will return later in the more general framework of the situation of the financial system), minimises the possibility that downward adjustments in house prices, should they occur, would significantly impair banks' ability to continue to efficiently finance the spending decisions of firms and households. Moreover, unlike in other countries, Spanish households have not started significantly to borrow against their increased housing wealth to directly finance current consumption plans.

In any event, the losses in competitiveness, household debt levels and house prices evidently entail a risk of the expansion being interrupted. The economic policies under national sovereignty thus have the important mission of preventing these risks from materialising and providing a solid foundation for growth. In particular, since monetary and financial conditions will most likely continue to be relatively generous for the needs of the Spanish economy in the foreseeable future, it will continue to be the responsibility of fiscal policy to help establish an overall macroeconomic stance that will contribute to mitigating spending pressure. However, the available instruments are limited in their effect on aggregate demand, which means that a major role must be played by microeconomic and structural reform policies that can influence the behaviour of supply and create a basis for more efficient markets and institutions and for increased productivity.

In 2004 fiscal policy achieved the expected results, since the budget on general government account was almost in balance (or in modest surplus if the effect of assuming RENFE's debt is stripped out) and the public debt/GDP ratio showed a fresh decrease. Despite this, there was a certain drift in primary current expenditure, offset yet another year by highly buoyant government revenue. From a more general standpoint, the momentum of improvements in the structural balance must not be allowed to slacken, since this would indicate a fall-off in the fiscal drive of recent years.

In the circumstances described, it is highly recommendable to make a fiscal effort which goes beyond that programmed in the fiscal plans in force, for at least two reasons. First, because a more ambitious fiscal policy would strengthen its role of stabilising and containing domestic demand in the short term, counterbalancing monetary and financial conditions. Second, because firmer improvements in the structural balance would leave public finances better placed to face the increased expenditure deriving from population ageing, even in a scenario of high immigration flows. Fiscal stability and fiscal discipline are basic assets of Spanish economic policy which, however, are not always easy to manage, as shown by the vagaries of the European fiscal framework. It is thus very important that the review of the Fiscal Stability Law and of the Autonomous (Regional) Government Financing system should not lead to a weakening of fiscal discipline.

In a situation in which it is necessary to make headway simultaneously in job creation and in productivity gains, the role of supply-side policies geared to improving the workings of the economy and expanding its potential growth is crucial. One of the main messages in the *Annual Report* presented today is precisely that it will become increasingly difficult for the Spanish economy to keep raising its levels of well-being if it does not make progress on both these fronts. Maintaining high levels of job creation is, and will continue to be, a powerful means of expanding the economy's growth potential, but it will be impossible to sustain economic momentum in the long term if the economy does not improve its competitive position in the increasingly dynamic international setting. And to do this, it is essential to significantly improve the poor performance of productivity.

Under this approach, labour market reform heads the list of transformations that are needed. A more flexible and efficient labour market is necessary to overcome the distortions that are contributing to a deterioration in competitiveness and to provide an appropriate framework so that firms will find sufficient stimulus for job creation, the introduction of new technologies, the efficient use of factors of production and the enhancement of productivity.

In this setting, the persistent ratio of temporary to permanent employees, which seems to have encountered a floor at levels above 30%, with the attendant negative consequences for productivity and human capital accumulation, makes it advisable to review the effectiveness of the incentives in force to hire permanent workers in recent years. This would involve redefining the measures designed to reduce non-wage costs linked to this type of employment and introducing incentives to rationalise the use of temporary employment contracts. It is also necessary to set in train a reform of collective bargaining to make the wage-setting mechanisms more flexible, so that compensation is brought into line with the specific conditions of the productive sector and of firms and with the characteristics of workers. This reform would also eliminate, or at least reduce the emphasis on, wage-indexation mechanisms.

The stepping-up of investment in training, in physical capital and in technological capital in line with the objectives of the Lisbon Agenda is fundamental for boosting productivity. As mentioned, Spain has notable weaknesses in the areas of innovation and of its incorporation and diffusion in the productive system. These weaknesses make it necessary to design specific policies to address this objective and to adapt the institutional and regulatory framework so that the smooth functioning of the markets will drive the innovation and development of new activities that will focus the productive structure on sectors in which demand and value added are greater.

As a result of the launch of the new Plan to achieve a dynamic economy and to foster productivity, certain measures were adopted to promote competitiveness (of a sectoral nature), which will unquestionably play a part in improving productivity. The Banco de España particularly welcomes those measures addressing the financial system. However, what is most important is that this Plan should clearly steer reform policy priorities in the right direction and maintain the momentum of reform. The commitments announced must be implemented ambitiously and complement other actions aimed at fostering improvements in human and technological capital and in the workings of markets and institutions.

This is not the appropriate setting for a detailed and exhaustive review of the range of measures and reforms required by the Spanish economy. I have referred only to some of the most necessary ones, but this list would be incomplete if I did not mention steps to mitigate the potential effects of household indebtedness and of house price rises on the sustainability of growth. The measures aimed at raising the supply of housing and its accessibility will not be sufficiently effective if they do not include a reorganisation of the land market, which remains one of the main unresolved issues facing the Spanish economy. Also, a more neutral tax treatment of house ownership and further measures to foster rental could improve the working of this market. There are also implications for the behaviour of financial intermediaries and I will look at these now as I review the main recent developments in the Spanish financial system.

The financial system

The international financial system benefited in 2004 from the favourable trends in train since 2003 and still apparent in the early months of 2005. Very low long-term interest rates, stable interest rate spreads both in emerging countries and in the corporate sector, the performance of the main stock market indices, low levels of volatility and ample liquidity all made for a relatively easy scenario that contrasted with the difficulties experienced at the beginning of the decade.

Despite this favourable environment, the financial situation is complicated by certain circumstances that cannot be ignored. First, financing activities are becoming increasingly complex in terms of both demand and management. Low interest rates have thus increased the appetite for risk and spurred the development of new financial products, such as credit derivatives, and of new intermediaries, such as hedge funds. These new possibilities mean that institutions have had to become much more sophisticated risk managers because of the singular features of these financial products and intermediaries, particularly their complexity and opacity.

If we factor in the natural doubts as to the sustainability of this scenario (not so much as to whether it will continue but as to how benign it will be), it becomes evident that the satisfactory behaviour of the markets and financial intermediaries should not be allowed to lead to complacency, but should be used to strengthen the soundness of institutions as a precaution against possible changes in the favourable central scenarios.

Spanish deposit institutions have not been unaffected by these developments. In fact, to the favourable factors listed above should be added, in the case of Spain, a highly favourable macroeconomic scenario and a growth differential with the core European countries in both output and employment. This, along with the good starting position of our institutions in terms of efficiency and competitiveness, enabled the soundness and international leadership of our financial system to be strengthened. Our institutions have thus been able to meet the demand for more and increasingly complex banking products and services, and at the same time improve their profitability. Naturally, however, the above comments on the international scenario and the need for markets and institutions to maintain their operational soundness apply likewise to Spanish institutions.

Thus in 2004 Spanish credit institutions again achieved very high levels of profitability, whether measured as growth on the previous year or as ROE, which was more than 14% higher than the average reported by their international competitors. The high business volumes, which more than offset the negative effects of low interest rates on net interest income, and the tight control over operating expenses, which enabled the efficiency ratio to be further improved, are the two basic factors behind this favourable performance. Moreover, business activity has been stepped up precisely through instruments that provide institutions with collateralised assets, specifically mortgage loans, which are characterised by lower default rates. Finally, this favourable earnings performance is also a result of the diversification of income sources, with significant growth of those associated with the provision of collection, payment and non-banking product services.

Solvency remains at levels comfortably above the minimum regulatory requirements, although the strong growth of business, and therefore of capital requirements, meant that the bank solvency ratio decreased slightly in 2004 with respect to 2003. In the case of Spain, this solvency was strengthened by a rigorous bad debt provisioning policy.

That said, the more optimistic and favourable the central scenario, the greater the need to pay careful attention to potential fragilities. In applying this caveat to Spanish institutions, we shall focus on the three lines of defence used by institutions to protect themselves from possible difficulties: risk management, which enables ex ante minimisation of difficulties, and profitability and solvency, which make it easier to absorb risks once they materialise.

As regards risks, the low levels of default unquestionably reflect not only the favourable financial and macroeconomic trends, but also improvements in the procedures for identifying, measuring and controlling those risks. The sharp increase in activity, however, poses certain questions to which some thought should be given. First, although the fastest growing instruments are secured loans, their concentration in the real-estate market, together with growing household indebtedness, should be taken into account by managers, since both factors (sectoral concentration and growing indebtedness) entail under alternative scenarios a greater risk, which should be analysed within the framework of an institution's medium- and long-term financial strategy, taking account of its financial equilibrium conditions.

Second, there is a need for the management systems used to incorporate the regular performance of stress tests under adverse scenarios, considering variations in real estate prices, changes in interest rates and other possible modifications in macroeconomic data. This analysis will be of use in regularly reviewing each institution's strategy and will determine the advisability of establishing internal control measures and how to ameliorate the residual risk incurred. Particular attention is required by those market segments, such as the financing of real-estate development activities, which have shown higher risk in the past.

In addition, collateral security must, as stipulated by the attendant regulations, be assessed as a market value calculated in a manner that is prudent and sustainable over time, i.e. it is possible that the experience of potential losses in adverse situations over the last twenty years may not be consistent with the characteristics of the current situation. This has to be taken into account by institutions in calculating the capital consumed by real-estate loans under the advanced Basel II approaches. But this need for prudent assessment is not limited to credit institutions: appraisal companies play a key role in Spain's financial system and hence it is essential for them to operate under the clear prudential guidelines laid down in their specific regulations.

The sustainability of results, their recurrence, the diversity of income sources and the ongoing search for efficiency are needed to strengthen the line of defence represented by the high profitability of Spain's institutions. In this respect, we must not overlook the behaviour of the liabilities side of bank balance sheets. The financing of this high volume of assets has been made possible by their access to efficient financial markets after Spain joined the euro area. This enabled them to supplement their traditional deposit-based financing, which despite its strong momentum is insufficient to finance lending activities. Although gearing is part and parcel of the lending business, that growing access to international financial markets entails a higher cost of financing which puts upward pressure on the average cost of borrowing and negatively affects income, which is something to be taken into account in forward-looking strategies.

The last line of defence is own funds and, within these, tier 1 capital. Indeed, only ordinary shares, reserves and preferential equity holdings allow both the absorption of possible losses and the continued engagement in banking operations. This, along with its long-term presence in own funds, explains why supervisors and markets pay particular attention to this component of regulatory own funds. Regarding preferential equity holdings, their long-term nature, their preferential use in absorbing losses and their non-participation in dividend distributions have led the Banco de España to allow them to rise to 30% of tier 1 capital. In addition, the characteristics of these securities and their frequent distribution through the network have led the Banco de España to remind institutions that they should take special care when distributing such a complex product to their retail customers, given the reputational risk in which they may incur.

Looking ahead, it is advisable to strengthen this policy. For example, it would be clearly desirable that, when the issues are marketed among retail customers, the pricing mechanisms should be based on the intervention of institutional investors. Further, as a means of recognising the processes of financial innovation, consideration should be given to the adoption of a more flexible treatment of the characteristics of the so-called innovative instruments in tier 1, which are basically preferential equity holdings with a step-up in remuneration after 10 years, not currently accepted as tier 1 capital by the Banco de España. This option should, in any event, be accompanied by a decrease in the weight of preferential equity holdings from the present 30% to 15%, in order to heighten the importance of the basic components of tier 1 capital, namely ordinary shares and reserves.

Moving on to regulatory developments, 2004 was a particularly eventful and, to tell the truth, difficult and complex year. It saw two projects with a direct impact on credit institutions: the IFRS (International Financial Reporting Standards) and the New Capital Accord, or Basel II.

The European Union decided that from January 2005 the consolidated accounts of groups with securities quoted on any regulated market in the EU have to be prepared using international accounting standards (IAS). Its aim in doing this was to assist the growing integration of the European single market by ensuring that investors have access to financial information with the highest possible level of homogeneity. In addition, the international financial system is strengthened, since the plurinational nature of IAS facilitates the convergence of these standards with those of the US.

The Banco de España, in accordance with its competence in the accounting regulation of Spanish credit institutions, decided to undertake a project to extend the use of IAS from consolidated financial statements to the individual, regulatory and prudential ones, thereby avoiding the cost and uncertainty of diverse accounting criteria. This initiative gave rise to the new accounting Circular 4/2004. Through this Circular, the Banco de España acknowledges and shares the benefits derived from the efforts to achieve greater accounting harmonisation, while pursuing, in its supervisory capacity, a legitimate interest in the quality of accounting standards and in their effective implementation.

Also, since the process of approval and adoption of the new international standards was marked by its complexity and underwent certain timetable difficulties, the Banco de España's new Circular was also intended to endow the process, as far as possible, with a greater degree of certainty.

The complexity of the new accounting standards arises not only from the process referred to, but also basically from the modifications contained in them, since they involve notable changes in numerous matters that are very important in credit institution management and that impose new responsibilities on managers in the election of accounting policies.

Although it is too early to make a detailed assessment of the introduction of the new accounting standards, which have only been in force for a few months, the initial evaluation by the Banco de España is positive, and the major efforts and work by financial institutions in this connection should be acknowledged.

As regards Basel II, June 2004 saw the publication of the final text of "A Revised Framework of the International Convergence of Capital Measurement and Capital Standards". The most notable new developments are that it allows institutions to use internal risk measurement methodologies if they meet certain minimum requirements and are accepted by the supervisor. The possibility of using the most advanced methodologies will depend on the development of risk management systems, on the effective integration of these systems into management, on the adaptation of the technological environment and on the availability of consistent and integrated historical information databases.

Although the Accord will not enter into force until 2007, work has commenced on the long and complicated task of development, implementation, internal validation by institutions and review by the Banco de España of these methodologies, at speeds which will inevitably differ depending on the preparedness of the institutions. Furthermore, the European Parliament is debating a directive to legally implement Basel II after appropriately adapting it to the specific features of EU institutions and markets.

It is difficult to state, in a nutshell, what the new Accord will signify. Perhaps most noteworthy are the three core ideas on which the three pillars rest: a recognition in regulation of sound practices in risk management, along with an incentive to encourage them; a strengthening of the supervisor's judgement, as an added factor of safety; and the importance of market discipline, i.e. of active scrutiny of the market, of shareholders and of creditors, which implies a continual strengthening of transparency. It is this latter aspect, relating to Pillar III, which is the least well-known, although it is that with the greatest potential in the medium term for disseminating best practices in risk management.

Of course, the completion of Basel II is only the beginning of the implementation process, and not just in credit institutions, but also in their supervisors. In this respect, I believe that our institutions and our supervisory model are in a magnificent position to lead the implementation process insofar as quality is concerned. And this process will yield better managed institutions and more effective supervision.

These two key regulatory issues raise other points. First, the development of IAS and Basel II make it necessary to strengthen international co-operation in supervision and regulation. The international expansion of Spanish banking and its presence in a larger number of jurisdictions with differing features raise the need to establish closer bilateral relations with the authorities of other countries, so as better to comply with the respective responsibilities. In addition, the new European legislation on financial conglomerates also addresses in depth the need for greater co-operation. Specifically, the EU has opted for a solution based on co-operation between supervisors as the most appropriate (and essential) approach. Indeed, this is the prevailing course of action at present, routed through, for example, the ECB Banking Supervisory Committee or the recently created Committee of European Banking Supervisors, a "level 3 committee" set up in application of the Lamfalussy approach to the banking sector. The functions of the Committee of European Banking Supervisors include promoting convergence of the supervisory practices of the EU Member States and increasing and improving co-operation between supervisors.

Growing supervisory co-operation will become unavoidable as further headway is made in the necessary process of integration of the single financial market. In this respect, we cannot ignore that the pace of integration is far from homogeneous. Thus, the integration of the interbank market can be classed as full, particularly in the euro area, and very high in the wholesale, the securities issuance and the large company and bank financing markets. By contrast, the retail market remains markedly local in nature and it will only become integrated insofar as its cultural and idiosyncratic barriers are progressively lifted.

The same is so of cross-border activity. Mergers and acquisitions of credit institutions have raised to forty the number of institutions with operations in various EU countries. If profitability is adequate, this trend will foreseeably continue and European institutions will keep exploring the opportunities for profitability and lower costs offered by operations of this type. Despite this, the more than 8,000 deposit institutions in the EU continue to exhibit a markedly local nature.

In short, co-operation in supervisory matters in the EU has to observe the principles of pragmatism and flexibility. Pragmatism involves acknowledging the role that the competent national authorities must play in supervising a single market with very different levels of integration in the various areas of business and, furthermore, it advocates an increasingly important role for the authority in the home country of pan-European institutions. Flexibility is needed to adapt the levels of co-operation to the pace set by developments in the integration of the various segments of the single market.

Finally, regarding the changes currently under way, a major source of such change is the intense regulatory process to which the banking sector is lately being subjected. The adaptation to the new accounting standards issued by the IASB, which in Spain are set out in the new accounting Circular, and the preparations for implementing the new capital accord are the two landmark projects which are undoubtedly calling for a major effort by European institutions. This effort is absorbing extensive resources and deserves our full support. In this respect, I consider that, after a process of intense regulatory change, we should focus on achieving proper implementation and allow ourselves to slacken the pace of regulatory developments in these areas. This will enable the far-reaching changes made recently to be digested and will ensure that the new standards are properly implemented.

From a different standpoint, allow me to share one last thought with you, which is intended to highlight the importance of providing appropriate information to financial statement users. Institutions are required to help customers to understand the products that they are offered, to assess them properly and, for this purpose, to identify the risks associated with each product and tailor them in terms of customer tolerance and affordability.

In this respect, the Banco de España has always recognised that the smooth working of the financial system requires well-informed consumers capable of making responsible decisions. For this reason, in February this year an Internet portal was set up for bank customers. It is receiving 2,000 visits daily. Its purpose is not to give advice or make recommendations, but to orientate consumers in their dealings with credit institutions and help to make information available to them. Well-informed consumers, together with an attitude of transparency on the part of institutions, help to increase market discipline, with the consequent favourable effect on competition and efficiency in the Spanish banking system.

I would not want to finish without conveying a message of confidence in our financial system. I am sure that Spanish institutions will, as in the past, show that they are capable of facing all the challenges to which I have referred. I therefore trust that the managers of institutions will act professionally and prudently, designing business strategies that are sustainable in the medium and long term. In this way, they will contribute not only to the stable functioning of the institutions for which they are responsible, but also to that of the financial system as a whole.

The inclusion as from last year of a chapter dealing with management aspects of the Banco de España allows me to be brief and to point out that in 2004 the branch restructuring plans, the staff renewal and redimensioning plan and the early retirement plan were completed and the negotiation of the 2002-04 collective bargaining agreement was finalised. All these reforms, which enable us to undertake appropriately our important mission and functions in the euro area, have been made possible by the effort and dedication of all the Bank’s staff, whom I thank for their attitude and their work.

Finally, I express my gratitude to all the members of this Council for their inestimable support and collaboration. I would like to conclude by remembering two people whose untimely loss we suffered last year: Ángel Pardillos, who was one of the victims of the 11 March attacks, and Eugenio Domingo, who shared, at this table, many sessions of this Council, both before and after his term of office at the European Central Bank.

Thank you.