Luis Ángel Rojo: Presentation of the Annual Report of the Banco de España

Address by Mr Luis Ángel Rojo, Governor of the Banco de España, to the Governing Council of the Banco de España on the presentation of the Annual Report, Madrid, on 20 June 2000.

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Gentlemen,

When this Governing Council met a year back to examine and publish the Annual Report of the Banco de España, the international economic setting was substantially different from at present. True, fears of a forthcoming worldwide contraction had faded. But doubts persisted over the strength of the recovery in those economies most affected by financial crises in the two preceding years and, therefore, over the speed with which the world economy would fully overcome the setback resulting from such disturbances. The doubts were progressively dispelled, however, in the second half of the year. The recovery firmed with greater speed than initially envisaged and it has led to a phase of expansion with forecasts for world output growth currently at above 4% for this year and the next, which might yet run for several years. These highly favourable expectations are, however, clouded by significant uncertainties which lie at the heart of current international concerns.

Among these concerns are, of course, those relating to the effects of the rise in oil prices since early 1999. This rise has largely involved a recovery in the price of crude from the low levels posted in the previous months of sluggish demand. But if the current high levels are sustained or rise further, there could ultimately be a contractionary monetary policy response, with adverse effects for the very countries regulating the supply of oil.

The greatest worries, however, surround the United States. The US economy has been the linchpin of the world economy over the past decade, but today it stands at an uncertain juncture. The stabilising effectiveness of macroeconomic policies, the greater competition resulting from globalisation, and the deregulation and increased flexibility of labour and product markets have created the conditions for greater cyclical stability, while moderating the wage rises associated with each level of unemployment and encouraging investment in new technology. During the 1990s, the US economy has enjoyed a lengthy expansion with strong job creation, a declining unemployment rate and low inflation. And, since 1996, when the cyclical upturn was already at an advanced stage and expected shortly to weaken, the US economy has shown renewed vigour. This fresh momentum has been linked to a surge in productivity growth, attributed to the more intensive and extensive use of new technology, which has allowed the unemployment rate to fall to very low levels, without significant increases in the inflation rate over a considerable period, and has also caused share prices to soar. However, the strong rise in overall demand in relation to supply (spurred partly by the effects of the sharp increase in share prices on consumption and investment) could not continue without eventually exacerbating pre-existing imbalances and causing others to emerge. Thus, the balance of payments deficit on current account, reflecting the sharp decline in US private-sector saving, has widened to barely sustainable levels, while the march of the economy at above capacity has led to the appearance of inflationary pressures on costs and prices in excess of what might be attributable to dearer oil.

The US economy requires an adjustment, and the monetary authorities have registered the fact. While the virtues of the so-called “new economy” are valid to some extent, they cannot preclude the ultimate emergence of the problems that have always concerned the old economy. The US Federal Reserve acknowledges that the explanation of recent economic developments is not satisfactory if no reference is made to the spur provided by new technology. But, at the same time, it points out that the productivity gains resulting from this spur have tended to generate even greater increases in aggregate demand than in potential supply. It concludes, in the words of Chairman Greenspan, that “until market forces, assisted by a vigilant Federal Reserve, effect the necessary alignment of the growth of aggregate demand with the growth of potential aggregate supply, the full benefits of innovative productivity acceleration are at risk of being undermined by financial and economic instability”.

Last July, the US authorities duly initiated a tightening of monetary policy pursuing a strategy of gradual rises in interest rates, only reinforcing this process in May this year in view of the vigorous US economy's stubbornness to adjust. It is difficult to anticipate whether the economy will move smoothly onto a sustainable growth path with stability or whether, on the contrary, the persistence of monetary restrictiveness to overcome the resistance encountered will ultimately lead to a sudden adjustment whose adverse effects might impact the rest of the world economy. The consequences of this impending adjustment in the United States are the main factor of uncertainty in the optimistic outlook for most of the industrialised and emerging countries. Naturally, mention should also be made of the doubts about the capacity of the Japanese economy to overcome its deep-seated problems in the short term.

In the euro area, the hesitant recovery embarked upon in the spring of 1999 progressively firmed in the second half of the year. Indeed, it has made way for an expansion underpinned by the strength of domestic demand and higher exports, which promises growth rates of more than 3% this year and next, and which might run on into the following years. The fears of recession surrounding the start-up of Monetary Union gradually gave way to concern to ensure stability in an upturn. As demand increased and growth expectations were revised upwards, the area began to experience price pressures, compounded by dearer oil, and it became evident that the low interest rate monetary policy adopted in the early months of EMU was progressively proving inadequate. The strong growth of the money supply and of credit, low real short-term interest rates and the weakness of the euro all portrayed an overly lax monetary policy that could fuel inflation pressures in the longer term. Consequently, the European Central Bank adopted last November a somewhat tighter policy stance which it has sustained with five increases in its intervention rates as the expansion has taken root.

The European Central Bank is an important and newly founded institution whose decisions are scrutinised by economists, markets and the media. Such close attention is to be welcomed and can contribute positively to the development of the common monetary policy. Inevitably though, as the institution takes its first steps, its decisions often give rise to confused and divergent interpretations. Sometimes this is because the transmission of intentions leaves something to be desired, and other times because observers pass the expression of such intentions through the prism of their prejudices. But the constant here is that monetary policy is not an exact science and it can be judged from a plethora of different positions. That said, the 18 months in which the common monetary policy has operated to date should suffice to bring observers round to the idea that the decisions of the European Central Bank have been geared to its primary goal of maintaining price stability in the area over the medium and long term. These decisions have been underpinned by inflation forecasts based on a broad range of indicators, among which those of a monetary nature are logically given privileged attention, especially the money stock. Of course, it can always be debated whether the decisions adopted with this basic aim and founded on the interpretation of the information available are appropriate or not. But it is much more difficult to maintain, for example, that such decisions have been deeply affected by the behaviour of the euro to the point of introducing confusion into the objectives pursued.

The European Central Bank does not, as it is sometimes claimed, practise "benign neglect" in respect of the euro. The euro may act as a generator of inflationary pressures and, as such, is an important element in the definition of the area's monetary conditions. Moreover, it is important for a new currency to have the public's confidence as regards its future capacity to retain its value. It is my view, however, that the euro cannot be the decisive factor in monetary decision-making. The successive rises in the European Central Bank's intervention interest rates over the past eight months have sought to adapt monetary conditions to the growing expansion while attempting to prevent the emergence of price pressures from harming durable growth in the area in future. Admittedly, the strong differentials (favourable to the dollar) in short- and long-term interest rates and expectations about their course have been one of the immediate determinants of the euro's weakness. But the European Central Bank has, fortunately, not been tempted to narrow spreads which are the result of different growth rates in the United States and in the euro area and of the efforts by the US authorities to realign overall demand and supply in the United States.

The euro area members are currently enjoying a most favourable economic situation. The expansion is running at a high rate overall and now extends to all the countries in the area (including Germany). It promises to continue narrowing the growth gap between the euro area and the United States given the high business and consumer confidence levels prevailing. The current inflation rate in the area is very moderate, both in relation to the US situation and to Europe's past experience, and the balance of payments on current account is running a surplus, in contrast to the burgeoning US deficit. The foreseeable continuation of this situation, assisted by a monetary policy firmly focused on price stability, will be propitious to the euro strengthening, although the rate at which this occurs will hinge decisively on how the adjustment sought by the US monetary authorities unfolds.

It is my belief that the common monetary policy, taken overall and with a perspective of 18 months, may be said to have been satisfactory. Its main problems have been its different significance and effect in the various countries of the area and, regarding implementation, those of the arrangements for liquidity allotment via regular tenders for euro area credit institutions.

The latter problem - to some extent a secondary one for monetary policy but an important one from the standpoint of the terms of access to liquidity for credit institutions - has arisen from the liquidity allotment system used in the regular (normally weekly) tenders. This system was based on a fixed interest rate at which the amounts bid by the institutions were satisfied according to a uniform percentage based on the total volume of funds that the European Central Bank wished to provide at each tender. Since the funds supplied had to be fully collateralised by the recipient institutions, and since the collateral volumes available varied greatly from one institution to another and from one country to another owing to the differing features of national financial systems, the amounts allotted and the rationing of funds at the fixed interest rate gave rise to a distribution of liquidity among institutions and among the Eurosystem countries that owed more to the relative volumes of collateral available than to actual liquidity requirements. When the European Central Bank judged that the volume of collateral required was only that needed to cover the liquidity allotted to each institution, overbidding by institutions became a structural feature of the system, becoming accentuated with time and increasing strongly in periods in which there were expectations of interest rate rises. In parallel, the fund rationing percentages applied in tenders declined and became more volatile, thereby heightening banks' difficulty in deciding on the size of their bids. Recently, the European Central Bank has decided to change to a regular tender system based on a variable interest rate (as hitherto applied in the fortnightly tenders) which, it is expected, will resolve the above-mentioned difficulties.

The first of the above problems is more important and is, moreover, inevitable. The single monetary policy is common to the entire euro area and is defined having regard to the situation and outlook for the countries of the area as a whole. Since cyclical positions and the transmission mechanisms for monetary measures vary from one country to another, the common or single monetary policy will never have the same significance (as regards its being more or less expansionary or contractionary) for all the economies of the area. When the common monetary policy adapted to the area's overall situation proves too expansionary or contractionary for a country in the area, that country has to offset this accordingly with a contractionary or expansionary fiscal policy, respectively, and, in the former case, pursue policies that increase flexibility and competition in the economy.

This problem, which is unavoidable in any monetary union, has been quite considerable in the first year and a half of Stage Three of EMU. The common monetary policy began at a time when external demand in the Eurosystem economies was weak owing to the international financial disturbances of the two previous years. Likewise, domestic demand was sluggish in some member states while surging in others, fuelled by strong interest rate cuts and the improved outlook resulting from the macroeconomic policies pursued to join EMU. Hence, the relatively accommodating common monetary policy adopted by the European Central Bank in view of the overall conditions of and outlook for the area was perhaps insufficient for some countries while excessively loose for those others (Spain among them) where demand and activity were advancing robustly. Later came the improvement in the world economy, the pickup in exports and the gradual strengthening of domestic demand across the area. And the European Central Bank, given the clearly expansionary climate taking hold, began the course of intervention interest rate rises it has followed to date. However, the recovery of exports and the strengthening of domestic demand have also spread to the countries in the area - including Spain - whose economies were already growing forcefully and have stepped up in pace in the closing months of 1999 and the opening months of the present year. Consequently, the common monetary policy has been tightened, but it is perhaps still too relaxed for the latter countries. These situations of relative monetary easiness are unimportant if temporary. But if they persist over time and are not sufficiently offset, they may ultimately generate demand pressures on supply in the countries affected. That may lead to losses in competitiveness the correction of which would exact a reduction in the growth rate of output and a fall in the level of employment.

Over the past three years Spain has run high GDP growth and job creation rates clearly above those in the euro area as a whole. And although the economic recovery in the euro area will lead to a narrowing of these differences this year and next, our economy will continue to experience high rates of expansion in this period. The government has pursued a fiscal policy which has lowered the general government deficit to 1.1% of GDP in 1999 (down from 5% in 1996), and promises to place it at 0.4% of GDP this year. It has further applied a deregulation and competition-enhancing policy of undoubtedly favourable effects for the price level and, in the short run, for the inflation rate. However, against a background of highly optimistic expectations, monetary conditions remain lax, as testified by the growth of the main monetary aggregates and the low level of real interest rates. Further, credit continues to rise at very high rates. The overall result is thus a heightening of demand pressure on trend output, with worrying effects. On one hand, the consumer price index has undergone a rise which, though largely attributable to exogenous factors (higher prices of oil and other commodities on international markets, the depreciation of the euro and bad weather), and despite the moderate behaviour of wages, also reflects the effects of demand pressure. This has taken the Spanish CPI to somewhat more than 1 percentage point higher than the average for the area. On the other, the resilience of demand has led to a very high growth rate of imports in real terms. And this, along with the rise in the prices of imported goods, has tipped the balance of payments on current account into deficit. Under these conditions, the Spanish economy needs to restrain the expansion of demand and increase the degree of flexibility in labour and product markets in order to sustain high, stable growth rates in the future. Specifically, it requires a policy to further reinforce fiscal consolidation, to push through greater labour market flexibility in industrial relations bargaining and to forcefully pursue deregulation and the infusion of greater competition in product and service markets. The Government’s announcement that it intends to act firmly along all these lines is thus to be welcomed and encouraged.

This desirable Spanish economic policy stance for circumstantial reasons has the advantage of coinciding with that required, to differing degrees, in most Eurosystem countries to overcome the structural problems that are at the very core of current difficulties. The United States is faced with a thorny issue of cyclical adjustment. But the euro area economies have a worrying point of reference in the US economy as regards matters such as the capacity to generate employment, the development and application of new technology and productivity growth. The euro area, in order to maintain and strengthen its position in the world economy, needs to increase employment among its population of working age and productivity so that its current expansion, exceeding its cyclical component, may lead to intense and sustained growth. That will require greater dynamism than the area has shown in recent years.

Winds of change are, of course, blowing across Europe. Corporate mergers and acquisitions have intensified of late and industrial restructuring is much more frequent than in the past. There are several forces behind this process. First, the heightened competition arising from the expansion of global trade in goods and services, which leads to size and strategy reviews and to cost-cutting drives. Adding to this in the euro area are the effects of the introduction of the single currency; this heightens competition in the area, highlights the industrial fragmentation of Europe and leads to the search for competitive edge through greater size. Privatisation and deregulation are also forcing former monopolies or oligopolies to shake off inertia, to compete and to restructure. Moreover, major European companies have tended to replace bank finance by resorting more to bond and equity markets. That has led them to pay greater heed to the requirements of stock market investors, moving closer to the Anglo-Saxon model of capitalism, to be more mindful of profits and to serve shareholders’ interests more. In turn, they have been led to undertake restructuring with a view to enhancing their effectiveness and cutting their costs.

Governments, for their part, have in recent years adopted a stance more favourable to fostering competition and limiting intervention, to assisting the creation of companies and to reducing a tax burden that is a deterrent to risk-taking. They are convinced that if they fail to do this, companies will, under the pressure of markets, emigrate to less regulated and lower-cost regions outside the euro area.

Despite these signs of greater dynamism, much remains to be done in the euro area in terms of increasing competition, reducing intervention, promoting innovation, boosting public and private research, and overcoming a nationalist bias which sees only a minor portion of corporate mergers cross borders and witnesses others being supported by governments to create dominant corporations of their nationality in the area.

The recent extraordinary European Council in Lisbon has highlighted Europe's backwardness in developing and applying new technology. This is not the only area where Europe lags behind, although it does appears to offer an explanation, at present, for the gap between the results achieved by the US economy and the European economies in recent years. Reflection on the range of factors and conditions bearing upon the progress and the absorption of the transforming effects that the new technology heralds leads inevitably to the general matter of the context in which economic activity unfolds and which encourages or hampers dynamic growth in Europe. Indeed, the shortcomings in research, education and technical and professional training which hinder scientific and technological progress, the inadequate levels of competition which hold back the introduction of new technology and the rigidities which prevent the replacement and reallocation of productive factors that are normally associated with technological innovation are problems no different from those that generally stifle productivity and job creation in Europe.

It is to be hoped that the course of action agreed upon in Lisbon will not be hamstrung by dissenting voices in the complex world of European politics and that the guiding principles of such action will extend beyond the field of new technology. It is also to be trusted that these programmes of action are structured around the goals, likewise formulated in Lisbon, of strongly increasing employment during this decade and of finding sound, viable social welfare systems in Europe. Such goals need not be eroded by greater economic and technological drive; rather, they should be tackled bearing in mind the likely technological future and the reality of population trends and of the resulting conditions, so as to design appropriate, sustainable social protection systems in the area. The European economies' apparent impending boom provides them with the opportunity to address a set of decisions geared to ensuring firmer and stable growth in the long run. Spain should participate purposefully in such reforming policies, which are currently the main challenge facing the euro area economies.

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Following the introduction of the euro, European financial markets have witnessed an acceleration of the trends discernible in the years prior to monetary union. These have been induced by growing deregulation, the introduction of remote access further to banking and investment services directives and the ongoing process of globalisation in economic and financial relations. The changes are introducing growing measures of consolidation and integration in European financial markets and paving the way for a more appropriate framework in which these markets may rapidly assimilate the effects of developments in information and communications technology.

The most rapid and direct effects of the introduction of the euro have been on the degree of integration of money markets, especially in the interbank deposit and derivatives (including most notably interest rate swaps) segments. This has been a consequence of the implementation of the single monetary policy and the sound functioning of the TARGET system.

In the market for fixed income securities, the defining characteristic of the year has been the strong growth of issues by non-financial private firms, which have resorted to the primary markets in many cases to finance mergers and acquisitions. The success of these placements has been assisted by investors' desire to diversify their portfolios and purchase the higher-yield instruments offered by private companies following the process of convergence in interest rates on European public debt. Further, the demand for bonds has benefited from the expansion of pension and mutual funds.

On the equity markets there has been a fresh increase in stock market capitalisation. This has come about due both to rising prices and a greater number of companies accessing the market. A key development in this area has been the establishment in the main European stock markets of a “new market” for technology or high-growth companies. The reporting, listing and trading rules of this market differ from those prevailing on the traditional markets.

Following the changes on derivative markets, equity markets are witnessing a deep-seated transformation, especially as regards trading. The construction of new electronic trading platforms has established a more competitive environment, characterised by a wealth of information, lower transaction costs and the elimination of entry barriers, all of which provides direct market access to a broader range of investors. This innovative process has prompted adaptation by the traditional market members. They have likewise offered electronic options for trading, and amended their governing structures, characterised to date by mutualism, which offered privileges to market members, through whom all transactions had to pass. As part of this process of adaptation to what will be a broader and less segmented market territorially, mention may likewise be made of the increasingly prominent role of strategic mergers and alliances between traditional market participants.

EMU has also led to advances in the consolidation of clearing and settlement systems. Nonetheless, it is premature as yet to talk of the speed or outcome of this integration process, which will probably lead to one or two major pan-European platforms being established.

Spanish financial markets have largely moved in step with other European markets following the introduction of the euro. They have also been influenced by the entry into force of the reform of the Securities Market Act and by the changes in the taxation of a good number of financial instruments. These events have generally tended to heighten competition in the markets and they have given extra momentum to financial disintermediation and to the internationalisation both of investor portfolios and end borrowers’ sources of financing.

The high degree of integration attained in the biggest segments of the euro area money market has allowed Spanish deposit money institutions, as a whole, to offset the decline in financing extended by the central bank with interbank loans obtained from the rest of the area. The system of periodic liquidity injections by the Eurosystem via fixed rate tenders and rationing (now under change) and the relatively modest volume of assets usable by Spanish banks as collateral for the liquidity received have adversely affected our institutions’ capacity to receive funds directly from the central bank; as a portion of what were previously domestic transactions are now cross-border ones, the domestic interbank market has shrunk considerably. At the same time, the integration of the money market has affected foreign banks with a presence in Spain: some such institutions have withdrawn or cut back their activity as their main source of business has disappeared.

In 1999, and generally in parallel with developments in the euro area, there was a slowdown in net issuance of public fixed income (reflecting the Treasury’s lower borrowing requirements) and a strong expansion of net issuance of private fixed income on the bond markets.

In the public fixed income segment, which remains the biggest and predominant one in total trading, there were several notable developments. First, reforms have been made to the group of market-makers, giving access to new non-resident market-makers without a presence in Spain. Further, an electronic public debt trading platform has been created, and the trading of public debt derivatives has fallen sharply as a result of the high substitutability between the products offered by various European centres following the launch of the euro, making for a strong concentration of these operations in the British (for short-dated terms) and German (for medium- and long-term maturities) markets. As to public debt clearing and settlement systems, the Spanish Public Debt Book-Entry System (CADE by its Spanish abbreviation) has established links with other central securities depositories and embarked on a venture to join forces with the Securities Clearing and Settlement Service (SCLV), which will be open to other systems. In this connection, the entity promoting the venture has been incorporated as a private company for the ultimate purpose of unifying the registration, clearing and settlement systems and thus improving the Spanish position vis-à-vis the foreseeable concentration into one or two European central depositories.

Private fixed income dominated the scene in 1999. Issuance increased fivefold on the previous year, although this figure should be interpreted bearing in mind the low starting level. The reasons for such a strong expansion in issues are to be found in the finance sought on this market by financial and non-financial corporations to fund their expansion; in the placing of private fixed income on the same tax footing as public debt for legal entities; and in the rapid advance of portfolio securitisation to convert holdings into assets that may be used as collateral for monetary policy and payment system operations. Private fixed income trading is still very modest in relation to total trading, but AIAF (the Spanish association of securities dealers) dealing doubled last year and it would be desirable if its initiative to link up to the Electronic Public Debt Platform were to prosper so that both public and private fixed income could be commonly traded. Both public and private debt could find a single clearing and settlement platform under the roof of a future union between CADE and SCLV.

Compared with the strong volumes of previous years, equity issues in 1999 were affected by the decline in privatisations. If this effect is stripped out, equity issues were up by over 50%, while trading increased moderately. Equity derivatives withstood the integration of European financial markets better than their fixed income counterparts, and held at positive growth rates. There were some significant structural innovations on equity markets. First, a market for Latin American companies called LATIBEX has been created, allowing the listing of certain companies from Latin American countries which are quoted in euro via the Spanish stock markets' electronic system and settled via SCLV. And more recently, the New Market has been instituted. The eligibility, listing and disclosure requirements of this market are better adapted to the particular features of technology and high-growth firms, whose financing requirements are also better served. Finally, the Spanish stock markets reached an agreement with seven other European exchanges to form a single pan-European trading platform, although little headway has been made given the difficulties of harmonising criteria and procedures and the new stock market merger plans in Europe.

Generally, the organised financial markets may be said to be undergoing a process of accelerated change and ongoing reforms under the pressure of the trend towards integration, accentuated by the introduction of the euro, and of technological innovation. Uncertainty persists over the foreseeably significant effects all this will have on the location of financial business in Europe. In any event, the process will lead to greater competition, cheaper operating costs in markets, greater diversification in investor portfolios and improved financing possibilities for companies. It is important that the institutional structure of our markets should be reformed with a view to increasing negotiating power vis-à-vis the mergers that will, no doubt, ultimately take place in the euro area.

Turning to financial intermediaries, and commencing with institutional investors, mention should be made of the modest increase in the net asset value of mutual funds, following the very strong increase in previous years, and the considerable growth in pension funds and insurance products. The lesser increase in the net asset value of mutual funds was due to the lower rise in the value of their holdings and to the lower net subscriptions of their shares by the public. The latter was the result, in turn, of the decline in the net financial saving of households and firms and of the lesser attractiveness of these shares compared with other investment alternatives (owing in part to the reforms detracting from the relative tax benefits of this type of product). By contrast, the fact that pension funds and insurance products retained significant tax benefits combined with their lesser degree of development meant that demand for them continued to grow. Institutional investors have been and remain the preferential vehicle used by final savers to attain greater diversification of their assets, seeking higher profitability and approving a greater internationalisation of the holdings. Such preferences on the part of the public are discernible in the composition of institutional investors' portfolios, where the increase in foreign holdings has been particularly notable since the introduction of the euro, at the same time as foreign positions in Spanish debt have increased.

I shall now turn to the basic group of financial intermediaries, namely deposit money institutions. Recently, they have had to face the challenges arising from the changes in monetary policy implementation arrangements, from the creation of a single money market in the euro area and from greater competition with deposit money institutions from the various countries now operating in the single currency. The notable capacity of Spanish institutions to respond and adapt to the new environment and harness its potential benefits should be highlighted.

In this respect, the fresh momentum given to the process of consolidation of the credit system, especially among the major banks, has been appreciable. Two major banking groups have emerged, accounting between them for around 40% of deposit money institutions' total assets. Moreover, these groups are pursuing a significant international strategy based chiefly on extending their activity to countries with a less developed banking culture to which they may lend their notable experience and in which they may expect satisfactory returns. That said, they are not forgoing a simultaneous increase in their presence and weight in the European banking market.

Another salient aspect of Spanish deposit money institutions' activity in 1999 was, for a further year, the expansion of credit to the resident private sector. The weight of this variable in the balance sheet continued to increase and showed very high growth rates, which are dangerous from a macroeconomic standpoint and insufficient from the perspective of banking prudence (a subject to which I shall return very shortly). The main factors behind this strong credit growth are well known. On the demand side, such factors include low interest rate levels, the favourable outlook for the economy and corporate restructuring, including the acquisition of companies in Spain and abroad, adding to which is the improved financial position of households and firms as a result of the lower interest burden on their debt and of the rise in the value of financial assets in recent years. Instrumental on the banks' side is the stiff competition between institutions, the optimism arising from historically low default rates and, no doubt, an easing of the conditions to be met to extend credit.

The strong expansion of credit could only be financed in part by deposits (despite the strong growth of sight deposits and the pickup in time deposits in response to their new tax treatment), while there was a heavy decline in asset sales under repurchase agreements to the private sector. Consequently, credit institutions had to raise sizeable net resources on the international interbank market (switching towards the euro area market), but also on domestic and foreign capital markets, taking advantage of the favourable conditions.

Deposit money institutions' results followed the same pattern in 1999 as in previous years. Their net interest, gross income and net income fell once more as a proportion of average total assets. Notwithstanding, pre-tax profits continued to increase since the decline in gross income was more than offset by lower writedowns and provisions against the background of a highly favourable economic situation.

However, in a strong economic upturn and in a context of significant financial transformation and technological progress, credit institutions must pay great attention to their operating costs and measures of efficiency and exercise particular caution with their strategies for profits, provisions and writedowns and capital. Cyclical upswings - when the demand for finance is intense, when the measures of disclosed bad debts are very low and when the climate of optimism tends to weaken the assessment of risks, the quality of their selection and the terms under which credit is granted - are periods in which problems that may later emerge, when operations mature or economic conditions change, are first sown. Accordingly, the Banco de España must continuously urge restraint on credit institutions and, when necessary, enact measures to strengthen prudence during phases of optimism.

The problems that may stem from the internationalisation of markets, from their volatility, from the development of new financial products, from the use of new technology and from the growing complexity of institutions are causing the BIS Committee on Banking Supervision and the supervisory groups of the European Union to consider fresh approaches towards solvency which will make themselves felt in the near future. These approaches have as their starting point the desirability of adapting the regulatory requirements governing credit institutions' capital to those resulting from an economic evaluation of the risks assumed taking into account both the objective characteristics of operations and the supervisors' assessment of the risk analysis, management and monitoring systems used by banks.

One significant idea making a mark in the new approach, and one that the Banco de España has advocated for some time, is the need to combine credit risk provisioning policy and capital adequacy policy. Credit risk remains the most important risk for the vast majority of banks and the main cause of bank failures. Inadequate assessment of the foreseeable failure of investments can make any capital adequacy ratio appear inadequate. International regulators had hitherto focused on the capital adequacy ratio, but they had scarcely looked into the prior problem of provisioning. This focus appears to be shifting with the new reflections on credit risk assessment methods.

Since it first began dictating accounting rules two decades back, the Banco de España has paid great attention to credit risk rating and provisioning. In 1999, these rules incorporated a somewhat pioneering idea but one which is in tune with the new global approach to provisions: the idea that the assessment of different individual operations at a specific point in time should be rounded off with an assessment of the potential risks of the portfolio over time, bearing in mind the cyclical movements of the economy, the correlation between general economic conditions and bank loan default, and the inertia of banks' portfolios and customers. It is sought to capture this dynamic element of risk with a new, so-called statistical provision that tends to take provisions for bad debts as a whole towards the average level required by bad debts over the course of the business cycle. In short, it is a stabilising mechanism which seeks to adjust the strong cyclical fluctuations of provisions. And it has been introduced at a time in which the economic boom has reduced disclosed portfolio credit risk to a minimum and in which, therefore, the specific provisions for loan losses are very low despite the strong expansion of credit. As the system is new, the initial values of the vector of coefficients defining the new statistical provision have been set with great caution, and no doubt fall somewhat short of the average burdens that insolvency risk has entailed in Spain's past experience or in the comparative experience of other countries. It is thus highly likely that the provisioning system will be revised in the near future to draw it closer to the reality of credit portfolio risk, and this likelihood will be even greater if credit institutions persist in lending at the very high current growth rates.

It would not be possible to conclude these thoughts on banking supervision without referring to the emergence of the internet, in the field of banking technology, as a new means of contact with the public. The Web induces all banks to offer these new access services at least passively, but it is leading some to a highly active virtual banking strategy. As this course of action is an entirely new one, it is difficult to assess economically the associated opportunities, which can naturally only be addressed following a rigorous, objective analysis of the projects involved and an appropriate assessment of the related investments. Undoubtedly, the internet will lead - and is in fact already leading - to an increase in competition on banking markets. This is because customers can compare the offers of various banks with greater ease and because banks wishing rapidly to gain market share will resort to tempting offers. In this connection, supervisors should insist that nobody make offers that are not economically rational and that cannot be sustained in the long run. Further, consumer safeguard systems are also valid and applicable to virtual banking, and the Banco de España has warned as much, without prejudice to the fact that it may adapt the current rules in some way to the particularities of the new medium.

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That marks the end of my address today, which is also the last of the series of speeches to this Governing Council which, during my eight years as Governor of the Banco de España, have accompanied the presentation of a like number of Annual Reports and corresponding Financial Accounts of the Spanish Economy.

During this period the Banco de España has striven to comply with the functions entrusted to it by law. To this end, it continued refining a monetary policy whose design and implementation was geared, under the constraints at each moment in time, to attaining price stability, until Spain joined the Monetary Union. It has also performed a regulatory and supervisory function contributing to the sound working and stability of the financial system and the payment system. And finally, it has sought to ensure in its services - from the preparation of studies and compilation of statistical information to supervision and operational tasks - a level of quality enabling it to perform its functions effectively.

The ongoing activity of the Bank in its areas of responsibility has, however, had to confront highly varied circumstances and adapt to changing institutional conditions. A few days after I took office in July 1992, the depreciation of sterling began that would eventually lead to the outbreak of the ERM crisis in September. This crisis violently shook the European economies for almost two years and was the result of the inadequate coordination of national monetary and exchange rate policies in the area following German reunification. It will probably be viewed by historians as the final, conclusive argument in favour of a monetary union in Europe. The crisis affected particularly harshly those economies, such as Spain's, which were at that time in a situation of great weakness. When it concluded in early August 1993, Spain appeared to be very far from being able to meet the convergence criteria set under the Maastricht agreement as requirements for EMU membership. Although serious doubts persisted over the possibility of creating the Union within a reasonable time frame, the European Monetary Institute embarked on the detailed preparation of the future Union at the beginning of 1994. The time available to pursue convergence policies would be limited if the schedules envisaged at Maastricht were to be met.

The legislation enacted on 2 June 1994 granting full monetary policy autonomy to the Banco de España, with a view to its future participation in the European System of Central Banks, was a landmark for our institution and enabled it to focus its efforts on the development of a stability-oriented monetary strategy geared to Spain joining the Union. The design of monetary policy was modified, defining its targets in terms of the inflation rate, and reporting and communication channels with Parliament and with society were extended to address existing problems and the results obtained. After some teething problems, the new monetary policy soon entered into a phase of highly positive achievements and, supported subsequently by a fiscal consolidation drive and continuously improving expectations, it contributed finally and significantly to the fulfilment on schedule of the convergence criteria.

At the same time, the Banco de España participated actively in the preparatory studies for EMU within the European Monetary Institute through numerous working groups and committees which paved the way for the resolutions adopted by its Council. It has continued doing this in the European Central Bank, contributing to the refinement and subsequent implementation of the common monetary policy and of the underlying mechanisms. All the foregoing has required considerable adaptation by our monetary system and by the Banco de España itself as from the successful "changeover to the euro" at the start of 1999.

In parallel, with regard to banking supervision, the serious crisis at Banesto in the early part of the period to which I am referring led to a strengthening of the supervisory area, while the range of institutions whose supervision was entrusted to the Banco de España was broadened. Further, the ongoing march of financial innovation, the growing technical sophistication of our credit institutions and the most significant changes in Spanish banking during these years, with rapid consolidation processes and the extension of activity into other geographical areas, have imposed significant reforms on the organisation and substance of supervision. I believe our supervisory arrangements have contributed to the prestige the Spanish banking system has acquired in the eyes of the world over these past years.

In sum, this period has had its difficult moments, but also greatly satisfying ones. Time will judge the role played by the Banco de España during these years, although I will venture to say I am optimistic in this respect. What I should stress is that the achievements have been the result of teamwork: by those whose work has been directly affected by the problems and transformation of monetary policy, of the payment system and of regulation and supervision; by those for whom frequent trips to Frankfurt to participate in meetings at which the new European monetary system has been forged or those for whom lengthy stays, away from their families, to carry out on-site inspection of credit institutions have been a regular feature of their lives; and by the rest of the Bank's staff, who have also felt the effect of such changes and have participated cooperatively and effectively in our common mission. My congratulations and gratitude to all of them.

I should convey my gratitude especially to the Deputy Governor, who has shared satisfactions and setbacks with me these past years, and to the Directors General, those present and those who have left the Bank during my term of office. Some debts cannot be repaid, and this is the case for those I have with them for their professional abilities, their commitment and their loyalty. I shall not seek to settle this debt with further words.

Finally, my sincere gratitude to this Council, to you the present members and your predecessors. During these years you have provided the Bank with your extensive knowledge, wise counsel and will to reach the right decisions and to contribute. Our meetings have been characterised by a high calibre of debate, seriousness and cordiality. Let my gratitude and best wishes to you all sound the final note of this somewhat lengthy coda.