Jaime Caruana: Key economic and financial developments in Spain

Address by Mr Jaime Caruana, Governor of the Banco de España, to the Governing Council of the Banco de España on the presentation of the Annual Report, Madrid, 15 June 2001.

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Ladies and gentlemen:

In July last year, Governor Luis Angel Rojo completed his six-year mandate, as envisaged under the Law of Autonomy of the Banco de España. During his term of office and that of the Deputy Governor, Miguel Martín, the Banco de España experienced at first hand the far-reaching reform and modernisation of our financial system, the process of economic convergence with Europe and the milestone of our accession to the Monetary Union. As this is the first time I am called upon to present the Annual Report to the Governing Council, I should like to begin by reiterating the gratitude of the Deputy Governor and myself for the legacy of independence, credibility and rigour bequeathed by our predecessors. The same values shall be our guiding principles in the coming years.

It is customary to devote this type of address to an analysis of the past year. Allow me to break with this tradition and begin by referring to the future, to the year 2002. With the physical introduction of euro notes and coins, that year will see the culmination of the transition to Monetary Union and may well symbolise a new phase for the Spanish economy based on economic and financial stability, integration and reform. Such principles will likewise underpin the work of this Bank in the future.

In the first part of this address, I shall highlight the key economic developments during the year 2000 and the opening months of 2001. In the second part, focusing on the financial system, I shall broach macroprudential issues, along with matters relating to the structure and the performance of the sector. Finally, I shall devote the third section to the role and activities of the Banco de España in this new stage.

World economy

Growth in the world economy in the year 2000 was, at 4.8%, unusually high. The industrialised economies, with the exception of Japan, and the emerging economies alike benefited from the boom climate. At the same time, inflation rose in the industrialised countries, owing partly to the surge in oil prices, and fell overall in the emerging economies. But the year 2000 was also a turning point; economic activity progressively lost momentum, highlighting weaknesses that need to be tackled.

As in previous years, the US economy was the driving force of this expansion. Nonetheless, although the United States saw its highest annual average growth for the past 16 years in 2000, the year also marked the end of the recent exceptionally lengthy and intense upturn. Signs of a slowdown became perceptible towards the summer and were confirmed as the second half of the year unfolded. As early as the second quarter the financial markets had signalled their concern at the first symptoms of a fall in corporate earnings. The decline in share prices was sharpest in securities linked to the new economy, and was accompanied by a rise in the risk premia on lower-rated bonds.

The opening months of the year 2001 have seen a continuing slowdown in the US economy and its extension to other areas, especially those with close trade links (Canada, Mexico and south-east Asia).

This sluggishness in the US economy is in contrast to the resilience shown to date by the dollar, not only against the euro but also in effective terms. Its robustness, linked to the relatively more favourable medium-term prospects for returns on investment in the United States, might well prove excessive given the US current-account deficit and the fact that the financial markets may occasionally, even for protracted periods, keep exchange rates some way off what fundamentals would appear to warrant.

In any event, doubts prevail over the intensity, duration and timing of the current phase of economic adjustment in the United States. These doubts are tied to a series of imponderables, including most notably: first, the extent to which the productivity growth rates observed to mid-2000 will be restored; next, the depth of the decline in consumption which, even were it to restore potentially more balanced levels of private saving in the long run, would also tend to heighten the loss of momentum of demand;

and lastly, the intensity and duration of the correction of corporate earnings, especially in the new technology sector and, in connection with this, the extent of the correction of share prices. The scale and duration of the slowdown in the United States will turn on the response to these questions.

The immediate prospects for the world economy appear to be closely linked to the US outlook, whether because of its direct influence or because the other economies are exposed to the same shocks. Before addressing the situation in Europe and Spain, I should briefly like to mention Latin America.

The influence of US economic developments on Latin America is through two channels: one real and one financial. The real channel, namely trade, is particularly marked in the case of Mexico, whose growth forecasts for 2001 have been revised downwards, while it is rather more tenuous in the case of the region's two other major economies, Argentina and Brazil. The financial channel partly offsets the adverse effect of the real channel by means of the feed-through to Latin America of US interest rate cuts, amounting to 2.5 points in the first five months of 2001. Overall, the slowdown in the US economy is expected to draw the cyclical positions of the main Latin American economies closer together.

Euro area

Economic results in the euro area in the year 2000 were favourable both in terms of growth and job creation. The buoyancy of the US economy until mid-year and the greater competitiveness arising from the depreciation of the euro contributed to this. On the negative side, the rise in oil prices has adversely affected economic expansion in Europe.

The euro area is not immune to heightening uncertainty on the international economic stage. In particular, the slowdown in the US economy may lead the diminishing growth path in Europe, initiated at the end of last year, to be prolonged. That will hinge on the intensity and duration of the deceleration in the United States and on the effect this may have on agents' confidence and on the financial markets. In any event, activity in the euro area may be expected to remain relatively buoyant insofar as domestic demand is underpinned by favourable income and financial conditions.

In the first half of 2000, monetary policy was progressively adapted to the deteriorating price outlook, against a backdrop of an improved economic situation. Gradual interest rate rises were implemented, though these did not prevent the monetary stance from being propitious to economic expansion across the area. Indeed, monetary conditions were clearly generous in certain countries which, like Spain, were ahead in the cycle and were experiencing greater price pressures.

Due to essentially temporary factors, euro area inflation climbed to above 2%. But the slowdown in US economic growth and the subsequent deterioration in the world economic outlook tempered inflationary risks as from the third quarter, paving the way in October for a halt in the succession of official interest rate rises. In its evaluation of inflationary risks, the European Central Bank (ECB) has since adopted a prudent stance, gradually modifying its assessment of macroeconomic conditions in the area on the basis of developments in its external environment and of the data available on their impact on the euro area. As a result, it trimmed its benchmark interest rate in May this year to 4.5%, estimating that the lower economic growth envisaged for the euro area should mitigate inflationary pressures in the medium run.

The ECB nevertheless monitors inflation developments in the euro area attentively. While the less expansionary economic climate is tending to moderate price increases, risk factors – associated mainly with uncertainty as to future wage restraint and to the feed-through to final prices of dearer energy and other imported inputs – remain which could delay the forecast reduction in inflation rates in the near future.

Having discussed the salient international economic developments over the past year, I should like to highlight two conclusions arising from such developments which merit special comment. The first is that technological progress does not imply the disappearance of macroeconomic disequilibria. And the second is the differing position of the US and European economies, as regards both their cyclical position and their medium-term growth outlook.

Technological progress does not presuppose the absence of disequilibria

Economic developments in the United States in recent years have been forcefully influenced by technological innovation. Their effect has been felt, primarily, in the new economy industries. But, gradually, they have also emerged in the more traditional industries as the latter have incorporated technological advances into their production and distribution processes. As a result, not only has there been a considerably higher economic growth rate than in the past two decades, but there is also increasingly firm empirical evidence that the rate of expansion of trend productivity may have been stepped up.

However, the fact that technical progress may provide a sustained boost to growth capacity does not mean, as the experience of recent years in the United States clearly shows, that macroeconomic disequilibria concurrently disappear. On the contrary, the favourable economic expectations in the wake of technological progress prompted a strong rise in share prices and, by means of the low cost of capital and the wealth effect, an expansion of domestic demand which, as from a certain point, outpaced the growth rate of potential output, even under the most optimistic scenario of the effects of the new economy.

The results of these maladjustments have been the notable decline in US household net financial saving (to -4% of disposable income), the significant increase in corporate debt and, for the economy as a whole, the widening of the already sizeable current-account deficit to 4.4% of GDP, albeit largely financed by direct investment.

This build-up in disequilibria, against a background in which signs of upward pressures on prices were also beginning to emerge, made it not only inevitable but also desirable that there should be a slowdown in the pace of aggregate demand to rates compatible with the economy's growth potential. And that necessarily entailed a temporary decline in productivity. The conclusion may thus be drawn from recent experience that technical progress and the structural changes it entails do not mean the disappearance or moderation of economic cycles. What technical progress does entail is an extension to the limits of sustained non-inflationary growth capacity.

Differences in the euro area economy

As indicated, the euro area economy has been affected by the deteriorating international economic climate and, in particular, by the sharp slowdown in the US economy. This is a natural consequence of the growing interdependence of the various regional economic areas, brought about by the increase in international trade and financial flows. Nonetheless, it would be mistaken to draw excessive parallels between economies which, with their differing cyclical positions and structural characteristics, do not share the same growth prospects.

In particular, many of the macroeconomic and financial disequilibria that have built up in the United States are not be found in the euro area. Although investment has remained buoyant in recent years in Europe, there is no sign of a surplus in capital goods being accumulated. Moreover, although the European saving ratio has declined in recent years, it is still holding at appreciably higher levels than in the United States. Finally, the private sector is in a less vulnerable wealth position, characterised by lower relative debt and by less exposure to fluctuations in financial asset prices.

The sustained high private saving ratio and the fiscal consolidation drive undertaken by the euro area Member States pursuant to the Stability and Growth Pact have helped the area as a whole achieve a healthy external position. Foreseeably, these factors will mean that the euro area may sustain, in the near future, a growth rate close to potential, albeit subject to the impact of developments on the international front.

Against this background, it should come as no surprise that monetary policy has differed on each side of the Atlantic. This discrepancy is, I believe, due not so much to differences in the statutory remit of the respective central banks but rather to economic situations departing from different bases and requiring different measures.

To meet the objective of increasing the economy's capacity for growth requires the contribution of strands of economic policy other than monetary policy. In this respect, the European governments have made headway in recent years in terms of fiscal consolidation, thereby increasing the room for manoeuvre available in public finances to withstand adverse cyclical circumstances. Likewise, mention should be made of the efforts to improve the workings of European product and factor markets, as part of the so-called Cardiff and Luxembourg processes. These have provided for significance advances in market integration and efficiency.

Despite these achievements, the challenges facing the European economy in the medium term go far beyond the scope of the economic policy measures and reforms applied to date.

Thus, in a setting where public finances should be ready to withstand the foreseeable budgetary consequences of the ageing of the population, effective additional measures to contain expenditure are generally needed to exert a positive and durable influence on public finances. Likewise, budgetary priorities must be established to favour those items, such as education or R+D, which can most contribute to increasing growth potential in the medium term. In many countries there is ample room to increase the efficiency of current tax systems. That said, in order to maximise their effectiveness, the measures aimed at improving the quality of public finances must not be at the expense of fiscal consolidation.

European structural policies must be pursued and deepened to achieve more integrated, flexible and competitive markets and to remove the obstacles to the development and use of new technologies. This is an important challenge requiring far-reaching reforms in widely differing areas such as the education system, the financial markets and the mechanisms regulating economic activity. Success here is pivotal if Europe is to aspire to competing in the cutting-edge industries and to satisfactorily increasing the economy's overall productivity.

Many of the factors indicated here are among the objectives set out by the European authorities in conclusions such as those of the extraordinary Lisbon summit last year. Notwithstanding, an air of fatigue is palpable in some countries in respect of fiscal consolidation and structural reform. The scale and significance of the challenges posed require that governments should not succumb to an excessively short-termist vision that diminishes the momentum of the reforms needed and hampers overall progress.

Spanish economy

For the Spanish economy, the year 2000 saw the culmination of a prolonged growth phase in which further headway was made in real convergence with the other European countries.

The year closed with a real GDP growth rate of 4%, six-tenths of a point above that for the euro area as a whole. Nonetheless, the growth rate of output moderated as the year unfolded as a result of the appreciable slowdown in national demand, which was offset only partly by the improved contribution of net external demand. The lesser momentum of demand was particularly evident in the capital investment component, which reacted promptly to the change in expectations.

Consumer spending also slowed amid the greater uncertainty, rising prices and the loss of financial wealth. But it is still holding at a sustained level as a result of the increase in employment. Lastly, exports of goods and services have remained highly buoyant, despite lower growth in foreign markets. This warrants reasonable optimism about the limited impact of the change in the international setting on our economy. But this will largely depend on the correction of certain incipient imbalances which gradually became apparent last year.

These imbalances have essentially been manifest in the price and cost differentials with the other euro area countries, in the savings shortage, in the loss of steam of the investment process and in the increase in the economy's borrowing requirements. As can be seen, all these imbalances are those characteristic of an economy which, after several years of uninterrupted growth, is at an advanced stage in the cycle (ahead of most of our trading partners). Their correction will be assisted by the slowdown in demand already taking place. Indeed, the moderation of consumption has halted the decline in the saving ratio and the slowdown in imports has lessened the deterioration in the external deficit.

Despite their eminently cyclical nature, these tensions also highlight structural shortcomings which continue to beset the workings of the economy. The risks arising from these imbalances should be tackled through the economic policy instruments available, bearing in mind that monetary policy is no longer available for domestic requirements.

Euro area monetary conditions have proved excessively generous for the Spanish economy in the light of the expansionary setting in which it was immersed and of the intensity of the external shock in the form of oil price rises. True, the monetary stance of the Eurosystem was altered as the inflationary outlook for the area as a whole changed. But real interest rates remained low and long-term rates declined. Moreover, the euro only ceased to depreciate well into the year, though it has subsequently shown fresh signs of weakness.

The foregoing factors translated into a high rate of expansion of bank lending to the resident private sector. This rate increased again last year by around 20%, although it has begun to show signs of easing in the opening months of the year 2001. Growth was particularly marked in loans for the purchase, construction and promotion of housing, against a backdrop of historically low real interest rates and stiff competition among institutions in this market segment. Hence, in addition to boosting domestic demand, the behaviour of credit has contributed to shaping a framework propitious to price rises in the property sector.

These relaxed monetary conditions were only partly countered by fiscal policy, which adopted a moderately restrictive stance. Fiscal policy results were better than scheduled, which has enabled a balanced budget to be forecast for the year ahead. Balanced public finances, which are so favourable for the economy, will tend to become entrenched with the disciplining procedures envisaged in the draft law on budgetary stability. Under this legislation, any extra budgetary policy leeway should be used to improve the general government financial balance.

Demand pressures contributed to inflationary tensions emerging. And these were accentuated by the rise in oil prices. As a result, the 12-month growth rate of the consumer price index (CPI) stood at 4% at the end of last year. In the early months of this year, the rate of increase of the CPI has stabilised at around this figure, as oil market pressures have yet to disappear. Adding to this have been the distortions in the market for meat products. At issue here in both cases are largely transitory factors which should abate in the coming months. This, combined with the deceleration of the economy, entails a significant change in the inflation outlook towards lower rates closer to the definition of price stability formulated by the ECB, a definition which should continue to be the medium-term reference for economic agents. There is a danger, however, that the feed-through of price rises to wages, via the inflation adjustment clauses that do not exist in most European countries, will delay the expected slowdown in consumer prices and, by exerting pressure on firms' costs, reduce the rate of growth and of job creation.

The continuing inflation differential with the euro area average is a cause for concern insofar as it may be indicative of problems of competitiveness. In the sectors (mainly manufacturing) most exposed to foreign competition, excessive cost increases lead, because they cannot be fed through to prices, to losses in profitability relative to foreign competitors. The sectors (mostly services) most sheltered from competition can, by contrast, pass through cost increases in full to prices and, indeed, harness the buoyancy of demand to increase margins, thereby contributing to maintaining inflation differentials. This behaviour is harmful, above all, to the competitiveness of the economy as a whole, but also to the development of those industries which seek to draw short-term benefit from the market power bestowed on them by restricted competition.

The Spanish economy is in a position to continue posting a rate of expansion of around 3% in the coming years, outpacing the euro area in this respect. But to achieve this it will be necessary to tackle appropriately the imbalances that have emerged after a long phase of rapid growth. Failing to do this would jeopardise the economy's competitiveness, which would be particularly worrying at a time of faltering world growth and heightening uncertainty.

Social agents must adapt their behaviour accordingly to the patterns of nominal stability that have inspired EMU, extending the moderation and stability that have presided over the initial years of the Monetary Union. It is thus a question of entrenching a new culture in which wage, rental and other income negotiations and price setting do not turn, as in the past, on a positive rate of inflation for the economy as a whole but rather on supply and demand in each specific case.

The year 2001 is particularly important for embedding the possibilities of growth in the continuing stability that has made the current phase of expansion possible. The different strands of economic policy must thus strengthen the economy's flexibility and improve market workings.

From this encouraging though not risk-free outlook, I believe two issues may be highlighted. First, the strengths and weaknesses of the job creation-intensive growth pattern we are following. And second, the importance of fostering conditions appropriate to increasing medium- and long-term growth potential.

Employment-intensive growth pattern

The growth pattern of the Spanish economy in recent years has been characterised by intense job creation and, consequently, by a moderate increase in apparent labour productivity. During the period 1997-2000, real GDP ran at an average annual growth rate of 4.1%, and employment at 3.5%. The increase in labour productivity was thus 0.6%. These figures contrast with those of the previous phase from 1980 to 1996, in which the growth rates of output and employment were 2.5% and 0.6%, respectively, making the productivity increase 1.9%.

For an economy such as Spain's, where the labour factor is still under-utilised, it seems advisable to follow a job creation-intensive growth pattern, even though this involves a phase of scant apparent labour productivity gains. This is provided that rates of investment and innovation are high and that the foundations are laid for subsequent improvement. Indeed, this is what occurred in the US economy.

The case of the US economy is illustrative in this respect. As will be recalled, the United States underwent, until the mid-nineties, a period in which its growth was based on employment, posting labour productivity rates of increase which scarcely exceeded 1% per annum. The flexibility of its labour market provided for greater relative growth of its labour-intensive services sector, at the expense of traditional manufacturing industry where labour requirements per unit of output are less. The substantial labour productivity gains, the outcome of the strong and persistent rate of investment and the diffusion of technological innovation, only became clearly apparent when the US economy reached a situation of virtually full employment.

If we compare this process with what has occurred in Europe in past decades, the greater rigidity of European labour markets can be seen to have led investment to be channelled towards relatively capital-intensive industries, slowing the expansion of the services industry. In fact, the services sector employs 60% of European labour today compared with 76% in the United States. The lesser capacity of Europe to generate employment translated into high unemployment rates (double that of the United States, on average) and into a relatively higher increase in apparent labour productivity, at that time, of over 1.5%. Consequently, the European economies, and Spain among them, are currently facing a phase that the United States has already left behind, and one that should be geared to reducing the prevailing high unemployment rate.

The challenge consists, precisely, of squaring the current job creation-intensive processes with increases in investment incorporating recent technological advances and providing for a better use of productive resources. The productivity gains arising from this process will become effective and manifest, with increasing intensity, as current unemployment is absorbed. In turn, low productivity makes the current growth phase particularly vulnerable to wage increases which, as they cannot be offset, pass through to greater unit labour costs.

Increasing growth potential

The temporary advisability of following a job creation-intensive growth model should not lead to an underestimation of the importance of boosting the factors underpinning the increase in the economy's growth potential, in which connection the full and effective use of the resources available does not suffice. It is also necessary to increase such resources quantitatively and qualitatively via investment in human, productive and technological capital. In this process entrepreneurial innovation and the incorporation of the new communications and information technologies play a pivotal role.

This will require flexible economic structures, whereby the policy of reforms in various areas must be pursued. The labour market is a case in point. Following the recent reforms, the focus should be on an efficient co-ordination of collective bargaining so that wages may grow in a differentiated manner and thus adapt to the specific conditions of firms. In turn, this differentiated wage growth will spur labour mobility across firms, industries and regions with different employment conditions. Likewise, policies aimed at increasing labour market participation, especially of those groups traditionally outside the market, should be reinforced. Reform in the market for land use, which is characterised by a lack of competition and transparency, would also help lift obstacles to inter-regional labour mobility. In education, investment in vocational training and in improving workers' skills must be stepped up. In particular, their adaptation to the new technologies is vital if the labour shortages in this area are to be reduced. Finally, the stock of both private and public productive capital must be increased through maintaining high rates of investment, equipping the country with the infrastructure and capital needed for a sustained increase in productivity.

It is thus a matter of seeing through the policy of reforms and the guidelines recently approved by Spanish economic policymakers. This is of paramount importance for continuing the process of convergence with the per capita income levels of the euro area, a process supported to date mainly by the robustness of employment. As we approach European rates of employment, continuing cuts in the differences will only be achieved if the rise in our productivity exceeds that of the euro area.

In the medium run, we should seek to attain a mix of buoyant job creation and high productivity rates. That means sustaining a high growth rate in a durable manner without this giving rise to upward pressures in costs, margins and prices. But this is only possible if we have an economy whose market workings and institutions are much more flexible than at present.

Financial stability

Moving on to financial stability issues, one of the salient phenomena of recent years is the growing significance of financial markets and their ever greater interrelatedness to the real economy.

In Europe, the development of capital markets is leading to a more balanced banking-market model. Household share ownership in the European Union has increased in recent years: whereas in 1995 they accounted for 26% of financial assets, this proportion had risen to 37% in 1999. And to this figure we must add indirect holdings via mutual funds, pension funds and other forms of collective investment, the popularity of which has increased visibly.

One immediate consequence of these changes has been to tighten the linkage between financial markets and the real sector. The fact that a growing portion of wealth is held in the form of securities, whose price can fluctuate 24 hours a day on the world markets, has evident implications for the dynamics of disposable income and consumption. In addition to this direct channel is that relating to the cost of capital and its influence on investment by firms. Lastly, the securities markets also play a key role in the formation of consumer and entrepreneurial expectations. Thanks to the constant information flows from these markets, these agents continually adjust their assessment of the economic environment.

The transmission channels from the financial sector to the real sector are, therefore, increasingly flexible, rapid and complex. Two relevant and interrelated issues have arisen from discussions on this area: the first is the extent to which the volatility of financial markets is being transmitted, also more intensely and rapidly, to the real economy; and the second questions whether financial markets amplify fluctuations in the real economy. Expressed otherwise, considering both issues in conjunction, what is being discussed is the extent to which the behaviour of the financial markets exacerbates the volatility and cyclicality of the real economy.

Regarding the first issue, there are recent examples pointing in opposite directions. There have been episodes, such as the Asian crisis, involving the intense transmission of financial turbulence to the real sector. However, it should also be acknowledged that the developed economies have shown a notable degree of resistance to certain financial disturbances. In this case, the stable course of real variables against such a volatile financial background should largely be attributed to the following factors. First, to the existence of healthy financial systems with sufficient room for manoeuvre to absorb the impact of varying shocks. Next, to a greater diversification of holders of financial instruments and of financial operators. And finally, to the prompt reaction of the authorities. Conversely, when these conditions were not present, pressures in the financial sector have tended to be transmitted relatively intensely to the real sector.

The possible explanatory factors of this potential amplification of the cycle in the financial sector are many-faceted and complex. These include most notably: heightened competition in the banking sector and in financial markets, which in an upturn leads to riskier strategies that are only corrected when the rise in bad debts highlights their consequences; a tendency of economic agents to over-react to changes in their environment; herding, on occasions, which reinforces trends; and the use of common assessment and risk management tools and a short-termist view of "shareholder value". All the foregoing induce sharper fluctuations in asset prices. Prudential regulations may also occasionally have proven conducive to an excessive emphasis on the short term when assessing risks.

What can the authorities do to counter these tendencies? In an area still open to discussion, several options present themselves. Firstly, it is essential to encourage within financial institutions a better knowledge of the risks assumed, a long-term orientation to analyses and, consequently, more prudent management. Secondly, it is advisable to promote greater heterogeneity among financial market players to avoid mimetic behaviour. Thirdly, a better understanding and evaluation of the behaviour of liquidity on markets is called for, on the part of both market participants and supervisors. Finally, it is for the regulatory authorities to introduce rules that do not promote short-termist strategies, but encourage counter-cyclical behaviour. This matter is particularly pertinent in the discussion of the new minimum capital regulation prepared by the Basel committee which, owing to its greater sensitivity to risk, is liable to introduce elements of cyclicality.

The statistical provision, introduced for prudential reasons in the year 2000 by the Banco de España, is in keeping with the wish to subdue cyclical behaviour. This provision draws on the fundamental principle that institutions should begin to recognise the expected losses associated with a loan as from the very moment it is extended, as there is a non-nil probability of default. A provision of this type introduces counter-cyclical elements in the behaviour of credit institutions by favouring a more accurate evaluation of loan portfolios.

Before discussing developments on the financial markets last year, I wish to reiterate the idea that a healthy and dynamic economy is only possible with solvent financial institutions and resilient financial markets. In Europe, in addition to the broad issues mentioned earlier, attaining this objective necessarily requires firm progress and resolve in integrating financial markets.

Financial markets

The introduction of the euro is a catalyst for market competition and integration in the euro area. But there are still obstacles preventing the process of integration of financial markets from moving at the desired speed. Perhaps the two extreme examples are, on one hand, the money market, which is illustrative of an integrated European market; and, on the other, the retail banking market, as an example of scant integration.

Two initiatives have sought to tackle the limited headway made towards the single financial market. The first is the European Commission's Financial Services Action Plan, which has given political impetus to legislative changes covering securities markets, pensions and investor safeguards, with the aim of providing a durable legislative underpinning for the single financial markets. The second initiative, derived from the difficulty encountered in implementing the aforementioned Action Plan, is the so-called Lamfalussy report. Given how slow and costly the promulgation of directives is in the securities field, this report proposes a genuine regulatory revolution. This will involve promoting directives whose technical aspects can be amended by the European Commission on the basis of recommendations from a committee of European representatives, further to the opinion of securities supervisors. This outline, which could be used in the future for other financial areas, is considered a sound means for achieving a truly integrated single financial market.

With these matters pending, integration among the various European financial markets continued in the year 2000. While the horizon was clouded by the odd failure such as the breakdown of the merger talks between the London and Frankfurt stock exchanges, other European securities markets entered into alliances in the areas of both trading and of registration, clearing and settlement. In Spain, the steps under way to integrate both the trading platform and the clearing and settlement systems may, in the near future, lead to a more efficient and better prepared unified market. With these arrangements, Spain can successfully operate in an industry of great importance for our economy and one which, in the future, is destined to undergo far-reaching change internationally.

The Banco de España has always encouraged moves towards the integration of the dispersed Spanish financial markets. Consequently, it supports and participates in such initiatives, which seek to infuse our securities markets with greater competitiveness and to give a more prominent role, in market management, to the institutions with the most significant trading interests on such markets.

Market integration in Spain is not only a means for ensuring a more efficient allocation of savings flows towards more productive investment. In a single financial market it is not just banking institutions which compete but the markets themselves. The future of the markets will hinge on their understanding the deep-seated changes in their operating environment and the competition facing them ahead.

Before moving on to the Spanish banking system, let me briefly refer to banks in Europe. In clear contrast to the integration of money and securities markets, European retail banking remains fragmented. And in recent years the burdens imposed by regulatory environments and supervisors on institutions wishing to expand their activities have been apparent. This is a situation that runs counter to the undertaking to achieve a single financial market and one which must therefore be tackled.

Banking system

As regards the banking system, Spanish institutions reaffirmed their maturity and performed favourably in the year 2000 against a somewhat more uncertain international backdrop and with a growing degree of competition. Nonetheless, the challenges ahead and the lower expectations of growth called for a careful design of the most appropriate responses in the medium and long-term.

Mention should first be made of the 13% growth of bank balance sheets, on consolidated data, with highly different performances in business at home and that abroad. While the banking system grew by around 6% in the domestic market, foreign business climbed strikingly by 48% as a result of foreign bank acquisitions. As earlier mentioned, there has been sharp growth in lending, offset in part by a reduction in public sector indebtedness to banks. The remaining portion has been financed by a notable increase in deposits, in particular time deposits (thanks to the favourable impact of the personal income tax reform), by a 14% increase in capital and, finally, by resorting to euro-area interbank market debt and to securities issues on international markets. Into the year 2001, the new State Treasury management system, jointly set up by the Directorate General of the Treasury and Financial Policy and the Banco de España, has provided a new source of liquidity for Spanish institutions, enabling them to reduce their indebtedness on the European interbank market by around 20%.

The expansion in business has allowed adequate levels of profitability to be sustained. This has been possible thanks not only to entities shoring up their net interest income, after it had been narrowing sharply for years, but also to their growing resort to commission charges. Against this, the downward stickiness of operating expenses has continued and remains the main weakness in our credit institutions' profit and loss account.

The growth of business and the results on the profit and loss account have come about at a time of capital soundness at most institutions, with default rates at historical lows.

That said, the forces for change in financial systems remain present, and that poses a challenge to institutions and supervisors alike. There are several points for consideration here.

The first concerns the heightening competition characterising both the markets for deposits and for loans. In the face of this, institutions have sought to avoid pressure on margins through the search for higher profitability or, what amounts to the same, through adopting riskier strategies.

A second reflection relates to the heterogeneity of the various banks' steps to seek out higher profitability. While some have opted to expand their balance sheet, albeit at the cost of narrower margins, others have preferred to contain their activity and focus efforts on improving margins. In other cases, industrial holdings have been the preferred means in the search for higher returns. Reaching an optimum size via mergers and acquisitions has been another of the methods chosen. Lastly, the internationalisation of activity has been one response geared not only to attaining greater size, but also to gaining access to less mature financial environments, with more favourable net interest income prospects. The increase in risk and the diverse solutions adopted, according to the particular strategy involved, highlight the need for all institutions to make every effort to improve their management and risk control systems.

The third reflection refers to loan defaults. Lending in Spain has been growing at a very high rate in recent years. A large portion of the lending portfolio is thus relatively recent and has been extended at the top of the economic cycle. It is often and rightly said that default problems are generated during an economic upswing, when excessive optimism leads institutions to relax lending policies.

The figures for actual defaults and for specific provisions do not reflect appropriately the risks arising from latent defaults in lending portfolios, which have grown most rapidly in recent years. This is the reason for the introduction of the statistical provision, which seeks to encourage better risk management and to approximate the average provision needed throughout a cycle on an adjusted historical basis. Its impact on profit and loss accounts, by reducing profits at times of plenty as at present, and restoring them at times of high loan losses, is significant.

There are two further aspects of financial institutions' risk profile which merit discussion. The first is credit risk concentration. Institutions must monitor exposures closely, both at the level of economic groupings and at the sectoral level, and their managers should pay particular attention to appropriate diversification.

The second is costs. If institutions are to have a healthy profit and loss account in the future, efforts to rationalise and cut structural costs must remain a priority for managers. Such rationalisation is not only needed in costs associated with the network; it must also encompass a review of central services costs. These cuts are fully compatible with the ongoing reinforcement of such areas as risk management, the adoption of new technologies, enhanced service quality, etc.

The final reflection refers to the quality of capital. Spanish credit institutions have been issuing preference shares with growing frequency. The resort to preference shares is logical and acceptable, provided that the levels involved do not impair the quality of capital and provided that, at the retail distribution stage, factors such as the potential future costs in terms of reputation (which are sometimes so difficult to gauge) are taken into account.

To conclude this section, I shall refer to how the ongoing change towards a more complex operating environment for institutions is affecting the definition of the regulatory and accounting framework at the international level. There have recently been two major initiatives in this area, both with far-reaching implications for bank management and strategy: the new Basel capital accord, and the process of implementation of International Accounting Standards in the European Union.

The main features of the new proposal of the Basel Banking Supervision Committee on capital adequacy, which replaces the 1988 capital accord that was in force in over one hundred countries, are as follows. First, to acknowledge a greater differentiation between the different levels of credit risk, to consider a selection of alternative methods for calculating capital and to attribute greater importance to banks' internal systems, introducing incentives for better risk management and control.

Second, and thanks to greater sensitivity to the risks assumed, the new Basel proposal allows for readier convergence between economic capital (the level of capital considered appropriate by bank managers and shareholders) and regulatory capital (that required by the supervisor).

Finally, the aspect of the new Basel Accord I consider most important is the integration into a single package of four basic elements: several capital calculation systems; quality of management, stressing the need for sound internal risk management systems; system validation by the supervisor, being respectful of banks' responsibility for management; and lastly, transparency, so that the market takes informed action.

I believe the New Accord, currently at the consultative stage, marks a step forward. It merits our support, although work must continue so that the calibration of its parameters may result in meeting the objectives set, namely to maintain an overall level of capital and to provide proper incentives.

Adapting to the new accord is a demanding task for all credit institutions, in whatever country. But I believe the soundness of Spanish institutions makes them among the best positioned for this change.

The challenges posed by the new Basel agreement to supervisors are on no less a scale than those faced by banks. Their implementation, scheduled for 2004, entails a new regulatory capital framework for supervisors which will be much more demanding than the current one in respect of human resources and technical knowledge, making it necessary to objectify qualitative elements of banks and their systems.

Given the range of regulations and supervisory practices at the international level, and the need for a level playing field accommodating not only different countries and sizes but also investment and commercial banks, the new accord requires a balanced design and increased international co-ordination among supervisors.

As regards the introduction of the International Accounting Standards (IAS) in the European Union, the aim is to promote the convergence of accounting practices across the European countries. This is certainly a desirable goal, which should pave the way for progress towards the creation of a single financial market. The practical experience of banking supervision over the last twenty years in Spain has demonstrated that accounting regulation has been a fundamental element in achieving a solid and stable financial system and efficient supervision. Moreover, accounting standards based on prudential criteria and conservative principles are not only essential for prudential supervision, but also for individual investors, who thereby have a guarantee that the information they receive is well-founded. This is why it is considered extremely important that accounting principles be reconciled with good banking practices, with modern risk management techniques and with the nature and time horizon of all types of banking operation.

The Banco de España in the new setting

The changes in the Spanish economy over the last 15 years have altered its position in the world. The data on the growing international presence of Spanish corporations, the increase in the financial resources flowing out of Spain, in particular towards Latin America, and Spain's greater presence in international economic institutions are revealing. All this is turning Spain into a leading player with increasing weight in the globalisation process.

The development of the role of the Banco de España in future will turn on the new institutional framework deriving from Monetary Union (loss of monetary sovereignty and membership of the Eurosystem) and also on the new position of the Spanish economy in the international setting.

The objectives and responsibilities assigned by law to the Banco de España can be grouped into two major categories: those relating to economic stability and those relating to financial stability, to which should be added important additional functions such as the management of reserves, banknote issuance, etc.

Among the activities relating to economic stability are those arising from membership of the Eurosystem, and the functions of monitoring, analysing and advising on the Spanish economy. The latter will continue to be a fundamental part of the tasks entrusted to the Bank.

The monitoring and analysis of the Spanish economy traditionally carried out by the Banco the España, as a basis for discharging its responsibilities, has acquired a new dimension with membership of the Eurosystem. In the new setting, investigation and research have a twofold purpose. First, they should contribute to the consolidation of a solid analytical framework for monetary policy decision-making and to the constant improvement of the strategy, instruments and procedures employed by the Eurosystem to perform its functions. And second, they should inform the analysis of the implications for the Spanish economy of the single monetary policy.

This has required new subjects to be tackled and traditional issues to be viewed from a fresh perspective. Among the new concerns included on the research agenda I should like to highlight three. First, the relations between the national economies that make up the euro area, including their similarities and divergences, the particularities of their monetary policy transmission mechanisms, and the national authorities' room for manoeuvre.

Second, the problems involved in adequately measuring inflation, a key variable both for decision-taking and for the behaviour of agents, which may be distorted by an underestimation of the improvements in quality incorporated into goods and services. This distortion may be particularly significant in the case of products subject to continuous technical improvements, such as IT products, capital equipment, means of transport, etc. In this respect, we are collaborating with the National Institute of Statistics in an investigation of the techniques that could be used to correct this distortion in certain Spanish sectors.

Third, the information relating to the financial stocks and flows of the Spanish economy and the behaviour of the various institutional sectors is being continuously improved.

In any event, although constant reflection is necessary in our daily work, we should not forget that the main objective of all analytical work is to improve the tools for dealing with risks and problems in the medium term. Examples of these are the conditions necessary to increase productivity and potential growth, or the financial sustainability of pensions, which depends so heavily on productivity itself and on the efficiency of the labour market.

The process of internationalisation that the Spanish economy has embarked upon in recent years has gone beyond the European sphere to reach other areas including, in particular, Latin America. This increasing international presence of Spain has made it all the more pressing and necessary to extend and raise the profile of the Banco de España's participation in the main international economic and financial fora. It is here that issues are regularly discussed and decided which, due to their significance and their global repercussions, are so important to Spain's interests. This is why the functions and responsibilities relating to the analysis of international economic and financial issues have been strengthened, as part of a determined strategy to develop the Banco de España's international relations.

A good example of this growing international presence is our membership of the Basel Committee on Banking Supervision, Here initiatives are being discussed that are of great importance for our supervisory activity, which I have already mentioned and which tie in with the second group of activities of the Bank, which could be grouped under the general heading of financial stability. Included here are tasks relating to banking regulation and supervision and to the payment system, and powers in relation to securities markets, especially for public debt.

The increasing complexity and diversity of new products, the constant evolution of the risks incurred by institutions, technological innovation, the opening of previously unknown distribution channels, concentration via mergers, acquisitions and alliances, international expansion and the changes in the international regulatory framework are factors contributing to the growing complexity and sophistication of banking business. These changes are obliging institutions to strive continuously to adapt and improve their management and control systems, and this naturally has to be reflected in the area of supervision.

In an increasingly complex and international operating environment, supervision should not be based exclusively on traditional rules and circulars It must also be capable of incorporating more flexible elements, including recommendations and codes of good practice. A good example is provided by the institutions' areas of corporate governance and risk control. The Banco de España is encouraging all credit institutions, whether or not they are listed on securities markets, to establish and comply with codes of good governance. It is also stimulating the adoption of modern risk management systems that have the support of top management and are understood and used integrally and rationally by the whole organisation.

As regards prudential supervision, in my opinion several features are necessary in order for it to be able to face the present challenges. First, I think that the regulatory and supervisory remit will increasingly be geared towards stimulating the sound management of institutions, giving particularly favourable treatment to risk management structures, systems and culture. Second, it must be capable of combining traditional supervision techniques, based on the valuation of assets and examination of accounts, with new techniques of a more qualitative nature, based on the so-called risk approach. Third, and depending on the priorities arising from the risk profile of the institutions, it must continue to combine the remote monitoring of institutions with on-site inspections. Fourth, it will be essential to maintain a high degree of co-ordination with the supervisors of other financial sectors and of other countries, both through bilateral relations and through multilateral fora. Fifth, it must provide incentives for a level of transparency sufficient for markets to be able to perform their scrutiny role. Finally, investment in technological resources and human capital will be fundamental. All this assumes the development of deeper collaboration and dialogue with the institutions since, respecting the autonomy of their responsibilities, supervisors and supervised share an interest in achieving stable and solid financial systems.

This is the background against which the Banco de España has been striving to strengthen its supervision techniques and to supplement the traditional methods with dynamic analysis of the quality of management and of the mechanisms for the assumption, monitoring and control of risks by credit institutions. Without abandoning our style of supervision, based on close, direct and continuous contact with institutions, we have embarked upon the task of deepening the analysis of qualitative aspects and of control. Such analysis was already conducted, but it will now be more systematic and more closely integrated into the supervisory process.

In order to achieve this improvement in the supervisory approach, we are formulating, at the Banco de España, a methodology that we have called "SABER". Besides being the Spanish acronym for supervision of banking activity under the risk approach [Supervisión de la Actividad Bancaria bajo el Enfoque Riesgo], it indicates that the aim of the supervisor is not only to obtain the most complete picture possible of the current situation of each institution, but also to be able to make the best possible prediction of its future evolution.

The Banco de España is also aware that the new circumstances require greater transparency on the part of supervisors. In this respect, the Banco de España is setting up additional channels of communication and dialogue on supervision procedures and on the currently effective and proposed regulatory and supervisory measures.

As regards payment systems, following the setting up of TARGET, the Trans-European payment system managed by the central banks of the European Union, of which our Settlement Service forms part, the Banco de España is focusing on other less operational aspects that are, notwithstanding, of no less interest. I should like to mention specifically two: the oversight of payment systems, especially in relation to real-time settlement in the main currencies and to the new payment instruments based on electronic media, and co-operation with other countries, basically in Latin America.

Replacement of national currencies by the euro

The introduction of the new euro notes and coins is an enormously important political project. For the first time since the advent of Monetary Union, the physical euro will reach all sectors of the Union's population. It is also an unprecedented logistical task, which has required the constant attention of the Eurosystem and the Banco de España in co-ordination with the Ministry of the Economy and the credit institutions and other sectors involved. Over the last twelve months a plan has been drawn up for the distribution of euro notes and coins. Its ultimate purpose is to place the notes and coins close to their ultimate users (industry, shops and the general public), so that a large number of transactions can be carried out in euro from the beginning of January 2002 and the exchange process can be completed by the end of February, as planned.

The production and distribution of notes and coins is proceeding satisfactorily and to schedule. The National Mint is complying scrupulously with its timetable and, to ensure smooth distribution, the Banco de España has already begun to move the thousands of tons of notes and coins from central depots to each of its branches in the provinces.

The ultimate success of the process will depend upon the collaboration of everyone involved: the Ministry of Economy, the Banco de España and the financial system, each conducting effectively, within its sphere of responsibility, the logistical process; employers, especially in the distributive sector, assuming the importance of the historic moment and acting high-mindedly; and finally, consumers, endeavouring to adapt, being vigilant, and rewarding those firms and products that best perform the change.

The Banco de España, like the other banks belonging to the European System of Central Banks, is conducting a campaign explaining the new notes and coins in order to educate the public about the process of exchange and the technical and security aspects of the new notes. This campaign is concentrating especially on the most vulnerable sectors of the population, such as the elderly and children.

Throughout this – I fear already lengthy – speech, I have tried to stress certain features of the Spanish economy and some of the challenges it faces, as well as the important role to be played by economic agents. In the financial sphere, I have insisted that a healthy and dynamic economy is only possible with solvent financial institutions and strong financial markets. Let me finish by acknowledging our commitment to these ideas of economic and financial stability.

When I took up my post in July last year, on behalf of the Deputy Governor and myself I asked – and gave thanks in advance – for the collaboration and dedication of all the staff of the Banco de España. The ensuing months have been an intense period during which the collaboration then requested has been exemplary. Today I wish to repeat my request for collaboration and once more express my gratitude in advance. I think that we are all aware of the major task performed hitherto by the Banco de España and that, for this work to continue, it is necessary to adapt to the new circumstances. I am sure that between us all we shall manage to implement the necessary changes successfully.

Finally, I wish to convey my gratitude and recognition to each and every one of the members of the Governing Council for their valuable contributions to the continuity of the institution at the time of change of Governor and Deputy Governor, and for their collaboration and support during the initial months of my term of office.