Jaime Caruana: Presentation of the Annual Report of the Bank of Spain

Address by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of The Basel Committee on Banking Supervision, to the Governing Council of the Bank of Spain on the presentation of the Annual Report, Madrid, 13 June 2003.

*   *   *

Ladies and gentlemen,

Twelve months ago, on presenting last year's Annual Report, I highlighted the significance of the year 2002 as the final step in the replacement of the peseta by the euro. Some of the features characterising economic developments last year were also discernible at that point: uncertainty and a crisis of confidence prompted by a wide-ranging set of shocks to which I shall refer during this speech.

This conjunction of factors is perhaps not so much the outcome of chance as it is of the fact that, in a globalised economy, shocks that might previously have had local effects now feed through rapidly and sharply to the world economy as a whole. Given this adverse external environment, it is worth reflecting on the conditions our economy should maintain to continue with the process of convergence towards the income levels of the most advanced countries. As on previous occasions, I shall commence with a brief review of the international economic environment.

The world economy experienced a modest, hesitant and, in terms of its geographical distribution, uneven recovery in 2002. Against a backdrop of notable uncertainty, the growth of the main economies was lower than expected. This was especially the case in the euro area but also in the United States, while stagnation continued in Japan. Certain emerging regions, such as Asia and Central and Eastern Europe, were more buoyant. But the economic results in Latin America were very poor. Inflation rates generally held at low levels and the trade imbalances between the main areas increased.

Some of the uncertainty bearing on the world economy was associated with a complicated geopolitical situation. Unfortunately, it cannot be said that all the factors holding back an international recovery are behind us. The swift conclusion of the Iraq war has eliminated some of the main factors of uncertainty and this, along with cheaper oil and improved stock market prices, should contribute to entrenching a scenario that allows a more robust though still moderate pace of growth, even though doubts remain about the vigour of growth in a climate of lacklustre private investment.

But the confidence crisis besetting the world economy was not only the result of the geopolitical situation. The disclosure of a series of irregularities in the financial statements of certain major companies, especially in the United States, fuelled a notable lack of confidence about the information provided to the markets and called into question not only companies' reported earnings, but also the suitability of accounting regulations and the independence of auditors and investment banks. Given a stock market climate already depressed by the ongoing correction of the bubble that affected the technology and communications sector, this lack of confidence further propelled the downward trend on the equity markets, which favoured the fixed-income markets. Moreover, the crises in certain emerging economies continued, especially in Latin America, and this also contributed to the general risk-aversion of investors on international financial markets.

A key feature of recent developments in the world economy is that the aforementioned shocks, whose common denominator is their impact on agents' confidence, affected all the developed economies and some of the emerging ones almost simultaneously. This highlights how, in an increasingly globalised world, the transmission channels on which expectations turn (and which exert a key influence on the financial markets) are extremely rapid. All economies, especially the most developed ones, are prone to the impact of this type of disturbance, whose origin may be very remote and whose relationship to a specific national economy's fundamentals may seem far-removed.

The loss of confidence stemming from the aforementioned shocks was, in turn, amplified by various deep-seated imbalances in the world economy which have not been corrected or have even worsened, including most notably the US current-account deficit and persistent deflation in Japan. These underlying weaknesses stoked up uncertainty and a climate of mistrust in various segments of the world economy, all of which contributed too to checking and postponing the onset of recovery.

Against this background of closely interacting national economies, mention should be made of the high dependence of the rest of the world on the US economy, which proved greater than expected, despite the fact that the results in the United States were not particularly buoyant. Such dependence is a cause for concern since the United States is, at the same time, the main source of growth for the rest of the world and the main raiser of savings on the international capital market, a situation that is hardly sustainable over the medium and long term. Moreover, the saving/investment mismatch in the United States has been heightened recently by the clearly expansionary bias of monetary and, above all, fiscal policy.

In these circumstances, a swift correction of the US external deficit, while undoubtedly desirable in the medium and long run, might affect numerous other economies most adversely in the short term through causing a contraction in the external demand of these economies at a time at which their growth is rather low. A lesson to be drawn from this complex situation is that when international economic disequilibria increase and swell out of all proportion, there is a risk that their correction will be at the least timely moment and with significant costs in terms of growth and well-being.

Last year the main economies adapted very differently to the above-mentioned shocks. The United States drew benefit from the flexibility of its economy, which allowed a better and swifter adaptation to a more demanding environment, while policies took on an unmistaken expansionary stance. Conversely, the Japanese economy had neither the flexibility to adapt, owing to its numerous rigidities, nor scope for stimulus from its demand-side policies, whose room for manoeuvre essentially petered out some time back. Finally, the euro area economy, also beset by structural rigidities, was relatively inflexible in that fiscal policy leeway was directly proportionate in each country to the consolidation drive pursued in the previous upturn, with room for manoeuvre proving greater in the case of the single monetary policy.

Consequently, the experience of recent years shows how vital it is to harness economic upturns so as first, to increase the flexibility of economies in order to absorb more readily the impact of adverse disturbances; and further, to give economic policies sufficient headroom in contractionary phases. In this context, it is of paramount importance that macroprudential policies should remain particularly vigilant and react promptly and decisively in the face of potential signs of weakness in the segments of the financial system under their supervision.

In the wake of the crises of recent years, an increasing number of emerging economies undertook - with varying degrees of ambition and success - structural reforms aimed at greater flexibility. Yet these improvements did not prevent crises from continuing in some of these countries, virulently so in Latin America in 2002. In late 2002 and early 2003, the economic outlook and the trend of financial variables in Latin America improved perceptibly, especially following the positive developments in Brazil and Argentina.

The recent crises have highlighted deep-seated shortcomings in the legal and institutional workings of these countries. Emphasis has thus been placed not only on the need to pursue policies supportive of monetary, financial and fiscal stability, but also on how important an institutional framework respectful of property rights and private enterprise is for fostering growth in these countries.

Factors of a more global nature have also been pivotal in the recent crises. These have been related to greater risk-aversion on international financial markets, which has caused capital flows to some of these emerging economies to shrink. International markets have, however, tended to be more selective, and there have been fewer episodes of crises spreading from one country to another, although contagion cannot be said to have disappeared completely.

The recurrence of these crises has led to reflection on the so-called “architecture” of the international financial system. Numerous reforms have been proposed in this connection. And some have been adopted, and are generally in the initial stages of implementation. Much remains to be done in this area, although the acceptance of sovereign bonds incorporating the so-called collective action clauses, issued by Mexico, Brazil and Uruguay, offer grounds for hope.

The euro area

In an international setting, as described, of a moderately expanding world economy and heightened geopolitical tension, the pace of growth in the euro area in 2002 was markedly weak. At 0.8%, it was far lower than had been expected at the end of the previous year. This performance has highlighted the considerable exposure of the euro area to global shocks and the burden the structural deficiencies still beleaguering the area entail for it.

However, although economic buoyancy has diminished across the board, there have been considerable differences in the growth of the different Member States. In particular, among the four major countries in the area, only Spain has remained moderately dynamic in this unfavourable setting, while the biggest economy, Germany, has deteriorated markedly. Thus, while high and growing synchrony has been observed over the past decade, this still remains below what should be the case for a fully integrated economic area. Persisting divergences underscore the need to refine the single market and reaffirm the role to be played by national policies when it comes to ensuring the proper functioning of each of the member economies.

It is also significant that the scant growth in the euro area in 2002 was mostly based on the contribution of the external sector. As a result, the shocks buffeting the European economy had a particular influence on internal demand, which was considerably slack throughout the year. That is a feature that may hold future growth back, once the euro has left its past weakness behind and has appreciated considerably against the dollar.

In any event, the bleaker outlook for employment and the deterioration in financial wealth were conducive to an increase in the household saving ratio, consequently reducing their propensity to consume. The sluggishness of expenditure naturally affected investment plans which, in turn, were discouraged by the decline in stock market prices, balance-sheet restructuring by the most debt-ridden companies and the tightening of lending conditions by banking institutions in certain countries.

The limited adjustment capacity of the European economy was manifest in the relative lack of responsiveness of nominal wages to the economic slowdown. Job creation was affected as a result, especially in the second half of the year. This lack of flexibility, along with the rigidities of price formation in the industries least exposed to competition, also hindered the moderation of inflation rates, thereby conditioning the European Central Bank’s monetary policy decisions.

The loss of momentum behind the process of reforms in 2002 is telling if it is borne in mind that the European economy is still far from achieving its goals in terms of greater flexibility and integration of the markets for goods and factors, the promotion of innovation and the incorporation of new technologies into productive processes.

Generally, demand-side policies contributed to tempering the scale of the slowdown, although the potential constraints on these policies were manifest throughout last year. In particular, the insufficient consolidation of public finances in certain countries in the previous upturn has considerably eroded the stabilising capacity of fiscal policy in the current cyclical phase. Therefore, a number of countries had to curtail the operation of the automatic stabilisers and some had to run budget deficits above 3% of GDP, which triggered the related excessive deficit procedures. Evidently, the unfavourable economic situation is testing the multilateral surveillance mechanisms of budgetary policies. But the report drafted by ECOFIN, based on a proposal by the Commission and recently taken up by the European Council, has contributed to reinforcing the validity of the Stability and Growth Pact and to clarifying its application.

The single monetary policy has also reacted to the cyclical slowdown, maintaining conditions propitious to the growth of economic activity while bolstering the credibility of its commitment to price stability. However, continuing inflationary pressures, linked in part to the aforementioned rigidities in price- and wage-formation mechanisms, have naturally limited the scope of the more relaxed monetary policy stance. In any event, the key ECB interest rate stands today at 2%, 125 basis points down on a year ago. That constitutes a tailored response to the weakness of economic activity and to the improved inflation outlook over the period to date, brought about by the substantial appreciation of the euro.

The economic environment has been appreciably alleviated in recent months by the rapid outcome of the Iraq war and, in particular, by the favourable impact of this on oil and stock market prices. Nevertheless, uncertainty over the European economy’s capacity promptly to embark on a path of sustained recovery has not been sufficiently dispelled. In particular, the hesitancy of the US economy, the deterioration in its current-account and budget deficits, continuing imponderables in respect of the international political situation and the current volatility of financial and foreign currency markets may affect the European economy’s growth prospects, given its dependence on the external environment. Along with these, there are other factors more specific to the area (such as the sluggishness of business investment, doubts about the scale of the consequences of the stock market crisis for demand, and the persistent weakness of some of the major Member State economies) that might delay the expected acceleration in activity in the euro area which, in all likelihood, will grow in 2003 below potential for the third year running.

On the institutional front, highly significant events for the process of European construction have taken place in 2003. The signing of the Treaty of Accession to the EU by ten new countries, which took place in April and will be effective in May 2004, marks the start of a phase of far-reaching changes which will pose sizable challenges for the competitiveness and cohesion of the area and for the strengthening of the effectiveness of the European institutions. In this connection, the European Convention plans in the coming weeks to announce its proposed draft of the future European Constitutional Treaty, which shall be agreed at the Inter-Governmental Conference to be convened in 2004. As regards monetary policy, the ECB Governing Council has, with a view to adapting the operating arrangements of the euro area to the possible entry of new members, recently recommended changes in its voting procedures, in accordance with the provisions of the Treaty of Nice. The proposed Recommendation was approved by the European Council of 21 March 2003 and introduces a rotation system whereunder the number of governors entitled to vote at any one time is restricted to 15, divided into three groups on the basis of their voting frequency. Without delving into the details of the approved formula, I should like to stress that the criteria of representativeness used in determining the voting rights of each member of the Council will place the Governor of the Banco de España within the first group of Governors, who are authorised to vote in the ECB governing council most frequently, on an equal footing with Germany, France and Italy.

The Spanish economy

In an adverse external setting, the key characteristic of the period analysed in the Annual Report was the capacity shown by the Spanish economy to sustain a comparatively high growth rate of 2%, and to continue generating employment, which increased by 1.3%. For yet another year, therefore, there was further headway in real convergence towards the average GDP per capita levels of the euro area.

This performance has confirmed a new pattern of response by the Spanish economy during cyclical downturns, which would in the past have given rise to sharp adjustments in activity and employment, following the prior build-up of forceful disequilibria. This change in the behaviour of the economy is partly related to the persistence of the expansionary effects derived from Spain’s membership of EMU, in terms of substantial interest rate cuts and a significant reduction in inflation expectations. Above all, however, the Spanish economy’s greater resilience to the external deceleration has been due to its present regime of macroeconomic stability and to the structural reforms undertaken.

In particular, I wish to stress the benefits arising from fiscal policy, which has enabled the balanced budget not to be jeopardised in the cyclical downturn. Also notable are the improvements in the workings of the labour market which, combined with the moderate increase in real wages, have continued to ensure high employment generation. This has been one of the most positive features of recent economic developments, and has helped underpin agents’ spending decisions and the process of real convergence, mainly via the increase in the rate of employment.

In terms of its components, growth in 2002 saw a prolongation of the trends already perceptible in 2001, and was based on the strength of household spending and the momentum of infrastructure construction. As explained in detail in the Annual Report, set against the significant slowdown in exports and the fall-off in capital investment, household consumption grew at a rate of close to 2% in 2002. This growth was underpinned by the increase in disposable income, contributing to which, in turn, were the interplay of net general government transfers to households and higher employment. Moreover, the rise in households’ property assets, to which I shall refer later, also helped sustain consumption, offsetting the losses in financial wealth brought about by the heavy stock market declines.

House purchases, the other component of household spending, have grown over the past two years at a lower rate than that observed in the period to 2000. More recently, this spending component has been subject to opposite-moving influences: on one hand, house-price rises may have dampened the demand for habitual dwellings; but on the other, the fact that the return on residential investment has held far above that provided by other forms of investment (financial assets in particular) has encouraged house purchases. In any event, investment in housing has continued to sustain the increase in construction. And further contributing factors here have been the forceful investment in infrastructure, carried out both by general government and by non-financial corporations related to this sector.

Although this consumption- and construction-led growth pattern has provided suitable support for progress in real convergence, some of the elements on which it is based are likely not to continue in the future. In particular, the intensity of the expansionary effects of the sizable decline in interest rates and the rise in property values will foreseeably diminish, both these factors, along with employment, having been underpinned by the buoyancy of household expenditure. Moreover, the fact that in the past households expanded their spending and reduced their saving (simultaneously increasing their debt, as I shall discuss later) means more moderate behaviour is to be expected -and desirable- in the future, geared to a restructuring of their saving ratio. Indeed, this began to be seen already in 2002.

As regards gross capital formation, investment in infrastructure has had a key part in enlarging the economy's productive capital stock. But it cannot play this leading role indefinitely. Consequently, it is particularly important that the flatness of business investment and, especially, of spending on capital goods in recent years, which has hampered productivity gains and the incorporation of technological innovations, should be put behind. In principle, the current high ordinary returns accruing to companies coupled with low financial costs are propitious to investment regaining buoyancy, as expectations progressively clear.

On the prices front, certain temporary factors, such as the physical introduction of the euro and dearer oil, fuelled increases in domestic prices, against the background of relatively sustained growth in consumer demand. This prompted a rise in the inflation rate, which stood at end-2002 at 4%. This increase in inflation has been partly reversed, thanks to the improvement in recent months which has seen this rate cut by around one percentage point. However, the bout of rising inflation last year fed through in part to wages, highlighting the importance of reinforcing wage moderation. In fact, the inflation differential with the euro area, despite narrowing recently, has remained persistent. And that may pose a risk for future competitiveness.

In the area of price formation, a cause for concern is the differences that continue to be seen in business margins, depending on whether industries exposed or not to competition are involved. In the former, mainly export-geared companies, the rate of change of prices has been virtually zero for over a year, reflecting the efforts exporting companies have to make to compete in markets experiencing a particularly delicate situation. In parallel, other industries less exposed to competition continue to increase their operating margins considerably.

The Spanish economy's resilience in the face of the adverse external environment in 2002 offers bright prospects for short- and medium-term developments, having placed it in a sound starting position for more dynamic growth as the international climate improves. However, the expansionary impulses stemming from EMU membership will tend increasingly to have a lesser effect, while the economy will have to address new challenges arising from the stiffer competition that EU enlargement will entail.

Consequently, the growth pattern may not reside so much on consumption and construction but will have to be underpinned to a greater extent by investment and exports, meaning that dynamism will depend particularly on their profitability and competitiveness. National economic policies will thus have to be geared to strengthening these elements by promoting macroeconomic stability, business profitability and the competitiveness of the productive system.

As earlier indicated, budgetary policy has contributed to domestic stability by means of fiscal consolidation and the control of the budget deficit. If in the future, against a background in which European monetary conditions will remain relatively generous for the requirements of the Spanish economy, demand pressures were to persist and contribute to sustaining an inflation differential unwarranted by the process of real convergence, it might be advisable to move towards a budgetary surplus position. That would additionally help tackle the problems of the long-term sustainability of the pensions system.

Maintaining competitiveness, which is one of the main long-term challenges, will require continuing wage moderation and higher productivity gains. To do this, certain changes must be made to the collective bargaining system so that settlements are more closely related to the specific situation of firms. It is also necessary to increase the incentives for the stable hiring of employees, reducing the segmentation and duality brought about by the still-high numbers of temporary employees as a proportion of the total labour force, despite the fact this proportion has fallen in recent years. In this respect, the reform of hiring arrangements in the past has been in the right direction, as it has reduced the differences in terms of costs between temporary and permanent employment contracts.

Stepping up investment in capital goods and establishing conditions conducive to the incorporation of technological progress, especially in the ICT field, are vital factors for boosting productivity gains in the economy. Nevertheless, as the experience of other countries (particularly the United States) has shown, to reap the potential benefits of the incorporation of new technologies through investment also requires setting a more flexibly working economy in place, pushing through structural and liberalising reforms, and designing an appropriate regulatory framework.

Structural reforms aimed at promoting flexibility, innovation, human capital formation and competitiveness should not be considered as having only medium- and long-term effects. The recent history of the Spanish economy illustrates the relative speed with which their effects have become visible, when they have been applied with perseverance and consistency. This is because they alter the expectations of agents, who incorporate the new framework into their behaviour almost immediately.

The foregoing takes on special importance in the face of the challenges EU enlargement entails. The similarities between the productive specialisation of our economy and that of the accession countries, combined with their low-cost and highly trained labour, pose a challenge to the Spanish economy, which has to face stiff competition in those industries in which Spain is more specialised. It will be necessary to bolster the competitive capacity of the Spanish productive structure through product-differentiation and quality-enhancing strategies, by improving its endowment of technological and human capital and by developing the technologically most advanced industries. But Spanish companies must also set in train strategies enabling them to harness the opportunities of enlargement and to increase their presence in the new areas of the single market, channelling their foreign direct investment efforts in that direction.

Financial aspects of the Spanish economy

Some of the financial features of recent developments in the Spanish economy are of particular importance. As I have said, monetary and financial conditions remained generous in the Spanish economy and, in step with this, financing received by households and firms grew by around 14% last year. This increase, which far outpaced the average for the euro area countries, led to a fresh increase in the private sector’s debt ratios which, in a few short years, have attained the average levels for the euro area.

Significantly, the ongoing resort by companies and, above all, by Spanish households to debt in order to finance higher investment and consumption levels is principally a reflection of the favourable impact on agents’ expectations of the new setting of macroeconomic stability, which provides for higher sustainable growth in income and employment.

One of the clearest consequences of the recent trend of financial flows in the Spanish economy has been the contribution made to curbing the scope of the recent cyclical downturn in Spain. That has helped the private sector maintain buoyant expenditure on the basis not only of its current revenue but also of its expectations of future income.

Moreover, the downward course of interest rates in recent years, which continued in 2002, has meant that the gradual growth of Spanish household and corporate liabilities has been accompanied by a less marked increase in the financial burden associated with these debts. Relative to the sector’s income, this burden tended to stabilise last year around levels which may be qualified as normal on international comparisons.

Yet it cannot be ruled out that the volumes of debt built up may ultimately affect the pace of economic recovery, since they restrict the headroom available for firms and households to continue increasing their resort to borrowed funds. Ideally, then, the growth rate of debt should moderate, so that the sector’s spending decisions may move more in line with current income, thereby maintaining the soundness of the financial position of Spanish households and firms. It should further be borne in mind that the greater levels of debt attained have also tended to heighten the sensitivity of agents’ spending decisions to changes in the variables determining the effective cost of financing.

In the case of households, most of the financing received has been earmarked for house purchases, the main component of household wealth. That has strengthened residential investment and prompted rapid growth in property asset prices.

A brief review of the past behaviour of the variables habitually considered as the basic determinants of property prices provides for a better understanding of their recent trajectory. Changes in the population pyramid, increased immigration, the growth of the demand for second homes by residents and non-residents and, above all, the continuous growth of income and the pronounced fall in interest rates are factors that help explain the trend growth of the relative price of housing in Spain. In addition, the unfavourable course of stock market prices in the last three years has enhanced the attractiveness of alternative investment opportunities, such as those offered by real estate.

Yet in a market such as that for property which, by its very nature, sees supply adjust relatively slowly, demand pressures such as those arising from the aforementioned factors may cause excessive price reactions that tend to be corrected subsequently. This appears to be the situation currently in our country where, even with a significant rise in the rate at which houses are built, property values may have exceeded the levels consistent with the trajectory of their determinants. In such a situation, it is likely -and desirable- that house-price growth rates will be brought back progressively and in an orderly fashion to levels more in line with their fundamentals.

This process, which should run parallel to gradual moderation in the resort to credit financing by the households and companies most directly involved in the real estate business, would prevent house prices from moving too far away from their equilibrium value. It would therefore reduce the likelihood of sharper adjustments ultimately taking place in the housing market, the influence of which on the overall working of the economy cannot be understated. For a sounder functioning of the complex markets for land and housing, at least two groups of measures would be required. On one hand, those aimed at influencing the determinants of house prices and, in particular, the regulations and practices restricting the supply of land. And on the other, those intended to correct the distortions behind the marked bias in the Spanish market towards owner-occupied as opposed to rented housing.

With regard to the financial system, the year 2002 was, once again, a particularly complicated one. Adding to the usual effects any economic slowdown and correction of excesses built up in upturns will involve were other factors, including most notably corporate and accounting shortcomings of a structural nature, which have undermined the very institutional foundations of markets. This crisis of confidence was exceptional due above all to the doubts cast on elements as fundamental as the recording of transactions at listed companies, the veracity of information provided to investors, conflicts of interest within companies and between these and their main financial agents or auditors, and the most elementary mechanisms of corporate governance.

Within this complex picture, two positive features should be underscored. First, one highly favourable aspect of recent developments in the world economy, which I mentioned in the presentation of last year's Annual Report, is the resilience generally shown by the financial system in the industrialised countries, which has limited the adverse effects of turbulence on the real sector. This resilience continued in 2002, although there are perceptible signs that the succession of shocks and the obstinacy of certain disequilibria might have eroded the solidity of certain segments of the global financial system in some countries. There would have been no such resilience were it not for the improvements in risk management introduced in recent years and for the margin for manoeuvre built up during the boom years. Second, the response by general government, with its three-pronged executive (including here the various supervisors), legislative and legal powers, has proven prompt and effective and has allowed many of the shortcomings in market fundamentals highlighted by the crisis to be corrected. Initiatives such as the Sarbanes-Oaxley Act in the United States; the amendments made in Spain by the Financial System Reform Measures Act; the boost to international accounting convergence between Europe and the United States, based on putting principles ahead of detailed rules; the reinforced supervision of auditors; the fresh momentum to improving corporate governance, etc., have all made for some progress in improving confidence.

Against this uncertain backdrop, Spanish deposits institutions likewise offered proof of resilience, along with greater strength in areas such as accounting, own funds and provisions. Combined with the growth differential the Spanish economy still enjoys, this has allowed Spanish institutions to negotiate the difficulties thrown up last year with a limited impact on their earnings, and this despite the difficulties in Latin American markets. In turn, historically low default levels in the domestic market, despite the strong expansion of credit in recent years, and the strength of own funds mean that, on the financial side, there are no constraints on the process of economic recovery.

In this setting, rising to the challenge of a complex international financial situation underscores the importance for institutions of continuing to strive to improve the efficiency and solvency of our system. They must apply greater rigour to the analysis, extension and monitoring of credit transactions and make recovery procedures more flexible. The heightened competition in the Spanish banking industry, with the subsequent benefits in terms of efficiency for borrowers and depositors, will - combined with historically low interest rates - require of banks a major drive to cut costs so as to increase efficiency.

The challenges posed by the current cyclical juncture should not see us forget other more structural and medium-term challenges affecting financial institutions and, specifically, banks, savings banks and co-operatives. Given the far-reaching consequences for banking, such challenges include most notably the New Capital Accord and the implementation of International Accounting Standards (IAS).

It should be clear that these new regulatory aspects go beyond a mere alteration of laws, decrees or Banco de España circulars. They are an innovation in the true sense of the term which will affect not only capital headings or financial statements but also business strategies, risk management, etc.

Take, for example, the issue of transparency, both in Basel II and in IAS. This does not involve merely disclosing specific information to the market. The requirements in this area represent a far-reaching revision of the means of compiling financial information. That will not only affect financial statements; it will also influence banks' decision-making arrangements. Undoubtedly, this revision will entail changes to information-gathering systems, both quantitatively and qualitatively.

Banks must therefore be prepared for the consequences of greater public scrutiny of how they do business. This involves not only giving more information, but explaining decision-making, and addressing the consequences that greater transparency may have for relations between managers and current and potential investors, analysts, depositors, credit rating agencies, auditors and, also, supervisors.

Turning to IAS, the Banco de España, as a supervisor with a legitimate interest in bank accounting, will continue to play an active role in shaping the accounting rules applicable to credit institutions. That said, it is vital that banking institutions should accept the qualitative changes imposed by the new accounting environment. Specifically, IAS impose greater responsibility - the corollary of their flexibility - on bank managers, which is in contrast to the current state of affairs, where the precision of accounting rules largely limits discretionality.

As to the more advanced features under Basel II (such as the internal ratings-based systems), there is occasionally an excessively mechanistic view of what is entailed. This is not a more complicated formula for calculating capital requirements. What the more advanced approaches under Basel demand, and recognise, are more sophisticated internal risk-management systems. Hence, and as the word "management" indicates, the systems should be effectively used and integrated into the bank's everyday analysis and decision-making at all levels.

Capital requirements calculated in a more sophisticated manner, and which encourage better risk-management techniques, should be underpinned by a suitable policy for capital. It does not suffice to have a sufficient and even comfortable overall volume of capital: what is needed is a strategy for capital that takes into account factors such as the permanence and quality of capital, market accessibility and the balance between shareholder remuneration and the institution's capitalisation. Too often, formulas for increasing capital through the use of subordinated debt or hybrid instruments to finance business expansion are resorted to, while at the same time the build-up in reserves from retained earnings slows. It is crucial for banking institutions to evaluate decisions on the level and composition of capital from a strategic and medium-term perspective.

These thoughts on the challenges to be faced would be incomplete without addressing the corporate governance of credit institutions. The Banco de España has a particular interest in this area as it considers it a basis for sound risk-management. It is duly assigning additional resources and focusing on the matter more closely. Far from being a passing fad, improving corporate governance should receive priority attention from banks. Not only because of the factors habitually cited, but also because the new environment of transparency associated with IAS and Basel II will simultaneously involve greater market scrutiny, a greater capacity for action by bank managers and, in sum, heightened responsibility for them.

My final comments relate to the internal changes at the Banco de España. The year 2002 has also been important in this respect in view of the reforms initiated, which will continue in the coming years. Last year the Banco de España successfully met the logistical challenge of substituting euro for pesetas. While the intensity of this process has diminished, it has nevertheless continued this year. I should like to reiterate my gratitude to the staff at the Banco de España for their efforts and dedication, which have been on a par with the historic significance of this event.

Likewise, last year saw the start of an ambitious plan to rationalise our network of branches, located in each and every Spanish provincial capital. The restructuring involves acknowledging what is a fact: namely, that many of the services provided by the branches do not -owing mainly to new technologies- require a physical presence. And those requiring physical presence can be more efficiently organised through a smaller group of better-equipped logistical centres. Following negotiations with employee representatives, the restructuring entails the progressive closure of 30 branches over three years. The first ten have already been closed, and those that are to remain are being upgraded.

The restructuring marks a further step towards the necessary reorganisation of the Bank so we may better adapt to our future responsibilities and challenges. It has been sought to strike a balance between the need for efficiency in the management of public interests and the desirable regional presence of our institution. The agreement reached with the employee representatives evidences our objective of squaring the need for reform with due respect and recognition of the work performed by the Bank's personnel in all the branches that are being closed. I should therefore like to convey my appreciation and gratitude to all our employees for their excellent work, with a special mention to those that have left us or are to do so in the near future after devoting so many years to the Banco de España.

Finally, my gratitude to those of you present on this Council today for your contributions, co-operation and support.