Jaime Caruana: The European monetary policy - main challenges in the current environment

Speech by Mr Jaime Caruana, Governor of the Banco de España and Chairman of the Basel Committee on Banking Supervision, at the "Euro Conference" organised by Nomura International, Tokyo, 13 November 2003.

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Let me first thank the organisers of this Euro Conference for their invitation to participate in this forum. It is a pleasure to have the opportunity to discuss with this distinguished audience the current situation and prospects of the euro area and the main challenges that the ECB and other monetary policymakers face in the present international environment.

In the last three years the world economy has undergone a period of low growth and some turbulence on financial and foreign exchange markets. The prevailing geopolitical uncertainty and the heavy stock market corrections - linked to reassessments of corporate profitability in the ICT sector and to the accounting scandals - have curtailed economic activity worldwide in a significant manner. Against this background, inflation rates stabilised at relatively low levels and some discussion about the risks of deflation emerged in the United States, while the Japanese economy remained stagnant.

Most recent data would suggest that some economies are already recovering and others are at the end of the tunnel. In particular, the US economy is growing at a high rate, substantially above potential, although a negative output gap appears to remain in place. Moreover, economic activity in many emerging market countries - singularly China - is expanding fast and economic conditions in Japan have improved significantly. In the euro area, activity was flat in the first half of 2003 but a gradual recovery might already be under way as a consequence of the more favourable external scenario, the increase in the market valuations of private securities and the strengthening of agents' confidence as reflected in survey indicators. Therefore, although the lack of harder data in Europe and other areas attesting to this new scenario obliges us to remain cautious, it is now very likely that world growth and trade will expand significantly next year.

I think it is worth emphasising that while the phase of weak economic activity has spread worldwide, the intensity of the slowdown has been relatively moderate in most cases. It is fair to acknowledge that this is, at least to some extent, attributable to economic policies. In fact, in the last few years the expansionary stance of monetary and budgetary policies has strongly supported demand across the globe. I believe it is no exaggeration to say that this response might have been partially inspired by the recent Japanese experience, which has brought the question of deflation prevention to the core of the economic debate. In my view, this debate about deflation was over dramatize in some cases.

At the same time, we should be mindful that the relative mildness of the slowdown coupled with strong policy impulses have not been conducive to the correction of the macroeconomic imbalances that built up during the expansionary phase. More specifically, while instrumental in keeping the economy running, the low-interest-rate-high-public-deficit policy of the US authorities, set against intense productivity growth in the economy, might arguably also have contributed to the expansion of private-sector indebtedness (particularly of households), to the inflation of housing prices and to the build-up of substantial fiscal and current-account deficits. I do not believe that these imbalances are an immediate threat for the ongoing world recovery. But, together with the lack of flexibility of exchange rate regimes in some dynamic emerging markets, they pose risks for the orderly evolution of the global foreign exchange markets. Financial imbalances, in the form of high private-sector debt or excessive asset valuations, are also present in other economies around the world and they represent an ongoing challenge for their monetary authorities.

Against this background of low inflation rates, low growth, some turbulence on financial markets and the interaction of financial imbalances and the real economy, what is the role of the monetary policy?. I would like to devote the next part of this address to some reflections on the role of monetary policy in promoting macroeconomic stability and the relevance of financial stability in that respect. I shall then try to draw some lessons for the proper design of monetary policy and look at how the Eurosystem's strategy - as recently reviewed - copes with what I believe are basic principles for the definition of monetary policy frameworks. I shall also attempt to cover some of the main policy challenges we currently face in the euro area. Finally I will say a few words about a different topic, financial stability policy and the status of the New Capital Accord.

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Possibly, one of the most relevant contributions of macroeconomic theory to the evaluation of public policy over the last few decades has been the development of a suitable dynamic framework which economists call the intertemporal utility approach. If, as is to be hoped, individuals do live for a number of years, their utility is not mainly related to consumption or income in a particular period but to the amount and temporal distribution of their life-time resources available for consumption. In that setting, social welfare is positively related to the growth potential of the economy, as this simply implies a larger size for agents' opportunity set. Moreover, as agents are normally averse to large fluctuations in consumption, aggregate welfare would also be positively affected by a stable course of economic activity.

In such a framework, the old and long-standing debate initiated in the 1930s on the effectiveness of fiscal or monetary policy in affecting output loses much of its relevance, as higher output over a short-term horizon does not guarantee welfare gains. Rather, the priority appears to be the analysis of the ability of different macroeconomic policy tools and approaches to enlarge the potential output of the economy and to mitigate the fluctuations of business cycles.

In terms of achieving higher sustainable growth, monetary policy has a clear role to play. This is a consequence of accepting two hypotheses for which there is ample theoretical and empirical support and about which there is broad consensus among economists, a rare event in the profession. The first is that inflation - even if moderate - prompts an inefficient allocation of resources, thereby damaging the economy's growth potential. The second is that inflation is essentially a monetary phenomenon in the long run. The corollary of these two results is straightforward. Monetary policy can contribute to maximising agents' welfare by delivering price stability over the medium term. It remains, however, to be seen whether it can also effectively achieve a lesser variability of real economic activity.

Arguably, in principle, price and output stability might not be contradictory targets as they could both be pursued in parallel. Indeed, inflation - insofar as it is linked to excessive demand pressure in goods markets - and GDP deviations from trend are related variables to some extent, at least in the short term. The problem is that this relationship is far from stable and, more importantly, tends to disappear when the economy is subject to supply shocks, as they typically push prices and output in opposite directions. Therefore, while price stability would normally favour smaller output fluctuations, they are not equivalent targets. This makes it necessary to set clear priorities since, as is well known, a single instrument is not suitable for achieving two different objectives.

The case for monetary policy as a powerful device to address excessive GDP variability is, however, much weaker than that of targeting price stability. In principle, there is little doubt that monetary policy actions do directly affect output in the short run, as they influence variables - mainly interest rates - which are among the main determinants of GDP components, such as private consumption and investment. But it is well known that the effects of changes in policy-controlled interest rates on real economic variables and prices are typically subject to long (sometimes two years or more) and variable lags. This is always an inherent difficulty for the design of monetary policy even if its objectives are set over the medium term. But it becomes a nearly insurmountable impediment to achieving targets, such as output stabilisation, that are defined over shorter-term horizons. In fact, many countries have seen in the past how an attempt by the central bank to mitigate cyclical output decelerations proved ineffective in the short run and destabilising over the medium term.

Clearly, then, any sensible cost-benefit analysis would assign monetary policy a primary goal of achieving price stability over the medium term. This of course does not amount to neglecting the relevance of business-cycle-related macroeconomic variables in monetary policy design. Indeed, output is, normally, a good leading indicator of price changes. Moreover, all components of aggregate demand play a key role in the transmission mechanism of monetary policy impulses to prices. That makes careful scrutiny of real economic conditions necessary in order to assess how adequate the monetary policy stance is.

In the same vein, price stability targets are normally defined by central banks with some degree of flexibility as they only become binding in the medium term. Therefore, monetary authorities do sometimes have some limited leeway to define the appropriate policy and, in particular, to regulate the speed of the adjustments required to set the controlled variables at the desired levels. It is perfectly logical that some sort of evaluation of the effects of different policy strategies on output fluctuations might at times be an important consideration when deciding on how to make the best possible use of the available room for manoeuvre.

Evidently, the speed of the adjustments becomes critical when economies face deflationary risks. The case of Japan in the last decade provides an insightful example on how difficult it might be for an economy to escape from a deflationary situation once this is the case. As soon as nominal interest rates approach their zero lower bound, monetary policy can do little to convince agents to spend money if real interest rates are still positive and there is no confidence as to the prospects of the economy. Even non-orthodox monetary actions such as massive injections of liquidity in the domestic markets or non-sterilised intervention in the foreign exchange market often provide only temporary relief.

Clearly, then, prevention is far easier than cure. And prevention obviously demands structural reform and sound fiscal policies; but it also requires monetary policy to react promptly and decisively. Given the difficult reversibility of deflationary spirals and their disproportionately high costs in terms of growth and welfare, it is logical that central banks set greater store by that scenario when deciding on interest rates.

Unfortunately, experience suggests that the usual analytical frameworks used by central banks when assessing macroeconomic conditions and prospects are not always sufficiently powerful to foresee low-probability extreme events such as full-blown deflations. With the benefit of hindsight, however, it is in most cases true that scenarios of persistently negative output and price growth have often been preceded by disorderly developments in asset markets or the financial sector as a whole. This brings me to the difficult issue of ascertaining what is the role of possible financial imbalances in monetary policymaking.

I think there is broad agreement that fragilities in the financial sector such as asset price misalignments, or balance sheet difficulties of economic agents, particularly financial intermediaries, do have a bearing on economic performance. Conversely, the macroeconomic outlook, to the extent it affects the risks faced by intermediaries and asset prices, obviously exerts an influence on the stability of the financial sector. Therefore, financial stability considerations may and must legitimately form part of the set of indicators the central bank uses for decision-making. Moreover, the synergies between macro and financial stability explain the involvement of most central banks - albeit with different specific areas of responsibility - in safeguarding the soundness of the financial system.

It can however be argued that, in practice, **detecting unsustainable financial developments**, such as asset market bubbles or excessive private-sector indebtedness, **is not normally an easy task** and that, therefore, anticipating a financial crisis is a complex matter. I tend to share the position of those arguing that even if central banks were able to identify serious risks of financial distress, there is a lot of uncertainty as to how financial imbalances would react to policy changes, and pure interest rate movements may be of limited effectiveness in correcting such risks. Furthermore, this strategy may prove difficult to communicate.

I would not however subscribe to the ideas of those who conclude from the above arguments that a benign-neglect attitude would be the most appropriate or even the only feasible approach by central banks. In fact, the latest evidence shows that while crises are difficult to predict, a combination of financial and real developments - such as excessive credit, liquidity or investment growth or sharp increases in asset prices - may provide informative signals in that regard. In addition, it cannot be denied that while monetary policy can hardly stop a speculative wave once it has gathered sufficient momentum, a timely and consistent monetary action might help in countering or, at least, limiting the strength of episodes of incipiently excessive debt accumulation or asset price overvaluations.

This is not, however, as easy as it may sound. First, because empirical evidence on the usefulness of asset prices in predicting future price and output developments is not conclusive. And second, because it should be recognised that financial stability considerations can hardly be incorporated into standard models and forecasting procedures. Indeed, it would be useless, if not unwise, to attempt to design a perfect mapping between a financial stability indicator and the macroeconomic projections on which policy decisions are normally based. But central banks could and should monitor asset prices and the financial position of all relevant economic agents insofar as such developments may, in very specific circumstances, provide useful insight into the risks that surround the macroeconomic outlook and, therefore, the prospects for price stability. By doing so, authorities can effectively contribute to reducing the risk of the economy facing deep and protracted recessions and, therefore, to increasing social welfare.

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These reflections on the role of output fluctuations, deflationary risks and financial imbalances in monetary policymaking would suggest, in my view, that the evaluation of central bank policy should take into account that there might always be several possible - yet not socially equivalent - strategies that could deliver stable consumer prices over the medium term. Therefore, although central banks' performance in terms of price stability should always be the overriding criterion when assessing their policy approach, the means and procedures employed to achieve the main objective are not irrelevant. In particular, the monetary policy strategy of the central bank may help by enhancing both its ability to deliver stable prices and the positive welfare effects of its actions. Let me turn now to describing these elements.

First, the strategy should incorporate *a clear specification of objectives and sufficient means to achieve them*. Central banks should not only be given a mandate fully compatible with social preferences, but also the required instruments to fulfil that mandate. At the same time, central banks should specify their targets clearly within an internally consistent monetary policy strategy and establish an effective operational framework permitting them to influence with sufficient precision the price formation mechanisms of the economy.

In particular, the monetary policy strategy should provide agents with sufficient information on the goals that the central bank is seeking to achieve and the way the monetary authority makes use of the relevant information available when taking policy decisions. By way of example, a clearly established policy objective that is perceived as consistent with a low probability of deflation would indeed reduce the likelihood of such an adverse scenario.

But the need to make use consistently of a clearly defined policy strategy does not mean adopting excessively rigid targets and analytical frameworks. Indeed, just as important as consistency is the credibility of the policy set-up and, in particular, the perception of compatibility between the targets, the decisions and the strategy of the central bank. If the monetary authority does not succeed in delivering such credibility, agents might fail to adapt their expectations about relevant variables - such as future consumer prices - in line with the targets of central banks. This would be conducive to inefficient private-sector decisions that would reduce the overall benefits of the policy pursued by monetary authorities.

Given the unstable nature of most economic relationships and the limited ability of central banks to fine-tune movements in prices and output, especially in the short run, credibility normally requires the monetary policy strategy to incorporate a reasonable degree of *flexibility* in the definition of targets and also in the weights attached to different economic indicators when assessing the monetary policy stance in different circumstances. As I have argued before, this is particularly relevant when deflationary risks become apparent or there are significant symptoms of financial instability.

In the day-to-day management of monetary policy it is not often easy to combine the requirements of clarity and consistency on one side, and flexibility on the other. There is always a risk that, by avoiding an excessive codification of targets and intermediate references, agents might perceive an exaggerated degree of discretion in the central bank's policy. The only good way I can think of for overcoming that risk is to adopt an appropriate communication policy.

It is certainly in the interest of central banks to ensure that the public at large is fully aware not only of policy decisions, but also of the analysis supporting them, within the strategic framework of monetary policy. This is probably the most efficient means of ensuring that monetary policy actions are properly understood and, therefore, incorporated by agents into their consumption and investment plans, in a manner compatible with the central bank's intentions. From that standpoint, *transparency* is much more than a logical counterpart of the institutional independence of central banks, as it helps to make them accountable to the public opinion. This is indeed a prerequisite for the smooth and effective functioning of monetary policy.

After reviewing what I consider important principles for the design of an adequate monetary policy strategy, we can try to assess the framework followed by the ECB. I think that the euro-area monetary policy complies fully with the principle of clarity of objectives and appropriateness of the means to pursue them. This is mainly the consequence of the mandate established in Article 105.1 of the Treaty of the European Union: *"The primary objective of the Eurosystem* - the original wording, of course, refers to the ESCB - *shall be to maintain price stability"*.

In accordance with that mandate, the Governing Council, feeling that further clarification of the goals of monetary policy was required, decided to announce publicly its own definition of price stability. Specifically, this concept was defined in 1998 as an annual increase below 2% of a harmonised index of consumer prices for the whole euro area. It also added, in line with the conceptual arguments I expressed before, that price stability, thus defined, should be seen as an objective to be maintained in the medium term. In the review that took place earlier this year the Governing Council confirmed that definition and clarified that, in pursuing its primary objective, it will aim to maintain the inflation rate close to 2%. This clarification is mainly meant to underlie our determination to keep a sufficient safety margin to guard against risks of deflation.

The monetary policy strategy of the ECB also incorporates a well-defined arrangement for the assessment of the prospects for price stability using two types of analysis. It contains, first, a comprehensive monitoring of all economic and financial conditions that are relevant for assessing the likely course of the relevant variables over the short and medium term. In addition, monetary analysis is conducted to evaluate longer-term trends of inflation. A cross-consistency exercise of both types of analysis is also conducted to arrive at a unified judgement. This framework is consistently used in policy deliberations and public statements, as well as in the reviews of the euro area economy regularly published by the ECB.

Continuing with this brief - and necessarily incomplete review - of the single monetary policy, I turn now to the capacity of the ECB policy framework to permit a flexible adaptation of monetary policy to changing economic conditions. In this regard, the first element I think might be worth mentioning is its medium-term forward-looking orientation. This element allows the ECB to avoid reacting to shocks affecting price developments insofar as they are perceived as transitory and, more importantly, it permits, as I mentioned before, the regulation of the adjustment process of monetary policy to the appropriate stance with the degree of gradualism or activism desired.

But flexibility also affects the way the ECB evaluates the information contained in the different indicators used in the regular monitoring of economic and financial conditions. Although some indicators tend to be more informative than others, in making its monetary policy decisions the ECB draws on all available information without committing itself to following a particular tool, model or rigid analytical framework at any cost.

Further, the explicit acknowledgment of the important role of monetary and financial variables and the regular monitoring of developments in the financial sector puts the ECB in a favourable position for identifying financial vulnerabilities that could affect the macroeconomic outlook at a relevant horizon. If that were the case, the current policy framework would naturally allow those elements to be flexibly incorporated into the relevant information set on which policy decisions are based.

The experience accumulated so far has shown the usefulness of this pragmatic approach for coping with a range of shocks that have impacted the euro zone since the outset of Monetary Union. The euro area economy has seen a substantial deceleration in economic activity since the turn of the millennium. While GDP growth was 3.5 % in 2000, it will barely be around half a percentage point this year. Despite these unfavourable developments in economic activity, inflation held persistently above the 2% reference contained in the definition of price stability. These apparently conflicting signals did not prevent the Governing Council of the ECB from cutting rates by a total amount of almost 300 basis points over the same period.

Indeed, a detailed analysis of developments shows that prices were subject to a series of successive transitory shocks - mainly on oil, agricultural products and indirect taxes - which, in a context of continuing wage moderation, did not entail future inflation developments that might make interest rate cuts unwarranted.

By making pragmatic use of the flexibility built into its monetary policy strategy, the ECB has succeeded in bringing interest rates to a very low level which, as of today, looks fairly appropriate to the current weak economic conditions. As I said before, these low interest rates and better financial conditions should help the economy to recover soon if the external environment continues improving as expected. Both net exports and domestic investment - after its unfavourable trend over the past few quarters - should progressively gather momentum. As a consequence, GDP should expand already in the second half of this year and gradually approach growth rates close to those of potential output in 2004. As for prices, at this stage we expect inflation to moderate over the next few months, although changes in indirect taxes and administered prices in some countries may limit the speed of the process.

As earlier stated, the complexity of monetary policymaking and the impossibility of following strict rules, since they would be hardly valid in all relevant circumstances, mean that a significant communication effort by the central bank is needed. The ECB has taken this task very seriously, going beyond the requirements of the EU Treaty, which were almost exclusively inspired by the need to ensure the accountability of the independent monetary authority of the euro zone.

Indeed, the ECB releases annual, quarterly and even monthly reports explaining its evaluation of the current economic situation and the prospects for price stability. Moreover, the President of the ECB appears before the European Parliament's Committee on Economic and Monetary Affairs each quarter and, jointly with the Vice-President, holds a press conference after the first Governing Council meeting each month.

As a result of these efforts, I think that most commentators now tend to agree that the ECB has substantially improved its communication policy. Indeed, recent analysis shows that the monetary policy of the ECB has become increasingly predictable to market participants, despite the need to adjust policy to a series of different shocks. More importantly, and communication has no doubt helped here, the ultimate objective of monetary policy has so far merited a high degree of credibility, as persistently reflected in most indicators of inflation expectations over the medium term.

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These are indeed very demanding times for economic authorities and central banks around the world. In the case of Europe, the recent establishment of a monetary union has added new questions to the list of challenges policymakers must face. Let me close this part of the conference with a short review of these issues.

As you well know, the European Monetary Union is a crucial step of a process initiated by a few countries some decades ago to establish closer mutual links not only in the economic sphere, but also in the political and social realm. In fact, in the next few months this process will take a fresh and considerable leap forward since European governments are currently discussing the draft of a new Constitutional Treaty, which would govern important aspects of the lives of up to 25 European countries in the near future.

That process of closer relationships among EU countries has been accompanied by a gradual convergence of their economic structures and cycles, which has contributed to the success of the EMU project. Nevertheless, it is a fact that some potentially relevant macroeconomic discrepancies among euro area countries still persist. European countries may well belong to the same region, with a similar cultural and political background, close economic links and comparable sectoral specialisation. But it is not surprising that they present some heterogeneity in their national economic structures in terms of the institutional features of their markets for goods and productive factors, the patterns of behaviour of national agents or their exposure to idiosyncratic shocks. Evidently, it would be unwarranted to aim to artificially promote a completely homogeneous euro zone. At the same time, attention should be paid to those discrepancies that reflect imperfections in the functioning of the national economies or the EMU as a whole.

In that regard, inflation differentials probably merit a distinguished place on the list of potentially relevant macroeconomic disparities. Although the dispersion of inflation rates across countries is relatively moderate, inflation differentials seem to be more persistent than in other long-established monetary unions. This makes the issue relevant, because it means that the effective monetary policy stance is not totally homogeneous across the euro zone. This poses a communication challenge for the ECB and affects the correct design of its policy objectives. Indeed, these considerations were to the fore in the strategy review published last May, as we clarified that the 2% reference for HICP was not only supposed to minimise the risks of deflation in the area but also to take into account inflation differentials across countries.

Recent analysis shows that inflation divergences are to a significant extent the result of a number of nominal and real rigidities present in individual countries. Therefore, structural rigidities not only reduce the efficiency and, therefore, the growth potential of the economy, but they also introduce distortions that affect the effectiveness of the single monetary policy. It follows that properly designed economic reforms in Member States are in the interest of the national economies and the smooth functioning of EMU.

The Eurosystem is thus qualified to speak out to promote structural reform in the euro area. This is so not only because the issue is of considerable importance in the European economy, but also because both the ECB and the National Central Banks are key players on the European economic stage, enjoying a position of political independence that makes their comments and analysis particularly influential.

One issue that has recently taken on great relevance is the stability of the framework for multilateral surveillance and binding rules for domestic fiscal policies at the EU level. As you all probably know, the notion was already embedded in the Treaty of the European Union approved in 1992, which establishes for each Member States a budget deficit ceiling of 3% of GDP. These rules were further refined in the Stability and Growth Pact, agreed by Member States in 1997, which also introduced the idea that, in order not to breach the 3% limit, the underlying budgets should be balanced in the medium term.

There is a clear economic rationale behind these rules. As the economic literature shows, fiscal discipline contributes forcefully to the success of price-stability-oriented monetary policy and the optimality of the prevailing policy mix. Therefore, it is necessary to prevent free-riding behaviour among those who might feel that, in a monetary union with no domestic currency any more, the penalties of pursuing imbalanced policies become diluted in the area as a whole.

Furthermore, the Stability and Growth Pact is inspired by the belief, which I fully share, that discretionary fiscal measures should be cautiously administered. Given the relatively sizable importance of built-in stabilisers in European budgets, the operation of these automatic instruments is, on most occasions, the best contribution budgetary policy can make to stabilise output fluctuations. By contrast, discretionary measures have proved many times to be destabilising and difficult to reverse. Ultimately, the experience in Europe in the last few decades shows that the more the authorities resort to discretionary measures, the fewer the possibilities they have to resort to budget stabilisation when needed in an economic slowdown.

Therefore, in my view, European budgetary rules - which are one of the basic underpinnings of the monetary union - offer an economically sensible combination of discipline and flexibility which, if properly implemented, ensures an appropriate management of public finances at all phases of the economic cycle.

Let me conclude this address by pointing out that the biggest challenge we will face, over the medium term, is that posed by EU enlargement. As you know, ten new countries are to join the European Union in May 2004. Since, as we expect, they will at some point meet the conditions to become fully fledged members of the single currency area, the Eurosystem and other European institutions should be prepared. This involves a wide variety of aspects including, among others, the composition and functioning of the ECB governing bodies and the development of new analytical tools to assess a new economic reality such as an enlarged euro zone. In fact, new rules governing the voting modalities within the ECB's Governing Council were adopted last March, while both the European Commission and the Eurosystem are making strong efforts to conduct and pursue analyses of those countries, their particular structures and the impact on the functioning of the Union. Enlargement will surely make some of the issues I have presented today become even more challenging. But I am convinced that it will ultimately contribute to bringing about a much stronger economic and political union for the benefit of all European citizens.

I have presented some reflections about the role of monetary policy against a background of low inflation and the presence of interactions between financial imbalances and the real economy. Let me conclude with a few remarks about the role of financial policy and the New Capital accord.

Indeed, the way monetary stability and financial stability interact with each other is a particularly interesting and complex topic, and the impact of specific measures on both fields is uncertain. As concerns financial policy, the regulators' task of ensuring the long-term soundness of the financial system entails creating the right incentives for market participants. Creating the right incentives, consistent with good market practices and sound risk management, appears to be an important means of promoting the safety and soundness of the financial system and, therefore, a good way of sustaining both the stability and growth of the economy.

I am convinced that when banking systems are adequately capitalised, risks correctly assessed within the appropriate time horizon and well-managed, and markets have sufficient meaningful information, the financial system becomes more stable, less procyclical, more resilient during periods of distress and therefore better able to promote sustainable growth.

This is why so many central banks, regulatory agencies and commercial banks have devoted our best resources to ensuring the success of the New Capital Accord, the so-called Basel II, and this is also why the new accord is based on three pillars: risk-sensitive minimum capital requirements, co-ordinated supervisory review and enhanced market discipline through greater transparency. The New Accord is therefore much more comprehensive than its 1988 forerunner.

You all know very well how important access to meaningful information is to take informed investment decisions and for the sound functioning of the markets. In this regard, let me emphasise the third pillar of the New Accord, namely market discipline. Bank regulators in recent years have begun to view markets as an ally to our system of supervision. We have consequently incorporated market discipline directly into the supervisory framework.

Markets value well-capitalised and well-managed institutions as much as supervisors do, and can create rewards for banks that manage their risks appropriately. Yet banks can be very complex institutions and no market discipline is possible without access to timely, accurate and comprehensive information on a bank's risk profile, its risk management processes and its outlook for the future. This is the purpose of the third pillar of the Capital Accord that reinforces significantly the other two.

Let me conclude by briefly mentioning the status of the Accord. We are now working hard to analyse all the comments that we have received during the consultative period. During our last Committee meeting last month, all members acknowledged our responsibility to develop a sound, consistent proposal. At the same time, we also recognised the need to resolve outstanding issues and release the New Accord as soon as possible to provide certainty so that banks can continue to prepare for the new rules.

In a statement to the press after our meeting, the members of the Committee undertook to work promptly and noted that we expect to take account of the remaining issues and complete the text of the New Accord in the coming months and not later than mid-year 2004.

In addition, we moved forward in a number of difficult areas. I would like to draw your attention to the proposals that the Committee developed to revise the treatment of credit losses. As you know, the Third Consultative Paper (CP3) calibrated regulatory capital on the basis of both unexpected and expected credit losses. This was intended as a practical compromise to account for differences in national accounting practices and supervisory authority regarding provisioning. The Committee now intends to align regulatory capital more closely to economic capital by calibrating it on the basis of unexpected credit losses alone. A supplementary mechanism will help to encourage banks to provide sufficiently for expected credit losses.

I would encourage those interested to read the statement outlining our proposed revision on the BIS website. We have also simplified the proposals for securitisation exposures, as we decided to replace the "Supervisory Formula" approach to unrated tranches with a simpler rule.

Also, as we move closer to finalisation, the Committee has stepped up its efforts to provide for a consistent implementation of the New Accord. Last August we published a set of principles for the cross-border application of the New Accord to promote closer co-operation and information exchange among supervisors. These implementation issues are very important to promote consistency and to reduce the burden of internationally active banks.

We are confident that the development of an incentives-based capital framework, accompanied by more consistent and focused supervisory review and a concurrent enhancement of market discipline, will improve the management of risk across the industry, promote broader financial stability and resilience, and ensure that the banking system is better able to promote sustainable growth in the economy.

Thank you very much for your time and your attention.