Jaime Caruana: Presentation of the Annual Report

Address by Mr Jaime Caruana, Governor of the Bank of Spain, at the presentation of the Annual Report to the Governing Council of the Banco de España, Madrid, 18 June 2004.

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Ladies and gentlemen,

The recovery in the international economy - which was described as modest, hesitant and uneven in the speech presenting last year's *Annual Report* - progressively gathered momentum during 2003 and early 2004, as well as extending to other regions. Adding to the initial buoyancy of the US economy was the considerable dynamism of a large number of east Asian countries, including most notably China. The Japanese economy, flagging in a marked depression during the previous decade, picked up clearly, and the central and eastern European countries sustained relatively high growth rates. Only the euro area, among the industrialised economies, and Latin America, among the emerging group, showed a more hesitant recovery in activity.

The favourable developments in the international economy were compatible with continuing low inflation, despite the notable rise in oil and other commodity prices. The risk of deflation which, at times, it was feared might affect some of the main economies, including the United States, faded as the recovery firmed. The sound behaviour, on the whole, of the financial markets and the trend of confidence indicators seem largely to indicate that expectations about the future course of the world economy are now brighter again.

The firming of the recovery is attributable in no small measure to markedly expansionary macroeconomic policies which, in many countries, have resulted in significant increases in public and private debt levels. Against a background of very generous monetary policies and ample global liquidity, the financial markets saw asset price rises and very low interest rates, which also helped anchor the pick-up in demand. Risk premia diminished on both private-sector bonds and on the sovereign debt of emerging markets, which received greater capital flows. As a result, the economic recovery and the soundness of financial markets fuelled one another, in a virtuous circle that has broadly been maintained in the opening months of 2004, although recently a rise has been seen in long-term interest rates and in emerging markets' sovereign risk premia.

Latin America was the emerging region which encountered most difficulty in joining the upturn in the world economy in 2003. Crises in certain countries and bouts of financial instability in others have prompted heavy exchange rate depreciations and upward price pressures in recent years. Against this, the authorities reacted with more restrictive demand-side policies that set back any take-off in their economies. As these policies have eased, and as external financing conditions have improved and the increase in commodity prices firmed, the Latin American economies have attained progressively higher growth rates, particularly as from the closing months of 2003. However, certain factors of vulnerability remain in the area. These relate to the high levels of public and foreign debt and to the high dependence on foreign capital, which advise perseverance in maintaining macroeconomic stability and in furthering structural reforms, especially those aimed at strengthening the institutional framework and the respect for property rights

One salient aspect, in my view, which arises from the examination of the international situation is the fact that the firming of the economic recovery did not contribute to correcting the external imbalances between the main regions. On the contrary, despite the marked depreciation of the dollar, both the US external deficit end the surplus of Japan and the rest of Asia increased, while the slight surplus in the euro area hardly changed. Possibly, the deprecation of the dollar may not yet have had a corrective effect on foreign trade flows since, as we know, this tends to come about with a considerable delay and, in the short term, the exchange rate deprecation may even lead the deficit to widen. But the scant impact of the dollar depreciation on the current-account balances of the main areas appears also to be related to the asymmetry in the reaction of the main currencies: while much of the nominal effective depreciation of the dollar in 2003 was bilaterally against the euro, the Asian economies and, to a lesser extent, Japan, checked the rising trend of their currencies by means of heavy intervention on the foreign-exchange markets which has contributed to increasing their already high levels of reserves even further.

It is something of a paradox that the decline of the dollar has been concentrated against the currences of the least dynamic economies whose current accounts are relatively balanced, while it has held very stable against the currencies of the highest-growth countries which account for most of the US trade deficit. In any event, the contribution exchange-rate movements may be expected to make in correcting global external imbalances is limited; what are needed are economic policy adjustments by the main countries. Not only was no headway made in 2003 in this area, but economic policies remained oriented, in certain cases, in the opposite direction to what was needed to reduce the imbalances, especially as regards the US budget deficit.

As mentioned, the international economic outlook has improved appreciably in 2003 and early 2004. In turn, the recovery will foreseeably take hold in those countries most ahead in the cycle, while those most behind are expected gradually to join the upturn. Nonetheless, certain risks remain and should be borne in mind when assessing the future course of the recovery.

An initial risk is that the persistence of current-account imbalances may exacerbate volatility on international foreign exchange and financial markets. Achieving a distribution of world growth more in line with more balanced current-account positions without jeopardising the recovery is, therefore, one of the main challenges facing the world economy.

In the case of the United States, the correction of the external deficit necessarily involves reducing the high budget deficit, which is a result of the highly expansionary fiscal policies pursued in recent years.

The United States and other countries must, in the near future, adjust their monetary policy towards a stance more in keeping with a more advanced cyclical position, departing from what are at present very low official interest rates that entail a notable stimulus for activity. In this respect, an appropriate communication policy, avoiding the overreactions to which financial markets are prone, is essential.

This is particularly important, moreover, given the continuing geopolitical uncertainties and the fact that the recent oil price rises, were they to become entrenched, would bear unfavourably on both price stability and the cause of global recovery, making the task of central banks more complicated.

In sum, ahead of the current upturn in the international business cycle, we should bear in mind one of the main lessons of previous cycles. This is, namely, the importance of taking advantage of the good times to make the adjustments needed to correct imbalances and to equip economic policies with greater room for manoeuvre that may be used when more difficult times arrive. It is therefore vital that the emphasis of economic policy shift from the short to the medium term, as regards both the fiscal and monetary strands of policy and structural reforms.

And it is also crucial to harness the upswing to bolster the financial sector, the soundness of which has enabled the world economy to better withstand the severe shocks it has undergone in recent years.

The euro area

Last year the euro area remained in a period of low growth that began in 2001. In the second half of the year the first signs of recovery were detected, which appear to have strengthened in early 2004. That said, the area remains far less buoyant than the rest of the main regions and its prospects are still considerably uncertain. This prolonged phase of relatively sluggish economic activity has been the outcome, among other things, of a series of global shocks and, more recently, of the pronounced appreciation of the euro amid heightening international financial imbalances.

But the unsatisfactory results of recent years also appear to be indicative of the excessive vulnerability of the European economy to developments in its external environment and of the chronic weakness of its internal demand, which favourable monetary and financial conditions have been unable to counter.

The performance of the euro area has proven somewhat disappointing when set against the expectations generated at the outset of Monetary Union over five years ago. Among other objectives, the Union was intended to increase the economic prosperity of European citizens. However, we should not ignore the progress made in overcoming some of the structural shortcomings during the process of monetary integration. In the past decade major headway has been made in many countries in areas such as the downsizing of the public sector, the efficiency of the tax system and, more unevenly, the workings of markets.

That should not prevent us from acknowledging the weaknesses the European economy still exhibits. In particular, in a more competitive international environment, the continuing rigidities in goods and labour markets and the absence of sufficient incentives for innovation and the incorporation of new technologies are inhibiting investment in Europe, to the beneft of other more dynamic geographical areas. As a result, growth potential is being significantly impaired. Likewise, population trends in Europe are exerting growing pressure on the financial viability of the current public arrangements for social security and health-care. That tends to make those aspects of labour regulation and tax systems that act as a barrier to joining the labour market and to the reduction of the dependency ratio even more onerous.

It may thus be the case in the current circumstances that agents perceive more clearly the potentially negative influence on their future income of structural deficiencies, and that this is inhibiting their propensity to spend. Accordingly, defining and boosting the reform agenda, in line with the commitments made at the Lisbon and Barcelona Summits, is not just necessary for ensuring greater sustainable growth in the medium tend; it is also a crucial requirement for improving agents' confidence and, thereby, contributing to the dynamism of activity, likewise in the more immediate term.

In a situation such as the present one, in which the flatness of private spending is largely a result of uncertainty about the future course of the economy, demand-side policies should be acknowledged to be of limited effectiveness in countering the weaknesses of output growth. When agents view the future with some mistrust, measures that are intended to be expansionary and geared to increasing activity in the short term may well prove counter-productive if they are perceived as unsustainable or even harmful in the medium term.

From this standpoint, it is vital for monetary policy conduct that the firmness of the central bank's commitment to price stability be reiterated, as an essential requirement for ensuring a higher level of well-being in the medium term. The ECB's actions have been consistent with this analysis: it has squared the reduction of interest rates to their lowest levels in recent decades, in step with the sluggish growth, with its drive to keep - through its actions and its communications policy - inflation expectations in line with its own definition of the objective of monetary policy.

The medium and long-term view is likewise essential for orienting budgetary policy. In the current economic conditions the *Annual Report* describes, discretionary measures entailing a significant deterioration in budgetary balances cannot be expected to have generalised expansionary effects on activity. This is because such measures may inhibit private spending and tend to exacerbate the challenges posed by population ageing. What is really important is that national budgets should not lead to structural imbalances that may jeopardise the sustainability of public finances and the proper functioning of Monetary Union. This is the best formula for contributing, at the current juncture, to reinforcing agents' confidence and boosting the favourable effects of European economic integration.

Against the background of the exceptional institutional characteristics of European monetary integration, it cannot be ignored that fiscal indiscipline in specific countries has negative externalities for the area as a whole; consequently, it is vital to maintain rules - such as those ìn the EU Treaty and the Stability and Growth Pact - limiting the fiscal autonomy of the Member States. This requirement is even more pressing now that ten new countries have joined the EU and expressed their wish to adopt the euro once they meet the attendant conditions.

Given the current difficulties with the EU's fiscal discipline arrangements, the priority would appear to be to ensure the proper functioning of the multilateral surveillance and control procedures of the current rules. Such rules should be accepted by all the Member States as the sole means of maintaining the effectiveness and credibility of the regulatory framework.

In any event, the upturn in activity that the European economy appears to have embarked upon should prove conducive to pushing through national governments' reform plans and to strengthening the fiscal commitments currently in place. That said, there are some uncertainties in the current situation, namely geopolitical instability, the rise in oil prices and the global macroeconomic imbalances which, naturally, affect the outlook for the euro area economy.

Despite such uncertainties, the European economy should post notably higher growth this year than last, on the basis of expanding export markets and a gradual recovery in internal demand. At the same time, the momentous step taken in European construction with EU enlargement should be an additional incentive for seeing through the economic and institutional reforms needed to revitalise European growth.

The Spanish economy

Addressing the behaviour of the Spanish economy in 2003 and in 2004 to data, I should begin by pointing out that our economy has, once again, managed to improve on the trajectory followed by the euro area. Internal demand in particular has continued to respond to the expansionary impulses provided by monetary conditions that have remained very generous for Spain's domestic situation. The more disciplined application of other economic policies and a more flexible reaction on the supply side of the economy, in line with the structural reforms undertaken, have helped maintain a setting favourable to the progressive strengthening of activity. This confrms that the slowdown which touched bottom in May 2002 has been put behind.

The growth differential with the euro area widened to almost two percentage points and held at around this level in 2004 Q1. As a result, real convergence continued apace last year and Spanish per capita GDP vis-à-vis the former EU-15 stood at 87.4%, one point up on 2002. Relative to the enlarged 25-member EU, this percentage rises to 94.4%, due to the lower level of development of the new members.

The buoyancy of the economy in 2003 and in early 2004 continued to be underpinned by the same foundations as in previous years, following a similar pattern. Firstly, as earlier mentioned, highly favourable financing conditions have remained in place. These have been characterised by low interest rates (which were cut further to historical lows), high rates of credit expansion and a notable rise in the value of non-financial assets, adding to which in 2003 was the rally on stock markets. Secondly, budgetary discipline has provided the necessary counterpoint to the stimuli stemming from monetary and financial conditions, giving soundness and firmness to the environment of macroeconomic stability. The resolve with which fiscal consolidation has been pursued in Spain was manifest in 2003 in a general government surplus of 0.3% of GDP and in a fresh reduction in the public debt ratio, which stood at 50.8% of GDP, far below the European average and the reference value set in the Treaty on European Union.

Any overview of the bases underpinning economic growth should also highlight, albeit in third place, the continuing support provided by strong employment generation. The moderation of labour costs, which fell again in real terms in 2003, and the greater flexibility of hiring arrangements as a result, inter alia, of the successive reforms introduced, were the factors behind the improved working of the labour market as from the late nineties which has led to a high capacity for employment generation. The improvement has proved to be a firm support for the sound performance of the economy, as it has enabled labour supply to increase, allowing a flexible response to increasing demand. Al the same time, the increase in employment has boosted household income expectations, which has helped sustain domestic demand.

The composition of the Spanish economy's growth has continued to be essentially underpinned by household consumption and construction. The improvement in the determinants of private consumption, which accelerated in 2003, was also assisted by the easing of the inflation rate last year. That made for an increase in the purchasing power of disposable income. Residential investment, despite the strong increase in the relative price of housing, continued to rise at a high rate. And this, combined with notable growth in public infrastructure works, fuelled the sustained increase in construction.

Investment in equipment and exports of goods and services also recovered in 2003, but their contribution to GDP growth was still modest. Indeed, it was these components which kept the pace of recovery moderate. Investment in equipment increased by 1.9%, leaving behind the heavy contraction of 2002. However, the pattern of its recovery is, so far, relatively weak in comparison with other similar cyclical phases. The financial restructuring being implemented by certain large corporations, which has limited their ability to spend on new projects, and persisting factors of uncertainty over the pick-up in demand may have been behind the as-yet subdued response of this investment component

Goods exports expanded at a faster rate than their markets, despite the loss of competitiveness induced by the appreciation of the euro. This favourable result was offset, however, by the sluggish behaviour of tourism and by the rise in imports, boosted by the euro appreciation. Consequently, net external demand exerted a significant contractionary effect on GDP, which has run into the opening months of 2004. It should be borne in mind, moreover, that the employment adjustment in the industries most exposed to foreign competition may be reflecting the fact that the defence of market share is, in some cases, based on unsustainable processes that erode the economy's overall competitiveness in the medium term.

Notable among the achievements in 2003 was the improvement in inflation which, after starting the year at a rate of 4%, ended it at 2.6%. This sizable downward adjustment partly reflects the removal of certain transitory elements from the index which had had an upward effect in 2002, but it was also the result of the restraining impact of import prices, favoured by the euro appreciation and the slowdown in oil prices. Overall, the reduction in inflation contributed to sustaining the purchasing power of income and provided for a narrowing of the inflation differential with the euro area to levels more in line with those experienced before the introduction of euro notes and coins.

Into 2004, economic trends in Spain point to a continuation of the path of gradual recovery, with no far-reaching changes in the composition of growth in the short run. Growth remains buoyed by similar factors to those driving it in the recent past, although investment in equipment can be seen to be firming. Nonetheless, the fresh outbreak of oil price rises has had a significant inflationary impact which has reversed part of the progress made last year and in early 2004. This new shock, to which the Spanish economy remains relatively sensitive, may, if it continues, entail a net drain on income. That would hamper the force of domestic demand, which would compound the foreseeably diminished momentum under such circumstances of external markets. Despite these risks, the outlook is for growth in 2004 and 2005 of around 3%, close to the economy's potential, which would be based on a very gradual change in its composition, as productive investment progressively strengthens in response to improved corporate earnings and to the completion of the restructuring currently under way.

The longer-term projection of this trajectory, to ensure the sustainability of growth rates above the euro area average, nevertheless requires far-reaching changes in the growth pattern to dispel the risks that have been incubated. It is crucial that investment in equipment should gain in momentum and that its greater vigour be accompanied by more expansionary, export-led net external demand. The improvement in these components would then provide for a situation in which the necessary moderation in household spending, especially on house purchases, did not lead to a loss of dynamism.

It should not be forgotten that some of the factors behind the buoyancy of expenditure may tend to lose steam or even disappear The most patent case here is that of the prolonged expansionary influence exerted by lower interest rates. The current scenario of exceptionally low interest rates is the result of a very particular economic situation at the European and international level. And although EMU membership ensures moderation in rates, it is likely these will return to more neutral levels as the recovery in the area takes hold. Nor is it conceivable that the exceptional intensity of employment generation per unit of output in recent years can become a permanent feature. Probably, once the labour market has been fully adjusted to a situation of price and wage stability and to a more flexible regulatory framework, the relationship between job creation and growth in the economy will resume a pattern more in step with long-term trends.

In this respect, it should further be borne in mind that the maintenance over a prolonged period of time of a strong expansion in domestic demand, driven by substantially generous monetary and financial conditions, entails pressures which, if they build up, may emerge precisely when some of the factors upholding growth begin to show signs of petering out.

The foregoing comments indicate that the favourable growth prospects for the coming years cannot be taken as guaranteed over the longer term. The Banco de España has been signalling the fact that the prevailing growth pattern harbours certain risks that may emerge in the form of a deterioration in competitiveness and financial imbalances in the households and non-financial corporations sector. Although the trajectory of the Spanish economy has not yet been hampered by the emergence of these risks, any future deterioration could impair further progress in real convergence.

Competitiveness can be undermined on several fronts. The first of these is the maintenance of a persistent inflation differential with the euro area. This differential is partly related to the fact the Spanish economy is ahead in the cycle, but it has also to do with the presence of elements of inertia in wage and price formation in Spain associated with structural shortcomings in certain markets for factors, goods and services. Another significant front is limited productivity growth, which is not only lower than in the United States but also than in most of the European countries. Admittedly, low productivity gains can be explained in terms of the intense employment generation in the economy and of a composition of growth which, in recent years, has been largely based on construction and on services. But they nevertheless reflect low productive investment, a limited incorporation of technological improvements into the stock of productive capital and the relative lack of competition in certain segments of the economy.

Safeguarding a sound competitive position for the Spanish economy is undoubtedly a priority for economic policy management within EMU. As I have said, the activities most exposed to foreign competition have begun to feel the effects of the losses in competitiveness that have built up. And after squeezing their margins in recent years, they have begun to adjust their staff levels. Competitive pressures are heightening, moreover, as new competitors emerge on the international scene with a similar specialisation pattern to Spain and with a notable edge due to their low labour costs. In particular, the enlargement of the EU to 25 countries, while entailing the opening up of potential new markets for Spanish products, means above all a substantial increase in competition. The Spanish productive system must prove itself able to respond to this with dynamism, innovation and flexibility, as it has in the past when opening up to its external environment.

The second source of risk lies in the patterns of financial behaviour of the private sector of the economy. It is well known that the strong growth of household and corporate demand has been accompanied by a notable rise in borrowing and in their debt ratios. Although this has not led to any deterioration in the financial position of these sectors (because their assets have also risen in value) or to rises of the same magnitude in their debt burden (thanks to lower interest rates), their higher indebtedness has made them more vulnerable to adverse changes in economic and financial conditions.

Household debt cannot grow indefinitely at the rapid pace of recent years. The higher indebtedness and the increasing weight of floating rate loans, along with the rising share of equities and real estate in households' asset portfolios, have made their spending decisions more sensitive to interest rate and asset price movements, in a situation complicated by the limited disposable savings remaining after debt service.

The property market is particularly significant in this respect because most household indebtedness is linked to house purchases. Although the supply of housing has responded fairly flexibly to the increased demand and the price trajectory has not departed substantially from the pattern seen in previous upturns, a certain degree of overvaluation of these assets is detectable in Spain. This overshoot, which was not corrected in 2003, makes it particularly necessary for buyers and sellers in this market to act cautiously. A gradual absorption of the overvaluation would establish a frarmework of greater financial stability for households and forestall interference in their consumption decisions.

To address the risk factors mentioned above appropriately, it is necessary to embrace a gradual change towards a growth pattern that is better balanced and more squarely based on those expenditure items that most contribute to building the economy's productive potential and competitiveness. The economic authorities can contribute to this by focusing the available economic policy instruments on sustained macroeconomic stability, market flexibility and higher potential growth.

In the case of fiscal policy, a primary role must continue to be played by budgetary stability to prevent demand-side pressures from exacerbating the existing risks, particularly in the present circumstances of monetary conditions that are overly generous given the degree of firmness prevailing in domestic spending. Consequently, the restrictive fiscal policy stance should be maintained and the budget balance further improved, in step with the foreseeable firming of the recovery. This stance is also needed to meet the medium- and long-term challenges to public finances. Here, the possibility that the current pace of revenue growth may not be sustainable in the future, the probable rise in financial expenditure (which has so far assisted consolidation), the foreseeable cutback in European funds from 2007 onwards and, in the longer term, the uncertainties over the sustainability of the pension system, are factors that strengthen the case for surpluses in public finances in good times to stave off the reappearance of major imbalances in the future.

From this standpoint, the allocation of pensions to the Reserve Fund with a charge to the social security surplus is unquestionably an essential part of this strategy, although the amount of the funds involved so far is small in comparison with the magnitude of the risk of increased pension expenditure due to population ageing. Therefore, an attempt will have to be made aver the next few years to entrench the social security surplus and thus ensure that this practice continues for a sufficiently long period at a sustained rate. That said, achieving a soundly based social security system in the medium term may require more ambitious policies, including reform of certain aspects of the pension systems.

At the same time, the maintenance of sustained growth over time requires a more efficient economy with a more flexible pattern of specialisation and a more intensive incorporation of new technologies. However, with a view to the future, this pattern, which has enabled a part of the considerable unemployment generated in the past to be absorbed, cannot be considered satisfactory. First, because the scant headway in productivity undermines the basis of competitiveness and, second, because demographic developments indicate that, within a few years, employment will tend to make a lower contribution to growth.

I am not going to list here the measures for raising productivity, but I would like to remind you of the fundamental role of structural reform in this respect. As pointed out in the *Annual Report*, it is particularly important to push ahead with labour market reform (in the areas of wage negotiation and hiring), improve the workings of the housing market (and of the related land market) and continue with the liberalisation of the network industries. Measures are similarly required to foster the incorporation of technological innovation in productive processes and to improve the stock of infrastructure and of public capital. The current house price situation means that urgent action is needed to overcome the restrictions on the supply of land via more flexible town planning to make building land more readily available and to improve the workings of the rental market. Finally, although the improvement of the services sector depends on many structural considerations, the importance of more flexible retail trade regulation for price formation and the economic system's overall efficiency should not be overlooked.

In short, without making any attempt to cover the entire scope of the economic policy requirements in the present situation, I do feel it is important to emphasise that fiscal stability and structural reforms can provide an appropriate means of addressing risks arising in relation to competitiveness and to the growing indebtedness of the non-financial private sector, which are the ones that could jeopardise the continuity of real convergence.

Financial system

2003 brought an improvement in the situation of the international financial markets and, in this favourable setting, the financial institutions of a good number of countries reported better results and higher profitability. The difficult times of past years, during which most institutions showed notable resilience, led many of them to undertake reforms designed to reduce costs, such as the sale of non-strategic assets, and these decisions should now be bearing fruit.

The improved situation of financial institutions at the international level seems to be borne out by the favourable outlook for their future performance that agents operating in the markets have. In 2003 this perception was reflected in rising stock market prices, reduced implied volatilities and narrowing risk premia.

Spanish deposit institutions, thanks to their sound initial position and the fact that the Spanish economy outperformed the EU average, were less severely hit by the difficulties of past years. They were thus in a position in 2003 to benefit from the favourable international financial situation, from the rebound of the securities markets, and from the continued strong relative performance of the Spanish economy.

In particular, Spanish deposit institutions enjoyed higher growth of earnings and profitability in 2003. This allowed the effects of a more competitive environment and low interest rates to be offset by larger business volumes and tighter control of operating expenses. Also, lower doubtful assets allowed bad debt provisioning to be reduced thanks to the smaller need for provisions to the specific fund (partly counteracted by changes in the statistical and general funds), thereby boosting the institutions' profit and loss accounts.

Solvency ratios held steady and default ratios stood at historical lows. Indeed, the solvency levels of institutions were not impaired by the faster credit growth because of the increase in Tier 1 and Tier 2 capital. The solvency of institutions was strengthened by the statistical fund, which has grown uninterruptedly since it was created in July 2000.

The improvement in earnings and ROE was, as mentioned above, due partly to the high growth in the business volumes of Spanish institutions and especially to lending to mortgage borrowers and to construction and property development firms. In particular, the growth of credit to property developers in 2003 was notable, and was not attributable to just a small number of institutions. It should be taken into account that this lending is markedly cyclical and that in past recessions it has shown high default rates. Moreover, the strong credit growth is an additional cause for concern, basically for two reasons. First, because Spanish household indebtedness is already higher than the euro area average. And second, because the growth of credit extended by institutions is not being accompanied by a commensurate increase in deposits. This produces a greater need for recourse to international financial markets, which may raise the average cost of bank liabilities and hinder profitability gains.

It is therefore not enough to have a strong profit and loss account; instituions must also look particularly hard at the sustainability of their current business model based on strong growth in lending volume, and at the possible alternatives to this model. In the medium term, cost contanment and continuous improvement in efficiency will be pivotal in ensuring sound profit and loss accounts. Spain's membership of the euro area, which has made its economy more stable, has nevertheless enabled a faster pace of credit expansion than traditionally seen in this country, without Spanish institutions having suffered notable financial imbalances. That said, their managers have to continue to act prudently and responsibly, considering possible changes in the economic situation that may arise during the course of the cycle and adopting strategies designed for the medium and long term.

Another matter on which institutions should reflect from this medium-term standpoint is the quality of their own funds. Indeed, it should be borne in mind that their strengthened ROE has been driven in the last decade by increased leverage of the quality of their capital (i.e. the growing weight of subordinated debt relative to capital stock and reserves). Insofar as that leverage is reaching a maximum, no further improvements in ROE derived from changes in the composition of regulatory capital should be expected.

The challenges to be faced by financial institutions are, however, not limited to those deriving from the more conjunctural factors; they are in fact largely traceable to the important changes in financial systems in the last few years. These changes include most notably the increasing degree of internationalisation of institutions; the ongoing emergence of more sophisticated and complex new products; the increase in risk transfer processes and, finally, the growing importance of a whole set of risks that not long ago were difficult to quantify.

Financial institutions have to respond to these challenges by improving their services to consumers and to society and simultaneously intensifying their efforts in two areas requiring a wide range of actions.

First, they have to step up the efforts made to date in designing and implementing robust risk management systems firmly based on corporate governance best practices. In recent years, institutions have become fully aware of their importance and have made considerable headway in this direction, supported by improvements in calculation methods, available technical capabilities and databases, among others. At the same time, they must not neglect the need to invest in human capital, an essential factor in banking. But these investments in technical and human resources - and this is an additional challenge - must not involve any let-up in the pursuit of greater efficiency, which is the key competitive factor in a world of increasingly integrated markets.

Financial institutions must therefore redouble their efforts to enhance their capabilities in relation to risk identification and the quantification of committed exposures. They need to design their strategies for managing risk, as well as their capital and liquidity, bearing in mind that economic and financial conditions vary over the cycle. The need for responsible and prudent action by managers is even more important in the context of the significant transformations financial systems are undergoing. As I have already mentioned, these have raised the profile of a whole set of risks that have been addressed only marginally in the past.

In particular, off-balance sheet operations, guarantees and forward operations, for example, require extreme vigilance on the part of financial institutions. This is because, among other reasons, identifying and assessing the risks they entail is sometimes not straightforward. Moreover, international corporate scandals have shown the great importance of reputational risk. In all such scandals the firms involved had excessively complex and insufficiently transparent organisation structures. employing in their operations special purpose vehicles located in opaque jurisdictions. In many of these cases the most basic mechanisms underpinning good corporate governance also failed.

The complexity of structure and the lack of firmly established corporate governance mechanisms in organisations is also conducive to operational risk, which has significant potential to cause institutions damage that is hard to repair. The latter have increased their efforts to develop methods to improve the measurement of this risk, but there is still a long way to go before this is achieved.

Such complex and opaque organisational structures also make it difficult for the institutions to know their customers properly. That brings me to the second element institutions need to focus on: getting to know, as far as they are able, their customers' activities. This would be in line with the greater concern at all levels to avoid the funds extended through the banking system being used, among other activities, for terrorist financing or money laundering.

Customer knowledge on the part of financial institutions has a second but no less important dimension. The products offered to financial-services consumers must be tailored to their needs, with the institutions helping them to assess the risks that they wish to and are able to assume. In a context of rapid credit growth like that in Spain, it would seem to be enormously important to help customers assess the commitments they are capable of assuming on the basis of both their present and future circumstances.

The challenges I have referred to justify the need for a response by supervisors and regulators. The focus of our concern is currently the promotion of the stable functioning of the financial system, and the need to boost the incentives offered to ensure that it continues to enhance the scope and quality of the services that it has traditionally offered to society.

The New Capital Accord is undoubtedly a significant step in this direction and represents a great opportunity for the banks to review, update and improve their capital strategies and risk management systems. It is, therefore, a suitable framework for boosting financial stability.

The New Capital Accord proposes a comprehensive approach based on the combined operation of a number of complementary elements and considering a broader set of risks than its predecessor. It is, moreover, a model for regulation based on the introduction of the incentives needed to stimulate prudent and responsible action by the institutions. These incentives will promote the establishment of appropriate risk measurement and management systems, such that the better they are, the lower the capital requirements applied to the institutions in recognition of this superiority.

The desire to offer alternatives and incentives is clear in the design of the Accord. For example, it proposes that institutions should have various alternatives for calculating their regulatory capital, ranging from the simplest possibilities based on the use of external rating systems, to other more complex ones based on internal rating systems designed by the institutions themselves. The requirements to gain access to the most advanced methodologies are, undoubtedly, considerably more demanding. That said, it is up to the institutions themselves to decide, on the basis of their specific operations and of their needs in general, which methodology they wish to apply. In fact, it is not clear that small and medium-sized institutions should opt, at least initially, to use the most advanced approaches. In particular, the Banco de España foresees that, both on account of the type of operations carried out by Spanish institutions and owing to the minimum requirements for access to the different methodologies, the number of those adopting the most sophisticated methods (i.e. the advanced IRS approach) will be limited and will be the result of a gradual process over time. In short, the adoption of the advanced Basel II models should be seen from a perspective of realism and the pursuit of excellence. As far as the Banco de España is concerned, quality takes precedence over any consideration of timing in the adoption of the advanced approaches.

As I have already mentioned, the implementation of the New Capital Accord will pose serious challenges for the institutions, which will be expected to step up the efforts they have no doubt already begun to make. The need to increase these efforts has become even more pressing since 11 May this year, when the Basel Committee on Banking Supervision approved the text of the Accord, which will be released at the end of June.

Also prominent in the area of regulatory reforms, which will involve significant challenges and whose implementation is imminent, is the introduction of the International Accounting Standards (IAS). In accordance with the mandate of the European Union, these standards will affect the preparation of the annual accounts of groups with securities listed on any regulated market of the Union from 1 January 2005. The challenges associated with the introduction of the IAS not only relate to the technical adaptation that will be required to comply with them; some of these standards may affect institutions' business strategy, since aspects such as provisions and the consolidation and amortisation of goodwill will be changed. Moreover, the new accounting rules will alter the role traditionally played by the managers of the institutions and their auditors; the proposed framework is more open and gives them a greater degree of responsibility in relation to the information supplied to the market.

The aims of the IAS relate, firstly, to the need for a single financial market within the EU and, secondly, to convergence between these rules and Anglo-American standards in the medium term, such convergence being an element that will strengthen the integration of the international financial system.

The Banco de España certainly acknowledges the benefits arising from the objectives of the IAS; but it also detects a need, owing to the complexity of the process and calendar problems, to make the transition simpler and to give it a greater degree of certainty. Also, the Banco de España considers that, from a supervisory standpoint, accounting is an essential element of credit institutions' regulatory and prudential framework. That is to say, accounting standards aiming to promote transparency and comparability among institutions must be compatible with good banking practice in relation to risk management.

As a result, the Banco de España, in accordance with its regulatory powers, and taking as its starting point the positive experience of the Spanish supervisory model, based on prudent accounting standards, is drawing up a new accounting/prudential circular. This will aim to ensure continuity with the aforementioned framework, as well as compatibility with the IAS, permitting a far-reaching and consistent reform of the current model. Accordingly, the new circular will assist institutions in complying with the IAS; it will select the most prudent options when the international standards propose more than one, so recognising the particularities of financial institutions; and, finally, by permitting a common accounting framework, it will prevent the choice of accounting options from being a factor that may distort competition.

Allow me to end this review of the challenges facing financial institutions by pointing out that their responses must be supplemented by market discipline and by the action of financial-services consumers.

In effect, market discipline is an essential supplement for supervisors; market participants, by rewarding those institutions that act appropriately, generate the necessary incentives for managers to behave prudently. Yet, for market discipline to be possible, market participants need to have the necessary information. This is why the promotion of transparency is of paramount importance, to ensure that institutions report information that is reliable and based on generally accepted valuation principles in a timely and opportune fashion. This qualitative and quantitative information must enable the results obtained by institutions, the risks they are assuming and the practices employed in their management and control to be assessed.

Finally, in a non-zero-risk world, the action of consumers of financial products and servces is, as I have already mentioned, very important. They should be expected to be responsible and active, searching for information and understanding the risk profile of products, especially those with a greater degree of complexity. With an approach based on these principles they will be able to take their decisions responsibly, assuming levels of debt that are reasonable, not only in the light of their sustainability at present, but also in the future.

However, consumers must not only have access to information, they must also be able to assess it. Institutions must play a role in this respect, offering their customers the products that best suit their needs and informing and advising them accordingly. In addition, in recognition of the importance of raising the acumen of bank customers, the Banco de España is developing a project to educate, through the Internet, the users of financial products and services. The project’s first phase will be available at the beginning of next year.

Allow me, like every year, to conclude by referring to other aspects of the management of the Banco de España. As part of our ongoing effort to increase the transparency and improve the communication of the Bank’s activities, this year’s *Annual Report* includes an additional chapter on the management of the Banco de España in 2003.

This chapter summarises the main tasks performed and the organisational changes made at the Banco de España. I should like to stress that the Banco de España has continued to press ahead with the reforms necessary to adapt the institution to its new challenges. All this has been possible thanks to the dedication, hard work and initiative of every member of staff, and I should like to express my sincere gratitude to all of them. There remain projects to be carried out and objectives to be achieved, and I therefore wish to express my desire that we will continue to work with resolve, striving to combine our efforts.

Lastly, my thanks to you, ladies and gentlemen, for your contributions, collaboration and support.