The euro area from the perspective of an EU central bank

The ***Deputy Governor***[(1)] *reviews the UK position on the proposed euro area and concludes that recent changes, including the operational independence to set interest rates given to the Bank of England, should make the relationship between the United Kingdom and the euro area, if it comes into being in 1999, constructive and stable. The* ***Deputy Governor*** *notes the considerable progress already made by the EMI towards developing payment systems for the euro area, but highlights the outstanding policy issue of whether intra-day credit should be made available to EU countries not included in the first wave of monetary union. The* ***Deputy Governor*** *argues that no such discrimination should be applied, in the interest of the efficiency—and hence attractiveness to potential users—of the system and to avoid unnecessary costs to commercial banks within the euro area.*

I am honoured to have been asked to speak at today's important conference. The development of a Europe-wide payment system is one of the most important challenges that still faces the European Monetary Institute (EMI) and its successor, the European Central Bank (ECB). And I congratulate the Bundesbank on having organised the day, with a collection of important contributions from around Europe, which ought to advance the issue significantly.

I have another particular thing for which to be grateful to the Bundesbank: the title of my contribution today, 'The euro area from the perspective of an EU central bank'. This title is pregnant with constructive ambiguity. It suggests, delicately, that the UK perspective on the euro area might be an external one, but of course without exactly saying so.

I am not in a position today to resolve that ambiguity for you. You will all have seen, I hope, that the attitude of our new Government to the European Union is an entirely constructive one. The Prime Minister and his Foreign Secretary have said that they wish to lead in Europe, and not to criticise from the sidelines. I think that message has been fully understood in Germany, and elsewhere.

As far as monetary union is concerned, however, no firm decision has yet been made. The Chancellor of the Exchequer has said that he is sympathetic in principle to the idea of a single currency for the whole of the European Union, as long as it is well-founded in sustainable convergence. And we can say that the United Kingdom's policies are likely to deliver fiscal convergence this year. The Chancellor has already said that he plans to stick with the public expenditure plans of his predecessor. And most economic forecasters believe that the Government will achieve the deficit convergence criterion this year, without any special accounting measures, and without the Chancellor needing to pay a visit to the vaults of the Bank of England.

Furthermore, you will know that the new Chancellor has granted the Bank of England operational independence to set interest rates. The first meetings of the new Monetary Policy Committee took place last night and this morning. I do not wish to imply that this change in the statute of the Bank of England, which will soon be put into legislation, renders us immediately Maastricht-compatible. It does not, and the Chancellor has emphasised that this is a British solution to a British problem. Nor do I wish to imply that the United Kingdom is likely to join in 1999. The Prime Minister has said that it is highly unlikely.

What is important to note, though, is that there is no question of the United Kingdom pursuing a disruptive, inflationary monetary policy outside the euro zone, if that is where we find ourselves in 1999. The Bank of England will, we are told, be given an inflation target that will be at least as tight as the 2.5% or less regime within which we have been operating in the last few years, and you may take it that we will do our very best to meet that. So the concerns that have been expressed about the potential behaviour of the United Kingdom as a 'pre-in' country not yet in the euro zone are, I think, wide of the mark (or should I now say, wide of the euro?).

I note, in passing, that we have heard rather less in recent months of the criticism current in 1994 and 1995 that the United Kingdom was engaged in competitive devaluation. Of course, just as we rejected the charge when it was applied to us, on the sound economic basis that it was impossible to achieve competitive real devaluations by monetary policy means, so we would not dream of implying that any other countries were engaged in such a policy now.

My conclusion from all this is that the recent changes have put the United Kingdom into a position where its relationship with the euro zone, if it comes into being on 1 January 1999, should be constructive and stable. There is no question of our pursuing destabilising policies on the

(1) At a seminar on 'The future of the payment system—reality and visions for Europe' organised by the Bundesbank in Frankfurt on 6 June 1997.

outside. I think that is an important background against which to consider the payments and settlements issues that are the subject of today's conference. I therefore make no apology for having spent a little time on these broader contextual questions before coming to the specifics.

Let me now turn, therefore, to the development of payment systems for the euro area.

I should begin by saying that, in most respects, we believe that a considerable amount of progress has been made by the EMI in the last couple of years. It has not been a straightforward exercise. It has required a high degree of collaboration between many central banks around Europe who operated a variety of different domestic mechanisms. That did not make the task of achieving appropriate and efficient linkages particularly easy. But in spite of these obstacles, a lot has been achieved already. Plans for the TARGET system, interlinking real-time gross settlement (RTGS) systems around Europe, are very well-advanced and, while we must all have doubts about the extent to which our systems will be fully ready for the great day, we are modestly optimistic.

Nonetheless, there are some outstanding policy issues on which firm conclusions have not yet been reached. Some are in the process of being addressed, like the question of how to charge for cross-border transactions. But one that troubles us particularly—the question of intra-day credit for countries potentially outside the euro zone but inside the European Union—has not yet been fully resolved.

We have argued, as you will know, that there should be no discrimination by the 'ins' against the 'pre-ins' and that intra-day credit should be available throughout the European Union. Others have argued that pre-ins should not have access to such credit, invoking a number of arguments related to monetary policy in support of that contention. We believe these arguments to be wrong and, furthermore, that to restrict the pre-ins' access to intra-day credit would be damaging for the euro zone itself. I would like to trespass on your patience for a few moments today to explain why we take that view.

But first, just a word about RTGS systems in general.

Central banks like real-time settlements systems. They promote them because they eliminate interbank receiver risk. TARGET is, in essence, automated correspondent banking between central banks, and offers the opportunity of extending that reduction in risk to cross-border payments. Banks will be able to make euro payments between themselves and the domestic RTGS systems as they do now in any other currency. If they wish to make a cross-border euro payment, their central bank will act as correspondent. It will debit the commercial bank's account, convert the payment message into the format used for the link between central banks, and send it through that network. The receiving central bank will automatically credit the receiving commercial bank's account. That commercial bank will be informed of the receipt through the second domestic RTGS system, and can then credit the customer. To central banks, this all sounds terrific.

Commercial banks, on the other hand, like the speed of real-time systems but do not generally prize highly the settlement finality that they offer. RTGS systems are more costly for banks because they have to offer collateral to secure their intra-day exposures. As a result, commercial banks often choose netting arrangements rather than gross systems. For example, they may choose CHIPS rather than Fed-wire in the United States, or EAF2 rather than EIL-ZV in Germany.

It follows from this that central banks have to work hard to market the benefits of RTGS systems if they are to wean commercial banks away from these other, cheaper but more risky, methods of payment.

The comparative advantage of TARGET over the EBA's proposed netting system and the correspondent banking mechanisms themselves is intra-day finality and speed. It will therefore be promoted as a premium service. But it will have to be at least as economical, robust, reliable and efficient as its competitors if it is to attract business. This is where the intra-day credit issue assumes importance for everyone, and not just for the pre-ins.

If there are restrictions on access to intra-day credit, it will have the effect of delaying payments, initially from out banks to in banks. There will be grit in the mechanism of RTGS that will have the effect of slowing payments down throughout the system. Out banks may wait for incoming payments from in banks before making their outgoing payments. This implies that commercial banks in the euro area will have to wait longer for their incoming payments, and may themselves have to delay their outgoing payments. Alternatively, they may obtain the intra-day credit necessary to make the system work efficiently and therefore have to bear the cost of the necessary collateral. Restricting intra-day credit to out banks, therefore, has the effects of:

- making TARGET payments and receipts slower for all participants, thereby undermining the principal marketing advantage of the system; and
- making the commercial banks within the euro zone bear a disproportionate share of the costs of obtaining intra-day credit.

By contrast, if intra-day liquidity is freely available throughout the system, the incentive to delay payments will be much reduced. The system will be faster and more reliable, and the cost of collateral will be more evenly shared by all participants, making it more attractive to everyone. TARGET would, as a result, be likely to have higher volumes, which would in turn allow it to charge a lower price, further reinforcing its status as the system of choice for high-value cross-border euro transfers.

These arguments seem to us highly persuasive. Why have they not yet won the day?

Some people argue that there is a competitive dimension that comes into play here—that restricting access to intra-day credit for out financial centres may make business gravitate towards financial centres within the euro zone. But such motives would run entirely counter to the spirit and perhaps the letter of the Single Market, so I am sure they are not at issue.

But it is also argued that there is a monetary policy question—that if central banks in non-euro zone countries are able to generate intra-day credit in euros, this will complicate monetary management for the euro zone as a whole. How can a monetary union allow credit in its currency to be created outside its borders?

This argument has a kind of commonsense feel to it when simply stated. But we do not believe that it stands up to rigorous scrutiny. Indeed, in our view there are no monetary policy issues that arise from the provision of intra-day liquidity in itself.

Moreover, it is increasingly understood internationally that the supply of intra-day credit has no implications for monetary policy. This is because such credit has to be repaid before the end of the day, and thus intra-day liquidity conditions have no bearing on the overnight or longer-term interest rates.

If intra-day liquidity did, however, spill over by accident into overnight liquidity, then clearly monetary policy conditions could in theory be affected. The actual effect would depend on the size and persistence of the spill-over and on the way in which monetary policy was being implemented. In the UK system, as in the proposed system of European Central Banks (ESCB), the focus is on steering interest rates. Managing liquidity is a tool, rather than an end in itself. So spill-overs matter only to the extent that they affect interest rates. In practice, our system and the proposed ESCB system are both built on the assumption that there will be shocks to the demand for, or supply of, liquidity and the systems incorporate mechanisms to provide overnight liquidity, quasi-automatically, to prevent disturbances to interest rates. The proposed ESCB lending facility is one such mechanism. Averaging reserve requirements would be another.

No one seems to suggest that the provision of liquidity overnight through the lending facility to a bank in the euro area, at its initiative and at a penal rate of interest, will undermine the ECB's control of monetary conditions. On the contrary, the facility is designed to help the ECB retain control.

Spill-overs from intra-day liquidity would have identical monetary effects to those from the provision of overnight liquidity through standing facilities. So perhaps on those grounds alone we should not be excessively concerned about them. Nonetheless, it is highly desirable that liquidity provided to payment systems and operations designed for monetary policy purposes are kept separate. So we have always accepted the need to minimise the risk of spill-over as far as possible. In the United Kingdom, we do this in two ways. We apply an earlier cut-off after which no customer payments are accepted by the CHAPS banks. And we apply penal rates to any overnight credit required to prevent a bank that has failed to balance its books by the end of the business day from going into overnight overdraft. So we make it uneconomic for borrowers to turn intra-day credit into overnight credit.

These are theoretical arguments, about the construction of the system. But we can go one better than that, because we now have had one full year of operation of our own domestic RTGS system, which was introduced in April of last year. What has been the experience during that time?

In fact there have been just ten days when the settlement banks collectively were overdrawn at the end of the day as a result of a failure to manage their own liquidity. On none of these days was there anything at all extraordinary or difficult in the behaviour of the money market. On the day of the biggest spill-over, when it was 0.16% of throughput that day, the overnight rate traded very close to our dealing rate until after our last round of operations, and then moved up to around the higher rate at which we were providing overnight liquidity. So if the concern is that spill-overs lead to lax monetary conditions, our experience indicates clearly that such a concern is misplaced. We have experienced no impact on any longer-term rates that might be more directly relevant to the transmission of monetary policy. Our conclusion is that transitory spill-overs, which are anyway few and far between, and small, are irrelevant to monetary conditions.

In our view, there is no reason why penal rates and early cut-off times should not be just as effective in the context of TARGET as they are in domestic systems. Nor why they should not be applied equally to ins and pre-ins. The monetary policy implications of any spill-over would be identical whether it occurred inside or outside the euro area. There is nothing inherently more damaging or difficult to manage from a spill-over on the outside. Nor is there any reason why intra-day liquidity outside is more likely to crystallise into overnight credit than it is inside. Indeed, our view is that in practice the likelihood of a spill-over may be greater within the euro area, since in banks will have an automatic right to translate intra-day credit into overnight credit through the ESCB lending facility. And no one, certainly not the Bank of England, is arguing for outs to have access to such a facility.

Our firm view, therefore, is that restricting the pre-ins' access to intra-day credit to pre-ins is both unfair to the pre-ins and an own goal on the part of the ins. This ought to mean that it will not happen. But so far we do not seem to be in a position where that conclusion is generally accepted.

So we need to consider what we would do were restrictions to be imposed after 1 January 1999.

Our view on that is clear. We will ensure that banks operating in the London market will be able to make cross-border payments in euros throughout the euro zone. There are a number of ways in which they could do that. We could provide access to TARGET with appropriate intra-day liquidity provided by the Bank of England. Or we could arrange for euro settlements to take place in London through correspondent banking connections or the successor to the ECU Banking Association clearing. But we still believe that if restrictions are imposed on pre-ins, the whole system will not be as attractive as it would otherwise be. This is because banks are less likely to plan to use TARGET if they are uncertain about the conditions of use, or indeed about the policy motives of its architects. But we will certainly ensure that UK-based banks are not competitively disadvantaged if the United Kingdom is not in the first wave of EMU participants. And we hope they will choose to use TARGET. That will only happen, though, if we EU central banks have made it so efficient that it becomes the system of choice for high-value payments.

But, as our new Prime Minister has made abundantly clear, we do not wish on this or any other issue to be on the sidelines of Europe. So we very much hope that some of our colleague central banks will reflect on the arguments we have advanced here and elsewhere, and that we can still collectively reach a solution that suits everyone.