Mr Hartmann reports on central bank involvement in the design, operation and oversight of payment systems

Speech by Mr Wendelin Hartmann, Member of the Board of the Deutsche Bundesbank and Chairman of the Committee on Payment and Settlement Systems (CPSS) of the G10 Central Banks, at a conference organised by the Organisation of Central and Eastern European Clearing Houses in Sofia, held on 6–8 October 1999.

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Central Bank involvement in payment systems

As I am sure all bankers are now aware, payment systems are going through a period of enormous change – and this is true in every region of the world. In my remarks this morning, I would like to look at the role central banks are playing in this process of change. Payment systems are a key component of a modern market economy, and therefore the way they function can have an important bearing on how efficient that economy is. In particular, they can have an important bearing on how well financial markets function. In Europe – and not least in East and Central Europe – this efficiency aspect of payment systems hardly needs spelling out. And alone this is sufficient reason why central banks should take an interest in payment systems.

But what I want to do in the next few minutes is focus on the importance of payment systems for achieving financial stability, rather than efficiency. This aspect of payment systems is perhaps less widely understood. Yet it is fundamental to understanding why central banks increasingly attach so much importance to the introduction of payment systems that are safe as well as efficient. In this context reliable real-time gross settlement (RTGS) systems are of particular interest. This type of payment system is an optimal basis for a well-functioning money market and therefore most suitable for the implementation of monetary policy. Thus, interest rates are finding an effective channel for the whole currency area.

Why financial stability is important ...

Let me start by briefly reviewing why financial stability is so important. Achieving stability in financial markets is part of the wider goal of achieving macroeconomic stability. What happens if financial stability is missing – what can be done if there is a financial crisis? Broadly speaking, one has two options. One is to provide unconditioned financial support for the market. But doing this involves the risk of undermining macroeconomic policy: looser monetary policy will finally cause inflation and ongoing asset price bubbles. Moreover, the provision of inadequate liquidity support can bring about moral hazard problems that make future instability more likely. The other option is to let the crisis run its course by doing nothing. This is, however, likely to lead to institutional failures, giving rise both to heavy costs for national treasuries and to a danger of systemic collapse with wider economic consequences. Recent developments in several South East Asian countries show that neither option is acceptable. So it is far better to try to prevent the financial instability emerging in the first place by performing a monetary policy which aims at stability and orderly market conditions.

... and why it is becoming harder to achieve

Financial stability has therefore always been important. But achieving financial stability is arguably harder now in open financial markets than it ever has been.

The proximate causes of this are well understood. First, financial markets have developed to be really international. Moreover, the fact that information, both substantiated and unsubstantiated, now flows almost costlessly and instantaneously around the world significantly increases the likelihood that shocks of whatever sort could be propagated elsewhere. Both insufficient and exaggerated market concerns about counterparty risk, or technical shortcomings in the payments infrastructure, could pose further threats to international financial stability if they lead to a sudden loss of liquidity in important markets or an inability to settle transactions. Achieving financial stability is thus increasingly difficult at the national level without international cooperation.

Second, the pace of change is increasing. The assessment of existing shortcomings in the system and possible solutions is made more difficult by the extraordinary pace of change in modern markets. Driven in part by dramatic advances in technology, the target at which policymakers must aim is constantly moving. As a consequence of recent technical developments the EU Commission issued a Directive which the German legislator also implemented in the Banking Act by declaring the issuance of e-money as being a banking activity. At present, discussion is going on about how to react to the increasing use of internet facilities for e-commerce.

Third, the volume of transactions, as well as their complexity and opacity has increased sharply as the cost of carrying out transactions has been drastically reduced. Investment banking has meanwhile developed to be the main field of activity of internationally operating financial institutions. Huge Highly Leveraged Institutions (HLI) are explicitly designed to profit from extremely high turnovers by very narrow margins.

The world is therefore a busier, more complex and more interdependent place. Underlying these proximate causes are perhaps two more fundamental causes. An obvious one is change in technology – both in processing power and in communications. But another fundamental cause is deregulation – the decision to put more emphasis on market mechanisms, whether in the move away from planned economies or in the liberalisation of existing market economies. In the financial sector regulators have to find a balance between direct control and allowing the market to find its own equilibrium. The increased emphasis on market mechanisms is in my opinion desirable because of the gains in economic efficiency it can bring. Furthermore, it is to some extent inevitable, since the changes in technology have been making regulations increasingly easy to avoid and thus direct control over markets and their participants – albeit still necessary – increasingly hard to maintain.

The need for a strategy to make payment systems safer

The result of the developments I have just described is a world where markets are more volatile – and where there is more chance that extreme movements in one market will spill over into others. From a regulator's point of view this volatility can be unnerving – so how can we cope? A crucial element is ensuring that the infrastructure is sound. In the financial system the infrastructure is based on three main pillars: the financial institutions, the markets they trade in and, of most interest to this conference, the mechanisms to settle financial transactions in those markets, in other words the payment systems. For the latter pillar adequate procedures of oversight are necessary in order to ensure a well-functioning technical basis.

So how do we go about strengthening the payments systems infrastructure to make it more stable? In the light of what I said earlier, I suggest we need a strategy that recognises that the pace of change is extraordinary, ongoing and irreversible. The strategy also needs to take into account the fact that transactions are becoming increasingly complex and interdependent and involve an ever-widening and changing range of participants.

This reality has three strategic implications. First, the strategy must be comprehensive across sectors to cope with interdependencies. This means that we should not tackle payment systems in isolation. To be fully effective, the changes to payment systems must be part of a broader plan of reform that also includes not just other settlement mechanisms but also the other two pillars of the financial system, namely financial institutions and financial markets.

Second, the strategy must be international. It has to recognise that we can no longer safely see payment and settlement system reform as a purely domestic matter. You only have to look at Euroclear, Cedel, TARGET, S.W.I.F.T., the planned CLS Bank, VISA and Mastercard to see truly international systems that are growing in importance and whose smooth and efficient operation has implications for an ever-increasing number of countries. And even systems that seem still to be purely domestic – those we use to make payments in our own currencies – are in reality increasingly interconnected. This is partly through overlapping memberships: many banks with extensive international operations are now direct participants in the payment systems of a number of different countries. Some leading European and American banks are simultaneously participating in all larger payment systems like CHIPS, Euro 1, EAF, CHAPS, etc. Highly sophisticated liquidity management systems are necessary to optimise the money flows around the globe. The estimated daily turnover in cross-border payments is as high as about USD 2,000 billion.

The interconnection of financial markets also arises because an important source of traffic in many "domestic" systems is the settlement of the domestic element of cross-border transactions; and as we continue to reduce the risks that arise when settling these international trades, we will find that our actions inevitably have the effect of making settlement in different countries more inextricably interdependent. The evidence of this interdependence is clearly visible when bank holidays are celebrated in the United States. Turnover in European Systems drops then by more than 50% and increases far above average the day after.

And third, the strategy must increasingly rely on market-led processes, albeit ones that complement, rather than replace traditional regulatory activity. Regulators are finding it difficult to keep up with a complex and rapidly changing financial system. Increasingly, therefore, they have felt it useful – perhaps necessary – to get the market itself involved in the regulatory process. So there is more emphasis now on consultation with the market by risk analysis and adequate means of oversight to determine the appropriate form of regulatory activity. And there is also more emphasis on self-regulation and on market transparency to complement traditional regulatory or oversight activity.

The role of central banks and the market

My colleague, Gregor Heinrich, will be saying more about the nature of international cooperation in achieving optimal payment systems. Before concluding, I would like to focus briefly on the relationship between central banks and the market in the reform process.

When it comes to the regulation of payment systems, the situation varies from country to country.

In general we can say that at one extreme are central banks that do not operate payment systems themselves and also do not have explicit regulatory powers over private sector payment systems. In these circumstances central banks have little choice but to work with the market by means of a permanent dialogue with its participants. At the other extreme are central banks that both own and operate the payment systems, and who may therefore be tempted to impose a solution on the market. But experience has shown that, even where it is possible to impose a solution, it is not necessarily the most effective approach. Accompanying consultation with the market often pays additional dividends.

Of course, cooperation is a two-way street. The market in turn must realise that commercial considerations, while important, cannot by themselves dictate the nature of necessary reforms. The central bank will usually have certain overriding interests (such as avoiding systemic risk) that are likely to be a lower priority for the market itself. So the central bank will typically have to set the objectives of the reform. And ultimately the central bank may have to override the wishes of the market in some areas.

But if the experience of the private sector is drawn on wherever possible, the objectives are likely to be met more effectively. This is partly because the market can exert a positive influence on the *design* of the reforms. A good example of this approach put into action is the strategy adopted by G10 central banks to tackle the issue of foreign exchange settlement risk: after the thorough analysis of the overall situation by the CPSS the market has been set the objective of developing appropriate multicurrency services, but how it reaches that objective is largely up to it to determine. And market involvement can do more than help to shape the form of the solution. *Implementation* of the reform is also likely to be much easier if it is on the basis of an agreed solution rather than one that is imposed. Such a solution necessarily includes a full agreement of the regulators of the internationally most used currencies.

Conclusion

Let me conclude by saying that the overriding importance of reliable, efficient and risk-free large-value transfer systems has been acknowledged worldwide. As a consequence of this situation, in my capacity as Chairman of the CPSS I have been appointed a member of the Financial Stability Forum. This new institution has been created by the heads of state of the G7 countries. It associates representatives of twenty countries – including financial regulators and central banks – as well as of international organisations like IMF, World Bank, OECD. Also seen from this angle I want to encourage all payment system experts and central bankers in this region to cooperate closely when designing or implementing new payment systems in their countries. Be assured that you will be supported by international bodies like the CPSS and the participating central banks to the extent needed and wherever possible.