

BANCO DE ESPAÑA

**Banco de España claims on the Eurosystem
in the Balance of Payments**

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I. SUMMARY

Until the establishment of EMU, the change in the reserves of the Banco de España was the counterpart of the total foreign transactions of other sectors. With EMU in place, the change in the balance of the account held by the Banco de España with the Eurosystem is, in general, the main counterpart of these overall transactions, which the Banco de España is required to provide, whereas the change in reserves is the result of the Bank's own asset management policy decisions in accordance with ECB guidelines.

The change in the account of the Banco de España with the Eurosystem is the main counterpart of all Balance of Payments transactions, whatever their original currency, the country of the non-resident, the resident institutional sector or the financial or non-financial nature of the transaction. It is, therefore, the main counterpart of all BOP items. Hence the analytical value of presenting this variable separately in the Balance of Payments.

II. RESERVES AS THE COUNTERPART OF BALANCE OF PAYMENTS TRANSACTIONS BEFORE EMU

Before the start of EMU, the reserves of the Banco de España were defined as its liquid assets in foreign currency vis-à-vis the rest of the world and were the counterpart of the total net result of all transactions between residents and non-residents.

This is illustrated by the following straightforward examples:

II.1. Transaction settled in foreign currency

Resident exporter in Spain X_A , holding an account with resident bank B_A , sells goods to customer X_B , holding an account with a non-resident bank B_B .

The transaction is settled in foreign currency. For the sake of simplicity, let us assume that bank B_A holds a mutual correspondent account with bank B_B . Discarding this assumption would lead to introducing transactions with banks and, where appropriate, interposed settlement systems, thus complicating operations. However, this would not affect the final result.

The starting point is a balanced position where economic agents hold the domestic/foreign currency mix of financial assets and liabilities they desire, in accordance with the prevailing interest and exchange rates and their expectations as to such rates.

Non-resident buyer X_B instructs bank B_B to transfer the amount in foreign currency -his currency- of his purchase to the account held by resident exporter X_A with the latter's bank B_A . The exporter, who starts from a balanced domestic/foreign currency position, requests that his bank credit the amount to his account in domestic currency.

The transaction will give rise to the following initial flows in the books of the participating residents:

1. An increase in the foreign currency assets of bank B_A , in the form of a rise in its deposits in the correspondent account with bank B_B .
2. An increase of the same amount in the domestic currency liabilities of bank B_A , in the form of a rise in the deposits of its customer X_A .
3. An increase in the export receipts of X_A .
4. An increase in the domestic currency assets of X_A , in the form of a rise in his deposits with bank B_A .

However, the initial domestic/foreign currency mix of the assets and liabilities of bank B_A has altered. As a result, bank B_A offers its foreign currency deposit against a domestic currency one on the foreign exchange market.

Let us assume, for simplicity, that this deposit is acquired by the Banco de España, with which bank B_A holds an account and that the Banco de España holds, in turn, an account with non-resident bank B_B . In that case, the following additional flows are recorded:

5. Fall in the foreign currency assets of bank B_A as its deposits with bank B_B decline.
6. Increase in the domestic currency assets of bank B_A , in the form of deposits with the Banco de España.
7. Increase in the foreign currency assets of the Banco de España, in the form of deposits with non-resident bank B_B ; i.e. an increase in its reserves.
8. Increase in the domestic currency liabilities of the Banco de España to resident bank B_A .

Of these flows only those exchanged between residents and non-residents, as shown under 1, 3, 5 and 7, are recorded in the Balance of Payments. Flows appearing under 1 and 5 cancel each other out. Therefore, the final result would be:

A receipt from goods exports.

A payment for increased reserves.

In practice, the assumption of an immediate and direct purchase by the Banco de España of the foreign currency deposit offered by bank B_A is not

realistic. Banks and other resident financial institutions which, as a result of own and customer foreign transactions, intend to buy or sell foreign currency, will do so on the market. Thus, for instance, Spanish banks whose customers have imported goods paid to their suppliers in foreign currency will demand foreign currency deposits in exchange for deposits in pesetas, as a consequence of similar transactions, though of the opposite sign, to those discussed above in relation to exports.

On balance, all transactions originating receipts under any item of the Balance of Payments, both on the current and financial accounts, by any institutional sector and in any currency, including the peseta (this will be explained later), will give rise to a supply of foreign currency. In turn, all transactions generating payments will bring about a demand for foreign currency, except in the case of offsetting receipts and payments, such as exports on credit.

Until the start of EMU, if total receipts exceeded total payments and the Banco de España did not offer a counterpart by purchasing the excess supply of foreign currency deposits, the peseta would appreciate, as changes in its exchange rate were the balancing mechanism. If appreciation was to be avoided, the Banco de España would purchase the excess foreign currency deposits and the balancing mechanism was the increase in reserves. In practice, the adjustment arose from a combination of both mechanisms, depending on the exchange rate policy of the Banco de España.

II.2. Transaction settled in pesetas

If the transaction with the non-resident was settled in pesetas, the adjustment mechanism was the same, whether operating through changes in reserves and/or in the exchange rate.

Let us assume that a non-resident investor purchases public debt issued by the Spanish Treasury in pesetas from a resident. The non-resident buyer will sell to his non-resident bank a foreign currency deposit against pesetas in order to pay the resident seller. In turn, the non-resident bank, whose currency/peseta mix of assets has changed, will purchase on the market a deposit in pesetas against a deposit in its currency. The result is similar to that of the previous case: increased supply of foreign currency deposits against deposits in pesetas, which will entail an increase in reserves, if the Banco de España does not offer a counterpart. Here the following entries are recorded in the Balance of Payments:

A receipt from portfolio investment in the general government sector.

A payment for increased reserves.

III. BANCO DE ESPAÑA CLAIMS ON THE EUROSISTEM AS THE COUNTERPART OF NATIONAL BALANCE OF PAYMENTS TRANSACTIONS AFTER THE START OF EMU

With EMU in place, the reserves of Member States are defined as national central bank liquid foreign currency claims on residents of non-euro area countries. Therefore, they do not include any type of euro claim or foreign currency claim on residents of euro area countries. The reserves of the Eurosystem as a whole are the sum of the reserves of member countries and of the ECB.

In the aggregate Balance of Payments of the euro area as a whole vis-à-vis residents of the rest of the world, the reserves of the Eurosystem, defined as above, are still the main counterpart of transactions between euro area and non-euro area residents. But in the Spanish Balance of Payments, reserves are no longer the main adjustment variable, which is instead the change in

the balance of the account held by the Banco de España with the Eurosystem. The change in reserves and in other assets and liabilities is the result of the Banco de España's own asset management decisions, in step with ECB guidelines.

If a resident bank in a euro area country, for instance Spain, holds unintended excess foreign currency deposits, it will offer them against euro deposits in a much wider market than when it was not in the euro area. On this market these deposits will be mainly demanded by the financial institutions of all euro area countries which have made foreign currency payments on own or customer transactions.

Notably, there are no reasons why the Banco de España should be the final buyer of these deposits. If total receipts from foreign currency external transactions by euro area residents as a whole exceed total payments, the supply of foreign currency deposits against euro will be higher than the demand for such deposits. In principle, if an appreciation of the euro is to be avoided, the ECB will offer a final counterpart to the market. The participation of the Banco de España and other euro area national central banks in the market will, in turn, depend on their own reserve management policies and on the ECB's general exchange rate policy and guidelines.

Therefore, after the establishment of EMU, even if total receipts exceeded total payments in the Spanish Balance of Payments, the reserves of the ECB and, where appropriate, those of the Banco de España and of the other euro area national central banks could decline if, in the euro area as a whole, payments to non-euro area residents were higher than receipts and the ECB wished to avoid the depreciation of the euro. As a result, the balance of all the foreign transactions recorded in the balance of payments of individual euro area countries is no longer tied to changes in their reserves. The exchange rate decisions of the ECB will be linked to the

results of the foreign transactions of euro area countries as a whole instead of to the Balance of Payments of Spain or of any individual Member State.

III.1. Settlement through Target

Before providing some illustrating examples, reference should briefly be made to the cross-border settlement mechanism for payments in euro through the Target system. It should also be pointed out that, although Target is a large-value payment settlement system, the close-out netting of cross-border retail transactions of the European Banking Association (EBA) settlement system is also conducted through Target.

The account held by the Banco de España with the Eurosystem increases as a result of resident banks' own or customer cross-border receipts through Target, and decreases as a consequence of payments. The account held by the receiving or sending resident bank with the Banco de España changes by the same amount. Transactions between the Banco de España and the Eurosystem are recorded in the Balance of Payments, as a transaction between a resident and a non-resident is involved, whereas the change in the account between the Banco de España and the resident bank is not recorded, as a domestic transaction is involved.

Thus, if resident bank in Spain B_A transfers euro through Target to resident bank in another EU country B_B , the transaction will be settled in its account with the Banco de España. The latter will debit the account of bank B_A and credit the account of the central bank of the country of residence of the beneficiary bank, whose account will, in turn, be credited. Therefore, the euro assets in the account of bank B_A with the Banco de España will decrease, whereas its claims on the final beneficiary of the transfer, bank B_B , will increase. The liabilities of the Banco de España to bank B_A , as well as its claims on the central bank of country B, will diminish. Hence, there will be a

decline in the claims of the Banco de España -or a rise in its liabilities, since a mutual account is involved- on the Eurosystem, i.e. the national central banks as a whole and the European Central Bank¹. Obviously, if bank B_A receives euro from bank B_B , the result will be an increase in the claims of the Banco de España on the Eurosystem.

III.2. The account of the Banco de España with the Eurosystem as the counterpart of the foreign transactions of other sectors. Examples

All the examples start from a balanced position in which economic agents hold the desired euro/other currency mix of financial assets and liabilities.

III.2.1. Foreign currency export. The buyer is a resident in a non-euro area country

Resident exporter in Spain X_A , holding an account with resident bank B_A , sells goods to customer X_B , holding an account with non-resident bank B_B of non-euro area country B. The transaction is settled in foreign currency. For the sake of simplicity, let us assume that bank B_A holds a mutual correspondent account in foreign currency with bank B_B .

Non-resident buyer X_B instructs his bank B_B to transfer in foreign currency – his currency- the amount of the purchase to the account held by resident exporter X_A with resident bank B_A . Starting from a balanced euro/other currency mix, the exporter instructs his bank to credit his account in euro.

¹ As from November 2000, settlement by novation through Target has entailed a change in the accounting method used; however, that does not affect the content of this note. The only difference is that, at the end of each day, the gross claims of individual national central banks on the other NCBs of the Eurosystem are netted into claims on and liabilities to the ECB. The accounting interposition of the ECB in the final daily flows between the national central banks does not alter the argument and outcome.

The transaction will give rise to four initial flows, identical to those of example 1 in section II.

1. An increase in the foreign currency assets of bank B_A , in the form of a rise in its deposits in the correspondent account with bank B_B .
2. An increase of the same amount in the euro liabilities of bank B_A , in the form of a rise in the deposits of its customer X_A .
3. An increase in the export receipts of X_A .
4. An increase in the euro assets of X_A , in the form of a rise in his deposits with bank B_A .

Now, however, and maintaining the same assumption as before that national Balance of Payments receipts exceed payments, the final net supply of foreign currency deposits by banks resident in Spain will not normally be acquired by the Banco de España, thereby enlarging its reserves; rather, it is foreseeable that, on the foreign exchange market for all euro area countries, this supply will be acquired by the banks and financial institutions of the other euro area countries. As will be explained, if they are finally acquired by the ECB or by central banks of other euro area countries, the outcome of the exercise will be the same.

To complete the example drawing on the four initial flows described, let us assume that bank B_A sells its foreign currency deposit to bank B_C , resident in euro area country C, in exchange for a deposit in euro. Bank B_A will transfer to bank B_C the deposit in foreign currency it holds against B_B . In turn, bank B_C will instruct its central bank to transfer the related amount in euro from the account it holds with the latter to an account in bank B_A . The central bank of C will debit the account of B_C and credit the funds to the account the Banco

de España has with it, so it may convey them to B_A . The flows that will arise are as follows (double-entry in each case).

5. An increase in the foreign currency assets of B_C in the form of deposits vis-à-vis B_B .

6. A reduction in the euro assets of B_C in the form of fewer deposits with its central bank.

7. A reduction in the euro liabilities of the central bank of country C to bank B_C .

8. An increase in the euro liabilities of the central bank of country C in the form of greater deposits with the Banco de España.

9. An increase in the euro liabilities of the Banco de España in the form of greater deposits with the central bank of country C.

10. An increase in the euro liabilities of the Banco de España in the form of greater deposits of bank B_A .

11. An increase in the euro assets of B_A in the form of greater deposits with the Banco de España.

12. A reduction in the foreign currency claims of B_A on bank B_B .

Of the twelve flows, only 1, 3, 9 and 12 are between Spanish residents and non-residents. Since transactions 1 and 12 cancel each other out, the final result in the balance of Payments would be:

A receipt from exports.

A payment for increased Banco de España's euro claims on the Eurosystem (in the form of claims on a central bank of the European System of Central Banks).

Removing the assumption that the net surplus supply of foreign currency generated by Spain's Balance of Payments transactions is purchased by banks resident in the euro area, the results are the same. Thus, if in the euro area as a whole all receipts exceed all payments, the ECB, in order to prevent the euro appreciating, can be the final purchaser of the total surplus and, consequently, of certain foreign currency deposits offered by Spanish banks. However, the final result in the Spanish Balance of Payments will also be an increase in the Banco de España's claims on the Eurosystem (on the ECB in this case).

The same result would arise if the final purchasers were euro area central banks. The reserves of these central banks (and of the Eurosystem) would increase (they would increase their foreign currency deposits against a bank, B_B , resident outside the euro area), but not those of the Banco de España; rather, the claims of the Spanish central bank on the Eurosystem would rise, via the same process of transfers via Target from bank B_A to the ECB or the central bank concerned. Although the Banco de España could also be the final counterpart, increasing its reserves, its position vis-à-vis the Eurosystem generally takes on greater importance in the adjustment mechanism.

Explained below is the outcome that would arise if the assumptions that the transaction is in foreign currency and with a non-euro area country were removed.

III.2. Foreign currency export. The buyer is a resident in a euro area country

If the export transaction were with a euro area resident, but were also a foreign-currency-denominated transaction, the outcome in the Spanish Balance of Payments would be similar: an increase in the Banco de España's position vis-à-vis the Eurosystem. From the standpoint of the Eurosystem as a whole, however, the result would not prompt any change in the reserves of the ECB since the supply of foreign currency generated by the Spanish bank receiving the funds for its exporting customer would be offset by the demand for the same amount by the other euro area bank.

III.2.3. Export in euro. The buyer is resident in a euro area country

If the transaction were in euro, and with a euro area resident, the result would also be an increase in the Banco de España's position vis-à-vis the Eurosystem. Nor in this case would there be a change in the Eurosystem's overall reserves.

III.2.3. Export in euro. The buyer is resident in a non-euro area country

If the transaction were with a resident of a non-euro area country and were denominated in euro, it could be settled via Target. Under this assumption it would also have a direct impact on the change in the Banco de España's claims on the Eurosystem. This would be the case if the non-resident bank were to use a bank resident in a euro area country other than Spain as a correspondent. Only if the transaction were settled via a correspondent bank resident in Spain would the result be an increase in export receipts, with the counterpart in an increase in euro deposits vis-à-vis non-residents of a resident bank, which are recorded in the Balance of Payments as a payment relating to a change in assets in "Other investment". In this case, there would be no direct Banco de España counterpart, the net total result of the transaction being zero.

The two cases illustrated involve a transaction in euro with a resident of a non-euro area country. Whether or not settlement is via a correspondent bank, or via Target, the non-resident bank of the buying customer, which has to purchase euro on the market, will offer foreign currency that will ultimately be acquired by the ECB (or by a central bank of the Eurosystem) if, area-wide, these types of transactions exceed payment transactions, and the ECB wishes to prevent the euro from appreciating. But only on certain occasions will the Banco de España offer a counterpart, with the subsequent increase in reserves. Generally, however, the adjusting item of the transaction will be the increase in the Banco de España's account with the Eurosystem.