Changeover to the single currency

The European Monetary Institute (EMI) published on 14 November a document ('The changeover to the single currency') setting out how a single European currency might be introduced within those countries participating in Stage 3 of Economic and Monetary Union (EMU). This was endorsed, with only small amendments, by the December European Council in Madrid.

This note, prepared by John Townend, a Deputy Director of the Bank and the Governor's Alternate on the EMI Council, describes the essence of the EMI paper, sets it in a UK context, and explains briefly the action which the Bank has subsequently taken to progress the work.

Introduction

The EMI paper explaining how the single currency might be introduced in practical terms addresses *technical issues only;* it represents a central bank contribution to the debate initiated by the European Commission in May 1995 when it published its 'Green Paper on the Practical Arrangements for the Introduction of the Single Currency'. Questions relating to the possible start-date for Stage 3 of EMU, or which countries might be eligible to participate, are for political decision and the EMI paper can offer no guidance beyond the Maastricht Treaty. The EMI paper, together with further input from the Commission, was discussed by Finance Ministers on 27 November and at the European Council in Madrid on 15–16 December. The changeover scenario adopted by the European Council is consistent with that described by the EMI. The European Council also decided to name the single currency the 'euro' and this name is therefore used here.

The United Kingdom is in a different position from other countries since it is not *required* to join the single currency area: this will be for decision by Government and Parliament. The United Kingdom is nevertheless fully committed to assisting in the technical preparations for Stage 3 so that the broad framework for the introduction of the euro would be technically satisfactory if it were to participate. The Bank of England has therefore been active in the discussions leading to the EMI document and supports its general thrust.

Where it helps the exposition, this note assumes that the United Kingdom is a participant in the single currency area in order to describe the relationship between transactions in sterling and euro during the transition when both denominations would co-exist: if the United Kingdom does not exercise its right to opt in, some, but not all, of the issues would remain relevant.

Timetable for the transition

The EMI paper sets out a provisional timetable for the transition, divided into three periods:

- a first period beginning with an announcement, some twelve months before the due date, that Stage 3 will start on that day and will initially comprise an identified group of countries: the European Central Bank (ECB) would be established early in this period;

- a second period beginning with the start of Stage 3, when participating countries' exchange rates (between each other) will be replaced by irrevocably locked conversion factors, during which the euro will begin to be used in the banking system alongside existing national currencies, but when there will be no physical euro banknotes or coin; and

- a final period which will begin with the introduction, no later than three years after the start of Stage 3, of euro banknotes and coin alongside existing national banknotes; and which will end, six months later, when national banknotes and coin cease to be legal tender. At that point the transition to the euro will be officially complete but central banks would continue indefinitely thereafter to exchange national currency notes and coin for euro.

Principles governing the transition

The paper sets out five basic principles to guide the transition process:

(i) it must be underpinned by a clear legal framework;

(ii) it must be as simple as possible and not confusing;

(iii) it must not impose unnecessary costs;

(iv) it must facilitate a single monetary policy; and

(v) there should be no compulsion to use, nor any prohibition from using, either the euro or the national currency during the transition.

What the transition might look like

The first period

The European Central Bank

Early in the first period, the ECB will be established and it will take final decisions, on the basis of preparatory work previously undertaken by the EMI and national central banks, on a wide range of operational issues to allow a seamless transition in the conduct of monetary policy for the euro area at the start of Stage 3. The date from which euro banknotes and coin will become available, no later than three years from the start of Stage 3, would also be announced by the ECB. The design of the notes would need to be finalised, together with the necessary preparations to allow production to begin.

Governments

During this period governments will need to effect the necessary legal changes, involving potentially both primary and secondary legislation at the European and national level, required to implement all aspects of the single currency.

A crucial element, which the EMI considers should be in the form of a Council Regulation with direct effect (an approach endorsed by the European Council), would be legislation to provide certainty about the status of the euro, in its irrevocably locked relationship to national currencies, to ensure equal treatment in law for transactions expressed either in national currencies or euro. The paper sets out a number of legal principles which any particular legal solution should satisfy, including that there should be legally enforceable equivalence between the euro and national currency units.

Conventions on rounding, for transactions which become redenominated from their original denomination into either national currency or the euro, would need to be established, and may need to be enshrined in law.

Private sector

The private sector, bank and non-bank, in the relevant countries will need to continue planning and preparing its response in the light of the announced framework for central bank and government actions.

The second period

At the start of Stage 3, participating countries' exchange rates (between each other) will be replaced by the irrevocably locked conversion factors. The euro will become a monetary unit in its own right: it will have a fixed conversion rate in terms of the monetary units of the participating countries.

Actions by central banks

The EU national central banks, together with the ECB, will constitute the European System of Central Banks (ESCB).

The ESCB will begin to conduct a single monetary policy for the euro area. The ultimate objective of monetary policy, enshrined in the Maastricht Treaty, is price stability and this is expected to be achieved, as is the case generally now, by establishing short-term interest rates at the appropriate level. Work is in hand in transforming this objective into a detailed framework for the conduct of monetary operations.

The ESCB will denominate its own internal accounts and conduct its monetary operations, and any foreign exchange operations, in euro. But, as explained below, this would not necessarily mean that the Bank of England's market counterparties would immediately have to change their own operations or way of accounting, because the Bank would make available conversion facilities to redenominate euro amounts into the equivalent sterling amounts for any account holder which so wished. In other words, a counterparty could continue to denominate its accounts, and operate, in sterling even though the Bank of England was denominating its own operations in euro.

What happens outside the Bank would depend in any event on the development of the payments and settlements infrastructure. In the United Kingdom this is largely owned and run by the private sector. Arrangements are already in train for CHAPS, the present same-day payments system (which provides net settlement at the end of each banking day), to be modified and linked to a real-time accounting system at the Bank to produce a real-time gross settlement system (RTGS) in 1996.

It is essential that the RTGS system not be disrupted at the start of Stage 3. It is equally important that the system be developed to allow the processing of domestic payments denominated in euro while continuing to accommodate payments denominated in sterling. The way in which this dual functionality would best be achieved is a technical matter for discussion with the banks. Cross-border payments would be facilitated through a European-wide linking of RTGS systems (called TARGET), the details of which have yet to be determined. It would also be possible to link to TARGET even if the United Kingdom did not participate in the euro area.

The development of securities settlement systems would also need to be considered.

It is expected that the main markets (domestic as well as foreign exchange) in the euro area would quickly become dominated by transactions denominated in euro. It may be sensible in some areas to agree elements of market standardisation, for example in price or interest rate quotation. In the United Kingdom this would be for discussion between the Bank and the financial community. But the availability of conversion facilities would allow those banks which have not geared themselves as quickly as others to cope with euro denominations to participate in these markets on equal terms.

Recommendations for government action

Publicity

The EMI recommends that governments engage in a campaign of public information as an essential prerequisite for the successful introduction of the euro.

The law

As mentioned above, legislation would have to come into effect at the beginning of this period establishing clearly the legal status of the euro. The European Council added that the substitution of the euro for national currencies shall not of itself alter the continuity of contracts.

During this period national currency banknotes and coin would remain the only legal tender since at this stage there would be no euro equivalent. In the United Kingdom only sterling notes and coin would be legal tender during this period.

Public debt

The EMI expects that, from the start of Stage 3, governments would issue new public debt denominated in euro; and the European Summit agreed that new tradable public debt *will* be issued from then in euro—particularly debt coming to maturity after 1 January 2002. That does not mean outstanding national currency debt need be redenominated and the EMI suggests this question be studied further.

Other actions

The EMI recommends that there should be national discretion to allow public sector authorities to accept receipts denominated in euro, where they so wish during this period; but that public sector payments in euro would best be delayed until euro notes and coin become available from the beginning of the final transition period.

Banks and non-banks

Banks and non-banks would need to decide how to change their activities in the light of the actions by central banks and governments. Consistent with the no compulsion, no prohibition principle, banks would be free to make transactions, and offer facilities, in euro from the start of this period, but they would only *have* to do so by the end of the transition. There may be little retail demand for euro facilities until euro banknotes become available.

The final period of transition

Cash

This period will begin with the introduction, no later than three years after the start of the previous period (that is, by 1 January 2002), of euro banknotes and coin which would immediately be legal tender, temporarily alongside national currency notes and coin. Anyone who wished would be able to exchange on demand, at commercial banks and the Bank of England, national currency notes and coin for the new notes and coin. After six months, by 1 July 2002, sterling notes and coin would lose their legal tender status, although they would continue to be exchangeable indefinitely at the Bank of England.

Non-cash

The introduction of physical euro would give an impetus to banks to provide euro denominated accounts to their retail customers and for the spread within the retail sector of the use of euro.

As noted above, public administrations are recommended to switch to using euro for their payments (such as social security benefits, civil servants' salaries and pensions) on a particular date early in this final period. By the time national currency notes cease to be legal tender, all transactions involving the public sector should have become denominated in euro. The European Council agreed that all public sector operations will use Euro by 1 July 2002: EU legislation will define the time frame and might leave some freedom to individual countries.

Taking the work forward

The EMI will continue to work on the technical details for the introduction of the euro, consistent with its mandate. The Bank of England and other national central banks will continue to participate in its work.

Separately the Bank is also taking forward its own discussions with the UK banking community on the details of the possible transition to the euro for the United Kingdom; and widening these discussions beyond banks to include other sectors. The Bank has therefore held a number of meetings with the different interest groups, including banks, building societies, the CBI, the Retail Consortium and a wide range of market associations. In each case the Bank has invited participants to identify areas where it would help the private sector in its own planning for the Bank to specify more precisely its own operations and actions; and to identify those areas where, although the Bank is not directly involved, it might help to provide a catalyst for co-ordinating actions (including in the payments and settlements area and in markets) within the private sector. The Bank has also stressed the importance of considering these questions *both* in the context of the United Kingdom as a participant in Stage 3 and in the context of Stage 3 beginning but the United Kingdom exercising its right not to opt in.