Practical issues arising from the introduction of the euro

On 16 September, the Bank published its second report in a broadly quarterly series on practical issues arising from the introduction of the euro. Introducing the report(1) the ***Governor*** *explains the background to the Bank's work in this area and the Bank's main aims: to inform people about what is happening, to identify where co-ordinated action is needed, and to stimulate the private sector to plan as necessary for itself. The* ***Governor*** *stresses that the report is not about the pros and cons of EMU membership, but about the technical preparations necessary whether the United Kingdom is in or out. He concludes by arguing that, so long as we are properly prepared, the opportunities for the City far outweigh the risks. John Townend, Deputy Director of the Bank, goes on to explain the ground covered in the report, highlighting five key areas: payments, securities settlement, trading, legal aspects, and the work of the EMI.*

The Governor's introductory remarks

Let me begin by reminding you that we began exploring the practical issues arising from the introduction of the euro with City institutions in particular at the end of last year—as soon as the Madrid Summit had agreed upon the transition scenario. Before that there was not a lot to talk about. The scenario itself (described in an article in the February *Quarterly Bulletin*(2)) made, in effect, a crucial distinction between wholesale activity in financial markets in euro—to begin on 1 January 1999—and retail financial activity in euro—which is unlikely to begin in any significant way until euro notes/coin begin to become available—three years later.

At the end of last year I asked John Townend, my alternate on the EMI Council, to take the lead in approaching all the relevant UK organisations (and there are over 50 of them—listed at the back of today's report) to begin preparing the UK financial and business community. The aims are essentially:

(a) to inform people about what is happening;

(b) to get the experts engaged in the process of identifying the issues needing to be addressed—they are the specialists in their various technical areas and most of the issues are intensely technical. Because of the sheer bulk of financial activity in the City there is much greater *professional expertise* and specialisation than elsewhere. That is why we need to involve so many different groups—payments experts for payments issues, particular market experts for the various market issues, legal experts, tax experts and so on. I must say that in their respective areas they are all making a tremendous input to the debate—not just within the United Kingdom but within Europe through the Commission;

(c) to identify where co-ordinated action is needed—either across the City as a whole, or within particular functional areas of the City, or potentially between finance and business and so on, and to ensure that co-ordinated/collective action is undertaken by the right people; and

(d) to stimulate the private sector to plan for the introduction of the euro on its own account—in a catalytic way.

The first fruits of that activity were reported in a low key way in May—*the First Progress Report*.(3)

A great deal has happened since May—that's why this *Second Progress Report* is a lot thicker; and people are now much more intensively engaged in the preparations for the euro.

Two main developments explain that:

(i) Increasing realisation of the *political* commitment to Monetary Union on the Continent, especially on the part of Chancellor Kohl and President Chirac, even though the economic conditions for Monetary Union have remained somewhat unpromising. Overall there is a growing conviction that Monetary Union will occur at least among a core group on 1 January 1999. This is not yet by any means certain, but a prudent planning assumption.

(ii) An increasing awareness of some of the implications: business associations, market authorities and individual businesses have thought much more about what it will involve for them—encouraged we like to think by John Townend's earlier efforts. But in any event the key issues—whether the United Kingdom is in or out—have

(1) At a press conference to mark its launch.
(2) 'Changeover to the single currency', *Bank of England Quarterly Bulletin*, February 1996, pages 88–90.
(3) 'Practical issues arising from the single currency', *Bank of England Quarterly Bulletin*, August 1996, pages 316–22.

now been more precisely identified by the experts, so there is a great deal more to talk about.

I suspect that this in turn means that some others—who are not so close to it—have suddenly woken up to the fact that a lot of preparation needs to be made, and some of them have started to worry that we will not be ready. The fact that they are worrying in this way is not necessarily a bad thing—it vaccinates us against complacency. But a lot of the concern is because they do not know what is going on and that is why we are giving a higher profile to this *Second Progress Report*.

Be clear, the *Second Progress Report* is not about the pros and cons of EMU; it is not about the pros and cons of UK membership; it is not even about the business implications for the City if the United Kingdom is in or out. It is about the technical preparations that we need to make—initially for wholesale financial market activity in the City—whether we are in or out.

Much of the recent debate has been about the perceived threats to the City if Monetary Union goes ahead and the United Kingdom stands aside. The truth is that with any major development of this sort there are potential risks as well as opportunities for the City. What we have to do, of course, is to minimise the risks and maximise the opportunities and that is the relevance of this exercise to that debate. I have no doubt myself that provided we are properly prepared—as we will be—then the opportunities for the City far outweigh the risks—whether we are in or out.

John Townend's introductory remarks

As the Governor has said, many of the practical issues raised by the introduction of the euro are indeed very technical and I will not attempt to take you through the *Report* in any detail. But let me begin by explaining the ground which it covers—which is essentially three-fold.

- First, progress in developing the United Kingdom's financial infrastructure—the arrangements primarily for making wholesale payments so that euro payments *can* be made in future through the banking system; and separately the preparations to allow the full range of euro financial instruments to be traded in the London markets.

- Second, progress in a number of issues—which we call overarching issues—like the way in which the euro will be introduced under the law; the way in which accounting and tax rules will be applied; and how 'rounding' will work when amounts in present national currencies are translated into euro and vice versa.

- Third, progress in the work of the EMI in Frankfurt, because it obviously helps planning here to be informed about how the future European Central Bank will work, ranging from how monetary operations will be conducted to what the size of the future euro banknotes will be, and so on.

The Governor has already explained the aims of our work and the way in which we are approaching the task, which is set out in the first chapter of the paper. Much of the technical work is being addressed by the professional associations and organisations across and beyond the City, with cross-industry groups coming together as necessary to address particular issues as they arise. The Bank is directly in touch with all this work, through bilateral contact and direct participation in the various working groups.

Turning then to substantive issues, I would single out five: payments; securities settlement; trading; legal aspects; and the work of the EMI.

The second chapter of the Bank's paper is wholly devoted to *payments* arrangements, covering both the development of the UK real-time gross settlement (RTGS) system to embrace the euro, whether we are in or out; and the future international linking of national RTGS systems known as TARGET.

It is worth making a number of points on this issue since it is a subject on which there has been some considerable confusion.

- While TARGET will link the RTGS systems of countries within the euro area, it is agreed that countries on the outside may also connect their RTGS systems to it. So there is no debate here.

- As a general matter, we would like to see as much use made of TARGET as possible, because RTGS systems remove some of the risks in payments systems and TARGET will extend these advantages across national borders, thereby facilitating payments for trade in goods and services across the entire single market in a less risky way.

- Where there *is* a debate, is about the terms on which central banks outside the euro area may have access to liquidity during the day.

- In our view access to intraday liquidity should be on equal terms for both ins and outs. This is because *intraday* liquidity is only to do with oiling the wheels of the payments system, enabling payments to be made and avoiding gridlock. It is nothing to do with monetary policy.

- But it can begin to affect monetary conditions if intraday liquidity spills over into overnight liquidity—though in practice only, we believe, if any spillover is persistent and in large amounts—and we believe this spillover effect is best addressed by applying a penalty rate to overnight credit, just as most central banks do now.

- At the end of the day this issue is not a 'show-stopper', since there are numerous alternative ways of making cross-border payments, which will also continue to exist in future. And trading in the London markets is unlikely in any event to be affected: it is notable that almost one third of global trading in the dollar and Deutsche Mark takes place in the foreign exchange market in London, even though there is no direct facility to make payments in either currency in London.

On *securities settlement*, the Bank is already taking the lead in setting strategy for the United Kingdom, in discussion with the securities industry, including the development of delivery-versus-payment arrangements. The paper—in Chapter 3—points to the need to consider the arrangements for settling euro securities, and making the associated payments, in the United Kingdom. The demand for this kind of facility may clearly be different depending on whether we are in or out.

On *trading*, Chapter 3 also sets out in some detail the *way* in which the whole range of financial market associations and exchanges have been working and the *kind* of issues on which they have been working. The Bank is involved here to the extent which we judge necessary. As an example of an area where we identified a gap and have acted to fill it, I would single out a working group on the gilt-edged market which we have established involving a wide range of interested parties, from the market-makers to end-investors, to consider all the practical issues raised by the euro. The kind of issues it is considering include how and when to redenominate the outstanding stock of sterling debt into euro; and a number of issues relating to market conventions—how precisely to calculate interest, how to cope with bank holidays etc—where conventions at present differ between countries. Many of the issues will be relevant only if we are in but some may also apply if we are out.

On *legal aspects*, it is clear that the way the euro is introduced under the law is very important; and of considerable interest to London's international financial markets, particularly in the area of continuity of contracts. The European Commission and the EMI have done a lot of work; and there is now a draft text of a Regulation which will be discussed at the forthcoming informal ECOFIN in Dublin. A London group of practitioner lawyers has been very active and effective in commenting on the text. Our general sense is that this aspect of the general preparations is coming out satisfactorily, though one or two technical issues remain to be resolved.

Finally on the *work of the EMI*, Chapter 6 sets out the present state-of-play on a number of the major areas, including how the future European Central Bank will conduct monetary operations. We are fully committed to playing our full part in all of the EMI's preparations.

Copies of the report are available from the Bank's Press Office; we will be publishing the third paper in our series on 16 December.(1)

(1) Please contact Public Enquiries, on 0171-601-4878.

Statistical implications of the single currency

On 10 July, the European Monetary Institute (EMI) issued a booklet explaining the statistical requirements for monetary union. It also published a more detailed reference document to enable central banks to pursue technical discussions with national banking associations and other reporting bodies. These booklets[(1)] were issued in July in order to accommodate the long lead times inherent in making changes to established statistical reporting systems. On the assumption that Stage 3 of EMU will begin in January 1999, some of the new statistics will be needed from mid-1998 in order to provide the necessary benchmark against which to assess developments after the start of Stage 3.

Because the United Kingdom has the option not to participate in monetary union, it will only collect the money and banking statistics required by EMU if it decides to join. The United Kingdom will implement, in advance, those proposals for harmonising statistics which make sense in a UK policy context and which are cost effective. For the remainder, the Bank of England's intention is to agree, with the British Bankers' Association, a stand-by additional reporting framework for banking statistics for possible introduction from January 1999.

In making the preparations for transition to the third stage of monetary union, the EMI has concentrated on harmonising the key statistics required for the conduct of the single monetary policy. These preparations are being made in full consultation with the national central banks, which are represented by the heads of statistical functions in the EMI's Working Group on Statistics (WGS), and by technical experts on a number of task forces. Although the Treaty on European Union specifies the possibility of the direct collection of data from economic agents by the European Central Bank (ECB), the intention is that the national authorities will continue to carry out the tasks of collecting and compiling the required statistics at national level prior to transmitting aggregated data to the ECB. Legal provisions to protect the confidentiality of individual data will be built into the system to cover occasions when the ECB needs to know the identity of individual reporters in order to verify the end product or understand significant events.

The statistics currently used by the Bank of England in assessing economic conditions in the United Kingdom are similar to those which the ECB is expected to need in order to define and implement the monetary policy of the monetary union. Although there will be differences in the constitutional and legal framework, the requirements of the end users—from policy-makers to market practitioners and academics—will remain focused on high quality and timely information on monetary and economic developments.

UK banking statistics will need to expand the level of detail on the transactions and positions of residents of the single currency area to broadly the same level of detail as is currently provided for domestic residents. This will be needed to enable proper consolidation of the banking statistics and monetary aggregates at EMU level. The current UK system is broadly compatible with EMI requirements in terms of the monthly statistical coverage of the UK monetary sector (ie banks and building societies combined) and the timeliness of data compilation. The EMI decision to introduce a statistical definition of a bank, known as a monetary financial institution (MFI), will have little structural impact on UK statistics. MFIs will comprise banks, building societies and money-market mutual funds, but the latter are expected to fall below the cut-off size for monthly statistical reporting. The EMI also requires a division of certain assets and liabilities according to their maturity at the time of issue. This is believed, by the WGS, to avoid the need for difficult judgments about the comparability of financial instruments to accommodate the as-yet-undecided definitions of the monetary aggregates (and possibly reserve requirements too).

A detailed balance of payments for the single currency area will be compiled quarterly, in line with the guidance issued in the International Monetary Fund's Balance of Payments Manual. The EMI has also formulated a requirement for key data to be provided monthly, as most EU member states use monthly balance of payments for monetary and foreign exchange policy purposes. At present, the compilation of the UK balance of payments, which is the responsibility of the Office for National Statistics, is in line with the international standards recommended by the IMF. These data are not compiled monthly. The United Kingdom has questioned the need for monthly data for policy and operational purposes in the single currency area in Stage 3, but has undertaken to review its situation in 1998, and meanwhile to make best estimates from the present reporting system. Because of the extra costs involved, and the United Kingdom's view of the limited value of monthly balance of payments statistics for monetary policy purposes, the decision on whether to collect such extra data would be taken at a later stage.

(1) Copies of these booklets can be obtained from the Bank of England's Monetary & Financial Statistics Division, telephone 0171–601 4312.