Prospects for the City—in or out of EMU

The ***Governor***[(1)] *reviews the outlook for the City in the context of EMU, stressing that whether or not the United Kingdom participates in the first wave, all EU countries have a strong collective interest in maintaining a constructive and co-operative environment throughout the European Union. The* ***Governor*** *notes that the City's current strength as a financial centre depends on a range of factors other than the national currency; nevertheless, he stresses the need for the City to be well prepared to take advantage of the opportunities that the euro will bring.*

Mr Chairman, you have asked me to speak specifically about 'the prospects for the City—in or out of economic and monetary union (EMU)'. You—very kindly, under recent circumstances—did not ask me to discuss the wider pros and cons, either of the project as a whole, or of UK membership. But perhaps I might nevertheless begin by making a more general point.

Perfectly reasonable people can legitimately disagree about EMU, both in principle and about the appropriate timing and pace of monetary integration. On the project as a whole, most analysts would acknowledge that there are real potential benefits, but that there are also real risks to be set against them; and most would acknowledge that these risks will increase if the politics of EMU are allowed to run ahead of the economics, so that countries are allowed, or even encouraged, to participate without first having achieved genuine and sustainable economic convergence—in substance and not just in some technical accounting form. On the question of British membership, the new Labour Government has spoken of 'formidable obstacles' to this country joining EMU in the first wave. But one thing is clear: everyone, 'in' or 'out', has an unambiguous interest, if EMU does go ahead, in doing everything we can to make it a success. And it is equally clear that those countries that participate in monetary union have a similar unambiguous interest in the economic prosperity of countries remaining, at least for the time being, on the outside.

Larry Summers, the Deputy Secretary of the US Treasury, writing about EMU in the *Financial Times* on Wednesday, said:

> 'The US is well served when Europe is vibrant economically and working to open its markets and strengthen its ties with the global economy'.

He might have been speaking for all of us here in Europe, 'in' or 'out', recognising that we have a mutual, and reciprocal, self-interest in each other's economic well-being.

So my general point is this. Whatever the outcome on EMU, it is vitally important that we continue to maintain, and strengthen, positive and constructive relationships throughout the EU area—and indeed beyond—in our national and collective interests.

For the United Kingdom, in particular, if we were to opt out of the first wave, this certainly means that during our EU Presidency, during the critical first half of next year, we must—as I am quite confident we shall—do everything we possibly can to ensure that the procedures leading up to the historic decisions run smoothly, and that the decisions themselves are timely and harmonious. But beyond that, it certainly also means that 'outs', or potential 'pre-ins', should not attempt to exploit any perceived—and certainly short-term—advantage from the additional policy freedoms they might have on the outside, but should, for example, persist in macroeconomic, fiscal and monetary, discipline in parallel with the EMU countries. It also means that the 'in' countries, for their part, have an identical self-interest in maintaining an open and constructive relationship with the 'outs'/'pre-ins'. Otherwise we would all be cutting off our nose to spite our face.

I make this general point, Mr Chairman, because this context seems to me to be relevant to any assessment of the economic prospects, of the economy as a whole or of any particular sector, inside or outside the euro area. In the rest of my remarks I assume that, 'in' or 'out', we shall be operating within a constructive, co-operative, environment throughout the European Union, for the powerful reason that this is in everyone's interest.

Against that background, let me turn to the prospects for the City.

I shall, in fact, concentrate on the case in which the United Kingdom does not participate in EMU in the first wave, because in the alternative case, the United Kingdom 'in' scenario, though there may be uncertainty about the overall macroeconomic implications, there is little reason to suppose that there would be any adverse implications for the

(1) In a speech at the Royal Institute of International Affairs Conference on Friday, 24 October 1997.

City in particular. The only possible disadvantage I see would result from the imposition of onerous regulatory or financial burdens—for example, onerous minimum reserve requirements—that might distort activity within the financial sector and/or drive it outside the euro area altogether.

So what then are the prospects for the City if the United Kingdom is, initially, 'out'?

The current strengths of the City—as a uniquely international, rather than simply a national or regional European financial centre—will be familiar to you. They include a vast, critical mass of markets and financial services in commercial and investment banking, securities and derivatives activity, investment and fund management, insurance and commodities and so on, involving an extraordinary concentration of the strongest financial businesses from all around the world. To give just one example, uniquely among the major countries we have more overseas-incorporated banks than domestic banks operating in our financial centre, and more than one half of the total deposits of the UK banking system is denominated in foreign currencies, worth more than £1 trillion—that's a one and twelve noughts—notwithstanding the current strength of sterling.

The particular strengths that have contributed to this massive concentration of international business are many and various. They include the English language; the convenient time zone; the ready availability of the relevant trading and other financial skills, as well as professional support services—in law, accountancy, tax, property, communications and so on. They include effective infrastructure. And they include importantly, too, an adaptive regulatory framework, which has in fact been remarkably successful in maintaining confidence in financial institutions and markets without stifling innovation and risk taking. All of these factors—and no doubt others—help to explain why some 600,000 people are estimated to be employed in finance and other business services in Greater London—a number that I believe is roughly equal to the total population of Frankfurt.

Now you will have noticed that none of these factors has anything to do with the question of the national currency used either here in the United Kingdom or in continental Europe.

The main impact of the advent of the euro on financial activity, as I see it, is that it will encourage the development of broader, deeper and more liquid markets in financial instruments of all kinds, where they are currently fragmented because they are denominated in the various individual national European currencies. The City of London thrives on liquid markets regardless of the currency —and it will thrive on the euro, whether the United Kingdom is 'in' or 'out'. Measured in these terms, the introduction of the euro represents an opportunity for London rather than a threat. I have no doubt whatever that there will be a vigorous euro-euro market in London, come what may, just as there is a vigorous market in euro-Deutsche Marks or euro-francs as well as eurodollars and euro-yen at present. The reality is that the location of financial activity does not depend upon the local currency. It will continue to be carried on wherever it can most conveniently, efficiently and profitably be carried on. And the fact that foreign-owned institutions—from Europe itself and from around the world—continue to build their presence here, despite the near-universal assumption that the United Kingdom will not in fact participate in EMU from the beginning, suggests that they share this perception.

I would hope that the rest of Europe would positively welcome the contribution that the City can, and I am confident will, make to the development of markets and other financial activity in the euro, because it is in their interest too. International or intra-regional trade and investment activity is not, at the macroeconomic level, a zero-sum game. It is a positive-sum game. And this is true of financial, just as much as of any other kind of economic activity. The prosperity of the City—whether the United Kingdom is 'in' or 'out'—is simply a particular case of the general point that I made at the outset. I welcome the prospect of increasing financial activity in Frankfurt, Paris, Milan or Amsterdam or wherever, because it will result in increased activity here too in London. And the converse is equally true. It is in this sense that the City is a major European, not simply a national asset.

Now some people may argue that 'offshore' markets in national or regional currencies complicate the conduct of national or regional monetary policy, with the implication that national or regional currencies should somehow be confined to their national or regional space. I must confess that this view seems to ignore the fact that it has in practice during the past 20 or 30 years proved perfectly possible for monetary policy to be conducted successfully despite the existence of the euro markets. And I do not see how one could realistically expect to contain the use of a major currency, which the euro will certainly be, within territorial borders.

But as I have made clear, the United Kingdom's interest—'in' or 'out'—lies unambiguously in doing all that we can to ensure that the single currency succeeds. And in this context we would, of course, co-operate with the ECB in any way we could, to avoid potential disturbance to European monetary policy, were this to occur.

Mr Chairman, London does not hold its pre-eminent position as Europe's major financial centre as of right. We must continue to earn it. If we are to take advantage—'in' or 'out'—of the opportunity that the euro will bring, then we must be technically well prepared.

We shall be.

There is increasing evidence that financial institutions in the United Kingdom are now taking the necessary steps to ensure that they are ready for the introduction of the euro, whether or not the United Kingdom joins EMU. In the early summer, we invited a representative sample of firms to confirm whether their preparations were on track. The response we received was broadly reassuring, though some of their preparations are dependent on decisions about the euro markets that have yet to be taken, as I shall explain in a moment. But the key point is that the urgency of the need to prepare is now widely recognised.

The Bank of England is playing a substantive role in the preparations in two complementary ways. Through our very active participation in the work of the EMI, we aim to make sure that the design of EMU, at least so far as the operations of the ECB are concerned, is capable of being delivered in a technical sense. This is the test that we have applied, for example, to the work of the EMI on the implementation of monetary policy and on the so-called 'changeover scenario'.

Our other role is to co-ordinate the preparations for the introduction of the euro in the City of London, to the extent that co-ordination is required. The Bank's role in helping the financial sector to prepare for the euro was recognised and reaffirmed by the Chancellor this summer, when he launched his complementary initiative to begin preparing the business community for the euro. In addition to making our own internal preparations at the Bank, we play a co-ordinating role in the financial community in three main ways:

- First, our job is to ensure that the necessary infrastructure is developed in the United Kingdom to allow anyone who wishes to do so to use the euro in wholesale payments and across the financial markets in London from the first day of EMU.

- Second, we aim to promote discussion between the EMI, national central banks and market participants across Europe about practical issues on which the market is seeking a degree of co-ordination.

- And third, we provide information: for example, through our quarterly series of editions on *Practical Issues Arising from the Introduction of the Euro*,(1) which is distributed to around 32,000 recipients across the City and beyond, including 4,000 directly abroad. And following the successful symposium we held early this year, we are planning to hold a further symposium next January at the Bank, on London as the international financial centre for the euro. Our theme will be: 'London will be ready'.

I shall now turn to the steps that we are taking to ensure that London will be ready for the euro, whether the United Kingdom is 'in' or 'out'.

(i) Payments and settlement infrastructure for the euro

First of all, the payments and settlement infrastructure. We are constructing payments arrangements in euro in London that we intend to be at least as efficient and cheap as anywhere else in Europe, even if the United Kingdom stays 'out'. In the United Kingdom, the real-time gross settlement system that came into operation in the spring of last year is being developed so that it will operate in euro. If the United Kingdom joins, the UK sterling system will effectively become a euro system. And in case the United Kingdom is 'out', a parallel euro system is under construction to sit alongside the sterling system: it will enable the members of CHAPS to process euro payments as a foreign currency within the United Kingdom and across borders within the European Union, through its link to the pan-European RTGS system—TARGET—that is being developed.

The idea behind TARGET is to link together in euro the national RTGS systems of EU Member States, so that large-value payments can be made or received between Member States throughout the EU area, with finality in real time, in exactly the same way as they can at present be made and received within Member States with national RTGS systems denominated in their own national currencies. One of the main purposes of TARGET is to support closer European economic and financial integration by reducing the risks in pan-European payments—just as national RTGS systems reduce the risk in national payment systems. The other main purpose of TARGET is to integrate the euro money market so as to ensure that the same short-term euro interest rate—determined by the single monetary policy of the ECB—prevails throughout the euro area. TARGET is a project that we strongly support.

It has been agreed that all EU Member States may connect their national RTGS systems to TARGET, whether or not they join EMU. The main policy issue outstanding concerns the terms on which the European Central Bank will grant intraday credit to the 'outs'. We see no monetary—or other—grounds for any discrimination against the 'outs'. If intraday liquidity to the 'outs' were to be restricted, the effect would be to increase the cost of using TARGET, and to damage the efficiency of the system for both 'ins' and 'outs'. That would simply divert euro payments to alternative mechanisms, including correspondent banking and the EBA's net end-of day settlement system. It would be unlikely significantly to deter the international use of the euro—if that were the objective—any more than lack of direct access to national RTGS systems deters the international use of the dollar or yen or Deutsche Mark now. Its main impact would be to make intra-European payments less secure. We would regret that.

Besides payments systems, the preparation of securities settlement systems for the introduction of the euro is a complex task in its own right. One of the reasons for this is

(1) Available from Public Enquiries at the Bank of England on 0171-601 4012.

that there are different approaches to securities settlement between different Member States and financial institutions. Another is that different approaches may be required to meet issuers' requirements for re-denomination. Even in one market in one country, the introduction of major changes in securities settlement systems can lead to teething problems, both in the central IT infrastructure and for individual institutions, as they learn how to apply the changes. Yet in the case of EMU, a number of Member States will switch to the euro more or less simultaneously at the start. This carries considerable risks of confusion and error, unless there is an extensive programme across Europe to explain the changes required in detail first. This is not, of course, a problem only for the United Kingdom.

(ii) Market framework for the use of the euro

The second important aspect of preparation is the development of a comprehensive market framework for the use of the euro in London. The euro Regulations help to provide the legal part of the framework.

To make sure that the euro market in London, as elsewhere in Europe, is as deep and liquid as possible, we also need to harmonise market conventions on new issues of securities in the euro money and bond markets, and conventions in the foreign exchange markets. Market associations now agree on the basis on which conventions in these markets should be harmonised, and the Bank has encouraged their initiative. The problem has been to see how EU-wide decisions will be taken. Harmonised practices may develop spontaneously in the markets, but there is no guarantee of this. So it is very helpful that the EMI Council decided with our encouragement in September to 'welcome and support' harmonised market conventions on the basis proposed by the market associations. We also welcome the EMI Council's decision in September to prepare for the computation by the ESCB of an effective overnight reference rate for the euro area.

There remains, however, a good deal to be done everywhere—in co-ordinating price sources, for example, as methods of re-denomination. But in all of these respects, London is well up with the game.

Conclusion

Mr Chairman, it is sometimes suggested that a perceived threat to its activity if we were 'out' will cause the City to press for early UK membership of EMU, and that this will be an important factor in the Government's decision. I am bound to say that I see very little sign of this. Certainly there are those in the City who advocate our early participation, but there are equally those who are more hesitant—just as opinions are divided elsewhere within the country. But for the most part, my impression is that City attitudes to EMU, whether for or against, reflect a broader assessment of the respective pros and cons for the country as a whole, rather than strong views about the implications for the City in particular. On the whole, I find that City opinion is relatively optimistic about its future prospects, 'in' or 'out'. And provided that we do indeed operate within a co-operative framework, and provided that we are indeed well prepared, the City has good reason to be optimistic.