

Briefing Paper

European Monetary Union and the United Kingdom

May 2006

Introduction

In January 1993, the twelve member states of the European Community became the Single European Market. They were joined in 1995 by Austria, Finland and Sweden; and in 2004 by ten mainly Eastern European states to bring total membership to 25. The single market means the free movement of goods, services and finance, and the right to work and live in any Member State.

The European financial common market, encompassing free movement of money and capital and freedom to provide services for brokers and financial undertakings, is an essential part of that market. It has resulted in community businesses and individuals being free to invest their money, open accounts and take out loans wherever they choose. Banks and other financial institutions can now offer 'financial products' without restriction and securities are quotable on all stock exchanges and issuable in all Member States of the Community. Insurance services can also be offered without restriction.

However exchanging currencies is a costly business, both for individuals who have to pay a commission whenever they travel abroad, and for companies which are obliged to devote some of their administrative resources to currency transactions. Therefore, the Single Market could only become more effective with the introduction of a Single European Currency (The Euro).

The Euro is currently the currency of twelve of the European Union's 25 member states. It was introduced on 1st January 2002 in place of the national currencies that had previously been used. The states that use the Euro stretch from the Mediterranean Sea to the Arctic Circle and have a combined population of 346million people. They are:

- Austria
- Belgium
- Finland
- France
- Germany
- Greece
- Ireland
- Italy
- Luxembourg
- Netherlands
- Portugal
- Spain

The member states that have yet to adopt the Euro are:

- Cyprus
- Czech Republic

- Denmark
- Estonia
- Hungary
- Latvia
- Lithuania
- Malta
- Poland
- Slovakia
- Slovenia
- Sweden
- United Kingdom

Most of these countries are relatively new accession countries to the European Union and many have plans to adopt the Euro in due course.

The United Kingdom Government and the Euro

The United Kingdom Government has stated that it is in favour of United Kingdom membership of the European Monetary Union in principle, but in practice they have established five 'economic tests' to assess whether economic conditions are 'right'.

The Treasury confirms that:

"Government policy on membership of the single currency is unchanged. It remains as set out by the Chancellor in his statement to the House of Commons in October 1997, and again in the Chancellor's statement on the five tests assessment in June 2003.

"In principle, the Government is in favour of United Kingdom membership of the European Monetary Union; in practice the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

"Since 1997, the Government's policy has been to prepare and decide. Early planning ensures that a possible future changeover would be smooth and effective.."

The 'Five Economic Tests' are:

- Sustainable convergence between the UK and the economies of the single currency
- Whether there is sufficient flexibility to cope with economic change
- The effect on investment
- The impact on our financial services industry and
- Whether it is good for employment.

The intention is that the Government will use these 'economic tests' as the basis to take a decision on whether to enter the European Monetary Union. If the Government recommends United Kingdom entry, it will be put to a vote in parliament and then to a referendum of the British people. Government, Parliament and the people must all agree.

The latest assessment of the situation was made by the Treasury in June 2003 at which time it was concluded that the United Kingdom was not yet ready to enter the European Monetary Union. The government stated that:

“Since 1997, the United Kingdom has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable or durable convergence or sufficient flexibility to cope with any potential difficulties within the Euro area.

“A clear and unambiguous case for United Kingdom membership of the European Monetary Union has not at the present time been made and a decision to join now would not be in the national economic interest.”

However, the government is continuing to keep the matter under review, has adopted a policy reform agenda and is taking practical steps to ensure that the United Kingdom will be able to meet the five tests.

In the meantime the government recommends that public, private and voluntary organisations should all make preparations for the introduction of the Euro so that the United Kingdom is able to make a smooth entry to the European Monetary Union should a decision to enter be taken.

The Outline National Changeover Plan and its subsequent versions are a key part of that process of preparation. They explain the practical aspects of possible United Kingdom entry, the work done so far, and the work planned for the future for both the public and private sectors. The third outline National Changeover Plan was published at the same time as the European Monetary Union assessment in June 2003. It included the possible timetable for a changeover, the management of it, and the impact on consumers, businesses, financial services, the voluntary sector and the public sector. Since then the government has published ‘Reports on Euro preparations’ that set out the progress that has been made.

In July 1998 the Government announced the establishment of twelve Regional Forums to make sure there was help for small and medium sized businesses (SMEs) to identify and take forward vital preparations for the introduction of the Euro on 1st January 1999 and beyond. The Regional Euro Forums, led by local business representatives and co-ordinated by Regional Government Offices, brought together representatives of key partners who have an interest in supporting business, for example Business Links, Chambers of Commerce, the Confederation of British Industry (CBI), Training and Enterprise Councils (TECs), Trade Unions, Banks, Local Authorities and other Public Sector Bodies. Their role was to identify key regional issues arising from the introduction of the Euro and their likely effect on regional business activity. Each forum is developing a regional Euro preparations strategy that will address action that needs to be taken at a regional level to support businesses preparing for the Euro. The Euro Preparations Unit (EPU) at the Treasury produces regular updates on the different Forum’s activities and case studies.

The Euro Preparations Unit was set up to provide support to help business and public authority preparations. Its aims are to ensure that businesses and public authorities are prepared for the implications of the introduction of the Euro in eleven other European Union countries and to complete the necessary planning and preparation required to enable United Kingdom entry. They have:

- Run a series of focus groups with the private and public sectors, to find out what they need to know and where they need assistance
- Produced a pack of fact sheets on different aspects of business preparations for the Euro
- Run seminars and campaigns to raise awareness in business of the strategic and practical implications arising from the introduction of the Euro and publicise the availability of more detailed information to help businesses to plan
- Produced a guidance document on “Local Government Preparations for the Euro”
- Published the Government’s “Outline National Changeover Plans”
- Produced a Central Government “Euro Changeover Plan”
- Provided an information telephone line to ensure that organisations have ready access to the information that they need to prepare
- Established an official Government website on the Euro, from which more information on the Government’s policy and publications on the Euro can be found and copies obtained.

A report on progress on the government’s reform agenda since the June 2003 assessment of the five economic tests was included in the 2005 budget statement. Progress included:

- The introduction of a symmetric inflation target as measured by the Consumer Prices Index (CPI)
- Reforms to address both supply and demand in the housing market through implementing a programme of change to increase supply and responsiveness as recommended in the Barker review and action taken in response to the Miles review on the mortgage market
- Reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets

In January 2006 the European Commission complained that the United Kingdom’s budget deficit was ‘excessive’. In particular, it was stated that because the deficit had been above 3% of Gross Domestic Product (the limit set under the Stability and Growth Pact) since 2003/04 it could no longer be thought of a ‘temporary’ or due to an ‘unusual event’. Joaquin Almunia, the European Commissioner for Economic and Monetary Affairs, said:

“The commission considers that the deficit is likely to remain above the 3% reference value in 2005/06 and 2006/07 in spite of recently announced fiscal measures.”

The Commission’s forecast is that the United Kingdom deficit will rise to ‘just below 3.5%’ in 2005/06 and will still be above 3% during 2006/07. The United Kingdom Treasury, however, predicts that the deficit will have fallen to 3% in 2005/06, 2.7% in 2006/07 and will fall to 1.5% by 2010.

The European Commission has therefore invoked their 'excessive deficit procedure'. This involved the Commission in making recommendations to the Council of Ministers that the United Kingdom budget deficit should be reduced. As a signatory to the Growth and Stability Pact the United Kingdom is obliged by treaty to follow the recommendations, although as it has not introduced the Euro, the European Union has no powers to act to oblige the United Kingdom to do so.

It is therefore unclear when it will be possible for the United Kingdom to join the European Monetary System and begin to use the Euro.

Preparations for the Euro in the United Kingdom

Before the Euro was introduced, the Bank of England stated that:

"Introduction of the Euro will have an impact on UK markets even if the UK does not join European Monetary Union; and if we do join, it will have an impact on the entire economy."

All organisations have been affected to a greater or lesser extent by the introduction of the Euro. Should the Euro be introduced in the United Kingdom these effects would be greater. Consequently there is a need for appropriate planning and research.

There are three areas on which initial planning and research should centre and they should be considered simultaneously, as they are all important, but none more so than the others:

- Strategic issues
- Awareness of European Monetary Union
- Systems software.

To consider strategic issues, organisations should undertake a strategic organisational analysis to consider the likely impact of the introduction of the single currency on the organisation's commercial environment or operational areas. Within this analysis particular attention should be paid to the impact of a potentially extended home market and the likely downward pressures on prices due to increased transparency within the Euro zone.

It is necessary to identify the choices and timescales available to the organisation for implementation of the Euro and the transitional periods and to determine when key decisions need to be made and evaluate the impact on these timescales.

The appointment of a high level manager, preferably at Board level, to lead and co-ordinate the organisation's response to European Monetary Union and to establish appropriate project management arrangements including a budget to fund this work is advisable.

There is a need to develop an organisational awareness of European Monetary Union and Euro related issues through an understanding of the European and national legislative processes which have established the European Monetary Union.

Organisations should identify relevant information sources, including the European Commission and associated bodies, national government, central banks, commercial banks, accountants, trade associations, the financial press, the Chartered Institute of Public Finance and Accountancy (CIPFA), The Federation des Experts Comptables Europeen (FEE), and HM Treasury. It should then be possible to identify and gather what information is available and summarise and disseminate it to members of staff. A process for regularly briefing staff on developments should be established.

There is a need to ensure that appropriate Systems Software is in place. In February 1999, Tony Blair MP, the Prime Minister, stated that:

“Where computer systems are being upgraded, all departments will build in Euro compatibility where that represents value for money.”

To do this, there is a need to identify which organisational systems will be affected. As most systems include cash or monetary transactions there will be a need to review and convert software in a number of areas. This will include systems for purchasing, materials, suppliers, fixed assets, stock, accounts receivable and payable, salaries and benefits, sales, accounts consolidation, payments, banking, treasury, ordering, costing, budgetary control and reporting, financial reporting, marketing and forecasting.

The dependencies between the various systems and software should be reviewed and the extent to which individual systems and software can be converted to adopt the Euro diagnosed. From this review and diagnosis, the priorities for change should be determined and a timetable for implementation established. It can be useful to start talking with hardware and software suppliers to determine what plans they have for conversion. Given the long lead times for large Information Technology projects, it is essential that businesses undertake adequate advance planning and preparation. There is a clear risk that there will be insufficient time and Information Technology resources to meet the demands of the single currency if businesses delay implementing their Information Technology strategies.

The Bank of England is represented on the General Council of the European Central Bank and has been active in the discussions covering the changeover to a single currency. The Bank has been taking a leading role in helping to prepare the United Kingdom financial and business community by:

- Disseminating information, communicating widely about the relevant issues and progress in addressing them
- Identifying where co-ordinated activity has been needed, particularly in developing the infrastructure of the financial economy to embrace the Euro
- Helping to ensure that the necessary work has been agreed and undertaken
- Acting as a catalyst to stimulate private sector activity where necessary
- Putting groups facing similar or inter-related problems in touch with each other.

In pursuing this role the Bank has continued to hold bilateral meetings throughout the City; primarily with associations representing segments of the financial community but also with senior executives responsible for each financial and commodity market and exchange. They have also maintained contact with representatives of industry, retailers and consumers.

The Government established a Business Advisory Group (BAG) in July 1997 to provide a two-way channel of communication between business and the Government on practical issues arising from the introduction of the Euro. Membership was drawn from a wide range of business organisations, as well as the Trade Union Congress (TUC) and the Consumers Association. Consultations through the Business Advisory Group and a parallel public sector network produced the following key messages. The Government needed to:

- Extend its consultation framework to involve key players at regional as well as national level
- Provide, as a matter of priority, key information to enable organisations in the UK to plan for the launch of the Euro
- Consider what steps the public sector might take to help businesses using the Euro
- Together with the private sector, take steps to forecast and monitor the use of the Euro.

To oversee preparations in the public sector, the Government established a Ministerial Group, led by the Treasury. Each government department nominated a Minister to sit on this group; they considered the implications at a detailed level. Each department also appointed a Euro co-ordinator, to be responsible for their own preparations. Subsequently this work is being led by the Euro Preparations Unit at the Treasury.

The Government published its First Outline National Changeover Plan on 23rd February 1999. In his address to the House of Commons at the time, Mr Tony Blair, the Prime Minister, outlined a timetable for British entry that could be considerably shorter than the one being followed by the eleven countries in the first wave. He repeated the Government's commitment to holding a referendum on the issue after the following General Election and he restated the Government's policy on membership of the single currency, as first set out by Mr Gordon Brown, the Chancellor of the Exchequer in October 1997. The third National Changeover Plan was published in June 2003 and the latest Managed Transition Plan was published in 2005. However, the promised referendum on the 'Euro' has not been held at the time of writing in May 2006.

Examples of areas where the single currency will affect local and other public authorities, even though the United Kingdom has decided to remain outside the Euro for the moment include:

- Investment policies are likely to change, as European Community regulations change to enable more freedom to invest, especially in the Euro (This is most likely to affect pension funds)
- Increased competition in the single market will affect contracting out, market testing and privatisation. European competitors that trade in the Euro may be at an advantage
- Important leadership role for public authorities to play in providing advice and disseminating information, both to the public and private sectors.

The United Kingdom government issued advice to local authorities on making preparations for the Euro in June 2003. When announcing the publication of the guidance, Gordon Brown MP, Chancellor of the Exchequer, said:

"It is now important that local authorities consult local communities and develop their own changeover plans."

Should they fail to do this they run the risk of being unable to trade in the only legal currency if the United Kingdom decides to join the Euro, and thus unable to meet their statutory responsibilities.

The guidance explains government policy on preparing for the Euro as follows:

“Preparations are an integral part of the Government’s policy on Economic and Monetary Union in order to ensure that the United Kingdom retains a genuine option to join the single currency if that is what the Government, Parliament and the people, in a referendum, decide. This guidance, developed in consultation with local authority representatives, should assist local authorities in making preparations. It aims to ensure consistency in approach on Euro preparations in local government with that of Government departments and other public sector bodies.”

The Government considers that preparations are important for local authorities as a Euro changeover would be relevant to them in their role as:

- Key service providers in highly visible areas
- Key partners for business, voluntary and community sectors
- Large local employers
- Communicators to citizens, local communities and businesses

The government notes that in the Euro area local government played a critical role by delivering key services uninterrupted during the changeover and by communicating with citizens. The government considers that as part of sensible risk management and forward business planning, local authorities should commence preparations to ensure that they could deliver a changeover around thirty months after a positive referendum.

The guidance covers the following areas:

- Introduction
- Planning Framework and Next Steps
- Key Business Issues
- Key Technical Issues
- Communications

The government has produced outline National Changeover Plans that have been periodically updated. These set out planning assumptions for a potential changeover. Planning is based on a four month period between a government decision and a referendum, and then a thirty month period between the referendum and ‘E-day’. It is calculated that it would take twenty months from the referendum to reach the beginning of the retail transition when Euro denominated retail financial services would start to be available and that part way through that period the United Kingdom would join the European Monetary Unit and fix the Euro-Sterling exchange rate permanently. Another ten months would elapse before Euro cash was introduced and the transition came to an end and all non-cash transactions would be denominated in the Euro. There would then be a further two months before the Pound Sterling ceased to be legal tender. The government considers that the best date for E-day would be 6th April as this would coincide with the start of a new tax year.

The guidance states that:

“A Euro changeover would have a large impact on a local authority’s business plan affecting nearly all services provided and internal systems, in particular: payroll, revenue collection, housing benefit, trading standards, retail and leisure services, education, and critically communications activities.”

For Initial Planning, the government’s planning checklist includes:

- Identify key business areas and policies that might be affected by a changeover
- Establish a programme management structure
- Resolve key business issues that would affect the overall corporate changeover strategy for a changeover as well as individual business areas
- Develop a changeover plan

For Key Business Issues, the government’s planning checklist includes:

- Transition Services
 - Through consultation with relevant stakeholders identify any transition services that would be provided
 - Ensure that other organisations’ transition plans are factored into corporate strategy
- Training Issues
 - Ensure training considerations are factored into changeover plans
- Cash Changeover Issues
 - Identify all services that involve, or could involve cash payments as well as smoothing issues
 - Discuss potential requirements with vending industry representatives
 - Consider staff training issues
- Consumer Issues
 - Ensure the principles for the consumer code and the implications of the Draft Public Sector Consumer Code of Conduct are factored into planning considerations
 - Ensure dual display requirements are fully considered and incorporated into plans
 - Consider how local trading standards offices and consumer support networks could best help protect consumers
- Procurement
 - Ensure systems planning is aligned with business needs
 - Consider Office of Government Commerce Gateway Reviews as part of overall project planning
 - Engage with other authorities and suppliers to ascertain Information Technology conversion needs
 - Consider innovative approaches to procurements
- Conversion and Rounding
 - Ensure key business areas are aware of conversion and rounding rules
 - Consider implications of vertical rounding and factor this into communications plans
- Smoothing
 - Identify amounts that might require smoothing, with the aim of keeping this to a minimum
 - Consider how smoothing might be achieved, noting that it ought to be in the citizen’s favour
 - Consider using ‘rough’ sterling amounts for a period of time

- Ensure technical plans are in place to deal with smoothing issues (for example, car parking meters or Information Technology systems changes)
- Factor smoothing considerations into communications plans
- Stored Data
 - Consider areas where there would be a business case for conversion of stored data
 - Using best practice guidelines, make appropriate plans for conversion

The guidance gives a case study related to valuations for business rates:

“Councils might need to convert databases to rateable values. This might be helpful in the scenario where a business ratepayer had paid business/non-domestic rates in sterling and after E-day the Government District Valuer changed the property’s rateable value retrospectively, meaning more or less rates were due. To avoid making comparisons in two currencies, a single currency system might provide administrative convenience.”

The government advises that once key business decisions have been made, authorities should start making technical preparations, most critically Information Technology preparations, particularly in areas with potentially long lead-in times such as housing benefit.

Guidance would be produced prior to any changeover about the recommended timing of the conversion of financial accounts from sterling to Euro. It is likely that authorities would have significant flexibility about the timing of any changeover of their internal financial systems. Furthermore, standard accounting and audit requirements would not change on the introduction of the Euro.

For existing local authority Private Finance Initiative contracts there would be:

- No change for the unitary charge paid by local authorities – the amount would simply be recalibrated in Euro
- No change in the debt repayments by the project company to the banks that will have been fixed through ‘swaps’
- No opportunities for refinancing due to the new interest rate regime

For Information Technology planning, the government’s planning checklist includes:

- Having considered business requirements, make an inventory of systems that might be affected by a changeover
- Develop user requirements for each system, followed by technical solutions and project plans
- Determine overall strategy for systems conversion – that is, phased conversion or ‘big bang’

The guidance states with regard to communications that:

“Timely and relevant information for business and citizens would be critical to the success of a United Kingdom changeover. Local authorities would play an important role in communicating key messages during any changeover, particularly to vulnerable groups, and helping to maintain consumer confidence. Authorities are encouraged to develop communications strategies that dovetail with national plans... and that would ensure effective communication to their customers during any changeover.”

For communications, the government's checklist includes:

- Ensure communications are a key part of planning in all business areas
- Devise communications plans that dovetail with national plans
- Identify key stakeholder groups, communication channels, key relationships and interdependencies and the needs of vulnerable groups

The latest 'Preparation report' was published in Autumn 2004. In the foreword, Stephen Timms MP, the Financial Secretary to the Treasury, said:

"The Government is committed to ensuring that the United Kingdom would be in a position to join a successful single currency, if that is what the Government, Parliament and the people, in a referendum, decide.

"It is important that all sectors recognise the need for continued preparations. I would encourage those organisations that have already considered the issues arising from possible United Kingdom changeover to review their plans as part of their normal business cycle and for those who have not, or who are unfamiliar with the timetable proposed in the third outline National Changeover Plan, to consider the issues raised.

"In the event of a changeover, the public sector would set an example, leading the way in achieving a smooth and effective changeover and protecting the interests of citizens. I would like to thank my colleagues across the public sector for their continued engagement in Euro preparations. The private and voluntary sectors have an important part to play, particularly the financial sector, and I am grateful for the engagement of the banks in this work."

The government considers that preparations in central government are well advanced. Central departments have plans in place and have provided evidence to the Euro Preparations Unit in the Treasury to demonstrate their achievements against the criteria for completing the planning phase first published in the Report on Euro preparations of April 2004.

Work with local authorities to produce model changeover plans continues and plans have been submitted.

The Scottish Executive is working with the Euro Preparations Unit and has prepared a departmental changeover plan. The Wales Assembly Government has finalised a consolidated Euro changeover plan with its programme board. Executive agencies and Non-departmental public bodies are also preparing Euro changeover plans.

The European Commission has reconstituted two working groups that assisted in preparations across the Euro area, namely the Directors of Communication (DirComII) and Public Administrators' Network (PANII). Meetings of these groups are attended by representatives of the Euro Preparations Unit.

In a United Kingdom changeover, all parts of the public sector would require a strategy for the treatment of financial information. Draft guidance on public sector accounting was first published in Annex H of the third outline National Changeover Plan to assist public sector organisations with appropriate preparations for possible United Kingdom membership of the European Monetary Union in line with United Kingdom government policy.

Conclusions

The Euro is now the established currency for 346million people living in twelve of the member states of the European Union and a major international trading currency.

Since 1957, the original six signatories of the Treaty of Rome have been building a Single European Market that has been joined by nineteen other European countries since. Currency instability was always seen as a barrier to the creation of the Single European Market and so, since the collapse of the Bretton Woods agreement, the European Union has concerned itself with monetary policy. Firstly, greater stability in the exchange rates between European currencies was sought. Secondly, it was decided to replace all the national currencies with the Euro. Twelve member states have adopted the Euro and most of the remainder have plans to do so.

The European Union considers that there are a number of benefits to having a single European currency that have been the major motivations behind the creation of the Euro. These are:

- Practical benefits for citizens who travel with the Euro.
- Enabling businesses and citizens to reap the full benefits of the European Union's Single Market
- Benefits for savers and borrowers from a single financial market
- Benefits to the economy as a whole of a single currency creating a single macroeconomic framework
- Advantages for Europe's international role
- Benefits related to the wider process of political integration

The United Kingdom government is in favour of the United Kingdom joining the Euro in principle. However, in practice it has established five economic tests that it wishes to see fulfilled before the entry of the United Kingdom. Furthermore, it has decided that government, parliament and the electorate (in a referendum) must all agree before the United Kingdom adopts the Euro. In the meantime it is urging all public, private and voluntary organisations to prepare for the introduction of the Euro at a future date.

Preparations should cover strategic issues, awareness of the European Monetary Union and systems software. A national changeover plan has been prepared and guidance issued to local authorities and others on the preparations necessary for the introduction of the Euro.

The Chartered Institute of Public Finance and Accountancy has established a Euro Panel and Euro Forum and has issued advice and guidance to public sector bodies on how to address the challenges and opportunities presented by European Monetary Union.

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