A REVIEW OF EUROPEAN ECONOMIC AND MONETARY UNION AND ITS IMPLICATIONS

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EUROPEAN ECONOMIC AND MONETARY UNION AND ITS IMPLICATIONS

A What is Monetary Union?

The basic characteristic of a monetary union amongst countries is of course the adoption of a common currency. A single currency naturally presupposes a single monetary policy, in which the internal and the external value (the exchange rate) of the currency is managed by a central authority. Accordingly, members of the monetary union secede their autonomy on such matters. They lose sovereignty over money supply and interest rates and over exchange rate management, key weapons of macroeconomic policy.

The internal value of the new currency clearly cannot be allowed to be undermined by profligate national governments. Accordingly, monetary union will also restrict national government sovereignty on aspects of fiscal policy, in particular on borrowing to meet public sector deficits, and therefore, by inference, the size of such deficits.

Although the idea of Economic and Monetary Union (EMU) in Europe goes back much further, the case for Economic and Monetary Union was initially examined in 1988 by a committee including all European Union (EU) central bank governors under the chairmanship of Jacques Delors. The Delors Committee Report was then agreed by leaders of EU Member States in June the following year and preparations were undertaken for the first stage of EMU to begin in July 1990, with the liberalisation of capital movements between most Member States. Final approval was given in December 1991 at the Maastricht European Council, which concluded the conference on revision of the European Community Treaties. The revised Treaty on European Union set out the objective of a single currency by the end of the century and provided the framework to meet this objective.

B The Microeconomic Benefits – Reducing Risk and Uncertainty

The Debate

The microeconomic benefits of a single European currency are essentially those which accrue to individuals or businesses flowing from the removal of risk and uncertainty associated with fluctuating exchange rates. For consumers and traders who deal with other EMU countries the benefits of joining monetary union would include:

1. The removal of charges incurred in the changing of Sterling into the foreign currency and vice versa
2. The removal of transaction costs incurred if one decides to cover the foreign currency exposure e.g. by the use of forward contracts
3. Greater certainty of the value of sales (if an exporter) or purchases (if an importer)
4. Greater certainty of returns (to the investor) and of costs (for the borrower)
5. Reduced managerial and administrative resources required to manage foreign currency portfolios
6. Reduced requirement to hold foreign currency or leave open positions.

In addition to these direct risk-reducing benefits, a common currency reduces exposure to economic risk that arises when exchange rate movements alter the relative competitive and strategic positions of companies.

In sum, adopting a common currency reduces costs, risks and uncertainty, and will facilitate long-term planning and encourage business investment.

The significance of the direct risk-reducing benefits can be argued to be limited in that:

1. Such benefits only apply to those who buy, sell, borrow, or lend in those European currencies that will merge into the euro. There are no benefits for:

   i) companies trading only in the domestic economy (numerically, the vast majority of trading entities)

   ii) companies who settle and require settlement only in their local currency

   iii) companies whose overseas trade is with entities in countries outside the single currency area.

2. Benefits 1 and 2 are one side of a coin, the second of which depicts equally commensurate losses of revenue to those institutions currently providing foreign currency exchange and exchange risk hedging services.

3. Similarly, whilst exchange rate fluctuations do create uncertainty (as noted in 3 and 4) the removal of the exchange rate fluctuations that cause the uncertainty has over a period of time a neutral effect on business profits. The trader who leaves his foreign currency exposure unhedged is arguably just as likely to gain as lose from any exchange rate fluctuations that arise between order and date of due payment.

Nevertheless, the benefits of reduced economic risk are not lessened by such considerations. For instance, in respect of the first limitation, even companies only trading domestically or only invoicing in the national currency can benefit from participation in the single European currency because, for example, competitors from participating countries cannot undercut them in the event of a euro depreciation. Also, in regard to the third limitation, it needs to be recognised that hedging serves to reduce the cost of volatility and alleviate potential financial distress. It is of little consolation to a firm to know that in the long run uncovered exchange fluctuations could have a neutral effect on its profits, when in the immediate term it is facing severe financial difficulty as a consequence of adverse currency movements.

Isle of Man Perspective

The scale of the microeconomic benefits to be had are likely to be only small when aggregated. The vast majority of Isle of Man trading companies, by number if not by size, are supplying the Island's domestic market only. To them the direct currency benefits are an irrelevance, as they are for those who are dealing only with UK companies and individuals and with partners outside of the euro area. It could be concluded then, that the total benefits from the removal of the currency risk that would arise from the adoption of the euro by the UK Government are small, since the Island's trade is overwhelmingly with the United Kingdom or beyond Europe. With the former there is no direct currency risk anyway; with the latter (ignoring the potential vehicle currency role of the euro) the risk would still remain. However, the economic risk of being outside the EMU area would still be a consideration.

C The Macroeconomic Aspect – more Stability, less National Sovereignty

The Debate

The macroeconomic benefits of a single currency are based on the presumption that the euro will be a "hard" currency, made so by strong anti-inflationary central monetary policies and prudent national fiscal policies. In such conditions the European economic environment will be stable, with low inflation, and generally low nominal interest rates. The strength of the currency will mean that the euro area interest rate will not need to be deployed as a weapon to control an otherwise volatile exchange rate.

Assuming that the monetary authority, the European Central Bank (ECB), can be so insulated, the direction of monetary policy, and in particular the setting of interest rates, will not be diverted from its true and proper course by political influence.

As a consequence of the microeconomic benefits to be had, there will be a greater inclination for companies within the euro area to trade with each other so as to avoid exchange risk and associated hedging costs that would otherwise exist in trade with companies operating outside of the euro area. Similarly, the euro area will be attractive to outside direct investment by non-EU based companies supplying EU countries.

The belief that the euro will be a hard currency is being questioned. Concerns have been raised at the less than strict interpretation of the criteria used to determine qualification in EMU, something which will allow the entry of those countries with only a short, and unconvincing, record of financial and monetary discipline.

Doubts over whether the European Central Bank can forever remain insulated from political influence have been raised, for example by French moves for a formalised structure which would allow for a politically determined economic overlay to be brought to bear on the policy decisions of the ECB.

But the principal doubts over the single currency project concern the extent to which, particularly if there is a wide membership, central monetary and interest rate policy can devise and impose a single monetary policy over such an economically diverse group of Member States.

These fears stem essentially from the absence of full business cycle and structural convergence amongst participant countries. The lack of synchronisation of the British business cycle and that for most other EU members is clear. Differences between the other members are generally less marked but still evident. The Maastricht criteria was partly an effort (inevitably superficial) to gauge economic convergence between European economies. To some extent it has in itself brought many countries' cycles closer together through pressuring governments to deploy deflationary fiscal and monetary policies, irrespective of their domestic market conditions, as they sought qualification.

The structural differences between national economies may also create stress and tensions between members. Essentially, it is argued, economic "disturbances" or "shocks" (i.e. events with systemic economic implications) may be either country-specific or else impact unequally between countries, because of differences in their internal economic structures and institutions, in their openness to foreign trade and capital movements, and in the extent of their network of internal and external economic linkages. Yet within economic and monetary union the monetary policy response cannot be differentiated, whilst any fiscal manoeuvring is also severely restricted, as noted earlier.

As an example of a country-specific "shock" one might cite the case of the recent spate of building society demutualisations in the United Kingdom which injected an estimated £35bn of potential consumer spending into the economy and which called for a direct policy response to try and avoid overheating and a build up of inflationary pressures. The response was a mix of marginally higher interest rates and small tax increases. Within EMU recourse would have had to have been to (larger) tax increases only, something which would have created early and significant political difficulties for the new UK Government.

As an example of a credible asymmetric shock, take a sudden increase in world oil prices. This would naturally be inflationary for all but particularly so for countries with a heavy dependence on oil for power generation or as a manufacturing input. However, for some countries, namely those who were suppliers of oil, there would be some counter-balancing economic benefit. Clearly, the ideal policy response required will be very different for a country which is, for example, a small consumer of oil but a significant producer and exporter of oil than one which is both a heavy and a totally import-dependent consumer of oil.

It is the recognition of this kind of difficulty and the loss of economic sovereignty that provides the major platform of opposition to monetary union. It is argued that national governments must have national policy weapons available to deal with national economic issues. Short term palliatives might come in the form of increased EU funding (particularly under the social cohesion fund plans, specifically designed with a view to offsetting what might be the deflationary effects of central monetary policy on individual countries) or in temporary derogations from rules governing government borrowing. In the longer term the answer is for greater convergence between national economies, greater mobility of capital and labour between Europe's areas, and generally increased flexibility of wages and prices.

For many, what these concerns and viewpoints highlight is that in order to avoid and defuse national and regional tensions, economic and monetary union must be followed by further political union.

Isle of Man Perspective

To the extent that the ECB operates a strict monetary policy and achieves financial and economic stability throughout Europe then clearly the Isle of Man economy would benefit from the adoption of the euro. If it can be assumed that the ECB will operate much along the lines of the German Bundesbank, and therefore treat the euro area as an extended Deutchesmark zone, then the task of maintaining the value of the currency, it could be argued, is in better hands than if left, judging on past history, with the UK authorities.

Isle of Man companies would also benefit from a greater tendency for companies in euro Member States to avoid exchange risk and deal with each other and from the added attractiveness of the euro area to foreign investment.

The Isle of Man has long been in monetary union with the United Kingdom and does not have an independent currency or the powers to effect interest rate and exchange rate changes. So there is nothing new here. However, the Isle of Man and United Kingdom economies have closely synchronised business cycles and closely aligned general economic conditions. Accordingly, the United Kingdom Government's decisions on interest rates (ideological differences and errors of judgement aside) are appropriate to Isle of Man circumstances. It could be doubted that a EMU-wide interest rate would be generally as suitable, at least in the short to medium term.

The elimination of exchange rate risk and interest rate variations between EMU countries will remove two significant obstacles to the cross-border movement of investment funds and business investments. It can be expected therefore that decisions concerning where to invest and where to locate will focus even more on tax advantages. Should Britain enter EMU then the Isle of Man could become more attractive to inward investment and the Island's ability to maintain its low direct tax will be even more critical. Clearly however, there is great potential here for conflict to arise in the future between EMU membership and, as seen in some European eyes, 'harmful' tax competition.

Should EMU not work to the advantage of the Isle of Man, then under the terms of Protocol 3 the Island could not of course become the recipient of any “compensatory” EU funding.

D **Timetable**

The Maastricht Treaty set out the timetable for the process of monetary union in three stages. Stage 1, involving economic and monetary co-operation and the development of the single market, was already in place when the Treaty was signed.

Stage 2 began in January 1994, with the creation of the European Monetary Institute (EMI), the forerunner to the European Central Bank. It is scheduled to end on 31st December 1998, when the euro becomes a currency in its own right. This stage of the monetary union process involves further co-ordination of Member States’ economic policies in preparation for monetary union. During Stage 2, detailed technical preparations have already been made for the introduction of the single currency, including drafting of legislation establishing the euro as a currency in its own right, planning of future monetary policy instruments and design of euro notes and coins. In March 1998, the European Commission and the EMI Council will publish convergence reports based upon economic data gathered during 1997. The Council of Economic and Finance Ministers (ECOFIN) will then present its recommendations on the possible participants in monetary union at the start of Stage 3 in May 1998. On the basis of these recommendations and the convergence reports of the Commission and the European Monetary Institute (EMI) Council, the European Council will then decide which Member States will continue on to Stage 3 on 1st January 1999 and will announce the bilateral conversion rates between the currencies of those countries to apply at that time. The conversion rates of those currencies against the European Currency Unit (ECU), and hence the euro, will not be set until the start of Stage 3, when the end-1998 exchange rates of non-participating ECU basket currencies, such as Sterling or Krone, become known. The basis that will be used in the setting of conversion rates has been left open, although use of exchange rate mechanism central rates is currently the most likely option.

Once the initial participants have been decided, the European Central Bank will be established to replace the European Monetary Institute. During the remainder of 1998, production of euro notes and coin will begin and any necessary secondary legislation made necessary by the creation of the new currency will be adopted.

Stage 3 will begin on 1st January 1999 with the irrevocable fixing of the exchange rates of all participating Member States and the creation of the single currency. From this date, the ECB will implement a single monetary policy for all participants, conducting all its market operations in euros.

Stage 3 can be split into two stages: Stage 3A, the transitional period which is scheduled to end, at the latest, on 31st December 2001, and Stage 3B, the dual currency period which is scheduled to last a maximum of six months from 1st January 2002 to 30th June 2002. Throughout both stages, national currencies will continue to be legal tender and the principle of ‘no compulsion/no prohibition’ will apply to use of the euro within the single currency area. However, in practice, use of the euro will be largely confined to the wholesale financial markets during Stage 3A, and mass retail use will not occur until Stage 3B begins and euro notes and coin are in circulation. Although Stage 3B is scheduled to last for a maximum of six months, the 1995 Madrid European Council meeting explicitly allowed for national discretion in choice of the end date of this Stage. Although national currencies must cease to be legal tender by 30th June 2002 at the latest, States may decide to reduce the length of Stage 3B due to the costs associated with dual currency circulation. The European Commission recommended in February that this period be kept to just a few weeks.

E Convergence Criteria

In order to participate in monetary union, EU Member States must meet a number of obligations related to Economic and Monetary Union. One of these obligations concerns the convergence criteria set out in the Maastricht Treaty, which states that Member States must have achieved a "high degree of sustainable convergence". Specifically, each state must meet the following four convergence criteria, assessed on the basis of 1997 data.

Price Stability

The average rate of inflation in the year prior to examination should not be more than 1½ percentage points above that of, at most, the three best performing Member States in terms of price stability.

The significance of this is that within a fixed exchange rate system, any persistent differences in inflation could cause competitiveness problems for individual Member States, leading to output and employment losses.

Public Finances

(i) Deficit Ratio:

The ratio of the government deficit to GDP may not exceed 3% unless the ratio has declined substantially and continuously and reached a level that comes close to the reference value, or alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

(ii) Government Debt Ratio:

The ratio of government debt to GDP may not exceed 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

These criteria, relating to fiscal discipline, aims to guard against inflationary pressure and the emergence of excessively high real interest rates.

Interest Rates

Average nominal long-term interest rates in the year prior to examination should not exceed by more than two percentage points the long-term interest rates of the three best performing Member States in terms of price stability.

The interest rate criterion presumes that long term interest rates reflect market expectations of future inflationary pressures and provide an indication of the durability of a Member State's convergence.

Exchange Rates

A Member State should respect the normal fluctuation margins provided for by the Exchange Rate Mechanism (ERM) without severe tensions for at least two years, in particular without initiating a devaluation of its currency's bilateral central rate.

Although the 'normal fluctuation margins' are now +/-15%, this provision was agreed when they were +/- 2.25%. This provision aims to provide a source of external discipline: if countries can demonstrate that their currencies can be kept stable for a period of two years, it should cause less of an economic disturbance when the step of permanently fixing exchange rates is taken.

There is debate over whether this criterion could, in practice, be applied to exclude any potential participants in monetary union. The widening of the fluctuation margins to such an extent may be argued to have reduced the level of currency stability and discipline demonstrated by membership of the ERM. If countries have achieved a sufficient level of economic convergence, exchange rates would be expected to stabilise of their own accord, making membership of the an ERM unnecessary condition. For these reasons, this criterion is held to be contestable. Accordingly, the question of whether this criterion will present an obstacle to the UK's participation in monetary union is subject to dispute.

The European Council has decided to establish a new exchange rate mechanism (ERM2) on 1st January 1999. This will replace the existing European Monetary System, as the features of this system will be largely unwound by the creation of the single currency. The structure of ERM2 will be centered on the euro, with upper and lower bands of 15%, and membership will be voluntary. There is also the possibility of formally agreeing narrower fluctuation bands on a case by case basis. The Monetary Committee of the European Council has prepared a draft Resolution setting out the objectives and features of ERM2. The draft Resolution also makes it clear that neither standard nor narrow fluctuation bands should prejudice interpretation of the exchange rate criterion.

Membership of ERM2 will be voluntary and the UK Government currently has no plans to join. However, the president of the European Commission has recently made calls for the UK to fix sterling against the euro, subject to narrow fluctuation margins, and has stated that it will be impossible for the UK to participate in monetary union at a future date without demonstrating at least two years of stability against the euro. The specific exchange rate conditions that must be met by countries not participating in the first wave of monetary union will shortly be decided by ECOFIN and it may be expected that the pressure on the UK to agree to fix sterling against the euro will intensify.

F First Wave Membership

The decision on which EU Member States will participate in monetary union from 1st January 1999 will be made in May 1998, based on qualified majority voting by the European Council. The Council will vote on the basis of recommendations to be made by ECOFIN in March 1998. These recommendations will be based upon economic data for 1997 and the European Commission's economic forecasts, which currently suggest that the majority of countries' economies are converging at a sufficient rate to allow them to participate in monetary union from 1st January 1999. All countries other than Greece are forecast to meet the inflation and interest rate criteria, and have already achieved deficit levels of 3.0% or less of Gross Domestic Product (GDP). Although the public debt reference value is unlikely to be met by more than four countries (United Kingdom, France, Luxembourg and Finland), most Member States are forecast to have sufficiently declining debt ratios to allow them to meet the requirements of this criterion.

If the European Commission's latest economic forecasts for 1997 are considered, only Luxembourg and Finland are expected to succeed in meeting all four economic requirements based on a strict interpretation of the convergence criteria. Germany and France failed to meet all four criteria in 1996 and Germany is forecast to be the only EU State with a rising debt ratio in 1997. However, a monetary union excluding either of these countries would be extremely unlikely and application of the convergence criteria is certain to be sufficiently flexible to allow both countries to participate in the first wave of monetary union. On the basis of the economic data shown above, the countries expected to make up a 'core' monetary union on 1st January 1999 are Germany, France, Luxembourg, Austria, Finland, Ireland and the Netherlands. Belgium is also expected to be within this core group, since its government debt ratio may be judged to be sufficiently diminishing despite its high level.

Economic Convergence

1996 Data:	Inflation Rate	Long Term Interest Rate	Public Finances: Deficit Ratio	Government Debt Ratio	Exchange Rate
Austria	1.5	5.7	2.8	66.6	YES
Belgium	1.7	5.8	2.6	124.7	YES
Finland	1.2	6.0	1.4	59.0	YES*
France	1.3	5.6	3.1	57.3	YES
Germany	1.8	5.7	3.0	61.8	YES
Ireland	1.5	6.3	(0.6)	65.8	YES
Luxembourg	1.6	5.8	(1.6)	6.7	YES
Netherlands	2.1	5.6	2.1	73.4	YES
Portugal	2.2	6.3	2.7	62.5	YES
Spain	2.0	6.3	2.9	68.1	YES
Italy	1.9	6.7	3.0	123.2	YES*
Greece	5.7	9.3	4.2	109.3	NO
Denmark	2.2	6.3	(1.3)	67.0	YES
Sweden	0.9	6.5	1.9	77.4	NO
United Kingdom	2.9	7.1	2.0	52.9	NO
Reference Value	**2.6**	**8.0**	**3.0**	**60.0**	

***** Has not yet been part of the Exchange Rate Mechanism for two years. (Finnish Markka joined October 1996; Italian Lira rejoined November 1996)

Source: European Commission. Autumn 1997 Economic Forecasts.

Although Spain, Portugal and Italy met none of the reference values specified by the economic criteria during 1996, they are now expected to be participants in the first wave of monetary union on the basis of 1997 economic forecasts. However, while they are forecast to have sufficiently reduced consumer price inflation, long-term interest rates and budget deficits to each meet at least three of the criteria in 1997, there are strong doubts over the sustainability of their economic convergence programmes. Accordingly, there is concern that inclusion of these countries at the outset of monetary union may create a ‘soft’ currency. Of this group, most doubt exists over the participation of Italy due to the size of its public debt, the largest in the euro area by a considerable margin, and the temporary nature of some of the Italian Government’s measures to improve public finances. Although Italy has reduced its budget deficit to meet the reference value of 3.0% of GDP during 1997, the European Commission expects this ratio to rise to 3.7% in 1998.

Of those countries wishing to participate on 1st January 1999, Greece is by far the most unlikely to do so, as the Greek economy is clearly not sufficiently convergent with other EU economies. However, the Greek government has undertaken budgetary measures with the aim of meeting the convergence criteria and joining monetary union on 1st January 2002. Its recent admission to the ERM facilitates entry at this time.

Of the remaining EU members, the United Kingdom and Denmark have negotiated an opt-out of the first wave of monetary union, but both may choose to join beyond that date. Sweden does not have a formal opt-out, but has chosen not to participate on 1st January 1999.

In summary, a group of eleven countries is now expected to join monetary union on 1st January 1999, despite concerns regarding the participation of countries, notably Italy, with less convergent economies. It is virtually certain that Greece will be unable to meet the convergence requirements to join monetary union in 1999. These expectations are reflected in a key assumption underlying the European Commission's latest economic forecasts, which is that short term interest rate differentials with Germany are assumed to have fallen to zero by 1999 in all Member States other than the United Kingdom, Denmark, Sweden and Greece.

G The Current UK Government Position

The British economy has always had a closer cyclical relationship with that of North America than with continental Europe. Similarly, movements in the Sterling exchange rate have coincided more with factors simultaneously affecting the value of the US dollar than any European currency. Even now, after almost 25 years of membership of the European customs union, the USA is the largest single overseas market for British goods, accounting for almost 15% of exports.

Apart from reasons of principle it is this lack of synchronisation with Europe that has cautioned UK governments against wholesale support of entry into EMU. The previous UK government had a "wait and see" policy about membership. The current government is essentially taking the same stance, whilst exhorting commerce and industry to prepare for the demands of a changed currency.

In his statement to the House of Commons on October 27th last year, the UK Chancellor of the Exchequer highlighted the need for proof of sustainable convergence before Britain could adopt the euro. Five criteria in all are to be used as tests to determine if and when EMU would be appropriate for the United Kingdom:

(i) sustainable convergence between Britain and the economies of a single currency

(ii) greater flexibility – particularly in the labour market but also in respect of market competition – so as to ensure the economy will be capable of adapting to inevitable changes following the adoption of the currency

(iii) improved conditions for the attraction of inward investment

(iv) benefits to the financial services industry

(v) greater employment opportunities.

Whilst confirming that the Government would wish to take Britain into a successful EMU, membership was ruled out for the lifetime of the current Parliament – "barring some fundamental and unforeseen change in economic circumstances".

There has been a certain amount of speculation since the statement as to the earliest and most likely date when entry could come about. Clearly the decision and the timing will depend upon:

(i) whether EMU is a success

(ii) the lifetime of the current Parliament

(iii) the outcome of the next General Election

(iv) the Government's flexibility in the interpretation of convergence of business cycles

(v) the outcome of the promised referendum

(vi) the speed of completion of the practical preparations needed.

The Treasury Report which accompanied the Chancellor's statement analyses business cycles in Europe, concluding that there is likely to be some narrowing in the gap between the UK and the rest before 1999 but that the differences that would still exist would make joining EMU "risky in the period soon after that".

Whilst, assuming the United Kingdom continues to meet the Maastricht criteria (and assuming a solution to the issue of whether the UK has to be a party to the ERM prior to membership), the UK could adopt the currency when it becomes a physical entity in 2002, the consensus of opinion is that membership a few years after this date is more likely.

H **Some implications of being outside Economic and Monetary Union**

The most obvious consequence of remaining outside monetary union in 1999 is that the UK will retain national control of monetary policy. The Bank of England will not participate in the monetary union of the European System of Central Banks (ESCB), nor will it transfer any foreign reserve assets to the ECB. However, the UK will continue to be required to regard its economic policies as a matter of common concern and to co-ordinate them with the Council in accordance with Article 103(1) of the treaty. Under the Stability and Growth Pact, the UK and other non-participating Member States will be required to prepare convergence programmes before the start of Stage 3. However, the UK will not be subject to the fines and sanctions that will apply to participating states under the Pact.

The UK will continue to participate in ECOFIN and will also participate in the Economic and Financial Committee, which will replace the current Monetary Committee at the start of Stage 3. However, the UK will not be among the States able to appoint members of the Executive Council of the ECB, nor will any UK nationals be eligible to become a member. Neither will the Governor of the Bank of England be a member of the Governing Council of the ECB, although he will participate in its General Council. However, the General Council will not take part in decisions regarding ECB policy, and will merely be informed of the actions and decisions of the Governing Council.

Accordingly, while it remains outside the euro area, the UK will be unable to influence ECB policies although it will have to accept those policies when it does participate. The disadvantages of this position are highlighted by monetary policy issues such as that concerning the imposition of minimum reserve requirements. These requirements are much more likely to be implemented with the absence of the UK from the ECB Executive and Governing Councils.

The UK is also likely to be excluded from discussions within the less formal 'euro Club' of participating Member States. The Government has requested that the UK be represented at all discussions other than those that relate solely to EMU, such as discussions regarding the rates at which a Member State would enter monetary union.

Exclusion from all the bodies and decisions referred to here leaves the UK vulnerable to policies, frameworks and methods being established without consideration to UK interests. On past record however, just how much sway a UK Government would have anyway should it be out of line with the overriding consensus is open to dispute.

Being outside the starting group in monetary union will allow Britain the advantage of seeing whether the euro and its institutions are a success. This vantage point is likely to result initially in Sterling being seen as something of a safe haven. Accordingly its current, somewhat overvalued, rate against European currencies would be sustained.

I Common Issues for Business

For all businesses, there are a number of common, overarching, issues deriving from the changeover to a new currency, some of which will exist even if the pound remains. The most important of these are in respect of:

1. continuity of contracts

2. the rules for conversion of values

3. financial and accounting systems

4. staff training and customer advice

5. corporate strategy.

The European Commission has been drafting regulations to ensure continuity of contract when the euro replaces other currencies, so pre-empting the legal argument that such a change constitutes *force majeure* and provides an option for contractual and legal arrangements to be terminated. This same regulation (under Article 235 of the Maastricht Treaty) also determined the straight one-for-one swap of ECU to euros in bonds and other long-term financial contracts. The regulation applies to all EU members, irrespective of whether they adopt the euro. Whether continuity of contract following EMU is enforceable under the laws of non-EU Member States is still under review. The application of the principle of *lex monetae*, a universally accepted principle of law, should ensure the continuity of contracts in third countries' jurisdictions. Under this principle, countries may exercise sovereign power over their own currencies and no country may legislate to affect another country's currency. Applying this to the introduction of the euro, it follows that in non-EU jurisdictions which respect the principle of *lex monetae,* references to currency in contracts set up in participating states will be interpreted according to European law. Consequently, continuity of contract during the conversion of currency references to the euro is then established by virtue of Article 3 of the Article 235 Council Regulation. European Commission contact with non-EU governments indicates that *lex monetae* is followed in all main financial centres. Additionally, some jurisdictions may take legislative action to further increase legal certainty in the interests of competition. This has already occurred in some jurisdictions, such as the State of New York.

The regulation also finalised the rules on conversion and rounding. Whenever at least one party to an arrangement is in an EMU Member State conversion rates between the euro and each national currency will be adopted to six significant figures with amounts to be converted from one national currency into another after first being converted into the euro. Where an application of the conversion methods produces a "halfway" result, then the sum is to be rounded up.

Even without Britain's membership, the introduction of the euro will require companies trading with the euro area to adapt their financial systems to accept the new currency. With membership, all companies will have to convert all their financial systems – payrolling, invoicing for sales and purchases, accounts, tax reporting and returns systems – using conversion and rounding rules as are laid down. All price lists and packaging bearing the price will need reprinting.

Staff training needs will impose an additional cost on companies and will be particularly important where staff have contact with customers and/or handle significant cash sums. The strains will be particularly telling in the transition period when staff might be required to handle both the euro and Sterling. Alongside staff training, companies will need to consider their approach to advising customers on new prices, a potentially sensitive issue where conversion from Sterling to euro produces inconvenient resultant values and will probably require some further adjustment.

One inevitable effect of the euro (and indeed a fundamental reason for the initiative) will be the further opening up of national markets and therefore increased competition between suppliers. The principal reason for this is in the resultant full comparability of prices between suppliers from different countries. A related consequence will be that international companies will find it much more difficult to segment markets to facilitate price discrimination.

The comparability of prices will lend an opportunity for companies to reassess their supply contracts and possibly widen their search for suppliers. Without any currency risk to worry about suppliers from other EMU countries may now come into consideration.

The matter of "inconvenient" prices referred to above will mean some companies having to think about redesigning packaging of their product, for example, changing volume and packaging contents in order to keep stated prices below psychologically important price thresholds.

One aspect of euro price transparency yet to gain much attention, but which will be of concern at both the company and the general economy level, is of wage and salary comparability. There must be a strong possibility of "wage emulation" developing, wherein employees demand pay parity with employees in similar jobs (particularly those in the same company) elsewhere in Europe, ignoring considerations such as differences in tax and other deductions and perhaps in productivity. The implications for corporate profitability and general inflation are clear.

Isle of Man Perspective

The issues raised above will be as real for Isle of Man business as anywhere else if or when the UK becomes an EMU Member. Indeed the impact may be felt earlier, with suppliers and customer demands needing to be accommodated.

Undoubtedly a range of professional and technical service supplies will benefit from the process of switching to a new currency — advocates, accountants, computer systems providers and programmers and general business consultants.

The biggest general business impact of the euro may come through the increased competition, the greater freedom and the reduced risk in trading and investing cross border. Already, global and specifically European forces are serving to encourage corporate mergers in professional and financial services. This trend can be further enhanced by EMU. The rationalisation of these sectors on the Island can be anticipated.

J Sectoral Issues

Financial Services Sector

All financial institutions within the euro area will be affected by the framework currently being prepared at the European Monetary Institute for the implementation of monetary policy within the euro area through the ESCB. The EMI will be replaced by the European Central Bank during 1998, in order to allow the ECB to implement monetary policy from the start of Stage 3.

The primary objective of the ECB will be to maintain price stability. It must also support general economic policies without prejudice to this objective. Subject to these considerations, the ECB must define and implement monetary policy without national prejudice or political influence. Although the ECB executive board will be counterbalanced by a group of EMU Member States' finance ministers, this group will be prohibited from compromising the independence of the ECB. The ECB will also be responsible for conduct of foreign exchange operations and for the holding and management of the official foreign reserves of Member States within the euro area. While the ECB's monetary policy responsibilities will relate to the single currency area, it will also have responsibilities towards Member States initially remaining outside.

The ECB must also ensure the smooth operation of euro payments systems. There will be a number of systems for making cross-border euro payments. Existing correspondent banking payment arrangements will continue to be available and end of day net settlement will be available through the ECU Banking Association (EBA) clearing system, which will be converted to deal with euro rather than ECU payments. Real time gross settlement, where payment is guaranteed and irrevocable, will be available through access to the Trans-European Automated Real Time Gross Settlement Express Transfer (TARGET) system, the proposed euro payment system that will link national systems. If the UK chooses to participate, the current Sterling Clearing House Automated Payment Systems (CHAPS) will be amended to deal with euro payments and will be linked to TARGET. Should the UK opt out of monetary union, a CHAPS euro system will run alongside the current system to provide a link to TARGET. The charges that financial institutions will incur through cross-border transactions have not yet been finalised.

One outstanding issue in relation to the TARGET euro payments system is the question of the ECB's terms of access to intraday liquidity for central banks outside the euro area. As stated above, TARGET is a real time rather than an end of day settlement system. In TARGET therefore, banks require liquidity in order to be able to complete transactions as and when required during the day. With restricted access to intraday liquidity, banks will tend to queue outgoing payments, executing them as and when incoming payments arrive to match them. If restrictions are placed by the ECB on the central banks of countries outside the euro area, the tendency for commercial banks within these countries to queue their outgoing payments will lead to an increased need for intraday liquidity within the euro area, causing cost and inconvenience for recipient banks. The Bank of England is pressing the EMI for unrestricted access to intraday liquidity, which is seen as a necessary condition if TARGET is to function as a high volume, widely used system. It is also looking at the possibility of providing its own credit to commercial banks should access to intraday liquidity not be forthcoming.

One issue that will be of concern to UK financial institutions is the question of whether the ECB will impose minimum reserve requirements as a measure of monetary control. Under the provisions of Article 19.1 of the ESCB statute, reserve requirements (liquid assets to be held at national central banks) may be imposed on credit institutions such as banks and building societies. This provision could be amended by the EU Council to extend its application to other financial institutions. The EMI has prepared plans for reserve requirements despite opposition from some Member States. If imposed, they would be based on the liabilities normally reported by banks and would be held with the central bank of the country in which the liability arose. It would not be necessary for the required reserves to be held each day, but on average during each month. Most States only have token reserve requirements and the Bundesbank is currently the only EU central bank to insist on significant non-interest bearing reserve requirements. The Bank of England ended the practice of using reserve requirements as a monetary policy instrument some years ago. This boosted the competitiveness of banks located in the UK and attracted foreign banking business to the UK, adding to London's status as an international finance centre. Consequently, the re-imposition of minimum reserve requirements would be strongly opposed by all UK banking institutions and the Bank of England is continuing to argue against their imposition.

Financial institutions will have to be prepared to handle all aspects of the single currency by the start of Stage 3 when use of the euro in wholesale financial markets will commence and accordingly, many preparations are already in place. Clearly, due to the nature of financial services, monetary union will directly affect financial institutions in the UK and the Isle of Man whether or not the UK participates.

A large proportion of the necessary preparations for the single currency revolve around the conversion of systems to deal with the euro, either as a foreign currency or a national currency. All payment systems and processes will have to be amended to deal with changes in market conventions, reference rates, price sources and settlement and payment systems. Banks, in particular, will have to ensure that account administration systems are equipped to cope with the euro from the 1st January 1999. Although most bank customers will not require euro account services until euro notes and coins are introduced, many businesses will require euro banking facilities from the start of the transitional period. Consequently, banks will have to be capable of providing services in both Sterling and euro whether or not the UK participates in EMU. This will not be restricted to simply providing euro denominated current account facilities, but also euro loans and deposits, payment and cash management services and a variety of euro investment services. There are also numerous practical issues related to the provision of account services that banks must consider, including:

i) conversion of account balances and accrued interest

ii) conversion of regular payment instructions

iii) restatement of interest rates applicable to all current, deposit and loan accounts

iv) redesign of account statements to show euro amounts and euro/Sterling conversions

v) conversion of exception limits (e.g. credit limits)

vi) reprinting of cheques and paying-in books for euro payments

vii) re-issue of cheque guarantee cards and conversion of sum guaranteed

viii) closing/conversion of foreign currency accounts for currencies replaced by euro.

It is not yet clear what charges will be made by banks for account services during the changeover to the single currency. Current regulations do not prohibit any charges being made for currency conversions. In practice, the imposition of bank charges and the rate of charge are matters that are likely to be decided by market forces. However, most banks do intend to continue to charge for the conversion of euro area national banknotes during the transitional period. The European Commission is currently examining whether conversion charges are compatible with the euro regulations and whether or not further legislative or non-legislative action, such as the introduction of a standard of ‘good practice’, is necessary.

Banks’ customer support services must also be prepared to deal with the transition to the single currency. Many major banks are already holding seminars and meetings for their corporate customers to improve understanding of the issues related to the introduction of the euro and provide information on potential banking requirements. Should the UK participate in monetary union, the scale of customer support necessary will increase greatly, as banks will need to provide detailed information on any account changes, including explanation of conversion and rounding methods, to their customers.

Should the UK participate in EMU, banks will then also have to undertake the extensive project of converting all ATMs and other cash handling machines to deal with euro notes. Cash management during the dual currency period will be an important issue for banks, requiring the accurate judgement of customer demands for the new currency and the ability to handle large volumes of cash.

Financial institutions will also have to consider their policy on bank holiday opening. TARGET will remain open all weekdays except Christmas Day and New Year’s Day. Members of CHAPS or CHAPS euro in the UK may then wish to remain open on UK bank holidays to facilitate cross-border settlements, leading to additional staffing costs for financial institutions.

Many banks and other financial institutions are faced with reductions in income resulting from the disappearance of national currencies. In particular, the potential returns from currency dealing and interest arbitrage will be affected. The effects of monetary union are already being felt to some extent, as market expectations of the likely entrants in the first wave of EMU lead to convergence of interest rates and bond yields and convergence of currencies towards their central parities within the Exchange Rate Mechanism. A further reduction in income may result from the expected expansion of the corporate bond market within the euro area, which is likely to prompt a shift away from traditional bank loan financing towards debt issuance. It is clear that financial institutions are faced with the immediate need to re-evaluate current investment and operations strategies in order to preserve income levels regardless of whether or not the UK participates in EMU.

Investment managers will face numerous issues related to the changing nature of financial markets within the euro area and investment strategies within participating countries may have to be fundamentally reconsidered. Particular considerations include:

1. Reduced ability to control risk through geographical diversification:
   The adoption of a single currency and increasing economic convergence of Member States will severely limit the ability to control risk through geographical and currency portfolio diversification. Investment managers may have to consider geographical diversification through holdings in markets such as the Far East, North America or emerging markets.

2. Changes in the basis of stock selection:
   Currently, stock selections are typically based on country specific weightings. Specific economic sectors and stocks are then considered in light of the weight assigned to a particular country. The adoption of a single currency will necessitate a change in this method of selection, with greater emphasis required on sector or industry specifics.

3. Shift towards equities investment:
   Monetary union is expected to lead to a marked increase in equities investment throughout the euro area. In particular, with the probability of lower bond yields, a shift towards equities may be likely to uphold returns in investments such as pension funds, which have traditionally been concentrated in bonds and fixed interest investments.

4. Reduced national portfolio weightings:
   The removal of exchange rate risk will increase cross border investment activity within the euro area, as risks connected with any particular stock can be more accurately assessed. This will reduce the proportion of domestic investments currently held within portfolios. This is particularly likely to occur within pensions funds, where current solvency requirements generally require fund value to be sufficient to meet liabilities at any time. Consequently, the proportion of pensions funds invested nationally will fall with the removal of the currency risk presently associated with investment in other European securities.

5. Use of indices:
   The use of national indices, for example in the assessment of benchmarked funds or within derivatives contracts, must be reviewed. FTSE International are currently devising a series of 'Eurotop' indices, in anticipation of the need for euro area wide performance indicators. MSCI, Dow Jones, and the German, French and Swiss bourses have also announced plans for similar pan-European indices.

The issue of continuity of financial contracts must be addressed by all financial institutions. The Bank of England has suggested that the terms of the Article 235 regulation will probably mean that specific continuity clauses will not be necessary in bond contracts. However, a number of market associations consider that it may be advisable to ensure continuity of derivative transactions by way of an express contractual provision since the legal framework for the euro does not address the issue of the disappearance or replacement of reference rates. The European Commission has stated that 'it appears that contracts including reference rates will not be discontinued' since many will include a fall back clause designating a substitute rate. It also expects that most parties will be able to agree on the replacement of a reference rate with a suitable substitute to execute a contract. However, the International Swaps and Derivatives Association has drafted a continuity provision that is already being used in new derivatives contracts.

Financial institutions in the UK will continue to be regulated by the UK bodies currently supervised by the Securities and Investments Board (SIB). The SIB has set up an EMU Working Group, which is working closely with the Bank of England to consider investor protection issues and the need to ensure orderly investment markets during the transition to a single currency.

Clearly the introduction of the euro will impact upon banking capital adequacy calculations. Here, the euro and its participant currencies will be treated as the same during the transition period i.e. there will be deemed to be no exchange risk between them.

Isle of Man Perspective

Monetary union will have a significant impact on the Island's financial services industry regardless of whether or not the UK participates. Clearly the practical considerations faced by domestic banks and financial institutions in the UK will be equally applicable in the Isle of Man. Additionally, the Island's offshore finance services industry will be affected by the fundamental changes that will occur in European financial markets.

Demand for the high level of expertise and experience of international investment offered by institutions within the Island's offshore financial sector is likely to increase in light of the expected increase in equities investment throughout the euro area. However, the likelihood of reducing returns from interest arbitrage and currency dealing will require movement into new geographical and currency markets and increasing innovation in the design of a number of financial products to ensure that the Island's competitiveness as an offshore jurisdiction is retained.

The introduction of a single currency and the further liberalisation of capital movements is likely to present opportunities for the Island's financial sector. The existence of a single currency and the removal of currency exchange risks may significantly expand the expatriate client base. Presently, this is largely restricted to expatriate UK nationals, investing in Sterling denominated investment products in order to take benefits in Sterling. With the introduction of the single currency, this client base would potentially extend to include expatriate nationals of all participating Member States.

In terms of the reduction in income from European currency dealing and interest arbitrage, it must be considered that the global nature of the Island's financial sector limits its dependence upon European markets and consequently the magnitude of such effects will be limited.

As noted, whether minimum reserve requirements are ever used as a tool of European monetary policy is still to be seen. If introduced, the requirement would not extend to Island banks, who would therefore be provided with a competitive advantage vis-a-vis EU banks.

Retail Sector

The retail sector will play a central role in the introduction of the single currency and extensive preparations in this sector are essential to consumer acceptance of the euro. Retailers face numerous practical issues related to the introduction of the single currency, with the issue of dual pricing perhaps being seen as the most expensive and burdensome, particularly for smaller retailers. Clearly some form of price conversion information must be provided for consumers, but it is undecided whether dual pricing will be made mandatory and, if so, whether any legislation should be imposed at EU or national level. Retailers are not in favour of a legal obligation for dual pricing, with concern that it would be an excessive burden as it would be implemented shortly after the introduction of the EU directive on unit pricing. This would mean that at least four prices would have to be displayed for each item during the dual currency period.

However, in the face of competition, dual pricing is likely to be widely implemented, as retailers must aim to ensure that they retain consumer confidence. The conversion rate from Sterling to euro will not be simple and retailers will have to deal with consumers' concerns over the maintenance of purchasing power and the reliability of price conversions. Consumers will need to adopt new reference values and will have to come to terms with new psychological price thresholds, perhaps involving changes in package volumes to maintain particular threshold prices. The confusion likely to result from a change in currency will necessitate comprehensive staff training to enable staff to answer customers' queries and address their concerns.

Price conversions will also be a difficult issue for retailers. As many items are priced either in terms of whole units, such as whole pounds, or at a psychological threshold values, the conversion from Sterling to euro will generally result in an unsuitable price that must either be rounded up or down. In some cases it will be possible for package volume to be altered, precluding the need for price rounding. However, for many items this will not be possible and retailers will be faced with the choice of rounding prices up or down. The ability to round prices up will be restricted, both by competition and by the need to retain consumer confidence. With the experience of decimalisation, many consumers will be extremely distrustful of price conversions. However, the ability to round prices down is also limited due to its effects on profit margins.

A further complication for retailers is handling of both Sterling and euro cash during the dual currency period. The circulation of both currencies will substantially increase the volumes of notes and coins handled by retailers. It may be necessary for retailers to operate dual currency tills, or use both Sterling and euro tills. Difficulties for both staff and consumers are likely to increase the length of time taken to pay for goods and increase staffing costs. These costs may be reduced by larger retailers with a number of checkout points, who may operate a number of euro-only or Sterling-only tills in addition to dual currency tills in order to speed up payment. However, this will not be possible for small retailers, who are likely to be most adversely affected by the dual currency period. The burden on larger retailers may also be alleviated to some extent by the use of non-cash payment systems. International credit card schemes such as VISA and Mastercard have already confirmed that they will be capable of catering for euro payments from January 1999. SWITCH, the UK's debit card scheme, is also working to meet this date.

The new euro cash itself may also cause some confusion for consumers, adding to retailers difficulties. The 10 euro is similar in size to the £1 note, the 20 euro note is similar to the £5 note and the 50 euro and £10 notes are of similar size. The euro coins will all be unfamiliar and some consumers may find it difficult to distinguish between some denominations. In addition to identifying euro notes and coins correctly, consumers will take some time to become familiar with the new set of euro values. If the current Sterling:ECU conversion rate is taken as an approximation of the Sterling:euro rate for illustrative purposes, the 10 euro note equates to roughly £6.75. Some of the smaller coin denominations will have very little value for consumers normally used to Sterling denominations. Using the same illustrative exchange rate, the 1 cent coin is worth slightly less than ¾ of one penny and the 20 cent coin is worth just over 13½ pence.

While increased price transparency will tend to exert pressure on retailers to reduce prices, it will also tend to reduce supply costs, as wholesale prices will become equally comparable. Additionally, the price volatility of many imported supplies will reduce as costs will cease to be dependent on exchange rates. Mail order retailers and other intermediaries are particularly well placed to take advantage of increased price transparency.

An additional issue is the conversion of vending machines. All vending machines will have to be reprogrammed or converted to accept euro coins. The main problem for operators is planning of the timetable for conversion. Conversion which is either too early or too late will cause loss of revenue. Clearly, it would be physically impossible for all machines to be converted concurrently with the issue of euro coins, so conversions must be staged in order to minimise the losses incurred.

Of prime concern to retailers is the timetable agreed in the Maastricht Treaty. The 1st January date chosen for the issue of euro notes and coin is possibly the worst time of year for retailers as it coincides with January sales. The European Commission Round Table meeting in May of this year rejected this date in favour of either Autumn 2001 or February 2002. Additionally, the length of the dual currency period was viewed to be too long, with a dual circulation period of only a few weeks preferred. In particular, if euro notes and coins were to be issued in Autumn 2001 to avoid the 1st January date, retailers would hope that national currencies were withdrawn before Christmas 2001 at the latest. Despite these considerations, ECOFIN has retained the 1st January 2002 as its preferred issue date.

Isle of Man Perspective

The introduction of a single currency will present numerous difficulties for the many small, local businesses within the Island's retail sector. The burden of dual pricing will cause upward pressure on costs while price competition from larger retailers is likely to increase, as they in turn face downward pressure on prices through increased price transparency and reduced scope for price discrimination. Small retailers will also face increased competition from larger stores due to the impact of the currency changeover on consumers. While larger retailers will have sufficient resources to retain consumer confidence through the conduct of comprehensive information campaigns, smaller retailers will be unable to do so.

An interesting possibility is of the Isle of Man retail industry making an early move into dual pricing should some of its members decide to dual price to facilitate the requirements of visitors from the Republic of Ireland.

One particular local 'retailing' sector for whom currency changeover will bring a number of problems is the gaming machine and amusement arcade sector. All machines will need adjusting, and decisions will need to be made on the standard coin (and hence charge) to be used for machine operating.

Manufacturing

All manufacturers trading with markets within the euro area will be affected to some extent by monetary union. One issue that will be of utmost concern to manufacturers is the irrevocably set rate at which Sterling would enter monetary union. Many manufacturers fear that the Sterling rate could be set at too high a level, causing a severe competitive disadvantage. With the removal of exchange rate variability, competitiveness could only be restored via price adjustments, requiring improvements in productivity and restraints on wage levels.

Additionally, competition will increase throughout the euro area with price transparency allowing cross-border price comparisons to be easily made. Moreover, increased price transparency will be accompanied by increased comparability of wage levels throughout the euro area. Employees' attempts to match wages without reference to differences in labour productivity will cause further pressures on manufacturers.

It will be essential for manufacturers trading within Europe to review business and marketing strategies to reflect the fundamental changes in the European market. Pricing policies must be reviewed to reflect both increased competition and the reduced ability to implement price discrimination. Supply contracts must also be reconsidered, as existing arrangements may cease to be cost efficient. Movement towards harmonisation of prices will inevitably result in non-price factors becoming an essential element within marketing strategies.

Manufacturing investment is particularly sensitive to interest rate levels and stability. Of all economic sectors therefore manufacturing stands to benefit most if the euro does produce lower interest rates.

Isle of Man Perspective

If EMU fosters investment then there is no reason why the Island's manufacturing sector would not share in the benefits. Indeed, to the extent that the removal of currency considerations serves to focus investors sights even more on tax advantages then the Island could be seen as increasingly attractive as a manufacturing base. It could be argued to be in a unique position for manufacturers: a user of the euro, within the EU common external tariff (because of Protocol 3), without trade barriers (because of the Customs Agreement with the UK) and with low corporate tax rates.

Accordingly, while the mobility of capital will be enhanced by monetary union, leading to increasing competition to attract new investment throughout Europe, prospects for new manufacturing investment in the Isle of Man should not be adversely affected and could be enhanced.

The Island's manufacturing sector trades heavily with the UK and the UK is historically the Island's main source of manufacturing investment. Consequently, remaining outside the common currency area will not significantly disadvantage the Island's manufacturing industry; unless, of course, UK industry itself suffers economic disadvantage as a consequence of non-participation.

Tourism

Although monetary union will remove the cost and inconvenience of currency exchange for tourists travelling within the euro area, this is not likely to have any significant net effect on tourism in Britain. While the removal of exchange costs may attract more tourists from within the euro area it will also increase the propensity of UK residents to visit holiday resorts outside the UK. Additionally, the prices of package holidays within the euro area are not expected to be affected significantly. Although travel industry costs are likely to fall to some extent due to the removal of exchange rate risk and hedging costs, income will also fall by a much larger proportion due to the removal of currency exchange business.

Isle of Man Perspective

Monetary union is unlikely to have any significant impact on the Isle of Man's tourist industry as only a small proportion of tourists visiting the Island each year are resident in European countries outside the UK. Although monetary union would possibly enhance the ability to market the Island within Europe, any consequent increase in European visitors would be offset by the diversion of UK resident tourists from the Isle of Man to European resorts.

With the UK unlikely to be in EMU at the commencement of the circulation of euro notes and coins, Irish visitors will, for the first time, be using a currency very different from their own. This is however unlikely to deter Irish visitors. It could even produce a situation where local shops begin to show prices in both Sterling and the euro, for the benefit of Irish visitors.

Agriculture

Monetary union will have implications for farmers in the UK through its effects on the agrimonetary measures currently applied under the Common Agricultural Policy (CAP). The current regime involves the use of "green rates" to convert CAP payments from ECU to national currencies, limiting the effects of national currency appreciation on farmers' incomes. Currently green rates are frozen in 10 Member States, including the UK.

In May/June 1998, the European Commission is due to make proposals for the changes to the current system necessitated by the introduction of a single currency. The Agriculture Council will then make decisions on the basis of these proposals before the end of 1998. Undoubtedly, there will be a radical overhaul of the current system, as current measures to deal with ECU/national currency conversions will become redundant in those countries participating in monetary union.

Since the UK will not be participating in the first wave of monetary union, UK farmers will continue to require measures to convert euro CAP payments to Sterling. However, current measures to protect the value of CAP payments, such as the freeze in green rates, will cease at the end of 1998. This will represent a large cost to UK agriculture, where the freezing of green rates has been estimated to have benefited farmers by approximately £400 million over two years. Additionally, the UK agricultural sector will face uncertainty over the scale of adjustment that will be faced due to the dismantling of the system of green rates, as it will be directly related to the movement of Sterling exchange rates during 1998.

Isle of Man Perspective

A Tynwald resolution establishes that levels of support to Manx agriculture should be maintained "on a similar basis" to those in the UK. Accordingly, the Isle of Man Government will review its support to Manx agriculture in response to any reform in CAP in order to try and prevent the Island's farmers being disadvantaged against their competitors.

K <u>Government Issues</u>

The Isle of Man Government is presently planning to ensure that necessary preparations will be in place for the eventuality of a single currency, irrespective of whether the UK participates in monetary union in 1999. There are numerous areas in which the Isle of Man Government must prepare for the changeover to a single currency. While it would be necessary for some preparations to be in place during a transitional period, many would not need to be implemented before the introduction of euro notes and coins.

1. Notes and Coins

   One of the most obvious points to be addressed by Government is the issue of new notes and coins. If the UK joins monetary union and Sterling is replaced by the euro, the Isle of Man will retain the right to issue its own currency. The provisions of the Currency Act 1992 would allow the Island to issue a new Manx currency which would be a 'substitute Euro', similar to the 'substitute Sterling' currently issued. The Government has been active in its preparations for a new currency as the retention of the Island's own currency through issue of the Manx euro has two significant advantages:

(i) It provides a positive public statement of independence for the Island; and

(ii) It allows for the continuation of the accrual of investment income from the issue of Manx notes and coins.

While it will clearly be necessary for the technical specifications of notes and coins to be the same as other euro issues, the Island is preparing its own designs for Manx euro notes and coins. It is planned that all eight coin denominations will be issued, with the smallest denomination being 1 cent (one hundredth of a euro) and the largest being 2 euros. It is initially planned to issue six of the full range of seven note denominations, from a value of 5 euros up to 200 euros. It is not currently envisaged that there will be sufficient local demand to warrant production of a 500 euro note, although this denomination could be issued at a later time.

2. Receipt of Payments

Treasury has already taken steps to amend Government's internal accounting arrangements so that in many cases it will be possible for payments to Government (including tax settlements) to be made in euros (Eurocheques and bank transfers; notes and coins from 2002). Government has already opened its own euro denominated account. It is intended that the Treasury's Finance Division will set a daily Government exchange rate for the euro.

3. Information & Education

A key issue for Government will be the question of consumer and business information. The Government has an essential role in the provision of public education, as changes in the services provided by Government will affect virtually all of the Island's residents. The majority of public information about the process of changing to a single currency will originate from the UK Government. However, the Isle of Man Government will be responsible for the provision of information for the Island's residents on the way in which the changeover will be managed as regards benefits, taxation, etc.

General business information and technical financial information is already being issued by UK institutions such as the Bank of England and the Confederation of British Industry. The Isle of Man Government will be prepared to provide specific information for the Island's businesses on requirements related to issues such as taxation or legislation. However, in a statement to Tynwald on 21st October 1997, the Chief Minister noted that the Isle of Man Government will not be in a position to provide financial assistance for the necessary business preparations for the single currency.

When developing an information and education strategy, Government will issue its own public information literature, based on that published by the UK Government. It is also likely that Government would wish to organise seminars with respect to the provision of business and consumer information. It is intended that a Single Currency Advice Office will also be established at an appropriate time as a central point for the provision of information and assistance.

4. Taxation

The changeover to a new currency will require the Treasury to convert the basis of all tax assessments and payments from Sterling to euro. The most obvious problem with this is the date of the currency changeover, which is aligned with the calendar year rather than the taxation year and may require a dual currency return to be submitted during at least one year.

A further point that must be considered is whether or not it will be necessary to offer a choice of taxation currency during a transitional period. A similar question concerns the filing of annual accounts. In compliance with the principle of ‘no compulsion/no prohibition’, some governments are planning to allow taxpayers to submit returns for tax years beginning on or after 1st April 1999 in either national currency or euro. Demand for this facility is likely to be limited to larger companies, as individuals and smaller businesses will be unlikely to use the euro until notes and coins are introduced.

5. Benefit Payments

All benefit payments must be converted into euro amounts when the new currency is issued. It will also be necessary to accompany any changes in benefits with comprehensive advice and information.

6. Legislation

There are numerous legislative issues that must be addressed if a single currency is to be implemented. In particular, all references to monetary amounts must be considered and provisions must be made to ensure that continuity of contract is upheld.

The Government intends to ensure that necessary legislation will be introduced to make provision for all changes required in Manx Law to facilitate the introduction of a single currency, if necessary. The legislative amendments necessary will be effected by the Monetary Union Bill, which is proposed for introduction during the 1998/99 legislative programme.

7. Financial Statistics

The introduction of a single currency will require the conversion of all budgetary, financial and economic statistics issued by Government. The presentation of such statistics both before and after a currency changeover will have to be considered. It may be necessary to publish financial or monetary information in terms of both Sterling and euro for a period both before and after the changeover in order to provide reference values for converted amounts.

8. Information Systems

Ensuring that all systems meet the necessary requirements to deal with the changeover to a single currency will be a large scale task that must be undertaken throughout all Government Departments. The problems associated with this task are compounded by the possible proximity of monetary union with the Year 2000 and its own set of computer issues. Treasury’s Information Systems Division is leading this work.

9. Expenditure and Resources

As revenue expenditure plans are formulated on a three year basis, Treasury will be asking Departments to begin considering the cost of preparations for monetary union. These preparations will represent an additional call on resources at a time when expenditure is necessary to ensure year 2000 compliance. While a large proportion of costs will be related to systems amendment, particular Departments might face other costs, e.g.:

i) replacement of all mathematics texts in schools and the IOM College

ii) replacement/conversion of all cash tills throughout Government

iii) editing and reprinting of all documents, forms and literature containing references to monetary amounts

L Post EMU

For reasons already noted to do with operating a single monetary policy across a diverse range of economies, there are likely to be tensions and stresses within EMU, particularly if initial membership is wide. Whilst a core, including France, Germany, Austria and the Benelux countries, have a history of financial discipline and of following Bundesbank policy, the fringe members have no such record. The Stability and Growth Pact is designed to reign in these nations and impose financial discipline. The Pact seeks to ensure that the 3% public sector borrowing-to-GDP ratio is maintained after EMU, and backs this up with a detailed monitoring and budgetary surveillance procedure and a system of fines for transgressors. Clearly this has the potential to exacerbate pressure on individual nations, imposing an extra financial burden at a time when control of public finances is already becoming difficult. Whilst the fines are not automatic and can be held back in defined circumstances there is still the risk of a country specific "shock" having an even greater destabilising effect as a direct consequence of the financial penalty.

Once inside EMU it is difficult on practical grounds to see how a member could revert to its previous currency. Proponents of EMU maintain that over time any conflicts of interest amongst members will be ameliorated through convergence, itself accelerated through the common monetary policy and budget discipline. Sceptics expect a gradual build up of dissatisfaction in certain Member States and anticipate, as a consequence, a softening of monetary policy to defuse tensions. In defusing internal pressures, the likelihood would be increased pressure on the external value of the euro. If policy is not softened and a Member Government becomes heavily indebted then, despite the terms of the Stability Pact, the pressure for the country to be bailed out would become intense. It is the difficulty of holding the line under EMU that leads many to conclude that EMU can only work indefinitely within political union.

Aside from further political integration what else might be on the EU agenda for the future? There is of course the expansion of the EU, with Estonia, Hungary, Poland, Slovenia, Cyprus and the Czech Republic in the first wave of prospective new entrants. Expansion will bring with it a whole new range of issues, from voting rights to funding.

The next "natural" issue for the European integrationists to focus on is direct taxation. There is already a strong body of opinion within the European Commission that views differential corporate and capital taxation between Member States as a distortion within the Single Market, and more recently this has been linked to concerns over future tax revenues.

M Treasury EMU Working Party

Objectives

The Treasury EMU Working Party was established with a number of objectives:

i) to assess the practical issues faced by the Isle of Man Government and the Island's business and financial community;

ii) to determine the role of the Government in providing information to the general public and business on the implications of the transition to a single currency; and

iii) to identify a strategy for public education and information.

Review of work to date

In line with these objectives, the Working Party has undertaken a number of activities during 1997. Local businesses were initially made aware of the existence of the Working Party early in the year, through the Treasury's consultative committees. The Working Party invited businesses to submit views on a number of considerations, including:

1. Awareness of monetary union.

2. The likely scale of preparations for monetary union.

3. The role of business and the Isle of Man Government in providing advice for customers on the single currency.

Views on the above points, and others, have been supplied by a number of businesses, providing a useful basis for consideration of the practical issues to be faced by the Island's business and financial community.

One of the central responsibilities of the Working Party is to ensure that all areas of Government are aware of the implications of the single currency. In order to disseminate information regarding practical issues likely to be faced, newsletters have been periodically issued to all Government Departments and Boards by the Working Party. Individual Departments have also been contacted in order to identify and address specific issues raised by the introduction of the single currency.

Departmental responses to the Working Party have identified a number of key issues. In particular, systems amendment has been identified as a major practical issue throughout Government. Almost all Government Departments will require amendments to computer systems in order to deal with a single currency. As a result, all systems and electronic equipment holding monetary data are currently being identified by a Treasury audit of all items of computer and electronic equipment throughout Government.

What Next?

The main tasks of the Working Party have now been completed, with the majority of the initial research having been carried out. The results of this work are incorporated in this paper. With current uncertainty over UK entry into monetary union and the indeterminate timetable for possible UK participation, the Working Party is continuing to monitor any developments and advise Government Departments of such developments through the issue of updated newsletters. It is also passing on information to enquirers from local businesses.

Abbreviations/Acronyms

ATM	Automated Teller Machine
CAP	Common Agricultural Policy
CHAPS	Clearing House Automated Payment Systems
EBA	Euro Banking Association
ECB	European Central Bank
ECOFIN	Council of Economic and Finance Ministers
ECU	European Currency Unit
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EU	European Union
GDP	Gross Domestic Product
TARGET	Trans-European Automated Real Time Gross Settlement Express Transfer