The City and EMU

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The City of London's leading position in international financial markets is the basis of its central role in the UK economy in terms of its contribution to UK GDP and tax revenue and the City's own balance of payments surplus.[1] The City's prosperity has long been associated with its international role and openness to foreign business, as illustrated eight centuries ago by the Magna Carta.[2]

Clearly the development of the UK's relations with the rest of Europe plays a critical role in the fortunes of the City. Over the past 40 years, that relationship has embraced membership of the European Economic Community (EEC), the evolution of the single market for financial services, and economic and monetary union (EMU). Tensions that arose in each of those phases in the relationship have resurfaced in the current financial and sovereign debt crisis.

Following President de Gaulle's rejection of British bids to join the EEC, his successor Georges Pompidou finally agreed in principle to UK entry at the 1969 Hague summit meeting of heads of state and government, but only on condition that a number of policies were adopted by the original six first. Pompidou's stance was to press for 'completing, deepening and only then widening' the EEC. 'Completing' meant establishing a Community funding structure that favoured France but not the UK, an issue that dogs relations to this day. 'Deepening' involved establishing a road map towards EMU (as well as a common foreign policy)—now the source of today's political and economic turmoil. 'Widening' meant enlargement to include Denmark, Ireland, Norway (which eventually opted not to join) and the UK, the latter's commitment to and membership of European institutions being almost continuously contentious.

In the event the UK joined the EEC in 1973, and it was anticipated that membership would enhance the City's ability to do business with Europe. This view was greatly strengthened by the prospect of a single market for financial services by

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[1] For details see e.g. 'London's place in the UK economy 2009–10', report published by the City of London, October 2009, http://217.154.230.218/NR/rdonlyres/E6EFAB4A-12FA-46FA-BA95-AC7A8C47B8B4/0/LPUK_200910.pdf2, accessed 21 Sept. 2012.

[2] 'All merchants shall have safe and secure entry into, and exit from, England, with the right to tarry and move about … for buying and selling … save in time of war …' This clause was almost certainly inserted as a result of City lobbying.

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1992, to be based on principles supported by the City. The single market was widely expected to improve the City's access to the European market and to strengthen the City's global role by increasing its ability to attract overseas firms from the Continent and further afield.

But now the single market's regulatory and supervisory framework, under which City opportunities in Europe were enhanced, is at risk of being rewritten by those who never fully accepted the principles on which the single market in financial services was originally based. At the same time the City has been under attack at home as well as abroad because of the liberal regulatory regime that contributed to its past success but also left the way open to financial irresponsibility, and its central economic role is accused of unbalancing the UK economy.

Moreover, the fears about Britain's sovereignty which were present when the December 1969 Hague summit agreed to open negotiations for British accession to the EEC have resurfaced, with some seeing a trade-off between sovereignty and some sacrifice of it to maintain access to (and influence on) the single market.

This article considers the following issues:

- views in the City about the pros and cons of EMU and UK entry;
- differences in the respective regulatory/supervisory philosophies of the City and the eurozone;
- the City's contribution to the practical implementation of the euro;
- the current dilemma: sovereignty or the single market?

City views on the pros and cons of UK entry

Opinions were divided on both whether or not EMU was in principle desirable for Europe and whether or not the UK should participate. A memorandum submitted by Barclays Bank to the 1990 House of Lords inquiry into EMU categorically stated: 'Barclays wholeheartedly supports the concept of monetary union.'[3] The written evidence to the same inquiry from the chairman of National Westminster Bank argued that a European single market would be difficult to achieve so long as currency differences existed because of the cost of cross-border transactions, although it also emphasized that 'substantial regulatory barriers persist and are likely to do so for some time'.[4]

Probably the most enthusiastic City support for EMU was that expressed by the chief economist to Lloyds Bank, Christopher Johnson. He strongly argued that EMU would remove currency volatility among participating economies by replacing separate national currencies and eliminate the cost of doing business across borders in different currencies; that a politically independent, strong European Central Bank (ECB) would reduce inflation across the single currency area, and that its monetary discipline would reduce interest rates among countries prone to an interest premium. These benefits would enhance the single market,

[3] House of Lords, Select Committee on the European Communities, Session 1989–90, *Economic and monetary union and political union* (London: HMSO, Oct. 1990), written evidence.

[4] House of Lords, Select Committee on the European Communities, Session 1989–90, *Economic and monetary union and political union*, Oct. 1990, written evidence by Lord Alexander of Weedon.

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induce more efficient allocation of resources, stimulate investment and lead to faster economic growth.[5]

Others were sceptical or downright hostile. They argued that a single monetary policy, and hence a single interest rate, for economies with disparate economic, financial and labour market structures, and different cyclical behaviour, was a recipe for disaster in the absence of a central fiscal authority to transfer resources to economies in need of help. For example, Tim Congdon of Lombard Street Research wrote: 'What would happen in the event of a crisis? There is no central government … national governments would refuse to bail out European banks … Monetary union can work with political union. And without political union, monetary union will fail.'[6] Likewise David Lascelles: 'Before too long … the unequal performance of participating countries will open up fissures and create strains that will drive monetary union to crisis point'—leading to either EMU breakup or the creation of a central treasury and centralization of taxation and financial supervision,[7] both of which were anathema to the sceptics.

(It should be noted that the issue of fiscal transfers had not been entirely ignored by the European Commission. A committee of eminent European economists chaired by Sir Donald MacDougall, former chief economist at HM Treasury, had been appointed to examine the question; in 1977 it produced a report for the Commission which demonstrated that fiscal transfers would be an essential condition for successful European integration.[8] But because of concern on the part of the Commissioner for economic and monetary affairs,[9] to whom the report was initially addressed, over weak financial management of the Community budget, the College of Commissioners never considered its findings.)

In essence, the dispute was over the question of whether or not the EU (or at least those countries which met the Maastricht inflation and fiscal deficit criteria) represented an optimum currency area.[10] If it did not, asymmetric economic shocks would be better managed by countries having freely floating exchange rates rather than locked rates or a single currency. The criteria for an optimum currency area are similar business cycles, free movement of labour and capital across borders, wage flexibility, and automatic fiscal transfers to stabilize economies. The sceptics claimed that these conditions were not met, but Johnson replied: 'The single market set out, in effect, to make the EU into an optimum currency area … To ask whether the EU is an optimum currency area is short sighted'—because it was in the course of becoming one.[11]

In short, the City sceptics stressed that EMU should not start unless and until all participants formed an optimum currency area because of the risks, whereas the

[5] Christopher Johnson, *In with the euro, out with the pound* (London: Penguin, 1996).
[6] Tim Congdon, *Lombard Street Research Monthly Report*, May 1998.
[7] David Lascelles, *Confidence in the City outside the euro* (London: New Europe, 1999).
[8] European Commission, *Report of the study group on the role of public finance in European integration*, Economic and Financial Series no. A 13 (Brussels, 1977).
[9] Private conversation.
[10] The concept derives from the reasoning of Robert Mundell, especially his paper 'A theory of optimum currency areas', *American Economic Review* 51: 4, 1961, pp. 657–65.
[11] Johnson, *In with the euro*.

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enthusiasts, by claiming the single market enhanced by EMU would eventually become an optimum currency area, sidestepped the problem of what would happen in a crisis within EMU before those optimum conditions came into existence.

The above division of opinion was reflected in the contrary views on UK membership of the common currency. City people sharing the Congdon/Lascelles viewpoint were hostile to UK membership, believing that the inevitable crisis they anticipated in the EMU area would lead either to its breakup or to the establishment of centralized fiscal and financial supervisory control, to the detriment of the City's competitiveness, accompanied by the end of UK political sovereignty. The advocates of UK membership, while arguing that these threats were exaggerated, were concerned about the risk that the UK would forfeit influence in the evolution of financial regulation and supervision by remaining outside the euro bloc.

As Johnson reported of a survey of City opinion:

> The EMU City Survey … by the OMLX Securities and Derivatives exchange found that 89 per cent of City managers thought a two speed EMU was most likely … Thirty five per cent thought the UK should be in the first tier and 59 per cent that it should not. Thirty eight per cent thought it would mean an increase in business for the City, 32 per cent that it would mean a decline, and 25 per cent that it would have no effect.[12]

As indicated above, a key issue for all was City competitiveness, including UK influence on financial regulation in Europe, and here again City opinions were divided. The EU legislation relevant to the single market in financial services is adopted by qualified majority voting, so there is no possibility of a UK veto; it is all down to negotiation and alliances. So the question was whether or not the UK's prospects of persuading a majority to support proposals beneficial to the City (or a blocking minority sufficient to ensure the rejection of any that threatened City competitiveness) would be at risk if the country were to stay outside EMU. The fear that the UK would lose influence by staying out was expressed in the evidence to the 1990 House of Lords inquiry given by the chairman of NatWest, Lord Alexander,[13] and by many others, including Johnson.[14] The sceptics argued that the risk of EU legislation likely or intended to damage the City being passed if the UK were outside EMU was 'absurd' as it would be discriminatory and contravene the single market.[15] The issue was revisited in the inquiry by the 2002 Commons Treasury Select Committee.[16] Lascelles reiterated his belief that discrimination against the City was most unlikely, whereas Michael Rake, head of KPMG and later deputy chairman of Barclays, stressed the risk of regulatory threat were the UK outside EMU.[17] The inquiry commented that the Corporation of London

[12] Johnson, *In with the euro*.

[13] House of Lords European Union Committee, *Economic and monetary union and political union*, Oct. 1990, written evidence by Lord Alexander of Weedon.

[14] House of Lords European Union Committee, *Economic and monetary union and political union*, Oct. 1990, written evidence by Lord Alexander of Weedon.

[15] See e.g. Lascelles, *Confidence in the City*.

[16] House of Commons, Treasury Select Committee, *The UK and the euro*, 6th Report, Session 2002–03 (Norwich: The Stationery Office, 23 April 2003).

[17] House of Commons, Treasury Select Committee, *The UK and the euro*, para. 89.

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itself had organized a survey which demonstrated 'the low ranking of the euro membership issue as a factor affecting the location of banking activity … UK membership is well down the list' of potential threats to the City.[18]

The issue of regulatory threat was an instance of the more general question of the impact on City competitiveness of EMU. EMU enthusiasts claimed that membership would enhance the global role of the City: 'The City could increase its dominance as a world financial centre by becoming the main marketplace for all single currency markets: money, foreign exchange, banking, derivatives and insurance. If the UK does not join the City will lose much of the share it might have had to continental financial centres in the single currency area.'[19] In contrast, sceptics stressed the attractive characteristics of the City, which would remain, in or out: openness to foreigners, and its unrivalled critical mass of markets, skills and support services.[20]

The issue was re-examined by HM Treasury in its 2003 report *UK membership of the single currency: an assessment of the five economic tests*.[21] It pointed out that in the four years since the start of EMU the City had attracted significant wholesale financial market business and would remain strong inside or outside EMU. But it also suggested that 'entry would offer greater potential to compete and capture the effects of greater EU integration that would arise from the single currency and other efforts to complete the Single Market'. As for influence within the EU, it concluded: 'The UK's influence over EU financial services policy should remain strong whether inside or outside.'[22] The question whether or not such a conclusion remains plausible today is picked up in the concluding part of this article.

Differences in regulatory/supervisory philosophy between the UK and the eurozone[23]

The issue of the potential effects of the UK's absence from EMU on its ability to influence EU legislation with an impact on the City arises because of concern about threats to City competitiveness resulting from a mixture of jealousy in continental financial centres[24] and genuine differences in the philosophy of regulation and supervision between the UK and most EMU members, especially most of the largest. Jealousy of and hostility towards City wholesale markets have been exacerbated by the financial crisis, which is sometimes attributed to the misdemeanours of 'Anglo-Saxon' capitalism.[25]

[18] House of Commons, Treasury Select Committee, *The UK and the euro*, para. 90, quoting Corporation of London, 'The impact on the City of UK Eurozone membership', Dec. 2002.
[19] Johnson, *In with the euro*.
[20] Lascelles, *Confidence in the City*.
[21] HM Treasury, *UK membership of the single currency: an assessment of the five economic tests*, Cm 5776 (London, June 2003).
[22] HM Treasury, *UK membership of the single currency*.
[23] HM Treasury, *UK membership of the single currency*.
[24] Not least because much if not all of the global business of their domestic banks is done in the City.
[25] For pre-single market examples of attacks on 'casino' finance, see Story and Walter, *Political economy of financial integration in Europe*, which explores this theme at length. For former French president Sarkozy's more recent denunciation of 'speculators', see 'French anger at speculators', *Financial Times*, 3 Feb. 2011.

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Although EMU was supposed to start only when the single market was complete, the fact is that in 1999, when EMU came into effect, numerous impediments to cross-border competition in financial services remained, arising from the maintenance of protectionist measures, national subsidies, failure by the Commission to enforce existing legislation, loopholes in key directives allowing countries to impede competition on grounds of 'the general interest' (whose?), discriminatory taxation and gaps in the coverage of the legislation. Some of the impediments were directed at the City and are considered below.[26]

The original single market principles for financial services were minimum harmonization, mutual recognition among national authorities, and home country supervision enabling a single 'passport' to establish branches (rather than locally authorized subsidiaries) and to sell throughout the EU whatever was authorized at home. The City interpreted this to mean freedom to raise and invest funds throughout the EU, freedom to compete in all countries without a local presence if an institution so chose, freedom to compete and to innovate, and an EU-wide market for company ownership.[27] It also favoured a regulatory regime based on judgement rather than 'box ticking' rules, and an approach which said 'anything is allowed if not explicitly forbidden' as opposed to saying 'nothing is allowed unless expressly permitted'. It also incorporated the optimistic belief that professional investors, especially the major wholesale market operators, needed only relatively light regulation, being large enough and expert enough to understand and manage the risks they faced sufficiently well themselves. The City philosophy tended to dominate EU legislation until the crisis; but it does so no longer.

The City's philosophy was never wholly accepted by many EMU states, especially most of the largest. Several disputes arose: examples include the French ban on Barclays France's payment of interest on current accounts (on grounds of 'monetary policy' and 'the general interest'), and French attempts to weaken if not destroy the international business of the London Stock Exchange through the insertion of damaging clauses in the Investment Services Directive[28] (which were defeated, mainly as a result of an Anglo-German deal). The appointment of a Frenchman, Michel Barnier, to the crucial post of Commissioner responsible for financial services in 2009 caused considerable disquiet, although he went out of his way to try to reassure the City that he had no hostile agenda.

Later, with specific relevance to the UK's self-exclusion from EMU, came the Bundesbank's attempt to exclude the Bank of England (BoE) from the TARGET euro liquidity system and the German finance ministry's insistence that the regulation guaranteeing continuity of financial contracts when national currencies were replaced would not apply outside the eurozone. Both positions were claimed to be reasonable as the euro was not, after all, the UK's currency—but either measure

[26] Fuller details can be found elsewhere. See e.g. Malcolm Levitt and Rodney Lord, 'EMU and the single market for financial services', in Levitt and Lord, *The political economy of monetary union* (London: Macmillan, 2000), pp. 175–84; also Malcolm Levitt, *Economic and monetary union Stage III: the issues for banks* (London: Centre for the Study of Financial Innovation, 1995).

[27] See City of London, *Creating a single market for financial services* (London, 2002).

[28] See Benn Steil, *The European equity markets: the state of the Union and an agenda for the millenium* (London: The Royal Institute of International Affairs and European Capital Markets Institute, 1996).

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could have had a devastating impact on the City.[29] The Governor of the BoE eventually persuaded the presidents of EMU central banks that City exclusion from TARGET would damage the euro, and the issue of legal certainty in the City was overcome when the Commission adopted a second regulation (partly for similar reasoning but also out of goodwill).[30]

The key feature of the City is its global role, including the presence of many non-EU firms. During the negotiations over the crucial 1989 Second Banking Directive this openness was threatened by the French demand (born out of fear of the presence of powerful non-EU banks in London) for a reciprocity clause which, as initially proposed, would have damaged the City's openness. This attempt did not command sufficient support from other countries or from the Commission to succeed.[31]

Regulatory philosophy apart, another contrast between the City and eurozone viewpoints is that because the City is a uniquely global market, it always assesses EU tax and regulatory proposals with that in mind, lest they threaten its global competitiveness and drive business offshore—to which the response nowadays can be 'good riddance'.[32]

Now some of the earlier battles are being refought. For example, the ECB is insisting that clearing of euro-denominated transactions must be done within the eurozone; many in the City see this as an attempt to repatriate business to Frankfurt and Paris, and it is being challenged in the European Court of Justice by the Treasury. The issue of third-country access has been reopened in the negotiations over the proposed directive on 'alternative investment funds'. That proposed directive targets in particular hedge funds and private equity, neither of which was a major cause of the financial crisis but which were and are targets of considerable hostility in some countries, including France and Germany.[33]

However, in contrasting the UK and the predominant continental regulatory philosophy, it is essential to note that the UK has abandoned its 'light touch' approach: the structure of regulation and supervision is being strengthened; the threat of contagion from casino banking to high street banking and taxpayer bail-out is being addressed by the UK Vickers reforms;[34] and the UK is taking a

[29] A leading continental central bank president had previously warned me of this German threat, but British officials were dismissive when I reported the conversation; my own bank, however, took it seriously and ensured there was sufficient collateral around its eurozone branches to acquire euros should the need arise.

[30] See also Malcolm Levitt, *Getting Brussels right: 'best practice' for City firms in handling EU institutions* (London: Centre for the Study of Financial Innovation, 2010).

[31] See Levitt, *Getting Brussels right*.

[32] Private conversations in Brussels; see also Levitt, *Getting Brussels right*.

[33] That hostility was exacerbated by the 'arrogant, aggressive behaviour' of hedge fund lobbyists when they went to Brussels to attack the proposal, which came as a surprise to them—despite plenty of indications that it was a real risk. For details see Levitt, *Getting Brussels right*.

[34] Independent Commission on Banking, *Final report*, 12 September 2011, http://bankingcommission.s3. amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf, accessed 21 Sept. 2012. The Commission, chaired by Sir John Vickers, was created in response to the banking crisis that saw billions of pounds of public funds used to prop up UK banks which would otherwise have failed. It proposed that high street banking should be 'ring-fenced' from the investment banking business within banking groups to reduce the likelihood that fundamental banking functions such as money transmission and retail banking would again be put at risk; in this way the reforms are intended to diminish the risk of taxpayer bailout in future; it also recommended stronger capital reserves and more robust corporate governance of banks including greater roles for independent non-executive directors. The government accepted the proposals.

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tougher stance on the need for bank recapitalization than many EMU countries. Nevertheless, the hostility and the attribution of blame for the crisis to the 'Anglo-Saxon' City persist, while the fiscal and financial irresponsibility of EMU governments and banks respectively in contributing to the crisis in the eurozone is often glossed over when the accusations are made, together with failure to acknowledge that EMU's fiscal structure was largely non-existent. What we now have is a damaging feedback loop between the banking and sovereign debt crises.

Three key points emerge from this analysis:

- Where the UK was able to get its way or at least reach an acceptable compromise, this was by careful behaviour and presence at the negotiating table, avoiding creating animosity among a majority of other countries and, essentially, forging alliances with other key countries. Whether this approach remains in place is debatable.
- Despite the existence of a mass of 'single market' legislation, there has always been a threat to the City from EU financial services policy, in contrast to the rosy view of the efficacy of the single market held by the EMU sceptics; and the latent threat has been exacerbated by the collapse of confidence in the structure of pre-crisis banking regulation and supervision in the EU.
- Unfairly or not, the City and the UK have lost a great deal of goodwill, partly as a result of blame for the liberal regulatory philosophy that they promulgated and that is blamed for creating the current economic and financial turmoil.

The eurozone's tentative efforts to strengthen the structure and instruments of financial supervision and regulation have profound implications for the City in conditions where suspicion, if not hostility, is exacerbated by the fact that the UK is not in EMU (while admonishing its leaders for slowness in putting things right). In all of this the City's contribution to the successful launch of the euro is ignored and largely unknown outside a very small circle.

The City's contribution to the practical implementation of the euro

In principle, European monetary union embraces two separable elements:

- first, a single monetary policy overseen by a European central bank which sets a common interest rate and where exchange rates of participating countries are locked;
- second, but not necessarily, a single currency.

It is possible to have the first without the second; and for those, especially in France, who wanted to remove the monetary hegemony of the Deutsche Bundesbank, the first was sufficient.[35] The Delors report,[36] which for all practical purposes

[35] See Stefan Colignon and Daniela Schwartzer, *Private sector involvement in the euro* (London: Routledge, 2003). Colignon records the doubts expressed by Giscard d'Estaing about a single currency, which he thought might be a step too far for the Germans.

[36] European Commission, *Report of the Committee for the Study of Economic and Monetary Union* (Luxembourg: Office for Official Publications, 1989).

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launched EMU, set out two options: a *common* currency, which would coexist with national currencies and which could be used for cross-border transactions; and a *single* currency, which would replace national currencies in their entirety. The empirical study which I led concluded that cross-border transaction costs would be lower with a single currency than a common currency and secondly that a single currency would represent a more convincing picture of the permanence of EMU.[37] This result was adopted by the European Commission and incorporated into the Maastricht Treaty.[38]

But *nowhere* in the Delors report or the Maastricht Treaty debates or documents was the scale of the task of introducing a new currency acknowledged. It was assumed that the single currency would be introduced on Day 1 of EMU relatively easily.

Clearly, with so much of the business of the City being denominated in national currencies due for replacement by the single currency it was essential to understand the practical implications of the euro changeover for the City as a whole and for each financial firm. The first to grapple with this was Barclays, while City-wide thinking came later. At Barclays, when I arrived in 1991,[39] it was agreed that IT experts should work with me to examine the practical implications of implementing the single currency. After all, it was conceivable that the UK would join EMU at some point, and in any event Barclays had branches in several continental countries intending to join. After careful analysis it was concluded that millions of lines of computer code would need to be changed and the changes tested and implemented within the bank, together with parallel change, testing and implementation across the interbank payment systems. We also estimated that the process could take up to three years and would cost a great deal. In due course comparable studies were initiated in other City institutions and the interbank payment organizations.

At that point Commission (and UK) officials with whom these findings were discussed were dismissive, believing that with modern computer systems all that was needed was a simple line of code instructing all existing currency amounts to be multiplied by whatever conversion factor was agreed as the exchange rate at which each national currency would be locked to the single currency. When the chairman of Barclays, the late Sir John Quinton, and the CEO of the City's Association of Payment and Clearing Services, Richard Allen, both presented the need for careful planning of the system's changes over several years, and at considerable cost, at a banking conference in Frankfurt they were met with similar disbelief, and this was replicated when Barclay's deputy chairman spoke at a dinner in Brussels attended by the chairmen of several continental banks.[40]

[37] Ernst & Young with the National Institute for Economic and Social Research, *A Strategy for the ECU*, foreword by Jacques Delors (London: Kogan Page, 1990). The study was funded by the Association for the Monetary Union of Europe (AMUE). My role was to ensure a thorough professional analysis; I remained personally agnostic about the merits of EMU. For a fuller account see Colignon and Schwartzer, *Private sector involvement in the euro*. With hindsight one might argue that a common currency would enable easier unscrambling of EMU, at least from a logistical viewpoint.

[38] Treaty on European Union, *Official Journal of the European Communities* C224, 31 Aug. 1992.

[39] I was appointed as adviser on the business implications of EU policies and legislation across the Barclays group, having previously advised financial firms as a partner at Ernst & Young.

[40] Colignon and Schwartzer, *Private sector involvement in the euro*, p 131.

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Conversations about Barclay's findings with senior IT people in several major continental banks demonstrated comparable concerns, and there was considerable admiration for the effort Barclays had put into its analysis. In those other countries, while there was political momentum for EMU, neither their politicians nor their boards of directors had given any thought to how a new currency could be put in place, and any effort to raise the issue was regarded as expressing scepticism about the project and/or exaggerating the scale of the task. The concept of dispassionate professionalism was often an alien one.

Given the scale and cost of the project, and the uncertainty as to when and where Stage 3 of EMU would start (the Maastricht Treaty proposed either 1997, if a majority of states met the necessary economic convergence criteria, or 1999 for whichever countries did meet those requirements by that time[41]), City analysis indicated that banks would be reluctant to make the large investments needed. Only when that uncertainty was removed would the investment in planning and implementing changes to IT systems proceed. Heads of IT in continental banks confirmed this was true elsewhere in Europe and were prepared to stress this view in the working group created by the Association for the Monetary Union of Europe (AMUE) to examine the issues (see below).

As well as IT systems, the issue of exchanging physical notes and coin was neglected by the EMU visionaries. When I spoke at a conference in Paris and, drawing on the experience of UK decimalization and the meticulous planning of the Decimal Currency Board, outlined the enormous challenge of minting, distributing and securely storing new notes and coins, withdrawing the old, and converting ATMs and cash machines for Day 1 of the introduction of the new money, I was struck by the angry response of the audience.[42] The anger arose because no official body at EU or national level had hinted at awareness of what needed to be done or their plans for doing it.

As well as bank IT systems and physical currency conversion, a third practical concern was that of legal certainty: would borrowers in high interest rate countries such as Italy insist on paying the new, lower rate once the lira was replaced and interest rates fell? Continental and UK officials were dismissive, claiming that according to *Lex monetae* this could not arise; but some banks in the City as well as some on the Continent were not so sure and argued for an EU regulation to ensure continuity of contract terms to remove all ambiguity. Again, continental and UK officials were dismissive.

It was in these conditions that the AMUE created a working group, which I chaired (with input from Barclays IT experts[43]), of bankers, central bankers and Commission officials to consider the issues. The consensus was that it could take

[41] It was implied (but not discussed) that a single currency would be introduced on the first day of Stage 3; the scale of the task was ignored.

[42] Malcolm Levitt, 'Introducing a single currency', in *The single currency: an immense challenge for banks* (Paris: European Financial Markets Association, 1994).

[43] Barclays took no position on the desirability either of EMU or of UK membership; the concern was that if politicians decided to install EMU it should be done in a way that recognized and minimized the costs and disruption incurred by banks.

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up to three years to convert bank IT systems, at considerable cost.[44] Some EMU zealots in the Commission thought the City input represented an attempt to sabotage EMU, but the results about timescales and the need for careful planning were accepted by the Commission,[45] although doubts about the legal question remained.[46] My main personal concern, based on the technical IT advice—I remained agnostic about the desirability and sustainability of EMU—was to convince the Commission that Stage 3 could not start with the single currency in everyday use as banks would not have sufficient lead time to prepare the systems changes needed, and new notes and coin could not be ready on time, because of uncertainty about when and in which countries EMU would start. The only solution was a phased transition: all monetary and currency operations and sovereign bond issues would be in the single currency from Day 1, but retail banking, notes and coin, and everyday conversion should come three years later, giving time for the transition. This advice was eventually accepted,[47] and it became the basis of the official EU transition to the single currency adopted at the December 1996 Madrid European Council.

However, the question of legal certainty proved particularly thorny. Intense lobbying by City organizations[48] continued in the week prior to the crucial 1996 Madrid summit—but the issue was not even on the agenda until Barclays General Counsel and I spent three hours convincing the Head of the Commission Legal Service of the need for a regulation. He in turn persuaded the Commission President, just hours before the Council meeting, to get it onto the agenda, and the Council agreed to a regulation.[49]

But I was warned that the German ministry of finance insisted the regulation would not apply outside the eurozone. This would have been devastating for the City; even if it was challenged in the European Court of Justice, the uncertainty could have lasted for years. However, the Commission accepted that such uncertainty would damage the launch of the euro and proposed a second regulation which guaranteed legal certainty throughout the EU.[50] (I believe also that a degree of goodwill towards the City existed in the Commission because of the practical advice offered on the implementation of the new currency, despite widespread City reservations about the desirability and viability of EMU.)

Finally, it should be noted that the City's concerns about the need for careful, coordinated planning across all financial institutions, together with the timescale and cost of the project, eventually induced the Bank of England—following pressure from the banks—to take a City leadership role, after initial scepticism about the scale of the task. It organized numerous meetings and produced a regular series of detailed booklets on the practical issues involved in the change-

[44] Some estimates put the cost at around half a billion ecus for large banks.

[45] AMUE, *Preparing the transition to the single currency* (Paris, 1994).

[46] Colignon and Schwartzer, *Private sector involvement in the euro*, pp. 129–144.

[47] See European Commission Directorate-General for Economic Affairs, *Green Paper on the practical arrangements for the introduction of the single currency*, COM (1995) 333 final, 31 May 1995.

[48] For example, the British Bankers Association and the London Investment Bankers Association.

[49] Council Regulation (EC) 1103/97. 17 June 1997.

[50] Council Regulation (EC) 974/98. 7 July 1997.

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over which were admired by banks throughout the EU, not least because nothing to rival their quality and precision was available outside the UK.[51]

To summarize, the City's focus on the massive IT system changes, the cash logistics and the legal framework required played a crucial role in focusing the attention of EU and national authorities on what needed to be done to ensure a smooth changeover to the new currency in the face of lack of awareness of these issues in both the Delors report and the Maastricht Treaty and scepticism about their validity for several years after concerns were first raised. The implicit assumption had been that the single currency could be introduced quickly and cheaply on the first day of Stage 3. Instead, the changeover had to be phased over three years. *Clearly, the challenges of changing banking IT systems, replacing cash and ensuring legal certainty face any country contemplating leaving EMU.*

The current dilemma: sovereignty or the single market?

A single market needs common rules, which constrain national sovereignty. But so long as the single market for financial services was largely compatible with the City's own ambitions the tension was muted in the City. This is no longer the case.

The negative feedback loop between the banking and sovereign bond crises has changed the picture. Eurozone banks at risk of collapse are bailed out by national governments facing falling revenues because of the recession and growing debt which is caused in no small part by the bank bail-outs; the banks were induced to buy the debt in question, which collapsed in value as confidence fell, reducing the value of bank assets, requiring additional national government support that further exacerbates the sovereign debt problem in a vicious circle that will continue unless some new solution is agreed. Moreover, hesitancy in taking steps to resolve the sovereign debt crisis, the deepening recession that threatens economic, social and political stability, and the virtually intolerable burden of interest and debt repayment have raised the risk that some country or countries might leave EMU or that EMU might collapse.

To deal with the matter two initiatives were launched in autumn 2011. One was the strengthening of European financial regulation and supervision, described as the creation of a banking union. The second was the proposal for a new treaty to strengthen fiscal discipline, a precondition for any enhanced, long-term fiscal support system. The UK rejected the proposed treaty at the December 2011 European Council when the Prime Minister failed to secure agreement to a draft protocol setting out provisions said to be essential to protect the City in any new arrangements for financial regulation and supervision.[52]

[51] Bank of England, 'Practical issues arising from the introduction of the euro', series published 1997–2002. Rob Close of Barclays was awarded an OBE for his contribution to City planning.

[52] The UK demands included a prohibition on giving EU supervisory agencies power of direct supervision of individual firms other than credit rating agencies; a national veto on giving power to EU supervisory agencies at the expense of national authorities' 'discretionary powers'; a veto on changing the location of EU supervisory agencies (the European Banking Agency is in London); no discrimination against a firm on the basis of where it is located; no EU authorization or supervision of firms operating within a single jurisdiction; protection for the UK taxpayer from any EU cross-border deposit protection scheme; and rejection of the

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At a time when the eurozone countries were struggling to stabilize EMU, this so-called veto caused annoyance; but UK officials point out that legislative proposals said to be essential for EU financial stability are sometimes a disguised attempt to secure commercial advantage at the expense of the City and they need to be guarded against. An example is the ECB's insistence that clearing houses handling significant volumes of euro-denominated business must be located within the eurozone, the subject of UK action in the European Court of Justice. In any event, while it is uncertain whether the veto caused lasting hostility, it is likely at the very least that any goodwill towards the UK on the part of many EMU countries has gone. Moreover, as a very senior former UK official put it: 'The eurozone crisis has given the others a once in a lifetime opportunity to rewrite the rules.'[53]

In 1999 a senior French treasury official said: 'Now that we have replaced the monetary hegemony of the Bundesbank our next objective is to create European financial supervision, based in Paris.'[54] The rationale for centralized supervision was not discussed in the City, where, as in Whitehall, it was believed centralization required treaty change which the UK could veto.[55] UK submissions to the 2009 de Larosière Committee on EU supervision failed to engage with the rationale for centralization but largely defended the status quo; that committee's conclusions led, predictably under the French presidency of the EU, to the creation of potentially powerful new EU regulatory agencies via qualified majority voting (QMV), not treaty change subject to UK veto. In urging the EMU states to develop their own financial supervisory/regulatory arrangements under the ECB, the UK government risks walking away from the negotiating table, a stance at variance with long-standing UK policy towards the EU. The emphasis on the role of the ECB is at variance with the alternative of enhancing the role of the EU-wide, London-based European Banking Authority (although the latter's standing was damaged by its widely derided stress tests of banks' capital strength). Moreover, the road chosen entails the risk that the single market will be difficult to sustain across all countries, whether in or out of EMU.

Whitehall appears to believe that Europe faces a choice between eurozone financial integration and stability on the one hand and, on the other, the single market. This is misleading: the issue is *what sort* of single market is to be pursued. The traditional UK interpretation was never fully accepted or implemented on the Continent, as noted earlier, and it is now very much on the back foot. The atmosphere has been soured by Franco-German determination to introduce a financial transactions tax, which the UK would veto as an EU measure (but which could be introduced by mutual consent among eurozone countries).

Reactions to the government's position on the part of City participants to whom I have spoken reveal considerable disquiet in some quarters over the government's stance at the December 2011 European Council, about which City institutions

proposed financial transactions tax (UK draft protocol, unpublished).

[53] Private conversation.

[54] Private conversation.

[55] The rationale is that it is impossible to have simultaneously freedom of capital movement, national financial supervision, a single market and financial stability.

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were not consulted.[56] There is concern that the constructive approach needed to persuade others to go at least some of the way towards the City's preferences was damaged and that friction rather than goodwill was created. There is a greater willingness among City figures with experience of dealing with the EU institutions and their counterparts in other financial centres than among Eurosceptic politicians to sacrifice a greater degree of sovereignty to secure the single market in which the City has thrived, along with an acceptance that tougher regulation is inevitable—and is coming *from the UK itself*, making the contrast between the UK and continental philosophies less marked anyway—and concern that the risk of discrimination against the City was exacerbated, not reduced, by the government's position and tone. There is also greater understanding than hitherto that much of what EMU countries want can be achieved by QMV or even a treaty among themselves, free from the threat of a UK veto. Thus while the UK government put the emphasis on sovereignty and protecting the taxpayer, at least some City opinion prefers a single market to fighting for current levels of sovereignty.

We now seem to face a number of scenarios. One is a new treaty, which some believe the UK could veto unless it gets concessions including repatriation of powers; but a treaty among the EMU countries and others is feasible without UK obstruction—or, as in the case of the current regulatory agencies, new arrangements could be introduced on the basis of regulations adopted via QMV. Another is to go along with a treaty or QMV regulations and hope to get concessions through compromise. But a hard line would be defeated, intensifying Eurosceptic pressure to leave the EU. Another, the apparent front-runner, is to urge the others to go ahead without the UK: this entails considerable risks, as noted above.

Senior people in the City recognize that not being part of an EMU banking union does not inoculate the City from measures that could make it very difficult for financial institutions, especially eurozone-based and non-EU firms, to do business in the City with the eurozone or in euros, making it all the more important to recreate goodwill and to be constructive. They appear to have conveyed this message and the need to be consulted to the Westminster government. But not everyone in the City sees things this way: a different view is taken in particular by the least regulated sector: hedge funds, for whom the EU is anathema anyway, especially in the light of the proposed directive on alternative investment funds; and they appear to carry considerable lobbying clout in governmental circles, not least because of their political financial contributions.

Conclusions

The City's Eurosceptics presciently warned that the absence of a robust fiscal architecture threatened the viability of EMU, while naively claiming that the single market would protect the City from adverse policies and regulations. The enthusiasts evaded fiscal issues and were worried that in remaining outside EMU

[56] For more detail, see also Malcolm Levitt, 'The City of London is charging to disaster', *Financial Times*, 14 June 2012; Malcolm Levitt, 'It is always better to be at the table', letter to *Financial Times*, 28 June 2012; Alex Barker and Brooke Masters, 'City's unaligned status over EU reform', *Financial Times*, 26 June 2012.

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the City would be damaged and the UK would lose influence, whereas until the 2007 crisis the City thrived.

The City's philosophy and interpretation of what a single market for financial services should look like largely held sway in the EU until the 2008 crisis. Now it is on the back foot in the EU—while supervision and UK regulation of the City are themselves being made less market-friendly, diminishing the contrast between the UK and the eurozone.

Practical City initiatives, including both banks and the Bank of England, made a considerable contribution to the successful introduction of the euro as a currency in banking and everyday use, agnosticism and scepticism about EMU notwithstanding.

EMU is now in existential danger, and the perception of EU regulatory and supervisory developments potentially inimical to the City has created tension between politicians determined to protect sovereignty and those in the City willing to make concessions to sustain access to the single market.

The coalition government in the UK appears to have adopted a policy of leaving the negotiating table, saying the issues thrown up by the banking and sovereign debt crisis are matters for the eurozone, even though fundamental changes to the philosophy, structure and substance of European financial regulation, with an inevitable impact on the City, are in prospect. The policy carries high risks for the City,[57] and by implication for the UK economy as a whole, given the City's central role. The policy is very different from the stance of previous administrations, under which, although not in EMU, the UK insisted on and achieved full access to negotiations affecting the financial sector and ensured crucial access to the TARGET system.

Finally, the professional contribution of some City firms and individuals to the 'plumbing' needed for the introduction of the single currency created a network of friendly contacts and a stock of goodwill which generated private early warnings on matters such as the threat to exclude the UK from TARGET and from the scope of the regulation intended to ensure legal certainty following the changeover to the euro; prompted the frank insight into French thinking on their ambitions for supervision and regulation; and facilitated successful persuasion of the Commission to propose a second regulation on legal certainty which included the UK. The general implication of this is that too many City lobbyists in Brussels fail to engage with the concerns of those from whom they want something and ignore opportunities to be helpful to them.[58]

At the time of writing (September 2012) it is far from clear how things will develop.

[57] Deputy Prime Minister Nick Clegg warned of the risks of marginalization in Europe in the *Financial Times*, 24 June, ignoring the point that the government has opted for self-marginalization: see Levitt, 'It is always better to be at the table'.

[58] For a detailed critique of City dealings with the EU institutions, see Levitt, *Getting Brussels right*.

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