European Monetary Integration

—Its Financial Impact and Implications for the Japanese Economy—

FOREWORD

The euro is finally to start as a single European currency next January. In this day of economic globalization, the euro represents a challenge to the reign of the dollar as the world's sole key currency, and it is applying pressure for reform.

The market of the European Union has an economic scale and trade volume roughly on a par with those of the United States. With this as its base, the euro should evolve into a key currency rivaling the dollar, providing that it develops into a stable currency along with the evolution of Europe's money and capital markets. A bipolar key currency regime is to be expected.

The outlook is that the euro will have a powerful impact not just on the status of the yen but also on the entire world economy, including its financial markets. An appropriate response will be needed in Japan on various levels, including government and corporate policies.

Thinking in this way, our institute in September 1997 established a committee of experts to research the prospects for and likely impact of a single EU currency. Taking time from their busy schedules, Chairman Akira Aoki of the company Japan Securities Finance served as the committee's chair, while Takuji Shimano, professor of economics at Gakushuin University, directed the research. The committee members included many influential figures from the worlds of business, academia, and journalism.

This report sums up the findings of the committee after more than a year of research. It considers the significance of and prospects for the euro, and it puts forward eight proposals. Our hope is to deepen understanding of what the single European currency will mean and to make a contribution to the Japanese response to this development.

Finally, I wish to express my extreme appreciation to all the committee members and others who spared their precious time to assist in the preparation of this report, notably committee chair Aoki and chief researcher Shimano.

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INTRODUCTION

The following is a report on the findings of a committee of experts who examined the prospects for and likely impact of the introduction of a single currency in the European Union. The committee was set up by the Japan Economic Research Institute in September 1997 and chaired by Akira Aoki.

The unification of European currencies is the outcome of the consistent political will and ideals of people in European countries who, after World War II, had their minds set on achieving peace and stability on the continent, and of the firm, continuous efforts toward regional integration. It is the outcome of the careful moves already made to deepen and expand integration in real economies and financial sectors. And it will probably move Europe much closer to its ultimate goal of political unification.

The euro will be more than a catalyst for energizing the region's economies. It will no doubt have a big impact on the world economy, so far dominated by the dollar. As soon as the euro becomes stable and gains the credibility of market participants, there will be moves to shift funds from dollars to euros. Countries around the world will make increasing use of the euro as a reserve currency, asset currency, and medium for settling transactions. The United States is likely to show more concern for policy coordination to reduce currency volatility. The conclusion to be reached is that the birth and growth of the euro will not just pose a challenge to the dollar's position as the sole key currency but also be an important factor in sparking policy coordination for the stabilization of the international monetary system.

Our committee looked into the impact of the euro on EU economies, qualitative and quantitative changes in global money and capital markets, and transformations in the international currency system. We also considered what response should be made by the Japanese government and business community. With the epochal advent of the euro at a time when Japan, too, is at a historical turning point, this report offers ideas on what companies and financial institutions should do. Proposals are also offered on what the government can do to support the yen, boost confidence in it, and internationalize it, as well as what policies seem best from a long-term macroeconomic perspective.

Our hope is that this report will be of service in formulating basic directions on this topic. In closing, we wish to express our gratitude to all the committee members and others who assisted our studies and the preparation of this report.

Akira Aoki, chair
Takuji Shimano, research director

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1. The Birth of the Euro

Attention is being focused on the advent of the euro, which is the end result of European monetary integration, because it represents an epochal event not just for Europe but for the world's political and economic systems.

First, the conventional idea that each country should possess its own currency is being scrapped. The countries that are participating in the unification of their currencies are embarking on a grand experiment involving the concept of what a state is. Economic and Monetary Union (EMU) is expected to enliven financial markets in the European Union, and it also represents a precondition for political union, the ultimate goal. To put it simply, the idea is "one Europe, one currency." Behind the success of the launching of this experiment is a history of regionalism in Europe, which has been propelled by the firm political will and ideals of the region's countries as they have sought for peace and stability on the continent since World War II. The region has a strong desire to recover its former position. In 1951 Western Europe formed the European Coal and Steel Community; in 1958 the European Economic Community came into being; in 1987 the Single European Act was approved; and in 1993 unification moved further with the establishment of the European Union. All this was the result of the shared desires of the EU's members.

Two economic motives have directly influenced the countries that have joined in using a single currency. The first is a desire to respond to globalization in financial markets, and the second is a desire to eliminate asymmetry in the coordination of exchange rates. In connection with the discussion to follow, here only the second motive will be treated.

Revisions of exchange rates had to be made more than 10 times under the European Monetary System, including those to meet currency crises in September 1992 and August 1993. The lesson that was learned from this was that the EMS was not all that effective in maintaining fixed exchange rates, that conversion in the economic fundamentals of the countries participating the EMS was essential for currency stability, and that while working toward this end, asymmetry in the burden of coordination would result from modeling monetary policies on those of Germany, the anchor of the EMS. France and other countries became convinced that only the introduction of a single currency could remove the need for continually adjusting currency values, and this led to the Maastricht Treaty.

The second major point is that the advent of the euro will challenge the dollar and apply pressure toward a revision of the current "dollar standard." Because the EMS is a currency system limited to the European region in a world where the dollar standard of the United States has reigned supreme, the EMS members have had no choice but to play a supplementary role in America's deliberate and self-fulfilling demands for coordination. Seen in the context of the international monetary system, the EMS members have been experiencing asymmetry in their coordination burden with the United States under the dollar standard. There have been, in other words, two types of asymmetry affecting the EMS members (with the exception of Germany), and both can be corrected or amended, the thinking goes, by using a single currency.

To rectify the asymmetry in coordination burdens under the dollar standard, Washington must prepare to approach policy coordination in a more symmetrical way. This is a precondition for the global emergence of a stable monetary system. Under the dollar standard, America has been able to take advantage of the privileges of a key-currency country; though it itself is in the red, it has been able to force countries in the black to make currency adjustments, and thus it will hardly move voluntarily toward realizing a monetary system that places a heavier burden on it. This means the advent of the euro will not lead immediately to reform of the dollar standard. But if Europe's money and capital markets expand and the euro emerges as a stable currency, a tendency of shifting from dollars to euros will strengthen. No doubt the euro will be increasingly used as a reserve currency, an asset currency, and a medium for settling transactions. This would be an epochal development challenging the monopolistic status of the dollar, and it might compel the United States to take a more constructive approach to policy coordination for stabilizing currencies.

As demonstrated thus far, European monetary integration and the advent of the euro will have a forceful impact. In this age of advances in information and communication technologies, which are fundamentally altering transaction methods and promoting the globalization of international financial activities, the euro has the potential of bringing about quantitative expansion and qualitative change in global money and capital markets. That is not all, moreover. Once the euro evolves into an international currency, it will be a source of pressure for revising the dollar standard. The ramifications will spread to Japan, the world's largest creditor nation. In particular, many lessons can be drawn from Europe's monetary integration for the Japanese financial system, which has been notably lagging behind the rest of the world in terms of institutional and market competition.

2. Formation of Unified Financial Markets in Europe

The 15 EU countries combined make up 31% of the gross world product; the United States makes up 27%. Moreover, the EU countries account for 20% of world trade, while the United States accounts for 18%. Consequently, allowing for the four EU countries that will not participate in a single currency for the foreseeable future, the monetary integration will result in an economic and market scale in the euro currency area nearly on a par with that of the United States. It is expected that when this economic powerhouse adopts a single currency, the resulting unified money and capital markets, already fully developed in terms of goods and services within their own markets, will rival the dollar in terms of scale and liquidity. This expectation has already prompted the realignment of the bond, stock, money and futures markets, ever-responsive to the globalization of international financial activities.

2.1 The Bond Market

In Europe, indirect finance has traditionally been more popular than direct. With the adoption of the euro, however, the scale of the bond market will increase, leading to a consequent increase in liquidity. This increase in scale will be caused by the reduction of exchange risk, as well as the integration of government bond markets—formerly segregated by national currencies—into a single euro-denominated bond market. It is possible that this will lead to a higher share of direct finance and the development of the corporate bond market.

In fact, international bonds issued in the first half of 1998, including Eurobonds, totaled $630.7 billion. This surpassed 1997 levels, and record-breaking levels are expected for the second year in a row. This reflects the eagerness on the part of American businesses to procure capital as they continue to enjoy a strong economy, as well as the high expectations felt by investors with regard to euro currency integration. By region, capital raised by bond issuers totaled $317.9 billion in Eastern and Western Europe combined (about 50% of the total), $177.3 billion in the United States (about 28% of the total), and $18.5 billion in Asia, including Japan (about 3% of the total). By currency, 45.4% of all bonds were denominated in dollars, 20.4% in marks, and 7.5% in ECU. The proportion of bonds issued in yen was 5.9% in 1997, but fell to 1.4% in the first half of 1998. Adding to marks and ECU those bonds denominated in the currencies of countries which will participate in the euro currency integration, Eurobonds will account for about 40% of all bonds issued worldwide.

The briskness of the European international bond market is an indication of confidence in monetary integration. At the same time, however, it is a reflection of the move by American bond issuers from the domestic market to Eurobonds and other global bonds for capital procurement. In fact, managing underwriters of Eurobonds and other international bonds are primarily American, with American securities firms such as Merrill Lynch, Morgan Stanley Dean Witter, and J.P. Morgan monopolizing the top ranks. This signifies that they have been quite successful at linking American business with American investors through the Eurobond market. This is similar to the high visibility Japanese banks and securities firms enjoyed in the late 1980s as managing underwriters of massive volumes of Eurodollar-denominated warrant bonds issued by Japanese firms.

This change in the makeup of bond issuers and managing underwriters cannot, however, be taken simply as a changing of lead managers between Japan and the United States. Rather, in the midst of the continuing globalization of finance, America's leading securities firms have judged that Europe's international capital market will enjoy continued success due to the euro, which is a global index, and have therefore expanded their base of activities. Thus both the dollar and euro are actively exploited. This is the reason for America's unwillingness to let the advantage of the once-segmented European markets, unified now by the euro, slip away. Japanese firms, in contrast, have been turning from the euro market to the domestic market for capital procurement due to Japan's economic recession and low interest rates. This should be cause for celebration in Japan, for it carries the double benefit of streamlining capital procurement costs and giving a boost to the Tokyo market. As was seen in the breakdown of bond issuance by currency, however, Japan's pullout of the European market was accompanied by a drop in the share of yen-denominated bonds—in stark contrast to the euro's international debut. As the slump in the yen-denominated foreign bond (samurai bond) market demonstrates, the fall in the yen's share is a natural consequence of the failure to promote the currency's internationalization.

2.2 The Stock Market

For Europe's larger enterprises it was customary to list their shares only on the domestic market, due in part to the fact that every country had its own legal system, tax system, and auditing procedures. The adoption of the euro will not only sweep away the segmentation of share listings into various domestic markets but also serve to catalyze the development of a single enormous European stock exchange (the Euro Exchange) resulting from the unification of Europe's various domestic stock exchanges. If this increase in market size leads to greater transparency, the Euro Exchange may become the world's second biggest stock market after the New York Stock Exchange. In particular it is anticipated that European institutional investors, such as mutual funds, insurance companies, and pension funds will allocate a larger proportion of their portfolios within the EU region, leading to a greater emphasis on stock investment than bond investment, due to the greater returns expected from investing in stocks. The adoption of the euro makes it easier to compare the performance of different companies, which will not only be reflected in share prices but will also heat up competition between companies. The longer it takes to overcome the Asian currency crisis and for Japan to recover from its recession, the more international investment funds will flow into the Euro Exchange.

Naturally, unification requires much coordination at the systemic level. For instance, it necessitates the shift from separate stock indices for each country to a single Europewide index. Already by the end of February 1998, Paris, Frankfurt, and Zurich had adopted the Euro STOXX 50 in cooperation with Dow Jones and had begun transactions. This index carries the stocks of 50 major firms from 10 of the 11 countries participating in monetary integration. On the other hand, the London Stock Exchange and the Financial Times adopted an index consisting of 300 of the top stocks in Europe, called the FTSE Eurotop 300. Market watchers are now waiting to see which of these indices will be used by the aforementioned stock exchanges. System-level coordination for stock buy-backs, the adoption of a stock option system, and ease of implementation is being advanced, as well as the harmonization of the laws governing corporations, accounting regulations, and regulations related to stock transactions in each country. Moreover, transactions through a next-generation electronic trading system (XETRA) has begun. After the entry into the third phase of monetary integration in January 1999, XETRA will become integrated with the London Stock Exchange's electronic transaction system and will include small-lot transactions on all stocks, including bonds and options.

2.3 The Money Market

Up until now, the London market (City) has held the overwhelming advantage over the other markets of Europe in terms of sheer size, the liquidity associated with all types of financial transactions (like euro currency, foreign exchange, euro repurchase agreements, and futures), and infrastructure for financial transactions (including personnel, transaction payment system, regulations, and taxes). The opinion at the City is that this advantage will remain unshaken even if Britain does not participate in Economic and Monetary Union (EMU). The reason behind this belief is the City's confidence that the depth of its markets and advantages of its infrastructure will further enhance its role and function as an offshore market for the euro.

It is a fact, however, that the adoption of the euro will effect major changes on the management strategies of financial institutions within euro countries. When the euro becomes the sole currency of the region, foreign and currency exchange business will disappear, leading to a reduction in fees chargeable for simple intermediary businesses. This is expected to lead to an increase of foreign exchange transactions with non-EMU currencies like the dollar. On the other hand, an urgent priority is establishing new management strategies and integrated business operations that make use of advanced information and communication technologies, so that the scope of capital borrowing and lending will not be limited to a firm's own country but will spread to encompass the entire euro zone. To put it in somewhat more concrete terms, what is needed is a move from individual business development conducted by each country to one in which the EMU functions as a single unit, as well as the creation of function-oriented satellites and networks. This restructuring, rather than an attempt at cutbacks through streamlining, is a bold strategy for the global development of Europe's money markets, particularly in the realm of asset management. By creating the conditions necessary to make markets within the euro currency area the preferred location for euro transactions, financial institutions will be able to satisfy the diverse needs of market participants while at the same time creating a management strategy capable of realizing a unified currency market of a scale rivaling that of the dollar, achieving economies of both scale and scope. The increased prevalence of mergers and acquisitions among European financial institutions in the late 1990s represents attempts to strengthen competitiveness and reorganize networks in response to these issues.

The increase in mergers and acquisitions among European financial institutions has resulted in the expansion of the investment banking role of these institutions. They have shed their indirect finance function and are focusing on asset management operations—such as the buying and selling of marketable securities and assets—to secure profits. This, it appears, is the direction that wholesale financing is heading. The successive acquisition of English merchant banks by European continental banks starting in 1995 has been due to the value perceived in these banks' finance technology and investment banking capabilities. This could also be said to have been stimulated by the creation of firms with massive securities and investment banking capabilities through so-called "megamergers" and acquisitions among American securities firms in 1997. The asset management business, in response to the increasingly large sums of capital managed, especially by institutional investors, began to demand skillful management performance. Customers are now won by offering new wholesale services and lowering their costs. Consequently, competition in the wholesale banking services takes place in the areas of price, network access, and globalization. Mergers and amalgamations are shortcuts to assuring massive capital strength, outstanding personnel, and global networks.

In the retail sector as well, the adoption of the euro has made the need for financial restructuring painfully clear. The key to a successful restructuring lies in the degree to which the current state of overly numerous banks can be rectified through coordinated integration. This situation is similar to that faced by Japanese institutions, and the actions taken in the retail financing sector in the euro area toward coordinated integration are therefore being closely watched in Japan. Although there is some variation from country to country in the euro currency area's retail finance sector, on the whole institutions have hitherto operated in the local currency and were sheltered from competition by regulations restricting new market entrants. Now, however, regulations are being abolished, and capital has come to freely cross national borders. With the adoption of the euro, the advantage of local financial institutions has all but vanished, heating up competition from other institutions, both domestic and foreign. The exchange rates in the European Monetary System have been stabilizing, tightening the interest rate margins of retail financial institutions and squeezing profits. For a time, the need to change over to new administrative systems with the euro's adoption will mean an increased cost burden for retail financial institutions, making specialization and tie-ups absolutely essential for them to survive.

2.4 The Futures Market

The adoption of the euro will likely serve to expand the swap market. According to International Swaps and Derivatives Association (ISDA) documents, each currency's share of swap transactions at the end of 1995 were as follows: 35% for both interest rate and currency swaps for the dollar; about 23% for interest rate swaps and 17% for currency swaps for the yen; and about 24% of interest rate swaps and about 19% of currency swaps for the mark, French franc, Dutch guilder, Belgian franc, and ECU combined. This means that the level of swap transactions in European currencies was greater than that in yen. Furthermore, if the lira and peseta markets are included, the European swap market is second only to the dollar market. Because most European currency swaps have been hedges against changes in exchange rates between European currencies, the adoption of the euro will mean a shift to dollar-euro and yen-euro exchanges.

In Britain, the City is continuing to develop its infrastructure so that it may grow as an international financial center even after the euro is introduced. The London International Financial Futures and Options Exchange (LIFFE), for instance, is ahead of the futures exchanges of Paris and Frankfort. LIFFE is presently studying a move to denominate the interest rate futures of euro country currencies in euro for products maturing after January 1999, thus advancing preparations to guarantee the liquidity of euro-denominated transactions on the exchange. In addition, LIFFE is anticipating the unification of currency-related transactions among participating countries following the adoption of the euro, as these transactions make up a large proportion of the exchange's products. To this end, LIFFE created transaction and payment links to the Tokyo International Financial Futures and Options Exchange (TIFFE), creating a listing for Euroyen interest rate futures in April 1996 in order to guarantee the diversity of its products even in this new environment. Then in 1997 LIFFE created links to the Chicago Board of Trade, creating a listing for 30-year U.S. government bond futures.

3. Monetary Policies of the European Central Bank

The policy measures of the European Central Bank (ECB) are concentrated on open market operations. These measures are expected to fulfill interest rate operations and liquidity control and exert a signaling effect on monetary policy. Some of the open market operations that will be available include weekly refinancing operations with a maturity period of two weeks (comparable to present repurchase agreements, or repos) and monthly refinancing operations with a maturity period of three months. On the other hand, permanent facilities available for setting upper and lower limits on interest rates include a marginal lending facility for setting upper limits and an interest-earning deposit facility for lower limits.

According to the terms of the Maastricht Treaty, policies for the exchange rate of the euro with currencies outside the EMU region can in general be set by the Ecofin Council based on the recommendations of the European Commission and in consultations with the ECB, as well as on the recommendations of the ECB. Needless to say, these policies must not violate the ECB's primary objective, namely price stability. At any rate, the ECB conducts euro value stabilization and coherent market intervention. The bank receives a maximum of 50 billion ECU in foreign reserves from the euro signatory countries in order to accomplish these goals.

The problem for the ECB exchange-rate policy is stabilizing exchange rates between those EU countries participating in monetary integration and those that are not. At the Dublin Summit of the European Council held in December 1996, an agreement was reached for an Exchange Rate Mechanism between the euro and non-EMU currencies, called ERM II. The central rate and scope for movement of the exchange rates between the euro and non-EMU currencies was set through consultation among the ECB, EU finance ministers, and non-EMU central bank governors. Countries which opted out of EMU, however, such as Britain and Denmark, do not plan to participate in the ERM II agreement, and in actuality current participation in ERM II is extremely limited. It is consequently necessary for participating and nonparticipating countries alike to coordinate economic and financial policy in order to assure stable exchange rates for the entire EU. The Ecofin Council and the ECB General Council were chosen to carry out this coordination. This coordination will make it possible for countries that opted out of the agreement, as well as nonparticipating countries, to receive substantially equal treatment. This is accomplished through the guarantee that both participating and nonparticipating countries alike will implement appropriate policies, including interest rate operations and exchange rate intervention, in response to unforeseen moves in interest rates. It is expected that this arrangement will make it possible for nonparticipating countries to conduct policy management with the goal of eventual entry into the euro region.

4. Economic Policy of EMU Member Countries

ECB monetary policy will go into effect starting January 1999. From that point, EMU member countries will no longer have the power to set monetary policy on their own. In addition, a unified currency will mean that they will no longer have the means to manipulate exchange rates in order to regulate foreign balances of payments. Most of the economic policy measures left to the member countries will be centered around fiscal policy. Speaking in terms of who controls which portions of economic policy, the ECB is responsible for monetary policy, while the member countries are given a wide range of authority with regard to fiscal policy. According to the Stability Pact, however, member countries must keep deficits to within 3% of GDP. This signifies that even if the ECB works to maintain the stability of the euro, if some member countries increase expenditures in a one-sided manner in order to pursue their own policy goals (for instance, increasing employment), this would threaten the stability of the euro.

Of the convergence criteria for the transition to the third phase of monetary integration, all member countries achieved stable, low interest rates and inflation. While some failed to clear the cumulative-debt-to-GDP ratio (60%), they were passed based on the recognition of substantial progress. Reduction of cumulative debt will be an extremely large burden on future fiscal policy for the member countries. These countries must adopt measures against their unbalanced levels of unemployment and balance of payments, and decrease cumulative debt (stock) through the maintenance of positive budgets (flow). Policy-setting authorities in all member countries must develop (mainly fiscal) policy to solve short-term policy problems as well as the long-term problem of paying off cumulative debt.

In this case, the greatest issues facing the policy-setting authorities in each country are the problem of which direction long-term and short-term interest rates will take, and whether to increase taxes and cut spending in order to reduce cumulative debt, based on the coordination of tax systems and the limitations of the Stability Pact. The former is dependent upon the unitary policy of the ECB, while the latter depends upon the fiscal and social security policies of each participating country. Consequently, the largest problem facing the EMU economy as it moves into the third phase of monetary integration is whether both of these can be coordinated effectively, or to be specific, whether a unitary monetary policy to build the foundations for stable growth and naturally increasing tax revenues in the EMU nations can be realized along with a multinational policy mix to balance the respective fiscal policies of each member country. The Stability Pact requires that every member country conduct disciplined fiscal management. The Maastricht Treaty sets out provisions for a convergence criteria for transition into the third phase but does not set out any provisions for the assurance of the stability of the euro. Germany in particular wishes the euro to be as stable as the mark has been; the result was the decision to place the rules of the Stability Pact in high regard, rather than allow each country to conduct discretionary fiscal management.

Regarding the future of the EMU, the degree to which the member countries can conduct regulated financial management is the key to the stability of the euro. During the second phase, the member countries implemented economic policy in coordination with other member countries, guaranteeing their mutual benefit. The greatest success of these joint activities was a general lowering of interest rates using a policy mix of retrenchment finance and easy money.

Another issue facing the EMU is the harmonization of tax systems. This as well requires the concerted efforts of the member countries. For countries with a high proportion of cumulative debt to GDP, however, the need to increase tax levels above those of other countries in order to reduce debt may be a great hindrance to the harmonization of tax systems in the third phase.

Focusing on this point, the fiscal policies of EMU members, including short-term policy goals, could become slanted toward national interests even if they conflict with the Stability Pact—particularly in times of recession—because of the limited policy measures in the third phase of integration. It is also possible that policy-making authorities of the member nations will give priority to the resolution of domestic economic problems rather than harmonization of tax systems when managing fiscal policy. Because monetary policy in the EMU is determined by the ECB and fiscal policy by each member country, it remains to be seen whether each country's economic policy can be made to respond to regional differences by means of a limited set of policy measures.

The worry over the ratio of cumulative debt to GDP is the possibility that differences between countries could be reflected in a risk premium, resulting in different long-term interest rates for each country. The unitary monetary policy of the ECB following the adoption of the euro will eliminate exchange risk and greatly reduce liquidity risk, payment risk, and legal system-related risk, but a risk premium for credit and default risk owing to cumulative debt will remain. If the countries attempt to reduce this risk premium, countries with higher levels of debt to GDP will be forced to maintain stricter fiscal controls than other member countries, resulting in different levels of fiscal autonomy between countries.

If, after the transition to the third phase, the possibility arises that differences could exceed the minimum permissible range, it would be necessary to relax the operation of the Stability Pact for a short time and to delay the implementation period for joint fiscal policy activities, such as the harmonization of tax systems. Under a unitary monetary policy, the EMU countries will need to strive for the convergence of prices while relying heavily on fiscal measures for policy management. Because policy options are limited, some collisions may occasionally occur.

5. The Euro and the International Currency System

5.1 Demand for the Euro

The value of the euro will be determined by the economic fundamentals of the euro area (growth, inflation, productivity, fiscal balance, balance of payments, and relative internal and external supply and demand of assets). Because the euro could become an international currency, the world is watching to see whether it will be weak or strong. The value of the euro against foreign currencies will depend on the degree to which it is used as a reserve currency, asset currency, and settlement currency, and on the demand for the euro relative to the dollar and the yen. It will also be decided by whether the euro starts off with an appropriate, well-balanced exchange rate.

The greatest demand for the euro is as a medium of exchange and means of payment, but it is its demand as an asset currency that will determine its value relative to foreign currencies. The unitary monetary policy of the ECB is to set policy goals whose first priority is price stabilization, and to set the goals of fiscal and monetary soundness and sustainable balance of payments. If this policy is successful, international demand will likely increase not only for the euro itself but for euro-denominated financial assets as well. As the euro's reputation as a stable currency increases, the demand for the euro as an asset currency will increase over the long term. This is a prerequisite for a strong euro.

One more reason to predict that the euro will become a strong currency is the changes in foreign reserves held by the 11 participating countries. These changes in levels of foreign currency reserve holdings, however, are temporary, short-term effects of the exchange rate against the dollar. As stated above, the final arbiter of the euro's value will be its long-term demand as an asset currency. Consequently, it will suffice here to cite the following four factors that could contribute to the uncertainty of the euro's value relative to foreign currencies after the transition to the third phase. First, there is no evident reason for the EMU countries to suddenly and greatly reduce their foreign reserves. There is no set "correct" level of foreign reserves. Moreover, it is uncertain what proportion of foreign reserves nonparticipating EU member countries will allocate to euros and what proportion to dollars. According to the ERM II agreement, starting in 1999 these countries will have some relationship with the euro, but if they plan on rapid integration into the euro region they could attempt to maintain a low level of exchange rate fluctuation with the euro, leading to higher demand for it. On the other hand, however, doubts about the stability of the euro relative to the dollar could lead them to hold onto their dollar reserves. The second factor is that when the EMU enters the third phase, the central banks of participating countries will swap their publicly held ECU for dollars or gold, leading to a higher proportion of dollars in the foreign reserves of these countries. The third factor is the uncertainty over the stability and credibility of the euro after it is launched. And fourth, some countries like China have expressed their intention to shift a portion of their foreign reserves to the euro, but it is not known precisely what level of shift from dollars to euros will be seen outside the euro region.

As stated above, the factors which will determine demand for dollars and euros are complex, but at this point it is not believed that there will be a one-sided sell-off of dollars and buying of euros. The liberalization of capital and deregulation starting in the 1980s resulted in the free movement of capital and development of information and communication technologies, leading to the rapid development of European money and capital markets in the 1990s. It is predicted that the birth of the euro will lead non-European investors to increase demand for euro-denominated assets, while investors within Europe will increase their preference for non-euro assets in order to diversify. In short, it is widely believed that the diversification of international portfolios will lead to a move away from the dollar. As was touched on earlier, however, the credibility and stability of the euro after its adoption are uncertain. Because of this, it is not thought that the shift to euro-denominated assets will proceed in one great rush. It is believed that this may lead to a slightly less than expected impact for the value of the euro relative to foreign currencies after entry into the third phase of monetary integration.

5.2 The Significance of a Bipolar Key Currency System

The basis for the euro's emergence as an international currency on a par with the dollar will be the scale of Europe's economy and trade. The base on which the euro is used will take up a greater proportion of the economy, and the euro will be increasingly used to finance trade between member countries. The EU and U.S. gross domestic product in 1996 were $8.4 trillion and $7.2 trillion, respectively; trade volume for the same year was $1.9 trillion and $1.7 trillion, respectively. One economist says that the factors determining whether a currency will play a global role are not only the size of its underlying economy and global trade but the economy's independence from external constraints, avoidance of exchange control, the breadth, depth, and liquidity of the economy's capital markets, and external position.

It is thought that the adoption of the euro will fully satisfy these conditions. First, the rapid realignment of Europe's money and capital markets is increasing their breadth, depth, and liquidity, increasing their ability to absorb shocks from abroad. This means that the volatility of the euro will be considerably limited. Second, a unified currency will mean that euro participating countries will eliminate exchange rate fluctuations, the ECB will implement a stability-oriented policy, and the fiscal management of each member country will be regulated by the Stability Pact. This means that the EMU could create a region of financial stability within the world economy. Third, the euro will give the EMU a more symmetrical relation with the international dollar-wielding Americans, paving the way for wide-scale international economic coordination.

The birth of the euro indeed suggests the possibility of a bipolar key currency system, but will this guarantee the stability of the international currency system? We cannot help noting that the greater the impact of the euro on the world's money and capital markets, the greater concern we will have for the potential effects of ECB's monetary policy on countries outside the euro area. In particular, the larger the proportion of world trade transactions that are denominated in euros, the more sensitive enterprises in non-EMU countries will need to be to euro exchange risk. This will no doubt lead to stronger calls for stability of the euro.

The expansion of the economic size of the euro region will reduce the euro's sensitivity to exchange rate variation, while at the global level the impact of the euro area's economic policies will increase. These factors lead many to say that the EMU will take a position of benign neglect (keeping an eye on but effectively ignoring the situation) with regard to exchange rates. It is a well-known fact that up until the present the United States has also followed a policy of benign neglect, but it is important to note that the United States and the EMU may take slightly different approaches.

Washington acknowledges that the dollar remains the key currency under the dollar standard despite the current system of floating exchange rates and that it is the duty of other currencies to adjust their exchange rates with regard to the dollar. This is a feature of America's benign neglect. On the other hand the EMU, being made up of 11 independent countries, will be hard pressed to maintain a policy of benign neglect indefinitely. If there is an unchanging long-term misalignment of exchange rates between the euro and some foreign currency (such as the dollar or yen) or an increase in volatility, the fact that significant differences in economic structure remain among EMU countries will mean that there will also be differences in the necessity and degree of economic adjustment caused by exchange rate levels. A gap in such adjustment costs could cause a conflict of interests between member countries, undermining the concept of European unity as well. If there is a possibility that exchange rate misalignment caused by a policy of benign neglect could have a negative effect on unification, the EMU will be left with no alternative but to begin exchange rate adjustment. In this respect, the EMU differs from the United States. The decision at the Luxembourg Summit of the European Council in December 1997 to use a wide range of economic data to monitor the exchange rate of the euro is good evidence that the EMU is more aware than anyone of the danger involved in a policy of benign neglect.

The reason why attention must be paid to the differences in the U.S. and EMU policy stance is that even if a bipolar key currency system is created, this will not lead immediately to international currency stability. In order to establish a stable international currency system, there must be cooperation between the central banks of the industrialized nations as well as the Federal Reserve Board and ECB, and especially the International Monetary Fund; further discussions are required on the exchange rate mechanism, fiscal and monetary policy based on sound monetary rules, and methods to prevent speculative pressure in order to establish an international currency arrangement that everyone is satisfied with. At present, however, the dollar takes an overwhelming share of international capital transactions and trade payment transactions, and the United States is determined to preserve the dollar standard because it is in its own national interest to do so and has not entered the debate over measures to assure a stable international currency system. There have even been some who have described the present situation as a nonsystem.

The birth and growth of the euro will, however, probably launch a global search for a stable currency system. America's debt exceeds $1 trillion, which is gradually eroding the dollar's position as an asset currency. Despite this, about half the world's $60 trillion worth of financial asset stock is still denominated in dollars, and only about 10% in European currencies. This indicates that the system of bipolar currencies will initially be unbalanced. Without a doubt, however, the market will eventually come to accurately reflect market realities. If the credibility of the euro progresses and dollar-denominated assets are transferred into euros, the operating capacity of the dollar's automatic circulation system will decrease, and the United States will have no other choice but to seriously address policy adjustment within the bipolar currency framework. The United States itself will start seeking a stable international currency system. As was stated before, the criteria for an international currency, namely scale of production and trade, are nearly equal in the euro and dollar regions. This should lead to an eventual balance in the stock of financial assets held in the two currencies. According to the provisional calculations of C. Fred Bergsten, director of the Institute of International Economics, the shift to euro-denominated financial assets will total about $700 billion. Adding the shift to the euro for exchange reserves, it will become nearly impossible for the United States to protect the present one-sided dollar key currency system. The birth and growth of the euro signifies a challenge to the dollar standard and the start of policy coordination to bring about a stable international currency system.

PROPOSALS

1. Appropriate Response by Japanese Companies and Financial Institutions

Proposal 1: Respond positively to the euro's introduction, regarding it as an business opportunity.

The emergence of the euro means greater profit opportunities for Japanese companies and financial institutions. Rather than passively react to the introduction of the euro as a factor pushing up costs due to, for example, the system changes necessitated, they should focus positively on the business chances provided and make an active response. This will mean looking into tax system harmonization within the EU and EU financial service-related directives, engaging in effective information gathering and market analysis and making more correct judgments on the developments in the international harmonization of accounting standards.

As of January 1999, all official transactions and the bulk of inter-corporate transactions, financial institutions included, will be euro-denominated. Exchange trading will begin between the dollar and the euro, the euro and the yen. Countries participating in the EMU will see more vigorous cross-border investment in money and capital markets, which have been quickly set up to accommodate the euro. Progress toward monetary integration will facilitate harmonization within Europe of the various types of standards relating to economic activities, and could even facilitate the creation of global standards. Market economy is expected to become the basis for a growing number and variety of transactions. Japan will need to push further ahead with elimination of its various regulations, while Japanese companies and financial institutions will find themselves forced to make an appropriate response to the development of EMU-related systems and market changes.

Firstly, with the bond and debenture markets to begin operating on a euro base in place of their domestic currencies, both outstanding and newly issued government bonds of EMU countries will be denominated not in domestic currencies but in euros as of January 1999.

Secondly, advancing monetary integration will increase the transparency of the bond and debenture markets, lending these greater liquidity and efficiency. As a result, bond and debenture markets will become more attractive in terms of both the procurement and investment of capital.

The introduction of the euro will eliminate the uncertainty factors of exchange and other market risks, while conversely boosting the importance of credit, liquidity, settlement, and systemic risks. This will be reflected in the yield differential (credit spread) that emerges among the various countries and issuing companies on the bond and debenture markets. Euro introduction will not create a single euro yield curve. Companies should carefully analyze various yield differentials and use these in investment risk diversification. Further, it should also be noted that with credit risk a major factor in yield differentials, credit risk assessment will become more important, increasing the role of credit analysts in running comparisons between the credit risk on the bonds in question and benchmark bonds.

Euro-based bond and debenture markets and euro stock markets will provide the perfect environment for the asset operations of institutional investors involved in globally-diversified investment. Where Japan's European investments to date have generally focused on national market and currency trends, selecting stocks within a single market will grow increasingly important in days to come, placing much heavier demands on the abilities of analysts of the various securities. At the same time, a close eye will also need to be kept on how currency substitution responds to dollar-euro exchange rate and long- and short-term interest rate trends, as well as to changes in U.S. and European fundamentals. Where the United States and Europe adopt a stance of benign neglect toward exchange rate changes, investors tend to expect major exchange rate swings. If this is in fact what happens, a deeper analysis of exchange risk will be needed than in the case of, for example, dollar-mark and dollar–French franc rates.

Proposal 2: Reorganize financial institutions into bases and satellites and rearrange networks.

For Japanese financial institutions to succeed in Europe, they will need to shift their operations from the previous country-specific focus to handling the EMU region as one unit, also moving swiftly to concentrate certain functions and shift others out to satellites and to reorganize their networks. In some cases, they may also need to form business tie-ups with European banks. It should be recognized that only those banks that have strengthened their competitiveness through such restructuring will be able to survive within the EMU.

The introduction of the euro will further intensify competition between EMU financial institutions. In the case of investment banking activities in particular, which handles securities and assets, competition is likely to stretch beyond European banks to encompass major U.S. banks as well, developing into fierce oligopolistic competition. Moreover, with European banks already well into the mergers and acquisition process, the wholesale banking area could become marked by stiff competition between capital giants. To continue to succeed in Europe, Japanese financial institutions will need to review their strategies and undertake a full-scale reallocation of their physical and human resources. Such efforts will be crucial in achieving a respectable business performance amid the fierce competition and thin profit margins in European money markets. This is another reason why Japanese financial institutions need to address the structural reform of domestic markets and the reorganization and revitalization of their own organization in keeping with the choice of their future course (for example, choosing between wholesale and retail).

2. The Credibility and Internationalization of the Yen

Proposal 3: Maintain yen credibility based on price stability and economic growth.

The most important element in securing the yen's status and maintaining its influence as an international currency is the yen's credibility, and it should be recognized that this will become even more important in the future. Yen credibility will only be achieved through domestic price stability and sustained economic growth.

As was noted in Fundamental Acknowledgement, there is a strong possibility that with the launching of the euro, the international currency order could polarize into the dollar and the euro as two key currencies in the future. Even if the EMU and the United States were to undertake discussions and policy coordination toward preventing destabilization, it is difficult to predict how the international monetary situation will turn out hereafter. While it will depend on the degree to which the euro is used outside of Europe, how to achieve the stability of the external value of the yen would, under the dual key-currency system, become a more complicated issue. Stabilizing the external value of a currency means ensuring that the exchange rate does not have a negative impact on domestic economic activities or domestic price levels by external transactions. Japan's policy authorities have focused to date mainly on the yen-dollar rate. Now, however, it will become important to also observe effective exchange rates weighted by current accounts.

Proposal 4: Make continued efforts toward the yen's internationalization.

For the yen to function as an international currency between the world's two major currencies, constant efforts will need to be made toward internationalizing the yen. The credibility of the yen will here again provide the foundation for this internationalization, while efforts will also need to be made to facilitate the operational usefulness of the yen.

To make the yen more international, it will not be enough simply to carry on with efforts to open Japan's market. Japan's financial markets and Tokyo's international financial markets both need to be further internationalized to improve the usefulness of the yen as an international currency. The internationalization of the yen began with the Japan-U.S. Yen-Dollar Committee in 1984, but Japan's markets have yet to be developed to the complete satisfaction of domestic and foreign market participants. For example, a withholding tax has to be paid on bond interest, while a transfer tax is still levied on securities transactions. As long as Japan holds on to regulations and tax systems absent in other international finance centers, the yen will not become sufficiently internationalized, and Tokyo will not become a competitive international finance center.

The extent of yen internationalization can be determined by the degree to which the yen is used in trade and financial asset transactions. Looking at the yen-denominated portion of the final import and export settlements of Japanese companies, this ratio peaked in March 1993 for exports and has been decreasing since. In the case of imports, the ratio has been decreasing since March 1995.

On the other hand, looking at the share of the yen in Euro-markets, this has increased to more than 20% in the case of the Euro-currency market, which handles short-term financial asset transactions, while the yen has also been gaining a growing portion of the Eurobond market, which covers long-term financial asset transactions, since the second half of the 1980s. However, this reflects an irregular bond-issuing practice owing to regulations in Japan's capital markets until the mid-1990s. Japanese companies issued bonds on European rather than domestic markets, which were then bought by Japanese institutional investors. It is not, therefore, a positive outcome of the yen's internationalization but rather the sad and negative outcome of the high bond-issuing costs caused by the remaining regulations in Japan's bond market as well as an underdeveloped trading market.

With the emergence of the euro as an international currency in addition to the dollar, even if the yen were to be successfully stabilized, making the yen fulfill a value-storing function, or, in other words, internationalizing the yen as an asset currency, would still not be so easy. As noted above, Japan must continue its unflagging efforts to increase confidence in the yen and to improve yen operations.

Proposal 5: Make an active contribution to Asian currency stabilization.

How Asian countries will maintain the stability of their currencies and achieve economic growth within a bipolar key currency system is of great relevance for the world economy. Japan should contribute actively to the financial stability of Asian countries, taking the lead to investigate the possibilities of various schemes and to supply the necessary capital as soon as possible.

Two key points should underlie Japan's strategy in terms of realizing the stability of Asian currencies. Firstly, Japan should contribute by taking leadership in Asian financial stabilization schemes and enhancing the yen's role. One cause of the Asian currency crisis that blew up in 1997 was that the crisis-hit countries had adopted dollar pegs. The currencies of these countries had, along with the dollar, been appreciating against the yen since 1995, losing international competitiveness. While the countries in question enjoyed high growth rates, domestic demand grew even faster, bringing about a current account deficit. Domestic macro imbalances and reduced international competitiveness were sufficient for investors to predict a sudden change in the overvalued exchange rates, and this put an abrupt brake on capital inflows from abroad. Moreover, the sudden capital outflow pushed plummeting exchange rates into an even steeper spin. Given the long history of economic relations between Japan and the rest of Asia, Asian countries need to adopt basket pegs with an appropriate yen ratio, rather than maintain dollar pegs. This would help to stabilize Asian currencies and would also promote sustainable economic development.

Secondly, Japan should play a role as the world's largest creditor country. Basket pegs with balanced yen, dollar, and euro ratios are not the only option in terms of Asian currency stability schemes. In Europe, the EMS set up the European Monetary Cooperation Fund and other short- and medium-term credit facilities aimed at exchange rate stabilization by supplying the necessary capital to member countries. In Asia too, it would be worth considering the establishment of an Asian currency stability fund to actively supply yen capital.

Moreover, alarmed that the momentum of the fall 1997 Asian currency crisis impacted on South America in 1998, the United States is currently considering whether it would be possible to set up a regional currency stability mechanism in South America. We would therefore like to stress again that establishing an Asian currency stability scheme would contribute above all to Asian economic development, and that the priority task at this point in time should be the internationalization of the yen with an eye to the Asian situation.

3. Macroeconomic Management from a Long-Term Perspective

Proposal 6: Learn from the process up to the launching of the euro and promote structural reform.

Currently standing at a turning-point in history, what Japan should learn from the historic emergence of the euro is the process of sustained efforts of European countries to engage in repeated discussions and to build consensus toward the goal of monetary integration.

The EMU bears out the fact that, as symbolized in the emergence of the euro, there is a strong likelihood of achieving a goal when the goal itself is clearly defined and the commitment is strong. Moreover, by setting a deadline within which to achieve this goal, the countries involved were able to approach macroeconomic management and structural reform from a long-term perspective. In the period leading up to the May 1998 Brussels European Council meeting, where the final decision was made on the countries moving into the third stage of monetary integration, all countries maintained a strong political commitment to participating in monetary integration, even being prepared to allow their economies to make a hard landing. As is apparent in the decision that double-digit unemployment rates were unavoidable in bringing down the fiscal deficit to the stipulated 3% of GDP, structural adjustment causes pain. That the European countries still sought to meet the convergence criteria was because they judged that insufficient effort to reduce their fiscal deficits would create inflationary expectations, pushing up the long-term interest rate and swelling interest costs, which would in turn further expand the fiscal deficit and increase outstanding debt, reducing both domestic and external confidence in their macroeconomic management.

Proposal 7: Establish clear targets toward the twenty-first century and clarify the responsibility for achieving them.

What is needed in the management of Japan's macroeconomy is to establish clear targets that look ahead to the shape of Japan in the twenty-first century, clarifying criteria and modalities toward achieving these targets. In doing so, Japan will need to observe global standards and clearly identify deadlines for achieving its goals.

The various structural reforms currently being pursued in Japan are simply a collection of structural reforms in different areas and do not present an adequate blueprint for the economy as a whole or, in other words, the goals to be achieved. Even in individual areas, there are many cases where deadlines have been set without clear criteria for what is to be achieved. The main parties in structural reform—the private sector—have become overly accustomed to homogeneous competition, whereby all parties advance along the same line, and are now avoiding painful structural reforms by trying to prioritize a soft landing in achieving their goals. In other words, the private sector is only paying lip-service to the need for structural reform and observance of market economy principles without making it clear where the responsibility lies for achieving structural reform. This presents little hope for the success of structural reform.

Looking at the swift development of money and capital markets and industrial reorganization that were occurring in the process of European monetary integration, it is clear that Japan, too, has to push ahead with financial reform and capital market development, including mergers and acquisitions that will accompany this, regardless of the pain involved. We would emphasize here that observing global standards and restoring the international competitiveness of the financial sector through industrial reorganization will be pivotal structural reforms in terms of increasing domestic and external confidence in the Japanese economy.

Proposal 8: Develop rules to attain policy targets.

To advance structural reforms despite their costs, rules need to be formed as to the responsibility for policy implementation, the order and direction of policies, and accountability for policy decisions and outcomes. These rules will bring additional burdens, but it should be remembered that not only will international pledges to achieve domestic goals increase confidence in Japan as an economic power but that observation of rules will also strengthen Japan's bargaining power in international negotiations.

EMU countries will pay a high price for monetary integration and the introduction of a single currency, losing the exchange rate as an adjustment tool, losing autonomy over their monetary policies, and paying the cost of the so-called democracy deficit resulting from the expansion and strengthening of the powers of pan-European bodies, such as the European Community. These costs are certainly large. But it was because governments, industries, and citizens were all convinced that European union would produce benefits outweighing these heavy costs, because they were possessed of a clear future vision, that the deepening and widening of European union became possible. The grounds for this conviction were, to use the terminology of economic policy, that policy authorities opted to observe rules rather than using their own discretion, resulting in a much clearer picture of the decisions they were making.

As international interdependence deepens, external shocks will inevitably impact on domestic economies. Dealing with shocks incurs costs. Observing rules is one means of minimizing these costs in an open economy. To keep these external shocks as small as possible, emphasis must be placed on observance of and confidence in rules for macroeconomic management.

Looking back over Japanese economic trends and the policies employed in the 1980s and 1990s, these are characterized by swings between external and domestic demand dependence in response to strong external pressure and the failure of discretionary policies on both the demand and supply side. In the early 1980s, during the recovery from recession, the economy relied on external demand, while in the late 1980s, as its closed markets and huge external surpluses were criticized internationally, the government boosted the economy through a shift to a domestic demand orientation centered on fiscal prescriptions. During the 1990s, amid continuing external pressure, domestic demand lost central place as rebuilding public finances became the priority task. In other words, in the 1990s, neither of the main players in economic recovery—exports and fiscal stimulus—came to the fore, with the usual situational discretionary policies reaching the limits of their effectiveness. Discretionary policy failure means a protracted policy recession. Important structural reforms on the supply side have merely accentuated this, achieving no positive results.

Domestic and external dissatisfaction and lack of confidence in the fact that the discretionary policies used for so many years not only lack transparency but have also failed to produce results have brought international confidence in Japan to a new low.

The failure to advance structural reform is causing a domestic economic slowdown and recession, not to mention domestic and foreign disappointment. To the extent that government regulations, including administrative guidance, and private-sector regulations within industries, continue to lack transparency, prospects for the future will remain dim, and consumer and investor sentiment will inevitably weaken. We would again reiterate the importance of macroeconomic management from a long-term perspective and of observing rules and restoring confidence in policy implementation.