ECONOMIC AND MONETARY UNION: THE EURO'S CHALLENGE TO THE DOLLAR AND THE YEN

Institute for International Monetary Affairs

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Preface

This occasional paper contains speeches for the symposium held on April 22, 1997, on the subject of "Economic and Monetary Union-the euro's challenge to the dollar and the yen", which was sponsored by Institute for International Monetary Affairs.

Mr. Gyohten, president of IIMA, in his opening speech, emphasized the importance of the introduction of the euro and its implication towards the world economy. Five panelists, Mr. Lamfalussy, President of the European Monetary Institute, Mr. Gaddum, Deputy Governor of the Deutsche Bundesbank, Mr. Walrafen, Senior Executive Vice-President of Caisse des Depots et Consignations, Mr. Lindsey, Former Member of the Board of Governors of the Federal Reserve System, and Mr. Kato, Vice Minister of Finance for International Affairs, Ministry of Finance delivered their views on the European Currency Union, followed by panel discussion presided over by Mr. Gyohten.

OPENING SPEECH AND PANELIST SPEECHES

OPENING SPEECH

Toyoo Gyohten

Europe stands at the gateway of an epoch-making era. In January of 1999, the Economic and Monetary Union will start and the single European currency, the euro, will be introduced.

Frankly speaking, the EMU seems not to have awakened much significant Japanese interest until very recently. The Japanese people have not paid sufficient attention to either the continuous efforts of the Europeans toward economic integration or the strong political determination that has supported them. Thus, they had remained skeptical of realization of the EMU.

Now, however, those who still have doubts are in the minority not only in Europe, but also in non-European countries such as the United States.

The EMU is reaching the final stages of the long road towards the European economic integration that has been being built over the fifty years following the Second World War. This process started with formation of the European Coal and Steel Community in 1952, and led to many other well-known milestones such as the European Economic Community in 1957, the European Monetary System in 1979, the agreement on the Treaty on European Union in 1991, and the establishment of the European Monetary Institute in 1994. This process has therefore experienced many important occasions, but crises also emerged several times.

Even after the framework for the EMU was agreed upon in the Maastricht Treaty, a currency crisis occurred from late in 1992 into mid-1993, causing currency stability in Europe to not be sustainable. Political leaders of major European countries have overcome these crises by virtue of a strong belief in and cooperation toward the materialization of economic integration.

Obviously, the significance of EMU for Europe differs from that for Japan. For Europe, it is a central issue on which its destiny depends. Success or failure of EMU will have an immeasurable impact on the European society, politics, and economics in the 21st century. On the other hand, Japan can neither participate in the EMU nor have any influence over it. In this respect, alongside the United States and other Asian countries, Japan is an outsider. In view, however, of the role played by Europe in the world economy, and of the importance of trade, investment, and financial transactions between Japan and Europe, it is natural that Japan takes great interest in the fate of the EMU, and is seeking its own ways of coping with it. The Japanese financial industry stands to be considerably affected, in as much as EMU will bring remarkable change in the currency, financial, and capital markets of Europe. They stand to gain or lose from the emergence of the single European currency, bear costs for the changeover in terms of both hardware and software, and become exposed to greater profit opportunities and risks as new products and new markets spring up. For Japanese non-financial industries, there will be advantages and disadvantages arising directly from the advent of the single currency. In addition, the introduction of the euro will eliminate differences existing among the price structures of nationally defined markets. For that reason, it is necessary to reconsider the selection of where to make direct investments for production or sales facilities, or allocating priorities in targeting specific markets to trade with.

For Japanese monetary authorities, the roles to be played by the euro in the international monetary system will be a matter of great interest and concern. They will be interested especially in any impact it may have on the status of the yen as an international currency, on Asian financial markets, and on the stability of exchange rates.

Although it is the majority view that the EMU will become a reality, there is as yet no definite assurance. Towards the end of the next year, Europe will have to tide over a period which will be, in a sense, more difficult and crucial than any time before. More importantly, even if the EMU does take place in January of 1999, whether it will develop as a solid and stable system seems to be even more uncertain. Furthermore, any failure arising after the launch of the new system will have an adverse effect on not only Europe, but also the other parts of the world economy.

Over the beginning of the 21st century, we will be living through a period crucial to the successful functioning of the single currency market. During the corresponding period, in Japan, the large-scale financial "Big Bang", starting with the removal of the foreign exchange controls, will take place. Correlation of the yen, dollar, and euro triad will depend on what kind of results these epoch-making developments in Europe and Japan will bring.

It is obvious that Japan most give great attention to the EMU. That is why we at the Institute of International Monetary Affairs organized this symposium, and I am pleased to have with us today a panel of five people of the highest caliber on the subject.

CONVERGENCE AND THE ROLE OF THE EUROPEAN CENTRAL BANK

Alexander Lamfalussy

Considerable progress has been made in the preparatory work for European Economic and Monetary Union. We have now reached a final consensus on all the major aspects of the organisation of the European Central Bank. This is quite an enterprise because we have had to pool the experience of fifteen different traditional operating techniques. No one has ever done that before. So, it really is a genuinely new and challenging experience.

With regard to operating techniques a large proportion of the work has been completed. We have worked out the method of operation for the monetary policy - a report on that was published a few months ago - and we have designed the payment system. All the necessary decisions concerning harmonisation of the accounting systems of the European national central banks have been made and we now know what the banknotes will look like. We have also made substantial progress with regard to the harmonisation of the statistical basis between the various countries, which is a very important part of the work. Of course, some of the major decisions affecting the operation of the European Central Bank will have to be made directly by the bank itself.

What we must accomplish between now and 1 January 1999 is the implementation of these decisions. Everything has to be in place by the time the Governing Council of the European Central Bank meets in its capacity as decision-maker on monetary policy at the beginning of January

1999. At that time, the Council will be ready to launch its first repo in euro. I do not expect any major problems to arise in this field, although I am quite sure that especially with regard to information systems something is bound to go wrong. However, I accept that as perfectly normal.

At the same time, a number of major decisions have been taken in areas where they are not exclusively, not principally, or not at all in the hands of the central banks, but rather in the hands of politicians, governments, or the Commission, or where there are overlapping responsibilities. Some of these are referred to below.

One major breakthrough was made at the European Summit in Madrid in December 1995 when the changeover scenario to the euro was planned and approved. It was decided how the changeover would begin, what would be the length of the transition period and the form the different phases would take.

A second major decision was taken more recently at the Dublin summit in December 1996, when the legal status of the euro during the transition period was defined. This was a major step forward, not only for all the financial market participants within the Community and within the future euro area, but also for those outside these areas. Our position is clear: the euro will be the legal tender of the euro area from the very beginning and there will be a legally enforceable equivalence between the euro and the national currencies as the latter continue to function during the three-year period of transition. This should remove any possible uncertainty about the continuity of contracts.

Third, major decisions were reached concerning the exchange rate between the euro and other currencies in countries which will not initially be part of the euro area. The task of establishing an exchange rate mechanism was basically the remit of the EMI Council. We have proposed setting up a sort of European Monetary System (EMS) or successor arrangement to the current Exchange Rate Mechanism (called ERM II) and this has been fully approved by the political authorities. We are now at the stage of drafting the contracts and expect them to be finalised shortly.

Fourth, a Stability Pact has been concluded between the governments of the EU Member States which is of great significance because it controls fiscal policy once countries join Economic and Monetary Union (EMU). One of the main problems we encountered was that once a country joined Economic and Monetary Union, inappropriate fiscal behaviour could no longer be penalised by law. The only form of penalisation which is available is to deny a country to access to EMU. Therefore, another mechanism must be provided whereby participating countries are compelled to adopt appropriately responsible fiscal policies. Such a mechanism has already been formulated. We, the central bankers, did not play a major role in this particular field; we simply informed the governments of the EU Member States of our desire to see the establishment of a strong and credible Stability Pact.

As stated above, it is clear that on the whole a very substantial part of the work involved in establishing the European Economic and Monetary Union has already been completed. Of the remaining tasks, the most important - and the most difficult - is the selection of the participating countries. In the second half of March next year, the European Commission on the one hand and the Council of the EMI on the other will publish their reports and assessments on the state of convergence and will make their own recommendations concerning the choice of the countries. The choice itself rests, of course, with the Heads of State or Government, who will probably meet in early May next year. The European Parliament will have to give its

own view on the reports and the Finance Ministers will have to make up their own minds as to what they are going to recommend to their respective Heads of State or Government after the content of the two reports has been disclosed. In order to avoid or to minimise the difficulties which might arise during that period, it was decided, for practical reasons, that the Finance Ministers would make their recommendations to their Heads of State or Government in the course of one weekend and that thereafter the Heads of State or Government would make their own decisions.

I am not in a position to assess how the Heads of State or Government will interpret the convergence criteria. However, I do have a view of the role I would like to see the Council of the EMI play in this matter. With regard to the criteria determining entry to the Economic and Monetary Union, the inflation criterion will pose few problems, as inflation in the countries of the EU has been decreasing quite dramatically over the last two to three years. Average inflation in the European Union is close to 2%, with extremely small deviations within a band ranging 1.5%to 2.5%. So there will be neither a problem of substance nor a problem of interpretation regarding this criterion. Nor are there likely to be many problems with regard to the long-term interest rate criterion, because interest rates have been converging sufficiently.

The exchange rate stability criterion would also appear to be unlikely to cause major difficulties. As you know, exchange rates have to be stabilised during the two-year period preceding the choice of the initial participating countries. Where problems could arise, however, is in the area of fiscal policies, where results have so far been disappointing. The last few years have shown a steady downward convergence of deficits but the last results for 1996 are still far from good. Much now depends on the results that the policies that have been enacted on budgets will actually produce this year.

With regard to the interpretation of the fiscal criteria, I would like to emphasise that I cannot speculate on what the Heads of State or Government will actually decide, although I do have some ideas of how I would see the interpretation carried out by the EMI Council. Referring to the fiscal criteria, one has to bear in mind that the Maastricht Treaty says three things and not one.

First, it establishes reference values, the 3% deficit ceiling and the 60% debt ceiling. Normally neither of these reference values should be exceeded.

Second, the Treaty says very clearly that exceptions, which it describes very carefully, can be accepted under certain circumstances. However, since these exceptions are not quantified, the Treaty is open to interpretation on this point.

Third, the Treaty makes an important point which is often overlooked, namely, that the results should be sustainable. In fact, the Treaty refers to sustainability twice: to cover all convergence criteria in general and, specifically, in respect of budgetary positions. Sustainability surely implies lasting more than one year. Of course, putting these three requirements together is going to be a difficult task professionally, quite apart from any political considerations, which are beyond the remit of the EMI Council.

At this point I would like to refer to the role of the European Central Bank in two specific areas: monetary policy and foreign exchange policy. The Treaty is absolutely unambiguous with regard to the ECB's monetary policy objectives, clearly stating that the primary objective of the European System of Central Banks (ESCB) will be to maintain price stability. This is an objective which is not formulated in such strong and such clear terms in

any of the existing central banks' statutes. I am not quite sure how the Governing Council of the ECB will interpret its mandate, but maintaining price stability has already become a tradition in central banking policy in all European countries.

It is not by accident nor by an act of God that inflation rates have come down in all European countries. It is because central bank policies have been converging in that direction for a number of years. So, since central banks have pursued these policies so far, there would appear to be no need for all or some of the banks to change them.

With respect to monetary policy strategy, the Governing Council of the ECB is free to decide whether to use a primary target, an intermediate target or a direct inflation target. The difference between these strategies should not be overemphasised, since even those who believe that a direct inflation target would probably be preferable accept without the slightest hesitation that one or more monetary aggregates ("Ms") have to be monitored very closely. There is simply no way of carrying out central banking policy without closely monitoring Ms. From the Bank of England Quarterly Review one can see how closely that is monitored in a central bank where the objective is direct limitation of price inflation. At the same time, in other central banks, of which the Deutsche Bundesbank is, of course, the clearest example, M3 is a priority intermediate target, which is followed on a medium-term basis. The Deutsche Bundesbank takes into account other developments as well, as can be seen from its Bulletin.

The selected monetary instrument will be short-term open market operations, probably using repos. There will be a corridor within which money market trades will develop, with a ceiling which will be provided by a sort of lombard rate and a floor provided by the rate on a deposit facility.

There will also be a certain number of special facilities to accommodate the needs of smaller banks. All this is now in the implementation phase and the EMI is currently involved in establishing a list of the eligible paper that can be used as collateral both for repos and for other market operations.

The foreign exchange policy of the future Economic and Monetary Union consists of foreign exchange inside Europe and foreign exchange with the rest of the world. Foreign exchange inside Europe will be governed by the ERM II agreement.

The possible exchange rate policy with the rest of the world - and in particular with the dollar and the yen - is clearly related to developments at the IMF. The main responsibility for that exchange rate policy rests with the governments of the EU Member States but the agreement on ERM II also lays down two clear principles. First, the governments - represented by the Finance Ministers - will have to consult with the European Central Bank. Second, foreign exchange rate policy must not imply any risk to the internal price stability of the euro area. This means that the European Central Bank cannot be forced to intervene in foreign exchange markets when the Bank judges that it is putting its own mandate, i.e. the price stability of the euro area, at risk. This is set out precisely in the document on the ERM II, which also states that the European Central Bank can suspend intervention if it considers that the intervention favours the third currency and increases domestic liquidity to the extent that it could undermine price stability.

As regards the possible role of the euro as an international reserve currency, it is likely that the euro will become, over time, a significant international reserve currency. What are the preconditions for that happening?

One precondition clearly concerns the monetary policy pursued by the

European Central Bank. As I have said, the monetary policy of the ECB will be aimed at achieving and maintaining internal price stability. The result of this will be that the euro will be a stable and basically strong currency, which will enable it to become, in the longer term, an international reserve currency.

A second precondition concerns the development of the government debt market denominated in euro. What investors look for in a reserve currency is not only a strong currency or even a transaction currency, but also one whose capital market is liquid enough and functions well. How is that going to happen for the euro? Of course, we cannot be sure, but I anticipate that a euro-denominated government debt market will develop more rapidly than might normally be expected. It was decided in Madrid that from 1 January 1999, all new government debt will be issued in euro and that the European Central Bank would operate in euro from that day on.

The interbank market will move into the euro instantaneously, not by decree, but just because it will be impossible to do business otherwise. If a bank's relations with the European System of Central Banks are in euro, the interbank market will follow suit. The need to issue new debt in euro combined with the need for all interbank transactions to be conducted in euro will put tremendous pressure on governments to accelerate the redenomination of their existing debt in euro. Again, this will not be decided by any treaty obligation but will be the result of competition among governments.

All this does not necessarily mean that there will immediately be a smoothly functioning market in government debt. Harmonisation of issuing techniques between governments is needed, too; coupons will have to be paid either quarterly, semi-annually, or yearly, for example. The details of government debt issue will need to be brought into line in order to be a single market in such instruments.

I would anticipate, but without any inside information, that there will be considerable pressure to proceed with this harmonisation. If this happens, then the euro is likely to become an important international reserve currency relatively quickly and will introduce a new element in the world financial markets, particularly with regard to the dollar and the yen.

EUROPEAN MONETARY UNION

Johann Wilhelm Gaddum

The project of a European monetary union was embarked on many years ago. For a long time, it was not taken quite seriously. This has now changed. In only about one year from now, the participating countries are to be chosen, and the European Central Bank is to be set up by July 1, 1998.

The Maastricht Treaty on European monetary union is part of the Treaty on European Union. The latter's political objective, namely to further develop the process of European integration, goes far beyond the purely monetary sphere. Economic calculations have never occupied the first place in European policy - they have frequently been merely a means to an end.

On the other hand, the Treaty requires the EU countries - quite rightly - to prove their economic and economic policy maturity, through the much-discussed convergence criteria, in order to be allowed to participate in monetary union. A low rate of inflation, broadly similar interest rates, stable exchange rates and a sustainable fiscal situation in respect of public finance are intended to provide a secure and strong basis for building a community of stability.

In respect of the monetary criteria of inflation rates and long-term interest rates, marked progress has been made in the European Union in the past few years. It is not only greater harmony in the trends which is to be noted. What is more important is that the figures are converging at a lower level. A number of countries have meanwhile reached a stage which can be more or less equated with price stability. Exchange rate fluctuations in Europe have decreased perceptibly.

The main problems at present are located at the fiscal level. The public finance situation is difficult in most EU countries. This applies to Germany, too. Germany's deficit last year according to the Maastricht Treaty definition, at about 3.8 % of GDP, was almost one percentage point above the reference value for meeting the convergence criterion. Although the overall debt level, at 60.7 %, relative to GDP, is lower than in most other European countries, it still exceeds the 60 % ceiling.

It is true that when assessing the German situation it has to be borne in mind that fiscal policy makers have had to deal with extraordinary challenges in the past few years resulting from German reunification. This has had an impact both on the budget deficit and on the debt level. At least half of the increase in the overall indebtedness of our central, regional and local authorities since 1989 has probably been attributable to the burdens arising from reunification. However, the awareness of the causes of the high public sector indebtedness does not alter the need to change the fiscal policy course or to stop the debt from rising further.

In this context, the key aim is to achieve long-term consolidation success which ensures a permanently sustainable public finance situation. Operations which only shift burdens to the next year or the next few years, are useless and also not in keeping with the objective set out in the Treaty. The objective of limiting indebtedness is to restrict the consequences of borrowing - that is the debt service - to a scale which is sustainable over the long term. The current year's figures, therefore, also have to be judged against the perspectives for the future.

The German Government has set itself the target of limiting the deficit

in the current year to 2.9 % of GDP and of continuing to reduce it even further subsequently. The size of the task facing German fiscal policy makers has grown even bigger as a result of the unfavourable labour market situation. For that reason, it will certainly not be easy to achieve this self-imposed fiscal consolidation target. It is still too early today to judge the results of the measures already implemented or announced.

In about one year from now, the heads of state or government will decide which countries fulfil the preconditions for participating in monetary union. By that time, the performance data for the 1997 financial year will be available as well. The choice of participants that has to be made in the spring of 1998 may mean that only a few countries join the monetary union in the first round. The Treaty provides for the possibility that not all European countries will participate from the outset. But it also gives them the right to join EMU at a later date if they fulfil the criteria.

There is nothing wrong with starting with a smaller range of participants if that makes it easier to launch a real community of stability. This is also in the interests of those who join later. The initial years will be crucial for determining the level of public confidence enjoyed by the European monetary union worldwide. The key factor for deciding which countries will participate in EMU should be that the criteria used for actually determining which countries qualify convince the public, the market, investors and savers alike of the credibility of the project.

With its eye set on the important date of January 1, 1999, the German banking industry has already embarked on conversion preparations across the board. According to a survey conducted in the spring of this year by the German Industrial and Trade Association (DIHT), 85 % of the banks have already started preparations. If it is further assumed that in the savings banks and cooperative bank sector the main burden of preparing for the euro probably focuses on their central institutions, one could say that the entire banking industry has begun the conversion process. It is not surprising that institutions which operate on a cross-border basis are preparing especially actively. This can also be seen in industrial firms and large commercial enterprises.

It is understandable that the banks and the financial markets are particularly interested in making conversion efforts. They are the institutions which are most affected by the envisaged currency reform. This applies not only in respect of the conversion process. Financial market players face constant, strong competitive pressures on a world-wide basis, that is in Europe, too. The introduction of the euro will increase this tendency. But, in turn, this will also enhance the efficiency of the banking industry.

The German universal banking system and the Anglo-Saxon specialised banking system will compete with each other in a single market with a single currency. That may lead to a redefinition of business boundaries. In this context the German big banks are particularly interested in British investment banking. I do not wish to rule out the possibility either that in future a greater degree of specialisation may be introduced into the German banking sector. Experience argues against the assumption that one type of institution is always capable of doing everything best.

In Europe the euro will lead to the creation of a single capital market. This is obviously also increasing competition between the financial centres. This presents a challenge both to borrowers and to the market organisation. At present the government bonds issued by the Federal Republic of Germany act as the benchmark in Europe. It intends to safeguard this position in the euro market, too, by providing clear maturity structures in the

market for Federal paper, by ensuring highly liquid issues as well as by being present across the entire yield curve through coupon stripping (from July 1997).

In the past few years Parliament has given the German financial centre a modern legal framework by passing the Financial Market Promotion Acts. Capital transfer taxes were abolished, the Federal Supervisory Office for Securities Trading was set up and legislation to combat insider trading was adopted. The opening of the German Financial Futures Exchange (DTB) and the introduction of the electronic stock exchange trading system IBIS has to be seen against the background of these preparations for competition. The German Stock Exchange assumes - and I share this assumption - that screen-based trading will gain increasing importance in future compared with floor trading. The modernisation of stock exchange trading, together with Germany's particularly efficient securities settlement system, should create good starting conditions.

Even if the preparatory work at the banks, on the stock exchanges, in industry and between the European central banks is being pursued systematically, it should not be overlooked that there are still problems and unsolved tasks. Thus, although the countries of Europe have agreed on implementing monetary union, they are retaining their sovereign power in the other policy areas, for example, in economic policy. How these national (regional) economic policies can be fitted in with the single monetary policy in Europe is something which we will have to learn by experience.

It is absolutely clear that there can be only a single monetary policy for the entire euro area, geared towards the final objective of "achieving and safeguarding monetary stability". Monetary policy cannot, and should not, be used for conducting regional policies. The European Central Bank will have to learn to resist potential political pressure towards paying attention to regional concerns. That is why it is important to ensure that the European Central Bank, like the Bundesbank, can conduct monetary policy completely free from political interference.

One imperfection that has to be tolerated is that the European Central Bank's monetary policy will not have exactly the same effects everywhere as long as there are differences in national financial market structures and as long as the different national economic cycles do not coincide. Fiscal policy can likewise be used only to a limited extent for evening out regional differences.

On the one hand, the nations of Europe are apparently not willing to develop the European Union further in the direction of a transfer union, that is to strenghten the mutual financial links between the member countries. On the other hand, the planned stability pact limits the national governments' leeway for incurring debt. This reminds economic policy makers again of the fact - and this can well be regarded as an advantage - that they must look for, and find, regulatory solutions. Ultimately, payment transfers can do no more than treat the symptoms.

The general subject matter of this symposium focuses on the potential challenge posed by the euro to the dollar and the yen. At present the US dollar is clearly the predominant world currency, even if its importance has decreased somewhat in the past two decades. The second most important reserve currency is the Deutsche Mark. The yen currently occupies third place. In the autumn of 1996, 62 % of the world's currency reserves were held in US dollars, 15 % in D-Marks and 7 % in yen. The other EU currencies, taken together, came to about 5 %. Thus, in respect of the world's currency reserves the dollar today has three times the weight of the EU currencies. There is no reason to assume that this ratio will change in the short run.

Precisely what role the euro will ultimately play in the concert of world currencies, beyond that of exercising a reserve function, depends on quite a number of factors. Thus, it is not surprising that opinions differ concerning the future competitive behaviour between the euro and the dollar. Of course, the basic prerequisites for being a global competitor are unlimited convertibility and the free movement of capital. At the political level, international investors demand stable and secure social conditions in a given country or region.

The economic strength of the entire European Union - in terms of its aggregate national product - is not inferior to that of the United States. Much the same applies to the respective share in world trade of both regions. Regarding the current account, the euro has favourable starting conditions. This may well be important over the long term, if the financial markets once again realise that a permanently large current account deficit may generate downward pressure on the currency and thus may become a handicap in competing for capital investment. At present the US current account deficit has an order of magnitude of about US$ 160 billion (expected for 1996), whereas the European Union, in total, runs a considerable surplus (1996: about US$ 85 billion).

Conditions are fairly evenly balanced in the bond market. In 1996 the six most important European currencies, taken together, more or less matched the importance of the dollar in respect of new issues of international bonds (40 % each).

A major role will be played not least by the stability performance of the euro expected by the financial markets, and thus the credibility of the monetary policy course pursued by the European Central Bank. At the institutional level, the ECB Statute has laid a corresponding basis for winning trust in advance. If monetary union is a success internally, there is a fair chance that the euro will also become a desirable currency at the global level, and may thus carry on, in that sense, the tradition of the Deutsche Mark.

EURO, ITS IMPLICATIONS FOR THE FINANCIAL SECTOR

Thierry Walrafen

The transition to the euro is a major challenge for the European finance industry . A single currency is a significant further step towards the completion of the single European market for financial services. For the banking and financial sectors of the countries within the European Union, it is a crucial change. But the introduction of the euro will also have consequences on the rapidly changing world of international finance .

In short, the euro means change, but not isolated change.

The changeover to the euro is just one more element added to the potent driving forces that have been at work for some time in the transformation of the banking industry. These forces are well known: rapidly evolving information technology and far-reaching deregulation-most notably the abolition of all exchange controls, and the extension of market mechanisms to regulate interest rates and credit distribution-have interacted, and brought about changes to the financial markets so dramatic, that when one looks backwards ten to fifteen years, it is not excessive to speak of a revolution. A single currency will give a strong additional impulse to this on-going transformation.

It will not be a spot change either.

January 1999 is an important date. Significant events will take place on this first day of the third and last stage of monetary union whose date has been set:

—the euro will become the currency of all the participating member countries;

—the responsibility for monetary policy will be handed over by the national central banks to the European Central bank.

But if the switchover is to be carried out on a predetermined date, its consequences and its influence in shaping the new features of the finance industry will be felt over a long period. More than a big bang, it is an ongoing process. This process is already under way ; it is now quite some time that the perspective of a single market for financial services has been introduced in the plans of the main players-indeed, the euro has been talked over for so long that it will hardly be seen as a novelty when it arrives.

This process will not end in January 1999; it will take years for all the participants in the markets to draw all the consequences from the new context and thoroughly to adjust their practices to operating in a single currency ; various markets will not be affected in the same way nor at the same speed-typically, a single currency will fundamentally alter the ways of conducting wholesale business, whereas retail banking will much less directly impacted.

Euro also means competition.

Abolishing currency barriers means extending the area open to level playing competition between the providers of financial services. To take advantage of this new environment, all firms will have carefully to assess

where their strengths and weaknesses lie. A clear view of one's own sources of competitive advantage will be necessary to all participants who wish to have success in the new environment.

Operating in a single currency, the market of the euro will be a wider, deeper and more transparent market than any of the national currency markets it will replace. This will significantly enhance its ability to compete in the global financial world where there is room only for a limited number of really global financial centers .

Let me come back to some of these points in greater detail.

1. Managing the changeover

Seen from the firm's point of view, strategic and marketing issues are crucial for success, but the first necessity remains to master the practical problems relating to the changeover. To the bank and finance industry, the currency is the raw material. The change of currency creates the need to adapt all systems to make them able to operate with the new input.

The change of a currency is not without precedent. All past experiences have shown that it is, from a practical point of view, a rather complex operation that requires careful planning, precise sequencing of events and good coordination. Defining the framework for the switchover is even more complicated when it involves replacing several national currencies by a European one-this is an unprecedented case. European institutions, national authorities, private sector representative bodies and, eventually, individual firms have to play their part if everything is to go well.

At the European level, it was the new Commission, coming into office in January 95, who gave impulse to preliminary reflexions that had already been initiated by its predecessors. The Green paper of the Commission was made public in June with a draft scenario suggesting a split between the switchover of wholesale transactions right from the effective start of monetary union, and the changeover for the operations of the general public at a later date when banknotes and coins in euro would be ready. In November 1995, the EMI (European Monetary Institute) itself came out with its own proposal, and finally, middle December 1995, at its Madrid meeting the European summit adopted the final scenario.

From then on, work began in earnest at national level. In France, this has led to a "Plan for the banking and financial community (the Paris plan)" which has been released in February 1997 by the "working group on the changeover to the euro" that had been set up a year earlier by the Banque de France and the French Association of Credit Institutions and Investment Firms (AFECEI, Association française des établissements de crédit et des entreprises d'investissement) . As a complement to these general principles, AFECEI also published very detailed technical terms of reference-altogether a good thousand pages-where information is provided on the operational procedures agreed upon. Implementation is now the responsibility of each firm, but it will be overseen by the Working Group and ad hoc steering committees made up of professionals will regularly monitor the progress.

The two main assumptions of the Paris plan are:

(1) There will be two key turning points in the changeover to the euro:

—the first in January 1999, when all financial markets will switch to the euro for transactions between professionals;

—the second and final one, in late 2001 or early 2002 (the Madrid summit decision states "at the latest on 1 January 2002") when bank notes and coins in euro are introduced allowing the replacement of French francs

by euros in all accounts and means of payment.

(2) Demand for euro denominated products, notably from non-financial firms, will emerge starting in January 1999, and the transitional period from 1999 to 2001 will call for a degree of flexibility and adaptability. But coherent solutions will have to be designed to save the general public from having to cope with two monetary units pending the introduction of euro bank notes and coins.

The main feature of the Paris plan is to call for a swift change of all monetary and financial markets to the euro right from the 1 January 1999:

—credit institutions' accounts with the Banque de France will be converted into the euro and managed in euro from then on;

—monetary and exchange rate policy operations by the Banque de France in execution of the decisions made by the European central bank will be conducted in euro;

—on the interbank foreign exchange market, transactions against third-country currencies and the currency quotes will be expressed in euro only; the banks will stop quoting the franc and other currencies of participating member countries;

—Paris interest-rate markets (money and bond markets) will operate in euro. The French Treasury will issue its new debt in euro, and convert all outstanding French franc denominated government debt into euro. For securities not yet converted, quotes will be given on the basis of the euro equivalent of their par value in francs;

—the Paris equity market will operate in euro. The prices for shares, investment certificates and convertible bonds in euro will be the only valid prices for market orders. Mutual funds will change their accounts to euro, and the break-up values in euro will be the only legally valid reference.

It is assumed that the mass of everyday transactions involving the general public will remain mainly denominated in francs up to the end of the transition period. Therefore bank relations with their retail customers will mostly be conducted in francs. Accordingly, the interbank clearing system will operate in francs. Transactions initiated in euro by customers will be possible, they will be converted in francs by the sending bank before transmission to the clearing system.

All other payments systems will operate in euro as from 1 January 1999, these include notably:

—the real time gross settlement system (TBF-Transferts, Banque de France), to be the French access point to TARGET being developed at the European level to handle large value payments and thus ensure effective transmission of the single monetary policy and a really single money market for the euro;

—all delivery-versus-payments systems for securities transactions.

Time is relatively short —there is not quite 650 days left before the set date, that is much less than 500 working days to go. But as I have already recalled, the matter has been under discussion for quite some time and it would be hard for a financial institution to pretend being caught unawares.

Taking Caisse des dépôts as a case study which I am in a privileged situation to observe-and I had better be since I am in charge of overseeing the preparation of the group-, we have set up a steering group that first met at the executive committee level in July 1995, just after the Cannes European Summit to which the Commission's Green paper had been presented. Preparatory work is now monitored on the basis of a monthly system of reporting. Special emphasis is currently put on computer systems adaptation since it is clear that all systems will have to be able to operate

under the new environment by mid-1998, so as to allow for the tests and commissioning during the second half-year, in due time to be ready before the actual starting date.

All operating units keep the full responsibility for their own adjustments, but they refer to the steering group and the executive committee whenever there is a need for decision. They keep in line with main general guideline calling for every one to respond to customers' wishes, and therefore be ready as of 1 January 1999, to satisfy requests for francs or euro whenever the choice is possible.

Of course the changeover and the necessary adaptations of data processing will have a cost. It is worth noting that concern over these costs to be borne by the financial intermediaries tend to diminish, rather than increase as would have normally been expected, the closer one gets to the deadline. This can be explained by two main reasons.

(1) Costs are bearable.

Making good use of the relatively long time span that is being made available to enforce the unavoidable software changes makes significant cost reductions possible. Indeed the pace of technological change is such that a very significant number of the softwares to be modified would have had to undergo significant reshaping, or even thorough redevelopment, in the years of the changeover. Introducing the euro in these new developments is not adding much extra cost.

Moreover many of the necessary modifications will be included in the ongoing maintenance carried over on a regular basis by in-house forces, there again, the cost of the euro-related adjustments will be limited and it will be rather difficult to isolate them.

To stick to the case of Caisse des dépôts, last September, the costs of adapting the data processing systems of the banking and markets departments was estimated in the range of 2 to 3% of administrative expenses for the two years to day one. No new evaluation of these costs have been made since then, but as yet I have no indication that they have been under-estimated.

(2) Costs are not the main issue.

At the aggregate level, there is little to be gained by insisting on the burden the financial sector will have to bear. Banks are not generally popular enough with public opinion that they could hope to raise support for their claim to be compensated for their costs. Even less so when it is clear that they will themselves directly benefit from the expenses to be incurred, and that is obviously the case for the bulk of the communication and training costs that make up, according to most estimates, nearly two-third of the overall amount-investiments in information technology being responsible for the remaining part in the range of one third to 40% of the total.

At firm level, since it appears that costs are bearable, there are other, more important issues to address. Predominance is given to assessing the fundamental changes the single currency will trigger and, on this basis, defining business strategy. Currencies are a major factor in structuring the banking and financial markets; financial players used to living with different national currency areas will have to adjust to the new, much larger, European currency area: this means more players competing on equal footing; with time, it will significantly alter the features of the industry by renewing the sources of competitiveness. As other fundamental changes, the introduction of the single European currency brings about risks one should try to evade, and opportunities one will seek to take advantage of.

Under such circumstances the costs of the changeover must be considered as investments, this is especially true of training and communication costs.

It is now time to address the issue of competition.

2. The dynamics of adjusting to competition

At first the main direct impact of the single currency will be felt on the capital markets, and to be more specific on interest rates markets.

Fully integrated money markets will result from monetary union. The European System of Central Banks, operating through the national central banks, will execute the monetary policy of the European Central Bank. The integrated European payment system (TARGET, Trans-European Automated Real-time Gross Settlement Express Transfer System) will interlink the national real-time gross settlement systems and the payment mechanism of the European Central Bank. Short-term funds will thus circulate freely and instantly. National intermediaries will not be able any more to put forward their privileged insights on their domestic policy-making and markets as an argument to seduce potential customers. From day one of phase B, that is from January 1999 onwards, there will be one monetary policy and therefore one set of money market rates.

The fragmentation of bond markets by exchange rates risks will disappear. One big market for fixed-income in euro will develop overtime.

One distinctive feature of this new integrated market for euro interest rates is the absence of a natural benchmark borrower recognised by all as the credit-risk free reference from which to derive a yield-curve. Typically, the central government, as the highest quality debtor, serves as the foundation for national fixed income markets. In the euro-zone, there will be not one but several governments qualifying as potential benchmark. It will be left to the markets to decide. Credit risk will hardly be a discriminating element. The central governments of most European union countries already enjoy triple A rating for their debt, internal and external and the Stability and Growth Pact, reinforcing the commitment to fiscal discipline already included in the Treaty, should prevent any significant increase of fiscal deficits or of overall government debt. It is therefore likely that credit risks remain close, rather stable, and low.

Competition between participating governments to qualify as the benchmark issuer is nevertheless open. But it is on the liquidity and transparency of their debt market that sovereign issuers try to build up their comparative advantage. As an example, the French Treasury, through modern debt management with competitive bidding procedures and a recognized system of primary dealers, offers products that cover the whole range of maturities from less than a year to more than twenty years; by the so-called "assimilation" technique, in which new tranches are regularly added, the liquidity of existing bonds is maintained. The French government has already announced its intention to convert all of its existing debt to the euro right from the start of monetary union in 1999, thus offering market players a large volume of euro-denominated debt securities. Other governments of countries eligible to monetary union also have been active in modernizing their debt management procedures to prepare for the new euro environment in which they will loose their privileged position of unchallenged benchmark on their home market.

Competition between issuers is not limited to central governments. The European Investment Bank, the financial arm for long term loans of the European Union, and the biggest supra-national borrower, has made its

own ambitions known. It has taken the lead in launching the first ever euro-denominated loan in January 1997. More recently, it has embarked in a program of parallel issues in the currencies of the countries most likely to participate in monetary union from the start, indicating that these bonds, as all subsequent debt issues, will be completely fungible-it is made possible since they all bear the same interest rate-and thus be ready to merge into one liquid issue in euro when it comes. These "tributaries", in EIB's words, will feed the liquidity of EIB's euro debt and, with it, the hopes of the Bank that it be recognised as the benchmark.

Related to the benchmark is the need for a yield curve for euro debt securities. There will be one yield curve for the euro. It could be derived from the interest-rate curve of the bonds of the benchmark issuer. But, given the importance of the liquidity factor, it could very well be that the reference yield curve will be made up of the most liquid credit risk-free negotiable debt security available on the markets for each maturity, disregarding the fact that they may have been issued by different borrowers, provided they are of comparable creditworthiness-for example, the French Republic being the benchmark for one and thirty year interest rates, and the Federal Republic of Germany for five and seven years.

The benchmark issue is more important for the market than for the borrower itself. The foremost concern of a borrower is to ensure that it gets access to the resources he needs at the best possible price. Many borrowers, including some government of smaller European countries, who have been selling their debt on their domestic market will need to reach to investors outside their home country. Signs are there that a number of issuers are aware of this necessity and already prepare for it. Especially in the last months, many new issues have been launched by borrowers seeking to raise their profile outside of their own national borders and offering products tailored to the needs of foreign European investors to which they had had until virtually no access.

For the financial intermediaries, whether as underwriters of new issues or active on the secondary markets, these developments mean new forms of competition.

It is well known that local players have a strong competitive advantage when it comes to issues in their national currencies. League tables consistently show that in each currency market the main issuing houses are local players. This is true in France for the French franc market, it is true in Germany for the Deutsche mark, it is just as true elsewhere. Close relationships with the borrowers, easy access to the investors and a good understanding of the behaviour of monetary authorities and of market reactions to monetary policy explain this privileged position of local intermediaries.

On the future single currency market, the understanding of monetary policy will be shared by a greater number of players. This main source of competitive advantage will not be restricted to any national group. A greater number of participants on an equal footing means a strengthening of competition. European houses' ability to compete will rely on the quality of the relationships they will establish with the main issuers. But, the placing power is also essential. To retain a significant share of business, it will be crucial to extend their customers base further outside of original national strongholds. The speed with which the savers will modify their behaviour is difficult to predict, but they will be inclined to taking advantage of the new possibility to diversify their portfolios opened by the euro.

The debate over the future international role of the euro is rather well-

known. But it is mainly conducted with a view to its consequences for the exchange rates or for the functioning of the international monetary system. These are of course very important issues. But although linked, they are different from the question which is the crucial one to the European financial community and which goes: will the euro eventually increase the volume of securities-related activity? or, will the market for the euro only end up no bigger than the sum of the volumes of activities denominated in the currencies it will have replaced?

There are good reasons to believe that in the medium term the euro will play an increased role as an investment currency. At first there may be some wait and see attitudes. And the European financial markets will not merge immediately in one really single market; aside from the currency, others factors of diversification will remain,-even if they are of lesser importance-taxes, laws and regulations...-But, with time, the credibility of monetary policy will be established and market practices will come closer together. With the liquidity and size of the European marketplace, stability will make the currency attractive for outside investors and borrowers. Over time, the euro should therefore develop in a major worldwide financial currency and increased business opportunities should therefore be coming to the European financial sector.

The last issue I want to touch upon briefly is that of the future geographical distribution of financial activities in Europe.

Competitive pressure, and with it some drive to more centralisation will certainly be felt. But it is very unlikely that it could lead in the foreseeable future to the concentration of a significant portion of the European financial sector in one single European financial center. Diversity of financial centers in Europe is there to stay. Competition will remain open and particularly intense between the major centers.

London should keep its lead, if only because with the euro more homogeneity will come to the market the comparative advantage of big volumes for commodity-type products (notably foreign exchange). Frankfurt will try to make advantage of the favour it was done by being selected to host the European Central Bank, and Paris has not given up putting forward its technological advance in systems and its achievements in developing a very active, efficient and transparent market place for all type of tradable debt securities.

It is difficult to predict who will eventually gain, or eventually ...lose. But one outcome is predictable: altogether the competitive drive will enhance the efficiency of the European financial sector. The main beneficiaries of these development will be of course the end users of these markets, investors and borrowers who will get better service at a better cost. But it will also lead to more creativity and adaptability of the European financial markets thereby increasing their ability to compete with other main global world financial centers.

Coming to the end of this presentation, I fully realize that I have left many questions unaddressed-may be there will be an opportunity to correct this when question time comes. But there is one issue that I have deliberately set aside, and that is the one relating to the probability of a punctual start for the euro in January 1999. Let me just assure you that this does not reflect any lack of understanding of the remaining uncertainties, nor is it a display of resolute wishful thinking. This is explained by the fact that I have presented the view of a European financial player. In such a position the question of whether Emu really comes forth is totally irrelevant: the probability that it occurs punctually is so great—that the risk not to be ready is

the risk that cannot be run. For Caisse des Dépôts, as for all main European financial players, there is only one motto to go by, and that is: "Don't worry, be ready".

EUROPEAN CURRENCY UNION

Lawrence B. Lindsey

Japan and the United States are mere observers to the unfolding of European Currency Union, not participants. After all, European Currency Union is and should be a purely European affair. But, as friends, allies, and trading partners, all with a common interest in the success of a liberal global trading and market based regime, we of course have an interest in the success of Europe. European Currency Union is a European Affair. But, in this world friends, neighbors, and partners often give advice and sometimes the advice is given even when it is not wanted. I hope that our good friends in Europe understand that we give our opinions (wanted or not) as friends, because we care about Europe's success and wish it well. We are not and do not wish to be the ones who must make the final decision regarding a common currency.

Therefore I am a little concerned with the title of this Symposium-EMU: The Euro's Challenge to the Dollar and the Yen. Frankly, the euro today is not so much a challenge to the dollar or the yen as it is a challenge to European policy makers who must conduct fiscal and monetary policy in the run up to currency union. In the foreseeable future, the most likely scenario for the relative importance of the dollar, yen and euro, is that the dollar and yen will continue with their current relative positions and the euro will assume the cumulative relative importance of the currencies which the euro might replace.

There are two potential deviations from the status quo that deserve comment. First, aggregation of currencies into a larger zone is most likely to

cause a reduction in the demand for the new currency relative to the total value of the currencies being replaced. This is because the sum of precautionary balances held by central banks, clearing houses, and others actively involved in transactions dealing with multiple currencies are greater when there are more currencies involved. In fact, this reduction in demand is the direct corollary of the efficiency gain that advocates of a single currency cite as one economic reason for this project.

The second deviation from the status quo that must be considered is that the euro will come to perform a store of value function which will make it a desirable asset to hold in place of dollars or yen. Stated differently, since little actual cash is held as a store of value, short term money market instruments in euro will come to replace T-bills in low risk, preservation of capital-oriented portfolios. This is an interesting idea and forms the core concept to those who envision the euro being a "challenge" to the dollar or the yen.

We should examine the premises here closely. There are currently European money market instruments denominated in European currencies which play this role. The Deutsche Mark is one leading example. So, one must ask why does one expect the euro to offer a better currency haven than the DM? One reason might be that the monetary arrangements behind the euro are "better" than those behind the DM in that inflation risk for the euro is lower than for the DM. While many might make the argument that the euro will be as good as the Mark in this respect, I have yet to hear anyone expect that it will be better. So this won't be the reason behind the "challenge" to the dollar or the yen.

The alleged "challenge" must therefore be based on some argument other than "quality". I think of this other argument as the "quantity" argument or the "aggregation" argument. For the euro to be a better store of wealth than the DM there must be some advantage to the size of the issuing agency. Under this theory, the dollar and the yen have their positions because of the size of their GDPs. Or, more precisely, the demand for a currency as a store of wealth must rise not only in proportion to the GDP of the issuing country, but MORE THAN in proportion to the issuing country. If this were not the case, then the same of amount of wealth would be held in euro as in DM, Francs, Lira, Guilder, and Peseta. Thus, for this aggregation argument to work in economic terms, demand must be related to economic size with an elasticity of more than one.

Is this plausible? Advocates of this argument most often point to the dollar, believing that the dollar is the preferred store of wealth throughout the world because of the size of the U.S. economy. But, what of Switzerland? The U.S. economy is perhaps 35 times that of Switzerland. If aggregation was all that mattered, then the dollar would have to play a store of wealth role in the world more than 35 times that of Switzerland, perhaps 50 or 100 times as much. Surely it does not.

In fact, even a times series analysis shows that this argument does not work. The ratio of U.S. currency to GDP fell from 4.7 cents on the dollar in 1970 to 4.15 cents in 1980. It then rose to 5.1 cents to the dollar in 1995. Over this entire period, the ratio of U.S. GDP to world GDP was diminishing slightly and continuously. If size or relative size had any real value, the ratio of currency to GDP would not have exhibited this pattern.

What clearly does matter is the quality of the currency as a store of value.1980 probably marked a low point for global faith in the U.S. dollar as our fiscal and monetary policies were clearly inappropriate and our global role in the world was in disrepute. The 1980s brought a revival in confi-

dence in the soundness of U.S. policy, both in terms of monetary policy and in terms of global leadership. The dollar rose accordingly.

Thus, as a store of value, the euro does not offer an obviously better alternative to the Deutsche Mark. It would be unlikely therefore, that there would be any sudden increase in the demand for the euro, relative to the current demand for the basket of currencies which the euro will replace. Thus, the alleged challenge to the dollar or the yen does not seem self evident in the foreseeable future.

Instead, as I mentioned, the challenge will be one for European policy makers. I say this due to my experience as a central banker for a currency which spans a continent. At any given time, some parts of our continent are in secular decline and others are enjoying a secular expansion. There is little that a monetary policy can do about such secular changes. Overlaid upon these secular changes is the fact that parts of the continent are also enjoying business cycle booms while others are enduring recessions. These business cycle changes are most often manifested in terms of rapidly growing incomes, tight labor markets, and particularly rising (or falling) real estate values. A monetary policy which might work in California might be totally inappropriate in New England or Texas. Yet, a single monetary policy must be implemented.

Of course, the absence of regional exchange rate adjustments is not the end of the world, macroeconomically speaking. In the United States we have two key adjustment mechanisms which moderate the impact of regional economic fluctuations: labor market mobility and fiscal transfers. Let us consider each in turn.

In any given year roughly 17 percent of all Americans change their residence. The figure is particularly high for younger people. Roughly one third of people in their 20s change their residence. Roughly one third of these movers changed their county of residence and more than 40 percent of these changed their state of residence. In total, some 7.7 million people change their state of residence in a given year.

This can provide an enormous amount of adjustment for a local economy. For example, during the California recession in the early 1990s, nearly 1.2 million people outmigrated from that state. The booming states of the Rocky Mountains absorbed a good many of these movers. The number of jobs in Utah, for example, rose 24 percent while Colorado had a 20 percent increase in the number of jobs. In Europe, cross national migrations simply do not approach this magnitude. While this may change in future decades, cultural, linguistic, and I might add, culinary, differences provide major obstacles to migration as a mitigating factor for regional business cycles.

The second major source of interregional macroeconomlc stability in the United States is automatic fiscal stabilizers. A progressive and uniform national tax structure performs this function in America. For example, had California's share of the national tax burden stayed unchanged between 1991 and 1994, it would have paid $11 billion more to Washington in that latter year. This is roughly $350 per capita or 15 percent of personal income tax collections. In Massachusetts, a similar calculation for their 1989-1992 business cycle estimated the automatic fiscal transfer at $550 per capita.

Tax cuts of this magnitude are large even as a part of intentional counter cyclical policy. Yet, they occur automatically as a part of the continent-wide fiscal system. Again the European Community lacks such an automatic fiscal regime.

In sum therefore, Europe seems to lack the alternative stabilizing mechanisms that help mitigate regional recessions in the United States. In the past, Europe used exchange rate fluctuations to help mitigate these regional recessions. In a single currency zone, it is unclear what alternative mechanisms might exist.

Let me return to my initial point of the discussion. Those of us from America and Japan consider ourselves friends of Europe. We are also supporters of a global world trading order which relies on and helps promote global economic growth. Our comments and concerns are merely directed at the fact that a single currency might not in practice turn out to be the economic panacea that many in Europe now hope.

We cannot legitimately comment on the political forces that are driving the monetary integration agenda. It may be that the political advantages, viewed from a European perspective, far outweigh any economic costs. Whatever the result, we wish our European friends well in whatever course of action they choose to pursue.

ECONOMIC AND MONETARY UNION

Takatoshi Kato

Macroeconomically speaking, as introduction of the single currency will remove exchange rate risks from transactions between participating countries, and as the European Central Bank will conduct a single monetary policy, various economic systems and standards will become increasingly homogeneous among the EMU countries. In the medium and longer term, as financial and capital markets in Europe become increasingly denominated in terms of the euro, they will show greater depth and stability, which should lend a further boost to intra-regional trade in Europe and increase activity in the financial and capital markets. While Europe will transform itself into a vast single market, incorporating currency and finance, economic activities with outside areas will also be activated. Thus financial institutions and investors outside the EMU area can gain access to financial and capital markets in Europe which will have become further strengthened.

There are no comprehensive statistics covering the extent of portfolio assets denominated in European currencies as a proportion to the total amount of those denominated in foreign currency held by the private sector in Japan. However, as of the end of February this year, large securities firms and major institutional investors in Japan had a total of $313 billion invested in foreign bonds. Of these, those denominated in pounds sterling amounted to an equivalent of about $18 billion, those in deutsche marks about $26 billion, those in french francs about $10 billion, and the total amounts invested in European currencies accounted for a little less than 20 percent of total Japanese investment in foreign bonds.

As to the effect of the introduction of the euro, Japanese financial institutions and investors currently believe that there will be no fundamental review of their portfolios by currency until the transition to the third stage of the monetary union in 1999. Some suggest, however, that after introduction of the euro, euro-denominated assets will be set to attract more investment if the euro-related markets become broader and deeper, reflecting increased liquidity flowing into these markets or as a result of a wider range of investment products newly offered.

In regard to the introduction of the euro, there are uncertainties such as, how the convergence criteria will actually be applied, how strictly the Stability Pact will be observed, and when the irrevocable conversion rates will be announced and at what level. Japanese financial institutions and investors are carefully monitoring the process of introducing the single currency, since their portfolio strategy will be affected very much by these factors.

Most of Japan's foreign currency reserves are kept in US dollars, which corresponds fundamentally to the currency composition of Japan's foreign trade. At the same time, there always exists the desire to diversify investment to spread out risks. In this light, we believe that the Japanese authorities should welcome the integration of European financial and capital markets and expansion and deepening of the single currency related markets.

Looking at effects on emerging Asian markets, many either have monetary systems based on currency baskets in which the US dollar plays a predominant role, or their currencies are pegged to the US dollar. This strong linkage between national currencies and the US dollar is unlikely to change fundamentally even after introduction of the euro. On the other hand, if the launch of the euro brings more efficient and active European financial and capital markets, and if the euro comes to earn international confidence backed by appropriate macroeconomic policies, preference for it as a financial asset may well rise in Asia, not only in Japan but also in emerging Asian markets.

As this analysis indicates, in order for the introduction of the single European currency to prove itself a valuable addition to the world economy, it is essential that the introduction process be conducted in an orderly manner, thereby avoiding any confusion concerning the changeover. We believe that two points will be particularly important:

- First, decisions on the parities between the euro and each of the participating countries' currencies should be made in such a manner and with such timing that it would serve to enhance market confidence.
- Second, even after introduction of the single currency, efforts to achieve the convergence criteria by the participating countries under the third stage of the EMU should be continued. That would strengthen confidence that convergence of the economic fundamentals of participating members is being firmly kept.

In addition, we in Japan strongly hope that, under the single currency, the entire European financial system, including settlement systems, will remain as open to the rest of the world as before. The introduction of the single currency will require non-EU companies to take on various costs, such as those related to revising computer systems, and so forth. Therefore we believe it necessary that the benefits of the monetary union should be provided to non-European countries as well.

We have actively exchanged views concerning the monetary union in

meetings of the European Commission or consultations with EU countries. In addition, at the Japanese Ministry of Finance, we established a study group for the EMU in November of last year, comprising representatives from academia, the judiciary, and financial experts. In that study group, we have engaged in very active discussions, from all angles, on the possible effects of the monetary union on the international monetary system, macroeconomy, international financial transactions, activities of Japanese financial institutions, and on legal aspects of the planned changeover. Particular attention is being paid to the question of how the continuity of existing contracts denominated in national currencies can be effectively ensured under the Japanese legal system in the post-changeover period, which has drawn wide attention especially in financial circles here. The study group plans to publish its findings in an interim report.

The advent of the euro will mean that an economic region comparable in size to the economic and financial markets of the United States will come into being, although its exact dimensions will depend on the number of participating countries. Much debate is going on as to what the world economy will look like with two major currency areas, or three, if one includes the yen. The role of the Japanese yen, as a currency for international transactions or as reserve assets, has so far been limited to approximately a 10 percent share of the world's total. In view, however, of the progress in horizontal and vertical division of labor underlying international trade involving Japan, and of the tendency of neighboring monetary authorities to diversify their reserve assets, the role of the yen as an international currency can be expected to rise gradually. To that end as well, we think it is important that we further revitalize the Tokyo market as one for yen financing and investment.

We are exerting our utmost efforts to completely reform Japan's financial system. This reform is known as the Japanese "Big Bang", which aims at revitalizing the Tokyo financial market and making it an international financial center on a par with New York and London by the year 2001. To pave the way toward that end, a bill for revising the Foreign Exchange and Foreign Trade Control Law has been submitted, and deliberations are going on in the Finance Committee of the Diet to make all external transactions conform to global standards and to fully liberalize foreign exchange operations, thereby hoping to reinvigorate financial markets in Tokyo.

We are proceeding at an accelerating pace with the deliberations on a comprehensive plan to complete all planned reforms by 2001, and the overall picture of which will become apparent this June. After that, we will continue to make relevant decisions and successive reform-related bills will be put on the agenda of the next session of the Diet. As Mr. Walrafen said in the conclusion of his remarks, "Don't worry, be ready." We will proceed with our best efforts, bearing his words in mind.

Appendix

Euro Changeover Scenario
Convergence Criteria
Stability and Growth Pact
International Monetary Chronology

Euro Changeover Scenario

early 1998	• Decision by the Heads of State or Government on the countries participating in the European Currency Area. • ESCB established. (ESCB:European System of Central Banks)
January 1, 1999	• The euro introduced in a non-cash form. • Irrevocable fixing of conversion rates between participating currencies and the euro. • ESCB begins the single monetary and foreign exchange policy in euro.
January 1, 2002 at the latest	• Euro banknotes and coins introduced and withdrawal of national banknotes and coins initiated.
July 1, 2002 at the latest	• Completion of changeover to the euro. • National banknotes and coins lose legal tender status.

Convergence Criteria

1. The Criterion on price stability

The average inflation rate of a country must not exceed that of, at most, the three best performing countries in terms of price stability by more than 1.5 percentage points for a period of one year before examination.

2. The criteria on government budgetary position

① Annual general government budget deficits must not exceed 3% of their GDP unless the ratio has declined substantially and continuously and is close to the reference value, or unless the reference value is exceeded only temporarily and as an exception while the ratio remains close to the reference value.

② Total general outstanding government debt must not exceed 60% of GDP unless the ratio is sufficiently diminishing and apporoaching the reference value at a satisfactory pace.

3. The criterion on exchange rate stability

A member state's currency must have participated in the Exchange Rate Mechanism of the EMS and been kept within its normal fluctuation margins without severe tension for at least two years before examination;the currency's bilateral central rate against any other participating state's currency must not have been devalued on the initiative of the country for the same period.

4. The interest rate criterion

The average nominal long-term interest rate of a member state must not exceed the corresponding average rates in, at most, the three countries with the lowest inflation rates by more than two percentage points for a period of one year before examination.

Stability and Growth Pact

Pact ensuring budgetary discipline by EMU countries

A. Surveillance and Sanctions

Member States in the third stage of EMU will be obliged to submit stability programmes to the European Commission every year and subject to agree sanctions for failure to act effectively on excessive deficits. The stability programmes will specify their medium-team budgetary objectives, together with an adjustment path for the government surplus or deficit ratio and the expected path for the government debt ratio.

B. Excessive deficit

A deficit over 3% reference value shall be considered to be excessive.

C. Exceptions

(a) Government deficit over 3% reference value resulting from an economic downturn shall be considered to be exceptional only if there is an annual fall of real GDP of at least 2%.

(b) An annual fall of real GDP of less than 2% is nevertheless exceptional in the light of further supporting evidence. In evaluating whether the economic downturn is severe, the Members State will as rule take as a reference-point an annual fall in real GDP of at least 0.75%.

D. Structure and scale of sanctions

(a) If a Member State fails to act in compliance with the succesive decisions of the Councill, the Councill will impose sanctions including a non-interest bearing deposit.

(b) The non-interest bearing deposit should be converted into a fine after two years if the deficit of the government concerned continues to be excessive.

(c) The amount of the deposit or fine will be made up of a fixed component equal to 0.2% of GDP and a variable component equal to one-tenth of the excess of the deficit over the reference value of 3% of GDP. There will be an upper limit of 0.5% of GDP.

International Monetary Chronology

1971	August	President Nixon announces the suspension of convertibility of the dollar into gold, the so-called "Nixon Shock" .
	December	Smithsonian Agreement, by which major currencies are revalued and new central rates are set.
1972	March	EC nations decide to form "Snake".
	June	Britain leaves the snake and floats the pound.
1973	February	The yen is floated.
	March	EC announces a joint float of six currencies.
	October	OPEC raises the price of crude oil by 70%, from $ 3.01 to $ 5.12 per barrel;the beginning of the so-called "Oil Shock".
1978	November	The U.S. announces measures to support the dollar, whicch then recovers quickly.
	December	OPEC nations begin raising oil prices, the so-called "Second Oil Crisis".
1979	March	European Monetary System is established.
1982	August	Mexico announces that it will not meet debt payments.
1985	September	The Plaza Accord declares that the dollar is too strong and calls for orderly appreciation of other currencies.G5 agrees coordinated exchange market intervention.
1987	February	The Louvre Accord declares that the dollar has fallen far enough and agrees to cooperate in stabilizing it.
	October	Black Monday.The Dow Jones Industrial Average falls 508 points.
1989	April	Delors Report on EMU is presented.
	November	Fall of Berlin Wall
1990	October	Reunification of West and East Germany.
1991	December	Collapse of the Soviet Union Maastricht Treaty is agreed on by EC nations.
1992	September	European currency crisis.Pound and lira leave ERM.
1993	August	ERM fluctuation bands are widened to ±15% around the central rates.
	November	Maastricht Treaty comes into force: Establishment of EU.
1994	January	European Monetary Institute is established.
	December	Mexican currency crisis.
1995	April	The yen exchange rate marks postwar high against the US dollar.
	December	EU nations agree on a new schedule for the changeover to the single currency.