Symposium on The Euro:
Its Promise and Challenge
to the World Economy
July 1999

Occasional Papers

No. 8

The Euro: Its Promise and Challenge to the World Economy

Published by
I I M A
Tokyo
1999

Contents

Opening Remarks

Toyoo Gyohten
President
Institute for International Monetary Affairs

It has been six month since the introduction of the euro, the European single currency, which is a result of 50 years of perseverance since the end of the Second World War. For the euro area, this is not just the finishing line of the road to the euro but also the beginning of the challenges to a new age. As you are all aware, the euro area, as a combined economic area, is second only to the United States in terms of population, GNP, and market size.

The US economy currently enjoys a high growth rate, low inflation, low unemployment, a booming stock market as a result of its rigorous pursuit of higher efficiency and its emphasis on information technology since the 1980s. Compared to this radiant state of the American economy, we must admit that the euro area is still struggling to invigorate its economy while fighting high unemployment and structural problems. Japanese and East Asian economies are also staggering and suffering from stagnation, with financial as well as business restructuring weighing heavily upon them. It seems the American economy is the sole winner among the global economies.

The question now is whether it is possible to conquer the difficulties and to navigate the global economy to a more balanced and stable development path. What strategies should the euro area and Japan be adopting to play their roles? Will the newly born euro be able to win the necessary confidence? Today's symposium was organized with these questions in mind.

I am most pleased to say that the members on our panel today are especially well qualified to discuss these questions.

May I also take this opportunity to thank The European Commission and the Friedrich Ebert Foundation for kindly co-sponsoring this symposium along with the Institute for International Monetary Affairs.

I would now like to invite Ambassador Jo／rgensen, the Head of the Delegation of the European Commission in Japan to make his opening remarks.

Introductory Remarks

Ove Juul Jørgensen
Ambassador, Head of the Delegation of the European Commission in Japan

Ladies and Gentlemen,

The launch of the euro at the beginning of this year will, I am sure, leave its mark on history. It is not only a major development in the process of European integration, it will also shape the monetary and financial environment in the world as a whole.

This is the first time—at least in modern times—that a group of countries has adopted a new common currency, in exchange for their different national currencies. That this change has gone so smoothly is in itself a major technical achievement. Given that the participating countries together constitute the world's second largest integrated economy, that achievement is all the more striking.

The advent of the euro means that we do at last have a genuine single market in Europe. Economic and Monetary Union completes the European Single Market by irrevocably fixing the exchange rates between the euro area countries. It thereby lowers transaction costs and makes prices more transparent in an economic union where goods, services and labour move freely. Gradually, this will spur greater competition and innovation in the euro area.

Additional strengths of the euro area are a favourable external position in terms of assets and current account, a highly trained and skilled labour force, and a high level of technology and innovation in production. Taken together, the economic opportunities to improve growth, employment and living standards in Europe in a lasting manner through Economic and Monetary Union are enormous.

As a consequence, we expect to see greater stability. The large and prosperous European market should be less vulnerable to external economic fluctuations. The euro area, taken as a whole, has become less dependent on external demand and more on the domestic euro area economy than was previously the case in individual member states.

The fact that the members of the euro zone are committed to pursuing healthy economic policies, based on sound fiscal policies, together with the vigorous policy of the European Central Bank to achieve price stability, will ensure that we exploit fully the potential of this large and integrated economy.

However, we are aware that sound macroeconomic policies alone are not sufficient in themselves to make Economic and Monetary Union fully successful. Economic and Monetary Union has made further structural reform necessary. Governments in the euro zone can no longer ignore overdue reforms. More flexible labour markets, deregulation, and reform of the welfare state are now at the top of the agenda of EU governments. There may be stresses and strains to begin with, but eventually these changes will become the basis for a vibrant and dynamic EU economy.

We also expect to see greater competition, as greater price transparency in the European market puts more power in the hands of consumers. This will create healthier firms, drive up the general level of productivity, and create new jobs. There is good evidence to suggest that EU business is consolidating in order to be able to meet these challenges. In the first six months of this year, about 450 billion euro worth of merger and acquisition deals were done in Europe, over 140 billion euro more than in the same period in 1998.

Finally, we expect that the euro will create new positive conditions for the acceleration of economic growth. One benefit is the potential for the reduction of risk premiums built into interest rates, which, in turn, will stimulate productive investment. Another benefit is that a wider and deeper capital market in the euro area will improve intermediation between savers and investors, making it easier and cheaper for companies to raise funds for investment, and stimulate provision of capital for new ventures.

All these benefits will become more and more evident as time goes by, and I am confident that it is only a matter of time before the four members of the EU which are still outside Economic and Monetary Union (Denmark, Greece, Sweden and UK) adopt the euro as their own currency.

The euro also has an important external dimension. As the new President of the European Commission, Mr. Romano Prodi, has pointed out, “ the giant stride towards economic and monetary union has introduced a major actor to the international stage－the euro－and brought with it a major responsibility for ensuring monetary stability and stimulating growth after the financial crisis of recent years."

The EU is ready to take up this responsibility and to encourage the emergence of a genuine tripolar system based on the euro, the dollar and the yen. This implies a need for stronger and more effective international economic cooperation. The EU is open and firmly committed to such international cooperation.

This will not mean, however, that the European Central Bank or any other European institution will pressurise foreign monetary authorities to use the euro. Nor does it mean that the ECB, and I am sure Mr. Noyer will confirm this, will express views or make recommendations to other monetary authorities on their foreign exchange rate orientations or their choices for the investment of reserves.

The euro will gain ground in the international financial markets on the basis of its own intrinsic merits: a high degree of anti-inflationary credibility, durable internal stability, the setting-up of broad and deep financial markets, the strength of its economy, and the position of Europe as the world's biggest trading economy.

It is for these reasons that the current value of the euro is not, in my view, a matter for undue concern. After all, the euro is simply behaving like a normal currency. It might well be that markets are underestimating the intrinsic strength of the euro. This may reflect the different conjunctural positions of the American and European economies, the difficulty of estimating the real value of assets denominated in a new currency, and also the background of the events that took place in the Balkans. These factors will not last long and, therefore, the relative weakness of the euro should be only a passing phenomenon.

What I said about the internationalisation of the euro is true also for the internationalisation of the yen. We welcome the measures undertaken by the Japanese government in the last year to internationalise the yen. We are convinced that an internationally oriented yen can play a relevant and positive role in the monetary and financial stabilisation of East Asia.

These measures are not intended to boost artificially the internationalisation of the Japanese currency, but to eliminate the obstacles which still exist to the yen playing its role in the international arena.

However, these measures alone will not be sufficient. As stated by the Ministry of Finance's Subcouncil on the Internationalisation of the yen, “ the first and foremost prerequisite for assuring broad acceptance of the yen as an international currency is to restore and to enhance domestic and international confidence in the Japanese economy by promptly stabilising the financial system through disposing non-performing loans and by achieving economic recovery. This requires the restoration of medium and long-term balance."

Our assessment is that Japan is on the right track for the recovery of its economy and the recent economic indicators confirm this trend; however, it is clear that a lot of adjustment and structural reform are still needed before strong, self-sustained economic growth can be achieved.

I would like to conclude my introductory remarks by congratulating the Institute for International Monetary Affairs and its president, Mr. Gyohten, for having organised this very timely and relevant symposium. Since I arrived in Japan in April last year, I have felt a strong interest for the euro and Economic and Monetary Union not only amongst politicians, government officials, businessmen and the media, but amongst the general public. This interest might be the expression both of anxiety and hope.

Anxiety, because it may convey the impression that a new economic superpower is born, and that Japan, particularly in a period of economic difficulties, risks marginalisation.

Hope, because European countries, notwithstanding their past conflicts, have been integrating and are cooperating in new ways that may be of interest for others.

Hope, also because the birth of the euro could help to redefine a more transparent and stable international financial architecture.

These hopes and fears, together with the natural interest of economic players in the implications of the euro, are helping to maintain a high level of interest in the euro amongst the Japanese people. The strong attendance at this symposium also attests to this.

The exceptional level of the panelists gathered today will make the discussion — I am sure — lively and informative. The European Commission is very pleased to be, together with the Friedrich Ebert Foundation, one of the two co-sponsors of the symposium. Mr. Joly Dixon, a senior Director of the International Economic and Financial Affairs Directorate-General of the European Commission, should have been among the panelists. However, last Friday night he was chosen by UN Secretary General Kofi Annan as Vice-Representative of the Secretary General for the Reconstruction and Economic Development of Kosovo. I hope you will understand that under these circumstances he regrettably cannot attend. I wish him luck for his new and very challenging job.

A final remark. There is one aspect of the euro which I think is too often forgotten: its psychological impact. The European Union has many achievements to its credit, but these tend to be taken for granted. The euro will—for the first time—give the Union a "face": it will identify the Union in a way which is practical and symbolic. Both for the citizens of the Union and for its partners around the world, that can only be positive.

Thank you very much.

The euro: six months after its introduction

Christian Noyer
Vice-President
European Central Bank

First, let me thank the organisers of this conference for inviting me to participate in this panel. Indeed, in my view, the title of this symposium, “The euro: its Promise and Challenge to the World Economy," has been well chosen. The introduction of the euro, which was successfully launched just over six months ago, marks a significant milestone in the process of European integration and will bring considerable benefits to the nearly 300 million citizens of the euro area. The introduction of the euro will have a profound impact on the world economy, as well as the euro area itself, in years to come. However, the euro area also faces a number of challenges if the full potential of the single currency is to be realised.

The organisers have specifically asked me to cover several topics. Therefore, I should like to start my remarks by considering the current economic situation and the outlook for the euro area. I shall then explain the relationship between monetary and fiscal policy in the euro area and deal briefly with the issue of differing economic situations in Member States. Finally, I should also like to comment briefly on the question of structural reforms.

1. The current economic situation and outlook for the euro area

Real economy

According to a preliminary estimate released by EUROSTAT in mid-June, overall output growth in the euro area stabilised in the first quarter of this year. Real GDP in the first quarter was up 0.4% on the previous quarter, following a gradual slowdown from 0.7% to 0.3% during the course of 1998.

Even though caution should be exercised when interpreting these figures, since they combine data compiled partly in accordance with the old methodology and partly with the new (ESA 95), two broad conclusions may be drawn :

1. While previous data had suggested a rather sharp slowdown in the last quarter of 1998, the revised data imply a pattern of slowing real GDP growth which was spread more evenly over the course of 1998.
2. The weakening of output growth came to a halt during the first quarter of 1999. Data for industrial production for April 1999 confirm this picture.

Although there is not yet a clear sign of a recovery in the industrial sector, it appears that the level of industrial production stabilised over the first few months of 1999; a clear improvement compared with the pronounced decline of around 1% in the last quarter of 1998.

There have also been positive indications of economic activity in the euro area in recent business and consumer surveys. In particular, there was a further slight rise in business confidence, supported by an improvement in production expectations and a more favourable assessment of export order books, which may be seen as representing the more forward-looking components of the survey. At the same time, consumer confidence remains at an extremely high level; this is consistent with the fact that private consumption has remained robust, supported by real income growth and higher employment.

With regard to developments in the external environment of the euro area, there have been some positive signs. US growth is expected to remain strong in the near term, forecasts of growth for the United Kingdom (a significant trading partner for the euro area) have recently tended to be revised upwards and, of course, the Kosovo conflict has ended. There are also indications that prospects for several emerging economies have improved as financial turmoil has subsided and access to international capital markets has become easier. Overall, recent forecasts for the world economy suggest that the outlook has stabilised and the risk of a global recession has receded.

In all, there have been some indications of a turnaround in the industrial sector and of an improvement in the external environment. Overall, growth is expected to strengthen in the course of this year and next. Most observers now expect that real GDP growth in the euro area will be around 2% this year (compared with close to 3% in 1998) and 2.5% or more in 2000.

Prices

In response to these new data indicating a stabilisation of overall output growth in early 1999 and an economic recovery during the second part of 1999 into the year 2000, market participants appear to have shifted their expectations towards a faster pace of economic growth. Combined with recent monetary and credit developments, this suggests that downward risks to future price stability have receded further. On the other hand, all indicators we use in our monetary policy strategy do not signal upward inflationary pressures. This is true for money, with a development of M3 that remains close to the reference value, and also for the other indicators (combining financial market and real economy indicators including wage developments) that we use in our broadly-based assessment of the outlook for price developments.

The euro area yield curve has steepened somewhat more recently, as a result of a partial spillover of the sharp rise in long-term bond yields in the United States and the release of slightly higher-than-expected real GDP data for the euro area for the first quarter of 1999. However, long-term nominal bond yields in the euro area remain low by historical standards.

Annual consumer price increases in the euro area rose slightly from 0.8% in January 1999 to 1.0% in May. This small increase is mainly due to the impact of higher oil prices. Excluding seasonal food and energy, which are two of the more volatile components of the Harmonised Index of Consumer Prices (HICP), the rate of increase in consumer prices has continued to fall slightly in recent months, to stand at 0.9% in May. Recent forecasts of international organisations for inflation in the euro area over the next one to two years generally point to a range of around 1.0-1.2% this year and 1.4% in 2000.

Hence, all available evidence points to the conclusion that both in the short and medium term, price developments should be compatible with the Eurosystem's definition of price stability, i.e. with increases in the area-wide HICP remaining below 2%.

Against this background, the Governing Council has decided during its recent meetings to keep interest rates on the monetary policy instruments unchanged.

Foreign exchange rate developments

Let me refer briefly to recent exchange rate developments. Since its launch in January 1999 the euro has fluctuated significantly against the currencies of our major trading partners but currently stands at a level that is broadly corresponding to the level of its constituent currencies that was observed in summer 1997.

This fluctuation has reflected a cyclical divergence between the euro area and the United States that is expected to diminish over the course of this year and thereafter. Given that the euro is a currency firmly based on internal price stability, it therefore has a clear potential for a stronger external value. Since the start of Stage Three of Economic and Monetary Union (EMU) the euro has become the second most important international currency in the world, and the policy of the Eurosystem will safeguard its internal purchasing power, which is a basis for a solid and stable currency over the medium term.

2. The Eurosystem's monetary policy and fiscal policies of Member States

I should like to emphasise that the Eurosystem's monetary policy strategy is geared towards the maintenance of price stability for the euro area as a whole. Before the establishment of Monetary Union, monetary policies in the countries that have now formed the euro area could, at least in principle, have reacted to country-specific developments. However, with the introduction of the single currency monetary policy decisions must be based on area-wide, rather than national, considerations. Clearly, to the extent that national developments have an impact on area-wide developments, the single monetary policy takes these factors into account, but the focus of monetary policy is on area-wide indicators.

The Treaty on European Union provides a fundamentally sound allocation of objectives and instruments between the single monetary policy and national fiscal policies in Europe. The Eurosystem is responsible for maintaining price stability. The Treaty also states that it shall support the general economic policies in the Community without prejudice to the objective of price stability. There is a widely shared view that maintaining price stability is the best contribution monetary policy can make to a high level of output and employment in the medium term.

As regards fiscal policy, the Stability and Growth Pact, which was agreed by EU Member States in order to avoid excessive deficits, provides countries in the euro area with a common code of fiscal conduct that requires discipline in the management of government finances. Member States are committed to respecting the medium-term budgetary objective of positions close to balance or in surplus. Safeguarding sound government finances is a means of strengthening the conditions for price stability and of achieving strong sustainable growth, which is conducive to employment creation. An open exchange of information among policy-makers is helpful for a proper assessment of the impact that fiscal policies have on developments in the euro area as a whole. This assessment will form one input—among others—into monetary policy decisions aimed at maintaining price stability over the medium term. One of the fora via which such an exchange of views is carried out is the regular Euro-11 meeting with the Ministers of Finance of the euro area in which the President of the ECB and I participate. Other exchanges will in the future take place in the macroeconomic dialogue established in the context of the European Employment Pact, which will bring together representatives of the Council of Ministers, the Commission, the ECB and the social partners in the form of a “macroeconomic dialogue." However, I should emphasise that these other exchanges remain limited to an exchange of information and do not interfere with the responsibility of individual policy areas.

3. The need for structural reforms to promote high and sustainable economic growth

I should like to emphasise how important it is that monetary policy is supported by structural measures to improve the functioning of labour, product and capital markets. This would also enable the economies of the euro area to operate at a higher degree of resource utilisation and thus make better use of the available productive capacity. In particular, it is widely recognised that the euro area faces a problem of high and persistent unemployment, which is largely structural in nature. There is therefore, a pressing need for measures targeted at making labour and product markets work more flexibly. Furthermore, flexible labour and product markets are also important to enable national economies to adapt to shocks, particularly those that do not affect the countries of the euro area equally. Monetary policy has to maintain price stability in the euro area as a whole, so national labour and product markets need to be flexible enough to adjust to such shocks.

Although some countries have adopted a wide range of measures, the progress made so far in pursuing structural reforms has been uneven and not yet satisfactory overall. However, there are some encouraging signs. Over the past few years, the European Community has stepped up its efforts in this field, aiming to co-ordinate and improve Member States' policies in the field of employment and labour market reform and to initiate reforms that improve the functioning of goods, services and capital markets. The experience of countries that have undertaken significant reform programmes shows that it takes time to implement structural reforms and even longer for the benefits of these reforms to materialise in full, but that these reforms bring about swift progress in employment creation and the reduction of unemployment.

Finally, let me stress that while there are challenges ahead, the independence of the Eurosystem, together with the clear mandate to maintain price stability in the euro area, provides a solid foundation for the long-term stability of the euro. The first six months of 1999 have seen the successful launch of the new currency. In the coming years the euro will make an important contribution to further economic and financial integration, helping to improve the growth potential of European economies.

Employment, Stability and Efficiency: Strategic Essentials of European Economic Policy under the Regime of the Euro

Heiner Flassbeck
Former Vice Minister of Finance
Federal Republic of Germany

The introduction of the euro is a powerful expression of the European Union's common responsibility for economic policy and its ability to take decisions. The euro, however, is not the culmination of the European unification process, but rather the beginning of a new quality of economic-policy challenges. Under the regime of the euro the national economies will irreversibly grow together to form a single European economy.

Competition forces the players on the European markets to look for the best economic conditions. This must be supported politically. Furthermore, common responsibility for economic policy includes the strengthening of market forces through the removal of various impediments to trade. This will become even more evident under the regime of the euro. At the same time the adjustment process must not be distorted by widely differing country-specific rules.

But functioning markets and allocative efficiency are not necessarily sufficient to solve the most urgent problem of European economic policy, the reduction of unemployment. This requires a sound macroeconomic policy, i.e. , a coordinated strategy of monetary, wage and fiscal policies.

Divergence and efficiency

Rational behaviour of companies and households may lead to inefficient structures in overall economic terms if the existing incentive systems are detriment to the conditions of a functioning single currency area. This fact has since long been agreed upon in the EU aid regime and generally in the single market philosophy. Further requirements must be fulfilled to prevent competitive distortions under the rule of the euro. In terms of economic policy, it is now also important to prevent the possibly significant allocative distortions that may be due to wages, taxes, social systems and environmental rules.

This does not mean the establishment of the harmonisation of country-specific rules as a separate objective of the Union. But it means to draw economic-policy conclusions due to the decision to introduce the euro. The transparency resulting from the euro and the fact that there are no longer any exchange risks generally lower the transaction costs in the eoro area. As a consequence, politically determined conditions for economic activity become to a greater extent than so far significant aspects of allocative decisions. This can be a problem for the economy as a whole when individual tax rules, for example, become more important for investors than the results of market and business-site analyses. Such politically determined decisions always lead to prosperity losses. And if individual Member States think that they need to adopt similar rules as a consequence, this results in competition for “bad" practices within the Union without any perspective to improve the result for all participants. Finally, especially those countries that count in particular on this “Business-site competition" may believe that they must either request additional transfer payments from Brussels or restrict their supply of public goods. For possible temporary benefits thus a high price has to be paid in form of a higher degree of dependency from common political decisions or from future development opportunities.

In view of the common responsibility for economic policy, this sort of competition must be prevented. Therefore, we need a minimum of coordination of framework conditions that are relevant for competition in Europe. Apart from a number of obvious cases, it cannot be said beforehand what this means in detail. Nobody can know today what dynamism will be triggered by the euro and which rules must some time in the future be regarded as "bad practice." It is to be expected in any case that the discrepancy between national autonomous decisions and the prerequisites for the functioning of EMU, i.e. between divergence and efficiency, will remain on the agenda of European economic policy. In this context, a European policy requires agreement that each individual Member State cannot benefit from Economic and Monetary Union unless all benefit.

Competition among states?

The widespread idea that states also compete with each other is based on the same idea as mercantilism. These ideas saw a remarkable revival after the transition to flexible exchange rates and the prevalence of supply policy. An autonomous economic policy and progress with regard to employment policy through the improvement of the national export bases were hoped for. Economic policy was increasingly reduced to the creation of relative competitive advantages given the allegedly theoretic justification of "competition of systems. The right core of this idea is the fact that policies must of course seek efficient control systems and should also learn from foreign experiences, i.e., the "best practice" of the other countries. If this leads to a rise in productivity, wages and generally incomes can of course rise quicker than otherwise.

But this “competition of systems" is wrong and counterproductive if it takes place via real depreciations. In the case of constant (nominal) exchange rates or within a currency area, this means that competitive advantages are gained by refraining from exhausting one's economic possibilities, i.e. living “below one's means." Wage increases below the productivity development are the most important strategic aspect of real depreciation. But real depreciations also take place when the tax burden is artificially lowered. This results in a reduction of the financing of state tasks and in the supply of public goods. Each strategy that aims at real depreciation is contrary to the idea of free trade. Within a single currency area, it is even destructive.

Competition is constructive among companies and states if it is a competition for the highest level of productivity. But it is destructive if it is competition in belt-tightening i.e., competition which aims simply at the reduction of costs by cutting expenditure without increasing the efficiency of the whole economic system. Competition cannot be efficient for the benefit of society unless the competitive conditions for companies are comparable and sufficiently stable. Competitive advantages must not be the result of the permissive adoption of framework conditions and of successful rent seeking. They must be the result of entrepreneurial efforts, i.e. the realisation of productivity gains by means of new products and methods which are produced under the “law of one price" for all competitors, i.e. at equal prices of all purchased materials and services, (including labour) for all companies. A European economic government must create and secure the necessary framework. This comprises four central efficiency conditions.

Conditions for functioning markets

The introduction of the euro is the first and at the same time the most important condition for efficient markets. Exchange risks no longer exist in the euro area. The stabilisation of exchange rates as permanent task has definitely been abolished through a unique political decision. The necessary theoretical basis was the result of a difficult process, which was also overlapped by political ideas. Many still regard the collapse of the Bretton Woods system as evidence of the impossibility to maintain fixed exchange rates. However, the expectations linked with flexible, market-determined currency systems have not at all been met.

The European governments have made such distortions impossible by deciding to introduce the euro. As a consequence, the industrial and political players are restricted to real economic adjustments. Thus the prevailing consensus on the inadequacy of changes in the value of money in time (inflation) to solve economic problems has been extended to analogous experiments regarding changes in the value of money in space (flexible exchange rates). On the basis of these results, Wicksell's claim vis-a-vis monetary policy is unequivocal: “ as currency is primarily a measure of value, it ought to be possible ... for a country to maintain that standard just as constant as, for instance, its standards of length, capacity or weight."

This logic behind the euro cannot stop at the present borders of the euro area. For this reason, the enlargement of the European Union must right from the start take into account how the currencies of the potential acceding countries can be adjusted to the euro. The question of the exchange rates between the large currency zones as well as between them and the emerging markets is based on the same logic.

The second efficiency prerequisite has been fulfilled with the decision to introduce a single currency. The national money and capital markets have become European markets. Under the guidance of the ECB, they will result in uniform interest rates. Thus one of the most important factors of allocative decisions, the price of money and capital, is defined throughout Europe. Jevon's law of indifference applies, one of the preconditions for allocative efficiency throughout the currency area is fulfilled.

The third precondition for efficient competition markets refers to the development of wages. In this context, the adjustment of the wage level upwards within the currency area cannot be the objective. Especially against the background of the German experiences after unification, such a wage-policy orientation must be avoided. But, on the other hand, an adjustment of the wage level via competition to the lowest level can and must also be avoided. In order to prevent both inflationary and deflationary effects of wage policy, unit labour costs must be held constant in absolute and relative terms, i.e. in each country and thus also between the individual economies. This precondition is fulfilled when the development of wages follows the development of productivity. In a medium-term period this means that the productivity gains in the individual countries are used as the basis of wage policy, since the fundamental decisions that are relevant for the development of productivity are still taken within the national framework. However, the inflation rate will be a unique European phenomenon from now on. Therefore, the relevant productivity gains must be supplemented by an additional factor that is in line with the common inflation objective. In the very long term, the average productivity gain throughout the currency area together with the normative inflation rate may gradually become the orientation basis.

Catching-up processes of individual countries are not prevented by constant unit labour costs throughout the currency zone. But they are rightly based on the parameter that is the only source of growing prosperity and higher incomes, namely productivity gains. Successful competition of companies for higher productivity gains rather than the flight into various types of real depreciation, i.e. a beggar-thy-neighbour policy, is decisive for lasting catching-up processes of individual countries. Isolated strategies of moderate wage agreements and tax cuts provoke counterreactions, that is a wage-cut and tax-cut race, which finally results in deflation and the reduction of real income for all.

The Member States are directly responsible for the fourth precondition for efficient competition markets, that is tax systems, special tax rules, tax bases and tax rates. There is no doubt about the general problem of differing taxes. With regard to the functioning of the single market, the harmonisation of indirect taxes is, therefore, an "Acquis communautaire" laid down in the relevant treaties. Due to the euro, the direct taxes are increasingly gaining significance. There is probably agreement that allocative decisions dominated by tax divergencies can be as distorting as, for instance, aids. They are a burden on the efficiency of EMU and thus the prosperity level. Therefore, they must be put on the political agenda of the Union. Analogous to the rule on indirect taxes in the EC Treaty, rules on direct taxes are also necessary. In its 1998／99 annual report, the German Council of Economic Experts in detail dealt with tax competition. According to the Council, the principles of transparency and equal treatment must be observed and it must be guaranteed that "the call for tax competition must not foster inadequate harmonisation efforts." The aim is in fact not the harmonisation of direct taxes, but rather the prevention of "real depreciation via taxes."

Social and environmental standards must be reconsidered against the background of the same objective.

The creation of the framework conditions for the European markets remains a permanent task of an “economic government." The clearer the consensus on the general efficiency conditions of markets, the easier is the necessary coordination. National measures and rules also must be reviewed with regard to the question whether they fulfil the conditions for the functioning of EMU.

More employment through wage and fiscal policies?

A framework of conditions for the European markets that is characterised by competition in the euro zone and political action is the basis for allocative efficiency and high productivity gains. For a long time the idea that this is roughly the task of economic policy prevailed among those responsible at the national and European levels. Laissez faire was the motto: Reduce the distortions on the markets that are due to state rules, create functioning markets and guarantee a stable money! This message of economic liberalism from the 17th century, which, paradoxally, is in principle contrary to mercantilism, saw a revival in the supply policies of the 70s and the 80s. Its message is not wrong, but it is only half of the truth. After a quarter of a century that saw unemployment rising at intervals, the belief that efficient markets automatically result in full employment of all resources has begun to waver.

There is a lack of 18 million jobs in Europe. They cannot be created by means of export surpluses. The European Union must solve its employment problem in a different way. Supply policy that aims at high productivity gains cannot be the solution as well. Productivity gains which do not induce higher real income and thus higher demand will even lead to the shedding of labour. Many citizens in Europe have been confronted with experiences of the rationalisation of production processes in the last few years. Therefore, many have come to the wrong conclusion that productivity gains are the reason for unemployment and redistribution of work is the only solution. Such ideas are, paradoxically again, the result of a policy that promised more employment through greater productivity gains.

Wage policy too cannot shoulder the full burden of the responsibility for employment. Wage increases that considerably exceed the overall economic productivity development have an inflationary effect and rightly call for restrictive monetary policy. This leads to a stabilisation crisis with inevitable negative reactions with regard to the supply of jobs. But the employment level is also jeopardised by rises in nominal wages that are below the overall productivity gain. Falling unit labour costs are the main reason for deflationary processes. The Great Depression at the beginning of the thirties is a deterring example. As soon as investors and consumers expect falling prices, demand is dwindling. The present economic situation in Japan shows how difficult it is to return to a cyclical recovery in such a constellation. For this reason, wage policy, contrary to the neo-classical approach, is not only an inadequate, but even a dangerous instrument of employment policy. Wage policy can and must stabilise costs and prices as the following graph demonstrates. It cannot do any more.

Unit labour costs and consumer prices in Europe1

1 EU15; weighted with 1996 nominal GDP on U.S. dollar bases at 1995 exchange rates.

Sources: OECD, research institute calculations,research institute forecasts for 1998 and 1999

In the Keynesian tradition, an important employment-policy role is often attributed to financial policy. In this context, people fail to see that for Keynes deficit spending is the ultima ratio only in case the monetary policy has been made full use of and interest rates tend towards zero. In this situation, a public spending programme to boost effective demand and to reverse expectations is in fact the only thing that remains to be done. But the European economy has not yet reached this stage. Monetary policy can still be used for employment purposes. Therefore, financial policy does not yet have to leave its consolidation path.

The role of monetary policy

Overcoming mass unemployment in Europe cannot succeed with outdated economic-policy patterns. The supply-policy strategy is able to raise labour productivity, but it cannot expand the volume of labour. Wage policy can stabilise demand and secure the value of money from the cost side. But its use as employment-policy instrument only results in inflationary or deflationary developments. Financial policy can directly shift purchasing power from the private sector to the public sector and vice versa. But in the short term it does not create higher employment. Deficit financing of public expenditure also is no means to sustainably reduce unemployment. Altogether the contribution of financial policy is restricted to the free play of automatic stabilisers and the short-term prevention of demand slumps. The latter may be necessary especially due to the impact of monetary policy.

The stabilisation-policy risks of wage policy, on the one hand, and the employment-policy limits of financial policy, on the other hand, inevitably raise the question which room of manoeuvre monetary policy has. The creation of money is an exogenous political act. Monetary policy, unlike fiscal policy, is not faced with the problem of "counterfinancing." It can give impetus to additional investments without having to fear the contractionary effects on the money, capital and commodity markets. The power of monetary policy over the price of money, the central allocation mechanism in modern economies, inevitably results in responsibility for investment and thus employment.

Political action is, needless to say, oriented towards the shaping of the future. Objectives need to be reached. This does not mean, especially with regard to employment policy, securing the status quo, but rather overcoming it by creating adequate conditions. A monetary policy which, for instance, is based on the growth of the current growth rate of production potential under conditions of high unemployment cannot fulfil this task. It is basically retrogressive in so far as it aims at financing a growth rate of the production potential that reflects i.a. the creation of unemployment in the past. As according to Schumpeter's theory of economic development monetary conditions are the driving force behind economic development, the relevant questions are: How much does the production potential have to grow so that employment rises considerably in the medium term? And which monetary conditions are necessary to achieve this potential growth. In Schumpeter's theory economic development is not only a question of the monetary alimentation of the process of development, but of its creation by adequate monetary conditions.

Nobody can predict which growth rates such a policy can achieve and how large the production potential will be in the medium term. We cannot know the economic dynamism and the potential production. Economic policy can rely on model statements (Hayek), that is on theoretically secured interrelations, which also can be proved empirically. Monetary policy has no additional basis. But the uncertainty about the production potential should not lead to a backward looking orientation of monetary-policy and the establishment of the present trend of the potential growth as an adequate standard. A retrogressive monetary policy is not able to assume responsibility for future developments and prevents other policy areas to take over this responsibility.

Coordination of the macro-policy

The existing consensus on the common responsibility for economic policy is a necessary, but not a sufficient precondition for the success of employment policy and the securing of price stability. Coordination means process management. However, the objective of coordination and the underlying strategic concept is often not clear. A wrong policy approach cannot be corrected by means of coordination. On the contrary. Procyclical fiscal policy on the basis of theoretical patterns that are disputed in macroeconomic terms may even deteriorate the employment crisis. For this reason, each economic-policy coordination must be preceded by a discussion of the economic interrelations, i.e. of employment theory. This task must not be simply delegated to science. Politicians must participate in the process of forming an opinion and accelerate it with critical questions.

As far as the consensus on theoretical positions and problem diagnoses is concerned, considerable progress has been made recently. Convergence exists with regard to basic economic-policy ideas. Thus a basis for coordinated economic-policy strategies has been created.

In summary, the following essentials of a European economic policy must be pointed out:

- Impediments and distorting state incentives that hinder competition on the European markets must be removed. This task is even more very urgent after the launch of the euro. It would, however, be an illusion to believe that it can ever be regarded as fulfilled. The dynamism of the markets, on the one hand, and the understanding that sufficiently harmonised framework conditions raise prosperity, on the other hand, will in the future as in the past remain the driving forces behind convergence and integration.

- Budgetary policies of the Member States must credibly be oriented towards medium-term consolidation. This is not in contradiction to the free play of automatic stabilisers. Industry must be able to rely on the fact that financial policy does not destabilise economic slumps through procyclical expenditure cuts.

— Wage policy plays a central role in terms of stabilisation policy. It must prevent both inflationary and deflationary potentials with wage rises within the framework of the overall economic productivity trend. It is the stabilisation anchor within EMU.

— Under these conditions, i.e. with a clear consolidation strategy of public households and slightly rising unit labour costs that are in line with the inflationary objective, the way is paved for a new monetary policy that gives an impetus to investments and does not jeopardise the stability objective at the same time.

The Euro, The Dollar and The Yen

Kenneth S. Courtis
Chief Economist and Strategist
Deutsche Bank Group Asia Pacific

I would like to thank the Institute for International Monetary Affairs, the European Commission, and the Friedrich Ebert Stiftung for the gracious invitation to be with you today and to be a member of such a distinguished panel. This meeting comes at a most interesting time. It occurs on the eve of the visit of Prime Minister Obuchi to Beijing, where people are extremely preoccupied by the weakness of the euro, and the recent efforts by Japan to weaken the yen. As China's currency is tied to the dollar, that means for Beijing that at the very moment it faces such enormous economic difficulties, its currency has strengthened against both the yen and the euro, which complicates still further the complex issues China must address.

It also is interesting that we are discussing essentially the same monetary policy, financial market and exchange rate issues today, as were discussed during the G-7 summit in Cologne, two weeks ago, and which will be discussed later this week in Shanghai, during the central bank governor's meetings. These discussions around the globe are a measure of sorts of how tightly and closely global markets and policy have become integrated. If there is one person who epitomizes that integration it is Toyoo Gyohten, to whom I pay deep tribute for the leadership which he has provided, not only for Japan, but for people around the world, as one of the really leading figures of international finance over these last decades. I say that as a banker, and, with much honor, I say that also as a friend of Toyoo Gyohten.

But today, Mr. Gyohten, on this panel, you have placed me in a most delicate position. I have been preceded by two eminent policy-makers, Christian Noyer, Vice President of the European Central Bank, and Heiner Flassbeck, former Vice Minister of Finance of the Federal Republic of Germany, and now find myself preceding Mr. Sakakibara, for whom our meeting today is almost the Sayonara party, as he will very soon be moving on to other important responsibilities from those as Vice Minister responsible for international matters, which he has handled with such brilliance in the Ministry of Finance.It is with a real and great honor that I am with you today and I wish to express my gratitude.

I purpose to divide my presentation into three parts. First, I will consider the euro, not as you might expect from a banker's perspective, but rather I invite you to think of the euro as if we were already ten years into the future, and to think what has happened, as it were, between today and the end of the first decade of the new millennium.

In the second part, I propose to return to the present. We have already heard the terms of the debate about Europe. They are very direct and simple. How does Europe increase its productivity? How will the political sclerosis, which characterizes much of Europe today, be broken, so economic reforms can occur? These reforms can unleash the forces which will work to increase Europe's competitiveness, generate rising productivity, and so allow Europe to maintain, indeed to increase real wages, and to avoid some of the more dire prospects for the euro, which the Cassandras relish in presenting.

In conclusion, I purpose to consider issues related to global currency markets, and, in particular, to consider mid-term issues for the G-3 currencies. Others on the panel are intimately closer to what may be happening in the next few days, and, like the rest of you, I await with great interest to hear their observations.

Europe Back to the Future

If we image looking back to Europe and to the world economy from ten years into the future, we will see that the l990's marked a seminal, historic shift in how the world economic system was structured, and how world politics operated. We have lived through the 1990s a series of changes, although not co-ordinated, but which have happened simultaneously, and which are directly related to our ideas about the future, to the nature of the world state system, to the relationship between markets and the state, and to the broader role of corporations, capital flows and global markets.

Looking on these developments from 2010, we will see, I believe, that Europe, in adopting the euro, began to reformulate some of the basic issues of what we have accepted previously, as given, such as what is a nation-state, and, indeed, what is the nature of sovereignty itself, and the role and scope of public policy. These issues are today very much at the center of the debate today about globalization. They are also central to addressing the issue of the balance between the three currencies – the yen, the euro, and the dollar – and of the relationship of these currencies to their immediate regions.

The important legacy of history, which has been one of the driving forces leading Europe to currency unification, is also important in shaping policy to address more immediate economics forces. When we think of Europe in 2010, will we be seeing re-emerge a sort of pre-1914 Europe, what some call the “Golden Age Europe," or will we have a

Europe, deeply integrated politically, at all levels, and at the same time tightly integrated to the world economy?

By 2010, the European Union will have expanded to some twenty-five countries. Its currency and capital markets will have become absolute pillars of the world financial system. Due to its size, and I believe, eventually, because of its dynamism, Europe of the euro will have an enormous impact on the Middle East, on the countries of Eastern Europe, the CIS, and across North Africa. As Europe develops over the first decade of the next century, the euro will become a very strong adhesive force and will cement together not only the conglomeration of European states, which is the European Union, and do so more tightly than most today yet understand, but it will also work to integrate ever more tightly these other regions with Europe.

Consider that by the year 2010, Europe will be 550 to 560 million people, with an annual per capita income of about 35,000 dollars, at today's prices. This huge market, considerably larger than that of the United States, will be the largest consumer of oil in the world. It will also be the world's largest trader. Many countries of Eastern Europe and the CIS, which today have, in effect, tied their currencies to the Deutsche mark or the euro, will hold a large part of their foreign exchange reserves in euros. Much of the rebuilding of their economies will be financed with funds raised in the euro-driven European capital markets, which by 2010, will be larger than those of the United States.

As we move through the decade ahead, the entry of the UK to the euro will also likely be resolved. Events are moving in the direction of the UK joining the euro, although the recent European elections should be seen as a warning of how strong the opposition in Britain remains.

Nevertheless, the interests of the City and of British-based industry, and so of very large portions of the UK work force, are becoming so strongly related to the euro, that over time these views are likely to prevail.

There will still be much speculation, even ten years from now, on what will be the effects of the euro on European corporate management. Will we see emerge a more Anglo-American type of corporate management, with highly liquid capital markets, and shareholder and consumer interests at the center of how corporations are managed? Or are we likely to continue with a more continental European approach, with tightly interlocking corporate-government relations, in which states are deeply involved in the capital markets, where national cross-shareholdings dominate, and the great corporate groups of Europe are essentially locked in struggle for market share?

My view is that we will see Europe evolve, more quickly than yet most realize, toward an Anglo-American type of corporate management. With that shift, we will see develop, a European-wide managerial class, composed of people from across Europe, who think and act in a broadly similar manner, and share similar management values.

By 2010, Europe will provide an alternative, equally liquid capital market to that of the U.S. With the euro as an investment currency, a trade, and reserve currency, it will be in direct competition to the dollar. As a result, East European, Middle Eastern and African central banks, indeed central banks from around the world, will have to convert a significant portion of their foreign exchange reserves into euros.Although countries such as Canada, Mexico, and Venezuela will still sell oil in dollars to America, by 2010 it is likely that oil will be quoted and paid for indifferently in euros or dollars. In these conditions, it will be difficult for the world's major corporations, wherever they are headquartered, not to have significant operations in Europe.

By the end of the next decade, Europe is likely to be the world's largest international investor, not only for the countries of Eastern Europe and the CIS, but also in parts of Latin America and India, and increasingly elesewhere in Asia. These same forces will also drive us to reorganize many of the international financial institutions we have today, and which are still largely American dominated. I think of the IMF, the World Bank, and other organizations. America is today at its apogee, Japan is at its bottom. The agenda ahead for Japan is a very heavy and complex one, and it is one which Japan remains largely to address. Europe faces equally daunting challenges, but with the euro it has embarked on a course for renewal. Much more is still to come.

Catalyst for Change and Reform

In many ways the euro will be the catalyst for much of that change. How will the euro play in addressing the issues of productivity, of growth, of competitiveness, and of job creation, and in breaking the political blockages to dynamic policy change?

A few weeks ago, we received a preliminary answer to that question when a company, which but two and a half years ago was close to bankruptcy, Olivetti, took over Italian Telecom, a company twelve times larger. It was the first hostile leveraged buyout of the euro. This transaction would not have been possible without the euro for the simple reason that it would not have been possible to raise 60 billion dollars within Italian financial markets alone.

Furthermore, so much vested interest within Italy was put into question by this deal, that in a Europe before the euro, it would simply would not have happened. Simply too much was at stake for that to happen.

Further, such an investment had to be financed in a “ national currency," because the cashflow of Italian Telecom was domestically generated. But the euro is the national currency in a very real sense for all of continental Europe. That simple but very important fact was at the center of this transaction and is what really made it possible.

In effect, what we have seen in the case of Olivetti's hostile takeover of Italian Telecom is an example of the tremendously powerful impact which euro capital markets will have in reorganizing corporate Europe. Olivetti in effect went to the euro debt market and raised these vast amounts of capital because the boundaries of the euro markets extended far beyond the limits of traditional Italian finance.

For example, the managers, say, of the fire fighters' pension fund of Uppsala, Sweden, care little about vested interest in Italy. What interested them in this deal was the return on their investment, the risk level which they were taking, and the quality of the paper Olivetti was to issue. When enough such investors said they liked the deal, and then realized that Olivetti with their support could take control of Italian Telecom, restructure the assets, and run them in a more efficient, dynamic and profitable manner, the deal, which before the euro would have never happened, all of a sudden became possible. Once Olivetti had 25-30% of the shareholders thinking like this, that sliced open like an over-ripe fruit the core shareholder structure of Italian Telecom, and made the transaction possible.

As we meet the fourth largest oil company in Europe has launched a hostile takeover bid for the third largest European energy company, in a euro-financed transaction. At the same time, three major financial institutions in Paris are struggling to reorganize themselves in a way which will allow them to prosper competitively within the broader European international financial market now emerging. Again the new euro capital markets make the financing of the transaction possible. My personal view is that the only viable outcome to this struggle among the three French banks is a European one, rather than a more narrow, “Franco-French" solution. Whatever happens in this first round, I would see emerging in a subsequent phase a broader, European based structure.

The new euro bond and equity markets, which are almost the size of America's capital markets, are largely outside the control of any European state. The Italian government, for example, has about as much influence over the new euro bond market, as the state of Ohio has over the U.S. bond market. That is to say, virtually none! The development of these integrated, European-wide capital markets, which the euro has in effect created, is now about to trigger a vast restructuring of European assets, which will release much of the under-utilized capital which is today locked up in the current structure of corporate Europe.

It is through the capital markets that the euro is a powerful catalyst driving change, and forcing the restructuring of much of the European economy. Over time these changes will lead to a much more competitive Europe. Managers will be forced to deliver higher returns, to be more focused, and more innovative. In time, and sooner than most of us yet think, the result will be higher levels of growth and income. While some will dig in their heels and try to slow the process, it is now in gear and is set to gain tremendous momentum. Over time these changes will work fundamentally to strengthen the euro and so they lead us to consider the G-3 currencies.

The Yen, the Euro, and the Dollar

There has been much effort in the last few weeks to strengthen the dollar against the yen. Whatever the success of these efforts, and one must raise the question as to whether Japan should be taking such measures, it is the case that were the yen to strengthen, it could well smother the nascent recovery of Japan's economy. But if we look beyond the immediate, in coaxing the yen to lower levels now, what could well happen is that we could see very quickly re-emerge a new round of highly speculative, yen-financed leverage. If that were to happen, it would set us up for a dramatic turn of events, such as occurred last fall, when the yen moved more than 15% in a few days.

Fund managers are typically measured on their performance relative to the main market benchmarks. So far this year, Japanese equities have strongly outperformed those of North America and Europe. If this trend continues over the summer, as I expect, and as US bonds sag further, by the end of the third quarter, fund managers around the world will face a panic situation. They remain heavily under-invested in Japanese assets, but Japan's markets continue to outperform. As a result, fund managers around the world will be forced to buy aggressively the yen in order to purchase Japanese equities. So the flow of funds into Japan will be huge over the second half of the year. That will force the yen dramatically higher. Any new leverage in the market now will make the situation even more complicated and difficult to manage later.

At the same time, I see U.S. interest rates continuing to move generally higher, and so the U.S. equity market will weaken, and probably more than most yet expect. The result for Japan's flow of funds is that less money will leave Japan, and more money will flow to Japan. The result is very simple: a stronger yen. I see the yen rising to 105-100 before year end. At that point, the Bank of Japan will face an extraordinary difficult choice. But the decision in effect will be imposed by the market.

Consider that in l991, Japan's debt to GNP was 51%. By 2001, it will be 151%, and that is unlikely to be the peak. In addition, to have a more complete picture, we need to include the net present value of the commitments of the government pension system, which is about 110% of GNP. So seen this way, and that is as any company or household woud do its balance sheet, claims on the state already exceed two and a half times Japan's GNP!

How will Japan deal with this situation, given the country's demographics trends? If interest rates were allowed to go to a high enough nominal level to attract sufficient capital from around the world to finance these obligations, we would end up with a hugely over-valued yen. That of course would de-stabilize a still very fragile financial system and economy. It would also have enormously negative effects for the rest of Asia and the world economy. So higher interest rates cannot be a solution.

Another option would be to increase taxes enough to pay down the debt. But that would have the same debilitating effect on the economy as did the Hashimoto tax increases in 1996. So what is the exit strategy for Japan from this fiscal dead-end?

As the yen strengthens over the coming months, the Bank of Japan will have to face the inevitable. As all of the other exits are closed, there will be but one option left, and that will be to monetize a very large portion of the debt that has built up over the last few years. That monetization, over time, will lead to lots of money seeping out of Japan, and so it will result in a substantially weaker yen than we have seen at any time in the last few years. Also, much of this new liquidity will go into asset markets, and so drive up both equity and land values in Japan, which will be supportive of domestic, consumer centered consumption. It will also play an important role in supporting asset values elsewhere around the world.

These developments will have other, more immediate implications for the region. Not so much for Korea or South East Asia, because through the Asia crisis these countries in effect broke their currency link to the dollar. Rather their currencies are today effectively linked to the yen. If the yen were to go to 160 to the dollar, the Korean won, which is now 10 to 1 relative to the yen, would fall toward 1,600 to the dollar. But the real problems that a yen devaluation would create are for China, with its dollar-linked currency. Inevitably, China, I believe, would devalue under these conditions, and, from Beijing's perspective, Tokyo would become the face-saving scapegoat.

As for the United States, the achilles heel of the seemingly ever so strong American economy is that it is financed with other people's money! This year, the U.S. will borrow net from the rest of the world some $330 billion dollars. That is almost a billion dollars a day. Last year, it borrowed $288 billion net; the year before it was $262 billion net. In

1996 the United States borrowed $248 billion net from the rest of the world. That is an annual increase of about 9%. At that rate, by the year 2003, the United States' net external debt will exceed 25% of America's total economy. At some point, it will no longer be possible to continue dealing with the situation with benign neglect as is the case today. A major risk we face is that this situation of increasing is dealt with through the currency markets. Historically, countries which have built-up net external debt at the rate which America is today, and on such a scale, have, at some point, seen very weak currencies. If there is no change in the present course that will also happen for the dollar, and to say the least, that would be more than destabilizing for the world economy.

As for the euro, at the very moment that Japan could be forced to monetize, and people start to become more concerned about America's expanding net external debt, the euro will be entering a period of cyclical recovery. Also, the effect of the euro triggering the restructuring of European corporate assets will make European equity markets very attractive for foreign investors. So we are likely to see very large flows of funds from investors around the world into the euro during the next few years. Indeed the next big move of the euro is not down, but up!

As 1999 began, central banks around the world were very interested in the euro, but they now have backed off some. However, as Europe begins to recover, I expect to see central banks continue long-term reallocations of their reserves to the euro. It is against this background, that although the euro looks weak today, on a two to three year period it will be quite strong.

The G-3 currencies are like great tectonic plates, which are now beginning to move. As they move, the shocks will have a huge impact on global markets. Indeed, the volatility of the last two years of crisis in the emerging markets could well appear modest in comparison.

In this regard, I noted in a recent article in the Australian Financial Review, and I am not sure if my co-panelist, Mr. Sakakibara, was quoted correctly, but if he was, I would agree with him. It is reported that he indicated that one of the main triggers of the Asian crisis was the 1995, US-Japan decision to drive down the yen and to drive up the dollar. As virtually all of the Asian currencies were tied to the US dollar, the weak yen-strong dollar policy of the United States and Japan, from mid-1995, basically made the rest of Asia non-competitive and almost overnight destroyed the profit base of much of the region. As a result, these countries could not pay back their debts, and that is what triggered not only the Asian crisis, but the global emerging markets crisis and massive difficulties of the global banking sector we have experienced the past two years. There were of course other factors, but the decision of Tokyo and Washington in 1995, the Reverse Plaza Accords as I have called it elsewhere, was the fundamental trigger of the crisis.

With the potential I see building in the world economy for sharply increased instability of the G-3 currencies, the efforts of the other members of this panel to think through how we could work to maintain some balance and stability is extremely important.

Conclusion

I conclude in putting Japan at the center of this question of currency market stability. Japan faces enormously difficult challenges in the re-capitalizing of the country's banking system. But, at the same time

Japan's insurance companies are hemorrhaging vast amounts of capital, given the massive mismatch between long-term bond yields and the payout commitments of the insurance industry. More broadly, the agenda ahead for Japan's economy is a very heavy one: difficult demographics, the debt to GNP issue discussed above, massive balance sheet restructuring, weakness in Japan's main export market of East Asia. In addition, Japan has lost ground technologically in the l990's. How will these issues be addressed? How Japan addresses these issues will largely determine the country's role in the world economy over the next decade and beyond.

A most interesting period of fundamental change has opened in Europe; it will have very significant global implications. To a large extent, this process has been set in motion by the advent of the euro.But for Japan we should consider what will be the catalyst for the even greater need for change the country faces, and which everyday is more urgent. Meanwhile, America, too content perhaps with its unprecedented prosperity would do well to address the building vulnerabilities of the dollar while there is still time to do so.

. The Birth of the Euro and the Future of Asia

Eisuke Sakakibara
Vice Minister of Finance for International Affairs
Ministry of Finance of Japan

The last speaker has the great advantage of being able to make his speech with the benefit of the comments made by previous speakers.

There were two incidents during the previous month that did not attract much attention from the markets nor governments. One is the question of the European Representation in G7. This is an issue over which the United States and Europe have been having heated debates in the past year or so, and the final ruling was made at the Cologne Summit. The result was that the Governor of the ECB and the European President will attend the first half of the G7 gathering and the governors of the national central banks will attend the second half.This decision in itself is not a major incident but it symbolises the fact that decision making within Europe has smoothed out and that Europe has begun to operate as one unit after the birth of the European single currency.

The other incident involves Mr. Noyer, who is here with us, and myself. On June 18 Japan delegated the ECB to intervene on its behalf in the foreign exchange market, and the operation worked out very smoothly. At the time, the market perception was that the core of the problem was the euro-yen exchange rate, that the yen had fallen to 122 yen to the euro. We knew that much of this fall was a result of speculative transactions, and so did the traders in the market. But there was a perception in the market that the ECB cannot intervene in the euro-yen market, and further, even if the ECB was entrusted with the operation, the ECB would be against the operation. However, immediately following the request from the Japanese government, the ECB intervened and did it quite efficiently. Although there was a case where the Japanese government bought the German mark in the Singapore market about 7 years ago, this was the first time the Japanese government officially requested a European central bank to intervene using a Japanese account.

I believe this will be seen later as a historic event. This is evidence that the decision making process of the ECB and the Euro Eleven has been smoothed out and that formal arrangements have been made despite various complicating factors. Although these two incidents are small by themselves, I believe they are clear indications that the European Monetary Union is off to a smooth start.

I agree with the prediction of both Dr. Courtis and Mr. Noyer that the euro will be strong in the long-run. In the short run, I believe that Europe will hit the bottom of the business cycle in the first quarter.However, as with the Japanese economy, Europe's recovery will be ambiguous. It is not at all clear if the economies of Japan and Germany have really hit the bottom. Although the strength of the euro will be affected in the short run by the European business situation as well as by American economic strength, I believe the monetary union shows the signs of dynamic growth potential in the medium to long term.

Dr. Courtis painted the “picture" in 10 years time, and in a way he was describing the birth of a new empire. According to Norio Noda, we are in the age of empires, and in the next 10, 20 years, we will see the European Empire developing with a strong integrating force.

Instead of going over the future of Europe, I would like to talk about the choices for Japan. I believe there are three. One is to join the European Empire, in other words to accept the euro and to join Europe. The second is to join the dollar sphere. These two are the most obvious choices. The last route is to have some regional currency-not going as far as a regional monetary union and to have that "picture" as the third pole. This is the most challenging route and compared to the first and the second choices, it has the least possibility of success. But in view of the national interest of Japan, we think that this third route is the preferred course to take. We have been vigorously promoting the New Miyazawa Initiative and the internationalisation of the yen, not so much to create a yen sphere but because we have a fundamental belief that we should envisage Asia as the third core of the international financial world.

It took 50 years for Europe to achieve this monetary union. Europe is complex with diversified cultures and characteristics, but compared to Asia, Europe can be regarded as one region, and Asia as a world on its own, it is more diversified from ethnic, religious, cultural and historical perspectives. It is not possible to have one description of Asia. Japan, South Korea and West Asia are very different, so are India and Pakistan. We cannot define the region by simply saying it is Asian. "Asia" is used as a contrasting perception to "Europe" but there is no clear definition of "Asia" by itself. I believe that unless we work to create a new regional cooperation in Asia, in the long run, Japan will be absorbed into the sphere of either the euro or the dollar pole.

Although I believe it is possible to create a third pole, I must confess I do not have a fully defined "picture." But we have taken a few steps. We are encouraging Asian governments and governmental organizations to issue bonds with a partial guarantee, possibly on the Samurai Bond

Market. One of the facts we were reminded of during the Asian crisis is that Asia, including Japan, China and as far as India, creates a significant proportion of the world's savings. But that money flows mainly into New York or Europe, the global capital markets, before flowing back into the region. And when those funds flow back into Asia, they are dollar denominated, so the Asian countries bear the burden of foreign exchange risk. Consequently, as Dr. Courtis pointed out, Asian countries suffered from the violent yen-dollar fluctuations. We are seriously studying ways to cycle the locally created savings in Asia. Singapore, Hong Kong and Australia all have the same aspiration. The way to achieve this is to create debt markets in Asia.I am not sure in what denomination the markets will operate. Whether it is in yen, in the form of a currency basket, in euro or in dollars, it is critical to create active debt markets with deep pockets in order not to have Asian savings absorbed into major global markets and then cycled back to Asia.

There are a number of equity markets in Asia, but they are used as the operating base for speculative activities. Looking at the debt markets, on the other hand, there are no government bond markets which form the core of debt markets in Asia, because until recently the Asian governments, with the recent exception of Japan, did not suffer from serious budget deficits. As a result Asia is lacking in debt markets, but we are seriously contemplating the idea. Bond issuance with a partial guarantee is one of the ideas we are pursuing, and at the same time we are seriously discussing the best ways to create debt markets.

There are various technical hurdles, such as those regarding settlement and arrangements between the central banks — delivery versus payment and gross settlement in the debenture market, creating a clearing mechanism similar to Euroclear, etc. These are all very technical and involve the central banks. Regardless of how many hurdles there may be, it is critical to nurture debt markets in Asia by developing shared infrastructure, and to establish Asia as the third pole in the next 10 to 20 years. It is not realistic to imagine that a single currency will result from this process, but it is important to keep in mind the significance of creating a mechanism that will not be at the mercy of the yen-dollar, dollar-euro, or euro-yen exchange rates.

I agree with Dr. Courtis' opinion that the countries in the Middle East, East Europe and Africa will choose to link or to fix their rates with the euro so as to avoid being vulnerable to foreign exchange fluctuations. In the Americas, we are already witnessing dollarization and a currency board system, supported by countries like Argentina. Faced with such tendencies, the medium to long term issue for us in Japan is to create debt markets and ultimately Asia's own unique financial system.

In the short term, it is important for Europe and Japan to work together. The United States has had and still has a huge influence on Japan in monetary, financial, and national security affairs. In order not to be too heavily tilted to the United States, it is important to develop our relationship with Europe as a countervailing force.

My earlier account of the intervention by the ECB in the yen-euro market was, though small, an indication of our will in this regard. In international arenas like G7, it is important for Japan and Europe to have a common front in order to argue our cases against the United States. Dr. Flassbeck and I have tried this approach many times at G7D, and although I cannot say that we succeeded completely, nevertheless, I feel it most important in the short run, to value and cultivate our relationship with the euro area. There already is a huge euro-yen market in Europe. The yen-euro market in Tokyo is, by contrast, relatively small, but since the equivalent market in Europe is well established we should not just emphasize the yen-dollar relationship but also yen-euro relations, and in the mean time make the best effort to create the third pole in Asia.

Panel Discussion

Gyohten: With Dr. Sakakibara's speech we come to the end of the keynote speeches by our panel. For the next hour, I would like to invite the members of the panel to exchange views, questions and counter arguments among themselves based on their speeches.

I would like to begin the debate by using my privilege as moderator and ask one question to each speaker before the four speakers begin their debate.

First, to Mr. Noyer, I was very impressed by your comments on the role of the European Central Bank, in other words its responsibility to stabilize prices in the euro area. However, looking at the euro area from outside, I am more concerned about the following three issues than with the stabilization of prices. First is the stabilization of the international value of the new currency, the euro. Second, the question of how you will solve the budget issue within the euro area. As you know, this is a source of much concern as has been evidenced by the abrupt fall of the euro precipitated by Mr. Prodi's comments. The third issue is the high unemployment rate. I believe that these three issues are the biggest problems for the euro area. So I would like to ask you what role the European Central Bank, or to be more specific, the monetary policy of the European Central Bank, can play to deal with these problems.

Dr. Flassbeck's speech was also very stimulating. The relationship between pay differentials and labor productivity, his arguments on avoiding bad customs with regard to taxes and on measures to cope with symmetric shocks and asymmetric shocks — they were all very intellectually fascinating. But all these issues come back to the question of how you will solve the euro area's economic difficulties, which is the key issue. Dr. Flassbeck held, until recently, one of the most senior positions responsible for policy making in the German government, which in turn bears the heaviest burden in solving the economic problems of Europe. So I would like to ask Dr. Flassbeck what remedies he prescribes.

Dr. Courtis's comments were also very interesting. His prediction that by the year 2010, Europe will be a major force moving international affairs was very stimulating. I completely agree with him that the euro will serve as a catalyst creating a strong adhesive power within Europe. However, the Europe he envisaged in 2010 is a Europe comprising 26 countries, and he sees the CIS, the Middle East, and North Africa, in other words the regions that are currently not in the EU, integrated into a broader European family. But if Europe enlarges to such a scale, the whole nature of Europe will be different from what it is today. Dr. Sakakibara mentioned that Asia and Europe are different in structure, and that is quite true. But if Europe becomes an extended family including the CIS, Middle Eastern and North African countries, Europe will no longer be a region capable of horizontal division of labor but will require, like Asia, or even more so, to have a vertical division of labor. If this occurs, the challenges that I have mentioned previously will become unbelievably difficult. So I would like to ask Dr. Courtis if his high expectation for Europe in 2010 takes these difficulties into account. On the other hand, I totally agree with him that there will be a lot of fluctuation among the dollar, euro and yen in the next several years.

Dr. Sakakibara pointed out the importance of developing debt markets, especially in East Asia, in order to cultivate the spirit of self reliance and to enhance cooperation within the region. I fully agree with that analysis. It is true that Singapore and Hong Kong, among the

East Asian countries, and Australia are quite eager to create their local capital markets, including the debt market. So Dr. Sakakibara's idea meets the aspirations of the region quite well. However, as he pointed out himself, it is a delicate question to decide in what currency the markets will operate. Each region wants to strengthen their local currency. Using the local currencies of Asia is preferable to using euro-dollars or euro-euros. But what will that currency be? Will it be euro-yen or local currencies like the Singapore dollar, Hong Kong dollar or Australian dollar? This is indeed a very delicate and difficult issue. It is clear from the examples of Europe and North America that the key factor for capital markets or debt markets to succeed is liquidity. In order to meet this criteria, the market has to be quite large. So the big question for East Asia is how to create markets that will have internationally acceptable liquidity and also will reflect the characteristics of the region.

Now, can I ask any one of you panelists, to try to respond to my questions, or to raise questions to others, or make comments, or even to present some opposing views to others. Who would like to lead the question? Christian?

Noyer: Thank you. I shall try to start with your questions. The three main items you mentioned were of major interest for observers outside the euro zone, but you can be sure they are also of great interest for citizens living within the euro zone. The first issue concerns exchange rate development, the so-called external value. One very important issue that everybody must have in mind is the choice of the First of January this year as the starting point which, of course, seems obvious, being the day of inception of the euro, but this gives by pure chance the totally wrong perception. If you look back a little further, you will see that during the last three or four months of '98, the constituent currencies of the euro increased in value sharply against the U.S. dollar. Furthermore, after the First of January the euro returned to its original position, or, roughly to the range that had been the range of the exchange rate between the European currencies and the dollar for the major parts of the years '97- '98- and this more or less reflects the fundamentals.

Of course, we would be concerned if the movement continued further, because this would not be consistent with the fundamentals. But this explains why, to a certain extent, this movement has been regarded as normal. You should keep this in mind, in order to understand what has happened during the first six months of the Euro. And having said that, it cannot be considered as the mark of a weak currency at all. Of course the exchange rate is the key factor of our assessment in monetary policy decisions, because it has an impact on price developments, and on the credibility of the currency, both of which the European Central Bank of course has full control. Therefore, we monitor the exchange rate developments very closely, and we have clearly stated that we are not interested in a weak euro; we want a currency that is solid and stable. You should also be reminded that we are so much committed to price stability that we commit ourselves to deliver in the short, medium, and long term, a currency that will completely maintain the purchasing power. And, when you maintain the purchasing power of a currency, you finally get a strong currency. It cannot be otherwise, because you are given something that is valuable. So, I am absolutely confident that the euro will be a strong currency in the international area.

The second item you mentioned was the convergence of fiscal situations. Of course, this convergence has already taken place to a very large extent. This is, as you remember, one of the basic criteria for joining Monetary Union, and all countries have had to converge to meet this. However, since the start of Monetary Union, governments have committed themselves to continue to converge to the same fiscal strategy, and this is what we call the Stability and Growth Pact. Of course there are some differences, as there can be differences in regions of the same country, simply reflecting the eventual cyclical difference between one country and the other. But the strategic goal is the same; that is to achieve, over the medium term, budgets close to balance or in surplus, and this is already achieved by countries which have experienced strong growth during the last two or three years, and still has to be completed by countries whose growth has been lower during the same period. We always have to reaffirm this goal, because it means that much progress is still to be made in some countries, even if the bulk of effort has already been made.

With regard to the rate of unemployment, we fully share the view that the high level of unemployment is fully unacceptable and is the major problem for our economies. But our conviction, and as I said, this is fully shared by institutions like the OECD or the IMF and a number of private institutions, is that unemployment in Europe is mostly of a structural nature. So, if macro-economic policy is not the reason for this high level of unemployment, if the bulk of it is structural, there is no way that monetary policy could solve a problem for which it is not responsible. This can only be solved by structural reforms addressing the structural problems. And this is indeed something that we have been constantly reaffirming and recommending. Now, it is really the task of the governments, not the task of the Central Bank. I would like to underline that even if it is probably more difficult in Europe than in other regions of the world because of long-standing traditions, the creation of Monetary Union is really a chance to address this problem. And I would like to underline that the European Commission has made tremendous progress in making concrete proposals addressed to each individual state because the rigidities are different from one another. Sometimes considerable changes have been undertaken and are misunderstood or not sufficiently realized by observers simply because results take time to develop. However, there have been a number of accomplishments and I believe that there will be many more. There is now a strong conviction, to my mind, among European governments to continue in that direction, and I am sure that the result will show up in due time. It will take time, but it will show up. Thank you.

Gyohten: Thank you, Christian. Do you have any comments to the other panelists at this point?

Noyer: Well, I just wanted to make a slight comment on a remark made by Heiner Flassbeck. I very much agree that Europe was seen, with the creation of Monetary Union, as one of the regions in the world that should help to strengthen the world economy and assist the recovery in Asia—and probably the slowing down of the economy in Europe has been somehow disappointing for European countries. But when you look at figures, when you look at real developments, it is extremely interesting to see that, for instance, if you take the four or five so-called Asian Tigers, and you look at what has been the development of exports from these countries to other regions of the world outside Asia, the rate of growth of their exports last year has been the same towards Europe as towards the United States. Knowing that the U.S. economy was growing faster than the European economy, it is extremely interesting to see that Europe is so open to the other economies in the world, that even when it is slowing down, it is providing the same sort of help to economies that were in a recession period and are now picking up and recovering. So, that is very important to keep in mind.

Gyohten: Thank you. Heiner?

Flassbeck: Thank you Mr. Chairman. I would like to make a comment to each of my collaborators here. And you are putting a very important question on the table which I touched only briefly. I thank you very much for giving me the chance to elaborate a bit more in detail the question of real convergence in the European Monetary Union. Real convergence is at this stage of the process of European integration really the most important point.As a German, with the experience of German political and monetary unification, it is easy to see that real convergence is the critical point now, because Monetary Union means that we have achieved monetary convergence in Europe. Thus, only one question remains, namely the one of real convergence.

I said already in my statement that the Monetary Union can only function properly if everybody sticks to the rule of the game. The rule of the game is a simple one: Everybody has to live up to its own means—do not live beyond your means and do not live below your means. If this is understood than, I think, Europe can solve the problem of real convergence. Let me make a very simple and selfevident example. Let Portugal, for example, as a country with very low wages and living standards in Europe have a productivity increase of, say, 5 per cent annually. This rather high rate may be due to its low wages which induce an inflow of capital. Germany on the other hand, one of the richest countries, may have a productivity increase of only 2 per cent. In this case my rule of the game means that nominal wages in Portugal will rise by 6 per cent (I take 1 per cent as the inflation target of the European Central Bank which adds to the productivity increase). Nominal wages in

Germany will in consequence rise by 3 per cent annually. If that applies, the competitive situation between two countries remains in equilibrium. Companies in both countries are still competing. Companies are winning and losing markets. But this happens "beyond the average". In the average we are in equilibrium and, at the same time, real convergence takes place. Portuguese real wages rise by 5 per cent, and German real wages rise by 2 per cent. Thus, we have real convergence as long as Portugal is a poor country.

This implies, and this is the lesson we have to learn in Europe, and this is the lesson that we can learn from the German experience, that every Nation in Europe can only rely on its own means. Nobody can and should hope that others will assist in solving his problems. That is to say, nobody can hope that there is a "big brother" and thus try to rely on solutions which are based on the transfer of real income from one country to the other. Transfers have been and still are a huge problem for Germany. For Europe huge amounts of transfers would be destastrous. This is true for the Europe of 15, and, I am absolutely sure, even more for a Europe of, say 21 or 25, whatever you take. The more countries we are, the larger the diversion of living standards, the less are Transfers the solution for disequilibria in trade. We could clearly recognize the lack of fiscal solidarity in the financial negotiations which had been taking place in March this year in Berlin. Europe will never achieve a huge redistribution of income. Politically as well as economically transfers are no solution. The way out of this political constraint are higher growth rates of the poorer countries. With a higher growth rate of productivity they can catch up in the long term without generating disturbing trade flows. We have opened our goods markets and they have access to our capital markets and this is a big chance to get more productive investment into your country. Thus, I am convinced that real convergence is possible with and without the monetary convergence. But real convergence is not primarily a European question, but a question that has to be answered on a national level.

The remark I want to make to Eisuke Sakakibaras statement is closely related to my general remark on the process of European integration. Namely, one of the main question for the world economy today is: Is there an alternative monetary system for Asia? And here I think we are too often subject of a certain illusion. We believe that we can open goods and capital markets whatever the monetary conditions of the participating countries are. We “can" open markets because we strongly believe that there is an exchange rate system which will allow smooth adjustments of trade and capital flows although the monetary conditions differ widely. Economists have “created" a flexible exchange rate systems which should solve all remaining problems. But think about it. Think about opening the markets further in Asia without monetary convergence and thus without a chance to build up an adequate exchange rate system, i.e., a system comparable with the former European Monetary System. I'm sure that is going to create much more crisis than we have seen up to now. The simple solution that economic theory offers, saying, “Just go for flexibility"doesn't hold. It has very often proved to be not the solution for very small open economies like the ones we have in Europe and in Asia. And if flexibility with market determined exchange rates is not the solution, then you - altogether in Asia—have to think hard about other solutions. What kind of solution is around? I think there are certain models which have proved to be workable. Just pegging your exchange rate vis a vis the dollar should definitely be excluded. It was a too simple model and everybody knew that it could not go on forever. But there are currency regimes similar to the ones we have tried in Europe which could work in Asia too. I mean different forms of crawling pegs or "fixed but adjustable rates" which all didn't prevent currency crisis time and again but served to contain the repurcussions of these crises much better than the non-systems in Asia. In this respect the European experience is crucial and it is absolutely right to say that we need much more collaboration between Asia and Europe because the Europeans have much more experience in this field than the Americans.

The European experience has shown that with different models, with different currency systems you can approach the same goal, namely, monetary conversions. And, in the least analysis, you need monetary conversion to get really open markets. Because open markets without monetary conversion are always disturbed by huge fluctuations of exchange rates and currency crisis and thus are not really open compared with a currency union or absolutely fixed rates.

Concerning the statement of Mr. Curtis I just want to underline that the euro in the medium term will be clearly a strong currency. This is not only true for its internal value. Mr. Curtis is absolutely right in stressing the point, that the domestic stability of the Euro sooner or later will lead to a stable external value too. There can be no doubt about this point. The only problem that we see time and again, and we see it right now, is that the markets tend to push a currency into a certain direction although the fundamentals are the other way round. And the fundamentals, again I fully agree with what Mr. Courtis said, are in favour of the Euro. Take the huge disequilibrium that we observe in the current account positions of Europe on the one hand and the United States on the other hand.The fundamentals are clearly in favour of a strong euro. But the markets tend to overshoot, given the interest rate differentials or other "noise"and thus disequilibria may in the first round become larger, and may only in the second round by an explosive turn-around of the markets be corrected.

The last remark I want to make is on Christian Noyer's speech. I agree with most of the points he mentioned, but I disagree strongly on one aspect of his analysis of the European “desease". This concerns the question of “structural unemployment". I do not want to go into an academic discourse here, but the question of structural unemployment is a very protracted one, and one should be careful in even using that word. But whatever definition you prefer for the “structural" aspects of unemployment, one thing should be absolutely clear. Whatever you can do to fight “structural unemployment" will only be successful in an environment of strong growth and investment dynamics. Take any country which has brought about wonderful structural reforms and which was really successfull in reducing unemployment: They all had, in addition to all the structural measures, very high growth rates. High growth rates are the key. If you are able to generate high growth rates then you may discuss which other assisting structural measures are necessary. I do not disagree that in Europe we need this kind of structural adjustment too. But without much higher growth rates, all the efforts in microeconomics will be in vain. Look at the growth performance of Europe compared to that of the United States in the 90's. The European performance is extremely poor. If we are not able to fight the new shock we are faced with in the aftermath of the Asian crisis we will even further fall behind. Thank you.

Gyohten: Thank you. Christian, you have anything to refute to what Heiner said?

Noyer: I fully agree that it depends on the different weight you may give to one issue or another. What I meant was that even if we enjoy a very high growth rate, if we didn't change the structural environment, that would lead to a small number of job creations, not sufficiently high to really solve the problem of unemployment. But, of course, it is easier to implement that with a higher growth rate. For instance, with structural measures you may facilitate the process to start businesses, to develop businesses, you may extend opening hours, you may create additional jobs in the same businesses, and so on. And that as I said will create higher potential for growth, higher growth closer to the potential and higher content of jobs for a given growth. But I fully agree that all this works better if you have good growth. So, I am in agreement with Heiner Flassbeck.

Gyohten: Good. So you agreed. All right. I think I had better give floor to Ken Courtis.

Courtis: Thank you Mr. Gyohten, I wish to follow up briefly on a question you raised for Christian Noyer, and then I will return to your questions to me.

Mr. Noyer, you said in you presentation that the policy of the ECB is to have a price stability of less than 2 per cent. Would you also agree that there is a price level that would be too low? And therefore should we not announce also a floor under which prices should not be allowed to fall?

Noyer: We have not given a precise figure for a very simple reason. This is because it could lead to extremely complicated discussions about the so-called " measurement bias." There has been a considerable amount of literature about that mainly in the United States, but in many countries nobody knows the exact " measurement bias." We are pretty sure that it is relatively small in Europe, not because we are more intelligent than others, but because our harmonized index for consumer price is a very new one. We have tried to cope with difficulties of the bias that others have identified, and our feeling is that the bias is very small. But it may still exist, even if it is extremely small. So, if we had said it is between 0 and 2 per cent, immediately somebody will stand up and say, “But the measurement bias, it must be zero point something." So to avoid that debate, we have said an increase of less than 2 per cent. An increase means that the permanent decrease in prices certainly would not be consistent with price stability. That is why I said deflation and inflation are for us two evils that we want to avoid, and that it is our policy to counteract it if there is any development in that direction. But I prefer not to give my own estimate of the measurement bias.

Gyohten: Well, I am sure our friends in the Bank of Japan will have much to share with you, Christian.

Courtis: Measurement bias exists in both directions, so one could discuss that if a target ceiling for prices is established, we should also have a floor, below which the ECB would work to reflate.

Mr. Gyohten, you raise the question of Europe's commitment to bringing 10-12 more countries into the European Union. Some will say “Because it is difficult, we can't continue." I do not want this to sound like it may sound, but I think we can say for Europe more broadly that the easiest has been done. In a sense, the difficult things start now.

If you think of what has happened in the last two or three decades, the core of this emerging Europe has rested on a very particular balance between France and Germany. But that balance has involved over time huge amounts of financial resources being transferred from a region to another. We all know that the common agricultural policy eats up a very large part of the budget, and that the regional development policies eat up a lot of the rest of the budget. It is quite clear that those policies, at least in their present form, cannot exist into the future. In fact, Mr. Flassbeck has already, in a very diplomatic way, told us earlier that the debate has now begun.

We all know there were difficulties and tensions in that debate a few weeks ago. Difficulties there may be, but that debate is inevitable as these policies are no longer sustainable. This debate will be intensified by the expansion of the European Union, and it will require very great statemanship and leadership to negotiate a transition to a new, stable and sustainable budget basis for Europe that will be 20, and eventually 25-26 countries.

All of these 25 countries or so will not all necessarily be part of the euro at first. The conditions for entering the euro, of course, are very high and demanding. But should these countries be allowed to be full and equal participants of the European Union, with its common market, the lower costs these countries have will allow them over the mid-term to have much higher growth rates than the rest of Europe. That is the case today for Ireland, and Portugal, for example. Over time then there will be an even broader convergence, such that some of these newer members will meet, quicker than most yet believe, the conditions for becoming members of the euro.

These developments will also change the balance of political power within Europe, particularly as many of the new members have a more central European bias. The result will be a shift in the center of gravity from the German-French central force of the last decades, to a much more central-European center of gravity. This power shift will pose very complex political issues for France in particular.

A second comment I would like to make is that the euro has already unleashed in the market, a force which we should not underestimate. In effect, the markets themselves will impose a restructuring of corporate Europe, and so will do some of the work that the politicians up until now have been unable or unwilling to do. The result is that the politicians may be the last to change! In this way Europe is similar to Japan!

At the same time, it is very important that we understand the role that the social policy has to play as we go through this transition. People who are in the mid-term feel threatened by the transition will start to resist the changes, and so make it more difficult to realize the potential that is now so close at hand. Social policy has to be used to help people who require such support through the transition.

The third question Mr. Gyohten raised concerns the G3 currencies. Let's be clear. What are the main characteristics of the world economy as we meet? We have excess capacity in virtually everything we trade. We have extremely high debt levels, not just in the emerging markets, but globally. We have structurally slow growth. If you have a company which has excess capacity, high debt, and slow sales, you are unlikely to invest in it! Well, that is what world economy is like today.

Those forces all came together last fall with the Asian and the emerging markets crisis. Financial institutions got into great trouble, as a global credit crunch stated. We had a financial “thrombosis" in the world economy as it were and the system started to cease up.

When you have a thrombosis, the doctor prescribes blood thinners, a medicine that makes blood more fluid and allows it to flow more easily, and that reduces the pressures. The doctors hope that over a time the blood clot becomes smaller, fiberizes, and new tissues form over it, and the blood flows smoothly again. But, of course, if one takes these blood thinners for too long, or they are too powerful, the capillaries in the brain start to leak, and that can also be fatal.

The monetary doctors, if I may say, have given us in the meantime a very strong dose of monetary medicine. We have had 132 interest rate cuts by OECD central since last fall, and one hike which happened last week. At the same time, the emerging economies have cut interest rates dramatically. This huge monetary easing has made the world financial system more fluid, and pressure has been reduced, as most of the new liquidity has gone into financial markets.

Now the problem, particularly for America, and that is key for the world economy, because the U.S. generated 62% of world growth in the first quarter this year, is that this liquidity is beginning to flow from financial markets into the real economy. Real estate prices are booming. Consumers are spending like there is no tomorrow, even though they have negative savings rate: The U.S. labor market is becoming tighter and tighter. Sooner or later, if things do not slow, we will start to have some real problems with prices, and therefore, with interest rates.

The U.S. central bank is working now, in one of the most delicate and difficult operations of monetary policy, to dampen expectations and the sentiment of consumers, without breaking them. If it breaks them, and the U.S. comes down too fast and too hard, and if Japan and Europe are still not growing, then obviously the emerging markets will not be able to export very much, and therefore, they will not be able to pay back their bankers. If that happens, then we will be very quickly back towards the type of crisis we had last fall.

I also wanted to ask Mr. Sakakibara, how from Tokyo he sees things in China. For good or bad, China committed itself, and has kept that commitment, to tie its currency to the U.S. dollar. The dollar is going up against the euro, and it seems some people in Tokyo want the dollar to go up against the yen, and that means driving the RMB up at the same time. The result of the weak euro and Japan's efforts to weaken the yen are that China is now importing deflation through its stronger currency, and is doing so in a context where it is already trapped in a deflationary cycle, with the very high debt levels of its banks, and its state-owned companies. Chinese government debt is also growing very quickly, and its tax system as we know remains antiquated.

Secondly, it seems to me that together the difficulties that the United States had in coming to an agreement earlier this year with PR China on WTO, coupled with the difficulties of the reform process in China, and with what happened in the Balkans, have had the result of weakening the reform leadership in the country. So I ask, is now the right time to be taking actions to make the RMB even stronger, relative to the currencies of its two or three main export markets? Are we not through these policies and in the absence of a broader regional policy coordination, increasing the difficulties China faces and so increasing substantially risks for the region?

Gyohten: Well, thank you again. You will be the last, Mr. Sakakibara. Could you make a comment?

Sakakibara: Well, Mr. Courtis' question about China. I am notorious for making remarks which are politically inappropriate. This is the day before our Prime Minister leaves for China, so I will refrain from making any critical comments on China. I have to be a vice minister for another two days or so.

With regard to Mr. Noyer and Mr. Flassbeck's debates, I was very much amused by Frenchman Mr. Noyer taking traditional Bundesbank positions, and defending the Bundesbank positions against the German criticism. And I remember the day, it was several months ago, when I met President Duisenberg. It was the day before he attended the ECOFIN Meeting. And he was saying that it was 11 against 1, but Christian was there, so he modified his statement, " It is 11 against 2." And he is going to be tortured by Mr. La Fontaine. That was the remark that he made. Both of you played that sort of scenario in a very diplomatic way, but I think the key question is: would the ECB continue to take a traditional Bundesbank position of always sort of adhering to the price stability and not really paying much attention to absorbing what Heiner called symmetrical shock, demand shocks, or supply shocks, or, does ECB have any policies whatsoever with regard to the exchange rate? These are the two key questions that I would like to ask Mr. Noyer.

And second, with regard to Mr. Courtis' point...Sure, lots of the corporate restructuring, market driven corporate restructuring would probably take place. It is taking place. It is taking place at the very rapid pace. You mentioned that, but one thing which worries me is that Europe, at least for the last three, four years has become increasingly Social Democratic. And there would be fairly strong resistance to this kind of aggressive corporate restructuring from the side of the labor unions and from the middle class and so on. How would you see the compatibility of this aggressive corporate restructuring versus the resistance from the Labor.

Gyohten: Thank you. So this is the chance for everybody for their last remarks. Any volunteers? Christian.

Noyer: Yes. I will be relatively short because I am building on what I said previously. To me, price developments and real economic developments, if macro economic policies in the medium term are soundly based, go in the same direction. That is to say, if there is an external shock, a symmetric shock, it will have an impact, of course, on economic developments, but it will also have an impact on price developments. So that when we act, to counteract, for instance, a risk of deflationary spiral, we not only provide price stability, and I must underline that for us price stability is not the lowest possible level of prices. It is to ensure that in the medium term the economy does not develop either a deflationary spiral or an inflationary spiral, so that it is providing the best possible balanced environment for growth and for combating unemployment. So, we should act with effects in both directions. And I could say the same regarding the risk of external shock, that would induce an overheating of the economy, and so on. Of course, we only have to act in a different way if there are inflationary pressures that develop outside fundamental economic reasons. That is, for instance, if wage developments are not following productivity growth as Heiner Flassbeck said, then there is a risk of inflationary pressure whatever the economic stance is, and the Central Bank has to react. But normally, for the traditional symmetric shock, there is no contradiction at all.

As for exchange rates, I do not wish to discuss this too much. We are much too often asked about exchange rates. I think I made it clear that we monitor these very closely. This is a very important indicator in our monetary policy, and we have proven that we are very attentive to that. And once again, we are not interested in a weak Euro, our objective is a solid and stable Euro in the short, medium, and a long term.

Gyohten: Thank you. Heiner, please make your last remark.

Flassbeck: Yes. Last remark: The question that was raised about the effects of monetary policy is the most important one, it is the question of prices and quantities. The effects of monetary policy on prices and on quantities cannot be separated if you are not living in a textbook world in which prices are "perfectly flexible". But this world doesn't and, in my opinion, should not exist. We should be happy that it doesn't exist, because a world in which we do not have major changes in quantities would be a poorer world. We like major changes in quantities because these changes are what we call real growth. As long as we want to have growth, development and structural change, prices and quantities cannot be separated. And in this case monetary policy always has an influence on quantities as well as on prices. Even more so, monetary policy acts through quantities on prices, that is the normal chain of events.

Sometimes the European discussion in this respect seems to me to be a bit outdated. Let me illustrate that with a certain example. If you ask economists in Europe the question: "What about fine tuning of monetary policy to steer the economy?" everybody would say, "Oh, terrible, no fine tuning. Fine tuning is out. Fine tuning was the model of the 70's or so." But if you then look at the United States, and Mr. Courtis just mentioned it, look at what the Fed did all over the 90's. This is the best example for fine tuning by monetary policy that you can imagine. Permanent fine tuning, week by week and month by month, was, up to now, the main ingredient of the unprecedented boom that the US have seen in the 90's. This is in my opinion the main lesson Europe has to learn. Only if Europe and the European Central Bank learn that microeconomic adjustment has to be complemented by macroeconomic management we will have a chance to catch up with the Americans.

Question and Answer Session

Questioner: I have a question for Dr. Courtis. I was at the Cologne Summit two weeks ago, and had the opportunity to detect the ambivalence of the people in Europe towards the euro. So I would like to ask your opinion on that. As Dr. Courtis mentioned, the European elections resulted in quite a disappointment for Prime Minister Tony Blair. I believe the same was true for Chancellor Schroder. After the election, Prime Minister Blair shifted his position quite extensively, though not quite 180 degrees. I am sure his shift in attitude was a reflection of how he understood the message of the people through the result of the election. How do you see the prospect of Britain joining the single currency?

My next question is to Dr. Flassbeck. At the Summit, Prime Minister Obuchi asked Chancellor Schroder “How is the euro doing?", to which Chancellor Schroder answered: “It is a good thing because it is supported by 40,000,000 people." I wonder where the number 40 million came from. Perhaps the interpreter made a mistake and it should have been 400 million. But the key point is that Chancellor Schroder is claiming that the euro has the support of the people. But my impression from talking to different people is that the euro is creating ripples of misgivings among different groups of people and in different countries. Perhaps they are not just ripples but waves. I am wondering whether this has anything to do with the attitude towards the center-left governments.

Flassbeck: If I understood the question right, I think the support for the euro is still there in Europe, but you have to be careful if you look at the priorities of the population in Europe. The euro is only at rank 10 or 15 or something like that. The most important thing is, definitely still unemployment. People want jobs. And there was a lot of promise around by introducing the euro that the euro will even create jobs. But, currencies do not create jobs. That is a problem. And what currencies do, they may bring about a framework in which policy then creates conditions under which jobs are created. That is a bit more complicated than just the currency to create jobs. This promise is a dangerous one. And it was a dangerous one, in my opinion. But people measure the success of the euro on this promise, and in two years', three years' time, when they get the coins and the bills, they will ask, " Well, what is the result of this kind of exercise that we have done?"

You see, up to now the euro is not very concrete. It is not there. It is just an idea in the heads of bankers, but it is not on the ground, so to say. And if that is going to happen, then we will see whether there is support for the euro or not.

But I think something else has shown up in the Blair-Schroder result of the European election, which in my opinion is even more important. The strange thing is that in all of Europe we have Social Democratic governments. Most of the countries, I think 11 or 13 have Social Democratic governments. Why is it? I think, that in one way or the other, people expect from the Social Democrats that they get something like a protection from this terrible globalization that is coming over us since the beginning of the 90's. Everybody is talking about globalization, globalization as a big threat. It is a threat to the emerging countries, and it is a threat to the industrialized countries. Nobody is rational and reasonable about globalization, but everybody is talking about these terrible things. And I think in the average population, it is something like that. I think what they expect from the Social Democrats is to give them certain help or protection from this threat of globalization. And if they do not do that; the Schroder-Blair paper that we have just seen in Germany is an example of that even the Social Democrats say, "Well, we cannot help you. You have to take up all these challenges."; then people are frustrated, and people do not vote for Social Democrats any more. And I think this is much more important than the question of the euro for the results of the European election.

Gyohten: Thank you. Ken, I think the question addressed to you is about the British accession to the euro.

Courtis: It is the case that the U.K. opposition made the European elections a referendum, in a sense, on the euro, that is that it made the U.K. joining the euro the central issue of the recent election. The government was perhaps overconfident; it was preoccupied with the Balkans, and was caught by surprise. I think that Mr. Blair probably sees himself, if I can do some amateur political psychology, as someone who has a chance, the will, and the desire to be a three-term Prime Minister. So, he will have to be convinced that he can handily win a referendum on the euro in, say, 2002, 2003, after the next UK elections, when he would be re-elected as Prime Minister. I think also that he needs to win 58 to 60% of the vote in order to close the debate. If he is unsure of being able to do that, I do not think he will take the risk of holding a referendum, and the U.K. could not join the euro without a referendum.

The euro has had some teething problems which have occurred during a cyclical downturn of the European economy. These developments have exaggerated the gap and performance between the UK and Europe. Prime Minister Blair and his government will have to make a very big effort to "sell" the euro to public opinion. That effort will be made less difficult if the euro countries also get on with their reforms.

The point has just been made, and the question is raised also by Sakakibara-san, about the apparent contradiction where you have Social Democratic governments, and yet it looks like we are going toward a market driven solution to many of the blockages of the European economy. Actually, I see no contradiction. In fact, that has been one of key reasons for the success of the U.S. in the 90s. Clinton has been in the center, but leaned to the left politically, and has tried to keep putting in place the type of social policies that would allow people, who could otherwise have been victims of these changes, not to be victimized, and to re-position themselves in the work force so that they do not oppose economic change. I think that is the role Social Democratic governments will have to plan in Europe.

I missed in my attempt to propose a question to Mr. Sakakibara about China. But I think before the end of Mr. Sakakibara's mandate, Japan's Prime Minister will not be going to the United States. So, let me ask a question, if I may, about the United States. In your comment, you said that Asia, and I have a lot of sympathy with this view, is a net exporter of mid-term capital to other economies, some of which are thriving economies, in part because of this financing from Asia. You suggest that Asia use more of that money in Asia. But how do you do that? What would be the implications for America and the world economy, indeed of Asia using that money at home rather than exporting it to the United States? What are the implications for U.S. interest rates? What are the implications for politics across the Pacific? What are the implications for defense policy coordination in Asia? These issues are extraordinarily important and vital ones.

Sakakibara: The proposition that I have been making with regard to developing a viable debt market within the Asian region is a medium to long term proposition. So we have to really think of the process which would not cause major disturbances in the world financial markets. Of course, the U.S. imports capital, which you have mentioned, year by year, and their outstanding amount of debt, which is 1.5 trillion dollar, is not sustainable. This is not a sustainable situation. So some kind of adjustment needs to be made by the United States as well. But the transition, we have to make sure that the transition would be a smooth one. I cannot prescribe a scenario for a smooth transition, but this is a challenge all of us are confronted with for the next two to three years. (I didn't answer your question directly.)

Questioner: I would like to address Mr. Noyer. Ever since the introduction of the euro, there has been a marked development in European financial markets and in European integration. A new overnight euro market was created, and as regards a euro-denominated government bond market, we hear that there was quite a competition over the benchmark between Germany and France. I am interested to know what the roles of the national markets are going to be in face of such integration of the financial and capital markets. Before the euro was launched, it was thought that all 11 markets in 11 countries would not be able to prosper, and as a consequence there would be integration of the markets. With the birth of the euro I understand that there is a substantial increase in mergers and integration in the Schroder exchange, Schroder settlements and financial futures markets. However, since the European Central Bank is carrying out its financial policies through operations in the national markets of the member countries, those markets still have important roles to play. But if in the future Britain adopts the euro and there are 12 markets involved, will it be possible for 12 markets to survive for financial policy operations? I have a feeling that there will be some integration, resulting in the creation of a number of large markets. I would like to hear your comments on this point.

Noyer: I think that the fixed income market is in the process of real integration. In fact, for the customer and for the investor, it is already by large a unified market. You were raising the question of bench marking, but with the exception of the 10 years point in the yield-curve, due to some disturbances of the futures contract underlying bond issues for the yield-curve as a whole, the French and German yield-curves are exactly the same, only two or three basis points in one way or the other. So, you have the bench-marking yield-curve, and the settlement and payment systems are connected, and the connections are more and more efficient. It works very well. You can really consider that the bond market and the short-term fixed income Schroder markets are really unified to a very large extent, and this is improving everyday. So, you can deal everywhere and you can buy and sell Schroder, put them in the custody service that you wish. That works quite well. It happened from the very beginning. This explains why the market has become more liquid than each of the previous markets was, and why the volumes have developed so rapidly. Mr. Courtis gave very impressive examples of consequences in terms of the capacity of companies to raise funds and to make big operations. It is absolutely clear that we have seen the emergence of corporate issues to an extent that was absolutely unknown in Europe before. I remember nine months ago when we were saying that normally the emergence of a unified market should help develop compartments of the market that are underdeveloped in Europe compared with the United States. These were corporate bonds, also money market paper, and that sort of thing. Well, this really happens. So, I think we will have a unified market. But the way we are organized in Europe is not at all comparable to the way the market is organized in the U.S., simply because we are establishing this at the end of the 20th century, whereas the Americans have created this at the beginning of the 20th century.

If you take the example of the Central Bank's operations, it is quite clear that at the time when the market developed in the U.S., it had to be physically in one given financial centre. So they developed it in New York because it was the major financial centre, and all the interventions of the Federal Reserve in the exchange market, but also in the money market, are made in New York. Only the discount facilities exist in the twelve Federal Reserve Banks. But we do not need to do that, simply because, in the meantime, there has been the creation of computers and telecommunication networks. We have been able to establish our own network, and we deliver the liquidity throughout the Euro area, through the sub-computers of the national central banks. That is really one operation of liquidity provision, but we do that in a decentralized way. Decentralized, in the sense that banks are plugged into the NCBs'. But the operation itself is completely centralized, and the money is evenly displayed. And where the money market works, it does not have to be concentrated in Frankfurt or Paris, or wherever it was, because if a bank in Paris is active in the money market, it will borrow funds in Finland and make a loan to a Portuguese bank, and borrow funds in Milan and lend it in Frankfurt, and that works very well. And all this goes through the inter-related network in our payment system. The target payment system that from the very beginning, from the first week after the inception of the euro, became the first payment system in the world. It was absolutely impressive. This unification continues, and I think for the investors, the advantages of a broadened liquid market already exist.

What if the UK was joining? Well, I do not see a major difference because there are no more reasons why the market should concentrate more in London today than it would concentrate in Frankfurt or Paris. Of course, all financial places will compete, trying to provide the best environment possible. But because of this technology that has been implemented, the future as I see it will be very widely spread with decentralized financial markets working in a very modern and efficient way, and there is no need to concentrate. Maybe the largest financial centres, if the costs are too high, will have difficulties in maintaining their relative strength.

Questioner: My understanding is that the supervisory role of the ECB is not very clear. But I am still interested in having Mr. Noyer's sentiment about what is going on regarding financial consolidation in Europe. Obviously, a unified capital market calls for cross-border merger between financial institutions. What we are seeing now are governments, it is obvious in Portugal, maybe not as of use, but also true for France, taking a very nationalistic, if not chauvinistic approach to the issue of banking consolidation. It is obviously of the interest of the ECB looking long term to have consolidation, strong players, and freed banking rules. Does this fit in the picture of having a unified capital market in this nationalistic approach taken by governments?

And to Mr. Courtis. I am, of course, very interested in small deliberation of what you meant by European outcome to this banking battle in France.

Gyohten: Thank you. Christian, you are very popular.

Noyer: I am very sorry because I will disappoint you. I will not comment on the policy of governments in Europe. I will refrain from that.

But I will take the opportunity of your question to briefly discuss the regulatory framework and the division of responsibilities. The criticism is raised very often that we have a complex system, and that this European Monetary Union is very dangerous because nobody is in control, or because it is controlled from a national point of view and if there is a crisis somewhere, it will simply not work. Well, if I may say, this must not be taken as a criticism at all, but compared with the American system, the European system is a model of simplicity, clarity, and easy understanding for the division of the responsibilities. Because, if you look at the other side of the Atlantic, you have State Regulators, you have the comptroller of the currency, you have the Federal Reserve, you have the FDIC, and numerous other institutions. But, in fact we all know that this works, because all these people work together. If you look inside the Federal Reserve System, it is clear that when there was a problem with the manufacturer, Hanover, the problem was not solved in Washington, it was solved in Chicago. When there was a problem with the LTCM, who organized the meeting? The Federal Reserve Bank of New York. So, it works. And of course, these people work together, they coordinate, and they have the same fundamental policies. It works very well in the U.S.. Why should it not work very well in Europe?

The picture is relatively much more simple. And one asks also, because then the response could be, " but the regulatory framework is not the same." But this is not true, because for many years we have been developing so-called " banking directives". A common framework and all legislations in Europe, all banking legislations, are simply copying the directives, that are in fact providing common regulatory frameworks in all the European countries. This has been developed for at least 15 years, and probably 20 years. And now, it is very similar in all countries, both for banking activities and financial services in general. So, I am pretty sure the system is sound and works quite well. And certainly the emergence of a unified market that has been described this afternoon will lead to a consolidation in the financial sector and one day or another that will be trans-border. That is obvious. But, I do not think personally that it is up to the monetary authorities to foster or hinder such a development. We simply have to check that what happens does not endanger the soundness of the financial system. For the rest, it is up to the economic actors to organize as they wish.

Questioner: This is a question for Dr. Sakakibara. Until right before the launching of the euro, there were concerns especially in Japan, that once the euro was introduced a substantial amount of funds would shift to the euro, especially from the dollar to the euro, creating a dollar crisis. So far this has not happened. What is the reason for this? Is it, for example, because of a significant pressure from the United States or is it because the central banks and the monetary authorities are exercising self restraint? Or is it because the euro is not attractive and so there is not much shifting? I would appreciate your analysis on this.

Sakakibara: I believe that there was quite a degree of irrational euro-phoria before the launch of the euro in 1998. Japanese corporate investors are very susceptible to fashion and are known for herd-behavior, and I believe that is the reason why euro-phoria was quite notable in Japan. As far as the monetary authorities are concerned, with or without pressure from the United States, we have no intention of suddenly shifting dollar assets to the euro. Naturally, after an intervention in the yen-euro market like the one I mentioned, assets in the euro will increase. But I do not believe that the authorities are thinking of a rapid shift to the euro. As other speakers have mentioned, I, too, think that the euro will become a strong currency in the medium to long term, but I do not believe that a rapid shift will occur. I believe what has happened is a readjustment after an exaggerated euro-phoria.

Gyohten: I think the time has come to end the 7th International Monetary Symposium. I would like to thank Ambassador Jo／rgensen and the four speakers on the panel for their very stimulating comments, and as one of the sponsors of the symposium I would like to express my appreciation to the audience as well for the very active exchange of views. Thank you.