THE EURO: FIVE YEARS ON

—Implications for Asia

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Preface

Five years have passed since the introduction of the euro and the currency is steadily increasing its role as an international currency as is shown by the fact that its share in international bond issues has almost exceeded that of dollar. In May of this year, ten Central and Eastern European countries joined the EU to form a single market of 450 million inhabitants: these ten new member states are working toward introducing the euro when the time is right. Economic integration in the EU continues to provide a stimulus to the Asian region recovering from the Asian financial crisis. Following on from the EU's experience, attempts such as the Chiang Mai Initiative and the Asian Bond Market Initiative show progress in stabilising the currencies and tapping into the large Asian savings.

Against this background, the Delegation of the European Commission in Japan and the Institute for International Monetary Affairs held a symposium bringing together panellists from the EU and the Japanese financial and industrial circles to discuss such issues as the future developments of the enlarged EU and the euro, what is the desirable currency and economic framework for Asia, what can be learnt from the EU and what is expected of the EU.

We hope this publication that records their speeches and discussions will be of any help to those who are interested in the development of Asian regional integration as well as the expansion of the EU and the euro. Please note all responsibility in compiling these speeches and discussions is solely of IIMA's as are any errors in their presentations here.

<u>Panelists</u>:

Lucas D. Papademos

Vice President, European Central Bank

1972	Master of Science in Electrical Engineering, Massachusetts Institute of Technology
1973	Research Assistant and Teaching Fellow, Massachusetts Institute of Technology
1977	Ph.D. in Economics, Massachusetts Institute of Technology
	Assistant and Associate Professor of Economics, Columbia University, New York
1980	Senior Economist, Federal Reserve Bank of Boston
1985	Economic Counsellor (Chief Economist), Bank of Greece
1988–	Professor of Economics, University of Athens
1993	Deputy Governor, Bank of Greece
1994	Governor, Bank of Greece
2002–	Vice-President of the European Central Bank

Toshihiko Fukui

Governor, Bank of Japan

1958	Graduated from the University of Tokyo Joined the Bank of Japan
1989	Executive Director
1994	Deputy Governor
1998	Chairman, Fujitsu Research Institute
2001	Vice Chairperson, Keizai Doyukai (Japan Association of Corporate Executives)
2003—	Governor, the Bank of Japan

Klaus Regling

Director-General, Economic and Financial Affairs, European Commission

1975	M.A. in Economics from University of Regensburg Joined the International Monetary Fund
1981	Economist, German Ministry of Finance
1985	Deputy Chief in the International Capital Markets Division/Representative in Indonesia, International Monetary Fund
1991	Chief of the International Monetary Affairs Division/ Deputy Director-General for International Monetary and Financial Relations/ Director-General for European and International Financial Relations, German Ministry of Finance
1999	Managing Director, Moore Capital Strategy Group, London
2001—	Director-General for Economic and Financial Affairs, European Commission

Alexandar Schaub

Director-General for Internal Market, European Commission

1973	Joined the Commission of the European Communities: Cabinet of Ralf Dahrendorf/ Deputy Head of Cabinet for Guido Brunner, Viscount Etienne Davignon and President Gaston Thorn/ Head of Cabinet for Willy De Clercq
1989	Directorate-General for External Relations and Trade Policy
1990	Deputy Director-General for "Internal Market and Industrial Affairs" and for "Industry"
1995	Director-General for Competition, Vice-President of the OECD Competition Committee
2002—	Director-General for Internal Market

Hajime Sasaki

Chairman and CEO, NEC Corporation

1961	Master of Engineering in the field of Electrical Engineering, Graduate School, University of Tokyo Joined NEC Corporation
1988	Associate Senior Vice President
1991	Senior Vice President
1994	Executive Vice President
1996	Senior Executive Vice President
1999—	Chairman of the Board

Robert A. Mundell

Professor of Economics, Columbia University

1953	Graduated from University of British Columbia
1956	Ph. D. in Economics, Massachusetts Institute of Technology
	Post-Doctoral Fellow in Political Economy, University of Chicago
1957	Taught at Stanford University and Johns Hopkins University (Bologna Center)
1961	Staff of the International Monetary Fund
1966-71	Professor of Economics, University of Chicago
1974—	Professor of Economics, Columbia University
1999	Received the Nobel Prize in Economic Sciences

Bernhard Zepter

Ambassador, Head of Delegation of the European Commission in Japan

1973	Joined German diplomatic service, Bonn
1974	Member of Cabinet of State Minister for European Affairs, German Ministry of Foreign Affairs
1976	German Embassy in Dakar, Senegal
1979	First Secretary at the German Permanent Mission to the North Atlantic Treaty Organization, Brussels
1982	German representative at the Secretariat of the European Political Cooperation
1984	German Ministry of Foreign Affairs dealing with the revitalization of the Western Europe Union
1990	Diplomatic Counsellor, Deputy Head of the Cabinet of Jacques Delors, President of the European Commission
1995	Deputy Assistant Secretary for European Affairs, German Ministry of Foreign Affairs
1997	Deputy Secretary-General of the European Commission
2002—	Ambassador, Head of Delegation of the European Commission in Japan

Moderator:

Toyoo Gyohten

President, Institute for International Monetary Affairs

1955	Graduated from the University of Tokyo
	Joined the Ministry of Finance
1984	Director-General, International Finance Bureau
1986	Vice Minister of Finance for International Affairs
1990	Visiting Professor at Princeton University
1992	Chairman, The Bank of Tokyo, Ltd.
1995—	President, Institute for International Monetary Affairs
1996—	Senior Advisor, The Bank of Tokyo-Mitsubishi, Ltd.

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1. Opening remarks

Toyoo Gyohten
President, Institute for International Monetary Affairs

Good afternoon, ladies and gentlemen. Thank you very much for attending this Thirteenth Symposium, which we are co-organizing with the European Commission's Delegation in Japan. I appreciate such a large number of attendance in the audience and would also like to express my sincerest gratitude to all those who took time coming over long distance to be on the panel today.

Today's symposium has as its theme "The euro: five years on – Implications for Asia." Later on, the panel members would give us various thoughts and observations from different angles. It's been five years since the launch of the euro, and its achievement, in one word, is indeed outstanding. It has been a radiant success. As an international currency, the position of the euro has been heightened steadfastly, and the European Union itself has significantly advanced its structural reform efforts in the past five years; joint efforts are under way, coordination is going on, and deepening and enlargement are represented in the increase in the number of members in the EU while the activities are further deepened.

Turning our eyes to Asia, on the other hand, likewise steadfast progress has been made. In 1997 the currency crisis took place in Asia, but having overcome the Asian currency crises, the Asian countries are now looking toward Europe to learn from Europe as they try to reinforce economic and other cooperation and coordination in the Asian region. Various free trade agreements are being concluded in the financial area; cooperative endeavors and undertakings are making headways. As you already know, the financing arrangements have been concluded between the central banks of the region, and efforts and initiatives are under way to develop bond markets in the region. And various studies and researches have been launched aiming at some common currency for Asia in the future. So, diversified activities in various fields are making progress here in Asia as well.

Looking toward the future of the global economy, the mono-polar economic structure with the United States playing a dominant role may not change right away, although the U.S. economy is also flooded with many problems and challenges. However, it seems these challenges and problems are getting more and more serious, which could imply that the mono-polar structure with its unstable nature need to be addressed from the global perspective, and it is a challenge that we need to commonly address to try to establish a more stable framework for the entire global economy. This means both Asia and Europe first of all need to strengthen and reinforce their economies. At the same time various economic cooperative arrangements are to be explored between Europe and Asia, especially in the business area, and strengthening those arrangements or relationship will be of heightened importance. For over fifty years European friends have made serious efforts toward economic and monetary integration, and in that process, they have given us a great deal of lessons that the Asian countries can learn from the European experience for the future of Asia.

So in today's Symposium, we expect to be able to hear very informative and useful comments and observations from the panel members to these variegated challenges and problems and issues. As I mentioned earlier, after listening to the presentations by the panel members we would have inter-panel discussion as well as panel members responding to the questions. We would like to entertain as many questions from the audience as possible, but for that I would also like to seek your cooperation as well.

So, this briefly concludes my greetings, and at this juncture I would like to ask Ambassador Zepter, the Head of Delegation of the European Commission in Japan to give his welcoming remarks.

Bernhard Zepter
Ambassador, Head of the Delegation of the European Commission in Japan

Mr. President Gyohten, Mr. Governor Fukui, Mr. Vice President Papademos, distinguished panelists and speakers, your Excellencies, Ladies and Gentlemen, let me first of all extend a very warm welcome to all of you on behalf of the European Commission. It is a great pleasure to be here today and to see how many of you have come to listen to our distinguished speakers.

The euro was introduced over 5 years ago and this would seem a good moment to take stock of the results of this unprecedented event in monetary history. The complex operation of switching over to euro banknotes and coins on New Year's Day 2002 was an undisputed success. The euro has become the accepted currency for day-to-day cash payments in 12 Member States of the European Union and has become part of every day life of the Union's citizens. The 10 new Member States of the enlarged European Union are gearing up to also introduce the new currency, possibly before the end of this decade.

European, as well as foreign, investors, traders and tourists, including many Japanese, are taking full advantage of the new possibilities offered by the euro. The euro has become an international currency for trade transactions, national reserves and a preferred currency for the issuance of financial instruments, in particular bonds. We will hear much more about these economic and financial themes today.

However, possibly the most important effect of the introduction of the euro is its role in forging a European identity. Very much like being able to freely travel without a passport across national borders, being able to pay with the same currency is a strong uniting factor for the people of Europe.

Today, some speakers will also look at the implications for Asia. I hope that our history of economic, political and monetary integration can be a source of inspiration for Asians in finding their own "Asian way" of integration.

This symposium is part of our wider campaign to give publicity to the euro, its history and possibilities. In this context, in order to reach the widest possible audience, we have published a "manga" about the euro in Japanese and we have issued a euro "Hello Kitty" mobile phone strap. The euro Hello Kitty has already become a collectors item and is traded in a sort of a black market over the internet. Of course, today, you will all receive a manga and a Kitty, as a gift of courtesy from the Delegation of the European Commission in Japan!

I am very proud that we have managed to persuade such an excellent group of top financial policy makers, private sector leaders as well as the main theoretician about economic and monetary union, to be with us today. Thank you very much for joining us. We are all looking forward to what you have to say.

2. The euro after five years: assessing its performance and global role

Lucas D.Papademos,
Vice President of European Central Bank

Thank you very much, Ambassador Zepter, Excellencies, Governor Fukui, President Gyohten, distinguished panelists and speakers, distinguished guests, ladies and gentlemen: I am really impressed to see so many attending this Symposium that is focusing on the euro, a symposium that also because of its name sounds to me like a birthday party for the euro.

The Organizers of this prestigious International Monetary Symposium have invited me to be the first speaker in the session, and this puts me in the privileged position to open the discussion and in this way to set the scene and hopefully the tone. I am delighted to be here among such a highly esteemed speakers in this event to mark the five years of the euro. Five successful years. Of course, "success has many fathers", as the saying goes. But as the central bank issuing the euro the European Central Bank has a particularly close, if I may call, "parental" relationship and responsibility. And that parental feeling applies to the Eurosystem, which comprises both the European Central Bank and the national central banks of the euro area.

The particular focus of our symposium is on the implications of the euro for Asia. But before we look at the future implications of the euro, I thought it would be part of our parental duty to also look back on how the euro has developed, as the Ambassador said, to take stock and put together a kind of a score-card of the performance of the single European currency: in what fields does the euro deserve straight "As"? And where would further efforts be needed to get to the top of the class? In the second part of my talk, I will address issues related to the international role of the euro.

II. The euro's scorecard after five years

Looking back on the period since the introduction of the euro in 1999, I will simply let the facts speak for themselves: during the first five years of the existence of our new currency, the average rate of inflation in the euro area has been precisely 2% which is in line with the ECB's definition of price stability. Even though inflation has occasionally risen above the 2% ceiling – as has been the case in recent months – this was a consequence of a number of shocks of various types, the most recent being the oil price shock. As the ECB's monetary policy strategy has a clear medium-term orientation, our response to supply shocks and euro area-specific shocks has been measured. What should be emphasised, however, is that in these first years of the euro's existence, inflation expectations have remained firmly anchored to a rate close to, or less than, 2%, as can be inferred from the yields of index-linked long-term bonds. Clearly, the markets and the public have confidence in the euro and in the ability and determination of the ECB to maintain price stability.

Today, this record sounds like a simple statement of fact. But for a central banker, it represents a great accomplishment and an indispensable asset for monetary policy-making – credibility. It is often said that credibility is easy to lose and nearly impossible to regain. The ECB, as a new central bank without a track record, had to gain it in the first place. Back in 1999, many observers expected that the quality of the new currency, in terms of the stability of its purchasing power or the associated prevailing level of market interest rates, particularly at the long end of the yield curve, would be something like the average quality of its legacy currencies. What we have witnessed instead is convergence towards the best performer. The euro area today is a zone of monetary stability, and interest rates are at levels last seen more than five decades ago. All of this provides very favourable conditions for economic growth. That these conditions have, unfortunately, not proved sufficient to support a high rate of sustainable growth is due to the constraining influence of other, non-monetary, factors.

Another factor underpinning the confidence of the European public in their new currency is the quality and integrity of euro banknotes and coins as well as the smoothness with which they were introduced. The “cash changeover”, by now almost three years ago, was a very complex operation involving an unprecedented logistical effort. Some 15 billion euro banknotes and 50 billion coins were prepared, produced and distributed, so that on 1 January 2002, over 300 million European citizens could hold the euro in their hands. Thanks to the thorough preparation by central banks, financial institutions and the private sector, the launch went very smoothly; the chaos predicted by some commentators never materialised. And European citizens welcomed the new currency with an unexpected enthusiasm.

All in all, I would say, the euro deserves straight “As” in fundamental areas, and more notably, as a stable and trusted currency. However, I do not wish to deny and conceal that there have been also some areas where things could have been done better, or where improvements can – and should – be made.

For example, we have to acknowledge that the cash changeover did have some undesirable effects on prices, in connection with their conversion from national denominations into euro. The irritation caused by some disproportionate price increases, especially in parts of the service industry, in a number of euro area countries, gained a lot of unfavourable publicity. Even though our statistics show that the cash changeover had a rather small one-off impact on inflation of around 0.1% to 0.3% on average across the euro area, people had the impression that inflation was much higher than the recorded change in the consumer price level. This gap between “perceived” inflation and actual inflation has gradually got smaller, though at a puzzlingly slow pace.

We should not forget either that the introduction of the single European currency represented a fundamental regime shift which clearly required certain adjustments in the way monetary policy-makers communicate with markets and the public. In 1999, the ECB was a new, unknown central bank; it had no history of decision-making. Its two-pillar monetary policy strategy was a novelty in the world of central banking; its economic environment was, and is, a heterogeneous, multi-country economy, and its political setting unlike anything we know from the nation-state. It is therefore hardly surprising that communicating the ECB’s monetary policy has been a real challenge which has meant for all of us – the Eurosystem at the sending end, and the markets and the public at the receiving end – a process of learning and adapting. It also took some time for the markets to fully understand our monetary policy strategy, that is, the conceptual framework on the basis of which the Governing Council assesses the economic outlook and the risks to price stability, takes decisions about the appropriate monetary policy stance, and explains these decisions to the markets and the public. By now, the understanding of our strategy has greatly improved, and the recent evaluation and clarification of the strategy has certainly helped to this end. The ECB today ranks as one of the most open, transparent and predictable central banks in the world, and we continually seek to improve our communication.

Overall, a lot has been achieved on this front, but improvements can still be made in other areas. For instance, much more progress remains to be made in respect of the integration of European financial markets. As economic theory would predict, the single currency has eliminated exchange rate risk and lowered transaction costs. This has indeed significantly reduced borrowing costs in the euro area. Deeper, broader and more liquid continent-wide financial markets have emerged, which have reduced liquidity risk premia, improved access to external finance and cut financing costs. Thanks to the credibility of the ECB's monetary policy, the euro area's low inflation environment has reduced inflation risk premia, and interest rates have remained lower and more stable across the maturity spectrum than would otherwise have been the case. All very positive indeed, I would say, but not quite "top of the class". If we take the deep, liquid and unified US financial markets as a benchmark, the euro area clearly still has some way to go, especially as regards the integration of equity markets, the establishment of common legal and regulatory frameworks, and the consolidation of the banking sector.

So, if we add it all up and look at the euro's scorecard after five years, I would say the result looks quite impressive. However, having extolled the successes of the euro "at home", I do not want to create the impression that Europeans have a particular penchant for navel-gazing and that Europe is "obsessed with its own internal dynamics." So now I will turn to the global impact of the euro, and notably its international role, a very fitting subject for this international symposium.

III. The international role of the euro

Back in 1998, before the launch of the euro, some policy-makers and economists predicted that the euro would quickly develop into an international currency. The new single currency zone would represent the world's largest trading area and an economy with a combined gross domestic product of some €7 trillion. And the euro's legacy currencies, notably the Deutsche Mark, had already established a certain international status. Some expected – or even hoped – that the international role of the euro would rival that of the US dollar. I should add that among central bankers, we always refused to frame the discussion in such terms.

Five years on, where do we stand? The international role of a currency is a complex phenomenon, so let me first look at the international *private* use of the euro, that is, its use by international borrowers, investors and traders. Afterwards, I will consider the international *official* use of the euro, that is, its use as an intervention, reserve and anchor currency. I will conclude with a few observations on the use of the euro as a parallel currency in some countries in Europe.

III.1. The international private use of the euro

The euro is today the second most widely used currency internationally, in capital markets, in foreign exchange market trading and in international trade. In international capital markets, our data for early 2004 show that the share of the euro in international debt securities gradually increased to around 31%, compared with a share of less than 20% for the legacy currencies prior to the launch of the euro. By comparison, the share of the US dollar has decreased slightly (from 47% in 1999 to 44% in 2004), and that of the Japanese yen has also declined (from 17% in 1999 to 9% in 2004).

What is particularly noteworthy is that the euro, both as an international financing and investment currency, has a strong regional focus. An analysis of the geographical breakdown of the outstanding stock of euro-denominated international debt securities shows that European countries near the euro area account for the largest share of issues of these securities. Moreover, the increase in the use of the euro as an investment and financing currency, relative to other currencies, has also been highest among residents of countries neighbouring the euro area. By contrast, borrowers in Asia, Latin America and the Middle East have continued to issue only a small fraction of their international bonds in euro.

Holdings of euro-denominated debt securities are very small in portfolios held in the United States. They are also small in Asia, but growing. It is in the countries neighbouring the euro area, such as the UK, Switzerland and non-euro area Nordic countries that such holdings are particularly high. The City of London is one of the main financial centres using the euro and corporations often use London-based specialised intermediaries to issue euro-denominated bonds outside the euro area.

A third feature of the role of the euro in international capital markets is that it is partly driven by the euro area residents themselves, as investors (both retail investors and banks) from the euro area have bought a significant share of euro-denominated bonds issued in international markets. This is especially the case in international debt markets. Likewise, a significant share of euro-denominated financial activity in the City of London originates from euro area-owned banks. These hold around 40% of euro-denominated assets of UK-resident banks.

Let us now take a closer look at the foreign exchange markets. The euro is today the second most actively traded currency in foreign exchange markets worldwide, accounting for 37% of foreign exchange transactions. This share has remained stable over the past couple of years. Globally, the euro has continued to be traded predominantly against the US dollar, as more than three-quarters of total worldwide foreign exchange activity involving the euro has been with the US dollar.

Finally, the euro is an important invoicing or settlement currency in international trade, which is a natural consequence of the euro area being the world’s biggest trading bloc. Our data show that in most euro area countries, the use of the euro seems to be more widespread for exports than for imports, and, in particular, for the exports of goods more than for the exports of services. Interestingly, we now have some indications that the euro is also being increasingly used in the international trade of EU countries that have not yet adopted the euro as their own national currency, even when trading with third countries. We derive this conclusion from data for most of the new Member States and the candidate countries, where, in the course of 2003, the share of the euro as an invoicing or settlement currency in international trade increased markedly, and more so than the growth in their trade with the euro area.

III.2. The international official use of the euro

What is the international *official* use of the euro, that is, its use by government authorities and central banks as an anchor, reserve and intervention currency? Before answering the question, I should emphasize that the functions of anchor, reserve and intervention currency are intricately intertwined. Under a floating exchange rate regime, foreign exchange market interventions are infrequent, as they are mainly conducted to calm disorderly market conditions. By contrast, countries operating any form of exchange rate peg and managed float intervene regularly so as to ensure that the respective exchange rate is consistent with the chosen regime. In conducting such interventions, they prefer to use the anchor currency which then also serves as their main reserve currency.

Today, roughly 50 countries use the euro as an anchor or reference currency in their exchange rate policies. While the composition of this group of countries has changed somewhat in recent years, the total number of countries has been stable. Indeed, the use of the euro in third countries' exchange rate regimes has a strong geographical and institutional underpinning, with many of these countries being close to the euro area, including most non-euro area EU member states, or having special institutional arrangements with the European Union, like the candidate countries, potential candidate countries and the countries of the CFA Franc Zone in West Africa. Overall, most of these countries are located in eastern and south-eastern Europe, in the Mediterranean and the Middle East and sub-Saharan Africa.

With regard to the use of the euro as a reserve currency, you are probably all aware that the relevant data are extremely difficult to obtain. What we do know is that from 1999 to 2003, global foreign exchange reserves rose by more than USD 1.3 trillion to about USD 3 trillion. By far the largest share of this increase is attributable to reserve accumulation in a few countries in Asia as well as in Japan, Russia and Mexico. These are countries which conduct an exchange rate policy which is either *de jure* or *de facto* oriented towards the US dollar. From this development, it could be inferred that most of the reserve accumulation probably pertained to the US dollar. Against this background, and bearing in mind that most countries near the euro area are small in economic and financial terms (compared with Asian and Latin American countries), it is no great surprise that the euro's share in global foreign exchange reserves is still rather small, although it has risen gradually from roughly 15% to almost 20%. Available evidence suggests that several central banks of the new EU Member States, candidate and potential candidate countries intervene in foreign exchange markets mainly by using the euro as intervention currency.

My final remark in this overview of the facts and figures relates to one specific international use of the euro: in certain countries neighbouring the euro area, the euro is used in *parallel* alongside the national currency, as a means of exchange, unit of account and store of value in people's everyday transactions. In the past, we could only estimate the amount and geographical dispersion of the euro's legacy currencies, notably the Deutsche Mark, in those countries. The cash changeover provided an excellent opportunity to bring out into the daylight the large amounts of Deutsche Mark that were stashed away under mattresses in these countries and that had to be exchanged into euro at the beginning of 2002. Net shipments of euro cash by euro area banks point to an outstanding stock of euro cash in non-euro area countries of at least €46 billion in mid-2004. In addition, euro-denominated deposits in a number of countries neighbouring the euro area increased substantially in the wake of the cash changeover, when households transformed a large part of their euro legacy-currency holdings into euro-denominated deposits in the respective banking systems.

This analysis of developments over the past five years leads us to the following three main conclusions: first, the international role of the euro has increased significantly, though rather gradually; second, it is based on a strong regional focus, notably on the regions near the euro area; and third, it was driven by substantial demand from euro area investors for euro-denominated bonds issued by non-euro area residents.

III.3. The outlook for the international role of the euro

This is where we stand after five years. What are the prospects for the international role of the euro? The internationalisation of a currency is a very gradual process, characterized by considerable inertia. For example, in foreign exchange markets, this inertia is caused by “dynamic economies of scale” and “network externalities”. These processes tend to transform an existing situation into a permanent one, as any shift from the use of one currency to another would require a significant shock. A further relevant example in this context is provided by the invoicing of commodities.

The internationalisation of the euro, like that of any other currency, is largely a market-driven process. Whether or not the euro is used outside the euro area for financing, investment or invoicing purposes is a matter of economic agents’ preferences. The Eurosystem’s policy is to neither support nor hinder the international use of the euro. This should not be interpreted as a policy of “benign neglect”, for the ECB can contribute to the euro’s internationalisation in various ways: first and foremost, by maintaining price stability in the euro area and safeguarding its internal purchasing power. And we are also promoting financial market integration in Europe and the development of deep, liquid and efficient markets that support the internationalisation of our currency.

Even though the international use of the euro has no specific implications and does not pose any challenges for monetary policy, the ECB, as the issuing central bank, closely analyses developments in this area. As I explained, despite the difficulty in obtaining the necessary data, the ECB continually monitors and analyses the role of the euro in international debt markets, foreign exchange markets, international trade and in third countries, taking account of both its official and private use. The results of this analysis are published regularly and are received with great interest, not only by scholars but also by the EU Finance Ministers and the European Parliament.

IV. Conclusion

Five years after its introduction, the euro is a solid, stable currency in which the markets and the public have confidence. And not just in Europe, but also globally – as the widespread international use of the euro clearly demonstrates. The euro is a success. When I said at the beginning that I felt privileged to be the first speaker and set the tone, this is what I had in mind. I know that subsequent speakers are likely to address issues which point to some major challenges facing the euro area economy, challenges that must be effectively tackled to improve its performance and growth potential. In confronting those challenges, the accomplishments of the euro in its first five years will undoubtedly prove to be great assets.

Thank you very much for your attention.

3. The Euro-Dollar Regime and the Role of the Yen: Their Impact on Asia

Toshihiko Fukui,
Governor of Bank of Japan

Thank you very much, Ambassador Zepter, and President Gyohten. I am delighted to be invited here today to speak before so many distinguished people.

1. The Euro as a Key Currency

Let me begin today by reiterating that the birth of the euro in 1999 was an epoch making event. It was an enormous task to say the least in the context of the international currency system. I remember the endless discussions leading up to January 1999, asking if the euro could or should be launched at all. There were even discussions on the potential breakup of the euro. The euro has come a long way since then, and I am here speaking about a "euro-dollar regime." Today, we can discuss the euro's potential to bring a sea change to the global financial architecture, without being criticized for fantasizing. I should congratulate my colleagues at the European Central Bank for this significant achievement.

The euro meets a number of criteria to function as a key currency alongside the dollar. First, the ECB has succeeded in building up confidence as the guardian of the euro, maintaining price stability. Second, the size of the euro area economy is equivalent to that of the United States. Third, there has emerged a deep and liquid capital market in euro-denominated financial instruments.

In the past five years, the importance of the euro has increased considerably. I will let some numbers speak for themselves. We can count more than 50 countries that link their currencies to the euro. More foreign exchange reserves are held in euro: between end-1999 and end-2003, the share of the euro increased from 14% to 20%. Furthermore, during the same period, the share of outstanding euro-denominated bonds has increased to 30% from 20% in cross-border issues.

How would this emergence of the euro impact the global economy?

Looking at a currency's function as the vehicle of international transactions, it would be most rational and economical if there were single global currency. There are obviously economies of scale and network externalities. On the other hand, from the perspective of a store of value, it would be desirable to diversify one's currency exposures.

Having said this, I would like to focus on the potential competition between currencies. The position as a key currency is not easily threatened. Inertia here plays a large role. In such a situation, the economy of the key currency is easily tempted to focus its economic policy on domestic considerations. In today's globalized economy, this could lead to undesirable ripple effects on the rest of the world, through the fluctuations of the external value of the key currency. If we have two competing currencies, and the role of the key currency is contestable, competition between them could lead to more attention to the external value of key currencies. This should have a positive effect on the stability of the global financial system.

2. The Role of the Yen and its Challenges

In this context, what kind of role can or should the yen perform?

I am a firm believer in the potential of the Japanese economy. Therefore, I believe that the yen can and should play a larger role in the global market. Looking back, Japanese prices have been stable for a long time. In addition, I can count a few more strengths: one of the largest pool of savings in the world; strategic location in Asia--the center of global growth; and state-of-the-art IT technology. These strengths must be funneled into the strengthening of the whole Japanese economy through appropriate economic policies. This, in turn, would assure the place of the yen in the global economy.

What are such policies? The answer boils down to two factors: one is to support the private sector to realize a vibrant economy and the other is to build efficient and liquid financial markets. In other words, policies must support structural reforms. Reforms not only in the private sector but also in the public sector are important. From the central bank's point of view, it is our responsibility to contribute to the sustainable growth of the economy through the maintenance of price stability. We must also enhance credibility through transparent formulation of policies. The central bank also has a role to play in invigorating financial markets. We are redoubling our efforts as a key player in the market and as a provider of market infrastructure.

Considering the deepening economic relations between Japan and the rest of Asia, Asia should benefit if the use of the yen could be facilitated. The yen could become a viable alternative in both fund management and fund raising. Asia's strong demand for capital and Japan's vast pool of savings could be a win-win combination.

3. Asia's Single Currency--a Dream or a Vision?

If the yen could play a larger role in the global economy, does it mean that Asia would become a "yen economic area?" More generally, could there emerge a currency that becomes an anchor in the region? Furthermore, could we see a common currency area in Asia?

For the near future, you would agree that this is quite unlikely. Economic structures of Asian economies are not only diverse but also ever-changing. Against this background, foreign exchange regimes vary greatly.

Without a convergence of economic conditions, it would be most inappropriate to lose flexibility through the adoption of an artificial framework, be it a currency peg or a single currency. Such an adventure could lead to an accumulation of imbalances within the system. Looking back on Japan's experience, such imbalances would always be corrected with a vengeance. This is a lesson that we should never forget.

Even if we concur that currency integration in Asia is probably a dream in the short term, could it be a vision in the medium to long term? In Europe, it took about 50 years before the euro was introduced. My Chinese friends often tell me that 50 years is just a blink of the eye in their four-thousand-year history. Nevertheless, in this rapidly changing global economy, Asia could have a single currency 50 years from now.

If this vision is to be realized, economies of the region must pass a few tests. First, we need to see further deepening of Asian countries' mutual dependence through division of labor. In this process, Asia would become more important in the global economy.

Second, we need the development of vibrant financial markets, capital markets in particular, in yen and other Asian currencies. In this context, liberalization of cross-border capital flows within the region is a key element.

Last but not least, we need to build both domestic and global confidence towards economic policies of Asian economies.

Already, I see encouraging developments in this direction. With regard to the first point, we are seeing a significant strengthening of economic linkages between Asian economies through trade and direct investment. For example, Asia's share in Japan's trade increased to around 45% in 2003 from around 30% in the first half of the 1990's. For the second point, cooperative efforts to develop regional financial markets are beginning to bear fruits. An example is the Asian Bond Fund II project, being developed by the 11 central banks of EMEAP economies, where EMEAP central banks will jointly invest in local currency denominated funds. As regards the third point, central banks in the region are now firmly focused on price stability and there is considerable progress in financial system reforms in each economy.

These encouraging signals are, if anything, rather endogenous and market driven in their nature. Yet, if we are to seriously explore the possibility of a single Asian currency, strong political will is going to be essential at some stage.

This is because, if the Asian economies are to achieve convergence at a high level, rather painful reforms are indispensable. This is obvious if we look how difficult it is in Europe to comply with the Stability and Growth pact.

The introduction of a single currency by itself does not solve problems in each economy. Neither does it yield economic growth. The full potential of a common currency can only be realized in so far as respective economies tackle structural problems in the process of achieving a monetary union.

Asian economies would experience significant dislocations if they were to form a monetary union without disciplined economic policies. In this context, we are paying attention to see if Europe could succeed in advancing structural reform and achieve stronger growth by exploiting the heightened economic potential brought about by the introduction of the euro.

Before I finish, I would like to emphasize that Asian integration would probably be soft-structured. Each Asian economy should endeavor to increase the attractiveness of their economy and currency for the time being. Initially, this would mean additional flexibility. We can then share our experiences. At the same time, we should ensure that cultural diversities in the region would be translated into creative energy, and not clashes of culture. Only then would we realize stable regional currencies, and the dream of a single currency would become a vision.

Thank you very much for your attention.

4. Impact of the introduction of the euro on the economy —Future challenges, in particular coping with an ageing population

Klaus Regling
Director-General for Economic and Financial Affairs,
European Commission

Thank you very much, President Gyohten. It is a pleasure to participate in this conference. And it is an honour to take the floor after Governor Fukui and Vice-President Papademos. Since they have told you all you wanted to know about monetary developments, I will focus my contribution on two other issues: the economic consequences of our almost six years old Economic and Monetary Union and the future economic challenges. The two elements are quite closely related. In fact, the specific institutional set-up of the Economic and Monetary Union, or EMU, has implications for the conduct of economic policy, for the very functioning of our economies, and therefore, for the way we deal with current and future challenges.

Mr. Papademos told you about monetary policy. Ensuring price stability for the euro area as a whole is the responsibility of the ECB. By contrast, fiscal policy and structural policies remain under the responsibility of Member States, but they are subject to rules and coordination at the European level.

This specific setup has been chosen for several reasons:

- Firstly, with a single monetary policy and in the absence of the exchange rate as an adjustment mechanism, Member States need the possibility to react to economic shocks through a change in the fiscal policy stance.

- Secondly, excessive fiscal deficits should be avoided because they can have negative effects on the other members of the euro area. Therefore, common rules, such as the Stability and Growth Pact, and coordination, mainly through the so-called Broad Economic Policy Guidelines, ensure that the euro area as a whole does not have to bear the cost of one member's fiscal slippage.

- Thirdly, structural policies are also of common concern. They should therefore be coordinated, because increased flexibility of product and labour markets can compensate for the absence of the exchange rate as an adjustment tool and also because they can raise the potential growth rate.

Some analysts have questioned, from the outset, this assignment of policy responsibilities. In particular, some doubted the viability of a monetary union without a full political union. I will argue that they have been too pessimistic. Nevertheless, practice has shown that the coordination of national and common policies is a difficult task, and major challenges in that field remain.

Let me now summarize the economic developments in the early years of EMU

With its emphasis on price stability and sound public finances, EMU has provided the kind of stable macroeconomic policy environment that was lacking in many European countries. The run-up to the launch of the euro saw significant reductions in inflation from average rates above 4 per cent in the early 1990s, and more than 10 per cent in some countries, to 1.5 per cent in 1998. The state of public finances has also improved considerably (deficits fell from more than 5 % on average and close to 10 % of GDP in some countries, in the early 90s to less than 3% during the last few years).

In addition, there is clear evidence that EMU has boosted trade among its members. The abolition of exchange rate risk and the enhanced transparency that came from pricing goods and services in a single currency have clearly encouraged more cross-border activity. Moreover, the attractiveness of the euro area as a destination for foreign investment has increased significantly since euro area members have attracted an increasing share of total FDI inflows into the EU.

The euro-area's growth performance since 1999 has, on the other hand, been mixed. Economic activity was unexpectedly buoyant in 1999 and 2000, with real GDP growth peaking at 3.5 per cent in 2000 – the highest level for a decade.

But the cyclical upswing did not last long. The euro area was hit hard by the slowdown in the global economy that set in from 2001 onwards. The turnaround finally occurred in the summer of 2003, and a recovery is now under way. The Commission expects growth to be around 2.1% this year and 2% in 2005.

The recovery is still to a large extent driven by net exports. This dependency on an external motor entails risks: In 2002, the quick recovery of the euro area stalled as soon as world import demand weakened.

This is why it is important to make progress on the structural front so as to be able to rely on domestic demand. The functioning of labour and product markets has improved in Europe – more than is often recognized. The liberalisation of network industries such as telecommunication has resulted in price reductions that were sometimes dramatic. Our research (Annual Review 2002) suggests that competition policies and regulatory reform have contributed to a reduction of price mark-ups by companies, thereby benefiting the consumer and improving the efficiency of the economy.

But let me stress that the most positive development has been in the area of labour utilisation. 15 million new jobs have been created in the euro area since the mid-1990s. The employment rate increased from 60.3% in 1999 to 62.5% in 2003. Moreover, employment appears now to be more resilient to slowdowns. Previously, every downturn in Europe resulted in a ratcheting up of the unemployment rate. This did not happen during the latest slowdown. In my view, this shows that the reforms largely enacted before the start of EMU have led to a clear reduction in the level of structural unemployment in the euro area.

However, labour productivity remains a concern. Labour productivity growth has decelerated from 1.7 per cent in the first half of the 1990s to only 0.7 per cent in the past five years.

KEY POLICY CHALLENGES

Given economic developments in recent years, what are our main policy challenges?

I will first talk about fiscal policy where, in the light of the experience gained so far, some adjustments to the coordination framework might be called for. The economic consequences of demographic trends are the second challenge I will address. They make an even stronger case for a sound fiscal framework, but their implications concern the economy as a whole. I will therefore thirdly talk about the necessity of further structural reforms.

Fiscal policy

As you know, an impressive degree of fiscal consolidation was achieved in the run-up to the launch of the euro. Current budgetary trends also compare favourably with the past, when economic downturns were typically accompanied by a serious deterioration in budgetary positions.

It is true, however, that we have encountered serious problems in implementing the fiscal framework. In 2003, less than half of all euro area Member States complied with the key objective of the Stability and Growth Pact: a budgetary position that is "close to balance or in surplus". In addition, we have witnessed considerable deviations from planned consolidation paths, and at least three countries in the euro area will have deficits above 3% of GDP this year.

These problems are partly due to the weak economic conditions but also reflect to some extent a lack of political will to implement commonly agreed targets and frameworks. Given more than five years of experience and in anticipation of 10 new EU member states that will join EMU in the future, the Commission has developed some ideas for improving the fiscal framework. The gist of these proposals can be summarised as follows:

First, budgetary developments should be seen in relation to the business cycle, long-term sustainability and structural policies to enhance the growth potential. Our ageing societies require a stronger attention to longer-term fiscal sustainability.

Second, the medium-term budgetary objective of the Stability and Growth Pact should take into account country-specific circumstances and look at the overall sustainability of public finances, while ensuring that public deficits remain below 3% of GDP. In practice, some countries with high debt levels may have to aim for a permanent surplus, while others with low debt, and higher potential growth, could be allowed to run small deficits in cyclically normal times.

Third, there should be more focus on government debt and fiscal sustainability, but not at the expense of the deficit criterion. The 3% deficit ceiling will remain the anchor of the system.

Finally, ensuring that countries take early action to correct excessive deficits is crucial, which requires strengthened procedures for enforcing this correction of excessive deficits.

These proposals are now being discussed with our member states and we are aiming for reaching a consensus during the first half of next year.

Ageing

The key challenge we face over the next few decades is ageing. This is a challenge Europe shares with many Asian countries, including Japan. In coming decades, both the size and age structure of Europe's population will undergo dramatic changes due to the current low fertility rates [1.5 per woman, whereas the replacement rate is 2.1] and increasing life expectancy.

The working-age population (i.e. aged between 15 and 64) is projected to decline very significantly in the enlarged EU starting in 2010 from 309 million to 251 million in 2050, a drop of 50 million persons or 18%. The population of older persons aged 65 and above will double from some 60 million today to 121 in 2050. The ratio of persons of retirement age (65+) to those of working age (15-64), the so-called old-age dependency ratio, will dramatically change: it is projected to double from some 25 % today to over 50% in 2050. In other words, the EU would move from a situation today of having 4 working-age citizens for every elderly one to a ratio of 2 to 1.

Could inward migration somewhat offset this trend, thereby offering a solution? In principle, migration could partially compensate the effects of low fertility rates and increasing life expectancy. However, migration control remains high on the political agenda of many countries already at the current levels of foreign population – some 4½ per cent of the population in the EU and less that 1½ per cent in Japan is foreign. Unless policy and public opinion radically change in favour of much bigger inward migration, it is most unlikely that the overall trend towards an ageing population will be altered significantly through more migration.

Obviously, ageing populations have a significant impact on the whole economy. Changes in living standards over time are largely dictated by underlying productivity and employment rate developments. Over the past forty years, we have become accustomed to increasing levels of prosperity as a result of sustained increases in labour supply and high levels of productivity growth. However, population ageing means that these sources of growth cannot be taken for granted in the future.

Since the working-age population in Europe will start to shrink, productivity growth needs to increase in order to avoid a fall in the potential growth rate. Our analysis shows that, as a "pure" result of ageing populations, potential growth in the EU-15 would be reduced from the present rate of 2-2¼% to about 1¼% by 2040. The negative impact on economic growth could be even more severe in Japan, whereas in contrast, potential growth rates are projected to remain robust at about 2½% in the US.

Growth developments along these lines will have a profound impact on global output distribution. The EU-15 would see its share in world output fall from 18% today to 10% in 2050, and the share of Japan would halve from 8% to 4% over the same period. In contrast, the US is projected to continue to increase its share of global output to some 26% by 2050.

Demographic changes also entail significant budgetary risks. Around two thirds of public expenditures are directly affected by demographic changes. Our projections indicate that population ageing will lead to an increase in public spending of between 3 and 7 percentage points of GDP in most Member States in coming decades with increased spending on pensions, health care and long-term care.

There are also some additional implications in a monetary union, since an unsustainable public finance position of a few members could complicate the implementation of the single monetary policy and possibly result in higher interest rates. This is why the Commission has tabled, as I mentioned, a proposal to strengthen the SGP framework.

Structural reforms

The other major element of the EU reform strategy is structural. It aims at increasing productivity and the growth potential of our economies. The Lisbon European Council in 2000 diagnosed slow growth as the key long-term EU challenge. It decided on a strategy to inject dynamism into the economy and agreed ambitiously to raise the potential growth rate to 3% by 2010 through the implementation of structural reforms.

Some important progress has been achieved since then; not only in the area of employment, which I mentioned earlier, but also with product market reform and financial market integration. Regrettably, it turns out that the overall pace of implementation of reforms is yet insufficient. Taking the example of the labour market, most progress has been made in relatively easy areas from a political point of view, such as active labour market policies, education and training measures and reductions in the tax burden on labour. Reform in politically more tricky areas has only just started.

As regards product market reforms, the integration process has raised the level of competition in European product markets. A key point of the current policy agenda is now to stimulate productivity growth. In this context, spending on Research and Development represents less than 2% of GDP in the EU compared to a bit more than 3% in Japan. The increase over the past years has been small, making it unlikely, at the current pace, that the 3% of GDP objective will be reached.

Structural reforms tend to be mutually reinforcing. It is therefore crucial to implement reforms in all areas and in all Member States of the EU. This is the main priority of the incoming Commission.

CONCLUSIONS

Still, I would imagine that the performance of EMU so far has impressed its sceptics, of which there were many, especially in the economics profession. The single currency has reinforced macroeconomic stability and increased the integration of product, labour and financial markets in Europe.

But further progress is now needed in many areas. The fiscal framework needs to be strengthened. Population ageing requires both sounder fiscal policies and the bold implementation of structural reforms. We need to increase the growth potential of our economies by being more productive. By addressing those issues, I am confident that we will manage to meet the challenges with success.

Thank you for your attention.

5. Financial integration in EU25—Lessons learnt and prospects for the future

Alexander Schaub
Director-General for Internal Market,
European Commission

President Gyohten, Ladies and gentlemen: I am very happy to be able to discuss with you today our achievements and our future goals in integrating the financial markets in Europe.

The introduction of the Euro more than five years ago was a decisive step on the way to an integrated European financial market. On the one hand, it became very clear that, even with a single currency, there were still too many regulatory obstacles that stood in the way of more cross-border activity. On the other hand, the introduction of a single currency for 12 Member States of the EU created just the necessary momentum on our way to more financial integration, not only for those 12 Member States but for the EU as a whole.

The rationale for financial integration

Financial integration is a key element of the EU's efforts to boost long-term growth and competitiveness in Europe. Indeed, a vibrant and growing economy needs to be supported by a sound and efficient financial marketplace. The Euro has established itself as a robust currency, recognized and trusted all around the world. But the currency alone is not sufficient. It is crucial that businesses have an easy and cheap access to finance. Investors must be able to channel their money towards the most profitable opportunities. Consumers should enjoy, in their daily life, innovative products and services at lower prices.

For these reasons, the integration of financial markets lies at the very heart of the so called "Lisbon Strategy". This ambitious 10-year roadmap launched in 2000 by Heads of State and Government aims at boosting the competitiveness of the EU economy, in order to increase significantly the EU growth potential and employment. The mid-term review of the Lisbon Strategy, led by the former Dutch Prime Minister Wim Kok, has underlined the even more urgent necessity of completing the Lisbon roadmap today. Indeed, the growth gap with North America and the most dynamic parts of Asia has widened, while Europe must meet the combined challenges of low population growth and ageing.

The new President of the European Commission, Mr Barroso, renewed the commitment of the Commission to boost the EU economy. He has made it very clear that the focus will be on growth, competitiveness and new jobs. Dynamic and highly competitive financial markets are not only desirable in themselves. They are an essential driver of growth in all other sectors of the economy and must be a cornerstone of efforts to boost the EU's economic performance. Therefore the vision that has guided our efforts in the financial field in the past is and will remain valid also for the Barroso Commission: deep, liquid and integrated markets are a goal worth striving for.

In short, Europe cannot achieve its economic agenda without modern, competitive and integrated financial markets.

Lessons learnt from the past 5 years

For the last five years, we have been working very hard to get closer to that goal. And, although some disappointment has been voiced on the overall delivery of the Lisbon strategy so far, there is a shared consensus that a lot has been achieved in the area of financial services. How have we done that?

In 1999 we started the Financial Services Action Plan, an ambitious legislative programme to bring the financial markets in Europe closer together. It has now been almost completed. We have been working closely together with the member states of the EU, with the European Parliament and with industry. Together we have been able to agree on wide range of issues. Let me give you a few examples:

- We have established a harmonised financial disclosure regime for issuers of listed securities, based on common accounting standards from January 2005;
- We have built a regulatory framework for the trading of financial instruments and defined rules on policing market abuse;
- We have set rules for the supervision of financial conglomerates.

Of course many of the measures still have to be transposed into the national law of the member states and still have to take effect. But already Europe has moved considerably closer to our vision of an integrated financial market. A European reflex has developed among investors and businesses.

Not only the legislative framework has profoundly evolved, but it now encompasses 10 new Member States. The enlargement that took place on 1 May 2004 was the most impressive one in the EU history. Our internal market now serves 450 million consumers and represents a GDP equivalent to that of the United States. Thanks to intensive preparation based on the full implementation of the 'acquis', the integration process went smoothly. And the EU financial sector is now ready to exploit the huge potential for future growth those new markets represent.

We are looking closely at the markets and how they develop. What we see is that in the wholesale sector there have been remarkable moves towards integration – integration that is leading to bigger markets, that is creating economies of scale and that is bringing down prices. The contribution of the Euro is indisputable. This is particularly true for the money market where the removal of foreign exchange risk has boosted liquidity and has thereby considerably reduced the cost of financing for credit institutions and corporate borrowers. It is also true for the bond and stock markets, but to a lesser extent. In these markets, infrastructures and legislation need some time to evolve, but significant progress has been made towards integration over the past 5 years. There have been a number of mergers and takeovers between European stock exchanges. In all exchanges, the share of EU participation is on the rise.

At the same time integration in the retail sector is lagging behind. It is difficult and it does take a long time to bring together 25 economies with 25 different legal systems and 25 different sets of consumer protection rules. Markets addressing the individual customer, such as bank lending and life insurance markets, have kept their local character. This is one of the fields where there is still need for targeted legislative action to address the shortcomings. For instance, the introduction of a single currency alone has not been sufficient to create a single payment area for all European citizens and businesses. For the end-consumer, it is incomprehensible that even with a single currency, cross-border payments or credit transfers are not as simple and as cheap as domestic operations. To end this situation, the Commission adopted in 2001 a regulation to align the prices of domestic and cross-border operations within the EU. As some difficulties remain, we are going to introduce a new legal framework for payments that will create a real single payment area, coherent with the existing single currency area.

The basis of the swift progress which we have made over the last five has been a fundamental change to the way how we prepare new rules and regulations. Transparent, open and evidence-based policy making together with thorough and wide consultation has become a crucial part of the preparatory phase of Commission proposals. Even more importantly, to keep up with the dynamic development in the financial markets, we have redesigned our way of producing legislation. In this so called “Lamfalussy Architecture”, the legislation lays down the core principles and objectives to be achieved. In a second stage, more detailed and technical implementing measures are adopted, on the basis of advice given by committees of national supervisors in the fields of securities, banking and insurance. Additionally, the committee structure provides a framework for increased cooperation between supervisors, and should ensure further supervisory convergence among Member States.

Prospects for the Future

Where do we go from here? There are three main challenges we face:
(1) implementation in all 25 member states, (2) consolidation of the internal market for financial services and (3) global cooperation. Let me say a few words on each of them.

(1) One of the immediate and overarching priorities is the effective implementation and enforcement of all agreed measures and rules in all Member States. As I have pointed out to you already, the measures that have been passed at a European level have not all become law in our member states. Even if they have been transposed into national law already, that does not necessarily mean they have been fully implemented yet. For the next few years, the Commission will look closely at what is going on at Member States’ level and, if necessary, take action to ensure a level playing field in the whole of the EU.

(2) The second priority is to consolidate the internal market for financial services. A number of initiatives have been taken by the Commission, and we should complete them on time. Let me mention the implementation of the new Basel Accord through a new Capital Adequacy Directive. We also launched the Solvency II project, which aims at establishing a more risk-based insurance solvency system. In the area of market infrastructures and corporate governance, the ongoing work will continue. More broadly, we need to keep a legislative framework in line with market developments. We cannot just simply rule out the possibility of other corporate scandals that would need a swift and adequate reaction, as we did when Parmalat or Ahold occurred.

(3) At the same time it is no longer enough for regulators to confine their attention to their home-country or continent. The financial industry organises itself more and more on a global scale. Spill-overs become more frequent and tend to have a much stronger effect. Therefore regulators and supervisors need to work together more closely. We cannot afford to be complacent and wait for problems to arise, but have to detect and solve them “upstream”. For this reason, the Commission has started regular dialogues with the US and Japan, and has intensified contacts with China. Accounting standards and auditing standards are just two of the issues that we discuss at the moment. There are real gains to be made from more convergence

and the mutual recognition of standards in these fields: markets become more open, costs for business decrease and prices go down.

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Europe has made decisive steps from fragmented national markets to a Single Financial Market. One of the most important of these steps was of course the introduction of the Euro. The final success will now largely depend on the capability of all institutions, authorities and market participants to consolidate the legislative framework and work towards removing any residual barriers during the next five years.

We have been successful in establishing a single currency for 12 of our Member States, and the Euro area will expand to new Member States. If we have achieved such an ambitious goal, there is no reason we should not succeed in establishing a single and truly integrated financial market for all the countries of the EU.

Thank you for your attention.

6. NEC's Business Strategies in Europe and Expectations for the Euro

Hajime Sasaki
Chairman of the Board, NEC Corporation

Thank you very much for the introduction. I am Sasaki from NEC. I would like to thank President Gyohten for inviting me and would like to pay respect to him for organizing this distinguished symposium. It is a great honor for me to be here participating in this symposium with distinguished panelists.

Today, I am going to talk about three points. First is the impact of EU enlargement as of May 2004, secondly, the history and the present status of NEC's business in Europe and thirdly, our expectations for the euro.

First point is the impact of EU enlargement. We, Japanese companies will welcome the enlargement of EU to 25 countries including new 10 members in Central and Eastern Europe, because we can enjoy benefits for our business activities through the expansion of single market as EU, which will result in the expansion of prospective market. At the same time, the customs clearance will become simplified, logistics systems will become more efficient. We can also enjoy the harmonization of standards and regulations which will make our business activities being preceded more easily. On the other hand, there are some concerns such as the wage increase in new member countries and drain of highly qualified personnel to the Western Europe. In the Central and Eastern European countries, there have been preferential treatments of investment in order to attract foreign investment aggressively. Since they are not in line with the EU standards, some of those preferential treatments might be eliminated or reduced. Furthermore, tariffs might be increased for some products such as video equipment because of the adapt ion of common custom duties in EU.

Now, I would like to explain the history of our European operations. In 1963, we established the first European liaison office in Brussels and in 1973, we set up sales companies in London and Dusseldorf when European Community consisted of 9 member countries. In 1993, the EU came to the presence and we established NEC Europe as European holding company to supervise marketing, sales and logistics on a pan-European basis. With the enlargement of EU to the Eastern Europe, we reorganized liaison offices in Warsaw and Budapest under the control of NEC Europe. Thus, we have improved our business structures over the last 40 years in line with each milestone of EU enlargement.

Our strategic business areas in Europe can be divided into three segments. Those are mobile solutions, IT solutions and semiconductor solutions. In mobile solutions, the major business is the third generation mobile network and "i-mode" platform and mobile terminals. In IT solution, we are providing security solutions using biometrics and also we are engaged in supercomputer business. In semiconductor solutions, we are focusing on four end-user sectors such as automotives, industrial, communications and consumers.

Let me briefly explain the outline of each of our business segments. In Europe, we are providing 3G mobile platform to 26 operators in 16 countries. This can be so called "3G-network" business.

We have entered into a strategic partnership with Siemens for 3G mobile network business in Europe. As a result, NEC-Siemens partnership accounts for 40 percent market share of the worldwide base station market.

“i-mode” was developed in Japan as a mobile internet service and we are providing platforms and handsets to these operators in Europe. Current subscriber of “i-mode” in Europe is estimated about 3 million.

Next is IT solutions. As for biometrics security, we have tied up with the German company called BDR (Bundesdruckerei). For the Athens Olympic Games, fingerprint ID-based enter-exit system was used at Deutsche House. Presently in Europe, e-Passport project is running embedding IC chip in the passport. Together with BDR we are participating in trials of this e-Passport in Germany, UK and Netherlands.

We have a long history of fingerprint identification system and we have deployed 118 systems to police offices in 22 countries worldwide. In Europe, we have already shipped our systems to several countries including UK, Spain, Netherlands, Sweden and Finland.

We are also quite active in supercomputer business in Europe. Europe actually accounts for 70 percent of our international business and when we look at customers by application, more than half of our supercomputers are used for weather observation. In our research laboratory in Bonn, Germany, we are developing application technologies of our supercomputers. The application technology of the world fastest Earth Simulator was actually developed in this research laboratory.

On November 9th, a supercomputer conference called “SC2004” was held in Pittsburgh, Pennsylvania. The report revealed “Blue Jean/L” prototype, which is under construction by IBM was ranked as the fastest among the top 500, new Columbia by NASA was ranked No. 2 and Japanese Earth Simulator was evaluated as No. 3. Indeed, the USA is intensively developing supercomputer projects standing on its dignity.

As for semiconductor solutions, our major customers are automotive manufacturers. As you can see from this slide, our semiconductor devices are used in every section of the automobile. These are the brief view of our business in Europe.

Now, I would like to explain our expectations for the euro. As I have explained earlier, the weight of European market is quite significant in our mobile terminal business. In financial year 2003, 15.5 million units were shipped, and among them 20 percent were to the European market. Currently, we are manufacturing mobile terminals mainly in China to maintain cost competitiveness. However, one third of export value to Europe is transacted in euro. Therefore, we expect a stability of the euro market.

By the introduction of single currency of euro, our exchange rate risk diminished, and we could centralize our currency hedge operations. As I explained in our history of business, we are doing business in various countries in Europe. Since 1988, we have been managing funds in Europe in an efficient manner. We started euro cash management in 1999 and 6 affiliated companies are efficiently managing cash and funds for us. In more concrete terms, there is a UK financial subsidiary called NEC Capital UK and this company collected surplus funds of affiliates and lend them to the affiliates who need funds. Thus, we can reduce the interest bearing debt and reduce the borrowing cost of NEC group companies in Europe.

I hope that the euro area will be expanded by the enlargement of EU to include more member countries and the euro will contribute further to the international currency regime as a key currency which reflects stable economic situation.

Lastly, I would like to share my expectations for deepening of the EU integration. EU is making a progress for further integration, but for taxation systems each country still has a different accounting formula. The plan to review this has already started and we expect the harmonization of corporate income tax in the area to be realized. I hope that the EU-wide consolidated taxation system will be in place, which will allow us to offset the loss and gains between parent companies and subsidiaries and branch offices. As a result, companies operating in Europe will be able to reduce their burden and they can develop more flexible business activities. There will be many challenges to achieve this goal. I sincerely expect a real deepening of EU integration to be achieved by overcoming those difficulties.

Thank you for you attention.

7. The Case for an Asian Currency?

Robert Mundell
Professor of Economics, Columbia University

It's a great pleasure for me to be here and to participate in this interesting forum, "The Euro: five years on: Implications for Asia." I am going to focus on the case for an Asian currency, linking it to the lessons from the experience with the euro. I have put a question mark at the end of the title because I believe that whether or not there is a good case for an Asian currency is conditional on the elimination of some political uncertainties.

I will divide my presentation into three parts: first, the lessons from the euro; second, the issue of China and the RMB exchange rate; and third, the case for an Asian currency.

I. Lessons from the Euro

I have just listened to excellent presentations from very experienced experts on the subject of the euro. But I want to touch on this history myself in order to put the lessons from the euro as I see them in perspective.

I will start with the Hague Summit, in December 1969, which made European Monetary Integration a goal of the Economic Community. The Hague Summit was followed by the Werner Report, presented in October 1970, which set the goal of monetary union in 1980. But there was then a long delay. The European Monetary System (EMS) was established in 1978, and the Exchange Rate Mechanism (ERM) a year later. It took another decade for the Delors Report, which came in the spring of 1989 just as the Cold War was ending. Then comparatively quickly in succession came the Treaty of Maastricht in December 1991, the European Monetary Institute in 1995, the European Central Bank in the middle of 1998 and then the euro in 1999. In the middle of 2002 the euro had replaced eleven national currencies. The euro is now well established as the second most important currency in the world.

The question I want to ask is: Why did the process of monetary integration take so long? In 1970 the goal of monetary union by 1980 was established. But it took another two decades! Does it mean that monetary integration has to be a long process?

I have a little anecdote about this. In the same month as the Hague Summit, I presented a paper to the American Management Association in New York entitled, "The Case for a European Currency." In this speech I made a plan for the European currency (which I called "europa"). A report of my speech was circulated by the Chase-Manhattan Bank in their newsletter, as a result of which I received a request for the paper from Frédéeric Boyer de la Giroday of the European Commission. Boyer later arranged for me to come to Brussels in June 1970 as a consultant to the Commission. In this way I had an input into the material that went into the Werner Report and the early plans for monetary integration in Europe.

In June 1970 I spent a week with the Commission in Brussels analyzing alternative routes to a European currency. As I was leaving, one of the officials (I think it was Raymond Barre) asked me a question: "Tell me, Professor Mundell, how long do you think it would take to put into effect one of these plans that you propose for a European currency?” I replied: “Well, assuming that there were no political difficulties, even then it’s technically a complicated thing. It would take at least three weeks!”

But of course it did not take three weeks, or three months, or even three years, but three decades! Why so long? Well, it was because in 1969 and 1970 there already was a fixed exchange rate international monetary system. The major currencies were all fixed to the US dollar, which was still (theoretically at least) convertible into gold. As a result of this system, convergence of the economies had already come about. The countries in Europe had more or less the same interest rates and the same inflation rates. Moreover, because of the discipline of fixed exchange rates, countries had close to balanced budgets. Under these circumstances, if the European leaders had got together and told the experts: “we want this European currency; make it happen in three weeks” the experts could have done it, and the euro would have come into being three decades earlier than it did.

<u>A first lesson</u> from European experience is that monetary union is easier if there is a large and stable external anchor.

After the breakdown of the gold exchange standard in 1971, and the breakdown of its short-lived Smithsonian successor, the easy route to a common European currency disappeared. Attempts to form a joint float against the dollar had failed in 1971 and 1973 largely because national jealousies prohibited one of the national currencies—the candidates were the pound, the mark and the franc—from assuming the role (and leadership position) as pivot currency. <u>A second lesson</u> from the European experience is that in the lead-up to monetary union, it is very convenient to choose one of the large national currencies as the lead currency, the pivot around which the others can revolve.

The 1970s were years of monetary disintegration compared to that which had existed under the dollar. But dollar weakness in the late 1970s provoked Europe back into action, with the creation of the European Monetary System in 1978 and the activation of the Exchange Rate Mechanism in 1979. But it was still a very slow road to integration, compared to that which would have been possible in 1969 or 1970.Generally speaking, over the four decades of flirtation with monetary union in Europe, the desire for monetary union has moved inversely with the strength of the dollar.

The EMS involved a great learning process that helped the project through sluggish periods and gave the participating countries a forum for settling differences. <u>A third lesson</u> from European experience is therefore that it is important to form an institution which can evolve and mature as political consensus grows.

When the ERM was formed it was designed as symmetrical system with no currency in a special position. The weight of Germany in the foreign exchange market made it hard to avoid the evolution of the ERM into a DM zone. Political opinion in France, however, was not willing to accept this. Only after a confrontation in the 1980s did President Mitterand acknowledge the leadership role of Germany. The problem arose again during the ERM crisis in 1992. Some countries wanted Germany to appreciate its currency. But, because of the anchor position of the DM, the other countries had to make the adjustment even though the asymmetric shock had occurred in Germany. <u>A fourth lesson</u> is that the decision-making power in the union cannot be shared equally by countries of different size but must rather reflect the realities of the economic power structure. Moreover, it is better to multilateralize bi-polar issues between the largest powers.

The ECB has done remarkably well for a new central bank. It has achieved a high degree of price stability keeping to the rules laid down in its constitutional commitment. There are, however, some weaknesses that hint at difficulties in the future. One is that enlargement to twenty-five countries will aggravate the decision-making process within the European System of Central Banks (ESCB). A second relates to the immaturity of the short-term capital market in Europe and the need for a short-term Treasury Bill that is a collective liability of the EMU countries. A third relates to the ECB's lexicographic focus on inflation targets while allowing huge and debilitating swings in the dollar-euro exchange rate; these huge gyrations in the euro have very different effects on different countries and different pass-through ratios. A fourth issues concerns the lack of coordination of fiscal policy and the difficulty Europe has of mounting a common front against the global slowdown.

Europe has been the victim, so to speak, of the wrong end of the dollar cycle. The dollar becomes strong during booms and weak during recessions, complementing stabilization policy in the U.S. But in Europe, whenever the cycles in the two areas coincide, the exchange rate moves in the wrong direction for stabilization policy in Europe. It is also important to bear in mind that exchange rate changes have asymmetric effects on different countries; this is one of the reasons why Britain, which is half a dollar and half a euro country, found it difficult to join the EMU. For this reason Europe would be better off with a monetary policy that reduces exchange rate fluctuations or even goes so far as to stabilize the euro with the dollar. <u>A fifth lesson</u> I would draw from this is that it is better for a prospective or actual monetary union to keep fluctuations against major currencies to a minimum.

II. China's Exchange Rate

Let me turn now to the second issue, China and its currency, the RMB. Modern China is now in its fourth generation of leaders. The Deng Xiaopeng revolution gave China low effective tax rates in both agriculture and industry, and concentrated economic growth in Special Economic Zones and many other centers of promise. Its growth since 1978 has been legendary, at about 9 per cent for over twenty-five years. Export-led growth has been an important part of the story, with China's exports soaring from 0.6 per cent of world exports to 6 percent today. Foreign exchange reserves are now over $600 billion and soaring manufacturing capacity has earned China the epithet of "factory of the world."

We have to see China's position today in relation to other areas of the world. Comparable GDPs are $12 trillion for the U.S., $8.5 trillion for the euro area, $5 trillion for the yen area, $1.9 trillion for the U.K. and $1.5 trillion for China. China represents about 3-4 per cent of global GDP, but it is still a poor country with a per caput GDP of 1,000 dollars, 1/40th that of Japan, and 1/25 or 1/30th of Europe or the United States. China's growth rate is much higher than any of the G-7 countries, but per caput income is still far below even its East Asian neighbors.

There has been and continues to be pressure on China to appreciate or float its RMB. I do not need to go into the specious arguments that have been used in this connection, that China is exporting deflation, that China is manipulating its exchange rate, that China needs to appreciate or float to worsen its bilateral trade surplus. The case against China's exchange rate is sometimes lumped together into "Asian currencies," a euphemism for the currencies of China and Japan even though Japan's currency is overvalued on a purchasing power parity basis whereas China's is undervalued. These specious arguments need not detain us here now that the US elections are over.

Throughout 2003 the argument was made that China should appreciate for her own benefit, to avoid "overheating" and this argument was used repeatedly in 2004. "Overheating" is a concept that applies when full employment is reached and is completely inapplicable to China, which has underemployment exceeding 200 million workers. China's inflation rate has been close to zero since 1997: 2.8% in 1997; -0.8% in 1998; -1.4% in 1999; 0.3% in 2000; 0.5% in 2001; -0.8% in 2002; and 1.2% in 2003. This is a better record at price stability than any G-7 country! It is true that in the middle of 2004 the inflation rate rose but it has since come down, and for the year as a whole will probably amount to 3-4%. But this is an inevitable consequence of the low dollar, a small defect put against the huge benefit for China of a stable yuan-dollar exchange rate.

My own view is that the fixed exchange rate system works best for China and that China should continue to allow its real exchange rate to improve with rising wage rates and gradually move toward convertibility by reducing exchange controls and reforming its exchange market.

The agitation for China to float has an older history. During the Asian crisis, China's currency went to a sharp discount against the dollar in the open market, to about 9.4 yuan. The IMF was advising China to widen the exchange margins or let the yuan float downwards like the other Asian currencies. The problem for China was aggravated because, in anticipation of the depreciation, FDI from Japan dried up. But instead of devaluing or floating, the Chinese Prime Minister Zhu Rongji made an unambiguous announcement that China would maintain its exchange rate for the foreseeable future. Adverse speculation then turned completely around and China made a great contribution to the stability of Asia during this critical period.

The pressure on China to float today is just repeating the mistake the international authorities made in the Asian crisis. Speculative money has been pouring into China and it has been urged on by several of the big banks who have advised their clients to speculate on an early appreciation of the yuan. The IMF has added to the pressure to float, and that policy is recommended in the IMF Article IV Consultations Paper with China, which was released in August 2004. But no argument was made in the paper showing how China would be better off by floating except that it would make it easier to control the money supply. Of course that is true: under a fixed exchange rate system, the money supply is and should be endogenous.

By fixing its currency to the dollar, China's currency becomes stable in terms of a much wider basket of goods in the world than its own national basket. China's economy is about 3-4 per cent of the world economy. But by fixing to the dollar—assuming the dollar is stable—China's currency becomes stable in terms of the much wider dollar area basket of goods, which is as much as one-third of the world economy.

Would appreciation or floating by China solve the problem of the huge US deficits? I don't think any economist would make that argument. The US deficit is caused by more fundamental factors. The U.S. was a debtor nation and had deficits up until World War I; then it became a creditor nation and had large surpluses between 1918 and 1970; then a kind of uneasy balance until 1982; and since 1982 the U.S. has had large deficits and since 1989 it has been a debtor nation. The explanatory power of China in this sequence is virtually nil.

China's role in the US imbalance is still small. Its current account surplus in 2003 was $45 billion and it is closer to balance in 2004. Even if China completely eliminated its surplus, and even if this gain went completely to reduce the US deficit, the latter would improve by less than 10 per cent. But in the real world, it is more likely that any reduction in China's small surplus would simply shift to another country. If China doesn't have the surplus, some other country will.

Last year Korea and Japan shifted over some of their exports from going directly to the United States. They were sent to China for assembly and finishing, and then re-exported to the United States. Suddenly the export surpluses of Japan and Korea went down, while the export surpluses of China went up. This meant that the headline bilateral U.S. trade deficit with China went up enormously. A correct measure of the deficit would be a value-added concept that corrected for re-exports.

What effect would substantial appreciation of the RMB in China? It would delay convertibility, cut down FDI, lower economic growth, aggravate problems of non-performing loans in the banks, create deflation in rural China and destabilize trade with the Southeast Asia economies. Substantial appreciation would be a very risky policy for the new leaders in China. It might even be politically destabilizing. As far as the rest of the world is concerned, an appreciation would have no effect on the U.S. current account deficit, which is driven by the combination of foreign demand for attractive earning assets and dollar assets in the United States and the ability and willingness of a strong US economy to incur debt.

More work need to be done to further the understanding of the US deficit. I might note here that the U.S. current account deficit is very similar to the situation of the United States in the 1960s when the dollar was the pivot for the fixed exchange rate monetary system. In the 1960s there were perhaps 50 or 100 conferences on the subject of the US balance of payments deficits. But they couldn't be corrected because the deficits were part of the system, the way the rest of the world acquired reserves. The same elements hold today under flexible exchange rates. Contrary to what advocates of flexible exchange rates argued in the 1960s, flexible rates would not eliminate the need for reserves. Rather reserves soared since flexible exchange rates not just in absolute terms but as a proportion of total trade. Dollar assets are a prime export of the United States and are likely to continue to be until the dollar is replaced as the de facto international currency.

So, the American balance of payment deficits in the 1960's were functions not of any particularly bad or good American policy; they were functions of the global demand for dollar reserves in the rest of the world. The rest of the world determined by its demand for dollar reserves the deficit in the United States. The U.S. for its part had to be willing to supply those assets, and incur obligations in debt and the short-term treasury notes that central banks accumulated. The situation is not fundamentally different now, after thirty years of the dollar being the de facto global money in the system. Far from decreasing the demand for dollars, flexible exchange rates increased it because it flexible exchange rates made other currencies lesser substitutes for the dollar. Firms and institutions need to have dollar assets in their insurance portfolios and pension funds. There is huge demand for dollar assets, which has reached now around 5 per cent of the U.S. GDP or about 1.5 per cent of world GDP. The latter is a more relevant calculation because it is income in the rest of the world that drives foreign demand for dollars. You take a little growth model of the rest of the world, growing with the demand for dollar assets, then you get something approximating the dollar assets that are acquired by them that are the counterpart of the current account deficit of the United States. Appreciation of the RMB wouldn't help the

U.S.; it would be no benefit to Japan; it would cause damage to Southeast Asia; it would destabilize the world economy and cut off a new motor to its growth; and, finally, it would sour international relations between China and Asian and the United States.

Most recently, the pressure has shifted from appreciation to floating. Is floating better for China? The first point that needs to be made is that floating is not a policy. Floating is the removal of a policy of a fixed exchange rate. Fixed exchange rate is a policy that delivers to a country more or less the inflation rate of the anchor, plus or minus a factor based on productivity considerations and the Belassa-Samuelson effect. So, moving from a fixed exchange rate to a flexible exchange rate, taking the RMB off the dollar isn't a policy; it's a removal of the policy.

Floating is consistent with hyperinflation or deflation. If countries want monetary stability it is not enough to float. They have to shift from the monetary rule of fixed exchange rates to another monetary rule, such as inflation targeting or fixing the money supply growth rate. Once a country realizes that shifting to floating does not give it any extra degree of freedom—it merely replaces one target with another—it becomes apparent that policy is not made any easier. Or rather, it is made easier only if monetary stability is looked upon as a soft constraint. The European Central Bank does inflation targeting, but nobody could believe that they have any extra degree of freedom to use it to confront the global slowdown, decrease unemployment or speed Europe's recovery. The interest rate has been kept constant throughout because the slowdown because the leaders are afraid of the consequences of changing it.

If China did shift to floating, it would have to be floating plus domestic inflation-forecast targeting. This is the policy followed by the Bank of England, the European Central Bank, Canada, and to a lesser extent, the United States. Are these good examples to follow?

From China's standpoint, shifting from the fixing the dollar to inflation targeting would mean shifting from stabilizing the RMB from its basket of goods that represents 33 per cent of the world economy to stabilizing 3-4 per cent of the world economy, China's local basket. This is not a good deal for China. Even if China has to suffer mild swings in its inflation rate that arise as a result of the swings of the dollar against major currencies, it is still better to keep the RMB stable in terms of that larger basket of goods representing 33% of the world economy than it is to stabilize its local basket of 3 per cent.

Of course I could make the same argument for Japan, although the issue really hasn't come up in Japan. I myself think that Japan would be better with a fixed exchange rate. Under the fixed rates of the pre-1971 period, Japan's real exchange rate appreciated with rapid wage expansion and perhaps a somewhat higher inflation rate than was desirable. But with the adoption of floating rates in the 1970s Japan's inflation rate increased with several years of two-digit inflation. In the floating period, combined with the forced appreciation of the yen in the 1980s and 1990s Japan got stuck with an overvalued currency that has imposed deflation on it ever since, not to speak of the mismanagement of the policy mix that has led to the largest public debt in the world. All things considered, despite the defects of US monetary policy, I think that Japan would have been better with the fixed exchange rate all the way through the post-War period. Take the manipulated exchange rate out of the policy equation!

In the case of China, it may be that because of increasing efficiency and productivity changes, China's real exchange rate will have to appreciate. But is it better for China for its

RER to appreciate by appreciation or by rising wages and some prices of domestic goods? We can compare two areas facing a similar situation in the 1980s, Japan and Hong Kong. Even though those countries were very different in size they experienced rapid productivity growth in the traded goods industries and real appreciation was required. Japan appreciated the yen, and Hong Kong fixed the Hong Kong dollar to the US dollar with a currency board (gold-standard) adjustment mechanism (more or less Japan's policy between 1949 and 1971). At the time of the Plaza Accord, in 1985, the dollar was 239 yen. Ten years later in April 1995, it fell to a low point of 78 yen, a tripling of the value of the yen against the major world currency in ten years. What would economic theory say about a tripling of a currency against the mainstream of the world economy when the latter was not on an inflationary binge? Well, you get all the problems for the balance sheets of companies that infected the banking systems and created the non-performing loans and weakness that are only now getting worked out.

Was this appreciation desirable? One test was whether its effects were sustainable. In the 1970s (if I am not mistaken) there was not a single Japanese bank in the top ten of the world. Suddenly all the top ten banks of the world were Japanese, with the American banks way down the list. Common sense should make us suspicious that such a result is not sustainable—although I know there were serious speculator and writers who were arguing that Japan was going to take over as the # 1 superpower. But that position changed later in the 1990s and the American banks came back.

Now for Hong Kong. That region established a currency board system in 1983 and has kept it since through the tense period of the turnover to China. Over the first decade of its currency board Hong Kong had an inflation rate that was a little higher than that of the U.S. because of rapid productivity growth in the traded goods industries. But in the late 1990s this excess inflation turned into a mild deflation, because of revised opinions about property values as well as the appreciation of the dollar. Hong Kong's performance was not perfect but it was better than it would have been with fluctuating exchange rates.

There are for China serious defects of inflation targeting:

- China has had no experience with inflation-forecast targeting and there is not enough information available to calculate the lags in the effect of monetary policy.

- China's economy still has a large state sector and the fixed exchange rate allows companies and China as a whole to import the scarcity relationships existing in a country like the United States.

- Fluctuations in the exchange rate would create wasteful shifts between the domestic and international sector and impede rational investment calculations.

- Because of the large and growing disparity between the regions monetary policy decisions would become in China a political football. Tensions would arise between the interests of the rapid-growing coastal regions and the more sluggish interior.

- Fluctuation in the dollar-yuan rate would cause the RMB to lose its moneyness, and real estate prices would soon be dollarized, a situation that exists in every country Latin American country that has a fluctuating exchange rate.

- The RMB's fixed value with the dollar has been a kind of guarantee to saver and fluctuations in the rate would cause it to lose its attractiveness as an abode of saving in a country where there are few alternatives.

- Flexible exchange rates would decrease the level of trade not only with the United States but with Asia, where the economies have become increasingly vertically integrated.

- Flexible exchange rates would exacerbate destabilizing speculation and the swings in the rate would be aggravated by speculation of the big banks and the derivative-intensive hedge funds that would weaken China's ability to manage its own economy. Paradoxically, the fixed exchange rate enhances China's independence in pursuing its important goal of achieving monetary stability.

- Flexible exchange rates would undercut movements toward free trade among the ASEAN + Three countries.

- Flexible exchange rates would reduce China's power in the international monetary system.

Fixed exchange rate is good for foreign investment, and keeps the growth rate going. Floating would subject China to a lot of more pressure, more or less the way the kind of Japan bashing, subject it to China bashing of the kind that Japan experienced in the 1980's and the 1990's. As long as the dollar is reasonably stable in terms of the U.S. price level, China should maintain its current policy.

I believe also that China's fixed exchange rate is good for the international monetary system. The flexible exchange rate system has proved to be a mistake. The EU's rejection of it for at least twelve of its members suggests that many countries need to find economic security in a wider grouping. The proliferation of currency area grouping around the world, in Africa, Latin America and Asia makes it clear that the present system is unsatisfactory. At the present time we have three or four currency-area islands of stability that dominate the scene. Within these currency areas there is a high degree of stability of price levels but huge gyration of exchange rates. If you can get the same or higher degree of monetary stability judged by inflation rates, why do you need fluctuations in the exchange rates?

III. An Asian Currency Area?

Let us now turn to the issue of an Asian currency. A number of issues come up. What kind of institution would be required? Where would it be located? Who would determine monetary policy? What currency would be used as anchor?

I will start with the last question. As I think I made clear in my discussion of the lessons from Europe, it is important to have and agree on a common anchor. What anchor for Asia?

The first candidate—among Asian currencies—is the yen, Asia's most important currency. The yen is now the third most important currency in the world, a demotion from the position a few years ago when it was displaced from second position by the euro. Other things equal, it would be the natural choice as an anchor for the Asian currency. But the rest of Asia would be unlikely to accept the yen as its anchor unless it had a voice in Japan's monetary policy. The chronic tendency of the yen to appreciate against the dollar would represent a problem for most of the Asian countries.

China's yuan is the second most important currency in Asia. Its defect is that it is inconvertible on capital account. To be sure the fact that it is fixed to the US dollar and that the yuan is at a premium in the unofficial market goes far to offset this defect. I believe that even now the yuan is being used to some extent as a reserve currency in South East Asia. But until it becomes convertible it would not qualify alone as the anchor currency for Asia.

A third possibility is a basket of the Asian currencies. This was the approach taken in the lead up to European Monetary Union; the euro was born out of the ECU. It would be easy to make a basket of a fixed value of the Asian currencies. But I don't see what use that basket would be at the present time. I don't see why such a basket would be a useful anchor for any Asian country. As likely as not, it would not have much more use than the SDR.

The anchor currency does not have to be an Asian currency. Just as a European currency could have been created much more easily based on the dollar, so an Asian currency could get its start and plan for the convergence of its economies while anchored to the dollar. As the most important currency of the twentieth century and still today, it has history on its side and is a natural choice for Asia. Of course the usual questions have to be answered. Can the dollar be relied on to be stable? Does the existence of a dollar cycle rule it out? Does the US balance of payments deficit make the dollar a risky choice? My own view is that while the dollar is not perfect it is better than any of the alternatives.

The euro might be a possibility. It is the second most important currency in the world and its recent strength has resolved any early doubts about its viability. But is it too unstable against the dollar? Look. The euro started off at $1.18, fell within a year and a half to 82 cents, and then soared over $1.35, huge swings of in only six years. Even though the European Central Bank has been successful in stabilizing the European Price Index, it has been at the expense of enormous instability of exchange rates.

Another possibility is gold. Gold is the historic anchor, and its contribution to global monetary stability for the thousands of years before 1971 is legendary. Without gold, it is extremely unlikely that the Bretton Woods agreements could have been negotiated and gold is still the second most important reserve asset in the international monetary authorities. The problem, however, is that gold by itself would not be as good an anchor for the Asian countries unless either the dollar or the euro were fixed to it. Gold is a good hedge in reserves against inflation and could become more important again in a comprehensive international monetary reform. But it is not an option for Asia to use on its own.

A weighted average of a fixed basket of the international currencies is a possibility. The main advantage of a basket of currencies is that it reduces the reliance on a single currency that is unstable. The SDR is an example. It was not always a "basket" currency. It started off as a substitute for gold, equal to 1/35th of an ounce or .888671 grams of gold. But in 1974, the international monetary authorities removed the gold link and turned the SDR in to a basket of 16 currencies, later reduced to 5, and now, with the creation of the euro, to 4 currencies. The SDR now is composed of dollars, with a weight of 45%, euros, with a weight of 29%, yen, with a weight of 15% and pounds sterling with a weight of 11%. If Britain joined the euro area, the SDR would have three currencies, 45% dollars, 40% euros and 15% yen.

Despite some defects of the dollar, the SDR has defects of its own and may not be better for Asia than the dollar. Any basket of currencies has a lack of transparency, and countries that have used baskets have notoriously altered the weights in the basket, often without notification. There is a lack of transparency and it imparts an unacceptable element of uncertainty into the financial decisions of the market. Moreover, stability of the US price level (in the sense of a stable and low rate of inflation) would mean that fixing to the dollar would result in stability of the Asian currencies in terms of 25-30% of world output, whereas fixing to the euro would involve swings of the US basket of goods against the Asian currencies. All things, taken into account, the fix to the dollar is superior to the fix to a basket such as the SDR (or some comparable basket).

The formation of a currency area cannot be considered without reference to political issues and power centers. The power configuration of any potential currency area plays a determining role in its governance. This is especially the case when considering a single-currency monetary union. Think for a moment about a single North American currency area, including Canada, the United States and Mexico, three countries that have already made up NAFTA. On economic grounds there is much to be said for such a monetary union and it could possibly result in a better monetary policy for at least two and perhaps all three countries. But a single currency union could not realistically be different from the use of the dollar in Canada and Mexico. The US economy is about twelve times that of Canada and more than twenty times that of Mexico. If North America were homogeneous politically, the weight of Canada and Mexico in the decision-making process would be les than 15%. It would be as if the Canada and Mexico were brought into the Federal Reserve System as the thirteenth and fourteen Districts. Even if Canada and Mexico were willing to scrap their currencies, the U.S. would not be willing to give up the dollar, the most important currency of the lat hundred years. Nor is it clear why Canadians and Mexicans who have the great advantages of geographical propinquity to the world's superpower would want the United States to give up its dollar. Nor would turning the dollar into a North American currency be a good bargain for the rest of the world.

The main point is that the United States is a major power center and that the only conceivable arrangements for a monetary union in North America would be union that used the US dollar and a monetary policy that was determined by the United States.

What are the power centers in Asia? Of course Tokyo and Beijing are the most important political capitals. Tokyo is by far the largest capital market, but Seoul, Shanghai, Shenzhen and Hong Kong are also important in North Asia. The main problem for an Asian monetary area is to solve (or finesse) the problems between the two giants of East Asia, and the political issues associated with North Korea and Taiwan. An Asian monetary area cannot get very far unless the members of it are part of a common security area, i.e., a zone within which the possibility of war has been ruled out.

The need for an enhanced position of Asia in the world system is apparent. Asia has come of age. There would be a lot of benefits of close cooperation in the monetary area between Japan, China and Korea and with the ASEAN countries. The integration of their economies has been accelerating since the Asian crisis. The time is ripe for specific proposals that will foster monetary integration. Asia is now under-represented in the international monetary system and a movement toward an Asian monetary area would signal its interest in redressing the balance. Five countries or areas—Japan, China, Korea, Taiwan and Hong Kong—have over $2 trillion in foreign exchange reserves, two thirds of the world's total. The Asian countries will now have an influential role in determining, through their portfolio decisions, the dollar-euro exchange rate. There is probably now an invisible floor for the euro against the dollar that will last until the portfolios of the major monetary authorities have been adjusted to an equilibrium level. These Asian portfolios are now underweight in euros but cannot be adjusted quickly, without dire consequences for global monetary stability. Asia now has the power to exert a significance influence on the international monetary system and to have a voice in its reform.

A great advantage of monetary integration in Asia would be stable exchange rates among the Asian countries. This could only be achieved by finding a strong anchor and commitment of each country to maintain the exchange rate with a suitable monetary policy. The Asian countries need to protect themselves against a repetition of the Asian crisis. Japan's proposal for an Asian Monetary Area at the time of the IMF Meetings in Hong Kong in 1997 was an excellent idea that was, I believe, mistakenly shunted aside by the United States. The proposal for an Asian Monetary Area at that time could have blunted the crisis and averted the fiasco, which was one of the most mismanaged crises in monetary history. Nothing has been done at the international level to protect reform the system or protect against another major crisis.

The case for an Asian monetary area cannot be made independently of the global economic situation which includes current imbalances and sweeping trends in trade. The headline imbalance is the US current account deficit. The counterpart of this deficit is the surplus of the rest of the world. Most of the countries that have the surpluses want them and feel they need them. Most countries in surplus feel they need the dollar reserves and earning assets that the U.S. can supply and is willing to supply in abundance. Developing countries are usually praised for improvements in their trade balance yet that is part of the counterpart of the increasing deficit in the United States. The countries in the rest of the world would be horrified if these surpluses were taken away. If the \$600 billion surplus were suddenly denied, the rest of the world would go into a crisis.

The U.S. deficit is not completely under the control of the United States. The current account deficit is determined by demand from the rest of the world for dollar assets and the supply of these assets from the United States. One side of the equation is that the U.S. has a deficit because the rest of the world finances it! The other side is that the U.S. has a deficit because it is willing to supply the assets that other countries want to hold. The dollar rises and falls according to whether the demand for dollar assets is greater than the supply.

When the dollar is strong, the U.S. Treasury says, "Yeah, we like the strong dollar." And when it's weak, it says, "Well, it's good for competitiveness during a slowdown." That actually amounts to an exchange rate policy. A strong dollar is always fine because if there is slack in the economy and no inflation risk, monetary policy can be expansionary. More important, in the long period of almost a century of fixed rates before 1971, even though the balance of trade (surplus) has moved contracyclically, the balance of payments (surplus) has moved cyclically because of the strength of the demand for money during booms and weaknesses during recessions. The pattern has been preserved under flexible exchange rates, with the trade balance (surplus) moving contra-cyclically, and the dollar moving cyclically (1981-2 was an exception because of the switch in the policy mix under Reagan). The dollar under flexible rates has therefore been moving in a direction that conforms to the needs of US stabilization policy. That is a good result from the standpoint of those countries that use the dollar as an anchor even though it may not be for other countries.

I have said that a currency area is a power center. But Japan and China are both power centers. How would the choice of anchor, the guidelines for monetary policy, and the choice of headquarters be influenced by that fact? The first point is to realize is that the idea of a single currency in Asia is not realistic at the present time. A single currency can only come about among countries that have a high degree of political integration, much higher than exists in Asia at the present time. If a monetary union is to be considered, it cannot be a single-currency monetary union on the EMU model.

If there is to be a monetary union in Asia, it would have to be a multiple-currency monetary union. A prerequisite of a fixed-exchange rate monetary union is a fixed exchange rate zone (FERMU) in Asia. This would only work if both China and Japan, as well as the other countries, agreed to accept a common inflation rate and a procedure for determining what would determine that exchange rate. Over the past few years, both China and Japan have experienced mild deflation, but recently, under pressure from the depreciating dollar, China's mild deflation has turned into mild inflation.

A FERMU could include a common currency but not one that replaces national currencies. The member countries could centralize a portion of their gold and foreign exchange reserves and national currencies in an Asian Reserve Bank and receive deposits of "Asian dollars" in exchange. The monetary policy of a Reserve Bank in Asia would be effected by buying or selling earning assets of the member countries in exchange for deposits of Asian dollars.

Quotas, which determine the amounts of the initial allocations of Asian dollars, and which would be payable half in reserves and half in domestic currencies, could be allocated in a formula that took account of both GDP and trade. Japan's quota should initially be two or three times that of China.

Currencies would be convertible into Asian dollars and the value of Asian dollars into US dollars or euros would be determined by the monetary policy of the ARB. In the early years of the monetary union, it would be desirable for the Asian dollars to be identified with the US dollar, building on its recognition and reputation. This is the way most other currencies have become established including the SDR, which was initially based on gold, and the dollar itself, which had the advantage of being a "ghost of gold."

A currency stabilization agreement among Japan, China, Korea and the ASEAN countries—and I assume that Taiwan and Hong Kong would also be included—would only be possible, I think, if it were centered on the dollar. China, Hong Kong and Malaysia are already fixed to the dollar. The key question relates to Japan. If Japan could improve upon its macroeconomic policy by fixing to the dollar, the stage would be set for a platform on which to build an Asian dollar. My own view is that Japan's economy would be improved by a stabilization of the yen against the dollar and the yuan and the other ASEAN countries. If Some room could be left for exchange rate changes in the early working of the agreement along the lines of the IMF agreement in 1944, or, along the lines of the ERM mechanism as it developed in the 1980s.

If Japan could see its way clear to stabilize its currency against the dollar—or in the early stages put a band around yen-dollar exchange rate—there would develop a huge area representing half the world economy. With the dollar, yen and yuan linked together, wouldn't it be likely that the other countries in East Asia want to join. It would set in motion new thinking about the fixed exchange rate zone among the APEC. A idea of free trade area within APEC doesn't make much sense without stability of exchange rates.

Would Japan be able to handle a fixed yen-dollar exchange rate? In my opinion it would. The most successful period of Japan's economy was in the period when the yen was absolutely fixed to the dollar and that exchange rate provided the guidelines for monetary policy in the Bank of Japan. For well-know reasons usually associated with Belassa-Samuelson effects, this fixed exchange rate gave Japan a higher rate of inflation than the United States, but it was an arrangement that worked well for Japan. It is true that Japan would have a temporary adjustment problem. A credible fixed exchange rate between the yen and the dollar would remove the expectation that the yen will appreciate along the same pattern as the past. The result would be a more expansionary monetary policy than has been followed in recent years, a shift from a falling to a rising price level and a rise in interest rates to international (dollar) levels.

Some consideration must be given also to how the United States would react to a fixed exchange rate zone in Asia centered on the dollar and the creation of an Asian dollar. The United State might think it should have a veto on such an arrangement. But it is not clear that it would be in US interests to exercise such a veto. An Asian currency area tied to the dollar would not be inimical to US interests and would blend with US proposals for a free trade area in the APEC countries.

The present international monetary system should not be considered sacrosanct. Far from being a system that was carefully designed, the leaders of the 1970s stumbled into the present arrangements. To the extent that there were any architects of the new arrangements, credit or censure would lie with George Schultz, Giscard d'Estaing and Helmuth Schmidt. But if I am not mistaken at least two if not all three of the architects have admitted that the breakup of the system in 1973 was a mistake.

By contrast with the Bretton Woods agreement, which was designed by just two exceptional people, (Keynes and White), the Committee of Twenty assigned to reform the system in the 1972-74 period was a crowd of mediocrities. As described by Robert Solomon in his extraordinary book, *The International Monetary System 1945-1976*, the number of people in the room, when either the ministers or the deputies met in plenary session, was over 150…".It was in despair that the Committee of Twenty had to give up on the possibility of negotiating a meaningful reform.

The need for a viable international monetary system that would include a universal unit of account and an anchor for currencies is more obvious than ever. There was such a system thirty years ago based on gold and the dollar. There was one a century ago, based on gold. There was also one 2000 years ago—albeit mainly in the Mediterranean Area—in the reign of Caesar Augustus. The idea of a world currency is no longer an idea meant only for the Ivory Tower. The classical economists supported it in the form of a gold standard. Keynes and White proposed it in their plans for Bretton Woods. The IMF Board of Governors endorsed the idea in the form of a gold-guaranteed SDR. Today many economists would agree to the need for it, and so would one of the most distinguished central bankers in the world, Paul Volcker, who has said that we need to level the playing field for the rest of the world and argues that the global economy needs a global currency.

How long would that take? I'm inclined to say that it could evolve from the present system fairly easily. But of course I know very well the possibility that we may repeat the anecdote I related about my views on a European currency back in 1970. But I think an important clue can come from the needs of Asia. You all know how closely the Japanese and Chinese economies have become in recent years, and how useful it would be for business in both those countries to have a fixed exchange rate or even better a common currency. The only way you could get the Asian countries to make their economies converge would be to anchor it to a strong external economy, and that today still means the US dollar. The big question then would be whether Japan would be able to move toward stabilizing its currency in terms of the dollar and cooperating with China to form an Asian currency area. Then other countries could join the system and--who knows—maybe so would Europe. Suddenly, we would be back into a kind of global fixed exchange rate area. Of course there would be many details to work out, including the important one of control of the common inflation rate. So I am happy to conclude on an optimistic note. The worst is not always inevitable!

Thank You.

Data is provided for the “narrow” concept of international issuance of debt securities (i.e., bonds and notes, as well as money market instruments), which is defined as issuance in a currency different from the currency of the country in which the borrower resides.

Data from the BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, conducted in April 2004. Similar evidence can be derived from foreign exchange trades settled via the Continuous Linked Settlement (CLS) where in 2003 and 2004 the euro accounted for around 44% of all settlements, a slight decline compared to the 2002/2003 when the euro share stood at roughly 48%.

Bulgaria, Croatia, Romania, Turkey

Four had deficits above 3% of GDP and another three between 1 and 3%. Their cyclically adjusted balances showed deficit of 0.9 to 3.9%.

8. Panel Discussion and Questions & Answers

GYOHTEN As you see we are running a bit behind time. After talking with panelists I came to a conclusion that we have to devise something to make the best use of the remaining half an hour or so. I have collected from the floor several questions and comments addressed to each panelist. So, what I will do is to convey these questions and comments to each panelist first of all. After that I would give five minutes to each panelist. In that very limited time, each panelist can make the best use of that time, either to respond to the questions or to make some fresh remarks in response to other panelist's provocative comments. Now, I will explain some questions already generated on us.

To Governor Papademos:

- When can we expect the new EU member states to introduce the Euro?
- The bank credits to the private sector in the central and Eastern Europe's new EU member countries will be growing. How does the European Central Bank distinguish between good growth and bad growth? That is whether the growth comes from the catch-up process and financial deepening or so-called bubble to be triggered by crowding in process.

To Dr. Regling and Dr. Schaub:

- What influence would the introduction of Euro have on the structural reform in Europe?
- If Euro was a success, why those countries who are not members of the Euro are performing better than those of Euro area?
- If major member countries cannot comply with the Stability and Growth Pact, and if the Commission cannot enforce any penalty on those countries, don't you think that the content of the pact itself contain something wrong?

To Governor Fukui:

- Political integration and the free flow of goods and people have been achieved in Europe. But without those factors what is the benefit of establishing a single currency in Asian region? Shouldn't the liberalization or freedom of the capital flow be the precondition for establishing a single currency?
- Prof. Mundell suggested that yen might be fixed to the dollar. What is your comment on Dr. Mundell's suggestion?
- In the currency integration in Europe, France and Germany played key roles in the process. But in Asia, Japan and China – can we expect those two countries similarly play the major roles?
- The role of the yen in Asia has been increasing. If it is widely used in trade and financial markets, then the monetary policy in Japan has to take into account not only internal factors but also external conditions. If you raise the interest rate in yen, then it will have an impact on companies who borrow in yen. So, what is the reaction of the BOJ? How does BOJ cope with this issue?

To Chairman Sasaki of NEC:

- According to your presentation, the weight of exports to EU is quite high in NEC's mobile terminal business. But because of cost competitiveness, you are manufacturing those terminals mainly in China. In relation to this, if you will further enlarge to the east, isn't it better for you to directly produce in Euro area rather than import from China? In deciding this, do you pay attention to the quality of labor and legal system? What will happen if there are more countries who adopt Euro?
- In the world strategy of NEC, what is your position in EU and Asia and the division of labor between the two regions? Of course, I think it is different depending on the business

size and depending on the projects.

To Prof. Mundell:

- What is your view on the idea to include non-regional currencies such as dollar and Euro in the common basket currency which is now being studied among some Asian scholars and officials? Do you think inclusion of those non-regional currencies in the Asian common basket is a feasible, desirable, advisable step?
- Quite different from Europe, the divergence between countries in terms of income levels is so great in Asia. So, it seems that the conditions for optimum currency block are not fulfilled in Asia. That means it is too premature to consider the introduction of a common currency in Asia. What is your view on this?

Now, these are the questions and comments addressed to each of you. As I promised, I would like to start with President Papademos to use your five minutes in whatever way you like.

PAPADEMOS: I will first respond to the questions addressed to me and then I will make a few general points triggered by remarks of other panelists. Let me start by responding to the first question that was raised. When can we expect the new EU Member States to introduce the euro?

The general answer is, of course, that they can introduce the euro when they fulfill the convergence criteria that must be satisfied for adopting the common currency, and when they have completed the necessary technical preparations. It is clear that, for economic and more general reasons, the principle of equal treatment will be applied. Recently, the European Commission and the European Central Bank published convergence reports that assess the degree of convergence that has been achieved in the EU countries that have not yet joined the euro area. These reports confirm that the initial conditions, the degree of convergence that has been attained, differ significantly. Some of the new Member States fulfill some of the criteria, but none of these countries fulfill all the criteria. Consequently, there is no unique timing and unique path for the adoption of the euro. In order to be more specific, I should add that one of the convergence criteria that must be met is the exchange rate stability criterion, which requires the participation of the currency of the Member State concerned in the exchange rate mechanism (ERM II) for a period of at least two years. This requirement by itself imposes a minimum time period before euro adoption. Thus, we could not expect any of the new Member States to join the euro area before about two and a half (2 1/2) years from now, that is before early 2007. I cannot really be more specific. A number of the new of Member States have announced publicly their intentions for joining the euro area in the future. These intentions will be tested and their economic convergence will have to be assessed over time on the basis of the convergence criteria. In 2007 it may be possible for some countries to adopt the euro. Other new Member States are going to join later on, many of them probably before 2010.

The question about the rapidly increasing bank credit to the private sector, if I understood it correctly, concerns the factors explaining the fast credit expansion in some new Member States and its implications for “good growth and bad growth”. Let me make a few pertinent remarks.

In a monetary union it is natural to observe different growth rates among Member States which reflect differences in local economic conditions and structures as well as differences in national economic policies affecting both the demand and the supply sides of their economies. In a number of the new Member States, but also in some of the euro area countries, we are indeed observing rates of credit expansion that are very high. These fast rates of credit growth are mainly the consequence of the fact that most of these countries achieved convergence, or made significant progress towards convergence, relatively recently. They have therefore experienced a fairly sharp fall in interest rates over the past few years, which has contributed, together with other factors influencing the demand for and supply of bank credit, to a much faster credit expansion than the average credit growth in the European Union. In the new Member States, these developments are also a consequence of the catching-up process and of financial deepening. This includes in particular the rapid increase in household credit for the purpose of purchasing residential property. Overall, financial developments in the new Member States have contributed to "good growth" that I would define as a sustained increase in activity which fosters and accompanies the expansion of the growth potential of the economy. This brings me to a number of additional points I would like to make in response to remarks by other speakers.

Robert Mundell, in his brilliant and wide-ranging speech, covered many topics and it would take us more than a "few weeks" to address them in depth. But I would like to respond to one remark he made about the European Central Bank. He said that the European Central Bank, by following an "inflation targeting" approach, had not paid sufficient attention to growth, or it did not have a sufficient degree of freedom in order to define an interest rate policy which would also support growth.

My first point is that, strictly speaking, the ECB has not adopted an inflation targeting approach, at least not in the specific sense such an approach is defined in central banking. But it is, of course, correct that we are aiming at maintaining price stability in the euro area. This is our primary objective over the medium term, and this objective has been quantified to mean that we aim at achieving a rate of inflation close to, but below, 2%. We believe that this policy is not incompatible with the support of growth in the euro area over the medium and longer term. On the contrary, we believe that by maintaining price stability we establish an essential condition, a necessary condition for sustained growth in the euro area. The low inflation that has been attained over the last 5 1/2 years and favourable market expectations of low inflation over the long term have contributed to having historically low short-term interest rates and long-term bond yields, in nominal and real terms, in the euro area. In this way, our policy of maintaining price stability has contributed to the euro area's growth.

I should also emphasize something that I mentioned briefly in my speech, namely that it is particularly important for a new central bank responsible for a new currency to establish its credibility, that is to establish its ability to achieve its primary objective in an effective and consistent manner. So, it was essential during the first formative years of the ECB that the attainment of price stability would be the overriding objective, as it should be all the time, by the way.

Another pertinent point is that the empirical evidence supports the view that the long-term growth performance of the euro area fundamentally reflects the effects of non-monetary factors. The policy implication, to put it very simply, is that it is necessary to enhance the supply-side of the economy to increase its long-term growth. Robert Mundell has emphasized the importance of the supply-side of the economy for growth, and I would fully agree with this. I think that by now it is widely recognized that a large part of the high unemployment rate in the euro area and the decline in its growth potential reflect structural factors and, consequently, the implementation of structural reforms in various areas is essential in order to help the euro area economy sustain a higher rate of growth.

A final point I would like to stress, which relates to the previous one, is that the average rate of growth of the euro area economy compared to the US since the mid 1990s is not a consequence only of a lower rate of productivity growth properly defined. It is also due to a number of other factors such as slower population growth and a lower degree of labour utilisation. The latter reflects the lower labour force participation rate and average working hours per person in Europe relative to the United States. This suggests that the performance of the European economy was affected not only by the pace of adopting and incorporating new technologies and efficient methods of production, but also by demographic developments and factors related to the functioning of the labour market and the preferences of European citizens about work and leisure, which in turn are influenced by regulations and institutional market rigidities. So the bottom line is that there is an urgent need to implement the appropriate reforms to boost productivity growth and increase labour utilisation so as to improve the growth potential of the European economy. The implementation of such reforms and the European Central Bank's monetary policy of preserving price stability will jointly contribute to achieve a lower rate of unemployment and a higher average rate of growth in the euro area.

GYOHTEN: Thank you very much, Governor. Now, Dr. Regling.

REGLING: Thank you, Mr. Chairman. You gave Alexander Schaub and myself three questions and he will address the first one. I would take the second and the third, but I would also want to make a comment on Prof. Mundell's intervention.

One of your questions was: If the Euro were a success, why are the countries in the EU that are not members of the Euro area performing better than those inside the Euro area?

This is a very popular argument. You find it particularly in the Anglo-Saxon press but one should be very careful with this argument. When you look at the EU, you have 25 countries, 12 that are members of the Euro area, and 13 that are outside. Of the 13, 10 are new member states that joined in May this year. These are countries with considerably lower per capita income and they should and will be catching up in the next few decades, implying that they should have very strong growth rates for a long time. This has nothing to do with the Euro area as they are catching up. This leaves three mature industrial countries, Denmark, Sweden, and the UK. Denmark has about the same growth rate as the Euro area. The UK and Sweden are doing considerably better. So why are these countries performing better? To a large extent, Lucas Papademos has already addressed this issue. These are countries that have been particularly successful in implementing structural reforms, the UK in the l980s and Sweden in the early 1990s. Substantial reforms, as explained in many of our publications, are done in some countries, lacking in others, and both the UK and Sweden have come far in this respect. Therefore, it is not surprising that their growth rates are higher. Also, let us compare similar countries that have undertaken structural reforms and have a similar economic structure, for example Sweden and Finland. Finland is inside the Euro area and Sweden is not. Sweden's growth rate is above the Euro area average, but Finland's growth rate is even higher. To conclude, one needs to be very careful in using generalized statements, such as the one above.

The second question was about the Stability and Growth Pact. The question was basically: If countries don't comply, and if we are not able to impose penalties, shouldn't the Pact be modified? I explained briefly in my introduction earlier this afternoon that we are indeed thinking about some modifications. It is important to underline, however, that the key provisions of the Pact are still good and valid, because the Pact basically wants to ensure that fiscal deficits do not interfere too much with the monetary policy of the ECB. We also want to avoid negative spill-over effects from countries with large deficits, and we want to achieve long-term sustainability in all countries. To achieve those objectives, today's basic rules are valid for the countries that are inside the Euro area today, namely to run a balanced budget over the cycle and not to exceed the 3% deficit ceiling. These objectives as such are not questioned by anybody or any government in the Euro area today. Even the countries that don't comply with these rules recognize that the objectives and the rules are the right ones. Also countries like Germany and France that have had deficits between 3-4% for a number of years basically confirm that they want to move to a balanced budget. Politically it is very difficult for them to get there, but they know that this is the right policy to follow. There is no fundamental disagreement about the Pact, but the day to day implementation is not easy.

Regarding Prof. Mundell's intervention, I would like to challenge one of his key points. Of course, it is not easy to challenge Prof. Mundell. I want to start by saying that I am extremely grateful to him – and I have been for a long time - for two reasons. First, he was one of the very few respected economists who supported the EMU project from the beginning. He can in a sense be considered as the father of EMU. The second reason is a very personal one. He does not know this, but my thesis when I did my master's degree in 1973 was on optimum currency areas. So, of course, I drew on his article from the early 1960s and that set me on the path to work on monetary issues for the rest of my life, first at the IMF, then in the German government and now in the Commission. I have devoted a lot of time to first contribute to creating the monetary union and then make it a success, and I am extremely grateful to him for setting me on this path.

Nevertheless, I want to disagree with one of the fundamental points that he made. When he described the creation of the monetary union and monetary integration in general in Europe and why it didn't happen faster, he concentrated very much on the political world and on the institutional setup. I believe that the reasons for why the process took so long were very much dictated by economic elements, which he did not address much today. To be able to create a monetary union, one has to create fairly homogeneous economies that are fairly similar in economic structure. This, for instance, requires free trade, full convertibility, something that was not implemented in Europe even in the late l980s. We first had to create the single market in Europe in order to be able to create a monetary union. In the 1970s and 1980s these preconditions were not in place, we did not have sufficient convergence. This is why we had the European currency crises with the snake in the l970s, and the exchange rate mechanism in the l980s and the l990s. We learned from these experiences and macroeconomic policies and developments became more convergent. I think that this was a precondition; otherwise external shocks would lead to asymmetric shocks in a number of countries. These economic elements are important, and I am saying this particularly as Asia looks to Europe and wants to learn from Europe's experience. Besides political cooperation, it is very important to also have substantial economic cooperation, integration and convergence. This will also be a precondition in Asia. This is a very long process. Therefore, you should not wait, but start now. Thank you.

GYOHTEN: Thank you very much, Dr. Regling. Now, Dr. Schaub.

SCHAUB: I could take the following questions, which you read out. What would be the influence on structural reform in Europe if the new member states join the Euro? I believe it will be the same type of influence you are seeing already in the member states, which are members, and that is first of all they have to respect the stricter disciplines. Lucas Papademos has elaborated briefly on this point. That would create more pressure on them to achieve structural reforms if there are difficulties. And it would create a stronger, larger transparency, so they could be easily in a situation which you can see, for instance, in Germany today, which has difficulties to respect Stability and Growth Pact, which has to make more drastic efforts to get some of the structural deficiencies in order. Overall and once the basic conditions to participate in this more demanding exercise are fulfilled, overall there would be a positive impact.

If I have another minute left, I would give it to Prof. Mundell so that he can react to Klaus Regling's doubts.

GYOHTEN: Thank you very much, Dr. Schaub. Now, Mr. Hirano, can you respond to those difficult questions on the governor's behalf?

HIRANO: Yes, I guess, I have five minutes and the governor left me with difficult questions. I cannot be a good substitute to the governor, but I will try my best to be a good complement. I think I heard four questions and I am going to try to respond to those questions in the reversed order.

First on the influence of the foreign factor on the monetary policy making. I think the monetary policy is discussed and performed against our thinking about our prospect of growth and prices of Japanese economy. The foreign factor influences the monetary policy to the extent that influences the growth and price prospect of Japan. So that the simple answer for the 4th question is that as the economy gets more globalized then the foreign factor assumes more importance in our thinking of growth and price prospect, and thus monetary policy considerations. That is for the 4th.

The question No.3, the second one I am trying to respond, is the role of Japan-China in pursuit of the currency integration in the future. I think what is most important here is to have a sort of collective mechanism or forum for the monetary and economic cooperation in this part of the world to begin with. Of course, given the importance of China, Chinese and Japanese economies here, both countries should have just to play a pivotal role to enhance this collective mechanism. For that to happen, I believe that the partnership so to speak between China and Japan should be enhanced, not only on the economic front but also on other front, inclusive of the political front. That is for Question No.3.

The question No.2, Prof. Mundell's recommendation over currency regimes to fix yen to dollar. I am quite sure my colleagues here are not happy with that proposal. There are a lot of recommendations about the currency regime for Japan. For instance, Prof. Svensson argues that Japan should depreciate its currency to fight again deflation. I also hear my colleagues' criticisms over our intervention in the currency market. I sense that many of my colleagues have the argument that Japan should be more receptive of currency appreciation. Also, Chairman Greenspan says that the currency regime does not matter if other elements of economies are flexible. There are a lot of opinions on the desirable currency regimes of the yen. Frankly, it is almost impossible to reconcile all those different opinions. For the specific recommendation by Prof. Mundell for the yen-dollar peg system, I just wonder if it is practical. Because pegging yen to dollar means for the Bank of Japan to give up the monetary policy and just to follow the monetary policy of the Federal Reserve. Now, we are operating in the environment of zero interest rate in the framework of quantitative easing. We have a lot of reasons to continue on this policy. Then, what would happen if we peg up our currency to the dollar? Maybe we should follow up the monetary policy of the Federal Reserve, and the Federal Reserve is actually raising rates. Would that be acceptable to Japan? I think it is quite dubious. That is one big question, big problem for us to peg the currency to the dollar.

The first and the last question, I find it the most difficult one. The possibility of setting a prerequisite for us to have a single currency in this part of the world. I would say there are lots of prerequisites and conditions for us to be able to pursue – to just pursue the single currency in this part of the world. One is the economic integration. This should be more deepened and enhanced. We see lots of remaining obstacles or impediments which prevent the trade flows in this region. Those barriers should be eliminated in the first place. Secondly we have to have the financial market integration. For this to happen, the capital controls which could be the most difficult impediment on the score should be relaxed or eliminated to invigorate the capital flow, the cross-border capital flow in this region. The third, I think this is the most important thing. That is the full convertibility of Renminbi (RMB). Otherwise, without this, it does not make any sense to talk about any currency regime here in this region as a region-wide currency regime. So that the full convertibility of RMB is the very strong prerequisite for us to imagine any kind of the common currency regime here. Of course, a credible mechanism to ensure the policy convergence in this region should be one of the conditions for pursuing the common currency. So that there are a lot. I would say. I think I used my time.

GYOHTEN: Thank you very much, Hirano-san. Now, let me ask Mr. Sasaki.

SASAKI: I would like to answer to the two questions first and then I would like to comment on the proposal of fixed rate among yen, RMB and dollar by Professor. Mundell.

First part of the question was whereas Europe is the major market of NEC's mobile business, why does NEC need to make cellular phone in China?

I think that we should decide the optimum production site by two viewpoints.

One is the distance from the headquarters and another is the distance from the marketplace where we sell the products.

In case of cellular phone, we should consider several factors such as the procurement of required parts, availability of assembly outsourcing candidate and logistics to the market. In case of our production volume of mobile phones, I think that production in China and export to European market will enable us to keep cost competitiveness. Actually, European cellular phone manufacturers also outsource from Chinese assembly partners.

In regard with the utilization of qualified workforce in Eastern Europe, I believe that the advantage of having qualified local people for the customization of cellular phone handset by country is significant as we need to provide different contents by different languages.

There has been historical background for our overseas production strategies. One time, there was a tariff in Europe and we promoted local production. Since the introduction of ITA, the situation has changed. Also, technological innovation is critical and progresses dramatically to maintain our competitiveness. We need to consider this factor to decide production site of the products.

Finally, I would like to comment about exchange rate of RMB relating to the Professor. Mundell's comment. For many Japanese companies including us, RMB is already included in the cost structure of the operation as an important factor. Therefore, a stable RMB exchange rate is preferable for us.

GYOHTEN: Thank you, Mr. Sasaki. Now, Prof. Mundell you have five minutes now.

MUNDELL: Thank you, I think I have 6 minutes. (Laughter)

The first question deals with the issue of differences in countries. Now, of course, Asian economies are very different from one another and the question is: If it is more different than European economies, does that mean that the Europe's example would be a bad one for Asia?

Well, firstly, to make it quite clear I want to say that I am not saying that Europe's example is the best example for Asia. After 50 years or almost 60 years of cooperation and integration, we are still calling it the Community. In all other institutions it has led to a much higher degree of institutional integration inside Europe. And convergence of Asia hasn't or hardly has got started in that direction yet. So, it is not a single currency that I am talking about in terms of the currency area in Asia. If any kind of monetary union could be achieved in Asia, it would be a multiple currency monetary union. Europe had a multiple currency monetary union between 1999 and 2002. 11 or 12 currencies were still existent over that period. But it was a coherent monetary union because there was no adverse speculation. Speculation dried up and it ended – speculative capital has ended and hedge funds could not make a diamond out of the whole capital market. The turnover of the market dropped down from 1.5 trillion dollars a day to 1.2 trillion just as a result of the 1999 movement actually.

Now, the big issue, one of the questions was: Does difference in per capita income development between the areas matter? Well, why do we think it should matter? Let's suppose you have a country like the Emirates, or Kuwait of oil or almost one product economies, very different structure from any other. That means that they should not be part of the same currency area as yet. Look at what has happened historically. Every single country that developed a national currency had developed it with vastly different types of economies inside. Look at the United States. In 1792, thirteen countries formed the common currency. They were very different. Then, the United States was tremendously different from the West, expanding out in every country. In Tokyo the countryside is different from the city. You find the islands in Japan that are of very different levels of development. But that does not mean you have the different currency. The basic function of a currency is the account function of a currency and that does not make any difference what the level of the development is. A poor man and a rich man can share the same currency. The only difference would have been under the coinage system; the poor man would have been using a coin and the rich man might have been using silver or gold coins. Now, here on the paper, it is just the matter of having extra zeros. Rich man uses notes with more zeros on it than poor people. But it is like denomination. There is absolutely no reason whatsoever. The gold standard gave the world a high degree of unity from 1931, and all the major countries were on the gold standard. Most of those countries were divided up among Empires including Japan, the United States, Britain, and all the Europeans countries. Within those empires, there was the common currency. Well, there might have been 20 times difference in per capita income between India, colony of Britain, and London. Yet, they had the same form of currency. There you could argue, " Oh, it would have been better if India had a different currency." But what would it have done? A new currency does not give new resources to a country. It only forms the major standard. It is the accounting system of capital. Europe has got rid of 12 currencies, replaced them, adding one, so, a net gain of 11 currencies, but instead of having 11 different pricing systems, different exchange rates you have one. This is tremendous economy of information quite apart from money changing and all the things that are obvious to travelers and those things. You got the unity of information. You could have the whole world and the same money. The only difference would be, "What would be the optimum number of currencies in the world?" In its friction rules of the world, we might say or we could say it is one. But you have to decide on what the common price level or inflation rate is. There is nothing in the economic theory that says the zero price level increase stable over the long run is necessarily better than 2% price level increase and countries de facto have elected for 2 or 3 percent inflation, and it is making easier in growing your economies in some ways to do so. There is nothing in the economic sense.

So, you need to have as many currency areas as there are optimal inflation rates in the world. If you say the world needs some choice of inflation rate and some countries should have 5% inflation and others would have 2% inflation, then you need two currency areas. If you have more than that, it does not make so much difference.

Now, this gets into the question about the accession countries to the EU. Are they going to join or not? When can they join? Well, the big issue is convergence, Does this give fixed inflation rate? The problem with those countries joining too early is that you cannot join a monetary union without fiscal stability. You have to have a fiscal balance, more or less, I think even 3% is too rigid. You need even more fiscal balance than that. This is a big problem. You cannot have the monetary area, if you have countries which expect to have huge budget deficits. That is the big barrier for those countries. As soon as the country decides it is going to go ahead and get the budget in balance, then you can join the monetary union. Look at little Estonia. In 1992 it fixed or set up the currency board against the Deutsche mark, then got into the Euro zone and it was ready for a monetary union before the European countries were.

Where the differences in per capita incomes make a huge amount of difference is when there is a political element in the union. The gold standard was the ingenious mechanism by which you could have the global monetary unity without political unification. Even enemies were all sharing the same gold standard. But there were different lines on each side. As you see in the case of Germany, when the Eastern zone came in, with nearly 1/3 per capita income, the commitment of West Germany was to bring it up to the level to be equalized. That is where the political line comes in. That is where Eastern Europe or Central European countries are with their per capita incomes half to 1/3 or a quarter of the level of richer countries. It is shocking to have such differences in per capita incomes and wage rates in these areas. It is a big problem because of the big differences in wage rates you have free migration. Migrations in the poor countries are going to send too many people to the rich countries, and there is going to be social disturbances and they won't be willing to accept that. That is the issue here now.

Dr. Regling's point. He does not exactly dismiss but he downplays the importance of this difference between 1970 and after August 15, 1971 and later when we went floating the exchange rates. I think it is fundamental. Of course, he is right that you have got a kind of better free trade system with market regulations, the one Europe market, and all those. You got the improvements in this direction. But usually you don't need to have it, because you had the most fundamental things done in 1970. In 1970 you had the budget stability in every country. You had budget balance. If you look around all the European countries in 1970s nobody would think 3% of GDP budget deficit would be grossly too much, because countries got used to the discipline of the fixed exchange rate zone against the dollar plus the possibility of changing it periodically when it became necessary. You had to have that, because they all knew then that if they had separate currencies, they had big budget deficits. Especially added to that was high debts. There would be speculation against the currency and the whole system would break down and there would be devaluation and they would be going into difficulty. And they all had that deficits. They may have gotten more integration on a better free market. There was the common market since 1958, it moved towards that, it was not complete, they kept moving toward that and it helped them so much. But the fundamental thing was the monetary and fiscal discipline.

Just compare the Italian case. They had a fixed exchange rate for something like 22 years from 1940s to 1971. Then they gave it up. They had the fixed change rate, they had the American inflation rate. And they had the budget balance. But look what happened to them. A complete loss of monetary and fiscal discipline in 1970s and 1980s. So I disagree with Dr. Regling. I think it is the fundamental thing.

The lesson for Asia is that you do need something, if you are going to have a fixed exchange rate zone in Asia. I am not talking about a single currency but fixed exchange rate zone. Then you have to bring about that discipline. If you don't have that discipline, it is not going to work. And you had that discipline prior to 1971.

Here is an issue of exchange rates. I remember in 1987 when I had a platform with the Akio Morita in Zurich. This was just after the Plaza Accord, or the Louvre Accord, which was February 1987. This meeting was around June 1987. The dollar against the yen had been going down all through that period, going down around the time of Louvre Accord. The yen had got to be in February about 160 or 165 to the dollar. But then after that, they all kept going down, down, down. It was around 130, 125 at the time of this meeting. I asked Morita if he thought that the Japanese industry could survive at 120 yen to the dollar. He went into discussion about the importance of exchange rates and uncertainties. He ended up with saying that if he could be sure this 120 exchange rate to the dollar was to be maintained for five years, then they could change the productivity in their company around, and they could survive very well at that exchange rate. This was after the rate had come down from 230 or 240 to half that, 120. So, that is the importance of fixed exchange rates for businessmen. I can agree it always was true. Businessmen normally in the United States hated the idea of flexible exchange rates. They really got pushed onto it by the financiers who never took this into account. I think that the fixed exchange rate is a very good thing.

The last point, fixing the dollar. I said, "To have an Asian currency area, I think an indispensable condition for that would be, if it is going to be an Asian currency that includes both the big powers in Asia, would be for Japan to fix its currency to the dollar." Then you would have the anchoring for convergence. I believe that is the only way and if it does not happen there will not be an Asian currency area. That is my view.

I am not saying that Japan should have to fix the dollar, but I said if you were going to have an Asian currency area, you have to fix the dollar, and there is no other way of getting it. I understand the difficulties. If you could think the dollar is now stable as it was – it was more important in the world being more stable – you could rely on the dollar. But it is not like it was in 1950s and 1960s, when Japan had its currency fixed to the dollar and had this wonderful period of economic growth, but you cannot do that now.

The optimal thing would be to fix the dollar, fix the yen, and if the other countries would go along, to a basket of the three currencies, which in that slide you may have seen DEY (Dollar, Euro, Yen), the DEY currency. You fix that, and all you would take would be for the Bank of Japan to take account of the exchange rate of yen against the DEY and for the United States to take it into account a little bit and for Europe to take that into account a little bit, and you get a great mitigation of the exchange rate fluctuations between these three huge currencies areas, each of which has price stability and doesn't need to have any kind of exchange rate fluctuations.

GYOHTEN: Thank you very much Prof. Mundell.

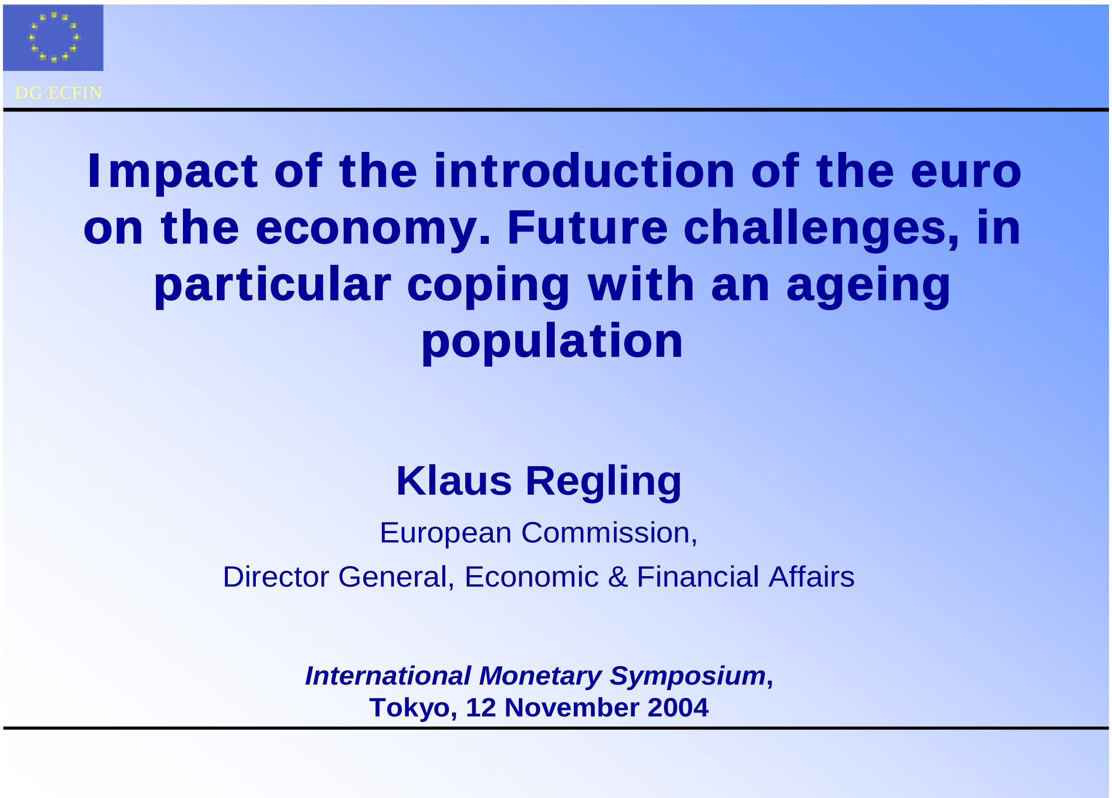
Now, I am afraid we have to conclude the session. I am sure that all of you can join me that this was extremely informative and fruitful four hours. The only regret I have is that we don't have more time. Before concluding I would like to repeat my heartfelt gratitude to all panelists who took the trouble of coming out to talk with you. I am sure your efforts will be more than rewarded by the deep sense of appreciation and gratitude of all audiences in this hall.

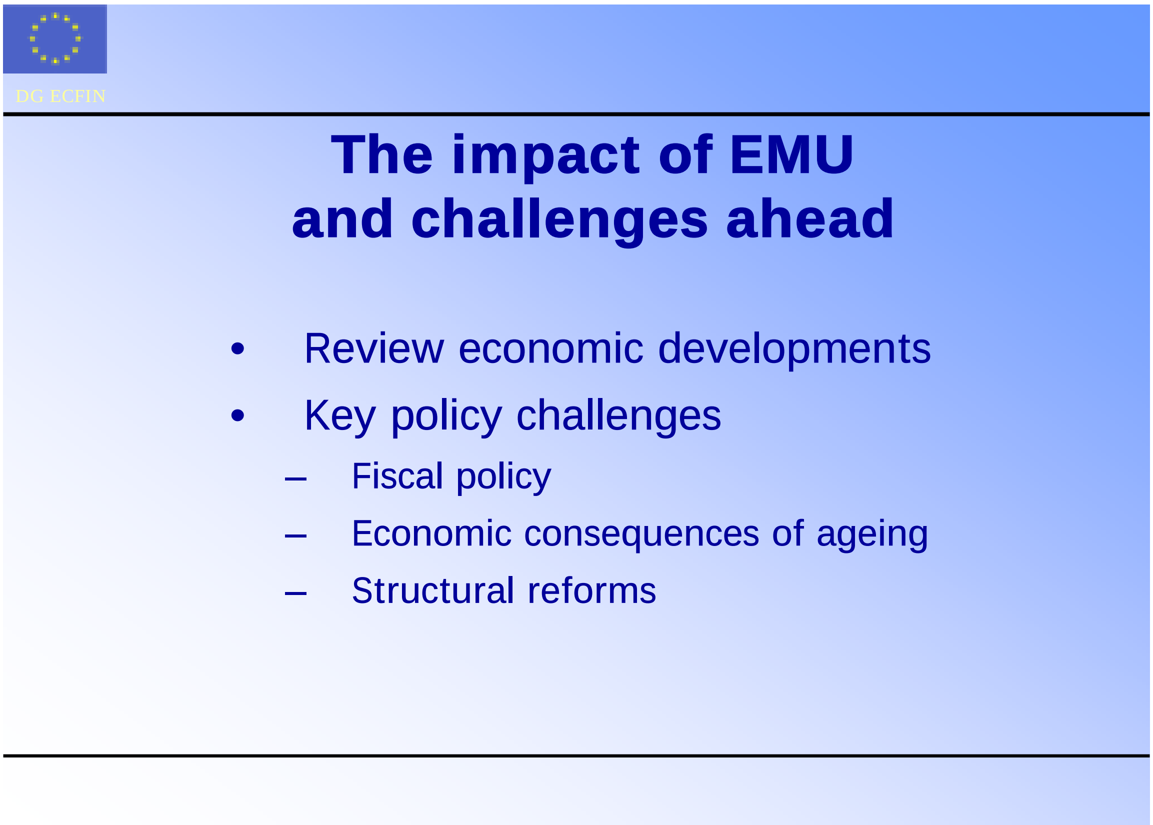
I would like to thank all staff of the European Commission and IIMA, who helped this meeting to make such a big success. And my thanks also go to the group of simultaneous interpreters who worked so hard with your excellent jobs.

Of anything else, I would like to thank all of you, my good audience for your attention and eagerness and patience. And wish you all the best.

Appendix

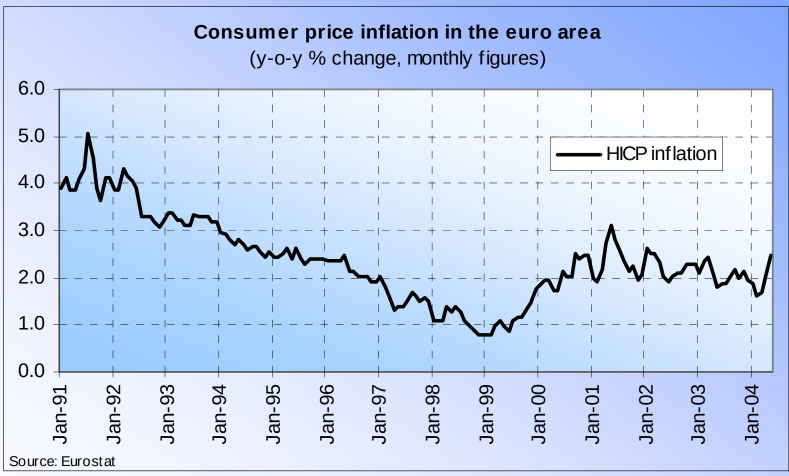
(1) Power Point Slides for Klaus Regling





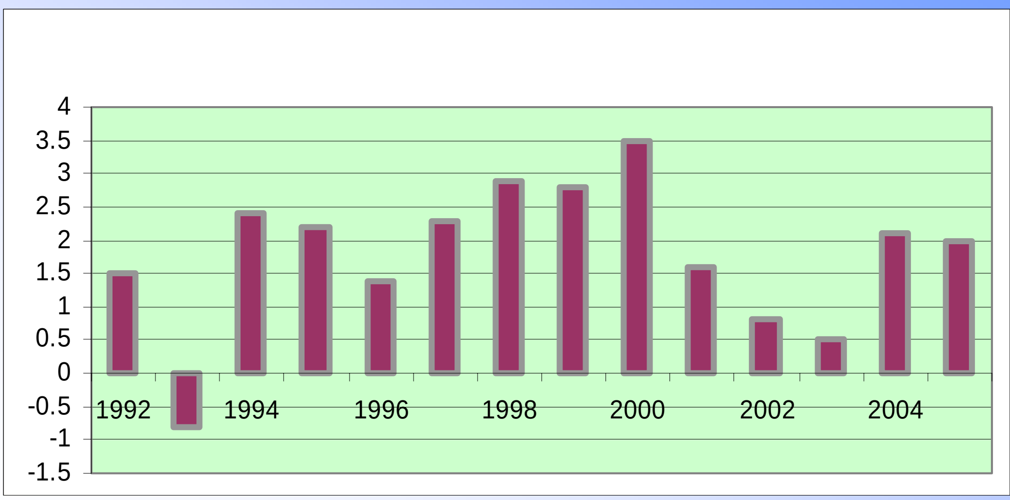
DG ECFIN

Inflation performance, euro area



DG ECFIN

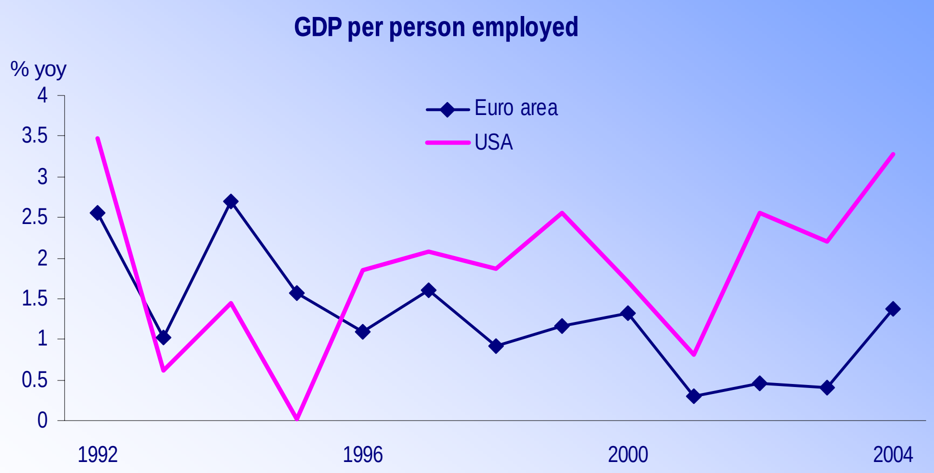
Euro area GDP growth



Source: EUROSTAT

DG ECFIN

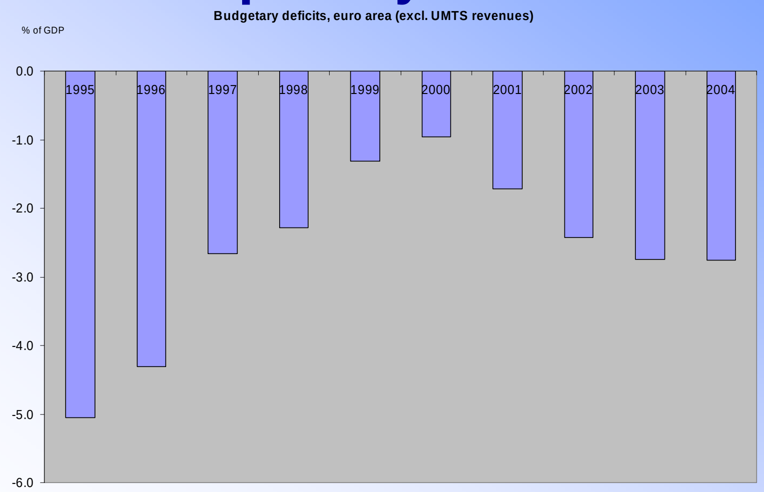
Labour productivity in the EU and US



Source: EUROSTAT

DG ECFIN

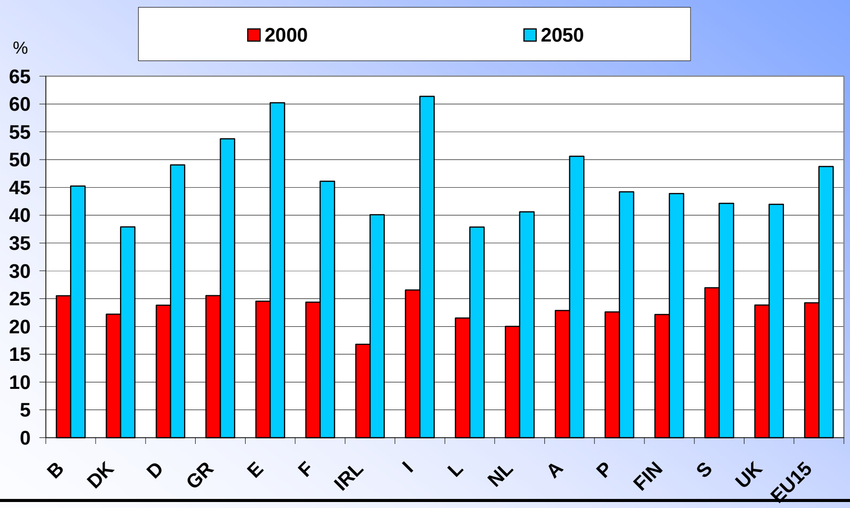
Budget consolidation interrupted by slowdown



Source: European Commission, Directorate-General for Economic and Financial Affairs

DG ECFIN

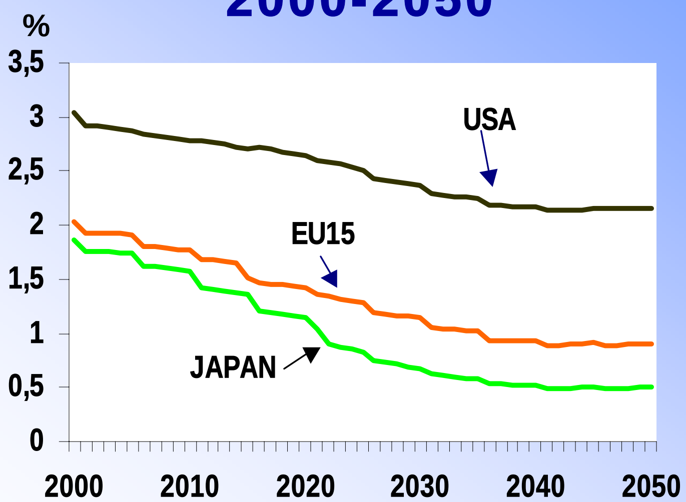
Old-age dependency ratio, 2000 & 2050



Source: European Commission, Directorate-General for Economic and Financial Affairs

DG ECFIN

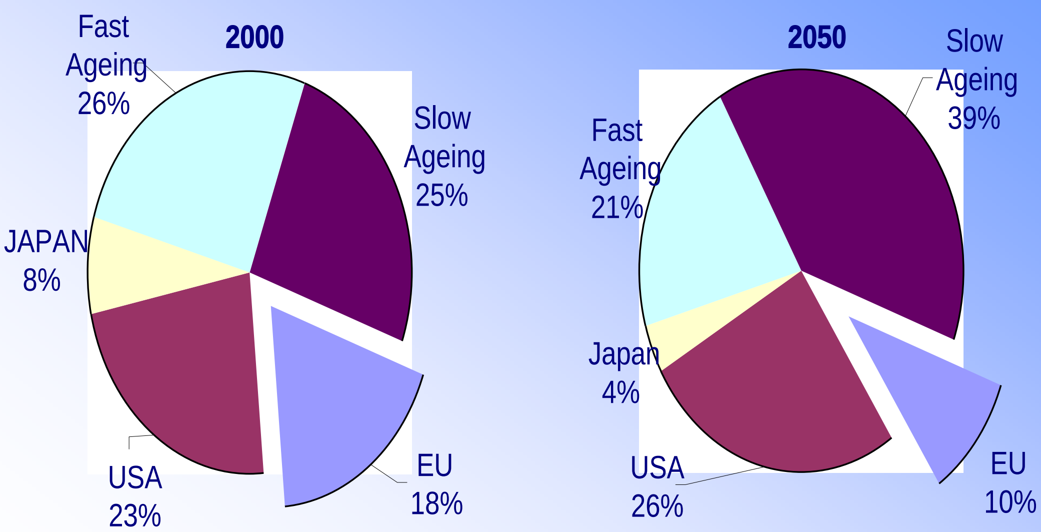
Potential growth in EU, US and Japan 2000-2050



Source: European Commission, Directorate-General for Economic and Financial Affairs

DG ECFIN

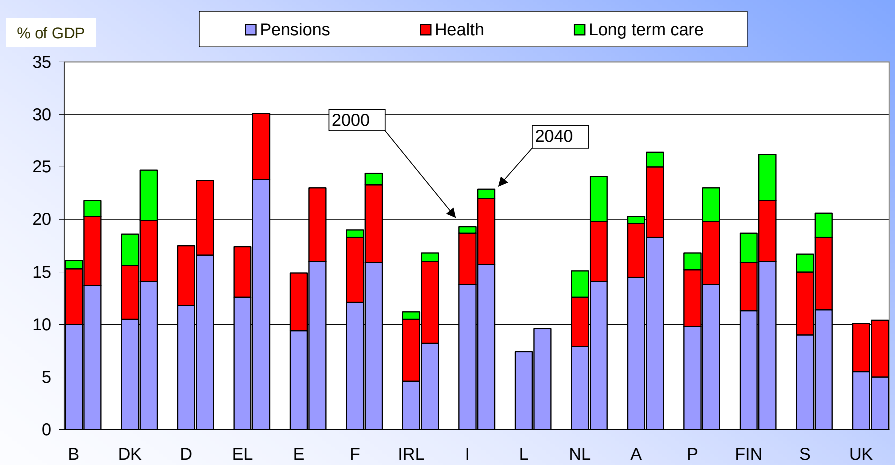
Global output distribution, 2000 & 2050



Source: European Commission, Directorate-General for Economic and Financial Affairs
Note: 'Fast ageing' countries include OECD members other than EU-15, USA, Japan, Mexico and Turkey, all Eastern European countries, Russia, China, Hong Kong, Korea, Singapore and Thailand. 'Slow ageing' countries include the rest of the world.

DG ECFIN

Age-related spending in the EU 2000 and 2040



Source: Economic Policy Committee

DG ECFIN

EMU as a catalyst for structural reform ?

- Earlier labour market reforms have started paying off: increased labour market resilience, lower structural unemployment
- Increased level of competition in product markets
- No acceleration in the pace or ambition of reforms linked to EMU

DG ECFIN

Positive overall assessment of EMU

✓ Macroeconomic stability against a background of unfavourable external shocks

✓ Greater trade and investment flows between euro area countries

✓ EMU has provided a spur to financial market integration

➢ Establish an effective and credible framework for budgetary surveillance

➢ Ensure sustainability of public finances in the long run

➢ Tackle the causes of slow growth by accelerating the pace of reforms

Appendix

(2) Power Point Slides for Hajime Sasaki

NEC's Business Strategies in Europe and Expectations for the Euro

November 12, 2004
Hajime Sasaki
Chairman of the Board
NEC Corporation

Empowered by Innovation NEC

1) Impact of May 2004 EU Enlargement

2) History and Present status of NEC's Business in Europe

3) Expectations for the Euro

Empowered by Innovation NEC

2

Impact of EU Enlargement

＝Japanese Companies welcome EU Enlargement＝

【Benefits】

1) Expansion of Single Market
   → Expansion of Prospective Markets
2) Simplification of Customs Clearance
   → Improving the efficiency of the Logistics System
3) Harmonization of Regulations, Technical Specs and Standards → Standardization of Business Activities

【Concerns】

1) Increase in Wages, Loss of Qualified Personnel to Western Europe
2) Elimination or Reduction of Preferential Treatments on Investment
3) Increase in Duty Rates due to Common Customs Duty
   example : Video Equipment

Empowered by Innovation NEC

3

NEC's European Business History

	History of EU/WTO	NEC's Sales Activities	Manufacturing/R&D/ Partnering Activities
		Est. of Brussels Liaison Office ('63)	
1970	Est.of EC ('67) (6 countries)	Est. of Vienna / Warsaw Liaison Office ('70/'73)	
	EC becomes 9 countries ('73)	Est. of Sales Companies in London & Dusseldorf ('73)	Est. semiconductor plant in Ireland ('74)
1980		Est. of Semiconductor Sales Companies (Italy, Germany, UK, France)	Est. semiconductor plant in Scotland ('81)
	EC becomes 12 countries ('86)	Est. of Sales Companies for Telecom & Volume Business (France, Italy, Spain, Sweden)	Est. Plant for Volume Business in Telford, UK ('87)
1990	Est. of EU ('93)	Est. Holding company (NEC Europe) in London ('93)	Strategic alliance with Bull ('93)
	EU becomes 15 countries ('95)		Est. R&D facilities in Bonn & Berlin ('94/'95)
	Enactment of ITA ('97)		
	Adoption of Euro ('99)		Strategic alliance with Siemens for 3G Mobile Solutions ('99)
2000	Circulation of Euro ('02)	Reorganized semiconductor sales to a pan-European structure	
2004	EU becomes 25 countries ('04)	Poland / Hungary Liaison Offices become branches of NEC Europe ('04)	

Powered by Innovation NEC

Strategic Business Areas in Europe

Mobile Solutions

- 3G Mobile Network
- i-mode Platform
- Mobile Terminals

IT Solutions

- Biometrics Security
- High Performance Computing (Supercomputers)

Semiconductor Solutions

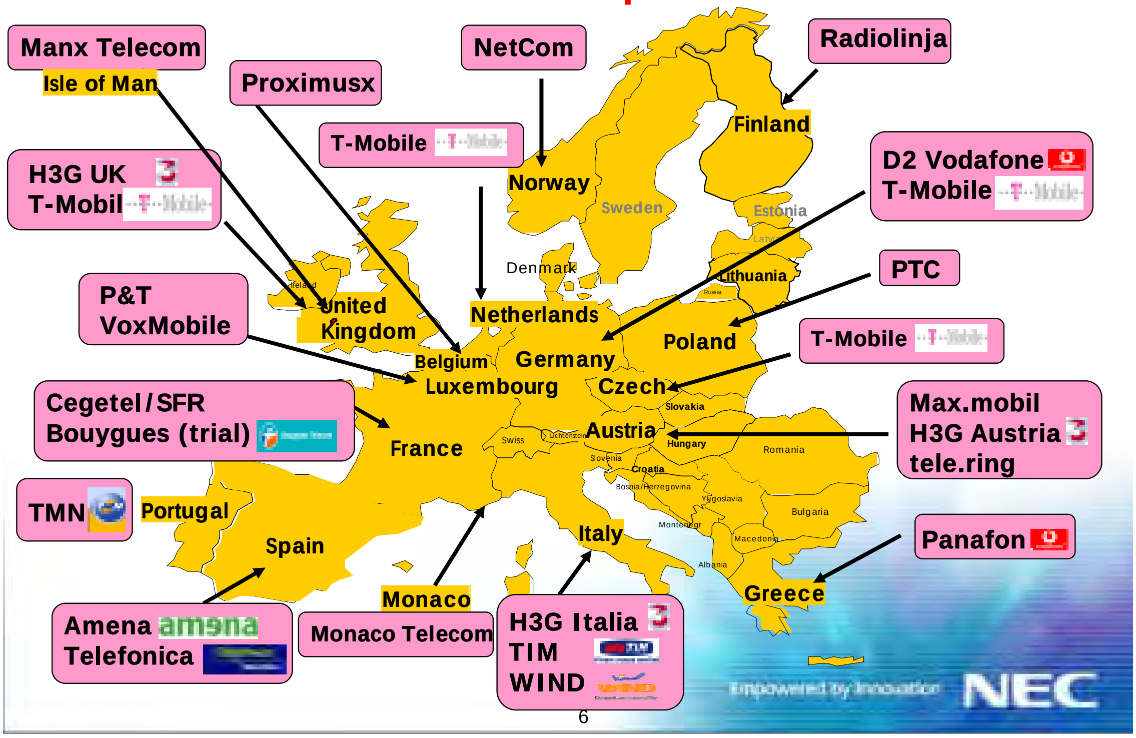
- Automotive
- Industrial
- Communication
- Consumer

Empowered by Innovation NEC

5

3G Mobile Network (1)

NEC has contracted with 26 operators in 16 countries



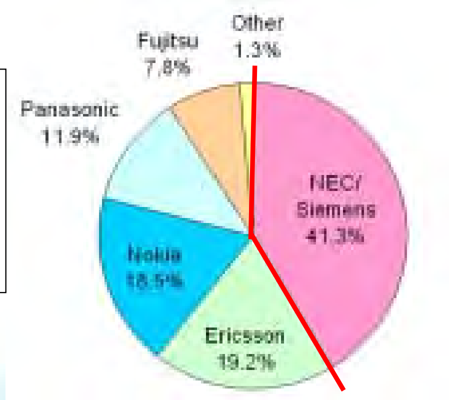
Empowered by Innovation NEC

6

3G Mobile Network (2)

NEC has entered into a strategic partnership agreement with Siemens and is offering 3G Mobile networks in Europe.

NEC/Siemens Team owns over 40% of the worldwide market for base stations commercially deployed.

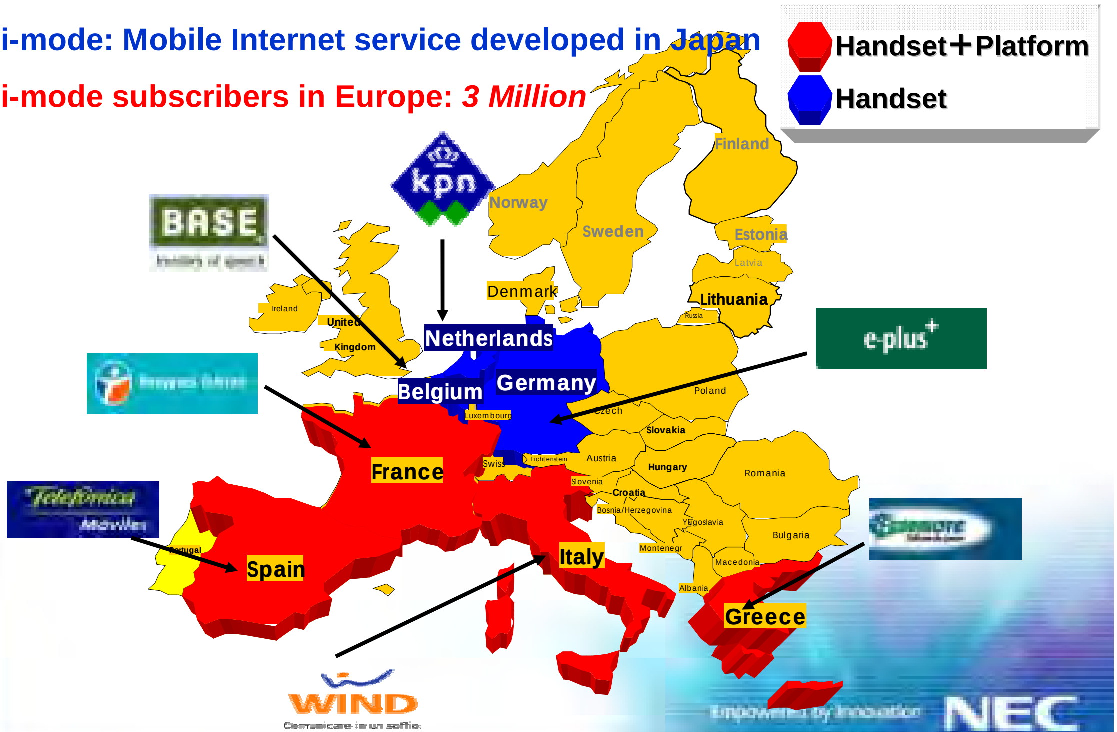


Source: Multimedia Research Institute (Dec. 10, 2003)

i-mode Service

i-mode: Mobile Internet service developed in Japan

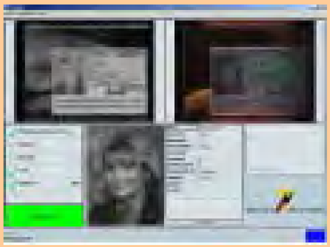
i-mode subscribers in Europe: *3 Million*



Biometrics Security

Alliance with Germany's BDR (Bundesdruckerei)

Deployed NEC's Enter/Exit system by using Finger. ID. at Deutsche Haus at the Athens Olympic Games



Participating in e-Passport trials in Germany, UK and Netherlands

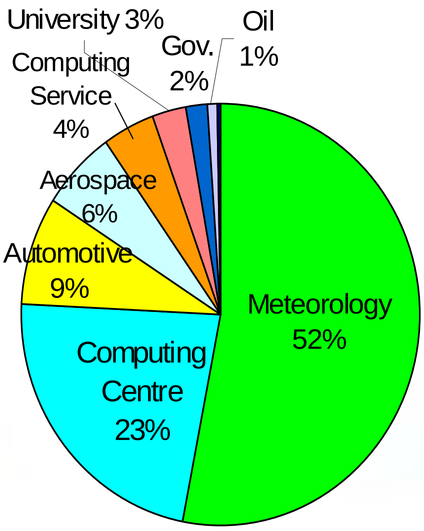
Automated Fingerprint Identification System (AFIS)

NEC has deployed 118 AFIS to 22 countries worldwide. In Europe, we have delivered systems to UK, Spain, Netherlands, Sweden, and Finland.

Supercomputers

Europe makes up 70% of International business

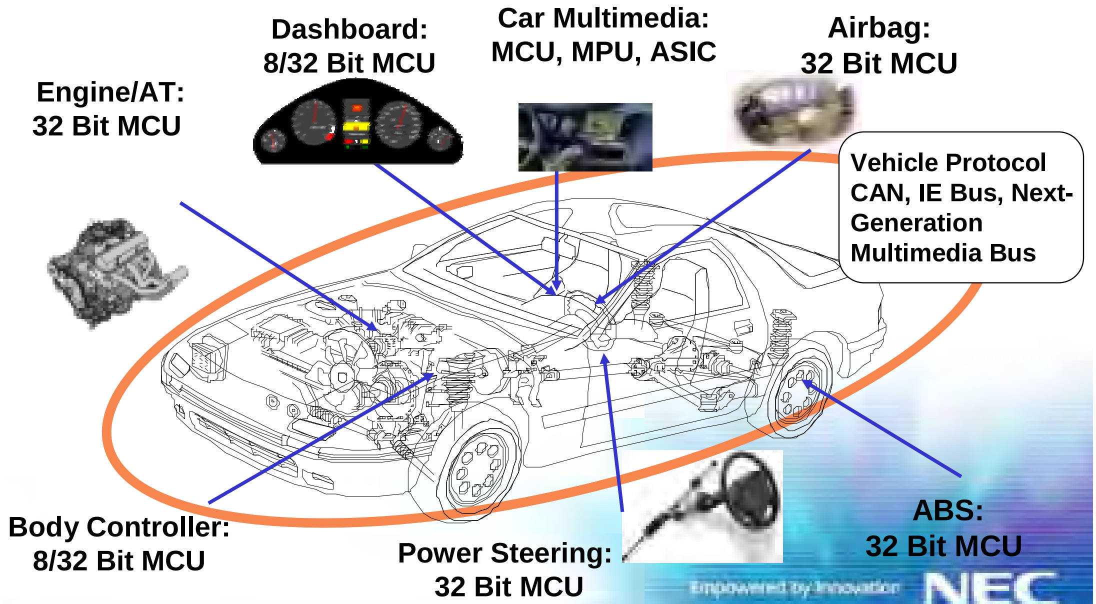
Customer Categorized by Application



NEC C&C Research Laboratories (Bonn) has developed the application technology of the Earth Simulator. It also participated in the meteorology project.

Semiconductor Solutions ~ Automotive Domains

High-Performance, Distinct Performance,
Development Simplicity, High-Reliability



Expectations for the Euro (1)

- **NEC's mobile terminal business places a high importance on export to Europe.**
  => 15.5 million terminals shipped in FY2003.
  => 30% were for overseas market, and 20% were for European market.
  (Production is mainly conducted in China due to its competitive cost.)

Transaction carried out in Euros makes up about one third of export value to Europe.
Therefore, a stable Euro market is preferable.

Expectations for the Euro (2)

- Introduction of unified currency in Europe is a significant advantage.
  => Decreasing currency exchange risks.
  => Intensive operation of risk hedging.

- NEC has been conducting Pan-European cash management since 1999.
  => Has realized an efficient capital utilization within European region.

Expectations for the Euro (3)

- Expect the realization of further effects

  => Continued expansion of Euro region by expanding member countries.

  => A stable economy in Europe will contribute to a strong Euro. This, in turn, will assist in the stabilization of the global currency system.

Expectation for Deepening of EU Integration

- **Unification of the taxation system (ex. Corporate Tax) and Adoption of Consolidated Taxation System within the EU**

More flexible business development

Appendix

(3) Power Point Slides for Robert Mundell

The Case for an Asian Currency?

Robert Mundell
Columbia University

Institute for International Monetary Affairs (IIMA)
Tokyo, Japan

November 12, 2004

Topics

- Lessons from the Euro
- China and the RMB Issue
- Is there a Case for an Asian Currency Area?

1. Lessons from the Euro

Lessons from the Euro

- Hague Summit, December 1969
- EMS, 1978
- Delors Report, 1989
- Treaty of Maastricht, December 1991
- EMI, 1995
- Banking Euro, 1999
- Complete Euro, 2002.

Why did it take so long?

Why did it Take So Long?

- The anchored dollar system.
- The Nixon Shock. Why did he do it?
- Smithsonian Dollar Standard
- Fluctuating Exchange Rates
- The Dollar Cycle

Leadership

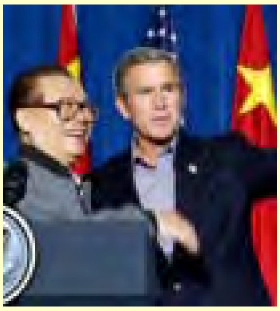
- From the Grid to the DM Area
- German-French Confrontation, 1980s
- EMS Crisis, 1992
- Determination of Common Monetary Policy

Weaknesses in EMU System

- Cumbersome Decision-making with Enlargement
- Immaturity in Short-term Capital Market
- Need for EU Debt Instruments
- Decision-Making at Ministerial Level
- No Defense against Dollar Cycle

2. China and the RMB Issue

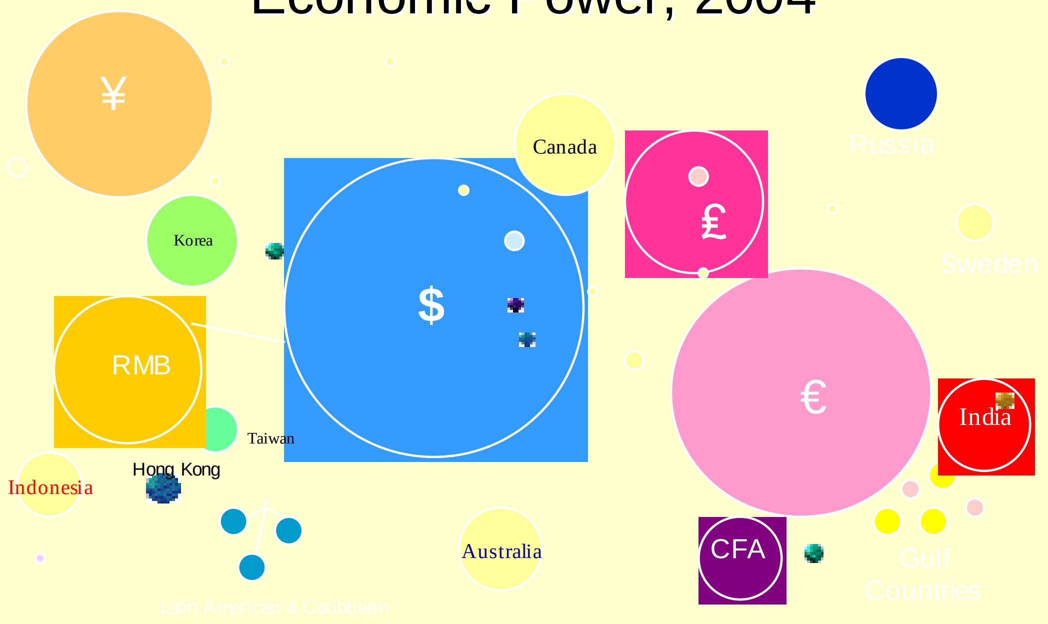
Four Generations of Leaders



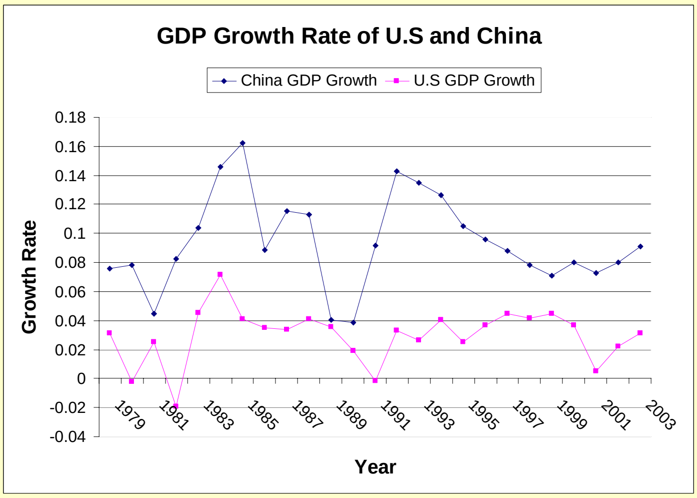
China's Rise

- 26 Years of 9% Growth
- Exports 6 % of World Exports
- Stable Price Level and Exchange Rate
- Annual FDI over $50 billion
- Soaring Imports and Exports
- Foreign Reserves over $450 billion
- Soaring Manufacturing Capacity
- Increasingly Hi-Tech Production

World Map of Currency Areas and Economic Power, 2004



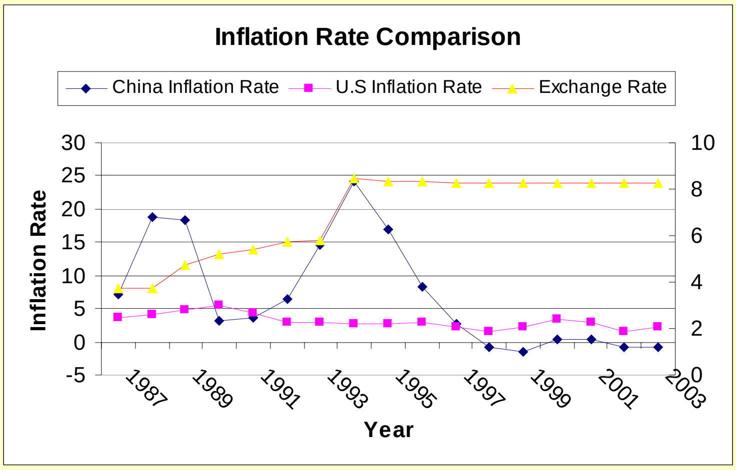
GDP Growth Rates: U.S. and China



Pressure on China to Appreciate or Float

- Japan's Charge of Deflation
- Charge of "Manipulation"
- US Bilateral Deficit with China
- Overheating Issue
- Dalian Conference
- IMF Managing Director
- G-7 Pressure

RMB Stabilization in 1994 Brought Price Stability to China, Managing Money Growth to Bring about a Soft Landing!



Discussion points

- No manipulation: RMB/$ fixed since 1994
- China not the cause of US deficits
- China cannot export deflation to countries on flexible exchange rates.
- Flexible Rates removes the anchor for monetary policy and is thus the opposite of a policy.
- Alternative for China could be inflation targeting but China has stabilized prices better by fixing to the dollar.

Effects of Substantial Appreciation on China

- Delay Convertibility
- Cut down FDI
- Lower economic growth from 7.5% perhaps to below 4% (disaster level).
- Aggravate problem of Non-Performing Loans in Banks
- Create Deflation in Rural China
- Destabilize South-East Asian economies

Effects of Appreciation on Rest of World

- No effect on US current account deficit
- No effect on Japan's deflation rate
- No effect on US employment
- Possibility of another Asian Crisis
- Derail growing consensus on Asian currency area.

Conclusion about Substantial Appreciation

- Great Damage to China
- Trivial Benefit to U.S.
- No Benefit to Japan
- Damage to Southeast Asia
- Destabilization of the World Economy
- Souring of International Relations, APEC, etc.

Query?

- Is it more important to keep a national basket of goods stable or to keep a wider international basket of goods stable?
- Should China keep its currency stable in terms of its local basket, 4% of the world economy, or its current basket, 33% of the world economy?
- Should Japan stabilize its local basket of 12% of world economy, or a wider basket of 12% + 33% = 45% of the world economy?

Defects of Inflation-Forecast Targeting

- China, no experience with inflation-forecast or monetary targeting in past thousands of years.
- Inflation-forecast targeting would make monetary policy a political football in China, between regions, town and country
- Aggravation of Speculative Capital Movements
- Instability of Real Exchange Rate

Defects of Inflation-Forecast Targeting, Cont'd

- Reduction in Asian role of RMB
- Reduction in confidence in RMB for savings accounts.
- Dollarization of asset prices, undermining role of RMB
- Reduction in Growth Rate
- Increase interest rates and unemployment
- Delay in convertibility

Conclusion About Floating

- Convertibility (on current account) into the dollar provides confidence in the yuan for savers.
- Floating would subject China to more continuous pressure than fixed, as in the case of Japan in the 1980s and 1990s and 2000s.
- As long as the dollar is stable in terms of the US price level, China should maintain its current policy.

Dysfunctional International Monetary System

- Three Islands of Stability: $-€-¥ Areas:
- Exchange Rate Instability
- Cause of Asian Crisis
- The Need for Stable Exchange Rates in Developing Countries
- World Currency Map 2004

3. ASIAN CURRENCY

Which Anchor for Asia?

- **Yen? Is it too deflationary for Asia?**
- **RMB? Is inconvertibility a barrier?**
- **ACU (Asian Currency Unit) basket?**
- **Dollar? Will it remain stable?**
- **Euro? Is it too unstable?**
- **Gold? Not feasible unless a large country fixed it?**
- **SDR? $.45 + €.29 + ¥.15 + £ .11.**
- **Gold not feasible unless a large country fixed it.**

Possibility of a Basket Anchor

- Basket anchors only useful if they are simple and easy for the public to understand.
- The Special Drawing Rights Basket was too complicated. It started off with 16 currencies some of which were inconvertible.
- Since then the IMF has improved the SDR basket. It now has four currencies.

The SDR Basket

- 45% $ + 29% € + 15% ¥ + 11% £
- Not a bad basket now and would be improved if Britain entered the euro zone.
- But it is still too complicated for general use. And unnecessarily complicated.

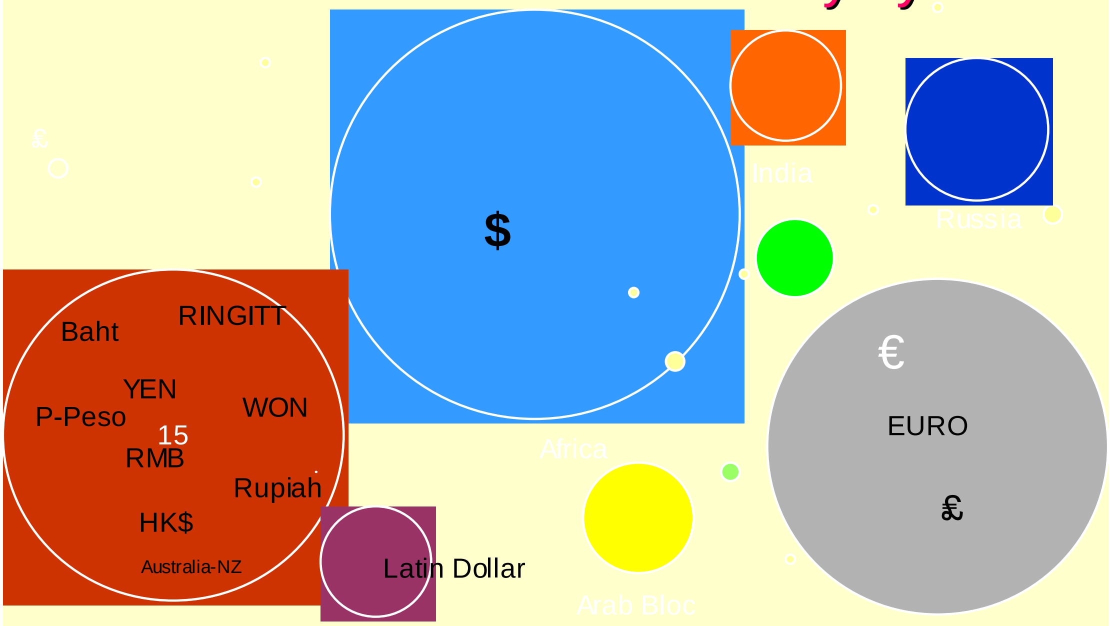
Currency Areas and Power Centers

- United States—New York
- European Union—London
- Japan—Tokyo
- China—Shanghai-HongKong
- What would be the financial center for the Asian Monetary Area?

Rise of Asia as an Economic and Monetary Force

- Recovery of Japan
- The Future of China
- Asia’s role in IMF
- Asian Currency Developments

An Asian Currency by 2015?

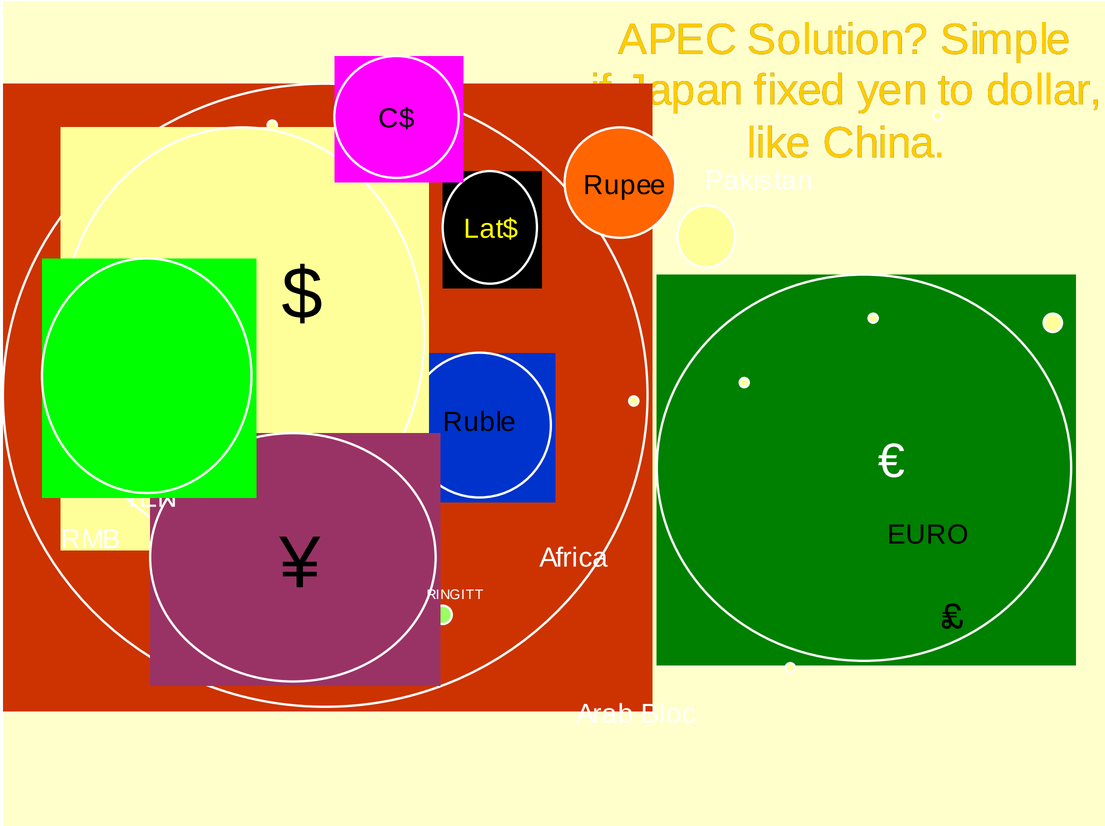


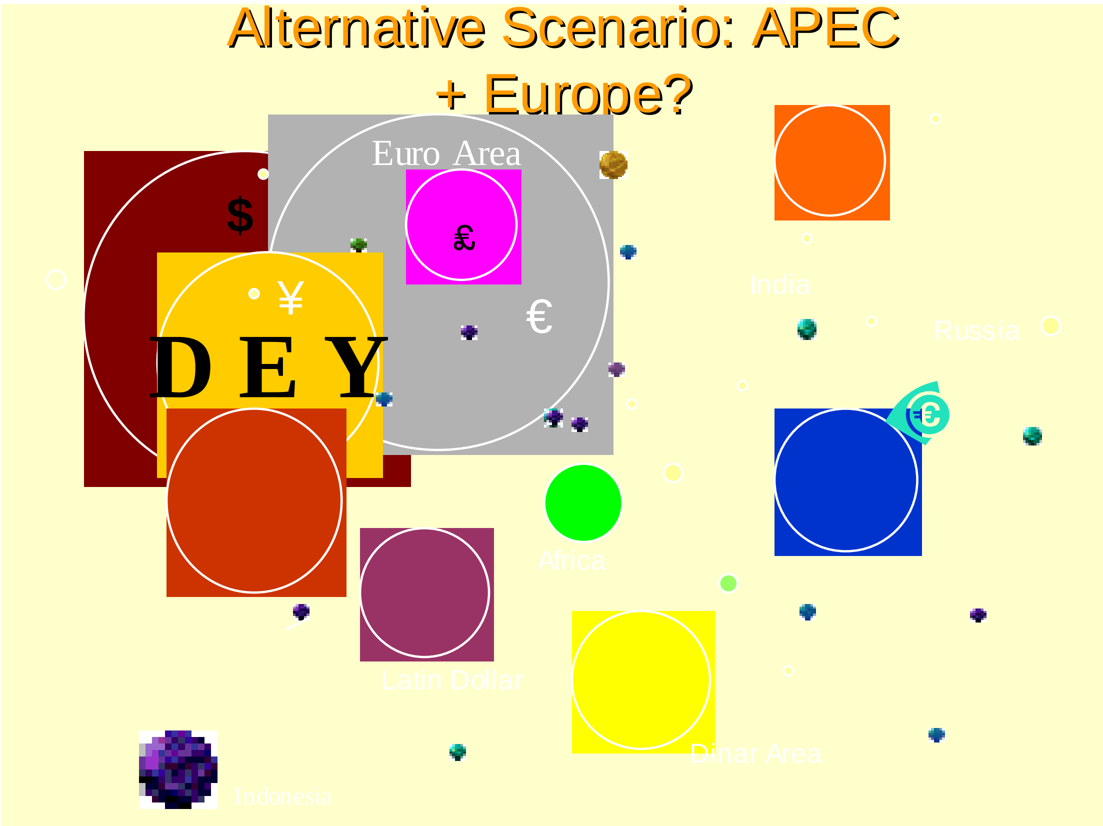
Implications of a Successful Asian Currency

- Avoidance of unstable exchange rates between Asian countries.
- Gains from a fixed exchange rate zone in Asia.
- Capturing of seigniorage.
- Reduction of US deficit.
- Increased trade and capital movements in Asia.
- Fall-back anchor if U.S. ejects countries (e.g., China) from dollar area.
- Increased power for Asia
- Mitigation of Exchange Rate Conflicts

Problems

- A currency area is a power center
- Japan and China both power centers
- Location of headquarters?
- What anchor? Inflation targeting?
- Importance of US anchor?
- Need for war-free Security Area
- Implications for US alliance?
  - **Next Steps?**
    - Currency Stabilization Agreement—Japan, China, Korea, ASEAN
    - Would Japan accept a Common Anchor with Dollar as the initial pivot for convergence.
    - Asian Monetary System (AMS) modeled after EMS.
    - Is an Exit Strategy Necessary?

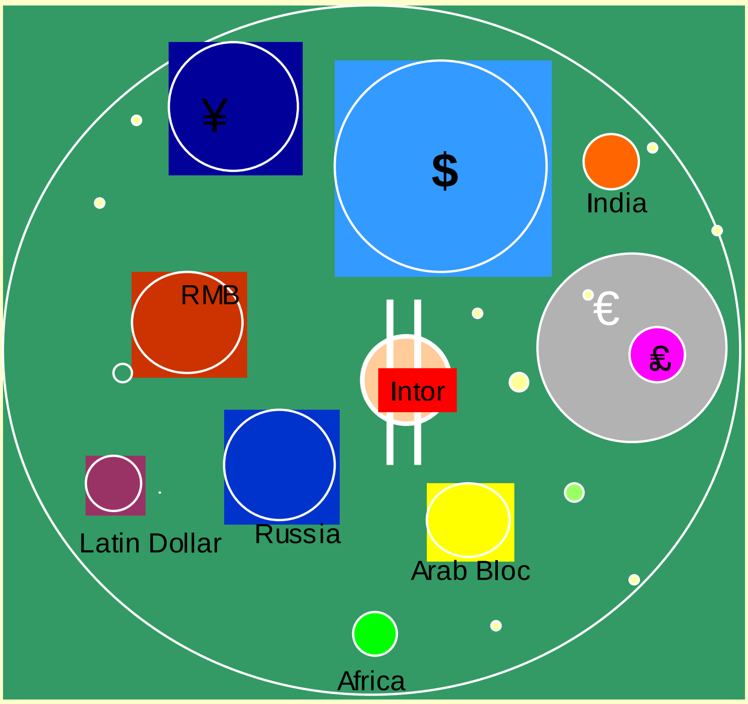

APEC Solution? Simple
if Japan fixed yen to dollar,
like China.
C$
Lat$
Rupee
Pakistan
$
Ruble
RMB
¥
Africa
RINGITT
€
EURO
Arab Bloc


Alternative Scenario: APEC
+ Europe?
Euro Area
$
¥
D E Y
€
India
Russia
Africa
Latin Dollar
Dinar Area
Indonesia

Need for a Better International Monetary System

- Need for a viable international monetary system
- Universal Unit of Account
- International Anchor for National Currencies

Global Solution?



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