

THE EURO, THE DOLLAR AND THE YEN

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

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

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

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

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

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

EUROPE BACK TO THE FUTURE

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

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

The important legacy of history, which has been one of the driving forces leading Europe to currency unification, is also important in shaping policy to address more immediate economics forces. When we think of Europe in 2010, will we be seeing re-emerge a sort of pre-1914 Europe, what some call the "Golden Age Europe", or will we have a Europe, deeply integrated politically, at all levels, and at the same time tightly integrated to the world economy?

By 2010, the European Union will have expanded to some twenty-five

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

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

As we move through the decade ahead, the entry of the UK to the euro will also likely be resolved. Events are moving in the direction of the UK joining the euro, although the recent European elections should be seen as a warning of how strong the opposition in Britain remains. Nevertheless, the interests of the City and of British-based industry, and so of very large portions of the UK work force, are becoming so strongly related to the euro, that over time these views are likely to prevail.

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

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

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

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

CATALYST FOR CHANGE AND REFORM

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

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

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

Further, such an investment had to be financed in a "national currency,"

because the cashflow of Italian Telecom was domestically generated. But the euro is the national currency in a very real sense for all of continental Europe. *That simple but very important fact was at the center of this transaction and is what really made it possible.*

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

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

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

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

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

THE YEN, THE EURO, AND THE DOLLAR

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

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

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

Consider that in 1991, Japan's debt to GNP was 51%. By 2001, it will be 151%, and that is unlikely to be the peak. In addition, to have a more complete picture, we need to include the net present value of the commitments of the government pension system, which is about 110% of GNP. So seen this way, and that is as any company or household would do with its balance sheet, claims on the state already exceed two and a half times Japan's GNP!

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

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

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

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

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

billion net; the year before that it was \$262 billion net. In 1996 the United States borrowed \$248 billion net from the rest of the world. That is an annual increase of about 9%. At that rate, by the year 2003, the United States' net external debt will exceed 25% of America's total economy. At some point, it will no longer be possible to continue dealing with the situation with *benign neglect* as is the case today. A major risk we face is that this situation of increasing is dealt with through the currency markets. Historically, countries which have built-up net external debt at the rate which America is today, and on such a scale, have, at some point, seen very weak currencies. If there is no change in the present course that will also happen for the dollar, and to say the least, that would be more than destabilizing for the world economy.

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

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

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

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

elsewhere, was the fundamental trigger of the crisis.

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

CONCLUSION

I conclude in putting Japan at the center of this question of currency market stability. Japan faces enormously difficult challenges in the re-capitalizing of the country's banking system. But, at the same time Japan's insurance companies are hemorrhaging vast amounts of capital, given the massive mismatch between long-term bond yields and the payout commitments of the insurance industry. More broadly, the agenda ahead for Japan's economy is a very heavy one: difficult demographics, the debt to GNP issue discussed above, massive balance sheet restructuring, weakness in Japan's main export market of East Asia. In addition, Japan has lost ground technologically in the 1990's. How will these issues be addressed? How Japan addresses these issues will largely determine the country's role in the world economy over the next decade and beyond.

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