

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

(Speech text by Toshihiko Fukui, Governor of Bank of Japan)

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 an “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 an "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.