The Yen, The Dollar and The Euro

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I am delighted to participate in this timely conference and to see so many friends on the program and in the audience. I would like to offer a few observations on how the project to establish a common European currency is progressing and then to trace through some of the implications of that currency, the Euro, for the dollar, the yen, and the financial markets more generally. But before turning to that important subject, I want to make some comments on the recent turmoil in the world's financial markets.

First, financial difficulties in Southeast Asian countries should have come as no surprise to those who were carefully following the available statistics. In fact, the situation turned out to be worse than the data portrayed because businesses, financial institutions, and their governments resist publishing full and accurate information. That is especially common in the emerging markets, where the norms of disclosure are still in their infancy. Participants in the financial markets were willing to give issuers the benefit of the doubt when financial values were on the rise, only to regret they did not have better data once the correction took place.

Second, contagion is a fact of life in the new structure of global finance that now exists. It is characterized by globalization, securitization, short-term performance driven portfolio management, deployment of a massive amount of leverage, heavy use of complex financial derivatives, and extraordinary trading volumes. All these activities depend on the existence of continuous markets and virtually unlimited liquidity. When those conditions fail, it becomes impossible to mark to market portfolios of questionable assets. Portfolio managers seeking to limit their exposure to unfolding problems sell whatever they can and in the most liquid market, often that of the United States or some other major financial center.

Third, the Southeast Asian financial crisis will probably have negative economic repercussions for the region -- especially for Japan. It will once again raise the specter of recession and of further distress among financial institutions. If there is further pressure in the Far East, the epicenter for financial disturbance will eventually be in Japan.

Fourth, the direct impact on the United States may be less startling. The perception of risk in our equity market may have increased, and consumer confidence will be impaired only if the current volatility continues. Some exports will be lost. However, the US economy is strong, far stronger than Japan's or Europe's.

Fifth, the United States is not in a position to play the kind of strong leadership role it played at the time of the Mexican financial crisis of 1995. Southeast Asia is far away; the issue of

immigration is moot. The financial resources are not available. There is no political support for a US-led operation. So the US Government is content to work in the shadows, as the IMF and the World Bank undertake a holding action.

Sixth, could the whole chain of events have been averted? Probably not. Most of the Southeast Asian countries involved would never have acquiesced to preventative measures, given the local economic, financial and political environment. Japan had ample warning that shifting abruptly to a far more restrictive fiscal policy would carry serious risks, given continuing economic and financial fragility, both for Japan and the whole region.

Seventh, the Big Bang in Japan is an inevitable event, but it comes at the wrong time in the financial markets. It will exacerbate the problems of the banks and, for the near term, weaken the yen further.

In sum, we are still in the first act of a drama that may play out in subsequent acts in many unforeseen directions over the months ahead.

Let me now turn to the issue of the Euro. My judgment is that chances are good that the common currency will go ahead on schedule and with broad participation. The reasons are as follows:

1. Monetary union has the firm support of the German Chancellor. Many German corporations and financial institutions also favor the Euro because they see it as bolstering their long-term strength and as preventing other countries from getting the kind of exchange rate advantages that occurred in the aftermath of Europe's currency crisis in 1992. Indeed, the recent massive depreciations of Southeast Asian currencies probably reinforces the argument that establishment of the Euro will help spare Europe from similar turmoil in the future. Finally, even those institutions that are not so sure the common currency will help their own businesses have a stake in the Euro going forward, since they are making large-scale investments to prepare for it.

2. It has the support of the French. They see the institutional apparatus of the European Community as the main antidote to German political dominance in Europe. In addition, they regard the common currency as the only practical alternative to the present monetary policy realities, in which the Bundesbank more or less determines the general policy line while other European central banks have little choice except to follow along, but without any direct influence on the Bundesbank's decision-making. Once the Euro and the European Central Bank are in existence, France and other countries will have considerably more say on how a European-wide monetary policy is conducted.

3. A core group that includes the Netherlands, Austria, and Belgium are already effectively linked to the Dmark and the German interest rate structure. It is a small step for them to move to a common currency. Thus, a country like Belgium will be admitted, even though that will mean bending or overlooking some of the Maastricht conditions.

4. Spain will be included, with strong German support. Portugal and Ireland are also likely to be in the first wave, but others are a question mark.

5. Prime Minister Blair's government will see political advantages in leaving open the possibility of eventual participation and will be more 'pro-European' in its rhetoric but that is as far as it will go. As the UK Chancellor of the Exchequer affirmed recently, the British will not begin seriously to consider joining the monetary union until the Euro has proved to be successful and is likely to endure. Even then there will be obstacles, since Britain's economy and financial system are not easily harmonized with the rest of Europe.

6. There is a question about whether Italy will be a participant from the outset. The Italian establishment sincerely wants to be a part of the exercise for domestic political and economic reasons. It is the best way of importing low interest rates and fiscal discipline. Moreover, Italy has many supporters in Europe, ranging from the French Government, which is looking for allies in Europe, to German businesses that do not want to have to compete with any future depreciation of the lira. Yet, others still fear that if Italy participated from the start, it would tip the odds toward higher European inflation and interest rates along with a chronically weak Euro. The decisive factor could be whether Prodi manages to stay in office and keep budgetary discipline on track.

I feel that once the decisions are made on who will be included in the first round, the most difficult balancing act will just begin for proponents of the Euro. That is to assure a skeptical public, certainly in Germany but to only a lesser degree in France and elsewhere, that a common currency will provide measurable economic and financial benefits without overselling it and thus risking serious disillusionment later. After all, a common currency is hardly a panacea for curing Europe's major problems: Too much regulation of business, inflexible labor markets, and unaffordable social programs. At best, it can be the logical next step in the so-far disappointing process of getting the Single Market to live up to its potential. The original architects of the Single Market strongly believed that it would lead to greater efficiency and thus higher potential economic growth, but up until now it has fallen well short of that ideal.

As for the implications of the Euro once it is under way, I want to draw your attention to the following points:

1. It is a fair generalization that the broader the membership in the monetary union, the less Bundesbank-like the policy decisions will be. Countries like France will not press for an overtly weak Euro, because it is recognized that a crude devaluationist bias would upset the financial markets and lead to higher interest rates. However, the French and others will push for a stable but 'competitive' Euro. Thus, the Euro is likely to emerge neither as a hard currency you have to own nor a weak currency you have to avoid, but as a 'normal' currency to be held or traded opportunistically. As such, the Euro will not displace the dollar as the leading international currency. Nor is it likely to diminish the international use of the yen very much either, since that is largely an Asian regional role.

2. A very important early impact of the Euro will be to change the currency denomination of the long-term liabilities of a broad array of financial institutions, such as insurance companies and pension funds. Those institutions are now often restricted to match assets and liabilities by currency and this regulation forces them to invest disproportionately at home. With the establishment of the Euro, they will be able to diversify into assets all across Europe because they will be recalibrated as Euro-denominated assets. So, for example, German institutions will increase their holdings of Spanish

stocks and bonds, while Spanish institutions will increase their holdings of Dutch securities, and so on down the line. This will be a plus for market activity, should encourage efforts to make European financial markets more uniform, and possibly will provoke some mergers of national trading systems.

3. However, there are also some possible negative effects during the first three years of transition, when domestic currencies and the new common currency will have to coexist. That will lead to some confusion, impair liquidity, and discourage central banks and other large institutions around the world from shifting very much of their reserves into the Euro right at the beginning. To the extent such investors maintain cash balances in Europe already, they will probably stay in the Dmark and wait to see how things develop. Therefore, the tendency would be for the Euro-denominated assets to be weaker rather than stronger because of these uncertainties.

4. Investors and issuers of new securities will spend a great deal of time trying to determine what the position of the new European Central Bank will be. This "due diligence" will have a couple of dimensions. First, there is no real information at the moment about how the new central bank will operate, about what economic and financial indicators it will follow, and how it will compute new European-wide measures of a whole range of important variables. The list would include calculations of the money supply (still a key determinant of the Bundesbank's monetary policy approach and presumably an important input into the European Central Bank's decisions), credit flows, inflation rates, and capacity utilization on a pan-European scale. Until this analytical foundation is clearly formulated, there are bound to be some market apprehensions.

Second, the "due diligence" will include a searching inquiry into just how much politics will intrude on monetary policy decisions. Today, European central banks face no significant monetary policy dilemma. Economic activity is only just now beginning to stir while inflationary pressures are dormant. But by 1999, cyclical conditions in Europe will be more challenging. Growth is likely to be considerably higher than it has been. While inflation will still be rather moderate, resource availability will begin to diminish. Plus, the United States will be finding it increasingly difficult to keep at full employment without encountering greater inflationary pressures. Thus, the new European Central Bank is likely to receive only a very brief honeymoon with either the politicians or the public. The markets will want to know how preemptive the new central bank will be. I suspect that the new central bank may take one or two modest actions away from monetary accommodation to build its inflation-fighter credentials but will not do anything that would seriously jeopardize economic recovery.

5. There will be periodic tests of the willingness and capacity of the European Central Bank to intervene to smooth out fluctuations in the value of the Euro relative to the dollar in the foreign currency markets. It is likely that the new institution will be hamstrung at least at first by unresolved questions about a number of key issues, such as:

- Will finance ministers dictate or otherwise have the authority to approve currency market intervention?
- Will national foreign currency reserves be amalgamated -- and if not how will foreign currency intervention be financed?

- Who will have authority to make drawings under existing international lending facilities?
- Will the new central bank be authorized to operate in the forward markets?

On each of these questions, my impression is that no one knows the answers yet. In fact, the basic question of who will have the power to determine foreign exchange rate policy is undetermined.

6. Under these conditions, we should not expect European financial markets to be calm. European interest rates are likely to fluctuate over an unusually wide range. Volatility of both the yen and dollar exchange rates with respect to the Euro will be quite high, reflecting both cyclical developments and shifting market perceptions about economic and financial prospects. Stock markets will also be at least as volatile as they have been lately. This is not the sort of environment that would readily attract a large volume of foreign capital; to the contrary we should expect capital to flow out of Europe, at least from time to time during the transition to the Euro.

7. The biggest test for the Euro will come when one of the key countries gets out of synch with its partners. Since monetary policy will not be able to be targeted very much to the circumstances in any one member country and by definition there will be no national exchange rate policy anymore, the sole policy instrument left is changes in national fiscal policy. If such a country overheats sooner and ends up with an inflation problem, a fiscal tightening would be called for and probably would be acceptable politically. But what if the country is out of synch because it cannot sustain economic expansion and hence requires stimulus? Here is where the real dangers lie: In a localized recession that the European Central Bank cannot or will not take steps to ameliorate. It is far from clear at present whether there will be enough latitude under the stability pact to ease fiscal policy. And even if there is, what if a fiscal expansion does not work quickly enough to boost economic activity? Will the national government in question be able to resist public demands for stimulus? Will it even be able to stay in office?

This is the nub of the problem. My feeling is that as soon as a dilemma case like this materializes (and eventually one probably will) financial market participants will immediately question whether that country will stay in the currency arrangement -- or seek to reestablish its own currency.

It may seem odd to talk about modalities of seceding from the Euro even before it is born, but it points to the Achilles Heel of monetary union: That is, there is no European-wide fiscal policy and therefore no systematic mechanism to transfer resources to members stung by economic downturns -- unlike the situation in the United States, for example, where both automatic stabilizers and discretionary programs can fulfill that function. But a European-wide fiscal policy approach presupposes a degree of political union that is far in advance of what is going to be feasible in the next three to five years.

It is precisely during this transition phase when weaknesses of the institutional structure will be exposed. That is when it will be apparent that strong, unified political leadership is a prerequisite for the success and maybe even the survival of the common currency experiment.