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Bank of Japan

The Future of the Euro: Challenges Ahead

*Remarks at a Panel Discussion
Hosted by the Deutsche Bank Group*

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I. Introduction

I am very grateful to the organizer for giving me the opportunity to participate in this panel hosted by the Deutsche Bank Group. The panel cannot be more timely: its theme, as I interpret it, is how the current eurozone crisis should be resolved and what the eurozone will look like in the future, with particular emphasis on the role of Asian investors, especially those from Japan. Since the European authorities share a firm commitment to save the euro, I believe that the whole project of the euro ultimately will succeed. Given the scale and complexity of the problems facing Europe, however, there is likely to be a long and bumpy road ahead toward a genuine monetary and economic union.

Today, I will share my views -- which also reflect some of the concerns of Japanese market participants -- on critical issues regarding the euro in three time horizons: short, medium, and long term.

II. Short-Term Challenge: Crisis Containment

Let me start with the short-term issue of crisis containment. In this respect, to convince investors is the key, and thus top priority should be given to having a strong firewall and putting in place powerful fire extinguishers in sufficient numbers.

Money markets remain stable currently, and sovereign bond yields in Spain and Italy have declined noticeably in response to the promise of bond purchases by the European Central Bank (ECB). However, the yields remain at elevated levels, while in contrast major European countries' shorter-end sovereign yields continue to be extremely low and in some cases negative due primarily to investors' preference for safety. In short, strong nervousness continues to linger in financial markets.

Thus, it is vital to prevent further shocks from triggering market disruptions. Right now, there seem to be no particular funding problems for financial institutions outside Europe, including those in Japan. Nevertheless, in view of the lingering nervousness among market participants globally, it is critical to alleviate the funding uncertainty to the extent possible.

The stability of eurozone money markets has been maintained by the ample liquidity

provision from the ECB. Still, how the European Stability Mechanism (ESM) and the ECB's bond-purchasing operations will play their role is the key to preventing contagion of a financial crisis across borders. In this regard, there are two issues. First, one may argue that once these operations start, it will become extremely difficult to cancel them outright even if the outcome is unsatisfactory, since cancellation might imply cutting the lifeline of the recipient (in other words, a classical time-inconsistency problem will arise). Thus, the success of these operations depends critically on their "gateway": how to craft the conditionality of the operations sufficiently to bring about the desired outcome, not sacrificing much in the recipient country, and how to construct the mechanism to ensure and encourage its compliance. Second, market participants are concerned with possibility beyond the immediate problem: in particular, (1) whether the ESM's firepower will be sufficient to fulfill its mandate; and (2) whether the ESM will be used flexibly and in a timely manner. In both respects, recent developments are encouraging, and it is anticipated that further clarification of these points will help dispel concerns in financial markets.

III. Medium-Term Challenge: Avoiding Further Negative Feedback

The second issue is how to avoid a further adverse feedback loop among fiscal conditions, the financial system, and the real economy. To this end, creating a European banking union has enormous significance. A banking union will also redress the inconsistencies in the current banking framework, that is, financial institutions operate freely within the euro area, while bank supervision and the safety net provision are fragmented along national borders.

For a banking union to be effective, it is crucial to secure sufficient funds to cover losses if the default of a financial institution occurs. This is a lesson Japan learned from the financial crisis of the late 1990s. In Japan, under the revised Deposit Insurance Act, when a particular financial institution's default raises real systemic concerns, the losses can be borne by not only the deposit insurance but also the national coffers. This ensures the credibility of Japan's financial safety net, thereby contributing undoubtedly to financial system stability.

To be sure, in Europe, loss sharing of this kind involves the difficult issue of fiscal transfer among member countries. It is very much hoped that appropriate measures will be taken in this regard in a European way.

IV. Long-Term Challenge: Convergence

Over the longer time horizon, economic convergence is a prerequisite for the euro area financial markets to become a genuine single market with high liquidity.

However, what we observe right now is divergence or fragmentation, not convergence. The economies of the euro area countries had not converged sufficiently when the euro was introduced, and the gaps among them widened further after the bubble burst in the middle of 2000s. Divergence is evident in unit labor cost growth and current account balances. Yield differentials in the European bond markets have also widened. Such market fragmentation has forced investors to reconsider country risks, which had been considered eliminated with convergence to a single financial market.

To accomplish a greater degree of convergence, while taking into consideration strong national identities and the slow process of population movements across borders, three options are often mentioned, ones that are not mutually exclusive. The first is to carry out so-called internal devaluation in the periphery. The second is to boost productivity and create value-added industries in the periphery. And the third is to implement fiscal transfer from the core to the periphery on the grounds of mutual benefits. Here I believe that the keys to success are the European people's belief in the euro system and their "solidarity" or the common cause of "European citizenship." Although achieving any of these options will take a long time and painstaking effort, it is hoped that the euro area nations will continue to do their best on these fronts.

V. A New Hope: Strengthening Market Infrastructure

Finally, I would like to touch briefly on the new hope seen in the strengthening of market infrastructure both in Europe and Japan. For many market participants, strengthening market infrastructure is important for sustained investment in Europe and elsewhere. In this regard, the Eurosystem has been pushing forward with TARGET2-Securities (T2S), a

single pan-European IT platform for securities settlement. At the same time, the Bank of Japan is working to revamp the Bank of Japan Financial Network System (BOJ-NET) to enhance the system's flexibility and accessibility. It is hoped that both of these initiatives will succeed in making global financial markets more resilient and efficient.

Thank you very much for your kind attention.