17 A Japanese Central Banker’s View of the EMU

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1. INTRODUCTION

It is a great pleasure for me to discuss or even just observe the development of monetary union, especially a plan for establishing a supranational central bank in Europe. I have been working for the Central Bank of Japan for almost twenty years. During this time I have experienced various aspects of central banking including bank examination, business condition analysis, and designing of payment systems. I have been considering what money is, what the essence of central banking is. The establishment of the European Central Bank seems to be the birth of a new central bank. As the birth of a new star provides a lot of information about the universe, the observation and discussion of the new central bank give us a very precious information about central banking and money. Developments towards a European Monetary Union has been attracting a lot of attention not only in the Bank of Japan, but also in the financial community in Japan as a whole. Since the Bank of Japan’s roles in the economy like other central banks are to conduct monetary policy, supervise private financial institutions, and provide payment services together with the function of the lender of last resort (LLR), I focus on these aspects.

As for the development towards an EMU, two major reactions in the Japanese financial community can be pointed out. Firstly, it is basically received favorably by our financial community. Secondly, it has stimulated reform of the Japanese financial system.

2. REASONS FOR THE FAVORABLE REACTION TO A EUROPEAN MONETARY UNION

Among the various reasons why the Japanese financial community welcomes the development towards the EMU, the following two reasons seem to be the most important.

2.1 Deregulation of Financial Markets in the European Community

When the 1992 program for the EC market was unveiled, there was a controversy about its characteristics in Japan. Some argued that the plan implies further deregulation of the financial market in the EC, while others asserted that it potentially implies the building of higher walls between markets of the EC and third countries, such as the United States and Japan. The former opinion, the deregulation hypothesis, has been proven right by the declaration that the reciprocity principle would not be strictly adopted. Many Japanese
financial institutions have been establishing subsidiaries in European countries to take advantage of the single European market.

2.2 The EC Economy and a European Central Bank

The second reason for a favorable reaction is due to expectations that the EMU will have positive effects on the real economy of EC. If this happens, it would be favorable for Japan since the economies of EC and Japan are interdependent nowadays.

Whether or not the EMU can bring positive effects on the EC economy depends in my opinion mainly on the structure and policy of the European Central Bank, a "European System of Central Banks". The first and the most important point for establishing the ESCB is that it should conduct stable monetary policy to control inflation. In other words, no economy can prosper without price stability. To achieve this goal, the ESCB should be independent from any political power in EC.

The second point is that the ESCB should develop a network which links existing central bank's payment systems in EC member countries. Without the linked payment network, it would be impossible to transfer funds smoothly from country to country and, consequently, capital movements among EC countries would be costly. Then, the difference among interest rates in member countries would not be diminished, which could cause volatility of foreign exchange rates. From this standpoint, it may be helpful to study the outcome of the funds transfer network among District Reserve Banks in the United States.

The third point is that it is necessary to shift the supervisory and rule-making power from government agencies, (national banking commission or ministries of finance) to the ESCB or national central banks. Since the central bank is also a kind of a bank, it is much more familiar with financial markets than government agencies. Therefore, supervision and rule-making are conducted better by the central bank than by individual government agencies. From this angle, it may be beneficial to compare central banks with or without their own supervisory power.

A fourth and related point is that in order to solve systematic risk problems in EC's financial markets, the lender of last resort function should be provided by the agency supervising the banking system, i.e. the ESCB or national banks.

3. REFORM OF THE JAPANESE FINANCIAL SYSTEM

Responding to the developments towards the EMU, there is in Japan a lively discussion about reforming the Japanese financial system. In Japan, banks are prohibited from engaging in securities activities according to Article 65 of the Securities and Exchange Law which was established after the World War II imitating the Glass-Steagall Act. The Financial System Research Council, an advisory body to the Minister of Finance, has recommended abolishment of the separation between banking and securities business by allowing a bank to establish a subsidiary engaging in securities business. In the discussion by the Council, the universal banking system in EC has been one of the most influential factors to consider for reform of the Japanese financial system even after the declaration that the reciprocity principle would not be strictly adopted. The reason is a concern about the possibility that the EC may effectively require Japan to adopt the universal banking system.
Although the separation principle will be abolished, banks will still not be allowed to engage in securities business within the same entity. Since it is not permitted in Japan to establish a bank holding company, a "fire-wall" between a parent bank and affiliates would be an instrument to avoid risk transmission from a securities subsidiary to a parent bank.

4. JAPANESE PERSPECTIVES ON A EUROPEAN MONETARY UNION

Let me discuss aspects of the EMU based on impressions from this volume. Since I am a member of the BIS payment system group, I would like to comment from this position.

My first comment is that the discussion of the EMU and the ESCB is unreasonably limited to monetary policy. As mentioned, the central bank is responsible not only for monetary policy, but also for payment services, the function of lender of last resort and for supervision.

It is therefore necessary to discuss those aspects of central banking when we think about integration of central banks. In this respect, the paper by Folkerts-Landau, Garber and Weisbrod is very interesting, since their argument stimulated me to think about the effect of linked payment systems on reserve requirement set by national central banks.

Furthermore, the presentation by Alberto Giovannini is also very interesting, because his instability hypothesis is strongly related to the lender of last resort-function of central banks.

My second comment is that the discussion on Monetary Union is unreasonably limited to the discussion of a single currency approach versus a competing currency approach. I think there is another type of distinction between, say, "top down approach" versus "bottom up approach". "Top down approach" means that the Monetary Union starts with the establishment of the ESCB which is responsible only for monetary policy. Then, the ESCB expands its scope to payment service, lender of last resort-function and supervision.

Conversely, "bottom up approach" means that the Monetary Union starts with the linking of payment systems of national central banks, and cooperation of national central banks in the function of lender of last resort. Then, the Monetary Union expands its scope to monetary policy. Since the central bank is also a kind of bank, it is very important to discuss the banking aspect of central banks when we discuss the supranational central bank. It is impossible to imagine a Federal Reserve System without linkage of payment systems of district reserve banks.

Thirdly, and finally, when we talk about money or currency, I think it is necessary to define the concept of money. Whether money means deposit money or cash money is very important, when we discuss different aspects of the Monetary Union.

In conclusion, I hope the European countries will succeed in establishing the ESCB through the bottom up approach, and then we would like to establish a global central bank by linking the ESCB, the Bank of Japan and the US Federal Reserve System.

FOOTNOTE

This paper represents the views of the author and are not those of the Bank of Japan.