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**“The Euro’s Performance as an International Currency  
and Implications for Asian Monetary Integration”**

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The Euro's Performance as an International Currency  
and Implications for Asian Monetary Integration\*

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## Introduction

On January 1<sup>st</sup>, 2002, a new currency came into circulation in twelve of the member states of the European Union. The introduction of the common currency, the euro, signalled the beginning of the final stage of European Economic and Monetary Union (emu).

The euro had been in existence as a common currency on paper in Germany, France, Italy, Belgium, Luxembourg, the Netherlands, Spain, Portugal, Ireland, Austria, and Finland, since January 1<sup>st</sup> 1999. After Greece adopted the common currency on January 1<sup>st</sup> 2001, there had been twelve countries that had the euro as a common unit of account. The introduction of notes and coins made the euro a tangible asset that people could now hold in their own hands.

The area comprising the twelve member states is called the Euro area, or Eurozone. Although the central banks of the twelve member states still exist, monetary policy for the Eurozone is decided and executed by a single central bank.

In 1999, the Eurozone accounted for an area of 2.495 million square kilometers (whereas Japan and the US are 378 thousand and 9.373 million square kilometers respectively), a GDP of €6.371 trillion (Japan was at €3.24 trillion, the US at €8.89 trillion on a PPP basis), and a population of 302 million (Japan had a population of 126 million and the US 272 million). Determining the optimal monetary policy for an area of this scale is no easy task. The business cycles are not always synchronized across countries, and each country still maintains an independent fiscal policy. Having to explain monetary policy in 10 different languages makes the task no easier. At the same time, international capital markets regard the relatively young ECB with a suspicious eye. These difficulties played no small part in the downward trend in the value of the euro versus the dollar and the yen since its inception in January 1999.

Yet, judging the economic and monetary unification a failure would be an error. The introduction of euro notes and coins went smoother than was expected even by the European authorities. Consumers are now able to easily compare prices across borders. European firms can issue debt in euros on a scale previously unattainable using the former sovereign currencies. These changes promote the effort to improve efficiency and M&A activity in Europe<sup>1</sup>. At the same time, the euro has risen to rival the US dollar as a debt

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<sup>1</sup> Artis (2002, pp.7-8) points out that in the retail banking sector, 'progress has, if anything, been negative' although this may be 'temporary'. Progress has been negative because banking mergers have been mostly intra-border, and bank supervision is in the hands of national Central Banks, which 'tend to "look after" their domestic constituency of banks'. Meanwhile, 'it has taken regulatory intervention by the Commission to ensure that

issuing currency.

This paper examines the euro's performance as an international currency, and touches upon the possibility of a unified currency for Asia.

### The value of the euro

On December 31<sup>st</sup>, 1998, the day before the introduction of the euro, the EU Economic and Financial Affairs Council announced the exchange rates between the euro and the old sovereign currencies. It also announced reference rates for the euro against the US dollar (1.16675 dollars to the euro) and Japanese yen (132.80 yen to the euro). Before full-fledged trading on the foreign exchange markets started on January 4<sup>th</sup>, trading began in London at 1 euro to 1.1685 – 1.1690 dollars. January 4<sup>th</sup> saw the euro trading in Tokyo at between 132.58 and 132.63 yen to the euro, closing at 134.95 yen.

These rates were not expected to be the highest for the euro. Based on the growing US current account deficit and Japan's runaway fiscal deficit, the markets and economists expected the euro to continue appreciating. This turned out not to be the case.

The euro depreciated until it showed a moderate reversal in November of 2000. By June of 2002, there was a sense in the markets that the tide had finally turned towards an appreciation of the euro against the dollar. Behind this change lay not only the 9/11 attacks but also a phenomenon collectively dubbed 'Enronitis', in which consulting companies, analysts, and the stock market in general had fallen out of favour. A declining dollar lowers the investment value of dollar denominated assets, giving extra momentum to the downward trend in the value of the dollar. In November 2002, the euro recovered parity with the US dollar. Still, the single currency is yet a long distance from the peaks in January of 1999.

There are four possible causes of the euro's decline; 1) high expectation for euro's appreciation, 2) the extraordinary performance of the US economy, 3) the problems facing the European Central Bank, and 4) changes in the foreign exchange market.

Regarding the first cause, as mentioned above, expectations were high for the euro when it was introduced. Investors built up large stocks of euro assets in search of exchange rate gains. When the anticipated appreciation did not take place, these asset holders began to dump the euro. The negative effect on the exchange rate was large, because the amount of accumulated stocks were large. The resulting downward pressure

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cross-border clearing charges are not more onerous than intra-border charges'.

on the euro fed back into itself by causing even more disappointment among investors.

The second reason for the euro's depreciation was the unprecedented strength of the US economy. Inflation and unemployment were low, no panic-inducing stock market crashes occurred. And the federal deficit, long a source of concern in the US, became a growing surplus. Any national or regional economy would pale in comparison to such an economy. In addition, productivity grew faster in the US than in the Eurozone. The impression that the US was further ahead in terms of structural reforms, and that it was generally a more dynamic economy also contributed to capital flows from the Eurozone to the US.

Investors from around the globe, including investors from the Eurozone, invested in the US. Eurozone residents showed preference for US stocks to US bonds, a reflection their high expectations for the future performance of US firms. In addition, European firms acquired or entered into alliances with US firms, facing increased competition in Europe following the introduction of the euro. According to statistics from the Bureau of Economic Analysis, the net flow in 1999 of foreign direct investment from the Eurozone to the US amounted to \$94.927 billion. In 2000 and 2001, although subdued, the figure was still high, at \$86.273 billion and \$66.614 billion respectively.

The depreciation of the euro can also be attributed to the third cause, the many problems that the ECB faced. A currency is sold because of a lack of credibility in the currency itself or the monetary authority behind it. In the EU, although monetary policy is now centralized, fiscal policy is still the domain of the individual member countries. What is more, the individual central banks for the member states still exist, and heads of state often independently comment on the level of the euro. It is no wonder, then, that the markets have doubts as to which institution has ultimate responsibility for the value of the euro, and what its policy is<sup>2</sup>.

Another problem is the difficulty in setting an 'optimal' monetary policy. Critics have argued that the Eurozone is not an 'optimal currency area', as the European Commission already admitted in 1992<sup>3</sup>. Economic theory predicted difficulties in economic

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<sup>2</sup> Henning (2002b) stresses that 'independence should not be confused with being apolitical', and notes that 'one of the most significant consequences of the introduction of euro cash' may be that it has 'given the ECB a direct relationship to European citizens as the guarantor of the value of money in their pockets'.

<sup>3</sup> Emerson, M., D. Gros, A. Italianer, J. Pisani-Ferry & H. Reichenbach (1992), p.46. The authors point out that conclusions drawn from the Optimum Currency Area theory "only holds within a specific and rather limited framework whose adequacy for today's analysis is questionable." They note that for instance the theory does not explicitly take into account the cost of exchange rate fluctuations. It must be noted, however, that this is not to argue that the Optimum Currency Area theory is not useful. The theory, on its own, does not help us judge whether monetary unification would or should take place. But it is very

management for the Eurozone under a common currency, which actually materialised. If the unemployed in one region of the Eurozone moved to the booming regions, then unemployment and economic circumstances would even out. Unfortunately, labor is not very mobile in Europe, and unemployment stays where it is. The Eurozone countries lost both monetary policy independence and the exchange rate tool. Now it is up to the unified Central Bank to conduct monetary policy that would stabilize the whole area. Finding a monetary policy stance that is appropriate for all participating states will continue to be the cause of more than a few headaches at the ECB, for the foreseeable future.

In addition, the ECB is tasked with jobs that are outside its mandate. In this respect, the position of the ECB is strikingly similar to that of the Bank of Japan. The ECB is mandated, first and foremost by the Treaty of Maastricht, with the task of price stabilisation<sup>4</sup>. Yet price stability is not the only concern that the ECB has when debating an interest rate change. It also has to consider the external value of the euro, and indirectly, the Eurozone's structural reforms. The markets, whether rightly or wrongly, view the Eurozone as being farther behind than the US in this respect. All things being equal, if this perception did not exist, then investment outflows to the US would not have been as large, and the euro would not have lost as much ground to the dollar as it did. In addition, the president of the ECB has actually mentioned structural reforms as a factor behind the ECB's interest rate decisions<sup>5</sup>.

Similarly, the slow progress of reforms is also affecting monetary policy determination for the Bank of Japan. Article 2 of the law governing the Bank of Japan states "(c)urrency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy". The official

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useful in analysing what the economic effects would be, once monetary unification is underway. Henning (2002b) mentions the 'Endogenous Currency Area Hypothesis' developed more recently, which states that 'monetary union will set in motion a set of policy reforms that would render the euro area optimal after the fact'.

<sup>4</sup> Article 105-1, Treaty on European Union states that "(t)he primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2." In contrast, the mandates of the US Federal Reserve Board, as defined in the Humphrey-Hawkins Act, included "economic growth in line with the economy's potential to expand; a high level of employment; stable prices (stability in the purchasing power of the dollar); and moderate long-term interest rates". The full name of this Act, enacted in 1978, was the "Full Employment and Balanced Growth Act". The act expired in mid-2002, but without much fanfare.

<sup>5</sup> The Financial Times of 12<sup>th</sup> November 2002 reports that Mr Duisenberg defended the ECB's decision not to cut interest rates by saying "(y)ou might find the answer if governments finally embark on ambitious structural reform programmes across the euro-zone."

explanation given for the August 2000 departure from the “zero interest policy” which had been in place since February 1999, was to normalize a “policy to counter crisis under extraordinary circumstances”, as they could now “foresee the end to deflationary worries” (author’s translation). Yet it can be construed from statements made by the Governor that the slow pace of reforms was also a consideration<sup>6</sup>.

The fourth reason for the euro’s retreat was the changes in the composition of the foreign exchange market that had taken place, or more specifically, the decline of ‘stabilizing speculation’. As the Nobel Prize winning economist Milton Friedman has asserted since the 1950s, speculators have a stabilizing effect on the market, because they buy when the price is low, and sell when the price is high. Before the Asian financial crisis and the Russian crisis, Macro hedge funds were dominant players in the foreign exchange market. They raised profits by speculating that an officially fixed exchange rate could no longer be maintained, due to unfavourable changes in macroeconomic variables. Their trading forced many a central banks to abandon their fixed exchange rates. For this reason, Macro hedge funds have been fingered as the primary culprit behind many currency crises, including the European crises of 1992 and 1993. Yet they can also be defended as bringing about reversals when the market moves in one direction for too long.

Since the end of the 1990s, however, these Macro hedge funds have no longer been as active. After the Asian Financial crisis, most countries became aware that free capital movement coupled with a fixed exchange rate was dangerous. This took away the opportunity for Macro hedge funds to make profits<sup>7</sup>. Then came the Russian debt default

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<sup>6</sup> For instance, Governor Hayami stated during a press conference on August 11<sup>th</sup> 2000, that we find ourselves “in an age when the private sector should voluntarily undertake technological advancement and structural reforms...” and that “maintaining the zero-interest rate policy would act as a drag on such forces” (author’s translation). A summary of this press conference, albeit in Japanese, can be found at [www.boj.or.jp/press/kisha064.htm](http://www.boj.or.jp/press/kisha064.htm).

<sup>7</sup> If the exchange rate is officially fixed, then the monetary authority is required to intervene in order to maintain the official rate. Thus, if there is net selling of the currency in the market, creating a downward pressure on the currency, the monetary authority has to buy the same amount as was sold. If there are no restrictions on capital mobility, then there are no caps on the amount that can be sold. Eventually, the foreign reserves will run out, the rate will become untenable, and there will be devaluation. Since this is what the seller was forecasting, it is very easy to walk away with (sometimes extremely) large sums. In order to prevent these “one-way-bets”, either capital controls have to be imposed, or the currency has to be allowed to float. In response to the Asian Financial Crisis, Malaysia imposed capital controls, while the other countries floated their currencies. Thus, it was no longer possible to profit from spotting a divergence between an exchange rate and macroeconomic fundamentals. To be sure, portfolio fund managers, who invest in different currencies, still exit. These investors also respond to macroeconomic variables. But they differ from macro hedge funds that seek short-term profits by affecting the level of the exchange rate.

crisis of 1998, and many Macro funds either scaled back their operations or closed altogether. Thus, when the Eurozone economies improved their performance, Macro funds were no longer there to provide the impetus for a reversal. Their absence meant the absence of a cue for a euro appreciation, which market watchers, economists and traders waited for and repeatedly predicted.

Of the four causes that have been examined, only the economic strength of the US has changed significantly as of November 2002. In addition, the change in the US economy is not as prominent in relative terms. Investors do not seem to be finding a good alternative to the USA. The US's current account deficit is expected to reach \$480 billion in 2002, or 5% of GDP. This implies a capital inflow of about \$1.9 billion every day the markets are open. In 2001, net capital inflows into the US averaged \$44 billion every month. And during the first seven months of 2002, portfolio inflows were enough to cover this comfortably, albeit from Asian rather than European investors<sup>8</sup>.

The Euro as an international currency.

The US dollar was the dominant currency in the post-World War II world. In order for the euro to challenge the dollar's dominance, it must be used as often as the dollar is used, by people around the world. Economic theory teaches us that a currency has three roles: a medium of exchange, a store of value, and a unit of account.

The share of a certain currency in world trade is often used as a measure of a currency's global importance as a medium of exchange. Yet this is not an appropriate yardstick for the euro, since intra-eurozone trade is not included in international trade statistics, even though it accounts for a large portion of trade for EU member states.

The same problem arises when trying to measure the medium of exchange role by the volume of trade in foreign exchange markets. Since the introduction of the euro, transactions between member state currencies are no longer counted as transactions between foreign currencies. This has had the effect of depressing the share of the euro as counterpart to foreign exchange transactions<sup>9</sup>.

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<sup>8</sup> Financial Times, Friday November 9 and Monday October 14, 2002. Henning (2002b) discusses the possibility of private capital inflows into the US drying up, as they did in 1987.

<sup>9</sup> This can also help explain why the euro declined in value against the US dollar. Generally, asset holders diversify their holdings between domestic and foreign currencies. After the introduction of the euro, all the member state currencies that became the euro were no longer foreign currencies. As a result, the ratio of foreign currency denominated assets fell in the portfolios of international investors. Their effort to hold foreign assets at the original pre-euro proportion led to higher demand for the US dollar as a foreign asset, in

Using the euro's share of foreign reserves as a measure of its use as a store of value is subject to the same caveat. After the introduction of the common currency, reserves held by member states in the form of other member state currencies were classified as asset holdings denominated in domestic currency. It is therefore not surprising that the share of foreign reserves held in member state currencies declined after the introduction<sup>10</sup>.

A measure that is related to foreign reserves is the exchange rate regime. This reflects euro's international use more accurately. There are over thirty countries other than the Eurozone countries that have exchange rate regimes that involve the euro in some form or other<sup>11</sup>. On October 9<sup>th</sup> 2002, the European Commission stated ten countries would be concluding membership negotiations by the end of the year. Of these ten, Bulgaria, Estonia and Lithuania have a currency board with the euro. Malta has a currency basket made up of the euro, Sterling pound and US dollar, while Cyprus maintains an exchange rate band against the euro. Furthermore, Bosnia Herzegovina fixes the exchange rate against the euro, while the euro is legal tender in Kosovo and Montenegro.

In the private sector, there was a marked increase in euro denominated bond issuance in 1999, which can be interpreted as an increase in the use of the euro as a store of value. This increase was due to changes in management style in the Eurozone area, for which the introduction of the euro was partly responsible. Due to the common currency, cross-border price comparisons became much easier, which increased competition. Larger private firms increased M&A activity, and began to focus more on shareholder returns. In addition, the euro bond market is much larger than the individual legacy

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exchange for the euro. Hence the euro depreciation against the dollar.

<sup>10</sup> The IMF (2000) uses the term "euro legacy currencies", and concludes that if the re-classification of euro legacy currency holdings is taken into account, the weight of the euro as a reserve currency did not change from 1998 to 1999. According to the report, euro holdings made up 12.5% of all international holdings at the end of 1999, and 12.7% at the end of 2000, trailing only the US dollar. The dollar has increased its share in the last 10 years, having increased its share from 50.6% in 1999 to 68.2% in 2000. The conclusions hold true for developing and developed countries. One might add that the Japanese yen has lost ground in the last 10 years, going from 9% to 6% for developed countries, and 6% to 4% for developing countries.

<sup>11</sup> According to the CIA World Factbook, as of January 2002, Andorra, French Guinea, Guadeloupe, Martinique, Mayotte, Monaco, Reunion, San Pierre-en-Miquelon and San Marino use the euro as legal tender. Benin, Burkina Faso, Cameroon, the Central African Republic, Chad, Comoros, the Congo, the Ivory Coast, Equatorial Guinea, French Polynesia, Gabon, Guinea-Bissau, Mali, Niger, Senegal, Togo, New Caledonia, and Wallis and Futuna Islands fix their currencies to the euro. In addition, Jordan has its currency pegged to a currency basket that includes the euro. Eric Teo Chu Cheow of the Singapore Institute of International Affairs reminds us that the Singapore dollar is linked to a basket comprising the euro, the US dollar and the yen.

currency markets. Thus the euro's introduction made it possible for much higher sums to be raised through bond issuance<sup>12</sup>.

In the first six months of 1999, euro bond issues totaled €325.3 billion, or 3.5 times the amount issued in the same period a year before. This was slightly higher than the amount of dollar denominated bond issues, which totaled €324.9 billion in the same period. If we look at the total amount of issuance between the beginning of 1999 and March 2001, euro denominated bond issues totaled €1740 billion, while there were €1680 billion worth of dollar denominated bond issues. Although bond issues by Eurozone governments are included in this figure, the real driving force behind the increase is private sector M&A activity. In 1999, bonds issued by European companies totaled \$265.6 billion, an increase of 130% on the previous year, of which \$120.3 billion worth were euro denominated, a ten-fold increase.

Even outside the EU, euro denominated bond issues doubled between 1998 and 1999. Euro denominated emerging market bond issues increased to €3.5 billion in the first half of 1999, which eclipsed the issue of dollar denominated bonds, at \$1.8 billion. Notable issues were the €20 million issue by Chile Telecom and Argentine Telecom and the €200 million issue by Petrolios Mexicanos. The Brazilian, Mexican, and Kazakh governments, as well as electric utilities from Korea and Estonia also issued euro denominated bonds.

An important consideration for bond issuers is the interest rate differential between the euro and US dollar. Another is the exchange rate. The weakening euro negatively affected issues between 1999 and the first half of 2000. Investors feared buying euro-denominated bonds, which may result in exchange rate losses. According to the BIS Quarterly Review March 2001 and 2002, euro denominated bond issues (equivalent to \$600.8 billion) surpassed dollar issues (at \$546.3 billion) in 1999, but in 2000 and 2001, dollar issues (\$609.3 and \$652.8 billion respectively) surpassed euro issues (equivalent to \$470.6 and \$597.5 billion respectively).

However, this does not change the firm international position of the euro as a currency in which to issue bonds. In March 2000, the Mexican government issued €1 billion worth of 10-year bonds, and the Venezuelan government issued €500 million worth of 5-year bonds. More recently, it has been reported that Iran was considering holding a portion of its \$17 billion foreign reserves in euros<sup>13</sup>. Between April and June of 2002, the

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<sup>12</sup> For instance, Olivetti acquired Telecom Italia in 1999 for €31.3 billion, an amount that could not have been absorbed by the Italian lira bond market. Their initial issue of euro denominated bonds of €9.4 billion is said to have been the largest issue ever, and a total of €16 billion were raised in to help pay for the acquisition by issuing euro bonds.

<sup>13</sup> Iran also issued euro denominated government bonds in July 2002, and has expressed

share of euro denominated bond issues was 47% of all issues, or 6 percentage points above that of dollar issues. Compared to the first quarter, there was a decrease of 23% in the issue of bonds in all denominations, but euro issues only decreased by 15% while dollar issues decreased by 35%.

The movement of the euro's exchange rate against the dollar and yen will continue to capture our interest. Yet a currency's status as a widely used key currency does not have a one-to-one relationship with the 'strength' or 'weakness' of a currency's external value. The US dollar is an excellent example. As discussed above, the use of a currency as a store of value, a unit of account, and a medium of exchange depends on factors such as the interest rate differential, exchange rate stability and how costly it is to buy that currency. A currency is costly to buy if it is "strong". Yet another important element of this cost is lack of liquidity<sup>14</sup>. Strength and stability are necessary, not sufficient conditions for a key currency. In other words, if a currency is a key currency, it is stable and strong. But just because these conditions are met, it does not mean that the currency is a key currency. The reason the Swiss Franc is not a key currency even though it is a strong, stable currency is because the Swiss Franc market is relatively illiquid. The Dutch guilder was also not a key currency for the same reason.

#### Lessons for Asian Monetary Union

Since the Asian Financial Crisis, there has been much debate on the optimal exchange rate regime for small open economies. The possibility of Japan taking a leadership role, expanding the role of the yen, and creating a monetary union in Asia along the lines of the emu has been raised. The Chiang Mai Initiative, announced in 2000, seemed to encourage the movement in this direction<sup>15</sup>.

Yet Asia is very different from Europe. There is no concept of a unifying 'Asia', which is comparable to the European's view of 'Europe'. Europe has a common history dating back to ancient Greece and Rome, something that is missing in Asia. While there was a teleological sense of self-determination in the creation of an integrated Europe, there

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its intention to start settling transactions such as trade payments in euros. More recently, it has been reported that the government of North Korea has ordered that all US dollar holdings by its residents be exchanged into euro holdings.

<sup>14</sup> Here, 'liquidity' in a market means the volume of trade, as measured by number and/or monetary value of transactions. When this is high, the cost of trading in that currency is low because the traders can easily find counterparts of their desired transactions.

<sup>15</sup> Henning (2002a) gives a detailed account and assessment of the Chiang Mai Initiative.

is a tendency for Asians to be more fatalistic, accepting things as they come about. The common history and the teleology were essential in the push for 'ever closer union' after World War II and eventual monetary integration in Europe. European unification and monetary integration took fifty years; Asian monetary integration will most likely take as long, if not longer.

There is, of course, no need for the long-term goal of Asian monetary integration to take the same path as emu. In other words, the sequence of events does not have to be the same; starting with cooperation over mineral resources, followed by atomic energy, and finally economic and monetary unification. Asia should work out how to pursue integration in its own way.

However, we must remember that when it comes to fixing exchange rates, we are dealing with markets. Experience has taught us that if the markets do not find the fixed exchange rate to be credible, the rate will be attacked and collapse in the blink of an eye.

There are three closely related reasons why European monetary integration was able to win the confidence of the markets. They are (1) the commonly shared history, (2) the existence of successfully established EU-level institutions, and (3) the credibility of the policy authorities driving integration forward. The authorities had credibility because they were perceived to be willing to sacrifice other objectives in the pursuit of integration. For example, the Deutsche Mark was arguably the most important national symbol to postwar Germany.

For Asian monetary integration to become a reality, Japan must promote the freedom of trade and investment, as well as the creation of institutions to support these efforts. Such activities will promote mutual understanding and trust, and create momentum towards integration in Asia. Yet, the most important requirement is to remove any doubt that Japan is committed to integration. Japan's commitment will become credible only if Japan persisted in the path towards integration, even if that meant giving away something precious in return. When Japan, with its 1400 trillion yen in private assets, 180 trillion yen in foreign assets, and \$400 billion in reserves, provides loans and swap arrangements, it will not be interpreted as a sign of Japan's readiness to pay the price for integration. Only by making dear sacrifices will Japan's commitment gain credibility.

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