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Enlargement and the international role of the euro¹

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ABSTRACT

How will enlargement of the European Union (EU) affect prospects for the euro as an international currency? Previously, I have argued that Europe's joint currency is fated to remain a distant second to America's greenback long into the foreseeable future because of three structural factors – relatively high transactions costs, due to inefficiencies in Europe's financial markets; a serious anti-growth bias built into the institutions of Economic and Monetary Union (EMU); and, most importantly, ambiguities at the heart of the monetary union's governance structure. In this essay I extend my earlier analysis, focusing in particular on the impact of enlargement on the governance structure of EMU. From the start, internationalization of the euro has been retarded by a lack of clarity about the delegation of monetary authority among governments and EU institutions. The addition of a diverse collection of new members, with significantly different interests and priorities, can only make the challenge of governance worse, exacerbating ambiguity at the expense of transparency and accountability. Enlargement will diminish, not expand, the euro's attractiveness as a rival to the greenback.

KEYWORDS

EMU; the euro; monetary governance; currency internationalization; EU enlargement.

I. INTRODUCTION

How will enlargement of the European Union (EU) affect prospects for the euro as an international currency? Will the addition of a dozen or possibly even more new members to the Economic and Monetary Union (EMU) enhance the euro's ability to challenge the US dollar for global monetary supremacy? Previously, I have argued that Europe's joint currency

is fated to remain a distant second to America's greenback long into the foreseeable future (Cohen, 2003). In this essay I extend my earlier analysis to consider the impact of enlargement on the euro's international role. My conclusion now is, if anything, even more skeptical than before. Enlargement, I submit, will diminish, not expand, the euro's attractiveness as a rival to the greenback. The dollar will remain the only truly global currency.

To date, progress in building a global role for the euro has been underwhelming. To some extent, this might be due simply to the inertia that is inherent in all monetary behavior – a well documented stickiness in currency preferences. Since the adoption of a new money is costly, involving an expensive process of adaptation, an already popular currency like the dollar enjoys a certain natural advantage of incumbency. My previous work, however, suggests that there are also more fundamental forces at work. Three factors, all structural in character, have been largely responsible for the euro's slow start as an international currency: relatively high transactions costs, due to inefficiencies in Europe's financial markets; a serious anti-growth bias built into the institutions of EMU; and, most importantly, ambiguities at the heart of the monetary union's governance structure. The analysis offered here suggests that adding new members to EMU will, if anything, simply make matters worse. Larger numbers will aggravate the negative impact of all three factors.

Of particular salience is the impact of enlargement on the governance structure of EMU. I am hardly alone in stressing the degree to which prospects for internationalization of the euro are dimmed by EMU's institutional inadequacies. The theme has featured in the work of economists (e.g. Eichengreen, 1998) and political scientists (e.g. Bieling, 2006) alike. From the start, it should have been clear that widespread acceptance of Europe's new currency would be retarded by a lack of clarity about the delegation of monetary authority among governments and EU institutions. My argument here is that the addition of a diverse collection of new members, with significantly different interests and priorities, can only make the challenge of governance worse, exacerbating ambiguity at the expense of transparency and accountability.

The organization of the essay is as follows. The first two sections set the stage for analysis. The first section reviews the story of the euro's internationalization to date, while the second outlines prospects for enlargement of EMU and what the addition of new members could mean for the currency's future. The main analysis then follows in three subsequent sections, addressing in turn the impact of enlargement on each of the three structural factors identified in my previous work. The results and implications of the analysis are summarized in a concluding section.

II. DREAM DELAYED

At its birth, the euro's future as an international currency seemed assured. Yet since the new money's introduction in 1999, acceptance beyond EMU itself has actually been quite slow, limited mainly to the euro's natural hinterland in and around Europe – 'the euro's turf', as economist Charles Wyplosz (1999: 89) calls the nearby region. In many respects, Europe's monetary union has been a resounding success. But in terms of its anticipated challenge to the dollar, performance to date can only be described as disappointing. Beyond the European region, in the global marketplace, the greenback remains as dominant as ever.

Grand ambitions

Europe's ambitions for the euro have always been grand. First and foremost, the joint currency was expected to help promote the EU's long-standing goal of an 'ever closer union among the peoples of Europe'. The benefits would be both practical and psychological. Not only would exchange risk within the group be eliminated, reducing transactions costs that hampered the construction of a single European market. One money for Europe would also provide a powerful new symbol of European identity, enhancing the sense that all Europeans belong to the same emerging community.

But that was never all. For many in the EU, there was an external ambition as well. On the broader world stage, EMU was meant to enhance Europe's role by creating a potent rival to the dollar, the leading international money of our era. Resentment has long simmered among Europeans sensitive to the inordinate power that the greenback's popularity gives to the United States – America's 'exorbitant privilege', in Charles De Gaulle's memorable phrase. Europe is the equal of the United States in output and trade. Why should it not be America's equal in monetary matters, too? Though the 'old dream of enthusiasts' (Zimmermann, 2004: 235) was never formally articulated as such, it was evident from the start. EMU was supposed to challenge the dollar for global supremacy. Wyplosz (1999: 76), an informed insider, calls this 'the hidden agenda of Europe's long-planned adoption of a single currency'.

The stakes were clear. Four distinct benefits are derived from widespread international circulation of a currency, supplementing internal gains: (1) a potential for seigniorage (the implicit transfer of resources, equivalent to subsidized or interest-free loan, that goes to the issuer of a money that is used and held abroad); (2) an increase of flexibility in macroeconomic policy, afforded by the privilege of being able to rely on one's own currency to help finance foreign deficits; (3) the gain of status and prestige that goes with market dominance, a form of 'soft' power; and (4) a gain of

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

influence derived from the monetary dependence of others, a form of 'hard' power. America had long enjoyed all four benefits. It is understandable that Europeans might desire a piece of the action, too.

Faith in the euro's potential was widespread. Fundamentally, international currency choice is shaped by three essential attributes. First, at least during the initial stages of a money's cross-border adoption, is widespread confidence in its future value backed by political stability in the economy of origin. No one is apt to be attracted to a currency that does not offer a reasonable promise of stable purchasing power. Second are the qualities of 'exchange convenience' and 'capital certainty' – a high degree of liquidity and reasonable predictability of asset prices – both of which are essential to minimizing transactions costs. The key to each quality is a set of broad and efficient financial markets, exhibiting both depth and resiliency.

Third, a money must promise a broad transactional network, since nothing enhances a currency's acceptability more than the prospect of acceptability by others. Historically, this factor has usually meant an economy that is large in absolute size and well integrated into world markets. The greater the volume of transactions conducted in or with an economy, the greater will be the economies of scale to be derived from use of its currency. Economists describe these gains as a money's 'network externalities'. Network externalities may be understood as a form of interdependence in which the behavior of one actor depends strategically on the practices adopted by others in the same network of interactions.

Europe's new currency was set to begin life with many of the attributes necessary for competitive success. Together, prospective members would provide an economic base roughly comparable to that of the United States, enjoying extensive trade relations around the world. The potential for network externalities, therefore, was considerable. Likewise, EMU would start with both unquestioned political stability and an enviably low rate of inflation, backed by a joint monetary authority, the European Central Bank (ECB), that was fully committed to preserving confidence in the euro's future value. Much room existed for a successful challenge to the dollar, as frequently predicted. Typical was the view of Robert Mundell (2000: 57), a Nobel laureate in economics, who expressed no doubt that the euro 'will challenge the status of the dollar and alter the power configuration of the system'. The conventional wisdom was unambiguous. The markets would ultimately elevate the euro to a top rank alongside the greenback. In the oft-quoted words of Jacques Delors, when he was head of the European Commission, *'le petit euro deviendra grand'*.

In fact, the only question seemed to be: How soon? Most analysts understood that the process would take time, owing to the natural advantage of incumbency. It took the dollar, for example, more than a half century to surpass sterling as an international currency, long after America emerged as the world's richest economy. However long it might take, though, the

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

process was expected to start quickly. Not everyone agreed with the optimistic forecast of Fred Bergsten (1997), a former US Treasury official, who predicted that Europe's new currency would achieve 'full parity' with the dollar in as little as 5–10 years. But few doubted that within such a time frame, significant signs of a shift toward the euro would become evident. By now, nearly a decade after the euro's introduction, the displacement of the dollar should clearly have begun.

The story so far

So what is the story so far? Viewed purely in exchange-rate terms, the euro's record of performance has been mixed. From an opening value of \$1.17 the currency initially drifted downward, sinking to a low near \$0.83 by mid-2000 and subsequently languishing at well below par for upwards of 2 years. In mid-2002, however, the euro began an impressive recovery, climbing decisively to a high above \$1.35 in 2004 before drifting down again in 2005, then up again in 2006. By mid-2007, the euro was once again above \$1.35.

Exchange rates, however, are not the issue. A currency's price is at best an imperfect indicator of its international status. What really matters is not price but *use*: the extent to which a money is voluntarily chosen by market actors outside EMU for the standard functions of medium of exchange, unit of account, and store of value. Central banks, of course, may also adopt the euro, as an intervention medium, currency anchor, or as part of their foreign reserves. But currency use by state actors understandably tends, for efficiency reasons, to reflect prevailing market practice. In the absence of political pressures, central banks prefer to use a currency that will be most helpful to them in managing their exchange rates and monetary policy. The key issue, therefore, is what happens to the preferences of *private* actors. If the euro is ever truly to challenge the dollar, it will be by displacing the popular greenback for any or all of the traditional roles of money in the broad global marketplace.

Viewed in these terms, there is little evidence yet of any significant progress. The expected fast start has not occurred. As of January 2008 the euro zone, as it is commonly known, will comprise 15 EU members. A look at the available data suggests that in most categories of international use (adjusting for the elimination of intra-EMU transactions) the euro has managed to hold its own as compared with the past aggregate shares of EMU's 'legacy' currencies. Hence, Europe's new money has easily taken its place as successor to Germany's old Deutschmark (DM), which among international currencies had already attained a rank second only to the dollar. But that is about all. As economist Hélène Rey (2005: 114) concludes, the euro 'has established itself immediately as the second most important currency in the world ... It has not, however, displaced in any significant

way the dollar as the currency of choice for most international transactions'. Indeed, after an initial spurt of enthusiasm, use in most market segments has actually leveled off or even declined in recent years (ECB, 2007). Worse, the only significant gains to date have been in the European Union's immediate neighborhood, including the EU's newest members before they joined, as well as other actual or potential candidate countries. In the words of the European Central Bank (2007: 7), a 'strong institutional and regional pattern continues to characterise the internationalisation of the euro'. Globally, Europe's new currency remains in the dollar's shadow.

The clearest indicator of a money's international status is the amplitude of its use as a medium of exchange in the foreign-exchange market, where average daily turnover now exceeds some \$2 trillion worldwide. Top currencies are bought and sold not only for direct use in trade and investment but also as a low-cost intermediary – a 'vehicle' – for the trading of other currencies. A vehicle role is a direct consequence of high market turnover, which yields substantial economies of scale. Typically, it will be less expensive for a market agent to sell a local money for a vehicle currency and then use the vehicle currency to buy the needed foreign money than it would be to exchange one infrequently traded money directly for another.

No currency has more market turnover than the dollar, reflecting the large size of the US economy and its leading role in world trade. The low transactions costs that result from high market volume explain why the greenback has long been the most favored vehicle for global currency exchanges, appearing on one side or the other of some 93 percent of all transactions in 2005–2006 (ECB, 2007). The euro, by contrast, entered on one side of just 39 percent of all transactions. That was higher than the share of the Deutschmark, which had appeared in 30 percent of transactions in 1998 (its last year of existence) but lower than that of all euro's legacy currencies taken together (53 percent) and actually down from a high of 41 percent in 2004–2005 (ECB, 2007). Only in trading in the Nordic countries and East-Central Europe, where commercial ties are largely concentrated on the EU, is the euro clearly the favored vehicle.

The greenback also remains the most favored vehicle for the invoicing of global trade, which adds the role of unit of account (currency of denomination) to that of medium of exchange (currency of settlement) for international contracts. Overall, the dollar is estimated to account for nearly half of all world exports – more than double the US share of world exports. The DM's share of trade invoicing in its last years, prior to its replacement by the euro, was 15 percent, roughly equivalent to Germany's proportion of world exports. Evidence from the International Monetary Fund (Bertuch-Samuels and Ramlogan, 2007) suggests that this share was maintained by the euro after its introduction in 1999 but has not yet shown any sign of increase except in neighboring European countries.

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

Likewise, the dollar remains the most favored store of value in global capital markets, where the euro has yet to catch on significantly as an investment medium for international portfolio managers. There has been some increased use of the euro as a financing currency (a vehicle for borrowing). Non-European borrowers have been attracted by the opportunity to tap into the much broader pool of savings created by the consolidation of EMU. Overall, the share of the euro in the stock of international debt securities rose strongly, from roughly a fifth in 1999 to nearly half by the end of 2005, before falling back by a few percentage points in 2006 (ECB, 2007). But again, most of the increase came from immediate neighbors (mainly recent or prospective EU members). Borrowers in Asia and Latin America continue primarily to use the dollar. Moreover, these developments represent growth only in the *supply* of euro-denominated assets. On the demand side, foreign investors so far have been slower than anticipated to add to their holdings of euro-denominated assets, despite the greater depth and liquidity on offer. Most issues have been taken up by European investors, making them in effect 'domestic'. Outside EMU, the euro's overall share of portfolios has changed little from the previous aggregate of legacy currencies. Similar patterns have also prevailed in international banking markets (ECB, 2007).

So far, therefore, the story is unencouraging – certainly not the happy outcome that so many had predicted. The old dream has been delayed. Other than within the European region itself, use of Europe's new currency has shown little sign of growth and may indeed have already begun to settle down. All this is a far cry from attaining full parity with the dollar in as little as 5–10 years.

III. DREAM REVIVED?

Yet despite the euro's disappointing performance to date, hope lives on, now buoyed by the prospect of a significant increase of membership. Enlargement of the EU will mean, in time, an expanded EMU, too. Bigger, it is said, will also be better. Greater numbers will enhance the currency's power and prestige, increasing its attractiveness as a rival to the dollar. Europe's grand dream has been revived.

Enlargement

The European Union's enlargement in May 2004 added ten new 'accession countries', bringing total membership of the EU to 25. Two more neighbors, Bulgaria and Romania, joined in January 2007; and yet others, including more successor states of the former Yugoslavia and even Turkey, hope to follow in the more or less distant future. All are legally obligated, sooner or later, to adopt the euro. The only question is when.

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

Upon entering the EU, each accession country is automatically enrolled in EMU with a 'derogation'. Simply put, derogation means that adoption of the euro is mandatory but only when the country is deemed ready. Several critical conditions must be satisfied first – the same so-called convergence criteria that were demanded of present participants before they could join EMU. The convergence criteria were first spelled out in the 1992 Maastricht Treaty (Article 109j), which brought the euro into existence. The four familiar conditions are:

1. Relative price stability – in practical terms, an average rate of consumer price inflation, observed over a 1-year period, that does not exceed by more than 1/2 percentage points the average rate of inflation in the 'three best performing Member States in terms of price stability';
2. interest-rate stability – in practical terms, a year-average nominal interest rate on a 10-year benchmark government bond no more than two percentage points above the average in the three best performing member states;
3. fiscal stability – specifically, a fiscal deficit below 3 percent of GDP and public debt totaling less than 60 percent of GDP; and
4. exchange-rate stability – specifically, participation in the pegging arrangement known as the Exchange Rate Mechanism (ERM) for at least 2 years while the country's currency trades against the euro without severe tensions, within 'normal fluctuation margins'. Because the present Exchange Rate Mechanism is a successor to an earlier arrangement that existed before 1999, it is usually referred to as ERM2 to distinguish it from its predecessor.

It is not expected that all accession countries will manage to satisfy the necessary conditions at the same pace. Key is the exchange-rate criterion. To date, only eight of the 12 new members admitted in 2004 and 2007 have even tried to commit formally to ERM2. These are Bulgaria, Estonia and Lithuania, which carried over their long-standing currency boards anchored on the euro; Cyprus, which already had a firm euro peg; Latvia and Malta, which converted basket pegs to the euro; and Slovakia and Slovenia, which moved from managed flexibility to stable euro pegs. The largest accession countries – the Czech Republic, Hungary, Poland, and Romania – so far have opted to preserve a higher degree of exchange-rate flexibility.

Accordingly, target dates for adoption of the euro vary considerably. The first to make the move were Slovenia, which joined the zone in January 2007, and Cyprus and Malta, which will enter in January 2008. Estonia, Latvia, and Lithuania had all hoped to join in 2007 or 2008 but have been forced to postpone because of excessively high inflation rates. Slovakia has tentatively penciled in January 2009 but may also postpone, while Bulgaria and the Czech Republic have in mind 2010 at the earliest. Hungary has

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

abandoned its target of 2010 without rescheduling. Poland and Romania have not even tried yet to set a timetable for joining.

Goals have slipped because disillusionment with the euro is on the rise, especially in the larger accession countries. Adoption of the euro was once viewed as a badge of honor. But policy makers have come to understand, as one recent study puts it, that while 'membership has its benefits . . . these benefits are not free. Being part of a currency union requires discipline, and the loss of the exchange rate as an instrument for coping with economic shocks can be costly' (Ahearne and Pisani-Ferry, 2006: 1). The convergence criteria are proving a very tough hurdle. Moreover, resistance is spurred by concerns over the prospective loss of monetary autonomy. In some instances, adoption could be delayed for years.

Much, obviously, remains uncertain. All we know for sure is that, sooner or later, the number of economies in the euro zone is supposed to be a lot bigger than it is now.

Size matters, but . . .

But will bigger really be better? The case for such a presumption seems clear. Larger numbers will mean an even broader transactional network, increasing exponentially the potential for network externalities. Hence, conclude many, the euro is bound to grow even more attractive as a rival to America's greenback. That is the logic of Mundell (2000: 60), for example, who has argued that 'the outlook for the euro is very favorable [because] as the EU expands into the rest of Central Europe, the euro will have a substantially larger transactional domain than the dollar'. Likewise, it is the logic of Jacques de Larosière (2002: 15–6), former managing director of the International Monetary Fund (IMF). 'The euro's position as a reserve currency will progress in the future', de Larosière asserts, because 'with the monetary integration of candidate countries to the European Union, we see the geographic reach of the euro is likely to expand considerably'. Prospects for Europe's money as an international currency are assumed to depend directly on the absolute size of its economic base.

Nowhere is the logic clearer than in the writing of Fred Bergsten, long one of the euro's biggest boosters. What qualifies a currency for international status? 'There is good reason', Bergsten (1997: 25, 27) contends, 'to believe that the relative size of key currency countries' economies and trade flows is of central salience. . . . The sharp increase in the size of the economy and trading unit underlying the European key currency could produce a quantum leap in the international role of that asset'. The old DM had first gained widespread acceptance when Germany accounted for no more than 9 percent of world output and 12 percent of world trade. The 12 original members of EMU would more than double both ratios; enlargement is adding even more. A dramatic rise in euro use, therefore, should

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

be expected as well. In Bergsten's (1997: 27) words: 'In the eventual steady state, a rise of 65–250 percent in the size of the relevant economic base could be expected, which would expand the potential size of the currency's role by 30–335 percent'.

Arguments like these, however, are far too simplistic to be taken seriously. As economist Barry Eichengreen (1997: 50, 52) has noted in a comment on Bergsten: 'This argument allows no role for other determinants. . . . One cannot forecast the international role of the euro simply by replacing a Germany that accounts for 9 percent of world output with an EU that accounts for 31 percent'. Size no doubt matters. Economies as small as, say, Norway or Sweden could never realistically hope to see their currency compete for global status. Patently, the network externalities would be too limited. But while a large economic base may be necessary, it is hardly sufficient. For a period in the 1980s, Italy's GDP surpassed that of Britain. No one, however, rushed to substitute lire for sterling as a vehicle for trade or investment. Clearly other factors matter, too.

IV. TRANSACTIONS COSTS

What are these factors? As indicated, my previous work suggests that three factors, in particular, have played a crucial role in the euro's story so far – transactions costs, an anti-growth bias, and issues of governance. The question is: How will enlargement affect each of the three? In each instance, my answer is unequivocal: Larger numbers will simply make matters worse. Enlargement will delay even more Europe's grand dream for the euro.

Market segmentation . . .

Begin first with transactions costs – the cost of doing business in euros. Transactions costs directly affect a currency's attractiveness as a vehicle for exchange transactions or international trade. At its birth, Europe's new money obviously offered a large and expanding transactional network, thus promising substantial network externalities. But even so, it was clear that the dollar would be favored by the natural advantage of incumbency unless euro transactions costs, which began high relative to the widely traded greenback, could be lowered to a more competitive level. The same scale economies that encourage use of a currency in the first place are also responsible for what specialists call 'hysteresis' or 'ratchet effects'. Adoption of a new currency tends to be resisted unless the money can be expected to be truly cost-effective.

From the start it was understood that the cost of doing business in euros would depend directly on what could be done to improve the structural efficiency of Europe's financial markets. The point was put most cogently

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

by economists Richard Portes and Hélène Rey (1998: 308): 'The key determinant of the extent and speed of internationalization of the euro will be transactions costs in foreign exchange and securities markets'.

On the face of it, prospects for euro transactions costs looked good. In purely quantitative terms, introduction of the new currency promised to create the largest single-currency capital market in the world. That expansion, in turn, was expected to trigger major qualitative improvements in depth and liquidity, knitting previously segmented national markets together into an integrated whole. As matters have turned out, however, Europe's reach has fallen considerably short of its grasp.

In practical terms, admittedly, much has been accomplished despite some foot-dragging by member governments. Integration at the retail level – the realm of bank accounts, mortgages, insurance policies, and the like – continues to be impeded by a plethora of interconnected barriers, including a diversity of settlement systems that fragment liquidity and reduce transactional convenience (Berglöf *et al.*, 2005). But change clearly has been significant at the wholesale level where, in the words of *The Economist* 'financial markets in Europe became much more integrated and more interesting' (*The Economist*, 2005: 10). The elimination of exchange risk inside the euro zone has intensified competition among financial institutions, encouraging cost-cutting, innovation, and consolidation. Progress has been particularly impressive in short-term money markets, syndicated bank lending, credit derivatives, and the corporate bond sector.

Nonetheless, it is evident that the dollar's cost advantage will persist so long as the EU is unable to offer a universal financial instrument that can match the US Treasury bill for international investor liquidity and convenience. This is a deficiency that will be difficult, if not impossible, to rectify so long as Europe, with its separate national governments, lacks a counterpart to the Federal government in Washington. Under the circumstances, the best the Europeans could do was to encourage establishment of selected benchmark securities for the public debt market. Gradually three euro benchmarks have emerged: the German Bund at 10 years, the French bond at 5 years, and the Italian bond at 2 years (Rey, 2005: 112). But such a piecemeal approach falls far short of creating a single market as large and liquid as that for US government securities. Full consolidation of the public debt market remains stymied by variations in legal traditions, procedures, issuance calendars, and primary dealer systems.

Notably, yield differentials in the public debt market have shrunk significantly since the euro was born, suggesting that interchangeability among national issues has increased somewhat. But the convergence of yields is far from complete. Investors continue to treat the debts of EMU governments as imperfect substitutes, mostly owing to differences in perceived default risk (Codogno *et al.*, 2003). And these differences of perception could eventually be compounded as a result of a decision by the ECB in

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

November 2005 to limit the collateral it will accept in refinancing ('repo') operations with European commercial banks. Previously, the ECB had accepted all euro-zone government bonds indiscriminately, as if the debts of EMU member states were all equally creditworthy. Now, however, the Bank intends to be more selective. Bonds must have a single A-rating or better from at least one of the three main rating agencies (Moody's, Standard and Poor's, and Fitch). Observers expect that this decision will lead commercial banks, over time, to be much more selective in their choice of issues, accentuating yield spreads (*Financial Times*, 9 November 2005).

On balance, therefore, segmentation of the public debt market has proved difficult to overcome; and that, in turn, means that the cost of doing business in euros remains a drag on the currency's attractiveness. Though efficiency gains in financial markets have been substantial, they clearly are insufficient on their own to significantly improve the euro's cost-effectiveness relative to the dollar. Owing to the greater liquidity and convenience of the US Treasury bill, America's greenback continues to benefit from the advantages of incumbency.

... Prolonged

None of this will be improved by enlargement. Indeed, the reverse is more likely to be true. Larger numbers, obviously, will make it even more difficult to overcome the segmentation of Europe's public debt market. The variety of securities, procedures, and dealer systems will become even more pronounced. Likewise, spreads are likely to diverge even more as compared with yields on the issues of present EMU members. The euro zone will be even further from creation of a universal instrument comparable to the US Treasury bill.

Indeed, larger numbers could even slow the pace of financial-market integration generally. The main reason is the more primitive level of development of institutions and regulatory arrangements in accession countries, as compared with EMU's original members. Banking systems, exceptionally, are relatively advanced due to widespread foreign ownership. In the 1990s, banks in the Baltic states and East Central Europe were largely privatized. Most ended up in foreign hands, bringing immediate benefits in terms of fresh capital and innovation. Other sectors, however, have lagged behind, especially markets for equities and derivatives. Regulatory and supervisory systems, despite efforts at modernization, are still largely deficient in such key areas as the assessment of credit risk (Schadler *et al.*, 2005: 41–2). Weaknesses like these are likely to encourage foot dragging by new members even more pronounced than that of existing EMU members, for two reasons.

First is the sheer cost of the adjustments that will be required to knit new entrants into the euro zone's nascent capital market. Since they start from

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

a lower level of development, they will need even more extensive reforms at both the retail and wholesale levels in order to get up to speed. But since these are by no means rich economies, governments could prove to be even more stubborn in their resistance to further market-opening measures.

Second is the higher risk of financial crisis in accession countries as they move into the euro zone. Most of these economies offer relatively high rates of return on capital, making them attractive targets for investment. Analysts generally expect that with the elimination of exchange risk, there will be even greater incentives for capital inflows, which eventually could generate overheating, asset price bubbles, and unsustainable increases of indebtedness. The risk is concisely summarized by a recent IMF study (Schadler *et al.*, 2005: 56, 65–6): ‘Rapid credit growth looms on the horizon for each [accession country] . . . A critical concern with rapid credit expansion is the risk of banking distress or even a banking crisis . . . Adjustment in the aftermath of overheating or asset price bubbles may well be difficult without an exchange-rate instrument to effect needed changes of relative prices’. Worries about such vulnerabilities could make governments even less willing to rush into the process of financial integration.

For both reasons, the path to efficiency gains in financial markets could be even more obstructed than in the present EMU. If anything, enlargement will prolong the segmentation of most financial markets in the euro zone, not just the public debt market. Significant reductions in the cost of doing business in euros, therefore, will long remain beyond Europe’s grasp.

V. ANTI-GROWTH BIAS

A second critical factor inhibiting the internationalization of the euro is a serious anti-growth bias that appears to be built into the institutional structure of EMU. By impacting negatively on yields on euro-denominated assets, this bias directly affects the currency’s attractiveness as a long-term investment medium.

When EMU first came into existence, eliminating exchange risk within the European region, a massive shift was predicted in the allocation of global savings as compared with holdings of European assets in the past. Yet as the ECB (2007) has ruefully noted, international portfolio managers have been slow to move into the euro. Liquid funds have been attracted when there was prospect of short-term appreciation. But underlying investor preferences have barely budged, in good part because of doubts about prospects for longer-term economic growth in the euro zone. In turn, one of the main causes for such doubts seems to lie in the core institutional provisions of EMU governing monetary and fiscal policy, the key determinants of macroeconomic performance. In neither policy domain is priority attached to promoting real output. Rather, in each, the main emphasis is on other considerations that tend to tilt policy toward restraint, imparting

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

a distinct anti-growth bias to the euro zone as a whole. As *The Economist* (29 April 2006: 38) laments, the euro 'has provided currency stability but has done little to promote growth'. Opportunities for future investment returns are therefore more limited than they might be otherwise.

Here too there is reason to believe that enlargement will simply make matters worse. Overall, the economies of accession countries may be small as compared with older members. Together, the EU's newest members have added no more than 10 percent to the GDP of the economic union as a whole. Nonetheless, the entrance of new members into the euro zone can be expected to tilt monetary and fiscal policy even more toward restraint, further dampening investment returns.

Monetary policy

On the monetary policy side, the European Central Bank, unlike many other monetary authorities, was created with just one policy mandate – to maintain price stability. Moreover, the ECB is formally endowed with absolute independence, largely insulating it from political influence. Legally, the ECB is free to focus exclusively on fighting inflation, even if over time this might be at the cost of stunting real growth. In practice, naturally, the ECB is not wholly insensitive to growth concerns. Nonetheless, the overall orientation of ECB priorities is clear. Summarizes Hannes Androsch (2007: 48), formerly finance minister of Austria: 'The ECB is obliged to focus on fighting inflation, not promoting general economic development, and they are overdoing it. . . . We are not fully using the growth potential I think Europe has'.

With enlargement, the ECB's restrictive bias may be expected to become even more pronounced owing to an inherent tendency toward higher inflation in the EU's new member economies. All of the accession countries are relatively poor as compared with the older partners. All will be seeking to catch up to the income levels of the more advanced economies by promoting productivity gains in key sectors. Generally, in such situations, productivity gains tend to be more rapid for tradable goods (exports and import-competing production) than for nontradables, since tradables face the most competition and tend to attract the largest share of technology-intensive foreign direct investment. However, as wages in the tradables sectors rise with productivity, they also bid up wages in nontradables production, which in turn forces up the prices of nontradables relative to those of tradables. The result is an increase of aggregate inflation even though tradables prices are held down by competition from abroad – a process known as the Balassa–Samuelson effect.

The pressures of the Balassa–Samuelson effect are already evident in many of the accession countries, including most notably the three Baltic states, all of which have been forced to postpone entry into the euro zone

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

because of high inflation. Only a few, such as the Czech Republic and Slovenia, have come even close to matching the low inflation experience of the EU's best performing economies. True, all the new members are making a determined effort to keep prices under control. With luck, most eventually may even be able to compress their inflation rates long enough to meet the first of the Maastricht Treaty's four convergence criteria (relative price stability). Once inside EMU, however, they almost certainly will find it difficult to suppress sustained price increases for long.

Over time, higher inflation in the accession countries could be avoided only by allowing an appreciation of their nominal exchange rate. But once they become part of the euro zone, that option is ruled out *ex hypothesi*. Hence, the average inflation rate for the EMU as a whole will be subject to systematic upward pressure, inducing an even more restrictive monetary policy than has prevailed until now. The ECB can be expected to get even tougher in fighting inflation. That in turn will lower even more prospects for growth of returns on euro-denominated assets.

Fiscal policy

The story is much the same on the fiscal policy side, where euro-zone governments have formally tied their hands with their controversial Stability and Growth Pact (SGP). The SGP, first set up in 1997, was intended to implement the 'excessive deficit procedure' called for by the Maastricht Treaty (Article 104c). In effect, it extrapolates from the third of the Treaty's four convergence criteria (fiscal stability) to the period after countries join the euro zone. The key provision is a strict cap on national budget deficits at 3 percent of GDP. The tight restraint makes it difficult for elected officials to use budgetary policy for contracyclical purposes, to offset the anti-growth bias of monetary policy.

Here also, we know, practice has increasingly diverged from principle, with a number of EMU's original members – including, most notably, France and Germany – repeatedly missing the SGP's 3 percent target. We also know that little has been accomplished to make the Pact more effective, apart from some limited reforms in 2005. To some, these facts mean that the SGP has no 'bite'. Empirical evidence, however, suggests that for most of EMU's smaller members the Pact has in fact exercised a significant discipline (Annett, 2006). Moreover, can anyone doubt that deficits might be even larger yet in the absence of the SGP? Historically, many EMU governments routinely ran deficits in excess of 3 percent; most had to struggle to qualify for membership in the first place. De facto, therefore, if not de jure, the SGP straitjacket remains a constraint on euro-zone countries, perpetuating an anti-growth bias in fiscal policy, too. And here also the restrictive impact is likely to become even more pronounced as EMU grows in size.

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

The reason is simple. EU membership imposes a heavy burden on government budgets. Once they join the club, new members must begin contributing to the central EU budget. They must also conform to all of the requirements of EU legislation, the *acquis communautaire*, which will compel them to increase spending on such vital needs as infrastructure, social services, and environmental quality. Though most will find some of the pressure alleviated by financial assistance from EU institutions, net benefits will be limited by cofinancing requirements. Overall, therefore, there is no doubt that fiscal policy in accession countries will be severely tested. Membership could raise budget deficits by amounts as large as 3 or 4 percent of GDP unless offset by higher taxes or parallel expenditure cuts (Kenen and Meade, 2003: 5–7).

Accordingly, most new members can be expected to be persistently preoccupied with deficit reduction, leaving little leeway for the use of budgetary policy to counterbalance a restrictive monetary policy. Apart from the three countries that have already been admitted to the euro zone (Cyprus, Malta, and Slovenia), only the Baltic states today seem able to live comfortably under the SGP's 3 percent cap. Elsewhere, substantial deficit problems are the rule, particularly in the largest accession countries. Almost certainly, austerity measures will be called for that could have the effect of retarding real growth.

The net impact will be considerable. It may be an exaggeration to claim, as has the president of the Czech Republic, that the rigidities of the SGP will create weak and dependent 'transfer economies' like East Germany after reunification (Klaus, 2004: 176). The outlook need not be that dismal. But for many of the accession countries, budget constraints clearly will be tight. It does not seem unreasonable, therefore, to expect that for entering countries budgetary policy will on balance be tilted even more toward restraint. Overall, the extra fiscal pressures will add substantially to EMU's anti-growth bias, again lowering prospects for improvement of returns on euro-denominated assets.

VI. GOVERNANCE

Finally, there is the governance structure of EMU, which for the euro's prospects as an international currency may be the biggest obstacle of all. The basic question is: Who is in charge? The answer, regrettably, has never been easy. From the start, uncertainty has reigned concerning the delegation of monetary authority among governments and EU institutions. In principle, the distribution of responsibilities is clear. In practice, however, the Maastricht Treaty – being the product of a complex political negotiation – naturally embodies a variety of artful compromises and deliberate obfuscations, resulting in a strikingly high degree of ambiguity about just how the euro zone is actually to be managed. Jurisdictional lines are anything

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

but transparent; the details of accountability are equivocal and obscure. None of this is apt to cultivate a comfortable trust in the euro. Indeed, market actors outside EMU may be excused for hesitating to commit themselves to what looks rather like a pig in a poke – even if transactions costs could be lowered to competitive levels and even if returns on European assets could be significantly improved.

Three key provisions may be cited. First is the governance of EMU's core institution, the European Central Bank. Second is the delegation of responsibility for ensuring financial stability across the euro zone as a whole. And third is the issue of external representation: Who speaks for the euro on the broader world stage?

The European Central Bank

Practical operational control of monetary policy lies in the hands of the ECB's Executive Board, made up of the President, Vice-President, and four other members. Overall managerial authority, however, is formally lodged in the Governing Council, which in addition to the six-member Executive Board include the heads of the central banks of all participating states, each with the same voting rights. From the start, it was understood that the large size and mixed representation of the Governing Council might be inconsistent with efficient or transparent governance.

The issue was obvious. Even before enlargement, the Governing Council – with the six Executive Board members and 12 national governors – was already bigger than the top managerial unit of any other central bank in the world. Observers were quick to question how decisions would be made with so many bodies around the table. Discussions would undoubtedly be time consuming and complicated. In the words of one informed observer (Meade, 2003: 129): 'The mere thought of a *tour-de-table* is exhausting'. Organization theory teaches that the costs of preparing and making policy rises not just in proportion but exponentially with the number of people involved. Hence, the conventional advice is to keep executive units small in order to maximize decision making efficiency. The prescribed size of the Governing Council was almost certainly too great for serious and productive dialogue. The ECB had a 'numbers problem'.

Sooner or later, it seemed, real power would have to devolve to a smaller 'inner' group formally or informally charged with resolving differences on critical issues, as so often happens in large organizations. But who would be included in this exclusive club? Would it be the Executive Board, which might be expected to take a broad approach to the euro zone's needs and interests? Or would it be a select coterie of central-bank governors, whose views could turn out to be more parochial? No one could be sure.

Enlargement simply makes the numbers problem worse. Upon joining the EU, all accession countries immediately gain observer status on the

Governing Council, with voting rights to follow once they adopt the euro. Now that Bulgaria and Romania have become EU members, that puts the number at 30, with even more governors to be added down the road as other candidate governments successfully negotiate their way into the club (or if Britain, Denmark, or Sweden ever decide to join). A gaggle of three dozen or more strong willed individuals could hardly be considered conducive to efficient decision making. As one source (Baldwin, 2001) commented sarcastically, enlargement would leave the Governing Council with 'too many to decide on where to go to dinner, let alone agree on how to run monetary policy for more than 400 million people'. Of particular concern, once EMU was up and running, was the risk that equal voting rights for all Council members would give excessive weight to smaller countries in setting policy parameters (Berger *et al.*, 2004; De Grauwe, 2004; De Haan *et al.*, 2004).

To their credit, Europe's leaders recognized the problem early on and sought to provide a remedy. In March 2003, following a proposal from the ECB, the European Council (comprising the heads of state or government of all EU members) approved a reform of the Governing Council restricting votes to a smaller total on a rotating basis (ECB, 2003). Membership of the Governing Council will continue to include the Executive Board and all national central-bank governors; moreover, all six members of the Executive Board will retain their individual votes. But voting rights of national governors are now to be limited to no more than 15 and will rotate among governors according to a specified formula, taking explicit account of the diversity among member states. The rotation will start in 2008, once total membership of the zone is brought up to 15 with the addition of Cyprus and Malta, and will be implemented in two stages, as follows:

1. With participation of between 15 and 22 member states, euro-zone countries will be divided into two groups, using size as a criterion. Size will be measured by a weighted average of an economy's share in total EU GDP and total assets of monetary financial institutions. A first group of governors originating from the five largest states will receive four votes. The second group of up to 17 governors will receive up to 11 votes.
2. Once participation on the Governing Council moves beyond 22 member states, a third group of up to five governors from the smallest countries will be formed with up to three votes. Correspondingly, the number of voting rights of the middle group will be reduced from 11 to eight. The four votes of the five biggest countries will remain unchanged.

The remedy, however, may be worse than the disease, creating more problems than it solves. On the one hand, the reform leaves intact the large number of bodies at the table. Every national governor, as well as the six Executive Board members, will continue to participate in all policy discussions, with full speaking rights. The approach has been defended on

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

the grounds that it is vital to promoting the legitimacy of the euro enterprise. No other EU institution denies representation to any member state. In addition, it is argued, full participation may be expected to facilitate consensus building and contribute to a better flow of information (Cukierman, 2004: 70). But the approach may also be criticized for perpetuating all the gross inefficiencies of the ECB's numbers problem. As one astute observer (Gros, 2003: 124) puts it, the Governing Council will remain 'more like a mini-parliament than a decision-making body'.

On the other hand, the reform introduces several new ambiguities that add even more uncertainty to decision making at the ECB. How, for instance, will votes rotate within each of the two (eventually three) groups? Will the rules for rotation be the same in all groups? How often will the membership of groups be adjusted as economies change in size? And could the formula for measuring size itself be changed at any time? Transparency is hardly served by such a complex arrangement.

Worse, the reform may well deepen rifts within the Governing Council, since the rotation model is so unabashedly state-based. Votes are allocated strictly along lines of national identity. In principle, governors are supposed to be fully independent professionals operating in a personal capacity, making monetary policy objectively for the euro zone as a whole. In practice, they may now be forgiven for thinking first of their own countries rather than in terms of collective interests. In the words of a prominent German economist (Belke, 2003: 122): 'The reform proposal does not meet the rationale of an integrative monetary policy ... It re-nationalises European monetary policy'. The current president of the ECB, Jean-Claude Trichet, has already more than once been forced to reprimand individual governors for publicly opposing established policies that seemed inconsistent with the needs of their home economies (*New York Times*, 3 February 2006: C6).

Of course, the danger can be exaggerated. In the Federal Reserve's key decision making body, the Federal Open Market Committee (FOMC), participation of district bank presidents is also based on a rotation model that allocates voting rights along geographic lines. Yet few observers worry that individual FOMC members will promote the interests of their regions at the expense of national objectives. The difference, however, is that Federal Reserve districts have nothing like the same sense of identity as do the sovereign states that comprise EMU. National allegiance remains a potent force in Europe that could, consciously or unconsciously, have a major influence on the deliberations of the Governing Council.

The danger would not be so serious if all EMU economies were largely convergent in real terms. The reality, however, is just the reverse. Econometric analysis shows little correlation of output shocks between accession countries, on the one hand, and the older members of the euro zone, on the other (Berger *et al.*, 2004; Hall and Hondroyannis, 2006; Pramora and Tamirisa, 2006). Except for Slovenia and, to a lesser extent, Cyprus,

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

synchronization of business-cycle activity between the two groups appears actually to have weakened since the euro was born (Sadeh, 2006). National policy preferences, therefore, appear likely to diverge sharply as well.

The shame is that an alternative model was at hand that might have avoided many of these problems. Reacting to the ECB's initial proposal, the European Parliament recommended a radically different approach based on a redistribution of authority between the Executive Board and Governing Council. A broader range of practical powers over interest rates and intermediate policy objectives would be delegated to the Executive Board, converting it into a full-fledged monetary committee. Responsibilities of the Governing Council, by contrast, would be limited to questions of general strategy and guidelines for the monetary regime. The Governing Council, which presently meets twice a month, would instead convene no more than once or twice a year.

With this alternative, no changes would have been required in either the size or the voting rules of the Governing Council. Lines of accountability, however, would have been far clearer. In its operations, the Executive Board would have been directly answerable to the Governing Council; the Governing Council, in turn, would have stood as the institutional embodiment of European monetary sovereignty. But member states, clearly, were reluctant to give up direct representation in the decision making process. Hence, the European Council never even seriously considered the Parliament's alternative model. Instead, the unwieldy proposal of the ECB was swiftly approved and ratified, storing up the risk of serious problems in the future.

Financial stability

Serious problems could also arise from EMU's provisions for maintenance of financial stability. No monetary regime is invulnerable to the risk of occasional crisis. At any time, asset prices could become excessively volatile, adversely affecting real economic conditions; or there might be a spreading contagion of illiquidity or insolvency among monetary institutions. Financial systems are inherently fragile. Unfortunately, the prevailing rules of the euro zone are not at all clear about who, ultimately, is responsible either for crisis prevention or for the management of crises should they occur. Transparency is not served in these circumstances, either.

According to the Maastricht Treaty, the European Central Bank is expected to 'contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system' (Article 105.5). But no specific tasks are assigned to the ECB to help forestall crisis, and none may be assumed by the ECB unless expressly delegated by the Council of Ministers (Article 105.6). Though linkages among national financial markets

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

have grown since the euro's birth, the ruling principle remains decentralization, otherwise known as subsidiarity – the notion that the lowest level of government that can efficiently carry out a function should do so. Formal authority for prudential supervision and regulation continues to reside at the national level, as it did before EMU. Each central bank is charged with responsibility for the financial institutions based within its own national borders.

Nor does the ECB have specific powers to deal with any crises that might occur. General language in the Maastricht Treaty does appear to empower the Bank to backstop TARGET, the large intra-European clearing system, in the event of a payments gridlock or other difficulties. One of the basic tasks of the ECB, declares the Treaty, shall be 'to promote the smooth operation of payment systems' (Article 105.2). But for any other contingency, such as a sudden wave of illiquidity in the banking sector, the Treaty is as uncommunicative as the Oracle of Delphi. Nothing is said about any authority for the ECB to act as a lender of last resort. Economist Garry Schinasi (2003: 3) says that this silence makes the ECB the 'ultimate "narrow" central bank'. The ECB has a mandate for price stability but not for financial stability.

The Treaty's silence has been a source of much debate. Some specialists interpret it as a form of 'constructive ambiguity' – an indication that, in practice, the ECB's crisis-management powers could be enhanced if and when needed. As one legal commentator (Lastra, 2003: 57) puts it: 'The wording of the subsidiarity principle leaves the door open for a possible Community competence'. But others disagree, arguing that because the responsibility has not been specifically transferred, it must remain at the national level. The Treaty's language is seen as restrictive rather than permissive.

In practice decentralization rules here, too. As in pre-EMU Europe, the lender-of-last-resort function is left to the individual central banks. And again, each central bank remains responsible only for financial institutions within its own national borders. Beyond that, all is opaque. No one, it appears, is directly accountable for the stability of the euro zone as a whole.

Can such a decentralized arrangement be counted on to assure smooth operation of the overall system? There is certainly room for doubt. What would happen, for instance, if in a given country a large financial institution with extensive cross-border business were to find itself in trouble? Would the national authorities be evenhanded in their response, fully recognizing the interests of claimants elsewhere in the euro zone? Or would they act protectively, even at the risk of conflict with the regulatory authorities of partner countries? We have no way of knowing. The scheme 'may work well', observes Schinasi (2005: 119–20), 'but this still remains to be seen . . . It is [not] obvious that national supervision in Europe would tend, as a first priority, to focus on European priorities . . . It is difficult to imagine

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

the national supervisor pursuing European interests first and national interests second'. Echoes the IMF (2007: para. 12) in a recent review of euro zone policies: 'Progress on the ground is being held back by the governance framework. The core problem is the tension between the impulse toward integration, on the one hand, and the preference for a decentralized approach, on the other ... This setting rules out efficient and effective crisis management and resolution'.

In short, the possibility that central banks might work at cross-purposes, provoking or aggravating a crisis, is certainly not outside the realm of possibility. There is no Invisible Hand for public agencies. Decentralized decision-making among governments without some form of coordination is potentially a recipe for disaster.

Here too, enlargement just makes the situation worse, for two reasons. First, once again, is the numbers problem. If uncoordinated decision-making is risky with 15 central banks in the game, how much more vulnerable would be an EMU of double that number? Recall organization theory's suggestion that with expansion, decision-making problems increase not just proportionally but exponentially. This does not mean that as the euro zone grows, financial instability becomes unavoidable. There is no certainty about such matters. But it does mean that with each new member, the probability of some kind of crisis keeps rising.

Second, compounding the numbers problem is the relative poverty of accession countries as compared with the present membership of EMU. On the one hand, this means that their supervisory institutions, on average, are apt to be more rudimentary – less practiced at the essential tasks of monitoring markets and assessing risk. On the other hand, it means that in their eagerness to catch up with the EU's more advanced economies, they are apt to do all they can to promote lending for productive investment. The combination is deadly. The result, as previously noted, could be an excessively rapid expansion of credit, testing the limits of financial prudence and risking overheating and asset price bubbles. The ice under the feet of the euro zone will grow increasingly thin.

External representation

Finally, there is the issue of external representation. Who is to speak for the euro zone on broader macroeconomic issues such as policy coordination, crisis management, or reform of the international financial architecture? Here there is no answer at all, leaving a vacuum at the heart of EMU.

No single body is designated to represent EMU at the IMF or in other global forums. Instead, the Maastricht Treaty simply lays down a procedure for resolving the issue at a later date, presumably on a case-by-case basis (Article 109). Some sources excuse this on the grounds that it achieves a balance between the need to convey a common position and the prerogatives

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

of member states. But that seems far too kind. In fact, it was a cop-out, a diplomatic formula to mask failure to reach agreement.

At a minimum, the text compounds confusion about who is in charge. At worst, it condemns the euro zone to lasting second-class status, since it limits the group's ability to project power on monetary matters. As booster Fred Bergsten (2005: 33) laments: 'Europe still speaks with a multiplicity, even a cacophony, of voices ... Organizational reforms that enable the countries making up Euroland to act together and speak with a single voice will probably be an essential prerequisite of full European equivalence with the United States'. The point has been best put by political scientists Kathleen McNamara and Sophie Meunier (2002: 850): 'As long as no 'single voice' has the political authority to speak on behalf of the euro area, as the US Secretary of the Treasury does for the American currency, the pre-eminence of the US in international monetary matters, as in other realms, is likely to remain unchallenged'. Washington has no single phone number to call when negotiations are required.

Clearly, the phone number cannot be in Frankfurt, where the European Central Bank is headquartered. In international monetary forums, countries are normally represented not by central banks but by finance ministers or equivalent – officials with the political clout to speak for their respective governments. The ECB obviously cannot claim that kind of authority. Indeed, it is difficult to imagine the elected governments of Europe ever delegating such a fundamental power to an institution that has been deliberately designed to be as free from political influence as possible.

Alternatively, some have suggested the appointment of a single individual with sufficient credentials and legitimacy to act as interlocutor for the euro zone (Henning, 1997; McNamara and Meunier, 2002; Zimmerman, 2004) – a Mr (or Ms) Euro, as it were. Precedent exists in the realm of foreign and security affairs, where EU members already agreed a decade ago to name a single High Representative to stand for them all – a Mr Europe (presently Javier Solana of Spain). But experience has shown that Mr. Europe's ability to speak authoritatively for the entire EU is persistently hamstrung by policy differences among individual governments. A single appointed official cannot ignore or overrule the preferences of diverse sovereign states.

The most practical solution would be a collective one, centered on the informal committee of EMU finance ministers that has emerged since the birth of the euro – what has come to be known as the Eurogroup. Like comparable EU institutions, such as the Council of Ministers or European Council, the Eurogroup could be represented at any given time by its chair; the chairmanship itself, as with those other institutions, rotates periodically among members. In 2005 the Eurogroup chair began attending meetings of the Group of Seven, but with no specified responsibilities. A more effective

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

approach might be to explicitly delegate authority to the chair to speak on behalf of the euro zone.

Some criticize the idea, fearing that it could lead to a politicization of monetary policy in the euro zone and might even compromise the independence of the ECB. But such apprehensions seem overblown. Participation in international forums by America's Treasury secretary, for instance, has by no means compromised the independence of the Federal Reserve. In fact, this kind of division of labor between central bank and finance ministries is the rule around the world, not the exception. For EMU, the advantage of the Eurogroup is that it does embody the necessary degree of political authority. At last, there would be not only a single number to call but also someone empowered to pick up the phone.

So what is stopping EMU? Romano Prodi (2004: 14), a former Commission president (and more recently Prime Minister of Italy) says that it is 'a lack of will'. But that is surely an oversimplification. The question is: Why is there a lack of will? The answer, plainly, has to do with the lingering influence of national allegiance. Though EMU members may share a joint money, their interests are hardly identical. Divergent circumstances and preferences make them reluctant to give up the right to speak for themselves. Even after more than half a decade of living with the euro, national identity trumps collective interest.

Once again, enlargement just makes the situation worse. Adding accession countries will not only amplify the numbers problem, complicating decision making. Entrance of such a diverse group of relatively poor economies will also multiply and deepen internal cleavages, making it increasingly difficult to hammer out common positions on external issues. The fundamental rationale for developing a single voice for EMU, McNamara and Meunier (2002: 851) remind us, 'lies in the potential . . . to project the image of a unified, strong Europe to key international political and financial actors'. Enlargement will leave the Europeans further from that goal than ever.

VII. CONCLUSION

The bottom line, therefore, seems clear. Bigger will not be better, despite the broader economic base and the increased potential for network externalities that comes with enlargement. On the contrary, bringing accession countries into EMU will only exacerbate the impact of factors impeding the euro's emergence as an international currency. By prolonging the segmentation of Europe's financial markets, larger numbers will delay any significant reduction of the cost of doing business in euros. By adding to inflationary and budgetary pressures, enlargement will reinforce the anti-growth bias built into the institutional structure of EMU. And by further complicating an already complex governance structure, new entrants will

REVIEW OF INTERNATIONAL POLITICAL ECONOMY

cloud even more the fundamental question of who is in charge. None of this is calculated to make the euro more attractive to outside users.

Could the risks be even worse? Could EMU founder under the weight of enlargement? Though unlikely, the possibility cannot be lightly dismissed. The euro zone's problems, writes the respected economist Anna Schwartz (2004: 25), 'will only worsen with the inclusion of new members. Is this a recipe for political disintegration? Would the euro survive political disintegration?' Others warn of 'EMU's coming stress test' (Gros *et al.*, 2005), which could lead to unilateral secessions. Italy is considered a prime candidate, owing to its deteriorating public finances, sluggish growth, and eroding competitiveness. In 2005 several prominent Italian legislators publicly called for reintroduction of the lira; one, a government minister, even tried to collect enough signatures for a referendum on the matter. They are unlikely to be the last European politicians to use the euro as a scapegoat for disappointing economic performance.

Given Europe's historical commitment to the integration process, however, breakdown seems improbable. EMU will not be allowed to fail. As *The Economist* (11 June 2005: 69) writes: 'A break-up of the euro area is still in the realm of small probability rather than likelihood'. The real question is whether EMU can succeed. Can the euro ever rise above its defects to become a genuine rival to the dollar? Will the 'old dream of enthusiasts', at long last, be realized?

The answer, regrettably, is also in the realm of small probability rather than likelihood. Nothing is impossible, of course – particularly if the United States continues to mismanage its own currency as badly as it has in recent years. America's payments deficit widened to over \$800 billion in 2006 (more than 7 percent of GDP) and could soon top a trillion dollars. The more the US deficit grows, threatening a crisis for the greenback, the more attractive the euro could begin to appear, whatever its defects. But that is hardly a case of leading from strength. The analysis offered here focuses on the case for the euro on its own merits, independent of what might happen to the dollar. That case, I conclude, is weak at best and likely to be made weaker by enlargement.

The fundamental problem for EMU is the mismatch between the domain of its currency and the jurisdictions of its member governments. The euro is a currency without a country – the product of an international agreement, not the expression of a single sovereign power. Its success, therefore, is critically dependent on the continued cooperation of EMU's member states, which can hardly be guaranteed for all time. Should it be any wonder, then, that outsiders might hesitate to commit themselves to the currency's future?

Monetary unions among sovereign states have existed before, of course, without major disruption. In the contemporary era one thinks of the CFA Franc Zone in Africa or the East Caribbean Currency Area. But these have

COHEN: ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

all involved relatively small developing countries with no aspiration to major currency status. EMU, by contrast, encompasses some of the largest economies on the face of the earth and has never hidden its grand global ambitions. Unfortunately, Europe's divisions have never been hidden, either. For that reason, prospects for the euro's international role were poor even before enlargement. Enlargement of the euro zone's membership will simply make them even poorer.

NOTE

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