

## The Euro at Five: Ready for a Global Role?

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The euro stands on the brink of becoming one of the world's two reserve currencies. Is it ready to fulfill its emerging global role? The overall verdict on the great European monetary experiment is mixed. *The Euro at Five: Ready for a Global Role?*, edited by Senior Fellow Adam S. Posen, establishes that on the one hand the euro has **delivered monetary stability to the eurozone, brought down interest rates and inflation expectations, and expanded European bond markets enormously**. On the other hand, **the introduction of the euro has failed to improve the performance of the major eurozone economies or to deeply integrate European financial markets**.

If overall growth in Europe continues to lag, investors will remain reluctant to switch into euro-denominated assets. This reluctance could leave a vacuum of international monetary leadership when the dollar declines. Such a vacuum would drag out the global adjustment process and add to financial uncertainty.

What accounts for this disappointing shortfall in the euro's impact? Economic and Monetary Union (EMU) was widely expected to transform (1) eurozone financial markets and (2) euro member countries' fiscal policy. Yet the policy reforms needed to ensure the overall success of EMU and its members' economies have not followed the euro's creation.

The contributors to *The Euro at Five* conclude that failures to break down national barriers within Europe hinder financial-market integration in the eurozone. Factors in the nonfinancial economy—such as legal differences, obstacles to more rapid real growth, transactions costs, and institutional gaps in financial supervision—combine to keep the eurozone from building financial markets that could rival those in New York or London. Other major constraints on the euro's rise to international prominence have been the underperformance of the major eurozone economies, their resulting resort to deficit spending, and the fragmentation of eurozone representation in the international arena.

The failure of the euro to induce significant structural reform and growth in Europe necessitates an active policy agenda. *The Euro at Five* advocates the following measures:

**Remove obstacles to financial integration in Europe.** Legal differences among member countries, regulations promoting risk aversion, and high transactions costs for financial services block the eurozone from achieving deep and integrated financial markets. The euro's launch has directly

integrated only overnight and money markets. Even repo markets remain nationally fragmented. The European Union must push ahead with its Financial Services Action Plan and, even more important, with the integration of a single European market in services.

**Strengthen the crisis response capabilities of the euro area.** Primary responsibility for banking supervision has remained at the national level, with supervisors further split by the type of financial institution covered. There is thus a strong risk that national supervisors will protect weak financial institutions. It is unclear whether the European Central Bank (ECB) has the legal capacity to act as lender of last resort, and this ambiguity must be removed.

**Deliver greater macroeconomic stabilization rather than make futile efforts to enforce the Stability and Growth Pact.** The transfer of monetary sovereignty to the ECB increased output volatility in some member nations. The major eurozone economies' unwillingness to adhere to the pact is thus a rational policy response to recession. Violators of the pact are also the most likely to benefit from the use of fiscal policy and the least likely to experience virtuous cycles whereby budget cutbacks produce growth and investment inflows. Thus fiscal discipline will remain a dead letter for the major eurozone countries until the ECB does more to stabilize their business cycles.

**Consolidate eurozone representation in the G-7 and the International Monetary Fund (IMF).** The euro's impending global role makes urgent the need to end Europe's fragmented overrepresentation in the international financial institutions. The euro area should rationalize its representation in bodies such as the IMF and speak with one voice. Such consolidation of the European voice at the Fund should also be encouraged because it would allow the eurozone to play a constructive role in increasing the representation of China and Asia more broadly.

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