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## Successes and Challenges for the Euro

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The fifth anniversary of the introduction of the euro presents an opportunity to reflect on the successes and challenges associated with this unprecedented achievement. I am very pleased that the Institute for International Economics has published this volume on the euro at five years. In particular, Fred Bergsten has been a staunch supporter of the euro since the beginning and has never failed in his conviction that it would be a success.

For more than a decade in the run-up to the adoption of the single European currency, not many economists in the United States shared this view. Some were skeptical that Europe would actually achieve this major step (or thought that only a very small number of European Union (EU) member states would make it in). And as with the completion of the Single Market at the end of 1992, which was met by talk in the United States of a potential “fortress Europe,” some Americans were wary that the single currency would make Europe more of a competitor than a partner to the United States. In retrospect, it is clear that Bergsten’s analyses and insights have been vindicated and that he was right in betting on the success of the euro.

The introduction of the euro has indeed been a major historic event. It marks the achievement of full integration in the monetary field for 12 of the present 15 member states of the European Union. The mere existence of national currencies was the last barrier to fully achieving the single European market and the ultimate step in reaping all of its rewards. The sin-

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gle currency has had real economic benefits for the countries that adopted it. A preliminary study by the European Commission indicates that trade within the euro area accelerated by 14 percent during the 1999–2002 period, while trade between euro area member states and the other three EU countries increased by only 9 percent.

If an underlying rationale for the Economic and Monetary Union was economic, the deepest reason for such a move was profoundly political and aimed at involving all European citizens in the process of European integration. As has been pointed out by former European Commission president Jacques Delors, whose *Memoirs* have just been published, the introduction of the euro has created “the perception of an emerging European identity.” The euro is the most visible example of the European Union’s “finalité politique” and contributes decisively to making the process of unification irreversible. The euro has also become part of daily life for more than 300 million citizens since the introduction of euro notes and coins on January 1, 2002, and it serves as a yardstick for the public to measure how far the integration process has come in only 50 years.

The biggest ever enlargement of the European Union took place on May 1, 2004. Enlargement from 15 to 25 members increased the European Union’s population by 20 percent (to more than 450 million people), while its GDP has grown by only 5 percent. This implies that at the moment of enlargement, the prosperity gap will increase by about 20 percent, twice as much as the income disparities increased when Greece, Portugal, and Spain entered the European Union in the 1980s. To foster growth so that these disparities may narrow over time will be a formidable challenge for Europe, a challenge that is bigger than those we had to face in previous enlargements and that will absorb a significant amount of EU budgetary resources in the years to come. But it is a challenge that can produce a very large reward.

Enlargement is in fact an unprecedented economic opportunity that, economists agree, will bring significant benefits to both old and new EU members. It will promote competition and favor a more efficient allocation of resources within the European Single Market. The new member states have performed particularly well in the past three years; despite the global slowdown, their GDP has grown at a rate close to 3 percent. But they still have a large untapped growth potential. This has been well understood by European—and also American—investors, who have significantly increased their presence in these countries ahead of their accession, correctly anticipating the economic opportunities for these countries in an enlarged internal market.

By joining the European Union, the acceding countries also become members of the Economic and Monetary Union. They are committed to eventually adopting the euro, and steps are being taken in that direction. But accession to the European Union does not mean automatic adoption

of the euro. Specific criteria must be met first, as laid out in the Maastricht Treaty. The new members will continue on a path of economic restructuring and economic and policy convergence as part of the process of getting in shape for the euro—a process that is guided and encouraged by the European Commission and other EU institutions. I am reasonably confident that by the end of the decade, the euro will have replaced the national currency in a number of them.

Institutionally, the introduction of the euro is so far the most important example of structured cooperation inside the European Union. This method allows countries that want deeper integration to move forward when the Maastricht Treaty criteria are met, and this method will also gain more prominence within the enlarged European Union. The draft Constitution presented by the European Convention last year provides for the development of such a method of integration. Despite the fact that it has not yet been possible to conclude negotiations among member states on a Constitutional Treaty, I remain optimistic about the chances for the treaty to be approved this year. The euro, enlargement, and the Constitutional Treaty would then become the three landmarks of a new phase of European political and economic integration that will enhance stability and prosperity within Europe and strengthen Europe's voice in the world.

Having set this context, I turn to the main topic of this volume: whether the euro is ready for a global role. In the five years the euro has been in place, it has established itself as a key currency on the international scene and as an alternative to the dollar. There are four criteria to assess the international role of a currency: (1) the share of the currency in global foreign reserves, (2) the share of bonds issued in the currency, (3) the share of demand for money market instruments denominated in the currency, and (4) the number of countries using the currency for trade transactions with foreign partners.

With regard to the first criterion, the share of the euro in global foreign exchange reserves increased from less than 15 percent in 1999 to almost 19 percent in 2002—still a long way from the dollar's share in reserves (about 65 percent in 2002), but growing steadily. On the second criterion, following the introduction of the euro, there was a surge in euro-denominated bond and note issues. At the end of 1998, the outstanding amount of bonds and notes denominated in the legacy currencies of the euro accounted for barely 28 percent of world issues, compared with 45 percent for dollar-denominated bonds and notes. By mid-2003, the gap had become relatively small; the share of issues in dollars had fallen to 43 percent, while the euro's share had increased to 41 percent.

Turning to the third criterion, the share of demand for money market instruments denominated in euros rose even more dramatically, from just above 17 percent to 46 percent, overcoming the share of issues in dollars, which declined from 58 percent in 1998 to 30 percent in mid-2003. Finally,

with regard to the fourth criterion, more than 50 countries now operate managed exchange rate arrangements that include the euro as a reference currency, either alone or with other reserve currencies. All four criteria seem to indicate a strong and increasing confidence in the euro as a key international currency.

The introduction of the single currency has had a fundamental impact on the European financial sector, as a catalyst for European financial integration and restructuring, and for the expansion of the financial market itself. The European Union is committed to the completion of a single market in financial services by 2005, a formidable task but one that the European Union is on its way to achieving. The EU-US financial services dialogue adds another promising area for cooperation to the transatlantic agenda. The EU has already modernized and unified its rules on prospectuses and created a single European patent, for example, and it is working toward a "single passport for investment services" to facilitate investment while protecting the investor. According to a European Commission study, an integrated European capital market could in the long run raise the level of GDP in the European Union by more than 1 percent—a boost EU economies could undoubtedly use.

The impact of the euro is being felt deep and wide, within the euro area and the European Union but also outside Europe's borders. The growing international role of the euro, including its profound impact on the financial sector, make it highly worthy of attention on the US side of the Atlantic.