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## EURO'S IMPENDING GLOBAL ROLE HAMPERED BY LAG IN EUROPEAN ECONOMIC REFORMS

Washington, DC—The euro has been a clear success and is poised to take on a global leadership role as the dollar declines. The Institute's new special report *The Euro at Five: Ready for a Global Role?*, edited by Senior Fellow Adam S. Posen, establishes that the euro

- has delivered monetary stability to the eurozone,
- trimmed interest rate and inflation expectations, and
- expanded European bond markets enormously.

The eurozone is comparable in size to the US economy, and the euro also now presents an alternative international currency to which capital markets will turn, should US global and fiscal imbalances weaken reliance on the dollar. Today's situation echoes the passing of international monetary leadership from the British pound to the dollar in the mid-20th century when a series of macroeconomic imbalances (as well as World War I) undermined the pound's global status and the new dollar option became attractive.

The introduction of the euro, however, has failed to date to improve the performance of the major eurozone economies. The contributors to *The Euro at Five* conclude that failures to break down national barriers within Europe keep the eurozone from achieving deep and integrated financial markets that could rival those in New York or

London. If overall growth in Europe continues to lag, investors will remain reluctant to switch into euro-denominated assets.

Thus the failure of the euro to induce significant structural reform 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 importantly, with the integration of a single European market in services.
- **Strengthen the crisis response capabilities of the euro area.** Too much financial infrastructure in the euro area remains based on national interests rather than European needs. 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 the volatility of output in some member nations (particularly Germany). The major eurozone economies' unwillingness to adhere to the Pact is thus a rational policy response to recession. The larger eurozone economies that violated the Pact are 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 the

Pact 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 need to end Europe's fragmented overrepresentation in the international financial institutions is made urgent by the euro's impending global role. The European System of Central Banks needs to speak for all the eurozone countries on monetary affairs and not split time with national representatives. The United States should encourage this development. Constituencies at the IMF need to be rationalized to bring together the eurozone membership, present and future, with one voice. Such consolidation of the European voice at the Fund would also allow the eurozone to play a constructive role, in coordination with the United States and Japan, to increase the Fund quotas of China and Asia more broadly.

#### About the Editor

**Adam S. Posen**, senior fellow, is the author, coauthor, or editor of *Restoring Japan's Economic Growth* (Institute for International Economics, 1998), *Inflation Targeting: Lessons from the International Experience* (Princeton, 1999) and *Japan's Financial Crisis and Its Parallels with US Experience* (Institute for International Economics, 2000). He has been a visiting scholar at the Bank of England, Deutsche Bundesbank, European Central Bank, and Federal Reserve Board, among other central banks, and a consultant to the European Commission, the International Monetary Fund, and to the US Council of Economic Advisors, Department of State, and Department of the Treasury. Prior to joining the Institute, he was an economist at the Federal Reserve Bank of New York and a research fellow at the Brookings Institution.

## About the Institute

The Institute for International Economics, whose director is C. Fred Bergsten, is the only major research center in the United States that is devoted to global economic policy issues. The Institute's staff of about 50 focuses on macroeconomic topics, international money and finance, trade and related social issues, and international investment, and covers all key regions—especially Europe, Asia, and Latin America. The Institute averages one or more publications per month; holds one or more meetings, seminars, or conferences almost every week; and is widely tapped over its popular Web site.

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

Adam S. Posen, editor

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