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ENLARGEMENT AND THE INTERNATIONAL ROLE OF THE EURO

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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 paper 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.

How will enlargement of the European Union (EU) affect prospects for the euro as an international currency? Will the eventual addition of ten or more new members to the Economic and Monetary Union (EMU) enhance the euro's ability to challenge the U.S. 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 paper 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.

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. 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.

The organization of the paper 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.

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 calls the nearby region (Wyplosz 1999: 89). 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. In the global marketplace, the greenback remains as dominant as ever.

Grand ambitions

Europe's ambitions for the euro have always been grand. Internally, the joint currency was expected to help promote the EU's long-standing goal of an "ever closer union among the peoples of Europe." Externally, EMU was meant to enhance Europe's role on the world stage 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 calls this "the hidden agenda of Europe's long-planned adoption of a single currency" (Wyplosz 1999: 76).

The stakes were clear. Four distinct benefits are derived from widespread international circulation of a currency: (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 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 pie, too.

Few knowledgeable observers questioned the euro's potential. 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 worth. Second are the qualities of "exchange convenience" and "capital certainty" -- a high degree of liquidity and reasonable predictability of asset value – 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, 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" (Mundell 2000: 57). Similarly, Daniel Gros and Niels Thygesen, two prominent European economists, asserted that "the most visible effect of EMU at the global level will be the emergence of a second global currency" (Gros and Thygesen 1998: 373). 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? For many, the answer was equally unambiguous: Very soon. Fred Bergsten, a former U.S. Treasury official, predicted a decade ago that Europe's new currency would achieve "full parity" with the dollar in as little as five to ten years (Bergsten 1997). Economists George Alogoskoufis and Richard Portes were even more enthusiastic, contending that "the fundamentals point toward a potentially large shift in favor of the euro.... The dollar would *immediately* lose its importance as a vehicle currency" (Alogoskoufis and Portes 1997: 63; emphasis added). The old dream did not seem unrealistic.

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 – first embarrassing, more recently a point of some pride. 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 two 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. Today the currency is back to a range very close to where it started in 1999.

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 euro zone, as it is commonly known, presently comprises twelve EU members. A look at the available data suggests that in most categories of use the euro has held its own as compared with the past aggregate shares of EMU's twelve "legacy" currencies. Hence Europe's new money has easily taken its place as successor to Germany's old Deutschmark (DM), which had already attained a rank among international currencies second only to the dollar. But that is about all. As economist Hèlène Rey 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" (Rey 2005: 114). In the euro's first years of existence, the only significant gains have been in the European Union's immediate neighborhood, including the EU's ten new members, before they joined, as well as other actual or potential candidate countries. In the words of the European Central Bank, a "regional pattern... continues to characterise the internationalisation of the euro" (2005: 7). Outside the European region, the dollar remains dominant.

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 according to the latest survey of the Bank for International Settlements (BIS 2005) average daily turnover in 2004 approximated some $1.9 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 U.S. 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 89 percent of all transactions in 2004 (barely changed from its 90-percent share in the first such survey by the BIS in 1989). The euro, by contrast, entered on one side of just 37 percent of all transactions in 2004. 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%). Only in trading in the Nordic countries and East-Central Europe 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 U.S. share of world exports. The DM's share of trade invoicing in its last years, prior to its replacement by the euro, was fifteen percent, roughly equivalent to Germany's proportion of world exports. Evidence from the European Central Bank 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 (ECB 2005).

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-Europeans 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 has risen steadily, from less than 22 percent in 1999 to some 31.5 percent in mid-2004, while the U.S. dollar share has modestly declined from

47 percent to 44 percent (ECB 2005: 13). But these developments represent an increase only in the *supply* of euro-denominated assets, not *demand*. 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. Overall, the euro's share of world portfolios has changed little from the previous aggregate of legacy currencies.

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 stabilize. Summarizes the ECB: "The euro [has] continued to expand some facets of its role as an international currency, while in other market segments a leveling-off has set in.... confirming the geographic focus of the euro's international role" (ECB 2005: 61). All this is a far cry from attaining full parity with the dollar in as little as five to ten years.

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 twenty five. Two more neighbors, Bulgaria and Romania, are expected to join soon; and yet others, including the successor states of the former Yugoslav Republic 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.

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 the twelve 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 one-year period, that does not exceed by more than 1½ 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 two 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. Quite the contrary, in fact. Key is the exchange-rate criterion. Only six of the ten new members, to date, have even tried to commit to ERM2. These are 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 Slovenia, which moved from a managed crawl to a stable euro peg. The four largest new members – the Czech Republic, Hungary, Poland, and Slovakia – 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 will be Slovenia, which is scheduled to join the zone in January 2007. Estonia and Lithuania had also hoped to join in January 2007 but have been forced to postpone because of excessively high inflation rates. Cyprus and Malta each aim for January 2008. Latvia had also aimed for 2008 but has, like its Baltic neighbors, been forced to postpone because of high inflation. Slovakia has tentatively penciled in January 2009, while the Czech Republic and Hungary have 2010 in mind. Poland has yet to set a target date. And even these goals may be subject to slippage. As of November 2005, only four of the ten – Estonia, Lithuania, Slovakia, and Slovenia – had actually completed formal plans for a changeover to the euro (European Commission 2005). Moreover, in a number of the accession countries, such as Poland, domestic political opposition to the euro is growing, spurred in particular by concerns over the prospective loss of monetary autonomy. In some instances, adoption could be delayed for years.

The current status of the ten accession countries is summarized in Appendix A. Much, obviously, remains uncertain. All we know for sure is that, sooner or later, the number of countries in the euro zone will 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 Robert Mundell, 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" (Mundell 2000: 60). Likewise, it is the logic of Jacques de Larosière, former managing director of the International Monetary Fund (IMF). "The euro's position as a reserve currency will progress in the future," de Larossière 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" (De Larossière 2002: 15-16). Prospects for Europe's money as an international currency are assumed to depend directly on the absolute size of the euro-zone.

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 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" (Bergsten 1997: 25, 27). 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 twelve original members of EMU would more than double both ratios; enlargement would add even more. A dramatic rise in euro use, therefore, should be expected as well. In Bergsten's 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" (Bergsten 1997: 27).

Arguments like these, however, are far too simplistic to be taken seriously. As economist Barry Eichengreen 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" (Eichengreen 1997: 50, 52). 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.

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

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, much has been accomplished, particularly 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.

Overall, however, momentum has been slow, in good part because of foot-dragging by member governments. In 1999, the Commission drew up a comprehensive package of reforms, the so-called Financial Services Action Plan, which was supposed to be completed by 2005. But while many ambitious new Europe-wide rules have been adopted under the Plan – such as the Conglomerates Directive of 2002 and the Markets in Financial Services Directive of 2004 – implementation by member governments has been spotty at best. National resistance to market-opening measures remains stubborn, especially at the retail level – the realm of bank accounts, mortgages, insurance policies, and the like – and in equity markets. Integration 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). As Romano Prodi, another former Commission head, has ruefully admitted: "The euro has spurred closer integration in the EU financial system [yet] there are still many obstacles – regulatory, legal and technical – that need to be removed" (Prodi 2004: 12).

Worse, in certain key respects, it is evident that the dollar's cost advantage will persist no matter what the EU does. Most critical is the lack of a universal financial instrument to match the U.S. Treasury Bill for liquidity and convenience – 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 five years, and the Italian bond at two years (Rey 2005: 112). But such a piecemeal approach falls far short of creating a single market as large and liquid as that for U.S. 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 a greater interchangeability among national issues. But the convergence of spreads 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 now be compounded as a result of a decision by the ECB in 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 will 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, in turn, to be much more selective in their choice of issues, accentuating yield spreads (*Financial Times*, 9 November 2005).

On balance, therefore, market segmentation has proved remarkably resilient; 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 have not gone far enough to significantly improve the euro's cost-effectiveness relative to the dollar. 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 will make it even more difficult to overcome the segmentation of Europe's financial markets.

The main reason is the more primitive level of development of institutions and regulatory arrangements in the accession countries, as compared with EMU's present 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: 41-42). 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 the new entrants into the euro zone's nascent capital market. Since they start from a lower level of development, they will need even more extensive reforms 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 the 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: "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" (Schadler *et al*. 2005: 56, 65-66). 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 of twelve. If anything, enlargement will prolong the segmentation of financial markets. Significant reductions in the cost of doing business in euros will long remain beyond Europe's grasp.

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 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 in a deflationary direction, imparting a distinct anti-growth bias to the euro zone as a whole. 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 the accession countries may be small as compared with older members. Together, they add less than 10 percent to the GDP of the EU as a whole. Nonetheless, their entrance into the euro zone can be expected to tilt monetary and fiscal policy even more in a deflationary direction, 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. Since EMU's start, the bias of monetary policy has mainly been toward restraint, not expansion.

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 (Schadler *et al*. 2005: 5).

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 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 present 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. Many specialists in Europe have called for the Pact's revision. But while some limited reforms were enacted in 2005, appeals for more radical changes have made no noticeable headway. To some, these facts mean that the SGP has no "bite." But can anyone doubt that deficits might be even larger yet in the absence of the Pact? 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.

The reason is simple. EU membership imposes a heavy burden on government budgets. Once accepted, 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 the 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. Only the Baltic states and Slovenia 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 (Czech Republic, Hungary, Poland, and Slovakia). 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 will be tight; and given the economic weight of the most fiscally troubled of the new members, it does not seem unreasonable to expect that for the entering group as a whole, budgetary policy will on balance be tilted in a deflationary direction. 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.

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 clear. From the start, uncertainty has reigned concerning the delegation of monetary authority among governments and EU institutions. The Maastricht Treaty, being the product of a complex political negotiation, naturally embodies a variety of artful compromises and deliberate obfuscations. The result is a strikingly high degree of ambiguity in provisions for the management of the euro zone. Jurisdictional lines are anything but transparent; the details of accountability are equivocal and obscure. None of this is apt to cultivate an easy confidence 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 twelve national governors – was already bigger than the top managerial unit in 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: "The mere thought of a *tour-de-table* is exhausting" (Meade 2003: 129). 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 ten accession countries immediately gained observer status on the Governing Council, with voting rights to follow once they adopt the euro. That would put the number at 28, with even more governors to be added down the road as Bulgaria, Romania, and other candidate governments successfully negotiate their way into the EU (or if Britain, Denmark, or Sweden ever decide to join). A gaggle of 30 or more strong willed individuals could hardly be considered conducive to efficient decision making. As one source 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" (Baldwin 2001). 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 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 once 15 countries have adopted the euro 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 the grounds that it should facilitate consensus building, contribute to a better flow of information, and strengthen the norm of collective responsibility (Cukierman 2004: 70). But it can also be criticized for perpetuating all the gross inefficiencies of the ECB's numbers problem. As one astute observer puts it, the Governing Council will remain "more like a mini-parliament than a decision-making body" (Gros 2003: 124).

On the other hand, the reform introduces several new ambiguities that add even more to uncertainties surrounding 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 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: "The reform proposal does not meet the rationale of an integrative monetary policy.... It re-nationalises European monetary policy" (Belke 2003: 122). 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).

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 the accession countries, on the one hand, and the older members of the euro zone, on the other (Berger *et al.* 2004; Hall and Hondroyiannis 2006). Except for Slovenia and, to a lesser extent, Cyprus, synchronization of business-cycle activity between the two groups appears to be quite weak. National policy preferences, therefore, are 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, much as the Board of Executive Directors at the International Monetary Fund is ultimately responsible to the Fund's Board of Governors. EMU's Governing Council, in turn, would have stood as the institutional embodiment of European monetary sovereignty. But member governments, clearly, were reluctant to give up their 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 may have grown among national financial markets 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 says that this silence makes the ECB the "ultimate 'narrow' central bank" (Schinasi 2003: 3). 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 puts it: "The wording of the subsidiarity principle leaves the door open for a possible Community competence" (Lastra 2003: 57). 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, "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 the national supervisor pursuing European interests first and national interests second" (Schinasi 2005: 119-120). 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 a dozen central banks in the game, how much more vulnerable is an EMU of double or perhaps even triple 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 on rising.

Second, compounding the numbers problem, is the relative poverty of the 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 laid 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 achieved a balance between the need to convey a common position and the prerogatives 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 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" (Bergsten 2005: 33). The point has been best put by political scientists Kathleen McNamara and Sophie Meunier: "As long as no 'single voice' has the political authority to speak on behalf of the euro area, as the U.S. Secretary of the Treasury does for the American currency, the pre-eminence of the U.S. in international monetary matters, as in other realms, is likely to remain unchallenged" (McNamara and Meunier 2002: 850). 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 – public 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, of course, 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 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 says that it is "a lack of will" (Prodi 2004: 14). 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 sovereignty. 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 the 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 remind us, "lies in the potential... to project the image of a unified, strong Europe to key international political and financial actors" (McNamara and Meunier 2002: 851). Enlargement will leave the Europeans further from that goal than ever.

CONCLUSION

The bottom line, therefore, seems clear. Bigger will not be better, despite the increased potential for network externalities that comes with enlargement. On the contrary, bringing the 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, the new entrants will 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, "will only worsen with the inclusion of new members. Is this a recipe for political disintegration? Would the euro survive political disintegration?"

(Schwartz 2004: 25). Others warn of "EMU's coming stress test" (Gros *et al*. 2005), which could lead to unilateral secessions. Italy's welfare minister, concerned about his country's weakening export performance, has publicly called for a reintroduction of the lire and even tried to collect enough signatures for a referendum on the matter. He is unlikely to be the last politician 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* writes: "A break-up of the euro area is still in the realm of small probability rather than likelihood" (*The Economist*, 11 June 2005: 69). 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 2005 (more than 7 percent of GDP) and could soon top a trillion dollars. The more the external 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 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? Never before has the world adopted an international money that was not backed by a centralized political authority.

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

APPENDIX A

ACCESSION COUNTRIES: CURRENT STATUS

	Target Date for Adopting the euro	ERM2 Participants	Current Exchange Rate Regime	Comments
Czech Republic	2010	No	Managed float since 1997	Inflation targeting regime. Public deficits are too high.
Estonia	Jan. 1st, 2007 (postponed to 2008)	Joined June, 2004	Long-standing currency board, pegged to the euro	Excessive inflation has forced postponement of target date.
Cyprus	Jan. 1st, 2008	Joined 2005	Hard peg to the euro	Interest rates unstable. Needs to speed up practical preparations.
Latvia	Jan. 1st, 2008 (postponed)	Joined 2005	Re-pegged from a currency basket to the euro	Excessive inflation has forced postponement of target date.
Lithuania	Jan. 1st, 2007 (postponed)	Joined June, 2004	Long-standing currency board, pegged to the euro	Excessive inflation has forced postponement of target date.
Hungary	2010	No	15% fluctuation band around central rate, though the exchange rate moves de facto in a limited range at the upper end.	Inflation targeting regime. Public deficits are too high.
Malta	Jan. 1st, 2008	Joined May, 2005	Re-pegged from a currency basket to the euro	Areas of concern include public finances, inflation, and national debt. Needs to speed up practical preparations.
Poland	No target date	No	Pure float	Inflation targeting regime. Public deficits are of concern, along with a lack of enthusiasm for the euro from political leadership.
Slovenia	Jan. 1st, 2007	Joined June, 2004	Moved from a tightly managed crawling peg to a euro peg	Application approved by the Commission in May 2006.
Slovakia	Jan. 1st, 2009	No	Managed float	Inflation targeting regime. Public finances are a problem.

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