The Success of the Euro, Globalization, and the EU Enlargement

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Abstract

The launch of the euro has been viewed as a further step in building a seamless European market and advancing the idea of a European political union. It is more than that. It provides a defense mechanism against some of the perils of globalization, while at the same time it has rendered the distinction between "tradables" and "nontradables" meaningless within the EMU thus making redundant the balances of payments among the partners. Moreover, the introduction of the euro constitutes a preemptive move in laying claim to one of globalization's biggest prizes, i.e., the very substantial benefits that accrue to the country (countries) that provide the world's reserve currency. The recent enlargement of the EU may necessitate the reconfiguration of (part of) the EMU into a closer political union for the euro to achieve its due reserve currency status.

1. Introduction

Globalization has been judged by many criteria and all have been found wanting. The broad world-reach of McDonald's, Blockbusters and the United Colors of Benetton is real and ominous, and acts as a universal bulldozer that homogenizes tastes internationally to the lowest common denominator. But it is not the essence of globalization nor does it represent, necessarily, one of its successes. The criterion of forming global exchange networks among countries and increasing the interrelationships between their economies comes closer to doing justice to the essence of globalization. The operational formulation of this form of globalization rests on the universal adoption of a common set of "rules of the game"[1] for economic interactions in the form of "free-markets, free-trade, laissez-faire." This brand of globalization, alias known as "the Washington Consensus," has been applied broadly in the quest for growth and development without having as yet produced any material evidence of success. The first high-profile case of globalization, Mexico, was bailed out in 1994. Since then it has continued its Sisyphean climb to development with disappointing results. The Asian Tigers showed great promise as development successes only to tumble simultaneously in 1997 into the abyss of failure. Their subsequent recovery has revealed the need for more attention to a mix of domestic and foreign policy that tempers liberalization with political and institutional reforms. More recently Argentina, the panegyric pupil of the Washington Consensus, met with the predictable catastrophic failure of dollarization, forcing it to take a hard second look at the political and social implications of "globalization on the cheap," without the proper institutional infrastructure in place (Yotopoulos, 1996, Chapter 12).

It is a trite proposition that free trade often produces losers, as well as winners. Globalization, an extreme form of free trade, also produces losers and winners, with the additional caveat that the result is not random: it is preconditioned on the extent to which the institutional infrastructure requisite for the success of globalization is in place or is lacking. And since globalization is institution-laden, and the creation of institutions is costly, one would have expected that the results of globalization would favor those who are able to influence institutional reform. To many this would be almost certain to

[1] Kreps (1994) defines "institutions" as the set of the rules of the game.

provide a systematic bias against the smaller and poorer countries, including the so-called developing countries, while the middle-income and developed countries are in a better position to enjoy the benefits of globalization.

The European Union (which is viewed in this paper as an integral unit, despite regional dissimilarities) is arguably the only case of successful globalization ("regionalization?") that has proceeded without identifiable loser nation-states. The success of the EU in relentlessly pursuing cohesion has leveled the playing field by establishing the institutional and economic preconditions for the success of the European economic integration –the preconditions that had been lacking in the failure cases of globalization noted above. The launching of the euro has been the decisive and bold step taken for leveling the playing field in order to seal the success of European globalization. The euro has already produced positive results for growth and development, as I will argue below, and it is capable of delivering in the future the most important "exorbitant privilege" for Europe: sharing with the dollar the spoils of the world's reserve currency. Moreover, the euro has contributed to underwriting (the civic and political) integration project in Europe, thus animating the vision that within a generation the citizens of Europe will have been bound more closely together with a shared social and civic identity.

2. The Euro as the Outcome of a Path-Dependent Process

If the European Community evolved as a historic necessity, the Economic and Monetary Union (EMU) became an economic inevitability, the result of a path-dependent process. The abolition of the (flexible) exchange rates within the EU was the important path taken at fork in the road that led to the eventual adoption of a common monetary policy and the common currency.

The present global regime of flexible exchange rates has a relatively short history. A regime of fixed exchange rates was adopted after World War II and it lasted for the duration of the Bretton Woods system of international finance. The bilateral exchange rates of various countries were initially fixed with respect to the dollar, which in turn was pegged to gold at the price of $35 per ounce. Thus the exchange rates of various currencies were aligned indirectly with the dollar-price of gold, which served as the anchor, despite the fact that gold was not the official backing for any national currency, nor was it circulating any longer in private markets in the US. Although a country could of course devalue its currency, devaluations were seldom seen. The world lived for almost 30 years after the War with a regime of virtually fixed exchange rates. These, incidentally, were 30 good years for the world economy. Historically unprecedented rates of growth of GDP were registered for most countries of the world at all ranges of income in the five continents. (Of the 75 countries tracked by the World Bank for the period 1965-1980 only 7 registered an annual GDP growth rate lower than 2.5 percent!)

The period of the relative stability in the foreign exchange markets ended abruptly in the aftermath of two expensive enterprises undertaken simultaneously by the US in the 1960s: the military adventure of the Vietnam War and the social engineering of the Great Society. Their funding entailed increasing the money supply and the international indebtedness of the country and thus the flow of U.S. Treasury bonds to foreign central banks. The banks, in turn, were willing to hold U.S. monetary assets in their reserves on the authority of the Bretton Woods Charter (article 4) that was interpreted as permitting foreign governments to present Treasury bonds to the U.S. Treasury Department in exchange for gold at the price of $35 per ounce (McKinnon, 1993). The system was convenient and stable as long as the anchor price of gold held and the promise that the gold would be forthcoming at the beckoning of the foreign custodians of U.S. monetary liabilities, the central banks, was credible. But credibility was shot as the dollar liabilities held abroad exceeded the gold reserves at Fort Knox. This led President Nixon to "close the (Treasury's) gold window," as the devaluation of the dollar became delicately known. The crisis of 1972 followed, with the price of gold skyrocketing to $500 per ounce. The dramatic devaluation of the dollar had forced, in fact, the rest of the world to underwrite some of the costs of the Vietnam War and of the Great Society in the form of their outstanding U.S. monetary assets being worth less in gold at its post-crisis price. Devaluation thus paid off for the U.S. without any mitigating cost: the dollar was the de facto reserve currency before devaluation – i.e., the central banks were willing to hold it in their reserves - and if anything the dollar improved its reserve-currency perch after gold exited the monetary picture.

The regime that succeeded the collapse of Bretton Woods had an important advantage: the flexible exchange rates act as stabilizers of trade flows while delivering a reality test on spendthrift governments. A deficit in the foreign account will lead to the devaluation of the domestic currency, which makes imports more expensive and grants a market-subsidy to exports, thus controlling consumerist excesses and restoring equilibrium. Devaluation of the currency promotes *good competition* –it provides the correct incentives for restoring comparative advantage. But this general statement comes with a number of caveats.

The gains of a devaluing country come at the expense of its trading partners. The partners that produce the imports certainly lose. And if the additional export incentives work and exports increase, the competing exporters may also lose. Devaluation can amount to a "beggar-thy-neighbor" policy. There is no gainsaying that some adjustments become necessary to avoid competitive devaluations in a "free trade association" or in a "common market" environment as in the case of Europe, where trade among the partners accounts for two-thirds of the member countries' foreign trade. A fortiori, when the European Community evolved into the European *Union* and free trade morphed from a self-rewarding aim into an instrument of a positive-sum exchange for the partner countries, devaluations of the "robbing-Portugal-to-pay-Spain" type became objectionable. The political-economic logic for coordinating exchange rates among EU members became unassailable. The European Monetary System (EMS) was introduced in 1979 and intended precisely to discourage competitive devaluations while also dealing with the wide differentials in the national rates of inflation. The pledge of most members to keep exchange rates within a narrow band (the exchange rate mechanism adopted, or ERM) provided a partial solution to monetary instability. The system was tested with the onset of globalization when capital liberalization was introduced at the preparatory stage leading to the single financial market. The European financial crises of 1992 were the unhappy outcome of this test.

On closer examination devaluation can pose additional problems for a devaluing country and by extension for the Union of European countries as a whole. The foreign exchange rate is a price that applies to tradables, commodities and services that enter international trade as imports and exports and are transacted in foreign exchange.

Devaluation makes these commodities more expensive (in domestic currency). There is also the non-tradable component in GDP, the goods and services that are generally produced and consumed within the country and are transacted in domestic currency. For devaluation to succeed, the prices of non-tradables need to remain unchanged, i.e., to decrease relative to the prices of tradables. (Should prices of non-tradables increase in tandem with the prices of tradables, the effect of devaluation is totally offset by a tantamount increase in the rate of inflation). The price, therefore, for the "success" of devaluation is the reallocation of resources from the non-tradable to the tradable sector. This result may or may not be socially desirable or Pareto-optimal in a given situation. In terms of the Peter and Paul metaphor, the devaluing Spain at the end engages in a "beggar-thyself" policy by bearing the cost of imposing contraction in its non-tradable sector and shifting resources to the tradable sector in order to protect the devaluation.

The costs of devaluation in the above cases are real, and especially so in the case of the EU that proposes to maximize the joint welfare of all the partners. Such costs, however, drop out in the wash on the grounds that the reallocation of resources among sectors reflects (and remedies) disequilibria that must exist in an economy. One case, however, where the devaluation-induced reallocation of resources to the tradable sector becomes a distortionary misallocation with distinctly sub-optimal results on the economy, is when the regime of free exchange rates is coupled with a regime of free (financial) capital movements. This distinction is germane since foreign direct investment would ultimately produce exports and may thus warrant a shift of resources to the tradable sector. A financial capital inflow, on the other hand, is likely to have a destination as a store of wealth, whether directly or indirectly. As mentioned already, this coupling of free markets in foreign exchange and in capital flows, financial and otherwise, is the essence of globalization. It has become the canonical case under the current (neo-liberal) system of international finance. It becomes necessary, therefore, to give special consideration to free flows of financial capital (hot money) to be used for speculative purposes and as a store of value.

Foreign currency serves as a medium of exchange in international transactions. Moreover, in a globalization state where there are no restrictions in the current or the capital account foreign exchange serves also as a "store of value" in the asset portfolio of agents. Citizens of developing countries, e.g., include in their portfolio *hard currencies* (grosso modo those of developed countries) for *asset-holding purposes*, if for no other reason to provide insurance against a future devaluation of the domestic currency. This is a process of *currency substitution* that becomes endemic in a globalization environment with free flows of (financial) capital. Currency substitution develops as the importance of the "quality" of a country's currency ratchets up from the closed, to the open, and to the globalized economy. In a closed economy the quality of a currency is largely immaterial: fiat money, tokens or give-away coupons can also serve for domestic transactions purposes with a lesser or greater degree of ease or difficulty. In an open economy the odds rise with the "quality" of the currency being reflected in the exchange rate that is used for international transactions. In the globalization state of the world the use of currency as a store of value grows in importance and then the ordinal ranking of currencies is of essence: from the reserve currency, to the hard, currencies, the soft, … and the worthless. In this case, currency becomes a *positional good*. The "best currency" substitutes in agents' asset portfolia for a wide swath of less-preferred currencies –and it gains the spoils of the *reserve currency* status.[2]

Currency substitution, therefore, has asymmetric outcomes in a globalization environment, working against the soft-currency countries, while citizens of hard-currency countries, sitting high in the positional-goods ladder, have not a matching interest in holding *soft currencies* (roughly those of developing countries). This additional (*asymmetric*) demand for the reserve currency ("dollar") makes the devaluation of the soft currency ("peso") a self-fulfilling prophecy. The effects of this type of devaluation are severely distortionary. Yotopoulos (1996) who has modeled and quantified this type of devaluation-induced misallocation of resources expresses the intuition as follows:

> "How is currency substitution, which relates to financial flows, transmitted to the real economy? Consider an equilibrium situation where a bundle of resources produces tradables (T) or nontradables (N), measured such that one unit of each is worth $1. Entrepreneurs should be

[2] The parallel literature on "positional goods" identifies them as the result of "a shared system of social status" where, e.g., it becomes possible for an individual (a good) to have a positive amount of prestige (reputation) such as a feeling of superiority, only because the other individuals (other goods) have a symmetrical feeling of inferiority, i.e., negative reputation (Hirsch, 1976; Frank and Cook, 1976; Frank, 1985; Pagano, 1999). In extending this literature to include foreign exchange as a "positional good" we postulate that in a free currency market, the simple fact that reserve currencies exist, implies that there are soft currencies which are shunned as inferior for some purposes, such as asset-holding.

> indifferent between producing one unit of T or one of N [defined as an optimum allocation]. But since the soft currency may be devalued, it becomes risky for the Mexican entrepreneur to produce (or hold) one unit of N that could not be converted for later spending into $1. Expressed in another way, entrepreneurs are attracted to producing T because this is the only way they can acquire $1 they wish to hold for asset purposes. With the relative productivities of the bundle of resources (measured at "normal" prices) remaining unchanged, N becomes undervalued and resources are biased towards T. … This dilemma does not exist for the D[developed] C[ountry] producer. In hard currency, $1 of T will always be worth $1 of N, as opposed to the soft currency, where the expectation of devaluation becomes a self-fulfilling prophecy"(Yotopoulos, 1996: 51).

This process of substituting one currency for another represents *bad competition* in the foreign exchange market, having provided the *wrong* incentives that reward those who hoard dollars. When coupled with free capital movements the spoils of devaluation go also to speculators who move financial capital (hot money) across borders for the purpose of placing a *one-way, cannot-lose* bet against the Mexican central bank. This type of *bad competition* can, in the limiting case, lead to serial devaluations thus provoking financial crises (Yotopoulos, 1996; Yotopoulos and Sawada, 2002). But whether a financial crisis ensues or not, the endemic devaluations of the 1980s and beyond have entailed very substantial costs, especially for the developing countries.

3. The Immediate Benefits of the Euro

The architects of the euro themselves approached the project of designing a common currency with trepidation and frequently displayed a willing suspension of disbelief regarding its chances for success. The history of proactive steps to assure "cohesion" (through increased integration and convergence) dates back to the Delors Report (Commission, 1989) that cautioned against the negative impact that the introduction of the euro might have on the weaker partners and recommended the pre-emptive adoption of counter-vailing compensatory policies (that eventually developed into the *structural* and *cohesion* funds of the EU). At the final stage of planning for the launching of the euro a coordinated program of institutional reforms was adopted (the Maastricht treaty) that aimed at leveling the playing field in order to make the success of the euro palpable. The same institutional infrastructure contributed to making the pan-European globalization a positive-sum experience for the respective countries involved.

The euro was successfully launched (on January 1, 1999) despite the disconcerting opposition of the purists, with none other than Robert Mundell (1993) leading the group,[3] on the grounds that the EMU countries did not satisfy the criteria of an "optimum currency area". On less solid grounds rested the jeremiads (or scare-tactics?) of others (e.g., Feldstein, 1997) arguing that the EMU would have less range of and power for its collective adjustment mechanisms than the existing policy instruments of individual states. It is remarkable that such an unprecedented and fundamental reform was ever embraced by sovereign, free-willing and consenting countries in the face of such a widespread misunderstanding of the nature of the "common" currency, such exaggeration of its costs (the danger of unleashing a civil war in Europe! Feldstein, 1997) and such trivialization of its benefits (the ease of travel and lower transaction costs, without the nuisance of repeated visits to exchange shops for the tourists who transverse the twelve countries of the EMU!) Such demonization of the Euro continues to this date and in very respectable venues (Cohen, 2003; Eichengreen and Leblanc, 2003; but vide also below on Barry and Berg, 2003).

The truth is that the EMU countries have by no stretch of the imagination adopted a fixed exchange rate (as per concerns of commentators such as Mundell, 1993, Feldstein, 1997, and Eichengreen and Leblanc, 2003, among others), and the euro has nothing in common with the precedent of the CFA Franc Zone in Africa or the Eastern Caribbean Currency Union in the Western Hemisphere (as per Cohen, 2003). Nor is it correct that the euro is simply the case of a single currency (with the corollary that there is a single monetary policy) " '[p]lus the E' in the EMU which can be interpreted as the single market with all that implies for a cross-border flow of goods, services, and factors of production" (Barry and Begg, 2003).[4]

The defining and unique characteristic of the euro as a single currency is that not only does it abolish the intra-Euro-zone exchange rates but it also abolished the pairwise

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[3] It should be noted that Mundell (2000) formally became a proponent of the Euro shortly after it was launched.

[4] Truth to be told, the last-mentioned authors get much closer to the point, although their statement is misleading. A federal economic policy and a federal budget that may be implied by the *'E'[conomic]* do not exist, but only coordination of national economic policies that is not sufficient for a true *Economic* and Monetary Union (EMU).

current accounts and balances of payment among the twelve countries of the EMU. In fact, this is tantamount to having *abolished non-tradability* within the Euro-zone, i.e., the notion that a component of GDP ("*non-tradables*") consists of goods and services that do not trade as imports and exports and therefore do not enter international trade.[5] Since haircuts are now traded in euros and so are VWs, Greece is able to earn more euros by producing more commodities that were previously nontradables (haircuts?) and thus import more VWs. It is certainly expansionary for Greece that it does not have to produce a specific subset of products, exports, to pay for its German car imports; and it is also expansionary for Germany. This is a privilege for most partners of the EMU (where the foreign exchange constraint was previously binding) and it is expansionary for all, whether they are among the richer or the poorer countries. It is the same privilege that Arkansas, a poor state in the U.S., enjoys because it does not need to produce exports to California in order to import Intel chips! Abolishing non-tradability does not make a poor country (state) rich, but it enriches both trading partners a little.

Abolishing exchange rates dispenses also with intra-Euro-zone devaluations, which in turn spares the nontradable sector the contraction that would have otherwise been imposed in an attempt to safeguard the devaluation, as mentioned in the previous section. Agriculture and nontradable services are the major beneficiaries of this feature of the euro in Europe. Even more important, the euro has eliminated the risk of currency-substitution-induced devaluations as described above. The serial devaluations that Europe suffered in 1992 at great cost in resource misallocation will remain as a footnote in the history of "old-Europe."

A functioning euro, given the size of the economy and its constituency, is also used as unit of account outside the Euro-zone. This makes the euro countries "price makers" instead of "price takers." It is advantageous for a country to have as much of its assets and liabilities as possible denominated in its own currency. To the extent this occurs, it affords national governments a relatively higher degree of economic independence from international monetary constraints as compared to non-euro members.

[5] The criterion of tradability in this context is not whether a good is transportable across borders, but instead the Ricardo (1917), Samuelson (1964), Balassa (1964) specification that rests on productivity differentials or factor proportions that ultimately determine whether a good enters the balance of payments as an export or import and is transacted in foreign exchange (Yotopoulos, 1996, Chs. 3 and 6).

The final result is that, even in a state of the world that prioritizes monetary stability, the euro makes it possible to influence investment and redistribution to a greater extent than what would have been expected under the (increasingly less-) constraining Stability and Growth Pact (SGP), even for a state that prioritizes monetary stability.

Last and not the least among the benefits of the euro is the avoidance of the indirect tax imposed on the rest of the world by the U.S. through its reserve-currency privilege in order to pay for the domestic and foreign imbalances that resulted from the premeditated heavy tax-cutting and the unthinking war-mongering of the Bush administration. To the extent that Europeans have been using the euro as an asset, instead of the dollar they were likely to hold in a previous era, they have not been held to pay the "reserve-currency/ sovereign-risk" bounty alluded to in the previous section, and to be further developed in the next section.

4. The Stealth-Benefit in Euro's Future: the "Exorbitant Privilege"

Seigniorage is the most explicit gain from issuing the reserve currency in the form of bills or coins. It amounts to the implicit interest-free loan that the reserve-currency holders extend to the issuing authority, a central bank or a treasury, for the use of the money that is widely held abroad in the form of an "asset." This gain is equivalent to the profit that American Express makes when people buy its traveler's checks, which they are willing to hold without receiving any interest. And unlike the gains of American Express that continue only as long as people have not spent their traveler's checks, the reserve currency, the dollar, remains in foreign hands indefinitely and so it represents an option (a claim) that may never be exercised against its issuer, the U.S. Treasury. The $10 trillion held abroad in the form of reserves or other monetary assets account for 60 percent of the total amount of dollars in circulation (Bergsten, 2004: 92). Estimates of the gains from seigniorage are as high as 1 percent of GDP per year, which is a large number in the current growth environment.

The seigniorage benefit is small change compared to the benefit that was featured in the previous section. The U.S. as the issuer of the world's reserve currency is effectively enjoying full tradability for all its products with the rest of the world, whether "tradable" or "nontradable." Nontradability has been abolished worldwide for the reserve currency country, in the same way as it has been abolished within the EMU for the twelve member-countries. Since everything is produced in dollars in the U.S., the production of more "nontradable" haircuts enables Americans to import more peacock-feather fans from China.

A related, yet paramount benefit of the reserve currency refers to "sovereign risk." Since the reserve currency is the unit of account and the medium of exchange in international transactions, the U.S. issues also its financial liabilities denominated in dollars, thus shifting the foreign-exchange risk to the lender. While non-reserve currency countries face a "hard" balance-of-payments constraint, the reserve currency country faces a "soft" constraint in the sense that it can accumulate foreign liabilities in its own currency without the need to use gold or foreign exchange as an asset. It is as if the reserve currency country were issuing its own credit card to finance its imbalances with the rest of the world with impunity – as long as the reserve currency maintains its reserve perch! This is indeed an "exorbitant privilege" that Charles de Gaulle greatly resented, seeing that the United States in their war in Vietnam in the 1960s enjoyed both guns and also enough butter to grease President Lyndon Johnson's engineering of the Great Society, while the French war in Vietnam a little earlier had bankrupted his country.

The exorbitant privilege allows in effect the reserve currency country to run a "deficit without tears." Since the debt is denominated in its own currency, it can be simply frittered away through inflation at home and/or devaluation abroad. Besides, the reserve currency country in its hegemonic position is powerful enough to simply change the rules as President Nixon did in 1972 when he decreed the effective nationalization of foreign gold reserves held at Fort Knox. For this intuition alone about the exorbitant advantages of the reserve currency Charles de Gaulle deserves to be considered as the inspirational grandfather of the bright future of the euro as reserve currency, in the way that Jacques Delors is the father of the euro of today.

While Lyndon Johnson (section 2 above) was acting as if deficits did not matter, President Ronald Reagan is credited with enunciating this position for foreign imbalances and fiscal deficits alike. Reagan, after all, was correct that deficits did not matter! At the time the U.S. was the only economic superpower, and besides, no foreigner would have held Soviet rubles as an asset in the 1970s. But the same is only partly true for the U.S.

today with the euro being the new kid in the reserve-currency block. The qualifier on the omnipotence of the dollar in the international economy is certainly beneficial for the stability of the international monetary system. The gaming between two competing reserve currencies would tend to err in favor of caution and make each currency more circumspect in protecting its reputation lest it loses its profitably prestigious reserve status.

In addition to the sizeable benefits that the advent of the euro has already brought to the countries of the EMU, and to the EU by extension, the most important prize of globalization, achieving the status of the (parallel) reserve currency, is within reach, but still lies in the future. The enlargement of the EU holds both advantages and disadvantages for this next big act of the euro.

5. The Euro and the Enlargement of the Union

The enlargement of the European Union is a monumental event in its own right. It was the historical destiny of Europe to embrace the countries that through an accident of geography found themselves on the wrong side of the Iron Curtain after the War. It is also the good fortune of Europe that the new entrants have dynamic and growing economies and younger and healthy demographics that could revitalize competition, the markets and economic growth, along with stimulating the flagging spirits in Europe at a very opportune time.

The interaction of the enlargement with the euro has to be analyzed with reference to the proximate objectives in the development of the common currency. The record of the euro since launching, and especially in the last two years, has established it as a global currency. It has by now reached the threshold for being anointed as a parallel reserve currency to the dollar. Given the "exorbitant privilege" that the reserve currency enjoys, the future enlargement of the EMU must be analyzed from the perspective of the contribution or the detriment that it could bring to achieving that goal.

The increase of the population of the Union by 20 percent and the increase of its GDP by 10 percent (in PPP terms) have made the EU twice as populous as the U.S. and equal in terms of economic weight. The size of the transactions domain of a currency is a very important factor in providing for its stability which in turn is a crucial attribute of a reserve currency. The larger the vital area of a currency, the better its ability to act as a cushion against shocks. The 1992 devaluation crises in Europe mentioned earlier would have never transpired in an EMU of 290 million people and combined GDP of more than one-half that of the U.S., let alone in the enlarged EU area of 490 million people and GDP equal to the U.S. Liquidity, which is the other crucial attribute of a reserve currency, is also a direct function of the transactions domain. The currency that is used by 300 million people is 30 times more liquid than a currency that is money for 10 million people. In the currency competition business the economies of scale, the economies of scope and the "network effects" are a very important factor. The euro has qualified on this criterion to be a Great Currency (Mundell, 2000).

Even before enlargement the euro was enjoying an increased amplitude of use for transaction purposes with coverage of the Eurozone's "clock-time," which is the European region, plus some neighboring areas such as the Mediterranean littoral area and Sub-Saharan Africa. The enlargement adds to this amplitude, whether the new entrants into the EU join immediately the EMU, as most have expressed the intension of doing, whether they use the euro in a currency-board system, as Slovenia has done, or simply they use it as a peg while they continue using their own currencies. The same happens when in an increased transactions domain people trade internationally in euros, or use the euro as a "vehicle" currency for trading other currencies.

There are of course advantages for some countries to continue using their national currencies for a certain period of time so that they retain the ability to adjust interest rates or devalue their currencies, tools commonly used by governments to manage their economies. Nevertheless, the success of the euro has been well noted by the ten newest members of the EU who have already started a race to adopt the common currency the soonest possible. Lithuania and Estonia are expected to take the first steps for joining the EMU as early as July and Cyprus and Slovenia would probably follow by the end of the year. This assumes that the EMU will follow in certain cases a truncated procedure for new entrants once they have met the Maastricht criteria, by shortening the two-year stay in the euro area's "waiting room" where a country's currency is tested to see if it can remain stable relative to the euro. All this depends, of course, on the twelve Finance Ministers of the EMU countries who will be deciding if a truncated process is desirable.

While enlargement in itself strengthens the economic fundamentals of the euro as a potential reserve currency it may have a negative impact in terms of the political criterion that mandates that a reserve currency country/union must also play a global political role besides being a global economic power. Europe so far has failed to consolidate its decision-making and to speak with one voice, except in trade negotiations that the EU has transacted with success. This task of consolidating decision-making has already become more difficult in the Union of 25. How can the objectives of domestic political stability and continuity, effective decision-making, and global-level political weight (all substantial additional preconditions for the euro raising claim to world currency status) be ensured in a 25-member EU that continues to operate largely along intergovernmental lines? Moreover, can macroeconomic stability be sustained in such a *sui generis* EU polity constantly subject to changeable intergovernmental alliances and bargaining? And how viable is in the longer run a lopsided EMU structure based on a full monetary union but nothing close to a political union to match it?

Similarly, coordination of monetary and fiscal policies is necessary in order to capture and fully realize the advantages of a reserve currency. In the present regime monetary policy is handled by the "independent" ECB (under the guidance of the12 Ministers of Finance) while fiscal policy is in the domain of the EU partners, given the ceilings of the Maastricht Treaty. The result is that as the domain of the euro increases on the way of the trajectory towards a reserve currency status, the seigniorage and other profits of the ECB increase, but there is no way to channel them into fiscal policy avenues. Even more important, in the same process the euro appreciates to the detriment of the European exporters and housewives, without the possibility of utilizing the borrowing capacity of the ECB as issuer of the reserve currency, in order to channel the benefits from the reserve status into a more lax and expansionary fiscal policy. The "faults" of the euro, in leading to increased prices and contraction are not in the Maastricht criteria, but rather in the intergovernmental structure of the EU that makes coordinated decision-making impossible.

The tangible gains that derive from the euro being a (parallel) reserve currency are sufficiently important that they may warrant reconfiguring the EMU into a closer political union in order to capture them for the benefit also of future members and in final analysis of the EU.

It appears some of these concerns have been addressed by the Nice Treaty, which (extending the Amsterdam Treaty's "closer cooperation" clauses) provided for the important potentiality of "enhanced cooperation," open to all member states but requiring a minimum number of eight. In light of the above, a Vanguard in the EU (probably belonging also in the EMU subset) of the "coalition of the willing" could form a real federation to provide the political leg for the euro as a reserve currency. The structure would be stable enough without being constantly blocked by reluctant partners. It is also conceivable that an EU Vanguard might be flexible enough to expand and accommodate some of the new entrants in the federal structure and in the EMU. At the same time it would allow EU members opposed to federation to take a back seat and limit themselves to the benefits of an essentially free trade area with the additional advantages of labor mobility and of potentially sharing in the benefits of the reserve currency. This multi-tiered Europe opens a back-door for the fulfillment of the political conditions that would move the euro further toward its potential as a reserve currency.

6. Conclusion

The unquestionable economic success of the euro, plus a number of unforeseen global events that have intervened more recently, have created a unique opportunity for the euro to achieve the role of a reserve currency in the international economy. Should that happen, the financial benefits that accrue to the EMU, and by extension to the EU, are substantial. Moreover, the existence of two parallel reserve currencies, instead of only one, will add to the stability of the system of international finance.

The main obstacles remaining in the process of achieving this unique outcome relate to the abilities of EU members to coordinate their policies so as to assume a significant global political role. Can this role be pursued successfully in the enlarged EU of 25 or is a default position to be sought in some type of "Europe of the Variable Geometry?"

Counterintuitive as it may be, the success of the euro as a potential reserve currency may not only have made it more difficult for the enlargement countries to join the EMU, but it may also warrant creating first an inner subset of eight of its members that form a real, *federal*, *economic* and monetary union in order to capture what Charles de Gaulle had called the exorbitant privilege of the reserve currency.

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