THE EU ENLARGEMENT AND INTEGRATION AS A CONTRIBUTION TO THE FINANCIAL STABILITY

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Abstract: A stable international currency and a big enlargement are both important projects of the European Union. In this paper we combine these two realities and emphasize the synergies of the enlargement in the external dimension of the euro area, as well as the advantage to the new Member States due to the financial stability sustained with the euro currency. Both the euro as a single currency and the synergies of the enlargement in the external dimension of the euro area, must be seen as a very important contribution to the financial stability of the global economy. With some words conveyed by Jean-Claude Trichet we can sustain better our message in this paper: "*I am convinced that EU and euro area enlargement will contribute positively to economic growth and welfare in the whole EU*" (2005: 3). In our opinion it is also a positive contribution to the economic growth and welfare in the global economy as a whole then induces a world financial stability through positive effects on the *economic promotion* and *political flexibility*. Both issues allow us to retain financial stability as a public good which is very important to the global economy.

Keywords: EU enlargement, integration and financial stability

JEL classification: E44, F36

INTRODUCTION

The integration and enlargement process of the European Union goes on with 10 more new acceding countries and with a new Member State in the Euro Area (Greece). These facts prove the dynamism of this project and offer new opportunities for the euro area economy to take into account the trade facilities, financial integration and its role in interest rates, which is very important within the context of a global economy. This new environment of the economy also offers a dimension giving the euro some characteristics of a strong currency such as: *a strong and stable economy*, *a low inflation rate*, *a positive trade balance* and an *international currency*. We think that some conditions for financial stability of the global economy have been created.

In this paper entitled "*The EU Enlargement and Integration as a Contribution to the Financial Stability*" first, we highlight the role of the euro as a vehicle and reserve currency and also identify some other characteristics of the euro as a strong and stable currency. Second, we refer the euro and the enlargement of the euro area emphasizing the EU economic integration in face of the EU monetary integration. Third, we highlight the EU enlargement, monetary stability and its external dimension through the impact of the euro on Europe's financial system, particularly, the integration of the money market and the government bond market. Both are crucial for financial stability, where the success of the euro related to the convergence of long-term market interest rates is considered as a very important contribution. This reality allows us to retain financial stability as a public good which will be referred to in the fourth point of this paper.

1. Currencies and International Trade

The globalization and integration process of the economy promoted the openness of the borders and induced the creation of other strong international currencies in the world.

For a better understanding of this point we try to identify some characteristics of the euro as a strong currency in order to show the importance of the external dimension for the euro area, namely through the new enlargement that can be seen as an enlargement of the real side of the EU economy and less as enlargement of the monetary side, because inside of each new Member State it is the local currency which solves the problems of means of payment; liquidity asset and store value. However, the euro finds a place as a vehicle currency in international transactions of these countries, which allow us to say that the EU also increases in monetary side.

1.1 Trade and Main International Currencies

The main international trade blocs - the EU, USA and Japan - tend to be following also the international position of each currency. Actually, the disproportion between trade and the main international currency is high and is changing very slowly the role as a vehicle currency and also as a store value.

We can identify some points that justify this situation:

- Since Bretton Woods, the dollar is the international currency;
- the share of US economy in the world economy;
- the role of open economy and market integration;
- market rules and financial liberalization.

Nowadays, we can observe some changes both in economics and financial environments, which have been promoted by technological development, mainly in the case of financial services. The free movement of factors tends to be positive for all intervenients in addition to the benefits of positive externalities of an open economy. The increasing economic openness needs to be followed by financial integration that has its main sustainability in monetary stability. The euro currency comes as a result of European monetary integration answering in this way the European economic integration, attenuating the vulnerability associated with several weak European weakness currencies.

Now, we have two main international currencies: the *dollar* and the *euro*, whose market tends to be shared between them, as a vehicle currency and also as a store value where a hard currency reserves is like the bank's cash.

The economic triangle (US, EU and Japan) does not correspond to a monetary triangle. The doubt is: *how will Asian monetary economy be in the future*? The strong commercial relationship between Japan and USA will tend to clarify the monetary interdependency. However, one important issue to be solved is which currency will be stronger in Asia in the future?

Two other relevant situations to be considered in this puzzle is to discover the role of Russia in the economic and monetary side even knowing that almost 40% of its trade is done with EU. Another important point is to orient the UK to the Monetary Union and induce in the euro the positive effects, mainly as a vehicle currency, where the commonwealth mustn't be forgotten.

The main traditional functions of a currency can be found also in the European currency, that is: a means of payment; liquidity asset and store of value. European monetary integration creates the opportunities for European financial integration, where one of the main results of integration of this market is the greater liquidity registering higher issuances volumes by the private and public sector. Euro issuance was particularly strong in 1999, rising by 20% relative to 1998 as refer EC (2002: 31).

The budget constraints and the new common currency manager by the European Central Bank explains this movement in the bonds market, where a large percentage of issuance belongs to the public sector. In 1999, 2000 and 2001, the public sector government issued about 50% of the bond markets (see Lopes, 2003:11). Despite its lower share in total issuance (comparing with US economy), sovereign issuance remains a dominant source of supply for the euro dominated bond market. In 2001, it still represented more than 40% of total issuance in euro.

In fact, the integration of the financial market drives us to a homogeneity yielding, across Member States, euro area government bond market and eliminates the exchange risk, as well as obliging improvements in budgetary conditions of euro area economies. The EU shows a relevant economic integration and also a promissory financial integration with the recent creation of EURO.

1.2 Euro's Future Role in the World Economy: Vehicle and Reserve Currency

Firstly, we must see the EU as the first commercial bloc in the World. Secondly the European exports to the rest of the world (net of what are currently counted as intra-Europeans exports) will be similar in magnitude to American exports. Our neighbours as in the case of Eastern European Countries are a natural market for the euro currency.

If we see the role in foreign Direct Investment and government bonds emission, we see the euro assuming a dual role as international and "domestic" currency, due to be used as a vehicle currency for private transactions, and the reserve currency for official interventions.

In an era of globalization this is an answer by the monetary side to the real side of the world economy, where there are more than 150 national currencies, but with the dollar's interbank predominance (almost 90 percent of interbank transactions). This fact allows the US price level to be fairly immune to fluctuations in the dollar's exchange rate against other currencies, mainly because 98 percent of American exports and 88 percent of American imports are invoiced in dollars. Additionally, for trade not directly involved with the United States, the dollar is heavily used as an invoice currency for manufactured exports from developing and transitional economies in Asia, Latin America, and elsewhere.

Within "Euroland" context the European Central Bank manages the monetary policy for all National European Central Banks where governments therefore do not have opportunities to create competitive trade advantages rescuing their economies from depression. The monetary policy of the European Central Bank has as the main goal the price stability with inflation less than 2%. This goal had been accompanied by the roles of the Stability Pact. Considering now the euro supply side, we think that economic growth rates and the sustainability of this currency must drive the returns of issuance the euro money to the EU Budget. However, the money supply can also be done through capital market because we witness to an *open* European Capital Market and a *closed* European Central Bank Policy for money supply. Additionally, monetary and financial integration offer opportunities to the euro to assume even more the role of an international vehicle currency, giving an increasing role in international trade.

2. The Euro and the Enlargement of the Euro Area

The euro, a single currency, is probably the most visible and tangible symbol of the European integration process as refers Jean-Claude Trichet (2005:1).

In this point entitled *the euro and the enlargement of the euro area*, we take into consideration the dimension of the euro as a single currency, the main characteristics of a strong currency, as is the case of the low and stable inflation rate, that is guaranteed mainly through the strategy of the monetary policy of the European Central Bank, and try to identify the role of them in the volatility of the euro as the currency of the Euro area economy. We also must consider trade between EU and an economy with a strong international currency, as well as with other important neighbours` economies due to their dimension of trade with the euro area economy.

2.1 The EU Economic Integration in Face of the EU Monetary Integration

The economic integration of the EU has been followed by the monetary integration given sense to the European Monetary System (created in 13th of March, 1979) with a currency of the system: European Currency Unity (ECU). The theoretical sustention of *one monetary system / one currency* was guaranteed. However, with the euro in 1999 (in circulation, only in 2002), there is a situation where that theoretical approach is not yet possible in order to implement the idea of *one market, one money*. However, this means that we already have a single currency and a single monetary policy for more than 300 million citizens.

So, the idea of *one market, one money* decided by Maastricht Treaty, in 1992, is not yet finished if we think about the EU12 with the EU15. The U.K., Denmark and Sweden, until now, prefer to stay with their own currency. The traditional welfare state in Sweden and a strong fiscal level in Denmark can explain the decisions of these countries. But in our own opinion this decision does not produce any negative effect in the euro currency. However, the same is not true with the U.K.. Its currency associated with its big economy can produce more positive advantages for the euro as a stable currency. However, the attitude of the U.K. faced with the euro is not surprising, due to the less enthusiastic attitude of U.K. politicians since the beginning of EU. In fact, looking at the external dimension of the euro, we think that these three EU Member States may be the next countries to adopt the euro as a currency of their economies.

For any of those EU countries the euro is the international currency. In the near future, we believe that when U.K. decides to adopt the euro, Denmark and Sweden will follow it. It is important to emphasize that Sweden already registers very good information about the convergence criteria: in 2004, the inflation rate was 1.3%; long-term interest rate by 4.7%, deficit 0,6% and debt 51.6%.

The euro-dollar competition goes on today, but the euro is seen as an overvalued currency. We must see this situation from two sides: first, a sight of a strong currency, that gives confidence to this new currency; second, as a difficulty for the Euro area exportations, decreasing by this way the growth rate in the euro area economy. In our opinion, after strong competition the euro tends to be not only a strong currency, but also a stable currency. The credibility of the euro has been the main goal of the monetary authorities; in the face of the enlargements and integration process of the EU.

It is the first time since Bretton Woods that a currency has been prepared to assume the role that, until now, only the dollar had the capacity to fulfill. It is in this year that the euro is entering its seventh year.

The euro area put together twelve economies that decided to leave each own currency changing, for the majority, a weak currency for a strong one. Their monetary and fiscal implications oblige more rigorous decisions by policy makers resulting in more advantages for the government and also, at the same time, in better returns to the enterprises and families as private economic agents. The *integration of monetary markets* and *convergence of long-term market interest rates* are mentioned as the main successes of the European monetary integration.

2.2 Economic and Monetary Integration in Face of New Enlargement of the EU

The process of European construction has now a very important step in its enlargement. It is the larger one in number of countries: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia. They are the 10 new Member States of EU after May 1, 2004, being these countries denominated the "acceding countries". These ten countries represent a big enlargement in territorial dimension, but a very low economic share. They only correspond to approximately 6% of euro area GDP. There are 75 million consumers, ¼ of the euro area consumers, now with 305 million. The monetary integration will be another step for all these new Member States, which must consider the convergence criteria such as price stability and solid budget situation.

All these acceding countries have disequilibria in their commercial accounts. The worst situation is occupied by Cyprus with 13% of the cover tax. In the best situation is Slovak Republic that registers 93%, in 2000. In 2001, it is Czech Republic that reaches the best place with 92%. The EU15 reaches 96% in this same year. In this context it is important to mention the commercial relationships between actual new Member States and EU, in 2001, using table 1.

Table 1: **EU Enlargement and Trade of Its New Members**

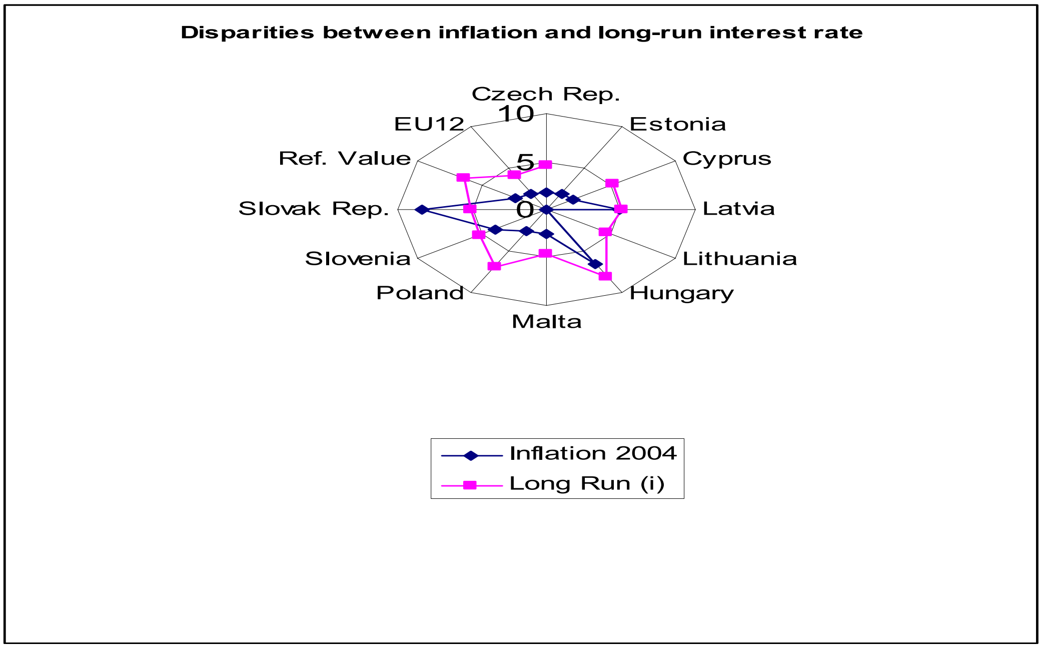
	Imports from EU	**Exports to EU**	Per capita income
	as % of total		
	2001		2001 (PPS)
Cyprus	55,5	49,0	18500
Czech Republic	61,8	68,9	13300
Estonia	56,5	69,4	9800
Hungary	57,8	74,3	11900
Latvia	52,6	61,2	7700
Lithuania	44,0	47,8	8700
Malta	63,6	41,3	-
Poland	61,4	69,2	9200
Slovak Republic	49,8	59,9	11100
Slovenia	67,7	62,2	1600
EU15			23200

Source: EC, Eurostat: General Statistics.

The majority of these countries have, in 2001, EU Member States as the destination for more than 50 % of their export. A large part of them has a positive commercial relation, for example, the Czech Republic imports 61,8 % but exports to EU 68,9 %; Estonia 56,5 / 69,4; Hungary 57,8 / 74,3; Poland 61,4 / 69,2. The main economies of these ten acceding countries are Poland and Hungary, which has in EU their main client for their export. Another dimension that makes sense to consider in this new enlargement is the disparity in *per capita* income. Through table 1 we can see that *per capita* average of EU15 is much higher that any other new Member State. All these economies must be using the Structural Funds of EU budget.

Now, it makes sense also to consider the challenge of EU with **enlarging the euro area** which is seen by Jean-Claude Trichet (2005:2) as one of the major challenge. He refers the following message: “The historic EU enlargement with ten countries on the 1st of May last year was only a first step in the process of economic and monetary integration of the new Member States”. Naturally, an important step in this process is to fulfill the convergence criteria in order to adopt the euro. In this context, it makes sense to highlight another observation of the Jean-Claude Trichet (2005:2): “All convergence criteria, relating not only to exchange rate developments but also to inflation, public deficit and debt, and long term interest rate, as well as legal convergence, will need to be achieved in a sustainable manner. Only when all the criteria are met on a sustainable basis, will a country be eligible for adopting the euro.” We would like to retain *two* of those variables: *inflation* and *long term interest rate*. It is important to know the level of each convergence criteria in the 10 new Member States, and also the disparities between them, as well as between EU12. Graph nº 1 gives us information about those two variables.

***Graph nº 1*: Disparities between inflation and long term interest rates within 10 new Member States and Euro Area, EU12**.



Considering the *inflation rate* in 2004[1]we can see Slovak Republic and Hungary as the two main countries with less convergence face *reference value* (2,4%)[2]. The Slovak Republic registers 8,4% and Hungary registers 6,5%. All 8 other Member States have values less than 5%. Another variable of convergence criteria that we can see through this graft is the long term interest rate. In this case, we can find more convergence between them, comparing with inflation, but it is interesting to say that EU12 get the lower price of the money (4.4%) and Hungary and Poland register the higher levels of long term interest rates with 8.1% and 6.9%, respectively.

This graft also allows us to read the dimension of the disparities of the real interest rate which also differ between them. Latvia comes as a country where the real interest rate is closer to zero, with 4,9% and 5% for inflation and long term interest rate, respectively.

[1] It is the average of inflation from September 2003 to August 2004.

[2] It is average of inflation registered in three Member States with better results in price stability. In this case they are: Finland (0.4%), Denmark (1.0%) and Sweden (1.3%). Then, the average is 0.9% and, adding 1.5%. Then, the reference value is 2.4%.

Poland, is the Member State where the real interest rate is higher (4.4%), face inflation and long term interest rate with 2,5% and 6,9%, respectively. Lithuania is a very interesting country, without inflation but with an interesting long term interest rate (4,7%). However, it is expected that, in general, the new Member States felt some difficulties associated with the financial efforts to co-finance the investments selected by EU for the investments of structural funds. Member States with a tendency to increase the deficit, as is the case of Poland with 5,6%, can face higher difficulties with its goal to join the euro area. These difficulties will increase in all financial markets where capital market is not yet developed enough.

3. The EU Enlargement, Monetary Stability and Its External Dimension

The EU enlargement and monetary stability are two important pillars of the European project. This can be seen by the enlargement to poorer economies and by the new steps in the integration process, as is the case of financial integration promoted with the introduction of the single currency.

This point presents an overview of the impact of the introduction of the euro on Europe's financial structure over the first seven years since the start of EMU, even knowing that payment system between Member States of the EU was, since 1979, through the ECU (European Currency Unity) which shows that the roots of the euro go back a long time, in fact more than twenty years. The whole sustainability of the euro today is not necessarily the result of efforts from the seven years of its existence but a work of several years before the euro birth. Obviously, the euro is not only the currency of the eurosystem but, necessarily, a second currency for other EU Member States and, obviously its international currency.

Within this step of the paper we would like to consider the real and monetary EU economy to better explain the importance of the external dimension for the euro area resultant of this recent EU enlargement. Germany, France, Italy, Belgium, Netherlands, Luxemburg, Austria, Finland, Spain, Ireland, Portugal and Greece are together using the same currency, thus protecting their own economies from the monetary instability provoked by other strong currencies. When we talk about the external dimension for the euro area we must consider various aspects and several economic motivations: first, the EU Member States out with the euro; second, the acceding countries, and finally, the rest of the world.

3.1 The Real and Monetary Side of the External Dimension for the Euro Area

The external dimension for the euro area must include two main components of the European economy: real and monetary sides. First, it makes sense to consider the real side as happened with European integration process. With this recent enlargement the EU increased more in population that in share of its economic value. However, looking at the economy as being its population as human capital, the role of these new Member States grows considerably.

Actually the role of the euro as an international currency and its contribution to international monetary stability creates a need to manage the supply side in the face of needs from the demand side. Several economic agents as the local and central governments, enterprises and families are the main share of the demand side. In other words, it is the real economy that determines the general equilibrium.

The increasing demand of the securities as real/financial assets also forces us to consider its demand in the real side of the economy. This variable can be measured through the role of the capital market in financing the public sector as well as the private sector. Considering the euro as an international currency, it is important not only to register its internal demand, but also its external demand that also depends on other variables like:

- the cover tax of the EU economy;
- share of EU in the World Economy;
- share of FDI of the EU in the World Economy;
- the role of capital market in financing the public sector;
- the role of capital market in financing the private sector.

A common characteristic in the majority of those variables is the increasing share of the EU in the world economy. Only the first one tends to be reduced due to the level of imports and exports of the acceding countries to the EU as we can see through table 1 showed in the point before.

Besides the real side, the general equilibrium of the EU economy also assumes the monetary side. In fact, the real economy of the EU15 is different from the EU12, which is the euro area economy. The new enlargement reinforces this gap between real and monetary European economy with EU12 and EU25, respectively. However, the role of the euro as an international currency reduces this disparity between real and monetary economy; particularly when the euro is used as store value. Additionally, the euro is increasingly used as a vehicle currency, mainly, in economic transactions between the euro area and EU countries. This disparity between real and monetary economy can explain, partially, the price of money, the price of the euro (measured by interest rate) being much higher than the dollar. During 2003 it was 2% and 1 %, respectively. Since June (2004), the dollar has tended to increase. This fact, can help to explain the decrease in investment in the EU reducing in this way the growth rates. Another point that can be used as a lever in order to create new steps for growth is to accept more flexibility, mainly in deficit criteria.

Faced with these points that we referred to before, it makes sense to retain some of the main variables that sustain the inclusion of the monetary external dimension in the euro area:

- Economic stability (average inflation rate);
- euro area interest rate (bond market);
- share of EU capital market in the economy;
- store value of the euro in the world economy.

The first two variables are advantageous for new Member States that result from their accessing process to the EU market. The mobility of capital and the main goal of price stability are also variables supported by the ECB that benefit all EU economy.

The *share of EU capital market in the economy* and the *store value of the euro in the economy* is a result of external dimension for the euro area. However, the store value of the euro in the economy must consider other parts of the world as is the case of Asia. The role of the euro as an international currency depends on all the factors referred to before, including both sides of the economy: real and monetary sides. The monetary stability tends to be visible in all markets of the financial system, but it is particularly to monetary market that, for now, it is necessary to pay attention.

3.2 The Money Market and the Role of Monetary Stability

The external dimension of the euro area can also be observed through the financial market that combines the money market, the bond market and the equity market. Herein, we only concentrate our attention on the money market.

The money market, as the short term market of the financial market, is the place where only some financial institutions can operate; but its decisions directly drive the fluctuation of interest rates and, indirectly, the returns and management of capital market. These facts explain the importance of the money market to the stability of financial market as European Commission (2001:137) states "…integration progressive des différents systèmes financiers nationaux au sein de l`Union …est accélérée avec l´ introduction de l`euro en 1999". Looking at the money market as the first of the financial market our attention goes towards the role of the monetary stability of the euro area in the external dimension.

The appearance of the euro area induces changes in all segments of the EU financial market and at the same time, in other financial markets of the world, and also helps to create the financial sector in the transition economies. After 1989, with German reunification, a new space was created in order to also organize a financial sector in this part of Europe.

Broadly speaking, the role of the financial sector in all economies is to channel resources from savers to private or public investment projects. However, in the case of transition economies in general, namely the large and relatively closed transition economies as China and Russia, the remaining privatization of large dominant banks makes the development of effective financial intermediation difficult. More than a decade after German reunification, the financial sector of transaction economies still suffer several problems. The majority of the transition economies, namely Poland and Hungary indicate that secondary markets for bad debt is extremely thin, and that recovery rates are consequently low on this type of asset.

Through the money market it is possible to transfer funds from individuals, corporations, and government units with short-term excess funds to economic agents who have short-term needs for funds. The secondary markets for money market instruments are a very important way to reallocate the amounts of liquid funds available in the market at any particular time. The increasing level of securities is also reflected in the growing popularity of money market funds which satisfy the three key requirements: efficient cash management, liquidity and yield. The money market instruments and their liquidity reduce more and more the traditionally available short-term deposits through the commercial banks. Additionally, the decrease in the interest rate of the short run deposits induces very interesting changes in the money market. First, it is used also as an investment market, being in the first position the bank deposits and in the second position the money market funds.

One very important characteristic of money market instruments is law default risk, that is the risk of late or nonpayment of principal and / or interest is generally small. It is a market with a quick return to the lender and its instruments can generally be issued only by high-quality borrowers with little risk of default, as is the case of the central, regional or municipal governments. This fact offers the money market the opportunity to sustain monetary stability promoting in this way financial stability.

4. European Financial Stability and the Euro as a Public Good

The impact of the euro on Europe's financial system includes all its financial markets and all its financial institutions where there are money markets, bond markets, equity market and foreign exchange market. From an institutional point of view, the financial institutions include the European Central Bank (ECB), the National Central Bank (NCB12) and the commercial banks with their intensive process of mergers and acquisitions that today are each more financial groups than traditional bank institutions. The reduction of cost of capital results also from the free movement of capital within EU Member States forcing the commercial banks to consider other financial business as security, factoring and leasing; transferring, at the same time, the risk of financial investment to the clients. On the borrower side, EMU has increased the attractiveness of market-based financing methods, by allowing debt issuers to top institutional portfolios across the euro area. The tendency to homogeneity in legal and institutional infrastructures and market practices promote further financial market development as is the case of Euronext. Hence, the euro is a sign of cooperation between national authorities and institutions as a means of achieving a more harmonized financial environment. Not less important is the impact of the euro on foreign exchange markets where the volatility, spreads, trading volumes and liquidity appear in a substantial way as stated by Galati and Tsatsaronis (2003). But in fact, the new currency is not only a *single currency*, but also an *international currency*, the introduction of the euro being more than an event of singular importance for the European economy; because the enlargement of new Member States increases the role of the EU also on the monetary side. The integration process makes the euro stronger as an international currency, including changes within the *macroeconomic environment*, *monetary policy* and *financial markets*.

In our opinion the lower interest rates registered today compared with the last fifty years (during the time when dollar was the only international currency), can prove to us some of the advantages of the euro as a new more international currency. The competition registered in international monetary market makes sense in an environment of globalization of the economy, particularly, the financial globalization, as is assumed by Tobin (1998). Both borrowers and lenders have new possibilities to diversify their financial strategies through deeper financial markets and cross-border facilities in a single market with the technological financial innovations. The robustness of the European financial system must include the importance of the euro area currency as a *public good*.

It is possible to identify positive externalities, due to the euro as a single currency but also due to the euro as an international currency. In the first case, when the euro eliminates foreign exchange risk as well as regulatory constraints; in the second case, the European financial markets became larger than its constituent parts, which facilitates and reduces the risk of instability of the dollar compared with currencies of the other economies.

The single market and the competition, offer the opportunity to benefit from the convergence in interest rates. This is one more positive externality with the euro, in this way, being a *redistribution factor of the EU*. Additionally, the ECB as the body responsible for printing the euro currency can contribute these advantages to the EU budget that, thus, helps the acceding countries more intensively. All of them have a lower per capita income than any EU Member States, even cohesion countries as Greece and Portugal. It is also possible to identify negative externalities for the countries that have institutional infrastructures less organized in their own financial system. Each country lost the possibility of self-financing the national budget that only can be compensated by the financial structures through money creation. However, we must consider that there is not any periphery in the financial system if we consider that money doesn't need transportation, allowing finance of the economy at a lower level of interest rate without introducing factors of monetary instability, as happens when money is printed in order to finance public accounts.

Retaining again the positive externalities of the euro, the inflation rate is also a good indicator, price stability being the main goal of the ECB. In this way, workers (with a fixed income) can maintain their purchasing power, but it isn't true with high inflation rates, as happened before the euro, in several Member States of the EU.

If we analyze this indicator in EU acceding countries we can see a big tendency to control inflation, it being a very important dimension of the euro and also an external dimension for the Euro area in international macroeconomic linkages. If we look at the exchange rate of the euro, we also see positive externalities when the euro has a lower value than dollar, improving the commercial trade and negative externalities when the opposite occurs, as is the case of the last months. With higher interest rates capital flows into the EU, but we lose money when we remunerate foreign capital, being a negative income flow.

But why is financial stability important and where are its positive externalities?

Financial crises are a phenomenon that occur in several parts of the world and include *debt crises*, *bank crisis* and *currencies crises*. All of them are very interrelated and each crisis causes enormous costs in developing countries and even in developed ones. Then it is not easy to identify all determinants for each crisis but it is essential to find the main factors that provoke this financial instability in order to reduce the probability of these occurrences. Considering the contribution of Schinasi (2004) financial stability is defined as its ability to facilitate and enhance economic processes, *manage risks*, and *absorb shocks*. These two dimensions of economic process only can be reached through multiple combinations that include elements of financial and real economics, the participation of private and public sector, and also need a consistent institutional and market structures.

The goal of financial stability can be used for each economy that has a currency "universally" accepted as the economy's unit of account and means of payment. But, in the context of globalization and particularly considering the integration phenomenon, the economies are more open and also more interrelated, as is the case of the European Union, where there is an Economic and Monetary Union. The acceding countries found special conditions for a reorganization of their own economies in their economic and monetary sides, in order to also achieve their own financial stability. With the *single currency* in the euro area the main conditions for the stability of each economy of the EU have been created, even for those which, until now, have stayed out of the monetary union. In this sense we can say that the euro provides services, as a private good, due to its individual benefits with cost of transactions, but also as a *public good* due to the stability offered to the economy. This idea of public good must be enlarged also to the rest of the world, particularly to the acceding countries through the promotion of multilateral trade, eliminating the vulnerability of exchange rates. In this way, the euro as a new international currency creates conditions for financial stability, which encompasses stability in monetary and capital markets.

The European economic and monetary integration goes on into the financial integration in order to sustain financial stability, with monetary and capital markets being involved in big transformations of their institutions and with new rules of the financial market. The ECB plays a very important role in all financial stability being the institution that has responsibility for implementing monetary policy in the euro area. With the EONIA (Euro over night index average), that is the reference rate for the euro area overnight rate[3], and the EURIBOR (Euro interbank offered rate)[4] interest rates, it has been possible to get monetary stability through the money market which is regularly used by the eurosystem to distribute liquidity to the market, in order to finance the economy at very low interest rates as an important factor of economic growth and also a way to control the danger of hyperinflation. In this case, we can also see financial stability as a public good, even more if we analyse the results of financial integration in the case of the government bonds market, where there is a convergence in the long-term interest rates. Other results can be found in other markets as is the case of monetary market. We must highlight the idea of the ECB (2004:23) where the integration of the euro area money market is referred to as:

- Essential to allow a smooth flow of liquidity between markets and across country borders;
- Necessary to the efficient allocation of resources in the euro area, and
- Important for promoting a more efficient pricing of short-term debt in the euro area.

All these points contribute to increasing the positive externalities of the European financial system.

If we see the cross-sectional standard deviation of the average overnight lending rates among euro area countries, we can confirm a big instability between 1994 and 1999,

[3] "I t is calculated by the ECB as a weighted average of all overnight unsecured lending transacctions undertaken in the interbank market by a number of contributing panel banks." ECB (2004:24).

[4] "Is the benchmark rate of the euro money market for a number of standardised maturities up to one year. For any given maturity, the EURIBOR reference rate is the rate at which euro interbank term deposits are offered by contributing panel banks." ECB (2004:24).

and a very high stability since 1999 until now with a standard deviation near zero. Taking into consideration the government market integration, the main importance has focused on the highly liquid 10-year maturity segment. There is a considerable convergence in government bond yields, mainly due to the substantial convergence of expectations across countries in the run-up to the euro launch. However, the credit risk and maturity have not entirely converged as show ECB (2004) where it is stated that Austria, France, and the Netherlands all share the AAA credit rating with Germany, in 2002 their governments had to pay on average 16.8, 8.4, and 11.1 basis points, respectively, more than Germany, (ECB, 2004: 39). In order to prove the big tendency to convergence it is important to retain the following information (ECB, 2004: 39): "Dispersions in monthly yields have fallen from an average of 1.98 in 1993 to 0.06 in 2002, or by more than 97 percent". With this contribution that focused on the 10-year maturity segment of the government bond market we can appreciate the degree of integration, promoting in this way financial stability as a public good, more yet due to the public sector benefits of financing with lower cost.

In our opinion looking at financial stability as a public good, namely through the convergence of the monetary conditions, can be considered as endogenous effects of monetary integration where, sharing a new single currency might set free forces, bringing the euro area countries closer. But, some progress has been made towards more financial integration in the euro area. As De Grauwe and Mongelli (2004:15) state "There is no doubt that this progress occurred, especially in money market and bond markets due to the introduction of the euro. Yet, the euro area is still far from a unified financial market". However, the economic integration leads to better risk sharing opportunities (income insurance) through financial market integration, where it makes sense to announce the success of **integration of the money markets** and, sometimes grossly underestimated, success of the **convergence of long term market interest rates**; mainly, the long term of government bonds which register a very low and stable value, its values being around 4%. Considering also *price stability* as the main goal of ECB with inflation around 2%, then we can conclude that EU is an economic and financial integration area that offers *financial stability* and *credibility* with its macroeconomic policy. This is a public good to the European economy and then to the global economy.

A previous conclusion in order to reinforce the interdependence between the main words in the title of this paper, *the EU enlargement and integration as a contribution to the financial stability of the global economy*, which are very important given the process of globalization in the world, we can retain the following message: “Today, the European economy benefits from benchmark long-term market interest rates well below 4%, a level which most issuers have never seen in the last fifty years. The reduction in the risk premia and the stabilization in inflation expectations at low levels is a major achievement which must be maintained by today`s and future economic policy making” (ECB, 2005:1). With these advantages of the euro for the European and global economy and, including the positive externalities provoked by this financial integration we find positive effects on economic promotion and political flexibility.

CONCLUSION

European financial integration and the enlargement to other EU Members States are the guarantee of monetary stability through the control of interest rates and price stability, as well as with an “individual” effort to control public accounts. The diversity and vulnerability of financial systems within EU tend to be reduced with financial integration, which is very promising with a single currency. Looking at the stable monetary economy, as a need for economic growth, and considering the financial stability which rises strongly with an increasing role of the euro as an international currency, it is believed that the EU can make a contribution to the rest of the world, namely through the relevance of financial integration in financial stability. We would like to conclude with a message conveyed by Jean-Claude Trichet (2005:3): “*I am convinced that EU and euro area enlargement will contribute positively to economic growth and welfare in the whole EU*”. In our opinion, it is also a positive contribution to economic growth and welfare in the global economy as a whole, then induces world financial stability through positive effects on *economic promotion* and *political flexibility*.

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