

Analysis of EMU as a Viable Common Currency Area

Jiaming Fei

Binghamton University, Vestal, NY 13902, United States

Abstract. The euro crisis has significantly influenced Europe's progress, but many experts continue to doubt the European Monetary Union's long-term viability. Those without independent monetary policy will be unable to support their economies through currency devaluation if an economic crisis occurs. Countries that are not experiencing a situation would also be affected. Overall, the EMU benefits individual countries while also benefiting the entire EU. Each nation has distinct benefits from utilizing the euro, notably during the financial crisis. A monetary union without a fiscal union would be a catastrophe, but a severe enough problem would motivate European countries to move closer together. The European Central Bank has also implemented a massive bond-buying program to keep borrowing rates low. The eurozone has been able to respond to the consequences of the coronavirus outbreak reasonably rapidly. The research conclusion of this paper indicates that during the euro's implementation, countries' cooperation and development should be bolstered, the issue of benefit-sharing should be thoroughly investigated, an exchange and cooperation mechanism between countries should be established under the unified currency system, and a community of interests should be established.

Keywords: Common Currency Area; EMU; Euro; ECB.

1. Introduction

The euro crisis has had a significant influence on Europe's development. The euro is, first and foremost, a symbol of European togetherness. It can foster peace and cohesion inside the EU while also protecting and restarting the European economy. However, many commentators doubt the European monetary Union's long-term viability. It is claimed that in the process of achieving the eurozone, Greece, Italy, and other countries purchased debt modification services from investment banks such as Goldman Sachs in order to meet the terms of joining the euro, resulting in a hidden problem that became the U.S. subprime mortgage crisis, which was triggered by the blockbuster European debt crisis.

Furthermore, when an economic crisis does break out, countries without independent monetary policies cannot boost their economies through devaluation and other means; thus, those without crises will also be affected. Britain's departure from the euro also casts doubt on the sustainability of Europe's monetary Union. Establishing the European Monetary Union is beneficial to some countries but beneficial to the whole.

As for the contribution of this paper, previous literature mainly analyzed it from the micro perspective and primarily focused on the influence effect and policy analysis of the euro. In contrast, this paper mainly studied it from the macro level, such as whether the eurozone can be used as a common currency area for sustainable development. Therefore, this paper makes an in-depth analysis of the problems existing in the development process of the euro and puts forward some suggestions and questions, hoping to provide some references for the reform and innovative development of the euro.

The rest of the paper is structured as follows. Section 2 is mainly the analysis of the euro. Section 3 is the conclusion and enlightenment.

2. The Analysis of Euro

2.1 Turnover

Between 2016 and 2019, the Euro's turnover grew, indicating an increasing proportion of worldwide trade on foreign exchange markets. In 2019, the average daily turnover of the EUR on

forex was over 2.1 trillion U.S. dollars, a substantial rise from the 470 billion U.S. dollars recorded in 2001. Fig.1 shows the Euro's global foreign currency market turnover from 2001 to 2019. (In billion U.S. dollars). Overall, the turnover or the trading volume of the Euro has been increasing gradually, which could be an indicator of acceptance and popularity of the currency.

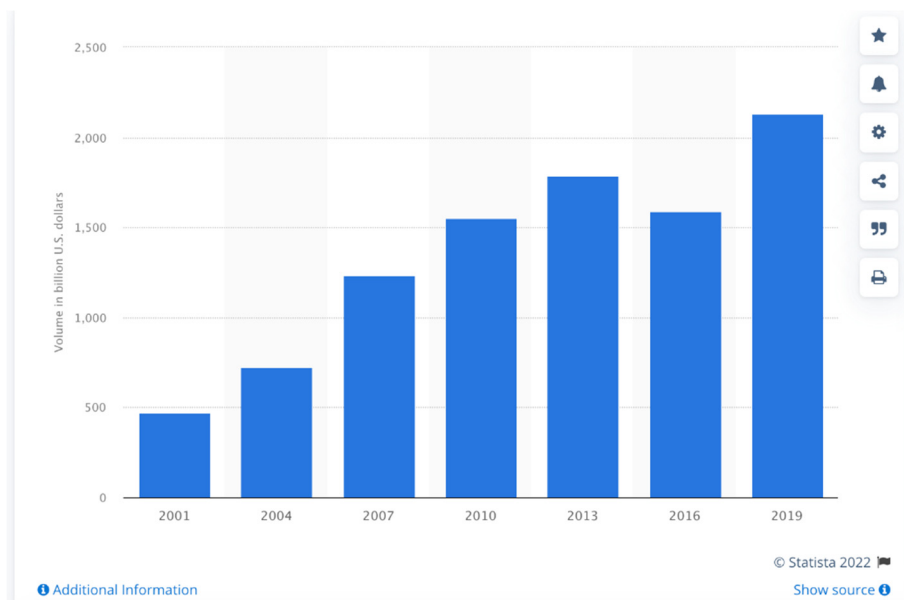


Fig 1. The average daily turnover of the EUR

Source: Statista

<https://www.statista.com/statistics/1204111/euro-activity-trading-day-global-currency-market/#:~:text=Turnover%20in%20the%20euro%20increased,U.S.%20dollars%20recorded%20in%202001.>

2.2 Onshore and Offshore Comparison

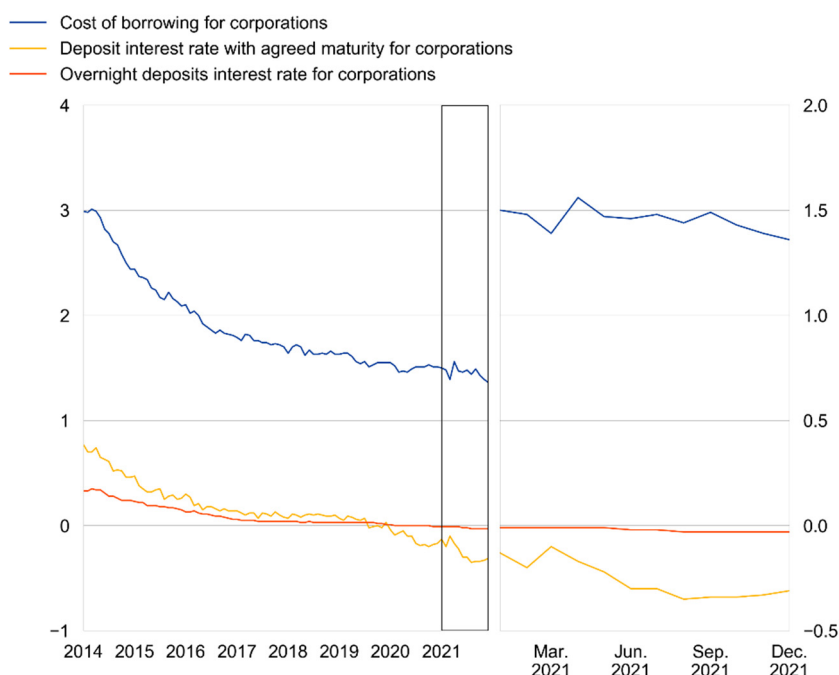


Fig 2. The Euro Area Bank Interest Rate

Source: ECB statistics

https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/ComunicadosBCE/NotasInformativasBCE/22/presbce2022_1en.pdf

Offshore Finance generally refers to the currency or securities transactions conducted in the financial market by parties without the nationality of the country where the financial market is located. However, the thorough international nature of the offshore financial market makes it possible for any ordinary offshore financial operation to involve the sovereign issues of multiple countries. One of them is the country where the financial market is located, the country where the currency is issued, the country where the financial institution is located, the country where the fundraiser is located, and the country where the fund provider is located. The graph below shows the Euro area bank interest rate statistics for December 2021 for the onshore interest rate. In December 2021, the composite cost-of-borrowing index, which includes interest rates on all loans to firms, remained essentially constant (Henning et al., 2007).

The Euro Interbank Offered Rate (Euribor) is based on the rate at which a group of European banks lends money to one another. The level of interest rates is mainly governed by supply and demand because Euribor is based on agreements between numerous European banks. External variables such as economic growth and inflation, on the other hand, might impact interest rates. Euribor rates are significant because they serve as the foundation for pricing and interest rates on various financial instruments, including interest rate swaps, futures, savings accounts, and mortgages. As for the Euro offshore interest rate, the graph below shows the movement of the Euribor. The graph illustrated that after the 2008-2009 Great Depression, the Euribor had decreased dramatically, and afterward, the interest rate maintained at a relatively low level and even hit below 0% from 2015 till 2022.

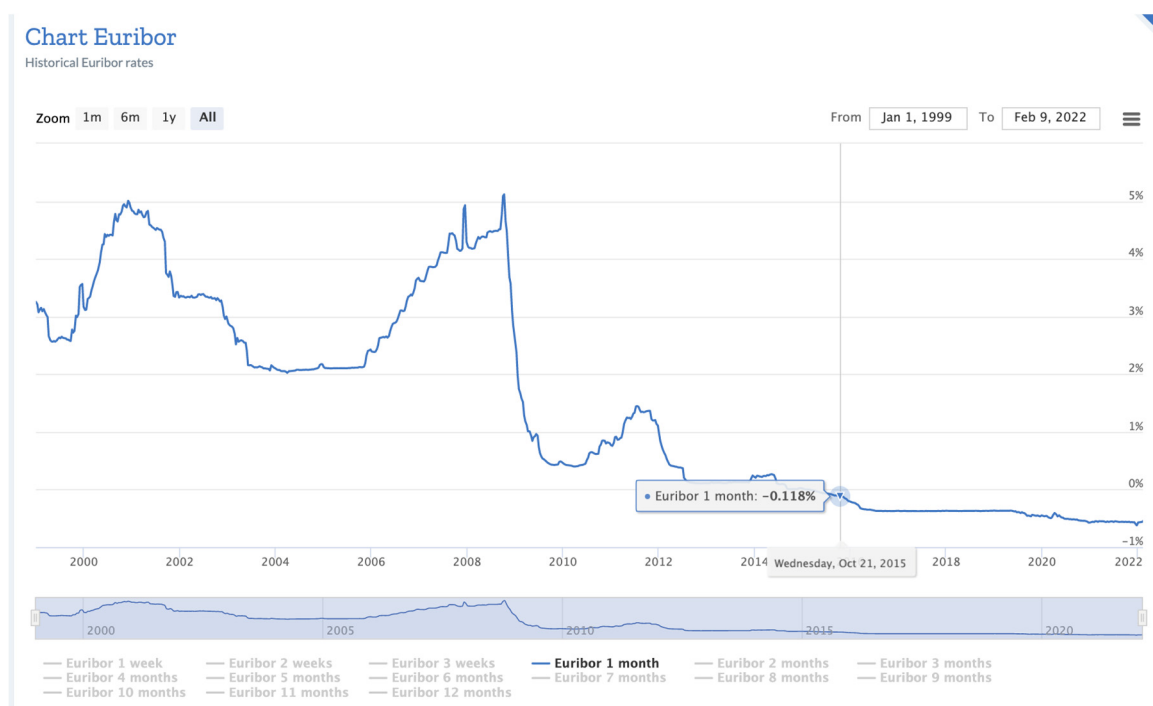


Fig 3. The Euribor rates from 2000 to 2022

Source: Euribor rates

<https://www.euribor-rates.eu/en/>

2.3 Euro Valuation and Outlook

The currency's value is like commodities in economic marketplaces, determined by supply and demand. The euro can be settled in one of three ways. One factor to consider is how many other foreign currencies the euro can purchase, such as dollars. That is how the exchange rate is calculated. They consider supply and demand, as well as future predictions. As a result, the currency's value changed throughout the trading day. The second option is to rely on the value of government bonds, which can be readily exchanged for euros on the secondary market. The third way is through foreign exchange reserves, which is the number of euros that foreign governments hold, and the more they

hold, the less the supply, because that makes the euro more valuable. If foreign governments sell all their euros and Eurobonds, they will depreciate more.

Nevertheless, in recent decades the euro has depreciated against the dollar, and the dollar has risen, as the dollar has strengthened against the euro as a haven. Overall, since the European sovereign debt markets are finally seeing outflows, German bunds, and Italian bonds were heavily sold last week, future rate rises are likely to be cautious considering the macro backdrop. The economy is growing, the omicron danger appears to be fading, and political infighting inside the European Union has subsided. As government bond rates break through and away from zero, foreign capital investment in Europe will likely rise. However, some short-term risks still exist because the US CPI is approaching 7%, the highest level in decades, the Fed is expected to raise interest rates, causing the dollar to rise and the euro to weaken. Furthermore, for geopolitical reasons, such as a probable Russian invasion of Ukraine, global markets, particularly in Europe, might be thrown into chaos. Given that the USD could be the safe-haven appeal, this would also boost the dollar to appreciate.

2.4 ECB Goals

Like that of other major industrial countries' currencies, the euro's current exchange rate regime is free-floating. The Eurogroup may set "general directions" for the currency's exchange rate policy under this system, as long as they do not contradict the ECB's primary goal of price stability. So yet, no clear course has been established. The European System of Central Banks (ESCB) is in charge of managing and holding member nations' foreign currency reserves and intervening in foreign exchange markets. When foreign exchange policy and monetary policy are inconsistent, either intervention cannot effectively alter the market exchange rate or the intervention size is too big, causing the domestic monetary policy to fluctuate. This may be true, mainly if the intervention is intended to counteract a trend in currency rate appreciation, which leads to the building of significant foreign exchange reserves that are difficult to sterilize.

The Exchange Rate Mechanism II (ERM II) was established on January 1, 1999, as the successor to the ERM, to ensure that exchange rate fluctuations between the euro and other EU currencies do not destabilize the single market economy and to assist non-eurozone countries in preparing for their entry into the eurozone. Non-euro zone members' currency rates can fluctuate against the euro within set limitations under ERM II. If necessary, intervention (buying or selling) may be employed to sustain the currency, keeping the exchange rate within a 15% zone versus the euro. The ECB and central banks from non-eurozone countries coordinated the action. The ECB's General Council monitors the ERM II's functioning and guarantees coordinated monetary and exchange rate policies. The General Council also oversees intervention tools in collaboration with member-state central banks.

3. Risk Analysis of Euro

3.1 Major Risk Factors

Several risk factors could affect the Euro. The first is economic growth in the eurozone countries, which will determine the demand for the Euro. The second is the employment rate of eurozone countries, whether they can create jobs, etc. The third is the budget deficit and national debt level of the eurozone countries, which will be a source of risk to the Euro to some extent since the economic crisis. Monetary policy by the European Central Bank and domestic and international politics will also affect the Euro. Changes in the list of countries that end up in the eurozone are also worth considering, as some of the riskier countries may also affect the Euro. From my perspective, I would suggest the dollar-based investor hedge long exposure on Euro as there is an increasing trend for the USD or, in other words, the dollar is strong and in appreciation. Thus, it needs to bear some low risk if it holds a long position on the Euro, adopting some hedge position by using the forward or options would be a good choice.

3.2 Possible Solutions

Forward contracts are tailored agreements in which both parties agree to acquire and sell assets at a specific price on a future date. Hedging and speculating are both possible with forwarding contracts. Futures contracts are standardized, whereas forward contracts are not. A *currency forward contract* is a legally binding contract in which the foreign exchange market locks in an exchange rate to purchase or sell currency at a future date. Currency futures are hedging tools that may be customized and do not need any upfront trading edge payments. Currency forwards can be tailored to a specified amount and delivery date. Forex forwards are over-the-counter contracts that lock in the exchange rate of a pair of currencies and are exchanged on the foreign exchange market. Interest rate differentials between the relevant currency pairings determine currency forward rates.

Prior to the expiration of the currency option, investors can buy or sell a specific currency at a predetermined rate of rights, but not obligations. As a result, currency options are also suitable for currency hedging, and currency options have specific advantages, such as low cost: the cost of entering the currency option is called a premium. Currency options are the most effective strategy to mitigate foreign exchange volatility risk while also providing some risk protection. Currency options provide the buyer with the freedom to exercise the option in the form of a non-binding option.

4. Conclusion

Whether EMU is viable in the long term, to sum up, the adoption of a single currency may cause problems for some EMU countries and call into question the viability of the monetary union. Nevertheless, the EMU major countries behave in a very similar and relatively consistent way, whereas the EMU periphery countries, such as Finland and Ireland, are different from their EMU partners in terms of the criteria for EMU. So, EMU may be a viable monetary union for the center, but I doubt the feasibility of a union with the periphery.

Because in the use of the euro, each country enjoys different benefits, especially in the financial crisis is particularly prominent. A monetary union without fiscal union would be a crisis, but on the other hand, a sufficiently severe crisis would be the driving force for European countries to move further towards federation. For example, when the COVID-19 crisis hit Europe hard, EU countries learned the lessons of the European debt crisis and quickly launched a massive stimulus package. The European Central Bank also deployed a massive bond purchase program to keep borrowing costs low, and the eurozone was able to deal with the impact of the coronavirus pandemic relatively quickly. The enlightenment brought by this article and the outlook for the future, in the process of implementing the euro, cooperation, and development between countries should be strengthened, the issue of benefit-sharing should be carefully studied, and the exchange and cooperation mechanism between countries should be established under the unified currency system to build a community of interests.

There are some limitations to this paper. First, the Euro itself has specific particularity, and the eurozone is changing dynamically. It is still possible for new countries to join the eurozone in the future. This paper does not study such dynamic changes. The second point is the lack of data and quantitative studies. If there is enough data, the VAR model can be used to evaluate the impact of the eurozone. In addition, future studies should focus more on how the eurozone coped with the financial crisis, such as how the eurozone coped with the COVID-19 induced financial crisis and how to ensure the long-term development of the eurozone through crisis response.

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