

Success or failure of the euro currency economics essay



Chapter 1:

Introduction:

When the European Union was founded in 1957 their initial endeavor was to establish a “ common market”. However they found this idea not taking shape as their financial objectives didn’t seem to prosper due to lack of a common c. In 1992, the Maastricht Treaty paved the way for a single c for the EU.

It’s been a decade since euro had been floated into the international markets. With its introduction in the rush for globalization saw many gains for euro in terms of increase in cross-border capital, trade, and outsourcing, securities and foreign exchange markets turnover as well as in cross-border asset holdings. The decade even saw a huge mounting up of foreign reserves due to growing current account imbalances. With euro taking the role of an international c, there had been drastic changes in the international markets with portfolios being shifted from dollar-denominated to euro-denominated which had led to depreciation in dollar. Moreover Bank of China’s opinion to support stronger currencies had added to the dollar depreciation.

Research aim:

The main aim of the research is to understand the sustainability of euro based on financial, economic and political factors. With the euro combining various markets into a single European market, consumer welfare has improved. This had led to convergence of money and capital markets through increased competition, market liquidity and transparency in operation with economies of scale and scope. Euro has gained the potential

of risk diversification and more efficient allocation of capital resources.

Elimination of exchange rate risk has increased price transparency, thereby reducing transaction costs and boosting competition in international markets.

Research objective:

The primary intention is to analyze if the future of euro is moving towards success or failure given the social, economic and political factors. While the euro c as well as its policy framework has attributed to stability and prosperity in euro area, the global crisis identified the necessity to strengthen European economic governance as a remedy against future challenges. Euro has gained importance in global markets by allowing global public and private investors to diversify their asset allocation and borrowers to find other sources of funding. Proper and timely actions by the European Financial stability Facility had helped a great extent in safeguarding euro so far. With the European Stability Mechanism being activated till June 2013, financial stability of the euro area is expected to be in full transparency so as to revive in times of financial distress.

Research questions:

Will the size of the economy help in sustaining the euro stability?

Will focus on international trade help in stabilizing?

Based on the size, depth, liquidity and openness of the domestic financial markets, can the euro be stabilized?

Is the euro stable enough to ensure easy convertibility of its c?

Can macroeconomics play a vital role in preserving euro stability?

Significance of the study:

The study aims to implicate the following:

Need for further economic amalgamation so as to tackle problems in times of crisis.

Need for a banking union thereby giving control to European Central Bank (ECB) to oversee all euro-zone banks in one step process.

Government efforts are needed in order to devise economic and fiscal outline which are essential to the euro c.

Efforts are also needed from financial market participants and supervisors, given that the maintenance of the financial market stability plays a crucial role for monetary and macroeconomic stability.

Research objectives:

The main objective of this report is to assess the success or failure of implementing a unified c, being the Euro c. Examining this topic yields a look into the viability of having a uniform c across a region with similar economic and political attributes.

When the idea of a single c was first suggested, doubts raised as to the credibility of the governance as each member states had different political heads. With the single c, however all these political heads would be combined as one governing body to govern all member states. However in a region with similar economic and political attributes, the idea seemed

successful with the formation of EU which consisted of European Council to manage course of actions and to suggest new laws; the European parliament to discuss on and endorse laws suggested by the council & finally the European Commission with personnel to accomplish the laws. The EU helped a great deal in providing effective governance in the Euro-zone which helped European economy overtake US economy in 2009 with a trade of \$14. 5 trillion against US trade of \$14. 3 trillion, thereby accounting to 40% of the world's economic power.

Further, researching the different factors and aspects of what makes a c succeed or fail in meeting its set objectives shall provide insight into understanding the dynamics of the relationship between members of the EU.

The vital factors that help judge the efficacy of a c are the size of the economy, political stability, and role in international trade, transparency and openness in domestic markets, easy convertibility to cash and impact of macroeconomics in preserving euro.

Relationship between EU members had been strengthened after the launch of euro. That's because almost 17 of the 27 member states have approved euro. It has also paved the way for a single monetary council to govern the functioning of euro throughout the euro-zone. Moreover cross border trade had increased which was mainly due to creation of single c which cuts transaction costs. Transparency had also been maintained with the euro in domestic markets without price fluctuations. Tourism had also increased with the launching of euro, as tourists didn't have to keep changing their currencies when travelling around the euro-zone. This way Euro ensured

easy convertibility of cash. Finally member countries which were financially rich in EU were used to backup poorer economies in EU, thereby ensuring financial stability whenever any of the macroeconomic components triggered a threat to EU. It was this backup which helped euro from failing to a greater extent when the 2008 crisis broke out.

The report also provides ground for analyzing the advantages of poorer EU member states adopting the Euro c. This will check the economic drive that can occur from having a monetary union between countries with varying economic statures.

The advantages of poorer economies joining the euro can be said to be both an advantage as well as a disadvantage. It's an advantage as even if they fail to repay bills owing to crisis, with the help of EMU they would get help from the richer economies in EU to repay the bills. Disadvantage can be attributed to the fact that salaries may be lesser in less productive areas when compared to salaries of employees in higher production areas. This advantage is due to the fact that all of these employees are now paid in Euros. So indirectly it can pose a threat as the standard of living may vary from place to place, but the salaries remain the same, thereby generating problems in getting even basic daily household things. For example, we may consider the following example between Greece and Germany.

Item

2000

2010

Greek

German

Greek

German

Number of cups made an hour

5

5

10

20

Employee wage per hour

5 drachma

5 euro

10 euro

12 euro

Cost of making a cup

1 drachma

1 euro

1 euro

0.60 euro

The above example gives an insight as to more production at lower price thereby encouraging more demand & gaining big. However Greece seems to be losing the race.

The report also will touch on the aftermath of failures in the Euro, if any, and the remedial measures that can be adopted in case of such failures. This also gives indication to other regions that may want to adopt the strategies used by the Euro while avoiding the negative aspects of the Euro example.

There is a perception in euro that it is working only in favour of France and Germany, but the real fact is these countries have achieved little in terms of bargaining success. Even if they had been doing well, it happens that in times of debt by other EU countries, such rich countries will have to take the burden of clearing unpaid bills, thereby making it impossible for such countries to decide on their infrastructure plans. Moreover in the aftermath of 2008 crisis, TARGET 2 set for the purpose of clearing euro combined all imbalances between banks in the euro-zone. However this failed to meet its objective right from 2007 & till 2011, there was an increase in the capital from weaker countries. When the entire euro-zone was undergoing crisis, Germany was doing relatively well, thereby showing diversification in thoughts in terms of social and political issues.

In order to prevent failing of euro, policies have to be effectively modified in such a way that there is a win-win situation between both the financially rich

and poorer countries, thereby ensuring equal competition. In times of crisis, EU member states can increase inflation rates for a while thereby ensuring their economic growth steady enough to get away from rising debts.

However these two can be achieved only with political integration by all EU member states.

Having a monetary union and examining its performance is an example set by the Euro. In case of a failure of the c, the report will try to highlight the possibility of discontinuing the circulation of the unified c and reverting to each country's earlier adopted c.

This success can be attributed to ECB cutting down the interest rates 3 times in 2012, thereby lowering borrowing costs & creating confidence among investors in euro market that a euro-breakup would not be imminent. In short to say, collapse of the euro is not bound to happen soon, however the stability of euro is unclear in the future.

Data collection method:

The first hand data will be gathered by distributing questionnaires and analyzing the results. The questionnaires shall be distributed on three banks in the Kingdom of Bahrain which deal with the euro c.

The secondary data has been taken from European commission website on inflation in the Euro area from 1960's to 2000's, fiscal position of the euro area in 1992, 1998 and 2007, mean intra-Euro-area correlation between Gross Domestic Product and Industrial Production, two indicators namely the number of years with negative gap & sum of negative gaps as a percentage of GDP, macroeconomic performance indicators.

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Sample selection and selection criteria:

The sample chosen are the employees of three banks in Bahrain who invest and deal with euro c. The banks are:

Arcapita

GFH - Gulf Finance House

ABC - Arab Banking Corporation

Survey methodology:

The methodology involved analyzing the parameters for significance with the data's obtained from first hand and second hand data which are the survey and other previously published material.

The magnitude of a country's financial system is very vital to decide on its prospective use in the global markets. The global trade and magnitude of a country's financial markets are related to the economic size. For instance, if we consider the export output between Korea and US, the former accounts for a much greater contribution. However as the US economy is 14 times larger than the Korean thereby making it embrace a much larger share in the world exports. The share of a country in international trade, the size and economy as well as the openness in financial markets forms determinants for demand of that country's c in global markets.

Chapter 2:

Literature reviews:

Some believe that Euro has failed to perform the required needs or reach the final destination of welfare for all. Instead it has become burden. Others believe that Euro has resulted in bringing a unity among the European nations which helped them to fight out the Economic depression seen in the last decade.

The convertibility of a currency also forms a major determinant for demand of that currency, because unless there are less restrictions money is exchanged smoothly thereby ensuring increase in demand of currency. For example after World War II, most of the countries except US restricted their convertibility of currency thereby making US dollar readily available in markets & increasing dollar demand.

Following table gives a justification to the above determinants:

Parameters

United States

Euro-area

Japan

Share of world GDP (%)

21.9

15.8

7.6

Share of world exports (%)

15. 3

19. 4

9. 3

Financial markets (\$ billions)

40, 543. 8

24, 133. 4

20, 888. 5

Bank assets (\$ billions)

7, 555. 3

12, 731. 3

6, 662. 5

Domestic debt securities outstanding (\$ billions)

15. 426. 3

5, 521. 9

6, 444. 9

Stock market capitalization (\$ billions)

17, 562. 2

5, 880. 2

7, 781. 4

Following are some more factors that help to support and strengthen the study:

2. 1 Macroeconomic level:

Price stability and low-cost borrowing by European Economic and Monetary Union (EMU) helped ensure macroeconomic stability in Europe. Euro helped put an end to changes in exchange rates within Europe owing to changes from outside Europe. The following graph shows improvement in inflation performance thereby leading to sharp decline in price volatility.

2. 2. distinction of the strength of the currencies

Similar lines of reasoning can be found in Magee and Rao (1980). They make a distinction between strong and weak currencies according to low and high inflation currencies. The intuition behind this being that in trade between low inflation industrial and high inflation developing countries, the low inflation currency of the industrial country dominates. Also, for trade in primary products a vehicle currency might be optimal. The importance of the choice between different currencies came back into the economic discussion when major exchange rates became flexible after the breakdown of Breton Woods in 1973.

Viaene and de Vries (1992) take strategic bargaining considerations into account and introduce a forward market. In their model, exporters and importers bargain over the invoicing currency. Both are assumed to prefer their own currency, respectively. Viaene and de Vries find that the dominance of the exporter's currency can be due either to the first mover advantage of the exporting firm or to the monopoly power of the exporter who is more likely to have bargaining power as the firm faces a wide spread demand and not many competitors.

2.3 Currency risk

Summing up the early literature, the main findings are that traders seek to avoid currency risk by using their own currency and that, in trade between industrialized countries exporters are in general more likely to be able to avoid the currency risk. When currencies are free to fluctuate there is, however, not only the issue of price uncertainty but also demand uncertainty.

2.4 Invoicing currency:

Donnenfeld and Zilcha (1991) present a first formal model in which a firm's choice of invoicing currency is analyzed. They are also among the first to develop a model on the Microeconomic level in which the firm optimizes its profits. The main finding of Donnenfeld and Zilcha is that LCP is optimal for the exporting firm if the total revenue curve is concave in the foreign price.

This is the case when the sensitivity of demand with respect to prices is not much higher the higher the price level. That is, if the price is set in producer currency and increases (in foreign currency) due to an appreciation of the

exporting firm's currency, profits will fall because demand will be reduced by more than the increase in profits due to the higher price received. In the case of depreciation, demand is not extended enough to compensate for the lower price the exporting firm receives, because demand is less sensitive to the price at the lower price level. If this is the case, higher variability in foreign prices, which comes with higher volatility in the exchange rate under PCP, lowers expected profits. Thus, under these conditions, high exchange rate volatility would lead the exporting firm to choose LCP.

2.5 Currency Market:

Friberg (1997) extends the literature by including into the model a forward currency market and the possibility to set prices in a third currency: vehicle currency pricing (VCP). As in Donnenfeld and Zilcha the choice of the optimal currency setting is closely linked to the price elasticity of foreign demand. The second best currency pricing strategy depends on the relative exchange rate volatilities. If the exchange rate towards the vehicle currency exhibits low volatility compared to the bilateral exchange rate of the exporter and importer, VCP is preferred and vice versa.

Now, even under LCP the demand for the firm's product is uncertain because the competitors might not price in local currency. In such a case fixing the relative price of the competing products can be important to the exporters so they might choose a common vehicle currency. This finding of choosing the currency of the competitor is also common to a number of other studies.

2. 6 Pricing Strategy:

In particular, Bacchetta and van Wincoop (2002) use a NOEM model to analyze the optimal pricing strategy of exporters. In a very elaborate general equilibrium framework that also takes into account exchange rate dependent costs they derive similar conclusions to those of Donnenfeld and Zilcha.

2. 7 demand sensitivity of costs and price

The driving factors for exporters to care about their relative prices are the demand sensitivity of costs and the price sensitivity of demand. It can be said that the higher the product differentiation, the lower the price sensitivity of demand. Exporters will, thus, prefer to invoice in their own currency if their products are highly differentiated, while they will pay attention to holding their relative prices constant if their products are less differentiated. This does not mean that less differentiated products are always invoiced in LCP, however.

2. 8 market share of the exporting country in the foreign market

Bacchetta and van Wincoop build into their model the market share of the exporting country in the foreign market - that is, the share of the market that is accounted for by firms from a particular country or monetary area. Demand risk is minimized by invoicing in the currency that is most "similar" to the average invoicing currency chosen by competitors (Bacchetta and van Wincoop 2002, p. 15).

For a monetary union, it is the market share of the entire currency union that matters and not the market share of an individual country. Exports of a

monetary union are therefore more likely to be priced in producer currency, and imports to a monetary union more likely to be priced in local currency, because the monetary union's market share is more likely to be dominant.

Goldberg and Tille (2005) call this behavior of choosing the currency of the competitor a "herding effect". In their partial equilibrium three country model a dominant share of a currency other than the one of the exporter or the importer can make vehicle currency pricing the optimal choice. This herding effect takes place for industries with homogeneous goods where producers aim at keeping their prices relative to the competitors stable.

Goldberg (2005) elaborates on this model by including a covariance between marginal cost and exchange rates. There is then also a "hedging motive" to choose a currency so that the exchange rate is correlated in such a way to shocks to exporters' costs that marginal costs are positively correlated with marginal revenue.

2.9 Two-country dynamic general equilibrium model

The most elaborate model so far was introduced by Devereux, Engel and Storegaard (2003). Using a two-country dynamic general equilibrium model with sticky prices, these authors analyze the implications of endogenous exchange rate pass-through. Their results show that the degree of pass-through depends on the relative stability of monetary policy; countries with relatively low monetary volatility experience low rates of exchange rate pass-through. The reason is that firms in both countries have an incentive to set their prices in the currency of the country with the low monetary

volatility. As a consequence, the country with low monetary volatility is shielded against exchange rate movements.

2. 10 The export pricing behavior

Engel (2005) analyses the export pricing behavior of firms in a static model, both in an environment with flexible and with fixed prices. He shows that the choice between producer currency pricing and local currency pricing is independent of the degree of sluggishness in price adjustment. Under flexible price adjustment, producer currency pricing is optimal if the variance of the export price in the firm's own currency is less than the variance of the price in the local currency of the importer. The same holds in an environment of fixed prices.

Summing up the theoretical literature the most important finding is that the optimal pricing strategies are very sensitive to the set of assumptions. In particular, the level of risk aversion and the existence of forward markets to hedge exchange rate risks matter for the results. First and foremost, however, the sensitivity of foreign demand to prices matters, which can be approximated by the homogeneity or differentiation of the product. When demand is sensitive to prices the market share of the exporting country, or more specifically, the currency used by the competitors matters. When the optimal currency choice depends on the currency used by competitors, herding in the same currency is optimal. Also, currencies of countries with monetary stability are more likely to be chosen as invoicing currency.

2. 11 The Failure of the Euro

Martin Feldstein (2012). As the author mentioned, the euro now shall be known as an experiment that failed. This failure, since the euro was first introduced, in 1999, was not an accident or the result of bureaucratic mismanagement but rather the inevitable results of imposing a single currency on a very heterogeneous group of countries. The adverse economic consequences of the euro include the sovereign debt crises in many European countries, the breakable condition of major European banks, high levels of unemployment crosswise the euro-zone, and the large trade deficits which now block most euro-zone countries.

The political goal of creating a harmonious Europe has failed too. France and Germany have dictated hurtful austerity actions in Greece and Italy as a state of their financial help. Paris and Berlin have clashed over the role of the European Central Bank (ECB) and over how the burden of financial help will be shared.

The early impetus that led to the European Monetary Union and the euro was political, not economic. European politicians rationalized that as the use of a common currency would instill in their publics a greater sense of belonging to a European community and that the shift of responsibility for monetary policy from national capitals to a single central bank in Frankfurt would signal a shift of political power.

Michael Sivy (2011), as usually said " big stories don't break, they ooze". The demise of the Euro is just such a story. Hence each time it oozes, U. S. stock markets drop. The collapse of the Euro, is now inevitable, in the authors'

view. When it happens, banks around the globe will be shaken and stock markets will plummet.

Academics, journalists and even government officials have projected a set of schemes to save the “ Euro” - new European financial institutions, Eurobonds backed by all the countries collectively and even a United States of Europe. However it is clear that any such scheme to save the Euro would find little political support. The breakup will perhaps be extremely painful. Nevertheless, the alternatives may be even more unpalatable.