ISSN 2278 – 0211 (Online)

The Impact of a Common Currency on the European Union

Abraham Mensah
MBA Finance Graduate Student, Department of Finance and Accounting,
Fort Hays State University, US
Ayooluwa Tomiwa Animashaun
MBA Finance Graduate Student, Department of Economics Finance and Accounting,
Fort Hays State University, US

Abstract:
This study examines the ramifications of adopting a common currency within the European Union (EU), focusing on introducing the euro. Initially prompted by optimistic expectations of economic stimulation and balanced budgets, the research critically assesses the economic, trade, and policy dimensions associated with a unified currency. Utilizing Mundell's optimal currency regions concept, the methodology establishes prerequisites for a successful monetary union, emphasizing vulnerability to macroeconomic shocks, labor market flexibility, and intra-regional commerce. Findings reveal that while a common currency eliminates foreign exchange expenses, reduces uncertainty in bilateral exchange rates, and facilitates investments, member states must sacrifice autonomy in monetary and exchange rate policies. The advantages include streamlined cross-border payments, enhanced trade, and improved movement of labor and products, while the drawbacks involve rigid monetary policies and limitations on policy tailoring to specific economic conditions.
To maximize benefits, the research proposes measures such as deepening economic integration, ensuring macroeconomic stability, and promoting political unity. The study emphasizes the importance of sound economic policies to complement the adoption of a common currency and mitigate potential challenges. In conclusion, the research offers a comprehensive understanding of the advantages and disadvantages associated with a common currency in the EU, providing a roadmap for effective navigation and suggesting interventions to ensure successful implementation.

Keywords: *Common currency, euro, European Union, monetary union, economic integration, macroeconomic stability, policy autonomy*

1. Introduction

We have once considered what would happen if a global common currency is required for all monetary transactions. Many people have high hopes that introducing the euro as a common European currency would quickly increase economic activity, employment, and balanced government budgets across the member states (Özdeşer, 2020). On the other hand, legislators and analysts are worried about the underwhelming economic performance of Euro land compared to the United States and certain nations that decided against the common currency. This performance has resulted in a series of debates about introducing a common currency and its effects on the nations of Europe. Moreover, these concerns intensify when we consider the irrational currency rates seen while travelling or transferring money internationally. The rates are astronomically expensive, and eliminating the many currencies might simplify the procedure for the banking institutions and us. Nevertheless, this reasoning is not unique, and we cannot conclude that embracing the expected currency benefits or harms the European Union. Therefore, the paper will focus on the influence of a common currency on the European Union.

2. Methodology

Past economic development models are needed to reveal a clear and consistent link between economic integration and economic growth. As a result, there is a possibility of coming across a circumstance in which a greater degree of economic integration might have both good and negative impacts on economic growth rates. Still, an explicit agreement is yet to be achieved. Therefore, various hypotheses and studies have been conducted on the economic logic of a common currency concerning its influence on economic development and trade. The deliberation was kicked off in the early 1960s when Mundell 1961 proposed optimal currency regions, supported by Abban (2020). This idea established the groundwork for explaining the impacts of using a common currency within a specific geographic region.

Given that a regional central bank was created and the local currencies of member states were substituted with the regional one due to adequate regional macroeconomic strategy, how will this influence the general growth pattern in the region? In order to address this inquiry, we must first establish specific ground rules. These prerequisites are essential for the monetary union's success and for its members to join. One of these criteria is that all regional economies are equally vulnerable to macroeconomic shocks. Second, there has to be sufficient flexibility in the labour markets to weather the shocks, and third, there needs to be a substantial volume of commerce between the member states. The classical theory of optimal currency regions proposes these characteristics necessary for a monetary union to arise among nations in a given region.

3. Findings/Evidence

The European Union nations' economies will gain and suffer from introducing a common currency. The principal advantages will result from removing the risks associated with making bilateral exchanges between the regional currencies and removing the transaction expenses associated with doing so. This exchange will help the European Union economy become productive, strengthen the E.U.'s economic cohesion, and foster growth in various sectors (Özdeşer, 2020). On the other hand, the primary drawback is that nations will have to forego the option of autonomously implementing monetary and exchange rate policies, making them more vulnerable to the potentially adverse spillover effects of macroeconomic imbalances. In this part, the paper will take a closer look at these and other potential benefits and drawbacks of a common currency for the European Union. In sum, although the advantages are modest, so are the expenses.

3.1. Advantages of a Common Currency in the European Union

Eliminating foreign exchange expenses for intraregional trade is the primary benefit of a common currency in the European Union. By adopting a common currency, businesses and individuals would no longer have to pay the charges and spreads that come with exchanging currencies from different regions. It will help cut down on the time and money needed to make cross-border payments inside the area, and it will also help cut down on the accounting and other internal expenses that companies incur when doing business in two or more of the region's nations (Feghehmajidi et al., 2019). Having less uncertainty regarding bilateral exchange rates is a further economic advantage of adopting a unified currency in the European Union. Currently, these values are set since most nations in the area have pegged their currencies to the U.S. dollar. However, there is always the chance that one or more countries in the region would modify their exchange rate pegs without consulting the others. This uncertainty may hinder the ability of risk-averse actors to engage in intraregional trade and investment due to the lag time between the formation of a contract and the receipt and transfer of money. In principle, this risk may be covered by forwarding or futures markets, but doing so is either not possible or too costly.

Other primary advantages of using a common currency come with higher levels of trade. Because there was no longer a need to exchange money, travelling became simpler. Most crucially, the dangers associated with currency fluctuations were removed from European commerce. Because of the euro, European firms now have an easier time negotiating favourable terms with their suppliers in other countries that use the euro (Feghehmajidi et al., 2019). This ensures that pricing is clear to consumers and boosts competition between businesses in nations that use the euro. The union can function more effectively due to improvements in the movement of labour and products across national boundaries.

Domestic and international investments inside the Eurozone are facilitated by and supported by the common currency. Investors in nations that use currencies other than their own are exposed to substantial foreign currency risk, which might cause them to allocate their funds inefficiently. Bonds are far more susceptible to exchange rate hazards than equities because bonds are less volatile. Because of how stable debt instrument prices are, currency fluctuations have a far more significant impact on returns than either interest rates or credit quality, as supported by Cheng (2020). Therefore, most investors see a poor risk-reward profile in foreign currency bonds. Companies that were doing well in nations with weak currencies had to pay high borrowing rates before the introduction of the euro.

On the other hand, less efficient businesses in countries with stable currencies benefited from cheap borrowing rates. When financing internationally, currency risk, not default risk, was the key concern. When nations with low interest rates adopted the euro, investors like those in Germany and the Netherlands could lend money to businesses in other Eurozone countries without worrying about their currency risk.

In theory, nations who join the common currency may rely on the assistance of their neighbours in times of distress. As a result of more significant economies of scale, the currencies of such nations tend to be more stable. A hurricane, for instance, may wreak havoc on even a wealthy, little Caribbean nation. However, the rest of the United States can assist Florida in rebuilding after a disaster. Since then, the U.S. dollar has proven to be one of the most reliable currencies. In 2020, the global crisis put Eurozone unity to the test. In the beginning, there was not enough cooperation, as Pérez (2021) supported. Worse still, several countries began shutting their borders off to one another. Interest rates were kept relatively low since the European Central Bank (ECB) routinely bought up enough debt in affected nations, notably Italy. Crucially, France and Germany backed a recovery fund of over 500 billion euros.

It is beyond the scope of this research to attempt to quantify the exact economic importance of these advantages associated with the common currency. However, compared to the advantages other regional blocks may accomplish by unifying their currencies, these gains in the case of the nations that make up the European Union are not anticipated to be very significant. The most important reason for this is that the extent of these advantages is vitally dependent on the quantity and value of the foreign currency transactions that take place within the territory, which in turn are mainly determined by the volume of commerce that occurs within the region (Feghehmajidi et al., 2019). Uncertainty exists

regarding the magnitude of this impact, but recent empirical research shows that a currency union may benefit cross-border commerce considerably. Therefore, raising the value of a common currency in this way would strengthen the economic standing of the European Union.

3.2. Disadvantages of a Common Currency in the European Union

Rigid monetary policy: For the member states of the European Union to gain the advantages of a common currency, they will need to be ready to accept the possibility that this may, in some scenarios, result in the incurrence of certain macroeconomic costs or disadvantages. The latter is primarily caused by the fact that every nation would be compelled to adhere to the common currency's exchange rate and the monetary policy established by the union. Therefore, this section will analyze some of the cons of the common currency in the European Union.

The lack of flexibility in monetary policy to adapt to regional economies is the biggest problem with the common currency. Prosperity, as measured by solid growth and low unemployment, is quite typical in many regions of the European Union. On the other hand, many people are affected by extended economic downturns and high unemployment rates (Li, 2020). The classic Keynesian approaches to these issues take a very different tack. Interest rates in the fast-growing nation must be high to forestall price increases, economic overheating, and collapse. The slow-growing nation's interest rates should be lowered to encourage consumer borrowing. Since there are more people out of work and available to work, nations with high unemployment rates should not have to worry as much about inflation. When using a common currency, such as the euro, it is only possible to increase interest rates in a strong-growth nation while concurrently lowering them in a poor-growth one.

Moreover, the introduction of the common currency resulted in the exact reverse of what would have been the recommended course of action for the economy amid the sovereign debt crisis in Europe. Investors were more concerned about the financial health of nations like Italy and Greece as economic development slowed and unemployment rates rose, which led to a rise in interest rates. Generally speaking, under a fiat money system, there would be no worries about the government's ability to remain solvent since the national government would be able to direct the central bank to issue additional money, as maintained by Frankel (2021). On the other hand, the autonomy of the European Central Bank meant that governments inside the Eurozone could not produce their currency. In certain nations, higher interest rates contributed to a rise in unemployment and brought about deflation and negative economic development. It is reasonable to assert that the introduction of the euro contributed to Greece's descent into an economic slump.

4. The Way Forward

4.1. Deepening Intraregional Economic Integration

Given the findings of the preceding section, it is evident that the European Union member states will need to increase their degree of economic integration to fully enjoy the advantages of a single currency. As was previously noted, a unified currency will assist in deepening integration, but it will only do so with sound economic policies and agreements in other areas (Borisova & Borisova, 2021). This may increase the attractiveness of a common currency by helping to boost intraregional commerce and investment.

4.2. Increasing Macroeconomic Stability

Each nation should avoid large macroeconomic imbalances so that the currency union's potential costs may be minimal. Because of this, it can come to regret not being able to set its own monetary and exchange rates. The same holds to reduce the likelihood of unfavorable effects caused by macroeconomic imbalances in one European Union member state spreading to other member states (Brychko et al., 2021). Therefore, countries looking to adopt a common currency must be especially wary of their budgets and the financial system's stability to avoid these potential disasters.

4.3. Political Integration

There is little doubt that the European Union nations' political commitment would be tested as they work to establish agreements on and execute the measures outlined above. Considering the past failures of monetary unions, this will likely need convincing the European Union's member states that the economic advantages of a single currency and deeper economic integration outweigh the costs of pursuing them (Gabel, 2018). They must also be eager to deepen their political union. Indeed, one of the most critical lessons from the history of monetary unions is that success requires not just economic but also political unity. Historically speaking, political integration has been the driving force for currency unification.

5. Conclusion

This study suggests that there are many reasons for the European Union to use a common currency, which, if done correctly, would help to improve economic efficiency across the board, strengthen regional integration, and promote economic growth. However, rigid monetary policy and other problems are only two of the numerous detrimental effects of a common currency on the member nations. Therefore, several interventions and suggestions, such as boosting macroeconomic stability and Political integration, need to be implemented to guarantee that the common currency, especially for the European Union, meets its aims with minimum unintended consequences.

6. References

i. Abban, S. (2020). The Prospect of the Proposed Currency Union on Intra-regional Trade: Southern African Customs Union. *Journal of Applied Economic Sciences (JAES)*, *15*(70), 759–773.
ii. Borisova, L., & Borisova, D. (2021). Assessment of interregional economic integration based on the integral indicator of the level of socio-economic development. In *E3S Web of Conferences* (Vol. 273, p. 08102). EDP Sciences.
iii. Brychko, M., Bilan, Y., Lyeonov, S., & Mentel, G. (2021). Trust crisis in the financial sector and macroeconomic stability: a structural equation modelling approach, *Economic Research-Ekonomska Istraživanja*, *34*(1), 828–855.
iv. Cheng, D. S. D. X. F. (2020). Evaluating the Use of Single Currency by Member States as Medium of Transaction-ECOWAS.
v. Feghehmajidi, A., Ahmad Zade, K., & Najafi, F. (2019). An Investigation of the Effect of a Common Currency on Bilateral Trade. *Journal of Money and Economy*, *14*(1), 63–84.
vi. Frankel, J. (2021). What three economists taught us about currency arrangements. *VoxEU. Org*, p. *1*.
vii. Gabel, M. (2018). Divided opinion, common currency: The political economy of public support for EMU. *The political economy of European monetary unification* (pp. 49–76). Routledge.
viii. Li, X. (2020). The Dollarization of the Cambodian Currency: Process, Causes, Advantages and Disadvantages. In *China–ASEAN Relations: Cooperation and Development Volume 2* (pp. 573–580).
ix. Özdeşer, H. (2020). Analysis of the Economic Impacts of the Euro, the Efficiency of the Euro in the Optimum Currency Area, and the Place of the Euro in Global Economics. *European Review*, *28*(2), 258–275.
x. Pérez, S. A. (2021). Competitiveness Revisited: Labour Costs, Financial Flows and the Case of Italy. *German Politics*, *30*(3), 340–359.