

Theoretical and empirical assessment of currency crisis' risk during currency participation in ERM II

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ABSTRACT: Currency participation in ERM II is conditional on the introduction of a fixed exchange rate regime. The fixed exchange rate is more at risk from a currency crisis than a flexible exchange rate. These concerns are also expressed in the official strategy for the introduction of the euro in the Czech Republic. We have evaluated the risk of a currency crisis using two methodological approaches. First, from an empirical perspective. In the history of ERM II, no currency has been affected by a currency crisis. Second, from a theoretical perspective. A currency crisis in ERM II can be explained by second-generation models that do not account for the fundamental causes of investor distrust. We define four specific risks associated with entry into ERM II (monetary policy trilemma, central parity setting, appreciation overshooting of the exchange rate, change of euro introduction date). We also explain why the central bank will try to maintain a fixed exchange rate in ERM II. We conclude that concerns over a currency crisis during the participation in ERM II are unfounded.

Keywords: euro, ERM II, currency crisis, euro area enlargement, fixed exchange rate

JEL Classification: F31, F 33, F 36

International Scientific Conference, 10-11 October, 2018
Pan-European University, Tomášikova 150/20, Bratislava, Slovak Republic

Economics, Management, Finance (EMF 2018)
New Trends and Challenges for Academics and Entrepreneurs

Proceedings of abstracts

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2018