Theoretical Analysis of the Effect of Fiscal Union: Keynesian Two-Country Model

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Summary

In this paper, we investigate the effect of fiscal union related to a Capital Markets Union for the euro area in a Keynesian two-country model with a monetary union and imperfect capital mobility.

We find that the increase in capital mobility between countries by creating a Capital Markets Union is a destabilizing factor, whereas an increase in fiscal transfers by creating a fiscal union is a stabilizing factor. However, it is difficult for the periphery countries to adopt expansionary fiscal policy, because periphery countries are required to obey fiscal discipline. Therefore, in order to have a successful Capital Markets Union, it is necessary to create a fiscal union together.

Furthermore, we also find that an expansionary monetary policy implemented by the European Central Bank and an expansionary fiscal policy have positive effects on the real national income of both core and periphery countries.

Keyword: Two-country model with monetary union type, Economic stability, Fiscal union, Capital Markets Union, Post-euro crisis

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