Chapter 7

Fiscal Harmonization or Fiscal Union in Eurozone?

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ABSTRACT

The aftermath of the financial crisis and following debt crisis that the European Monetary Union faced in 2008 required re-examining the architecture of the Euro area and a cost/benefit assessment of the monetary union. When one examines the causes of the crises, one sees that EMU’s financial architecture stands out. Although there is a common monetary policy application authority within EMU, local economies can carry on with their own autonomous fiscal policies without any effective control mechanisms. Problems with structures caused arguments about EMU’s architecture. It is clear that there is a need for changes in EMU’s architecture in short term for euro to survive. The objective of this chapter is to present some suggestions to the policy makers and to point out the problems with the architecture and mechanisms needed to be brought into being in order EMU to survive with the ongoing crisis.

INTRODUCTION

With financial liberalization wave that increases since the mid-1980s, the financial bonds of both developed and developing countries solidified gradually in global scale. Solidifying the financial bounds caused lead to the cooperation between financial markets of the countries. There are two main effects of financial integration on economies. The first of these effects is to make capital distribution more effective and the second is to diminish the risk of diversifying of the countries. More effective source distribution will lead to positive results like development in global scale.

Financial integration has three main qualities. All of the participants in the market are required

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to be subject to the same rules while buying and selling present financial equipment and services in the market and they should be considered as equals while carrying out the transactions actively in the market and they should have equal access to all kinds of financial equipment and services. In this case, we can say that related market is fully integrated (Lieven et al., 2004). In other words, financial integration as a related concept with financial markets defines the integration of financial markets either regionally or globally. Solidifying the financial integration is one of the most important steps towards financial integration of euro area and political integration at last.

Fiscal integration comes as a different term than financial integration. When we examine the literature, we can see that fiscal union or fiscal integration concepts are used in different contexts. Fiscal integration on the other hand, attributes to the harmonization of financial policies. Fiscal union is defined as public expenses of union countries, acting in harmony with other countries as having a single budget in terms of fiscal issues such as taxation and risk sharing activities. In summary, debt activities within fiscal union shall be carried out with common bond, taxation and public expenses shall be regulated or evaluated by single supranational mechanism.

European Monetary Union is said to contribute to the financial integration between union member countries. Besides, Europe sets an example as having the most advanced financial integration (Allen and Song, 2005: 22-23). However, the issue of sustaining the financial stability is more important than enabling it. European financial integration is more advanced than Canada and USA examples but there is no financial sustainability yet (Carney, 2014; Draghi, 2014). For EMU, it is thought that 2008 financial crisis and fiscal union lies behind the problems that Euro area architecture currently have. As Krugman (2013) stated “without fiscal integration, a monetary union may have lethal consequences.”

The problems started with 2008 financial crisis pointed out to the problems within EMU architecture. Within this context, in order to solidify the fiscal part which is absent within EMU, some policy applications have been implemented. In terms of fiscal integration of European area, Maastricht Criteria (such as the budget deficit below %3 level of GDP, total debt level below %60 of GDP) that the countries need to meet in order to be a part of European monetary union and Stability and Growth Pact that constituted for making financial rules definite are the applications that aimed at removing the deficit of common fiscal rules for Euro to stay stable. However, determination of the monetary policies within single unit and carrying out the fiscal policies by many authorities without any harmony between them is a subject that countries put emphasis on especially after 2008 financial crisis.

The architecture of monetary union has made Euro area extremely fragile in front of financial instabilities. Current problems within Euro area architecture has led to 2008 global crisis and increased the need to evaluate the cost and benefits of integration again (Ho, 2009). Costs and benefits of the integration are discussed within optimum currency area theory.

OPTIMUM CURRENCY AREA

The theoretical framework of monetary union is comprised by Optimum Currency Area Theory. Optimum Currency Area constitutes a theoretical framework to identify the common currency while presenting the characteristics of the countries that will generate the monetary union. In this context, optimum currency area tries to reveal the optimum size of the currency area by researching costs paid and gains earned by the countries that prefer to use the common currency.

Optimum currency area theory was developed in 1961 by Mundell. Contributors to the theory