ADVISORY LETTER

TOWARDS ENHANCED ECONOMIC AND FINANCIAL GOVERNANCE IN THE EU

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Foreword

In December 2011, the Advisory Council on International Affairs (AIV) decided to issue on its own initiative an advisory letter examining the successive bank and sovereign debt crises in Europe. Earlier, in January 2010, the AIV issued the advisory report 'The EU and the Crisis: Lessons Learned' (no. 68). The shortcomings it identified in crisis prevention and crisis management also apply to the present crisis.

The AIV's aim in issuing this advisory letter is to put forward several ideas on how to strengthen economic and financial governance in the European Union. The AIV believes that such measures should go hand in hand with efforts to strengthen political and public support for the EU.

This report was prepared by a joint committee consisting of: C.G. Trojan (chair), Dr W.F. van Eekelen, Professor S.C.W. Eijffinger, Dr F.A.W.J. van Esch, Dr L. Noordegraaf-Eelens, Professor K. van Paridon, Professor J.Q.T. Rood, Dr A. Schout, Professor A. van Staden, Ms M.C.B. Visser and Professor J.W. de Zwaan. They are all members of the AIV's European Integration Committee. The working group also included: Ms M. Sie Dhian Ho (AIV), Dr E.P. Wellenstein (honorary member of the AIV) and M.G. Bos (SER, external member). The secretariat consisted of T.D.J. Oostenbrink (AIV executive secretary), assisted by M.V. Buijs (trainee).

The AIV adopted this report at its meeting on 3 February 2012.

Introduction

In its advisory report (no. 68) on the financial crisis, the AIV pointed to a series of shortcomings in crisis prevention and crisis management. The subsequent sovereign debt crisis has clearly showed that the EU has failed to tackle three issues that are vital for achieving robust economic and monetary union: *budget discipline*, *bank supervision* and *economic policy coordination*. This is only partly due to lacunae in the existing treaties. Although the provisions on economic policy coordination are insufficiently enforceable, the EU does have the power to tighten them. European supervision of banks that operate on a European scale and strengthening the regulatory framework for financial services are definitely tasks which were laid down by treaty but were implemented far too feebly until it was too late. Budget and debt discipline was neither exercised by all member states nor enforced by treaty instruments. The member states, led by Germany and France, set the Stability and Growth Pact (SGP) aside in better times. This was accompanied by macroeconomic imbalances in various eurozone countries and the failure of national macro- and micro-prudential supervision of financial institutions. The present crisis began with the collapse of the US housing market, which subsequently exposed the excessive vulnerability of the banking system (whose capital buffers were far too small to cover risks) and major systemic risks (resulting from mutual lending). The massive bailout of systemic banks, together with far-reaching economic stimulus measures to escape recession and out-of-control budget deficits, have led to an unprecedented sovereign debt crisis and the present euro crisis, which raise fundamental questions about the future of the eurozone. The inadequate recapitalisation of many European banks has resulted in the bank and debt crises becoming intertwined. This makes it more difficult to find a way out of the crisis.

The AIV is convinced that the European Union and its member states – in cooperation with the IMF – are still able to resolve the crisis. But this depends on whether national and European politicians are able and willing to learn from the current crisis, make crisis management far more effective and convincing, and lay the foundations for a more crisis-proof eurozone.

The AIV also believes that a robust and sustainable economic and monetary union will require greater interdependence and a more far-reaching division of powers between individual countries and the EU. Existing treaties provide a basis for this. However, these developments should go hand in hand with efforts to strengthen political and public support. The present financial crisis has led to a crisis of confidence. The lack of confidence of the financial markets and European citizens stems from the failures of EU governance. Successive decisions – which can only be described as always 'too little, too late' – have systematically undermined that confidence. In this advisory letter, the AIV will first try to draw a number of lessons from the measures taken so far to tackle the bank and sovereign debt crises. It will then present some thoughts on how to strengthen economic and financial governance in the EU with a view to the decisions to be taken at national and EU level in the months ahead. The AIV is aware that restoring lasting confidence will take time and require a deeper analysis of both the effectiveness and democratic legitimacy of EU governance in all its facets and how it is anchored nationally. The AIV believes, however, that first it is essential to ensure the eurozone's short-term stability so that we can enter calmer waters in which we can carry out further reforms and promote sustainable economic growth.

The lessons of the bank and debt crises

Bank supervision and financial regulation

The first wave of crisis largely originated in the financial sector, and partly blew over from the US. If there is one key lesson, it is that the financial markets were not adequately supervised and there was insufficient recognition that financial innovations had generated systemic threats that were hugely underestimated. The sharp increase in the complexity and interdependence of financial systems ultimately had effects that were unforeseen or unforeseeable. The supervision of the banks failed, and this continued even after the fall of Lehman Brothers. The same applies to internal supervision at the banks.

The bank crisis did, however, give a significant push towards more EU supervision. The recommendations of the De Larosière report were largely followed and have now been incorporated into EU legislation that entered into force in early 2011. The new legislation provides for the establishment of a European Systemic Risk Board for macro-prudential supervision and a European System of Financial Supervisory Authorities for micro-prudential supervision, with three European authorities being created: the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA). The system comprises a network of national and European regulators. Although the latter have a number of limited statutory powers, the emphasis remains on national supervision. The size and composition of the new European supervisory authorities also raise questions. Experience with the new prudential system is too limited to evaluate it at this time. The AIV regards the measures taken as merely the first step towards effective EU supervision. Given the significant transnational integration of financial institutions and markets, such supervision is necessary for a structural solution to the crisis. As far as financial regulation is concerned, the bank crisis has triggered important 'sticking plaster' legislation and new rules for hedge funds, private equity and alternative investment funds. Some 40 other Commission proposals are under consideration. Decisions on them must ultimately lead to far stricter financial regulation.

The AIV believes that rapid and effective decision-making on the Commission's proposals should be given high priority. It also believes that the member states must give the new EU prudential authorities sufficient scope to prove themselves. But fully fledged EU supervision can only exist in practice if the regulator can intervene where necessary and has access to an EU resolution mechanism or fund. The division of costs among member states remains a thorny issue in this regard. The AIV is of the opinion that these follow-up steps should be explored by a new 'De Larosière group'.

In recent years governments have had to intervene on a massive scale to keep banks afloat and prevent payment transactions and the economy from being disrupted. This creates a serious moral hazard. It is therefore important to reduce the banking system's vulnerability by substantially increasing capital buffers to strengthen banks' own loss-absorbing capacity. The Basel III accords provide for a gradual increase in the minimum capital buffer as a percentage of risk-weighted assets. In key banking centres such as the UK and Switzerland, serious consideration is being given to requiring additional capital buffers. The European Commission wants the Basel minimums to also be included as maximums in the Basel III implementation directive. In the AIV's view, there is no reason to prohibit national authorities from setting higher capital requirements for systemic banks in certain areas, provided they are non-discriminatory. By strengthening their own capital, there will be less chance of banks needing to fall back on the deposit guarantee system. Deposit insurance will remain necessary to prevent a run on the banks. But as the supervision of banks becomes more strongly European, it will make increasing sense to give the collective guarantee for account holders a European form as well. However, this must not lead to banks using collectively guaranteed deposits for proprietary trading. There is therefore good reason to also set clear rules for proprietary trading at EU level.

Budget discipline
With the establishment of the European semester and the Euro Plus Pact, and above all through the adoption by the Council and Parliament of the 'six-pack' of economic governance measures, the EU and the Eurogroup have created a much stronger framework for coordinating national economic and fiscal policy and for enhanced budget discipline. The SGP has been given teeth with the introduction of semi-automatic sanctions in both the preventive and corrective phases. The excessive deficit procedure can now also be set in motion on the basis of the national debt's changing relationship to medium-term budget targets. Minimum requirements are being set for national budget frameworks and there will be a procedure for monitoring and correcting macroeconomic imbalances. The semi-automatic nature of the sanctions will be guaranteed by applying reverse qualified majority voting.

In its letter to parliament of 7 September 2011, the Dutch government called for an independent EU budget authority, accountable to a designated member of the European Commission with discretionary powers to make recommendations and impose sanctions. This Commissioner should possess an 'intervention ladder' that allows increasing degrees of intervention in countries' fiscal policies. This suggestion was partly adopted by Commission President José Manuel Barroso, and the Euro Summit on 26 October 2011 also welcomed the Commissioner's stronger role in ensuring tighter supervision and additional enforcement. The two regulations proposed by the Commission on 23 November 2011 (under article 136 of the Treaty on the Functioning of the EU (TFEU)) give further substance to tighter supervision of euro countries by the Commission, with special provisions for those countries involved in an excessive deficit procedure. For programme countries and countries contending with serious financial disruption, the Commission's supervision – together with the ECB – goes several steps further. In addition, a link is established between the treaty, EU institutions and emergency assistance (EFSF/ESM), which is partly intergovernmental. These measures as a whole largely meet the wishes expressed by the Dutch government in the above-mentioned letter to parliament.

The decisions made at the Euro Summit on 9 December 2011 go even further. This particularly applies to the introduction of the 'golden rule': the budget deficit must not exceed 0.5% of GDP (1% for countries with a limited debt burden), and cyclical variations must not exceed 3% of GDP. In addition, the maximum time limit for reducing the national debt to below 60% of GDP is set at 20 years. This also applies to the introduction of the reverse qualified majority rule in the full excessive deficit procedure. German Chancellor Angela Merkel pressed for a treaty amendment and, after the UK had blocked this option, a parallel treaty. These same measures could perhaps also have been taken under article 126 (14) of the TFEU (amending Protocol no. 12) or (for euro countries only) under article 136 of the TFEU.

The majority of the budgetary rules in the fiscal compact have already been either decided (six-pack on economic governance) or proposed by the Commission or are possible under article 136 of the TFEU. The parallel treaty as such, on which European heads of state and government reached agreement at an informal meeting on 30 January, could therefore have been very brief. The drafters apparently believed that a short treaty would not have enough appeal. What already falls under the existing secondary legislation (i.e. the six-pack) or has been proposed under it is now to be duplicated in the treaty text. This will certainly not win any design awards. Nevertheless, adoption of the treaty will send an important political signal that the euro countries are serious about introducing and enforcing strict budget discipline. Furthermore, a major political hurdle will be overcome, especially as far as Germany is concerned, en route to a more effective approach to the sovereign debt crisis. Overall, however, no new institutions will be created and no *explicit* intergovernmental decision-making procedures will be introduced. Moreover, the text includes several safeguards to ensure that Union law is applied and has precedence. Nevertheless, we should remain vigilant when it comes to practical implementation and above all the role of the Eurogroup Working Group (EWG) of officials that prepares Eurogroup meetings. The AIV believes it is imperative for budget supervision and enforcement to rest with the European Commission and, as part of secondary legislation, to fall under the scrutiny of the European Court of Justice. The AIV believes that the leakage of these powers to intergovernmental structures is undesirable and contrary to the Netherlands' interests.

The primacy of EU law, including secondary legislation, must be put beyond question. The AIV would point out how much of the foregoing has already led to secondary EU legislation thanks to the Community approach. That contrasts with the failure of recent efforts to tackle the crisis. The dominant approach has been intergovernmental decision-making in the Councils, with key decisions generally being prepared exclusively in consultations between the leaders of Germany and France. While we understand that the German Chancellor in particular was confronted with domestic political dilemmas (and still is), the AIV would note that the difficult compromises that Berlin and Paris had to reach before any decision was possible largely stemmed from the widespread feeling that the EU had responded inadequately and too late at almost every turn. The AIV would observe that here, too, considerable improvements have already been introduced through secondary EU legislation (without any vetoes by member states and with significant input from the European Parliament). The Community method is no guarantee of finding timely and appropriate solutions, but it does increase the chance of well-thought-out decisions being taken and being implemented more effectively. It also helps to ensure greater objectivity in analysing the issues at hand. The AIV would further point out that the Community method allows more room for the interests of smaller countries because the power relations between member states are constrained by the operation of the European institutions.

Economic policy coordination

The Lisbon strategy for 2010 taught us that the open method of coordination, which is essentially based on peer pressure, is too discretionary and too bureaucratic in practice to lead to any significant structural reforms. So far, it has only been possible to enforce structural reforms on the basis of the conditions attached to loans to programme countries, i.e. on an intergovernmental basis. The recently adopted procedure for macroeconomic imbalances is aimed at inducing member states to make the necessary structural reforms at an earlier stage. In the preventive phase the European Commission will use a scoreboard to preventively assess all member states to identify any imbalances. The scoreboard includes indicators for balance-of-payments current account, net international investment position, export market share, real effective exchange rate, private sector debt, public debt, credit growth and housing prices. These indicators may prompt the Commission to conduct an in-depth analysis. If such analysis leads to the conclusion that an excessive imbalance exists, the Council can impose binding policy recommendations on the member state concerned along with a deadline for submitting an action plan. If no effective action is taken, this can eventually lead to an annual fine of 0.1% of the member state's GDP. There are no automatic or semi-automatic sanctions. On the one hand, this is understandable and wise, since the individual indicators for a macroeconomic imbalance cannot be translated directly into policy recommendations but need to be assessed together. On the other hand, there is a risk that member states will ultimately be unwilling to be sufficiently critical of one another in the Council and to apply sanctions where necessary. Past experience shows that this is a real danger.

The various economic policy procedures have been pooled and, to align them better with national decision-making processes, have been anchored in the European semester, which is opened at the start of the year by the European Commission's Annual Growth Survey. The European Parliament's active involvement in the six-pack framework has also given it more involvement in the various procedures, in the form of an economic dialogue with the Commission and Council. The new structure offers ample opportunities to rid economic policy coordination of its discretionary and bureaucratic nature. It is now mainly up to the member states to fulfil their obligation under article 121 of the TFEU to regard their economic policies as a matter of common concern.

Restoring economic growth is urgently necessary in order to reduce excessive debts in an orderly and socially acceptable manner and to prevent liquidity problems from degenerating into solvency problems. Now that neither national budgets nor bank balances allow much scope at all for stimulating growth, the challenge is to strengthen the potential for economic growth through policy reforms, at both national and EU level. The financial and economic crisis is therefore one more reason to seriously tackle the new Europe 2020 strategy. A combination of national policy and Community action must lead to sustainable growth and jobs by improving the competitiveness of the EU as a whole. The EU's instruments remain basically the same as before: the internal market, the EU budget and external policy. Eliminating the internal market's shortcomings and making more targeted use of the EU budget (especially for achieving a European knowledge area) can strengthen the growth potential of the EU and its member states.

Offering prospects for growth is particularly important for countries contending with serious budget deficits, such as Greece, Portugal, Spain and Italy. It is hard to imagine that these countries will be able to drastically reform their public finances successfully if the conditions for economic recovery are not created at the same time. Above all, this will require efforts by the countries concerned, such as improvements in the operation of the labour market. A question that arises, however, is whether it would be better to use the EU budget for this purpose, especially the Structural Funds and the Cohesion Fund. These funds are substantially underused. There are billions of euros in pledged funds that Greece and Portugal in particular have not yet taken up. This is due partly to problems concerning the details of programmes and projects, and partly to problems with the release of the necessary national cofinancing. For these countries, the cofinancing regulations have now been temporarily relaxed. But further steps are required if optimum use is to be made of the reserved funds to promote growth and structural reforms in the countries under enhanced financial supervision and dependent on financial assistance. The AIV believes that it should be possible to use the Structural and Cohesion Fund resources available to these countries as part of the structural adjustment programmes that they are pursuing.

The lessons of unreliable European statistics and forecasts
An economy cannot function efficiently without statistics that are beyond all doubt. Financial institutions and governments base decisions for the short and long term on their best forecasts. The introduction of the euro and the SGP required a system of reliable macroeconomic statistics from the outset. The phrase 'too little, too late' also applies to verification of the figures. Ever since the euro was introduced, there were doubts about the reliability of national budget figures and these doubts have only increased with time. Greece is a case in point. There are also parallels with the SGP. When, in response to Greece's first revision of its budget figures in 2004, the European Commission made concrete proposals

to give itself (in the form of Eurostat) more powers regarding inspection visits, these were weakened by the Council. It was not until 2010 that the Council approved the expansion of Eurostat's powers that had been requested earlier. It is equally important to base budget preparation on sufficiently cautious forecasts of economic growth and to use multi-year budget frameworks and benchmarks for the development of government deficit and debt.

Management of the sovereign debt crisis

Few people foresaw that the bank crisis would escalate so quickly into a sovereign debt crisis. The EU treaties, which are based on a no-bailout clause, do not provide for massive financial assistance in order to manage such a crisis. In the eurozone there is no lender of last resort. No account was taken of the fact that members of a monetary union are more vulnerable to liquidity problems. Countries belonging to a monetary union incur debts in a currency over which they themselves cannot exercise any control. Furthermore, significant shifts in market sentiment have occurred that, owing to spill-overs via integrated financial markets, do not just affect countries that have pursued unsound policies for many years, such as Greece. A combination of high interest surcharges and a shrinking economy can cause liquidity problems to degenerate fairly quickly into solvency problems, which are far more difficult to solve. It is therefore imperative to tackle liquidity problems in a vigorous and effective manner.

As noted earlier, the response to the sovereign debt crisis since the potential bankruptcy of Greece came to light can best be summed up as 'too little, too late'. The political situation in potential donor countries was certainly a factor in this. The extent of the Greek problem was initially underestimated, as was the risk of contagion. The first Greek support operation, worth €110 billion, consisted of bilateral loans from the IMF and the euro countries. It slowly became clear that, without emergency assistance, Ireland and Portugal, too, would not be able to meet their payment commitments. This led to the creation of two loan facilities for eurozone countries in difficulties: the European Financial Stabilisation Mechanism (EFSM), based on article 122 (2) of the TFEU with a €60 billion lending capacity guaranteed by the EU budget, managed by the European Commission; and the European Financial Stability Facility (EFSF), a private company registered in Luxembourg with a €440 billion lending capacity guaranteed by euro countries, managed by the 17 eurozone finance ministers. The total lending capacity (until 2013) was therefore €500 billion, to which the IMF added another €250 billion. Reaching agreement on this support framework was a laborious process, as were the support operations for Ireland and Portugal, in which these two facilities (and the IMF) were involved. For the Netherlands, the IMF's participation was a precondition from the outset. The entire process that eventually led to these decisions and support operations was unable to restore the confidence of the financial markets. Private sector involvement (PSI), to which the ECB had objected, failed to do so as well.

The sovereign debt crisis had by then developed into a euro crisis. Mainly at Germany's instigation, this led to the idea of a permanent mechanism, the European Stability Mechanism (ESM), intended to take over the tasks and funds of the EFSF and EFSM as from 2013 (now changed to 2012). To this end, the simplified revision procedure under article 48 (6) of the TEU will be used to add a third paragraph to article 136 of the TFEU, giving euro countries the power to jointly set up a stability mechanism. The European Council took a decision on this on 25 March 2011. However, this amendment will not enter into force until all 27 EU countries have approved it at national level. The Treaty establishing the ESM was signed on 11 July 2011, but still has to be ratified. A total of 44 ratifications are required: from the 27 EU member states for the TFEU amendment and the 17 euro countries for the ESM Treaty. The ESM itself, aside from its indirect connection with article 136 of the TFEU, is purely intergovernmental. The Commission and the ECB will have observers on the ESM's Board of Governors and will be involved in assessing programme countries.

Over time, however, it became clear that a significant second Greek support operation (involving a 'haircut' for private banks) was necessary and that the EFSF did not have enough firepower to prevent the risk of contagion to countries such as Spain and in particular Italy. The decisions taken at two European Councils and Euro Summits in July and October 2011 respectively failed to restore the confidence of the financial markets. Sharp rises in the interest payable on government bonds in Spain, Italy and Belgium brought the euro crisis to boiling point. No decision was made at the Euro Summit in December 2011 either on increasing the firepower of the EFSF/ESM. The Euro Summit in March 2012 will examine the options further. It has, however, been decided that the ESM will take effect earlier than planned (on 1 July 2012) and that decisions to provide emergency assistance can be made in urgent cases by super-qualified majority (meaning that a small country can no longer block such a move). Private sector involvement *ex ante*, as in the second support operation for Greece, will no longer take place. Loans will be provided in accordance with the IMF's principles and practices. In December it was also decided that euro countries and other EU member states would provide up to €200 billion to the IMF in the form of bilateral loans to strengthen its funds. However, it has since become clear that this amount will not be achieved. That is one reason why the AIV would warn against high expectations regarding the IMF's ability to help resolve the euro crisis. The fact that Europe, despite its wealth, has not so far proved able and willing to mobilise the necessary resources does not send a convincing and confidence-inspiring signal to other potential financiers, such as China.

It has also become clear that the decisions taken at the last Euro Summit failed to convince the financial markets. Enhanced budget discipline may have an effect in the longer term, but in the short term it is mainly Italy's €300 billion national debt, which needs to be refinanced in 2012, that threatens to seriously undermine the eurozone's financial stability. The AIV therefore believes that a substantial increase in the emergency fund's firepower is required to restore the financial markets' confidence in the short term. The recent lowering of France's and Austria's AAA credit rating shows once again that the eurozone does not have time on its side. Now that Italy has a reform-minded government, it is vital to make short-term arrangements to refinance Italy's very sizeable national debt at an affordable interest rate.

Until the emergency fund has a sufficiently convincing size, the ECB will remain under pressure to manage the crisis by providing liquidity. This creates a risk of the ECB being forced into an inappropriate role. The AIV considers the ECB's independence to be a valuable asset. Besides guaranteeing price stability, the ECB is also the guardian of the eurozone's financial stability. In both the bank crisis and the sovereign debt crisis, the ECB has pursued an innovative policy in providing liquidity to the banking sector and has also bought up a massive amount (over €210 billion worth) of government bonds on the secondary market. In addition, the ECB recently provided banks with almost €500 billion in three-year loans. It is therefore acting as a backup facility to guard against the collapse of the eurozone's financial system. The AIV believes that while the ECB must do whatever is necessary in this regard, heads of state and government must not assign primary responsibility for tackling the crisis to the ECB. It is reasonable to expect member states with a relatively favourable budget balance (or a considerable balance-of-payments surplus) to do more to help solve the debt problem.

At present, perceptions are dominated by the weakest members of the eurozone, whereas the eurozone as a whole, in terms of the size of its budget deficit and national debt, is in a better position than the United States, for example. The introduction of a system for central financing of governments within the eurozone in the form of the issue of eurobonds could eventually provide a lasting solution, but only if individual member states first put their budgets in order and set a manageable course. To strengthen the incentives for budget discipline, the eurobond system must be prudent in its design, allowing interest surcharges and insurance premiums to rise in line with relative deficits and debts. The introduction of eurobonds need not lead to higher interest charges in countries like Germany and the Netherlands provided disciplinary measures are credible enough. The resulting deeper markets for public debts in euros will boost liquidity. The introduction of such a eurobond system will most probably require a treaty amendment.

Strengthening political and public support

As noted in the introduction, the euro crisis has become above all a crisis of confidence. The largely ineffective action taken by European heads of state and government has seriously undermined confidence in the euro and the EU not only in the financial markets but also among large sections of the population. This is confirmed by recent opinion polls. The AIV therefore believes that it is essential to strengthen public support to secure the future of EMU and the EU itself. A three-pronged strategy may be useful in this regard.

First, the EU must effectively tackle the present debt problem to prevent further erosion of public support. We have already mentioned the need to substantially increase the emergency fund's firepower and for the ECB to play an active supporting role. It will probably be impossible to avoid a certain degree of shared responsibility and risk in the repayment of member states' debts. Consequently, there should be no taboo on the idea of eurobonds, in whatever form. The AIV advocates a careful assessment of their advantages and disadvantages. It also believes that future financial crises can only be averted by further financial and economic integration. For the AIV, it is crystal clear that more structural solutions regarding budget discipline, bank supervision and reduction of macroeconomic imbalances are indispensable, and that this entails more a far-reaching redistribution of powers at national and EU level.

The AIV realises, however, that it is not sufficient to considerably strengthen the position of EU institutions (especially the European Commission) without devoting special attention to their relations with the public. These institutions are far removed from the EU's citizens and enjoy little public esteem. Increasing the democratic legitimacy of EU decision-making is therefore a second (and essential) part of the strategy referred to above. In the recent period, politicians have mainly relied on strengthening the output legitimacy of EU economic and financial governance; that is, they assumed that most of the public would find the action taken by the responsible EU bodies to be justified and acceptable provided it led to the desired policy results. The AIV is convinced that such legitimacy is necessary but that it will certainly not be sufficient in the long run to retain the public's confidence – assuming it can be regained. To win broad support for the European edifice, legitimacy will therefore also need to be drawn from other sources, such as greater public involvement in policy development (input legitimacy), more extensive accountability on the part of leading EU officials, and greater transparency regarding measures by EU administrators (administrative legitimacy). Not least, a more visible role should be sought for national parliaments in EU decision-making. For instance, public debates on important EU draft legislation in national parliaments may stimulate public interest.

In support of this view, the AIV would argue that the importance of other sources of legitimacy is increasing precisely because (as explained above) the crisis can only be solved through further economic and financial integration in politically sensitive areas. Stringent fiscal measures in member states are required at a time when many feel that the burden is not being shared fairly between those who 'caused' the crisis and those who are now its 'victims'.

Thanks to the most recent decisions on strengthening budget discipline, the SGP can now be implemented effectively. The EU now has the power to set rigorous parameters for national budgets. Opinions may differ as to whether this power has a sufficiently democratic foundation. Given the European Commission's heavy responsibility in this regard, its accountability must in any event meet strict standards. The European Parliament's existing instruments for scrutinising and, if necessary, rectifying the Commission's exercise of its executive powers seem inadequate. Moreover, the public perceives the European Parliament itself to be part of the problem of the remoteness of EU institutions. The important legislative role that the European Parliament now plays is not sufficiently highlighted.

The question of democratic credentials also applies to the powers relating to the structural reforms required in member states' economies. The involvement of EU officials in structural economic policy issues carries the risk of further increasing public distrust of the EU, if the public's preferences are not sufficiently taken into account. The more the exercise of these powers affects issues that are inherently political (e.g. organisation of the economy and burden distribution), the greater that risk will be.

The scope of this advisory letter does not allow a comprehensive analysis of the fundamental and complex problem of the EU's democratic legitimacy, let alone the proposal of a workable solution. In a report on the position of the European Parliament to be published later this year, the AIV hopes to put forward proposals that address part of this issue. The AIV underlines the value of an in-depth debate on how the EU's political and administrative system, with its crisscrossing horizontal (supranational, national and subnational) and vertical (policy sector) connections, can be transformed into one in which the public feels represented and conflicts can be visibly resolved. Political parties and civil society organisations should play an active part in such a debate.

The third component of the strategy for restoring confidence concerns the role and responsibility of member states' governments with regard to communicating with the public and the need to win support both inside and outside parliament. National governments will have to clarify the necessary reforms for European citizens and show more conviction than they have to date in highlighting how 'more Europe' can increase our prosperity. Ever shifting remarks by politicians, in our own country as in others, have done nothing to strengthen public support – on the contrary. What is needed is a firm political course and a clear explanation of the major interests at stake for a country such as the Netherlands. The internal market and the euro are two sides of the same coin. According to the calculations of the Netherlands Bureau for Economic Policy Analysis (CPB), the Netherlands has done very well out of the internal market. Since the introduction of the euro, lower transaction costs and more competition have given a major boost to trade. If the euro were to collapse, it would have disastrous consequences for the Dutch economy. All studies and scenarios point in this same direction.

It is precisely these major interests that make the broadest possible support in the States General so imperative. Given the attitude towards the EU of the party that normally provides the government with parliamentary support, the government is forced to seek alliances with opposition parties on this crucial issue. The AIV believes that the letters sent to parliament in September and October 2011 provide a sound basis for this approach.

The task at hand is to ensure that the public debate now under way is vigorously continued. Political leaders and parties should present the public with the prospect of a European future which allows them to believe in the EU again.

Final considerations and recommendations for enhanced economic and financial governance in the EU

The euro crisis has forced European leaders to try and strengthen the foundations of economic and financial governance in the EU – substantively, procedurally and institutionally. However, governance remains fragmentary and the tension between the Community method and the intergovernmental approach makes it difficult to arrive at coherent and effective policies. But since the EU treaties simply do not provide for emergency assistance, there has been no choice but to pursue an intergovernmental route.

We have seen above that the Community method has allowed considerable progress to be made in the areas of bank supervision, financial regulation, enhanced budget discipline and economic policy coordination. In all these fields, the European Commission has been able to exercise its right of initiative again and co-legislation by the Council and Parliament has proved effective. The European semester should in any event facilitate coordinated action on macroeconomic, fiscal and structural policy. The supplementary agenda for euro countries in the Euro Plus Pact is at least a first step towards a more coordinated approach to structural reforms.

The management of the sovereign debt crisis has been fragmentary and wavering. There are too many captains on the ship. The division of responsibility is unclear. The key role of the European Council/Euro Summit is undisputed, as is the importance of Franco-German cooperation. However, sufficient counterweight needs to be provided; in this regard, the UK's decision to drop out is regrettable. On the other hand, Italy's return (under the Monti government) to the heart of European cooperation is a positive development. Nevertheless, the top-down approach clearly has its limitations. The proliferation of European Councils and Euro Summits, whose decisions are not implemented promptly, if at all, does not increase confidence in EU governance. Twice-yearly Euro Summits and monthly consultations between the Euro Summit President, European Commission President and Eurogroup President may be useful, but they will not result in essential changes to the decision-making process. Strengthening the administrative structures of the Council Secretariat and the EWG involves a risk of duplication regarding Commission services and the role of the ECB, where sufficient expertise is already present.

In the light of the foregoing, the AIV has arrived at the following final considerations and recommendations:

- The AIV believes that for the time being existing treaties provide sufficient scope for enhancing economic and financial governance in the EU and laying the basis for a crisis-proof eurozone. This requires all countries concerned to show discipline, commitment to the common interest and a certain degree of solidarity to mitigate the most painful elements of adjustment processes and jointly create new prospects for restoring growth and jobs.

- The AIV is of the opinion that the Community method offers the best safeguards for efficient and sound policy and that the leakage of powers to parallel intergovernmental structures is not in the Netherlands' interest.

- The AIV believes that the initiating role of the European Commission needs strengthening and that the Commissioner for the euro should perform a pivotal role in the EU's economic and financial governance. His presence at Euro Summits and European Councils – when economic and financial issues are being discussed – could be a first step. His chairing of the Eurogroup could also be considered.

- The AIV is of the opinion that discussions should begin now on making European supervision of banks more robust, including a European crisis resolution mechanism. These follow-up steps could be explored in a new De Larosière group.

- The AIV believes that in addition to enhanced budget discipline, which is already clearly beginning to take shape, high priority should be given to structural measures to tackle macroeconomic imbalances and to providing growth prospects for those countries which now need to radically reform their public finances.

- The AIV advises the government and parliament to anchor the European semester firmly in national policy processes, especially as regards budget preparation and adoption.

- For countries that are under enhanced supervision and are dependent on financial assistance, the resources available from Structural and Cohesion Funds should be used to support the structural adjustment programmes these countries are pursuing.

- As far as crisis management is concerned, the refinancing of Italy's debt at an affordable interest rate should be given top priority in the short term. The emergency fund's firepower should be increased. The AIV believes that the EFSF and ESM should in any event be used in tandem in 2012.

- Finally, the AIV believes that the necessary structural solutions demand greater interdependence and a more far-reaching redistribution of powers between national and EU level, which cannot be accomplished without strengthening political and public support. To that end, a strategy is required that is geared mainly to increasing the democratic legitimacy of EU decision-making. To secure long-term acceptance of the European project, it is necessary not only to offer effective solutions to major policy issues but also to enable the public to influence the direction of the integration process as a whole. National parliaments and political parties have a special responsibility in this regard.

Glossary

Alternative investment fund	Fund engaged in unconventional methods of investment (e.g. hedge fund)
Annual Growth Survey	Annual analysis of economic growth in EU member states; this report by the European Commission opens the European semester
Bailout	Financial rescue operation
Basel III	Standards and requirements for the size and quality of banks' capital
Cohesion Fund	One of the EU's Structural Funds. It is intended to support member states where per capita GNP is less than 90% of the EU average
Community decision-making	EU decision-making method characterised by active involvement of supranational institutions (European Commission, European Parliament and Court of Justice). As a rule, a majority of member states is sufficient to take decisions in the Council
De Larosière group	Group of experts, headed by former IMF chief Jacques de Larosière, on strengthening EU supervision of financial institutions
Euro Plus Pact	Agreement (2011) under which EU member states assume non-legally binding obligations, mainly aimed at making their
Eurobonds	EU bonds. EU member states mutually guarantee repayment of, and payment of interest on, these centrally issued loans
Europe 2020 strategy	Long-term growth strategy for the European Union
European semester	EU framework for coordinating member states' economic and fiscal policies
European Systemic Risk Board	EU financial regulator established in 2010
Eurostat	Statistics office of the European Union
Haircut	Reducing the value of debt
Hedge fund	Type of unlisted investment fund engaged in speculative, mostly short-term investments
Input legitimacy	The public accepts the actions of political institutions to the extent that they are able to directly or directly influence those actions

Intergovernmental decision-making	Method of decision-making among national governments. Member states cannot be forced to participate against their will
Lender of last resort	Role of a central bank authorised to provide credit if no other institution is able or willing to do so
Macroeconomic imbalances procedure	Eurozone procedure for tackling major macroeconomic imbalances between and within member states with the help of corrective measures
Moral hazard	Situation where governments, institutions and individuals are tempted not to take unpleasant measures or make sacrifices if they can rely on others to cushion the harmful consequences of not doing so
Output legitimacy	The public accepts the actions of political institutions to the extent that those actions lead to effective governance and the desired policy results
Peer pressure	Encouraging or persuading states and/or individuals to change their policies in a desirable way; informal process in which peers influence one another
Private equity fund	Unlisted investment fund that buys up companies or group divisions with a view to selling them for a profit
Proprietary trading	Situation where a financial institution makes high-risk investments on its own account in order to make a profit
Reverse qualified majority	Decision-making rule according to which a recommendation by the Commission is deemed to have been adopted unless the Council decides by a qualified majority of votes to reject the recommendation within a certain period that begins hen the Commission presents the recommendation to the Council
SGP	Stability and Growth Pact, containing binding agreements on budget rules for EU member states
Six-pack	Six EU laws (five Regulations and one Directive) governing supervision of financial and economic policy in EU member states
Spill-over	Knock-on effects of economic activities and/or policy processes in certain areas on activities and processes in other (usually neighbouring) areas or other member states
Structural Funds	EU funds for reducing differences in prosperity between regions and between member states

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