IS THE EUROZONE STORMPROOF?

ON DEEPENING AND STRENGTHENING THE EMU

No. 105, July 2017

ADVISORY COUNCIL ON INTERNATIONAL AFFAIRS
ADVIESRAAD INTERNATIONALE VRAAGSTUKKEN
AIV

Members of the Advisory Council on International Affairs

Chair	Professor Jaap de Hoop Scheffer
Vice-chair	Professor Alfred van Staden
Members	Professor Tineke Cleiren
	Professor Joyeeta Gupta
	Professor Ernst Hirsch Ballin
	Professor Mirjam van Reisen
	Monica Sie Dhian Ho
	Lieutenant-General (ret.) Marcel Urlings
	Professor Joris Voorhoeve
Executive Secretary	Tiemo Oostenbrink

P.O. Box 20061
2500 EB The Hague
The Netherlands
telephone + 31 70 348 6060
e-mail aiv@minbuza.nl
www.aiv-advice.nl

Members of the Committee on the EMU

Chair
Professor Alfred van Staden

Members
Dr Femke van Esch
Professor Sylvester Eijffinger
Marnix Krop
Professor Kees van Paridon
Dr Adriaan Schout
Carlo Trojan

Executive secretary
André Westerink

Contents

Foreword

Introduction – Are we on top of things? *7*

I Convergence or divergence in the eurozone 13

- **1.1 Are there signs of convergence?** 13
  - ***I.1.1 EMU indicators*** *13*
  - ***I.1.2 Economic policies, institutions and governance*** *15*
  - ***I.1.3 Macroeconomic indicators*** *16*
- **I.2 Promoting real convergence** 19
- **I.3 Conclusion** 22

II Financial union: completing the banking union and creating the capital markets union 23

- **II.1 Introduction** 23
- **II.2 Banking union** 23
- **II.3 Capital markets union** 26
- **II.4 Conclusion** 27

III Monetary stability 28

- **III.1 Introduction** 28
- **III.2 Strengthening since the crisis** 28
- **III.3 The permanent rescue fund** 29
- **III.4 The role of the IMF in support programmes** 30
- **III.5 Towards a European Monetary Fund** 31
- **III.6 Exit scenario: thinking the unthinkable** 32
- **III.7 Conclusion** 34

IV Fiscal union 35

- **IV.1 Introduction** 35
- **IV.2 Current status** 35
- **IV.3 A fiscal stabilisation function?** 37
- **IV.4 Possible follow-up measures** 40
- **IV.5 Conclusion** 42

V Governance of the eurozone 43

- **V.1 Introduction** 43
- **V.2 The lack of decisiveness and control** 43
- **V.3 Conclusion** 46

VI Conclusions and recommendations 47

Annexe I Request for advice

Annexe II Economic policy indicators, institutions and governance

Annexe III List of persons consulted

Annexe IV List of abbreviations

Foreword

On 6 October 2016, the Advisory Council on International Affairs (AIV) received a request from the Minister of Foreign Affairs for an advisory report on the further development of the eurozone, one of the key issues in the current process of European integration. The request referred to a report entitled 'Completing Europe's Economic and Monetary Union' drawn up by the President of the European Commission in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank and the President of the European Parliament (the Five Presidents' Report). It sets out steps that need to be taken to improve economic governance of the eurozone and ultimately bring about financial and fiscal union.

Although steps have already been taken to strengthen the eurozone, the government nevertheless understands the need to carefully weigh up the options available within the current treaty frameworks to strengthen economic and monetary union (EMU). The government stated that it would appreciate receiving an advisory report on this issue from the AIV, based on the following questions:

1. What steps can be taken within the limits of the current treaty framework to strengthen governance of the EMU in order to promote growth and the ability to absorb shocks in individual member states and the EMU as a whole?
2. What steps can be taken within the limits of the current treaty framework to promote real economic convergence within the eurozone?
3. Can the Advisory Council explain the implications of the individual steps in questions 1 and 2 for the Netherlands' economy and financial interests?
4. To what extent can the individual steps aimed at strengthening governance of the EMU and promoting real convergence influence political and economic cooperation at a wider EU level, with member states outside the eurozone – e.g. regarding decision-making on and the integrity of the internal market?

The request for advice is attached as Annexe I.

This advisory report has been prepared on the basis of these four questions. It is structured as follows. The introduction briefly recounts the economic and financial crisis of 2008/2009, the subsequent euro crisis of 2010/2012 and the measures taken in response. It also asks whether the measures taken and planned will be sufficient to withstand another crisis. Three possible scenarios are outlined: a gradual, step-by-step strengthening of the EMU,[1] a 'great leap forward' and an exit scenario. The AIV calls in this advisory report for a gradual, incremental strengthening of the EMU but does not rule out the possibility of one of the other scenarios occurring.

Chapter I considers whether the eurozone has experienced the intended economic convergence in recent years. The AIV concludes from empirical research that this has

1 Under treaty law, all EU member states are also EMU members. In practice, however, 'EMU' commonly refers to the countries that have introduced the euro. The non-euro countries in the EU participate in the EMU in so far as they have committed themselves to complying with certain basic rules, such as guaranteeing the independence of their central banks and coordinating their economic and monetary policies with those of the euro countries.

not been the case; the eurozone has undergone divergence rather than convergence, with the northern and the southern euro countries experiencing considerable differences in their economic development. In answer to question 2, chapter I then looks at potential economic solutions for achieving economic convergence in the eurozone in the years ahead.

Chapter II considers the creation and strengthening of the financial union, the most important parts being the banking union and the capital markets union. The AIV puts forward several proposals to further strengthen the financial union – proposals that it believes will benefit citizens and businesses not only in the Netherlands but across Europe.

Chapter III looks at monetary stability and the measures already taken to strengthen it. It concludes that although the measures were essential, they will probably be inadequate for withstanding a future crisis. The AIV therefore proposes measures to further strengthen monetary union and outlines a pathway to a European Monetary Fund. This chapter also discusses the possible withdrawal of one or more countries from the eurozone. The AIV considers this scenario neither likely nor desirable but it cannot be entirely ruled out.

Chapter IV presents measures to strengthen fiscal union, something the AIV also believes is necessary. It looks at the fiscal stabilisation function for the eurozone, a fiscal capacity and various ways to achieve it. The AIV thinks such proposals deserve serious consideration and should not be summarily dismissed. This is especially true in the light of Emmanuel Macron's recent election as President of France, as the Franco-German duo may resume their role as the driving force behind further European integration. Plans to further strengthen the eurozone will probably feature prominently in this context.

Chapter V considers governance of the eurozone, which also requires further strengthening, in the AIV's opinion. In response to the first question in the request for advice, this chapter sets out proposals for doing so, partly along the lines suggested in earlier AIV advisory reports on this issue.

In response to question 3, these chapters, especially chapter I, also consider the potential implications for the Netherlands' economy and financial interests of the individual steps set out in response to questions 1 and 2, and their implications for political and economic cooperation at a wider EU level, with member states outside the eurozone (question 4). Question 4 is considered only in passing, however, as the AIV believes it has lost most of its practical relevance on account of the UK's announcement that it will leave the EU.

This advisory report was prepared by a committee consisting of Professor A. van Staden (chair) and Ms F.A.W.J. van Esch, Professor S.C.W. Eijffinger, M. Krop, Professor C.W.A.M. van Paridon, A. Schout and C.G. Trojan (members). The committee's executive secretary was A.R. Westerink, assisted by M.L.I. van Laake (trainee). C.W.J. Devillers and J. Nuijten were involved in the preparation of this report as civil service liaison officers from the Ministry of Foreign Affairs.

The committee consulted a number of experts to prepare this report. Their names are listed in Annexe III. The AIV is very grateful to them for their input.

The AIV adopted this advisory report on 7 July 2017.

Introduction – Are we on top of things?

The agreement reached on the EMU in December 1991 as part of the Treaty of Maastricht cannot be seen in isolation from the fall of the Berlin Wall on 9 November 1989 and the subsequent reunification of Germany. It was particularly important to France for Germany to be integrated more deeply into European cooperation. There were, and still are, important economic arguments in favour of the EMU, such as lower transaction costs, the removal of exchange rate uncertainties and the further levelling of the economic playing field, but in the view of many authors political factors played a decisive role in the creation of the EMU.[2] The AIV shares this broadly accepted view. The Five Presidents' Report of June 2015 puts it this way: 'The euro is more than just a currency. It is a political and economic project.'[3] The foreword to the Commission's Reflection Paper on the Deepening of the Economic and Monetary Union two years later states: 'But it [the single currency] has always been much more than a monetary project. It was conceived as a promise of prosperity – and that is how it must remain, also for those that will become members of the euro area in the future.'[4] It is also relevant in this context that a 2017 Eurobarometer survey found that about 72% of the eurozone population was in favour of the single currency.[5]

The euro has experienced numerous serious crises in recent years. The 2008 financial crisis, for example, had consequences not only for individual banks but also for government budgets. Some countries, such as Greece, Spain, Portugal, Cyprus and Ireland, had to weather a severe storm. Many others were also dealt hard blows. In the following phase, attention focused chiefly on the aforementioned countries, with Greece being the most problematic. At the same time, in recent years the ECB has pursued an aggressive monetary strategy that has substantially increased the money supply. Its goal was to stimulate demand and lower the rate of inflation in the euro area to less than or close to 2% in the medium term. The accompanying fall in interest rates brought some fiscal relief, especially for the Southern European countries. Interest and repayment commitments became considerably less onerous. This all played out against the backdrop of long-term economic stagnation, high unemployment, at times serious budget and balance of payment deficits, and rising debts.

The political conditions necessary to maintain and strengthen the EMU are still very important. This is demonstrated by the clear limits that seem to have been reached in the willingness of many sections of the population in the Southern European countries to make further sacrifices in order to restore public finances to health and implement structural reforms. There is also resistance, especially in Germany, Finland and the Netherlands, to the substantial financial transfers made to member states in difficulties.

2 Segers, M. and B. van Riel (November 2012). 'De weeffouten in de EMU' ('The design faults in the EMU'), Openbaar Bestuur, pp. 2-6.

3 Juncker, J.C. et al. (2015), 'Completing Europe's Economic and Monetary Union'. See: <https://ec.europa.eu/commission/sites/beta-political/files/5-presi dents-report_en.pdf>.

4 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', p. 3. See: <https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_en>.

5 Ibid., p. 8.

Moreover, doubts are still raised about the effectiveness of the assistance provided to, for instance, Greece. The Netherlands Court of Audit concluded in a recent report that it was not sufficiently clear what the money from the rescue funds was spent on and that the EU had too little control over this.[6] While Northern European countries have doubts about the measures' effectiveness, the Southern European countries point out that a large eurozone boosts exports from countries such as Germany and the Netherlands, which would not happen if their currencies appreciated in value. These opposing views calls for a review of the common interests in the euro and the structures established for it.

These factors feed the continuing – at any rate underlying – uncertainty about the future of the euro and thus the future of the European integration project as a whole. German chancellor Angela Merkel explicitly linked the two during the crisis in 2011. 'The euro is much more than a currency,' she said. 'If the euro fails, Europe fails.' She also said 'We need a stability union.'[7] Her words were in keeping with an earlier speech she had given when awarding the Charlemagne Prize to Donald Tusk in 2010.[8] Germany is an important advocate of European cooperation and its political goal is still to maintain the currency union in whatever way it can. But would a new German government take the same course if Berlin were again called upon to support eurozone economies on the verge of collapse?

Other questions also have to be answered. Most importantly, after all the changes in the eurozone, are we now on top of things? Have the main problems been successfully identified and have targeted policy changes and new institutional arrangements structurally improved the situation in the eurozone? Are countries, banks and the eurozone as a whole capable of benefiting from the current positive economic developments and are they strong and adaptive enough to absorb any future shocks? Do we no longer need to fear situations like those that arose after 2008? Can we conduct financial and economic policy that will further strengthen the euro? In other words, are we on top of things?

The eurozone is undeniably economically and financially stronger now than it was just a few years ago. Several studies, including those by Eurostat and the German *Institut für Wirtschaftsforschung*, have found that the economic climate in the eurozone has substantially improved in recent years[9] and the eurozone economy is expected to continue growing in the coming period.[10] There is therefore no acute danger at present of the currency union collapsing. This is due chiefly to the generally favourable

6 Netherlands Court of Audit (2015), 'Emergency Assistance for Euro Countries during the Crisis'.

7 See: <https://www.nrc.nl/nieuws/2011/09/08/euro-voor-merkel-meer-dan-een-munt-12034139-a1176658>.

8 See: <http://www.karlspreis.de/de/preistraeger/donald-tusk-2010/laudatio-der-bundeskanzlerin>.

9 See: <http://ec.europa.eu/eurostat/documents/2995521/8009160/2-03052017-AP-EN.pdf/a1d315bd-e14b-408e-8623-d2c3786d7cf7> and <http://www.cesifo-group.de/ifoHome/facts/Survey-Results/World-Economic-Survey/Economic-Climate-for-the-Euro-Area/Archive/2017/Economic-Climate-Euro-Area-20170504.html>.

10 *Het Financieele Dagblad* (2017), 'Economisch klimaat in eurozone in tien jaar niet zo goed' ('Economic climate in the eurozone not been so good in 10 years'). See: <https://fd.nl/economie-politiek/1200550/economisch-klimaat-in-eurozone-in-tien-jaar-niet-zo-goed>.

development of the world economy, but the steps taken in recent years to fully or partially rectify the shortcomings in the design of the EMU laid bare by the financial and economic crisis have certainly helped. In the AIV's opinion, the eurozone is now better protected against the adverse effects of new economic and financial crises than in 2008/2009 and 2010/2012. The ECB's role as the de facto lender of last resort and the policy decision to introduce quantitative easing as a means to lower interest rates and therefore encourage investment have been critical in this improvement. The ECB's stance, however, has raised questions about the limits of its mandate. Other mechanisms introduced to stabilise the eurozone, either temporarily or permanently, include the European Stability Mechanism (ESM), the European Semester and further steps to complete the banking union.[11] We will return to the measures taken so far later in this report.

Nevertheless, harder times may be coming. The world economy will inevitably slow down at some point in the future. It cannot be said exactly when or to what extent, but it will. Will national economies be able to withstand the slowdown? In other words, will they be able to keep their budget deficits to less than 3% of GDP and mitigate the consequences for growth and jobs? Other setbacks are also conceivable. Major changes in the energy market, for instance, may lead to scarcity and rapid price hikes. Countries may suffer natural or man-made disasters, such as mass migration, terrorism or cyberattacks. Such events affect national economies to different extents, which is why we call them asymmetric shocks. Some countries will be in a better position to respond and rebound than others. Finally, it cannot be ruled out that the eurozone will be hit by a financial and economic crisis comparable to the 2008 crisis, with all the inevitable consequence for banks and financial markets.

As noted above, virtually all eurozone economies have performed well in recent years. This is undeniably good news. Yet it is also clear that there were significant differences in the extent to which countries absorbed the financial and economic shocks. To put it bluntly, the economic and financial situation in the northern eurozone members has developed considerably better in the years since the crisis than that in most of the southern members. Growth recovered faster, budget deficits were brought under control earlier, debts did not rise as high and unemployment fell sooner and far more quickly. In consequence, the hoped-for, and perhaps anticipated, convergence in the eurozone receded further from view. It became clear in the aftermath of the crisis that disparities in, for instance, the national debt and the budget deficit had widened. Countries like Greece, Portugal, Italy and Spain are still contending with considerably higher budget deficits and national debts (as a percentage of GDP) than most of the northern member states.[12]

In this regard, it is worth noting that as well as economic differences there are still significant institutional differences, especially between the northern and southern member states. They include the quality of public administration, the reliability of national statistics offices, the protection of established professional and business interests, and confidence between employer and employee organisations. Institutional

11 Haas, J. & K. Gnath (2016), 'The Euro Area Crisis: A Short History', Jacques Delors Institute, pp. 7-8.

12 For budget deficits and surpluses, see: <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=teina200>. For national debt (as a percentage of GDP), see: <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=teina225>.

differences are partly responsible for the southern economies' weaker performance since the recent crises. To date, moreover, these member states have lacked the will to implement meaningful reforms to shockproof their economies and strengthen their competitiveness. The Commission's Reflection Paper on the Deepening of the EMU, which was published at the end of May, also concludes that there are still significant economic and institutional differences among the member states.[13] Like the Commission, the AIV thinks reducing both economic and institutional differences is of prime importance, as properly functioning national institutions can contribute to economic growth and employment in the eurozone.

The economic situation in most EMU member states is currently relatively stable, but the outbreak of a new crisis at some point in the future cannot be ruled out. In view of the above-mentioned divergence, significant institutional differences and the European institutions' lack of effectiveness and decisiveness, the AIV thinks the EMU is inadequately prepared to weather such a crisis. The economic policies of the euro country governments are overreliant on the ECB's policy of quantitative easing; the fiscal situation in many euro countries leaves no room for anti-cyclical fiscal policies. The governments concerned are still making too little headway towards completing the banking union, while the governments of the southern member states are failing to make essential structural reforms. Furthermore, public and private debt levels are very high. The average national debt in the eurozone is more than 90% of GDP, while bank balance sheets include at least €900 billion in non-performing loans.[14] For all these reasons, the EMU member states are facing a fundamental choice about the future design and strengthening of the EMU.

Broadly speaking, the AIV believes there are three conceivable scenarios, which are not mutually exclusive. Firstly, the member states could continue on the same course and strengthen the EMU step by step. Alternatively, some, but perhaps not all, member states could make a 'great leap forward' and take far-reaching steps towards a political union with a common financial and economic policy. This would require greater centralisation of powers. Both these scenarios are based on steps, large or small, towards further integration. These scenarios form the backdrop to the measures considered later in this advisory report to further strengthen the EMU and its various components.

A third scenario, given the persistence of worrying developments in certain euro countries that may continue to underperform, is that one or more countries voluntarily or involuntarily decide to leave the eurozone. The AIV is not suggesting that this scenario is either probable or desirable but it cannot be ruled out. That is why it is explicitly considered in this report. A withdrawal would evidently have to be 'controlled' in order to prevent economic disruption. This would almost inevitably entail the suspension of the free (external) movement of capital and support for the withdrawing country's new currency. The potential economic impact of such a withdrawal on the growth prospects of the Netherlands and the other eurozone countries is also considered. The consequences

13 European Commission (2017), 'Reflection Paper on the Deepening of Economic and Monetary Union'. See: <https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_en>.

14 See, for example: <http://www.cpb.nl/sites/default/files/omnidownload/CPB-Notitie-30mei2016-CPB-Risicorapportage-financiele-markten-2016.pdf>.

would vary depending on which country withdrew (temporarily or permanently); the country's economic importance and Dutch trade relations with it would be crucial factors for the Netherlands.

Of these three scenarios, the AIV favours a gradual, step-by-step strengthening of the EMU, as it would provide the best guarantees for the long-term future of the currency union and would enjoy sufficient popular support. To enable further steps and measures, the AIV will look at the necessary strengthening of the EMU both within the current treaty framework and also, where necessary, outside it.

In the AIV's opinion, a scenario involving a managed, permanent or temporary withdrawal from the eurozone as described above would not be incompatible with the gradual strengthening of the EMU. It could improve the eurozone's ability to absorb shocks, for example, and strengthen its competitiveness. How this could be achieved is considered later in this report.

The AIV's preferred scenario builds largely on the integration process implemented to date. After all, the member states will probably not be willing to take big steps towards closer integration in the near future and such steps would not enjoy sufficient popular support in certain member states. Far-reaching reforms are therefore as good as ruled out. The great economic and political pressure exerted by the crises has shown, however, that steps can be taken if the need for cooperation is strong enough. Future circumstances may also force further steps towards integration. The steps could include measures to strengthen financial supervision, ensure the sustainability of public finances and encourage the capital markets to finance the real economy. Such steps are in line with Scenario 1 in the Commission's recent white paper on the future of Europe.[15]

As said, besides the scenario involving a contraction of the eurozone and the scenario of a gradual, step-by-step strengthening of the EMU, a 'great leap forward' could be taken towards political integration.[16] This scenario would enjoy relatively little popular or government support in the Netherlands and the wider EU at present, but is worth considering, especially in the light of the recent election of the pro-European and reform-minded Emmanuel Macron as President of France. His election manifesto called for a separate budget for the eurozone, with expenditure being decided by a euro-parliament and managed by a euro minister of finance and economic affairs. These ideas are echoed in the European Commission's reflection paper. The question, of course, is whether Germany would accept them. It would probably support Macron's idea that the 'surplus countries' (such as Germany and the Netherlands) should invest more in order to restore balance to the eurozone, especially if President Macron seriously pursues his

15 European Commission (2017), 'White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025'. See: <https://ec.europa.eu/commission/white-paper-future-europe-reflections-and-scenarios-eu27_en>.

16 Comparable with Scenario 5 in the Commission's recent white paper, 'Doing Much More Together'. See: European Commission (2017), 'White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025'. See: <https://ec.europa.eu/commission/white-paper-future-europe-reflections-and-scenarios-eu27_en>.

reform plans for his own country.[17] A revival of the Franco-German axis, and thus of the European integration process, can in any event not be ruled out. Steps towards further integration will depend in part on the outcome of the German election in September 2017. If the steps are to enjoy sufficient support in the eurozone member states, the general public must be engaged in the integration process and clearly understand why the steps are both necessary and in the interests of citizens and businesses. It is essential that the measures satisfy the requirement of democratic legitimacy, not least because the German constitutional court insists that parliament's right to approve and amend the budget must be safeguarded. These requirements will also be of decisive importance to the Netherlands.

The third scenario also touches on the question of whether the euro, a currency without a state, is doomed unless radical measures are taken in the longer term to rectify the EMU's design faults.[18] The design faults include the absence of a European centre of government befitting a political union that could force the euro countries to respect the rules and a euro budget big enough to absorb asymmetric shocks in the member states. The scenario associated with taking steps in this direction agrees most closely with Scenario 5, 'Doing Much More Together', in the Commission's white paper, i.e. the 'great leap forward' option. Within the eurozone, but also in countries wanting to join it, this scenario entails far stronger coordination of social, fiscal and budgetary affairs and EU supervision of financial services. The EU would also provide additional financial support to promote economic development and to respond to shocks at regional, sectoral and national level.[19]

Proposals and potential measures based on the three scenarios – gradual strengthening of the EMU, a 'great leap forward' and the exit scenario – are elaborated in this advisory report. The next chapter first analyses why the trend has been towards divergence rather than the desired convergence. The degree of convergence among the euro countries influences the economic foundations of monetary cooperation. An analysis of whether the euro countries' economies are growing closer together or growing apart can provide important insights into how the currency union has developed since its introduction. On the basis of such an analysis, suitable measures can then be proposed for each scenario to achieve the required convergence.

17 Krop, M. (2017), 'Maakt de verkiezing van Emmanuel Macron Europa stormbestendig?' ('Does the election of Emmanuel Macron make France stormproof?). See: <https://www.clingendael.org/nl/publicatie/maakt-de-verkiezing-van-emmanuel-macron-europa-stormbestendig>.

18 Stiglitz, J.E. (2016), *The Euro: How a Common Currency Threatens the Future of Europe*.

19 European Commission (2017), 'White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025'. See: <https://ec.europa.eu/commission/white-paper-future-europe-reflections-and-scenarios-eu27_en>.

I Convergence or divergence in the eurozone

I.1 Are there signs of convergence?

The AIV analysed a limited dataset to determine whether there had been convergence among the eurozone countries in recent years. It first considered the indicators used in the Maastricht Treaty, then indicators commonly used to measure economic performance and finally a series of indicators concerning structural developments. Where possible and meaningful, the standard deviation of the differences among countries in a particular year is shown below. The AIV looked in particular at the relationship between six northern euro countries (Germany, Belgium, Luxembourg, Austria, Finland and the Netherlands) and six more southern euro countries (Portugal, Spain, Italy, Greece, France and Ireland).[20] These groups of countries are often compared with each other in the political debate, especially on the sensitive subject of compliance with EMU requirements. A weighted average was calculated for each group. This can be based on either the national GDP or the population size of each country. The figures below are based on population size as differences in GDP are limited. The data runs from 1991 (in some cases from 1995) to 2015/2016 and is taken largely from the Organisation for Economic Co-operation and Development (OECD).

I.1.1 EMU indicators

The Maastricht Treaty made accession to the eurozone dependent on a country's budget deficit, government debt, inflation and interest rates.

Differences in the budget deficit have been fairly stable. With the exception of a short period around 2010, the standard deviation was relatively constant in the period 1995-2015. The northern euro countries, however, have performed better than the southern euro countries since 2007.

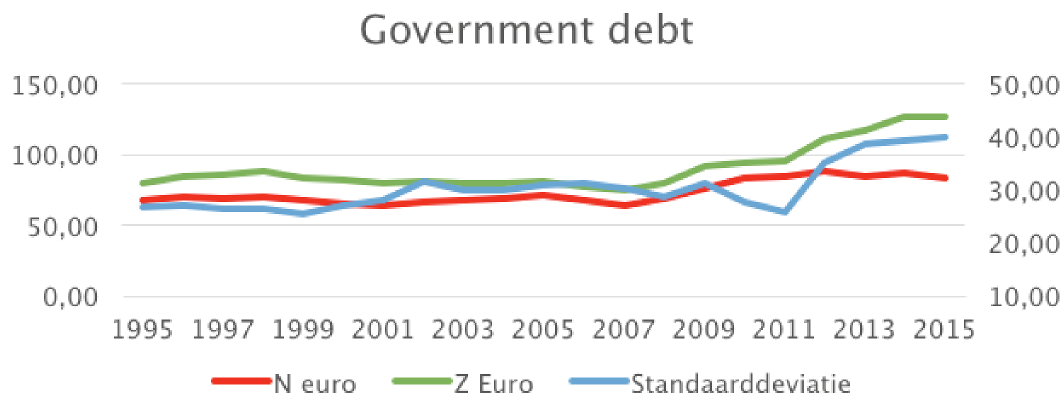
Figure 1. *Budget deficit, 1995-2015*

[Standard deviation N euro S euro]
NB: Decimal commas should be read as decimal points]

20 The inclusion of Ireland in the southern euro group is debatable. However, the use of a weighted average means its significance is limited.

Government debts, however, have clearly diverged since 2011. After 2011, the debt ratio of the northern euro countries remained more or less stable but that of the southern euro countries rose sharply. The standard deviation also increased as from that year.[21]

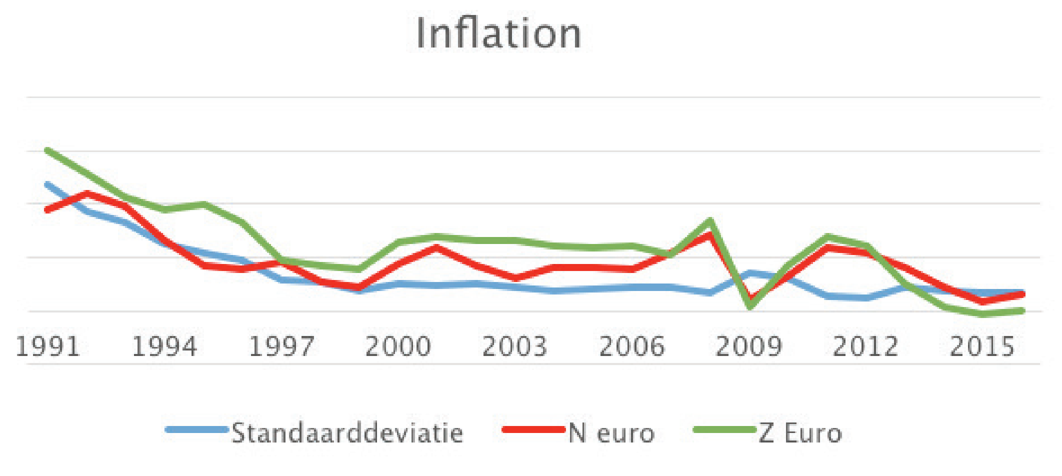
Figure 2. *Government debt, 1995-2015*



[N euro S euro Standard deviation
NB: Decimal commas should be read as decimal points]

The rate of inflation has converged. Inflation in both the northern and southern euro countries has fallen sharply and is now almost the same. As a result, the standard deviation has steadily declined. This convergence of the rate of inflation has been an almost global phenomenon. It is not unique to the eurozone. The AIV did not investigate the causes of this convergence.

Figure 3. *Inflation, 1991-2015*

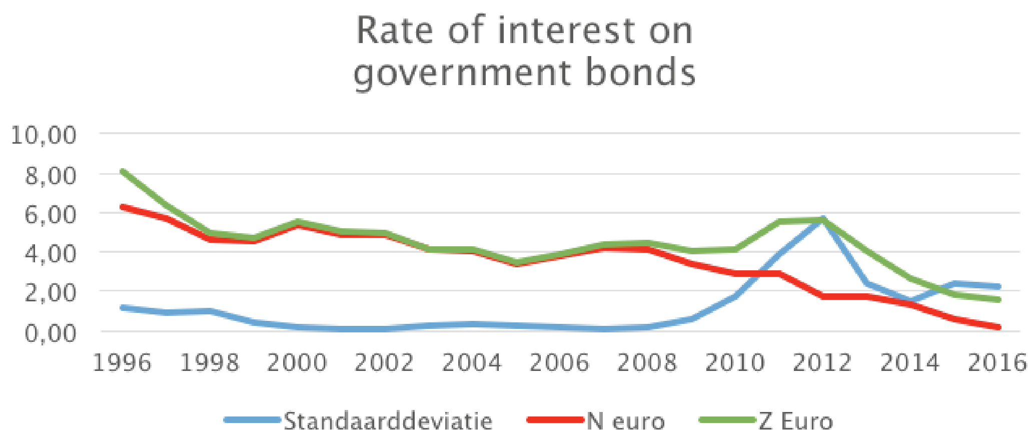


[Standard deviation N euro S euro
NB: Decimal commas should be read as decimal points]

21 Where two vertical axes are used, the right-hand axis relates to the standard deviation.

Finally, interest rates. For a long time the differences were limited but they increased very sharply after 2008. They have narrowed again since 2012 but the standard deviation is still markedly higher than before 2008.

Figure 4. *Rate of interest on government bonds, 1996-2016*



[Standard deviation N euro S euro
NB: Decimal commas should be read as decimal points]

This brief analysis shows that the euro countries have diverged rather than converged. In two cases (government debt and rate of interest on government bonds), the standard deviation increased during the period studied, in one case (inflation) it fell markedly and in another case (budget deficit) it remained more or less unchanged. In all cases, the differences between Northern and Southern Europe have widened since 2008 and show no sign of decreasing.

I.1.2 Economic policies, institutions and governance

Since the launch of the euro, attention has been paid to the member states' economic policy, their governments' ability to act decisively, the support they received to implement reforms and the social partners' response to positive and negative developments. In this area, too, there seems to be a divide between the northern and southern euro countries. Where assistance programmes have been necessary, e.g. in Ireland, Portugal and Greece, the talks covered issues ranging from social, financial and economic policies, the tax burden and pensions to spending cuts and changes to labour market agreements.

What conclusions can be drawn? Are there distinct differences between the Northern and Southern European countries? Many factors are at play: the political constellation, the relationship between political forces and social partners, the extent of regulation, political will and the determination to make necessary reforms, and society's general resilience in adapting to the inevitable changes in circumstances. The greater a country's resilience, it is assumed, the more favourable its economic performance. Unfortunately there are no benchmarks to measures these aspects at present. For the purposes of this report, four suitable indicators were used:

1. the Sustainable Governance Indicator (SGI)
2. the Product Market Regulation (PMR) indicator
3. the Distance to Frontier (DTF) score
4. average position in the World Economic Forum (WEF) index.

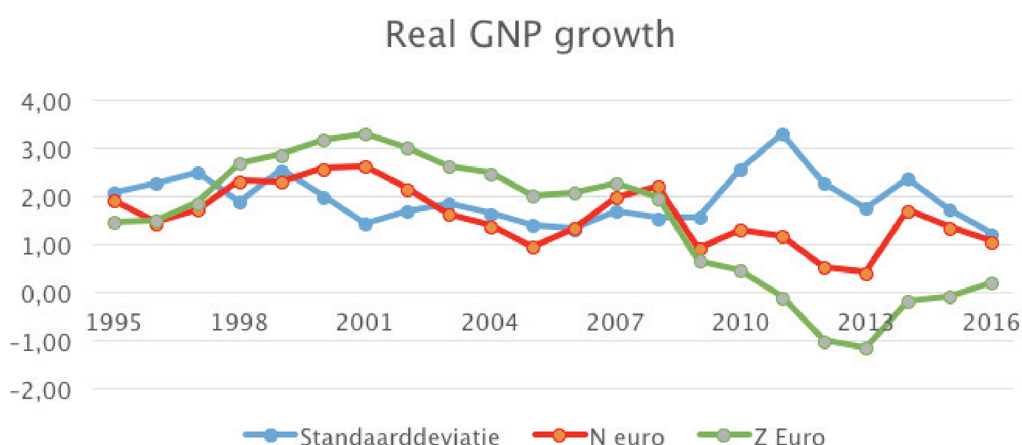
It is beyond the scope of this report to consider these four indicators in detail. Further information on them can be found in Annexe II. Suffice to say that these indicators provide an insight into differences in the economic policies, institutions and governance of the Northern and Southern European countries. The SGI has a wide range of components but data is only available for a short period of time and trends over time are uncertain. Longer time series are available for PMR and DTF based on the World Bank's Doing Business (DB) project, but their scope is restricted to the degree of regulation and competition on product markets and is therefore far smaller. It can rightly be asked whether these indicators accurately reflect differences in the implementation of economic policies and the willingness to reform. Assuming that they are in any event indicative, the SGI and the DB indicator suggest that the Northern European countries are faring better than the Southern European countries, the DB indicator shows a decline in the differences, while the PMR indicator shows that the differences are modest and both groups have seen a marked fall in regulation. The figure in Annexe IV shows that on average the Northern European countries rank significantly higher on the WEF index and the differences with the Southern European countries increased during the period studied, 2007-2017.

I.1.3 Macroeconomic indicators

A provisional conclusion from the above is that not all the indicators considered here paint a consistent picture of the Northern European countries faring better and the differences widening. Nevertheless, the overall picture is that there are differences and they favour the Northern European countries. But what can be said about actual economic performance? Is it converging or diverging? This section looks at the following indicators: economic growth, unemployment, balance of payments, unit labour costs and per capita GNP.

The standard deviation for the growth of GNP was fairly constant during the period studied but here, too, Northern and Southern Europe diverged after 2008. The gap has narrowed, however, in recent years.

Figure 5. *Real GNP growth (five-year average, 1995-2016)*[22]

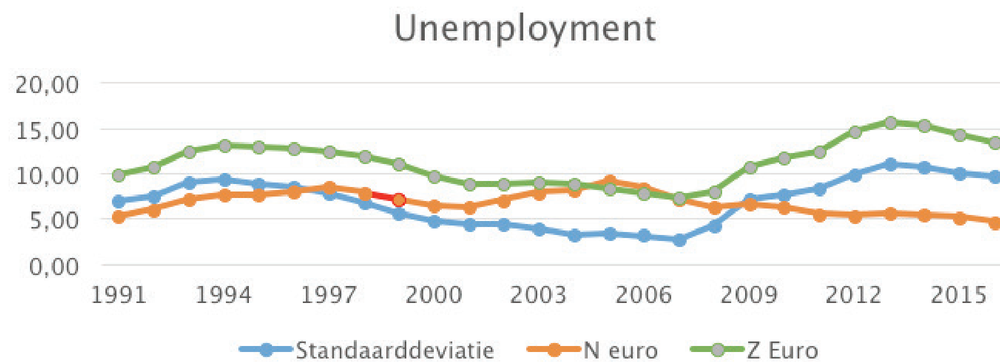


[Standard deviation N euro S euro
NB: Decimal commas should be read as decimal points]

22 A five-year moving average has been used in order to eliminate outliers.

The calculation of unemployment produces a slightly different picture. Two distinct periods can be identified: before 2008, when differences in unemployment in Northern and Southern Europe steadily declined and eventually disappeared around 2007, and after 2008, when the differences increased rapidly again, with falling unemployment in the north and rising unemployment in the south. After 2008, the standard deviation also rose significantly.

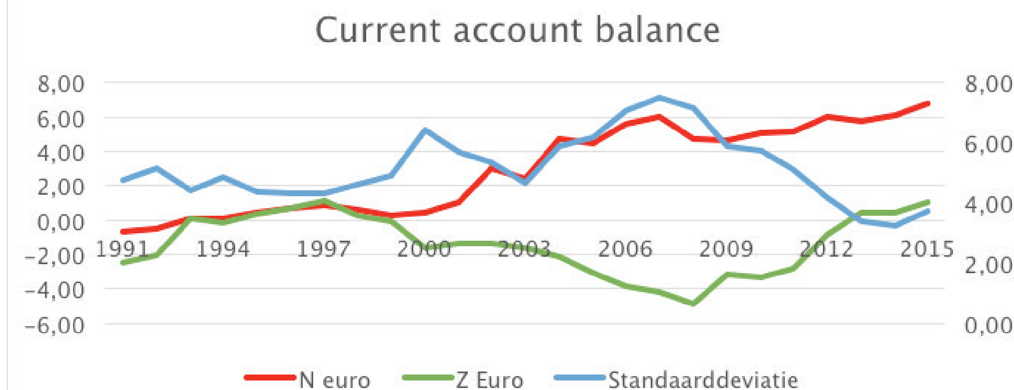
Figure 6. *Unemployment, 1991-2015*



[Standard deviation N euro S euro
NB: Decimal commas should be read as decimal points]

The balance of payments situation is often mentioned in the euro debate. In contrast to the massive deficits in, for example, Greece, there are substantial surpluses in the Netherlands and Germany (this is considered further in the next part of this chapter). The figure below clearly shows the difference. The surplus on the current account balance in the Northern European countries has risen almost linearly from zero in 1992 to more than 7% in 2015. At the same time, the Southern European countries have reported a substantial deficit, although it has gradually declined since 2008. This is probably also due to the strict austerity policies that some of these countries have had to introduce, which have depressed demand in general and demand for imports in particular. The standard deviation initially rose sharply but fell markedly again to less than its initial value after 2008.

Figure 7. *Current account balance, 1991-2015*



[N euro S euro Standard deviation
NB: Decimal commas should be read as decimal points]

The final indicator relates to unit labour costs.[23] It shows the extent to which wage rises more or less keep pace with changes in productivity. The underlying premise is that structural productivity growth is reflected in wages. If the two more or less keep pace with each other, unit labour costs are stable. If wages rise more quickly than productivity, unit labour costs increase, and if productivity rises faster, unit labour costs decrease. Even if unit labour costs increase, the impact need not be dramatic. If all competitors report the same trend, the consequences will be limited. The figure below shows that the differences between Northern and Southern Europe have been limited. The standard deviation has also remained stable and has actually declined slightly over the period studied.

A very recent *Bruegel Policy Contribution*[24] reveals how several relevant indicators have developed in Germany, France and Italy since 1998. The indicators are real exchange rates based on unit labour costs, current account balances, productivity and labour compensation. The report shows that Germany scored better than France, which in turn fared better than Italy. The last two indicators were decisive. In Germany, productivity growth clearly exceeded the increase in labour compensation, in France both indicators moved more or less in tandem, while in Italy the increase in labour compensation was significantly higher than productivity gains. This explains why the real exchange rate in Germany developed relatively favourably and, in part, why there was such a large current account surplus. The differences have not increased since the 2008 crisis but they have not decreased either. If the solution has to be sought in France and Italy, as Germany constantly argues, it will have a deflationary impact on those countries' economies. And this, in turn, would again bolster the fortunes of anti-EU parties.[25]

Figure 8. *Unit labour costs, 1992-2015*

[Standard deviation N euro S euro]

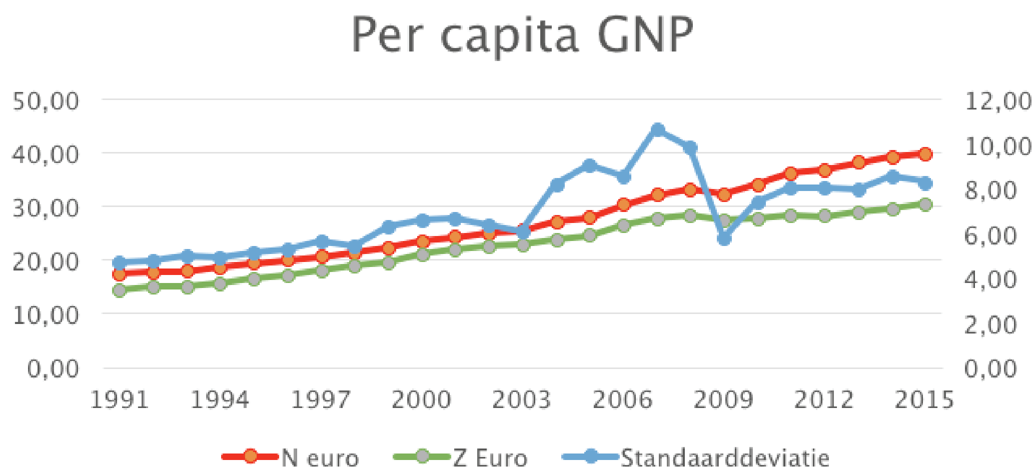
23 The data is taken from the Cologne Institute for Economic Research, which has been publishing it for many years.

24 Berger, B & G. Wolff (2017), 'The global decline in the labour income share: Is capital the answer to Germany's current account surplus?', *Bruegel Policy Contribution*, no. 12, April 2017.

25 See, for example, Wolf, M. (2017), 'Emmanuel Macron and the battle for the eurozone', *Financial Times*, 17 May 2017.

The final indicator to be considered is per capita GNP. It increased in both Northern and Southern Europe but the increase after 2008 was far smaller in the south than in the north. The difference in 2015 was roughly €1,000, which means that per capita GNP was 25% lower in the south than in the north. The standard deviation also increased during the period studied.

Figure 9. *Per capita GNP, 1991-2015*



[N euro S euro Standard deviation
NB: Decimal commas should be read as decimal points]

The final conclusion to be drawn from this section is that the Northern European countries performed better than the Southern European countries on four of the five indicators studied (GNP growth, unemployment, current account balance and per capita GNP) during the period concerned, especially after 2008. The two groups were roughly comparable only regarding unit labour costs, and the standard deviation increased significantly only with regard to per capita GNP. For the other indicators, the final value did not differ significantly from the initial value, even though the differences increased in the intervening period. The differences between the six Northern European countries and the six Southern European countries have tended to increase rather than decrease in recent years. The Commission also noted in its reflection paper on deepening the EMU that divergence had increased in the eurozone since the crisis.[26] A cautious trend towards convergence has been seen in recent years but the differences are still considerably bigger than they were around 2008.

I.2 Promoting real convergence

This section looks at a number of options and steps that could contribute to the desired convergence. The focus is on answering the second question in the request for advice: What steps can be taken within the limits of the current treaty framework to promote real economic convergence within the eurozone? The AIV will not confine itself to steps within the limits of the current treaty framework but, where necessary, it will also consider essential steps that may require an amendment of the Treaties at some point. Chancellor Merkel and President Macron also acknowledge that treaty amendments may

26 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union'.

be necessary, as became clear during their meeting of 15 May 2017.[27]

Some of the economic steps that can be taken within the current treaty framework are considered in this chapter. Other steps that can also promote convergence but are more closely related to the financial union, monetary stability and/or the fiscal union are considered in the following chapters.

In an initial assessment of the Five President's Report, the government stated that the report's economic proposals largely agree, in the short term, with the three priorities set by the government itself:[28]

1. further reforms of national economies to strengthen the eurozone's growth potential and ability to withstand future crises;
2. full exploitation of the single market, an essential component of a more resilient EMU;
3. better governance, i.e. optimally functioning and reliable public administration in the member states.

The AIV agrees with the choice of these three priorities; they are also consistent with several other ideas and proposals put forward by authoritative institutions and think tanks. In a 2015 article in its *Economic Bulletin*, for example, the ECB outlined three conditions for promoting sustainable convergence in the eurozone and strengthening the EMU's ability to absorb shocks.[29] They are:

1. macroeconomic stability, including the reduction of external, private and public sector debt to sustainable levels;
2. greater economic flexibility in the eurozone countries concerned, in part by means of measures to increase competition on the goods, services and capital markets and reduce rigidity, especially in the product and labour markets in countries such as Greece, Italy, Portugal and Spain;
3. higher total factor productivity growth, in part by improving the quality of labour, increasing the proportion of highly skilled workers, improving the quality of capital, partly by investing in ICT and in technological advances that promote growth potential, and by creating and/or strengthening a national institutional framework that supports innovation in businesses.

The ECB also recognises the importance of the single market and its completion, with the convergence process being supported by closer economic integration, including integration of the capital markets and further development of the capital markets union (see also chapter II on the financial union). The ECB notes that although significant progress has been made in the free movement of goods, there has been less progress in cross-border trade in services. Services account for more than 70% of the EU's economy but there has been far less integration in the services sector than in the goods

27 See: <https://www.ft.com/content/bb96944c-399b-11e7-821a-6027b8a20f23>.

28 Letter to parliament, 23 June 2015, Parliamentary Papers 21 501-20, no. 996.

29 ECB (2015), 'Real convergence in the euro area: Evidence, theory and policy implications', E*conomic Bulletin*, issue 5.

market. This is due in part to the nature of the services sector.[30] Implementation of the 2006 Services Directive is leading to the greatest improvements in countries with many and/or high barriers, in particular Greece, Spain, Italy and Portugal.

Higher labour mobility and the attendant movement of human capital and skills can also support convergence. Higher labour mobility can help absorb country-specific or sectoral shocks. Although there was an increase in the number of labour migrants to Germany and Austria in particular during the crisis years, labour mobility in the EU is still substantially lower than in, for example, the US. Apart from linguistic and cultural differences, the lack of harmonisation among national social insurance systems is seen as an obstacle.

The Commission believes that the European Semester should play a part in promoting convergence in both the eurozone and the EU as a whole. In its recent reflection paper on deepening the EMU, it states that coordination of national economic policies is essential and the European Semester should remain the core vehicle for further steps towards stronger convergence.[31] The AIV agrees that good coordination of national economic policies is key to promoting convergence but notes that giving the European Semester too many tasks may undermine the mechanism's efficiency. It is therefore important that the European Semester's tasks do not become too extensive.

In the AIV's opinion, satisfying the aforementioned conditions will lead to more convergence in the eurozone. The AIV is fully aware that political circumstances and institutional realities in the euro countries prevented the conditions from being satisfied in the past and may well do so again in the years ahead. Nonetheless, the recent election of President Macron and the forthcoming German election may trigger a new dynamic in Europe. There are signs of a revival of the Franco-German axis. Such a development could provide the desired leadership in Europe and serve as a springboard for new initiatives.

It has to be asked to what extent the eurozone countries are willing to trade their interests and to what extent strong economies in particular, such as Germany, are willing and able to support economic reforms in France and elsewhere. On the one hand, the AIV has no doubt that France must take real measures to make its labour market more dynamic, reduce government restrictions on business, and cut public expenditure in order to remain below the 3% budget deficit limit and reduce the national debt. On the other, it believes that Germany, as part of an agreement with France, must be prepared to invest substantially more, especially in infrastructure and ICT, and where necessary and possible increase German workers' wages in order to create a more level competitive playing field with the southern euro countries. There is every reason to do this, as the huge current account surplus on Germany's balance of payments is just as much at odds with the objectives of the macroeconomic imbalance procedure as

30 See: <https://www.ecb.europa.eu/mopo/eaec/html/index.en.html>.

31 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', p. 24.

excessive budget deficits are with the rules of the SGP.[32]

A grand bargain between Germany and France along the lines outlined here would probably increase the pressure on Italy to modernise its economic structure. Germany's willingness to increase national expenditure (both investments and consumption) could also make it easier for the Italian government to win support for painful measures at home.

A simultaneous investment and reform process could stimulate economic growth in the weaker eurozone countries and thus promote eurozone convergence. In the AIV's opinion, the Netherlands should not hide, figuratively speaking, behind Germany's broad shoulders. In relative terms, the Netherlands' current account surplus is even bigger than Germany's. The AIV believes that the Netherlands, together with Germany, should actively support the establishment of investment programmes and the like and stimulate domestic demand by ensuring that wage rises stop lagging behind the increase in labour productivity or even exceed the increase in productivity temporarily in order to rectify distortions of competition. It should be borne in mind, of course, that there are significant differences in productivity trends between the various sectors of the Dutch economy. These differences seem difficult to reconcile with uniform wage increases.

In reply to question 3 in the government's request for advice, the steps available to the Netherlands also have implications for the Netherlands' economy and financial interests. The likely reduction in the volume of Dutch exports due to higher labour costs would probably be matched by an increase in consumer expenditure in the Netherlands and elsewhere in the eurozone. Some of the increased consumer purchasing power in the Netherlands would 'leak' abroad in the form of higher demand for products and services (e.g. holidays) from other euro countries, but this would serve the goal of promoting economic growth in the weaker euro countries and should therefore be welcomed. A policy of reducing the balance of payments surplus in favour of greater convergence in the eurozone would undoubtedly have an impact on employment in the Netherlands. Reducing the volume of exports would also have negative effects but there would also be positive effects connected with the higher purchasing power of Dutch consumers. Further study is required to determine how the positives would measure up against the negatives.

I.3 Conclusion

The AIV is convinced that a policy based on a trade-off of interests as described above is a more practicable way of future-proofing the currency union than transforming it into a transfer union, with substantial, long-term transfers from the northern to the southern euro countries. As noted above, voters in the northern countries would not let a decision in favour of such a union go unpunished.

The following chapters make several other proposals regarding financial union, monetary stability and fiscal union that can directly or indirectly help promote convergence in the eurozone.

32 See also Rodenburg, P., 'Macro-economische onbalans en herbalancering in de eurozone' ('Macroeconomic imbalance and rebalancing in the eurozone'), TPEdigitaal, 2016, volume 11 (1), pp. 94-112. See also *The Economist*, 'The German problem. Why Germany's current account surplus is bad for the world economy', 8-14 July 2017, p. 7.

II Financial union: completing the banking union and creating the capital markets union

II.1 Introduction

The financial crisis of 2007-2008 was due principally to excessive bank lending and the introduction of new financial products such as derivatives, whose economic value lacked transparency. The crisis broke out in the US but the close ties among financial institutions on both sides of the Atlantic meant it quickly spread to Europe. The ensuing euro crisis in 2010-2012 exposed the great vulnerability of many European banks. One of the main causes was the lack of adequate capital buffers in the form of equity. In the Netherlands too, systemic banks – i.e. banks that play a vital role in the payment transactions system – could be saved only by major support operations or even direct state intervention (nationalisation).

The idea of a banking union was conceived as a way of better equipping European financial institutions to deal with a repeat crisis. Its creation is heavily dependent on banks' willingness to share in each other's risks, as explained below. The more the risks are spread across as many banks in as many countries as possible, the more willing they will be. At present, however, the risks are still distributed asymmetrically, especially between the financial institutions in the northern and southern euro countries.

As the title of this chapter suggests, 'financial union' has two components: banking union and capital markets union. The latter can be seen as a response to the fragmentation of financial markets both within and between member states.

II.2 Banking union

The debt problem is characterised by a nexus of public and private debt. Banks in distress that have to be rescued with public money to prevent dislocation of the financial system can exert so much pressure on the national debt position that budget deficits can be financed only at very high interest rates. Bank crises are therefore a direct threat to governments' financial resilience. Conversely, unsustainable government debts weaken the banking system because in certain circumstances the government is no longer able to redeem debt instruments that are held privately. The package of measures introduced in the six-pack, two-pack and Fiscal Stability Treaty (see chapter IV) are intended primarily to ensure that government debt is reduced to or remains at a sustainable level. The banking union is designed to improve financial stability and strengthen the banking sector in the eurozone. Strengthening the banking sector must primarily ensure that the financial institutions' solvency (i.e. their debt/equity ratio) does not represent a threat to their continuity. A secondary objective is to protect taxpayers from the cost of rescuing banks and safeguard deposit holders against the consequences of banks collapsing.

The banking union can be summarised as an arrangement in which the 19 countries that make up the currency union conduct a common policy on banking operations.

The union is also open to non-euro countries.[33] It is based on three pillars: the Single Supervisory Mechanism, the Single Resolution Mechanism and the Single Deposit Guarantee Mechanism. The first pillar, the Single Supervisory Mechanism, came into force on 4 November 2014. Banks are supervised by the European Central Bank (ECB) in cooperation with national supervisors such as the Dutch central bank (DNB). The form of cooperation depends on the size of the bank. The decisive factor is the bank's or banking group's 'significance'. The criteria applied to determine significance include the total value of assets,[34] economic importance in the country of establishment and the importance of cross-border operations. The ECB is the lead supervisor of 'significant' banks. Every year it prepares supervision plans in consultation with the national supervisor. Although the ECB is the lead supervisor, the national supervisors play an important role in the implementation of the plans. Their role is even more important in the supervision of banks that are not classified as 'significant'; as a rule national supervisors retain primary responsibility for the less significant banks. The ECB supervises these banks indirectly by keeping an eye on them. It supervises them directly only if it believes that this would be more expedient.

The AIV understands that capacity problems on the one hand and lack of information on local circumstances on the other have allowed national supervisors to retain a significant say in European bank supervision. It believes the balance of supervision between the ECB and national supervisors should be shifted towards the former. In other words, greater centralisation is necessary, especially in view of the enormous volume of non-performing loans that are outstanding. The ECB still makes too little use of its powers to supervise less significant banks directly. In some member states (such as Italy and Germany) smaller regional banks are closely involved in the world of politics and public administration. Partly for this reason, their supervision is perhaps not as strict as it should be; their capital buffers are too low and there is little pressure on them to write off non-performing loans.[35]

The second pillar of the banking union is the Single Resolution Mechanism, which came into force on 1 January 2016. Its purpose is to provide the assistance necessary to ensure the orderly resolution of failing banks. The assistance is provided from the Single Resolution Fund (SRF). Failing banks are resolved either by means of a restructuring plan or bankruptcy proceedings. To prevent taxpayers' money being used, shareholders and creditors will systematically be required to bail in, in accordance with the EU Directive establishing a framework for the recovery and resolution of credit institutions and investment firms. The AIV is encouraged by the fact that the distressed Spanish bank Banco Popular was recently rescued without state aid, which was not the case

33 The EU member states outside the currency union can participate by having their competent national authorities enter into 'close cooperation' with the ECB.

34 The minimum limit for total assets is €30 billion.

35 Bas Jacobs, professor of economics and public finance at the Erasmus School of Economics, for instance, believes that although supervision has been tightened up, few lessons have been learned from the banking crisis. Capital requirements are still far too low. He does not spare the Dutch central bank either, claiming that it sides with the banks too often when conducting its supervision. 'Should anything go wrong with our banks again,' he says, 'it's still the taxpayer who will foot the bill.' See the article on Klaas Knot, 'Soeverein in al zijn vezels' ('Sovereign in all his fibres'), de Volkskrant, 28 March 2017, in which Jacobs is interviewed.

with the Italian bank Monte dei Paschi di Siena[36] (see also section III.2). Under an intergovernmental agreement, the SRF will be built up over a period of eight years. It will be composed of contributions of at least 1% of the amount of covered deposits of all credit institutions licensed in all participating countries. This will add up to an estimated capital of €50 billion. The contributions made by national banks will be transferred to the common fund, which will initially consist of compartments corresponding to the participating countries. The compartments will be gradually merged (mutualised) after a transitional period.

The AIV notes that, despite the establishment of the Single Resolution Mechanism, there will still be a need for a common backstop, at least until the SRF reaches its target level. But even when it has, the target level may be inadequate to carry out major resolution operations. In its reflection paper on deepening the EMU, the European Commission also underlines the need for a common backstop for the SRF and the European Deposit Insurance Scheme.[37] In accordance with the roadmap to complete the banking union, the participating countries reached agreement with the Single Resolution Board at the end of 2015 on a harmonised loan facility agreement that will provide national credit lines to support the national compartments of the SRF in case there are funding shortfalls in a national compartment following bank resolutions during the transition period. The AIV thinks that national credit lines should be budget-neutral, i.e. the cost should not be borne by the participating member states' public finances. Any national assistance should therefore be repaid by means of retrospective contributions from the financial sector.[38] The roadmap provides for the introduction of a common backstop by 2024 as a final step. The backstop would replace the national credit lines. A political problem that cannot be ignored, however, is that the eurozone countries that have restored their banks to health are wary of transferring funds to countries that have failed to take timely measures to reorganise and restructure their banks.

The European Deposit Insurance Scheme (EDIS) is the banking union's third pillar and is regarded as its crowning achievement. The scheme will gradually replace the national systems, which under EU rules already guarantee savings accounts worth up to €100,000 in the event of a bank failure. The EDIS will be created in three stages. The first stage is confined to introducing reinsurance as a safety net should the national systems prove insufficient. In the second stage, the safety net will gradually be supplemented by means of compulsory contributions from banks so that it accounts for an ever greater proportion of the savings guarantee in the event of a bank failure. The risks will not be spread across all countries participating in the banking union until the third stage. The system was to become fully operational in 2024. However, in mid-2016, EU finance ministers (Ecofin) postponed the establishment of EDIS. It was agreed that the negotiations would begin

36 That the fragmented Italian banking system, with its many small and inefficient banks, is a source of great concern was demonstrated again by the collapse of two other banks in June 2017, Veneto Banca and Banca Populare di Vicenza. In both cases the Italian state had to provide substantial financial support to resolve the situation. Apart from shareholders, only the professional investors holding bonds (and not small bondholders) had to contribute. The operation was therefore not a complete bail-out.

37 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', pp. 20-21.

38 Juncker, J.C. et al. (2015), 'Completing Europe's Economic and Monetary Union', p. 13. See: <https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf>.

only when sufficient progress had been made on a series of measures to limit risks in the financial sector. The postponement decision was taken largely on the urging of Germany. Germany did not want its banks and indirectly its taxpayers to guarantee banks in other countries in the banking union before they had eliminated the bad risks, and especially the hidden risks, in their balance sheets. In effect, this is the same problem as that faced by the Single Resolution Mechanism: a conflict of interests and lack of trust between the financially strong and the financially less strong countries.

In view of the European Deposit Insurance Scheme's great importance to financial stability, the AIV emphatically calls for the further strengthening of banks with weak balance sheets by means of recapitalisation, possibly through their acquisition by financially strong banks. This will require enhanced European supervision and compliance with agreements on the formation of a common resolution fund.

II.3 Capital markets union

In September 2015 the European Commission launched an action plan for a capital markets union in order to create an integrated market for capital. This union, which is scheduled to be introduced in 2019, has two aims. The first is to encourage investment by making more diversified sources of finance available, especially for small and medium-sized enterprises and start-ups. In comparison with other parts of the world (especially the United States), the EU makes less use of financing sources that are complementary to bank finance. Such sources include the equity and bond markets, venture capital, crowdfunding and the asset management sector. To create a genuine *European* capital market, the obstacles to cross-border investment in European businesses and infrastructure projects must be removed so that businesses can raise the finance they need more easily, no matter where they are located.

The union's second aim is to increase the stability of the financial system as a whole. This aim is based on the concept of private risk-sharing among countries. As the cost of business insolvency as a result of the crisis is passed on not only to investors in the home country but also to investors in other countries, part of the shock of business termination will be absorbed elsewhere. At the same time, crises in the banking sector will have less impact on a business's access to finance if alternative sources are available. In other words, businesses will be less vulnerable if the risks in the financial system can be spread more widely.

It is therefore argued that creation of the capital markets union is also an important step towards completing the economic and monetary union.[39] It would also be a positive development with a view to strengthening European competitiveness. Spreading risks across borders and increasing market liquidity are expected to reduce business costs, although an important condition must first be fulfilled (see the next paragraph).

The AIV believes further steps are needed for businesses to benefit in full from the potential advantages of a capital markets union. A harmonised legal framework is needed to ensure capital flows can cross national borders more easily and that financial sectors are not hindered by borders. Differences in national legislation currently obstruct investments by transnational enterprises. These differences impede the creation of a

39 European Commission (2015), 'Capital Markets Union: an Action Plan to boost business funding and investment financing', press release, 30 September 2015.

level playing field in the EU's financial markets. The AIV is therefore more inclined to support the suggestion[40] that a 'rule book' be drawn up (or completed) with binding instructions on the harmonised implementation of European capital markets legislation. With this in mind, the European Securities and Markets Authority should be strengthened so that it becomes an effective watchdog for the implementation of European financial rules. In its current, predominantly coordinating, role it cannot adequately guarantee the required predictability. Transaction costs are being kept unnecessarily high by uncertainty about how the member states implement the rules.

II.4 Conclusion

The slow implementation of the European financial union, in particular the banking union, is an important reason why the eurozone is still inadequately prepared to withstand the next crisis. The ECB's role as lead supervisor of significant banks may be a big step in the right direction but there are risks attached to the large say that national supervisors still have in actual supervision, and not only the supervision of less significant banks. This is particularly true given that the requirements for holding capital buffers are still relatively low. Another concern is the obstacles that have effectively been thrown up by setting strict conditions for the creation of the Single Resolution Mechanism. The AIV, too, looks upon this mechanism as an important instrument for increasing the stability of the financial system. Progress can be made only if the risks of weak banks are not borne disproportionately by a small group of financially strong countries. The same applies *mutatis mutandis* to the creation of the Deposit Insurance Scheme.

40 Enderlein, H. et al. (2016), 'Repair and Prepare: Growth and the Euro after Brexit', Bertelsmann Stiftung and Jacques Delors Institute, p. 29. Véron, N. and G.B. Wolff (2015). 'Capital Markets Union: A vision for the long term', *Bruegel Policy Contribution*.

III Monetary stability

III.1 Introduction

When the banking crisis spread from the US to the EU at the end of 2009, triggering an unprecedented sovereign debt crisis, the currency union was inadequately prepared to withstand it. European crisis management was initially hesitant and fragmented. In an advisory letter of February 2012, the AIV described it as ‘too little, too late’.[41] The scale of the problems in Greece and the risk of contagion were initially underestimated.

The first support programme for Greece consisted of loans from the IMF and the euro countries. When Ireland and Portugal also needed support programmes, two temporary loan facilities were established, the €60 billion European Financial Stability Mechanism (EFSM) guaranteed by the EU budget, and the €440 billion intergovernmental European Financial Stability Facility (EFSF) guaranteed by the euro countries.[42] A further €250 billion was mobilised by the IMF. The support programmes for these countries and a substantial second support programme for Greece, however, proved inadequate to restore financial market confidence. This led to the establishment of the European Stability Mechanism (ESM), a permanent rescue fund with a real lending capacity of €500 billion. This decision, too, failed to convince the financial markets. It took a statement by the ECB’s president, Mario Draghi, ‘to do whatever it takes’ and a decision by the ECB ‘to provide a fully effective backstop to the government bond markets’ (outright monetary transactions – OMT) to allay the tension on the financial markets.[43]

Under pressure from the twin shocks of the banking crisis and the subsequent sovereign debt crisis, a raft of measures has been introduced relating to financial regulation, banking union, budgetary discipline and economic policy coordination.

III.2 Strengthening since the crisis

Financial services regulation has been tightened up, bank capital requirements have been increased, centralised bank supervision was introduced in the form of the Single Supervisory Mechanism in November 2014, the Single Resolution Mechanism and Single Resolution Fund were introduced in January 2016, and the first steps were taken towards the European Deposit Insurance Scheme (see chapter II). Fiscal discipline has been strengthened by the establishment of the European Semester, consisting of the Stability and Growth Pact for budgetary coordination and the macroeconomic imbalance procedure for macroeconomic coordination. The six-pack and two-pack further tightened

41 AIV, ‘Towards Enhanced Economic and Financial Governance in the EU’, advisory letter no. 19, The Hague, February 2012.

42 For Ireland, see: <https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-ireland_en>. For Portugal, see: <https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-portugal_en>.

43 See: <https://www.ecb.europa.eu/press/pressconf/2012/html/is120906.en.html>.

up the agreements in this area (see also chapter IV). Draghi's statement and the announcement of OMT prompted a sharp fall in interest rates, and the rates in Germany and those in countries like Spain and Italy have been largely brought into line with each other. The process has been further strengthened by interest rate cuts, the provision of liquidity to banks (Long-Term Refinancing Operations, LTROs, and Targeted Longer-Term Refinancing Operations, TLTROs) and the repurchase of government bonds under the QE programme.

On the whole it can be concluded that monetary stability in the eurozone has been significantly improved in recent years. Nevertheless, the AIV doubts whether the monetary system will be able to absorb very serious economic shocks such as those in 2009/2010 in the longer term. The reasons for this include the high sovereign debts of Greece and Italy, with 70% of the Italian debt being internal debt. Furthermore, precautionary recapitalisation measures have been taken for problem banks in Italy. The AIV also considers the agreement reached with the European Commission regarding capital aid for Monte dei Paschi di Siena to be a positive development. Under the agreement, the Italian state will probably have to inject billions into the bank to save it from bankruptcy, assuming the ECB declares that it is solvent. But private parties will assume the non-performing loans and holders of subordinated loans will have to contribute to the costs. The non-performing loans in Italy and elsewhere, however, are a persistent concern. Furthermore, the situation may be complicated by future political developments in Italy.

Draghi's statement and the OMT decision restored calm on the financial markets but they also tested the limits of the ECB's mandate. The ECB's quantitative easing (QE) policy has raised many questions, particularly in Germany and the Netherlands, about its effectiveness for achieving the inflation target. Low interest rates in the southern euro countries have also not contributed to the implementation of necessary structural reforms. Although it would be beyond the scope of this report to consider the effectiveness of QE, the AIV would note that the limits to the bond-buying policy have already been reached in a number of countries. The ECB's toolkit is not inexhaustible and the euro countries cannot walk away from their own responsibility to ensure the monetary system is shock-resistant.

One of the shortcomings of the current system is that support programmes and related conditionalities are not considered unless a crisis is already manifest and a country has requested assistance from the ESM. This applies to programme assistance, ESM loans for direct bank recapitalisations and OMT. Furthermore, decision-making on programme support and the monitoring of the conditions is complex and time-consuming. Many actors are involved (European Commission, IMF, ECB, Eurogroup president, Eurogroup, Euro Summit) and there are many factors that delay and obstruct the process. The recent implementation of the third support package for Greece is a harbinger of what is to come.

Finally, in the AIV's opinion, the ESM's intervention options, including in a preventive phase, should be speeded up and widened, and political steering and decision-making should be made more efficient and effective.

III.3 The permanent rescue fund

The ESM is a permanent rescue fund that has replaced the EFSM and EFSF. Since 1 July 2013, it has been the only rescue fund for all euro countries. It has a real lending capacity of €500 billion, an issued capital of €700 billion, of which €80 billion has

been paid up, and a AAA rating. Since it came into force in July 2012, it has granted programme loans to Greece and Cyprus and a loan to Spain to recapitalise its savings banks. The ESM is based on an intergovernmental treaty referred to in the amended article 136 of the Lisbon Treaty (article 136 (3), TFEU).[44] It makes use of the EU institutions (European Commission, ECB, CJEU) and is managed by the Eurogroup. The ECB's governors are the finance ministers who make up the Eurogroup.

The emergency loans granted by the ESM are subject to strict conditions and are usually released in tranches. Public finances must be put in order by means of structural reforms and usually strict agreements on spending cuts. Budget agreements must be incorporated into national law. Countries can also apply to the ESM for a loan specifically to grant emergency credit to banks. These loans are not subject to the same conditions as programme loans. Since 2014, distressed banks have been able to apply directly to the ESM for recapitalisation loans.

Support programmes are negotiated with the applicant country by the European Commission in consultation with the ECB, IMF and ESM. The Troika (Commission, ECB and IMF) supervises compliance with the programme conditions and plays a major role in the release of loan tranches. The final decisions are taken by the Eurogroup. This is usually a very protracted procedure. Several dozen meetings were held for the support programmes for Greece alone. The formal decision is taken unanimously by the ESM's Board of Governors. In urgent cases, decisions can be taken by qualified majority (85% of the issued capital), with the large countries having a veto. The Netherlands can therefore be outvoted unless it finds allies.

III.4 The role of the IMF in support programmes

From the outset, the Netherlands and Germany made the IMF's participation and involvement a firm condition. The IMF has many years' experience in granting loans under strict conditions and knows how to ensure compliance with them. The European Commission does not have this experience. The Netherlands and Germany also had doubts about the Commission's resolve. The IMF accordingly took part in the support programmes for Greece, Ireland and Portugal from the very beginning.[45] The IMF programme in the second Greek assistance package ended on 1 February 2016. The IMF also took part in the ESM assistance package for Cyprus and provided important technical assistance in the ESM recapitalisation of Spanish savings banks.

The IMF's role is laid down in the ESM Treaty. The preamble states: 'A euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF.'[46] The IMF is therefore a permanent participant in the programme negotiations and a member of the Troika, alongside the European Commission and the ECB, that oversees compliance with the loan conditionality. The IMF's input, certainly in the initial years of the support programmes, was unmistakeable – and indispensable. In the light of developments in recent years, however, it could be asked whether the IMF should continue to be involved. The IMF's experience is based on

44 Treaty of Lisbon: <eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:C:2016:202:FULL&from=EN>.

45 See: <http://www.imf.org/en/About/Factsheets/Europe-and-the-IMF>.

46 See: <https://www.esm.europa.eu/legal-documents/esm-treaty>.

its relations with countries and national central banks. As described in chapter III, this has been affected by decisions on the banking union and particularly on the introduction of centralised bank supervision by the ECB (Single Supervisory Mechanism). Moreover, the Commission's staff have gained a great deal of expertise and experience from the successive support programmes.

Decision-making on the third assistance package for Greece was complicated by an additional factor. The Netherlands and Germany insisted on the participation of the IMF, but the IMF judged Greece's sovereign debt to be potentially unsustainable and made its participation conditional on substantial debt relief first. This created a Catch 22 situation. The Eurogroup ultimately succeeded in breaking the deadlock by means of an IMF stand-by arrangement of up to USD 2 billion, with payment being linked to clarification of how the debt would be reduced at the end of the programme as the IMF wished. There had previously also been a difference of opinion between the IMF and the northern eurozone countries in particular about austerity policies during a recession. External factors also put the IMF's ongoing participation in eurozone support programmes in doubt. There is growing criticism in the other IMF constituencies about the IMF's close involvement in Europe. They argue that the EU is rich enough to sort out its own problems. This criticism will only increase with the Trump administration's America First policy.

In the AIV's opinion, therefore, an end to the IMF's participation is a realistic possibility and steps will have to be taken towards a European Monetary Fund. The end of the IMF's role, according to the AIV, would be a logical turn of events.

III.5 Towards a European Monetary Fund

In the AIV's opinion, the ESM should be transformed step by step into a European Monetary Fund. As an EU institution, the European Monetary Fund should ultimately be integrated into the Union's legal framework in a similar fashion to the European Investment Bank (EIB). This would require an amendment of the EU treaties. As noted above, Chancellor Merkel and President Macron suggested at a recent meeting that France and Germany no longer ruled out an amendment, but at present it is likely to remain a distant prospect. The euro countries must first put their budgets in order and reduce their sovereign debts, and there must be genuine economic convergence. As explained in chapter I, this is not happening at present.

In the meantime, the ESM should be enhanced so that it can operate more decisively in urgent situations. The AIV heartily agrees with the suggestion made by the Bertelsmann Stiftung and the Jacques Delors Institute that the euro countries should jointly guarantee an additional €200 billion contribution to create a rapid response facility within the ESM (ESM+).[47] Such a facility could consist of issued and partly paid-up capital and could be used, where necessary, to buy sovereign debt on the secondary capital market. The AIV is aware that the use of such a facility involves risk-sharing but the ECB's bond-purchasing policy is in effect also risk-sharing. This form of direct intervention by the ESM would place responsibility squarely with the euro countries and enable it to respond effectively at a very early stage. It should also be borne in mind that the ECB's use of OMT requires the prior approval and implementation of a programme. Accountability

47 Enderlein, H. et al. (2016), 'Repair and Prepare: Growth and the Euro after Brexit', Bertelsmann Stiftung and Jacques Delors Institute.

and democratic control, moreover, would be easier if operational assistance were provided from the ESM rather than by the independent European Central Bank. All these factors require an amendment of the ESM Treaty, which would probably meet with less resistance than an amendment of the EU treaties. Such an amendment could also create an opening to provide ESM loans to the Single Resolution Mechanism if a backstop were necessary at the end of the transition period.

Recent comments by Wolfgang Schäuble, the German finance minister, suggest he would prefer budgetary supervision to be transferred from the Commission to the ESM and a future European Monetary Fund.[48] The AIV opposes this on principle because the ESM, and by extension a European Monetary Fund, uses national funds to finance support programmes in the euro countries. It is based on an intergovernmental agreement. The Commission's budgetary supervision, by contrast, is largely laid down in Community legislation, supplemented by the Fiscal Stability Treaty. It would be wrong to conflate very different tasks and responsibilities associated with different legal frameworks.

III.6 Exit scenario: thinking the unthinkable

The previous sections mainly looked at options to strengthen the currency union with its current composition. The current total of 19 euro countries will probably increase, in accordance with the Treaty, especially as countries that have not yet introduced the euro are required to align their financial, economic and monetary policies with the common interests of the Union.[49] Situations may arise, however, where one or more countries unavoidably have to leave the eurozone temporarily or permanently. The withdrawal of one or more countries from the eurozone would be as painful as it would be complicated. If the exit were sudden and took place without external assistance, the risk of shocks on the financial markets would be considerable. There might also be widespread panic in the country or countries concerned. If savers thought the government intended to abandon the euro, they would immediately empty their bank accounts in anticipation of potential exchange gains on their euro banknotes. A bank run would be close at hand.

Another foreseeable consequence would be deposit holders transferring their savings en masse to foreign accounts. Suspending the free movement of capital would then be inevitable. Countries on the brink of leaving the eurozone might also infect other

48 In a speech on 13 January this year (see http://www.wolfgang-schaeuble.de/fest%c2%adre%c2%adde-von-dr-wolf%c2%adgang-schaeu%c2%adb%c2%adle-beim-fes%c2%adt%c2%adakt-70-jah%c2%adre-eu%c2%adro%c2%adpa-uni%c2%adon-deutsch%c2%adland-zur-zu%c2%adkunft-der-eu/) he said: 'We could further develop the European Stability Mechanism in the direction of a European Monetary Fund: we could enable it to identify and monitor risks in the member states and, where appropriate, to manage the risks, in a dialogue with a state.' See: <http://www.reuters.com/article/us-eurozone-schaeuble-idUSKCN12S1B7?il=0> and: <http://www.faz.net/aktuell/wirtschaft/eurokrise/griechenland/griechenland-krise-schaeuble-will-eu-kommission-entmachten-13725683.html>. See also Winkel, R. (2017), 'Europese Commissie vreest concurrentie bij begrotingstoezicht' ('European Commission fears competition on budgetary supervision'), *Het Financieele Dagblad*. See: <https://fd.nl/economie-politiek/1193053/europese-commissie-vreest-concurrentie-esm-bij-begrotingstoezicht>.

49 All EU member states that satisfy the convergence criteria are required to introduce the euro. Only the UK and Denmark have an opt-out. With the UK's forthcoming exit from the EU, its opt-out will of course no longer be relevant.

countries with limited financial stability and drag them down with them. This risk of contagion was a major reason for external lenders (strong euro countries and the IMF) to support Greece in the summer of 2015 when the monetary crisis there threatened to get out of hand, even though the Greek economy accounts for only a modest proportion of the overall EU economy. There were also strong geopolitical arguments against the exit of a country like Greece from the currency union. Its withdrawal could have created a political vacuum that would allow a country like China to increase its financial influence there. It would not have been in Europe's interests to have China's trade and investment system swallow up Greece's ports, for example.

Despite the evident risks and disadvantages, the AIV believes an exit scenario must be considered. If the Eurogroup fails to integrate politically and if reforms and spending cuts lead to a drastic cut in living standards but not to economic recovery, the introduction of a cheaper currency may be the only remedy to restore a national economy's competitiveness. The resultant increase in exports, it is assumed, would revive the economy. This scenario also assumes that the financially strong countries, especially Germany, would conclude that there were no longer compelling political reasons to preserve the eurozone's integrity come what may. In an extreme exit scenario, three Southern European countries, Italy, Portugal and Greece, could voluntarily leave the eurozone and introduce their own currencies.[50]

Having a broad-brush exit scenario can facilitate an orderly withdrawal, if necessary. Orderly withdrawal cannot be achieved without the involvement of the European Central Bank. The ECB would have to make targeted interventions to ensure that the new currencies gradually attained the values accepted by the financial markets. A significant depreciation against the euro would be the inevitable cost of restoring competitiveness. Thanks to the ECB's interventions, however, the depreciation would be controlled and all interested parties could adapt to the new situation. The countries that retain the euro must likewise be prepared for a decline in the currency's value. Losses would be suffered on the write-down of the withdrawing countries' liabilities, especially their TARGET2 balances.[51] This could also result in a loss for the Dutch economy. The euro's exchange rate would eventually recover, *ceteris paribus*, not least because the need to support the distressed European economies would gradually disappear; the exchange rate could even rise further, which in turn would adversely affect exports.

An exit scenario could have several modalities. Withdrawal could mean a definitive farewell to the eurozone or simply a suspension of membership for a given period of time. Rejoining should reflect the new competitive relations. The withdrawing countries could opt to link their new currencies to the euro within a set bandwidth. If they decide not to link to the euro, the exchange rate would be determined solely by the financial markets, with the risk of large fluctuations.

50 In particular Scenario 4, 'Two Speeds'. See: Boonstra, W. et al. (2017), 'Four Scenarios for Europe. A Struggling Europe in a Changing World', Rabo Research.

51 Abbreviation of Trans-European Automated Real-time Gross Settlement Express Transfer System, a payment system between the commercial banks in the eurozone in which payments are facilitated by the national central banks with the ECB acting as the clearing house.

III.7 Conclusion

The AIV is in favour of a step-by-step transformation of the European Stability Mechanism into a European Monetary Fund. One step should be the creation of a separate facility to enable a fast response to the acute financing needs of participating countries. In the AIV's opinion, this would best serve monetary stability in the eurozone. Such a facility could also lead to the ECB no longer having to act as de facto financier of budget deficits and confining itself again to its original tasks. It cannot be ruled out, however, that circumstances may force some countries to leave the monetary union temporarily or permanently in order to escape from a prolonged period of economic stagnation. The AIV therefore recommends that the responsible monetary authorities further elaborate exit scenarios by way of contingency planning so that a clearer understanding of the pros and cons develops in the political debate.

Circumstances are conceivable that might make such a scenario inevitable but anticipating them may contravene the Treaty principle that the monetary union must comprise all EU member states (barring the UK and Denmark) as soon as this can be done responsibly. The Treaty on the Functioning of the European Union therefore also contains provisions on the member states that are not part of the eurozone (article 140 ff, TFEU). This subject, however, is closely related to the future configuration of the European Union. It will be difficult for the EMU to continue functioning without a more coherent financial and economic policy. If the Treaty were to differentiate between member states at some point in the future according to their degree of integration, a provision could be included that allows for both an enlargement of the eurozone and a contraction if necessary.

IV Fiscal union

IV.1 Introduction

A monetary union is sustainable in the long term only if its fiscal discipline is credible, and if there are sufficient instruments to promote economic convergence and cushion major macroeconomic shocks. These are essential elements for ensuring monetary stability. The Five Presidents' Report issued in July 2015 also stated that responsible national fiscal policies were essential in a monetary union.[52] They must perform a double function: guarantee the sustainability of public debt and ensure that fiscal automatic stabilisers can cushion country-specific economic shocks.

In the years immediately following the 2010-2012 euro crisis, the fiscal rules of the Stability and Growth Pact (SGP) were – to put it mildly – not applied consistently by all eurozone member states and did not always produce the desired results. Various additional measures have therefore been taken in recent years to improve and strengthen fiscal policies in the EMU. Of particular note are the six-pack (the package of legislative measures governing the supervision of the EU member states' financial and economic policies), the two-pack (a supplement to the six-pack, which came into operation in December 2011, aimed at strengthening the Commission's supervision of the euro countries' national budgets) and the Treaty on Stability, Coordination and Governance (TSCG, or Fiscal Stability Treaty). The Fiscal Stability Treaty builds on and supplements the rules in the SGP. It obliges the eurozone member states to introduce uniform, permanent and binding fiscal rules in their national legislation. The new governance framework, which has been developed and expanded in this way, is intended to provide for sufficient ex ante coordination of the annual budgets of the eurozone and to strengthen surveillance of countries in financial difficulties. The enhanced budgetary surveillance and the common approach to macroeconomic imbalances come together in the European Semester, which has been operational since 2013. The AIV explained these reforms in detail in its advisory report of April 2014.[53]

IV.2 Current status

An important component of the agreed measures is the *excessive deficit procedure* (EDP). Another is the *macroeconomic imbalance procedure*, which can be used to encourage structural reforms. The EDP means that member states with excessive deficits or debts are subject to additional supervision and must reduce their excessive deficits within a set period. The Commission monitors the situation during the year by means of regular economic forecasts and data from Eurostat. The Commission can request more information or recommend further measures in the case of countries that are unlikely to reduce their deficits on time. Euro countries in the EDP are more likely to receive financial sanctions, which can gradually be increased. If the deficit is not reduced, a fine can be imposed of 0.2% of GDP, rising to 0.5% of GDP if the statistics are fraudulent. Financing from EU regional funds can also be suspended, including for non-euro countries. A fine of 0.1% of GDP can be imposed on the parties to the Fiscal

52 See: <http://www.consilium.europa.eu/nl/policies/emu-report-2015/>.

53 AIV, 'Public Support for the European Union: Building Trust', advisory report no. 88, The Hague, April 2014.

Stability Treaty if they do not transpose the Treaty provisions into their national legal systems correctly.

Most decisions on sanctions in the EDP are taken by reverse qualified majority voting: fines are deemed to be approved by the Council unless they are opposed by a qualified majority of the member states. This had not been possible before the six-pack came into operation. Furthermore, the 25 member states that signed the fiscal compact had earlier agreed that decisions to place a member state in the EDP, for example, would be taken by reverse qualified majority voting. This means that the budgetary discipline rules must be strictly observed. The European Commission is responsible for budgetary surveillance and the application of the EDP. It should be noted, though, that the Commission is apparently reluctant to impose the sanctions provided for in Community law and the Fiscal Stability Treaty when budget deficits are clearly excessive. This raises questions about the extent to which political considerations should influence the Commission's budgetary surveillance. In the AIV's opinion, the final political decision lies with the ministers, who, as noted above, can oppose the Commission's recommendation by reverse qualified majority (article 7, Fiscal Stability Treaty). This does not mean that the Commission's role is purely mechanical and it should not exercise discretion when deciding whether or not there are exceptional circumstances within the meaning of article 3 (3) of the Fiscal Stability Treaty. It does mean, however, that an independent opinion must be given that is unrelated to the influence wielded by the member state concerned.

In 2016 the European Court of Auditors published a report on the application of the EDP in Cyprus, the Czech Republic, France, Germany, Italy and Malta between 2008 and 2015. Its general conclusion was that the EDP's legal basis was sound and generally supported by clear internal rules and guidelines but the rules were not applied consistently or transparently. Furthermore, the European Commission did not adequately update its underlying assumptions or share its surveillance findings with all member states.[54] These findings are in line with the Five Presidents' Report, which found that the measures taken to date were inadequate and the governance framework therefore needed to be strengthened further. This should be done, for example, by establishing an advisory European Fiscal Board that would coordinate and complement the national fiscal boards established under the EU Directive on fiscal frameworks. According to the five presidents, the Fiscal Board would lead to improved compliance with the common budgetary rules, a better informed public debate and better coordination of the national fiscal debate. The advisory Fiscal Board has since been established (see below).

The European Commission has so far launched more than 40 EDPs. The AIV would note that not a single procedure has led to the imposition of sanctions, not even symbolic fines. Strict enforcement of the rules is evidently incompatible with the stubborn political reality in the member states. The AIV again calls for the independent and neutral application of fiscal surveillance and the enforcement of the rules as the best guarantee for effective fiscal discipline. The AIV recommended in its advisory report entitled 'Public Support for the European Union: Building Trust' that an autonomous service be established within the Commission similar to Eurostat to promote the independence and objectivity of economic analyses.

54 See: <https://www.rekenkamer.nl/onderwerpen/eu-governance/begrotingsdiscipline-en-macro-economisch-toezicht/de-buitensporigtekortprocedure>.

The AIV found that the macroeconomic imbalance procedure was complicated and had so many shortcomings that it is unable to bring about the necessary structural reforms in practice. In an ideal world, countries with budget surpluses would encourage investment and countries with budget deficits would make structural reforms. To date, neither has happened. The northern countries with budget surpluses first want the southern countries to start introducing structural reforms. The AIV noted in chapter I, however, that the new political situation in France opens the door to a Franco-German agreement that may break this impasse.

IV.3 A fiscal stabilisation function?

Effective fiscal discipline is a condition for further steps to deepen the economic and monetary union. This particularly applies to the prospect of a fiscal union. In the AIV's opinion, a fiscal union is not on the cards as long as some euro countries still have irresponsibly high sovereign debts. The AIV nevertheless thinks it is important to elaborate upon the concept of a fiscal union. The Five Presidents' Report and the Commission's recent Reflection Paper on the Deepening of the EMU emphasise the budget's function as a macroeconomic stabiliser, particularly with regard to the eurozone. The current EU budget is not intended to fulfil a macroeconomic stabilisation function, not least because of its modest size (less than 1% of the EU's total GNP). Nevertheless, policy reforms could be linked more closely to the use of the structural and investment funds already in place.

Aside from the macroeconomic stabilisation function, there is also a growing call for the common financing of certain public goods. Protecting the EU's external borders and the reception of asylum seekers, especially in Greece and Italy, are the most frequently heard examples. Discussion of such examples, however, falls outside the scope of this report. This chapter therefore focuses on the possible introduction of a macroeconomic stabilisation function in the eurozone.

In the longer term, a fiscal stabilisation function must be introduced for the eurozone, according to the five presidents, based on the following principles.

- It may not lead to permanent transfers between countries or to transfers in just one direction.
- It may not weaken the incentives to pursue healthy national fiscal policies or to tackle national structural weaknesses.
- It must be developed within the framework of the EU.
- It may not be a crisis management instrument, as the European Stability Mechanism (ESM) already fulfils that function.

In an initial assessment of these proposals, the government acknowledged the importance of an independent opinion on the member states' fiscal conduct, but it also indicated that further clarification was necessary before an opinion could be given on the usefulness of and need for an advisory European Fiscal Board (EFB),[55] as referred to above. This stance, however, has been superseded by the Commission's decision on 21 October 2015 to establish an independent advisory European Fiscal Board.[56] In

55 Letter to parliament 21 501-20, no. 996, 23 June 2015.

56 European Union, Official Journal L 282/37, 28 October 2015.

response, the government said that although it commended the Commission's intention to increase the transparency of the SGP's application, this could have been achieved without establishing a new European institution. Furthermore, the government thought the chosen structure made it very doubtful whether the EFB could operate completely independently of the Commission.[57]

The government wrote in a letter of 23 June 2015 that the Netherlands had opposed a fiscal stabilisation function on several occasions as better alternatives were available to cushion shocks (buffers, flexible economies, properly functioning capital markets, ESM rescue fund for asymmetrical shocks with major consequences). The government thought a common budget would not be a fitting solution for symmetrical shocks.

Not everyone shares this resistance to a fiscal stabilisation function. Maria Demertzis and Guntram Wolff of the Brussels-based Bruegel think tank, for instance, issued a background paper on 9 September 2016 setting out the options for a small fiscal capacity.[58] The capacity is mainly intended to fund European public goods such as external and internal security, climate policies and migration policies beyond what was already funded from the EU budget. The capacity would also provide resources for pan-European investments. Moreover, an insurance system, such as a European unemployment reinsurance scheme, could be established to help eurozone countries affected by large shocks. These proposals are considered below.

According to the authors, the added value of such a fiscal capacity is that it would provide common solutions to problems shared by European citizens. It could also contribute to the cyclical stabilisation of the eurozone as a whole. Maintaining sound national fiscal policies, however, would remain crucial to allow the necessary fiscal space so that the automatic stabilisers could play their roles in full, they write.

In response to these and similar proposals and ideas, the Netherlands and a group of like-minded member states said during the informal Ecofin meeting that they opposed the establishment of a fiscal capacity and that too much was being expected from just one instrument.[59] In the first instance, member states should modernise their own economies. Asymmetric shocks in the eurozone, moreover, are few and far between and most are cyclical. According to the government, this means that the member states experience economic shocks almost simultaneously and a fiscal capacity that absorbed each other's shocks would not help.

Other member states observed that the SGP's fiscal rules provided enough scope to cushion cyclical shocks provided member states ensured that their budgets were consistent with the medium-term objective (MTO). Member states also argued that the further development of the capital markets union would enable private channels to absorb shocks better, as in the US, and pointed to the need for further economic convergence. According to many member states, consistently observing the rules in the

57 Letter to parliament 21 501-20, no. 1051, 6 November 2015.

58 Demertzis, M. & G.B. Wolff (2016), 'What are the prerequisites for a euro-area fiscal capacity?', Bruegel *Policy Contribution*, no. 14.

59 Report of the Eurogroup and informal Ecofin meeting in Bratislava, 9 and 10 September 2016, Parliamentary Papers 21 501-07, no. 1394.

SGP and elsewhere and implementing the agreements made, including those on the banking union, are of prime importance. Furthermore, according to the same member states this is not the time for a treaty amendment, which would probably be necessary for such a new initiative.

Opinions in the EMU on the direction of appropriate follow-up measures towards fiscal union seem to be split. Member states agree that the current system will not provide enough certainty should a new crisis break out but they disagree about the follow-up steps needed to strengthen the EMU. The northern and southern EMU members also seem to be divided on fiscal matters. Proposals by southern member states regarding common euro bonds or further integration of social security systems, for example, usually meet with a very cautious response from countries such as the Netherlands and Germany, which view them as conduits to channel money from national taxpayers mainly in the northern member states to other member states. They therefore insist on strict compliance with the current fiscal agreements, partly because they feel that the northern euro countries are continually being asked to show solidarity with other eurozone countries without the southern member states making concrete reforms or exercising fiscal discipline.[60]

Although the AIV understands the arguments against a fiscal capacity put forward by the Netherlands and other countries, it, like the Commission, the ECB, the European Parliament and certain other countries, thinks a fiscal capacity and similar proposals deserve serious consideration. Assurances must be given that the right of member states' parliaments to approve and amend the budget will not be eroded. In principle, a fiscal capacity could increase the EMU's shock resistance. The member states must understand, though, that they first have to put their own budgets in order and reduce their sovereign debts before such steps can be taken. It must also be borne in mind that there will be many treaty-related institutional and political obstacles to the eurozone having its own budget. Decisions to this end also risk straining relations with the Eastern European countries that have not yet joined the currency union. This is also relevant to the fourth question in the request for advice, regarding the extent to which steps to strengthen the EMU will influence political and economic cooperation with EU member states outside the eurozone.

A final opinion on whether a budget for the eurozone is desirable and appropriate largely depends on the details. The AIV applies the following principles.

1. The creation of a separate fiscal capacity may not weaken national governments' responsibility for pursuing national fiscal policies in compliance with the SGP. Euro countries with high debt positions that are incapable of pursuing anticyclical fiscal policies independently may receive only temporary support during a serious depression.
2. Logically, the fiscal capacity should be used to support euro countries hit by asymmetric shocks, such as natural disasters, cyberattacks and selective sanctions imposed by third countries. Clear criteria must be formulated for determining whether external circumstances are responsible for the government's force majeure situation.
3. The fiscal capacity may not be used to finance public services that are in the interests of all EU member states, such as the initial reception of refugees, control of the external borders or the procurement of common weapons systems. These services must be funded from either the regular EU budget or specially created funds.

60 The Economist (2017), 'Special report: The future of the European Union', 25 March 2017.

4. There must be clarity about how the fiscal capacity is financed. Several options are available: the introduction of an EU tax, additional VAT-based contributions or a direct GNI-based contribution. The AIV would prefer financing to be similar to that for the ESM.
5. Democratic control must be assured in all variants of a fiscal capacity for the euro area.

Below, the AIV considers a number of proposals that have frequently been made by think tanks and others, and discussed at formal and informal meetings of the Ecofin ministers. They were recently raised in the Commission's reflection paper on deepening the EMU, which has already been referred to several times.

IV.4 Possible follow-up measures

Steps must first be taken towards a European reinsurance system to complement national social systems. This option deserves serious consideration. One proposal is to establish an institution that ensures the unemployed in the various member states receive a benefit from a European unemployment insurance scheme.[61] The benefits paid to the unemployed in the member states would be financed from contributions from employers or employees subject to this European unemployment insurance system. CEPS, a Brussels-based think tank, stresses in one of its publications that such an insurance system could be an important stabiliser; it would accumulate reserves in good economic times and draw on them as the number of unemployed increased during a recession.[62] Demertzis and Wolff (Bruegel) also propose in their article on deepening the EMU that providing European public goods, such as unemployment insurance, is a logical next step.[63] They stress that it need not by definition be operationalised at EMU level; this could also be done at EU level. According to the Commission, such a system would provide more breathing space for national public finances and make it possible to emerge from the crisis faster and stronger.[64]

In the AIV's opinion, such an insurance system would have the advantage of furnishing EU citizens with concrete proof that the EU provided social security to its citizens. Furthermore, it would be logical from a macroeconomic angle, as it could function as a stabiliser. It is uncertain, however, whether a European reinsurance system should be introduced by the EU or by the eurozone. Citizens in non-eurozone countries must not feel discriminated against. It is also uncertain what would happen if the long-term financing fell short of the total benefits to be paid out. It should be borne in mind that, to date, the Netherlands and certain other countries have always been fairly sceptical about such proposals on account of the transfer of funds from Northern to Southern

61 Da Costa Cabral, N. (2016), 'Which budgetary union for the E(M)U?', *Journal of Common Market Studies*, 54(6), pp. 1280-1295.

62 See: <https://www.ceps.eu/publications/european-fiscal-union-economic-rationale-and-design-challenges>.

63 Demertzis, M & G.B. Wolff (2016), 'What are the prerequisites for a euro-area fiscal capacity?', *Bruegel Policy Contribution*, no. 14.

64 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', p. 26. See: <https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf>.

Europe, as mentioned above. The Commission considers a European unemployment insurance system, as outlined here, a serious option. It notes, however, that the member states' national labour market policies must be more closely aligned before such a system could be introduced. The Netherlands, too, thinks further labour market integration is important and the situation in other, weaker member states must be improved as unemployment in some southern countries is still considerably higher than in the Netherlands and Germany. The difference in unemployment rates is shown in figure 6.

A second option is to create a 'rainy day fund' as a common buffer for use during an economic recession. The Commission also considers such a fund to be a serious option for strengthening the EMU.[65] A rainy day fund could work in several ways. A European buffer could be created from annual contributions from national budgetary authorities and used during an economic downturn. The CEPS describes this type of fund as a temporary transfer of money among the member states. Countries are net contributors in good economic times and net recipients during times of recession.[66]

Another option for a rainy day fund would be to link a financial aid system to the economic cycle in a different way. The fund would receive contributions from member states when their economies outperformed their output potential, the maximum GNP that is sustainable in the long term. The fund could be used in times of weaker economic performance to bring GNP closer to the output potential. In effect, it would involve anticyclical adjustments.[67]

At the heart of both the above variants of the rainy day fund is the creation of a buffer in good economic times that can be used as a stimulus during a recession. Such a system entails risks, though. There is a significant risk of several member states finding themselves in economic difficulties at the same time, especially if a future financial crisis spreads across the entire eurozone. It is certainly conceivable that several eurozone member states would then apply to the fund at the same time without significant contributions being made. The buffer's ability to support countries in difficulties would then depend on the reserve built up in previous years. This proposal is also largely dependent on the EMU countries with relatively strong economies being willing to make substantial contributions to a fund that will probably be used mainly to help member states with weaker economies. Mechanisms could, however, be built into the fund or into the unemployment insurance scheme to prevent permanent, one-way funds flows in the longer term.[68] The AIV thinks such a fund could also be in the interests of the Netherlands, despite the short-term costs to the country, because it could contribute to economic and financial stability within the eurozone. Mechanisms would have to be in place, however, to stop the stronger countries, including the Netherlands, permanently contributing to a fund that is used solely by weaker economies.

65 Ibid., p. 26.

66 See: <https://www.ceps.eu/publications/european-fiscal-union-economic-rationale-and-design-challenges>.

67 Da Costa Cabral, N. (2016), 'Which budgetary union for the E(M)U?', Journal of Common Market *Studies*, 54(6), pp. 1280-1295.

68 Andor, A. et al. (2014), 'Designing a European unemployment insurance scheme', *Intereconomics*, 49(4), pp. 184-203.

A third option, the euro bonds model, would enable member states to continue contracting loans even during economic downturns. By issuing euro bonds with guaranteed repayment to the lender, member states could temporarily borrow funds, subject to conditions, at a lower interest rate. The system would be based on issuing euro bonds as a percentage of GNP to act as a buffer for member states that want to borrow money before they are forced to appeal to the ESM programme. A similar option would be to create a European Debt Agency (EDA), which issues its own bonds and so creates a liquid market for euro bonds. Member states experiencing serious economic problems could then use EDA bonds to increase their debt issue to up to 20% of their GNP without strict conditions. Further financial aid would be the outcome of negotiations and based on strict conditions and the implementation of structural reforms.[69]

Large strides towards complete fiscal union are probably near-impossible at present. As noted above, the AIV thinks such a fiscal union is not on the cards as long as some euro countries have irresponsibly high sovereign debts and economic convergence among the euro countries is inadequate. In the AIV's opinion, however, there are still opportunities to strengthen the eurozone's shock resistance and/or to take joint steps towards an insurance system to supplement and strengthen the SGP. Some of the options above could be put into practice outside the EU budget and operate as autonomous institutions (linked to the funds). They could accordingly be introduced without the further transfer of sovereignty from the member states to the EU and, in the AIV's opinion, they deserve serious further study. The intergovernmental agreements they would require would have to be approved by the national parliaments. Since in the final analysis they would be providing liquidity support, an enhanced ESM could also qualify. It is therefore to be applauded that the Commission has promised to study concrete options for a macroeconomic stabilisation function in the eurozone in order to encourage a discussion on the specific design of such a function, and prepare the member states for putting in place such a capacity by 2025 at the latest.[70]

IV.5 Conclusion

Introducing a separate budget for the eurozone is certainly an option in the long term and could be the final step in deepening the EMU. It should obviously be accompanied by a further strengthening of euro governance and its democratic control (see the next chapter). In the AIV's opinion, such steps cannot be taken without a treaty amendment. By definition, the EMU can be deepened only gradually. Significant steps can be taken, however, under the current treaties. If necessary, they can be backed up by intergovernmental agreements, as in the past. Nonetheless, the steps must eventually lead to a substantial treaty amendment that rectifies the design faults of the past, incorporates the current hybrid structure into the Community treaty framework and underpins the EMU with more sustainable and solid foundations.

69 Da Costa Cabral, N. (2016), 'Which budgetary union for the E(M)U?', *Journal of Common Market Studies*, 54(6), pp. 1280-1295.

70 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', p. 26. See: <https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf>.

V Governance of the eurozone

V.1 Introduction

Further to the final conclusion in the previous chapter, this chapter considers whether the shortcomings in crisis management procedures and budgetary supervision highlighted in earlier chapters can be resolved by strengthening financial and economic governance of the eurozone. The AIV believes this is partially possible, but notes that national institutions must function properly if governance is to be practicable and effective. In particular, the machinery of government must be reliable (and not too cumbersome) and the tax authority must be able to collect the taxes due from businesses and individuals. The latter is not yet the case in some countries (see chapters I and IV).

V.2 The lack of decisiveness and control

The Protocol on the Euro Group annexed to the Treaty of Lisbon states that the ministers of the member states whose currency is the euro meet informally. The European Commission and the ECB take part in the meetings, which are prepared by representatives of the finance ministers (Eurogroup Working Group). The ministers elect a president for two and a half years by majority vote (currently Jeroen Dijsselbloem). The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the Fiscal Stability Treaty) states that the heads of state or government of the euro countries, together with the President of the European Commission, meet at Euro Summits at least twice a year. The President of the ECB is invited to take part in such meetings. The AIV notes that the above meetings are informal, closed and lack transparency. This is due in part to the fact that the legal basis of the eurozone's governance is partly Community-based and partly intergovernmental.

The President of the Euro Summit is appointed at the same time as the President of the European Council and for the same term of office (two and a half years). The Eurogroup is responsible for preparing the meetings. The President of the European Parliament can be invited to be heard. The President of the Euro Summit reports to the European Parliament. Referring to Protocol 1 of the TFEU, article 13 of the Fiscal Stability Treaty provides for a conference of the relevant committees of national parliaments and the European Parliament in order to discuss budgetary policies and other issues covered by the Treaty. Article 16 of the Treaty states that within five years of the date of entry into force of the Treaty (i.e. no later than 1 January 2018), on the basis of an assessment of the experience with its implementation, the necessary steps will be taken with the aim of incorporating the substance of the Treaty into the legal framework of the European Union. This is consistent with the statement in the Reflection Paper on the Deepening of the Economic and Monetary Union that 'these arrangements can be translated into an agreement on the democratic accountability of the euro area, signed [...] in time for the next European Parliament elections in June 2019. Further down the road this agreement could be integrated into the EU Treaties.'[71]

71 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', p. 29. See: <https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_nen>.

In its advisory letter of February 2012 entitled 'Towards Enhanced Economic and Financial Governance in the EU', the AIV noted that the majority of the rules on budgetary supervision and coordination of economic policy in the Fiscal Stability Treaty have already either been decided in Union law (six-pack and two-pack) or proposed by the Commission or are possible under article 136 of the TFEU.[72] The AIV believes it is imperative for budgetary 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 competences to intergovernmental structures is undesirable. It therefore concludes that, for the purposes of clarity, legal certainty and accountability, there is every reason to integrate the provisions of the Fiscal Stability Treaty, in so far as they relate to budgetary discipline and the coordination of economic policy, into the legal framework of the EU in accordance with article 16 of this Treaty.

The AIV advisory report of April 2014 entitled 'Public Support for the European Union: Building Trust' considers the governance and democratic legitimacy of the Fiscal Stability Treaty in detail.[73] The measures required to strengthen fiscal discipline and coordination of economic policy make deep inroads into national competences. The agreements in effect relate to the common exercise of national competences. Accountability and democratic control therefore lie with both the national parliaments and the European Parliament, with the main thrust of the AIV's recommendations in its report of April 2014 being to strengthen the control exercised by national parliaments. The relationship between national parliaments and the European Parliament should not be seen as a zero-sum exercise. More specifically, the AIV report considers the conflict between optimal capacity to act and democratic legitimacy (national and European). The same report also considers differences in approach and method: intergovernmental versus Community and hybrids of the two. The analysis made at the time and the solutions proposed are still relevant. The AIV is also still not in favour of a separate eurozone parliament; it would lead to a schism between the eurozone countries and the other member states of the Union. An additional parliament would also increase public confusion.

Monetary governance of the eurozone has, by definition, a more specific character on account of the ECB's independence and the euro member states' close involvement in support programmes. Intergovernmental action was the obvious approach to support programmes. Regardless of the no bail-out clause in the EU Treaty, in the final analysis national funds and guarantees were used and they were backed by national taxpayers.

Regarding the effectiveness of crisis management, experience shows that it leaves a lot to be desired. Decision-making is complicated and slowed down by the many actors involved, often with contradictory agendas. In the AIV's opinion, the permanent President of the Eurogroup should be the principal negotiator of ESM assistance programmes and, in close consultation with the Commission, should be given a broad mandate from the Eurogroup ministers to fulfil this function.

As suggested in the AIV advisory report of April 2014, it would be logical to make the Vice-President of the European Commission for Economic and Financial Affairs the permanent President of the Eurogroup in due course. This arrangement would be similar to that of the High Representative (HR) for Foreign Affairs and Security Policy. The AIV thinks there

72 AIV, 'Towards Enhanced Economic and Financial Governance in the EU', advisory letter no. 19, The Hague, February 2012.

73 AIV, 'Public Support for the European Union: Building Trust', advisory report no. 88, The Hague, April 2014.

is a certain logic to combining the job of permanent Presidency of the Eurogroup with that of Vice-President of the Commission for the Euro, comparable to combining the position of High Representative with that of Vice-President of the Commission. As in the case of the HR, support programmes are concerned chiefly with intergovernmental policy, and combining the positions has the advantage of enhancing policy coherence. In the context of the EMU, too, the argument in favour of policy coordination should carry a lot of weight. Coordination is frustrated by the centralisation of monetary policy (exclusive competence of the EU), while primary responsibility for fiscal policy, tax policy and economic structure policy has so far remained with the member states.

The appointment procedure could be the same as that for the Commission President: nominated by the European Council and approved by a majority in the European Parliament, i.e. double legitimation. Although the EU treaties do not provide for such an appointment, with a view to the installation of the next Commission it could initially be arranged through an Interinstitutional Agreement. A double-hat arrangement would have the advantage that the Eurogroup's president could rely directly on the Commission service tasked under the ESM mandate with conducting programme negotiations and supervising compliance with their implementation. This service has already gained a great deal of experience negotiating loan conditions and supervising compliance with them. Such an arrangement would also make it easier for the European Parliament to exercise its control function, as it could hold the Eurogroup's president to account in his capacity as a member of the Commission. Finally, this combination of positions would best express the hybrid character of euro governance. The Reflection Paper on the Deepening of the Economic and Monetary Union also proposes such an arrangement in the longer term. It states: 'Moreover, the functions of a permanent Eurogroup Chair and of the Member of the Commission in charge of the EMU could be merged.'[74] The Commission rightly considers this merger in the light of the growing size of the eurozone and the transformation of the Eurogroup into a configuration of the Council. It is conceivable that the Eurogroup will eventually coincide with Ecofin, which would make euro governance clearer and more transparent.

One of the Eurogroup's important tasks is to discuss and reach agreement on ESM assistance programmes. As noted above, the programmes are based on an intergovernmental treaty that involves the European institutions (European Commission, ECB and CJEU). On behalf of the ESM, the European Commission negotiates the loan conditions in consultation with the IMF and ECB and supervises compliance with them together with the IMF and ECB (Troika). It goes without saying that support programmes have an intergovernmental basis; the loans and grants are ultimately provided by the member states. The formal decision is taken by the ESM's Board of Governors.

Owing to the many actors involved, decision-making is laborious, inefficient and time-consuming. This is borne out by the many meetings that were necessary to release tranches in the Greek programmes. In the AIV's opinion, the permanent President of the Eurogroup should in any event have a wider mandate. In the distant future, these tasks, as explained in chapter III, could be assumed by a European Monetary Fund. The Eurogroup is also the political body that takes the final decision on enforcing the rules on budgetary discipline (EDP) in euro countries. As noted above, sanctions proposed by the Commission can be opposed by reverse qualified majority. According to the AIV, the Commission, as an independent institution, should supervise compliance with the rules

74 European Commission (2017), 'Reflection Paper on the Deepening of the Economic and Monetary Union', p. 27. See: <https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf>.

transparently and consistently. The Eurogroup finance ministers can put forward political arguments and attach more weight to exceptional circumstances.

To better enable national parliaments and the European Parliament to exercise their joint democratic control of assistance programmes, formulas can be devised based on article 13 of the Fiscal Stability Treaty. This article provides for an interparliamentary conference of representatives of the relevant committees of national parliaments and the European Parliament. The AIV believes such a broadly composed conference would be a suitable body to discuss common budgetary policies and other issues covered by the Treaty. The AIV has already observed that a broadly-based conference as referred to here could help national parliaments coordinate their position on recommendations of the Commission and proposals of the Council and the European Council.[75] The AIV also refers to the informal talks between members of the European Commission and the President of the ECB on the one hand and national parliaments on the other that have got off the ground in recent years. These talks have proved their worth with a view to the provision of information on the EU and national feedback. This is especially true for the House of Representatives. The involvement of members of the European Parliament in these exchanges of ideas would increase their practical impact.

V.3 Conclusion

The AIV concludes that the current hybrid system of euro governance has clear limitations. Under pressure from the member states, the Commission is reluctant to impose sanctions. The Eurogroup's deliberations are not transparent and cannot pass the test of democratic control. The Eurogroup's finance ministers, however, can be held to account by their national parliaments. But there are clear shortcomings in their accountability to the European Parliament even though the ground rules of budgetary discipline are largely founded on Community law (six-pack and two-pack). On the other hand, the European Parliament must take the measures necessary to ensure the duty of accountability is effective, for example by establishing a separate committee for the euro.

The AIV further concludes that if the permanent President of the Eurogroup were also the Commission Vice-President for the Euro, this would improve the situation, especially as regards the latter point. This would make it easier to render account to the European Parliament. However, the AIV thinks it would be undesirable and even confusing to call such a position the Minister of Finance for the Eurozone. That would politicise the Commission's role as an enforcer and supervisor of budgetary discipline when it needs to be completely independent. The establishment of a separate budget for the eurozone, which would be modest in all variants, would also not justify the presumptuous title of Minister of Finance.[76]

75 AIV, 'Public Support for the European Union: Building Trust', advisory report no. 88, The Hague, April 2004, p. 30.

76 Ideas and proposals for a eurozone finance minister have been circulating for a long while and were given fresh impetus by the arrival of President Macron. See, for example: <http://bruegel.org/2017/05/what-could-a-euro-area-finance-minister-mean/?utm_content=buffer8a028&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer+(bruegel&utm_source=POLITICO.EU&utm_campaign=b076c3f809-EMAIL_CAMPAIGN_2017_08_01&utm_medium=email&utm_term=0_10959edeb5-b076c3f809-189887225>. See also the article by Sylvester Eijffinger: <https://www.project-syndicate.org/commentary/european-alexander-hamilton-fiscal-union-by-sylvester-eijffinger-2017-08>.

VI Conclusions and recommendations

In its request for advice on the further development of the euro of 6 October 2016, the government asked the AIV to weigh up the options available within the current treaty frameworks to strengthen the EMU, in particular steps aimed at strengthening governance of the EMU in order to promote growth and the ability to absorb shocks in individual member states and the EMU as a whole, and in order to promote real economic convergence within the eurozone. The government also asked the AIV to explain the implications of these steps for the Netherlands' economy and financial interests. Finally, the government asked the AIV to examine the extent to which the individual steps could influence political and economic cooperation at a wider EU level, with member states outside the eurozone.

The AIV found that the various measures taken to strengthen the European currency union since the euro crisis of 2010-2012 had certainly strengthened governance of the eurozone and improved the financial and economic situation in the euro countries. But the progress made will be insufficient to prevent a new euro crisis. There are doubts about the ability of the eurozone and the EMU in a broader sense to take decisive action in a crisis. Decision-making will be complicated and frustrated by the many actors with poorly defined tasks and responsibilities. To improve governance of the euro, competences urgently need to be defined more precisely and the responsible common institutions must be allowed to do their work impartially. The semi-established banking union and capital markets union should also be completed without undue delay.

However, confidence must first be restored within the currency union. It has been shaken in the recent past by the inadequate enforcement of the agreements reached in Maastricht (1991) and Amsterdam (SGP, 1997) regarding a shared and common responsibility for the euro. Not all decisions on the accession of countries to the eurozone were taken with the necessary care. Partly as a result, certain euro countries have inadequately respected their undertakings to keep public finances within the treaty limits (budget deficit of not more than 3% of GDP and public debt of not more than 60% of GDP) or to strengthen and converge their economies. Oversight of the euro countries was also lax. The European Commission was particularly negligent in this respect, although it can be partially excused owing to the lack of support it received from the larger member states.

All these aspects of the euro architecture were starkly revealed by the financial and economic crisis of 2008 and the subsequent euro crisis, and placed extreme pressure on the single European currency. Amid the cacophony as to whether solidarity or solidity should have priority, a financial assistance facility was established and subsumed under a separate ESM treaty in 2012. It offered countries in difficulties, such as Portugal, Ireland and Greece, shelter from the storm on the financial markets so that they could put their finances in order. But this has not eliminated the difficulties faced by all countries with excessive deficits and debts. Some, such as the Netherlands, have resolved their problems largely on their own. Others have been too busy looking at what other countries were doing to do much themselves. Economic divergence has been reduced since 2014 but we cannot yet speak of convergence. All manner of repair and reinforcement work has been initiated, including the introduction of the European Semester.

The fact that calm has returned to the eurozone since 2012 has more to do with the financial markets' confidence that the ECB will not let the euro fail no matter what (and has therefore stretched its mandate somewhat), and that Germany is in effect guaranteeing the currency, than with their belief in the euro system's own self-healing ability. A further recovery in confidence among the euro system participants is of prime importance in strengthening this ability and the euro's resilience to crises. This will also be necessary to deepen the EMU, to truly stabilise the euro in the long term and to make the currency a desired instrument of European integration. Despite the 'euro neuroses' of recent years, popular support for the euro is growing in the eurozone (and even in EU countries that have not yet adopted the euro as their currency).

Can confidence in the eurozone be increased? Yes, without doubt, and for the following reasons:

a. The wave of euroscepticism has peaked. After the Brexit referendum and the outcome of the US election, it seemed inevitable that continental Europe would be consumed by national populism, but the tide turned within a few months. The economic and sociocultural breeding ground for populist movements has not yet disappeared but the recent outcome of the political process in France points to a change in the political climate. It offers the prospect of a new European élan. Emmanuel Macron, a social liberal, was elected President on a platform of structural reform of the French economy and in-depth investment in European cooperation. He is specifically eying the functioning of the eurozone. If he succeeds in restoring political and economic dynamism to France, this could also be of great importance to Europe. Germany, which increasingly stood without its traditional ally, France, during the euro crisis, would in any event welcome France's return to the European stage, almost irrespective of the outcome of the upcoming German elections. France and Germany are expected to significantly step up their dialogue in the coming months and to propose new initiatives after 24 September. Regardless of their specific substance, fresh momentum in the Franco-German relationship could make a significant contribution to restoring confidence in Europe and within the euro area. It could trigger a breakthrough in the eurozone's 'north-south conflict' and the Southern European member states' acceptance of the need for structural economic reforms. The Northern European member states must in turn be willing to tackle structural imbalances in their own economies, thereby stimulating a recovery in the eurozone's overall balance. There are no guarantees that confidence will be increased but these new relations definitely present an opportunity.

b. That opportunity will be strengthened by the wind of change blowing through Brussels. One outcome of the EU's recent 'existential crisis', including euroscepticism, is that the European Commission has now adopted a more 'listening' attitude and acknowledged that European cooperation can be approached from a variety of angles. This process of dialogue and discussion with the member states, the European Parliament and civil society has so far produced an openly formulated White Paper on the Future of Europe and reflection papers on the opportunities and threats of globalisation, the social dimension of Europe and, more recently, deepening the economic and monetary union. The EMU reflection paper wisely makes a distinction between short-term improvements in the EMU (before 2019), partly on the basis of decisions already taken, and measures that may be taken in a later phase (up to 2025) to complete the architecture of the euro edifice. In the current changing climate, the paper paves the way for democratic discussion and decision-making on the future of the euro. The present AIV advisory report draws on several of the suggestions made in the reflection paper (without necessarily adopting them).

c. The above reasoning is reinforced by the economic recovery. Technically, economic recovery in the EMU area began nearly five years ago but not many EU citizens noticed. It began slowly and its reach was fragmented. Furthermore, some countries, and some population groups, benefited more than others. But it has spread far more widely in the past two years and is becoming more noticeable in more parts of the eurozone. The economy is now growing and employment is increasing throughout the eurozone. The outlook for the next few years is also encouraging, even for countries in an ESM programme. This opportunity could be squandered of course by continued irresponsible public spending, but the more favourable climate can also be used to invest in a stronger economic order and greater equilibrium in the eurozone as a whole. The European and national debate should address these issues.

In general there are three ways of looking at the further development of the EMU: pessimistically, optimistically and realistically.

The first begins by assuming that the political, institutional, socioeconomic and cultural/ social differences among the euro countries are irreconcilable. That they are so great that some countries should not have been admitted to the euro in 2002. And that the crisis has exacerbated them to such an extent that they are now insurmountable. In other words, some counties should abandon the euro and reinstate their national currencies in order to restore their national revenue models and create new opportunities for national prosperity. An optimist would see a great deal of potential in such a hypothetical exit, whereas a pessimist would be more likely to expect a country leaving the euro to go from bad to worse and the exit to destabilise the eurozone as a whole. The AIV is inclined to take the latter view.

The second, optimistic approach assumes that the euro is a currency without a state and the arrangement can only work in the long term if the EMU evolves towards a political union. In other words, a stable, crisis-resistant euro needs the creation of certain ‘state functions’ at European level to ensure that the entire euro area forms not only a monetary union but also a genuine economic union. This would entail, among other things, a federalisation of budget policies, fiscal policies and social policies, and, of course, a governance structure that encompasses both the European and the national dimension, including the necessary democratic legitimacy. An optimist would see many compelling reasons for such a centralisation of powers and also many opportunities. A pessimist (realist?) would see storm clouds on the horizon.

The third, realistic approach is more pragmatic. This approach, too, requires strengthening the euro and continued European integration in this regard. It differs from the second approach in that it does not entail a ‘great leap forward’ but a gradual, step-by-step approach. Stabilisation of the euro is a far longer process in this scenario but could ultimately arrive at the same result as the second. The idea behind this approach, however, is that it would enjoy support and enough lifebelts would be available to mount an emergency euro rescue. A pessimist would fear for the euro’s survival in an emergency. An optimist would opt for pragmatism in combination with an exit option.

The AIV is an advocate of the third approach: a gradual, step-by-step strengthening of the EMU. This option forms the backdrop to the measures proposed in this advisory report to further strengthen the EMU’s various components. Regarding the feasibility of these further steps and measures, the AIV looked not only at the existing treaty framework, as suggested in the request for advice, but also, where necessary, outside it. It also looked in passing at two other approaches. If the Franco-German duo launches new initiatives regarding the euro (and broader European integration) in the coming

months, it is conceivable that they will include elements of the second approach. The Netherlands should be prepared for this if it wishes to bring any influence to bear. In this connection, this advisory report explores a number of aspects of deeper fiscal union. In the longer term, one or more euro countries may fail to meet the budgetary discipline and economic convergence requirements to such an extent that they would be better off leaving the eurozone, either temporarily or permanently. The necessary contingency plans for such a withdrawal should be made now.

Before proposing ways to bring about the required economic convergence in the eurozone (question 2 in the request for advice), this report first considered whether economies have converged or diverged in recent years. The empirical studies cited in the report are fairly unambiguous in their conclusions. Since 2000 and the introduction of the euro, and especially since 2008, economies have diverged rather than converged. The figures analysed mainly show a growing disparity between Northern and Southern Europe. On the basis of four indicators (GNP growth, unemployment, current account balance and per capita GNP), the northern countries fared better than the southern ones during the period studied and especially since 2008. The AIV therefore concludes that there has been little convergence in the eurozone in recent years.

How can economic convergence be promoted in the coming years? To answer this question the AIV drew on, among other things, an ECB publication that outlines three conditions for promoting long-term eurozone convergence and strengthening the EMU's resilience to negative shocks. The three conditions are:

1. macroeconomic stability;
2. greater economic flexibility in the eurozone countries concerned (i.e. those lagging behind);
3. higher total factor productivity (TFP) growth.

So far, these economic conditions have clearly not been met, or at least not sufficiently. Policy within the eurozone in the coming years must therefore be directed at satisfying these conditions, which are considered in detail in the report. Countries such as the Netherlands and Germany will also have to take steps, such as setting up more investment programmes and stimulating domestic demand by ensuring that wage increases stop lagging behind the increase in labour productivity. In answer to question 3 in the request for advice, such steps have implications for the Netherlands' economy and financial interests. For example, the volume of Dutch exports is likely to fall due to higher labour costs, but there will also be positive effects connected with Dutch consumers' increased purchasing power.

In addition to the economic conditions and factors mentioned above, other factors play an important role in economic convergence. They include an efficient banking system as part of the financial union. To this end, effective banking surveillance is a prime requirement. The AIV understands that capacity problems and lack of information on local circumstances have led to national supervisors still having a significant say in the exercise of European banking surveillance. The AIV believes the balance of surveillance between the ECB and national supervisors should be shifted towards the former.

Despite the establishment of the Single Resolution Fund, the AIV notes that a common backstop is still required to complete the financial union. This will certainly be the case until the fund reaches its target level, but even then it still may not be able to carry out major support operations. The Commission noted in its recent reflection paper on

deepening the EMU that a common backstop is also necessary for the Single Resolution Fund and the European Deposit Insurance Scheme. In the context of the road map to complete the banking union, the creation of special lending facilities is the first step towards this goal.

Given the great importance to financial stability of a Deposit Insurance Scheme at European level, the AIV calls for the vigorous recapitalisation of banks with weak balance sheets in order to restore them to health. This will necessitate enhanced European surveillance and compliance with the agreements made on the composition of the Single Resolution Fund.

The AIV thinks that further steps are necessary for businesses to benefit in full from the potential advantages of a capital markets union. A harmonised legal framework is needed to facilitate cross-border capital flows and ensure that financial sectors are not impeded by national borders. Differences in national legislation currently hinder transnational investments and undermine efforts to create a level financial playing field in the EU.

The slow implementation of European financial union, especially the banking union, is one of the main reasons why the eurozone is still insufficiently prepared to withstand the next crisis. Although the leading role that the ECB now plays in the surveillance of major banks is a large step in the right direction, national supervisors have retained a strong voice in banking surveillance, and not only in relation to smaller banks. This harbours risks, especially in light of the relatively low capital buffer requirements. Another concern is the obstacles thrown up in creating the Single Resolution Fund. The AIV, too, sees this fund as an important instrument for increasing stability in the financial system. Progress can only be made if a limited group of financially strong countries are not disproportionately exposed to the risks of weak banks. The same applies *mutatis mutandis* to the creation of the Deposit Insurance Scheme.

Monetary stability, it can be concluded, has improved considerably in recent years. Nevertheless, the AIV has doubts about the monetary system's resilience to very serious economic shocks in the longer term, as in 2009/2010. One reason for this is the untenably high sovereign debts of Greece and Italy.

Regarding the macroeconomic imbalance procedure, the AIV concludes that it is complicated and has so many shortcomings that in practice it cannot bring about the necessary structural reforms. In an ideal world, countries with budget surpluses would encourage investment and those with budget deficits would make structural reforms. To date, neither has happened. Nevertheless, the AIV is not without hope that, with the recent election of President Macron, France and Germany can reach agreement based on a mutual exchange of interests.

Regarding budgetary surveillance and enforcement, the AIV believes above all that they should be the responsibility of the European Commission and subject to review by the European Court of Justice as part of secondary legislation. The AIV believes leakage to intergovernmental structures in this field would be undesirable.

In response to question 1 in the request for advice regarding the options for strengthening EMU governance, the AIV refers in its advisory report to, among other things, the importance of strengthening accountability and democratic control by both national parliaments and the European Parliament. The AIV also proposes that the Vice-President of the European Commission for the Euro should be the permanent president

of the Eurogroup. Other proposals to strengthen EMU governance are detailed in the report and also included in the recommendations.

With regard to a possible fiscal capacity, the AIV, along with the European Commission, the ECB, the European Parliament and several European countries, thinks that serious consideration should be given to proposals to create such a capacity. It must be made clear that the fiscal capacity will complement healthy national budgetary policy, not replace it. In other words, a fiscal capacity may not lead to permanent one-way financial transfers between countries.

Regarding the influence of the individual steps proposed by the AIV for political and economic cooperation at a wider European level, with member states outside the eurozone, the AIV touches upon this question (question 4 in the request for advice) only in passing in its report. In the AIV's opinion, this question lost most of its practical relevance when the UK announced its intention to leave the EU.

Recommendations

On the basis of the analysis in the advisory report, as reflected in the above summary and conclusions, the AIV makes the following recommendations.

Strengthening the governance of the EMU

1. The **effectiveness of the governance** of the EMU, especially as regards crisis management, should be strengthened. To this end, the AIV recommends that the permanent president of the Eurogroup be appointed chief negotiator of ESM assistance programmes. The ministers of the euro countries must give the president a wide mandate so that he can carry out his duties efficiently.

2. As suggested in the AIV's advisory report of April 2014, the **Vice-President of the European Commission for the Euro** should be appointed permanent president of the Eurogroup in due course. This would be comparable with the position of the High Representative for the Common Foreign and Security Policy. The appointment procedure could be the same as that for the Commission president: nomination by the European Council and approval by a majority of the European Parliament. This 'double hat' arrangement would strengthen the European Parliament's control function, as the Commission is tasked under the ESM mandate with supervising compliance with and implementation of assistance programmes, without undermining the national parliaments' control function.

3. Regarding **budgetary surveillance**, the AIV recommends that the final opinion on compliance with EMU obligations remains (?) at the political level, i.e. with the ministers, who, by reverse qualified majority, can oppose the Commission's recommendations (article 7, Stability Treaty). This does not mean that the Commission should act purely mechanically and should not have discretionary power to decide on the presence of exceptional circumstances within the meaning of article 3, paragraph 3 of the Stability Treaty. In the AIV's opinion, it means that the Commission's assessment should not be influenced by the clout of the member state concerned. An autonomous service should be established within the Commission to ensure the objectivity and independence of economic analyses.

4. The AIV calls for **the close involvement of national parliaments** in controlling support operations for countries in acute financial difficulties (programme countries). After all, national funds are being transferred and guarantees are being given that are backed up by national taxpayers. The AIV therefore recommends that national parliaments periodically express an opinion, based on independent reports, on whether programme countries' are using emergency credit effectively.

5. In the context of creating the **capital markets union** as a vital part of the financial union, the AIV recommends that the position of the European Securities and Markets Authority be strengthened so that it can operate as an effective watchdog for the implementation of European financial rules. In its current, predominantly coordinating, role, it cannot sufficiently ensure the predictability necessary in this field. Transaction costs are unnecessarily high because of the uncertainty about how member states implement the rules.

Promoting real economic convergence

6. To promote real **economic convergence** in the eurozone, euro countries that are lagging behind in terms of economic growth and employment should take measures to increase competition on goods, services and capital markets. They should also reduce the rigidities in their product and labour markets. To this end, the AIV recommends that a best efforts obligation be introduced at the highest political level, i.e. at the level of the heads of state and government of the euro countries.

7. To support **economic reforms** in the southern euro countries, the Netherlands, together with Germany, should play an active and incentivising role in establishing investment programmes and the like and stimulating domestic demand by ensuring that wage increases stop lagging behind the increase in labour productivity.

Further proposals to strengthen EMU

8. To complete the **banking union**, the AIV recommends that the proposals made in the Five Presidents' Report be adopted in order to open up a credit line from the European Stability Mechanism (ESM) to the Single Resolution Fund to serve as a common backstop. The AIV equally supports the idea that this facility should be budget neutral in the medium term, i.e. it should not be funded from the member states' public finances. This means that any assistance provided by the ESM must later be reimbursed by contributions from the financial sector. The AIV also calls for an increase in the capital buffers of financially vulnerable banks.

9. Regarding **monetary stability**, the AIV recommends that the speed and scope of ESM interventions be increased, including during a preventive phase. To this end, the creation of a rapid response facility, a special fund guaranteed jointly by the euro countries, could be of great value. The AIV further recommends that the ESM be gradually transformed into a European Monetary Fund (EMF) in due course. Ultimately, this EMF, as a Union institution, would be integrated into the EU's legal framework along the lines of the European Investment Bank (EIB).

10. Regarding the ongoing debate on the introduction of a separate **fiscal capacity for the euozone**, the AIV believes that such a capacity could, in principle, increase the EMU's resilience to shocks. The AIV recommends that further proposals for fiscal union be assessed against a number of principles: (1) the euro countries' undiminished

responsibility for sound national budget policies, (2) the temporary duration of budget support to countries that are not yet able to implement anticyclical budget policies, (3) a strict definition of asymmetric shocks, (4) the fiscal capacity may not be used to finance public services that benefit all EU member states, and (5) effective democratic control.

Withdrawal from the eurozone

11. With regard to a possible withdrawal from the eurozone, the AIV recommends that the responsible monetary authorities draw up **exit scenarios** by way of contingency planning so that the advantages and disadvantages are more clearly understood in the political debate. Although a withdrawal may be inevitable in certain circumstances, anticipatory measures would contravene the principle laid down in the treaties that the monetary union should include all member states (with the exception of the United Kingdom and Denmark) as soon as feasible. The Treaty on the Functioning of the European Union therefore includes provisions for the member states that are not members of the eurozone (article 140 ff, TFEU). However, should the Treaty at some point in the future differentiate between member states based on their degree of integration, a clause could be included to regulate both the enlargement and any necessary contraction of the eurozone.

Request for advice

Professor J.G. de Hoop Scheffer
Chairman of the Advisory Council on International Affairs
P.O. Box 20061
2500 EB The Hague

Date 6 October 2016
Re Request for advice on deepening EMU

Dear Professor De Hoop Scheffer,

The further development of the eurozone is one of the key issues in the current process of European integration.

The report entitled 'Completing Europe's Economic and Monetary Union' drawn up by the President of the European Commission in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank and the President of the European Parliament (the Five Presidents' Report) sets out the steps that need to be taken to improve economic governance of the eurozone and ultimately bring about financial and fiscal union. The government has expressed its views on the report and the associated proposals in various responses (Parliamentary Papers 21501-20, nos. 996 and 1051).

Steps have already been taken to strengthen the eurozone, and the European Commission is preparing measures for the longer term on the basis of the Five Presidents' Report. The government sees no reason to take major steps towards further integration of the eurozone. Nevertheless it understands the need to carefully weigh up the options available within the current treaty frameworks to strengthen economic and monetary union. The government would appreciate receiving an advisory report on this issue from the Advisory Council on International Affairs (AIV) next spring, based on the following questions:

1. What steps can be taken within the limits of the current treaty framework to strengthen governance of the EMU in order to promote growth and the ability to absorb shocks in individual member states and the EMU as a whole?
2. What steps can be taken within the limits of the current treaty framework to promote real economic convergence within the eurozone?
3. Can the Advisory Council explain the implications of the individual steps in questions 1 and 2 for the Netherlands' economy and financial interests?
4. To what extent can the individual steps aimed at strengthening governance of the EMU and promoting real convergence influence political and economic cooperation at a wider EU level, with member states outside the eurozone – e.g. regarding decision-making on and the integrity of the internal market?

I look forward to receiving your report.

Yours sincerely,

Bert Koenders
Minister of Foreign Affairs

Economic policy indicators, institutions and governance

As noted above, four indicators were used to prepare this advisory report. They were:

1. the Sustainable Governance Indicator
2. the Product Market Regulation indicator
3. the Distance to Frontier score
4. the average position on the World Economic Forum index.

The first is the Sustainable Governance Indicator (SGI), published by the *Bertelsmann Stiftung*.[77] It collates a large number of variables relating to economic, social and sustainability policy performance, the quality of democracy and the quality of governance. Data is available on 41 countries, including the 12 euro countries considered in this report. Unfortunately the project began only recently and data is available for only 2014 to 2016. The results from these three years are averaged here. The table below shows the results for the three main categories. The Northern European countries perform markedly better than the Southern European countries in all three categories.

Table: SGI indicators for the 12 euro countries, average 2014-2016

	Policy performance	Quality of democracy	Quality of governance
Northern Europe	7.00	8.37	7.04
Southern Europe	5.50	7.03	6.00

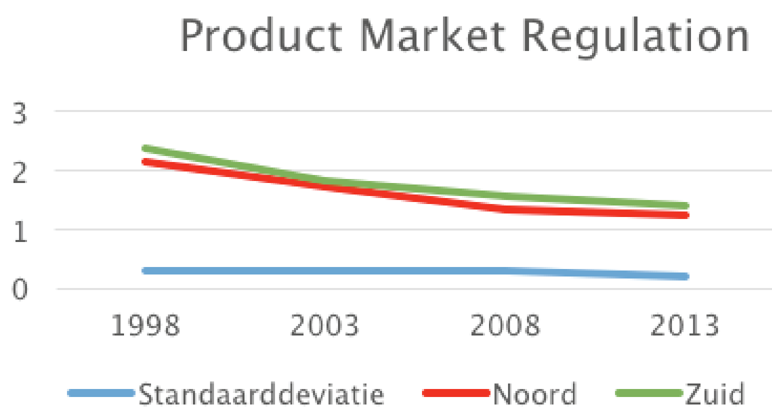
The second indicator is the OECD's Product Market Regulation (PMR) indicator.[78] It is more limited than the SGI but is available for a longer period, namely for the years 1998, 2003, 2008 and 2013. The idea behind the PMR indicator is that a competitive product market environment that allows new firms to win market share, efficient firms to grow and inefficient ones to exit, can help boost economic growth and living standards. To optimise this environment, product market regulation should not hamper competition, and, second, an effective antitrust framework needs to be in place that safeguards a level playing field among firms. The OECD has developed indicators in both these policy areas.

The Product Market Regulation indicator reveals only marginal differences between the Northern and Southern European countries. Both groups show a steady decline. The standard deviation, which was already modest, has also declined slightly. This implies that competition is increasingly facing fewer regulatory restrictions and competition policy is placing fewer and fewer restrictions on competition and is allowing optimal competition.

77 See: <http://www.sgi-network.org/2016/>.

78 See: <http://www.oecd.org/eco/growth/indicatorsofproductmarketregulationhomepage.htm>.

Figure 10. *Product Market Regulation, 1998-2013*



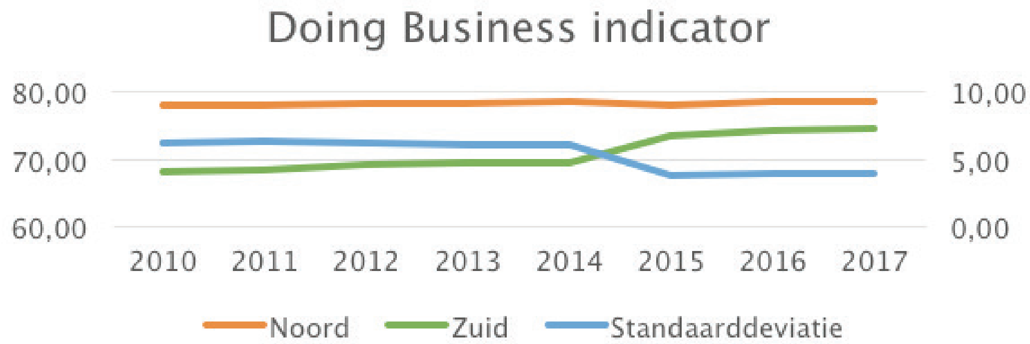
[Standard deviation North South]

The third indicator used in this report is the World Bank's Doing Business (DB) indicator,[79] which has been compiled from 2003 to 2017. The Doing Business project provides objective measures of business regulations and their enforcement. It looks at small and medium-sized businesses and measures the regulations applying to them throughout their life cycle. It aims to encourage countries to introduce more efficient regulations by offering measurable benchmarks. This indicator is more limited in scope than the SGI and its orientation is comparable with that of the PMR indicator.

The Distance to Frontier (DtF) score has been developed in order to increase accessibility. It measures the distance of each economy from the best-performing economy. It reveals the gap between a particular economy's performance and the best performance. For each indicator the score runs from 0 to 100, where 100 represents the best performance. Data for the overall indicator is available as from 2010. The figure below shows that the Northern European countries have performed better than the Southern European countries but the gap has declined markedly since 2013. In 2010 it was 10 percentage points but in 2017 it was just four percentage points.

79 See: <http://www.doingbusiness.org/>. In the first year, five datasets were compiled for 133 countries and, in 2017, 11 datasets for 190 countries.

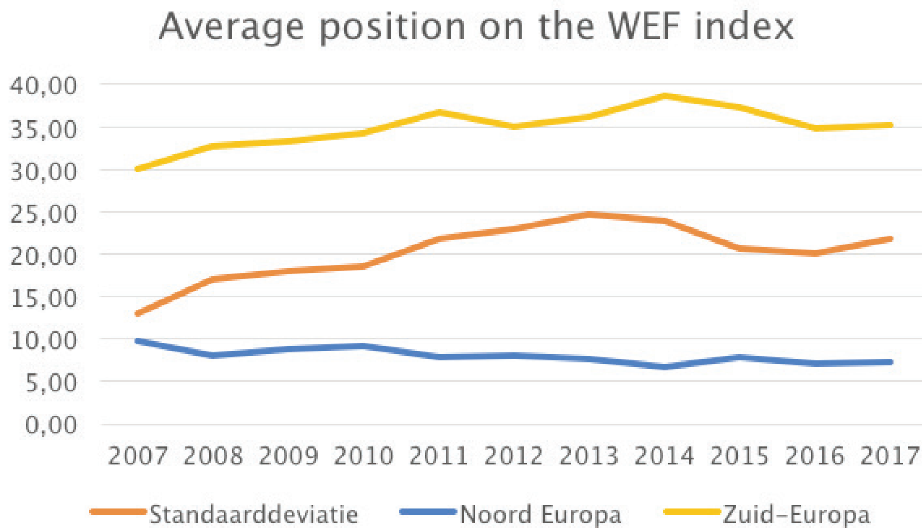
Figure 11. *DB indicator, 2010-2017*



[North South Standard deviation
NB: Decimal commas should be read as decimal points]

The final indicator is the relative position on the index of most competitive economies, as published by the World Economic Forum. An economy's competitiveness is determined by its performance in 12 pillars: institutions, infrastructure, macroeconomic environment, health, primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation. In total, data has been compiled for 110 indicators. Figure 12 shows that the Northern European countries score significantly higher and the gap with the Southern European countries widened during the period analysed, 2007-2017, as did the standard deviation.

Figure 12. *Average position on the World Economic Forum index, 2007-2017*



[Standard deviation Northern Europe Southern Europe
NB: Decimal commas should be read as decimal points]

List of persons consulted

Professor L.H. Hoogduin	Professor of Economics at the University of Groningen, former Governing Board member of De Nederlandsche Bank
Professor K.H.W. Knot	President of De Nederlandsche Bank, Professor of Economics of Central Banking at the University of Groningen
Professor C.N. Teulings	Montague-Burton Professor of Labour Economics at the University of Cambridge, former director of the Netherlands Bureau for Economic Policy Analysis
Dr J.A. Vijlbrief	Treasurer General at the Ministry of Finance
Dr A.H.E.M. Wellink	Former President of De Nederlandsche Bank

List of abbreviations

AIV	Advisory Council on International Affairs
CEPS	Centre for European Policy Studies
CJEU	Court of Justice of the European Union
DB	Doing Business
DNB	De Nederlandsche Bank
DTF	Distance to Frontier
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDA	European Debt Agency
EDIS	European Deposit Insurance Scheme
EDP	Excessive Deficit Procedure
EFB	European Fiscal Board
EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism
EMU	Economic and Monetary Union
ESM	European Stabilisation Mechanism
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
ICT	Information and Communication Technology
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
OMT	Outright monetary transactions
PMR	Product Market Regulation
QE	Quantitative Easing
SGI	Sustainable Governance Indicator
SGP	Stability and Growth Pact
SRF	Single Resolution Fund
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
US	United States
VAT	Value Added Tax
WEF	World Economic Forum

Previous reports published by the Advisory Council on International Affairs

1 AN INCLUSIVE EUROPE, *October 1997*
2 CONVENTIONAL ARMS CONTROL: urgent need, limited opportunities, *April 1998*
3 CAPITAL PUNISHMENT AND HUMAN RIGHTS: recent developments, *April 1998*
4 UNIVERSALITY OF HUMAN RIGHTS AND CULTURAL DIVERSITY, *June 1998*
5 AN INCLUSIVE EUROPE II, *November 1998*
6 HUMANITARIAN AID: redefining the limits, *November 1998*
7 COMMENTS ON THE CRITERIA FOR STRUCTURAL BILATERAL AID, *November 1998*
8 ASYLUM INFORMATION AND THE EUROPEAN UNION, *July 1999*
9 TOWARDS CALMER WATERS: a report on relations between Turkey and the European Union, *July 1999*
10 DEVELOPMENTS IN THE INTERNATIONAL SECURITY SITUATION IN THE 1990s: from unsafe security to unsecured safety, *September 1999*
11 THE FUNCTIONING OF THE UNITED NATIONS COMMISSION ON HUMAN RIGHTS, *September 1999*
12 THE IGC AND BEYOND: TOWARDS A EUROPEAN UNION OF THIRTY MEMBER STATES, *January 2000*
13 HUMANITARIAN INTERVENTION, *April 2000**
14 KEY LESSONS FROM THE FINANCIAL CRISES OF 1997 AND 1998, *April 2000*
15 A EUROPEAN CHARTER OF FUNDAMENTAL RIGHTS?, *May 2000*
16 DEFENCE RESEARCH AND PARLIAMENTARY SCRUTINY, *December 2000*
17 AFRICA’S STRUGGLE: security, stability and development, *January 2001*
18 VIOLENCE AGAINST WOMEN: LEGAL DEVELOPMENTS, *February 2001*
19 A MULTI-TIERED EUROPE: the relationship between the European Union and subnational authorities, *May 2001*
20 EUROPEAN MILITARY-INDUSTRIAL COOPERATION, *May 2001*
21 REGISTRATION OF COMMUNITIES BASED ON RELIGION OR BELIEF, *June 2001*
22 THE WORLD CONFERENCE AGAINST RACISM AND THE RIGHT TO REPARATION, *June 2001*
23 COMMENTARY ON THE 2001 MEMORANDUM ON HUMAN RIGHTS POLICY, *September 2001*
24 A CONVENTION, OR CONVENTIONAL PREPARATIONS? The European Union and the ICG 2004, *November 2001*
25 INTEGRATION OF GENDER EQUALITY: a matter of responsibility, commitment and quality, *January 2002*
26 THE NETHERLANDS AND THE ORGANISATION FOR SECURITY AND COOPERATION IN EUROPE IN 2003: role and direction, *May 2002*
27 BRIDGING THE GAP BETWEEN CITIZENS AND BRUSSELS: towards greater legitimacy and effectiveness for the European Union, *May 2002*
28 AN ANALYSIS OF THE US MISSILE DEFENCE PLANS: pros and cons of striving for invulnerability, *August 2002*
29 PRO-POOR GROWTH IN THE BILATERAL PARTNER COUNTRIES IN SUB-SAHARAN AFRICA: an analysis of poverty reduction strategies, *January 2003*
30 A HUMAN RIGHTS BASED APPROACH TO DEVELOPMENT COOPERATION, *April 2003*
31 MILITARY COOPERATION IN EUROPE: possibilities and limitations, *April 2003*
32 BRIDGING THE GAP BETWEEN CITIZENS AND BRUSSELS: towards greater legitimacy and effectiveness for the European Union, *April 2003*
33 THE COUNCIL OF EUROPE: less can be more, *October 2003*
34 THE NETHERLANDS AND CRISIS MANAGEMENT: three issues of current interest, *March 2004*
35 FAILING STATES: a global responsibility, *May 2004**
36 PRE-EMPTIVE ACTION, *July 2004**
37 TURKEY: towards membership of the European Union, *July 2004*
38 THE UNITED NATIONS AND HUMAN RIGHTS, *September 2004*
39 SERVICES LIBERALISATION AND DEVELOPING COUNTRIES: does liberalisation produce deprivation?, *September 2004*
40 THE PARLIAMENTARY ASSEMBLY OF THE COUNCIL OF EUROPE, *February 2005*
41 REFORMING THE UNITED NATIONS: A closer look at the Annan report, *May 2005*
42 THE INFLUENCE OF CULTURE AND RELIGION ON DEVELOPMENT: Stimulus or stagnation?, *June 2005*
43 MIGRATION AND DEVELOPMENT COOPERATION: coherence between two policy areas, *June 2005*
44 THE EUROPEAN UNION’S NEW EASTERN NEIGHBOURS, *July 2005*
45 THE NETHERLANDS IN A CHANGING EU, NATO AND UN, *July 2005*
46 ENERGISED FOREIGN POLICY: security of energy supply as a new key objective, *December 2005***

47 THE NUCLEAR NON-PROLIFERATION REGIME: The importance of an integrated and multilateral approach, *January 2006*
48 SOCIETY AND THE ARMED FORCES, *April 2006*
49 COUNTERTERRORISM FROM AN INTERNATIONAL AND EUROPEAN PERSPECTIVE, *September 2006*
50 PRIVATE SECTOR DEVELOPMENT AND POVERTY REDUCTION, *October 2006*
51 THE ROLE OF NGOS AND THE PRIVATE SECTOR IN INTERNATIONAL RELATIONS, *October 2006*
52 EUROPE A PRIORITY!, *November 2006*
53 THE BENELUX: the benefits and necessity of enchanced cooperation, *February 2007*
54 THE OECD OF THE FUTURE, *March 2007*
55 CHINA IN THE BALANCE: towards a mature relationship, *April 2007*
56 DEPLOYMENT OF THE ARMED FORCES: interaction between national and international decision-making, *May 2007*
57 THE UN HUMAN RIGHTS TREATY SYSTEM: strengthening the system step by step in a politically charged context, *July 2007*
58 THE FINANCES OF THE EUROPEAN UNION, *December 2007*
59 EMPLOYING PRIVATE MILITARY COMPANIES: a question of responsibility, *December 2007*
60 THE NETHERLANDS AND EUROPEAN DEVELOPMENT POLICY, *May 2008*
61 COOPERATION BETWEEN THE EUROPEAN UNION AND RUSSIA: a matter of mutual interest, *July 2008*
62 CLIMATE, ENERGY AND POVERTY REDUCTION, *November 2008*
63 UNIVERSALITY OF HUMAN RIGHTS: principles, practice and prospects, *November 2008*
64 CRISIS MANAGEMENT OPERATIONS IN FRAGILE STATES: the need for a coherent approach, *March 2009*
65 TRANSITIONAL JUSTICE: justice and peace in situations of transition, *April 2009**
66 DEMOGRAPHIC CHANGES AND DEVELOPMENT COOPERATION, *July 2009*
67 NATO'S NEW STRATEGIC CONCEPT, *January 2010*
68 THE EU AND THE CRISIS: lessons learned, *January 2010*
69 COHESION IN INTERNATIONAL COOPERATION: Response to the WRR (Advisory Council on Government Policy) Report '*Less Pretension, More Ambition', July 2010*
70 THE NETHERLANDS AND THE RESPONSIBILITY TO PROTECT: the responsibility to protect people from mass atrocities, *June 2010*
71 THE EU'S CAPACITY FOR FURTHER ENLARGEMENT, *July 2010*
72 COMBATING PIRACY AT SEA: a reassessment of public and private responsibilities, *December 2010*
73 THE HUMAN RIGHTS OF THE DUTCH GOVERNMENT: identifying constants in a changing world, *February 2011*
74 THE POST-2015 DEVELOPMENT AGENDA: the millennium development goals in perspective, *April 2011*
75 REFORMS IN THE ARAB REGION: prospects for democracy and the rule of law?, *May 2011*
76 THE HUMAN RIGHTS POLICY OF THE EUROPEAN UNION: between ambition and ambivalence, *July 2011*
77 CYBER WARFARE*, December 2011**
78 EUROPEAN DEFENCE COOPERATION: sovereignty and the capacity to act*, January 2012*
79 THE ARAB REGION, AN UNCERTAIN FUTURE, *May 2012*
80 UNEQUAL WORLDS: poverty, growth, inequality and the role of international cooperation, *September 2012*
81 THE NETHERLANDS AND THE EUROPEAN PARLIAMENT: investing in a new relationship, *November 2012*
82 INTERACTION BETWEEN ACTORS IN INTERNATIONAL COOPERATION: towards flexibility and trust, *February 2013*
83 BETWEEN WORDS AND DEEDS: prospects for a sustainable peace in the Middle East, *March 2013*
84 NEW PATHS TO INTERNATIONAL ENVIRONMENTAL COOPERATION, *March 2013*
85 CRIME, CORRUPTION AND INSTABILITY: an exploratory report, *May 2013*
86 ASIA ON THE RISE: strategic significance and implications, *December 2013*
87 THE RULE OF LAW: safeguard for European citizens and foundation for European cooperation, *January 2014*
88 PUBLIC SUPPORT FOR THE EUROPEAN UNION: building trust, *April 2014*
89 IMPROVING GLOBAL FINANCIAL COHESION: the Importance of a Coherent International Economic and Financial Architecture, *June 2014*
90 THE FUTURE OF THE ARCTIC REGION: cooperation or confrontation?, *September 2014*
91 THE NETHERLANDS AND THE ARAB REGION: a principled and pragmatic approach, *November 2014*
92 THE INTERNET: a global free space with limited state control, *November 2014*
93 ACP-EU COOPERATION AFTER 2020: towards a New Partnership?, *March 2015*

94 INSTABILITY AROUND EUROPE: Confrontation with a New Reality, *April 2015*
95 INTERNATIONAL INVESTMENT DISPUTE SETTLEMENT: from ad hoc arbitration to a permanent court, *April 2015*
96 DEPLOYMENT OF RAPID-REACTION FORCES, *October 2015*
97 AUTONOMOUS WEAPON SYSTEMS: the need for meaningful human control, *October 2015**
98 DIFFERENTIATED INTEGRATION: different routes to EU cooperation, *October 2015*
99 THE DUTCH DIAMOND DYNAMIC: doing Business in the Context of the New Sustainable Development Goals, *January 2016*
100 WELL CONNECTED? On relations between regions and the European Union, *January 2016*
101 SECURITY AND STABILITY IN NORTHERN AFRICA, *May 2016*
102 THE PROTECTION OF CIVILIANS IN ARMED CONFLICTS: well-trodden paths and new ways forward, *July 2016*
103 BREXIT MEANS BREXIT, towards a new relationship with the UK, *March 2017*
104 THE WILL OF THE PEOPLE? The Erosion of Democracy under The Rule of Law in Europe, *June 2017*

Advisory letters issued by the Advisory Council on International Affairs

1 Advisory letter THE ENLARGEMENT OF THE EUROPEAN UNION, *December 1997*
2 Advisory letter THE UN COMMITTEE AGAINST TORTURE, *July 1999*
3 Advisory letter THE CHARTER OF FUNDAMENTAL RIGHTS, *November 2000*
4 Advisory letter ON THE FUTURE OF THE EUROPEAN UNION, *November 2001*
5 Advisory letter THE DUTCH PRESIDENCY OF THE EU IN 2004, *May 2003****
6 Advisory letter THE RESULTS OF THE CONVENTION ON THE FUTURE OF EUROPE, *August 2003*
7 Advisory letter FROM INTERNAL TO EXTERNAL BORDERS. Recommendations for developing a common European asylum and immigration policy by 2009, *March 2004*
8 Advisory letter THE DRAFT DECLARATION ON THE RIGHTS OF INDIGENOUS PEOPLES: from Deadlock to Breakthrough?, *September 2004*
9 Advisory letter OBSERVATIONS ON THE SACHS REPORT: How do we attain the Millennium Development Goals?, *April 2005*
10 Advisory letter THE EUROPEAN UNION AND ITS RELATIONS WITH THE DUTCH CITIZENS, *December 2005*
11 Advisory letter COUNTERTERRORISM IN A EUROPEAN AND INTERNATIONAL PERSPECTIVE: interim report on the prohibition of torture, *December 2005*
12 Advisory letter RESPONSE TO THE 2007 HUMAN RIGHTS STRATEGY, *November 2007*
13 Advisory letter AN OMBUDSMAN FOR DEVELOPMENT COOPERATION, *December 2007*
14 Advisory letter CLIMATE CHANGE AND SECURITY, *January 2009*
15 Advisory letter THE EASTERN PARTNERSHIP, *February 2009*
16 Advisory letter DEVELOPMENT COOPERATION, The benefit of and need for public support, *May 2009*
17 Advisory letter OPEN LETTER TO A NEW DUTCH GOVERNMENT, *June 2010*
18 Advisory letter THE EUROPEAN COURT OF HUMAN RIGHTS: Protector of civil rights and liberties, *November 2011*
19 Advisory letter TOWARDS ENHANCED ECONOMIC AND FINANCIAL GOVERNANCE IN THE EU, *February 2012*
20 Advisory letter IRAN'S NUCLEAR PROGRAMME: Towards de-escalation of a nuclear crisis, *April 2012*
21 Advisory letter THE RECEPTOR APPROACH: A question of weight and measure, *April 2012*
22 Advisory letter OPEN LETTER TO A NEW DUTCH GOVERNMENT: The armed forces at risk, *September 2012*
23 Advisory letter TOWARDS A STRONGER SOCIAL DIMENSION OF THE EUROPEAN UNION, *June 2013*
24 Advisory letter FULL SPEED AHEAD: Response by the Advisory Council on International Affairs to the policy letter 'Respect and Justice for All', *September 2013*
25 Advisory letter DEVELOPMENT COOPERATION: Beyond a Definition, *May 2014*
26 Advisory letter THE EU'S DEPENDENCE ON RUSSIAN GAS: How an integrated EU policy can reduce it, *June 2014*
27 Advisory letter FINANCING THE INTERNATIONAL AGENDA FOR SUSTAINABLE DEVELOPMENT, *April 2015*

28 Advisory letter THE FUTURE OF SCHENGEN, *March 2016*
29 Advisory letter THE FUTURE OF ODA, *December 2016*
30 Advisory letter EU-UKRAINE ASSOCIATION AGREEMENT: the need for ratification, *December 2016*
31 Advisory letter RUSSIA AND THE DEFENCE EFFORTS OF THE NETHERLANDS, *March 2017*
32 Advisory letter THE DUTCH GOVERNMENT'S PRESENCE ABROAD, *May 2017*

* Issued jointly by the Advisory Council on International Affairs (AIV) and the Advisory Committee on Issues of Public International Law (CAVV).

** Joint report by the Advisory Council on International Affairs (AIV) and the General Energy Council.

*** Joint report by the Advisory Council on International Affairs (AIV) and the Advisory Committee on Migration Affairs (ACVZ).