

Colophon

This is a publication by the Advisory Division of the Council of State of the Netherlands (November 2017).

Text

Council of State – The Hague

Authors

Age Bakker

Peter van den Berg

Staff

Erwin van Dam

Jeroen Hessel

Design and layout

Xerox/OBT – Den Haag

Contact

Council of State

Kneuterdijk 22

2514 EN The Hague

PO Box 20019

2500 EA The Hague

www.raadvanstate.nl

voorlichting@raadvanstate.nl

Table of contents

Summary and conclusion	5
1 Introduction	13
2 The Economic and Monetary Union	19
2.1 The Economic and Monetary Union	21
2.2 EMU and European integration	21
2.3 Chosen structure and fundamental principles	22
2.4 Overall developments assessed in terms of the objectives	23
2.5 The euro crisis: proven flaws and shortcomings	25
2.5.1 'Anticipated' deficiencies	25
2.5.2 'Unforeseen' deficiencies	27
2.6 Adjustments over the past few years	28
2.7 Evaluation of the strengthened monetary union	30
2.8 Conclusion	33
3 Compliance with and enforcement of the rules and agreements	35
3.1 Applicable rules and agreements	37
3.1.1 Current regulatory framework	37
3.1.2 Experiences of compliance and enforcement	37
3.1.3 Explanations for a lack of compliance	39
3.2 The significance of rules in European economic governance	40
3.3 Options for improved compliance and enforcement within the existing framework	42
3.4 Conclusion: rules and agreements are necessary but do not suffice	45
4 Assessing the possible directions for the future of the EMU	47
4.1 Ongoing debate about the future of the EMU and the EU	49
4.2 Various ways of thinking	50
4.2.1 General direction of the proposals	50
4.2.2 Combination and definition of specific measures	51
4.2.3 Democratic involvement and accountability	52
4.3 Views difficult to compare	55
4.4 Assessment framework	55
4.4.1 Basic principle: sustainably reliable and self-evident	55
4.4.2 Socio-economic objectives	56
4.4.3 Political, institutional and legal preconditions	58
5 Considerations for possible future directions of EMU	61
5.1 The nature of possible future directions of EMU	63
5.2 Completing what has already been agreed	63
5.3 Disintegration or dissolution of the monetary union	65
5.4 New balance between central and 'decentral' functioning	67
5.5 Deeper integration	70

6	The EMU's development from the perspective of the Netherlands	77
6.1	Defining the Dutch interest	79
6.2	No regret measures	80
6.3	Alternative choices in the further development of the EMU	83
6.4	Consequences and trade-offs involved in the options	85
6.5	Concluding remarks	88
	Appendix: Overview of the current regulatory framework	91
	Literature consulted	94
	List of abbreviations used	97

Summary and conclusion

The Dutch House of Representatives has requested the Advisory Division of the Council of State to advise on improving compliance with European rules concerning the Economic and Monetary Union, and on the advantages and disadvantages of various options for the future of the monetary union. These questions are part of an ongoing debate regarding the future of the monetary union. The European Commission is expected to put forward concrete proposals in response to this debate at the beginning of December 2017. This advice should help to prepare for this discussion, and provide insight into the implications of the various options and their significance for the Netherlands.

This report has four objectives. First of all, the report aims to provide structure for future considerations in the form of an assessment framework for the possible directions, which the EMU may take. It also connects the economic, legal, political and institutional aspects. Moreover, this advice abstracts from political views regarding 'more or less Europe' by mapping out various directions for the EMU, while making the advantages and disadvantages and possible trade-offs transparent. Finally, the report explicitly considers Dutch interests in shaping the future of the EMU.

The EMU cannot be viewed separately from the overarching process of European integration (chapter 2). After all, the EMU was conceived as a logical step in completing the internal market to yield additional benefits. It was intended to make exchange rate crises impossible, provide monetary and fiscal stability, and further stimulate the integration of trade and financial flows. As such, the EMU was also meant to increase prosperity.

In monetary terms, the EMU has brought a great deal of stability. The euro has proved to be a successful and credible currency, through the sustainable, low rate of inflation and the relatively stable exchange rate. The real fear prior to the introduction of the euro that the 'hard' Dutch guilder would be exchanged for a less hard currency has not materialised. In other areas, however, the EMU has not fully met expectations. The euro has helped to intensify trade – from which the Netherlands has benefited greatly as a trading nation – but for the eurozone as a whole it has on balance failed to deliver higher economic growth and, furthermore, has led only to a limited extent to the anticipated economic convergence of the participating countries. Although the global financial crisis has also brought problems for many countries outside the EMU, the problems in the eurozone are intensified due to a number of deficiencies in the original set-up of the monetary union.

Some of these deficiencies are in line with concerns expressed even before the start of the EMU. For example, the Stability and Growth Pact (SGP) proved inadequate in enforcing budgetary discipline in all circumstances, and the necessary structural reforms barely got off the ground. This failure to comply with the rules and agreements left many Member States insufficiently able to absorb shocks. Other shortcomings were not anticipated, however. Specifically, the risks of the global deregulation of financial markets, which more or less coincided with the start of the euro, were not sufficiently recognised, and were not considered at all in the set-up of the EMU. As a consequence, the rules contained insufficient guarantees to tackle imbalances such as worsening competitive positions, rising balance of payment deficits and increasing private debt. The intertwining of national governments and banks was a 'blind spot' for a long time. The EMU thus had insufficient instruments to manage a crisis.

The eurozone Member States and the European institutions have done much to address these deficiencies in a relatively short period. Measures implemented include tightening existing rules and agreements, establishing the European Stability Mechanism (ESM) for Member States with problems, and forming the Banking Union. As a result the EMU is now stronger. Nevertheless, there is still doubt as to whether it will be economically and politically resilient enough in the face of new crises, and whether it is able to provide the economic and social perspectives needed to ensure long-term popular support for the euro.

The monetary union has also taken on a different character than expected. Despite the no-bail-out clause, Member States have shared financial risks, including through the ESM; the European Central Bank (ECB) acts as a safety net out of necessity, taking it to the limits of its mandate. Furthermore, the European influence on national policy has increased considerably. These solutions, reached under pressure, have resulted in greater institutional complexity, which has changed the balance of democratic involvement in such a way that it may threaten the democratic legitimacy of the EMU.

The monetary union benefits from greater compliance with and enforcement of the current rules and agreements (chapter 3). In particular, compliance with the fiscal rules under the European treaties and the SGP, and the economic rules under the macroeconomic imbalance procedure (MIP). Experience concerning compliance with the various agreements is mixed. The fiscal rules appear to have had a certain steering effect.

The corrective arm has worked relatively well, although there has been frequent use of discretionary options to extend deadlines. However, compliance with the fiscal rules in the preventive arm is low. The authority to impose sanctions has never been exercised. With respect to macroeconomic supervision, Member States only acted upon the recommendations directed at them to a limited extent. Nevertheless, the European Commission and the Council of Ministers have never started legal proceedings against a Member State.

This report offers various possible measures for improving compliance and enforcement (see table A). How effective these will be will depend to some extent on the further political and institutional development of the monetary union. In any event, simplifying the rules and limiting the scope for discretion will help to improve compliance and enforcement. It should also be noted that there are limits to the extent that Member States can be bound by rules, certainly in politically sensitive policy areas to which agreements may relate. Specifically, agreements concerning structural reforms, where national policy preferences play a role, hit on politically sensitive grounds.

Table A: Options for improved compliance and enforcement

- 1 *Fewer and more simplified rules*
 - Fewer targets and indicators
 - Less scope for discretionary assessment
 - Focus on deviations outside a margin
- 2 *Introduction of positive incentives*
 - Financial support for structural reforms
 - Link to structural and cohesion funds
 - Link to stability fund
- 3 *Enforcement separate from political consideration*
 - More frequent voting with reverse qualified majority
 - Allow appeal to the Court of Justice
 - Reinforce the role of independent authorities
- 4 *A different mix of central and 'decentral' enforcement.*
 - Tighter enforcement mechanisms at the European level
 - Tighter enforcement mechanisms at the national level
- 5 *More free market mechanisms*
 - Tighter no-bail-out clause
- 6 *Strengthening implementation capacities*
 - Technical assistance

Therefore, more needs to be done to improve the monetary union's resistance to shocks and to fully exploit its economic potential (chapter 4). Improvements are conceivable in various areas, but there is a lack of consensus about how the EMU should develop further. A public debate is needed on the future of the euro, with a reasoned framework of assessment that brings together the relevant economic, social, political and legal aspects. This would also provide a framework for assessing proposals concerning further development of the EMU (table B). A sustainable monetary union requires all these aims to be achieved to a certain minimum level. The ambition for a particular aim may be greater, but at the cost of a different aim.

Table B: Aspects for assessing EMU proposals

Socio-economic aspects

- a The EMU needs to effectively absorb normal cyclical fluctuations.
- b The EMU must have the capacity to withstand crises.
- c The EMU supports prosperity and social progress in all Member States, and gives Europe a stronger voice on the world stage.

Political, institutional and legal aspects

- a Greater authority at the European level needs sufficient support.
- b Decision-making within the EMU must be democratically legitimised and transparent.
- c Decisions taken in the context of the EMU must be embedded in a legally coherent way.

The report uses this assessment framework to analyse the advantages and disadvantages of the main directions that play a role in the debate about the future of the EMU, and the trade-offs between each of the directions (chapter 5).

One option is simply to conclude what has already been agreed at the financial level. Completing the Banking Union will help to further diminish the current negative interplay between banks and national governments. The proposed European capital market union would stimulate more robust forms of financial integration. Completing this will be no minor undertaking, and the obstacles along the way should not be underestimated. Assessed against socio-economic aspects, this option should yield considerable gains. However, this option does not involve any major changes at the political/institutional and legal level, and neither does it address the

insufficient enforcement of rules and agreements. There is thus still the risk that shocks will not be effectively absorbed.

One direction – that is often considered to be a risk – is disintegration or dissolution of the monetary union. However this was done, it would involve high economic and political costs. In the short term, the greatest costs would be from financial instability. There would be severe exchange rate fluctuations, and even the suggestion of withdrawing from the monetary union or the collapse of the currency would lead to large outflows of capital because citizens and companies would move their money to countries deemed to be ‘safe’. If ever the irreversibility of the euro were compromised, there would also be an increased risk of a domino-effect caused by speculation on the financial markets. In the longer term, reintroducing national currencies would have a downward effect on the functioning of the internal market, with negative consequences for prosperity and social progress. This would also have major political consequences, and seriously damage European integration.

One possible way of further strengthening the EMU is to place responsibility for complying with agreements more firmly at the level of the Member States (‘decentral’ option). For this to be possible without endangering the existence of the EMU, there needs to be greater market discipline through strict application of the no-bail-out clause. This would require the introduction of a debt restructuring mechanism to settle Member States’ unsustainable debts. There would need to be measures in place to prevent this from resulting in irreversible damage to the financial sector. In this respect, completing the Banking Union is a *conditio sine qua non*. The ECB’s current role as a safety net could be reduced.

Under this option, socio-economic performance is largely dependent on the policy efforts of the Member States themselves. The risk is that of insufficient improvement in the capacity to absorb shocks, while market discipline is not sufficiently effective, just as in the past. The advantages of this route are primarily at the political/institutional level. Restoring greater influence to Member States over their policy may increase the support for measures. The question in the long-term is whether it is politically realistic to leave enforcement of the rules entirely to the Member States, when at the same time at least some mutual financial support will probably be needed in times of crisis if major financial instability is to be avoided.

A final way of strengthening the EMU is deeper European integration (‘central’ option), building on the Banking and

Capital Markets Union. The shaping and enforcement of the economic and fiscal rules would then be at a more central level. Economic policies would be better aligned, with greater mutual risk-sharing between Member States, for example in the form of a joint fiscal capacity, or by financing part of government debt via an EMU-wide safe asset.

This approach would enable improvements in socio-economic performance, provided agreements were met and enforced. This may reduce the chance of new imbalances, while centralising the authority and the corresponding instruments will increase the ability to respond in crises. Stronger emphasis on European instruments that promote structural reforms improves the socio-economic perspective. At the political/institutional level, the scope for national policy decreases, with the risk of political resistance in response, leading to insufficient enforcement of the rules after all. A further risk is that extending public risk-sharing increases the chance of unilateral or permanent transfers between Member States.

Finally, these potential further developments are assessed from the perspective of Dutch interests, and Dutch policy preferences (table C).

Table C: The Dutch policy preferences

- 1 A stable and open trading system.
- 2 Macro-economic policy discipline and supervision of compliance with rules and agreements.
- 3 Sufficient policy competition and functioning of the free market.
- 4 Adjustment to imbalances rather than financing them.

The conclusion is that the open, and internationally-oriented Dutch economy has a great interest in the euro (chapter 6). The euro enables some 60% of Dutch foreign trade to be completed with no exchange rate risk. The collapse of the monetary union, or one country leaving, would be extremely costly, and not in Dutch interests. The Netherlands would benefit from a self-evident irreversibility of the euro. A number of measures are thus needed in any event, regardless of what direction the EMU takes in its further development. These ‘no regret’ measures include simplifying agreements and rules, with only limited scope for discretionary assessment. In addition to imposing sanctions for non-compliance, temporary positive financial incentives for structural reforms will strengthen the monetary union. At the financial level,

the EMU needs strengthening in any event, along the lines already agreed, including – once problem loans and government debt on bank balances have been settled satisfactorily – completion of the Banking Union and development of the Capital Markets Union. The cost of crises will then be borne more by private investors. There also needs to be greater democratic accountability. One option here within the current treaty provision frameworks is to arrange an inter-parliamentary conference with the European Parliament and the national parliaments to discuss EMU matters. The Dutch House of Representatives and the Senate could conceivably also better align their processes to the European decision-making process.

In addition to these ‘no regret’ measures, there are other changes that are in the Dutch interest which would strengthen the monetary union and support for it, and reduce the risks. These focus on three areas: more stringent enforcement of rules and agreements, dealing with the financial problems of governments in trouble, and mechanisms to allow Member States to share specific economic risks.

In the ‘decentral’ option described above, which is based more on the accountability of the individual Member States, enforcement of agreements by strengthening the position of the national supervisory bodies is combined with the disciplinary effect of the market through credible application of the no-bail-out clause. Where unavoidable, debts are properly restructured. Structural reforms are primarily enforced by the markets. The biggest risk for the Netherlands with this development is that Member States nevertheless develop problems as the result of non-compliance and failing market discipline, with negative consequences for the entire eurozone. To limit this risk, there could be a financial safety net in the form of a European Monetary Fund (EMF) that would offer temporary financial support under certain conditions, and agree preventive packages designed to avoid imbalances. In the most extreme case, a central supervisory authority would need the power to intervene.

In the ‘central’ option, which is based more on accountability on the part of the European institutions, rules and agreements are enforced through greater authority at the European level, with a certain degree of risk-sharing to increase the EMU’s growth potential. Member states that are lagging behind are then offered financial support for their structural reforms. The greatest risk for the Netherlands under this development is that Member States feel less pressure to adjust and undertake effective structural reforms. To limit this risk, an independent supervisory authority could be established, and public

risk-sharing would have to be restricted to temporary financial support under certain conditions. Far-reaching structural extension of public risk-sharing, in the form of a European fiscal capacity, European unemployment insurance or eurobonds, is less appealing from the Dutch perspective so long as there are major structural and institutional differences between Member States. However, it could be in Dutch interests to contribute to financial support that is intended to diminish these differences, and thus reduce the EMU’s vulnerability.

In this development, with its greater focus on integration, a first option for improving democratic accountability is to aim for greater European Parliament engagement. However, citizens will not always see this as a sufficient expression of democratic legitimacy. Therefore, in a ‘central’ approach, the alternative of establishing a new parliament for the eurozone should be considered. This will require amendment to the Treaty. There are four possible approaches to this: a new, directly elected body, a body comprising members of the European Parliament elected in the eurozone countries, a body formed from national members of parliament from those countries, or a hybrid form of these last two. If the eurozone parliament was (partly) made up of national parliamentarians, they would have a double mandate; as well as being a member of their own parliament, they would also be a member of the eurozone parliament.

Hybrids of these two options for the future of the monetary union are also possible. It is thus conceivable that only Member States that fail to comply with the rules and agreements will come under tighter European supervision. That increases national accountability, and acts as an incentive to getting one’s own house in order. Furthermore, transforming the ESM into a financially stronger EMF would, depending on the specific arrangements, allow the ECB to have a more limited remit, rather than it being forced to act as a safety net on too many occasions, as is currently the case. That would be in Dutch interests. In the long-term, supervision of the banks could be handled by a separate European authority, leaving the ECB to concentrate on its core task of monetary policy.

The challenge is to find a future-proof form for the EMU that effectively bridges the gap identified between European decision-making and democratic legitimacy. The answer may be to establish a separate commission within the European Parliament to focus on the eurozone, or to establish a separate eurozone parliament. The Dutch parliament’s procedures could also better anticipate the European decision-making process.

However, achieving greater parliamentary involvement is still no guarantee for public support. In addition to high-level democratic decision-making (input legitimacy), the EMU also needs the acting authority and results to convince citizens (output legitimacy).

The monetary union acts as a counterweight to a rapidly changing international balance of power. It is in the Dutch interest to continue to share responsibility for the further development of the EMU, because that gives us the opportunity to continue the Dutch, successful economic model on the basis of an irreversible currency, and retain open markets in a prosperous Europe. The Netherlands will benefit from investing in the EMU, out of enlightened self-interest.

Introduction

1

On 7 February 2017, the Dutch House of Representatives adopted a resolution proposed by Member of Parliament Pieter Omtzigt.¹ In this resolution the Advisory Division of the Council of State is asked to report on possibilities for improving compliance with European rules and agreements and to identify the advantages and disadvantages of different political and institutional options for the future of the euro. In her letter dated 23 February 2017, the President of the House of Representatives presented the Advisory Division of the Council of State with the following, specific questions to be elaborated:²

- 1 *How could enforcement be improved with regard to the different rules and agreements made to guarantee the euro's stability, reliability and resilience to shocks.*
 - a) *What are the existing agreements, with which objective were they concluded, and in which treaties are they established (such as the Maastricht Treaty, the Stability and Growth Pact, and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union)?*
 - b) *Which agreements have been complied with by Member States of the eurozone since the introduction of the euro? Which agreements have proven difficult to enforce? Is it possible to ascertain the underlying cause of this?*
 - c) *What options are there for better safeguarding compliance with the agreements?*
- 2 *Which political and institutional options does the Council of State distinguish for the future of the euro? What advantages and disadvantages are involved in each option?*

The House of Representatives presented these questions to the Advisory Division of the Council of State in the context of an increasingly intense debate about strengthening the euro and about the future of the Economic and Monetary Union (EMU). Specific proposals are being discussed among circles of academics, policymakers and politicians, while in his annual State of the European Union speech on 13 September 2017, European Commission President Jean-Claude Juncker announced that the Commission will present concrete proposals for strengthening the EMU, which will be discussed at a special 'Euro Summit' about the future of the eurozone in December. The Coalition Agreement of the new Dutch government, which was presented on 10 October 2017,

contains specific commitments,³ and on his departure the former German Finance Minister Schäuble issued a 'non-paper' about the future of the EMU.⁴ It is important to be prepared for this upcoming discussion and always have a clear understanding of the implications for the Netherlands and the Dutch interest, bearing in mind the Netherlands will have to negotiate with 26 other European Member States, 18 of which also have the euro as their currency, and therefore will have to make compromises. Consequently the outcome of negotiations is, by definition, uncertain and can only be steered to a certain extent.

With this in mind the Division explored where its added value lies. It concluded, after first broadly examining the issue, by speaking to experts and direct stakeholders and perusing a large number of reports, academic studies and discussion papers, that the added value is threefold. Firstly the Division considers that the debate is helped by providing a structure, which can be useful when assessing the possible directions in which Europe could head. There are a large number of proposals, and an equally high number of opinions. However, an analysis of the different proposals reveals that the number of perspectives is limited and lends itself to an assessment framework. Secondly, the Advisory Division of the Council of State noted that discussions related to the euro are usually conducted within specific disciplines, but are rarely interdisciplinary. Linking economic, legal and political-institutional aspects, as strived for in this report, could offer major added value. Lastly, the Division found that discussions are usually conducted on the basis of underlying premises related to the desirability of further European integration. Therefore, discussions about the substance quickly become clouded by political views of 'more or less Europe'. The Division wanted to abstract from this by examining several conceivable directions for the future of the Economic and Monetary Union and thus identify how different options that address existing problems, are mutually reinforcing or exclusive. The Division analyses, based on the principle that monetary union is a given fact, the advantages and disadvantages offered by the options – also in relation to the Dutch interest – and strives to clarify the trade-offs between the proposals: each choice has consequences for the next, and more of one often means less of the other.

1 Parliamentary papers II 2016/17, 34 287, No. 4.

2 Letter from the President of the House of Representatives dated 23 February 2017.

3 Vertrouwen in de toekomst (Trust in the Future), Coalition Agreement 2017-2021 between the VVD, CDA, D66 and ChristenUnie, 10 October 2017, pages 49-50.

4 W. Schäuble (2017), Non-paper for paving the way towards a Stability Union.

The Division also looked at the risk of monetary union collapsing. However, it concludes that this risk involves such high costs and practical obstacles – in economic and political terms – that the collapse of the monetary union must be considered to be highly undesirable.

When compiling this report the Advisory Division of the Council of State adopted the following methodology. Firstly, as mentioned above, it broadly examined available studies, reports and discussion papers, of an academic as well as more policy-oriented nature. During a working visit to Brussels, the Advisory Division of the Council of State obtained information from representatives of different European institutions, think tanks and the Permanent Representation of the Kingdom of the Netherlands to the European Union. Insights acquired during the working visit were subsequently assessed during a session with experts from diverse academic and policy-related backgrounds. On several occasions the Division conducted background discussions with people and institutions that possess relevant knowledge and expertise, including the Ministry of Finance, De Nederlandsche Bank (Dutch Central Bank, 'DNB') and the CPB Netherlands Bureau for Economic Policy Analysis.

The resulting report is structured as follows. *Chapter 2* describes the background of the Economic and Monetary Union. This chapter positions the creation of EMU within the broader process of European integration and examines the extent to which the common currency fulfils its original objectives. We move on to examine the faults and the shortcomings of the monetary union such as those that manifested full-scale during the euro crises, and the way in which European policymakers have tried to address these shortcomings in recent years.

One of EMU's faults that emerged is the fact that in practice, Member States of the eurozone only complied to a limited extent with European fiscal rules such as those established in the Stability and Growth Pact and European rules and agreements on structural reforms and boosting competitiveness. This is the subject of *Chapter 3*. This chapter deals with the regulatory framework in the Pact, including additions and amendments since 2011. Experiences of compliance with and enforcement of the rules are mixed, which can largely be explained by the nature of the rules and the way in which they must be enforced. The chapter finally outlines several options to improve compliance with and enforcement of the rules within existing frameworks. Therefore this chapter is closely linked to the first question from Parliament to be elaborated.

Chapters 4 and 5 examine the second question to be elaborated and describes possible directions for the future of the euro. *Chapter 4* first addresses the current discussion about the future of the euro, and outlines and structures the different proposals. In this chapter the Division develops a framework for assessing the various lines of thought. In this assessment framework both socio-economic and political, institutional and legal aspects are included. Future modifications of the EMU's framework must at least ensure that the euro is able to withstand a subsequent economic downturn or financial crisis. The EMU must also offer economic perspectives to residents of all Member States that have adopted the euro as their currency. Popular support for the euro is best served by clearly demarcating competences and responsibilities, taking into account the principle of subsidiarity and ensuring that decision-making is conducted in a democratically legitimate and transparent manner, based on coherent legislation.

In *Chapter 5* the Advisory Division of the Council of State sets out the different directions for the euro's future and weighs them using the assessment framework developed for this purpose. The first direction builds on measures already implemented in recent years and assumes that what has been agreed, particularly in terms of the Banking Union and the Capital Markets Union, will be completed. The measures taken in this direction are necessary in order to address apparent economic-technical imperfections, but are probably inadequate for restoring the trust of citizens in the monetary union in the long-term. In this context the disintegration of monetary union still remains a risk. Given the expected high economic and political costs, such a scenario is undesirable. Therefore, continued strengthening of the monetary union is recommended. To this end, Chapter 5 develops two separate lines of thought. One presupposes the restoration of effective market discipline combined with more decentralised elements with regard to the enforcement of and compliance with fiscal rules and macroeconomic agreements. The other presupposes further European integration, with stricter enforcement of rules at the central level and strengthening EMU governance and institutions.

Chapter 6 brings the different approaches together and assesses them in relation to the Dutch interest. From this perspective a primary concern is the need for improved compliance with and enforcement of the rules and agreements made. A second necessary step involves finalising the requirements for an EMU that operates effectively in economic-technical terms, including completing the Banking Union. Even then, EMU needs to be further developed. Several directions are

conceivable, which could be pursued to a greater or lesser degree. The Advisory Division of the Council of State does not express a preference, but outlines the advantages and disadvantages of the directions, the trade-offs and the diverse implications for the Netherlands. For this purpose circulating proposals are considered in relation to the possible support they offer for the Netherlands' policy preferences. These preferences include maintaining an open and stable trading system, international cooperation on topics of a cross-border nature, policy discipline and respect for agreements, an adequate level of policy competition among countries and market functioning, application of the subsidiarity principle and adequate democratic accountability. More specifically, in the Dutch interest it is important that Member States adjust to imbalances, and that in principle financial support is temporary and must focus on economic strengthening aimed at making permanent financial support unnecessary.

With regard to strengthening the EMU, the Netherlands' primary concern is that in substantive terms it must contribute to structural reforms in participating countries that make the EMU as a whole more robust and stable. In recent years it has become evident that this is not a natural process, but that it requires political decisions and collective efforts by the Member States themselves, which cannot be replaced by common rules. In their efforts Member States can be offered support, provided it is temporary. However, room for permanently sharing public risks within the eurozone, will only arise if and when Member States grow closer together as a result of structural reforms.

The Economic and Monetary Union

2

2.1 The Economic and Monetary Union

In 1992, Member States of the European Community took a very important step in the process of European cooperation with the Treaty on European Union (TEU, 'Maastricht Treaty').⁵ As part of the Economic and Monetary Union, as of 1 January 1999, the national currencies of the Member States that satisfied the accession criteria stipulated in the treaty were replaced by a single, common currency. Henceforth, monetary policy was determined by the European Central Bank (ECB) at the level of the euro area. Budgetary policy remained in the hands of Member States, but was bound by the rules of the Stability and Growth Pact. In 1999, the non-cash euro was introduced in 11 Member States; 12 Member States participated when euro banknotes and coins were introduced three years later. Today, in 2017, the eurozone consists of 19 Member States.

However, the financial crisis of 2008 also undeniably exposed a number of flaws in the original set-up of the EMU. Therefore, since the crisis, ways have been sought to safeguard the stability of the eurozone as a whole. To this end, coordination of Member States' budgetary policy and economic policy was strengthened at the European level and new stability instruments were introduced to help out Member States facing financial difficulties.

A lot was achieved in a relatively short period in terms of institutional reinforcement. As a result the monetary union is stronger and the economic outlook has improved. The euro has proven itself to be a sound currency with low inflation and a strong position on international foreign exchange markets: the euro is a 'hard' currency. The question is whether this would have been the case if the different national currencies were still in place. It demonstrates that the original suboptimal framework has not prevented positive results being achieved following some adjustments. Nevertheless, the question remains whether the existing structure will also prove to be sustainable in the long-term. Questions remain about the coherence of the measures taken and there is doubt about whether the EMU is resistant to new crises and centrifugal forces.

5 Treaty on European Union, Maastricht, 7 February 1992 (*Treaty series* 1992, No. 74).

2.2 EMU and European integration

The EMU cannot be viewed separately from the process of European integration, as it unfolded after the Second World War. Countries sought cooperation to ensure peace and political stability and to work towards an 'ever closer union' in accordance with the Treaty of Rome from 1957.⁶ Moreover, this political objective was pursued through cooperation that was originally focused on economic issues, culminating in a common market with the free movement of goods, services, persons and capital. This process of European cooperation and integration to realise a single internal market without internal borders was successful because it delivered specific, directly discernible advantages for citizens and businesses, while in political terms it was less difficult to give up policy autonomy in these areas.⁷

European cooperation gradually expanded to include more non-economic policy areas and encompass an increasing number of countries. First and foremost, progress in this integration process was determined by the political will of Member States to cooperate, partly influenced by geopolitical events such as the fall of the Berlin wall in 1989. In addition, European integration also acquired its own internal dynamic. As cooperation and integration advanced, new practical problems continuously emerged that also required a European solution. Due to increasing globalisation the number of areas requiring a European approach as a result of cross-border effects, such as combating terrorism, migration, the environment and financial regulation, also increased.

Economic and Monetary Union was viewed as a logical step in the process of European integration, which would offer additional advantages. Firstly, there was the realisation that the advantages of the internal market were not being fully achieved as long as trade flows were still impeded by the existence of different currencies that fluctuated vis-à-vis each other. Hence, as early as 1970, the proposition of a monetary union in the Werner Report. Europe had always strived for

6 Treaty establishing the European Economic Community, Rome, 25 March 1957 (*Treaty series* 1957, No. 91), preamble.

7 Cooperation focused on policy areas with relatively large economies of scale and cross-border effects, and relatively minor differences in policy, and in preferences between countries. European cooperation did not get off the ground in areas in which differences in preferences were greater, such as defence. Hence a plan for a European Defence Community failed in 1954.

some stabilisation of the mutual exchange rates after the collapse of the post-war system of fixed exchange rates, first with ‘the snake in the tunnel’ and then with the European Monetary System (EMS) from 1979. However, the fundamental problem that a system of fixed but adjustable exchange rates is susceptible to speculation on financial markets, remained. Exchange rate crises occurred regularly, and became increasingly frequent and severe from the Eighties, when capital movements were deregulated and capital flows increased significantly worldwide. In addition, many European Member States were struggling with persistently high rates of inflation, significant budget deficits and high government debt.

The regular crises that hit the EMS went hand in hand with political loss of face and formed an obstacle for further integration. The internationally operating European business community lagged behind competitors with a sizeable home market in larger currency blocks. The EMU was intended to finally resolve this issue, and consequently boost mutual trade and financial flows. Inflation would decline with a strong, independent European Central Bank that would pursue a credible monetary policy, inspired by the model of the Deutsche Bundesbank. At the same time the budgetary convergence criteria would ensure that Member States brought their public finances under control before they could join the monetary union. Therefore, EMU would ensure macroeconomic stability and a decrease in interest rates. Consequently EMU would increase prosperity.

EMU also appeared to be a logical step for *political* reasons. After the fall of the Berlin wall a point of concern was how a large reunited Germany could be embedded in Europe in a sustainable geopolitical manner. The EMU offered the possibility of binding Germany more tightly to Europe, and the pursuit of a monetary union thus gained extra political momentum. An additional political advantage for the other EU Member States was that they would have more influence on monetary policy in the monetary union, which was *de facto* determined by Deutsche Bundesbank prior to the launch of EMU. Lastly, another political advantage offered by EMU was that the common currency would strengthen the EU’s position as an economic power. This was viewed as a welcome development due to increasing globalisation and the economic emergence of countries such as China and India.

2.3 Chosen structure and fundamental principles

The structure of the Economic and Monetary Union and the transition thereto was established in the Maastricht Treaty in

1992. The EMU strived to eliminate monetary obstacles within Europe and thus forms a logical next step in completing the single market. EMU is characterised by three core pillars, which are summarised in (current) Article 119 of the Treaty on the Functioning of the European Union (referred to hereafter as TFEU): coordination of economic

policy, a single monetary policy and sound public finances.⁸ The Maastricht Treaty takes a far-reaching step, since monetary policy is placed in the hands of a common institution, the European Central Bank (Article 119, second paragraph), with the primary objective being to maintain price stability.⁹ Without prejudice to this main goal, as a secondary objective the ECB should support the European Union’s general economic policies.

At the same time other EMU components revert to less far-reaching instruments of European cooperation: rules and the coordination of policy (Article 119, first and third paragraphs). The result was that while monetary policy became an exclusive matter for an independent, European authority, economic and budgetary policy became a shared competence of Member States and the Union.¹⁰ These policy areas largely remained in the hands of Member States, while the role of the

8 Article 119, TFEU states:

- 1 For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States’ economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.
- 2 Concurrently with the foregoing, and as provided in the Treaties and in accordance with the procedures set out therein, these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union, in accordance with the principle of an open market economy with free competition.
- 3 These activities of the Member States and the Union shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

9 Article 127, first paragraph, TFEU.

10 See, for example, ECJ 27 November 2012, C-370/12, Pringle, ECLI:EU:C:2012:756, point 50.

EU was limited to taking regulatory and coordinating measures, partly via non-binding instruments. Since unsustainable public finances could have cross-border effects and could undermine trust in the robustness of the common currency, the rules in the Treaty imposed on Member States' budgetary policy are most binding.

In other economic areas there is a light form of control via non-binding instruments such as the broad guidelines for economic policy and the Lisbon Strategy aimed at structural reforms and innovation. In contrast to these relatively light forms of European control, the Treaty includes a number of safeguards, namely the prohibition of monetary financing (Article 123 TFEU), of privileged access to financial markets (Article 124), of bail-out (Article 125) and of excessive deficits (Article 126). Member States would not be responsible for the government debts of other Member States as a result of the no-bail-out clause in the Treaty: the idea is that a Member State in difficulties must cope with the situation itself. The prohibition of excessive deficits is also further reinforced by the Stability and Growth Pact (SGP), which originally consisted of a resolution of the European Council and two Regulations.¹¹

The Maastricht Treaty formally establishes the obligation to join the EMU as soon as Member States satisfy the convergence criteria. Although only Denmark and the United Kingdom obtained a formal opt out, in practice other Member States, such as Sweden, have not complied with the accession obligation either. The Treaty not only contains the basis for EMU, but also reinforces the emphasis on social aspects for the EU as a whole. Thus social progress, a high level of protection and social justice were added to the EU's goals (now Article 3 TEU). Moreover, in its policy and actions, the European Union acquired the obligation to take into account a high level of employment, adequate social protection and combating social exclusion (current Article 9 TFEU).

11 Resolution of the European Council of 17 June 1997 related to the Stability and Growth Pact (OJ 1997, C236, page 1), Regulation (EC) No. 1466/97 of the Council of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ 1997, L 209, page 1) and Regulation (EC) No. 1467/97 of the Council of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ 1997, L 209, page 6)

2.4 Overall developments assessed in terms of the objectives

In monetary terms the EMU has brought a great deal of stability. The euro has proved to be a successful and credible currency, through a sustainable, low rate of inflation and the relatively stable exchange rate, even during the financial crisis and the euro crisis. The euro's purchasing power has been stable and does not lag behind that of the Dutch guilder. Average inflation in the Netherlands since the euro was introduced on 1 January 1999, amounted to 2.0% per year, compared with 2.9% per year over the previous twenty years. The real fear prior to the introduction of the euro that the 'hard' Dutch guilder would be exchanged for a less hard currency, has not materialised.

In addition to the internal stability of the euro, there is greater external stability than before. Since its introduction the euro has hovered within a 15% margin vis-à-vis the US dollar, compared with a 24% margin for the Dutch guilder during the previous sixteen years.¹² To the Dutch business community the introduction of the euro means that since then around 60% of foreign trade can be handled without any exchange rate risk. Major exchange rate crises, which were so typical of the previous period, have no longer arisen since the introduction of the euro.

Mutual trade and capital flows have increased in the euro area as a result of this monetary stability. The dynamics of the internal market have been boosted by the euro and this has provided a positive counterbalance to lower domestic demand in the Western world. Multiple studies reveal that, as expected, the euro has had a positive effect on trade flows and other capital flows, including direct foreign investment in the euro area.

However, in other areas the EMU has not fully met expectations. The EMU has not yet provided additional economic growth. Following a period of initial, favourable economic growth, recovery in the euro area after the crisis lagged behind that in other Western economies. Ten years after the beginning of the crisis, real GNP of the euro area has only increased by 3.5% (first quarter of 2017 compared with the fourth quarter of 2007). Countries outside the euro area, such as Sweden and

12 The margins are calculated as the standard deviation of the bilateral exchange rates over the period concerned, expressed as a percentage of the average rate.

the United Kingdom, performed considerably better during the same period, with almost 12, respectively 9% real growth. These countries did reap the indirect benefit of monetary stability in the euro area, however.

The crisis in confidence in the euro area has caused a significant backlog compared with the multi-year economic growth trend, that has not yet been made up. The euro area was not well prepared for the financial crisis and there was insufficient budgetary margin to take compensating measures. Emergency measures had to be taken to support the financial sector and help countries in trouble. Only recently a more positive growth outlook for the euro area can be seen.

Moreover the EMU has only resulted in the aspired forms of convergence to a limited extent. Convergence is a broad term that encompasses multiple aspects. The accession criteria in the Maastricht Treaty focused on *nominal* convergence. In the run-up to EMU, the Member States' economies indeed converged in terms of inflation and interest rates. Public finances also improved in many Member States. The average budget deficit in the euro area fell from 5.2% of GDP in 1992 to 1.5% of GDP in 1999.

When the euro was introduced, it was expected that the EMU would also automatically result in *real* convergence. It was thought that the euro would have the effect of promoting *income* convergence between countries and regions. Poorer Member States lagging behind in terms of prosperity would catch-up to some degree thanks to increasing monetary stability (they had previously suffered more from high inflation and exchange rate crises with a weak currency) and the greater opportunities offered by the internal market. It was also expected that their growth potential would increase, because they had to implement structural reforms to maintain their competitive position now that the exchange rate adjustment instrument had disappeared. Therefore it was assumed that a necessity for structural reforms would emerge, imposed by the market, so that the similarity of EMU Member States' economic structures would increase (*structural* convergence). As a result of deeper mutual integration, the economies of EMU Member States were also expected to develop more in synchrony with each other (*cyclical* convergence). It was expected that all in all EMU would gradually demonstrate increasingly greater convergence in nominal and real terms and thus operate ever more in line with the economic criteria that apply to optimal currency areas (see text box 1).

Since the beginning of EMU, these different aspects of convergence have either been achieved to an insufficient degree or not at all. Some Member States, including the Baltic States, which only joined EMU later could, on balance, actually catch-up with their income levels compared with the rest of the euro area to a certain extent, as a result of a policy of extraordinary structural reforms. Their per capita income increased from 37% of the EU average in 1999, to 71% in 2015. However in terms of relative income growth, on balance there has been divergence between the economies of the northern Member States of the euro area on the one hand and the southern Member States on the other.

Initially a 'pseudo-convergence' seemed to take place in southern Member States, influenced by the boost of confidence resulting from the introduction of the euro. Domestic demand rose sharply fuelled by strong lending and the abundant development of real estate markets. However, the corresponding faster wage growth led to a deterioration of competitiveness and sharply rising deficits on the current account of the balance of payments. In the southern Member States of Greece, Italy, Ireland, Portugal and Spain, the average deficit on the current account rose from 0.9% of GDP in 1999 to 5.8% of GDP in 2007. At the same time, in Member States such as Germany and the Netherlands, who had focused on wage restraint and structural reforms, surpluses on the current account increased. In the rest of the EMU the surplus increased from 0.6% GDP in 1999 to 4.0% in 2007. Financing these imbalances initially proved easy, because the surpluses in the north enabled capital exports to Member States in the South and because financial markets applied inadequate risk differentiation. At the European level, coordination and monitoring tools proved incomplete and too weak to effectively influence this development.

These imbalances were exposed during the financial crisis. Several Member States were hit hard by the crisis in the form of capital outflows and sharply rising capital market interest rates. They often lacked the initial budgetary room for manoeuvre to absorb major shocks such as the financial crisis. The necessary adjustment was exacerbated by the need to clean up irrecoverable loans on bank balances and moderate wages to restore the competitive position.

Several southern Member States struggled with a deeper and longer-lasting recession and unemployment rose (far) more quickly than elsewhere in the EMU. Between 2008 and 2013, the average GDP of Greece, Italy, Ireland, Portugal and Spain shrunk cumulatively by almost 10%, and unemployment rose

by 9.4 percentage points to almost 18%. In the rest of the EMU, average GDP grew during the period by, on balance, 3% and unemployment rose by just 0.6 percentage points to 7.4%.

In the run-up to the crisis, differences in economic structures between Member States had actually increased. This was despite the realisation that Member States needed structural reforms to operate in the EMU and regardless of European rules and agreements such as the Lisbon Strategy. Apparently, following accession to the EMU there was no sense of urgency, which led to reforms being postponed – partly due to the generous financial conditions and easy financing of deficits. What is striking is that income inequality within countries with delayed reforms is usually far higher than elsewhere: the Gini coefficient, which provides an indication of the income inequality in a country, of Cyprus, Greece, Italy, Portugal and Spain is, on average, 33.8, compared with 26.7 in the Netherlands (2015 figures).¹³ In these countries it proved difficult to implement reforms that affected the existing rights of protected groups, and this perpetuated income inequality related to the people in a weaker position on the labour market or the unemployed that receive no protection. A visible shift only recently emerged, now that many Member States are reforming due to the pressures felt after the crisis.

All in all there was no income convergence between the twelve original EMU Member States (see Table 1). During the period between 1999 and 2016, Greece fell behind even more and Portugal has not improved its position. In contrast, Spain has been able to improve its relative position across the period as a whole. Italy shows the greatest relative decline in GDP per capita. On the other hand Germany, the Benelux countries and Austria have been able to increase their relative income lead. After Luxembourg and Ireland (where the figures are strongly influenced by specific factors such as the profits of major international companies) the Netherlands maintains its position as the country with the highest GDP per capita in the EMU. Therefore, one may conclude that northern Member States have been able to profit more from the euro than southern Member States, partly thanks to their domestic policy.

Table 1: GDP per capita in the original 12 EMU Member States

(% of average)	1999	2016
Portugal	72.0	71.5
Greece	75.0	62.6
Spain	80.9	84.7
France	99.3	98.0
Finland	100.6	101.2
Italy	103.7	89.1
Belgium	104.2	109.4
Germany	108.0	114.6
Ireland	109.8	167.9
Austria	111.9	117.3
The Netherlands	117.6	119.2
Luxembourg	205.3	250.8

The performance of the eurozone with regard to convergence would have been better if there had been greater focus on structural reforms for product and labour markets and if bank balance sheets had been cleaned up more quickly after the crisis, as in the United States. On balance, economic performance would also have been better if there had been a more equal distribution between adjustment and financing, both before and after the crisis. In the run-up to the crisis, it was easy to finance deficits, resulting in sharply rising imbalances and a large burden to reform when funding dried up. International institutions such as the International Monetary Fund (IMF) claim that the aggregate demand in the euro area would have been better maintained after the crisis if Member States with a strong competitive and balance of payment position, including Germany and the Netherlands, would have temporarily allowed a greater boost to expenditure. However, Germany and the Netherlands remained focused on improving their own fiscal position, though largely in line with fiscal rules in the Stability and Growth Pact. This meant that the need to reform was placed to a greater extent on Member States with a deficit. The SGP thus has an asymmetrical character since structural budget deficits are not permitted, while budget surpluses are not subject to any limits.

2.5 The euro crisis: proven flaws and shortcomings

2.5.1 'Anticipated' deficiencies

The global financial crisis had negative consequences for many countries outside the EMU. However, the negative impact in the euro area was exacerbated by a number of deficiencies in

¹³ The Gini coefficient is expressed as a number between 0 and 100. The closer the number to 0, the smaller the inequality.

the original set-up of the EMU, brought to light by the euro crisis. Some of these deficiencies were not anticipated, but already before the start of the monetary union concerns were raised whether the eurozone adequately constituted an ‘optimal currency area’ in view of the differences in the economic structure of the participating Member States, and the limited transfer of sovereignty to the European level (see text box 1). The disappearance of mutual exchange rates made it impossible to absorb shocks through exchange rate adjustment and consequently alternative adjustment mechanisms were required in the monetary union. Critics pointed out that these were available to a lesser extent than, for example, in the United States, which despite major differences between States, still comes closer to an optimal currency area. Labour mobility between Member States in the eurozone is relatively low and the European budget too small to absorb shocks. As a result the fear was that the EMU would suffer more from cyclical fluctuations.

There were also concerns about the asymmetry between the single monetary policy and decentral budgetary and economic policy, based on shared competences of Member States, the Council and the Commission. There were fears that compliance with the agreed rules and criteria would (or could) not be adequately enforced. Therefore, some observers expected that the monetary union would ultimately need a form of political unification that would promote greater unity of budgetary and economic policy. However, it was unclear whether the monetary union would naturally grow towards this or what such a political union would actually involve.

Text box 1: Monetary union economic requirements: EMU versus the US

The theory of optimal currency areas offers a guideline for the economic requirements for monetary union. It describes the characteristics that are decisive for successfully merging countries’ currencies. The criteria are applied to determine how vulnerable countries are to economic shocks and the alternative adjustment mechanisms that are available. The theory is not entirely ‘conclusive’ in the sense that in practice not a single monetary union fulfils all the criteria. What stands out is that financial aspects, which played such a major role in the euro crisis, are underdeveloped in the theory.

Based on the original theory and recent literature about the euro crisis a number of criteria can be used to make a comparison between the EMU and the US.

- **Asymmetric shocks.** The most recent studies do not identify any major difference in the asymmetry of shocks in the *short term* between Member States of the EMU and the different States of the US. However, competitiveness, credit expansion and current account balances do differ within the EMU in the *long term*.
- **Labour mobility.** In the EMU labour mobility between and within Member States is considerably lower than between States in the US.
- **Wage and price flexibility.** Wages and prices in the EMU are less flexible than in the US, mainly because labour and product markets are relatively rigid due to stricter regulation.
- **Private risk sharing via financial markets.** Thanks to fully integrated stock and capital markets in the US, the largest share of economic shocks are absorbed by the private sector, because residents of other States bear the risks. In the EMU this private risk sharing is less developed than in the US.
- **Federal budget.** In the US the federal budget absorbs part of the shocks, albeit to a lesser extent than the instrument of private risk sharing mentioned above. In the EMU budgetary stability must be entirely managed in a decentralised manner.
- **Stability of government debt funding.** In the US funding of government debt is relatively stable, because almost all debt is federal and the Federal Reserve can act as a *lender of last resort*. Many States have a legal obligation to balance their budgets. However, in the EMU almost all debt is decentralised and there was no central *lender of last resort* until the launch of the ECB’s Outright Monetary Transactions (OMT) Programme in 2012.
- **Interaction between banks and governments.** During the EMU crisis, negative interaction between banks and governments occurred because the banking sector is relatively large and banks have large amounts of their national government’s bonds on their balance sheets. In the US the banking sector is smaller and more diversified, while there are predominantly federal monitoring and resolution mechanisms. The Banking Union should eradicate this negative interaction in the EMU.

Some of the proven deficiencies in the EMU's set-up are linked to these previously cited concerns or unfulfilled expectations. The SGP's instruments proved inadequate for enforcing fiscal discipline in all circumstances once Member States had joined the monetary union. The European Council of Ministers or the European Commission regularly shied away from enforcement and there was a great reluctance to impose sanctions. The rules were perceived as being imposed externally – there was insufficient ownership – and there were also objections that they took inadequate account of special circumstances. After the Council rejected the Commission's proposal in 2003 to penalise France and Germany, which had both failed to satisfy the fiscal rules for the second year in a row, the Pact's credibility came under pressure. The SGP was reformed in 2005. As a result the Pact became less rigid and offered more flexibility to take into account diverging circumstances in a Member State. Moreover, although it was clear that Member States required structural reforms and alternative adjustment mechanisms to compensate for the disappearance of the exchange rate instrument, in order to function effectively in the EMU, such reforms barely got off the ground in the lead up to the crisis.

The consequence of this failure to comply with the rules and agreements was that many eurozone Member States were not adequately able to absorb shocks when needed during the crisis. Due to the lack of reforms the Member States' capacity for adjustment left a lot to be desired, while incomplete compliance with the fiscal rules frustrated the room for manoeuvre to stabilise budgetary policy. Since Member States did not sufficiently distance themselves from the 3% threshold for the budget deficit in the SGP in good times, in times of recession expenditure had to be cut relatively early on. Government debt decreased less than if there had been full compliance with the rules. All in all, initial budgetary and structural positions in many Member States were inadequate for coping with the consequences of the financial crisis.

2.5.2 'Unforeseen' deficiencies

Nevertheless, the euro crisis also brought to light shortcomings in the EMU's set-up that had not been anticipated. The crisis was not only due to a lack of compliance with and enforcement of the rules. During the years prior to the financial crisis, Spain and Ireland largely complied with fiscal rules. In 2007, Spain had a government debt of 36% of GDP and Ireland of 24% of GDP. In these Member States the crisis stemmed more from excessive lending by banks and the emergence of housing bubbles. In the end the government had to step in, resulting in large budget deficits. For a large part the

shortcomings in the EMU's set-up that had not been anticipated are also related to the significant increase in the importance of financial factors in Western economies since the Maastricht Treaty was signed 25 years ago. The beginning of the EMU coincided with a policy of deregulation and liberalisation of the financial sector, preceded by a general liberalisation of international capital movements. This resulted in rapid financial development and integration worldwide. Financial institutions became more intertwined and increasingly invested across the border. Bank balance sheets experienced strong growth, often amounting to several times the size of the economy of their home country. When the financial crisis started to unfold in 2008, the average size of the banking sector in the euro area was 340% of GDP. In individual Member States the size varied from 170% of GDP in Italy to 470% of GDP in the Netherlands and 860% of GDP in Ireland.¹⁴

The risks involved in this strong financial development were for a long time insufficiently acknowledged in economic theory and by policymakers in almost all developed countries. The EMU's architecture did not take it into account either. Financial factors barely played a role in the Maastricht Treaty, which mainly focused on nominal economic objectives such as low inflation and stable budgets. Financial factors did not play a role in the theory of optimal currency areas either, which predominantly focused on real economic indicators such as more effective adjustment to economic shocks. Consequently the euro crisis exposed new deficiencies.

The original structure of the EMU contained inadequate safeguards for combating financial-economic imbalances. The economic rules in the EMU primarily focused on public finances, but did not pursue any, or barely any, other aspects of macroeconomic policy. Based on the view that henceforth, the eurozone was a single entity, increasing differences in competitiveness and imbalances on the current account of the balance of payments were not considered a problem for a long time and accordingly, there was no policy response. No account was taken of the possibility that funding for these deficits could no longer be available in times of crisis. There was also little or no regard for possible unsustainable developments in the growth of credit, house prices and private debts. It now proved necessary to act on these gradually accumulating imbalances

14 Since the euro crisis the average size of the banking sector in the euro area fell to around 290% of GDP in 2016.

early on, to prevent such serious crises occurring, which might question a country's participation in the EMU.

The original set-up of the EMU also failed to take the risks of the financial sector for Member States into account. Within the monetary union, supervision of the financial sector remained a national matter, even though banks were getting larger and their operations more international. The problems in the financial sector that manifested in the crisis were so large that intervention was required. Rescue operations had a major effect on national public finances, all the more since the banking sector in many EMU Member States had become relatively large – and thus costly to rescue. At the same time, European banks are vulnerable to the creditworthiness of their respective governments, because their balance sheets include substantial holdings of their home country's government's bonds. During the crisis, this led to a negative interaction between the two, which increased the financial turmoil significantly. The intertwining of national governments and banks was a 'blind spot' and was only acknowledged later.

Lastly, the original set-up took no account of the possibility of a financial crisis occurring within the monetary union: there was no stress scenario. The EMU had no instruments for effectively dealing with a potential crisis, but relied entirely on the no-bail-out clause in the Maastricht Treaty (Article 125 TFEU). However, its application proved to be problematic now that the greatly expanded financial integration had increased the risk of mutual financial contagion, and of sudden outflows of capital and excessive reactions on financial markets. EMU Member States also proved more vulnerable than other countries with their own currency. One of the reasons for this was that EMU lacked a *lender of last resort* that could supply national governments with liquidity in the case of a financial emergency. This was also an important factor for the euro crisis to develop. In combination with the above deficiencies, it led to such great financial turbulence that full enforcement of the no-bail-out clause would have resulted in high costs.

2.6 Adjustments over the past few years

Under pressure of the crisis, eurozone Member States have taken important measures that address the proven deficiencies and that strengthen the architecture of the EMU. Three measures stand out: adjustments to the rules and agreements, the establishment of a support mechanism for Member States in trouble, and the creation of the Banking Union.

Reinforcing rules and agreements

To reinforce compliance with and enforcement of the fiscal rules in the SGP, a number of important adjustments were implemented from 2011 onwards. They are enacted in seven Regulations and one Directive (the so-called 'Six Pack' (2011) and 'Two Pack' (2013)).¹⁵ These adjustments strive to strengthen the 'preventive' and 'corrective' arms of the Pact focused on preventing, respectively curbing, excessive budget deficits. They also provide for recommendations and sanctions to be applied 'automatically' in many cases, since a Commission recommendation can only be rejected by the Council by a qualified majority. This makes it more difficult for the Council to block sanctions recommended by the Commission in the event of a violation of the rules. At the same time the SGP has become less mechanical, because it offers more room for taking into account the specific economic circumstances that apply in a Member State. All things considered, in the SGP the Commission's discretionary powers to press Member States to adjust their budgets are increased.

Moreover, in 2012, 25 EU Member States concluded the Fiscal Compact, part of the Treaty on Stability, Coordination and Governance in the EMU (TSCG).¹⁶ Member States are obliged to incorporate part of the European fiscal rules in national legislation, preferably in their constitution. The intention is that Member States internalise the rules more effectively as a result and assume 'ownership' of the European fiscal rules. This addresses the shortcoming that the rules were considered too often as being imposed externally. Compliance with the rules will be monitored by independent, national supervisory authorities.

15 The Six Pack includes the following regulations: Regulation (EU) 1173/2011, Regulation (EU) 1174/2011, Regulation (EU) 1175/2011, Regulation (EU) 1176/2011 and Regulation (EU) 1177/2011, and Regulation (EU) 2011/85. The Two Pack includes the following regulations: Regulation (EU) 472/2013 and Regulation (EU) 473/2013.

16 The Fiscal Pact (Title III TSCG) stipulates that parties to the treaty shall strive to balance their budgets (Article 3, first paragraph (a)). Countries will anchor this principle in national law (Article 3, second paragraph) and design a corrective mechanism that is automatically activated if compliance with the medium-term objective for the structural balance, or the prescribed path to this objective, fails (Article 3, first paragraph (e)). If government debt exceeds 60% of GDP countries must annually improve it by one twentieth of the difference (Article 4). In addition countries must establish independent authorities that will monitor compliance with the rules (Article 3, second paragraph).

The final element in adjusting the rules and agreements involves macroeconomic supervision being reinforced with the introduction of the Macroeconomic Imbalance Procedure (MIP). In principle it will address the proven flaw that Member States implemented structural reforms insufficiently and focused too little on strengthening national adjustment mechanisms. Based on the MIP procedure the Commission will annually assess the risk of Member States being faced with imbalances. An initial stocktaking is performed using a scoreboard featuring different indicators with threshold values.¹⁷ These indicators concern, for example, the balance on the current account, competitiveness, growth in house prices and lending and the rate of (youth) unemployment. The Commission performs follow-up studies for Member States that clearly exceed these established threshold values. If the Commission concludes that the imbalance is 'excessive' the Council of Ministers may issue policy recommendations for addressing the imbalance. If Member States do not act upon these recommendations, the Council may ultimately impose fines.¹⁸

Establishing support facilities

A second reform intended to address the proven deficiencies concerns the establishment of facilities that may provide Member States in trouble with temporary financial aid. The safeguards included in the Maastricht Treaty ultimately proved to be untenable under the immense pressure of the crisis: despite the no-bail-out clause financial support was needed for Member States – also in the interest of banks in other Member States, which had provided generous lending and had taken insufficient account of the risks. Once Member States had agreed on temporary emergency arrangements such as the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stabilisation Facility (EFSF),¹⁹ a permanent fund was created in 2012: the European Stability Mechanism (ESM). The ESM has over €500 billion in financial resources thanks to capital contributions and guarantees from EMU Member States. The ESM can provide governments that have lost access to the capital market with temporary financial support subject to strict conditions (conditionality). This ensures that financial turbulence, capital flight and contagion

may be prevented and absorbed more effectively in the event of future crises.

Out of necessity the ECB also provided a lot of financial aid during the crisis. The ECB had to provide long-term liquidity support to banks on a large scale. This resulted in rising balances of the central banks of eurozone Member States in the TARGET2 system (see text box 2). In addition, it proved necessary to buy government bonds of Member States hardest hit by the crisis, while later it was announced that this measure could, in principle, be unlimited under specific conditions.

Text box 2: How the TARGET2 system works

TARGET2 is the ECB system used by European banks to process (cross-border) payments for their account holders. When a payment is transferred by an account holder in one Member State to an account holder in a different Member State a parallel transaction is processed in the background between the national central banks of the two Member States. At the end of each business day, the balance is drawn up and for each central bank it is established whether there were net payments or receipts. Not the bilateral position of one central bank in relation to the other is relevant in this regard, but the net position of the individual central bank in the system as a whole. This net position subsequently results in an obligation or a claim from the central bank concerned vis-à-vis the ECB; in TARGET2 individual national central banks do not have any obligations or claims with regard to *each other*.

In the EMU the balances of the individual national central banks in the TARGET2 system were close to balance for a long time. However, during the years of the crisis the balances rose significantly, with deficits in southern Member States and surpluses in the North. If the balances were relatively low before the crisis, during the years of the crisis the balances rose sharply to almost €1,000 billion in 2012. This was related to the capital movements from the peripheral Member States to the relatively strong Member States, but also to the ECB's policy to provide liquidity on a large scale to commercial banks that had no other options to fund themselves as a result of the inter-bank and financial markets drying up. Since the peak of the crisis, the balances have decreased somewhat, but recently there was again an increase, partly influenced by the ECB's unconventional monetary policy.

17 See Articles 3 to 5 inclusive of Regulation (EU) 1176/2011 on the prevention and correction of macroeconomic imbalances.

18 See Article 3, second paragraph, of Regulation (EU) 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

19 Regulation (EU) 407/2010 (OJ 2010, L 118, page 1).

Based on the integrity of the monetary union, the TARGET2 balances as such are not problematic. They are the result of a lack of confidence in (the banking sector of) weaker Member States, but are actually administrative balances, which are not ‘settled’. This would be different if a Member State were to leave the monetary union. In this case the central bank of the Member State in question would have to settle (in euros) a potentially negative balance (debt) in the TARGET2 system. If the central bank concerned cannot satisfy its obligations, this could result in a loss for the remaining central banks in the Euro system, which would be distributed in proportion to the share in the ECB’s capital key.

Banking Union

The third reform concerns the establishment of the ‘Banking Union’. In a common supervisory framework it provides for a single supervisor – the ECB – that supervises all major banks, a Single Resolution Mechanism in case a bank is in trouble, and a common deposit insurance scheme.²⁰ With the Banking Union the intertwinement between banks and national governments – one of the unforeseen deficiencies of the EMU – is reduced. To avoid taxpayers footing the bill for the costs, from now on private lenders will bear a share of the losses (so-called ‘*bail in*’). A share of the costs of the resolution of insolvent banks may also be paid by the European resolution fund, which is gradually replenished by the banks. A common deposit insurance scheme (EDIS) as the final element of the Banking Union is still in the pipeline.²¹

20 The Single Supervisory Mechanism is established in Regulation (EU) 1024/2013 and Regulation (EU) 468/2014, the Single Resolution Mechanism in Regulation (EU) 806/2014.

21 A European deposit insurance scheme would reduce the vulnerability of national insurance schemes in the case of a major local shock, and thus the negative interaction between banks and national governments. See the European Commission proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme (COM(2015) 586). In October 2017, the Commission proposed the scheme be introduced gradually and in stages (European Commission Communication of 11 October 2017 on completing the Banking Union, COM(2017) 592).

2.7 Evaluation of the strengthened monetary union

The various adjustments implemented in recent years have definitely reinforced the architecture of the EMU. Important deficiencies have been addressed, public finances in many Member States have visibly improved and the capital position of banks has been strengthened. A number of Member States that were hit particularly hard by the crisis, including Ireland and Spain, have implemented significant structural reforms and managed to regain an upward growth path. Greece has put the worst of the crisis behind it, even if the burden of debt still casts a shadow on its future prospects. At the same time some of the measures taken in a number of EMU Member States are controversial. There are also a number of important points to make with regard to the adjustments implemented.

In socio-economic terms one important point is that the recent amendments have considerably reduced the risk of new crises, but in themselves do not yet offer Member States and citizens the economic and social perspective necessary to ensure sustainable popular support for the euro (see Chapter 4). To this end the economic functioning of the EMU could still be improved further. Also, more needs to be done in Member States as well as at the European level, to improve the adjustment related to normal cyclical fluctuations. There are still many obstacles to private risk sharing in the EMU, because a Banking Union may have been created but there is still no Capital Markets Union. The negative interaction between banks and governments may also have been reduced, but not fully eliminated. Without a Capital Markets Union financial markets and bank balances in the EMU continue to retain a national ‘bias’ that perpetuates this negative interaction between banks and governments and hinders the absorption of local shocks by the private sector in other Member States. A Capital Markets Union would make the EMU more crisis-resistant than it is at the moment; text box 5 in Chapter 5 explores this topic in more detail. It is also desirable for the EMU to contribute more than it currently does to economic development and prosperity in all Member States. To date it has proven difficult to stimulate Member States to implement structural reforms that contribute to growth capacity and convergence in the EMU.

From the political-institutional perspective one important point is that as a result of the adjustments, the monetary union has acquired a different character than originally intended in the Maastricht Treaty. One of the fundamental changes is that Member States share financial risks despite the no-bail-out

clause in the Maastricht Treaty. This not only occurred explicitly through facilities such as the ESM, but also implicitly via the ECB's balance sheet. Consequently, the credibility of the no-bail-out clause has largely been lost in practice. In the context of risk sharing the ECB has assumed a decisive role in combating the financial crisis and its aftermath, due to the lack of political decision-making. Due to the pressure of the circumstances and the deficiencies that came to light during the euro crisis, tools were also created by the ECB that were not provided when the EMU was designed. In 2010, the ECB set up the Securities Markets Programme (SMP) in which government bonds were purchased on a large scale from Member States that found themselves in trouble. Since 2012, the ECB can, in principle, use the Outright Monetary Transactions (OMT) Programme – the SMP's successor – under certain conditions, to buy up unlimited government bonds from European governments in difficulties, although this programme has not yet been used. During the crisis, the ECB also provided extra long-term liquidity to European banks, which contributed significantly to the higher balances in the TARGET2 system. Since 2015, in the context of the policy of Quantitative Easing, the ECB purchased government bonds and corporate bonds in all Member States on a large scale (between 60 and 80 billion euro a month). The objective of this policy is to ensure monetary easing – as applied by central banks in many other developed countries – for the euro area as a whole, partly because the aftermath of the crisis led to lower inflation than the definition of price stability, with the risk of economically harmful deflation.

From a monetary point of view the ECB's actions were necessary, because the intertwining of government debt and bank balances threatened to deadlock the monetary transmission mechanism. At the same time the ECB, as a result of the proven deficiencies in the EMU's structure and the ineffectiveness of other institutions of the EMU, acquired a role that extends to the boundaries of its mandate, due to the design and large-scale implementation of its instruments. Due to the lack of a central budgetary authority the ECB acted as the EMU's custodian. Following questions from the Bundesverfassungsgericht in Karlsruhe, the German Federal Constitutional Court, the European Court of Justice ruled that the SMP and OMT programmes fall under the ECB's mandate and do not conflict with the prohibition of monetary financing (Article 123 TFEU).²² The Bundesverfassungsgericht

accepted this ruling – albeit with a few ifs and buts.²³ The Bundesverfassungsgericht has since asked the Court of Justice to also rule on the question of whether monetary financing is involved in the purchasing programme used for Quantitative Easing.²⁴ As a result of these measures the financial risks to the ECB's balance sheet increased significantly and therefore the risks EMU Member States share.²⁵

Moreover an institutional issue arises with regard to placing monetary policy and supervision under the same roof. Since European supervision had to be established under serious time pressure, it is understandable that it was brought under the ECB's umbrella. The question is whether this is the most desirable situation in the long term, given that supervision and monetary considerations do not necessarily always run parallel and that tension may arise between the two tasks.

No internationally accepted best practice exists for this: some countries have brought supervision and monetary policy under one roof, others have separated the two tasks.

Combining the two tasks may provide synergies for increased effectiveness. This is why the United Kingdom restored the task of banking supervision to the Bank of England after the financial crisis. On the other hand, there is a risk that the primary task of the ECB – monetary policy – is compromised by concerns about the stability of the banking sector.

The unrestricted application of the interest rate tool may be hampered by considerations of financial stability. An increase in interest rates could also cause problems for banks in weaker countries. The monetary transmission mechanism could also be compromised if banks' lending is limited by supervisory rules. To a certain extent this conflict of interests is acknowledged by separating the supervisory roles within the ECB and placing them with the Supervisory Board.²⁶ More generally one could question whether it is desirable, from a perspective of checks and balances to place monetary policy and the

22 ECJ 16 June 2015, C-62/14, Gauweiler, ECLI:EU:C:2015:400, points 93 to 126 inclusive.

23 BVerfG (German Federal Constitutional Court) 21 June 2016, 2 BvR 2728/13 et al. (OMT).

24 BVerfG 18 July 2017, 2 BvR 859/15 et al. (quantitative easing). Referred to by the ECJ as C-493/17.

25 The ECB decided not to apply risk sharing to a portion of government bond purchases in the context of the monetary easing policy.

26 Nevertheless, decision-making ultimately rests with the Governing Council of the ECB, because it is the ECB's only decision-making body, pursuant to European treaties. However, the Governing Council of the ECB can only fully approve or reject the decisions prepared by the Supervisory Board.

supervision of large banks in the hands of a single legally independent, central European authority.

Another fundamental change in the EMU's set-up is that the degree of European influence on national policy has increased significantly. This not only applies to Member States that have had to implement far-reaching reforms and expenditure cuts in exchange for a financial aid programme; the rules have also been extended under 'normal' circumstances. The SGP and MIP have become sizeable and complex as a result of the extensive set of secondary regulations and soft law, which can be applied by the Commission with a wide margin of appreciation. This may become problematic, depending on the competences under the Treaty, now that this margin of appreciation in the SGP does not relate to 'technical' and implementation issues, but to the policy areas that are often viewed in political terms as the core of Member States' own socio-economic policy. The consequence is that debates on the (democratic) legitimacy of the application of the rules may arise quickly (see Chapter 4). Moreover, there is a risk that the complexity and discretionary assessment margin comes at the expense of compliance with and enforcement of the rules (see Chapter 3).

A more general point that emerges with regard to the solutions that were often agreed upon under intense pressure, is the institutional complexity that has been created as a result. In the past period, institutional developments within Europe have largely taken shape by what was feasible in political and practical terms in a short period of time; at times agreement between all Member States was not possible or financial support at the EU level was insufficient. In addition to Community instruments various other instruments were applied: new treaties (outside the regular European treaties), policy coordination, general guidelines and diverse forms of cooperation. Although the TSCG is not formally part of the European legal order, it does partly rely on the EU institutions. The traditional 'unity' of the institutions is broken as a result. The ESM, as well, is based on a treaty that is not formally part of European Union law.²⁷ This all illustrates that the consistency of legal anchoring could still be improved, for example, by incorporating these treaties in European Union law over time.

27 Although the ESM is based on the TFEU, in which eurozone Member States are expressly authorised to introduce a euro stability mechanism: see European Council Decision 2011/199/EU of 25 March 2011 (OJ 2011, L 91, page 1) third paragraph of Article 136 TFEU.

Lastly, there are important issues in the area of democratic involvement and accountability, which ultimately may negatively impact the EMU's democratic legitimacy.²⁸ Decisions at the European level are often jointly taken by representatives of Member States without making effective control possible at the parliamentary level in each Member State. This results in a different balance in terms of democratic legitimacy: with regard to decision-making governments occupy a dominant position, whereby *de facto* they can only be controlled to a limited extent by their parliaments. The increasing institutional complexity of the EMU hampers the involvement and accountability of parliaments as well. Lastly, the ECB's independent position leads to decisions which, although taken in view of monetary considerations, carry major financial risks, detract from the intention behind the no-bail-out clause and are only subjected to democratic control to a limited extent.²⁹

It is clear that European treaties have few specific regulations for matters that only concern the eurozone. The European Commission and the European Parliament may have agreed a practical working method for discussing subjects that affect the European Semester and the SGP, but this working method has not been formally laid down. Democratic accountability for decisions taken by the Eurogroup is also limited. The Eurogroup, consisting of the finance ministers of eurozone Member States,³⁰ is not a formal configuration of the Council of Ministers and thus does not fall under the rules related to openness and transparency (Article 16, paragraph eight, TEU). Nevertheless, in practice the Eurogroup plays a major role in preparations for decision-making, which became particularly evident during the crisis. The Eurogroup is not accountable to

28 This issue must be considered in the context of the broader debate on the 'democratic deficit' in the EU. See Chapter 4.

29 Nevertheless, the ECB tries to promote the transparency and accountability of its policies. When implementing monetary policy the ECB uses press conferences, makes the minutes of its meetings public and regularly engages in dialogue with the European Parliament. A number of ECB supervision-related matters have also been established in legislation. Every year the ECB must publish a report about the implementation of its supervisory tasks and must respond to questions from the European Parliament and national parliaments (Articles 20 and 21 of Regulation (EU) 1024/2013 of the Council of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ 2013, L 287, page 63)).

30 Protocol No. 14 to the Treaties.

the European Parliament, but its members are accountable to their respective national parliaments. Partly due to the limited circulation of Eurogroup documents and the special circumstances in which decisions are sometimes unavoidably taken at the European level, the image emerges in which national parliaments can only hold their minister of finance accountable to a limited degree when it comes to discussions held in the Eurogroup and the resulting measures.

In addition, during the crisis intergovernmental treaties were concluded that are not formally part of the European Union's legal order. The European Parliament as well as, for example, the European Court of Auditors, do not play any role or have any competences with regard to these treaties.³¹ Other provisions related to openness and transparency that apply to the EU institutions do not apply to the ESM either.³² In its earlier recommendation on the ESM treaty the Advisory Division of the Council of State equally pointed out that it deems the lack of control mechanisms in the EU context problematic.³³

When it comes to contributions from national parliaments, the picture differs from one Member State to another. Various national constitutional courts have confirmed the role of national parliaments with regard to the ESM and some have fine-tuned it. The German Bundesverfassungsgericht established that the German Bundestag must continue to have the right of consent with regard to fundamental budgetary decisions related to revenues and expenses, also if these arise

from international or European obligations.³⁴ In its recommendation on the ESM treaty the Advisory Division of the Council of State also pointed out that, partly in light of the right of the Dutch parliament to approve the budget,³⁵ a provision must exist at the national level that does justice to the need for democratic control of the actions performed by the competent minister in the context of the ESM.³⁶

Such a provision is possible, similar to that incorporated in the German ESM-Gesetz;³⁷ this matter is taken up in section 4.4.3. However, in practice the role of national parliaments appears limited. National parliaments may be formally involved but in practice they actually lag behind due to the need to act swiftly, e.g. in the context of the ESM.³⁸ This is often viewed as problematic in Member States. The fact that national parliaments previously agreed with the related intergovernmental treaties, may not detract from this finding.

2.8 Conclusion

The EMU created a strong currency with low inflation, which in terms of purchasing power is on a par with the 'hard' currencies such as the German mark and the Dutch guilder that preceded it. The euro has contributed to intensifying trade within the euro area, from which the Netherlands has been able to profit as a trading country par excellence. However, the EMU has not satisfied the expectation that it would increase convergence between participating Member States. This is partly because the EMU does not function as a fully-fledged economic union with all corresponding instruments. But it is also due to the fact that Member States did not adequately implement structural reforms that promote growth in their respective countries. The result is that the burden of

31 The Advisory Division also elaborated on this matter in previous recommendations and advice. See the Advice from the Advisory Division of the Council of State of 1 March 2012, on the ratification act of the Treaty establishing the European Stability Mechanism (W06.12.0042/III), Parliamentary papers II 2011/12, 33 221, No. 4, as well as the Advice from the Advisory Division of the Council of State of 18 January 2013, related to anchoring democratic control for reforms of economic governance in Europe to combat the economic and financial crisis (W01.12.0457/I), Parliamentary papers I 2012/13, 33 454, No. AB.

32 Article 32, fifth paragraph, of the Treaty establishing the European Stability Mechanism explicitly states: 'The archives of the ESM and all documents belonging to the ESM or held by it, shall be inviolable'.

33 Parliamentary papers II 2011/12, 33 221, No. 4.

34 For the first time in two rulings about the EFSF, the predecessor to the ESM: BVerfG 7 September 2011, BVerfGE 129, 124; BVerfG 28 February 2012, BVerfGE 130, 318. Subsequently repeated in the rulings on the ESM and the OMT.

35 Article 105 of the Constitution.

36 Parliamentary papers II 2011-2012, 33 221, No. 4.

37 Gesetz zur finanziellen Beteiligung am Europäischen Stabilitätsmechanismus.

38 Advice from the Advisory Division of the Council of State of 18 January 2013, related to anchoring democratic control for reforms of economic governance in Europe to combat the economic and financial crisis (W01.12.0457/I), Parliamentary papers I 2012/13, 33 454, No. AB, page 11.

adjustment to imbalances in practice mainly rested with Member States with a deficit.

Far-reaching convergence will appear to be an illusion. Also within large federal states such as the United States and Germany highly divergent developments persist, sometimes for prolonged periods of time. In the United States because of concentration and specialisation of economic activities on the East and West Coast, large areas in the centre of the country are left behind. In Germany, almost thirty years after reunification, there are still major differences in income levels between former West and East Germany. Just as the differences between the north and south of Italy are proving tenacious, despite major financial injections by the Italian government. If countries themselves cannot succeed in achieving internal convergence, one cannot expect this to occur forcibly via the EMU. The differences within the euro area will continue to exist and could even increase. What makes the situation different is that, as long as the euro is not viewed as irreversible, persistent differences may translate into the political sentiment among parts of the population that economic opportunities for a Member State could be better outside the monetary union. This political choice does not exist in the US. Another thing that makes the situation different is that the euro area has insufficient clout to take compensatory measures.

Furthermore, the beginning of the EMU coincided with a policy of deregulation and liberalisation of the financial sector, preceded by a general liberalisation of international capital movements. The associated risks were insufficiently acknowledged for a long time and were not considered at all in the EMU's set-up. Financial factors barely played a role in the Maastricht Treaty, which mainly focused on nominal economic objectives such as low inflation and stable budgets. The original structure of the EMU also failed to take the risks of the financial sector for Member States into account. During the crisis, this led to a negative interaction between the two, which increased the financial turbulence significantly. The intertwining of national governments and banks was a 'blind spot' and was only acknowledged later.

The deficiencies in the EMU's design – some of which were anticipated, some of which were not – have been addressed. However, they also give rise to questions about the complexity of regulations and institutional diversity created, questions related to compliance with and enforcement of the rules and agreements, and to democratic legitimacy and questions about the role of the ECB. In order to gain sustained trust in the EMU, first and foremost compliance with and enforcement of

the necessary rules and agreements must be ensured for the system to function effectively. This will be discussed in more detail in Chapter 3. Ultimately the success of the EMU stands or falls with satisfactory economic, social and political results and prospects for residents of all participating Member States. With this in mind an assessment framework is introduced in Chapter 4 for weighing up further conceivable developments. The assessment framework will be used to assess the possible options for the further development of the EMU in Chapter 5, partly based on proposals made for alternative instruments and institutional developments.

Compliance with and enforcement of the rules and agreements

3

3.1 Applicable rules and agreements

3.1.1 Current regulatory framework

The Maastricht Treaty forms the basis for the economic governance of the EMU. It stipulates that Member States must consider their economic policy as a matter of common interest and will coordinate it in the Council. Multilateral surveillance takes place in order to flesh out coordination of economic policy. In addition the Treaty imposes rules related to the budgetary policy of Member States: the budget deficit may not exceed 3% of GDP, and government debt may not exceed 60% of GDP.

The provisions in the Treaty are elaborated in the Stability and Growth Pact (1997). The Pact consists of two components: the ‘preventive arm’, for Member States whose public finances satisfy the threshold values established in the Treaty, and the ‘corrective arm’, for Member States for which this is not the case. In principle Member States in the preventive arm must strive for a budget that is in balance, or that shows a surplus. If this is not the case, Member States must annually improve their cyclically-adjusted deficit (the structural deficit). Requirements also apply to the growth of public expenditure. The Six Pack (see paragraph 2.6) made it possible to impose penalties on eurozone Member States in the preventive arm of the Pact.

The corrective arm of the Pact applies to Member States with an excessive deficit. In principle, an excessive deficit must be corrected within a year. A deviation is possible in the case of special circumstances; the deadline may also be extended. At the Commission’s proposal the Council establishes whether there is an excessive deficit and issues a recommendation to the Member State to resolve the excessive deficit within a certain period of time. In addition, the structural balance must improve annually. If a Member State does not respect the recommendations and possible subsequent warnings, the Council, at the Commission’s proposal, may impose sanctions, generally in the form of a financial penalty.

The Six Pack also reinforces surveillance of the Member States’ macroeconomic policies. The financial crisis and the euro crisis unequivocally revealed that long-lasting imbalances may accumulate on different markets (such as property markets) that may subsequently lead to a banking crisis and/or a budgetary crisis. Preventing long-lasting imbalances is important for sustainable economic growth and employment, stability and social progress in the euro area. In 2011, an alert mechanism was introduced that helps identify macroeconomic

imbalances at an early stage, using a scoreboard featuring threshold values for a series of indicators, such as the balance on the current account of the balance of payments, competitiveness, the growth of lending and private debt.

Every year the Commission identifies Member States it believes are struggling with imbalances or run the risk of doing so. With regard to the Member States concerned, following a discussion in the Eurogroup and the Council, the Commission performs an in-depth review, the aim of which is to ascertain whether imbalances exist in a Member State, and whether they are ‘excessive’. Imbalances are deemed excessive if they could jeopardise the effective functioning of the EMU. A Member State is issued with recommendations to correct any imbalances. In comparison with fiscal rules, the macroeconomic agreements are less uniform and more qualitative in nature; they do not have any automatic triggers either. In the context of the Macroeconomic Imbalance Procedure (MIP), for eurozone Member States a sanction mechanism exists, in case Member States do not follow up the Council’s recommendations related to the implementation of corrective measures. The penalties consist of imposing an interest-bearing deposit or, in the event of repeated non-compliance, a fine.

The preventive arm of the SGP and the Macroeconomic Imbalance Procedure are brought together in the context of the European Semester, which acquired a legal basis with the Six Pack in 2011. The European Semester also contains the assessment of the national reform programmes that Member States submit in the context of the Europe 2020 strategy. Recommendations in the context of the SGP and the MIP, along with recommendations related to the national reform programmes, are viewed as a whole and at the Commission’s proposal are issued by the Council to the Member States in the form of country-specific recommendations.

A more detailed overview of the current regulatory framework is included in the appendix.

3.1.2 Experiences of compliance and enforcement

Fiscal rules / Stability and Growth Pact

Experience concerning compliance with the various rules and agreements is mixed. The accession criteria in the Maastricht Treaty certainly had a disciplinary effect in the run-up to the beginning of the EMU on 1 January 1999. The average budget deficit in the euro area fell from 5.2% of GDP in 1992 to 1.5% of GDP in 1999. Although government debt initially increased, a slight decrease was visible as of 1996. Nevertheless

government debt in many Member States stayed above the threshold of 60% of GDP. In practice, the disciplinary effect of the accession criteria that occurred in the run-up to the EMU appeared to wear off once Member States joined the EMU. Budget deficits rose once more after 1999.

When assessing compliance with the rules in the SGP, it must be considered that the Pact serves an underlying goal, i.e. to ensure that Member States pursue a prudent budgetary and economic policy in order to avoid negative spillover effects in the monetary union. In assessing the effectiveness of the SGP the extent to which the fiscal rules led to a prudent budgetary policy is more relevant than the question of whether Member States did or did not respect specific rules. One could argue that in this context the issue of whether or not Member States annually comply with the exact, uniform threshold values of 3% of GDP respectively 60% of GDP in the Treaty is less relevant.³⁹ Differences in economic structures, institutional arrangements and demography also mean that these uniform targets cannot in themselves ensure that the underlying goal of sustainable public finances for all Member States will actually be achieved. The fiscal rules do appear to have had a certain disciplinal effect; there has been a substantial reduction in budget deficits in many Member States of the eurozone. Today, budget deficits in, for example, the United States, Japan and the United Kingdom are still clearly higher than in almost all eurozone Member States.

Research conducted into compliance with fiscal rules during the period 1999–2013 reveals a mixed picture.⁴⁰ The 3% of GDP target was respected in the majority of cases but this did not apply to the debt criterion. Approximately half of eurozone Member States had government debt in excess of 60% of GDP for most of the period concerned. The financial crisis played a major role in this regard; after the crisis, only six eurozone Member States maintained their government debt below the 60% threshold. If the threshold is exceeded, compliance with the rules is possible if the debt at least decreases in the direction of 60% of GDP at a satisfactory pace.

39 The threshold values of 3% and 60% of GDP for, respectively, the budget deficit and government debt are consistent with annual, nominal, economic growth of an average of 5% (composed of real growth of 3% and inflation of 2%). If real growth were to be structurally lower than 3% a lower budget deficit would need to be applied for debt to end up at 60% of GDP in the long term.

40 L. Eyraud and T. Wu (2015), *Playing by the Rules: Reforming Fiscal Governance in Europe*, IMF Working Paper, No. 15/67.

The fiscal rules are designed to take account of special circumstances, such as the financial crisis, and are less mechanical than they appear at first glance. At the same time this hampers assessment of compliance and affords a margin of appreciation by the Commission and the Council, which subsequently reduces the transparency of the enforcement.

Research performed by the Netherlands Court of Audit regarding the 1999–2012 period, shows that eurozone Member States were not placed in the excessive deficit procedure in 8% of the years during which they did not comply with⁴¹ the fiscal rules. The vast majority of these cases concerned a situation in which government debt exceeded 60% of GDP and did not show a downward trend. It also appears that during the same period, on average Member States were allocated 4.5 years to put their budget in order, and that in 14 of the 22 excessive deficit procedures opened the original deadline was extended. The duration, as well as the extension of the deadline are consistent with the related rules established in the SGP. The Dutch Central Bank (DNB) examined the extent to which Member States followed up on recommendations related to the scope and pace of deficit-reducing measures in the context of the excessive deficit procedure.⁴² It reveals that Member States comply with a substantial part of these recommendations.

The DNB also studied compliance with the preventive arm.⁴³ With the exception of Luxembourg and Finland, during 1999–2013, all eurozone Member States had structural budget deficits that exceeded their medium-term objective; six of the original twelve eurozone Member States have actually never met the target. Moreover, requirements for improving the structural budget balance in the direction of the medium-term objective are only respected to a limited extent: there is virtually no correlation between the improvement required in the preventive arm and the actual change achieved on the structural balance.

One can conclude that compliance with rules in the corrective arm is relatively good. However, compliance with the fiscal

41 Court of Auditors (2014), *Europees economisch bestuur: Europese coördinatie van begrotings- en macro-economisch beleid en de positie van Nederland* (European economic governance: European coordination of fiscal and macroeconomic policy and the position of the Netherlands), 9 September 2014.

42 DNB (2016), *Naleving Stabiliteits- en Groeipact vooral goed als het slecht gaat* (Compliance with the Stability and Growth Pact particularly good when times are bad), DNBulletin, 22 December 2016.

43 Ibidem.

rules in the preventive arm is poor and there is little disciplinary effect, especially during good economic times.

Macroeconomic surveillance

To date the Commission has never proposed launching an excessive imbalances procedure against a Member State related to macroeconomic surveillance. In this case a Member State would have major macroeconomic imbalances that require urgent corrective measures. Nevertheless during 2012–2016, the number of Member States subjected to an in-depth review by the Commission in the context of MIP, did increase: in 2012 this applied to twelve Member States, in 2016 there were nineteen. In 2017, this figure decreased to thirteen. In addition the number of Member States with imbalances in the course of this period may have decreased (from twelve in 2012 to six in 2017), but the number of Member States for which the Commission established excessive imbalances did increase each year (from zero in 2012 to six in 2017). Apparently they were not deemed serious enough to start an excessive imbalances procedure.

With regard to the Netherlands, the Commission has established macroeconomic imbalances every year since 2013, although they never qualified as ‘excessive’. In particular the large surplus on the current account of the balance of payments and the relatively long balance sheets of Dutch households (high mortgage debts combined with large but blocked pension assets in the second pillar) also form a recurring point of concern for the Commission. The number of country-specific recommendations the Council has issued to the Netherlands has varied between five in 2012 and two in 2017. Several themes recur every year in this regard. This specifically concerns the recommendation to further limit mortgage interest deductibility and to reform the pension system. Recommendations related to reforming the property rental market and maintaining R&D expenditure have also been included every year since 2012. Moreover, there have recently been recommendations related to making the labour market more flexible and to the position of self-employed people, as well as the recommendation to consult with social partners to achieve higher wage development. Other country-specific recommendations have been (partially) implemented. Examples include the recommendations to increase the retirement age and reform long-term care.

Country-specific recommendations

Research into the effectiveness of the European Semester shows that, in general, Member States only follow-up the country-specific recommendations issued to them to a modest

extent, and that the extent to which Member States have followed up on ⁴⁴recommendations in recent years has decreased. When the country-specific recommendations are broken down, it appears that recommendations related to compliance with fiscal rules are followed-up slightly more than recommendations in the context of the procedure for macroeconomic imbalances. ⁴⁵ Follow-up of this last category of recommendations is either extremely limited or non-existent: since the launch of the MIP (2012) and recommendations issued in that context, 7% or fewer of the recommendations are subject to full or substantial implementation each year. This means that for 93% of recommendations Member States’ follow up is extremely limited or non-existent. ⁴⁶ At the beginning of 2017, the Commission reported that progress in over 90% of recommendations issued in 2016 was minimal or non-existent. This also applied to recommendations issued to the Netherlands in 2016. Just a handful of recommendations were substantially or fully implemented. It should be pointed out however, that the nature of the recommendations, related to resolving macroeconomic imbalances through structural reforms, mean that full implementation of the recommendations will require several years, as a result of which progress measured over one year will inherently be limited.

If the implementation of the country-specific recommendations imposed in the context of the European Semester are compared to the implementation of recommendations by international organisations such as the OECD and the IMF, it appears that the extent to which the recommendations by the different institutions are followed up is *grosso modo* similar. The measures for improving surveillance in the Six Pack and the Two Pack have still not led to Member States following up country-specific recommendations in the context of the European Semester more often. ⁴⁷

3.1.3 Explanations for a lack of compliance

Lack of compliance and enforcement of rules and agreements may be explained by several factors. The most fundamental factor may be that in the system of European policy coordination, national policymakers bear primary accountability to national

44 Z. Darvas and Á. Leandro (2015), The limitations of policy coordination in the euro area under the European Semester, Bruegel Policy Contribution, No. 2015/19

45 Ibidem.

46 European Parliament (2017), Implementation of the Macroeconomic Imbalance Procedure, In Depth Analysis, 13 June 2017.

47 Ibidem.

parliaments, in which the diverse national interests are expressed. Unless serious common threats exist, such as those that emerged during the euro crisis, coordination between national policymakers remains difficult. Additionally, enforcement of the policy areas relevant to the EMU are, at present, not purely technical in nature, but will continue to be based on considerations of political opportunity.

The complexity and number of fiscal rules and macroeconomic agreements also constitutes a complicating factor. The fiscal rules differ between the corrective and preventive arms, involve the actual budget deficit, structural deficit as well as growth of public expenditure minus certain taxation measures. The permitted growth of the expenditure and structural government deficit depend on the potential growth of the economy, which can only be estimated. To do justice to the macroeconomic context there are additional agreements about how to take account of the business perspective and of investments from European funds. The structural balance is not perceivable as such but is constructed on the basis of econometric estimates, which in practice are also adjusted multiple times based on new figures. The non-transparent calculation method does not promote compliance.

The set of indicators used to assess macroeconomic imbalances contain eleven economic variables. With regard to the fiscal rules there is still a relatively straightforward relationship between instruments and objectives (budget deficit). This holds only to a lesser extent for the macroeconomic indicators (for example, current account of the balance of payments), and there is also considerable more interconnection with the specific institutional structure of an economy.

One potential explanation for the lack of enforcement is also the dual role played by the Commission in the application of the rules. It has two separate responsibilities in this regard. First and foremost, the Commission has to establish whether a Member State is failing to comply with the rules. Secondly, it must ascertain whether the circumstances mean it is appropriate to issue a recommendation to the Council to impose a penalty or not. In practice these two responsibilities are intertwined and the Commission has a considerable margin of appreciation in assessing whether a Member State has made adequate budgetary efforts, and to assess whether a certain macroeconomic imbalance is 'excessive'. On the one hand this makes it possible to take account of special circumstances and the specific situation of Member States. On the other it also increases the risk that rules are applied randomly and inconsistently, and not strictly enough.

The macroeconomic rules and country-specific recommendations have only come into being since 2012, a relatively short period. They relate to issues that have always been at the heart of national economic policy and are traditionally the subject of national policy debates between political parties and social organisations. Recommendations from Brussels related to institutional reforms of the labour market, pensions or the housing market gained little attention and support in Dutch politics. Although institutional decisions in these areas could have cross-border significance for the functioning of the eurozone, decisions in these areas are considered by many to be exclusively a national matter. Empirical research shows that reforms are only set in motion to a far greater degree under pressure from financial markets, if Member States need a programme of financial aid to which conditions for reform are attached, or if the rate of unemployment in a Member State becomes very high.⁴⁸ Sanctions have never been imposed, not related to fiscal rules and not in the procedure for macroeconomic imbalances. Use of this instrument against sovereign Member States is apparently viewed in political practice as a 'nuclear option'.

3.2 The significance of rules in European economic governance

In the previous section it was established that, with regard to compliance with the fiscal rules a mixed picture emerges, while compliance with rules and agreements in the context of the MIP leaves a lot to be desired. Before discussing specific options to improve compliance with and enforcement of the rules, it is useful to place the significance of the rules and agreements involved in European economic governance in a broader context.

In principle it is possible to differentiate between compliance by Member States, enforcement of compliance through external supervision, and promoting compliance using market mechanisms. Compliance involves mechanisms that guarantee or encourage a Member State to respect the rules and obligations. This may include internal coercive or surveillance mechanisms, such as monitoring by an independent national supervisory body. In contrast enforcement principally involves external supervision and coercion from outside the Member State. Lastly, market mechanisms are mechanisms whose effects require a Member State to respect the rules, without further decision-making by competent supervisors.

48 Z. Darvas and Á. Leandro (2015), The limitations of policy coordination in the euro area under the European Semester, Bruegel Policy Contribution, No. 2015/19

European rules and agreements related to fiscal and macro-economic policies of the Member States differ considerably in their nature, as well as in the extent to which they are formally and materially *binding* and *enforceable*.⁴⁹ The EMU's regulatory framework contains both binding and non-binding, enforceable and unenforceable rules and agreements. The Europe 2020 strategy, for example, is based on a notification by the Commission and is thus non-binding (soft law).⁵⁰ Therefore, governance and alignment related to this strategy take place through the open coordination method, which presupposes voluntary cooperation and 'soft' coordination and steering mechanisms.

In contrast, the provisions are more binding when it comes to the budgetary policy of Member States. The Treaty stipulates that all EU Member States must avoid excessive deficits.⁵¹ The corresponding targets, specified in a Protocol (No. 12) to the Treaties, are binding for all Member States. The Treaty also applies a specific enforcement regime in the event a Member State does display an excessive deficit. However, the Treaty places this enforcement regime explicitly in the hands of both the Commission and the Council: the latter decides, with a qualified majority, at the former's proposal. A role for the Court of Justice is explicitly excluded in the Treaty.⁵² Therefore, assessment of whether or not a Member State respects the rules and agreements is *political* and not *legal* in nature. During the subsequent steps of the enforcement regime, the Council may issue increasingly urgent recommendations to the Member State concerned, with the option of imposing (financial) penalties as the *ultimum remedium*.⁵³

49 Legal instruments are 'binding' if the addressees of the regulation must comply with the rules stipulated therein. This applies at the European level, for example, to treaties, regulations, directives and decisions (see Article 288 TFEU). Binding legal instruments are 'enforceable' if non-compliance is sanctioned by the Commission and the Council, or if access to the courts, *in this case* the European Court of Justice, is provided for effectively enforcing the legal instruments (see Articles 258 to 260 inclusive TFEU).

50 See the European Commission Communication of 3 March 2010 on – EUROPE 2020 – A strategy for smart, sustainable and inclusive growth, COM(2010) 2020.

51 Article 126, first paragraph, TFEU.

52 Article 126, tenth paragraph, TFEU.

53 To a certain extent the Council's 'recommendations' are, in theory, less non-binding than the term implies. A sanction may be imposed if a Member State repeatedly fails to act on the recommendations. This not only applies in the corrective arm of the SGP, but also in the preventive arm and in the MIP.

The rules in the context of the preventive arm of the SGP based on Regulation (EC) 1466/97 are also binding for all EU Member States. In the spring, all Member States must submit a stability or convergence programme including (a path leading to) an objective for the medium term with regard to the structural balance. If a Member State takes insufficient measures to achieve the adjustment path in the direction of the medium-term objective for the structural balance, the Council may, at the Commission's proposal, issue a recommendation to the Member State concerned to take policy measures. In the preventive arm the Council may also impose penalties on the eurozone Member States, based on Regulation (EU) 1173/11, if a Member State does not take measures as a result of the Council's recommendations. In contrast to the corrective arm, the Treaty does not formally exclude recourse to the Court of Justice by the Commission, the Council or a third Member State.

The rules and agreements in the context of the procedure for macroeconomic imbalances closely resemble those in the preventive arm of the SGP. The rules and agreements are legally binding and contain, for eurozone Member States, a sanction mechanism based on Regulation (EU) 1174/2011. In the MIP the Treaty does not exclude the Commission, the Council or a third Member State challenging a negligent Member State for the European Court of Justice either.

However, the extent to which rules and agreements are binding and enforceable in the *formal* sense, says nothing about the extent to which they are actually respected and enforced in the *material* sense. Firstly, the degree to which sovereign states can be bound by rules, and will thus comply with them, appears to have its limits. The fact is that the budgetary and economic policy in the EMU is in the hands of Member States. The Union's traditional legal set of instruments (regulation and enforcement via the Court), which may have been successful in relatively technical policy areas such as the internal market, can be applied less effectively in areas such as Member States' fiscal and macroeconomic policy. It is easier to prohibit Member States from doing something than forcing them to take measures. The authors of the Treaty were also aware of the fact that overly high expectations should not be fostered with regard to enforcement, as they made decision-making related to the excessive deficit procedure a matter of political, and not legal, assessment. The reality in recent years has been that when it comes down to it, this political assessment resulted in the Commission or the Council repeatedly shying away from the *ultimum remedium* of penalties. Likewise, in cases in the existing framework, where formal

recourse to the Court is available (in the preventive arm of the SGP, as well as in the MIP), it is hard to imagine that the Commission, the Council or a third Member State would decide to pursue it. Thus the material significance of this possibility is also limited. One has to conclude that enforcement of the European rules is subject to limitations.

This does not mean that the rules, and corresponding sanction mechanisms as *ultimum remedium*, have no value; one can assume they do have a disciplinary effect. Adopting fiscal rules, sometimes established in legislation, is also increasingly becoming best practice within sovereign states. With regard to macroeconomic agreements best practices are also emerging through assessments by international organisations such as the IMF and the OECD. In practice, international competitiveness and innovation rankings form a powerful incentive for undertaking structural reforms. At the same time it is realistic not to foster overly high expectations with regard to compliance with and the enforcement of European rules that Member States must bind in their fiscal and macroeconomic policy. Therefore, national ownership of rules and agreements, and involving citizens in the reasons why structural reforms are necessary are definitely as important as external coercion.

Lastly, one must acknowledge that the shaping of rules and enforcement mechanisms always involves compromise, in which policymakers have to weigh up each other's different objectives and interests. Rules are intended to effectively prevent imbalances, but other considerations are also relevant. Rules must offer enough flexibility for relevant institutional differences between Member States and in the case of unexpected events and crises. It is also important that adequate attention is devoted to the democratic accountability of the enforcement. Among other things, this involves parliaments at least being able to exercise control over enforcement of the rules and at least exerting control over the choices made. In practice, these objectives are difficult to reconcile in their entirety and choices are unavoidable to a certain extent. Therefore, the advantage of improved enforceability of the rules must be weighed against the effects on sovereignty, democratic legitimacy and transparency and accountability. This is different when Member States, partly because they previously disregarded recommendations or did not comply with the rules, encounter difficulties and have to call on support mechanisms. It is then justifiable to impose requirements for structural reforms that are focused on guaranteeing repayment of the aid – so that the available resources are returned and can be used once more – and that help prevent countries getting into trouble again.

3.3 Options for improved compliance and enforcement within the existing framework

There are a number of options for improving compliance and enforcement of rules and agreements (see Table 2). Measures may be applied that are more or less far-reaching and combinations of measures are also conceivable. The ultimate choice and effectiveness of strengthening compliance and enforcement will also depend on the broader political and institutional context of the monetary union, and the way in which it is developed further (see Chapter 5). In the end a lack of compliance was just one of the causes of the euro crisis.

At the same time the broader context referred to in the above paragraph must be taken into account. There are limits to the extent to which Member States can be bound by rules, certainly in the politically-sensitive policy areas the EMU rules concern. Specifically, agreements concerning structural reforms affect areas where national political preferences come into play. This is true to an even greater extent if strict enforcement has major economic and social consequences in Member States, as during the euro crisis. In short, it is to be expected that enforcement in any possible configuration will partly be based on political considerations and thus will not result in full compliance.

Table 2: Options for improved compliance and enforcement

- 1 *Fewer and more simplified rules*
 - Fewer targets and indicators
 - Less scope for discretionary assessment
 - Focus on deviations outside a margin
- 2 *Introduction of positive incentives*
 - Financial support for structural reforms Link to structural and cohesion funds
 - Link to stability fund
- 3 *Enforcement separate from political consideration*
 - More frequent voting with reverse qualified majority
 - Allow appeal to the Court of Justice in the case of specific legal obligations
 - Reinforce the role of independent authorities
- 4 *A different mix of central and decentral enforcement*
 - Tighter enforcement mechanisms at the European level
 - Tighter enforcement mechanisms at the national level
- 5 *More free market mechanisms*
 - Tighter no-bail-out clause
- 6 *Strengthening of implementation capacities*
 - Technical assistance

Fewer and more simplified rules

The first option is to reduce the number of rules and/or simplify existing rules. The framework has gradually become increasingly complex, because the rules have been amended on multiple occasions to be able to take the circumstances that applied at the time into account. Consequently the rules became less mechanical and at the same time the scope for discretionary assessment increased. However, this hampers enforcement because rules are most effective if they are simple. Simplification makes it easier to explain the rules, verify compliance and create support. On the other hand, simple rules can be inflexible in the case of unexpected shocks. Therefore, it is important to make rules robust in various circumstances.⁵⁴

There are different ways of simplifying rules. The first is to reduce the number of objectives, so that there is greater focus on the areas on which policies can concentrate most effectively. For example, the existing fiscal rules contain criteria for the actual balance, the structural balance, government debt as well as growth of real public expenditure. The existence of multiple criteria means that in practice an overall assessment is needed if some criteria are fulfilled and others are not. In addition, the calculation method used for the structural balance and real expenditure growth is complicated, does not go uncontested academically, and leads to repeated adjustments. According to the Dutch Central Bank a rule for the actual deficit and a multi-year expenditure benchmark could suffice.⁵⁵ According to the same study, the number of indicators in the MIP could be reduced from the current fourteen to four.⁵⁶

Another way of achieving simplification is to limit the number of exceptions and scope for discretionary assessment. This reduces the temptation to ‘condone’ deviation from the rules and promotes uniformity of the application between the different Member States. At the moment, for example, in the MIP it is unclear on which basis the Commission decides whether an imbalance is ‘excessive’ and also on which policy areas recommendations are issued. Lastly, rules can be simplified

if they focus more on deviations that fall outside a certain margin (the corrective arm of the rules) and less on the state of affairs within this margin. The preventive arms of the SGP and the MIP currently include detailed rules for situations that do not (yet) actually constitute an obvious problem.

An important point related to the options for simplifying existing rules and reducing them to a limited set of simple rules of thumb, is that their application and enforcement must take place separately from macroeconomic circumstances. This could sometimes be somewhat blunt and considered unreasonable in Member States that have to cope with the consequences thereof. Therefore simplification of the rules will probably only be effective if their enforcement acquires a more automatic, apolitical character (see below). The basic principle of ‘what’s good for the goose is good for the gander’ could contribute to the consequences of simplified rules being accepted more in the knowledge that other Member States would be treated in the same way.

Introduction of positive incentives

A second way of increasing compliance is by improving incentives for compliance. The current rules primarily use financial penalties (fines or non-interest-bearing deposits), but these are not imposed in practice. The scope of financial penalties was expanded with the introduction of the Six Pack (for example, a fine of maximum 0.5% of GDP in the excessive deficit procedure).⁵⁷ However, the political loss of face when sanctions are imposed is considerable and the Commission is (very) reluctant to apply the penalty instrument, out of fear of inducing a negative attitude towards ‘Brussels’ or rattling the euro. Moreover, a problem with financial penalties is that they could worsen the situation of the Member State concerned, at least in the short term. Therefore, one could consider the option of doing away with financial penalties and working with positive (whether or not financial) incentives. Positive incentives could promote support for measures in Member States. This may increase Member States’ ownership of compliance with the rules, instead of them feeling they are imposed by external enforcement. An example of a positive incentive is the idea that Member States commit to certain structural reforms in contracts subject to financial compensation. Similar ideas include the plan to link payments from the structural and cohesion funds to compliance with rules, and the plan to provide Member States that fulfil certain criteria with access to a European budgetary stabilisation fund.

54 Therefore, one option is to steer budgetary policy based on the real growth of expenditure, instead of the cyclically-adjusted structural balance, which appears volatile and prone to error.

55 See J. Hessel, N. Gilbert and J. de Jong (2017), *Munt slaan uit de euro. Opties bij het versterken van de muntunie (Capitalising on the euro. Options for strengthening the monetary union)*, DNB Occasional Study, vol. 15(2).

56 These would comprise indicators for the price competitive position, the current account, lending and the growth of house prices.

57 Article 12, third paragraph, Regulation (EC) 1467/97.

Enforcement separate from political consideration

A third way is to make enforcement of the rules less the subject of political consultation. Political considerations make the Council of Ministers reluctant to agree to proposals for sanctions presented by the Commission. Therefore the penalty instrument could be reinforced by giving it a more mechanical character. This would imply a restriction of the Council's power to deviate by qualified majority from a Commission proposal. This seems more acceptable if accompanied by a simplification of the rules, so that the scope for discretionary appraisal is reduced. On the other hand, a more mechanical application of the rules and the set of penalty instruments could be at odds with the public acceptance thereof. One option is to use other types of penalties, such as the temporary suspension of voting rights.

Another possibility is to increase the weight of the legal status of agreements, by converting soft law into more enforceable instruments and by providing the possibility of appeal to the Court of Justice in the case of non-compliance with the rules where this is not currently possible.⁵⁸ However, when it comes to policy choices a judge is a less appropriate body and in practice the Court of Justice has, as yet, also been cautious in detailed assessments thereof.⁵⁹

One could also consider assigning specialist, independent authorities, which have already been partly set up, a greater role in the enforcement of and compliance with rules. This could be (a network of) independent, national supervisory authorities (such as the national independent fiscal institutions and national productivity boards) or at the European level (such as the European Fiscal Board). A combination is also conceivable, in which national supervisory authorities cooperate with a coordinating authority at the European level. These bodies currently fulfil an advisory role, but it would be possible to assign them more powers related to enforcement, whether or not accompanied by the capacity to impose penalties or refer issues up to the European level. One point of

concern in this respect, from the perspective of democratic legitimacy, is that the legal competences of the budgetary authority and the rules they monitor must be properly defined. This requires simple rules with minimal scope for discretionary judgement. Furthermore, full transparency and public accountability is necessary.

A different mix of central and 'decentral' enforcement

A fourth way of improving compliance and enforcement is to change the mix of central and 'decentral' elements. As explained in the previous paragraph, a recurring problem is that states taking decisions autonomously only allow themselves to be governed by rules imposed from above up to a limit. Sometimes a greater degree of centralisation is put forward for enforcement, in order to improve compliance. This centralisation could be achieved via independent European bodies such as a more powerful European Fiscal Board or a new European Monetary Fund to be set up, or also via more political authorities such as a European 'Minister of Finance' that is sometimes proposed. Based on this rationale, rules at the central level are more effective since this level is better able to weigh up cross-border effects in decisions and rules than Member States. On the other hand, centralisation requires central competences to be enhanced and could result in public support waning even more in Member States if rules do not adequately reflect national preferences and circumstances.

This is why further 'decentralisation' of enforcement to the level of Member States is another proposed manner of promoting compliance. Support and 'ownership' could increase in Member States by making the latter more responsible for compliance with the rules. Consequently, Member States would internalise the rules more effectively and comply automatically. This degree of 'decentralisation' imposes strict requirements on the quality of national compliance mechanisms and institutions. Lastly, a combination of central and 'decentral' enforcement is conceivable, in which supervision from the central, European level becomes more intrusive, depending on the extent to which Member States fail to comply with the rules and the 'decentral' supervision mechanisms appear ineffective.

More free market mechanisms

A fifth way of improving compliance with the rules and agreements is to strengthen market mechanisms. When the EMU was developed, the anticipated disciplinary effect of financial markets did not materialise, or at least not sufficiently. In practice, financial markets tend to react too late and often

58 Based on Article 126, tenth paragraph TFEU, it is currently not possible to challenge Member States with an excessive deficit that do not comply with the Council's recommendations before the European Court of Justice.

59 See ECJ 13 July 2004, C-27/04, Commission/Council, ECLI:EU:C:2004:436 on the excessive deficit procedure, ECJ 27 November 2012, C-370/12, Pringle, ECLI:EU:C:2012:756 on the ESM Treaty, and ECJ 16 June 2015, C-62/14, Gauweiler, ECLI:EU:C:2015:400 on the OMT of the ECB.

too abruptly. One way of increasing the disciplinary effect of financial markets is to improve the credibility of the no-bail-out clause. This instrument may play a role in the context of a more ‘decentral’ enforcement structure (see Chapter 5).

Strengthening of implementation capacities

Lastly, compliance with the rules could be promoted over time by supporting Member States with weak implementation capacities by providing technical assistance. Structural reform measures can only be implemented effectively if the national institutions that have to implement these reforms have adequate resources and manpower to do so. Technical assistance from Member States with a long tradition of strong institutions, the Commission and international organisations with the relevant expertise could be useful in this respect.

3.4 Conclusion: rules and agreements are necessary but do not suffice

When answering the first question in the request for advice, it should be noted that the obligations and rules imposed on participants must be respected and enforced in order to promote credibility and trust in any system. The conclusion can be drawn that the choices made regarding fiscal rules and macroeconomic agreements are, in general, insufficiently respected and enforced. Member States’ compliance with the MIP agreements is particularly poor, while the Commission and the Council make inadequate, or no, use of the enforcement instruments provided for ensuring compliance.

In this chapter several options have been presented for increasing the chance of compliance and improving enforcement. In principle, their application will increase the capacity for absorbing economic shocks, reducing economic and budgetary imbalances sooner and lowering the risk that the ECB will have to test the limits of its mandate once more in order to safeguard the euro. In the choice of strengthening compliance and enforcement mechanisms, political realities will have to be taken into account, however, in theory, simplification of the rules is appealing, but in the political reality it may evoke resistance and thus countervailing pressures. The same could apply to depoliticising the enforcement decisions by setting up an independent budgetary authority. Increased discipline from financial markets could help improve compliance and may reduce the need to call on the political capacity for enforcement. However, finding a credible form of market discipline is not easy and is uncertain, since markets may be wrong and tend to react too late and too abruptly.

Compliance with and enforcement of fiscal rules and agreements are necessary for the euro area to function effectively. This can be improved, as we have argued. However, compliance with and enforcement of the rules are not sufficient, for two reasons. Firstly, any instrument aimed at improved compliance and enforcement may also raise objections, and its effectiveness largely depends on the institutional setting in which it is applied. This is why a system dependent on enforcement alone, is insufficiently sustainable. Moreover, other factors play a role that cannot always be translated into agreements or rules. Member States such as Ireland and Spain ended up in difficulties while they did comply with the rules that applied at the time. One reason for this is that shocks may also originate from the financial sector. This issue is being addressed through the introduction of a Banking Union, while the introduction of measures that contribute to a Capital Markets Union will further increase resistance to financial shocks.⁶⁰ Nevertheless, problems may also have a political or social origin, in which rules and agreements cannot be foreseen, or at least not sufficiently.

In the current set-up of the EMU the political capacity for compliance and enforcing the rules has certain limits. Improving compliance and enforcement is necessary and certainly feasible to a certain extent, but there will still be a risk that in certain circumstances it will test the political capacity, and that the rules will still not be respected. In this sense there are limits to what can be expected from stricter enforcement. At the same time a lack of enforcement is harmful to mutual trust between Member States and the trust of citizens in the EMU.

To achieve long-term sustainability of the EMU there are also political and social preconditions that must be fulfilled. At least some promotion of convergence between Member States and of social progress is required to ensure the sustainable functioning of the euro area. It is therefore necessary to examine additional steps and alternatives. This brings this report to the second question to be elaborated in the advice, which is addressed in the next chapters. Besides the predominantly economic and financial conditions for the euro area to function effectively

60 The Commission compiled a plan of action that lists a large number of (potential) measures that should help establish a Capital Markets Union (Commission Proposal of 30 September 2015 for a decision of the European Parliament and of the Council on the Mobilisation of the Flexibility Instrument for immediate budgetary measures under the European Agenda on Migration COM(2015) 486).

there are also conditions related to the political-institutional design, legal anchoring and a suitable structure for the required democratic legitimacy and accountability. This demands a broader assessment framework for defining further measures to strengthen the euro area.

Assessing the
possible directions
for the future of
the EMU

4

4.1 Ongoing debate about the future of the EMU and the EU

The ongoing debate about the euro, and about possible improvements to the EMU, illustrates that the single currency is still not self-evident 18 years after its introduction. In the recent years of the crisis, attention mainly focused on solutions for immediate problems. Now that economic growth has returned to the eurozone as a whole, the debate is shifting to strengthening the EMU in order to repair the proven shortcomings and avoid a recurrence of events of the previous years if and when a new crisis emerges. The measures taken during the preceding period have undoubtedly reinforced the EMU's framework, but broad consensus exists that in its current form the monetary union is still work in progress. On the other hand there is far less agreement about the way in which the EMU should be developed further.

For the EMU to function effectively, better compliance with and enforcement of existing rules and agreements is needed but this, in itself, is not enough to raise the EMU's shock resistance to the desired level and fully exploit the economic and political potential of monetary union. Additional improvements to the monetary union are conceivable in several areas. At the *economic* level it is possible to improve countries' capacities to absorb shocks. It would also help if future crises are solved more quickly and result in less economic and financial damage. Moreover, to retain popular support for the euro it is important that participation in the monetary union offers citizens broadly supported economic and social prospects. To achieve this it would help if all Member States in the monetary union have sufficient expectations of economic growth and employment. At the *political-institutional* level it would benefit democratic legitimacy if European decisions and the distribution of responsibility took place along less ambiguous lines, based on a broadly supported vision for the further development of the EMU and with a reinforced and more self-evident legitimacy in countries, through the clear involvement of their parliaments. Lastly, the *legal* anchoring of the rules and agreements could be more streamlined with clearly defined responsibilities.

The debate about strengthening the EMU cannot be viewed separately from the broader debate about the future of the European Union, since the monetary union is closely intertwined with the process of European integration (see text box 3). There is no consensus about the future of the EU either.

At the beginning of this year the Commission published a White Paper containing various directions.⁶¹ At one end of the spectrum the document includes a business-as-usual scenario with the scenario of far deeper European integration at the other, and in-between scenarios ranging from reduced integration, to solely the rules of the single market, to a multi-speed Europe in which one or several groups of Member States take more far-reaching measures, and of a Europe that integrates more in some areas but less in others.

Text box 3: The future of European integration

The EMU and the common currency must be viewed against the background of the process of European integration. Chapter 2 explained that the EMU is partly a political project, which was viewed 25 years ago as a necessary and logical step in the integration process. This does not mean that the creation of the euro was an inevitable and unavoidable step. Deeper integration without an EMU would have been possible, but the consequences of this decision, if it had been taken at the time, will never be known. However, it is certain that a common currency without European integration would not have been imaginable; in this sense the two are inextricably linked.

Nowadays, European integration and the EMU are linked even more closely. Although an integration process without EMU would have been conceivable at the time, it is now less likely that the European integration process would survive the euro's demise. Conversely, the euro would not survive the unravelling of the integration process. The euro must derive its soundness and reliability from the soundness and reliability of the European cooperation from which it was created. To this extent, a mutual interdependence between the two exists.

It implies that the EMU's development must take as a starting point the present state of political-institutional integration, unless steps involving the EMU form part of a broader reform of the European Union.

61 European Commission White paper of 1 March 2017 on the Future of Europe, COM(2017) 2025.

The connection to the further development of European integration does not mean that eurozone Member States cannot take any more far-reaching steps. The Treaty does not stand in the way of this. Strengthening the EMU to achieve better results and fully exploit its potential may require a distinct institutional structure within the euro area, with changes of the decisionmaking procedures and democratic accountability thereof.

There are at least as many different views of the future of the European Union as there are about the future of the EMU. The result of the Brexit referendum illustrates that the benefits of European integration are no longer universally seen as self-evident. In recent decades the debate on the advantages and disadvantages of this integration has intensified, partly under the influence of major steps such as the (continued development of the) monetary union and expansion of the EU. Fundamental discussions about democratic legitimacy and distribution of power between the EU and Member States play a role as well as the question of whether the EU should only promote economic integration or also devote more attention to the social dimension.

In addition, the EU is faced with the challenge of how to provide effective solutions to cross-border issues such as migration, climate change, terrorism and the effects of globalisation. As a result, the nature of the measures the European Union must take, and as a consequence the nature of the integration process, is changing. It no longer concerns purely 'technical' matters, but also topics such as climate change, migration, combating the negative effects of globalisation or rescuing banks or governments.

Consequently, European policy is shifting from devising rules and regulations to responding to crises and fundamental changes. Under pressure of the financial crisis extraordinary measures were taken to sustain the monetary union and new rules and institutions were introduced. In accordance with their nature, these measures are far-reaching for Member States and citizens, and thus more political in nature. They often concern problems Member States cannot resolve independently due to their cross-border nature, but in which Member States may have significantly divergent political preferences. European measures can easily be perceived as invasive, which may cause Member States to resist a far-reaching transfer of competences. Moreover, the quality of

institutions and implementation differs considerably from one country to another, which means that support for solidarity and shared responsibility between Member States is put under pressure, while the measures taken give rise to questions about democratic legitimacy.

4.2 Various ways of thinking

Opinions vary greatly about the future of the EMU. This is apparent from the large number of publications, from the policy-oriented as well as the academic perspective. Given the second question in the request for advice on the political and institutional options for the future of the euro, it is useful to first briefly outline the different proposals for improvement or reform of the EMU that are currently circulating. Although it is not practically possible to provide an all-encompassing overview of all proposals circulating, it is possible to clarify the main directions along which the debates are conducted at the moment. These directions recur in Chapter 5 in which the Advisory Division of the Council of State outlines political and institutional options for the future of the euro in answer to the second question.

4.2.1 General direction of the proposals

Firstly, the overall direction of the proposals differs. Some plans argue for far-reaching or even deeper integration. This is demonstrated in successive proposals by the different European Union institutions. The blueprint for a deep and genuine EMU by the Commission from 2012, the proposal by the President of the European Council of the same year, the 'Five Presidents' Report' from 2015 and the Commission proposals in the recent reflection paper on the future of the EMU, all imply a reinforcement at the central, European level and increased solidarity between Member States over time.⁶² Greater solidarity between Member States could be achieved by mutualisation of debt, in which risks of government debt are shared, but also by a macroeconomic stability mechanism at the European level, which could be used if a Member State suffers a cyclical downturn.

62 See the Communication from the Commission of 30 November 2012 on a blueprint for a deep and genuine economic and monetary union (COM(2012) 777 final), the report 'Towards a Genuine Economic and Monetary Union' by H. H. van Rompuy in association with J.M. Barroso, J.C. Juncker and M. Draghi, 5 December 2012, the report 'Completing Europe's Economic and Monetary Union' by J.C. Juncker in association with D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz of 22 June 2015, and the European Commission Reflection Paper of 31 May 2017 on the deepening of the economic and monetary union, COM(2017) 291/291.

Some, mainly Anglo-Saxon economists, also come to the conclusion that further integration is needed, based on the theory of optimal currency areas. Whereas in the run-up to the EMU this theory was used as an argument for not introducing the euro at all, most of these economists believe that now that the single currency does exist, improvements must be identified that result in the monetary union fulfilling the characteristics of an optimal currency area more effectively. In their opinion this requires deeper integration and steps to increase mutual solidarity between Member States. If these steps are not taken, in this vision the single currency will never be sustainable in the long term. High profile economists such as Stiglitz and Krugman belong to this group.⁶³

Other lines of thought assume that deeper integration is not necessary per se to make the EMU sustainable over time. They refer, for example, to the limited support for deeper integration that appears to exist in Member States at the moment. Therefore the plans based on this direction advocate for credible restoration of the no-bail-out clause in the Maastricht Treaty. Member States would no longer receive any aid if they encounter financial problems. Instead, their government debt would be restructured in a crisis situation, in which the related costs would be borne by the private sector.⁶⁴ This would increase market discipline. This could also imply less integration in other areas, for example if the restoration of the no-bail-out clause is accompanied by less stringent fiscal rules established at the European level. As a result, Member States regain scope to formulate their own budgetary policy to a certain extent. Others argue for creating an option for Member States to temporarily leave the EMU.⁶⁵ Since in this type of scenario Member States would regain access to the exchange rate instrument, necessary economic reforms could be implemented at lower social costs than if they would have to be implemented within the monetary union. Finally, there are those that support leaving the monetary union completely.

63 See, for example, J. Stiglitz (2016), *The euro. How a common currency threatens the future of Europe*, W.W. Norton & Co. Both Stiglitz and Krugman are of the opinion that European policy to quickly reduce deficits is one-sided and exacerbated the crisis in some countries. In their view there should be more scope for a stimulating budgetary policy.

64 See, for example, B. Eichengreen and C. Wyplosz (2016), *Minimal conditions for the survival of the euro*, *Intereconomics*, vol. 51(1), pages 24-28; M. Sandbu (2015), *Europe's Orphan: The Future of the Euro and the Politics of Debt*, Princeton University Press.

65 See H.W. Sinn (2013), *Relaunching Europe: Problems, Reform Strategies and Future Options*, CESifo Forum 3/2013 (September).

In addition to regaining the exchange rate instrument, Member States could once again implement a monetary and budgetary policy that is better aligned to the specific economic situation in their countries. The idea is that in the long term this could lead to increased economic prosperity. According to some studies the Netherlands could, on balance, also benefit from leaving the EMU and the EU.⁶⁶ However, such a step is not consistent with the Dutch monetary tradition, focused on a low rate of inflation and linking the exchange rate to a sound anchor country. The many more recent studies about Brexit also point out that leaving the European Union has, on balance, a negative impact.

4.2.2 *Combination and definition of specific measures*

Within the broad directions outlined above, the visions differ in terms of the combination and sequentiality of measures. Not all supporters of deeper integration are convinced that Member States should move to jointly issue debt securities in the form of 'eurobonds'. Some supporters only accept an increase in mutual solidarity between Member States if at the same time agreements are made about structural reforms that Member States must implement. Others, including the Dutch Central Bank, advocate for taking limited but necessary steps in the near future and only taking further-reaching measures in the long term.⁶⁷

The exact design and elaboration of specific measures differs considerably, which may also confuse the debate. Highly divergent details are proposed in plans currently circulating, such as a European fiscal capacity, a European Monetary Fund or a European 'Minister of Finance'.⁶⁸ A fiscal capacity or stability mechanism could take the form of a European scheme for investment protection, a European reinsurance

66 See, for example, Capital Economics (2014), *Nexit: Assessing the economic impact of the Netherlands leaving the European Union*. A report by Capital Economics for the Party for Freedom.

67 See, for example, J. Hessel and N. Gilbert and J. de Jong (2017), *Munt slaan uit de euro: Opties voor verdere versterking van de EMU* (Capitalising on the euro: Options for strengthening the EMU), DNB Occasional Studies, vol. 15(2); H. Enderlein, E. Letta *et al.* (2016), *Repair and Prepare: Growth and the Euro after Brexit*, Bertelsmann Stiftung/Jacques Delors Institute. See also Advisory Council on International Affairs (AIV) (2017), *Is de eurozone stormbestendig? Over verdieping en versterking van de EMU* (Is the eurozone stormproof? On deepening and strengthening the EMU), AIV-advice No. 105.

68 See, for example, G. Wolff (2017), *What could a euro-area finance minister do?*, Bruegel blog post, 17 May 2017, and A. Sapir and D. Schoemaker (2017), *We need a European Monetary Fund, but how should it work?*, Bruegel blog post, 29 May 2017.

scheme for national unemployment benefits or a so-called ‘rainy-day fund’ to which Member States could resort in the event of major economic shocks.⁶⁹ A European ‘Minister of Finance’ could, in addition to taking over the tasks of the current Commissioner for economic and financial affairs related to supervising fiscal rules and the MIP, be assigned competences related to a European budgetary stability mechanism and/or issuing eurobonds.⁷⁰ Definitions and modalities of a possible European Monetary Fund also differ considerably. Some, for example, want decision-making on financial aid programmes to no longer take place through unanimity but through qualified majority. Others also want to assign the EMF competences for restructuring debts or enforcing fiscal rules. Lastly, several options related to a ‘safe asset’ for the Eurozone are circulating.⁷¹

4.2.3 Democratic involvement and accountability

Most proposals for strengthening the EMU acknowledge that not only the financial-economic framework needs to be strengthened, but – in parallel – also the mechanisms aimed at democratic involvement and accountability within the monetary union. This would also increase the transparency of the decision-making process. In the debate the issue of democratic involvement and accountability primarily focuses on the role of parliaments at the national and European level respectively. This is linked to the question of whether, and if so how, the relative position of other institutions needs adjusting, such as the governments of Member States, the European Commission, the European Council and the ECB.

69 See, for example, the European Commission Reflection Paper of 31 May 2017 on the deepening of the economic and monetary union, COM(2017) 291. This fund could be structured in many different ways. Funds could be automatically redistributed between Member States based on formulas agreed in advance (such as using fixed ex-ante formulas based on indicators for the economic cycle), though more discretionary assessment power is also conceivable, as is the option to bind payments to other criteria such as the implementation of certain reforms.

70 The term European ‘minister of finance’ could also give rise to misunderstandings, because in the European context the role will have competences that differ from those of a national minister of finance in the context of Member States.

71 These could be common bonds with a public guarantee from all EMU Member States (*eurobonds*), or a securitised basket of bonds from individual countries (*sovereign bond backed securities*).

Text box 4: Democratic legitimacy: several perspectives

A fruitful debate on the democratic legitimacy of the EMU is not possible if one does not explain the angle from which one approaches the issue. Based on the views developed in the academic literature, a distinction is made between various types of democratic legitimacy, i.e.⁷² input, throughput, output and feedback legitimacy.⁷³ Opinions on the adjustments deemed necessary vary, depending on the type on which one wishes to place the emphasis.

With regard to *input legitimacy* political choices are considered legitimate if the will of the majority of citizens is reflected. In our current parliamentary system this is evident when decisions are supported by a parliamentary majority. In the case of *throughput legitimacy* the emphasis is on process legitimacy: transparency, awareness and predictability of the political decision-making process legitimise the decisions taken. From the *output perspective* political choices are legitimate if they effectively promote the general interest. It emphasises public performance; if specific results are achieved, the assumption is that this will create adequate support among citizens. Lastly, *feedback legitimacy* involves accountability and feedback. Accountability is provided to democratic bodies and voters with respect to exercising public powers and spending public funds; government actions can be assessed and adjusted if necessary.⁷⁴ In practice all these forms of legitimacy play a role but are often valued differently in the way they interact.

These different perspectives lead to diverse views about the question as to whether and how existing constitutional arrangements must be amended. One could take the view that popular support will not be increased through further institutional adjustments; in this view the EU, with its dual legitimacy (via citizens and Member States) is sufficiently

72 See, for example, F.W. Scharpf (1999), *Governing in Europe: Effective and democratic?*, Oxford University Press.

73 See, for example, E. Spolaore (2015), *The political economy of European integration*, in: H. Badinger and V. Nitsch (ed.), *Routledge Handbook of the Economics of European Integration*, pages 435-448.

74 Council for Public Administration (ROB), *Democratische legitimiteit van samenwerkingsverbanden (Democratic legitimacy of cooperation partnerships)* (January 2015), page 7.

democratic. In this view the emphasis lies on the decisive role of politicians; they must demonstrate that Europe contributes to peace, democracy, welfare, employment and justice: 'Results will be crucial to convince Europeans. The output will be decisive'.⁷⁵ Others observe a democratic deficit on account of the European Union's constitutionally unbalanced growth in the sense that the executive and legal institutions of the EU – the European Commission and the European Court of Justice – have disengaged from the democratic processes in Member States and steer an independent course in the EU.⁷⁶ Consequently, in this view citizens and parliaments in Member States are insufficiently involved; there is inadequate 'input legitimacy'.

In this view the situation would be insufficiently compensated by an increasingly powerful European Parliament. There is no parliamentary relationship of trust between the Council of Ministers and the European Parliament: ministers take their seats in the Council based on their national ministerial capacity, and not because they have the confidence of the European Parliament. Research also shows that European elections are overshadowed by national elections, and national political considerations are decisive in voting behaviour. Moreover, critics point out that turnout for the European Parliament elections structurally lags behind that for national elections, also because in European elections power – the issue of who is going to 'rule' in the EU) is not the issue at hand.⁷⁷ The latter may change somewhat as European elections appear to increasingly influence the presidency of the

Commission. Furthermore, the competences of the European Parliament have been gradually expanded, making it a co-legislator as a rule, on equal footing with the Council. Nevertheless criticism of the European Parliament has not disappeared. This also explains why the solution is (partly) being sought in increasing input from national parliaments. Since 2009, Article 12(b) of the TEU establishes that national parliaments actively contribute to the functioning of the EU and that they have the possibility to directly influence decision-making within the EU.⁷⁸ The latter deviates from the principle of a strict separation between the national and European layers of governance. It is also an important step in the direction of increasing intertwinement between the European and the national decision-making process.

The above basic principles and developments have an impact on the ongoing debate about institutional reinforcement of the EMU. Obviously, the special characteristics of European economic governance play a role in this regard. Some of the decisions, such as the ESM, are established in intergovernmental agreements. Others are captured in secondary European Union legislation that only applies to eurozone Member States. It is also important to note that measures are increasingly taken by independent bodies, such as the ECB, which are not subject to democratic supervision. These particularities lead to additional complications when shaping parliamentary involvement and control.

Obviously, the question of whether, and if so, which institutions must be strengthened, and how, is closely linked to the direction that is chosen for the monetary union. If the monetary union is strengthened in a direction that leads to deeper European integration, it seems logical that the position of the European Commissioner for economic and financial affairs is strengthened. Options in this respect are appointing the Commissioner as the permanent President of the Eurogroup, or promoting him/her to the position of European 'minister of finance', whether or not with responsibility for a European stability mechanism, and/or issuing a new European 'safe asset'.⁷⁹

75 H. van Rompuy (2015), *Bespiegelingen na vijf jaar Europa* (Reflections after five years in Europe), in: L. van Middelaar and P. van Parijs (ed.), *Na de storm. Hoe we de democratie in Europa kunnen redden* (After the storm. How we can save democracy in Europe), Lannoo page 18. Other authors also believe that there is a democratic deficit. See A. Hinajeros (2015), *The Euro Area Crisis in Constitutional Perspective*, Oxford University Press, pages 159-160 with literature reference.

76 D. Grimm (2015), *De kracht van terughoudendheid in de Europese Unie* (The power of restraint in the European Union), in: L. van Middelaar and P. van Parijs (ed.), page 123. See above, D. Grimm (1995), *Does Europe need a Constitution*, *European Law Journal*, vol. 1(3), pages 284-288.

77 B. Crum (2013), *Saving the Euro at the Cost of Democracy?*, *Journal of Common Market Studies*, vol. 51(4), pages 614-630.

78 See also Protocols No. 1 and 2 to the Treaties.

79 See in this context, for example, the European Commission Reflection Paper of 31 May 2017 on the deepening of the economic and monetary union, COM(2017) 291.

If the decision is taken to strengthen the position of the Commission, this also implies an expansion of the role of the European Parliament because implementation, accountability and control would be placed at the same level.⁸⁰ It is conceivable that these tasks could be assigned to the European Parliament as a whole, or to a configuration that consists of Members of the European Parliament comprising just eurozone Member States. Although existing treaties do not make this distinction, one could consider creating a separate commission within the European Parliament, composed exclusively of eurozone Member States' MEPs.⁸¹ The extent to which greater involvement of the European Parliament will obtain support, largely depends on the viewpoint adopted in the debate on democratic legitimacy (see text box 4).

In addition to increasing the role of the European Parliament, there is the option of strengthening national parliaments in the European institutional context, even in the context of deeper European integration. One of the proposals for strengthening the role of national parliaments, the mildest variant, is to create, within the existing framework, an inter-parliamentary conference of the European Parliament and national parliaments, as provided for in the Treaties, which discusses EMU matters.⁸²

Another option for increasing the involvement of national parliaments in European decision-making, would be to reintroduce a dual mandate for national parliamentarians, in the sense that they could also be a member of the European Parliament in addition to their national parliament. This dual mandate was abolished at the time of the European Parliament election in 2004,⁸³ but had the unintentional effect of distancing European decision-making from citizens. This reflects the perceived insufficient legitimacy of the European Parliament, but it also follows from the limited powers it has

with respect to the Eurozone. The possibility of a dual mandate, in which a number of parliamentarians are both members of their national parliament as well as the European Parliament could change this. This may have consequences that go beyond the eurozone alone; it requires reflection on the role and position of the European Parliament and its members in a more general sense. There is also the question of whether this option is very realistic in the short term because it requires a treaty amendment.

The next option,⁸⁴ which also requires a treaty amendment, is to set up a new parliament solely for the eurozone. Four configurations are conceivable for the composition of such a parliamentary body especially for the eurozone: a new, directly elected body, a body comprising members of the European Parliament members elected in the eurozone Member States, a body formed from national members of parliament from these countries, or a hybrid of these last two. Even if this body was comprised solely of members of national parliaments, it concerns a new community body and not an inter-state body.

These proposals all presuppose a strengthening of the EMU in the direction that leads to deeper European integration. With this in mind all kinds of variants are feasible, leading to either an expansion of the European Parliament's role and/or that of national parliaments within the European framework (see text boxes 9 and 10 in Chapter 5), depending on the viewpoint adopted and on the consideration of the advantages and disadvantages of the different variants. If, in contrast, one strives for a stronger 'decentral' allocation of responsibilities (see also Chapter 5 for a more in-depth discussion), an increased role for national parliaments will be a logical consequence. Allocating Member States (more) competences also implies there will be greater involvement of and accountability to national parliaments within the constitutional framework of individual Member States than before. Whether additional European arrangements that contribute to democratic legitimacy will still be necessary, depends on the question of how many central aspects this variant will include.

80 Also refer, in this context, to the Advice by the Advisory Division of the Council of State issued to the Senate of 18 January 2013, related to anchoring democratic control for reforms of economic governance in Europe (Parliamentary papers I 2012/13, 33 454, No. AB).

The following passages have been partly derived from this advice.

81 In this context, refer to the European Economic and Social Committee Opinion dated 27 May 2015 on completing EMU: The political pillar (2015/C 332/02).

82 Title II, Protocol No. 1 to the Treaties.

83 See Article 7, second paragraph of the Act concerning the election of the representatives of the European Parliament by direct universal suffrage of 20 September 1976 (OJ 1976, L278).

84 As the most far-reaching option it advocates institutionalising the role of national parliaments in the EU in the form of a separate chamber alongside the EP. The EU would then have to be transformed into a bicameral system. Apart from the consideration of whether or not this would be desirable or feasible, this option is not applicable in the context of the euro's future in the short term, partly because of the geographic discrepancy between the EU and the eurozone, not all EU Member States belong to the eurozone.

The European Parliament as well as national parliaments could play a role ex Article 12 TEU. In a more ‘decentral’ line of thought, the creation of a separate eurozone parliament with its own competences is probably less obvious.

In addition to parliamentary input (input legitimacy) the EMU’s effectiveness from the perspective of democratic legitimacy is also important; if the results are disappointing due to a lack of decisiveness, popular support is likely to decrease accordingly (output legitimacy, see text box 4).

4.3 Views difficult to compare

The proposals for the future of the EMU are justified by the proven shortcomings and the political need to increase popular support for the EMU. Nevertheless, the proposed improvements differ considerably, depending on the analysis of the functioning of the EMU, the preferences on what constitutes desirable economic policy, the desired degree of mutual solidarity between Member States and the vision of the future of European integration. Also, improvements are possible from very different economic, social, political or legal perspectives and reasoning. Proposals that focus on the economic functioning of the EMU lead to other recommendations than proposals that focus on the democratic legitimacy of decisions. Some plans have the sole purpose of avoiding future crises as much as possible and limiting their effects, while other plans also want to improve the functioning of the EMU in ‘normal’ circumstances.

This means the proposals are not always easy to compare or reconcile. What is desirable or necessary in economic terms may be unacceptable from the political perspective or impossible from a legal point of view. Accordingly, some conceivable improvements to increase economic convergence and improve political sustainability require a treaty amendment, which is not politically realistic in the short term. This means that in practice solutions are sometimes adopted that cannot always satisfy all the relevant aspects. A relevant example is the ECB taking measures, which were necessary to restore confidence in the euro, but which evoked different reactions in various Member States and raised questions from the point of democratic legitimacy. The nature of the economic, social, political and legal aspects are so different that they cannot always be easily compared.

With this in mind, it is useful to reflect on the elements that come into play when assessing the different proposals for the future of the EMU. A public debate on the possible options

and alternatives is served with a well-reasoned assessment framework that connects the different economic, social, political and legal aspects.

4.4 Assessment framework

4.4.1 Basic principle: sustainably reliable and self-evident

To achieve a long-term sustainable EMU, one, probably uncontroversial, basic principle is key. For the single currency to fulfil its role, the euro’s functioning must be economically and politically satisfactory, and be sustainably reliable and self-evident. If monetary union produces too many negative economic outcomes, political differences of opinion between Member States, or measures that are considered controversial in Member States, the single currency’s existence will be repeatedly up for discussion. In this case the monetary union is no longer sustainable. Proposals that require frequent political adjustment and intervention in the functioning of the EMU thus conflict with a currency’s sustainable reliability and self-evident existence.

The EMU’s set-up and structure must be policy neutral and enable Member States to follow national political preferences for shaping socio-economic policy within the preconditions that apply to participation in the EMU. Member States’ policy preferences and policy traditions differ considerably from one Member State to another and will also vary in time. Examples include views on the desirability of fully-fledged market functioning of markets, the role of the state in the economy, or the structure of the labour market. The preconditions for EMU participation encompass, as described above, areas that are important for economic functioning and that are established in SGP and MIP procedures. In principle these ensure that the EMU satisfies the technical requirements that a common currency area imposes, if it wants to be economically viable. However, if a more or less mechanical application of the technical preconditions for the EMU leads to developments that undermine political support in one or more Member States, the euro’s long-term sustainability will also be jeopardised.

Another, equally uncontroversial, basic principle is that the EMU is not an objective in itself, but an instrument for achieving underlying objectives. These objectives include – in ascending levels of ambition – achieving stability, growth, employment and prosperity in participating Member States, promoting the European integration process and contributing to social progress in participating Member States (see, for example, the objectives laid down in Article 3 TEU) and

giving Europe a more powerful voice on the world stage. Lastly, democratic legitimacy and legality are also preconditions for the functioning of the euro.

Table 3: Aspects of assessing EMU proposals

Socio-economic aspects

- a The EMU needs to effectively absorb normal cyclical fluctuations.
- b The EMU must have the capacity to withstand crises.
- c The EMU supports prosperity and social progress in all Member States, and gives Europe a stronger voice on the world stage.

Political, institutional and legal aspects

- a Greater authority at the European level needs sufficient support.
- b Decision-making within the EMU must be democratically legitimised and transparent.
- c Decisions taken in the context of the EMU must be embedded in a legally coherent way.

Therefore, the underlying objectives and preconditions for the functioning of the EMU are examined in order to produce an assessment framework (see Table 3). Successively, they include socio-economic objectives (stability, growth, social progress) and political-institutional and legal objectives (democratic legitimacy and legality). We also address the specific Dutch interest in these objectives. A long-term, self-evident monetary union requires all these aims to be achieved to a certain minimum level. It is possible to strive for certain objectives with greater ambition, but this may compromise another objective. It is this interaction between objectives that leads to political discussions and therefore benefits from a well-reasoned assessment framework. In Chapter 5 a number of directions for the EMU are considered in more depth and assessed using this assessment framework. In Chapter 6 these proposals are appraised from the perspective of the Dutch interest.

4.4.2 Socio-economic objectives

The effectiveness of the EMU's functioning in socio-economic terms determines the extent to which the EMU results in positive economic prospects for Member States and citizens. This is extremely important for confidence in and popular support for the euro, and thus for the long-term sustainability of the monetary union.

Capacity to adjust to normal cyclical shocks

The EMU needs to effectively absorb normal cyclical fluctuations.

Member States participating in the EMU must be able to adequately absorb 'normal' cyclical shocks, so that these shocks do not cause some Member States to structurally lag behind.

For an optimal currency area to function effectively the extent to which economic cycles are synchronised and the flexibility of economies are relevant. It would be useful if the economies in the EMU grew closer together in terms of competitiveness, the capacity to adjust and the quality of institutions. This depends on the willingness of Member States to implement structural reforms, whether or not encouraged by European measures.

In addition, the extent to which automatic budgetary stabilisers can do their job is relevant. The scope for countering cyclical setbacks with a fiscal response, is related to compliance with the fiscal rules in the SGP. Especially compliance in good economic times determines whether countries have enough fiscal space to allow the deficit to increase in bad times. In addition, stability may be provided by a federal budget for the euro area as a whole.

Recently it became clear that structures in Member States relevant for the functioning of the economy are not 'naturally' converging. Likewise, the relative size of the European budget and that of the Member States will not fundamentally change automatically. Therefore, it is realistic to assess options from the existing pluriformity of economic policy and structures within the euro area, and take into account the institutional limitations to decision-making and possibilities for enforcement. There are also limits to Member States' 'capacity to change'. This means that a balance will have to be found between the existing relative autonomy of Member States with regard to socio-economic policy and increased effectiveness of the EMU in the general interest of the Member States as a whole.

Preventing and absorbing crises

The EMU must have the capacity to withstand crises. A minimum necessary precondition for a sustainable, self-evident monetary union is that there are sufficient possibilities for keeping the monetary union stable in the event of major shocks. This means that there must be sufficient options for preventing future crises and, if one does occur, resolving it without jeopardising the existence of the EMU.

The extent to which Member States are able to avoid new crises in the future, and the accompanying economic (and

political) costs, is related to the effectiveness of European rules to prevent macroeconomic imbalances. The MIP must tackle long-lasting divergences in, for example, wage costs and current account positions at an early stage. In addition the costs of new crises also depend on the available financial safety nets for banks as well as governments, and on the mechanisms for dealing with financial institutions in default or unsustainable government debts. In recent years, major steps have already been taken in these areas (see Chapter 2), but additional steps are possible.

The costs of future crises also largely depend on the risk of the EMU's irreversibility being jeopardised. If, during a crisis, there is a risk that a Member State will voluntarily leave the EMU or is forced to do so, this may set in motion large capital flows, even if financial safety nets are available. This became apparent when, in the summer of 2015, there was disagreement about extending the Greek financial support programme. Moreover, there is a risk that financial markets will speculate on the exit of other vulnerable EMU Member States. This contagion would have a major effect on the EMU's crisis-resilience.

Prosperity and social progress

The EMU supports prosperity and social progress in all Member States, and gives Europe a stronger voice on the world stage. To gain popular support for the euro it is important that participation in the EMU contributes to economic prosperity and social progress. A monetary union that offers Member States no prospect for relative improvement and effectively tackling unemployment in their own countries, or that does not provide participating Member States with the confidence that they can achieve more growth collectively than individually, and from which each Member State can benefit, will continuously be an electoral issue. Member States must also have adequate scope for shaping social policy. To achieve this it helps if the EMU's set-up contributes to strengthening the competitiveness of EMU Member States in relation to the rest of the world. This will also contribute to the prosperity of the euro area as a whole. A common currency thus strengthens the economic and political clout of Europe in a global context. When European countries are able to act as a single block, they are able to defend their interests more effectively in international negotiations and international forums such as the IMF and the G20. This argument is becoming increasingly important now that the economic power of emerging countries such as China and India is growing. Consequently the relative weight of individual EU Member States is shrinking in the global economy.

One important caveat is that social policy as well as the capacity for growth of countries only depend to a small extent on the monetary system, and thus on the euro. Both are primarily determined by the policy and structural characteristics of the countries themselves. Global factors also play a role, such as demography, technological development, globalisation and competition from low-wage countries such as China and India.⁸⁵ Therefore, one risk is that Member States will wrongly attribute problems with respect to a lagging growth potential or economic prosperity to the euro. However, years of low economic growth in Italy is not so much the consequence of the euro, but rather the result of structural problems in the Italian economy. It is thus necessary to avoid burdening the set-up of the monetary union with dimensions that must actually be resolved by other means.

The Dutch interest

The Netherlands suffered as a result of the crisis, as did other countries, but it had the advantage that the Dutch economy operated in the context of a single currency. The Dutch export sector benefited from the fact that the exchange rate of the euro was relatively low due to problems in southern Member States. Without the euro, during the crisis a national Dutch currency would have probably appreciated vis-à-vis other countries, with a detrimental impact on the Netherlands' competitiveness. More generally, with its open, export-oriented economy, large transport sector and international-oriented pension funds and other financial institutions, the Netherlands par excellence benefits from an effectively functioning monetary union. It is in the Dutch interest that the EMU is better able to absorb shocks and crises and is more focused on economic growth. Even if this is achieved using measures that are not necessarily required by the Netherlands itself, on balance, these can still be useful if this stimulates other Member States to improve their economies. Targeted and conditional financial contributions by the Netherlands and other strong eurozone Member States could temporarily help Member States facing difficulties to restore their growth potential and thus be recuperated as a result of increased export opportunities. At the same time it is in the Dutch interest for Member States to have adequate incentives to keep their own house in order. It is especially important for the Netherlands that the rules are applied uniformly, that financial transfers are temporary and conditional, and that the EMU's

85 In this context see the European Commission Reflection Paper of 10 May 2017 on Harnessing Globalisation, COM(2017) 240.

structure remains focused on the principles of efficiency and the market economy.

4.4.3 Political, institutional and legal preconditions

To retain support for the euro and achieve long-term sustainability of the monetary union, the EMU must also function effectively in political-institutional terms and be based on coherent legal anchoring. This contributes to a more self-evident legitimacy for the euro among citizens and their representatives in Member States. In this respect a useful distinction can be made between, on the one hand, the case for a transfer of competences from Member States to the European level, and if so, under which conditions, and on the other hand the case in which a transfer of competences to the European level has already taken place and further decisions and measures are needed for the actual implementation. Both situations give rise to questions about subsidiarity and democratic involvement and accountability.

Subsidiarity and national policy scope

Greater authority at the European level needs sufficient popular support. One important aspect related to popular support for the euro is the extent to which central European decision-making influences the scope for policy making of individual Member States. It could be beneficial for Member States to surrender part of their policy scope, if they are able to jointly achieve a stronger global competitive position and be more effective when tackling cross-border issues such as climate change or terrorism. This is only increasing in importance as a result of globalisation and the growing economic power of emerging economies.

At the same time in practice increased powers at the European level is a sensitive matter in many Member States. This is definitely the case with regard to policy areas that are more political in nature and come closer to tasks that have until now been reserved for Member States, such as social policy or labour market policy. Expansion of European control is traditionally a sensitive matter in the area of taxation and parliaments' power to approve the budget.⁸⁶ Therefore to retain support for the EMU it is important that the influence from

86 See, for example, the advice issued by the Advisory Division of the Council of State to the Senate on 18 January 2013, on anchoring democratic control for reforms of economic governance in Europe (Parliamentary papers I 2012/13, 33 454, No. AB) and the ruling of the German Bundesverfassungsgericht on the ESM (BverfG 12 September 2012, 2 BvR 1390/12).

'Brussels' is not perceived as unnecessarily oppressive in Member States. This requires, for example, that the principles of subsidiarity and proportionality (Article 5 TEU) be taken into account. Although the 'yellow' and 'orange card procedures' were created for this purpose, in which, based on Article 12 of the TEU, national parliaments can directly exert influence on the European decision-making process,⁸⁷ this is easier to achieve in theory than in practice.

As far as influence from Europe on the national policy scope is concerned, the way in which the transferred powers are applied at the European level is important. Firstly, this applies to the impact the European level has on the implementation of the policy of Member States, such as budgetary policy, economic policy and banking supervision. It should be noted that even stricter enforcement of existing budgetary rules may *de facto* involve a certain transfer of powers. Secondly, the extent to which at the European level control is exercised on budgetary resources, e.g. through solidarity mechanisms such as the ESM or a European budgetary stability fund, is relevant. In this regard it is politically important that these types of European 'liability' for problems in Member States are accompanied by adequate European control of the policies in these Member States, to ensure that transfers also effectively lead to improved growth potential. Solidarity would be too heavily burdened if temporary financial transfers would become permanent, or if the aid repeatedly went to the same Member States.

Democratic involvement and accountability

Decision-making within the EMU must be democratically legitimised and transparent. Although the democratic legitimacy of decision-making in the EU has continuously been a topic of discussion (see text box 4), the euro crisis intensified the urgency of this debate. Influence of the European level on national policy expanded in various areas. The scope for national parliaments to shape or control policy is thus legally reduced and has actually become more limited. Given the increasing intertwinement between the European and national decision-making process in general, and the complex legal structure of the eurozone, the way in which democratic involvement and accountability is safeguarded as well as the

87 By Protocol No. 2 on the application of the principles of subsidiarity and proportionality. A yellow card requires a third of all parliaments to issue a negative subsidiarity opinion, and an orange card requires half to issue a negative opinion. To date, two yellow cards have been issued, and no orange cards.

roles of the various institutions at the European and national level is not always clear; thus input legitimacy of the decision-making process is under discussion. In addition the measures needed during the crisis have had a major impact on countries and citizens, and were not appropriate per se for all countries due to the divergences in the EMU. Therefore the policy choices made are more likely to lead to discussion: their output legitimacy is, as such, not automatically guaranteed either.

Only certain basic standards exist for democratic involvement and control.⁸⁸ In general, these terms concern the involvement of citizens, directly or through representative bodies, with legislation, governance and control of the government's actions. Involvement and control through general representative bodies made up by general elections is usually considered as a yardstick for democratic involvement. However, the method, extent and corresponding institutional arrangements, differ from one democracy to another. There are no general applicable standards. Therefore the existing institutional arrangements in the Netherlands, respectively in the European Union, logically serve as the starting point. The related frameworks are established nationally in the constitution, the constitutional practice and organic laws.⁸⁹ At the European level the basic principles for democratic involvement are specifically laid down in Title II of the TEU.⁹⁰

These basic standards must be applied in their mutual context taking the special characteristics of governance of the EMU into account. With this in mind the scope for the 19 parliaments in the context of the individual eurozone Member States – and thus also for the Dutch parliament – to shape or control policy, is limited in practice. This specifically applies to crisis situations in which governments are expected to act faster and more decisively than at other times ('output legitimacy').⁹¹ With the aim of democratic involvement and accountability it is also important that in recent years the focus of European action has shifted from legislation to implementation, the latter sometimes executed by European institutions

that are legally independent. In the context of the EMU this specifically applies to the ECB. Increasing the democratic character of the decision-making process presupposes a clear delineation between the independent decision-making of the monetary authorities and the political decision-making of the institutions created for this purpose.⁹² Reinforcing the joint capacity for decision-making and actions, and the related democratic supervision, helps prevent the ECB from acting in the vacuum.

Lastly, in a more general sense the basic standards cited above imply that adequate accountability and transparency is also necessary outside of parliaments. In addition to parliaments that represent citizens and influence decision-making on their behalf, each citizen and social organisation individually has the right to participate in the public debate and express their opinion about decisions to be taken and those already taken by the government. Decision-making must take place in as open a manner as possible and bodies and institutions must involve citizens as much as possible in the decision-making process to make it possible for them to exercise these rights.⁹³

Legally coherent anchoring

Decisions taken in the context of the EMU must be embedded in a legally coherent way. Ideally, measures are based on the TFEU and binding legal instruments. However, in practice some of the measures are the result of intergovernmental agreements outside the European Treaties (ESM Treaty, TSCG). The disadvantage of this is that legal anchoring becomes fragmented, which makes transparency and accountability more difficult. Another disadvantage is that measures do not fall under the standard legal order of the European Union. Therefore the extent to which measures taken can ultimately be incorporated in European Union law is relevant. In this respect in all cases the advantages offered by incorporation in the Community system and the disadvantages thereof, must be taken into account, and attention must be devoted to the position of national parliaments. In general, one important question is whether reinforcements are possible within the existing treaties or require a (politically sensitive and time-consuming) amendment of the treaties.

88 For more details see the Advice by the Advisory Division of the Council of State issued to the Senate of 18 January 2013, related to anchoring democratic control for reforms of economic governance in Europe (Parliamentary papers I 2012/13, 33 454, No. AB, pages 5-9.

89 The Advisory Division specifically refers herewith to the Government Accounts Act 2001.

90 See Articles 9 to 12 inclusive of the TEU.

91 See text box in section 4.2.3.

92 See, for example, P. Leino and T. Saarenheimo (2016) On the limits of EU economic policy coordination, ADEMU working paper series (September).

93 In this context see Articles 10 and 11 TEU.

The Dutch interest

With regard to the Dutch interest a number of conflicting considerations are relevant with respect to the national scope for policy making. A fundamental consideration is that the Netherlands, being a medium-sized Member State, has more interest in mutual relationships being governed by law and rules than by relationships solely based on power. On the one hand, the Netherlands could, on balance, benefit from some strengthening of European control and a certain degree of mutual solidarity, if this improves the economic functioning of the EMU. In this respect one should consider that in the Netherlands there has traditionally been strong support for a policy based on stability. Moreover, the Netherlands traditionally scores well overall in international rankings of competitiveness. In this regard stricter European rules may have a greater impact on the policy scope of other Member States than that in the Netherlands. On the other hand, there is a risk that the European Commission or the Council will ultimately opt for measures that disproportionately affect the Netherlands, due to its relatively strong position, or that are considered less appropriate. This could, for example, result in increased solidarity, as a result of which the Netherlands once again ends up paying for Member States whose affairs are not in such good order. The specific structure of measures will ultimately determine whether this can be avoided (see Chapters 5 and 6). Moreover, in principle the Netherlands benefits from the highest possible degree of (democratic) legitimacy of decision-making in the EMU. In this regard the Dutch interest does not deviate much from that of other EMU Member States.

As far as the legal anchoring of measures is concerned, the Netherlands has traditionally attributed great importance to them falling under the scope of European Union law. To this end, it was considered that the Commission would weigh up the interests of all Member States and form a countervailing power to the political influence of the larger Member States. Due to the changing character of the European integration process (see text box 3), in which there is more action in areas that affect all Member States (climate change, combating terrorism, migration), perhaps the arbitrating role of the Commission is still significant, but a political trade-off between Member states will also be important. As European policy gains ground in these areas, anchoring it in the Treaty is in the Dutch interest, based on legal certainty and equal treatment for all Member States. This also applies to the various aid mechanisms that were established in the context of the euro crisis outside European treaties.

Considerations for possible future directions of EMU

5

5.1 The nature of possible future directions of EMU

This chapter continues to answer the second question the Dutch House of Representatives has put forward for advice. Below, the possible, inherently consistent directions for the future of the EMU are described that are presently circulating. The directions outlined are a combination of the options for improved compliance with and enforcement of the rules and agreements as described in Chapter 3 and other measures. Based on the assessment framework presented in Chapter 4, the advantages and disadvantages of each direction are analysed, and the trade-offs between the different directions are identified.

Some explanation is required to enable the reader to properly understand the significance of the directions outlined. Firstly, the latter are not explicit blueprints for a specific structure for the EMU. The approaches are relatively broad and could be implemented in a more or less far-reaching manner. Several configurations of measures are possible within the directions and the elaboration of specific measures may differ. An indication is provided, however, of the measures that are essential for the various approaches.

Secondly, the different directions should not be viewed as entirely equivalent options of which a free choice is possible. The directions have been selected because they play a major role in the policy debate on the EMU, but this does not mean that all directions are equally desirable or even feasible. The outlined directions are not the only options for shaping the EMU either: combinations of measures from several directions are conceivable. In Chapter 6 the relationship between the directions is further clarified and the possible combinations are described. More generally, there is the question of how independent, specific choices will be possible in practice. For the Netherlands it will be more an issue of steering the developments pursued by other Member States as much as possible in the preferred direction, rather than striving for its own optimal combination of measures.

5.2 Completing what has already been agreed

Description of the direction

Before, we outlined a number of amendments made to the EMU's framework in response to the crisis: the fiscal rules were fine-tuned, the MIP was introduced, a Banking Union with common supervision and resolution mechanisms was launched and the development of a Capital Markets Union was initiated. Furthermore, a financial safety net in the form of the ESM for Member States facing liquidity problems has been introduced.

These adjustments undoubtedly strengthened the monetary union and improved its capacity for absorbing another crisis.

Yet the EMU has still not been 'completed'. Realising and implementing structural reforms continues to be difficult in many Member States, as illustrated by the extremely limited compliance with country-specific recommendations in the context of the MIP. Compliance with fiscal rules and agreements also leaves a lot to be desired despite efforts made to tighten them. In addition, the negative interaction between banks and governments has not (yet) been fully eradicated: the Banking Union has still not been completed. Many banks continue to have substantial portfolios of non-performing loans and bonds from their respective governments on their balance sheet, while there is no European deposit insurance scheme and the Single Resolution Fund (SRF) does not yet have a common backstop. There is still a lot of work to be done to complete what has already been agreed.

Completing the Banking Union will help further diminish the current interaction between banks and their national governments. As part of this the European deposit insurance scheme to be introduced will ensure that deposits across the eurozone as a whole benefit from the same level of protection. As a European deposit insurance scheme distributes risks across the EMU, bank account holders are less dependent on the financial capacities of their national banking sector and government. Consequently they will be less inclined to claim or relocate their assets in the event of a crisis. To this end, before a European deposit insurance scheme can be introduced, European banks must continue to clean up their balance sheets and a solution must be found for the substantial amount of non-performing loans.⁹⁴ In addition, a limit is needed for the amount of government bonds banks may have on their balance from their respective governments (through the introduction of concentration limits and/or risk weights).

The proposed European Capital Markets Union would stimulate more robust forms of financial integration (see text box 5). The Capital Markets Union should make it possible for the mutual risks between Member States, which at the moment are mainly carried by governments and banks, to be borne much more by the private sector.

94 The Commission tries to satisfy this in its recently amended proposal for a single deposit insurance scheme to be introduced in stages. See the European Commission Communication of 11 October 2017 on completing the Banking Union, COM(2017) 592.

Text box 5: The Capital Markets Union

The Capital Markets Union is not one specific measure, but a series of major or minor initiatives aimed at further strengthening the internal market for capital to increase funding options within the EU. Although free movement of capital is one of the traditional four freedoms included in the TEU, in practice there are still diverse obstacles to the cross-border movement of capital. Many financial market segments are still fragmented along national lines. Partly as a result, European capital markets are less developed and less integrated than, for example, in the United States.

Improved functioning of the internal market for capital would offer a number of advantages to Member States and the EMU as a whole. Savers, institutional and other investors would have more options for spreading their money internationally and seeking the best return. The Capital Markets Union would provide businesses, especially SMEs, with improved access to international sources of funding. Consequently financing investments would be less dependent on banks, which curtailed lending after the crisis, and increasingly turn to the international capitals market channels such as venture capital and crowdfunding. Lastly, the Capital Markets Union would contribute to more robust forms of financial integration and make it easier to distribute financial risks, which increases Member States' capacity to adjust to shocks (see Chapter 2).

In 2015, the Commission drafted an action plan containing highly diverse measures to establish the Capital Markets Union.⁹⁵ The Commission aims, for example, to stimulate equity funding, e.g. through amending the Prospectus Directive. Measures are also proposed to promote forms of transparency and standardise securitisation once more. The possibilities of achieving a certain degree of harmonisation for national insolvency law are also examined. Lastly, the effectiveness of current European financial market surveillance bodies will be improved, such as the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA). The intention is to introduce these measures in 2019.

95 European Commission Communication of 30 September 2015 related to the Action Plan on Building a Capital Markets Union, COM(2015) 468.

An intermediate assessment performed this year reveals that the Commission has now presented specific proposals for half of the measures,⁹⁶ which will be finalised in association with the Council and the Parliament. Proposals for the remaining measures will follow. Some initiatives, such as harmonising insolvency law, remain challenging and controversial. Therefore, the extent to which all the proposed measures will be implemented in a timely manner is uncertain.

To complete this task a roadmap has been agreed at the European level, containing different measures that must be taken in close conjunction.⁹⁷ Completion of these financial measures will not be an easy feat and the obstacles ahead should not be underestimated. Striving for a Capital Markets Union inherently involves sensitive debates on, for example, the potential harmonisation of insolvency law. The European roadmap has not yet settled the substantive and political debates on the structure, sequentiality and cohesion of the measures. Moreover, several measures that have already been decided are characterised by long implementation paths before they will be fully up and running. The SRF will not reach its full capacity until 2024, for example, and no decision has yet been taken on a credible common backstop in the event that the fund contains insufficient liquidity to support a bank in difficulty. This approach stands or falls with the political will to jointly complete the roadmap.

Assessment in terms of socio-economic aspects

According to the roadmap, in socio-economic terms considerable progress would be made by completing the Banking Union and the Capital Markets Union, because cyclical shocks could be absorbed more effectively. Member States' capacity to adjust would, however, mainly be determined by structural reforms. This also applies with regard to compliance with fiscal rules, because the risk that Member States would have insufficient scope for the automatic stabilisers to work, would still remain. Improved compliance with the SGP and the MIP remains crucial for being able to absorb cyclical fluctuations more effectively.

96 European Commission Communication of 8 June 2017 on the Mid-Term Review of the Capital Markets Union Action Plan, COM(2017) 292.

97 Conclusions of the Council of 17 June 2016 on a Roadmap for completing the Banking Union (Press Release 353/16).

The crisis resilience of the EMU will steadily improve if the Banking Union and Capital Markets Union are completed. If the size of non-performing loans on bank balance sheets is reduced and concentration limits for own government bonds are implemented, banks will be less vulnerable to governments that encounter difficulties and vice versa. This restricts the potential negative impact of a crisis. Compliance with the SGP and MIP remains crucial in this respect, because otherwise there will still be a risk of new crises and a new call for solidarity between Member States. The scope of the ESM is too small to rescue large Member States if they end up with serious problems. ESM decision-making procedures are also too slow to be able to respond quickly enough. As a result, the ECB may have to step in again when another crisis occurs. The role of the ECB could be reduced somewhat in this direction, but it continues to potentially bear major responsibility.

As long as national governments are unable to implement structural reforms that promote growth, the completion of agreed measures provides insufficient prospects that the objective of the single currency to increase economic prosperity and social progress in all Member States will actually be achieved. However, completing the Banking and Capital Markets Unions does reinforce the financial unity of the eurozone and thus the role it can fulfil in international discussions.

Assessment in terms of the political-institutional and legal aspects

From an economic-technical perspective the anticipated measures in this direction are needed to address the proven deficiencies, but they do not essentially alter the institutional architecture of the monetary union. There is still a mix of instruments, which partly operate in the context of the EU, partly in the smaller Eurogroup, and partly outside the European treaties. The ECB also continues to potentially play a major role, reaching the limits of its mandate. Therefore this perpetuates the undesirable situation in which it is difficult for the European Parliament and national parliaments to get a grip on decisions taken in the various forums (prior to and after they are taken).

Support for some essential steps in this direction – the introduction of a European deposit insurance scheme and the expansion of the SRF – is still uncertain as long as confidence in banks and governments has not been restored in several weaker Member States. Since enforcement of the SGP and the MIP is vital, the risk remains that the public debate will

continue to be fed by criticism related to the institutional architecture of the EMU, the impact ‘Brussels’ exerts on national (budgetary) policy, the perceived lack of democratic legitimacy and the risk that intervention, whether or not via the ECB, will still be necessary if Member States get into difficulty.

5.3 Disintegration or dissolution of the monetary union

Description of the direction

A completely different direction – which is often viewed as a risk and advocated to a lesser extent – is disintegration or dissolution of the monetary union. As long as the measures taken are insufficient to sustainably increase public confidence in the single currency, debate on the possibility or the desirability of the monetary union’s disintegration could be rekindled from time to time. However, withdrawal of Member States also remains a risk under different circumstances, if measures are chosen for which there is a lack of popular support in some Member States.

In theory, disintegration could take place in several ways. One possibility is that one or more weaker Member States leave the EMU, either because they see no other option for economic recovery due to financial market pressure, or because they are forced to leave because of their failure to comply with the rules and agreements. Another possibility is that one or more stronger Member States decide to withdraw from the monetary union because, under pressure from domestic public opinion, they are no longer prepared to contribute to financial support for Member States facing difficulties. The political and economic costs involved in this type of scenario largely depend on the way in which one or more Member States withdraw from the monetary union (voluntarily or forced, in an orderly or chaotic manner), but are expected to be significant in all cases. In all scenarios European integration as such would come under serious pressure.

Depending on the circumstances, it could make a difference if a smaller Member State ultimately withdrew or whether this concerned one of the larger Member States. In the first case it is conceivable that this would be manageable for the rest of the EMU, whereby efforts could focus on the Member State in question ultimately returning to the monetary union. At the same time, this would compromise the irreversibility of the euro. This could have adverse effects for all Member States, due to the risk of a domino effect to other weaker Member States resulting from speculation on financial markets. If a large

Member State were to leave the monetary union it seems plausible that the monetary union as a whole would disintegrate and Member States would revert to their respective, national currencies. In these circumstances it is likely that several (groups of) Member States would want to retain a common currency in one form or another. The Netherlands too – that has always strived for stable exchange rates with strong trading partners – could seek connection with like-minded Member States.

In this scenario it appears economically less plausible for weaker Member States to pursue a common currency, which would result in multiple ‘peripheral’ currencies within the European Union. At the same time, political factors must play a fundamental role in decisions about monetary cooperation if this direction were to materialise. The historic significance of the European Union for peace and prosperity in Europe is built on the post-war Franco-German reconciliation, with Italy and the Benelux countries as key partners, and on the later integration of new democracies and market economies in Southern and Eastern Europe. Accordingly, this is inextricably linked to the EMU’s functioning.

Assessment in terms of socio-economic aspects

The disintegration of the monetary union, in whatever way, would have far-reaching consequences and be accompanied by high economic and political costs for the Netherlands, the other Member States and the European Union as a whole.

The withdrawal of one of the EMU Member States would definitively end the irreversibility of the monetary union. This irreversibility forms the basis of the monetary union. If this is no longer an established fact, it could lead to a dynamic that – partly due to speculation on financial markets – cannot be predicted and is thus not manageable. The EMU’s disintegration would be very costly for all parties. Earlier monetary unions have disintegrated or been dismantled in the past, e.g. in the former Soviet Union, former Czechoslovakia and former Yugoslavia, but the circumstances have fundamentally changed since then. Mutual trade and financial integration have progressed much further, which means the costs of disintegration have increased significantly.

In the short term the greatest economic costs would primarily consist of financial instability. Very large exchange rate fluctuations will likely occur, resulting in excessive movements in which foreign exchange markets may overshoot. The northern Member States’ currencies are expected to appreciate sharply, with negative consequences for those Member States’

competitiveness. Moreover, as a result of increased financial integration currency fluctuations would lead to high losses on assets for investors, banks and pension funds in all Member States. The value of debt securities issued in euros or another currency other than the new national currency will significantly increase if a Member State experiences devaluation. This lowers the chance of repayment. Disintegration of the monetary union could in addition damage the real economy, because in any case temporary restrictions would have to be imposed on (the continuity of) payment transfers and the free movement of persons, goods and services. Lastly, long-term disputes could arise about the denomination of contracts, which would also result in great uncertainty on financial markets.

Disintegration of the monetary union could also have consequences for the outstanding balances in the ECB’s TARGET2 system. As long as the continuity of the single currency is guaranteed, these balances pose no problem (see text box 2 in Chapter 2). However, if the monetary union falls apart, these balances would have to be settled. Substantial sums are involved.

An additional complicating factor is that any conjecture of the currency disintegrating in itself would already cause large-scale capital outflows, because citizens and businesses will try and prevent losses by moving their money to ‘safe’ countries. To prevent this, (temporary) restrictions would also have to be imposed on the free movement of capital and substantial financial emergency support would be required for banks and governments.

The costs of disintegration appear to exceed benefits even in the long term. In the short term, restoring the exchange rate instrument would increase Member States’ capacity to adjust to economic shocks. Member States would be able to use the exchange rate instrument more easily if another shock took place. Moreover, the central banks of Member States would have increased scope to implement their own monetary policy, aligned to the economic situation in the Member State concerned. On the other hand, a devaluation only offers temporary solace because the problems that constituted the rationale for withdrawing are usually structural in nature. In addition, the exchange rate instrument becomes blunt from frequent use: devaluation ultimately results in higher inflation and higher interest rates. In anticipation thereof the interest rate may increase immediately following withdrawal if markets doubt the future credibility of the budgetary and monetary regime of the Member State in question. Moreover the risk of exchange rate crises would return, with all its associated disadvantages.

This is a major disadvantage for economies such as that of the Netherlands, which is highly focused on foreign trade. As mentioned previously, circa 60% of Dutch foreign trade is conducted with other eurozone Member States, without any exchange rate risk. Therefore, it is also likely that, in this type of scenario, the Netherlands would seek to link its monetary and exchange rate policy to strong trade partners, especially Germany, as was the case prior to the introduction of the euro.

It may be expected that the reintroduction of mutual fluctuating national currencies would have a negative impact on economic integration in the euro area and on the functioning of the single market, with negative consequences for economic prosperity and social progress. The extent of this effect depends, among other things, on the legal and political repercussions of withdrawal, which are hard to predict.

Assessment in terms of the political-institutional and legal aspects

Disintegration of the monetary union would have major political consequences and would severely damage European integration. The control of economic policy that Member States would regain to a certain degree, comes at a high price. Political relationships within Europe would suffer long-term harm and seriously damage the European Union as a whole. In addition, a distorted political balance may also influence other aspects of European integration, probably even more far-reaching than Brexit. As a result the EU will be less capable of addressing cross-border issues and defending its interests in a world of increased globalisation.

Since European treaties do not contain regulations related to withdrawal from the monetary union (after all irreversibility forms the basis for the currency), the question is how disintegration of the monetary union would unfold. It appears highly likely that the procedure would be chaotic. The legal implications for the remaining applicable rules and EU membership are also unclear. It could lead to existing treaties having to be reviewed and renegotiated.

5.4 New balance between central and ‘decentral’ functioning

Description of the direction

One possible direction for strengthening the EMU’s governance and functioning is to increase responsibility for policy and compliance with rules and agreements at the level of Member States, combined with reinforcing market discipline through credible restoration of the no-bail-out clause. This will increase the scope for policy competition based on

national preferences, which will increase Member States’ ownership of their own effective functioning within the EMU. At the same time it will be necessary to strengthen certain European responsibilities, to make it possible to allocate more responsibility for other areas at the national level, without jeopardising the existence of the EMU. Several combinations and modalities of measures are possible.

In this approach the steps already taken and still partly to be taken, as described in the ‘Completing what has already been agreed’ direction, including completing the Banking Union and Capital Markets Union, are considered given. *Grosso modo* the following aspects are important.

Firstly, a new distribution of responsibilities requires that Member States are encouraged to comply with rules and agreements in other ways rather than (only) through exhortations by the central European level. To this end market discipline must be improved by applying the no-bail-out clause more strictly. This can only be achieved in a credible manner if financial markets are convinced that mechanisms exist, which directly affect them and that will be applied immediately if a Member State ends up in difficulty. Otherwise, financial markets will continue to speculate that other Member States will ultimately step in.

Therefore, credible application of the no-bail-out clause would require the introduction of a sovereign debt restructuring mechanism at the European level, which could be used to resolve unsustainable debts of Member States. In a restructuring (in the form of a write down of and/or extension of the maturity of issued debt securities) the original creditors (usually private bond holders) are initially bailed in, whereby they will have to take a loss. These creditors are usually part of the private sector, because most government bonds generally end up in the hands of private individuals, businesses and financial institutions. The objective of such a mechanism is to establish clear agreements in advance with regard to the circumstances under which such a decision is taken, the procedures used and the measures that can be taken to restructure a Member State’s debts. This prior clarification avoids painful measures being delayed for too long and uncertainty on financial markets resulting in speculation and harmful capital flight. One obvious option is to incorporate this mechanism in the ESM (by amending the ESM Treaty) and converting it into a European Monetary Fund (see text box 6). This ensures that any restructuring takes place before Member States are eligible for financial aid from the ESM. Consequently any losses resulting from a restructuring are

borne by the private investors that originally took the risks when purchasing the government bonds. Restructuring at a later point leads to the risk of other Member States that have provided support also having to take a loss.⁹⁸ Thanks to the restructuring mechanism compliance with rules and agreements is ultimately enforced by markets, instead of by mechanisms at the European level, because markets have an incentive to differentiate between Member States.

Text box 6: ESM and EMF

The ESM, set up in 2012, is an emergency fund for all eurozone Member States with a maximum lending capacity of €500 billion. It can extend credit to Member States facing difficulties if they agree to a bail-out programme with the other Member States proposed by the troika of the European Commission, ECB and IMF. To this end the ESM attracts funds from the international capital market under favourable conditions based on its Triple A rating. This rating is insured by the capital guaranteed by all Member States amounting to €700 billion, of which €80 billion has been paid in. The ESM has extended programme loans to Greece and Cyprus and a loan to Spain for the recapitalisation of banks.

Because the ESM is only able to act at a late stage proposals have been put forward to make the ESM more effective by setting up a ‘rapid response facility’ that can also be used in a preventive manner. This facility would reduce the need for the independent ECB to step in during emergency situations, while the ESM’s resources and mandate can be democratically governed.

Proposals have been put forward to convert the ESM into a ‘European Monetary Fund’, to be integrated in the Treaty as a body of the European Union. The EMF could itself agree programmes with Member States in difficulty and thus take over from the troika. By analogy with the IMF it is conceivable that resources and the mandate for the EMF are approved by national parliaments, but that decision-making related to programmes and the provision of financial support, exclusively in the form of revolving credit, is handled by a governing board to be set up by Member States.

This increases its ability to act swiftly.

In this treaty configuration it is also feasible that responsibility for surveillance related to fiscal rules and economic rules be allocated to the EMF. This offers the advantage that the EMF would have access to all relevant information necessary to quickly formulate a programme conditional for extending credit. This could accelerate the decision-making process and simplify monitoring of the conditions.

Secondly, in this approach credible application of the no-bail-out clause without causing irreparable damage to the financial sector is vital. For this to happen completing the Banking Union is a *conditio sine qua non*. Without a Banking Union, and without measures aimed at reducing the current ‘bias’ for banks to include national government debt on their balance sheets, any restructuring of government debt could result in major risks to financial stability. If such bias still existed, the restructuring would cause major losses for the domestic banking sector, which would have to be partly absorbed by the national government.⁹⁹ The initiatives related to the Capital Markets Union could also help limit financial damage from restructuring.

Thirdly, in this direction the role of public financial safety nets such as the ESM and ECB could be reduced. Since private creditors take the first hit by the introduction of a debt restructuring mechanism, the size of public safety nets can be reduced. It may also be possible to reduce the ECB’s role of lender of last resort, which would enable it to focus on its primary mandate of achieving price stability. Other Member States will not have to step in as quickly via the ESM either. As a result, the no-bail-out clause will be *partly* restored. Whether this direction will also make it possible to *fully* restore the no-bail-out clause and, for example, abolish the ESM, is questionable. Past experience suggests that market discipline is not always optimal. Higher interest rates do not always trigger better policy: before the EMU was launched southern European Member States displayed little monetary or fiscal discipline despite high interest rates. Moreover, financial markets tended to react late and abruptly, which meant that countries were vulnerable to crises, contagion and capital flight. Therefore, full application of the no-bail-out clause is risky, especially in the current, far-reaching financial integration in

98 This is why the amortisation of the Greek debt is controversial. Since at present, it is almost entirely in the hands of other governments, instead of the private sector, the former would have to take a loss.

99 This was the case, for example, when the Greek debt was restructured, which means that it delivered relatively little debt reduction in practice.

the EMU. This is why a form of financial safety net is still required, to prevent problems in Member States leading to high costs. This direction is not accompanied by other solidarity mechanisms such as a European fiscal capacity or a European unemployment fund.

Thanks to improved market discipline direct European involvement in national budgetary and economic policies of the Member States can be reduced. Chapter 3 describes several ways to achieve this using the decentral approach. One of these is to leave enforcement of the commonly agreed European rules to national bodies, such as enhanced independent budgetary authorities and national competitiveness boards. In addition, current fiscal and economic rules may be simplified. It is also possible to assign Member States more freedom to shape rules and enforcement mechanisms. Other options include hybrid forms of decentralisation, in which national supervisory mechanisms are in charge as long as certain threshold values are not exceeded (such as a budget deficit of less than 3% and a debt ratio of less than 60%), but in which European authorities can intervene if, nevertheless, serious problems arise.

The role of the European Commission could thus shift, depending on the chosen structure of the distribution of responsibilities between Member States and the European level. It is plausible that the European Commission, or an overarching European surveillance body, would monitor national surveillance bodies and, as the ultimatum remedium, is allocated powers to intervene if market discipline is inadequate if a Member State does not comply with the rules and agreements in the event of failing national surveillance.

In this variant democratic accountability is provided through national institutional arrangements. National parliaments must confront their governments about the policy implemented, and can involve the assessment of national fiscal authorities. An increase in accountability measures at the European level is less obvious in this variant.

Assessment in terms of socio-economic aspects

a Capacity to adjust to cyclical shocks

Under this option, socio-economic performance of the EMU and its Member States largely depends on the policy efforts of the Member States themselves. This involves the risk that it will not be as easy to absorb shocks. In the end, there are fewer opportunities for coordinating the policies of Member States. In addition, it seems likely that to a certain extent enforcement of the rules and agreements will be less effective than in the

current set-up. Another risk is that decentral enforcement will not prove effective enough to strengthen the EMU.

Decentralisation may increase the legitimacy of and popular support for measures, but experience shows that policymakers also tend to postpone painful measures. Effective enforcement at the decentral level is thus highly demanding with regard to the effectiveness of national political and supervisory institutions. However, the quality of these institutions differs greatly within Europe, while there is no guarantee that institutions that are effective in one Member State will also function well in a different political and cultural context.

b Preventing and absorbing crises

The degree of crisis resilience is also unclear in this direction. An important role is assigned to national bodies combined with a high degree of trust in the disciplinary effect of the market. There is no clear picture of the latter's effectiveness. On the one hand, in some cases the market does exert a disciplinary effect and Member States are forced to take measures. On the other, past experience shows that in practice markets often react too late and too abruptly, with the risk of negative spillover effects between countries. As a result, crises are not avoided, but rather postponed and exacerbated, while in this direction the powers to respond are reduced.

This approach thus requires a well-considered sovereign debt restructuring mechanism. However, its introduction is risky as long as Member States with high levels of debt have not yet reduced these to sustainable levels. Otherwise it cannot be ruled out that financial markets will anticipate debt restructuring. More fundamentally, the risk of excessive reactions from financial markets remains and as a result, in the decentral direction the EMS, (preferably converted into an EMF), remains necessary to prevent severe problems if crises occur.

c Prosperity, social progress and international position

If market discipline and policy competition enforce structural reforms this could increase growth potential. Past experience has also shown, however, that due to the accumulated shortfall vis-à-vis other eurozone Member States, it will be difficult for weaker Member States to recoup lost terrain on their own. As a result of the more limited options for coordinating the budgetary and economic policies of Member States at the European level, the question is whether this direction will contribute to increased economic growth and social progress within the monetary union. This raises questions about the sustainability of a 'decentral' approach in the long term, because the picture of a non-performing monetary union, which doesn't live up to expectations, may persist in public opinion.

Increasing Member States' own responsibility will likely not make it easier for Europe to speak with one voice. At the same time, the establishment of an EMF would make it easier to operate as a single entity in international institutions such as the IMF.

Assessment in terms of the political-institutional and legal aspects

a Subsidiarity and national policy scope

The advantages of this direction are primarily at the political-institutional level. An increase in national responsibility reduces the chance that enforcement of the rules and agreements in Member States will be perceived as oppressive and 'Brussels' meddling. Since Member States regain influence over their national policies, the legitimacy of and popular support for measures could increase. European taxpayers would not have to step in as quickly when other Member States encountered problems, because private parties are liable first via the agreed debt restructuring mechanisms. However, the debate on the democratic legitimacy of the ESM/EMF will continue to exist, especially if it is allocated restructuring power.

It is unsure whether this direction could be politically stable in the long term, as the question remains to what extent making Member States fully responsible for enforcing the rules is politically realistic, if at the same time it is likely that some form of financial support remains necessary to avoid major financial instability when Member States end up in financial difficulty. If this power of enforcement leaves a lot to be desired, there is the risk of a configuration that ultimately is not sustainable in both economic and political terms as this could imply that in future crises Member States would once more have to share financial risks, but would no longer have the option of influencing the risks through European rules related to national policy. This risk could possibly be mitigated if the functioning of national surveillance bodies would be supervised at the European level.

b Democratic accountability

From the perspective of democratic accountability a 'decentral' approach may be less problematic, mainly because Member States assume more responsibility and as a result national parliaments play a relatively greater role in shaping and governing policy. This imposes demanding requirements on policymakers' self-discipline and on the effectiveness of national surveillance bodies. While current national surveillance bodies largely play an advisory role, in this direction they will have to obtain increased powers when enforcing the rules

and agreements, to prevent advice from national surveillance bodies being put aside as a result of political opportunism. However, in this case the risk remains that problems currently experienced with democratic legitimacy at the European level are not fundamentally addressed, because independent, national surveillance bodies can still enforce European rules and agreements as binding. As a result the policy scope of the government and parliament will decrease. Consequently, the perception that Member States have to conform to 'Brussels' rules and agreements indirectly, via binding decisions taken by national surveillance bodies, may persist.

c Legally coherent anchoring

It is unsure whether this direction requires a treaty amendment. In itself it is possible to introduce a debt restructuring mechanism by amending the ESM Treaty, but this does not change the fact that it is still desirable to ultimately integrate this treaty in European Union law. The extent to which a meaningful new distribution of responsibilities is possible is uncertain within the current applicable budgetary and economic rules in the Treaty. Some believe it is necessary to amend the treaties in order to legally ensure the ECB limits itself to its primary mandate of achieving price stability because the European Court of Justice has authorised the ECB's current operations under the existing treaties, albeit subject to conditions.

5.5 Deeper integration

Description of the direction

Another possible direction for strengthening EMU's governance and functioning is through deeper European integration. Also in this approach, as described in the 'Completing what has already been agreed' direction, including completing the Banking Union and Capital Markets Union, are taken as given. This direction could be pursued to a greater or lesser degree and many different combinations and versions of measures are possible. *Grosso modo* the following aspects are plausible.

Firstly, shaping and enforcing the economic and fiscal rules would be handled at a more central level. A European authority would be responsible for doing so, which could take the form of an independent budgetary authority at the European level (such as a reformed European Fiscal Board), as well as a European Commissioner with extended powers. This authority would be charged with the task of enforcing the SGP and the MIP and in certain circumstances could force Member States to take measures and implement reforms. The authority could coordinate Member States' policies by focusing more on divergences between Member States and on

the macroeconomic policy framework for the EMU as a whole. Incentives are required to achieve this, not only negative ones (fines), but also positive ones, to encourage Member States to comply with the rules and agreements. One could also consider assigning the European Court of Justice a greater role in enforcement by opening up appeal to certain decisions taken by the European authority. In short, the enforcement would primarily be handled at the European level; market discipline plays a secondary role.

It is conceivable that in this approach Member States would also shift to deeper cooperation in other areas, such as structural reforms that promote economic convergence through common standards for structural policy, by reinforcing the EMU's social dimension and harmonising fiscal and labour market laws and legislation. Moreover, influence from the European level on national policy scope would, at times, increase dramatically.

Deeper integration would increase mutual solidarity between Member States and as a result the involvement of national resources. This may take place through a common fiscal capacity (see text box 7), to which Member States could resort in the event of asymmetrical shocks, and that could provide a budgetary boost to the EMU as a whole in certain circumstances. This budgetary capacity could be funded by national payments or – as often advocated, but currently less evident – by taxes levied at the European level.

Text box 7: Types of common fiscal capacity

The idea of a common fiscal capacity at the European level dates back to before the EMU was introduced, but emerged once more after the euro crisis. The differences between the plans in circulation mainly concern the objectives pursued: to contribute to stabilisation of the economic cycle or funding European public goods (such as guarding external borders, cross-border investments, environmental policy). There are also different ideas about the preconditions for making such capacity economically effective and politically acceptable.

Initially the proposals focused on a *stabilisation fund*, in which asymmetrical shocks in Member States are absorbed by resources automatically redistributed between Member States, based on an indicator for the position of the economic cycle. The advantage is that no discretionary decision-making is required (and

thus no time-consuming political debate) and that any redistribution is temporary. Therefore, no permanent transfers between Member States take place, the latter being the aim of the structural and cohesion funds. However, in practice the design of the fund will prove difficult. A fund based on the output gap would not have been particularly effective the past decade as cyclical fluctuations were relatively synchronous. Redistribution would have occurred from Member States in a mild recession to Member States in a severe recession. Moreover redistribution based on a variable that cannot be detected statistically, such as the output gap, would also open up a political debate.

A European *unemployment insurance scheme* is proposed as an alternative. The problem this entails is that unemployment in Member States not only depends on cyclical fluctuations, but is mainly related to the institutional structure of the labour market and the social security and tax systems. These differ significantly from one Member State to another and therefore, it is highly likely that this may lead to permanent redistribution, which is politically-sensitive. To prevent this substantial harmonisation of national institutions is needed, but for this there currently appears to be little support.

Other plans focus on an *investment fund* to promote growth for the euro area as a whole, which may only be used in special circumstances (a 'rainy-day fund'), such as extremely severe recessions. Greater European fiscal stimulus would have relieved the ECB's monetary policy over the past years. The challenge is that discretionary decision-making is required, which involves the risk that the use of resources and selection of projects will be politicised. Administrative preparation, cost-benefit analyses and spatial planning procedures make it difficult to schedule projects in a timely fashion so that they actually contribute to cyclical stabilisation.

Lastly, there are proposals for focusing the fiscal capacity on *structural reforms*. Member States would receive funds for accompanying policies when taking measures, as a result of which incentives for implementing structural reforms are reinforced. This improves the functioning of the monetary union and promotes convergence of income in the EMU. This approach could also be linked to the above-mentioned investment fund or to the structural and cohesion funds.

A common fiscal capacity requires decisions about the funding process: from Member State contributions, from European taxes or from an independent European lending capacity.

The stability of financing Member States' government debt could be increased by funding part of the government debt using an EMU-wide *safe asset* (see text box 8). It would significantly reduce the risk of financial market turbulence. This increased solidarity reduces the need for the ESM and the ECB to intervene. The extent to which this would actually materialise depends on the exact set-up, but could be far-reaching in theory.

Text box 8: Forms of EMU-wide safe assets

During the euro crisis, vulnerable Member States' government bonds did not seem as safe as originally thought and investors fled to the bonds of stronger countries, such as Germany and the Netherlands. This capital flight caused funding problems in the vulnerable Member States, which were mitigated by financial support from the ESM. Another possible way of preventing capital flight is to create a safe bond for the euro area as a whole: an EMU-wide *safe asset*. The advantage offered by this safe bond is that market parties no longer have a reason to dispose of bonds from Member States that end up in difficulty. Banks are also safer if they replace bonds on their balance sheets from their respective governments with these safe assets.

The main forms of safe assets are *eurobonds*, bonds that are issued centrally for the euro area as a whole, and are jointly guaranteed by all eurozone Member States. These bonds are used to fund deficits in individual Member States. Apart from the above advantages, a major drawback of eurobonds is that they increase moral hazard. Member States will be less inclined to do their utmost to implement sound budgetary policy, since market discipline for individual Member States is reduced and because other Member States provide a guarantee. This also increases the risk that other Member States will ultimately be liable if a Member State allows its debt to increase so much that it can no longer repay.

To limit the risk of moral hazard, there are various plans that propose only partial or temporary funding of Member States' government debt in the form of

eurobonds. In addition, Member States would have to issue their own bonds as well, for example, for the part of government debt that exceeds 60% of GDP. The advantage is that a certain degree of market discipline is retained. One could also consider eurozone Member States shifting to joint debt issuance in the form of eurobonds, but that 'on the flip side' differentiation does take place with regard to the rates of interest applied to the individual Member States, e.g. based on their respective levels of debt.

One related proposal concerns *Sovereign Bond-Backed Securities* or European Safe Bonds. Countries continue issuing their respective bonds, but they are bought up, bundled in a fixed ratio for all Member States, divided into tranches and sold on. If one of the countries is unable to honour its reimbursement, a write down occurs and private bond holders bear the losses. These bonds differ significantly from eurobonds because there are no public guarantees. The disadvantage is that the products are complex. It remains uncertain whether risks are sufficiently incorporated to retain market discipline. This perpetuates the risk that other governments will still have to compensate for losses, if confidence in the safe asset were to wane in the case of significant write downs.

In this approach steps must also be taken to increase democratic legitimacy and legal embedding. If the executive and surveillance role is reinforced at the European level, in whatever form, this should also involve reinforcement of democratic control at the European level. This could be achieved by increasing the European Parliament's role (whether or not via a European Parliament commission solely comprising members from eurozone Member States), setting-up an inter-parliamentary conference or establishing a special parliamentary body for the eurozone (a eurozone parliament). Each of these configurations offers advantages and disadvantages and involves issues that still need to be resolved (see section 4.2.3).

If the solidarity mechanisms function properly and could be applied more quickly, one could consider ending decision-making based on unanimity. This relatively drastic measure in the direction of deeper integration requires a substantial increase in the involvement of various democratic institutions, including greater parliamentary involvement at the national and European levels. Therefore, it is obvious that the new European fiscal authority needs to be accountable to parliament at the European level, which means to the European

Parliament or to a new parliamentary body yet to be established for the eurozone.

Assessment in terms of socio-economic aspects

a Capacity to adjust to cyclical shocks

This direction would enable improvements in socio-economic performance, subject to strict compliance with and enforcement of the rules and agreements. The capacity to adjust to shocks could increase, as Member States strengthen their economies through structural reforms and because there is improved enforcement of the rules. If Member States lagging behind improve their competitiveness, structural differences between Member States will decrease. Improved enforcement of the rules and agreements could significantly reduce the risk of new imbalances and new crises occurring. One condition to achieve this is that central enforcement functions effectively and rules and agreements are indeed strictly enforced. One risk is that the expansion of the solidarity mechanisms could be counterproductive, because they could lead to structural adjustments in Member States being postponed (moral hazard).

b Preventing and absorbing crises

The risk of a crisis occurring is reduced in this approach, while the decisiveness to respond increases due to the centralisation of powers and instruments. If enforcement of the rules and agreements takes place at the central level and could therefore take place credibly, it seems likely that crises will occur less often. Moreover, instruments exist that are able to limit the effects of a crisis. The safe asset for the eurozone means that individual Member States would be less dependent on the market, thus reducing the financial damage if problems arise. In the event of a severe economic downturn a European macroeconomic stabilisation mechanism could also provide a budgetary stimulus using European funds, which can reduce the consequences of a crisis. One important condition in this regard is that enforcement is carried out strictly and effectively.

c Prosperity, social progress and international position

Greater emphasis on convergence between Member States through the use of European instruments that promote structural reforms, increases growth potential and improves economic perspectives in the long term. All Member States can profit from this, especially open economies such as that of the Netherlands. Greater economic growth from which all eurozone Member States would benefit could increase popular support for the monetary union. In this approach European Member States could act as a single block at the international level, which enables them to be more effective in international

negotiations and in international forums such as the IMF and the G20. This could give Europe a stronger voice on the world stage, but does require consensus to be established in consultations between Member States.

One risk in this approach is that expanding mutual solidarity and public risk sharing increases the chance of unilateral or permanent transfers between Member States. Currently popular support for this is low in many Member States. The chance of this mainly arises if compliance with and enforcement of the rules and agreements leave a lot to be desired and if Member States still differ too much in economic terms. This risk could be reduced if specific conditions are attached to enforced measures, but cannot be avoided completely. In these circumstances additional risk sharing would weaken rather than increase political support for the EMU. One solution for this is to only move towards deeper public risk sharing when Member States have demonstrated visible progress in diverse aspects of convergence.

Assessment in terms of the political-institutional and legal aspects

a Subsidiarity and national policy scope

The greatest controversies involved in this approach are found at the political-institutional level. The scope for policy-making decreases at the national level and increases at the European level. A genuine risk is that political resistance to this transfer of the scope for policy-making could ultimately result in European rules and agreements that are inadequately effective and inadequately enforced. It remains to be seen how effective a European authority can be in enforcing rules and agreements, which will, after all, always be politicised to a certain extent when it comes to EMU-relevant policy areas (see Chapter 3). As a result due attention needs to be given to the preconditions necessary to ensure that governance centralisation actually improves compliance with rules and agreements. The precise modalities are relevant in this regard, including the structure of the rules, as well as the composition of and voting arrangements within decision-making bodies.

b Democratic accountability

Increased power at the European level offers the possibility of addressing a number of problems more quickly, more effectively and with less mutual distrust. Since implementation, accountability and control are exercised at one and the same level, democratic legitimacy could be increased, at least in theory. However, the question remains whether this would also be perceived as such in Member States, even if the monetary union performed better in terms of economic growth and

employment. The European Parliament is only acknowledged and recognised as an expression of democratic legitimacy to a limited extent by European citizens. The question is whether this would be different if a new eurozone parliament or inter-parliamentary conference were established.

The answer to this last question partly depends on the chosen variant and the interpretation thereof. Two main directions can be distinguished. On the one hand there is the option to increase the power of the European Parliament, on the other to increase the power of national parliaments in the European institutional context. Both directions offer advantages and disadvantages. A hybrid form in which both MEPs as well as members of national parliaments play a role is also conceivable.

Text box 9: Increasing parliamentary input: the European Parliament and national parliaments

1 Increasing the power of the European Parliament

Greater involvement of the European Parliament offers the advantage that this may be done within the current frameworks of the European Union and that this is consistent with the pursuit of convergence between eurozone and other Member States of the European Union. Increasing the power of the European Parliament also leads to less complexity than a separate parliament for the eurozone. On the other hand, more formal competences for the European Parliament will not necessarily lead to citizens also acknowledging and recognising it as an expression of democratic legitimacy. It is doubtful whether the variant, in which a separate commission is set up within the European Parliament, comprising solely members from eurozone Member States, is politically and legally feasible. It would imply that all MEPs agree to this configuration and that those who would not take part in the decision-making process, jointly agree not to partly exercise the responsibilities for which they were elected. Moreover, this approach implies, even though not in a formal legal sense, a 'de facto' breach of the institutional unity of the European Parliament. In practice another parliament would be formed.

2 Increasing the power of national parliaments in Europe

Firstly, one could consider setting up a eurozone parliament, partly or solely comprising members from national parliaments (see text box 10 below). This implies abandoning the objective of unity of the European institutions and convergence between eurozone and other

Member States of the European Union. A parliamentary body especially for the eurozone would further institutionalise the distinction between the European Union and the eurozone, and thus also the divergence between the two. Consequently, this would increase the complexity of the system as a whole. However, a separate eurozone parliament would offer the advantage that it creates a distinct forum for the eurozone in which only parliamentarians from Member States directly involved would participate. The President of the European Council of eurozone heads of state (established in the TSCG (Article 12)) could be made accountable in the eurozone parliament. At present he is not accountable to any institution. The European Commissioner for economic affairs would also be accountable to this parliament.¹⁰⁰

3 Hybrid forms

Hybrid forms are possible to a certain extent. One option is to set up, within the current frameworks, an inter-parliamentary conference of the European Parliament and national parliaments, as provided for in the TFEU (Title II, Protocol No. 1), which debates EMU matters. The TSCG already provides the option for this,¹⁰¹ but its significance could be expanded by, for example, assigning it power to issue binding recommendations on growth, competitiveness, employment, budgetary matters and social policy.¹⁰² It is difficult to estimate in advance the extent to which the introduction of an inter-parliamentary conference would meet expectations. A conference in which representatives of national parliaments jointly debate budgetary policy and other eurozone-related matters, could improve the mutual exchange of information, but the extent to which this will actually result in greater (perceived) involvement in the decision-making process is unclear. Lastly a hybrid form involving a eurozone parliament being established, comprising members of the European Parliament and national parliaments of eurozone Member States, is also feasible (see text box 10 below).

100 One consequence of this is that the European Commissioner may be confronted in the eurozone parliament with a resolution for rejection and as a result may feel the need to step down, while he/she may still have the confidence of the European Parliament.

101 Article 13 TSCG.

102 See, for example, the European Economic and Social Committee Opinion dated 27 May 2015 on completing EMU: The political pillar (2015/C 332/02).

If one were to opt for a separate eurozone parliament there are several ways to structure it. Here too, the final consideration depends on the chosen perspective of the desired democratic legitimacy. The way in which such a parliament would be composed is also crucial. Various challenging issues must be solved when elaborating each possible variant.

Text box 10: Four possible configurations for a eurozone parliament

Four configurations are possible with regard to the composition of a eurozone parliament.¹⁰³

1 A directly elected eurozone parliament

A new, directly elected body offers the appeal that European citizens are directly involved, but it also increases the complexity. The question is whether European citizens are able to understand the differentiation between competences and duties in this new parliament and those in the European Parliament, and will be sufficiently motivated to (continue) to exercise their right to vote. In view of the low rate of participation in European Parliamentary elections the question is whether this option fulfils a need and could offer solace from the perspective of democratic legitimacy. Therefore, the choice of a different option is more plausible.

2 A eurozone parliament comprising MEPs

A separate parliamentary body for the eurozone comprising MEPs from eurozone Member States could offer enough appeal because it may formally create a new institution, but uses parliamentary members that have already been elected, and thus also provides a link with the European Parliament. The caveat that European citizens presently give little recognition to the European Parliament, also applies here. This variant hardly differs materially from the option in which a separate commission is set up within the European Parliament, consisting exclusively of members of eurozone Member States. In this sense a fully separate parliamentary institution consisting exclusively of MEPs is not logical.

3 A eurozone parliament comprising members of national parliaments

A separate eurozone parliament comprising parliamentarians appointed from national parliaments implies that national parliamentarians would have a dual mandate. In addition to being members of their respective national parliaments, they would also be members of the eurozone parliament. From the perspective of democratic legitimacy this offers the advantage that there is a direct connection between European decision-making and parliamentary democracies within Member States. In this variant national parliaments acquire a relatively strong institutional position at the European level. The disadvantage of this variant is that divergence between eurozone and other Member States of the European Union is greatest here. In this case, two independent parliamentary bodies would exist for the eurozone and the European Union that are composed in a totally different way.

4 A eurozone parliament comprising MEPs and members of national parliaments

In this variant the second and third variant is combined in a parliamentary body composed partly of members originating from national parliaments and partly of MEPs elected in eurozone Member States. This approach is consistent with the increasing intertwining of the European and national decision-making processes and could reduce the gap between national democratic involvement and that at the European level.¹⁰⁴

When elaborating the third and fourth variant, diverse challenging questions arise, such as the decision-making process (per country, per capita or per weighed vote) and questions about the role of members (independence from outside influence) appointed by national parliaments and whether they have to reflect the entire national parliament or can be appointed by the majority. In countries with a bicameral parliamentary system, a decision must be taken about involving both or just one of the houses.

103 This text box is largely derived from the Advice by the Advisory Division of the Council of State issued to the Senate of 18 January 2013, related to anchoring democratic control for reforms of economic governance in Europe (Parliamentary papers I 2012/13, 33 454, No. AB, pages 15-17.

104 To a certain extent this builds on Protocol No. 2 to the Treaties on the basis of which national parliaments have already been assigned an independent role in the European decision-making process.

A number of the variants discussed involve a dual mandate in which parliamentarians combine membership of their respective national parliaments with that of a parliamentary body at the European level. This would serve the aim of making a positive contribution to democratic legitimacy, because a direct connection is made between the European decision-making process and parliamentary democracies anchored in Member States. The advantages must be weighed up against the potential disadvantages of a practical nature, such as limited available time and capacity.

c Legally coherent anchoring

A treaty amendment is required to legally anchor the different elements involved in this approach. During the treaty amendment the intergovernmental treaties concluded during the crisis could also be incorporated in European Union law.

The EMU's
development from
the perspective of
the Netherlands

6

6.1 Defining the Dutch interest

Progress to strengthen the EMU is not self-evident

Improvements were needed to ensure the proper functioning of the EMU, because its original set-up contained deficiencies. In this sense the EMU is an unfinished project, but it is subject to continuous development. This is almost inevitable in a structure in which 19 countries cooperate in a monetary union, the scope of which is unprecedented in historical terms.

The EMU's development did not proceed automatically. While it was originally thought that EMU would gradually strengthen 'organically', following a 'natural path', in practice it appeared that political decisions would be needed along the way. Since political decisions were absent, this led – sometimes out of necessity – to the application of technocratic solutions, which came at a cost, such as limited democratic legitimacy. Some of these solutions have made the functioning of the EMU more complex or even problematic, including failure to apply the no-bail-out clause, the positioning of the Eurogroup of ministers of finance, and the role of the ECB.

The previous chapters outlined the historic developments and the possible future directions for the EMU and described the corresponding advantages and disadvantages. This concluding chapter brings the previous chapters together and assesses lines of thought and proposals. For this the assessment framework designed for this purpose (see Chapter 4) is applied from the perspective of the Dutch interest – which does not imply that this conflicts with the European interest or the national interest of other Member States.

Disintegration extremely costly for the Netherlands

First and foremost, the common currency is in the interest of the open and international-oriented Dutch economy. The EMU created a strong currency with low inflation, which in terms of purchasing power is on a par with the 'hard' currencies such as the German mark and the Dutch guilder that preceded it. The euro has contributed to intensifying trade within the euro area, in which the Netherlands has been able to profit as a trading country par excellence. The euro enables some 60% of Dutch foreign trade to be conducted without any exchange rate risk. Therefore, disintegration of the EMU would have major consequences for the Netherlands, for our exporters, our pension funds, our role as a transport hub and for our appeal as a location for international businesses. The Netherlands benefits, more than most other countries, from the possibilities for trade offered by the EMU and the internal market because of its geographic location, the

structure of its economy – highly focused on exports – and the strength of its institutions and market sector.

Therefore, unilaterally withdrawing from the euro is not in the Dutch interest. Judged against the assessment framework from Chapter 4 this reveals that it would entail major negative financial and economic consequences. The Netherlands' attractiveness as a business location would be hit disproportionately hard, especially if surrounding countries were to remain in the EMU. Exchange rate fluctuations would have negative effects on exports and lead to losses of assets, including for pension funds that have invested a substantial share of their assets (circa 87%) abroad. The threat of exit would also set in motion speculative capital flows that could lead to funding problems for banks and the government. In addition there are practical obstacles that make it difficult to introduce a new currency within a short period of time (coins and banknotes have to be replaced) and disintegration of the monetary union could also damage the real economy in another way, because temporary restrictions would have to be imposed on payments and the free movement of persons, goods and services. Lastly there are further consequences for Dutch political influence on European integration and on shaping policy that will ultimately affect the Netherlands. The example of Brexit clearly demonstrates this.

Therefore, it is also in the Netherlands' interest to keep other Member States in the monetary union. Technically, if a smaller Member State were to leave the monetary union it could still be managed as an 'accident', but the downside is that this would inevitably compromise the irreversibility of the EMU. If Member States end up in difficulty as a result of a shock or crisis it could lead to market speculation and contagion, which could spread to other Member States. If the currency's existence is repeatedly put into doubt it would alter the EMU's functioning and increase the costs of new crises. In short, the Netherlands benefits from a self-evident irreversibility of the euro.

The Dutch interest in further strengthening

Although the continued existence of the EMU is in the Dutch interest, this does not mean that this applies to every adjustment of the EMU's functioning. The further development of the EMU does not follow an automatic route, but will be the outcome of complex negotiations between European Member States, each with diverse, national policy preferences and socio-economic models. The debate has gained momentum following the recent elections in France and Germany, and European Commission initiatives. Further steps also appear

simpler now that the economy of the euro area is doing well and the ECB has not yet started winding down its policy of quantitative easing.

The Dutch position and the Netherlands' policy preferences must be determined on this basis. New measures would preferably have to be consistent with this. Chapter 4 presented an assessment framework with socio-economic as well as political-institutional and legal criteria. Building on this, the Advisory Division of the Council of State believes the following aspects are specifically important to the Netherlands (Table 4).

Table 4: The Dutch policy preferences

- 1 A stable and open trading system.
- 2 Macroeconomic policy discipline and supervision of compliance with rules and agreements.
- 3 Sufficient policy competition and functioning of the free market.
- 4 Adjustment to imbalances rather than financing them.

Firstly, the Netherlands, being a trading country par excellence, has an interest in international stability and an open trading system, in Europe and beyond. This contributes to promoting and keeping export possibilities open. Therefore, the Netherlands also has an interest in European and international cooperation in topics with a cross-border character. Being a medium-sized economy with modest territorial weight, it is severely affected by external developments. A strong, organised Europe also has more clout in international negotiations.

Secondly, the Netherlands has traditionally adhered to macroeconomic policy discipline and international institutions that monitor compliance with rules and agreements. As a medium-sized Member State it is fundamental for us that mutual relationships are governed more by laws and rules, rather than by power relations. Therefore, the Netherlands is traditionally attached to strict and equal application of the rules with regard to all Member States, preferably through a strong, central authority as a counterbalance to large Member States. Application of the principle of subsidiarity and adequate democratic accountability is also required.

The third basic principle concerns sufficient policy competition and functioning of the free market, which offer opportunities for economic prosperity and social progress. Our open economy depends on global developments on which the

Netherlands has no direct influence, and therefore policies have primarily focused on adjusting to changing (international) circumstances, e.g. through structural reforms that maintain or increase competitiveness.

Lastly, a final preference is the prevention of and adjustment to economic imbalances rather than financing them via support programmes. This preference is also guided by the fact that Member States with a surplus on the balance of payments, including the Netherlands, usually have to foot the bill of financing imbalances in the eurozone. If financial support is still required for Member States in difficulty, in principle it must be temporary and focus on economic strengthening, aimed at making permanent aid superfluous.

The above preferences and interests can be used to assess the proposals for strengthening the EMU. They can be helpful to safeguard the Dutch interest when assessing the proposals put forward by others. In doing so it goes without saying that trade-offs exist between the different aspects and that it will not be possible to fully achieve them all.

6.2 No regret measures

Although there are several possible choices with regard to the future of the EMU, a number of measures seem necessary, regardless of the broader direction in which the EMU develops. The Advisory Division of the Council of State distinguishes a number of 'no regret' measures.

Compliance with and enforcement of rules and agreements

First and foremost, improved compliance with and enforcement of the rules and agreements is also in the Dutch interest. On the one hand the agreed rules have guided budgetary policies, perhaps more than initially thought. The budget deficit and government debt of the euro area as a whole compare favourably with those of the United States and Japan.

On the other hand, major differences still exist between Member States with regard to compliance with the targets and criteria. In some Member States government debt is a persistent problem, in which achieving the target of 60% of GDP is still a long way off. Debt reduction would be simpler if Member States focused more effectively on implementing structural reforms that promote economic growth. However, agreements related to structural reforms (MIP) benefit from a lesser degree of compliance than those that are fiscal-related, with the effect that growth in some southern Member States structurally lags behind the northern Member States. A greater

focus on debt reduction and structural reforms would make the euro area more robust and more resilient to shocks.

Compliance with and enforcement of the rules and agreements is necessary in all cases. In this advice the Advisory Division of the Council of State lists specific options for achieving this (see Chapter 3). The attractiveness and effectiveness of these options are partly determined by the choices made for the further development of the EMU. Some methods for improving compliance require a different distribution of competences and therefore are optimally suited to a more 'central' development. Other methods accentuate compliance in Member States and point in the direction of a more 'decentral' development. Intermediate forms are also plausible, such as principally organising compliance monitoring at the decentral level, but making the influence of the central, European level more intrusive, depending on the extent to which Member States fail to comply with the rules and decentral compliance and enforcement mechanisms appear ineffective.

There are also improvements that work well in all the possible future developments of the EMU. These include simplifying the rules and limiting the scope for discretionary assessment for enforcement based thereon. Simplifying fiscal rules and limiting the scope for discretionary assessment could help improve compliance and simultaneously increase national ownership of rules and agreements. One remark in this regard is that as rules become more mechanical in nature, it becomes more difficult to take into account the specific circumstances in a Member State and intervention can be perceived as unreasonable.

Although improving compliance with and enforcement of the rules and agreements is certainly conceivable, expectations should not be overly high. The question remains whether the national, political reality in Member States will allow itself to be adequately steered by increased enforcement, whether it is organised at the national or European level. By definition, improving enforcement mechanisms involves limiting national headroom, also for the Netherlands, which itself finds it difficult to organise sufficient political support for following up European recommendations in the context of the European Semester related to the labour market, mortgage interest deductibility and reforming the pension and tax systems.

Imposing financial sanctions is viewed as the ultimatum remedium by the Commission and the Council, given that they are not actually used. Although retaining this instrument

appears useful as a threat, the Advisory Division of the Council of State sees better prospects in applying reductions of financial contributions in the case of non-compliance, respectively in temporary positive financial incentives for structural reforms actually implemented. Membership of the eurozone involves obligations and these warrant a stronger link to financial contributions from the European budget. One could consider linking financial aid provided by Europe to regions lagging behind, through investment funds and the structural and cohesion funds, to compliance with agreements on reforms. One could also consider reducing other budget items for Member States if they do not respect agreements. This could increase incentives to comply, especially with regard to structural reforms.

Completing what has been agreed

Experience in recent years has taught us that improved enforcement of rules and agreements is not enough for the EMU to function effectively in all circumstances. The unforeseen impact of deregulation of financial markets and the negative interaction between the financial sector and the real economy when the EMU was set up, means it is indispensable that the EMU is also strengthened in financial terms, starting along the lines already agreed. This will be difficult enough in itself and require considerable political capital.

Steps have already been taken towards setting up the Banking Union, but it has not yet been completed. Completing the Banking Union, by introducing a European deposit insurance scheme and creating a common financial backstop for the banking resolution fund, could break the current negative link between banks and their national governments. Therefore, completing the Banking Union is a mandatory requirement for a shock-resistant EMU. However, expansion of the risk-sharing elements in the Banking Union is only possible if the (substantial) remaining risks on bank balance sheets are further reduced beforehand. As a result of these risks there is currently inadequate popular and political support for the proposed forms of risk sharing. There is a fear that Member States with a better capitalised banking sector will have to compensate for less capitalised banks with non-performing loans in other Member States. Therefore stricter governance is needed to restructure the sizeable portfolios of non-performing loans in southern Member States (in Italy non-performing loans comprise 14% of the assets of all banks) using a credible common strategy. It is also necessary to impose limitations on the amount of bonds banks have on their balance sheets from their respective governments, e.g. through adjusted capital requirements. This will prevent banks in a Member State being

hit immediately and hard if its government encounters financial difficulties, or in the worst case scenario, is forced to restructure its debts.

In a completed Banking Union the costs of failing banks are shared by all Member States. This would only be acceptable if the ECB, as the supervisory institution, and the European and national resolution authorities have sufficient grip on the structure of risks and if the bail-in principle is strictly applied when closing banks. The strength of these agreements made will have to prove its worth. Recent experience of resolving problem banks reveals a mixed picture.¹⁰⁵ This demonstrates that in practice, application of European legislation encounters political resistance.

Sharing banking and other private risks would be more manageable if the European capital market were to function more as a single market. The proposals that aim to establish the Capital Markets Union deserve support, because the latter would strengthen the functioning of the internal market for capital, as argued in Chapter 5. The Capital Markets Union would contribute to more robust forms of financial integration and would make it easier for private risk sharing to play a greater role. This will mean that costs of future shocks and crises are borne more by private investors that entered into these risks based on market considerations instead of by governments – and thus taxpayers – of the other eurozone Member States.

Increasing transparency and accountability

Lastly, it is also necessary to strengthen the mechanisms focused on democratic involvement and accountability within the monetary union, and to increase transparency of the decision-making process.

Although drastic changes to the role of parliaments depend on the broader direction in which the EMU develops, a certain measure of increased parliamentary involvement is conceivable in all possible directions. It is important that where there is

105 In the resolution of three banks declared bankrupt, private bond holders only bore the costs for the Spanish Banco Popular. The resolution of two Italian banks was left to the national authorities due to their limited system relevance. The Italian authorities did not implement any bail-in and still provided public support – albeit within the applicable legislation – partly because the bonds were distributed between a large number of private savers that were insufficiently aware of the risks.

currently scope for parliamentary involvement, parliaments should be enabled to fulfil their powers on substance and exert control or influence in the most important decisions in a timely manner. In order to be effective in these situations the House of Representatives and the Senate could conceivably better align their procedures to the European decision-making process. This not only concerns gathering information, but also selecting measures or decisions expected to have a substantial impact on the Netherlands, the timely exploration of the potential consequences of proposals and decisions and establishing a ‘gateway’ to desired or unwanted outcomes. In the latter a balance must be found between national parliamentary control and the government’s required scope for negotiation at the European level.¹⁰⁶ Subsequently, with regard to the final result achieved the possibility of retrospective accountability exists using the standard parliamentary instruments.

National parliaments can only effectively fulfil such a role if the problems they currently face when controlling the European Union, are tackled. In the Council of Ministers a large number of diverse decisions are taken where it is difficult to oversee by whom, where and when these decisions are taken. The necessary documentation for the preparation of the Council meetings is often hard to come by and when it is made available there is often limited time to discuss it. Therefore, national parliaments can only effectively fulfil their role if there is also consideration of the way in which transparency of the decision-making process could be increased.

Democratic legitimacy may also be improved at the European level, such as by setting up a separate commission in the European Parliament composed of exclusively MEPs from eurozone Member States. This commission could deliberate eurozone matters with the European Commissioner for economic and financial affairs. One could also examine how this commission could deliberate with the President of the Eurogroup. Besides increasing the role of the European Parliament, in the current treaty-based framework one could consider increasing the role of national parliaments in the European institutional context, such as by setting up an inter-parliamentary conference of the European Parliament and national parliaments, as provided for in the TFEU, which would discuss EMU matters.

106 See, for example, the Advice issued by the Advisory Division of the Council of State on guarantees for the transfer of powers, Parliamentary papers II 2013/14, 33 848, No. 15, page 12.

In addition it is desirable that the complexity of institutional arrangements be reduced and the coherence of legal anchoring be increased. Some of the measures that are the result of intergovernmental treaties outside the European Treaties (ESM Treaty, TSCG) should be incorporated in European Union law. This would simplify transparency and accountability, and the measures would fall under the standard legal order of the European Union. In this regard the Advisory Division of the Council of State is of the opinion that one should weigh up these advantages and the way in which delineation of the competences between the European Parliament and national parliaments reduces the distance to the citizen. The next section explores options that could result in reinforced democratic legitimacy in the EMU's development.

6.3 Alternative choices in the further development of the EMU

The 'no-regret' measures mentioned above would signify substantial progress from the perspective of the Dutch interest, compared with the current situation. However, further adjustments are desirable to secure sustained popular support for the monetary union in the long term. This involves possible choices in several policy areas, such as regulatory complexity and democratic legitimacy, which must be viewed in conjunction to arrive at logical, consistent approaches.

Distribution of responsibility for enforcement

The first important choice involves the way in which compliance with the rules is organised. As explained above, the effectiveness of these options is partly determined by the choices made in the further development of the EMU. One question in this respect is whether this must be achieved by increasing power at the central level or by assigning Member States more responsibility combined with a greater disciplinary effect of financial markets.

By placing more responsibility for enforcement of the rules and the agreements at the level of the European institutions – subject to effective structure and implementation – improved enforcement and better coordination, e.g. of structural reforms, is possible. Placing responsibility for enforcement with national authorities increases national ownership. Hybrid solutions are plausible, such as in relation to the extent of the centralisation or decentralisation of enforcement of the rules and agreements in the SGP and the MIP. It is conceivable that with regard to the SGP rules, decentral enforcement mechanisms would be applied as long as countries comply with the thresholds for the budget deficit (less than 3% of GDP) and government debt

(less than 60%) or as long as there are no excessive imbalances in the MIP procedure, but that central enforcement mechanisms would apply if countries exceed these thresholds.

The role of market discipline, the no-bail-out clause and financial safety nets

The second option relates to the question of how government funding problems will be tackled in future crisis situations. Different approaches are conceivable. One involves increasing market discipline through stricter application of the no-bail-out clause. This requires an orderly mechanism for restructuring government debt, as well as strengthening the Banking Union to prevent major negative effects of restructuring on the banking sector. Another possibility is expanding (the clout of) public safety nets such as the ESM. These approaches do not have to be mutually exclusive; a greater role for debt restructuring could be sought in conjunction with financial safety nets. From the perspective of the interest of the Netherlands the priority should be that financial support is only temporary and is used to adjust imbalances through structural reforms.

One frequently cited suggestion is to convert the ESM into a European Monetary Fund (EMF). This could, to a certain extent, depoliticise decision-making related to the use of emergency funds in Member States in difficulty. The formation of the EMF would enable a reduction of the role of the ECB in the troika, alongside the Commission and the IMF.

A review of the role of financial safety nets along these lines offers the possibility of a more fundamental review of the role of the ECB. The lack of effective crisis instruments and the lack of decisiveness in other institutions (Member States, the Commission) within the monetary union's architecture, saw the ECB forced to set up new monetary instruments, just as many other central banks in developed economies. However, the substantial government bond buying programmes have led to debates on the question of how these programmes relate to the prohibition of monetary financing and the no-bail-out clause.

The latter illustrates that with the accumulation of new instruments and competences a situation has developed in which the ECB assumes such a weighty position that it puts the *checks and balances* under pressure vis-à-vis the budgetary authorities and thus gives rise to questions of democratic legitimacy. Over time this could severely damage the credibility of the ECB, which derives its independence from the treaty-based mandate, in which price stability is its main objective and other objectives may only be pursued if they do not jeopardise the primary objective.

In the long term, the Advisory Division of the Council of State also sees advantages in placing bank supervision, presently exercised by the ECB under the responsibility of a separate, independent European authority, so that the ECB can focus on its main task of monetary policy. The way in which account is taken of the weak capital position of banks supervised by the ECB when monetary policy is shaped and instruments are used, means that monetary and supervisory objectives could become mixed up.

As the economic architecture of the EMU is strengthened – the ‘E’ in EMU – concurrently reassessing the role of the ECB also seems possible. However, a more limited remit for the ECB is only possible if the role it was forced to fulfil during the crisis is now performed in an alternative manner. The role the ECB fulfils in the EMU cannot be viewed in isolation, but partly depends on the alternative available mechanisms, and of the decisiveness demonstrated by Member States and the other institutions in the euro area. Consequently, the ECB will automatically focus more on its primary objective and thus have to take fewer far-reaching measures as compliance with the rules and agreements improves, a completed Banking Union limits the interaction between banks and governments and financial support to Member States in difficulty is organised via the ESM (or EMF).

The choice of possible further solidarity mechanisms

The third option concerns the degree of more or less far-reaching mutual public risk sharing and the design of the accompanying solidarity mechanisms. This risk sharing could involve debt financing (through eurobonds or other forms of a *safe asset*), stabilising shocks (such as via a European unemployment insurance or a ‘rainy-day fund’), or stimulating investments and structural reforms (see text boxes 7 and 8 in Chapter 5). Solidarity with Member States that are lagging behind could be increased by focusing aid on structural reforms in the Member States concerned. Structural reforms help increase growth capacity in Member States and thus promote economic prosperity and social progress. The European cohesion fund was established to reduce economic and social inequalities and promote sustainable development in Member States with a GDP per capita lower than 90% of the EU average. Financial aid from this fund can already be suspended if a Member State’s budget deficit is too great and its measures taken to rectify it are deemed insufficient. One could consider also linking payments from the fund to the progress of structural reforms.

One question that arises is the level of ambition the eurozone must pursue in socio-economic terms. Reducing economic and social differences and promoting social progress are among the objectives stipulated in the Maastricht Treaty. For popular support for the euro it is important that participation in the EMU does not obstruct the achievement of economic prosperity and social progress in any way. Support for structural reforms in Member States lagging behind could provide a positive boost. A monetary union that offers Member States no prospect for improvement or boosting employment, or that does not provide participating Member States with the confidence that they can achieve more growth collectively than individually, and from which each Member State can benefit, will continuously be an electoral issue. However, this need not immediately translate into European policy. The differences between Member States are too great and a certain degree of policy competition between Member States is desirable, consistent with the diverse preferences and policy traditions of Member States. Social policy and labour market legislation are largely a national competence; an overly legal interpretation at the European level would further increase the perceived remoteness of European decision-making. Therefore, most efforts in this area will have to be made by Member States at the national level.

Deeper strengthening of democratic legitimacy

The institutional structure and the democratic control of governance of the eurozone must be improved if one opts for the further development of the EMU. The question of which institutions must be strengthened, and how, is closely linked to the direction being taken. If one opts for an approach that increases responsibility at the European level, both European and national democratic control and accountability mechanisms will have to be aligned accordingly. This requires strengthening at the European and national level. To achieve this various options are possible that will each have to be judged on their merits. Depending on the choice either the position of the European Parliament or that of national parliaments could be strengthened at the European institutional level. Combinations of variants are also possible in which national parliamentarians acquire a dual mandate.

An increase in democratic accountability measures at the European level may be less evident in a more ‘decentral’ variant.

Decision-making related to measures to increase the democratic legitimacy of the monetary union, could sometimes present the dilemma of the desirability of parliamentary

involvement on the one hand and (the need for) decisiveness on the other. In 'normal' circumstances standard democratic procedures can and must be followed in the decision-making process, within the established frameworks in national and European regulations. However, in times of major and acute (financial) stress, during which decision-making sometimes has to take place under great pressure of time, it will not always be possible to follow all the 'standard' democratic procedures. Neither is this necessary, per se, if the outcomes of the decision-making is acceptable and that the decision-making process was followed correctly and accountability can be provided at the end. This essentially involves the relationship between the different forms of democratic legitimacy (input, throughout, output and feedback legitimacy, see text box 4 in Chapter 4), which must always be assessed together.

Issues related to democratic legitimacy will also have to be tackled when converting the ESM into an EMF. The EMF will have to be subjected to appropriate institutional *checks and balances* with regard to its role in providing temporary financial assistance, compiling adjustment programmes and pursuing surveillance tasks. One could take the example of the IMF governance model, with appropriate changes relevant in the context of the EMU. Accordingly, decision-making related to specific cases would be implemented by a 'board of executive directors', issued with a mandate by a 'council of governors' (consisting of the ministers of finance of Member States). This board could function as the 'day-to-day management' and develop and implement policies and rules within a strict mandate formulated by the council of governors. For its financial resources the fund would still have to call on Member States, as national parliaments' approval is required as in the case of any capital increase for the IMF. The latter would mean that national parliaments would have direct influence (as is currently the case for the IMF) on the size of resources allocated to the fund by the Member State concerned, but that decision-making related to use of the resources for specific support programmes lies with the day-to-day management of the EMF, appointed by Member States. Such a set up increases the decision-making power in situations of acute crisis. National parliaments lose direct control in specific situations, but they can address their minister of finance, in his/her capacity as governor, on the position adopted by the EMF at any time. The previous comments related to the importance of openness and transparency also apply here if one is striving for real parliamentary control of the acts of one's respective ministers.

6.4 Consequences and trade-offs involved in the options

The options cited above must be considered together to arrive at consistent combinations. Several variants are possible. The proposals in circulation can largely be summarised along two separate lines of thought, which both require fundamental choices. The first is a development in which increased responsibilities are assigned at the level of Member States and the disciplinary effect principally relies on financial markets. The second is a development of the EMU in which closer cooperation is achieved through more central mechanisms to absorb cyclical and structural differences between Member States, and the disciplinary effect principally rests on decision-making at the European level.

Both directions are conceivable and could be pursued to a greater or lesser degree. The Advisory Division of the Council of State does not put forward a preference, but believes it is useful to bear in mind the implications for the Netherlands when assessing them. Both variants involve advantages as well as disadvantages. Moreover, it will not be possible to achieve all the objectives at the same time: both directions involve trade-offs. It is important that the choice is made with the knowledge and acceptance of the corresponding trade-offs and disadvantages. It would be damaging for the acceptance and legitimacy of the choices made if their corresponding disadvantages would repeatedly give rise to discussion.

Increased responsibility at the national level

A development that increases responsibilities at the level of Member States is especially advantageous from the perspective of policy competition, subsidiarity and political legitimacy. This requires a predetermined and transparent mechanism for restructuring government debt. It will encourage markets to assess risks realistically and thus react sooner. This development relies heavily on market discipline and on the willingness and ability of Member States to respect agreements of their own accord. Therefore it demands a great deal of self-discipline from Member States, though this has not (generally) proven self-evident in the past. A lot will depend on the authority and the perseverance of national supervisory bodies and this will limit national parliaments' room for manoeuvre – as is currently the case with European rules and agreements. If national authorities and parliaments ignore advice from national supervisory bodies this disciplinary element of the decentral development becomes redundant. If the disciplinary effect of financial markets does not improve either – in the past markets have reacted too late – there may be the

temptation to disregard fiscal rules, to allow the accumulation of macroeconomic imbalances and still postpone structural reforms.

Therefore the greatest risk posed by this ‘decentral’ development is that Member States will still end up in difficulty due to a lack of compliance and failing market discipline. This means that the EMU may not function more effectively than is currently the case, and the economic potential of the monetary union will not be fully exploited. The (substantial) risk will persist of new crises emerging, in which the question is how stable financial markets will be without any form of financial safety net. This more ‘decentral’ variant with a full return to the no-bail-out clause could then lead to high economic costs. If the no-bail-out clause is fully restored Member States could soon be confronted with funding problems, which means the debt restructuring instrument will have to be used relatively often. However, debt restructuring involves costs, for the Member State concerned as well as for bond holders. This is why the mere threat of debt restructuring could set in motion speculative capital outflows, which exacerbate countries’ problems. The ultimate consequence could be that the Member State is required to withdraw from the monetary union. Depending on the circumstances in, and the size of, the Member State in question, this could involve significant costs, also for the Netherlands, and call into question the irreversibility of the EMU.

From the perspective of democratic accountability this approach may be less problematic, mainly because Member States assume more responsibility and as a result national parliaments play a relatively greater role in shaping and controlling policy. However, since this approach also needs common provisions, there is still the risk that current problems experienced with democratic legitimacy at the European level will not be fundamentally addressed, and consequently the perception that Member States have to comply with ‘Brussels’ rules and agreements may persist.

If the current European debate about the future of the EMU were to result in this more ‘decentral’ development, it is important that these disadvantages are limited as far as possible. Three elements are important for addressing these shortcomings.

Completing the Banking Union is essential. Firstly, a fully-fledged Banking Union is essential to prevent the amortisation of government debt directly resulting in problems in the banking sector and thus increasing the negative interaction between

national governments and banking sectors. Although all the proposed reinforcements of the Banking Union contribute to this, stricter regulation of portfolios of government bonds on bank balances is particularly important.

Financial safety nets are still necessary. Although the no-bail-out clause would acquire more weight than it currently has, in this approach the EMU cannot avoid excessive reactions from financial markets and contagion in the case of future crises, without any form of financial safety net. Moreover, one must acknowledge that countries that restructure their debt will, in practice, lose long-term access to private capital markets. To guarantee the credibility of the more effective functioning of the no-bail-out clause, this safety net could take the form of an EMF that provides financial support under strict conditions.

Provide a form of European enforcement of fiscal rules and economic rules in special circumstances. Since financial safety nets are unavoidable this may result in a risky structure because in the event of future imbalances in a Member State, other Member States would have to step in via the EMF, without having the option of exerting influence through European rules at an earlier stage. Influence could be exerted through the policy conditionality of the EMF programmes once a Member State finds itself in difficulty, but the possibility of exerting influence beforehand to prevent problems would lie entirely at the level of Member States in this approach. If this enforcement proves to be ineffective, recourse will be made to the EMF more often, with all the costs this entails. Therefore, certain forms of European enforcement also deserve consideration in special circumstances. This could also take the form of preventive (*precautionary*) arrangements with the EMF focused on preventing imbalances.

Increased responsibility at the European level

A development in this direction *grosso modo* means increasing competences at the European level and a certain expansion of public risk sharing. Public risk sharing could be used in a more or less far-reaching manner and there are several proposals in circulation on this theme. Besides the introduction of a common deposit insurance scheme as the final element of the Banking Union, this could involve converting the ESM into an EMF, setting up stabilisation mechanisms and a European budget capacity, and the option of introducing a European ‘safe asset’.

If one opts for a development in this ‘central’ direction, it could provide economic advantages as enforcement of the rules improves and the extension of public risk sharing results

in a more effective absorption of shocks and crises in the future. Consequently the EMU will function better in economic terms, crises will emerge less often and there is a greater focus on economic prosperity and social progress.

Nevertheless, this more 'central' development also involves disadvantages. There is a serious risk of *moral hazard* if greater public risk sharing leads to Member States being less disciplined with regard to debt reduction and feel less pressure to implement structural reforms, because they can count on receiving aid if things go wrong. There is also the risk that in this approach stronger Member States, including the Netherlands, will have to provide aid to weaker Member States relatively often. In the long term this could decrease mutual trust and support for the euro in some Member States.

Therefore, in this approach improved compliance with the rules is essential. As this is accompanied by improved enforcement, by strengthening European governance and assigning far-reaching competences at the European level, this limits Member States' room for manoeuvre, which also applies to the Netherlands. At the same time, a combination of sanctions and positive incentives offer more chance of compliance than is currently the case. However, this is not guaranteed, and depends on the effectiveness in practice. If there is inadequate support in Member States for a further increase in European competences, there is a real risk that the measures agreed will not be effective enough. This has happened more often in the past. Another risk is that the increasing centralisation will lead to European policy choices that are not, per se, in the Dutch interest, such as measures that overly obstruct mutual policy competition between Member States. This would be the case if one opted for European harmonisation in certain policy areas, based on the average European standards, instead of on the basis of *best practices*.

If the current European debate about the future of the EMU were to result in this more 'central' development, it is important that these disadvantages are limited as far as possible. This could take place along the following four lines.

Strict enforcement must be effectively guaranteed when elaborating the central competences. For example, one could consider not only assigning surveillance of fiscal rules to a political authority (such as a European 'minister of finance' as some suggest), but giving an independent surveillance authority (such as a reformed European Fiscal Board) a greater role. Economic forecasts and policy analyses must be positioned independently.

In addition, there must still be sufficient policy competition, albeit with certain minimum levels to prevent a race to the bottom.

Public risk sharing must remain limited to temporary financial support.

Any expansion of solidarity mechanisms and public risk sharing will have to be linked as much as possible to transfers between Member States that have a *temporary* character. Proposals will have to be assessed in relation to the risk that Member States will be complacent (*moral hazard*) and the risk that unilateral and/or permanent transfers will take place. The risk involved in a European mechanism or fiscal capacity for stabilisation of the economic cycle is that countries will not focus enough on increasing their capacity to adjust. The impact of the economic cycle and the impact of inadequate structural factors will in any case be difficult to separate. Therefore, a European unemployment insurance could lead to permanent transfers due to large institutional differences in labour markets and social security systems, as long as structural reforms lag behind other Member States.

Other forms of *structural* public risk sharing, such as eurobonds or other forms of safe assets, will only eventually become an option if and when the economic and fiscal risks in Member States have decreased significantly because, for example, government debt has been brought down close to the 60% target in Member States. Radical expansion of public risk sharing in the euro area only seems feasible if enforcement of the rules has been demonstrably improved and if Member States have converged as a result of structural reforms.

Conditions related to fiscal policy and structural reforms are invariably linked to financial support. Temporary transfers whose added value is clear because they structurally increase the growth potential of the receiving Member State – and thus guarantee repayment – should not be a problem. The existing structural and cohesion funds and the instruments of the European Investment Bank (EIB) could be strengthened by, as mentioned previously, linking availability to structural reforms. Positive financial incentives, such as in the form of a structural reform fund, also deserve consideration. Temporary financial support from the ESM/EMF can also play a useful role if Member States find themselves in difficulty, due to the link with policy conditions that strengthen the economy. In this way, public risk sharing, to which the Netherlands would contribute, is justified because it contributes to recovery, prevents contagion and thus increases the shock resilience of the eurozone as a whole.

Adequate democratic legitimacy must be provided when shaping the central competences. If the monetary union is strengthened in a direction that leads to deeper European integration, it is obvious that the position of the European Commissioner for economic and financial affairs is strengthened and – in parallel – the European Parliament. Implementation, accountability and control would then be exercised at the same level. This could be achieved by allocating competences to the European Parliament as a whole, or to a configuration therein that consists of Members of the European Parliament comprising just eurozone Member States. Although current treaties do not make this distinction, one could consider creating a separate commission within the European Parliament, comprising exclusively eurozone Member States' MEPs.

Greater involvement of the European Parliament, or a commission thereof, could offer the advantage that operations are conducted within the existing framework of the European Union. On the other hand, more formal competences for the European Parliament will not necessarily lead to citizens also acknowledging and recognising it as an expression of democratic legitimacy. Reintroducing the possibility of a dual mandate for national parliamentarians could reduce the perceived distance between the national and European democratic levels. Consideration of this option has consequences that go beyond the eurozone alone; it requires reflection on the role and position of the European Parliament and its members in a more general sense. There is also the question of whether it is very realistic in the short term because this option requires a treaty amendment.

The next option, which also requires a treaty amendment, is to set up a new parliament solely for the eurozone. To achieve this several variants exist. A eurozone parliament could consist of MEPs of eurozone Member States or representatives of national parliaments. A combination of the last two options is also possible. An advantage offered by a eurozone parliament comprising national parliamentarians could be that it creates a dual mandate; they would be members of the eurozone parliament as well as members of their respective national parliaments. From the perspective of democratic legitimacy this offers the advantage that there is a direct connection between European decision-making and parliamentary democracies anchored in Member States. In this variant national parliaments acquire a relatively strong institutional position at the European level. The disadvantage of this variant is that divergence between eurozone and other Member States of the European Union is greatest here. In this case, two independent parliamentary bodies would exist for the

eurozone and the European Union as a whole (the eurozone parliament and the European Parliament) that are composed in a totally different way. This disadvantage could be mitigated to a certain extent by arranging the eurozone parliament as a mixed composition, consisting of MEPs as well as members from national parliaments. The question that arises in all these variants is whether a separate eurozone parliament would increase the complexity for citizens. Diverse challenging issues must also be solved when elaborating them.

Lastly, adequate accountability and transparency is also necessary outside of parliaments. This enables public scrutiny of whether decisions have been taken legitimately and whether rules have been applied proportionally. One must stress that public support is not guaranteed with the achievement of parliamentary input.

The latter also refers to another dimension in the debate on democratic involvement: the development, currently underway in many democracies, that a growing number of citizens feel increasingly less responsible for and represented by the decision-making process of the legislator or administration, regardless of whether it follows democratic procedures. This phenomenon is highly prominent in relation to decision-making in the European Union and in the eurozone. The remoteness from 'Europe' perceived by many citizens will not be reduced, at least not easily, by increased parliamentary involvement and control, or through other institutional arrangements (referendums). Lastly, an adequate response to this is not least a question of political (power of) conviction and appealing arguments, including from the perspective of the Dutch interest. This points to the need to achieve a balance between input legitimacy and output legitimacy: in addition to high-level democratic decision-making, the EMU also needs authority and results to convince citizens when necessary.

6.5 Concluding remarks

The further development of the EMU does not follow a self-evident path. The Advisory Division of the Council of State does not choose between the various possible directions. Diverse political implications are involved. Stricter enforcement of the rules and agreements in the 'central' development through assigning European institutions greater power to intervene implies that the Netherlands also accepts it must act if requested to do so. Conversely, if the Netherlands is not prepared to relinquish national policy scope when issued with binding recommendations, the same applies to other Member

States, which implies that we may have to be content with an EMU that does not fulfil its potential. There are also dilemmas and trade-offs that require political consideration. One cannot rule out that we will have to be satisfied with 'sub-optimal' solutions, in economic-technical terms, given the diverse policy preferences of the 19 euro Member States. In an international context this is not unusual and is also acceptable, as long as the risks can be overseen and democratic legitimacy is at an acceptable level.

In addition, many proposals that would strengthen the EMU from an economic-technical perspective – because they bring the EMU closer to an optimal currency area – could be detrimental to national policy preferences and detract from democratic accountability processes. On the other hand, far-reaching proposals for democratic accountability sometimes undermine the urgently needed decisiveness and speed to act that is required for a monetary union to function effectively in rapidly changing financial markets.

The fact is that the EMU consists of Member States with different policy preferences, socio-economic models and income levels. The responsibility, for example, for measures and reforms involving the labour and products market and social security lays, first and foremost, at the national level. This means that some differences will remain structural. In federal states, such as the United States, as well as Germany, structural differences between regions also exist, but these differences are expressed in federal politics and do not question the fundamentals of the federation as such. This is not the case in a monetary union of independent Member States in which national politics determines the scope, and is perceived by many citizens to take priority over European politics. This is precisely the dilemma in more central developments in which economic imperatives conflict with achieving adequate social and political support and organising sufficient democratic legitimacy.

The challenge is to find a future-proof form for the EMU that effectively bridges the perceived gap between European decision-making and democratic legitimacy. This is a broader phenomenon in a world of increasing globalisation, in which economic developments are largely determined by corporations and financial institutions operating on a global level, and by developments on international capital markets.

As far as European integration is concerned, Member States jointly determine what is organised collectively and what is not. In addition, if competences of the European institutions

are strengthened one must consider that the Netherlands forms an integral part thereof and contributes to the structure and the nature of the European Union's decision-making process. In this sense there is no absolute antithesis between Member States on the one hand and 'Brussels' on the other. With this in mind, the balance of executive responsibilities between individual Member States and the Community level from the Dutch perspective could shift or be further delineated. For the Netherlands it is paramount that matters on which it can exercise little or no influence independently, can be better arranged collectively. The monetary union, in providing major advantages to the Netherlands, at the same time involves the duty to contribute to its effective functioning, which after all depends on the efforts of all participating Member States. Therefore, there is also a task for politics to clarify that cooperation and joint agreements generally offer far more opportunities for serving the national, Dutch interest than would be the case if the country acted on its own.

This applies even more in a union with a single currency in which the Netherlands must reach agreement with other Member States and in which policy margins and the scope for national preferences are, by definition, slim. The monetary stability the EMU provides is a major public good. Therefore, it is in the Dutch interest to promote and tightly anchor the euro's irreversibility.

The international dimension is also relevant in this endeavour. The monetary union acts as a counterweight to a rapidly changing international balance of power and offers Europe the chance to exert meaningful influence in a global context. The EMU is home to just 4.5% of the world population, but is good for 19% of global GDP. Deeper economic integration involves a stronger position on the world stage and this offers an opportunity to propagate the Netherlands' values and preferences. In a time of international tensions and threats to an open world order, the foothold provided by a common currency that performs well from the Dutch perspective is a major asset.

The departure of the United Kingdom from the European Union means that a new balance of power will have to be sought in Europe and that the Netherlands will have to carefully consider alliances with Member States that have similar preferences. For the Netherlands the United Kingdom's departure means losing an ally in open market thinking. At the same time the Netherlands should realise that the majority of the 19 Member States in the eurozone strive for structural reforms and to reduce government debt.

The reality is that the EMU will require continuous maintenance. To do so the Netherlands can align itself with developments that offer the chance of strengthening the EMU in a way that is consistent with national preferences. This advice provides an assessment framework to achieve this. It is in the Dutch interest to continue to share responsibility for the further development of the EMU, because that gives us the opportunity to continue our successful economic model on the basis of an irreversible currency, and retain open markets in a prosperous Europe. The Netherlands benefits from investing in the EMU, out of enlightened self-interest.

Appendix: Overview of the current regulatory framework

The Maastricht Treaty forms the basis for current European economic governance of the EMU. It stipulates that Member States must consider their economic policy as a matter of common interest and coordinate it in the context of the Council.¹⁰⁷ Multilateral supervision takes place in order to safeguard deeper coordination of economic policy.¹⁰⁸ In addition the Treaty imposes requirements related to the budgetary policy of Member States.

Member States are obliged to avoid excessive deficits in their budgetary policy.¹⁰⁹ The threshold values for an excessive deficit are set out in Protocol No. 12 to the Treaties: in principle the government deficit may not exceed 3% of GDP, and government debt may not exceed 60% of GDP.¹¹⁰ A deficit is not considered excessive if the excess is of an extraordinary and temporary nature and is limited in scope, or, if government debt exceeds the threshold value, if the debt decreases at a satisfactory pace.¹¹¹ The Council, at the Commission's proposal, ultimately decides if there is an excessive deficit.¹¹²

If this is the case, at the Commission's proposal, the Council once more issues a recommendation to the Member State to rectify the excessive deficit within a certain period of time.¹¹³ In principle, the recommendation is not made public, unless the Member State does not effectively act upon the recommendation.¹¹⁴ If a Member State remains in default, the Council, at the Commission's proposal, can warn the Member State concerned to take measures to reduce the deficit within a certain period of time.¹¹⁵ The Council can use the steps described above to exercise coercion, but neither other Member States nor the Commission can file a complaint with the Court of Justice if a Member State does not comply with the thresholds.¹¹⁶ Other measures are possible, including

imposing a fine on the Member State.¹¹⁷ Decision-making in the Council related to the different steps in the process is organised on the basis of a qualified majority, in which the vote of the Member State concerned does not count.¹¹⁸ EU Member States participating in the TSCG have agreed that in principle they will support the Commission's proposal for a recommendation to a Member State in an excessive deficit procedure, unless a qualified majority does not agree with the recommendation.¹¹⁹

The provisions in the Treaty are elaborated in the Stability and Growth Pact (1997). The Pact was originally established in a resolution and two regulations, which were subsequently modified several times. Regulation (EC) 1466/97, amended by Regulation (EC) 1055/2005 and Regulation (EU) 1175/2011, elaborates multilateral surveillance of the fiscal and macroeconomic policy of Member States and pertains to the preventive arm of the Pact. In this arm Member States must submit an annual stability programme (eurozone Member States) or convergence programme (non-eurozone Member States),¹²⁰ which includes a medium-term budgetary objective (MTO) for the structural government balance. In principle for eurozone countries this involves a lower threshold for the MTO of -0.5% of GDP,¹²¹ unless a country's government debt is far below the threshold of 60% of GDP and there are limited risks for sustaining public finances in the long term.¹²² As long as a Member State's structural balance does not comply with the MTO, it must improve by 0.5% of GDP annually as a baseline, in which the size of the government debt and economic cycle is also taken into account: for a debt in excess of 60% of GDP and in good economic times, a larger adjustment is carried out, while in less positive economic times a less severe adjustment is permissible.¹²³

107 Article 121, first paragraph, TFEU.

108 Article 121, third paragraph, TFEU.

109 Article 126, first paragraph, TFEU.

110 Article 1, Protocol No. 12 to the Treaties.

111 Article 126, second paragraph, TFEU.

112 Article 126, sixth paragraph, TFEU.

113 Article 126, seventh paragraph, TFEU.

114 Article 126 seventh and eighth paragraphs, TFEU.

115 Article 126, ninth paragraph, TFEU.

116 Article 126, tenth paragraph, TFEU.

117 Article 126, eleventh paragraph, TFEU.

118 Article 126, thirteenth paragraph, TFEU.

119 Article 7, TSCG.

120 Article 3, first paragraph, resp. Article 7, first paragraph, Regulation (EC) 1466/97.

121 Article 3, first paragraph (b), TSCG.

122 Article 3, first paragraph (d), TSCG.

123 Article 5, first paragraph, Regulation (EC) 1466/97.

As long as there is lack of compliance with the MTO, the Regulation imposes limits on the growth of public expenditure.¹²⁴ Lastly, when assessing whether or not a Member State satisfies the conditions, account is taken of structural reforms that a Member State implements and of the existence of any special circumstances.¹²⁵ If a Member State takes insufficient measures to achieve the adjustment path in the direction of the MTO, the Council may, at the Commission's proposal, issue a recommendation to the Member State concerned to take policy measures.¹²⁶ The Six Pack made it possible to impose sanctions on eurozone Member States in the preventive arm of the Pact. If the Member State does not take any measures as a result of the Council's recommendation, the latter may, at the Commission's proposal, oblige the Member State to lodge an interest-bearing deposit.¹²⁷ A Commission proposal to that effect is deemed to have been adopted, unless a qualified majority of the Council rejects it.¹²⁸ Only eurozone Member States vote on these decisions, with the exception of the Member State concerned.¹²⁹

The corrective arm of the Pact applies to countries with an excessive deficit. Not every violation of the thresholds in the Protocol to the Treaty automatically implies an excessive deficit exists. As noted above, a deficit is not deemed to be excessive if violation of the threshold of the government deficit is of a special and temporary nature and is limited in scope, for example as a result of an unusual event or a serious economic downturn.¹³⁰ A government debt in excess of 60% of GDP does not automatically lead to an EDP either if it decreases at a satisfactory pace. This is the case if the difference with the reference value decreases on average by at least one twentieth per year, over three years.¹³¹ In principle an excessive deficit must be rectified within one year after it has been established.¹³² A deviation is possible in the case of¹³³ special circumstances and the deadline may also be extended.¹³⁴

124 Article 5, first paragraph, Regulation (EC) 1466/97.

125 Article 5, first paragraph, Regulation (EC) 1466/97.

126 Article 6, second paragraph, Regulation (EC) 1466/97.

127 Article 4, first paragraph, Regulation (EU) 1173/2011.

128 Article 4, second paragraph, Regulation (EU) 1173/2011.

129 Article 12, first paragraph, Regulation (EU) 1173/2011.

130 Article 2, first paragraph, Regulation (EC) 1467/97.

131 Article 2, first paragraph (bis), Regulation (EC) 1467/97.

132 Article 3, fourth paragraph, Regulation (EC) 1467/97.

133 Article 3, fourth paragraph, Regulation (EC) 1467/97.

134 Article 3, fifth paragraph, Regulation (EC) 1467/97.

However, the structural balance must improve annually, with a baseline of at least 0.5% of GDP.¹³⁵ If a Member State does not comply with the Council's recommendations and warnings, the Council may impose sanctions on the Member State concerned, in principle in the form of a fine, possibly supplemented with other sanctions stipulated in the Treaty.¹³⁶ With regard to these sanctions in the context of the corrective arm, the Commission issues a proposal, which the Council may only reverse by a qualified majority.¹³⁷ Only eurozone Member States vote on these decisions, with the exception of the Member State concerned.¹³⁸

In addition to fine-tuning surveillance of fiscal policy, the Six Pack also reinforces surveillance of the Member States' macroeconomic policies. It focuses on the detection, prevention and correction of macroeconomic imbalances and allows the possibility of sanctions if a Member State does not act upon the Council's recommendation.

In 2011, an alert mechanism was introduced that helps identify macroeconomic imbalances at an early stage, using a scoreboard featuring threshold values for a series of indicators.¹³⁹ Every year the Commission identifies Member States it believes are struggling with imbalances or run the risk of doing so.¹⁴⁰ With regard to the Member States concerned, following a discussion in the Eurogroup and the Council, the Commission performs an in-depth review, the aim of which is to ascertain whether imbalances exist in a Member State, and whether they are excessive.¹⁴¹ Imbalances are deemed excessive if they could jeopardise the effective functioning of the EMU.¹⁴² If, based on the in-depth review, the Commission finds that there are imbalances, it reports the latter to the Council, European Parliament and the Eurogroup. On the Commission's proposal, the Council subsequently issues recommendations for preventive measures to the Member State concerned.¹⁴³

135 Article 3, fourth paragraph, Regulation (EC) 1467/97.

136 Article 11 Regulation (EC) 1467/97.

137 Article 6, second paragraph, Regulation (EU) 1173/2011.

138 Article 12, first paragraph, Regulation (EU) 1173/2011.

139 Articles 3 and 4 Regulation (EU) 1176/2011.

140 Article 3, third paragraph, Regulation (EU) 1176/2011.

141 Article 5, first and second paragraph, Regulation (EU) 1176/2011.

142 Article 2 Regulation (EU) 1176/2011.

143 Article 6, first paragraph Regulation (EU) 1176/2011.

If the Commission also finds there are excessive balances it issues a report to the Council, the Eurogroup and the European Parliament. On the proposal of the Commission, the Council may subsequently establish recommendations, in which the excessive imbalances are set out and the Member State concerned is advised to take corrective measures. The recommendations include a series of specific policy recommendations to be followed up and a deadline is established before which the Member State must submit a plan with corrective measures.¹⁴⁴ The Council assesses this plan using a report from the Commission. If the Council deems the plan inadequate a Member State must submit a new plan.¹⁴⁵ The Commission supervises compliance with the plan and reports to the Council on this matter.¹⁴⁶ If the Council, on the Commission's proposal, finds that the Member State has not taken the recommended corrective measures, it will issue another recommendation to the Member State in which non-compliance is established and new deadlines are specified for the corrective measures.¹⁴⁷ A Commission proposal to that effect is deemed to have been adopted, unless a qualified majority of the Council rejects it.¹⁴⁸

Regulation (EU) 1174/2011 provides a sanction mechanism for eurozone Member States in the event that Member States do not follow up on the Council's recommendations on the corrective measures to be taken. The sanctions consist of imposing an interest-bearing deposit or, in the event of repeated non-compliance, a fine.¹⁴⁹ The sanctions are established in a Council directive, on a proposal from the Commission, but can only be reversed by a qualified majority.¹⁵⁰ Only eurozone Member States vote on these decisions, with the exception of the Member State concerned.¹⁵¹

The preventive components of the SGP and the Macroeconomic Imbalance Procedure are brought together in the context of the European Semester, which acquired a legal basis with the Six Pack in 2011.¹⁵² The European Semester also includes the assessment of the national reform programmes that Member States submit in the context of the Europe 2020 strategy. Recommendations in the context of the SGP and the MIP, along with recommendations related to the national reform programmes, are viewed as a whole and are issued by the Council to the Member States in the form of country-specific recommendations, at the Commission's proposal.¹⁵³

144 Article 7, first and second paragraphs, Regulation (EU) 1176/2011.

145 Article 8, second and third paragraphs, Regulation (EU) 1176/2011.

146 Article 10, first paragraph, Regulation (EU) 1176/2011.

147 Article 10, fourth paragraph, Regulation (EU) 1176/2011.

148 Article 10, fourth paragraph, Regulation (EU) 1176/2011.

149 Article 3, first and second paragraphs, Regulation (EU) 1174/2011.

150 Article 3, third paragraph, Regulation (EU) 1174/2011.

151 Article 5, first paragraph, Regulation 1174/2011.

152 Article 2-bis Regulation (EC) 1466/97.

153 Article 2-bis, third paragraph, Regulation (EC) 1466/97.

Literature consulted

A. Alesina, G. Tabellini and F. Trebbi (2017), Is Europe an optimal political area?, *Brookings Papers on Economic Activity*, March 2017.

Advisory Council on International Affairs (AIV) (2017), Is de eurozone stormbestendig? Over verdieping en versterking van de EMU (Is the eurozone stormproof? On deepening and strengthening the EMU), AIV-advice No. 105.

Court of Auditors (2014), Europees economisch bestuur: Europese coördinatie van begrotings- en macro-economisch beleid en de positie van Nederland (European economic governance: European coordination of fiscal and macro-economic policy and the position of the Netherlands), 9 September 2014.

F. Amtenbrink and R. Repasi (2017), Compliance and Enforcement in Economic Policy Coordination in EMU, in: A. Jakab and D. Kochenov, *The enforcement of EU Law and Values*, Oxford University Press.

A. Bakker (2015), Europe is urgently in need of a reappraisal of solidarity, *DSF Policy paper Series*, No. 52.

R. Baldwin and F. Giavazzi (ed.) (2015), *The Eurozone Crisis: A Consensus View of the Causes and a Few Possible Solutions*, VoxEU e-book.

A. Bénassy-Quéré, X. Ragot and G. Wolff (2016), Which fiscal union for the euro area?, *Bruegel Policy Contribution*, No. 2016/05.

A. Bénassy-Quéré and F. Giavazzi (ed.) (2017), *Europe's political spring. Fixing the eurozone and beyond*, VoxEU e-book.

M. Bijlsma and J. Hessel (2016), De balans tussen publieke en private risicodeling in de EMU (The balance between public and private risk sharing in the EMU), *Economisch Statistische Berichten*, vol. 101, pages 358-361.

S. van den Bogaert and A. Cuyvers (2016), Of Carrots and Sticks, in: B. Steunenberg, W. Voermans and S. Van den Bogaert (ed.), *Fit for the future? Reflections from Leiden on the Functioning of the EU*, Eleven international.

L. Buchheit, A. Gelpern, M. Gulati, U. Panizza, B. Weder di Mauro and J. Zettelmeyer (2013), *Revisiting sovereign bankruptcy*, Committee on International Economic Policy and Reform, Brookings.

Capital Economics (2014), *Nexit: Assessing the economic impact of the Netherlands leaving the European Union*. A report by Capital Economics for the Party for Freedom, London.

G. Claeys, Z. Darvas and A. Leandro (2016), A proposal to revive the European Fiscal framework, *Bruegel policy contribution*, No. 2016/07.

G. Corsetti, L. Feld, R. Koijen, L. Reichlin, R. Reis, H. Rey and B. Weder di Mauro (2016), *Reinforcing the Eurozone and Protecting an Open Society, Monitoring the Eurozone 2*, CEPR Press.

B. Crum (2013), Saving the Euro at the Cost of Democracy?, *Journal of Common Market Studies*, vol. 51(4), pages 614-630.

Z. Darvas and Á. Leandro (2015), The limitations of policy coordination in the euro area under the European Semester, *Bruegel Policy Contribution*, No. 2015/19

M. Dawson and F. de Witte (2016), From balance to conflict: a new constitution for the EU, *European Law Journal*, 22(2), pages 204-224.

Dutch Central Bank (DNB) (2016), *Naleving Stabiliteits- en Groeipact vooral goed als het slecht gaat (Compliance with the Stability and Growth Pact particularly good when times are bad)*, DNBulletin, 22 December 2016.

B. Eichengreen (2007), *The breakup of the euro area*, NBER Working Paper No. 13393.

B. Eichengreen (2014), *The eurozone crisis: the theory of optimum currency areas bites back*, Notenstein Academy White Paper, No. 2014/04.

B. Eichengreen and C. Wyplosz (2016), Minimal conditions for the survival of the euro, *Intereconomics*, vol. 51(1), pages 24-28.

- H. Enderlein, E. Letta, J. Asmussen, L. Boone, A. de Geus, P. Lamy, P. Maystadt, M. Rodrigues, G. Tumpel-Gugerell and A. Vitorino (2016), *Repair and Prepare: Growth and the Euro after Brexit*, Gütersloh, Bertelsmann Stiftung/Jacques Delors Institute.
- European Commission (1990), *One Market, One Money. An evaluation of the potential benefits and costs of forming an economic and monetary union*, European Economy No. 44.
- European Commission (2012), *Communication related to a blueprint for a deep and genuine economic and monetary union*, COM(2012) 777, 30 November 2012.
- European Commission (2017), *White paper on the future of Europe*, COM(2017) 2025, 1 March 2017.
- European Commission (2017), *Reflection paper on the social dimension of Europe*, COM(2017) 206, 26 April 2017.
- European Commission (2017), *Reflection paper on Harnessing Globalisation*, COM(2017) 240, 10 May 2017.
- European Commission (2017), *Reflection paper on the deepening of the economic and monetary union*, COM(2017) 291, 31 May 2017.
- Opinion of the European Economic and Social Committee on *Completing EMU (2015): The political pillar*. (2015/C 332/02), 27 May 2015.
- European Parliament (2017), *Implementation of the Macroeconomic Imbalance Procedure, In Depth Analysis*, 13 June 2017.
- L. Eyraud and T. Wu (2015), *Playing by the Rules: Reforming Fiscal Governance in Europe*, IMF Working Paper, No. 15/67.
- L. Eyraud, V. Gaspar and T. Poghosyan (2017), *Fiscal Politics in the Euro Area*, IMF Working Paper, No. 17/18.
- J. Fernandez-Villaverde, L. Garicano and T. Santos (2013), *Political Credit Cycles: The Case of the Eurozone*, *Journal of Economic Perspectives*, vol. 27(3), pages 145-166.
- J. Frankel and A. Rose (1998), *The Endogeneity of the Optimum Currency Area Criteria*, *The Economic Journal*, vol. 108, pages 1009-1025.
- Gilbert and J. Hessel (2012), *De Europese overheidsfinanciën tijdens de crisis (European government finances during the crisis)*, *Economisch Statistische Berichten*, vol. 97, 166-169.
- P. de Grauwe (2011), *Governance of a Fragile Eurozone*, CEPS Working Document 34.
- D. Grimm (1995), *Does Europe need a Constitution*, *European Law Journal*, vol. 1(3), pages 284-288.
- D. Grimm (2015), *De kracht van terughoudendheid in de Europese Unie (The Power of Restraint in the European Union)*, in: L. van Middelaar and P. van Parijs (ed.), *Na de storm. Hoe we de democratie in Europa kunnen redden (After the storm. How we can save democracy in Europe)*, Lannoo.
- J. van de Gronden (2013), *Bestrijding eurocrisis en de EU-begrotingsregels: alleen handhaving van afspraken of ook soevereiniteitsoverdracht? (Combating the euro crisis and EU fiscal rules: exclusive enforcement of agreements or also the transfer of sovereignty?)*, *SEW*, vol. 61, pages 354-369.
- L. Guiso, P. Sapienza and L. Zingales (2016), *Monnet's error?*, *Economic Policy*, vol. 31(86), pages 247-297.
- J. de Haan, J. Hessel and N. Gilbert (2015), *Reforming the Architecture of EMU. Ensuring stability in Europe*, in: H. Badinger and V. Nitsch (ed.), *Routledge Handbook of the Economics of European Integration*, pages 408-429.
- J. Hessel, N. Gilbert and J. de Jong (2017), *Munt slaan uit de euro. Opties bij het versterken van de muntunie (Capitalising on the euro. Options for strengthening the monetary union)*, *DNB Occasional Study*, vol. 15(2).
- A. Hinajeros (2015), *The Euro Area Crisis in Constitutional Perspective*, Oxford University Press.
- J.C. Juncker in association with D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz (2015), *De voltooiing van Europa's Economische en Monetaire Unie (Completing Europe's Economic and Monetary Union)*, 22 June 2015.
- W. Kok (2004), *Facing the challenge. The Lisbon strategy for growth and employment*, Report from the High Level Group chaired by Wim Kok.
- V. Kreilinger and M. Larhant (2016), *Does the eurozone need a parliament?*, Policy Paper No. 176, Jacques Delors Institute.

- M. Krop (2014), *Hart van Europa. Hoe Duitsland ons uit de crisis leidt en tegen welke prijs* (Centre of Europe. How Germany is leading us out of the crisis and at what cost), Prometheus/Bert Bakker.
- L. van Middelaar (2016), *De Europese Unie en de gebeurtenissenpolitiek* (The European Union and the Politics of Events), inaugural lecture given at Leiden University, 23 September 2016.
- L. van Middelaar and P. van Parijs (ed.), *Na de storm. Hoe we de democratie in Europa kunnen redden* (After the storm. How we can save democracy in Europe), Lannoo.
- A. Moravcsik (2002), In defence of the 'democratic deficit': reassessing legitimacy in the European Union, *Journal of Common Market Studies*, vol. 40(4), pages 603-624.
- P. Krugman (2012), *Revenge of the Optimum Currency Area*, in: D. Acemoglu, J. Parker and M. Woodford (ed.), *NBER Macroeconomics Annual 2012*, vol. 27, pages 439-448.
- P. Leino and T. Saarenheimo (2016), *On the limits of EU economic policy coordination*, ADEMU working paper series.
- F. Papadia (2017), *Italian economic growth and the euro*, Bruegel blog post, 26 July 2017.
- B. van Riel and M. Bos (2014), *Versterking van de EMU: in hoeverre ook soevereiniteitsoverdracht? (Strengthening the euro: accompanied to what extent by the transfer of sovereignty?)*, *SEW*, vol. 62, pages 179-190.
- H. van Rompuy in association with J.M. Barroso, J.C. Juncker and M. Draghi (2012), *Towards a Genuine Economic and Monetary Union*, 5 December 2012.
- H. van Rompuy (2015), *Bespiegelingen na vijf jaar Europa* (Reflections after five years in Europe), in: L. van Middelaar and P. van Parijs (ed.), *Na de storm. Hoe we de democratie in Europa kunnen redden* (After the storm. How we can save democracy in Europe), Lannoo.
- M. Sandbu (2015), *Europe's Orphan: The Future of the Euro and the Politics of Debt*, Princeton University Press.
- A. Sapir and G. Wolff (2015), *Euro-area governance: what to reform and how to do it*, Bruegel Policy Brief, No. 2015/01.
- A. Sapir and D. Schoenmaker (2017), *We need a European Monetary Fund, but how should it work?*, Bruegel blog post, 29 May 2017.
- F.W. Scharpf (1999), *Governing in Europe: Effective and democratic?*, Oxford University Press.
- W. Schäuble (2017), *Non-paper for paving the way towards a Stability Union*.
- M. Segers (2014), *Waagstuk Europa. Nederland en de grote Europese vraagstukken van vandaag* (European venture. The Netherlands and the major European issues of today), Prometheus/Bert Bakker.
- H.W. Sinn (2013), *Relaunching Europe: Problems, Reform Strategies and Future Options*, CESifo Forum 3/2013.
- J. Snell (2016), *The Trilemma of European Economic and Monetary Integration, and Its Consequences*, *European Law Journal*, vol. 22(2), pages 157-179.
- E. Spolaore (2015), *The political economy of European integration*, in: H. Badinger and V. Nitsch (red.), *Routledge Handbook of the Economics of European Integration*, pages 435-448.
- J. Stiglitz (2016), *The euro. How a common currency threatens the future of Europe*, W.W. Norton & Co.
- C. Teulings, M. Bijlsma, G. Gelauff, A. Lejour and M. Roscam Abbing (2011), *Europa in crisis. Het CPB over schulden en de toekomst van de eurozone* (Europe in crisis. The CPB on debts and the future of the eurozone), Uitgeverij Balans.
- L. Versteegen, B. van Groezen and L. Meijdam (2017), *Het profijt van deelname aan de euro* (The benefit of participating in the euro), *Economisch Statistische Berichten*, vol. 102, pages 33-37.
- G. Wolff (2017), *What could a euro-area finance minister do?*, Bruegel blog post, 17 May 2017.
- C. Wyplosz (2015), *The Centralization-Decentralization Issue*, *European Economy discussion papers*, No. 14.

List of abbreviations used

GDP	Gross Domestic Product
GNP	Gross National Product
BverfG	Bundesverfassungsgericht (German Federal Constitutional Court)
DNB	De Nederlandsche Bank (Dutch Central Bank)
EBA	European Banking Authority
ECB	European Central Bank
EFB	European Fiscal Board
EFSF	European Financial Stabilisation Facility
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMF	European Monetary Fund
EMS	European Monetary System
EMU	Economic and Monetary Union
EP	European Parliament
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
EU	European Union
ECJ	European Court of Justice
IMF	International Monetary Fund
MIP	Macroeconomic Imbalance Procedure
OECD	Organisation for Economic Cooperation and Development
OMT	Outright Monetary Transaction Programme
SGP	Stability and Growth Pact
SMP	Securities Markets Programme
SRF	Single Resolution Fund
TARGET2	Trans-European Automated Real-time Gross settlement Express Transfer system
TEU	Treaty on European Union
TSCG	Treaty on Stability, Coordination and Governance
TFEU	Treaty on the Functioning of the European Union