Showing our colours for a stable and resilient European economy

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Management summary

European economic cooperation requires continuous maintenance to cope with exogenous shocks and internal political dynamics. There is no predefined route, however. It is therefore important that the Netherlands shows its colours in terms of the intended path to a stable and resilient Europe. Showing your colours means being explicit with regard to the direction in which European cooperation should develop, being honest about pros and cons of a specific choice and showing a readiness to accept the consequences of that choice. A shared vision of the intended path enables the Dutch government to chart its own course and can help it to respond to unforeseen economic and political developments.

Economic cooperation has intensified since the decision was taken nearly thirty years ago to introduce the euro. Experience shows that the biggest integration steps are often taken in times of crisis. The financial crisis, for example, spurred further integration and led to the banking union. The European sovereign debt crisis led to the establishment of the European Stability Mechanism (ESM) to provide a safety net for governments in financial difficulty.

More recently the COVID-19 crisis has caused an unprecedented shock to the European economy. Although the consequences for people and economies are not yet entirely clear, there is no doubt that the crisis has given fresh impetus to European economic cooperation. At the same time, existing vulnerabilities in the European economy became more prominent, such as high public debt in a number of Member States. Once again major new European instruments, such as the *Next Generation EU* recovery fund, have been established. The European Commission will for the first time be able to borrow money in the capital market to finance Member States' policy expenditure.

The latter point was the specific reason for the request made to an independent European Economy Expert Group (hereinafter: the Expert Group) to outline possible action strategies for the Dutch government in order to make the European economy more stable, robust and resilient. The Expert Group was also asked to examine various policy options with various consequences for European integration.

The Expert Group sees integration as the process of transferring powers from the national to the European level on the basis of treaties and underlying regulations adopted by the Member States. In this report, written from an economic and financial perspective, the Expert Group describes the action strategies the Netherlands could adopt in the area of integration in forthcoming legislative periods. To that end it contains an analysis of the main existing and anticipated vulnerabilities in the financial, economic and monetary field (Chapter 2). The report then assesses a wide range of potential measures that could make the European economy as a whole more stable and more resilient (Chapter 3). These measures are then grouped into four coherent sets of measures, which we call integration preferences, from which political policymakers will need to choose (Chapter 4).

Show your colours

The Expert Group recommends that action is taken on the basis of a broader vision and a shared integration preference. In the fourth chapter the Expert Group therefore outlines four coherent policy packages. These 'integration preferences' differ in terms of speed (gradual or accelerated), uniformity (all Member States simultaneously, or multi-speed) and the main mechanism used to achieve stability and resilience (policy coordination or market discipline).

The integration preferences have their roots in various political and ideological preferences. In turn, these preferences are based on beliefs as to the best way to increase the stability and resilience of the European economy. The Expert Group regards those preferences as a given. On the basis of those preferences, appropriate measures have been selected with the aim of increasing stability and resilience. The Expert Group does not rank the integration preferences in this report, but this does not mean they have the same impact on the stability and resilience of the European economy. This point is addressed in the discussion of the integration preferences themselves.

The four integration preferences are accompanied by consistent packages of policy measures. These comprise, for example, measures to promote growth, drive down public debt and reduce the interdependence between banks and governments. Consistent action based on a shared integration preference would increase the Netherlands' influence on European development. The Expert Group emphasises that a pick-and-mix approach to those integration preferences would be undesirable as it would involve pursuing an inconsistent policy; the Expert Group believes that parties should also be clear as to the downsides of the measures and the risks involved in any particular integration preference. In the forthcoming legislative periods there will doubtless be new developments and European initiatives that are not covered in this report. The existence of a shared framework will make it possible to anticipate such developments in good time.

The Expert Group believes the future of the Netherlands lies in the European Union (EU) and Economic and Monetary Union (EMU). The Netherlands owes its prosperity in part to the internal market. At a time of fundamental geopolitical changes the Netherlands is stronger as a Member State of the EU. In order to maintain that strength, solutions must be found at EU level for a number of major issues which the Netherlands and other EU Member States will face in the decades ahead: climate change, demographic change, migration and geopolitical challenges.

Vulnerabilities

The Expert Group believes the European economy features six fundamental vulnerabilities that have already manifested itself: (1) declining and divergent growth potential; (2) protracted accommodative monetary policy; (3) undiversified financing of the economy; (4) high private debt; (5) high public debt; and (6) interdependence of governments and banks. Future challenges, notably the financial and economic consequences of population ageing and the climate transition, must also be tackled appropriately. That is a precondition for addressing the vulnerabilities.

The vulnerabilities and foreseeable developments are mutually reinforcing and thus pose a growing challenge to the stability and resilience of the European economy. For example, low growth potential impedes the reduction of public debt while also limiting the scope to absorb the costs of population ageing and climate change. The purchase programmes deployed by the ECB to maintain price stability weakens the incentive to limit government debt, while high government debt in turn poses a risk to financial stability. Combined with high private debt and the interconnectedness of banks and governments, this makes the economy vulnerable to economic shocks. The vulnerabilities thus undermine the economy's ability to absorb shocks and adapt.

Divergence among European economies further increases the challenges to the functioning of the EU and the EMU. Divergent debt-to-GDP ratios lead to major differences in Member

States’ national fiscal space to stabilise the economy after a shock. Such divergences particularly affect the functioning of the euro area, because its centralised monetary policy limits Member States’ scope to tackle imbalances through their own monetary policy. In addition to causing economic complications, divergence also impacts preferences and policy choices in the various Member States and support for joint measures. Commonality is particularly important given the interconnectedness of the economies: shocks that initially affect a single region may subsequently spread throughout the EU or the euro area. Divergence results in varying degrees of resilience between Member States. Partly as a result, the ultimate consequences of these shocks will not be the same across all Member States, making it politically more difficult to formulate a joint response to these shocks.

Measures

The report outlines a wide range of measures aimed at reducing the vulnerabilities and increasing the stability and resilience of the European economy (Chapter 3). Many of these are not new proposals, but are already part of ongoing European policy debates.

The Expert Group outlines measures aimed at sustainable stable growth and convergence, reducing the interdependence between banks and governments, lowering the high levels of public debt and scaling back the accommodative monetary policy. These measures can be deployed both in normal times and in response to an economic shock.

A number of policy areas can be identified at EU level to promote sustainable and stable growth. First, the single market could be strengthened, benefiting all Member States and providing a basis for European integration. The range of budgetary instruments available to the EU could be combined more effectively by focusing them on common goals, including growth-promoting measures that generate economies of scale (cross-border projects, research).

The Expert Group considers it important to have a framework that encourages countries to effectively reduce high public debt, preferably during good times. The report identifies debt-reduction options involving policy agreements on the setting and supervision of budgetary rules, as well as a stronger role for market discipline, a stronger framework for the restructuring of public debt and better pricing of exposures to governments.

Progress in the banking union is desirable for the stability and resilience of the European economy. The report identifies measures that would further reduce the interdependence between governments and banks, drawing a distinction between precautionary and crisis measures. Precautionary measures make banks more resilient, so they are better equipped to absorb losses themselves. Crisis measures ensure that problems in individual banks spill over as little as possible to other banks and governments.

The independence of the ECB limits the Dutch government’s scope for monetary policy action. Governments nevertheless have the power to decide on the ECB's mandate, which is why the Expert Group sees opportunities to redefine the mandate. Governments could also ease the pressure on the ECB by deploying the appropriate budgetary instruments.

Integration preferences: a political assessment

Individual measures are assessed in Chapter 4. The Expert Group sees a number of measures that fit in with all integration preferences. These include measures to deepen the internal market, strengthen the capital markets union and focus the EU budget as far as possible on common goals. We call these ‘no regret’ measures.

The report also identifies a number of measures which feature in current policy debates but which, in the Expert Group's view, would in no way contribute to stability and resilience, such as a *green golden rule* to allow additional budgetary expenditure on sustainable investments, or financial repression by keeping interest rates artificially low to reduce debt.

The other measures have been grouped in four integration preferences. These are consistent policy packages aligned with possible political preferences for European financial and economic integration. Policy choices reflect policymakers' visions of future European cooperation. The integration preferences rely to differing extents on market mechanisms and policy coordination to tackle vulnerabilities in the European economy. They also differ in terms of the degree of uniformity in the integration of European Member States and in terms of the speed and extent of integration. We thus arrive at four preferences: (1) gradual; (2) accelerated; (3) multi-speed; (4) more market-driven.

Integration preference 1) gradual

In the *gradual* integration preference the key principle is that countries themselves are primarily responsible for reducing public debt, increasing potential growth and maintaining a healthy financial sector. Budgetary discipline remains a key motive, so no fundamental additional measures will be taken at European level to tackle the vulnerabilities. Small steps can still be taken towards further integration, the aim being to introduce measures on which all Member States can agree. Examples of small steps include improving the countercyclicality of budgetary rules and subjecting them to more independent supervision, setting aside resources for unexpected and as yet unspecified shocks to be deployed on the basis of unanimous decision-making and providing emergency liquidity between national deposit guarantee schemes for savers. This integration preference relies on Member States' readiness to tackle vulnerabilities themselves. The Netherlands accepts that the pace at which this happens will be slower than it would like. The choice of this integration preference therefore entails the risk that crisis situations will require more extensive measures to be taken under great time pressure, most probably leading to economically suboptimal solutions. In such situations it will be difficult to propose necessary reforms as counter conditions. Counterbalancing this disadvantage is the advantage that other countries cannot take for granted that the Netherlands will make additional resources available.

Integration preferences 2) accelerated and 3) multi-speed

In the integration preferences for further integration a distinction is drawn between uniform integration (accelerated) and multiform (multi-speed) integration. Both integration preferences assume that economic divergence in the euro area entails considerable risks and costs. In these integration preferences a strong and well-balanced European economy is necessary to maximise the benefits of the single market and promote Dutch interests amid global geopolitical interests. In this case the Netherlands becomes a pioneer of deeper European integration. Convergence is pursued through new collective European facilities, a larger EU budget and a fully integrated banking union, which together provide a joint means of strengthening stability and resilience. In these integration preferences the Netherlands may opt to make a financial contribution to help resolve economic legacy issues in Member States and may opt to share risks in order to keep the divergence under control. In exchange, the Netherlands demands that reforms be undertaken, aimed at reducing economic vulnerabilities.

Examples of instruments that can contribute to this objective include a stabilisation function for economic shocks and a fund for strengthening economic structures. The possibilities also include joint bond issuance up to a certain level of debt as a percentage of GDP. The crisis framework for failing banks is expanded, including setting up a European deposit guarantee scheme. These instruments can help reduce divergences and at the same time ease the pressure on monetary policy. The establishment of such new collective instruments in exchange for reforms nevertheless entails moral hazard, the risk being that Member States will take advantage of these arrangements without implementing adequate reforms themselves. This would impair the resilience of the European economy and may result in high costs for the Netherlands. If the Netherlands opts for one of these integration preferences, preconditions should be set to limit such costs.

In the *accelerated* integration preference, all Member States simultaneously take part in the new collective facilities, in the belief that divergence must be countered by tackling vulnerabilities jointly. By contrast, in the *multi-speed* integration preference, not all Member States participate in further integration from the start. Significant additional participation safeguards are built into specific collective facilities to counter the risk of moral hazard. In this variant, for example, Member States have to resolve certain problematic economic legacy issues of their own. The Netherlands would opt only to share risks with Member States bearing similar risks. The ultimate goal in this integration preference, however, is that all Member States participate in all arrangements, but Member States are only permitted to participate if they are deemed sufficiently healthy on the basis of objective financial and economic factors. Member States with low public debt, for example, can already start joint bond issuance or a stability mechanism, and Member States with high debt can join once they have reduced their debt to a certain level. An important principle here is that countries are not penalised for failing to achieve goals, but successful debt reduction is rewarded with access to the joint facilities. If the Netherlands opts for this integration preference, it will be necessary among other things to establish exit criteria to prevent countries from breaching relevant agreements after gaining access to a facility. The design of the ESM's precautionary credit line, as provided for in the new ESM Treaty, could serve as an example for this approach. Member States would be rewarded for strengthening their economy, but some may fail to keep up, leading to a "multi-speed Europe". There would then be a risk of countries being excluded from certain arrangements for long periods. This could further widen divergence and reduce financial stability. In turn, this could lead to pressure being exercised to allow Member States to gain access to facilities in spite of not meeting the criteria.

Integration preference 4) more market-driven

The *more market-driven* integration preference is based on the premise that the Netherlands is not sufficiently confident that policy coordination will reduce the divergence. Furthermore, retaining the room to pursue its own policies is fundamental to the Netherlands. It seeks to prevent powers increasingly being transferred or "shared", either on a creeping basis or under the immense pressure of a crisis. Its guiding principle in this integration preference is that, ultimately, only market forces have sufficient power to instil sufficient discipline. The Netherlands therefore wishes to revive the no-bailout clause and thus compel Member States to achieve economic convergence under their own steam. The Netherlands is, however, actively calling for an increase in private risk-sharing in the banking union and the capital markets union to mitigate negative spillovers between countries. This could be done, for example, by increasing levies on the banking sector and pooling funds that can be deployed in the event of bank failures. An inevitable consequence of the emphasis on more market forces and the no-bailout clause is that it creates the possibility that an individual country may cease to be a member of the euro area.

Full reliance on market discipline would be very risky in the short term due to the current high level of public debt, which could lead to delays in the renewed reliance on market forces. This would impair the stability and resilience of the euro area, as well as the ECB's room for manoeuvre, which would be constrained over the long term. In this integration preference the Netherlands therefore attributes high priority to accelerated reduction of high public debt. This is why the Netherlands calls for a joint debt reduction fund under appropriate conditions to encourage faster debt reduction.

The Netherlands aims first to convince Member States of the desirability of market discipline and the need to tackle excessive public debt. However, if other Member States wish to integrate further by means of new joint arrangements, the Netherlands will seek opt-outs from specific arrangements such as collective debt, a successor to the recovery fund or a permanent macroeconomic stabilisation function. The Netherlands will choose to do so because the risks of moral hazard, permanent transfers and restriction of its own budgetary autonomy outweigh the potential benefits of increased financial stability. However, deliberately charting a different course might potentially weaken the Netherlands's negotiating position in other policy areas.