



**Contributions from the Sherpas
of the Member States to
the Five Presidents' Report**

PORTUGAL

Second Contribution



TOWARDS A STRONGER ARCHITECTURE FOR THE EURO AREA:

Increasing trust

Fostering convergence

The European project was conceived as a way to create a truly cohesive European order to allow all our peoples to live and work together in peace while having equal opportunities. The convergence of economic possibilities between our countries is at the core of the common project we share. Nevertheless equality of opportunities for our societies to prosper together is a precondition for this process to come about.

The European project has mobilized each one of our countries for a long time. This is why we have been deploying resources and, at times, high doses of political will. The benefits of what we were able to achieve as Europeans appear clearly in the prosperity and integration of our societies despite our different historical and cultural backgrounds as nations. However we have to recognise that this is a continuously evolving project and also that our future will continue to require vision as well as determination.

Whatever the good intentions behind it, the European project as initially conceived had several imperfections. As of today it is easier to recognize the shortfall in mechanisms supposed to ensure that the national will of Member States would be aligned at any time with the need to implement the convergence measures conducive to the pursuit of our common interests. As a consequence, for several years we witnessed a gradual but relentless build-up of macroeconomic imbalances within the euro area which ended in a series of sudden stops. When flaws were revealed, questions about the true irreversibility of the euro further magnified the crisis and compelled countries, and the euro area as a whole, to struggle to recover credibility and rebuild mutual trust. Sovereign and banking crisis were therefore a consequence of national competitiveness crises and inadequate fiscal policies amplified by imperfect financial integration and a “doom loop” between sovereigns and banks.

In that context, the most urgent changes made to the euro area governance focused on reinforcing the so-called “economic” leg of the Economic and Monetary Union and on strengthening financial integration. Significant advances have been made due to the introduction of the European Semester and with the first stages of the Banking Union. The adoption of the Fiscal Compact in 2011



laid the basis for the ensuing steps furthering the integration. In fact, the risk of political and economic fragmentation was a real one up to 2012 and not yet completely overcome. The political commitment embodied in the new fiscal framework and the decisive actions taken by the ECB helped us steer through the storm and increased confidence among Member States and in the Euro. Similarly, the institutionalization of financial assistance instruments, ultimately with the European Stability Mechanism, provided the safety net for urgent and deep changes needed to overcome adjustment processes in countries like Portugal.

This is what we achieved. But we cannot stop here. This should be seen merely as the first phase in our response to the crisis.

We should now be entering a second phase of reforms— and above all agreeing to lasting solutions. This is the right sequence not only to ground firmly the emergency responses of the last few years, but also because we have to deal with the crisis legacies. We ought to address this problem now otherwise we risk permanently weakening the European project.

This second phase is about smart and deeper integration in key areas. And it should reflect the undeniable specificity of the euro area in the context of the whole EU as well as its role in the global economy. Promoting balanced prosperity in a monetary union where a single monetary policy applies to countries with wide-diverging growth paths, while coexisting with national fiscal sovereignty, requires reforms specific to the euro area. However, given the close relationship between the euro and the deepening of the Single Market, these proposals should be viewed as a call for common responsibility and an opportunity to all Member States whether they already belong or are awaiting to join the euro area. The reform of the euro area's architecture should bridge the institutional divide between the euro area and the rest of the Union.

Also, the political context is not irrelevant. The rise of populist, extremist and sometimes even outright anti-European political movements should be seen as a warning of the risks of *political* fragmentation in the EU. A long-term, future-oriented reform of the euro area architecture is therefore crucial in order to face these challenges successfully. We need a renewed political commitment.

The Report prepared by the Four Presidents in 2012 envisioned a stronger EMU architecture founded on deeper financial, fiscal and economic integration with stronger cohesion and democratic legitimacy. So far, we have taken important steps in the direction of a banking union and increased EU surveillance and control over national fiscal policies and macroeconomic imbalances. Nevertheless, we have come short in our targets for fiscal and economic integration and we still have some distance to cover before reaching a full



banking union. Moreover, other pillars identified in that report remain untouched. It is crucial for us to work on them now.

As it was stated by Mario Draghi, the ECB President, “until we have completed EMU, which means achieving the minimum requirements in *all areas* for our union to be truly sustainable, doubts about its future will never entirely fade away.”

I. A more coherent framework for structural policies

The European Semester was a significant improvement in European economic integration. In spite of dealing with policies that lie outside the Union’s reach, it has had a real impact in the political debate about structural policies in the European Union and within Member States. The consequences of decisions thus taken at the European level have an impact on everyday life of our citizens. National constituents were for a long time unaware of the policy choices that successfully participating in a single market and in a monetary union entails. Thus the Member States are now able to have a more comprehensive and informed view of individual policies that are instrumental for growth, both in the euro area and in the EU as a whole.

Moving forward, the European Semester Recommendations should be more streamlined, focused and verifiable: their implementation should be underpinned by a much higher level of political commitment, thus ensuring a much leaner process having an earlier and more direct impact on national policy choices. The European Semester should be revised and simplified, making it more operational and effective. Namely, through proposing flagship indicators; making country specific recommendations more focused on a limited number of policy priorities and more centered on policies with positive spillover effects on all Member States; reflecting euro area specificities and recommendations in the country specific recommendations of each affected Member State– a European Recommendation. At the same time, the macroeconomic imbalances procedure should become more effective in tracking the build-up of imbalances and allowing a proper balance between stocks and flows.

In the scope of this new European Semester, priority should be given to areas crucial to productivity levels, such as labour market, public administration and business environment, and in line with progress in Single Market areas, such as services and product markets; a more systematic assessment of implementation and outcomes should be provided by the Commission. In parallel, greater capacity to make and execute decisions is needed at the EU level.



Additionally, since we acknowledge that fiscal coordination is a requirement to avoid negative spillovers from bad national decisions, we must conclude that fiscal coordination is also required to explore positive spillovers. This objective of an aggregate stance for fiscal policy does not require a budgetary union. It stands rather for the determination of the budgetary situation of the Union as a whole – which can be reasonably accomplished via national budgets. However, without taking the whole budgetary situation into account we may find ourselves with adequate national budgetary situations but with inadequate aggregate fiscal stance. This is a particular case in which the whole can be other than the mere aggregate sum of its parts. That points to an additional layer of discussion regarding the question of flexibility and resilience in fiscal policy – namely guidance on the overall fiscal stance of the EU and the euro area in particular.

II. A Financial Union for Growth and Stability

As regards the Banking Union, the urgency of the crisis in 2012 concurred with a step forward in its creation. However, the same urgency bound us to an admittedly incomplete agreement. A complete banking union, which definitely severs the link between sovereigns and banks, and permanently reverses financial fragmentation, is crucial to the economic as well as political functioning of the EU. A genuine financial union is a key instrument to allocate finance and investment where it is most needed and therefore to increase productivity and growth. Smart financial regulation will prevent us from socializing losses that may arise. But, more importantly, a truly European banking system is the only way to increase trust in the euro and in its irreversibility irrespective of individual political decisions or choices. For that, we should urgently move forward with a common deposit guarantee scheme and with a common backstop that upholds both the common deposit guarantee and the single resolution fund.

In the same vein, we should make visible progress on the Capital Markets Union and create a European Insolvency Scheme.

This means widening and deepening all our financial markets, large and small, with instruments that enable investors to invest funds in Europe, in securities issued by European financial and non-financial companies. The aim is to give European businesses, especially small and medium-sized enterprises (SMEs), access to different and cheaper forms of financing in order to increase investment and create more jobs. The increase in scale, as well as the availability of new instruments, would be a great step forward in creating a level-playing field for European businesses regardless of their geographical



location. It is also a question of harmonization of instruments, of standard information on issuers, of the existence of investment platforms.

III. A Fiscal Framework that Fosters Convergence

A fundamental element of this reformed architecture of the euro is a European Monetary Fund (EMF). An institution such as the EMF would not comprise univocal and permanent transfers between countries, nor would remove the need for fiscal discipline at national level. It would be an instrument of common responsibility, greater credibility and economic soundness.

Deepening the Economic and Monetary Union also requires some fiscal capacity. This need became obvious during the crisis. Fiscal capacity for the euro area alone is justified by the fact that euro-countries have fewer instruments to deal with necessary adjustments and also because making the bulk of adjustments depend solely on internal real depreciation undermines economic real convergence. In turn, deeper convergence diminishes considerably the risk of sovereign crisis and the need for financial assistance. This fiscal capacity should be funded by own resources and have access to financial markets.

The EMF would have three main functions.

First, the euro area needs to consolidate the financial adjustment mechanism allowing technical and financial support to individual Member States that face unsustainable situations. This assistance is to be provided on the basis of a commitment to an economic and fiscal adjustment path and its continuance is to be conditional on the progress of the adjustment. The EMF is to be more autonomous from Member States in terms of the decision-making process, albeit not severed from them, equipped with technical ability and financial capacity to act quickly and in an informed way. In practice, the creation of the Fund requires the integration of the ESM. Moreover, it would allow for a single institution to supervise and monitor the progress of adjustment programs, which means that the ECB and the IMF would be dispensed from the mission that they have had so far. This would have the merit of representing a maturing of the European approach to crises such as these. And it would remove the ECB from an awkward and legally challenged position as a monitoring institution in this sort of national assistance programs. Finally, it would concur to a unified representation of the euro in international financial diplomacy.

Second, the EMF would be endowed with fiscal capacity in order to finance national structural reforms (according to a mutually agreed understanding and with proper conditionality) with positive spillovers to the euro area as a whole, as well as investment projects focused on expanding or modernizing the



infrastructure upon which the Single Market depends – much along the lines defined by the Juncker investment plan. Importantly, acting as a catalyst for investment, the fiscal capacity would contribute to internal rebalancing within the euro area and therefore to a more symmetric macroeconomic stance. This function should be activated whenever deemed necessary and does not have to be fulfilled as a permanent device.

Third, in the longer run and following a consensus in the euro area over complementary ways of funding, the EMF would also support limited shock-absorbing instruments in order to improve the resilience of the euro area as a whole, prevent contagion across the Union, and reduce the economic and social costs associated with adjustments. This would respond to the need to find economic mechanisms that perform a stabilization role to deal with idiosyncratic shocks or asymmetrical effects of common shocks. While some of these shocks result from bad national policies, others do not. A shock-absorbing function would allow some sort of cross-border risk-sharing to help reduce adjustment costs for countries affected, limit the need to resort to financial assistance and prevent disruptions in social cohesion. Along the lines suggested by the Report prepared by the Four Presidents in 2012, this could take the general form of an insurance-type mechanism between the euro area countries and would require a greater degree of harmonization between economic policies and institutions of the participating Member States. The most obvious example of such a function would be a European complement or partial substitute to national unemployment insurance schemes, or partially europeanising active labour market policies.

So far the Union has compensated for the lack of appropriate fiscal capacity by pooling national financial resources. This happens, for example, with the ESM or, to some extent, with the new investment plan. This approach is fraught with difficulties. By linking the fiscal capacity of the euro area to national financial resources, any intervention becomes a zero-sum game and a form of redistribution of the resources of some States to other States. This generates too high political transaction costs and hinders the capacity to act effectively on the part of the euro area. Ultimately, it also corrodes the social and political foundations of European integration.

The sources of EMF revenues should be in the future determined by what makes the European project more legitimate to its citizens whilst making visible the reasons for its existence and the economic activity it generates or regulates. In an appropriate stage of integration, priority should be given to consider euro area own resources to fund this fiscal capacity. Once this capacity is integrated into the Fund, its designation would have to reflect this specific capability.



Therefore, we propose to call it at that stage European Monetary and Fiscal Fund (EMFF).

It is only by detaching euro area own resources from national contributions that we can create the conditions for the Union to discuss seriously the policies to be funded by such resources. Furthermore, this way alone will allow us to legitimate common responsibility within the Union on any meaningful and lasting basis. The European Commission should consider the several technical options available, but from a political point of view it would be important that this assumption of common responsibilities be related to the different degree to which different social/economic groups benefit from European integration and, particularly, the single currency. Obviously, regardless of which option is ultimately to be taken, strict fiscal neutrality for European citizens must be guaranteed. Likewise, it must fully preserve the integrity of the Single Market. It is not about how much it is paid but how it is paid.

IV. A Governance Framework that yields executive power and greater legitimacy

A European Monetary Fund encompassing a financial capacity for the Eurozone requires more ownership and shared responsibility, which means a more resilient and better supported institutional framework that should be based on the Eurogroup. Also, a well-functioning Monetary Union requires an institution responsible for the economic policy of the euro area – a genuine counterpart to the ECB responsible for the single monetary policy. And not least, it requires a seat of decision-making accountable for the whole, which means that it requires political empowerment and accountability. To increase confidence in the euro and provide the necessary framework to decisions that will be taken in the European interest, several options could be envisaged. One could be a structure headed by a permanent President of the Eurogroup appointed by the European Council and subject to a hearing by the European Parliament. Another one could be a permanent structure headed by the President of the Eurogroup appointed by the European Council, who would be simultaneously Vice-President of the European Commission, and would also be subject to a hearing by the European Parliament. Other options may be considered. However, the option to be chosen should not widen the gap between the euro area and the rest of the Union. Thus, the nomination process needs in any case to be inclusive and conducted by the European Council.

In any case, the President of the Eurogroup would be also in charge of the EMF. This will yield more executive power to the President of the Eurogroup and



ensure greater independence in enforcing fiscal and economic rules as well as in defining common policies. Euro area Member States – through the Eurogroup – must continue to provide political input and ensure the necessary control that strikes a balance between democratic accountability and the more efficient decision-making process.

Additionally, a European independent Fiscal Council needs to be factored in this renewed governance structure for the euro area as it will allow for increasing independent evaluation and consistency in the political and technical monitoring of national budgets and reform programs.

V. Conclusion

Since its beginning many political reasons concurred for the establishment of a non-fully-fledged Economic and Monetary Union. We all knew what the missing elements were but we deliberately decided to make this an evolving process to be completed over the years. And much has been accomplished but we believe time has come to go the extra mile and have a stronger and fully-fledged Economic Monetary Union.

We acknowledge that these proposals are quite ambitious, but we do believe that the challenges we are facing demand a comprehensive and determined common response benefiting all our citizens and future generations.

They must not be regarded as a call for solidarity. This is a call for common responsibility in facing challenges that affect us all without no exception and a call for the establishment of the convergence instruments that are required. A more integrated euro area will make it stronger to resist centrifugal forces and an even more mobilising project for those who are yet to join it.

A new President's Report should fully assess the proposals thus put forward, analyse whether and when they can be implemented and provide a renewed roadmap. Following the concept of the Commission's Blueprint but also taking into account the experience gained in recent years, it should distinguish what can realistically be put in place in a relative short span of time and what corresponds to a longer term vision of an institutional framework which embeds the right incentives for further integration while deepening democratic legitimacy and accountability. However, as regards the time sequencing, it seems reasonable to outline the following priorities: 1 - accelerate the implementation of the Banking and Financial Union; 2 – create in the short-term a EMF incorporating the ESM; 3 – establish in the longer-term a fiscal capacity for the euro area, thus transforming the EMF into a EMFF.



Finally, agreement of wills on where we are heading must come before the discussion on its technical and legal requirements. An institutional debate on the legal requirements for the implementation of these proposals is not to be shunned. However, in our view the existing Treaties already offer enough flexibility to accommodate these reforms.