From Lever to Club?

Conditionality in the European Union During the Financial Crisis[1]

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Abstract

How did the European Union come to develop so many instruments of conditionality in its response to the Eurozone debt crisis, despite the well documented limitations of such measures in other contexts? This article argues that major EU actors—Council, Commission, and Central Bank—were influenced by their own recent and positive experiences with conditionality, especially in the EU's enlargement in the early 2000s. However, as we also show, despite the promise of conditional instruments in these two earlier episodes, further EU reliance on conditional policies has not brought the positive outcomes the main European institutions—here the Council, Commission, and ECB—had hoped for. As EU institutions turned to harder and harder forms of conditionality in the Euro crisis, they relearned many of the negative lessons of conditionality familiar from the broader literature and ultimately had to concede that the apparent success of its conditionality tools in the earlier enlargement and global financial crisis (GFC) phases was exceptional. The article documents the evolution of conditionality between these two periods, showing how the conditionality instruments used by the EU changed over time, beginning as a "lever" to assist the accession of candidate states in the enlargement period, and evolving into a "club" used to impose macroeconomic discipline in the aftermath of the GFC of the late 2000s. It shows why this preferred approach to the Euro crisis failed and was ultimately downgraded as Eurozone policy shifted in favour of monetary measures in which conditionality played only a marginal role.

Keywords: enlargement - Eurozone – conditionality – financial crisis – bailouts

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Introduction

How did the European Union, which had virtually no experience with conditionality twenty years ago, develop so many instruments of conditionality in its dealings with its member states? An obvious answer is that the Euro crisis provided a context for emergency conditional lending and the EU's cooperation with the IMF brought knowledge of conditionality. Yet this answer is incomplete. After all, the EU's prior emergency loans to its members in the 1990s did not come with conditions. And the IMF often worried the EU was pushing conditionality *too hard* during the Euro crisis.

We suggest that major EU actors—Council, Commission, and Central Bank—all came to view conditionality instruments as highly promising. This conclusion, in itself, is also puzzling. After all, a vast literature details the problems of conditionality in both IMF and World Bank settings (Dreher 2009). Prominent barriers to success include commitment problems of recipient governments (Vreeland 2007), incomplete information (Spraos 1986), inconsistent signalling (Bird and Rowlands 2004), moral hazard issues (Ramcharan 2003), mis-diagnosed political feasibility (White and Morrisey 1997), and political interference (Stone 2008). Our conclusion—based on dozens of interviews in the Commission, Council, Central Bank, and IMF—is that this long and chequered history of conditionality outside Europe never registered much with the key actors inside Europe. Much more important were these actors' own recent and positive experiences with conditionality: namely, the EU's enlargement conditionality of the early 2000s and the macroeconomic conditionality it used before the Eurozone crisis in non-Eurozone Central and Eastern Europe (CEE). We show below that despite the promise of conditional instruments in these two earlier episodes, further EU reliance on conditional policies has not brought the positive outcomes the main European institutions—here the Council, Commission, and ECB—had hoped for.

Conditionality is a fairly new tool for the EU, prominent only since the accession of ten new member states in 2004 and 2007. Since 2008, it then morphed into an increasingly widely-used instrument, first and for a shorter period, on Latvia, Hungary and Romania, which needed immediate bailout programs. But the EU has also deployed conditionality vis-à-vis the Southern European member states, particularly Greece, Spain, and Portugal (as well as Ireland). We document this evolution, summarise the changes in conditional instruments and show the limitations of conditionality during the Euro crisis such that conditionality was ultimately downgraded after about 2015 and substantially eclipsed by a new monetary policy regime known as quantitative easing.

We do not pursue here a strong causal argument that each stage of conditionality *uniquely determined* the subsequent one.[2] But our interviews have shown us that a range of EU actors did perceive earlier rounds of conditionality—the CEE enlargement and liquidity episodes just mentioned—that joined pressures for conditionality emanating from Northern European creditor states and from the IMF. As EU institutions turned to harder and harder forms of conditionality in the Euro crisis, they relearned many of the negative lessons of conditionality familiar from the broader literature and ultimately had to concede that the apparent success of its conditionality tools in the earlier enlargement and global financial crisis (GFC) phases was exceptional.

Consistent with that broader literature, the EU has discovered that digging deeply

[2] Demonstrating this connection would require additional interviews in all major EU institutions.

into the most sensitive policy domains of its members proved a complex and costly means of achieving macroeconomic stabilization. Of course, conditionality was also important in mollifying angry voters in Northern European creditor states (Matthijs and McNamara 2015).[3] Given the way that the Euro crisis was framed in Germany, Berlin would not have given assistance without some conditionality (Brunnermeier, James, and Landau 2017; Jacoby 2015). But the disappointments we document below suggest an EU tendency to overattribute success to conditionality in earlier periods. Indeed, while conditionality was useful during enlargement, it was hardly the EU's only tool, nor did it always succeed (Kelley 2006a). EU enlargement always depended on much more than conditionality. For example, Bruszt and Langbein (2015) show that the EU used a range of other informal instruments to help develop CEE states for membership (see also Bruszt and Vuchov 2017). Yet, as noted, EU conditionality was soon deployed on troubled non-Eurozone EU member states in that same region. And the EU approach to Southern Europe elevated the conditionality tool to an even more central place in its policy mix between the onset of the Euro crisis in 2010 and the start of the ECB's quantitative easing in March 2015.

The scholarly literature also seems to have overattributed success to conditionality (Jacoby 2006). For example, many sophisticated works of scholarship on the CEE region—eg. Vachudova 2005—have been subsequently stylised and simplified in citations, such that the EU role is reduced to "active leverage" or conditionality. Meanwhile, Vachudova's claims about "passive leverage" and indeed a range of other instruments are downplayed or even forgotten. To be sure, Commission officials are

[3] Not that austerity ideas came exclusively from Northern states. See Helgadóttir (2016).

generally well aware of the shortcomings of their conditionality instruments and have worried about the ineffectiveness of conditionality tools against backsliding of 2004 entrants like Hungary and Poland (Kelemen and Poland 2017; Scheppele 2015); meanwhile, the endemic corruption of 2007 members is also seen as resistant to conditionality, and some have claimed that conditionality was essentially irrelevant for some states in the Western Balkans (Börzel 2011).

Yet notwithstanding scholarly ambivalence about conditionality, we see an explosion of conditional instruments being used on existing member states. Greer (2014) argues that these EU-imposed conditions have strong affinities with IMF conditions familiar from long experience.[4] Indeed, much of the macroeconomic conditionality carried out by the Commission was done either with the IMF and World Bank—the non-Eurozone rescue cases—or with the ECB and the IMF in the so-called Troika—the Eurozone rescues cases (Henning 2017). We agree the IMF mattered to conditionality's design (Lütz and Hilgers 2019). But the enthusiasm with which conditionality was adopted, and the ways in which earlier experiences with enlargement also fed into the EU's approach to the financial crisis and its consequences for the Eurozone, make it worthwhile to trace the intellectual history of the idea of conditionality across these distinct periods. The rest of this article shows how conditionality instruments used by the EU changed over time, beginning as a "lever" to assist the accession of candidate states in the enlargement period, and evolving into a "club" used to impose macroeconomic discipline in the aftermath of the GFC of the late 2000s.

[4] Lütz and Kranke stress Commission orthodoxy relative to the more lenient IMF (2014), while Woodruff (2014) stresses the extreme orthodoxy of the ECB in the initial phases of the Eurocrisis (before the launch of QE). See also Clift (2019).

Stylised differences: EU conditionality across enlargement and macroeconomic crisis

Table 1 provides a stylised summary of the differences in conditionality in enlargement and during the two macroeconomic crises. Conditionality toward CEE states in the late 1990s and early 2000s (top row) promoted institutional convergence on EU-15 practices. EU Single Market *regulations* have "direct effect" and often required little *legislative* work by candidate states. EU *directives* required legislation and often also required new bodies to be established or heavily reformed. If we focus on the 33 policy "chapters" in the Commission's screening process, many were surely very important—free movement, energy, environment, public procurement. But almost none involved the basic structures of constitutional democracy and few centrally affected sensitive core state functions of citizenship, defence and foreign policy, or economic choices about fiscal, social, and labour market policy.[5] These were neither constitutional nor economic straightjackets, as evidenced by the wide range of structures chosen by the CEE states (Bohle and Jacoby 2017). At the same time, conditional measures were flanked with many non-conditional policies, including trade access, FDI promotion, and promoting the extension of the value chains of West European MNCs (Brustz and Vukov 2017). Finally, since the EU

[5] The EU's Copenhagen criteria, which included democratic rule and a functional market economy, did involve core state functions. We treat these as a pre-requirement for opening negotiations. But the EU generally did not use its formal conditionality instruments for core state functions. For the 33 screening chapters, see https://ec.europa.eu/neighbourhood-enlargement/policy/conditions-membership/chapters-of-the-acquis_en

controlled the central reward promised through conditionality—full membership in the EU—conditionality was highly credible.

Table 1 About Here

This was not the case for more recent crisis-era conditionality in both CEE—where Latvia, Romania and Hungary[6] all had joint EU-IMF programs—and Southern European states, some of whom have had Troika programs that included the EU Commission and the ECB alongside the IMF. These have had a quite different character. First, the affected states are already EU members, including both recent (CEE) and long-time (Greece, Portugal, Ireland, and Spain) member states. Second, conditionality here is very much focused on core state functions in fiscal, labour market, and social policy domains—all areas of traditional member state prerogative. Third, the flanking measures have been both narrower and deeper. On the one hand, the rewards for the conditioned behaviour have been almost exclusively monetary, primarily in the form of liquidity assistance for banks or programs to purchase the bonds of states. At the same time, the amount of money provided by or with the help of the European institutions is far higher than what was available in the pre-accession programs.[7] Yet despite the vast sums of money spent in crisis states, the EU is only in a position to reward crisis state policies with the promised liquidity. It cannot, of course, give them stable fiscal balances, let alone economic growth. Simply put, happy economic outcomes are not the EU's to

[6] Hungary and Romania are not EMU members, and Latvia was not at the time of the IMF program.

[7] Official pre-accession assistance for the relevant 2000-2006 budgetary period amounted to 22 billion euro, which includes, Phare, ISPA, and SAPARD. See http://ec.europa.eu/enlargement/archives/questions_and_answers/11-22_en.htm#costs

bestow, and additional liquidity—though badly needed—cannot be linked to a concrete outcome in quite the same way EU membership could.

Thus, despite some commonality in the instruments developed and deployed in the these periods, there are significant differences in scope conditions. The next section recaps the development of conditional instruments in the EU enlargement process before we turn to an analysis of the ways in which conditionality has been deployed after the 2007-8 global financial crisis and post-2010 Euro crisis.

The EU discovers conditionality: The 2004 and 2007 enlargements

The rapid rise of conditional tools in the EU is surprising. Historically, the EC/EU made little use of conditionality (Grabbe 1999). The EC/EU mostly followed a legal logic in which the costs and benefits of intergovernmental and supranational modes of policy making were shared by all member states. In other words, the "Community Method" was a joint decision-making process with no quid pro quo for "compliance." Other EU policy modes—regulatory, distributive, and coordinative—also had no prominent role for conditionality (Wallace 2015). At most, one might see proto-conditionality in the structural funds, which member states received only if they fulfilled complex requirements (Hooghe 1996). Conditionality was mainly a minor EU tool in its dealings with third countries (and then only rarely) (Smith 2003). When the EU made below-market emergency loans to member states in the 1990s, it used no conditionality. Even EU enlargement waves through the mid-1990s required prospective members to adopt the EU's (then-much smaller) *acquis communautaire* but not to undertake the wide range of special steps required of prospective CEE members (Steunenberg and Dimitrova 2007, 3-

4). Preparations for European Monetary Union (EMU) in the late 1990s finally brought major conditional elements in the Stability and Growth Pact (SGP) for EMU members (see below).

Conditionality developed further when the Council announced a "membership perspective" for states in the former Eastern Bloc. This required translating the now-vast corpus of EU legislation into institutional targets for the states pursuing membership (Grabbe 1999). The promotion of legal, institutional, and behavioural reforms went far beyond prior enlargements, and the Commission developed several conditionality tools. These included conditional aid instruments (Phare), "screening," national programs for the adoption of the *acquis communautaire*, and the Commission's annual reports on each prospective member (Jacoby 2004; Bruszt and Vukov 2017). As noted earlier, these programs were also flanked by private FDI that incorporated the region into the production chains of Western European firms (Timmer et al 2014; Jacoby 2010).

In short, EU conditionality was focused on one major goal (membership), generally targeted non-core state functions, and was flanked by trends that promoted the rise of CEE up the commercial value chain. On balance, EU actors had reasons to feel satisfied with their conditional tools by the mid-2000s. All CEE states subject to enlargement conditionality were allowed to join the EU. Had this not been the case, second thoughts about conditionality might have registered sooner. When the EU established an instrument for its geographical "Neighbourhood," it modelled the policy on enlargement conditionality (Kelley 2006b; Lavenex and Schimmelfennig 2007). Since every Commission Directorate General was involved in enlargement through the legislative approximation and monitoring functions, experience with conditionality also was spread widely across the Commission's staff.

Macroeconomic conditionality outside EMU: Another apparent success

While the broader Commission chalked up a series of successes with ex ante enlargement conditionality, DG ECFIN officials also learned about more standard ex post conditional instruments from their interactions with the IMF with the outbreak of severe balance of payments problems in CEE in 2008.[8] We show that EU conditionality underwent a radical shift in focus and technique with the onset of the global financial crisis and then the Euro crisis. At one level, this is unsurprising since the IMF had long used macroeconomic conditionality for crisis-hit countries. The EU, however, had only used ex ante conditionality as part of its aid programs in the Balkans (Anastasakis and Bechev 2003). It had never used IMF-style ex post conditionality—where policy reforms are agreed to follow aid disbursement—far less with its own member states. But it had seen enlargement conditionality work and in ways far more successful than the broader conditionality literature would lead us to expect (Dreher 2009).

Moreover, the EU's first foray with macroeconomic conditionality also appeared successful. The first member states to experience the new version of EU macroeconomic conditionality were Hungary, Latvia and Romania—none then Eurozone members—who turned in 2008 to the EU and the IMF to deal with severe balance of payments problems. Hungary achieved a $25 billion package, with roughly two thirds coming from the IMF

[8] See Clift (2019); Woodruff (2014) links conditional policies also to ordoliberal impulses emanating mostly from Germany. Again, CEE enlargement and (later) macroeconomic experiences were not the only way ideas about conditionality entered the EU institutions.

and a third from the EU. Latvia took $5 billion (less than the $7 billion allocated) from the IMF and EU, while Romania received $20 billion in March 2009 (Henning 2017). The Commission thus joined the IMF in a process that seemed to restore current account balances without destroying state budgets while bringing some growth to CEE countries.[9] Hungary regained access to financial markets in less than year. Latvia's program lasted longer but also resulted in early repayment (Aslund 2010); Romania's exit took still longer but also succeeded (Ban 2017). Substantively, the essentially liberal reform path reinforced the "market fundamentalism" that informed views at the Commission (and also in Berlin) (Woodruff 2014).[10]

Thus, it is understandable the Commission entered the post-2010 period overconfident in both its conditional tools and its substantive market liberal prescriptions. After all, conditionality had worked once in the ex ante fashion of enlargement—CEE states had to meet reform conditions *before* joining—and it worked again in more traditional ex post fashion after 2008—where CEE states in crisis received emergency liquidity support but then pushed through painful reforms that restored market access ahead of schedule.

Yet CEE cases of macroeconomic crisis were different from those that would soon break out in Southern Europe. First, the CEE cases came close on the heels of the meltdown in US and UK financial markets and were properly diagnosed as *financial and banking crises* and not of *public debt* (Blyth 2017). Second, their resolution went hand in

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[9] The ECB had little involvement because these were not Eurozone members (Latvia joined later). See Aslund 2010.

[10] To be sure, local officials sometimes radicalised structural reforms beyond what the EU and IMF required. See Ban (2016, Chapter 9).

hand with sustained investment spending in the region (especially by German auto manufacturers) (Timmer et al 2014).[11] Third, the CEE crisis states' non-membership of EMU meant they could devalue their currencies.[12] Fourth, with the partial exception of Latvia, their banking bailout bills were paid mostly by outsiders (e.g., Nordic, Austrian, and Italian banks) (Epstein 2017).[13]

Macroeconomic conditionality in the Eurozone: From lever to club

Since 1998, EMU membership had been conditional on states' success in meeting "convergence criteria" established by the Maastricht Treaty (Dyson and Featherstone 1999). Two salient features resulted for future EU conditionality. First, the success of economically weaker member states in achieving demanding fiscal and monetary targets suggested to many policy-makers that conditional pressures could induce governments to adopt the "right" policies, overcoming domestic opposition (Ferrera and Gualmini 2010). Second, however, there was evidence of states "gaming" the process to meet the convergence criteria more painlessly. Accounting tricks of various kinds artificially reduced debt figures, most notably in Greece (European Commission 2010a).

This combination of successful ex ante conditionality with mistrust towards the weaker Southern economies' commitment to continued fiscal rigor reinforced calls for close supervision of EMU governments. However, the main instrument for achieving this—the Stability and Growth Pact (SGP)—was not successful in conditioning member

[11] That said, while FDI inflows to the region remained positive, they fell sharply in magnitude after 2008. See Bohle and Greskovits (2019, 1075-8).
[12] Of the three, only Hungary took this route.
[13] However, Ban (2019) shows that the Romanian state also guaranteed bank balance sheets as part of the Vienna Agreement.

state fiscal stances, particularly once France and Germany had violated its strictures (de Grauwe 2010). But the SGP did reveal an enthusiasm for external supervision and disciplining, particularly present amongst Northern European EMU members nervous about pooling monetary sovereignty with the South.

The Eurozone crisis began with Greece's slide into insolvency in 2010. Unlike with ex ante enlargement conditionality, however, there was no time to demand policy change prior to an EU response. And unlike with ex post macroeconomic conditionality in CEE, Southern Europe saw not only crises of liquidity but also of both legacy debt and large banking sector meltdowns. Conditionality would therefore move beyond the "leverage" characteristic of the enlargement process to become a more coercive instrument for disciplining member state governments: a "club" rather than a "lever."

The €110 billion May 2010 Greek bailout agreed by the Troika had to overcome a good deal of political resistance, and this explains some of its harshness. European elites felt a tension between avoiding broader contagion and creating moral hazard. They also were constrained by Article 125 of the Lisbon Treaty that outlawed direct bailouts of indebted EMU governments or debt monetization. The Troika lent Greece the money, but on condition that it implement drastic austerity measures to reduce its debt and introduce politically contentious structural reforms. By imposing harsh conditions on Greece, it was thought that moral hazard would be attenuated. And the more unpleasant the conditions, the more it would signal that bailouts would not be an easy option for profligate Eurozone governments (Jacoby 2015; Geithner 2012).

However, this punitive approach also made austerity more likely to provoke a deepening of the economic crisis, cancelling out whatever fiscal gains were painfully achieved (Blyth 2013, Ch.2). The 2010 Troika programme imposed a brutal economic adjustment on the Greek population, demanding that Greece reduce its general deficit by 11% of GDP over three years (Henning 2017, 85, 261 Annex 1). Senior IMF officials opposed the bailout package, predicting it would lead to a deep recession and increased financial problems (Wroughton et al 2015). But the Commission—following key member states—insisted on harsh fiscal adjustments that went well beyond what the EU had ever before asked of states—member or prospective member—and beyond the level of harshness the IMF thought workable or wise. Pay for civil servants was slashed, and public investment cut by €500 million; meanwhile revenue raising measures equalling 4% of Greek GDP were required by raising sales taxes and taxes on tobacco, and alcohol (Henning 2011, 37). In other words, the Troika prescribed how the axe was to fall in order to pay Greece's debts, drawing on the experience of the IMF's structural adjustment programmes typically applied to developing countries (Greer 2014). Greece agreed to consult the Troika before "modifying" any measures or "adopting new measures that may deviate from the goals of the programme" (IMF 2011).

On top of this fiscal medicine, the Commission also diagnosed structural economic weaknesses, arguing that Greece "underperforms in many structural policy areas," notably "rigid product and labour markets" that would "undermine the Greek economy's capacity to adjust" (European Commission 2010b, 6). The Programme thus laid down an ambitious plan for the reform of the Greek state and economy, with a conditionality regime to make further disbursements of aid dependent on achieved agreed reform targets. Not only would Greeks face cuts in government spending and tax rises, but they would also be exposed to a variety of marketizing reforms which disrupted established business practices, adding regulatory uncertainty to the strains on internal demand.

Predictably, a second bailout soon was needed because of the sharper than forecast collapse of Greek GDP in the wake of the austerity measures introduced and the spiking of interest rates across the Eurozone periphery sparking fears of contagion. The second Greek rescue package, worth €164.5 billion, was agreed in late 2011 (European Commission 2012). This package brought additional conditions, including a 22% minimum wage cut and reductions in social expenditure of €1.6 billion (Henning, 2017, 264) as well as the introduction into "the Greek legal framework [of] a provision ensuring that priority is granted to debt servicing payments" (Eurogroup 2012). Conditionality tools thus altered the constitution to attempt to prevent the Greek state spending on its citizens' money that could repay international creditors. Greece's third bailout, in June 2015, contained even harsher measures than initially planned after the left-wing Greek government had called a referendum on the original proposal for assistance from the European Stability Mechanism (Schelkle 2017, 173), revealing with renewed clarity the disciplinary function of conditionality.

Other Troika programmes revealed similar EU inclinations toward detailed, intrusive and sometimes quite harsh use of conditions. The 2011 Irish bailout, worth €85 billion, prescribed detailed cost-cutting measures such as a public sector pay freeze and a €1 cut in the hourly minimum wage. The 2011 Portuguese bailout, amounting to €78 billion, required a cut in average public sector wages by 5%, a reduction in national civil servant numbers by 1% in both 2012 and 2013 (Henning, 2017, 126, 263), cuts in pension spending by 3.4% of GDP, and tax hikes worth 1.7% (Neuger and Reis 2011). In

Ireland and Portugal together, around 400 distinct measures were recommended by the Troika (Kincaid 2016: 32). Cypriot conditionality was similar to that of Greece and Portugal, involving VAT raises and a freeze on public sector wages (Griffiths and Todoulos 2015, 15).[14]

The EU's bailout conditionality carried a clear political message. As Angela Merkel told the *Bild am Sonntag,* "These countries can see that the path taken by Greece with the IMF is not an easy one. As a result they will do all they can to avoid this themselves."[15] And according to former US Treasury Secretary Timothy Geithner's memoirs, EU leaders took the view that, "we're going to teach the Greeks a lesson. They are really terrible. They lied to us. They suck, and they were profligate and took advantage of the whole basic thing, and we're going to crush them" (Geithner 2012). By attaching painful and extensive conditions to financial assistance, European policy-makers accentuated a power hierarchy between the financially troubled member states and their creditors. Given the politics of creditor states, the EMU's no bailout clause, and the poor performance of the EMU periphery, some form of conditionality was likely unavoidable. But whether the EU was wise to push conditions the IMF found harsh and counterproductive is questionable. At several points, the old conditionality levers were wielded as clubs, inflicting wounds which have destabilised the politics of the periphery states in lasting ways.

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[14] Spain differed in that its bailout was later (2012), smaller (€40 billion), came not from the Troika (but from the EU's then-new European Stability Mechanism) and provided funds to backstop Spanish banks rather than government borrowing (although the two were connected).

[15] "Eurozone approves massive Greece bail-out," *BBC News*, 2 May 2010 http://news.bbc.co.uk/1/hi/business/8656649.stm

The revenge of the technocrats: Conditionality and the ECB

While the ECB already had a voice in conditionality through its position in the Troika, it also developed novel forms of conditionality of its own. The financial distress of the Euro crisis gave the ECB leverage to insist on specific policy measures in return for emergency liquidity assistance (Henning, 2017, 66-69). The ECB demanded of certain member states specific policy responses as a precondition for enhanced liquidity. For example, then-ECB President Jean-Claude Trichet made liquidity provision conditional on specific austerity pledges by Greece, Portugal, and Ireland. In Greece and Portugal, ECB funding was also made conditional on pledges by opposition parties to respect the arrangements should they come to power (Woodruff 2014: 100).

The debt crisis therefore provided the ECB with a new instrument to shape member state fiscal policy, a central concern of monetary union that had eluded the SGP (Wyplosz 2013). Yet Trichet exploited the opportunity to go even further and developed implied conditionality in other areas, notably the labour market. He even sought to use conditionality in countries not then subject to economic adjustment programmes. Trichet sent detailed letters to the governments of Italy and Spain in late summer 2011 calling for "intensified austerity, labour market reforms and a liberalised reorganization of collective bargaining" (Woodruff 2014, 100). As in the Troika's formal bailouts, these letters included specific recommendations. The Berlusconi government was exhorted to freeze public sector salaries, privatise local utilities, loosen labour market regulations, and abolish the provincial tier of the administration, none of which were within the ECB's traditional remit (*Corriere della sera* 2011). While the letters did not mention enhanced liquidity conditions then being considered by the ECB, press reports indicate that most observers understood the reforms to be a quid pro quo for further ECB bond purchases. Both governments ultimately made Trichet's suggested changes, though in the Italian case this involved deposing Silvio Berlusconi as Prime Minister and replacing him with former European Commissioner Mario Monti (Klein 2017).

Trichet's successor, Mario Draghi, extended ECB conditionality. The Draghi-led ECB promoted a new "Fiscal Compact" that would effectively constitutionalise for the EMU the German-Swiss innovation of a federal "debt brake." Pushing the Fiscal Compact was one of Draghi's first moves in late fall 2011, and access to the newly-created ESM was made conditional on ratification of the Fiscal Compact (European Parliament 2014, 102).[16] As a result, some member states (including Greece, Spain, Italy, and Portugal) were required to amend their constitutions to incorporate commitments to balanced budgets (European Parliament 2014).

The crisis finally began to be brought under control when the ECB acted in a future-oriented way to embed conditionality into a provisional program, that of Outright Monetary Transactions. Under Draghi's leadership, the ECB embedded conditionality into any future use of OMT, which allowed the ECB to engage in unlimited intervention in bond markets. In other words, monetary policy responses were made conditional on fiscal policy changes or on labour market or other structural reforms. The application of these arrangements evolved as the most acute phase of the Eurozone crisis was overcome, particularly since the beginning of quantitative easing substantially diminished member

[16] For reasons of space, this article does not discuss the role of ESM conditionality. For that dimension, see Howarth and Spendzharova (2019); Matthijs (2017); and Schelkle (2017).

state financing pressures (European Central Bank 2015). Ironically, conditionality requirements not only made little contribution to the resolution of the euro crisis, but instead it is widely accepted that a promise of *unconditional* monetary firepower, in the form of Draghi's "whatever it takes" commitment was the key to calming the markets. The need to avert a run on sovereign debt and national banking systems was superseded to some extent by concerns over the legitimacy of supranational micromanaging and the rise of populist forces demanding a restoration of national sovereignty, most notably in Greece, Spain and Italy (Hopkin 2015). This shift brought a softening of the European institutions' stance on conditionality and a less ambitious approach to structural reforms and debt reduction in the troubled member states.

However the idea of the idea of macroeconomic conditionality still appeared in other EU programmes, such as the structural funds for the 2014-2020 budget period (Jouen 2015). Member states' structural fund access would depend on each state's compliance with broader requirements of economic (but not political) governance (van Hecke, Bursens, and Beyers 2016). A group of states known as the "Friends of Better Spending" (Austria, Denmark, Germany, the Netherlands, Sweden, and the UK) supported the proposal, which won Council backing. If a member state fails to comply with steps listed under macroeconomic coordination and subsequently falls into a too-large budget deficit, its access to structural funds would be suspended. The proposal was opposed by the association of regional governments on the grounds that regional governments could lose access to funding as a result of (national) spending patterns they cannot control (van Hecke, Bursens, and Beyers 2016). The final legislation foresees that structural fund projects can be "suspended" by the Commission if a state is in excessive deficit and also "cancelled" if such deficits persist (Jouen 2015, 5).[17]

Conclusion: Levers and clubs revisited

This article has analysed how the EU developed ex ante conditional instruments during the enlargement process of the 2000s and then developed ex post conditional instruments after the onset of the global financial crisis in 2008. Though the EU's initial forays into conditionality appeared remarkably successful, we argue that the contemporary EU has overextended its relatively new conditionality tools and that this choice exacerbates an over-reliance on both austerity and on a partly outdated catalogue of structural reforms. The Southern European Eurozone experience shows that conditionality has significant limitations in achieving the goal of growth-enhancing structural reform. Notwithstanding stiff doses of austerity and structural reforms, not until the ECB's decisive move to quantitative easing did growth truly return to the Eurozone, and even then the Southern countries failed to catch up with their previous growth trajectories.

Conditionality also works differently in cases where countries are already inside the EU and the Eurozone. In the absence of a specific reward for reform, elected politicians have less incentive and fewer resources to mobilise political support for reforms. The experience of the same countries' accession to the single currency in the 1990s is instructive—policymakers were able to win support even for unpopular measures by evoking the sunny uplands of a more prosperous future within the euro area.

[17] Democratic backsliding in Hungary and Poland have generated interest in subjecting structural funds to rule-of-law conditionality from 2021 onwards.

Romano Prodi's "Euro tax" is a good example of this. By contrast, short-term negotiations on the release of tranches of bailout funds or the provision of central bank financing lack these characteristics, in part because national policymakers understand bailouts are of mutual advantage to creditors and debtors.

Another obvious difference from ex ante enlargement conditionality is that the macroeconomic policies upon which emergency liquidity is made conditional are unable to achieve the broad goal of structural reform that implicitly or explicitly informs them. Specific fiscal requirements aimed at reducing deficits do not preclude that inefficient, corrupt or clientelistic patterns of public spending and regulation can continue. Exhortations to reform economic institutions, such as labour market regulations, can fall on both the legislative process, as measures are watered down (such as for instance labour reform in Italy), or in implementation, as judicial institutions reverse or nullify the intended effects of reform. These are among the classic barriers that IMF conditionality had always faced in poorer countries and were prominent in the pessimistic literature on conditionality developed out of those experiences (Dreher 2009). The apparent success of CEE enlargement conditionality and CEE macroeconomic conditionality outside the Eurozone was thus always likely to be a poor guide to its use on heavily-indebted Eurozone members.

The sober assessment of ex post conditionality in the Eurozone also invites some reconsideration of the apparent success of the two earlier episodes. While ex ante conditionality before enlargement both achieved membership and generally has not been followed by backsliding on *policy measures* (Sedelmeier 2016), there is evidence of backsliding on *core democratic institutions* and *rule of law* in Hungary, Poland, and, more briefly, Romania. Moreover, Hungary and Romania both engaged in brutal deflation in the wake of their EU-IMF bailouts, which generated a backlash against the parties of austerity. To be sure, there is no one-to-one link between a state being the object of conditionality and later political extremism—after all, Latvian democracy has remained intact after its bailout, while Poland's government has eroded constitutional norms despite never needing a bailout. But an essential weakness remains in that conditionality sits uneasily with member state-level democratic institutions. If what the Troika or the Commission want is unacceptable to democratically elected representatives, or even to those involved in implementing policy, then it is likely to fail. In this sense there is a principal-agent dynamic, with the member state governments acting as agents with far greater knowledge and control of national institutions than any external monitors can muster.

We conclude that the EU's new ex post conditionality was overly aggressive and that it was unlikely to bear the fruit the Council and Commission desired. This failure resulted from the flawed nature of the theories underpinning the policy programme deployed and the predictable political backlash to the bullying nature of some of the adjustment programmes imposed as conditions of financial rescues. In sum, up to now conditionality in the Eurozone context seems to be working much as the experience of structural adjustment programmes in other parts of the world would predict. As Greer (2014) explains, "The null hypotheses from the large literature on structural adjustment policies suggest that the (they) will: be badly implemented; be neutral or bad for growth; be bad for equity and the poor; have unpredictable policy consequences; and will allow incumbent elites to preserve their positions." Preliminary evidence from Southern Europe has confirmed that the same problems are arising. One caveat to this, however, is that established partisan and governing elites in Southern Europe are under severe pressure, with electoral breakthroughs by populist alternatives in Greece, Italy and Spain threatening an outright rejection of the policy prescriptions imposed from outside.

This is in contrast to the more benign role—though with caveats just noted—conditionality appeared to play during enlargement and during macroeconomic stabilization outside the Eurozone in CEE. By comparing the cases we can see that conditionality has been more likely to succeed when used as a "lever" to facilitate reforms by supportive national elites, particularly when relating to the politically less controversial non-core state functions involved in the membership perspective, and where the European institutions have the ability to control the rewards for compliance. In the Eurozone debt crisis, these conditions have been lacking. National elites were often less than supportive, particularly since the measures imposed were politically highly sensitive, and extremely painful for national populations in the short-term, with uncertain benefits in the long term. Although financial assistance was a reward available for compliance, it preceded the actual implementation of the conditional measures, whereas the long-term reward, a return to economic growth, was not a gift European decision-makers could bestow.

These new Commission and ECB roles in exercising conditionality in core state functions help shed light on otherwise puzzling developments elsewhere in the literature.[18] For example, recent research on the European Council and the Council of

[18] The ECB also used conditionality on the question of exactly how the Irish retired bond debt.

Ministers explicitly denies any prominent role for “hierarchy” in the “new” (e.g., post-crisis onset) domains of economic governance and monetary policy (Puetter 2014). According to this view, as member states have grown wary of the Community Method, they have developed new instruments in economic policy, but increasingly rely on intergovernmental processes marked by substantial and sustained “deliberation” among the member states. This has entailed a major shift by the Council towards inter-state coordination in various fora. Integration thus increases but without legal delegation. Instead, cooperation prevails, though defection remains an open possibility.

Applying this broad argument to the case of economic policy, Puetter finds that the member states have sought to limit the Commission’s role in these new areas and have also prevented ECJ oversight by use of new treaties (e.g. ESM) or intergovernmental agreements (e.g., Fiscal Compact) with no authority for the ECJ. Puetter shows that the instruments of control at the Council level are not legally binding, and we can accept the idea that states can break these commitments. The evidence for this is substantial (Hallerberg and Baerg 2016). Where we break from Puetter is our insistence that quite a lot of conditionality and “hierarchy” is being used (see also Börzel 2016). Thus, we insist on the crucial point that—whatever deliberation is going on at the Council level—other agents, such as the ECB and the Commission, are both willing and able to flank and try to enforce the agreed policies.

Not only has this latest episode of conditionality had decidedly mixed results in policy evaluation terms, it has ruthlessly exposed European decision-makers and voters to the trade-offs involved in participation in the European project, and in particular its monetary aspect. European Union membership can mean non-elected technocrats arriving on missions to open up member state governments' books and demand the implementation of deeply unpopular policy measures, with little pretence that there is much scope for negotiation. Predictably, this has placed pro-European political elites in debtor countries under political pressure, creating opportunities for nationalistic appeals to make electoral hay. Even when the populist threat can be held off (for now), as in Spain or Portugal, member state governments can appeal to European decision-makers for a softer touch, for fear of something worse. The limits of conditionality are ultimately to be found in the electoral nexus at the member state level.

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Table 1: Stylised differences in the three phases of EU conditionality

	States affected	**Conditionality type**	**Policy areas affected**	**EU measures flanking conditionality**	**Criteria for success**
Conditionality in CEE during early 2000s	Candidate states with a membership perspective	Ex ante (e.g., states must meet conditions prior to reward)	Primarily non-core state functions	Trade access, FDI promotion, value-chain incorporation	Is EU membership achieved? (Yes for all)
Conditionality in CEE during initial GFC	Eurozone non-member states in liquidity crises	Ex post (e.g., states receive liquidity prior to meeting conditions)	Central bank supervisory powers	Emergency liquidity assistance of various kinds	Is market access restored? (Yes, for all)
Conditionality in Eurozone periphery in debt crisis period	Eurozone member states in liquidity crises	Ex post (e.g., states receive liquidity prior to meeting conditions)	Core state functions, (fiscal, public employment, labour market, social policy)	Emergency liquidity assistance of various kinds	Is sustainable economic growth restored? (No, semi-permanent central bank assistance and monitoring of structural reforms)