The use of overly intrusive conditionality in Greece is threatening the European project

blogs.lse.ac.uk/europpblog/2015/06/01/the-use-of-overly-intrusive-conditionality-in-greece-is-threatening-the-european-project/

6/1/2015

With pressure growing on Greece ahead of a scheduled IMF debt repayment, there is still no agreement between the country and its creditors on the release of further financial assistance. **Harald Sander** *writes that one of the key problems in Greece has been the attempt by creditor states to impose an overly intrusive form of conditionality in exchange for support. He argues that the real aim of the conditions attached to assistance should be to ensure debts are repaid, not to insist on the details of reforms, and that the use of policy conditionality of the kind experienced in Greece poses a threat not just to the euro, but to the European project as a whole.*

A Greek default may be only a matter of weeks away unless an agreement on the reform programme between Greece and "the institutions" will be reached. But Greece demands to renegotiate the whole programme, while the institutions, fearing a precedent, insist on sticking to the obligations. Thus, a default could simply result from a fundamental disagreement on the institutions' conditionality, finally triggered by a deliberate decision of the creditors.

Jeroen Dijsselbloem, President of the Eurogroup, Credit: EU Council Eurozone (CC-BY-SA-3.0)

Prominent economists like Barry Eichengreen, Paul Krugman, or those organised in the Eiffel Group have recently urged for a less intrusive conditionality and more self-responsibility of debtors, though with varying intensity and differing arguments. What is wrong in asking Greece to fulfil its obligations as articulated forcefully by German finance minister Wolfgang Schäuble? Or it should we agree with Yanis Varoufakis who blames austerity as the only deal-breaker?

Against this background, this piece argues that using deeply intrusive policy conditionality is a flawed approach in the context of European integration for at least three reasons: first and most evidently, the institutions' conditionality has often proven dysfunctional and too painful for debtor countries; second, the use of extensive policy conditionality is an ad-hoc approach with unequal burden sharing between debtors and creditors; third, too intrusive conditionality is in conflict with democratic decisions in debtor countries, which can put the idea of a Europe in which nations participate as equals in jeopardy.

To put it in terms of a European version of Dani Rodrik's political trilemma: in the absence of a political (and fiscal) union, it is not clear how much national sovereignty Eurozone members, both debtors and creditors, are willing to give up as the price for a functioning common currency area.

Why policy conditionality in the Eurozone?

No rules were in place to deal with rescue packages when the Greek debt crisis triggered the Eurozone crisis in

2010. At that time, only the International Monetary Fund (IMF) had experience in emergency lending to sovereign countries. Hence the IMF was brought in and jointly with the EU Commission and the ECB, finance-for-reform programmes were designed by the "troika", now known as "the institutions". Policy conditionality had entered the Eurozone.

A short look at IMF conditionality and its evolution is therefore helpful. Its primary function is to ensure repayment of balance-of-payments loans of revolving IMF funds. Its secondary function, to act as a catalyst to unlock private funds, became relevant in the developing countries debt crisis of the 1980s and the Asian crisis of the late 1990s, when IMF funds were not sufficient. A tertiary function was added in the late 1980s and 1990s: to promote a set of far-reaching market-oriented economic, some would say "neoliberal", reforms, which became known as the "Washington Consensus", which sometimes developed further to an "extended Washington Consensus", or even to a "reform overreach" into internal politics.

Today the rescue programmes are arranged under the umbrella of the European Stability Mechanism (ESM), which readily took over the concept of strict conditionality – not least to overcome the supposedly resistant electorates of the creditor countries and the reluctance of financial markets to provide further finance.

The flaws of a too intrusive conditionally

But strict conditionality does not necessarily mean intrusive policy conditionality. Recall that the primary function of conditionality is to secure repayment or to avoid default and recourse on guarantees, respectively. Thus, IMF/ESM conditionality has to solve primarily one issue: it must determine the overall level of adjustment required, i.e. setting the quantitative goals to ensure repayment. Doing this and being strict in this respect is fully justified.

In the Eurozone context this is predominantly done by setting quantitative goals for the primary government budget surplus, i.e. the surplus after paying interest on debt. It determines how much debt can be paid back in a given year. However, in practice agreeing on this target is controversial. Many observers hold that the demands are too often too high, especially in the case of Greece and overstretching the economic and political reform resources of a country, not least as too ambitious austerity targets can be self-defeating. Moreover, the tightness of the targets depends critically on the willingness of the creditors to support the debtor, which is a function of both, solidarity in the Eurozone (or rather the lack of it) and the recognition of the debtors' own responsibilities.

But now imagine that debtor and creditors are in agreement on the overall objective. Why then not leave the choice of policy instruments to national decision makers? If two different instruments would have the same effect with respect to the target, it could be left to democratically elected governments to decide, e.g. whether to tax only the rich or increase tax rates for all. But what if there is disagreement on the effectiveness of the instruments? Theoretically there are three options:

The first one is imposition of conditions. This option was chosen when the crisis broke out and it has been and still is an important argument in creditor countries to sell financial assistance to their electorates. Of course, the conditions are officially based on a "memorandum of understanding", but in reality "agreeing" can mean different things. And what happens, if a newly elected government like Syriza does not agree anymore?

There are strong arguments against arranged programmes. First, they are often inconsistent. In a self-assessment the IMF has admitted that the initial programme for Greece was overly optimistic. To be fair, it is a long way from taking measures toward reaching the goals. In particular, complex structural reforms of labour markets or pension systems – whatever their value for the economy in the long run is – have often very little or uncertain and sometimes even detrimental impacts on reaching the overall (budget) targets.

Second, in as much as arranged measures do not deliver the expected results it would not be fair to let the debtor pay for it. Rather, this is a strong argument in favour of debt-for equity swaps as a more efficient solution as the creditor would also pay for incorrect prescriptions. Third, arranged programmes lack programme ownership, but as

the IMF assessment on the Greek programme has pointed out, strong ownership is essential for successful reform and compliance.

The second option is to leave the choice of instruments to national governments, eventually letting them pay for their own mistakes. The danger is that a default may be followed by an exit from the currency union, thus rendering the Eurozone fragile. While this was a serious problem some years ago, today it is more thinkable that a sovereign default would be possible without leaving the euro. However, a Greek default would be costly to creditors: the official exposure amounts to about €4350 for a German or French family of four. Consequently, option three, consensus – if need be with a little help of independent experts – is the method of choice to moderate both disagreements on programmes and the political trilemma.

Towards a conditionality for a Europe of equal nations

An overly intrusive conditionality is not only economically dysfunctional, but can lead to deep and long-lasting political disruption in Europe. Ultimately it may not only put the currency union, but also the whole European project in jeopardy as it contradicts the basic idea of European nations as equals. Therefore, the Eurozone is well advised to focus on the primary function of conditionality – securing repayment – with realistic overall targets, a fair burden sharing, and strict enforcement. For going deeper, a consensus among equals, not imposition is the method of choice.

For sure, massive reforms are urgently needed in Greece and elsewhere, but in the absence of a politically united Eurozone this remains ultimately the responsibility of governments of democratic nations. Europe should assist in designing effective reforms rather than seek to impose them. After all, building mutual trust has made Europe a model of successful integration.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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