

## THE RISE AND FALL OF CONDITIONALITY IN EU ECONOMIC GOVERNANCE: TOWARDS SYMMETRY?

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*L'articolo analizza l'evoluzione delle politiche di condizionalità durante la crisi dell'euro, prendendo anzitutto in esame i nuovi strumenti di assistenza agli Stati membri in difficoltà finanziaria e le riforme adottate per rafforzare il coordinamento delle politiche economiche e la sorveglianza sulle politiche di bilancio. In secondo luogo, si discute il ruolo della condizionalità quale metodo generale di gestione della governance economica europea. In terzo luogo, si esamina criticamente l'impiego delle politiche di condizionalità, negli ultimi anni, che non ha ridotto le asimmetrie nel contesto dell'UEM ma, al contrario, le ha accentuate. Infine, si avanza una proposta per l'adozione di un sistema di condizionalità bilaterale che favorisca, alla luce dei principi e degli obiettivi emergenti dal diritto primario, la simmetria tra le politiche economiche degli Stati membri e la condivisione degli oneri di aggiustamento macroeconomico.*

*This paper aims at analysing the evolution of conditionality since the beginning of the crisis. First, it provides a brief overview of both financial tools developed during the last few years to help Member States in difficulty and the reforms to reinforce macroeconomic coordination and budgetary surveillance; second, it draws a distinction between conditionality stricto sensu and lato sensu, meaning that conditionality is not merely macroeconomic conditionality but a general concept enshrined in EU economic governance; third, it discusses critically the issue of symmetry, which is the core problem of the euro area; finally, it advances the proposal for a system of bilateral conditionality, based on EU principles and objectives, in which the burden of macroeconomic adjustment is shared between debtors and creditors.*

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## 1. Introduction

Over the last decade, conditionality has assumed an increasing role in EU economic governance. Currently, it is considered the *trait d'union* between economic policies coordination and the adoption of financial assistance programmes to help Member States in difficulty. At the very beginning of the crisis, conditionality was perceived as the best tool to ensure macroeconomic adjustment by Member States in deficit while leaving them ownership of requested reforms. Nowadays, there is a widespread debate about issues raised by the deployment of conditionality especially in euro area Member States and its capability of solving the asymmetrical relationship between debtors and creditors.

This paper aims at analysing the evolution of conditionality since the beginning of the crisis. First, it provides a brief overview of both financial tools developed during the last few years to help Member States in difficulty and the reforms to reinforce macroeconomic coordination and budgetary surveillance; second, it draws a distinction between conditionality *stricto sensu* and *lato sensu*, meaning that conditionality is not merely macroeconomic conditionality but a general concept enshrined in EU economic governance; third, it discusses critically the issue of symmetry, which is the core problem of the euro area; finally, it advances the proposal for a system of bilateral conditionality, based on EU principles and objectives, in which the burden of macroeconomic adjustment is shared between debtors and creditors.

## 2. Dealing with sovereign debt crises: a new framework

When Greece was put under enormous pressure by financial markets in 2010 and financial instability was spreading throughout the euro area, the EU primary law framework offered no quick solutions to the debt crisis problem. While for EU Member States with derogation, articles 143 and 144 TFEU provide tools for balance of payments difficulties through mutual assistance and, if needed, financial assistance, there is no such mechanism for euro area Members<sup>1</sup>. The reasons behind this asymmetry can be found in the preparatory documents of the European Commission before the signature of the Treaty of Maastricht: the belief was that balance of payments between

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<sup>1</sup> See Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments.

Member States would have disappeared with a currency union. This would have been possible through the role of capital markets, acting as a sort of private clearing union and forcing to automatic adjustments (real convergence) the Members of the Union<sup>2</sup>. If one looks at the euro crisis as a balance of payments crisis between the peripheral and the core Member States, it will soon be clear that the euro crisis is, first and foremost, more related to governance than public debt, and, specifically with the lack of both a short-term mechanism to deal with sudden stops and a long-term mechanism to rebalance current account disequilibria and restore confidence and growth<sup>3</sup>. To overcome these fundamental flaws, many measures were adopted over the last few years. As for Greece, bilateral loans of EU member States were assembled by the EU Commission along with the financial assistance of the International Monetary Fund<sup>4</sup>. At the same time, two financial mechanisms were created with different structures and legal bases: the EFSF and EFSM<sup>5</sup>. While the former was the result of an intergovernmental agreement between euro area Members, the latter was the expression of art. 122 TFEU and thus an integral part of the EU legal framework. Despite the differences, conditionality is a common feature of these two tools<sup>6</sup>. According to the Preamble of the EFSF Agreement, the availability of financial means is «conditional upon the relevant euro area Member States which request such loans entering into memoranda of understanding». After the request for a loan is advanced by a euro area Member State, the MoU is negotiated by the EU Commission along with the ECB and, eventually, the IMF under the supervision of the Council. After

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<sup>2</sup> European Commission, *One Market, One Money: An evaluation of the potential benefits and costs of forming a monetary union*, in *European Economy*, 1990, n. 44, 95.

<sup>3</sup> See MERLER - J. PISANI-FERRY, *Sudden Stops in the Euro Area*, in *Bruegel Policy Contributions*, March 2012, 2.

<sup>4</sup> The Greek government in the beginning of 2010 submitted a request to both the IMF and the euro area Member States for loans. The conditions of the so-called first bail-out programme were outlined in the *Memorandum of Understanding on specific economic conditionality* signed on 3 May 2010, published in *The Economic Adjustment Programme for Greece*, in *European Economy Occasional Papers*, 61, 2010, 59. The conditions of the IMF assistance were coordinated with those of the euro area but formally separated: see *Memorandum of Economic and Financial Policies* and the *Technical Memorandum of Understanding*.

<sup>5</sup> See Council Conclusions, Economic and Financial Affairs, Council Extraordinary meeting Brussels, 9/10 May 2010.

<sup>6</sup> See, for details, DE GREGORIO MERINO, *Legal developments in the Economic and Monetary Union during the debt crisis: The mechanisms of financial assistance*, in *Common Market Law Review*, 2012, 1618.

the revision of the Agreement in 2011, the EFSF could provide new forms of assistance to requiring Member States as long as “policy conditionality” is imposed. As for the EFSM, art. 3 of Regulation 407/2010 provides that the Council decision to grant a loan or a credit shall include the «general economic policy conditions which are attached to the Union financial assistance». Loans or credits through the EFSM are granted after a “discussion” between the Member State seeking assistance and the Commission, together with the ECB.

Since both the EFSF and the EFSM were supposed to be temporary tools, the persisting financial instability of the euro area made it clear that a permanent mechanism to deal with financial distress and sovereign debt issues was needed. The Report of the Task Force on economic governance to the European Council already suggested the establishment of «a credible crisis resolution framework for the euro area, capable of addressing financial distress and avoiding contagion» by operating with «very strong conditionality»<sup>7</sup>. In line with this recommendation, the ESM was established through an international agreement while the European Council started the simplified revision procedure to amend the TFEU in order to create a proper legal basis for such a mechanism and in March 2011 the Decision amending art. 136 TFEU was adopted<sup>8</sup>. Therefore, the concept of “strict conditionality” has gained a primary law status, even though the effects of the Treaty amendment as well as its relationship with the ESM Treaty have been questioned<sup>9</sup>. At any rate, the ESM’s fundamental aim is that of ensuring «the financial stability of the euro area as a whole and of its Member States» by means of stability support «under strict conditionality, appropriate to the financial assistance instrument chosen»<sup>10</sup>. Art. 12 of the Treaty further clarifies that: «conditionality may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions».

Alongside financial assistance measures, a substantial reform of EU fiscal and macroeconomic surveillance took place as a result of the financial crisis.

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<sup>7</sup> See *Strengthening Economic Governance in the EU, Report of the Task Force to the European Council*, Brussels, 21 October 2010, 11.

<sup>8</sup> See European Council Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro.

<sup>9</sup> See, among others, CRAIG, *Legal Reasoning, Text, Purpose and Teleology*, in *Maastricht Journal of European and Comparative Law*, 2013, 5 et. seq. and DE WITTE - T. BEUKERS, *The Court of Justice approves the creation of the European Stability Mechanism outside the EU legal order: Pringle*, in *Common Market Law Review*, 2013, 805 et seq.

<sup>10</sup> See art. 3 of the Treaty Establishing a European Stability Mechanism.

According to the main interpretation, endorsed by both the then French and German governments, the lack of fiscal discipline by peripheral Member States, during the previous years, was the main cause of the sovereign debt crisis. For this reason, fiscal surveillance was reinforced through an overall reform of the Stability and Growth Pact and the signature of an international agreement, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union<sup>11</sup>. The latter is linked to the ESM financial assistance as the Preamble of the ESM Treaty states that: «It is acknowledged and agreed that the granting of financial assistance in the framework of new programmes under the ESM *will be conditional*, as of 1 March 2013, on the ratification of the TSCG by the ESM Member concerned and, upon expiration of the transposition period referred to in Article 3(2) TSCG on compliance with the requirements of that article»<sup>12</sup>.

Moreover, a new framework to deal with macroeconomic imbalances across the Union, with a corrective arm only for euro area Members, was introduced. In particular, the main scope of the Macroeconomic Imbalance Procedure (MIP) is to tackle current account imbalances between euro area Member States<sup>13</sup>. The logic behind this framework is outlined in the Report of the Task Force on EU Economic Governance: «Given vulnerabilities and the magnitude of the adjustment required, the need for policy action is particularly pressing in Member States showing persistently large current-account deficits and large competitiveness losses. Also, in Member States

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<sup>11</sup> The reform of the Stability and Growth Pact was announced by the Commission in May 2010. Both the preventive and corrective arms of the Pact were emended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. On legal issues raised by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, see CRAIG, *The Stability, Coordination and Governance Treaty: Principles, Politics and Pragmatism*, in *European Law Review*, 2012, 231 et. seq.; PEERS, *The Stability Treaty: Permanent Austerity or Gesture Politics?*, in *European Constitutional Law Review*, 2012, 441 et. seq.

<sup>12</sup> See ESM Treaty, Whereas No (5). The same link can be found in the Preamble of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

<sup>13</sup> The preventive arm of the MIP is laid down in Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances while the corrective arm was introduced by Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

that have accumulated large current account surpluses, policies should aim to identify and implement the structural reforms that help strengthen their domestic demand and growth potential»<sup>14</sup>.

The need to correct macroeconomic imbalances was perceived in both deficit and surplus Countries but in deficit Countries was considered *particularly pressing*. This is why some authors have argued that the MIP has an asymmetrical structure as it is more centred on current account deficits than current account surplus: asymmetry that is apparently not grounded on economic reasons<sup>15</sup>.

### 3. Shades of conditionality in EU economic governance

In recent years, the term conditionality has been used to describe political, economic and social implications of macroeconomic adjustment programmes in the euro area. This form of conditionality has the same features of that of the IMF: lacking not only a legal basis but even a model for euro area conditionality, the IMF policy «of providing loans and financial aid to developing countries under a strict set of macroeconomic conditions»<sup>16</sup> was considered as an archetype by EU institutions and Member States. Even in the IMF context, the debate over conditionality has a long history. It began during the Bretton Woods Conference and it was, essentially, a debate between creditors and debtors. Keynes, who represented a deficit Country (the UK), was in favour of an automatic system to offset balance of payments deficits. On the other side, White, in representation of a surplus Country (the USA), was against an automatic or semi-automatic system for financing balance of payments deficits and supported some sort of policy scrutiny before granting assistance<sup>17</sup>. The outcome of the Bretton Woods conference on the topic is well-known: art. V of the Article Agreement was the result of a compromise between the American and the British proposals with an unclear formulation. Thus, conditionality was

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<sup>14</sup> See *Strengthening Economic Governance in the EU*, cit., 8.

<sup>15</sup> DE GRAUWE, *In search of symmetry in the eurozone*, in *CEPS Commentary*, 2 May 2012, 4-5. See *infra*.

<sup>16</sup> Cf. BARAGGIA, *Conditionality Measures within the Euro Area Crisis: A Challenge to the Democratic Principle?*, in *Cambridge Journal of International and Comparative Law*, 2015, 270.

<sup>17</sup> LOWENFELD, *International Economic Law*, Oxford, 2003, 513.

attached to IMF loans only through an evolutive interpretation of art. V<sup>18</sup>. Only after the reform of the Fund, a proper legal basis for conditionality was included in the Article Agreement. The debate on IMF conditionality is relevant as long as it reveals that the discussion over conditionality basically regards the position of debtors and creditors in the international economic system. As suggested by R. M. Lastra, the imposition of policy conditions is similar to a collateral used by a commercial bank as a guarantee for a loan. Indeed, from a creditor's point of view, this reasoning could appear simply logical because «a country with external payments problems is spending more than is taking in. Unless economic reform takes place, it will continue to spend more than it takes in»<sup>19</sup>. This rationale, which inspired the policies of the IMF, is similar to the one which regulates financial assistance in the euro area. Creditor Member States, mainly due to domestic policy motivations, were simply not willing to grant financial assistance without any collateral. The collateral took the form of macroeconomic adjustment programmes negotiated by the so-called Troika (now the Institutions), with the Member State requiring assistance.

In this respect, conditionality - now defined in art. 136, par. 3, TFEU as *strict conditionality* - is a new concept for the euro area and, generally, for the EU. However, with regards to its evolution, Bini-Smaghi has underlined that conditionality can be seen as a broader (and older) concept in the EU legal order<sup>20</sup>. It is impossible to address all the various shapes that conditionality could take in different areas and policies of the EU. Looking solely at EU economic governance, conditionality cannot be merely identified with a tool designed to regulate financial assistance to euro area Members.

Firstly, conditionality is applied in case of mutual assistance and, specifically, when medium-term financial assistance is provided to a

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<sup>18</sup> Once the IMF was operational, on the meaning and the implications of art. V, Section 3, there was a «a strenuous controversy between those who argued that the Fund could challenge a member's representation and refuse a request or postpone action on it, and those who insisted that there was no such power and that a request must be honoured». See GOLD, *Use of the International Monetary Fund's Resources: "Conditionality" and "Unconditionality" as Legal Categories*, in *The Journal of International Law and Economics*, 1971, 1. According to Gold, the first definition of conditionality in the practice of the IMF appeared already in the Annual Report of 1964.

<sup>19</sup> See LASTRA, *The International Monetary Fund in Historical Perspective*, in *Journal of International Economic Law*, 2000, 516 – 517.

<sup>20</sup> BINI-SMAGHI, *Governance and Conditionality: Toward a Sustainable Framework?*, in *Journal of European Integration*, 2015, 757.

Member State with derogation. Indeed, once mutual assistance is granted, the Council «shall adopt directives or decisions laying down the conditions and details of such assistance»<sup>21</sup>. In addition, following a Commission's initiative or a Member State's request, the Council shall decide on «the economic policy conditions attaching to the medium-term financial assistance with a view to re-establishing or ensuring a sustainable balance of payments situation»<sup>22</sup>. As mentioned, medium-term financial assistance is just one of the tools to give effect to articles 143 and 144 TFEU. According to art. 143 TFEU, the Commission shall investigate the position of the Member State with balance of payments difficulties as far as «such difficulties are liable in particular to jeopardise the functioning of the internal market». This is to say that the ultimate objective of mutual assistance is to preserve the functioning of the internal market since balance of payments crises can disrupt intra-EU trade and capital flows. It is also worth noting that, before the Treaty of Maastricht, mutual assistance was the general arrangement to deal with economic and financial distress in the EEC, under articles 108 and 109 TCEE. Historically, mutual assistance has been applied few times. To give an example, the Council granted mutual assistance to Italy, in 1974, during the energy crisis, providing also financial assistance through the then medium-term fund<sup>23</sup>. In the case of Italy, the Directive contained a set of broad policy conditions such as the restriction of «the expenditure and number of semi-public bodies», an increase of direct taxation and a decrease in petroleum products consumption<sup>24</sup>.

Secondly, the abrogation of a derogation necessary for the introduction of the euro in a Member State is based on conditionality. The Council decides whether a Member State fulfils the conditions on the basis of the four nominal criteria, namely price stability, government budgetary sustainability, observance of normal fluctuation margins in the ESM and long-term interest rates durability<sup>25</sup>.

Thirdly, the ECB's monetary policy has been characterized in the last few years by an increasing role of conditionality. At the beginning, ECB's conditionality was just “implicit”, meaning that it was not formalised in a

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<sup>21</sup> Cf. art. 143, par. 2, TFEU.

<sup>22</sup> See art. 3, par. 2 (b), of Regulation (EC) No 332/2002.

<sup>23</sup> See Council Directive of 17 December 1974 granting medium-term financial assistance to the Italian Republic (74/637/EEC) on the basis of Council Decision of 21 December 1978 amending Decision 71/143/EEC setting up machinery for medium-term financial assistance.

<sup>24</sup> See art. 7 of Council Directive 74/637/EEC.

<sup>25</sup> Art. 140 TFEU.



document like a MoU<sup>26</sup>. According to A. Viterbo, “implicit conditionality” took various shapes during the crisis through: the assessment of the adequacy of certain Member States’ bonds as eligible assets for refinancing operations in the Eurosystem; the monitoring on national authorities of the ECB’s Governing Council on Emergency Liquidity Assistance provided by National Central Banks; pressures on governments in financial distress during the SMP and so on. With the launch of the OMT programme, the ECB’s conditionality became explicit: «A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme»<sup>27</sup>.

Furthermore, the relationship between the ESM and fiscal surveillance in EMU is governed by conditionality. As mentioned, the ESM assistance is conditional on the ratification of the TSCGE. Moreover, in the *Pringle* judgment, the Court of Justice clarified that conditionality is not important *per se* but as long as it ensures the respect of EU law in providing financial assistance<sup>28</sup>. In particular, conditionality, under the ESM Treaty, «can take the form of a macro-economic adjustment programme» and «is intended to ensure that the activities of the ESM are compatible with, inter alia, Article 125 TFEU and the coordinating measures adopted by the Union»<sup>29</sup>. In this sense, conditionality is the *trait d’union* of financial assistance and economic policy coordination. A similar (even if not equal) conclusion was reached by the Court in the *Gauweiler* case<sup>30</sup>. Discussing the link between conditionality and the activation of the OMT programme, the Court states that it serves as a preclusion for the purchasing programme to act «as an incentive to those States to dispense with fiscal consolidation». To put it differently, by making the implementation of the OMT conditional upon full compliance with

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<sup>26</sup> See VITERBO, *La politica di condizionalità della BCE: problematiche e prospettive*, in PORCHIA (ed.), *Governance economica europea. Strumenti dell’Unione, rapporti con l’ordinamento internazionale e ricadute nell’ordinamento interno*, Napoli, 2015, 100 et seq. and SACCHI, *Conditionality by other means: EU involvement in Italy’s structural reforms in the sovereign debt crisis*, in *Comparative European Politics*, 2015, 79 et seq.

<sup>27</sup> See ECB Press Release *Technical Features of Outright Monetary Transactions*, 6 September 2012, available on [www.ecb.europa.eu](http://www.ecb.europa.eu). For details, see VITERBO, *La politica di condizionalità della BCE: problematiche e prospettive*, cit.

<sup>28</sup> Case C-370/12 *Pringle v. Government of Ireland*, Judgment of the Court 27 November 2012, (no. 72).

<sup>29</sup> *Pringle*, (no. 111).

<sup>30</sup> Case C-62/14 *Gauweiler and Others v. Deutscher Bundestag*, Judgment of the Court 16 June 2015 (120).

macroeconomic adjustment programmes, coherence between monetary policy and fiscal consolidation would be ensured. Ironically, while in both the *Pringle* and *Gauweiler* judgements conditionality is regarded as a tool to safeguard EU law, many prominent scholars consider conditionality a threat to the rule of law. It is far beyond the scope of this article to discuss the potential or actual conflict between the rule of law and the euro area bail-out programmes<sup>31</sup>. However, there is a link between such conflict and the attempt to complete the process of institutionalisation of conditionality<sup>32</sup>. Apart from the amendment of art. 136 TFEU, this attempt has been made through Regulation 473/2013<sup>33</sup>. Indeed, according to the ECB's opinion, the Regulation's purpose is to give «an explicit basis to the practice of stronger monitoring of Member States experiencing financial market tensions or receiving financial assistance»<sup>34</sup>. Similarly, the Commission considers the Regulation as an attempt «to embed in the EU legal framework the working practices established under [...] intergovernmental instruments»<sup>35</sup>.

Finally, it is well-known that there is no central government in EMU. Macroeconomic convergence in EMU is essentially based on market conditionality, that is to say the ability of a Member State to respect conditions imposed by market forces. This is evident in the multilateral surveillance procedure, where, if it is established that the economic policies of a Member State are not consistent with the broad guidelines on economic policies, the Council could eventually make its recommendations public<sup>36</sup>. The *rationale* of such publicity is that of warning financial markets so they can start pressuring the Member State concerned, mainly via the level of interest rates on government bonds. This mechanism was explicitly suggested by the Delors Report: «Market forces can exert a disciplinary

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<sup>31</sup> On this discussion, see KILPATRICK, *On the Rule of Law and Economic Emergency: The Degradation of Basic Legal Values in Europe's Bailouts*, in *Oxford Journal of Legal Studies*, 2015, 325.

<sup>32</sup> See BARAGGIA, *Conditionality Measures within the Euro Area Crisis: A Challenge to the Democratic Principle?*, cit., 273; IOANNIDIS, *EU Financial Assistance Conditionality after 'Two Pack'*, in *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht*, 2014, 2.

<sup>33</sup> Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.

<sup>34</sup> Opinion of the European Central Bank of 7 March 2012 on strengthened economic governance of the euro area (CON/2012/18).

<sup>35</sup> EU Commission Memo, *'Two-Pack' enters into force, completing budgetary surveillance cycle and further improving economic governance for the euro area*, 27 May, 2013.

<sup>36</sup> See art. 121, par. 4, TFEU.

influence. Financial markets, consumers and investors would respond to differences in macroeconomic developments in individual countries and regions, assess their budgetary and financial positions, *penalize* deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies»<sup>37</sup>.

So, this sort of conditionality through market, which can be also depicted as “implicit”, is at the root of the EMU project.

The above examples suggest that there is a *lato sensu* conditionality, which encompasses the entire EMU governance and is not merely related to a macroeconomic adjustment programme. As stated by the Court of Justice, conditionality «can take the form of a macro-economic adjustment programme»<sup>38</sup> but can also be deployed by other means, in different contexts, with either soft and hard law instruments and can be even implicit as in the case of ECB and market conditionality.

#### 4. The “neglected variable”, asymmetries and the fall of conditionality

There is a new consensus among economists about the roots of the euro crisis: the accumulation of macroeconomic imbalances between core and peripheral Member States. This is made clear if one looks at current accounts before and during the financial crisis. Giavazzi and Spaventa already defined current accounts as the “neglected variable” of the euro area<sup>39</sup>. Along with them, economists with different and sometimes opposite backgrounds converge on the view that the root of the sovereign debt crisis could not simply be identified with excessive government deficits in some undisciplined Member States but was a more complex phenomenon related to the accumulation of divergences which eventually led to balance of payments disequilibria in the euro area<sup>40</sup>. As previously noted, before the

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<sup>37</sup> Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community*, 17 April 1989, 15.

<sup>38</sup> Pringle, (no. 111).

<sup>39</sup> See GIAVAZZI - SPAVENTA, *Why the Current Account May Matter in a Monetary Union: Lessons from the Financial Crisis in the Euro Area*, in *CEPR Discussion Paper*, 2010, 1.

<sup>40</sup> See, among others, GROS, *The Eurozone crisis and foreign debt*, in BALDWIN - GIAVAZZI, *The Eurozone Crisis. A Consensus View of the Causes and a Few Possible Remedies*, London, 2015, 121 et seq., MERLER - PISANI-FERRY, *Sudden Stops in the Euro Area*, cit. 2; CESARATTO, *Controversial and novel features of the Eurozone crisis as a balance of payment crisis*, in *Quaderni del Dipartimento di Economia Politica e Statistica*, 2012, 1; SINN - WOLLMERSHÄUSER, *Target loans, current account balances and capital flows: The*

EMU was launched, the Commission excluded that a balance of payments crisis could occur within a monetary union. In the same vein, IMF staff considered a balance of payments crisis and, consequently, the usage of Fund resources in EMU, extremely unlikely<sup>41</sup>. Thus, even the IMF, was caught unprepared by the crisis. In particular, a recent paper of the IMF acknowledges that «there was no discussion of how to design conditionality in Fund-supported programs in currency union members»<sup>42</sup>. In other words, if it is correct to say that IMF policy on conditionality inspired euro area conditionality, it is equally fair to say that the former was not conceived to be deployed in a monetary union such as the euro area. Then, the IEO final Report on euro crisis and the IMF confirm the criticisms, specifically, on euro area structural conditionality which was «extensive and intrusive»<sup>43</sup>. Besides, the strategy of imposing conditionality to achieve internal devaluation and restore competitiveness «in the absence of currency depreciation as a policy instrument [...] did not work as quickly or effectively as envisaged, especially against an external environment of low inflation and slow growth»<sup>44</sup>.

The dilemma faced by the IMF is that in a currency union many economic policy tools are outside the control of the Member State concerned but under the control of a supranational institution (e.g. the ECB) and other Member States. In particular, if one acknowledges that the crisis is due to current account imbalances, Member States in surplus exercise a *de facto* hegemony on the entire currency union. This is exactly what happened in the euro area, where core Member States forced the entire euro area to restrictive fiscal policies. These policies, however, have neither reduced macroeconomic imbalances among Member States nor resolved the euro area stagnation (low growth and low inflation). In fact, painful austerity

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*ECB's rescue facility*, in *International Tax and Public Finance*, 2012, 468. To be precise, the euro area crisis is related to “foreign borrowing” and not to public finances. The crisis, however, did not evolve as a conventional balance of payments crisis because «the Eurosystem (consisting of the ECB and national central banks) provided liquidity to crisis countries (and their banks) through facilities such as Long-Term Refinancing Operations (LTRO) and Emergency Liquidity Assistance (ELA), as well as through the area-wide settlement system known as TARGET2». See IEO, *The IMF and the Crises in Greece, Ireland, and Portugal*, 2016, 9 – 10.

<sup>41</sup> Cf. RUSSELL KINCAID, *The IMF's Role in the Euro Area Crisis: What are the Lessons from the IMF's Participation in the Troika?*, in *IEO Background Paper*, July 8 2016, 3.

<sup>42</sup> See, for details, TAN, *IMF Engagement with the Euro Area versus Other Currency Unions*, in *IEO Background Paper*, July 8 2016, 21.

<sup>43</sup> IEO, *The IMF and the Crises in Greece, Ireland, and Portugal*, cit., 25.

<sup>44</sup> *Ibidem*, 26.

measures to reduce imbalances by peripheral Member States have not been counterbalanced by internal revaluation by means of an increase of prices and wages in core Member States<sup>45</sup>. Even the European Commission, which, at the beginning of the crisis, was depicted as one of the main advocates of austerity, has finally drawn some conclusions on the lack of symmetrical policies during the crisis. At the start of the 2017 annual cycle of the European Semester of economic policy coordination, the Commission stressed the need for an expansionary fiscal policy by «those who have fiscal space»<sup>46</sup>. According to the Commission's approach, a positive fiscal stance in the euro area as a whole would boost growth, thus reducing internal imbalances, and would help lower the euro area's current account surplus with the rest of the world<sup>47</sup>. The Commission warns that the reduction of asymmetries within the euro area is not just an economic problem but has its own legal dimension. In fact, while there are rules «essentially designed to prevent excessive levels of deficit and government debt»<sup>48</sup>, expansionary policies can only be recommended not enforced. This is described as «an asymmetry of the EU fiscal framework: the rules can proscribe high deficits (also to avoid high debt) but they can only prescribe the reduction of budgetary surpluses, without imposing it»<sup>49</sup>.

## 5. What can be done: towards bilateral conditionality in EMU?

The problem of symmetry in EMU has a long history. The most macroscopic asymmetry is that between monetary and economic policy: while the former is conducted at a supranational level, the latter is managed by national authorities<sup>50</sup>. This asymmetry has shown all its limits during the euro crisis and is perceived as the main threat to EMU's future. Without any doubt, the development of a budgetary capacity to overcome the economic

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<sup>45</sup> DE GRAUWE, *In Search of Symmetry in the Eurozone*, in *CEPS Policy Brief*, No. 268, May 2012, 3.

<sup>46</sup> Commission's Communication, *Towards a Positive Fiscal Stance in the Euro Area*, (COM(2016) 727 final), 2.

<sup>47</sup> On the benefits of an expansionary fiscal stance in the euro area, recently B. EICHENGREEN, *Is Germany Unbalanced or Unhinged?*, in *Project Syndicate*, May 11 2017.

<sup>48</sup> COM(2016) 727 final, 2.

<sup>49</sup> *Ibidem*.

<sup>50</sup> See, among others, CAFARO, *L'Unione economica e monetaria dopo la crisi*, Napoli, 2017, 4; VERDUN, *An "Asymmetrical" Economic and Monetary Union in the EU: Perceptions of Monetary Authorities and Social Partners*, in *Revue d'intégration européenne*, 1996, 59.

crisis and asymmetrical shocks within a federal political system would be the best solution to the problem of asymmetry. Nevertheless, there are overwhelming legal and political constraints to fiscal integration. First and foremost, fiscal integration has different meanings in different Member States. While in some Countries economic integration means the development of a Union of solidarity, namely a transfer union within a federal system, in core Member States, such as Germany or The Netherlands, economic integration means the restoration of the Union of stability enshrined in the Maastricht order, namely sound public finances and monetary stability through the temporary mutualisation of national public debts<sup>51</sup>. Secondly, emending EU primary law seems not only politically difficult but it could also lead to constitutional disputes<sup>52</sup>. The development of a transfer Union, having the promotion of jobs and growth as main objective, might be perceived as the end of the Union of stability by the *BVerfG*, for example. Furthermore, deploying a redemption fund to restore the Union of stability might have disruptive effects on social and economic rights and even on national identities. For these reasons, while fiscal federalism is certainly a noble political idea, in order to tackle asymmetries in euro area policies, a more pragmatic approach is needed.

Assuming that the main tool to restore symmetry in the euro area, as suggested by many economists, is an internal revaluation in Member States in surplus, that is to say policies to boost domestic demand and reduce net exports, the issue of how to promote an expansionary fiscal stance can be considered *de iure condito* and *de iure condendo*. In the current framework, it is true, as pointed out by the Commission, that expansionary policies can only be recommended by way of the procedure laid down in art. 121 TFEU. A more effective, even if indirect, way to promote expansionary policies could be the enforcement of the MIP. As anticipated, the main aim of the MIP is to prevent the emergence of internal and external imbalances, with particular attention to current account disequilibria among Member States<sup>53</sup>. However, once in force, the regulations on macroeconomic imbalances have produced poor outcomes. This is due to several reasons related, among other

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<sup>51</sup> See, for example, the proposal by the German Council of Economic Experts of a European Redemption Fund advanced in 2012, available on [www.sachverstaendigenrat-wirtschaft.de](http://www.sachverstaendigenrat-wirtschaft.de).

<sup>52</sup> Similarly, WOLF, *Emmanuel Macron and the battle for the eurozone*, in *Financial Times*, 16 May 2017.

<sup>53</sup> For a detailed description of the MIP, see EU Commission, *The Macroeconomic Imbalance Procedure. Rationale, Process, Application: A Compendium*, in *European Economy, Institutional Paper*, 2016, 15.

things, to the development of the MIP scoreboard by the Commission (containing a sort of favour for current account surpluses)<sup>54</sup>. At any rate, the main paradox is that, while through the preventive arm of the Stability and Growth Pact a Member State is asked to reach the medium-term objective (MTO), namely a budgetary position close to balance or in surplus, lowering macroeconomic imbalances, so as to comply with the MIP framework, could imply expansionary fiscal policies derogating from the MTO rule<sup>55</sup>.

In a *de iure condendo* perspective, supporting expansionary policies requires the introduction of a secondary law framework with a new regulation or with amendments to existing ones. The main aim of the new framework would be to reconcile the aforementioned conundrum between the MTO rule and the need to lower current account surpluses. A solution would be the provision of a waiver to the MTO rule as long as a correction of macroeconomic imbalances is needed. Moreover, the European Commission should be responsible for setting the expansionary fiscal target, whilst the composition and quality of the fiscal stance can only be recommended as the ultimate decision falls under the competence of Member States. Such an advancement would be just a starting point to reduce asymmetries in EMU without altering EU primary law.

There are several legal bases for the introduction of such framework. Firstly, since persistent current account surpluses may lead to instability, by jeopardising the proper functioning of both the EMU and the internal market and provoking disruptive phenomena, such as massive capital outflow, credit crunch, collapse of financial institutions and so on, the new overarching principle of financial stability could be used to help prevent new crises<sup>56</sup>. Secondly, art. 119 TFEU considers the sustainability of balance of payments as a guiding principle of the EMU not only for member States with a derogation but even for euro area Member States. Thirdly, general principles

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<sup>54</sup> For the scoreboard developed by the Commission, according to art. 4 of Regulation 1176/2011, see Commission Staff Working Paper, *Scoreboard for the surveillance of macroeconomic imbalances: envisaged initial design*, SEC(2011) 1361 final.

<sup>55</sup> It is worth adding that, according to art. 1 of the *Fiscal Compact*, which is part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the balance budget rule is respected when the structural balance reaches the MTO «with a lower limit of a structural deficit of 0,5 % of the gross domestic product at market prices». When the debt/GDP ratio is significantly below 60% and there is no risk for sustainability of public finances, the lower limit can reach 1% GDP.

<sup>56</sup> On the development of the principle of financial stability during the crisis, see LO SCHIAVO, *The Role of Financial Stability in EU Law and Policy*, Alphen aan den Rijn, 2017, 61.

of EU law, such as solidarity and cooperation, require that the burden of macroeconomic adjustment is shared between creditors and debtors. One way to further enhance this last argument would be the introduction of *bilateral conditionality* if a Member State is experiencing financial distress and is subject to enhanced surveillance according to Regulation 472/2013. In other words, when a Member State is facing a current account deficit and has to adopt a restrictive fiscal stance, Member States with current account surpluses should cooperate to help lower the macroeconomic imbalance by means of internal revaluation measures, thus ensuring symmetry in tackling crises within EMU. In this respect, it is worth noting that art. 2, par. 2, of Regulation 472/2013 already provides that the alert mechanism established by the MIP shall be used to assess whether a member State is threatened by serious difficulties. Nothing prevents the Commission from assessing the position of Member States with persistent and substantial current account surpluses and, where appropriate, to force them to enhanced surveillance.

Another problem in promoting symmetrical policies in Member States in surplus is that of incentives. It is known that EU economic governance is based on two kinds of sanctions: economic sanctions (a non-interest bearing deposit or a fine) and market sanctions (mainly, in the form of higher interest rates on public debt). While budgetary surveillance is based on the possibility to adopt an economic sanction, the multilateral surveillance, as noted above, is based on financial markets pressures<sup>57</sup>. Both types of sanctions could be useless in incentivising a positive fiscal stance. As for the economic sanctions, the imposition of a 0,1% GDP deposit to Member States running a 7 or 8% GDP surplus, as laid down by art. 3 of Regulation 1174/2011, is likely to be ineffective. With respect to capital markets, the current levels of interest rates on German bonds confirm that financial markets tend to reward, rather than punish, exporting countries, even if they are members of a monetary union. A new framework to incentivise expansionary fiscal policies should therefore be based on other means. As the current account position is directly related to trade balance, the best solution would be to allow national authorities of a deficit Member State to impose restrictions to the free movement of goods or capitals *vis-à-vis* the Member State in surplus. Although this would be the most effective mechanism, issues of compatibility with EU primary law would certainly raise. A simpler option would be to set the amount of sanctions on the basis

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<sup>57</sup> See *supra*.



of the volume of the surplus in order to reach a point where running a current account surplus is no longer advantageous for the Member State concerned.

## 6. Conclusions

Although conditionality has been strongly criticized in the last few years, it remains a crucial tool for EU economic governance. The Greek experience with macroeconomic adjustment programmes certainly represents a paradigm of the “fall” of conditionality in the euro area. On the whole, structural measures failed to impose internal devaluation and ended up being politically, socially and even economically unsustainable. This is not to say that internal devaluation through conditionality was unnecessary but it was not counterbalanced by symmetrical policies by core Member States. Overcoming conditionality would require a decisive step towards a fiscal and political union. Since this hypothesis is not likely to happen in the near future, we follow the opinion of Bini-Smaghi in claiming that the priority is that of «improving the current model of conditionality»<sup>58</sup>. Conditionality is an encompassing concept of EMU governance, not just related to macroeconomic adjustment programmes. This is why conditionality can be a useful instrument to promote symmetrical policies in the euro area, especially between creditor and debtor Member States. In particular, this paper advances the proposal of moving from a system of unilateral conditionality to a system of bilateral conditionality in which the burden of macroeconomic adjustment is shared among Member States. The Commission already recommended a positive fiscal stance by those who have fiscal space in order to reduce internal and external imbalances. While the Commission’s approach has to be welcomed, some secondary law amendments would certainly be beneficial to design symmetrical policies in case of macroeconomic imbalances, tackle financial and economic instability and enhance cooperation and solidarity among Member States.

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<sup>58</sup> BINI-SMAGHI, *Governance and Conditionality: Toward a Sustainable Framework?*, cit., 757.