

Conditionality: High Time for Clarity

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The Euro area crisis has accustomed us to disconcerting swings in sentiment. All too often, the hope raised by new – even bold – initiatives gives way to dejection, as vacillation and delays block effective implementation. Examples abound in the last two years: those presently at the forefront regard the prospects for a genuine banking union and, in the shorter term, the full deployment of the arsenal of instruments that, at least on paper, are at the disposal of the EFSF and the forthcoming ESM. Without such a deployment, even the ECB's bond purchases program, valiantly launched in early September, remains stuck at the starting gate.

The main obstacle to the initiation of the ECB's Outright Monetary Transactions (OMTs) lies in the uncertainty surrounding the type of conditionality linked to the EFSF-ESM program, a prerequisite for the central bank to intervene. The arsenal available to the EFSF-ESM is a complex mix of interventions having different aims, to be delivered in turn via different facilities. The aims are essentially three: the support of macroeconomic stability; the financing of bank recapitalizations; and the purchase of government securities on the primary or secondary markets.

Except for macro-stability support, which can only be delivered through a full-fledged stability loan (such as those granted to Greece, Ireland and Portugal), other interventions may take the form of precautionary credit lines. These in turn can be of two types, both with rather cryptic names: the precautionary conditioned credit line (PCCL) or the enhanced conditions credit line (ECCL). The ECB has prescribed that access to OMT purchases is contingent on agreement on either a full macroeconomic adjustment loan or on a precautionary ECCL program, i.e. one with strengthened or "enhanced" conditionality. This was preferred to the PCCL, which is subject to lighter, *ex ante* conditionality, with pre-established eligibility based on adherence to existing EU recommendations.

Aside however from some rather general guidelines set out in a little-known EFSF paper of November 2011, the type of conditionality that would be attached to an ECCL program, and to the linked ECB purchases, remains

largely undefined. The oft-repeated official mantra is that conditionality must be "strict and effective" (as per the ECB press release of September 6, where conditionality is covered in its first and longest paragraph). But the interpretation of the phrase is far from uniform, with contrasting views for example from EU Commissioner Olli Rehn ("there will be no new conditions," but only a prioritization and "a clear timetable") and Eurogroup President Jean-Claude Juncker ("conditions will be very tough").

Nor is it clear via which facility, and with what sort of conditionality, will bank recapitalization funds be released – a key issue for Spain. Although the indecisiveness of Mariano Rajoy's government is problematic, it is also understandable that there be some hesitancy in the face of the unknown, accompanied by behind-the-scenes maneuvers to avoid procedures that are feared to be overly intrusive.

One of the first tasks of the ESM's Board of Directors should thus be that of putting an end to this uncertainty, implementing Art. 14 of the ESM Treaty by adopting "detailed guidelines on the modalities for implementing the ESM's precautionary financial assistance."

The ESM's Board of Directors, though due to start operations in October, remains however to be appointed. It is to be drawn "from among people of high competence in economic and financial matters" (Art. 6 of the Treaty). We trust the Monti government to choose wisely, as it has indeed done for the next IMF Executive Director for Italy, in the person of Andrea Montanino, former economic advisor to Tommaso Padoa-Schioppa.

Whoever the ESM Directors turn out to be, they would do well to read an IMF report released on September 17, which reviews the experience of applying Fund conditionality in 159 programs over a period of almost ten years (from 2002 until September 2011). This survey, conducted approximately every 5 years, is used to assess and, if need be, modify the conditionality guidelines that guide the IMF's lending activities – a process of monitoring and transparency that should also be followed by the ESM.

There are many lessons to be learned, including the importance of keeping conditionality parsimonious and focused on macro-critical issues. In the current European context, there is above all a need to realize how important it is to modulate conditionality in precautionary arrangements, so that they are actually used in a timely manner.

It is not enough to perfunctorily repeat, time and time again, that conditions need to be "strict and effective." This blanket, yet vain, attempt to placate the Bundesbank sits at odds with the variety of the ESM's interventions and instruments. Conditionality must, above all, be appropriate to the instrument

chosen and to the country's circumstances. The nascent ESM, an ambitious European project, will need to show greater clarity and refinement in this respect, achievable only with adequate independence of its Board of Directors and, above all, of its Managing Director Klaus Regling and its staff. October will begin to tell.