

### Session 3 – Kemal Dervis' Presentation

#### *Skewing the Enforcement of Conditionality – a true story*

During tenure as a minister, one of the key issues was the banking crisis in Turkey. With support from the Bretton Woods institutions, in particular the legal and economic work performed by the World Bank, Turkey had created a banking supervision agency, an agency that was supposed to be very independent, and indeed legally was so.

At the time however, there was a coalition government of three parties, and each party leader had appointed two of the seven Board members, with one other being nominated from the largest party. It was soon discovered that every one of those Board members was very loyal to their party leaders. The relationships were quite informal, formally the Board members were independent, but in fact the Board was highly politicized, exactly what the establishing law was initially trying to avoid.

As a result, one day at midnight, the reformers who had supported the independence of the banking supervision agency rushed a motion into parliament when most deputies had left or were sleeping, managed to field a quorum, and fired all except one of the seven supervision members, and appointed six others who were true professionals and independent personalities not beholden to any special group or interest. The one remaining Board member was kept because he had too much political support. Although the move was a necessary step to get the banking supervision agency to truly behave independently, it was a gross violation of the explicit condition set by the World Bank, and hence should have been a matter of contention.

#### *The case for Conditionality*

If we are going to continue to be in a constrained aid resource environment where there is selective allocation of aid resources, there is always going to be some form of conditionality. There must be some sort of rules on which aid allocation is based, and these rules, whatever they may be, form some kind of conditionality.

#### *Allocation of Aid Resources*

If the rules on how to distribute aid are as impartial as possible, in other words as technically and economically driven as possible, as opposed to being driven by geo-strategic, military or other interests, we are better off as a world. Recognizing that there are going to be allocation rules, there is something to be said for making them as economic and as socially biased as possible, as opposed to the big powers giving money to whomever happens to be their ally at the time. The most recent example of which is Iraq's debt reduction, that has been the largest in recent history, not for any particular economic reason except that it is politically important.

#### *Need for a Comprehensive Programme*

One should be careful to keep a comprehensive coherent economic programme, the concept of comprehensiveness being distinct from the multiplicity of actually binding legal conditionalities.

Drawing a parallel with the Turkish experience, the year 2000 Programme was in many ways a macro-economically fairly well-designed and carefully thought out programme. The programme relied on an exchange rate regime that was going to become more flexible with time, and since Turkey had had strong inflation for twenty years, it was very important to deflate. However, the programme missed some key points such as the banking system supervision system. When one has a weak banking system and then experiences a run on the banks, it can easily result in an attack on the currency, which is what happened in Turkey. So weaknesses in banking supervision in many ways was one of the key causes of the failure of the whole macro-programme, and of the crash Turkey experienced in 2001, and in many ways was an example of how the programme was not comprehensive enough.

### *Streamlining – A Universally Positive Good?*

When we focus on streamlining, it's important to try to focus on what is critically important and what is not vitally important, but we should also keep in mind that economies are inter-dependent. If you miss one important point in the picture, you are likely to pay for it, and therefore we can't push streamlining too far.

### *Conditionality and Ideology*

We need to rid conditionality and policy advice of ideology. A lot of the policy advice in the past, especially in the 1980s, was driven by the influences from the Reagan/Thatcher conservative revolution where certain ideological buzzwords were more important than the actual substance of the policy. The World Bank and others have distanced themselves from such practices, but it's very important to keep reminding ourselves that policy advice should be based on analysis and empirical facts, rather than on knee-jerk ideology.

The mistake the International Monetary Fund made in some ways early on during the Asian crisis, which it corrected fairly quickly, was to immediately jump to the knee-jerk reaction: fiscal restraint as the number one priority, whereas in fact the nature of the Asian crisis was quite different.

### *Quality of Fiscal Policy*

The quality of fiscal policy is as important in a medium-term framework as the actual size of the deficit or of the primary surplus. To many economists it is clear that a government expenditure that actually creates net wealth for the government, in other words a good investment, is something very different in terms of long-term fiscal sustainability than a simple current expenditure or social transfer. Lumping these two types of expenditures together in Fund conditionality and focusing solely on the overall deficit is a big mistake, as opposed to making sure that the fiscal policy is conducted in a truly growth-supporting way.

### *International Codes and Standards*

We still view the world too much through a framework of nation states, state actors, developing countries, developed countries and international institutions, while the reality is much more complex. There are divisions within states, there are reformers and conservatives, there are vested interests everywhere, and the move within the PRSP framework, within the comprehensive development framework to really have all partners involved in the debate is a very welcome move.

In this context, the building of standards and codes internationally is a very important part of the picture. Standing by certain codes of conduct is not a conditionality imposed on any particular country by others or by international institutions, but rather an attempt by the world community to make rules together by which everyone should play and stick to.

One of the biggest problems in this type of scenario is that often times some of the very powerful countries break the rules first. In parallel, big corporations and big interests have often captured the agenda in the past and were able to draft the rules to their advantage. One of the clearest examples of this is the TRIPs; the TRIPs in the Uruguay round were really put there in response to very intense lobbying from the pharmaceutical lobby by the United States and the rich countries.

However, the WTO in theory is a very democratic organization, because small poor developing countries can actually block an agreement, which isn't the case in many other international organizations. The accommodating

rules permit such countries that were previously thought to be at a disadvantage, to stand in defense of their agenda. This is a point that is often overlooked by the protestors who fancy themselves as champions of the poor.