TESTIMONY OF STUART E. EIZENSTAT
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

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Thank you for the invitation to testify before your Committee on the issue of the future of the World Bank. I am appearing before you in my capacity as co-chair , with former Under Secretary of Commerce Grant Aldonas, of the Atlantic Council Commission on Transatlantic Leadership of the Global Economy, which issued a report in April of this year on ways in which the United States and European Union (EU) should work together to reform the major institutions created after World War II to manage the world economy--the World Bank and International Monetary Fund (IMF), the G-8 (originally the G-5), the International Energy Agency (IEA), the Organization for Economic Cooperation and Development (OECD), and the World Trade Organization (WTO), originally the General Agreement on Tariffs and Trade (GATT). We came to the conclusion that major changes in governance and focus of these international institutions were necessary in light of the enormous transformations in the world economy which have occurred since these institutions were created, or they risked being antiquated. Because the World Bank is the focus of this hearing, I will stress our recommendations for the Bank, and to an extent, the IMF, as well as reference recommendations others have made. To the extent that I go beyond the Atlantic Council recommendations, these would be mine alone.

In the past 50 years, the international economy has undergone major changes. For one thing, economic power has shifted east and south, but these organizations, and certainly the World Bank and IMF, have not sufficiently taken this shift into account. Today, China, India, Brazil, Russia and other emerging countries represent 45 percent of global GDP (on a purchasing power parity basis), up from 39 percent in 1995. They also represent 40 percent of world exports and 65 percent of foreign exchanges. Their economic position is now comparable to the combined positions of the U.S. and EU. Yet these countries have a much less central role in global economic governance than their economic importance dictates.

Another major change is the remarkable growth of global private financial markets that are increasingly available to developing nations, without the time delays, and conditionality of funds from the World Bank and IMF. In part this is a function of the success of the Bank and Fund in reducing poverty and encouraging good macro-economic practices by developing countries. These private funds overwhelm the amount of money available through traditional foreign assistance, and from public funds through the Bank and Fund. National finance ministers can often secure a loan for a major infrastructure project in matter of weeks from the private sector, instead of waiting a year or more for World Bank approval. For example, in 2005, private debt flows and new equity flows to sub-Saharan Africa in 2005 were \$3.8 billion and \$24.7 billion respectively, while the World Bank's net disbursements to sub-Saharan Arica in 2005 were \$3.1 billion. (See Report of the External Review Committee on Bank-Fund Collaboration, February 2007, "The Malan Report," p. 15).

A third development is the new entrants into overseas development assistance, particularly from countries like China, which has started funding roads, energy projects and other infrastructure projects in Africa and elsewhere, often for political or narrow economic interests, and without any interest in the political and human rights conditions in the countries, like Sudan, and often using their own workers, rather than those of the host countries, to build the projects they finance.

All of these factors impose significant challenges to the World Bank and IMF, including the desire by emerging economies to have more input into their governance. The Fund is doing far less lending to far fewer countries than in the past, in part a victim of its own success, as developing countries employ sound fiscal and monetary policies, build up currency reserves, and have less reason to borrow from the Fund, with its tough conditionality, and in part because of an aversion to the tough, though necessary medicine, the IMF administered during the Asian financial crisis in the late 1970s. Now, in a significant contraction, the IMF has only 10 non-concessional programs currently in place, with five of them precautionary. (Malan Report, p.15). The Bank is seeing many of its projects financed more quickly by the private sector or by aggressive ODA funding from countries like China. Moreover, many of its low income client countries have graduated into middle income status.

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We believe that the World Bank and the IMF both continue to be highly relevant, however. No other private or public institution can do the kind of macro-economic surveillance that the IMF employs, to prevent future crises. For the Bank, in the past 10 years or so some one billion people have risen above the poverty line. While much of this reduction has come from countries like China and India, that have begun to employ sounder economic policies of encouraging foreign investment, entering into the global trading system through the WTO, and running foreign reserve surpluses, the Bank's programs have played a role as well, with its $20 billion mixture of grants and loans.

Private lenders prefer their borrowing country-clients to be members of the IMF and World Bank. As The Economist Magazine noted, "Poorer countries (in Asia and Latin America) still rely on aid. In the richer ones, the development banks (The World Bank and its regional equivalents) still have a big role in long-term financing for infrastructure." I saw this personally in the work I did with BP on the BTC pipeline project, where IFC financing helped elevate environmental and social protections for Azerbaijan, Georgia, and Turkey, the three BTC countries. Moreover, development countries "are wise to diversify their borrowing." And, "Above all, the conditions attached by multilateral lenders provide reasonable assurance that money will not be wasted." (May 12, 2007, Vol. 383, No. 8528, p. 14).

No private capital will finance many of the projects financed through the World Bank's IDA program. It is the world's most poverty-focused aid agency, with 81 of the world's poorest countries, 40 in Africa, IDA-eligible. IDA has a presence on the ground in 64 of the 81 IDA-eligible countries, supporting countries that range in income from $100 per capita to $1025, spanning four continents and 2.5 billion people. A main factor in allocating IDA resources is the performance of countries in implementing policies and developing the institutional framework necessary to promote economic growth and reduce poverty. Performance is assessed through a publicly disclosed Country Policy and Institutional Assessment system.

Moreover, IDA has a greater capacity to deliver development assistance on a larger scale and in more sectors than any other aid agency, and certainly than the private sector. It finances projects and programs, services and capacity building across all areas of development policy--from macroeconomic policy, infrastructure, human, social, urban and rural development, the environment, and governance.

IDA is playing a major role in African development. In FY 07, half of IDA lending, or about $5.5 billion, will go to Africa, more than a third to infrastructure essential to sustainable development.

In addition, IDA works on a country-based business model aligned with the country's own Poverty Reduction Strategies, working with both borrowers and other donors to promote integration and coordination of macro- and micro- reform, and helps countries formulate sector-specific strategies and reforms. IDA allows partner countries to draw on lessons learned from other IDA and IBRD countries.

No other private or public institution can address complex cross-sectoral issues like IDA,--such as linkages between exchange rate policy and export diversification; macro-stabilization and banking sector reform; energy, agricultural policies and deforestation; environmental conservation and development of an eco-tourism industry; micro-finance and women's empowerment; access to clear water and pubic health benefits.

Another reason that the Bank and Fund continue to be relevant, is the rise of new issues arising from globalization, beyond traditional trade and capital flows, which require their assistance, and cannot be satisfied by the private sector alone, such as "global warming, energy security, the spread of communicable diseases, and demographic changes." (See "The Malan Report.")

Some critics state that one of the World Bank's major flaws is its continued lending to middle income countries like China, that can now access international capital market at a lower interest rate than the Bank charges. The majority report of the International Financial Institution Advisory Commission established by Congress in 1998 (Report, March 8, 2000), chaired by Professor Allan Meltzer, called for dramatic changes. (See also, "Reforming the IMF and World Bank" by Allan H. Meltzer and Jeffrey Sachs, AEI Online, March 8, 2000) They concluded that even more than the IMF, the Bank has failed to adjust to fundamental changes in the world economy by continuing to lend to countries like Argentina, Mexico, Brazil, and China that have access to private capital markets, and has fallen short of the helping the poorest countries, who need to Bank the most. The majority recommended phasing out lending operations to the richer developing countries with access to private capital, and providing grants rather than loans for poverty relief to poor countries. They also suggested moving much of the World Bank's regional efforts in Asia and Latin America to the regional development banks, leaving the World Bank primary responsibility for Africa until the African Development Bank is ready to take responsibility, and also dealing with the remaining poor countries in Europe and the Middle East

All claims should be written off against HIPCs that implement an effective economic and social development efforts under the Bank's supervision. For poor countries without capital market access, assistance for institutional reform should be conditional upon implementation of specific institutional and policy changes. They would phase out all assistance to countries with capital market access or per capita incomes more than $4000.

Following the release of the Meltzer Commission Report, the U.S. Treasury Department, which I was serving at the time as Deputy Secretary, released a rebuttal of parts of their recommendations. Some though not all of Treasury's comments related to the practicality of changes and the timing and pace of the recommendations. The Atlantic Council did not take a position on the details of either the Meltzer Commission report or the Treasury's rebuttal.

But because I would like to associate myself with the response by Treasury, permit me to summarize Treasury's points, specifically related to the World Bank.

Treasury noted that if the Commission's proposals had been in effect at the time of the Asian Finance crisis, neither the IMF nor World Bank would have been able to respond to the crisis that spread across emerging markets during the 1997-98 period. By essentially taking the World Bank out of the development finance business for countries with a per capita income above $4000, the Commission's reforms would have eliminated the most cost-efficient and effective international development institution, with the greatest concentration of development experience and expertise. They would have also precluded support for economic restructuring and private sector development in Easter Europe and the former Soviet Union, as well as in Asia and Latin America. The promotion of financial sector reform and capital market development, trade liberalization, privatization, and agricultural reform in emerging market economics that have the bulk of the world's population would have been precluded.

In addition, by eliminating the IFC and MIGA, the private sector financial operations of the Bank, an important part of the Bank's capacity to promote private enterprise, privatization of state-owned firms, and the development of domestic capital markets, would have been precluded.

Moreover, Treasury believed that by transferring financial capacity to the regional development banks, the effectiveness of the overall development effort would be compromised, by reducing the role of the institution with the most experience and competence in development and poverty reduction. By eliminating the capacity of the MDB's to provide emergency lending at times of financial crisis, the Commission would make the crisis response of the IMF less effective.

China will receive some $1.0 to $1.5 billion in IBRD lending this year. Why would countries like China remain interested in IBRD financing, and why should IBRD shareholders support such lending? China and other middle income countries get not only project loan financing, but technical knowledge that is not available from the private sector. The IBRD is a neutral, disinterested partner that acts in the best interests of the country, and has no other agenda, such as creating a new market for a particular good or service. China remains eligible because its per capita income of about $1300 is well below the $5685 IBRD graduation level. These countries are not eligible for IDA financing and do not crowd out other IDA recipients. Indeed, part of the income IBRD earnings is transferred to IDA.

The Bank's lending to China has achieved development results that are beneficial to China, East Asia, and the world, with the Bank's independent evaluation unit rating more than 90 percent of the over 200 projects the Bank has completed in China as successful in meeting their objective. For the world to reach the Millennium Challenge Goals, China, still home to the second largest group of extreme poor after India, has to do even more to address poverty.

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The World Bank nevertheless faces challenges which we believe require significant reform. There have been positive changes at the Bank. For example, the Bush Administration and Congress have insisted on some of the reforms advocated by the majority report of the International Financial Institution Advisory Commission, such as substituting grants for loans to the poorest countries, setting explicit conditions that can be monitored, and introducing incentives for countries to meet those conditions. Also, Congress required an independent performance audit of some International Development Association (IDA) programs and insisted on greater transparency at the World Bank. (Allen H. Meltzer, "New Mandates for the IMF and World Bank", <u>Cato Journal</u>, Vol. 25, No. 1 (Winter 2005). p.15.

Our Atlantic Council Commission recommended a number of signficant reforms.

1. Selection of Top Leadership of the World Bank and IMF Should be Chosen on the Basis of Merit not Nationality.

Our Atlantic Council Commission concluded that it is far past time for Europe and the United States to give up their monopoly on naming the heads of the Bank and Fund, the former always an American, the latter always a European. We said that the "United States and the EU (should) give up their automatic leadership of these institutions." This is an antiquated and unfair precedent that fails to recognize the changes in the world economy and the growth of Asia, Latin American, and African nations. Moreover, with the special focus of the World Bank on development, it may not produce the best leaders, who are experts on development. It leads these nations to want to go their own way. For example, the Chiang Mai initiative has established a mechanism for lending among Asian governments.

The current duopoly by Europe and the U.S. feeds the capacity of radical leaders like Hugo Chavez of Venezuela to argue that they will leave the IMF and World Bank and to encourage Latin nations to create a new body, the Bank of the South, to make loans to Latin American governments without what he calls "neoliberal" strings.

With Paul Wolfowitz's departure at the end of June, President Bush can send a powerful signal to the world that he is turning a corner on American unilateralism by throwing open the contest to the entire world, and supporting the best candidate, regardless of nationality. That would turn the tragedy of the Wolfowitz incident into a plus for America's image in the world, and for the future management of the world. This would be consistent with our Atlantic Council's call for this change to be instituted at the time of the next election, then, of course, not anticipating the Wolfowitz episode.

2. World Bank and IMF Governance Should Reflect Actual Economic Power and Influence.

Emerging economic powers in Asia and Latin America are seriously under-represented in voting power and board representation. The Atlantic Council Commission report stated that "If developing countries and emerging economic powerhouses are to take these institutions seriously and become real stakeholders in their success, rather than give priority to regional institutions which compete, they must be given a genuine leadership role."

Our Atlantic Council Commission recommended two significant reforms to rectify this situation. First, European representation should be consolidated into two seats, an EU Euro zone and a EU non-Euro zone seat, to promote more European cohesion and more unified positions, and make room for new leaders. Because EU Member States are still represented in the IMF and World Bank by national governments, EU countries are over-represented, with seven directorships out of a total of 24, with Switzerland holding an eighth European directorship.

Second, we recommended that U.S. and European representation should be re-balanced in terms of voting shares and executive directors. The IMF has already embarked on a process of re-examining its current distribution of voting shares, and in September 2006, four countries—China, South Korea, Turkey, and Mexico—received slight increases in their shares. But this is widely seen as insufficient, and the Fund has pledged to overhaul its voting structure over the next two years. The representation at the Bank should follow suit.

3. There is Confusion and Overlap in the World Bank and IMF Programs, with Inadequate Consultation and Coordination.

Our Atlantic Council Committee found that the Bank and Fund have responded to the changes in the international economic environment in part by reaching out beyond their mandates, in effect seeking new business. Since they work in many of the same countries at the same time, this leads to inefficient overlap in their programs. We also concluded that there was insufficient coordination between staff efforts in the same nations. The lack of collaboration has costs in the wasting of public assets, conflicting advice to recipient nations, and a failure to meet the needs of members.

As the Malan Report notes, there are obvious links between the Fund's major mandate of macroeconomic stability, and the Banks concerns about improving the quality of public spending, or between the Fund's focus on global monetary stability and the overall development prospects of nations, which is the Banks' concerns.

While the Malan report notes examples of good collaboration and improvement in cooperation, citing the collaboration between the Financial Sector Assessment Program (FSAP), the Heavily Indebted Poor Countries (HIPC)—a Clinton Administration initiative--debt sustainability analysis and Reports on Standards and Codes, the Atlantic Council and the Malan Report felt there were significant gaps in cooperation.

But there are also overlapping efforts. For example the IMF's medium-term strategy and its role in low-income countries, especially in the financial sector, overlap with Bank programs. The Malan Report has noted that the Fund's financing activities in low income countries has moved beyond its core responsibilities and overlaps with Bank work in development finance, based upon the vague concept of "protracted balance of payments need." (Malan Report, p.10)). This has spread the Fund "too thinly across development-related work", by moving into areas beyond its core capability, such as "civil service, land and energy sector reforms; privatization; property rights; and judicial reforms", all of which should be the World Banks' responsibilities. (Malan Report, p.43).

Our Atlantic Council Commission made a number of recommendations to deal with these issues.

(1) We recommended a clearer delineation of responsibilities between the Bank and Fund, with each focusing on their core strengths so they are better able to cooperate in developing countries. This should not be based on the income of the recipient countries, with, for example, the Bank taking the lead for low-income countries, and the Fund with middle-income countries but on their specific needs.

The Meltzer Report of 2000 argues that the Fund should focus on global financial stability, including the quantity and quality of information available to private lenders and reducing the risk of financial crises, while the Bank should focus on sustainable development and poverty reduction.

By contrast, the IMF should focus on providing the policy advice, macroeconomic assessments, and surveillance that will encourage private capital markets to handle most imbalances, while remaining prepared to be the lender of last resort. As the Malan Report suggested, the IMF should gradually withdraw from providing long-term base-line financing to low income countries in the context of a development program.

The new Policy Support Instrument of the IMF, a non-financial instrument for low-income countries, can, in the words of the Malan Report, "facilitate the gradual withdrawal of the Fund from long-term financing in the absence of a present balance of payment need." The Fund should continue to provide short-term balance of payments financing. (Malan Report, page 11). The Fund should take on a more active role in addressing global economic imbalances and do more to prevent imbalances, especially among the poor and emerging economies.

Because of this Committee's focus on financial services, the Malan Report's recommendation is sound that a clearer delineation of responsibilities between the Fund and Bank would be interesting here, as well. Thus, the IMF would take the lead where there are domestic or global stability issues, such as the "soundness and stability of the financial system, macro-financial linkages, balance sheet and other risk analysis of systemic importance, capital account liberalization or channels of transmission of implementing monetary policy." The World Bank would take the lead where financial sector development issues are more important, such as "banking system reform, capital market development or specialized lending institutions focused on specific 'development' objective, such as agricultural and small to medium enterprises lending and institutions." (Malan Report, p.12).

In facilitating achievement of the UN's Millennium Development Goals and increased aid flows, the Fund needs to undertake analysis of the macroeconomic consequences in low-income countries of the Bank's poverty reduction strategies. As the Malan Report states, the Fund has the lead in managing the exchange rate and fiscal and monetary consequences of the increased aid flows the G8 has promised. (Malan Report, p.45).

(2) The Atlantic Council Commission recommended closer coordination between the Fund and Bank by "double-hatting" executive directors.

This would help foster close collaboration between IMF and World Bank teams working in individual countries. By seeking a greater alignment between the Fund and Bank boards, as the Malan Report suggests, appointing the same person to serve as executive directors at the Bank and Fund would help assure greater coordination and collaboration and reduce duplicative programs. The Malan report also recognizes the advantage of having the "same Director being on the Board of both the Fund and the Bank." (Malan Report, p. 8).

(3) The Atlantic Council Commission recommended that planning should begin now for an eventual merger, no later than 2030.

The Malan Report suggests a number of ways to achieve greater collaboration, such as a standing Bank-Fund working group (Malan Report, p.8); strengthening the review function of the World Bank's Poverty Reduction and Economic Management unit in the World Bank so it can work more effectively with the Fund's Policy Development and Review Department in dealing with low-income countries (Malan Report, p.11); and strengthening the Joint Implementation Committee to foster cooperation (Malan, p. 45).

But, these changes will not achieve the kind of coordination needed, without a merger. There are inherent overlaps that only a merger can alleviate. For example, the Fund needs to take into account the sectoral level and the composition of public spending, within the Bank's responsibility, in order to achieve macroeconomic stability. (Malan Report, p.10). The Fund must rely on the Bank's sectoral assessments for its work on macroeconomic stability and the aggregate effects of aid (Malan report, p.11). The Bank must provide the Fund with advice in analyzing the sectoral aspects of public expenditures, for the Fund to do its work on the quality of fiscal aggregates in considering the quality of public expenditures. (Malan Report, p. 12).

As the Malan Report notes, for the Fund to manage the macro-economic consequences of increased aid flows, there must be an assessment of the sectoral issues and how to effectively use resources freed up by debt relief. (Malan Report p.45).

More broadly, the IMF's "work on macroeconomic stability and the aggregate effects of aid and debt relief cannot be separated from what is happening at the sectoral level." (Malan Report, p.

43). Moreover, there is an obvious relationship between a macro and growth focus. In addition, the effort to invigorate the Joint Implementation Committee have not been successful.

All of this indicates the advantages of having the IMF and World Bank under one roof.

4. Greater Accountability of World Bank Programs.

There has been an improvement in the internal review of Bank programs. But I personally believe that more needs to be done to determine the effectiveness of the poverty reduction. The monitoring that Congress insisted upon for some IDA programs should be extended to the entire World Bank and its affiliates, (Meltzer, Cato Journal, p. 15). Here, the recommendation of the Meltzer Commission is on point in calling for an independent performance audit, or the establishment of an internal, independent group, like the Government Accounting Office, so that it is a more effective development bank.

Moreover, the emphasis that both Jim Wolfensohn and Paul Wolfowitz have placed on anti-corruption efforts, as well as by organizations like Transparency International (on whose advisory board I sit), is essential to sustainable development. The World Bank has estimated that $1 trillion a year is paid in bribes in all countries. (Meltzer, Cato Journal, p. 16). While the approach to be taken to dealing with corruption is open to debate, the need to make this a key feature of the Bank's work is essential to achieve the UN Millennium Goals on poverty reduction.

Stuart E. Eizenstat was the co-chair with former Under Secretary of Commerce for International Trade Grant Aldonas of the Atlantic Council of the United States Commission on Transatlantic Leadership for a New Global Economy (April 2007), for which Frances G. Burwell served as Project Director and Rapporteur). Mr. Eizenstat was President Jimmy Carter's Chief Domestic Policy Adviser and director of the White House Domestic Policy Staff (1977-1981), and held a number of senior positions in the Clinton Administration from 1993-2001, including U.S. Ambassador to the European Union, Under Secretary of Commerce for International Trade, Under Secretary of State for Economic, Business & Agricultural Affairs, and Deputy Secretary of the Treasury. He heads the international trade and finance practice at Covington & Burling, LLP, which has conducted an internal investigation for the World Bank unconnected to the issues presented here.