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WORLD BANK LENDING TO IRAN

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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WORLD BANK LENDING TO IRAN

Wednesday, October 29, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND
INTERNATIONAL MONETARY POLICY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Judy Biggert [chairwoman of the subcommittee] presiding.

Present: Representatives Biggert, Maloney, Sherman, Hooley, Gutierrez, Frank (ex officio) and Emanuel.

Chairwoman BIGGERT. [Presiding.] This hearing of the Subcommittee on Domestic and International Monetary Policy, Trade and Technology will come to order.

Without objection, all Members' opening statements will be made a part of the record. The policy is that the subcommittee Chair and Ranking Minority Member are recognized for 5 minutes each. All of the Members are recognized for 3 minutes each and we will alternate between the majority and the minority.

Mr. FRANK. I ask unanimous consent to switch time allotments with the gentleman from California.

Chairwoman BIGGERT. Without objection.

Mrs. MALONEY. Madam Chairman, also I would like to give my remaining time to the gentleman from California, since he worked so hard to secure this hearing. I will probably just be talking 3 minutes.

Chairwoman BIGGERT. Without objection.

Good morning. We meet here today to discuss the World Bank's lending to Iran. In particular, we will take a look at whether U.S. objectives and priorities are best served through the current policy of opposing World Bank loans to Iran. The issue is somewhat complicated by the fact that while the United States holds the largest voting bloc on the board of Directors of the World Bank, we do not hold the majority of the shares. So the first point to keep in mind is that we cannot alone direct or dictate the bank's lending decisions with respect to Iran or any nation.

The second key point is that the World Bank's charter requires that lending decisions be based solely on economic considerations and not on political factors. Views also differ on whether the World Bank is the appropriate venue or effective mechanism for the conduct of U.S. foreign policy. This is especially questionable with respect to Iran, where the proportion of World Bank lending in rela-

tion to the country's economy is minimal; $42 million in funds disbursed to a country with a GDP of $115 billion.

Beyond these complications are the more important issues related to our national security. There is no question that Iran is the leading state sponsor of terrorism in the world. Since 1996, the United States Executive Director to the World Bank has been required to vote against any lending to any terrorist states, including Iran. But despite our "no" votes, four loans have been approved for Iran since 2000. Some Members of Congress believe it would be useful to augment the political voting restriction with economic consequences whenever the U.S. loses a vote on lending to Iran. Mr. Sherman on our committee has proposed legislation that would in fact reduce funding to the World Bank by the amount of money that the World Bank provides to Iran. The funding would instead go to the U.S. Agency for International Development.

We will this morning explore how the U.S. works within the World Bank to discourage lending to Iran pursuant to its statutory direction. We also will explore whether elimination of U.S. funding to the World Bank, tied to the World Bank's activities in Iran, would be successful in discouraging the World Bank to lend to Iran.

We also will hear testimony from expert witnesses on whether it is wise to attempt to further ostracize Iran from the international community by restricting its access to World Bank funding and personnel.

At this time, I would like to yield to Ranking Member Maloney for her opening statement.

Mrs. MALONEY. I thank the gentlelady for yielding.

Today, U.S. forces are stationed in Afghanistan where they fight the war on terror. A few hundred miles away, our military is under daily attack working to establish a functioning democracy in Iraq. Geographically between these two nations lies Iran, a country of extreme strategic important with which the United States government has only the most remote diplomatic contacts.

This morning, the subcommittee considers the question of whether the U.S. should support World Bank projects in Iran. This is a profoundly important period in Iran's history and many Iran watchers, especially in Europe, argue that the World Bank engagement in the country will yield positive long-term results. In fact, there is an article in the international section of the New York Times today, which I would like to place in the record, entitled "A Change of Heart in Teheran."

Chairwoman BIGGERT. Without objection.

Mrs. MALONEY. Reform President Mohammad Khatami was reelected in 2001 with 77 percent of the vote. Despite the large margin of victory, Khatami has disappointed many of his supporters by failing to successfully enact major reforms and the hardline mullahs remain a powerful political force in the country.

The country's energy-based economy also faces major challenges as the post-Islamic revolution baby-boomers reach employment age and require jobs. The World Bank activities with Iran are proposals aimed at alleviating poverty and building up the public infrastructure. The bank also offers much-needed technical assistance to the country, which must pursue ways to diversify its economy. These

projects remain highly controversial because Iran continues to support some of the most evil terror organizations the world has ever known. Iran provides assistance to Hezbollah in Lebanon and to terror groups that oppose the Israeli-Palestinian peace process, including Hamas and Islamic Jihad.

The country is also thought to harbor al Qaeda, and President Bush has included it in the so-called "axis of evil." Iran remains subject to sanctions passed by Congress and support by past and present administrations because of its numerous human rights violations. Most frightening, Iran has actively worked to develop nuclear weapons and only signed an agreement backing away from additional development on October 21 of this year.

No matter how Members feel about individual projects in Iran, there is also the U.S. credibility at the World Bank and in multinational organizations in general. The U.S. is the only world superpower, but we do not hold a veto on the bank. Despite U.S. opposition, these programs are moving forward at the World Bank because of the overwhelming support of the Europeans.

While I support the current U.S. position, I look forward to hearing the panelists today. Specifically, I look forward to a discussion of whether our resistance to projects that fund public works and poverty alleviation plays into the hands of Iranians hardliners who benefit by stoking anti-Americanism.

I look very much forward to this hearing and I especially want to thank Representative Brad Sherman from California for all of his work on this issue, for his amendments and his projects and for suggesting the topic today.

I yield my remaining time to Mr. Sherman.

Chairwoman BIGGERT. Would you like to hold that until we hear from the Ranking Member and then include that?

Mrs. MALONEY. Yes.

Chairwoman BIGGERT. Okay. The Ranking Member?

Mr. FRANK. Thank you, Madam Chair. I have another meeting that I have to go to, but I did want to take my 3 minutes and yield the rest of my time to the gentleman from California, who as the gentlelady from New York has mentioned is really the main reason we are here today. I appreciate the majority agreeing to this hearing, the chairman of both the full committee and the subcommittee, in response to concerns that the gentleman from California brought forward.

We worked earlier this year in cooperation with Treasury to meet our obligations with regard to the International Development Association and related agencies, and I am very much for that. I have been a supporter of the work of the World Bank, although I have pushed for some changes in it. It is important for the bank to understand, and I would guess that there might be a person or two here who worked for the bank, that they are not allowed to testify before us, but they are perfectly free to sit in the room and listen to us, and I would think they are probably doing that.

A continuation of this kind of lending to Iran jeopardizes American support for the bank. I regret that. I think the bank plays a useful role, and I think partly because of the work that has been done here in the House of Representatives in particular, we have improved that role, although it is still not perfect, but giving money

to Iran from several standpoints seems unwise to many of us. First of all, a country that is able to pursue a nuclear weapons program hardly ought to be able to plead poverty when it comes to dealing with the needs of its people.

Secondly, we have a regime that is violative of human rights internally and of the requirements of civility between nations externally. I understand that our votes in the bank have been against this, but I think we need to do a better job of lobbying and we need to convey to others that we are putting things at risk. We are not here talking about the alleviation of desperate poverty. I am prepared to make some concessions in that regard. We are talking about a country that has significant energy resources and I do not think that if we were to deny these loans we would be plunging Iran into any significantly worse economic situation.

I believe that as people understand that the United States's participation in the World Bank is going to this extent to the benefit of Iran, resistance to that participation will go up. Let me say this as a supporter of the bank, I think the bank should consider itself lucky. Treasury should consider itself lucky that this was not a year that we were being asked to vote funds directly for the World Bank itself. I think that would be a very significant problem in the current context and should be.

So I again want to express my appreciation to the gentleman from California. This is a very serious warning, not to the U.S. Treasury, although they could do more, I think, but mainly to other countries that have votes on the board of the World Bank. If they continue, they will make the job of American cooperation with the bank, which I regard as a very desirable thing, much harder than it is.

Thank you, Madam Chair.

Chairwoman BIGGERT. Thank you.

The gentleman from California, Mr. Sherman, is recognized for I think a grand total of 7 minutes.

Mr. SHERMAN. Thank you, Madam Chair, for having these hearings, and hopefully they will lead to a markup of the legislation that I have authored that you have described. I expected to be here for every minute of these hearings. As you may know, my new Governor is holding a meeting in light of the fire situation affecting my own district and our entire state. I will need to be at part of that meeting, but I will be here every minute I can be.

Our policy toward Iran can best be described as continuing schizophrenia. That is to say, the Clinton administration, the Bush administration before September 11, and the Bush administration after September 11 have continued a schizophrenic policy. Part of that schizophrenia is illustrated by our difference in approach between Iran and Iraq. Iran is maybe 3 years from a nuclear weapon, and already has other weapons of mass destruction. Iraq might have been 30 years from a nuclear weapon, had the U.N. continued to do its job, maybe longer. Iran is harboring al Qaeda today, including those who did the bombings in Riyadh that killed Americans and Saudis so recently. It is the number one state sponsor of terrorism, Saddam never achieved that title, and as our Ranking Member indicated, a terrible human rights record as well.

So we have a schizophrenic policy that is illustrated by our economic policy. On the one hand, we have the Iran-Libya Sanctions Act. Not only do we prohibit our oil companies from doing business with Iran, we punish the oil companies of our allies who choose to invest in Iran, or at least we threaten to. So we punish others who do business as usual, but we do business as usual. Clinton announced and Bush continues $150 million of non-energy imports from Iran, for no reason other than to facilitate that regime's economy. It does nothing for ours. And even after September 11, this continues. I do not think that the need to import Iranian caviar is vital to our national security. Those imports continue.

Then we have elements of the administration hinting that maybe Iran should be the next invasion target, while other elements of the administration have pretty much allowed money to go indirectly from the U.S. Treasury to the terrorists in Teheran. That has happened through the World Bank. American law requires us to at least go through the motion of voting no, but what really happens at the World Bank is with winks and nods and behind closed doors.

What has the World Bank done? They have approved since May 2000 some $432 million, but fortunately they have only disbursed $38 million. Immediate strong action from this administration could prevent further disbursements. In addition, they are considering projects of $150 million, another $240 million, $70 million and $84 million projects totaling $540 million. The administration could take strong action and prevent those. We have a $1 billion question between that which has been authorized or is likely to be authorized in the World Bank, and that which has been disbursed, at least a difference of roughly $950 million.

Now, one thing that the apologists for the World Bank do is make what I call the "separate fingers" argument. They argue that IDA, one finger of the bank, is separate from IBRD, another finger of the bank. But what does the World Bank say on its Web site? IBRD, the entity that is giving the money to Teheran, and IDA, the entity that we give money to, what does it say? IBRD and IDA are run on the same lines. They share the same staff, the same headquarters, report to the same President, and use the same standards when evaluating projects. IDA simply takes its money from a different drawer. I think when they make the "separate finger" argument, they are giving us the finger.

Now, money is fungible. The government in Teheran must make some domestic expenditures in order to obtain power. That regime spends the minimum necessary to show its people it is doing a little something for them, and takes every additional penny that they can get their hands on to kill as many Americans as possible. Every extra penny is an extra bullet aimed at us.

This committee and this Congress contain many people who support foreign aid. When we give that foreign aid to bureaucrats who believe in helping those in Teheran meet their financial needs, we endanger American support for foreign aid. Money is fungible. The government in Teheran must make some domestic expenditures, and then they can spend our money instead of theirs. They can use their money for terrorism.

Today, we hopefully will learn what the administration will do to stop these disbursements and how that fits into an overall policy

to economically isolate this regime until such time as it changes its policies. I realize $1 billion is not the be-all and end-all, but what does it do when the World Bank sends subsidies to the terrorists in Teheran? It puts the stamp of approval of the most prestigious economic institution in the world on doing business as usual with that government. How could anybody doubt that you should do business as usual with that government? The World Bank subsidizes them.

So hopefully we will learn that an administration that can invade one country can at least stop loans to a country that is a far greater threat to American security. I know it has been pointed out that the World Bank charter does not explicitly say that there should be political considerations, but I would note that if the World Bank had made loans to Hitler had it existed at that time, the United States would not have just rolled over. We would not continue to participate, and we certainly would not have given those same bureaucrats more funds. It is time for us to realize that the regime in Iran is developing nuclear weapons aimed at us, and the American people will pay for foreign aid only if it is treated carefully.

I yield back.

Chairwoman BIGGERT. The gentleman's time has expired.

At this time, I would like to introduce our first panelist, beginning with the Honorable William Schuerch, Deputy Assistant Secretary for International Development of the U.S. Department of the Treasury. Welcome. Deputy Assistant Secretary Schuerch was named Deputy Assistant Secretary of the Treasury for International Development, Debt and Environment Policy on March 15, 1998, after acting in that capacity since September 16, 1996. He serves as policy adviser to both the Assistant and Under Secretaries of International Affairs. Mr. Schuerch has responsibility for formulation of international debt policy and of a wide range of economic, financial and environmental policy issues pertaining to U.S. participation in the MDBs.

Welcome, Mr. Schuerch. Without objection, your written statement will be made part of the record, as will the other panelists on the second panel. You will be recognized for a 5-minute summary of your testimony. After that, we will have questions and our Members will keep their questions to a limit of 5 minutes also. If you would care to begin? Thank you.

STATEMENT OF HON. WILLIAM E. SCHUERCH, DEPUTY ASSISTANT SECRETARY, DEPARTMENT OF THE TREASURY

Mr. SCHUERCH. Thank you, Vice Chairman Biggert and Ranking Member Maloney, and distinguished Members of the subcommittee. We welcome the opportunity to testify today on the implementation of U.S. policy on multilateral bank lending to Iran.

As you know, it is not a new policy and this administration agrees with the Congress that Iran should not have access to MDB lending. I want to assure you that the Treasury Department and the U.S. Executive Director at the World Bank, while not fully successful, have consistently and actively sought to block all proposals of assistance for Iran.

I want to make points about the bank itself, however. The bank plays a critical role in helping the United States achieve its efforts to increase world economic growth, reduce poverty, build open-market economies, and encourage the growth of civil society through most of the world. Second, the bank is an important foreign policy tool for the United States and is a vehicle for leveraging our foreign assistance resources throughout the globe. The bank has played critical roles in responding to democratic and market openings in central and eastern Europe and in what we used to call the newly independent states of the former Soviet Union, in Bosnia and Afghanistan, and in combating terrorist financing. Concerning Iraq, it has completed a needs assessment. It will manage a trust fund for other donors, and it has recently pledged significant resources for rebuilding.

Now, as concerned bank lending to Iran and U.S. policy, our efforts to block these resources is consistent with congressional intent for both terrorism and human rights. We share congressional concerns that have been clearly demonstrated this morning. We are deeply concerned about the weapons of mass destruction programs in Iran, particularly a nuclear program, and we have a quite active interaction at the moment with the International Atomic Energy Agency that is going on. We also believe Iran needs to make very substantial economic reforms.

U.S. efforts to block World Bank assistance to Iran were fully successful for seven years, from July 1993 to May 2000. During this time, there was a consensus among G-7 nations blocking all lending to Iran. Unfortunately, in May 2000 the coalition split. Other Members began supporting re-engagement in Iran due to their expressed views that engaging with Iran's reformers would support their efforts against Iran's hardliners. This view is still evident as negotiations go on over Iran's nuclear program.

In addition, commercial opportunities in Iran for U.S. companies which could not compete due to U.S. sanctions, have been enticing many partners. Thus, despite the U.S. no votes and abstentions from France and Canada, the rest of the World Bank's executive board approved two loans, a $145 million sewerage project and an $87 million primary health care and nutrition project. Later, in May 2001, the executive board discussed an interim strategy for Iran. It proposed low-income housing, sewerage, urban upgrading and community-based infrastructure and employment creation projects. We opposed that strategy and raised our concerns about the bank's engagement with Iran.

Since then, despite ongoing efforts with other shareholders not to support lending, a $20 million loan for environmental management and an $180 million loan for earthquake recovery occurred in 2003. Additionally, the IFC approved in December 2002 a $5 million investment on a joint venture with a private Iranian bank, a major French bank and the IFC. This was the IFC's first investment in 25 years. The U.S. voted no and lobbied against it with other shareholders.

This is the full picture of MDB lending, but as others have said already, there is a pipeline that I will not describe in detail, I think it has been reasonably described, of additional projects. The numbers that line up are substantial in terms of totals of millions of

dollars. It is a four-project long list. In summary, from July 1993 to May 2000, U.S. efforts to block World Bank and MDB assistance to Iran were completely successful. Colleagues shared our views that it was inappropriate for the bank to engage with Iran. Since that time, as colleagues have changed their views and decided that engagement had some benefits or potential benefits, the bank has ended up approving $432 million, primarily for basic human needs-type activities.

I want to emphasize that the lending that has occurred from the World Bank is from its hard-loan window and from its private sector window. It is not from the International Development Agency. As such, lending to Iran is provided at market rates, not concessional rates and maturities. The IFC funding, while supporting investments in Iran, is not providing assistance to the government of Iran itself, but to private companies. The World Bank is an organization of 183 member countries. The U.S. is its largest shareholder. We have a 16.4 percent interest. That share is not controlling, nor do we have rights to veto individual lending decisions. This is fundamentally a weighted democracy structure, weighted by contribution levels primarily.

Blocking MDB support for a country is difficult. Occasionally, it has been possible when substantial international outrage exists over specific events. There are a few examples. In 1989 after the Tiananmen Square incidents in China, it was possible to block lending to China for approximately 1 3/4 years. After that point, the coalition would no longer support that action and the U.S. has been voting in opposition to China in the bank ever since, while others have been supporting. Nuclear testing by Pakistan and India in 1998 led to concerted efforts. Those efforts held the coalition together for 2 years and held up non-basic human needs lending. Beginning in 1987, in the case of Burma, there has been a much more successful effort due to the repression of opposition leaders by the military junta. That effort continues and has continued in its success.

Basically, I think the facts indicate it is extremely difficult to hold together an international consensus in response to specific events and even to continuing events. These are the extreme exceptions in the history of the bank, and I would say even if one looks at bank projects and votes on the bank board, there are only one or two instances where they have been turned down once offered in the board. So there is much discussion behind the scenes before things are brought forward.

Finally, Madam Chairman, I would like to emphasize this administration's consistent voting record against MDB assistance to Iran and our continued efforts to discourage World Bank engagement. The administration will continue to oppose bank lending until meaningful political, economic and human rights reforms have taken place. We will also continue our efforts to marshal support from other donor countries, bank management and other shareholders in order to stop lending to Iran.

Thank you.

[The prepared statement of Hon. William E. Schuerch can be found on page 37 in the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Schuerch.

I will now recognize Members for 5 minutes each to ask questions, and would recognize myself first of all.

Mr. Schuerch, could you give us more specifics? What is the Treasury Department doing really to convince other members of the World Bank to limit the amount of monies that they would give to Iran?

Mr. SCHUERCH. The Treasury does a range of activities. It meets with other shareholders. The U.S. Executive Director has discussions with the Executive Directors of other constituencies in the institution; makes very clear the U.S. position in opposition to lending. The U.S. has been particularly strong on the matter. I know in the Congress it is less focused on the difference between being opposed and being against lending, but in fact U.S. law requires opposition. It does not require us to vote no in the World Bank on these loans, and yet we have chosen, because of how serious we take the issue, to vote no in every instance in the case of Iran.

I also directly interface with senior officials in these institutions, managing Directors, vice Presidents, and also in the case of the IFC, with the head of the IFC, and directly express the U.S. position on membership issues and on votes issues when we think that is important enough, and that has certainly been done on Iran on a number of occasions. Sometimes we have meetings where the G-7 Executive Directors get together and usually that is the case when we have coalitions of this sort. They are very candid discussions and push as well. We also have relationships and use the State Department's contacts through diplomatic channels.

Chairwoman BIGGERT. Thank you. What would happen for the U.S. Executive Directors of the World Bank to support development loans for Iran? What would have to happen that they would vote yes for those?

Mr. SCHUERCH. To get other shareholders?

Chairwoman BIGGERT. No, for the U.S. to vote for the funds.

Mr. SCHUERCH. I do not think I am prepared to lay out a specific line of individual actions. There is a broad, complex relationship with Iran. There are very strong feelings. Mr. Sherman has been quite eloquent on concerns about terrorism, and others have also, weapons of mass destruction and nuclear issues, human rights issues, Middle East-related terrorism issues. I think we have enough flexibility that if one were looking at questions of responsiveness, there is flexibility to shift between an abstention and a no within the law. We have not chosen to do that.

Chairwoman BIGGERT. If Mr. Sherman's language became law, would it affect the World Bank's commitments to countries other than Iran by lowering the overall amount of funds the bank could commit?

Mr. SCHUERCH. Mr. Sherman's characterization of the non-severability between IDA, the International Development Association, and funds going to the World Bank, I would like to respond to because these are very different institutions. They have different charters. He is accurate in saying they have the same staff and the same chairman of the board, but the fact is they have different corporate structures. They are legally different corporations and they have totally different financing mechanisms. The World Bank, we

provide paid-in capital and callable capital. We go to markets to borrow private sector money and those loans go at market rates.

If you look at IDA, it is a direct appropriation from the Congress. It is provided to countries with incomes a little over half the wealth of Iran. Consequently, any cut in IDA dollars in fact impacts a whole different set of countries, and in fact the poorest of the countries, the ones that have been receiving HIPC resources for example, and not the Iran-type countries.

Chairwoman BIGGERT. Would H.R. 2466 restrict future emergency earthquake funds or other humanitarian aid from the World Bank to Iran?

Mr. SCHUERCH. I should be clear that we are actively opposed to that piece of legislation. We do not believe it will have a direct affect on decisions in the bank of other shareholders on lending to Iran, or certainly not on loans that have already been approved by the board. It would reduce resources available for the poorest countries in the world.

Chairwoman BIGGERT. Thank you. My time has expired. The gentlewoman from New York, and Ranking Member?

Mrs. MALONEY. I thank the Chairlady for yielding.

I really would like to follow up on the eloquent statement of my colleague, Brad Sherman, when he mentioned in his opening statement that money is fungible. Critics of the World Bank projects in Iran have argued, as he did today in his opening statement, that funding going to these projects frees up funding for the country's government to possibly spend money on arms and potential weapons. Do you agree with this statement? Could you elaborate on what precautions are being taken to prevent the bank from inadvertently boosting Iran's ability to spend more money on odious items such as weapons and support of terrorist activities?

Mr. SCHUERCH. The fungibility argument is one that I have been dealing with in foreign aid matters for over 20 years. It comes up repeatedly. It comes up related to our own bilateral aid programs with the USAID. It is an argument that says if we give a country a dollar, we can pick the most odious thing it is doing and claim our dollar is funding that, rather than the best thing a country is doing, and claim our dollar is funding that. So it is an interesting rhetorical exercise.

But let me talk to the bank itself. The bank actually provides money for specific purposes. It audits the use of those resources and makes appropriate assurances that its resources are going for the purposes they have been approved for. There is an external evaluation. There is a group that looks at corruption issues and so forth. So it is also true the bank has different types of funding mechanisms. It can give balance of payments resources. It can give cash transfers for sector policy issues. It can give programmatic lending, which is direct support to budgets.

I think it is worth noting that none of the loans that have come to the bank board propose any of that sort of activity or support for Iran. They are all project-specific loans, sewerage projects, health projects and so forth. The bank will take appropriate actions to ensure that the resources go for those purposes.

Mrs. MALONEY. In how many countries is the World Bank participating in which the United States is opposed to funding any

projects? Is Iran by itself, or are there other countries in the same status?

Mr. SCHUERCH. There are many countries that are caught in legislative provisions that have been put in. I think it is fair to tell you we have, and I do not know if the count is perfectly accurate, I suppose there are perceptions on that, but we have 38 different pieces of legislation that direct voice and vote of the United States in the World Bank and in the other institutions.

I would say the most parallel ones in this particular case probably is the China vote. We have been voting no on all lending in China, except basic human needs lending in China, since 1989, since Tiananmen Square. As I said earlier, it was an effective approach in terms of other shareholders and holding coalitions together for approximately 2 years. We are alone voting no in those instances. Burma has been more successful, but the others are more complex. We vote against Iraq lending. It is on a terrorism list. There are others on the human rights list. So Iran is not alone in this circumstance and it is not alone in the circumstance that loans move forward over U.S. objections to these voice and vote principles.

Mrs. MALONEY. Currently, when the World Bank considers funding a project in Iran, does the U.S. participate in the discussions about the scope of the project, or do our representatives just simply assert a no vote? Are we part of the negotiations? Do we try to structure to make sure that it is not spent for an odious reason, or do we simply say no? How does it work?

Mr. SCHUERCH. It is a sensitive question. It works differently on different matters at different times. I want to address the question of the charter of the bank, to give you a little perception, because there are sensitivities about public perceptions about what the U.S. does related to the World Bank or can do, and the sensitivities of those of other shareholders. In some respects, any activities that we undertake that the bank acknowledges and takes part in are activities that other shareholders also have the right to take part in.

Mrs. MALONEY. How much shareholding do we have in the bank?

Mr. SCHUERCH. We have 16.4 percent of the World Bank.

Mrs. MALONEY. We have 16.4 percent. Are we the largest shareholder in the bank?

Mr. SCHUERCH. We are the largest single shareholder. If you talk to many, they would honestly and accurately characterize the United States as running the World Bank. It is clearly not the case, and it is clearly not the case in this instance or in the China lending instance. But we do have influence and we do use that influence behind the scenes as much as we can. I think I am a little reluctant to describe it because I do not want to, frankly, encourage other countries to complain about this by putting it in the public record.

I do want to say that the bank's charter is not only, as Mr. Sherman described, one that does not have politics explicitly in it. It is exactly the opposite. It explicitly has statements against politics in decisionmaking. I say this not to describe U.S. attitudes, but to describe the culture in which other shareholders, and frankly this charter passed the United States Senate. Article four, section 10 of the charter says the banks and its officers shall not interfere in the

political affairs of any member, nor shall they be influenced in their directions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purposes stated in article one.

So it is quite clear on this subject. We get this explained to us from other shareholders repeatedly. It is a situation which we live with because certainly the bank was created for economic purposes. It was also created broadly for political purposes.

Chairwoman BIGGERT. The gentlewoman's time has expired.

Mr. Sherman, you are recognized for 5 minutes.

Mr. SHERMAN. I am flabbergasted that you say that we are not required by law to vote no against loans to Iran and that it is somehow a major concession from the administration to those of us who do not want to see Iran develop nuclear weapons, that you in fact vote no. I am told that the statute says that we are supposed to use our voice and our vote to oppose loans. If you are required by statute to oppose something, you kind of ought to vote no. I may have that wrong, but I do not think so.

More importantly, I am quite concerned that much of your testimony could be viewed as a description of why these loans are okay. You talk about earthquake aid, but this earthquake aid, which is like emergency aid getting directly to the people, isn't this money going to Iran more than 2 years after the earthquake? Isn't it just kind of free cash to reimburse them for whatever they have already spent? Could you characterize this earthquake aid as emergency immediate money getting there in the weeks following the earthquake?

Mr. SCHUERCH. Let me first address your comments on the word "oppose" in the legislation. I think we ought to be clear and we ought to have no misunderstanding on this issue. There are provisions of law that require the U.S. executive branch vote against lending in certain circumstances. That use of legislative language requires us to vote no. There are other provisions of law that require us to oppose, and those provisions of the law permit abstentions, which is the most typical behavior pattern, and no votes.

Mr. SHERMAN. If I can interrupt, clearly Congress is going to have to write its language to provide less flexibility to an administration if you think it is that a statute requiring opposition allows something other than voting no, but in fact you do vote no, so that it not the issue.

I have such limited time. I would like you to respond to the rest of that question for the record, because I want to go on to another question. You act as if we have no influence with the Europeans; that all we can do is beg; get down on our knees and beg again. And then if they vote against us, well, gee, there is nothing we can do about it. When it came to the issue of bananas, none of which are grown in the United States, we turned to the Europeans and threatened retaliatory tariffs. Have we ever indicated to any government that we would deprive them or their citizens of a single penny if they voted to in effect send World Bank, much of it ours originally, to those who are developing nuclear weapons to smuggle into American cities? One penny, one nation, one instance?

Mr. SCHUERCH. I will answer that directly very quickly, but you should also be aware when you are looking at the no versus abstain issue that the Congress changed the law as it related to terrorism in 1994, and switched from a mandatory no vote to an opposition position. So there is no doubt that the people writing the legislation understood its meaning.

In terms of the latter question, have we threatened different sorts of trade sanctions and so forth tied to the World Bank?

Mr. SHERMAN. Or anything, maybe like skipping a Presidential visit; not letting them come to the Fourth of July party. Have we deprived them of a single hors d'oeuvre? Or have we basically said, you can vote the way you want to; you can subsidize the nuclear destruction of American cities, if it ever comes to that; and you will not lose a single hors d'oeuvre?

Mr. SCHUERCH. I think what I would say to you is, in short, I am not aware of us threatening France or Germany or Japan or Italy with that kind of behavior over this issue in the World Bank at any time.

Mr. SHERMAN. So we were much tougher in defending our banana exports than in defending the American people from the terrorism and nuclear weapons programs of Iran.

Mr. SCHUERCH. We have deep and complex relationships with our major allies that cover subjects much broader than this one.

Mr. SHERMAN. Just to reiterate what I said, this administration cares more about our banana exports, which we do not even grow here, than it does defending American security from this threat. That is kind of what these hearings are all about.

Mr. SCHUERCH. I think you better count the number of troops that we have over in this part of the region, if that is what you think.

Mr. SHERMAN. Oh, there is Iraq. How many troops do we have in Iran?

Mr. SCHUERCH. This issue is much broader than Treasury and a few dollars out of an international institution that has a weighted voting structure. We have Americans next door to this country day by day by day and dying day by day, so the characterization is not one we agree with.

Chairwoman BIGGERT. The gentleman's time has expired.

The gentleman from Illinois is recognized.

Mr. EMANUEL. I would like to thank the Chairlady.

As indicated in the papers today, the Iraq Governing Council is negotiating with Iran a swap deal relating to oil and electricity, similar to what it is doing with Syria. Are we beginning to see the changes in how the Administration deals with countries that are, (A), developing nuclear weapons; and (B), supporting terrorist groups such as the Hezbollah, al Qaeda, and the Islamic Jihad? Is there now a shift in the way the Administration is dealing with on the original list of the axis of evil?

Mr. SCHUERCH. I think a broad discussion of American foreign policy vis-a-vis Iran versus North Korea versus other countries, whether they are on the axis of evil list or whether they are behaving in ways we do not support is really an appropriate role for the State Department, which is in charge of this. The Deputy Secretary yesterday was in the Senate Foreign Relations Committee, and

there have been other articles in the New York Times this morning.

Mr. EMANUEL. You can appreciate, then, how some of us could be confused. I read what the Deputy Secretary, Mr. Armitage, said. We have the issue of the World Bank. We have the issue of the Iraqi Council. Some of us are left with the job of connecting dots and trying to explain it. So all I am saying is, I am not here to have a global discussion of the administration's foreign policy. But you can understand that for those members of the great unwashed over here, it is a bit confusing.

Mr. SCHUERCH. I think what I would say to you is that there are a multiplicity of foreign policy tools. One looks at what is available and one looks at the specific country situation, and one looks at their relationships with one's allies and one makes judgments about which tools to use because of their likelihood of success in different circumstances. It has not yet been a judgment of the United States government that doing something different than voting no in international institutions on lending to Iran and encouraging others to do so would be more successful than switching to an abstention or to a yes vote for some specific reason. I am not sure where your argument leads. I suppose you support a no vote in these circumstances.

Mr. EMANUEL. No. My argument actually is, one, whether you want to go up to the limit. Look, I think that for 15 years, three different administrations have tried to communicate to a moderate element in Iran. The interesting thing is every time you try to find that, when you really need them, you can't find them, but we spent 15 years trying to communicate with them. If one says offering financial incentives to Iran, whether through the World Bank or through an energy swap, is part of an emerging strategy, or saying we want to have a dialogue, as the Deputy Secretary said today in the paper and in testimony yesterday, I am interested in that as part of an overall strategy. But there are moments in which we list them on the axis of evil, say they are developing nuclear weapons, think it is a high priority to stop it.

We know they are supporting terrorist groups, and yet we are giving them financial incentives. All I am merely saying, for me, it is a bit confusing. I am well aware of the nuances in foreign policy, but to list Iran on the axis of evil and then offer financial incentives is an interesting strategy. I am saying, is that part of the overall comprehensive strategy, or is Treasury going one way and State going another?

Mr. SCHUERCH. We have not offered them financial incentives.

Mr. EMANUEL. Would you agree that we are funding the Iraqi National Council, given that the United States is supporting the reconstruction, some of the funding for Iraq does come from the American taxpayers, when you do an electricity-for-oil swap?

Mr. SCHUERCH. I misunderstood you to suggest we are actually supporting Iran with finance.

Mr. EMANUEL. I do think they are going to probably generate some economic interest from that, wouldn't you? I do not think they are going to engage in that economic activity if it is not in their own self-interest.

Mr. SCHUERCH. I guess what I would say to you is that when one gets in circumstances where one is trying to influence countries, whether they be in the situation in Iraq or Iran or North Korea, it is often the case that there is a back-and-forth in relationships. Sometimes there are financial aspects to it. Sometimes there are financial aspects with other allies to that process. It is not a process that the Treasury Department is in the middle of on a day-to-day basis at all. There are no current plans that I am aware of to revisit the current policies in lending and votes on lending or discouraging others from supporting lending to Iran in the multilateral banks.

Mr. EMANUEL. No further questions.

Chairwoman BIGGERT. Thank you.

Perhaps the basic question that we are skirting around, is the World Bank the best tool to use to accomplish U.S. foreign policy goals in Iran. Perhaps you would be willing to address that in writing, since we do not have the time, or discuss it briefly.

Mr. SCHUERCH. I want to comment on it briefly. I think if one understands the history of the creation of the bank and the regional banks and the shift in their mission from post-World War reconstruction to a much more development focus, we need to understand that a lot of the international economic system created after World War II was created because of a recognition of failing of dealing with economic dislocations post-World War I that in many people's minds were directly relevant to World War II.

I think when we look at it, the bank is a good tool for long-term strategy; for encouraging development, which we believe fundamentally favors democracy and opening of markets and free-trading systems, and a fair and level playing field, if you will. When one tries to use it explicitly on a short-term foreign policy basis or even a medium-term one, it is a much more difficult tool to either hold other shareholders together in support of a specific action, or to be successful influencing the country itself. Cutting off assistance to Iran, which we certainly have been voting for, one has to look at the dynamics and the size differentials of what one is talking about. Iran is a country with an economy of about $106 billion a year. The amount of resources we are talking about in the bank, which admittedly for the vast majority have not been disbursed yet, are a very small sum.

Thank you.

Chairwoman BIGGERT. Just one last question, then. I notice that there was a rather sizable amount of money that has not been disbursed. Could you just give us a reason for that? Is that because it is programmed to continue over a number of years? Or do they have to fulfill certain steps of what they are trying to accomplish to get the money?

Mr. SCHUERCH. If I were going to be aggressive, I could try to assert that the United States has been successful behind the scenes in order to stop the disbursement or slow it down substantially. There are $390 million or so of undisbursed resources out of the $432 million that has been approved. If I were to take that position and argue it, it would have particular problems with other shareholders. I think if you were to ask that question of bank management, they would tell you that Iran is a particularly difficult place

to do business in, and they are having trouble getting started and starting up programs. So it is an initiation factor in their mind.

Thank you.

Chairwoman BIGGERT. Thank you very much for appearing before us this morning.

Mr. SCHUERCH. Thank you.

Chairwoman BIGGERT. We will now turn to the second panel, if they want to come up and take their places. Welcome. Thank you very much for joining us today. I know that our Members are in and out. They said that they would be back in a few minutes, so we will continue on.

First of all, we are going to hear from Dr. Ray Takeyh, Director of Studies for the Near East and South Asia Center for Strategic Studies at the National Defense University. Dr. Takeyh has written widely on Iran, political Islam, and terrorism, with many of his pieces in scholarly works, having appeared in the Financial Times, Washington Post, Foreign Policy and the Middle East Journal. Second will be Dr. Patrick Clawson, Director for Research at the Washington Institute for Near East Policy. Dr. Clawson is also a prolific author, having written more than 30 articles on the Middle East which have appeared in such scholarly media as Foreign Affairs, International Economy, Oxford Bulletin of Economics and Statistics, and the Middle East Journal. Dr. Clawson is currently senior editor of the Middle East Quarterly.

Welcome both of you. If you would like to begin, Dr. Takeyh, again, 5 minutes summary of your testimony, and then there will be questions.

STATEMENT OF RAY TAKEYH, PROFESSOR OF NATIONAL SECURITY STUDIES AND DIRECTOR OF STUDIES, NEAR EAST AND SOUTH ASIA CENTER, NATIONAL DEFENSE UNIVERSITY

Mr. TAKEYH. Thank you very much for inviting me. I will spend my 5 minutes, since I have already submitted a statement for the record, dealing specifically with the three questions that we were asked to consider, the first question being whether we believe that restricting U.S. contributions is a helpful policy.

As I mention in my testimony, I believe the type of pressure that works on Iran is multilateral pressure spearheaded by Iran's traditional lending partners, traditional trading partners, the Europeans and the Japanese. The recent example of Iran subscribing to IAEA's additional protocol reveals that theocracy's policies are not immutable, and confronted with concerted international pressure, Iran will behave properly.

Should the suppression of the World Bank loans be part of a larger multilateral strategy of pressure, I believe they will be effective. But in and of themselves, they are unique and a single gesture of U.S. dissent is unlikely to be as productive as Washington intends. Moreover, I believe at a time when the United States is involved in Iraq, confrontation with another international organization, given the troubles with the United Nations in the past year, is not helpful. Moreover, World Bank is an institution that is necessary for reconstruction of Iraq and perhaps the politicization of these loans in that particular sense is unhelpful.

The second question, is the bank lending a significant factor for Iranian management of its economy? I would suggest that Iran's economy suffers from structural flaws that prohibit free market reforms. In the aftermath of the revolution, Iranian clerics created an economic system that benefits themselves and a very narrow group of merchants within the Bazar. This narrow collection of people tend to dominate the trading sector, the manufacturing sector. Corruption is endemic in this economic system. Therefore, I believe the level of corruption now has increasingly reached Iran's oil industry through a network of ostensibly private companies that have positioned themselves as compulsory partners for foreign investors seeking access to Iran's petroleum market.

In this particular economy, the World Bank's loans, which are a rather paltry sum compared to the level of international investment that Iran gets, are unlikely to affect Iran's key military and spending priorities. The fact, as I said, remains that the sums involved are not large enough to make an impression on Iran's ruling elite. Again, the type of economic leverage that may do so would be reduction of trade and investment by Iran's largest partners, the Europeans, the Japanese and the East Asian community.

At a time when theocracy requires a substantial amount of international investments to rejuvenate its economy, particularly to deal with the problem of youth unemployment, the investment that is coming from the international community is absolutely critical. The imposition of trade barriers by those international actors will make an impression on the theocracy and compel it to alter its priorities. However, limited World Bank loans are unlikely to have such a dramatic impact.

Finally, whether World Bank loans and secession of those loans are going to make an impact on Iran's nuclear spending, once more I am not hopeful that suppression of World Bank loans will have the impact that is ascribed to them. Unfortunately, nuclear weapons are beginning to emerge as the centerpiece of Iran's deterrent strategy. Iran lives in a dangerous neighborhood with instability on all its corners, and a rather massive of American power on all if its peripheries. Iran's defense planners are learning some lessons from Operation Iraqi Freedom, namely that Saddam's purported possession of chemical weapons did not constitute a deterrent against the United States, and perhaps the possession of strategic weapons will. So in that particular sense, given the emerging centrality of nuclear weapons in Iran's strategic calculus, the World Bank loans are unlikely to disturb that planning.

However, this is not to suggest that Iran's nuclear calculations are immune from international pressure, but that pressure has to be multilateral and sustained. The recent Iranian acceptance of IAEA's additional protocols came about only after the European Union suggested that they would not sign additional trade and cooperation agreements, and the Japanese similarly suggested that they will not participate in completion of the oil exploration agreements with Iran. That essentially pushed Iranians over the threshold.

The combined pressure of the United States and its allies ultimately can compel important concessions from Iran. I do not see U.S. attempts to suspend World Bank loans as having the same

type of an impact. A carefully crafted international consensus that combines American pressure and European determination, in my view, is the best manner and the only manner of obstructing Iran's proliferation tendencies.

I would be happy to go into these in the question-answer time, but I will limit my opening remarks to the 5 minutes.

[The prepared statement of Ray Takeyh can be found on page 41 in the appendix.]

Chairwoman BIGGERT. Thank you very much.

Dr. Clawson?

STATEMENT OF PATRICK CLAWSON, DEPUTY DIRECTOR, THE WASHINGTON INSTITUTE FOR NEAR EAST POLICY

Mr. CLAWSON. Thank you very much for letting me speak here today. I have submitted a statement that I ask being included in the record.

There are two important considerations in judging U.S. reaction to World Bank lending to Iran are, first, how important is World Bank lending to Iran; and second, how does lending to Iran fit within World Bank practice. Let me address these in turn.

First, how important is World Bank lending to Iran? Iran faces difficult economic times for the next decade because its baby-boom, born after the 1979 revolution, is entering the labor market. A recent report from the International Monetary Fund predicted that Iran would need to mobilize $4 billion a year in foreign loans and direct investment if it is to achieve a level of growth which stabilizes unemployment. If Iran does not have access to that kind of foreign capital, Iran would suffer further from the loss of expanded oil exports that those foreign funds would finance. If Iran's oil exports were to stagnate at the 2002-2003 level, Iran would have $11 billion a year less in income by 2008-2009. In other words, the foreign funds and the expansion in oil exports they make possible are central to Iran's economic plans and could be key to preventing youth unrest that could threaten the current hardline government.

Lending by the World Bank would under any circumstances be a small part of the $4 billion a year Iran needs to raise from abroad. However, as the World Bank correctly emphasizes, its lending has a catalytic effect on other lenders and investors. That is, lenders and investors are more likely to place their funds in a country where the World Bank has found that the business climate and economic policies are sufficient to merit World Bank lending. In other words, World Bank lending could have a significant impact on Iran's ability to raise international capital, and therefore on its economic prospects.

That said, it is by no means clear that restricted access to international capital would lead Iran to reduce its military spending. It is quite possible Iran would respond to any shortfall in foreign loans and investment by cinching its belt in further. An additional complication is that Iran's international economic situation is highly dependent on the price of oil. Relatively small swings in world oil prices are as important to Iran's economic prospects as are its access to international capital.

In short, World Bank lending will matter much more to Iran if oil prices declined father than expected. If Iran faces tough eco-

nomic times due to low oil prices and lack of access to international capital, that could strengthen popular protests against the hardline government. At the same time, that hardline government could well decide to make whatever sacrifices are needed to keep the nuclear program on track.

Let me turn briefly to the question of how would lending to Iran fit with World Bank practice. Iran has a highly distorted economy which makes it a poor candidate for World Bank funding. As it does in other countries with such poor economic policies, World Bank lending to Iran should be confined to social services and to semi-humanitarian loans. The United States should press hard to ensure that the World Bank does not bend its usual procedures, which are to insist on economic reforms and appropriate policies before the bank can lend to a sector. It would be entirely consistent with World Bank procedures for the United States government to vigorously lobby the bank's management and executive board about the inappropriateness of lending to a country with as poor economic policies as those of Iran.

Raising more explicitly political objections is more problematical, but it could be considered, particularly if Iran is found in violation of its obligations under the nonproliferation treaty, where it would be appropriate for the Security Council of the United Nations to consider actions such as banning all new loans from international financial institutions.

I should note that there are many voices which call for basing bank loans on explicitly political criteria. As Mr. Schuerch explained, the bank's approval of loans to Iran was made in large part because of an explicitly political judgment on the part of European countries that it would be appropriate to aid Iran's reformers. If decisions about lending to Iran are to be made in the future as they have been in the past, on such explicitly political grounds, then bank loans to Iran will become an international imprimatur for Iran's government. That would be most unfortunate.

[The prepared statement of Patrick Clawson can be found on page 33 in the appendix.]

Chairwoman BIGGERT. Thank you very much. Again, we will have a question period for 5 minutes each and I will yield myself 5 minutes.

Dr. Takeyh, I think I will ask the same question that I asked at the end to Mr. Schuerch. Is the World Bank the best tool to use to accomplish U.S. foreign policy goals in Iran?

Mr. TAKEYH. I think as Patrick was saying, World Bank has been part of the American international policy objectives. In a sense, its creation was designed to rehabilitate the European economies, and then that mission was expanded to include other nations as well, the idea being that such rehabilitation will promote democracy and alliance systems not inconsistent with America's national interest objectives.

However, in this particular case, my concern is that suspension of those loans, or some sort of American confrontation with the World Bank, is not appropriate at this time, given the fact that the World Bank and other international institutions are going to be utterly critical in reconstruction of Iraq. Once again, we have to use those international institutions in a constructive manner.

Also, I do not believe that it will have the salutary impact that it seems to be suggested, namely that the suspension of those loans to Iran will have a material impact on some of its most troublesome decisions regarding its terrorism portfolio or its weapons of mass destruction. It is important to recognize that Iran has been under a considerable degree of economic pressure from the United States, and indeed the international community, since the inception of theocracy. For some self-defeating reason, it has maintained its support for Hezbollah and other such organizations. So closing Iran's terrorism portfolio will require broader multilateral effort, as opposed to sort of a contentious argument within yet another international organization.

Chairwoman BIGGERT. Going a little bit further, with Iran agreeing to tougher United Nations inspections, I think at least, and I just glanced briefly at the article today and I am not so sure that is going to continue for too long, suspending its uranium enrichment program and cooperating with the International Atomic Energy Agency, would action on Congressman Sherman's legislation be wise at this moment?

Mr. TAKEYH. There are a lot of problems with the sort of agreement that Iran has reached with the IAEA, namely whether actually Iran will suspend enrichment of uranium. The position of Iranians is that they reserve the right to suspend when they want, and resume enrichment of uranium as they wish. It is the EU position that negotiated this agreement that they have to stop enrichment facilities.

Would passage of this legislation have a material impact on those particular deliberations? I suspect not. This is a part of a larger set of discussions that Iranians are having with the Europeans, and it has to do with a multiplicity of interests and concerns that Europeans and other members of the international community have. There are a lot of problems with this deal, because under the auspices of IAEA's additional protocols, Iran can do a lot of research and activity for its nuclear infrastructure. But in and of itself, this particular legislation is unlikely to make those IAEA protocols even tougher. Even the enhanced, tough IAEA protocols are not going to stop Iran's weapons research program. That is the problem with IAEA, not World Bank versus IAEA.

Chairwoman BIGGERT. Thank you.

Dr. Clawson, let me ask you, and you having worked at the World Bank, do you think it is the best tool to use in accomplishing U.S. foreign policy goals in Iran?

Mr. CLAWSON. No. It is certainly not. The question is whether or not it is one of an appropriate set of tools. Clearly, the World Bank would be a relatively small portion of our total toolbox that we use in dealing with Iran. I would quite agree with Ray that action at the World Bank would be much more effective if we were able to secure agreement with our European partners on a joint stance. I think the question that has to be considered is, how can the United States government most vigorously and forcefully and effectively lobby the European governments towards that combined stance at the World Bank? It may be useful for this committee to decide how useful it would be to have some kind of congressional push for the administration in its lobbying efforts.

Mr. TAKEYH. The World Bank loans will actually play a larger role if the issue of Iran's nuclear weapons goes from IAEA to the U.N. Security Council. If Iran is deemed in noncompliance with its IAEA nonproliferation commitments, then potentially this issue can go to the U.N. Security Council, and under the auspices of the Security Council a range of multilateral sanctions will be considered. One of them would be suspension of not just the World Bank loans, but all international lending organizations. In that particular sense, World Bank loans do have a role to play, but we are not at that stage yet.

Chairwoman BIGGERT. What U.N. sanctions would have the most affect on the Iranian economy?

Mr. CLAWSON. On the Iranian economy, that is quite a different question than on the Iranian nuclear program. On the Iranian economy, blocking access to international capital would be a powerful signal that the Security Council regards Iran as a problematic country, and would frankly scare off the international oil companies that are talking about large-scale investments in Iran. It is the additional oil revenue that would be produced by the investments of those international oil companies that are really central to Iran's plans for growth. So scaring off international oil companies is what is going to have the impact. You probably do not have to ban the international oil companies in order to have that impact. You could probably get almost all of that impact by just banning new loans by international financial institutions to Iran.

Mr. TAKEYH. I think there is a paradigm of success enacted through the U.N., namely that sanctions that were imposed on Libya as part of the Lockerbie process. I don't think anyone is going to necessarily stop buying Iranian oil. They did not stop buying Libyan oil when Libyans were blowing up European aircraft in the air. Nevertheless, those U.N. sanctions had a significant and important impact on the Libyan economy in the sense that they prohibited financial transactions, technology transactions, travel restrictions, and so on. They did make an impression on the Libyan regime.

A similar set of sanctions enacted through the U.N. and adhered to by all the members of the Security Council, and indeed the international community, can have a similar effect. I do not necessarily think that it is going to stop international countries that rely on Iranian oil, that an increasingly large amount will stop buying this. Nevertheless, as Patrick said, once the U.N. Security Council makes prohibitions, it has intangible effects in terms of deterring foreign investments because Iran becomes a very risky area and the international investment community is inherently risk-averse.

Chairwoman BIGGERT. I think, Dr. Takeyh, that you commented in September that the U.S. Government should be flexible in its relations with Libya, since they were beginning to comply with international standards. You stated that they should be removed from the terrorist list. Do you feel the same way about Iran?

Mr. TAKEYH. No. I do not think Iran is the same say. Libya is no longer, according to documents by the State Department itself, engaged in terrorism in the sense that it is no longer participating and supporting rejectionist Palestinian groups and so forth. Libya has to remain on the terrorism list ostensibly because it had failed

to come to terms with the Lockerbie sanctions, with the compensation for the families. Iran is very much engaged in terrorism. It is an important supporter for Palestinian rejectionist groups, Hezbollah, and therefore Iran has earned its place on the terrorism list. I do think that that classification should be sustained in the case of Iran. Libya is a different sort of an issue.

Chairwoman BIGGERT. Thank you. I have run out of time.

The gentleman from California is recognized.

Mr. SHERMAN. Thank you. I first want to extend an offer to you gentlemen, but especially to the Deputy Assistant Secretary who was here earlier, to come to my district and explain why my taxpayers should be funding foreign aid if even a portion of it is being administered by bureaucrats who feel it should be sent to Teheran.

Dr. Clawson, it is said by looking at documents, that the World Bank does not make any of its decisions based on politics or the political or military actions of the borrowing country. Has the World Bank in effect denied loans at some time or another to China, South Africa, India, Pakistan, and Iran for political rather than economic reasons?

Mr. CLAWSON. I would say that in many of those cases, the political objections we have against a country are also objections about their economic policies. For instance, I worked at the International Monetary Fund when there was a very controversial loan considered for the South African government that many of us on the staff thought was a scandal because South Africa's apartheid policies were not just a political policy, but they had a profound economic impact on the country by introducing labor market distortions and rigidities. We thought that it was entirely appropriate for the IMF not to lend.

Mr. SHERMAN. But the World Bank's decision not to lend to China right after Tiananmen Square was not as a result of Tiananmen Square being a change in Chinese economic policy, although there was certainly an economic effect of the entire world scene.

Mr. CLAWSON. I would argue that after the Tiananmen Square episode, the Chinese government slammed on the brakes in making reforms on the state-owned enterprises and reversed direction on a lot of the efforts to introduce more market-oriented reform and to respect private property.

Mr. SHERMAN. Since my time is limited, I will interrupt you and take another tack. Is it possible that developing nuclear weapons and perhaps smuggling them into the United States, funding terrorism, sheltering al Qaeda, could lead to events that adversely affect the Iranian economy and its credit-worthiness?

Mr. CLAWSON. Yes, sir, but I would suggest that we can just rely upon rather more traditional World Bank considerations. This is an economy which by most estimates 70 percent of the economic activity is controlled by these shadowy foundations.

Mr. SHERMAN. So we have lots of good reasons not to lend money to Iran from the World Bank.

Mr. CLAWSON. Exactly.

Mr. SHERMAN. Okay. There is this idea that if you are walling off Iran economically, that no one brick is important. But you have ILSA, you have stopping World Bank loans; you have eliminating

all non-energy exports from Iran to the United States; you have efforts to stop further trade deals between Europe and Iran. Are all those bricks of some importance to building that wall, or are some of them irrelevant?

Mr. CLAWSON. They all have some importance. Some are great big huge bricks, and some are relatively small bricks.

Mr. SHERMAN. But if you are trying to build a wall, you try to put up all the bricks you can.

Mr. CLAWSON. And hopefully to have as large bricks as you can.

Mr. SHERMAN. Yes. Can you think of any other bricks? What other ways can we demonstrate to the Iranian people that they will be better off economically if their government changes its policies? What other bricks am I missing?

Mr. CLAWSON. I would think it would also be useful for us to put forward some of the carrots that would be available. In other words, a policy that shows that there are carrots that are available if you were to change your approach would also be helpful.

Mr. SHERMAN. I look forward to being an original cosponsor of the repeal of the "I" in ILSA when that government is no longer developing nuclear weapons and supporting terrorism. I look forward to finding additional ways to help the Iranian people.

Have there been times at the World Bank where the United States has, what should I say?, used all of its force, bare-knuckles or whatever, or just loud voice to stop a loan from the World Bank, situations where we have done more than just vote no, then have tea and crumpets with the people who voted yes?

Mr. CLAWSON. Absolutely. As a former bank staff member, I would rather not go into my experiences as a bank staff member.

Mr. SHERMAN. Wait a minute. This is not the CIA here.

Mr. CLAWSON. Fair enough, but I was, after all, an employee.

Mr. SHERMAN. Do you guys take some secret handshake loyalty oath, the hit squads if you violate?

Mr. CLAWSON. I can say, sir, that there were many occasions on which the United States——

Mr. SHERMAN. I am going to ask you to say specifically. You are not under subpoena here, but this is a congressional committee. Why should our tax dollars go to an organization that is more secretive than the CIA? They would answer the question, at least in closed session.

Mr. CLAWSON. International organizations, sir, I have to be concerned about their ability to work with all member governments. I think part of the great merit that U.S. membership in these organizations brings is that we can extract out of these governments information that we might not otherwise get. It comes in part because of the confidentiality of the employees.

Mr. SHERMAN. All I can say is, maybe you could come to my district and explain why money should go into a process that the American people who are paying at least 16 percent of the cost are deprived of finding out what is really going on. And also, how do you go to African countries and pound the table about the desirability of transparency when the World Bank itself gives opaque a new and startling definition?

I see my time has expired, but I look forward to a World Bank that practices what it preaches.

I yield back.

Chairwoman BIGGERT. Talking about the transparency of the World Bank, I was going to ask the question, if you can attribute the pace of disbursements to projects in Iran to the World Bank transparency and accountability requirements, which may be reacting to the level of corruption and mismanagement by the Iranian officials, it seems to me that it is pretty transparent. If you could comment on that?

Mr. CLAWSON. I would quite agree with you, and point out that Iranian observers also agree. There have been comments made in the Iranian press that the World Bank is insisting on a level of honesty in business transactions which is not the norm in Iranian procedures.

Chairwoman BIGGERT. Okay. Could you comment, then, just on the level of corruption within Iran's government and the business community?

Mr. CLAWSON. Outrageous, which is yet another reason why lending to Iran should be approached very carefully, because the Iranian observers tell us that the degree of corruption in Iran has grown very substantially over the course of the Islamic Republic. There have been numerous court cases which have revealed stunning levels of corruption in Iran.

Chairwoman BIGGERT. Dr. Takeyh, could you comment on that? What do you think is the view of the U.S. business community on economic sanctions and the prohibition against doing business with Iran?

Mr. TAKEYH. I would echo what Patrick said. The level of corruption has grown since the Islamic Republic, and there was a fairly high threshold before that. So this is a system that is rewarding a very narrow collection of people. These philanthropic organizations, the bonehs, that have metamorphosed into business conglomerates. The problem with their conduct is not only they are unaccountable, not only they do not pay taxes, but because they dominate sectors of industry and their corruption is profound. Almost any business transaction that you want to do in Iran today, you require some sort of a back pay to somebody.

Having said that, I am not involved in the American business sector, but I suspect that there are those who are willing to commercially interact with Iran, simply because the profits are high enough, particularly in terms of the petroleum sector. They are used to dealing with countries where there is some degree of financial opacity and corruption as a matter of course. Iran is a very difficult place to do business, and that in and of itself is a deterrent to foreign investment. There has been an attempt to pass foreign investment laws, but they have not been as successful as they should be.

So I would suggest that if there was an absence of U.S. sanctions, I suspect many American companies, both in petroleum and non-petroleum sectors, will actually bear this difficult business environment and return to Iran.

Chairwoman BIGGERT. I understand that foundations or quasi-government entities may be providing the majority of funding for Iran's nuclear program. Does that affect your analysis of the role

of the World Bank lending in Iran and its possible impact on the nuclear program?

Mr. TAKEYH. No. I think Iran has made a determination as a nation-state that it will pursue a robust nuclear research program. I do not believe they have made a decision to cross the nuclear threshold, but I think they are going to cuddle awfully close to that line. Bonehs I do not believe are instrumental in this. I think it is a national governmental decision made by all the relevant parties, not reformers, not conservatives. This is one of the few issues that everybody sort of comes together on. There is a consensus within this fractious body politic that nuclear weapons potentially could serve Iran's strategic deterrent interests. It is not a factional issue. It is a national one.

Chairwoman BIGGERT. So it does not matter if its foundations are quasi-government. It is the whole state that has made that policy.

Mr. TAKEYH. Some of the most ardent proponents of nuclear arms are similarly proponents of democratic transition.

Chairwoman BIGGERT. Okay. You said that despite some movement towards reform, the hardliners still maintain considerable political and economic control in Iran.

Mr. TAKEYH. Yes. The reform movement has not succeeded in dislodging the institutional influence of the hardliners. They maintain institutional control of the judiciary, key economic sectors, security services and foreign policy national security apparatus. The reform movement has power over elected institutions, but those elected institutions have not been able to infringe on the fundamentals of the conservatives' power. This is an evolutionary process. It may do so at some point, and we are in the beginning stages of democratic transition. It took many years for European countries and others to reach a more accountable, decentralized democratic polity. But at this particular stage, a snapshot would reveal that Iranian hardliners are in charge of the national security apparatus.

Chairwoman BIGGERT. So then how effective has the policy of economic isolation been, since there is no restriction on oil sales?

Mr. TAKEYH. In the absence of that, I am not quite sure it has been as effective. We have had economic sanctions on Iran since the inception of theocracy, yet this behavior on terrorism and weapons of mass destruction and destabilization of its neighbors has continued. The argument has been made that by having economic sanctions, whose cost is very difficult to quantify, but there is undeniable cost, that Iran will be deprived of revenue to invest in its terrorism portfolio. Yet at the same time, the terrorism portfolio is rather robust and intense. So there is a sort of a contradiction in that.

On issues that Iran has made an ideological or strategic commitment, it has not been deterred by imposition of unilateral American sanctions. If those sanctions become multilateralized, if the Japanese and Europeans begin to disinvest from Iran, that is a different category of issues.

Chairwoman BIGGERT. My time has expired.

Mr. Sherman?

Mr. SHERMAN. Thank you.

Dr. Takeyh, you talk about IAEA leading to U.N. Security Council, perhaps prohibiting further loans. Could this also prevent the disbursement of funds under loans already made?

Mr. TAKEYH. Patrick could speak about the World Bank procedures better than I can.

Mr. CLAWSON. Absolutely. I think that would be the normal thing to do.

Mr. SHERMAN. Dr. Clawson, what could the United States do to at least slow and use questions to slow the actual disbursement of loans already made?

Mr. CLAWSON. We can carefully examine the procedures that are being used for the procurement. It would indeed be quite appropriate, given the history of corruption in Iran and its track record, for us to look very carefully at the kind of procurement decisions being made, to make sure that bank rules are not being bent or twisted.

Mr. SHERMAN. Dr. Takeyh, we accept imports basically in three categories, nuts and fruits, carpets and caviar. Which political-family entities tend to control those three industries?

Mr. TAKEYH. I am betting the answer you probably already know is the Rafsanjani family. I think we sort of both know how this dance is going to go.

Mr. SHERMAN. So the decision by the Clinton administration continued both before and after September 11 by the Bush administration, in effect three different decisions, is basically putting caviar in our mouths and dollars in the Rafsanjani family pocket.

Mr. TAKEYH. It is not putting caviar in our mouths.

Mr. SHERMAN. In the mouths of certain Americans.

Mr. CLAWSON. And hurting California pistachio producers.

Mr. SHERMAN. That would be true as well. I know we don't have any carpets or caviar in California, though, and I would be happy to close off any one of those three.

Mr. TAKEYH. The robust Rafsanjani financial conglomerate benefits from those transactions, yes.

Mr. SHERMAN. And unlike oil where all you need to do is find one or two customers willing to pay a world price, oil being fungible and kind of an economic necessity, those luxury-type items need as many markets as possible. In the absence of markets, the price available to Iranian producers would decline.

The bill I have put forward not only would take money away from the World Bank, but give it to USAID. There are two arguments for the World Bank, one, maybe it is more efficient than USAID; makes better decisions. The other is the idea of leverage. Now, put leverage aside, because we go to donor conferences where USAID puts some money on the table and leverages that. And whether it is a donor conference or just discussions, every dollar USAID gets from Congress is a reason for parliaments in Europe to provide more money to their organizations. In terms of efficiency, does USAID spend money in the countries that need it, as effectively as the World Bank?

Mr. TAKEYH. The procedures and operations of an international lending organization is not my specialty. Patrick might know better about it.

Mr. SHERMAN. Dr. Clawson I think should be addressing that.

Mr. CLAWSON. Unfortunately, the answer on the whole is no.

Mr. SHERMAN. The World Bank is somehow smarter at spending money?

Mr. CLAWSON. The World Bank is both smarter at spending the money and subject to less bureaucratic reporting requirements, which are a significant problem in the efficiency with which USAID can carry out its operations.

Mr. SHERMAN. We have to get you over to the I.R. Committee and try to make USAID more efficient, although reporting requirements seem to be called for in dealing with countries with such opaque economic systems.

Dr. Clawson, which members of the World Bank seem to be pushing forward and arguing for these loans to Iran, and any idea why?

Mr. CLAWSON. I am not familiar with the debates going on there, but I would just point out a very interesting phenomena. As Mr. Schuerch pointed out, those who opposed the loans to Iran were the United States, Canada and France. So it is an interesting situation in which we and the French found ourselves on the same side, opposing a number of countries that are traditionally our allies, for instance, the British government.

Mr. SHERMAN. Did France do that as a favor to us or out of agreement with some of the arguments that are being made in this room?

Mr. CLAWSON. Agreement with some of the arguments being made in this room, and they said so explicitly.

Mr. TAKEYH. Particularly proliferation. The French are very aggressive on the Iranian proliferation issue, and they have the best intelligence on it.

Mr. SHERMAN. I am done. Thank you very much, gentleman.

Chairwoman BIGGERT. Thank you.

And thanks to the panel for your insights and your input today. We really appreciate your being here. Let me just add that the chair notes that some Members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will be open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

With that, this hearing is adjourned.

[Whereupon, at 11:42 a.m., the subcommittee was adjourned.]

A P P E N D I X

October 29, 2003

Opening Statement

Chairman Michael G. Oxley
Committee on Financial Services

Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

"World Bank Lending to Iran"
October, 29, 2003

Good morning. I want to thank Mr. King for convening this important hearing to consider the World Bank's lending to Iran and its relationship to U.S. policy regarding that country. The issue came up during the mark-up of legislation authorizing the World Bank's concessional lending window (the International Development Association "IDA") this spring.

Iran is sufficiently prosperous to disqualify it from IDA's concessional loans. Instead, it borrows funds from the World Bank at close to market rates for a range of development needs. Information provided by both the World Bank and Deputy Assistant Secretary Scheurch in his testimony today indicate that such lending is increasing, despite a clear foreign and international financial policy within the United States that this kind of engagement with Iran is undesirable and inappropriate.

It is troubling to learn that the reason for increased availability of World Bank funding to Iran is due primarily to European efforts to increase engagement with this country rather than to an assessment of that country's economic needs. This hearing will explore whether and how the United States can become more effective in promoting its foreign financial policy goals within the World Bank.

This hearing comes also at a sensitive time. Close scrutiny of Iran's nuclear program is beginning under the auspices of the International Atomic Energy Association (IAEA). Views differ among our expert panel today on whether continued engagement with Iran through the World Bank will facilitate or hinder the U.S. and European foreign policy goals of limiting or eliminating Iran's nuclear program. I am particularly interested to see the debate concerning whether in fact the World Bank's lending activities can have a direct or indirect impact on this activity since I understand that Iran's nuclear program is primarily funding through outside foundation or quasi-governmental sources rather than the government's budget.

I commend the Treasury Department for its efforts in this area to date, pursuant to statutory direction. Our goal here is to explore whether mandates to require U.S. "no" votes are sufficient to advance our broader goals within Iran. Some Members of our Committee believe that other, stronger measures are needed in this area. As the Committee of jurisdiction for the multilateral development banks, this is the appropriate venue to discuss these important issues.

Statement of The Honorable Rahm Emanuel
Committee on Financial Services
Subcommittee on Domestic and International
Monetary Policy, Trade and Technology
October 29, 2003

"World Bank Lending to Iran."

Mr. Chairman, thank you for holding this important hearing on the impact of World Bank lending to Iran. I also thank our distinguished witnesses for taking the time to share their views with us today.

The most recent State Department human rights report stated that President Khatami's regime continues ***"to pursue policies that threaten the interests of the United States, including support for terrorism, violent opposition to the Middle East peace process, pursuit of weapons of mass destruction, ballistic missiles, and advanced convention weapons, and suppression of human rights."***

Recent elections and protests in Iran indicate there is strong opposition to the radical clerics who have controlled Iran to the detriment of its citizens for the past 25 years. Although Iran's recent announcement that it would halt production of enriched uranium and submit to international inspections of its nuclear facilities supervised by the IAEA is a positive step, it remains to be seen whether those obligations will be met.

The Anti-Terrorism and Effective Death Penalty Act of 1996 requires the U.S. Executive Director to the World Bank to vote against new lending to Iran. Despite this mandate, however, the U.S. has been outvoted several times by other World Bank Board members, resulting in huge loans to Iran for four projects totaling $423 million, of which $37 million has been disbursed to date.

This international generosity comes while Iran enjoys the second-largest economy in the Middle East with a GDP of $115 billion and bountiful natural reserves – it is in fact the second-largest OPEC oil producer and has the second-largest natural gas reserves. Nevertheless, Iran continues to seek handouts from the World Bank, which is currently considering four additional loans to Iran in the amount of $540 million.

In this difficult economy with huge supplemental appropriations for Iraq and skyrocketing deficits and dramatic spending cuts here at home, I strongly support H.R. 1950, which instructs the Secretary of State to directly communicate to foreign governments that the U.S. opposes new World Bank lending to Iran. I was proud to vote for this bill when it was passed by the House overwhelmingly, and I strongly encourage the Senate to take it up as soon as possible. We must continue to apply strong diplomatic pressure on our allies in Europe, Asia, and elsewhere with the aim of defeating any new World Bank loans to Iran until its government takes real steps to improve relations and contribute to the stability of the Middle East.

As *Reuters* reported this morning, Deputy Secretary of State Richard Armitage said that the U.S. is ***"prepared to engage in limited discussions with the government of Iran about areas of mutual interest as appropriate."*** I look forward to hearing from the Administration about the specific policy options it is considering in this area, and to hearing from our witnesses today.

Thank you, Mr. Chairman. I yield back.

IMPACT OF WORLD BANK LOANS TO IRAN

BY PATRICK CLAWSON

Statement for the October 29, 2003 Hearing of the House Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy, Trade and Technology

Two important considerations in judging U.S. reaction to World Bank lending to Iran are: how important is World Bank lending be to Iran, and how would lending to Iran fit with World Bank practice? Let me address those two issues in turn.

How important is World Bank lending to Iran?
Iran faces difficult economic times for the next decade, because its "baby boom" after the 1979 revolution is entering the labor market. To prevent mushrooming youth unemployment – and the attendant risk that youth will take to the streets against the Islamic Republic – Iran needs to create at least 700,000 jobs a year. Despite growth averaging 5.8 percent per year in the last three years,[1] job growth has been well under that level; the last available data show that job creation averaged 255,000 a year in 1997-2000.[2] Youth unemployment has been contained only by expansion of university education and a wave of emigration (by some estimates, 180,000 a year) – neither of which are sustainable solutions over the next decade. Job creation could in theory come from economic reform, especially lessening the heavy weight of corruption, but there is no stomach among Iran's rulers to take that route. Their preferred approach is to secure sufficient foreign funds to meet the job creation challenge.

A recent International Monetary Fund (IMF) report on the Iranian economy predicted that Iran needs to mobilize $4 billion a year in foreign loans and direct investment if it is to achieve a level of growth which stabilizes unemployment, that is 5.4 percent per annum on average.[3] The report assumes that Iran will secure significant foreign investment in the oil industry and that Iran will borrow $3 billion a year. If Iran did not have access to that kind of foreign capital, it would suffer directly from the $4 billion a year shortfall and it would suffer further from the loss of the expanded oil exports that those funds would finance. In particular, the IMF forecasts that the foreign funds will allow Iran to expand its oil exports from 2.3 million barrels per day in 2002/03 to 3.9 million in 2008/09. If oil exports stagnated at the 2002/03 level, Iran would have $11 billion a year less by 2008/09. In other words, the foreign funds and the expansion in oil exports they make possible are central to Iran's economic plans – and could be key to preventing youth unrest that could threaten the current hardline government.

Lending by the World Bank would under any circumstances be a small part of the $4 billion a year Iran needs to raise from abroad. After all, since lending resumed in May 2000, the World Bank has approved loans totaling $432 million, or less than $150 million a year. It will be interesting to see what the World Bank staff proposes as a lending program for Iran for the next few years in the Country Assistance Strategy (CAS) report to be presented to the World Bank

Executive Board by June 2004. However, the magnitude of World Bank lending understates its impact. As the World Bank correctly emphasizes, its lending has a catalytic effect on other lenders and investors, that is, lenders and investors are more likely to place their funds in a country where the World Bank has found that the business climate and economic policies are sufficient to merit World Bank lending. In other words, World Bank lending could have a significant impact on Iran's ability to raise international capital and therefore on its economic prospects.

That said, it is by no means clear that restricted access to international capital would lead Iran to reduce its military spending, including spending on its nuclear program. The record of the last few years is discouraging in the regard. Iran faced a real problem in the mid- and late-1990s due to the imposition of U.S. sanctions in 1995 and the U.S. pressure on lenders and investors not to put their funds in Iran. Not only was Iran's access to new lending and investment reduced, but it also had to make large payments on the foreign debt it incurred in the heady days after the end of the Iran-Iraq war in 1989, when more than $30 billion flowed into Iran over four years on the false expectation that the Iranian economy would boom. Iran's response to this tough situation was to restrict civilian spending enough to repay the debt, while at the same time devoting enough resources to make unexpected progress in its nuclear program. From this experience, it is quite possible that Iran would respond to any new shortfall in expected foreign loans and investment by cinching in its belt further.

An additional complication is that Iran's international economic situation is highly dependent on the price of oil. Oil prices were quite a bit higher the last few years than they were in the mid- and late-1990s. The spot price for Dubai oil averaged $24.30 in 2000-02 compared to $15.99 in 1993-99. [4] That difference meant an extra $7 billion a year for Iran. With that money, Iran was able to repay most of its foreign debt and build up a cushion of $21.8 billion in foreign exchange reserves as of March 2003.[5] In other words, Iran used the extra income from the high oil prices to reduce its vulnerability to economic pressure and to build up a substantial cushion. This makes Iran much less susceptible to economic pressure. And if the price of oil were to stay at the average 2002/03 export price of $27.10 per barrel instead of declining to $19.70 by 2006/07 as assumed by the IMF, Iran would earn an extra $9 billion a year in revenue. Indeed, relatively small swings in world oil prices are as important to Iran's economic prospects as are its access to international capital.

In short, World Bank lending will matter much more to Iran if oil prices decline faster than expected. If Iran faces tough economic times due to low oil prices and lack of access to international capital, that could strengthen popular protests against the hardline government; at the same time, that government could well decide to make whatever sacrifices are needed to keep the nuclear program on track.

How would lending to Iran fit with World Bank practice?

Iran's highly distorted economy makes it a poor candidate for World Bank lending. The revolutionary foundations ("bonyads") control up to 70 percent of the non-oil economy, and they are dens of corruption and special dealing. The entire economy is distorted by the heavy

subsidies on domestic energy, which the Iranian government estimate cost $11 billion a year, or nearly 10 percent of national income. The pernicious effects of the energy subsidy include excessive consumption of electricity, which is one reason Iran is investing in so many new power plants.

As it does in other countries with such poor economic policies, World Bank lending to Iran should be confined to social services and semi-humanitarian loans, such as the present Bank loan for earthquake reconstruction, sewage, and environmental protection. The United States should press hard to ensure that the World Bank does not bend its usual procedures, which are to insist on economic reforms and appropriate policies before the Bank can lend to a sector. It would be particular scandalous were the Bank to lend to the electricity sector in Iran, given that Iran is wasting more than a billion dollars on the construction of a nuclear power plant when the electricity could be much more economically produced using Iran's ample natural gas. For more than twenty years, the World Bank has had a policy of avoiding loans for the electricity sector in any country building a nuclear power plant. The economic stupidity of the Bushehr nuclear power plant is ample reason for the World Bank to stay away from electricity loans to Iran; one need not raise the many proliferation concerns which Bushehr entails.

It would be entirely consistent with World Bank procedures for the U.S. government to vigorously lobby the Bank's management and Executive Board about the inappropriateness of lending to a country with as poor economic policies as those of Iran. Raising explicitly political objections is a different matter. The ethos of the World Bank, reflected in its charter, is that loans should be decided on economic and financial criteria. It would be difficult to gain international consensus to change this approach. Furthermore, there are grave risks to U.S. interests if foreign policy considerations dominate decisions about World Bank lending. Many governments oppose aspects of U.S. foreign policy, and they could be tempted to bloc World Bank loans to U.S. allies. An important case in point is the World Bank's announced intention to lend $5 billion to Iraq by 2007. Were foreign policy considerations to weigh heavily in World Bank calculations, gaining approval for that lending to Iraq could be problematic.

There is one circumstance in which the World Bank would almost certainly let politics determine its lending to Iran, and that is if the UN Security Council were to order action. In the event Iran is found by the International Atomic Energy Agency (IAEA) to be out of compliance with the Treaty on Non-Proliferation of Nuclear Weapons (NPT), the Security Council will face the question of what actions to take to press Iran. The Security Council is likely to be reluctant to start with far-reaching steps such as comprehensive economic sanctions. In the search for more measured restrictions on Iran, surely banning access to lending by international financial institutions such as the World Bank deserves consideration.

In short, the U.S. government can vigorously press against World Bank lending to Iran because of its poor economic policies. Raising more explicitly political objections is more problematic, but should be considered through the Security Council if Iran is found in violation of its NPT obligations.

Patrick L. Clawson is Deputy Director of The Washington Institute for Near East Policy. His previous positions include five years as senior research professor at the Institute for National Strategic Studies of the National Defense University and senior economist for four years each at the Foreign Policy Research Institute, the World Bank, and the International Monetary Fund. His books and monographs include *How to Build a New Iraq After Saddam* (The Washington Institute for Near East Policy, 2002, edited); *The Last Arab-Israeli Battlefield? Implications of an Israeli Withdrawal from Lebanon*, (The Washington Institute for Near East Policy, 2000, with others); *Dollars and Diplomacy: The Impact of U.S. Economic Initiatives on Arab-Israeli Negotiations* (The Washington Institute for Near East Policy, 1999, with Zoe Danon Gedal); *Iran Under Khatami* (The Washington Institute for Near East Policy, 1998, written with others); *Iraq Strategy Review* (The Washington Institute for Near East Policy, 1998, edited); *U.S. Sanctions on Iran* (Emirates Centre for Strategic Studies and Research, 1997); and *Energy Security in the Twenty-First Century* (National Defense University Press, 1995, edited). Dr. Clawson is senior editor of *Middle East Quarterly*. He was graduated with a Ph.D. from the New School for Social Research and a B.A. from Oberlin College. He speaks Persian (Farsi), Hebrew, and French, among other languages.

Notes

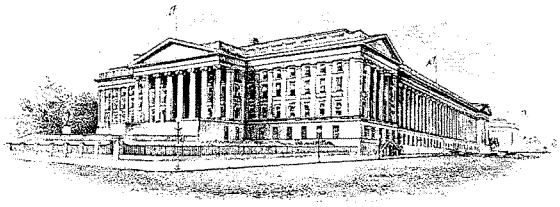
1. International Monetary Fund, "Islamic Republic of Iran: Staff Report for the 2002 Article IV Consultation," August 1, 2003, p 6.

2. IMF 2003 Staff Report, p 17.

3. IMF 2003 Staff Report, p 34, which is the "baseline medium-term scenario under current policies" through 2008/09.

4. BP Statistical Review of World Energy, June 2003, p 14.

5. IMF 2003 Staff Report, p 34.



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Testimony by Deputy Assistant Secretary of Treasury William E. Schuerch
before the House Financial Services Subcommittee on Domestic and International
Monetary Policy, Trade and Technology
October 29, 2003

Implementation of United States Policy on
Multilateral Development Bank Lending to Iran

Chairman King, Ranking Member Maloney, and distinguished members of the Subcommittee, we welcome the opportunity to testify today on the implementation of United States policy on Multilateral Development Bank lending to Iran. As you know, this is not a new policy and this Administration agrees with Congress that Iran should not have access to multilateral development bank resources. I want to assure you that the Treasury Department and the U.S. Executive Director at the World Bank, while not fully successful, have consistently and actively sought to block all proposals for World Bank Group assistance to Iran.

World Bank Role: Before discussing lending to Iran, there are a few points to be made about the critical role of the World Bank Group itself. First, the Bank plays a role in helping the United States achieve its efforts to increase world economic growth, reduce poverty, build open market economies, and encourage the growth of civil society. Second, the Bank is an important foreign policy tool for the United States, and is a vehicle for leveraging our foreign assistance resources throughout the globe. The Bank has played a critical role in responding to the democratic and market openings in Central and Eastern Europe and in what we used to call the Newly Independent States of the Former Soviet Union, in Bosnia, in Afghanistan and in combating terrorist financing. Concerning Iraq, it has completed a needs assessment; it will manage a trust fund for other donors, and it has recently pledged significant resources for rebuilding.

Afghanistan: In addition to committing $500 million in concessional loans and grants over a four-year period beginning in 2002, the Bank is playing a key role as the administrator of the Afghanistan Reconstruction Trust Fund. Projects funded by the Bank so far include the rehabilitation of crucial transportation infrastructure including the Kabul-Doshi road, the Kabul airport, and the Salang Tunnel, as well as other public works, power supply, and emergency infrastructure work. The International Finance Corporation (IFC) has committed to finance two projects in Afghanistan, a $1.25 million equity investment in October 2002 to support micro-financing and a $7 million loan in June 2003 to support a hotel project.

Combating Terrorism Financing: At the request of the United States, following September 11th, the World Bank increased its efforts to ensure that Bank funds are not diverted to terrorists or their agents. The Bank is working with borrower countries to clarify its due diligence requirements. The Bank also has been increasing technical assistance and support for capacity building; working to improve understanding of the development cost and governance impact of money laundering and financial abuse; working with relevant anti-money laundering groups; and enhancing anti-money laundering (AML) diagnostics.

Iraq: Most recently, we are working with the Bank and other donors to ensure financing for Iraq reconstruction. The Bank, along with the United Nations, joined the Iraq International Advisory and Monitoring Board (IAMB) and played a central role in carrying out the development needs assessment over the past summer – in the process, losing a member of Bank staff in the attack on UN headquarters in Baghdad. Last week, the Bank publicly committed at the Madrid pledging session that, once other factors including debt sustainability, settlement of arrears, the security situation on the ground, and governance issues are resolved, we could anticipate as much as $3 to $5 billion in reconstruction assistance.

Iran Lending: Now, as concerns World Bank Group lending to Iran and U.S. policy; our efforts to block these resources is consistent with Congressional intent on both terrorism and human rights. We share Congressional concerns about terrorism and abuse of human rights, Iran's WMD programs, particularly nuclear, which are currently being investigated by the IAEA, and also believe that Iran needs to aggressively pursue economic reforms.

Regarding economic reforms, we believe that while Iran has recently undertaken exchange rate and trade liberalizing measures, the authorities have failed to take full advantage of historically high world oil prices to implement much-needed macroeconomic and structural reforms. The economy continues to suffer from over-centralization, structural weaknesses, excessive expenditures on non-productive activities, and poor governance. To address these problems, Iran must broaden, deepen, and accelerate the reform process. Although some progress has been made to cut subsidies in retail gasoline prices and certain food staples, the system of poorly targeted subsidies, especially energy subsidies, continues to place a significant burden on the fiscal deficit and must be overhauled. Administrative controls on production, credit and exports should be rolled back substantially. More aggressive financial sector reforms are needed to modernize banking supervision and the payments clearing system, to begin taking concrete steps to privatize state banks, and to reduce directed credit. In addition, labor market reform should be pursued to make it easier to hire and fire workers by reducing high dismissal costs and excessive

regulation, and to allow markets, as opposed to the government, to determine salaries in various sectors.

The United States' efforts to block World Bank Group assistance to Iran were fully successful for seven years, from July 1993 to May 2000. During this time, we developed a consensus among the G-7 nations enabling the blocking of all World Bank lending to Iran. Unfortunately, by May 2000 the coalition split when other members of the G-7, particularly the Europeans, began supporting re-engagement with Iran. Some of this re-engagement was due to their expressed view that engaging with Iran's "reformers" would support them in their efforts against Iran's hardliners – a view which is still evident as the Europeans negotiate with Iran over their nuclear program. In addition, the commercial opportunities in Iran, where U.S. companies could not compete due to U.S. sanctions, have been enticing to many of our G-7 partners. Thus, despite U.S. "no" votes in May 2000, and abstentions from France and Canada, the rest of the World Bank Executive Board approved two loans to Iran: a $145 million loan for the Tehran Sewerage Project and an $87 million loan for the Second Primary Health Care and Nutrition Project. Later, in May 2001, the World Bank Executive Board also discussed an Interim Assistance Strategy for Iran. The strategy proposed lending during the following two years for low income housing, sewerage, urban upgrading, and community-based infrastructure and employment creation schemes for the poor. We opposed the strategy, again raising our serious concerns about the Bank's engagement with Iran. Since then, and despite our ongoing efforts to convince other World Bank shareholders not to support further lending to Iran, the World Bank Executive Board approved additional projects for Iran: a $20 million loan for an Environmental Management Support Project in April 2003 and a $180 million loan for the Earthquake Emergency Recovery Project in June 2003.

Following this new lending in the World Bank, the IFC Executive Board, in December 2002, approved a $5 million investment in a joint venture between a private Iranian bank, a major French bank, and the IFC. This was the first IFC investment in Iran in 25 years. Again, the United States voted "no" and lobbied other countries to join us in opposing the loan.

While this is the full picture of MDB lending to Iran since 1993, in the interest of full disclosure, I want to point out that there are currently four additional projects in the World Bank pipeline for Iran: an $150 million project to establish a local development fund, an $80 million project for low-income housing, an $120 million project for water supply and sanitation and an $295 million project for urban "de-urbanization."

In summary, from July 1993 to May, 2000, U.S. efforts to block World Bank Group assistance to Iran was fully successful because our G-7 colleagues shared our view that not engaging with Iran was the appropriate policy stance. However, since May 2000 our colleagues have taken a different view, lending to Iran has totaled $432 million primarily for basic human needs and aimed at lower income levels.

I want to emphasize that the lending to Iran that has occurred is from the World Bank's International Bank for Reconstruction and Development (IBRD) window and from the IFC. It is not from the International Development Agency (IDA). As such, lending to Iran is provided at

market rates, not concessional rates and maturities. The IFC funding, while supporting investments in Iran, is not provided to the Iranian Government itself, but to private companies.

Conclusion

The World Bank has 183 member countries. The U.S. is the largest single shareholder with a voting share of 16.4%, but does not own a controlling interest in the institution or a veto on specific lending decisions. Blocking MDB support for a country is difficult, but occasionally has been possible when there is substantial international outrage following specific events. Some examples are the 1989 events in China's Tiananmen Square, nuclear testing in1998 by India and Pakistan, and, beginning in 1987, the repression and house arrest of opposition leaders by the military junta in Burma. Inevitably, however, as the force of immediate international outrage wanes, it becomes difficult to sustain the international consensus that is needed to continue to block lending to a country.

Finally, Mr. Chairman, I would like to emphasize this Administration's consistent voting record against assistance to Iran and our continued efforts to discourage World Bank engagement with Iran. The Administration will continue to oppose Bank lending until meaningful political, economic, and human rights reforms have taken place. We will also continue efforts to marshal support among other donor countries, with Bank management, and other shareholders to limit World Bank Group support to Iran.

Thank you.

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House subcommittee on Financial Services

Iran and World Bank Loans

Much has changed in the Middle East during the past year. Saddam's tyranny has been finally displaced and even the most recalcitrant Arab despots are speaking the language of political reform. In the midst of these cataclysmic changes, the one state in the region whose priorities and policies appear constant is the Islamic Republic of Iran. On the surface, the clerical state seems committed to its course of confrontation with the United States and to its defiance of international norms on issues such as terrorism and proliferation of weapons of mass destruction.

The remarkable events of the recent past, however, have had a subtle yet perceptible impact on Tehran's foreign policy, opening the possibility of international pressure having a measurable impact on Iran's behavior. Throughout the late 1990s despite the assumption of the presidency by the reformist Muhammad Khatami, factional politics, competing centers of power and the legacy of revolution obstructed Iran's uneasy transition from a revisionist to a pragmatic state. Too often, national interests were sacrificed at the altar of revolutionary dogma.

However, the exigencies of the post Iraq war period and the massive projection of US power on Iran's periphery have finally shattered old taboos and engendered a new consensus behind a foreign policy of pragmatism. For the first time, the clerical estate is exhibiting much more sensitivity toward international opinion and is finally responding to multilateral diplomacy. Paradoxically, it took the arrival of the more hawkish Bush administration and its wars in the Middle East to finally press Tehran toward a more judicious suppression of its retrograde revolutionary impulses.

As the recent Iranian acceptance of the IAEA mandates reveal, should the international community come together and press Iran, Tehran will respond positively. The suspension of World Bank loans to Iran can make an impression on the recalcitrant theocracy only if they are part of a larger, multilateral strategy. The mere denial of such loans to Iran, absent other measures, will have only a marginal impact and is unlikely to fundamentally alter the demarcations of the debate within Iran's corridors of power.

The trajectory of Iran's Foreign Policy: Since the Islamic Republic's inception in 1979, Iran's international orientation has undergone a steady yet halting march toward pragmatism. For Ayatollah Ruhollah Khomeini, the founder of the republic, the export of the revolution overrode the demands of Iranian national interest and the restrictions of statecraft. The Grand Ayatollah saw himself as acting not on behalf of a state, but the entire Islamic community. He therefore felt limited compunction about interfering in the

internal affairs of sovereign states. Iran would continuously sacrifice its tangible interests in order to foment uprisings in the Gulf, intensify Palestinian rejectionism and provoke unneeded confrontations with the United States. International isolation, economic hardship and a devastating eight-year war with Iraq were the sole byproducts of Khomeini's divisive diplomacy.

Khomeini's passing in 1989 inevitably led to a reassessment of Iran's foreign relations, as the task of reconstruction after the Iran-Iraq war necessitated coming to terms with the international community. However, the continued primacy of revolutionary passions prevented a fundamental break with the past. The substantive revision of Iran's orientation had to await the ascendance of the moderate cleric Muhammad Khatami to the presidency in 1997. Although Khatami and his reformist allies failed to usher in a liberalized theocracy, they did set the stage for Iran's integration into the international community and generated an internal coalition that was much more sensitive to international sensibilities and concerns.

The reformist foreign policy focused on expansion of trade, cooperative security measures and diplomatic dialogue as a means of advancing Iran's interests and projecting its influence. Along these lines, Iran normalized relations with the Gulf states and the European Union and resisted the temptation of exporting its Islamist message to the contested lands of Central Asia. Ideological dogma and the propagation of revolutionary Islam were not only inconsistent with the reformist perspective, but also had a limited utility in the age of globalization.

Khatami's accomplishments, however, were qualified. Policies on key issues such as Iran's hostility to the United States and the Israeli-Palestinian peace process continued to derive from a self-defeating ideological calculus. Confident of their ideological verities and secure in their confrontational posture, Khomeini's remaining disciples—particularly the Spiritual Leader Ayatollah Ali Khamenie—employed their impressive institutional powers to undermine initiatives designed to lessen tensions with the "Great Satan." Beyond ideological rigidity, Iran's factional politics held foreign policy issues hostage to the domestic political stalemate. The conservatives, mindful of the enormous popular credit that reformers would reap should they succeed in normalizing ties with Washington, systematically subverted all such efforts. Through much of the late 1990s, Iran was a perplexing state whose foreign policy was driven by a contradictory mixture of revolutionary convictions and practical considerations. The Islamic Republic had reached an impasse.

The reactionary elements of the Iranian state could afford their confrontational ideology, as the benefits garnered by such militancy outweighed the costs. The American colossus was too distant, its leaders too fickle and its struggles against terrorism more symbolic than real. The Bush administration, however, with its expansive vision for the Middle East and its military displacement of two recalcitrant regimes, has now confronted the Iranian Right with realities it can no longer ignore and responsibilities it can no longer evade. A powerful coalition of reformers and conservatives is coalescing around the understanding that, in the altered regional landscape, Iran must come to terms

with the international community. Although Iran's domestic political terrain is still too fragile and contested for a grand deal, it is uniquely suitable for sustained international pressure. Iran's theocracy is much more attuned to the demands of the international community and is much more prone than in the past to make concessions should it confront international solidarity.

Multilateral Success: No other issue has disturbed the Bush administration and indeed the entire international community, more than Iran's desire for nuclear weapons. The largely completed Bushehr plant, the extensive uranium enrichment facilities in Natanz and similarly advanced uranium conversion plant in Esfahan indicate that Iran has invested considerable sums in its nuclear infrastructure. The Bush administration's success in this realm came when it crafted a multilateral consensus against Iran's proliferation tendencies. The successful US diplomacy managed to obtain a unanimous resolution through the IAEA demanding Iranian compliance with its non-proliferation agreements. The US pressure alone would not have succeeded had it not been buttressed by concrete measures by the Europeans and Japan. The European Union's refusal to complete its trade and cooperation agreement with Tehran unless the theocracy accepted the mandates of the IAEA made an important and indeed decisive impression on Iran rulers. In the meantime, Japan was similarly important in propelling Iran toward the proper path, as Tokyo resolutely refused to sign additional commercial contracts with Iran, particularly in the area of oil exploration, until Tehran abided by its non-proliferation pledges. The combined pressures of US and its allies ultimately forced Iran into acquiescing to the IAEA and accepting its enhanced protocols.

The reality remains that Iran's militancy is not constant; its pragmatic curtailment of terrorism in the Persian Gulf and Europe demonstrates that diplomatic pressure can encourage moderation from the Islamic Republic. The lessons of the experience of the European and Gulf states are indeed instructive. Long-standing practices of the Islamic Republic were the assassination of dissidents living in Europe and support for opposition forces in the Gulf sheikdoms. These reached their apex in 1992, when Iranian agents assassinated exile Kurdish leaders in Mykonos restaurant in Berlin. The 1997 conviction of Iranian agents in a Berlin court led the European Union to promptly withdraw its envoys from Tehran while Germany imposed trade restrictions on Iran. Given the value of European commercial and diplomatic ties, Iran abandoned the practice of targeting exiles abroad and in essence, closed one of the darker chapters in its terrorism portfolio. Similarly, a precondition for Saudi Arabia and the Gulf states normalizing relations with Iran was its cessation of support for opposition groups within those countries. Once more, given the strategic and economic value of resumed relations, Iran ceased its interference in the internal affairs of Gulf states. Both episodes reveal that confronted with multilateral economic pressure, Iran will accept the demands of the international community and cease its objectionable practices.

Conclusions: The suspension of World Bank loans to Iran will not impact Iran's deliberations on issues of terrorism and weapons of mass destruction. The trajectory of Iran's foreign policy and its overall conduct reveals that the theocracy responds only when it is confronted with multilateral pressure spearheaded by its important commercial

partners, particularly the EU and Japan. A US policy that encompasses American pressure and European determination will have far-reaching effects on Iran and extract important concessions from the theocracy. Should the suspension of the World Bank loans to Iran be part of a larger, concerted, multilateral economic pressure then it will produce the desirable results. However, as a solitary measure, it is unlikely to be an effective tool of coercing Iran in the right direction.

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