S. HRG. 110–929

REFORMING KEY INTERNATIONAL FINANCIAL INSTITUTIONS FOR THE 21ST CENTURY

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

REFORMING INTERNATIONAL FINANCIAL INSTITUTIONS

THURSDAY, AUGUST 2, 2007

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

50–355 WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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U.S. SENATE,
SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:36 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Evan Bayh, (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN EVAN BAYH

Chairman BAYH. I am pleased to call to order the hearing of the Subcommittee to focus on reforming key international financial institutions for the 21st-century.

I want to thank our chairman, the Banking Committee Chairman, Senator Dodd, for his assistance in arranging the hearing and for his support in looking into these important matters.

I also want to recognize the leadership of Senators Biden and Menendez on the Foreign Relations Committee. We sort of have, in some ways, a hybrid hearing here today. We had this experience for the full Banking Committee yesterday, focusing on some aspects of global trade where there was joint jurisdiction between the Finance Committee and the Banking Committee. Today we have the Banking Committee and the Foreign Relations Committee.

So I am fully respectful of their leadership, of their jurisdictional rights, and look forward to cooperating and working with them on these important issues and want to thank them also for their focus on the subject of today's hearing.

We have Senator Martinez, my colleague and friend, the ranking minority member with us today. Mel, I want to thank you for your leadership.

Also Senator Casey, thank you, Bob. Good working with you. And I appreciated your forbearance during my testimony the other day before the Foreign Relations Committee. You were very kind to chair that important hearing. I hope it went well after I left.

What I would like to do is just make some brief comments of my own, then Mel, look to you and Bob to you for your comments. I will then introduce our panelists and call on you in order.

I think our ground rules today, I will be generous with the time. If we could, for the oral comments, try to shoot for 5 minutes give or take. The full written statements you have been kind enough to submit will be submitted in their entirety. If you have to go over a few minutes, that is OK. But please do not be Senatorial in the length of your remarks. We will try and be a little briefer than that here today. And then we will go to questions and alternate among members of the Committee who are here, try to keep our questions to 5 minutes. If there is need for a second round, we will do that.

Let me give my own brief opening remarks, Mel, and then I will turn to you.

Chairman BAYH. Almost exactly 63 years ago, in fact it was July 1944, some of the worlds most celebrated economists gathered in Bretton Woods, New Hampshire to design a system of trade, monetary policy, and development that would prevent the catastrophic events that led to the Great Depression and World War II from recurring.

Then Secretary of State Cordell Hull, British economist John Maynard Keynes, and other luminaries articulated policies on trade, monetary policy, and poverty alleviation and created an international architecture to promote those policies.

Today we gather with some notable experts of our own to ask whether these lofty objectives can be achieved or are being achieved and whether the structure established to promote them is working well or whether fundamental reform is in order to achieve these objectives in the context of the 21st-century.

Since Rodrigo de Rato will be leaving his post as Director of the International Monetary Fund, this is an opportune time to take a close look at the institution, its effectiveness, and what reforms may be needed. Yesterday the Banking Committee took an initial step toward dealing with the problem of exchange rate manipulation domestically. Today we have an opportunity to discuss what relevant international financial institutions can be doing to address this issue. In fact, I think you can argue that an absence of multinational focus on this issue has left nations such as our own to deal with it unilaterally. And that is what we began to do in yesterday's Banking Committee, along with our brothers and sisters in the Finance Committee.

In recent years, the IMF was able to help reestablish financial stability after crises in Asia and elsewhere. Today the IMF is struggling to define its purpose. The American public is more concerned about exchange rate manipulation that at any point in our history. And yet the IMF seems completely unable to address this problem.

China's increasing undervalued currency is a glaring reminder that the IMF is unable to manage international exchange rates. Or if it is able, has so far been unwilling.

The United States faces a dilemma on another issue of whether to grant increased voting rights in the IMF for countries that apparently are violating one of its primary tenets.

With regard to the World Bank, like the IMF, 2007 marks a shift in leadership. In June the Bank welcomed former U.S. Trade representative Robert Zoellick as its 11th president. The motto of the Bank is "Working for a world free of poverty" and all nations should support that important objective.

Unfortunately for the IMF, the World Bank suffers from its own set of problems. Many believe that the Bank has become too willing to accept corruption as just another cost of doing business in certain countries and has internal staff that resists efforts to change.

The question before us is whether the Bank, as currently constituted, is an effective instrument for achieving the very noteworthy objective of poverty alleviation. Many believe the Bank has become too willing to—the vast majority of the Bank, excuse me. The vast majority of the Bank's IBRD lending is in countries that no longer need the Bank for development finance. What should the role of the public and private sectors be in such circumstances?

The Bank's consideration of using country systems procurement directly conflicts with the direct wishes of the U.S. Senate, as expressed in previous votes. What should be done about that?

Accountability, apparently, has all too often broken down, whether for bad lending decisions or for evaluating performance based on results rather than just the volume of loans which have been approved. Success all too often appears to be defined by the volume of activity rather than the amount of poverty actually alleviated.

These are some of the important questions we have gathered to explore today. We are fortunate to have a distinguished group of panelists, as I mentioned. But before we turn to them, I would first like to give my colleagues an opportunity for their perspective.

Senator Martinez, we will begin with you.

STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Mr. Chairman, thank you very much and appreciate very much you calling this hearing. It is very timely, particularly doing so right before our August recess. I thank the panel for taking time from your busy schedules to be with us on a hot August afternoon.

The International Monetary Fund and the World Bank are very important components of our financial system in the world and I think it is telling that the last time there was a hearing on these institutions was in 2004. So it is more than time that we address it and look to you for your guidance and your comments.

It is a very dynamic world in politics and economics that we live in, and so therefore it is important that we take a temperature check, that we see where things are relevant to today, and the relevance of these institutions going forward.

So I welcome each of you here today and thank you for your time and look forward to hearing your expertise in this very important topic.

I am very interested in hearing your views about the changing role of the IMF and what impact the current and projected economic environment might have on its relevancy. I am also concerned that the IMF and the World Bank continue to decline as relevant institutions to the global financial systems and whether they might, if that continues, be replaced by more regionalism. That would have, I think, a negative impact as we look to certain regions of the world. One in which I am very interested in is Latin America. I know that there are potential there for rogue states or, frankly, things that I do not think would be in the best interest not only of our country but of the world financial system.

I am also very interested in your testimony as it relates to corruption within the institutions. Misallocation of resources by officials who do not have the public interest at heart is a big concern to me. So I would like to know to what extent you believe corruption is plaguing the developing world, as well as your thoughts on how effective these institutions are at dealing with that very specific problem.

The IMF and World Bank are critically important to the international financial framework and since their inceptions their goals have been to increase economic and financial stability and to raise economic growth and reduce poverty. While the goals are still relevant, the institutions need to be equal to the challenge to meet the changing world in which we live and to address the goals that have been set.

So I look forward to hearing your comments and to our discussion as the afternoon wears on.

Mr. Chairman, I thank you again for your courtesy and for calling this hearing at a very timely moment.

Thank you.

Chairman BAYH. Thank you, Senator Martinez.

Senator Casey.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Chairman Bayh, thank you very much for calling this hearing and Ranking Member Martinez as well. Thank you for your leadership on this.

And to our panelists, I have to say I will be somewhat parochial here and mention that Dr. Lerrick has some roots in Pennsylvania at Carnegie Mellon and we are grateful that he is here. I hate to do that but when you come from a State like Pennsylvania it is important to mention people that are making use of the great institution that Carnegie Mellon is. Thank you very much.

And all of the panelists, because your testimony today and the information you provide through question and answer gives us a great insight into these issues, very important issues for the world, for our country in terms of governance, in terms of reform. One of the problems for me today as I will not be able to stay very long. I have to preside over the Senate. There was an emergency change when one Senator had to change their time. So one of the responsibilities that these two distinguished senators to my left do not have as much of because they have been here longer is to preside over the Senate. So I have to show up when I am called.

Senator MARTINEZ. I also have another affliction, that I happen to be in the minority.

[Laughter.]

Senator CASEY. We are going to be trading hours, maybe.

So I may not be able to ask any questions today but I did want to thank you for your testimony and appreciate what you are trying to do in providing that testimony.

I think a lot of the issues that will be discussed today and beyond today, either in your presentations or submitted for the record, are critically important. Just noting a few of them, the IMF enforcement authority and its ability to enforce its authority with regard to member responsibilities, a proposal that has been floated to change the distribution quotas in order to give developing countries and emerging market countries more influence in the organization. We would like to hear about that, obviously. But a whole series of important issues that bring to bear all of the experience that you bring to this hearing today in your testimony. So we are grateful to that.

Contrary, I guess, to popular belief these hearings provide us with a lot of important information. The expertise and the knowledge and experience you bring here gives us the kind of foundation of knowledge that we cannot just get among ourselves. We all have great staffs and this, I think, amplifies their understanding of some of these issues. So we are grateful to that and we are grateful for the service that you are providing today and we look forward to your testimony.

Thank you very much.

Chairman BAYH. Thank you, Senator Casey. We fully understand when you need to leave to preside.

Senator Martinez, one of the few benefits of being in the minority is you do not have the obligation of presiding on the floor. So that is finding a silver lining, I understand, but an important one nonetheless.

I want to thank all of you for your time today. I know you are very busy and could be doing other things. At least a couple of you have appeared before the Subcommittee before on other topics so I am grateful to have you back once again.

I am going to make very brief introductions, so if I leave out a lot of the good things that I have here about each and every one of you, I am just doing that in the interest of time and hope you will understand.

First, with regard to Dan Tarullo, thank you for coming back. Dan Tarullo is a Professor of Law at Georgetown University where he teaches in the areas of international economic regulation, banking, and international law. He spent a year as a Senior Fellow at the Council on Foreign Relations and is currently a Nonresident Senior Fellow at the Center for American Progress. He served in a variety of other important capacities, is widely published. Dan, it is good to have you back once again.

I will just complete the introductions and then we will just start with you.

Adam Lerrick, thank you for coming back once again, you have been before us previously. I think Argentina was the subject at that time. Some of these things are recurring. Perhaps you will be on that subject again one day.

Adam Lerrick is the Friends of Allan H. Meltzer Professor of Economics and Director of the Gailliot—did I get that correct? Gailliot Center for Public Policy at Carnegie Mellon University. He is currently a visiting scholar at the American Enterprise Institute. While at AEI, he is studying international capital markets, financial crises, sovereign debt researching, and economic development including the impact of aid and the role of multilateral institutions. Dr. Lerrick, thank you for being with us once again today.

Next we are pleased to have Karin Lissakers. With a last name like mine, I am always sensitive to try and get the pronunciations correct. I have been called a variety of things over the years, but rarely Bayh until people have met me and heard my pronunciation for the first time.

Karin is Director of the Revenue Watch Institute, a nonprofit organization that promotes transparent and accountable management of oil, gas, and mining revenues and helps countries realize the full economic benefit of their natural resource wealth. She has held senior posts in Government and the academic world. Ms. Lissakers was U.S. Executive Director of the Board of the International Monetary Fund from 1993 to 2001, representing the Fund's largest shareholder during a period of turmoil, the international markets, and a U.S.-led campaign to redesign the international financial architecture and reform the IMF, including opening its policies and practices to public scrutiny.

Karin, thank you. And you should know, I spoke with Larry Summers earlier today who had many, many positive things to say about both you and Dan and his work with both of you. So thank you for your presence here today.

Next we have Diane Willkens. Ms. Willkens is President and CEO of Development Finance International, which she founded in 1992. DFI is a member of the National Foreign Trade Council and Ms. Willkens' testimony will reflect the Council's perspective on this subject. She leads a 20-person team providing a broad range of international development Bank project and export finance consulting services to U.S. and non-U.S. firms. With nearly two decades of experience working within the dynamic international development setting, DFI is recognized for its practical understanding and long-term relationships with a full array of stakeholders. Diane, thank you for your time today, as well.

Mr. Tarullo, we are pleased to start with you.

STATEMENT OF DANIEL TARULLO, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. TARULLO. Thank you, Mr. Chairman, Senator Martinez, Senator Casey.

As your introductory remarks have suggested, the Bretton Woods Institutions are showing their age, this for both external and internal reasons. Externally, the environment in which they operate has changed dramatically not just since 1944 when they were founded but really in the last 10 years. The emergence of middle income countries with large current account surpluses, the related phenomenon of the shift in global economic weight more toward Asia, the huge almost unanticipated increases in flows of portfolio capital the world, along with the astonishing proliferation of new financial instruments have all changed fundamentally the world in which these two institutions function.

Internally, they have been somewhat maladaptive to these external changes. It is true they have both adjusted to new conditions before. This time around though they both seem to be having more difficulties.

Perhaps this is because of the tendency of most organizations over time to evolve into bureaucracies. Perhaps it has something to do with the inability of the U.S. to provide as much leadership as it has in the past. It is much easier to change an international institution in a multilateral world with a nation willing and able to provide leadership than it is to change an institution in a multipolar world.

My second point is that despite these difficulties, the successful adaptation of both of these institutions is very much in the interest of the United States. This again for two separate sets of reasons. First, the missions of these institutions are, in and of themselves, as important as they have ever been. For the Bank, providing the international public good of development through assisting developing countries in providing public goods within their own economies continues to be central to the foreign policy interests of the United States.

For the Fund, promoting international financial stability may be a very different kind of task than it was 10, 15 or 20 years ago, but it is just as important for providing the backdrop for a well functioning real economy here and throughout the world.

But there is a second set of reasons, alluded to by Senator Martinez, as to why the successful reform of these now troubled institutions is very important to us. The fate of the Bretton Woods Institutions is, in many respects, a bellwether for the future of the multilateral economic system that the United States was so instrumental in founding and has been so instrumental in maintaining over the last 63 years. The alternative, as the Senator suggested, is in all likelihood not a new set of multilateral institutions, nor a vacuum, but instead the turn toward regionalism in much of the world but particularly in the fast-growing countries of Asia.

Now it is true that the predictions of regionalism that have been made off and on for the last 20 years have proven at best premature, and at worst just wrong. But I think there is no doubt but that the palpable weakening of the multilateral system will lead to the growth of regionalism in all its manifestations.

This is quite probably bad for economic world welfare and it is certainly an adverse development for U.S. influence. U.S. influence over the rules and norms by which the international economy is structured and, I would say more generally, U.S. influence in all foreign affairs capacities.

So my third point: given the difficulties these institutions face and given the importance of their success what kind of vigorous but constructive criticism can we on this panel, and more importantly you in the Senate, offer? Well, the core problems of the institutions actually vary, I think, in a fundamental way. The two have been joined at the hip since their creation at Bretton Woods. They stare across 19th Street at one another even today. But they actually are quite differently situated in their missions. And thus, the right reform agenda area varies, as well.

At the Bank the problems are largely managerial. To be sure, there are lots of different views of optimal development strategies. But the very fact that the Bank has 500 different lending decisions every year means they can pursue simultaneously different strategies. In these circumstances though they have got to change the fundamental nature of their operations. They need to assure the maximum effectiveness of Bank assistance in promoting development. And that is why my suggestions for change in my written testimony focus on things like outcome oriented lending, systematic program evaluation, the kinds of mechanisms which would shift their mode of operation.

The Fund, in my judgment, faces a much more serious problem. There is a lack of consensus as to what the role or roles of that institution should be in the world today, a lack of consensus among the Fund's members.

It is true that the Fund's leadership has not been as strong as it should be. It is absolutely true that its performance in things like surveillance has been sometimes distressingly weak. But at root the absence of agreement among nations as to what the Fund should be doing is going to impede even the best management at the Fund from adapting that institution to today's international financial challenges.

And let me close briefly by suggesting that those are, first and foremost, once again becoming the guardian of exchange rate stability in the world. This is a task which the Fund performed for its first 25 years under the par value system. It has not been doing it consistently in the last 30 years. It needs to do it again. As Senator Bayh suggested, it has to this point failed in doing so.

Second, it needs to address the new sources of potential international financial disruption. The meltdown—the next financial crisis will probably not be based in a fast-growing emerging market because they are sitting on huge reserves. We do not know where it will come from but the events of the last couple of weeks suggest to us that, for example, a meltdown of international derivatives markets is not so far fetched.

Also, the growth of sovereign wealth funds poses a new kind of challenge.

The management of the Fund has laid out a modest reform agenda. It is moving in the right direction. It is not particularly ambitious. I have some skepticism as to how well even that agenda will be moved forward. So I think we all, in and out of Government, in and out of the executive branch, need to focus attention on how we will produce the conditions that will lead the Fund to a new set of missions.

Thank you so much.

Chairman BAYH. Thank you, Mr. Tarullo.

We look forward to following up with some questions on your very informative testimony.

Dr. Lerrick.

STATEMENT OF ADAM LERRICK, PROFESSOR OF ECONOMICS, CARNEGIE MELLON UNIVERSITY

Mr. LERRICK. Thank you, Mr. Chairman. It is always a pleasure to appear before this Subcommittee. The questions posed are always insightful and demanding.

I will concentrate my oral remarks on the World Bank though I will be happy to discuss the Fund, on which I have numerous opinions as well.

The question of the World Bank which Professor Tarullo talked about is what should the World Bank do in a new world? While China is buying a $3 billion stake in private equity giant Blackstone with the expectation of a 25 percent annual return, the World Bank is busily lending to China at a 5 percent interest rate which does not even cover the Bank's own cost of funds.

While India's multinationals, many of them state-owned, are acquiring industrialized nation assets and invest in the developing world to fuel an economy exploding at 10 percent per annum, the Bank has just doubled its lending to India to almost $4 billion, most at a zero interest rate, which constitute a gift of $1.5 billion from industrialized nation taxpayers. The Bank should not be subsidizing projects the Indian government does not think worth financing at market rates.

While the world reached out at the millennium to forgive the debt of 18 of the globe's most impoverished economies, the Bank piled on another $10 billion of net new loans, raising their Bank indebtedness by almost 50 percent. The Bank should not continue to lend in the same old way with the expectations that its losses will always be made good by rich countries.

As globalization transforms the world economy, the Bank is one of the losers. Its historic comparative advantage is gone and its role inevitably diminished. There are powerful new competitors in the market. Private capital now channels 300 times the funds offered by the Bank to the emerging world and will finance any project the Bank would consider. Nations moving up the economic ladder—China, Brazil, India, and Russia—are funding and building the infrastructure and industry for even the poorest countries in exchange for access to raw materials and export markets. China alone will send $25 billion to Africa over the next 3 years, which is 50 percent more than the funds the Bank will send to that continent.

While Bank presidents come and go, a bureaucracy hostile to change and clever at manipulating an unwieldy multinational board is flouting the Bank's founding articles, bending the rules, distorting the facts, concealing losses, and lowering standards. The Bank is desperate to maintain the illusion of relevance to emerging countries that no longer need its money and no longer want its advice.

The Bank was established 60 years ago in what is now financial prehistory. Its core mission was to solve two shortcomings in the global economy: a shortage of money to finance development and a shortage of knowledge in developing nations. The Bank would borrow from the world's financial centers and couple loans with advice to speed the growth of poor countries. In the last 20 years the world has changed dramatically but the World Bank has refused to change with it.

Today the private sector dwarfs official funding and emerging nation leaders are just as smart, just as skilled, and know their countries infinitely better than anyone at the Bank. Yet 80 percent of Bank loans flow to just 12 middle income governments led by Turkey, Brazil, Mexico, and China. If the Bank stopped lending tomorrow to its major borrowers, no one would notice. It provides only 0.3 percent of the funds sent by the private sector.

Loans to middle-income countries are clearly good for the Bank's balance sheet and beef up its image of influence. But Bank reasons for continuing to lend to the prosperous are specious and refuted by the facts. The Bank does not lend, as it claims, where the poor live. More than half of Bank loans since 2000 flow to six upper middle-income nations where only 10 percent of the developing world lives. In the creditworthy countries the Bank courts, the hardhearted private sector is ready and willing to finance pro-poor projects on the same guarantee the Bank demands. If Brazil's full faith and credit is on the line, private capital does not care if the proceeds are used to vaccinate Indians in the Amazon or to build nuclear warheads.

Far from generating a surplus for the poorest countries, lending to middle income nations is draining resources. To compete with the market the Bank has waived fees and interest spreads, reducing its operating margin by 50 percent. All in the Bank does not cover its administrative costs and now loses $500 million per annum on its emerging economy loans. The Bank's reported $1.5 billion net income comes from the $2 billion return on its $37 billion of zero cost capital.

Every 3 years the industrialized world is required to write a big check to the World Bank to fund the International Development Association, the arm of the Bank that focuses on 81 of the globe's most underprivileged countries. Zero interest rates make these loans a 70 percent gift. The price tag for the 2008 cycle will be $32 billion, of which $10 billion is the first installment on a $46 billion debt relief promise to reimburse the Bank for past bad loans. The total U.S. share will be $4 billion to $5 billion.

A dangerous precedent has been set. Whenever rich nation taxpayers fund the Bank, there is an open-ended obligation to cover future Bank mistakes.

At the Bank the need to know is an insider's prerogative that does not extend to world taxpayers, those in the industrialized world that provide the funds and those in the developing world that assume the debt. What do we know about Bank lending to the poor? And what doesn't the Bank want us to know?

We know that after 60 years and $600 billion there is little to show for Bank efforts. Bank aid was not behind the impressive economic gains in China, India and Indonesia where all the progress in poverty reduction has been concentrated. We know that for two decades the Bank continued to pour money into countries clearly unable to repay and concealed the truth by rolling over worthless loans until the G–7 governments were forced to assume the debts and make the Bank whole. We know that the Bank continues to tolerate corruption, which in Africa alone has diverted between $100 billion and $500 billion into offshore bank accounts. We know the lack of effectiveness of Bank projects is startling. By the Bank's own numbers 59 percent of investment programs worldwide and 75 percent in Africa failed to achieve satisfactory long-term results over the 1990–99 decade.

There is a common thread. The overwhelming priority has been to ship off funds even when there is no deserving destination. Before handing over the 15th IDA replenishment, we need to know more and should not be deterred by claims of confidentiality or the cost and complexity of documentation. The Bank's internal evaluation group is captive and its findings suspect. Calls for an external performance audit have been stonewalled. We want the answers to very simple questions that the Bank is afraid to ask. How many babies were vaccinated? How many miles of roads are functional?

How many cubic meters of wastewater were treated? How many children can read?

Transparency and accountability are close at hand on the Internet. For every one of the 280 projects the Bank approves each year, there already exists detailed reports in electronic form ready to be delivered to a public website. Disclosure would not be a burden. Ghanaian parents will monitor World Bank funding for their children's schools. Zambian farmers will look for roads ready to carry their produce to market. Africa fighting malaria and other NGO's will see if the mosquito nets are hanging in place. Opposition politicians and political watchdogs will know if funds and equipment have been spirited away. A whole universe of activist shareholders will keep count every step of the way. The world will become the independent evaluator of the World Bank and reach collective judgment.

Thank you.

Chairman BAYH. Thank you, Dr. Lerrick.

Ms. Lissakers.

STATEMENT OF KARIN LISSAKERS, DIRECTOR, REVENUE WATCH INSTITUTE

Ms. LISSAKERS. Thank you very much.

I think it is very useful for committees of the Congress to pose the question periodically are these international financial institutions relevant? And are they effective in executing their mission?

As I note in my testimony, there were certainly a number of reform measures in the 1990s. But the demands of the world changed and the institutions need to change with them.

I also note that there were some big institutional issues that were never resolved in the 1990s and should have been. When you talk about effectiveness of an institution one obvious key player is the leader of the institution. And I have to say that the process by which we choose the heads of the Bank and the Fund are both an embarrassing anachronism and undermine both the credibility and the effectiveness of the institutions. It is simply no longer acceptable that, to put it crudely, a few rich white guys who should decide in a closed room who heads an institution with more than 180 shareholder governments and then simply presents the person, take it or leave it, which is what has been the case. It may have been defensible when they were first founded, but it is no longer defensible.

I was very disappointed that the U.S. missed the chance to change the process when the opening arose most recently in the World Bank.

The Europeans now have a chance to change the process by actually opening up the selection. I am afraid they, too, are about to miss that opportunity. And I hope that Congress will speak forcefully on the issue and say that the two institutions and their governments should decide now, not wait until the next opening, that there will in the future be a merit-based and open and proper selection process so that whoever ends up as the head of the institution has the wide support and confidence of the members. I think there has been weak leadership and it has cost both institutions in recent years.

The second and related reform that is incomplete that has been talked about a lot but still not resolved is the necessary redistribution of quotas, voting rights and voice representation in the boards of the two institutions. There is now a serious misalignment between not just the influence of emerging market countries in these institutions but also their share of the responsibility and their share of the financial obligations of these institutions that go with voice and influence and vote.

There is a process under way to redistribute shares. I am just concerned that what is being talked about so far that came out last year's annual meeting will not really go far enough. I again think that Congress can be very helpful in keeping the pressure on and saying if you are going to do this and go through this complex exercise, you should do it right and really solve the problem once and for all. And solving it does not mean taking voting shares out of the U.S. hide. If anything we are underweight in the current voting formula. And I think the members all accept that.

I would note also, with regard to your concern or Congress's recent concern on China's exchange rate posture that one of the factors that is weighed in deciding how big a country's quota is its openness. In the past it has only looked at the trade account. I think Congress should suggest that openness should also the capital account, which is directly relevant to the exchange rate, pegging exchange rates and so on.

The third internal reform is to give the developing countries a bigger voice in the institution. The board discussions, sort of like Congress, may seem very arcane and tedious at times but it actually is an—the boards are a very important forum, not just because they have the ultimate decisionmaking power but because that is also the forum where the peer review and the discussion of policies really takes place.

It is so clear that the developing countries are underrepresented in terms of just presence in the executive boards. IMF has 24 members. A country like South Africa gets to sit in the executive director's chair once every couple of decades because it is part of a 19–country constituency where each country has to take a turn and sit for 2 years. It is actually more than a couple decades.

In the meantime, Europe has eight chairs in this 24-member board and at this stage they do not need eight chairs to repeat the common EU policy that they have adopted. But that is what is happening. And it really is up to the Europeans to get off the chairs and make room for more developing country executive directors.

I was sorry to see that the Singapore reform agenda that came out of last year's annual meeting did not include this question. Apparently the European members remain dug in and I think the U.S. should be much tougher on that score. It actually has, in its power, the ability to force that issue to be resolved, which I would be happy to speak to.

In terms of relevance and larger institutional effectiveness questions, it is true obviously that the IMF is much less important now as a source of finance. I think we cannot necessarily count on that always being the case because we know that just when we think the world economy is cruising along, something is just about to happen and we may be due for one of those periodic decadal eruptions.

But on a continuing basis it really is a talk shop. It is true that members have lost, important members have lost interest in the IMF, the Asians most notably. They have created their own defense chest in huge currency reserves and their own fora for discussing policies. I think that is unfortunate. We need multilateral, truly multilateral, institutions to discuss and resolve important global issues. And the Fund and the Bank are really what we have that are truly universal and we should do everything we can to preserve them. That, again, goes to the voice and vote move.

In terms of have we gotten enough poverty reduction bang for the development buck, I think it is pretty obvious the answer is no. And I think finally development economists agree that money alone does not solve poverty and conflict problems. In the end it is institution building, governance, and accountability that eliminate poverty and conflict. In the end, change in the developing countries, as elsewhere, has to come from the inside.

And that means that the institutions like the World Bank, that are trying to address these issues, really have to put their efforts not into financing or general lending, development lending, but put much more effort and much more targeted effort into institution building, encouraging effective laws, proper fiscal financial regimes, creating a healthy business environment in these countries and fighting corruption, of course.

We were very pleased to see the effort that Paul Wolfowitz put into the anticorruption program in the Bank's external activities. We certainly hope that Bob Zoellick will build on that, not diminished the focus.

I think both the Bank and the Fund have recognized the need for a different approach to development and structural reform. I think they have been quite effective in some areas. The IMF has really had a huge success in instilling good central banking institutions and policies. You can see the result in lower inflation around the world. But on other issues that they have not performed as well.

Governance accountability and anticorruption are the focus of much of our work. These are inherently political and therefore it is very hard for the Bank and the Fund to do much. But they can insist when they invest, for example as the IFC does, in very large extractive industries projects, that all the payment flows are fully transparent and accounted for.

Extractive revenues are one of the biggest sources of graft and resource looting in the very poorest countries and the Bank and the Fund can play—especially the Bank—a direct role in countering that by the way they manage. So can the U.S. Congress, the U.S. Government, in its policies *vis-a-vis* OPIC conditions for funding and guarantees. And we hope to see a law passed by Congress this year that would require extractive companies to publish all of their payments country by country to foreign governments as a direct counter to the kind of massive corruption that is underway.

Thank you, Mr. Chairman.

Chairman BAYH. Thank you, Ms. Lissakers. I look forward to asking some questions and getting some additional perspective from you.

Ms. Willkens.

STATEMENT OF DIANE WILLKENS, PRESIDENT AND CEO, DEVELOPMENT FINANCE INTERNATIONAL

Ms. WILLKENS. Thank you, sir.

Mr. Chairman and Senator Martinez, thank you for the opportunity to testify today to share a private sector perspective on the World Bank.

I am testifying on behalf of my company, Development Finance International, as well as the National Foreign Trade Council, a business organization of 300 American companies whose mission is to advance open and rules-based trade. I serve as the Chair of an Ad Hoc NFTC working group on the World Bank.

It has been my privilege over the years to work with some of the world's leading private sector firms—such as Hewlett-Packard, GE, BASF, and Philips, to name a few—in their pursuit of sound business policies with the Bank and its sister institutions and have been involved in sectors as diverse as health information and communications technology, education, agriculture, environment and transportation.

I would like to begin by emphasizing the important role of the World Bank and the regional development banks since their creation after the second world war. As we have heard, as part of the Bretton Woods Institutions, the World Bank continues to serve a vital multilateral institution and advancing sound and sustainable economic development and alleviating poverty in the developing world.

We welcome President Zoellick in his new role and encourage his furthering the Bank's collaboration with the private sector. With his depth of international experience, record of accomplishment in several prominent high-level trade and foreign policy positions in the U.S. and commitment to helping the developing world grow and prosper, there is no one better qualified to lead the Bank today.

My testimony will touch on several areas where the Bank could and should improve its policies and interaction with the private sector in meeting its overall mission. With the shift in the World Bank's relative importance, given the abundance of capital liquidity around the globe, it is in the Bank's own interest to find flexible new ways of working with others, including the private sector.

Many of my comments have direct relevance, as well, to the regional development banks since they follow closely the lead of the World Bank.

What I would like to do is highlight five overall recommendations that are elaborated in the written testimony. Number one, we believe the World Bank should better recognize that the private sector is both a key stakeholder and enabler of sound economic development and should incorporate the private sector into its planning and its operations. U.S. companies which operate and invest in developing countries bring numerous best practices through their presence and contribute meaningfully to economic growth and development. The private sector should be viewed more as a partner rather than an afterthought in the development of major new policies.

Number two, the Bank should push forward with critical initiatives on governance and anticorruption. The Bank should strengthen its role in promoting accountable and transparent practices, especially in procurement, an area that is most susceptible to corruption on both the demand and the supply side.

The private sector from the U.S. as well as several European countries have been very concerned about recent proposals by the Bank to abandon World Bank international best practices in procurement and effectively lower the Bank's standards on international competitive bidding. Our concerns relate to fundamental issues that define the business environment and investment climate in these developing countries.

The Bank's recent proposal involves adopting a more hands-off approach in favor of the procurement systems of its country clients. However, as the OECD said in its Paris declaration of 2005, where corruption exists it inhibits donors from relying on partner country systems.

And again in 2007, in the OECD's paper on bribery in public procurement it was said a multiplicity of rules will have a negative effect on transparency and lead to uncertainties and high transaction costs both for the procurement agencies and potential suppliers.

As designed, the Bank's recent proposals go against its own important overall initiatives on anticorruption and improved governance and they should not be implemented.

Number three, there continues to be a strong case for better coherence between the WTO and the World Bank, particularly in the area of trade capacity building and mainstreaming trade. This will be even more critical if the Doha Round concludes successfully. For example, an agreement on eliminating needless red tape at the border through a WTO agreement on trade facilitation will require substantial hands-on capacity building and other assistance which the World Bank is well equipped to do.

Number four, we recommend that the World Bank Group find creative new ways to engage other governmental organizations such as the export credit agencies. Further, we suggest that the political risk insurance provided by the World Bank Group's Multilateral Investment Guarantee Agency, known as MIGA, be available for transactions beyond investments in order to support sales that do not fit the export credit agency model. Namely we encourage eliminating the equity requirement for debt transactions and allowing support for subsovereign and/or parastatal transactions.

MIGA's continued improvements to process transparency and responsiveness will be essential to its future and sustainable growth of its mission.

And finally Number five, the U.S. Government should enhance its efforts to ensure the U.S. companies have an equal and a fair opportunity to compete for World Bank funded contracts. Within the multilateral development banks we would like to see representation of the U.S. private sector interest that is similar to the representation afforded European and Asian private sector, namely long tenured, highly experienced procurement experts within each of the multilateral institutions working on behalf of the U.S. private sector.

In closing, the challenges facing the World Bank are many as the institution defines its changing role. The private sector is committed to working with the Bank in constructive approaches to the development challenges and the opportunities before us.

Thank you for the opportunity to appear today and I welcome your questions and, with your permission, I would also like to supplement the written testimony with copies of correspondence between the private sector and the Bank concerning procurement.

Chairman BAYH. Without objection, we would be happy to entertain that supplementary testimony.

Thank you. It is always good, Ms. Willkens, to get a perspective from the private sector. Pragmatic reality-based observations are always helpful, even in Washington.

We will now turn to questions. Mr. Tarullo, I will begin with you. I will try and keep mine to five minutes. Actually, I guess they have given me seven, Mel, so then I will turn to you. And if we need a second round, we will do that.

Mr. Tarullo, you mentioned that the challenge facing the Bank is primarily managerial. The challenge facing the Fund is one of defining its mission in the 21st century. And you suggested that it could beef up its role as a guardian of orderly exchange rates among the countries of the world.

Do you have any suggestions about how the Fund can do that besides mere surveillance and commentary? Is there anything practical that can be done?

Mr. TARULLO. Well, I would not underestimate the importance of good surveillance as a first step, Senator. I think we need to distinguish that kind of surveillance that has been done to date and what I and others would regard as more rigorous surveillance.

Chairman BAYH. Define for us what more rigorous surveillance would entail. And then the reason I wanted to follow up on this is, as you know, several of us have been engaged in our own surveillance of exchange rate policies of other countries. To date mere commentary does not seem to have had much of an impact.

Mr. TARULLO. One of the big problems right now is that when we talk about redefining the Fund's mission, everybody understands that to mean China currency. And when one is talking about institutional change but everybody thinks it is really about a particular country at a particular moment positions, to put it mildly, tend to get dug in because it is about a specific issue rather than about the larger issue. That is a reality and we need to face that reality.

Chairman BAYH. How can we back that up and not have the Fund appear to have become an instrument of U.S. policy but instead be an objective arbiter of sound global economic policy?

Mr. TARULLO. That, I think, is exactly the goal. In fact, from my perspective as a U.S. citizen I do not think they have been doing a particularly good job in the last few years in pursuit of our interests, much less in pursuit of global interests. It comes back to are they going to be honest and forthright in their surveillance?

The IMF's own——

Chairman BAYH. If they are, do you think that will have an impact?

Mr. TARULLO. I think it is a first step, and I will say why. The IMF's own internal evaluation operation concluded that their performance in surveillance, including surveillance of China, is just not very good. They soft-pedal things. Their economic prognostication is not good. My understanding is—this is not on the record, but my understanding is that they declined U.S. request for special consultations on China's practices.

That suggests that the Fund, rather than trying to push to the limit its role under its current mandate——

Chairman BAYH. Why the reticence?

Mr. TARULLO. Why? I cannot explain that, to tell you the truth, except that they have become a bit of a political—they have become an institution which is caught between the politics of multiple strong countries.

I will say, this gets actually to something that Karin Lissakers has mentioned——

Chairman BAYH. Their reticence is going to implicate their relevance here if it continues.

Mr. TARULLO. Exactly.

Chairman BAYH. Can we segue to her comments? I think you were about to touch on this.

Mr. TARULLO. Yes. Is that what you were getting at?

Chairman BAYH. I was going to get at that, and then perhaps some of the structural changes. We have a moment here where the leadership of both the Fund and the Bank will be new, presumably will be set for 5 years. Perhaps this is a moment to address the mechanisms through which future leaders will be taken and perhaps address voting rights and those sorts of things to elicit more interest and participation by some of the countries. But at the same time the Fund has to be able to call it the way it sees it, if it is going to have any impact.

Mr. TARULLO. The thing—what we have had at the Fund, we have now had two straight heads of the Fund who have left early. The first explicitly to go back and reenter German politics. Mr. de Rato says he has got to leave because he has got to pay for his kids' education but the rumors were all over that he was——

Chairman BAYH. I am tempted to say that he should move to the Bank, but I will not.

Mr. TARULLO. That does not help. And although, as Karin suggested, it would have been better to have a more open-ended process, if Mr. Strauss-Kahn is going to be the next head of the Fund one would have thought that one thing the United States could do is to ask him A, are you going to stay for 5 years? The rumors are that President Sarkozy put you into the Fund to get you out of France politics. When they open back up again, are you going to go home or are you going to stay here and finish the job?

B, what do you think about the Fund's performance on surveillance? What should its role be? Because I think if you are getting from the top demands that there be good honest analysis, an analysis which seems to me as invariably going to produce the outcome that China's exchange rate policies are currently destabilizing, then you are at least beginning down the path for a multilateral consensus on what needs to be done.

And C, I would ask him, as a European, whether he agrees with the consensus that seems to exist in the rest of the world that Europe is overrepresented and some of the fast growing emerging markets are underrepresented.

So I do not want to overstate what the Fund can do and the Managing Director can do on his own. But it seems to me that they have underutilized such influence and potential as they do have. As a result, you and your colleagues on the Finance Committee I think really feel as though you have no choice but to begin putting pressure from an external source. I think you and Senator Baucus and Senator Schumer and Senator Graham would all probably prefer the 3 years ago we had had real change.

Chairman BAYH. Real change accomplished in the context of a multilateral effort, as opposed to having to go at it on our own. That leads to all sorts of frictions, which are not helpful.

My question is designed—and I would be interested in the comments by any of the panelists—to really revitalize the Fund, their role, increase the weight that is attached to their advice so that perhaps we will get some consensus about what needs to be done. Perhaps if we can give more buy-in on the parts of these countries, they will start to accept some of that so we can reduce the level of global economic friction, which is not helpful and in the long run not sustainable.

I am going to turn to Mel here than I have got some other questions. But would anybody else—Ms. Lissaker, would you like to comment on that? Or Dr. Lerrick?

Ms. LISSAKERS. I think that one of the major reasons the IMF has been so weaken in recent years is not just the quality of the leadership at the top of the institution but the quality of the leadership of its major shareholder. The U.S., as far as I can see, for the last 8 years has basically ignored the Fund. It has not asserted itself and aggressively asserted——

Chairman BAYH. I think the record should reflect she is referring to the executive branch, Mel?

Ms. LISSAKERS. Yes, if there is there any ambiguity.

I was amused when——

Chairman BAYH. Following the financial crises of the 1990s, our attention has been focused on other things and it has become sort of an afterthought?

Ms. LISSAKERS. My sense is it is part of a larger lack of interest in multilateral approaches, but we will leave that aside.

I have been amused to have former board members—I mean my former colleagues at the IMF Board say you know, we used to complain about the U.S. pushing everybody around and constantly pushing an agenda and pushing this reform and that reform in Congress. Now we are all looking around and saying where is U.S. leadership in this institution?

The fact is we are the dominant member and without it these institutions will not be strong and they will not be effective, either in terms of advancing what we see as our interests but also in terms of international resolving important fundamental global issues like the very important global currency imbalances.

Chairman BAYH. My time has expired and Dr. Lerrick, we want to hear from you and then Senator Martinez. Is it your opinion then, Ms. Lissakers, that if we can get better leadership at the Fund and a greater engagement level from its principal shareholder, our own Government, that its surveillance will be taken seriously and perhaps followed by some of the countries who can benefit from it? Or are we naive in thinking that they will not continue to pursue their more narrow self-interest?

Mr. LERRICK. I think you have to focus on how the world—first you have to ask a very simple question. What do you want the Fund to do today? And the same for the World Bank. No one has asked that question of either institution.

Someone needs to sit down, the leadership, as Karin would say the members possibly. But the leading members need to sit down and say we have decided the new role of the IMF is X and the new role of the World Bank is Y. Now finance ministers, Secretary of the Treasury, central banks, go and implement it. No one has done that to date.

Coming back to I think where you started Mr. Chairman, which has to do with China, which is that hot topic now. One of the oldest lessons of international economics is there is nothing that can force a country running a balance of payments surplus to adjust because if they are willing to just keep accumulating reserves there is no mechanism to force them to change.

A deficit country will eventually run out of reserves and they will be forced to adjust but a surplus country is not forced to adjust.

The question of China and the role of the IMF and the role of surveillance has, I think, been overemphasized and the potential role the Fund can play grossly exaggerated. Because really, first, what makes us think that the IMF is better at determining reference exchange rates than the market? It is just an opinion of one group of people.

And second, the IMF has no enforcement capability. This is very simple. If the IMF comes to a surplus country and says we need your exchange rate is grossly undervalued, it should be 30 percent higher, 20 percent higher, whatever the number is. And the country responds that is your opinion. What is the IMF going to do? Is the IMF going to impose financial penalties on the country? Is the IMF going to have them thrown out of the WTO? Is the IMF going to say their banks, their commercial banks cannot participate in the international clearing systems? Of course not.

And so there really is no capability for the IMF to enforce its views. And the idea of naming and shaming countries into submission is very innocent, to say the least.

China is a very powerful country. The Chinese understand these issues very well. But it is important to recognize that to the Chinese government the overwhelming, the overarching goal is social stability. And they must absorb every year, they must create 30 million new jobs just in order to keep the economy growing because of the massive amounts of numbers of people coming from the countryside into the industrialized coast. That is what they are going to focus on.

And so far they have focused on an export-oriented growth model, just like all of Asia. It has been very successful. That is what they are going to continue to focus on.

When the IMF says—you saw how adversely the Chinese government reacted when the IMF announced just 2 weeks ago its new role of establishing exchange rates. The Chinese immediately reacted sort of like that is none of your business. It is a sovereign right and we are not going to listen to you. And so I think you then have to figure out why, when you deal with any country, especially a powerful country, why it is in that country's self-interest to make the adjustments you want them to do. Not why it is in the U.S.'s self-interest or the European's self-interest. You have to convince the Chinese. And it is going to be a very long-term process. And in my opinion the adjustment of the Chinese exchange rate—and it is clear the exchange rate is undervalued and they are subsidizing their exports through the undervalued exchange rate. There is no difference of opinion. How much a change in the exchange rate would actually affect the U.S. economy and the current account deficit is a great debate.

My own view is a 20 percent revaluation of the renmimbi would have an infinitesimal effect on the U.S. current account deficit and on U.S. manufacturing employment. All of China, first of all most of Chinese experts are simply processing where the domestic content, the value added in China is 20 percent or less. So they buy the inputs in dollars, they sell the outputs in dollars. A 20 percent revaluation is going to change the price by 4 percent.

And second, even if you could have a major impact on the cost of Chinese consumer goods, our imports would not shift to U.S. domestic producers. They would shift to Mexican producers, Brazilian producers, Indonesian producers. And so for the rallying cry of many of the Senate and the Congress that we just need to force China to revalue its exchange rate and that will solve our current account deficit is naive to say the least.

Chairman BAYH. That is a topic worthy for discussion. It is not the subject of our hearing here today. We get a variety of opinions on that.

The question here today is whether we should try and have some sort of multilateral institution, not to substitute its judgment for the judgment of the market but instead encourage the market to value currencies as well as other things and to invest that institution with as much legitimacy as we can.

I would be delighted to have you answer the question about why you think the mission should be in the next round but my time is way past expired. Senator Martinez, we would love to hear from you.

Senator MARTINEZ. I was picking up right on that actually. I enjoyed your comments because yesterday in this very room we were having a discussion on the very issue and some of us expressed a strong opinion that it would be foolish for the United States to pretend that we cannot continue to be the great trade nation that we have been with protectionist policies. That would be designed to create a false sense of security where it would not exist otherwise and that we should be competing with the world and in the world.

But anyway I was going to ask you, based on the fact that you were part of the Meltzer Commission, what recommendations of that commission you would find were useful? Which ones have been adopted? Where should the IMF be going in the future, in your estimation and the estimation of the Commission? What should the role be really?

Mr. LERRICK. I was very disappointed when I saw an interview with Mr. Strauss-Kahn in the Financial Times 2 years ago where he said that one of the principal functions of the IMF, equally important to global financial stability, was reducing the gap between the rich and the poor are. I did not think that was the IMF's job. I thought that was the World Bank's job.

The IMF has a very simple function as laid out in its articles, which is to increase the stability of the international financial system. That is its job.

If we want it to continue that job, we have to think of it in a new world. The IMF has created a world where there were no international capital markets. There were exchange controls. It was a gold standard. That world is gone.

You have to think what does it mean to improve the stability of the financial system today?

Clearly, the IMF cannot pay the role—and many of us believe it should not have played the role it did in the 1990s in intervening in all of the financial crises with bailout packages. We consider that that increased the frequency and severity of such crises and was counterproductive and the IMF failed in that mission.

But that is no longer an option for the Fund. $30 billion, which at that time was thought to suffice to stem a financial crisis in a large emerging market country, would now be gone in a matter of minutes with the size of the financial flows. The IMF does not have the financial capability to intervene in a financial crisis even in a middle income emerging nation today.

It certainly does not mean the IMF should be out there lending to the poorest countries. That is the job of the World Bank. And it certainly does not mean the IMF should be out there giving its opinions on exchange rates or imbalances between different countries.

The IMF has one asset though that is extraordinarily value for the stability of markets, which is its information gathering and its data collection and dissemination process which is grossly undervalued. It is a very small part of the Fund in terms of its visibility.

But remember what creates crises are surprises. Markets hate surprises. If you improve the quality and timeliness of information you will do much work to reduce the frequency of crises and reduce their severity when they occur. And that is what the IMF, in my opinion, should focus on, which is it has done an extraordinary job at creating the requisite data and information the country should supply to the markets. It should improve that even more for countries government sectors and for their financial systems.

And by providing that to the market the Fund is going to do far more to increase the stability of the system than any other of these more grandiose rolls it is now seeking.

Senator MARTINEZ. Mr. Tarullo, we were talking earlier about the regionalism and the potential for that. I wonder if you might elaborate on this and discuss what already you have seen in terms of the building of regional institutions and whether the rise of regional and economic institutions could have a serious adverse effect on the United States economy?

Mr. TARULLO. Thank you, Senator.

The rise of regionalism obviously is most advanced in Europe in the form of the European Union and the European Monetary Union. We tend to think of it, as indeed I do, most acutely in the case of Asia because these are the fastest growing economies in the world. And it is, I believe, in our interest to integrate those economies successfully into the global economic system as importers as well as exporters. And in order to do that they are going to have to turn more toward domestic demand led growth.

All of those things are, I think, accomplished more easily through the multilateral mechanisms of the WTO and the International Monetary Fund than they would be trying to do it bilaterally.

The Asian countries, in the aftermath of the Asian financial crisis in 1997 and 1998, have skepticism bordering on rejection of the multilateral financial system, certainly the IMF. They feel that they were left in the lurch, that they were stuck with the aftermath of the crisis. They feel that the Fund's response was insufficient instead of excessive.

And so the one area in which regionalism has actually moved forward concretely in Asia is on finance and in the monetary area. That is to say discussions among the central banks and agreements to have resources pooled in the event of a financial crisis.

Now countries that are running massive current account surpluses and sitting on $1 trillion of reserves are not going to face a current account crisis anytime soon. So it is not as though these mechanisms are going to be activated. But it seems to me that they portend ill for what our role should be, which is anchoring a multilateral system that is moving—in that part of the world—is moving toward a set of economies that consume domestically, that import as well as export. And I think to the degree that regionalism takes hold in the monetary area it is more likely to take hold in the trade area as well.

My last comment on this is it is not inevitable. People talk as though it is inevitable. I do think it is inevitable, for two reasons. One, if you reenergized the multilateral institutions there is an alternative. And two, many countries, including countries in Asia, will be more comfortable with a multilateral system than one in which there is a dominant regional power. That is the United States, for much of the world, serves as a counterweight to regional powers as well as sitting up there as the big global power. And I think we ought to take advantage of that desire on the part of a lot of other countries to provide stronger multilateral leadership.

Senator MARTINEZ. Mr. Chairman, my time is up but I would like to just maybe follow up with one quick question because perhaps this might do it. I think we are going to have votes coming up shortly.

Ms. Lissakers, you mentioned about the elections of the leadership of the organizations and the preeminent role, I guess, of the United States perhaps advocating for a more open process. And while that sounds on its face to be a good thing, I also wonder whether or not the current system has not served the institutions well. In other words, whatever other problems there may be going forward, is the election of leadership and the way it has been done in the past at the root of whatever the problems may be? And would a different process yield a better outcome necessarily?

Ms. LISSAKERS. I do not think there is a guarantee that it would yield a better outcome. One certainly would not want to emulate the U.N. model where the position just gets handed from one continent to the next to the next. That is definitely not a model to emulate.

There was actually a joint World Bank/IMF Board committee on reforming the selection process while I was on the board and we came up with a process where the initial—where any country could nominate. But there would be a screening committee that would not be governmental but would be eminent persons who were widely and internationally respected.

Some could include former managing directors our heads of the World Bank but other respected individuals, from a mix of backgrounds, from business, from academia, and so on. And they would then short list of candidates to get away from this political horse-trading that goes on in most multilateral institutions and then present the short list for the votes and straw votes to the two boards, to the members.

I still think that is actually a pretty good model and I think it would be a significant improvement to the current one. You just cannot have—I mentioned earlier how important it is for these institutions to be effective promoters of sound governance and public accountability. How can they really do that credibly when their leaders are selected in this totally non-open or accountable manner?

Senator MARTINEZ. But I am encouraged by what you suggest, which is perhaps a semi-open process which would have a short list drawn together by an elite group of people. I think that may yield a better outcome than just throwing wide open.

Yes, sir, you wanted to comment?

Mr. LERRICK. Very quickly, Senator Martinez. Again, before you discuss how the leadership should be chosen you should decide what you want the institution to do. Let me give you an example. If you want these institutions to continue as lending institutions, with that as a major function that they play, the leadership should be chosen from the creditor members. There is no example in the private sector where borrowers get to determine how the bank is run because borrowers only want three things: more money, lower interest rates, and longer maturities.

Senator MARTINEZ. Or loan forgiveness.

Mr. LERRICK. Or loan forgiveness. That is the extreme of longer maturities, lower interest rates, and more money. And so therefore, if you have a system where you want these institutions to be lending large amounts of money, it has to be the creditors that determine policy.

Senator MARTINEZ. Thank you, Mr. Chairman.

Chairman BAYH. Thank you, Senator Martinez.

I would be interested, Mr. Tarullo and Ms. Lissakers, if you would comment on something that Mr. Lerrick mentioned and at least alluded to. I think in Article I of the IMF part of its mission is to "maintain orderly exchange arrangements amongst its members."

Dr. Lerrick, I interpreted your remarks as being that that should not be a part of its mission. Further—and I do not want to get into the wisdom of the policy about the Chinese management of their currency or what our reaction should be, but I interpreted your remarks as being that we essentially should not have a global entity that comments upon the wisdom or lack thereof, of that, that it should be sort of a free-for-all. And if our country, in spite of your opinion, if a majority of American policymakers disagree with your point of view, we should take unilateral action vis-a-vis the Chinese, as opposed to trying to establish some sort of international consensus.

Mr. LERRICK. No, Senator, I believe the Fund can certainly provide its opinion, but that is all it is is an opinion. The Fund says well, what we believe this is what the appropriate exchange rate should be——

Chairman BAYH. No, but——

Mr. LERRICK. Remember, that article was written under a system where, first of all, the entire world economy was dominated by industrialist economies.

Chairman BAYH. Might they not say that it is nobody's business to determine what the Chinese currency's value should be, but it is a job for the market to do?

Mr. LERRICK. Certainly one can say that. In fact, in today's financial markets, that is what is going to occur.

Chairman BAYH. But not with regard to China's currency.

Mr. LERRICK. There you have a question of whether the Chinese government has the sovereign right to try to influence the value of its currency. And that is a debatable point. That is one of the things——

Chairman BAYH. I do not want to get too far down on that path but there are different questions about whether they are, in fact, managing their currency. And if so whether, even if they have the right to do that, then presumably other countries should also have the right to do something in reaction to that if they so choose.

Mr. LERRICK. Absolutely.

Chairman BAYH. It is sort of an every country for themselves and you get the bilateral action and reaction as opposed to some sort of multinational entity.

But I was curious, Mr. Tarullo and Ms. Lissakers, if I mischaracterized your position, Mr. Lerrick——

Mr. LERRICK. I think you have not totally mischaracterized it. I think the fact of the matter is the Fund does not have the ability to play the role that that article you are quoting assumed it did. And it had that role—even if it had that role in 1945, which it really did not, that capability, it certainly does not have it today.

And then the question is do you want to try to have an institution—when you asked why has the Fund been too reticent to assert itself aggressively in certain cases? Maybe because the fund understands that all that will happen if it asserts itself aggressively is that it will lose the remaining credibility it has.

Chairman BAYH. Is moral suasion, Mr. Tarullo and Ms. Lissakers, something that it would be beneficial?

Mr. TARULLO. Look, none of us should be and I do not think anybody here has overstated the potential for the Fund in managing exchange rates. But I would disagree with Dr. Lerrick on the potential that the Fund, or indeed any multilateral process has, for the following reasons.

First, I do not—if you have got a process, an analytic process, that is regarded as credible and as not having a particular vested interest in anyone's outcome and that process acquires credibility over time, as it must, then it can serve as—the staff report can serve as the starting point for a discussion.

Second, of course you cannot force any country to change whatever its exchange rate policy may be. And of course, in a highly legalistic sense, it is a sovereign prerogative of the country.

But the whole nature of international economic interaction, and indeed international interaction, is that countries talk, they come together, they negotiate, they play one another's interests, desires and outcomes in order to try to maximize their position. And when a country concludes that it is not particularly useful for its standing in the rest of the world, that it is eliciting negative reactions that are getting in the way of achieving their ends in other areas, and importantly where they can see how their own self-interest, in this case, actually does lie in eventually revaluing their currency, then I think you have got the potential for a helpful process.

You know one thing, the first G–7 summit that President Clinton ever went to, in 1993 in Tokyo, as you recall we were still running—still. Then we were running significant budget deficits. That changed and now we are back to the budget deficits.

But at that time, when the president got back he was just shaking his head, both literally and metaphorically, saying all he was hearing from the other leaders the drag, the dangers the U.S. budget deficit was posing to the global economy.

We are talking about the leader of the free world who is affected by the fact that other leaders say here is a problem you are posing for us.

I, in my capacity as his sherpa, felt the same thing, although by the time I was sherpa we had made progress on the budget deficit. It does not seem as though anybody can force the most powerful country in the world to do something in particular. And they cannot. But what they can do is to cooperate more or cooperate less on your own initiatives.

And I think that, just as the G–7 process at the proper moment in history, which we are long past, actually was valuable for the G–7 countries, sharing views yes but also creating some not-so-subtle pressures on one another, I think that can be true here as well.

But like Dr. Lerrick, I would not overstate the—the IMF is not going to become an adjudicator of exact precise exchange rates. It neither can do it and I agree with him it should not do it either.

Chairman BAYH. Dr. Lerrick I will get back to because you did ask a very good question, which is defining what its mission should be going forward, and we have not really gotten back to that, which I would really like to. Ms. Lissakers, I would like to hear from you.

But it does seem as if there is some overlap here. Dr. Lerrick you said, of course, they can comment and offer their opinion and so forth. Not with an expectation they can force anybody to do anything.

Mr. Tarullo, what you are saying is that the more that is viewed as being an objective, informed opinion about why it is in someone's best interest to take a course of action that has some utility. It is not a panacea but it has some utility.

Mr. TARULLO. If it begins a process. If the report is just sitting out there it does not get you too far. there will be a story on it in the Financial Times and that will be about the end of it.

But if it is the beginning of a process and the de Rato idea on multilateral surveillance seems to me to have some merit, even though it was not particularly an impressive first set of results because it says OK we are going to have reports first to try to get some objective analysis. And then we are going to try to replicate the old G–7 model in a new forum with the right players, which the G–7 clearly does not have.

Chairman BAYH. Ms. Lissakers.

Ms. LISSAKERS. Mr. Chairman, you said a few moments ago look, if these multilateral institutions are not effective and they are not working then why shouldn't countries just go their own way, adopt unilateral policies, respond as they need to to make things happen?

Chairman BAYH. That is not my desire. It is just my observation in a vacuum that is what is likely to happen.

Ms. LISSAKERS. And that is exactly the scenario that the founders of the Fund especially had in their heads and the Bank when they created them. The original mission of these institutions was precisely to prevent that from happening and to give countries an alternative and effective channel to address issues that affected them directly but also required the participation and cooperation of other countries to resolve. And that is exactly where we are.

So I think the original mission is still valid. The question is whether the techniques and the approach of the institutions are still effective. And clearly they have to change. The fact is the Fund does not try to set exchange rates anymore. It does an analysis which says if you, China or another country, allow your exchange rate to float and let the market set the rate, this is roughly where we think you will end up right now. This is what we think is probably an equilibrium exchange rate.

That is an analytic point against which the U.S. can and does use to go to the Chinese and say the Fund analysis and our own analysis shows clearly that your exchange rate comment, by any market measure, is undervalued. You need to adjust. The real impact is exactly what—effectiveness or not—is through the mechanisms Dan described, which is the governments, the member governments of these institutions collectively bearing down on a member that is acting in a way that is contrary to the best analysis and policy guidance and saying you are out of line. You need to adjust your policies.

Sometimes that works and sometimes it does not. But it is this peer review mechanism that is the real value and that we should not discard, as Adam, I think would——

Chairman BAYH. Yes, Dr. Lerrick.

Mr. LERRICK. Very simply, Mr. Chairman, Professor Tarullo raised what I consider an extraordinary good example of the problems the Fund faces in this role. A year and a half ago the Fund announced the major initiative of the multilateral surveillance mechanism where—as opposed to the Fund speaking one-on-one to individual countries of what they thought the problem was they would bring together groups of countries who were part of a global problem and we will work out a solution together.

It was extraordinary—and after the first year there was a big announcement in April, this spring, of how successful the Fund had been at this. I was asked to come in after the announcement was made to meet with the senior management of the Fund where they told me look at the extraordinary success of the multilateral surveillance program. And they pulled out the announcement. And on the announcement it said the United States is going to reduce its fiscal deficit and its current account deficit; the Germans and the other Europeans are going to make their labor markets more flexible, work to make their labor markets more flexible; the Chinese are going to work to make their exchange rate more flexible.

I asked, I said well what on this piece of paper is any different than what these same governments have announced many times before officially in writing? And their response came back but we got them to put it all on one piece of paper instead of five pieces of paper.

And I said well, what is that great achievement? And they said well, if you do think getting it all on one piece of paper instead of five different pieces of paper is a success, well then you will not be impressed by the multilateral surveillance mechanism. I think that is an example you should think about.

I think there is an immediate stage between the multilateral system——

Chairman BAYH. They are working hard to save the rain forest, Dr. Lerrick. Less paper, fewer trees.

Mr. LERRICK. But I think there is an intermediate stage between the totally multilateral approach that, of course, people would love and this every country goes its own way. I think that is based on countries' self-interest.

I think what will happen is, as you will see, is that companies will pair off into regional groups or into select groups where if it is a problem you will see the United States speaking directly to China. The United States is not just going to go off by itself and impose certain sections without at least attempting to discuss the problems with China. I think that is Secretary Paulson's strategy, has been his strategy. I think you will continue to see that. And what you will see is I think the choice is not——

Chairman BAYH. It has borne about as much fruit as the document you just described.

Mr. LERRICK. Of course, but I do not think the multilateral IMF system will bear much more fruit. But I think that it is what you are going to see, this intermediate stage where there will be regional or bilateral discussions.

Chairman BAYH. Let's move to something, if we might, that Mr. Tarullo mentioned as what he felt was part of a mission going forward for the IMF. That was sovereign growth funds, I think you mentioned, trying to analyze what the effect of that is going to be.

Dr. Lerrick if you are correct, and you probably will be for the foreseeable future, China will be running large surpluses. They have questions about what to do with those surpluses. They are in the process of making equity investments, the Blackstone investment just got a lot of attention and so forth and so on.

Is a legitimate function for the Fund going forward to at least begin to explore the consequence of nation-states making equity investments of this type?

Mr. TARULLO. Senator, I would say not just equity investments but investments of all sorts.

Chairman BAYH. It is kind of ironic, we advise most countries to reduce the role of government in their own economies and now their governments will be taking ownership interests in the economies of other countries.

Mr. TARULLO. This is, in part, an example I think of be careful what you wish for. I recall not very long ago a number of prominent economists advising countries to diversify the destinations of their reserves not simply in terms of currency but also higher yielding instruments.

In direct response to your question, it seems to me that there are two sets of concerns one of which is a concerned that this Committee addressed last year and that you just wrapped up not so long ago, which is the CIFIUS kinds of concerns. That is, the potential acquisition of an industry, a company, in a country which raises national security type issues if it is held directly or indirectly by the government of another country.

As you may have noted, Chancellor Merkel of Germany has recently evinced her anxiety at the prospect for sovereign wealth funds doing that.

I think that that kind of issue is best handled directly through a CIFIUS-like process, as you all have amended it.

The second set of issues, though, gets to the aggregate effects of these financial flows on global financial stability. And it seems to me that the Fund not only has a role going forward, it ought to have had a role over the last several years. Because the data dissemination standards which Dr. Lerrick mentioned a few minutes ago would appear to me to be a logical place for the addition of some standards on disclosure of the practices of countries in investing there foreign exchange reserves. And that that would help tell us where the money is going. It would help everyone, markets, governments, the Fund itself, know whether there are asset flows into some areas and some kinds of instruments which could be potentially destabilizing.

So I think at the very least the Fund should be doing that and has not to date.

Chairman BAYH. Dr. Lerrick, Ms. Lissakers—and Ms. Willkens, I have not forgotten about you. I have some questions for you, too. We just sort have gotten off in an area of their expertise for the time being.

Mr. LERRICK. Mr. Chairman, Professor Tarullo is absolutely right. The Fund should focus, in my opinion, on its mandate which is how do you improve the stability of the system? The way you improve the stability is identifying sources of instability.

Whatever the source could be, it could be sovereign investment funds, it could hedge fund leverage, it could be derivatives. That is what the Fund should be focusing on, gathering the information, setting the disclosure standards, getting that information out to the markets and to policymakers so they know where the risks are.

Because if they know where the potential risks to the system are market participants will take preventive action so that they will not be caught, to protect themselves against that risk. And policymakers like the Fed or the European Central Bank will know where the potential source of instability is. And that, in my opinion, is the most valuable role for the Fund. The advent of sovereign growth funds or investor funds is certainly a new phenomenon. The Fund should be studying, gathering information and disseminating it to the market.

Chairman BAYH. What do we do in a case where perceived national interest may differ from systemic risk to the global economy?

Mr. LERRICK. That is not the Fund's job. National interests are the job of national governments. Again, if you define the Fund's job as maintaining global financial stability.

Chairman BAYH. What if the policies of a nation-state run the risk of destabilizing the global economy?

Mr. LERRICK. Then you get back to the system of what is the enforcement mechanism?

Chairman BAYH. And the answer to that is none.

Mr. LERRICK. The answer to that is at this stage we do not have one on the international level. We were just possibly—in theory you could try to have some ad hoc coordinated action by different member governments.

Chairman BAYH. Coalitions of the willing.

Mr. LERRICK. Coalition of the willing or the frightened.

Mr. TARULLO. Senator, it is not a binary world here. We are not limited to institutions that either have rules that are subject to a quasi-adjudicative process that are then enforced in some respects, or a kind of everything goes, it is all up to you.

The world is mostly composed of intermediate levels of cooperation, discussion, and pressure. And I would say that although Dr. Lerrick and I agree, I think, substantially on the sovereign wealth fund issue and what the Fund should be doing about it, I would go a step further and say it seems to me that when the kind of trend that you mentioned becomes evident, it ought to be a function of the Fund to have a discussion of that in an appropriate forum with the appropriate people there.

And to say well, it is just talk, it is just a discussion, I think is to overlook how much difference talking and discussion has made among central bank Governors of major countries in the last 30 or 40 years. You do not read about that in the FT but it makes an enormous difference in people understanding about the consequences of what they are doing and communicating with one another.

Chairman BAYH. Ms. Lissakers, and again what had occurred to me is I think what Dr. Lerrick said is exactly right. The Chinese care about domestic stability. They are undergoing great change.

They need to promote rapid rates of growth to accommodate that change. And it is quite possible that what will promote stability within China may have a different impact, if it goes on for some period of time, for the rest of the world. Or perhaps not. But at least there needs to be someone that renders an objective opinion about that.

Ms. LISSAKERS. I think we should not underestimate the government of China's level of sophistication about the policy choices, the complex policy choices they face. Any policymaker who observed or participated in the financial crisis in the 1990s came away, I think, convinced that fixed exchange rates are very dangerous in a fundamental way because they lead financial players to take excessive risks. It creates a very distorted incentive system.

The Chinese, I think, have seen that in their own domestic financial systems. They have had a terrible banking problem. I believe—I have not followed this closely—that they have used some of their large foreign exchange reserves to shore up and reform their banks and recapitalize those banks.

That is a very important step for them to have the choice of loosening their exchange rates. Because if you look at the Korean example, which Korea had huge foreign exchange reserves when it blew up, which is one of the reasons they took everyone by surprise, their crisis. But their banks had all these hidden exposures that the Fund, among others, had not carefully monitored. And it led to a massive economic crisis for Korea. That is certainly an experience the Chinese do not want to repeat. And that, I would assume, is one of their concerns about not moving rapidly on exchange rates. But they also have the growth. They are very export dependent.

I think, like every government, they face conflicting push and pull and pressures and they are treading very carefully. In the end, they are going to have to make their decision of what is in China's interest. I think where the Bank and the Fund can be useful and the dialog with members can be useful is in showing them why they need to make a change for themselves, they need to make the exchange rate move. And there are ways to do it that would avoid any major financial crisis.

But in the end not the IMF, not the U.S. has—can alone make them do something that they think is fundamentally against their economic and political interest.

Chairman BAYH. If I could shift for just a moment, we have been focusing here on the Fund. I thought Dr. Lerrick made an interesting point, and he has written about this. That is the Bank's practice of continuing to lend to middle income countries, some of which enjoy these very large reserves and are now engaged in investing in ownership stakes abroad and so forth. I would be interested in other panelists' view about what is the continued legitimacy of the Bank being involved in countries with those sorts of reserves? Shouldn't they be required to spend some of their own reserves internally before the Bank basically—and they can borrow on equal terms with, in some ways, fewer strings attached in a private credit markets. What is the legitimate role of the Bank in this sort of situation?

Ms. Willkens, we have neglected you, and then Ms. Lissakers.

Ms. WILLKENS. It has been a privilege to get the education I have, so thank you.

There are many projects that the Bank is doing in the middle income countries that private credit markets would not touch. They would not touch a primary education project. They would not touch a malaria or HIV/AIDS project. There is no profitable return on those. So the question then becomes whether the government is going to use its only resources.

Chairman BAYH. Are those IDA projects?

Ms. WILLKENS. No, I mean IBRD. I am speaking of IBRD, as well.

Chairman BAYH. Let's let her finish, Dr. Lerrick.

Ms. WILLKENS. So you have a range of projects and in the public sector lending that the Bank does on the IBRD side my observation over the last 10 years has been by and large these projects are projects that are not going to have a large profitable return that the credit markets would expect.

And as we heard, some of the challenges facing us going forward in these middle income countries are going to be trade, trade capacity, normalization——

Chairman BAYH. I guess my question to you would be I am sure they are worthy projects. If we are looking at a country that has hundreds of billions of dollars of their own reserves, why shouldn't they undertake those worthy projects in their own country first before calling upon the rest of the world?

Ms. WILLKENS. That is a good question. Today, I think the Bank offers the expertise. I have always said that the World Bank has two things it sells. It sells expertise and it sells money. And to the extent the Bank maintains an international best practice expertise in some of the new areas that it is pressing forward on, then I think the Bank is a legitimate offerer of finance.

Chairman BAYH. I will have a few questions about some internal management issues. Dr. Lissakers and then Dr. Lerrick.

Ms. LISSAKERS. Unless you change the incentive structure for the Bank, that pattern of behavior is not going to change. There are three, I think, major incentives. One, loans to middle-income countries are the major source of income, operating income for the Bank, as I understand it. And if they stop lending to middle-income countries the Bank is going to have a serious budget problem.

Chairman BAYH. That is interesting, they are a major source of revenue for the Bank and yet they are not profitable and so the private sector would not make them?

Ms. LISSAKERS. They generate interest income for the Bank. You can argue with how the Bank keeps its books. But certainly that is what people at the Bank—you can understand I am less familiar with the internal interstices of the Bank's funding. But that is certainly what I have been told.

Second of all, I know in the past at least—I do not know if it is still true—career paths were really determined by your ability to push loans out the door. That was the most concrete measure of——

Chairman BAYH. Success is measured by the volume of loans undertaken?

Ms. LISSAKERS. Right.

But the third one is that the members like these loans because they are very often tied to procurement of goods from the richest manufacturing countries. Not always but very often. And the members want to see these institutions generate a lot of procurement from their own manufacturers.

Chairman BAYH. Dr. Lerrick.

Mr. LERRICK. Senator Bayh, I think there is a misunderstanding about the type of project the World Bank funds. The first premise is every IBRD loan carries the government guarantee. It does not matter whether the loan is for an AIDS project, to build a power plant, to build a road, for primary rural education. The central government is the entity on the hook.

Once that entity is on the hook, the private sector does not care what you do with the money. It does not care whether you are financing on AIDS Project or building a power plant. In fact, if you look at a prospectus for a public bond offering for Brazil or for Mexico or for Korea or Indonesia, the use of proceeds section simply says general government purposes. The government has total discretion as to how it uses the funds.

So to say that the markets are not willing to finance pro-poor programs is just incorrect. Any pro-poor program the Bank will fund, the private markets will fund.

Second, the question of the income on loans to middle-income countries, the Bank does not make its income off of lending to middle income countries. They do not even cover their administrative budget from it, from the spread. The way they really make their money is the Bank has on its balance sheet almost $40 billion of zero cost capital, which is the initial cash contributions of the members when they join the Bank; and second the accumulated past retained earnings the Bank made when lending was profitable.

It is the income on that $40 billion that is paying all of the expenses at the Bank. Because very simply $40 billion invested in U.S. Treasury notes at 5 percent generates $2 billion a year of income. The World Bank's net income reported last year was $1.7 billion. So that proves that there was a net loss on its lending activities of at least $300 million.

Mr. TARULLO. Senator, can I just make one point on this issue, because there is a certain irony here since I sat on a group considering what the World Bank should be doing in which I was the one saying they should not be lending to middle income countries so much. And in this forum I just want to offer a couple of reasons why although that should be the direction in which things move there may be reasons to have some lending to middle income countries for some time.

First, as somebody as already referred to, part of what the country buys is expertise. If you look at the—there have been cases in which a middle income country is paying higher interest on a Bank loan than it could have gotten in private capital markets and that is because they are buying something different.

Now we could say that should be a market transaction, too. But there is, I think, a global interest in some of the interaction that takes place because the things like environmental standards, things like treatment of minorities are dealt with differently when there are Bank standards attached to the lending. And we are talking about some countries in which those values have not been internalized. That does not justify——

Chairman BAYH. So there are non-economic values, perhaps that——

Mr. TARULLO. That are sort of global goods, in some ways.

The second thing is, to return to a theme that you and I actually were talking about in the Fund context, it may be that there is more of a global package here that is eventually going to re-energize both institutions and pull China and other countries more into them.

That package is probably going to consist of, it is going to consist of, a reallocation of quotas and more voting influence. It is going to consist of a greater sense of expectation upon China's own practices in a sort of reciprocal fashion.

But I wonder whether some sense of continued access to some Bank resources for some limited period of time might not end up being de facto a piece of that.

I guess my point is all the things we are talking about in both institutions are separate in one sense, in an analytic sense. They could be tied together in the larger task of trying to move the institution forward.

Chairman BAYH. Dr. Lerrick, you mentioned, and I cannot recall the amount precisely, $3 billion or $4 billion will be the U.S.'s part of the additional capital being put into the World Bank over the next 3 years? Is that about right?

Mr. LERRICK. It will be approximately—it has not been determined yet. It will determined next year, but it will be between $4 billion and $5 billion.

Chairman BAYH. Mr. Tarullo, then help me explain to the average American taxpayer why—I would have to assume they will believe that this money is going for the very worthy purpose of helping to alleviate global policy and that kind of thing—why some of that should be invested in China——

Mr. TARULLO. Dr. Lerrick, you are talking about IDA; right?

Mr. LERRICK. Those funds will go to IDA.

Chairman BAYH. Those are not lent to middle income countries?

Mr. TARULLO. That is for the 80 poorest.

Chairman BAYH. Great. That helps to clarify that then.

Ms. Willkens, yes.

Ms. WILLKENS. There is IDA going into China and there is some IDA money going into India, as well. By the most part they have graduated to IBRD. But for far western provinces, you still find IDA money mixed in.

Chairman BAYH. Out in the weaker area?

Ms. WILLKENS. Yes.

Mr. LERRICK. Not for China. China graduated 3 years ago out of IDA. India—Ms. Wilkins is absolutely right. India is going to receive more than $2 billion this year of IDA funds. And you certainly can ask the question why India which is, as a government policy, limiting foreign private investment in order to maintain control over its economy, is borrowing at zero interest from the World Bank to finance projects that the private sector would be happy to fund. And that is in India. India is a continued IDA borrower. In fact, I think it will be the largest IDA borrower this year.

Chairman BAYH. Any of you want to address—and our time is about running out. We have got five votes coming up here. And you have been very patient so far.

Anything that can be done to perhaps address some of the internal incentives in the Bank, this culture of lending I think it is referred to? Is there really any accountability for loans that go bad? And is success—how do we deal with success being evaluated on the volume of activity as opposed to the effectiveness of the activity?

Mr. TARULLO. Let me just mention two things quickly, Senator. One is changing the design of the lending itself to get away from what we call conditionality, conditions about what the government is supposed to be doing generally when it receives the money, and moving much more directly to outcomes as the goal of the loan and quite explicitly meeting those outcomes as a condition for renewal or supplementing of the lending.

I think that kind of approach has manifold benefits. One is that it creates a kind of internal disincentive for there to be funds siphoned off for corruption or things to operate inefficiently because if they do that there is not going to be renewal.

Secondly, it gives a different kind of criterion on the basis of which one can evaluate the loan officer's performance. Did the lending that she moved out the door end up having good outcomes as opposed to just looking at the net amount of money.

Chairman BAYH. Doesn't this get to some of your concerns, Ms. Willkens, where the Bank has quite a cadre of excellent economists and people who can give a macro view of things but perhaps not enough people who are expert at actually making the resources translate into the on the ground results that we are looking for? Has that been part of your observation?

Ms. WILLKENS. I was relieved, I think the direction you were heading, these internal measurements would be very useful. What the private sector has had a lot of concern with over the last several years, especially under President Wolfensohn, was the increased push out the door for what they called sectoral adjustment lending, $300 million to the health for Mexico for what?

And then the issue came up how are you going to measure what was supposed to be achieved? And no one knew. And by the way, there were no procurement rules that applied to that $300 million.

So for internal measurements of effectiveness and satisfactorily addressing the objectives of the project, that has never been a strong suit of the Bank and that could be improved.

On the ground yes, the companies we work with, all of them would say that the need for sector expertise and project management expertise on the ground is extra important. The banks have all declared they are going to increase their infrastructure lending over the next two to 3 years. Engineers are passe in the Bank in the last 10 years. So the Bank really needs to beef up in the infrastructure sectors, we think, to be able to support effective measurements and effective and actually timely implementation of the projects.

Chairman BAYH. How vigorous do you think we should be in insisting on some of these internal reforms as going hand-in-hand with the new tranche of funding?

Mr. LERRICK. Senator Bayh, I think economists believe that bad incentives are the root of all evil. Clearly the Bank and, in fact, the entire aid business—the failure of aid are due to the bad incentives.

Aid has clearly been a failure, development aid has clearly failed. The problem is that you need to reform the incentives throughout the entire system. Within the Bank the incentive is just the volume of lending. It has never been what results, what performance has been achieved by that loan or that grant.

In fact, when it was mentioned what recommendations the Meltzer Commission came up with were implemented or not implemented, the key recommendation to do with the World Bank was to shift to a system of performance-based aid, that in essence you only delivered aid based on measured, verified performance. And it is not very difficult. We are not talking about complicated projects. How many children were vaccinated? How many cubic meters of water were treated? But the incentives are not there.

In fact, the concept of performance-based grants which became the platform of President Bush——

Chairman BAYH. Why is there a resistance to that sort of thing internally within the organization?

Mr. LERRICK. It makes life hard. It is a lot easier to fly into Rio, Sao Paulo or Brasilia and sign a $500 million loan to the Brazilian government than to go off into the bush and try to measure 50 $1 million vaccination programs. It is a tougher job and the Bank does not really want to do that and it makes their life difficult.

But I think when you go back, there is a fundamental flaw in the entire aid concept which is that the donors are more desperate to give than the recipients are to receive the money. Once you understand that problem it makes it almost impossible to make aid to work. Because if the World Bank comes to a country and says we want you to enforce these anticorruption standards and the country says we do not want to, and the Bank says OK, we will still give you the loan. What is going to happen? That is one of the great problems.

The problem—and you saw it at the G–8 summit in 2005 in the world's leaders stood up and said we are going to give all the debt relief, we are going to double aid, and then we are going to double it again. And it is going to be focused on the very poor countries such as Africa. The problem is that if you actually enforce these anticorruption standards there would be no destination in Africa to ship the money to.

And since the overwhelming goal of the aid community is to ship the money, they are going to keep sending it with or without the corruption. That is the main problem.

Chairman BAYH. Ms. Willkens.

Ms. WILLKENS. I agree with many of the remarks that were made. I think the World Bank, though, has an opportunity here. And one of it, as its core deliverables and its expertise.

One of the reasons they have not been able to measure how many vaccines are being delivered out there in the remote areas is there have not been the tools, there have not been the technology, there have not been reporting systems, there have not been statistical collections able to then roll up and report out. But if you look at the World Bank's pipeline now you will see a handful of five to eight statistical projects under review in the pipeline for approval. And over time I think the Bank has an opportunity to take a leadership position to create those statistical gatherings that will empower analytical review of the projects.

Chairman BAYH. Is it your impression in your dealings and the companies you deal with, their dealings with the Bank, that there is an openness to requiring more accountability in terms of insisting upon not just inputs but results? Or are they culturally resistant to that sort of thing?

Ms. WILLKENS. Private sector, absolutely receptive to it——

Chairman BAYH. No, no, the private sector. I am asking about the Bank.

Ms. WILLKENS. The Bank themselves. In large part where the tools are available to measure we find receptivity to the measurements. Now understand I deal in the health and the information technology sectors and the like where these measurements are very core to the companies that are doing the business as well. So the two come together and there is a lot of alignment and partnership in proposing solutions.

The other point I wanted to make on corruption though, as private sector we are quite concerned that we see the Bank lowering the floor on international standards. Again, I see this as an opportunity for the Bank to come in and use its bully pulpit and use its position to start creating a gold standard for positive efforts made, anticorruption efforts made, and in international best practice and to put them in place.

And we are seeing a few African countries where leadership has changed fairly dramatically where we think, especially in Africa, there is a chance for several countries to take a—become the gold standard—probably should use a different word than gold in Africa—but become the guiding Good Housekeeping seal of approval there for transparency and good governance.

Chairman BAYH. Just two final questions, one Ms. Willkens for you and then one generally. There is a move afoot, as I understand it, at the Bank to give more discretion to the recipient countries in terms of managing these projects. Has it been your experience that when that has been the case too often the specifications for procurement have been so finely tailored as to make only one provider eligible for receiving the funds? Would that only run a greater risk perhaps of corruption? Or to play off on something Ms. Lissakers said, the countries providing the credit want their companies to provide it. Perhaps there is management on the part of the recipient countries, too.

Ms. WILLKENS. The proposal you are speaking of is something known as country systems in procurement and it was a proposal—you mentioned this in your opening—a proposal that the Congress, in the Foreign Ops bill of 2006 specifically conditioned 20 percent of the IDA funding on the basis that the World Bank withdraw their country systems proposal. That was done, the IDA money was released, but the new country systems proposal hit the table in May of this year. It looks worse than the proposal that was withdrawn at Congress's request.

So what we are concerned about is yes—and I have a host of examples where the specifications look like a vested interest that has gotten to the government.

What happens today for a company as we have, through a series of protections under the World Bank guidelines and the standard bidding documents, the ability to basically move into the World Bank procurement officers and get remedy before that procurement is completed and contracts are awarded.

Under the proposal of the Bank that is on the table today, those contracts would be let and 2 years from now the World Bank would be able to come in and look at the project and see what went wrong. But we are very concerned about the lack of a methodology, a lack of a statement of international best practice in procurement by the Bank and really the kinds of safeguards that will keep U.S. companies—and I should say, Senator, as well, European countries involved in these projects. There is quite an alliance that has been built over the last 2 years to urge that the World Bank keep in place its procurement policies for international competitive bidding to protect against this kind of shenanigans and many, many more.

Chairman BAYH. Mr. Tarullo, you mentioned that some of the loans perhaps are given to promote values that it is difficult for the marketplace to capture. Would one area perhaps be in the area of biodiversity, for example, projects related to that? Or projects that span national borders that perhaps it is difficult for a single country to capture the entire value?

Mr. TARULLO. I would think again, Senator, in line with the notion that the Bank should be providing public goods, I do not know enough to make a judgment as to the conditions under which such lending or technical assistance would be useful. But you have defined a situation of a public good issue. That is where the Bank should be concentrating its efforts, not in areas where private investment, even without government guarantees, would be forthcoming.

Chairman BAYH. A final observation, I gathered from all of your testimony that you all would embrace a robust focus upon eliminating corruption. I gather that there are some people who think that that is just sort of the cost of doing business in some of these countries and if that is what it takes to grease the wheels in the short run to get some of these things done well, that is OK.

But I gathered from your testimony that in the long run that does more to undermine the cause of helping the poor than any sort of expediency in the short run might justify. Is that a fair observation? Anybody here today want to stand up for corruption?

Ms. LISSAKERS. I would just like to say, in defense of the Bank, that I think that is an area where there is a genuine effort to move away from simply accountability in projects to the outside world to the Bank or to its members but to reach out to local civil society. In the countries where we work on the extractive industry transparency, the Bank has been quite supportive and is trying to do more to build up the capacity of local citizens to demand information and accountability from their own governments. That in the end is the only solution or cure to the widespread corruption problem.

I do not think it is systematic enough in the Bank and I do not think it is embedded across the board in its activities. There is a long way to go. But I agree absolutely, the Bank should be a promulgator of best practice and it should be absolutely rigorous on that score, as should the member governments, which is why I mentioned the importance of OPIC, for example, saying if we are going in and guaranteeing a project in extractive industries that are highly prone to corruption, we are going to safeguard that by insisting that the companies that benefit from our guarantee publish what they pay to the government where this project is taking place. That is good for business. It is good for development.

Mr. LERRICK. Senator, I would like to come back to a point you raised earlier which is the Congress next year is going to have an opportunity when the Treasury comes for an appropriation for the IDA funding, IDA 15, to focus on just the issues you raised. Should there be performance evaluation of IDA projects? Should we have transparency? Should we know what the project was supposed to do? Know what the project did do? Not just us, the public.

And I think that is where the Congress has its ability to actually influence the outcome and help the poor in the developing world, which is to attach conditions to this funding which I do not think any reasonable person could object to, which is we want minimum standards of performance evaluation. We want minimum standards of disclosure and transparency to know that two things: one, the money of the industrialized world taxpayers are being well used. And when you go back to your constituency and say we just gave $4.5 billion to help the poor, I think you would want to know something more than well, it went to the central bank and who knows where it went after that. And say well this is the people—because the American people I think are very generous and would be happy to provide the funding if they know it is doing good. But they are suspicious that it is not, and rightly so. This is the Congress's opportunity to put in some standards of disclosure and performance monitoring.

Mr. TARULLO. Senator, if you are going to take that opportunity, I would urge you to do it sooner rather than later. That is, do not wait until the Treasury Department is coming up looking for the IDA funding because then everybody is going to get in a crunch.

Just let me hypothesize for a moment. A Dodd-Shelby-Bayh-Martinez letter to Bob Zoellick saying we have conducted some hearings, we have listened to a lot of people. This is the way we are looking at the Bank and we know you are going to be or Treasury on your behalf is going to be up here next year looking for IDA funding. These are the kinds of things we are going to be looking at and we just want to let you know now.

And then that last key little paragraph, we look forward to our staffs discussing this issue in the coming year.

Chairman BAYH. I think that is an excellent suggestion, Mr. Tarullo. I have asked my own staff to follow up on that.

I want to express my gratitude to all of you for your advice today, for your patience.

Just one editorial comment of my own, with regard to the Bank, and then I will wrap it up.

It seems to me that an entity devoted to alleviating global poverty has a special responsibility to operate efficiently and to not squander resources and perhaps to bend over backwards to ensure that the way it treats its own employees is generous but not lavish. That sends the wrong signal as well.

Having said all of that, thank you very much. I think these are very important questions you have helped shed some light on here today. I look forward to following up with you.

And I am going to follow up on your suggestion, Mr. Tarullo, to reach out to some of my colleagues and begin this dialogue with our policymakers sooner rather than later.

Thank you all very, very much.

[Whereupon, at 4:43 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

UNITED STATES SENATE
Subcommittee on Security and International Trade and Finance
Committee on Banking, Housing, and Urban Affairs

Hearing on
Reforming Key International Financial Institutions for the 21st Century
August 2, 2007

Prepared Statement of
Daniel K. Tarullo

Mr. Chairman, Senator Martinez, Members of the Subcommittee, thank you for your invitation to testify this afternoon. I am a Professor of Law at Georgetown University Law Center and a non-resident senior fellow at the Center for American Progress. I testify today in my individual capacity as an academic, with no client interests or representation.

As the title of this hearing suggests, the international financial institutions created at the Bretton Woods conference in 1944 are showing their age. The world around them has changed dramatically: Capital now flows in amounts and at a pace undreamed of in the mid-twentieth century. The number of member countries has increased by a factor of greater than four, to the present level of 185 in both the International Monetary Fund and the World Bank. The world's economic weight is shifting towards Asia.

Over the years, the Fund and the Bank have made many policy mistakes of both commission and omission (though one hastens to add that these policies were usually agreed to, and often encouraged, by the institutions' largest members, beginning with the United States). And, like most organizations more than sixty years old, the Fund and the Bank have taken on certain internal features and practices that are not advantageous for responding to these new conditions.

Many commentators have concluded that, for both the external and internal reasons just mentioned, far-reaching changes are needed in both institutions. Indeed, in the past decade, some on both the left and right ends of the political spectrum have suggested that one or both institutions have outlived their usefulness. As my testimony this afternoon will demonstrate, I agree that extensive change is needed. However, my call for change rests squarely on the belief that it is very much in the interest of the United States that these two institutions successfully adapt so that they can more effectively confront the new challenges and take advantage of new opportunities. Thus, as we call for reform, it is important that these calls be cast less as threats to the Fund and the Bank than as the kinds of demands we would place on any organization that has a vital role to fill but is not currently up to the task.

In the balance of my statement I will try to place in context the current calls for reform by identifying both the similarities and the differences in the situations of the two institutions and thus the right agendas for reform. Though the two institutions are closely tied in many ways, they are faced with quite different challenges today. In some sense, the problems of the

Bank are fundamentally management problems – extensive, to be sure, but largely within the capacity of the Bank's senior management to address, assuming even moderate levels of cooperation from major countries.

The Fund, on the other hand, truly faces an identity crisis. It has fallen rapidly from perhaps the most influential international institution (though not a beloved one) a decade ago to the point where its very relevance to contemporary problems has been called into question. Although not without its own shortcomings, the Fund management has tried to address this situation by proposing changes in Fund structure and practice. But management cannot on its own overcome the resistance and disagreement among some of its most important members.

In the last half of my statement, I will suggest some specific changes that could be part of, though by no means comprehensive, reform agendas for both institutions. The changes I identify are built on the different nature of the challenges confronting the two institutions.

The Context for Reform

Let me begin by making three points that provide some important context for crafting reform agendas for the Bretton Woods institutions.

First, beginning with their simultaneous creation towards the end of World War II, the IMF and the World Bank have been complementary parts of a single system. Their governance structures are similar. The physical proximity of their headquarters has facilitated considerable informal interaction among Fund and Bank staff.

More fundamentally, the missions of the two institutions are, to a considerable extent, dependent on the existence of the other. Although their missions are distinct, requiring different forms of expertise, the tasks of either become harder to perform if the other is ineffective. Thus, for example, development assistance to build needed infrastructure will yield a lower return in a country plagued by financial instability. Conversely, financial stability will not translate into sustained growth in a developing country lacking the most basic forms of physical and human capital.

This relationship between the two Bretton Woods institutions has important implications for shaping a sensible reform agenda. Most obviously, the mutual dependence means that the success of reforms in one organization depends, albeit indirectly, on the success of reforms in the other. Yet the very co-existence of the institutions means that each should be allowed to concentrate on its own missions, which require very different kinds of expertise.

In particular, we must resist the temptation to turn the IMF into a development institution. It *is* imperative that the Fund appropriately calibrate its conditionality and technical assistance policies to the differing circumstances of developing countries. There is no question but that the Fund has at times, including at some very important times, failed to do so. But making these important modifications to its policies in pursuit of financial stability is a very different matter than engaging in longer-term lending that is oriented more towards development than to financial stabilization. The Fund staff is, to be honest, not particularly well-suited to development lending. I wonder whether it might not be best to transfer any resources dedicated for long-term lending to the Bank.

My *second* contextual point is that this is not the first time these institutions needed to reorient their operations in quite basic ways. As the formal name of the World Bank – the International Bank for Reconstruction and Development – reminds us, the first anticipated order of business of that institution was reconstruction assistance in the theaters of the Second World War. The very first loan made by the Bank and, in real terms still one of its largest, was to France. The Netherlands, Denmark, Luxembourg, Belgium, Yugoslavia, Italy, and eventually Japan were also recipients of loans through the early 1950s. In the wake of the Marshall Plan and reconstruction, the Bank shifted the focus of its operations to development. Although it still lent money, often for some of the same immediate purposes as in its reconstruction efforts, doing so in developing countries required a focus quite unlike that needed where the emphasis was on rebuilding something that had recently existed.

The reorientation forced on the Fund was considerably more dramatic. The IMF began as guardian of a fixed exchange rate system, in which each member state's currency was set at a "par value," defined by reference either to gold or to the dollar. Although a country could change its par value in the face of a "fundamental disequilibrium" – and, in theory, even then only with the approval of the Fund – such changes were expected to be rare. And, in fact, they were exceptional, at least among developed countries, until the late 1960s. But then, for a complex set of reasons that I need not fully rehearse here, a combination of divergent inflation experiences, reluctance of surplus countries to revalue their currencies upwards, increased international capital flows, and the unsustainable guns *and* butter policy of the United States placed increasing stress on the system.

In 1971 President Nixon ended the convertibility of dollars into gold and, thereby, unilaterally abrogated the par value system that had been agreed at Bretton Woods. After an unsuccessful effort to restore a more or less fixed exchange rate system, the IMF Articles of Agreement were changed to permit countries to choose their own exchange rate arrangements. Yet the revised Article IV also created obligations in each IMF member, including one of special interest today – to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The Fund had a continuing role in achieving international financial stability, but now that role was to be played through its power of "surveillance" over its members' exchange rate policies, rather than through enforcement of specific par value obligations.

I will return later to the role the Fund has been and, more importantly, should be playing in overseeing the exchange rate obligations of its members. For now, I want simply to note that, with the end of the par value system, the IMF as an institution was forced to change its role in a fundamental way. As is well-known, much of its activity was redirected towards dealing with financial crises in developing and emerging market countries, many of which had not even existed as independent nations in 1944. Thus, like the Bank, during its lifetime the Fund has already had to make dramatic changes in its work. Today both institutions may face watershed moments, but not for the first time.

A *third* contextual point for considering reform of the Bretton Woods institutions is that their failure or, what is much the same thing, irrelevance would have repercussions far beyond the potentially deleterious effect on international financial stability or development. These two institutions have been at the center of the multilateral economic system created sixty years ago. Their decline would both reflect and accelerate a basic change in how the rules and norms of the international economy are formed. Over time, the most likely direction of such change would be towards stronger regional arrangements – particularly, though not exclusively, in Asia. It is true that the long-predicted rise of regionalism has, at least outside Europe, not been realized. And it is also true that recent regionalist efforts in Asia have proceeded only in fits and starts. But I think it quite likely that a palpably weakened multilateral system would prod many of these efforts forward.

The erosion of a genuinely international economic system could well have a negative effect on world economic growth. It would surely reduce American influence over what would be a more fragmented global economy. It is only slightly melodramatic to say that the fate of the Bretton Woods institutions, particularly the Fund, will be a bellwether for the adaptability of the existing multilateral economic system to the new conditions of the 21st century.

One System, Two Institutions, Two Reform Agendas

The preceding three points make clear that the two Bretton Woods institutions are linked in important ways. They also share some basic problems. *First*, there is uncertainty and disagreement over how each institution should respond to the global economic changes mentioned earlier. At a high level of abstraction, there is general agreement on what each institution should do: The Bank should promote development, and the Fund should promote financial stability. Try to get much more specific, though, and consensus breaks down.

Second, both face challenges to the legitimacy of their governance structures. At the Fund these challenges go directly to the allocation of quotas and voting rights, with important emerging market countries understandably feeling that their growing economic importance is not reflected in their influence with the Fund. At the Bank, too, there are complaints about quota allocations and voting rights. But there the more immediate governance concern is the degree to which recipient countries are able to participate in the key discussions that shape Bank policies.

Third, both institutions face medium-term funding difficulties with a common origin – the reduced demand for their resources. Both institutions derive a considerable portion of their operating revenues from the spread between the interest they charge on loans and what they pay for those funds – either to capital market actors for borrowed funds or to members as interest on their paid-in capital. The absence of financial crises has meant that few countries have drawn on Fund resources in the last five years. The Bank has lent progressively less to middle-income countries. Its lending to poorer countries takes place more through the IDA, whose concessional rates are insufficient to replenish available resources, much less provide operating expenses.

Despite these similarities, the problems faced by the two institutions differ in important ways. Consider the point about funding. In most respects, this is a good news story: The successful development of the middle-income countries and their concomitant access to global capital markets are reducing their need for Bank funding. Similarly, the absence of financial crises has meant that emerging market countries have not needed Fund assistance. While this trend creates a funding problem for the Bank, it hardly eliminates the need for the Bank's services – the challenge will be to come up with the resources to assist the poorer countries that pay lower interest on their loans.

At first glance, it looks as though the Fund faces a situation analogous to that at the Bank – the recent period of financial calm will eventually end, new kinds of crises will erupt, countries will once again be knocking at the Fund's door, and the task will be to intermediate the necessary resources.

This may yet be the next chapter in the Fund's history. But it might not, because something else has occurred during this period. Many of the emerging market countries that in the past would have been quick to approach the Fund at signs of a financial crisis have elected to self-insure through the accumulation of massive foreign exchange reserves. Ironically, then, the effort by these countries to avoid a position of dependence in the Fund's principal activity of the last thirty years – lending to developing countries in financial crisis – has contributed to the re-emergence of global imbalances and exchange rate friction. These new conditions require the Fund to revive its old role as overseer of foreign exchange policies, although in very different circumstances from the par value system established sixty years ago. To date, the Fund has been unable to do so.

Thus, while each institution is affected by the same transformations of the global economy, and while each is in need of far-reaching change, there are important distinctions in their situations. These differences have implications for the reform agendas that are indicated for each.

The Bank's policies are regularly attacked as ineffective, as insufficiently grounded in the needs and preferences of recipient countries, as wasted because misappropriated by corrupt officials of recipient governments, as burdening developing countries with more debt, and as anachronistic in light of the growing ability of emerging market countries to access capital markets. More fundamentally, there has been a long and vigorous debate among academics and policymakers over the theory of economic development and the assistance policies that will help achieve this goal. It is almost literally true that, no matter what the Bank does, *someone* will think it is misguided.

Sustained and, in some cases, fundamental disagreement among acknowledged experts over the core precepts for successful development assistance certainly complicates the task of the Bank's senior management. But these disagreements need not be resolved for the Bank to pursue its mission in a responsible way, because the Bank need not commit to a single strategy. In Fiscal Year 2006 the IBRD lent $14.1 billion for 112 projects in 33 countries. The International Development Association, the concessional financing arm of the World

Bank Group, lent $9.5 billion for 167 projects in 59 countries of the world's poorest countries. The International Finance Corporation, the entity within the World Bank Group that invests in private sector activities, committed $6.7 billion in debt or equity to 284 projects in 66 countries. Among the three parts of the World Bank Group providing capital or assistance, that is a total of 563 different projects in a single year. Despite the separate identities of these entities, lending decisions in all three are made by essentially the same group of executive directors.

With this many operations, the Bank can simultaneously pursue multiple strategies. Indeed it should and has. Under these circumstances, though, it is imperative that the Bank maximize the effectiveness of its lending and assistance policies. A critical part of that task is that the Bank be organized to learn what policies succeed under what circumstances. Just as critically, the Bank must adjust its future activities to take account of what has been learned. As I will suggest in a moment, these observations provide a starting point for a reform program at the Bank.

The IMF confronts a more fundamental challenge to its position. While different strategies for development can be simultaneously pursued by the Bank, the Fund's mission of maintaining global financial stability requires a more cohesive approach. Yet there is no agreement on what the Fund's role should be in overseeing member countries' foreign exchange and macroeconomic policies in the face of large global current account imbalances. Indeed, there is not even a working consensus among Fund members as to how much of a threat these imbalances pose for financial stability.

Such norms of behavior as exist in Article IV have not been clearly elaborated by the Executive Board or Fund management. Indeed, since the demise of the Bretton Woods par value system, the Fund has not been consistent in its attention to exchange rate policies and problems. At times, as during the British and Italian currency difficulties in 1992, the Fund was quite active. At other times it has stayed in the background (or, perhaps, been confined there by some of its more influential members, who may have preferred handling the issue themselves in the G-7).

In the last thirty years, most countries whose policies were in need of adjustment eventually faced pressures on their currencies that led them to the Fund for assistance.[1] Under those circumstances, the Fund had sufficient leverage through its conditionality policies to require changes in country policy in return for access to Fund resources. These conditionality policies were at times misguided and, even when not misguided, were generally unpopular – the routes out of a crisis are never pleasant. The point, though, is that the Fund had influence. Today, in contrast, the Fund has little or no more influence on China or any other emerging market country with large accumulated foreign exchange reserves than it has traditionally had on the United States – which is to say not much. Moreover, it is possible that the importance that those countries attach to the Fund could decline further.

[1] Not Britain and Italy, of course, which is why the 1992 ERM problems elicited a Fund response more directly address to exchange rate surveillance.

Another concern – suppose the next global financial crisis arises not from unsustainably high exchange rates and excessive foreign currency debt in emerging markets, but from a meltdown in global derivatives markets. The former is obviously less likely in light of the aforementioned foreign exchange reserves. The latter looks a bit less far-fetched than it might have a couple of weeks ago. Should the Fund have a role to play in responding to such a crisis? As we sit here today, it is clear that the Fund does not have the capacity to assume such a role. So if the answer to that question is yes, a lot of work will be required.

Yet another issue – those massive foreign exchange reserves to which I keep referring are no longer being held solely in the form of the government securities of the United States and other "hard currency" countries. The countries holding those reserves are creating so-called sovereign wealth funds, designed to invest in asset classes extending far beyond government securities. While the prospect of these government funds purchasing sensitive companies in other countries has garnered considerable publicity and elicited expressions of political concern from the likes of German Chancellor Angela Merkel, these funds could also inject a new element into the international financial system. The lack of transparency in the holdings and activities of those funds raises the danger not just – and perhaps not principally – of politically motivated decision-making in the investment and disinvestment of those funds, but also of a financial impact that could occur with the movement of large sums in and out of equities, bonds, and other financial instruments. To date, the Fund has done little more than express concern about this development. It has not, for example, attempted to incorporate sovereign wealth fund policies into its existing standards for economic transparency by its members.

It should by now be clear that internal institutional reforms initiated by Fund management will not be sufficient to cure what ails it. Ultimately, the fate of the Fund depends upon whether the world's established economic powers can agree with the world's rising economic powers on a reinvigorated role for that institution in the oversight of exchange rate policies and in responding to new forms of global financial dislocation. But internal reforms of the Fund, such as reallocation of quotas and voting power, will be an essential part of any such rapprochement. Moreover, even accounting for the admitted handicap of being caught between its disagreeing members, there are problems with the Fund's senior management and staff that need to be addressed.

A Reform Agenda for the Bank

As I suggested earlier, I will not set forth here a comprehensive development strategy for the Bank to follow – in no small part because I have none to offer. But, as I also suggested earlier, one need not have such a singular strategy in order to better fulfill the Bank's mission of promoting development. What is needed is an extensive overhaul in the Bank's staffing and operations – all with the aim of maximizing the effectiveness of its lending and technical assistance. From among the many proposals for Bank reform advanced in recent years, here are some that could be pieces of a reform agenda directed to this goal:

Change the Size, Mix, and Incentives of the Bank Staff. I have been struck by the number of former Bank officials and staff – all committed to the Bank having a central role in promoting development – who believe that the Bank is too large to be effective. It has more than 10,000 employees, four times the number at the IMF. Despite some laudable recent steps to move more staff into the field, around 85% of these employees are based in Washington. The Bank has a lot of work, to be sure, but one invariably comes away with the impression that there are often just too many people in each meeting and on each project. While becoming more nimble should be sufficient motivation to pare the size of the staff in the coming years, financial constraints will eventually force this move in any case. As the Bank's lending to middle-income countries declines, the reduced lending yields less interest, which is a principal source of its administrative budget. Better to begin a gradual and orderly process of downsizing now, rather than to wait for the crunch.

As the size of the staff must change, so must its composition. Too many Bank employees – although smart and dedicated – do not really have the kinds of background and training that are most important for a development institution. Generalizations on such matters risk misleading more than they elucidate. Still, some examples are important to put on the table. I would venture to say that there are still too many academically-oriented economists on the staff. The Bank needs to be a center of thinking about development, but its research staff should, as explained below, be more oriented towards program evaluation. It should draw more on the Bank's operational experience to develop and test hypotheses about development policy. That is where its comparative advantage almost surely lies, not in empirical studies that could be conducted by academic economists around the world.

Conversely, there are probably too few Bank employees who have relevant experience in health care, infrastructure operations, education, and the other areas in which the Bank concentrates its activities. It may be that people with such backgrounds are not so likely to apply for positions with the Bank. In that case, some proactive recruiting may be called for.

Finally, as has been noted by many others, the incentive structure for Bank employees still overvalues moving money (in the form of loans) out the door. If we want Bank staff to concentrate their energies on (a) what works and (b) the poorer countries with the greatest development needs, then they must be assured that their prospects for promotion will not be limited by spending time in a poor country carefully designing a project tailored to specific conditions in that country.

Design and Evaluation of Projects. If there is agreement that the goal of the World Bank is to maximize the effectiveness of its lending and technical assistance activities in promoting development, then those activities should presumably be designed to maximize desired outcomes. If a project is designed to increase the availability of potable water, for example, then its success should be judged by how many additional people gain access to drinking water. My understanding is that these performance measures are generally not central to the goals and assessment of IBRD and IDA lending.

Not all projects are susceptible to such readily quantified goals and, even where they are, the setting of reasonable baseline expectations may not be an easy task. But a concerted effort within the Bank to focus more on results would have several important advantages:

- It would make decisions on later lending for similar purposes to the same government more informed. When subsequent lending was reduced because of poor performance, it would advance the goal of maximizing the utility of available resources by channeling those resources to governments that use them most effectively. This impact on additional lending would also provide an indirect but effective check on the corruption or inefficiency of recipient governments.
- It would allow the Bank to reduce the use of conditionality in its lending activities, a practice that has managed to be both relatively ineffective and controversial at the same time.
- It could contribute to a reorientation of incentives for Bank staff by providing an additional set of measures for their performance.
- It would facilitate evaluation of Bank projects and, thereby, both further the goal of maximizing the effectiveness of Bank resources and provide important knowledge to other official development institutions, bilateral development agencies, and private foundations.

The importance of thorough evaluation of Bank (and, indeed, all development assistance) activities cannot be overstated. Without it, an essential tool for maximizing the effectiveness of those activities is lacking. As just suggested, incorporating more performance and outcome measures in projects at the design stage will effectively build evaluation into the project. But even a significant move in this direction will not obviate the need for judicious use of rigorous impact evaluations, which assess the difference a program actually makes by comparing outcomes to those observed in similar circumstances where the program is not operative. Increasingly sophisticated experimental and quasi-experimental tools have been refined by specialists in the field of program evaluation.

The Research Department of the Bank has undertaken a Development Impact Evaluation initiative (DIME), which began publishing evaluation reports last year. While this initiative is welcome, it is too early to tell if the research staff has the requisite program evaluation experience and independence to produce first-rate, objective impact evaluations. Of real concern in this regard is the recent report of an independent panel that examined World Bank research. The panel was critical of the research techniques used in many instances and, more disturbingly, found that the research was used "to proselytize on behalf of Bank policy, often without taking a balanced view of the evidence, and without expressing appropriate skepticism."[2]

Given the inevitable tension between program evaluations and the interests of any institution in showing itself in a favorable light, it may be necessary to take additional steps to assure genuinely independent, state-of-the-art impact evaluation. This might be done, as suggested by the Center for Global Development, through a consortium of official and private

[2] Abhijit Banerjee, Angus Deaton, Nora Lustig, and Ken Rogoff, An Evaluation of World Bank Research, 1998-2005 (2006), at 6.

donors to sponsor and finance evaluations; through creation within the Bank of a program evaluation unit with institutional protections assuring its autonomy; through contracting out evaluations; or through some combination of these devices.

Reforming Governance. The subject of governance in international institutions seems to elicit a constant stream of discussion and proposals. There are many changes worth considering at the Bank. However, in keeping with my effort to present an illustrative rather than comprehensive list of reforms, I will limit myself to two ideas pertaining to the Executive Board that have particular relevance for the goal of increasing the effectiveness of the Bank's development activities.

To say the Bank's Executive Board is an unwieldy governance instrument is to understate the matter. Governing boards – whether in corporations or non-profits – are rarely in residence at the institution. Their purpose is to provide oversight of management in the interests of shareholders or the founding principles of an organization. It is expressly not supposed to substitute for management. Yet the Bank's resident Executive Board does just that, passing on every loan made by the institution. The purpose, presumably, is to ensure control by the countries that are the Bank's shareholders. But the result is an enormous expenditure of time and money. I have heard estimates that the resources required to support *each* executive director are in excess of $60 million per year. Bank staff spend a huge amount of time preparing for Board meetings. And yet, with rare exceptions, the Executive Directors – while often outstanding civil servants in their countries – are rarely influential enough to affect the policies of the country (or countries) they represent.

Abolition of the resident board is clearly not in the cards, and I am not even certain it would be desirable. But the Executive Board should not be involved in what is literally the day-to-day business of approving loans and projects at the IBRD, IDA, and the IFC. As a routine matter, the Bank management ought to be able to give final approval to individual projects, though obviously the President would have to exercise sound judgment in knowing when to consult with the Board. Instead, the Executive Board should be acting more like a normal board of directors – providing general oversight of management and strategic direction for the Bank.

It does not appear that an amendment to the Articles of Agreement would be necessary to make this change. The current Articles appear to grant the Board of Governors (consisting generally of finance ministers) sufficient authority to change the role of the Executive Board, although obviously the question would need a full legal analysis before proceeding. A second change would be to add 2-4 non-voting members to the Board in order to increase the involvement of smaller developing countries. If the Board gets itself out of the business of approving every loan and into the business of providing oversight and strategic direction, it will profit from additional recipient country voices on how to frame a set of effective policies and practices.

A Reform Agenda for the Fund

The starting point for considering reform for the Fund is the agenda laid out by Roderigo Rato, the recently departed Managing Director. In late 2005 and early 2006, he presented a program addressing many of the perceived problems in the IMF. Here are the elements of his program that, for present purposes, are most relevant, along with a report on the progress in implementing the proposals and my comments on the proposals:

Improvement in Article IV Surveillance of Member Country Policies. The principal means of Fund oversight of exchange rate policies since the demise of the par value system has been through its "surveillance" of country policies and member obligations regarding exchange arrangements under Article IV, including the obligation to "avoid manipulating exchange rate policies in order to prevent balance of payments adjustment or to gain an unfair competitive advantage over other members." Since, almost by definition, countries sitting on large reserves will not need Fund resources, its influence over them must rest principally in its clear, objective, and forthright identification of problems and of policies that depart from these obligations.

To be honest, the Fund's record on so-called "bilateral surveillance" has not been a very good one. Until the Managing Director's initiative, it had not revised its standards for surveillance of exchange rate policies since 1977 and, even within the terms of that rather dated document, it had not really applied those standards to Fund members in anything resembling a rigorous fashion. This, I should add, is not just a conclusion that many outside observers have reached, but one endorsed by the Independent Evaluation Office of the IMF itself in a recent evaluation of Fund exchange rate policy in the post-Asian crisis period of 1999 through 2005. Indeed, the Fund at times seemed interested principally in avoiding the issue since, I am told, it has turned down multiple requests for special consultations on China's policies in recent years.

Mr. Rato proposed, among other things, that bilateral surveillance focus more directly on county exchange rate policies and their effects on global financial stability. In June of this year, the Executive Board adopted a new decision on bilateral surveillance in which it incorporated the essence of the Rato proposals. Of most interest is the Board's addition to its list of "principles" for member exchange rate policies the point that a "member should avoid exchange rate policies that result in external instability."

At least on paper, then, the pieces are in place for a more pointed and relevant bilateral surveillance process. But the legacy of staff and managerial underperformance remains and, until we see a change in practice – especially where large and influential countries are involved – it is reasonable to retain a measure of skepticism. Moreover, it remains to be seen whether the countries whose policies might be critically reviewed will be moved to change those policies.

Creation of a Multilateral Surveillance Process. Rato rightly observed that even a well-functioning bilateral surveillance process is not optimal for dealing with global problems, including the current large global imbalances. He proposed a new multilateral surveillance process to complement traditional bilateral surveillance. In effect, the process would be a variation on the G-7 process, but with the involvement of financially important countries like China and Saudi Arabia that are not G-7 members. As you know, the G-7 operates strictly by consensus and has nothing approaching rules or an enforcement mechanism. The thought seems to be that, by holding these discussions under the IMF banner, there is an additional measure of pressure on participants.

In April 2006 the Fund's ministerial-level International Monetary and Financial Committee agreed to this extension of surveillance arrangements. The first such consultation was subsequently held, involving the United States, the Euro area, Japan, China, and Saudi Arabia. In something resembling G-7 communiqué fashion, the shared understandings and policy commitments of the participants were reported in April of this year.

To be honest, the results were underwhelming. There was little, if anything, new in the statements and commitments of the participants. This was only a first effort, of course, so it is fair to give the process more time to develop. But there are some grounds for concern in the statements of some Fund officials – in private as well as in public – that tout these results as significant. If this is the Fund's idea of significant, the aspirations for the process are clearly not high enough.

Quota Reallocation. As Dick Cooper and Ted Truman of the Peterson Institute of International Economics have convincingly argued, changes in the IMF allocation of quotas and voting power may be the linchpin in efforts to reform the Fund. Quotas determine both the amount of capital that a member must pay in to the Fund and the voting rights that it will have in Fund decision-making. As Cooper and Truman also point out, quotas are symbolically important as an expression of a country's economic standing and therefore, in their words, a "realignment of voting shares is central to preserving support of the Fund by all of its members and thereby to the Fund's relevance and legitimacy in promoting global growth and economic and financial stability."[3]

The formula that is used in allocating quotas is thus critical to the Fund's character and operations. GDP is a key part of the formula, but other economic measures such as reserves and current international payments are also factored in to the current formula. There is obviously no single "right" formula to weight the various economic indicia. While the Articles of Agreement of the Fund require a review of quotas every five years, there has been a predictable conservatism in reallocations in the past, since countries whose quotas would fall under a new or updated formula will usually resist change. The result is that the quota system today looks demonstrably out of line with trends in the global economy. As you would expect, China and other emerging countries hold quotas less than their growing importance would suggest. As you might also guess, the countries whose quotas are arguably the most inflated are many of the smaller European countries.

Roderigo Rato proposed a two-step process for reforming the quota system. In the first step – which has since been completed – China, South Korea, Mexico, and Turkey received

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[3] Richard N. Cooper and Edwin M. Truman, The IMF Quota Formula: Linchpin of Fund Reform, Peterson Institute of International Economics Policy Brief Number PB07-1 (February 2007).

small increases in their quotas. His second, much more controversial step, was that the Fund adopt a new formula and enact another round of quota increases in 2008, when the next five-year review of quotas is supposed to be completed. He did not have the temerity to propose his own formula, and wisely so, I would think.

I will not engage here in a technical discussion of formulas that might, or should, be adopted. I would just say two things. First, it is essential that, for both substantive and symbolic reasons, the formula be changed to give larger quotas to the fast-growing emerging market countries. Second, and related to the first point, this can be accomplished through giving greater weight to GDP than in the current formula, but to cap its impact on the quota shares of the older, slower-growing industrialized countries (as, de facto, the current U.S. quota is capped). Obviously other factors should and will be included, but the basic changes in the world economy are most directly reflected in the shift in the share of output towards those emerging market countries.

Under virtually any formula that might be imagined, the United States will retain a quota over the 15% level necessary to block major changes in Fund policies. This, I am pleased to say, is not a case where U.S. interests clash with those of new economic powers. The problem, as I earlier mentioned, really lies with the European countries – both the quota shares allocated to the smaller countries and the fact that three members of the European Union have their own executive director position on the Board.

Financing Fund Activities and Lending: As earlier mentioned, the decline in Fund income generated through lending to member countries is creating a budgetary problem. At the same time, with the size of existing Fund resources dwarfed by international capital flows, the capacity of the Fund to respond effectively to a financial crisis has been in doubt since at least 1997. Rato, apparently wanting company before going hat in hand to ask members for additional resources, appointed an Eminent Persons Group (which, unlike so many groups given that title, really was eminent) to consider a new income model for the Fund. In January of this year, the Group reported its recommendation that Fund income be supplemented from three sources: investment of its reserves and current quota resources in a broader range of assets; creating an "endowment" from the proceeds of limited sales of its gold holdings; and charging for services to member countries. I note in passing that the proposal for gold sales could require Congressional approval.

These recommendations were presented against the backdrop of Rato's prior call for a general quota increase, but the Group indicated that it was addressing the issue of income for Fund activities, rather than resources available for lending as such. Whether a quota increase would be sufficient to provide the Fund with the resources it might need in a future financial crisis is of course unknown. But there is a good enough chance that it would be insufficient to explore other potential sources of crisis resources. One possibility would be an agreement with some of the countries holding large foreign reserves, along the lines of existing arrangements with the United States and other countries that allow the Fund to supplement its resources by borrowing specified amounts from those countries under certain crisis circumstances.[4]

Of course, the receptivity of Congress, or anyone else, to these proposals must rest on an assessment of the Fund's relevance and capacity for effectiveness in assuring international financial stability. It would be counter-productive to starve the IMF for resources and then demand it shape up. But it seems to me that the processes of IMF reform and additional funding are, and ought to be linked. It makes little sense to proceed with one unless the other is also proceeding forward.

New Selection Process for Managing Director. In his list of reforms, Rato repeated the calls of others for a new method of selecting a Managing Director. As you know, since the founding of the Bretton Woods institutions, convention has been for an American to head the Bank and a European to head the Fund. Neither the United States nor Europe has shown great interest in changing this convention, despite the growing resentment of the rest of the world. Of course, Rato did not stay long enough to give substance to this proposal. Indeed, his unexpected and premature departure virtually assured that the old convention would prevail, as it seems to be doing.

Just having inserted an American as president of the World Bank, the United States was hardly in a position to challenge the convention. Indeed, the United States has duly endorsed Dominique Strauss-Kahn, who was identified for the job by President Sarkozy of France and endorsed by the European Union. Let me be clear: he is a very credible candidate. But some questions to him are in order.

We should at least know if he will commit to stay for a full five-year term, barring some obvious extraordinary circumstance. We have now had two consecutive European managing directors who have left the position early. The first returned to Germany explicitly to reenter German electoral politics. Rato said he was leaving early because of his children's educational expenses, but rumors abound that he too will soon reenter domestic politics. Even if he does not, the leadership of the Fund at this most delicate of times is suffering by these frequent turnovers. Since both French and American media speculated that President Sarkozy was nominating a prominent Socialist in order to *remove* him from French politics, we should assure ourselves that M. Strauss-Kahn will not leave the Fund early if a political opening presents itself at home.

It is also important to elicit M. Strauss-Kahn's views on other issues, such as the Fund's surveillance activities to date. While he will not be able to force members to change their policies, he would as Managing Director have the authority to instruct Fund staff to present rigorous and forthright reports on how Fund members are complying with their Article IV obligations.

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[4] These are known as the "General Arrangements to Borrow" and the "New Arrangements to Borrow." Each was last activated in 1998 as the Asian financial crisis spread to other parts of the world.

To sum up, it is no exaggeration to say that the continued relevance of the Fund may be determined in the next few years. Fund management has taken certain steps to respond to the new challenges. While immediate past performance in surveillance is not particularly encouraging, we can for the present adopt a wait-and-see approach to the revised bilateral and new multilateral surveillance methods. As to changing attitudes of the Fund's members, essential to any real progress, I am afraid that skepticism is warranted here as well. China, like other surplus countries in the past, is disinclined to adjust its policies to help deficit countries. The United States, for its part, cannot seem to decide if it wants to address this issue bilaterally or multilaterally.

Finally, I note that I have concentrated here on the key issues that will determine whether the Fund is relevant to the international financial circumstances of the 21st century. There are other elements of the Rato reform agenda that I have omitted, such as a proposal for a new lending facility. Similarly, I have omitted mention of some of the Fund's secondary missions, such as providing technical assistance. These are important functions and, by and large, ones that are being well-performed by the Fund. Their omission from my discussion is really a compliment to the Fund staff engaged in those activities.

Conclusion

The agendas I have sketched out today are obviously quite different. The agenda for the Bank is more micro and management oriented, as befits that institution's situation. The agenda for the Fund is really about its basic role in the world today. As you and other Members of Congress consider these institutions and appropriate reform agendas, I would like to make one suggestion.

Neither institution has ever been as diligent as it should be in communicating with Congress. Their primary U.S. interlocutors should be Treasury Department officials, of course, but it hardly needs saying that you must approve quota increases. More generally, you probably shape public attitudes towards the institutions more effectively than the Treasury can. I hope that officials of the Bank and Fund will contact you more regularly. But, if they do not, I hope you and your staffs will take the initiative.

Thank you for your attention. I would be pleased to answer any questions you might have.

All Eyes on the World Bank

Statement Presented to the
Subcommittee on Security and International Trade and Finance
of the
Committee on Banking, Housing and Urban Affairs
of the
United States Senate

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August 2, 2007

While China buys a $3 billion stake in private equity giant Blackstone, with the expectation of a 25% annual return, the World Bank is busy lending to China at a 5 % interest rate which does not even cover the Bank's real cost of borrowing. The Bank should not be lending to the world's third largest economy.

While India's corporate multinationals, many State-owned, acquire industrialized nation assets and invest in the developing world to fuel an economy exploding at 10% per annum, the Bank has just doubled its annual lending to India to $3.8 billion, most at a zero interest rate that adds up to a built-in gift of $1.5 billion from industrialized nation taxpayers. In a country where foreign investment is massed on the doorstep, the Bank should not be subsidizing projects the government does not think worth financing at market rates.

While the world reached out at the Millennium to forgive the debt of 18 of the globe's most impoverished economies, the Bank piled on another $10 billion in net new loans, raising their Bank indebtedness by 50%. The Bank should not continue to lend in the same old way with the expectation that its losses will always be made good by rich countries.

As globalization transforms the world economy, the Bank is one of the losers. Its historic comparative advantage is gone and its role inevitably diminished. There are powerful new competitors in the market that do not exact the social and economic strictures the Bank has always sought to impose. Private capital now channels 300 times the funds offered by the Bank to the emerging world and will finance any project the Bank would consider. Nations moving up the economic ladder--China, Brazil, India and Russia--are funding and building infrastructure and industry for even the poorest nations in exchange for access to raw materials and export markets. China alone will send $25 billion to Africa over the next 3 years, 50% more than the funds coming from the Bank.

Bank staffers label these latest lenders "rogue creditors". But is the world instead dealing with a rogue institution? While presidents come and go, a bureaucracy, hostile to change and clever at manipulating an unwieldy multinational board, is flouting the Bank's founding articles, bending the rules, distorting the facts, concealing losses and lowering standards. The Bank is desperate to maintain the illusion of relevance to emerging countries that no longer need its money and no longer want its advice.

The Bank was established sixty years ago in financial prehistory. Its core mission was to solve two shortcomings in the global economy: A shortage of money to finance development and a shortage of knowledge in developing nation governments. The Bank would borrow in the world's financial centers and couple loans with advice to speed the growth of poor countries. In the last 20 years, the world has changed dramatically but the World Bank has refused to change with it. Today, the private sector dwarfs official funding and emerging nation leaders are just as smart, just as skilled and know their countries infinitely better than anyone at the Bank.

At its very inception, the Bank was enjoined from competing with the private sector. Developing economies were to be nourished only until they had gained the financial credentials to attract private capital on their own. This was called "graduating". But the Bank won't let go. Eighty percent of loans flow to just 12 middle-income governments led by Turkey, Brazil, Mexico and China. If the Bank stopped lending tomorrow to its big borrowers, no one would notice. It provides only 3/10 of 1% of the funds sent by the private sector.

The Bank is losing its best clients. As the interest subsidy compared to market borrowing has collapsed from 12% per annum to 3%, major emerging nations have shifted from net borrowers of $15 billion in the 1999-2002 period to actually repaying loans of $17 billion over the 2003-2006 timeframe. To stem the tide, the Bank has lowered its interest rates and all but done away with the policy conditions that were the very reason for its lending. When standard subsidies are not tempting enough, the Bank is paying countries to stay on the borrowing list. In behind-the scenes arrangements, rich donor governments pay the interest on behalf of prosperous middle-income borrowers, reducing loan costs to 55 cents on the dollar.

Loans to middle-income countries are clearly good for the Bank's balance sheet and beef up its image of influence. But Bank reasons for continuing to lend to the prosperous are specious and refuted by the facts.

The Bank does not lend as it claims where the poor live. More than half of Bank loans since 2000 flowed to six upper middle income nations where only 10 per cent of the developing world lives---Turkey, Brazil, Mexico, Argentina, Colombia and Romania enjoy a per capita income of more than $8,000 on a purchasing power parity basis.

In the creditworthy countries the Bank courts, the "hard-hearted" private sector is ready and willing to finance pro-poor projects on the same guarantee the Bank demands. If Brazil's full faith and credit is on the line, private capital does not care if the proceeds are used to vaccinate Indians in the Amazon or to build nuclear warheads.

Nor is the Bank the sole source of funds for development projects with long-term horizons. During the past six years, 30 emerging World Bank borrowers have issued bonds in the market with maturities stretching into the future 25 years and more, well beyond the limits of Bank terms.

An outdated ambition, counter-cyclical stabilization of volatile market financing, requires more resources than the Bank can muster. If private flows were to collapse by 50%, Bank funds would still represent less than 1/100th of the total capital moving into middle-income economies.

Far from generating a surplus for the poorest, lending to middle-income nations is draining resources. To compete with the market, the Bank has waived fees and interest spreads reducing its operating margin by 50%. All-in, the Bank does not cover its administrative costs and now loses $500 million per annum on its emerging economy loans. The Bank's reported $1.7 billion net income comes from the $2 billion return on its $37 billion of zero-cost capital.

The Bank must recognize that it is in the development business not the lending business.

Every three years, the industrialized world is required to write a big check to the World Bank to fund the International Development Association (IDA), the arm of the Bank that focuses on 81 of the globe's most underprivileged countries. Zero-interest rates make these loans a 70% gift. The price tag for the 2008 cycle will be $32 billion of which $10 billion is the first installment on a $46 billion debt relief promise to reimburse the Bank for past bad loans. Total US share will be $4-5 billion. A dangerous precedent has been set: Whenever rich nation taxpayers fund the Bank, there is an open-ended obligation to cover future Bank mistakes.

The Bank is not here today to answer hard questions. Like all multilaterals, it is protected by diplomatic immunity. But, at the Bank, the Need to Know is an insider's prerogative that does not extend to world taxpayers---those in the industrialized world that provide the funds and those in the developing world that assume the debt. Governments that borrow are equally content to leave failure and its causes in the shadows.

What do we know about Bank lending to the poor and what doesn't it want us to know? We know that after 60 years and $600 billion, there is little to show for Bank efforts. Bank aid was not behind the impressive economic gains in China, India and Indonesia where all the progress in poverty reduction has been concentrated. We know that for two decades, the Bank continued to pour money into countries clearly unable to repay and concealed the truth by rolling over worthless loans with enough added to cover interest owed until the G-7 governments were forced to assume the debts and to make the Bank whole. We know that the Bank continues to tolerate corruption which, in Africa alone, has diverted between $100 and $500 billion into off-shore bank accounts. We know that the lack of effectiveness of Bank projects is startling. By the Bank's own numbers, 59% of investment programs world-wide and 75% in Africa failed to achieve satisfactory sustainable results over the 1990-99 decade. There is a common thread. The overwhelming priority has been to ship off funds even when there is no deserving destination.

Before handing over for the 15th time still another IDA replenishment, we need to know more and should not be deterred by claims of confidentiality or the cost and complexity of documentation. The Bank's internal Independent Evaluation Group is captive and its findings suspect. Calls for an external performance audit have been stonewalled. We want the answers to questions the Bank is afraid to ask. How many babies were vaccinated? How many miles of roads are functional? How many cubic meters of wastewater are treated? How many children can read?

Transparency and accountability are close at hand on the internet. For every one of the 280 projects the Bank approves each year, there already exist detailed reports in electronic form ready to be delivered to a public website. Disclosure would not be a burden for the Bank. Exhaustive loan approvals set out objectives, technical specifications and estimated costs. Loan completion reports by lending officers are delivered to senior management. Complete audits on 25-30% of programs are executed by the internal evaluation group.

Ghanaian parents will monitor World Bank funding of their children's schools. Zambian farmers will look for roads ready to carry their produce to market. Africa Fighting Malaria and other NGOs will see if the mosquito nets are hanging in place. Opposition politicians and political watchdogs will know if funds and equipment have been spirited away. A whole universe of activist shareholders will keep count every step of the way. The world will be the independent evaluator of the World Bank and reach a collective judgment.

Testimony of Karin Lissakers
Director, Revenue Watch Institute
Before the Sub-Committee on Security and International Trade and Finance
Committee on Banking, Housing and Urban Affairs
U.S. Senate
August 2, 2007
on
Reforming Key International Financial Institutions for the 21st Century

Mr. Chairman, Members, thank you for inviting my testimony to the sub-committee today.

I am not new to the issue of IFI reform. During my tenure representing the U.S. on the IMF executive board in the 1990s, the Clinton Administration embarked on an ambitious effort to redesign the international financial architecture, including the IMF and the World Bank. Large-scale debt relief for the poorest countries, escalating interest charges for IMF loans to encourage early repayment, a new financial data disclosure standard for all member governments, and a dramatic increase in the institutional transparency of the IFIs themselves were among the results. As President of the Bank, Jim Wolfensohn de-centralized and moved a large part of the staff out into the field.

However, some big institutional issues were left on the table. The most obvious reform that is long overdue is changing the way the heads of the two institutions are selected. The "convention" that Europe and the United States alone should decide the leadership of institutions with memberships of more than 180 countries each is an embarrassing anachronism. More importantly, it damages the effectiveness of the institutions and hurts the credibility of the West's commitment to proper governance. The convention should be done away with immediately, and an open, merit-based selection process put in its place. The U.S. missed an opportunity to break new ground with the selection of a successor to Paul Wolfowitz, making not even a nod in the direction of openness or choice. Some European states have promised to do better regarding Rodrigo de Rato's successor at the IMF, but I am skeptical they mean it. It looks to me as if the European candidate will sail through without serious competition. If I am right, then the members need to take up the issue soon, not waiting until the next vacancy when the pressure to get someone in place quickly will surely trump pressure for change. The U.S. and Europe need to get off their pedestals, and the rest of the world needs to keep up the pressure until there is a new and defensible process. The current one is a disgrace.

The other big – and related – change urgently needed is to redistribute quotas, voting shares and board seats to reflect global economic realities and to give the rapidly growing emerging market powerhouses like China, Korea, Brazil, Turkey, South Africa the influence *and* responsibilities in the global institutions commensurate with their economic standing.

The IFIs are mutual support and peer review mechanisms. The more globally integrated the world economy becomes, the more important having well functioning multilateral institutions will be. But members that are underrepresented will tend to look to other devices or go their own way. One can already see that the Asian countries have lost interest in the IMF and are more focused on their own regional arrangements and discussions. That is not good for global cooperation and does not serve U.S. interests, either.

The IMF is much less important now as a source of balance of payments financing for members. Consequently, its leverage, its ability to directly influence or pressure country policies is more limited; member governments have to *want* to listen to the institution's views. Countries like China or Turkey are more likely to pay attention if they see themselves as fairly represented in the institutions' decision-making and if they have a financial commitment matched to their economic strength. That is not currently the case. The serious misalignment of quotas and voting shares undermines the effectiveness of the institutions, including their effectiveness on exchange rate surveillance, a topic that is getting a lot of attention in Congress right now. I am not suggesting that quota adjustments alone will solve the problem, but they are necessary and helpful in reinforcing a cooperative international approach to problems like global financial imbalances.

The question of "voice", i.e. actual physical representation in the executive boards of the institutions, is also important, particularly for relations between the Bank and the Fund and developing countries. Important developing countries are under-represented in the 24-member boards. It is absurd, for example, that South Africa gets to hold an IMF board seat only once every couple of decades, because it is in a group of 19 African countries sharing one board chair. Meanwhile, European members occupy eight of the Board's seats even though, most of the time, most of the European representatives simply repeat the common positions they have agreed through the EU. It is long overdue for the Europeans to consolidate their representation in the IFI boards and vacate seats in favor of developing and emerging market countries.

With regard to the quality of the policy advice these institutions give to countries, I want to make a few observations related to the issues the Revenue Watch Institute concerns itself with, namely governance, poverty and conflict in extractive industry intensive economies.

Development economists agree that money alone, whether development aid or commodity windfalls, does not solve the problems of poverty and conflict. Institution building, governance and accountability are the real keys to economically successful, peaceful societies. And those are a lot harder to tackle than simply writing loans. Both the Fund and Bank have made significant strides in these areas. I think one can credit the Fund's efforts to help build independent, well-administered central banks with the dramatic improvement in monetary policy and lower inflation around the world. Likewise better fiscal management. In fact, a lot of emerging market countries have done better in recent years than the major industrial economies in managing their public finances.

Governance and accountability pose the biggest challenges to international intervention because they are inherently political and the IFIs are supposed to stay out of politics. The IFIs and their members now rightly treat governance as an economic issue and have taken steps link economic support to governance. But performance is uneven. We were pleased with the commitment Paul Wolfowitz made to toughening the Bank's anti-corruption policies, and we hope his successor will be equally forceful on that front. The Fund also now pays a great deal more attention to transparency and accountability issues, but more sustained, systematic efforts are needed.

Transparency and accountability issues are particularly acute in the resource-rich countries and especially in a time of high commodity prices. Both the Bank and the Fund have tried to tackle the so-called "resource curse" issues, and the G8 countries have repeatedly stressed their support for important initiatives like the Extractive Industries Transparency Initiative, which both institutions support.

Transparency – public information – is the best way to ensure public accountability. One very important and welcome policy change by the World Bank's investment arm, the IFC, concerning extractive industries (EI) revenue and contract transparency came into effect on January 1, 2007 as part of the overhaul of its environmental and social standards. As of the beginning of this year, the IFC now requires disclosure of payments made by oil, gas and mining company clients to host governments.[1] In addition, it requires disclosure of some contract information for "significant" new EI projects, i.e. the relevant terms of key agreements that are of public concern.

Unfortunately, the IFC has so far not provided any information on client compliance with these new requirements. It has only stated that, since September 2004, all EI clients have agreed to revenue transparency. Despite repeated requests from civil society groups, the IFC has not provided information on where this revenue payment information can be found on a project-by-project basis. On the issue of contract disclosure, the same situation prevails and, even worse, IFC staff has said it will not require disclosure of contract fiscal terms, which are clearly of "public concern". Improved oversight in this regard is critical, as transparency will help the IFI's to better achieve their development agendas and will also serve to help repair the mistrust of these important institutions that has set in within some quarters, particularly civil society in many developing countries.

[1] "IFC also promotes transparency of revenue payments from extractive industry projects to host governments. Accordingly, IFC requires that: (i) for significant new extractive industries projects, clients publicly disclose their material project payments to the host government (such as royalties, taxes, and profit sharing), and the relevant terms of key agreements that are of public concern, such as host government agreements (HGAs) and intergovernmental agreements (IGAs); and (ii) in addition, from January 1, 2007, clients of all IFC-financed extractive industry projects publicly disclose their material payments from those projects to the host government(s)."

Congress has a key role to play in the oversight of U.S. executive branch participation and policies in the IFIs. One clear example of the positive role Congress has played in the past is the "Pelosi Amendment" passed in 1989. This law requires the US executive director at an IFI to abstain from any vote on a loan that "would have significant impact on the environment" unless the board of directors and affected groups have been provided with an environmental impact assessment (EIA) at least 120 days prior to the vote. The enactment of the Pelosi Amendment led directly to the adoption of environmental assessment policies at all of the development banks. Congress should resist any effort to weaken this standard.

More recently, Congress played an important role through language on revenue and contract transparency that, for the past two years, has been part of the Foreign Operations Appropriations bill. The language directs the Treasury Department to not approve any assistance by an IFI for extractive industries in a country that does not have in place systems for transparently managing its EI revenues. This year, a strengthened provision has been included in the Senate Foreign Operations that recently passed out of committee. In a similar vein, the Senate will soon be considering House-approved language conditioning OPIC guarantees and financing for extractive projects on the transparency of payments by companies to beneficiary governments, and on the governments taking steps to make extractive revenue streams fully public. We look to the Senate to strengthen that provision. We also hope Congress later this year will approve legislation to require extractive industries to publish what they pay to foreign governments, as U.S.-based and foreign companies are already doing in countries that have adopted EITI. The IFIs can be much more effective if their policies and the policies of individual shareholders are consistent and mutually reinforcing.

Thank you.

Testimony of Diane Willkens
President, Development Finance International, Inc.

"Reforming Key International Finance Institutions for the 21st Century"

U.S. Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Security and International Trade and Finance

August 2, 2007

Mr. Chairman, thank you for the opportunity to testify today to share a private sector perspective on the World Bank. My name is Diane Willkens. I am President and CEO of Development Finance International, Inc. (DFI). My company works on behalf of a number of companies bidding on World Bank procurements and collaborating with the World Bank on key development objectives. I am testifying today on behalf of DFI and the National Foreign Trade Council (NFTC), a business organization of 300 American companies whose mission is to advance open and rules-based trade. I serve as the chair of an NFTC ad hoc working group on the World Bank.

I have worked with private sector companies to access World Bank projects and participate in development projects around the world for nearly 20 years, beginning with the launch of Digital Equipment Corporation's focus on the World Bank in the late 1980's and continuing with the founding of Development Finance International, Inc. in 1992 until today. Our corporate headquarters is in Washington, D.C., home of the World Bank and the Inter-American Development Bank. We have an office in Manila, Philippines, headquarters of the Asian Development Bank, a partner in Tunisia, headquarters of the African Development Bank, and an alliance partner in Brussels to focus on European Union-funded business.

Over the past nearly 20 years it has been my privilege to work with some of the world's leading private sector firms such as Hewlett-Packard, GE, BASF, and Philips, to name a few, in their pursuit of business and sound policies with the World Bank and its sister institutions. On a sector basis, DFI has been very involved in areas crucial to development, including health care technologies, malaria prevention and treatment of infectious diseases, information and communications technology, education from primary through tertiary, agriculture, the environment and transportation.

Importance of the World Bank and other International Financial Institutions and Summary Recommendations

I would like to begin by emphasizing the important role of the World Bank and the regional international development banks since their creation after the Second World War. As part of the Breton Woods Institutions, the World Bank continues to serve as a vital multilateral institution in advancing sound and sustainable economic development and alleviating poverty in the developing world. We welcome President Zoellick in his new role and encourage his furthering the World Bank's collaboration with the private sector. With his depth of international experience, record of accomplishment in several prominent high level trade and foreign policy positions in the US government, and commitment to helping the developing world grow and prosper, there is no one better qualified to lead the Bank.

My testimony will touch on several areas where the Bank could and should improve its policies and interaction with the private sector in meeting its overall mission. With the shift in the World Bank's relative importance given the abundance of capital liquidity around the globe, it is in the Bank's own interest to find new flexible ways of working with others, including the private sector.

Key overall recommendations include the following, some of which I will go into more detail below:

1. The World Bank should better recognize that the private sector is both a key stakeholder and enabler of sound economic development. It should incorporate the private sector into its planning and operations. US companies which operate and invest in developing countries bring numerous best practices through their presence and contribute meaningfully to economic growth and development. They should be viewed more as a partner rather than as an afterthought in the development of major new policies.

2. The Bank should push forward with critical initiatives on governance and anti-corruption. It should strengthen its role in promoting accountable and transparent practices, especially in procurement, which is an area that is most susceptible to corruption on both the demand and supply side. The private sector from the U.S. and several European countries has been very concerned about recent developments to abandon World Bank international best practices in procurement policies that effectively lower Bank standards on international competitive bids and adopt a more hands-off approach. These moves go against the Bank's recent important overall initiatives on anticorruption and improved governance.

3. The Bank should help safeguard vulnerable emerging market economies from the predatory and unsavory practices of certain new lenders. In the case of China for example, as a new major ender/investor/grantor, the US private sector is seeing examples of disregard for the environment, labor and social standards. We encourage the Bank to require adherence by lenders in Borrowing to consistent ethics for its member countries. This is particularly relevant with the Bank's renewed focus on infrastructure, which will require billions in future investment.

4. There continues to be a strong case for better coherence between the WTO and the World Bank, particularly in the area of trade capacity building and mainstreaming trade, and between the World Bank and other institutions such as the World Health Organization (WHO) on vital malaria and other health initiatives. Better coherence with the WTO will be even more critical if the Doha Round concludes successfully. For example, a WTO agreement on eliminating needless red tape at the border through a WTO agreement on trade facilitation will require substantial hands on capacity building and other assistance, which the World Bank is well equipped to do.

5. We recommend that the World Bank find creative new ways to engage other governmental organizations, such as the export credit agencies. Further, we suggest that the political risk insurance provided by the World Bank Group's Multilateral Investment Guarantee Agency's (MIGA) be available for transactions beyond investments in order to support sales transactions that do not fit the export credit agency model. Namely, we encourage eliminating the equity requirement for debt transactions

and allowing support for subsovereign/parastatal transactions. Continual improvements to process transparency and responsiveness will be essential to the future and sustainable growth of MIGA's mission.

6. The US Government should enhance its efforts to ensure US companies have an equal and fair opportunity to compete for World Bank procurements, similar to what the Europeans and Asian countries have in place with long-tenured, highly experienced procurement experts.

Procurement Today and Critical Role of International Best Practices

The World Bank provides an estimated $22 - $23 Billion annually in loans and grants to support nearly 250 development projects globally. Nearly every World Bank project requires consultant services, goods, or civil works for successful implementation. The acquisition of these goods and services, totally billions of dollars each year, must be conducted with economy, efficiency, fairness, and transparency to ensure the integrity of the institution and confidence in the processes. While this testimony focuses on the World Bank, the regional development banks have agreed to follow the lead of the Bank to implement consistent procurement policies.

The first place where many US private sector firms engage with the World Bank is in the pursuit of a contract funded by the World Bank and being tendered in the Borrowing country under an international competitive bidding process governed by World Bank rules and guidelines. While not perfect, and subject to continued revision and improvement, the World Bank procurement guidelines and standard bidding documents have come to represent international best practice.

Although the detailed rules and guidelines for procurement are beyond the purpose of this testimony, certain key principles are essential elements of the private sector engagement with the World Bank. Namely, it is of paramount importance to the private sector that international competitive bidding be conducted under known and reliable rules applying standard and predictable bidding documents is vital to the US private sector.

Whether a contract will be subject to international competitive bidding or dealt with locally through national procedures is typically determined by the estimated size of the contract. The World Bank has set an international competitive bidding threshold for each Borrower country, an estimated tender value above which any tender must be conducted under international competitive bidding or ICB. Typically in the $200,000 to $400,000 range, this process ensures that contracts of measurable value will attract wide-spread visibility, encourage competition and the procurement will deliver the economy and efficiency important for the Bank's Borrower countries.

In recent years, the private sector has seen rise in these thresholds as well as a structuring of a certain Bank projects in such a way that the ICB rules no longer apply. The effect of these actions effectively deprives the private sector from knowing about the opportunity in any reliable publication or website and most importantly, subjects the tender process to local rules that are often non-transparent and bear little resemblance to World Bank practices. Essentially, it is often each man (or woman) for themselves.

Meanwhile, Borrowers lose the ability to attract competitive offers and appropriate technical solutions from expert companies.

In those cases where ICB is required, the World Bank maintains responsibility for a series of decisions, known as "prior review" over the final steps in this tendering and contracting process, from pre-approval of tender documents, to review of bidders' questions and concerns, to a review of the evaluation report from the Bidder, through to final contracting. At the same time, the Bank holds the Borrower responsible for conducting the tender according to Bank rules and guidelines.

These "prior review" protections, together with the World Bank guidelines and mandated standard bidding documents, provide an essential safety net for private sector firms doing business under Bank-funded projects. Many of the firms with whom we work would not be doing business in a great number of countries funded by the Bank without this essential oversight and prior review by the Bank. There is simply too much corruption and too many opportunities and creative ways for a procurement process to be derailed. This raises risk to unacceptable levels for many US firms, and as a result, lowers the number of bidders, which in turn distorts best value / lowest price selection for the Borrower – a lose/lose situation.

At the same time, the Bank's own procurement practices could be improved by applying more, not less, oversight to Borrowers' practices, including in the area of technical specifications as qualifying criteria. It is often in this non-glamorous area of preparing tender documents where lack of Bank oversight opens the door to bias and influence in selecting suppliers for World Bank funded contracts. The Bank should encourage that bidders demonstrate proven capability to perform all tender requirements including after-sales services and training with a capable service organization able to respond in a timely manner. Too often equipment and / or technology are procured under Bank-funded projects without a sustainable infrastructure that allows successful operation and maintenance over time, thus jeopardizing the project success.

We applaud the World Bank's initiative to review the unique procurement rules related to information and communications technology projects with leading private sector firms. Among the important discussions points today is industry's request for an update for the Manufacturers Authorization Form (MAF) and discussion with the Bank about ways to conform warranty liability as a result of the requirements of Sarbanes-Oxley and revenue recognition challenges. These are the types of engagements that are so important for US firms, the results of which determine whether or not the private sector is able to participate in billions of dollars of World Bank funded projects.

"Country Systems"

The Bank can and should play an instrumental role in promoting transparency and good governance and encouraging a "no tolerance" policy for corruption, the result of which would be a healthy environment for private sector growth. The Bank should be involved in capacity building in each of these areas with active lending and grants within a programmatic approach.

Despite the critical importance following international best practice in procurement, the World Bank has lately been moving toward a new system that would erode those important principals. As the Bank formulates its proposal for the proposed use by Borrower countries of their own procurement systems ("Country Systems") in place of the Bank's, the Bank has the opportunity to bring procurement standards in these countries up to the Bank's own standards, rather than settling for a lowest common denominator. However, this is not the direction being set today. Further, while this testimony focuses on the World Bank, the regional development banks follow the lead of the World Bank on these matters.

Unfortunately, and of great concern to the NFTC and a number of other trade associations, including NAM and the US Council for International Business, at this time the Bank is continuing to push forward a failed proposal to use country systems for Bank-funded procurement. At a recent June Board meeting of the Bank, Bank staff reintroduced a 2005 country systems proposal that the Bank itself had withdrawn from consideration in late 2005 after pressure from Congress, European and US private sector, concerned NGOs, and the US Executive Director, among others.

Congress rejected the '05 proposal in the 2006 Foreign Operations Appropriations bill. At the same time, in the 2006 Foreign Operations Appropriations, Congress required that the Secretary of Treasury certify that certain requirements be met by the World Bank so as to receive a 20% IDA hold-back. The Secretary of Treasury was not able to make that certification as to other procurement safeguards to have been undertaken by the Bank. Yet, despite Congress' problems with the 2005 version, the Bank revived the proposal in a weakened 2007 version.

Among other shortcomings, the 2007 proposal incorporates the application of a procurement assessment and benchmark tool developed by the OECD-Development Assistance Committee (OECD-DAC) and issued for use under the co-signature of the World Bank Chief of Procurement Policy.[1] However, both the World Bank and the OECD-DAC Secretariat have admitted that this tool represents a "watered down" version of the assessment methodology set forth in the 2005 proposal. The OECD-DAC tool is woefully inadequate to the task at hand and should be scrapped. For example, the OECD-DAC tool downgrades the importance of such lynchpins of transparent procurement in such areas as:

- open and freely accessible advertising of procurement,
- competitive hiring of qualified procurement staff,
- document retention system that maintains adequate procurement records, and
- final payments timely made as stipulated in the contract.

With both the Country System proposal and the OECD-DAC tool, the cart is before the horse. Before any Country Systems proposal can be considered, or a tool developed to assess and measure procurement systems, the World Bank should use its

[1] OECD-Development Assistance Committee, Methodology for Assessment of National Procurement Systems, Version 4, July 17, 2006.

expertise and leadership position to articulate a strong international standard for procurement practices. Once articulated using the contributions of world-class procurement experts, the Bank will then be in a proper position to begin to define a methodology around which any procurement system can be properly, fully, and independently assessed. Until these prerequisites are met, it is inappropriate and premature for the Bank to resuscitate a previously-rejected proposal for country systems in procurement.

Since 2005, we have and continue to make several recommendations to the Bank on how to improve any country systems proposal. We have been supportive of the potential use of country systems for National Competitive Bidding (NCB) only and urged that ICB be taken off the table until experienced is gained under NCB. There is much to be gained in a dedicated effort to build procurement capacity in procurement with the Bank's technical support. To this end, we have urged that the World Bank articulate a international best practice standard for procurement, something today that is lacking. Once such a standard is set, we are encouraging full engagement with the private sector in a technical working group that will create a credible assessment tool for benchmarking procurement systems against an acceptable international standard.

Improved governance is a foundation of sound economic growth. For example, having in place accountable and transparent government institutions and policies is fundamental to a well-functioning economy. The World Bank's annual *Doing Business* report provides a good example of the range of policy issues involved in the ease by which companies can do business in a given country. It is not only a useful guide in comparing countries in how they stack up against each other, it also highlights the range of policies and issues which comprise a well-governed economy in terms of its regulatory environment, customs facilitation and other key policies.

Effective anti-corruption and improved governance is critical to government procurement because it is where billions are spent by governments and where corruption on both the supply and demand side is most likely to occur. Not all countries have strong anti-bribery laws in place like the US and where corruption exist, US companies stand no chance of winning contracts based on fair, transparent competition. With large developing countries increasingly competing for these projects, this is a major challenge for US companies. One further practical approach would be requiring that all companies participating in World Bank funded procurements be required to put into place and enforce a sound anti-bribery policy. The same zero tolerance should be put in place for officials in the Bank's Borrower countries.

Private Sector Partnership in Health and Education Initiatives

Health and education rank among sectors of vital important to the developing world and for which the Bank has numerous key initiatives underway. The private sector is a key stakeholder in many of these initiatives. I would like to briefly summarize some of these initiatives and highlight some areas where practices and policies can be improved.

Malaria

Among many health challenges facing developing countries, malaria is estimated to kill 3,000 children every day. The World Bank has been a leader with several other institutions in providing technical assistance, funding, and a procurement tool kit for the acquisition of goods and services. However, for the private sector to remain committed to the challenge and be able to deliver the types of innovative technologies needed, such as long-lasting insecticide nets, the World Bank needs to work proactively with the World Health Organization, other donors, and the private sector as partners.

- Market entrants should be treated equally in qualification processes to avoid appearance of favoritism or "inside" tracks.
- Industry will walk away if the profitability is not there - long-term contract manufacturing should be an option.
- World Bank should reconsider a central purchasing process which would increase transparency and effectively eliminate country discretion.
- Efficiency in distribution in-country has to be improved and the World Bank can take a lead role in working with NGOs and others on the ground keeping core competencies with manufacturers and core distribution competencies where they best fit.
- Standardization of tender specifications would improve production efficiencies such as size and color.
- Purchasing of essential elements that deliver long-term protection (e.g. bursting strength, wash resistance) should be included in specifications and tender decisions.

Higher Education

Due in part to the rising strength of countries such as China and India, as well as the exodus of skilled workers away from many developing countries, countries in Latin America, Africa and elsewhere are concerned about their ability to develop and retain skilled workers and attract private sector investment. We applaud the World Bank's recent renewed focus on Science, Technology and Innovation and its nascent work with Borrower countries to create the educational capabilities that will deliver a trained engineering and technical labor force able to attract private sector investment and deliver job creation.

This effort is vital to long term country economic development and essential to the ability of companies to invest and grow in markets such as Africa where companies like Oracle have stated publicly that a major constraint to investment and growth is the inability to fill job openings with trained staff. As this focus gains momentum, we hope that the thinking and planning takes gender into account and includes a special focus on attracting and including women in ICT.

We encourage the World Bank to emulate the Inter-American Development Bank in creating a competitive funding window for countries to suggest and develop projects that deliver a regionally-based public good where working together across similar countries can deliver efficiency and leverage energy and enthusiasm.

In a highly innovative and exciting multi-stakeholder program involving the private sector that is being funded by the Inter-American Development Band, three Caribbean countries will soon begin a coordinated university-level program to harmonize engineering accreditation criteria with the US and Canada. The result will be a market for skilled labor and the encouragement of wide spread educational and employment development in the region.

US Commercial Representatives and Procurement Experts at the MDBs

In the mid-90's, after a highly successful model set by a career employee of the Commerce Department in representing US commercial interests and procurement matters at the World Bank, Congress mandated that the Commerce Department place a commercial representative in each multilateral development bank. Unfortunately, these positions have been filled largely by US and Foreign Commercial Service employees on assignments ranging as little as a few months to several years. Over the last 15 years, the US private sector has seen a steady changing of the guard in these positions at all of the development banks. This practice allows barely enough time for an individual to begin to understand the machinations of these institutions, and certainly deprives the US of continuity as well as institutional memory in the representation of US interests in procurement matters.

Many of our trading partners and competitors, such as New Zealand, the UK, Germany, and Sweden for example, have career employees serving 10, 15 and 20 years in their posts. This gives them a strong advantage over the US in competing for World Bank and other MDB contracts. The US government should staff these positions with highly experienced senior procurement people with a desire and intention to remain in post and learn the Bank from the inside out.

Closing

Thank you for the opportunity to appear today. The challenges facing the World Bank are many as the institution defines its changing role. The private sector is committed to working with the Bank in constructive approaches to the development challenges and opportunities before us.