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WHAT TO DO ABOUT THE WORLD BANK

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ORAL TESTIMONY

The World Bank is currently facing a deep crisis of relevance. The Bank's market has changed fundamentally in the past decade, but the Bank continues to operate in much the same way and with much the same products as a decade ago and more.

The change in the Bank's market was dramatically symbolized just last week while the US and European governments were fighting over President Wolfowitz's future. The African Development Bank held its annual meeting not in Africa but in Shanghai. This event will be looked back on as a milestone in the history of the twenty first century.

The main message of my testimony is that the World Bank can potentially add much more value to the solution of some of the world's most urgent problems than it has been doing; and that the US Congress and the next administration can help it do so by signaling strong support for a revived World Bank.

In the immediate future, that means supporting the current administration in selecting a first rate candidate as the next president, who has an excellent record as a leader and manager of a large complex organization; and it means the Congress paying over the still outstanding US payments on IDA 14.

Looking beyond the immediate future, the Congress should support the World Bank in taking more of a leadership role in several genuinely global problem areas. In its *traditional* products of aid projects and economic advice to governments of developing countries, the Bank faces a whole array of new competitors – such as China and Korea, which have become big sources of financial assistance to poorer countries, private consulting firms, which have developed superior skills in many of the Bank's traditional areas of expertise (such as banking and finance, and private sector development), and also the Gates foundation and other private foundations have become major players. But the Bank retains a big comparative advantage over these other entities based on its combination of (a) its inter-governmental guarantees, (b) its own large revenue base, and above all, (c) its global reach.

The Bank can and should take a much bigger role in tackling one of the biggest questions of our time, namely, how to decouple economic growth from carbon emissions? The Bank has much experience of translating economic policies into investment plans and investment plans into investments on the ground. It should use its experience to take the general conclusions in reports like the IPCC report and the Stern report and spell out what the general conclusions mean for specific countries, like China, Russia, Brazil, Bangladesh; and then help these governments work out country programs focused on decoupling their economic growth from their emissions.

This would lead the Bank to develop new financing instruments in order to accelerate the take-up of climate-friendly technologies. For example, a carbon fund – or, since the fund should not be tied only to carbon, a "climate-stabilizing" fund. Such a fund would enable a developing country government – eg China and India– to borrow from the Bank for a power station and choose a state-of-the-art minimum carbon emission technology even though it is more costly than a standard technology, with the fund rather than the government bearing the incremental cost.

Such a fund could be used to accelerate the uptake of climate friendly investments in the power sector; in transportation (eg railways in Africa); in forestry; and in still other sectors.

Some of the finance should come straight from World Bank reserves. The reserves are currently around $36 bn., while the Bank needs only around $25 bn. to maintain its all-important AAA credit rating. Some of the difference between $25 bn. and $36 bn. should be diverted to the climate-stabilizing fund. The fund would also receive grants from OECD governments and private foundations.

This is just one small example of how the Bank could be playing a significant catalytic role in addressing climate change. For it to reposition itself in the new market it needs to undertake some organizational changes and develop new streams of revenue. I leave the details to my written testimony. The bottom line is that even though we would not start with the present World Bank if we were creating the post 1944 world anew, the present World Bank is what we have got to work with. It needs US support to reposition and restructure itself to fulfill the valuable role that it is almost uniquely able to play in the world.

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This House committee hardly needs reminding that in much of the rest of the world the world's lone superpower is seen as arrogant, incompetent and indifferent. The present Congress and the next administration can help to restore American moral and political leadership in the world by, among many other ways, taking a constructive oversight role at the World Bank. And from the Bank's side, it urgently needs the Congress to signal its strong support for a revived and redirected World Bank with the requisite leadership and finance for it to help solve an array of genuinely global problems.

The fighting between Europeans and Americans over President Paul Wolfowitz's future has obscured the fact that the Bank faces a deep *crisis of relevance*, a crisis which pre-dates Wolfowitz but which his presidency did little to address. Last week's annual meeting of the African Development Bank in *Shanghai* – not Africa – dramatized how much the Bank's context has changed in the past decade. [1] Yet the Bank continues to operate in much the same way and with much the same products as a decade ago.

[1] William Wallis, "China changes dynamics of African loans", Financial Times, 19-20 May 2007.

The first big change in the Bank's market is that it is increasingly squeezed as a provider of finance and knowledge between:

(1) China and Korea as large new providers of unconditional financial assistance, especially but not only in Africa (China now gives more financial assistance to Africa than the World Bank does; and more to Cambodia and Laos than the Bank does);

(2) the regional development banks, which are often more trusted in their region than the World Bank;

(3) private consulting firms with superior skills and experience in many areas where the Bank has been active; and

(4) private foundations like the Gates Foundation.

The second big change in the Bank's market is that more and more of its borrowing countries are moving from low- to middle-income status. Within five years China's average income may have risen to the level which makes it ineligible to borrow from the World Bank Group; yet for more than a decade it has been the Bank's biggest borrower. Vietnam, the second biggest borrower from IDA (the soft-loan facility), will be ineligible for IDA funds within four years. Middle-income countries like China are less interested in the Bank's loans and more interested in the Bank's knowledge; which raises the question of whether and how the Bank should transition to making development knowledge rather than finance its main product. Middle-income countries tend to be less interested specifically in "poverty reduction" and more interested in how to generate prosperity in a more general way.

The third big change is that new and genuinely global problems have shot to the top of the agenda of world politics in the past decade. These include a whole gamut of international environmental issues, including climate change, deforestation and loss of biodiversity, and massive rural-to-urban migration (at the rate of 2 million people a month in East and South Asia). The World Bank, as the biggest and financially strongest of the multilateral organizations with global reach, should be well positioned to take a leading role in analyzing these problems and formulating lines of solution. But the Bank has yet to make this international environmental agenda and its ramifications into national policies central to its operations.

So the Bank should use the opportunity provided by the arrival of a new Bank president to step back and ask five basic questions:

(1) what kinds of "global public goods" does the world need;

(2) where – in what product lines -- can the Bank be competitive viz a viz private firms; in other words, what is the appropriate division of labor between the Bank (and other multilateral development banks), on the one hand, and the private sector, on the other;

(3) what role should the Bank play in middle-income countries (assuming that it continues to offer its existing products in low-income countries) – especially in China, which contains hundreds of millions of very poor people, is keen to draw on development

knowledge from the rest of the world, but is also rapidly emerging as a major source of financial assistance to poor countries;

(4) how should the Bank change its organizational structure, its product lines and its revenue sources to respond to the new challenges; and

(5) should the Bank continue to take "poverty reduction" as its central mission, when governments in much of the middle-income world think of the general spread of prosperity rather than "poverty reduction" per se as their major economic objective (even as the number of people in poverty is falling in many middle-income countries, notably China)?

IMMEDIATE ISSUES

1. *The presidency*

The Bank has been seriously damaged during the Wolfowitz presidency, and it must now get a president who is first rate. There are two issues. First, the search must be transparent, and unrestricted as to nationality. "We are not in 1944 anymore", to misquote the Wizard of Oz. The American monopoly on the presidency of the Bank and the European monopoly on the managing directorship of the Fund is a legacy of the Second World War. There is no good reason for the twin monopolies to continue. Put the other way around, there is no good reason why an Asian or a Latin American or anyone else cannot be the president of the World Bank. Even after giving up its monopoly America would still have the loudest voice at the Bank, because of its shareholding. Afterall, the US Treasury is by far the most important voice in the IMF, even though it appoints only the No. 2 position rather than the top.

Second, the new president must have an excellent record as a leader and manager of a large complex organization. Appointing someone with a high reputation as a policy advisor or financial technician is not good enough.

2. *IDA 15 (International Development Association)* IDA currently has a big hole in its finances as a result of (a) the multilateral debt relief initiative, and (b) US non-payment of all its pledged payments to IDA 14. Hence IDA's capacity to assist the poorest countries is hobbled.

LESS IMMEDIATE ISSUES

1. The central challenge of climate change

The Bank's big comparative advantage comes from its almost unique global reach. It should reposition itself to take a much stronger role in international environment issues than hitherto, and above all in climate change. Climate change is the biggest problem facing the world (bigger even than HIV/AIDs and nuclear proliferation). It affects us all, but it most affects poor countries of the tropics. Unless climate change solutions are applied in developing countries, the biggest problem facing humanity will not be solved.

The time is now ripe for a Big Push on climate change, because the key necessary ingredients are in place: (a) the science (eg IPCC reports), (b) the economics (eg Stern Report), and (c) public awareness of the imperative to act now to make the world safer from climate change and its consequences (including distress migration on a mass scale, and civil and inter-state wars).

So the question is, what should be the Bank's role in helping to decouple economic growth from carbon emissions? The Bank has much experience of translating economic policies into investment plans and investment plans into investments on the ground. It should use its experience to take the general conclusions in reports like the IPCC and Stern and spell out what the general conclusions mean for specific countries, like China, Russia, Brazil, Bangladesh; and then help these governments work out country programs focused on decoupling economic growth from emissions.

The Bank should develop new financing instruments in order to accelerate the take-up of climate-friendly technologies. For example, a carbon fund – or, since the fund should not be tied only to carbon, a "climate-stabilizing" fund. Such a fund would enable a developing country government – eg China – to borrow from the Bank for, say, a power station and choose a state-of-the-art minimum carbon emission technology even though it is more costly than a standard technology, with the fund rather than the government bearing the incremental cost.

Such a fund could be used to accelerate the uptake of climate friendly investments in the power sector; in transportation (eg railways in Africa); in forestry; and in still other sectors.

How could such a fund be capitalized? Some of the finance should come from World Bank reserves. The reserves are currently around $36 bn., while the Bank needs only around $25 bn. in reserves to maintain its all-important AAA credit rating. Some of the difference between $25 bn. and $36 bn. should be diverted to the climate-stabilizing fund. The fund would also receive grants from OECD governments and private foundations.

The fund would not depend only on altruism. Contributors would get carbon credits in return. And the fund would open new markets for private firms in environmental technologies (carbon capture technologies, for example, and wind power). So business would have a distinct interest in the fund too.

The Bank should also do more by way of piloting schemes for later scaling up by governments and the private sector. It has already played a catalytic role of this kind in the case of carbon trading. It spent $15o million on a pilot carbon trading scheme, which went on to become a $30 bn. market. This role of piloting experiments in ways of mitigating and adapting to climate change should be greatly expanded. One especially important direction of experimentation is carbon trading in the sectors of forestation and land use. 20-30% of carbon emissions come from land use practices and deforestation. Yet these sources have been quite neglected in mitigation schemes; less than 1% of carbon trading relates to these sectors. The Bank is well positioned to pilot schemes to expand this kind of carbon trading.

2. *Organizational change and new sources of revenue*

To enable it to be more effective in linking country programs to global issues such as climate change, the Bank should modify its organizational structure. The current structure is too much weighted towards countries as the unit of operations and budgeting, prompting country departments to operate in more or less separate silos, coordinating rather little with other country departments even in the same region. For example, the Russia country director based in Moscow in practice has little contact with the country directors of surrounding countries, each of whom burrow down into their own countries. The East Asia region works on forestry issues country by country, ignoring the dynamics of the regional forestry market. The management teams of the East and South Asia vice presidencies last met to coordinate their regional strategies more than 10 years ago – even as governmental and commercial contacts between China and India grow by the day.

If the Bank is to give much more emphasis to climate change and other global issues like HIV/AIDs it needs to organize itself with more staff and budget weight given to technical specializations of various kinds; and with the regional level given explicit recognition as a unit of strategy.

As part of this refocusing it could cut down on the number and staff of country offices.

The Bank should also be developing new sources of revenue. One is fee for service: in middle income countries (like Russia) it should be selling services, while in low income countries it should continue to provide such services for free. Until the Bank starts to put a price on its knowledge it will remain driven by the need to lend. Governments in China and Russia, for example, have a strong demand to learn about development experiences elsewhere for possible application at home. The Bank could offer to do studies on the relevant subjects (railway organization, for example) in return for an appropriate fee. Until now, by contrast, the Bank has undertaken studies more at its own initiative and without charging, as the hopeful basis for future *loans*. But in practice the Bank did not worry too much whether the governments actually read the reports; because the studies were driven less by the government's demand than by the supply-side spending imperatives and natural curiosity of the commissioning units of the Bank.

Fee for service in middle-income countries is one new kind of revenue stream. Another is lending to sub-national units, like regional governments, without a sovereign guarantee, charging a somewhat higher price than for loans with a sovereign guarantee.

The other side of this refocusing is a cut back in Bank activity in some sectors where it has been active, but where it no longer has an advantage in skills compared to private firms or other public agencies. Much of its work in banking and finance falls into this category; also in private sector development.

3. *The dilemma of the project model of aid*

Much of the Bank's work continues to be done in the form of discrete projects, as is also true of most bilateral aid donors. The map of Cambodia and many other poor countries is densely spotted with red flags, each representing an aid project. From the donor's perspective, the project model has several advantages over more general forms of assistance (like budget support), particularly in terms of accountability and impact assessment. And from the country's perspective, discrete aid projects with direct input from foreign experts can be very effective in delivering health care, schools, roads, drinking water to specific localities.

But there is a real dilemma. A little noticed disadvantage of the project model is its negative backwash effects on the capacity of the national civil service to steer development and implement projects without heavy reliance on foreign experts. Nationals who might otherwise strengthen the national civil service are employed by the aid projects, and frequently use the aid projects as a ladder into jobs in the international circuit. More general forms of assistance, such as budget support, have the advantage of potentially strengthening the capabilities of the state. The big question is how budget support can be given against rising standards of auditing of public accounts.

4. *The good governance agenda*

The Bank can play a useful role in pushing and advising on civil service reform and legal and judicial reform. But although the Bank talks a lot about good governance and has good governance country programs, it has few regular staff with skills in this area. For example, the East Asia and Pacific region has only one regular staff person in headquarters with skills in civil service reform, and a few other non-regular staff in country offices; and no regular staff person able to undertake programs in legal and judicial reform.

During the Wolfowitz presidency the governance agenda was widely discredited because Wolfowitz reduced governance to "corruption", as though the primary way to improve governance was to curb corruption. Moreover, the Bank under Wolfowitz used "corruption" selectively to advance geopolitical objectives, punishing some countries for "corruption" while not punishing others which scored equally badly on the Bank's corruption measures. Now that Wolfowitz has gone (or is going), the broader agenda needs to be staffed up.

5. *World Bank – IMF links*

The Bank is tied to the IMF through cross-conditionality, such that if an IDA – eligible country (of which there are over 80) is not "approved" by the Fund the World Bank's operations in the country are severely curbed as a result of an informal, not formal rule. This link should be broken. It may happen that the Bank agrees with the Fund's conditionality – but its hands should not be tied by a semi-automatic block on its operations if the Fund decides the country is not meeting its conditions. One reason is that the Fund's conditions can be developmentally very damaging. For example, in Sub-saharan

Africa the Fund imposes conditions via the targeting of inflation: if inflation rises above 5%, for example, tighter restrictions kick in on the amount and use of aid money, including from the Bank.

6. Governance of the World Bank

The Bank's Board of Governors should consider revising the existing formula for voting shares and capital contributions so as to give more weight to both economic size and population, and so as to adjust shares at regular (say five yearly) intervals in line with changes in economic size and population. This would mean, for example, a rise in China's share, and a fall in that of Russia and the US. The US should in any case give up its permanent veto (it is the only country able to veto certain kinds of actions without securing support from any other country, another 1944 legacy). These changes would shift the Bank towards a governance structure intermediate between the Security Council and the General Assembly: no permanent veto powers, but also not equal country weights.

Bank's board of executive directors could be made more effective by (a) enlarging it from 24 to 26, with the extra two seats going to Africa – so that Africa's 40 + countries would be represented by 4 executive directors rather than two. Also, all the constituencies should be rebalanced, so that each executive director would be responsible to a constituency of between 6 and 10 countries – as compared to the present, where eight executive directors represent only their own country and two others represent more than twenty each. Finally, the executive directors from developing countries should have terms of not less than 4 years and not more than 6 years.

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