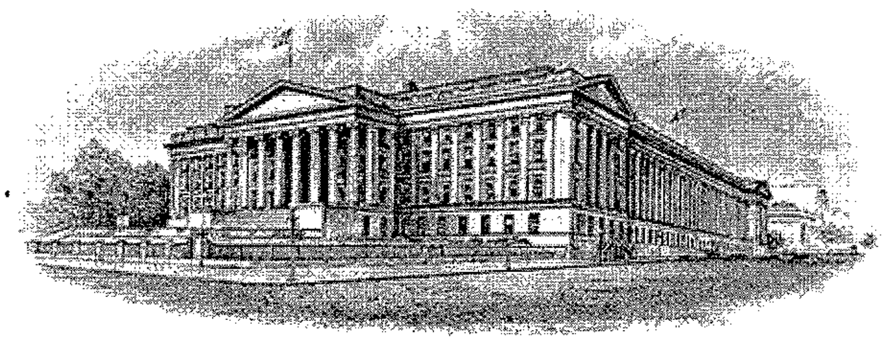

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF ASSISTANT SECRETARY CLAY LOWERY BEFORE THE SENATE FOREIGN RELATIONS COMMITTEE ON PROMOTING INFRASTRUCTURE THROUGH THE MULTILATERAL DEVELOPMENT BANKS

Chairman Lugar, Ranking Member Biden, Members of the Committee, I am pleased to have the opportunity to discuss the importance of infrastructure to achieving our shared goal of promoting economic development and reducing poverty. The multilateral development banks (MDBs) have an important role to play in helping developing countries meet this vital need. Theirs is a broad engagement that encompasses direct funding to catalyze other financial flows; creating the enabling environment to stimulate private investment flows, both domestic and foreign; supporting innovative approaches that can be scaled up if successful; putting in place safeguards to address and mitigate adverse social and environmental impacts; and taking steps to reduce corruption.

<u>Importance of Infrastructure</u>

Infrastructure is essential to economic growth and productivity – it is the fundamental investment backbone for the private sector, essential for delivery of social services, improves regional integration, and is a fundamental jump-start for countries coming out of conflict. As many studies have shown, the economic returns to infrastructure are high. The returns depend on the region and the quality of the infrastructure, but research by the World Bank suggests, for example, that a 10 percent increase in Latin America's infrastructure assets could result in an extra 1.5 percentage points of growth per year. Another World Bank model indicates that if the growth of investment in Africa's infrastructure had equaled that of East Asia during the 1980s and 1990s, the average African would be roughly 30% wealthier today. This is a conservative estimate as one specific small scale example demonstrates – an ADB study showed how the establishment of a new road in a Vietnamese village raised the per capita income of the local households by 30 percent between 1993 and 1998.

Infrastructure – whether related to transportation, water supply and sanitation, energy, or communication – is a vital input into private sector development, including small and medium enterprises. This is not unique to the developing world; the dynamism of the U.S. economy is due in large measure to the foresight of investments in such infrastructure basics as the interstate highway system – which is now celebrating its 50th anniversary – and efficient local and regional electric power grids. We often take these for granted, but they are not taken for granted by the poor in countries where clean water and reliable energy are luxuries, if they exist at all.

Infrastructure also is essential to the delivery of social services and human capital development, such as by providing power to health care clinics or to light and heat rural classrooms. Improving access to clean water and sanitation services also affects economic growth and poverty reduction directly by improving health and labor productivity through reductions in water-borne diseases and reducing the amount of time people spend fetching water. According to the World Health Organization, each year roughly 1.7 million lives are lost to unsafe water and inadequate sanitation.

Infrastructure can play an important role in promoting regional integration and entry into the global economy, which is a particularly important development challenge in countries with small labor markets and limited natural resources. Singapore is one example of an economy that has flourished because it put in place the infrastructure needed to become an international trading center, which helped it graduate, long ago, from official development assistance.

Countries emerging from conflict or natural disasters need fast responses to rebuild infrastructure facilities as a starting point for reconstruction of the economy and restoration of basic services. The current government of Afghanistan, for example, recognized that civil war and a legacy of neglect had left the country facing a serious infrastructure shortfall. The MDBs have helped the government to prioritize, design, finance, and implement projects and regulatory systems to overcome this legacy. Despite the substantial challenges, we are already seeing results. Financing from the Asian Development Bank (AsDB) for a private sector cellular phone provider, for example, has led to rapid distribution of telecommunications services that are so reliable that even the U.S. officials based in Afghanistan use them. Reconstruction of the country's highway network is proceeding steadily, with the AsDB completing a vital road between Kandahar and Spin Boldak, at the Pakistani border, and the World Bank completing roads that are helping to connect Kabul to Tajikistan. Moreover, travel time to go end-to-end on the Kabul-to-Kandahar Highway, which was also financed by USAID, has fallen significantly from 16 hours down to 5 or 6 due to recent improvements in road conditions. These roads are help get goods to market and provide the basic infrastructure that will allow Afghanistan to achieve its vision of becoming a land bridge connecting Central and South Asia.

Infrastructure Needs

Infrastructure needs in both low-income and emerging market economies are vast. While calculations vary, even the lower-end estimates by the World Bank suggest that developing countries need to devote around 5.5 percent of GDP to infrastructure investment, which is well above the average level of investment in the sector, currently around 3.5 percent of GDP. The under-investment reflects not only declining official assistance flows (recently reversed by most of the MDBs), but more importantly investment climates considered inhospitable by many private sector investors.

The U.S. has encouraged increased attention to infrastructure by the multilateral development banks (MDBs) recognizing that developing countries' needs were not being met and that investment flows from the private sector were declining, particularly in the wake of the Asian financial crisis. In 2003, the World Bank adopted an Infrastructure Action Plan that has scaled up infrastructure investments, expanded the range of instruments and funding sources, and catalyzed private resources. Other MDBs, with U.S. urging, are creating special funding facilities, such as the Infrastructure Facility of the Americas at the Inter-American Development Bank and the Infrastructure Consortium for Africa established at the African Development Bank. The Asian Development Bank has expanded its infrastructure lending in the last few years, primarily in energy, water supply and management, rural transport, and telecommunications. The EBRD has important initiatives in power and energy, municipal and environmental infrastructure, transport and telecoms.

In addition to providing direct financing (loans, grants, equity and guarantees to mitigate risk), the MDBs support infrastructure development by strengthening the policy and regulatory framework, giving analytical and diagnostic support – such as investment climate assessments and country infrastructure studies – and building institutional capacity to manage infrastructure investments. It is also critical that the MDBs do more – directly and indirectly – to attract both foreign and domestic private-sector investment in critical infrastructure.

Successful Projects and Innovative Approaches

Much is known about the controversial projects which the MDBs have helped finance and which have commanded a great deal of U.S. officials' time and resources. However, to focus exclusively on these operations is to overlook a substantially greater portion of projects that are likewise having a positive impact on economic activity and social well being. Let me use this opportunity to highlight examples where MDBs have supported innovative infrastructure proposals and projects that meet pressing public needs.

- The AfDB is helping the countries of Senegal and Mali to complete the missing road links between Bamako and Dakar and thereby reduce transport costs and promote further economic integration between the two countries and their neighbors. The project aims, by 2010, to reduce the amount of time for goods removal at the Dakar port from seven to two days; to reduce the border crossing time from one day to two hours; and to reduce the distance to fetch water from 5 km to less than 1 km. The project will also be partially financed by private transport sector operators in Senegal and Mali.

- The World Bank has helped to complete a network of water and sanitation services in Ahmedabad, India, that has increased the daily profits from vegetable farming by women living and working in local slums and has sharply reduced the incidence of disease. A World Bank water supply and sanitation project in Uttar Pradesh empowers local communities to make design choices and procure goods and services.

- The IFC has made a number of investments in locally owned firms, such as Celtel, a cellular telephone company operating in Africa that subsequently witnessed remarkable success. Within seven years of starting up operations, Celtel grew to operating in 14 countries and serving around nine million subscribers.

- In the Kyrgyz Republic, the EBRD is working with a state-owned joint-stock power company to improve the efficiency and reliability of electric power transmission and distribution in the Talas region, as well as to support private involvement in power and improve collection and reduce commercial losses. It is an important step towards private management of power distribution for the first time in the Central Asian region.

This is just a sampling; there are many other infrastructure projects that I could cite.

The way forward

I will not sit here and tell you that everything has gone well in this sector. I am well aware that many infrastructure projects – those funded by the MDBs as well as by other sources – have been affected by mismanagement, cost overruns, and outright corruption. The World Bank recently produced a lessons learned paper in which it identified a number of common issues that prevented it from achieving better results on its infrastructure engagements. The main culprits included inappropriate project design, delays in addressing access for the poor, insufficient management of expectations of private sector participation, late recognition of the importance of environmental and social sustainability, a lag in addressing corruption issues, and weaknesses in communications with stakeholders. When these things happen, infrastructure investments become enduring reminders of these inefficiencies, and send a negative signal to both donors and the private sector. These are important lessons and as the largest shareholder in the MDBs, we will continue to work to see that these lessons are reflected in the Bank's operations going forward.

First, we will work to enhance the application of proper safeguards, to offset or reverse the problems through regular scrutiny and oversight of MDB projects and policies – including, where we can afford it, to conduct site specific scrutiny.

Second, we strive to set the highest standards across the MDBs, in terms of fiduciary controls, procurement practices and environmental and social safeguards. As I said in my remarks on anti-corruption to this Committee in March of this year, Treasury is advancing a comprehensive reform agenda at the MDBs to attack corruption around the world and to root out corruption within the MDBs. Particularly germane to the infrastructure sector is sound revenue management. Through our interventions, we have secured key policy and project-related reforms, such as the transparent accounting and reporting of project related revenue flows to make sure that these projects are accountable. For example, following strong U.S. leadership, the International Development Association (IDA) agreed to require that financial assistance for any project with a significant impact on revenues should be predicated upon the government having in place a functioning system for accounting for revenues and expenditures. We will continue to work to ensure that public disclosure by MDBs is the norm.

Third, we must continue to raise the bar on securing results-oriented approaches that build in monitorable targets and benchmarks to measure and track results in MDB-financed projects. We have seen progress in this regard: now all of the MDBs are producing results measurement frameworks for their on-the-ground investments. We will closely monitor a new pilot project by the World Bank to strengthen the risk profile of infrastructure projects during the design phase and develop benchmarks and indicators that will trigger needed remedial action during project implementation.

Fourth, one of the lessons from experience is that access for the poor raises a distinct set of issues for project preparation and implementation. This requires dialogue with shareholders that goes beyond the local elites and government to include the poor. Access for the poor also requires new approaches for structuring projects. One potential approach that is being used is output-based aid. This model uses targeted subsidies for reducing service costs for the poor while allowing private infrastructure providers to pursue cost recovery. In Cambodia, for example, private service providers were selected on a competitive basis to roll out water and sanitation services to villages. To make sure that this did not exclude the poorest inhabitants, who otherwise might not have enough money to pay the up-front costs of getting hooked up to the system, an incentive payment was provided directly to the service provider for each eligible poor family that was connected to the network.

Finally but no less importantly, the MDBs will need to do a better job in engaging private capital and promoting the market's role in delivering services. Because official development assistance provides only around five to ten percent of current spending on infrastructure, the MDBs' engagement will need to demonstrate both selectivity and "additionality." By "additionality," I mean that the MDBs have to bring something to the table that the host country or private sources cannot or will not. And where the Banks do engage, they should demonstrate that they are picking high-impact projects. Until 1997, there was a steadily increasing appetite by the private sector for investing in developing country infrastructure sectors. The Asian financial crisis and several high-profile project failures have cut those private flows in half, but this trend can be reversed with the right policy and regulatory framework and with assistance to help countries develop bankable projects.

Given the vast infrastructure needs and the shortage of public and official finance, the international financial institutions need to find effective ways of unlocking private investment flows by addressing specific market failures. We firmly believe that innovative proposals can employ small amounts of official finance to catalyze orders of magnitude more in private investment. That's the kind of leveraging of public money we like to see. As one example, we know that private investors often have a hard time obtaining information on which infrastructure proposals make economic sense and which are largely driven by politics. We have developed an innovative initiative in the IDB, targeting official money to reduce investors' search costs for good projects that gets at precisely this problem.

If the MDBs are to catalyze increased volumes of private capital, they will need to: (1) address the regulatory regime obstacles so that investors have a degree of certainty and a clear path for cost-recovery; (2) promote realistic expectations about the benefits of private capital; and (3) seek new mechanisms such as output-based aid and public-private partnerships that address the sustainability of private infrastructure services. We are committed to working with the banks to help countries put in place this framework.

In closing, I welcome your interest in this very important aspect of the work of the multilateral development banks and I look forward to your questions.

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