Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: May 22, 2019, “The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System, Part II”

The Committee on Financial Services will hold a hearing entitled, “The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System, Part II” on May 22, 2019 at 9:00 a.m. in room 2128 of the Rayburn House Office Building. This hearing is to continue to take testimony from the Honorable Steven T. Mnuchin, Secretary, U.S. Department of the Treasury, and is a continuation of the hearing that began on Tuesday April 9, 2019, at 2 p.m. Section 1705 of International Financial Institutions Act (22 U.S.C. 262r–4) requires the Secretary of the Treasury to present annual testimony on the status of efforts to reform the International Monetary Fund (IMF) and the state of the international financial system. The Department of Treasury is the lead agency for U.S. engagement with the international financial institutions. In the House, the Financial Services Committee has jurisdiction over U.S. participation in these multilateral institutions.

Even before World War II ended, political leaders from the 44 Allied countries met at Bretton Woods, a New Hampshire resort hotel, in 1944 to create the institutional framework for the post-World War II economic and monetary order. The Bretton Woods conference gave birth to two international financial institutions that have underpinned global cooperation and played a critical role in the international financial architecture in the succeeding 75 years—the International Monetary Fund (IMF) and the World Bank.

International Monetary Fund (IMF)

The IMF plays an important role in safeguarding the international financial system and promoting financial stability through its principal activities of surveillance, financing, and technical assistance. Through surveillance, the IMF monitors economic and financial policies of its members and of the global economy, highlights possible risks to domestic and external stability, and advises on needed policy adjustments. The IMF also provides loans to countries experiencing financial crises, including debt, currency, and banking crises, and provides technical assistance and training to countries to help strengthen their capacity to design and implement effective policies. 1

The United States is the largest financial contributor to the IMF, providing 17.46% of the Fund’s total resources. The U.S. contribution gives the U.S. the largest voting share (16.52%) of all IMF members, including a veto power over major IMF decisions, though not individual lending decisions.

1 Report to Congress from the Chairman of the National Advisory Council on International Monetary and Financial Policies, United States Department of the Treasury, June 2018
IMF’s financial resources

The IMF has the following three main financing sources totaling $1.4 trillion:

1. **Member quota subscriptions** are the primary source of IMF loans and are the foundation of country representation at the IMF. Each member country of the IMF is assigned a quota, which broadly reflects its size and position in the world economy. A member country’s quota determines its financial commitment to the IMF, its voting power, and its level of access to IMF financing.

2. **The New Arrangements to Borrow (or NAB)** is a multilateral borrowing arrangement that serves as the IMF’s main backstop for quota resources. Through the NAB, 40 member countries ready to lend additional resources to the IMF in the event of a major financial crisis or to deal with exceptional situations that pose a systemic threat. Under NAB procedures, every five years, the Executive Board votes on whether to renew the NAB a year before the current renewal period is up. The current renewal period expires in November 2022, which means Treasury will need to decide by November 2021 whether or not to continue U.S. participation in the NAB.

3. **Bilateral borrowing arrangements** between the IMF and individual countries were put on the books in large measure as a backstop for the Euro area crisis, and many key European central banks have indicated that the borrowings should be viewed as temporary and are set to expire in 2020.

Although the IMF’s combined financial resources total around $1.4 trillion, the bilateral loan arrangements ($400 billion) are set to expire next year. If the U.S. decides to withdraw its $40 billion from the NAB in 2022, IMF financial resources could be cut by up to 30% over the next several years. If other NAB countries were to follow the U.S. and also decline to renew their NAB commitments ($200 billion), total IMF resources could then be cut almost in half, which would significantly undermine the Fund’s ability to deal with inevitable future crises.2

**IMF’s 15th General Review of Quotas**

The IMF is currently undertaking its 15th General Review of Quotas, with the goal of completing the review no later than the Annual Meetings in October 2019. The review will assess the adequacy of the IMF’s financial resources and the distribution of voting power in the Fund. Today, the IMF’s current shareholdings do not reflect emerging market countries’ growing economic clout and have in turn fueled their interest in alternatives institutions, such as the recent creation of two China-led multilateral development banks. At the April hearing with Secretary Mnuchin, the Secretary confirmed that the Administration will oppose any quota increase under the current review, effectively halting a decade of progress reforming the governance of the Fund to make it more representative, legitimate, and therefore, more effective. This will be viewed as shortsighted to some, as it allows Japan and Europe to maintain their overweight voting power, and of course none of this will be lost on China or other underrepresented emerging markets.3 The Administration’s rejection of any possible governance reform through quota negotiations could also alienate China and other emerging markets, which, in turn, might cause them to drift away from the multilateral institutions and increasingly towards regionalism.4

**China’s lending putting developing countries at risk of debt distress**

The IMF has articulated its concerns about the rising sovereign debt of many developing countries.5 Loans from China’s many lending institutions, especially those associated with China’s Belt and Road Initiative

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3 “Mnuchin must not be shortsighted when deciding on IMF funding,” by Meg Lundsager, The Hill, April 9, 2019.
(BRI), lack transparency, making the amount and terms of much of that debt unknown. China’s opaque lending arrangements complicate the IMF’s capacity to monitor global financial risks for many emerging-market and developing countries. The Center for Global Development has identified eight countries that are at risk of sovereign debt distress in large part because of China’s lending to them for BRI projects—Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro, Pakistan, and Tajikistan. Some Members of Congress and the Administration have argued that the United States should not support loans to countries through the IMF, such as Pakistan, whose debt-burden has increased because of “predatory” lending by China.

**IMF’s Work on Income Inequality**

The IMF’s research on income inequality has shown that excessive inequality tends to reduce the pace and durability of growth and that policymakers should not be afraid to adopt measures that ensure shared prosperity. IMF economists have found that well-designed redistribution policies can contribute in positive ways to sustainable growth and promote equity without undermining efficiency. Examples of such policies include replacing general price subsidies with cash transfers to the poor, reducing tax loopholes that benefit the rich, making tax systems more progressive, including in some cases expanding the personal income tax base, and combating tax evasion.

**The Importance of Gender Inclusion in Economic Life**

Fund research has shown that the exclusion of women in economic life exacerbates income inequality and lowers living standards for everyone. This research is the latest to wade into the subject of inequality and growth at the IMF which, under Christine Lagarde’s leadership, has over the past several years been more willing to test economic orthodoxies. A recent paper by IMF economists has argued that one of the most potent drivers of inequality is the exclusion of women from the work force in large parts of the world and their lower pay in those countries where they do work, which drags down growth in both developing and advanced economies.

**The World Bank and Regional Multilateral Development Banks**

The World Bank (formally known as the International Bank for Reconstruction and Development) was originally established to support reconstruction in post-war Western Europe and Japan, but expanded its operations both geographically and substantively. Today, with over 188 member countries, the Bank’s mission is to reduce extreme poverty and boost shared prosperity around the world. Cold War competition with the Soviet Union also led to the formation of a series of regional development banks—the African Development Bank (1964), the Asian Development Bank (1966), and the Inter-American Development Bank (1959) that provide more specialized lending and technical assistance. In 1991, at the end of the Cold War, the European Bank for Reconstruction and Development was established to help former Soviet republics and Central Eastern European countries transition into sustainable market economies with a commitment to democratic principles.

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6 “Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective,” by John Hurley, Scott Morris and Gailyn Portelance, March 4, 2018


8 “Redistribution, Inequality, and Growth,” by Jonathan D. Ostry, Andrew Berg, Charalambos G. Tsangarides. *International Monetary Fund, Research Department, Authorized for distribution by Olivier Blanchard, April 2014.


The United States is the largest shareholder in the World Bank, the Inter-American Development Bank, and the European Bank for Reconstruction and Development; the co-largest shareholder (with Japan) in the Asian Development Bank; and the largest non-regional and second-largest overall shareholder in the African Development Bank.

**The Next World Bank President**

On January 7, 2018, World Bank President Jim Yong Kim announced that he would resign by February 1, three years before the expiration of his second five-year term. Although any member of the board of governors of the World Bank can nominate a president, there has been a longstanding custom since 1944 that an American would be appointed as president of the World Bank, while a European would be appointed as the managing director of the IMF. Earlier this year, President Trump nominated Treasury Under Secretary for International Affairs David Malpass to be the next World Bank president. In testimony before the Monetary Policy and Trade Subcommittee in November 2017, Under Secretary Malpass characterized the World Bank and other multilateral development institutions as inefficient and “often corrupt in their lending practices,” ultimately only benefitting their own employees. He also expressed the view “that globalism and multilateralism have gone substantially too far, to the point that they are hurting U.S. and global growth.” Much of the commentary on Malpass’s nomination has focused on his disdain for multilateral solutions to global development challenges, and his criticism in particular of the World Bank, which he has characterized as obsolete in an era of accessible private capital markets. Under Secretary Malpass was approved by a unanimous vote of the bank’s board of executive directors on April 5, 2019.

**2018 World Bank Capital Increase Package**

On April 21, 2018, the United States joined other World Bank members in supporting a significant injection of new capital into the World Bank’s main lending arm, the International Bank for Reconstruction and Development (IBRD), as well as the bank’s private sector lender, the International Finance Corporation (IFC). Specifically, members endorsed a $60.1 billion capital increase for the IBRD, which would raise the IBRD’s capital from $275 billion to $335 billion, and a $5.5 billion capital increase for the IFC, which would more than triple the IFC’s capital base from $2.57 billion to $8.1 billion. With the exception of small selective capital increases to adjust relative shareholding, the Bank has raised its capital base four times: 1959, 1979, 1988, and 2010, all with U.S. support.

**Using IDA Funds to Subsidize Private Firms**

The International Development Association, or IDA, is the arm of the World Bank that provides grants and highly concessional loans to the world’s 77 poorest countries. Every three years IDA donors come together to negotiate the amount of new resources required to replenish IDA’s lending program and to discuss lending policies and priorities. The current IDA replenishment, IDA-18, created a Private Sector Window (PSW) that allocates $2.5 billion of IDA’s concessional funds to the World Bank’s private sector investment arm, the

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14 Statement of Under Secretary David Malpass before the U.S. House Financial Services Subcommittee on Monetary Policy and Trade, December 12, 2018.
15 The United States is the largest IDA donor historically, though for most recent replenishment (IDA-18), the U.S. became the second largest donor behind the United Kingdom.
International Finance Corporation (IFC)\textsuperscript{16}, and its private sector guarantee arm, the Multilateral Investment Guarantee Agency (MIGA), to subsidize private sector investments in lower-income countries and fragile and conflict-affected states.\textsuperscript{17}

The rationale for this mechanism is that by transferring risk to IDA, the IFC would be able to attract private finance investments with high development impact in poor and fragile states that would not otherwise happen. There is concern, however, that the IDA Private Sector Window, as implemented by the IFC, is using an approach that provides unreported levels of subsidies to private firms selected without competition on the basis of unsolicited proposals.\textsuperscript{18} There is also some concern about the risk that market incentives could result in prioritizing financial returns over positive development impacts, and that this will be difficult to monitor given that the PSW transforms comparatively transparent aid money into opaque private finance. The IDA PSW also appears to ignore the World Bank’s own principles on the use of concessional public resources to subsidize the private sector, which includes ensuring that subsidies are justified, transparent, competitively based, focused on impact, and guarded against rent-seeking opportunities.\textsuperscript{19, 20, 21}

\textsuperscript{16} The International Finance Corporation (IFC) is the private sector arm of the World Bank focused exclusively on the private sector in developing countries. Its mission is to catalyze private investments in projects and countries that other private sector actors might deem too financially risky. IFC does this through a range of instruments, including loaning to private investors, guaranteeing loans, taking an equity stake in an investment, and offering advisory services.

\textsuperscript{17} “IDA18 IFC-MIGA Private Sector Window,” brief by the International Finance Corporation.

\textsuperscript{18} “Aid Transparency and Private Sector Subsidies at the IFC,” by Charles Kenny, January 17, 2018. Center for Global Development


\textsuperscript{20} “Multilateral Development Bank Principles to Support Sustainable Private Sector Operations,” April 21 2012

\textsuperscript{21} “Policy Guidelines for Managing Unsolicited Proposals in Infrastructure Projects,” The World Bank and International Finance Corporation. Updated April 1, 2019