Statement to the Subcommittee on Monetary Policy and Trade

House Financial Services Committee

David R. Malpass, Under Secretary of the Treasury for International Affairs

Chairman Barr, Ranking Member Moore, and Members of the Financial Services Monetary Policy and Trade Subcommittee, thank you for holding this hearing and for inviting me to testify this morning.

One of the Trump Administration's top objectives is to achieve faster U.S. and global growth in ways that improve after-tax wages for American workers. This involves ambitious reforms for taxes, regulation, trade, energy, financial regulation, infrastructure, and the budget. As Secretary Mnuchin said in October: "Better policy choices could remove structural impediments and unlock the economy's longer-term growth potential. Our agenda is aimed at restoring much needed dynamism to the U.S. economy."

This growth agenda draws on work throughout the Treasury Department, and we welcome the opportunity to work with your Committee. For example, a key driver of growth is the effectiveness of the financial regulatory framework, so that small- and medium-sized businesses are able to get the capital they need to be more productive and create more jobs. This will require improvements at multiple U.S. regulators, as well as a more growth-oriented approach in multilateral regulatory institutions.

Today's hearing is focused on global growth and the role of the international financial institutions (IFIs). These include the International Monetary Fund, the World Bank Group, and several other multilateral development banks (MDBs). I've presented a table and partial balance sheet of some of these IFIs below.

MDB Balance Sheets

Billions USD (unless otherwise noted)

	Assets	Liabilities	Equity
International Bank for Reconstruction and Development	405.9	366.1	39.8
International Development Association	197.0	38.6	158.5
International Finance Corporation	92.3	67.2	25.1
African Development Bank /1	29.7	20.6	6.6
Asian Development Bank	178.9	129.5	49.4
European Bank for Reconstruction and Development /2	56.2	40.2	15.4
Inter-American Development Bank	126.0	94.0	32.0
North American Development Bank	1.8	1.2	0.6

/1 Billions UA
/2 Billions Euro
All figures are gross of derivatives

IBRD Balance Sheet			
2017 - Billions USD			
Assets	405.9	**Liabilities**	366.1
Loans	177	Borrowings	206
Investments/Liquid Assets	73	Derivative Liabilities	153
Derivative Assets	150	Other Liabilities	7
Other Assets	6		
		Equity	39.8
		Paid-In Capital	16
		Retained Earnings	24
Total	406		406

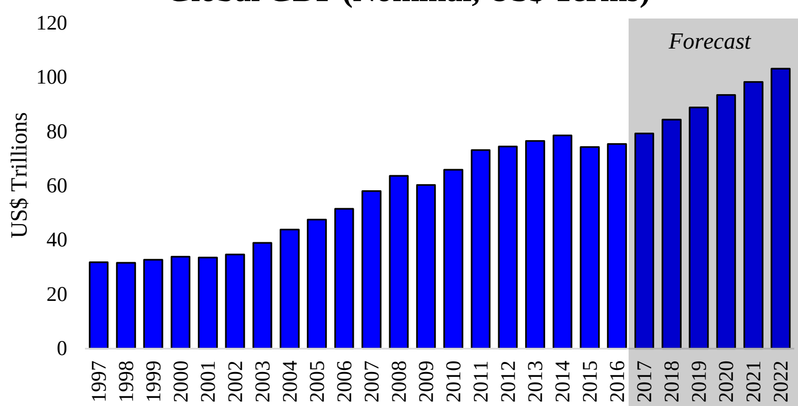
In today's testimony, I will focus primarily on the World Bank and IMF, but all of the IFIs present their own set of challenges and opportunities.

Global Growth Taking Hold

The context for today's discussion is a global growth improvement in recent quarters, though it remains well below its true potential. Between 1997 and 2007, the global economy grew 4 percent per year on average; however, average annual growth in the decade since then has slowed to 3.3 percent. We believe faster global growth rates are possible, sustainable, and will be a key factor in improving wages for American workers.

However, following the 2008 financial crisis, there was an unusually weak recovery both in the U.S. and abroad. Per the IMF, world GDP, which stood at $73 trillion in 2011, was stuck at $74 trillion in 2015 and $75 trillion in 2016. For the U.S., the post-2008 recovery was the first in U.S. history to actually result in lower real median income. IMF projections show that a resumption in growth is underway, with world GDP rising to $79 trillion in 2017 and $84 trillion in 2018. The acceleration of U.S. growth to 3 percent in the second and third quarters is a welcome contributor to this advance.

Global GDP (Nominal, US$ Terms)



Source: IMF World Economic Outlook October 2017

Role of Multilateral Development Finance

With growth accelerating and the world financial system relatively stable and liquid, now is an opportune time to discuss the role of multilateral development finance in global growth and prosperity. As a preface, I want to make a clear distinction between isolationism, which we oppose, and our view that globalism and multilateralism have gone substantially too far, to the point that they are hurting U.S. and global growth.

In his remarks to the United Nations General Assembly in September, President Trump articulated a vision of international affairs in which each country's government has a responsibility, first and foremost, to serve its own people. Out of this self-interest emerges a constructive international order in which nations and their people are enriched through trade, cooperation, and innovation. The President is travelling in Asia this week, promoting growth, investment, security in the Indo-Pacific, and trading relationships that are fair and reciprocal.

It is very clear that the U.S. benefits from freer, more prosperous neighbors, trading partners, and like-minded societies around the world. To promote that, the U.S. needs to be actively engaged in global affairs including global growth efforts and global security. We do this both in our self-interest and as a world leader that champions and embodies personal freedom, property rights, the rule of law, and human progress.

We recognize that successful international relationships include multilateral institutions, but the challenge for them is to have clear, focused missions and deliver results effectively, and with accountability to participants.

To give you a sense of the magnitude of the challenge, Treasury's Office of International Affairs, which I head, is currently participating in nearly 100 international working groups and organizations. Each has the goal of benefiting the world, but each requires staff time, energy, and often travel. I joined Treasury in early August, and I will work to review these various processes to determine which of them can be wound down, scaled back, or converted to financial plans based on restraint rather than expansion. I have had the opportunity to make these points at the IMF, World Bank, G-20, Financial Stability Board, and the Asia-Pacific Economic Cooperation (APEC) Finance Ministerial Meeting, and it will need to be a continuous process in our international affairs work program.

As an example, our U.S. representative gave a statement earlier this week at the Steering Committee meeting of the Global Agriculture and Food Security Program (GAFSP) in Rome that the U.S. is not expecting to make any future contributions to GAFSP and that GAFSP should be wound down, with donors exploring options to return future reflows to donors. The U.S. government and other donors provide funding to support similar agricultural investments in poor countries through other institutions and funding sources. Furthermore, MDBs are capable of institutionalizing the lessons learned and of continuing GAFSP projects without separate donor support. For reference, the United States is the largest historical contributor to GAFSP, having contributed $653 million.

New Sources of Capital

It used to be the case that a large part of the flow of external capital to developing countries came from banks using syndicated loans, often under encouragement or pressure from governments. This culminated in the Latin American debt crisis of the 1980s. The Brady Plan in 1989 began the process of securitizing large portions of this debt, creating major new sources of capital for development.

For many countries, this securitization of sovereign debt has enabled the availability of local currency debt in longer maturities, providing a cushion against shocks. In the early years of this decade, Chile faced a catastrophic drop in the price of copper, one of its major industries and exports, yet survived without a recession in part due to these innovations in international finance.

Separately, the structure of world interest rates has moved much lower as history moves further away from the devaluations and high inflation of the 1970s. Huge amounts of capital available at lower interest rates than in the past are now available as investors reach for yield globally.

These three transformations – the securitization of sovereigns, the lengthening of maturities for local currency debt, and the decline in the structure of interest rates – are truly stunning in the history of international finance, fostering greater accountability and market-based capital flows that should add materially to global growth and prosperity.

While welcome, these developments also create at least three challenges for multilateral development finance. First, governments increasingly have access to more capital and low-rate credit than their capacity to manage the inflows responsibly. Tajikistan, Mozambique, and Ghana have taken advantage of capital markets access and obtained financing in bond markets, but their experiences are a cautionary lesson to others that the availability of increased financing must be coupled with appropriate transparency, the capacity to prudently manage liabilities, and the capability to deploy resources efficiently.

Second, a growing number of countries have taken advantage of low interest rates and the proliferation of global capital markets to tap investors beyond their ability to repay. Creditors, including the MDBs, should be cautious about exacerbating unsustainable situations in borrowing countries – particularly those with capacity constraints that hinder their ability to properly manage their debt.

And third, the role of the MDBs has to change dramatically, so that they focus less on the volume of finance they provide and more on the goal of providing high-quality services that are not available elsewhere. MDBs must improve the tools and methods they use to analyze additionality, guard against crowding-out, and maximize development impact. We should set as a goal that every project and intervention an MDB undertakes moves a borrower along a continuum toward the ability to finance their own development without donor support. In seeking this transformation, we need to challenge the multilateral organizations to rethink their methods and operations.

The MDBs can use their knowledge and analytical capabilities to not only contribute to this dialogue, but also to continue to work with capacity-constrained countries to create the enabling environment for responsible private sector borrowing.

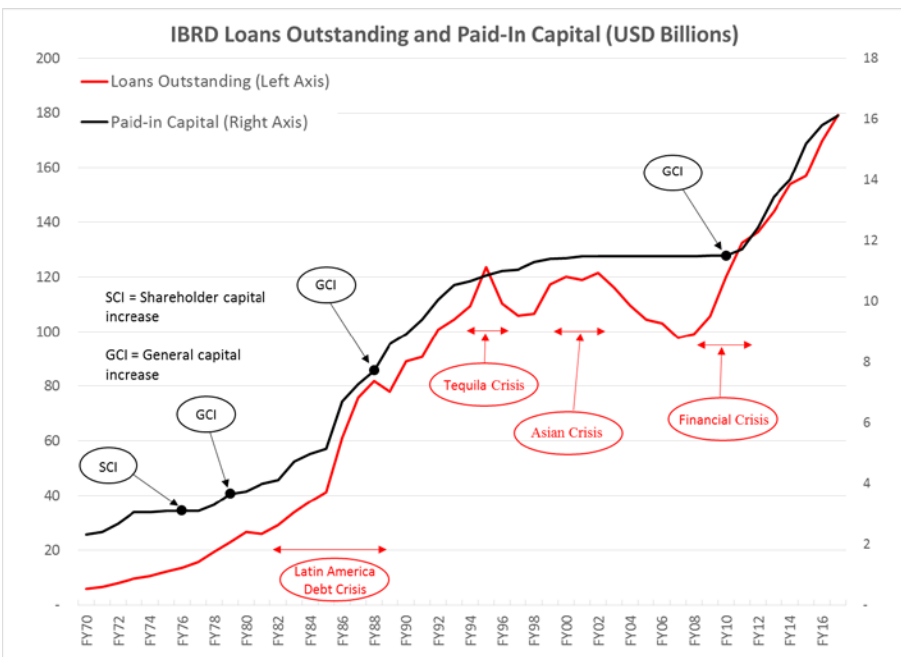
Private capital has been behind many of the innovations that have produced the greatest measurable results in fostering growth and lifting people out of poverty. Some examples of these innovations include financial technology, mobile telecommunications, microloans, digital currencies, and social entrepreneurship.

In sum, we should take full advantage of this period of relative stability in global finance to transform development finance. To this end, the Administration is moving on a constructive and transformative agenda that seeks to reconcile large multilaterals aimed at meeting the challenges of earlier decades with a world of relatively plentiful private sector capital.

World Bank Reforms

The World Bank is the largest of the development finance institutions. Working with the previous Administration, it secured a 50 percent increase in the financial capacity of the International Development Association (IDA). It has asked the current Administration to work toward large capital increases for the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC).

The business model of the MDBs' non-concessional windows, including the IBRD, is to leverage the capital that shareholders provide (paid-in capital) by borrowing from markets using loan guarantees from shareholders (callable capital). MDB capital increases are generally intended to permit sustainable lending levels to address increased development needs or crises.



We welcome a dialogue on World Bank reforms. As discussed, there is a historic transformation underway in the availability and sophistication of private sector funding for development finance. President Trump has made clear the importance of other donors doing their fair share, and of U.S. and other donor funding not displacing the private sector. Further, we should observe how countries absorb the new capital flows expected from the 18th replenishment of IDA, to which the U.S. has committed to contributing $3 billion and allowing substantial leveraging of IDA's equity capital, the expected reflows of previous concessional lending.

Additionally, the World Bank is facing major problems in its graduation process – implementing a system in which the allocation of its resources moves dynamically from countries where the necessity for external multilateral finance has declined to countries that are capable of effectively absorbing multilateral resources and have substantial needs.

IBRD Engagement with Graduation-Eligible Countries

A key policy concern at the World Bank is its track record of continuing to lend large amounts to countries that have higher per capita incomes and ready market access. When the World Bank does not graduate these countries, less funding is available to reach countries with greater development needs, and there is an excess burden placed on shareholder capital. The World Bank's relationship with countries should change as they move up the income ladder and gain access to wider sources of financing – shifting from lending to a greater focus on knowledge transfer and the buildup of domestic capital markets.

Between 1985 and 2008, on average, 10 percent of IBRD annual lending went to graduation-eligible countries. Since 2009, countries eligible for graduation have received, on average, 40 percent of IBD lending. Pre-crisis, World Bank management and graduation-eligible countries generally adhered to the graduation policy. Countries that were wealthier, more creditworthy, more institutionally developed, and less vulnerable to shocks were more likely to have graduated, and between 1990 and 2016, there was an average three year lag between crossing the income threshold and graduation.

During the 2008-2009 financial crisis, access to private capital became more difficult for many developing countries, and IBRD lending to graduation-eligible countries increased significantly, particularly in the form of large, quick-disbursing policy loans.

Many graduation-eligible countries, even those with strong market access, have continued to demand IBRD financing. Graduation-eligible countries tend to see the IBRD as a stable source of financing and development expertise, and also may be reluctant to formally graduate to preserve access to the IBRD in the event of another crisis.

Adherence to the graduation policy has progressively weakened. Currently, 25 countries have incomes above the threshold, though not all borrow from the IBRD every year. 19 of these countries have been above the threshold for longer than five years. Nearly half are rated investment grade or better, and six of these countries are defined by the World Bank as high-income, with per capita income exceeding $12,475.

This leaves a lot of room for improvement. The Articles of Agreement set forth two broad criteria for IBRD lending: (1) that given prevailing market conditions, a borrower would otherwise be unable to obtain the loan under reasonable conditions, and (2) that private capital is not available on reasonable terms. In 1973, the IBRD established an income threshold (currently $6,895 per capita) that would signal a country's eligibility for graduation (making it "graduation-eligible") and trigger the start of discussions between World Bank management and country authorities on graduation. A subsequent 1982 policy further called for the consideration of "a country's level of development and overall economic situation" and "a country's capacity to sustain long-term development without further recourse to the bank's financial resources." The policy stipulates that graduation from new IBRD lending should normally occur within five years after a country reaches the income threshold, with the length of the phase-out depending upon a country's ability to access external capital markets on reasonable terms and its progress in establishing key institutions for economic and social development. These subjective factors allow World Bank management and the graduation-eligible country considerable leeway.

According to World Bank management, graduation discussions take place in the context of negotiating new Country Partnership Frameworks (CPFs), which are strategy documents that Bank staff and the borrowing country develop to guide World Bank engagement over a set period (usually three to six years). Treasury has not found these graduation discussions to be serious or meaningful, and based on our observations, the decision on whether to even formulate a graduation plan is left to the borrowing country. We have strenuously argued for a more rigorous, transparent, and rules-based process.

During discussions in 2016 on the Forward Look, a medium-term strategy for the World Bank intended to inform subsequent discussions on a potential capital increase, the previous Administration secured two significant policy commitments. First, there was a commitment in the Forward Look that the IBRD would build up its portfolio for countries below the graduation threshold. Second, the Forward Look indicated that it would more narrowly focus its engagement with graduation-eligible countries on advisory services and the use of more tailored financing instruments for purposes of crisis preparedness, improving domestic resource and private sector mobilization, debt management, and capital markets access.

World Bank management, meanwhile, has neglected these commitments in the Forward Look and instead seeks to maintain or increase its strong engagement with graduation-eligible countries on the view that it wants to work against poverty in middle-income countries; wants the portfolio diversification available from lending to more creditworthy countries; and covers some of its overhead by lending to easier, less risky countries. Even in 2017, the biggest borrower from the IBRD was China, which received $2.4 billion in new financing and has outstanding exposure of $13.3 billion.

We think the World Bank can do a better job meeting its commitments to poorer countries while still pursuing a financially-sound business model. An overriding objective for the Administration is to ensure the World Bank is directing its resources to the people who need them most in the countries with the least access to private capital. Not only does this help ensure that each marginal dollar is as impactful as it can be, but it also guards against public money displacing private investors. Ultimately, the World Bank's success should be marked by the number of countries that eventually graduate from borrowing altogether. This calls for an efficient graduation process based on an enforceable graduation policy with tangible measures of success.

Given this divide in viewpoints, the Administration is seeking a framework in which we can execute a strong growth agenda while working cooperatively with other governments. To that end, the President has nominated, or will soon be nominating, eminently qualified individuals to serve as representatives on the boards of the World Bank and other international financial institutions.

Treasury believes that the World Bank currently has the resources it needs to fulfill its mission and that the Bank should develop proposals in which the Bank's organic capital accumulation alone could be sufficient to support future lending targets. The state of the world, that of capital markets, and that of countries is vastly different today than when the World Bank's capital structure was developed, and we think now is an opportune time to rethink the structure and mission, so that the World Bank can maintain its leadership role in multilateral development finance.

Impact of China in International Finance

A key driver of global poverty reduction has been the progress major emerging markets have made in moving away from planned economies to market-oriented economies. It is in this context that I have expressed concerns about China's direction. As its portion of world GDP increases, China's market liberalization is a critical factor in whether global growth will be sustained well into the future.

China's gradual liberalization was welcome. Price liberalization was powerful. There was some progress in rebalancing the economy away from excess investment toward consumption and services. China also sought to reduce corporate and financial leverage, and to address growing risks in the financial sector. We welcomed those, but are concerned that the liberalization seems to have slowed or reversed.

Recently, the role of the state in China's economy has been increasing. State-owned enterprises have not faced hard budget constraints, and China's industrial policy has become more and more problematic for foreign firms. Export credits have grown large.

This is not the kind of market-based reform that China has undertaken in the past, or the kind of reform that China needs. It is critical that capital be allocated more effectively and that China stop engaging in massive subsidies that distort global markets and harm U.S. competitiveness. China's unfair trading practices are unsustainable and harmful to the growth and prosperity of the U.S. and many other nations. The Administration is committed to achieving a fair and reciprocal trading and investment relationship with China, including through market-based reforms.

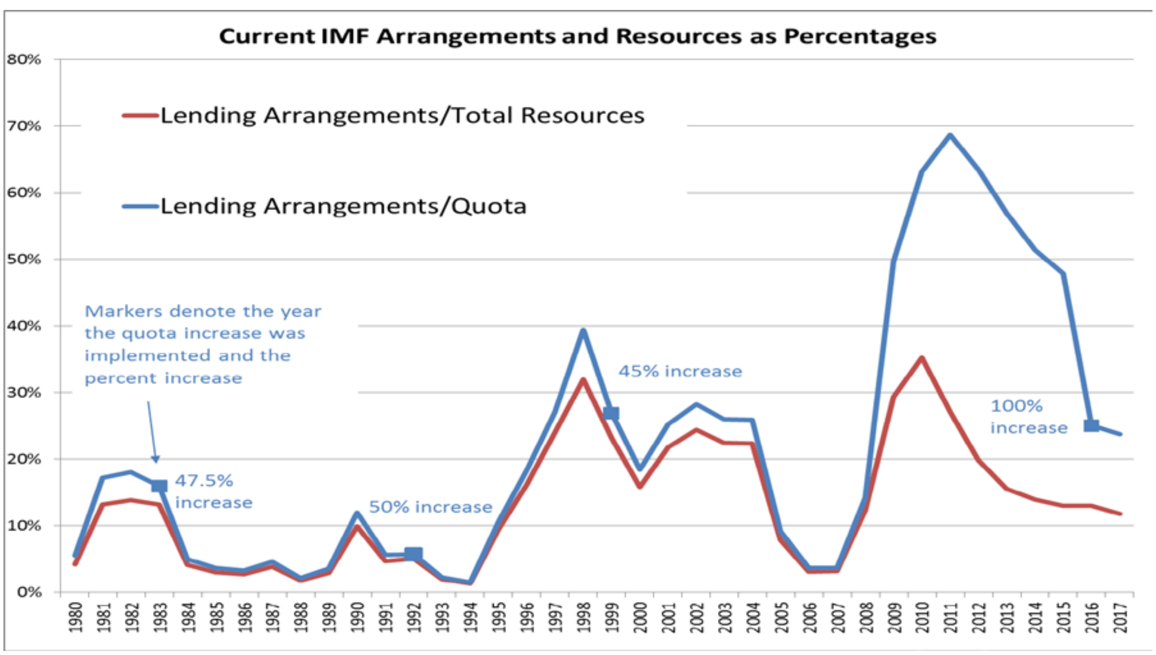
Role of the International Monetary Fund

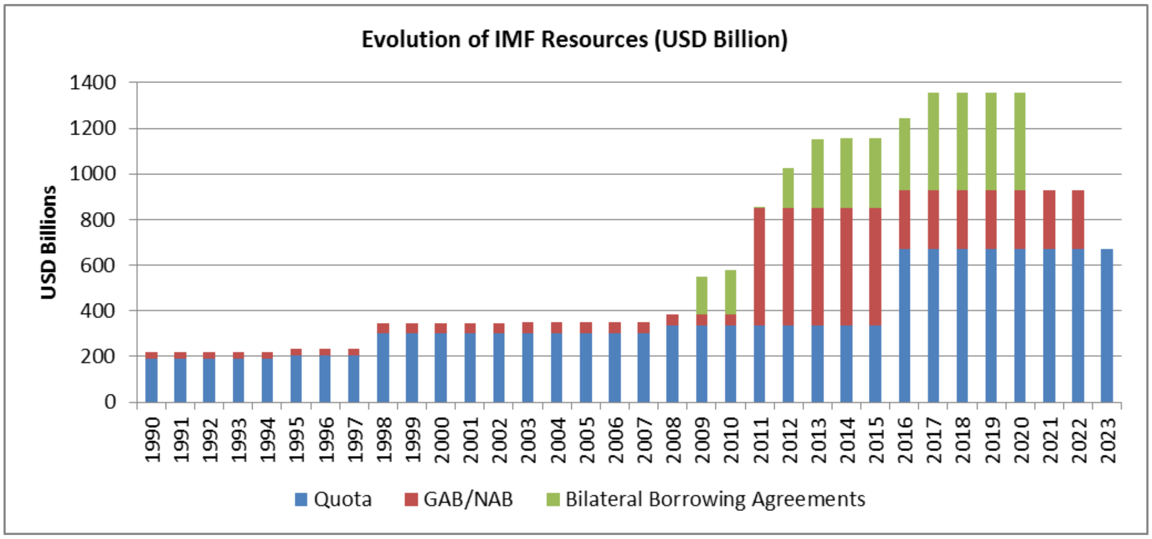
The IMF operates in the same global context – an improving world growth outlook with an unusually high availability of private sector capital. It faces the challenge of redefining its role at a time when it currently has ample resources, but faces unknown future challenges.

The shift in recent years toward local capital markets large enough to fund a portion of internal development not only reduces reliance on donor resources like those from the World Bank, but also acts as a buffer against volatile capital flows, one of the problems addressed by the IMF.

The pattern of IMF financing has historically tended to respond to global financial cycles rather than the size of available IMF resources. Since 1980, the IMF has, on average, committed only about 20 percent of its available resources. Country requests for assistance surged in the mid-1980s, in part due to the Latin American debt crisis, and in the 1990s as a result of emerging market crises in Russia, Korea, Indonesia, Turkey, and Mexico. Quota increases in the 1990s and in 2016 helped IMF resources catch up to large spikes in crisis lending.

At its peak, the IMF in 2011 had committed about 70 percent of its available quota resources, due to the Global Financial Crisis and its aftermath in Greece and the euro area. By design, IMF lending is generally far below available resources, as the perception of the IMF "running out of resources" during a crisis period could inadvertently cause the market to flee vulnerable countries and worsen global spillover effects.





1. Total IMF resources. Data through 2017 provided by the IMF. Data for future years are based on current quotas and the current schedule for when borrowing arrangements will expire, and thus are subject to change.
2. Most of the Bilateral Borrowing Agreements were absorbed into the New Arrangements to Borrow (NAB) from 2011 onward. The 2016 agreements have an initial term to end-2019, extendable through end-2020 with creditors' consent.
3. The current NAB period ends in November 2022.

The IMF needs to advance reform programs that have, as a goal, higher median incomes and that help incentivize the market-based allocation of capital, underpinned by dependable money at the core.

The IMF has a key role to play in pressing for timely, accurate, and comprehensive debt information from borrowers and creditors. It must promote stronger debt management processes in low income countries. We welcome the IMF's work to strengthen the low-income debt sustainability framework and look forward to its implementation next year. Similarly, we are encouraged by IMF efforts to incorporate a heavier focus on public corruption, which not only wastes limited public resources, but also acts as a deterrent to private sector investment and growth.

Because sustained global excess imbalances pose substantial risks to future economic growth, a key priority for the Administration is overseeing progress in efforts to correct such imbalances. The IMF does, and should, play a critical role in advising, informing, and helping member countries achieve global economic stability and stronger economic growth. The IMF must be a more forceful advocate in making clear policy recommendations that surplus and deficit countries can implement in order to address global imbalances. As a first step, we have urged the IMF to elevate the External Sector Report to flagship status and will engage with the IMF as it seeks to strengthen the External Balance Assessment model next year.

Additionally, the uptick in global growth and the relative calm in international markets has presented us with an opportunity to advance policies to further stimulate both domestic and global growth. Notably, we included the following, new language in the International Monetary and Financial Committee (IMFC) communique and the APEC Finance Ministerial Statement:

> *Strong fundamentals, sound policies, and a resilient international monetary system are essential to the stability of exchange rates, contributing to strong and sustainable growth and investment. Flexible exchange rates, where feasible, can serve as a shock absorber.*

Exchange rate instability has been a major cause of investment uncertainty and the cost of cross-border investments, and the current stability, supported by strong fundamentals, should encourage investment and growth worldwide.

The IMF will begin the 15th General Review of Quotas in 2018 with a goal, as decided by the IMF's Board of Governors, to complete it no later than the Annual Meetings in October 2019, with any changes taking effect in 2020 and beyond. The review will assess the adequacy of the IMF's resources and determine whether to adjust members' quotas and quota shares. There is no assumption of larger quotas, and the Administration has not yet made any decisions regarding the 15th review. It is Treasury's view that the IMF currently has ample resources to fulfill its mission, following the implementation of the 14th quota review last year. In the upcoming review, we will support IMF reforms in line with the U.S. goal of promoting global growth, while ensuring that the U.S. maintains its veto on key issues within the IMF.

Conclusion

The Administration wants economic growth not only for the U.S., but for the whole world. It is not a zero-sum game where our achievements must come at another country's expense. Sustainable and inclusive prosperity builds on itself and is critical not only for climbing out of poverty and creating wealth, but also for global security.

U.S. leadership and strong relationships with our allies and partners will be critical to advancing a policy agenda that contributes to rising median income, a level playing field for American firms, and prosperity that contributes to national security. Just as my colleagues are working with Congress to embark on reforms intended to spur domestic economic growth, I look forward to working with you to improve the growth trajectory for the global economy for the benefit of all Americans.

Thank you for your time, and I am pleased to take any questions.