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COMMITTEE SUBCOMMITTEE ON NATIONAL SECURITY, INTERNATIONAL
DEVELOPMENT AND MONETARY POLICY

ON

HOW AMERICA LEADS: AN EXAMINATION OF MULTI-LATERAL
DEVELOPMENT INSTITUTIONS

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Chairman Cleaver, Ranking Member Hill, and distinguished members of the Subcommittee, it is an honor to appear before the House Financial Services Committee, Subcommittee on National Security, International Development and Monetary Policy regarding American leadership at the World Bank Group and the authorization of capital increases for the World Bank and the International Finance Corporation (IFC).

Legislation to authorize capital increases for the International Bank for Reconstruction and Development (IBRD) and the IFC comes at a crucial moment for the United States, the institutions and the global economy.

We all recall the dangerous moment in 2008, when the world economy fell off a cliff, and the strong response of the World Bank and the MDBs to the G-20 call to stretch their balance sheets. In large measure, that response is why you have capital increase authorization requests before you today.

Speaking of the institution I know best because I lived these moments in the U.S. Executive Director's chair, the IBRD component of the World Bank dramatically increased its loan commitments from the \$13 billion per year range to an average of \$34.6 billion per year in the three years from July 1, 2008 to June 30, 2011, for a total of \$103.8 billion in commitments during the period.

Without more capital, the World Bank could not continue that pace, let alone return to the pre-crisis commitment level of \$13 billion per year, without slicing through the bottom of its target risk coverage range, which is part of its strategic financial adequacy framework. That is why the World Bank came to the Congress in 2011 for a capital increase. Notwithstanding that increase, for some, even though the crisis subsided, increased levels of lending became the aspirational new normal. IBRD lending commitments have averaged \$23 billion per year for Bank fiscal years 2015-2019, and the capacity of the Bank to confront any new crisis disappeared. Many said that more capital was needed.

The United States Treasury has responded intelligently. The Treasury realized that the Bank needed to maintain the capacity to increase its commitments in the event of a crisis, but to preserve this capacity, the Bank could not carry on lending at an ever accelerated pace, particularly by continuing to lend in high volumes to middle-income countries with per capita incomes near the graduation level and ready access to the capital markets. Instead IBRD needed to increase the volume of its lending going to its members further down the per capita income range. At the same time, IBRD needed to discipline its spending.

In light of the package of reforms negotiated by Treasury, which would restrict annual lending commitments to a level that can be sustained in real terms over a rolling ten-year horizon through organic capital accumulation alone, we can now say that without Congressional support for more capital, the crucial economic development and poverty reduction mission of the World Bank will suffer, along with the American reputation for leadership in important international institutions. The same will hold at the IFC, which also confronts depleted capital following its strong response to the financial crisis of 2008 and its new initiatives to expand investment in low-income and fragile states.

What is the role of the World Bank Group (WBG) and its relevance in today's world? As it has been since 1944, the WBG plays a vital role in U.S. national security, the U.S. economy and U.S. job creation by promoting global economic growth and reducing poverty. The Bank also contributes to the promotion of U.S. foreign policy objectives of sustaining peace and stability, promoting security and combatting terrorism.

U.S. leadership is vital in ensuring that WBG operations contribute to safeguarding national and economic security. The WBG does not automatically pursue our interests. It takes strong leadership to achieve that result.

On the leadership question we start from a good point. We were leaders in the creation of IBRD at the Bretton Woods conference in 1944 and present at the creation of the IFC.

Our leadership manifests itself in part through our financial support. We are the largest shareholder in IBRD and the IFC, because we have contributed the most capital. Without U.S. participation in the capital increases, that situation would change and it will be said that the United States is withdrawing from the world and making way for other ascendant powers.

Our leadership also manifests itself through the quality of the ideas we present for pursuit of the MDBs' economic growth and poverty reduction mission. We do not possess 50% of the votes in any of the MDBs, so we cannot unilaterally block any particular loan or impose any particular policy. Although the MDBs have a strong American presence, they are not U.S. government agencies or U.S.-controlled entities, so we must use our diplomatic voice to secure the outcomes we desire.

If the United States does not subscribe to the capital increases, our soft power, our ability to persuade others will be reduced. Other shareholders will simply say we do not care anymore. In some cases they may even take up the subscriptions we cast aside and try to install themselves as the dominant force in the institutions.

We should not forfeit the position we currently have. At times, our approach to the MDBs can be seen as tough love, but frequently tough love is appreciated by other shareholders. They know that the institutions would not be financially sustainable if we did not speak up for stronger financial discipline, improved governance and accountability and enhanced development impact and effectiveness. But if we do not participate in the capital increases, our messages in these areas will fall on deaf ears.

Members may be asking themselves what was the process for determining the need for capital contributions and the level of the U.S. capital contributions? Why is any new capital needed in a world with large amounts of capital flowing to many emerging markets?

Indeed, to some markets, there do appear to be significant capital flows. But those flows are increasingly volatile. In fact, some of the countries which experienced substantial inflows and currency appreciation in recent years have witnessed reduced inflows and currency depreciation as global capital markets have retreated. Many African countries entered the capital markets in the last decade, but nowadays markets are ever more selective.

The communiqués from the October meetings of the G-20, the International Monetary and Finance Committee (IMFC), the Development Committee and the speech of Treasury Secretary Steven Mnuchin to the IMFC all resonated with warnings of downside risk, potential over-indebtedness and potential declines in economic growth. If major developed countries have difficulties, developing countries will be affected. Indeed with globalization, the correlations among markets have become very high.

Growth cannot come only from developed nations; in fact, more than half of all economic growth in the planet is now coming from developing countries. They represent export markets for us. If global growth stalls, those markets could be lost. Therefore, it is extremely important for us that the World Bank and the IFC carry on with their financial support for economic growth and poverty reduction among their clientele, particularly the lower income IBRD clients and the private sector in low-income and fragile states. Without more capital this will not be possible.

How does an MDB know it needs capital? How does an MDB measure the shortfall? At the World Bank, management and the Board of Executive Directors followed a rigorous analytical process employing a strategic financial adequacy framework. This involved examination of the Bank's risk bearing capacity, stress testing and measurement of the sustainable equity-to-loans ratio (E/L ratio).

There was a debate about the proper trajectory for future Bank lending. Some thought the status quo was adequate. Others wanted the Bank to move to a much higher level of lending. If those voices had prevailed, the capital increase would have been three times as large. As negotiated, however, the IBRD capital increase will require \$206.5 million per year for six years from the United States, about 20% of what the United States currently provides annually to the International Development Association, the soft-loan window of the WBG for the poorest countries.

In the negotiations, the United States insisted that a hard look be taken at all elements of the financial equation, including loan pricing, compensation, administrative budgets, and net income allocations. As a result, many reforms were adopted in these areas. For example, the IBRD has already adopted a differential loan-pricing system and new discipline on the single-borrower limit.

The United States also sought reforms to make the Bank a more efficient and effective vehicle for development financing. These included a greater focus on development results. The United States had successfully pushed the results agenda in IDA negotiations, and now it is included for IBRD projects. The Bank now releases a Corporate Scorecard to demonstrate that it not only measures money disbursed but development results.

The United States also insisted on improved governance and accountability. This started with a very significant change in the approach to the Bank's disclosure policy. As a result, those who follow the Bank now have access to much more information about its policies, plans and decisions.

The Inspection Panel has also been nurtured from a fledgling pilot twenty-plus years ago to an active oversight mechanism available to individuals and communities that feel themselves

aggrieved by the Bank's failures to follow its own safeguards and procedures in undertaking a project. The United States has been a stalwart defender of the Inspection Panel's independence, and it has become the model for similar mechanisms at the other MDBs. Following a review, currently underway, it should become even more effective.

One of the very attractive features of the World Bank for the United States is the ability to leverage U.S. contributions. At the same time, the Bank is very conservatively managed in order to remain in high standing in the financial markets. Since 1945, the United States has paid in a little less than \$3.0 billion in capital contributions. With that capital and that of others, the Bank has made more than \$600 billion of loans to 137 countries.

The Congress can calculate that for every dollar it authorizes for World Bank paid-in capital, more than six dollars will be paid in by other shareholders. The Bank itself is then able to leverage the paid-in capital by borrowing in the capital markets of the world to obtain lendable resources five times greater than the paid-in capital. The resulting loans generate income and through the build-up of retained earnings, the Bank can fund even more lending. World Bank capital contributions are truly a force multiplier for American taxpayers.

Committee members about to embark on the legislative process may wonder what policy directives or conditions should accompany an authorization to participate in MDB capital increases. Based on the experience I had deploying the voice and vote of the United States, please allow me to suggest the following general philosophy.

Politics is politics, and there will always be subjects on which the Congress or even individual Members will want to influence U.S. policy. Nevertheless, please try to resist the urge to legislate everything. Maybe report language will do. Certainly in my experience, report language was taken very seriously. Treasury brought these items to my attention, and I advocated as strongly for these positions as for others that appeared in legislation.

Second, when the Congress feels that the Executive needs legislative guidance, whether because the Congress thinks the Executive is evading an issue or because the representatives of the American public need to go on record on a particular point, please pay careful attention to precise wording. Please remember that the World Bank Group has both public and private sector windows. In many countries the private sector cannot change policy the way the public sector can. In such situations, it makes little sense to oppose all IFC or MIGA operations for companies operating in a country because we do not like what the government of that country is doing. Yet, if the Congress does not make its intention clear, Executive Directors will have to oppose all operations at both the public and the private-sector windows, without distinction.

Today's passions and circumstances can change. Please remember this and periodically review mandates or consider the inclusion of sunset provisions. Also, inconsistent or contradictory mandates have been known to exist.

Finally, when adopting mandates, please remember that we cannot veto individual loans. As much as U.S. Executive Directors may advocate, there may be subjects on which we stand alone. Once Bank managements realize what those subjects are, they have the ability to embarrass the United States by presenting loans for our allies in circumstances in which they know that we

will have to oppose. This happened on several occasions during my tenure. If the legislation had been less prescriptive, there would have been more room for diplomacy, and the overall objective of the Congress might have been met. Unfortunately, with very tight language, counterparties had no incentive to negotiate.

In conclusion, I respectfully submit that this Committee should move forward with authorization legislation for the World Bank and IFC capital increases. It is the right decision for U.S. national and economic security.

Further, now is the time to act; the consequences of waiting are potentially severe. If we do not move forward, we risk our voting rights falling below the 15 percent threshold needed to prevent amendments to the articles of agreement, something the financial markets count on to be sure that callable capital is reserved only to pay bondholders. In short, negative action, inaction and delay would all be detrimental to U.S. interests.

I commend the World Bank and the IFC capital increases to you and thank you for your attention. I stand ready to answer any questions you may have.