The BRICS Bank and Reserve Arrangement: towards a new global financial framework?

At this summer’s summit held in Fortaleza, Brazil, the five countries which form the BRICS – Brazil, Russia, India, China and South Africa – agreed on the establishment of their own financial institutions: the New Development Bank (NDB) and the Contingent Reserve Arrangement (CRA). The New Development Bank is to lend for infrastructure and sustainable-development purposes, both in BRICS countries and other developing and emerging economies. In this context, developing countries are looking for a new source of financing with more flexible conditions. The CRA is an agreement among the BRICS’ central banks for mutual support during a sudden currency crisis. The agreements were signed on 15 July 2014 – after two years of negotiations – but still need to be ratified by the members’ legislatures.

Discontent with the Bretton Woods institutions...

The creation of the two establishments follows persistent discontent on the part of the BRICS with the International Monetary Fund (IMF) and the World Bank. Even after several rounds of reform, the five BRICS countries hold just under 13% of voting rights at the World Bank, despite representing more than 40% of the world’s population and over a fifth of global GDP. The misalignment between economic power and voting rights is substantial in the IMF too. Here, the BRICS economies enjoy only 11% of votes. Moreover, the 2010 reform of the IMF’s governance, intended to provide some increase in the voting power of the emerging economies, including the BRICS, has not been ratified after being blocked by the US Congress.

...led to the New Development Bank...

The NDB will be established with an initial subscribed capital base of US$50 billion. Each of the five countries contributes US$10 billion and receives equal voting rights. At a later stage, the capital base can be widened to US$100 billion. Membership will also be open to other countries as either borrowing or non-borrowing members. The voting power of each member will be equal to the number of subscribed shares. However, the BRICS will always maintain at least 55% of the total voting power, while the voting power of non-borrowing member countries (i.e. advanced economies) must not exceed 20% (with at most 7% per individual country). This leaves a maximum of 25% of shares for borrowing members, i.e. developing countries and emerging economies interested in buying NDB shares in order to gain voting representation and a (small) say in decision-making. The NDB’s headquarters will be in Shanghai. Its presidency will rotate among the five countries at five-yearly intervals, with the first president coming from India. The first chair of the Board of Governors (which convenes annually) will be from Russia, and the first chair of the Board of Directors (responsible for general operations) from Brazil. The bank will set up its first regional office in South Africa.

...and the Contingent Reserve Arrangement

The NDB will be accompanied by a Contingent Reserve Arrangement (CRA) comprising a pool of US$100 billion of currency swaps, with China contributing US$41 billion, Brazil, the Russian Federation, and India US$18 billion each, and South Africa US$5 billion. In effect, the CRA is a pledge to help each other in times of crisis rather than a true fund. In the event of a balance of payments crisis, in which a country’s central bank might be in need of foreign exchange to support the value of the home currency, a member could turn to its partners for resources to do so. Another scenario for its use would be a short-term liquidity problem, in which a government temporarily runs out of the foreign exchange resources it needs to meet its obligations.
How does the Reserve Arrangement compare to the IMF...

The US$100 billion of the CRA is substantial but much smaller than similar operations. In comparison, the IMF has about eight times more resources at its disposal. The borrowing limit for each member is set at a multiple of each member’s CRA commitment. For China that multiple is half of what it has committed, while for Russia, India and Brazil it is equal to their total commitment, and South Africa could receive twice its US$5 billion commitment. However, the CRA will only provide more than 30% of the maximum each member could access, after requesting the IMF to implement a programme for monitoring the borrowing country’s economic performance.

The fund is certainly not big enough to serve as a full-scale bailout instrument. Nevertheless, it has a sound economic rationale, safeguarding financial stability. Despite their strong economic fundamentals, some of the BRICS countries were recently hit by a wave of instability following the US Federal Reserve’s increase in interest rates. The resulting capital outflow put their currencies – along with those of other emerging economies – under pressure. The CRA is designed to help in events of this type. Moreover, the CRA was relatively easy to create and although the details of its operation have yet to be worked out, its mere presence might deter (some) speculative attacks.

...and the New Development Bank to other multilateral Development Banks?

Its capital base of US$50 billion is smaller than those of the major multinational development banks. In comparison, the World Bank and the European Investment Bank (EIB) have a capital base five to six times larger, and the African Development Bank has twice the NDB’s subscribed capital. But there are also development banks with smaller capital bases, such as the Development Bank of Latin America (US$10 billion). The bank is to offer loans, equity investments, guarantees and technical assistance in support of public or private projects, including public-private partnerships – just like other development banks.

How much it could lend out annually will depend on how much money the NDB can raise on international capital markets on the back of its capital and the credit ratings of its holders. For comparison, the EIB and the World Bank each lent out over US$30 billion in 2012, and the Development Bank of Latin America (CAF) – US$9.3 billion in the same year. Estimates of the possible initial annual lending capacity of the NDB range from about US$5 to 14 billion per year, figures that could go up if the capital base is widened and the NDB succeeds in establishing a good reputation on the capital markets.

Perspectives...

For the institutions to become operational, myriad operational and administrative issues still have to be agreed upon. Whether the hopes of some developing countries for a new source of development capital without the tight strings attached by Bretton Woods’ conditionality actually will be realised, remains uncertain. The announcement that the NDB will be a ‘bank of projects and not of policies’ points in that direction. However, to keep financing costs low, the new bank will need to build up a good reputation quite soon. Therefore, it needs a sound portfolio of performing debts and low default rates. How it will achieve that without putting relevant conditions on potential borrowers remains to be seen.

The new bank will certainly be under intensive international scrutiny to respect environmental, human resettlement and corporate responsibility safeguards adopted by other multilateral development banks over the years. Judging by the experiences of Brazilian and Chinese development banks – which often favour investments by export-oriented (home) industries and (mega-) projects in extractive industries – this will certainly be a challenge for the New Development Bank.

Moreover, the BRICS remain a rather dissimilar group of countries. China’s economy is larger than those of all the other members combined. It is difficult to imagine that this would not show in the workings of the new institutions. China will not be happy to subsidise the borrowing of other emerging economies like India, whose companies might compete with Chinese businesses for export markets. Therefore, major power struggles are to be expected if one of the countries were to feel its own interests were being threatened. Yet despite all the possible shortcomings and still-open questions, the New Development Bank and Contingent Reserve Arrangement have the power to become significant players in the international financial architecture. Their mere creation sends out the message that emerging and developing economies do have options. Although the European Union has not formally reacted to the agreement, the Commission had previously welcomed the development of additional development financing options, provided they are complementary to existing institutions.