

LSE Global South Unit WORKING PAPER SERIES

Working Paper No. 2/2015.

Reshaping the Financial Architecture for Development Finance:
The new development banks.

By Rajiv Biswas.

ABSTRACT.

In 2014 several groupings of developing countries agreed to set up a series of new multilateral development finance institutions. These include the BRICS-sponsored New Development Bank, the Asian Infrastructure Investment Bank and the Silk Road Fund. This paper examines the role these new institutions might play in reshaping the international financial architecture of development finance. A key concern of developing countries is the widening gap between the weight of developing countries' GDP in the global economy and their voting rights in the IMF and World Bank governing structures. Unless substantial reforms are made to the distribution of voting rights, the asymmetry between the importance of developing countries to the world and their governance of the Bretton Woods institutions will continue to worsen, particularly for the Asian BRICS. Recognising that these new development finance initiatives can strengthen its political and economic ties with other developing countries, China has played a significant leadership role in launching these initiatives, and has become the key source of capital for the new institutions. However, a major challenge for these new institutions will be to craft governance structures and decision-making procedures that have a high degree of integrity, transparency and independence from political influence when making lending decisions.

Keywords: development finance; BRICS; Bretton Woods system; China; New Development Bank; Asian Infrastructure Investment Bank.

In July 2014, the BRICS nations agreed to create a new development bank that would be provided with an initial capital of US\$ 50 billion. Their decision reflects the growing discontent amongst developing nations that the governance structure of the Bretton Woods institutions has not evolved to reflect the increasing weight of emerging markets in global GDP. The new bank, if successfully implemented, could give the BRICS nations greater influence in global development financing.

BRICS' DISCONTENT WITH THE BRETTON WOODS ARCHITECTURE.

The decision by the BRICS nations in July 2014 to establish a new development bank in which they would hold at least 55% of the capital is their answer to mounting discontent with the voting structure of the Bretton Woods institutions, which remain dominated by the US and Europe.

When the IMF and the IBRD were created at the Bretton Woods Conference in 1944, the governance and voting structures of these institutions, with a total of 44 founding member nations, were dominated by the US and Europe. With the decline of colonialism in the 1950s and 1960s, the number of member countries of the IMF and World Bank rose from 44 to 188 as the former European colonies gained independence. Moreover, the share of world GDP belonging to developing countries has risen significantly. The world economy has changed dramatically in the seventy years since Bretton Woods, but the IMF and World Bank's governance structures have hardly evolved since 1944.

Despite the sustained efforts of developing countries to urge reforms of Bretton Woods to reflect the greater economic weight of developing nations, the pace of changes in the distribution of voting rights has been glacial, even while the status quo is distorted, most notably for China amongst the BRICS nations. For example, the US controls 16.75% of voting rights in the IMF, while China, the world's second largest economy, has 3.81%. Even France, with a GDP in nominal US Dollar terms around one-third the size of China's in 2013, has 4.29% of IMF voting rights, slightly more than China's. The share of IMF voting rights of the BRICS as a whole currently totals 11.04%, whereas their share of world GDP is 21.2%.

TABLE 1. BRICS VOTING RIGHTS IN THE IMF COMPARED TO GDP.

(GDP share measured in nominal US Dollar terms; IMF Voting Rights as of August 2014)

| | % Share of IMF Voting Rights | % Share of World GDP |
|--------------|------------------------------|----------------------|
| China | 3.81 | 12.4 |
| India | 2.34 | 2.6 |
| Russia | 2.39 | 2.8 |
| Brazil | 1.72 | 3.0 |
| South Africa | 0.78 | 0.5 |
| TOTAL | 11.04 | 21.2 |

Sources: IMF; IHS

With China and India having grown more rapidly than the US and Europe for decades and projected to continue to do so over the next two decades, the disproportion of the BRICS share of IMF voting rights compared to their share of world GDP can only widen unless substantial reforms are made to the governance and voting rights structures of the Bretton Woods institutions.

Based on IHS' long-term projections of world GDP, China will be the world's largest economy by 2025, when it will account for 19.9% of world GDP, while India is projected to account for 5.5%. The Asian BRICS alone will thus have over 25% of world GDP, compared to their combined IMF voting rights total of 6.15% at present. Unless there is far more rapid progress in IMF voting right reforms than is currently evident, the Asian BRICS will confront a major asymmetry between their weight in the global economy and their role in the governance of the IMF.

Equally provocative to the developing nations in regard to the governance of the Bretton Woods institutions is the agreement between the US and Europe that the Managing Director of the IMF should be European and the President of the World Bank should be American. This convention has been adhered to since the foundation of the IMF and World Bank; no developing country national has ever led either multilateral institution in the last 70 years. President Obama attempted to make amends for the unfairness of this state of affairs by nominating a US citizen of Korean ethnicity to become the World Bank President in 2012.

But this does not fundamentally redress the gross imbalance between the BRICS' weight in

the global economy and their voting rights in the Bretton Woods institutions. The concerns amongst developing countries about the delay to IMF quota and governance reforms were reflected in the G20 Finance Ministers and Central Bank Governors Meeting held in Istanbul on 9-10 February 2015. This was a key issue highlighted in the G20 Communiqué released after the meeting:

We remain deeply disappointed with the continued delay in progressing the IMF quota and governance reforms agreed in 2010 and the 15th General Review of Quotas, including a new quota formula. Recognising the importance of these reforms for the credibility, legitimacy and effectiveness of the IMF, we reaffirm that their earliest implementation remains our highest priority for the Fund. (Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting, Paragraph 9.)

RESHAPING THE FINANCIAL ARCHITECTURE.

Their efforts to reshape the Bretton Woods governance structures having essentially come to naught, one initiative that has been under discussion since 2012 amongst the BRIC countries was the establishment of their own development bank. A resolution to do just that was formally approved by the BRICS at their summit in South Africa in 2013, and detailed planning was subsequently undertaken in the lead-up to the 6th BRICS Summit in Fortaleza in July 2014. There and then, the formal decision was taken to set up the “New Development Bank” (NDB) which had initial authorised capital of US\$ 100 billion and initial subscribed capital of US\$ 50 billion, along with a Contingent Reserve Arrangement (CRA) with capital of US\$ 100 billion.

An Inter-Governmental Agreement was signed on 15 July 2014 by Brazil, Russia, India, China and South Africa to establish the NDB and CRA. The initial subscribed capital of the NDB will be provided in equal shares by the five founding member countries.

The remit of the NDB will be to finance infrastructure and sustainable development projects, while the CRA is to be an external account support facility to help developing countries manage balance of payments crises.

The NDB is set up to provide loans, equity participation, guarantees and other financial instruments. The BRICS members also intend the NDB to have discretion to co-operate with international organisations, as well as public and private organisations, particularly with international financial institutions and national development banks.

The Fortaleza Declaration claimed that the NDB will strengthen co-operation among the BRICS, and also supplement the work of multilateral and regional financial institutions in global development. The Declaration pointedly added that the BRICS members were “disappointed and seriously concerned” that the 2010 IMF reforms had still not been implemented, and that the IMF governing structures needed to be modernised to reflect the reality of emerging markets and developing countries.

The genesis of the NDB has at its core the determination of the BRICS to reshape the international financial architecture to reflect their growing economic weight (though they have averred their intention to co-operate with existing multilateral and regional financial institutions). The NDB constitutes a dynamic mechanism for achieving this outside the Bretton Woods framework, while at the same time offering considerable flexibility for the BRICS and other developing countries to expand their subscribed capital in the NDB as the weight of their own economies increases in the global economy. In contrast, this has proven very difficult to do within the Bretton Woods governance structures.

SIZE OF CAPITAL OF THE NDB.

While the initial capital for the NDB is to be provided in equal shares by the five BRICS countries, the initial capital of US\$ 100 billion for the CRA will be underwritten in greater share by China, which will provide US\$ 41 billion of it. With foreign exchange reserves of US\$ 3.8 trillion, the depth of China’s financial strength will be the key underpinning of the NDB and CRA, as well as a potential source of considerable replenishment capital as the NDB and CRA commence operations. The important role China plays in the NDB is reflected in the decision to locate its headquarters in Shanghai.

The initial capital of the NDB is not necessarily limited to the BRICS’ US\$ 50 billion, as other developing countries will be invited to join and subscribe capital to the NDB. If the NDB is able to attract significant subscribed capital from other sovereign states in addition to the BRICS, it would considerably increase the amount of total development finance that the NDB is able to provide. By way of comparison, as at June 2014, the total subscribed capital of the World Bank was US\$ 233 billion, with paid-in capital of US\$ 14.4 billion and Total Shareholder’s Equity of US\$ 39 billion.

One of the strengths of the World Bank is its credit rating, reflecting its sound financial position as well as the strength and diversity of its government shareholders. Standard and

Poor's gave the World Bank an AAA foreign currency credit rating in its April 2014 report, and Moody's gave it an Aaa long-term issuer credit rating in January 2014. The World Bank's strong credit ratings from international rating agencies, combined with its extremely sound financial management and liquidity position, give it excellent access to international capital markets for its programs.

In comparison, the NDB will probably have a less favourable financial profile in the view of international capital markets, due to the smaller number of government shareholders and their lower sovereign credit ratings in comparison to the major shareholders of the World Bank. In addition, the financial governance and loan portfolio of the NDB will not have an established track record to begin with, which will also lend it a less favourable credit rating in international financial markets, and make the cost of borrowing higher.

On the other hand, the NDB is likely to benefit from its access to funding from the state-owned banks of the BRICS countries, notably Chinese state-owned banks, which could provide a very large potential source of financing for the NDB.

Stephany Griffith-Jones, the eminent professor of development economics at Columbia University, has recently estimated that, given initial capital of US\$ 100 billion, the NDB could be lending up to US\$ 34 billion annually in 20 years' time (UNCTAD Discussion Paper No. 215, April 2014); which is roughly equivalent to the current annual lending of the World Bank.

The exact annual lending levels of the NDB will be determined by a complex mix of factors, but the key point is that the governance structure of the NDB does allow for the future growth of the Chinese and Indian economies to be readily matched by increased capital subscriptions to the NDB. If the total size of the Chinese and Indian economies does indeed reach 25% of world GDP by 2025, as IHS long-term projections indicate, this would result in very sizeable increases in the NDB's total capitalisation and in its annual lending to developing countries.

CHINA'S PARALLEL INITIATIVES.

China has launched other initiatives to expand infrastructure financing for developing countries in Asia. In October 2014, 21 Asian countries agreed to establish a new Asian Infrastructure Investment Bank (AIIB) for which China will provide up to 50% of the initial

capital. In November 2014 at the APEC Summit, President Xi also announced the creation of the new Silk Road Fund to improve connectivity in Asia, for which China will provide US\$ 40 billion of capital.

China is uniquely positioned amongst large emerging markets to be capable of funding significant development finance initiatives like the NDB, with foreign exchange reserves estimated at US\$ 3.8 trillion as at December 2014. Recognising that such initiatives will strengthen its political and economic ties with other developing nations, China has now begun to exercise more significant leadership in global development finance. In addition to the NDB in July 2014, China has led an initiative to create an Asian Infrastructure Investment Bank (AIIB), of which the Memorandum of Understanding was signed by 21 Asian countries on October 24th 2014. The AIIB had initial authorised capital of US\$ 100 billion, with subscribed capital likely to be around US\$ 50 billion. China has stated its willingness to provide up to 50% of the initial capital for the AIIB. The headquarters of the AIIB will be located in Beijing.

The AIIB has raised concerns in some quarters about a potential rivalry with the World Bank or the Asian Development Bank, with some major Asia-Pacific countries having remained on the sidelines. For many Asian developing countries, however, the AIIB is a much-needed additional source of infrastructure finance, and the Chinese initiative has been warmly welcomed by many of them.

Like the NDB, the AIIB creates a mechanism for China and other developing countries to reshape the global financial architecture in development finance. China is redoubling its efforts to expand its role in international development finance by committing US\$ 40 billion to a new Silk Road Fund that is to finance infrastructure connectivity in emerging Asia. China made the announcement at the November 2014 APEC Leaders' Summit in Beijing.

From the Chinese perspective, the NDB, AIIB and Silk Road Fund achieve a number of strategic objectives. Firstly, they provide developing countries a source of development financing that is not under the dominion and tutelage of the Bretton Woods institutions with their lending conditionality and their one-sided governing mechanisms.

Secondly, China will be the key source of capital for these new institutions, which from a geopolitical perspective extends China's influence amongst developing countries, even while

it positions itself within the institutional membership as *primus inter pares* rather than the dominant shareholder driving all decision-making.

Thirdly, these new development institutions will be an important counterbalance to the political weight of the West, giving China a greater voice in global development finance. This will become more important politically and economically for China as it becomes the world's largest economy, given that its participation in the World Bank and IMF belie its stature in the global economy.

THE CHALLENGES AHEAD.

The New Development Bank and the AIIB and Silk Road Fund will face considerable hurdles, not least of which are the crafting of an efficient governance- and a world-class prudential regulatory structure that can avoid the pitfalls of overt politicisation of the new institutions. However, with the correct design, the BRICS' New Development Bank could become an important new lender addressing the economic development and infrastructure financing needs of developing countries worldwide. The establishment of the BRICS' Bank at the same time as the AIIB and Silk Road Fund has the potential to significantly reshape the global financial architecture of development finance.

The governance of the new multilateral finance institutions is very much under scrutiny. To a large extent, this reflects international perceptions about issues such as corruption in developing countries, with the BRICS countries still poorly perceived by international standards. Transparency International's Corruption Perceptions Index, which ranks 175 countries, in 2014 had South Africa the highest ranked amongst the BRICS, at 67th, with Brazil in 69th place, India 85th, China 100th and Russia 136th. This is on an international ranking spectrum in which Denmark was 1st and North Korea and Somalia were ranked equally last, at 174th.

A key challenge for the founding countries of the NDB, AIIB and Silk Road Fund will be to establish governance structures and decision-making systems having a high degree of transparency, integrity, and independence from political influence in making lending decisions.

Well-established international best practices for governance of financial institutions exist already, and the BRICS central banks as well as other central banks from developing

countries have considerable experience in these principles through their regulatory and supervisory responsibilities in their domestic banking systems. There is enough capacity and knowledge within the BRICS to craft best practice standards for the NDB and the other institutions now being created.

Another major challenge to the BRICS and other developing countries in attempting to reshape the international financial architecture stems from significant foreign exchange reserve constraints, which most developing countries still face. NDB, AIIB and Silk Road Fund bear potential to rapidly transform global development finance. On the other hand, it is unlikely the developing countries as a group can play a significant role in international crisis prevention and resolution for developing countries in the near to medium term, with even some of the largest developing countries facing considerable challenges due to volatile international capital flows.

The constraints on the foreign exchange reserves of both Russia and India have been tested by recent economic crises. India's economic crisis in 2013 triggered a protracted depreciation of the rupee that forced the Reserve Bank of India to intervene in currency markets over a period of months, and deplete its foreign exchange reserves, in order to smooth the depreciation. The Russian economic crisis that commenced in 2014 is still unfolding: capital flight in 2014 was estimated by the Central Bank of Russia at US\$ 128 billion (The Moscow Times, November 10, 2014). The Central Bank is estimated to have used up US\$ 80 billion of its foreign exchange reserves to intervene to stabilise the sharp depreciation of the rouble in 2014 (Reuters News, December 17, 2014). Total foreign exchange reserves are estimated to have declined from US\$ 510 billion at the end of 2013 to US\$ 416 billion by mid-December 2014.

On the other hand, China's capacity to intervene to stabilise global crises could increase significantly if China manages to introduce full currency convertibility and establish the yuan as a global reserve currency. But this is still a long-term goal.

CONCLUSION.

The developing countries' long-simmering discontent over the Bretton Woods financial architecture, notably the allocation of voting rights, has resulted in a revolution in global development finance that is being led by China.

China's rapid economic ascent over the last two decades has led to its having become the world's second largest economy. In the process it has acquired the capacity to act as the financial mainstay of a number of new initiatives for development financing which can be led by developing countries.

Thwarted in playing the leading decision-making role in the IMF and World Bank that it deserves, China has instead led the creation of new multilateral development finance institutions governed by the developing countries. China is using its vast reserves to lend financial strength to these institutions, although other developing countries are also providing capital.

The NDB, AIIB and Silk Road Fund combined bear potential to significantly increase the total multilateral financing available for economic development in the medium-term, and will give developing countries a greater voice in governing global development finance in the next decade and beyond.

For the present, however, the capacity of the BRICS and other developing countries to intervene in financial crisis prevention and resolution remains limited due to constraints on the foreign exchange reserves of most large developing countries, with the possible exception of China.

REFERENCES.

Griffith-Jones, S., “A BRICS Development Bank: A Dream Come True?”, UNCTAD Discussion Paper No. 215, March 2014.

Moody’s Investors Service, Credit Analysis, “IBRD (World Bank)”, January 31, 2014.

Moscow Times, “Russian Central Bank Increases Capital Flight Estimate by USD 38 Billion”, November 10, 2014

Standard and Poor’s Rating Services, Ratings Direct, “International Bank for Reconstruction and Development”, April 2014.

Reuters News, “Global Forex Reserves Poised to Record First Quarterly Drop Since 2008/09”, December 17, 2014.

Transparency International, Corruption Perceptions Index 2014, December 3, 2014.

ABOUT THE AUTHOR.

RAJIV BISWAS.

Asia-Pacific Chief Economist for IHS Global Insight.

Former Director for Southeast Asia for The Economist Group.

Former Senior Economist for the International Finance and Capital Markets Department of the Commonwealth Secretariat.

Rajiv.Biswas@ihs.com