BRICS Bank Future Hinges on Governance

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The New Development Bank promoted by the BRICS grouping is an idea whose time has come. It will be small in relation to the Bretton Woods institutions but it can still reduce developing country dependence on the existing institutions and turn out to be an alternative source of development finance to both the members of BRICS and other developing countries. Its success, however, will depend on the quality of oversight and governance at the new bank.

The leaders of Brazil, Russia, India, China, and South Africa (BRICS), meeting in Fortaleza in Brazil, got together in a circle to clasp hands for the trademark "photo-op" that is typical of such summits. They did not come away empty-handed. The New Development Bank (NDB), conveniently described as the BRICS bank, will come into being two years after the idea was set in motion at the BRICS summit in India. For the bank to become operational will take another two years though.

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Laudable Mission

This is not another regional development bank. It is a bank of economies that are seen as becoming more important in the global economy in the years to come. Of the five countries involved all but one are hungry for cash to finance growth. The one that has cash to spare, China, is willing to spread it around in order to win friends and influence people.

So the idea has plenty going for it. The mission – of financing infrastructure in the BRICS and other developing economies to whom membership will be available down the road – is laudable. How well the bank shapes up will hinge on whether it can get its governance right.

Western commentators have been quick to pour cold water on the idea. They say that the five promoters of the bank have little in common – in terms of the size of their economies, their political structure and their geopolitical interests – except that they are tied together by an acronym coined years ago by former Goldman Sachs economist Jim O'Neill. The point can be brushed aside. One could say the same of the leading international organizations of the world as well – the United Nations, the World Bank, the International Monetary Fund (IMF), the World Trade Organization, etc. Nations come together under the banner of an Institution not because of a shared ideology, political structure or culture but because they have a common interest in doing so.

As the same commentators acknowledge, the NDB is a response to a failure on the part of western nations, especially the United States (US) – to give the BRICS countries their due in terms of voting power in the two leading multilateral financial institutions – the IMF and the World Bank. The BRICS countries have a share in the vote of only 11% at the IMF although they account for nearly 25% of the global economic output. If the creation of NDB helps bring about long overdue reform at the Bretton Woods twins, it will have served a valuable purpose.

Reducing Dependence

However, the NDB is not just about inducing change at west-dominated international institutions. It is, first, a serious opportunity to show the world that it is possible to run a multilateral institution (whose members vary in their political and economic clout) along egalitarian lines. Second, it has the potential to reduce, over time, the dependence of the NDB's member countries on the IMF/World Bank as also western financial markets.

On the first point, the bank has got off to a great start. A sticking point in the early negotiations was China's seeming attempt to dominate the institution by contributing the highest share of paid-up capital (something it can easily afford). This has been resolved by the decision that all members will contribute an equal amount in capital, $10 billion each. Of the $50 billion in initial capital, $10 billion will be in cash, to be paid in installments over seven years; the rest will be by way of guarantees.

The bank's capital will eventually go up to $100 billion. In addition to paid-up capital, the NDB will have a Contingency Reserve Arrangement (CRA) of $100 billion intended to help members tide over liquidity crises. China will contribute $41billion, Brazil, India and Russia $18 billion each, and South Africa $5 billion.

Equally impressive are the compromises reached on the location of the bank and on positions of leadership in the bank. India yielded to China's insistence on locating the bank at Shanghai and, in return, gained the right to nominate the first president. (The presidency will be for a term of five years and will rotate among the members.) A Brazilian will chair the first board of directors and a Russian the board of governors. Further, according to the *Financial Times* (16 July 2014), decisions involving important policymakers are to be taken by consensus, in effect giving veto powers to all members. This is a considerable improvement over the functioning of the IMF-World Bank.

In respect of the second point, the NDB's potential to reduce the developing world's dependence on the leading multilateral agencies and western markets, three questions arise. One, in what way will the NDB meet the expectations of member countries? Two, can it provide funds that are large enough to make a difference? Three, will the NDB be a worthwhile alternative to the present sources of funds?

Expectations of Members

To begin with the first question, the expectations of the five member countries are not the same. China is in the happy position of not requiring funds from the bank. It would be more than happy to use the bank as a means of improving the returns on its surpluses that are today overwhelmingly parked in US government securities. It will also be looking for opportunities to promote yuan-denominated trade among the BRICS economies and the broader developing world. Indeed, the other promoters too will want to facilitate greater use of their currencies for trade. Although this possibility has not been flagged at the moment, it could well become part of the bank's mandate.

India, Brazil, and South Africa could use the funds available from the NDB to meet their large requirement for infrastructure. Russia has its own compulsions. Given its vulnerability to oil price fluctuations, it could use access to an alternative pool of liquidity. In the near future, it would welcome any means available to offset the impact of US sanctions imposed following Russia's annexation of Crimea and its intervention in Ukraine. So, yes, the BRICS bank is well placed to cater to the differing needs of its members.

As for the scale of funding, the $20 billion in cash towards capital can be leveraged up to, say, $200 billion. (Theoretically, all of the $100 billion in capital, including guarantees, can be leveraged but this could result in a fall in the rating of the bank.) Now, $200 billion is not large, in relation to, say, the Indian private sector's need for infrastructure funding of $500 billion in 2012-17 or the $2.5 trillion said to be required for south Asia. But it is a useful contribution. As other countries join in as members and chip in towards capital, more funds would be available for lending. Moreover, the CRA of $100 billion should come in handy to the BRICS economies whenever the reversal of quantitative easing by the US Fed gathers steam.

One should not underestimate the potential for growth if the bank gets its act right. An article in the *Washington Post* notes that CAF, a development bank promoted by Latin American countries in order to bypass stringent rules on infrastructure lending, today funds more infrastructure than the World Bank and the Inter-American Development Bank together ("What the New Bank of BRICS Is All About," Raj M. Desai and James Raymond Vreeland, *Washington Post*, 17 July 2014).

Effectiveness

Lastly, the question of how effective the NDB will be in fulfilling its mission. The answers are to be found on the liabilities side as well as the asset side of the bank. The IMF and the World Bank enjoy the highest rating. The NDB's rating will be derived from the five sovereigns that have promoted the bank and hence is likely to be lower – at least until such time as the bank is able to build up assets of the highest quality (also unlikely, given that emerging market risks are perceived to be intrinsically higher). This does mean that NDB funds will be costlier than those of IMF/World Bank.

Which raises the question: what does the developing world have to gain from borrowing from the NDB rather than from the World Bank or, for that matter, the international capital markets? Well, for one thing, neither developing country sovereigns nor companies enjoy ready access to the latter institutions and markets, it is not as if funds are available from them on tap or in the amounts they would like.

Second, we do know that borrowing from the international agencies comes with strings attached: it is linked to purchases made from or contracts given to western nations. Once these costs are factored in, the lending rates of NDB may not compare unfavourably with those of the international agencies. Third, financial markets may be cheaper but they often seize up. A BRICS bank could turn out to be a reliable provider of funds.

On the asset side, it is imperative that the NDB makes a commercial success of its lending if it is to grow and acquire credibility. This means that its management must be insulated from political pressures to lend. The five promoters of NDB must do what it takes to protect the autonomy of management and the independence of the board of directors.

The new institution must also guard against the bane of all multilateral agencies, namely, pressures to give jobs to influential bureaucrats and their kith and kin as also those of politicians. If the quality of human resources is compromised, the prospects for the NDB will be dim.

Two measures that could contribute to ensuring sound governance must be taken at the very outset. The selection of personnel above a certain level must be done by a committee of outstanding professionals chosen by the five promoters (and not necessarily drawn only from the BRICS economies). An office of independent evaluation must be constituted that will review processes, outcomes, and performance on various dimensions every year to start with.

In sum, the NDB is an idea whose time has come. Its initial structure is promising and refreshingly different from that of the IMF-World Bank. Whether it succeeds in the long run hinges entirely on the quality of governance. Since the stakes are high–bringing about a change in the international financial architecture, no less–the promoters have every incentive to put their best foot forward.