NDB: A pivot to financial alternatives

The BRICS Bank wants to complement existing multilateral arrangements while simultaneously creating an alternative architecture; it can begin by tying up with existing Asian liquidity support systems and forging a non-dollar clearing system

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Introduction

The global financial crisis (GFC) of 2008 exposed numerous faultlines in the international monetary system and in the global financial architecture (GFA). In addition, globally trusted benchmarks, such as Libor and Brent, were found susceptible to manipulation and distortion. Also, the global financial system was subjected to unilateral geopolitical objectives, like the U.S.-imposed economic sanctions against Iran.

Consequently, in 2008, the G20, an existing multilateral grouping, was transformed and upgraded—from an annual meeting of finance ministers and central bankers to a leaders' summit—to handle the GFA's infirmities[1]. However, the G20 has achieved only partial success, with no noticeable progress on either reducing global imbalances or on addressing the GFA's weaknesses, as was promised in 2009.

As a result, untrammelled portfolio capital flows from developed economies to emerging markets—considered dangerous, volatile, and unregulated—have now driven many emerging nations to seek regional initiatives.

BRICS is such an initiative, though it is distinctive from other similar groupings—its member countries are not geographically contiguous. Another unique feature is the low intensity of trade and investment among each other, [2] even though economics was a primary motive for these countries forging a common platform. The other compulsion was to seek an alternative to the dominant GFA and the concomitant governance structure in various multilateral development banks.

The formation of BRICS and its leaders' intentions were initially met with scepticism. However, these leaders have delivered on some of their promises—BRICS nations formally launched the New Development Bank (NDB) and the Contingency Reserve Arrangement (CRA) at the Fortaleza Summit in 2014, [3] fulfilling a long-held promise.

The NDB and the CRA are delivery platforms for development finance and emergency liquidity support, respectively. Both are designed to provide an alternative to the multilateral governance orthodoxy prevalent at the International Monetary Fund (IMF) and World Bank. All BRICS leaders (as well as newly-appointed NDB president K.V. Kamath) have emphasised that the NDB does not purport to replace the existing multilateral institutions, but will complement them, while offering an alternative financing model for sustainable development.

The first steps to intensify economic relations have already been taken. The NDB has signed, in Ufa, Russia, a memorandum of understanding with five national development banks [4] from each BRICS country; it also signed agreements, in Fortaleza, with five export credit guarantee companies. The agreements are expected to "…enhance trade and economic relations between member countries".

The individual pieces

The agreement to set up NDB, signed by the five BRICS leaders, states the bank's mission: "The Bank shall mobilize resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries, complementing the existing efforts of multilateral and regional financial institutions for global growth and development." [5]

This has three components: one, the NDB will finance infrastructure and sustainable development projects; two, the financing will be done in BRICS and "other emerging economies and developing countries;" three, the NDB will complement the efforts of existing multilateral institutions.

Each of these components encapsulates BRICS's philosophy and strategy. It is important to note that, apart from infrastructure projects, there is an emphasis on financing sustainable development—and on this front western financial institutions and civil society in emerging economies diverge widely in terms of approaches and ideologies. Perhaps the NDB will provide a different approach to financing sustainable development.

The CRA agreement—expected to provide liquidity support to BRICS members during balance of payments crises, a service that even the IMF provides—echoes similar sentiments: "…this contingent reserve arrangement shall contribute to strengthening the global financial safety net and complement existing international monetary and financial arrangements." [6]

Interestingly, both agreements contain phrases that subscribe to furthering the global cooperation framework while simultaneously trying to create alternative arrangements.

What are the potential new frameworks and how they can be strengthened further?

First leg: a monetary union

Challenging the governance framework will require creating an alternative to the existing international monetary system, including the reserve currency mechanism. BRICS summit communiques also mention this. The Durban Declaration of March 2013 states: "We support the reform and improvement of the international monetary system, with a broad-based international reserve currency system providing stability and certainty. We welcome the discussion about the role of the SDR [special drawing rights] in the existing international monetary system including the composition of SDR's basket of currencies." [7]

It might be worth examining whether the concept of an Asian monetary union or a single Asian currency are options that can be revived. This currency, if it materialises, could rank alongside the dollar and euro as a globally significant unit, given the underlying trade volume. Many scholarly discussions have toyed with the idea of currency internationalisation and what it will mean for BRICS in general and for all emerging economies in particular. In reality, an Asian currency union is still some distance away, but some building blocks have already been put in place.

There is, for example, a move to form an ASEAN Economic Community (AEC) which, according to the ASEAN's website, will have the following characteristics: a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy. [8] According to audit and consulting firm KPMG: "The AEC project could lead to an even

more effective integration into the global value chains. And this will continue to make ASEAN a strategic economic region that is expected to exceed the global growth average for the foreseeable future." [9]

The AEC was a reaction to the 1997-98 financial crisis. The crisis also prompted some additional structural changes. ASEAN+3 [10] implemented a liquidity support mechanism, the Chiang Mai Initiative Multilateralisation (CMIM) and, in the process of multilateralising the arrangement, it created the ASEAN+3 Macro-economic Research Office (AMRO). These two initiatives are discussed later in this paper.

Two other initiatives were added as a fallout of 1997-98: the Asian Bond Markets initiative (ABMI), supported by the Asian Development Bank, which also now includes a Credit Guarantee and Investment Facility (CGIF). The ABMI was born at a 2003 meeting of ASEAN+3 finance ministers, primarily to avoid the 1997-98 currency and maturity mismatches from short-term foreign currency borrowings. [11] The CGIF was established in November 2010 to provide credit guarantees for local currency denominated bonds issued by investment grade companies in ASEAN+3 countries. [12]

The Asian crisis also prompted the Japanese government's Research Institute of Economy, Trade and Industry [13] to moot an Asian currency union. Since then, much has been written and debated about the proposal, though little progress was made.

The U.S. and Europe had opposed the idea when it was first proposed. Numerous other hurdles—such as the lack of an institutional framework (for example, an external independent central bank like the European Central Bank, which might require member countries to cede control of their monetary and fiscal powers)—have delayed implementation of the currency union.

A political consensus is also missing. Plus, while the currency union model encompasses ASEAN+6 (ASEAN+3 along with India, Australia and New Zealand), all the other institutions or mechanisms—CMIM, AMRO, ABMI, CGIF, or even plans for AEC—are still stuck at ASEAN+3. Therefore, the integration of Asia's economic community is still partial, and not representative of the region's economic flows.

Even if launched in the near future, it is unlikely that all BRICS members will be in a position to, or agree to, adopt a common Asian currency. There are three other choices:

One, BRICS countries launch their own currency, which would be used exclusively by the five members. But this is not without its attendant problems. A common BRICS currency will also require the setting up of an institutional framework like the Asian currency union. This is unlikely to be favoured soon. In addition, the spectre of Eurozone's current economic travails is likely to be a big deterrent.

The second option, widely favoured, is to expand the scope of IMF's Special Drawing Rights (SDR) and make it representative of the world's changing trade and economic imperatives. But the IMF's recent review to include the Chinese renminbi—in addition to the dollar, euro, yen, and pound sterling—once again ended in status quo, with a decision postponed to September 2016. [14] Unless the IMF decides to review its eligibility criteria for including other currencies, the objective of reforming the SDR mechanism and using it as an alternative international reserve currency will remain elusive.

The interim answer may, therefore, lie in trading and settling in local currencies. [15] ABMI and CGIF have already created the infrastructure for the launch, subscription, and trading of local currency bonds. The infrastructure for settlement of local currencies also exists,

though it might need some resuscitating: the Asian Clearing Union (ACU), which saw diminished volumes after economic sanctions were imposed on Iran, could be the right vehicle. Some academics, such as monetary theorist Ashima Goyal, also favour the idea of reviving regional payments systems like the ACU, which can then provide a counter-balance to the dollar. [16]

The NDB may explore the option of creating an infrastructure for settlement of local currency trading beyond the current ACU members, or provide a thought leadership role in expanding the ACU mechanism to a larger catchment area, even though its current mandate does not explicitly mention it. But there are clauses in the agreement that also implicitly allow the NDB to interact with other regional institutions.

In any case, the NDB agreement empowers the institution to also lend in local currency: “The Bank in its operations may provide financing in the local currency of the country in which the operation takes place, provided that adequate policies are put in place to avoid significant currency mismatch.” [17] Combined with the Delhi Summit decision to start invoicing intra-BRICS trade in local currencies, there is a potential for dovetailing this effort with the work already done by the ACU.

The NDB then should later explore methods of integrating its local currency settlement framework, bond issuance platform and credit guarantee programme with non-BRICS ASEAN+6, as well as with other similar platforms in Africa and South America, such as the South African Development Community (involving South Africa, Lesotho, Namibia and Swaziland).

This might help create some momentum in non-dollar and non-euro trade, which will lead to lower transaction costs. This is critical for increasing global trade and investment volumes.

Second leg: strengthening the safety net

The second leg of a future NDB-based governance structure involves the liquidity support mechanisms, CRA and CMIM. Both owe their birth to similar needs and analogous concerns raised by East Asian countries and BRICS nations. In sum, both are similar in intent and design. There is another similarity: an inability to sever the umbilical cord with the IMF. In that sense, the CRA continues with the ASEAN trend of using plurilateral monetary arrangements to complement, and not supplant, the IMF.

Both the arrangements allow countries to borrow only a small percentage without entering into an arrangement with the IMF. [18] In CMIM and CRA, only 30% can be borrowed from the pool without reference to the IMF. The CMIM is believed to be working towards increasing this to 40%. Over time, this has to obviously grow further till the IMF-linked portion becomes insignificant.

The reasons for the IMF linkage have not been explained. There are conjectures though: that a liquidity crisis in any country is likely to be triggered by structural problems and not speculative forces, which would then require structural adjustments that the IMF is best qualified to provide. Another view is that the CMIM does not have the capacity to differentiate between a liquidity and a solvency problem. [19]

There is another probability: the CMIM as well as CRA not only lack the fundamental capability to assess structural flaws in an economy, but both might also be diffident about dictating a structural adjustment programme to another sovereign. The two arrangements are plurilateral groupings and lack the political or moral authority to impose conditions,

especially after criticising the IMF for frequently undermining sovereignty. The IMF, on the other hand, is still seen as an independent multilateral organisation despite the lack of shareholding reforms in the institution.

However, both CMIM and CRA also have an equal chance of failure given their inherent structural flaws. The CMIM has already faltered once—in the aftermath of the 2008 GFC—even though it has been in existence since 2000. South Korea approached the U.S. and Japan, instead of tapping the CMIM, for liquidity swaps post-2008. The problem was a proliferation of bilateral swap lines; that has now been replaced with a multilateral structure, under which all the different swap lines are governed by a single agreement. In cognisance, CRA has started off by pooling its funds. But the efficacy of both will be tested during the next global crisis; and, given the general unpredictability of financial upheavals, the two arrangements will have to be prepared for all eventualities.

There is, thus, an urgent need to make both CMIM and CRA relevant and battle-ready. This can be achieved if some kind of bridging arrangement is drawn up between both the schemes—an agreement that allows members to access both pools in a crisis. At a later stage, this arrangement can be extended to other new members as well.

The first reason for the bridging arrangement is the insufficient size of the IMF-delinked funds. In a payments crisis, the non IMF-linked amount will not be adequate to achieve stabilisation. This defeats the purpose of the framework. It is probably early days to judge the CRA's efficacy on the basis of the initial funds; it is likely that there is a tacit agreement to induct more members later, like the NDB, and enhance the pool. The agreement with CMIM should then form the first stage of that proposed expansion.

China is a common member in both CMIM and CRA. India is a part of ASEAN+6, the logical extension path for CMIM, which started off with ASEAN and was later extended to ASEAN+3. Pooled together, the CMIM and CRA combine will have $340 billion ($240 billion plus $100 billion), making it a formidable alternative to other existing multilateral arrangements.

There is another reason for the CRA to seek combined pooling: the CMIM has already created a regional macro-economic surveillance unit, AMRO SPELL OUT. Its purpose, according to AMRO'S website, is "…to monitor and analyse regional economies and to contribute to early detection of risks, swift implementation of remedial actions and effective decision-making of the CMIM." AMRO can become a credible surveillance unit, and deliver independent macro-economic surveillance and analysis, only if its membership expands, leading to deeper diversity and capacity. [20] Therefore, expanding with the CRA makes eminent sense since the structure is already in place.

The pooling of resources will, of course, not be easy; there will be numerous political obstacles. Even assuming some kind of linkage is achieved, associated headaches could arise. Friction is bound to grow between what is a regional grouping (ASEAN+3) and the growing role of BRICS as the sole representative of emerging economies and the visible face of an alternative governance architecture. However, if the BRICS leadership has so far managed to overcome its own inherent incompatibility through consensus and discussions, it should also be able to manage contradictions with the CMIM. Also, as mentioned above, China is a common member; it can play a vital role in bringing the two together.

In conclusion, there are no set formulae or established norms. The NDB will have to debate and discuss internally—as well as cooperate, coordinate, and consult with civil society—for building an alternate financial architecture, even if it has to be done within the

confines of the existing framework. This is its mandate, this is what the developing countries require from the NDB.

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