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Financing Global Development: The BRICS New Development Bank

Summary

The UN Conference on Financing for Development in Addis Ababa in July 2015 will pave the way for the implementation of the post-2015 development agenda. The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses building blocks of a new framework for development finance.

The BRICS New Development Bank (NDB) was created in mid-2014 by the governments of Brazil, Russia, India, China and South Africa. It will have a fairly large capital contribution – initially of US$ 50 billion – from BRICS countries and can grow up to $100 billion with contributions from other countries. It will fund investment in infrastructure and sustainable development on a significant scale. The NDB will provide valuable resources to help fill the massive gap in investment in infrastructure and sustainable development resources in emerging and developing economies, which has been estimated to reach at least US$ 1 trillion annually. It will also give emerging and developing countries a greater voice in the development finance architecture.

Other emerging economies are also creating institutions. Thus, BRICS leaders have also created new institutions, such as the Contingency Reserve Arrangements (CRA), in BRICS countries to provide official liquidity in times when balance of payments adjustments are needed. Furthermore, with China's initiative, the Asian Infrastructure Investment Bank (AIIB) is being created. It will have 57 potential member countries, including all major European economies (such as Germany, the United Kingdom and France), with the largest share of the capital being contributed by China. China also announced the creation of the New Silk Road Bank to fund investment in infrastructure connections within Asia as well as those linking to Europe and Africa.

The creation of these new institutions contributes in a valuable way to the aims of financing sustainable development, as will be discussed in the Financing for Development conference in Addis Ababa on 12–16 July 2015.

BRICS bank to close infrastructure gap

In Fortaleza in July 2014, the heads of state of Brazil, the Russian Federation, India, China and South Africa agreed to set up the New Development Bank. It was agreed by these governments that the NDB would be based in Shanghai, with a regional centre in South Africa, and that the first president – to serve for an initial period of five years – would be an Indian citizen. The plan is to have a rotating presidency, which would imply a Brazilian president after the Indian one. Mr KV Kamath was appointed as the first president of the bank in May 2015.

Emerging and developing countries have significantly increased their weight in terms of global GDP and global economic growth. Perhaps most importantly, some emerging and developing economies have accumulated very large, long-term foreign exchange assets, which they have typically placed in sovereign wealth funds. Many of these resources are invested in developed countries with relatively low yields.

At the same time, there are significant unmet needs in the emerging and developing countries in the field of infrastructure as well as in more environmentally sustainable forms of development. A shortfall of investment of approximately US$ 1 trillion annually has been identified by Bhattacharya, Romani, and Stern (2012) and by others, beyond what is likely to be financed by current institutions.

The persistence of such a major deficit would constrain future growth of developing and emerging economies, as well as imply that a large proportion of the world's population will continue to lack access to electricity and clean water. Furthermore, much crucial investment in sustainable development, such as in renewable energy, would not take place. Thus, there is a strong case for a major increase in investment in infrastructure and more sustainable development, based on the need for growth, structural change, (e.g. the massive movement of people from rural to urban areas), inclusion as well as sustainability and resilience.

New emerging architecture of international development banks

A clear case for new institutions such as the NDB could be made due to the fact that emerging and developing countries have the necessary savings and foreign exchange reserves to finance a new development bank that can contribute towards financing such crucial investment. Furthermore, its existence – together with other development finance institutions financed mainly or completely by emerging and developing economies – clearly strengthens the voice of these countries in the development finance architecture and provides much needed additional finance.

It is very welcome that the leaders of the BRICS nations have created the NDB for infrastructure and sustainable development. This institution will be a complement to – not a substitute for – existing financial institutions, both in the public and private sectors. Furthermore, it is a positive development to have healthy competition between established development finance institutions and the new ones being created.

It is encouraging that BRICS leaders have also created other institutions, such as the CRA, amongst BRICS countries, which can provide official liquidity in times of need.

The AIIB is being created due to the initiative of China and other Asian countries (excluding Japan). It will have 57 potential member countries, including all major European economies, but the largest share of capital is being contributed by China – reportedly 75 per cent of the capital will be contributed by Asian economies. China has also announced the creation of the New Silk Road Bank to fund investment in both land and maritime Asia infrastructure connections within Asia as well as those linking to Europe and Africa.

There are important similarities between the NDB and other development banks, such as the World Bank, which also started with a focus on infrastructure.

The scale of lending of the BRICS bank needs to be large enough to make a meaningful impact, given the significant level of needs identified. The impact of a BRICS bank must also be measured in terms of its capacity to enact leverage through its co-financing of projects in the private and public sectors.

National and regional development banks, as well as the World Bank, will be natural partners. Indeed, the creation of the NDB and the AIIB also reflects a shift towards a greater emphasis on public development banks, regionally as well as nationally. There is a growing consensus that well-run public development banks can play a positive role in funding the real economy, especially in light of the limitations of the private financial system in doing so. This is the case in particular in certain sectors, such as infrastructure, where long-term finance is required before investments become profitable, often beyond the maturity dates that the private banks are willing to lend for, especially in poorer countries. Investment in sustainable development – for example renewable energy, where important environmental externalities exist – is also a case in which investment is being insufficiently funded by private finance and can be successfully funded by public development banks.

Appropriate design of financial instruments

An important issue is the quality of the loans being made by the new development banks. There is a potential trade-off between the pace of growth of a portfolio of loans and the quality of the loans. Though the scale of operations is clearly important, loans of high quality are a priority, as they maximise the likely development impact of the

projects and minimise the risk of default – the latter is key for improving the credit rating of the NDB. It is also important that the NDB and the other new development banks, such as the AIIB, make profits on their loans, as those can be reinvested, allowing for an expansion of capital, which will facilitate increased lending. As regards the point on maximising development impact, it is key that these banks contribute to the structural transformation needed to achieve sustainable and inclusive growth. In this context, it is also important that these new banks meet good social and environmental standards as well as standard conditions of transparency, and that they encourage the private banks through whom they channel funds to be equally transparent. This last point is also necessary for multilateral development banks such as the World Bank.

A second issue is the degree of financial "sophistication" of the instruments used. Firstly, the more complex the products are, the longer they take to be designed and implemented. So-called plain vanilla loans can be made much faster than loans with more complicated structures. Transactions involving equity take even longer (though they have desirable features, such as capturing part of the "upside" if projects are very profitable). Secondly, the experience of the North Atlantic crisis (normally called global financial crisis) indicates that complexity often breeds opaqueness and leads to greater risk and future losses. Indeed, though a BRICS bank may wish to assume greater project risks (e.g. investing in very poor countries) when these projects have potentially large developmental or other benefits, it should avoid taking financial risks that could lead to substantial losses.

Capital and potential lending volume

The New Development Bank was created by the BRICS governments with a total capital contribution of US$ 50 billion, of which 20 per cent, or US$ 10 billion, is being paid-in. Non-BRICS countries (emerging and developing, as well as developed ones) were also able to contribute capital – either right at the beginning or after the bank was established – of an additional $50 billion of capital. However, BRICS countries would always have a minimum of 55 per cent of the total capital.

Assuming a total capital endowment of US$ 100 billion, of which 20 per cent has been paid in, the level of annual lending could – according to preliminary estimates made in Griffith-Jones (2014) – reach, after 20 years, a stock of loans with a value of up to US$ 350 billion, equivalent to about $34 billion of annual loans. The latter amount could be used for investment projects worth at least US$ 68 billion annually, given that there would be co-financing by private and public lenders and investors. The capital will be paid-in on a set schedule over seven years following final ratification of the agreement by all BRICS countries, which will slow down this growth of lending somewhat.

This implies that, after a period of 20 years, the level of lending of the BRICS bank would become comparable to the current total level of annual European Investment Bank (EIB) lending, which in 2012 reached US $32 billion in lending for infrastructure. The EIB is the largest regional development bank and is far larger than the World Bank regarding its level of lending – total World Bank lending for infrastructure reportedly reached US$ 22 billion in 2012. Therefore, under this scenario, after 20 years the NDB would be lending significantly more for infrastructure than the World Bank currently does.

It seems to be a positive development that the BRICS created the bank on their own, as negotiations may have been less complex and therefore quicker. However, it is also positive that there is a future option for broadening membership.

A BRICS development bank would lend to both the BRICS countries themselves and to other developing countries. Furthermore, it would be desirable for it to have a balanced portfolio of loans that include middle- and low-income countries from different regions, as this would make the bank more creditworthy, both because middle-income countries may be more creditworthy than low-income ones, and because it would ensure the benefits of geographical diversification. However, given that the AIIB will be focussing on Asia, there may be a case for the NDB to put a somewhat greater focus on Africa and Latin America.

The role of the BRICS bank in the development finance architecture

A BRICS bank would provide a valuable addition to the existing network of multilateral, regional and national development banks, which seem to perform far better – including their support for productive development through infrastructure investment – if they work closely with national development banks, which have far greater local knowledge. Similarly, national development banks can operate better if they have the financial and technical support of banks – the kind of support that the NDB will offer.

A BRICS bank can – and will – initially benefit from the experiences and expertise of existing successful development banks, such as the World Bank at the multilateral level; CAF and EIB at the regional level; and Brazil's BNDES, the German Development Bank (KfW), the South African Industrial Development Corporation, the China Development Bank as well as others at the national level.

The development of large and effective BRICS institutions, such as the NDB and the Contingent Reserve Arrangement, can provide a valuable platform for the BRICS to advance reforms in the international financial and development architecture that favour developing and emerging

countries in general. The scale of the new institutions, as well as the speed in establishing them, will significantly enhance the potential bargaining power for encouraging meaningful reform.

In this sense, as mentioned, it is very positive that other important initiatives were launched after the New Development Bank was created – in particular, the creation of the Asian Infrastructure Investment Bank in early 2015. The focus of future lending will also be on infrastructure, but it will have a more regional (Asian) character. The Chinese contribution to the AIIB's total capital of US$ 100 billion is far larger than the contribution to the NDB, as China will have the largest share in the bank. Furthermore, the AIIB seems to have sought the participation of other countries more actively, both emerging (especially in Asia) and developed ones. As a result, there are 57 member countries that have applied to join, including 16 of the 20 largest economies. All major Asian countries (except Japan) and all major West European countries (including Germany, the United Kingdom, France and Italy) will join, as will the BRICS countries.

Three features of the new development finance institutions being created are worth highlighting. Firstly, their creation implies an important shift in the international development finance architecture towards "Southern" or "Southern-dominated" institutions. This implies a reflection in the financial sphere of the changes that have been happening in manufacturing and other sectors. "Southern" – or developing and emerging – economies have assumed much larger roles; their status regarding macro-economic variables has also changed regarding, for example, their growing proportion of global savings and the foreign exchange reserves generated.

Secondly, some of these new institutions – particularly the AIIB and Silk Road Bank – imply a large role for China, a country that is also concentrating strongly on production in sectors such as world manufacturing and infrastructure capacity. It also holds a very high proportion of the savings and foreign exchange reserves of emerging and developing economies. In this sense the NDB is different, in that the capital of the bank will be comprised of equal shares of the BRICS countries.

Thirdly, it is interesting that the BRICS countries have actually chosen to create public development banks, in much the way that developed economies created such institutions in the post–Second World War period. Though clearly funded in the private capital markets – with co-financing from private and public lenders as well as private investors – the new development banks are owned and capitalised by national governments. They therefore provide a valuable instrument for helping implement and fund national, regional and global strategies. They can also help achieve policy aims, such as helping to achieve the Sustainable Development Goals.

Literature

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