Alternative Multilateral Development Banks and Global Financial Governance

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Abstract

What impact will the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB), two multilateral banks created in 2014 outside the established Bretton Woods system, have on multilateral lending shares in the future? Will these new institutions led by China and the BRICS grouping of China, Brazil, India, Russia and South Africa help rebalance multilateral development finance away from Western dominance? The answer depends on three factors. First of all, the pressure for the BRICS to '"exit" rises with past, present and expected failure of '"voice" reform in the established international financial institutions (IFIs). Second, excess demand for multilateral soft loans and, third, the potential lending capacity by the NDB and AIIB are quantified to assess how much relative business — hence political influence — the existing IFIs might lose to the new competitors. It is estimated that the NDB and the AIIB combined will attract sufficient co-financing to rival the established multilateral development banks (MDBs) in annual lending. This article concludes that infrastructure finance will benefit from the creation of the NDB and the AIIB by tapping the considerable saving potential in China and other BRICS countries. The new institutions should therefore be supported, not discouraged, by western governments and donors as well. As the new MDBs introduce choice for potential borrowers in terms of funding cost and modalities, they are well advised to join these new institutions rapidly for their own benefit. Competition in multilateral development banking may have a negative impact on loan enforcement mechanisms. The IFIs of the existing Bretton Woods system and the new development banks will have to unite by imposing cross-default clauses to safeguard their preferred creditor status.

Key words: Multilateral development lending; Asian Infrastructure Investment Bank; New Development Bank; Bretton Woods; BRICS; China foreign policy

Introduction

With hindsight, 2014 may well be remembered as the year when serious competition was built into multilateral development banking, especially for the World Bank and the Asian Development Bank (ADB). The new BRICS bank, officially called the New Development Bank (to be headquartered in Shanghai), was launched at the sixth summit of the BRICS countries, held in Brazil in July 2014. The bank will have starting capital of $50 billion, with Brazil, Russia, India, China and South Africa initially contributing $10 billion. At the end of October 2014 more than 20 Asian countries (including India and, a month later, Indonesia) signed a memorandum of understanding (MOU) to create the Beijing-based Asian Infrastructure Investment Bank (AIIB) as founding members. The MOU specifies that the AIIB will have $100 billion authorized capital, which China will pay in half. Initial subscribed capital is set at $50 billion. The NDB has been established with a global remit to lend to developing countries. The AIIB is focused on Asia. Both new institutions are intended to concentrate on funding infrastructure projects. (At the APEC summit in November 2014, Chinese president Xi Jinping also announced the creation of a new Silk Road Fund to improve connectivity in Asia, for which China will provide $40 billion of capital funding.)

In a broader setting, the establishment of multilateral development banks (MDBs) outside the established Bretton Woods system can be viewed as China's shadow global diplomacy that aims at undermining the U.S.-led governance structures established after World War II. China's foreign policy is working systematically toward a realignment of the international order through establishing parallel structures to a wide range of international institutions [Heilmann et al., 2014]. Is competition building, therefore, to the existing Bretton Woods system and western dominance? The U.S. Treasury tried to oppose the China-led AIIB by lobbying Australia, Indonesia and Korea against joining the new bank and by pointing out that it would fail to meet environmental standards, procurement requirements and other safeguards adopted by the World Bank and the ADB [Perlez, 2014].

Can China and the BRICS countries help rebalance multilateral development finance away from western dominance through the creation of the NDB and the AIIB? First of all, viewed through Hirschman's [1970] antinomy of "exit" versus "voice," the cost of exit drops with past, present and expected failure of voice reform in the established international financial institutions (IFIs) [see also Gehlbach, 2006]. Second, excess demand for multilateral soft loans and the potential lending capacity by the NDB and AIIB will define the scope for how much relative business — hence political influence — the existing IFIs might lose to the new competitors. Third, reputation and refinancing cost will determine whether and how fast the newcomers will succeed in building leverage on paid-in capital by tapping global bond markets. Based on these answers, this article concludes that the existing Bretton Woods system is likely to lose market share and preferred creditor status.

Uneven Representation

The recalibration of the world economy — and the shift of the centre of gravity toward East Asia — is still not reflected in the executive councils of the MDBs [OECD 2010; Quah 2011]. The current imbalance of capital shares and voting rights in the existing multilateral banking system to the detriment of emerging market and developing countries (EMDCs) is well documented by Vestergaard and Wade [2014], who also show that the scope and pace of governance reforms have been dismal in the established international financial institutions (IFIs). Moreover, the EMDCs can have little hope that the advanced countries will relinquish their control over the ADB and the World Bank in particular through meaningful voice reform [Vestergaard and Wade, 2013].

The more imbalanced the system is in terms of representation and voice, the higher the pressure to rebalance toward fairer representation by creating institutions parallel to the established multilateral banks. The creation of the AIIB and the NDB corresponds to exit in Hirschman's antinomy [Hirschman, 1970]. Both exit and voice carry costs. The cost of exit is fragmented multilateralism. The cost of the failure of voice reform in an imbalanced system is the incapacity to influence priorities, principles and procedures in multilateral development lending. As the BRICS countries succeed in organizing shadow institutions to the established Bretton Woods system, the value of the EMDCs' exit option may make exercising voice in the established system relatively less attractive, even though it will probably increase the effectiveness of voice. Voice and exit are complements once exit has been organized (by creating new shadow institutions), but are substitutes when seen from the perspective of the initial decision to exercise voice or to organize exit [Gehlbach, 2006, p. 402]. As Hirschman [1970] outlines, a country's reasons for loyalty to the established system, such as the desire of the United States to safeguard military protection, raise the cost of exit.

The BRICS countries represent 46% of the world's population, 21.6% of world gross domestic product (GDP) in current dollars and almost 30% in revised 2011 International Comparison Program (ICP) purchasing power parity weights [IMF, 2014]. In contrast to these population and income shares, the five BRICS countries together have just 13–14% of the shares and votes at the World Bank, according to the International Bank for Reconstruction and Development (IBRD) (see Table 1) [World Bank Group Finances, 2015]. The G7 group of advanced countries represents only 15% of the world's population, and the group's share of world GDP now corresponds roughly to its voting shares at the IBRD if measured in current dollars (46.2%). However, measured at the revised 2011 ICP purchasing power parity weights, the G7 group now accounts for just 32.8% of world GDP — by that yardstick the G7 members are clearly overrepresented in shares and votes at the World Bank.

Table 1: IBRD Statement of Subscriptions to Capital Stock and Voting Power, Oct 2013

Country Group	Capital Stock Shares,%	Voting Power,%
BRICS	13.87	13.23
G7	43.71	41.49

Source: Author's calculation; World Bank Group Finances [2015].

The IMF quota system, which determines each member's financial contribution and voting power, fails even more blatantly to reflect the reality of a changing world. The BRICS states have only 10.3 % of IMF quota. European countries, by contrast, are allocated 27.5% for only 18% of output. To add insult to injury, the IMF presidency is reserved for a European, while that of the World Bank routinely goes to an American. The reforms agreed to in 2010 would have doubled the IMF's capital to $720 billion and transferred six percentage points of quota to poorer countries. However, international financial reform and the G20 suffered a serious blow in 2014 after the United States Congress refused to ratify this IMF capital increase agreed to four years ago.

By staying overrepresented in the executive boards of the World Bank, IMF and regional development banks, Europe has also been a stumbling block for reforms. Although overrepresented, however, Europe's voice is weakened by not being united. Meanwhile, the U.S. retains a blocking minority at the IMF, and jointly with allies, an informal block at the other international financial institutions. Advanced economies have reneged on their promise to support greater voice and representation in global governance arrangements for the BRICS countries and other emerging economies. BRICS economies therefore have little incentive to take on greater responsibility as important stakeholders of the global economy and as financiers of global public goods.

Firmly ruled by Japan and the U.S., the Asian Development Bank provides an especially stark case of distorted representation. The ADB members who are also members of the OECD hold 64.6% of total subscribed capital and 58.5% of total voting rights. By contrast, China and India (the other three BRICS countries are not ADB members) together hold a mere 10.9% of voting rights (see Table 2). Japan and the U.S. are by far the biggest shareholders in the ADB with 15.7% and 15.6%, respectively. China, whose economy in dollar terms surpassed Japan's in 2010, has just 5.5% of voting rights; India, soon to be Asia's and the world's most populous country, holds 5.4%. So far, the ADB has been directed by the Japanese. Policy positions are usually framed within the parameters set by the U.S.-Japan relationship, which has effectively limited higher representation of, and core funding by China and India in particular.

Table 2: ADB Subscribed Capital and Voting Power, end 2013

Country Group	Subscribed Capital Shares,%	Voting Power,%
BRICS (China and India)	12.8	10.9
G7	45.0	37.8

Source: Author's calculation; Asian Development Bank [2014].

An immediate consequence of uneven representation is the negative impact on available capital resources (to which China could amply provide) and hence lending capacity. Financial constraints on both the Asian Development Fund (ADF) concessional window for low-income country clients and ordinary capital resources (OCR) for middle-income countries are stretching ADB's capacity to the limit.[1] If the ADB is to maintain meaningful levels of involvement in poor ADF countries, it has to find creative ways to enhance its financial capacity — or it has to change representation. Although Japan is the largest financial contributor to the ADB, its fiscal resources are limited by rapid ageing, and the country is at risk of declining to the status of a "‘middling donor" [Sawada, 2014].

Low expectations for the rebalancing of the governance of the established institutions in the foreseeable future have also fostered the establishment of the new parallel banks. Emerging and low-income countries have been inadequately represented in the financial institutions built and dominated by the West, and prospects for better representation in the future are bleak [Vestergaard and Wade, 2013]. Voice reform has made no headway in reaching agreement on criteria for reallocating votes in the future. Due to the "‘preemptive rights principle," voting power reform at the World Bank can only be achieved if all member countries agree.[2] It is of course difficult to negotiate substantial voting power realignment when every member country that stands to lose voting power has a veto. This is why the voting power reform was eventually based on a loosely administered "quota framework," as opposed to a rules-based formula. The BRICS countries were therefore right to conclude that developed countries have no intention of giving up voice and voting power in the established multilateral institutions.

The Financing Gap for Multilateral Soft Loans

Over the last 20 years, 3.8% of world GDP has been spent on (economic) infrastructure. Annual infrastructure spending has on a downward trend in advanced economies, falling from 3.6% of GDP in 1980 to 2.8% in 2008, but has been rising in emerging market economies over the same period, growing from 3.5% to 5.7%. This growth is driven by particularly high fixed-capital investment in Asia, especially in China [McKinsey, 2010].

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[1] The ADB has recently presented a new proposal to enhance its financial capacity through a modified management of its capital resources. The proposal entails terminating the heavily subsidised ADF loan operations and combining ADF loans (and part of ADF liquid assets, projected to be $35.3 billion in total) with the OCR balance sheet in January 2017. This would increase OCR equity from a projected $17.9 billion to $53.2 billion. The ADF would henceforth provide only grant assistance, while the ADB would continue concessional lending through its OCR window.

[2] The World Bank's Articles of Agreement stipulate that increases in its capital require a special majority — 75% of votes. At the same time, however, each and every member country has a right to "subscribe to a proportionate share of the increase" whenever a decision is made to increase the Bank's capital [World Bank sources quoted in Vestergaard and Wade 2013, p. 159].

Potential future demand for concessional flows from the NDB and the AIIB and their relative lending capacity will determine what share of the business — hence political influence — the existing Bretton Woods institutions and western-led regional development banks might lose to the new competitor banks. Most of that demand arises from infrastructure investment needs, which are not easily quantifiable. Yepes [2008] has estimated infrastructure investment needs in developing countries at on average 6.6% of GDP, with wide differences depending on income levels (see Table 3). The 2014 IMF update of the *World Economic Outlook* estimated the combined 2013 GDP of emerging and developing countries at 39.2% of the world total, which totalled roughly $74 trillion that year. The group of emerging and developing countries therefore produced a nominal GDP of $29 trillion in 2014. Following Yepes's [2008] estimates, therefore, their annual infrastructure investment spending needs would be roughly $2 trillion.

Table 3: Current Annual Infrastructure Expenditure Needs (% of GDP)

Country Income	Investment	Maintenance	Total
Low income	7.0	5.5	12.5
Lower middle-income	4.9	3.3	8.2
Upper middle-income	1.3	1.0	2.3
Total developing	2.7	4.3	7.0

Source: Yepes [2008].

What do these numbers imply for the current gap in infrastructure financing in developing and emerging countries? The gap can be defined as the difference between investment needs and resources, or the funds needed to maintain economic growth and available funds. If infrastructure investment needs are difficult to estimate, it is even more difficult to estimate the infrastructure financing gaps. It should be kept in mind that such estimates are typically "baseline figures" needed to keep pace with anticipated economic growth, rather than reaching any "social optimum." The estimates are, of course, highly difficult and uncertain, and subject to qualifications and criticism. Current annual spending on infrastructure in developing and emerging countries has been estimated at $0.8 trillion–$0.9 trillion by Griffith-Jones [2014] who has assembled evidence of the shortage of long-term financing, especially to finance infrastructure, in the developing and emerging countries.

Table 4: Gross Annual Flows by Mainstream Multilateral Development Banks, 2012

	Concessional	Non-concessional	Total
AfDB	1.9	3.5	5.4
ADB	1.9	6.8	8.7
IDA-IBRD	10.3	15.1	24.5
IDB	1.6	6.5	9.1
Total	15.6	31.9	47.6

Source: Organisation for Economic Co-operation and Development [2014].

Existing MDBs contribute merely $40 billion–$60 billion while the bulk is being financed from national government budgets ($500 billion–$600 billion) (see Table 4). Various sources have estimated the annual spending on developing-country infrastructure required to finance access to water, electricity, transport and other infrastructure needed to combat poverty, deprivation and climate change at $1.8 trillion–$2.3 trillion [surveyed in Bhattacharia and Romani, 2013]. The resulting financing gap would be around $1.0 trillion–$1.4 trillion. As pointed out by Eichengreen [2014]: "China may not have an infrastructure deficit, but it has something else: large construction companies that welcome the opportunity to undertake additional projects abroad. Hence the incentives of the BRICS bank's prospective creditors and borrowers are happily aligned."

The Potential Lending Capacity of AIIB and NDB

How much of that financing gap are the new institutions likely to satisfy? The NDB will have $100 billion of initial authorised capital and $50 billion of initial subscribed capital, (as well as the Contingent Reserve Arrangement with $100 billion of capital). The AIIB will have $100 billion of initial authorized capital, with subscribed capital also to be around $50 billion. As will be shown, the potential impact on multilateral development lending from these parallel institutions could be very substantial, reaching about the same annual lending level as the established MDBs did in recent years.

The new banks will first begin as development funds; similar to the concessional windows of the established development banks [Reisen and Garroway, 2014] these are usually backed by the members' tax bases. They are yet to turn into full development banks with a capital window. Usually, these capital windows tap global bond markets thanks to AAA ratings at very low borrowing costs that they can lend (not grant) to borrowers in turn.

Both the NDB and the AIIB, however, are likely to benefit from having good access to funding from the state-owned development banks of the BRICS countries, such as from Brazil's BNDES (Banco Nacional do Desenvolvimento) and the China Development Bank. These national development banks would provide — in addition to expertise and management skills — a very large potential source of co-financing. Foreign exchange reserves constitute another funding source.

As the NDB and the AIIB will be providing infrastructure lending rather than grants, the return on capital from these investments could be higher than the current returns the BRICS countries are getting from their foreign exchange reserves; a large share of which is currently invested in low-yielding U.S. government bonds. At the end of 2013, the five BRICS countries had accumulated foreign exchange reserves of $5.1 trillion, of which China alone possessed $3.9 trillion. Clearly, China will play a major role in both banks as a key source of capital. It has the financial firepower to close a large part of the infrastructure financing gap — given the right incentives and institutions.

To obtain leverage on paid-in capital beyond national public resources, a good reputation and low refinancing costs will be crucial for the NDB and the AIIB. How much time will it take for them to generate the reputation (knowledge and "certification value") that the existing IFIs have already acquired? In general, the selection, monitoring and enforcement of loans are fundamental to the reputation of MDBs [Buiter and Fries, 2002]. Whether and to what extent the newcomer banks will be able to attract additional capital from private sources will depend on the combination of features listed by Chelsky, Morel and Kabir [2013]: a strong financial position; preferred creditor status; technical expertise; prudent risk management policies; credible application of well understood standards in project design, execution, and corporate governance; a long-term perspective; and cross-country experience.

It could be argued that all five BRICS nations suffer from at least one shortcoming that likely leads to higher borrowing costs on international capital markets and hence lending costs that exceed those of the established development banks: inconvertible currencies; closed capital accounts; intransparent and illiquid local financial markets; fragile and unreliable legal systems; and thinly traded currencies that currently are under cyclical depreciation pressure. However, the close relationship to state capital that stands ready to be deployed as leverage makes these points relatively less relevant for the AIIB and the NDB. Moreover, due to superior growth, the income levels of the BRICS nations have recently been converging with the income levels of the richer countries, which is likely to cause structural appreciation pressures (and lower funding costs compared to the advanced countries) due to the Balassa-Samuelson effect, unless sovereign bond spreads outweigh these funding advantages.

Ratings and sovereign bond spreads have been extensively analysed in the empirical literature. Previous work on sovereign ratings had identified per capita income levels and the level of economic development as among the most important ratings determinants, which arguably reflected the positive OECD-country bias built into the Basel I framework for risk weighting of the regulatory bank capital. A study based on recent data (following the Basel II regime that had abandoned the OECD bias) is by Erdem and Varli [2014]. They find that the most relevant factors for sovereign ratings are budget balance/GDP, GDP per capita growth, governance indicators and reserves/GDP for Standard and Poor's (S&P). Moreover, their model predicts up to 93% of all credit rating levels on a quarterly basis from 2002 to 2011. Applied to China, the implicit guarantor of the AIIB and the NDB, these determinants should translate into competitively low spreads and hence low refinancing costs. In fact, China has a lead over the United States, the implicit guarantor of the World Bank and other MDBs, in terms of GDP growth and reserves/GDP.

Refinancing costs are not driven only by the liability side of the bank's balance sheet, however. It is equally important to have an asset portfolio that holds creditworthy borrowers and minimizes arrears and default. The IBRD and the International Development Association (IDA) are not very transparent on arrears; a recent source calculated almost $2.1 billion (1.37 billion special drawing rights) of arrears by 2011, the bulk from seven countries [IDA, 2010, table 2]. For the AIIB and the NDB to do better (or at least as well as the IDA), the new banks may be well advised to follow China's example of imposing project (rather than policy) conditionality, which seems to generate less corruption and waste than the West's fragmented approach [Saidi and Wolf, 2011]. It would be wise, from the perspective of reputation and refinancing cost, to focus on sustainable infrastructure project financing (rather than broad poverty reduction measures). This is where China and the other BRICS nations command a comparative (and at times, absolute) advantage relative to advanced-country creditors.

To estimate the level of annual loans the two new banks could generate I follow an estimation procedure suggested by Griffith-Jones [2014] for the NDB. Based on the figures for the Latin American development bank Corporación Andina de Fomento (CAF), the two new banks should be able to achieve a credit leverage of 2.4 on their equity capital. Note that the CAF has obtained ratings of only AA- (S&P, Fitch) and Aa3 (Moody's) and that China has access to deep co-financing funds available from public assets; consequently, the actual leverage ratio for the AIIB may be higher. The authorised equity capital is $50 billion each for the AIIB and the NDB over the next 20 years. The combined annual lending potential totals $24 billion, applying the credit leverage ratio obtained by CAF (2.4) on the total stock of loans ($240 billion) and assuming an average loan maturity of ten years. This equates to approximately half the current amount provided in loans by the established development banks (as shown in Table 4). Consequently, in the future one third of global multilateral development loans could be issued by providers other than the established multilaterals. The AIIB and the NDB are thus likely to have a discernible impact on global governance.

Outlook

To the extent that it helps cover some of the current infrastructure financing gaps, the establishment of BRICS-led MDBs will be beneficial for global development. Moreover, the new banks organize "voice" for EMDCs and rebalance representation of the non-OECD countries in multilateral development lending. This is likely to speed up voice reform even in the established multilaterals. Competition is building for the existing Bretton Woods system.

So why are the U.S. lobbying against those banks? Perlez [2014] cites a senior Obama administration official: the Treasury Department had concluded that the new bank would fail to meet environmental standards, procurement requirements and other safeguards adopted by the World Bank and the ADB, including protections intended to prevent the forced removal of vulnerable populations from their lands. By contrast, the ADB has become so encumbered with restrictions that it now takes up to seven years on average for a project to go from proposal to approval to completion, the official said.

Another concern, not yet publicly discussed to my knowledge, is that the establishment of alternative source of multilateral funding will weaken the enforcement mechanism of the existing MDBs. They might also lose their preferred creditor status, which ultimately depends on the borrowers' expectation to obtain further financing from a specific institution. When borrowers are able to switch between MDBs under different regimes (U.S.-led versus China-led), they have less reason to fear sanctions due to defaulting against, say, the US-led Bretton-Woods institutions. Buiter and Fries [2002] had discussed this after the creation of the European Bank for Reconstruction and Development (EBRD): a basic mechanism for fostering compliance with the terms and conditions of MDB loans to the public sector involves the dynamic incentives that arise from the repeated interaction between borrowing governments and the MDBs. The potential for repeated loans, together with the credible threat to cut off future lending when terms and conditions are not met, can be exploited to help ensure borrower compliance.

The incentive mechanism arising from repeated interactions is more effective when borrowers face limited access to alternative sources of financing. Therefore, it must indeed be envisaged that the incentive for borrowing countries to comply with the terms and conditions of, say, IDA loans will diminish as the end of the lending relationship nears and is replaced by loans from the AIIB or the BRICS bank. To be sure, the loss of preferred creditor status is a potential threat for both types of MDBs, established and new. They thus have an incentive to cooperate in defining and implementing mutual cross default clauses in their loan contracts.

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