Deutsches Institut für Entwicklungspolitik

Years | 1964 – 2014

German Development Institute

Will the BRICS bank change the global financial architecture?

By Helmut Reisen,
ShiftingWealth Consult

The Current Column

of 28 July 2014

Will the BRICS bank change the global financial architecture?

Bonn, Berlin, 28 July 2014. The new BRICS bank has been launched at the sixth summit of the BRICS countries. Can this new institution influence the balance of power among the multilateral development banks, breaking the dominance of the industrialised western countries, which has been unchallenged since the Second World War, and turning it in favour of the large emerging economies?

An imbalance

The balance of power in the global economy, which has shifted rapidly towards East Asia since the end of the last century, is still not reflected on the executive councils of the multilateral development banks. The five BRICS countries have 13 % of the voting rights at the World Bank, despite representing 46 % of the world's population and just under 20 % of its income. By contrast, the G7 countries have over 41 % of the voting rights. The key industrialised nations have failed to deliver on their promise of ensuring that the other countries are given a greater voice and more representation within the global development finance architecture. This has also removed any incentive for the major emerging economies to assume greater responsibility for the global economy and for the production of global public goods.

The Asian Development Bank (ADB), firmly in the hands of Japan and the United States (who each have just under 16 % of the voting rights), is a particularly extreme case. ADB members from the OECD countries hold 64.6% of the capital and 58.5 % of the voting rights. China and India (the other three BRICS countries are not ADB members) combined have barely 11 % of the voting rights. China, whose gross domestic product (GDP) has outstripped Japan's since 2010, has 5.5 % and India 5.4 %. A shortage of capital and diminished potential for lending are the direct result of this distorted pattern of representation. While China could quickly redress the situation, China and India's shares of the voting rights are limited by Japan (an ageing donor) and the United States, thus providing a strong incentive for the establishment of the BRICS bank.

Financing shortfall and potential

Future demand for low interest loans from the new BRICS bank and the bank's potential to issue such loans will determine how much business and political influence are lost by the existing development banks. There is a huge shortfall in long-term finance for infrastructure. A UNCTAD Discussion Paper authored by Stephany Griffith-Jones puts the current annual infrastructure costs in developing countries and emerging economies at just under USD 0.9 trillion, with multilateral development banks contributing a mere USD 40-60 billion to these costs. By contrast, the annual financing needs of non-OECD states are estimated to be between USD 1.8 trillion and USD 2.3 trillion. This leaves an annual financing shortfall of over USD 1 trillion.

Unlike the other BRICS countries, China has sufficient reserves to make up this shortfall. The asymmetry in financial clout between the five BRICS countries is often downplayed, and yet it is crucial to the potential of the new BRICS bank to issue loans in future. The bank has USD 50 billion in initial capital, with each founding country providing one fifth of this amount. USD 10 billion is a small sum for the Chinese, but for South Africa it corresponds to 2.5 % of GDP and 9% of public revenue. However, each state is only required to pay USD 2 billion up front, with the remainder provided by a deposit protection fund. Other states are also free to contribute up to 45 % of the initial capital. At the same time, it is important to note that the requirement for each of the BRICS bank's founding states to have equal voting rights will significantly cap the new institution's financial clout, thereby limiting its geopolitical influence as well. This may explain why China is also set to launch the Asian Infrastructure Investment Bank (AIIB), a development bank that is expected to have USD 100 billion in initial capital, twice the volume of the BRICS bank.

A shift in the balance of power?

A new development bank must build up its reputation carefully in order to keep its refinancing costs down and find solvent financing partners. This will require borrowers who are able and willing to pay, as well as a low rate of default on payments. It is possible to establish a good reputation very quickly by focusing wisely on sustainable project financing in the infrastructural sector; this is where the BRICS countries have a comparative advantage in terms of experience. Based on the figures for Latin American development bank CAF, the new BRICS bank should be able to achieve a credit leverage of 2.4 on its equity capital. Assuming it establishes and maintains a good reputation, this could grow to USD 100 billion over the next 20 years, with annual lending climbing to over USD 30 billion. This would equate to around half of the current amount provided in loans by the established development banks. Even without taking into account the AIIB, at least one third of multilateral development loans are likely to be issued by providers other than the established multilaterals in future. This will also have an impact on global governance.