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The BRICS Initiatives Towards a New Financial Architecture: An Assessment with Some Proposals

Sunanda Sen*

It is heartening to observe that developing countries, led by China and other BRICS members have been successful to organise alternative sources of credit flows . aiming for financial stability, growth and development . Setting a goal to avoid the IMF type of loan conditionalities and the dominance of US dollar in global finance, these new institutions provide a much needed turn in the global financial architecture, especially in the background of the on-going demands for austerity as are currently imposed on Greece by the troika of IMF, the ECB and the EU. It is rather ironic that the Western financial institutions as well as the EU are not in a mood to provide any option to Greece short of complying with the disciplinary measures as a pre-condition for Greece to continue with the Eurozone and its common currency, the Euro .

Limitations of the on-going global financial architecture at command of the IMF and its member nations in the OECD brings to the fore the need for new institutions which can provide alternative solutions. The launch of the financial institutions by the BRICS seem to chart out an alternative route which may turn out as superior in achieving a superior global financial order.

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BRICS-led financial institutions

Financial Institutions as have been set up for the purpose include the (just inaugurated) Asian Infrastructure Investment Bank (AIIB), the BRICS (or New) Development Bank (NDB) , the BRICS-led Contingency Reserve Fund (CRF) and the Silk Road projects.

Of above the NDB will have $50bn as starting capital contributed by individual members, to be increased to $100 billion over time. Of those, Brazil, Russia, India, China and South Africa will have an initial contribution of $10 billion each to bring the total to $50 billion. No member can increase its share of capital without the consent from others. While new members from outside BRICS can join in as members of the NDB, capital share of the initial members, ie of the BRICS, is not allowed to fall below 55 per cent. It may be pointed out that the shares of capital stock in the NDB not only represent equity of the contributing member, but indicate a country's direct representation in the decision-making process of the Bank.[1] Shares of individual NDB members also determine its direct representation in the decision-making process of the Bank. In addition to providing liquidity to its members to meet balance of payments crisis , the Bank aims to provide protection against global liquidity pressures, say, in the wake of the United States' exit from its expansionary monetary policy under the QEs.

As for the CRF, scheduled to start lending in 2016, the five BRICS members collectively agreed to earmark $100bn from their foreign-exchange reserves, to be used for swap lines by members . Out of the initial capital, China contributes $41 billion, Brazil, Russia and India $18 billion each, and South Africa another $5 billion. Thus unlike the BRICS bank, contributions to which are equally shared—CRF is being funded more by China. The Fund is scheduled to start lending in 2016.[2,3]

While controversies relating to the propriety of the NDB have fizzled down to some extent, the installation of the AIIB portal in

June end has rekindled the debate, questioning the legitimacy of such institutions led by China.

The AIIB's initial capital of $100bn, while funded by contributions from members of BRIC, is open to contributions from non-members from both advanced as well as developing countries , thus making for 57 founding members despite the opposition by US and Japan.. The UK was even subjected to reprisals by US which continues to oppose the idea of an Asian bank led by China. The AIIB, as with the other Brics institutions, proclaims to avoid the norms set by the Bretton Woods institutions (BWIs) as conditional financing.

As for the AIIB, it is commended as a vehicle for providing the much needed credit for infrastructures in the developing countries the need for which, by 2020, would be between $1.8bn to $2.3bn. The facilities as above , as held, will also will reduce the dependence of countries for infrastructural needs, on official sources , which in any case is rather meagre.[4]

Opposition to the BRICS institutions, from the advanced countries, indicate the mind-set of the Bretton Woods institutions and their patron, the United States, to continue with the asymmetric power relations in the prevailing structure of the global finance relations.

Reservations have continued to be voiced on the feasibility as well as the desirability of the BRICS institutions , especially with the initiative of China. Among the specific questionings, membership to non-BRICS nations in the newly instituted AIIB has raised concerns that the newly formed group will include countries rather dissimilar, both in size and governance. The link of infrastructure projects to the proposed Silk Road open new sources of critiques, especially on the possibility of a hegemonic role by China . As for the CRF, doubts are expressed if loans can be managed without conditional clauses. As it has been put by an expert, "…in contrast to development finance, the incentives of potential lenders and borrowers are not aligned "

Examples of failed attempts , as in case of the Chiang Mai initiative has been cited in this context . Thus despite its virtue in attempting to offer short term liquidity which is not tied to conditionalities, the CRF, as pointed out by an expert, may remain as" an empty symbolism"[5]

Looking back, reservations on the workability as well as desirability of the BRICS-led financial institutions harp on the major role China is supposed to play in their management. The reason behind lies in the disproportionate economic strength of China in the region , as the second largest economy in the world which has amassed massive volumes of official reserves at $3 trillion or more, supported by the twin surpluses between the trading and capital account combining the ability to manoeuvre in the geo-political sphere.

A matching of ability and willingness as with this alternative pole led by China thus seems to have been effective in challenging the prevailing order, managed and controlled by the advanced countries in the West and led by the United States. Concerns on the BRICS institutions may eventually turn out to be rather futile with workable solutions acceptable to the group.

Proposal for a Clearing Arrangement within the BRICS in local currencies

Doubts, as above, concerning the potentials of the BRICS institutions, however, can be of less relevance , especially in view of the contributions which those offer in setting up a new financial architecture for the Emerging economies by delinking those from the network of global finance run by the BWIs.

We draw attention , in the following pages, to the recent moves by the BRICS countries to trade in local currencies by using swaps and other bilateral payments arrangements. Subject to the scale of such transactions, such practices may change the prevailing pattern of external payments and its settlements in the world economy while changing the status of the US dollar as an unit of account in trade and payments. For BRICS nations the practice would also help to mitigate the tendencies of vulnerability as arise from their transactions in dollar-dominated global finance.

Suggestions are there in the literature for setting up a possible clearing account among developing countries, in line with the Keynes-Sempill scheme. The latter, originally advanced in the context of reconstruction needs of post-WWII years[6] provided the basis for the Keynes Plan for a Clearing Account which, however, was not acceptable to the creditor nation , USA. The plan , as pointed out,[7] still has the potential to sort out the problems faced by the developing countries, especially for those with chronic trade deficits.

Relying on the proposal as above, and extending further, we offer a scheme of clearing account for settlement for payments among BRICS members which avoids the use of dollar or any other currency as a numeraire. Our scheme follows what Keynes called the" banking principle", which is defined as "…necessary equality between credits and debits, of assets and liabilities" As Keynes pointed out,"… if no credits can be removed outside the banking system, but only transferred within it, the bank *itself* can never be in difficulties.[8] "The framework, while providing the basis for what he proposed as a Clearing Union where "..credits were automatically provided to the debtor countries to spend"[9], did not, however come through, largely due to the conflict of interest between UK which was a major debtor country at end of WWII and USA the major creditor.

We propose a similar clearing account system for countries within the BRICS. Each of these nations within the group can settle the bilateral trade surpluses and deficits with each of the individual nations without involving use of non-BRICS currencies. The prevailing cross exchange rates of currencies for individual countries can be used to settle the two-way transactions in local currencies, say the deficit country paying back the surplus in the local currency of the same country. Problems in settling the trade balances may be sorted out by using cross rates of currencies. To avoid volatility in exchange rates under uncertainty, those cross rates can even be frozen by having forward contracts in order that those are not affected by exchange rate variations in terms of each other non–BRICS currencies like US dollar.

Net balances in intra- BRICS trade, denominated in the respective currencies of the surplus/deficit countries, can remain within the BRICS and be deposited with the NDB (BRICS Bank). The sum , a pool of local currencies can be utilised to create more trade within the group when those are used by the BRICS members to finance additional trade within the region . Alternately, the sum can be lent out by the NDB to members , subject to the consent of all members, as consistent with the norms specified in the original agreement..

We provide below a matrix of the bilateral trade balances between individual BRICS members for 2014. The individual bilateral balances and their aggregates are in US dollars. A separate column provides the balance in local currency units (LCUs) using the nominal exchange rate for each currency in US dollars. The aggregates will indicate the balance in individual currencies which can be utilised by members by using the cross exchange rates, frozen by using forward rate contracts. As suggested in our clearing account proposal, individual members' aggregate bilateral balances , in LCUs at a specific point in time, could be utilized by those nations to settle their trade balances. The balance in LCUs is be obtained by using the cross exchange rates vis-à-vis the dollar, which are frozen by using forward rate contracts. It is expected that the measure would generate additional demand for goods within the BRICS while restraining, say, the use of Chinese trade surpluses to purchase dollar assets like US Treasury bills.

The anomalies in bilateral trade data in the table, reported on a gross basis indicate the need to qualify the above by looking at trade data on a value added basis at domestic sources. The problem can be detected in the discrepancy between the bilateral trade balances reported by the respective trade partners. Efforts

Table1 Net Bilateral Trade Balances within the BRICS, 2014

	Trade Balance (in billions of dollars)							
Trading Partners	Brazil	China	India	Russian	Total Intra-BRICS Total Balance (in billion of dollars)	Exchange Rate	Noninal Dollar	Total Intra-BRICS Trade (in billion of local currency units)
Brazil	—	8.68	-3.22	0.29	1.11	6.86	2.35	16.12
China	-18.40	—	31.46	9.93	-1.27	21.72	6.16	133.80
India	2.48	-32.79	—	-1.35	-1.60	-33.26	61.00	-2028.86
Russian Federation	-1.52	-17.88	0.95	—	-0.49	-18.94	38.38	-726.92
South Africa	-0.63	-3.75	-2.31	0.002	—	-6.67	10.85	-72.37

Sources: UN Com trade Database; World Bank, WITS Database[10] made by the World Trade Organization to draw attention to the issue in their "Made in the World" initiative (Maurer 2011) offer some data that may help to narrow down such discrepancies. We are unable, at this stage of our research, to look beyond gross trade data, despite their limitations.

It may be mentioned here that bilateral clearing arrangements provided a way out for some European countries including Germany in the interwar period to settle the external payments problems. We also mention an earlier work by the present author[11] on the use of the 'Rupee Payments arrangements' between India and the East European countries during the sixties which considerably facilitated transactions between the two by opening up new channels of trade and its settlement.

Conlusion

To conclude, the BRICS financial institutions, along with the proposed clearing account will herald a new set of financial architecture which has the potential to be beneficial, not just for the BRICS but for global financial system at large. Since those settlements will <u>not</u> rely on dollar or other major currencies as unit of account, exchange rate fluctuations across such currencies will not impact the cross rates between the individual BRICS currencies as long as kept frozen with forward contracts renewed over time. Moreover, arrangements to use the trade surpluses of individual BRICS members, by those in deficit would add to demand within the BRICS by creating new channels for intra-BRICS trade. The transfer of surpluses to meet deficits can even be treated as a loan , to be adjusted to similar other transactions of the NDB. Moreover, trade surpluses earned by individual members (say China) will remain within the Brics as investment and will not be used as assets in US dollar , avoiding sources of vulnerability. Finally the Brics may devise ways and means to channelize the capital flows in a manner which strengthens the Brics institutions and generate real demand, say with infrastructures, rather than spurious activities of a speculative nature.

Endnotes

[1] Barry Eichengree, " Banking on the BRICS" http://www.project-syndicate.org/commentary/barry-eichengreen-is-bullish-on-the-group-s-new-development-bank--but-not-on-its-contingent-reserve-arrangement

[2] http://en.wikipedia.org/wiki/new_development_bank

[3] http://en.wikipedia.org/wiki/new_development_bank

[4] Stephany Griffith Jones" Brics Development Bank: A Dream Coming True"? Unctad Working Paper No.215 March 2014

[5] Barry Eichengreen,op.cit

[6] Jan Kregel, " Emerging Markets and International Financial Architecture: A Blueprint for Reform" Levy Economics Institute Working Paper no 833

[7] ibid

[8] J.M Keynes, The Collected Writings of John Maynard Keynesedited by D.E MoggeridgeVol 25. Activities 1940-44:.Shaping the Post War World: The Clearing Union. London Macmillan p40 cited in Kregel, op.cit p8

[9] Kregel, op.cit p8

[10] Data collected by ZicoDasgupta for this table is gratefully acknowledged.

[11] See SunandaSen, India's Bulateral Payments and Trade AAgreementsBookland 1964

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