INCUBATING AN ALTERNATIVE FINANCIAL ARCHITECTURE WITHIN BRICS

(REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM SERIES)

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EXECUTIVE SUMMARY

- When the BRICS forum was initially created in 2009, it held out the promise of a different world order, particularly for an alternate international financial system
- From the perspective of geoeconomics, three distinct trends had converged:
  - The western financial system had lost credibility after the trans-Atlantic crisis
  - Globally trusted benchmarks were being manipulated
  - The western financial system was being misused for unilateral geopolitical goals
- The author recommends that the BRICS forum incubate new global institutions and trading paradigms in a new approach called -- Alternate Financial Architecture.
- This six main components of the architecture are:
  - A mechanism for enabling trade in local currencies
  - A clearing union for settling trade in local currencies of the five BRICS economies
  - A re-insurance market for global shipping insurance to ensure smooth transport
  - A sophisticated trade agreement that includes trade in services, movement of professionals, and protection of invested capital
  - A credit rating agency that assessed companies based on local characteristics of the BRICS economies
  - A benchmark for crude oil pricing that was more reflective of global energy trade
- Unfortunately, domestic economic and political compulsions forced the BRICS countries to look inward for many years and ideas for the Alternate Financial Architecture remained on paper.
- Even as the BRICS countries struggled to cooperate with each other, individually the five countries continued to respond to global developments. In particular:
  - Emergence of sophisticated trade deals between developing countries
  - Emergence of new mega-FTAs:
  - Emergence of new regional economic communities
  - Emergence of a Chinese Financial Architecture
  - Emergence of other multilateral economic forums
- It appears that in large measure, the world has already moved beyond the needs of what the BRICS forum can provide – to itself or globally. But that is a shortsighted view.
- Two critical reasons why the BRICS forum remains important:
  - Only other multilateral forum with global heft
  - Opportunity to represent the middle-income and developing countries
- Given the opportunity that BRICS forum still has on the world stage, it is important that priority be accorded to the design of the Alternative Financial Architecture and that its components be incubated within BRICS.
- There are three impediments to monitor:
  - Impediment 1 – Business remains a reluctant stakeholder
  - Impediment 2 – Probability of getting co-opted by the West
  - Impediment 3 – Risk of a Chinese Financial Architecture
- There are three catalysts for consideration:
  - Catalyst 1 – Address global challenges together
  - Catalyst 2 – Manage transnational business projects jointly
  - Catalyst 3 – Government support is critical in key areas
  - Catalyst 4 – Institutionalize regulatory mechanism

THE ECONOMIC GENESIS OF BRICS

When the BRICS forum was initially created in 2009, it held out the promise of a different world order, particularly for an alternate international financial system. The five countries came together amidst growing frustration with the western financial system that was being misguided and misused by the rich western countries.

At inception, western political leaders, economists and scholars sneered at the unlikely forum, calling it an investment banker's suggestion taken too far (referring to Jim O'Neill's 2001 paper for Goldman Sachs that originally coined the term).

At the time, legitimate incompatibilities were exposed. Geopolitically, they had never spoken with one voice, at least not deliberately, on any issue: Arab upheavals, Ukraine, Iran etc. Geoeconomically, the economies were too diverse to integrate – Brazil and Russia are energy dependent economies, China is a manufacturing economy and South Africa and India are service-driven. They are also all geographically disparate. Many of these incompatibilities remain.

Over time, the BRICS countries had hoped that these incompatibilities would be overshadowed by the latent economic synergies. All economies were facing socio-economic unrests and needed to create jobs quickly. They had young internet-savvy populations that were waiting to be capitalized. Each economy was modernizing and integrating economically with the world. They also had to address global issues such as climate change in parallel, something that the West did not have to do when they were developing. The similarities were hopeful.

From the perspective of geoeconomics, three distinct trends had converged, catalyzing the formation as well as the expectations from the BRICS forum.

First, the western financial system had lost credibility after the trans-Atlantic crisis. The unraveling of the mortgage-backed securities market starting in 2007 demonstrated how consumption and greed were driving the financial system without any heed to regulations. Many banks failed. Other institutions such as the credit-rating agencies that survived could no longer be trusted for sound judgment.

Second, globally trusted benchmarks were being manipulated. The LIBOR benchmark for interest rates and the BRENT benchmark for crude oil pricing were found or being investigated for manipulation between 2013 and 2014. These benchmarks were present ubiquitously through the global financial system – from projections on country growth rates to interest payments to current account deficit calculations. They were so well entrenched that no one knew how to change them or what to substitute them with, even though it was universally acknowledged that tampering was taking place at the highest levels of management of these global institutions.

Third, the western financial system was being misused for unilateral geopolitical goals. Economic sanctions on Iran are a case in point. The US and EU were able to choke countries such as India and China from paying Iran for oil by blocking SWIFT and other dollar-based clearing systems. India could not raise insurance for transporting Iranian crude. It was a stark reminder to all the countries of the grip western countries have on the global financial system.

HOPE: AN ALTERNATIVE FINANCIAL ARCHITECTURE

This convergence provided the ideal environment for the BRICS countries to envision a viable alternative for global economic leadership. The BRICS Bank and $100 billion Contingency Reserve were good measures to show tangible support for the forum by all the five countries.

But more could have been done.

Between 2012 and 2015, the author recommended that the BRICS forum had the opportunity to introduce new global institutions and trading paradigms into a new phenomenon which he titled -- Alternate Financial Architecture.

These six main components of the architecture are listed below:

1. A mechanism for enabling trade in local currencies
2. A clearing union for settling trade in local currencies of the five BRICS economies
3. A re-insurance market for global shipping insurance to ensure smooth movement of goods
4. A sophisticated trade agreement that includes trade in services, movement of professionals, and protection of invested capital
5. A credit rating agency that assessed companies based on local characteristics of the BRICS economies
6. A benchmark for crude oil pricing that was more reflective of global energy trade

Unfortunately, domestic economic and political compulsions forced the BRICS countries to look inward and some of the ideas for the Alternate Financial Architecture that could have been considered for the BRICS forum to experiment and incubate remained on paper.

India had a long period of political stasis between 2011 and 2014 until a change in political leadership gave BJP a majority mandate. China's repositioning of its economy in 2012 from an export-driven to a domestic consumption driven economy decelerated the speed with which it was integrating globally. China, Brazil, Russia and India's economy suffered from the aftermath of the western financial crisis and also a scare on the depreciating value of their currencies in 2014, forcing a review of the liberal foreign capital regime. Also, in 2014, Ukraine and the subsequent economic sanctions in diverted Russia's attention towards its domestic economy.

Clearly, the gumption for experimentation waned and evolution of the BRICS forum stalled.

As a result, the BRICS countries continued to do business with their traditional economic partners. Europe remains Russia's economic partner, South-East Asia and East Asia remain China's economic partners, South Africa is still focused on business within the African continent, Brazil is better integrated in Latin America than anywhere else, and India remains glued to the US, UK, Europe as it has always been.

WHILE BRICS WAS SLEEPING …

Even as the BRICS countries struggled to cooperate with each other, individually the five countries continued to experiment with foreign economic initiatives. This indicates that the latent potential for the BRICS countries to cooperate remains. Some of these models have already been tested bilaterally. On other issues, the countries have been forced to create a strategy by the changing global economic paradigms.

Five global developments are of particulate note here:

Emergence of sophisticated trade deals between developing countries: The India-ASEAN FTA in services is an example of how a sophisticated trade agreement can be signed between two developing regions. As the name suggests, it goes beyond goods to include agreements on movement of capital, labor and technology. Such an agreement between the BRICS countries could have been a game-changer. The western countries have for long resisted the inclusion of movement of professionals and mutual recognition of standards with developing countries. But BRICS had the chance to introduce it.

Emergence of new mega-FTAs: The push for mega FTAs such as the Trans-Atlantic Trade and Investment Partnership (TTIP) and the Trans-pacific partnership (TPP) is leaving BRICS behind. It shows that the US and other western countries are not going to cede space on the global trading giants table easily. The agreements are designed to exclude BRICS countries and to capitalize on the west's deep harmonization in regulatory standards. Once in play, it will shift global value chains away from countries like China and India. China will be the worst affected because it currently benefits the most from hosting the manufacturing facilities.

Emergence of new regional economic communities: By the end of 2015, the ASEAN group of nations will come together as an ASEAN economic community, only few steps short of creating an economic union like the EU. This will lead to a harmonized set of rules and standards for economic integration within the 10 countries. This is a credit to the political leaders of the region who have incrementally and steadily steered the regional forum into a formidable economic alliance, gently including new players like Myanmar. The economic heft of the ASEAN Economic Community as a whole will be a real counterbalance to economic giants such as the US, EU, China and India.

Emergence of a Chinese Financial Architecture: China's plans for Asian Infrastructure and Investment Bank (AIIB) came as a surprise to most across the globe. The support for AIIB has already diffused the energy being put into BRICS Bank. However, what is less known is that AIIB's true impact is only apparent when studied against the One Belt, One Road (OBOR) economic vision that China has put out concurrently. AIIB is positioned to play an important role in facilitating transnational payments and financing development projects included in the OBOR that spans from Central Asia to South-East Asia. It could be the genesis of a new Chinese financial architecture in the making that will force smaller economies to adopt a Renminbi-based financial system.

Emergence of other multilateral economic forums: B20, the business forum that supports the G20 forum has emerged as a powerful new forum for global business dialogue. Since its conception in 2010, the forum has become an important bridge between business and foreign economic policy. The forum has met regularly since then on the sidelines of the G20 Summits to advise world leaders on global economic governance.

THERE IS MERIT IN THE BRICS FORUM … STILL

All these developments demonstrate that the global economic integration was evolving but leaving BRICS countries out. Thus, it would appear that in large measure, the world has already moved beyond the needs of what the BRICS forum can provide – to itself or globally.

But that is a shortsighted view. Two critical reasons why the BRICS forum remains important:

Only other multilateral forum with global heft: It still remains the only formidable alternate multilateral forum. The equal shareholding of BRICS Bank was an experiment to demonstrate that the five countries with differing interests can come together to work on a common mandate. The success of this experiment would have bigger implications for world order than, say, the success of AIIB that is led by one country. It provides competition to the World Bank and IMF, and can force them to reform, at worst.

Opportunity to represent the middle-income and developing countries: Too much of the world's resources are focused on too few issues and regions. Since 9/11, budgetary allocations and financial aid have been committed towards securing Iraq and Afghanistan, stabilizing West Asia, and trying to ease the west out of the recession. However, much of the world - approximately 70% of global population - lives in relatively stable, middle-income or developing countries that are looking to BRICS for new models of growth and development. China is an obvious and shining example to them on how best to execute development projects. But other countries also have much to offer. For instance, Brazil's success with socio-economic programs and sustainable development has important takeaways for both advanced and developing countries. South Africa's banking system still remains one of the best in the world. Russia's technical prowess, specifically in defense and space remains unmatched. And India's eco-system of free private enterprise, bottom-up development and democracy offers a valuable model.

COMPONENTS OF THE ALTERNATE FINANCIAL ARCHITECTURE

Given the opportunity that BRICS forum still has on the world stage, it is important that priority be accorded to the design of the Alternative Financial Architecture and its components be incubated within BRICS.

Immediately, the design of the individual components can be initiated by:

1. **Enabling trade in local currencies**: A Multilateral Agreement on Extending Credit in Local Currencies was signed at the 4th BRICS Summit in New Delhi in 2012. That must immediately be activated so that the five local currencies of the BRICS countries can be made available for trade. China is experimenting with bilateral currency swaps already and already has 21 such agreements to its credit.
2. **A mechanism for settling local currencies:** If trade is to be enabled with local currencies, a clearing union to settle the payments between countries is needed. Here, lessons from the Asian Clearing Union set up in 1974 (but now practically defunct) can be learned and improved upon. Such a mechanism will speed up economic integration between the five countries.
3. **A re-insurance market for transport:** Shipping and other transport companies often need billion-dollar insurance schemes to insure their cargo. BRICS countries can jointly create and manage a reinsurance market similar to the London-based International Group of P&I Clubs.

Outside of the West, Hong Kong already has a deep insurance market that can be leveraged to begin this exercise.

4. **A forward-looking trade agreement:** Services will play an important role in all the BRICS countries in the future. A new FTA in services between the BRICS, one that includes movement of professionals and mutual recognition of standards and regulations, will give an immediate boost to economic integration. The India-ASEAN FTA in services can be used as a template.
5. **A credit rating agency system:** A fair credit rating agency system can be created based on the local characteristics of middle-income and developing countries. Russia and China have already expressed interest publicly by encouraging RusRating and Dagong Global to create a new framework. Another parallel effort called ARC is being led by the international consortium of agencies from Portugal, India, South Africa, Malaysia and Brazil.
6. **A global benchmark for crude oil:** Since the BRICS forum is made up of two energy-producing countries and three energy-consuming ones, an energy benchmark that better reflects the pricing of crude oil can be unique initiative. Russia already has benchmarks such as ESPO and India too has commodity markets that can grow up to provide accurate pricing of energy commodities.

THE IMPEDIMENTS

Impediment 1 – Business remains a reluctant stakeholder: Corporate decisions are usually based on profit motives. This is especially true for businesses in South Africa, Brazil and India where government's influence in executive decisions of companies is minimal. At the moment, firms in all five BRICS countries find it easier to conduct business with their traditional markets and using the dollar-based payment architecture. Unless, there is external support by the government or a change in business models, business will be reluctant to take on the costs of transitioning to the alternative architecture.

Impediment 2 – Probability of getting co-opted by the West: In 2012, the BRICS countries contributed $75 billion to the IMF to bailout the European countries. Getting co-opted by the West in their initiatives or into the existing western financial architecture will make the formation of the Alternative Financial Architecture difficult.

Impediment 3 – Risk of a Chinese Financial Architecture: The scale of China's economy already makes it an outlier in the BRICS framework. However, the creation of AIIB as a competitor to the BRICS Bank and the rapid internationalization of the Renminbi through bilateral currency swaps against a multinational multi-currency system could diffuse the effort needed by BRICS to create an Alternative Financial Architecture. Most countries, including India, are reluctant to shift away from a western financial architecture for fear of being trapped in a Chinese-dominated one.

THE CATALYSTS

Catalyst 1 – Address global challenges together: There is universal agreement that issues such as Climate Change and preservation of ecological resources cannot be addressed by one country alone. This is an opportunity for the BRICS to collaborate and fund technologies that will help middle-income and developing countries leapfrog to the next generation of business models and introduce paradigms for growth that rejuvenate the environment.

Catalyst 2 – Manage transnational business projects jointly: There are very few instances of successful projects that the BRICS have managed jointly. One area of common interest could be collaboration in energy assets. India and China have already invested in oil fields in Sudan together. Separately, they are developing LNG infrastructure and the related pricing markets. Russia and China have a $400 billion gas pipeline deal. Brazil is a leader in bio-fuels and in harnessing natural resources for domestic energy consumption. South Africa, still dependent on coal, is looking for new sources. These synergies can be utilized for purchasing energy assets globally, building the required infrastructure, and selling the energy in the global markets.

Catalyst 3 – Government support is critical in key areas: While excessive government support in business may not always be useful, there are some softer elements of collaboration that require immediate attention. The onus of funding research and providing translation services so that business analysts, journalists, scholars, and the general public in the BRICS countries can understand about each other and learn from each other, is very important. This role can only be taken on by the governments and the BRICS forum. Without this, the BRICS countries will continue to remain alien to each other.

Catalyst 4 – Institutionalize regulatory mechanism: For all its faults, the western financial system has also developed institutionalized monitoring and vigilance mechanisms to deal with loopholes and manipulation. The manipulation of LIBOR was quick to be recognized by the authorities and resolved by the British government. The manipulation of BRENT was being investigated by the European Commission. The BRICS forum also needs institutionalized mechanisms for the continuous monitoring and reevaluation of the new financial architecture and its related instruments.