Theme

Reform of the International Financial System and the future of the BRICS born Institutions

Title

BRICS Bank as an alternative to the current international financial system in developing countries

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ABSTRACT

The current financial system has reached the peak of its effectiveness. It can no longer address the needs of those it claims to represent it is in light of these observations that alternatives are being sought that provide inclusive and equitable development for all. The Bretton-Woods institutions do not seem to have the capacity to reinvent themselves and hence it has become paramount to find ways in which the system can be replaced. Economically, socially and politically they continue to serve the interests of the architects of the system at the expense of the intended recipients. In light if these circumstances, the BRICS bank would be an alternative that though not yet big enough at the moment might start to challenge the Bretton Woods system at least ideologically. By fostering a transparent regulatory framework, visionary leadership, equitable conflict resolution mechanisms, robust risk assessment criteria and a common aspiration the BRICS bank will achieve its goal of economically, socially and politically fostering a more inclusive, equitable and sustainable growth for all.

1. INTRODUCTION

The international financial system is defined as the system and institutions that oversee the facilitation of international means of payments for the exchange of goods and services. Much like a financial services sector in a country this happens to be a similar system at a global scale. This system by extension will also be responsible for the currency movements in the world not only of trade but also for wealth preservation but also financing activities. The current financial system is headed by two Bretton-Woods institutions namely the World Bank and the IMF.

The World Bank's mandate is to finance development worldwide, stepping in to provide funds for projects that the private sector would not typically engage in. The most prominent arm of the World Bank being the International Bank for Reconstruction and Development. The IMF's mandate is to facilitate for financial stability through providing funds to fill in current account deficits that may have been experienced through trade or the payment of international transactions that happen between countries. The IBS helps settle claims across countries as they transact in international trade and investment as characterized mainly by FDI flows across the globe from regions of low economic yield to those with high economic yield.

With this mandate in mind it is crucial that these financial institutions deliver the objectives of these mandates to member participants equitably, helping them acquire infrastructure for their economies while keeping their financial systems stable. However as recent history has shown these institutions have only helped to extend United States dollar hegemony across the world with these institutions basically playing the role of extending American foreign policy on other member states. Via the voting structure of these institutions the ability the rest of the world to wrest itself from American self determination has been greatly handicapped. Currently the US holds a critical mass of voting power that can cripple any moves in international financial market that can impede on its ability to maintain its hegemony on the rest of the world.

2. THE PROBLEMS WITH THE CURRENT FINANCIAL SYSTEM.

The reform of the international financial system is focused on the following aspects: international monetary system, international financial institutions and international financial regulatory system. (Xue Lai, 2009).The problems in the system should be dealt with in these three areas. The issue of influence of the Bretton woods institutions has historical basis in America leading the recovery process post WWII and imposing on itself the responsibility to ensure financial and monetary stability in the world economy. These financial arrangements are clearly seen in the domination of America in the operation of these financial institutions. Though it may have been beneficial to have America dominate these institutions in the recovery process and through to the 1970's, the current picture of global trade however no longer reflects the need to reconstruct a world coming out of a world war but rather a need to relocate the centre of global economic power to catapult the globe into a new dimension of economic operation. This can only be done by leveraging the growth which is being experienced in emerging markets such as the BRICS.However the US has failed on the mandate it took upon itself as Mungqi (2009) observes:

> *"De facto, the US Dollar standard in the international monetary system enables the United States to irresponsibly neglect its current account deficit and the foreign exchange rate for its currency. As long as there is no replacement for the US Dollar as the international key currency, the United States can use the Dollar to import cheap goods and services. By doing so, the US was able to use an inflationary monetary policy for its own goods while neglecting the asset bubble. However, excessive debt in the US, both public and private, eventually leads to adjustment. When commodity prices surged, and other product and service prices rose, the inflationary monetary policy had to change. Once the monetary policy was adjusted, the financial market responded, triggering the subprime loan crisis. Subsequently, the entire world had to follow the US in stimulating the economy with inflationary monetary and fiscal policies, starting a new cycle of bubble creation. In this process, the US could reduce its debt relative to GDP, while the rest of the world had to suffer in sharing the costs. This is why the international*

community reached consensus on the urgent need to reform the international financial system."(Munqgi, 2009).

The mechanism with which the international institutions voting rights are determined has been identified as an impediment to reflecting the emerging significance of emerging economic powers and the adoption of developmental policy positions. The determination of voting power in the current financial dispensation as seen in the activities of the international monetary fund are seen by the allocation of voting rights that is determined by a country's GDP,and a host of other macroeconomic policy variables. The outcome across time has that the USA has maintained the largest share of votes in the World Bank. Consensus on a policy or action is achieved at 85% and currently the US holds about 17.68% of the votes implying that it can veto any policies that it is not interested in pursuing. An example of policy inflexibility and the resistance to change manifested by the US was seen in 2009 as Mungqi,2009 notes

> *"Obviously, the G20 have not reached consensus on key issues. The US tried to focus exclusively on stimulating recovery and sought to avoid any major reform that might undermine the Dollar standard. Although the US accepted a compromise on an IMF fund increase and SDR expansion, and even proposed to adjust voting shares between Asian and European countries, Washington is not likely to accept any reform that challenges the dominance of the US Dollar. At the second G20 London Summit, leaders reached some consensus in this regard. IMF financial resources will be increased to US$ 500 billion. SDRs will expand to 250 billion. Surveillance of the financial markets will be strengthened. However, key issues such as inter-national key currency stability, exchange rate regimes, an adjustment mechanism for imbalances of international payments have not really been touched upon."*

This skewed representativeness no longer reflects the wishes of members especially in the emerging and developing economies. There are several quarters in the banks membership that feel that the terms on which the loans are disbursed to recipient countries and the prescriptive tone with which they are handed down is tantamount to the perpetuation of American dominance. The contribution that emerging economies especially the BRICS are making to the world economy are overlooked in the disbursement of voting quotas and the economic ideology accompanying the loans is detrimental to the soft resource based economies where most of the balance of payments and infrastructure backlogs exist. Emerging economies are not able to vote on decisions that affect their economic destinies and on projects that affect their current livelihoods. This situation makes for a compelling case for urgent reforms in the structure and management of the Bretton woods institutions. Could the BRICS offer a solution?

3. THE CREATION OF BRICS BANK

In response to the unfair representation of BRICS institutions on the World Bank and IMF, the BRICS countries in 2014 met in Fort Aleza, Brazil and decided to form a BRICS bank; a bank which they could use to finance their developmental agendas. It comprises of two institutions namely the New Development Fund and the Contingency reserve arrangement (Panova, 2014).The Bank has an authorized capital of $100 billion and currently has a subscribed amount of $50 billion. Its mandate is to finance infrastructure and "sustainable development" projects (The Economist, 2014). The CRA's mandate is to tide over member countries in financial difficulties. It is not a tangible fund but rather a web of bilateral promises to make $100 billion of foreign reserves available to BRICS countries on need, with each country being able to draw a multiple of its contribution.

The main reasons why this bank was created was to bolster investment into infrastructure which four of the member banks(with the exception of Russia) need to overcome the waning growth prospects that their economies face. The second reason for the formation was to create a front which can help, for instance china invest in India without seeming as if it is now dominating the economy thereof. The third reason was to reform the old world order by presenting one which will now include fairness, inclusiveness and diversity as its underlying tenets (Panova, 2014).

All members have equal voting rights in the bank which would make this a paradigm shift from the way the IMF and World Bank ideology. Since the group has five members it will take at least 3 members to agree to make a decision and none of the members have veto power to stop the other four members from taking an action. Despite the setting up of the Bank, the infrastructure bank has a lot of ground to cover before it can challenge the current financial system. The World Bank estimates that the infrastructure funding gap in South East Asia alone amounts to $2.5 trillion over the next ten years. However this does not stop the bank form being able to make a difference where it matters particularly in developing countries.

4. OPPORTUNITIES AND THREATS

The BRICS bank has by its nature and objective a unique opportunity with which it can become the preferred lender to the developing world. However for every opportunity there exist threats that could impede in the developmental agenda that the bank has been constructed to achieve. This section deals with the opportunities and threats that the bank faces as it delivers on the financial reform that the international financial system so badly needs.

4.1. Opportunities

There are numerous development challenges that the World Bank and IMF framework did not look into. Unfortunately these have been the very reasons development in the developing economies was not being realised. An Oxfam report put the challenges that the BRICS bank could tackle as follows:

> "*The association of five major emerging national economies, Brazil, Russia, India, China and South Africa (BRICS) has a special responsibility towards helping the world achieve its goal of ending extreme poverty, reducing inequality and achieving sustainable development, as they collectively represent some of the world's greatest challenges and achievements. Despite remarkable strides made in reducing poverty within India and China, BRICS countries still house nearly half of the world's poor and have experienced a rise in inequality in recent years. The creation of a BRICS Bank, and with it the promise of reforming the global development architecture, offers a real and concrete opportunity for governments of these countries to ensure development financing is sensitive to the needs of those who are poorest and most marginalized."(Oxfam: 2014)*

In light of these challenges it is imperative for the BRICS bank to recognize that though it has made numerous achievements in as far as economic development is concerned, it also has to take a look at the inclusivity of that growth and foster social change through the instruments that it will create in the BRICS bank.

The millennium development goals are lagging behind in the developing countries and the BRICS bank could be utilized as a catalyst for the achievement of these. The connectivity of the BRICS economies can enable them to be leader nations in the attainment of these goals for instance, South Africa is connected to the SADC region and China has got strong links to the ASEAN nations. The BRICS bank could be the financial catalyst that will bring about the quick attainment of the millennium development goals at a global scale.

The focus of the environmental sustainability of investments made by Bretton woods institutions has been questionable. They have been involved in projects that have been environmentally unfriendly and have reduces the quality of life for the poorest of the poor. The BRICS bank must bring more awareness to global issues such as environmental, social and governance issues into its investment frameworks. However how this will work well will depend on how standards can be set and this happens to be one of threats outlined in the next section.

4.2. Threats

The bank faces threats from five areas that could be risk areas to the longevity and performance of these BRICS born institutions. These five aspects are the regulatory framework of the bank, the leadership of the bank, conflict resolution in the bank, the financial stability (securedeness) of the bank and finally the aspirations of the Bank. These aspects are discussed in the following subsections:

4.2.1. Regulatory Framework

The leaders need to determine the regulatory framework of the bank and agree on it as soon as is possible. This provides a clear pathway for which the bank can operate; what investments to enter into and which ones not to and for what reasons. This will act as the rules to which all member nations shall abide to and whose fair application is going to create the much needed goodwill that should characterise an international finance institution.

4.2.2. Visionary Leadership

There will also be a need for continued strong leadership in the bank. It is also important to laud the initiative that has been taken by the current leadership to shape the foundations for the Bank. Going forward there should not be a shortage of such visionary leadership to take the bank into the future. Clauses for the selection for future BRICS bank leaders could help in perpetuating the vision of the BRICS bank.

4.2.3. Conflict Resolution Mechanisms

Conflict in between bank members is bound to arise, especially with the extension to include more than the five founder members if not among the initial five members themselves. There should be clearly laid down rules for how conflicts of interest are going to be settled by the bank. This could be difficult looking at the political orientation of the existing members with some coming from democracies and others coming from non-democracies. There could be a compromise that could bring in a new means through which conflict resolutions can be solved between group members with diverse political backgrounds.

4.2.4. Robust Risk Assessment Policies

Security concerns exist for the bank in terms of the nature of its operations. There is a need to assess risks adequately and finance sustainable projects which will give an adequate return to be able to perpetuate the survival of the bank. The bank will have a focus on development finance; it could give loans at lower tariffs and fewer conditions, but keep the attainment of development goals such as equality and poverty alleviation at its core. Sufficient risk mitigation capabilities will have to be hammered out amongst the founder members to come up with a mix that they can all support and stand behind.

4.2.5. Common Aspiration

The bank will also have aspirational differences amongst the members. The biggest risk being that of looking like a front for Chinese hegemony. The BRICS has the risk of taking developing economies off the US loans only to indebt it to itself with the attendant benefits of being able to access the resources of indebted countries as a means to repay debts. Ideologically speaking, the philosophy that informs the lending and to whom lending should be done is equally as crucial. If the issue of how the bank should make the BRICS look in the next 30 or so years is not settled it could create fissure that could leave the bank much like other financial institutions which sought to challenge the World Bank but fell by the wayside.

These are threats that could break the Bank going forward and much activity will have to be focused on these areas to launch and sustain the Bank going forward. We believe that settling on these questions will test the political will of the governments represented but being able to overcome them and create a bank which exists in a new social, political and economic paradigm will pose the most potent threat to the Bretton Woods institutions since their existence and open up the path to the institution of a new international financial architecture.

5. CONCLUSIONS

The current financial system has reached the peak of its effectiveness. It can no longer address the needs of those it claims to represent; it is in light of these observations that alternatives are being sought that provide inclusive and equitable development for all. The Bretton woods institutions do not seem to have the capacity to reinvent themselves and hence it has become paramount to find ways in which the system can be replaced. Economically, socially and politically they continue to serve the interests of the architects of the system at the expense of the intended recipients. In light if these circumstances, the BRICS bank sounds like an alternative that though not yet big enough at the moment might start to challenge the Bretton woods system at least ideologically now but hopefully economically and politically in the future and foster a more inclusive, equitable and sustainable growth for all.

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