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New Development Bank: A Contribution to Development Finance

The BRICS countries at their sixth Summit held at Fortaleza, Brazil on 15 July 2014 decided to establish the New Development Bank (NDB) and the Contingent Reserve Arrangement (CRA). We examine in this policy brief: (i) the governance structure of the NDB, (ii) the additional resources that it might mobilise for development, (iii) the current economic situation of developing countries and, therefore, their financing needs, (iv) the significance of the NDB as a provider of development finance in the current international situation, and (v) its ability to change the international aid architecture.

The NDB has moved from concept to reality in a relatively short time. The idea of setting up of a BRICS-led South-South Development Bank, mainly funded and managed by BRICS countries to recycle surpluses into investment in developing countries for infrastructure and sustainable development projects mooted by India was discussed at the BRICS Finance Ministers and Central Bank Governors' meeting held on 25 February 2012 on the sidelines of G20 Finance Deputies, Central Bank Governors and Finance Ministers' meeting in Mexico City. The leaders, believing insufficient long-term financing and foreign direct investment is available for infrastructure development in developing countries asked their finance ministers to examine the feasibility of establishing a South Bank. The first meeting of experts to examine the viability of this idea was held in New Delhi on 19 March 2012. Subsequently, the BRICS Leaders at their Fourth Summit held at New Delhi on 29 March 2012 agreed to the establishment of a New Development Bank. After further analysis by experts and finance ministers, the Leaders decided at the Fifth BRICS Summit on 27 March 2013 in Durban to establish the New Development Bank. The articles of agreement were subsequently accepted at the Sixth Summit.

Governance Structure

The NDB has been set up by the BRICS countries with the provision that membership is open to all members of the UN. In this it is similar to the World Bank whose membership is open to all countries.[1] The presidency, it seems, will be retained by the BRICS founder members and will rotate among them. The subscriptions of the other countries joining as members of the NDB, and thus their voting power, will be determined by the Governing Council. No principles have been laid down on how the subscription and voting power for new members will be determined. The original members have equal subscriptions and equal voting rights. The voting power of the original members will not be allowed to fall below 55 per cent. This implies that if the founding members are united they would exercise a veto power at the NDB as most decisions will be taken by a simple majority. Their 55 per cent contrasts with the 34.86 per cent share of the five largest members in the World Bank and the 39.39 per cent share in the IMF. Of course, major decisions in the IMF and the World Bank organisations require a much larger percentage, upto 85 per cent in some cases. In the NDB, if some BRICS countries combine with other

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members then a decision can be reached which might be against the wishes of a majority of the original members who would thus not exercise a veto power. This is in contrast to the IMF and the World Bank where the US alone can exercise a veto power. Similarly, a consortium of the four largest European countries can exercise a veto in these institutions.

The voting share of non-borrowing members in the NDB cannot exceed 20 per cent, which implies that the developed countries, if they become members, will not have a controlling power even as a group. Furthermore, the voting power of a non-founding member cannot exceed 7 per cent of the total which would reduce the clout of any individual developed country. This also implies that a non-borrowing country can only form a blocking coalition if it combines with all the other founding members; the lack of a founding member in a blocking coalition would have to be compensated by usually at least another two non-voting members joining the coalition.

Developing countries have long criticised the convention that the head of the World Bank should be from the US and that of the IMF should be from Europe. While in the former case the US has a monopoly, in the latter case it can be argued that the directorship of the Fund, the managing director (MD), is open to almost 40 countries. In reality, of course, the 11 MDs who have headed the IMF till now have come from only six countries with France contributing five MDs. With the restrictions on the presidency of the NDB the BRICS countries open themselves to criticism that they are running a non-democratic organisation as it does not adhere to the one country one vote principle. Furthermore, these rules may weaken the case of the BRICS countries for changes in the governance structure of the IMF or the World Bank. These rules ensure that developed countries are unlikely to have a controlling voice in the NDB and that developing countries will in the main determine how the NDB operates.

The Resources of the NDB

The authorised capital of the NDB is US$ 100 billion, of which US$ 50 billion will be from the original members.[2] US$ 10 billion will be the paid in capital from the original members and it will be paid in seven instalments as noted in Table 1.

The first instalment is due in six months after the agreement is ratified and the second payment is due after another year. Therefore, the earliest the NDB is likely to start operations in a significant manner is the beginning of 2017. At that time its subscribed capital would be just US$ 2 billion. This can be compared to the World Bank, which started after the Second World War, namely 70 years ago when prices were much lower, with an authorised capital of US$ 10 billion, of which 20 per cent was paid in. Subsequent increases in capital have been largely in the form of callable capital. For instance, of the total authorised capital of US$ 191 billion at the end of 2010 only about 6 per cent or about US$ 12 billion was subscribed, the rest was callable. Similarly, of the US$ 81 billion increase agreed in 2010, only 6 per cent was subscribed. More important than the subscribed capital are

[1] The details of the governance structure and the subscriptions are contained in the agreement that can be accessed at http://brics6.itamaraty.gov.br/media2/press-releases/219-agreement-on-the-new-development-bank-fortaleza-july-15

[2] *ibid.*

Table 1: Schedule of Payments to the NDB (US$)

Instalments	Amount	Cumulative Amount
1	750	750
2	1250	2000
3	1500	3500
4	1500	5000
5	1500	6500
6	1750	8250
7	1750	10000

Source: http://brics6.itamaraty.gov.br/media2/press-releases/219-agreement-on-the-new-development-bank-fortaleza-july-15 the accumulated reserves, which are almost twice the size of the subscribed capital. The World Bank's loan portfolio of about US$ 200 billion is mainly supported by its borrowings from the market, which are supported by its large callable capital. Its annual commitments are about US$ 14 billion.

The US$ 10 billion paid in capital of the NDB at the end of the seventh instalment would compare very favourably with the US$ 18 billion paid in capital of the World Bank. The additional funds made available by the NDB could thus be substantial. They would be particularly important as aid flows from both multilateral and bilateral sources have been relatively stagnant in recent years. But the resources of NDB would have two shortcomings as compared to the World Bank. The NDB would not have any significant reserves and these are larger for the World Bank than its paid in capital. Furthermore, the World Bank is able to leverage its own resources by considerable borrowings from capital markets. The ability of the NDB to similarly leverage its own resources is still open to question, and may face some challenges as discussed below.

The amounts that the NDB (and the Asian Infrastructure Investement Bank) can lend are considerable and may presage a shift in the source of global development finance. Whether this occurs will depend on the evolution of the world economy and the needs of the economies of the individual members. The members of NDB can be divided into those which have current account surpluses, namely, China and Russia, and those who have current account deficits, India and South Africa. Brazil is on the margin running sometimes small surpluses and at other times small deficits. Countries with deficits are financing their contributions to the NDB by borrowing from other sources, which, in the case of India, are predominantly NRI deposits and portfolio inflows. This would limit their ability to contribute to an enlargement of the capital base of the NDB. This would not be a handicap if the NDB could leverage its capital base to borrow from international capital markets.

In brief, while the NDB has the potential to substantially increase the investment funds available to developing countries it is an open question as to how far it will be able to realise this potential, and even if it is able to realise its potential this might take about a decade. The NDB is devoted entirely to funding of infrastructure. The share of infrastructure in bilateral aid from DAC countries has declined over the years.[3] Its importance in the World Bank's portfolio has also decreased. The NDB can make a significant contribution to creation of infrastructure.

The Current Economic Situation of Developing Countries

This section seeks to analyse the role that the NDB can play in the economic development of developing countries. From the beginning of the debt crisis in 1982 till the end of the 20th century developing countries in Latin America (LA) and Sub-Saharan Africa (SSA) fared very poorly. The only region where developing countries did well was Asia, both South Asia (SA) and East Asia (EA). Per capita incomes grew between 1983 and 2000 at an average annual rate of 6.1 percent in East Asia and 3.3 per cent in South Asia, whereas they grew at only 0.8 per cent in LA and declined by 0.7 per cent a year in SSA. After a recovery in the period before the financial crisis as per capita incomes in LA and SSA grew between 2006 and 2008 at an annual rate of 3.7 and 3.1 per cent, respectively, these countries, however, have been hit hard as the growth rate in SSA dropped to 1.3 per cent and in LA to 1.7 per cent during 2009 to 2011. But the problem does not seem to be a shortage of savings as the ratio of gross fixed capital formation (GFCF) to GDP has been maintained in SSA at the high rate of 24 per cent it had reached before the financial crisis from a low point of about 17 per cent in the 1980s. Similarly, the GFCF GDP ratio in LA had also increased from the low point in the 1980s and 1990s and has been maintained after the 2008 crisis.

The most disturbing aspect of the performance of LA and SSA has been the deterioration in the current account balance (CAB) since the 2008 crisis. The CAB has deteriorated in LA

[3] See various annual reports of the OECD Development Cooperation.

by about 2 per cent of GDP whereas in SSA it has deteriorated by almost 3 per cent of GDP. The current account could become a significant constraint to rapid growth in the future, particularly as investment has a high import content.[4] By making more foreign exchange available it may prevent a potential decline in investment in future.

Another disquieting feature of economic performance in developing countries, and here that includes SA, is the poor performance of the manufacturing sector. The share of manufacturing in GDP has been declining in almost all regions except EA.

FDI inflows are unlikely to be large when growth is low. Fresh sources of capital are required to help the struggling economies in LA and SSA grow faster. Both the NDB and the CRA can contribute to this.

Contribution of NDB to Development Finance

Total flows from all multilateral agencies were about US$ 57 billion in 2013, of which about 15 per cent each were from the World Bank and from IDA, the soft loan arm of the World Bank.[5] Of this about US$ 40 billion is aid.[6] IDA is the largest single multilateral agency providing soft loans.

Initially the resources of the NDB would be quite small compared to those from the multilateral agencies as a whole and within that from the World Bank and IDA. However, by the end of the pay in period for capital which is almost a decade it would provide substantial additional resources. Furthermore, it could leverage its paid in capital by borrowings from the capital markets as the World Bank has done. The cost at which it would be able to borrow creates a policy dilemma for the NDB. The World Bank has been able to borrow more cheaply than individual developing countries as it was owned mainly by the developed countries which had and continue to have high credit ratings. Furthermore, the initial presidents were very conscious of the need to retain the confidence of markets. To increase confidence in the ability of the NDB to service its market borrowings it may have to charge a high enough interest rate. But this would limit the appeal of its funds to developing countries.

It can be seen from the total amount available from multilateral sources of nearly US$ 57 billion the NDB would be a small contributor at least in the initial years, though with a potential to make a substantial contribution in later years.

The NDB and the Aid Architecture

The NDB was seen by many analysts as a challenge to the World Bank. But we shall argue below that the main challenge to the World Bank may come from the Asian Infrastructure Investment Bank (AIIB). The AIIB has yet to be formally set up but in many aspects it may be seen to have a better potential than the NDB.

a) The NDB and the World Bank Group

As noted above, the World Bank Group has two wings providing development finance. The World Bank provides loans at rates marginally lower than the London Inter-Bank Rate (LIBOR). It can do so as it borrows at low rates internationally and mixes the amounts with its own resources which it considers to have zero cost. So it is able to provide loans at rates of interest substantially lower than what developing countries would have to pay if they borrowed directly from international capital markets. However, the poorest countries depend on cheap loans from IDA. These amounts are contributed by governments at no charge to IDA. Governments contribute funds every three years in order to keep IDA functional. Funds lent by IDA are not raised on private capital markets. Similar two different sources of funds and types of loans are also available from other multilateral development banks. For instance, the African Development Bank disbursed US$ 1.2 billion in 2013 but the African Development Fund, the soft arm, disbursed US$ 2.2 billion.[7]

The NDB could compete against IDA or the World Bank. NDB would have to provide cheap loans in order to compete against IDA. Then the BRICS countries would have to augment the facilities offered by the NDB either by paying in amounts to enable it to subsidise loans to poorer countries or to have a special soft window as the

4 Reasons for this deterioration could be that first commodity prices have declined and commodities still figure importantly in the export baskets of many of these countries. Second, these regions have been the least successful in exporting financial and IT related services which are the most dynamic components of world trade.

5 See http://www.oecd.org/dac/stats/data.htm

6 Aid is defined as flows that have at least a 25 per cent grant element.

7 http://www.oecd.org/dac/stats/data.htm

World Bank and regional development banks have. Subscriptions to the soft window would have to be in addition to the amounts promised to the NDB. This is so because if the NDB is going to leverage its own resources by borrowing from international capital markets it must charge enough to repay these loans. It is unlikely that the NDB will compete with IDA.

b) NDB and the AIIB

On 24 October 2014, a signing ceremony held in Beijing, formally recognised the establishment of the AIIB. Twenty one countries, all Asian, participated in the meeting and signed the bill. Subsequently, more countries joined as founding members, all countries that join by March 31 2015 would be considered founding members. There are 31 members as of 17 March 2015 and these include European countries such as the UK, France, Germany and Italy who had earlier held off.[8]

The AIIB would also have an authorised capital of US$ 100 billion. But clearly the AIIB is making headway in attracting members in contrast to the NDB which has not yet attracted any new members. The Chinese who are contributing US$ 50 billion to the AIIB are obviously going to dominate it. The obvious point is that China seems more interested in the AIIB which is a Chinese initiative and is pushing to get countries to join. No similar push is being made to get countries to join the NDB. Countries may have come to the conclusion that the AIIB is a more serious endeavour.

Of course, the two may have separate spheres of operation. The AIIB is restricted to Asia. It may then be likely that the NDB will operate mainly in LA and SSA.

c) Demand for Loans

There is also a question of the demand for loans from the NDB. As noted above, the poorest countries borrow mainly from the soft arms of multilateral banks. Over the next decade many large Asian countries that borrow from IDA, namely India, Bangladesh, Vietnam, etc., would have graduated from IDA. The World Bank committed in FY 2014 to Bangladesh, India and Vietnam US$ 6.2 billion out of its total commitments of US$ 22.2 billion.[9] Consequently, even if the resources of IDA remain constant, by the time the NDB reaches a significant size considerably greater amounts would be available to poorer countries in other regions mainly Africa as SSA has almost half the 77 IDA eligible countries. There would be no need for these countries to borrow from the NDB unless a soft loan facility is established in the NDB. Of course, the funds available to IDA could be proportionately reduced in which case more funds would not be available to SSA. Funds available to IDA may not increase if some of the other options for use of IDA money are accepted. These are that IDA gives loans for poverty reduction purposes or to depressed areas even in middle income countries. Another option that has been suggested is that IDA lend for projects that provide global or regional public goods.[10]

Furthermore, the aim of the NDB is to lend for infrastructure development. As noted above, the AIIB has been set up for Asian countries. This implies that the clients of the NDB will largely consist of middle income countries in Latin America and in Africa. Here it could make a significant contribution as the Inter-American Development Bank disbursed US$ 2.5 billion, of which one billion was in soft loans and the African Development Bank disbursed US$ 3.2 billion, of which US$ 2.2 billion was soft aid. If the NDB is able to leverage its capital it could provide significant additional funding to these two regions.

The NDB can really contribute to development in middle income countries. While aid to low income countries was about 30 per cent of gross fixed capital formation (GFCF) during 2011-12, itself down from an earlier 40 per cent before the financial crisis and even 50 per cent in the 1990s, it was only about 3 per cent for the lower middle income countries and about 1 per cent for upper middle income countries. Of these limited amounts of aid that these middle income countries receive a decreasing portion is for infrastructure. The needs of these countries both for infrastructure and for reduction of poverty, which is now mainly

8 Australia and South Korea who had also refrained from becoming members at US insistence are expected to also become members soon.

9 See http://www.worldbank.org/ida/financing.html

10 For a discussion of these various options see Todd Moss and Benjamin Leo, IDA at 65 : Heading Towards Retirement or a Fresh Lease, Working Paper No. 246, March 2011, Center for Global Development, Washington D.C.

concentrated in these countries, are considerable. These countries can borrow from private capital markets. But long gestation infrastructure projects, whose return is in terms of higher overall economic activity, may not always be suitable for financing by private capital markets. The NDB can fill a lacuna in the current aid architecture to the extent that the interest rate on NDB loans is affordable. The World Bank can borrow at a much lower cost than individual developing countries and passes on the lower cost to its borrowers. It is to be seen what would be the borrowing cost of the NDB and whether this will be low enough for its loans to be attractive to middle income countries.

Another important issue is the purposes for which the NDB would make loans. It has been set up to provide loans for infrastructure development. However, loans for infrastructure development would only contribute to economic growth if they are accompanied by investments in sectors producing goods and services. Aid to goods producing sectors such as agriculture and industry have declined in relative importance.[11] The decline in agricultural loans is held responsible for the lower growth in Sub-Saharan Africa till the mid 1990s. It is also held to be responsible for the slow growth of agricultural output that contributed to the huge increase in food prices in 2007 and 2008. Also the manufacturing sector has been doing poorly in nearly all the regions of the world and its share in GDP has been declining. Consequently, the concentration of the NDB on only infrastructure may need to be re-visited.

d) Operating principles for the NDB

Developing countries have complained that the process of project approval at the World Bank is very time consuming and absorbs considerable amounts of scarce administrative resources. Furthermore, the World Bank attaches many conditions to the loans it grants. Developing countries have not imposed conditions on their activities under their cooperation programmes. Also they do not seem to take as much time or require as much administrative work. Many traditional donors have joined the AIIB; but they have expressed concerns about the quality of the projects and whether there would be as much concern about social effects of projects or ensuring transparency and honesty. If the NDB can maintain a high standard of project implementation without imposing conditions or following the practices of the World Bank, it will have made a significant contribution to improved project preparation and implementation procedures, and thus to the aid architecture.

Conclusions

The NDB will start slowly but has the potential to become an important source of finance, particularly for infrastructure development, which has been neglected, particularly by bilateral donors. Concentration on infrastructure development alone would be justified if it was the only constraint to growth of agriculture and industry. Otherwise, this exclusive concentration on financing infrastructure development may have to be rethought. The NDB can bring in new ways of preparing and implementing projects which get away from the heavy handed mode of operation of the World Bank which is claimed by developing countries. Finally, it is important that the BRICS countries seek to attract other countries to the NDB and start operations as soon as possible. Otherwise, an impression might gain ground that the AIIB is more likely to become operational and be a serious institution.

11 See http://www.oecd.org/dac/stats/data.htm

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