The New BRICS Institutions as Contestable Multilateralism

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Las Nuevas Instituciones del BRICS como Multilateralismo Disputable*

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Resumen

Dadas las externalidades de la oferta de financiamiento internacional para necesidades de balanza de pagos y de desarrollo, existen buenos argumentos para justificar la presencia de instituciones multilaterales que coordinen esta provisión. Sin embargo, imperfecciones en el diseño específico de estas instituciones —por ejemplo, la apropiación de rentas y la imposición de condicionalidad excesiva para incentivar la participación de países acreedores ( tradicionalmente del mundo industrializado) —, hacen que difícilmente se logre el óptimo social. El importante crecimiento económico de países emergentes ha significado que esta apropiación de rentas se torne “disputable” (en la terminología de Baumol), y por tanto es posible que la oferta de financiamiento multilateral se acerque más al óptimo social. Es en esta perspectiva que se puede entender el surgimiento de las nuevas instituciones de los BRICS, como el Fondo Contingente de Reservas.

The New BRICS Institutions as Contestable Multilateralism

Summary

Due to the existence of externalities in the supply of international financing for balance of payment support and development, there are good arguments to justify the presence of multilateral institutions that coordinate this provision. However, imperfections in the specific design of these institutions, for instance through rent appropriation and the imposition of excessive conditionality to incentivize the participation of creditor countries (traditionally advanced economies), hinder the achievement of the social optimum. The significant economic expansion of emerging markets has made this process of rent appropriation “contestable” (in the terminology of Baumol), and therefore it is possible that the supply of multilateral financing will approach further the social optimum. It is from this perspective that the appearance of the new BRICS institutions, such as the Contingent Reserve Arrangement, can be understood.

* Based on remarks prepared in Stephany Griffith-Jones’s presentation “El Nuevo Rol de China y el BRICS Bank en la Arquitectura Financiera Internacional”, on November 26th at Columbia Santiago – CIEPLAN. I am thankful to José De Gregorio and Yan Carrière-Swallow for comments on a previous draft.
In July 2014, the BRICS countries agreed to create a New Development Bank (NDB) and a Contingent Reserve Arrangement (CRA). This has raised a number of interesting questions regarding the future evolution of the international financial architecture. For instance, how active will these new institutions be? How different will their actual procedures such as conditionality and access, compared to international financial institutions (IFIs) such as the World Bank and the International Monetary Fund? Will the governance arrangements of the latter evolve due to “competition” from these new institutions? This note does not attempt to answer these specific questions, but rather puts them in a conceptual context that recognizes both the rationale of and need for multilateral action for the provision of global public goods, as well as the inevitable pitfalls in governance that such provision could entail.

I take as a starting point the theory of contestable markets, first advanced by Beaumol et al. (1982) for the purpose of assessing market structure and industrial organization, and later applied to the theory of international trade.

Contestable market theory posits that, as long as there are no barriers to entry, markets can remain both concentrated and competitive. Concentration does not create market power, as the threat of new entrants deters non-competitive behavior by incumbents, and thus achieves efficient market outcomes. Free trade can be an example of contestability at work, as domestic producers, even if they have a significant share of the market, cannot exert market power as the access to international trade determines—in principle—local pricing.

How does this apply to the multilateral sphere in international finance? It is clear that before the significant economic and financial growth of China (and to a lesser extent the growth of the other BRICS), the hurdles towards the creation of multilateral organizations similar to the Bretton Woods institutions were simply too high, both financially and organizationally. The creation of the NDB and CRA are witnesses that this is not the case anymore. However, the analogy needs to be explored in more depth, as it is also clear that the provision of multilateralism, through cooperative institutions that funnel resources for either development finance or balance of payment support, is not an intrinsically profitable endeavor.

**The case for multilateralism**

The existence of several imperfections or externalities has been pointed out as the rationale to justify a cooperative approach to international finance and development. These imperfections relate both to the ability of individual economies to implement socially productive investments, and to the existence of cross-border positive externalities (for instance in common trade areas, so as to foster maritime and land transportation infrastructure) that need to be internalized by supranational institutions. The former can be linked to the insufficient institutional development in less developed economies, and hence to

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the administrative and political inability of their governments to finance and develop socially profitable investment projects. The latter, due to the need to integrate less developed areas within the same economic zone.

The evolution of the agenda for development finance encapsulates the case for these initiatives. Post-WWII multilateral initiatives focused on reconstruction, economic convergence, and infrastructure, all areas where arguably there are positive externalities. The subsequent shift of development banks towards social sectors and sustainable development is also proof that the scope of externalities remains. More recently, in the case of currency unions and monetary policy constrained by the zero lower bound, fiscal policy can theoretically be a powerful tool for macroeconomic stabilization, with relevant cross border effects, but not necessarily internalized.

In terms of international finance, the strongest cases for multilateral action come from the innocent bystander problem, the inefficiency of competitive devaluations, and the high cost of self-insurance. The innocent bystander problem stems from an initial balance of payments crisis resulting from a deterioration of fundamentals and poor macroeconomic policy-making in one economy that then spills over to other economies, even if they do not suffer from the same misalignments. This non-fundamental contagion would therefore create “excessive” volatility in the recipient economy. The competitive devaluation situation results from political-economy incentives in countries that implement macroeconomic adjustment not through shifts in domestic spending directly, but by altering relative prices so as to shift foreign demand towards domestic goods. Finally, in the context of volatile capital flows and terms of trade, it makes sense to devise insurance mechanisms to prevent balance of payments tensions, of which self-insurance (via reserve accumulation) is one alterative, arguably a costly one.

The existence of these externalities can more succinctly be rationalized by the lack of spontaneous cooperative action in an environment of independent jurisdictions and sovereign states. Thus, to achieve an efficient outcome one can think of a multilateral approach. Given externalities in international development and finance, the provision of financing is inefficiently too low and too expensive (from the private standpoint). Multilateral institutions can boost the supply of funding for purposes of development or balance of payments stabilization, and thus aim to achieve a socially efficient outcome in the presence of externalities. A simple supply and demand diagram, the demand for funding and the supply of finance, along with the existence of externalities, helps to illustrate this point. (Figure 1)

**The costs of imperfect governance in multilateral organizations**

In practice, it is unclear how the appropriate structure for multilateral organizations should be to achieve socially efficient outcomes. On the one hand, multilateral arrangements between sovereign states are not bound by tough cross-country enforcement mechanisms (for good reasons), and the

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2 See Fay and Toman (2010).
3 The existence of a common lender across economies that is subject to liquidity constraints could be one example of non-fundamental contagion.
incentives at each country level to engage in multilateral agreements are low and politically costly. On the other hand, the creation of incentives for countries to participate in the multilateral provision of finance might end up skewing incentives and delegitimizing multilateral governance.

Figure 1 – Achieving socially efficient outcomes through multilateralism

Examples abound of these types of imperfections. The lack of progress in finalizing the 2010 Quota and Governance reform at the IMF, the political aversion in advanced and developing economies to deploy foreign aid, the perceived legitimacy deficit in the corporate governance structure of the Bretton Woods institutions, the apparent lack of evenhandedness in the treatment of specific country cases because of political reasons, are all circumstances that will curtail the achievement of a socially efficient outcome.4

The imposition of conditionality to access multilateral finance is also potentially subject to inefficiencies. Austerity programs could be ill-designed and depress the productivity of investment projects. Complex governance structures, such as the IMF-EU-ECB Troika, imply different layers of incentives and

4 Specifics on issues such as the role of the IMF as a trusted advisor, the governance of the IMF, conditionality, and the relationship with member countries, can be found in the completed evaluations by the Independent Evaluation Office of the IMF (www.ieo-imf.org). See also Sundaram (2011), and Reinventing Bretton Woods Committee (2009).
negotiation procedures, which could distort conditionality in favor of specific interests of creditor entities, and so on and so forth, potentially also depressing the demand for investment or finance.

Thus, inefficient multilateral entities might fail to achieve a socially efficient outcome, but they could go some way towards it. Figure 2 shows one example of this situation, where the imperfections in the operation of multilateral organizations both constrain the supply of multilateral funding and depress the productivity of projects.

**Figure 2 – The effect of imperfect multilateral institutions**

Still, the costs of imperfect multilateral organizations do not necessarily imply that they will lead to a socially inefficient outcome, as shown in Figure 3. Rather, they achieve a second-best outcome, better than the market equilibrium (with a welfare gain measured by the yellow area), but below the socially efficient outcome (the green triangle being unrealized welfare improvements).

Part of these costs can also be rationalized as rent seeking by the imperfect multilateral organization, for a number of reasons. For instance, the “laundry list” approach to conditionality, where bilateral issues are added to funding programs independently of their overall social benefit, and for the purpose of
incentivizing the participation of creditor countries. Some real-life examples of this situation arose during the Asian crisis, and arguably as well during some of the programs in the peripheral Eurozone.\(^5\)

Figure 3 – Assessing the costs of imperfect multilateral institutions

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\(^5\) The IMF has actually recognized some of these issues. See, for instance, the 2008 evaluation on conditionality by the Independent Evaluation Office of the IMF.
Making multilateralism contestable?

The creation of the NDB and the CRA prove that the hurdles for the creation of multilateral organizations have been overcome by large emerging economies. Rent seeking or appropriation of the surplus from imperfect multilateral organizations is now therefore contestable. A possible practical implication of this new contestability of multilateralism is that the second-best solution would approach the efficient outcome, and the overall welfare loss from imperfect multilateral organizations would be reduced. (Figure 4)

Figure 4 – The Impact of Contestable Multilateralism

The constitution of the NDB and the CRA is suggestive that some of these features may be at play. For instance, the CRA takes a cue from the Chiang Mai Initiative Multilateralization, whereby a fraction of its resources can be accessed without an ongoing IMF program. But, this delinking is not absolute, as the CRA treaty establishes that members have to in any case be compliant with some IMF obligations as stated in Article IV and Article VIII, pertaining to provision of information and surveillance of exchange.
arrangements. Moreover, the use of delinked resources is limited to six-month terms. As for access to resources, it is also noteworthy that the CRA remains denominated in US dollars, and in terms of governance, the treaty states explicitly that decisions will be taken by consensus, except those related to the review and modifications of the instruments, access, limits and multipliers, as well as the approval of new members.

It is interesting to compare the governance structure of the CRA in terms of its voting with the current and 2010 implicit voting power at the IMF, as measured by the pre-2010 Quota and Governance Reform (QGR) and the agreed voting shares implicit in that reform. The CRA establishes that the weighted voting power of its initial contributing members is evidently similar to the agreed upon voting structure in 2010, which has not been ratified yet. (Table 1)

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<tr>
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<th>IMF voting shares (1)</th>
<th>2014 CRA</th>
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<tbody>
<tr>
<td></td>
<td>Pre 2010 QGR</td>
<td>2010 QGR</td>
</tr>
<tr>
<td>China</td>
<td>0.35</td>
<td>0.43</td>
</tr>
<tr>
<td>Russia</td>
<td>0.22</td>
<td>0.18</td>
</tr>
<tr>
<td>India</td>
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<td>0.19</td>
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<tr>
<td>Brazil</td>
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<tr>
<td>South Africa</td>
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<td>0.04</td>
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Arguably, other developments in international finance also show the increased role of other institutions apart from the IMF in providing multilateral financing. One example is China’s Asia Asian Infrastructure Investment Bank. Another is the significant increase in currency swap agreements between the People’s Bank of China and a very diverse group of economies (Figure 5). Both show the potential role and magnitude of non-traditional IFI sources of financing.

Final remarks

Multilateral organizations will likely remain “second-best” solutions to the provision of public goods such as development finance and balance of payments support, given the difficulty of collective action between sovereign states, and the need to incentivize participation by creditor countries. This inherent inefficiency can be reduced by improving the contestability in the appropriation of the rents created by said incentives. Thus, the creation of new institutions needs to be welcomed, as it should help limit the imposition of inadequate conditionality by incumbent multilateral organizations, as well as promote the adoption of governance reforms that align current voting structures and leadership to changing global circumstances.

The relevant changes that have been occurring in some spheres of the IMF’s involvement reflect that contestability already has been at play. Some examples are the pragmatism displayed in the new views
of the Fund regarding capital account policies, which represent a significant shift from the nineties focus on liberalization, the importance of inclusive growth, policies taken on concessional financing and also frameworks for debt restructuring, among others, all show that the Fund is cognizant of the changes in the global economy. Whether the NDB and the CRA lead the Fund and other IFIs to continue advancing in that direction remains to be seen, but as Griffith-Jones (2014) indicates, they are likely to prove to be complements rather than substitutes to the current multilateral organizations.

Figure 5 – RMB/local currency swap lines outstanding (in USD billions)
References


