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The increasing role of emerging market economies in multilateral financing arrangements

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Background

The International Monetary Fund (IMF) and the World Bank were established at the end of the Second World War after a conference in Bretton Woods in New Hampshire in the United States. They are often referred to as the Bretton Woods Institutions (BWIs). Today, the membership of the institutions comprises 188 countries – almost all the countries of the world. They are truly global institutions.

Stalemate in implementing changes in the governance of the IMF is among the factors said to have motivated large emerging market economies to establish new multilateral institutions. Thus a brief background will be provided specifically on the IMF.

Structure and governance of the IMF

Since its inception, the IMF has been at the center of the international monetary system. It is a forum for collaboration among the member countries on economic and financial policies. It carries out its mission through surveillance of the global economy and the economic policies of the member countries, through financial assistance to countries in need, and through technical assistance to its members.

The IMF is a quota based institution, i.e. each member country makes a financial contribution to the IMF, called quota. A special quota formula is used to calculate each member country's calculated or theoretical quota. The formula is such that the quotas broadly reflect the relative economic role or position of members in the world economy.

Total IMF quotas are adjusted regularly through so-called quota reviews. Most often the reviews lead to increases in total quotas so as to permit the IMF to have sufficient financial resources to perform its role. Changes in the member countries' quotas in a quota review result not only from an application of the quota formula itself, but also from ad hoc and proportional adjustments which means that the distribution of quotas is not exactly as it were if they were distributed strictly on the basis of the formula.

The USA has the biggest quota, 17.69 percent of total quotas, while Tuvalu[2] has the smallest, 0.001 percent of the total. Each member country is assigned a share of the total voting power in the IMF broadly reflecting the relative size of its quota. Certain decisions, including

1 Senior adviser in the International Economy Unit of Norges Bank. A somewhat shorter version of the note was written at the end of the summer 2015 for a meeting of Nordic and Baltic officials. Anne Berit Christiansen, Morten Jonassen, Hans Petter Wilse, Halvor Hvideberg and Hege Eliassen made very helpful contributions to the note. Remaining errors are the responsibility of the author.

2 Tuvalu is a Polynesian island nation in the Pacific Ocean, midway between Hawaii and Australia.

amendments of the Articles of Agreement, require an 85 percent majority of the voting power to become effective. The USA alone has 16.75 percent of the total voting power which gives it effective veto power in key decisions. Quotas are also a reference for deciding the size of loans under financing arrangements with the IMF.

The highest decision making authority in the IMF is the Board of Governors where each member country is represented. A 24-member Executive Board takes care of the daily business of the IMF. Together, the 24 Executive Directors represent all 188 member countries. Large economies, such as the USA and China, have their own seat at the table, but most countries are grouped in constituencies representing four or more countries. The largest constituency includes 24 countries. Each Executive Director commands the combined votes of the member countries which he or she represents. The Nordic and Baltic countries together form a constituency in the IMF, represented on a rotating basis by a joint Executive Director.[3] Currently, the Nordic-Baltic Constituency has 3.4 percent of the total voting power in the IMF.

Global economic shifts and the 2010 reforms

In recent years, an important feature of global developments has been the rapidly growing relative economic size of emerging market economies. Not surprisingly, they have demanded that their increased share in the global economy should be reflected in the IMF (and the World Bank) through higher relative quotas and stronger representation. As an illustrative example, the calculated quota share of emerging market and developing countries (EMDCs) in the IMF has risen from 39.6 per cent of the total on 2008 to 48.7 per cent in 2015. This means that if IMF quotas were today based on the current formula, EMDCs would command a 48.6 percent voting share in the IMF rather than 39.6 percent.

Important changes were agreed in 2010, *the 2010 Reforms,* motivated *inter alia* by the need to recognize global economic shifts. These changes included a doubling of IMF quotas ("the 14th review of quotas"), a significant shift of relative quotas from advanced countries to emerging market economies, and a reduction in European advanced country Executive Directors by 2 in favor of emerging market representatives. Furthermore, a review of the quota formula itself was to be undertaken and completed by January 2013. The current formula was adopted in 2008.

The 2010 agreement was adopted by the IMF's Board of Governors before the end of that year. The final step is the formal ratification by the member countries. The agreement is such that none of the changes comes into effect until they all are ratified. The ratification requires an 85 percent majority of the total voting power in the IMF. This means that the agreement will not come into effect unless and until the US ratifies them through its legislative process. The expectation was that the 2010 Reforms would come into effect in the fall of 2012. However, the US Congress has so far not given its consent to the changes, and the reforms

[3] Executive Director in the period from January 2013 to January 2016 is Audun Grønn of Norway.

remain on an indefinite hold. The consequence is that the growing relative size of dynamic emerging market economies in the global economy is neither reflected in IMF quotas nor in their voting power in the IMF.

Initiatives of Emerging Market Economies (EMEs)

The brewing frustration among emerging market economies who feel that the cards are not equitably dealt in the Bretton Woods Institutions, combined with the inability of the United States to ratify the 2010 IMF reforms, are among the reasons behind the emergence of new multinational institutions and arrangements. In 2014, the BRICS[4] agreed to establish the Contingency Reserve Arrangement (CRA) and New Development Bank (NDB), while China took the initiative to establish the Asian Infrastructure Investment Bank (AIIB) as well as the Silk Road Infrastructure Fund. The purpose of the CRA is to provide short-term balance of payments support, potentially coordinate with the IMF, while the activities of NDB and the AIIB will resemble those of the World Bank.

The BRICS institutions

At their leaders' summit in 2014, the BRICS agreed to establish the NDB and the CRA, both with an initial capital of USD 100 billion. Membership in the NDB is open to all UN members, and the treaty on the CRA allows for the addition of new members. So far, however, membership in both the NDB and the CRA is limited to the BRICS countries.

On the website of the NDB[5] it is stated that it is a "multilateral development bank operated by the BRICS states […] as an alternative to the existing US-dominated World Bank and International Monetary Fund". The NDB shall mobilize resources for infrastructure and sustainable development projects in BRICS and other emerging and developing countries, complementing the efforts of other multilateral and regional financial institutions. The NDB formally opened in Shanghai on July 21, 2015, and is expected to begin operations in early 2016. It intends to cooperate closely with development banks in each of the member countries and specifically with the AIIB. According to the recently appointed President, "…the NDB will be different from other multilateral institutions like the World Bank and Asian Development Bank (ADB), […] it will have a different mindset that is required for the developing countries and it will be a lot more flexible in its operations. Its policy mindset will be driven by all stakeholders and not just the lenders".[6]

Initial subscribed capital in the NDB is USD 50 billion and initial authorized capital USD 100 billion, evenly distributed among the five founding members. Paid-in capital will be USD 10 billon.[7] The voting power of each member shall equal its subscribed shares in the capital stock of the Bank. The Headquarters are in Shanghai. The Agreement on the Bank states that no increase in the subscription of any member to the capital stock shall become effective

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[4] Brazil, Russia, India, China and South Africa.
[5] http://ndbbrics.org/agreement.html
[6] http://www.ndtv.com/india-news/brics-promoted-new-development-bank-to-start-operations-by-april-kv-kamath-775321. The President is K.V. Kamath, Indian national with a long experience from banks and international financial institutions.
[7] For comparison, indicators of size of selected institutions are shown in an appendix table.

which would have the effect of reducing the voting power of the founding members below 55 per cent of the total voting power; increasing the voting power of the non-borrowing member countries above 20 per cent of the total voting power; or increasing the voting power of a non-founding member country above 7 per cent of total voting power. Thus the founding members are secured a lasting dominant position in the Bank.

According to Article 1 of the treaty on the CRA, it "is a framework for the provision of support through liquidity and precautionary instruments in response to actual or potential short-term balance of payments pressures."[8] It is a form of swap arrangements between the central banks of the member countries. Drawings beyond 30 percent of maximum access require an on-track arrangement with the IMF. Completion of the ratification process of the CRA[9] was confirmed at the BRICS leaders' summit in July 2015.

The initial total committed resources of the CRA are USD 100 billion. China commits USD 41 billion, Brazil, Russia and India USD 18 billion each, and South Africa USD 5 billion. The countries shall be able to access resources subject to maximum access limits equal to a multiple of each country's individual commitment. China has a multiplier of 0.5, Brazil, Russia and India of 1, and South Africa a multiplier of 2.

Governance of the CRA is constituted by a Council of CRA Governors (the "Governing Council") and a Standing Committee. The Governing Council comprises one Governor and one Alternate Governor appointed by each country. Governors must be a Finance Minister, Central Bank Governor, or hold an equivalent post. The Governing Council shall take decisions by consensus and be responsible for high level and strategic decisions of the CRA.

The Standing Committee is responsible for the executive level and operational decisions of the CRA and comprises one Director and one Alternate Director appointed by each Party; these shall be appointed from central bank officials unless decided otherwise by the respective country.

The AIIB

In October 2014, China and 20 other Asian countries signed a Memorandum of Understanding on the establishment of a development bank to finance infrastructure investment in the region. The AIIB plans quickly gained great momentum and the Articles of Agreement list 58 countries, 17 European ones, which will be members of the Bank.[10] On its website the AIIB is said to be "conceived for the 21st century, built on the lessons of experience of existing multilateral development banks and the private sector. […] Its modus operandi will be lean, clean and green." [11] Its initial authorized capital is USD 100 billion, of

[8] http://brics6.itamaraty.gov.br/media2/press-releases/220-treaty-for-the-establishment-of-a-brics-contingent-reserve-arrangement-fortaleza-july-15
[9] http://brics6.itamaraty.gov.br/media2/press-releases/220-treaty-for-the-establishment-of-a-brics-contingent-reserve-arrangement-fortaleza-july-15
[10] Articles of Agreement of the Bank - http://www.aiibank.org/uploadfile/2015/0629/20150629094900288.pdf - complete list of members in the appendix
[11] http://www.aiibank.org/html/aboutus/AIIB/

which USD 20 billion will be paid-in. Subscribed capital to date is USD 98 billion. As of this writing, the articles of agreement of the AIIB had been signed by 51 countries. Denmark, Finland, Iceland, Norway and Sweden are among the founding members. All the BRICS are members. Notable by their absence are the US and Japan.

The AIIB is expected to commence operations before the end of 2015. Observers have pointed out that it will take time for the bank to get into full operation. It still remains to be decided who will be its clients, what will be its activities and on what terms it will lend, not to mention to assemble expert staff. Among projects financed by the AIIB are likely to be large infrastructure projects such as power plants, airports and seaports, filling a gap left by other institutions. Part of the reason for that gap is said to be that big projects have environmental and social aspects that have raised problems for other multilateral lenders.[12] At the same time, the AIIB is developing standards in these areas, as well as in overall governance, that are expected to be in line with best practice in international financial institutions. "Jin Liqun, the president-designate of the AIIB, said it would abide by the toughest environmental and social standards in its lending and model itself in many ways on existing multilateral development banks."[13]

Regional members contribute 75 percent of the capital of the AIIB. Among these, the largest contributor is China, followed by India, Russia, South Korea, Australia and Indonesia. Of the non-regional members, Germany, France, the UK and Brazil will contribute significant capital. Within these two groups the allocation is based on GDP.

Voting shares are allocated on the basis of capital shares, basic votes and founding member votes. China will have a 26.06 percent voting share (30.34 percent of the capital). This will give it effective veto power, as important decisions will require at least 75 percent of the votes[14]. Nine of the twelve directors on the Board of Directors will represent regional members.

The Articles of Agreement state among other things that the Bank shall be guided by sound banking principles in its operations. The Bank shall have a Board of Governors, a Board of Directors, a president, one or more Vice-Presidents, and such other officers and staff as may be considered necessary. Each member appoints a Governor and an Alternate Governor. The Board of Governors can delegate any or all powers, except specifically defined ones, to the Board of Directors

The Board of Directors shall be responsible for the direction of the general operations of the Bank and shall, exercise all the powers delegated to it by the Board of Governors. The Board

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[12] See for example: Mike Callaghan: *Beijing should hasten slowly on AIIB*, The Interpreter, July 1, 2015 - http://www.lowyinterpreter.org/post/2015/07/01/Beijing-should-hasten-slowly-on-AIIB.aspx
[13] Financial Times October 26, 2015: *AIIB head avows to be clean, lean and green – and fast* - http://www.ft.com/intl/cms/s/0/b6f95846-7b0d-11e5-a1fe-567b37f80b64.html#axzz3pehq2NDt
[14] Philippa Brant: *Four observations about the AIIB's Articles of Agreement*, The Interpreter, June 30, 2015 - http://www.lowyinterpreter.org/?COLLCC=3648763498&&page=2

of Directors shall meet as often as the business of the Bank may require, periodically throughout the year. The Board of Directors shall function on a non-resident basis.

The Board of Governors, through an open, transparent and merit-based process, shall elect a president of the Bank by a Super Majority (a Super Majority vote of the Board of Governors requires an affirmative vote of two-thirds of the total number of Governors, representing not less than three-fourths of the total voting power of the members). The President shall be Chairman of the Board of Directors but shall have no vote, except a deciding vote in case of an equal division. He may participate in meetings of the Board of Governors but shall not vote. A Chinese official has been selected as President-designate. European countries have actively participated in the preparatory work, contributing to an inclusive AIIB.

The principal office of the Bank shall be in Beijing.

The Silk Road Fund

In 2014, China announced its intention to establish a Silk Road Infrastructure Fund, pledging USD 40 billion to that purpose. "China's strategic goals behind the Silk Road Fund and other moves, as many analysts agree, are making more efficient use of its huge foreign-exchange reserves, facilitating the yuan's internationalization, exporting technologies, and deepening the economic and trade relationship with surrounding countries."[15]

"The AIIB is […] a critical element of China's "one belt, one road" strategy, which encompasses two initiatives, the overland Silk Road Economic Belt, connecting China to Europe, and the 21st Century Maritime Silk Road, linking China and South East Asia, the Middle East and Europe."[16]

The initiative calls for the integration of the targeted region, covering large parts of Asia, the Middle East and Eastern Europe, into a cohesive economic area through building infrastructure, increasing cultural exchanges, and broadening trade. The goal of the fund is said to be to "break the connectivity bottleneck" in Asia. The Silk Road Fund will apparently welcome investors from Asia and beyond to take part in the project. Details on the fund and how precisely it will work do not seem to be easily available. The governor of China's central bank has reportedly said that the fund has started work along the lines of a long-term private equity venture[17].

Changes in the global architecture and the role of China

The establishment of the NDB, the CRA and the AIIB reflects frustration among large EMEs with the slow pace of governance reforms in the IMF in particular, but also generally with Western dominance of established international financial institutions, including the regional

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[15] http://www.marketwatch.com/story/the-real-reason-behind-chinas-silk-road-fund-2014-11-10

[16] Andrew Sheng and Xiao Geng, *The AIIB and Global Governance*, Project Syndicate April 27, 2015 - http://www.project-syndicate.org/commentary/aiib-china-global-leadership-by-andrew-sheng-and-geng-xiao-2015-04

[17] Reuters, February 16, 2015 China's $40 billion Silk Road fund starts work along PE lines: central bank http://www.reuters.com/article/2015/02/16/us-china-silkroad-idUSKBN0LK03720150216

development banks. China has been the decisive driver of this development. Without its participation and leadership, little of significance would probably have happened. However, in isolation this can hardly be viewed as a radical shift in the global financial architecture. It will take time for the two new development banks to establish themselves and become fully operational and significant players in their fields. "The emergence of a new international financial architecture today is not likely to be accomplished by a single event. The establishment of the AIIB as a China-led international development bank may seem to be a momentous turning point from a US-dominated financial governance system. But it is only the latest event in more than a decade of increasing Chinese involvement in minilateral financial cooperation. […] Whatever change comes about with the new institutions is likely to be reformist rather than revolutionary."[18]

Nonetheless, these developments entail a move towards a somewhat more fragmented global system. The NDB and the AIIB will focus on infrastructure investments for which there is great need in many developing and emerging market countries. Their activities will more likely complement those of other institutions. "Given massive global demand for infrastructure finance […] the AIIB should not be considered a threat to the World Bank, the ADB, or other multilateral lenders. Nonetheless, it will compete with them, owing to its distinctive – and probably more efficient - approach to lending."[19] Thus, the new banks may provide healthy competition with the established ones owing to their planned distinctive – and probably more efficient – approach to lending. The AIIB can also be seen as reflecting the higher income level and capital availability in Asia, especially in China, and thereby the increased capacity to finance own investment needs, much the same way as Europe does through the European Investment Bank (EIB) and the and the European Bank for Reconstruction and Development (EBRD). Now it has also emerged that China has applied for membership in the EBRD[20].

The CRA represents an addition to the global financial safety net which in itself is welcome. But it is relatively modest in size, less than half the size of the Chiang Mai Initiative.[21] The link to IMF financial programs means that the IMF will be a key institution in the activities of the CRA. The CRA thus resembles existing Regional Financing Arrangements (RFAs)[22]. But "the global public good of financial stability risks being under-provided if it is reliant on regional solutions."[23]

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[18] Hongying Wang: *The Asian Infrastructure Investment Bank: A New Bretton Woods Moment? A Total Chinese Triumph?* CIGI Policy Brief No. 59, April 2015 - https://www.cigionline.org/sites/default/files/policy_brief_no_59.pdf

[19] Andrew Sheng and Xiao Geng: *The AIIB and Global Governance*, Project Syndicate April 27, 2015 - http://www.project-syndicate.org/commentary/aiib-china-global-leadership-by-andrew-sheng-and-geng-xiao-2015-04

[20] Financial Times October 25, 2015: *China applies to join EBRD to build ties with Europe* - http://www.ft.com/intl/cms/s/0/b34d5a78-7994-11e5-933d-efcdc3c11c89.html#axzz3pehq2NDt

[21] The Chiang Mai is a multilateral currency swap arrangement among Asian countries. It was launched in 2000. Its current size is USD 240 billion. The CMI has never been activated.

[22] In addition to the Chiang Mai Initiative, these include inter alia European crisis mechanisms, the Arab Monetary Fund (AMF) and Latin American Reserve Fund (FLAR).

[23] Andrew G. Haldane, Chief Economist, Bank of England: *Managing global finance as a system*; Maxwell Fry Annual Global Finance Lecture, Birmingham University, 29 October 2014. http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech772.pdf

China will preside over the G20 in 2016. A Lowy Institute paper[24] argues that China will likely pursue a combination of pragmatic and opportunistic approaches that do not reflect any overarching 'grand strategy' toward global economic governance. It argues that G20 has the potential to help China expand its role in global economic governance while retaining the fundamental building blocks of the current governance architecture. Moreover, China has a strong incentive to demonstrate its capacity as a 'safe pair of hands' when it comes to managing economic cooperation between the major economies. The authors conclude that one should not expect any dramatic break by China with existing institutions and processes, nor any immediate effort to supplant them with new governance structures. In the last two decades China has taken a pragmatic approach towards dealing with the Bretton Woods system, and this pragmatism is also reflected in China's approach to pushing for a reform of BWI governance. But the BWIs are no longer the only players in global economic governance. Despite the modest contribution of the BRICS process, the group is emblematic of the potential shift that a China-led process aimed at diversifying global economic governance may entail. China's increasingly important role in the global economy means that its support is critical to both the continued relevance of the BWIs and the future of initiatives like the BRICS ones, and thus to the overall design of the system.

In a 2014 CIGI paper, Alex He found that China had gained immensely from its participation in the G20.[25] According to him, the view of many Chinese scholars is that the country's critical weakness within the G20 summit process is its inability to shape the forum's agenda, and to craft a strategic framework for engaging with other G20 nations. The perception was that Western officials continued to hold monopoly power over how global policy challenges are framed and they usually possessed greater expertise and were better familiar with the rules and operation of global economic institutions.

Conclusion

The evolution of the global financial system has political and economic roots. The emergence of new institutions and arrangements is to be viewed in the light of the greatly increased relative economic strength of EMEs which has not been recognized to their satisfaction in the financial and governance structures of established institutions. The long delay in ratifying the 2010 IMF reforms is already leading to a more fragmented global financial system and safety net, as *inter alia* stated by Bank of England Deputy Governor Minouche Shafik in a speech on September 22, 2015: "Unfortunately, signs of fragmentation of the global financial safety net are obviously in part a reaction to the failure to implement the 2010 quota and governance reforms to bolster the IMF's resources and the representation of emerging market

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[24] Hugh Jorgensen and Daniela Strube: *China, the G20 and global economic governance*, Lowy Institute for International Policy, November 2014, http://www.lowyinstitute.org/files/china-g20-global-economic-governance_1.pdf

[25] Alex He: *China in the G20 Summitry: Review and Decision-Making Process*, CIGI Papers No. 46, October 2014 https://www.cigionline.org/sites/default/files/no.46.pdf

economies."[26] It remains to be seen how the new development banks interact with established multilateral development banks. China will wield very strong influence in shaping the priorities and practices of the AIIB and probably also the new BRICS institutions. Its ambitions are also exemplified in the Silk Road Fund. The noteworthy success in establishing the AIIB may be viewed as an important foreign policy milestone for China.

The emergence of China as a major economic power is the key element in the recent developments. China will no doubt seek to further increase its influence and shape developments to suit its ambitions and interests. Preferably China will see it in its own interest to play an increasingly active role also within the established multilateral institutions. For that to happen, it must be recognized as the economic power that it has become. By the same token, the importance of other EMEs must also be recognized. However, China's policies vis-à-vis multilateral institutions are likely to be decisive for the whole group. The coherence of the relatively heterogeneous BRICS group will probably determine its influence.

The IMF's role remains critically important. It is the key institution in the global financial safety net, as a provider of advice, analyses, and financial assistance, and as a forum for global collaboration. The new development banks will not compete with the IMF, and the CRA is but a small addition to the global financial safety net. Its establishment does not as such affect the IMF's relations with RFAs in general. A direct competitor with the IMF will not be easily established. However, without implementation of the 2010 Reforms, the IMF's legitimacy may become increasingly questioned. China has so far been a loyal and constructive participant in the IMF, but when and if it sees that its interests are better served in other settings, it may very well decide to pursue them. The success in establishing the AIIB will not deter.

[26] Minouche Shafik: *Fixing the global financial safety net: lessons from central banking*, September 22, 2015. http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech841.pdf

Appendix:

Asian Infrastructure Investment Bank (AIIB) - membership

"Regional":		*"Non-regional":*
Australia	Maldives	Austria
Azerbaijan	Mongolia	Brazil
Bangladesh	Myanmar	Denmark
Brunei	Nepal	Egypt
Cambodia	New Zealand	Finland
China	Oman	France
Georgia	Pakistan	Germany
India	Philippines	Iceland
Indonesia	Qatar	Italy
Iran	Russia	Luxembourg
Israel	Saudi Arabia	Malta
Jordan	Singapore	Netherlands
Kazakhstan	Sri Lanka	Norway
South Korea	Tajikistan	Poland
Kuwait	Thailand	Portugal
Kyrgyz Republic	Turkey	South Africa
Laos	UAE	Spain
Malaysia	Uzbekistan	Sweden
	Vietnam	Switzerland
		United Kingdom

Indicators of the "size" of selected institutions:

Subscribed capital:

Asian Infrastructure Investment Bank: USD 98 billion

New Development Bank: USD 50 billion

World Bank: USD 233 billion

Asian Development Bank: USD 103 billion

Inter-American Development Bank: USD 144 billion

European Bank for Reconstruction and Development: EUR 29.7

Total size of IMF quotas: SDR 238 billion = USD 336 billion