The New BRICS Institutions as Contestable Multilateralism[1]

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In July 2014, the BRICS countries agreed on the creation of a New Development Bank (NDB) and a Contingent Reserve Arrangement (CRA). The materialization of these new institutions has led some popular press to claim that they "will cut out Western Dominance," "will release Africa from World Bank tyranny," and "be a building block for a New World Order."[3] I believe it is useful to put the creation of these two institutions in a proper 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.

A valuable point of view to see these new institutions is the theory of contestable markets, first advanced by Beaumol et. al. (1982) for the purpose of assessing market structure and industrial organization, and also 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 is an example of contestability, 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 rest of the 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

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[1] Comments to Stephany Griffith-Jones' "El Nuevo Rol de China y el BRICS Bank en la Arquitectura Financiera Internacional," presented on November 26th at Columbia Santiago – CIEPLAN.

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[3] http://www.theguardian.com/commentisfree/2014/jul/17/brics-development-bank-africa-world-bank-tyranny, http://rt.com/business/173008-brics-bank-currency-pool/, http://www.huffingtonpost.com/parag-khanna/new-brics-bank_b_5600027.html

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

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.[4] 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 be in theory a powerful tool for macroeconomic stabilization.

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.[5] This non-fundamental contagion would therefore create “excessive” volatility in the recipient economy. The competitive devaluation situation results from political-economy incentives in economies 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.

These externalities require a multilateral approach to reach the efficient outcome. In a nutshell, if these externalities (in international development and finance) are large enough, the provision of financing is inefficiently too low and too expensive (from the private standpoint). Multilateral institutions in principle boost the supply of funding for purposes of development or balance of payments stabilization, and thus theoretically they achieve a socially efficient outcome. A simple supply and demand diagram, for instance illustrating the demand for funding and the supply of funding, along with the existence of externalities, helps to illustrate this point. (Figure 1)

The costs of imperfect governance in multilateral organizations

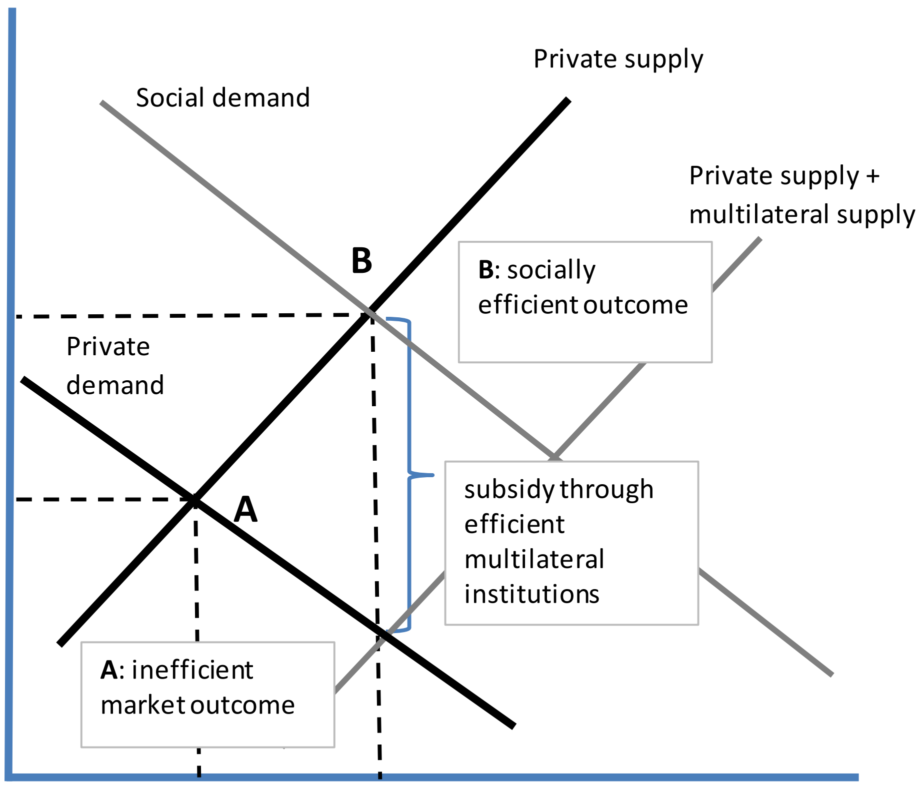
In practice, it is unclear how the appropriate structure for multilateral organizations should be so as to achieve socially efficient outcomes. On the one hand, multilateral arrangements between sovereign states are not bound by cross-country enforcement mechanisms (for good reasons), and the incentives

[4] See Fay and Toman (2010).

[5] The existence of a common lender across economies that is subject to liquidity constraints could be one example of non-fundamental contagion.

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

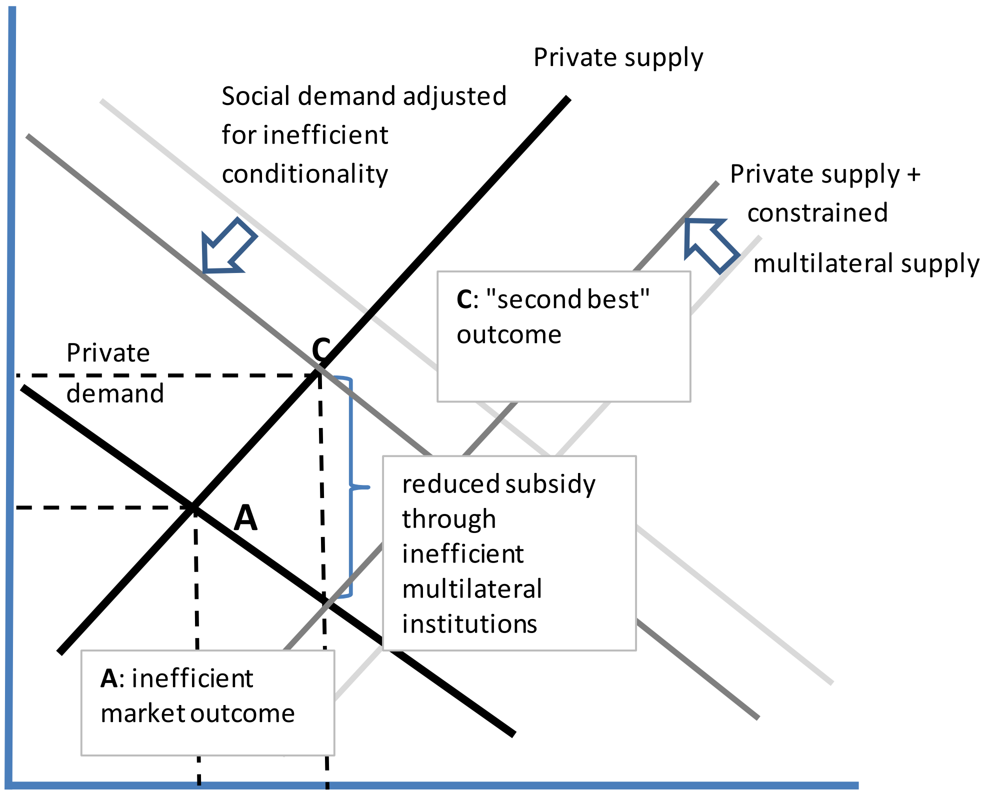


Examples abound of these types of imperfections. The lack of progress in finalizing the 2010 Quota and Governance reform, the political aversion in some advanced economies to deploy foreign aid, the perceived lack of legitimacy in the corporate governance structure of the Bretton Woods institutions,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

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 negotiation procedures, likely distorting conditionality in favor of specific interests of creditor entities, and so on and so forth, potentially also depressing the demand for investment or finance.

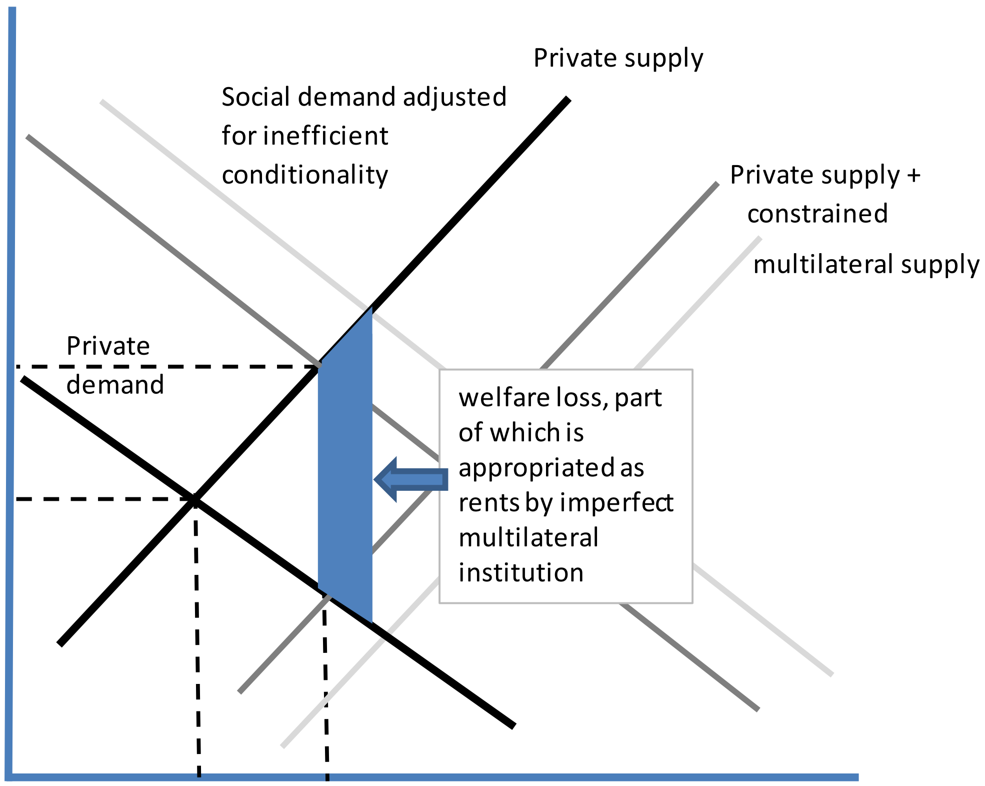
Thus, inefficient multilateral entities might fail to achieve a socially efficient outcome, but they could go some way towards it. Figure 2 shows one example of this situation, where the imperfections in the operation of multilateral organizations both constrain the supply of multilateral funding and also 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. Rather, they are likely to achieve a second-best outcome, better than the market equilibrium, but below the socially efficient outcome. Figure 3 shows the costs of inefficient multilateral organizations. 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.[6]

Figure 3 – Assessing the costs of imperfect multilateral institutions



Making multilateralism contestable?

The creation of the NDB and the CRA prove that the hurdles for the creation of multilateral organizations have been surpassed 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)

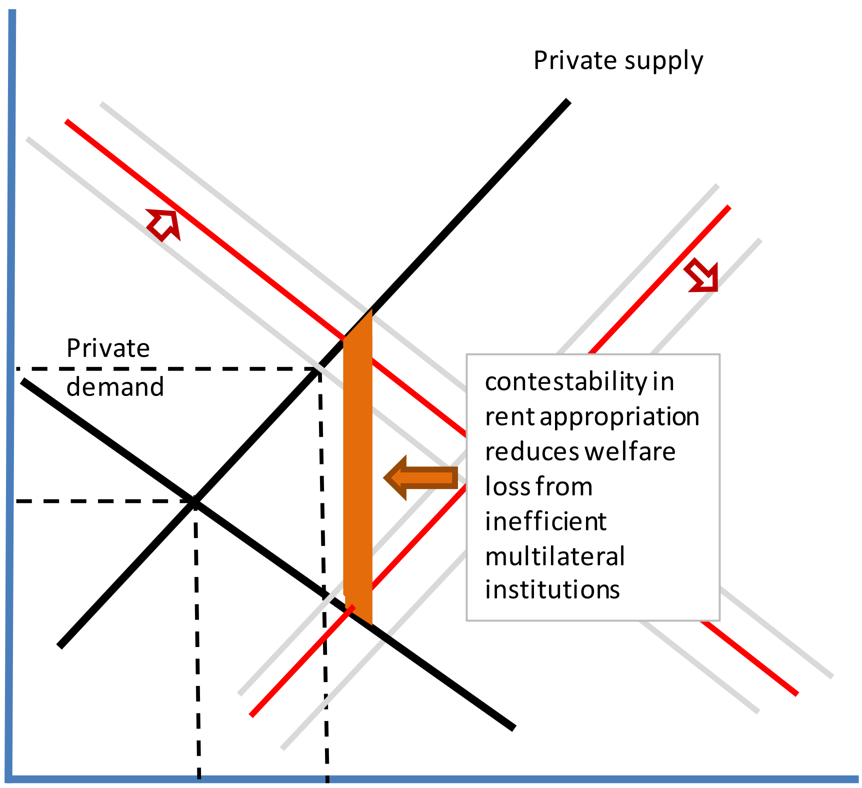
The constitution of the NDB and the CRA is suggestive that some of these features may be at play. For instance, the CRA takes a cue from the Chiang Mai Initiative Multilateralization, whereby a fraction of its resources can be accessed without an ongoing IMF program. But, this delinking is not absolute, as the CRA treaty establishes that members have to in any case be compliant with some IMF obligations as

[6] The IMF has in fact recognized some of these issues. See for instance Independent Evaluation Office (2008).

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. The CRA establishes that the weighted voting power of its initial contributing members will be 40% for China, 18.1% for India, Brazil and Russia, and 5.8% for South Africa. The equivalent distribution of voting power at the IMF board for these countries is 34.5, 15.6, 21.2, 21.7, and 7.0 percent in terms of current voting power and 42.9, 15.7, 21.2, 21.7, 4.5 percent in the yet to be implemented 2010 quota and governance reform. The similarities are evident.

Figure 4 – The Impact of Contestable Multilateralism



Final remarks

Multilateral organizations will remain "second-best" solutions to the provision of public goods, 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 rent appropriation through existing multilateral institutions. 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 incentivize the adoption of governance reforms that align current voting structures and leadership to changing global circumstances. Whether the NDB and the CRA move significantly in this 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.

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