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The Contingent Reserve Arrangement and the International Monetary System

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The BRICS countries established a new Development Bank and the Contingent Reserve Arrangement (CRA) at their sixth summit at Fortaleza, Brazil on 15 July 2014. This note examines the implications of the CRA both for the international monetary system and how far it meets the needs of the individual BRICS countries. It also looks at some of the important features of the current international monetary system and its shortcomings, in order to analyse the implications of the CRA for the system as a whole. In the second part of the analysis we examine the pattern of current account deficits of these countries and their reserve position in order to judge their likelihood of needing balance-of-payments (BOP) deficit financing.

A US 'Veto' in the International Monetary System

What is 'international money' and how is its supply controlled? Two other significant questions arise with regard to the international monetary system. First, what are the resources available to countries in need of BOP deficit financing and what are the mechanisms of adjustment when a country faces a BOP imbalance? Second, is the burden of adjustment on both, the surplus and deficit countries, or is there an asymmetry whereby deficit countries have to make the adjustment, as they would soon run out of the available resources for financing a BOP deficit whereas surplus countries may not be under any pressure to adjust?

Under the current system, international money consists of the quotas that countries have at the IMF and their stocks of convertible currencies, mainly US dollars. If there is no quota increase, a country can increase its reserves only by running a BOP surplus. If the surplus is with the US then the world supply of dollars would increase. If the surplus is with other countries, then the existing supply would be merely re-allocated. For the supply of dollars to increase for the whole world, the other countries as a whole must run a current account surplus, namely the US must run a current account deficit. This depends on US policies. IMF quotas are periodically reviewed and if the members agree, they can be increased. Any such

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increase requires an approval by members holding 85% of the votes. If the quotas are not increased, countries would have to increase their holdings of dollars as trade increases. This implies that countries are essentially extending a low interest loan to the US, which thus has a vested interest in preventing an increase in IMF quotas. Since the US has over 17% of the IMF's voting rights and a quota increase requires an 85% vote in favour, the US can block a quota increase. There is a moral hazard problem, as the US (that gains from quotas not increasing) can block any quota increase. The supply of international money is, therefore, beyond the control of almost any other country.

BOP deficit financing is of two kinds. One is private financing - countries running a deficit can borrow from private capital markets through bonds or from private commercial banks. Such financing is now readily available to many countries and definitely to the BRICS countries, to meet normal current account needs. But private financing dries up when a country faces a crisis. In fact, a crisis can be defined as a situation when private financing is not available. Countries have then to take recourse to official financing, namely borrowing from the IMF. In crisis situations when the amounts that a country needs to borrow may be multiples of what it is entitled to borrow from the Fund, special provision may need to be made. The Fund may need to activate special discretionary financing. Conditions for borrowing from the Fund may be quite severe and may consist of issues that may have nothing to do with the crisis. For instance, a major factor behind the East Asian crisis of 1997-98 was excessive borrowing by the private sector. Yet, one of the conditions being imposed on those countries at that time was privatization. In fact, recent crises raise the issue of moral hazard in a serious way. Crises have been caused by over-borrowing by the private sector, yet the conditions imposed by the Fund are on the public sector and not the private sector; this does not deter future over-borrowing by the private sector.

A consequence of IMF conditionalities has been that countries are reluctant to borrow from the Fund and have been building up their reserves as a precautionary measure. This has created an additional problem in the working of the international monetary system. Reserve accumulation by poor countries implies lending by poor countries to the much richer US which is a misallocation of resources. This also reduces the incentive for the US to change the system.

Since the amount of BOP financing is limited, deficit countries are under pressure to adjust and bring their accounts into balance. There is no similar pressure on surplus countries. The only limit on reserve accumulation of surplus countries is that reserve accumulation leads to a higher money supply and may raise the rate of inflation. So long as the surplus countries are able to contain inflation they are under no pressure to adjust. Such an asymmetric burden of adjustment is contrary to the original Keynes proposal that required both deficit and surplus countries to take adjustment measures. There is also an asymmetry between the US and the other countries. If other countries run a deficit they have to adjust, as they would otherwise run out of reserves. If the US runs a deficit it need not adjust, as other countries would willingly hold the dollars it supplies, since dollars are international money.

Prospects for the CRA

Will the CRA usher in a new architecture in the international monetary system? No new international money is created by the BRICS. Presumably the loans to countries requiring BOP deficit financing will be in convertible currencies, mainly the dollar, and will be repaid in those currencies. Since no new international money is created, the BRICS countries will have no control over the supply of international money. This also implies that though an additional source of BOP financing is now available, the burden of adjustment will remain on the deficit countries. Surplus countries will be under no pressure to adjust.

The major difference the CRA will make is that additional BOP deficit financing will be available. But the amounts that will be available to the BRICS countries are very small particularly if they do not have an IMF programme. Without an IMF programme, China would be able to borrow US$6 billion and South Africa US$3 billion while the other countries would be able to borrow US$5 billion. The current account deficits that Brazil, India and South Africa are currently running are much larger. With an IMF programme, which means that the BRICS countries agree with the appropriateness of IMF policy recommendations, the additional amounts that could be borrowed would be about US$7 billion for South Africa and US$13 billion for Brazil, India or Russia. This should be compared to the IMF-approved lending to Russia of US$38 billion (SDR 24.786 billion) in the 1990s. In 2002 alone, the IMF approved a standby programme for Brazil of US$30 billion. Similar rules apply to the Multilateralized Chiang Mai Initiative (MCMI) in East Asia. Nobody has as yet borrowed under it. South Korea preferred to activate its bilateral swap programme with the federal reserve of the US at the time of the 2008 crisis rather than borrow under the MCMI.

The CRA would not as yet make a substantial difference to the international monetary system nor would it make a difference to the amounts that would be available to the BRICS countries to meet any BOP crisis. But it is a small beginning to break the monopoly of the Bretton Woods institutions. It is certainly a signal that the developed countries should be more serious about reforms in these institutions. However, the developed countries are unlikely to be so inclined, unless they are convinced that the BRICS or other groups of developing countries are mounting a serious challenge to the hegemony of the World Bank and the International Monetary Fund.

Some Unanswered Questions

What could the future goals for this BRICS initiative be? Any longer term goal has to transcend the needs of the five partners in the BRICS. It could be to provide developing countries with alternatives or it could be to bring about an internationalisation of the renmimbi; of course, the latter does not preclude the former. Though Chinese policymakers have started the process of internationalising their currency and make no secret that such is their goal, it is still a long way off and would require adoption of capital account convertibility and a vibrant, large and flexible capital market in China. Since it will take considerable time to develop such a capital market with all the necessary institutional features, we concentrate on exploring the consequences, if the objective of the CRA is to provide developing countries with alternatives.

Reaching the goal of providing developing countries with alternatives will require several steps. First, membership would have to be opened up to all developing countries. Their rights and obligations would have to be codified. Would the members have to subscribe and would their subscription determine the amount they can borrow from the CRA or would the amount they can borrow be independent of their subscription? How would their voting power be determined – will the CRA adopt the UN principle of one country, one vote? The latter runs the risk of the BRICS losing their hold over the institution. When the developed countries have lost control of UN organisations such as UNESCO or FAO they have regained it by not providing the money for running these organisations.

Also, the BRICS have agreed on a rotation of the headship of the BRICS Development Bank amongst themselves. So the headship is determined for 25 years. But if other developing countries are admitted they might object to such a reservation as developing countries currently do about the selection of the heads of the World Bank and the IMF.

Apart from governance issues, a number of operational issues will have to be tackled as they had to be at the IMF during its initial years. Apart from the amounts and the accompanying terms of credit, the conditions if any that would be attached to the credit would have to be determined. The question of whether there will be regular reviews of the economic situation in the member countries and related issues would have to be resolved. The primary issue will be that of the ensuring that any country facing a deficit and that approaches the CRA for a loan, follows policies that will ensure that the deficit will be reduced to manageable terms. If the conditions are similar to those imposed by the IMF there would be no incentive for developing countries to borrow from the CRA. In essence, the CRA could evolve into another IMF without perhaps the developed countries. It is obvious that such a development could take several years but the CRA has the advantage of learning from the IMF's experiences.

Meanwhile, what are the implications for India and for Sino-Indian relations? Here, relations between the US and the UK during the establishment of the IMF are instructive. The UK had been the premier economic power before being replaced by the US. Furthermore, the US wanted to ensure that the structure of the post-War system would solidify its power. It sought to ensure the dismemberment of the system of Imperial Preferences and that of the Sterling bloc. There is no such situation of China seeking to replace India and ensure that its top position is solidified. Furthermore, the US and the UK despite their rivalry had a long history of cooperation that is lacking in the Sino-Indian case.

What the exact mix of cooperation and competition between India will be is difficult to predict. But India is undoubtedly economically much weaker than China is and not in a position to challenge it. Chinese wishes are therefore likely to win the day unless India is able to develop more cogent and credible arguments for whatever proposals it may put forward at the BRICS Bank and the CRA. It might also be the case that the other BRICS countries may also not want China to become too dominant. There was no such counterweight to the US at the end of the Second World War.

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