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## **ADB Working Paper Series**

### **Whither Multilateral Development Finance?**

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**Abstract**

Multilateral development finance is at a critical juncture. In the past 70 years, it has developed through four distinct stages. The Bretton Woods conference established the World Bank and the International Monetary Fund in 1944 to finance post-war reconstruction and stabilize the global economy. The second stage saw the establishment of regional development banks in the 1950s and 1960s. This was followed by the emergence of subregional banks. In the fourth stage, from the mid-1970s to the 2000s, specialized vertical funds were established to address global issues, and private development finance expanded. The multilateral financial architecture now has a multitude of development banks and funds. As the architecture enters the next stage, the development agenda is changing rapidly. Financially constrained traditional donors are unwilling to recapitalize the existing banks, while emerging donors want to reduce the role of traditional donors and increase their own funding. Emerging-economy bilateral programs are expanding. At the same time, new multilateral initiatives are advancing fast. The BRICS countries' New Development Bank and related contingent reserve and the PRC's Asian Infrastructure Investment Bank initiative have added to the pressure for reform, and to the risk of fragmentation. An alternative financial architecture may take shape led by emerging economies, playing down coordination and well-established development, safeguard, and governance criteria. However, there is also an opportunity for genuine reform to ensure a new and innovative multilateral architecture.

**JEL Classification:** F33, F34, F35, O19.

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# 1. INTRODUCTION

July 2014 marked the 70th anniversary of the establishment of modern-day multilateral development finance. The United Nations Monetary and Financial Conference, commonly known as the Bretton Woods conference, was held on 1–22 July 1944 at the Mount Washington Hotel in Bretton Woods, New Hampshire, in the United States (US). The conference agreed on the establishment of the International Bank for Reconstruction and Development (IBRD), which has evolved into the five institutions that make up the World Bank Group, and the International Monetary Fund (IMF).<sup>1</sup> The two institutions were intended to finance reconstruction of countries devastated by the Second World War and stabilize the world economy, and became operational in 1945. As the reconstruction of Europe and Japan neared completion, in the 1950s the institutions shifted their focus to developing countries.

In the past 70 years, multilateral development finance has evolved dramatically. From the initial two institutions the world now has a multitude of development banks and funds. These include what are commonly known as the multilateral development banks (MDBs), a variety of subregional banks and funds, and several specialized vertical funds.<sup>2</sup> Large private foundations with a development focus have also recently emerged. The current combined capitalization of the MDBs and smaller development banks is about \$1.1 trillion, nearly nine times the current value of the original \$10 billion capital base of the IBRD.<sup>3</sup>

The global environment in which the banks and funds operate has also changed beyond recognition. The IBRD and IMF were established in the context of post-war devastation, economic instability, and an intense scarcity of capital. In many developing countries, capital scarcity prevailed into the 1980s or beyond. Initially the MDBs, which were backed mainly by western funding, were needed simply to respond to the demand for investment by helping to channel funds from capital-rich to capital-poor countries.

This situation has now been turned on its head. Traditional donors face financial constraints and are unwilling to consider recapitalizing the MDBs. Public financial flows from emerging donors, in particular the People's Republic of China (PRC), are growing fast. Emerging donors are willing to recapitalize the MDBs, and have floated several proposals for new financial institutions. The proposal by Brazil, the Russian Federation, India, the PRC, and South Africa (BRICS) for a New Development Bank (NDB) and contingent reserve and the PRC's proposal for an Asian Infrastructure Investment Bank (AIIB) are advancing rapidly. At present, private investment in infrastructure far outweighs the lending of the MDBs. With the exception of economic and financial crises, in most countries the MDBs play an increasingly marginal role.

The multilateral development finance architecture has evolved in four distinct stages. A fifth is currently taking shape, which promises major change. On the one hand, there is concern that the multilateral architecture could fragment, with competing centers emerging that do not work

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<sup>1</sup> The World Bank Group consists of the IBRD, the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency, and the International Centre for the Settlement of Investment Disputes.

<sup>2</sup> The MDBs are generally defined as including the World Bank Group and the five regional banks: the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, European Investment Bank, and Inter-American Development Bank.

<sup>3</sup> The IBRD's original capital was equivalent to about \$133 billion in 2013 terms. Capitalization figures indicate the multilateral banks' capacity to raise capital on financial markets and to lend. However, they do not capture the large concessional and grant funds channeled through the banks.

closely together. There is a possibility that expanding development finance driven by emerging economies will play down coordination and well-established economic, development, environmental, social, and governance criteria. On the other hand, there is an opportunity for genuine reform. What challenges will multilateral finance face in the future? What are the implications of the establishment of new financial institutions for the existing MDBs? And how are these changes likely to impact the future development of the financial architecture? The ongoing changes need to be viewed in the context of the banks' histories.

## **2. THE BRETTON WOODS BASELINE**

The World Bank and IMF were established by 44 countries led by the allied powers. This was reflected in their initial governance structures, which were dominated by the Western allies. The US accounted for a third of the votes in each institution, and, together with the United Kingdom (UK), the Soviet Union, France, and European allies, for over two thirds. As the World Bank expanded to its current membership of 188 countries, voting rights were adjusted. However, even with the most recent adjustment in 2010, France, Germany, Japan, the UK, and the US have 37% of the votes, and the borrowing countries 34%. Viewed in terms of income level, high-income countries have nearly 61% and middle- and low-income countries 39%. The founders also reached an informal agreement that the president of the World Bank would come from the US and the managing director of the IMF from Europe, which, despite pressure for change from developing countries, has held for 70 years.

The World Bank has served as the model and benchmark for the other multilateral banks. At the same time, its skewed power structure and many of the policies that emerged to guide its operations, and those of the IMF, have pitted the Bretton Woods institutions against developing countries and provided an incentive for the latter to establish alternative development banks. The World Bank's initial Keynesianism was reflected in fiscal liberalism, policy prescription, and a focus on physical infrastructure. The abandoning of the gold standard in the early 1970s and the signing of the Plaza Accord in 1985 were followed by the emergence of the Washington consensus, a set of broad policies supported by the World Bank, the IMF, and the US Treasury Department (Williamson 2004). Structural adjustment lending was a key tool of the Washington consensus. The one-size-fits-all conditionality played down the social costs of adjustment, fuelling debate and criticism (Cornia, Jolly, and Stewart 1987). It also strengthened the position of other development banks as an alternative source of finance.

## **3. REGIONAL EXPANSION**

By the late 1950s it was clear that the World Bank alone was insufficient to meet the financing needs of the developing world. There was growing discontent among developing countries with the World Bank for concentrating its lending on Asia, in particular India and Pakistan, and with its relatively uniform policy prescription.

At the same time, developing countries were finding their own voice. The first large-scale Asian and African conference was held in Bandung, Indonesia in 1955. It condemned colonialism and approved a declaration on the promotion of world peace and cooperation, which endorsed respect for the sovereignty and territorial integrity of nations, and abstention from intervention or interference in the internal affairs of another country. The Bandung Conference led to the establishment of the Non-Aligned Movement in 1961 and provided an important backdrop for the emergence of regional banks in Africa and Asia.

The first regional financial institutions, however, were set up in Europe and Latin America. The European Investment Bank (EIB) was established in 1958 under the Treaty of Rome, to support European integration. It now also finances infrastructure investments in prospective European Union member countries and developing countries. The EIB has expanded to become the largest of the MDBs, with a capital base and lending that surpass the World Bank.

The Inter-American Development Bank (IDB) was the first regional development bank, established in 1959. It took shape in the context of strong Latin American regionalism, in particular the Organization of American States, and firm ties between the US and Latin America. The founders drew heavily on the model of the World Bank (White 1970: 140–150). At the same time, the Latin American countries were dissatisfied with the prescriptive approach of the World Bank, which downplayed national development strategies, and the fact that the World Bank did not at the time lend for social sectors, and wanted a bank more in tune with their own priorities. Initially, the World Bank's president, Eugene Black, was openly hostile to the establishment of the IDB, although he subsequently moderated his views and served as an advisor on the establishment of an Asian regional bank (White 1970:144–145; Watanabe 1977: 9).

The establishment of the African Development Bank (AfDB) in 1964 was burdened by the continent's colonial history. The two principal former colonial powers, France and the UK, were unable to agree on supporting the bank, and without their support the US was unwilling to take a lead role. As a result the AfDB was established with no participation from developed countries and a small capital base. It got off to a slow start and had initial difficulty defining its role in the context of large post-colonial bilateral aid programs in the continent (White 1970: 91–110). In 1972 the concessional African Development Fund was set up with the participation of major donors, and in 1982 the membership in the AfDB was opened to developed economies, which significantly expanded its capital base.

The Asian Development Bank (ADB) was established in 1966 and benefitted from the experience gained in establishing the other regional banks (Watanabe 1977: 1–14). ADB had the strong support of two key donors, the US and Japan. In the negotiations on establishing ADB, it was agreed that the president would come from Japan and the headquarters would be located in the Philippines, a strategic ally and former colony of the US. Given ADB's modest resource base compared with the World Bank, it was initially agreed that India, whose vast financial needs would have overwhelmed ADB, would continue to borrow only from the World Bank. India and the PRC, which joined ADB only in 1986, started to borrow only in the late 1980s.

The regional banks differed from the World Bank in several key respects. Their governance structures gave the regional countries a much stronger voice. The charters of the African and Asian banks limit non-regional shareholding and voting rights to 40%. In ADB, which initially had three regional donors (Australia, Japan, and New Zealand), borrowers currently have 38.3% of the votes. In the IDB the Latin American countries have slightly over half the votes, to ensure them a majority, and the non-Latin American countries slightly less than half. The regional banks expanded lending to countries and sectors inadequately covered by the World Bank, and focused on project and sector investments rather than policy-based lending.

## **4. SUBREGIONAL EXPANSION**

The regional expansion, however, was insufficient to meet all financial needs, and numerous subregional banks emerged. The Caribbean Development Bank was established in 1969 and is specialized in the needs of small island countries. The Andean Development Corporation (Corporacion Andina de Fomento, CAF), funded by 16 Latin American countries, Portugal and



Spain, was established in 1970 and currently has a capital base of \$10 billion. Due to high leveraging and a focus on revenue-generating investments, its lending now exceeds that of the World Bank in Latin America. Under the leadership of Saudi Arabia, the Islamic Development Bank was founded in 1973 to provide development finance for the Islamic world.

A number of smaller subregional banks were also set up in Africa and Central America.<sup>4</sup> The five Nordic countries established their own investment bank in 1976 and in 2005 expanded its membership to include the three newly independent Baltic countries. The Nordic Investment Bank has a capital base of €6.1 billion, and an affiliated fund for climate change investments in developing countries. The Black Sea Trade and Development Bank was established in 1997 by the Russian Federation and 10 other littoral countries, and in 2006 the Russian Federation, Belarus, Kazakhstan, and three other central Asian countries agreed on the establishment of the Eurasian Development Bank.

The subregional banks address specific project and investment needs and play a significant role in their respective subregions. However, with limited capitalization, they remain globally modest players. Many rely on cooperation and joint financing with the large MDBs, and often also rely on their larger partners to conduct due diligence and project preparation. The capitalization of the MDBs and subregional banks is set out in Table 1.

**Table 1: Subscribed Capital and Lending of the Multilateral Banks**

<b>Development Bank</b>	<b>Subscribed Capital in 2013 (\$ billion)</b>	<b>Lending in 2012<sup>a</sup> (\$ billion)</b>
African Development Bank	100.3	5.0
Andean Development Corporation	10.0	9.3
Asian Development Bank	165.0	13.3
European Bank for Reconstruction and Development	27.2	12.1
European Investment Bank	329.1	70.7
Inter-American Development Bank	171.0	11.1
Islamic Development Bank	23.1	9.8
World Bank	276.0	33.5
Others <sup>b</sup>	20.7	6.7
<b>Total</b>	<b>1122.4</b>	<b>171.5</b>

<sup>a</sup> Figures for the World Bank are for its fiscal year 2012–2013. All other figures are for calendar 2012. Euros (for the EBRD, EIB, and Nordic Investment Bank) have been converted to US dollars at a rate of 1.36; Islamic dinars, which are equivalent to IMF special drawing rights (for the Islamic Development Bank) at 1.538; and FCA francs (for the West African Development Bank) at 655.957.

<sup>b</sup> This includes the Black Sea Trade and Development Bank (with capital of \$3.5 billion), Caribbean Development Bank (\$1.5 billion), Central American Bank for Economic Integration (\$2.1 billion), East African Development Bank (\$0.2 billion), Eastern and Central African Trade and Development Bank (\$2.0 billion), Eurasian Development Bank (\$1.5 billion), Nordic Investment Bank (\$8.4 billion), and West African Development Bank (\$1.5 billion).

Source: Respective bank websites (accessed on 27 December 2013).

## 5. VERTICAL SPECIALIZATION

The growing number of global issues that needed to be addressed across national boundaries highlighted weaknesses in the predominantly country-driven approach of the MDBs and led to the fourth stage, the establishment of vertical funds for specific issues. The stage was also

<sup>4</sup> The Central American Bank for Economic Integration was established in 1960, the East African Development Bank in 1967, the West African Development Bank, serving French and Portuguese speaking countries, in 1973, and the Eastern and Southern African Trade and Development Bank in 1985. All are small, with capitalization of about \$2 billion or less.

marked by a rapid expansion in small specialized trust funds administered for the donors by the MDBs, and private development funds.

The first issue to require focused action was global food security, sparked by the sub-Saharan food crisis of the early 1970s. The crisis led to the convening of the World Food Conference in 1974 and the establishment of the International Fund for Agricultural Development (IFAD) in 1977. The IFAD was intended to reduce food insecurity by investing in food production and addressing rural poverty. Reflecting the abundance of oil money in the 1970s and a concern to reduce the role of the Western donors, its initial voting rights were divided equally among three groups, the Organisation for Economic Co-operation and Development (OECD) countries, the Organization of the Petroleum Exporting Countries (OPEC) countries, and developing countries.<sup>5</sup>

This was followed by the collapse of the Soviet Union, which led to the establishment of the European Bank for Reconstruction and Development (EBRD) in 1991 to support the transition of Central and Eastern European countries to a market economy. The EBRD has a specific regional mandate, but is also vertically specialized. Following its initial role in facilitating economic transition, it remains focused on private sector development.

Other issue-driven vertical funds include the Global Environment Facility (GEF), founded in 1991 and administered under the World Bank, and the Global Fund to Fight AIDS, Tuberculosis and Malaria, established in 2002. The Global Fund has its own governance structures, and raises funds through a wide range of public and private partnerships.

The fourth stage also witnessed the growth of private development funds. The largest is the Bill and Melinda Gates Foundation, which was founded in 1994 and concentrates on healthcare and poverty reduction. In addition to the Gates family, it is supported by the investor Warren Buffett. In contrast to the MDBs' country-focused approach, the Gates Foundation is issues and results driven. For example, in a drive to prevent infectious diseases, including AIDS, polio, and malaria, it has focused its investment on vaccines. In 2013 the Gates Foundation had an endowment of \$38.3 billion, and in 2011 its grant expenditure reached \$4.4 billion. It is a major contributor to the Global Fund, and in the health sector has become a significant global player.

## 6. A PLETHORA OF INSTITUTIONS

Compared with the initial Bretton Woods framework, the multilateral institutional setting has changed dramatically. Johannes Linn, former World Bank vice president, observes that "the multilateral assistance architecture, previously dominated by the MDBs, is now a maze of multilateral development agencies, with a slew of subregional development banks, some exceeding the traditional MDBs in size" (Linn 2013). The large number of financial institutions has expanded the financial coverage of countries, sectors, and issues. A complex network of partnership and joint financing arrangements has emerged among the banks and funds. The varying mandates, legal requirements and financing procedures have also strained overstretched borrower governments. Inevitably, inefficiency, ineffectiveness, and overlap have increased.<sup>6</sup>

The plethora of financial institutions has highlighted the importance of donor coordination. It contributed to the pressure for the establishment of the Paris, Accra, and Busan coordination

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<sup>5</sup> Voting rights in IFAD have subsequently been adjusted to take into consideration donors' participation in funding replenishments.

<sup>6</sup> For a discussion of weak coordination among development banks in Latin America, see Prada (2012).

arrangements (OECD 2005, 2008, 2011). It has also put the question of competition in a new light. There is a strong case for having competing sources of development financing, to provide comprehensive coverage, develop specialized knowledge, and foster innovation and alternative approaches (Wihtol 2013). However, it is important to distinguish between providing competing financing within a coordinated framework and outside such a framework. The expansion of alternative financing, bilateral or multilateral, that is not discussed or coordinated with other donors or financiers risks undermining coordination efforts, including increasing transaction costs for other donors. It also risks playing down accumulated development experience and can offer borrowers a convenient means to sidestep due diligence, or the application of best practices to address environmental, social, governance, and integrity issues.

The emerging multilateral architecture includes both institutions that operate firmly within established coordination arrangements and ones that do not. The role of banks that are not an integral part of coordination arrangements is growing. The annual lending of the CAF is currently on a par with that of the IDB, the PRC's lending in Africa through the China Development Bank (CDB) exceeds that of the World Bank, and the Brazilian Development Bank's lending in Latin America surpasses that of the World Bank and IDB. Going forward, a key question will be to what degree these emerging institutions, and the AIIB and BRICS bank when they are established, coordinate with others. There are already clear signs that coordination is weakening and the financial architecture fragmenting.

## **7. THE BACKDROP FOR CHANGE**

The economic backdrop for the fifth stage of multilateral development finance has also changed dramatically. The 2008–2009 global financial crisis, stagnating growth in Europe following the crisis, and sluggish economic recoveries in Japan and the US have set the stage for deep-felt donor fatigue. Traditional donors are financially constrained and are concerned with conserving their resources rather than expanding their bilateral programs or recapitalizing the MDBs. Economic power has shifted significantly to new growth centers. Emerging donors, mainly the PRC, the other BRICS countries and several other emerging economies, are expanding their bilateral assistance and engagement in multilateral finance. The PRC's growth is tapering but remains strong, and is projected to remain in the 7%–8% range in coming years, which will provide it with ample fiscal space to expand its bilateral and multilateral funding.

The tasks and mandates of the banks have also changed. The IBRD was set up for post-war reconstruction, and the MDBs initially focused on physical infrastructure. This was followed by a growing focus on agriculture, poverty eradication, and social investments. The World Bank shifted to rural development in the mid-1970s and structural adjustment in the 1980s. In response to criticism of its adjustment lending, it subsequently increased social sector lending. The 1990s saw a stronger focus on country-driven strategies in the World Bank and regional banks. The establishment of vertical funds marked a shift to a more issues-driven approach. The Millennium Development Goals established by the UN in 2000 provided specific targets in poverty reduction, health, and education.

What future challenges will multilateral finance need to address? Poverty will remain a challenge, but as more low-income countries transition to middle-income status, poverty reduction programs are likely to become more targeted. Nancy Birdsall, president of the Center for Global Development, sees a world in 2030 in which the focus of external assistance has shifted from poverty eradication to increasing median consumption in developing countries. The focus will be on narrowing the divide between the economically insecure and the secure middle class, and will be addressed through borrowing rather than traditional official development

assistance (ODA) (Birdsall 2013). The growing number of middle-income countries will bring new challenges. Rapid urbanization will entail enormous infrastructure investments.<sup>7</sup> Avoiding the middle-income trap, again, will require education and human resource investments, and rapidly urbanizing and aging populations bring enormous health challenges. All are likely to figure prominently on the multilateral banks' agenda. So will natural disasters, economic and financial crises, and the need to support global public goods related to environmental management and governance.

## 8. EMERGING-ECONOMY DONORS

The role of emerging-economy or non-traditional development finance is an important part of the equation. The ideological underpinnings of non-traditional assistance can be traced back to the 1955 Bandung Conference and the Non-Aligned Movement. Non-traditional donors consider themselves partners rather than donors. In defining its financial support to developing countries, the PRC stresses that it is itself a developing country, does not provide development assistance, and should not be considered a donor. Rather, the PRC defines its financial support as south–south cooperation.

Coordination with other donors has been a particularly thorny issue for the emerging economies' expanding programs. The 2005 Paris Declaration on Aid Effectiveness and the 2008 Accra Agenda for Action were intended to provide a global framework to enhance aid coordination and effectiveness (OECD 2005 and 2008). Traditional donors, MDBs and several smaller banks and funds were all signatories and agreed to apply the Paris and Accra principles to their development finance. Of the BRICS countries, Brazil, the Russian Federation, and South Africa were signatories, while the PRC and India were not.

Emerging donors criticized the Paris Declaration for its north–south orientation and being focused on traditional aid flows. The 2011 Forum of Aid Effectiveness held in Busan, Republic of Korea, aimed to address these concerns. The ensuing document referred to development cooperation rather than aid, was more focused on developing country needs, and recognized a broad range of partnerships, including south-south cooperation and the role of the private sector (OECD 2011). It was also loosely worded and did not tie the signatories to specific follow-up action. Donors and partner countries, many multilateral organizations, and all five BRICS countries are signatories of this looser mechanism.

The five BRICS countries are not members of the OECD Development Assistance Committee (DAC). The DAC encourages emerging donors to provide official data on their development assistance, but so far the Russian Federation is the only BRICS country to do so. The PRC has taken a firm position and does not participate in donor coordination mechanisms either among donor agencies or at the country level. It does not provide transparent statistics on its financial assistance or the conditions on which the support is provided.

Estimates of the emerging economies' aid are therefore imprecise. Current estimates put the PRC's bilateral assistance at between \$4 billion and \$25 billion a year, depending on the definition used. The PRC's assistance is provided mainly through the China Development Bank and the Export-Import Bank of China, and is largely in support of investments made by PRC state-owned enterprises to provide the PRC's economy with raw materials and energy.<sup>8</sup> The

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<sup>7</sup> Bhattacharyay estimates the infrastructure needs in 2010–2020 in the Asia and the Pacific region alone at over \$8 trillion (Bhattacharyay 2008: 32–37).

<sup>8</sup> This is well documented in Sanderson and Forsythe (2013).

PRC's cooperation focuses on Africa, Asia and selected countries in Latin America, mainly Venezuela and Bolivia. Brazil provides foreign aid of up to \$1.2 billion annually, and focuses on Latin America, Africa and Portuguese-speaking countries. India provides up to \$2.2 billion annually, mainly for its neighbors Afghanistan, Bhutan and Nepal. The Russian Federation and South Africa are smaller donors, with annual programs of about \$500 million and \$150 million respectively.<sup>9</sup>

Emerging bilateral assistance also has implications for multilateral finance, particularly when it is offered as an unencumbered and "easier" alternative. The PRC and other emerging donors stress that their support is free from the conditionality linked to much multilateral assistance. However, this assertion ignores the point that many of the MDBs' requirements are simply best-practice development banking, to ensure that investments are justified, well planned, economically and financially viable, and address or minimize social and environmental externalities.

The expansion of the Nigerian railway system is a frequently cited case. In 2006 the World Bank was planning to provide a grant to support institutional reforms and address corruption in Nigeria's notoriously inefficient railway system prior to providing a loan for the railway's physical expansion. However, the World Bank had to withdraw from the project when the PRC offered the government attractive financing, linked to PRC contractors and rolling stock, but without the reforms proposed by the World Bank (Naim 2007). Halper cites several other cases in which the PRC has stepped in with bilateral financing, driven by political or economic interests, when recipients were unwilling to address policy or governance concerns raised by the World Bank or the IMF (Halper 2010: 75–100).

## 9. EMERGING DONORS' MULTILATERAL ENGAGEMENT

Non-traditional donors have stepped up their engagement with multilateral finance in three ways, by engaging more proactively with the MDBs, by pushing for reform in their governance and decision-making structures, and by seeking to establish alternative financial institutions. The emerging economies would like to reform the MDBs' development agenda, have for many years been pushing for change in the distribution of voting rights in the World Bank and quotas in the IMF, and are dissatisfied with the slow pace of reform.

Voting rights in the World Bank were adjusted in 2010 and the developing countries' share increased marginally, while in the IMF a similarly modest reform in member countries' quotas remains unimplemented. The change was approved by the IMF's board of governors in 2010, including the representative of the US administration, but ratification of the change has run into Republican-led opposition in the US Congress. The resulting unwillingness of the US to reduce its dominance in the IMF is frustrating both developing countries and the management of the IMF (IMF 2014).

The disconnect in the IMF between economic power and voting rights is substantial. With a combined share of world GDP of 24.5%, the four major BRICS economies (Brazil, the PRC, India, and the Russian Federation) command only 10.3% of the votes. In contrast, with 13.4% of world GDP, the four large European economies (France, Germany, Italy, and the UK), command 17.6% of the votes (Wade and Vestergaard 2014). In the face of growing calls for change, the election in 2011 of the French Christine Lagarde as managing director of the IMF

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<sup>9</sup> The paucity of reliable data on the BRICS countries' bilateral programs is highlighted by Dornsife (2013).

and in 2012 of the Korean-American Jim Yong Kim as president of the World Bank simply reinforced the impression that the Western powers are in no hurry to reduce their influence.<sup>10</sup>

Emerging donors have also made modest contributions to the concessional funds of the MDBs. The BRICS countries have made modest contributions to the soft windows of the World Bank and the regional banks, as have other middle-income countries in Asia and Latin America. Several proposals have also been floated for new, regionally focused financial institutions, particularly in Asia. A proposal for an Asian monetary fund received a frosty reception from the US Treasury Department, Japan's Ministry of Finance, and the IMF. Two significant proposals for the establishment of new financial institutions are discussed below.

## 10. THE NEW DEVELOPMENT BANK AND CONTINGENT RESERVE

The most notable emerging-economy initiative is the proposal by the BRICS countries for their own development bank and contingent reserve, to support countries in financial difficulty. The initiative reflects the emerging economies' growing dissatisfaction with the Bretton Woods institutions, and has also been used to push for an acceleration of reforms in the multilateral architecture.

The rationale behind the NDB differs significantly from that behind the other multilateral institutions, which were established to address specific financing needs. The NDB is driven by a politically expedient concept rather than the need to mobilize funds and expertise to address a specific financing gap.

The BRIC concept was first set out in 2001 in a Goldman Sachs Global Economics paper by Jim O'Neill.<sup>11</sup> The four BRIC governments liked the concept, which highlighted their principal common denominator, rapid economic growth, and began to meet to discuss issues of common interest. In 2009 they started to convene their own summits. Feeling the need to include an African country, in 2011 they invited South Africa to join, expanding the concept to BRICS.

The BRICS countries do not form a coherent group. In fact, recent slowing of economic growth, their key unifying factor, has brought their differences to the fore. The BRICS countries have widely divergent political systems. Brazil, India and South Africa are functioning democracies, the PRC has a one-party system, and the Russian Federation is an autocracy. All five would like to shift the balance of power in the World Bank and IMF, but Brazil, India, and South Africa would also like membership in the UN Security Council. The PRC and the Russian Federation are already members and have little interest in the issue. The countries' economies are very different. The PRC's is based on industrial exports, the Russian Federation's on natural resources. India's economy suffers from bureaucracy and weak infrastructure, while Brazil's export-driven economy is vulnerable to external shocks. South Africa's economy is by far the smallest of the five, and in O'Neill's view is too small to justify membership in the grouping (O'Neill 2011: 108).

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<sup>10</sup> Reflecting growing pressure for change, in 2011 developing countries nominated several strong candidates for the World Bank presidency, although the US choice prevailed. At the senior staff level, however, change is evident. In 2008, the PRC national Justin Yifu Lin was appointed to the prestigious position of World Bank chief economist, the first from a developing country, followed in 2012 by the Indian Kaushik Basu.

<sup>11</sup> At the time, O'Neill was chief economist at the London office of the investment bank Goldman Sachs. The initial BRIC concept included four countries, Brazil, the Russian Federation, India and the PRC (O'Neill 2001).

The BRICS countries approach the bank initiative very differently. The bank is initially expected to focus on financing infrastructure. India's finance minister has indicated that the bank should complement the role of the current international financial institutions. Brazil, the Russian Federation, and South Africa all need infrastructure financing. The PRC, on the other hand, needs to secure its energy and raw material sources, but seems unlikely to borrow. The PRC's Ministry of Commerce has indicated that it would like the bank to provide a vehicle to invest in infrastructure in developing economies and to promote exports and raw material imports (Mei 2013). It has also indicated that it would like the bank to be modeled on the CDB, suggesting that it would like it to adopt a similar approach to identifying its investments.

Following over 2 years of negotiations, at the BRICS summit held in the Brazilian city of Fortaleza in July 2014, the countries agreed on the parameters for the establishment of their own financial institutions. The NDB will be established with an initial subscribed capital base of \$50 billion, with each of the five countries contributing \$10 billion and receiving equal voting rights. The initial subscriptions will be paid over a period of several years, reflecting the shortage of capital in several BRICS countries. The NDB will be accompanied by a Contingent Reserve Arrangement (CRA) comprising a pool of \$100 billion of currency swaps, with the PRC contributing \$41 billion; Brazil, the Russian Federation, and India \$18 billion each; and South Africa \$5 billion (Harding, Leahy, and Hornby 2014).

In addition to the capital base and voting rights, the thorniest issues for the BRICS countries to reach agreement on were the location of the bank's headquarters and arrangements for the presidency. Following difficult last-minute negotiations, the founders agreed that the NDB's headquarters would be in Shanghai, and that the presidency would be rotated among the five countries every five years, with the first president coming from India. They also agreed that the first chair of the board of directors would come from Brazil and the first chair of the board of governors, which convenes annually, from the Russian Federation (*Economist* 2014).

The NDB and CRA reflect the founders' ambition for a new global financial framework, and the BRICS countries have announced that they expect to start operations in 2015. The agreements establishing the NDB and CRA need to be ratified by the members' legislatures. For the institutions to become operational, the members will also need to agree on a raft of operational and administrative issues. The need to ensure equal voting rights placed constraints on the NDB's initial capital base, and it will therefore start as a modest-sized player. However, given the PRC's comfortable fiscal position, there is potential for relatively rapid expansion of the capital base, which would allow for an accelerated expansion of the NDB's role relative to other banks.

## **11. THE ASIAN INFRASTRUCTURE INVESTMENT BANK INITIATIVE**

The second major emerging-economy initiative is the PRC's proposal for the establishment of an Asian Infrastructure Investment Bank (AIIB). The PRC has for several years discussed establishing a new bank to provide financing for Asia's infrastructure needs. The AIIB proposal gained momentum in late 2013 under the PRC's new leadership, and was formally announced by PRC Finance Minister Lou Jiwei in March 2014. The proposal was discussed on the sidelines of ADB's annual Board of Governors meeting held in Astana, Kazakhstan in May 2014, and an announcement providing more details is expected in Q3 or Q4 2014.

It is premature to assess an institution that is still being established and on which facts are not available, but several issues have already drawn international attention. The first relates to the countries likely to participate in the AIIB. In May 2014, it was reported that the PRC had

approached 16 countries, including Kazakhstan, Mongolia, Pakistan, the Republic of Korea, Sri Lanka, and selected Western donors. India, Japan, and the US were not approached, indicating the leading role that the PRC intends to play. Qi Jianguo of the Beijing-based China Foundation for International Studies commented that “ADB is mainly led by Japan, and the World Bank is mainly led by [the US]. And so the AIIB is mainly led by [the People’s Republic of] China” (Bloomberg 2014). More recent reports indicate that 22 countries have shown an interest in participating in the AIIB, including several capital-rich countries in the Middle East (Anderlini 2014), and that Japan has indicated reluctance to participate (*China Daily* 2014).

Second, questions have been raised about the lending priorities and criteria that would guide the AIIB’s operations, and its relationship with existing multilateral banks. The NDB initiative is seen as an alternative to the Bretton Woods institutions, but has not indicated a clear financing agenda. In contrast, the PRC has clearly indicated that the AIIB is intended to provide financing for Asia’s vast infrastructure needs, for which financing from existing MDBs is inadequate. In a recent statement, Minister Lou noted that the AIIB will differ from ADB by focusing on infrastructure financing rather than poverty reduction. Zhao Jianglin of the Chinese Academy of Social Sciences pointed out that, consistent with the PRC’s policy of not interfering in other countries’ internal affairs, the AIIB is unlikely to attach policy conditions to its loans (Bloomberg 2014).

At the same time, commentators have highlighted that it will be important for the AIIB to apply due diligence and safeguard standards to its investments that are consistent with best practice standards applied by existing MDBs (Miller 2014). In response to these concerns, Jin Liqun, head of the AIIB preparatory group under the PRC’s Ministry of Finance, has indicated that he has confidence that the PRC can build a bank up to high international standards that will address key issues including project evaluation, environment protection, and improving people’s livelihood (*China Daily* 2014).

In March 2014, the PRC indicated that the AIIB would be established with a capital base of \$50 billion, provided mainly by the PRC. As interest in the AIIB has grown, the PRC has indicated that it is targeting \$100 billion, including \$50 million from governments and at least \$50 million from financial institutions and private capital (Zheng 2014). On the one hand, the experience of the existing MDBs suggests that it will take several years for the AIIB to become fully operational. On the other hand, the strong demand in Asia for infrastructure financing and the large pipeline of projects could facilitate a relatively quick start up. Once the AIIB is operational, it would not be difficult for the PRC to increase its capital base, bringing it on a par with the existing MDBs. Commenting on this shift in the multilateral architecture, a recent paper by the research firm Gavekal Dragonomics referred to the AIIB and NDB initiatives as a “Chinese Bretton Woods” (Miller 2014).

## 12. ALTERNATIVE SCENARIOS

Multilateral development finance is at a critical juncture. The development agenda, and the financial architecture for development, are undergoing rapid change. There is a shift away from an agenda driven and financed by traditional western donors to one in which emerging economies are key players. Several major borrowers are now also donors. There is a general expectation that emerging economies will assume a greater leadership role. This involves not only the provision of finance, but shaping the development agenda.<sup>12</sup> Traditional donors and MDBs are no longer seen as the only source of innovative development thinking. Indeed,

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<sup>12</sup> For a discussion of the post-Washington consensus agenda, see Birdsall and Fukuyama (2011).



already in the 1950s, when the World Bank was lending only for physical infrastructure, the Latin American countries were asking for social investments. More recently the concept of conditional cash transfers was developed in Latin America. Several emerging economies, most notably the PRC, are now offering their own development experience as a model.

There are two broad scenarios for the future development of the multilateral architecture. The first entails reform of the current system, including significant reform of the financing and decision-making structures of the existing MDBs to make room for an expanded role within the system for the emerging economies. The second entails a bifurcation or fragmentation of the current system and the emergence in parallel with existing institutions of strong multilateral and bilateral institutions driven by the emerging economies. The scenarios are not clear-cut, and in both scenarios banks driven by emerging markets and private development funds will continue to play an important role.

The recent growth of an alternative architecture financed by emerging economies and operating outside established aid coordination mechanisms has raised concerns among traditional donors. Once the NDB and AIIB are established, they will need to determine their respective relationships with the existing financial architecture. Will the new banks seek to become genuinely multilateral, building on decades of international development experience, making full use of established due diligence and safeguard standards, and identifying projects for joint financing with other development banks? Will the NDB expand its membership beyond the five founding countries, and will the AIIB, once established, seek to expand its membership?<sup>13</sup> Will the new banks provide transparent data on their financing and coordinate with other donors at the country level?

The implications of the expansion of alternative financing, outside coordination mechanisms, on the multilateral architecture remain unclear. Of the BRICS countries, currently only the Russian Federation provides the DAC with data on its assistance. As non-traditional aid increases, the paucity of such data may become a concern. In countries that are reliant on non-traditional flows, it is already difficult for development partners to get a comprehensive picture of financial flows or undertake reliable debt sustainability analysis, an essential tool for best-practice development lending. As uncoordinated flows expand, lack of reliable data may have a negative impact on other donors' abilities to plan, negotiate, and implement their assistance effectively.

From a global perspective it is also important to consider whether the emergence of an alternative architecture is institutionally the most efficient approach. The financial architecture is currently burdened by a multitude of institutions, which has raised concerns about overlapping and conflicting mandates and reduced efficiency. The existing banks and funds have built up a wealth of institutional knowledge and experience. A key question is whether the interests of the donors and the borrowers would best be served by building on current institutions or encouraging the architecture to proliferate further.

### **13. A NEW ARCHITECTURE?**

After 70 years of evolution, the multilateral financial architecture is in need of comprehensive review. Expanding emerging-economy finance poses a challenge to the MDBs, but the current situation also offers an opportunity for genuine reform. Without reform, the MDBs are likely to

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<sup>13</sup> At the 2013 China Development Forum, Joseph Stiglitz (2013) stressed that the PRC should take a more active role in redefining global governance. When presenting his paper, Stiglitz stressed the importance of the BRICS bank being genuinely multilateral.

become increasingly marginalized and the institutional framework increasingly fragmented between traditional MDBs and new lenders. Three sets of issues stand out.

First is the governance structure of the MDBs. The 2008–2009 global financial crisis triggered a shift in global financial governance which had been a long time coming. The G20 heads of state, including Brazil, the PRC, and India, convened in Washington, DC in November 2008 to discuss a global stimulus program, and the G20 has since played a more significant role in coordinating the global agenda alongside the G7 developed nations (Birdsall and Fukuyama 2011). The 2010 adjustment in World Bank voting rights is considered insufficient by the emerging economies, while reform in the IMF is still awaited. The governance structure of the Bretton Woods institutions reflects an outdated economic reality and will continue to be criticized by emerging economies.

Second, and closely linked, is the question of what role the MDBs and other banks will play in channeling the significant financing at the disposal of the emerging markets. Western countries are currently unwilling to consider recapitalizing and expanding the MDBs' operations, but have also resisted proposals for the establishment of new institutions. Emerging economies, including Brazil, the PRC, and India, are willing to recapitalize the MDBs, and are also willing to channel capital into new institutions.<sup>14</sup> The emerging economies support the use of special capital increases in the MDBs, accompanied by a corresponding adjustment in voting rights. The notion is rejected by Western economies, as it would reduce their share of votes.

If the MDBs are unable to offer effective institutional solutions to absorb available capital, the emerging economies can be expected to channel the capital through national development banks and their own multilateral banks. The economist Ravi Kanbur puts it more bluntly: "Unless there is rapid reform of current global institutions like the World Bank to satisfy the demand for net flows, knowledge and certification, and influence, the world will see the creation of more institutions like the BRICS bank" (Kanbur 2013: 27). The key question is whether the MDBs' shareholders want to encourage an alternative architecture or use existing MDBs as the basis for a new architecture. There is little evidence that the Western donors are considering the issue strategically. Their generally negative position to an expansion of existing institutions seems to be "penny wise and pound foolish," driven by current resource constraints and with little regard for the evolving architecture.

Third, are the MDBs being innovative enough in addressing their resource constraints? In the face of deep-seated donor fatigue and the large number of institutions vying for donor resources, the current financial structure of the MDBs' lending suggests that they should be more innovative. The MDBs' core financial model, based on sovereign guarantee ordinary lending and donor-driven concessional lending and grant operations, has changed little since the 1950s.<sup>15</sup> The MDBs' private sector operations have expanded in recent years, but remain modest, as does their non-traditional fund-raising and cooperation with private foundations. A recent report by the consulting firm McKinsey suggests several areas in which the MDBs could be more innovative in raising resources.<sup>16</sup>

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<sup>14</sup> A discussion of the respective pros and cons of strengthening existing institutions and establishing new ones can be found in Kawai (2013: 19–33).

<sup>15</sup> To its credit, the ADB is working on an innovative way to raise capital by incorporating return flows from concessional lending in its balance sheet.

<sup>16</sup> These include tapping into diaspora remittances through bonds, working with a wider range of private-sector partners including sovereign wealth funds and pension funds, and offering matching funds to attract contributions from private foundations (Bensoussan, Ruparall, and Taliento 2013).

Will a new multilateral architecture emerge, or will the architecture become increasingly fragmented? Birdsall sees two major groups of financial actors in the future, the MDBs and a growing number of national and borrower-driven development banks. Parallel to this, transfers from high-income countries to finance global public goods will gradually replace current bilateral ODA (Birdsall 2013). Linn, on the other hand, sees reforming the MDBs as a means of building on the status quo and forestalling the need for new institutions (Linn 2013). Kanbur notes that from a global perspective it is inefficient “for new institutions to be created when the old ones could in principle be reformed to reflect new realities and economic weights.” He considers radical reform of current institutions the first best option, but concedes that this is unlikely given the reluctance of traditional donors to support such reform (Kanbur 2013: 24).

The Bretton Woods institutions were set up 70 years ago with a clear purpose. Since then the multilateral architecture has evolved and proliferated, and is currently facing entirely new challenges. Multilateral development finance has now reached a turning point and is in need of comprehensive review and reform. The key question is whether global governments can get together to agree on such reform, or whether the architecture will simply continue to evolve.

Strategic planning in the MDBs tends to be compartmentalized. Each MDB undertakes its strategic planning individually, with a focus on institutional priorities, relations with client countries and development partners, operational priorities, and internal management.<sup>17</sup> This approach tends to neglect the broader architecture, which is beyond the scope of any single MDB. As a result the individual trees are well tended, but the forest grows wild. Neither the divergent positions taken by the traditional and emerging-economy donors nor the MDBs’ compartmentalized strategic planning give grounds for optimism that comprehensive reform of the multilateral architecture is on the horizon.

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<sup>17</sup> ADB’s strategic framework for 2008–2020 is a commendable example (ADB 2008). In October 2013, the World Bank Group published a new corporate strategy, which highlights working together with a wide range of public and private development partners, but provides little broader vision on the future of the multilateral financial architecture (World Bank Group 2013).

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