New bank, new paradigm

In the BRICS' world, markets are managed, not free

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August 12, 2014 – *CIC-Opencanada.org*

The New Development Bank recently parented by the BRICS is not just another international financial institution. It also challenges the Bretton Woods institutions — the International Monetary Fund and the World Bank — and the rich industrial countries that have controlled them. How? By presenting an alternative paradigm of economic growth and development.

To understand the genesis of the paradigm shift, one has to go back at least 30 years, when neoliberal thinking became embedded in the economic policies of the U.S, the U.K. and other Western industrial countries particularly after Ronald Reagan and Margaret Thatcher came to power around 1980. Liberalization, privatization, lower taxes, flexible labour markets, and downsizing of government became the order of the day.

However, at the same time as the neoliberal paradigm was in the ascendant in the West, an economic transformation was under way based on a completely different policy framework on the Asian Pacific Rim. Japan, South Korea, and Taiwan led a group of countries in East Asia achieving rates of economic growth higher than six per cent per annum — far above growth rates realized historically by the Western industrial countries. Moreover, their rates of poverty diminished rapidly — an accomplishment clearly relevant to developing countries around the world. By the 1990s, a number of other countries had joined the league of rapidly-growing countries, including China and India.

The economic policies propelling these emerging markets were distinct, in crucial ways, from the basic tenets of neoliberal policy. In particular, they did not share the neoliberal emphasis on privatization and economic liberalization. Instead, the role of the state was given far greater priority, facilitating the growth of the private sector by helping to access markets, acquiring technology and providing financing. State-owned corporations were often key to their strategies, but these typically worked in partnership with the private sector. International trade and capital flows were managed rather than given free rein. The new paradigm aimed at "managed markets" rather than "free markets".

When the Asian financial crisis erupted in 1997, the IMF and World Bank unleashed reform programs on the countries in distress. East Asian countries were profoundly dissatisfied by intrusive neoliberal policies seeking reforms of labour laws and privatization of state-owned firms, and other domestic policy changes. The financial crisis, in the view of distressed Asian countries, was caused not by these policies but by unfettered and volatile international capital flows.

Accordingly discussions were launched about creating an "Asian Monetary Fund" based in the region with policy conditionality more compatible with Asian countries' distinct policy framework. This idea was rejected by the United States and other Western industrial countries — and in so doing, it contributed to the eventual creation and design of the BRICS bank.

Rebuffed in this attempt to reform the international financial architecture, East Asian countries began to build up their foreign exchange reserves by ensuring their currencies gave them a competitive edge, generating steady trade surpluses. This policy of "self insurance" aimed at creating such a huge pool

of foreign exchange reserves that they would never need to turn to the IMF in the event of a speculative attack or a financial crisis.

And by 2006, with Russia and Brazil joining India and China (and South Africa in 2010), the emerging-markets club of the BRICS was born. While Russia, Brazil, South Africa and India all follow quite different strategies from China and the East Asian countries generally, what unites them is the importance of the state as a central player in development. State-owned enterprises play a key role, alongside the private sector in economies in which markets operate, although not as freely as in Western industrial countries. Collectively, the BRICS also possess significant economic and political clout, with 40 percent of the world's population and 20 percent of world output.

A final milestone on the road toward the BRICS bank was the Global Financial Crisis, which started in the United States and Europe in 2007-2008. Thanks to the creation of the Group of 20 in 2008, which included all five BRICS countries, a second Great Depression was averted. China in particular played a crucial role with its huge fiscal stimulus that helped maintain global aggregate demand for the next three years. China went further by suggesting that the international currency system be reformed. But as with previous demands for reforming the international financial architecture this one was also rejected.

Here was yet another reason for creating a new development bank. The policy of accumulating a huge pool of foreign exchange reserves, which exceeded US$7 trillion by 2013 in emerging markets and developing countries, was hostage to the vicissitudes of the U.S. dollar—the world's key reserve currency. The expansionary monetary policy (known as "Quantitative Easing") followed by the U.S. in its attempts to recover from the Great Recession after the financial crisis meant that rates of return on dollar-denominated assets (such as U.S. T-bills) were abysmally low. And while the dollar had retained its value through the financial crisis, who knows what the future holds, particularly with the flood of dollars created by Quantitative Easing? It made more sense to invest in real assets, and to invest not in the rich countries but in the emerging markets and developing countries, with their huge unmet needs for infrastructure.

Thus, the notion of a New Development Bank took form. The BRICS had the resources, with China possessing most of all. They desired to pursue development and financial cooperation in a different way from the Bretton Woods Institutions and other established international financial institutions. After several years of discussion, the principal underpinnings of the New Development Bank were announced at the BRICS Summit in Fortaleza, Brazil, on July 15. It is not only a multilateral bank (like the World Bank), with an eventual capitalization of US$100 billion, but it also revives the idea of an Asian Monetary Fund, with a "Contingent Reserve Arrangement" to pool US$100 billion in reserves to support any of its members facing a financial crisis.

The policies under which the new institution will operate remain to be seen. For now, the New Development Bank has been welcomed — including by the World Bank — as an additional source of funding for huge infrastructure needs by the emerging markets and developing countries over the next decade. In South Asia alone these amount to US$2.5 trillion. However, in the longer term, the New Development Bank and its Contingent Reserve Arrangement are unlikely to be mere replicas of the World Bank and IMF. Instead, expect a different discourse around "the need to manage markets in the quest for prosperity and stability".

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