

The BRICS' New Development Bank and the EU's options

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Executive Summary

- > Global economic governance is currently undergoing a significant transformation led by China and its emerging economy partners.
- > China's increased activism on the global stage rests on the reform of established organisations, the design of parallel institutions, the revitalisation of neglected frameworks and the creation of novel networks.
- > One example of the creation of a new institution concerns the New Development Bank, which is set to complement the World Bank's efforts, but may also dilute the very standards in development finance that the EU has long championed.
- > After an initial focus of two years on Brazil, China, India, Russia and South Africa (BRICS), the Bank will co-opt new members.
- > After failing to show a united front vis-à-vis the Asian Infrastructure and Investment Bank (AIIB), EU member states should now seize the opportunity to respond strategically to a new global institution created by non-traditional powers.

Following decades of unchallenged Western dominance, the global governance system is currently being reshaped. Key emerging powers led by China have set out to increase their influence in global – economic – governance. Since Chinese President Xi Jinping took power in March 2013, Beijing has pursued global governance reform as a strategic objective. Its multi-pronged approach relies on the reform of established multilateral structures, the creation of parallel institutions, the revitalisation of neglected organisations

and the promotion of novel networks that do not build on existing fora. This contribution focuses on China's and its BRICS partners' (Brazil, Russia, India and South Africa) aspiration to counter the traditional bodies of global economic governance through the establishment of parallel structures. More specifically, this Policy Brief assesses the challenge that the BRICS-led New Development Bank (NDB) poses to the European Union (EU) in the field of development policy and identifies ways in which the EU could respond to this challenge.

The NDB: complementary to or competing with existing economic governance fora?

On 15 July 2014, the leaders of the BRICS countries gathered in Fortaleza, Brazil, to sign the treaty establishing the NDB. The Bank is only one of a series of parallel multilateral institutions created by emerging powers in recent years. Others include the Contingent Reserve Arrangement (a BRICS alternative to the International Monetary Fund) and the Asian Infrastructure and Investment Bank (a China-led competitor to the Asian Development Bank). According to its Articles of Agreement, the NDB aims to 'mobilize resources for infrastructure and sustainable development projects in BRICS and other emerging market economies and developing countries'. The NDB is only the second multilateral development bank (MDB) with a global rather than regional focus besides the World Bank. It is also the first formal multilateral institution with global reach that is led by non-Western powers, reflecting the shifting balance of global economic power from established to emerging powers. The lack of a precedence of the BRICS centrally sitting at the table in a global economic governance context also means that it is unknown if the rules guiding the NDB's lending practices will differ from those observed by the Bretton Woods institutions.

The NDB is headquartered in Shanghai and has a starting capital stock of \$50 billion to be raised to \$100 billion over time. The capitalisation of the Bank began on 14 January 2016, when founding members made their first

contributions worth a total of \$750 million. The initial transfers form part of the Bank's paid-in capital that is expected to total \$10 billion (\$2 billion per founding member) to be paid through seven tranches between 2016 and 2020. The NDB also has a subscribed capital of \$40 billion that shareholders must provide when requested by the Bank. The management aims to leverage two to two and half times – that is, use various financial instruments, including borrowed capital, to increase the potential return of its investments – the current capital of \$750 million and lend up to \$2 billion this year. The NDB first intends to raise funds through the issuance of bonds in the Chinese bond market. This is due to the triple-A rating the Bank has acquired in the country, which will allow the institution to borrow relatively cheaply.

According to its founders, the NDB responds to the recognition that the existing set of financing schemes is inadequate to meet investment needs in infrastructure projects – a central pillar of development from the perspective of most developing countries. The Shanghai-based institution, according to official rhetoric, will reduce this gap by promoting improved connections in and between developing countries through the provision of infrastructure finance. As such, the Bank has been heralded to be complementary to traditional donors, who have largely neglected this aspect of development finance. Judged from this angle, the NDB may indeed act as a platform through which the BRICS seek to better respond to developing country needs informed also by their own recent experience with rapid economic catch-up. This new source of infrastructure finance may also be seen as an opportunity by the companies of developed countries (including those of the EU) wanting to and capable of doing business in the Global South. Importantly, however, the Bank is only expected to open its doors to non-BRICS countries after July 2017. This is essential as the Articles of Agreement specify that project tenders are only open to member countries.

In addition to complementing existing MDBs, the NDB seems to be driven by three further objectives. First, the institution can also be considered as a by-product of its founders' disillusionment with the deeply ingrained disparity and the consequent democratic deficiency of global economic governance. By offering a real alternative to the World Bank, the five-country bloc also generates greater sense of urgency about the need for further reform of traditional international financial institutions, especially with regard to voting rights and governance mechanisms.

Second, it also reflects frustration with the cumbersome and overly bureaucratic lending operations of the

traditional lenders. Some of the innovative solutions, including the non-resident – and unpaid – board of directors and governors, are hoped to accelerate lending by granting greater room for manoeuvre to the Bank's resident management. At the same time, some see this as an explicit attempt on the part of the founders to limit future members' influence on the senior management recruited from BRICS countries. This argument, however, contrasts with the fact that, at the time of writing, the Bank is actively recruiting both young and senior professionals from all over the world.

Lastly, the NDB will also have an impact on the 'rules of the game' in development finance, the extent of which remains to be seen. On the one hand, the BRICS are known to regard economic growth as a top priority, showing reluctance to subscribing to stringent standards of governance or environmental and social protection. The emergence of a new MDB on the horizon may therefore also lower standards of lending in development finance in the medium to long term. This is because, to remain competitive, existing institutions (such as the World Bank) may need to adjust their standards regarding issues such as government backing of bidding companies, opaque bidding processes or lower environmental standards. The impact of lower standards and conditionality may also imply a higher risk of default, which will certainly be felt by the Bank when it looks to the international capital markets to leverage its financial resources. Some of these concerns have, nonetheless, been somewhat allayed lately as the NDB President K.V. Kamat has repeatedly declared the Bank's intention to focus on green investments (e.g. solar projects) in its initial operations. In any case, given that the founders themselves have differing attitudes towards environmental and social regulation, it may take a while to create a common policy framework among themselves.

In addition to these considerations, the NDB could also serve to undermine the prevalence of the US dollar as the leading currency in international finance. As specified in its founding documents, the Bank 'may provide financing in the local currency of the country in which the operation takes place'. In practice, this presently means that the Bank will lend in BRICS currencies, with the first loan to be performed in renminbi in China.

How the EU can react to the NDB

In Europe, the increased activism of China and its BRICS partners in global economic governance has so far not been seen as a development that merits strategic thinking at the EU level. As the AIIB case demonstrated, EU member states tend to privilege bilateral economic relations in their dealings with China and welcome the

country's growing appetite to play the multilateral game. Such a position, however, often ignores that the Beijing-led multilateral institutions also serve geostrategic purposes, which are often contrary to EU interests. Arguably, when faced with new multilateral structures emanating from emerging powers, the EU's fundamental interest lies in ensuring consistency between the policy approach of the institutions it champions and that of the new ones. As Alyson Bailes puts it, the EU's 'deepest interest lies in making others – and eventually the world – more like itself'. But how can this be done most effectively? Article 32 of the Treaty on European Union offers guidance to member states' action in this regard. It states that 'before entering into any commitment which could affect the Union's interests, each Member State shall consult the others within the European Council or the Council'. While often overlooked, it is worth pointing out that the possibility of a joint EU response to the AIIB was also briefly explored in the COREPER (the Council's main preparatory body) and the Economic and Financial Committee but was eventually dismissed largely due to the UK's unilateral decision to join the Bank.

Assuming that member states draw the lessons from the AIIB case and manage to form a united front *vis-à-vis* the NDB, four fundamental scenarios can be envisaged about how the EU might react to it once the Bank starts co-opting new members: isolating it, shaping it, joining it individually, or joining it collectively.

First, in order to safeguard the primacy of the institution the NDB is seeking to mirror (the World Bank), EU member states could adopt an isolationist approach, refusing to consider membership and encouraging others to do the same. Such a reaction would, however, be hard to reconcile with the widely recognised need for infrastructure investment in emerging and developing countries, and also with repeated EU calls for the BRICS to assume increased responsibilities internationally.

Second, similarly to the United States' response to the AIIB, EU member states could make their accession contingent upon the strict observance of certain social, environmental and other standards by the Bank. Surely, the co-option of developed countries could benefit the NDB by boosting its creditworthiness and therefore its ability to create a portfolio of well-performing debts. Yet, given that divergence from the World Bank's perceived bureaucratic and rigid policies is among the NDB's key priorities, it is unlikely that membership of developed countries will suffice to pressure the BRICS into

compromising on their alternative approach to development policy.

The third option is that EU member states willing to bear the financial cost of membership join the Bank with the aim of influencing its evolution from the inside. This could entail regular consultations on the NDB's agenda within certain preparatory bodies of the Foreign Affairs Council, such as the Working Group on Development Cooperation, with the aim of coordinating the EU position. Although not resulting from a collective decision, the European response to the AIIB is most reminiscent of this path. The downside of this option is, however, that it does not necessarily guarantee a coherent EU representation within the Bank, allowing EU member states to follow individual considerations and to counteract the interests of EU member states not present in the NDB. Such divisions would be highly disadvantageous given that the prospective cumulative voting power of developed countries in the NDB is limited to maximum 20% of the total votes.

A fourth possibility is EU membership in the Shanghai-based institution. So as to achieve the Union's key interest *vis-à-vis* the Bank, that of ensuring consistency between World Bank and NDB standards, this option might be the most rewarding for the EU. The NDB operates in the area of development policy where the relations between the EU and its member states are guided by shared parallel competences. In practice, this means that the EU has the competence to carry out activities and conduct a common policy, but the member states can also exercise competence. While the EU is only a member of one MDB – the European Bank for Reconstruction and Development – the Treaty of Lisbon encourages EU membership in other such bodies, too (Art. 21(1), second para., TEU).

Although the EU has not yet formally reacted to the NDB, the European Commission welcomed the creation of additional development financing options, provided they are complementary to existing institutions. A form of membership for the Commission – on behalf of the EU – in an area of shared competence is a rather complex yet not unprecedented exercise (OECD-DAC Committee). Despite concerning an area of exclusive EU competence, the capital increase of the European Investment Fund (EIF) – where the Commission is a shareholder – in May 2014 represents one example of how this could be put into practice in the post-Lisbon context. The involvement of the European Investment Bank (EIB) could be more straightforward, as this institution has a track-record of

financing its participation in other bodies with own resources, if approved by the EIB board.

EU membership in the NDB is, however, not a purely intra-EU business. There are external obstacles, too. In line with the realist stance of the BRICS on state sovereignty, the NDB's establishing treaty currently restricts membership to members of the United Nations, with the possibility of granting observer status to international financial institutions in its Board of Governors – a criterion the EU does not fulfil. Yet, the mandates of most international organisations are not set in stone. Hence, EU member states could try to shape – whether from the inside as members or from the outside, through existing bilateral strategic partnerships with the BRICS – the mandate of the evolving institution, including a joint campaign for a Regional Economic Integration Organisation (REIO) clause (a prerequisite to EU membership in international organisations).

No time for 'wait and see'

China's and its BRICS partners' increased activism in global governance is an ambivalent development from an EU perspective. While their recent efforts to shape the global economic governance system may be interpreted as a

proof of their adherence to some form of multilateralism, the new institutions also serve to advance their own strategic interests. Hence the need for Europeans to come together and assess how each of the new structures impact on their political and economic interests.

When interests converge, EU member states have no reason not to support the increased willingness of the emerging powers to play a greater role in global economic governance, including their endeavours to improve on certain long-standing practices. When interests diverge, however, Europeans would be better off defending the established standards and norms that they have championed for decades. For the moment, the evolution of the NDB is at too early a stage to determine in which of these categories it falls. Nonetheless, building on the lessons of the AIIB case, EU member states would be well-advised to keep a strategic eye on the NDB and identify levers of influence to shape its evolution right from its inception. *No time for 'wait and see'!*

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