



The Contingent Reserve Arrangement: A Redesign of the International Monetary System

The BRICS countries established the New Development Bank (NDB) and the Contingent Reserve (CRA) Arrangement at their sixth Summit at Fortaleza, Brazil on 15 July 2014. This policy brief examines the implications of the CRA both for the international monetary system (IMS) and how far it meets the needs of the individual BRICS countries. It looks at (i) the governance structure of the CRA, (ii) the resources available to the CRA, (iii) the important features of the current international monetary system (IMS), (iv) the role of the International Monetary Fund (IMF) in this system, (v) the shortcomings of the current IMS, particularly from the viewpoint of developing countries, and (vi) the role the CRA can play in overcoming these shortcomings, particularly its significance for the BRICS countries.

Governance Structure of the CRA

The governance structure of the CRA consists of a Governing Council (GC) and a Standing Committee (SC). Each member country will be represented on both. Though the Governing Council can approve the entry of new countries, it is not specifically stated whether the new members will be represented on the Governing Council or the Standing Committee. Nor is any criteria specified as to who is eligible to apply for membership. Presumably, the GC will also decide on the contribution of any new

entrant. Unlike in the case of the NDB, where many of these matters are explicitly dealt with in the agreement, this is not the case for the CRA.

The party that chairs the BRICS shall act as the coordinator of the GC and the SC, which implies that the coordinators' positions will be short term ones. All decisions of the GC will be by consensus. Also, all decisions of the SC will be on the basis of consensus except those related to the use of the resources of the CRA. These will be by a simple majority of the weighted voting power. The CRA will come into force thirty days after the deposit of the fifth instrument of accession.

Resources of the CRA

The members will contribute US\$ 100 billion to the CRA of which China will contribute US\$ 41 billion, Brazil, India and Russia each will contribute US\$ 18 billion and South Africa will contribute US\$ 5 billion. The amount that each can borrow from the CRA is a multiple of their contribution and the multiple varies among the countries. The multiple is 0.5 for China, 1 for Brazil, India and Russia and 2 for South Africa. So, China can borrow up to US\$ 20.5 billion, Brazil, India and Russia each can borrow US\$ 18 billion while South Africa can borrow US\$ 10 billion. The amount the countries can actually borrow will depend on whether they have a

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programme with the IMF or not. Without an IMF programme a country can borrow only 30 per cent of the total amount it is eligible to borrow. So, China would be able to borrow US\$ 6 billion and South Africa US\$ 3 billion while the other countries would be able to borrow about 5 billion. To borrow the remaining 70 per cent of what they are eligible to borrow the country is required to have an IMF programme.

The amounts that the countries can borrow from the CRA can be compared to what they can borrow from the IMF. China's quota at the IMF is about US\$ 13.4 billion, that of India and Russia is just over US\$ 8 billion while that of Brazil is about US\$ 6 billion and that of South Africa is US\$ 2.6 billion. Countries can borrow up to twice their quota in any year and cumulatively up to six times their quota under the extended fund facility (EFF). So in any year China could borrow almost US\$ 27 billion, India and Russia about US\$ 16 billion, Brazil about US\$ 12 billion and South Africa about US\$ 5 billion. The amounts these countries can borrow from the Fund in any year is about the same as they can borrow in total from the CRA, though they can borrow much more cumulatively from the IMF. The ability to borrow from the CRA, is particularly substantial for South Africa, who can borrow twice as much from the CRA as it can borrow in a year from the IMF; the amounts that the other members of the CRA can borrow from the CRA are also quite considerable. However, they also can borrow from the IMF under other programmes. Under the Precautionary and Liquidity Line (PLL) they can normally borrow up to 250 per cent of their quota, but this can be increased to 500 per cent of their quota if they are faced by a particularly severe Balance of Payment (BoP) situation. Under the PLL for a two year programme they could borrow 10 times their quota. Obviously these amounts

are considerably larger than what they can borrow from the CRA.

Important Features of the Current International Monetary System

Before we discuss the impact of the CRA on the international monetary system (IMS) we note some important features of an IMS. Important features include: what is the international money and how its supply is controlled, the resources available to countries in need of BoP financing, what are the mechanisms of adjustment when a country faces a BoP imbalance and whether the burden of adjustment is on both the surplus and deficit countries or whether there is an asymmetry that deficit countries have to adjust 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.

a) Current System of International Money

Under the current system, international money consists of the quotas that countries have at the IMF and their stocks of convertible currencies mainly 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, viz. the US must run a current account deficit. This depends substantially on US policies.

The IMF quotas are periodically reviewed and can be increased if the members agree. Any such increase requires an approval by members holding 85 per cent of the votes.

Another important issue related to the supply of international money is whether it can be varied to maintain a high level

of international economic activity or to support a stable world economy. This was an important question for Keynes and his design of the institution, which he called the Clearing Union (CU), would have allowed the CU to act as a global central bank. But the IMF as set up cannot act as a stabilizer of international economic activity.

While the IMF can act as a lender of last resort to countries facing severe BOP problems, it cannot stem a banking crisis in any particular country. When in 2008 such a crisis affected the banks in a number of countries, e.g. the US, the UK, Iceland, Ireland and banks in the eurozone, the central banks and governments of the affected countries had to act to shore up their banking systems.

b) Balance of Payments Imbalances Financing and Adjustment

The BoP financing is of two kinds: One is private financing and the other is official financing from the IMF. Before the Second World War most BoP financing was from private sources. Occasionally, because of foreign policy considerations a government would provide financing to another government. During the Great Depression of the 1930s private financing for meeting BoP deficits dried up as most countries could not service their existing loans. Consequently, the designers of the post war economic governance system arranged for official financing from the IMF. And for more than two decades after the end of the war the IMF was the main, if not the only, source for BoP financing.

Gradually, the private financing market recovered as countries, mainly the middle income countries in Latin America, became more credit worthy and banks were flush with funds, particularly after the 1973-74 oil price increases as OPEC countries deposited their surpluses with Western banks. Financing is now readily available to

many countries from private capital markets through bonds or from private commercial banks, and definitely to the BRICS countries. But private financing dries up when a country faces a crisis. It dried up after the 1982 debt crisis or the 1997 Asian financial crisis. In fact a crisis can be defined as a situation when private financing is not available. Countries have then to resort to official financing, namely borrowing from the IMF.

In crisis situations the amounts that a country needs to borrow may be multiples of what it is entitled to borrow from the Fund, given its quota, because quota increases have not kept pace with the requirements of trade and private capital flows. For instance, US\$ 50 billion was made available to Mexico during the 1994 crisis. Of this, US\$ 20 billion was contributed by the US, US\$ 17.8 billion by the IMF, US\$ 10 billion by the BIS, US\$ 1 billion by a consortium of Latin American nations, and about US\$ 1 billion by Canada. Of the US\$ 17.8 billion pledged by the IMF, about US\$ 7.8 billion or 300 per cent of Mexico's IMF quota was to be available immediately. The remaining US\$ 10 billion would be provided by the IMF to the extent that contributions of governments and central banks fell short of the targeted amount of US\$ 10 billion. The Fund thus needed to activate special discretionary financing through special provisions because the quota amounts were insufficient. This implies that the countries providing this additional financing could require the IMF to impose specific conditions for the grant of the loan.

Since the amount of BoP financing is limited, the 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 as dollars are international money.

The Role of the IMF

An important objective of the IMF was to ensure a stable and growing world economy. Since the world economy grew at unprecedented rates between the end of the Second World War and the oil price rises of 1973-74, its responsibility for a stably growing world economy receded into the background. Attention during this period was focused on the need to ensure a proper growth of international reserves. Reserves during this period consisted mainly of gold, IMF quotas and dollars. The dollar was convertible into gold and this created what came to be known as the “Triffin paradox”. Since gold supply was increasing slowly growth of international reserves necessary to support rapid growth of world trade would require increases in IMF quotas or supply of dollars. The supply of dollars could only be increased by the US running deficits. After a while dollar holdings would become large relative to the US gold stock and people would lose confidence in the ability of the US to convert these dollar holdings into gold and there would be a run on the dollar and a collapse of the system. On the other hand, if the US did not run deficits there would be insufficient reserves and world trade would stagnate. So the choice seemed to be between stagnation of world trade and collapse of confidence in the dollar unless IMF quotas were increased.

Special Drawing Rights (SDRs) were introduced in the IMF so reserves could be increased without the US running deficits. However, the US has prevented any large increases in the SDRs or in IMF quotas. If quotas do not increase, countries wanting more reserves will hold more dollars, namely, US government bonds or bills, such holdings give low rates of returns. So, in essence, countries are giving low interest loans to the US. Thus, the US government gains from not allowing quotas to increase. The question of confidence in the US dollar in terms of its convertibility into gold has disappeared as the dollar is no longer convertible into gold. Lack of confidence in the dollar will now manifest itself by people converting dollars into some other currency (s). But when doubts about the international system arise, as they did in 2008, people move into dollars preferring them to other currencies.

Furthermore, the IMF imposes conditions on countries borrowing from it, viz. deficit countries, but not on surplus countries. These conditions essentially reduce the level of demand in deficit countries. But there is no equivalent increase in demand in the surplus countries. So the level of economic activity in the world economy is lower than what it would be if the IMF would behave differently.

In brief, the IMF has not been able to provide a framework that would provide for stable growth and proper use of the world's resources.

Shortcomings of the System

a) The Supply of International Money

As noted above, any increase in quotas requires an approval by 85 per cent of votes. Since the US has over 17 per cent of the IMF's voting rights, the US can block a quota increase. If quotas are not increased, countries would have to increase their holdings of dollars as trade increases and

this means that countries are essentially extending a low interest loan to the US. Therefore, the US has a vested interest in preventing an increase in IMF quotas. There is a moral hazard problem as the US that gains from preventing a quota increase can block any quota increase. The supply of international money is, therefore, beyond the control of almost all countries.

Nor is the supply varied to maintain a high and stable level of economic activity in the world economy. The supply varies according to the requirements for management of the domestic economy of the US.

b) BoP Financing and Adjustment Asymmetries

The IMF has imposed various conditions on countries borrowing from the IMF. As noted above, these conditions may have little relevance to the cause of the problem. A consequence of IMF conditionality has been that countries are reluctant to borrow from the Fund and have been building up their reserves as a precautionary measure. When capital flows were not significant a country was expected to hold reserves equal to three months worth of imports. Once private capital flows became significant countries were expected to hold reserves equal to their short term liabilities. The reserve holdings of developing countries used to be about the same relative to their imports as the reserve holdings of developed countries. But whereas developed countries continue to maintain the same reserve import ratio as earlier, this ratio has increased very rapidly for developing countries, especially after the 1997 Asian financial crisis. Currently, many developing countries are holding considerably larger reserves than this. A possible explanation for this could be that in a crisis not only do foreign loans become unavailable and short term foreign loans flow out, the residents of the country may

convert some of their assets into foreign currency and take it out. Such outflows have become easier as many countries have liberalized outflows. In this case a quick appraisal of the adequacy of reserves would be to compare them to M2 as liquid assets can be converted into foreign currency to be exported. There is no analysis yet of an adequate reserves to M2 ratio.

This accumulation of reserves, while appropriate from the viewpoint of individual countries, creates additional shortcomings in the working of the IMS. Reserve accumulation by poor countries implies that their scarce savings are being hoarded rather than being invested. For instance, during the years before the 2008 global financial crisis many developing countries were running current account surpluses and accumulating reserves while their investment to GDP ratio remained stuck at a low rate so that growth was slower than what it could have been. Also, reserve accumulation by developing countries means lending by poorer countries to the much richer US, and this is a misallocation of resources. Since the US used this borrowing for consumption the growth of the world economy was slower than what it could have been. The ability of the US to borrow cheaply also reduces the incentive for the US to change the system.

The working of the IMS creates asymmetries that lead to a misallocation of resources and significant underperformance of the world economy.

The CRA and Reform of the IMS Implications for the BRICS Countries

The amounts that will be available to the BRICS countries would be substantial if they have an IMF programme; this would not be the case if they do not have an IMF programme. The Current Account Deficits

(CAD) that Brazil, India or South Africa are currently running are much larger than what they can borrow from the CRA. Even the amounts that they could borrow with an IMF programme should be compared to the IMF approved lending to Russia of US\$ 38 billion (SDR US\$ 24.786 billion) in the 1990s. In 2002 alone, the IMF approved a stand by programme for Brazil of US\$ 30 billion.

Similar rules differentiating as to whether a country has an IMF programme or not apply to the Multilateralized Chiang Mai Initiative of East Asia (MCMI). Nobody has as yet borrowed under it. 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.

Borrowings from the CRA are for a period of six months if the country does not have an IMF programme and can be renewed at most thrice. So the maximum period is two years. For an IMF linked programme the initial period of a drawing is one year and it can be renewed twice so that the maximum period for a borrowing is three years. This short period contrasts with the repayment period of four and a half to ten years for an IMF loan under the EFF.

Will the CRA usher in a new architecture to the IMS? No new international money is created by the CRA. The loans to countries requiring BoP financing will be in convertible currencies, but the agreement specifies only the dollar, and will be repaid

in dollars. Since no new international money is created the BRICS countries will have no influence over the supply of international money which will continue to be mainly managed by the US. 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 CRA would not as yet make a substantial difference to the IMS.

The CRA provides additional BoP financing to the BRICS countries, but the additional amounts made available would not be sufficient for their needs, particularly if they are faced with a BOP crisis. Furthermore, the period for which countries can borrow under the CRA is quite small compared to borrowings from the IMF. Also, it is as yet not clear whether other countries would be allowed to be members of the CRA and under what conditions. But it is a small beginning to break the monopoly of the Bretton Woods institutions. It is as a bather on the seashore tentatively sticks a toe in the water to judge the temperature of the water. Maybe the CRA is meant to be a signal that the developed countries should be more serious about reforms at these organizations, as such reform has been lagging despite agreement at the G20. However, the developed countries are unlikely to be serious about the reform of the Bretton Woods institutions unless they believe that the BRICS or other groups of developing countries are mounting a serious challenge to the hegemony of the Bretton Woods institutions.

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