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Article

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Will the AIIB and the NDB Help Reform Multilateral Development Banking?

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Survey Article

Abstract

What will be the future impact of the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB), two multilateral banks created in 2014 outside the established Bretton Woods system, on multilateral lending shares? So far, the bulk of multilateral lending has been provided by institutions created and ruled by the west. Will the new institutions led by China and Brazil, Russia, India, China and South Africa (BRICS) help rebalance multilateral development finance away from western dominance? The answer comes in three steps: first, the pressure for the BRICS to 'exit' rises with past, present and expected failure for 'voice' reform in the established international financial institutions (IFIs). Second, excess demand for multilateral soft loans and, third, the potential lending capacity by the AIIB and the NDB are quantified to assess how much relative business – hence political influence – the existing IFIs might lose in favour of the new competitors. Based on current evidence for loan-equity leverage ratios in established multilateral development banks (MDBs), it is estimated that the NDB and AIIB combined will attract sufficient cofinancing to rival the established MDBs in terms of annual lending. The combined loan portfolios (*c.* US$230 billion) of AIIB and NDB 2 would equal the combined loan portfolios of ADB and International Bank for Reconstruction and Development (IBRD), according to a simple scenario presented in this survey article.

Infrastructure finance will thus benefit from the creation of the New Development Bank (NDB) and Asian Infrastructure Investment Bank (AIIB) by tapping the considerable saving potential in China and Brazil, Russia, India, China and South Africa (BRICS). The new institutions should therefore be supported, not discouraged, by western governments and donors as well. The new multilateral development banks (MDBs) may introduce choice for potential borrowers in terms of funding cost and modalities, but they need to respect procurement and environmental standards to generate sustained development benefits. Competition in multilateral development banking may have a negative impact on loan enforcement mechanisms. The international financial institutions (IFIs) of the existing Bretton Woods system and the new development banks will have to unite by imposing cross-default clauses to safeguard their preferred creditor status.

Multilateral lending is shifting away from western dominance

With hindsight, 2014 may well be noted as the year when serious competition has been built into multilateral development banking, especially for the World Bank and the Asian Development Bank (ADB). The new BRICS bank, officially called the NDB (to be headquartered in Shanghai), has been launched at the sixth summit of the BRICS countries, held in Brazil in July 2014. The bank will have subscribed starting capital of US$50 billion, with Brazil, Russia, India, China and South Africa initially contributing US$10 billion. Authorised capital is US$100 billion, paid-up capital will be US$10 billion, with US$40 billion calleable on demand. 3

Representatives from 21 Asian countries signed the Memorandum of Understanding on Establishing AIIB on 24 October 2014 in Beijing. By the end of March 2015, almost 50 countries – two-third Asian, one-third nonregional – had filed applications to join as founding members of the Beijing-based AIIB. Its subscribed capital is US $50 billion, half of which is paid in by China.

Like the NDB, the authorised capital for the AIIB is US $100 billion, the paid-up capital US$10 billion. The NDB has been established with a global remit to lend to developing countries. The AIIB is focused on Asia. Both new institutions are intended to concentrate on funding infrastructure projects. One of the major barriers to economic development in low and middle-income developing countries is the lack of critical infrastructure such as ports, railways, roads and power. Although the two new banks were launched in 2014, the decisions to create them reflects the growing discontent for many years among developing nations that the governance structure of the International Monetary Fund (IMF)and World Bank has not evolved to reflect the increasing weight of emerging markets in global GDP. AIIB and NDB can be viewed as part of a concerted Chinese attempt to build a Sinocentric global financial system, as an alternative to US hegemony, as voice reform in the established IFIs has failed. At the Asia-Pacific Economic Cooperation Leaders' Summit in November 2014, China's President Xi also announced the creation of a new Silk Road Fund to improve connectivity in Asia, for which China will provide US$40 billion of capital funding. The BRICS also had suggested in July 2014 an IMF-style contingent reserve facility (Contingent Reserve Arrangement (CRA)), for which the five countries agreed to earmark $100 billion of their foreign-exchange reserves for swap lines on which all members are entitled to draw. The China–Africa Development Fund and the China–Community of Latin American and Caribbean States (CELAC) infrastructure fund are further examples of recent attempts to develop a global Sinocentric finance infrastructure.

In a broader setting, the establishment of MDBs outside the established Bretton Woods system can be viewed as China's *shadow global diplomacy* that aims at undermining US-led governance structures since the Second World War. China's foreign policy is working systematically towards a realignment of the international order through establishing parallel structures to a wide range of international institutions (Heilmann et al., 2014; Wang, 2014). Is, therefore, competition building for the existing Bretton Woods system and western dominance? The US Treasury has tried to oppose the China-led AIIB by lobbying Australia, Indonesia and South Korea against joining the new bank and by pointing out that it would fail to meet environmental standards, procurement requirements and other safeguards adopted by the World Bank and the ADB (Perlez, 2014). After the UK decision to join AIIB in March 2015, an avalanche of western and Asian countries filed application to join the AIIB, however. China's magnetic attraction and the isolation of the US and Japan became palpable in fast motion (Halligan, 2015).

Can China and the BRICS nations help rebalance multilateral development finance away from western dominance through the creation of the NDB and the AIIB? First, viewed through Hirschman's antinomy of exit vs voice (Hirschman, 1970; Gehlbach, 2006), the cost of *exit* drop with past, present and expected failure for *voice* reform in the established IFIs. Second, excess demand for multilateral soft loans and the potential lending capacity by the NDB and AIIB will define the scope for how much relative business – hence political influence – the existing IFIs might lose in favour of the new competitors. Third, reputation and refinancing cost will determine whether and how fast the newcomers will succeed in building leverage on paid-in capital by tapping global bond markets. Based on these answers, the paper concludes that the existing Bretton Woods system is likely to lose market share and preferred creditor status.

Uneven representation

The recalibration of the world economy (OECD, 2010; Quah, 2011) – with the centre of gravity shifting toward East Asia – is still not reflected in the executive councils of the MDBs. The current imbalance of capital shares and voting rights in the existing multilateral banking system to the detriment of emerging market and developing countries (EMDCs) is well documented by Vestergaard and Wade (2014) who also show that the scope and pace of governance reforms have been dismal in the established IFIs. Moreover, the EMDCs can have little hope that the advanced countries relinquish their control on the ADB and the World Bank in particular through meaningful voice reform (Vestergaard und Wade, 2013).

The more imbalanced the system is in terms of representation and voice, the higher the pressure to rebalance toward fairer representation through creating institutions parallel to the established multilateral banks. The creation of AIIB and NDB corresponds to exit in Hirschman's antinomy (Hirschman, 1970). Both exit and voice carry cost. The cost of exit is fragmented multilateralism. The cost of voice in an imbalanced system is the incapacity to influence priorities, principles and procedures in multilateral development lending. As the BRICS nations succeed to organise shadow institutions to the established Bretton Woods system, the value of EMDCs' exit option may make voice in the established system relatively less attractive, even though it will probably increase the effectiveness of voice. Voice and exit are complements once exit has been organised (by creating new shadow institutions), but are substitutes when seen from the perspective of the initial decision to exercise voice or to organise exit (Gehlbach, 2006, p. 402). Hirschman's concept of loyalty by a country to the established system (say, to safeguard military protection by the US) is reflected in a greater cost of exit.

Which degree of representation and voice can be considered fair and would also minimise moral hazard in multilateral institutions? This is a philosophical question hard to answer. For simplicity, voting rights corresponding to percentage shares in purchasing power adjusted GDP will be considered as balanced, even representation. The BRICS represent 46 per cent of world population, 21.6 per cent of world GDP in current dollars and almost 30 per cent in revised 2011 ICP purchasing power parity weights.[1] In contrast to these population and income shares, the five BRICS together have just 13–14 per cent of shares and votes at the World Bank, according to the 'IBRD Statement of Subscriptions to Capital Stock and Voting Power' (Table 1). The G7 group of advanced countries represents only 15 per cent of world population; its share of world GDP corresponds roughly now to its voting shares at the International Bank for Reconstruction and Development (IBRD) if measured in current dollars (46.2 per cent). However, measured at the revised 2011 ICP purchasing power parity weights, the G7 group now accounts for just 32.8 per cent of world GDP; by that yardstick the G7 are clearly overrepresented by shares and votes at the World Bank.

The IMF quota system, which determines what each country pays in and how many votes they are given, fails to reflect the reality of a changing world even more. The BRICS states have just 10.3 per cent of quota. China, in particular, has a disproportionately low share of voting rights, with only 3.81 per cent of IMF voting rights even though it accounts for an estimated 12.4 per cent of world GDP. European countries, by contrast, are allocated 27.5 per cent for just 18 per cent of output. To add insult to injury, the IMF presidency is reserved for a European, while that of the World Bank routinely goes to an American. Reforms were agreed in 2010 that would have doubled the IMF's capital to $720bn and transferred 6 percentage points of quota to poorer countries. The reforms were never ratified by the US: in 2014, international financial reform and the G20 have suffered a serious blow after the US Congress refused to ratify a capital increase for the IMF agreed four years ago.

Europe has been a stumbling block toward reform as well, staying overrepresented in the executive board of World Bank, IMF and regional development banks. Although overrepresented, Europe's voice is not united and hence weaker than necessary. Meanwhile, the US retains a blocking minority at the IMF (and informally, joint with allies, at the other IFIs). Advanced economies have reneged on their promise to support greater voice and representation for the BRICS and other emerging economies in global governance arrangements. BRICS have thus little incentive to take more responsibility as important stakeholders of the global economy and as financiers of global public goods.

The ADB, firmly ruled by Japan and the US, provides an especially stark case of distorted representation. ADB members who are also members of Organisation for Economic Co-operation and Development (OECD) hold 64.6 per cent of total subscribed capital and 58.5 per cent of total voting rights. By contrast, China and India (the other three BRICS are not ADB members) combine a mere 10.9 per cent of voting rights (Table 2). Japan and the US are by far the biggest shareholders in the ADB with 15.7 per cent and 15.6 per cent, respectively. China, whose economy in dollar terms surpassed Japan's in 2010, has just 5.5 per cent of voting rights; India, soon to be Asia's and the world's most populous country, has 5.4 per cent. Needless to say, the ADB has so far always been directed by the Japanese. Policy positions are usually framed within the parameters set by the US–Japan relationship, which has effectively limited higher representation of, and core funding by, China and India in particular.

An immediate negative consequence of uneven representation is the negative impact on capital resources (to which China could amply provide) and hence lending capacity. Financial constraints on both the concessional window Asian Development Fund (ADF) for low income country clients and ordinary capital resources (OCR) for middle income countries are stretching ADB's capacity to the limit.[2] If ADB is to maintain meaningful levels of involvement in poor ADF countries, it has to find creative ways to enhance its financial capacity – or it has to change representation. Although Japan is the largest financial contributor to the ADB, its fiscal resources are limited by rapid ageing, with the risk to turn Japan into a 'middling donor' (Sawada, 2014).

The new parallel banks have also been fostered by low expectations that the governance of the established institutions would rebalance in the foreseeable future. While emerging and low income countries have been inadequately represented in the financial institutions built and dominated by the west, prospects for better future representation are bleak (Vestergaard and Wade, 2013). Voice reform has made no headway in reaching agreement on criteria for reallocating votes in future. For the World Bank, due to the 'preemptive rights principle',[3] voting power reform can only be achieved if all member countries agree. To be sure, it is difficult to negotiate

Table 1. IBRD statement of subscriptions to capital stock and voting power, Oct 2013

Country group	Capital stock shares, per cent	Voting power, per cent
BRICS	13.87	13.23
G7	43.71	41.49

Source: Author's calculation; https://finances.worldbank.org/Shareholder-Equity/IBRD-Statement-of-Subscriptions-to-Capital Stock-a/rcx4-r7xj.

Table 2. ADB subscribed capital and voting power, end 2013

Country group	Subscribed capital shares, per cent	Voting power, per cent
BRICS (China + India)	12.8	10.9
G7	45.0	37.8

Source: Author's calculation; www.adb.org/ar2013.

substantial voting power realignment when all member countries which stand to lose voting power have a veto. This is why the voting power reform was eventually based on a loosely administered 'quota framework', as opposed to a rules-based formula. So the BRICS were right to conclude that developed countries have no intention of losing voice and voting power in the established multilateral institutions.

The financing gap for multilateral soft loans

Over the last 20 years, 3.8 per cent of world GDP has been spent on (economic) infrastructure. Annual infrastructure spending has been trending down in advanced economies, from 3.6 per cent of GDP in 1980 to 2.8 per cent in 2008, but has been rising in emerging market economies, from 3.5 per cent to 5.7 per cent. The latter figure is driven by particularly high fixed-capital investment in Asia, especially China (McKinsey, 2010).

Potential future demand for concessional flows from the NDB and the AIIB and their relative lending capacity will determine what share of the business – hence political influence – the existing Bretton Woods institutions and western-led regional development banks might lose in favour of the new competitor banks. Most of that demand arises from infrastructure investment needs, which are not easily quantifiable. Yepes (2008) has estimated infrastructure investment needs at 6.6 per cent of GDP on average in developing countries, with wide differences depending on income levels (Table 3). The 2014 IMF update of the *World Economic Outlook* estimated the combined 2013 GDP of emerging and developing countries at 39.2 per cent of the world total, which roughly totalled $74trn that year. The group of emerging and developing countries thus produced a nominal GDP of $29trn. So their annual infrastructure investment spending needs would run at roughly $2trn, following the Yepes (2008) estimates.

What do these numbers imply for the current infrastructure financing gap in developing and emerging countries? The gap can be defined as the difference between investment needs and resources, or the funds needed to maintain economic growth and available funds. If infrastructure investment needs are difficult to estimate, infrastructure financing gaps are even more so. It should be kept in mind that such estimates are typically 'baseline figures' needed to keep pace with anticipated economic growth, rather than any 'social optimum'. They are, of course, highly difficult and uncertain, and subject to qualifications and criticism. Current annual spending on infrastructure in developing and emerging countries has been estimated at $0.8–0.9trn by Griffith-Jones (2014) who has assembled the evidence for the shortage of long-term finance, especially to finance infrastructure, in the developing and emerging countries.

Existing MDBs contribute merely $40–60bn (Table 4) to that sum while the bulk is being financed from national government budgets ($500–600bn). The annual spending on developing country infrastructure to finance access to water, electricity, transport and other infrastructure needed to combat poverty, deprivation and climate change have been estimated by various sources (surveyed in Bhattacharia and Romani, 2013) at $1.8–2.3trn. The resulting financing gap would be around $1.0–1.4trn. As pointed out by Eichengreen (2014), China may not have an infrastructure deficit, but it has something else: large construction companies that welcome the opportunity to undertake additional projects abroad, 'Hence the incentives of the BRICS bank's prospective creditors and borrowers are happily aligned'.

The potential lending capacity of AIIB and NDB

How much of that financing gap are the new institutions likely to satisfy? The NDB will have initial authorised capital of US$100bn and initial subscribed capital of US $50bn (and also a CRA with capital of US$100bn). The AIIB will have initial authorised capital of US$100bn, with subscribed capital also to be around US$50bn. As will be shown, the potential impact on multilateral development lending from these parallel institutions can be very substantial, reaching about the same annual lending level as the established MDBs did in recent years.

The level of leverage (loan to equity ratio, the reverse of usable capital to loan ratio) depends on the risk bear-

Table 3. Current annual infrastructure expenditure needs (per cent of GDP)

Country income	Investment	Maintenance	Total
Low income	7.0	5.5	12.5
Lower middle-income	4.9	3.3	8.2
Upper middle-income	1.3	1.0	2.3
Total developing	2.7	4.3	7.0

Source: Yepes (2008).

Table 4. Gross Annual Flows by Mainstream MDBs, 2012

	Concessional	Nonconcessional	Total
AfDB	1.9	3.5	5.4
ADB	1.9	6.8	8.7
IDA-IBRD	10.3	15.1	24.5
IDB	1.6	6.5	9.1
Total	15.6	31.9	47.6

Source: OECD (2014).

ing capacity of a MDB. MDBs forgo such leverage opportunity if they transfer amounts to special funds or trust funds which do not use a capital base to mobilise resources from financial markets and pass the amounts received from donors to beneficiaries at a rate of 1:1. A very simplified MDB balance sheet has the loan stock on the asset side and paid-up capital plus borrowings on the liability side (Bulow and Rogoff, 2005). A trust fund (concessional window) with no borrowings can thus achieve a loan-equity ratio of one only. Borrowings at the level of equity enable a loan-equity ratio of two, borrowings double the size of equity push the loan-equity leverage ratio to three.

The new banks will start as trust funds first; similar to the concessional windows of the established development banks (Reisen and Garroway, 2014), these are usually backed by the members' tax bases or official foreign exchange reserves. They are yet to turn into full development banks with a capital window also. Usually, these capital windows tap global bond markets thanks to AAA ratings at very low borrowing cost that they can lend (not grant) to borrowers in turn. AAA-rated MDBs in 2014 recorded a loan stock-usable capital ratio of between 2 and 4 (Table 5). Usable capital of one US$, defined as paid-up capital plus reserves, thus could underpin a loan stock portfolio of US$ 2 to 4 at the four leading AAA-rated MDBs.

In the case of the AIIB and the NDB, above future bond market borrowings, both are likely to benefit from having good access to funding from the state-owned development banks of the BRICS countries, such as from Brazil's *Banco Nacional do Desenvolvimento* (BNDES) and the China Development Bank. These national development banks would provide – apart from expertise and management skills – a large potential source of co-financing. Foreign exchange reserves constitute another funding source.

As NDB and AIIB will be providing infrastructure lending rather than grants, the return on capital from these investments could be higher than the current returns the BRICS are getting from their foreign exchange reserves, with a large share currently invested in low-yielding US government bonds. At the end of 2013, the five BRICS had accumulated foreign exchange reserves of $5.1trn, of which China alone possessed $3.9trn. Clearly, China will play a major role in both banks as a key source of capital. It has the financial fire power to close a large part of the infrastructure financing gap – given the right incentives and institutions.

Table 5. Loan-Equity* Ratios at AAA-rated MDBs, latest

MDB	ADB	AfDB	IADB	IBRD
	3.6	2.1	3.0	3.9

Source: Various press releases and annual reports (accessed on 30 March 2015 at the MDB websites).
**Equity is defined as the sum of paid-up capital and reserves.*

To obtain leverage on paid-in capital beyond national public resources, high reputation and low refinancing cost will be crucial for NDB and AIIB. How much time will it take for them to generate the reputation (knowledge and 'certification value') that the existing IFIs have acquired already? In general, the selection, monitoring and enforcement of loans are fundamental to the reputation of MDBs (Buiter and Fries, 2002). Whether and to what extent the newcomer banks will be able to attract additional capital from private sources will depend on the combination of features listed by Chelsky, Morel and Kabir (2013): a strong financial position; preferred creditor status; technical expertise; prudent risk management policies; credible application of well-understood standards in project design, execution, and corporate governance; a long-term perspective; and cross-country experience.

The AIIB can be expected to obtain AAA rating by the leading rating agencies. Apart from strong support by the major shareholder China, the recent joining by highly rated nonregional countries (including G7 countries) will lay the foundations of high intrinsic financial strength. Compared to the AAA-rated African Development Bank (AfDB), the AIIB will likely be less burdened by credit-negative considerations than the AfDB, which is burdened by a challenging operating environment across Africa. The regional exposure to Asia and the sectoral exposure to infrastructure should confer the AIIB a loan portfolio with relatively strong credit quality.

As far as the NDB is concerned, it could be argued that all five BRICS nations may suffer from at least one shortcoming that should lead to higher borrowing cost on international capital markets and hence lending cost that exceed those of the established development banks (Langhammer, 2014): inconvertible currencies; closed capital accounts; intransparent and illiquid local financial markets; fragile and unreliable legal systems; and thinly traded currencies that currently are under cyclical depreciation pressure. However, the close relationship to state capital that stands ready to be deployed as leverage makes these points relatively less relevant for both AIIB and NDB. Moreover, the BRICS have been converging recently toward income levels of the richer countries via superior growth, which actually should cause structural appreciation pressures (and lower funding cost compared to the advanced countries) due to the Balassa–Samuelson effect, unless sovereign bond spreads outweigh these funding advantages. For potential AIIB and NDB borrowers, therefore, currency swaps need to be offered to minimise currency mismatches due to potential appreciation risk.

Ratings and sovereign bond spreads have been extensively analysed in the empirical literature. Former work on sovereign ratings had identified among the most important ratings determinants also per capita income levels and the level of economic development, which arguably reflected the positive OECD-country bias built into the Basel 1 framework for risk weighting of regulatory bank capital. A study based on recent data (along the Basel 2 regime that had abandoned the OECD bias) is by Erdem and Varli (2014). They find that the most relevant factors of sovereign ratings are budget balance/GDP, GDP per capita growth, governance indicators and reserves/GDP for standard and poor's (S&P). Moreover, their model predicts up to 93 per cent of all credit rating levels on a quarterly basis from 2002 to 2011. Applied to China, the implicit guarantor of the AIIB and the NDB, these determinants should translate into competitively low spreads and hence refinancing cost. In fact, China has a lead over the US, the implicit guarantor of the World Bank and other MDBs, in terms of GDP growth and reserves/GDP.

Refinancing costs are not only driven by the liability side of the bank's balance sheet, however. It is equally important to have an asset portfolio that holds creditworthy borrowers and minimizes arrears and default.
7 IBRD and IDA are not very transparent on arrears; a
8 recent source summed up almost $2.1bn (1.37bn SDR) in arrears by 2011, the bulk from seven countries (IDA,
9 2010, Table 2). For the AIIB and the NDB to do better (or at least as well as IDA), the new banks may be well advised to follow China's example of imposing project (rather than policy) conditionality, which seems to generate less corruption and waste than the west's fragmented approach (Saidi and Wolf, 2011). It will be wise, from the perspective of reputation and refinancing cost, to focus on sustainable infrastructure project finance (rather than broad poverty reduction measures). This is where China and the other BRICS command a comparative (and at times, absolute) advantage relative to advanced country creditors.

AIIB and NDB can be seen as covering a potential borrower base similar to ADB and IBRD. Table 6 compares the paid-up capital of the four banks as well as actual and prospective loan portfolios.[4] Recent data show paid-up capital to stand at US$5.9bn for the ADB, backing a total loan portfolio (outstanding plus undisbursed) of US $75bn. The respective numbers for the IBRD are paid-up capital of US$14bn that underlies a total loan stock of US $152bn. If both AIIB and NDB succeed in building reserves from retained earnings and other sources, they could eventually reach similar loan- (paid-up) capital ratios as ADB (12.7) and IBRD (10.9). Applying these respective leverage ratios to AIIB and NDB, their paid-up capital (US$10bn each) could end up underpinning a loan portfolio of US$127bn (AIIB), and US$109bn (NDB).

Table 6. Paid-up capital and total loan stock, US$bn

MDB	Paid-up capital	Loan portfolio	Loan-Capital ratio
ADB	5.9	75	12.7
IBRD	14.0	152	10.9
AIIB	10.0	(127)	(12.7
NDB	10.0	(109)	(10.9)

Source: Various press releases and annual reports (accessed on 30 March 2015 at the MDB websites). 12

The combined loan portfolios (*c.* US$230bn) of AIIB and NDB would equal the combined loan portfolios of ADB and IBRD, absent (negative) substitution or (positive) agglomeration effects respectively (presented in parentheses in Table 6). While it is much too early today to be confident whether the newcomers will reach the financial performance achieved by ADB and IBRD, the scenario laid out here might well suggest that AIIB and NDB will reach as a group annual lending levels similar to the two established MDBs. Consequently, expect the China and BRICS led banks to have a discernible impact on multilat- 10
eral development lending, and thus on global financial 11
governance.

Outlook

The establishment of BRICS led MDBs will be beneficial for global development to the extent that it helps cover some of the current infrastructure financing gaps. Moreover, the new banks organise 'voice' for EMDCs and rebalance representation of the nonOECD countries in multilateral development lending. This is likely to speed up voice reform even in the established multilaterals. Competition is building for the existing Bretton Woods system.

So why are the US lobbying against those banks? Perlez (2014) cites a senior Obama administration official: the Treasury Department had concluded that the new bank would fail to meet environmental standards, procurement requirements and other safeguards adopted by the World Bank and the ADB, including protections intended to prevent the forced removal of vulnerable populations from their lands. By contrast, the ADB has become so encumbered with restrictions that it now takes up to seven years on average for a project to go from proposal to approval to completion, the official said.

Another concern (not publicly discussed yet to my knowledge) is that the establishment of alternative source of multilateral funding will act to weaken the enforcement mechanism of the existing MDBs. They might as well lose their *preferred creditor status*. Willem Buiter and Steven Fries (2002) had discussed this after the European Bank for Reconstruction and Development had been created: a basic mechanism for fostering compliance with the terms and conditions of MDB loans to the public sector involves the dynamic incentives that arise from the repeated interaction between borrowing governments and the MDBs. The potential for repeated loans, together with the credible threat to cut off future lending when terms and conditions are not met, can be exploited to help ensure borrower compliance.

The incentive mechanism arising from repeated interactions is more effective when borrowers face limited access to alternative sources of financing. Therefore, it must indeed be envisaged that the incentive for borrowing countries to comply with the terms and conditions of, say, IDA loans will diminish as the end of the lending relationship nears and is replaced by loans from the AIIB or the BRICS bank. To be sure, the loss of preferred credi-
13 tor status is a potential thread for both types of MDBs, established and new. They have thus an incentive to cooperate in defining and implementing mutual cross default clauses in their loan contracts.

Notes

1 VI BRICS Summit (2014) [online]. Available from: http://www.brics6.itamaraty.gov.br/about-brics/economic-data
2 ADB has recently presented a new proposal to enhance ADB's financial capacity through a modified management of its capital resources. The proposal entails terminating the heavily subsidised ADF loan operations and combining ADF loans (and part of ADF liquid assets, projected to be US\$35.3bn in total) with the OCR balance sheet in January 2017. This would increase OCR equity from a projected US\$17.9bn to US\$53.2bn. ADF would henceforth provide only grant assistance, while ADB would continue concessional lending through its OCR window.
3 The Bank's Articles of Agreement stipulate that increases in the Bank's capital require a special majority – a 75 per cent majority of votes. At the same time, however, each and every member country has a right to 'subscribe to a proportionate share of the increase' whenever a decision is made to increase the Bank's capital (World Bank sources quoted in Vestergaard and Wade (2013, p. 159)).
4 Griffith-Jones (2014) provides estimates about prospective lending levels for the NDB based on future paid-in capital of US \$20bn and on the loan-equity leverage ratio obtained by CAF (2.4), the Latin American development bank. Her estimates add capital of both nonBRICS emerging and developing economies, as well as the minority share for developed economies, for initial total capital to reach US\$100bn and paid-in capital could increase to US\$20bn. This would mean an initial level of total lending of almost US\$50bn – that is US\$5bn annually initially with average loan maturity at ten years – with accumulated profits reinvested in contributed capital. After a period of ten years, the author reckons that the NDB could be lending US \$7bn annually.

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