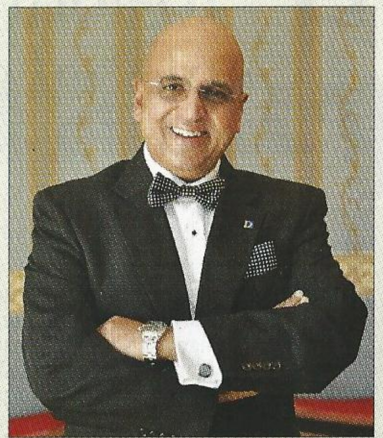
BANKING ON KNOWLEDGE

Monetary policies significantly impacted by growth, inflation and currency volatility

By Dr R Seetharaman

The leaders of Brazil, Russia, India, China and South Africa (Brics) announced at the sixth annual Brics summit held last week in Fortaleza, Brazil, the creation of the New Development Bank (NDB) to finance infrastructure and "sustainable development" projects, with $50bn in capital.

The Brics Development bank work on an equal-share voting basis, with each of the five signatories contributing $10bn for the capital. Brics have also created $100bn Contingent Reserve Arrangement (CRA), which member states can draw on in financial emergencies when their foreign exchange reserves become dangerously depleted. The CRA — unlike the pool of contributed capital to the Brics Development bank, which is equally shared — is being funded 41% by China, 18% from Brazil, India, and Russia, and 5%



from South Africa. The Brics group constitutes about 18% of global GDP and the NDB bank will be parallel to the existing World Bank and IMF.

Brics Development Bank is a new chapter in Global Governance. It aims for better financial co-operation among the member countries and will be headquartered in China. It will also develop a global monetary policy considering the developments of emerging economies.

Earlier to stop currency speculation during the Asian Crisis, many Asean nations plus China, South Korea, Japan had established a network of bilateral currency swap agreements which became the "Chiang Mai Initiative". Also in late 1960s, major countries in South America created the "Development Bank of Latin America" to provide infrastructure loans, which had less regulations than those imposed by the World Bank. The developing economies need further infrastructure development and, despite the existing multilateral development banks, infrastructure investment gaps still prevail and hence Brics Development Bank can play a key role in global development finance in relation to such economies.

The summer of 2013 witnessed shocks in

currency markets on account of concerns of tapering by the Federal Reserve and the Indian rupee touched Rs 68.8 per dollar, Brazil real touched BRL2.45 and Russian Ruble touched RUB33 respectively.

Even though the fear of fed tapering has calmed down the markets, significant currency volatility of summer 2013 impacted the current account deficits of countries such as India and Brazil. The recent Fed minutes confirmed that the US central bank's monthly bond purchases would probably end in October 2014 and showed that policymakers debated the complexities of unwinding a stimulus programme that has flooded the financial system with over $2tn. However, US Fed Chair Janet Yellen has indicated that Fed will hike interest rates sooner and higher than expected if the labour market continues to improve more quickly than anticipated by the Fed. Significant spike in US bond yields on account of expectation of interest rate rises could create currency volatility and in such circumstances, the Brics CRA can play an important role.

Chinese Yuan is the most stable currency compared to the rest of Brics currencies on account of a more effective state control of its exchange rate versus the US dollar and has steadily improved its forex-related export competitiveness over the past several years. The use of Yuan has been increasing with China having a programme to internationalise its currency by allowing the Yuan to be used to settle cross-border trade. Since then, China's trading partners have increasingly been able to use the Yuan when paying for imports or receiving payments for exports.

The structural disparity between China and the rest of the Brics members is of significant importance for Brics Development Bank. This could make coordination in terms of operations and funding priorities a challenging exercise. China's track record of keeping the Yuan exchange rate in support of their global trade indicates they may strive to keep the forex advantage within the Brics group as well, increasing risks of currency-related challenges in it.

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