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Goodbye to 2017, a Trump-dominated year

Finance Monthly

The year 2017 is fast ending and a new year 2018 will soon be starting: a good time to take stock. The past year was dominated by President Trump of the United States, who put his stamp on world affairs in many ways. He offended allies and foes alike, while catering to his voter base. The changes he made to US policies on the UN, climate change, trade and (as the year ended) on the Palestinian-Israeli conflict, changed the world in many ways. Developing countries, affected in 2017, are worried what next will change in 2018.

This issue of the South Bulletin contains many articles on the global economy. Although in 2017 the economy performed moderately, it has built up many vulnerabilities that will adversely affect developing countries should a new financial crisis break out. Our articles point out the new and old sources of instability and vulnerability, and call for the South to be cautious and to prepare for the next crisis.

This is the 100th issue of the South Bulletin. We hope our readers will appreciate and benefit from it, and from other issues to come! Season's Greetings to all our readers!

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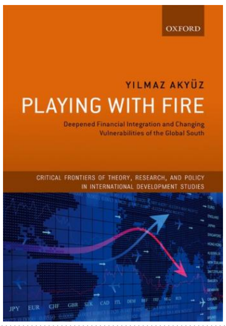

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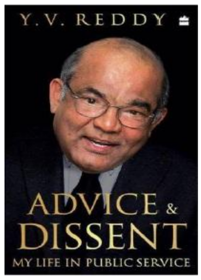


Goodbye to 2017, a Trump-dominated year

In 2017, Donald Trump dominated the year by using US clout to change many aspects of global relations, and not for the better.

Saul Loeb/AFP/Getty Images

Trump's policies and pronouncements had a major impact on the world, causing shockwaves on trade, immigration, migration, climate change and the environment, and international security issues.

By Martin Khor

What a year it has been! As 2017 slips away, and 2018 dawns, many wonder if the world will ever be the same.

Credit or blame goes mainly to United States President Donald Trump for this radical change. This time last year, after he won the presidential elections, it was a toss-up whether Trump would implement his campaign promises or become a more statesmanlike President.

After all, most election candidates are extreme on the campaign trail to win votes, then become moderate on assuming office. Not Trump. For the past year, he has ruled as if he was catering to his extreme right voter base, with its narrow, anti-foreign and anti-internationalist views.

Trump's policies have been in line with implementing his America First inauguration slogan, which really meant the America of his voter base, and with the accompanying sentiment, why should we bother about the rest of the world? And he reached out directly to his base and the world public via a daily dose of tweets.

Many Americans (which increasingly include many Republicans) were aghast. And the rest of the world received one policy pronouncement after another with a mixture of disappointment, incredulity and outrage. The list includes insults to traditional allies (Australia, Germany, Canada, Mexico, United Kingdom) and traditional and new foes real or imagined (North Korea, Iran, several Muslim-majority countries whose citizens now can't enter the US) and with threats to economic rivals especially China but also countries with trade surpluses with the US, whom he labelled "cheaters."

The new US leadership threatened NATO, paralysed the G7, pulled the US out of the Paris climate agreement, UNESCO and Global Compact on Migration, reduced funding for the United Nations and its agencies, and stopped all funding to the Green Climate Fund.

Trump's policies were especially worrying for developing countries on trade issues. He pulled the US out from the TPPA (Trans Pacific Partnership Agreement) and initiated a renegotiation of NAFTA (North America Free Trade Agreement).

These by themselves may not be a bad thing, if the changes the US wants are for the good of all sides, since FTAs involving the US have many serious flaws. But the evidence is that although most of these FTAs are already biased towards American interests, the Trump administration wants to ensure that new US FTAs will have even more benefits going to the US, for example through opening markets even wider for US products and even more stringent intellectual property provisions that favour US corporations.

Trump at first threatened to impose a 30-45 per cent tariff on imports from China and Mexico, but this has not been done (at least not yet). Then the Republican Congress leaders put forward a border adjustment tax scheme (as part of tax reforms) that would place a 20% tax on all imports; this plan was eventually withdrawn after many US companies that rely on imports protested.

The Trump administration then revived its unilateral trade weapon, Section 301 of the US Trade Act 1974, which the US had hardly used since the World Trade Organization was established. In August, Trump initiated that an investigation be conducted to see if Section 301 tariff increases should be imposed on China for alleged violation of intellectual property and for requiring US companies to transfer technology. The use of Section 301 is not in line with WTO rules; if the US returns to its old bad habit of taking unilateral trade actions, it will open the door to a global trade war.

Just as worrying was the new US attitude towards multilateral trade relations and the WTO. It showed its contempt for the WTO's dispute settlement system by blocking replacements for retiring Appellate Body members, thus reducing the WTO's capacity to arbitrate trade disputes. It has refused to recognise the work done so far in the Doha work programme, giving the view that Doha is dead, and given notice that it wants a revamp of the concept and use of the WTO's special and differential treatment principle that is so important for developing countries.

The year is ending with two more shocks. First, Trump announced that the US recognises Jerusalem as the capital of Israel, going against the previous

AP

People gather at the UN General Assembly, prior to a vote, December 21, 2017, at the United Nations headquarters in New York.

US policy, the official UN position and the status quo (where the city is presently shared between Palestine and Israel). This move, planned by his son-in-law and not the State Department, has been opposed even by US allies. And it has triggered outrage across the developing world, with protests held in many parts of Palestine (resulting in increasing numbers of deaths and injuries) and other countries.

The new US policy destroyed any remaining hopes, if any, of a solution to the Palestine-Israel conflict in the foreseeable future, and is likely to trigger another tragic round of bloody clashes in a region already fraught with wars.

Second, the US brought its antagonism to the present trading system to the Ministerial conference of the WTO held in the first half of December in Buenos Aires. Its entrenched position refusing to recognise the WTO's 16-year-old Doha agenda, or to honour a previous Ministerial commitment to create a permanent solution to a food security issue (known as public stockholding), or to acknowledge the principle and new proposals for special treatment of developing countries, was the main reason why the conference ended without the traditional Declaration and key decisions. It also leaves the WTO in unchartered territory.

The Trump effect certainly dominated events and trends in 2017. The biggest fear is that by design or accident or even an insulting tweet, conflict may break out between the US and North Korea, escalating into a nuclear war. If at least this can be avoided, we can thank our lucky stars. So low have expectations of the world order fallen.

The year will also be remembered for the depths of inhumanity inflicted on fellow humans.

Top of the list is the persecution of the Rohingya in Myanmar. Since end-August, about 650,000 Rohingya crossed to Bangladesh to find refuge, at least 6,700 had been killed in the first month (according to a Doctors Without Borders survey) and many of their houses and villages had been burnt. Despite widespread condemnation, including the top UN human rights official terming this as "elements of genocide", the future of the Rohingya is both uncertain and bleak.

Natural calamities continued unabated. Many countries across the world suffered from storms, cyclones and hurricanes that wreaked destruction (with some Caribbean islands recently experiencing almost total physical and economic wipe-out); earthquakes caused damage in other countries; forest fires swept across parts of California and elsewhere, and drought affected millions of people in Africa.

We are more and more witnessing the effects of climate change. The warmer atmosphere holds more water vapour, with higher potential for rainfall, while the warming oceans affect weather patterns, resulting in more powerful tropical storms and hurricanes.

But during the year, efforts to counter global warming were still at much too slow a pace. According to a recent report, global Greenhouse Gas emissions are estimated to have risen again in 2017, after a few years of decline. Details on how to share the burden of transition to a low-carbon world have still to be worked out, and this hampers the speed of environmental action. The US pulling out of the Paris Agreement and the about-turn in its domestic climate change policies made things worse.

The UNFCCC Conference of Parties session in Bonn in November discussed the details of interpreting the global framework of how countries should implement aspects of the Paris Agreement. There was some progress, but also evidence that major differences remain, especially on North-South lines.

The global economy performed moderately well in 2017. The US, Europe and Japan had more positive economic growth, though they have yet to recover from the financial crisis that began in 2008. China's economy expanded by near to 7%. Buoyed by exports, Asian developing countries will attain better-than-expected 6% growth in 2017, according to latest Asian Development Bank estimates.

Some experts are however warning about the massive build-up of debt and predict another bout of **domestic and international** financial instability, that will also manifest in volatility in capital flows and foreign exchange rates. So whether the 2017 momentum can be sustained, or whether 2018 will witness a bursting of the economic bubble, is unclear.

But that's not the only thing that is unclear. As the year ends, and a new year begins, there is great uncertainty in many areas and issues in the world.

Martin Khor is the Executive Director of the South Centre.

Contact: director@southcentre.int

"Another Crisis in the Making?" – a report on the South Centre debate

A South Centre debate on the state of the global economy and finance on the occasion of the book launch of *Playing with Fire, Deepened Financial Integration and Changing Vulnerabilities of the Global South* authored by Dr. Yılmaz Akyüz, Chief Economist of the South Centre, took place on 10 November 2017 at the *Palais des Nations*, UN Office in Geneva, Switzerland. Below is a report of the meeting.

by Adriano José Timossi

A South Centre debate "Another Crisis in the Making?" on the state of the global economy and finance took place on 10 November 2017 at the *Palais des Nations*, UN Office in Geneva, Switzerland. It was held on the occasion of the book launch of *Playing with Fire*, *Deepened Financial Integration and Changing Vulnerabilities of the Global South* authored by Dr. Yılmaz Akyüz, Chief Economist of the South Centre, published by Oxford University Press.

The meeting was moderated by Mrs. Yuefen Li, Special Advisor on Economics and Development Finance of the South Centre, with presentations by Dr. Richard Kozul-Wright, Director of the Division on Globalization and Development Strategies (GDS), UNCTAD, Dr. Y.V. Reddy, South Centre Board Member and Former Governor of the Reserve Bank of India, and Dr. Peter Dittus, Former Secretary General of the Bank for International Settlements (BIS). Dr. Yılmaz Akyüz, the author, responded to various comments and observations made by the panellists.

"Playing with Fire is a comprehensive account of financial integration of emerging and developing countries supported by a wealth of data and information. It also includes discussion of new vulnerabilities to external financial shocks. The book aids understanding of destabilizing interactions between key international markets for emerging and developing countries through a new concept of commodity-finance nexus. It takes a critical look at foreign direct investment." (Oxford University Press).

The debate

Mrs. Yuefen Li opened the meeting with a brief introduction of the South Centre, noting that it undertakes research in several areas of interest for developing countries including global macroeconomic and financial issues. She noted that the speakers attending the debate have all published recently important books on the topic of the debate. *Advice and Dissent: My Life in Public Service* by Dr. Reddy; *Revolution Required: The Ticking Time Bombs of the G7 Model* by Dr. Dittus, co-authored with Dr. Hervé Hannoun, former Deputy General Manager of the BIS; and UNCTAD's latest *Trade and Development Report* prepared under the guidance of Dr. Kozul-Wright also discuss similar issues.

Speaking on the topic of the debate, Mrs. Li said that 20 years from the Asian financial crisis and 10 years from the subprime crisis, there is now a significant build-up of financial fragility in the world economy and the book *Playing with Fire* is extremely timely. It provides a wealth of data and information and most importantly, it has in-depth and insightful analysis of the integration of emerging and developing economies into the global financial system, the problems they have encountered in the process and the vulnerabilities entailed.

Dr. Richard Kozul-Wright welcomed Dr. Akyüz's book as it brings new and challenging insights to the discussions on development policy. The UNCTAD economist noted that *Playing with Fire* provides a comprehensive treatment of global financial linkages of emerging and developing economies and the vulnerabilities they entail. In this regard, the book describes

From left to right: Dr. Y.V. Reddy, Dr. Peter Dittus, Mrs. Yuefen Li, Dr. Yılmaz Akyüz and Dr. Richard Kozul-Wright.

two sets of linkages. First, the institutions, innovations and policies that propelled finance to its vanguard role in what Dr. Akyüz describes as finance-led globalization or what UNCTAD calls "hyper-globalization". Secondly, the linkages which trace the impact of financialization in the world economy.

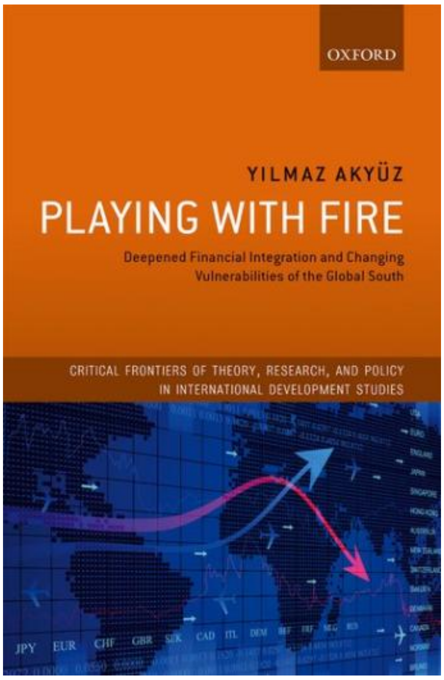
Focusing his presentation on the linkages, Dr. Kozul-Wright enumerated three key relations raised in the book; namely, the finance-inequality nexus, the finance-commodity nexus and the nexus between finance and foreign direct investment, and provided a brief analysis of each of the three topics.

On the finance-inequality nexus, there is a huge literature in the past decade on the rise of finance and financialization in the world economy and the increasing of inequalities and its consequences, Dr. Kozul-Wright said, giving the example of the work done by Stiglitz and Piketty. He recalled that already in the 1990s the issue was first brought to attention by UNCTAD in its Trade and Development Reports, prepared under Dr. Akyüz's guidance, addressing the relationship between rising inequality and growing dominance of finance.

What is different in this book is that Dr. Akyüz links it to the debate that has surfaced in the post-crisis period about the potential danger of secular stagnation, emphasizing the role of inequality and underconsumption. He emphasizes globalization, financialization and the shift towards more neoliberal policy regimes as the key factors reducing the bargaining power of labour, rather than the technological challenges and demographic pressures or more traditional explanations of secular stagnation.

This is also an issue covered in this year's Trade and Development Report, which shows that the rise of finance has been a leading factor in the rising of inequality and has been, as consequence, a major source of fragility and crisis in many economies since the late 1970s, Dr. Kozul-Wright noted. Policy measures adopted in crisis and post-crisis periods strongly influenced by finance failed to trigger a strong recovery while increasing inequality in various ways.

Dr. Y. V. Reddy noted that Dr. Akyüz's book combines important elements of academic work, policy and institutions. He stressed that the two books *Playing with Fire* and *Revolution Required* of the panel speakers are important readings for the topic of the debate as they illustrate well the current situation and challenges ahead. He read some key passages from *Revolution Required* in comparison with the central themes of *Playing with Fire:*



"The global financial system remains fragile. The world economy struggles to recover. Climate change accelerates. Digitization and globalization depress wages. Income inequality is on the rise. Geopolitical turbulences are spreading. Lies are presented as truths. Truth remains unspoken. And people are angry. Karl Marx thought that capitalism was sowing the seeds of its own destruction, eventually leading to a revolution. We believe that rather than anonymous forces, it is the policies of the G7 countries that are now undermining the foundations of the market economy. The G7 policies in the domains of monetary policy, fiscal and macroeconomic policy, prudential policy, defence and climate change policy have a common feature: They are lax, reckless, and irresponsible".

"A monster has been created which is still not under control. Increasingly it seems as if the 2008 Great Financial Crisis may only have been a dress rehearsal for a worse crisis which lies ahead. It will come as the result of the excessive use of the money printing press, the build-up of asset price bubbles, the debt accumulation encouraged by low or negative interest rates."

Dr. Peter Dittus said that *Playing with Fire* is a very timely book because it analyses some of the fragilities that will make the next crisis very difficult to deal with. The book has a very compelling logic as it describes and examines in depth and with richness the financial integration between emerging and developing countries and advanced economies.

Looking at the detailed analysis of the book one can see that vulnerabilities of emerging and developing economies have actually increased today. This, despite the fact that many countries have moved to floating exchange rates, accumulated large amounts of reserves and pursued much better fiscal policies. The fragility and potential exposure to a crisis in the world has actually increased, and policy options to deal with it have decreased. This is an important message of this book.

Dr. Yılmaz Akyüz, responding to some of the comments made by the panellists, noted that there are many common grounds between the two books, *Playing with Fire* and *Revolution Required,* even though they were written independently and they focus on different parts of the world – the Global South and advanced economies, respectively. This may be partly because they both draw on data, information and research provided by the BIS.

The book

Playing with Fire is about the financial integration and vulnerabilities of the Global South. Integration accelerated in the new millennium after a series of crisis. It has been greatly facilitated by monetary and financial policies in advanced economies, notably the US. These policies are designed to generate debt-driven growth in the face of a chronic demand gap created by growing inequality and underconsumption.

The US Fed has pursued progressively looser monetary policy since the 1980s, creating a downward bias in interest rates and upward bias in debt, not only at home but also globally. This policy generates boom-bust cycles in credit and asset markets. These in turn aggravate the demand gap by increasing inequality, and reduce supply capabilities by distorting resource allocation, thereby necessitating even bigger bubbles to sustain growth.

The policy of rapid liquidity expansion and low interest rates has given rise to a search for yield and greater appetite for risk. It has therefore played a key role in the growing international lending and investment in emerging and developing economies. External financial liberalization in these economies themselves also played an important role. Some of the measures taken were designed with the objective of reducing external vulnerability. However, in reality they have created new sources of vulnerability without removing the old ones.

Many of these economies have taken certain measures to increase their resilience to financial shocks, as mentioned by Dittus. However, useful as they are, these can prove inadequate in the face of a severe external financial shock and massive and sustained exit of capital. It is not possible to anticipate when and how this might occur, but the credit and asset bubbles under way for almost a decade do not look sustainable.

Adriano José Timossi is Senior Programme Officer of the Global Governance for Development Programme (GGDP) of the South Centre.

Playing with Fire *provides an empirical account of deeper integration of emerging and developing economies into the global financial system and discusses its implications for stability and growth, focusing on the role of policies in the new millennium in both emerging and developing economies and the United States and Europe.*

– Oxford University Press, extract from the back cover description of the book

South should prepare for the next financial crisis

The Asian financial crisis started 20 years ago and the global financial crisis and recession 9 years back. When a new global financial crisis strikes, the developing countries could be more damaged than in the last crisis as they have become less resilient and more vulnerable. They thus need to prepare from being overwhelmed.

By Martin Khor

A debate is taking place as to whether the time is now ripe for a new crisis. Most economists and commentators think not, as an economic recovery, admittedly weak, appears to be taking place in developed economies.

On the surface, the present situation seems quite good. The US, Europe and Japan are having very good economic growth rates compared to the most recent years and China's GDP may grow close to 7% in 2017, according to one estimate.

There has not been big capital outflows, as feared, from developing countries in response to the phasing out of the quantitative easing policies in the US and now Europe. Most mainstream economists are optimistic about world economic prospects in 2018.

But below the calm surface, the waters are boiling and churning. Whether the deep-seated problems boil over shortly into full-blown crisis, or continue to fester for some time more, is hard to predict. But the world economy is in trouble.

Amidst a weak global economy recovery, many serious risks remain, wrote Martin Wolf, the Financial Times' chief economics commentator, on 5 July. "The possibly greatest danger is a collapse in global cooperation, perhaps even an outbreak of conflict," he said.

"That would destroy the stability of the world economy on which all depend…We in the high-income countries allowed the financial system to destabilise our economies. We then refused to use fiscal and monetary stimulus strongly enough to emerge swiftly from the post-crisis economic malaise.

"We failed to respond to the divergences in economic fortunes of the successful and less successful. These were huge mistakes. Now, as economies recover, we face new challenges: to avoid blowing up the world economy, while ensuring widely shared and sustainable growth. Alas, we seem likely to fail this set of challenges."

A comprehensive and in-depth analysis of the global economic situation and how it affects developing countries is given in a recent paper by the South Centre's chief economist Yılmaz Akyüz, assisted by Vicente Yu.

The US and Europe have wrongly managed the aftermath of the 2008 crisis by policies that will have very adverse effects on most developing countries, according to the paper, "The Financial Crisis and the Global South: Impact and Prospects."

The developing countries went through the 2008 crisis without much harm, because of certain conditions, which no longer exist.

Meanwhile, these countries have recently built up new and dangerous vulnerabilities which expose them to serious damage when the next crisis strikes. It is thus imperative that the developing countries review their precarious situation and act to protect their economies to the extent possible to reduce the effects of the new turmoil.

Akyüz says the post-2008 crisis has moved in a third wave to several emerging economies after having swept from the US to Europe. A central reason is the wrong crisis response policies of the US and Europe.

"There are two major shortcomings: the reluctance to remove the debt overhang through orderly restructuring, and fiscal orthodoxy," adds Akyüz. "These resulted in excessive reliance on monetary policy, with central banks going into uncharted waters including zero and negative interest rates and rapid liquidity expansion through large bond acquisitions.

"These policies not only failed to secure a rapid recovery but also aggravated the global demand gap by widening inequality and global financial fragility by producing a massive build-up of debt and speculative bubbles. They have also generated strong deflationary and destabilising spillovers for developing economies."

When a new crisis comes, developing countries will be harder hit than in 2008. Their resilience to external shocks is now weak, due to three factors.

First, many developing economies deepened their integration into the international financial system, resulting in new vulnerabilities and high exposure to external shocks. Their corporations built up massive debt since the crisis, reaching US$25 trillion (95% of their GDP); and dollar-denominated debt securities issued by emerging economies jumped from $500 billion in 2008 to $1.25 trillion in 2016, carrying interest rate and currency risks. Moreover, foreign presence in local financial markets reached unprecedented levels, increasing their susceptibility to global financial boom-bust cycles.

Second, the current account balance and net foreign asset positions of many developing countries have significantly deteriorated since the crisis. In most countries, foreign reserves built up recently came from capital inflows rather than trade surpluses. They are inadequate to meet large and sustained capital outflows.

Third, the countries now have limited economic policy options to respond to adverse developments from abroad. Their "fiscal space" for counter-cyclical policy response to deflationary shocks is much more limited than in 2009; they have significantly lost monetary policy autonomy and lost control over interest rates due to their deepened global financial integration; and flexible exchange rate regimes are no panacea in the face of financial shocks.

"Most developing economies are in a tenuous position similar to the 1970s and 1980s when the booms in capital flows and commodity prices ended with a debt crisis as a result of a sharp turnaround in US monetary policy, costing them a decade in development," warns Akyüz. It would be hard for some of them to avoid international liquidity or even debt crises and loss of growth in the event of severe financial and trade shocks.

Unfortunately, the South has not been effective in reflecting on these problems nor in taking collective action. Global reforms are required to prevent the major countries from transmitting the effects of their wrong policies to developing countries; and global mechanisms are needed to prevent and manage financial crises.

There have been many proposals for reform in the past but hardly any action taken due to opposition from developed countries. "Now the stakes are too high for developing countries to leave the organisation of the global economy to one or two major economic powers and the multilateral institutions they control," concludes Akyüz.

If his wide-ranging analysis is correct, then what we are experiencing at the end of 2017 is the "calm before the storm." The financial crisis crisis that started in 2008 has never ended but has gone through twists and turns. It will eventually enter more dangerous territory due to new factors fanning the flames.

The underlying causes are known, but what is yet unknown is the specific event that will trigger and ignite a new phase of the crisis, and when that will happen.

When the new crisis takes place, developing countries will be in a less fortunate position to ride through it compared to 2008, so there is even less reason for complacency.

Each country should analyse its own strong and weak spots, its vulnerabilities to external shocks, and prepare actions now to mitigate the crisis in advance, rather than wait for it to happen and overwhelm its economy.

Asian Financial Crisis: Lessons Learned and Unlearned

Much of what has recently been written about the Asian crisis on the occasion of its 20th anniversary praises the lessons drawn from the crisis and the measures implemented thereupon. But they often fail to appreciate that while these might have been effective in preventing the crisis in 1997, they may be inadequate and even counterproductive today because they entail deeper integration into global finance.

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Finance sector employees protest in Bangkok in November 1997.

By Yılmaz Akyüz

Debates are taking place on whether there will be another financial crisis, whether in some part of the world or that is global in scope. Governments draw lessons from financial crises to adopt measures to prevent their recurrence. However, such measures are often designed to address the root causes of the last crisis but not the next one. More importantly, they can actually become the new sources of instability and crisis.

Much of what has recently been written about the Asian crisis on the occasion of its 20th anniversary praises the lessons drawn and the measures implemented thereupon. But they often fail to appreciate that while these might have been effective in preventing the crisis in 1997, they may be inadequate and even counterproductive today because they entail deeper integration into global finance.

An immediate step taken in Asia was to abandon currency pegs and move to flexible exchange rates in order to facilitate external adjustment and prevent one-way bets for speculators. This has a lot to commend it, but its effects depend on how capital flows are managed.

Under free capital mobility no regime can guarantee stable rates. Currency crises can occur under flexible exchange rates as under fixed exchange rates. Unlike fixed pegs, floating at times of strong inflows can cause nominal appreciations and encourage even more short-term inflows. Indeed nominal appreciations have been quite widespread during the surges in capital inflows in the new millennium, including in some East Asian economies.

Second, most emerging economies, including those in Asia, have liberalized foreign direct investment regimes and opened up equity markets to foreigners on the grounds that equity liabilities are less risky and more stable than external debt. As a result, non-resident holdings as a percent of market capitalization have reached unprecedented levels, ranging between 20 and 50 per cent compared to 15 per cent in the US.

This has made the emerging economies highly susceptible to conditions in mature markets. Since emerging economies lack a strong local investor base, the entry and exit of even relatively small amounts of foreign investment now result in large price swings.

Third, they have also sought to reduce currency mismatches in balance sheets and exposure to exchange rate risk by opening domestic bond markets to foreigners and borrowing in their own currencies. As a result sovereign debt in many emerging economies is now internationalized to a greater extent than that in reserve-currency countries.

Whereas about one-third of US treasuries are held by non-residents, this proportion is much higher in many emerging economies, including in Asia. Unlike US treasuries this debt is not in the hands of foreign central banks but in the portfolios of fickle investors.

Although opening bond markets has allowed the sovereign to pass the currency risk to lenders, it has led to loss of autonomy over domestic long-term rates and entailed a significant exposure to interest rate shocks from the US. This could prove equally and even more damaging than currency exposure in the transition of the US Fed from low-interest to high-interest regime and normalization of its balance sheet.

Fourth, there has been extensive liberalization of the capital account for residents. Corporations have been encouraged to become global players by borrowing and investing abroad, resulting in a massive accumulation of debt in low-interest reserve currencies since 2008.

They have also borrowed through foreign subsidiaries. These are not always repatriated and registered as capital inflows and external debt, but they have a similar impact on corporate fragility. Hence the reduction in currency mismatches is largely limited to the sovereign while private corporations carry significant exchange rate risks.

Fifth, limits on the acquisition of foreign securities, real estate assets and deposits by resident individuals and institutional investors have been raised or abolished. A main motive was to relieve upward pressures on currencies from the surge in capital inflows. Thus, liberalization of resident outflows was used as a substitute to restrictions over non-resident inflows. Although this has led to accumulation of private assets abroad, these would not be readily available at times of capital flight.

Sixth, banking regulations and supervision have no doubt improved, restricting currency and maturity mismatches in bank balance sheets. However, banks now play a much less prominent role in the intermediation of international capital flows than in the 1990s. International bond issues by corporations have grown much faster than cross-border bank lending directly or through local banks and a very large part of capital inflows now goes directly into the securities market.

These measures have failed to prevent credit and asset market bubbles in most countries in the region. Increases in non-financial corporate debt since 2007 in Korea and Malaysia are among the fastest, between 15 and 20 percentage points of GDP. At around 90 per cent of GDP Malaysia has the highest household debt in the developing world. In Korea the ratio of household debt to GDP is higher than the ratio in the US and the average of the OECD.

International Reserves

Asian economies, like many others, are commended for building self-insurance by accumulating large amounts of international reserves. Moreover, an important part of these came from current account surpluses, not just capital inflows. Indeed, all countries directly hit by the 1997 crisis made a significant progress in the management of their external balances in the new millennium, running surpluses or keeping deficits under control.

However, whether or not these reserves would be sufficient to provide adequate protection against massive and sustained exit of capital is highly contentious. After the Asian crisis, external vulnerability came to be assessed in terms of adequacy of reserves to meet short-term external debt in foreign currencies.

However, there is not always a strong correlation between pressure on reserves and short-term external debt. Often, in countries suffering large reserve losses, sources other than short-term foreign currency debt play a greater role. Currencies can come under stress if there is a significant foreign presence in domestic deposit and securities markets and the capital account is open for residents.

A rapid and generalized exit could create significant turbulence with broader macroeconomic consequences, even though losses due to declines in asset prices and currencies fall on foreign investors and mitigate the drain of reserves.

In all four Asian countries directly hit by the 1997 crisis, international reserves now meet short-term external dollar debt. But they do not always leave much room to accommodate a sizeable and sustained exit of foreign investors from domestic securities and deposit markets and capital flight by residents.

This is particularly the case in Malaysia where the margin of reserves over short-term dollar debt is quite small while foreign holdings in local securities markets are sizeable. Indeed its currency has been under constant pressure since mid-2014. As foreign holders of domestic securities started to unload ringgit denominated assets, markets fell sharply and foreign reserves declined from over $130 billion to $97 billion by June 2015. In October 2015 the ringgit hit the lowest level since September 1998 when it was pegged to the dollar. Currently it is below the lows seen during the turmoil in January 1998.

In Indonesia reserves exceed short-term dollar debt by a large margin, but foreign holdings in its local bond and equity markets are also substantial and the current account is in deficit. The country was included among the Fragile 5 in 2013 by Morgan Stanley economists for being too dependent on unreliable foreign investment to finance growth.

Capital account regimes of emerging economies are much more liberal today both for residents and non-residents than in the 1990s. Asset and currency markets of all emerging economies with strong international reserves and investment positions, including China, have been hit on several occasions in the past ten years, starting with the collapse of Lehman Brothers in 2008.

The Lehman impact was strong but short-lived because of the ultra-easy monetary policy introduced by the US. Subsequently these markets came under pressure again during the 'taper tantrum' in May 2013 when the US Fed revealed its intention to start reducing its bond purchases; in October 2014 due to growing fears over global growth and the impact of an eventual rise in US interest rates; in late 2015 on the eve of the increase in policy rates in the US for the first time in seven years.

These bouts of instability did not inflict severe damage because they were temporary, short-lived dislocations caused by shifts in market sentiments without any fundamental departure from the policy of easy money. But they give strong warnings for the kind of turmoil emerging economies could face in the event of a fundamental reversal of US monetary policy.

Should self-insurance built-up prove inadequate, economies facing large and sustained capital flight would have two options. First, seek assistance from the IMF and central banks of reserve-currency countries. Or second, engineer an unorthodox response, even going beyond what Malaysia did during the 1997 crisis, bailing in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills, and using selective controls in trade and finance to safeguard economic activity and employment.

The Asian countries, like most emerging economies, seem to be determined not to go to the IMF again. But, serious obstacles may be encountered in implementing unilateral heterodox measures, including creditor litigation and sanctions by creditor countries. Deepening integration into the inherently unstable international financial system before attaining economic and financial maturity and without securing multilateral mechanisms for orderly and equitable resolution of external liquidity and debt crises could thus prove to be highly costly.

Yılmaz Akyüz is Chief Economist of the South Centre.

This article draws on a recent book by the author: Playing with Fire: Deepened Financial Integration and Changing Vulnerabilities of the Global South, Oxford University Press, 2017 (see https://global.oup.com/academic/product/playing-with-fire-9780198797173?q=9780198797173&lang=en&cc=gb# for more information).

The Financial Crisis and the Global South: Impact and Prospects

Before the world economy can fully recover from the crisis that began a decade ago, there is a widespread concern that it may be poised for yet another crisis. Many developing countries find themselves in a tenuous position with an uncanny similarity to the 1970s and 1980s when the combined booms in capital flows and commodity prices that had started in the second half of the 1970s ended with a debt crisis as a result of a sharp turnaround in the US monetary policy.

ADB

A more volatile global economic landscape has left individual economies more vulnerable to external shocks.

By Yılmaz Akyüz and Vicente Paolo B. Yu III

The world economy has not fully recovered from the effects of the financial crisis that began a decade ago in the US. Despite the recent cyclical bounce-back global income growth remains well below the levels recorded in the run-up to the crisis. Recovery in the US has been sluggish by historical standards and unbalanced between the poor and the rich, and finance and industry. The Eurozone has been unable to resolve its financial crisis let alone economic and social crisis. Potential growth has fallen in both the US and Europe because of inadequate demand, weak investment and sluggish productivity growth. Exceptional monetary policy measures introduced to deal with the crisis are still in place.

The economic landscape is not much better in the global South. The crisis has moved in a third wave to several emerging economies after having swept from the US to Europe. Major emerging economies that were expected a few years ago to become global locomotives are now struggling to revive growth. The jury is still out on whether the second largest economy, China, will be able to avoid financial turmoil and growth collapse.

A central factor responsible for this state of affairs is policies pursued in response to the crisis in the US and Europe. There are two major shortcomings: the reluctance to remove the debt overhang through timely, orderly and comprehensive restructuring, and fiscal orthodoxy. These resulted in excessive reliance on monetary policy, with central banks going into uncharted waters including zero and negative policy interest rates and rapid liquidity expansion through large acquisitions of public and private bonds.

These policies have not only failed to secure a rapid recovery, but also aggravated the global demand gap by widening inequality and global financial fragility by producing speculative bubbles and a massive build-up of debt almost everywhere, by some additional $50 trillion since 2008, outpacing the growth of world nominal income. They have also generated strong deflationary and destabilizing spillovers for emerging and developing economies (EDEs).

The fortunes of EDEs traditionally varied with conditions in international commodity markets because of their dependence on commodity exports. However, global financial conditions have increasingly become a stronger influence because of their deepened integration into the international financial system, financialization of commodities, and mutually reinforcing impulses between international financial and commodity markets, described as commodity-finance nexus. There has been a strong correlation between commodity prices and capital inflows to EDEs in the new millennium, and growth in the South has gone up and down with them.

Conditions in global financial markets are shaped by policies in major advanced economies, notably the US, while China has a strong influence on commodity prices. The boom in capital flows resulting from the very same credit and spending bubbles that culminated in a severe crisis in the US and Europe, and the so-called super cycle in commodity prices, largely due to increased demand by China and other major EDEs, came to an end with the collapse of Lehman Brothers in the US in 2008. However, the downturn was short-lived. Capital flows recovered rapidly due to the sharp cuts in interest rates and rapid monetary expansion in the US and Europe. Commodity prices also picked up thanks to a massive investment package introduced by China in response to contraction of its exports to the US and Europe and a rapid recovery in EDEs.

The boom in capital flows started to dampen in 2014 on expectations of tighter monetary policy in the US. In 2015, for the first time in many years, net capital flows became negative and reserves declined in EDEs, just as their current account financing needs increased. Currency and assets markets came under strong pressure after sustained booms supported by capital inflows. The downturn in commodity prices that started in 2011 coincided with a slowdown in China and other EDEs. Declines in energy prices have been steeper than other commodities because of excess supply created by large investment projects financed with cheap money, notably in US shale oil. They have depressed growth not only in EDEs but also globally because of sluggish demand in advanced economies.

World trade slowed significantly from the mid-2000s. This is caused not so much by the rise of protectionism as structural factors. First, there has been no more big-bang liberalization. Second, the expansion of global supply chains has lost its initial momentum. Third, the slowdown in investment has led to a decline in trade relative to income since investment is more import-intensive than consumption. Fourth, the rebalancing of external and domestic demand by China has resulted in a slowdown in its imports because Chinese exports are more import intensive than domestic spending. Finally, there is significant import substitution in export sectors in China where imported parts and components have gradually come to be produced domestically.

There have also been significant shifts in global balances. First, current account balances have been moving against EDEs and in favour of advanced economies. The sharp decline in commodity prices is an important but not the only factor. Second, there is a remarkable convergence between current account balances of the US and China and a significant decline in China's bilateral trade surplus with the US. Finally, current account of the Eurozone shifted from deficit to surplus as a result of austere policies pursued in the region. German surplus as a per cent of GDP now surpasses China's by a large margin.

Global economic prospects depend on how systemic and structural problems would play out. Growing inequality in major advanced economies and China is creating a problem of underconsumption and restraining aggregate demand. The attempt to address the demand gap with debt-driven spending bubbles generates significant financial instability. In the same vein, the beggar-thy-neighbour policies pursued to overcome stagnation by relying on foreign demand are a source of tension in the international trading system.

These difficulties could be aggravated by policies advocated by the new US administration. On the macroeconomic side they could produce a steeper path for US interest rates and stronger dollar – factors anathema to financial instability and crises in the South through their effects on capital flows and commodity prices. Tariffs and export subsidies advocated could also hit EDEs since they account for a large proportion of US imports and trade deficits. Japan and Germany also run high surpluses in absolute terms, but as a per cent of GDP, top five countries running surpluses with the US are EDEs.

Global prospects also depend crucially on developments in China. Its efforts to create a vibrant domestic consumer market have so far yielded little results and it keeps going back to debt-driven investment bubbles as growth falters. It faces a secular decline in growth, from double-digit levels to some 6 per cent. Although its corporations are over-indebted, a Lehman-type meltdown is highly unlikely in view of close state control over creditors and debtors. Global spillovers from a financial turbulence in China can be expected to remain more limited than those from the subprime crisis.

Even in the absence of renewed external trade and financial shocks, EDEs are unlikely to repeat their pre-crisis growth performance in the years ahead because of weak investment, slow productivity growth and a less favourable global economic environment. Their resilience to external shocks is weak, particularly in comparison to that during the subprime crisis. The deepened global financial integration of many of these economies has resulted in new vulnerabilities and heightened their exposure to external financial shocks. Their policy options are limited in responding to deflationary and destabilizing external impulses.

Many EDEs find themselves in a tenuous position with an uncanny similarity to the 1970s and 1980s when the combined booms in capital flows and commodity prices that had started in the second half of the 1970s ended with a debt crisis as a result of a sharp turnaround in the US monetary policy. It would now be difficult for some of them to avoid liquidity and even debt crises in the event of severe and durable financial shocks.

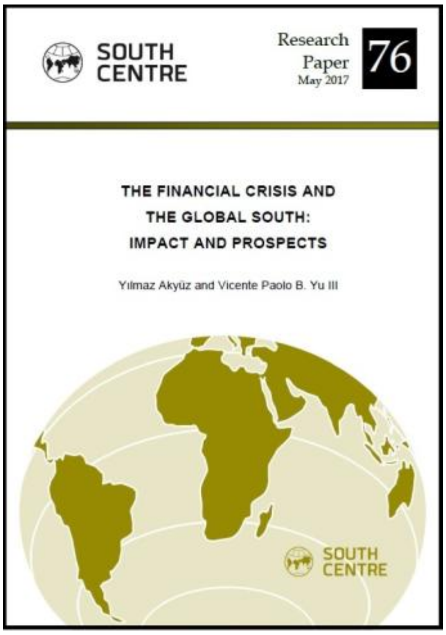
This state of affairs raises three sets of policy issues for the global South. The first one concerns the policy response to a possible tightening of global financial conditions resulting from a reversal of ultra-easy monetary policy in the US. EDEs need to avoid "business as usual" response, hiking interest rates, using reserves and borrowing from the IMF and resorting to austerity to maintain an open capital account and stay current on debt payments. Rather, they should seek to bail in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills, and use selective import controls to safeguard economic activity and employment.

Second, they need to rethink global integration. Most EDEs have allowed too much room for global market forces to drive their development, relying excessively on foreign markets and capital, and transnational corporations. The pendulum has swung too far, particularly in investment and finance and would have to be rebalanced.

Finally, the challenges that EDEs now face raise once again the question of global economic governance – reform of the international trading and financial architecture so as to discipline beggar-thy-neighbour policies of major economic powers, to reduce exposure of the global South to external shocks, and to introduce adequate mechanisms for the prevention and effective management of financial crises with international origins and consequences. Although some of these have found their way from time to time into the international agenda, particularly after bouts of virulent crises, hardly any action has been taken to bring them to conclusion because of opposition of major advanced economies.

The global South has not been very effective in pursuing these matters and suffers from a collective action problem. Political solidarity and a common reflection may be needed among EDEs about the policy response to the next major turmoil and in setting priorities and the agenda for change in global economic governance.

Yılmaz Akyüz is Chief Economist and Vicente Paolo B. Yu III is Deputy Executive Director of the South Centre.



This article is the executive summary of **South Centre Research Paper 76 (May 2017): The Financial Crisis and the Global South: Impact and Prospects by Yılmaz Akyüz and Vicente Paolo B. Yu III.** You can download the paper here: https://www.southcentre.int/research-paper-76-may-2017/.

South Centre launch of Dr. Reddy's "Advice and Dissent"

A very interesting and revealing book *Advice and Dissent* by Dr. Yaga Venugopal Reddy was launched at the South Centre on 9 October 2017.

Dr. Reddy is internationally known as the person who was responsible for steering the banking and financial system of India so cautiously and so well that India did not embark on premature financial liberalisation and thus avoided the kind of systemic financial shock and crisis that has hit so many other developing countries, notably the East Asian countries in the second half of the 1990s.

Dr.Reddy was the Governor of the Reserve Bank of India, the country's central bank, in 2003-2008. Before that he had also been Secretary (the top civil servant) in the Finance Ministry, and after that he was Chairman of the Finance Commission (2013-2014). His distinguished career saw him grappling with many crucial policy issues, and serving many of India's top political leaders and senior officials.

Dr. Reddy is presently also a member of the Board of the South Centre, and has brought his experience and wisdom in service to the Centre.

The book launch was attended and facilitated by other South Centre Board Members (including Ms. Evelyne Tall, who chaired the function, and Dr. Omar El-Arini), H.E. Mr. Abdul Minty, Convenor of the South Centre's Council of Representatives, Dr. Yılmaz Akyüz, the Centre's Chief Economist who presented a review of the book (see next page), Mr. Vicente Paolo Yu, Deputy Executive Director of the Centre, Dr. Reddy himself (who spoke about his experiences and answered questions) and many diplomats from Geneva-based Missions as well as staff of UN agencies.

About the book

A journalist once asked Y.V. Reddy, 'Governor, how independent is the RBI?' 'I am very independent,' Reddy replied. 'The Reserve Bank of India has full autonomy. I have the permission of my finance minister to tell you that.'

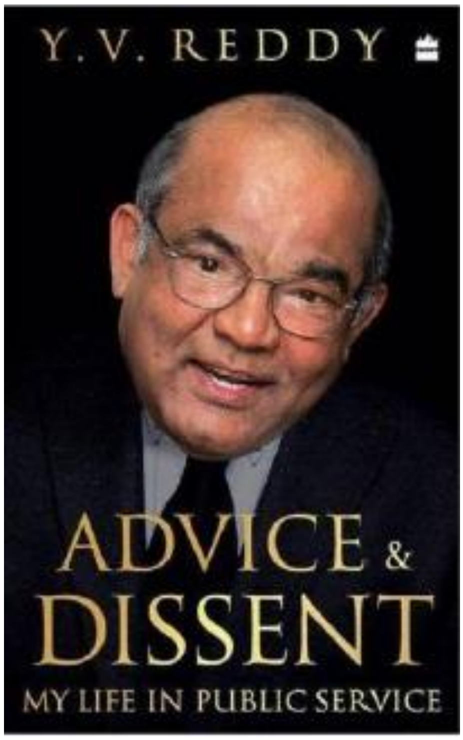
Reddy may have put it lightly but it is a theme he deals with at length in *Advice and Dissent*. Spanning a long career in public service which began in 1964, he writes about decision making at several levels. In his dealings, he was firm, unafraid to speak his mind, but avoided open discord.

In his book, Reddy gives an account of the debate and thinking behind some landmark events, and some remarkable initiatives of his own, whose benefits reached the man on the street. Reading between the lines, one recognizes controversies on key policy decisions which reverberate even now.

This book provides a ringside view of the Licence Permit Raj, drought, bonded labour, draconian forex controls, the balance of payments crisis, liberalisation, high finance, and the emergence of India as a key player in the global economy. He also shares his experience of working closely with some of the architects of India's economic change: Manmohan Singh, Bimal Jalan, C. Rangarajan, Yashwant Sinha, Jaswant Singh and P. Chidambaram. He also worked closely with leaders like N.T. Rama Rao, as described in a memorable chapter.

As governor of the RBI from 2003 to 2008 he presided over a period of high growth, low inflation, a stable rupee and ample foreign exchange reserves—a far cry from the 1991 crisis he lived through and describes in vivid detail, when the country had to mortgage its gold to meet its debt obligations. He is credited with saving the Indian banking system from the sub-prime and liquidity crisis of 2008 that erupted shortly after his term at RBI ended.

Dr. Reddy provides insight into post-crisis reflection undertaken by several global institutions on the international monetary system and financial architecture. In addition, he describes the development of the Fourteenth Finance Commission report, which he chaired, and is considered a game changer.



With his irrepressible sense of humour, *Advice and Dissent* is a warm, engaging account of a life that moves easily from his career in the districts as a young public officer to the higher echelons of policy making, in a trajectory that follows change in the country itself.

About the author

Dr. Yaga Venugopal (Y.V.) Reddy was Governor of the Reserve Bank of India from 2003 to 2008. He was Chairman of the Fourteenth Finance Commission in 2013-14. Previously, he worked in the Government of India as Secretary in the Ministry of Finance, and in the Government of Andhra Pradesh as Principal Secretary. He is also a recipient of the Padma Vibhushan, India's second highest civilian award. Currently, he is Honorary Professor at the Centre for Economic and Social Studies in Hyderabad. He is also a Board member of the South Centre.

The above is an extract of a description of the book that was put out by the publisher.

Comments on Y.V. Reddy's "Advice and Dissent"

The comments below were made at the launching of the new book *Advice and Dissent* written by Y.V. Reddy, former Governor of the Reserve Bank of India and Member of the Board of the South Centre, held at the South Centre, Geneva, on 9 October 2017. Yılmaz Akyüz is the Chief Economist of the South Centre. The book is published by Harper Business.

By Yılmaz Akyüz

I enjoyed very much reading this book and learned a lot about India and its reserve bank. I was impressed by the clarity and sincerity with which Dr. Reddy expressed his views and experience. The book contains many lessons in central banking and in "making of a wise man" particularly for those born without many privileges.

On the book I'll confine my comments to areas within my competence – monetary and financial policies. I make these comments not only on the basis of what is written in the book but also of observations I made both in UNCTAD and the South Centre as someone who watched macroeconomic and financial developments in the developing world.

Central bankers are generally conservative people. They do not like their monies going down in value against goods and services and they often practice inflation targeting. Most of central bankers also dislike their currencies losing too much value against other currencies because that could also lead to inflation. But they do not always worry about their currencies gaining too much against other currencies even though this impedes exports and poses the risk of a sharp correction and instability. Not many of them worry about their monies losing value against financial and real assets – bonds, equities and property – that is, about asset price inflation or bubbles even when markets clearly display irrational exuberance, as remarked by Greenspan in 1996 during the dot-com bubble.

In these respects this book describes an unconventional and, I daresay, an unorthodox central banker; someone who is pragmatic not doctrinaire in managing inflation, the exchange rate and financial stability.

We are told that in India monetary policy was designed and indeed delivered price stability. But inflation targeting was rejected because the Reserve Bank of India (RBI) "felt that arguments in favour of inflation-targeting were not relevant to India". In other words, India was not broken in that respect and hence did not need fixing.

Monetary policy in India traditionally kept a close eye on employment and the real economy. The book talks about the developmental role of the RBI in matters related to credit. Thus the RBI watched not only the aggregate volume of credit, but also its distribution among different sectors and activities, particularly to rural areas. Dr. Reddy's previous involvement as a civil servant in development planning was evidently important in giving a new twist to this traditional mission of the RBI.

Exchange rate stability was also a major concern but the RBI did not practice exchange rate targeting of one sort or another. At a time when the mainstream viewed currency interventions as ineffective, the RBI used them successfully. In August 1997, soon after the onset of the Asian crisis, the RBI felt that the rupee was overvalued and faced the possibility of a sharp correction. Dr. Reddy, as a deputy Governor, advocated an induced correction despite opposition from the government which favoured overvalued rupee as a sign of national pride. In the event the induced exchange rate depreciation played an important role in moderating the impact of the Asian crisis on India.

During the Asian crisis India used "several administrative measures of control and command types over [capital outflows] to manage exchange rate volatility" when the rupee came under pressure. However, in the new millennium the Indian government did not favour restrictions to curb excessive capital inflows because they went against their "reform credentials" while the RBI was in favour of restraints on capital inflow and its Governor, Dr. Reddy was talking about Tobin tax. Thus occasionally, as interventions became expensive and difficult, India had to allow the currency to appreciate or resort to liberalization of capital outflows by residents. Both were risky and I am sure the RBI was aware of that. Appreciations risked a sharp correction while liberalization of outflows as a countercyclical measure tends to lead to a one-way traffic; assets piled up abroad by private residents in good times do not return when capital flows are reversed.

The RBI under Dr. Reddy was quite unorthodox in its view of and intervention in asset markets. It seems that financial stability was a main concern to the RBI while the government exhibited a benign indifference. In the 1990s Dr. Reddy had argued against extending the involvement and exposure of banks to equities to provide a boost to equity markets because of the risks involved for the stability of the banking system. In retrospect this was judicious after the Japanese experience where equity exposure of banks was an important part of the difficulties faced after the bursting of the equity bubbles of the 1980s. In the new millennium when lazy banking in India was transformed into crazy banking, starting to fuel asset bubbles, the RBI watched credit growth not only with a view to inflation but also to asset prices, notably property markets. It stood ready to raise interest rates even in the absence of any acceleration of inflation. They did not permit the kind of derivatives that proved fatal in the making of the subprime crisis in the US.

Dr. Reddy appears to have been even more unorthodox when it came to foreign banks. He writes: "Foreign banks … were keen to penetrate deeply into our system. However, we successfully resisted premature onslaught". For, "instead of removing the constraints on our banking system and improving its efficiency through reform, we were inviting foreign banks to run our system". For several years the World Bank had been actively promoting foreign ownership of banking in developing countries on grounds that they would bring competition, improve efficiency in intermediation and generate resilience to external shocks. The RBI stood against the wind for many good reasons explained in the book. International banks are known to practice regulatory arbitrage, shifting large deposits to offshore accounts in order to avoid high reserve requirements. They have also advantages over local banks in supplying letters of credit through their head

(Continued on page 20)

South Centre Statement to the G24 Ministerial Meeting

Below is the statement by the South Centre's Executive Director Mr. Martin Khor which was distributed during the Ministerial Meeting of the Group of Twenty-four held in Washington DC on 12 October 2017. The G24 is the main group representing the developing countries at the International Monetary Fund and the World Bank.

A view of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development Finance Ministers and Central Bank Governors' Meeting

Yet another looming financial crisis

On the basis of standard indicators, the global economy has not fully recovered from the 2007-08 financial crisis. Policies pursued in the US and Europe in response to the crisis have failed to restore rigorous and sustained growth but produced significant financial fragility. Despite the recent upturn, global growth remains well below the rates seen before the outset of the crisis.

Debt in both advanced and developing economies has accumulated massively as a result of the ultra-easy monetary policies pursued in the US and Europe. Asset and credit bubbles and excessive risk taking have resurfaced, as was the case before the crisis. As a result, central banks are hesitant in normalizing monetary policy. But the longer the ultra-easy monetary policy is pursued, the more difficult it will be to get out of it without creating significant instability and economic contraction. In any case, as it happened in the US in 2007-08, the process of debt accumulation, financial bubbles and excessive risk taking can end in a severe crisis even in the absence of a fundamental shift in monetary policy in major advanced economies.

Because of their closer integration into the international financial system, almost all developing countries are now vulnerable to the onset of another financial crisis, irrespective of their balance-of-payments, external debt, net foreign assets and international reserve international positions, although these could play an important role in the way such shocks impinge on them.

A large majority of developing countries, notably those in Latin America, Africa and South Asia, have negative net asset positions (their external liabilities exceeding external assets by a large margin). Most of them are now running current account deficits because of weak commodity prices and sluggish export markets in the major economies. Even those with positive external asset positions and current account balances are vulnerable to external financial shocks because their financial markets are closely linked with markets in advanced economies.

During the Lehman turmoil in 2008, currency and financial markets of countries with strong reserve and foreign asset positions such as China came under severe pressure. At that time, however, financial shocks were short-lived thanks to a significant monetary easing in the US and Europe in response to the crisis. A sharp reversal of capital flows now can wreak havoc in currency and financial markets of all developing countries and can push deficit countries not only into a liquidity crisis but also a debt crisis.

Developing countries have made significant efforts to accumulate unprecedented amounts of international reserves since the beginning of the decade. However, in the majority of cases, these came from capital inflows rather than current account surpluses. Thus, there are corresponding foreign liabilities. In fact, foreign liabilities exceed reserves by a large margin since an important part of capital inflows have been used to finance current account deficits. Therefore, in most cases reserves can turn out to be highly inadequate in meeting the foreign exchange shortfalls that could result from a combination of a sharp and sustained decline of capital flows and export earnings.

In the event of a severe and sustained liquidity and balance-of-payments crisis, flexible exchange rates adopted in most emerging economies since the recurrent crises of the 1990s and early 2000s may well be unable to absorb the shocks and allow the economies to achieve a soft landing to a lower level of activity. Rather, currencies can come under severe stress, resulting in serious difficulties for corporations which have been borrowing heavily in reserve currencies as well as for sovereigns in many low income countries which have gone to international markets for the first time, taking advantage of low interest rates and favourable risk appetite.

As shown over and again, hiking domestic interest rates under such conditions cannot be expected to restore capital inflows and balance-of-payments equilibrium. Such an action would in all likelihood make matters worse by pushing the economies into deeper recession.

Preparing for the next financial crisis

Developing countries should make contingency plans about how to respond to a renewed crisis rather than assuming/hoping that no such shocks would ever happen. They can strengthen South-South mechanisms and shore up other international arrangements in anticipation of such a crisis.

In responding to a severe balance-of-payments shock, developing countries should not simply go back to business as usual and use their reserves and borrow from the IMF and adopt austerity in order to remain current on their obligations to foreign creditors and investors and keep their capital account open. They should, instead, seek to involve private lenders and investors in the resolution of liquidity and currency crises by introducing, inter alia, exchange restrictions and temporary debt standstills.

It would be extremely difficult to avoid debt crises after so many years of financial excesses and debt build-up. Should the world economy turn down and incomes collapse, an important part of the debt piled up since 2008 could become unpayable, notably the debt incurred by private residents and sovereigns in emerging and developing economies (EDEs). The international community should not muddle through in resolving international debt crises, as done during the Latin American crisis in the 1980s and more recently in the Eurozone. Rather, they should seek orderly and equitable debt resolution drawing on widely accepted principles of insolvency regimes.

In the event of a payments crisis, developing countries should undertake measures to ration foreign exchange, prioritizing imports of essential medicines and in order to sustain domestic production. This will mean imposing controls on non-essential imports for the time being. These measures should be supported by the IMF, where necessary, through lending into arrears, but such lending should be for current account transactions – not debt service – in order to avert import compression and contraction in economic activity.

The IMF lacks resources to effectively address any generalized sharp contraction in international liquidity that may result from the normalization of monetary policy in the US and/or a massive flight to safety.

In any case major central banks, notably the US Federal Reserve, as the main originators of global financial fragility that now threatens the South, should assume responsibility for the provision of adequate international liquidity. This can be done through a large special drawing rights (SDRs) allocation. The IMF can designate major central banks to purchase SDRs from EDEs who want to use the SDRs allocated to them. A decision can also be made to allocate SDRs only to EDEs or to non-SDR countries excluding Eurozone members. In this way, balance sheets of major central banks would be expanding by purchasing SDRs from those who want to use them.

Alternatively, the US Federal Reserve and other major central banks can act directly as a quasi-international lenders-of-last-resort to EDEs facing severe liquidity problems through outright purchase of locally and internationally issued sovereign bonds of these economies to shore up their prices and to provide liquidity. They could also establish swaps to supplement reserves of non-reserve issuing countries.

At the onset of a crisis, developing countries should activate various South-South mechanisms for liquidity provisions; they should be delinked from IMF programs and extended. There is the Latin American Reserve Fund established in 1978 by seven Andean countries to provide balance-of-payments support and improve investment conditions of reserves held by member countries. It has been operating without linking liquidity provision to IMF programmes.

There are two other arrangements— the Chiang-Mai Initiative Multilateralization (CMIM) of East Asian countries and the Contingent Reserve Arrangement (CRA) of BRICS (the grouping of Brazil, Russian Federation, India, China, and South Africa).

The CMIM had started as bilateral swaps to complement, rather than substitute, the existing international facilities before it was multilateralised at the end of 2009. The initiative has never been called upon; during the Lehman collapse, the Republic of Korea, and Singapore approached, instead, the US Federal Reserve and Indonesia secured finance with a consortium led by the World Bank. CMIM has several shortcomings making it almost unusable. It does not have a common fund, but is a series of promises to provide funds, with each country reserving the right not to contribute to the specific request by a member. Its size is too small, some 1.5 per cent of total GDP of the countries involved; and access beyond 30 per cent of quotas is tied to an IMF program.

The CRA is widely praised as a strong political sign of solidarity among EDEs. While it is too early to pass judgement on it, it does not look very much different from the CMIM. It is designed to complement rather than substitute the existing IMF facilities. Its size is even smaller than the CMIM, less than one per cent of the combined GDP of BRICS, and access beyond 30 per cent is tied to the conclusion of an IMF programme.

Revitalizing international action on the part of the South

The times call for the ramping up of political solidarity among developing countries. The stakes are getting too high now to continue with business as usual. Developing countries could consider convening a series of discussions among themselves about the policy responses required in the event of another widespread financial disorder. Such a discussion could also involve examining priorities and the agenda for change in global economic governance arrangements. The contributions of the G24, as well as the G77 and other groupings of developing countries, will be critical and timely. The South Centre stands ready to do its part in these efforts.

South Centre Statement for the UNCTAD Intergovernmental Group of Experts on Financing for Development

Below is the South Centre's statement at the meeting of the UNCTAD Intergovernmental Group of Experts on Financing for Development held on 8-10 November 2017 in Geneva. It was presented by Ms. Yuefen Li, the Centre's Special Advisor on Economics and Development Finance during the meeting's first session.

South Centre Special Advisor on Economics and Development Finance Yuefen Li speaking at the first session of the UNCTAD Intergovernmental Group of Experts on Financing for Development.

Let me first extend my congratulations to UNCTAD on this occasion of the first session of the Intergovernmental Group of Experts on Financing for Development. This is an opportune time for UN Member States, through the work of this intergovernmental group of experts, to be informed of and understand better the systemic challenges and opportunities that countries all over the world now face in pursuing economic growth and sustainable development.

As the IGE is meant to make recommendations with respect to domestic resource mobilization and improving international development cooperation, it is important for the IGE to be cognizant of key systemic trends and issues.

The global community is facing another looming financial crisis. On the basis of standard indicators, the global economy has not fully recovered from the 2007-08 financial crisis. Policies pursued in the US and Europe in response to the crisis have failed to restore rigorous and sustained growth but produced significant financial fragility. Despite the recent upturn, global growth remains well below the rates seen before the outset of the crisis.

Debt in both advanced and developing economies, especially in the former, has accumulated massively as a result of the ultra-easy monetary policies pursued in the US and Europe. Asset and credit bubbles and excessive risk taking have resurfaced, as was the case before the crisis. The process of debt accumulation, financial bubbles and excessive risk taking can end in a severe crisis even in the absence of a fundamental shift in monetary policy in developed economies. There is an important rationale for an international debate on national fiscal policies pursued by mature economies and their impact on global economic conditions and spillovers to other countries.

The economic landscape is not much better in the global South. The crisis has moved in a third wave to several developing countries after having swept from the US to Europe. Major developing countries that were expected a few years ago to become global locomotives are now struggling to revive growth.

Because of their closer integration into the international financial system, almost all developing countries are now vulnerable to the onset of another financial crisis, irrespective of their balance-of-payments, external debt, net foreign assets and international reserve positions, although these could play an important role in the way such shocks impinge on them.

Hence, for many, if not most, developing countries, enhancing domestic resource mobilization over the near - and medium-term will become increasingly difficult. At the same time, the continuation of austerity measures and other fiscal policies undertaken by developed countries in response to the global financial crisis have resulted in cutbacks in budgetary allocations for official development assistance and other forms of development cooperation. These difficulties could be aggravated by policies advocated by the new US administration (such as on tax cuts and trade protectionism).

Even in the absence of renewed external trade and financial shocks, developing countries are unlikely to repeat their pre-crisis growth performance in the years ahead because of weak investment, slow productivity growth and a less favourable global economic environment. Their resilience to external shocks is weak, particularly in comparison to that during the subprime crisis. The deepened global financial integration of many of these economies has resulted in new vulnerabilities and heightened their exposure to external financial shocks. Their policy options are limited in responding to deflationary and destabilizing external impulses.

Many developing countries find themselves in a tenuous position with an uncanny similarity to the 1970s and 1980s when the combined booms in capital flows and commodity prices that had started in the second half of the 1970s ended with a debt crisis as a result of a sharp turnaround in the US monetary policy. It would now be difficult for some of them to avoid liquidity and even debt crises in the event of severe and durable financial shocks.

This state of affairs raises three sets of policy issues that the IGE on FFD should consider.

First is the policy response to a possible new global financial crisis resulting from a reversal of ultra-easy monetary policy in the US, Euro zone countries and other mature economies. Countries should be prepared for policy responses for the next financial crisis through more systemic multilateral approaches to international debt resolution and cooperation and the use of heterodox fiscal and other policy instruments.

Developing countries should **not** hike interest rates, use reserves and borrow from the IMF and resort to austerity to maintain an open capital account and stay current on debt payments. Rather, developing countries should seek to bail in international creditors and investors by introducing, *inter alia*, exchange restrictions and temporary debt standstills, and use selective import controls to safeguard economic activity and employment.

Second, developing countries need to rethink global integration. Most developing countries have allowed too much room for global market forces to drive their development, relying excessively on foreign markets and capital, and transnational corporations. The pendulum has swung too far, particularly in investment and finance and would have to be rebalanced.

Third, international cooperation and action on Financing for Development should be revitalized. For both developed and developing countries, the stakes are getting too high now to continue with business as usual. The times call for an in-depth, honest, and systematic discussion at the multilateral level between the developed and developing countries on ways and means in which the systemic and structural deficiencies of the global macroeconomic governance system can be addressed in the spirit of international cooperation, with a sense of urgency in order to avert the next global financial crisis from occurring.

Through the IGE, countries could start a discussion about the policy responses required in the event of another widespread financial disorder. Such a discussion could also involve examining priorities and the agenda for change in global economic governance arrangements. In this context, the United Nations, including UNCTAD through the IGE-FfD, would be the best multilateral policy forum for an improved and enhanced North-South engagement on FfD issues and their systemic underpinnings.

The past eight to ten years have seen some major initiatives in setting and reforming tax rules and standards. In view of developing countries' greater reliance on taxation as a main source of revenue and their weak capacity in tax collection and rule enforcement, it is of utmost importance to make the rules and standards setting process inclusive to ensure that the interests of these countries would be well protected. In this context, it is crucial to affirm and enhance the role of the United Nations, in particular the UN Tax Committee. International cooperation on tax issues should be deepened and tax competition should be curbed. Significant shifts in tax policies by major economies should be well communicated and assessed to minimize possible negative spillovers. Developing countries are advised to exercise caution in signing tax treaties to preserve their legitimate taxing rights.

The just leaked out Paradise Papers have once again shocked the world with the enormous scale and complexity of tax avoidance, particularly by multinational corporations, through offshore tax havens. It demonstrates clearly the weak international framework in curtailing tax avoidance and also the urgent need for tackling this problem. The legality of such kind of abusive practice should be discussed and measures to stamp such activities be taken.

Illicit financial flows out of developing countries have been increasing. Its negative impact on tax collection, foreign reserve accumulation and fight against poverty is enormous. Though the strengthened international tax cooperation can contribute to reducing the illicit financial flows, it is far from sufficient. Fraudulent mis-invoicing of trade by multinational and local companies has constituted a significant share of IFF. Efforts to curb this kind and other illegal practices like corruption, illegal trafficking and transfer of funds would be of great importance in the fight against IFF.

In concluding, the South Centre would like to highlight the importance of having the IGE come up with recommendations that member States can consider in order to promote financing for development and achieve its objectives as defined in the mandates coming from UNCTAD XIV, the Addis Ababa Financing for Development Conference, and the 2030 Agenda for Sustainable Development.

South Centre holds side event at UN General Assembly

In a side event of the high level segment of the 72nd session of the UN General Assembly, developing country delegations carried out a lively discussion on the challenges confronting developing countries in the context of the new vulnerabilities created by the state of the global economy and the challenges of pursuing Agenda 2030.

The event, held on 21 September 2017 in New York, entitled "Rethinking Development in the Context of the 2030 Agenda," was co-convened by the Permanent Mission of Tanzania to the United Nations and the South Centre.

Below is a brief report on the key issues of the South Centre side event prepared by Dr. Manuel Montes, Senior Advisor on Financing for Development of the South Centre.

By Manuel F. Montes

Dr. Manuel Montes, Senior Advisor on Financing for Development at the South Centre, welcomed participants by noting that the General Assembly is an important location for the setting of global norms and standards in multilateral development cooperation. Other multilateral venues, such as Geneva, Rome, among others are more appropriate for reaching agreement on specific applications of agreed standards and to complete their implementation.

Dr. Montes cited A/RES/69/319 which agreed on principles for sovereign debt restructuring in 2015. He also pointed to the July meetings convened by Rome-based UN agencies, including the Global Forum on Food Security and Norms, which introduced to New York delegations agreed norms over agriculture and trade suitable for SDG 2, ending hunger.

In opening the side event, Ambassador Modesto Mero noted that the Inter-Agency Task Force 2017 report on examining the scale of investment and the rate of economic growth in 2016 finds that the rate of growth is not sufficient to meet the ambitious goals of Agenda 2030. In rethinking development cooperation for the Sustainable Development Goals (SDGs) there are three areas that require focus: (i) the importance of national institutions in all countries for implementing the 2030 Agenda; (ii) attention to special challenges to implementation for developing countries and in particular least developed countries (LDCs); and (iii) how to make various international and local stakeholders engaged in supporting countries in the implementation of the SDGs.

Participants at the South Centre side event at the UN General Assembly.

The SDGs are vast and inclusive containing 17 goals that involve standard issues of energy, industrialization, trade, external debt, social development, macroeconomic issues, among others. The goals also include social and environmental issues. Obviously in the process of rethinking, new areas will emerge needed to support the implementation of the Agenda 2030. These include the Reform of the UN development system, international tax cooperation and, in addition, there is a matter of upgrading the scale of finance for Agenda 2030.

Ms. Nicola Barker-Murphy, Counsellor, Economic Affairs, Permanent Mission of Jamaica to the United Nations, discussed the challenges facing middle income states with the burden of external debt in raising their investment to meet the goals of Agenda 2030. Economies in this situation need to take serious consideration of innovative sources of finance. Jamaica is exploring new sources of domestic, international and private financing. Some of these include improving capacity for tax audits to address transfer pricing; exploring options for 'green fees', debt-for-nature swaps and diaspora bonds; facilitating social impact investment; and establishing a philanthropy platform.

Jamaica completed a map of its data capacity in relation to the SDG indicators. The mapping exercise concluded that out of 223 relevant indicators, Jamaica already produces 66 (29.6 per cent) and has data to produce 69 (30.9 per cent). The UN development system is yet to complete its transition from the MDGs to the SDGs, given that more than 50 per cent of its budget remains focused on the first six (6) SDGs.

Counsellor Barker-Murphy described the continuing threats represented by climate change. Investing in disaster risk reduction is a precondition for developing sustainably in a changing climate. The number of weather-related hazards has tripled, and the number of people living in flood-prone areas and cyclone-exposed coastlines doubled. The trend is expected to continue to increase. In the Carribean, one hurricane can wipe out progress built up over many years. She discussed the imperative of undertaking programs both to boost growth and employment and to build resilience to climate change.

Mr. Tarik Iziraren, Deputy Director for Policy and Strategic Partnership, UN office for South-South Cooperation, highlighted the potential for south-south cooperation to overcome many obstacles to sustainable development faced by developing countries. South-South cooperation involves concerted efforts among equals and among societies closer together in level of development.

Mr. Iziraren explained that the immediate challenge is to make sure that developing countries have the institutions to identify their needs and to access technology and resources from other developing countries. Building this capacity is a key effort of the UN office on south-south cooperation. He also explained that the office serves as a clearinghouse and assists in the maintenance of information to facilitate development cooperation among developing countries.

Ms. Shari Spiegel, Chief, Policy Analysis and Development Branch, Financing for Development, UNDESA, noted that because of Agenda 2030 the UN in New York has ratcheted up its role in global norm setting, particularly in issues that used to be decided in the Bretton Woods institutions. The design of monitoring systems and some monitoring activities themselves are being undertaken in New York. She emphasized the domestic resource mobilization challenges facing developing countries, including questions about illicit financial flows and tax cooperation.

There is a great variety of actors in the private sector (not one uniform private sector), both domestically and internationally, and mobilizing finance from this source will require that developing countries become more involved in international discussions in designing principles and norms over private finance. This includes the question of how decisions on allocating public resources to subsidize private development finance will be made.

In his own presentation, Dr. Montes shared recent analysis from the South Centre that indicate the increased vulnerabilities of developing countries especially with the prospect of the tightening of international liquidity, particularly those with heightened international private liabilities. Developing countries must rethink the manner of their international integration. Emerging and developing countries must confront the situation that the global economic governance - referring to the international trading and financial architecture - needs restructuring so as to discipline beggar-thy-neighbor polices of major economic powers, to reduce exposure of the global South to external shocks, and to introduce adequate mechanisms for the prevention and effective management of financial crises with international origins and consequences.

Dr. Mariama Williams, Senior Program Officer, the South Centre, presented the main channels of climate change-related financing, particularly those related to the obligations of developed countries stemming from the UN climate change framework convention. The Paris Agreement re-affirmed the developed countries' commitment of $100 billion, per year, by 2020 to developing countries' climate adaptation and mitigation actions, extended the time period to 2025 and urged scaling of climate finance from the $100 billion as a floor beyond 2025.

However, all estimates of the scale of climate finance needed by developing countries, especially the over $4 trillion (or approximately $349 billion per year) financing cost estimated in the Nationally Determined Contributions of some developing countries, show that the available announced quantum of financing is inadequate for meeting the climate finance need of developing countries. The implementation of the public aspect of this climate finance is clouded with uncertainty on many fronts, including how the resources will be raised and the channels through which the financing will be made available.

What exists under the UNFCCC financing mechanism is the approximately US$10 billion committed to the Green Climate Fund (GCF). The Board of the GCF, which comprises 12 developing country and 12 developed country board members, has set up the operational and institutional structure for the flow of funds to developing countries. These include readiness and preparatory support of US$1 million per year, per country, for countries to set up their own domestic processes to interface with the GCF and to directly access the fund's resources, a one-time US$3 million adaptation planning and preparedness grant and assorted project preparation facility. However, developing countries must rapidly build their capability to make concrete plans to meet their climate change commitments and enhance their capacity to generate country funding programme pipelines. The GCF board must urgently and effectively tackle the unfortunately bureaucratic process in the Secretariat that is creating the slow disbursement of funds to developing countries with approved projects.

In the open discussion, participants highlighted the complicated and slow process in which countries have experienced to obtain climate finance. Many developing countries are gearing up quickly to shape their development plans to realize Agenda 2030, including projects in mitigation and adaptation. As part of South-South cooperation, governments can share experiences in seeking climate finance among themselves to accelerate their learning processes.

There was a discussion of the question of enhancing and defending multilateral action in a time of heightened economic interdependence and climate change. How can productive multilateralism require accountable actions on the part of states whose policies generate spillovers and systemic impacts, while preserving adequate scope for national action so that all states can faithfully fulfil their sovereign duties to the people they represent?

Related documents:

Report: Approaches by Developing Countries to Reforming Investment Rules; South-South Dialogue and Cooperation is available here: https://www.southcentre.int/wp-content/uploads/2016/09/Ev_160720_UNCTAD-XIV-Investment-Side-event-Report_EN.pdf

Report: Inaugural Annual Forum Developing Country Tax Policies and Cooperation for Agenda 2030 is available here: https://www.southcentre.int/wp-content/uploads/2017/10/Ev_1612_Inaugural-Annual-Forum-Tax-Cooperation-Report_EN.pdf

Comments on Advice and Dissent...

(Continued from page 13)

offices with better terms. These put local banks at a competitive disadvantage. Furthermore, rather than increasing resilience to external shocks, foreign banks can become instruments of transmission of shocks from their home countries, as seen during the Eurozone crisis.

The record of the RBI under Dr. Reddy in building foreign exchange reserves was also notable. When many others were focussing on short-term debt in assessing reserve adequacy, the RBI pursued a national balance sheet approach (which I also used in my recent book), noting that since reserves were not earned from export surpluses, there were all kinds of liquid external liabilities associated with them. There was no rationale for building a Sovereign Wealth Fund with borrowed reserves, as suggested in some quarters, or divert them to investment in infrastructure.

Mr. Reddy's pragmatism as well as benign global conditions were certainly responsible for what he calls "a governor's dream – high growth, low inflation most of the time, stable rupee and a robust banking system". He was aware that these were not only due to good policies and structural changes as advocated by many people in the government. There were important positive cyclical, temporary elements that were closely associated with favourable global financial conditions and these called for caution in policy making at all levels.

I fully agree with Dr. Reddy that the RBI has been highly skilled in managing several externally induced shocks and in preempting the transmission of global uncertainties such as the Asian Crisis and US sanctions after the nuclear tests and so on. Economic if not political shocks are likely to continue in the period ahead given the financial excesses we have had in many parts of the world, notably in the US, Europe and China since 2008. Shocks ahead can be much more durable than those generated by the collapse of Lehman Brothers in 2008. That shock was temporary, immediately followed by a significant monetary easing in the US and a rapid recovery in capital flows to emerging market economies (EMEs). But the next one could be intense and more permanent. India is also financially much more open today than it was during the Asian crisis. The IMF warned in July that excessive reliance of India on debt finance and portfolio flows could create significant external financial vulnerabilities. Furthermore, India has come to be mentioned alongside China as a potential source of instability. For instance the World Economic Forum argued last September that "Debt Boom in India and China threatens new financial crisis."

Finance is a major driver of recent Indian expansion. Financial companies now account for 36 percent of the country's publicly traded companies, an increase of 11 percentage points during the past five years. Bad loans have doubled in the past two years, largely on account of public sector banks, albeit still low compared with some other EMEs. All these are serious matters of concern since Indian external sustainability hinges on three not-so-reliable sources of foreign exchange flows – services exports, remittances from workers and capital inflows, including occasional borrowing from non-resident Indians. Now that Indian growth is slowing, it is not clear how all this might play out particularly if global financial conditions tighten. Still, the likelihood of the Indian boom ending with a bust cannot be dismissed.

The last time India had a balance-of-payments crisis was in 1991. At the time when we were looking into it in UNCTAD we found it quite puzzling. Dr. Reddy tells us in the book that the crisis happened for many reasons, political and economic, as well as global and domestic. The sharp rise in the oil bill due to the Gulf war is mentioned as the main cause. But price hikes were limited. Oil prices were around $18 at the end of the 1980s. They went up to $23 in 1990 but came down to $20 in 1991-92. These cannot really explain the sharp rise in the oil bill from $287 million per month in June–August 1990 to $671 million in the next six months. On the other hand a current account deficit of 3 per cent of GDP itself is not a reason for loss of creditworthiness and a balance-of-payments crisis. Furthermore, following the Brady initiative for debt relief in Latin America, the global financial environment became benign in the early 1990s and interest rates were cut sharply in the US with the bursting of the Savings and Loans bubble. Indeed money started pouring in emerging economies so much so that starting in 1991 we in UNCTAD cautioned them, notably Mexico, for consequent difficulties. All these suggest that it is not obvious when and under what conditions the international finance can hit you. This gives all the more reasons to be extra cautious -- this is also one of the key messages of Dr. Reddy's book.

SOUTH BULLETIN

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South Centre website:
(in English, French and Spanish)
www.SouthCentre.int

South Centre
Tel: +41 22 791 8050
Email: south@southcentre.int

South Centre Book Launch: *Advice and Dissent* – Dr. Y.V. Reddy's Life in Public Service