FORUM: Economic and Social Council

ISSUE: Measure to Avoid Global Default and Decrease External Debt in the Time of Financial Crises

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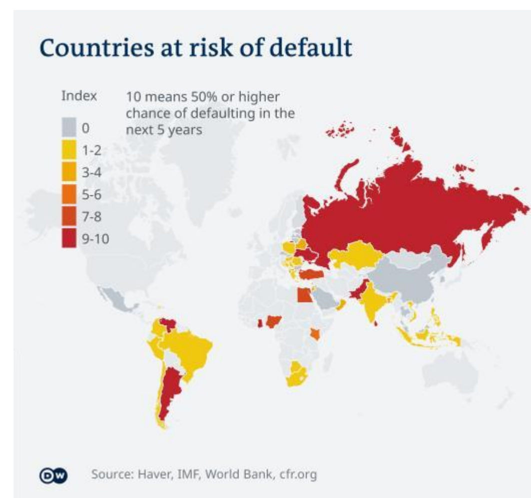
Introduction

Throughout the history of economics, there have been many financial crises, including the Asian Financial Crisis in 1997 and the Global Financial Crisis of 2008. These crises have led to severe currency depreciation, skyrocketing debt-to-GDP ratios, and global recessions which threw numerous countries into periods of economic hardship. This financial crisis has threatened the world with the risk of worldwide default and high external debt. Moreover, the recent COVID-19 pandemic has exacerbated these vulnerabilities. In the past 3 years, there have been 18 sovereign defaults in 10 developing countries, the highest in 20 years, and, astonishingly, 34 countries are currently in high debt distress.



Map showing countries at risk of default

Addressing the issue of global default and external debt is essential for the economic health of individual countries and their societies. Approximately 40% of humanity lives in countries that spend more on interest payments than health or education. Hence, the rising external debt and risk of default also influence not only the governments but also members of society. Moreover, the interconnected nature of the modern economy means that the economic instability of one country can have a spillover effect on other countries, affecting the economies worldwide. Thus, it is vitally important to implement effective debt relief initiatives, as well as develop overarching strategies to prevent global defaults and rising external debt. This report will investigate the current risks caused by these issues, international actions, and possible solutions to mitigate and prevent the economies from collapsing in times of financial crisis.

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Background

1977 Asian Financial Crisis

There are other financial crises that occurred even before COVID 19 pandemic. Asia's financial crisis, also known as the "Asian Contagion" occurred between 1997 and 1998 trigged by a series of currency devaluations that led to the Asian economy to be destabilized. The starting point of this crisis was when the Thai government ended the local currency to the US dollar. This decision was made by the government after they have used excessive amounts of foreign exchange reserve to protect the currency from speculative attacks. Speculative attacks are large scale actions that are taken by investors to sell a country's currency quickly when they believe the currency is being overvalued or if the fixed exchange rate is unstable. A few weeks after Thailand has discontinued to defend its currency, other Asian countries such as Malaysia, Philippines, and Indonesia were forced to let their currency depreciate due to increasing speculative pressure and loss of investor confidence for Asia. By the time, Indonesian rupiah was down by 80%, Malaysian ringgit by 45%, and even other Asian countries such as South Korea faced a depreciation in won by 50%. Collectively, the spillover effect of currency depreciation has led to significant drop in capital inflows of more than $100 billion in the first year of the crisis. Due to the currency depreciation, the existing external debt has increased, and the capital flight has led to countries relying on borrowing to cover current account deficits and other financial needs from other countries or monetary funds. Therefore, the foreign debt-to-GDP ratios rose to 180% in four large economies in the Association of Southeast Asian Nations (ASEAN) during the worst of the crisis and led to continued defaults in Asian countries.

Protest in South Korea showing the impact of financial crisis

2008 Global Financial Crisis

In 2008, there was a global financial crisis when there was extreme stress on global financial markets and banking systems. During 2007, the US's economy has shown economic growth, stable rates of inflation, and low unemployment. Due to this environment, the house prices were expected to grow quickly. These expectations that house prices would rise quickly have stimulated households and property developers to borrow imprudently and build houses. However, the mortgage loan was tied to the price of the house, so there were many risky borrowings by investors who were seeking short-term profit by 'flipping' houses and by 'subprime' borrowers (these individuals have faced higher risks in paying back the loan because they have low credit). Also, lenders sold large amounts of loans to investors called

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mortgage-backed securities (MBS) which consisted of thousands of individual mortgage loans although these investors were not aware that they were buying high-risk asset. Furthermore, the governments and banks' regulation of subprime lending and MBS products were too weak and insufficient. At last, borrowers were unable to repay their loans, and the house prices dropped. Therefore, investors were unwilling to purchase the MBS, leading the price of MBS to decline.

Thus, the spillover effect to other countries started the global financial crisis in 2008. Foreign banks were actively part of the US housing market during the boom, including purchasing the MBS. At the same time, US banks operated extensively in other countries. This interconnectedness has led to the downfall of the US housing market to affects global financial systems. This financial stress has triggered investors to begin pulling out money out of banks and investments funds, and businesses worldwide were less willing to invest, and consumer confidence dropped. This led to governments around the world launching large-scale rescue and bailout packages to support the banks. Also, to stimulate growth for the economy, many fiscal programs were implemented and sourced from foreign lenders. Furthermore, the capital flight has forced the government seek funding from foreign sources instead of from available domestic financing. The currency depreciations were another reason why the burden of external debt has increased. According to the International Monetary Fund (IMF), global external debt as a percentage of GDP has increased from 60% in 2007, and 80% by 2014, showing the trend of increasing external debt.

Problems Raised

Unexpected Depreciation in Exchange Rates

If a country experiences a financial crisis, then investors and speculators will withdraw the investments made from the currency of that country. Therefore, the demand for the currency will decrease, thus leading to the depreciation of the currency. The unexpected depreciation in exchange rates will raise the debt burden, because the value of money has dropped, meaning that it will cost more to pay back the external debt for the governments. Also, the higher outflow of the foreign exchange reserves will further lead to pressuring the currency's value downwards. Then, this may lead to inflation in the country because the depreciation of currency will increase the costs of imported goods and services. Countries especially those that are relying on imported goods which are mostly Less Economically Developed Countries (LEDCs), will especially be adversely affected by the devaluation of

Credit rating of countries

currency. Due to the high costs of these goods and services for businesses, overall consumer price inflation will happen.

Slower Economic Growth

According to Moody’s Analytics, a subsidiary of Moody’s Corporation that carries out credit analysis and financial risk management has showed that nation’s default can cause severe consequences to its economy. Moody’s Analytics has projected that a default that lasts for even a few weeks can be a starting point for a recession in the country. In the case of the US, this could result in the loss of nearly 6 million jobs, a decline in the stock market, or the wipeout of $12 trillion of household wealth. If the government fails to meet the debt obligations, the situation will exacerbate because the federal government will have limited abilities to support households and businesses. Furthermore, a default will lead to increased consumer and business confidence. A drop in consumer consumption and investments, will impact the real Gross Domestic Product (GDP) of the economy, hence leading to slower economic growth. Moreover, a default will likely cause a downgrade in credit ratings. This will lead to an increase in interest rates and the cost of borrowing for external funding. If the countries face an economic crisis but have a low credit rating, it could be more challenging for countries to borrow money from foreign lenders.

Decline in Trade and Investments

Decline in trade during COVID-pandemic

Global default may lead to fewer trade and investments between countries during financial crises. If More Economically Developed Countries (MEDCs) start to default, confidence of both companies and businesses will decline. Hence, they will be less engaged in foreign transactions and trade. Again, global default will cause investments to drop due to the instability of the country’ s financial market. This will create a recession across many countries and affect trade relations and international financial systems. The trading relationships with the rest of the world determine the extent of impact in the manufacturing sector. If the trade is not as active as before, many countries’ businesses and firms may fail. During the economic crisis caused by the COVID-19 pandemic in 2019, there has been a dramatic decrease in trade for goods and services and even a fall in Foreign Direct Investment (FDI) especially during the second quarter of 2020.

Social Consequences

There are also social consequences to global default and high external debt. The government with high debt will lack flexibility in their fiscal policies. Governments will not have enough ability to invest in infrastructure, provide transfer payments or other social programs to the people in the country. Similar to what many countries experienced during the previous financial crisis in 1997 and 2008, many people were unemployed. As in the US during 2008, the unemployment rate reached 10%. However, the government could not provide effective fiscal policies to overcome the recession in the short period of time.

International Actions

G20 Debt Service Suspension Initiative (DSSI)

An Official Photograph of G20

During the COVID pandemic, the UN has supported countries worldwide suffering from debt through expanding the debt moratorium. At the start of the pandemic, the World Bank and the International Monetary Fund have urged the G20 to set up a Debt Service Suspension Initiative (DSSI). Starting from May 2020 to December 2021, the initiative has suspended $12.9 billion in debt-service payments for the participating countries under DSSI. The World Bank and IMF continued to support the implementation of DSSI by monitoring spending and enhancing debt transparency. This international action helped to prevent global default and helped to reduce the external debt burden for these countries.

Debt Relief under the Heavily Indebted Poor Countries (HIPC) Initiative

In 1996, the IMF and the World Bank group launched the Heavily Indebted Poor Countries (HIPC) to ensure that countries with unmanageable debt burden would not lead to default. The HIPC has been further supported by the Multilateral Debt Relief Initiative. With the help of the IMF and World Bank, countries can receive 100 % relief on eligible debts. The total cost of aiding under the HIPC initiative has been recorded at $76 Billion. Debt relief is especially beneficial to the LEDCs, because it reduces their burden of external debt, allowing them to spend 5 times more on education health, and other social services rather than debt services. For 36 countries that are receiving debt relief, debt service pavements have declined about 1.5 percentage points of GDP between 2001 and 2015.

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Commercial Bank Debt Reduction

During 1988 and 1989, multiple proposals were made by France, Japan, and the United States to strengthen debt strategy for debt reduction. Supported by international organizations such as the World Bank, and official creditors, there has been a three-pronged approach to external debt. First is the adoption of sound economic policies, with a stronger emphasis on increasing foreign and domestic investment. Second, receiving timely support from the IMF and the World Bank for countries' reform programs for financing debt services. Last, active participation from commercial banks to provide financial support through the negotiation of debt reduction and new lending.

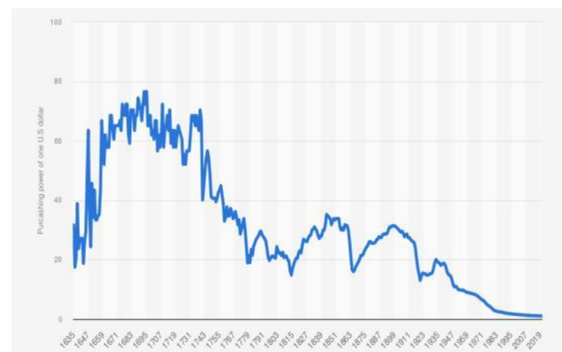
Key Players

International Monetary Fund (IMF)

The International Monetary Fund (IMF) is a global organization that works to achieve sustainable growth and prosperity for 190 member countries. The IMF continues to support economic policies that promote financial stability and monetary cooperation. These policies are crucial for the productivity and economic well-being of a country. Moreover, the IMF fosters international financial stability by offering policy advice, financial assistance, and capacity development for member countries. During the financial crisis of 1997, 2008, and even during the COVID pandemic, the IMF has supported countries with external debt and worked to prevent global default.

United States (US)

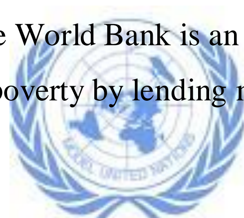
The United States is relevant during the time of financial crisis because it the US is the world's largest economy. Since there are many countries that are closely tied to the US through trade, the economic situation in the US can may rapidly influence global trade and economic activity. The US dollar is the world's primary reserve currency. Hence, the instability of the dollar can affect global liquidity and financial markets.



Decline in value of dollar from 1635 to 2020

World Bank Group

Similarly, the World Bank is an international development organization owned by 187 countries. Its aim is to reduce poverty by lending money to the poorest member governments to improve their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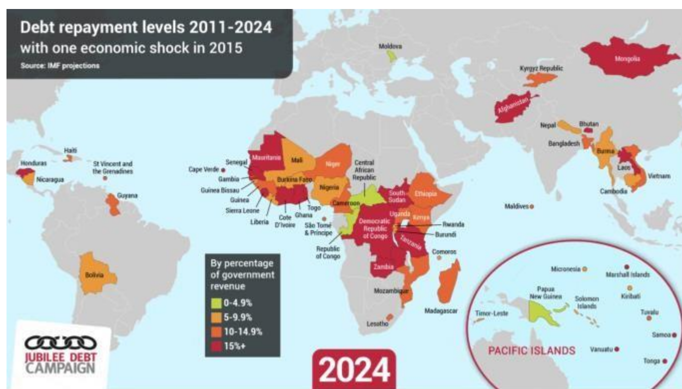
economies and standards of living. The World Bank focuses on helping the LEDCs for their development projects. In the case of LEDCs, the interest rates offered by the Bank are almost 0%, and the Bank lends money to MEDCs at interest rates lower than loans from commercial banks. In collaboration with the IMF, the World Bank also supports countries during financial crises by funding and reducing their debt.

Bank for International Settlements (BIS)

The Bank for International Settlements is an international financial institution owned by the member central banks. The primary goal of this institution is to foster international monetary and financial cooperation while serving as a hub for its member central banks. The BIS regularly holds meetings for policy discussion to share their economic and financial situation, as well as to develop coordinated policy actions. Additionally, BIS monitors global financial markets and international banking systems to identify and react to risks. Also, the BIS provides liquidity to central banks through its banking service to help manage their reserves and funding needs.



Debt repayment levels 2024 for LEDCs

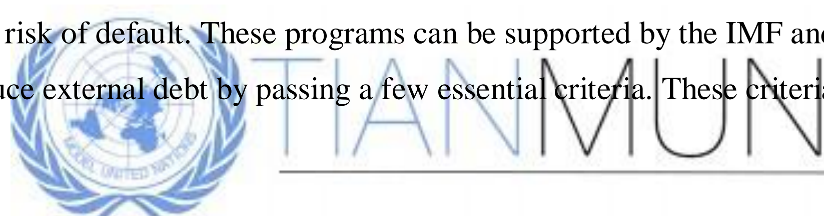
Less Economically Developed Countries (LEDCs)

As mentioned in the problems raised section, LEDCs are especially vulnerable during times of financial crisis and debt. Most of the LEDCs have low credit and, therefore, face higher interest rates. Then, the costs of borrowing increase, putting more burden on debt, and increasing the risk for default. Also, the fact that most of the LEDCs rely heavily on exports of a few primary commodities can be an issue because excess specialization can make their economies vulnerable to price volatility in global markets. For development purposes, LEDCs often seek funding from foreign sources due to limited domestic savings. Hence, high levels of accumulated external debt can make LEDCs especially vulnerable during financial crises.

Possible Solutions

Government Debt Relief Programs

As mentioned above, there can be various debt relief programs exist for countries that are facing economic crises and risk of default. These programs can be supported by the IMF and the World Bank, which may help reduce external debt by passing a few essential criteria. These criteria can include certain



requirements the government should implement for the economy or a track record of good performance under programs supported by international organizations. Countries that have successfully met the criteria can then receive debt relief. These government debt relief programs are especially helpful for HIPCs who are facing unmanageable debt burdens.

Issuing Bonds

Governments can issue bonds to borrow money as an alternative to raising taxes. Through issuing new bonds, the country can use them to pay off older debt. Moreover, issuing sovereign bonds can help to pay down old debt but also attract foreign investment. The influx of foreign capital could support the necessary funding to meet its external debt obligations. Also, there are development bonds that can be issued to stimulate economic growth. For example, these projects may include infrastructural improvements, education, and healthcare. Another benefit of development bonds is that it is beneficial for long-term growth. In times of financial crisis, economic growth is often slowed, however, with the implementation of development bonds, economic productivity will improve, hence helping to pay off external debt.

Monetary Policy

Another possible solution to this issue is using expansionary monetary policy. Central banks in countries can stimulate economic activity and manage debt through lowering interest rates. By lowering interest rates, the costs of borrowing will decrease, therefore, it will encourage more consumption and investments. This may lead to overcoming the recession and increasing the employment rate. Therefore, once the economy has recovered, the increase tax revenue can be used for paying off external debt. Since raising taxes can worsen the economic well-being of people during financial crises, implementing monetary policy and indirectly stimulating the economy could be a more beneficial approach. Therefore, many countries such as the US, and the European Union (EU) have employed this strategy during times of economic stress.

Federal Reserve Conference on Interest Rates

Bailout

Another way to reduce external debt and avoid default is through bailouts. A bailout is a financial assistance program offered to a business or country to prevent it from collapsing. It involves the injection

of capital, often in the form of loans and grants. The bailout will help to stabilize the financial system in the short term, although countries are still required to repay the assistance in the future.

Strengthening Financial Regulations

International regulatory bodies such as the IMF can ensure consistent financial regulations. Moreover, there can be capital requirements imposed by these bodies for banks and financial institutions to manage and absorb losses during a financial crisis. Also, there can be regular stress tests for banks and financial institutions to qualify resilience to economic shocks. Moreover, there can be regular meetings for countries to discuss sustainable economic policies. Through these managements, there can be a lower chance of an outbreak of the financial crisis spreading to other countries.

Glossary

Bailout

Act of giving financial assistance to a failing business or economy to prevent from collapsing.

Capital Flight

Occurs when assets or money flow out rapidly from a country, often because of economic consequences.

External Debt

External debt refers to the portion of a country's debt that is borrowed from foreign lenders such as commercial banks, governments, or international financial institutions.

Financial Crisis

Financial crisis refers to any broad variety of situation in which financial assets suddenly lose a big part of their nominal value.

Fiscal Policy

Fiscal policy refers to the government's intervention in the economy using government spending and taxation.

Foreign Direct Investments (FDI)

Foreign direct investment refers to the purchase of an asset in another country, often by Multinational Cooperation (MNCs).

Global Default

While this term is not a standard term in economics, global default is when multiple countries are unable to pay back their debt and the sovereign state of the countries is unstable.

Inflation

Inflation is the increase in the general price level in an economy over a certain period.

Interest Rates

Interest rates are the amount of interest due per period, as a proportion of the amount lent, deposited, or borrowed.

Recession

Significant and prolonged downturn in economic activity where Real GDP decreases and unemployment increases.

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