Economic and Financial Affairs Council (ECOFIN)

Contents

Letter from the Director

Hello delegates,

Welcome to INMUN 2020! My name is Dhruv Iyengar, and I am delighted to serve as the chair for ECOFIN. I'm currently in the 12th grade and plan to pursue economics and finance for my further studies. I'm proud to have an amazing Assistant Director by my side in Siddharth Dey. He is in the 12th grade and is a passionate MUNner in his own right.

My MUN journey began four years ago, and it has been something I've thoroughly enjoyed throughout. MUN, for me, has been more than a platform for collaboration and constructive debate, but it has allowed me to make new friends, learn more about global affairs, and develop important life skills like critical thinking and compromise. MUN has allowed me to expand my horizons and grow as a person beyond the four walls of a conference hall.

As your chair, I will be moderating your committee, and am extremely excited to see the debate, collaboration and fun that is in store for all of us! With an agenda like ours, I hope all of you are actively involved and interested in the activities of the committee and I hope this is a memorable learning experience for all of you.

Above all, I want each and every one of you to feel comfortable and empowered every time you speak. I understand the hesitancy and fear that comes with a MUN, especially for first-timers, but I hope to create a comfortable environment for all of you. If you have any questions, concerns or confusion of any sort, feel free to reach out to me, or my assistant director. We would be happy to guide you through any difficulties you might face. Looking forward to a fantastic INMUN 2021!

Best,
Dhruv Iyengar.

Introduction to the Committee

The Economic and Financial Affairs Council (ECOFIN) is the Second Committee of the General Assembly, combating issues across the economic/financial spectrum. In particular, it tackles questions relating to economic growth and development such as macroeconomic policy queries, eradication of poverty, sustainable development, globalisation and interdependence.

In this session, the committee will consider the significant rise in debt as a result of the Covid-19 pandemic. This is a global issue threatening countries ranging from east to west, north to south.

ECOFIN's importance on a global stage cannot be understated; the committee has taken up various agendas which are of international importance, such as finding mutually economically beneficial solutions to the West Bank and Gaza conflicts or ensuring the economic and financial sovereignty of the Arab population in the occupied Syrian Golan. The ECOFIN has had varied success in its operations over the years, and is often restricted by the fact that its suggestions are not binding. However, the ECOFIN has made several recommendations to the Security Council which have been passed successfully.

Understanding Debt

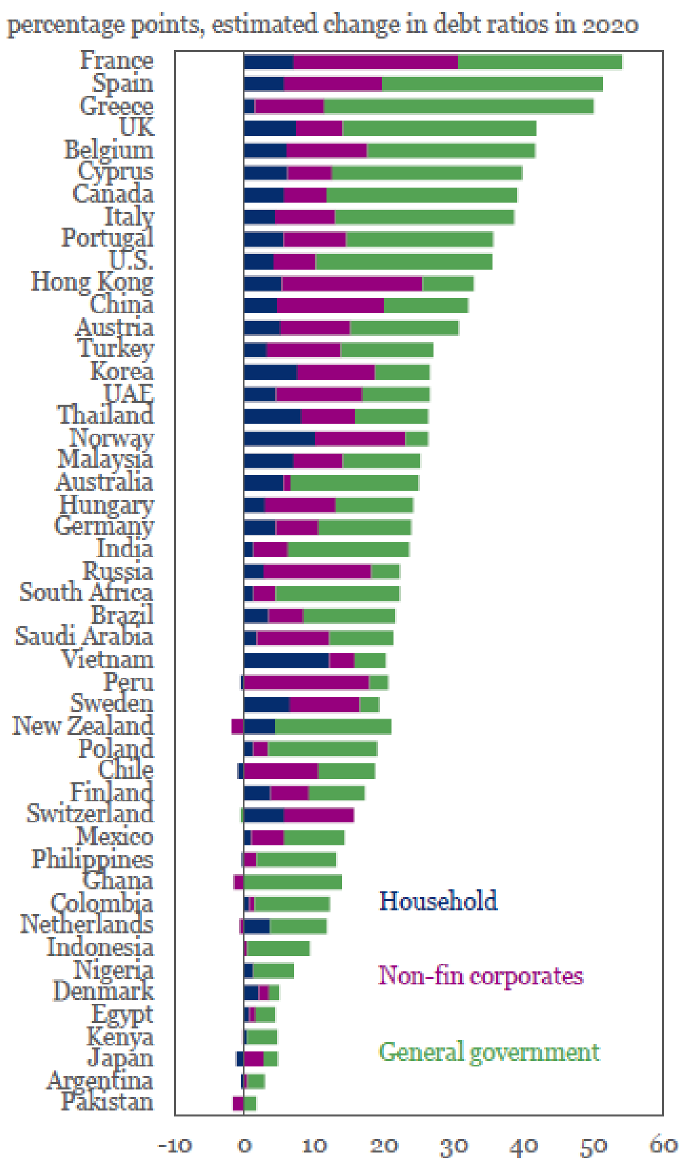
Individual Debt

At a fundamental level, debt refers to the sum of assets, with or without interest, that is owed to a lender as a repayment for borrowing. In the modern world, individuals acquire debt through commercial bank loans, mortgage loans, car loans, and credit card expenditure. Why people actually borrow money can be explained by a multitude of factors, but most noticeably borrowing is motivated by financial requirements and interest rate fluctuations.

Amid the COVID - 19 pandemic, we are seeing a significant rise in private borrowing levels in low-income countries, as lacking social security nets and persistent economic restrictions have stripped many of a steady source of income (See Figure 1). In South Africa, for example, household debt as a percentage of disposable income increased from 72.9% in 2019 to 77.1% in 2020 (Mathe & Maeko, 2020). Similarly, in Cambodia, the 3.3 million households hold a staggering 2.7 million microloans as of late 2020 (Blomberg & Dara, 2020).

However, with no imminent prospects for a significant expansion in global employment rates due to unpredictable market conditions and lingering financial damage from the lockdowns, many households are likely to remain under fiscal duress from mounting debt (World Bank, 2021). This poses a serious threat : if households continue to remain heavily indebted as economic restrictions are slowly lifted, economic recovery may prove cumbersome as large debt obligations are likely to cause a drag on consumer spending on goods and services.

Figure 1 : Debt levels in 2020



Source: IIF, BIS, IMF, National sources

Furthermore, high household debt levels also have implications on economic resistance to exogenous shocks. As the 2008-9 financial crisis displayed, unexpected economic shocks can trigger chronic credit defaults. Hence, economies with high household indebtedness are likely to remain structurally vulnerable to any upcoming financial crises.

Yet another issue to consider is the rise of loan sharks and unregulated lenders. In light of the financial desperation that has plagued emerging and developing economies, there has been a noticeable rise in illegitimate sources of finance.

In Cambodia, borrowers have generally relied on microfinance institutions (MFIs) to get access to loans, albeit at the risk of high interest rates, the use of land titles as collateral, and extreme pressure to repay. However, amid dampened economic conditions, which has hampered repayment abilities, many vulnerable Cambodian borrowers are now turning to instant cash offers from unregulated loan sharks to meet existing debt obligations. This has made several households fall prey to disastrous loans at rates as high as 50%. Simultaneously, a dangerous land seizure crisis is also playing out, as many families are opting to sell off property instead of indebting themselves further.

A similar story has played out in South Africa : unsecured and unregulated debt levels have risen by between 30% and 40% from 2019 to 2020. The growth in demand for non-traditional financial sources has naturally also fuelled the growth of the unsecured lending industry in South Africa. In 2019, the National Credit Regulator (NCR) valued the industry at nearly $15 billion, but it has only expanded ever since and continues to remain in a prime position to exploit hopeless borrowers.

External Debt

There exists several definitions of external debt, but for the purposes of this committee we will adopt the IMF's internationally accepted definition :

Gross external debt is the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to non-residents to repay principal, with or without interest, or to pay interest, with or without principal (IMF, 1988).

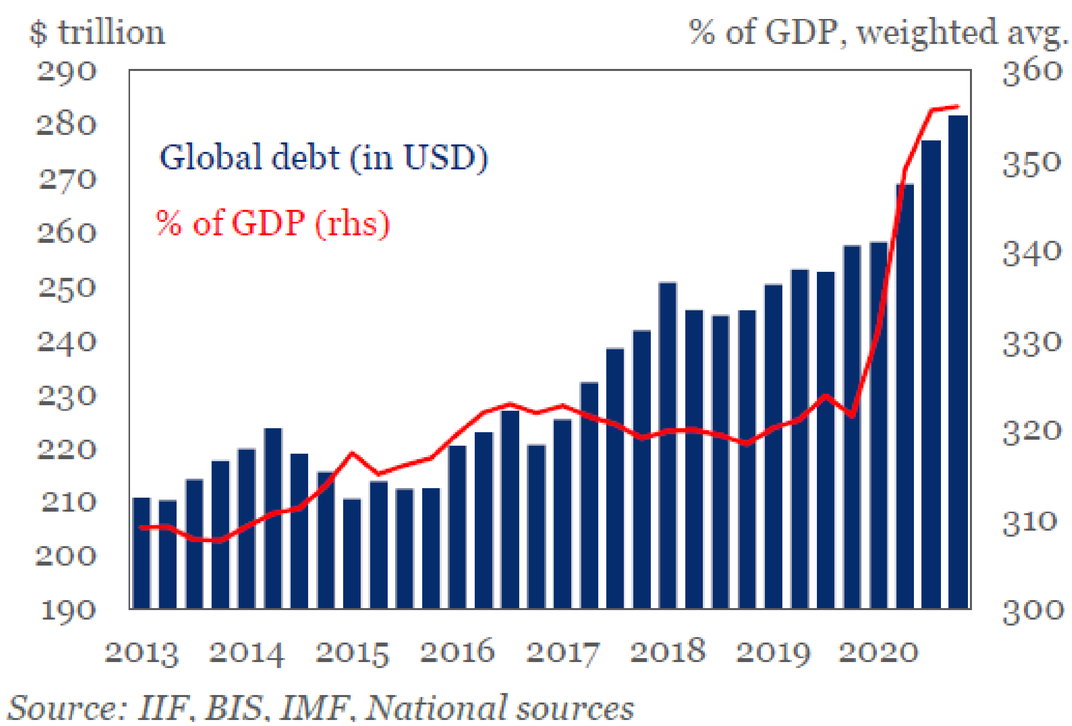
In lay man's terms, however, external debt simply refers to the portion of public national debt that is borrowed from foreign sources. When acquiring external debt, most nations will borrow from foreign governments or international financial institutions (IFIs) such as the International Monetary Fund (IMF) and World Bank.

While discussing external debt, it's also essential to have a complete understanding of commonly used indicators of debt sustainability. The debt-to-GDP ratio is a widely used metric in this field, and it is defined as the ratio between a country's public debt and its gross domestic product (GDP). By comparing what a country owes with its national output, the debt-to-GDP ratio indicates that particular country's ability to pay back its debts. Other indicators may include a country's foreign debt to exports ratio or government debt to current fiscal revenue ratio.

External Debt : 2010-2019

The last decade was critical in global development : virtually all emerging market and developing economies (EDMEs) made strides towards economic modernization and deployed expansionary fiscal policies to stimulate financial advancements. Yet what often goes unnoticed was the funding for these policies - the expansion in EDMEs was largely the result of external funding, which naturally ballooned global external debt. In fact, the last decade was labeled as the fourth global "debt wave" by the IMF (Kose et al, 2020) (See Figure 2).

Figure 2 : Global debt

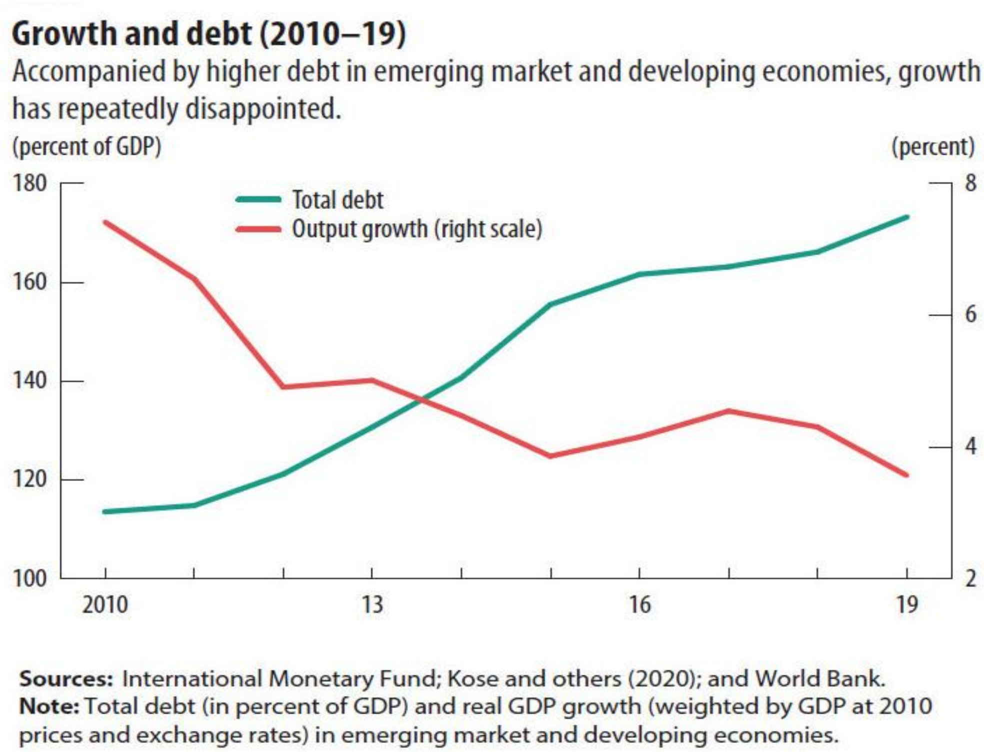


Credit : Jones (2021)

In particular, median public debt among 59 countries classified as low-income developing economies by the IMF rose from 38.7% of GDP to 46.5% between 2010-14 and 2017 (IMF, 2019). For the same set of nations, debt servicing represented, on average, 12.2% of government revenue in 2018, up from 6.6% in 2010 (Griffiths, 2019).

However, in spite of noticeable growth, economic output by the EDMEs significantly lagged behind the rise in external debt (See Figure 3), and some countries were already experiencing difficulties with debt obligations. Nevertheless, financial tranquility was maintained through positive growth outlooks and severe debt duress only emerged after the pandemic surfaced. However, knowledge of pre-existing debt obligations is still essential, as they help explain current developments.

Figure 3 : Global debt vs. growth (2010 - 19)



Credit : Kose et al (2020)

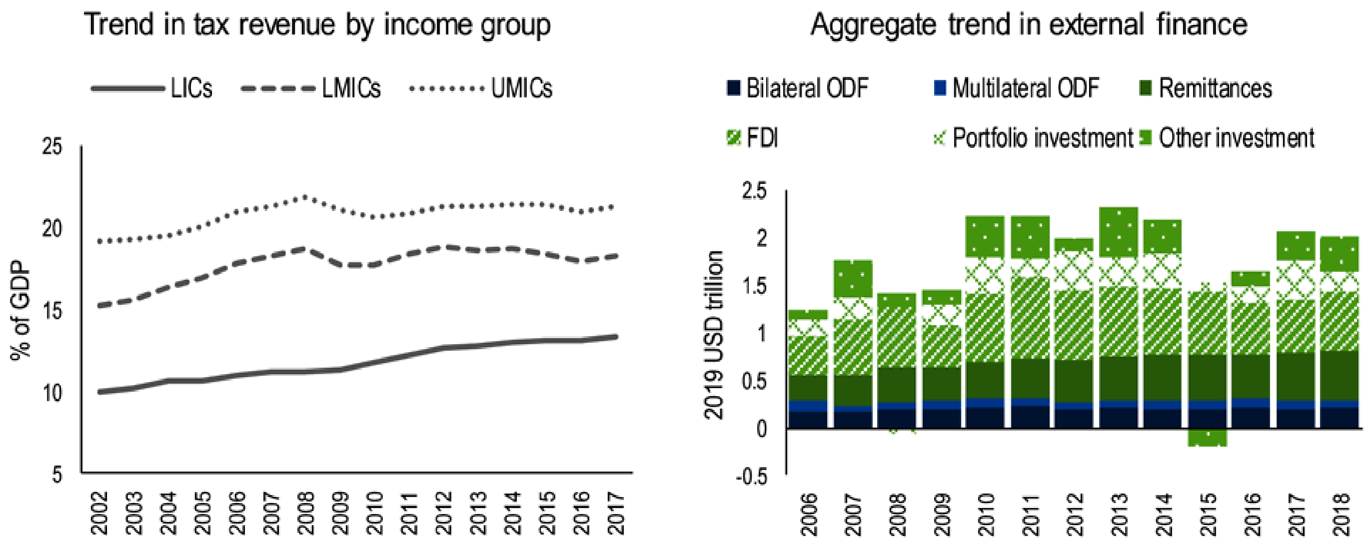
External Debt & COVID-19

As the pandemic struck in early 2020, most nations faced an unexpected surge in the necessity for healthcare investment, unemployment benefits for furloughed workers, grants for small and medium sized enterprises (SMEs) and fiscal injections to offset the impact of lockdowns. However, most EDMEs, along with several developed economies, seemed to lack the fiscal space needed to fund such policies. For example, UNESCAP (2020) found that several developing Asian and Pacific nations lacked the fiscal space to "sustain necessary countercyclical measures and invest in priority areas."

The lack of fiscal space can perhaps be best explained by declining tax revenues - the primary source of domestic finance - in the years prior to the crisis. For instance, in 2017, of the 124 countries eligible for official development assistance (ODA), 46 had a tax-to-GDP ratio below 15%, which is widely considered a benchmark to promote sustainable economic growth (Gaspar et al, 2016; OECD, 2020) (See Figure 4). Furthermore, findings from the OECD *Global Outlook on Financing for Sustainable Development 2021* also suggests that national savings as a percentage of GDP - another essential domestic resource - had remained significantly smaller in low-income countries when compared to middle-income countries and developed nations.

Anyhow, with limited fiscal space, existing debt obligations, collapsing government revenues (particularly for commodity exporters and tourism and other services-dependent countries), and a considerable surge in spending needs at the onset of the pandemic, a majority of EDMEs were completely reliant on external loans to muster the storm. In this regard, the IMF and world bank have played a substantial role in disaster management funding. The IMF has lent $110,188.38 million in financial assistance and debt service relief through the means of several lending instruments such as Catastrophe Containment and Relief Trust (CCRT), Rapid Financing Instrument (RFI) and the Rapid Credit Facility (RCF). Likewise, In 2020, the World Bank provided support upwards of $100 billion, and also pledged to make $160 billion available in financing capacity by June 2021

Figure 4 : Pre COVID - 19 tax revenue and external finance trends in ODA eligible



countries

Source : OECD (2020)

Although, the funding from the aforementioned IFIs and several other bilateral/multilateral agreements have been instrumental in curtailing the impacts of the pandemic, it has come at a significant cost. Analysis from the The Institute of International Finance demonstrates that the pandemic added $24 trillion to the global debt over 2020, leaving the worldwide debt-to-GDP ratio at over 355% (Jones, 2021). For context, this means that the global economy has a debt obligation of $3.55 for every dollar it earns.

Mapping the Flow of Capital in a COVID-19 Ridden World

The Global Health crisis facing the world has resulted in huge increases in external debt for countries. Public debt for emerging markets has skyrocketed to levels unseen for the last 50 years, and many developing countries have increasingly taken on debt on non-concessional terms - from private lenders and non-Paris Club members.

Developing and Emerging economies who have previously accumulated huge amounts of debt in a bid to foster quicker economic growth have been blindsided by the COVID-19 crisis. These countries have had balance of payment imbalances for years, as their external debt rose, and, now, with the economic shock of COVID-19, Emerging Markets and Developing Economies (EMDEs) are suffering due to the high percentage of domestic debt held by foreign firms and countries. This interrupted the flow of capital greatly, as foreign investment was cut and production ceased.

Likewise, increased household and non-financial corporations borrowing still create a high risk of debt distress for EMDEs during growth slumps. The recent Global Financial Stability Report shows that vulnerabilities are higher in countries with increased corporate and non-financial sector debt involving higher-risk activities within a low-yield environment. Today, household debt and non-financial corporations' debt together constitute more than 60% of total EMDEs debt according to the recently published Institute of International Finance data.

In 2020, investment volumes declined on an aggregate basis by 23%. Investors' reluctance to inject money in the midst of a global financial and health crisis resulted in some markets suffering more than others. Asian investment fell a whopping 44% in 2020, European investment by 20%, the Americas by 32% and the Middle East by 8%. The Middle East's relative success with stopping the spread of COVID-19 can be pinpointed as the primary reason for this.

As capital shortages increase in the developing world and foreign investment continues to fall, ECOFIN must collaborate with governments to solve the crisis at hand.

Consequences of the Global Rise in External Debt

The Future of The Sustainable Development Goals

The sustainable development goals (SDGs) were adopted in 2015 with the hope of attaining "peace and prosperity for people and the planet, now and into the future." However, our ability to accomplish these goals seems to hastily become an optimistic ideal, instead of a realistic goal, as we inch closer to the deadline. Prior to the pandemic, financing for the SDGs already looked gloomy. For example, OECD (2018) reported that private funding has seen substantial reductions with foreign direct investments (FDI) dropping by 30% over 2016-17. In 2014, the UN reported that financing for the SGDs in developing countries was approximately $2.5 trillion behind the actual target (UNCTAD, 2014). Therefore, at the onset of the pandemic, the stature of financing for the SDGs was subpar at best, but the exorbitant rise in external debt only stands to worsen the situation.

The large costs of debt servicing that accompany external debt are likely to interfere with national spending on the SDGs as is. However, with many countries choosing to devalue their currencies against the dollar, in a bid to restore interest in exports, debt servicing costs are likely to rise even further as nearly two-thirds of external debt held by lower middle income countries (LMICs) is in terms of the American dollar (IIF, 2020). On the whole, the availability of financial resources for the SDGs seems to be interminably decreasing, while spending needs are only increasing with the pandemic undoing years of progress in sustainable economic development. Precisely, we seem to be falling prey to the "scissor effect," as described by OECD (2018).

The obvious solution, especially with record low global interest rates, seems to be additional borrowing until the economic tide turns towards prosperity. Alas, the global economy adopted the same policy after the global financial crisis (See Figure 5). However, this is a clumsy solution at best. The deterioration of countries' sovereign credit rating (See Figure 6) due persistently poor economic environments has made accessing funds in international capital markets a costlier and more unwelcoming process. Resultantly, hopes of additional borrowing to finance rising needs is a very unlikely prospect for developing countries. Besides, the potential security offered by low interest rates may disappear at a moment's notice, if investor confidence were to turn with the development of global vaccine distribution.

Figure 5 : External debt trend post the global financial crisis

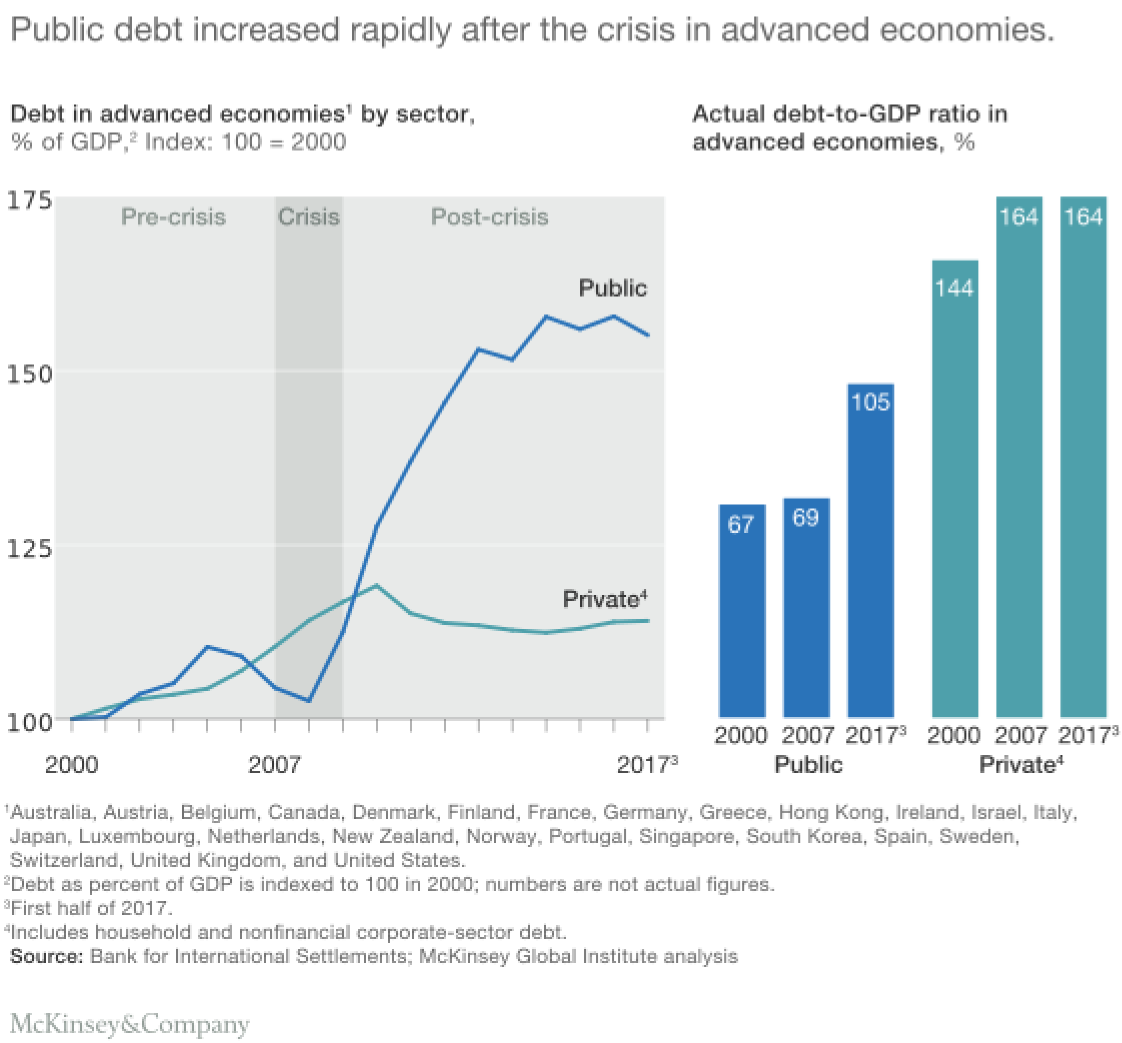
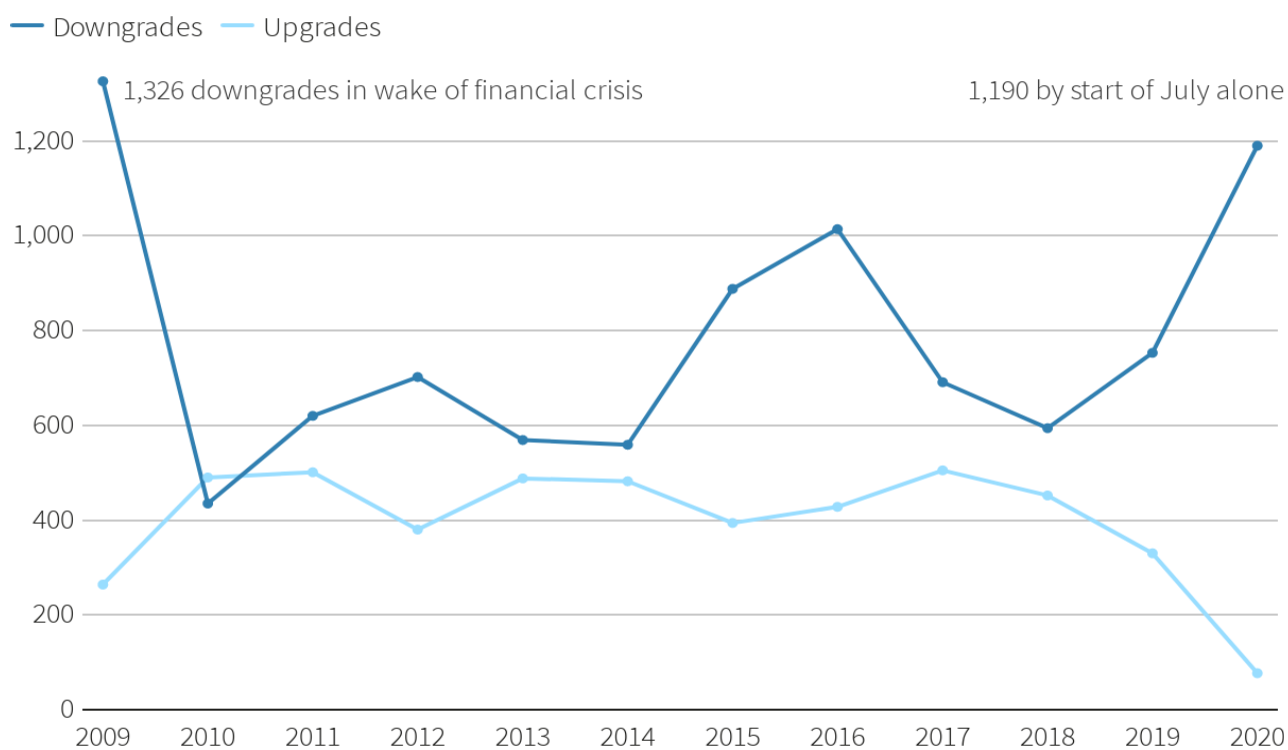


Figure 6 : Sovereign credit rating 2009 - July'2020

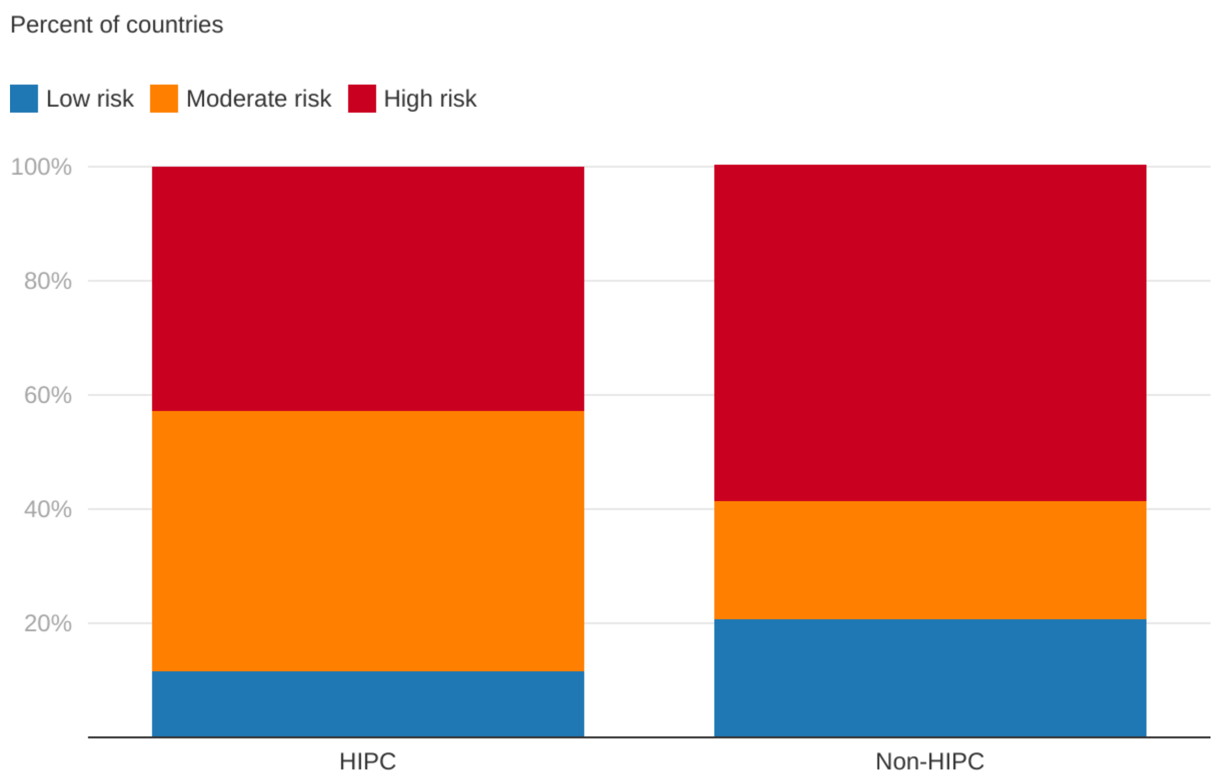


Source : Jones (2020)

Sovereign Debt duress & Defaults

The IMF categorizes a country as being in debt distress when the country is already experiencing difficulties in servicing its debt, as evidenced, for example, by the existence of arrears, ongoing or impending debt restructuring, or indications of a high probability of a future debt distress event (IMF, 2021). At the end of 2020, seven countries - Grenada, Mozambique, Republic of Congo, São Tomé and Príncipe, Somalia, Sudan and Zimbabwe - were in debt distress, while 28 countries are at high risk and 23 countries are at moderate risk of debt distress (IMF 2020) (See Figure 7). This has exacerbated existing debt risks and made these countries extremely vulnerable to non-economic crises, such as natural disasters, by gravely shrinking fiscal space.

Figure 7 : Risk distribution of external debt



HIPC = Heavily Indebted Poor Countries. Defined as in IMF (2020). Based on a sample of 69 economies with available data, as of September 30, 2020.

Source: Nagle & Sugawara (2021)

However, the problem becomes even more intricate as we analyse sources of debt for countries in duress. Although, a majority of external debt held by LMICs is owed to official bilateral and multilateral lenders, a noticeable component of their external debt is also owed to non-traditional sources of private credit, such as commercial banks and international bond markets. This is a consequential factor as government debt obligations to private creditors isn't included in the existing G20 debt moratorium. Consequently, middle-income countries will be required to repay at least a third of their total external debt over the course of the pandemic (UNICEF, 2021). In addition, as borrowing from non-paris club members has increased in the face of the pandemic, several EDMEs hold non-concessional debt, which can severely complicate debt resolution, such as rescheduling or standstills, if necessary.

Additionally, for countries in debt distress, or at high/moderate risk, social spending on basic services may also prove to be arduous. As per data from UNICEF (2021) and government spending watch (2020), rising debt levels remain a potent threat to basic social expenditure, especially in countries that aren't availing the IMF's debt relief programs. For instance, in 2020, South Sudan spent over 11 times more on debt service than on education, health and social protection combined. While, this may be an obvious consequence, it holds immense implications for the future - UNICEF (2021) found that "children in these countries may also be more likely to live in households experiencing monetary poverty post-COVID-19."

The Current Debt Moratorium

On May 1st 2020, the G-20 economies announced a suspension on the repayment for all official bilateral debt for all international development association (IDA) countries. This initiative comes after a plethora of advocacy for the policy from several subject experts and strong support from both the World Bank Group (WBG) and IMF.

The basis for the policy is rather simple : developing economies are simply struggling to cope with the financial requirements necessary to properly combat the virus amid steady fiscal outflows and high debt servicing costs. The debt standstill promises to alleviate a significant financial burden from developing countries and allow them to allocate resources on priority areas such as upgrading healthcare infrastructure and protecting endangered SMEs that suffer from low cash reserves.

However, the current debt standstill falls short on many counts. Firstly, singular focus on IDA nations has left many low and middle income countries that require help out of the equation. Although, the dilemma is not as severe in low and middle income countries, debt servicing costs still comprises almost a quarter of government revenues in the median middle-income country (UNDESA, 2020).

Secondly, the debt standstill model only affects bilateral lenders, while the participation of private lenders is only sought on a discretionary basis. Although IDA nations largely rely on official lenders, private external debt still comprises a significant portion of the external debt owed by small island developing states (SIDS) and middle income countries. For example, commercial debt, largely in the form of debt bonds, constitutes more than 50% per cent of the external debt held by the six SIDS. It is also worth noting that commercials aren't completely absent in IDA nations. According to the UNDESA (2020), commercial debt increased by more than three times between 2010 and 2019, rising from 5 to 17.5 per cent, in IDA nations. Consequently, any moratorium that means to veritably help indebted nations must include debt owed to commercial lenders.

Question A Resolution Must Answer (QARMAs)

- What policy measures can be taken to help low-income households with debt repayment?
- How can governments eliminate loan sharks and other illegitimate lenders amid a climate of financial desperation?
- What is the role of the international community in ensuring debt sustainability in low-income countries?
- Is a renewed and more inclusive debt moratorium necessary and fiscally possible?
- How can developing countries ensure ample fiscal space for potential future crises?
- What financial measures can be taken to resume progress in the achievement of the SDGs?

Closing Remarks

Delegates, we hope this Background Guide has been helpful to you. For any queries, feel free to contact us:

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