Economic and Financial

Shanshan Cao
Undersecretary-General

Matthew Glowasky, *Chair*

The Ivy League
Model United Nations Conference
Nineteenth Annual Session

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ILMUNC 2003
The Ivy League Model United Nations Conference

Dear Delegates,

Welcome to the General Assembly of ILMUNC 2003! The GA is the largest deliberative organ of the United Nations, composed of representatives of all member states. This year, ILMUNC is simulating five GA committees with topics ranging from the regulation of chemical weapons to the prohibition of human cloning.

My name is Shanshan Cao, and I am the Under Secretary General of the General Assembly. This very long title basically means I will be in charge of the five GA committees – my responsibility is to make sure each committee runs smoothly and that delegates enjoy themselves and are engaged in productive debate and negotiation.

I am currently a sophomore at Wharton, University of Pennsylvania, and my concentration is Finance and Accounting. I have been involved with Model United Nations for five years, starting as a freshman in high-school. In my junior year, my school attended ILMUNC, and I enjoyed the conference so much that it became one of my main considerations when applying for college.

I hope you will enjoy ILMUNC as much as I did, and I encourage you to email me any questions you have concerning UPenn's Model United Nations program or just applying-to-college concerns in general.

See you at conference!

Sincerely,

Shanshan Cao
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ILMUNC 2003
The Ivy League Model United Nations Conference

Esteemed delegates,
It is with great pleasure that I welcome you to the Second Committee of the General Assembly at ILMUNC 2002, the Economic and Financial Committee. My directors and I know that you have diverse ILMUNC committees from which to choose, and we thank you for electing to sit in our committee, ILMUNC's finest.

While my only model UN participation as a delegate occurred last spring in Brazil, ECOFIN will mark my fifth time serving as moderator, both at the secondary and undergraduate levels. A native Philadelphian, I attended high school in Portland, Oregon, and now study Finance and French at Penn. This summer, I worked in investment banking in San Francisco, and I have always been interested in economics and finance. I look forward to meeting all of you and exploring your own intellectual interests in committee this January.

In preparation for conference, I would like you all to research our topics, as well as the world economy at large. One of the most common complaints that I hear from delegates is that sessions are unbalanced in terms of participation, and I think the best way to eschew this situation is to do your research so that you are fully prepared to contribute to the discourse.

While I would like to further introduce myself and my dais staff and welcome you to ECOFIN, I have sold my soul to the financial devil this summer and must return to work. I wish you the best of luck in both your studies and recreation at school, and look forward to seeing you in January. If you have any questions either about committee or any other pressing matters in your lives, please feel free to email me.

Very truly yours,

Matthew Glowasky
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COMMITTEE HISTORY

Economic and Financial

The Economic and Financial Committee is the Second Committee of the United Nations General Assembly. Like the other GA committees, ECOFIN deliberates on all issues and aspects of international peace, security, and development. It was created to discuss and debate a broad range of economic topics. The Second Committee advises the General Assembly on topics including trade sanctions, international banking, regulation of financial institutions, and economic development. Any topic with a monetary, financial, or economic scheme may be allocated to the Second Committee. ECOFIN considers topics encompassing virtually every United Nations agency.

ECOFIN therefore works closely with many other UN organs, especially those concerned with economic issues. The UN Conference on Trade and Development, a permanent organ of the General Assembly, reports directly to the Second Committee. The work of a number of agencies reporting to the Economic and Social Council, such as the United Nations Environment Programme and the United Nations Development Programme, also work closely with ECOFIN. The two organizations created by the Bretton Woods Conference in July of 1944, the International Monetary Fund and the World Bank, deal with issues related to the work of the Second Committee, as do the International Fund for Agriculture and Development (IFAD) and the Organization for Economic Cooperation and Development (OECD).

The Second Committee uses the reports of all of these organizations as a point of departure for its own debate, and helps them coordinate their efforts. Historically, ECOFIN has played a coordinating and operational role in implementing policies developed by or with other UN organizations.

Increasing economic interdependence has recently brought ECOFIN to the forefront of international discourse. Recently, important topics discussed by the Second Committee have included sustainable development, globalization and interdependence, and external debt crises. Additionally, ECOFIN has been closely involved in initiatives relating to the United Nations Decade for the Eradication of Poverty (1997-2006).

In February 2000, the General Assembly adopted resolution 54/109, the International Convention for the Suppression of the Financing of Terrorism. As the UN's primary forum for financial affairs, ECOSOC will have take a leading role in the coming years to help improve financial regulation and tracking and help states implement this Convention.

TOPIC ONE

Microcredit and its Role in Sustainable Development

Introduction

The eradication of poverty has been a primary goal of the United Nations since its inception. Countless international aid programs have been established to build infrastructure and promote sustainable development around the world. In many cases, however, these programs failed to improve the standard of living for the world's most impoverished people. Over the past three decades, an important new tool to combat poverty has been developed: microcredit, the granting of small loans directly to entrepreneurs too impoverished to qualify for traditional loans.

Statement of the Issue

Attendees of the Microcredit Summit in 1997 set themselves a goal of reaching 100 million people worldwide by 2005. Although many new microfinance institutions were established during the 1990's, their goal remains far from realization. International coordination is needed to ensure the establishment of new microbanks and the expansion of those currently in existence. The task of this committee is to ensure that the regulation and coordination of microbanks as financial institutions progresses to provide incentives for their establishment and expansion.

Introduction to Financial Institutions and Microbanking

We rely on banks every day of our lives, whether we are cognizant of it or not. When we need to borrow money to finance a house, or a car, or a college education, we seek out banks, which make us loans. Conversely, when we have extra money that we want to save in order to earn interest, we open accounts at banks. When banks lend money, they charge interest, which is in essence a fraction of the amount borrowed that is repaid to the bank to cover its services. If, for example, you wanted to buy a bicycle for $100, you could borrow the money from the bank and repay it in one year at 9% interest. At the end of the year, you would repay the bank $109. If, on the other hand, you wanted to put $100 into a savings account, at the end of the year you could withdraw your $100 plus $5 in interest, if the interest rate were 5%. Because the interest rate on funds borrowed from banks is higher than the interest rate the banks pay out on savings deposits, the bank profits; this is called "interest rate spread."

Much of the world's population lives in remote and impoverished areas where access to banks is limited. These people also need the opportunity to borrow money to finance their businesses and their lives. However, because most live in poverty and have no sustainable source of income, they cannot borrow money from banks. In response to this need, microbanking was created. Microbanks are organizations, both private and public, that make very small loans to people, which is why the field is called microfinance. Often these loans are as small as $50 or $100. The borrower agrees to repay the principal of the loan, in addition to interest accrued, at specified intervals. The interest rates charged by microbanks are generally much higher than commercial banks in the developed world because the risk of default (that is, of non-repayment) is greater. In Guatemala and Honduras, for example, the average interest rate is around 26%.[1] Because of the small scale of the loans, repayment is common.

Organization of Programs

Microbanking does, however, offer advantages that conventional banking does not. First, as discussed before, since the interest-rate spread is so great, microbanking presents a very profitable enterprise to financiers. At the same time, however, operating a microbank takes plentiful administrative resources, since managing a small loan often takes as much time as managing a larger loan in a commercial setting. Therefore, it may take 1000 microloans to generate the same profit for the bank as one standard loan. Thus far, the profitability of microbanking has been difficult because of the high costs of operation.[2]

Another advantage of microbanking lies in how the microbanks are organized. Unlike a commercial bank, where there is a one-to-one relationship between the client and the loan officer at the bank, in a microbank there is often a group relationship. Instead of working with the bank individually, the clients are arranged in groups, which then work with the bank. A sort of mutual-dependence arises among the clients, making them more likely to repay their loans. The groups usually undergo extensive training for the programs, which require a significant time commitment from each member. A stronger working relationship develops among the borrowers and the bank than that between a commercial banker and borrower. Other implications of group organization are discussed below.

A third advantage of microbanking lies in the savings side of the operations. Many people in areas where microbanks operate have successfully run profitable businesses and have currency that they want to put into a savings account at a bank in order to earn interest. Also, once people have received their microloans, they often earn more money that they want to save. Microbanks can offer savings opportunities to these individuals. The deposits that citizens make can be loaned out to other borrowers, and this cycle can continue, allowing more microloans to be created. The cyclic nature of microbanks has led many experts to believe that microcredit may become a lasting tool for creating sustainable development.

Microcredit and Development

One of the greater challenges facing any organization attempting to engender sustainable development is how to manage programs at the personal level. Underdeveloped countries lack the infrastructure, especially the information systems, of developed countries, which makes the developer's task more difficult. In, for example, the United States, large banks can keep track of millions of customers accounting for billions of dollars in loans and savings. Computer databases and control practices and procedures allow for such consolidated large-scale operations. In a developing nation, on the other hand, credit agencies have not and cannot adopt similar standards, making such operations impossible. In these countries, many governments and lenders have found microcredit a useful tool for reaching out to indigent citizens, especially in rural areas where organizing a bank would be doubly difficult because of low population density. Many people in developing countries do not have access to commercial development loans for myriad reasons, particularly because of the absence of banks in rural areas, and because many poor farmers do not meet the often stringent credit guidelines of commercial financial institutions. In such cases, microcredit can be used as the primary tool for sustainable development.

Microcredit programs offer advantages to participants extending beyond the loans themselves. Many programs are community-based, making them ideal forums for disseminating information of use to the borrowers, especially data on health, legal rights, sanitation and other relevant concerns of the poor. Generally, the borrowers are grouped together, and the group is used as a means of mitigating the default risk of any individual borrower: if a member defaults on his or her loan, the whole group is equally responsible. In many rural areas, the people who form the groups know each other well, so if a member does not repay his or her loan the whole group will suffer. Hence, microborrowers have an additional incentive to make loan payments. Also, as the members profit from the funds they borrowed, they will begin wanting to save their money and earn interest on their savings. The entire group will pool its savings and be eligible for better interest rates when they invest their savings. Thus, microbanking, in theory, suggests sustainability, which is partly why it has received so much attention in the international arena over the past decade. The Global Development Resource Center (GDRC), a global development agency, and the World Bank now estimate that there are now over 7000 microcredit organizations operating globally, and that these banks aid over 23 million poor people in developing economies worldwide, of which nearly 14 million are considered to be among the poorest people in the world.[3] Currently, about $7 billion U.S. dollars are invested in microcredit organizations worldwide.

The Role of Women in Microcredit

Microcredit has received special attention from women's rights proponents worldwide. Traditionally, women entrepreneurs and other disadvantaged parties have had difficulty obtaining loans from commercial lenders and development agencies because they do not have sufficient income to qualify for traditional loans. While many governments in developing countries have begun to take steps to improve women's access to capital, in others, progress has been more latent. In these areas especially, microcredit has come to be relied upon by women and other groups without adequate access to financial assistance. This is doubly important because in Africa, for example, women comprise 60% of the total agricultural workforce and produce 80% of total food output.[4] Many microcredit programs, such as MUDE (Women in Development, in English), which operates in the indigenous regions of Central America, only work with women.

History

Microcredit is a relatively new phenomenon: most organizations have been in existence for twenty years or less. Contrary to many accounts, microlending originated in developing countries and then made its way to the United States and Europe.[5] The Grameen Bank in Bangladesh is credited as the first microcredit organization. It was founded when Dr. Muhammed Yunus, an economics professor at Chittagong University, realized that traditional economics and banking theory did not apply when working in rural areas without infrastructure. His first loan was for $6 in 1976. Dr. Yunus created the group model that is currently prevalent in microcredit, and by 1987, his Grameen Bank serviced over 250,000 Bangladeshi citizens; it now serves nearly two million. Since then, nearly one-third of the Grameen Bank's clients have risen above the poverty line.[6] Today, the Grameen Bank is considered the most effective microcredit organization in existence, and it has become the largest nongovernmental organization (NGO) in Bangladesh.[7]

Microcredit thus emerged as a new avenue leading to global sustainable development. During microfinance's early days, most global development programs tried to fight poverty by building infrastructure, such as roads and other public works projects. Economists theorized that by improving a country's public services, the standard of living of its citizens would improve.[8] Microlenders took another approach. Instead of funneling in the money at high levels, the loans were made directly to the citizens in need. Since the Grameen Bank began in the 1970's, hundreds of other microbanks have opened, following Dr. Yunus's example. Other major microcredit organizations include the Association of Asian Confederation of Credit Unions, a consolidated group serving 1.5 million borrowers, and the World Bank, which has created several groups to practice microfinance to alleviate poverty. Some microbanks, like Accion International, operate as non-profit organizations, taking private donations and using this money to make microloans. Others, such as Fundusz Mikro in Poland, operate as for-profit banks, receiving funding from deposits made by microsavers.

Present Status of Microlending Worldwide and Future Potential

Although a relatively new tool in the arsenal of global sustainable development, microcredit has enjoyed success nearly everywhere it has been implemented. Repayment rates have hovered around 97% for several years, and the annual growth rate of outstanding microloans has approached 30%, or approximately ten times the annual growth of the United States economy.[9] The largest microcredit organization worldwide, the Grameen Bank in Bangladesh, reports that 98% of its loans are repaid each year, and that 94% of its 1.8 million clients are women. At present, it is estimated that only 2% of the world's population has access to financial services other than commercial lenders. Estimated immediate demand for microloans is seven million borrowers—these individuals are prepared to enlist in microcredit groups at any time. Additionally, demand for microsavings opportunities is even greater than demand for loans. These people have money that they would like to save in order to earn interest. Microcredit organizations often act as microsavings banks as well, which means that both sides can have their demand met. Still, however, much of the money distributed through microlending ends up in the hands of men. In these cases, women will join microcredit groups and be responsible for repaying the loan, while their husbands or other gentlemen will use the funds in their enterprises.

Relevant International Action

Although microcredit is a fairly new financial tool, it has received much attention in the international community. In February 1997, in response to concerns raised regarding women's role in development at the Beijing Conference, a Microcredit Summit was held. Representatives from worldwide met in Washington, D.C., and attempted to devise a unilateral plan to set the direction of microcredit over the coming years. The leaders at the Summit agreed that by the year 2005 a reasonable goal would be to have 100 million people worldwide using microcredit as a means of improving their standard of living. The result of the Summit was the creation of the group's *Declaration and Plan of Action*, which outlined four principal goals for microcredit. First, and most importantly, microcredit should reach the poorest families.[10] Traditional development programs, focusing generally on fortifying infrastructure, cannot often reach out to the most indigent in a developing country. Microcredit, on the other hand, has proven most effective at reaching the poor. The Summit's second objective was to direct microcredit programs toward helping women.[11] In order to strengthen the programs already in place, the Summit's report outlined a plan to make microcredit organizations self-sufficient financially.[12] Economists have theorized that one major factor contributing to the success or failure of a microbank is whether or not the bank can be run self-sufficiently. Programs that are run as for-profit companies, generating loans from the savings people have invested in the bank, will persevere and be most effective in the long run, says Dr. Jamshed Ghandhi, a pioneer in microfinance.[13] Finally, the Summit aimed to ensure that each borrower has a positive experience with microcredit and that the loans given actually improve people's lives. The Campaign will have failed if 100 million families are reached, but the institutions are not strong enough to continue providing services to future clients. The Campaign will have failed if 100 million families are reached, but there is little impact on the lives of the clients and their families.[14]

The United Nations General Assembly passed a resolution later in 1997 as a call for action for microfinanciers (the text of Resolution 52/194 is presented in the annex). After extensive research, the General Assembly decided that microcredit would be a key component in the U.N.'s First Decade for the Eradication of Poverty, which began in 1997.[15] In addition, because of the increased attention on the role of microcredit, the World Bank has stepped up as the leader of the coordinated international effort for microcredit. The World Bank has created the Consultative Group to Assist the Poorest (CGAP), a body that brings together Western donor countries in a unified effort against poverty. The CGAP represents 25 microcredit agencies, and serves to help the various agencies address the problems currently present in microfinance. The United Nations has also set up a number of organs under the United Nations Development Programme (UNDP). These groups assist the actual microlenders by providing training and a system of controls to ensure that the microbanks are operating efficiently.

Analysis and Possible Solutions

Although many argue that microcredit has seen enormous success given its relatively short history, it is by no means a perfect science. Because each developing economy differs in its characteristics, each microbank has developed differently and has its own idiosyncratic practices. While the Microcredit Summit and subsequent international action have brought together the world's various organizations, there are still thousands of independent microbanks that are not benefiting directly from the efforts of the World Bank and the United Nations. Additionally, in order to meet the goal of providing microcredit to 100 million of Earth's poorest residents, much more expansion is necessary in the field. Despite the 30% annual growth rate, larger operations are needed to reach this goal. A larger organization can take advantage of cost efficiencies that smaller ones cannot, making the entire operation more efficient. At present, only three microcredit organizations serve over one million people, and many serve only several thousand. However, because only certain banks have become profitable to date, smaller banks have limited incentive to grow larger and increase their losses. As the scale and scope of microcredit broaden, loan delinquency will likely become a problem, and interest rates may need to become more standardized. Standards for analyzing the credit risk of borrowers on a large scale are necessary. What is further needed is consolidation and cooperation among existing programs on the international level. Banks like the Grameen Bank have been around for a long time and have overcome many of the hurdles now facing newer microcredit programs. An international forum for shared experiences would help start-up microbanks achieve success sooner.

One way to possibly make microbanks more profitable would be to increase the savings side of the equation. While at present many donations come from the developed world, increasing savings in developing nations would provide an additional source of funding for microbanks. Moreover, since estimated demand for savings institutions exceeds demand for loans, the potential for loan growth exists.

However, money and profitability represent only one facet of microcredit. While increasing profitability in the industry will lead more agencies to participate, the main focus must be on the success of the projects, measured not only by the total dollar value of the loans, but also by how microcredit increases people's access to necessary resources. Measuring this is very subjective, so unilateral standards must be carefully developed. Many microbanks offer social services and empowerment training to group members, while others maintain a purely financial relationship. Microcredit, because of its group nature, provide ideal alley for disseminating social services to impoverished peoples. Again, a coordinated effort is needed to ensure that microborrowers receive not only their loan but support services educating them on how to use the funds to improve their situation.

Another challenge facing microbankers and other development personnel is finding which 100 million people are actually the poorest. Thus far, banks have been successful at targeting needy segments of the population. However, as the field broadens drastically over the coming years, discriminating between those who desperately need microcredit and those who could benefit from traditional aid will become more difficult.

Microcredit has proven itself an effective way to reach poor women and others incapable of obtaining help on their own. However, because women and other handicapped people tend to be less proactive in seeking help, it must be the microcreditors' responsibility to seek out those in need. Additionally, improved women' rights will help microcredit benefit even more families.

Conclusion

The next few years will be exciting for participants of microcredit. Because of the fresh nature of the industry, opportunities for individuals and groups to pioneer new ideas and practices will be plentiful. However, microcredit also faces many problems that new practices face, and its practitioners will have to devise solutions to overcome these hurdles. Because of the need for standardization and cooperation worldwide, this issue must be discussed further in the international arena.

Endnotes

1 Author's personal data bank.
2 Lecture by Jamshed K. S. Ghandhi, Ph.D., The Wharton School, University of Pennsylvania.
3 Microcredit Summit Campaign 2000 Report.
4 MICROFACTS: Data Snapshots on Microfinance. The Global Development Research Center's Virtual Library on Microcredit. *http://www.gdrc.org/icm/data/d-snapshot.html*
5 Mountain Microenterprise Fund's History of Microcredit.
6 Microcredit Continued (BYU website)
7 Microcredit An effective development tool for helping those who need help the most. Black-Schaffer, David. Working Paper.
8 Ibid.
9 *microfacts.*
10 Microcredit Summit Campaign 2000 Report.
11 Ibid.
12 Ibid.
13 Lecture by Jamshed K. S. Ghandhi, Ph.D., The Wharton School, University of Pennsylvania..
14 Microcredit Summit Campaign 2000 Report.
15 Role of Microcredit in the Eradication of Poverty-Report of the Secretary General. Prepared as per Resolution 52/194, passed 18 December 1997.

Further Reading

Microcredit Summit Campaign. http://www.microcreditsummit.org
Garson, José. Microfinance and Anti-Poverty Strategies: A donor perspective. http://www.undp.org/uncdcf/pubs/mf/mf-contents.htm
The Virtual Library on Microcredit. http://www.gdrc.org/icm
Grameen – Banking for the Poor. http://www.grameen-info.org
Fundusz Mikro. http://www.funduszmikro.com.pl

Annex

52/194 Role of microcredit in the eradication of poverty
Date: 18 December 1997
Meeting: 77
Adopted without a vote
Report: A/52/628/Add.6
The General Assembly,

Taking note of the report of the Secretary-General on the observance of the International Year for the Eradication of Poverty (1996) and recommendations for the rest of the First United Nations Decade for the Eradication of Poverty (1997-2006),

Recognizing that people living in poverty are innately capable of working their way out of poverty with dignity, and can demonstrate creative potentials to improve their situation when an enabling environment and the right opportunities exist,

Noting that in many countries of the world, microcredit programmes, by providing access to small capitals to people living in poverty, have succeeded in generating productive self-employment,

Also noting that microcredit programmes have proved to be an effective tool in freeing people from the bondage of poverty, and have led to their increasing participation in the mainstream economic and political process of society,

Bearing in mind that microcredit programmes have especially benefited women and have resulted in the achievement of their empowerment in a world where more women than men live in absolute poverty and that the imbalance continues to grow,

Recognizing that microcredit programmes, in addition to their role in the eradication of poverty, have also been a contributing factor to the social and human development process,

Noting that the qualitative and quantitative development of microcredit institutions and their capacity to reach the marginalized groups requires the provision of an enabling environment, including a policy framework for the financial sector, as well as linkages to the formal financial sector,

Bearing in mind the importance of microfinance instruments such as credit, savings and related business services in providing access to capital for people living in poverty,

Noting that the provision of finance to microcredit institutions should be commensurate with their absorptive capacity and that efforts should be made to strengthen and enhance that capacity,

Also noting the positive references in support of the role of microcredit contained in the final documents of the Twelfth Ministerial Conference of the Non-Aligned Movement (New Delhi, 4-8 April 1997), the Ninth South Asian Association for Regional Cooperation Summit (Male, 12-14 May 1997), the Organization of African Unity Summit (Harare, 2-4 June 1997), the substantive session of 1997 of the Economic and Social Council (Geneva, 30 June-25 July 1997) and the Commonwealth Heads of Government Meeting (Edinburgh, 24-27 October 1997) as well as the Group of Seven statement on economic and financial issues (Denver, Colorado, 21 June 1997),

1. Welcomes the launching of different microcredit initiatives in recent years and acknowledges their important contribution to the eradication of poverty, empowerment of women and social upliftment;

2. Welcomes also the outcome of the Microcredit Summit, held at Washington, D.C., from 2 to 4 February 1997, which through its Declaration and Plan of Action, endorsed a global campaign to reach 100 million of the world's poorest families, especially women of those families, with credit for self-employment and other financial and business services, by the year 2005;

3. Notes with satisfaction that, as called for in Assembly resolution 51/178 of 16 December 1996, many United Nations agencies and the World Bank actively participated in the Summit and thus contributed to its successful outcome;

4. Takes note of the Declaration and Plan of Action of the Microcredit Summit, the communiqué issued by the Council of Heads of State and Government at the Summit, and messages to the Summit from the Chairman of the Group of 77 and China and the Secretary-General of the United Nations;

5. Recognizes the important contributions being made by the United Nations system and by the Consultative Group to Assist the Poorest, sponsored by the World Bank, to develop and disseminate best practices among all organizations engaged in the provision of financial services on a sustainable basis to people living in poverty;

6. Encourages all involved in poverty eradication programmes to consider incorporating microcredit schemes in their strategies;

7. Also encourages them to adopt policies that support the development of microcredit institutions and their capacities so that credit and related services may be made available to increasing numbers of people living in poverty;

8. Calls upon the international donor community to support the strengthening of existing and emerging microcredit institutions in the developing countries, especially the least developed and the African countries;

9. Also calls upon the relevant organs, organizations and bodies of the United Nations system, in particular its funds and programmes and the regional commissions, as well as relevant international and regional financial institutions and donor agencies involved in the eradication of poverty, to explore including the microcredit approach in their programmes as a tool for the eradication of poverty and further developing, where appropriate, other microfinance instruments;

10. Calls upon all concerned non-governmental or-

ganizations, other actors of civil society and the private sector to support and incorporate, as appropriate, microcredit and related services in their programmes for the eradication of poverty;

11. Requests the Secretary-General, in collaboration with relevant organizations of the United Nations system, including funds and programmes and the World Bank, to submit to it at its fifty-third session a report on the role of microcredit in the eradication of poverty in the follow-up to resolution 52/193 entitled "First United Nations Decade for the Eradication of Poverty";

12. Decides to include future discussions of the role of microcredit under the item entitled "Implementation of the First United Nations Decade for the Eradication of Poverty (1997-2006)".

TOPIC TWO

Debt Relief

Introduction

The assemblies of the United Nations affect many facets of life, from the basics necessities of existence to the procedures of international politics. The Economic and Financial Committee is charged with discussing issues relating to all aspects of the systems by which we create, exchange and transfer money, goods and services. As the 2nd committee of the General Assembly, it represents the widest possible spectrum of nations of the world. In an age when economic and financial actions have increasingly international repercussions, the Economic and Financial Committee is a necessary forum for every nation to debate domestic policies and international consequences.

Statement of the Problem

Acquiring debt is a commonplace tool for governments, organisations and individuals to supplement their financial resources, purchase basic necessities, and fund essential programs. However, the poorest countries of the world face a daunting problem. Their debt burdens are so great that governments, non-governmental organizations, creditors and international institutions such as the World Bank and the International Monetary Fund acknowledge they will never be able to pay them off. Efforts to do so only exacerbate the poverty and deprivation already faced by the country by diverting scarce resources away from primary education, basic health care, rural development, or HIV/AIDS prevention.

Half of the population of the Heavily Indebted Poor Countries (HIPC) lives on less than US$1 a day, and almost half lack access to clean drinking water and sanitation. A citizen of a HIPC has an average life expectancy of 51 years, as opposed to 62 years for a citizen of another developing country. Poverty, malnutrition and lack of access to health care lead to high levels of child mortality: of 1000 live births, 156 die before the age of five. 47 million primary school age children in HIPC countries are out of school, two thirds of them girls. As a result of this, women's literacy rates in Burkina Faso, Mozambique, Ethiopia, Niger and Senegal are below 25 per cent. Conditions in HIPC countries have remained unchanged for the most part despite years of development initiatives, and in some cases have actually deteriorated. However, developing countries spend more than four times more on debt service payments than on education and health care combined. Given the urgent need for investment in primary education, basic health care, sanitation, finding a manageable solution to the burden of debt has become an imperative for international creditors, national governments, and non-governmental organisations.[1]

History

After World War II, the American dollar emerged as the world's currency. By the 1970s, international private banks possessed great sums of highly liquid American currency, often called Eurodollars or Petrodollars. They eagerly extended loans to Third World countries, especially in Latin America, at rates so low that the real interest rate was often negative. From 1972 to 1982 the external debt of developing nations multiplied from $100 billion to $800 billion, and by 1987 it totalled $1000 billion.[2] In Africa and Asia, debt were composed of bilateral loans from governments, and later the IMF and World Bank, rather than commercial loans from private banks. These loans were often conditional on agreements to buy industrial products from the lending country.[3] Loans were also intended for infrastructure projects, or other initiatives to increase the export capability of the developing nation.

I October 1979, Paul Volker, the chair of the US Federal Reserve Board, and Margaret Thatcher, then Prime Minister of Great Britain, announced an increase in interest rates. Coupled with a drop in inflation beginning in 1981, real interest rates became positive rather than negative. At the same time developing nations experienced a severe loss of demand in their export markets in the First World, and a drop in the price of many raw materials. These factors combined to make it very difficult for indebted nations to meet the increased interest payments on outstanding loans. In August 1982, Mexico announced it would default on its external debt. In order to prevent a global financial destabilisation, within 72 hours the international community had come up with almost $4 billion from creditors, public institutions and governments. Many other Latin American nations also suspended payment on the interest of its debt, such as Brazil in 1987.

Despite these emergency measures the debt burden of developing nations continued to grow throughout the 1980s and became increasingly unmanageable. Investor uncertainty after the Mexico crisis in 1982 prompted private banks to charge higher interest rates on loans to developing nations. By 1984, 90% of loans from the IMF required the implementation of a strict austerity program. Governments had to offer guarantees of debt service to both private banks and public institutions, put in place policies of deregulation of capital markets, devaluation of currency and privatisation of national industries, and remove subsidies for domestic industries and barriers to international trade.[4] The Baker Plan of 1986-1988 linked new lending from private banks and the World Bank to economic liberalisation and compliance with IMF adjustment policy. Rescheduling the debt was another popular solution, but it delayed repayment rather than reducing the amount of debt. By 1989 it was evident to lenders that most of the debt they held was worth much less than face value. Banks, countries and international institutions provisioned their debts at 30 to 40 cents per dollar.[5]

Pressure from industry groups in developed nations, anxious about loss of jobs in export sectors, fuelled calls for partial forgiveness of the debt of developing nations. The Brady Plan of 1989 to 1994 aimed to reduce the debt burden of highly indebted poor nations by writing off some of the principal or reducing the debt service or interest payments on that debt.[6] The IMF continued to require that countries follow a Structural Adjustment Policy (SAP) or Enhanced Structural Adjustment Facility (ESAF) of liberalisation, deregulation and privatisation to create a better climate for foreign investment in the country and promote exports in order to receive assistance.

Although Latin American countries, for the most part, opened their markets and sold off their national industries in the 1990s, their debt burdens are higher than ever, both absolutely and in terms of debt service payments. Sub-Saharan Africa has seen its debt burden treble between 1980 and 1998, while the volume of exports has actually risen. The Asian crisis in 1997 demonstrated the fragility of the 'Asian Tigers'; after 1997 developing countries had to double the yield on their debt to cover risk premiums demanded by lenders.[7] Even though developing countries paid $1.7 trillion between 1980 and 1992 in debt service payments, foreign debt remained at $1940 billion in 1995, triple what it was in 1980. Efforts thus far have been unsuccessful at removing the debt burden as a significant obstacle to development.

Relevant International Actions

In the 1980s commercial banks, governments and multilateral institutions started to become involved with reducing rather than contributing to the debt burden of developing nations. The Mexican crisis of 1982 scared lenders into investigating ways that highly indebted poor countries could reduce their debt without destabilising the world financial system. Until the late 1990s most solutions were based on trade liberalisation principles such as those outlined in the Structural Adjustment Policies of the IMF. The Paris Club and private banks also reached agreements with some debtor countries to reschedule foreign debt. Before the turn of the millennium a concerted international movement grew to forgive the debt of the most heavily indebted poor countries.

The Jubilee 2000 campaign, a global network of non-governmental and faith-based agencies, mobilised widespread support in developed and developing countries for partial or complete forgiveness of outstanding loans for the most heavily indebted poor countries.[8] Jubilee 2000 and other international NGOs contended that market and export-driven solutions such as the Baker and Brady Plans, or the Structural Adjustment Plans of the IMF, were impediments to development rather than engines of economic growth.

In response to these charges and their own research, the World Bank and the International Monetary Fund introduced the Heavily Indebted Poor Countries Initiative, in September 1996.[9] It outlined the programs and procedures by which certain countries could have part of their debts forgiven by the IMF, World Bank, Paris Club creditors, and private banks. 26 out of the 41 least developed countries were eligible for the program. In order to receive assistance under the original HIPC framework, the IMF had to determine that a country had adhered to an Enhanced Structural Adjustment Facility (ESAF), which involved macro-economic stability, trade liberalisation and privatisation. Under HIPC, the Paris Club would forgive up to 80% of the outstanding debt, and possibly offer 80% forgiveness of debt service payments. Targets of 200%-250% debt to export ratio and 280% debt to revenue ratio were set.[10]

By the time the World Bank and the International Monetary Fund convened for their Annual Meeting in 1999, it was clear the HIPC program, by their own criteria, was doing little to help the poorest countries. Bureaucratic delays and the requirements of the ESAF made it difficult for most countries to qualify. Only 9 countries, out of 29 that were eligible, had met all the criteria for debt relief. Even after debt relief, Zambia, Tanzania, Senegal, Mauritania and Cameroon still spent more on debt service than on education and health care combined.[11]

HIPC2 was unveiled to provide deeper and quicker debt relief to more heavily indebted poor countries and help them meet development targets such as reducing illiteracy and child mortality, and improving access to primary education, health care, safe drinking water and sanitation. The new initiative made poverty reduction the primary goal of debt relief, made the decision-making process of the IMF and World Bank more transparent, and gave more control over the entire process to governments and civil society. 36 countries were eligible for increased debt relief under the new framework. The time scale was reduced to three years from six years, subject to a country's successful implementation or demonstrated commitment to a Poverty Reduction Strategy Paper (PRSP) instead of an ESAF. The level of debt relief was increased to reach a maximum 150% debt to export ratio and 250% debt to revenue ratio.

The Economic and Financial Committee of the United Nations has passed many resolutions regarding the external debt burdens of developing nations. It has also drafted a Programme of Action for the Least Developed Countries (A/CONF.191/11) which calls for action on debt relief. Some resolutions to consider include: 48/165 21 December 1993, 50/92 20 December 1995, 51/164 16 December 1996, 52/185 18 December 1997, 53/175 25 January 1999, 52/303 25 January 2000, 55/184 22 January 2001, and most recently 56/184 31 January 2002

Analysis

Although many nations carry large nominal debts, developed nations are better able to put the borrowed funds to productive use and manage the interest and principal of their debts. For countries with a strong trade balance and diversified export industry, debts can be financed from internal revenue, foreign currency reserves, government bonds, and other mechanisms. These debts are instruments of growth rather than impediments. However, the most heavily indebted poor countries face double difficulties in making debt service payment, managing the principal of their loans, and having resources for the needs of the country. They are unable to produce and export enough high-value products to make sufficient income. Also, their foreign currency income is often subject to drastic changes according to unpredictable factors such as climate and exchange rates. There are at least three main factors that explain why foreign debts have been so detrimental to economic prosperity and the well-being of developing countries. First, many loans should not have been offered at all with such terms and conditions as were attached. Second, the loans were squandered on large-scale infrastructure projects and nepotistic government contracts, or lost into the foreign bank accounts of corrupt dictators and officials. Finally, efforts to liberalise trade, follow austerity policies, and devote resources to low value-added exports came at the expense of investment in development.

Much of the problems facing developing nations and their creditors today could have been avoided back in the 1960s and 1970s, when these nations first started borrowing in international financial markets. Private banks were eager to recycle the vast amounts of liquid assets they were holding, primarily for oil-rich depositors in the Middle-East. They made increasingly risky loans to governments that offered the environmental and human resources of their countries as collateral. Loans were offered to governments with little assurance that those monies would be used in productive or beneficial ways. Many countries were undemocratic or had unstable financial systems, as the Asian financial crisis demonstrated. A better risk assessment might have meant smarter loans were offered at the onset, and banks would not have had to charge higher risk premiums later to recoup their losses.

The conditions and terms attached to these loans exacerbated the debt burden. Real interest rates were negative before 1979, but afterwards rising interest rates and falling inflation meant that real interest rates grew by 10 to 20%. Such drastic increases in interest rate meant that highly indebted poor countries spent most of their foreign currency on debt service. When they were unable to meet debt service requirements, as was frequently the case, they took out new loans to cover the interest payments. These loans were added to the principal of outstanding debt at even higher interest rates. Consequently, the loans taken out in the 1980s and 1990s had higher real interest rates than the loans from the 1970s they were intended to finance. Variable interest rates, and the subsequent spiralling increase in debt service payments, explains how developing nations could pay $1.7 trillion between 1980 and 1992 and still have $1.9 trillion in foreign debt in 1995.

Although intended to provide the resources for economic growth, analysis has revealed that many loans were never used for their original purpose, or were used for projects that did little to strengthen the domestic economy or export capacity. At a fundamental level, much of the loan money was stolen by corrupt dictators and government officials. Nepotism was rife, and lucrative contracts and subsidies were awarded to friends and family. Other public funds were spent on luxurious homes, cars, travel, or pet projects. Some loans never made it into government coffers in the first place. As much as 80% were deposited directly into accounts in North America and Europe. For example, Mobutu Sese Seko of the Democratic Republic of Congo (formerly Zaire) had $8 billion in private bank accounts in 1990.[12] Corruption robbed citizens of resources that might have been used for economic growth, and left them holding the bill.

Developing countries did not have free reign to use what funds were left over after corruption had taken its toll. Bilateral loans often came with requirements that governments purchase manufactured goods from the lending country. Scarce foreign currency was spent on technologies and products from developed nations. The import of these products was more beneficial for producers in lending nations than for the countries who imported them. Manufactured goods did little to address the problems of illiteracy, disease, malnutrition and infrastructure, and reduced the foreign currency available for debt service. When the purchase of weapons was tied to a loan, sometimes the presence of arms exacerbated regional instability. Multilateral loans from the IMF and World Bank were often designed for large-scale infrastructure projects such as hydroelectric dams. Again, allocating these funds to other initiatives might have strengthened local economies and increased the well-being of citizens.

Once the loan money had been spent, whether on debt service for old loans, manufactured goods from developed countries, or corrupt politicians, the indebted developing country faced the problem of attempting to pay it back. The obligations to bilateral and multilateral lendors took precedence over national interests. An environment was created where policies to ensure payment were ineffective and detrimental to the stability and development of the indebted poor country. Exogenous factors in international markets and the environment confounded even the best efforts.

Indebted countries had to guarantee payments to commercial banks, governments and multilateral institutions, and agree to undertake specific domestic policies. Progressively higher interest rates lead to spiralling debt service payments as loans were taken out at higher rates to cover previous unpaid loans. Austerity programs such as the IMF Structural Adjustment Programs linked compliance with further loans or debt rescheduling. SAPs put the emphasis on export-driven growth, focusing on raw materials, cash crops, and basic manufactured goods. Developing nations were committed to producing low value-added goods that were subject to drastic changes in commodity prices and weather. There were social and environmental costs to these market-oriented policies, which hindered long-term economic growth without creating foreign currency revenue. Liberalised financial markets also opened the door for capital flight. Factors in developed nations such as subsidies on agricultural products and trade barriers on manufactured goods thwarted export-driven economic growth. Attempts to meet debt service requirements and adhere to macroeconomic policies did little to relieve the debt burden, and hindered sustainable economic growth or development.

In the 1980s, when interest rates rose sharply and inflation fell, the real interest rate on private loans increased substantially. Latin American countries such as Brazil, Mexico and Argentina, where debt was mostly composed of commercial loans, experienced huge increases in the amount of debt service and the cost of new borrowing. Economic conditions internationally meant that the market for their exports shrunk in 1980-1981, and in 1982 the price of these raw materials also dropped.[13] Latin American countries especially became locked into a cycle of taking out new loans at high interest rates to pay for debt service on loans whose variable interest rates were also rising.

By 1984 most multilateral loans from the IMF or World Bank required that a country adhere to Structural Adjustment Program, or SAP. Trade liberalisation, deregulation, fiscal restraint, privatisation of national industries, elimination of subsidies and trade barriers, and devaluation of currency were common requirements of the SAPs.[14] They were intended to raise foreign currency that could be used for debt service, and create an open capital market that was conducive to foreign direct investment. However, the conditions imposed by the SAPs were quite strict, and the expectations for economic performance were overly optimistic.[15] When unpredictable events occurred, such as a recession in the developed countries or a natural disaster in a developing country, the conditions of the SAPs could not be met. Fiscal restraint provoked social unrest as citizens demanded budgetary spending on employment programs, infrastructure, health and education.

Highly indebted poor nations lost their ability to meet debt service payments as the value of their exports dropped. Even though volumes increased, the revenue from these exports, in foreign currency, dropped by more than half. In 1992 the terms of trade for developing nations were 52% worse than in 1980. This was a result of the emphasis on specialising in raw materials, cash crops and basic manufactured goods. For example, most of Bolivia's exports consisted of silver, and for Zambia, copper. Commodity prices were highly unstable and developing countries experienced drastic changes in their foreign currency revenue. The demand for primary goods fell as industrial products were miniaturised, and cheaper artificial substitutes were found for raw materials such as rubber. Unfortunately, demand for raw materials and cash crops was not price-sensitive: as productivity improved, the price of exports dropped and per capita income fell even as quantity increased.[16] Importing high value-added manufactured goods and exporting low value-added primary goods did not facilitate growth of a strong manufacturing sector in developing nations. Rather, it encouraged specialisation in unprofitable industries, and did not generate sufficient stable income from exports.

Exports of manufactured goods and agricultural products to developed nations face two barriers: subsidies and trade restrictions. The European Union, the United States and Japan subsidise agricultural products such as wheat, corn, rice and fruit, the very products developing nations are encouraged to export. In some cases developing countries end up importing products they used to export, such as rice or bananas. About $40 billion is lost each year by developing countries due to subsidies.[17] Restrictions on manufactured goods exclude developing nations from lucrative markets.

Possible Solutions

Various solutions to the debt burdens of highly indebted poor nations have been explored over time. In the 1980s, rescheduling debt or taking out new loans were the most common courses of action. The Baker Plan of 1986 was based on these principles, and was favoured by Paris Club creditors and multilateral institutions such as the IMF and the World Bank. However, rescheduling debt delayed payment without creating the conditions by which highly indebted poor nations could reduce their debt service or principal. New loans, at higher interest rates, only exacerbated the debt burden.

The Brady Plan in 1989 responded to calls for reduction and forgiveness of debt. Some countries were somewhat successful at reducing their debt burden, but as the subsequent financial crises in Mexico, Argentina, and Asia demonstrated, there was little real progress towards stability. [18] Solutions that are being proposed by international campaigns like Jubilee 2000 involve partial or complete forgiveness of the debt of the most heavily indebted poor countries. Resources that are not used on debt service payments would be directed to poverty reduction initiatives.

Bloc Positions

The most heavily indebted countries are located in sub-Saharan Africa, Latin America and Asia. Countries in sub-Saharan Africa have the highest debt to revenue ratios, receive the least foreign direct investment, and suffer the most abject poverty. Lack of industry, low literacy rates, political instability and climate conditions contribute to the inability of most countries in sub-Saharan Africa to service their debt. Latin American countries have had mixed results in developing strong financial markets. Mexico, Brazil, and Argentina have had ongoing currency crises over the past two decades. Smaller economies, such as Honduras or Bolivia, suffer from very high debt burdens and little development. Until 1997, Asian countries had enjoyed strong economic growth and were largely able to service their debt. However, the Asian crisis and subsequent emergency loans have sometimes created a conflict between Asian government policies and the conditions imposed by the IMF.

Lender nations (the USA, Japan, Canada and many European nations) are eager to avoid currency crises and defaults on loans. Stability and profitability are essential, and internal pressure has prompted many governments to voluntarily forgive much of the external debt owed them by the poorest nations. However, allegations of corruption, neglect, and exploitation from developed and undeveloped nations governments, and international institutions, have created an atmosphere of mistrust that makes reaching mutually beneficial agreements very difficult.[19]

Endnotes

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TOPIC THREE

The Non-Observed Economy

Introduction

How does a shadow economy develop? The answer is rooted in elementary economic theory: when the cost of complying with the law exceeds the benefits, firms and individuals choose to operate illegally. The result has been the formation of a complex, multi-trillion dollar entity prospering just outside the bounds of the traditional economy. Tax fraud is on the rise and black markets for illegal goods and services are expanding at an alarming rate. An understanding of the sources of non-observed economic activity, as well as its ramifications, is imperative in devising methods to halt its spread.

Statement of the Issue

In attempting to evaluate the size of the world economy, we typically look to official statistics on trade, investment, consumption, and output. However in doing so, we ignore a dynamic force with tremendous economic impact: the non-observed economy (NOE). It has many names: shadow, underground, parallel, and informal, to name a few.[1] Though difficult to measure due to its informal and criminal nature, its influence on the international economy cannot be overlooked. According to The Economist, underground activity in developed countries on average is equivalent to 15% of reported GDP, and up to 33% in developing countries. In 1998, the IMF estimated that the total world GDP (after accounting for currency and base-year differences) was approximately $39 trillion. Assessments of the size of the global NOE run as high as $9 trillion— a volume equal to the output of the United States.[2]

The nature of the NOE precludes a precise measurement of its size, and empirical studies vary widely in their estimates due to differences in definitions of its scope and measurement methods. Underground activities may be both illegal (e.g. bribery), and legal (unreported sales). Generally, it is the misrepresentation of these activities for taxation purposes that makes them contributors to the underground economy.[3] On a macroeconomic level, the result is a distortion of income distributions and GDP figures, slower economic growth, and diminished tax revenue. On a microeconomic and social level, underground activities promote crime, undermine the work ethos of a society, and can drive legal firms out of business by generating unfair competition and inequalities in taxation.[4]

History and Relevant International Action

Historical trends in the size and importance of black markets and underground economies vary depending region and time period under consideration. However, there seems to be a strong correlation between government actions and underground activity: generally, a higher level of government regulation leads to a higher proportion of underground activity.[5] In some instances, this relationship may be offset by the effectiveness of the government in combating underground activities, as well as the severity of punishments for engaging in them. Thus the highly regulated economies of Nazi Germany and Soviet Russia, each backed by extensive secret police networks and punishments for "economic crimes" as harsh as the death penalty, saw relatively small black markets. Once some of the more extreme measures were abolished, in the USSR for example, non-observed activity expanded rapidly.[6]

Though World War II had a diminishing effect on black markets in Germany and Russia, the war did the opposite in the free market systems of Allied nations. In the United States for example, rationing and price controls fueled a sharp expansion of the black market by shrewd traders and contractors.[7] Supporting this theory is economic evidence which suggests that the ratio of currency stock to demand deposits declined for much of the early 20th century, until World War II when the demand for currency rose sharply, indicating the emergence of an underground economy where cash was used as the primary means of payment.[8]

More recently, organizations have struggled with another complex issue related to the NOE: its contribution to the misrepresentation of important economic indicators. For nations and international organizations, these statistics are used for a host of policy decisions (discussed in more detail below). Errors in the statistics due to the presence of shadow activities can result in misguided policy decisions. A number of bodies, including the International Monetary Fund (IMF) and the United Nations Economic Commission for Europe (UN/ECE), have recently issued systems of accounts that address these inaccuracies. These have included the General Data Dissemination System of the IMF, the System of National Accounts (1993), the ILO's Resolution Concerning Statistics of Employment in the Informal Sector (1993), and the European System of Accounts (1995). Each calls for the inclusion of the illicit sector in accounting practices; however, they fail to provide developing countries with guidance for implementation. Currently, Statistics Netherlands and the Statistical Office of the European Union (Eurostat) are examining the feasibility and possible methodology of including shadow elements in official statistics.[9]

Analysis

As mentioned earlier, although there are clear benefits to knowing the size of the underground economy, it is inherently difficult to generate a reliable and consistent estimate.

The most direct estimation method is the survey; however the results hinge on the honesty of respondents.

Other methods include the use of information from monetary aggregates, which base size on changes in currency demand. An example of this type of approach is the "currency demand model." The theory underlying this approach is that as an economy expands, the ratio of currency stock to deposit demand falls as transactions are increasingly settled by check instead of cash. If this ratio rises, as it did for many countries during and after the Second World War, it signals a corresponding rise in underground activity (usually conducted in cash).[10] Another monetary approach uses the demand for currency and an estimate of the extra currency in circulation to gauge the size of the shadow economy. Monetary approaches have been criticized because they rely on assumptions of two key variables: an estimation of the quantity of currency in the shadow economy, and an approximation of the velocity of that currency.[11] Both variables are abstract and impossible to verify, yet have a strong impact on the results of the measurement.

Another prominent issue in the debate over measurement is the extent to which savings plays a role in the underground economy. This figure is completely unknown because, though it is likely that much of the illegal income generated in this sector is "stuffed under the mattress," it is an undeniable reality that money laundering—the channeling of currency from the underground economy to the official economy—takes place frequently.[12]

Much of the difficulty in measuring the size of the underground economy stems from the lack of consensus on the definition of its scope. Definitions tend to fall into two broad categories: those based on a monetary approach and those based on a behavioral approach. The former defines the shadow economy as all production, both legal and illegal, that is hidden from income tax. Those who adhere to this definition regard theft and extortion as transfers because they do not generate added value for the economy.[13] The behavioral approach, best summarized by Edgar Feige, categorizes activity based on "whether the activity adheres to the established, prevailing institutional rules of the game… Adherence to the established rules constitutes participation in the informal economy… whereas noncompliance or circumvention of the established rules constitutes participation in the informal economy."[14] However, this approach may lead to an overestimation of size of the problem.

In the broadest sense, underground economies consist of both legal and illegal activities. Examples of underground activities that are legal include after-hours work and "under the table" transactions conducted on a cash or barter basis. Both are otherwise legal activities, except that perpetrators do not pay taxes on them. This circumvention of taxation and/or regulation laws places them in the realm of the underground economy.[15]

Illegal activities can be divided into four groups: criminal, informal, household, and irregular. Criminal activity refers to illegally produced goods and services, such as the production and trade of illegal narcotics or child pornography; informal activities are those which circumvent the costs of the law and, as a result, lose out on its benefits (illegal workers would fall into this category); household refers to illegal household production; and irregular activity generally refers to tax evasion, discussed above.[16]

Monetary and fiscal policy makers rely on precise estimates of economic indicators in order to establish effective economic policy. Underground economic activity in the production and employment sector can seriously distort these statistics. The inaccuracies that result have implications on a country's economy, no matter their level of development. Additionally, the international bodies rely on these statistics when allocating quotas, establishing voting rights, and determining access to credit. Thus, incorrect economic data can have far-reaching implications both in- and outside of a member state's economy.[17]

The ability of the underground economy to undo macroeconomic reforms and steps toward liberalization can be attributed to a lack of regulatory activity and transparency at the micro level.[18] In most developing states, the practice of "greasing the palms" of officials to obtain licenses or sidestep burdensome regulations is a common practice. In India for example, the government of former Prime Minister Rajiv Gandhi estimated that only seventeen percent of government money earmarked for development ever reached its intended beneficiaries.[19] In Russia, it is estimated that ninety percent of all private sector production, sales, and profits, and forty percent of all family income go unreported. Economists at the University of New Mexico estimate that Russia's GDP and per capita income are twice what is officially reported.[20]

In some developing countries, the system of corruption that sustains many sectors of the shadow economy has been institutionalized by excessive controls and regulations. Government officials who profit from this corruption see no reason to curtail its spread. Steven Cheung, Head of the School of Economics and Finance at the University of Hong Kong, suggests that "many controls and regulations are implemented or maintained with only one purpose in mind: to open up opportunities for corruption. In most countries, controls or regulations that do not bear on corruption are not going to last very long because people in power will not support them."[21]

Though developed countries also deal with a fair share of corruption and regulation issues, they face more pervasive tax evasion issues. One alarming trend is an apparent change in attitudes toward tax evasion. In Canada, polls indicate that 19% of citizens would hide income if they could get away with it. Forty-nine percent say that if they could, they would pay cash to avoid the Goods and Services Tax (GST) and provincial sales taxes.[22]

Money laundering is also an important concern for developed states. Global demand for currency notes in large denominations, like the $100 bill, is widely attributed to their popularity as a payment method in the cash-driven black market.[23] The European Central Bank's decision to issue 100, 200, and 500 euro notes will shift underground demand away from the $100 bill. According to the Center for Economic Policy Research, "…a major question is whether, in attempting to exploit the demand for large denomination euro notes, Europe will be facilitating tax evasion and illegal activities… However, the revenue benefits obtained by catering to the currency needs of the underground economy may well be an accounting illusion. When lost tax revenues are taken into account, the net benefits to the governments' balance sheets are likely to be quite small."[24]

The fact that a nation's shadow economy is thriving suggests that current economic policies are faulty or misguided. As mentioned above, a shadow economy often develops when agents find government regulations are too burdensome. According to basic economic theory, high entry costs to legality, such as license and registration fees, as well as high costs of remaining legal, such as taxes, red tape and labor/environmental requirements, will cause rational agents to move into the underground economy. However, an optimal level of taxation and regulation will not put an end to underground activities if inefficiencies still exist. Some academics propose that there is a disturbing trend inherent in underground economies.[25] The diminished tax revenue that results from underground activity inhibits the government's ability to provide public goods, such as law and order. As the quality and availability of these public goods decreases, the incentive to remain in the official economy also declines. Thus, government revenue from the official economy shrinks further, and again agents are driven to the informal sector.[26]

Furthermore, while some activity in the underground economy is clearly illegal (such as drug trafficking and child labor), other activities may be desirable. Especially in developing or transition economies, the black market can smooth inefficiencies and may provide basic needs to the population which would otherwise be out of reach due to excessive government regulation.[27] Many economists argue that shadow economic activity has helped to mobilize an entrepreneurial spirit in transition economies. Moreover, much of the income generated in the shadow economy is almost immediately funneled back into the official economy through consumption. Still, the consequences of black market activity remain largely problematic, especially in transition economies. According to economist Katrina Ott, "…we find that in transition countries, which have a weak institutional structure for supporting market economic activity, underground economies pose a grave danger, that of undermining the establishment of the rule of law that is increasingly seen as a necessary component of successful transition."[28] A report by the International Labor Organization notes that, "…while informal sector employment may provide employees with basic subsistence needs, it does so in the face of oppressive and/or unsafe working conditions; incomes usually at or below the poverty line; restricted access to state-provided social protection, training, and social services; and frequent exploitation and infringement of workers' rights."[29]

Thus an important question for governments to consider is whether or not the benefits of the shadow economy outweigh its costs. Is there a way to discern the overall effects of underground activity on growth and development? The research remains unclear.

Possible Solutions

In formulating solutions to this problem, members of the committee will be forced to consider tough questions. What are the policy ramifications of the exclusion of the shadow economy in official statistics? How do we reconcile the subtle benefits of shadow economic activity with its more obvious drawbacks? What measures can we take to encourage underground firms and individuals to return to the legitimate economy? What sectors of the economy are most in need of deregulation? What steps should governments take to increase transparency and reduce corruption?

When crafting resolutions, delegates must remember that the mechanisms which sustain an underground economy in a single country have economic ramifications that stretch well beyond its borders. At the same time, member states' national sovereignty must be respected.

In considering this issue, it is easy to stray into a discussion of the broad social ramifications of underground activity, which range from terrorist funding networks to prostitution to illicit traffic in small arms. However, debate and solutions must remain focused on the pressing economic and financial ramifications of the topic. A thorough understanding of effective steps that states have taken in the past to reduce shadow activity will help member states in evaluating the current success of governments, as well as in devising methods for further improvements.[30]

Though it is tempting to increase taxes and regulatory activity in order to solve the problem, delegates must realize that doing so will only exacerbate the issue. Instead, delegates should consider deregulation programs, restructuring of the private sector, and reduction of taxes as possible solutions.[31]

Bloc Positions

Transition Economies

Estimated size relative to GDP: 7-43%

The estimated size of the shadow economy in transition countries depends largely on the level of economic and political liberalization, as well as the success of macroeconomic stabilization. The economies generally grew out of a tradition of underground behavior cultivated during the Cold War, and reinforced by the transition to a market economy. According to research by Matthew Fleming et al. at Columbia University, shared characteristics include a continuum between official and unofficial sectors (there is no sharp delineation between the two) in which there is easy and frequent movement into and out of the official economy, high visibility of underground activities, and accessibility of state and social services to agents in the unofficial economy. However at the same time, many transition economies struggle with high levels of crime due to shadow activities, and there is little conclusive evidence as to the importance of one sector over the other.

Developing Economies

Estimated size relative to GDP: 13-76%

Because of the level of diversity among developing economies, there are very few shared characteristics. The strongest link among the economies seems to be the presence of the informal sector and its ramifications on unemployment. According to the ILO, 93% of all urban jobs created in Africa in the 1990's came from the informal sector. Still, the criminal sector in developing economies cannot be ignored and is highly developed, especially with regard to narcotics, traffic in goods and people, and prostitution.

Developed Economies

Estimated size relative to GDP: 8-30%

As detailed above, developed countries face pervasive money laundering and tax evasion issues, as well as issues with the overseas holding of US currency. Countries of southern Europe have large irregular sectors; and the high tax rates of Scandinavian countries tend to drive informal activity. Of particular concern to developing countries in this committee are the misrepresentation of economic statistics and the effect that this phenomenon has on aid packages.[32]

Conclusion

Given the level of globalization and economic integration on the world stage, it is clear that a subterranean economy in a single country does not operate in isolation. The unrecorded volume of transactions, as well as the resulting loss of tax revenue, promote inflation, distort exchange rates, and drive legitimate firms out of business. Thus, the continuing growth of the shadow economy poses a serious threat to economic stability that can no longer be ignored.

Endnotes

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