Proceedings of CONF-BPS 2025 Workshop: Sustainable Business and Policy Innovations
DOI: 10.54254/2754-1169/158/2025.19693

The Causes, Impacts, and Solutions of the Global Debt Crisis

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Abstract: The global debt crisis, typified by rising government debt, jeopardizes global economic stability. This paper focuses on the key factors, which include expansionary fiscal policies, inefficient tax structures, and monetary policy issues such as high interest rates. The consequences are widespread, including unemployment, currency depreciation, financial market instability, and long-term economic stagnation. The research identifies inequities, disturbed global trade factors, and the worsening of poverty as consequences that last. Proposed solutions include progressive taxation, fiscal discipline, strategic monetary policies, and more international collaboration to alleviate fiscal imbalances and foster long-term recovery. This research provides actionable strategies to mitigate the crisis, emphasizing progressive tax reforms, sustainable fiscal and monetary strategies, and international cooperation, offering pathways for governments and institutions to achieve economic recovery and long-term debt sustainability.

Keywords: Economic Inequality, Sovereign Debt, Debt Sustainability, Financial Crises.

1. Introduction

Economic stability and prosperity are seriously threatened by the global debt crisis, which is defined by the fast accumulation of debt by countries all over the world [1]. Using both historical and current data, this paper explores the crisis's main causes, effects, and possible solutions. Low interest rates, expansive fiscal policies, global economic shocks, and fundamental economic vulnerabilities in both rich and developing countries are some of the many contributing elements to the crisis [2]. Furthermore, the research investigates the increase in government borrowing as a result of economic downturns, social expenditure demands, and insufficient tax collections, all of which contribute to rising debt. The debt crisis has far-reaching consequences, with excessive debt levels straining national budgets, diminishing fiscal flexibility, and crowding out public expenditures in critical services like healthcare and education [3]. Debt crises can result in economic stagnation, decreased living standards, and rising inequality when governments are obliged to implement austerity policies that harm vulnerable populations. Furthermore, growing debt burdens in developing nations have contributed to currency devaluation, inflation, and greater sensitivity to external economic shocks, exacerbating global financial instability [4]. In response, this report proposes policies to the global debt issue, such as progressive tax changes, sustainable fiscal and monetary policies, and targeted foreign help. This research offers an in-depth understanding of the global debt crisis as well as useful

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strategies for governments and international organizations to deal with this urgent problem in order to create stability and lasting economic recovery.

2. The causes of the global debt crisis

2.1. Fiscal policy factors

2.1.1. Inflationary Pressures

When aggregate demand exceeds supply, expansionary fiscal policies—which involve raising government spending or lowering taxes to boost economic growth—inevitably result in excessive inflation. This inflation erodes real income by lowering households' purchasing power, as earnings frequently fail to keep up with rising costs. As a result, consumer spending and general economic stability may deteriorate, worsening inequality and social instability [5]. High inflation raises the cost of goods and services, putting a burden on public budgets and making it more difficult for governments to efficiently manage debt repayments. This is because inflation may create higher interest rates as central banks strive to control price levels, raising governments' borrowing costs [6]. Furthermore, inflation-linked debt loads increase, putting additional pressure on fiscal capacity in the long-term viability of public finances, especially in economies with already high debt levels. Zimbabwe's late-2000s expansionary fiscal policies resulted in high inflation and ensuing economic turmoil. To revive its unstable economy, the government expanded public spending and created large quantities of money to cover shortfalls, resulting in hyperinflation. Inflation rates surged, hitting 79.6 billion percent in 2008, drastically reducing real incomes as wages failed to keep pace with rising prices. This loss of purchasing power plunges millions into poverty, disrupting the economy and weakening consumer confidence. The accompanying economic instability made it practically difficult for the government to efficiently manage debt repayments, as tax and export earnings collapsed under the strain of the crisis [7].

2.1.2. Inefficient Tax Systems

Regressive taxes, which impose a higher burden on lower-income individuals in proportion to their income, may unintentionally contribute to fiscal deficits by lowering consumer spending and economic growth. Lower-income consumers often reduce discretionary expenditure due to taxes like sales taxes or VAT, leading to reduced economic demand. This loss may slow economic growth and lower revenue from other sources, such as corporate and income taxes. Furthermore, regressive taxes usually fail to generate sufficient money to cover deficits since low-income earner has a lower ability to pay than wealthier individuals [8]. This imbalance may generate a vicious cycle in which insufficient revenue generating necessitates additional borrowing, increasing budgetary deficits while increasing the burden on already strained lower-income populations. The implementation of a VAT in Saudi Arabia in 2018, initially set at 5% and then increased to 15% in 2020 could demonstrate this cause. VAT is paid equally on all goods and services, therefore lower-income households, which spend a larger share of their incomes on consumption, bear a greater relative burden than wealthier households. Regardless of its revenue-generating goal, the tax's regressive nature can reduce total consumer spending, particularly among lower-income groups, diminishing economic activity and limiting the VAT's capacity to produce considerable funds. When consumer confidence falls, the tax may not generate enough to fund budget shortfalls, particularly in oil-dependent nations like Saudi Arabia that rely significantly [9].

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2.2. Monetary Policy factors

2.2.1. High interest rate

Central banks raise interest rates to combat inflation by increasing the cost of borrowing for governments and businesses, perhaps leading to unsustainable debt levels. Higher interest rates force governments to allocate a larger amount of their budgets to debt repayment, leaving less money for essential public investment on infrastructure, healthcare, and education. Higher borrowing prices might discourage enterprises from investing and expanding, slowing economic growth and reducing tax revenues, which governments rely on to finance debt [10]. Countries with existing high debt-to-GDP ratios are particularly vulnerable, as increasing debt servicing costs can trigger fiscal crises, forcing them to choose between new borrowing and debt restructuring, resulting in a trade-off. This interplay may cause a vicious cycle of economic instability, as rising interest rates intended [11]. An example is a case in Argentina in recent years. In response to surging inflation, the Argentine central bank raised interest rates sharply, reaching levels as high as 118% in 2023. While this aimed to stabilize prices, it significantly increased borrowing costs for both the government and private businesses. For a country already burdened with significant external debt, higher interest rates made debt servicing increasingly unaffordable, straining public finances. Businesses faced similar challenges, as the elevated cost of borrowing stifled investment and economic activity, further undermining growth prospects. This situation underscores how aggressive rate hikes, while necessary to curb inflation, can escalate the risk of a debt crisis in economies with substantial pre-existing liabilities, creating a delicate balancing act for policymakers [12].

2.2.2. Global Spillover Effects

Tightening monetary policy in a large country, such as the US Federal Reserve rising interest rates, frequently causes capital outflows from developing economies, raising borrowing costs and increasing the danger of a debt crisis. For example, during the US Federal Reserve's 2022-2023 interest rate hikes, investors withdrew capital from developing countries in search of higher returns in the United States [13], causing Argentina, Turkey, and Pakistan's currencies to depreciate significantly. Currency weakening made it more difficult for these countries to repay their dollar-denominated loans, and rising global borrowing rates put additional strain on their fiscal capacity. In other cases, such as Sri Lanka in 2022, similar factors aided in severe economic downturns and debt default [14]. The effects of stricter monetary policy in advanced economies highlight developing markets' sensitivity to global financial movements, particularly those with large levels of external debt and insufficient foreign exchange reserves. This demonstrates how tighter monetary policy in developed economies can destabilize developing markets, particularly those with existing vulnerabilities, such as high debt, low reserves, or large current account deficits.

3. The short and long term impacts of the debt crisis on the global economy

3.1. Impacts in the short term

In the short term, a debt crisis causes unemployment through a combination of reduced government expenditure, decreased company investment, and weaker consumer confidence. When a debt crisis strikes, the economy faces budget deficit, and the financial sector struggles to satisfy obligations. Widespread financial instability may result from high interest rates, growing borrowing costs, and restricted credit availability for both firms and governments. Governments frequently raise taxes and reduce expenditure to control debt in an effort to restore budget surplus. Wages are reduced as a result of these policies, which lower people's disposable income as taxes rise. Consumers cut back on

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spending when they have less money to spare, which lowers the demand for products and services. This drop in consumer demand hits businesses hard which investors become more cautious in producing goods and services and calculating profit. They may pull back on investments, fearing lower returns, and companies may pause expansion plans due to uncertainties in future demand. This reduces capital inflow into the economy, stalling growth and innovation [15]. Hence, it will lead to a decrease in overall economic output, reflected in a declining GDP. As the economy contracts, firms face fewer sales and profit margins, forcing them to slash expenses. To preserve resources, firms may consider layoffs or hiring freezes. As more people lose their jobs, disposable incomes fall even further, resulting in an endless cycle of less spending, lower GDP, and rising unemployment. For instance, the 2008 global financial crisis triggered widespread job losses as companies worldwide scaled back operations and governments implemented austerity measures to stabilize their economies [16]. In the troubled countries of the Euro-zone – Portugal, Ireland, Greece, and Spain – the harmonized OECD unemployment rates increased from 8.1% to 11.1%, 4.6%–13.7%, 8.3%–12.9%, and 8.3%–20.5% between 2007 and the third quarter of 2010, respectively [17]. A study also shows how rising in public debt will have impacts on unemployment in Nigeria. It is estimated from the Auto Regressive Distributed Lag Approach long run test that 1% increase in public debt on the average, will bring about 1.6% increase in unemployment rate [18].

Financial market volatility rises when there is a short-term debt because investors actively monitor and respond to any economic or political developments that could affect debt payments. Short-term debt necessitates consistently refinancing, thus even minor market fluctuations can have an immediate impact on the borrower's capacity to repay. Investors who anticipate these dangers may begin selling stocks or bonds, causing prices to move more rapidly and increasing market volatility [19]. As this volatility builds, uncertainty grows around the financial stability of companies or governments with high short-term debt. To offset this heightened risk, investors typically demand higher risk premiums, which are essentially additional returns to compensate for the added uncertainty. This leads to increased borrowing costs and further instability in financial markets. In more extreme cases, investors may transfer funds to safer assets, such as US Treasury bonds, or remove capital entirely from hazardous markets, a process known as capital flight [20]. This outflow of capital further depresses asset prices, causes liquidity shortages, and exacerbates financial market instability, making it even more difficult for borrowers with short-term debt to meet their payments.

During a debt crisis, a country's currency frequently depreciates, or loses value, as investors and markets perceive more risk and want fewer assets in that currency. This depreciation happens when investors sell assets related to the struggling currency in search of safer investments elsewhere, reducing demand and driving down the currency's value [21]. As the currency weakens, import prices rise because it takes more local money to acquire the same quantity of foreign items. For countries reliant on imported goods which can sell at a high price can quickly translate into broader price increases within the domestic economy, contributing to inflation. This inflationary effect is often particularly challenging for a country already dealing with a debt crisis. As prices rise, consumers experience a decrease in purchasing power, and businesses face higher production costs, which can squeeze economic growth further [22]. Additionally, a depreciated currency makes it more expensive to repay debt denominated in foreign currencies, worsening the debt burden and potentially pushing the country into an even deeper financial crisis.

3.2. Impacts in the long term

3.2.1. Structural Economic Changes

Structural economic changes can have a long-term impact on the debt issue, resulting in long periods of recession as governments prioritize debt repayment above public spending [23]. This budgetary

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restriction often results in lower investment in important areas like as infrastructure, education, and R&D, inhibiting economic growth and innovation. With limited resources allocated to future-oriented activities, economies will experience slower productivity gains and reduced competitiveness [24]. This cycle may eventually strengthen systemic inefficiencies, worsen social inequities, and delay recovery, with long-term consequences for economic stability and development.

Another long term impact is debt crisis can lead to increased in poverties and inequalities. Due to structural change, industrials are now shifting to service-based economies, globalization, and advancements in technology due to the unequal distribution of opportunities and resources in adapting to these shifts. This can further exacerbate poverty and inequality [25]. These transitions often lead to job displacements, as industries that previously provided stable, well-paying employment decline or become automated, leaving many workers structural and cyclical unemployed. Furthermore, the benefits of these changes tend to concentrate among individuals with access to education, capital, or specialized skills, widening income disparities. In regions reliant on traditional industries, the lack of investment in infrastructure, education, and social safety nets can deepen poverty, creating a cycle of inequality that hinders upward mobility and economic stability [26]. As a result, structural economic transformations, while fostering overall growth, disproportionately disadvantage vulnerable populations.

3.2.2. Changes in Global Trade Relationships

Changes in global trade connections may significantly change trade patterns and alliances, with long-term consequences for global trade dynamics. Established trade flows may be interrupted as governments reconsider trade partnerships, which are influenced by geopolitical conflicts, economic nationalism, and supply chain vulnerabilities [27]. This results in alliance realignment and the formation of new regional economic blocs, such as those based on self-reliance or strategic partnerships. Over time, these trends may lead governments to implement protectionist policies, such as tariffs, quotas, or subsidies, to safeguard domestic industries from foreign competition. These measures, while intended to enhance local economies, may result in reciprocal trade actions, diminished global trade efficiency, and increased economic isolation [28]. The rippling effects include weaker global economic growth, fragmented markets, and limited collaboration in addressing global challenges like climate change or supply chain resilience.

4. Solutions to deal with the global debt crisis

4.1. Fiscal Policy Adjustments

4.1.1. Reducing Budget Deficits

Cutting expenditures or increasing revenues are key techniques for managing budget deficits and stabilizing economic conditions, especially in the context of a global debt crisis. Reducing public sector wages, reducing subsidies, or postponing capital projects all contribute to lower immediate government spending, resulting in smaller budgetary gaps [29]. Measures to enhance revenues, such as raising taxes or enhancing tax collection efficiency, boost government income, allowing countries to satisfy financial obligations without accumulating more debt. Governments can reduce their reliance on debt to minimize interest payments and develop fiscal buffers, resulting in improved economic stability. These efforts also boost investor confidence, enhance credit ratings, and free up funds for targeted spending on important services or growth-stimulating initiatives, allowing countries to recover more sustainably while limiting the dangers associated with excessive debt [30].

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4.1.2. Tax reforms

Tax reform is an important way to address the debt crisis since it ensures a more equitable and progressive tax structure. Governments can generate significant additional money by raising tax rates on wealthy individuals and corporations or closing loopholes that allow for tax avoidance. This strategy ensures that individuals with better financial capacity contribute proportionately more, reducing the fiscal burden on low-income households, which are frequently the most affected by austerity measures. A progressive tax system promotes social equity by lowering income inequality and increasing faith in government [31]. These measures can stabilize public finances without limiting economic growth by not overburdening the vulnerable groups, resulting in a more sustainable path out of the debt crisis. The Revenue Act of 1935, enacted in the United States during the Great Depression, is a well-known example of progressive taxation that addresses economic issues. Also known as the "Wealth Tax Act," it considerably raised taxes on the wealthiest individuals and corporations [32]. This legislation aimed to address the era's economic disparities while also raising additional revenue to fund New Deal programs aimed at alleviating widespread poverty and unemployment. By focusing on richer individuals and corporations, the Act avoided putting more financial hardship on lower-income households already suffering from the economic crisis. The higher income aided public works projects, social welfare programs, and economic recovery efforts, illustrating how progressive taxation may meet fiscal needs while promoting social fairness during times of crisis.

4.2. Monetary Policy Interventions

4.2.1. Lowering Interest Rates

Central banks can help handle a debt issue by lowering interest rates, which reduces the cost of borrowing. This makes funding more accessible and inexpensive for businesses, enabling them to invest and create job opportunities. Lower interest rates also lessen the burden of debt servicing on consumers, resulting in more disposable income and increased consumer expenditure [33]. Together, these characteristics promote economic growth, increase tax revenue for governments, and improve their ability to manage public debt. Central banks contribute to a more dynamic economic environment, reducing reliance on borrowing. Furthermore, when economic growth accelerates, firms and consumers are better positioned to satisfy their debt obligations, easing strain on the financial system and helping to long-term fiscal stability [34].

4.2.2. Increasing Liquidity

Quantitative easing, a monetary policy in which central banks purchase government bonds and other securities, can help to alleviate a debt crisis by ensuring banks have sufficient capital to lend, hence increasing economic activity. For example, during the 2008 Global Banking Crisis, the US Federal Reserve used it to inject liquidity into the banking system [35]. By purchasing large amounts of government bonds, the Fed reduced long-term interest rates, making borrowing more affordable for businesses and consumers. This increased investment and expenditure, hence boosting economic growth and increasing government revenue through higher tax collection. Similarly, the European Central Bank used similar strategy throughout the Eurozone debt crisis to maintain financial market stability and prevent sovereign defaults. These steps not only improved recovery, but also reduced the relative weight of debt as a growing economy made it easier for governments and households to manage their obligations [36]. As long as it is effectively implemented, it can break the cycle of stagnation and high debt, paving the way for financial sustainability.

DOI: 10.54254/2754-1169/158/2025.19693

4.2.3. Stabilizing Currency Markets

Central banks can also interfere in foreign exchange markets to stabilize currency that is overly unstable, which is critical for sustaining financial market stability and managing a debt crisis. Currency changes can generate uncertainty for investors, raise the cost of servicing, and disrupt financial systems [37]. Central banks can reduce volatility and restore currency credibility by buying or selling foreign reserves, as well as directly affecting exchange rates. For example, during the 1997 Asian Financial Crisis, several central banks in impacted nations intervened in currency markets to stabilize their failing currencies, averting additional financial chaos [38]. A stable currency minimizes investor anxiety, attracts international investment, and provides predictable trade and debt payments. This stability promotes economic growth and strengthens the government's capacity to manage debt sustainably by maintaining lower borrowing costs and fostering trust in the financial system.

4.3. International Assistance and Cooperation

International support and cooperation such as the International Monetary Fund (IMF) and the World Bank can fully address financial debt crises. These banks make loans to countries in debt crisis, providing rapid aid to stabilize economies and meet urgent financial obligations. In addition, they provide technical assistance and policy advice to governments in order to help them undertake structural reforms that restore fiscal balance, strengthen governance, and drive economic growth [39]. For example, during the 2008 global financial crisis, the IMF supplied emergency money to nations such as Greece, therefore preventing debt defaults and stabilizing the Eurozone. Similarly, the World Bank promotes long-term development projects, such as infrastructure and social programs, in order to promote long-term growth [40]. By combining financial aid with customized policy guidance, these organizations enable countries to regain economic stability, reduce debt burdens, and create conditions for recovery and development.

5. Conclusion

The global debt crisis creates multiple challenges to economic stability, resulting from systemic fiscal and monetary policy imbalances, which get worse by external shocks and governance inefficiencies. Its short-term impact, such as unemployment, financial market volatility, and currency instability, cause vulnerabilities, while its long-term consequences, such as structural economic stagnation, rising inequality, and disturbed global trade dynamics, threaten long-term growth.

Effective solutions include targeted fiscal changes, equitable taxes, and appropriate monetary interventions. Governments and organizations may reduce risks, improve financial resilience, and promote equitable growth by encouraging international collaboration and implementing sustainable development strategies. The integration of urgent stabilization initiatives with long-term structural reforms is critical for tackling the crisis and achieving a balanced recovery that prioritizes both economic stability and social equality.

Authors Contribution

All the authors contributed equally and their names were listed in alphabetical order.

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