Questions That Matter

Sovereigns | How To Recoup The Cost Of COVID?

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It will take growth and fiscal pragmatism to repair the damage COVID-19 has inflicted on sovereign balance sheets.

How this will shape 2021

The pandemic's toll on sovereign balance sheets will exceed that of the global financial crisis. We project a 13.7% of GDP average increase in government debt across developed economies during 2020, compared with a 12.3% rise during the first two years of the last global financial crisis. By the end of 2021, the debt of 10 OECD sovereigns, including four of the five largest, will exceed 100% of GDP. The increase in debt-to-GDP ratios in developed economies will likely slow down during 2021 as the pandemic subsides, permitting growth to recover and tax revenue to normalize.

Despite multi-year highs on debt-to-GDP ratios, governments in advanced economies have never borrowed so cheaply. By contrast, in emerging markets, the cost of debt is on the rise

An aversion to sharp budgetary cuts may focus rich global policymakers' minds on delivering productivity-enhancing reforms

What we think and why

For debt-to-GDP ratios to stabilize by 2023, OECD governments would have to consolidate their budgetary positions by 6.4% of GDP on average over the next three years, and by over10% of GDP for Canada, the U.K., U.S., Japan, and Italy. Increased growth or a period of higher-than-expected inflation would trim the amount of budgetary consolidation required, assuming nominal borrowing rates remain low.

Fiscal policy is unlikely to tighten swiftly, given uncertainties regarding the social and economic aftershocks of the pandemic. Nevertheless, as consumption recovers in 2021 and 2022, governments are set to benefit from a fiscal windfall. In some cases, this means debt-to-GDP ratios could start declining as soon as next year.

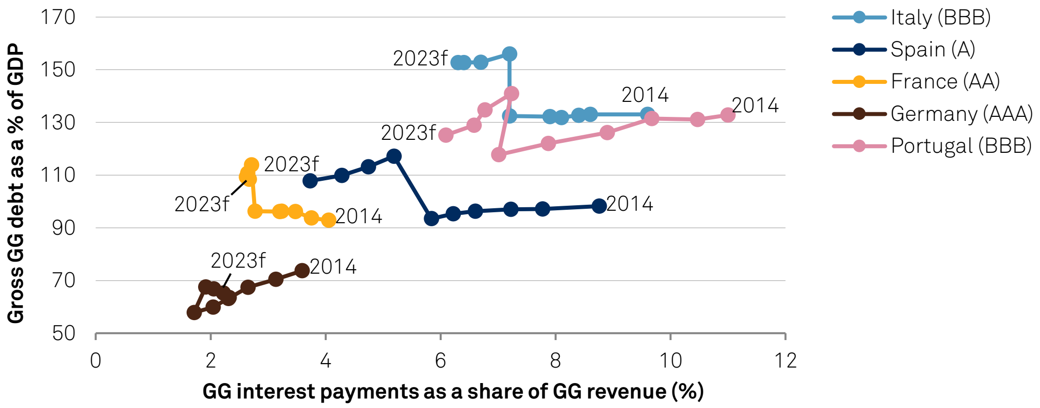
It may still be possible for wealthy economies to grow their way back to more sustainable debt to GDP levels. There is still low-hanging fruit in OECD economies where female participation remains low, informal economies are large, or investment in education has yet to recover from sizeable cuts made in the years after the global financial crisis. In Europe, the elimination of still-substantial barriers to trade in services across the single market could also stimulate employment and growth, as would plans to raise EU public investment. Improving the ease of doing business via judicial and administrative reforms might attract more private investment. More jobs and higher incomes would make debt more manageable.

Despite debt-to-GDP ratios being at multi-year highs, governments in advanced economies have never borrowed so cheaply. To counteract the disinflationary consequences of a severe demand shock, OECD central banks will continue to cover the fiscal cost of the pandemic during 2021 by buying government bonds equivalent to net public-sector borrowing. As a consequence, average interest expense-to-revenue ratios of most OECD members are expected to remain close to all-time lows through 2023.

By contrast, in emerging markets, the cost of debt is on the rise (see charts 22 and 23). We expect the number of emerging-market sovereign defaults during 2021 will remain above historical averages as fiscal distress intensifies.

Chart 22

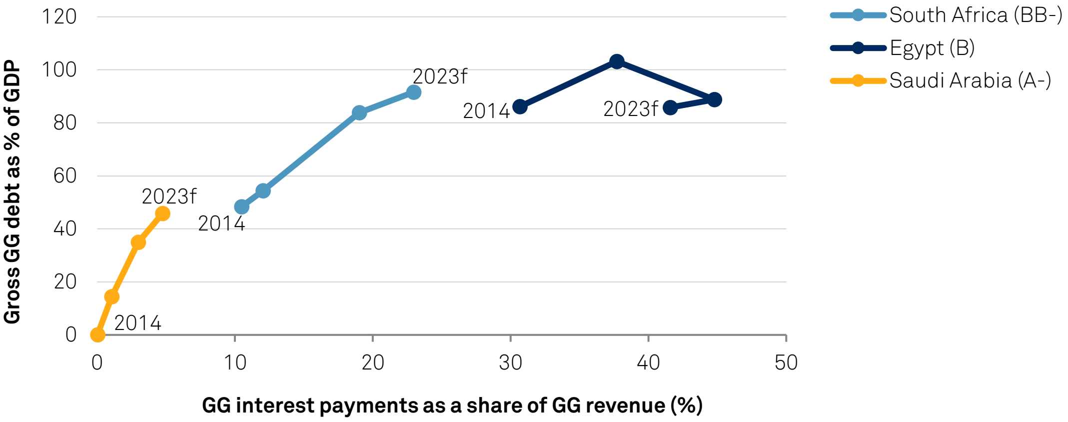
Eurozone Developed Markets: More Debt, Less Interest
GG sustainability supported by ECB policy measures, 2014-2023



Source: S&P Global Ratings.
Long-term sovereign rating in parentheses. ECB--European Central Bank. f--Forecast. GG--General government.

Chart 23

Emerging Markets: More Debt, More Interest
General government debt and interest payments, 2014-2023



Source: S&P Global Ratings.
Long-term sovereign rating in parentheses. f--Forecast. GG--General government

What could go wrong

Governments may fail to implement unpopular economic reforms. It is too soon to gauge the social, economic, and political impact of the pandemic, but COVID-19 seems to have accelerated the pre-pandemic trend of rising income inequality. Any permanent economic dislocation from the pandemic could cement opposition to labor and other market reforms, with negative implications for growth and sovereign ratings.

Governments may shrink away from unpopular expenditure cuts, particularly if the pandemic permanently elevates long-term unemployment in hard-hit sectors. An absence of fiscal consolidation, combined with gridlock on structural reforms, could also pave the way for a return of inflation. An unexpected rise in prices might temporarily boost nominal tax receipts, and inflate away debt, but at the cost of economic competitiveness and financial stability. Few central banks would be willing to "look through" rising wage and price pressures indefinitely. Any unexpected hikes in real interest rates in developed economies would be detrimental to debt sustainability, and ratings.

This report is an extract from the S&P Global Ratings report, "Global Credit Outlook 2021: Back On Track?"

This report does not constitute a rating action

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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