The emerging market COVID-19 debt surge – no crisis on the horizon, yet

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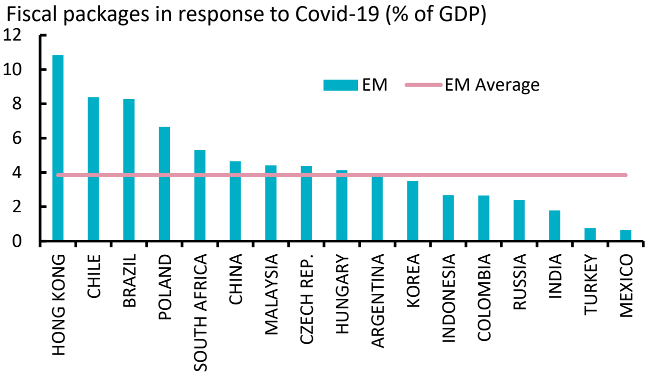
Key points

- As with advanced economies, the pandemic has led to a massive increase in public spending in emerging markets
- Debt levels have been rising in developing economies since the previous financial crisis, but until recently had been in private corporate debt rather than government debt
- Rising public debts were generally not perceived as an immediate threat before the pandemic with falling interest rates containing debt servicing costs
- Emerging market sovereigns have increasingly focused more on domestic issuance, which has reduced their dependence on foreign exchange flows
- Financing issues have surfaced for some fragile countries. Several defaults and restructurings have already taken place
- Among the bigger emerging markets, we take a closer look at debt sustainability in Brazil, South Africa and India.

Pandemic strains budgets and debts

As a result of the COVID-19 pandemic, governments across emerging and developed markets worldwide have introduced large increases in public spending. As always, the degree of variation across the emerging market (EM) space is large, with fiscal packages ranging between 0.6% of GDP in Mexico – the least generous – to as high as 8% in Poland and Brazil (Exhibit 1).

Exhibit 1: Covid-19 adding strain to public accounts

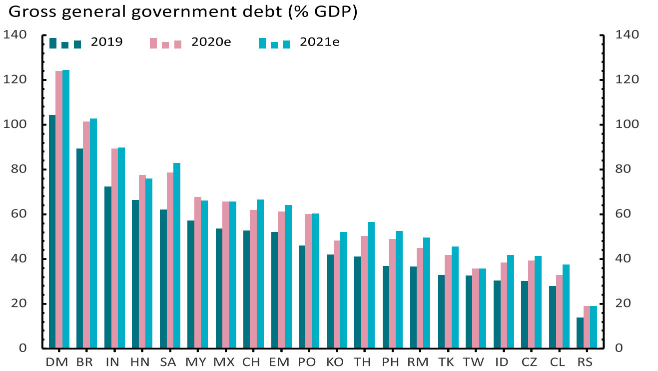


Source: IMF and AXA IM Macro Research, Oct 2020

Additional support is likely to be forthcoming next year where fiscal space remains. In countries where debt trajectories have risen to dangerous levels, spending could be capped. Where possible, increased use of unconventional monetary policy tools may be needed to allow for additional spending, while striving to maintain loose financing conditions in the context of higher government borrowing. Quantitative easing (QE) cannot be used to the same extent in EM as in advanced economies, as its success largely depends on credible fiscal consolidation plans which need to be worked upon to insure fiscal sustainability in the medium term. A global recovery may trigger a rise in global interest rates, which could lead to higher domestic rates (or capital flight) triggering stress in highly indebted EMs.

Additionally, the virus outbreak and the lockdown measures imposed in most emerging countries early this spring caused a sharp drops EM GDP. Restrictions in advanced economies proved an additional external shock affecting exports as well as tourism activity – an important source of funding as hard currencies flow into these countries.

Exhibit 2: Covid-19 to push EM public debts higher



Source: IMF World Economic Outlook Oct 2020 and AXA IM Macro Research

The fall in GDP will lead to a significant rise in public-debt ratios this year, which will persist into at least 2021 (Exhibit 2). According to the latest International Monetary Fund (IMF) estimates, the overall emerging markets' average could rise above 60% of GDP this year and reach 64% by 2021, up from 52% in 2019. The level may not seem overwhelming, particularly when compared to above 100% debt-to-GDP ratios for a lot of advanced economies, and it may not raise concerns of imminent systemic risk either. Still, some big EMs – Brazil, India and South Africa – face increasing financing needs, which could threaten their financial stability. However, for now we do not expect this to trigger a genuine EM systemic debt crisis.

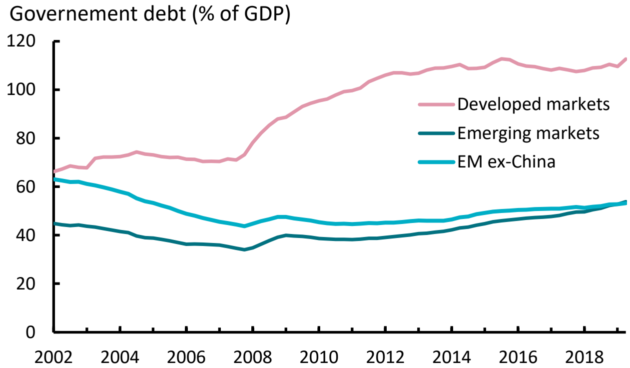
History shows that past EM debt crises have usually been rooted in large macroeconomic imbalances such as current account and/or fiscal deficits, financed with short-term foreign currency denominated debt making these countries vulnerable to liquidity runs. Currency crises caused collapses in exchange rate pegs, triggering severe banking, corporate and sovereign payment crises. Poor banking regulation, market distortions, political and/or external shocks have also played a role in past EM emergencies.

More recently, things have changed. For example, fixed or semi-fixed exchange rate regimes have been abandoned. Addionnally, the current COVID-19 economic shock has reduced EM current account deficits so far, reflecting a collapse in domestic consumption – although admittedly not for all. The recent rise in local debt issuance makes EMs far less vulnerable to foreign exchange shocks and foreign investor portfolio flows. As such, we believe that the likelihood of genuine EM debt crisis has decreased. Still, particular attention needs to be drawn to smaller, lesser-developed and more vulnerable countries, which have tapped bond markets in the last decade, attracting foreign investors in search of higher yields. Recent successful restructuring events have seen positive outcomes in terms of the rapidity of the resolutions, thanks to international creditor support such as from the IMF.

The pre-COVID-19 EM debt trend

Before the pandemic there was little sense of an imminent EM debt crisis. Undeniably, debt levels had been on a rising trend across emerging markets since the 2008/2009 crisis, but this had been primarily in private corporates rather than government. Public debts were generally also rising, although much less so than in the advanced economies (Exhibit 3). According to the Bank of International Settlements, the overall EM government bond market was worth $13tn at the end of last year.

Exhibit 3: EM ex-China public debt not threatening

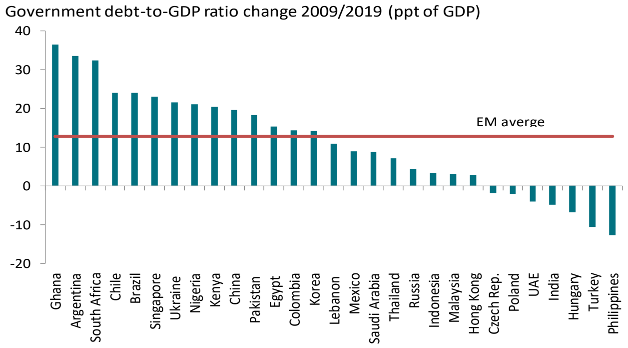


Source: Institute of International Finance (IIF) quarterly debt Q1 2020 and AXA IM Macro Research, Oct 2020

The increase in sovereign issuance was generally not perceived as an imminent threat before the pandemic. The average EM debt ratio level was relatively benign, hovering around 52% of GDP at the start of this year, having risen by 12.8 percentage points (ppt) of GDP over the past decade – albeit with great divergence, as always, between individual sovereigns.

Among the countries that have seen the largest increases in government debt during the last decade, we note Ghana, Argentina, South Africa, Chile and Brazil. Many of these countries already had elevated debt levels and the pandemic will push these even higher – for some, it may end up testing their creditworthiness (Exhibit 4).

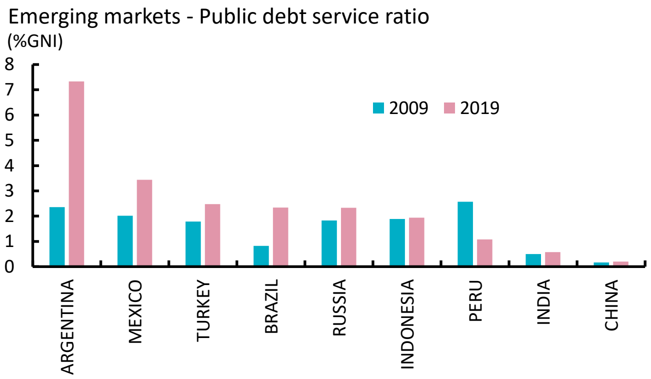
Exhibit 4: Rising debts during the past decade



Source: IIF and AXA IM Macro Research, Q4 2019

For most countries, the ability to service debts has not been severely affected with low levels of global interest rates keeping debt interest burdens relatively low. Excluding Argentina, which faced another debt crisis[1], debt service in major emerging markets remained generally below 3% of gross national income (Exhibit 5). Consider Brazil – the average rate of interest on new domestic debt issued in the 12 months to August fell to 4.85% from 5.13% in the year to July, according to the Brazilian Treasury. Barely four years ago, this stood at 14.5%.

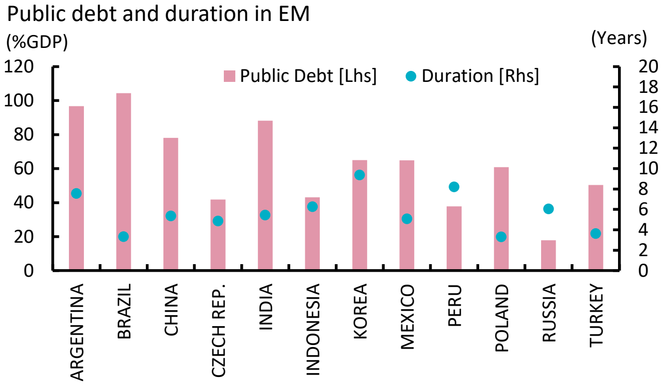
Exhibit 5: Debt service remained broadly well-behaved



Source: World Bank and AXA IM Macro Research, Oct 2020

Among big emerging markets, government debt duration averages somewhere around five to six years, with Brazil, Poland and Turkey exhibiting the shortest durations of 3.3 to 3.6 years (Exhibit 6). As central banks across the world cut policy rates aggressively, while long-term EM interest rates remained at best unchanged (steepening yield curves), EM governments may be increasingly tempted to finance themselves through short-term issuance. Their debt profile will become more dependent on their capacity to rollover debt, exposing them more to exogenous short-term shocks.

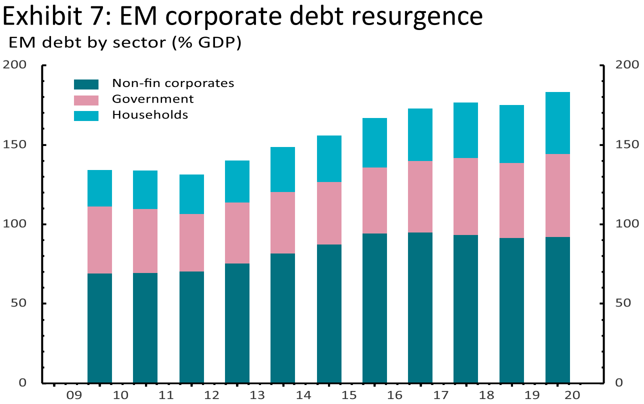
Exhibit 6: Various duration for EM public debt



Source: IMF, Reuters and AXA IM Macro Research, Oct 2020

An important feature of the EM government bond market in the past decade has been the steady growth of local currency bond issuance. Indeed, local markets of developed countries have generally turned towards more domestic financing options. At the end of 2019, local currency government bonds accounted for almost 90% of the overall sovereign bonds outstanding. This has risen to $11.6tn in 2019 from $1.8tn in 2004. The corollary of the rise of local issuance is the relative decline in EM's hard currency denominated bond issuance, not in absolute terms, but rather as a share of the EM sovereign debt universe, with sovereign external debt amounted to $1.4tn – up from $0.5tn in 2004. As such, reduced foreign debt exposure leaves EMs relatively less reliant on foreign capital inflows and thus less vulnerable to FX volatility stemming from external shocks.

Exhibit 7: EM corporate debt resurgence



Source: IIF quarterly debt Q1 2020 and AXA IM Macro Research, Oct 2020

We also note the sharp rise in private sector debt over the past 15 years (Exhibit 7), with EM corporate debt rising by 10.8 times, while the sovereign debt market rose by 4.7 times over the same period. Corporate debt could also act as a liability to the sovereign in case of a sudden sharp increase in financing conditions. This could occur either through the interest rate channel as yields rise sharply or via the currency depreciation channel for indebted corporates in foreign

[1] Unsustainable buildup of debt, rapid depreciation of the currency, economic contraction and spiking inflation since 2018 led Argentina to yet another IMF financial assitance program (the largest in the institution's history) in order to avoid default. The newly elected Fernández government implemented a series of reforms but engaged in debt restructuring negotiations as of 2019. Covid-19 induced economic turmoil eventually brought about the 9th Argentinian defaut on dollar bonds in May 2020 and a subsequent restructuring struck in September.

currency – or conditions that result in rising corporate defaults. The subsequent rise in non-performing loans (NPL) can also threaten countries' banking sectors. A banking crisis can require governments to absorb the losses, which in turn can prompt a sovereign crisis. We see particular risks in Turkey in this respect, where non-financial corporate debt has risen to more than 65% of GDP – up from 35% a decade ago - most of which is in foreign-currency denominated form.

Debt financing issues, the role of multilateral creditors and the need for genuine growth

A number of vulnerable countries, particularly in the low-income group, are facing reduced revenue generation capacity because of the pandemic, this is particularly the case for Sub-Saharan African (SSA) countries. According to the International Institute of Finance (IIF), 2020 government debt-to-revenue ratio will exceed 480% across the 35 countries eligible for the G20 Debt Service Suspension Initiative. Their external financing needs are expected to remain high at around 10% of GDP in 2021, varying from 2.5% in Comoros to near 100% in Mozambique. A lot of countries, including Angola and Zambia, will face external financing needs above 20% of GDP.

So far this year, Lebanon defaulted in the first quarter (Q1) and its debt restructuring is ongoing, while Ecuador has ensured a similar fate. Suriname restructured part of its debt in July, Belize restructured in August, and after announcing intentions to restructure its own debt, Zambia missed a coupon payment in October. In such situations, multilateral creditors like the IMF play an important role. The IMF is often a major lender; its involvement is often necessary to achieve meaningful cash flow relief and debt sustainability. In Ecuador, President Lenín Moreno's commitment to the IMF clearly provided an important source of reassurance to bond holders. After all, the objective of any successful restructuring is to enable issuers to regain access to markets as quickly and efficiently as possible.

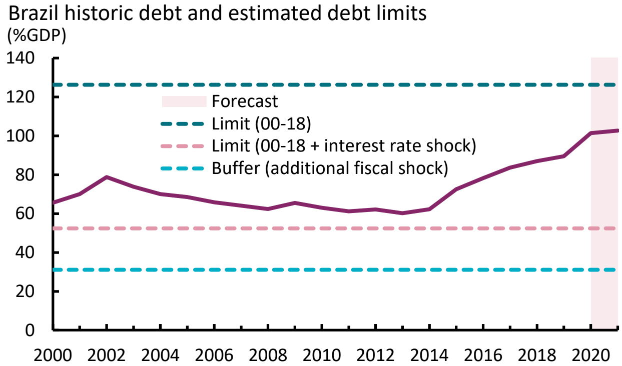
Among the bigger emerging markets, we are particularly worried about the debt trajectories of Brazil, South Africa and India. These economies are very different and yet share a common feature – they have all seen a weaker growth trend over the past decade, raising questions about expansion potential and their ability to see government revenues rise enough to ensure debt sustainability. After all, for each and every country around the globe, the pandemic magnified their structural flaws or advantages, but emphasized the need to revive economic growth – ultimately the most genuine solution for debt sustainability in the long run.

Brazil: A cloudy horizon

Brazil's debt already stood out and will only be exacerbated by the 2020 crisis. Past fiscal profligacy and broader policy errors explain part of this historic debt trajectory. Additionnally, Brazil's growth foundations have weakened. Since the 1980s, the lack of investment caused a retrenchment of industry, reducing the absorption of labour released by the agriculture sector. With high formal labour taxation, a large informal sector arose. Brazil's GDP per capita (in constant dollars) was more than twice as large as South Korea's in 1980 but is now less than half. The crisis will magnify these traits. Will Brazil take this as an opportunity to address its past shortcoming? Or will the pandemic push it into a vicious debt-spirling circle?

COVID-19 pushed Brazil into recession, but its economy appears to be bottoming out now. In fact, Brazil looks on course to outpace most EM countries thanks to government efforts to reduce the impact of the pandemic. So far, Brazil has announced fiscal measures amounting to 12% of GDP. Monetary policy easing has also proved supportive through significant interest rate cuts – the Selic rate was cut by 225bp to 2% in February – liquidity support and capital relief to financial institutions as well as capital requirement adjustments.

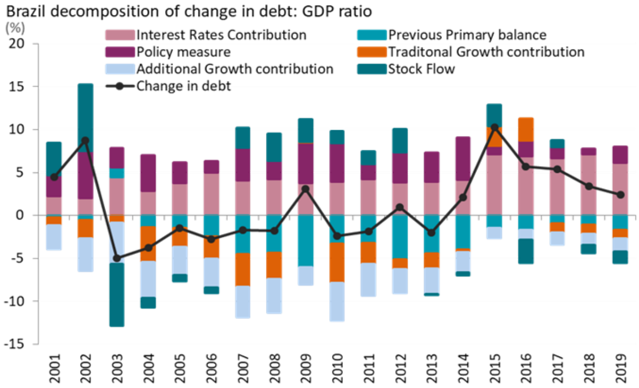
Exhibit 8: Brazil public debt dynamics



Source: Datastream, IMF and AXA IM Macro Research, Nov 2020

By declaring a state of "public calamity", the Congress agreed to breach[2] the anticipated 2020 budget spending rule (i.e. primary budget deficit was targeted at R$124.1bn, circa 1.8% of GDP) allowing for the material increase in government spending. The coronavirus-related fiscal measures are expected to deliver a primary deficit of 8.3% of GDP this year, according to the IMF. Brazil's public debt is expected to increase sharply in 2020 to 101.4% of GDP from 89.5% (Exhibit 8). Future government spending and the path of economic growth will therefore be critical to the debt trajectory in the coming years.

Exhibit 9: Brazil public debt dynamics



Source: Datastream and AXA IM Macro Research, Nov 2020

Historically, we found that periods of rising public debt have been mainly explained by interest payments on debt, higher public spending and weak economic growth (Exhibit 9), like during the 2008/2009 and 2014/2015 recessions, when global commodity prices crashed, inducing a deep economic crisis aggravated by a political crisis.

The 2008/2009 recession marked the end of a period during which monetary and fiscal policy were managed through the implementation of the Tripod[3]. Public debt increased by 3.2ppt to 65.5% of GDP and the primary balance declined by 1.9ppt of GDP over the period. The difference between interest payments on debt and GDP growth increased significantly to -0.7% (-6.1% average until 2009).

The 2014/2015 recession saw GDP falling by -3.5% year-on-year, its sharpest contraction since 1981. By this time, Dilma Rousseff's government abandoned the "tripod" in favour of "The New Economic Matrix" implying more government interventionism which, combined with falling commodity prices in 2014, had a devastating effect on public finances. Primary balance shrunk to 0.9% of GDP from 4.0% of GDP. Public debt ballooned by 12.4ppt to 72.6% of GDP in 2015.

The pandemic will push debt even higher, impacting GDP as well as the primary balance. Yet, other parameters mitigate the credit impact of the rising debt. Key interest rates are at lowest historical levels, reducing debt servicing costs. The debt's sensitivity to FX moves has been reduced, only 6% is labelled in hard currency. Nevertheless, the trajectory of Brazil's public debt will depend on the ability to implement reforms that will stimulate structural growth in a context in which fiscal challenges will remain at play.

[2] On December 13, 2016, the Senate approved an amendment to the Constitution imposing a ceiling on public spending for the next 20 years. The amendment establishes that the government can only spend the same amount that was spent in the previous year, corrected only for inflation.

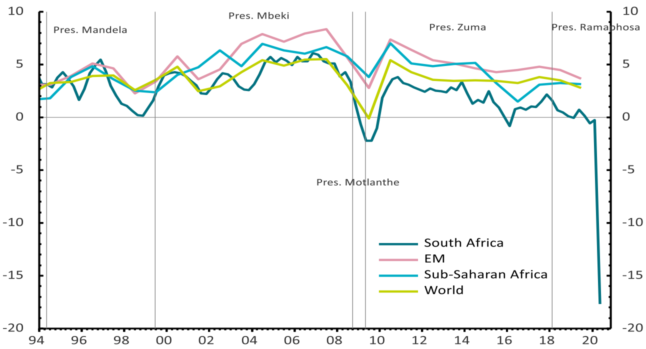
[3] During President Cardoso's second mandate (1999-2002) a new economic policy regime has been adopted, based on the so called macroeconomic tripod: inflation targeting; floating exchange rate; and primary budget surplus targeting.

South Africa: Struggling with fiscal consolidation

Africa's most industrialised economy was already in recession before the pandemic struck. Imposing one of the world's strictest lockdowns only heightened its woes. Since the 2008/2009 financial crisis, the South African economy has underperformed the world's, EM's and SSA region's average growth levels in each year (Exhibit 10) – a trend that is likely to persist for longer. High inequality, public sector dominance, corruption, low productivity and savings rates, high poverty levels and social tensions are some of the structural issues the country still needs to tackle, while managing the pandemic recession and sanitary crisis.

Exhibit 10: A decade-long economic underperformance

South Africa: GDP comparison (% yoy)



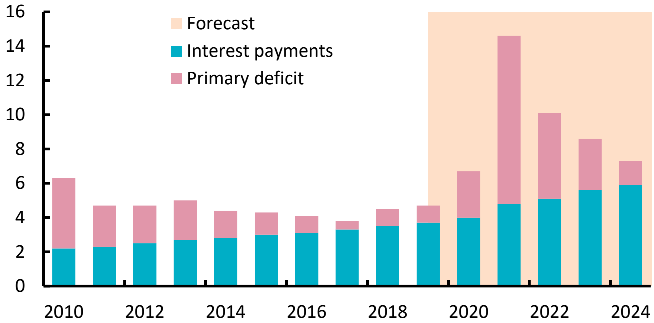
Source: Datastream and AXA IM Macro Research, Q1 2020

Surging spending related to the pandemic compounds a deterioration in public finances stemming over the years from low growth, overspending and policy mismanagement. The government revised its fiscal deficit targets upward: COVID-19 fiscal spending is likely to push the primary deficit to close to 10% of GDP this year – the budget deficit is seen at 14.6% of GDP this year, gradually shrinking over the years yet above 7% through 2023 (Exhibit 11). The country recently secured a $4.3bn IMF emergency loan under the Fund's Rapid Financing Instrument (RFI), a first since the 1993 crisis, alleviating short term financing constraints.

Exhibit 11: Official medium-term deficit assumptions

South Africa - Main budget deficit

(%GDP)



Source: South African National Treasury, 2020 MTBPS, AXA IM Macro Research, Oct 2020

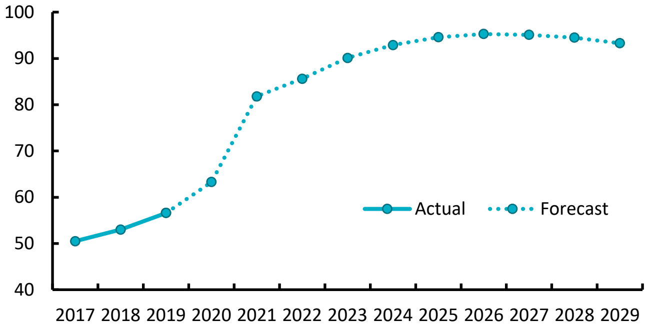
The latest official economic projections were released in its Medium-Term Budget Policy Statement (MTBPS). Public debt is now expected to peak two years later than official expectations elaborated last summer (in 2025) and at a higher level (95.3%) than previously thought, a more realistic trajectory and yet likely still too optimistic (Exhibit 12). Behind these official projections of debt consolidation lie significant expected improvements on both the expenditure and revenue side. The government is aiming to achieve growth-supportive fiscal consolidation, still keen on funding infrastructure investment.

The cornerstone of these projections lies above all on the government's ability to keep non-interest spending well below the nominal growth rate through 2023. The expenditure effort is almost exclusively concentrated on expected savings coming from the wage bill to the tune of 5.6% of GDP. Freezing civil servants' salaries for the next three years as proposed in the MTBPS will put the governing African National Congress (ANC) on a collision course with its labour union allies, posing an undeniable execution risk of the fiscal consolidation plan. Additionally, revenue expectations will depend on the speed of the economic recovery, both domestically and globally. At a time when countries around the world return to some form of lockdowns with infection rates worsening, downside risks on the revenue side are on the rise.

Exhibit 12: Official expectations of debt consolidation

South Africa - Gross loan debt outlook

(%GDP)



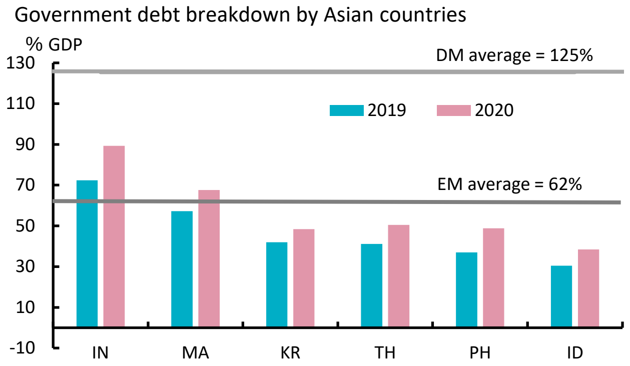
Source: South African National Treasury, 2020 MTBPS and AXA IM Macro Research, Oct 2020

The path to fiscal sustainability is long for South Africa. Debt service costs are now in excess of 4% of GDP (expected to reach 6% by 2024) and have been the fastest-growing expenditure item since 2011. Yields have recovered from the coronavirus blowout when the lockdown started, but remain high at around 9%, suggesting the risk associated with the country's debt trajectory. Not to mention contingent liability risks from state-owned enterprises, which remain high and largely unaddressed. All in all, public debt is likely to reach 100% of GDP before it consolidates. On a positive note, external financing vulnerability is low (12% of its public debt is denominated in foreign currencies), deep financial markets and monetary flexibility may help the sovereign kick the can further down the road for a while longer.

India: The underlying burden

Asia's government debt is edging higher. However, compared to developed markets' average of 125%, the debt ratio for Asia in general is nowhere close to that level. In fact, even on a relative scale to the overall EM average, Asia still looks pretty solid (Exhibit 13).

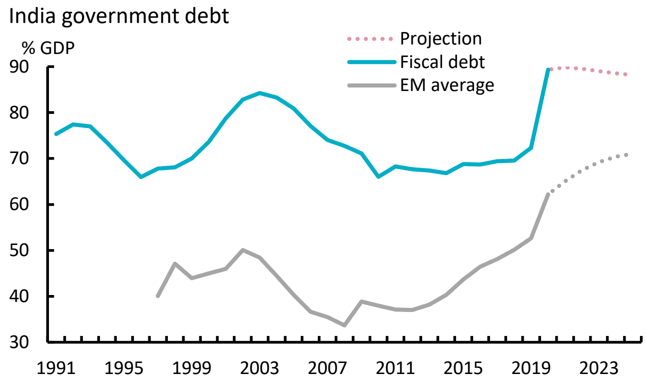
Exhibit 13: Public debt is generally low for Asia



Source: IMF and AXA IM Macro Research, Nov 2020

Within Asia, however, India is to be highlighted given that its public debt has constantly been above the EM average (Exhibit 14) and ranks among the most indebted large developing markets. The Indian government's debt-to-GDP ratio stood at 66% in 2010, and since then, has been heading higher, reaching over 72% in 2019. India's high debt is a product of persistent fiscal deficits, which marks the worst among all EM Asian economies. The key reason for its precarious fiscal position has been its struggles with tax collection. Total government revenue received was around 20% (for both central and states combined), which was much lower than the EM average of 27%. The narrow tax revenue base is not surprising for India, as it is limited by the large low-income population. In fact, over two-thirds of total tax revenues come from indirect tax collection, such as goods and services tax.

Exhibit 14: Public debt path for India

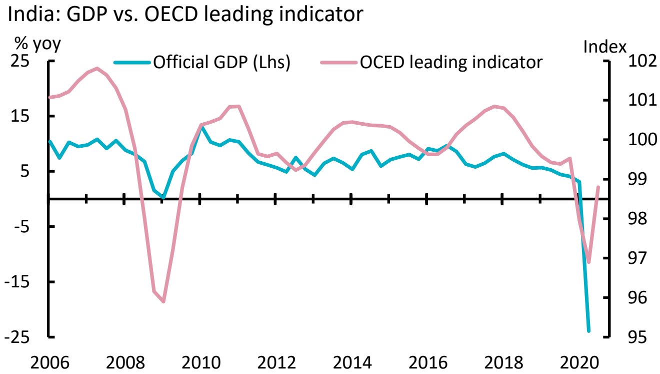


Source: IMF and AXA IM Marcro Research, Nov 2020

This year, in response to the coronavirus pandemic, like its Asian peers, the Indian government has significantly increased public spending. Coupled with the fall in tax revenues and economic activities, public debt will likely jump by 17ppts to almost 90% of GDP by 2021 – the highest level on record. As a result, a surge in public debt will put a cap on how far the government can further increase spending, leaving available fiscal space rather limited in the upcoming years. Going forwards, according to the IMF's forecast, the headline debt ratio is projected to stabilize in 2021, before moving to a gradual downward trending path (Exhibit 14).

Overall, despite the already high debt burden, India has also been increasingly constrained by its low growth as well as a weak financial system. While GDP growth averaged 7.5% from 2005 to end-2019, its trend has been declining from an average of 8.3% between 2005 and 2011 to 6.7% between 2012 and 2019. By the June-quarter this year, growth contracted by an unprecedented -23.9% following the COVID-19 outbreak (Exhibit 15).

Exhibit 15: Sharp growth deceleration due to COVID-19



Source: CEIC, OECD and AXA IM Macro Research, Nov 2020

On the back of the entrenched growth slowdown and a persistently high debt problem, India's macro fundamentals have been further exacerbated by vulnerabilities in the financial sector that have spread from public sector banks, to non-bank financial institutions to private sector banks. This indicates the ineffectiveness in applying key macroeconomic, fiscal and financial sector reforms that would strengthen or preserve India's sovereign credit profile.

Overall, the pandemic dampened the economic and fiscal outlook, and has served as an extra layer of stress to the economy and its financial system. This could potentially lead to a more severe and prolonged erosion in fiscal strength going forward. It is therefore particularly important for the policymakers to kick-start growth and continue to implement structural reforms necessary to bring India back on a rising growth trend.

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