Economic Views – EM Fiscal Deficits in the COVID-19 Shock

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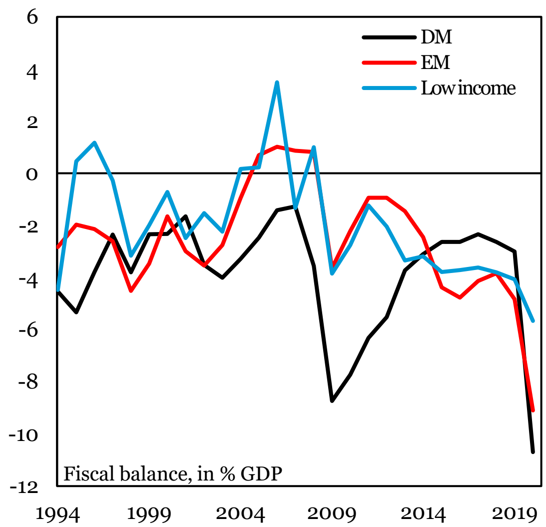
- EM fiscal deficits will widen substantially this year, …
- in the context of limited sources of external financing.
- Private deleveraging is unavoidable in this situation, …
- to redirect scare financial resources to the fiscal deficit.
- These trends will be very pronounced in South Africa.

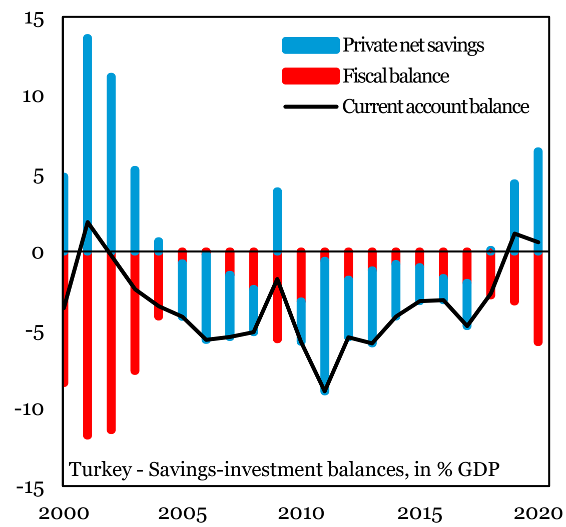
Virtually every country in the world will run a wide fiscal deficit this year to deal with a global health and growth crisis. Deficits will be an order of magnitude larger than in the global crisis, especially in EM (Exhibit 1). For countries issuing reserve currencies, funding large fiscal deficits may be straightforward. The picture is more nuanced in EM, where currencies depreciate, bond yields increase, and capital flows reverse in global crises. In this note, we approach the EM fiscal outlook from the perspective of domestic and global net savings. Wide fiscal deficits around the world mean unusually negative net savings by governments that need to be funded by a net savings surplus in the private sector. In other words, as the public sector leverages up across the world, the private sector needs to deleverage at large scale. At the country level, this "constraint" can be eased borrowing from abroad. However, our capital flows trackers and net bond issuance data suggest some EMs may find it hard to borrow large sums from abroad this year. This implies unusually large private sector deleveraging (positive net savings) to make space for fiscal deficits. In cases like South Africa, the private sector may have to absorb unprecedented amounts of government bonds to make a wide fiscal deficit feasible under limited foreign borrowing.

Exhibit 1. Fiscal deficits widening globally.



Source: Haver, IIF

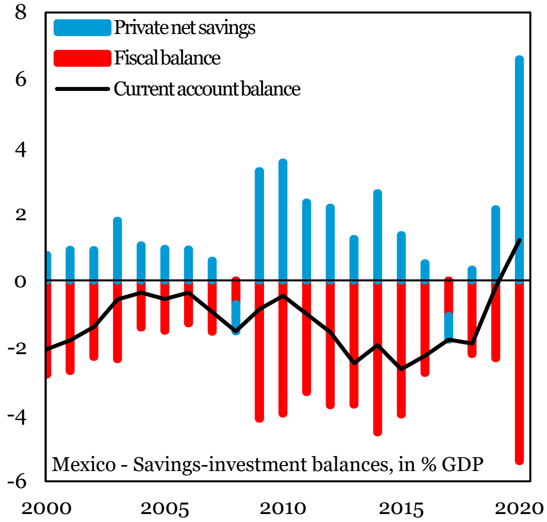
Exhibit 2. Private deleveraging in Turkey, …



Source: Haver, IIF

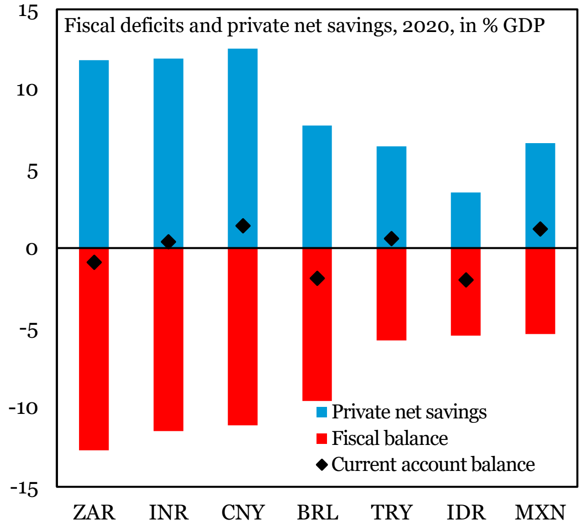
Fiscal balances reflect savings-investment decisions of governments, where a deficit implies increased net borrowing. Together with the private sector savings-investment decision, they determine the gap between national savings and investment, which in turn pins down the current account. If savings exceed investment, a current account surplus and lending to the rest of the world occur. This is a useful framework to think about the macroeconomic implications of large fiscal deficits. Exhibit 2 decomposes Turkey's national saving and investment by sector, linking it to the current account. Most of the time, neither the public nor the private sector save, which implies persistent current account deficits. When external financing dries up as in 2018, the current account deficit vanishes and someone needs to start saving more (ie, deleveraging). In Turkey and elsewhere, it is usually the private sector, as the government uses fiscal deficits to fight the growth slump current account adjustments come with. This year, we do not think Turkey will have foreign funding to run a current account deficit, which means that a widening fiscal deficit will come hand in hand with pronounced deleveraging in the private sector (albeit nowhere near the 2001 crisis). Mexico is in a similar situation, even though the fiscal deficit will widen less than in other EMs (Exhibit 3).

Exhibit 3. … as well as Mexico.



Source: Haver, IIF

Exhibit 4. The local private sector funds EM deficits.

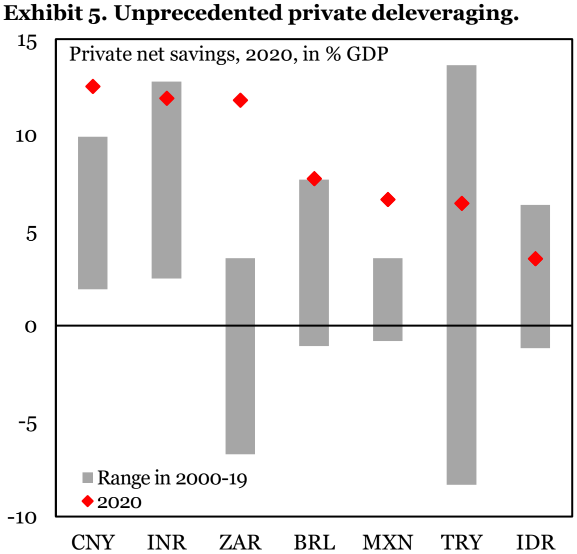


Source: Haver, IIF

The pattern in Turkey and Mexico we discussed above will repeat itself across EM (Exhibit 4). Governments will run unprecedented fiscal deficits in an environment where current account balances are small due to weak capital flows. Private sector deleveraging will ensue, in some cases to a degree not seen in the last twenty years (Exhibit 5). South Africa sits at one end of the spectrum, as we expect the fiscal deficit to surpass 12% of GDP and a negligible current account deficit. In this context, the domestic financial system (banks and pension funds) will have to absorb an unprecedented amount of government bonds (Exhibit 6). This is the case even after factoring in drawdown of government deposits, 1.8% of GDP in loans from IFIs, SARB purchases at the monthly pace seen in March, and continued bond sales to foreigners.

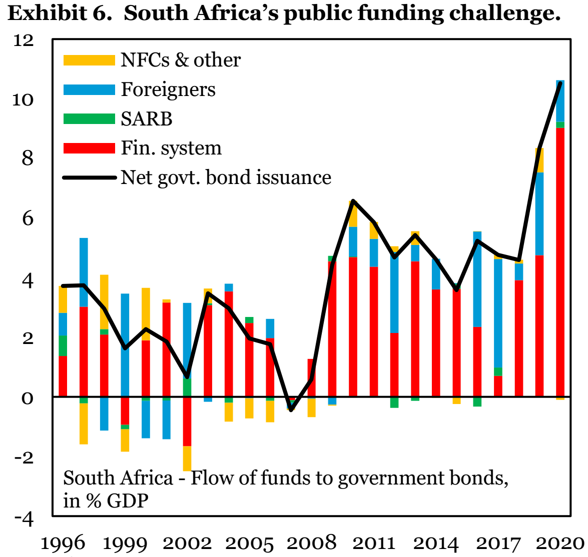
EM deficits will widen substantially this year. In normal circumstances, twin fiscal and current account deficits would emerge, risking crowding out of private sector investment. Now the situation is different. Recession is inevitably pushing the private sector into a savings surplus and policy action via larger fiscal deficits is trying to stop domestic demand from falling off the cliff. The size of these sectoral swings in net savings is unprecedented and will result in large-scale private deleveraging.

Exhibit 5. Unprecedented private deleveraging.



Source: Haver, IIF

Exhibit 6. South Africa's public funding challenge.



Source: Haver, IIF

