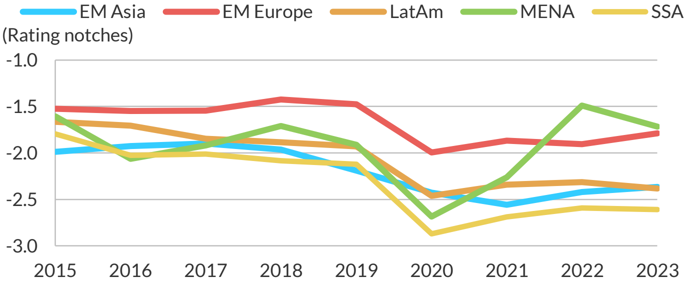
Global Fiscal Recovery Interrupted

Improvements in 2021 will slow in 2022 and again in 2023

Median Fitch Fiscal Indexes by Emerging-Market Region[a]



[a] Lower index calculation is consistent with a weaker fiscal position
Source: Fitch Ratings

The Covid-19 crisis resulted in a record 51 downgrades of 33 sovereigns in 2020. Fitch Ratings downgraded several sovereigns more than once, and there were six multi-notch downgrades. Rating actions were driven primarily by fiscal deteriorations, with almost all sovereigns running larger deficits, resulting in higher debt ratios. The average sovereign rating is 0.4 notches lower than end-2019.

Fiscal recoveries began in 2021 in both developed markets (DMs) and emerging markets (EMs). Deficits as a share of GDP were smaller compared with 2020 for three-quarters of sovereigns – the highest share since 2004. Debt ratios also declined for most sovereigns in 2021, benefiting from growth recoveries in addition to the smaller deficits.

The Fitch Fiscal Index (FFI) combines the four fiscal variables in the Sovereign Rating Model, allowing comparisons of fiscal positions across sovereigns at a point in time and intertemporally. The 2022 and 2023 global FFI medians confirm continued – but much slower – fiscal recoveries. On the 2022-2023 pace, the median global fiscal position would return to its pre-pandemic level in 2029.

Global fiscal performances and prospects are being affected by higher commodity prices, inflation, and borrowing costs, as well as slowing real GDP growth and the war in Ukraine. Additionally, climate risk mitigation, digital transformations, infrastructure investment and income equality issues are shaping fiscal plans, mostly on the spending side and primarily in DMs.

Unlike central banks, fiscal authorities will not necessarily interpret higher inflation and lower growth as pulling in opposing policy directions. Covid-19 recovery spending can pivot to confront inflation challenges. Most Fitch-rated sovereigns have already enacted fiscal policies to help households and businesses cope with higher prices. Fitch expects more of such policies if inflation remains elevated.

Higher commodity prices and inflation more generally also have positive fiscal implications. Sovereigns with commodity-related receipts are experiencing a surge in revenue, and part of the 2021 global fiscal recovery is attributable to nominal revenues growing more quickly than forecast due to rising prices.

Policy interest rates are rising, and Fitch believes this marks an end to the era of very low government borrowing costs. It is real interest rates that matter, however, and especially real rates relative to real GDP growth – the relationship that drives debt dynamics. Moreover, it will take time for higher rates to be fully reflected in interest service burdens, depending on debt maturity profiles.

EM fiscal positions are more regionally divergent than they were pre-pandemic. The severity of the pandemic, its economic implications and policy responses varied by geography. Exposures to commodity prices and the war in Ukraine are additional factors. The median FFI for the Middle East & North Africa region is the strongest in 2022, while sub-Saharan Africa is the weakest.

Related Research

Global Economic Outlook (March 2022)
Sovereign Data Comparator (March 2022)
Anti-Inflation Measures Add to Fiscal Risks (March 2022)
Global Fiscal Deterioration Amid Coronavirus (February 2020)

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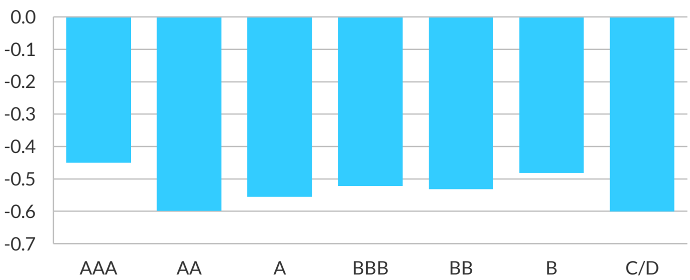
2020 Fiscal Shock

With the onset of Covid-19, global fiscal positions deteriorated quickly as governments enacted large spending programmes and – to a lesser extent – tax cuts to offset the economic effects of the pandemic on households and businesses. Declines in revenue and increases in spending were typically experienced both in nominal terms and relative to GDP.

Using the FFI (see textbox opposite), fiscal pressures in 2020 pointed to 71 notches of downgrades across the 119 rated sovereigns, or 0.6 notches per sovereign on average. The biggest fiscal deteriorations were in Maldives, Aruba and Seychelles, and the smallest (actually slight improvements) were in Lesotho, Turkmenistan and Pakistan.

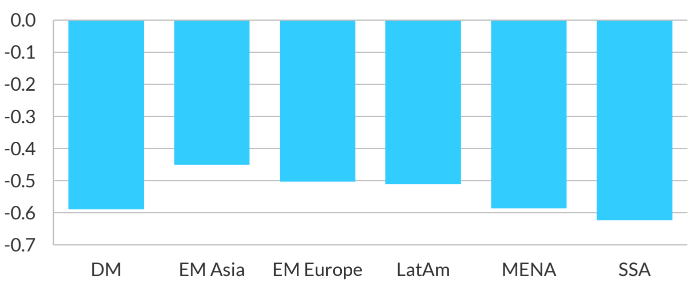
Medians by rating category and region confirm the consistency of the 2020 fiscal shock. The 'AAA' category and emerging Asia had the smallest deteriorations, but they were not meaningfully different from the 'AA' and 'C/D' categories or sub-Saharan Africa, where deteriorations were the largest.

Median 2020 FFI Change by Rating Category



Source: Fitch Ratings

Median 2020 FFI Change by Region



Source: Fitch Ratings

2021 Fiscal Recovery

The fiscal recoveries of 2021 were nearly as widespread as the 2020 shock. The FFIs for more than 80 sovereigns improved, and the median global improvement was the largest since 2004. Recoveries were stronger in EMs than DMs, consistent with DM spending increases in 2020 being bigger than those in EMs and remaining elevated in 2021, and EM revenues recovering more quickly last year. Nearly one-quarter of the global FFI deterioration in 2020 was recovered in 2021.

Fitch Fiscal Index

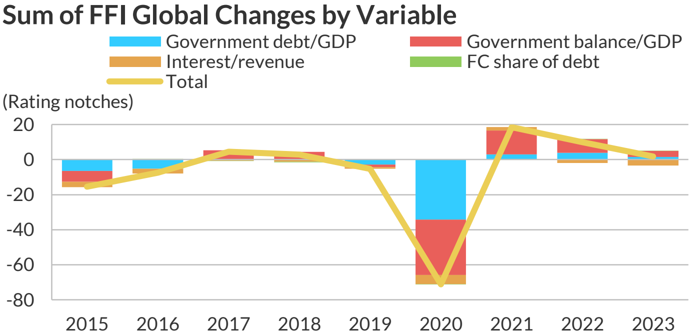
The Fitch Fiscal Index (FFI) is available as an interactive tool on Fitch Connect. The FFI combines the public finance variables in Fitch's proprietary Sovereign Rating Model (SRM) – also available as an interactive tool – to facilitate cross-country and intertemporal comparisons of public finances positions. The four public finance variables in the model are:

- general government balance relative to GDP;
- general government debt relative to GDP;
- general government interest payments relative to general government revenue; and,
- the foreign-currency share of general government debt.

The SRM uses centred three-year averages of the variables, ensuring a forward-looking assessment that also preserves a degree of stability with respect to rating outcomes. The FFI is calculated on a single-year basis to emphasise annual variations in fiscal performance, which can be useful for comparisons as well as anticipating possible changes in SRM and thus ratings. Variable weights in the Index are drawn from the SRM. The FFI is expressed as a number that corresponds to the combined impact of public finance variables on the sovereign rating in a single year. The scale is rating notches as per Fitch's Long-Term Foreign-Currency Issuer Default Rating scale.

One of the most notable aspects of the reversal in fiscal performance between 2020 and 2021 was the lack of real improvement in debt/GDP ratios. The FFI allows for a breakdown of the change in overall fiscal score into the component variables (see chart below, which sums the changes for all sovereigns). While ratings pressure in 2020 was nearly evenly split between larger government deficits and higher government debt, the recovery in 2021 was driven largely by deficit reduction, with debt reduction contributing little.

Sum of FFI Global Changes by Variable



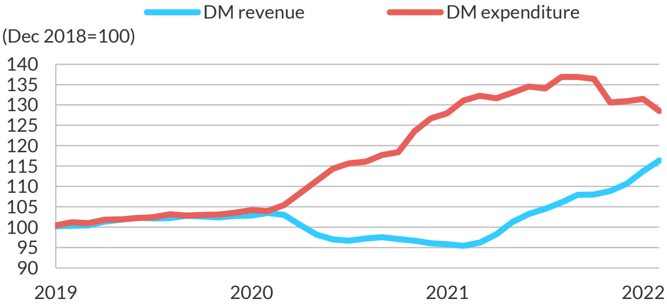
Source: Fitch Ratings

This is consistent the global median debt/GDP ratio, which increased from 56% of GDP in 2019 to 69% in 2020, but then fell to only 68% in 2021. The median fiscal deficit widened from 1.6% of GDP in 2019 to 7.2% in 2020, then narrowed to 4.8% in 2021. With the debt and deficits remaining higher than 2019 levels, it is evident the fiscal recovery in 2021 was only partial.

DM Versus EM Balances

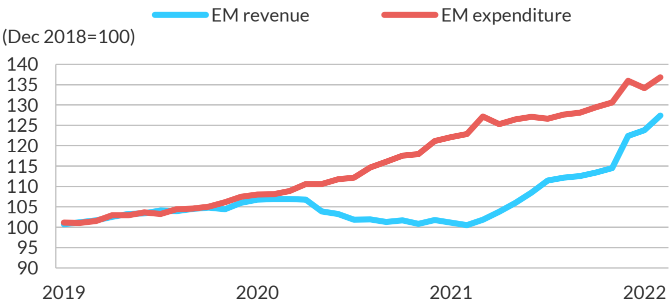
There were important differences in the DM and EM policy responses to the pandemic that have shaped subsequent fiscal recoveries. The charts below show median DM and EM revenues and expenditures derived from nominal 12-month sums of central government data for 51 sovereigns (selected based on the availability of monthly fiscal data). The 12-month sums are set to 100 as of December 2018 to accentuate how pre-Covid-19 revenue and spending trends in 2019 were interrupted in early 2020.

DM Monthly Fiscal Performance



Source: Fitch Ratings

EM Monthly Fiscal Performance



Source: Fitch Ratings

DM spending rose significantly above the 2019 trend in 2020 and 2021 before beginning to turn lower, while revenues declined in 2020 and began to recover quickly in early 2021. In contrast, EM spending in 2020 did not deviate as much from its 2019 trend, and the widening fiscal gap in 2020 was due mostly to weaker revenues. EM revenues declined by less than those in DMs in 2020 and recovered more quickly in 2021.

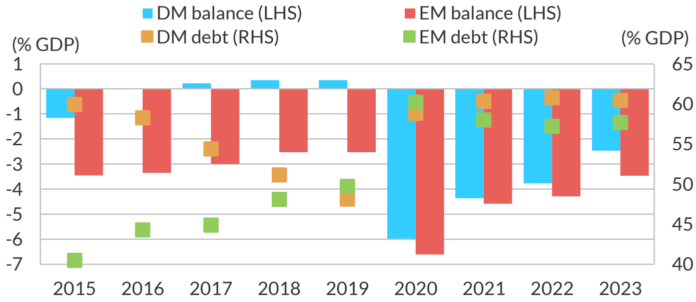
The 2021 revenue recoveries in both DMs and EMs were stronger than Fitch and most governments had forecast, and we attribute this to several factors:

- Economic recoveries in many countries were led by the goods sector, as the services sector was affected more by mobility restrictions. A goods-intensive recovery is likely to be a more tax-intensive recovery, as goods are easier to tax and less prone to informal (outside the tax net) activity.
- Mobility restrictions discourage face-to-face transactions and encourage the use of electronic payments. Fewer cash transactions facilitates greater tax compliance.
- Higher commodity prices are usually beneficial for government revenues in commodity-exporting countries. This is not necessarily 'offset' by corresponding revenue losses in commodity-importing countries, so the net effect of higher commodity prices can be higher global government revenues. If prices remain elevated in the medium term, negative economic effects in importing countries are more likely to take hold, with a corresponding effect on government revenues.
- Higher inflation affects both revenue and expenditure. Since many countries have just come through extended periods of low inflation, it is not easy to forecast whether revenue or expenditure will increase more quickly, at least in the short term.

Recovery Stalls in 2022

The partial fiscal recovery of 2021 will continue at a much slower pace in 2022 and 2023. Fitch forecasts that more than 80 sovereigns will experience an improved FFI for the second consecutive year in 2022 – the most widespread two-year fiscal improvement since 2005-2006 – but the changes are small. By end-2023, we forecast that less than half of the global fiscal deterioration in 2020 (as measured by the FFI median) will have been reversed.

Global Fiscal Medians



Source: Fitch Ratings

On the 2022-2023 pace of recovery, it would take until 2029 for the median global fiscal position to return to its 2019 level. This seems a long time, but compares well with the period after the global financial crisis (GFC). Neither DM nor EM median fiscal positions ever returned to pre-GFC levels. Given the view among some observers that there was "too much austerity" following the GFC and that mistake should not be repeated after the Covid-19 crisis, it is possible the FFI may not recover by 2029. A downturn in the economic cycle would makes recovery even less likely.

Fitch publishes annual forecast of key macroeconomic and credit variables for rated sovereigns on a quarterly basis. Updates in March 2022 took account of the war in Ukraine and higher global oil prices, and fiscal balance revisions in emerging Europe and the Middle East & North Africa (MENA) went in different directions (see table below). EM Europe deficits are forecast to be higher, but the median MENA fiscal balance forecast changed from a deficit to a surplus on higher oil prices.

At the global level, we forecast median growth to be lower and median inflation higher, and the median fiscal deficit forecast for 2022 increased to 4.2% of GDP from 3.8%. Despite the weaker fiscal balance, the surge in inflation results in a downward revision to the global government debt/GDP ratio.

Global and Regional Forecast Medians

	March 2022 Comparator		December 2021 Comparator	
	2022	2023	2022	2023
Global real GDP growth (%)	3.4	3.3	4.0	3.5
Global inflation (avg. %)	5.3	3.0	3.2	2.5
Fiscal Balances (% GDP)				
DM	-3.8	-2.5	-3.5	-2.4
EM Asia	-5.4	-4.5	-6.0	-4.6
EM Europe	-4.4	-3.8	-3.1	-2.8
LatAm	-3.5	-2.8	-3.8	-2.9
MENA	2.4	2.6	-3.3	-3.1
SSA	-4.9	-3.8	-4.9	-3.6
Government Debt (% GDP)				
DM	59.7	59.4	61.9	61.4
EM Asia	61.6	59.5	63.9	62.0
EM Europe	50.2	48.9	48.2	47.3
LatAm	60.3	60.2	63.3	64.7
MENA	66.6	67.1	66.4	67.3
SSA	65.9	64.5	72.2	70.5

Source: Fitch Ratings, Sovereign Data Comparator

Using the FFI to translate fiscal outcomes to ratings, the incomplete fiscal recovery implies the average global sovereign should be about one-third of a notch lower in 2022 compared with 2019. The average global rating is currently four-tenths of a notch lower than end-2019. Changes in actual ratings will never be perfectly aligned with those implied by the FFI, since the FFI covers only one year of data (see textbox on page 2); Fitch can apply Qualitative Overlays to either offset or supplement rating changes driven by fiscal variables in the SRM, and there are three other analytical pillars to consider in the *Sovereign Rating Criteria* – structural features, external finances and macroeconomic performance, policies and prospects.

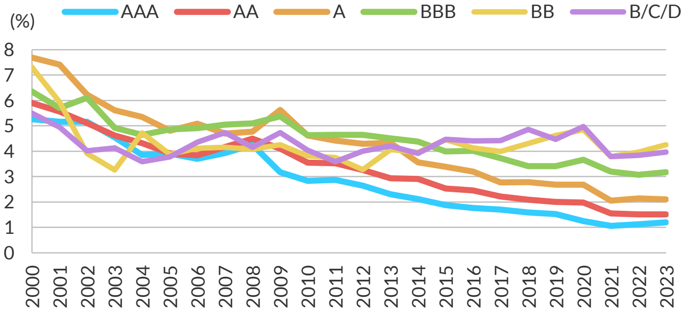
The End of Lower Interest Rates

In an environment of rising global interest rates, the interest service burden will be a more important driver of fiscal performance in the FFI and SRM, albeit with two caveats. First, it takes time for higher market interest rates to affect government effective interest rates (the average rate a government pays on its entire debt stock), as only newly issued debt is subject to the higher cost of borrowing.[1] Second, EM sovereigns facing higher rates in domestic markets can usually switch to borrow more in DM markets, taking on currency risk but typically paying lower interest rates. The increased credit risk associated with a higher share of foreign currency is reflected in the inclusion of this variable in the SRM.

For DM sovereigns, low and declining interest rates and interest service burdens (interest payments/revenue) have been prominent features of the fiscal landscape in recent years, and a critical point in the debate over sustainable government debt burdens. In 2012, the median DM interest service burden was 5.1%; by 2019 it had declined to 3.1% on a reduction in the debt ratio (54%-of-GDP to 48%) and the effective interest rate (3.4% to 2.0%).

The steady decline in the median DM effective interest rate is forecast to end in 2022, with Fitch projecting an effective rate of 1.4%, the same as 2021 and 2023. DM sovereign interest payments are forecast to be steady at 1% of GDP and 3% of revenue, both multi-decade lows.

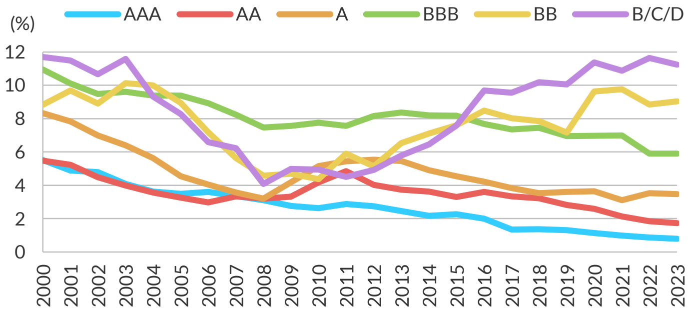
Median Effective Interest Rates by Category



Source: Fitch Ratings

Interest rates that are no longer falling – and supporting lower interest service burdens – are new in a contemporary context to DMs, but not to EMs. The end of lower interest rates was more than a decade ago for sovereigns in the 'BB' category and those rated lower (see chart above). Without the steady decline in effective interest rates, rising EM government debt burdens have meant rising debt service burdens as well (see chart below).

Median Interest Service Burdens by Category



Source: Fitch Ratings

Higher Inflation Settles In

Our March Global Economic Outlook highlights the pick-up in US services inflation and rising wage inflation. Additionally, there is a growing risk of inflation expectations becoming unanchored from the Federal Reserve's 2% inflation target. These considerations speak to the possibility of higher inflation lasting for an extended period.

Monetary policy is typically associated with the official sector's response to higher inflation, but there is also fiscal policy to consider. As of March, 66 of 120 Fitch-rated sovereigns had introduced fiscal measures to cushion the impact of higher prices on

[1] Notable exceptions include interest payments on inflation-indexed securities and debts subject to variable interest rates that reset periodically.

households, with a near-equal number opting for price controls (29) and subsidies (28), and slightly smaller numbers rolling out new grants (23) and cutting indirect taxes (21). With inflation continuing to exceed expectations in many countries, we expect additional fiscal measures to be introduced and the fiscal burden of inflation to grow. Given potential social instability concerns around higher prices, the risk of additional measures is judged by Fitch to be higher in EMs, though our earlier research did not confirm this to have been the case so far, as the DM fiscal responses to inflation were as common as those in EMs.

EM inflation always runs higher than DM inflation, though the gap between medians in 1Q22 (2pp) was lower than the 20-year average (3pp). This is different than the previous global inflation spike in 2008 when median inflation was 7pp higher in EMs than DMs.

All else equal, higher inflation should mean weaker exchange rates and additional fiscal pressure on EMs based on the increase in foreign-currency debt servicing. With the Federal Reserve raising interest rates and the US dollar strengthening against the yen and euro, it might be expected that EM currencies would be under greater pressure than they have been year-to-date. The Federal Reserve's trade-weighted nominal dollar exchange-rate indexes confirm the dollar is stronger against DM currencies than against EM currencies so far this year. For EMs, this is a serious risk to monitor, and in some it is already an issue, as not every sovereign's exchange rate is aligned with the Federal Reserve index and it is improbable that EM currencies will outperform those of DMs during a period of global financial tightening.

Greater Fiscal Divergence

The fiscal effects of the pandemic were more pronounced in sovereigns with weaker fiscal positions – where recoveries have also been slower (according to the FFI) – contributing to a greater divergence of global fiscal outturns. This is confirmed, for example, by a growing gap between the strongest and weakest FFIs that began in 2020 and continues in 2022.

The average FFI of the five strongest fiscal positions in 2019 (Macao, Estonia, Luxembourg, Switzerland and Azerbaijan) was equivalent to about four rating notches higher that the average of the five weakest fiscal positions (Lebanon, Japan, Sri Lanka, Egypt and Greece). By 2022, the gap had increased to more than five notches between the strongest (Kuwait, Abu Dhabi, Azerbaijan, Luxembourg and Saudi Arabia) and the weakest (Sri Lanka, Lebanon, Japan, Ukraine and Greece).

With three of the strongest fiscal positions in 2022 being Gulf Cooperation Council sovereigns, the effects of higher oil prices are clear. But the fiscal recovery of non-oil-exporting sovereigns with strong positions was already evident in 2021, when FFIs for Estonia, Luxembourg Switzerland, Azerbaijan and Singapore ranked at the top. The weakest sovereigns got marginally weaker in 2021.

Greater fiscal divergence is consistent with greater ratings divergence. Prior to the pandemic, the long-term average (monthly) number of sovereigns rated 'CCC' or lower was less than three, while it has risen to 10 over the past 24 months. Current global credit conditions and those anticipated for the next year suggest continued fiscal and rating stresses ahead.