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FEATURE

# Brace for the fiscal fallout

## Healing government finances won't be easy

Akrur Barua

The fiscal cat will soon be on the prowl and belling it won't be easy.

LONG AFTER COVID-19 is defeated, the physical and emotional scars of the pandemic will continue to haunt people. But that won't be the only thing that policymakers will have to worry about in the months and years ahead. Getting government finances back to health may be one of the toughest tasks that policymakers the world over face in the medium to long term. Governments have been forced to step in at an unprecedented scale—to tackle the virus, aid vulnerable households, and provide relief to businesses affected by the pandemic. And while these measures have brought relief to health care efforts and economic activity, they have also led to a sharp rise in government deficit and debt levels across the globe.[1]

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While deteriorating fiscal health is low in the order of policymakers' worries at this moment, it does present a steep challenge for medium- to long-term economic fundamentals. Lessons over the past decade, from emerging markets to advanced nations, should be a grim reminder that at some time over the next few years, fiscal prudence will have to take precedence. And it won't be an easy task, for sure. Widening income and wealth inequality will make it difficult for governments to cut down on benefits even as higher taxes to fund current expenditure may not result in intended increases in revenue in economies with weak taxation structure. Unorthodox policies may be a way out for some—central banks' financing part of government debt will likely go against age-old economic fundamentals but may find more takers in certain economies. For others, fiscal reforms are a way out, but they need to start early as the costs of pushing the can down the road are high as the last decade revealed.

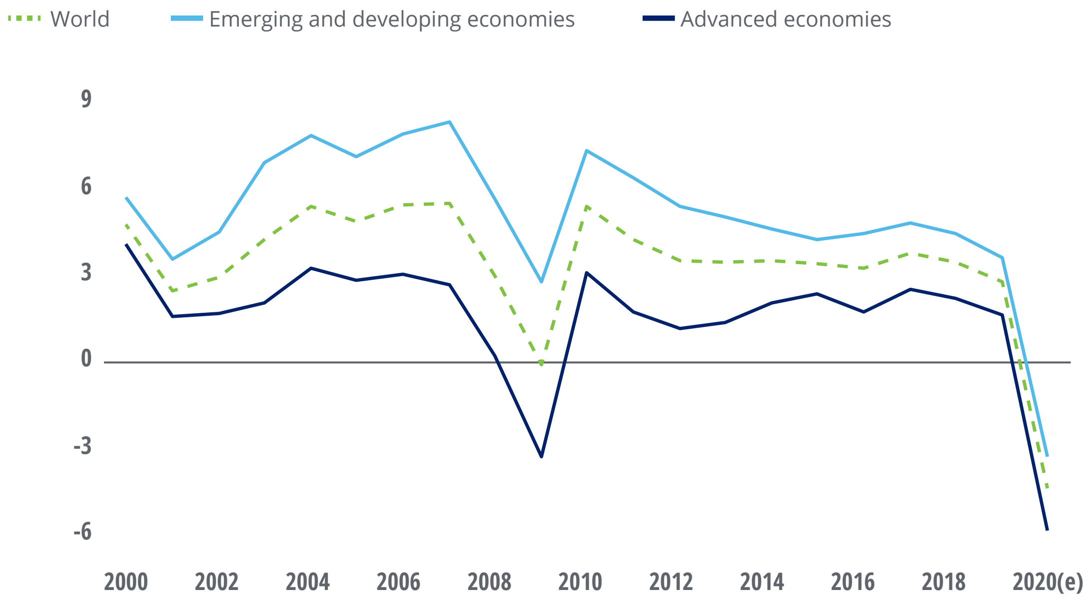
## COVID-19 has battered economies harder than the previous recession of 2008–2009

The economic fallout of the current pandemic has been harsher than anything in recent memory. In 2009, due to the global financial crisis, world GDP fell by about 0.1% (figure 1), according to the International Monetary Fund (IMF).[2] This time around, the IMF estimates, the contraction is much harsher—4.4% in 2020. And unlike in 2009 when emerging economies[3] took up the burden of driving global growth, this time around they too likely contracted due to the pandemic (figure 1). While the global economy is *expected* to recover this year, much will depend on the trajectory of the pandemic. Even as hope is rekindled with rollout of vaccines, covering a sizeable section of the population to achieve herd immunity[4] will take time—maybe another year or even two. The sharp spread of the virus[5] in many parts of the world in recent months has forced some governments—like in the United Kingdom and other parts of Europe—to reintroduce social-distancing restrictions, yet another sign that a return to pre-COVID-19 normal is still some time away.

FIGURE 1

**The world economy suffered more in the pandemic than in the global financial crisis of 2008–2009**

Annual GDP growth (%)




Notes: "e" denotes IMF estimates.
Sources: IMF (sourced through Haver Analytics); Deloitte Services LP economic analysis.

## Government revenues were hit in 2020 even as expenditures soared

COVID-19 and its economic fallout have impacted fiscal health of governments in three ways. First, governments across the world have incurred large health care–related expenditure to counter the pandemic, especially on virus testing, contact tracing, and vaccine development and procurement.[6] The IMF estimates that additional spending or revenue foregone in the health sector through October 2020 totaled 1.5% of GDP in the United Kingdom, 1% in Japan, and 0.9% in Canada.[7] This year, governments' expenditure on vaccinations will likely go up, especially in emerging economies with large populations, such as China and India, where the task of inoculating people below the poverty line will largely fall on governments.

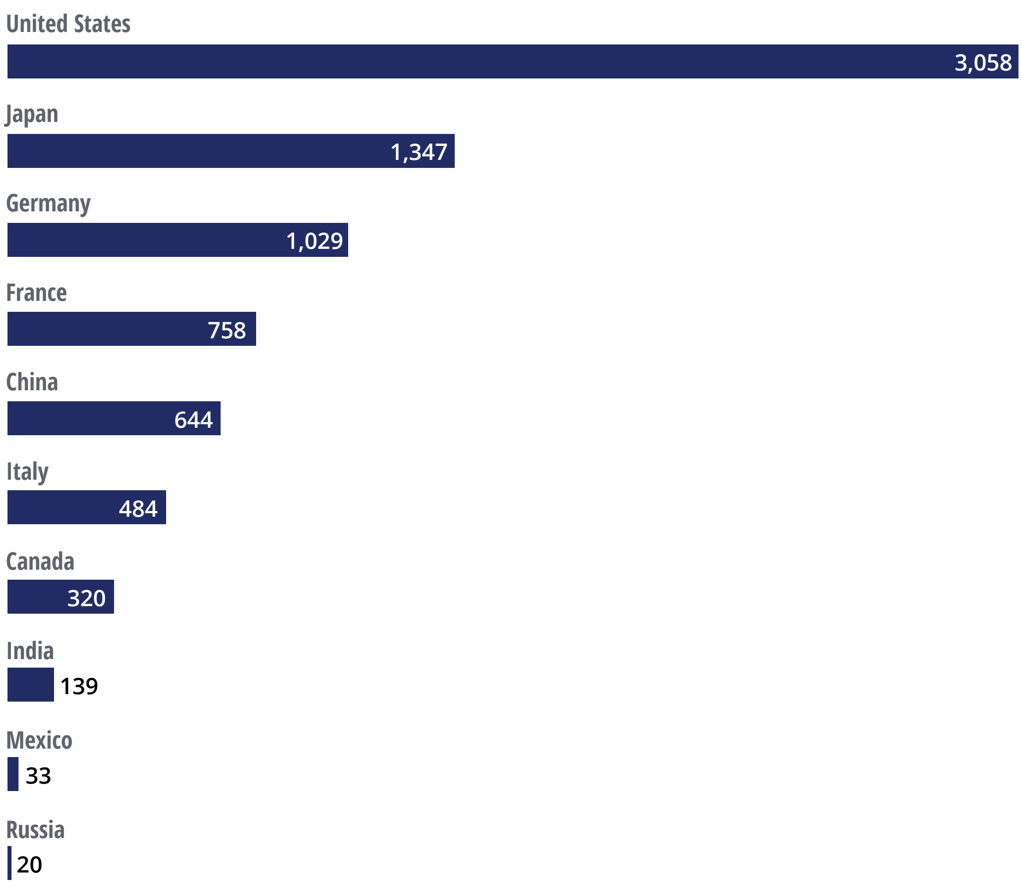
Second, economic contraction has meant that revenue growth for governments fell sharply in 2020. In the United States, gross federal government receipts fell 39.7% year-over-year in Q2 2020. Although receipts rebounded in Q3, they were down again slightly in October and November, underscoring the importance of economic growth to government revenues. Similarly, state and local government revenues in the United States have been hit as well.[8] In Germany, tax revenues were down by 8% in the first 11 months of 2020 compared to a year before, while in China, a nation that fared relatively better economically than many others last year, general government revenues fell 5.3% during that period.

Third, to counter the economic downturn and provide relief for impacted households and businesses, governments across the world have enacted record amounts of stimulus in addition to support from monetary authorities. In the United States alone, the total fiscal and monetary stimulus—spread almost equally between the two—amounts to about US$6.5 trillion or a little more than 30% of GDP.[9] In Japan, the total value of the stimulus, including for health care, is 11.3% of GDP and is being complemented by liquidity support worth 23.7% of GDP. Emerging economies too have engaged in strong fiscal intervention to cushion the economic fallout of the pandemic, although the degree of stimulus on average is less than advanced economies. Among key emerging economies, Brazil's fiscal package was the largest at 8.3% of GDP, followed by South Africa (5.3%) and China (4.6%). Other economies, like India and Turkey, have opted for more liquidity support through monetary authorities than large amounts of fiscal stimulus. In fact, central banks across the world have been active with asset purchases (figure 2) with the scale of purchases far outpacing that during the downturn of 2008–2009.

FIGURE 2

**Central banks across the world stepped up asset purchases in 2020**

Change in central banks' assets between February and November 2020 (US$ billion)




Sources: Haver Analytics; Deloitte Services LP economic analysis.

## Governments the world over will be wary of rising debt and deficit levels

With revenues down and expenditures soaring, governments across the world are staring at rising budget deficits. According to the IMF, the general government fiscal deficit for advanced economies, on average, is expected to have risen to 14.2% of GDP in 2020 from 3.3% in 2019.[10] The deficit among key advanced economies last year was likely the highest in Canada (19.9% of GDP), followed by the United States (18.7%), and the United Kingdom (16.5%). Emerging and developing economies suffered as well with general government fiscal deficit, on average, likely to have risen to 10.4% in 2020 from 4.8% in 2019; the surge in the emerging economies' deficits is, however, smaller than that in advanced economies. The shortfall in budgets in 2020 is likely to have been the highest in Brazil (16.8% of GDP), followed by South Africa (14%), and India (13.1%). Although deficits will likely decline as GDP recovers and the need for further fiscal intervention reduces, it will likely take about four to five years, on average, for levels to return to prepandemic levels.

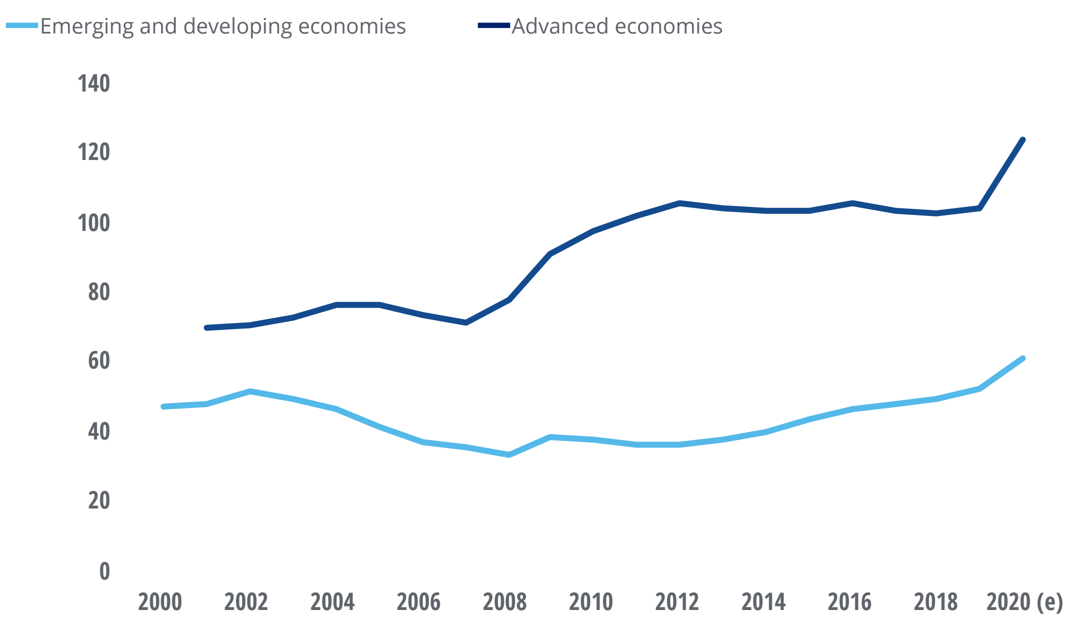
To make up for lost revenues in 2020 and to support stimulus measures, debt issued by governments has surged, thereby leading to a rise in total government debt. The gross-government–debt-to-GDP ratio is expected to have touched 270% of GDP in 2020 in Japan while in the United States, the debt is estimated to have risen to 130% of GDP. And it's not just advanced economies that are facing the burden of higher government debt, emerging and developing economies too have been impacted (figure 3).

Deficits may be easier than expected to tackle, especially if larger-than-expected number of vaccinations drive down incidences of the virus and,

FIGURE 3

### Economic and strong fiscal stimuli have led to a surge in government debt

General government gross debt as percentage of GDP




Notes: "e" denotes IMF estimates.

Sources: IMF (sourced through Haver Analytics); Deloitte Services LP economic analysis.

hence, stoke a sharp rebound in economic activity this year. But *easy is relative*—drawing down debt poses significant problems for many countries given lost revenues in 2020 and record borrowing during the year. Also, the experience of the previous global business cycle suggests that many countries have struggled to bring down debt levels after engaging in stimulus. Other than Germany, key advanced economies, for example, struggled to get their debt levels back to prerecession levels in the economic recovery of 2010–2019.

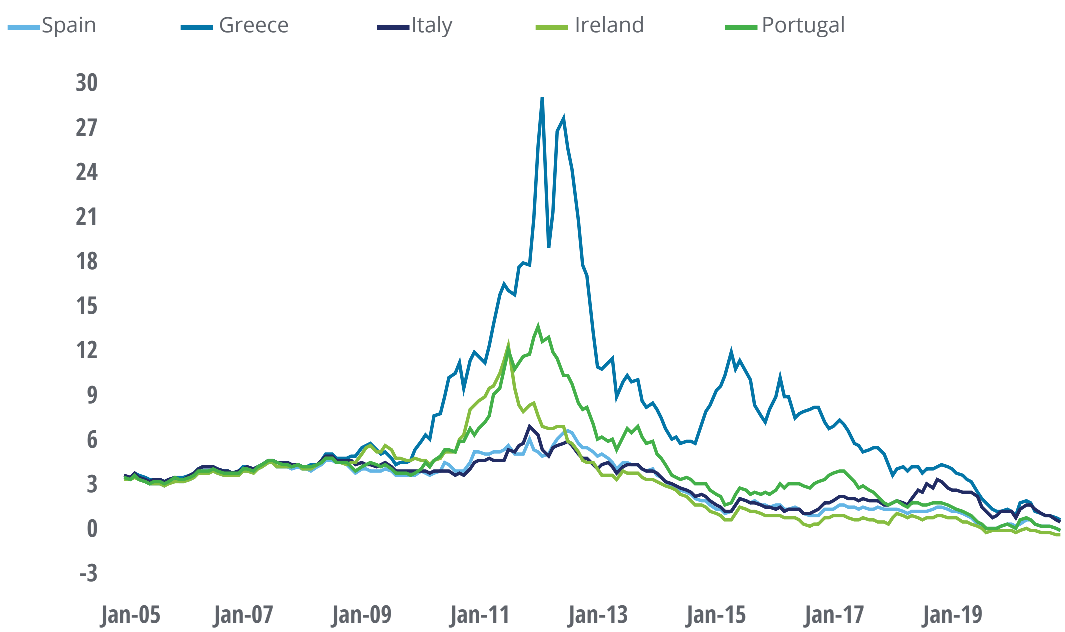
## The risks from the fiscal fallout

For governments, low borrowing costs (because of loose monetary policy) will provide a breather in the near term. Yet, it may not take much time for bond yields to come under pressure, especially if potential GDP growth doesn't rise and the fiscal math fails to add up in the medium term. For example, between 2013 and 2015, bond yields in Brazil surged due to rising debt and deficit levels, absence of reforms to curb spending, loss of central bank credibility to counter inflation, and sovereign ratings downgrades. It's not just emerging economies that are at risk here; advanced economies too have had their problems. The eurozone debt crisis (figure 4) of the last decade is a good example.

FIGURE 4

**Amid the eurozone debt crisis, bond yields spiked for debt-laden economies in 2010–2012**

Monthly average of secondary-market yields of government bonds with average maturity of 10 years (%)




Sources: Haver Analytics; Deloitte Services LP economic analysis.

It is also important to note that unlike in the previous crisis, central banks have likely expended much of their firepower this time around in trying to stimulate growth, provide liquidity, and complement fiscal measures. Any hint of central banks reversing their asset purchases program in the medium term will likely push up borrowing costs, as happened in the United States during the "taper tantrum" of 2013. So far, loose monetary policy hasn't been accompanied by inflation. That may change if commodity prices surge in 2021, both on increased demand as economies revive and due to US dollar weakness.

For emerging markets, attempts by policymakers in advanced economies to heal fiscal health and curb monetary expansion in the medium term may create problems for currency values in addition to cost of borrowing. In 2014–2017, when major central banks started rolling back years of asset purchases and low interest rates, liquidity flowed out of emerging markets. That had a significant impact on emerging market bond yields and currency values.[11] For example, in 2015, the Indonesian rupiah fell by 12.8% against the US dollar and the Malaysian ringgit by 19.3%; the following year, the Chinese yuan fell by 6.6% and the Indian rupee by 4.7%. While emerging economies' healthy foreign currency reserves moderated the impact in 2015–2017 and are likely to provide support in the near to medium term as well,[12] domestic economic fundamentals in these economies may likely not end up being as strong as in prepandemic years.

Low-income economies may also have to resort to external borrowing given their underdeveloped bond markets and limited access to market financing. Although these economies' external debt has reduced sharply since the 1990s, it has been edging up in recent years—from 25.7% of gross national income in 2015 to 32.9% in 2019.[13] Any surge in external borrowing due to the pandemic—and at a time when GDP and export growth has suffered—will add to the debt burden and servicing costs of these economies. While the G-20 group of countries has halted debt service payments for poor nations by extending the Debt Service Suspension Initiative till July 2021,[14] it may not be enough. Further sops, if not partial debt forgiveness, may be inevitable to prevent reversing years of economic, social, and political progress.

## Belling the fiscal cat won't be easy

So, what should governments do to tackle their high fiscal burden? At first glance, the easy prescription—cut spending or raise taxes, or perhaps a mix of both—may suffice. Yet, such a strategy may be too simplistic. Fiscal support to the economy is crucial in the near term, especially when economies are operating without some of their sectors, such as travel, hospitality, and food services, functioning at full capacity. Pulling the plug on support to such sectors and unemployed individuals may prevent an economic rebound transforming into a stable recovery. Beyond the near term, withdrawing support from vulnerable households, especially those with low income and minimal assets, will be problematic given that the pandemic has only increased the inequality.

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The situation will likely demand a dose of unorthodox measures in addition to traditional measures. For example, what some central banks may consider is to convert part of their holdings of government debt into zero-coupon perpetual bonds.[15] This may be an option for advanced economies like Japan[16] where the central bank accounts for a large share of government debt—the

Bank of Japan holds 40% of total government debt—and the economy faces deflationary pressures and demographic challenges to aggregate demand.

For others, especially emerging and developing economies, any form of deficit financing, however, may be a step too far. A more prudent approach would be to reform government finances by improving the taxation structure, including ease of paying taxes and widening the tax base. Such steps will not only raise revenues, but also enhance economic competitiveness and potential GDP growth, especially if they are coupled with a long-term plan to move spending away from current expenditure to more capital outlays.

Reforms, such as those in Brazil (including pension reforms) and in debt-burdened economies in the eurozone in the last decade, may serve as good examples of the need for reforms and the pitfalls of leaving it till late. It will, therefore, be beneficial for governments to get a fiscal reform plan in place sooner than later. Central banks have long learned the harsh lessons of falling behind the curve. Governments will do well to take a cue.

# Endnotes


1. Haver Analytics, accessed in January 2021. Unless otherwise stated, all data is sourced through Haver Analytics.
2. International Monetary Fund, *World Economic Outlook*, January 2021. The other estimates and forecasts provided in this section use the same source, unless otherwise stated.
3. The definition of advanced economies, emerging economies, and emerging and developing economies is as per the IMF definition. For more, refer to IMF. The words "economies" and "markets" are used interchangeably while referring to economic blocs.
4. World Health Organization, "Coronavirus disease (COVID-19): Herd immunity, lockdowns and COVID-19," December 31, 2020.
5. Johns Hopkins University, "COVID-19 dashboard by the Center for Systems Science and Engineering (CSSE) at Johns Hopkins University (JHU)," accessed January 12, 2021.
6. Akrur Barua and Monali Samaddar, *G7 economies: In an uncertain recovery*, Deloitte Insights, September 25, 2020.
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8. Daniel Bachman, *United States Economic Forecast: 4th Quarter 2020*, Deloitte Insights, December 16, 2020.
9. The fiscal package for the United States is based on calculations by the Deloitte US Economics team. For other countries, as discussed in this section, the figures are from the IMF's *Database of fiscal policy responses to COVID-19*, which is updated till October 2020.
10. IMF, *World Economic Outlook*. The other estimates and forecasts provided in this section use the same source, unless otherwise stated.
11. Rumki Majumdar and Akrur Barua, *Are emerging economies prepared as the global liquidity tap turns off?*, Deloitte Insights, March 13, 2018; Haver Analytics, accessed January 12, 2021.
12. International Financial Statistics, International Liquidity: Total Reserves and Gold, sourced through Haver Analytics on January 12, 2021.
13. The World Bank, "International debt statistics," sourced through Haver Analytics, January 12, 2021.
14. *Economist*, "Why securing debt forgiveness for poor countries is so hard," October 17, 2020.
15. Perpetual bonds have no redemption date and offer coupon payments to the lender; if there is no coupon payment involved, then such a perpetual bond translates to a zero-coupon perpetual bond.
16. Deloitte, *CFO Insights: Japan (Q3 2016)*, 2016; William Pesek, "BOJ's perpetual QE quandary," *Japan Times*, July 19, 2016.

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# Acknowledgments

The author would like to thank **Monali Samaddar** from the economics team for her research contributions for this article.

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