The Fiscal Impact of the Coronavirus Outbreak

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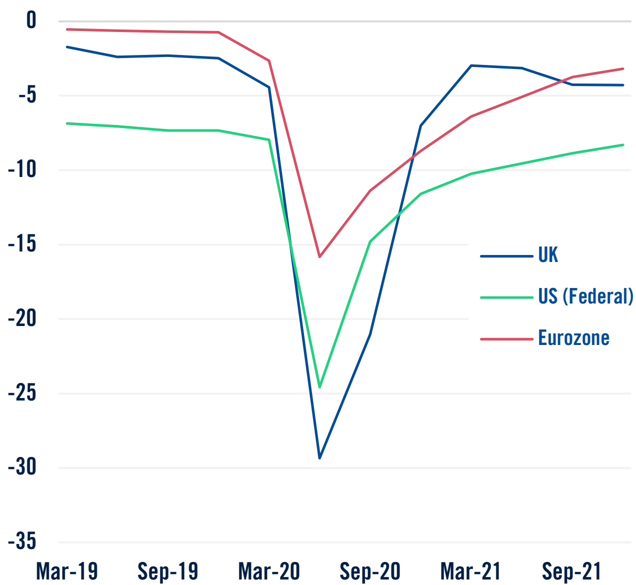
Budget deficits in advanced economies in 2020 are set to rise enormously due to the impact of the coronavirus and the policies deployed to tackle it. We forecast deficits of 11-15% of GDP this year, levels previously unseen outside wartime periods. Helped by massive quantitative easing, most economies will be able to finance these deficits easily and their bond yields look set to remain low. The resultant rise in and levels of government debt, while high, are also not extreme by historical standards. But there are still fiscal risks for some economies and medium-term dangers including high debt slowing growth and governments tightening fiscal policy too fast.

The coronavirus is set to have a massive impact on the world economy in 2020, with global GDP forecast to slump by 4.5%, a sharper decline even than during the global financial crisis. We also expect an enormous rise in budget deficits. For the US, UK, and Eurozone, we expect deficits in Q2 of about 15-30% of GDP see fig. 1.

Fig. 1: Budget Deficits

% OF GDP



Source: Oxford Economics / Haver Analytics

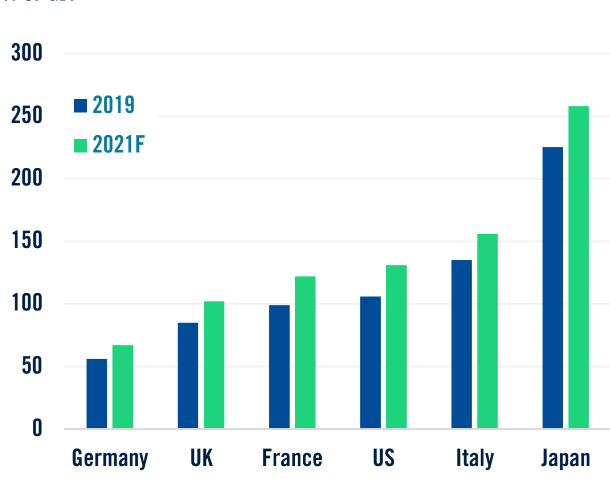
Budget deficits this year will be bloated by a sharp drop in revenues due to the weakness of economic activity and by the high costs of policies put in place to preserve the supply side of the economy. We estimate that for these three economies tax reliefs, special spending programs and wage and income support will account for around two-thirds of the rise in this year's deficit. Other elements will include assumed losses on government loan guarantees (which may be substantial) and the operation of 'automatic stabilisers' – reduced tax revenue and high social spending due to lower GDP and higher unemployment.

Even assuming a strong rebound in GDP from Q3 onwards, government deficits for all of 2020 are likely to be 11-15% of GDP. Such deficits are larger than after the global financial crisis (i.e. in 2009-2010) and have only previously been seen in wartime.

Will deficits on such a scale be financially destabilising? They will certainly lead to sharp rises in government debt ratios, of 20% of GDP or more in many economies by 2021 see fig. 2.

Fig. 2: Government Debt Increase

% OF GDP

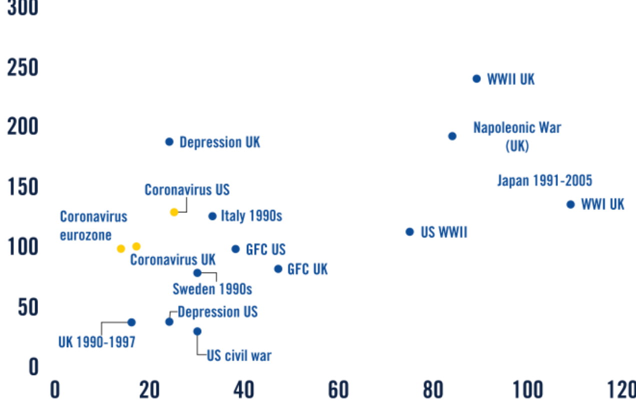


Source: Oxford Economics / Haver Analytics / Bank of England

However, neither the scale of the debt rises or the debt ratios that will result are unprecedented historically. UK debt levels were far higher after the Napoleonic wars, WWI, and WWII, while Japan has lived with debt levels over 200% of GDP for many years. Rises in the debt ratio were also bigger in the great depression see fig. 3.

Fig. 3: Historical Public Debt Buildups

PEAK DEBT LEVEL, % OF GDP

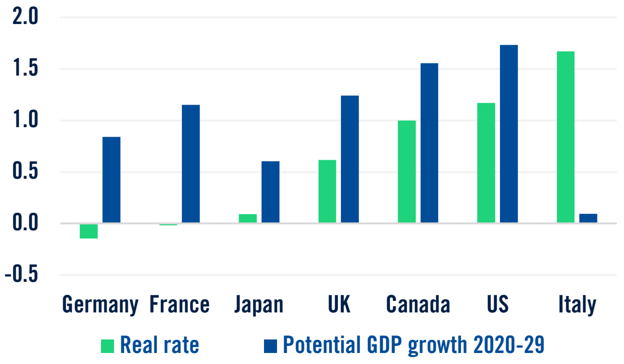


Source: Oxford Economics/Bank of England
Rise in debt, % of GDP

The larger advanced economies, at least, can also finance the needed borrowing in 2020-21 helped by high global demand for 'safe' government bonds, reserve currency status in the US, and large-scale quantitative easing (QE), which holds down borrowing costs. Indeed, we estimate government bond purchases by central banks this year will soar to US$3.5-4 trillion, enough to cover most of this year's government debt issuance in the US, UK, Eurozone, and Japan. Central banks will hold 20-40% of government debt by end-2020.

Due to these factors, borrowing costs for most of the G7 economies are very low. Government bond yields are negative in some places and average borrowing costs on outstanding debt are historically low as a share of GDP and well below potential growth rates see fig. 4. We think this situation is likely to continue, making dealing with the debt rise caused by the coronavirus outbreak easier. One partial exception to this is Italy, where borrowing costs are rather less favorable.

Fig 4: Real Interest Cost and Potential Growth



Source: Oxford Economics
Note: Real rate based on forecast average interest cost on government debt in 2020.

There are nevertheless still some risks associated with the big budget deficits and sharp debt rises we expect in 2020-2021. For economies without an independent central bank and lacking monetary credibility, holding down borrowing costs using QE is not an option. This especially applies to emerging economies.

It is also possible that high debt levels could negatively affect medium-term growth. Some studies suggest that as public debt ratios rise above 85-95% of GDP, growth suffers, with each 10% of GDP rise perhaps cutting long-term growth by 0.2% per year. On this basis, we might have cause for concern with around half of the largest advanced economies likely to have debt levels above this 'danger threshold' next year see table 1.

Table 1: Debt-to-GDP ratio

%

Consumer Items	2019	5yr change*	2021F
Japan	225	10	258
Italy	135	-1	156
US	106	2	131
France	99	4	122
Spain	95	-4	117
Canada	95	3	115
UK	85	-2	102
Germany	56	-12	67
Australia	45	8	65
Netherlands	49	-15	57
Sweden	49	-7	54
Korea	44	1	53
Switzerland	26	-4	32

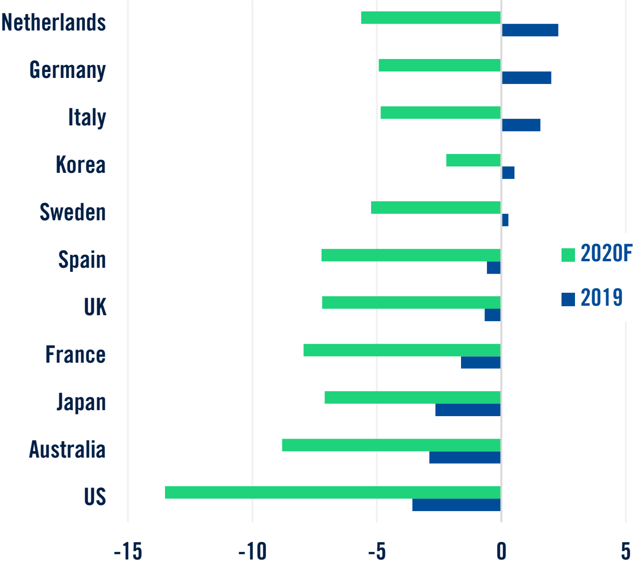
Source: Oxford Economics
*Average ratio 2019 minus average of 2014

However, several recent studies suggest the evidence for the existence of such a 'danger threshold' is weak, and instead point to the trajectory of debt being more important. This suggests that if coronavirus debt surges can be contained and debt ratios start to fall again quickly, the negative consequences ought to be modest. But how easy will this be? We note that for some economies such as Japan and France, debt ratios were already high and rising over the last five years. But other economies like Germany, the Netherlands, and Sweden have done much better.

Perhaps the biggest risk is that governments rush into austerity measures as the virus recedes. The temptation to embrace austerity is obvious. But with many economies running primary deficits even before the virus hit (see fig. 5), the scale of austerity needed to start quickly shrinking the debt ratio would be unpopular and possibly unsustainable. Moreover, it could harm growth to an extent that makes the austerity effort self-defeating. This risk is increased by the danger that the virus prompts firms and households to boost savings and cut spending over the medium-term, requiring fiscal policy settings to stay loose to hold up growth.

Fig. 5: Primary Budget Balances

% OF GDP



Source: Oxford Economics / IMF
*ex-interest

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