DISCUSSION PAPER

Financing the Pandemic:
The Political Economy of Rising Government Debt

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Introduction

It has been almost a year since the world first heard about the novel coronavirus that would become infamously known as Covid-19. Already at the onset of the pandemic, international financial institutions, most notably the International Monetary Fund (IMF), were warning against high levels of government debt around the world. After several rounds of lockdowns, which severely constrained economies around the world, government debt is at historically high levels and continues to rise at a rapid pace. According to the IMF, $2.6 to $3 trillion of government debt has to be serviced by the end of 2021. The IMF also projects that global economic output will contract by 4.4% in 2020 (IMF, 2020). These two trends, rising debt levels and plummeting growth, are laying the groundwork in many countries for a major fiscal collapse. This paper discusses the political economy of high and rising government debt around the world in the context of Covid-19 pandemic.

To slow the spread of Covid-19, governments around the world have enacted radical measures, including closures, limitations on movement, and total lockdowns. In this environment, governments have extended massive financial support packages to both households and firms to reduce human suffering and keep businesses afloat. The costs have been massive. Simultaneously, tax revenues collapsed because both production and consumption levels have declined dramatically. The widening deficit between rising government spending and declining tax revenues has been financed via growing government debt. While necessary to mitigate the shock in the short run, debt-financed government spending is not feasible in the long-term. Given the uncertainty about the pandemic's trajectory, there are well-founded fears that we may be facing a global fiscal crisis in the near future. The weakest governments may soon start to default on their debts, creating a domino effect across global economies.

Although it affects all countries, the pandemic's injurious effect on fiscal balance is not symmetrical the world over. Developing and emerging market economies are impacted more than rich developed economies because, unlike developed countries, which can borrow and trade in their own currency, developing countries' spending is largely limited by their access to external loans denominated in foreign currencies. Moreover, most developing countries already had very high levels of debt at the beginning of the pandemic. Now, developing country debt along with repayment costs (interest payments) are rising exponentially. Unless these trends change quickly, a series of defaults in the developing world seem unavoidable. This could lead to another 'lost decade' for developing countries, similar to the experience of the 1980s. This would mean millions of people falling into poverty and 30 years of poverty reduction in the developing world lost.

One potential way to avoid a worst-case-scenario is radical debt relief for the world's poorest countries, many of which are on an unsustainable trajectory in terms of their debt liabilities. Because tax revenues are in free fall and export earnings have seriously declined, many developing countries will not be able to revolve their debts unless they are suspended or written down. This has serious implications, particularly amid a global pandemic. Losing access to foreign sources of funding would potentially entail a drastic increase in both economic and human damage in many of these countries. Given this, several very influential economists have put forth the case for debt restructuring by multilateral institutions and private creditors. The IMF, G20, and the World Bank have already taken action in this regard, however, measures taken thus far have not matched what is needed to put these countries on a stable path.

This paper advances the idea that the pandemic has been a seismic event for government economic policies around the world. Even after the pandemic is brought under control, its consequences are likely to have a major long-term impact on issues ranging from government fiscal behaviour to international borrowing and trade. Moreover, rising government debt will serve to tilt the economic balance between developed and developing countries in favour of the former due to the fact that developed economies have much wider fiscal flexibility than developing countries. However, in the case of a catastrophic economic downturn in developing countries, such as another lost decade of economic growth, there may be damaging side effects for developed countries as well. Unless developed economies act quickly and boldly to alleviate the debt burden of developing countries, the potential for a total collapse in international finance and trade will substantially increase. This may also lead to a new wave of migration towards developed countries, with significant implications for domestic politics in these countries.

A Debt Pandemic

Since the beginning of the pandemic, governments around the world have imposed stringent measures to contain and mitigate the impact of Covid-19. In the process, millions of businesses have been shut down, unemployment has soared, and those who are fortunate enough to continue working have been forced to work from home. In this environment, governments have extended financial support to businesses to keep them afloat and avoid a total economic collapse, while supporting households through various measures including cash transfers, subsidised credits, and increased services (Basbay, 2020a). All these measures have meant increased government spending. Moreover, to tackle the pandemic, health systems had to be strengthened, putting even more strain on government budgets. Alongside this considerable expansion in government spending, tax revenues have effectively collapsed because taxable economic activities both in production and consumption have drastically declined.

It should be noted that when the pandemic started, most governments around the world were already sitting on large amounts of debt, accumulated in the aftermath of the 2008 global financial crisis. For a long time, as part of what economists call a 'quantitative easing', interest rates have been kept very low and central banks have provided large amounts of liquidity to financial markets. While there were discussions among analysts and policymakers on how to revert this trend, the global economy is now facing yet another round of quantitative easing and excessive borrowing. Yet, this time monetary expansion has been combined with a fiscal expansion. As pandemic-related economic and human costs increased, governments have been forced to borrow more and more in order to keep helping their citizens and boost health systems overwhelmed by Covid-19.

As the pandemic is not over, most governments are continuing to support millions of families and businesses. No one really knows how long it will take, but unless an effective vaccine or treatment is made available at a large scale and economic activities recover quickly, most economies will not be able to maintain their current spending measures without borrowing at exponentially rising rates, if they are able. According to IMF estimates, in developed economies, government debt to GDP ratio will increase by 20% and reach 125% by the end of 2021. What this means is that government debt in these countries will be on average considerably higher than the annual value of goods and services produced. In developing and emerging economies, it will increase by around 10% and reach 65% of GDP, which is also very high considering that base income levels are quite low in these economies (IMF, 2020).

Table 1: **Government Debt to GDP ratio - 2020 or latest**

DEVELOPING COUNTRIES		DEVELOPED COUNTRIES	
NIGERIA	18.2	AUSTRALIA	34.7
BANGLADESH	21.2	SWEDEN	37.7
SAUDI ARABIA	29.5	SOUTH KOREA	39.9
CHILE	32.5	NORWAY	40.4
INDONESIA	33.5	DENMARK	41.4
THAILAND	39.2	CANADA	53.3
TURKEY	39.4	NETHERLANDS	55.2
UKRAINE	51.2	ISRAEL	58.4
INDIA	52.7	GERMANY	67.4
VIETNAM	54.3	AUSTRIA	82.6
MEXICO	54.6	EU AVERAGE	87.8
POLAND	55	UNITED KINGDOM	96.6
MALAYSIA	59	SPAIN	110.2
EGYPT	65.4	FRANCE	114.1
SOUTH AFRICA	69.4	UNITED STATES	125.5
PAKISTAN	83.3	ITALY	149.5
BRAZIL	85.6	GREECE	187.4
ARGENTINA	91.7	JAPAN	214.4

Source: CEIC

Even in rich developed economies, worries are growing that governments may not be able to keep spending at the current rates. As the level of the UK government's debt reached 2 trillion pounds for the first time since the World War II, UK Finance minister Rishi Sunak explained that current government subsidies cannot be sustained for long: "Today's figures are a stark reminder that we must return our public finances to a sustainable footing over time, which will require taking difficult decisions" (Giles, 2020). In the US, the Senate used its powers to the fullest extent and spent massively, adding a total of $4 trillion to central government debt since the pandemic started. US government debt has now surpassed $27 trillion, amounting to 125% of the GDP (CEIC, 2020; Trading Economics, 2020). This is the highest debt-to-GDP ratio the US has seen since World War II. For comparison, at the onset of the 2008 global financial crisis, this figure was less than $10 trillion.

The situation is not very different in other major economies, including the EU and Japan. When the pandemic started, EU economies were still recovering from the European debt crisis of 2010. Currently, the debt-to-GDP ratio stands at 87.8%, however, some members of the Union are in a more challenging position. Southern countries in particular that were most affected by the 2010 crisis, including Greece, Italy, Spain and Portugal, still have a lot of debt and very limited fiscal capacity. EU members have agreed to a fiscal liquidity support package, which amounts to 13% of the Euro Area GDP and favours fiscally weaker members, however, the pandemic is still having an asymmetric effect on member-states. According to analysts, this divergence in growth performance, due to differing fiscal capacities, creates political and social tension between member states (Fleming & Arnold, 2020). In Japan too, government debt has broken a new record and reached more than 200% of the GDP (CEIC, 2020). In fact, Japan has had the highest debt-to-GDP ratio in the world for quite some time.

High debt ratios cause much bigger problems for developing countries and emerging market economies. Unlike developed economies, developing countries usually have to borrow from abroad, which also comes with balance of payment problems. To keep businesses afloat and households safe, governments continue spending at the expense of ever-growing external debts denominated in foreign currencies. Furthermore, developing countries are expected to experience a 20% decline in remittances from citizens living abroad and a major decline in export revenues, putting more pressure on their balance of payments with the rest of the world (UNCTAD 2020; Bulow et al., 2020). In such a case, many developing countries will be compelled to take additional loans at higher and higher costs, finding themselves in a debt spiral.

So far, the initial shock of the pandemic has not led to a full-fledged debt crisis thanks to the favourable environment of low-interest rates. However, if foreign creditors start to sense that countries' debt levels are becoming larger than their repayment capacity, they may become reluctant to lend further, at least not at similar rates (Clements et al. 2003; Bhattacharya & Clements, 2004). Given that economic activities have been slowed, if not halted, by pandemic mitigation strategies, severely limiting tax revenues, these countries are being driven into a vicious cycle. They will continue borrowing, which will make them riskier countries and increase interest rates, which in turn makes it even more difficult to service debts and revolve loans (Pfeffermann, 1985). This type of vicious cycle invariably leads to a 'debt crisis'. As default rates are rising, unless there is a serious attempt to restructure debts, a total reckoning seems increasingly likely. These countries will have to make a difficult decision between lowering public spending when their citizens need it most or defaulting on their loans.

Even if a complete recovery takes place within a reasonably short period, many agree that the repercussion of exponentially growing government debt will be felt for years to come. Reinhart and Rogoff (2009) argue that it is a rule rather than an exception that after such dramatic increases in debt levels, financial crisis follows, as it did 89 times before between 1827 and 2002. If another debt crisis ensues, this will have important implications for government fiscal behaviour. According to some, this could mark the end of neoliberal austerity and the beginning of a new Keynesian age in developed economies. Namely, governments will begin to tax and spend more and claim a larger role in the economy (Basbay, 2020b). Of course, for poor developing economies, where increasing tax revenues and government spending is not much of an option. The implications of this include increased poverty and less government capacity.

The Growing Divergence Between the Developed and the Developing World

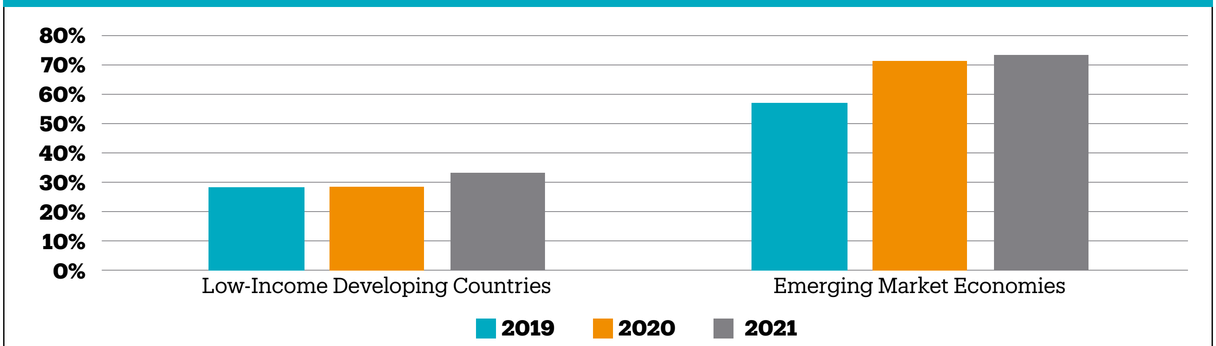
According to Martin Wolf, Chief Economics Commentator at the Financial Times, the Covid-19 crisis underlines "the most fundamental macroeconomic inequality between countries" (Wolf, 2020). At least in the short to medium-term, developed countries can spend whatever they want, run huge deficits and accumulate debt at exponential rates because their currencies are internationally acceptable, whereas developing countries do not have these options. Governments in developed countries can simply issue more bonds and sell them to their own central banks, which in turn creates the necessary liquidity to finance expanding government spending during the pandemic, or any economic downturn, with few limitations. In the case of the US, this is even more salient because the US dollar is the world's most commonly used currency, held by central banks around the world in vast amounts as a reserve currency. This is the so-called 'exorbitant privilege' of the US.

The US has quickly added $3 trillion to the Federal Reserve's balance sheet, which already stood at $2.8 trillion prior to the pandemic (U.S. Department of the Treasury, 2020). Similarly, the balance sheet of the European Central Bank has accumulated 2 trillion euros since the pandemic started and reached almost 7 trillion euros by October. This amounts to around 60% of the European Union's GDP. Note that in the aftermath of the global financial crisis between 2008 and 2018, this figure rose from 10% to 40%, but it took the pandemic to realise nearly the same increase in only 7 months (European Central Bank, 2020; Piketty, 2020). In Japan, the Central Bank's balance sheet has swollen by almost 20% since last February. The Bank of Japan has already been dominating the country's financial markets, which is why the current trends in other major economies are called the "Japanification of world finance". The central bank's assets have now reached the equivalent of 137% of gross domestic product (Trading Economics, 2020).

Developing countries, however, do not have this privilege. Their capacity to use a similar mechanism to finance spending is limited in the short run and non-existent in the long run. Unlike developed economies, they do not have the luxury of issuing more currency to finance increased spending. Any attempt to boost spending through such a money creating mechanism would quickly lead to hyperinflation. Unlike developed economies, they are not immune to defaulting on their debts or balance of payment problems, primarily because their currencies are not internationally acceptable and cannot be used in international trade. To increase their spending capacity, governments in developing countries have to take loans from abroad denominated in foreign currencies. In a major economic crisis such as the one brought on by the pandemic, this has significant implications.

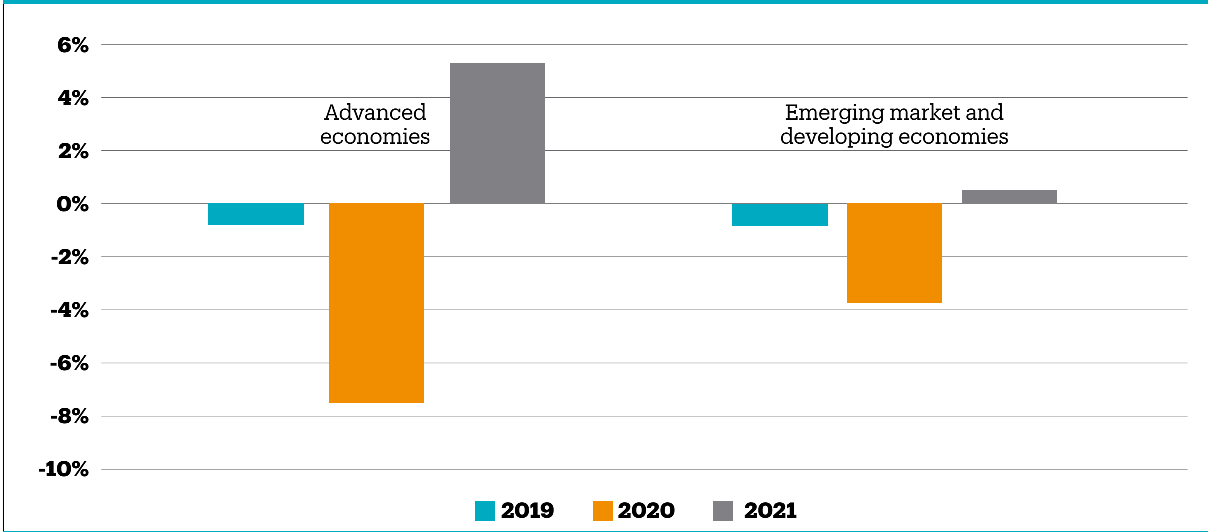
It is more than likely that many developing and emerging economies will find themselves in default in the near future due to rising repayment costs. So far, they have avoided a financial collapse mostly due to favourable conditions in the global money markets. Interest rates are low and developed countries' central banks continue flooding the global economy with liquidity. Needless to say, these loans are denominated in dollars or other major developed country currencies, so developing countries will have to acquire more foreign exchange in order to be able to pay back these debts. However, due to the pandemic, international trade has also deteriorated. According to UNCTAD (2020), developing country exports dropped by 18% in the second quarter of 2020, and as many developed countries are fast entering a second round of Covid-19 lockdowns, demand for developing countries' exports will probably take another hit. As a result, developing countries are facing serious pressure on their foreign currency earnings at the same time their debt repayment costs are increasing.

Table 2: **Public Debt Service Costs** *(Principal payment + interest) / Government Tax Revenue*



Source: IMF 2020

Table 3: **Change in structural primary fiscal balance, % of potential GDP**



Source: IMF 2020

There is a fear that we are seeing a replay of the 1980s when steadily rising public debt levels in Latin America led to a major economic downturn in developing and emerging market economies. After government debt became unmanageable, reaching as high as 50% of the region's GDP in 1982, it became clear that Latin American countries, including major economies such as Brazil, Mexico and Argentina, were no longer able to service their debts. Ultimately, sixteen Latin American countries rescheduled their debts and fell into a deep recession which lasted for almost a decade. As a result, all real wages dropped by 20% to 40% (Devlin and French-Davis 1995; FDIC, 1997). The situation also affected other developing countries in Africa and South-East Asia, leading to the so-called 'lost decade'.

If developing countries default on their debts, this may lead to another spiral of increasing unemployment and rising poverty globally. Such a scenario would erase the achievements of the last 30 years in reducing global poverty and fuel instability and violence in the poorest parts of the world. This could also lead to another big wave of migration towards rich developed countries. After the so-called migration crisis of 2015-16, politics in Europe and North America are already strained due to the rise of far-right politics, xenophobia, and racism. Another migration crisis caused by a serious economic collapse in developing countries would be pouring fuel on the fire. So, in many ways, the pandemic has far-reaching consequences.

(Vural Elibol - Anadolu Agency)

Ways Forward: Debt Relief?

Access to credit has proven to be crucial for integration into world trade and finance. When it is managed well, credit puts developing countries on a faster development path through higher investment and faster growth (Rao, 2001). Access to borrowing is especially important during the pandemic because these countries need to continue spending on health care, which may be critical for mitigating health consequences of the pandemic, and on supporting their citizens and firms in order to limit economic damage. In other words, for developing countries, consequences of a debt crisis or a cessation in credit flow go beyond short-term financial considerations; Covid-19 has the potential to wreak havoc across more than 100 low- and middle-income countries, leaving serious human, economic and social damage in its wake if capital flow to these economies ceases.

According to many economists, the current situation calls for creditors to consider debt relief or a major restructuring of developing country debts. Already in March, after the UN called upon creditors to consider debt relief for the world's poorest economies, the IMF suspended debt service of 25 African countries for the year. G20 countries have followed suit and announced a debt service suspension initiative (DSSI), which was extended in October until mid-2021. Along with a debt moratorium, both the G20 and the IMF extended new credit lines to poor developing countries. In the first six months of 2020, the IMF issued $124 billion in new loans (Stiglitz & Rashid, 2020). However, private creditors have been less enthusiastic about debt structuring. Given the current trends, developed countries probably need to further write down or restructure a substantial amount of debt, especially in the private sector, so developing countries can continue borrowing more from the international community.

One common objection to debt relief is that it may be rewarding and reinforcing irresponsible behaviour by governments. When there is a perception that rising public debt is caused by reckless policies (for instance, by populist government spending), creditors usually refrain from debt relief with the view that such policies usually feed into 'moral hazard' problems in the future. Namely, that governments in developing countries may continue to spend expecting similar relief in the future. However, Covid-19 is obviously not developing countries' fault; nor do they have many options other than increased borrowing. These countries are failing to repay their debts, not because of populist consumption or mismanagement of investments, but because of the pandemic, which they did not cause. This does not change the consequences of the rising debt ratio, however, it may lead developed countries to change their approach to debt relief. The current situation has been exacerbated by reasons that are beyond their control, so there is hardly a case against debt relief due to moral hazard.

On 13 November, the G20 will come together in an extraordinary meeting to discuss a framework for tackling the mounting debt problem of low-income countries. They are expected to write down or restructure a substantial amount of debt owed by the least developed economies. In the last meeting, they decided to work on a debt structuring scheme on a case-by-case basis; namely, those countries that are facing the most debt stress will be helped first. However, there are major divisions between creditor countries. China, in particular, has so far refused to write down government debts (Shalal, 2020).

Needless to say, a debt suspension is unlikely to solve the long-term problems of developing countries. Facing a Covid-19-related contraction, most such economies have no option but to continue spending foreign funds on the immediate needs of their economies rather than well-paying long-term investments (e.g. human capital, infrastructure) or improvements in overall production capacity. In other words, newly extended loans do not create payment capacity so it is very likely that these countries will ultimately struggle to pay their debts. Moreover, these countries already had very high levels of debt at the onset of the pandemic, and debt servicing as share of GDP had been steadily increasing for a while. Increasing instability and unpredictability due to the pandemic will gradually translate into higher interest rates in developing economies, and thus a higher cost of revolving already heightened debt levels.

Nevertheless, to reverse this trend, developing countries must stabilise their economies so that they can reduce the cost of borrowing before engaging with long-term reforms to reduce debt levels. So, debt relief is still very helpful and important. Of course, the nature of the debt relief is also very important. According to Stiglitz and Rashid (2020), poor restructuring will cause nothing but another and potentially deeper financial crisis in the near future, as was the case before with Argentina and Turkey, both of which suffered even deeper crises after IMF-supervised debt structuring schemes achieved nothing more than short-lived relief. Therefore, developing country debts should be restructured in a way that would not only avoid a possible derailing of financial markets in the short run but also put these economies on a more stable long-term trajectory. This requires taking radical measures aimed at taking government debt under control.

At a recent event, the chief economist of World Bank, Carmen Reinhart said that developed countries should "be bold" about debt structuring if they want to avoid another lost decade. Reinhart believes that a debt suspension would ultimately achieve little; instead, developed countries should consider a debt write-off. She also points to the fact that the rights of creditors are much better represented than those of debtors (Reinhart, 2020). According to Stiglitz and Rashid (2020), one effective way to avoid a debt crisis is sovereign debt buybacks. They propose a mechanism through which the IMF can buy developing countries' debt holdings from private creditors through auction, which should reduce the amount of debt these countries owe because creditors normally prefer safe payment from the IMF over a risky future payment from the debtor countries even if the former comes with a discount on the face value of the debt. In return, debtor countries will be required to commit to employment-generating investments at home. According to Stiglitz and Rachid (2020), such a scheme would put countries on a sustainable path by reducing debt and boosting growth at the same time, without punishing creditors.

Conclusion

As should be apparent by now, economies around the world, especially developing countries, are going through a severe stress test. Massive fiscal spending to keep economies afloat under pandemic restrictions combined with declining tax revenues have translated into increasing debt burden while also making it more difficult to service already accumulated debt. Following the 2008 global financial crisis, the Covid-19 pandemic marks another episode of quantitative easing and rising debt rate around the world, while many countries still sit on government debts accumulated during the 2008 crisis. Even in developed economies, governments are looking for ways out of the current situation. The current situation may lead to a transformation of the government's role in the economy, particularly in developed economies. For example, we may see more proactive governments with larger budgets and more involvement in the economy, marking a return to the Keynesian policies of the post-World War 2 period.

In developing countries and emerging market economies, the Covid-19 pandemic has deepened imbalances dramatically. Governments in developed economies have the option of expanding their spending with little limitation in the short run, because their currencies are acceptable internationally, whereas developing economies are unlikely to withstand a second shutdown, except for the ones with a strong liquidity position, a rare occurrence. Developing countries will be forced to either default on their debts or reduce government spending on services and poverty alleviation when their citizens need it most. It is possible that these countries, especially in Sub-Saharan Africa and Latin America, will face another 'lost decade'. Such a scenario would mean that serious achievements in poverty reduction in the poorest parts of the world in recent decades will be lost. Until we reach some degree of economic equilibrium post-pandemic, these economies will continue to need access to foreign funds.

Economists in academia and policy circles claim that a radical debt structuring is necessary to avoid a catastrophic situation in the developing world. Needless to say, debt relief does not solve the problems of these economies in the long-run but may give them enough space to restructure their respective economies. Given the conditions, this may be imperative not only for reducing suffering in poor economies but also to avoid adverse effect in developed economies. This is because mass poverty in the developing world can imply a global recession or at least a partial fall in international trade and finance. Not to mention, mass suffering in developing countries may trigger another wave of migration towards richer parts of the world in the global north. It seems to be in the benefit of all to save developing economies from ever-increasing debt in order to avoid anaemic low global income growth as well as political and social instability.

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