



# Six Risks to the Post-Coronavirus Recovery

Policymakers face obstacles in getting the economy back on track.

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## KEY INSIGHTS

- Once the initial post-lockdown economic surge has abated, the global economy faces six key risks to its long-term recovery.
- These include a second wave of the coronavirus, deteriorating U.S.-China relations, and defaults in the U.S. nonfinancial corporate sector.
- Other risks include fiscal consolidation in developed markets, a fiscal crisis in emerging markets, and another eurozone debt crisis.



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The easing of the coronavirus lockdowns has led to a resurgence of global economic activity in recent weeks. However, many businesses will not be able to continue after suffering major revenue losses, and millions of workers have lost their jobs. Will this resurgence turn into a durable economic recovery, or will the post-lockdown green shoots wither and die?

Historically, following a recession it takes, on average, six quarters for gross domestic product (GDP) to reach its pre-recession level. The size of the economic shock and the unique circumstances of the current recession suggest that it will take a little longer this time. We believe that there are six key risks that present acute challenges to the economic recovery. These are:

1. A second wave of the coronavirus
2. Flaring up of U.S.-China tensions

3. A wave of defaults in the U.S. nonfinancial corporate sector
4. Fiscal consolidation in developed markets
5. A fiscal crisis in emerging markets
6. A resurgence in populism that leads to another eurozone debt crisis

Below, we discuss these risks and assess the threat each poses to the global economic recovery.

### **A Second Wave of the Coronavirus**

Most, if not all, countries in the world are far from the threshold of contagion that would ensure herd immunity, and it may take a while to produce a vaccine for COVID-19 (the disease caused by the coronavirus), despite positive developments in that area. Against this backdrop, the key question becomes whether common sense social distancing will allow us to reopen our economies

“Common sense social distancing will be a drag on economic growth...”

without driving up the reproductive rate of the virus. The experiences of South Korea and Singapore, and early indications from Europe, provide some hope that this may be possible. If it is possible for countries to reopen most sectors of their economies without triggering a serious second wave of contagion, the global economic recovery will, most likely, continue.

Common sense social distancing will be a drag on economic growth as it prevents certain sectors, in particular the hospitality industry, from operating at pre-crisis levels of capacity. However, this is still a much better outcome than a second lockdown, which would result in a double-dip recession. The key question is whether it will be possible for people to function as economic agents until a vaccine is discovered.

#### **U.S.-China Tensions**

The U.S. presidential election is looming, and China is portrayed as a villain by both the Republicans and the Democrats. The core tensions in the U.S.-China relationship are structural: Since it was founded, the U.S. has positioned itself the defender of freedom and has fought wars with the justification that it seeks to protect democracy anywhere in the world. China is an authoritarian regime without democratic accountability that seeks to make the world safer for authoritarian regimes.

The U.S. has tried to integrate China into the global economy in the hope that, over time, growing prosperity will encourage its citizens to demand more democracy. However, it is now clear to everybody in the U.S. policy apparatus that this effort has failed. At the same time, China is getting ahead in the technology race, which means the U.S. faces a more formidable challenge from a competing governance system than it ever did from the Soviet Union.

Uncertainties over the future of U.S.-China relations, the pressure to

relocate supply chains, and restrictions on the export of technology and other trade are headwinds to growth and risks to the recovery. Friction in the relationship has clearly escalated over the past months, with a tightening of the controls on technology exports and the introduction of the National Security Law in Hong Kong. There will be plenty of noise ahead of November's presidential election, and it remains possible that President Donald Trump could withdraw from the phase I trade deal to galvanize political support. On balance, we believe that the phase I trade deal will survive, but with diminishing conviction. Risks of other missteps are aplenty, with great sensitivity around Hong Kong- and Taiwan-related issues.

#### **U.S. Nonfinancial Corporate Defaults**

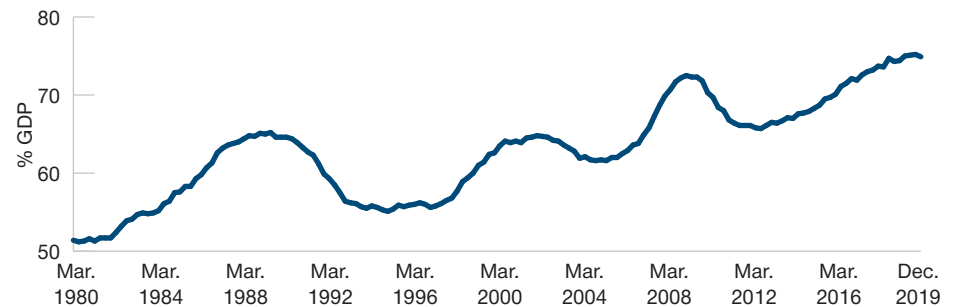
U.S. nonfinancial corporates (NFCs) have taken on a substantial amount of debt in recent years. According to the Federal Reserve, the debt of the NFC sector has risen from 66% of GDP in 2012 to 75% of GDP in 2019. The re-leveraging of nonfinancial corporate balance sheets has, interestingly, not been associated with a major capex boom. As such, the increase in leverage appears to indicate financial engineering (leveraging of earnings, increased dividend payments, mergers and acquisitions) rather than the accumulation of a macro imbalance in need of a recessionary purge. The rise in leverage is partly a response to a reduction in the cost of debt and partly just a reflection of the traditional rhythm of the business cycle: As the cycle matures and profit margins come under pressure, earnings are leveraged more aggressively to generate shareholder returns.

This raises the question of whether a tsunami of corporate defaults is likely to wash over the economy, causing significant losses to the balance sheets of leveraged financial intermediaries. We are less concerned about this than the consensus view, for three reasons: First, the debt has been assumed at very low interest rates, which keeps the cost of

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## U.S. Nonfinancial Corporate Debt Has Surged in Recent Years

(Fig. 1) It is now around 75% of GDP



As of December 31, 2019.

Source: International Monetary Fund.

servicing the debt at a surmountable level; second, the U.S. government has provided a lot of support for the sector through the USD 660 billion Paycheck Protection Program; and third, the balance sheets of leveraged financial intermediaries are, in part due to financial regulation, in a much better position than they were prior to the global financial crisis. Based on the low cost of servicing the debt and the absence of a capex boom, our internal models point to a default rate for the U.S. high yield sector in the 7%–9% range. Of course, should the economy be hit by another shock, such as a second lockdown, all bets are off—no company survives without revenues.

### Fiscal Consolidation in Developed Economies

Governments have taken significant steps to support their economies during the crisis. The fiscal deficit of the average developed economy is projected to be around 7.2% of GDP in 2020,<sup>1</sup> compared with a peak of 6% of GDP during the 2007–2008 global financial crisis. This potential increase in the fiscal deficit will lead to a sharp rise in the debt stock. Most developed market economies have the institutional infrastructure to monetize the deficits

through quantitative easing, and in most cases the stock of debt will never be reduced—countries will simply “grow out of it.” For this reason, we are not overly concerned about the ballooning debt stocks in the developed economies.

A more pressing issue is whether economic growth will be sufficiently resilient to withstand the headwind that follows when countries inevitably embark on fiscal consolidation (policies aimed at reducing deficits and debt accumulation). We believe that fiscal consolidation will follow a similar path to that seen during the global financial crisis, when temporary measures were extended as far as possible before being phased out slowly. On the eve of the coronavirus shock there were few real economy imbalances, so it is likely that if fiscal consolidation is paced appropriately, growth can withstand the headwind from the fiscal tightening. If, however, policymakers come under pressure to reduce deficits more quickly, there is the potential for missteps.

### A Fiscal Crisis in Emerging Economies

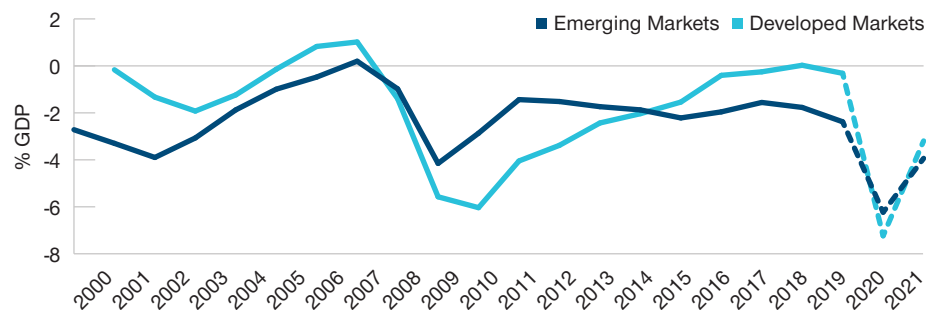
Although we remain relatively calm about ballooning debt stocks and the financing of fiscal deficits in the developed economies, we are more concerned about the fiscal trajectory of the emerging

<sup>1</sup>Source: IMF World Economic Outlook Update, June 2020.

South Africa and Brazil are among the emerging market countries at risk of fiscal crises.

## Developed and Emerging Markets Face 2021 Deficit Reduction

(Fig. 2) Emerging markets' weaker infrastructures will make it more painful



As of April 15, 2020.

2020 and 2021 deficit figures are projections from the IMF World Economic Outlook report.

The developed markets included in the calculation were the United States, United Kingdom, Austria, Belgium, Denmark, France, Germany, Italy, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, Canada, Japan, Finland, Greece, Iceland, Ireland, Malta, Portugal, Spain, Australia, and New Zealand. The emerging markets included in our calculation were Turkey, South Africa, Brazil, Chile, Colombia, Mexico, Peru, Israel, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, Russia, China, Ukraine, Czech Republic, Slovak Republic, Poland, and Romania.

Source: Bank of International Settlements.

economies. Developed economies can, to a large extent, monetize their deficits because they benefit from strong institutional infrastructures that anchor money demand (a ballooning fiscal deficit in the United States is unlikely to lead to a run on the U.S. dollar). Most emerging market economies are plagued by weaker institutional infrastructures, reducing their capacity to shoulder fiscal deficits.

The combination of (too) large fiscal deficits and a reliance on monetization raises the possibility that the fiscal experiment in the emerging economies will end with currency runs and, in particularly grave cases, to an inability to finance the debt stock. In addition to a large fiscal deficit, the countries that are particularly exposed find themselves reliant on external financing, i.e., with a current account deficit. A reliance on external finance is inherently a more fragile arrangement than financing debt domestically.

South Africa and Brazil are among the emerging market countries at risk of fiscal crises. South Africa has a soaring fiscal deficit, a current account deficit, and a high stock of debt—a risky

combination—especially for an economy that has been struggling for years to contain a much smaller fiscal deficit than the one they entertain today. In addition, the pressing need to deliver a future fiscal consolidation interacts with a fragile political environment: President Cyril Ramaphosa, the lone reformer in the government, is constantly under attack from the opposition. A brutal fiscal consolidation is likely to leave Ramaphosa increasingly vulnerable to political challenges, and anything that undermines Ramaphosa undermines investor confidence.

Brazil also has a high debt stock and a large fiscal deficit, but its current account deficit is relatively small and well financed. Relative to South Africa, the government in Brazil has a real drive to reform the economy. However, its history of high inflation means that inflation expectations in Brazil, and by extension the Brazilian real, are much less stable than in many other economies. This is problematic as the central bank is likely to rely on balance sheet expansion to finance part of the fiscal deficit. The risk in Brazil is that local investors, to preserve purchasing power of their

“...It is difficult to explain to electorates that they must pay to generate employment in another country...”

savings, could try to convert their local currency assets into foreign currencies, thereby causing a run on the real.

Other countries at risk include Turkey, which already underwent a significant adjustment during its economic crisis in 2018. Turkey remains vulnerable due to an unorthodox management of the economy, a high level of foreign indebtedness, and limited external buffers. Colombia also appears vulnerable as the combination of a large fiscal deficit, a wide current account deficit, and adverse terms of trade shock has left it dependent on external financing.

Non-China emerging markets account for 21% of global GDP. This means that while a fiscal crisis in emerging market economies would hurt the global economy, its impact would likely be manageable. The unique circumstances of each emerging market country will also create idiosyncratic opportunities.



### Another Eurozone Crisis

Southern eurozone countries have experienced a decade of depressed growth, which has left their populations frustrated and angry. The promise that being part of a single currency would bring prosperity has not been met, which has energized populist policymakers as electorates have demanded greater state support and fiscal transfers from the financially stronger members of the eurozone.

The economic damage caused by the current crisis is likely to only further strengthen the populists' cause. Although southern European governments are clearly not to blame for the virus itself, their lack of fiscal freedom, which frustrates their ability to respond

effectively to the crisis, is of their own making. This presents a challenge to other members of the eurozone, which have their own challenging domestic situations to deal with: It is difficult to explain to electorates that they must pay to generate employment in another country when there are not enough jobs at home. When that other country is run by a populist, it becomes even more difficult.

The EUR 750 billion Franco-German Recovery Fund is an attempt to deliver enough fiscal solidarity to quell the populist surge, but whether it succeeds remains to be seen. The devil is in the details, and we worry that the EU will become embroiled in a discussion over what poorer member states need to deliver in return for receiving loans and transfers. We are encouraged by the steps toward pan-EU fiscal solidarity, but we remain skeptical that we have seen the end of populist policymakers. I believe voters in financially challenged eurozone countries can, after a decade of abysmal growth, look forward to another decade of scarce opportunities—hardly the bedrock of a stable political environment.

### Policymakers Face Major Challenges

After the initial post-lockdown surge in economic activity wanes, a truer picture of the health of the global economy—and how long the recovery should take—will begin to emerge. The risks to this recovery are numerous. Even if none of the risks described above succeeds in derailing the recovery by itself, each of them, and their interaction, will provide headwinds and challenges to governments determined to keep the recovery on track. How politicians and policymakers respond to these challenges will be one of the defining themes of the next few years.



## **WHAT WE'RE WATCHING NEXT**

The two biggest risks on our list are a second wave of the virus and a flare-up in U.S.-China tensions. We believe countries that ease lockdowns will inevitably see some uptick in infections—the question is whether those upticks will be controlled or uncontrolled. We will be watching closely for any evidence either way. Regarding U.S.-China relations, the key question is how President Trump will respond if he continues to lag former Vice President Joe Biden in the polls—and specifically whether he chooses to position himself as tougher on China in order to galvanize support.

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