The debt burden of the COVID-19 crisis

The COVID-19 pandemic has shaken us to the core and has become a major part of our lives. It has changed our habits and altered the world we live in. From the small to the big: from replacing football or the weather as an informal (and formal) conversation topic to plunging the global economy into the worst recession in modern times. The COVID-19 crisis will also shape the world of the future. In these pages we have discussed teleworking, digitalisation and international trade.[1] Another of its legacies will be a large sack of debt. How much will it weigh and how will it dictate our lives in tomorrow's world? We will explore these questions in the following pages of this Dossier, but first, let us begin with the data.

Size, scope and speed

Faced with an exceptional blow, the rise in debt will also be exceptional: in size, speed and scope. The public sector will absorb the bulk of the increase, due to its capacity to borrow more and under better conditions (lower interest rates and longer maturities). As the table shows, this borrowing will push public debt up to almost unprecedented levels (the only historical precedents are closely linked to major wars).[2] Furthermore, the increase will be extremely sudden. For instance, Italy and Spain are expected to experience a surge in debt equivalent to 25 pps of GDP in a single year, whereas it took five and three years, respectively, to accumulate a similar increase following the 2007-2008 financial crisis (and that was starting from a position with greater fiscal margin).

Moreover, the table shows that the surge in public debt will occur in both advanced and emerging economies. Indeed, although the increases are somewhat smaller among emerging economies, their situation is particularly delicate because they have less fiscal margin to play with, they are more dependent on foreign financing and they are more prone to debt crises. This is why the debt relief programmes launched by the G-20, the IMF and other international agencies are particularly important.[3]

Public debt: forecasts for 2020 and all-time highs

	Forecast: increase (pps)	Forecast: level (%)	All-time high (based on available data)
Advanced economies	17	122	Year 1835 (165%)
US	22	131	Year 2020
Japan	15	252	Year 2020
United Kingdom	10	96	Year 1947 (264%)
Euro area	16	101	–
Germany	12	72	Year 2020
Spain	25	121	Year 1880 (162%)
France	21	119	Year 1921 (237%)
Italy	25	160	Year 1920 (160%)
Netherlands	11	60	Year 1834 (247%)
Portugal	23	140	Year 2020
Emerging economies	9	62	Year 1882 (108%)
China	11	65	Year 2020
Brazil	9	98	Year 1884 (121%)
Mexico	8	61	Year 1986 (78%)
Emerging Europe	7	37	–

Source: *CaixaBank Research, based on our own forecasts (for Spain and Portugal), forecasts from the consensus of Focus Economics of September 2020 (for the rest of the euro area) and from the IMF's Fiscal Monitor of April 2020 (the rest). Historical data from the IMF (Historical Public Debt Database).*

Whereas this increase in public debt is occurring from an already high starting point, households are generally starting from much lower levels of debt than in the run-up to the 2007-2008 financial crisis (see first chart). This at least suggests that they face the COVID-19 crisis with healthier balance sheets. However, the picture in the case of corporate debt is somewhat more mixed. Over the past decade, firms have clearly reduced their levels of debt in countries such as Spain, Italy and Portugal, while in the US and Germany their levels of debt have remained more moderate, and in France, high. Despite this, vulnerabilities have emerged, such as the deterioration in the quality of corporate debt in the US, especially due to the relatively large number of companies at risk of becoming «fallen angels» (companies whose debt is apparently investment grade but would become speculative grade with only a small downgrading of their credit rating) and the growth of debt among companies that already had high levels of debt to begin with.[4] In addition, among emerging economies there has been a sharp rise in corporate debt in China, which has more than tripled since 2008.[5]

First clues in the data

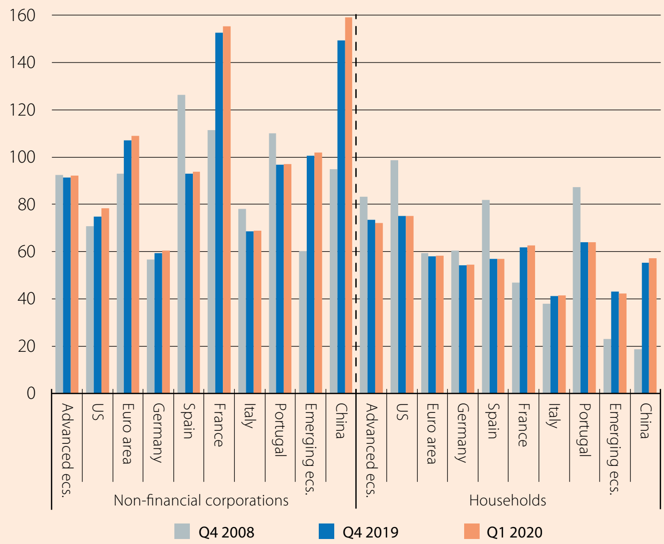
China is precisely one of the first countries for which we have data to assess the initial impact of the COVID-19 crisis on private debt[6] and it is significant: while household indebtedness barely increased by 2 pps of GDP in Q1 2020, non-financial corporate

1. See the Dossier «The world after COVID-19» in the MR05/2020 and the Dossier «Teleworking, a legacy of the pandemic» in the MR09/2020.
2. The final scale of the increase is uncertain, since it depends on how much GDP will end up falling by in 2020 (this will determine the final scale of the automatic stabilisers, the discretionary measures and the public credit guarantees that are ultimately implemented).
3. See C. Arellano *et al.* (2020). «Deadly Debt Crises: COVID-19 in Emerging Markets». NBER Working Paper.
4. At the beginning of the year, between 10% and 15% of 'investment grade' corporate debt was just one or two notches away from dropping to 'speculative grade'. Recently, we analysed both of these vulnerabilities in the Focus «The vulnerabilities of corporate debt in the face of a historic shock», in the MR05/2020.
5. We analyse its vulnerabilities in the Focus «China's corporate debt: a reason for concern?» in the MR10/2016.
6. In China, the economic slump caused by the COVID-19 outbreak was concentrated in Q1 2020, the last quarter for which the BIS has published good-quality data on debt in an international comparison.

debt surged by 10 pps, bringing it close to the high points of 2015 and 2016 that caused so much concern. As for advanced economies, information is still scarce because the impact of the COVID-19 outbreak was concentrated in Q2 2020. Nevertheless, the first data available for the US[7] show a jump in corporate debt and relative normality among households: between January and June, non-financial corporate debt rose by 9.4% (around double the total increase registered in 2019), while household indebtedness remained much more stable (+1.9%, a figure similar to that registered in the same period last year). In fact, when this data is disaggregated, it is clear that measures such as moratoriums on loans (especially mortgages) and public guarantees for credit lines have prevented a strain on household and corporate balance sheets. Moreover, the average US household has actually improved its financial safety net as a result of the aid received, precautionary savings and the recovery in financial asset prices. In any case, while the bulk of the rise in debt is likely to occur in the public sector given the large battery of economic measures introduced to combat the COVID-19 crisis, the improvement in household balance sheets is probably temporary. Furthermore, for both firms and households, much will depend on what happens to economic activity and the labour market over the coming quarters.

Private debt at the global level

(% of GDP)



Source: *CaixaBank Research, based on data from the BIS.*

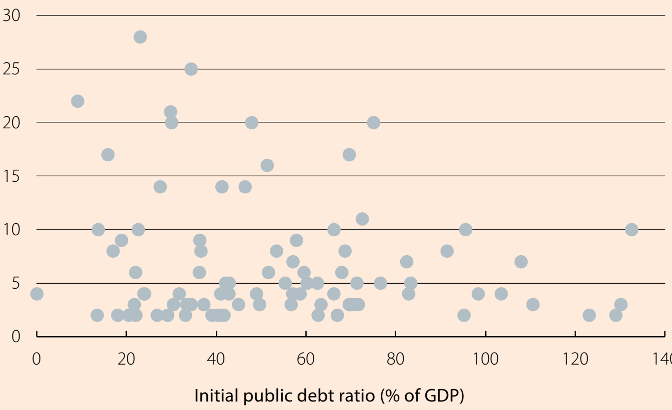
A less heavy burden than it appears?

In the following pages of this Dossier, we will analyse the lessons offered by other historical episodes and the potential consequences of this sharp, sudden and widespread rise in debt. But first, it is important to emphasise that the increase in debt is a necessary and effective response aimed at softening the blow of an unprecedented fall in household and business incomes: borrowing involves cutting this exceptional decline up into smaller pieces and spreading them over time. In fact, the economic policy response itself encourages and facilitates debt growth, both in the public sphere (with a vast increase in spending through automatic stabilisers and discretionary measures) and in the private sphere (through guarantees and an accommodative monetary policy).

In assessing the new world of debt that awaits us, we must consider on the one hand the increase in the levels of debt (an increase that is exceptional but necessary and, as we shall see, feasible to manage), as well as the burden that this debt will entail on the other hand (debt payment flows compared to income flows of households/businesses/governments). In an environment of low interest rates and with debt financed with long maturities, this debt burden should be manageable. It can even be eased if the current low interest rates are used to refinance old debts. The key, however, lies in ensuring that the economic recovery is as dynamic and sustainable as possible: if economic activity stagnates and suffers permanent damage, then household, business and government incomes will suffer and the debt burden will be heavier. Furthermore, provided that the recovery is on course, tackling the reduction of the debt will also be key. It may be tempting to rely on the comfort provided by an income growth (g) that exceeds interest payments (r), but historical experience advises caution: as shown in the last chart, the higher the debt, the shorter and less frequent these periods of r<g tend to be.[8]

Public debt and r-g

Duration of the r-g<0 episode (years)



Note: *Sample of 17 advanced economies between 1950 and 2016.*
Source: *CaixaBank Research, based on data from Jordà et al. (2017). «Macrofinancial History and the New Business Cycle Facts». NBER Macroeconomics Annual.*

Adrià Morron Salmeron and Javier Garcia-Arenas

7. The New York Fed's Quarterly Household Debt and Credit Report, and the Financial Accounts published by the Federal Reserve Board.
8. See W. Lian *et al.* (2020). «Public Debt and r - g at Risk». IMF Working Paper. The authors empirically expand on and support this fragility.