SPECIAL REPORT

The soft underbelly of South America

October 2020

Highlights

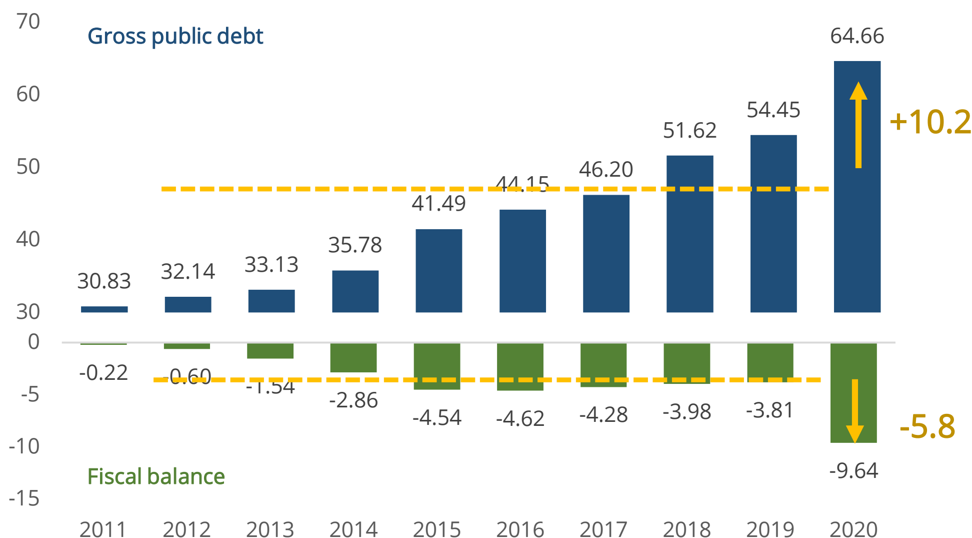
- Fiscal constraints endanger governments efforts to revive economy given social backdrop
- Debt sustainability will depend in parts from additional international support to governments
- Fiscal support across South American economies represent ca. $304bn, or 8.3% of 2020 GDP
- Multilateral institutions support amount to 0.5% of South America's combined 2020 GDP

Executive Summary

Fiscal vulnerabilities among South American sovereigns had already been building up in the years leading to the coronacrisis. This was primarily driven by unfavourable changes in commodity prices and exchange rates, as well as more challenging economic growth conditions. Then, the pandemic happened and with it a severe economic shock with an estimated regional GDP reduction of ca. 9.8% in 2020 (c.f. IMF, WEO October 2020), pushing many countries into deep socio-economic stress and millions back into poverty.

To contain the economic fallout, governments responded forcefully by implementing various fiscal measures thanks in part to international support, but is it enough?

Exhibit 1: General Government Gross Debt and Fiscal Balances, 2020 in South America (Percent of GDP)



Source: IMF, WEO October 2020

To be sure, multilateral organisations have increased emergency support to governments in the form of loans and grants amounting to 0.5% of South America's combined 2020 GDP to date, while several countries have also tapped the international markets with bond issuance amounting to $18 billion. This is however a paltry amount compared to the fiscal stimulus announced by governments, representing just over $300 billion, or 8.3% of 2020 GDP.

As such, we would argue that international organisations and creditors have not done near enough to provide South American governments with increased fiscal space to help them mitigate the socio-economic stress. Indeed, giving them more breathing fiscal space would allow governments to find their way back into an economic recovery, thereby enhancing debt sustainability all together. The risk being that fiscal constraints next year would exacerbate the social crisis under-way and plunge these economies farther into the drain. This at a time when debt-to-GDP ratios have increased substantially, thereby raising the spectre of a regional sovereign debt crisis as seen in the 1980s.

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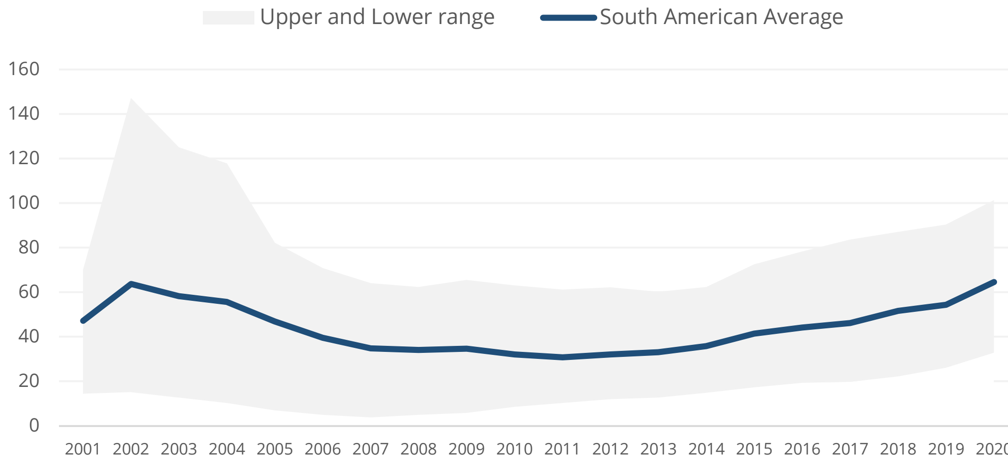
Sovereign debt before the pandemic

In the years leading up to the Covid-19 crisis, sovereign debt in South America was rising. The average government debt ratio had increased from a 2011 low average of 30.8% of GDP to 54% by 2019 (Exhibit 2 – excl. Venezuela), with an average growth rate of 9% pa. over that period. Worryingly, the IMF expects to see an average increase of 10% in debt-to-GDP ratios across the sub-continent, with Brazil notably reaching 101% debt-to-GDP ratio, while most countries will have debt ratios over 50% in 2020. Of note, since 2012, Argentina, Chile, Ecuador and Paraguay have all experienced double-digit average growth in debt to GDP ratio.

Exhibit 2: General government debt % GDP



Source: IMF, WEO, October 2020

That being said, there are several mitigating factors that currently sustain debt affordability and gives some governments fiscal space to manage the rise in spending and debt. Namely, the current low interest rate environment, depressed economic activity, and limited inflationary pressures should allow some central banks to keep interest rates at a relatively low levels for an extended period of time.

To be sure, regional interest payments (see Exhibit 3) have remained relatively stable over the past decade, in spite of rising debt levels. This is in part thanks to the extraordinary amount of liquidity provided by central banks in the US and EU, which has helped to maintain interest rates down. Indeed, ultra-low interest rates led to a search for yield with investors flocking into higher and riskier emerging market assets, thereby often driving interest rates down, as can be seen in exhibit 4.

Exhibit 3: Interest payment % government revenues

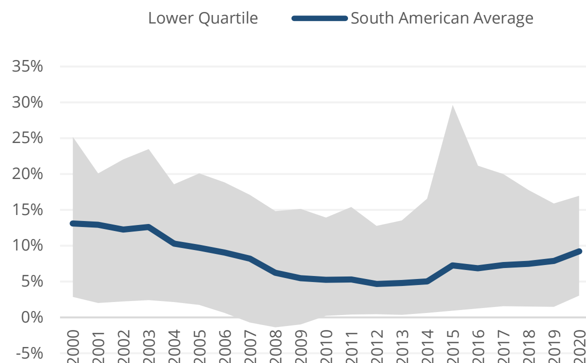
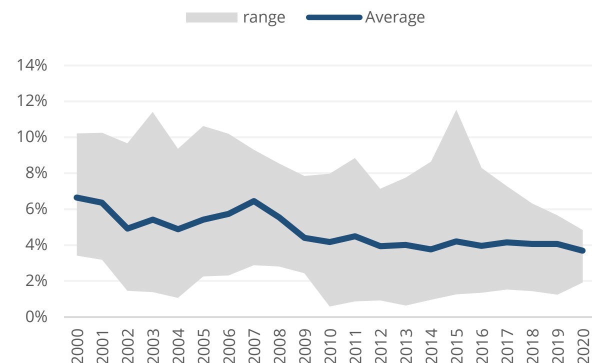


Exhibit 4: Interest payment % gross government debt



Source: IMF, WEO, October 2020

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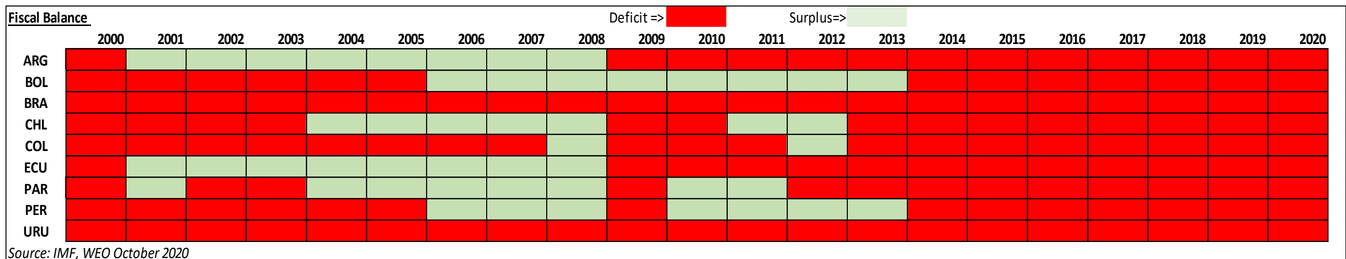
This is of importance as the burden of servicing debt has been kept in relative check, despite an average interest payment as a percentage of government revenues growing from a low 4.7% in 2012 to ca. 8% in 2019. Again, it is noteworthy that Brazil - albeit improving for the last 3 years - tops the range with interest payment averaging 21% of government revenues over the past 5 years, while interest paid (as a % of government debt) has been declining but remains high relative to regional peers. Of note, interest payment burden has been on the rise for all economies over the past few years.

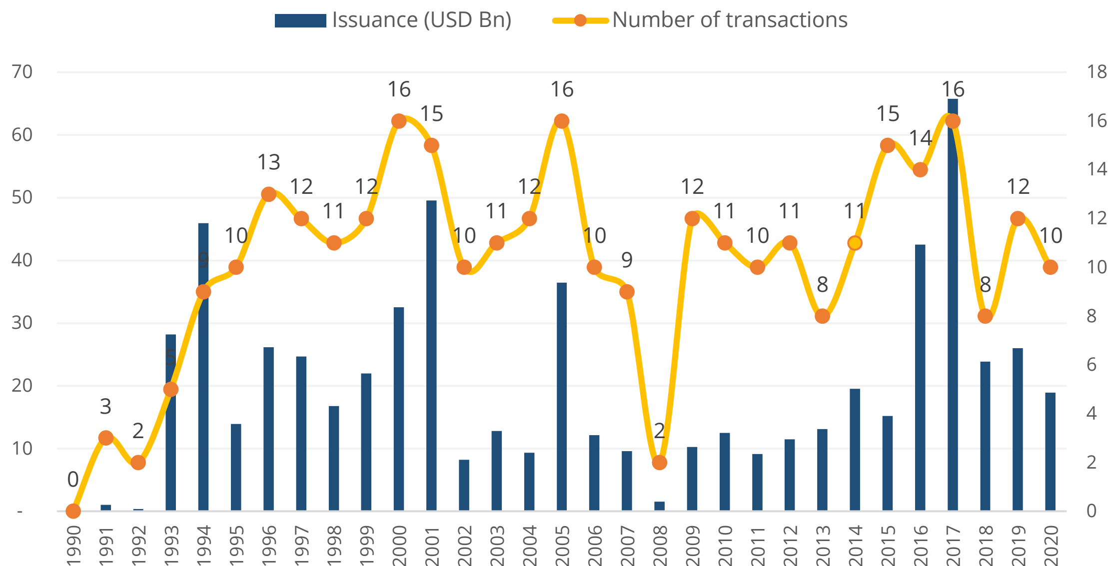
Generally, we can thus observe that rising public burdens in South America started to deteriorate in the wake of the global financial crisis, and then even more so when the China-led commodity-boom ended in 2012/2014, which left large fiscal deficits across the region, as well as large current account deficit.

Exhibit 5: Fiscal Surplus / (Deficit)



Besides, declining domestic savings rates together with wide financing gaps, such as in infrastructure, meant governments had to tap into external funding to support economic growth. This was helped in part by the ultra-low global interest rates environment and investors' search for yield. For instance, in 2019, South American sovereigns issued $26 billion in foreign currency bonds, albeit lower than the record year of over $65 billion in 2017. Looking back at the past 30 years, we can see that foreign currency bond issuance dollar amount increased by 20% between the years 2010-2019 vs the previous decade 2000-2009.

Exhibit 6: Foreign currency sovereign bond issuance (USD billions and number of transactions)



Source: BIS Statistics Explorer

The soft underbelly of South America

On the positive side, an increase issuance of sovereign bonds helps to diversify a country's investor base and subjects a government to market discipline especially during crises. However, it also increases exposure to volatility and investor sentiment, as well as potentially higher borrowing costs than multilateral or bilateral loans. Of note, while multilateral institutions continue to play an important role for the weaker economies in the region, public debt is by and large mostly owned by the private sector.

Exhibit 7: Holders of debt (aggregate data)

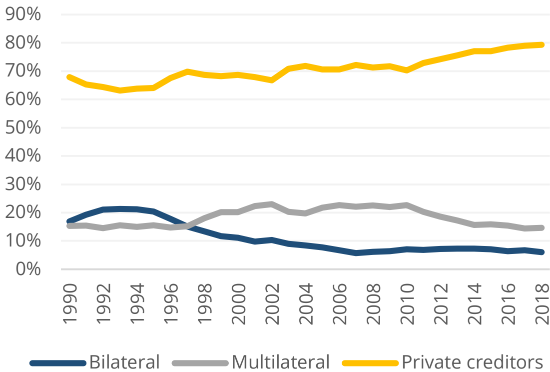
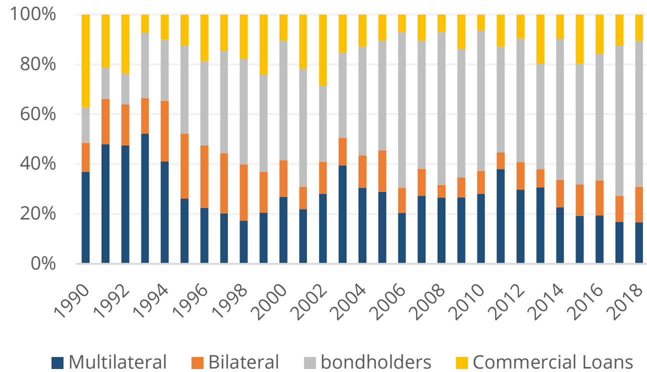


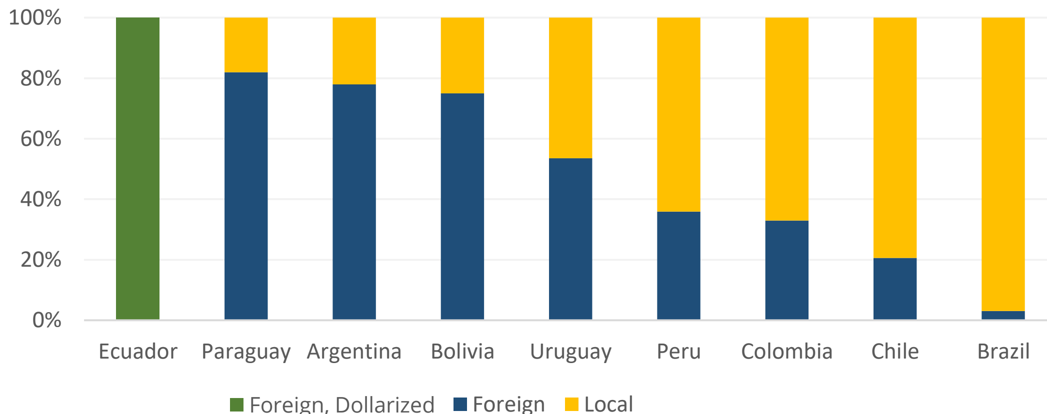
Exhibit 8: Debt service by creditor type



Source: World Bank

Finally, exchange-rate depreciation also had an adverse impact on sovereign balance sheets as a sizeable share of South American public debt is denominated in foreign currencies (especially US dollars). Moreover, even though South American economies have tried to reduce their reliance on dollar-denominated debt, there is no complete insulation from U.S. monetary shocks as the "taper tantrum" episode demonstrated. For memory, the Fed had hinted at the possibility of tapering its bond purchases sooner than previously expected, causing bond yields to rise sharply.

Exhibit 9: Public debt 2019 - foreign vs local



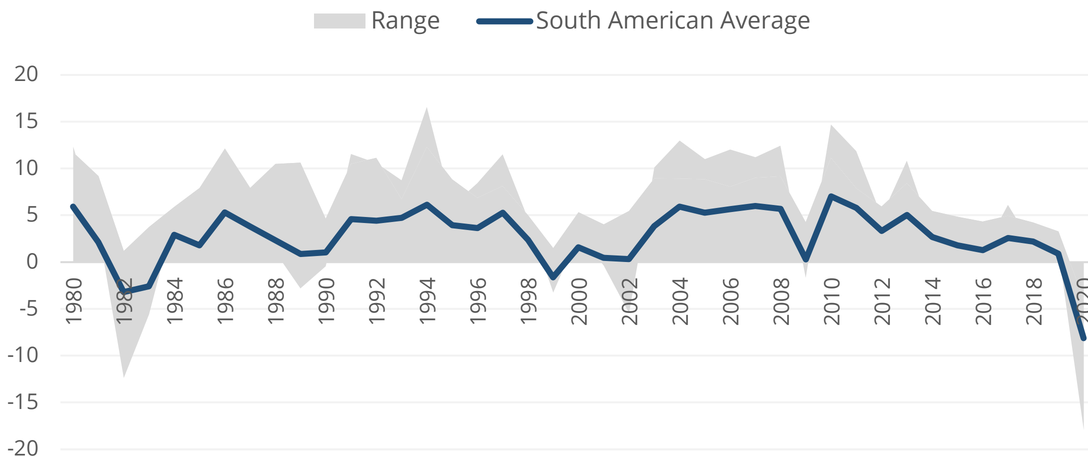
Source: Central Banks

Nevertheless, the key to shoring up the domestic economy lies in establishing strong policy framework, incorporating a prudent fiscal policy, a credible inflation target, and exchange rate flexibility. This would help countries to build robust balance sheets that can withstand investor scrutiny at times of acute risk aversion.

Constrained fiscal capacity

South America has been hit hard by Covid-19 cases, with a substantial number of fatalities (c.f. Annex I) compared to other regions of the world. As such, we fully expect that the socio-economic repercussions of this crisis will be severe. In addition, the IMF recently forecasted average real GDP to shrink by ca. 8% across South American economies (excluding Venezuela) for 2020.

Exhibit 10: Real GDP growth in South American countries



Source: IMF, WEO October 2020

Certainly, South American economies have been impacted in 2020 via lockdowns by: i) severe demand and supply shocks impacting both domestic economic activity and intra-South American trade, ii) declines in commodity prices and depreciations of domestic currencies (Brazilian Real and Argentinian Peso down respectively ca. 40% and 30% year-to-date vs US dollar); and iii) lower investment inflows and exports, aside from some Agri-products from Brazil/Argentina.

Economic hardship from this 2020 crisis could push more than 3 million South Americans to poverty according to the World Bank (c.f. Poverty and Shared Prosperity 2020). This called for a forceful policy response aimed at providing income relief to vulnerable persons, supporting strategic economic sectors and small and medium-sized enterprises in the short-term, and bolstering economic recovery programmes over the longer run. But such measures come at significant cost as the IMF estimates an average primary deficit amounting to 7% of GDP, or in other words, ca. $243 billion in 2020 (excl. Venezuela).

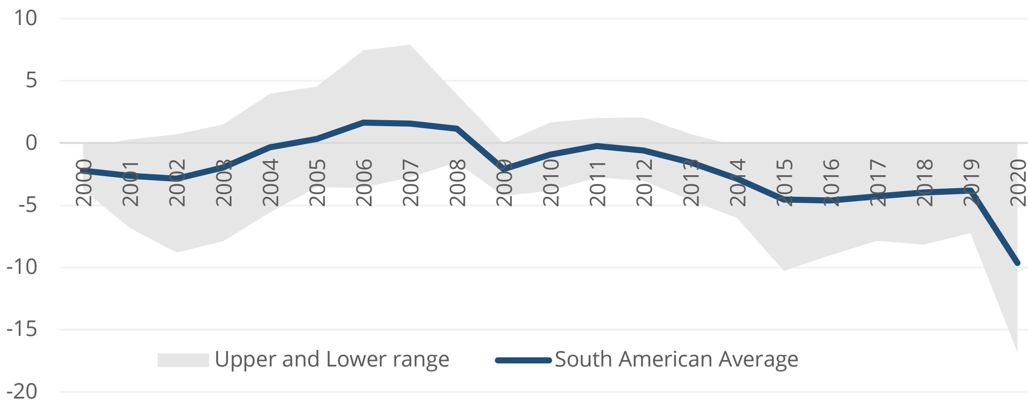
Exhibit 11: Primary deficit % GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ARG	0.211	-1.252	0.235	3.226	5.219	5.152	3.286	2.55	1.865	-0.488	-0.538	-1.587	-1.696	-2.64	-3.5	-4.418	-4.762	-4.228	-2.269	-0.409	-8.527
BOL	-1.452	-4.218	-6.192	-5.059	-2.616	0.756	6.997	4.28	5.547	1.659	3.059	2.059	2.779	1.613	-2.404	-5.904	-6.253	-6.712	-6.951	-5.848	-6.968
BRA	3.378	3.2	3.189	3.239	3.689	3.745	3.151	3.238	3.789	1.943	1.204	2.941	1.922	1.713	-0.633	-1.884	-2.497	-1.765	-1.659	-0.953	-12.014
CHL	-0.055	-0.038	-0.683	0.114	2.545	4.979	7.63	7.725	3.576	-4.44	-0.311	1.518	0.791	-0.389	-1.347	-1.861	-2.367	-2.262	-1.098	-2.301	-8.074
COL	0.757	1.295	0.29	1.285	1.426	2.062	1.692	1.846	2.2	-1.052	-1.252	0.089	1.821	0.947	-0.161	-1.715	-0.351	-0.497	-2.497	-0.04	-6.18
ECU	5.464	4.102	3.647	3.525	4.044	2.585	4.767	4.287	1.703	-3.012	-0.764	0.507	-0.196	-3.55	-4.218	-4.688	-6.67	-2.343	-0.699	-0.457	-5.839
PAR	0.855	1.678	-0.304	1.439	2.016	2.059	2.799	2.615	2.999	0.13	1.118	1.958	-0.76	-0.496	0.07	-0.991	0.493	0.11	-0.559	-2.581	-6.29
PER	0.4	0.128	0.765	0.557	1.061	1.565	3.956	5.181	4.084	-0.269	1.165	3.037	2.967	1.689	0.695	-1.214	-1.316	-1.925	-0.86	-0.182	-7.929
URU	-0.961	-0.697	0.452	3.248	4.041	4.126	3.695	3.726	1.507	1.221	1.964	2.007	-0.125	0.457	-0.546	0.269	-0.26	-0.133	0.604	-0.552	-2.919
VEN	7.53	-1.195	3.735	5.383	6.227	7.07	0.483	-1.191	-2.015	-7.222	-3.173	-6.079	-6.94	-8.147	-11.873	-9.011	-10.593	-22.96	-30.994	-9.971	n/a

Source: IMF, WEO October 2020

Many South American governments lack the required fiscal space to implement such programmes without further threatening public debt sustainability. The IMF estimates that South America's regional public debt ratio would thus increase by around $297 billion from 54% of GDP to about 65%.

Exhibit 12: Fiscal Surplus / (Deficit) % GDP

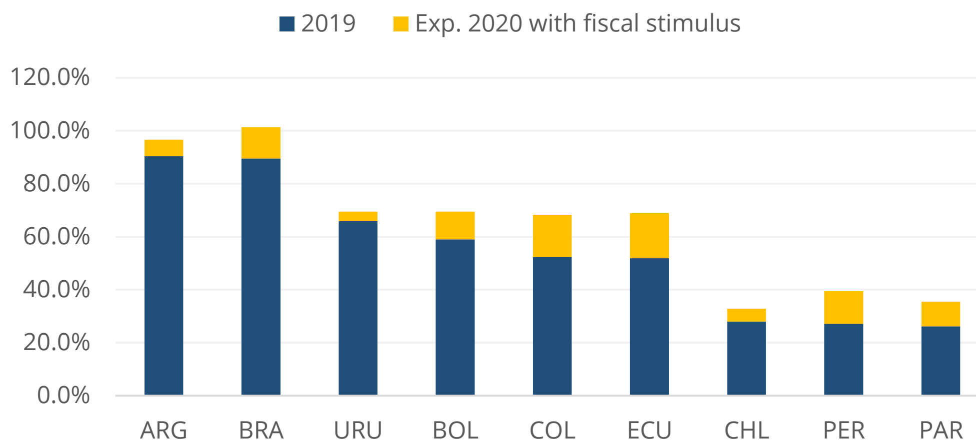


Source: IMF, WEO October 2020

As mentioned before, deteriorating debt and interest payment profiles represent a core spending constraint now. Interest payments is expected to cost reach ca. 20% of government revenues in Brazil in 2020, and double digits also for Colombia and Ecuador – presenting a not inconsequential bottleneck for central governments at a time of heavy spending demands.

At the same time, tax revenues will shrink considerably for commodity exporters, notably those dependent on oil and gas – such as Colombia amongst others – given the subdued global economic activity and drop in Brent crude prices from $66 a barrel at end-2019 to around $40 at time of writing. Commerce, tourism, the hospitality/transport sector and remittances revenues have also declined significantly. More generally, the squeeze on public finances from lower revenue and rising expenditure will hamper government efforts to finance support for households, workers and businesses. In addition, we can expect soaring borrowing costs for the private sector, which will also hit their ability to pay taxes.

Exhibit 13: Estimated public debt ratios FY 2020 under current scale of fiscal stimulus



Source: IMF, WEO October 2020

Finally, we should not forget that rating agencies would probably expect a return to fiscal constraints in 2021, in addition to signs of economic recovery. Failure to provide a clear direction with regards to the future of fiscal policy or a sense of governments' ability to regain control of public spending post-crisis, would probably lead to further credit downgrades, which could aggravate debt sustainability through higher cost of funding, or sudden withdrawal of capital.

The old white knights come back!

Given the fiscal constraints, many South American economies lack the resources to tackle the coronacrisis alone. This was immediately recognised by the international community who mobilised to provide emergency financing and support of South American governments. (see Annex II for an overview of international fiscal support by South American country).

Multilateral institutions have provided emergency financial support for South American governments in the form of loans and grants, amounting thus far to around 0.5% of South America's 2020 GDP (Exhibit 14). The IMF has agreed to provide around USD 8.5bn in emergency lending to South American governments, mostly through a temporary doubling of annual access limits under its Rapid Financing Instrument and Rapid Credit Facility. The Inter -American Development Bank (IDB) has been active with ca. $5 billion pledged for governments and private sectors, mostly in the form of loans. Finally, the World Bank has made $2 billion available in financing to 6 countries by early October.

Exhibit 14: Emergency multilateral financing to date ($ bn)

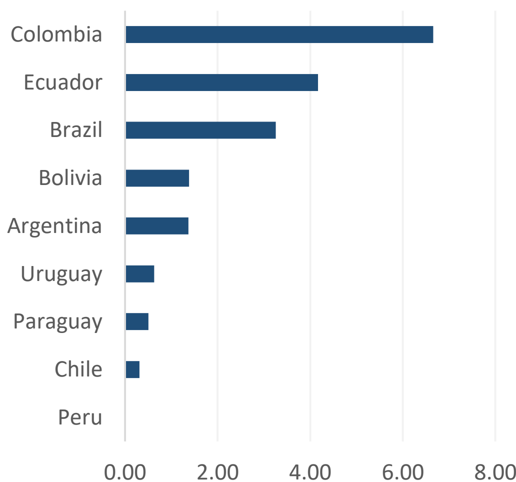
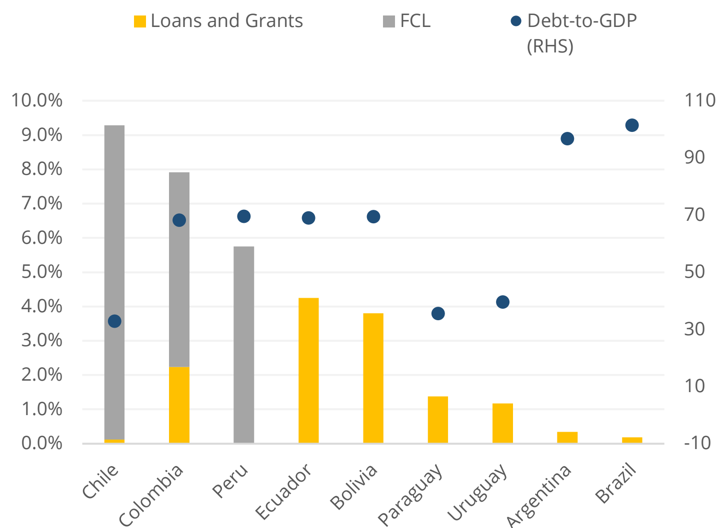


Exhibit 15: International Fiscal Support and Debt Levels % of 2020 GDP



Source: IMF, WB, IDB, CAF, NDB

In addition, the IMF has provided a precautionary line in the form of a Flexible Credit Line to some countries, namely Chile, Colombia, Peru, who see the value in having access to this line in times of high volatility, having had the negative experience of sudden capital movements in the past. But not every country has access to that line, as a country would need strong fundamentals and institutional policy framework already in place to qualify. Furthermore, the IMF is also making a Short-Term liquidity line available to help countries during these tumultuous times.

Overall, multilateral financial support for South American governments in this crisis help governments' creditworthiness and capacities to bridge the 2020 economic and public health crisis, mitigating to some extent the damage to economic and financial systems development, and easing immediate liquidity risk especially. But the amount of aid given is a trivial amount compared to the stimulus already being given by governments and the amount they will need before the economy recovers.

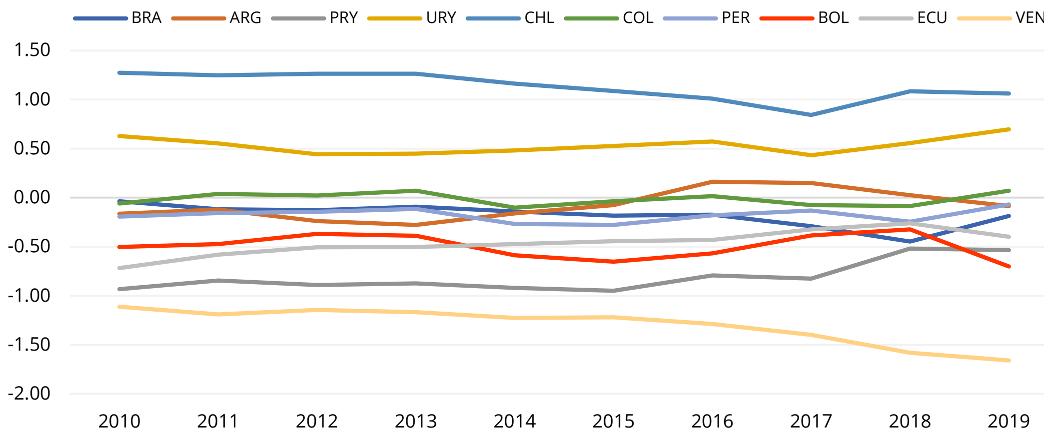
Indeed, many countries are facing unprecedented socio-economic stress, given the collapse in economic conditions, which will push many to the brink if the economic conditions do not recover in 2021. In this context the IMF and other multilateral lenders are probably not doing enough at present as countries will be spending a significant amount of their revenues on paying debt, and this raises debt sustainability concerns in several countries, especially if a return to growth takes a few years.

As such, it may be worth looking into expanding the Debt Service Suspension Initiative (DSSI) to middle-income countries in the region. For memory, the DSSI was proposed by the IMF and the World Bank and endorsed by G20 Finance Ministers and the Paris Club countries last April. The programme grants temporary debt service suspension on all official bilateral credits due between 1 May and 31 December 2020 for up to 73 eligible developing nations to help free resources for social, health and economic spending in response to the pandemic. No country in South America is currently eligible for this debt-relief.

For sure, debt-relief programme or debt-suspension could help an economy's underlying growth dynamics and debt sustainability. Indeed, hypothetical savings on debt service resulting from suspension of 2020/21 interest and principal repayments would be significant for several South American governments that are not current participants. What's more, the IMF could use other tools to provide debt-service relief such as its Catastrophe Containment and Relief Trust given the health crisis and some of the climate related problems in South America (droughts, fires etc.)

In any case, such debt-relief measures should come with strings attached, focussed on (i) improving debt oversight to ensure that funds are used for intended purposes, and (ii) enhancing debt transparency to strengthen accountability and easing informational bottlenecks, but also as it would be useful for governments themselves in making better informed decisions. This could reduce government waste in the use of immediate debt relief linked resources, as undoubtedly, there is generally a lot of wasteful spending. Indeed, aside from Chile and Uruguay, all other South American countries tend to score below average in the government effectiveness index, and fare even worse on average on the control of corruption index published by the World Bank.

Exhibit 16: Government effectiveness



Source: The Worldwide Governance Indicators, 2020 Update

Of note, in order to participate in the DSSI, the beneficiary sovereign has to commit to using savings to preserve social, health or economic spending in response to the pandemic, with contingent spending monitored by the IMF and the World Bank.

That being said, despite the clear short-term benefits, such conditionalities may be one of the main reasons why governments would have reservations in participating in such programme, which are primarily designed to help ease repayment stresses in 2020, and possibly 2021. Such programmes are unlikely to address underlying solvency problems that may rise, as it is very unlikely that any creditor would write-off debt all together. But providing a bit of leeway now could avoid significant costs down the line.

At the time of writing, a global economic recovery is underway. This can be to some extent attributed to a very strong and broad fiscal and monetary policy response to the pandemic in advanced economies, as well as strong economic recovery in China. However, as the IMF recently noted in its World Economic Outlook update: "...economic activity is likely to remain subdued until health risks abate". Indeed, risks of continued economic disruption remain high, particularly in South America where a social-and-governance crisis appears to be underway too, with a high potential to drive governments to increase their spending and thus debt-to-GDP ratios thereby endangering debt sustainability.

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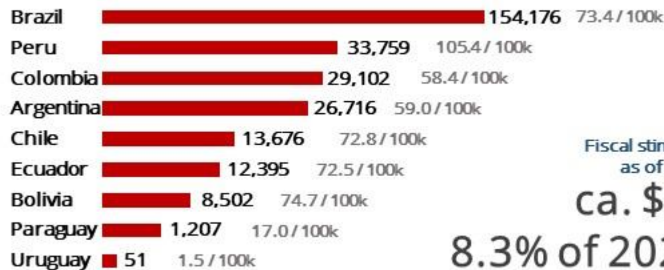
Annex I

+8.9 mn Confirmed cases

279,584 Deaths*



Fiscal stimulus announced as of September 2020

ca. $304 Bn

8.3% of 2020 GDP

Policy package

HEALTH
Increased spending (virus diagnostics, hospital equipment and construction of clinics and hospitals, lower taxes and import levies on essential medical supplies).

VULNERABLE PEOPLE
Cash transfers and relief payments, social security benefits (low-income beneficiaries), unemployment insurance, and payments to minimum-wage workers; Mortgage payment delays and subsidies for rentals; Subsidies, forbearance and continued provision of utility services; Food assistance.

BUSINESSES
Support for hard-hit sectors, exemption from social security contributions, grants to cover payroll costs; Liquidity provision, subsidized loans and credit guarantees for lending to SMEs; Delayed tax payments.

** Johns Hopkins Coronavirus Resource Center – Figures for October 20, 2020*

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Annex II – (In USD millions)

	IMF	World Bank	IDB		CAF		NDB (BRICS)
	Loans	Loans	Loans	Grants	Loans	Grants	Loans
Argentina	0	35	990	0	340	0.4	0
Bolivia	327	424	582	0	50	0.4	0
Brazil	0	0	1,902	0.075	350	0	1,000
Chile	0	0	308	0	0	0	0
Colombia	5,300	1,000	0	5	350	0	0
Ecuador	2,643	780	344	0	400	0	0
Paraguay	274	20	210	0	0	0	0
Peru	0	0	0	0	0	0	0
Uruguay	0	20	555	0	50	0.4	0
Venezuela	0	0	0	0		0	0
	8,544	2,279	4,891	5.075	1,540	1.2	1,000

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