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EMERGING MARKETS' POST-PANDEMIC FISCAL ADJUSTMENT: THE REVENUE SIDE

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While economies around the globe are now recovering from the worst of the pandemic, all are currently in a weaker fiscal position and have much bigger government debts than they did at the end of 2019. Within the emerging markets community, participants and policymakers are now turning their attention to debt restructurings and other initiatives to reduce the debt of poor countries.[1] Leaving the merits or shortcomings of these initiatives aside, when looking across various EMs, we see a divergence in the ability to implement fiscal adjustments that would both reduce a country's debt burden and provide a sufficient buffer against another exogenous shock. Assessing which countries have been more fiscally responsible and, therefore, find themselves in a better position to raise government revenues, provides some needed clarity on the current investment opportunities across the emerging market debt sector.

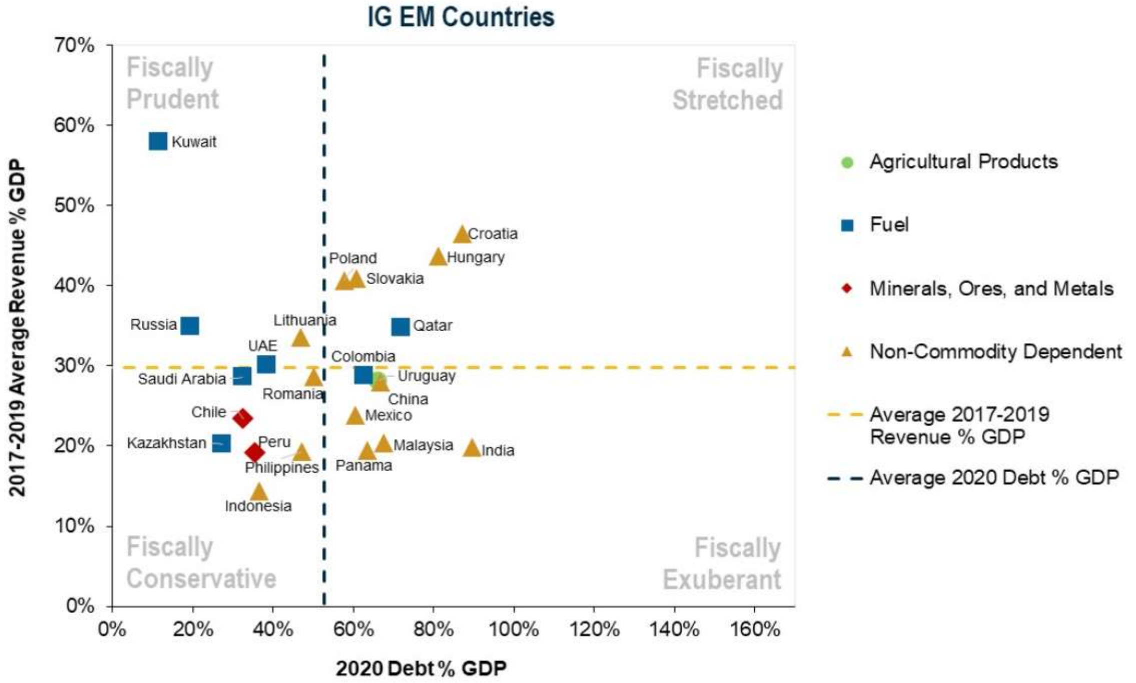
This post focuses on a country's capacity to increase revenues - as we do not expect expenditures to be reined in quickly due to pandemic-related spending pressures, the need to boost economic growth, and the increased cost of servicing debt. While the particular method chosen to reduce a country's debt burden is a matter of politics and its unique policy, an assessment of the initial fiscal conditions indicates the feasibility or difficulty of such an adjustment. Clearly, other variables, such as exchange rates, growth, and inflation, matter when assessing debt sustainability, and in a subsequent post we will take a closer look at expenditures, but here we focus purely on the fiscal side and on revenues in particular.

A Path to Raising Revenues

By plotting the ratio of a country's debt to GDP at the end of 2020 against its average ratio of fiscal revenue to GDP over 2017-2019, we can assess whether a country is already highly taxed against its debt and, in turn, how difficult it would be to increase revenues as a means to reducing its debt burden.[2] We then calculated the sample averages of our two variables to divide countries into four quadrants: those that are Fiscally Stretched (high debt/high taxes), Fiscally Exuberant (high debt/low taxes), Fiscally Conservative (low debt/low taxes), and Fiscally Prudent (low debt/high taxes).

We have conducted this analysis for two groups of EMs: investment grade and high yield countries (Figures 1 & 2). We also highlight countries that are commodity exporters, as well as the type of commodity exported, because commodity-dependent revenues are considered more volatile and, therefore, a revenue-enhancing policy could be more complicated to implement.

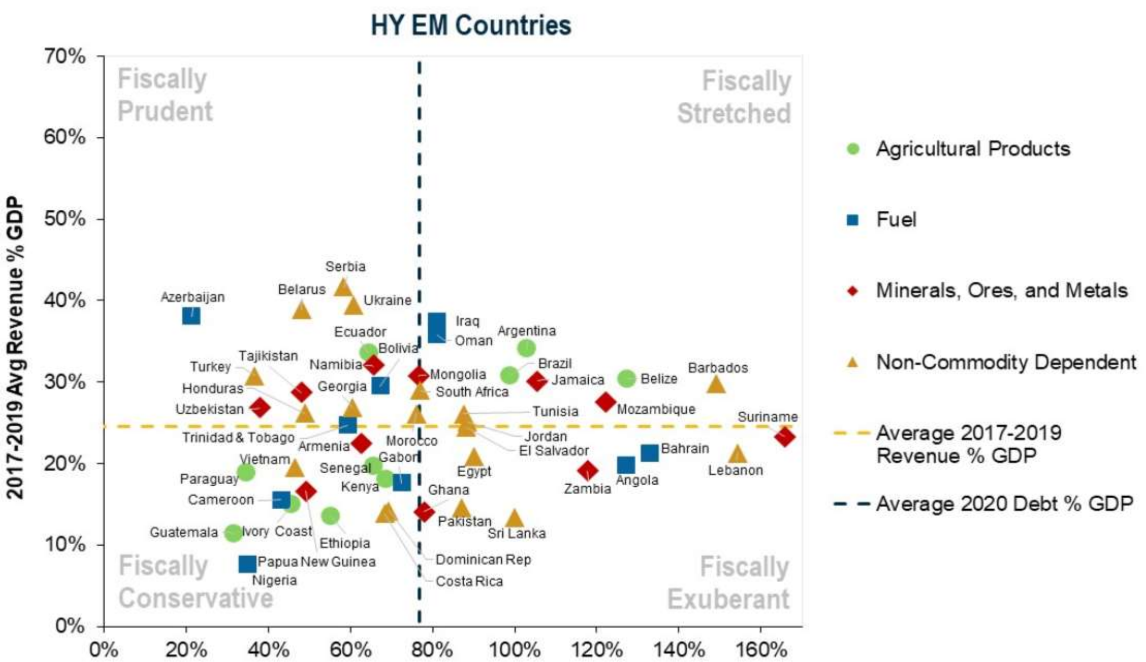
FIGURE 1: FEW IG EM COUNTRIES ARE FISCALLY STRETCHED



Source: International Monetary Fund as of May 2021.

It is reassuring that very few IG countries appear in the Fiscally Stretched quadrant and that four of the five are members of the European Union. These EU countries are all eligible for grants sized at over 5% of GDP through the Next Generation EU program, providing each with the means to increase spending without adding to their debt stock. Furthermore, these countries also have access to low interest loans from the EU representing another 10% of GDP. Therefore, raising additional revenue on top of their already high relative levels is significantly less pressing.

FIGURE 2: FISCALLY CONSERVATIVE HY EMS HAVE ROOM TO RAISE REVENUE



Source: International Monetary Fund as of May 2021.

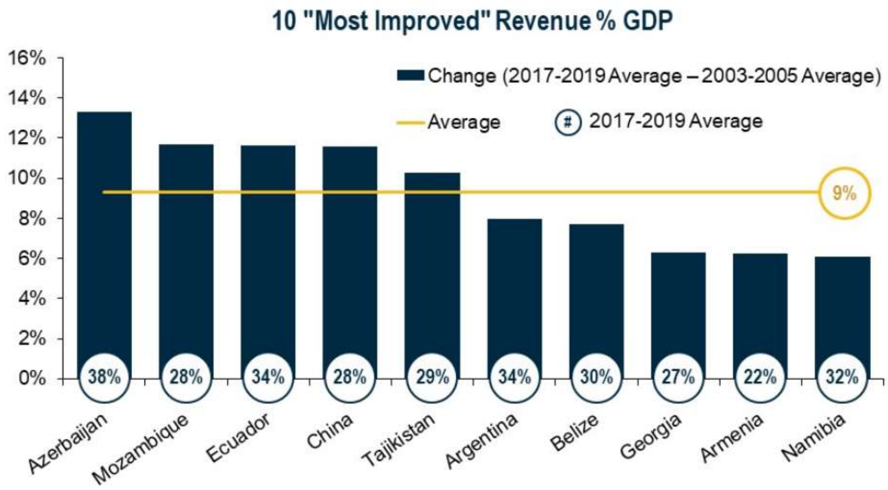
The situation is far more differentiated across the HY universe. Here, few commodity or regional regularities emerge except within the Fiscally Prudent quadrant, which is mostly populated by former communist countries.

Turning to the Fiscally Conservative quadrant, the vast majority of Sub-Saharan African countries exhibit a lower than average ratio of government revenue to GDP. These fiscally conservative countries appear to represent those with the easiest paths, both practically and politically, to implement a fiscal adjustment.[3] These countries have been more fiscally responsible than their peers and may have an easier time raising government revenues going forward.

Top 10 Most Improved

With the understanding that increasing government revenues is often a politically difficult decision, especially when an economic recovery has not yet fully materialized, we looked at countries that implemented the largest increase in revenues to GDP over the past 15 years (Figure 3).

FIGURE 3: SIGNIFICANT INCREASES IN GOVERNMENT REVENUES ARE POSSIBLE



Source: International Monetary Fund as of May 2021.

While the data in Figure 3 extend over a long period and progress is influenced by the country's initial debt-to-GDP ratio, the columns show that a significant increase in revenues is possible. Whether that increase is politically feasible is another matter altogether.

While our analysis shows a varied fiscal picture across EMs, two main points are worth highlighting. First, the composition of exports does not appear to determine a country's fiscal situation and, therefore, grouping commodity exporters by revenue fluctuations - due to the volatility of commodity prices - requires a more careful analysis. Second, many HY EMs are in the Fiscally Conservative quadrant, meaning that they have been more fiscally responsible than their peers and, as a result, merit further consideration as an area for investment.

[1] The two main initiatives taken by the G20 to reduce the debt burden of low-income countries are the Debt Service Suspension Initiative (DSSI) and the Common Framework for Debt Treatments beyond the DSSI. See https://www.imf.org/en/About/FAQ/sovereign-debt.

[2] We have excluded data for the revenue/GDP ratio for 2020 because they are distorted due to the pandemic and are not representative of a country's average fiscal pressure. Conversely, Debt/GDP represents the actual debt burden a country faces.

[3] Ethiopia is in this quadrant, which supports the market's confusion around the announcement that it is seeking to restructure its debt. Ethiopian authorities appear to be sending mixed signals and no final decision has yet been made.

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