Fitch Ratings 2021 Outlook: Global Sovereigns

Coronavirus Front and Centre

Fitch's Sector Outlook: Stable

Many competing influences will affect the global sovereign outlook in 2021. Uncertainty over the immediate and longer-term economic implications of coronavirus will continue to exert pressure on public finances through automatic stabilisers and the implementation of more active policy measures. Short-term fiscal concerns will be set aside by most sovereigns with access to funding, be it from markets, central banks, or bilateral and multilateral creditors.

More positively, the emergence of medical solutions to the virus and the depth of economic decline in 2020 suggest that on a year-on-year sequential basis, the environment for sovereign credit will be more favourable in 2021. Combined, these considerations support a stable sector outlook

Rating Outlook: Negative

The share of sovereigns on Negative Outlook has exceeded 30% since May 2020, and peaked at 40% in August. The previous high was 25% during the 2009 global financial crisis, but that share was only in place for six months. About half of downgrades in 2020 that were eligible for an Outlook (rated 'B-' or higher) were assigned a Negative Outlook, indicating that a number of sovereigns will probably lose several rating notches in the current cycle. This is not unique to a crisis period, as Negative has been the most common Outlook after a downgrade since 2000.

Rating Distribution Weighting: Toward Speculative Grade

The 'BBB' category was the largest as recently as 2015, when it was overtaken by the 'B' category, which has since included about 30 sovereigns. If two of the four sovereigns currently rated 'BBB-'/Negative are downgraded, there will be more speculative grade than investment grade sovereigns for the first time. The average global sovereign rating has been in decline for a decade and could soon dip below 'BBB-', though the investment grade share of rated government debt remains very high, at about 93%.

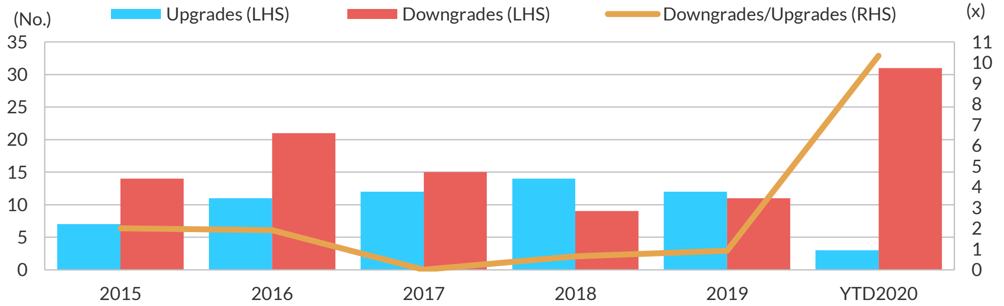
What to Watch

- Health spending and support measures to counteract economic pressures associated with the virus and possible lockdowns will determine 2021 fiscal outturns, at least relative to 2020.
- The impact of higher government debt on public finances depends in part on interest service burdens, which will remain manageable in the short term for developed markets.
- Emerging-market sovereigns have enjoyed a greater degree of policy flexibility than envisaged, but there are risks around stretching that flexibility too far.
- Low global rates and supranational funding mean emerging-market external finances are broadly favourable, except at the bottom of the rating scale where there may be more defaults.

James McCormack, Head of Sovereigns

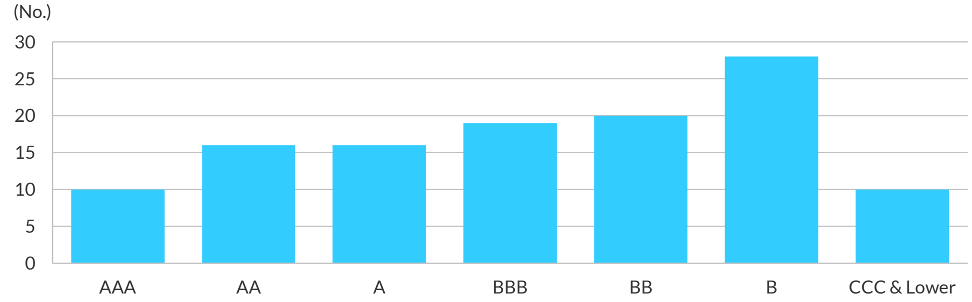
"Fitch Ratings expects fiscal priorities to be focused on dealing with either the direct consequences of the coronavirus, such as the need for more healthcare spending, or its economic aftermath, depending on the spread of the virus and availability of vaccines."

Global Sovereign - Rating Changes



Source: Fitch Ratings

Global Sovereign - Rating Distribution



Source: Fitch Ratings

Virus Economics and Policy Responses to Determine Fiscal Positions

The biggest sovereign credit uncertainties entering 2021 are unchanged since 2Q20: the unknown path of coronavirus; the degree to which governments impose lockdowns to tackle the virus; the economic impact of these lockdowns; and fiscal responses to alleviate those impacts. But with a rollout of vaccines now looking imminent, Fitch expects economic recovery to begin mid-year. Even so, while coronavirus arrived quickly, it is likely to recede only slowly, with varying degrees of persistence across countries.

Fitch expects fiscal policies to be flexible in 2021, as they were in 2020, adjusting to the needs of stop-and-start economies for at least the early part of the year. This makes forecasting more difficult but our global medians point to improvements in 2022. Median fiscal balances by rating category are all forecast to improve next year, with the biggest gains in the 'AAA', 'AA' and 'A' categories, which experienced the biggest deteriorations in 2020. Most of the lingering fiscal effects from coronavirus will be on spending, with medians of expenditure as a share of GDP higher in 2021 than the five-year average to 2019 in all rating categories.

Government Debt Higher, but Not Funding Costs

Wider fiscal deficits translate quickly to higher government debt ratios, especially when accompanied by deep economic contractions. In 2020, the majority of Fitch-rated sovereigns experienced both, pushing debt ratios higher. We forecast that 2021 will be more favourable in terms of debt dynamics, with almost all rated sovereigns forecast to have positive nominal GDP growth, even though pressures on fiscal balances will remain.

The global sum of government debt (converted at average annual exchange rates) will reach about USD78 trillion at end-2020 and USD84 trillion at end-2021, approaching 100% of global GDP. Debt is not evenly distributed, however, with the US, for example, accounting for about one-quarter of world GDP and one-third of world government debt. As such, the median global government debt ratio is more stable than the sums might imply; the 2020 median is forecast at 60% and the 2021 forecast is 62%.

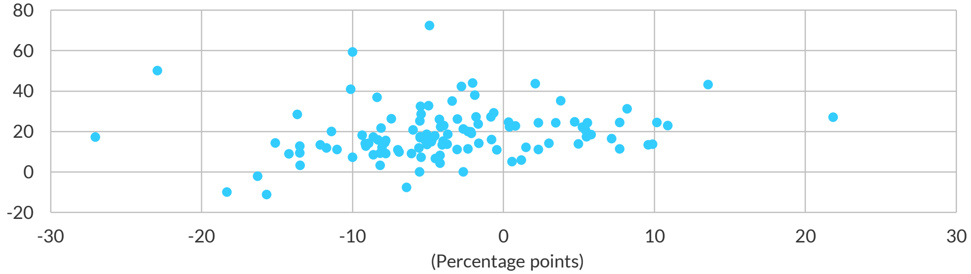
Longer-Term Fiscal Consequences of the Coronavirus

The fiscal impact of the coronavirus was felt first in the need to increase spending in the health sector, then to support households and businesses affected by lockdowns and resulting weakness in demand. Recovery will not take hold firmly until vaccines are widely available, but there is a growing policy consensus that there will be an ongoing need for fiscal support even as economies begin to strengthen.

The IMF, for example, is calling for policymakers not to withdraw stimulus too quickly, arguing that the economic aftermath of the crisis will be characterised by high unemployment along with increased income inequality and poverty. Governments that are not fully motivated by the economic reasoning for continued stimulus may act on concerns about associated political or social instability, especially in jurisdictions with implicit 'social contracts' in which political rights and freedoms are exchanged for economic growth and stability.

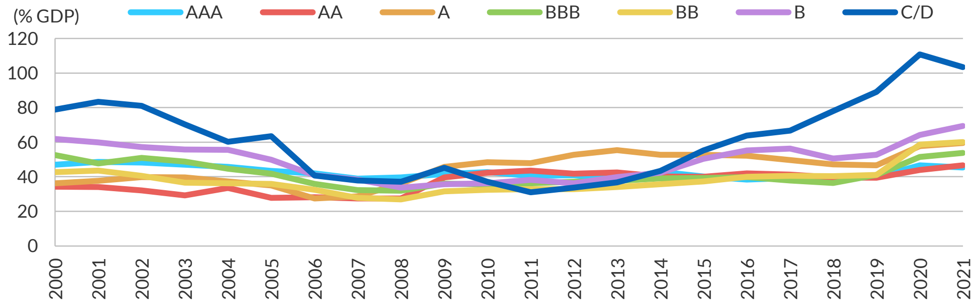
2020 Changes in Nominal GDP and Government Debt

(Percentage points of GDP)



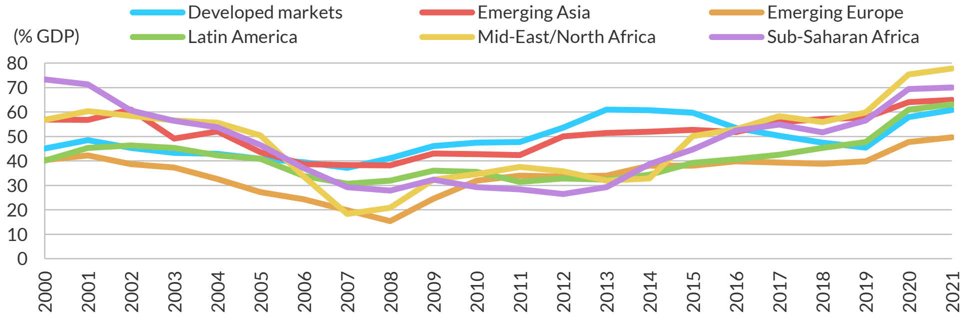
Source: Fitch Ratings

Government Debt/GDP Medians by Category



Source: Fitch Ratings

Government Debt/GDP Medians by Region



Source: Fitch Ratings

The median global effective interest rate continues to decline, as it has done for more than a decade, consistent with central bank policies intended to keep interest rates low and government funding costs curtailed. Fitch expects this to continue into 2021, with the median effective rate for developed-market and emerging-market sovereigns forecast to reach new lows, at 1.7% and 3.9%, respectively.

Declining effective rates have not prevented interest service burdens – interest payments as a share of government revenue – from rising globally, reflecting the effects of growing debt stocks, though there is a marked difference between developed and emerging markets. In developed markets, the median interest service burden should remain below 4% in 2021, lower than it has been for most of the past decade. In emerging markets, we forecast the median interest service burden to stay at just over 10%, more than double what it was as recently as 2012.

Emerging-Market Policy Flexibility

One of the lessons of 2020 was that central banks in emerging markets have greater policy flexibility than they had been exercising previously. Several engaged in explicit balance-sheet expansions, based on the accumulation of domestic assets – policies formerly in the sole domain of developed-market central banks. Justifications from emerging-market policymakers were that the crisis called for one-off measures, and expansionary balance-sheet operations would be discontinued when conditions return to 'normal'.

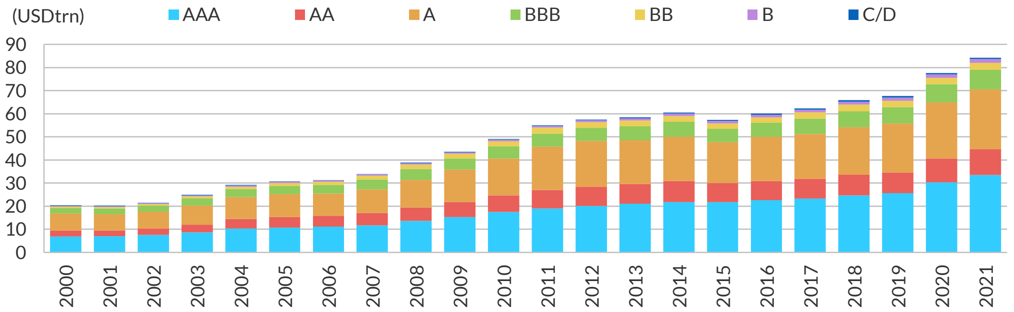
Fitch believes it will be important for emerging-market central banks to explore this newfound flexibility carefully, and to remain well within the confines of policy parameters established by developed-market central banks. The retention of market confidence is critical for any central bank, and currency volatility that could accompany doubts about central bank independence or concerns about direct monetary financing of governments over an extended period would be much more disruptive in emerging-market economies.

Emerging-Market External Finances

Funding conditions for emerging-market sovereigns in 2021 appear broadly favourable. Central banks in developed markets will not be tightening policy, keeping global benchmark interest rates low. Central banks in emerging markets will also be in no hurry to raise rates. Multilateral development banks will continue to provide support, and the Group of 20 Debt Service Suspension Initiative is available into 2021, covering at least official bilateral debt obligations.

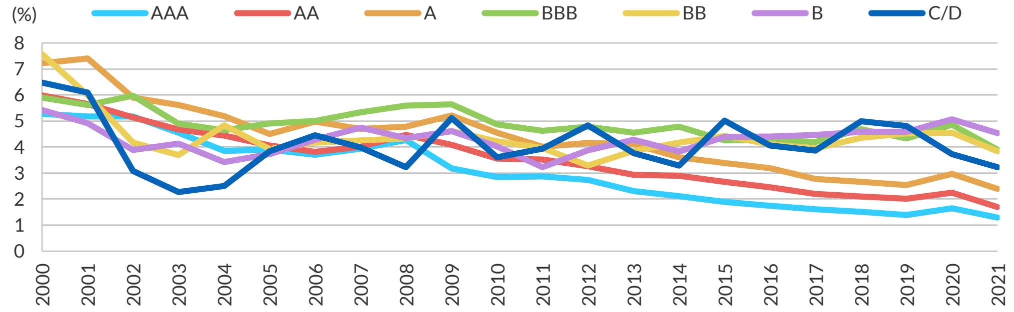
However, favourable funding conditions will not prevent pockets of acute emerging-market stress and possible defaults next year. There was a record number of defaults in 2020 (four), and 11 countries are rated below 'B-', another record. The rise in emerging-market external debt in the years leading up to the coronavirus shock has been well documented, and contemporary credit stresses in most instances will be better understood in that context.

Global Government Debt in US Dollars



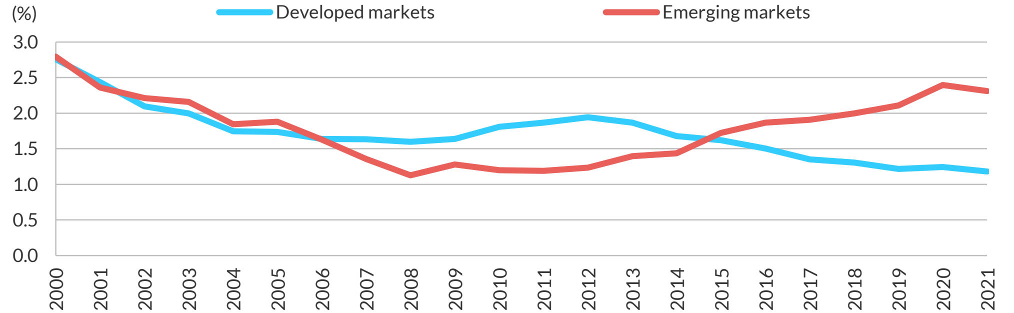
Source: Fitch Ratings

Effective Interest Rate Medians by Category



Source: Fitch Ratings

Global Effective Interest Rate Medians



Source: Fitch Ratings

Outlooks and Related Research

2021 Outlooks
Global Economic Outlook

Analysts

James McCormack
+852 2263 9625
james.mccormack@fitchratings.com

Tony Stringer
+44 20 3530 1219
tony.stringer@fitchratings.com