The world economy shrank in 2020. GDP contractions of an average of 5% in G7 countries, 7% in countries in Latin America and the Caribbean, and 2% in emerging and developing Asia were recorded by the IMF. Government debt as a share of GDP has significantly increased across all continents in 2020. Most economists expect that the effect of the pandemic on GDP will be temporary, as they predict a recovery for the global economy in 2021 as the economic impact of the Covid pandemic eases. The pandemic effects on government debt may be, however, permanent. The current high debt levels may constrain government policy and economic growth in the foreseeable future.

Figure 1 shows that the increase in government debt as a share of GDP in 2020 was around 15% for most regions in the world. Advanced economies could sustain large government debts before the pandemic. The G7 and Euro area’s current average debt to GDP ratios are around 100-140% in 2020. Emerging economies’ current average debt to GDP ratios are between 40-80% in the same year. The substantial increases in government debt in 2020 reflect not only the GDP decline but also an increase in government expenditures to support businesses and families, which were
heavily affected by the lockdown policies to fight the spread of the Covid-19 virus.

The global increase in government debt to GDP ratios of about 15% in 2020 is the critical data point I will use to understand the future of the global economy.

Whether current high debt levels could constrain global economic growth in the future depends on the sustainability of current debt levels. The global easing of monetary policy by Central Banks in 2020 kept government bond markets liquid and debt services reasonably cheap for most countries.

Still, not all countries were able to service their debt, in particular their external debt. Six countries defaulted at least partially in their debt obligations in 2020. This was the highest number of defaults recorded by Moody’s-rated sovereign bonds since 1983, as there are usually only 1 or 2 defaults a year. Countries that have defaulted on the part of their debt include Argentina, Ecuador, and Zambia.

Warnings of a widespread sovereign default crisis by the IMF chief-economist Carmen Reinhart led the IMF to lend to struggling countries to help them to fulfil their new and old debt obligations. The European Commission has also organised the EU recovery fund to support spending by member states using debt issued by the European Commission. These policy decisions have helped to keep sovereign risk so far under control.

Significant debt levels may still be a risk for the future of the global economy. Any constraint to global market liquidity may lead to portfolio reallocation away from perceived high-risk bonds. This includes the bonds issued by many emerging economies with a history of defaults. As central banks in advanced economies have inflation targeting mandates, persistently high inflation may lead to tightening monetary policy, increasing the cost of debt in advanced and emerging economies. With the current historic high debt levels, even small increases in interest rates may increase the perceived sovereign risk of emerging economies debt. The affected countries may then struggle to service their debt and issue new bonds, leading to reductions in government expenditure with consequences for economic growth. If a debt spiral materialises, we could even observe sovereign defaults with implications for the countries’ ability to finance economic growth.

In the case of advanced economies, the current extraordinary debt to GDP ratios are likely to be sustainable as long as the economy grows faster than the debt interest rate. While the current environment of a high growth recovery and loose monetary policy sustains current debt levels, monetary policy tightening is expected in the next two years as the economy moves back to the previous level of economic growth before the pandemic inflationary pressure increases.

The European Debt Crisis in 2012 reminded us that sovereign risk and default might damage growth heavily also in advanced economies. The austerity measures implemented by the UK government in 2010-15 were initially a response to government deficit levels perceived as unsustainable. The rating agency Moody’s has recently downgraded some investment-grade government bonds of advanced economies, including Hong Kong and the UK. Although the agency explained that domestic political
decisions were the cause of the downgrades, it is not clear how long debt rating agencies will disregard the effects of the covid crisis on countries’ risk in servicing their debt.

I am currently working on a quantitative model to forecast sovereign default events and compute sovereign default probabilities. The model was estimated with data from 50 countries, including emerging European, Asian, African and Latin American economies covering 1980 to 2020. As expected, country-specific economic and political characteristics have a key role in determining the likelihood of sovereign default. However, my preliminary results suggest that an increase in the short-term interest rate in G7 economies leads to an overall rise in sovereign risk. Increases in debt to GDP ratio also have positive effects on sovereign risk. The empirical model also suggests that external debt to GDP and foreign direct investment to GDP ratios are vital in explaining variations in the sovereign risk of a specific country in the long run.

Probabilities of sovereign default are generally higher for countries with a history of default. In addition, default probabilities increase with the levels of external debt to GDP and decrease with economic growth. What are then the odds of a major global economic downturn in the next five years?

Based on my argument so far, a major global economic downturn may arise from a widespread debt crisis caused by tightening of credit conditions (either because of monetary policy or deficiencies in the credit market) that moves investors away from risky government bonds. Depending on the number of countries affected by the crisis, IMF interventions leading to debt restructuring may be harder to implement in a timely manner successfully. The 80’s Latin American sovereign debt crisis took a decade to be resolved; that is, countries were cut off from external debt markets for many years. Even if a future sovereign default crisis mainly affects emerging market economies, global economic growth will slow down.

What are the odds of a widespread sovereign debt crisis following up the current covid crisis and recovery? Inflation is currently above or borderline 2% in Canada, the UK, the US, and the Euro Area. Policymakers interpret the current increase in prices as temporary because it is mainly caused by global supply chain issues linked to the pandemic. If inflation persists in 2022, many of the G7 central banks are likely to raise rates. The tightening of credit conditions that will follow may trigger investors to reallocate their portfolio towards advanced economy bonds, leading to liquidity issues for emerging economies’ external debt.

Using quarterly data for the last ten years, the unconditional probability of a sovereign default in any of the 50 countries included in my sample is about 2%, as data from a set of emerging economies with no history of default are included. Conditioning on IMF country forecasts for GDP growth and debt to GDP for 2021 and 2022 and the assumption that short-term rates in G7 countries will stay as now (an average of 0%), the average across countries default probabilities are 11% in 2022 Q4. If rates increase by 100-basis-points on average in 2022, the average likelihood rises to 13%. If an additional 100-basis-points
raise occurs in 2023, the average cross-country probability of default increases to 15% in 2023_Q4.

In summary, the loose fiscal policy response to the Covid pandemic has increased the likelihood of a global sovereign default crisis in the medium term. The probabilities of sovereign debt default in the next two years are still reasonably low for most countries. Still, they are set to increase in the next five years as monetary policy tightens credit in advanced economies. I estimate that the chance of another major downturn in the next five years is 1 in 10.

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