FTSE Russell's Market Impact Hub provides market navigation insights and analysis across asset classes on the impact of COVID-19.

The hub features data, analysis and commentary from FTSE Russell's award-winning research team to support institutional investors.

Recent posts provide a deeper dive into the impact of Covid-19 on bond markets

Can Emerging Market sovereigns cope with Covid-19?

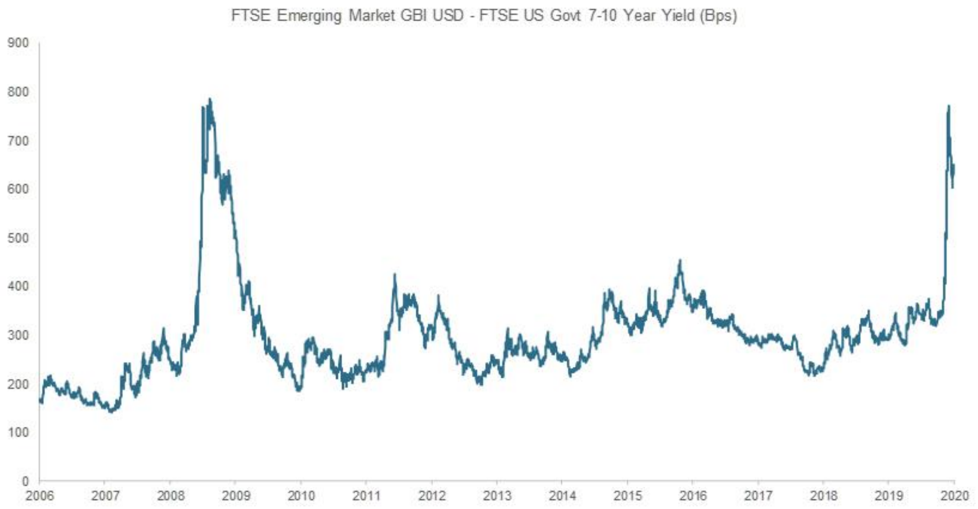
April 29, 2020

By Robin Marshall, director, fixed income research, Global Markets Research FTSE Russell.

Concerns about a wave of EM defaults has recently emerged

Some commentators have expressed concern about a wave of Emerging Market (EM) debt defaults, based on the scale of the Covid-19 shock, declines in commodity prices, the expansion in EM debt since the GFC, the strong US dollar and inadequate public health systems. Recent credit spread widening, particularly in EM dollar debt, reflects these fears. Chart 1 shows the spread widening has been substantial in US dollar EM, even after recent narrowing on IMF policy proposals. Lower credit spreads on EM local currency debt are explained by the fact EM sovereigns (just like G7 governments) can print money, or raise taxes, to repay their local currency sovereign debt. In contrast, the US dollar debt creates a currency mismatch between their assets and liabilities. Therefore, default rates in local currency debt are lower, which is reflected in credit ratings*.

Emerging Market credit spreads versus US Treasuries



Source: FTSE Russell. Data as of April 28, 2020.

Default concern is concentrated on EM dollar debt and because Covid-19 is a global shock

The EM fixed income asset class also escaped contagion in recent years and actual default rates were lower than predicted in the GFC, partly because EM economies grew by 3% in 2009, benefiting from spillover effects

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He previously worked as director of fixed income at Smith and Williamson Investment Management for 14 years, and before that, at JPMorgan Chase as managing director for Economic and Policy Research for 18 years.

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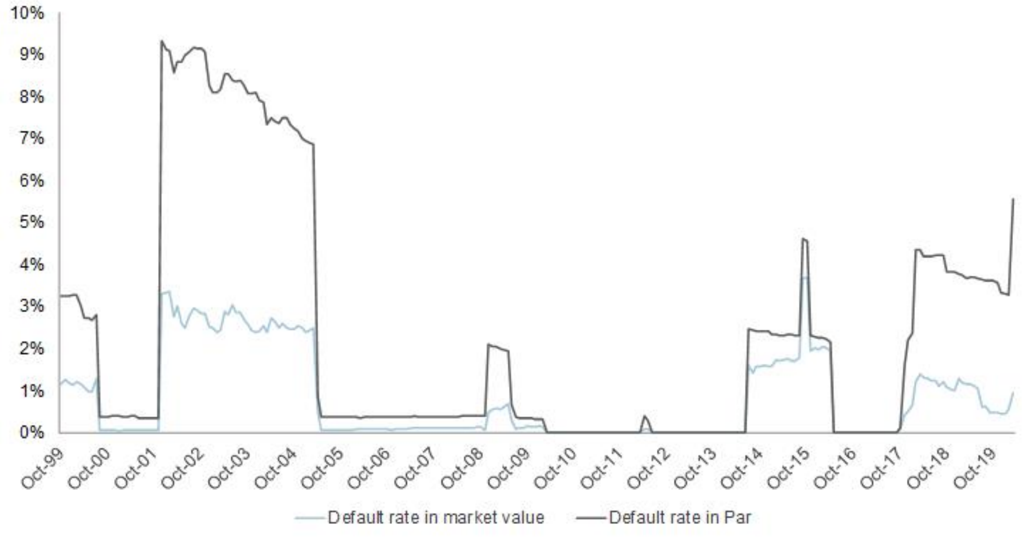
from G7 QE. But the Covid-19 shock is global, so risks to EM economies are higher in 2020/21. The IMF's baseline forecast is that EM economies will contract by 1% in 2020 but achieve 6.6% growth in 2021 (April 2020 forecasts). A 2020 contraction, and failure of the V-shaped recovery to materialize, would be a much bigger challenge for EM debt solvency arithmetic, particularly if developed economies switch demand away from global supply chains, rooted in EM economies.

Credit spreads imply much higher default rates than those seen historically

Default probabilities can be approximated from credit spreads; assuming a recovery rate of 40%, credit spreads of about 700bp in US dollar debt, reached in the early stages of the Covid-19 shock in March, would imply a default rate of about 16% (depending on the liquidity premium in credit spreads). Current spreads nearer 600bp would imply a default rate of about 10%. Chart 2 shows these would be high default rates historically, which may reflect the scale of the economic and financial shock (note that after a sovereign default on one bond, the FTSE EMUSDGBI Extended Index assumes all its issues are in default).

EM$ (USD) Sovereign Debt Default Rate



Source: FTSE Russell. Data as of March 31, 2020.

But failure of a V-shaped recovery to emerge in 2021 is main risk

Because this is a global shock, and not an EM specific event, a global policy response has resulted. The US Fed and ECB have broadened their QE purchases, and the US has approved a fiscal stimulus of about 9% of GDP, and an extended US dollar swap facility to ease global dollar liquidity (March 2020). The IMF enters the crisis able to lend an extra $1 trillion compared with $250bn before the GFC (IMF, April 9), and has expanded the Rapid Credit Facility and Financing Instruments by an initial $100bn. The GFC was followed by a $500 billion increase in the IMF's Special Drawing Rights allocations, in 2009, and although a further increase is not yet agreed, the G20 has agreed to freeze bilateral government loan repayments for lower income nations, until the end of 2020 (from May 1). These policy responses do not remove solvency risks from EM sovereigns but help ease financial conditions globally. Failure of a V-shaped recovery to occur in 2020/21 seems the main risk.

***** The credit rating of the FTSE Russell Emerging Market (local currency) government bond index is A-, compared to BBB- for the FTSE Russell (USD) Govt. Bond index.

Is some moral hazard required to save the world economy?

April 24, 2020

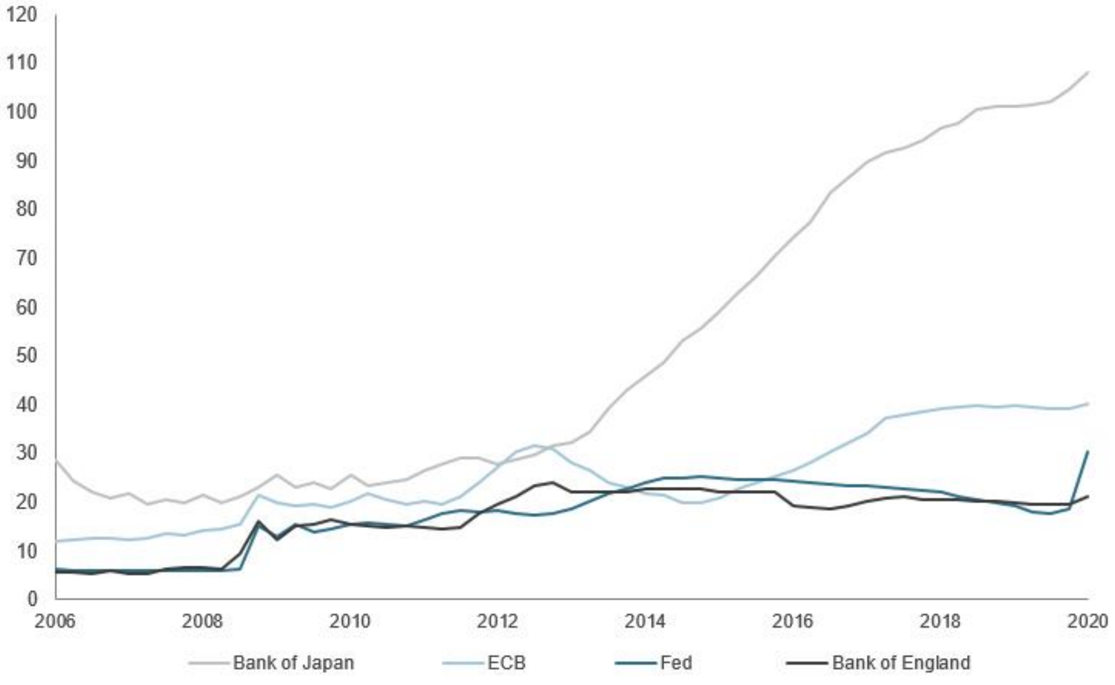
By Robin Marshall, director, fixed income research, Global Markets Research, FTSE Russell

The sheer scale of the Great Lockdown impact is forecast to dwarf the GFC

The sheer scale of the economic contraction caused by the coronavirus shock and Great Lockdown is emerging (although much still depends on the length of the Lockdowns, unemployment levels, business survival rates and how far consumer behavior adjusts). For example, the IMF now projects the Great Lockdown contraction as the greatest since the 1930s depression, dwarfing the GFC recession, with an estimate of -3% global growth in 2020 vs only -0.1% in 2009 (IMF, April 2020).

Some central banks have implicitly conceded marginal changes to the QE programs used in the GFC are unlikely to restore acceptable levels of employment and inflation. Therefore, both the Fed and ECB have now broadened their QE asset purchases to include lower grade corporate credit. But these changes still remain modest given the IMF is forecasting an output loss of about $9 trillion in the global economy from Covid-19. At least central banks have balance-sheet room to expand QE programs substantially.

Central bank balance sheets as a % of GDP



Source: FTSE Russell / Refinitiv. Data as of April 2020.

…forcing policy makers to consider responses on a scale previously unimaginable

Given high debt/GDP ratios, alternatives to debt-financed fiscal stimulus, like helicopter money (fiscal stimulus financed by printing money), have been raised (see FTSE Russell blog post on Helicopter Money. Theoretically, central banks are not limited in the amount of extra reserves they can create, so this could be done on a huge scale to finance government stimulus.

For the EU, where the IMF is forecasting a contraction of 7.5% in 2020, but the impact of the shock is uneven, the urgency of the joint policy response is driven by the existential threat to the future of the Eurozone posed by the shock. ECB President Christine Lagarde has already proposed some form of coronavirus bonds be issued by Eurozone members, and the Spanish government has proposed a €1.5 trillion perpetual coronavirus bond in the Eurozone to finance economic recovery.

Helicopter money raises governance and moral hazard concerns

But moving beyond debt-financed fiscal stimulus and QE programs raises issues of governance and moral hazard*****. Bank of England Governor Andrew Bailey has declared the BoE will not be financing central government through helicopter money because “Using monetary financing would damage credibility on controlling inflation by eroding operational independence” (Financial Times, April 5, 2020). But there is evidence from the UK central government’s Ways and Means Facility that it is already using money from the BoE to finance expenditures (just as it did during the GFC, on a modest scale).

But central banks could impose strict conditions on the money financing of government

The concern about governance and moral hazard with helicopter money is that without appropriate checks and balances, governments may use central bank money printing to finance reckless expenditures, jeopardising the economy and currency (as in Zimbabwe). Yet there is no reason why proper governance cannot be introduced, with the central bank controlling the process, just as central banks currently control QE programs.

Strict conditions could be imposed on how, and when this emergency central government account at the central bank could be used, including reference to the inflation target, and financial stability. Central banks already come very close to monetary finance of central government in QE programs, buying government bonds. The main difference being that this is designed to be temporary finance, to be unwound in future, as opposed to a permanent increase in the money stock in helicopter money. After a massive deflationary shock to global demand, it could be argued economic conditions for helicopter money, with appropriate governance controls, are appropriate.

Some moral hazard may be inevitable, if central banks are to do enough to meet the challenge

The scale of the global policy challenge means trade-offs for policy makers between adopting more radical policy, like helicopter money, to restore economic stability, and the risk of moral hazard, are becoming more acute. Already, extending QE purchases to corporate bonds, including sub-IG bonds, means central banks have accepted some deterioration in the asset quality of their purchases and an increase in moral hazard.

Buying equities as part of QE, and a move to full-blown helicopter money would extend these risks and the moral hazard. But erring on the side of doing too little and allowing economic conditions to spiral downwards in a self-feeding contraction, like the 1930s, might carry even higher risks.

***Moral hazard** is defined as a situation in which an individual has an incentive to increase their exposure to risk, because they do not bear the full cost of that exposure.

For more insight

On Wednesday May 13th, 2020, Robin is a hosting a webinar where he will provide a review of, and insight into, the impact of Covid-19 on global bond markets.

He will discuss fixed income market performance and macro-economic drivers, across conventional, inflation-linked, corporate and MBS indexes and markets.

His analysis will be framed within the context of the Covid-19 crisis and will draw upon key findings from our Market Maps 'Fixed Income Insight' report, published recently.

Register / Access the Webinar playback recording

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