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The Coronavirus Debt Threat

Developing nations as well as advanced ones will soon face a health emergency and its economic consequences.

By Carmen M. Reinhart and Kenneth Rogoff
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The elderly wait to collect their pensions in Guayaquil, Ecuador, March 20.
PHOTO: SANTIAGO ARCOS/REUTERS

As the pandemic lockdown continues, governments and central banks in the world's largest economies are responding with stimulus programs aimed at limiting the damage while holding societies together. But as the paralysis persists and deepens, the odds of a rapid "V-shaped" economic recovery are fast diminishing.

Our 2009 book, "This Time Is Different," documents financial crises over eight centuries. A central theme, controversial at the time of the global financial crisis, is that recessions that are accompanied by severe financial crises are deeper and recoveries slower than conventional "business cycle" recessions. Weakening financial-industry balance sheets and the inefficiencies associated with widespread default, personal and corporate, inflict severe damage on economic activity. This is often amplified by increased uncertainty and risk-aversion.

The current collapse is poised to shatter records for crisis depth. Duration is still an open question.

We have ranked crises since 1870 by severity, combining the magnitude of the initial contraction with the time it took to return to the pre-crisis peak in per capita gross domestic product.

At the moment, even in a scenario of rapid recovery, available data indicate that many countries—including the U.S.—are heading for contractions in the first half of 2020 that are unprecedented in the sheer depth of their "sudden stops," as measured by peak-to-trough declines in per capita GDP.

Even a relatively quick exit from the economic standstill in China, parts of Europe and the U.S. wouldn't avert crises in many middle- and low-income countries—or a deep global recession. Economic growth had been falling in many emerging markets before the novel coronavirus emerged. External debt, both private and public, had continued to climb. For most countries, central bank foreign-exchange reserves are significantly off their peaks. For many commodity producers, repaying hard-currency debt, mostly in dollars, will be impossible as commodity prices flirt with historic lows and investors show more aversion to risk.

For countries that don't rely on commodity exports, the situation is hardly better. The pandemic has bitten into global trade and all manner of manufacturing supply chains. For countries that depend on tourism, the immediate prospects are especially grim. Private financing for emerging markets has come to a halt, and multilateral government lenders such as the International Monetary Fund don’t have nearly the resources to fill the gap.

As the pandemic continues to interrupt normal economic life around the world, the number of countries at once facing an acute scarcity of financial resources and a health emergency will increase dramatically. In some of those cases, emergency policies to cope with the pandemic will take priority over the repayment of debt. Defaults won’t be limited to private personal and corporate debt. Argentina, Venezuela and Lebanon will soon have company.

An urgent question is how to figure out the inevitable debt rescheduling that will be needed in many corners of the global economy. There have been calls for a debt moratorium for small businesses and homeowners in advanced economies. This makes sense. If the capacity to generate income is suspended while in lockdown, debt repayments should also be placed on hold temporarily. As an emergency measure that lifts discretionary income and may limit lasting damage to individual and corporate credit scores, such proposals can be integrated with stimulus policies.

But the problem brewing outside the richest advanced economies must also be addressed. A comparable crisis-relief measure to deal with sovereigns hit by the pandemic needs to be worked out with the IMF and World Bank. The largest creditor for many of the world’s poorest countries is China, which will also have to come to the table. Ecuador is a case in point. The country has among the highest coronavirus infection rates in Latin America, and its revenue from oil exports has collapsed.

If the economic paralysis extends too long, advanced economies won’t be spared, either. Consider Italy’s predicament. With a debilitating collapse in output, limited fiscal capacity, and a dire humanitarian problem, is it really supposed to devote scarce resources to debt repayment instead of hospitals? Other countries in Europe may face the same dilemma. In Italy’s case the response is less clear-cut than for emerging markets, as much of Italian debt is held by domestic residents, not foreign investors.

Our research has shown that heterodox solutions to unsustainable debt, including debt forgiveness and restructuring, have been widely practiced by both advanced and developing economies over the past two centuries. For the moment, however, the worst-hit households, companies and governments need an outright moratorium.

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