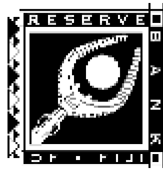


IMPACT OF THE PANDEMIC ON GOVERNMENT DEBT AND POSSIBLE SOLUTIONS

This article builds on the previously published article "Understanding Government Debt" and discusses how the COVID-19 pandemic has affected the Government's fiscal position and identifies policy options for managing debt, going forward.

The global economy was jolted by the coronavirus pandemic a year ago and has since then seen a halt in international travel and tourism along with a collapse in consumption, investment and international trade. In many countries, economic activity has also been adjusted to accommodate various lockdown and social distancing measures.

To save lives and mitigate the impact of the pandemic on incomes, consumption and output, global fiscal support has reached nearly US$14 trillion. In a similar manner, central banks cut their policy rates and swiftly deployed a range of other policy measures to supply the financial system with liquidity to support credit flows and finance government deficits.

How has the pandemic affected Fiji?

Prior to the pandemic in 2019, the tourism industry contributed around 34.0 percent to Fiji's Gross Domestic Product (GDP). Visitor arrivals totalled 894,389 while an additional 74,537 day-visitors came through cruise ships. According to the World Travel & Tourism Council, the industry supported around 90,700 jobs or around 26.3 percent of total employment.

The sudden and unprecedented halt in international travel and tourism from March 2020 led to a massive 83.6 percent drop in visitor arrivals in 2020. In total, around 146,905 tourists visited Fiji in 2020 – a level not seen since 1971.

As borders closed, firms involved in tourism and related sectors either scaled back or stopped operations completely. Consequently, thousands became unemployed or had to endure massive reductions in work hours and wages & salaries. The huge decline in income from those working in the tourism industry then affected other industries that relied on the spending power of tourists and tourism workers.

The tax revenue Government collects from both locals and tourists nose-dived. The unprecedented rise in unemployment and the massive fall in household and Government income given the economic interlinkages eventually led to an estimated 19.0 percent contraction in GDP in 2020, the largest in our modern history.

How has Government revenue performed?

The RBF estimates that the tourism industry contributes around $1.0 billion towards the Government's tax revenue each fiscal year (FY) that commences from August until July. In the first six months of this FY, the Government's total revenue of $964.8 million was lower by 36.6 percent ($557.7m) on an annual basis. Nonetheless, compared to the forecast for the first six months, the Government's revenue performed better-than-expected by 12.5 percent ($107.3m) mainly attributed to the one-off grants received and higher-than-budgeted tax revenue collection of around $26.7 million.

What happened to Government's expenditure?

Government expenditure was budgeted to rise to $3.7 billion (+$321.7m) in the current FY. In normal times, the Government would adjust its spending relative to its revenue to maintain a reasonable deficit. However, during such a crisis, fiscal support is needed to finance health care, stabilise household incomes and ensure the sustainability of businesses and the recovery of the broader economy.

In the first six months of this FY, the Government's expenditure totalled $1.5 billion which was lower by 11.5 percent ($195.6m) than the same period in the FY 2019-20. The decline in spending was largely driven by operating and capital transfer payments (-$113.7m), tertiary education loans scheme (-$36.8m) and wages & salaries (-$33.6m). Compared to the forecast for the first six months, the Government's expenditure was also lower by 23.7 percent ($470.4m) due to lower spending across all categories.

Given falling revenues, the budget deficit was projected at $2.0 billion in the current FY. However, given the reduction in actual spending by the Government and a higher-than-budgeted revenue outcome, the net deficit is now expected to be lower.

The budget deficit is still much higher than the deficits prior to the pandemic. Based on the current fiscal performance, government debt is likely to be around $8.2 billion or 87.6 percent of GDP at the end of July 2021, given the slower-than-expected economic recovery this year. In addition, the crisis is also likely to spill over to the next FY, requiring another high budget deficit thereby placing additional pressure on the rising debt trajectory.

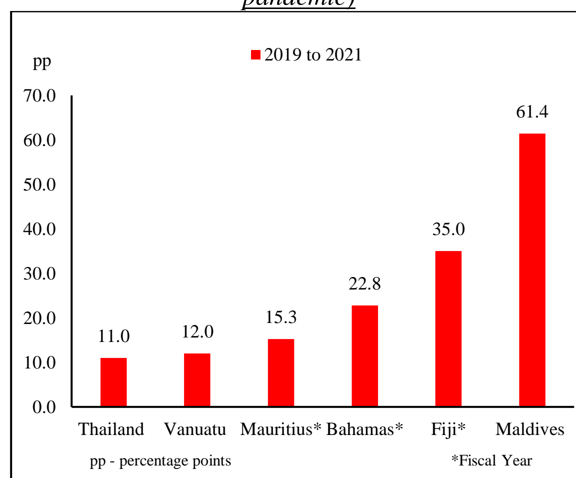
How have other countries performed?

Governments across the globe have had to finance large fiscal stimulus packages, to help economies and people recover from the impact of COVID-19. As such, the impact of the pandemic on Government finances is not exclusive to Fiji. A similar trend of an upswing in debt has occurred in other tourism dependent countries after falling revenues and rising expenditures forced governments to run large deficits while the economy contracted severely (Chart 1). This ranges from around an 11 percentage points (pp) increase in the debt-to-GDP ratio in Mauritius to over 61pp in Maldives where tourism respectively contributes 18.8 percent and 56.6 percent to GDP.

Similarly, developed countries such as Australia and New Zealand, which are not predominantly tourism-oriented, have also increased their expenditures in response to the pandemic and have also had a surge in their debt stock. Australia's debt is expected to increase from 34.5 percent of GDP in the last FY to 44.8 percent of GDP in the current FY, while New Zealand's debt is forecast to rise from 26.4 percent of GDP to 39.7 percent of GDP in the same period.

Chart 1: Pandemic-induced Changes in Government Debt

(Percentage points increase from prior to the pandemic)

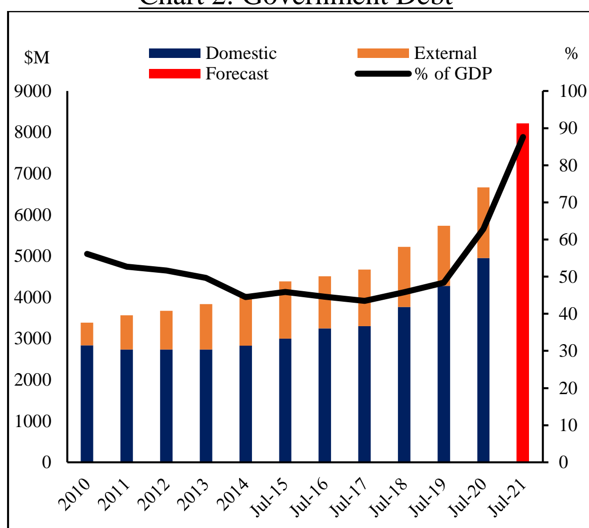


Sources: International Monetary Fund (IMF), Asian Development Bank and Country Reports.

What is Fiji's debt outlook?

The value of the Government's debt has increased continuously over time as the Government predominantly ran a budget deficit (except in 1988, 1998 and 2008). The Government's debt stock increased from about $40.2 million in 1970 to $1.4 billion in 2000, then rose further to $3.4 billion in 2010 and totalled around $6.8 billion at the end of 2020 (Chart 2).

Chart 2: Government Debt



Sources: Ministry of Economy and RBF

Conventionally, government debt is deemed sustainable when current and future debt service obligations (interest and principal repayments) are ably met on time without any recourse to debt relief, rescheduling, accumulation of arrears or compromising economic growth. Therefore, debt sustainability goes beyond the dollar value of the debt and includes other factors such as:

1. *The cost of debt or interest rate* – a lower interest rate is preferred over a higher one as it implies lower debt service costs;
2. *The maturity of debt* – longer maturity debt instruments are more desirable as there is more time to meet the repayments or to refinance the debt;
3. *The composition of debt* – a higher proportion of external debt poses greater exchange rate risks;
4. *Government's ability to repay* - the lower the debt servicing obligations relative to the Government's revenue, the better, as it implies less revenue is spent on repaying debt and more is available to spend in the economy.
5. *Size of the economy* - the larger the economy's GDP, the larger its capacity to hold debt. According to the IMF's debt sustainability framework, for countries with market access (ability to borrow funds on a commercial basis from financial markets) like Fiji, a debt-to-GDP ratio of below 70 percent is desirable.

Fiji has never defaulted on its debt. While interest payments on previous debt are expected to rise to 24.7 percent of the budgeted revenue in the current FY, from 13.0 percent in the last FY, Fiji is still well placed to meet these obligations over the medium term as the impact of COVID-19 on revenue is expected to be temporary. If revenue rebounds to pre-COVID levels, this ratio will decline sharply. In addition, most of the additional loans during the pandemic have been sourced from multilateral institutions at concessional rates therefore the growth in interest payments will be much lower than the growth in debt stock.

The Government's contingent liabilities are an added risk factor to the outlook. As at October 2020, the Government's explicit guarantees for statutory bodies' debt was around $888.6 million or around 9.5 percent of GDP. This includes guarantees for the Fiji Sugar Corporation, Fijian Hardwood Corporation Limited and the recently added Fiji Airways. If these guarantees are called upon, the Government's debt will rise further.

Notably, as the crisis prolongs, maintaining such a high level of debt will prove challenging. A continuously high debt-to-GDP ratio will mean more money will be spent on debt servicing relative to the provision of the Government's services. Therefore, concerted policy actions will be needed to reverse the rising debt-to-GDP trajectory.

Policy options

The recovery of the Fijian economy is contingent on the resumption of quarantine free international travel and tourism. However, until that eventuates, the Government's increased spending is necessary to support households and firms affected by border closures as well as those affected by the continuous barrage of natural disasters.

The Government also has to maintain its usual social protection and welfare programmes and continue investing in the maintenance of public infrastructures (e.g.

roads) and the provision of basic services such as water, sanitation, law & order, health and education. Therefore, in the short term where revenue has plummeted and the country awaits the resumption of international travel, the Government has limited options but to incur large budget deficits and take on more debt.

Hence, while awaiting the re-opening of borders, some specific policy options for the Government include:

1. Cutting unproductive expenditures and realignment of priority spending (where feasible) so that adequate funding is available to assist those affected by the pandemic and there is continued provision of essential services by the Government;
2. Working smarter with fewer resources and raising the productivity in the provision of Government services;
3. Continued social protection programmes and unemployment benefits to avoid households from falling into poverty;
4. Scaling back and reprioritising capital projects to focus on maintenance rather than new projects in a cost-effective manner;
5. Accelerating reforms in the 'ease of doing business' and removing bottlenecks and bureaucracy faced by the private sector in order to fast-track local investment projects.

However, once international travel and tourism resumes, tax collections pick up and the economic recovery is on solid footing, the Government must ensure that the budget deficit is reined in significantly to improve debt sustainability and build fiscal buffers for future economic shocks over the medium term. As such, the following policies are recommended:

1. Strict fiscal consolidation by curbing Government expenditure;
2. Increasing Government's revenue from the current 17.4 percent of GDP to above 20.0 percent of GDP by broadening the tax base;
3. Maintaining the reduction in tourism-related taxes to ensure a rapid pickup in visitor arrivals;
4. Continuing structural reforms to improve the ease of doing business and attracting both local and foreign investment;
5. Supporting and incentivising economic diversification by promoting other economic sectors such as information and communication technology and business process outsourcing to take advantage of our educated and English-speaking workforce; and
6. Promoting initiatives that raise potential output such as increasing the female labour force participation rate, investments in green energy and low carbon dependency that create new sources of jobs and economic growth.

Given the substantial impact of the pandemic on the economy and the Government's revenue in the current environment, budget deficits are expected to be higher. Unfortunately, this means that there will be more accumulation of debt in the short term. However, once borders reopen, it is imperative that concerted policy actions are undertaken to reverse the rising debt trajectory and rebuild fiscal buffers for future economic shocks.