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COVID-19: Fiscal Response Will Lift Local And Regional Government Borrowing To Record High

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PRIMARY CREDIT ANALYSTS

Felix Ejgel
London
(44) 20-7176-6780
felix.ejgel@spglobal.com

Celia Franch Lopez
London
+ 44 20 7176 0100
celia.franch_lopez@spglobal.com

SECONDARY CONTACTS

Daniela Brandazza
Mexico City
(52) 55-5081-4441
daniela.brandazza@spglobal.com

Stephen Ogilvie
Toronto
(1) 416-507-2524
stephen.ogilvie@spglobal.com

Anthony Walker
Melbourne
+ 61 3 9631 2019
anthony.walker@spglobal.com

Kensuke Sugihara
Tokyo
(81) 3-4550-8475
kensuke.sugihara@spglobal.com

See complete contact list at end of article.

Key Takeaways

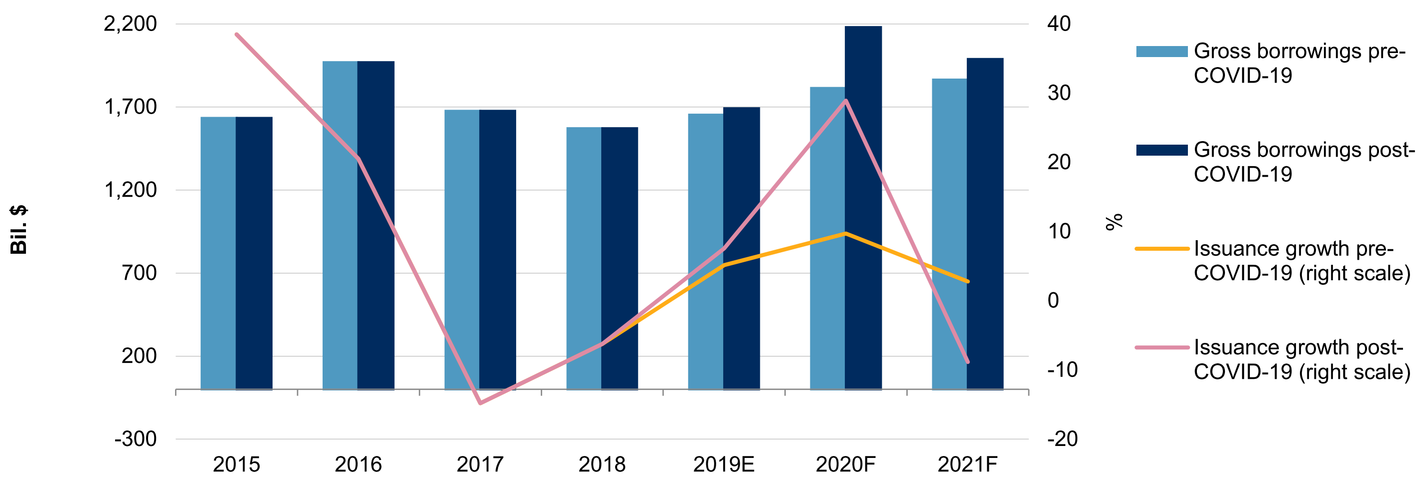
- Revenues will decrease and borrowing needs will increase for local and regional governments (LRGs) substantially above our previous February forecasts because of recession triggered by the coronavirus pandemic.
- We expect subnational borrowings to swell in 2020 and simmer down a bit in 2021. Over these two years, annual borrowings will increase 10% on average, well over our previous 6% forecast, and reach about US$2.1 trillion.
- Consequently, we also expect a substantial increase in bond issuance, especially in China and developed markets, with the exception of the U.S. We anticipate global issuance to reach US$1.7 trillion on average in 2020-2021.
- With rising borrowing and subdued economic activity, LRGs will face an increase in their debt burdens. By the end of 2021, Canada will increase its subnational debt to about 55% of GDP, followed by Spain, Japan, and China with about 25%-30%.

S&P Global Ratings assumes that a continuing global recession will further increase the funding needs of local and regional governments in 2020-2021. We estimate that annual borrowings will now rise about 10%, compared with our previous forecast for 6% growth. As a result, borrowings will exceed US$2 trillion a year on average over the next two years (see chart 1). Widespread social-distancing measures are leading to a much weaker economic performance than we projected three months ago. As a result of a reduction in activity, local and regional governments (LRGs) will face a reduction in their own revenue. Their borrowing needs will depend on the depth and longevity of recession, availability of additional transfers from the central government, and appetite of subnational governments to pursue a countercyclical financial policy.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Chart 1

The Recession Is Set To Lift Annual LRG Borrowings Above $2 Trillion In 2020-2021



E- Estimate F - Forecast. Source: S&P Global Ratings.

We assume that Chinese provinces as well as regional governments in many developed markets, primarily Australia, Canada, Germany and Japan, will likely apply a countercyclical fiscal policy to support local economies, maintain employment, and increase or at least sustain infrastructure-related spending during the downturn. As a result, in 2020 we expect a reversal of a multiyear downward trend in annual subnational borrowings in Germany and Japan, while borrowings in the other three countries will grow much faster than we previously envisaged.

We anticipate that most LRGs in Italy, the Nordics (Denmark, Finland, Norway, and Sweden), and Spain will pursue a less aggressive fiscal policy by reducing discretionary spending. Consequently, the borrowing needs of subnational governments in these countries will increase only moderately compared with our previous forecasts. Moreover, Spanish and Italian LRGs will continue to cover most funding needs with loans from the central government or their financial arms.

In our view, LRGs in many emerging-market countries will increase borrowing compared with their initial plans, even if they minimized discretionary spending, because central governments will struggle to provide substantial additional support. Moreover, the dependence of LRGs in Brazil, Mexico, and Russia on tax proceeds from commodity sectors will likely exacerbate the impact of the global recession, as the pandemic has put downward pressure on commodity prices (see "S&P Global Ratings Cuts WTI And Brent Crude Oil Price Assumptions Amid Continued Near-Term Pressure," published on March 19, 2020).

As regional governments in many large developed markets and Chinese provinces rely on capital markets as a prime source of funding, we project that annual bond issuance will increase 12% and reach US$1.7 trillion in 2020-2021. Slightly more than half of this will be placed in emerging markets addressed in this article--China, India, Russia, Argentina, Brazil, and Mexico--with the rest issued in developed markets. Outside the U.S., LRG bond markets are very concentrated--a few large issuers place most bonds in each country.

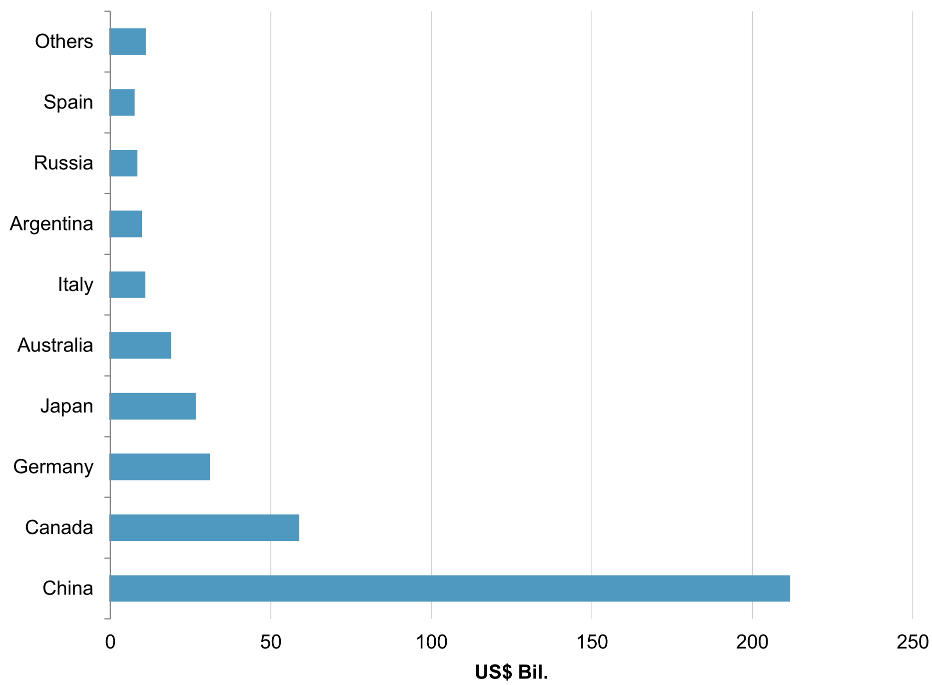
With the pickup in planned borrowings, we estimate the global subnational debt stock will reach a new record high by the end of 2021. Canadian LRGs will collectively remain the most indebted in the world, followed with a large gap by Spanish, Japanese, and Chinese governments. Despite a surge in borrowings, the direct debt burden of Chinese LRGs will remain moderate. However, they are closer to Canadian peers in terms of debt to GDP if off-balance-sheet debt is added.

Large Regions In Developed Markets Outside The U.S. Will Join China In A Revival Of LRG Borrowing

We expect large regions in Australia, Canada, Japan, and Germany to join Chinese provinces in the effort to support local economies badly hit by COVID-19 pandemic. This policy will lead to a material increase in borrowing (see chart 2).

Chart 2

Bond Issuances Of Chinese Provinces Will Account For More Than 50% Of COVID-19-Related Additional Global LRG Borrowing In 2020



Source: S&P Global Ratings.

Even before the pandemic struck, we expected Australian state infrastructure spending would reach record levels in 2020, especially across the three largest states by population and GDP--New South Wales, Victoria, and Queensland. With no more further major privatizations in the pipeline, we expect the consolidated deficit of Australian states will widen and financial asset holdings will diminish as states deliver large transport infrastructure projects. The anticrisis financial stimulus will further fuel state borrowings, which will increase 43% on average over 2020-2021.

Following the decision of the National People's Congress, we expect that borrowings of Chinese provinces and special municipalities (Tier 1 LRGs; only these governments are allowed to raise borrowings) will expand at a strong 21% on average in 2020-2021 compared with our previous expectation of 12% growth (see chart 6). Elevated investments in local infrastructure projects, coupled with the policy direction of reducing LRGs' dependence on off-budget activities, will result in widening deficits and the need for increased bond issuance. The proceeds of these bonds will cover both the infrastructure funding gap left by local government financial vehicles' (LGFVs) less-pronounced borrowing activity, as well as rising refinancing of bonds coming due. We see a low chance, however, of China's LRGs being able to quickly reduce their dependence on off-budget borrowings. We believe most Tier 1 LRGs will largely roll over their bonds by tapping China's capital market. China's investors appear supportive of holding municipal bonds, especially in the times of heightened volatility in the markets. We assume that in 2020 China will make up more than 40% of global subnational borrowings (see chart 3).

In our view, the borrowing plans of Canadian provinces, German states, and Japanese cities and prefectures will change even more dramatically in 2020-2021. In the beginning of this year, we projected that subnational borrowings in Canada would continue to stagnate, while in Germany and Japan they would continue to decline. We assumed that large regions in these countries strive to consolidate their budgets and reduce debt burden.

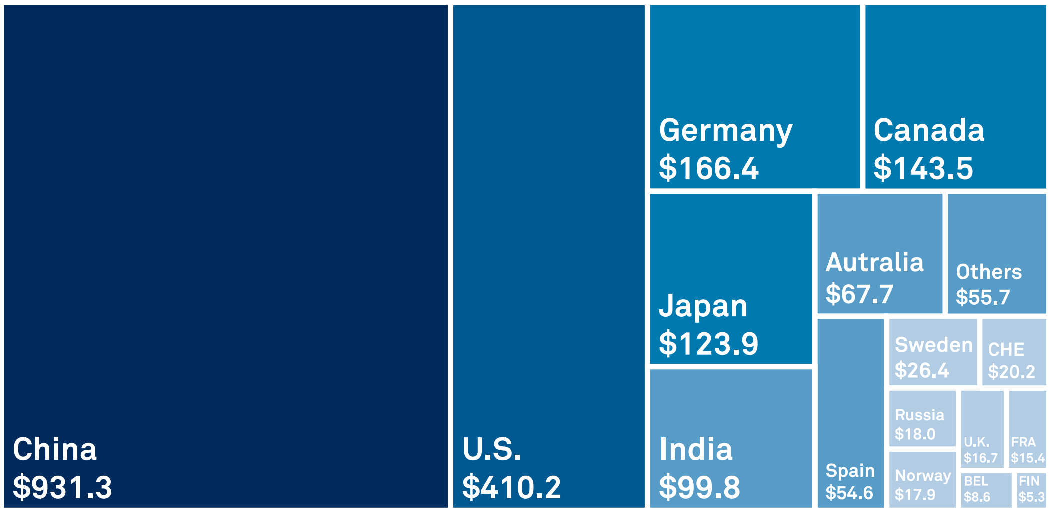
Following the virus-related hit on local economies, though, we now observe that large regions and cities in these countries are revising their financial policies. They will likely provide support packages to local economies and increase spending. This will spur annual average LRG borrowings by 6%-9% in Germany and Japan and by 20% in Canada over 2020-2021.

Among the countries with high subnational debt, we expect a very limited change in borrowing plans in India and the U.S. after the pandemic. Many U.S. state and local governments are receiving a substantial amount of support from the federal government for COVID-19-related costs, which will reduce their need for their own borrowings. Nevertheless, LRGs in the U.S. will continue to sell debt for their own capital needs. The ability to finance capital projects with debt is particularly important for LRG borrowers in the U.S. because the growing need for pension contributions has tested expenditures for many of them. These cost pressures can crowd out other costs, such as pay-as-you-go capital spending. The significant changes made to the U.S. tax code in late 2017 severely curtailed local LRGs' ability to refinance outstanding debt. However, the taxable bond market has filled the gap nicely in this traditionally tax-exempt market, allowing many issuers to continue to pursue cost-effective refunding opportunities.

Indian LRGs largely follow Chinese peers in their focus on infrastructure spending. Nevertheless, we estimate that borrowing in India will rise slowly--only about 7% on average in 2020-2021--despite a substantial recession in the country. The central government believes that increasingly risk-averse investors might have limited appetite for subnational borrowings beyond already approved quotas. We anticipate states' own sources to grow at a slower pace in the wake of a lower GST (goods and services tax) collections that will lead to cuts in spending.

Chart 3

We Forecast Australia, Canada, China, Germany, And Japan To Make Up 66% Of Global LRG Borrowings In 2020 (Bil. $)



BEL--Belgium. CHE--Switzerland. FIN--Finland. FRA--France. Note: U.S. data is for municipal borrowings, including local and regional governments and other public-sector entities, such as health care, higher education, and transportation. Source: S&P Global Ratings.

We don't expect Nordic LRGs to increase their borrowings compared with our previous forecast. We assume that central governments will provide sufficient support to cover losses of municipal budgets. In the Nordics, higher gross borrowing stems from rising refinancing and infrastructure spending needs linked to demographic pressures. Infrastructure spending in Nordic countries is largely carried out by LRGs themselves, or by LRG-owned companies, and has risen in response to relatively fast population growth. We include the debt of subsidiaries in our calculation of Nordic LRGs' debt given the widespread practice of raising funds for infrastructure-related spending via municipal companies.

Due to the peculiarities of the Spanish regional financing system, revenues of normal status regions will remain largely intact in 2020 and 2021 despite an ongoing recession, especially after the central government announced a support package to compensate regions for lost revenue and additional expenditures incurred due to the pandemic. Consequently, we expect only a moderate increase of subnational borrowing compared with our previous forecast--mostly to meet refinancing needs. Regions in this country will focus on budget consolidation over the next two years given high levels of outstanding debt, and still high deficits in an international context.

For Italy, we anticipate a noticeable increase in subnational borrowings in 2020, but from a very low level of 2019. The central government encourages the LRGs to increase investment in infrastructure, but spending priorities during the pandemic could be diverted to health care and social care spending. Most borrowings will be made in the form of 30-year liquidity anticipation from Cassa Depositi e Prestiti, the state lending arm.

LRGs in France, Switzerland, and the U.K. may not rely on massive support from central governments, but we expect them to constrain the increase of budget deficits and therefore borrowing needs. Most French LRGs will likely stick to balanced budgets or small deficits and finance investments primarily with operating surplus. Borrowings there will be mostly driven by refinancing needs. In Switzerland, the Canton of Geneva has partially capitalized its pension fund, spurring LRG borrowings in 2020 for reasons other than COVID-19.

Lower commodity prices and limited central government support will lift LRG borrowing needs in Mexico and Russia. In 2020-2021 we now expect a moderate uptick in Mexico compared with our previous expectation for deleveraging. We expect that Mexican states will respond to ongoing budgetary pressures by raising short-term debt in 2020-2021 after years of declining annual borrowings. We also expect borrowings structured by the central government to be transferred to LRGs to compensate for budgetary shortcomings. Similarly, in 2020 we project Russian LRGs to record the largest deficit since the beginning of the century. After a several years of trending downward, the borrowings of Russian regions are set to rebound strongly over the next two years. In Brazil, we expect a plateauing of regional borrowing, as well as a fiscal package that includes the possibility of debt renegotiation mostly with public banks and MLIs.

Provincial governments in Argentina have already announced debt restructurings over the past few weeks. That's why we have ratings at 'CCC', 'CC', and 'SD'. We estimate that gross borrowing would likely surpass $9 billion in 2020, assuming that provincial governments can finalize debt restructuring this year. It would, in our view, lift their gross borrowings substantially in 2020 and potentially in 2021 depending on how long this process lasts.

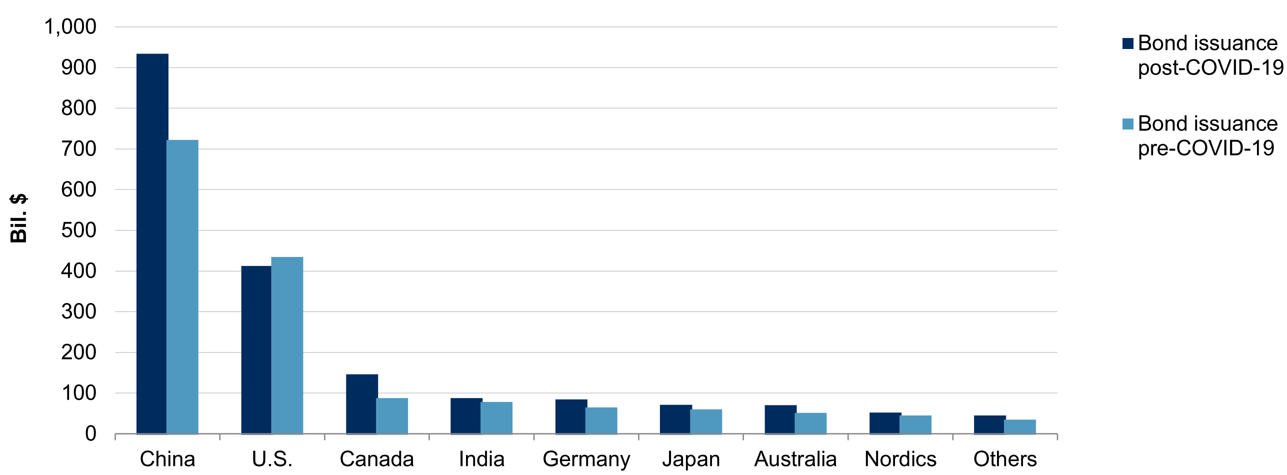
Bonds Remain The Chief Funding Source

Globally, funding for LRGs is dominated by bonds, although funding sources vary by country. We expect issuance of subnational bonds to reach the equivalent of $1.7 trillion globally in 2020-2021, which would cover around 85% of LRGs' funding needs.

Chinese Tier 1 governments dominate global bond issuance in the local government sector. Based on our forecast, they will make up about half of new bond placements in 2020 (see chart 4).

Chart 4

Due To The Pandemic, Canadian, Australian, And German Regions Will Accelerate Bond Issuances Faster Than Chinese Provinces In 2020



Source: S&P Global Ratings.

While most LRGs raise debt directly, Nordic LRGs refinance most of their funding via public-sector funding agencies (PSFAs). In most cases globally, LRGs place bonds domestically and in the local currency, while PSFAs, Argentine provinces (now restructuring their debt), and some Canadian provinces place bonds in different currencies. Chinese and Canadian provinces, Australian states, and U.S. public-sector entities rely entirely on the capital market. We also understand that bond proceeds cover about 80% of Indian and Nordic LRG borrowings. Bonds will cover about half of German and Japanese LRGs' funding needs. Late 2018 saw a gradual return of some Spanish autonomous communities to the capital market after years of covering their borrowing needs with central government liquidity funds. However, stricter enforcement of compliance with fiscal targets prevented some Spanish regions from issuing. We now expect their return to the capital market to be delayed to 2021, with bonds accounting for less than 20% of Spanish regions' 2020-2021 borrowings.

Until recently, U.K. LRGs covered most of their funding from the government's Public Works Loan Board (PWLB). However, following the government's decision in October 2019 to increase the interest rate for borrowings from PWLB by 100 basis points, we have seen a sectorwide shift away from PWLB toward commercial borrowings, with the U.K. Municipal Bond Agency launching its first bond issuance in January 2020.

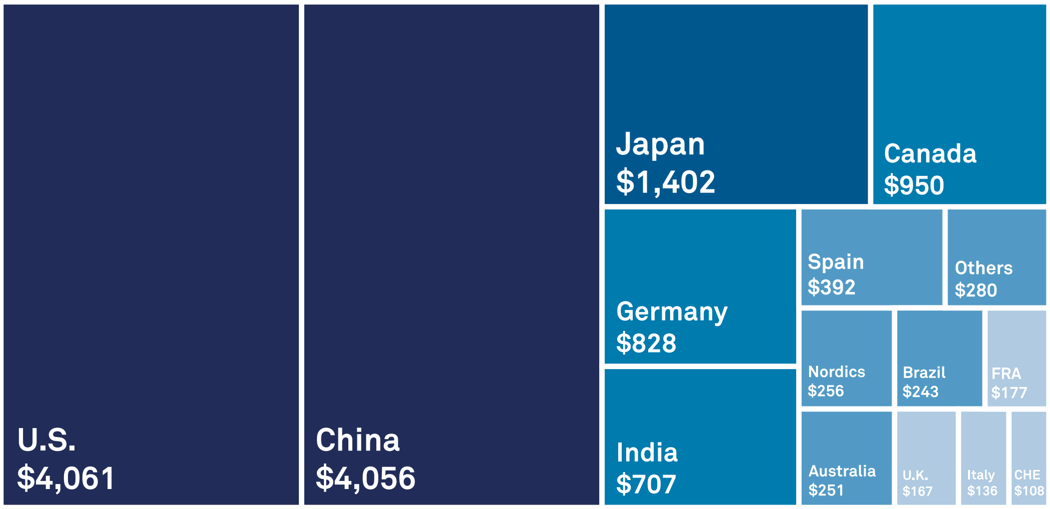
In contrast, Italian and Austrian LRGs cover almost all their funding needs by borrowing from the central government and its agencies. Multilateral financial institutions (MLIs) such as the European Investment Bank and the European Bank for Reconstruction and Development provide a substantial portion of funding for Central and Eastern Europe. Brazilian and French LRGs rely both on MLIs and public banks. In Mexico, bank loans comprise over 80% of LRGs' financing sources.

LRG Debt Stocks Rise To New Heights

The increased borrowing will lift global outstanding debt of LRGs to a new record high of about $14 trillion by the end of 2021. Global LRG debt stock remains very concentrated geographically. With fast-growing borrowings in China and stagnating borrowings in the U.S., we assume that these two countries will have a very similar volume of debt stock by the end of 2021--at about US$4 trillion or about 30% of the global stock each (see chart 5). Another five countries-- Japan, Canada, Germany, India, and Spain--account for about another 30% of the total. Overall, emerging market LRGs are set to make up more than 40% of global subnational stock by the end of 2021.

Chart 5

We Forecast Chinese Provincial Debt To Equate U.S. Municipal Debt By Year-End 2021 (Bil. $)



FRA--France. CHE--Switzerland. Source: S&P Global Ratings.

Collectively, Canadian LRGs will remain the most indebted globally with debt to GDP approaching 55% by the end of 2021 (see chart 6). After a substantial upward revision of the borrowing plans for 2020-2021 and lower economic activity, we expect LRGs debt in Japan and Spain to increase closer to 30% of GDP.

Chart 6 - COVID-19 Outbreak Leads To Higher Debt Burden Of LRGs Globally, Most Noticeably In Canada And Australia

Despite a fast-expanding debt stock, the consolidated indebtedness of Chinese LRGs (excluding LGFVs) still lags its peers. We project their direct debt will reach about 26% of GDP by 2021. Including LGFV's debt, though, Chinese LRGs' indebtedness would be comparable with that of Canadian peers and may overtake them in the near future.

Countries Covered In This Report

Our survey on global LRG borrowing encompasses 29 countries. We consider this sample as representative of global LRG debt. We have also published separate and more detailed analyses of projected borrowings in the LRG sectors of various regions (see the Related Research section below).

We base our survey on data collected from statistical offices, as well as on our assessment of the sector's borrowing requirements and outstanding debt, which includes bonds and bank loans. The reported figures are our estimates and do not necessarily reflect the LRGs' own projections. For comparison, we present our aggregate data in U.S. dollars.

Related Research

Global and regional

- Local Government Debt 2020: Global Bond Issuance Will Climb To US$1.55 Trillion, March 2, 2020
- Ratings History List: Canada And Latin America Local And Regional Government Ratings Since 1975, May 29, 2020
- Ratings History List: Asia-Pacific Local And Regional Government Ratings Since 1975, May 29, 2020
- Ratings History List: Europe, Middle East and Africa Local And Regional Government Ratings Since 1975, May 29, 2020
- Overview Of International Public Finance Rating Actions Since March 10, 2020, May 21, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020

Region- and country-specific

- COVID-19: French Departments Face Marked Revenue Losses, While Regions Swerve Near-Term Fallout, May 28, 2020
- China's Local-Government Deficits Could Rise To 25% On NPC Targets, May 26, 2020
- COVID-19 Could Further Strain Swedish LRGs' Budgets, May 20, 2020
- COVID-19 Response Will Push Russian Regions To Post Highest Deficits In 20 Years, Despite Federal Support, May 7, 2020
- COVID-19 Will Test The Financial Flexibility Of LRGs In Germany, Switzerland, And Austria, April 27, 2020
- COVID-19: Spanish Regions' Budgets Will Deteriorate In 2020, But Institutional Strengths Mitigate The Risks, April 7, 2020

Other

- Economic Research: COVID-19 Deals A Larger, Longer Hit To Global GDP, April 16, 2020

This report does not constitute a rating action.

Contact List

PRIMARY CREDIT ANALYST

Felix Ejgel
London
(44) 20-7176-6780
felix.ejgel@spglobal.com

PRIMARY CREDIT ANALYST

Celia Franch Lopez
London
+ 44 20 7176 0100
celia.franch_lopez@spglobal.com

SECONDARY CONTACT

Daniela Brandazza
Mexico City
(52) 55-5081-4441
daniela.brandazza@spglobal.com

SECONDARY CONTACT

Stephen Ogilvie
Toronto
(1) 416-507-2524
stephen.ogilvie@spglobal.com

SECONDARY CONTACT

Anthony Walker
Melbourne
+ 61 3 9631 2019
anthony.walker@spglobal.com

SECONDARY CONTACT

Kensuke Sugihara
Tokyo
(81) 3-4550-8475
kensuke.sugihara@spglobal.com

SECONDARY CONTACT

Alois Strasser
Frankfurt
(49) 69-33-999-240
alois.strasser@spglobal.com

SECONDARY CONTACT

Alejandro Rodriguez Anglada
Madrid
(34) 91-788-7233
alejandro.rodriguez.anglada@spglobal.com

SECONDARY CONTACT

Carl Nyrerod
Stockholm
(46) 8-440-5919
carl.nyrerod@spglobal.com

SECONDARY CONTACT

Sabine Daehn
Frankfurt
(49) 69-33-999-244
sabine.daehn@spglobal.com

SECONDARY CONTACT

Jane H Ridley
Centennial
(1) 303-721-4487
jane.ridley@spglobal.com

SECONDARY CONTACT

YeeFarn Phua
Singapore
(65) 6239-6341
yeefarn.phua@spglobal.com

SECONDARY CONTACT

Patrice Cochelin
Paris
(33) 1-4420-7325
patrice.cochelin@spglobal.com

SECONDARY CONTACT

Susan Chu
Hong Kong
(852) 2912-3055
susan.chu@spglobal.com

ADDITIONAL CONTACT

Wenyin Huang
Hong Kong
+ 852 2532 8007
Wenyin.Huang@spglobal.com

ADDITIONAL CONTACT

Ruchika Malhotra
Singapore
(65) 6239-6362
ruchika.malhotra@spglobal.com

ADDITIONAL CONTACT

Natalia Legeeva
Moscow
(7) 495-783-40-98
natalia.legeeva@spglobal.com

ADDITIONAL CONTACT

Michael Stroschein
Frankfurt
(49) 69-33-999-251
michael.stroschein@spglobal.com

ADDITIONAL CONTACT

Mariamena Ruggiero
Milan
(39) 02-72111-262
mariamena.ruggiero@spglobal.com

ADDITIONAL CONTACT

Omar A De la Torre Ponce De Leon
Mexico City
(52) 55-5081-2870
omar.delatorre@spglobal.com

ADDITIONAL CONTACT

Manuel Orozco
Sao Paulo
(55) 11-3039-4819
manuel.orozco@spglobal.com