Box 2

PUBLIC DEBT SCENARIOS IN BRAZIL AND MEXICO OVER THE NEXT DECADE

Public finances in Latin America

The COVID-19 pandemic marked an inflection point for public finances globally in general and in Latin America in particular. The fiscal measures adopted in 2020 to cope with the health emergency caused public debt to balloon and adversely affected its dynamics. Although this situation has partly reversed in subsequent years, public debt remains above its average for the last three decades in most of the region's countries. Against this background, robust fiscal rule frameworks and public debt sustainability take on renewed importance.

Latin America's main economies have one or more fiscal rules, which seek to bolster their budgetary frameworks, thereby ensuring that public finances are stable and sustainable and that public funds are managed transparently. They do this by setting limits and rules on debt levels, deficits and government expenditure and/or revenue. Most of the region's economies suspended their fiscal rules during the pandemic, but virtually all of them have already reactivated the fiscal rules or implemented an overhauled version of them.[1]

However, public finances in some of the region's countries are still exposed to considerable challenges, such as persistent budget deficits, often accompanied by primary deficits and high interest payments, and the need to ensure sufficient fiscal space to deal with negative shocks in the future.[2]

In this setting, government forecasts and analysts' consensus paint a considerably different outlook for public finance dynamics. Given this uncertainty, it is important to present different scenarios for public debt dynamics. The analysis in this box focuses on Brazil and Mexico, the region's two biggest economies.

A new tool for examining debt sustainability

A new debt sustainability analysis (DSA) tool is used to calculate different scenarios for public debt dynamics. This tool builds on those available at the Banco de España[3] to reflect some particularities of Latin America (and other emerging market economies), insofar as it factors in the important distinction between public debt denominated in local and foreign currency.[4]

The tool provides paths for the main macroeconomic variables that determine the possible future courses of public debt, such as real GDP growth, inflation, interest rates and the primary balance. In addition, it captures the interactions between these variables, such that the shocks in the model spread as they would according to economic theory. For example, in addition to affecting the primary balance, a fiscal policy shock also directly and/or indirectly impacts the course of GDP, inflation and the interest rate.

Scenarios for the course of public debt in Brazil and Mexico

Different scenarios for Brazil and Mexico that show how changes in fiscal policy could affect public debt dynamics are presented below.[5]

Three scenarios are simulated for each country. Under scenario 1, which is common to both countries, the structural primary balance remains at its 2024 level throughout the projection horizon (see Charts 1 and 3). This should be construed as a no-policy-change scenario that describes public debt dynamics in the event the structural primary balance remained unchanged with respect to its 2024 level. It should be noted that the Brazilian and Mexican Governments have already presented fiscal plans for the coming years and projected

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1   For more details on the status of the fiscal rules in Latin America, see pages 24 and 25 of Banco de España. (2024). *Report on the Latin American Economy. Second half of 2023*.

2   For more information on the region's fiscal position, see Banco de España. (2024). *Report on the Latin American Economy. Second half of 2023*, and International Monetary Fund (IMF). (2024). *Fiscal Monitor*. For more information on the situation of the region's sovereign wealth funds – state-owned investment vehicles often funded by the revenues from exploiting natural resources – which in the main have not received new deposits since 2019, see ICEX-IE. (2023). *2023 Sovereign Wealth Funds Report*.

3   Pablo Burriel, Iván Kataryniuk and Javier J. Pérez. (2022). "Computing the EU's SURE interest savings using an extended debt sustainability assessment tool". Documentos Ocasionales, 2210, Banco de España, and Mario Alloza, Jorge Martínez, Juan Rojas and Iacopo Varotto. (2024). "Public debt dynamics: a stochastic approach applied to Spain". Documentos Ocasionales, 2420, Banco de España.

4   For a detailed description of the tool, see Iván Kataryniuk, Raquel Lorenzo Alonso, Enrique Martínez Casillas and Jacopo Timini. (2024). "An extended Debt Sustainability Analysis framework for Latin American economies". Documentos Ocasionales, 2412, Banco de España. The paper details the equations governing the different economic variables and their interactions and the methodology used to calibrate the necessary parameters.

5   The public debt dynamics scenarios reflect data up to 2024. The model's simulations begin in 2025. If no consolidated data are available for 2023 and 2024, IMF estimates and forecasts are used.

Box 2

PUBLIC DEBT SCENARIOS IN BRAZIL AND MEXICO OVER THE NEXT DECADE (cont'd)

their fiscal paths, including the structural primary balance, in accordance with the reforms that have already been or are about to be implemented.

The two remaining scenarios focus on the differences between the Governments' projections for, and analysts' expectations of, the fiscal policy stance over the coming years.

Under scenario 2, over the coming years the structural primary balance will match the fiscal targets reported by

the Governments in 2024 (see Charts 1 and 3). For Brazil, this means primary balance equilibrium in 2025 and a surplus of 0.25% in 2026 and 0.5% in 2027.[6] For Mexico, this means a primary surplus of 0.9% in 2025, 0.5% in 2026 and 0.3% in 2027.

Under scenario 3, the structural primary balance over the coming years will match the analysts' expectations reported in the surveys conducted by the central banks (see Charts 1 and 3).[7] For Brazil, this means a primary deficit of 0.6% in 2025, 0.5% in 2026 and over 0.3% in

Chart 1
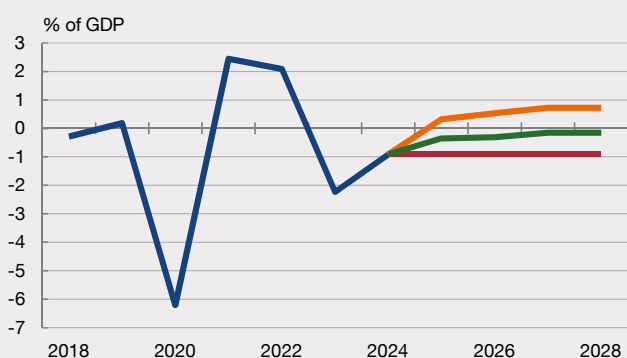Brazil. Structural primary balance (a)

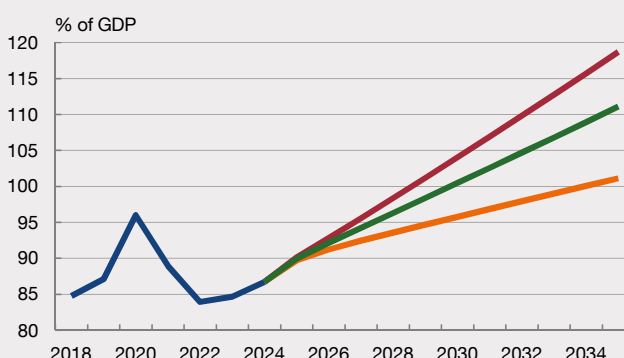Chart 2
Brazil. Public debt

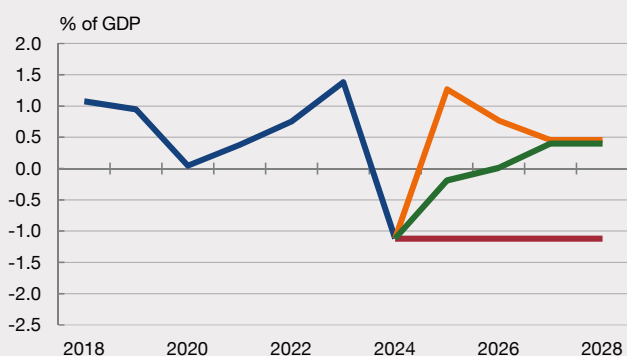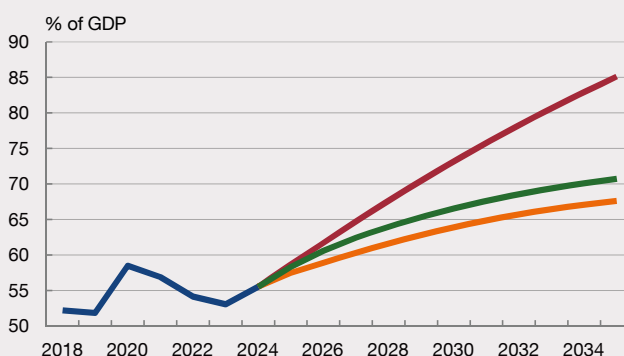Chart 3
Mexico. Structural primary balance (a)

Chart 4
Mexico. Public debt

- Data to 2023 and IMF forecast for 2024
- Scenario 1: structural primary balance at its 2024 level
- Scenario 2: primary balance according to the state budget
- Scenario 3: primary balance according to analysts' expectations

SOURCES: Banco de España, IMF, Refinitiv, expert surveys conducted by the central banks and state budgets.

a In 2028 and subsequent years the structural primary balance remains at the same level as in 2027.

6   In the projections, the structural primary balance remains unchanged from 2027 until the end of the projection horizon.

Box 2

PUBLIC DEBT SCENARIOS IN BRAZIL AND MEXICO OVER THE NEXT DECADE (cont'd)

2027. For Mexico, this means a primary deficit of 0.4% in 2025 and 0.2% in 2026 and a primary surplus of over 0.2% in 2027.

In the case of Brazil, under scenario 1 – the structural primary balance remaining at its 2024 levels (-0.9% of GDP) – public debt would grow by around 30 percentage points (pp) in ten years (see Chart 2), to approximately 120% of GDP in 2035. However, were the Government to achieve the primary balance targets announced in 2024 (scenario 2), it would significantly limit public debt growth – to around 15 pp over the same time horizon – and the public debt-to-GDP ratio would stand at 100% in 2035. Lastly, were the primary balance to perform in line with the analysts' consensus (scenario 3), public debt would increase by around 25 pp, to exceed 110% of GDP in 2035.

Turning to Mexico, the structural primary balance remaining at its 2024 level (-1.1% of GDP) over the following years (scenario 1) would see public debt growth similar to that of Brazil, i.e. around 30 pp in ten years (see Chart 4). In the event of a fiscal adjustment in line with that announced by the Government (scenario 2), public debt growth would be much lower (around 10 pp), with the public debt-to-GDP ratio standing at around 65% in 2035. Lastly, were the primary balance to perform in line with the analysts' consensus (scenario 3), public debt would increase by around 15 pp, to stand at around 70% of GDP in 2035.

In both countries, the Governments' planned fiscal adjustments (scenario 2) would have a considerable impact on economic growth. In 2025 GDP growth in Brazil and Mexico would be some 0.7 pp and some 1.2 pp, respectively, lower than under the no-policy-change scenario.

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7 In Brazil, the new fiscal rule in force introduces a percentage-of-GDP primary balance target and greater flexibility for the growth of real primary government expenditure. The expert surveys conducted by the Banco Central do Brasil use the same unit of reference. To calculate these scenarios in the DSA tool used, the shock to the structural primary balance is calibrated to achieve these specific primary balance targets. In Mexico, the expert surveys conducted by the Banco de México report data on the public sector's financial requirements and the budget balance. To calculate these scenarios in the DSA tool used, the shock to the structural primary balance is calibrated to achieve some specific primary balance targets calculated by assuming that the interest payments forecast by the analysts are equal to those expected by the Government.