

A Global Shock with Idiosyncratic Pains: State-Dependent Debt Limits for LATAM during the COVID-19 pandemic

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Publication Date: Tuesday, 12 of October 2021 Abstract

Fiscal sustainability in five of the largest Latin American economies is examined before and after the COVID-19 pandemic. For this purpose, the DSGE model in Bi (2012) and Hürtgen (2020) is used to estimate the Fiscal Limits and Fiscal Spaces for Peru, Chile, Mexico, Colombia, and Brazil. These estimates advance the empirical literature for Latin America on fiscal sustainability by offering new calculations stemming from a structural framework with alluring novel features: government default on the intensive margin; dynamic Laffer curves; utility-based stochastic discount factor; and a Markov-Switching process for public transfers with an explosive regime. The most notable additions to the existing literature for Latin America are the estimations of entire distributions of public debt limits for various default probabilities and that said limits critically hinge on both current and future states. Results obtained indicate notorious contractions of Fiscal Spaces among all countries during the pandemic, but the sizes of these were very heterogeneous. Countries that in 2019 had positive spaces and got closer to negative spaces in 2020, have since seen deterioration of their sovereign debt ratings or outlooks. Colombia was the only country to lose its positive Fiscal Space and investment grade, thereby joining Brazil, the previously sole member of both groups.