International Commentary — January 22, 2025

What Options Do Emerging Market Policymakers Have? Part 2

Can Governments Deliver Fiscal Stimulus to Support Growth?

Summary

With emerging market economies, in our view, most vulnerable to the global economic and policy landscape in 2025, we continue our series of reports on policy response options by examining fiscal policy space (i.e., capacity for governments to deploy fiscal stimulus). Similar to our work on monetary policy space, we built a framework to analyze public finance positions. Our framework is designed to identify countries that can deploy fiscal stimulus without experiencing major financial market or economic consequences. In short, most developing economies do not have adequate space for fiscal stimulus, complicating growth prospects across the emerging markets. Despite constrained policy space, select governments—such as in Brazil and Mexico—may pursue looser fiscal policy, which in our view, risks local financial market stability.

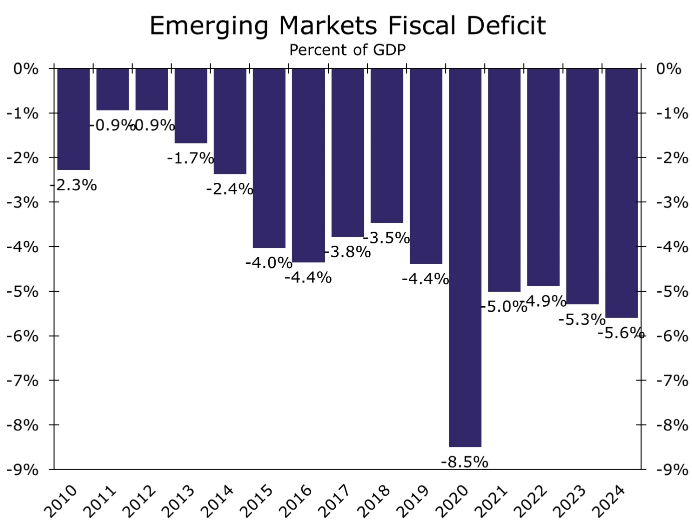
Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

Worsening Public Finances Complicates Fiscal Policy Space

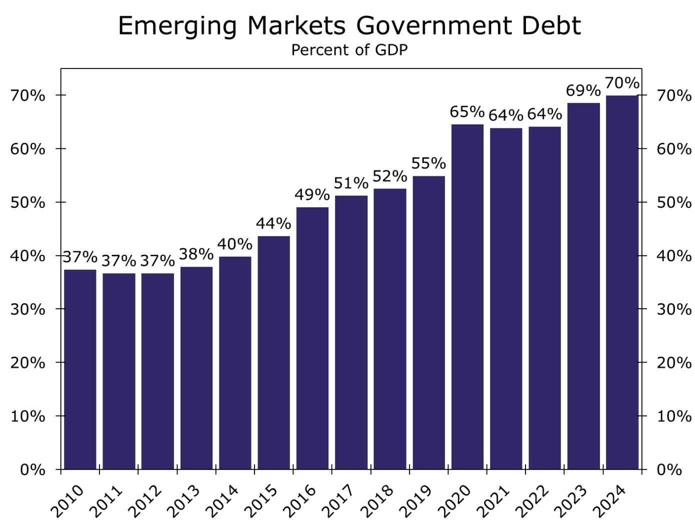
In Part I of this series of reports on policymaker options in the emerging markets, we made the point that emerging market economies are particularly vulnerable to the 2025 global economic and policy landscape. We pointed out how, in our view, the global growth environment is likely to be lackluster this year due to expected Trump administration tariffs, levies that emerging nations are particularly sensitive to. Part I also highlighted that central banks across the developing markets may not have adequate monetary policy space to lower interest rates by enough to materially offset the economic impact of tariffs. As of now, our monetary policy space framework indicates that only select institutions can cut interest rates multiple times without experiencing severe negative financial market and economic consequences (i.e., FX depreciation, renewed inflationary pressure, financial instability, etc.). Less-than-adequate central bank capacity for lower interest rates means policymakers have to rely on other forms of policy intervention to support economic growth. In that sense, support mechanisms will need to come in the form of more expansionary fiscal policy. But, is looser fiscal policy an option finance ministers can pursue? Public finance positions have worsened over time as debt burdens have risen and fiscal balances have shifted deeper into deficit. To that point, in aggregate, the emerging market sovereign fiscal deficit has widened from 2.3% of GDP in 2010 to over 5.5% of total emerging economy economic output at the end of last year (Figure 1). Similar trends exist for the sovereign debt burden as debt levels have jumped from 37% of GDP immediately after the Global Financial Crisis to 70% of GDP at the end of 2024 (Figure 2).

Figure 1



Source: IMF and Wells Fargo Economics

Figure 2



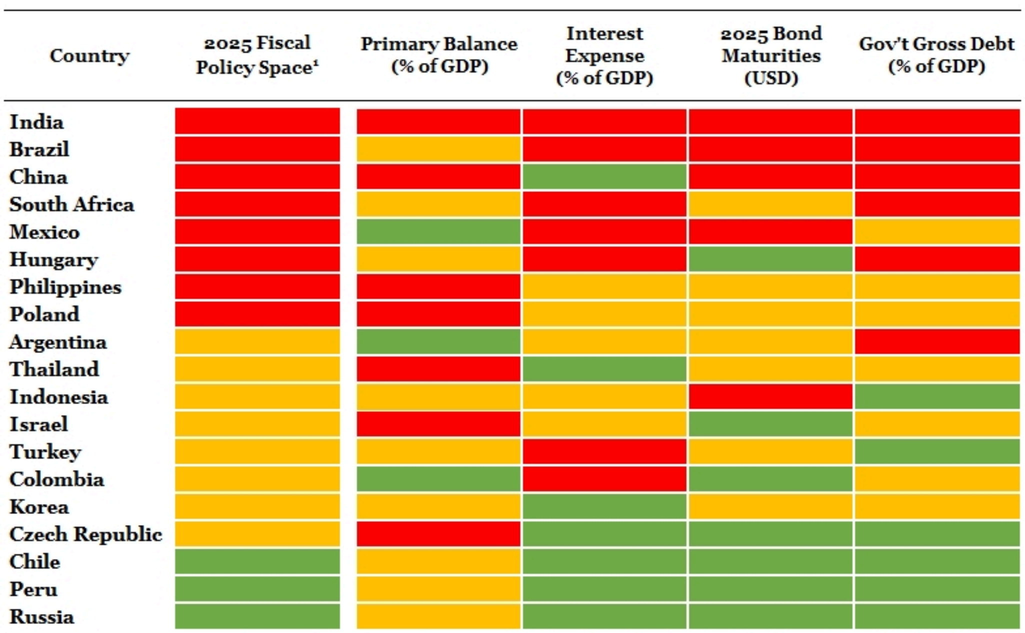
Source: IMF and Wells Fargo Economics

To get a sense of scope for looser fiscal policy, we created a heat map style framework. Similar to our monetary policy space framework, we are making an assessment of which countries can deliver fiscal stimulus without experiencing significant markets repercussions. Our framework incorporates indicators that we believe can determine a government's financial capacity to push forward with fiscal stimulus. These indicators include a government's primary balance (i.e., revenues minus expenses, excluding debt service costs) to determine if whether a core fiscal surplus is on track to be achieved or whether an administration is running an operating deficit. A primary fiscal surplus would be associated with capacity to deliver fiscal support, while an existing deficit would likely act as a restraining factor. We also included a debt service cost indicator in order to account for interest expenses on existing debt and the fiscal drag servicing outstanding borrowing creates. Combined with primary balance data, including debt service costs in our analysis, gives us a comprehensive picture of a government's overall fiscal balance. Also included in our fiscal policy space framework are government bonds that are maturing in the next 12 months. While principal payments on maturing bonds could be paid off through multiple operations—such as selling down state-owned assets or drawing down FX reserves—most governments opt to refinance and rollover coming due debts. Upcoming bond repayments, especially if principal payments are sizable, could potentially restrain future fiscal stimulus plans, or vice versa. We also included upcoming maturities as the combination of principal repayments and fiscal balance equates to a sovereign's overall financing needs. The more extreme the financing need, the less space for fiscal stimulus. And finally, the last metric we incorporated into our framework is the sovereign debt burden. Financing new deficits or refinancing maturing bonds, typically contributes to a larger sovereign debt stock. In a scenario where debt burdens become too large, default risks can rise and capacity for fiscal stimulus can be constrained.

An Assessment of Fiscal Policy Space in the Emerging Markets

Our framework is designed to aggregate these individual indicators into an overall assessment of fiscal policy space. Once variables are aggregated, we can make an overall judgment on fiscal policy space across the emerging markets as well as develop takeaways at the individual country level. As far as high level takeaways, our framework suggests governments across the emerging markets do not have sufficient space to deploy fiscal stimulus to offset slower global growth and Trump administration tariffs, at least without encountering negative financial market and economic consequences (Figure 3). To that point, we analyzed public finance positions of 19 developing countries, and according to our framework, 8 have no space for fiscal stimulus (India, Brazil, China etc.). Our framework also reveals that another 8 countries have only limited space to offer fiscal support (Argentina, Thailand, Indonesia etc.). Thematically, countries that have “no fiscal space” or “limited fiscal space” score poorly on most public finance metrics. These countries are associated with primary balance deficits, high debt service costs, large upcoming bond repayments and high debt burdens, although certain countries do score well on select indicators (e.g. China's low interest expense or Mexico's primary balance surplus). At the individual country level, we observe that for countries that contribute materially to overall global GDP growth and emerging economy growth, our framework identifies those countries as having no fiscal policy space. In that sense, public finance metrics associated with India, Brazil, China and Mexico appear especially weak. Given significant fiscal stimulus is not an option that can be pragmatically pursued in these countries, overall developing economies are likely on track for below-average growth in 2025.

Figure 3



¹ Green indicates "Adequate Fiscal Policy Space", Orange indicates "Limited Fiscal Policy Space", Red indicates "No Fiscal Policy Space"

Source: IMF, Bloomberg Finance L.P. and Wells Fargo Economics

During the early part of this year, we made the point that fiscal policy decisions in emerging market nations will be more closely scrutinized by market participants. We felt fiscal responsibility was largely being ignored by a growing number of nations—particularly within Latin America—but across multiple regions as well. We initially flagged Brazil as a country likely to be punished by financial markets for a lack of fiscal discipline (see: Brazil's Fiscal Fiction to Foil BRL). Indeed, Brazil's financial markets came under severe pressure toward the end of last year as the Lula administration pursued underwhelming budget cuts and still expansive fiscal policy despite an overheating economy and growing deficits.

Our concerns regarding Brazil's fiscal situation have not dissipated, and we maintain our view that President Lula will continue to deliver inadequate spending cuts while also delivering fiscal support to improve his re-election bid in 2026. In the context of our fiscal policy framework, should our view materialize and Brazil's public finance position worsen going forward, volatility in Brazilian financial markets should return and persist over an extended time horizon. Also in the context of our fiscal policy space analysis, we view Mexico as having no fiscal policy space. A lack of fiscal policy space in Mexico is notable as the country is directly targeted for tariffs by the Trump administration. Given strong trade linkages and Mexico's reliance on U.S. consumer demand, Mexico's economy is arguably most vulnerable to changes in U.S. trade policy. No space to deploy fiscal stimulus is part of the reason why we expect Mexico's economy to enter recession in 2025; however, should the Sheinbaum administration pursue fiscal support as means to generate local economic activity, we believe local financial markets could also experience a bout of volatility. Mexico's 2025 budget already contains, in our view, optimistic growth and revenue assumptions, and should expenses rise as a result of looser fiscal policy, Mexico's financial markets could come under pressure similar to Brazil's selloff in late 2024.

The last country we highlight is China. China is in an interesting, yet difficult, position when considering potential fiscal stimulus. On one hand, China's economy is in secular decline as a result of multiple imbalances. Deploying fiscal stimulus can support growth, both domestic and global, and also result in broader capital inflows for China. Not long ago, Chinese policymakers hinted at pending fiscal stimulus that prompted a surge in local financial markets that spilled over into a wave of optimism across global financial markets. On the other hand, one of China's imbalances is a massively overleveraged economy, across both the private and public sector. New fiscal stimulus will contribute to an already wide fiscal deficit and elevated debt burden, and likely exacerbate China's leverage issues. While fiscal stimulus to offset tariffs may be welcomed by market participants—in contrast to our framework's output—the caveat is that any near-term fiscal support is a short-term positive development that would likely only fuel China's long-term debt problems. Exacerbating China's imbalances risks longer-term financial stability, a trade off we believe Chinese authorities are unwilling to make at this time. To that point, we believe Chinese authorities recognize the lack of fiscal space available, and we doubt Chinese authorities have appetite for large-scale fiscal stimulus given the precarious state of China's public finance position. We laid out this view in detail across two publications (see: This Time Is Not Different For China and China Economic & FX Outlook: Scenario Analysis), and our view for no major fiscal stimulus contributes to our forecast for China's economy to slow from the 5% growth pace seen in 2024.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey Woessner	Economic Analyst	704-410-2911	Aubrey.B.Woessner@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Ali Hajibeigi	Economic Analyst	212-214-8253	Ali.Hajibeigi@wellsfargo.com
Coren Miller	Administrative Assistant	704-410-6010	Coren.Miller@wellsfargo.com

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