Economic Analysis

Will we see the first fruits of fiscal consolidation in 2017?

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- **As of this year, public debt as a percentage of GDP will stop increasing**
- **2017 will be the first year since 2008 with a fiscal primary surplus**
- **It is positive that the federal government sets a target for a fiscal primary surplus of 1% of GDP for next year**
- **It is adequate that the federal government is taking the average of GDP growth forecasts from private sector analysts as its forecast**

The federal government is on course this year to both obtain a fiscal primary surplus and reduce the historical balance of public sector borrowing requirements as a percentage of GDP. It is worth mentioning that the federal government expects to meet both fiscal targets even without taking into account the Bank of Mexico's operating surplus of 1.5% of GDP, which was transferred to the federal government last week. Meeting these targets would send a positive signal to financial markets and credit rating agencies regarding the federal government's commitment to a more responsible and sound management of public finances. Given the current economic conditions of relatively high interest rates, a more restrictive monetary policy in the U.S. and a slowdown in private consumption growth, meeting the targets will become even more important for Mexico's economic dynamics in 2017 and 2018.

Continuing the fiscal consolidation this year and afterwards is essential to lower the historical balance of public sector borrowing requirements as a percentage of GDP

In the document of Economic Policy General Pre-Criteria for 2018, which was published last week, a forecast revision of some public finance indicators for year-end is provided. In particular, it highlighted the favorable adjustments made to the primary surplus and the historical balance of public sector borrowing requirements. In the case of the first indicator, the Mexican finance ministry increased its forecast from 0.4% to 0.5% of GDP. As for the second indicator, the finance ministry reduced its forecast from 50.2% to 49.5% of GDP. It is worth mentioning that these two adjustments do not take into account the Bank of Mexico's operating surplus. The inclusion of such surplus assuming no negative macroeconomic surprises, according to the finance ministry, would imply forecasts of 1.6% and 48.0% of GDP, respectively.

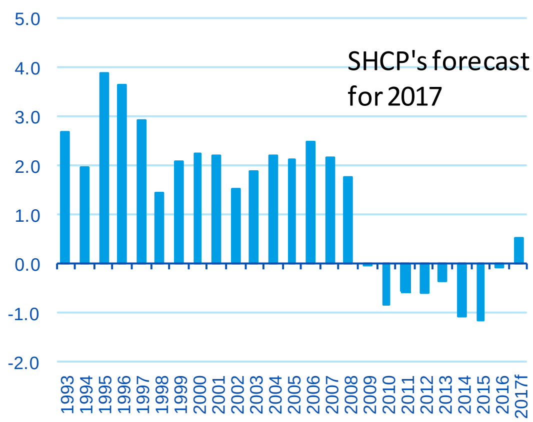
If expectations for the aforementioned indicators were met, we would be seeing the first fruits of the fiscal consolidation undertaken in recent years. **There has not been a primary surplus in public finances since 2008 and the historical balance of public sector borrowing requirements (as a percentage of GDP) has**

not stopped increasing from that year (Figure 1). Without any question, achieving significant primary surpluses (as a percentage of GDP) this year and in the following years is a necessary condition for reducing the share of public debt in GDP.

Given that preliminary data indicates that the historical balance of public sector borrowing requirements closed at 50.2% of GDP in 2016, a lower level (without including the Bank of Mexico's operating surplus) by 2017 year-end would interrupt the upward trend of this broader measure of public debt (Figure 2). Consequently, meeting the finance ministry's new forecast of 49.5% of GDP would send a positive signal to financial markets and credit rating agencies regarding the federal government's commitment to a more responsible and sound management of public finances. Ongoing fiscal consolidation could be reflected on a downward trend of the historical balance of public sector borrowing requirements (as a percentage of GDP) in the coming years.

Figure 1

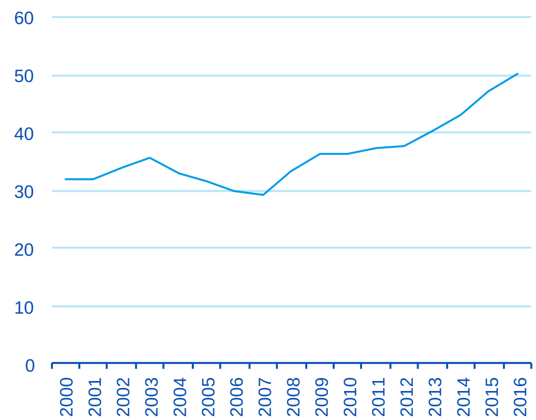
Primary balance of public finances (% of GDP)



Source: BBVA Research with SHCP data

Figure 2

Historical balance of public sector borrowing requirements (% of GDP)



Source: BBVA Research with SHCP and INEGI data

In 2018, in order to achieve a primary surplus of 1.0% of GDP, tax revenue and non-programmable spending will have to perform better than in recent years

The Pre-Criteria document mentioned in the first paragraph also contains information on economic growth forecasts for 2017 and 2018. The Mexican finance ministry has announced expected ranges of 1.3% to 2.3% and 2.0% to 3.0% for real GDP growth in 2017 and 2018, respectively. This does not necessarily imply that its point forecasts are 1.8% and 2.5% (the mid-range figures), respectively. Using the data provided by the finance ministry for this year's nominal GDP forecast and its corresponding GDP deflator, we can infer that the point forecast is 1.5%. This figure is in line with the median of growth forecasts found in the Citibanamex survey of March 21. Meanwhile, the inferred point forecast for economic growth in 2018 is 2.5%, which coincides exactly with the mid-range figure. Based on that survey, the median of growth forecasts is 2.2%.

For 2018, the finance ministry expects to see a moderate adjustment to spending of 0.2% of GDP with respect to Mexico's 2017 Expenditure Budget. Such ministry also indicates that this adjustment will allow public sector borrowing requirements to decrease to 2.5%, a 1.0% primary surplus and a continued drop in the historical balance of such requirements to 49.2% of GDP. Assuming that the aforementioned expenditure adjustment is made, it is important to mention that meeting these targets depends to a great extent on a favorable evolution of tax revenue and non-programmable spending. As the uncertainty caused by the Trump effect and the future of the commercial relationship between Mexico and the US tails off, we expect to see both higher economic growth in 2018 and more exchange-rate stability. These two factors will have a positive effect on tax revenue and non-programmable spending.

Conclusions

If the new 2017 forecasts for the primary surplus and the historical balance of public sector borrowing requirements were met, the Mexican government would be showing a firm commitment to a more responsible and sound management of public finances. This is essential to reduce the likelihood of a reduction in Mexico's sovereign rating. It is worth mentioning that if financial markets anticipate a reduction of one notch, such action might both increase the likelihood of capital outflows and complicate Pemex's financial position due to higher funding costs. Furthermore, a downward revision of this rating would also be difficult to absorb in the current international context of US monetary policy normalization and relatively low oil prices.

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