Economic Analysis

Primary surplus of at least 0.5% of GDP in 2019 to stabilize the ratio of public debt to GDP

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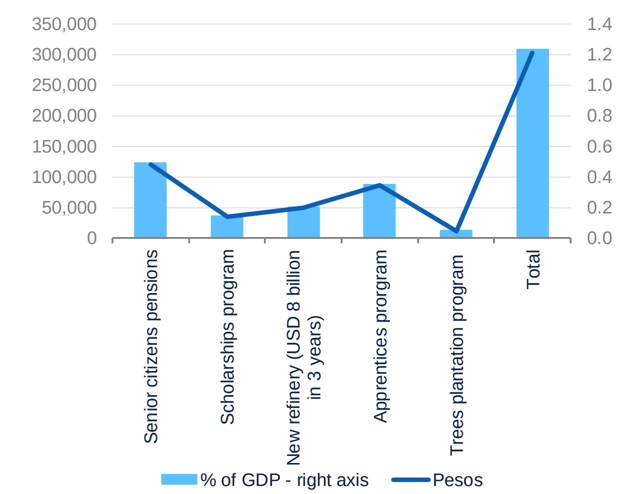
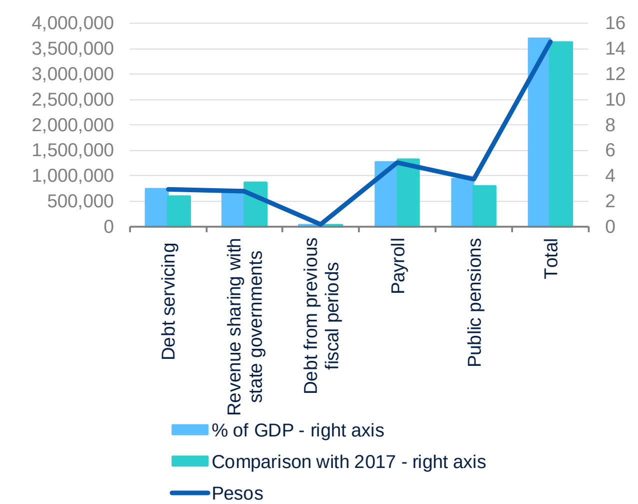
The fiscal policy of the next federal public administration's will face significant challenges regarding fiscal discipline due to the implementation of new social programs, the construction of a refinery and other non-discretionary expenditure which will involve an additional cost of around 1.5% of GDP (Figures 1 and 2). Nonetheless, the new federal government has reaffirmed its commitment to generating a primary surplus of 1.0% of GDP in 2019. Assuming a conservative scenario with no increase in public revenues as a percentage of GDP in 2019, obtaining this surplus would imply public spending cuts of 2.5% of GDP.

Figure 1. AMLO's new social programs and other projects (millions of pesos and % of GDP)



Source: BBVA Research with data from YouTube

Figure 2. Non-discretionary public spending and other committed expenditure (millions of pesos and % of GDP)



Source: BBVA Research with data from YouTube

To improve the sustainability of public finances in Mexico, the new federal government will have to continue the efforts made in 2016 and 2017 by the outgoing government towards fiscal consolidation. Nevertheless, it is important to acknowledge that federal governments of various administrations have always implemented a policy of increased public expenditure, regardless of the phase of the cycle that the Mexican economy is going through. In other words, the GDP elasticity of public spending in Mexico averaged 1.1 from 1994 to 2017, which implies a fiscal policy that has not been countercyclical (something desirable) when GDP has been above its potential. In contrast, in OECD countries the average GDP elasticity of public spending is approximately -0.25.[1] That is to say, the central governments of these countries have policies that encourage public savings in good times and set them aside for bad economic years.

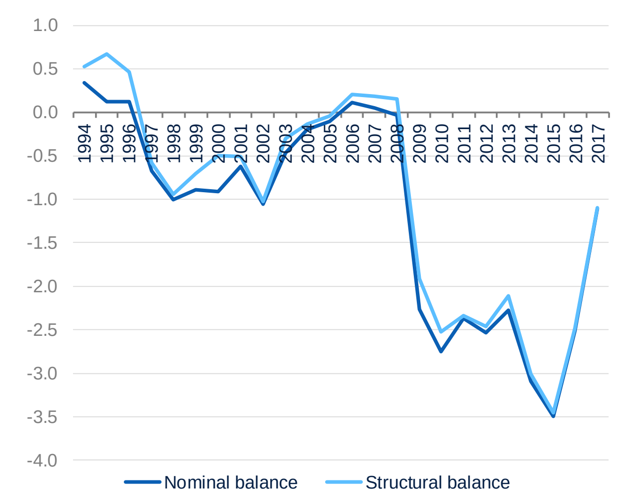
1: See Box 5.4 in Carnot, Koen and Tissot (2005) for more information on GDP elasticity of public expenditure and various items of public revenue in OECD countries.

The Mexican federal governments' questionable practice of spending more without taking into account the economic cycle is reflected on a nominal public balance that has always been below the structural public balance (Figure 3). Ideally, we should see a nominal public balance above the structural public balance in the expansive phase of the cycle and vice-versa. The continuing efforts towards fiscal consolidation on the part of the incoming federal government might possibly bring the nominal public balance above the structural public balance in the expansive phase of the economic cycle.

The stabilization of public debt as a share of GDP is one of the goals that the incoming federal public administration has set out to reach. For this to be possible, the public deficit should not exceed nominal GDP growth multiplied by the level of public debt as a percentage of GDP.[2] In other words, a level of public deficit equivalent to the product of these two factors would, *ceteris paribus*, hold the ratio of public debt to GDP steady. If we added the cost of debt servicing to this stabilising level of public deficit, we would obtain the minimum primary balance that holds such ratio steady.

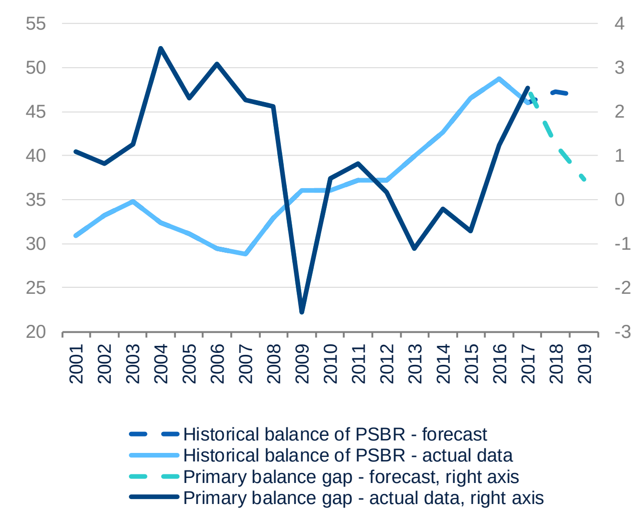
Generating a primary surplus is a necessary but not sufficient condition for attaining a stable ratio of public debt to GDP. Consequently, the primary surplus observed must be at least equal to the minimum primary surplus that holds public debt constant as a percentage of GDP. As can be seen in Figure 4, when the primary balance gap is positive (the primary balance observed is greater than the minimum primary balance), the historical balance of public sector borrowing requirements (as a share of GDP) tends to fall, and vice-versa. It is important to mention that this relation is not completely robust due to periods in which the public debt denominated in foreign currency fluctuates in peso terms because of significant exchange rate movements.

Figure 3. Nominal and structural public balances (% of GDP)



Source: BBVA Research with data from SHCP

Figure 4. Primary balance gap and historical balance of public sector borrowing requirements (% of GDP)



Source: BBVA Research with data from SHCP and YouTube

Our own forecast exercises indicate that, *ceteris paribus*, the historical balance of public sector borrowing requirements (as a share of GDP) could remain stable at a level around 46.5% of GDP if next year the federal government obtained a primary surplus of at least 0.5% of GDP. Nevertheless, higher economic growth or lower financing costs that those estimated for 2019 would reduce the level of the minimum primary surplus required to hold such balance constant.

2: See Box 5.5 in Carnot, Koen and Tissot (2005) for more information on the methodology used to determine the public deficit that holds the ratio of public debt to GDP constant.

References

Carnot, N., Koen, V. and Tissot, B. (2005). Economic Forecasting and Policy. Second edition. Palgrave MacMillan.

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