Economic Analysis

Mexico needs a counter-cyclical fiscal policy; a fiscal council would help

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Considering the current circumstances of almost zero economic growth, there is no need to aim for a primary surplus similar to the one planned for this year (1% of GDP) in 2020. If properly reported, a smaller primary surplus may be welcomed by the markets.

Undoubtedly, it is imperative that Mexico maintains fiscal discipline and avoids an upward trend in debt as a percentage of GDP. It is necessary to maintain the fiscal anchor in order to preserve the country's good macro-economic fundamentals, especially in this time of uncertainty caused by some of the decisions made by the new administration, such as canceling plans for the new airport in Mexico City. For this, I think we should aim to have a very low structural deficit.

Structural deficit is deficit that occurs throughout economic cycles; it is estimated based on the potential growth of the economy rather than the actual growth seen. This means that it is possible to have a more lax fiscal policy in parts of the economic cycle with less growth and a more restrictive fiscal policy when the economy is seeing more growth, while always taking care that the deficit does not grow structurally. Thus, fiscal balance is achieved in the medium term while simultaneously cushioning the negative effects of stages with lower economic growth. This is a counter-cyclical fiscal policy.

The key to implementing such a policy is that it must be credible. In other words, markets can tolerate a more relaxed fiscal policy when there is less growth in the economy as long as it is credible that policy will become more restrictive when the economy recovers. In this regard, Mexico will have its work cut out given recent history. Let's not forget that the country had a primary fiscal surplus each year from 1995 to 2008, without exception. That meant that debt as a percentage of GDP fell to around 27%, very low for an emerging country. This cycle of fiscal prudence broke down in 2009 when the economy shrank.

I think it was appropriate to relax fiscal policy in the context of a severe economic downturn. The problem is that the country did not have a primary surplus again until 2016, when markets and rating agencies gave the government a wake-up call and debt had reached almost 50% of GDP. This made it clear that the Fiscal Responsibility Act needs to be reviewed as it did not prove enough to force the government to have a primary surplus again when the economy recovered.

Implementing a counter-cyclical policy involves several challenges. One is the one I have already mentioned regarding the credibility that would be achieved by having a clear legal framework that leaves no doubt that fiscal policy should be restrictive in parts of the cycle with higher growth. Another is to have an adequate estimate of the potential growth of the economy, otherwise it is not possible to determine which part of the cycle we are in. This will be complicated in the current environment where the potential growth rate is lower than a few years ago due to a lower investment balance.

I believe that a good way of achieving this objective would be to form an independent tax council responsible, among other things, for determining such potential growth. Work should be done on the legal framework so that a counter-cyclical policy can be implemented. That will take time.

In the meantime, and in the absence of such a framework, I do not think it would be overly prudent to propose a budget with a primary fiscal deficit for 2020, even in this setting of stagnant growth; the surplus must continue. However, that does not mean it is necessary to propose a primary fiscal deficit of 1%; a deficit of between 0.2% and 0.4% would be welcomed by the markets and would help to cushion the effects of the economic slowdown. An economy that is not growing must not have such a restrictive fiscal policy.