Economic Analysis

2018 Fiscal Program: the government proposes a fiscal consolidation effort of 0.5% of GDP

Javier Amador / F. Javier Morales / Carlos Serrano / Mariana A. Torán

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- **The program is based on realistic economic assumptions**
- **The continuation of fiscal consolidation is positive**
- **The budget will mean that debt as a percentage of GDP will continue to decline in 2018**

Improved fiscal prospects in the short term; the public debt could be reduced to 47% in 2018

Last Friday, the SHCP (Ministry of Finance and Public Credit) delivered the fiscal program for 2018. It presents a responsible budget based on realistic assumptions. We estimate that Congress will authorise it without substantial modifications. It proposes a reduction of the fiscal deficit, measured by the public sector borrowing requirements (PSBRs), from 2.9% approved for 2017 to 2.5% of GDP by 2018, involving a primary surplus of 0.9% of GDP, which compares favourably with the figure of 0.4% approved for 2017. The 2.5% deficit for 2018 is greater than the 1.4% estimated for 2017 because the latter includes Banco de México's Operating Surplus (BMOS) of 1.5% of GDP obtained in March this year. Thus, if we compare the figures without the non-recurring gains from Banco de México (Banxico), the proposed improvement for the fiscal deficit is 0.5% of GDP. If this budget is met, debt as a percentage of GDP will continue to decline next year, reaching a level of 47.3% of GDP in 2018 (vs. 50.1% at the close of 2016 and an estimated 48.0% at the end of this year). The budget considers the following assumptions:

- It estimates a GDP growth rate of between 2.0% and 3.0% for 2018, with the median point of 2.5% being rather higher than our estimate (2.0%),

- An average price per barrel of export oil of US$46 (vs. US$43 in 2017) and an exchange rate of 18.1 ppd. An increase in oil production of 2.0% (to 1.98 million barrels per day or bpd), but a reduction in the export platform of 10.1%, falling from 989,000 bpd to 888,000 bpd. A current account deficit of 1.8% of GDP.

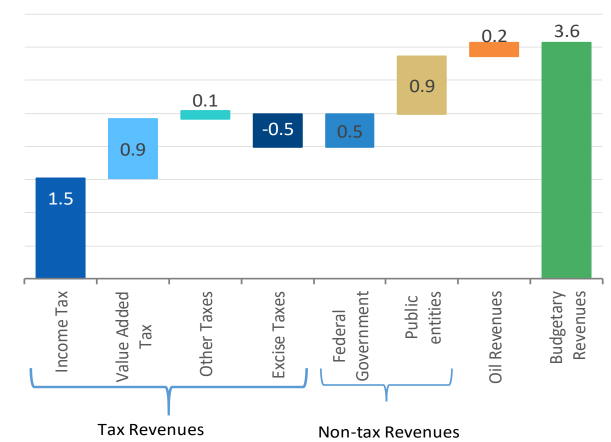
- A convergence of inflation with the 3.0% target is expected at the end of 2018 (BBVA Research: 3.7%) and a stable monetary rate of 7.0% (BBVA Research: 6.0% at the end of the year).

Among downside risks for the Mexican economy, the 2018 General Economic Policy Guidelines (CGPE 2018) identifies: 1) Problems related to NAFTA renegotiation, 2) Lower than expected US economic growth, which would result in a lower growth rate of exports. 3) Less favourable conditions than expected in international financial markets, which would generate more restrictive external financing conditions. 4) Lower international oil prices or lower dynamism of crude oil production platform, which would have a negative impact on public sector oil revenues.

A slight increase in budgetary revenues is estimated

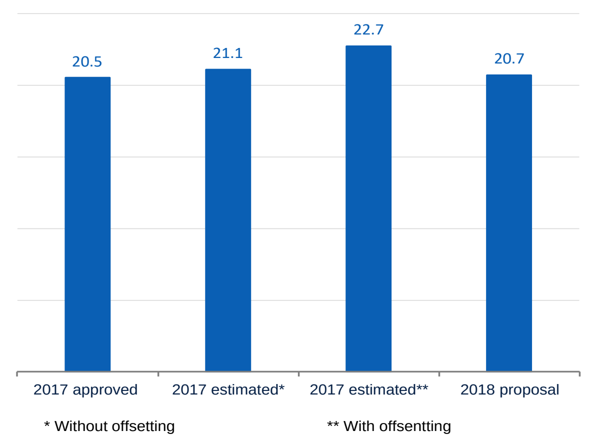
For 2018, budgetary revenues are proposed for 4,735 billion pesos (bp), an amount that represents a real increase of 3.6% compared to budgetary revenues approved for 2017. This dynamism will be driven mainly by the increase in tax revenues, in particular, taxes collected through the income system (which will contribute 1.5 percentage points (pp) to the actual variation) and value added tax (VAT), whose contribution will add 0.9 pp. This performance is explained by the favourable evolution observed in tax revenue collection during 2017 and the increased economic growth expected for 2018. In turn, non-tax revenues will contribute 1.4 pp to the real growth rate and oil revenues will have a contribution of 0.2 pp (Figure 1).

Figure 1. Contribution to the real variation in budgetary revenues, percentage points (2018p vs 2017a)



Source: BBVA Research based on information from the SHCP

Figure 2. Budgetary revenues (% of GDP)



Source: BBVA Research based on information from the SHCP

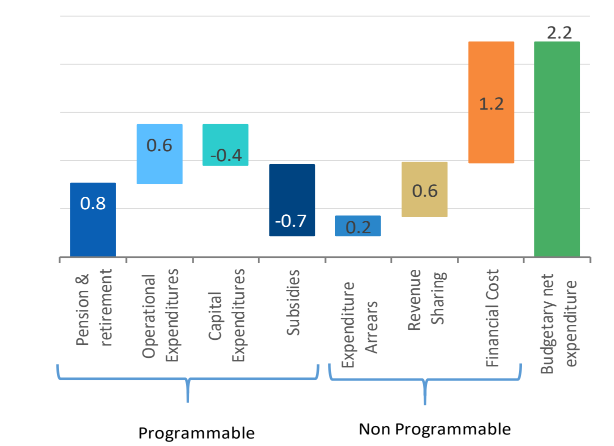
As a percentage of GDP, budgetary revenues are expected to rise to 20.7% in 2018, slightly higher than that approved in 2017 (20.5%). It should be noted that, by the end of 2017, budgetary revenues are expected to account for 21.1% of GDP, without considering non-recurrent revenues (without offsetting). This increase of 0.6 percentage points over the amount approved is due to higher than budgeted tax revenues and oil revenues. If the non-recurrent revenues associated with BMOS by 1.5 percentage points of GDP and other surplus revenues by 0.1 percentage points of GDP[1] are also considered, the estimated revenues for 2017 (with offsetting) would rise to 22.7% of GDP (Figure 2).

1: The BMOS amounted to 321.7 bp and 32.8 bp of surplus revenues that by law are specifically earmarked was also received.

The financial cost of debt and the payment of pensions are the main sources of pressure on public spending

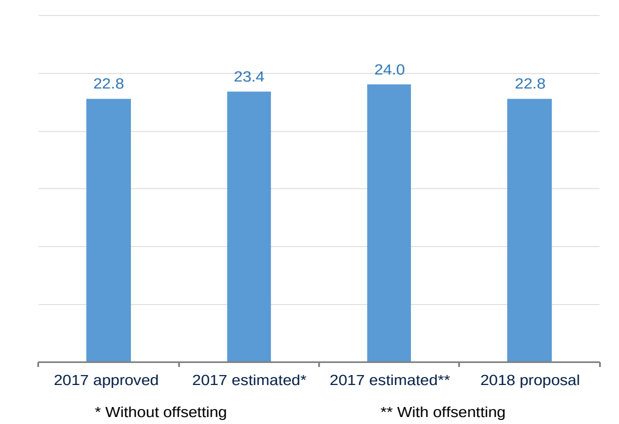
For the 2018 Expenditure Budget, net paid expenditures of 5,201.7 billion pesos (5,236.4 bp accrued) are proposed. This amount represents a real increase of 2.2% over net paid expenditures approved for 2017. The main spending pressures would come from the financial cost of debt (which would contribute 1.2 pp to the real increase) and the expense associated with pensions and retirement (which would contribute 0.8 pp to growth). On the other hand, the growth in revenue sharing to states and municipalities would contribute 0.6 pp, the same contribution as the proposal for operational expenditures (unlike the budget proposed and approved in 2017, where for the latter item there was a reduction effort). Finally, capital expenditures (which includes the physical investment of the public sector) will continue to absorb the containment effort, as will expenditures on subsidies (Figure 3).

Figure 3. Contribution to the real variation in budgetary net paid expenditures, percentage points (2018p vs 2017a)



Source: BBVA Research based on information from the SHCP

Figure 4. Budgetary net paid expenditures (% of GDP)



Source: BBVA Research based on information from the SHCP

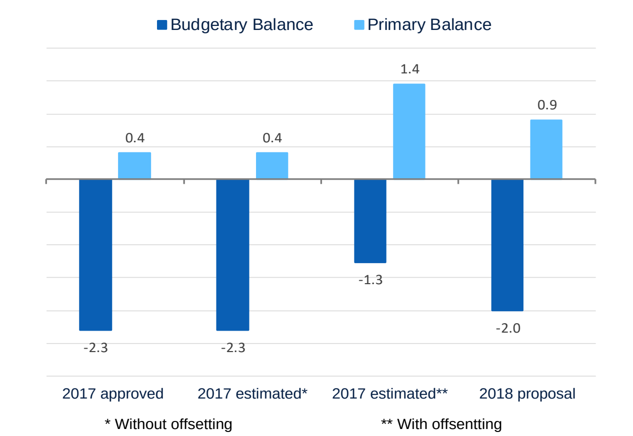
As a percentage of GDP, in 2018, public sector expenditures would reach 22.8%, equal to that approved for 2017. By the end of 2017, net expenditures without offsetting (i.e. not including the application of resources obtained from BMOS and specifically earmarked surplus revenues) is expected to be 23.4% of GDP, 0.6 percentage points above the amount authorised for the year. This increase would be financed by 0.6 percentage points from higher-than-budgeted revenues. Meanwhile, when considering BMOS revenue and specifically earmarked surpluses[2], the net expenditures with offsettings would come to 24.0% of GDP. (Figure 4).

2: According to the Federal Law on Budget and Fiscal Responsibility, 30.0% of the BMOS must be used to strengthen the Financial Revenue Stabilisation Fund (FEIP) and to increase assets that strengthen the Federal Government's financial position.

A primary surplus of 0.9% of GDP is proposed, higher than that approved for 2017, implying a fiscal consolidation effort of 0.5% of GDP

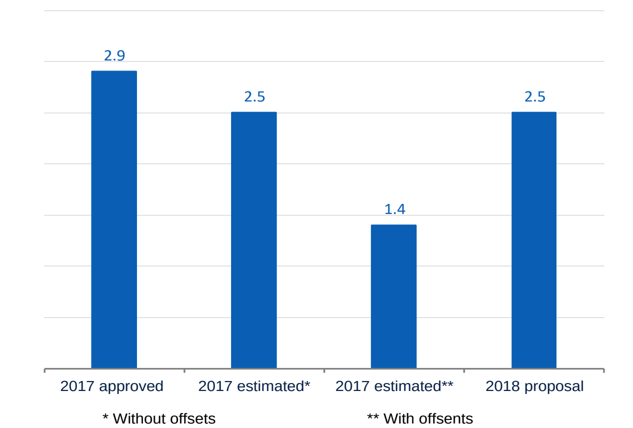
The proposed dynamic for public revenues and expenditures would result in a budgetary deficit in 2018 equivalent to 2.0% of GDP, less than the deficit approved for 2017 (2.3%). On the other hand, when the expenditure associated with the financial cost of public sector debt is deducted, a primary surplus of 0.9% of GDP would be achieved in 2018, higher than that approved for 2017 (0.4%). It is noteworthy that the public balance targets approved for 2017 can still be achieved without taking into account the BMOS and other surplus revenues. If these incomes are taken into account (along with associated earmarked expenditures), the budgetary deficit will amount to 1.3% of GDP, while the primary surplus will reach 1.4% of GDP in 2017 (Figure 5).

Figure 5. Public Balance Sheets 2017-2018 (% of GDP)



Source: BBVA Research based on information from the SHCP

Figure 6. Public sector financial requirements (% of GDP)



Source: BBVA Research based on information from the SHCP

On the other hand, the broader measure of the fiscal balance, the Public Sector Borrowing Requirements[3] (PSBRs), would reach 2.5% of GDP in 2018, lower than the 2.9% approved for 2017. By the end of 2017, without taking into account offsetting operations, PSBRs would be 2.5% of GDP, while considering such operations PSBRs would achieve an equivalent to 1.4% of GDP, the lowest indicator observed since 2008 (Figure 6).

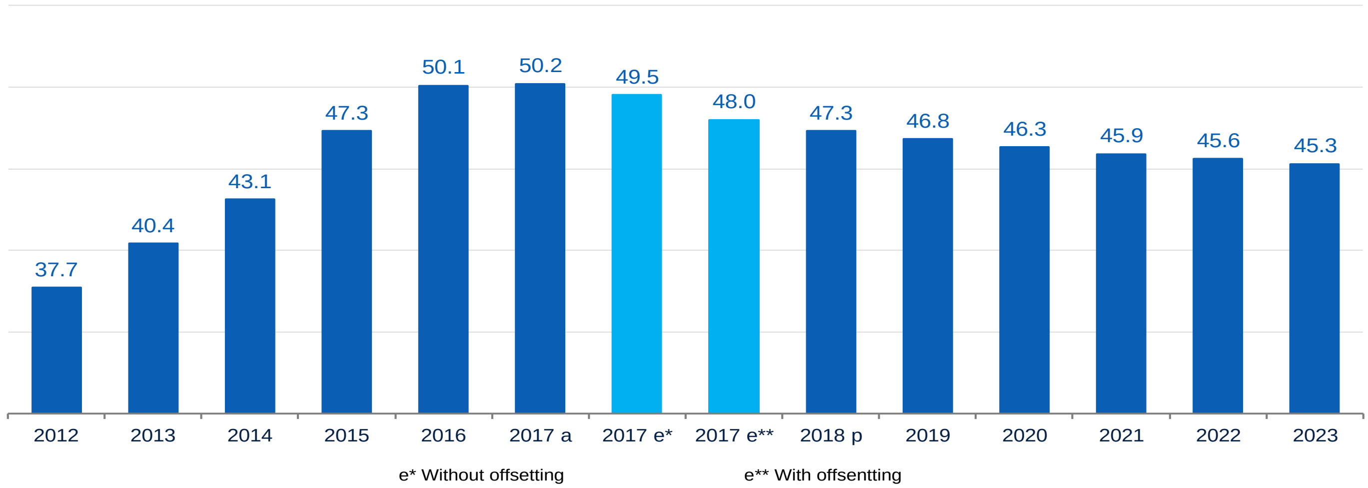
The broader public debt measure, the SHRFSP, will maintain the downward trend initiated in 2017

For 2017, it is estimated that, without taking into account offsetting operations, the Historical Balance of Public Sector Borrowing Requirements (HBPSBRs) will amount to 49.5% of GDP, 0.7 percentage points lower than the percentage

3: RSFPs measures the financing needs to achieve the objectives of public policies, whether of the entities attached to the public sector or the entities of the private and social sector acting on behalf of the government. RFSPs groups together, among others, the traditional public balance, the financial requirements of the Bank Savings Protection Institute (IPAB), after deducting transfers from the Federal Government, public investment projects financed by the private sector (PIDIREGAS) and financial requirements of the National Infrastructure Fund (FONADIN) and the expected loss or gain of credit granted by development banks and development funds.

approved for 2017. If the resources associated with the BMOS are considered, HBPSBRs will be equivalent to 48.0% of GDP. Meanwhile, with the proposed reduction in PSBRs (2.5% of GDP) and the increase in the primary surplus (by 0.9% of GDP), HBPSBRs is estimated to be equivalent to 47.3% of GDP in 2018 (Figure 7).

Figure 7. Historical Balance of the Public Sector Borrowing Requirements (% of GDP)



Source: BBVA Research based on information from the SHCP

Assessment

The 2018 budget offers no surprises and the government remains committed to fiscal consolidation and reduction of public debt as a percentage of GDP. We consider the goal of real growth in budgetary revenues to be attainable, mainly because in recent years the revenues observed at the end of the fiscal year, not including extraordinary revenues, have surpassed the revenues approved in the budget. Given the recurrence of these results, it would be desirable to have more transparent mechanisms to allocate surplus revenues (over and above those budgeted), so that a larger proportion is used to improve fiscal balances and not to finance expenditures above those budgeted at the beginning of the year. As in 2017, the main spending pressures come from the financial cost of public debt and the payment of pensions and retirement. We consider that it would be advisable to consider measures to contain the expansion of revenue sharing to states and municipalities, as well as strategies to achieve the recovery of public investment, so as not to compromise the growth potential of the economy. The new government needs to seek mechanisms to reverse the recent trend in public investment.

We consider that the improvement in public balance sheets and the efforts to maintain fiscal discipline in order to continue the downward trajectory of public debt are positive. This discipline should be retained in the future, maintaining the primary surplus target each year to avoid repeating the increase of 12.4 percentage points of GDP in public debt between 2012 and 2016. In addition, it will be necessary to seek mechanisms so that expenditure reduction efforts do not come from the consistent reduction of public investment expenditures, in order to maintain the fiscal balances, but contribute to the growth of economic activity.

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