Economic Analysis

Public debt could rise by 15 percentage points of GDP in 2020

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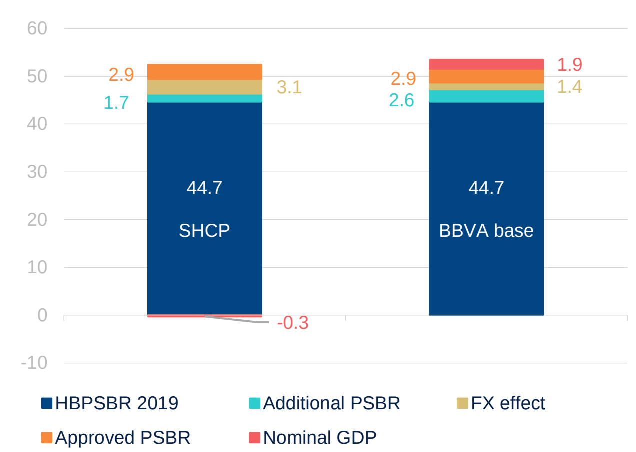
- **A year-on-year fall in real GDP ranging between 7.0% and 12.0% in 2020 would cause the HBPSBR (Historical Balance of Public Sector Borrowing Requirements) to rise from 44.7% to 53.4% and 59.2% of GDP, respectively**
- **In the case of a real GDP annual contraction of 7.0% in 2020, the HBPSBR would rise by 8.7 percentage points of GDP due to increased PSBR, lower nominal GDP and depreciation of the peso. The contribution of these factors to the increase would be 5.5, 1.9 and 1.4 percentage points, respectively**
- **In the event of a 12.0% year-on-year contraction of real GDP in 2020, the increment of 14.5 percentage points of GDP in the HBPSBR would also be due to increased PSBR, lower nominal GDP and depreciation of the peso. The contribution of these factors to the increase would be 6.3, 5.0 and 3.2 percentage points, respectively**
- **While the lower nominal GDP would directly cause approximately 35% of the total increase of 14.5 percentage points, it would also have an impact in the form of additional PSBR to those approved by Congress for 2020. These would account for 24% of the increase**
- **Our GDP estimates assume that there will be no countercyclical fiscal response. Therefore, we think that the federal government should avoid a deeper fall in economic activity through a reallocation of public spending that expands the fiscal stimulus package**
- **A countercyclical fiscal response could also be implemented to dampen the economic impact of the pandemic, provided that a fiscal reform is simultaneously announced and comes into effect once the sanitary contingency is left behind us**
- **Thus, not only would a higher public debt-to-GDP ratio and a reduced fiscal space going forward be averted, but it would also accelerate the post-pandemic economic recovery**
- **Without fundamental changes in fiscal policy, the investment-grade status will most likely be lost next year**

While the HBPSBR fell by two tenths of a percentage point to 44.7% of GDP in 2019, the large economic contraction expected in 2020 will cause it to rise again significantly. In its 2021 General Economic Policy Pre-criteria document, the Ministry of Finance (SHCP, for its acronym in Spanish) estimated that the HBPSBR will stand at 52.1% of GDP at year-end. It should be noted that all estimates of the official public finance figures for this year reflected in that document were based on an economic growth forecast of -3.0%. According to our estimates, a year-on-year fall in real GDP ranging between 7.0% and 12.0% in 2020 would cause the HBPSBR to rise to between 53.4% and 59.2% of GDP, respectively.

In this document we quantified the impact of certain factors used to determine the HBPSBR (% of GDP). The most salient of these factors are: the PSBR approved by Congress; additional PSBR to cover the fall in tax revenue; currency depreciation and its impact on the revaluation of debt denominated in foreign currency; and the lower nominal GDP and its direct impact on the denominator of the ratio of public debt to GDP.[1] Using the macroeconomic assumptions made by the SHCP for 2020 and some others to revalue in pesos public debt denominated in foreign currency, we can see that the year-on-year increase of 7.4 percentage points estimated by the SHCP could be attributed to higher PSBR (4.6 percentage points) and the depreciation of the peso (3.1 percentage points). Given that the GDP deflator used was 3.5% with a real growth forecast of -3.0%, nominal GDP would be growing by 0.5%. The contribution of nominal GDP to the aforementioned ratio was therefore negative (-0.3 percentage points).

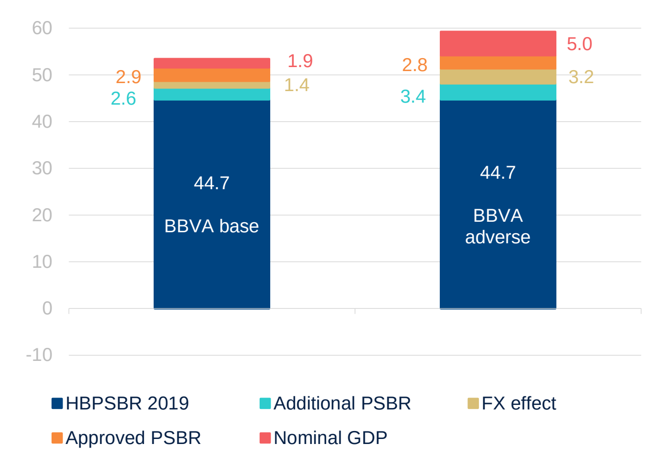
In the case of a year-on-year fall in real GDP of 7.0% in 2020, the HBPSBR would rise by 8.7 percentage points of GDP due to higher PSBR, lower nominal GDP and depreciation of the peso. The contribution of these factors to the increase would be 5.5, 1.9 and 1.4 percentage points, respectively. Figure 1 shows the contributions of the aforementioned factors to the year-on-year increases estimated by the SHCP and BBVA in this baseline scenario.

Figure 1. **Contribution of factors to the HBPSBR in SHCP forecasts and the baseline scenario for 2020** (% of GDP)



Source: BBVA Research based on data from INEGI and SHCP

Figure 2. **Contribution of factors to the HBPSBR in the baseline and adverse scenario forecasts for 2020** (% of GDP)



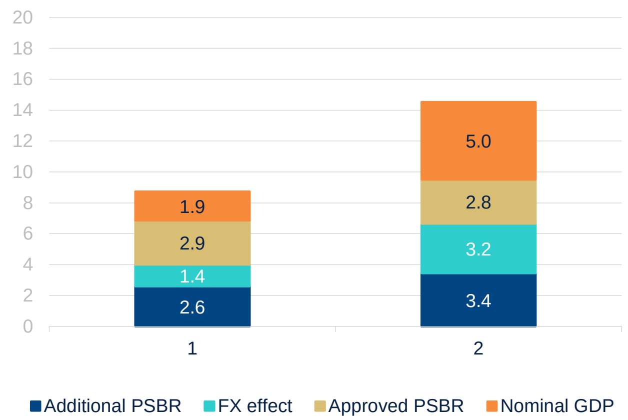
Source: BBVA Research based on data from INEGI and SHCP

In the event of a 12.0% year-on-year contraction of real GDP in 2020 (adverse scenario), the increment of 14.5 percentage points of GDP in the HBPSBR would also be due to increased PSBR, lower nominal GDP and depreciation of the peso. The contribution of these factors to the increase would be 6.3, 5.0 and 3.2 percentage points, respectively. Figure 2 shows the contributions of the aforementioned factors to the year-on-year increases estimated by BBVA in the baseline and adverse scenarios.

1: For more information on the fall in tax revenue, please see the document "Risk of a sharp drop in public revenue in 2020" at the following link.

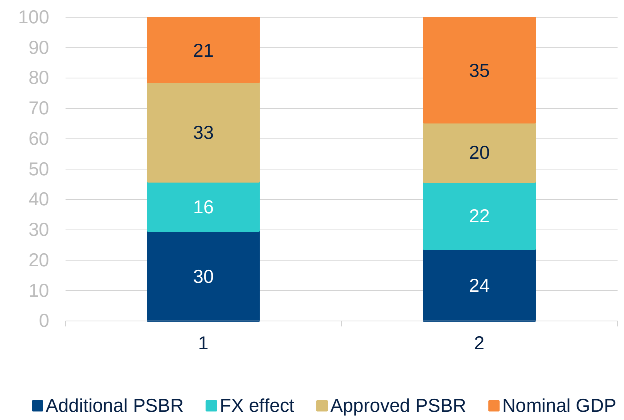
Figure 3 shows the breakdown of the rise in the HBPSBR (% of GDP) in BBVA's baseline and adverse scenarios for 2020. Figure 4 shows the incidence of the aforementioned factors (% contributed to the total increase). In particular, the contributions of nominal GDP stand out for both their direct impact (on the denominator of the ratio) and their indirect impact (on additional PSBR to cover the fall in tax revenue). In the baseline scenario, these impacts would be 21% and 30%, respectively. In the adverse scenario, the direct and indirect contributions of nominal GDP would be 35% and 24%, respectively.

Figure 3. **Breakdown of the rise in the HBPSBR under the baseline and adverse scenarios for 2020** (% of GDP)



Source: BBVA Research based on data from INEGI and SHCP

Figure 4. **Impact on the rise in the HBPSBR under the baseline and adverse scenarios for 2020** (%)



Source: BBVA Research based on data from INEGI and SHCP

Conclusions

We expect the outlook for public finances to be extremely complex from this year onward. The HBPSBR, the broadest indicator of public debt, will rise significantly as a proportion of GDP in 2020. The forecasted sharp annual contraction in economic activity will be a highly decisive factor in the size of the increase due to both its direct impact and its indirect impact with respect to tax revenue. Therefore, we think that the federal government should avoid a deeper fall in economic activity by reallocating public expenditure to expand the fiscal stimulus package as it stands to date. A significant countercyclical fiscal response (which could be up to six percentage points of GDP and would help to finance additional expenditure) could also be implemented provided that a fiscal reform is simultaneously announced and comes into effect once the sanitary contingency is left behind us.

A countercyclical fiscal response like the one suggested would not only prevent a higher public debt-to-GDP ratio and a reduced fiscal space going forward, but it would also accelerate the post-pandemic economic recovery. A greater economic recovery would mean a more sustainable trajectory for public debt in the medium term, even if such a countercyclical fiscal response were implemented. A situation wherein public debt were 65% of GDP and growth were stronger would be preferable to one wherein public debt were 60% of GDP but the potential growth rate were significantly lower. Moreover, the government should use income stabilization and emergency funds to supplement the revenue used to counter the negative impacts of the pandemic with respect to health and social welfare. Otherwise, using them would only increase PSBR without becoming an effective countercyclical fiscal policy instrument.