RESEARCH REPORT

MACROECONOMY

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ORDINARY BALANCE POSTING A DEFICIT IN 2021

When will we see a return to balance ?

Attijari Global Research

EXECUTIVE SUMMARY

In a context of an economic shock, the ordinary balance in Morocco would go into negative territory for the first time since the 2012-2013 crisis with a deficit of MAD -15 Bn according to the 2020 AFA. With a view to a close dissipation of the health crisis, and a resumption of economic growth in 2021, it is legitimate to wonder about the Treasury's ability to return to an ordinary surplus, a key indicator of a healthy situation for public finances.

For this stake, we observe the historical evolution of the revenue and ordinary expenditure pair of the Treasury, to emerge with a structural behavior far from any cyclical distortions. This analysis is instructive in terms of identifying levers for a balanced budget. It turns out that the increase in tax revenues is fueled only marginally by economic growth or by the broadening of the base. While non-tax revenues, deemed irregular, support income. Likewise, the most significant cost savings are rooted in subsidies reform, while considering the efforts to limit the increase in the wage bill and the active management of the debt which makes it possible to contain the increase in its cost.

This structure of public finances made it possible, starting 2014, to restore an ordinary surplus balance. Still, this balance did not ultimately withstand a shock. In this context, we believe that the recovery of the ordinary balance is more a need for revenue enhancement rather than cost savings. Indeed, the expenditure structure supports our remarks. The dominant share has little improvement leeway.

Following an analysis of the different headings of ordinary income & expenditure, we believe that a return to break-even would be possible starting from 2022-2023. Our projection is based on a number of factors which would contribute to the rebound in revenue towards its pre-Covid-19 level.

In the end, we would like to remind you that the purpose of this exercise is not to come out with a target level of the ordinary balance from 2022, but rather to list the main items to monitor, to identify their room for improvement, all this to define the Treasury's overall capacity to return to its pre-crisis balance.

Abdelaziz LAHLOU
Chief Economist
ab.lahlou@attijari.ma

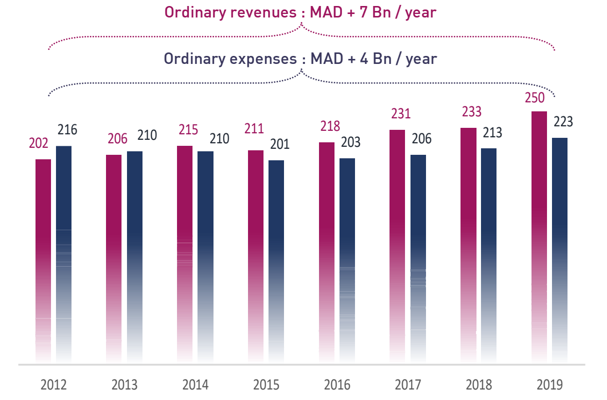
THE BUDGET BALANCE IN MOROCCO ... BETWEEN ACHIEVEMENTS AND FRAGILITIES

The FY 2012, which had recorded a slide in the ordinary balance to MAD -14 Bn, was a turning point for the monitoring of public finances in Morocco. Since then, the Ministry of Finance pursued a rigorous policy of management of ordinary Treasury resources and expenditure, which made it possible to gradually restore a surplus. This latter reached an average level of MAD 24 Bn over the last three years [2017-2019].

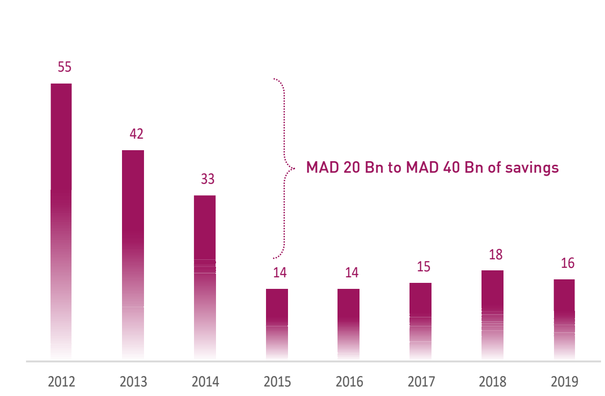
It is clear that the increase in tax revenue during the period (2012-2019) was only marginally fueled by economic growth or even by the broadening of the base. Indeed, representing 85% of ordinary Treasury revenue, tax revenue shows an AAGR of 2.7% (+MAD 5 Bn on annual average), lower than that of GDP growth established at 3.3%.

Non-tax revenue, deemed irregular, supports the global Treasury revenue. Evolving at a more sustained pace (i.e. + MAD 2 bn on annual average), these are fueled by other non-tax revenues and privatization revenues, while monopoly revenues are stable over the entire period.

Evolution of ordinary revenues and expenses (in MAD Bn)

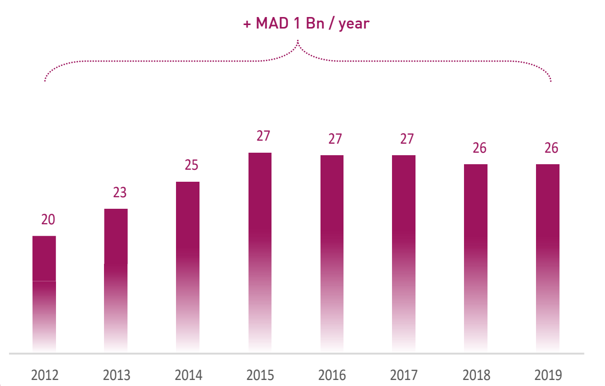


Evolution of subsidy expenses (in MAD Bn)

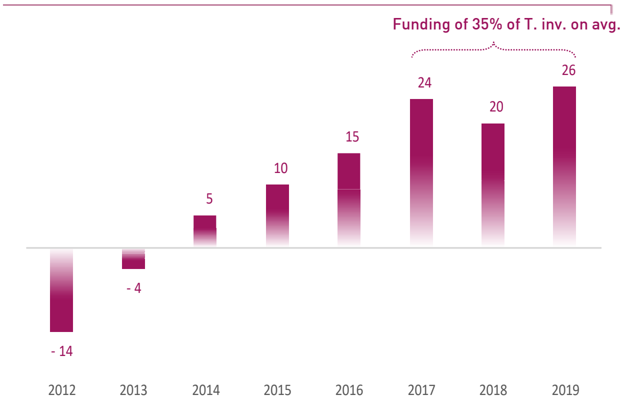


On the other hand, ordinary expenses show a AAGR of 0.5% during the entire period (2012-2019), representing an annual additional cost of nearly MAD 1 billion. The most significant cost savings finds origin in the subsidies reform. This allowed savings of MAD 20 Bn to MAD 40 Bn dirhams compared to the base year. It should be highlighted that there are also considerable efforts to limit the wage bill inflation (+MAD 2 Bn), and an active debt management which makes it possible to contain the increase in its cost (+ MAD 1 Bn). Such efforts were somewhat hampered by the consequent increase in other State operating costs (+MAD 4 Bn).

Evolution of interest expense (in MAD Bn)



Evolution of ordinary balance (in MAD Bn)



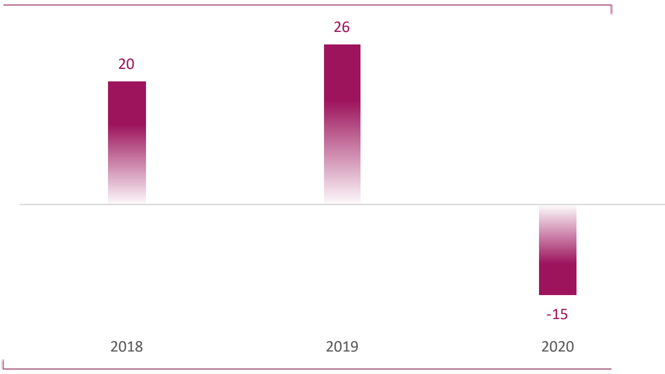
This structure made it possible to re-establish, starting FY 2014, a surplus in ordinary balance . It reflects the Treasury's commitment to use debt financing for investment and not to cover recurrent expenditure. Thus, during the period (2014-2019), ordinary expenditure was completely self-financed, while a negative ordinary balance will require recourse to debt to fund the balance over ordinary income.

Sources: Ministry of Finance, AGR computations

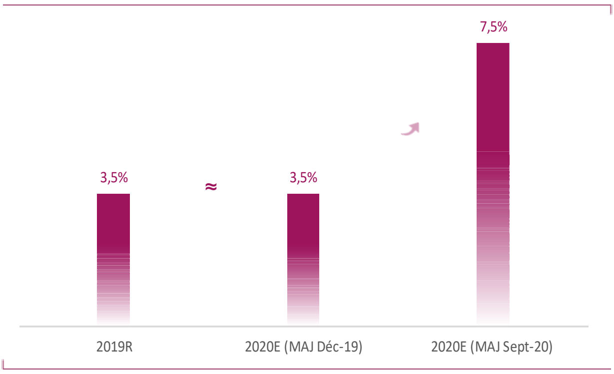
PUBLIC FINANCES UNDERMINED BY THE COVID-19 SHOCK

The shock magnitude of Covid-19 pandemic combined with the desire to put the citizen's health at the center of concerns had a considerable economic impact. In terms of economic growth, the GDP decline is estimated at 9.2 pts (-6.6% against + 2.6% pre-Covid-19), while at the level of public finances, the ordinary balance is negative for the first time since FY 2014 while the fiscal deficit would increase by almost 4 pts (7.5% against 3.5%).

Covid-19 impact on primary balance (in MAD Bn)



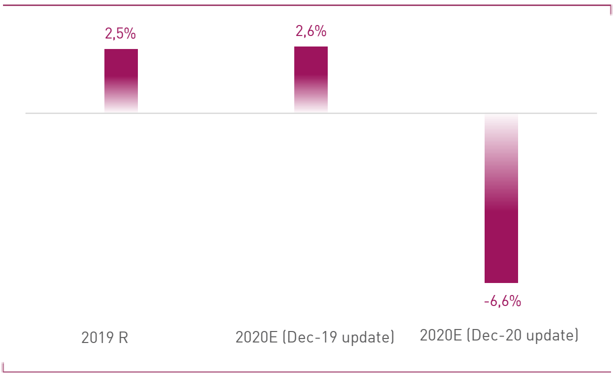
Covid-19 impact on fiscal deficit (GDP %)



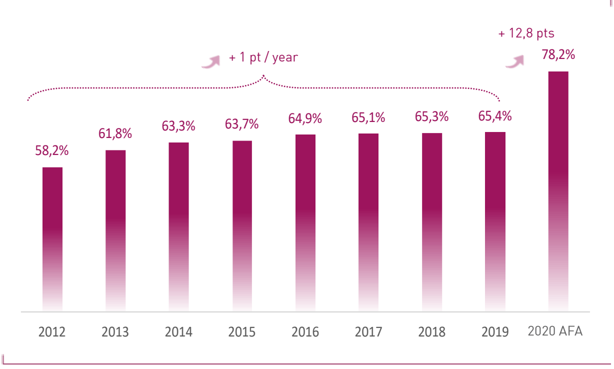
In this context, the 2020 AFA sheds light on the origins of these deviations from the 2020 FA:

- A shortfall of MAD 41 Bn in ordinary revenue, the bulk of which (MAD 35 Bn or 85%) comes from tax revenue. On the one hand, the Corporate Tax is affected by the collection waivers of the most affected sectors, and by the drop in profits of the main contributors. For its part, Income Tax is feeling the effect of the decline in property transactions, while the wage portion is proving resilient due to the marginal contribution of the most affected segments by job losses. While domestic and import VAT receipts suffer from the consumption decline ;
- A decrease in ordinary expenditure of MAD 4 Bn explained mainly (MAD 3 Bn or 70%) by savings in subsidy expenses.

Covid-19 impact on GDP growth (%)



Evolution of Treasury debt (GDP %)



Ultimately, debt would record an unprecedented increase of 12.8 points to 78.2% of GDP in 2020 according to our estimates. This increase can be compared to an average increase of 1.0 point during the (2012-2019) period. This is explained by a scissors effect of an increase in financing needs simultaneous with a fall in outstanding GDP :

- The increase in Treasury requirements which practically doubled in 2020 to MAD 83 Bn against MAD 42 Bn a year earlier. This finds source from a situation of ordinary balance loss deepened by a stabilization of the investment effort for the need for economic recovery ;
- The expected decline in GDP amount explained by real GDP under-performance of 5% and low inflation[1] estimated at 0.4% in 2020.

Sources: 2020 AFA, Bank Al Maghrib, AGR estimates

(1) We use the inflation figure instead of the GDP deflator mainly to reflect the small increase in prices.

AN ORDINARY BALANCE IN DEFICIT IN 2021 ... A RETURN TO BALANCE NOT GOING TO HAPPEN SOON

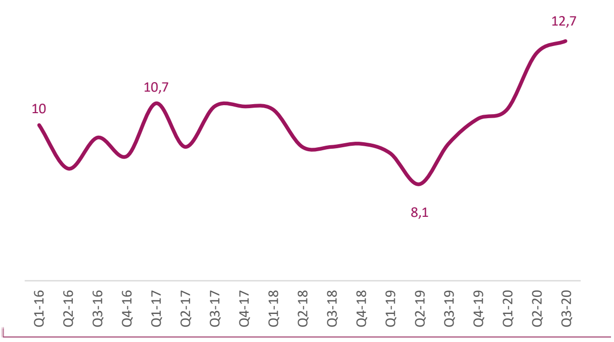
Taking into consideration the hypothesis of a gradual dissipation of the pandemic starting Q2-2021, FY 2021 would resume with economic growth of +4.8% according to the FA 2021. However, in terms of fiscal balance, the ordinary balance would remain in deficit set at MAD -10 bn. In this context, we raise the following question: What would explain such a delay in restoring fiscal balance ?

The delayed effects of the Covid-19 shock on the Treasury revenue

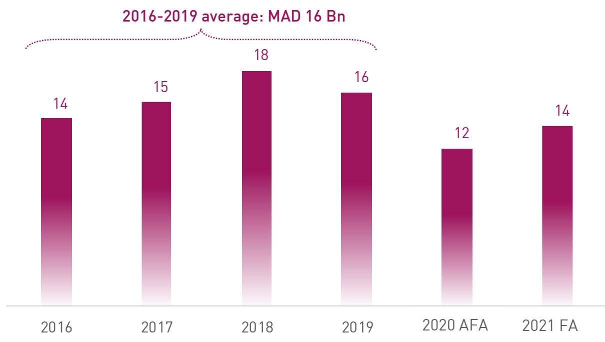
The collateral damage from the Covid-19 shock is not expected to fade in 2020. In fact, Tax Revenues, the main contributors to the Treasury's revenue, are expected to record a decline further in 2021 after that recorded in 2020 (Cf. annex). We can explain this poor performance in particular by :

- The impact of rising unemployment on Consumption ;
- The forecast of a reduction in Individual and Corporate Tax bases for participants to the Covid-19 solidarity fund. As a reminder, this fund collected, excluding the contribution from the Treasury, almost MAD 24 Bn which can be amortized over a maximum period of 5 years ;
- The anticipation of a further decline in Corporate Tax base linked to the possibility for companies to amortize over 5 years the fixed costs incurred during periods of under activity observed during the Covid-19 pandemic.

Quarterly evolution of unemployment rate (%)



Subsidy expense evolution (in MAD Bn)



The need to fuel economic growth through public spending

The current economic context calls for strong State participation in funding economic growth. To this end, the ordinary expenditure would register an increase of 4.0% in FY 2021 after 6.3% in FY 2020. This rebound, which contrasts with the 0.5% growth rate of observed during the period 2012- 2019, takes into account :

- The impact of social discussions on wages which is estimated at MAD 7 Bn in 2021 and the maintenance of the level of enrollments observed during the 2016-2020 period with 23,503 new positions in addition to 17,000 others dedicated to AREFs [1];
- The gradual return of the subsidy expense to a normative level in the event of a recovery in global activity which would lead to an automatic raise in butane gas prices.

All of these aforementioned items lead to an ordinary deficit of MAD -10 Bn. Certainly lower compared to that expected during FY 2020 (MAD -15 Bn), this level once again violated the so-called golden rule of reserving exclusively debt financing for investments.

Sources: Ministry of Finance, HCP, AGR computations

*(1) Regional Academies for Education and Training

RECOVERY : MEANS AND HORIZON

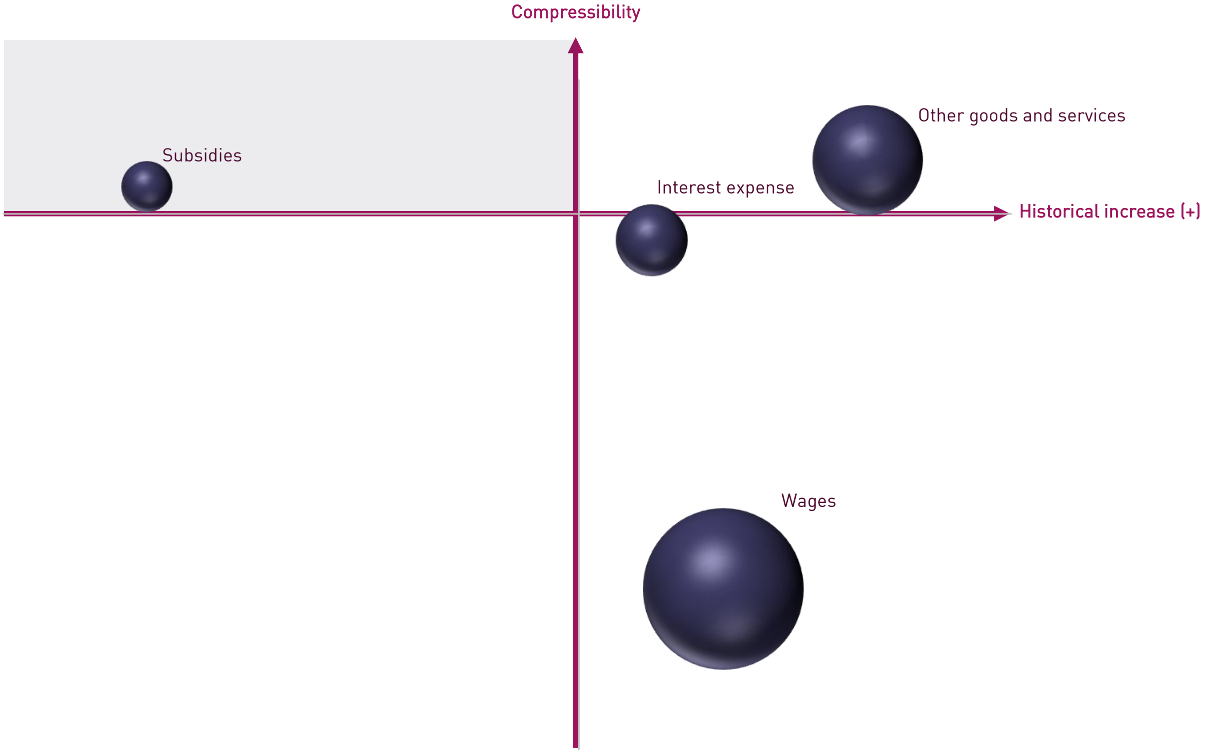
At this point, we raise another question: After the fiscal slippage forecasted in FY 2020 & FY 2021, is the Treasury capable of accomplishing a rebound and restoring the equilibrium of the ordinary balance, and if so, by what horizon?

Our aim is not to come out with a precise level of ordinary balance over a given horizon, but rather to list the main items to be monitored, to identify their room for improvement, all this to define the overall capacity of the Treasury to return to its pre-crisis balance.

The recovery of the ordinary balance: An issue of raising revenues rather than saving costs

We believe that the recovery of the ordinary balance is more of a revenue enhancement issue rather than cost savings. Remember that these, although relevant up to a certain threshold, diminish over time. Indeed, the expenditure structure supports our remarks. The dominant part has little leeway :

Representation of the main expenses' weight and rate of change



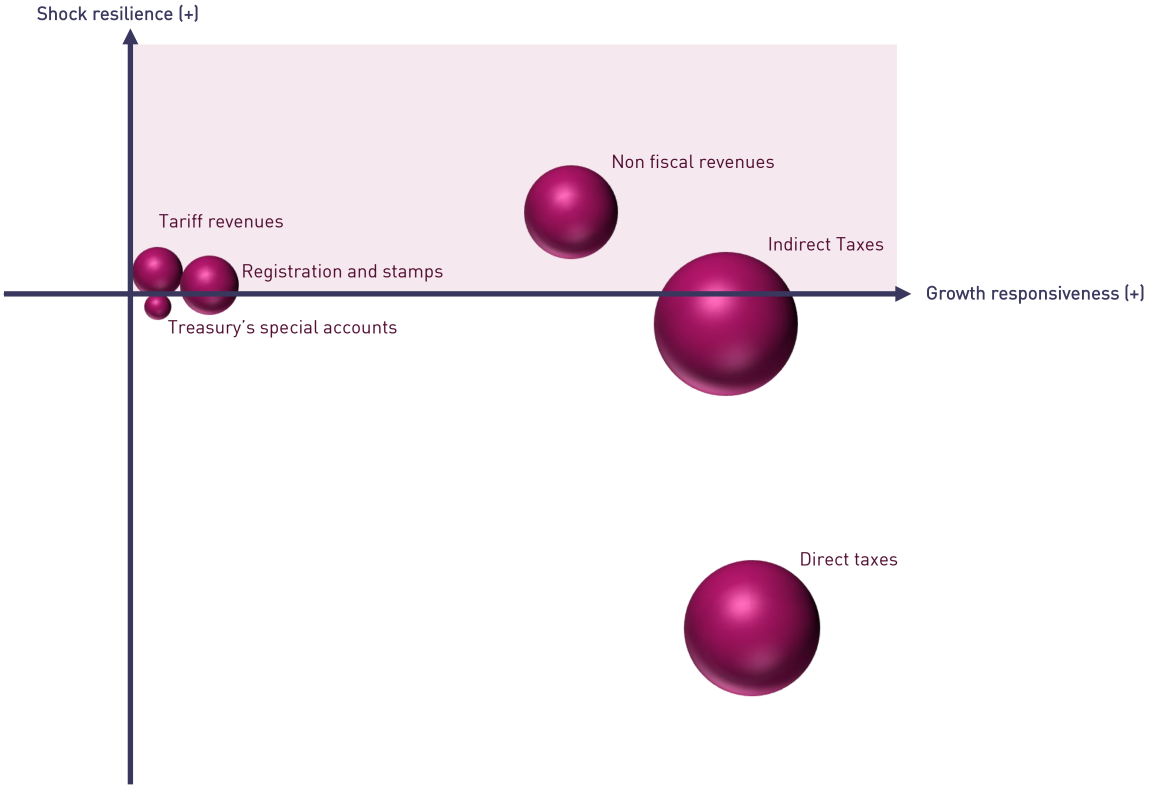
- Wages and cost of debt are unlikely to fall : These account for more than two-thirds (68%) of recurrent expenditure in 2021, and would present little scope for savings in a context of shock. It should be remembered that already in the pre-Covid period, their growth was slowed down to an average annual rate of + MAD 2 Bn for wages and MAD +1 Bn for the cost of debt ;
- The reform of the subsidy program is again the most prominent cost saving : The advance made in the process of targeting the population beyond the experience gained during the Covid-19 pandemic would allow this reform to be accelerated. As a reminder, the subsidies absorb an annual budget varying between MAD 12 Bn and MAD 18 Bn, of which nearly 80% is devoted to butane gas.

Source: AGR

RECOVERY : MEANS AND HORIZON (END)

On the other hand, revenues enhancement would present disparate complexity levels :

Representation of the main revenues' weight and rate of change



- Direct Tax revenues, a real work in progress for public finances : Historically during the (2012-2019) period, the growth of Direct Tax revenues was slower than that of GDP. Conversely, these are very affected in times of shock, and would drop by MAD 16 Bn (-15%) in the space of 2 years (2020-2021). In this context and beyond the economic rebound, the Treasury expects a return on stimulus actions, in particular tax amnesties, the creation of an investment fund of MAD 15 Bn and the tax incentives granted to new enrollments by companies;
- Tariff revenues on an upward trend : This goes hand in hand with the resumption of international trade flows and a stability of tariff rates as a whole ;
- Non-tax revenues, a real booster for the Treasury : An economic recovery would contribute to an increase in monopoly revenues and above all would present the necessary conditions for the relaunch of the privatization program.

Based on the analysis of the various income & expenditure headings, we believe that a return to equilibrium would be possible from the years 2022-2023. Debt recourse would thus once again be exclusively dedicated to investment.

Source: AGR

ANNEX

Treasury ordinary revenues and expenses

(In MAD bn)	2016	2017	2018	2019	2020 AFA	2021 FA
Ordinary revenues	**218**	**231**	**233**	**250**	**223**	**237**
Fiscal revenues	**189**	**201**	**209**	**212**	**186**	**196**
Direct Taxes	85	93	96	96	88	80
Indirect Taxes	79	84	89	91	78	90
Tariffs	9	9	10	10	8	11
Registration and stamps	16	15	15	15	13	15
Non fiscal Revenues	**26**	**26**	**20**	**34**	**34**	**38**
Other	**4**	**4**	**4**	**4**	**3**	**3**
Ordinary expenses	**203**	**206**	**213**	**223**	**237**	**247**
Goods and services	**162**	**164**	**169**	**181**	**197**	**206**
Wages	105	105	106	112	136	140
Operating expenses	57	59	62	70	61	66
Cost of debt	**27**	**27**	**26**	**26**	**28**	**28**
Subsidies	**14**	**15**	**18**	**16**	**12**	**14**
Ordinary balance	**15**	**24**	**20**	**26**	**- 15**	**- 10**

Sources: Ministry of finance, AGR computations

ATTIJARI GLOBAL RESEARCH

HEAD OF STRATEGY
Taha Jaidi
+212 5 29 03 68 23
t.jaidi@attijari.ma
Casablanca

MANAGER
Lamyae Oudghiri
+212 5 29 03 68 18
l.oudghiri@attijari.ma
Casablanca

SENIOR ASSOCIATE
Mahat Zerhouni
+212 5 29 03 68 16
m.zerhouni@attijari.ma
Casablanca

ASSOCIATE
Omar Cherkaoui
+212 5 22 49 14 82
o.cherkaoui@attijari.ma
Casablanca

CHIEF ECONOMIST
Abdelaziz Lahlou
+212 5 29 03 68 37
ab.lahlou@attijari.ma
Casablanca

MANAGER
Maria Iraqi
+212 5 29 03 68 01
m.iraqui@attijari.ma
Casablanca

ASSOCIATE
Meryeme Hadi
+212 5 22 49 14 82
m.hadi@attijari.ma
Casablanca

INVESTOR RELATIONS ANALYST
Nisrine Jamali
+212 5 22 49 14 82
n.jamali@attijari.ma
Casablanca

SENIOR ANALYST
Inès Khouaja
+216 31 34 13 10
khouaja.ines@attijaribourse.com.tn
Tunis

FINANCIAL ANALYST
Josiane Ouakam
+237 233 43 14 46
j.ouakam@attijarisecurities.com
Douala

FINANCIAL ANALYST
Jean-Jacques Birba
+225 20 21 98 26
jean-jacques.birba@sib.ci
Abidjan

Equity

BROKERAGE - MOROCCO

Abdellah Alaoui
+212 5 29 03 68 27
a.alaoui@attijari.ma

Rachid Zakaria
+212 5 29 03 68 48
r.zakaria@attijari.ma

Anis Hares
+212 5 29 03 68 34
a.hares@attijari.ma

Kaoutar Sbiyaa
+212 5 29 03 68 21
k.sbiyaa@attijari.ma

Alae Yahya
+212 5 29 03 68 15
a.yahya@attijari.ma

ONLINE TRADING - MOROCCO

Nawfal Drari
+212 5 22 49 59 57
n.drari@wafabourse.com

Sofia Mohcine
+212 5 22 49 59 52
s.mohcine@wafabourse.com

UEMOA - CÔTE D'IVOIRE

Mohamed Lemridi
+225 07 80 68 68
mohamed.lemridi@sib.ci

BROKERAGE - TUNISIE

Abdelkader Trad
+216 71 10 89 00
trad.@attijaribank.com.tn

CEMAC - CAMEROUN

Yves Ntchoumou
+237 2 33 43 14 46
n.ntchoumou@attijarisecurities.com

Bonds / Forex / Commodities

MOROCCO

Mehdi Mabkhout
+212 5 22 42 87 22
m.mabkhout@attijariwafa.com

Mohammed Hassoun Filali
+212 5 22 42 87 09
m.hassounfilali@attijariwafa.com

Btissam Dakkouni
+212 5 22 42 87 74
b.dakkouni@attijariwafa.com

Dalal Tahoune
+212 5 22 42 87 07
d.tahoune@attijariwafa.com

EGYPT

Ahmed Darwish
+202 27 97 04 80
ahmed.darwish@barclays.com

TUNISIA

Abdelkader Trad
+216 71 80 29 22
trad.abdelkader@attijaribank.com.tn

MIDDLE EAST - DUBAÏ

Serge Bahaderian
+971 0 43 77 03 00
sbahaderian@attijari-me.com

WAEMU - CÔTE D'IVOIRE

Abid Halim
+225 20 20 01 55
abid.halim@sib.ci

CEMAC - GABON

Youssef Hansali
+241 01 77 72 42
youssef.hansali@ugb-banque.com

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Global Research