Strengthening the Credibility of Public Finances

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Raphael Espinoza and Paolo Mauro
IMF Fiscal Affairs Department

Based on work by Hassan Adan, Cristian Alonso, Bryn Battersby, Carlos Goncalves, Gee Hee Hong, Andresa Lagerborg, Roberto Perrelli, Amanda Sayegh, and Andrew Womer.

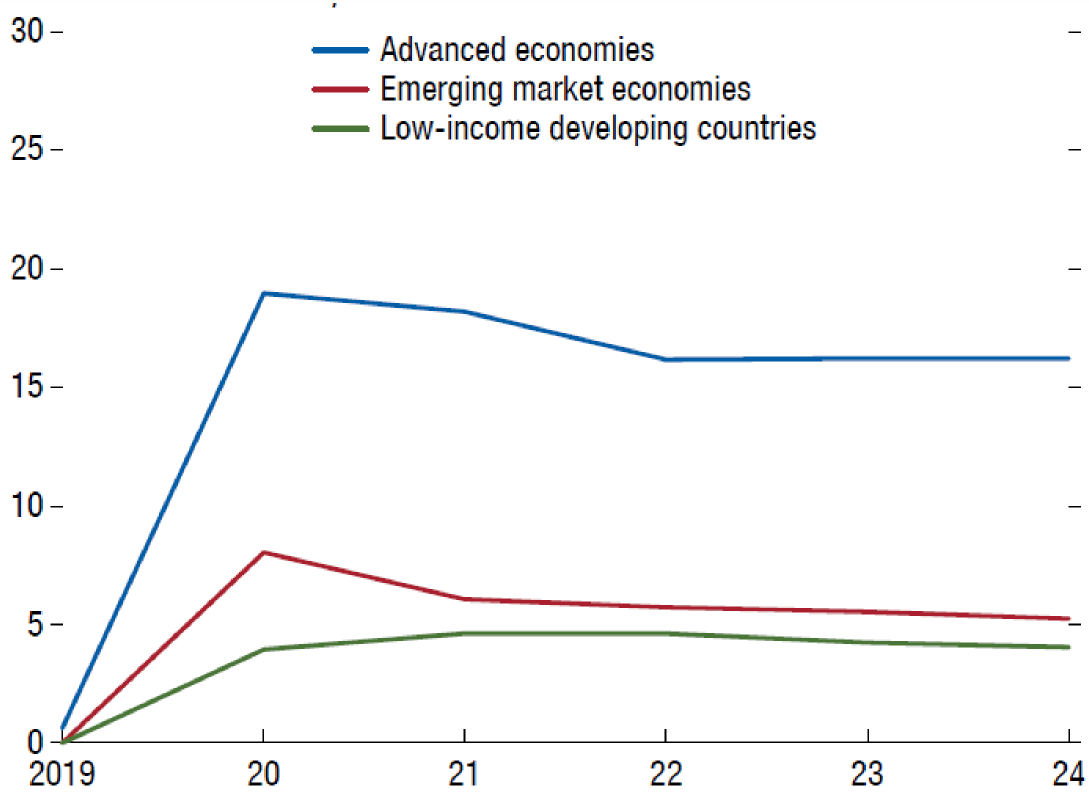
Chapter explains value of credibility and how it can be strengthened

Debt has risen in most countries and several countries under market scrutiny

Three main questions

1. Should the rise in debt be reversed, and if so, when?
2. What are the risks to debt going forward?
3. What features of fiscal frameworks are important to strengthen credibility?

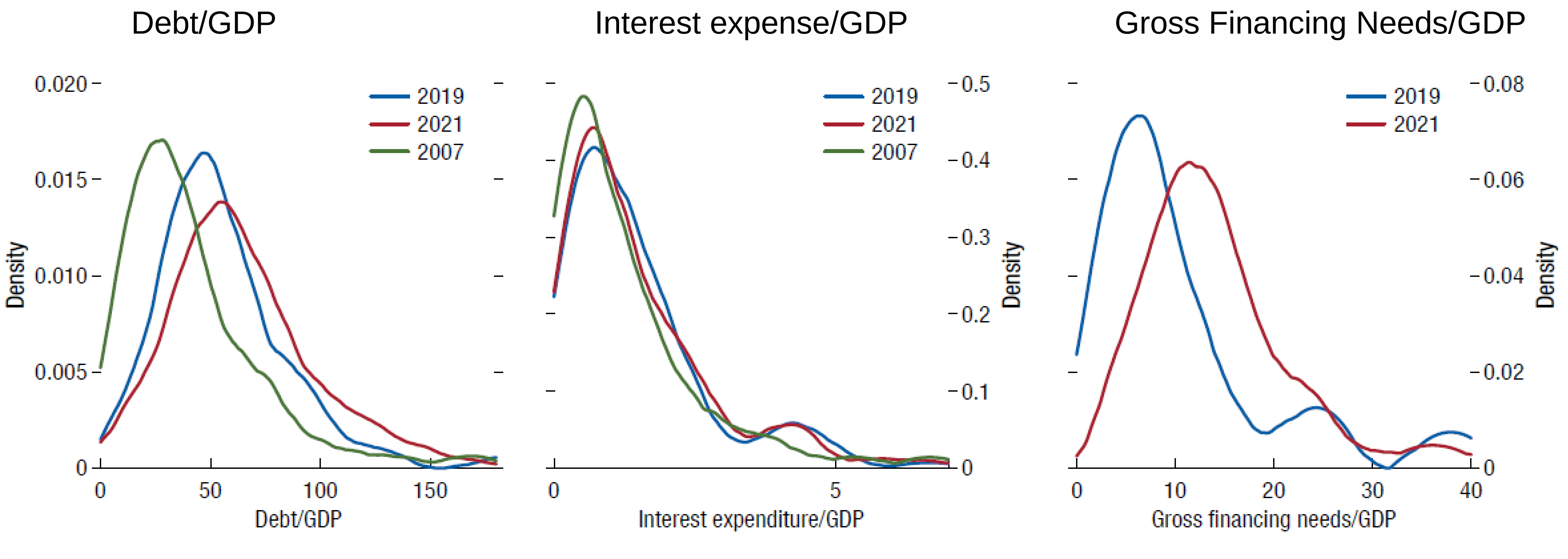
The Effect of the COVID-19 Pandemic on General Government Debt, 2019–24 *(Change relative to prepandemic projections, percent of GDP)*



Sources: IMF, World Economic Outlook database;
Note: Prepandemic projections refer to projections in the October 2019 *World Economic Outlook*.

Higher debt and financing needs but stable interest burden

Distribution Across Countries of Key Indicators, 2007, 2019, 2021



Source: IMF staff calculations.
Note: Panels 1 and 2 both covers 194 countries; panel 3 covers for 56 countries. The increase in gross financing needs is almost entirely due to larger deficits.

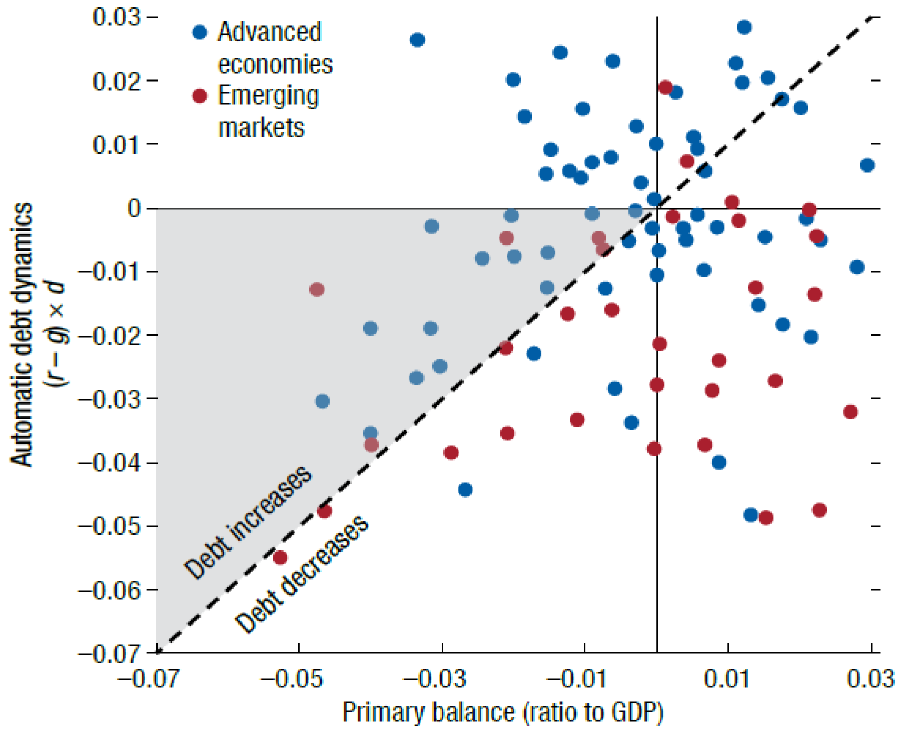
Can low interest rates save the day?

Low rates and the growth recovery will provide breathing space.

But in the past, not enough to stabilize debt, especially in advanced economies

This is seen by decomposing debt dynamics between primary balances and contribution of interest rate-growth differential

Contributions of the Interest Rate–Growth Differential and Primary Balance to Debt Dynamics



Source: IMF, April 2021 World Economic Outlook.
Note: Data are reported as the contribution to change in the debt-to-GDP level over a 10-year period, in percentage points. The definition of “debt increases/decreases” follows the condition $\Delta d_t > 0$ when $(r\text{-}g)d_{t-1}$ > primary balance$_t$. Each dot represents the change in the debt-to-GDP ratio for a country-decade.

There is a risk that interest rates or risk premia could rise

Short-term financing risks also important.

A few sovereign defaults have happened, and several countries under the scrutiny of markets

But overall, rates have been stable. Why?

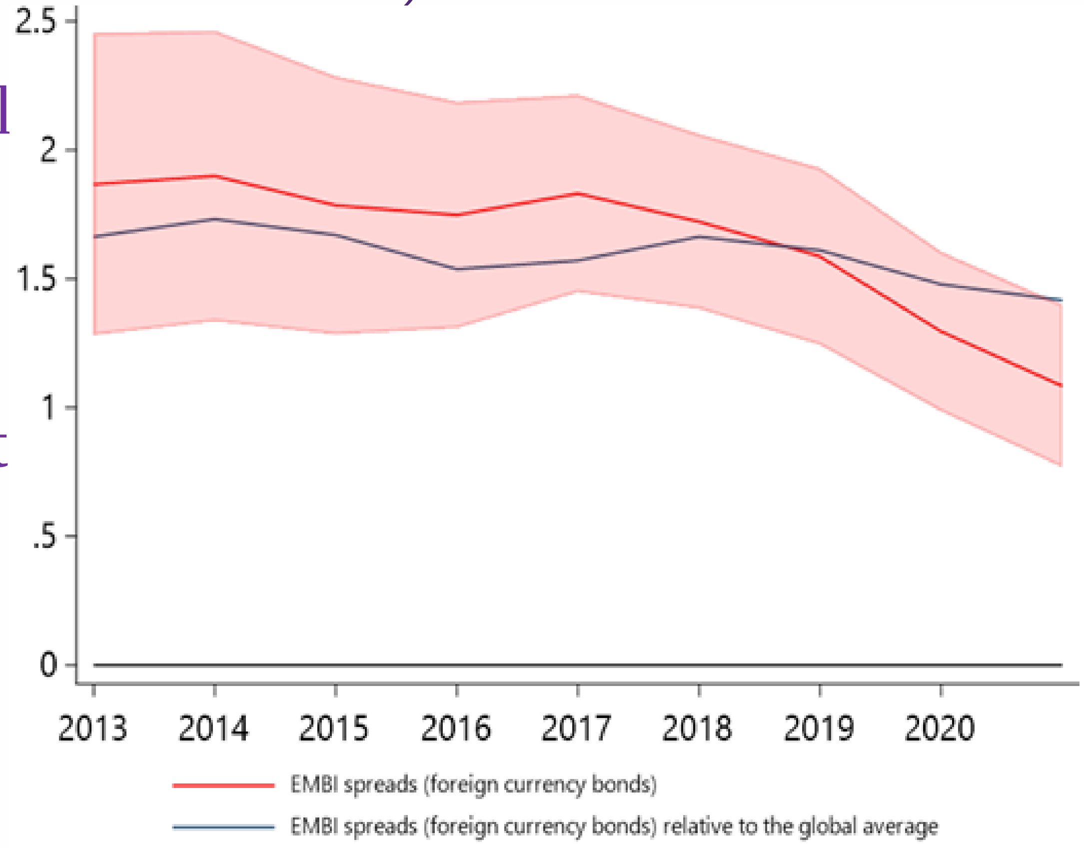
- Trend decline in sensitivity of risk premia to debt
- But maybe due to global factors such as QE
- Specifics of COVID crisis: huge increase in demand for savings

No guarantee favorable risk premia will last

In addition, risk that monetary policy tightens in AEs

Sensitivity of Spreads to Debt

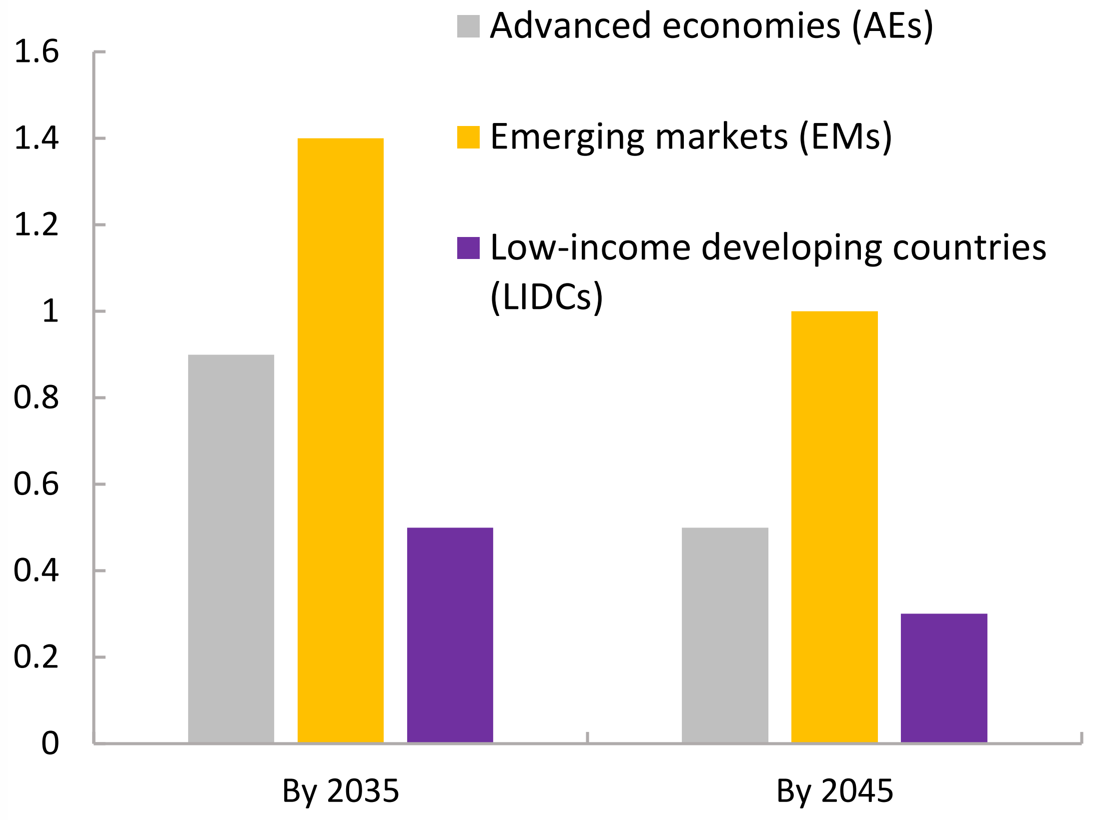
(regression coefficient of log(spread) on debt-to-GDP ratio)



Sources: IMF, J.P. Morgan; and IMF staff calculations.
Notes: Shaded areas denote 90 percent confidence intervals. Blue line: regression controls for all possible global factors using time dummies, so that the regression can be interpreted in terms of the sensitivity of spreads to the difference between debt and the average debt across countries in each period.

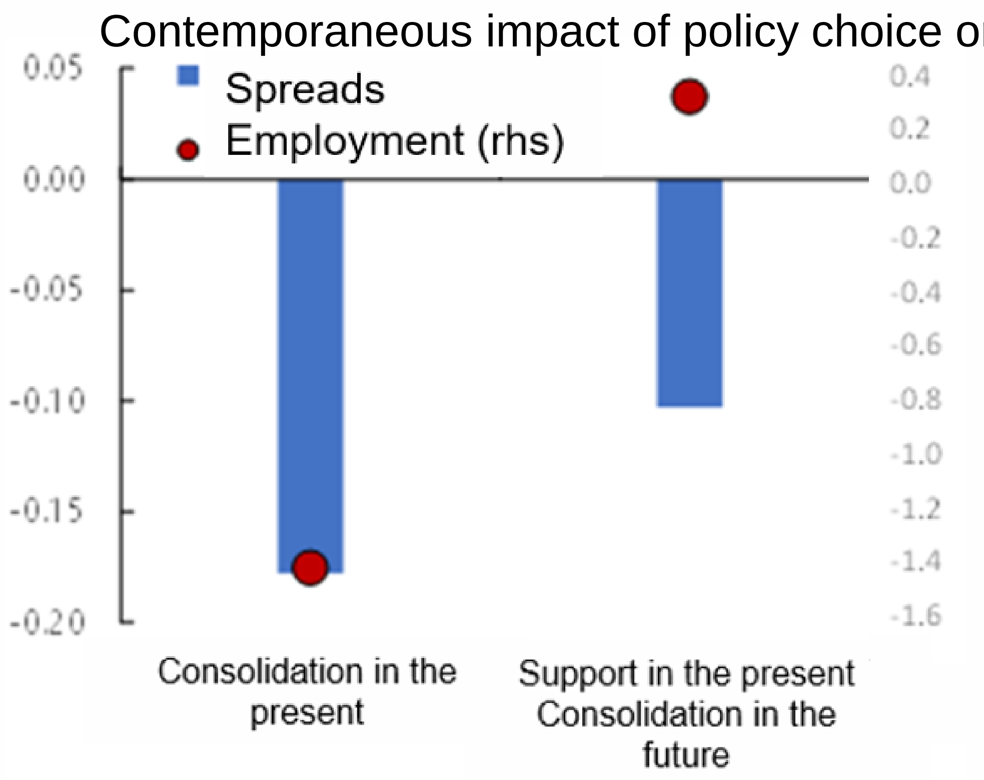
Reducing debt will be a marathon, not a sprint

Increase in primary balance, compared to 2010-19 average, required to return to 2019 debt level



Note: The calculations assume that the primary balance in 2021-23 is as in the WEO baseline, long-term growth rates are constant and equal to staff projections for 2024-2026 and effective real interest rates (interest bill/stock of debt) after 2023 are 1 percent for AEs and 2 percent for EMs

Promising to contain deficits in the future should afford fiscal space, allowing countercyclical policy



Source: Based on stochastic model by Bianchi, Ottonello, and Presno (2021).
Notes: “Stimulus in the Present + Consolidation in the Future“ corresponds to a loosening of the primary deficit by 0.1 percent of GDP in the current year and a tightening by 0.5 percent of GDP in the following year. “Stimulus in the Present + Selective Consolidation in the Future” makes it conditional on growth

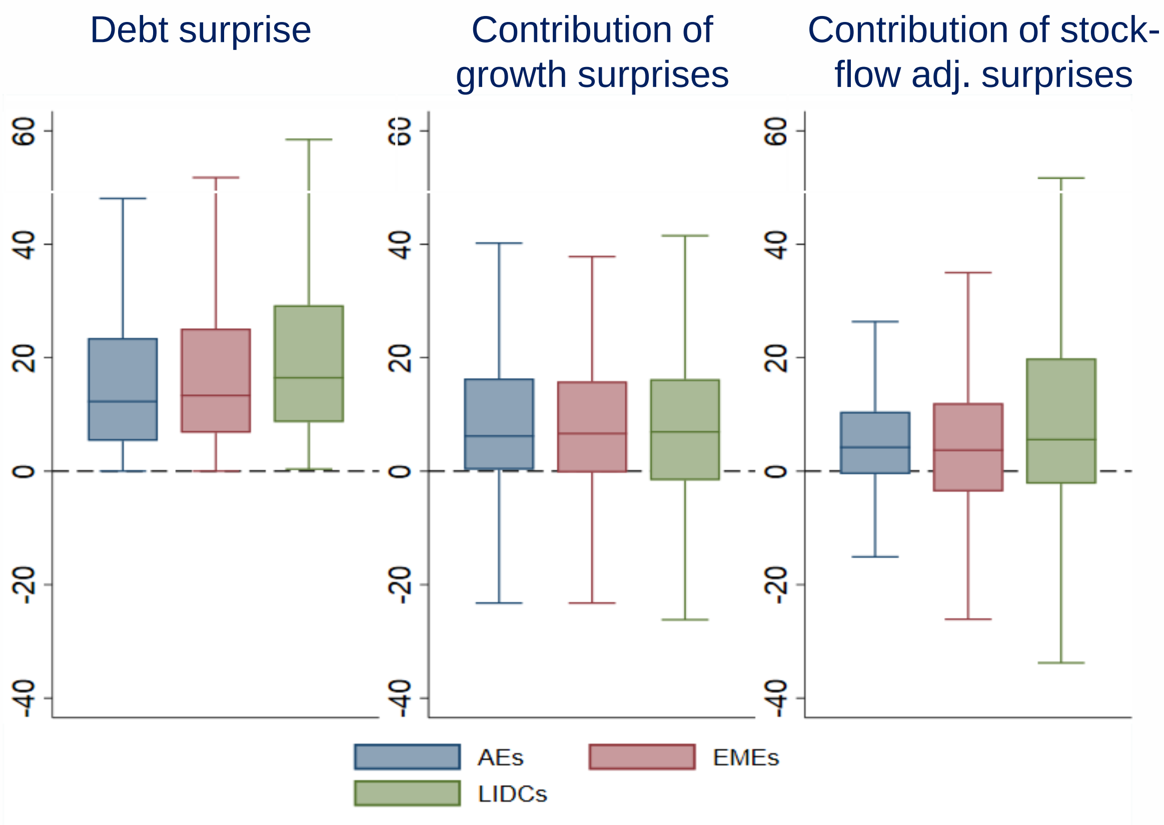
There are also upside risks to debt going forward

Debt jumps occur most often during and in the aftermath of crises

Fiscal objectives should account for risks:

- Buffers should be bigger if risks are larger
- Institutional coverage of rules should include source of risks
- Budgeting should include expected losses and present costs of contingent liabilities
- Risk mitigation can reduce fiscal exposure

Unexpected Jumps in Debt, 5-year horizon (pc of GDP)



Notes: Decomposition uses projections at the 5-year horizon, obtained from the WEO October vintages over 1995-2019. Realized changes are compared to the projections for the main components of the debt's law of motion. To control for the impact of automatic stabilizers and policy measures on primary fiscal balances, the decomposition follows the approach of Mauro and Zilinsky (2016).

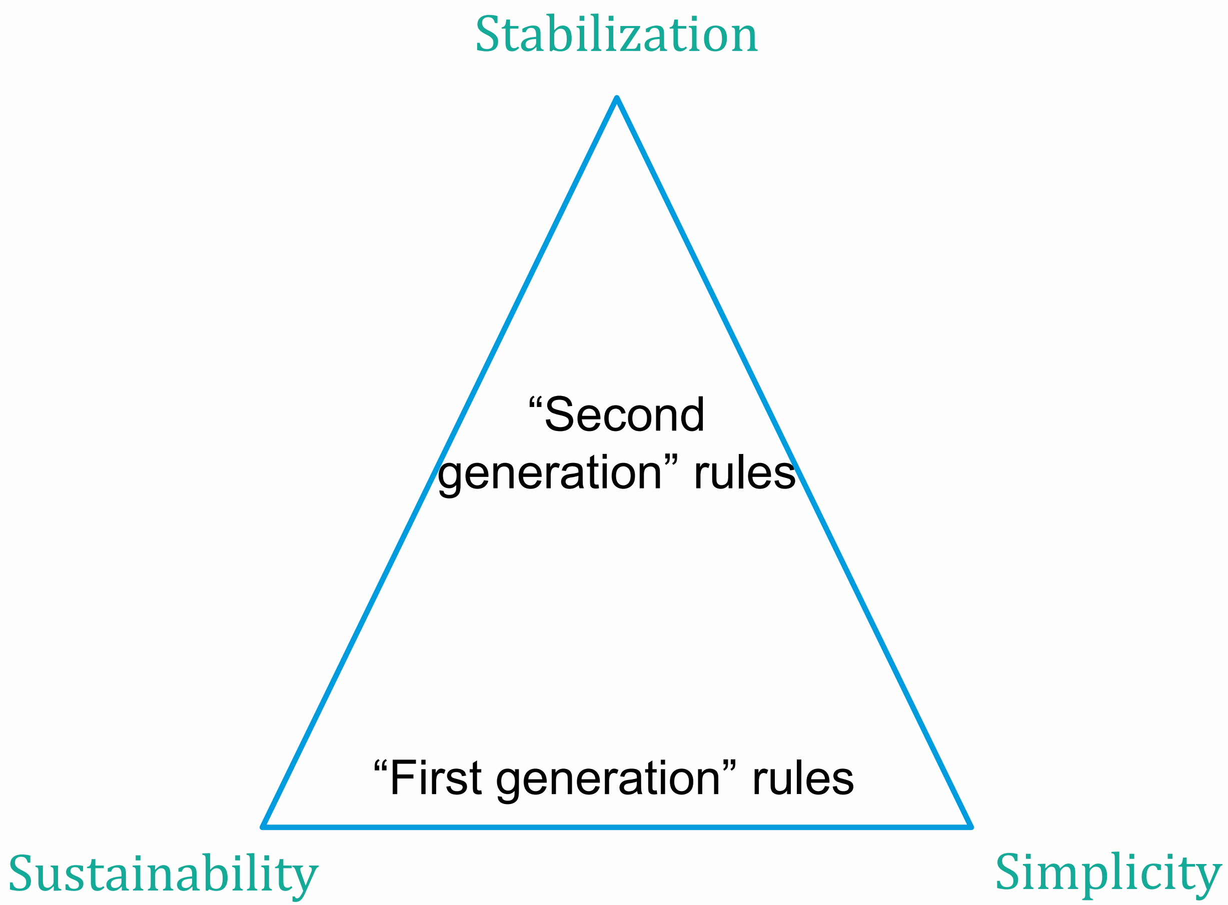
Fiscal frameworks can help build credibility, but balancing act

Fiscal frameworks increasingly sophisticated

- Long-term fiscal objectives
- Medium-term budget framework
- Procedural rules
- Numerical fiscal rules
- Fiscal reporting
- External oversight

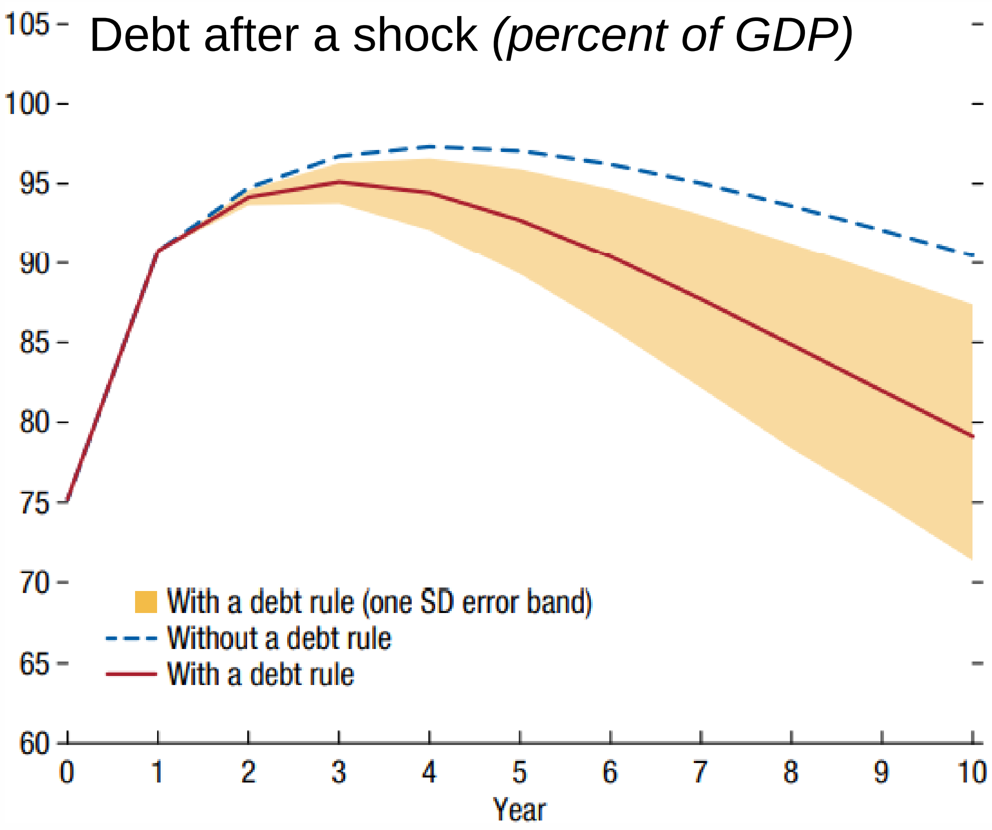
Satisfying three key objectives a challenge

The trilemma in the design of fiscal rules



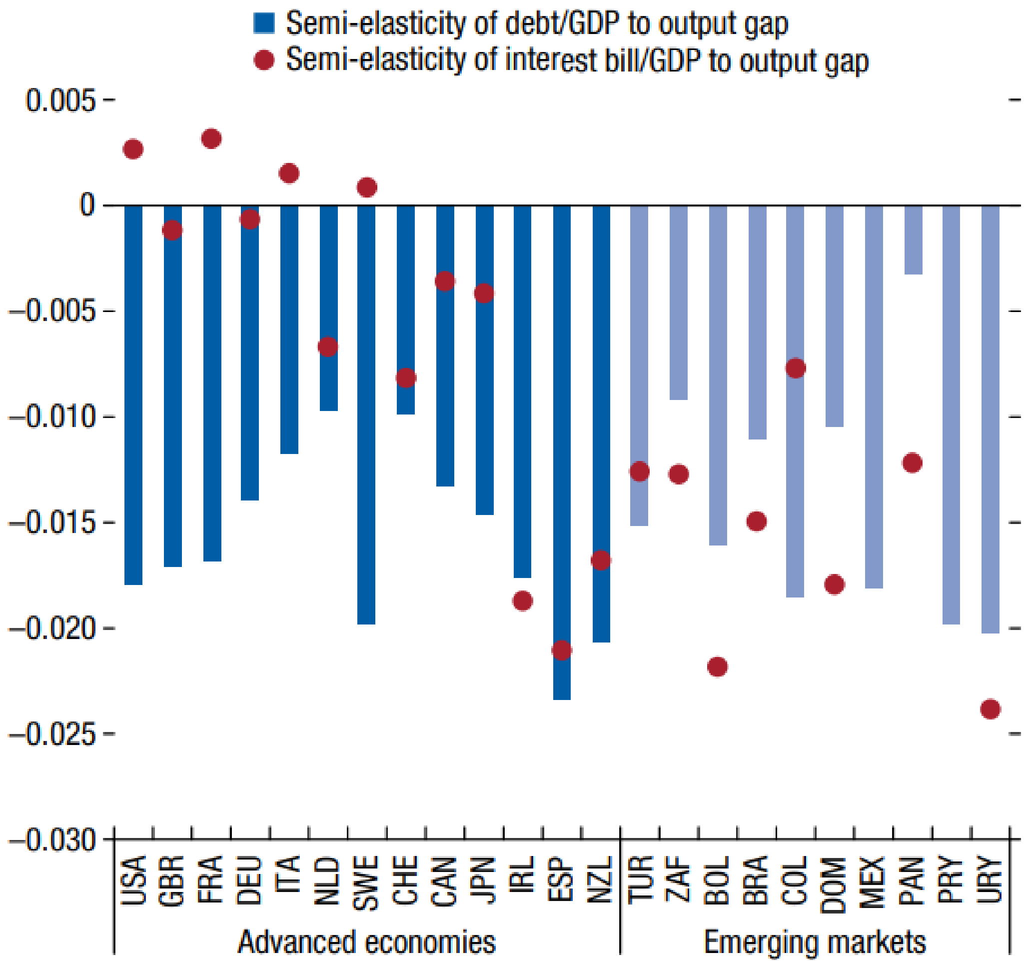
Existing fiscal anchors have contributed to sustainability

Budget balance rules and debt rules have been associated with fiscal prudence



Source: David, Goncalves and Perrelli (forthcoming).
Note: Based on panel estimation of fiscal reaction function linking primary balance to past debt, for 55 countries over 1970-2018. Illustrative simulation using estimated coefficients from the panel estimation and calibrated to average debt of advanced economies in 2019 and their average debt increase in 2020.

Interest bill could play the role of an anchor, but risk of being procyclical in EMs



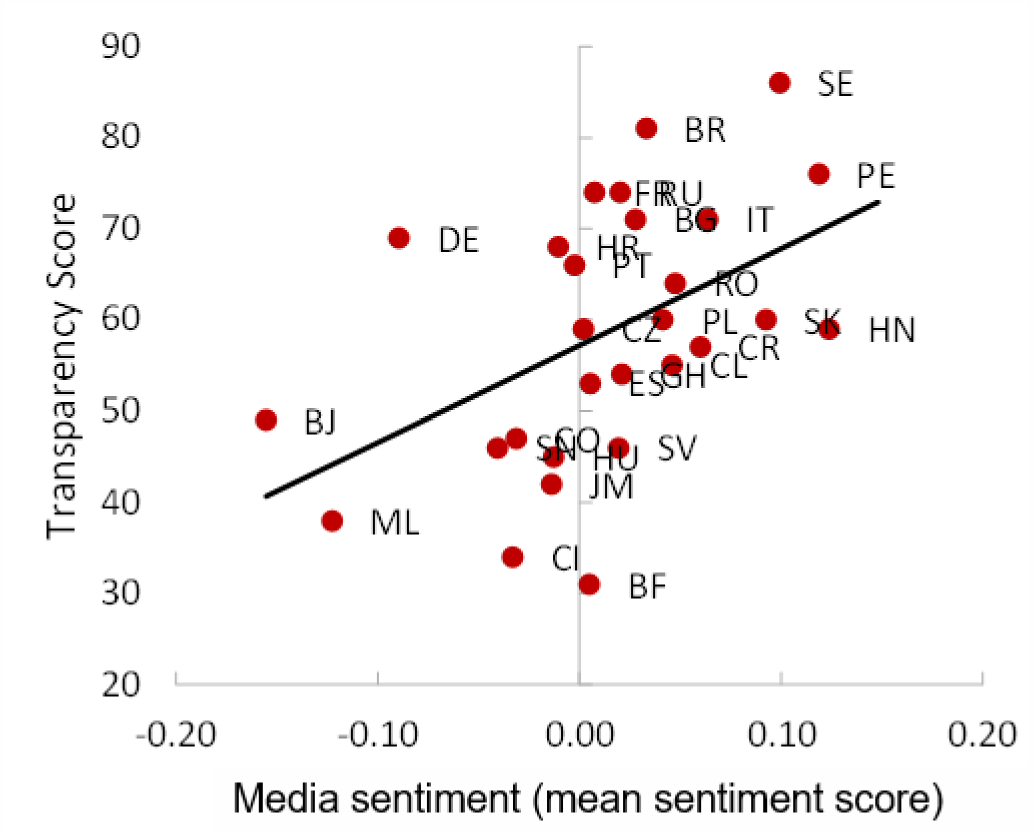
Note: Because the semi-elasticities are negative, a lower (more negative) value means a stronger sensitivity to the output gap. Estimated country-by-country over 1985–2019.

Old and new proposals to increase flexibility

- More flexibility could be provided by
  - ✓ focusing on procedural rules where institutions are strong
  - ✓ selecting expenditure rules
  - ✓ giving more fiscal space when monetary policy constrained

- Recalibrating numerical rules
  - ✓ Impact on credibility unclear
  - ✓ Context and communication key
  - ✓ Fiscal transparency seems to improve media reaction

Media reaction to suspension of fiscal rules in 2020 and Index of Fiscal Transparency



Source: Factiva; Open Budget Survey 2019; and staff calculations
Note: Based on newspaper articles published in a two-week window around suspension of fiscal rules and referencing the suspension of the rule (38 articles per country on average). The mean sentiment score captures the tone (positive or negative) of the newspaper articles

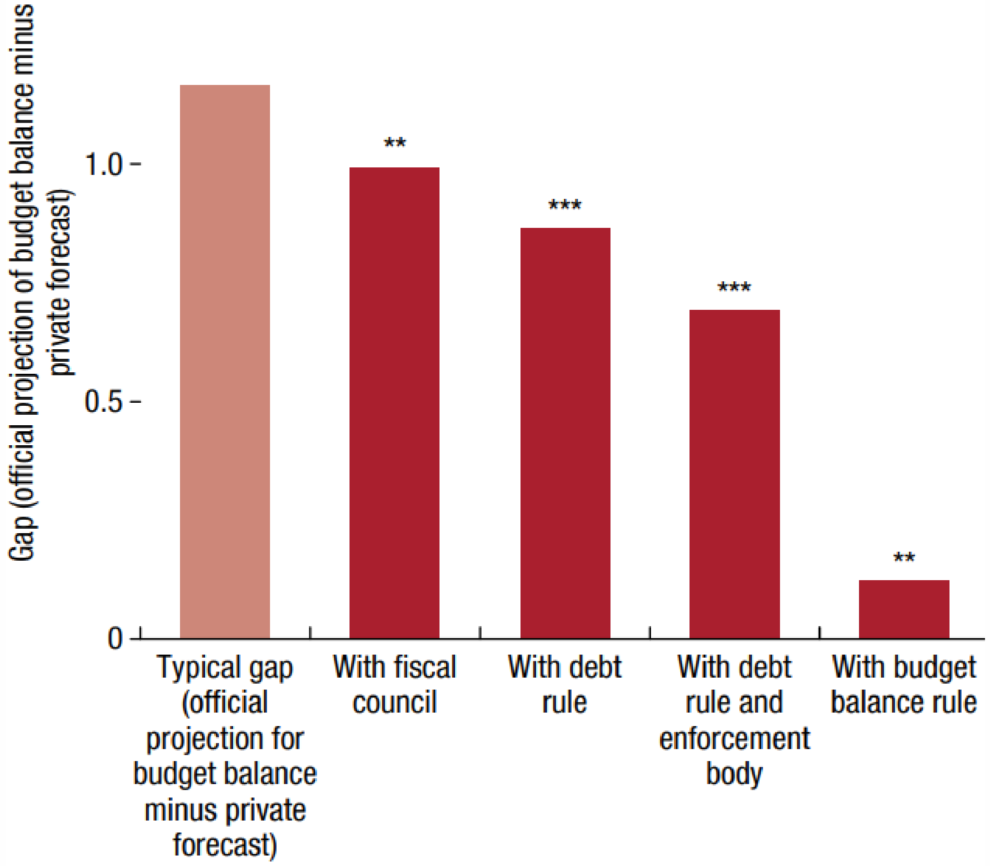
Good fiscal frameworks help communicate to the public

Measure of "credibility of budgets"

- Difference between of official projection and private sector projection for deficits
- Constructed using official announcements and deficit forecast by professional forecasters (Consensus Forecast): 32 countries, 1997-2019

Correlates well with existence of fiscal rules and enforcement mechanisms

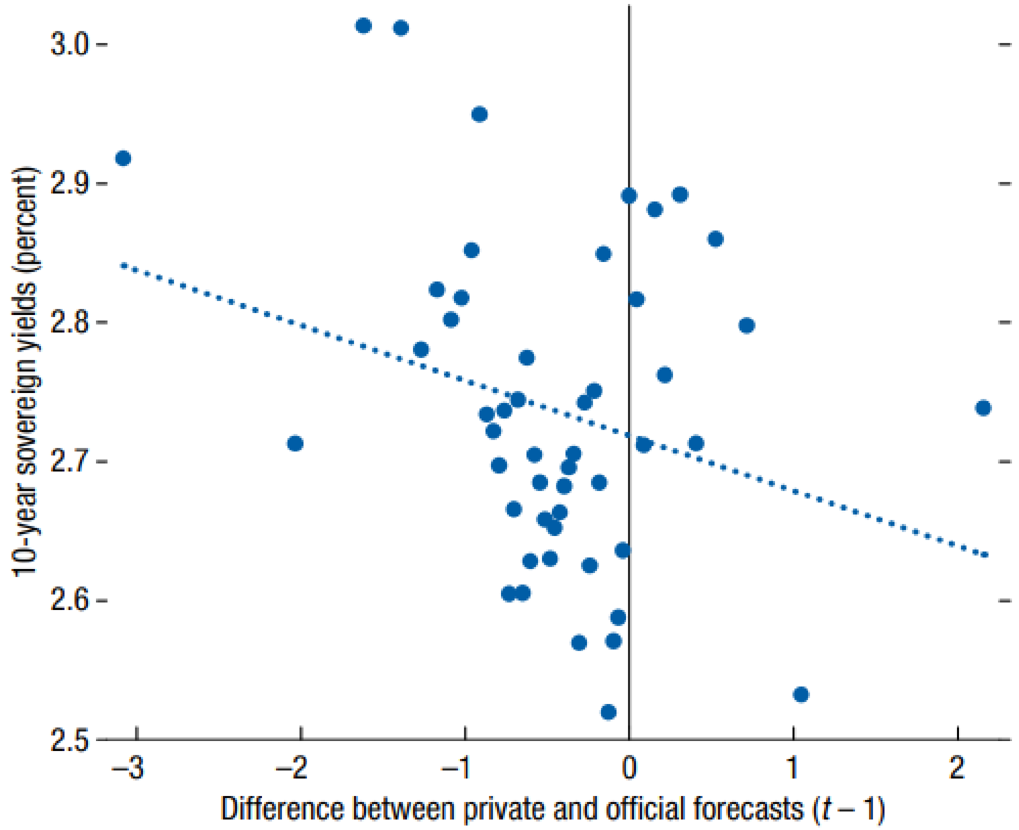
Impact of Fiscal Framework on credibility
(gap between official projection for budget balance and private forecast of budget balance)



Sources: IMF Fiscal Rules Database, Consensus Forecast, Bloomberg
Note: The typical gap is positive because the official projection is usually more optimistic than the private sector's. A lower gap thus indicates more credibility. Based on regressions on 423 observations, covering 23 AEs and 9 EMs over the period 1997 -2019

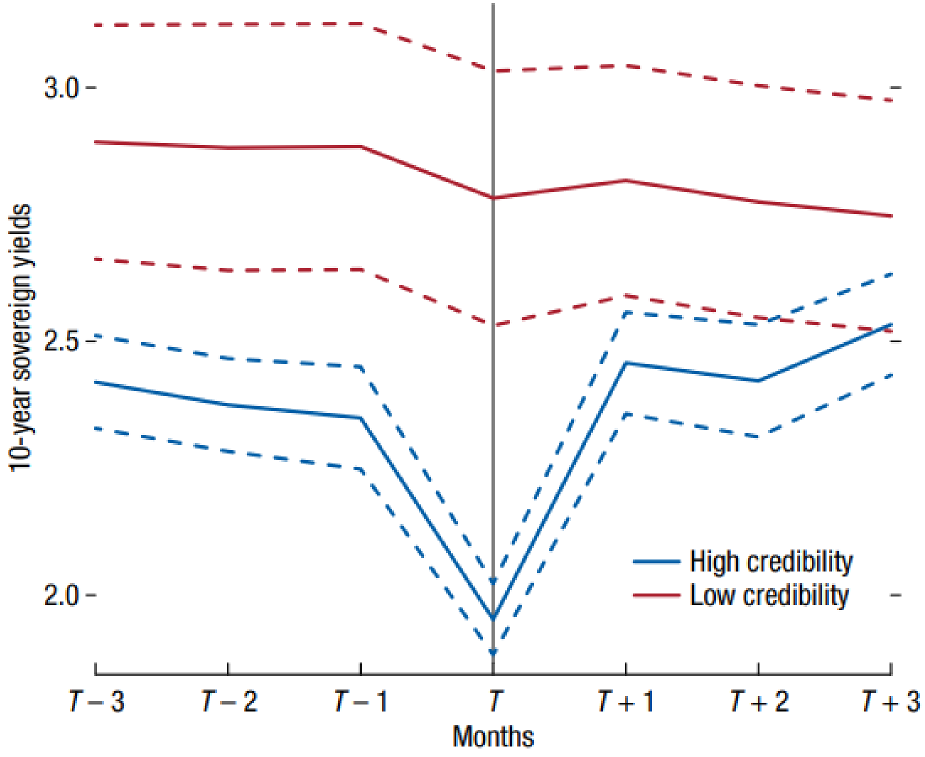
Strengthening credibility can make financing easier and buy some time

There is a good correlation between funding costs and the credibility of budgets



Sources: Bloomberg Finance L.P.; and IMF staff estimates.
Note: Bin scatter plots are based on 3,071 observations covering 34 countries from 2001 to 2019. The bin scatter plot groups the observations into 50 equal bins. Robust regressions include a range of controls

Governments whose budgets are believed by markets see a drop in yields at the time of announcements



Note: Credibility of announcements is measured using the difference between official projections for the balance and private projections. ‘High credibility’ is defined as credibility above 75th percentile, while ‘low credibility is defined as credibility below 25th percentile. Based on 23 AEs and 9 EMs from 2001 to 2019, excluding announcements made during the GFC and in years of sovereign debt crisis. 1sd error bands.

Key takeaways

- Debt is high and creates risks; fiscal consolidation necessary to reduce debt
- Debt reduction should wait till recovery on strong footing
- Strong fiscal frameworks can buy time
  - ➢ they make fiscal policy more credible, and this eases financing
- Choice of fiscal anchor and fiscal rule is country-and period-specific.
- Numerical rules work as intended
  - ➢ but important to keep in mind stabilization and simplicity
- Reforming fiscal framework more successful with:
  - ➢ Flexibility to accommodate conjunctural situation
  - ➢ Political consensus
  - ➢ Fiscal transparency

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Strengthening The Credibility Of Public Finances
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