

**IMF Working Paper**  
Fiscal Affairs Department

**Trust What You Hear: Policy Communication, Expectations, and Fiscal Credibility**  
**Prepared by Nicolas End and Gee Hee Hong\***

Authorized for distribution by Paulo Medas  
February 2022

**IMF Working Papers describe research in progress by the author(s) and are published to elicit comments and to encourage debate.** The views expressed in IMF Working Papers are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

How do policy communications on future fiscal targets affect market expectations and beliefs about the future conduct of fiscal policy? In this paper, we develop indicators of fiscal credibility that quantify the degree to which policy announcements anchor expectations, based on the deviation of private expectations from official targets, for 41 countries. We find that policy announcements partly re-anchor expectations and that fiscal rules and strong fiscal institutions, as well as a good policy track record, contribute to magnifying this effect, thereby improving fiscal credibility. Conversely, empirical analysis suggests that markets reward credibility with more favorable sovereign financing conditions.

JEL Classification Numbers:	E61, E62, E65, H11, H30
Keywords:	Fiscal credibility, fiscal policy, forecast errors, private expectations, fiscal institutions, fiscal rules, fiscal councils, fiscal surprises
Author's E-Mail Address:	<a href="mailto:nend@imf.org">nend@imf.org</a> , <a href="mailto:ghong@imf.org">ghong@imf.org</a>

\* End: Japan Bank for International Cooperation (JBIC), Tokyo. JBIC accepts no liability whatsoever for any direct, indirect, or consequential loss of any kind arising out of this working paper or its materials.

WORKING PAPERS

# **Trust What You Hear:**

## **Policy Communication, Expectations, and Fiscal Credibility**

Prepared by Nicolas End and Gee Hee Hong<sup>1</sup>

---

<sup>1</sup> We would like to thank, without implication: Olivier Blanchard, Vitor Gaspar, Paolo Mauro, Paulo Medas, Ricardo Reis, Sheth A tsi and participants of the Workshop on the October 2021 Fiscal Monitor and the Bank of Spain presentation. We are grateful to Raphaël A. Espinoza, Antonio Fatás, Takuma Hisanaga, Irene Yackovlev and Christoph Rosenberg for their detailed comments. We are also indebted to Metodij Hadzi-Vaskov for sharing data, Tatiana Gorianinova and Andrew Womer for their kind support with data collection, and Andre Vasquez and Joni Mayfield for helpful assistance. All remaining errors are our own.

# Contents

Glossary	<a href="#">6</a>
Executive summary	<a href="#">7</a>
<b>1 Introduction</b>	<a href="#">8</a>
<b>2 Indicators of fiscal credibility</b>	<a href="#">13</a>
2.1 Definition . . . . .	<a href="#">13</a>
2.2 Data . . . . .	<a href="#">17</a>
2.3 Stylized characteristics of fiscal credibility . . . . .	<a href="#">19</a>
<b>3 Announcements, surprises, and anchoring</b>	<a href="#">21</a>
<b>4 What supports fiscal credibility?</b>	<a href="#">27</a>
4.1 Fiscal frameworks . . . . .	<a href="#">29</a>
4.2 Fiscal transparency and communication . . . . .	<a href="#">31</a>
4.3 Track record and fiscal adjustments . . . . .	<a href="#">33</a>
<b>5 Conclusion and policy implications</b>	<a href="#">34</a>
<b>Appendices</b>	<a href="#">42</a>
<b>A Market rewards of fiscal credibility</b>	<a href="#">42</a>
<b>B Data sources</b>	<a href="#">46</a>
<b>C Detailed regression results</b>	<a href="#">50</a>
<b>D Figures</b>	<a href="#">58</a>

# List of Figures

1	10-year Sovereign Yields around the Time of Budget Announcement (T) . . . . .	<a href="#">11</a>
2	Fiscal Balance Forecasts: Private vs. Official Forecasts . . . . .	<a href="#">18</a>
3	Forecast Errors: Government vs. Private (in percent of GDP) . . . . .	<a href="#">19</a>
4	Fiscal Credibility Indicators: Country Averages . . . . .	<a href="#">20</a>
5	Fiscal Credibility and Past Projection Performances . . . . .	<a href="#">22</a>
6	Fiscal Credibility around the Release of New Official Forecasts . . . . .	<a href="#">23</a>
7	Official Plans for Fiscal Adjustments vs. Private Forecast Updates . . . . .	<a href="#">23</a>
8	Construction of <i>Fiscal News</i> . . . . .	<a href="#">24</a>
9	Impact $\hat{\beta}_h$ of Fiscal Surprises on Private Forecast (in Percentage point of GDP) . . .	<a href="#">26</a>

10	Credibility Response to New Fiscal Targets (in Percentage point of GDP) . . . . .	<a href="#">27</a>
11	Discrepancy between Private and Official and Deviations from Fiscal Rules: EU example . . . . .	<a href="#">30</a>
A.1	Sovereign Risk: Expectations and Market Price . . . . .	<a href="#">43</a>
A.2	Announced Fiscal Actions, Credibility and Sovereign Yields . . . . .	<a href="#">44</a>
D.1	Perceived Bias and Macroeconomic Indicators . . . . .	<a href="#">58</a>
D.2	Pass-Through of Fiscal News: High Credibility vs. Low Credibility . . . . .	<a href="#">58</a>

## List of Tables

B.1	Official Budget Documents . . . . .	<a href="#">46</a>
B.2	Data Coverage . . . . .	<a href="#">47</a>
B.3	Macroeconomic, Fiscal, and Institutional Data . . . . .	<a href="#">48</a>
B.4	Open Budget Survey Questionnaire (excerpt) . . . . .	<a href="#">49</a>
C.1	Non-linear Relationship between Forecast Errors and Fiscal Credibility . . . . .	<a href="#">50</a>
C.2	Fiscal Rules, Frameworks, and Credibility . . . . .	<a href="#">51</a>
C.3	Public Engagement and Publication of Budget Documents and Credibility . . . . .	<a href="#">52</a>
C.4	Independent Fiscal Institutions and Credibility . . . . .	<a href="#">53</a>
C.5	Transparency and Quality of Budget Forecasts and Credibility . . . . .	<a href="#">54</a>
C.6	Government Track Records and Credibility . . . . .	<a href="#">55</a>
C.7	Composition of Announced Fiscal Plans and Credibility . . . . .	<a href="#">56</a>
C.8	Sovereign borrowing costs and fiscal credibility . . . . .	<a href="#">57</a>

## Glossary

AMSE	Aix-Marseille School of Economics
AR	Auto-regressive
CDS	Credit default swap
CEPR	Centre for Economic Policy Research
CPDS	Comparative Political dataset
DBP	Draft budgetary plans
ECB	European Central Bank
EU	European Union
FGLS	Feasible generalized least squares
GDP	Gross domestic product
IBI	Independent budgetary institution
IFES	International Foundation for Electoral Systems
IMF	International Monetary Fund
JEL	Journal of Economic Literature
MONA	IMF's Monitoring of Fund Arrangements
NBER	National Bureau of Economic Research
OBI	Open Budget Index
OBS	Open Budget Survey
OLS	Ordinary least squares
PBSS	Publications of pre-budget statements
PEFA	Public expenditure and financial accountability
PIMA	Public investment management assessment
RMSE	Root mean squared error
SCP	Stability and convergence plan
SGP	Stability and Growth Pact
SSRN	Social Science Research Network
WEO	IMF's World Economic Outlook
WUI	World uncertainty index

## Executive summary

How do policy communications on future fiscal targets affect market expectations and beliefs about the future conduct of fiscal policy? This paper is about credibility and communication of fiscal policy. It investigates how effective policy communication can bolster a government's credibility and anchor expectations. Credibility is about having private agents trust that policymakers will deliver with respect to their mandate or stated objectives. In the fiscal realm, when *credible* governments announce fiscal strategy or targets, the public expects them not to deviate. Governments need to be perceived as committed to fiscal discipline through clear communication, demonstrating sufficient administrative capacity and political will. When the public sees the government as credible, in other words, *believes that the government will achieve its announced objectives as much as possible*, the difference between private expectations and official forecasts should be minimal.

We develop quantitative indicators of fiscal credibility, using the expectations of professional forecasters about the overall fiscal balance and analyzing how they deviate from the official targets announced by governments. We introduce three fiscal credibility indicators, *bias*, *skepticism* and *unanchoring*, to capture different aspects of the discrepancy between private and official expectations. Official announcements of new fiscal targets have an *anchoring effect*, as fiscal credibility improves on average by 0.2-0.4 percent of GDP when new targets are announced. However, the announcements are met with skepticism. By comparing growth projections, we find that disagreements about the macroeconomic outlook are not as important for fiscal credibility as one could have expected.

The strength, in terms of size and speed, of the anchoring effect of policy announcements depends on the institutional framework and past fiscal performances. Fiscal rules, which refer to lasting numerical constraints on budget aggregates, and strong fiscal frameworks, help fiscal credibility by reducing the discrepancy between professional and official forecasts and disagreement among private forecasts. Fiscal slippages and downward revisions to fiscal targets worsen credibility, confirming that credibility is based on reputations built over time; credibility is gained when governments strive to commit to their fiscal plans, and erodes when fiscal actions are insufficient to deliver on these plans. In turn, we find that improved fiscal credibility is rewarded with lower borrowing costs, highlighting that governments should strive to hone their credibility.