An Analysis of Korea's Fiscal Sustainability and an Estimation of its Target Fiscal Balance

From the 1997 currency crisis in Korea, the fiscal account, excluding the public pension balance, remained in deficit because fiscal expenditures were disbursed on a large scale for financial structural reforms, expansion of the social safety net and economic stimulus packages. As a result, the ratio of national debt to nominal GDP increased from 11.9% at 1996 year-end to 22.4% at 2001 year-end. In fact, the ratio may continue to rise due to the latent factors of fiscal expansion, including the burden of bearing public fund losses, the shift to a deficit on the Public Pension Fund, outlays related to social welfare, and so on. Under these circumstances, the chances are that the stability of Korea's national debt will be impinged. For the sustainability of fiscal policy, national debt should be restored to its original level on a medium and long-term basis, even if it increases in the short-term.

This paper analyzes the sustainability of fiscal policy during the period of the first quarter of 1978 and the third quarter of 2000 using Bohn's (1998) multi-variate model and shows that stability has been reduced since the currency crisis. This decline is attributable to the sharply increase in national debt, caused by the huge fiscal deficit maintained for the three years from 1997, when the currency crisis broke out, to 1999. Since then, however, the consolidated fiscal account has improved greatly together with the pick-up of economic activities; the burden of paying interest on the sovereign debt was

eased thanks to low interest rates; and Korea's national debt ratio is much lower than that of other OECD member countries. Taken all these circumstances into account, it can be safely judged that the level of national debt in Korea is not a cause for concern. Yet, large scale of fiscal disbursements could be made in the future, the sustainability of fiscal policy should be kept under constant review.

Meanwhile, the U.S., member states that are full member of EMU(European Monetary Union) and many other countries, whose national debt ratios are a problems due to the worsening of their fiscal soundness, have operated or still operate the fiscal rule system. The EMU set as convergence criteria for the adaption of the euro ceilings on the fiscal deficit and the public debt at within 3% and 60% of nominal GDP, respectively; most of the member states complied with these conditions and improved their fiscal soundness as a result. In Korea, a Special Act for the Fiscal Soundness, which stipulates the ratio of the scale of the fiscal account to nominal GDP and the formulation of a sovereign debt management plan, has been submitted to National Assembly.

In this regard, this paper seeks to estimate the medium- and long-term target level of the fiscal deficit that would maintain national debt at its present level (20%), despite the pressure for its increase imposed by the government's share of losses on public funds. The target deficit level is found to be –1.3% of nominal GDP, which is the same level as the average fiscal deficit ratio (-1.3%) during the period of 2000 and 2001. Therefore, with the present fiscal policies and stable economic growth, the debt ratio can be maintained at its present level(20%) in the long run even if the national debt ratio rises temporarily due to the losses on public fund.

Since the fiscal deficit target level, in effect, is obtained only through a public fund loss. In order to operate the fiscal account target level as the actual fiscal policy rule, other factors such as medium- and long-term real economic conditions, and fiscal expenditures and revenues should be considered in a more comprehensive manner. Implementation plans should also be reviewed in detail, based on the achievement of a social and political consensus because some of them may face resistance. In addition, although the law requires the observance of the target ratio as in the case of other countries, discretionary powers should be given to the fiscal authorities, to a certain extent, in order not to detract from the rule of fiscal policy in maintaining economic stability over the medium and long term.