

**EXECUTIVE
BOARD
MEETING**

SM/21/22
Correction 2

March 19, 2021

To: Members of the Executive Board
From: The Secretary
Subject: **Republic of Korea—Selected Issues**

Board Action: The attached corrections to SM/21/22 (3/3/21) have been provided by the staff:

**Factual Errors Not
Affecting the
Presentation of
Staff's Analysis or
Views**

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Questions: Mr. Bauer, APD (ext. 39455)
Mr. Swiston, APD (ext. 39640)

when the growth performance is robust from a cyclical perspective. Another design challenge for the provision will be how to achieve fiscal savings in “good” times to avoid procyclicality in a cyclical upswing.

Box 1. Quantitative Studies on Long-Term Optimal Debt

Quantitative studies on the long-term optimal government debt emphasize the liquidity benefits of government debt. The basic assumption is that private agents (e.g. households) face idiosyncratic income risks and imperfect financial markets. The benefit of higher government debt is that it provides households another asset for precautionary savings, which makes self-insurance easier (Aiyagari and McGrattan, 1998). Another benefit is that—other things equal—raising government debt implies less need for raising taxes today. Therefore, higher government debt relaxes the liquidity shortage of households and firms that otherwise would have to borrow more in the (potentially frictional) private market if there is a tax hike today (Azzimonti and Yared, 2018).

But higher debt is not costless. Three types of costs are explicitly considered in the quantitative literature.¹ First, all else equal, a higher government debt level may result in a higher interest rate and lower private investment (crowding out effect). Second, a higher debt level also implies higher interest payments, which will have to be financed through distortionary taxes. Third, a higher market interest rate caused by higher government debt also favors richer households (who have more savings and assets) and hence exacerbates inequality.

Overall, the desirable long-term government debt level is a quantitative question. Studies in this area, which are mostly calibrated to U.S. data, derive a broad range of optimal long-term debt levels from -100% of GDP (Floden 2001, Vogel 2014) to 145% of GDP (Azzimonti and Yared 2018), depending on modeling details, especially the types of costs considered and the efficiency of government transfers. However, once all three types of costs mentioned above are considered in the cost-benefit calculation of higher government debt, the results of the quantitative studies generally indicate that the optimal government debt level would be negative for the United States.

Some caveats should be taken into account when interpreting the quantitative results from the literature and their implications for Korea. First, almost all the studies cited above are calibrated to the U.S. economy. Second, in this literature, “government debt” refers to “net” debt instead of “gross” debt. Hence, an open question is what the suitable measure of “net” debt is. We think that the suitable measure of net debt should be the amount of gross debt netting out liquid financial assets – as liquidating non-financial assets, such as government buildings, is likely to affect other critical government functions. By this measure, Korea’s net government debt position is about -2147% of GDP as of 2019.²

¹ There are obviously other types of costs, such as higher debt crisis risks and the consideration of intergenerational redistribution. However, these types of costs are typically not explicitly accounted for in this line of literature.

² Data is from FY2019 National Account Settlement Report. Liquid government assets such as cash, deposit and securities amounted to 59 percent of GDP as of 2019. A big chunk of these assets was in the form of the reserve assets of National Pension Scheme (NPS). On the liabilities side, general-government debt (which has a broader coverage than D1) was about 3842 percent of GDP.

18. An expenditure rule in lieu of a deficit target could be considered to achieve countercyclicality without reliance on a slowdown provision, albeit it would raise other implementation challenges. Under expenditure rules, revenue fluctuates with the economic cycle, while expenditure growth is subject to a pre-determined ceiling path. As a result, the fiscal deficit is