

Assessing the mean reversion behaviour of fiscal policy: the perspective of Asian countries

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This article investigates fiscal policy sustainability in 10 Asian countries by adopting a battery of unit root tests. Univariate unit root tests reveal that the fiscal stance in these countries follows a nonstationary process while the opposite conclusion was drawn for the same dataset using the commonly employed panel unit root techniques. By utilizing the series-specific panel unit-root test recently developed by Breuer *et al.* [2002, SURADF (Seemingly Unrelated Regression Augmented Dickey-Fuller)] that allows testing for the presence of nonstationarity within individual cross sections of the panel, we found that only cross sections four out of 10 countries in the panel are stationary. This means that fiscal deficits in most Asian countries are in violation of their intertemporal budget constraint and that the deficits are too large.

1. Introduction

In the past decade or so, the issue of size and sustainability of fiscal deficits has received increasing attention from economists and policymakers alike.¹ International organizations have also dwelt into wide-ranging plans and surveillance programmes in assessing and monitoring fiscal budgets of their member countries (Chalk and Hemming, 2000; IMF, 2002). The purpose is to determine whether the fiscal imbalances in the developing world need to be curtailed before they become economically unsustainable. From a policy perspective, maintaining a sustainable balance is one of the core requirements

for a stable macroeconomic environment in order to maintain sustainable growth. Huge and persistent internal imbalances might lead to a hard landing for countries that appear to be insolvent. Besides, the role of fiscal policy as the stabilizing tool in developing economies has been widely recognized.² The aim is to keep the level of output close to its potential while maintaining inflation and external imbalances at acceptable levels. Empirical studies by Hemming *et al.* (2002) and Gupta *et al.* (2005), among others had concluded that the fiscal policy is effective in stabilizing and stimulating the economy.

The impact of the 1997 Asian financial crisis is yet to be seen. A great challenge to the Asian countries is

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¹ The general view is that budget deficit is sustainable if the intertemporal government budget constraint holds in present value terms. A violation of government intertemporal budget constraint would indicate that the deficit is not sustainable.

² The Asian financial crisis is a case in point. In the aftermath of the crisis, most of the countries severely affected by the turmoil employed fiscal stimulus to put the economy back on track. Indeed, countries like Malaysia were able to recover much faster because they did not have a fiscal debt problem.