INFLATIONARY PRESSURES: DIAGNOSIS AND OUTLOOK

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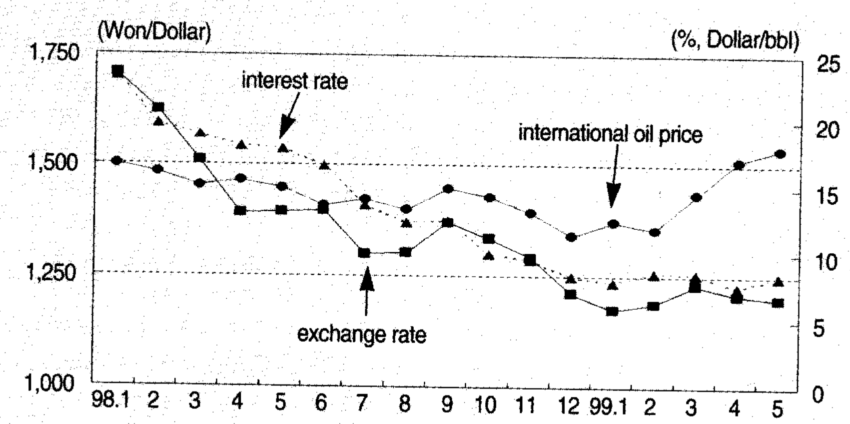
To the delight and surprise of many at home and abroad, the Korean economy is recovering at a faster pace than expected. According to the Bank of Korea late last month, the economic growth rate was recorded at 4.6% year-over-year during the first quarter of 1999. In particular, the rapid recovery of private consumption, which rose by 6.3% during the same period, steered the high economic growth even with the continuous slowdown of investment and exports. Concerns for inflation are spreading amid such unfavorable circumstances as the pressure to raise public service charges and the soaring international oil price. Taking the possibility of inflation into consideration, the monetary authorities decided to withhold its plan for additional interest rate cut; with confidence backed by the recovering economy, they also allowed long-term interest rates to rise gradually.

Diagnosis of the Inflationary Pressures

Demand Side: In a recovering period, the demand-side inflationary pressures tend to materialize very slowly because, by using idle labor forces and facilities, production increase can be made easily. In the case of the Korean economy, the manufacturing operation rate, which stood at 80% before the IMF era, was recorded at a merely 71.3% on average during the first quarter of 1999, while industrial production has shown an upward trend for six consecutive

Figure 1. Recent Trend of Cost-Related Variables

International oil price, exchange rate and domestic interest rate



1) Figures are monthly averages
2) Interest rate: Corporate bond yield with 3 years
3) International oil price: WTI spot price

months since November last year. In particular, many economists view the high surge in private consumption as rebounding from the excessive contraction last year, and thus not as overheating. Consequently, the inflationary pressures from the demand side are not significant yet.

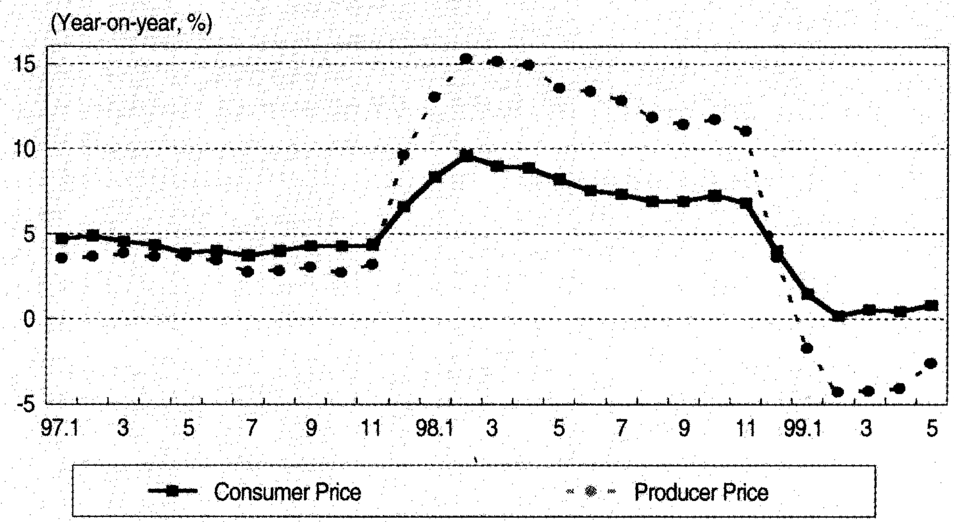
Supply Side: The cost side factors including the international oil price, exchange rate, interest rates and wages are showing relatively stable movements so far. The upward trend of the international oil price, which jumped up to 18 dollars per barrel in early May, fell down to 15~16 dollars per barrel. Prices of raw materials in international markets are also unlikely to rise high because of the sluggish recovery of the world economy. In the domestic financial market, on the other hand, the won/dollar exchange rate is showing a continuous downward trend to around 1,160~1,190 won/dollar, owing to the dominant dollar supply thanks to the current account surplus and increasing inflow of foreign investment. Furthermore, the domestic interest rates still remain at the low level in the neighborhood of 8%, thanks to the government's determination to boost the economy.

Others: The government's strong will to stabilize prices, the correction stage in the booming stock market and relatively low inflationary expectations among consumers would help prices remain stable. Having judged that price stability is critical for the economic recovery, the government has been displaying its strong will to stabilize the prices through policy efforts such as tax cuts, curbs on public service charges and price stability of agricultural products. Frequent corrections have been settling down the stock market and, by doing so, weakened the likelihood of excessive consumption due to an increase of wealth through the stock market boom. What is more, the general public's inflationary concerns remain at a moderate level, because the economy is in its early stage of recuperation.

Implications and Outlook

All things considered, the overall inflationary pressures are not estimated to be high enough to raise concerns. The recent trend of consumer price indexes supports this assessment. During the first half of this year, consumer price has risen merely by 0.7% year-over-year, dropping

Figure 2. Recent Trend of Price Indices



month-on-month in two consecutive months.

Some unfavorable factors may emerge during the second half of 1999. Above all, high private consumption and sluggish investment may result in a sudden jump in demand pressures, which will possibly create a bubble and inflation. The overheated bourse and real-estate market supported by abundant liquidity may steeply increase the likelihood. It will be inevitable to allow some of the public service charges to rise, followed by the hike in the private service fees. In addition, the cost side factors such as the domestic interest rates and wages are expected to climb in line with the economic recovery. As the expansion of money supply affects the price level generally with a time lag, the inflationary effects of the stimulus policy, adopted at the year-end of 1998 could be visual from the second half of this year.

In spite of these unfavorable factors, however, prices will be able to remain stable at least through the second half of this year, because the stabilizing factors are expected to dominate. Since the official price indices are measured on a year-on-year basis, the excessively high inflation in 1998 may also contribute to the stable price indices. Therefore, the consumer price index is forecast to reach 2.8% year-on-year during the second half of this year. The annual consumer price is also forecast to rise slightly by 1.9%, which is quite low when compared to the government's original target of 3%.

However, it is possible that the situation will worsen in 2000, when the economy is expected to fully feel the recovery. Also, the technical effect from this year's low price index would lead the consumer price index to stay in the 4~5% range. Therefore, it is possible that the government will switch to a tight monetary policy, starting from the fourth quarter of this year to alleviate the inflationary pressure, pushing the domestic interest rates up higher. VIP