

COST-PUSH INFLATION AND RESTRUCTURING

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With the higher-than-expected economic recovery, the Bank of Korea and the Korea Development Institute (KDI) recently warned of the possibility of economic overheating and thus of inflation. The fact that GDP grew more than 12% in the third quarter of this year seems to support their argument. The question centers not only on the reality of this argument but also on the cause, that is, whether or not the inflation would come from demand-side factors, as noted in the argument.

The current economic situation and past experience, such as macroeconomic statistics, however, cannot support this argument in several aspects. First, there seems to be enough room for further growth based on the demand expansion. In order to judge whether the economy is overheating or not, economists usually estimate the "potential growth rate" and compare it to the expected or actual growth rate. The current (actually for the year 2000) potential growth rate is estimated to be 5.5%~6.0%¹⁾, which means that the Korean economy is not likely to be overheated, whereas next year's real growth rate is forecast at around 6%.

Second, since the economy has experienced a severe downturn in the aggregate demand during the past two years, there is still overcapacity in the economy in spite of the relatively strong rebound on a year-on-year basis. In fact, according to an estimation by the Hyundai Research Institute, the size of Korean economy's aggregate demand, when

converted into won, will be 464 trillion won in 2000, whereas that of the aggregate supply is to be over 480 trillion won.

Third, the fact that unemployment rate is still high supports the argument that demand-pull inflation would not happen next year. Natural unemployment rate will obviously edge up beyond the past level. However, it would be around 4% at most. The current unemployment rate as low as 4% is a temporary phenomenon affected by seasonal factors. Next year's unemployment rate is predicted to remain around 5% on average. Fourth, some argue that the increased money supply will exert upward pressures on the price level. Yet, facing the reduced velocity of money circulation due to restructuring, this prediction needs more solid grounds to be convincing.

Nevertheless, the possibility of cost-push inflation should not be easily neglected. Above all, the rising trend of import prices will continue mainly because of high oil prices. Fortunately, the won's strength may mitigate the external pressures. The general level of wage is another factor, since many expect more active labor union movement in the following year. Owing to the economic recovery, real estate values and interest rates are other factors.

If this is the case, it is not a wise choice to employ tightened demand-side policy because it would lead to a bigger shrink in growth. Rather, flexible demand-side policy coupled with speedy restructuring which could offset cost-side pressures would be an adequate solution for the policy-makers. **VIP**

1) It is estimated by using the Hodrick-Prescott Filtering Method, with exclusion of data from 1998 and 1999 when most economic indicators showed abnormal movements.