

WORRIES OF STAGFLATION

Dong Chul Park
(dcpark@hri.co.kr)

Concerns are mounting that the Korean economy may face both stagnation and inflation. Firstly, the recent economic slump is likely to continue. After entering an economic slowdown in August 2000, facility investment and exports have seen negative growth, and recently, even private consumption has started to contract. In addition, the tragic terrorist attacks on the US and the resulting fears of war in the Middle East appear to have further delayed the Korean economy's recovery.

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The most important condition for overcoming the current economic slump is the recovery of the world economy starting with that of the US. This is due to Korea's high export dependence. However, the possibility of a global recovery in the short term is getting even lower. First, the world's financial markets are in a state of turmoil as reflected in unstable stock markets, exchange rates, and interest rates due to the uncertain prospects for the global economy. Second, with market participants becoming increasingly uncertain, there is a chance that consumption and investment sentiment in individual countries will contract rapidly, and international trade is also expected to decrease. For example, GDP growth in the US this year is expected to record a mere 1%.

After the US terrorist attacks, the central banks and governments of the developed world announced they would actively intervene to minimize financial market instability and provide economic stimulus. However, because the world economy is already in a very uncertain situation, financial and real indicators are not expected to recover in the near term, and therefore Korea's export performance is unlikely to improve either.

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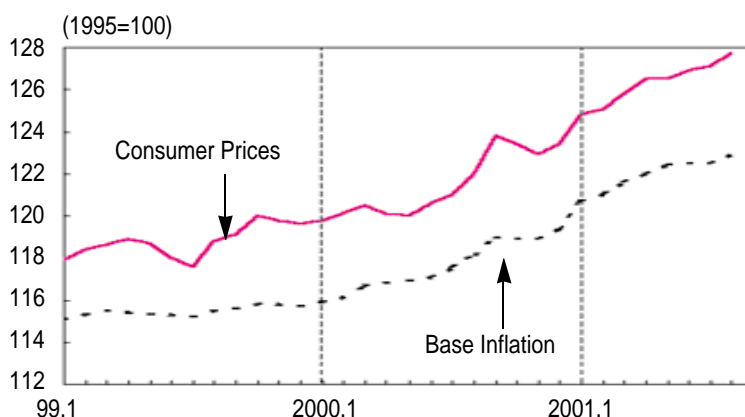
In light of the above, the domestic slump is expected to last one or two more quarters than previously expected, and the economy is unlikely to recover before late next year. In this case, the economy would have contracted for about 25 to 30 months. Considering that economic contractions since the 1970s have averaged 17 months, rarely exceeding 20 months, the latest contraction may be the longest since 1970.

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Second, there are also fears of domestic inflation due to hikes in world prices for oil and raw materials. With the current economic slowdown, supply-side factors such as the hike in public services fees are bringing inflationary pressure. During the continued slump since August 2000 to July this year, prices rose by 4.1%.

Oil prices, which were relatively stable, are threatening to rise with the

Figure 1. Price Trends (1996=100)



heightened tension in the Middle East. Considering that a five dollar increase in oil prices leads to a 0.4 to 0.5% hike in inflation, the threat of inflation is currently quite serious. In addition, with inflationary factors such as the 2002 World Cup, and two upcoming elections, price levels will be even further boosted.

Meanwhile, economic stagnation is deepening. Due to hikes in world prices for oil and raw materials, import prices will rise, and the delayed recovery of the semiconductor and IT markets is cutting export prices. The resulting deterioration of Korea's terms of trade can only pull down the country's GNI growth. In the second quarter, GNI grew by only 1%, and if the trend continues, growth may fall into the negative. Due to inflation, gloomy employment prospects, and fall in real purchasing power, market participants are expected to suffer even more in the future.

The economy is currently exposed to the risk of stagflation, and the economy's growth potential is also falling. Due to uncertain domestic and international prospects and the dragged out restructuring, facility investment and capital stock growth rates have plunged, and there is also a lack of R&D or human resource investment. As a result, growth potential is estimated to have fallen to 4% in the first quarter. Under such a decrease in growth potential, or the economy's overall supply capacity, efforts to increase effective demand will result in inflationary pressure, which introduces another policy constraint.

To prevent an episode of stagflation and improve growth potential, stimulus policies should be used to revive effective demand, while efforts are also made to expand the economy's aggregate supply capacity. Despite this fact, the authorities have set a policy line focused on economic stimulus. Although aggressive policies are needed in light of the current situation, an exclusively stimulatory policy is not appropriate because it will only result in short-term inflation. A policy mix of increasing effective demand and simultaneously expanding the economy's aggregate supply capacity is the best alternative. **VIP**

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