ECONOMIC POLICY ADJUSTMENT? NEED FOR CAUTION

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Recently, there has been a clear sense of economic recovery. Real economic indicators such as production and consumption showed significant improvement from last year. The export growth rate returned to a positive level, and facility investment also recovered. Amid this recovery, consumer and business expectations are rising rapidly. The stock market is enjoying a sustained bull market, and the foreign exchange market is also stable.

With the economy recovering so quickly, some observers are beginning to argue that signs of overheating exist. Based on these concerns, they are suggesting that current policies such as the interest rate stance or the front-loading of the budget should be re-examined.

The policy authority thinks that a policy shift would be premature, considering that facility investment or exports have not yet shown definite uptrends. However, it is not impossible for an earlier-than-expected hike in call rates or revision of budget front-loading.

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Careful consideration should be given however, before deciding on such a policy shift from stimulatory to contractionary. First, although some signs of overheating may exist, they are extremely partial and limited. The operation rate in manufacturing industries is still under 80, and the size of the construction market is smaller than it was before the financial crisis. Although facility investment and exports are said to have entered a recovery phase, they have just started to show a slight upturn from a long slump. The cyclical fluctuation of the coincident index, which reflects current economic conditions, recorded 99.2 in January, merely indicating that the economy is coming out of its trough.

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Considering these points, it can be said that the economy is just starting to enter an upturn phase. If the policy authority changes its policy stance at this point, the recovery may be delayed. In particular, in light of the fact that consumption and construction are the engines of domestic economic growth, there is a possibility that the economic recovery may retreat. Although things might be different if facility investment or exports clearly led economic growth, the current reality is different.

Second, a policy shift would bring more harm than benefit. Contractionary policy would caues household debt burden to increase, possibly leading in the extreme case to household bankruptcy and increased bad debt in financial institutions. In addition, financing costs for business would increase, and the financial market would become polarized, heightening the likelihood of worsened corporate financial structure and failure of borderline companies. The loss of policy consistency would also bring confusion to economic participants.

Maintaining policy consistency will raise the predictive ability of market participants.

Of course, if the government changes its policy, market participants may get the impression that the economy is definitely recovering. However, past experience shows that market participants cannot overcome their lack of faith in the consistency or accuracy of government policy. Maintaining policy consistency will raise the predictive ability of market participants. This is even truer at present, when there is still uncertainty about economic recovery.

The policy authority should not be swayed by the current economic debate, and should not show discord between different government branches. The policy authority should first distinguish short and long term policies and implement short term policies that fit a long term vision. The greatest long term task for the Korean economy is to expand growth potential. Even if effective demand temporarily or partially exceeds aggregate supply, the economy's aggregate supply capacity should be fostered rather than restricting effective demand. To achieve this, corporate investment should be encouraged, and the quantity and quality of human resources should be improved. In addition, if the world economy starts to recover in earnest, new and substitute investment by businesses should be allowed to continue so that they can flexibly respond to world demand.

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Short term policy should be implemented with such a long term vision in mind. First, real economic growth should be brought up to the level of potential economic growth (5 to 6%). Although there are some forecasts that growth in the first quarter, and even for the year, will exceed 6%, the limits to growth in private consumption and the incomplete recovery of facility investment and export make it unlikely that the potential growth rate will be reached too quickly. It will not be too late for a policy shift when exports show a definite recovery.

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Second, economic policy should be conducted efficiently through a policy mix. Since the economic recovery is in its early stage, there are many factors of uncertainty. At such times, the economy should be closely monitored on a monthly basis, and fine-tuning should be carried out. As a hike in call rates or change in fiscal policy would affect the entire economy, they should be avoided if possible, and partial problems should be addressed with specific solutions.

The right policy direction would be to maintain the current macroeconomic policy stance while taking microeconomic measures for different sectors such as real estate. Of course, although there may be problems in the effectiveness or sustainability of micro policy, it is desirable because it minimizes factors of confusion in the overall economy. VIP