Economic Focus

Low Inflation and Policy Priorities

In 1999, the Korean economy experienced a record low inflation rate, with the consumer price rising by only 0.8% and the producer price falling by 2.1%. Considering that 1998's consumer and producer prices increased 7.5% and 12.2% respectively, one can notice how much lower inflation rates were in 1999. If such low inflation continues in 2000, it would greatly help the Korean economy escape from its "high cost structure". In the hopes of sustained low inflation, the Korean government chose price stabilization as its policy goal at the beginning of the year. In fact, the government forecast that consumer prices for the year would rise by less than 3%, which was the lowest estimate among experts on the Korean economy. The conservative government forecast of a 6% growth rate reflects the government's will to stabilize the economy even at the cost of lower growth.

● *Policy measures for price stabilization can deteriorate growth*

One can raise a couple of concerns about the government's view. First, the policy tools used to stabilize the price level should be carefully determined. In order to control inflation, the government may depress aggregate demand by tightening monetary policy or by raising the interest rate which will bring a decreased growth rate. It is not easy to judge which the Korean economy needs more: low inflation or a high growth rate. Policymakers, however, should note that depressing aggregate demand while the unemployment rate is still above 4% may bring negative results. While tightening monetary policy or raising the interest rate would alleviate demand side inflation pressures, the government should realize that it can also mitigate cost side pressures by encouraging R&D and invigorating investment.

Another easy measure that policymakers may be inclined to use is to allow the Korean won's appreciation by not intervening in foreign exchange markets. The expected excess supply of foreign currencies in the domestic market this year would make the won's appreciation easy. The won's appreciation would help price stabilization, one can easily understand this by recalling that high inflation in 1998 resulted from the hike in the exchange rate. On the other hand, the won's appreciation would deteriorate Korea's current account. Considering that the cumulative current account surplus for the last two years was 67 billion dollars and foreign reserves totalled 75 billion dollars, one might say Korea does not need such a large current account surplus. But, if we consider that Korea's huge current account deficit was the main reason for the 1997 currency crisis, it seems reasonable to maintain the surplus for the present.

● 3~4% inflation rate is not high for Korean economy

Another point that we should consider is whether a 3% inflation rate is high enough to deteriorate the Korean economy's long term growth. A 3~4% inflation rate may not be prohibitively high considering that the Korean economy had experienced remarkably low inflation in 1999. During the past several decades, Korea's consumer price index never dropped below 4% except in 1999, while it is unreasonable to expect that any structural change concerned with price occurred in the last two years. This means immoderately low inflation below 3% might lead to a low growth rate and unnecessarily high deterioration of the current account.

Corporate and financial restructuring brought a stabilized domestic financial market and a stock market boom, which both contributed to Korea's economic recovery last year. In addition, the world economic recovery and low interest rates in advanced countries gave rise to trade surpluses and low interest rates in the domestic market. However, if the government tightens policy, the domestic financial market and stock market will be dampened, while an appreciated won would decrease the trade surplus. In return, the result would be a minor decrease of inflation. Therefore, policymakers should remember that a low inflation policy may cause high costs in terms of the growth rate and external balance.

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