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Emerging Insight

Korea: BoK preview – A prolonged balancing act

15 February 2024

GEM Fixed Income Strategy & Economics
Global

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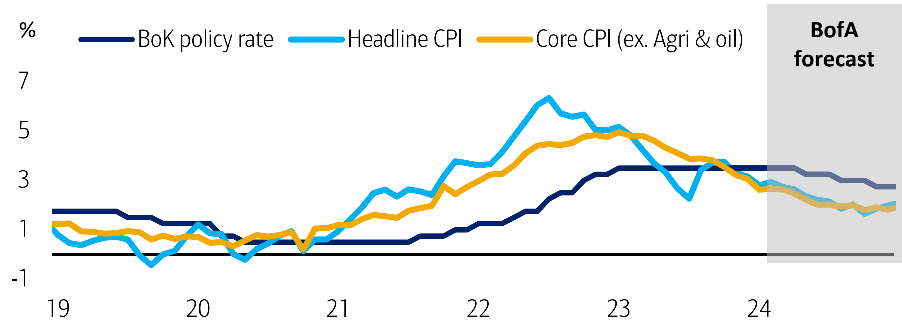
Key takeaways

- BoK likely to hold rates at 3.5% on Feb 22, the 13 straight month. One new MPC member (Kunil Hwang) assigned this week
- We expect balanced tones amid ongoing disinflation but mixed external factors (mainly better C/A but less dovish Fed)
- Key to watch: BoK's view on Fed, disinflation trend, housing market, Corp Value-Up Program, and MPC members' policy stance

By Benson Wu and Ting Him Ho

Exhibit 1: BoK policy rate and CPI forecast

We expect a continued disinflation trend to warrant a rate cut cycle later this year



Source: CEIC, BofA Global Research estimates

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Korea in Focus

The BoK will conduct its second MPC meeting of the year on Feb 22nd with a new member (Kunil Hwang). Ahead of the meeting, a mixed bag of external factors amid subsiding domestic inflation likely paves the way for another balanced tone in the meeting. As such, we expect a hold decision (of 3.5%) in the Feb meeting, the 13th straight month since the last pause (Exhibit 1).

Overall, we believe the continued export-led recovery will continue to support the domestic economic growth and to provide a favorable environment for the financial market.

Glossary

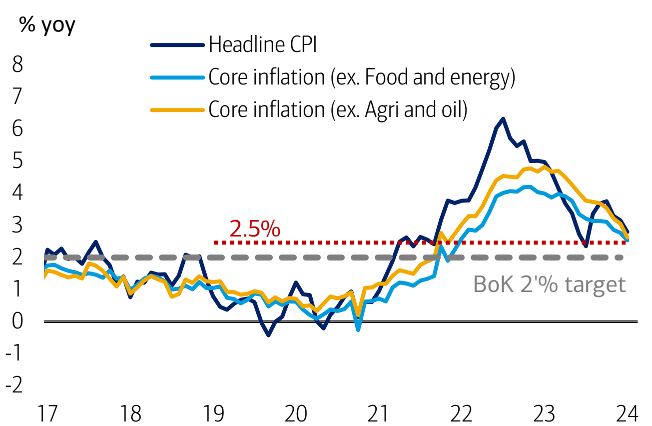
BoK: Bank of Korea
C/A: Current Account
Fed: Federal Reserve
FOMC: Federal Open Market Committee
MPC: Monetary Policy Committee

A favorable disinflation trend ahead the Feb meeting

Ahead of the BoK meeting on Feb 22nd, we see a more favorable disinflation trend on the way. In Jan, headline CPI inflation edged down to 2.8% yoy from 3.2% previously (Exhibit 2), and core inflation also moderated to 2.5%, the first time since Dec 2021. The disinflation was broad based across goods and services (Exhibit 3). Goods inflation inched down to 3.1% yoy, driven by lower oil prices, processed food inflation and utility inflation. Services inflation also edged down to 2.6% yoy. Dining inflation moderated to 4.3% yoy (0.3% mom s.a.) from 4.4% yoy, while the stickiest part, ex-dining personal service inflation, also dropped to 3.0% (0% mom s.a. vs. 0.4% previously).

If there is limited upside surprise from the oil prices, coupled with continued softening trend in services inflation, headline inflation is likely to remain below 3% in 1Q before falling further towards 2.5% by Apr, while the core inflation could drop to 2.3% by May at the earliest. This will enable BoK to vastly ease its concern about inflation, and to further pivot towards an easing stance, in our view.

Exhibit 2: CPI inflation and core trend (% yoy)
Headline CPI now on a gradual disinflation trend



Source: Haver, BoK

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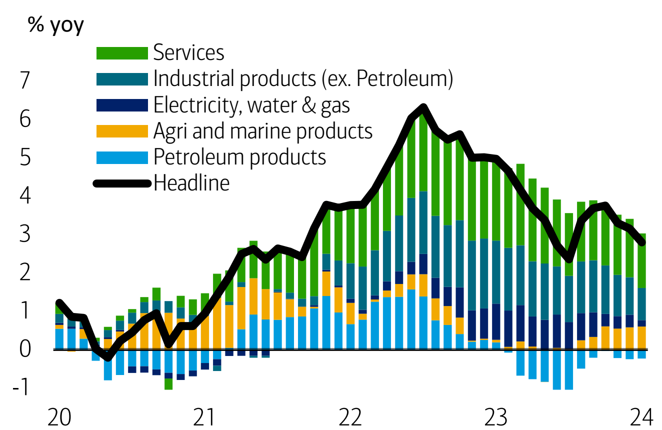
Exhibit 3: CPI inflation by key breakdown
The disinflation was broad based across goods & services



Source: Haver, BofA Global Research

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While external conditions came in mixed

Meanwhile, external conditions seem to be more mixed. On the bright side, we noted that the FX outlook is being supported by the strong equity inflow and current account position.

Strong equity inflow triggered by Corporate Value-Up Program

Recently, foreign inflow into Korean equities has significantly risen following the announcement of the Corporate Value-Up initiative from Korea's Financial Service Commission (see also Korea Financial Flows – Feb 2024). In short, the objective of the program is to eliminate the "Korea Discount" and boost the corporate value of companies trading below book value. Although details of the plan are yet to be finalized, foreign investors have already taken measures and chased after sectors with a low P/B ratio.

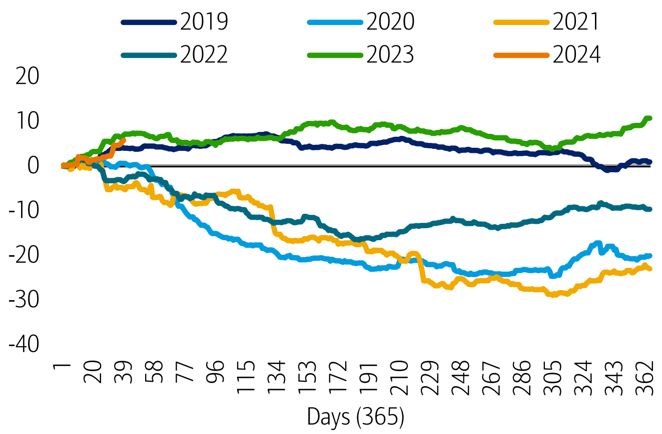
In aggregate, year-to-date net inflows in Korean equities are at a similar pace as Jan 2023 during initial months of China reopening (Exhibit 4). Our FX strategist expects foreign equity inflows to be sustained, alongside multiple re-ratings on single stocks by our equity analysts.

Strong C/A position thanks to a pick-up in trade surplus

Another supporting factor for the FX stability came from the recovery in C/A account. In Dec, C/A surplus picked up to USD7.4bn from USD3.9bn in Nov (Exhibit 5). This was helped by a further rise in trade surplus (USD8.0bn) and a rebound in primary income surplus (USD2.5bn). Given the robust growth in semiconductor exports, bullish guidance from key Korean exporters (See Jan Trade: Exports rebounded on LNY effect) and rising momentum in global activities (See Global Wave: Moving on up), we expect sustained export growth to be a key driver of current account and external conditions in 2024.

Exhibit 4: Year-to-date net inflows into Korea equities

Year-to-date net inflows in Korean equities are strong and are at a similar pace as Jan-2023 during initial months of China reopening



Source: CEIC, BofA Global Research

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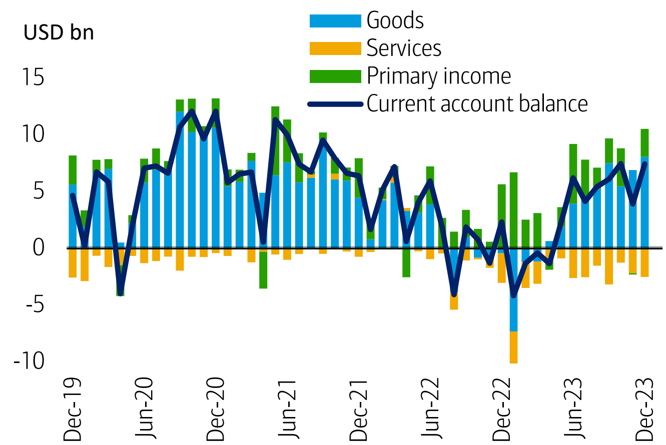
Exhibit 5: Current account balance

C/A surplus rose in Dec, driven by higher trade and primary income surplus



Source: Haver, BofA Global Research

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Higher inflation in the US and change in Fed pricing

That said, despite the upbeat outlook from the equity and export fronts, the BoK's decision will still be constrained by the Fed and potential upside on inflation, in our view.

Notably, Fed is likely to remain hawkish for longer after the higher-than-expected US inflation print. In Jan, core CPI and headline CPI in the US rose by 0.4% and 0.3% mom, respectively, higher than the consensus of 0.3% and 0.2% mom. As a result, headline inflation moderated to 3.1% yoy but core inflation held at 3.9% yoy. In particular, core services inflation accelerated to 0.7% mom, reflecting a pickup in shelter and non-shelter services. It raises concerns that the road ahead for inflation (especially services inflation) might be bumpy.

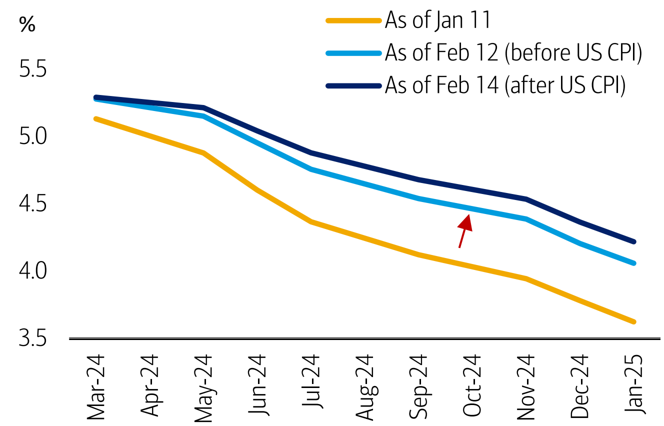
Although our US economists expect some of the inflation strength to fade, a March cut is now firmly off the table and the likelihood of a Fed's May cut has significantly reduced (see US Watch: January CPI Inflation: detour from disinflation). Indeed, compared to the time around Jan BoK meeting, market consensus on Fed rate cut has sharply reversed (Exhibit 6), from a 100%-implied probability of a cut in May to only around 30% now.

Continued disruption at the Red Sea and potential impact on inflation

Meanwhile, disruptions around the Red Sea continue. Red Sea vessel transits have declined to less than a third of 1H December (Exhibit 7, see Shipping & supply chain high frequency tracker #57). Of which, the drop has been most notable for containers and car carriers, while crude tankers are less disrupted. As a result, our shipping analysts have moved the base case to Red Sea diversions persisting until mid- to late-2024.

Despite limited disruption on total shipments to Korea, imported inflation could accelerate with a rise in container rates (and insurance costs). Our shipping analysts have penciled in 50% QoQ average rates in 1Q24 before a gradual decline through 2024 (-10-15% QoQ).

Exhibit 6: Market pricing of Fed Fund Rates
Compared to Jan, market is now pricing much less Fed cuts for 2024



Source: Bloomberg, BofA Global Research

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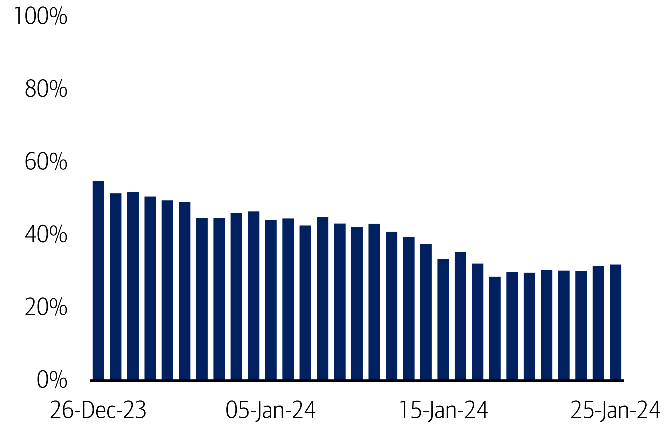
Exhibit 7: Red Sea total vessel arrivals vs 1H Dec levels (%), 7D MA
Overall arrivals are less than 1/3rd of 1H of December level in late January



Source: Clarksons, BofA Global Research

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The recent rise in the North-South Korea tensions

Last but not least, tensions between North and South Korea have been on the rise as North Korea accelerated military demonstrations and hinted threats of further conflict with its neighbor and the US. In our view, it may post some impact on the FX stability in the near term, though the potential escalation remained as a tail risk.

Taken together, despite domestic disinflation and external factors that support a more stable FX outlook, we note that those tail risks may weigh on the near-term BoK policy decisions, and to prevent the BoK to pivot soon, at least before the May meeting, in our view.

Key areas to watch for in the Feb meeting

In addition to the fundamental factors discussed above, the new MPC member is another key to watch, in our view. This week, the BoK appointed Kunil Hwang as a new MPC member, with tenure until Apr 2027 (Exhibit 8). This is a replacement of CS Park who left the board in Dec for another senior government post. Judging from the latest press conference, Hwang will likely be mildly hawkish on monetary policy, as he flags that inflation is still far exceeding the target while household-debt risks remain elevated. The market also expects Hwang to closely look after PF loan risks, given his previous work experience.

Exhibit 8: Background of all MPC members
This week, the BoK appointed Kunil Hwang as a new MPC member, with tenure until Apr 2027

Name	Date Appointed	Current End of term	Recommended by	Policy stance	Education
Yoon-Je Cho	21-Apr-20	20-Apr-24	Minister of Ministry of Strategy and Finance	Ultra-hawk who has voiced the need for rate hikes throughout the current rate hike cycle since early 2021	BA in Economics, Seoul National University, Korea MA and PhD in Economics at Stanford University, US
Young Kyung Suh	21-Apr-20	20-Apr-24	Chamber of Commerce and Industry	Neutral. Her experience in BoK likely highlights data dependence and focus on core monetary variables	BA in Economics at Seoul National University MA & Ph.D in Economics at George Washington University, US
Chang Yong Rhee, Chairman/ governor	**21-Apr-22**	**20-Apr-26**		**Innately dovish with long-term policy weight on pro-growth, pro-private sector; near-term hawkish on inflation concern**	**BA in Economics, Seoul National University, Korea** **Ph.D. in Economics, Harvard University, US**
Sang-dai Ryoo, Senior Deputy Governor	21-Aug-23	20-Aug-26		Appears neutral in an Oct press conference which did not lean to either side of further tightening or easing	BA in Economics, Seoul National University, Korea Ph.D. in Economics, State University of New York, US
Sung Hwan Shin	13-May-22	12-May-26	Federation of Banks	Innate dove who stood against rate hike in August 2022; near-term likely joins hawkish camp on inflation concern	BA in Economics at Seoul National University, Korea MA and Ph.D in Management at MIT, US

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This week, the BoK appointed Kunil Hwang as a new MPC member, with tenure until Apr 2027

Name	Date Appointed	Current End of term	Recommended by	Policy stance	Education
Yongsung Chang	21-Apr-23	20-Apr-27	BoK Governor	Appears as a hawk who is highly guarded against underestimating inflation. In his previous working papers, Chang pointed out the potential underestimation of inflation due to statistical methods in Korea; nominated by BoK Governor	BA and MA in Economics at Seoul National University, Korea Ph.D in Economics at University of Rochester, US
Kunil Hwang	13-Feb-24	20-Apr-27	Financial Services Commission	Appears as a hawk who is highly guarded against inflation risks and household debts, with experience of looking into real estate PF risks	BA in Economics at Yonsei University, Korea MA in Economics at University if Oregon, US

Source: BoK, BofA Global Research

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Overall, we believe the continued export-led recovery will continue to support the domestic economic growth and to provide a favorable environment for the financial market. In addition to the above factors, we see below factors are also the key to watch for the monetary policy direction: **1)** How the BoK will assess the US monetary policy trajectory after the latest expressions from the Fed; **2)** How the BoK views the current disinflationary trend especially when the core inflation has moderated to the 2.5% hurdle; **3)** their assessment of the housing market and the PF loans, and consequences to financial stability; **4)** how the BoK assesses the impact from introduction of Corporate Value-Up Program; and **5)** The stance of all MPC members going forward.

News and Views

Mexico: Pemex receives additional aid from the Federal Government with a DUC tax credit

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On February 13, 2024, the Federal Government granted a fiscal stimulus to Mexico's state oil company Petroleos Mexicanos (Pemex), which gives the latter a tax credit equivalent to 100% of the shared-utility right (DUC, in Spanish) for the months of October 2023 and until January 2024. The amount of the credit could be deducted from the DUC payable on either the 2023 fiscal year or in 2024. In the same line, the Federal Government also granted a tax credit for payments of the hydrocarbon extraction right. The conditions of this second tax credit are identical as for the DUC tax credit.

- **To follow:** The aid provided to Pemex by the Federal Government comes just a few days after the rating agency Moody's announced the reduction of Pemex's corporate debt to B3 from B1 while maintaining the negative outlook. According to Moody's, "Pemex would be near default without the Government's support." This tax credit, however, deteriorates the fiscal position of the Mexican Government. We estimate that the amount of the tax credit could range between 0.25 to 0.30% of GDP, hence potentially increasing the primary fiscal deficit for the public sector from the current 1.2% of GDP in the 2024 budget to close to 1.5%.

Mexico: Nominal wage growth remains high at 9.3% yoy in January

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Nominal wages increased 9.3% yoy in January, down from 9.5% in December (10.2% a year ago). By sector, public employees' wages increased 4.0% yoy (vs. 4.4% in December) and private employees' wages increased 10.0% yoy (vs. 10.2% in December). In real terms, overall wages grew 4.2% yoy, with public employees' wages decreasing for the second month in a row at -0.8% yoy and private employees' wages growing 4.9% yoy.

- **To follow**: Wages continue to grow at high rates since November, putting upside pressure on prices. This is another indicator that goes against Banxico's intentions of cutting rates in the near future. Regardless, we still believe that Banxico will proceed nonetheless and cut rates as soon as in March.

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