Minutes of the Monetary Policy Board Meeting

August 2022

Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

August 2022

Ⅰ. Outline

1. Date of meeting: Thursday, August 25, 2022

2. Place: Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:
   Rhee, Changyong, Chairman (Bank of Korea Governor)
   Cho, Yoon-Je
   Suh, Young Kyung
   Joo, Sangyong
   Lee, Seungheon (Senior Deputy Governor)
   Park, Ki Young
   Shin, Sung Hwan

4. Monetary Policy Board members absent: none

5. Participants:
   Kang, Sungjun, Auditor
   Lee, Hwan Seok, Deputy Governor
   Bae, Joon Suk, Deputy Governor
   Min, Jwa Hong, Deputy Governor
   Lee, Sang Hyeong, Deputy Governor
   Lee, Jongryeol, Deputy Governor
   Yang, Seok Jun, Director General of Reserve Management Group
   Kim, Woong, Director General of Research Department
   Lee, Jeong Wook, Director General of Financial Stability Department
   Hong, Kyung Sik, Director General of Monetary Policy Department
   Kim, In Koo, Director of Financial Markets Department
   Oh, Kum Hwa, Director General of International Department
   Sung, In Mo, Deputy Press Officer
   Han, Seung Chul, Director General of Monetary Policy Board Secretariat
   Choi, Mun Seong, Head of MPB Team

1) This English version is a summary of the minutes of the Monetary Policy Board Meeting. It was produced at the working level and is not an official document.

Ⅱ. Summary of Discussions on the Current Economic Situation

After briefings by staff on *Economic Outlook* (Aug 2022),[2] *FX and International Finance Trends*, and *Financial Market Trends*, the discussions of the Monetary Policy Board (MPB) members covered the following areas.

Members assessed that, despite sluggish exports in line with weakening global demand, the domestic economy had sustained growth above its potential level, boosted by a recovery in private consumption following the lifting of COVID-19 restrictions and by continued robust employment conditions. Meanwhile, some members noted that uncertainties surrounding external conditions, such as the Ukraine crisis and policy stances of major central banks, existed on the future growth path.

In terms of inflation, members assessed that inflation had accelerated as demand-side pressures as well as supply-side pressures, such as a rise in commodity prices, geopolitical risks and the rising exchange rate, had been acting as upward pressures on core inflation. Some of the members judged that, although short-term inflation expectations had recently declined slightly and long-term inflation expectations had been anchored, there were growing concerns about inflation persistence, considering the interaction between inflation and wages and changes in economic behavior in a high inflation environment. Some members stressed the need to maintain the current stance to help anchor inflation expectations and prevent high inflation from being entrenched.

In addition, members assessed that the domestic financial markets had been stable overall and financial imbalances that had accumulated so far had been easing somewhat. Some of the members emphasized that it would be necessary to prepare against growing instability of the external sector due to the worsening global financial conditions including the rising won-dollar exchange rate in line with the strengthening US dollar, the narrowing current account surplus and a possible foreign capital outflow owing to the widening gap between domestic and overseas interest rates.

Some members also stressed the need to pay close attention to the impact of a global economic recession on the domestic economy, labor market conditions in major countries and individual industries, and foreign currency liquidity risks following a growing supply-demand imbalance in the swap market.

2) An English version of *Economic Outlook* is posted on the Bank of Korea website (https://www.bok.or.kr/eng/bbs/E0000634/view.do?nttId=10071646&menuNo=400069&pageIndex=1).

Ⅲ. Summary of Discussions Concerning Monetary Policy Decision

The main details of the MPB members' discussions concerning a change in the Bank of Korea Base Rate were as follows.

All members took the view that, in overall consideration of the domestic and international financial and economic environments, it would be desirable to raise the Base Rate to 2.50% from the current 2.25% at this meeting.

One member judged that it would be appropriate to raise the Base Rate by 25 basis points to 2.50% from the current 2.25% at this meeting.

The member judged that the domestic economy was still maintaining growth exceeding its potential. The member stated that, while the pace of increase in exports was easing and facilities investment was continuing to undergo an adjustment, private consumption was showing sound growth. The member added that labor market conditions were showing favorable movements with the number of persons employed showing a substantial increase and wages maintaining a solid upward trend. The member expected these growth trends to continue for some time, while the Research Department projected growth for the second half of this year to be in the mid-2% range and expected growth slightly exceeding its potential to continue for next year. However, the member saw that there were high uncertainties surrounding the future growth path associated with the Ukraine crisis, the policy stances of major country central banks, and economic slowdowns in major countries including China. The member thus stressed the need to pay attention to these points.

On the price front, the member mentioned that consumer price inflation had risen further to the lower-6% range in July, despite declines in petroleum product prices. The member judged that, while consumer price inflation was expected to fall gradually after the fourth quarter of this year in consideration of a base effect, its peak could be delayed or it could fall slowly. Looking at external conditions, the member stated that a risk of rises in energy and grocery prices stemming for instance from the Ukraine crisis and climate change remained, and the significantly risen Korean won to US dollar exchange rate had been acting as cost-side upward pressure. The member noted that growth exceeding its potential was continuing to drive up demand-side inflationary pressures, and upward pressure on public utility fees had been built up after having been contained so far. The member emphasized in particular the concerning possibility of greatly heightened inflation expectations accelerating the upward trend of inflation through for instance wages. The member took the view that it would be necessary to keep a close watch on the possibility that the high inflation phase could be prolonged due to the increased persistence of inflation if such destabilizing factors at home and abroad persisted.

On the financial stability side, the member assessed that the substantially built-up financial imbalances at home had been reduced somewhat, as domestic market interest rates and stock prices had been showing stability of late, household lending had reversed to a slight decline, and housing prices were falling modestly. However, the member commented that destabilizing factors remained in the external sector, as the Korean won to US dollar exchange rate remained high due to US dollar strengthening, and the current account surplus was narrowing due to worsened trade conditions.

Taking all these into consideration, the member judged that the biggest threat facing the domestic economy for the moment was the entrenchment of the high inflation phase. The member commented that, most importantly, high inflation would decrease real income, thus posing a threat to the basic livelihood of the low-income vulnerable group, while bringing about substantial harmful consequences by for instance distorting the consumption and investment decisions of economic agents through changes in expectations about real returns. The member stressed that if high inflation became firmly entrenched, a large growth loss would be unavoidable going forward, and the external soundness of the Korean economy would be undermined through the further weakening of the won and increased capital outflow pressures. The member thus presented the view that the challenge for monetary policy would be preventing the high inflation phase from taking root in the domestic economy.

The member commented that the Base Rate appeared to have now reached the neutral range as the Bank of Korea had been reducing the accommodative monetary policy stance since August last year. However, the member judged that it would be necessary to maintain the Base Rate hike stance for some time to control inflationary pressures in the domestic economy and high inflation expectations. The member took the view that firmly securing market confidence by reconfirming the Bank of Korea's will and capability to achieve price stability domestically and internationally through the maintenance of a consistent policy stance would be a very important task.

Another member judged that it would be appropriate to raise the Base Rate to 2.50% from the current 2.25% at this meeting.

The member judged that the economic trend was slowing somewhat, due to the combined effects of various risk factors, such as high inflation and delayed recovery in global supply chains. The member added that major countries could enter economic recessions depending on the degree to which downside risk factors, such as a worsening of the economic slowdown in China, would materialize from next year.

The member mentioned that, although the domestic economy was recovering at a moderate pace, supported by rapid improvement in private consumption, the recovery trend could weaken somewhat, due to the materialization of the impacts of a global economic slowdown from the second half of this year. The member saw that prices were showing high growth exceeding 6% and projected that demand-side inflationary pressures would continue for some time. The member also judged that, since high wage growth was continuing in the labor market, it would not be easy to rule out a possibility of additional inflationary pressures stemming from the interaction between wages and prices.

The member stated that the soundness of the external sector was partially weakening, due to a significant rise in the Korean won to US dollar exchange rate in the FX market, the narrowing of the current account surplus, and a sustained rise in the external debt ratio. The member judged that, although the sharp rise in the Korean won to US dollar exchange rate was largely attributable to the strong dollar in line with the US Federal Reserve's strong tightening stance, and the domestic economy's overall fundamentals such as official foreign reserves remained favorable, amplification of such instability could negatively affect domestic price and real economic trends.

Finally, the member saw that there was some degree of credit risk aversion in the financial market, due to the widening of credit spreads for corporate bonds. The member noted that, although household lending growth was slowing, the household lending to income ratio still remained high. The member thus expressed the opinion that a continuation of the downward stabilization trend was needed.

Taking into consideration these domestic and overseas economic conditions, the member saw a need to raise the Base Rate by 25 basis points. The member judged that, although consumer prices and short-term inflation expectations were estimated to have fallen slightly, due to declines in international oil prices and in some commodity prices of late, inflationary pressures caused by demand-side factors were continuing, with the output gap remaining positive, and there were also upside risks to supply prices.

However, the member noted that, given that Korea was a small and open economy, and that the effects of monetary policy would be seen after a time gap, a Base Rate policy that accounted solely for domestic factors could increase uncertainties surrounding the domestic economy. The member particularly expected that excessive Base Rate hikes would increase downside risks to the domestic economy at a time when the future growth outlook for the US economy remained unclear and the outlooks for the EU and Chinese economies were not optimistic. The member thus expressed the opinion that it would be appropriate to exercise caution about the degree of a Base Rate hike.

Finally, the member noted that, from the perspective of the Balance of Payments, Korea generally saw sustained net inflows of foreign domestic bond investment funds during the past inversions of the US and Korean policy rates, but judged that if the inversion period were to last longer with the interest rate gap widening going forward, it would not be easy to rule out a possibility of some foreign capital outflows.

Taking all these points into consideration, the member stated the following: first, the market was already expecting a 25 basis point tightening; second, considering domestic and overseas risk factors, tightening that exceeded market expectations could amplify economic uncertainties; third, a halt to the tightening stance could destabilize long-term inflation expectations, thus resulting in the entrenchment of high inflation; and fourth, keeping the Base Rate unchanged could result in capital outflows at a time when the US Federal Reserve was expected to hike its policy rate hike by 50 or 75 basis points in September. The member noted that it would be appropriate to adjust the pace of tightening going forward, depending on the evolution of domestic and overseas economic conditions in the future.

One member judged that it would be desirable to raise the Base Rate to 2.50% from the current 2.25% at this meeting.

The member assessed that, although exports and investment had exhibited slower growth and households' real purchasing power had declined due to inflation, the domestic economy had exhibited relatively favorable growth in the first half of this year, led by consumption and the services sector. The member noted that, according to Statistic Korea's household income and expenditure survey, households' monthly average net income had increased by 6.0% year on year in the first quarter and by 6.9% in the second quarter, growing evenly across all decile income groups. The member mentioned that, looking at employment indicators, the number of persons employed, the labor force participation rate, the employment rate and the unemployment rate had remained favorable until July. The member meanwhile forecast consumer price inflation to remain high at around 6%.

The member expected that global economic slowdown and inflation would start to have clear negative effects on the domestic economy in the second half of this year, and noted that the US and other major countries had been accelerating interest rate hikes amid the ongoing Ukraine crisis and zero-COVID policy in China. The member mentioned that inflation remained high although global inflationary pressures had been weakening somewhat. The member presented the view that, without fundamental changes in the current trend, the global economic growth rate for next year was likely to be below 3% and that the domestic economy would also slow due to its heavy dependence on external trade.

The member evaluated that a global economic slowdown would significantly undermine the contribution of exports to growth and delay a recovery in facilities and construction investment. More specifically, the member stressed that the recent increase in manufacturing inventory had been attributable mainly to slowing demand and was highly likely to work to slow down manufacturing production and facilities investment going forward. The member stated that private consumption would continue to improve, led by face-to-face services, but its growth would be limited by weakening real purchasing power due to high inflation. The member added that improvement in consumption would be also weakened by the growing proportion of households whose consumption would be limited by the increasing DSR (ratio of monthly debt repayment to income) following interest rate hikes and also by ongoing adjustments in asset prices. The member took the view that, according to Statistic Korea's household income and expenditure survey for the second quarter, the upper 20 percent of households in terms of income that belong to the fifth decile group had reduced their nominal consumption expenditure and their average propensity to consume had declined by as much as 8.7%p from a year earlier, indicating that people were preemptively preparing against an economic recession.

The member mentioned that the Base Rate had been raised since August last year and the individual borrower-level DSR regulation had been strengthened, causing the long-lasting household debt growth to come to a halt and the economy to enter a deleveraging phase. The member added that, while the curbing of household lending had been the primary effect of interest rate hikes, the effect of slowing down domestic demand, such as consumption and investment, would become apparent with a time lag and inflationary pressures would ease gradually accordingly. The member however argued that, as housing prices and household debt relative to income were at already high levels in Korea, the pace of economic slowdown was highly likely to accelerate due to high interest rates during an economic downturn, and that, with this in mind, even if the Base Rate is raised further to cope with inflationary pressures, it would be necessary to carefully adjust the pace and degree of such rate hikes.

One member stated that it would be appropriate to raise the Base Rate to 2.50% from the current 2.25% at this meeting.

The member commented that, looking at the changes in economic conditions of late, the trade-off between growth and inflation had grown, due to higher inflation and worsened economic conditions. The member stated that, while the price outlook presented by the Research Department appeared to take a neutral path overall, downside risks associated with the worsening of the economic slowdown and upside risks related to a resumption of the rise in international commodity prices both appeared to be high. The member raised concern that since wage growth that had been concentrated in some manufacturing industries with strong performances and service industries so far was spreading to broader industries, this could act as a channel of increased persistence of inflation.

The member judged the downside risks to the growth path to predominate. The member saw that manufacturing shipment had fallen and inventory had increased, due to slower demand at home and abroad of late. The member projected that exports which had driven growth so far would be sluggish, due mainly to a slowdown in import demand in major countries, a contraction in the semiconductor cycle, and growth of overseas investment. The member added that private consumption would be constrained by growth in debt and income imbalances during the COVID-19 pandemic. The member saw that the number of persons employed and the economic participation rate would increase, especially for the elderly and youth groups, but anticipated that the gap between growth and employment was likely to continue, due to a sustained slump in the quality of employment.

The member judged that, although the trade-off between growth and inflation had expanded, given that the growth gap remained slightly positive and the inflation gap had widened sharply, it would be appropriate to place a focus on curbing prices in the conduct of monetary policy for some time. However, the member evaluated that, given that there were concerns about downside risks to growth and private debt repayment burdens of the vulnerable groups in particular had increased, it would be desirable to reduce the degree of Base Rate increase to 25 basis points this time. The member commented that the gap between domestic and overseas interest rates could widen, as major country central banks including the US Federal Reserve would sustain large policy rate hikes for some time, but it would be difficult to say that there were great concerns about capital outflows. The member projected that inflows of foreign bond investment would continue, given that foreign bond investment had seen net inflows during past periods when domestic and overseas interest rates were inverted, and the volume of long-term investment for the purpose of investment diversification and based on fundamentals had increased.

The member commented that the price and growth trends and financial stability conditions would be considered together in a balanced manner in Base Rate rate operations going forward. However, the member judged that it would be appropriate to maintain a gradual Base Rate hike stance if the current path forecast continued to hold that even if price inflation reached a peak in the second half of this year, prices would fall at a slow pace, and economic growth would not deviate greatly from its potential. The member expressed the opinion that it would be desirable to increase the degree of monetary tightening next year as well, while flexibly determining the size and pace of further Base Rate increases depending on changes in domestic and overseas economic trends going forward.

Another member presented the view that it would be appropriate to raise the Base Rate to 2.50% from the current 2.25% at this meeting.

The member assessed that the global economy continued to slow amid sustained uncertainties. As for the US, the member mentioned that, while employment had been favorable, it was highly uncertain when a full-fledged economic slowdown would begin and how the US Federal Reserve's policy measures to tackle inflation would affect the extent of the economic downturn. Concerning Europe, the member noted that, although the services sector had been recovering, consumption of goods was sluggish and the economy was heavily exposed to shocks from rising energy prices. The member expressed the opinion that downside risks predominated on the growth side while upside risks carried more weight with respect to inflation, due to external factors such as geopolitical risks, the evolution of the Chinese economy, and major country monetary policies.

Regarding the domestic economy, the member stated that household income had been increasing and private consumption had been recovering rapidly, but heightened uncertainties could limit consumption growth. The member forecast that the contribution of exports would decrease substantially compared to last year. The member added that employment and production had been growing to exceed their potential levels, while growth momentum had been slowing gradually.

The member presented the view that concerns about persistent inflation was the reason for supporting a Base Rate hike despite the reduction in global liquidity and a possibility of an economic downturn. First, the member noted that there existed latent risks of increases in agricultural product and energy prices as well as existing supply shocks from geopolitical risks. The member added that the US Federal Reserve's continued rapid monetary tightening could keep the US dollar strong and give rise to additional inflationary pressures through the exchange rate channel. The member also argued that, in the current high inflation environment, changes in economic behavior could affect the persistence of inflation. The member took the view that, if the current high inflation environment continues with inflation having exceeded its medium-term target (2%) for more than two years by the first quarter of next year, economic agents would have a stronger tendency to aggressively collect price information and reflect it in their decision-making, and as a result, interactions between inflation expectations and inflation could strengthen inflation momentum.

The member also stressed the need to consider demand-side inflationary pressures. The member noted that, looking at the previous periods of high inflation in 1998 and 2008, inflation had returned to its medium-term target of 2% within a year after reaching its peak, and this had been attributable to a sharp fall in the output gap due to demand shocks. The member added that this time, however, since the economy was sustaining growth at its potential level, demand-side inflationary pressures were highly likely to continue unless there were additional large external shocks. The member expressed the opinion that demand-side inflationary pressures were acting as upward pressure on core inflation and that attention should be paid to the clearer positive correlation between the output gap and core inflation since the pandemic.

The member assessed that the recent slight fall in short-term inflation expectations and anchoring of long-term inflation expectations were positive developments. The member, however, presented the view that it was a bit too early to stop worrying about inflation momentum, as CPI components that had risen to a greater extent than July's consumer price inflation of 6.3% accounted for 43% of total items, underlying inflation remained on the rise, and the PPI had also continued to increase month on month for the seventh consecutive month.

The member emphasized the need to maintain the current rate hike stance for the time being, considering that the central bank's policy responses could affect demand-side inflationary pressures and inflation expectations. The member noted that the less inflation expectations were anchored, the more impacts supply shocks would have on the real economy and the weaker the monetary policy transmission channels would become, requiring even greater Base Rate hikes later on. The member added that it would be more appropriate to operate monetary policy with a focus on ensuring price stability, if a certain degree of slower growth was tolerable, and that this would contribute to stabilizing the economy over a medium- to long-term horizon. The member argued that it would be necessary to sustain the current policy stance for the time being while monitoring how a global economic downturn would affect the domestic economy.

One member presented the view that it would be appropriate to raise the Base Rate to 2.50% from the current 2.25% at this meeting.

The member judged that the global economy had exhibited slower growth and inflationary pressures seemed to be weakening somewhat, in line with the recent fall in oil and grain prices and the easing of pressures from supply disruptions, but the situations and shocks individual countries were faced with varied substantially. The member noted that in the euro area a delay in the natural gas supply would continue to act as upward pressure on inflation, and in China a slump in the real estate market and risks related to COVID-19 restrictions had been weighing on economic recovery. The member also mentioned that US consumption, corporate earnings and employment remained favorable and there were ongoing upward pressures on inflation, and those from the services charges in particular. The member argued that, despite the slowing economy, inflationary pressures continued overall and uncertainties remained high.

Concerning the domestic economy, the member stated that, despite the worsening external economic conditions and the contracting sentiment of the general public, overall economic activity indicators had been favorable, and expected the output gap to remain positive this year and the next. The member noted that private consumption had remained strong, boosted by improvement in services sector consumption, and forecast that private consumption was unlikely to shrink rapidly in the second half as well, supported by employment growth and wage increases. As to investment, the member mentioned that the sluggishness in construction investment had been easing while facilities investment had improved at a somewhat slower pace. The member noted that export growth had been slowing due to the base-period effect from last year's strong performance and a slowdown in demand from China. The member expressed the view that the economy was likely to slow gradually, given domestic and external economic conditions, ongoing interest rate hikes, households' transfer income that would decrease from the first half, consumption, and worsening corporate sentiment.

The member stated that, despite the six previous Base Rate hikes, financial market conditions had been stable overall. The member added that government bond yields had declined due to concerns about a global economic slowdown, and foreign stock investors, after their net sales so far, had shifted to a net buying position since July. The member noted that bank lending to households had continued to slow, while bank lending to the corporate sector remained on a sharp rise.

The member stated that, unless global oil prices resurged, inflation was likely to ease gradually due to a base effect. The member added that inflation pressures seemed to remain high, however, considering how the future price path would be affected by the sustained demand-side inflation pressures, a rise in prices of agricultural, livestock and fisheries products, demand for higher wages and corporations passing on production costs to consumers. The member stressed that attention should be paid to the possibility of inflation remaining high substantially above its target level for a considerable period of time, given that inflation expectations had increased significantly this year, core CPI items had made a gradually increasing contribution to inflation, and inflation had been spreading to a wide range of areas, particularly personal services charges.

The member presented the view that, taking into overall consideration the domestic and overseas economic conditions mentioned above, the priority of monetary policy for now should be placed on easing the persistence of high inflation and the current rate hike stance should be maintained so far as it does not undermine financial market stability. The member added that, in order to make high inflation less persistent, it would be necessary to raise the Base Rate to the upper limit of the neutral interest rate or a level slightly above the limit. The member evaluated that, at a time when this year's growth rate was forecast to exceed its potential level and the output gap to remain positive this year and next, placing the monetary policy focus on stabilizing inflation at an early stage, even if somewhat weighing on aggregate demand growth, would help the domestic economy sustain stable growth in the medium- to long-term and minimize social welfare losses.

Ⅳ. Results of Deliberation on Monetary Policy Directions

Incorporating the outcome of the above discussions, the following Monetary Policy Decision statement was compiled. All MPB members supported the decision unanimously.

<u>Monetary Policy Decision</u>

☐ The Monetary Policy Board of the Bank of Korea decided today to raise the Base Rate by 25 basis points, from 2.25% to 2.50%. The Board judges that the policy response to prevent the entrenchment of high inflation should be continued as inflationary pressures and inflation expectations have remained high, although economic downside risks have increased at home and abroad.

☐ Currently available information suggests that global economic downside risks have increased, affected by the prolonged Ukraine crisis and significant policy rate hikes in major advanced countries, while inflation has remained high. In global financial markets, major price variables have fluctuated significantly due to changes in expectations for the pace of the US Federal Reserve's policy rate hikes. Looking ahead, the Board sees global economic growth and global financial markets as likely to be affected largely by the movements of international commodity prices and global inflation, economic indicators and monetary policy changes in major countries, and geopolitical risks.

☐ Downside risks to the Korean economy have increased with the slowdown in exports owing to weakening of economic growth in major countries, while private consumption has continued to recover. Labor market conditions have continued to improve, with the year-on-year increase in the number of persons employed remaining high. Going forward, GDP growth is projected to be 2.6% in 2022 and 2.1% in 2023, below the May forecast of 2.7% in 2022 and 2.4% in 2023, as export growth has slowed.

☐ Consumer price inflation has remained high in the 6% range due to the accelerating price increases in agricultural and personal services, although increases in the prices of petroleum products have somewhat moderated. Core inflation (excluding changes in food and energy prices from the CPI) and the inflation expectations of the general public have stayed high in the upper-3% range and the 4% range, respectively. Looking ahead, it is forecast that consumer price inflation could decline due to the decrease in global oil prices but will remain high in the 5-6% range for a considerable time as core inflation continues to rise. Consumer price inflation is projected to be 5.2% in 2022 and 3.7% in 2023, substantially above the May forecast of 4.5% in 2022 and 2.9% in 2023.

☐ Volatility in domestic financial markets has increased, influenced by global financial market movements. Long-term market interest rates have rebounded after a considerable decline, and the Korean won to US dollar exchange rate has risen significantly due to US dollar strengthening. Household loans have decreased slightly and housing prices have shifted to a decrease.

☐ The Board will continue to conduct monetary policy in order to stabilize consumer price inflation at the target level over a medium-term horizon as it monitors economic growth, while paying attention to financial stability. The Board sees continued rate hikes as warranted, as inflation is expected to remain high, substantially above the target level, despite the increase in economic downside risks and underlying high uncertainties surrounding domestic and external conditions. In this process the Board will determine the size and pace of further increases of the Base Rate while thoroughly assessing the degree of persistence of high inflation, the pace of growth, financial stability conditions such as capital flows, monetary policy changes in major countries, and geopolitical risks.