Minutes of the Monetary Policy Board Meeting

July 2022

Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

July 2022

Ⅰ. Outline

1. Date of meeting: Wednesday, July 13, 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

4. Monetary Policy Board members absent: none

5. Participants:
   Lee, Hwan Seok, Deputy Governor
   Bae, Joon Suk, Deputy Governor
   Lee, Sang Hyeong, 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
   Kim, Hyun Kee, Director General of International Department
   Park, Yang Su, Director General of Economic Research Institute
   Park, Young Chool, 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 *Recent Economic Developments* (July 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 a recovery in private consumption, driven by face-to-face service consumption and ongoing favorable labor conditions, domestic economic growth was slowing due mainly to sluggish investment as well as slowing export growth stemming from a weakening of economic growth in major countries. Some of the members expected growth to remain higher than its potential level, despite external uncertainties surrounding the future growth path.

In terms of inflation, members assessed upside risks to inflation as having increased significantly and inflation as having been accelerating, with consumer price inflation reaching 6.0% in June, due to stronger demand-side pressure, as well as sustained pressure on the supply side, including a rise in commodity and food prices. Some of the members stressed the urgent need to reduce inflationary pressure and stabilize inflation expectations, even if this would mean a loss of growth compared to the current level, in consideration of the interaction between inflation and wages, the lag of cost increases to consumers through prices, and the lag of monetary policy, although there were uncertainties surrounding the future path.

In addition, members assessed that it would be necessary to be ready for increased volatility in the foreign exchange market in line with worsened global financial conditions, as risk aversion was strengthening due mainly to monetary policy normalization in major countries and to concerns about a global economic slowdown. Some of the members presented the view that it would be necessary to prevent a sharp widening of the gap between domestic and overseas interest rates through a Base Rate hike.

Some members also stressed the need to pay close attention to the possibility of risks, such as heavier debt-servicing burdens and housing price declines in times of interest rate hikes, and of interest rate hike shocks in vulnerable sectors, spilling over into the larger financial system.

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2) An English version of *Recent Economic Developments* 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 2.25% from the current 1.75% at this meeting.

One member presented the view that it would be appropriate to raise the Base Rate by 50 basis points to 2.25% from the current 1.75% at this meeting.

The member mentioned that global inflation had been accelerating since the second half of last year due to the combined effect of supply shocks caused by the COVID-19 pandemic and the Russia-Ukraine war, and due to the demand recovery that was based on the significantly accommodative monetary and fiscal policies since the pandemic. The member noted that, in response to this, major countries had been rapidly adjusting such accommodative monetary policies and that the adjustments so far and expectations of further adjustments had been bringing down asset prices and reducing global liquidity. The member also assessed that these adjustments had also been noted in consumer and investor sentiment, leading to a slowdown in the momentum of economic recovery.

The member noted that inflation concerns were growing even further in Korea as well, with inflation expectations surging to 3.9% from 3.3% a month before, and CPI inflation for June reaching 6%, and went on to state that supply-side and demand-side factors driving inflation each accounted for roughly 50% of the inflation.

The member mentioned that private consumption in Korea had been showing a rapid recovery led by consumption of face-to-face services, while exports had slowed significantly due to slowing overseas demand and supply disruptions. The member noted that the average capacity utilization ratio and PMI of the manufacturing sector had declined and the sluggishness of facilities investment had eased somewhat affected by improved supply disruptions, while construction investment had remained sluggish owing to rising material prices, strikes, and worsening weather conditions. The member assessed that the employment situation was favorable overall, with the number of persons employed continuing to rise and the unemployment rate remaining low.

The member assessed that financial market volatility had increased as major price variables had reflected expectations of tighter financial conditions in line with rapid policy rate hikes in major countries. The member mentioned that household lending had exhibited slower growth owing to lending regulations and rising lending rates, while corporate lending had continued to grow significantly. The member presented the view that, in terms of liquidity, M2 growth remained high compared with the 10-year average before the pandemic and, although the corporate bond market had somewhat contracted recently, overall funding conditions in the corporate sector seemed favorable.

The member evaluated that the priority of monetary policy in the current economic situation should be reducing inflationary pressure and stabilizing inflation expectations and that the current Base Rate remained accommodative, below the estimated range for the neutral interest rate. The member argued that the economic growth rate for this year and next was expected to be adjusted downward somewhat but would not deviate far from the potential growth path and that, unless inflation expectations are addressed actively, the Korean economy could pay a higher price in the long run. The member assessed that, although the current high inflation was attributable largely to supply-side factors, the central bank should take aggressive monetary policy measures to cope with it even if they weigh on economic recovery, since there were only limited options to resolve supply-side inflationary pressure. The member went on to state that, since steep rate hikes by the U.S. were expected, it would be necessary to ease growing pressure on the FX sector in line with the widening U.S.-Korea interest rate differential.

The member added that it would be necessary to further adjust the Base Rate while continuing to closely analyze the inflation trend, changes in the conditions for economic growth, and financial market conditions, and while monitoring monetary policy changes in major countries.

Another member judged that it would be desirable to raise the Base Rate to 2.25% from the current 1.75% at this meeting.

The member mentioned that the domestic economy was maintaining growth exceeding its potential. The member stated that, while export growth was slowing moderately and facilities investment was continuing to undergo adjustments, private consumption, led by service sectors, was showing sound growth, and the member forecast that the domestic economy would maintain steady growth momentum, boosted by the effects of supplementary budgets. The member noted that labor market conditions were showing favorable movements with the number of persons employed maintaining its substantial uptrend and wages showing a solid upward trend. 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 the spread of COVID-19. The member thus stressed the need to pay attention to these points.

The member noted that prices had risen rapidly and consumer price inflation had climbed to the 6% level in June, but upside risks still appeared to be large. The member commented that, as the steep uptrend in prices had continued since the middle of last year and had gathered pace of late, inflation expectations were rising rapidly and there was a growing possibility of this leading to an interaction between inflation and wages going forward. The member stressed the need to keep a close watch on the possibility that a high inflation phase could take root in the domestic and global economy if such destabilizing factors at home and abroad persisted.

Looking at the financial situation, the member stated that financial conditions were continuing to show a reduction in the degree of accommodation, with market interest rates rising substantially and stock prices falling considerably. However, the member added that it would be necessary to consider the point that real interest rates were actually falling, given the recent steep rise in inflation expectations. The member noted that financial conditions did not appear to be greatly constrained given that M2 growth remained high at the 8% level. Meanwhile, the member commented that the Korean won to U.S. dollar exchange rate had risen, working as additional upward pressure on prices.

On the financial stability side, the member assessed that the widening of imbalances in the financial sector at home were being curbed, as growth in domestic household lending was slowing and housing prices were falling slightly. However, the member took the view that the external sector could become less resilient as large-scale overseas investment by, for instance, institutional investors, was continuing, while the current account surplus had been narrowing of late.

Taking all these into consideration, the member stated that there were growing risks that macroeconomic stability and external sector balances could be shaken going forward, due to higher inflation of late, and that it would be necessary to continue policy measures in response with a focus placed on price stability for some time. The member especially stressed the need to prevent growth momentum of inflation itself from setting in by raising the Base Rate as rapidly as possible to the neutral level, as prices had risen steeply of late and inflation expectations were also rising rapidly. The member saw that a large rate hike would have some negative impacts on the current growth trend, but that this was unavoidable to secure stability in the medium- to long-term macroeconomy, and that the rate hike would help enhance the domestic financial market's ability to absorb shocks from increased volatility in international financial markets and would ease pressure for an increase in imbalances in the foreign exchange sector. In the meantime, the member presented the view that the ensuing difficulties faced by vulnerable sectors should be addressed with appropriate microeconomic policy measures through concerted policy efforts.

Meanwhile, the member stated the need to decide on the timing and the degree of further Base Rate adjustments by closely monitoring the development of external uncertainties and any resulting changes in the paces of growth and inflation at home.

One member took the view that it would be appropriate to raise the Base Rate to 2.25% from the current 1.75% at this meeting.

The member saw that a main reason for the current Base Rate hike was inflation and stated that consumer price inflation in June (year-on-year) was 6.0%, the highest since November 1998 when consumer price inflation stood at 6.8%. The member explained that inflation was largely triggered by overseas factors, including supply chain issues, China's lockdown measures, and the Russia-Ukraine crisis, but that inflationary pressure on the demand side had been gradually increasing of late with half of the current inflation being caused by demand-side factors, and the diffusion index for core items maintaining growth. In addition, the member noted that one-year-ahead inflation expectations among the general public stood at 3.9% as of June.

The member mentioned that there were also some positive aspects, such as somewhat slower month-on-month price inflation growth and the anchoring of long-term inflation expectations among experts at 2.0%. However, the member expressed the opinion that a Base Rate hike was unavoidable in overall consideration of the level and trend of inflation, growing demand-side factors, and a rise in short-term inflation expectations. The member saw that what was worrisome in deciding on a 0.5%p Base Rate hike was an unintended sudden economic downturn following the rate hike. However, the member judged that inflation urgently needed to be dealt with first to prevent high inflation from becoming entrenched and that the real economy could withstand the rate hike at the current level. The member saw that the real economy could not deviate greatly from the potential GDP path, although consideration should also be given to the quality of employment, demographic changes, and the possibility of structural change during the COVID-19 pandemic. The member noted that the low unemployment rate and the very high job vacancy rate meant that even if there would be a slight downturn in the economy, if the job vacancy rate signifying labor demand were to decline first, losses on the employment side would be relatively small.

The need to prepare against factors causing disturbances in the FX market in line with foreign portfolio investment net outflows was partially considered in this month's decision. The member particularly emphasized that the volume of capital outflows could increase in a short period of time if the U.S. Federal Reserve's rate hikes were larger than expected and if international financial markets became unstable at a time when the expected return on won-denominated financial assets had fallen due to the widening gap between domestic and overseas interest rates. The member went on to stress the need to prevent the interest rate gap from widening to a worrisome extent.

The member expressed the view that the factors mentioned above had been taken into consideration in determining the degree of a Base Rate hike for this month, but that the rate hike should be accompanied by monitoring of vulnerable sectors. The member first noted that a Base Rate hike would add to the debt-servicing burden of economic agents. The member added that, during a period of rate hikes, a concerning situation could arise with respect to vulnerable household borrowers, young people with excessive debt, small business owners with deficits or who suffer from liquidity shortages, and insolvent firms, and that the proportion of households whose consumption would be limited by rising interest rates could grow rapidly. The member presented the opinion that it would be necessary to closely monitor these vulnerable groups and also to preemptively examine measures to deal with household loans that might turn sour, businesses and financial institution liquidity problems, and the resolution of non-performing loans.

The member also mentioned the need to prepare against a possible drop in housing prices to a greater extent than expected. The member added that there were views that such a risk was relatively low in Korea, where household loans were concentrated mostly among high-income and high-credit borrowers, but according to the Survey of Household Finances and Living Conditions, real estate accounted for more than 70% of assets across all income quintiles and the share of their financial liabilities was much lower than that in advanced countries. The member presented the view that this indicated that a very small proportion of liquid assets, regardless of income level, would serve as a buffer against shocks such as a housing price decline.

The member also noted that it would be necessary to prepare against the possibility of shocks to vulnerable groups developing into systemic risks in order to fulfill the central bank’s mandate of ensuring financial stability, and that it would also be necessary to pay attention to overseas factors. The member stated that, at a time when U.S. dollar supply and demand conditions had been worsening for some time, it would be important to closely monitor global risk factors and changes in indicators of external soundness in order to maintain Korea’s international credit standing.

One member judged that it would be appropriate to raise the Base Rate to 2.25% from the current 1.75% at this meeting.

The member noted that, looking at recent economic conditions, growth in major countries had weakened, the pace of global trade growth had slowed, and in financial markets, the U.S. dollar had strengthened further and volatility in interest rates and stock prices had increased. Accordingly, the member commented that Korea's export growth had slowed, but the extent of the slowdown appeared to be limited thanks to structural demand expansion in the IT sector, and to private consumption, particularly face-to-face services, which were continuing to recover. The member judged that, although downside risks to growth were high due to worsened export and investment conditions and to the resurgence of COVID-19, the economy would be able to maintain growth at a level higher than its potential, as long as there were no large deteriorations in domestic or overseas conditions.

With regard to prices, the member noted that, amid ongoing pressure on the demand side, pressure on the supply side, including oil prices, exchange rates and wages, had increased further, and, as a result, consumer price inflation stood at 6.0% in June, the highest level since 1998. The member forecast that, while prices would rise somewhat slowly as a slowdown in global demand would lead to oil and grain price declines, high prices would continue for a considerable time.

The member judged that it would be appropriate to raise the Base Rate by an unprecedentedly sharp 50 basis points at this meeting in consideration of recent economic and financial conditions and suggested a few reasons for this judgment.

First, the member judged that the pace of price rises and the range of inflation diffusion were far exceeding expectations and the upside risks appeared to be greater, considering prolonged geopolitical risks, the resurgence of COVID-19, and supply chain disruptions, and the possibility of worsened weather conditions. The member stressed the importance at this juncture of preventing a vicious cycle of interaction between inflation expectations and actual prices, as wage growth was expanding with inflation expectations rising rapidly. The member saw the need to speed up Base Rate hikes given that interest rate policy would be transmitted to prices after a time lag of several quarters. The member presented the opinion that, according to an analysis by the Bank of Korea Research Department, growth for this year and the next was unlikely to be lower than the 2% level, and thus it would be necessary to place a priority on price stability for some time. The member added that it would be necessary to recall historical experiences, that a further surge in inflation would inevitably lead to a larger rate hike and to a loss of growth in the future.

The member also considered the need to actively respond to the possibility of capital outflows, as global liquidity was declining and tendencies toward risk aversion were growing due to financial tightening and concerns about an economic slowdown in major countries. The member noted that, while a reversal to a net outflow had been seen concerning foreign exchange supply and demand conditions, the short-term external debt ratio had increased and foreign portfolio investment continued to show a net outflow since the beginning of this year, and thus related concerns were growing. The member took the view that, while sound fundamentals, such as macroeconomic stability, were important to ensure soundness in the foreign exchange sector, it would also be necessary to prevent a rapid inversion of the gap between domestic and overseas interest rates, during a period of soaring global interest rates, as seen recently.

The member saw that a Base Rate hike would help deal with financial imbalances by ensuring stability in household debt and curbing corporate lending. The member judged that the entire financial system would be able to withstand a large rate hike, considering that private debt growth so far had been led by high-income and high-credit borrowers. The member noted, however, that default risks in vulnerable sectors, including vulnerable households and corporate borrowers, heavily indebted youth, and self-employed business owners lacking liquidity, could all be much greater, and thus it would be necessary to seek separate supplementary measures to alleviate their principal and interest repayment burdens.

Taking into consideration the economic and price outlooks and financial conditions, the member saw a need to maintain the Base Rate hike stance for some time. However, the member judged that it would be desirable to maintain a gradual pace of Base Rate hikes, considering economic uncertainties at home and abroad, and the time lag of monetary policy, unless price inflation ran well above the expected trajectory.

Another member judged that it would be desirable to raise the Base Rate to 2.25% from the current 1.75% at this meeting.

The member mentioned that the global economic recovery had been weakening significantly due to slowing trade growth and ongoing high inflation. The member noted that global prices remained on the rise in most countries, centering on energy and food prices, and upward pressure was spreading widely. Concerning the domestic economy, the member judged that consumption and the services industry were leading the economic recovery, while export growth was slowing and investment was sluggish. The member stated that the growth rate for this year would be somewhat below the Research Department's May forecast (2.7%) and that Base Rate hikes would act as an additional downside risk. The member presented the view that the annual inflation rate would substantially exceed the previous forecast (4.5%), and that the future direction of the price path would depend mostly on overseas factors, such as developments in the Ukraine crisis, fluctuations in international commodity prices, and changes in global aggregate demand.

The member assessed that, despite slowing growth, inflationary pressure made it difficult for the central bank to make monetary policy responses. The member judged that, considering the fact that cost increases are passed on to prices with a time lag, inflationary pressure would continue for the time being. The member, meanwhile, mentioned that last year's 4.1% growth, boosted by strong exports, had led to significant increases in household income and employment this year, and that pressure on consumption demand had accordingly increased substantially. The member noted that the number of persons employed, the economic activity participation rate, the employment rate, and the job openings-to-seeker ratio had all risen, that the unemployment rate gap had remained negative for several months, and that total time in employment had increased by more than 4% from that during the pre-pandemic period, despite a gradual decline in working hours per person. The member evaluated that the increase in earned income and excess savings during the pandemic would support consumption to some extent, and that, since consumption was at a low level given employment and household income, household consumption could expand further despite the decrease in real purchasing power due to inflation. The member also forecast that, despite sluggish investment and slowing exports, aggregate consumption would lead economic growth this year, just as government consumption maintained last year's strong growth.

The member mentioned that, considering such inflation and employment conditions, there were good reasons to maintain the rate hike stance and that the Base Rate would be continuously adjusted for some time, consistent with real economic activity and the inflation outlook. The member however expressed the view that, since uncertainties over the mid- to long-term neutral interest rate level had increased due to global inflation shocks and prolonged supply disruptions, it would be necessary to respond while carefully examining how prices and the economy respond to interest rate hikes and how financial variables fluctuate.

The member meanwhile expected that international financial markets would remain highly volatile for the time being, as in the domestic FX sector price variable volatility had increased, some external soundness indicators had worsened in the domestic FX sector, the risk of global economic recession has been growing, and the U.S. Federal Reserve has been accelerating rate hikes since the previous MPB meeting. The member stressed that, although vulnerabilities had not yet been exposed, careful examination was needed as to how worsening global financial conditions affect the stability of the domestic FX sector.

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.

Monetary Policy Decision

☐ The Monetary Policy Board of the Bank of Korea decided today to raise the Base Rate by 50 basis points, from 1.75% to 2.25%. The Board judges that a pre-emptive policy response to prevent the entrenchment of high inflation is of greater importance for some time as high inflation is continuing and becoming broad-based while short-term inflation expectations are rising sharply, although economic downside risks have increased at home and abroad.

☐ Currently available information suggests that global economic growth has weakened, affected by the prolonged Ukraine crisis, while inflation has remained high. In global financial markets, risk aversion has strengthened due to the acceleration of policy rate hikes in major countries and consequent concerns about economic slowdown. The US dollar has remained strong and stock prices have fallen considerably, while government bond yields in major countries have fluctuated significantly. Looking ahead, the Board sees global economic growth and global financial markets as likely to be affected largely by global inflation movements, monetary policy changes in major countries, geopolitical risks, and COVID-19 restrictions in major countries.

☐ The Korean economy has continued to recover. Private consumption has sustained its improvement and sluggishness in facilities investment has eased, while export growth has somewhat slowed. Labor market conditions have continued to improve, with the year-on-year increase in the number of persons employed remaining high. Going forward, while private consumption is likely to sustain its recovery, GDP growth this year is projected to be somewhat below the May forecast of 2.7%, affected by the slowdown in exports owing to weakening of economic growth in major countries. Uncertainties surrounding the economic outlook are judged to be elevated.

☐ Consumer price inflation has risen significantly to 6.0% due to the ongoing sharp rise in the prices of petroleum products and the accelerating price increases in other expenditure categories. Core inflation (excluding changes in food and energy prices from the CPI) and the inflation expectations of the general public have increased to close to 4%. It is forecast that consumer price inflation will remain high at above 6% for some time and run substantially above the May forecast of 4.5% for the year overall. Core inflation is forecast to remain elevated at 4% or higher for a considerable time.

☐ In domestic financial markets, long-term market interest rates have risen considerably, due to expectations about policy rate hikes at home and abroad, while stock prices have fallen sharply driven mainly by concerns about global economic slowdown. The Korean won to US dollar exchange rate has risen significantly, reflecting the global strengthening of the US dollar. Household loans have increased slightly and housing prices have remained steady.

☐ Considering inflation and economic conditions, though economic downside risk is indeed high, uncertainties remain elevated, and thus the Board sees it as important at this time to curb the spread of inflation expectations through a 50-basis-point rate hike to prevent acceleration of inflation.

☐ 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 run above the target level for a considerable time. In this process the Board will determine the size and pace of further increase of the Base Rate while thoroughly assessing the trends of growth and inflation, the risk of a buildup of financial imbalances, monetary policy changes in major countries, and external economic conditions including geopolitical risks.