Minutes of the Monetary Policy Board Meeting

October 18, 2018

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(October 2018)

Ⅰ. Outline

1. Date of meeting: Thursday, October 18, 2018

2. Place : Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:

   Lee, Juyeol, Chairman (Bank of Korea Governor)
   Lee, Il Houng
   Cho, Dongchul
   Koh, Seung Beom
   Shin, Inseok
   Yoon, Myun-Shik (Senior Deputy Governor)
   Lim, Jiwon

4. Monetary Policy Board members absent: none

5. Participants:

   Jang, Ho Hyun, Auditor
   Lim, Hyung Joon, Deputy Governor
   Huh, Jin Ho, Deputy Governor
   Shin, Ho Soon, Deputy Governor
   Ryoo, Sang Dai, Deputy Governor
   Chung, Kyuil, Deputy Governor
   Suh, Bong Gook, Director General of Reserve Management Group
   Lee, Hwan Seok, Director General of Research Department
   Sohn, Wook, Director of BOK Economic Research Institute
   Shin, Woon, Director General of Financial Stability Department
   Park, Jongseok, Director General of Monetary Policy Department
   Lee, Sang Hyeong, Director General of Financial Markets Department
   Lee, Seung Heon, Director General of International Department
   Kim, Hyun Kee, Press Officer
   Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
   Sung, Kwang Jin, Head of MPB Team

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

Ⅱ. Summary of Discussions on the Current Economic Situation[2)]

After briefings by staff on "Economic Outlooks for 2018 and 2019," "FX and International Finance" and "Financial Market Trends," the discussions of the Monetary Policy Board (MPB) members covered the following areas:

Members evaluated that, despite slowdowns of economic growth in Japan and China, **the global economy** had continued to show strong growth, led by the strength of the US economy. Members also mentioned that the volatility of price variables, such as stock prices and exchange and interest rates, had increased significantly in **the global financial markets**, affected chiefly by the escalating trade tensions between the US and China and concerns about US policy rate hikes.

Concerning **the domestic economy**, members' evaluation was that facilities and construction investment had continued to go through corrections, exports had remained buoyant, and consumption had maintained modest growth. Members also mentioned that the growth forecasts for this year and next had been adjusted downward to 2.7 percent, in reflection mainly of the faster paces of correction in facilities and construction investment and the negative impacts of the US-China trade conflict on Korea's exports.

Concerning **inflation**, members noted that consumer price inflation had accelerated to 1.9 percent in September, boosted largely by increases in international oil and agricultural product prices, while core inflation had remained at 1.0 percent with declines in administered prices having continued effects. Members mentioned that the CPI growth forecast for this year had remained at 1.6 percent, while that for next year had been

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2) English versions of "Economic Outlooks for 2018 and 2019," "FX and International Finance" and "Financial Market Trends" are posted on the Bank of Korea website.

adjusted downward from 1.9 percent to 1.7 percent.

As to **the domestic financial markets**, members assessed that the escalating US-China trade tensions and concerns about the US Fed’s rate hikes had caused stock prices to fall significantly and the Korean won to depreciate greatly, and volatility had increased due to temporary outflows of foreign securities investment in October. Members also mentioned that household debt was expected to stabilize, thanks for example to government measures, but its growth had continued to outpace that of household income, while sole proprietor loans had also maintained strong growth, all of which required constant attention.

Ⅲ. Discussions Concerning Monetary Policy Decision (Summary)

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

The majority of members shared the opinion that, in overall consideration of the domestic and international financial and economic environments, it would be desirable to keep the Base Rate at its current level of 1.50 percent for the intermeeting period, while two members called for a 0.25 percentage point hike.

One member took the view that it would be desirable to raise the Base Rate from the current 1.50 percent to 1.75 percent at this meeting.

The member evaluated that, with the buoyancy of the US economy, the global economy had continued to show favorable growth on the whole, and forecast global trade to maintain favorable growth. With regard to the domestic economy, the member noted that exports had remained strong and private consumption had shown modest growth, while investment had remained sluggish and employment had continued to worsen. The member mentioned that the government measures to stimulate the economy and strengthen the income base were expected to have positive effects on private consumption, but there also existed factors holding it back, such as sluggish employment. The member also noted the ongoing corrections in facilities investment, which had shown a sharp increase last year in the semiconductor sector in particular, and in construction investment, which had remained buoyant for the past several years. The member evaluated that exports had declined, due mainly to the decrease in the number of working days during September and also to a base effect, but remained favorable overall, with the daily average export value hitting a record high. The member noted that employment had been better than anticipated last month, but significant improvement seemed unlikely next year as well.

The member noted that, taking all this into consideration, the Bank of

Korea's Research Department had made downward adjustments to the economic outlooks for this year and next as well as a significant adjustment to the employment outlook, and went on to argue that the growth rate might fall short of its potential, although only slightly, this year and next. The member forecast inflation, having increased significantly in September driven chiefly by oil price hikes, to nearly reach its target at around the end of this year or the beginning of next year. The member judged that demand-side inflation pressures had not yet been large, however, due to the lower-than-expected core inflation.

Looking at the estimates of output and inflation gaps based on the discussion above, the member judged that the Bank of Korea would have to maintain its accommodative monetary policy stance, but unlike advanced countries that had experienced massive deleveraging since the global financial crisis in 2008, Korea had seen steady household debt growth and thus financial stability was gaining even greater importance. The member mentioned that the past several years of low interest rates seemed to have contributed, to some extent, to household debt growth and housing price rises in some regions, and expressed the view that household debt should be considered when making monetary policy decisions since its growth had been outpacing that of household income. The member noted that, while there were concerns that a rate hike could add to the burden of vulnerable borrowers, the Bank of Korea should supplement the government's efforts by carrying out stress tests to continually analyze vulnerable borrowers, and stressed that, although household debt was within a controllable range at the moment, a close eye should be kept on it so that it would not grow excessively, which would create a debt trap and make it difficult for the central bank to raise its policy rate.

Lastly, considering Korea's strong macroeconomic conditions as well as its economic fundamentals, such as the current account surplus and foreign reserves, the member mentioned that reversals of the policy and market rates between the US and Korea seemed unlikely to cause massive capital outflows immediately. The member added, however, that since some heavily indebted emerging market economies with weak economic conditions might remain unstable, and since concerns had been raised about China-related risks due mainly to the US-China trade conflict, a prolongation and widening of the rate inversion might add to market volatility, and it would be therefore necessary to closely monitor the consequent effects.

In summary, the member judged that, given the facts that the growth rate was unlikely to deviate far from its potential level and that consumer price inflation was forecast to near its target, it would be appropriate to place a greater focus on financial stability and reduce the degree of monetary policy easing to some extent. In particular, the member expressed the view that slower growth and sluggish employment were seen to have resulted from structural factors, such as the weakened competitiveness of core industries, rather than from cyclical factors, which could not be sufficiently dealt with through monetary policy measures alone, and added that in this regard it would be necessary to make medium- and long-term efforts to increase the potential growth rate. Recalling the previous events when excessive credit had caused bubbles to form and burst, weakening the financial sector’s soundness and intermediary role and ultimately worsening the real economy to a great extent, the member stressed that it would be extremely important to ensure financial stability for stable growth, and expected that monetary policy would have signaling effects.

Another member expressed the view that it would be desirable to raise the Base Rate from the current 1.50 percent to 1.75 percent at this meeting. The member assessed inflation as nearing its target over a medium-term horizon amid weak but sustained demand-side pressures, and expected that a slight reduction of the accommodative monetary policy stance was unlikely to weaken demand-side pressures enough to have a significant effect on inflation but could contribute to curbing the widening of financial imbalances somewhat. The member also argued that, at a time when demand-side pressures were forecast to support the economy thanks to the accommodative fiscal policy, it would be desirable to change the monetary policy stance for harmonious policy operation as well.

The member judged that the economic growth rate for this year seemed to have declined somewhat rapidly due to the base effect from excessive construction investment over the past few years and the readjustment of IT-related facilities investment that had shown fast growth last year, but recorded growth was within the margin of error of the forecast path and at the level of the potential growth rate, which itself had remained on a downward path. In addition, the member anticipated a continuation of demand-side pressures, supporting inflation thanks mainly to a potential accommodative fiscal policy, while private consumption had been maintaining relatively strong growth. The member also expressed the view that the recent low inflation had been attributable mainly to the continued decline in administered prices and added that consumer price inflation with these administered prices counted out had been exceeding 2 percent since the beginning of this year, with sticky prices in particular being above target for the past few years. The member mentioned that survey-based inflation expectations and forecasts for consumer prices of goods and services of companies related directly to the real economy had remained within the 2 percent range. The member also expected consumer price inflation to gradually near its target, boosted by inflation pressures following the global economic recovery.

The member mentioned that the recent low interest rate environment had contributed to boosting the economy and raising the growth rate above its potential level, but with the increased leverage accumulating in the real estate sector, the demand-pull effect seemed to have gradually declined, and investment in other sectors had not produced sufficient added value. The member attributed this phenomenon to structural factors, such as the restructuring of the global economy, the decline in the core working-age population, and relatively rigid labor and commodity markets. The member also noted that a possible shortage of retirement funds due to rapid population aging had been encouraging leveraged short-term investment, leading to speculation in real assets. The member presented the view that, with growth in private-sector credit continuing to outpace that of nominal GDP, stronger macroprudential regulations alone could not effectively curb widening financial imbalances but would only create a balloon effect. In this regard, the member mentioned that it would be important to reduce the degree of monetary easing to weaken inefficient incentives for investment and curb financial imbalances.

The member also judged that, to prepare for a global economic downturn and the major impacts it would have on the Korean economy, it would be important at this point in time to prevent the accumulation of financial imbalances while carrying out intensive structural reforms to enhance the efficiency of the economy as a whole and to ensure policy space. The member went on to state that these efforts could boost future consumption further and minimize the inflation gap over the medium-term horizon.

One other member presented the view that it would be desirable to hold the Base Rate at its current level of 1.50 percent for the intermeeting period while observing conditions a little longer.

First, the member noted that the Bank of Korea Research Department had revised downward the growth forecasts for this year and next by 0.2 percentage points and 0.1 percentage points, respectively, to 2.7 percent each. The member added that these forecasts reflected the widening of corrections in facilities and construction investment, and the negative impacts of the US-China trade dispute on exports. The member saw that growth was somewhat weaker than existing forecasts, but at 2.7% it was generally not deviating from its potential level and the GDP gap was holding steady at around zero. The member commented that consumer price inflation was forecast to be 1.6 percent this year, the same as the previous forecast, and 1.7 percent for next year, 0.2 percentage points down from the previous forecast. The member's assessment was that, although the forecasts were somewhat below the inflation target of 2%, they were generally continuing to moving closer to the target level.

In terms of financial and foreign exchange markets, the member noted that stock prices had fallen greatly and the Korean won had weakened drastically, due mainly to the escalating US-China trade dispute and concerns about US rate hikes, while foreign portfolio investment had seen substantial albeit temporary outflows. In this regard, the member pointed out that, despite Korea's strong economic fundamentals and external soundness, markets could see episodes of heightened volatility depending upon future developments in major risk factors. The member commented that, although household lending growth had slowed somewhat, its absolute level was very high, and it was still continuing to outpace income growth, while sole proprietor loans had grown steadily, led by borrowing related to real estate and leasing, resulting in a large increase in financial exposures to real estate. Given these developments, the member stressed that close attention should be kept on the risk of the accumulation of financial imbalances in the Korean economy, even though the government's recent policy measures had helped weaken the upturn of apartment prices in some parts of the Seoul Metropolitan region.

Next, concerning the monetary policy response, the member presented the opinion that policy signals and assessments of recent macroeconomic and financial stability conditions, when considered comprehensively, pointed to a need to reduce the degree of monetary easing. The member added that such a policy path appeared even more desirable in light of the developments in monetary policy normalization in major countries, including continued rate hikes by the US Federal Reserve in the future, and given the need to secure policy space over a long-term horizon. The member noted that projections of growth and inflation were being revised downward, albeit slightly, despite the fact that growth and inflation had not deviated from the earlier forecasts, and members' opinions were mixed regarding market expectations about the timing of a hike in the Base Rate.

Given these points, the member presented the view that it would be better to keep the Base Rate at its current level for the intermeeting period while keeping a close watch on relevant conditions a little longer, since there was no pressing reason to rush to hike the Base Rate at this meeting.

One member, meanwhile, presented the view that it would be appropriate to hold the Base Rate at its current level for the intermeeting period, while examining future developments in domestic and international economic conditions a little longer.

The member evaluated that the global economy had maintained growth exceeding its potential, despite trade conflicts among major countries and financial unrest in some EMEs. The member raised concerns that most of the growth improvement since the second quarter had come from the US. The member, however, offered positive assessments as well, noting that the finalizing of a revision to the North American Free Trade Agreement had led to a view that the US-China trade dispute might not spread globally, and that some indicators in the euro area and Japan were also showing signs of improvements. The member projected the global economy to show relatively robust growth for some time, in consideration of the expansionary fiscal policies of major countries and the domestic demand stimulus measures of EMEs with favorable external soundness.

Looking at the domestic economy, the member judged that it was sustaining growth consistent with its potential. The member, however, noted that attention was being paid to the fact that the divergence between exports and domestic demand had continued, with exports continuing their strong growth but the correction in investment being more persistent and deeper than expectations. Judging from leading indicators, however, the member did not expect the gap between exports and domestic demand to widen further. The member took the view that, with respect to facilities investment in particular, its decline could stabilize or reverse to a moderate rise, given the number of machinery orders received. With regard to employment, which had shown sluggishness due to a mix of structural, policy and cyclical factors, the member pointed out that the number of persons employed in the services sector had fallen by a narrower margin when controlling for seasonal factors, and the number of persons employed in the manufacturing sector had increased moderately for three consecutive months. The member, however, expressed the view that, as the degree of improvement was weak and changes in policies that could affect consumer and corporate sentiments continued at home and abroad, it was appropriate to take some time to monitor the relevant developments.

With regard to inflation, the member noted that consumer price inflation had risen substantially to 1.9 percent, due to higher international oil prices and agricultural product prices and the ending of a temporary reduction of electricity fees. The member, meanwhile, commented that core inflation had recorded only 1.0 percent, due to the sustained influences of a drop in administered prices. The member presented the opinion that, although underlying price trends were difficult to judge, inflationary pressures were estimated to be gradually mounting, given the gradual retreat of factors that had limited inflation for the past several years. The member added that import prices and other supply-side factors were starting to induce domestic inflation as global prices entered an expansionary phase, while the inflation expectations of the general public had risen slightly of late. The member saw that demand-side inflationary pressures were no longer acting in a downward direction, but the effects of reduced administered prices were likely to continue for some time. The member thus forecast that consumer price inflation was unlikely to deviate far from the current level for the time being.

Finally, as to financial stability, the member noted that, although household debt was growing at a slower rate, it was still increasing faster than household income, and growth in sole proprietor loans was also high. The member thus pointed out the need for constant attention to risk from the accumulation of financial imbalances. In addition, the member commented that volatility in price variables had heightened in the financial markets due to the emergence of uncertainties related to the Fed’s rate hikes, and as there were significant uncertainties surrounding the future political agendas and trade and monetary policies of major countries, attention should be paid to the relevant risks.

Another member expressed the view that it would be desirable to hold the Base Rate at its current level for some time to buffer against downside risks to the macroeconomy, while paying attention to whether inflation caused by recent cost-side factors would continue and to the possibility of an accumulation of the macroeconomic risks in the real estate market.

The member’s assessment was that the Korean economy was sustaining growth in the mid- to upper-2% range, boosted by the booming world economy, and exports were keeping up their robust growth in the third quarter as well, despite protectionism and the possibility of a slowdown in the manufacturing sector. The member, however, pointed out that the terms of trade had worsened due to a sustained rise in oil prices, and thus export growth was having a very limited impact on domestic demand. In other words, the real GDP growth rate was holding steady as net export growth stemming from lower import volume had offset a decline in the contribution of domestic demand to growth, resulting in the slowdown of GNI and nominal income growth.

In terms of domestic demand, the member assessed that consumption was growing steadily owing to expanded government spending, noting that an expansionary fiscal policy and a high income growth rate were likely to act as upside risks, while sluggish employment and a contraction in the business income of self-employed business owners would serve as downside risks. The member, meanwhile, commented that corporate spending such as construction and facilities investment had contracted and was unlikely to rebound quickly.

With regard to inflation, the member assessed that it could reach close to its 2% target temporarily in the fourth quarter, due mainly to rising oil prices and to base effects. The member, however, commented that core inflation was still in the 1% range, while core inflation excluding administered prices remained flat in the mid-1% range, and thus underlying prices were not highly likely to rise rapidly.

With respect to asset prices, the member commented that the monetary authorities could not easily address every fluctuation in asset prices, nor were they entrusted with this responsibility. However, the member mentioned that policy attention needs to be paid only if nationwide asset bubbles accompanied with rapid leverage increase formed because future price adjustments could cause a major negative shock to financial markets and the macroeconomy. In this regard, the member's assessment was that the recent surge in apartment prices in some parts of the Seoul Metropolitan region did not appear to be a nationwide macroeconomic phenomenon, but rather appeared to have been triggered by housing demand differentiations by region and type, and there was no clear evidence that it was accompanied with the rise in household debt. The member thus noted that it was desirable to first utilize macroprudential policy to address these issues selectively.

Meanwhile, the member noted that domestic long-term market interest rates had been running considerably below US long-term interest rates, which reflects financial market woes on Korea's growth and inflation. The member added that capital movements and exchange rate fluctuations due to the differences in the macroeconomic fundamentals between Korea and the US should be understood as part of natural adjustments.

One other member expressed the view that it would be appropriate to hold the Base Rate at its current level, since real economic growth was holding steady around its potential growth path, albeit with some signs of slowing, and inflation growth was more moderate than expectations.

On the external front, the member's assessment was that, with respect to advanced economies, economic growth in Japan and the EU had been slowing somewhat since the second half of this year, although the US economy was maintaining solid growth. The member also assessed that emerging market economies were maintaining overall growth, as slower growth in China was offset by robust growth in India and ASEAN countries. The member expected global trade growth to continue to be impacted by the slower growth in advanced economies next year, as in the second half of this year, but the extent of such impacts to be limited, as emerging market economies accounted for a steadily increasing share of world trade. The member expressed the opinion that Korean exports were likely to sustain their strength, in reflection of the trends of the world economy and trade, but export growth would slow moderately from the second half of this year.

On the domestic front, the member saw that the correction in construction investment had continued and the correction in facilities investment seen since the second quarter of this year would continue in the second half of this year as well. The member, however, expressed the opinion that private consumption was maintaining moderate growth and the sharp increase in government spending this year was buffering sluggish investment. The member noted that, given that the correction in construction investment was an underlying trend, investment would recover somewhat from its current level but was not expected to contribute to growth. The member also assessed that, in the future, growth in domestic demand would be dependent upon an increase in private consumption.

The member noted that, with respect to private consumption growth, it had shifted to a trend of recovery from a prolonged downturn in the second half of last year and had exceeded GDP growth year-on-year until the first half of this year, but the savings ratio in the household sector still remained high, and thus it was uncertain whether the growth could be maintained. The Bank of Korea Research Department currently forecast the economic growth rates for this year and next to be 2.7% each, and projected private consumption to increase by 2.7% this year and maintain growth at the same level next year, even if boosted by expanded government spending. The member assessed these forecasts to have some downside risks.

With regard to inflation, meanwhile, the member noted that consumer price inflation had picked up somewhat, while core inflation had fallen to the lower- to mid-1% range. The member presented the view that this was due to a slight decline in inflation expectations and to weak drivers for the buildup of underlying inflationary pressures stemming from moderate growth in domestic demand, led by consumption. With respect to the price path, the member thus expected consumer price inflation to fluctuate in reflection of changes in supply-side factors such as oil prices, with core inflation increasing moderately.

Regarding the Research Department's downward revision to its core inflation estimates—1.2% for this year and 1.6% for next year—the member's assessment was that, given that core inflation had generally exhibited rigid movements, the Research Department's forecast for next year had some degree of downside risk, with administered prices as an uncertainty variable.

Ⅳ. Results of Deliberation on Monetary Policy Directions

Incorporating the outcome of their earlier discussions, a statement was compiled reflecting the views of the majority.

However, Mr. Lee, Il Houng and Mr. Koh, Seung Beom expressed clear opposition to the idea of keeping the Base Rate at its current level and argued for raising it by 0.25 of a percentage point.

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Monetary Policy Decision

☐ The Monetary Policy Board of the Bank of Korea decided today to leave the Base Rate unchanged at 1.50% for the intermeeting period.

☐ Based on currently available information the Board considers that the global economy has continued its sound growth. The global financial markets have shown increased volatility, with government bond yields rising and stock prices falling in major countries. Looking ahead the Board sees global economic growth as likely to be affected by factors such as the movements toward spreading trade protectionism, the paces of monetary policy normalization in major countries, and the directions of the US government's economic policies.

☐ The Board judges that the domestic economy has sustained a rate of growth at its potential level generally, as consumption and exports have shown favorable movements although the adjustments in facilities and construction investment have persisted. Employment conditions have remained sluggish, with the number of persons employed having risen only slightly. Going forward the Board expects domestic economic growth to be somewhat below the path projected in July, but to sustain a rate that does not diverge significantly from its potential level. It anticipates that investment will slow but that the trend of steady increase in consumption will continue, and that exports will also sustain their favorable movements thanks to the buoyancy of the global economy.

□ Consumer price inflation has risen to the upper-1% level, due mainly to an acceleration in the pace of increase in agricultural product prices and to the ending of a temporary reduction of electricity fees. Core inflation (with food and energy product prices excluded from the CPI) has remained at the 1% level, and the rate of inflation expected by the general public has been in the mid- to upper-2% range. Looking ahead it is forecast that consumer price inflation will fluctuate in the mid- to upper-1% range. Core inflation will also gradually rise.

□ In the domestic financial markets, stock prices have fallen significantly and the Korean won-US dollar exchange rate has risen to a considerable extent, in line mainly with the escalation of the US-China trade dispute and the rapid decline in stock prices globally. Long-term market interest rates have increased, in reflection of the changes in interest rates in major countries. Household lending has sustained its higher rate of expansion than in past years, although the amount of its expansion has lessened somewhat. Housing sales prices had risen substantially in some parts of Seoul and its surrounding areas, but their pace of increase has slowed since the Korean government's announcement of measures to stabilize the housing market.

□ Looking ahead, the Board will conduct monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation can be stabilized at the target level over a medium-term horizon, while paying attention to financial stability. As it is forecast that inflationary pressures on the demand side will not be high for the time being, and that the domestic economy will sustain a rate of growth that does not diverge significantly from its potential level, the Board will maintain its accommodative monetary policy stance. In this process it will judge whether it is necessary to adjust its accommodative monetary policy stance, while closely checking future economic growth and inflation trends. It will also carefully monitor conditions related to trade with major countries, any changes in the monetary policies of major countries, financial and economic conditions in emerging market economies, the trend of increase in household debt, and geopolitical risks.