Minutes of the Monetary Policy Board Meeting

February 2020

Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1]
(February 2020)

Ⅰ. Outline

1. Date of meeting: Thursday, February 27, 2020

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, MyunShik (Senior Deputy Governor)
   Lim, Jiwon

4. Monetary Policy Board members absent: none

5. Participants:
   Jang, Ho Hyun, Auditor
   Ryoo, Sangdai, Deputy Governor
   Chung, Kyuil, Deputy Governor
   Lee, Seungheon, Deputy Governor
   Park, Jong Seok, Deputy Governor
   Suh, Bong Gook, Director General of Reserve Management Group
   Lee, Hwan Seok, Director General of Research Department
   Shin, Woon, Director of BOK Economic Research Institute
   Min, Jwa Hong, Director General of Financial Stability Department
   Lee, Sang Hyeong, Director General of Monetary Policy Department
   Kim, Hyun Kee, Director General of Financial Markets Department
   Yang, Seok Jun, Director General of International Department
   Park, Young Chool, Press Officer
   Chae, Byung Deuk, 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

After briefings by staff on *Economic Outlook (February 2020)*,[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, looking at the global economy, uncertainties surrounding the global economy and trade had increased due to the new COVID-19 shock amid weaker growth in major economies. Members diagnosed that volatility in global financial markets had increased, with government bond yields and stock prices falling substantially in major countries. Looking ahead, members saw global economic growth and the global financial markets as likely to be affected largely by the degree of the spread of COVID-19.

Members' evaluation was that since the end of last year the domestic economy had been showing signs of partial recovery thanks to reduced uncertainties related to trade disputes and to the completion of semiconductor price adjustments. Members, however, saw that uncertainties had increased greatly due to the unforeseen COVID-19 outbreak. By sector, members expected large negative impacts on private consumption and the services sector, due mainly to a contraction in domestic consumption and a decline in the number of foreign tourists. Members noted that the impact on the manufacturing sector appeared to have been limited so far, but if the spread of COVID-19 continued for a prolonged period of time, negative impacts such as adjustments in employment and investment could increase. Members' assessment was that, although inflation was following the expected trajectory, showing a faster increase due to the easing of supply-side downward pressures, there was a possibility of heightened volatility in consumer prices due to the spread of COVID-19.

Finally, in the domestic financial markets, members assessed that stock prices and long-term interest rates had fallen due to strengthened risk aversion stemming from the spread of COVID-19, and stressed that it was necessary to pay attention to the possibility of greater volatility. Members judged that, since housing prices continued to show upward trends, particularly in some parts of the Seoul metropolitan area, and household lending showed steady growth, it was necessary to keep a constant eye on a possible buildup of financial imbalances.

2) An English version of *Economic Outlook* is posted on the Bank of Korea website.

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 presented the view 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 1.25%, while two members called for lowering it by 25 basis points.

One member presented the view that it would be appropriate to lower the Base Rate from the current 1.25% by 25 basis points at the current meeting.

The member noted that a new negative shock, COVID-19, had hit the domestic economy since the January MPB meeting. The member saw that growth in major economies had been revised downward due to the shock in China, a major axis of global trade and the division of labor structure. The member thus saw that world growth for this year would likely remain at a level not very different from that in 2019, contrary to initial expectations. The member commented that the new shock had expanded uncertainties surrounding global trade, which had sharply contracted due to the shock from the US-China trade dispute last year. The member's evaluation was that, although a virus or natural disaster generally acted as a temporary shock, it had become difficult to predict the severity and duration of the impacts of COVID-19 on consumption and investment patterns and economic sentiment on a global basis, since the spread of COVID-19 had accelerated in multiple countries including Korea in the last week. Therefore, the member expected that it would be possible during the second quarter or later to judge whether world trade would show a recovery this year compared to last year.

Taking a detailed look at domestic demand, the member expressed the view that, even before the COVID-19 shock, consumption in January had already reversed to a substantial decrease, which appeared to have been led by consumption of passenger cars. The member noted that this implied that the consumption recovery seen in December and the fourth quarter of 2019 was mainly because demand for passenger car purchases had been pushed forward due to a temporary cut in the individual consumption tax. Seeing no clear recovery in consumption, the member judged a sharp contraction in domestic demand, including consumption, to be inevitable due to the COVID-19 shock, at least during the first quarter. The member found it hard to come up with a meaningful growth forecast for this year in the current situation with COVID-19 spreading. The member, however, noted that, based on an optimistic scenario in which the COVID-19 outbreak would be contained in the first quarter, growth at around 2% would be possible.

Meanwhile, the member noted that inflation was generally following the movement of the expected path. The member expected consumer price inflation to continue to fluctuate due to one-off factors, such as agricultural and livestock products, with core inflation in the mid- to upper-0% range acting as an underlying trend.

The member saw that, if the economic growth rate for this year remained unchanged from the previous year's level due to the COVID-19 shock, the negative output gap would likely be the largest since the global financial crisis. The member judged that it was highly likely price inflation for this year would be less than 1%, given weak inflation in the period of 2012 to 2013 and in 2019, years with relatively large negative output gaps. The member set out the view that, in overall consideration of the above-mentioned economic and inflation trends, it would be appropriate to cut the Base Rate by 25 basis points to 1.00%.

Another member presented the view that it would be desirable to keep the Base Rate at the current 1.25% level at the current meeting, as was done at the previous meeting, for the following reasons.

The member first noted that for now it was more necessary to selectively support vulnerable groups and specific industries in response to a contraction in economic sentiment and production setbacks stemming from COVID-19. The member added that, although domestic conditions remained uncertain and the negative spillover effects on the global economy were large, COVID-19 was not yet forecast to cause permanent losses in domestic production capital and labor.

Next, the member assessed that prices in January, which did not fully reflect the effects of COVID-19, continued to recover, albeit weakly. The member noted that, for instance, consumer price inflation in January with administered items excluded had risen to the 2% range.

In addition, the member judged that monetary policy at the current level of the Base Rate was sufficiently accommodative in light of the neutral interest rate incorporating inflation expectations and the equilibrium interest rate based on productivity of the real economy.

Finally, the member pointed out that the short-term benefits of additional easing could be smaller than the medium-term costs, because the financial imbalances that had built up due to low interest rates were reflected in the economic structure in a multifaceted manner. The member thus emphasized that, in order to ensure price stability in the medium term, it had become more important to rethink this dynamic trade-off. The member explained the reasons as follows.

The member noted that theoretically a downward trend in the neutral interest rate could be explained by growth in the savings ratio estimated based on financial assets. The member commented that the savings estimated based on financial assets had expanded from 2.3 times GDP in the mid-1980s to 4.4 times now, while the savings ratio from Korea's national accounts remained flat at the mid-30% level of GDP, showing no major change during the same period. The member added that this meant that the value of the expanded savings had fallen to half of the level seen in the 1980s on a real purchasing power basis.

The member's assessment was that the decline in the neutral rate was due to this expansion in financial assets, and the current neutral interest rate level was running well below the equilibrium interest rate of the real economy that represented capital productivity. Accordingly, the member presented the opinion that resources induced by leverage had been inefficiently allocated and the expansion in financial assets had not been accompanied by growth in real production capacity, and these two factors had led to expanded financial imbalances.

Specifically, the member noted that the value of accumulated facilities investment relative to GDP in Korea remained almost unchanged from the level seen in the 1980s, while the value of accumulated construction investment relative to GDP had increased by more than 1.7 times during the same period. The member went on to argue that this investment herd behavior had caused returns on construction investment to be reduced from 1.5 times returns on facilities investment to 0.5 times during the same period. The member stated the opinion that this implied that, had there been a policy to secure a market environment that could guarantee efficient allocation of investment, the potential growth rate in Korea would have been higher than now.

The member's assessment was that financial imbalances not only threatened stability in the financial markets, but also caused a decline in the potential growth rate and acted as downward inflationary pressures on the real economic side. The member went on to point out that if this issue were addressed by maintaining the policy rate at a level lower than the neutral interest rate, which had already fallen below the equilibrium interest rate, the markets' self-recovery function would weaken and the burden on the economy would increase in the medium term. The member emphasized once again that in the current situation in which the buildup of financial imbalances had expanded not only in Korea but also in most advanced economies due to the negative side effects of prolonged accommodative monetary policies, it was very important to rethink the dynamic trade-off mentioned above. The member, however, presented the opinion that, if the spillover effects of COVID-19 continued to increase and the economic outlook worsened so as to raise concern about permanent losses in the economy, the mix and degree of macroeconomic policies should be changed in response.

Another member presented the view that it would be appropriate to keep the Base Rate at its current 1.25% level at the current meeting.

The member's judgment was that, according to major economic indicators at home and abroad published since the previous MPB meeting, as manufacturing sluggishness had eased, led by IT industries, the global economy had been having more positive effects on Korea's exports and manufacturing sector. The member, however, assessed that this economic trend would likely be disturbed greatly for some time due to the spread of COVID-19, and thus uncertainties surrounding the future growth path had heightened substantially. The member noted that, looking at the past SARS and MERS incidents, economic shocks stemming from infectious diseases or other non-cyclical factors had frequently caused short-term volatility, rather than leading to permanent production losses. The member, however, noted that COVID-19 was spreading very fast and widely and was heavily weighing on the economy of China, the biggest trading partner for Korea. The member thus saw that the short-term shock to the domestic economy could be much greater than past incidents of infectious diseases.

The member mentioned that, given the role of Chinese manufacturing industries in the global supply chain and global trade flows, and the amount of local production by major Korean enterprises, production setbacks in China caused by the COVID-19 outbreak were direct and indirect risk factors for the domestic economy. The member voiced concern that if the COVID-19 outbreak lasted for a long time, closures, employment adjustments and investment corrections in major industries could continue and severely harm the growth path in the medium- to long-term through a vicious cycle associated with demand conditions. The member, however, expected that unless the spread of COVID-19 lasted for an exceptionally long time, the rebound in the growth rate over a medium-term horizon could be larger than in the past, through a rapid recovery in pent-up demand typically seen in the manufacturing sector, as well as through a gradual recovery in the services industry sector. The member thus expressed the opinion that in estimating downside risks to the future growth path, it was necessary to use various scenario analyses to take a balanced look at the possibility of heightened volatility stemming from short-term shocks and the possibility of changes in the economic trend in the medium term.

With regard to consumer prices, the member noted that consumer price inflation had increased sharply due to an easing of supply-side downward pressures. The member's judgement was that, although consumer prices were likely to be more volatile in the short term depending upon the government's COVID-19 response measures and supply-side factors, the outlook that consumer price inflation in 2020 would be higher than in 2019 was still valid.

Meanwhile, the member noted that, in the financial markets, stock prices and long-term interest rates had fallen due to strengthened risk aversion affected by the spread of COVID-19, but capital flows in the credit market and foreign capital flows remained relatively stable. The member commented that this was somewhat differentiated with the SARS outbreak in 2003 and the MERS outbreak in 2015, primarily due to high expectations that the recent accommodative monetary policy stances in major countries would be continued for a long time. The member, however, stressed that the financial markets could be destabilized greatly in line with the developments in the spread of COVID-19, and therefore external soundness conditions and potential risk factors at home and abroad should be closely examined and prepared against.

The member thus expressed the opinion that, in overall consideration of economic conditions at home and abroad, it would be appropriate to hold the Base Rate at its current 1.25% level at the current meeting, while closely monitoring overall macroeconomic and financial market conditions at home and abroad for the time being. The member's assessment was that, although the economic growth forecast for 2020 had been revised downward this time, if the impacts of the spread of

COVID-19 were excluded, the current assessment of economic conditions and economic forecast were not very different from those in November last year, and inflation was evolving in line with original expectations. Looking at possible responses to cushion the economic shock, the member expressed the view that, referring to past cases of infectious diseases, where the spread was usually contained within three months, the amplitude of economic activity could be stabilized in the medium- to long-term horizon more effectively by, for example, using the Bank Intermediated Lending Support Facility, which would allow selective support to specific sectors that had suffered damage, instead of cutting the Base Rate, which affects the economy with a time lag. The member also judged that, as the past two Base Rate cuts had worked to increase the degree of financial easing, liquidity in the current financial markets appeared to be sufficient to support the real economy. The member also noted that the credit cycle was estimated to be in an expansionary phase, and real estate-related exposures were relatively large. The member added that, given these points, it was necessary to constantly keep an eye on the possibility of a buildup of financial imbalances.

One member presented the view that it would be desirable to cut the Base Rate to 1.00% from the current 1.25% level.

The member mentioned that the economic downturn had been easing since the fourth quarter last year, as uncertainties related to the US-China trade dispute had decreased, the semiconductor price correction had been completed and monetary policies had been eased at home and abroad. The member, however, evaluated that it had been difficult to expect a significant economic recovery, as the exports outlook had remained unclear and domestic demand in the private sector had continued to be sluggish. The member pointed out that, in this situation, the COVID-19 outbreak was placing an additional burden on the domestic economy. The member assessed that as of now it was difficult to measure how serious the virus shock would be and how long it would last, but it was seen to act as a substantial downside risk to the domestic economy in the short term, causing a decline in domestic consumption and travel demand, a fall in exports demand from China and other regional economies, and setbacks to production owing to disrupted global supply chains.

In terms of inflation, the member’s assessment was that it was uncertain whether the downward trend of underlying inflation was reversing, with core inflation remaining in the upper-0% range but consumer price inflation having rebounded to stand at 1.5% in January. The member expected consumer price inflation to gradually decline to the level of core inflation due to the decreasing impacts of factors causing short-term fluctuations, such as agricultural product and oil prices. The member also expressed concerns that a reversal of the underlying inflation trend would be even more unlikely if shocks from the virus outbreak lasted for a long time.

The member meanwhile assessed that the surge in apartment prices in Seoul and some of its surrounding areas that had recently been the focus of public attention was the result of the recent acceleration of the widening gap over the past several decades between housing prices in the Seoul metropolitan region and the provincial areas and also between apartment and non-apartment prices, on the back of worsening economic sluggishness in the provincial areas and stronger restrictions on apartment supply. The member expressed the view that this widening gap was a serious social issue as it was a main factor deteriorating wealth inequality among regions and generations and that appropriate measures were accordingly required. The member took the view, however, that, given the fact that the Nationwide Housing Price Index was not rising rapidly, it seemed hard to find a good rationale for using monetary policy, which affects the formation of absolute prices nationwide and indiscriminatingly, to respond to fluctuations in apartment prices in the Seoul metropolitan area.

The member argued that, in light of this, it would be advisable to cut the Base Rate from the current 1.25% to 1.00% this time to support recovery of the domestic economy, which was facing growing negative shocks from the virus outbreak, and to help underlying inflation gradually converge to the target level.

Another member presented the view that it would be desirable to keep the Base Rate at its current 1.25% level at the current meeting.

The member noted that it was the outbreak and spread of COVID-19 that had exerted an enormous impact on domestic and foreign financial and economic conditions since the January meeting. The member’s assessment was that, although it was difficult as of now to predict how far the virus would spread and how long it would last, it would definitely have substantial negative impacts on consumption, investment and exports by contracting domestic and overseas demand and causing production setbacks.

The member mentioned that prolongation of these negative impacts would put downward pressure on inflation as well as growth, and in light of this, the recent sharp decline in market interest rates, and the market expectations of a Base Rate cut reflected in it, were somewhat natural phenomena. The member however expected that a Base Rate cut would have only a limited positive effect on growth and inflation at this point in time. The member went on to evaluate that, amid weakened transmission of monetary policy overall since the global financial crisis, rate cuts were unlikely to improve the economic conditions in a situation where economic activities including consumption and investment shrank not because of economic factors but because of those related to healthcare and security.

Furthermore, looking at past outbreaks, the member forecast that the worst would be limited to the first quarter of this year. The member also stressed concerns about an additional buildup of financial imbalances as potential side effects of a Base Rate cuts.

In conclusion, the member took the view that it would be desirable to leave the Base Rate unchanged at its current level of 1.25% for the intermeeting period, and monitor virus outbreak developments and their impacts on domestic and overseas financial and economic outlooks for the second quarter onwards. The member meanwhile emphasized that, with the spread of COVID-19, it would be necessary to employ the Bank Intermediated Lending Support Facility to expand financial support for the troubled services sector due to the decrease in the floating population of Korean residents and foreigners and the reduction in events, and also for some manufacturers suffering from production setbacks owing to the disruption of global supply chains and the closure of workplaces. The member added that this would effectively help the economy recover rapidly once the virus subsided.

One member expressed the opinion that it was desirable to keep the Base Rate at 1.25%.

The member evaluated that the domestic economy had seen signs of recovery in some sectors since the end of last year, but uncertainty had recently increased significantly due to the COVID-19 outbreak. The member went on to state that, looking at the global economy, major countries excluding the US were exhibiting weaker growth while the possibility of a rapid weakening of the Chinese economy had emerged, and added that oil prices were continuing to decline while international trade remained sluggish.

The member mentioned that economic indicators had shown positive signs up until January, suggesting that there would not be any further economic slowdown this year, but economic agents had become more anxious, as seen in the recently plunging Consumer Sentiment Index and Business Survey Index. By sector, the member pointed out that private consumption and the services sector had been hit hard, and expressed concerns that the fall in service exports resulting from a decline in the number of foreign inbound tourists, as well as the contraction in consumption by Korean residents, was highly likely to continue for some time. The member stressed that, in the manufacturing sector, production setbacks in China had not yet caused a substantial delay in the intermediate goods supply or substantially slowed down production by China-based Korean firms, but a continued nationwide spread of the virus could negatively affect the manufacturing sector, and therefore close monitoring was required in this regard. The member added that it would be necessary to continuously examine future developments of facilities investment and exports, which had been expected to pick up due to improvements in the semiconductor industry and the ending of the US-China trade dispute.

The member meanwhile expressed the view that, as the domestic financial markets had become far more volatile in line with surging uncertainties in the international financial markets, it would be necessary to closely monitor financial and FX market developments and, if needed, take bold measures.

The member noted that it was difficult as of now to predict the effects of the spread of COVID-19, but looking at the past examples of the SARS and MERS outbreaks, in each case the economy had shown rapid recovery once the epidemic subsided. The member emphasized however that, considering China's remarkably heightened profile in the global economy as well as in the Korean economy, it should not be overlooked that the current virus outbreak could have enormous negative effects on economic recovery.

Finally, the member mentioned that, in terms of financial stability, the government's real estate measures were expected to slow household debt growth, but the effects could be seen later than expected.

Taking all these points into consideration, the member judged that at this point it was necessary to keep a close watch on virus developments and consequent macroeconomic and financial market conditions while maintaining the accommodative monetary policy stance. The member argued that support measures focusing on troubled sectors would be more effective, and expected that expanding the Bank Intermediated Lending Support Facility could be an appropriate measure.

Ⅳ. Results of Deliberation on Monetary Policy Directions

Incorporating the outcome of their earlier discussions, the following Monetary Policy Decision statement was compiled reflecting the views of the majority.

However, Dr. Cho, Dongchul and Dr. Shin, Inseok expressed clear opposition to keeping the Base Rate at the current level and argued for cutting it by 0.25 percentage points.

Monetary Policy Decision

☐ The Monetary Policy Board of the Bank of Korea decided today to leave the Base Rate unchanged at 1.25% for the intermeeting period.

☐ Based on currently available information the Board considers that the pace of global economic growth has continued to slow with the ongoing sluggishness in trade. Volatility in global financial markets has increased. Government bond yields and stock prices have fallen in major countries and the US dollar has strengthened with the spread of the COVID-19 outbreak. Looking ahead, the Board sees global economic growth and the global financial markets as likely to be affected largely by the severity of the COVID-19 outbreak and developments in global trade protectionism and geopolitical risks.

☐ The Board judges that economic growth in Korea has weakened. Although the sluggishness in facilities investment has eased, consumption has contracted and exports have slowed owing to the spread of the COVID-19 outbreak while the adjustment in construction investment has continued. Employment conditions have continued to improve, with the increase in the number of persons employed having risen. GDP is forecast to grow at the lower-2% level this year, below the November projection (2.3%), and the Board judges that uncertainties regarding the future growth path are high due to the impact of the COVID-19 outbreak.

☐ Consumer price inflation has risen to the mid-1% level, due largely to an upturn in the prices of agricultural, livestock and fisheries products and to the larger increase in petroleum product prices. Core inflation (excluding changes in food and energy prices from the CPI) has increased to the upper-0% range, and the inflation expectations of the general public have remained at the upper-1% level. Looking ahead, it is forecast that consumer price inflation will run at the lower-1% level and then fall slightly to record around 1% during this year, and core inflation will run at the upper-0% level.

☐ Volatility in domestic financial markets has increased. Long-term market interest rates and stock prices have fallen sharply and the Korean won-US dollar exchange rate has risen considerably, affected by the spread of the COVID-19 outbreak. The rate of household loan growth has risen slightly, and housing prices have increased at a relatively high rate, especially in the areas surrounding Seoul.

☐ 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 expected that domestic economic growth will be moderate and it is forecast that inflationary pressures on the demand side will remain at a low level, the Board will maintain its accommodative monetary policy stance. In this process it will judge whether to adjust the degree of monetary policy accommodation, while thoroughly assessing the severity of the COVID-19 outbreak, its impact on the domestic economy, and changes in financial stability including household debt growth. Also, the Board will closely monitor developments in global trade disputes, the economies of major countries, and geopolitical risks.