Minutes of the Monetary Policy Board Meeting

July 13, 2017

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1]
(July 2017)

Ⅰ. Outline

1. Date of meeting: Thursday, July 13, 2017

2. Place: Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:

   Lee, Juyeol, Chairman (Bank of Korea Governor)
   Hahm, Joon-Ho
   Lee, Il Houng
   Cho, Dongchul
   Koh, Seung Beom
   Shin, Inseok

4. Monetary Policy Board members absent: none

5. Participants:

   Ha, Sung, Auditor
   Kim, Minho, Deputy Governor
   Yoon, Myun-Shik, Deputy Governor
   Lim, Hyung Joon, Deputy Governor
   Huh, Jin Ho, Deputy Governor
   Jeon, Seung-Cheol, Deputy Governor
   Suh, Bong Gook, Director General of Reserve Management Group
   Chang, Min, Director General of Research Department
   Sohn, Wook, Director of BOK Economic Research Institute
   Shin, Ho Soon, Director General of Financial Stability Department
   Park, Jongseok, Director General of Monetary Policy Department
   Lee, Hwan Seok, Director General of Financial Markets Department
   Lee, Seung Heon, Director General of International Department
   Seong, Byung Hee, Press Officer
   Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
   Lee, Dong Won, Head of MPB Team

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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 Outlook for the Second Half of 2017’, ‘FX and International Finance’ and ‘Financial Market Trends’, the discussions of the Monetary Policy Board (MPB) members covered the following areas:

With regard to **the global economy**, members’ assessment was that, along with improvements in world trade, the recovery of the global economy had been sustained, centering around advanced economies. Members also evaluated that **international financial markets** had been stable overall, despite changes in expectations of major countries’ monetary policy stances and geopolitical risks.

Concerning **the domestic economy**, members’ evaluation was that the Korean economy had been showing a recovery, with exports and investment remaining buoyant and consumer expectations indicators improving, while private consumption had not yet exhibited substantial improvement. With regard to **prices**, meanwhile, members noted that consumer price inflation had been nearing its target of 2 percent, while core inflation had fallen below the target.

As to **the domestic financial markets**, members mentioned that household debt had maintained strong growth and attention should be paid to the possibility of consequent financial instability and constraints on monetary policy. Members also stressed the need to closely monitor the trend of household debt in line with related government measures in the coming months.

2) English versions of 'Economic Outlook for the Second Half of 2017' and 'Financial Market Trends' are 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:

Members shared the opinion that, in overall consideration of the changes in the domestic and international financial and economic environments, it would be desirable to hold the Base Rate at its current level of 1.25 percent for the intermeeting period.

One member expressed the opinion that it would be desirable to keep the Base Rate at the current 1.25 percent this month.

The member noted that the global economy had been showing recovery along with improvements in international trade, and that with consumer price inflation gradually nearing its target, major advanced countries were hinting that they could shift away from monetary easing policies as the US had. The member expressed the view that the prolonged monetary policy easing stances had been a result of the delayed achievement of inflation targets due to the weakening linkage between real economies and inflation since the global financial crisis, and that this had in turn been attributable to global structural factors. Furthermore, considering these structural changes, the member mentioned that the increasing side effects of monetary easing, as well as the inflation gap, should be taken into consideration in assessing the future monetary policy stance. In this regard, the member pointed to surging debt undermining the consumption expansion and the overheating of the stock and housing markets due to low costs of capital relative to medium-term natural interest rates.

As to the Korean economy, the member noted that, although exports had been improving along with global economic recovery, they were not yet having clear trickle-down effects on consumption, and that this seemed to have been attributable to the high rate of savings resulting from the population structure, a reduced consumption base due to income imbalances, and decreased capacity for consumption in line with growing household debt. The member went on to argue that the recent buoyancy of construction and IT-related facilities investment had not led to a fundamental turnaround in household consumption. The member also mentioned that, despite the sustained accommodative monetary policy stance, core inflation had remained below 2 percent in Korea, similar to that of other OECD countries, suggesting that domestic consumer price inflation had been largely driven by global structural effects, and that consumer price inflation had been also nearing 2 percent, owing to external one-off factors such as oil prices. Meanwhile, the member's evaluation was that capital allocation had been concentrated in profit-seeking through leverage, raising concerns about financial instability, and that household consumption had been affected more by debt-servicing burdens than by the easing of liquidity restrictions, adding to the negative side effects of the accommodative monetary policy stance.

In overall consideration of the above-mentioned matters, the member argued that it seemed to be time to review the current monetary easing policies, but due to uncertainties about the recovery of the domestic economy, about whether core inflation had been approaching its medium-term target, and about the effects of the government's recent real estate policy, any decision to change the monetary policy stance should be made in consideration of trade-offs between the pace of growth in household debt and the consumption-led recovery.

Another member presented the view that it would be appropriate to hold the Base Rate at its current level of 1.25 percent for the intermeeting period, and pointed out a number of major considerations for the appropriate conduct of monetary policy.

First, the domestic real economy had continued to improve, with growth led by exports and investment in the second quarter as well. However, with the recovery in private consumption remaining sluggish, facilities and construction investment, having recently exhibited strong growth, seemed to have entered a correction phase, and manufacturing and services production had weakened somewhat. Boosted by favorable performances during the first quarter, the growth path had moved upward, raising the annual growth forecast, but growth momentum was likely to weaken somewhat in the second half, affected chiefly by weakening export growth and corrections in construction and facilities investment. However, the growth rate was likely to remain similar to its potential level in the second half as well. Second, looking at inflation, consumer price inflation was expected to rise at a somewhat slower pace in the second half, owing chiefly to the stabilization of agricultural, livestock and fisheries product prices and the weakening base-period effects of oil prices, but would likely approach near its target level later on. Core inflation, on the other hand, had continued to fall short of the 2-percent level, due mainly to the lack of demand-side pressures, and these pressures were unlikely to increase substantially for the time being, considering that the narrowing of the negative output gap was attributable to the declining potential growth rate rather than to sufficiently strong aggregate demand. Third, the improving trends in production sector slack had shown signs of faltering, with the sales to inventory ratio rising and the average capacity utilization ratio declining in the manufacturing sector. The slack in the labor force, meanwhile, had increased for the third consecutive month in June, with growth in the unemployment and time gaps more than offsetting the lack of substantial changes in the participation gap. Fourth, looking at financial stability conditions, with upward pressures on long-term market rates growing due to risk aversion in reaction to the changing global monetary policy stances, the spread between long- and short-term yields had widened, while credit spreads had narrowed slightly, led by a recovery in investor sentiment following improvements in corporate performances. In the credit market, meanwhile, household lending had maintained strong growth owing mainly to increased housing transaction volume and demand prior to the implementation of real estate measures, while lending to SMEs had exhibited slow growth despite the economic recovery. In overall consideration of the above-mentioned real economic and inflation trends and financial stability conditions, the member assessed that it was advisable to keep the Base Rate at the current level for the intermeeting period.

One other member presented the opinion that, while keeping the Base Rate unchanged at its current level for the intermeeting period, the Bank of Korea should see if the recent export-driven economic recovery spreads to the domestic demand sector.

The member noted that exports and manufacturing facilities investment in the Korean economy had expanded in line with continued economic recovery in advanced economies. The member commented, however, that the real sector had shown no marked change with core inflation indicators remaining at the mid-1% range, running below consumer price inflation. The member also observed that household debt was still continuing to grow at a worrisome level.

The member stated that the most notable aspect of the past two to three months was the surge in consumer expectations, which existing analysis results implied would lead to higher private consumption for the corresponding and following quarters. However, the member assessed that the relevant indices had not been showing any marked trend of recovery in actual private consumption. In addition, the member pointed out that the sharp increase in consumer sentiment had appeared with the launch of the new government, which has been placing emphasis on household income, and thus consumer expectations may be significantly influenced by the actual implementation of the government policy. Meanwhile, the member stated that manufactoring and service production-related indicators in the second quarter seemed to have been somewhat insufficient to be confident that the trend of economic recovery in the previous quarter was continuing. The member particularly noted that typical domestic demand areas, such as the wholesale & retail trade and food & accommodation industries, were continuing to show sluggishness since the second half of last year.

Taking these factors into overall consideration, the member judged it difficult to say that the expansion in exports seen since the second half of last year was having spillover effects on domestic demand, and also expressed a lack of confidence that the Korean economy was continuing to show the rapid pace of recovery needed for underlying inflation to accelerate to the 2% target level. The member, thus, presented the view that, while maintaining the current accommodative monetary policy stance, it was desirable to assess if the economy would see a sustained recovery at a pace sufficient to boost inflation. In addition, concerning the trend of sharply increasing household debt, the member added that it was necessary to actively cooperate with the relevant policy authorities by strengthening public policy regulations and macroprudential policies to prevent markets from underestimating the household debt risk.

One member, meanwhile, expressed the opinion that it would be appropriate to hold the Base Rate at its current level for the intermeeting period, while keeping a close watch on whether improvements in consumer sentiment would lead to a recovery in private consumption, whether household debt would stabilize, and the trend of the price path.

The member noted that the rate of quarter-on-quarter GDP growth stood at 1.1% in the first quarter of this year due to large increases in exports and facilities investment, and that a possibility of a recovery in household consumption had emerged thanks to improvements in consumer sentiment. The member noted that, as a result, expectations had emerged that this year’s economic growth rate could be adjusted upward from the previous forecast. The member stated that, with strong exports and facilities investment driving growth in the second quarter, exports had increased on the back of a boom in the semiconductor market, and global trade volume had been showing improvement, but consumption had continued to mark time, despite improvements in sentiment indices.

The member noted that the 2.8% growth forecast released by the Bank of Korea Research Department in July seemed to be neutral with similar upside and downside risks, given that the recovery from stagnation in consumption was still insufficient. The member went on to assess that this improvement in the economic outlook showed that the Korean economy was returning to a balanced growth path. The member, however, pointed out that the price path had not been showing a commensurate change. The member noted that, while consumer prices had not differed greatly from their original projection, core inflation had actually slowed to the mid-1% range in the second quarter. The member then offered three hypotheses why the price path had been insensitive to the real economic trend. First, the formation of inflation expectations of economic agents may be adaptive, relying upon past inflation figures and failing to reflect the future economic outlook. Second, the mid- to long-term economic outlook of economic agents, which reflects their inflation expectations, may still not be bright. Third, the global low inflation environment may be influencing the price path in Korea as well. The member then noted that the second hypothesis seemed to better fit the recent Korean economy, and in this case, the appropriate monetary policy operation would be to check if the recent recovery in consumer sentiment leads to an actual recovery in consumption and take actions in response accordingly.

The member, meanwhile, cited household debt as the biggest risk factor when keeping the Base Rate unchanged at the current level. The member noted that, although there was little likelihood of a household debt overhang escalating into a crisis in the financial sector, the consequent macro risk was not small. The member also raised concerns about a growing possibility that spillover effects from negative shocks, such as an economic recession or housing price declines, could expand due to heightened vulnerabilities to household income and housing price risks. The member also commented that the current interest rate decision was based on the premise that household debt growth will gradually show downward stability throughout this year and next year, owing for example to policy measures to stabilize the housing market and ensure financial soundness.

Another member expressed the opinion that it would be desirable to keep the Base Rate unchanged from the current level for the intermeeting period.

The member assessed that, with trends of recovery in the world economy and trade volume continuing, on the domestic economic front, private consumption had improved moderately from its sluggishness, and exports and investment had also remained buoyant. The member then noted that, considering these domestic and overseas factors, the Bank of Korea had adjusted the economic growth outlook for this year upward, and went on to state that, if policy effects from the government's execution of the supplementary budget are considered, additional upward adjustments might be made. The member, however, pointed out that since there were several downside risks as well, such as China's trade restrictions related to Korea's THAAD deployment, stronger trade protectionism, and geopolitical risk related to North Korea, it was necessary to constantly examine the relevant developments. The member noted that GDP for this year and next year was expected to grow at the level of the potential growth rate, and consumer price inflation was forecast to increase to near the inflation target. The member, however, expressed the opinion that, considering the downside risks to inflation, such as the weakening of the global reflation trend, it was necessary to wait and see further whether economic growth would show trends consistent with its forecast, while maintaining the current accommodative monetary policy stance at this point in time.

The member, meanwhile, pointed out the need to keep a close watch on the possibility that financial stability issues could constrain monetary policy, through close analyses of domestic and overseas financial markets going forward. The member stressed that, although overall financial market conditions remained stable, factors making for instability, such as policy rate hikes by the US Federal Reserve, changes in its reinvestment policy, and geopolitical risks related to North Korea, persisted. The member also emphasized the need to continuously monitor trends of foreign portfolio investment as well. The member noted that, concerning household debt, its growth was expected to slow in the second half, due for instance to the implementation of the related government measures and increases in market interest rates, but it was necessary to keep a close watch on the relevant developments. The member also emphasized that, while higher market rates may rein in the increase in household debt, they could also work to increase the household debt burdens of vulnerable groups.

Ⅳ. Results of Deliberation on Monetary Policy Directions

Incorporating the outcome of their earlier discussions, a statement was compiled with the unanimous consent of all the members.

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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 1.25% for the intermeeting period.

☐ Based on currently available information the Board considers that the global economic recovery has continued to expand. The global financial markets have shown generally stable movements, although their volatility has risen somewhat due to fluctuations in international oil prices and to changes in expectations related to the monetary policies of major countries. Looking ahead the Board sees the global economic recovery as likely to be affected by factors such as the directions of the US government's economic policies, the pace of monetary policy normalization by the US Federal Reserve, the movements toward spreading trade protectionism, and the direction of international oil prices.

☐ The Board judges that the solid trend of domestic economic growth has continued, as exports and investment have improved although the pace of increase in consumption has remained weak. On the employment front, the trend of year-on-year increase in the number of persons employed has slowed, and the employment-to-population ratio and the unemployment rate have risen. The Board sees the domestic economy as likely to continue its trend of recovery going forward, and forecasts a rate of GDP growth for this year higher than the April projection

(2.6%). Exports will sustain their trend of improvement, thanks chiefly to the global economic recovery, and domestic demand activities will also recover moderately, owing to improved economic agents' sentiments.

☐ Consumer price inflation has continued at the 2% target level, in line mainly with increases in the prices of agricultural, livestock and fisheries products. Core inflation (with food and energy product prices excluded from the CPI) has stayed in the mid-1% range, and the rate of inflation expected by the general public has remained at the mid-2% level. Looking ahead the Board expects that consumer price inflation will for the time being fluctuate at around the 2% level, and for the year as a whole show the level (1.9%) projected in April. Core inflation appears likely to be in the mid- to upper-1% range.

☐ In the domestic financial markets, price variable volatility has expanded somewhat, with the Korean won-US dollar exchange rate having risen considerably, in line with changes in expectations related to the monetary policies of major countries and with increases in geopolitical risks, and long-term market interest rates having increased in concert with government bond rates in major countries. Stock prices have continued to climb, on the effects for example of the trend of solid domestic economic growth and expectations of improved performances at major companies. Household lending has sustained its high rate of increase exceeding past years' levels, although the amount of year-on-year increase has lessened somewhat. In the housing market, the trends of rising sales and leasehold deposit prices have expanded, centering around Seoul and its surrounding areas.

☐ 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 the inflationary pressures on the demand side are not expected to be high although the domestic economy is expected to show solid growth, the Board will maintain its stance of monetary policy accommodation. In this process it will closely monitor any changes in the monetary policies of major countries, conditions related to trade with major countries, the directions of the government's economic policies, the trend of increase in household debt, and geopolitical risks.