Minutes of the Monetary Policy Board Meeting

February 27, 2018

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(February 2018)

Ⅰ. Outline

1. Date of meeting: Tuesday, February 27, 2018

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
   Yoon, Myun-Shik (Senior Deputy Governor)

4. Monetary Policy Board members absent: none

5. Participants:

   Ha, Sung, Auditor
   Lim, Hyung Joon, Deputy Governor
   Huh, Jin Ho, Deputy Governor
   Jeon, Seung-Cheol, Deputy Governor
   Shin, Ho Soon, Deputy Governor
   Suh, Bong Gook, Director General of Reserve Management Group
   Lee, Hwan Seok, Director General of Research Department (acting)
   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
   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 ‘Recent Economic Developments’, ‘FX and International Finance’ and ‘Financial Market Trends’, the discussions of the Monetary Policy Board (MPB) members covered the following areas:

Members’ assessment of **the global economy** was that, with economic expansion in the US and other advanced economies continuing, emerging economies had been gradually showing clearer economic recovery, driven for instance by the stability of commodity prices and the favorable trend of trade growth. Members also evaluated that, with respect to **the global financial markets**, with long-term interest rates in major countries rising and stock markets fluctuating, the volatility of interest rates and exchange rates had expanded.

Concerning **the domestic economy**, members’ evaluation was that, despite a slowdown in construction investment, the Korean economy had continued to exhibit growth in line with the path projected in January, with exports and facilities investment sustaining buoyancy and consumption maintaining its trend of recovery, albeit at a moderate pace. Members, however, added that there was a need to pay attention to changes in export and employment conditions in line for instance with stronger protectionism by the US and a foreign automaker’s decision to shut down a factory in Korea, while bearing in mind that employment was growing, led by export manufacturing industries, and employment growth was slowing in the service industries closely associated with domestic demand.

Concerning **inflation**, members noted that consumer price inflation was expected to gradually approach the target level after a time gap with economic activity recovering, given that (i) the slowdown in inflation in

2) English versions of ‘Recent Economic Developments’ and 'Financial Market Trends' are posted on the Bank of Korea website.

January was mainly attributable to non-cyclical factors such as a freeze in insurance premiums and the base effect from prices of agricultural, livestock and fisheries products, and that (ii) the rate of increase in the business cycle-sensitive price index was in the upper-1 percent range.

As to **the domestic financial markets**, members' assessment was that, with stock price volatility rising, the yield curve had steepened and the term premium had risen in the bond market, but corporate bond credit spreads and foreign currency liquidity conditions were stable. Members emphasized that, although slower growth in household lending was continuing, there was a need to continually monitor credit lending growth and the impacts of the surge in real estate prices in some areas of Seoul.

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 domestic and international financial and economic environments, it would be desirable to keep the Base Rate at its current level of 1.5 percent for the intermeeting period.

One member expressed the view that it would be necessary to maintain the accommodative monetary policy until economic recovery firms up such that the trend of decline in underlying inflation is reversed.

The member noted that as major advanced economies had recently shown rapid paces of recovery, the negative GDP gap was estimated to be almost closed or to have turned positive. The member's assessment was that, in the US in particular, with the labor market assessed as being at full employment, there were signs of typical demand-pull inflation driven by wage hikes, providing logical and substantive grounds for monetary policy normalization. The member added that the Euro area and Japan were maintaining very accommodative monetary policies, as price inflation was still running well below target, although labor force slack had declined rapidly with economic growth continuing to significantly exceed potential growth.

The member noted that, unlike the reflation trend in advanced economies, core inflation in the Korean economy had been continuing to decline, albeit at a moderate pace, to the lower-1 percent range over the past two years. The member commented that this suggested that, in contrast to other advanced economies, domestic demand in the Korean economy had not recovered sufficiently to boost price inflation overall. The member added that, given that there was also little sign of improvement in employment in the domestic demand-led services industry, the projection that ‘consumer price inflation will approach its 2-percent target in the second half of this year, dependent upon economic recovery’ also seemed somewhat uncertain.

The member pointed out that a decline in the inflation rate could act to effectively tighten the monetary policy stance by raising real interest rates, even if the Base Rate remained unchanged. The member then emphasized the need to review how accommodative the current Base Rate of 1.50 percent actually is. The member thus judged it necessary at this juncture to set the primary goal of monetary policy as an increase in price inflation through recovery of domestic demand. To this end, the member expressed the view that it was necessary to monitor whether economic recovery firms up such that labor market conditions improve and the trend of decline in price inflation is reversed, while maintaining the current level of the Base Rate for some time.

Another member took the view that it would be desirable to hold the Base Rate at its current level of 1.50 percent for the intermeeting period.

The member’s assessment was that, as exports and facilities investment continued their strength despite a slowdown in construction investment, and as consumption was maintaining a trend of recovery, albeit at a moderate pace, the domestic real economy was sustaining growth not deviating far from the path projected in January. The member judged that, although the trend of improvement in exports concentrated in IT was gradually spreading to non-IT sectors, the trend of recovery in private consumption was not enough to drive well-balanced growth in the overall economy. The member thus found it still too early to have confidence that there had been a tangible reversal to a positive GDP gap.

The member noted that consumer price inflation had slowed greatly in January, due mainly to the strengthening of the won and declines in prices of livestock products, and that core inflation was also declining significantly, due to the deceleration in price growth in the services sector, particularly in the personal services sector. The member saw heightened downside risks that this year's movements of consumer price inflation and core inflation would fall short of the path projected in January, due to the recent slowdown in inflation. Looking at underlying price movements, meanwhile, the member noted that, although core inflation excluding regulated prices had slowed, this was mainly attributable to non-cyclical factors, such as a freeze in insurance service charges, and business cycle-sensitive prices were maintaining a trend of increase similar to that of the previous month. The member thus judged that demand-side inflationary pressures were not declining significantly.

Regarding production slack, the member noted that, despite the buoyancy of exports, the average capacity utilization ratio in the manufacturing sector had declined to hit the lowest level of late, due to sluggish production in the existing leading machinery industries such as automobiles and shipbuilding. Regarding the labor market, the member's assessment was that, although the number of persons employed had increased by a greater margin, particularly in the construction and manufacturing sectors, and the unemployment rate had also remained unchanged year-on-year, the slack in the labor force had increased slightly due to growth in the time and participation gaps.

Looking at financial stability conditions, the member noted that the yield curve in the capital market had steepened, due to a synchronization of domestic long-term interest rates following a large increase in global long-term interest rates. With respect to the stock market, the member judged that an outflow of foreign portfolio investment had led to a large-scale correction of stock prices and higher price volatility, and in the bond market, the term premium on bonds had risen due to higher preferences for short-term bonds, as well as an inversion of domestic and overseas interest rates. The member noted that, in the credit market, the slowdown in household lending growth had weakened, due mainly to growth in housing-related credit lending, despite a rise in lending interest rates. The member thus noted that there was a need to carefully observe the trends of stabilization of household debt, together with future developments in the housing economy.

Based on the results of this examination of real economic activity, price movements and financial stability, the member assessed that, despite recent improvements in economic activity, current economic conditions had not yet reached a level where it could be verified that there were tangible declines in spare capacity in production and labor through the spread of robust and well-balanced growth, and the consequent sustainable rise of demand-side inflationary pressures.

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.

First of all, the member forecast that underlying inflation would bottom out in the first quarter of this year and rebound afterwards. The member's assessment was that personal service fees, sensitive to domestic demand, had been moving close to 2 percent; prices of industrial products, sensitive to global business activities, and those of agricultural, livestock and fisheries products, under the influence of exogenous variables, had remained in the mid-1 percent range; and public service charges as well as monthly housing rental payments and housing leasehold deposit prices had remained low, within the 1-percent range. Taking all these into consideration, the member estimated the current inflation pressures at the mid to upper 1 percent range, somewhat below the target, and expected inflation to near its target if global inflation rose and this led to an increase in industrial product prices. The member mentioned that this forecast presupposed that continuing domestic demand pressures, albeit weak, would be sustained. The member also forecast the output gap to remain positive, even if slightly, with exports continuing to grow, consumption maintaining the trend of improvement, facilities investment undergoing a modest adjustment from its high level, and construction investment continuing to go through a correction as expected.

The member noted the need to additionally examine how growth and the price path have been affected by financial imbalances, global economic recovery and structural characteristics of the economy. Regarding financial imbalances, the member expressed the view that the recent accommodative policy seemed to have caused an unsustainable supply of resources to real estate-related sectors as well as excessive construction investment, and added that accumulated inefficiency of resource allocation would slow down economic activities and weaken inflation pressures. Meanwhile, the member mentioned that Korea’s economic growth would benefit should the global economy continue to improve, for example through global trade channels, and this would lead to a rise in neutral interest rates. The member went on to state that even if the policy rate was maintained at its current level, there thus remained a possibility of an increase in the degree of monetary easing. The member also pointed out that due to structural problems, such as population aging, capital-intensive technological innovation, the rigid labor market and heightened barriers to entry, the inflation pressures suggested by the Phillips curve seemed to be substantially limited, and went on to argue that while a substantial part of this problem should be solved by structural reform, it was related to financial imbalances and thus was being reflected in monetary policy decision making.

The member presented the view that, with all the above-mentioned factors taken into consideration, there was a need for an interest rate hike in the medium term, but there also existed uncertainties regarding the price path, and went on to argue that thus it would be necessary to adjust the accommodative monetary policy stance while closely watching how Korea’s neutral interest rates move in line with changes in external conditions, conflicts between resolving financial imbalances and boosting domestic demand, as well as the effects of structural reform underway.

One member, meanwhile, expressed the view that it would be desirable to keep the Base Rate at its current level of 1.50 percent for the intermeeting period.

Looking at the economic situation since the January 18th Monetary Policy Board meeting, the member mentioned that concerns were raised about the possibility of consumer price inflation deviating from its target, as it had fallen to 1.0 percent in January, with economic sentiment seeming to have withered somewhat due mainly to stock price corrections and long-term interest rate hikes around the globe, the strengthening of US trade protectionist measures and a foreign automaker's decision to close a factory in Korea. However, the member's assessment was that the recent rise in global financial market volatility was attributable to the accelerating growth of the global economy, to growing inflation pressures and to the notion that major countries might normalize their monetary policies faster than originally expected. The member went on to forecast that, since Korea, as a small open economy heavily dependent on external economic conditions, would be affected by such global growth and price movements, the Korean economy would sustain strong growth at its potential level, as forecast in January. The member expected inflation to gradually near its target, in line with economic recovery and with a time lag, given that (i) the slowdown in consumer price inflation in January had stemmed largely from non-cyclical factors such as the freezing of insurance premiums and the base effect from agricultural, livestock and fisheries product prices, and that (ii) business cycle-sensitive price inflation had registered growth of a little under 2 percent.

With respect to the domestic financial and foreign exchange markets, the member's assessment was that the volatility of price variables had heightened significantly, but not enough to raise concerns about market unrest. However, as there remained controversy at home and abroad about whether stocks and some other assets were overvalued, and there remained a possibility of a further hike in market rates, the member argued that it would be necessary to closely monitor market conditions. The member also stated that, despite the slowing trend of household debt growth, bank lending to households continued to show faster growth than usual in January and credit loans were growing faster than home mortgage loans, and that it would be therefore necessary to remain on the alert and keep an eye on these developments in terms of financial stability risks.

Regarding the monetary policy decision in response, the member stated that, as future growth and inflation were expected to reach the potential and target levels, respectively, and there recently were growing expectations of major countries' monetary policy normalization, there still remained the need to further adjust the degree of monetary easing. The member added, however, that it would be advisable to hold the Base Rate at its current level of 1.50 percent this time, given the somewhat heightened uncertainty at home and abroad and the fact that more time was required for inflation to converge to the target. The member went on to argue that attention should be paid to prevent excessive concerns about downside risks from having negative self-fulfilling effects through a contraction in economic sentiment.

Another member expressed the view that it would be desirable to hold the Base Rate at its current level, since inflation pressures, currently requiring more consideration in policy decision-making, had not yet shown signs of materialization.

Looking at the real sector, the member's assessment was that the real economy had remained close to the growth path forecast in January, driven chiefly by faster recoveries of the global economy and trade. The member judged that factors contributing to global economic growth that would affect the Korean economy remained favorable overall although the US trade protectionist policies which were taking shape, as seen in the safeguard measures recently coming into effect, were considered as risk factors undermining the global trade environment. The member also assessed domestic demand as overall being on the path forecast in January, and evaluated that, while facilities investment in the IT sector had been brisk affected by strong semiconductor exports, the slowdown in construction investment had been establishing itself as a trend as expected and the January index had not yet exhibited a clear sign of faster recovery in private consumption. The member argued for the necessity of closely examining the movements of these real economic factors since February, when factors contributing to consumption growth, such as the Winter Olympic Games and the Lunar New Year holiday, were concentrated. In terms of supply, the member noted that, although change in the number of persons employed had improved somewhat, rising to 334,000 in January after having declined substantially to 257,000 at the previous year-end, this increase had been seen mostly in the agriculture, forestry and fishery and manufacturing sectors. With this in mind, the member pointed out that the causal chain whereby consumption-led domestic demand recovery sustained growth, which in turn led to employment improvement in the labor market, especially in the services sector, was insufficient.

In terms of inflation, meanwhile, the member noted that, with consumer price inflation registering 1.0 percent and core inflation 1.2 percent in January, continuing decline in inflation as in the second half of last year, had been already projected in the January forecast. However, the member assessed the degree of the slowdown as somewhat larger than expected, mentioning that factors at work included the effects of a government measure to restrain the price growth of regulated items, as well as the inflation conditions in which domestic demand and employment had not shown full-scale improvement.

Finally, concerning financial stability, the member mentioned that although there had not been any significant changes in the month-to-month trend of household debt and its slowdown was expected to continue, ongoing monitoring was needed of how the upward trend of real estate prices in some regions including Gangnam would affect household debt. The member also noted that stock market volatility had heightened in countries all around the world in line with the upsurge in US stock market volatility, and went on to state that, given that this phenomenon had been caused by a change in policy projections that the strengthening of the US growth momentum would speed up the US Fed's policy rate hikes, this phenomenon could be seen as being a result of normal capital flows and price corrections reflecting the shifting perceptions of the real economy.

One other member presented the view that it would be desirable to strengthen the monitoring of real economic trends, including those of business activities and inflation, as well as the increase in domestic and overseas financial market volatility, while holding the Base Rate at its current level of 1.50 percent for the intermeeting period.

The member noted that the domestic economy had sustained a modest recovery in line with the favorable global economy, but market sentiment had remained weak. The member expressed the view that private consumption was expected to recover in February, boosted largely by the Lunar New Year holiday, but more time for observation was needed to judge whether private consumption would continue to recover as originally forecast. The member also argued that closer examination was needed of changes in exports and employment situations in line chiefly with the recent foreign automaker issue, US trade policy and conditions in shipbuilding and other vulnerable industries, and that attention was needed to be paid to the effects of the government's real estate policy on construction investment and employment in the construction sector. The member mentioned that consumer price inflation had registered a mere 1.0 percent and core inflation had fallen to the lower 1 percent range in January, pointing to a possibility of greater downside risks than originally expected, and also noted a need to keep a watch on whether consumer price inflation would reach 1.5 percent in the first half of this year as forecast in January. The member judged that this year's growth rate was unlikely to deviate far from its potential level and the output gap was accordingly unlikely to turn significantly positive, and stressed that it would be necessary for the time being to maintain the accommodative monetary policy and continue to monitor the recovery in private consumption and improvement in employment conditions.

With respect to financial stability conditions, meanwhile, the member took the view that there was a growing need to cope appropriately with the recent rise in global financial market volatility, while at the same time paying attention to the accumulation of financial imbalances due to the accommodative monetary policy so far. The member noted that there were growing concerns that the stabilization of household debt might be affected negatively if the surge in real estate prices in some areas of Seoul were to spread to other regions, and also other concerns that household debt burdens might increase in line with a fall in housing prices in some regions that had seen a large increase in the housing supply. The member went on to argue that close examination in cooperation with the government was needed of real estate market conditions and the trend of household debt. The member also expressed the view that, in the lead-up to the March FOMC meeting where a policy rate hike was highly likely to take place, it would be necessary to closely monitor developments in the international financial markets and to examine how the heightening global financial market volatility would affect emerging market economies.

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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<u>Monetary Policy Decision</u>

☐ 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 acceleration in global economic growth has continued. Volatility in the global financial markets has increased substantially, with government bond yields rising and stock prices falling in line mainly with strengthening expectations of monetary policy normalizations in major countries. Looking ahead the Board sees global economic growth as likely to be affected by factors such as the paces of monetary policy normalization in major countries, the directions of the US government's economic policies, and the movements toward spreading trade protectionism.

☐ The Board judges that the solid trend of domestic economic growth has continued, as exports are sustaining their buoyancy and consumption and facilities investment have shown favorable movements, although construction investment has declined. The trend of improvement in employment conditions appears to have remained moderate, even though the extent of increase in the number of persons employed accelerated in January owing to temporary factors. Going forward the Board expects domestic economic growth to be generally consistent with the path projected in January. It anticipates that investment will slow, but that the trend of steady increase in consumption will continue, due in large part to improvements in household income conditions, and that exports will also sustain their favorable movements thanks to the buoyancy of the global economy.

☐ Consumer price inflation has slowed to the 1% level recently, in consequence mainly of declines in the prices of livestock products and of a reduction in the extent of increase in personal service fees. Core inflation (with food and energy product prices excluded from the CPI) has fallen to the low 1% range, and the rate of inflation expected by the general public has remained at the mid-2% level. Looking ahead it is forecast that consumer price inflation, after remaining in the low- to mid-1% range for some time, will pick up and gradually approach the target level from the second half of this year. Core inflation will also gradually rise.

☐ In the domestic financial markets the volatility of price variables has expanded considerably, in reflection of global financial market movements. Long-term market interest rates have risen, stock prices have declined and the Korean won-US dollar exchange rate has fallen, after having previously increased. Household lending has shown a higher rate of expansion than in past years, although the amount of its expansion has continued to decline. Housing sales prices have shown low rates of increase overall, but have risen faster in some parts of 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 it is forecast that inflationary pressures on the demand side will not be high for the time being, while the domestic economy is expected to continue its solid growth, the Board will maintain its accommodative monetary policy stance. In this process it will judge carefully whether it is necessary to adjust its accommodative monetary policy stance further, while closely checking future economic growth and inflation trends. It will also carefully monitor any changes in the monetary policies of major countries, conditions related to trade with major countries, the trend of increase in household debt, and geopolitical risks.