Minutes of the Monetary Policy Board Meeting

May 25, 2017

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(May 2017)

Ⅰ. Outline

1. Date of meeting: Thursday, May 25, 2017

2. Place : Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:

Lee, Juyeol, Chairman (Bank of Korea Governor)
Hahm, Joon-Ho
Jang, Byung Wha (Senior Deputy Governor)
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
Chang, Min, Director General of Research Department
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
Suh, Bong Gook, Director General of International Department
Lee, Seung Heon, Press Officer
Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
Lee, Dong Won, Head of MPB Administrative Support 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 ‘Recent Economic Developments’, ‘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 the global economic recovery had gained strength, with the growth momentum of the US economy recovering, and the trends of growth in the euro area, Japan and major emerging market economies all improving, boosted by global trade growth. Members also evaluated that **international financial markets** had remained stable, with the trend of rising stock prices continuing.

Concerning **the domestic economy**, members’ evaluation was that, while private consumption still marked time, the pace of growth had expanded, led by exports and investment.

With regard to **the domestic financial markets**, meanwhile, members mentioned that, despite North Korea-related geopolitical risks, inflows of foreign portfolio investment had continued, stock prices had risen and the Korean won-US dollar exchange rate had declined.

As to **prices**, members noted that consumer price inflation had reached its 2-percent target level in April and core inflation had fallen slightly to the mid-1-percent range.

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2) English versions of 'Recent Economic Developments' 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 the Bank of Korea should keep a close watch on changes in financial and economic conditions at home and abroad, and developments of domestic and overseas risk factors and their impacts, while maintaining the Base Rate at its current 1.25-percent level for the intermeeting period. First, the member anticipated that the economic growth rate would continue to be slightly above the April outlook. The member then presented the view that, although there were potential downside risks to growth, such as increased protectionism, monetary policy normalization by the US Federal Reserve, and geopolitical risks, growth would likely be supported by continuing global economic recovery, improvement in economic sentiment, and the new administration's expansionary fiscal policy. Second, the member noted that consumer price inflation had remained at the 2-percent target in April as well, and this trend would likely continue for the time being. The member commented that, although core inflation had fallen slightly in April, it was unlikely to deviate greatly from 1.7-percent April projection for the year as a whole. Third, concerning financial conditions, the member noted that, although household lending in April had grown faster than most years, the pace of growth had decelerated compared to 2016. The member then expressed the opinion that it was necessary to wait and see whether household lending growth would continue to slow, considering that the extent of the deceleration in household lending growth was not yet large, and that the stock of new apartments available for sale was expected to show solid growth. The member noted that, although the financial markets were showing stable movements overall, some had raised the concern that market participants' perceptions of risks were excessively optimistic, and against this backdrop, a small shock could greatly heighten price variable volatility. Accordingly, the member pointed out the need to keep a careful watch on developments such as political uncertainties in the US, and risks related to North Korea's nuclear tests. The member, meanwhile, noted the need for close examination of the impacts of the new administration's economic policy on the conditions for the conduct of monetary policy, such as macroeconomic and financial stability conditions. For instance, the member noted that an expansionary fiscal policy could work to reduce the need for the prolonged accommodative monetary policy stance to support economic recovery, and the government's household debt measures could reduce financial stability risk, thus providing more room for the Bank of Korea to flexibly conduct its monetary policy in line with changes in macroeconomic conditions.

Another member maintained the opinion presented at the previous meeting that, while keeping the Base Rate unchanged at its current 1.25-percent level for the intermeeting period, the Bank of Korea should keep a close eye on the extent to which the recent export recovery spreads to the Korean economy as a whole. The member noted that the trend of world economic recovery had been spreading since the second half of last year, and the gradual monetary policy normalization in the US was proceeding smoothly. Accordingly, the member saw that foreign demand and the relevant manufacturing production in the Korean economy were gradually increasing, led by semiconductors and petrochemical products. The member also noted that facilities investment was maintaining a faster-than-expected pace of recovery. In addition, the member judged that construction investment, which had increased rapidly for the past two years together with household debt, remained buoyant. The member then expressed the view that, if these recent economic movements continued, economic growth in Korea could exceed 2.6 percent, the forecast made in April by the Research Department of the Bank of Korea. However, the member noted that, since the recent positive changes in conditions had been led by some export industries, it was hard to say that spillover effects were spreading to the economy as a whole. The member pointed out that, while there had been a significant rebound in the consumer sentiment index, which had previously plunged from the fourth quarter of last year, consumption-related real indicators still remained weak, and such lackluster consumption demand had been acting as a constraint in reversing the trend of decline in underlying inflation, which had fallen to the mid-1% range for the past two years. Therefore, the member judged it desirable to maintain the current level of monetary policy accommodation to ensure that underlying inflation approaches the target level, as a recovery in foreign demand would be linked to consumption demand. The member noted that, in this process, it was necessary to keep a close watch on how the Korean macroeconomy would be affected in the future by the policy direction of the new administration, by any adjustment in the housing market, which is linked with household debt, and by changes in the intensity of China’s tourism restrictions on Korea.

One other member expressed the opinion that it would be desirable to keep the Base Rate unchanged from the current level of 1.25 percent for the intermeeting period. The member noted that uncertainties regarding estimates of the GDP and inflation gaps had increased since the global financial crisis, and added that, in the case of the GDP gap, it seemed difficult to estimate it via the same method used in the past, due to fast-changing global demand, the long-term downward trend of exports and resulting slowdown in domestic demand, and the degree of preparation for population aging. The member also assessed that the link between inflation and the GDP gap seemed to have weakened, with economic rent to certain industries and businesses firmly entrenched due to the concentration of consumption expenditures on them and due to their consequent monopolies. The member argued that, as mentioned above, when these criteria are unclear, it is necessary to examine the results of recent policies before assessing their appropriateness. The member mentioned that the accommodative policy stance had been maintained to achieve the inflation target, in order to narrow the GDP gap and provide time for restructuring. The member noted that such monetary accommodation had propelled economic activities in the short term but had not led to a rise in core inflation, and financial imbalances had increased steadily. With regard to financial instability, the member noted that a substantial part of household debt had been held by those with higher credit ratings and higher incomes, and on average all income quintile groups had maintained positive net financial assets, and therefore this seemed unlikely to spread to systemic risk. However, the member went on to point out that housing market conditions should be taken into consideration since a substantial part of household debt was from housing construction, and the gap between the increased demand in the housing market through liabilities and the actual final demand would determine the degree of financial instability. Meanwhile, the member expressed the view that, if the US Federal Reserve normalizes its interest rates with global demand picking up, this would boost exports, leading to upward adjustments of neutral interest rates, and if the spillover effects of exports are sufficient to increase consumption, responding with an interest rate hike could contain the buildup of financial instability without causing substantial changes to the current accommodative monetary policy stance. However, the member went on to state that more careful considerations of exports' spillover effects on domestic demand and of developments of financial instability were needed before adjusting the monetary policy stance, and expressed the view that it would be desirable to keep the Base Rate at its current level of 1.25 percent for the intermeeting period.

Meanwhile, one member expressed the opinion that it would be appropriate to keep the Base Rate unchanged in May. The member's assessment was that, in the real sector, exports had been stronger than expected with a boom in the global semiconductor industry, leading the strong growth in Korea's facilities investment, particularly in the semiconductor industry. Meanwhile, the member noted that private consumption had remained stagnant despite strong exports and facilities investment and improvements in the consumer sentiment index, and added that whether consumption would recover would be the key to forecasting how far this year's growth rate would exceed its April forecast of 2.6 percent. Next, with regard to inflation, the member noted that, although the real economy had been exceeding its forecast path, inflation had remained close to its original projection. The member went on to evaluate the price path for this year as thus far unlikely to greatly exceed its originally forecast path. However, the member mentioned that the need for a reexamination of the future path of consumer price inflation had grown significantly due to the sustained improvements in the real economy. In line with this, the member said that attention should be paid to whether and how much consumption, which had been stagnant, would recover, and to the global economic recovery and consequent developments of global price trends. Finally, in terms of financial stability, the member stated that, although having grown at a somewhat slower pace than in 2016, household debt maintained stronger growth than usual, and pointed out that there were concerns about the recent rapid growth of housing prices, particularly in Seoul and the surrounding area, and the substantial amount of stock of new apartments planned for sale. Going forward, the member noted that it would be necessary to pay attention to the possibility that expectations regarding the new government and improvements in economic sentiment could lead to instability in the housing market, while monitoring the future trends of household debt. Concerning FX swap and FX market stability, meanwhile, the member's assessment was that overall market conditions had remained normal and stable, with capital flows and prices reflecting real economic conditions, while the sustained geopolitical risk and the US Federal Reserve's rate hike stance had only limited effects on the flows of global investment funds into Korea and related price variables. Taking these points into overall consideration, the member 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 the real economy would grow further and the trends of the price path and household debt.

Another member pointed out a number of major considerations for the appropriate conduct of monetary policy. First, the domestic real economy had continued to show gradual improvement, boosted by sustained strong exports and facilities investment and better-than-expected housing market activities and construction investment, which together offset the sluggish recovery of private consumption. As corporate performances were improving and economic sentiment was picking up, the effects of strong exports on domestic demand, including private consumption and employment, were expected to take shape gradually, albeit in a limited manner. Second, with regard to prices, while personal service inflation had been on a gradual rise, growth in overall core inflation-related indexes had decelerated. This implied that, despite improvements in economic activities, demand-side inflationary pressures remained weak due to the limited spillover effects on inflation due to overall domestic demands, and accordingly a careful watch would be needed on future spillovers of prices and core inflation trends. Third, the slack in manufacturing production seemed to have improved, albeit gradually, with the average capacity utilization rate rebounding in line with the rate of growth in manufacturing production continuing to exceed the growth in its capacity. Meanwhile, the overall slack in the labor market worsened somewhat, as the unemployment and time gaps widened, which more than offset the narrowing of the participation gap in accordance with a year-on-year decrease in the number of potential job seekers. Fourth, with regard to financial stability conditions, short-term and long-term market rates and corporate bond spreads showed stable movements, while foreign portfolio investment inflows continued with the sustained risk appetite in the international financial markets. However, the member pointed out that it would be necessary to prepare for the risk of a shift from the low volatility regime of major asset prices to a higher volatility regime, as risk aversion sentiment against emerging market assets could strengthen again if market expectations of the Trump administration's policies weaken and the US Fed begins to discuss in earnest plans to reduce its asset holdings. In addition, despite the government measures to strengthen supervision, household debt remained on a steep rise. Since construction activities were likely to remain favorable for the time being and the stock of new apartments available for sale was rising, it would be difficult to rule out the possibility of a continued increase in the household debt-to-income ratio. 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 unchanged from the current level of 1.25 percent for the intermeeting period.

One other member expressed the opinion that it would be advisable to hold the Base Rate at its current level at this time. The member's assessment was that the growth rate for this year was likely to exceed the April forecast of 2.6 percent, as the global economy and trade had continued to show recovery and, looking at the domestic economy, facilities and construction investment and exports had shown favorable movements. The member also mentioned that there existed upside risks, including expectations of the new government's economic policy and a possibility that China would ease its trade restrictions. In addition, the member pointed out that consumer price inflation had risen by 1.9 percent year-on-year in April as well, remaining near its 2-percent target. However, the member argued that the current accommodative monetary policy stance should be maintained, as more time seemed to be needed for private consumption to recover, the output gap remained negative, and consumer price inflation was unlikely to exceed its target for the time being. Furthermore, the member pointed out the need to bear in mind that downside risks could arise due to destabilizing factors, such as moves to strengthen trade protectionism and geopolitical risks, and the member also stated that there was a need to closely monitor and analyze the global economy. The member expressed the view that, although the domestic financial markets had remained stable overall and foreign bond and portfolio investment had continued to flow in, it would be necessary to constantly examine the effects of the US Fed’s rate hikes and geopolitical risks. Meanwhile, the member stressed that, while household debt growth seemed to have slowed gradually due chiefly to the government’s risk management efforts, the trends of housing markets, including the market for new apartments, should be closely monitored.

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, with for example the trend of rising stock prices continuing. 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 political uncertainties in major countries.

☐ The Board judges that the trend of domestic economic growth has expanded, as exports and investment have improved although the pace of increase in consumption has remained weak. On the employment front, the number of persons employed has continued to rise significantly year-on-year, although the unemployment rate has also risen as job search activities have increased. Going forward, domestic economic growth is expected to be slightly above the path projected in April. The Board judges that consumption will likely continue its modest trend of growth, but that the trends of improvement in exports and investment should expand compared to the April forecasts.

☐ Consumer price inflation has continued at the 2% target level, in line mainly with increases in the prices of petroleum and agricultural, livestock and fisheries products. Core inflation (with food and energy product prices excluded from the CPI) has fallen slightly to 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 not diverge greatly from the April projection (1.9%). Core inflation appears likely to show a level in the mid- to upper-1% range.

☐ In the domestic financial markets the trend of stability has continued, with stock prices rising and the volatility of long-term market interest rates showing a low level, in reflection of global financial market movements. After having risen, owing in part to the emergence of geopolitical risks, the Korean won-US dollar exchange rate has fallen as political uncertainties domestically and abroad have eased. Household lending has sustained its high rate of increase exceeding past years’ levels, although the amount of increase has shown signs of lessening, centering around banks. Housing sales prices have exhibited slight upward movements, 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 trend of domestic economic growth is likely to expand somewhat, the Board will maintain its stance of monetary policy accommodation. In this process it will closely monitor the progress of monetary policy normalization by the US Federal Reserve, conditions related to trade with major countries, the directions of the new government's economic policies, the trend of increase in household debt, and geopolitical risks.