Minutes of the Monetary Policy Board Meeting

August 11, 2016

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(August 2016)

Ⅰ. Outline

1. Date of meeting: Thursday, August 11, 2016

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
Chae, Sun Byoung, Director General of Reserve Management Group
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
Sohn, Wook, Director of BOK Economic Research Institute
Lee, Seung Heon, Press Officer
Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
Park, Cheol 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:

With regard to **the global economy**, members’ assessment was that the US economy had shown robust growth with its employment indicators improving, that although markets had quickly steadied after the Brexit shock, the trend of recovery in the euro area had weakened due mainly to sluggish exports, and that the Chinese economy had maintained its growth, led by consumption. As to **international financial markets**, some members evaluated that global stock prices had risen substantially, lifted by expectations for additional monetary easing by major countries, while international oil prices had fallen sharply on weakened expectations for resolving the oversupply issue.

Concerning **the domestic economy**, most members assessed that, while the sluggishness of exports had continued, domestic demand had improved modestly, with consumption and construction investment picking up. However, uncertainties surrounding the growth path were judged to be increasing.

With regard to **the domestic financial markets**, meanwhile, members noted that stock prices had risen and the won-dollar rate had plunged, as expectations for monetary policy easing in major countries and improved global risk appetite induced inflows of foreign portfolio investment. Furthermore, they judged long-term market interest rates to show slight fluctuations at very low levels.

As to **prices**, members noted that consumer price inflation had fallen from 0.8% the month before to 0.7%, in line with a slowdown in service fee growth as the effects of public transport fare hikes dissipated. They also commented that core inflation had fallen slightly month-on-month to 1.6 percent.

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 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 its current level for the intermeeting period, as domestic and overseas economic conditions had not changed much from the previous month and economic growth had been holding to the existing forecast path. The member also presented the view that, as the Korean economic structure had been rebalanced toward domestic demand and services and away from exports and manufacturing, attention should be paid to the interpretation of various economic indicators as well. The member stressed that, for example, since there had been a shift in the focus of investment demand from volume to knowledge production, attention should be directed toward improvement in investment quality, rather than the amount invested. The member also emphasized that it was more important at this juncture to focus on appropriate changes and innovations in goods, including manufactured and service goods, rather than on growth in manufacturing production. The member judged that, given the structural changes in the Korean economy, reduced productivity, population aging, and monetary easing in major advanced countries, it was necessary to maintain a low interest rate stance for the time being. The member, however, noted that, since the ultimate goals of monetary policy were to achieve potential growth and maintain inflation at the target level by revitalizing consumption and investment while securing financial stability, much thought should continue to be given to the most effective ways to harmonize macroprudential and monetary policy tools to achieve these goals.

Another member expressed the opinion that, while maintaining the Base Rate at the current 1.25% level for the intermeeting period, it would be best to keep a careful watch on changes in risks to the macroeconomy and financial stability. The member stressed that, taking into overall consideration domestic and overseas economic conditions, special attention should be paid to two points in the conduct of monetary policy. First, uncertainties surrounding economic growth and the price path were very high. Second, despite measures to improve the quality of household debt, risks to financial stability were increasing as the amount of such debt continued to sustain strong growth. The member also presented the opinion that a careful watch should be kept on growth in household debt, developments in asset markets, progress in corporate restructuring, monetary policy changes in major countries and protectionist stirrings.

Another member pointed out a number of major considerations for the appropriate conduct of monetary policy. First, the member stated that risk factors in the second half, such as corporate restructuring, the anti-solicitation law and a possible resumption of rate hikes by the US Federal Reserve, had already been reflected in the July forecasts, and therefore it was too soon to predict that growth would depart significantly from the forecast path. Second, the member argued that the downside risks to the price path for the second half were increasing, due mainly to the falls in oil prices and the strengthening of the won against the dollar. Third, the member pointed out that there had been no significant improvements with respect to the slack in the manufacturing sector, which had increased substantially in line with weakening production resulting chiefly from the worsening export slump, and went on to state that overall labor market slack continued to improve in July but potential labor market instability had increased. Based on an overall examination of labor market slack and the trends in inflation and the real economy, the member argued that while keeping the Base Rate at its current level of 1.25 percent for the intermeeting period, it would be necessary to examine the spillover effects of the previous Base Rate cut and observe how things progressed with the supplementary budget while keeping a careful watch on the developments and related effects of the above-mentioned factors, which are giving rise to uncertainties at home and abroad. The member added that, as the Base Rate had decreased to its lowest level in history, various risk factors were becoming apparent in terms of financial stability, including increased household lending by non-bank financial institutions and the possibility of greater risk-taking incentives for financial institutions, and accordingly close monitoring was required and preemptive action should be taken as necessary.

Meanwhile, another member expressed the opinion that it would be appropriate to keep the Base Rate unchanged for the intermeeting period, given that construction investment and consumption had led economic growth during the second quarter of this year, that the economy in July had not deviated far from the forecast, and that headline inflation was expected to converge to the medium-term inflation target in the first half of next year. First, looking at business activities, the member stated that considering the fast growth in housing construction since the second half of last year, construction investment, particularly in housing construction, would likely experience corrections, which the member judged as desirable. Furthermore, the member evaluated consumption as having shown gradual improvement if the effects of the slowdown in automobile sales resulting from the termination of individual consumption tax cuts in June were excluded. In terms of propensities for consumption, meanwhile, the member expressed the view that the average propensity to consume (APC) had declined since 2011, and that attention needed to be paid to the fact that the APC had declined much more among homeowners compared to non-homeowners during the past five years. The member also assessed that this phenomenon was likely attributable either to the fall in the values of assets held by homeowners in line with the declines in housing prices from 2011 to 2013 or to the growth in their precautionary savings. The member went on to state that, given that housing price rises prior to 2010 were not seen as a bubble, that the delinquency rate of household loans remained low, and that the recent sharp increase in household loans had been supported by the borrowing capacities of households, the increased precautionary savings of senior homeowners might have had a major impact on the decline in their APC, and their longer residual life expectancies might have acted as a factor accelerating this decline. In terms of financial stability, the member put forward the view that, since household lending had grown rapidly since 2014, a careful watch on the soundness of the household sector balance sheet was imperative in order to seek the optimal mix of monetary, fiscal and macroprudential policies from the second half of this year. Finally, in terms of inflation, the member assessed that, although July's headline inflation stood at 0.7 percent due to low oil prices and exchange rates, the headline inflation forecast of nearly 2 percent for the first half of next year was still valid, with the effects of oil price declines fading away and inflation rising gradually.

One other member expressed the opinion that it would be necessary to keep an eye on future macroeconomic developments while maintaining the Base Rate at its current level of 1.25 percent. The member noted that, while no significant change had been seen with respect to anemic global growth, markets had steadied quickly after the Brexit shock, and this had helped ease the risk aversion of global finance capital, leading to a resumption of capital flows into Korea and other EMEs. On the domestic side, the member's assessment was that, although exports had remained sluggish, construction investment had continued to pick up and consumption indicators in May and June had also been relatively favorable. However, the member judged that with housing prices stabilizing in line with the sharp increase in the housing supply, the driving force behind the currently favorable construction investment was likely to gradually weaken. Moreover, the member assessed that the recovery of consumption indicators was largely attributable to the one-off factor of individual consumption tax cuts on automobiles, and thus it did not necessarily imply a further continuation of consumption recovery. The member also called attention to the fact that a tangible recovery of exports was unlikely in the short term, and that a careful watch needed to be kept on macroeconomic uncertainties resulting from the restructuring of vulnerable sectors and on the growing possibility that inflation might fall somewhat short of the original forecast path. In this regard, the member considered it appropriate to monitor future macroeconomic developments while holding the Base Rate at its current level for the intermeeting period. The member also stressed that an improvement in the soundness of household debt was a necessary condition for a more flexible monetary policy.

Another member pointed to the need to hold the Base Rate at its current level for the intermeeting period and observe the progress of macroeconomic policy for a little while longer. The member mentioned that a preemptive Base Rate cut had been made in June this year and that the government’s supplementary budget combined with accommodative monetary policy would likely affect consumer and investor sentiment positively. The member went on to state that in-depth analyses should continue to be made of various risk factors, including the household debt issue, the stability of the financial markets amid changes in domestic and external conditions, the effects of corporate restructuring and the profitability of financial institutions. With regard to the household debt issue in particular, the member argued that it was necessary to closely examine the effects of the Base Rate cut on the growth in household debt, and also look at the shift to household loans issued by non-bank financial institutions rather than banks following implementation of a guideline to encourage banks to strengthen their mortgage application screening, along with the related effects and policy responses. In addition, the member put forward the view that, although the international financial market and the Korean FX market had stabilized following the Brexit decision, it would be necessary to monitor the FX market, in which excessive unidirectional expectations seemed to have formed, and the member also stated that the possibility that changed circumstances could lead to another US Federal Reserve rate hike should not be overlooked. In addition, the member mentioned that attention must be paid to the effects of corporate restructuring on the profitability of financial institutions and on the financial markets, and also to the possibility of a bond market crunch, while examining how continuously low interest rates have affected the profitability and investment patterns of financial institutions. Finally, the member stressed that the central bank should pay careful attention to the risk factors mentioned above while maintaining its monetary easing policy.

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 Bank of Korea considers that the trend of economic recovery in the US has been sustained and that the Chinese economy has maintained its moderate pace of growth. However, the improvements in the euro area have weakened. The Bank of Korea forecasts that, while the global economy will maintain its weak recovery going forward, it will be affected by factors including changes in the monetary policies of major countries, the uncertainties related to Britain’s exit from the European Union, and economic conditions in emerging market countries.

☐ Looking at the Korean economy, exports have remained on their trend of decline but domestic demand activities including consumption appear to have continued their albeit moderate improvements. The sentiments of economic agents have meanwhile improved slightly. On the employment front, as the number of persons employed has increased, the employment-to-population ratio rose and the unemployment rate fell in July compared to those in July of last year. The Bank of Korea forecasts that the domestic economy will sustain its trend of modest growth going forward, owing chiefly to expansionary macroeconomic policies, but in view of economic conditions domestically and abroad judges the uncertainties surrounding the growth path to be high.

☐ Consumer price inflation fell from 0.8% the month before to 0.7% in July, in line mainly with a slowdown in the rate of increase in service fees. Core inflation excluding agricultural and petroleum product prices also declined to 1.6%, from 1.7% in June. In the housing market, sales and leasehold deposit prices showed low rates of increase. Looking ahead the Bank of Korea forecasts that consumer price inflation will remain at a low level for the time being, and then gradually rise as the effects of the low oil prices diminish.

☐ In the domestic financial markets since July, stock prices have risen and the Korean won has appreciated to a large extent against the US dollar, as foreigners' securities investment funds have shown net inflows owing chiefly to expectations of monetary policy easing in major countries. The won has meanwhile appreciated against the Japanese yen, in line with the won's relative strengthening. Long-term market interest rates have shown slight fluctuations at low levels. Household lending has sustained a trend of substantial increase at a level exceeding that of recent years, led by mortgage loans.

☐ Looking ahead, the Bank of Korea will conduct monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation approaches the target level over a medium-term horizon, while paying attention to financial stability. In this process it will closely monitor the trend of increase in household debt, any changes in the monetary policies of major countries, and the progress of corporate restructuring.