Minutes of the Monetary Policy Board Meeting

January 13, 2017

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(January 2017)

Ⅰ. Outline

1. Date of meeting: Friday, January 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
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 strong growth, the euro area had maintained its gradual improvement, and the Chinese economy had sustained its stable growth. Members also evaluated that **international financial markets** had been stable overall, with Treasury bond yields exhibiting slower growth and stock prices rising, particularly in advanced countries, as the anxiety that had followed the US presidential election and US Fed's rate hike eased. However, members assessed that the Chinese yuan and some EME currencies had weakened significantly and remained highly volatile.

Concerning **the domestic economy**, members' evaluation was that domestic demand had shown weaker improvement due to the sluggishness of facilities investment and manufacturing production, which had more than offset the recovery in exports.

With regard to **the domestic financial markets**, meanwhile, members mentioned that long-term market interest rates had fallen and stock prices had risen with the stabilization of the international financial markets, but the Korean won-US dollar exchange rate had remained highly volatile and bank household lending had declined.

As to **prices**, members noted that consumer price inflation had risen to a level of around 1½ percent in the fourth quarter with international oil and agricultural product prices increasing, and that core inflation had stood at a little above the 1½ percent level.

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 pointed out a number of major considerations for the appropriate conduct of monetary policy. First, with regard to the domestic real economy, the member stated that, although economic sentiment had withered due to the heightened uncertainties at home and abroad, domestic demand had sustained gradual growth and exports had shown improvement, but uncertainties surrounding the future growth path had increased even further. Second, the member stated that consumer price inflation had accelerated in the fourth quarter of last year, boosted largely by hikes in oil and agricultural product prices, while core inflation had slowed due mainly to a slower pace of growth in industrial product prices. The member also noted that consumer price inflation was expected to accelerate, and inflation pressures were forecast to weaken somewhat toward the end of the year with the lapse of supply-side factors. Third, the member argued that substantial slack in the manufacturing sector had improved somewhat, as demand-side pressures from facilities investment had rebounded and the average capacity utilization ratio had risen with the sluggishness in the manufacturing sector easing somewhat, but that improvement in the slack in the labor force had continued to slow with the time gap, including the time-related underemployed, increasing slightly. In terms of financial conditions, the member stated that, as surges in market interest rates after the US presidential election had eased, the spread between long- and short-term yields and corporate bond credit spreads had narrowed somewhat, foreign equity investment had shifted to a net inflow and outflows of bond investment had stabilized, but the potential instability of securities fund flows had heightened due to the narrowing of the gap between domestic and overseas interest rates. With regard to household credit, the member noted that non-bank lending had maintained strong growth and therefore a careful watch should be kept on the effects of stronger prudential regulations on the non-banking sector. Concerning corporate credit, meanwhile, the downturn phase of the corporate credit cycle had continued owing to the sharp decreases at both large corporations and SMEs and to sustained net corporate bond redemptions.

Based on these considerations, the member stated that it should be borne in mind that, although there seemed to be a need for additional monetary easing in macroeconomic terms, domestic and external uncertainties and financial stability risks had also increased further, and at this point in time keeping the Base Rate at its current level was considered to have larger benefits than adjusting it, in consideration of the following points. First, a substantial part of the negative output gap had been attributable to a shortage of external demand and was therefore difficult to address through Base Rate adjustments, and the global manufacturing sector and the terms of trade were showing signs of recovery and their future trends needed to be monitored. In addition, the member emphasized that global reflationary pressures had been transmitted to the domestic economy and also that consumer price inflation was very likely to near its target this year. In addition, the member noted that, with the Base Rate below the neutral interest rate, the tightening of financial conditions following a rise in long-term interest rates was not yet at a concerning level, and that long-term interest rates, having been lowered excessively due chiefly to the effects of advanced countries' quantitative easing, had been normalized to some extent, which would have the positive effects of curbing the exposure of the financial system to real estate risks and the risk of further debt leveraging.

In this regard, the member argued that it would be desirable to keep the Base Rate at its current level of 1.25 percent for the intermeeting period and retain policy space, while closely examining how developments of domestic and external risk factors would affect the future growth and price paths.

Another member expressed the view that it would be appropriate to keep the Base Rate at its current level of 1.25 percent for the intermeeting period. The member mentioned that, in the current circumstances, the growth rate was forecast to reach a level of around 2½ percent and consumer price inflation to near its target of 2 percent this year, but continued attention needed to be paid to how the Korean economy would be affected by changes in the real and financial markets following US rate hikes. The member assessed the US rate hikes begun two years ago as having strengthened the synchronization of medium-term interest rates between Korea and the US and caused the intersection of the yield curves to move toward the short-term one, and as a result, foreign investment funds had been redeemed, adding to capital outflows. With these points taken into consideration, the member expected that, in the case of US rate hikes led by US economic improvement, the US yield curve would move upward and the Korean yield curve would steepen up to the point of medium-term rates, contributing to some easing of the inefficient distribution of funds that had threatened financial stability. The member also pointed out that if a recovery of exports works to improve the real economy, this would cause the neutral interest rate to rise, which would not bring about significant changes under the current monetary easing policy. The member also took the view that, while exports were picking up in accordance with the global economic recovery, it would be necessary to promote structural reform rapidly and rearrange medium- and long-term strategies to create an environment in which households can shift from leveraged spending to income-based spending, and also to continue to prepare for population ageing through overseas investment. The member assessed current global downside risks as somewhat large and mentioned that if these risks materialize, policies should be determined in consideration of the channels through which the risks would be transmitted to the Korean economy and also of what shape they would take. The member went on to stress that, amid global economic uncertainties and the need to pay attention to stability in the Korean financial markets, Korea's monetary policy should focus on achieving the inflation target, the nominal anchor for the Korean economy.

One other member expressed the opinion that, while maintaining the Base Rate at its current level for the intermeeting period, the Bank of Korea should keep a close watch on downside risks to the macroeconomy. The member noted that the world economy was sustaining its moderate recovery, and there had recently been signs of reflation. The member went on to comment that, accordingly, exports were shifting to an increase with export prices in Korea increasing, and consumer price inflation was gradually accelerating. The member also noted that the steep rises in market interest rates had eased, and foreign exchange supply and demand conditions remained stable. Against this backdrop, the member assessed that some positive movements had been observed. For instance, with the capacity utilization ratio recovering, particularly in the automobile industry, manufacturing production showed a relatively substantial rebound in November, and demand for semiconductors increased. The member, however, stated the need for paying further attention to downside risks to the macroeconomy overall. The member commented that, in contrast to the rebound in the manufacturing industry, the pace of growth in services production had slowed. The member also expected growth in the construction sector to slow, as the real estate market was stabilizing and the rapid increases in the housing supply would end this year. The member anticipated that a tangible recovery of the overall growth of the Korean economy was unlikely, despite a partial rebound in exports. The member then noted that, with such conditions making it difficult to be optimistic about the overall economy, underlying inflation was unlikely to converge toward the 2% target. Concerning household debt, the member expected it to continue to increase substantially in 2017 as well, given the already signed collective loans and the low interest rate environment. The member, however, expressed the opinion that, if the real estate market remained stable, the pace of increase in household debt was likely to slow gradually. Taking these factors into overall consideration, the member judged it desirable to maintain the Base Rate at its current level for the month, and to keep a close watch on economic developments and overall Korean macroeconomic trends, such as changes in household debt growth and the pace of the housing market slowdown. The member also presented the view that it was also desirable to maintain channels of communication with the fiscal authorities to prevent fiscal policy from tightening, while continuing cooperation with the financial authorities to ease the rapid increase in household debt.

One member, meanwhile, took the view that it would be appropriate to keep the Base Rate at its current level for the intermeeting period. With respect to the real economy, the member noted that, as for production indicators, the index of all industry production had risen after declining for two consecutive months, and the drastic decline in the average capacity utilization ratio in the manufacturing sector had stopped, while as for demand indicators, construction work value had shifted to an increase. The member noted that exports, in particular, had continued to grow in December after beginning to increase in November, and this was mainly attributable to industrial factors, such as a recovery of world semiconductor market demand. The member positively evaluated this point, saying that exports had become more likely to maintain their upward trend going forward. In terms of prices, the member forecast that consumer price inflation would converge closely to the 2% target level around the third quarter, influenced by a rebound in oil prices. The member, however, stressed the need to pay attention to whether inflation would remain at the target level after the second half of this year, when the base-period effect from oil price declines would disappear. Concerning financial stability, the member noted that household debt had showed signs of stabilization for the first time, with bank household lending growth decreasing considerably in December. The member viewed household debt as likely to stabilize this year, considering that household debt growth was largely linked with the growth of housing prices. The member, meanwhile, stated that, although concerns had been raised about capital outflows and the worsening of Korea's external soundness due to an inversion of Treasury bond yields in Korea and the US since the second half of 2016, the possibility that the inversion would trigger financial instability was low, given that there were no signs of abnormal capital flows going beyond normal market mechanisms. The member commented that, in overall consideration of the aforementioned assessments, the negative inflation and GDP gaps had both widened somewhat, which suggested that circumstances might call for a more accommodative monetary policy. The member, however, expressed the view that it was desirable to make the Base Rate decision in a more cautious manner, for three reasons. First, if the US economic recovery leads to sustained increases in the US policy rate and market interest rates, monetary policy easing in Korea could expand automatically. Second, uncertainties surrounding the estimation of the GDP gap in Korea have been higher than ever. Third, although household debt is expected to stabilize, it is necessary to check actual household debt developments.

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 forecast that, although growth in private consumption and construction investment would slow, the Korean economy would maintain its modest growth thanks to improvements in exports and facilities investment. The member, however, presented the opinion that the Bank of Korea should closely monitor and respond to the possible materialization of downside risk factors, such as growing household debt burdens, a contraction in economic sentiment stemming from political uncertainties, and a weakening of global trade growth following strengthened trade protectionism. The member also assessed that the Korean economy should speed up its restructuring efforts, support economic recovery with accommodative fiscal and monetary policies, and cope with several risk factors at the same time. The member went on to stress that, in order for these efforts to succeed, it was very important to support job creation through economic stimulus. Meanwhile, with respect to household debt, the member noted that effects were expected from several government measures. The member then went on to express the opinion that the Bank of Korea, together with the government, should continuously and closely monitor household debt and real estate market conditions. The member also took the opinion that, although the international financial markets had been relatively stable, vigilance needed to be maintained concerning market developments in emerging market economies and capital flow conditions in Korea going forward. The member noted that it was necessary to make active efforts to maintain Korea's international credit standing, which set Korea apart from other emerging market economies.

One other member expressed the opinion that, while maintaining the Base Rate at its current level for the intermeeting period, 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 in particular.

In making such judgment, the member gave important consideration to macroeconomic and financial conditions, as follows. First, with respect to economic conditions, although economic growth seemed to have slowed somewhat in the fourth quarter of 2016, the pace of growth was still consistent with the Bank of Korea's October 2016 outlook. Concerning the growth outlook for 2017, there was great uncertainty as to how the actual trend of growth would play out due to various potential domestic and overseas upside and downside risks, and stated that a gradually higher trend of growth was expected in the second half of 2017 thanks primarily to improved exports, led by the global economic recovery. Next, looking at price conditions, consumer price inflation had increased to the mid- to upper-1% level in the fourth quarter of 2016 and was expected to converge closely to the 2% inflation target going forward. Consumer price inflation as presented in the January economic outlook stood at 1.8%, and upside and downside risks to the future inflation path were assessed to be neutral in view of conditions at home and abroad. In the financial markets, price volatility had fallen and the volume of foreign bond investment outflows had decreased with international financial markets becoming stable. The USD/KRW rate, however, had showed wide fluctuation in January, influenced for instance by changes in expectations related to US monetary policy. 5-year Treasury bond yields in Korea and the US had been inverted since mid-December 2016, following 10-year Treasury bond yields. Since there were several potential risk factors in the domestic and overseas financial markets related to the direction of the new US administration's economic policy, the pace of the Fed's monetary policy normalization, the movements of the Chinese yuan's exchange rate, and domestic and overseas economic conditions, the member thought that the volatilities of price variables and capital flows could increase again going forward. Meanwhile, although bank household lending had grown at a slower pace of late, the member found it difficult at this juncture to judge whether this represented a trend, since it was also affected by one-off factors.

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 trend of global economic recovery has expanded somewhat, led by the US and some emerging market economies. Global financial market volatility has diminished, as the trends of rising government bond rates in major countries have subsided and stock prices have risen. Looking ahead the Board judges that the global economic recovery will be affected by factors such as the directions of the new US government's economic policies, the pace of monetary policy normalization by the US Federal Reserve, and the movements toward spreading trade protectionism.

☐ In Korea, the slump in exports has eased but the Board judges the pace of domestic economic growth to have slowed somewhat, as the recovery in domestic demand activities has weakened. Employment conditions have been somewhat sluggish, with the number of persons employed having continued to decline in the manufacturing sector while its trend of increase in the service sector has slowed as well. The Board sees the domestic economy as likely to continue its trend of moderate growth going forward, and forecasts a rate of GDP growth for this year in the mid-2% range. The trend of recovery in domestic demand activities is expected to be limited, due to deteriorations in economic sentiment for example, but exports will likely improve thanks chiefly to the global economic recovery.

☐ Consumer price inflation has risen to the mid-1% level, in line with the easing of downward price pressures on the supply side. Core inflation (excluding food & energy product prices from the CPI) has been in the mid- to upper-1% range, while the rate of inflation expected by the general public has remained at the mid-2% level. Looking ahead the Board forecasts that consumer price inflation will gradually rise to near the 2% target level by around the middle of 2017, on the effects mainly of the increases in international oil prices, and that core inflation will maintain a level in the mid- to upper-1% range.

☐ In the domestic financial markets, the volatilities of both stock prices and long-term market interest rates have subsided somewhat as the global financial market has stabilized. The Korean won-US dollar exchange rate has continued its uptrend seen since October of last year, in line with the strengthening of the US dollar globally. The upward trends of housing sales prices have slowed, centering around Seoul and its surrounding areas. Household lending has continued its substantial increase, but the amount of increase in that by banks has shown signs of lessening recently.

☐ Looking ahead, the Board 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. As the inflationary pressures on the demand side are not expected to be high, given the moderate pace of domestic economic growth, the Board will maintain its stance of monetary policy accommodation. In this process it will closely monitor the uncertainties in domestic and external conditions and their effects, the progress of monetary policy normalization by the US Federal Reserve, and the trend of increase in household debt.