Minutes of the Monetary Policy Board Meeting

October 19, 2017

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[3)]
(October 2017)

Ⅰ. Outline

1. Date of meeting: Thursday, October 19, 2017

2. Place : Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:

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

4. Monetary Policy Board members absent: none

5. Participants:

   Ha, Sung, Auditor
   Kim, Minho, Deputy Governor
   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
   Chang, Min, Director General of Research Department
   Sohn, Wook, Director of BOK Economic Research Institute
   Park, Jongseok, Director General of Monetary Policy Department
   Lee, Hwan Seok, Director General of Financial Markets Department
   Lee, Seung Heon, Director General of International Department
   Seong, Byung Hee, Press Officer
   Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
   Lee, Dong Won, Head of MPB Team

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3) 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[4]

After briefings by staff on 'Economic Outlook for 2017 and 2018', 'FX and International Finance' and 'Financial Market Trends', the discussions of the Monetary Policy Board (MPB) members covered the following areas:

Members' assessment was that **the global economy** had been continuing to recover steadily and global trade had been increasing. Members also evaluated that the favorable conditions in **international financial markets** would continue for the time being, but FX and asset market volatility was likely to increase in line largely with changes in major countries' monetary policies.

Concerning **the domestic economy**, members' evaluation was that exports and facilities investment had been showing growth, boosted chiefly by the favorable performances of the semiconductor and IT sectors, and consumption had maintained a modest recovery. The outlook for economic growth had been upgraded in reflection of the global trade recovery and the buoyancy of the semiconductor sector.

Members noted that **prices** were forecast to approach the inflation target, but a little more observation was needed since there had been no clear inflationary pressures.

As to **the domestic financial markets**, members mentioned that the markets had been stable overall despite geopolitical risks. Members also noted that, although household debt growth was likely to slow down, there were concerns about the accumulation of financial imbalances.

4) English versions of 'Economic Outlook for 2017 and 2018' 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:

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

One member expressed the opinion that it would be desirable to raise the Base Rate from the current 1.25 percent to 1.5 percent this month.

The member noted that global trade and major countries' investment and industrial production had been expanding as the cyclical recovery of the global economy took root. The member mentioned that, led by the buoyancy of the IT sector, exports and facilities investment would likely contribute significantly to Korea's economic growth, and this trend was expected to continue next year. The member also forecast solid quantitative growth in non-IT exports and a gradual increase in related trickle-down effects on domestic demand. With regard to construction investment, the member's assessment was that its growth rate had peaked but that it would increase slowly until next year. The member also noted that, although private sector consumption had exhibited a downward trend, the supplementary budget for this year and fiscal expansion during next year would likely boost economic activities in macroeconomic terms.

The member then projected that the aforementioned external environment, trickle-down effects and expansionary fiscal and monetary policies would help GDP growth reach 3 percent this year and close to 3 percent next year as well. The member also noted that, with the Korean economy's potential growth rate continuing to decline, the output gap was estimated to have already turned positive, and core inflation was therefore expected to near its target in the medium term.

In terms of financial stability, the member mentioned that household debt had increased to exceed household disposable income, reducing household consumption capacity and dragging down the potential growth rate. The member added that a large part of the negative side effects of the accommodative monetary policy stance on the real economy had been the inefficient allocation of resources, as seen in flows of capital being excessively concentrated in the real estate market.

The member assessed that Korea’s economic growth was already exceeding its potential level and thus the medium-term direction of the economy appeared to be set. The member went on to state that, in order to maximize policy effectiveness, it would be appropriate to weaken the accommodative monetary policy stance somewhat, in alignment with other macroprudential policies, thereby eliminating the aforementioned side effects and achieving a balance between monetary policy and expansionary fiscal policy in the future. The member took the view that, considering the need to preemptively adjust monetary policy in a situation where heightened North Korea risk had not produced any noticeable shocks on the real economy, this seemed the right time to adjust the degree of monetary easing. The member added, however, that steady and fundamental structural reform was needed in order for the Korean economy to shift from a cyclical to a broader recovery.

Another member presented the view that, in overall consideration of real economic and inflation trends and financial stability conditions, it would be appropriate to hold the Base Rate at its current level of 1.25 percent for the intermeeting period. The member then made a number of points in connection with this opinion.

First, looking at the domestic real economy, goods exports and facilities investment had grown faster than expected, as the buoyancy of the semiconductor sector more than offset the North Korea risk, construction investment experienced a relatively modest adjustment, and the growth path for the second half of this year moved slightly upward, affected by the execution of the supplementary budget. As a result, the output gap was estimated to have become less negative. External demand was expected to remain favorable next year as well, led by economic recoveries in both advanced and emerging market countries. However, since construction and facilities investment was likely to go through larger adjustments and, despite increased fiscal expenditures, private consumption was forecast to show modest recovery, medium-term growth was expected to be generally consistent with the pace of potential growth.

Second, with regard to inflation, consumer price inflation and core inflation had shown opposing trends; consumer price inflation had recently exceeded its target level, boosted chiefly by the base-period effect of electricity tariffs and a rise in agricultural product prices, while core inflation had been showing a modest decline since the second half of last year. Consumer price inflation was expected to fall back below its target, with the effects of regulations and one-off supply-side factors fading away toward the end of the year, and core inflation was forecast to narrow the gap with consumer price inflation, with downward pressures eased somewhat in line with the modest economic recovery.

Third, the overall slack in the manufacturing sector had not shown significant improvement, as the average capacity utilization ratio fell again, with an increase in manufacturing production seen mostly in some export items such as IT products. The slack had continued to increase in the labor market as well, with the participation gap showing a sharp increase year-on-year as in the previous month, more than offsetting a slight decline in the unemployment gap.

Fourth, in terms of financial stability, the Korean financial markets had shown favorable resilience despite the North Korea risk, led chiefly by improved corporate performances. In the credit market, growth in household lending by both banks and non-banks had slowed slightly, owing largely to a drop in the housing transaction volume since the implementation of housing market stabilization measures. However, this slowdown in household debt growth seemed unlikely to continue, as group loans to purchasers of new pre-sale apartments, loans for leasehold deposits, and credit loans were likely to grow steadily, and housing prices in the Seoul metropolitan area were rising again.

One other member presented the view that it would be desirable to hold the Base Rate at its current level of 1.25 percent for the intermeeting period, while raising it at an appropriate time in the not-distant future and reducing the degree of monetary easing gradually.

First, looking at recent economic conditions, the member noted that the GDP growth forecast for this year, as projected by the Bank of Korea Research Department, was revised upward to 3.0 percent from 2.8 percent, while the forecast for next year remained unchanged at 2.9 percent. These figures showed that the domestic economy was maintaining sound growth despite heightened domestic and overseas uncertainties, and that the output gap, which had remained slightly negative, would turn positive soon. The member commented that, by sector, with exports remaining buoyant, the consumption recovery was expected to expand. The member also stated that, although facilities and construction investment would likely show slower growth, the growth level would be still high.

Looking at price conditions, the member mentioned that, since the flattening of the Phillips curve, which implied a weaker linkage between growth and prices, had been witnessed across the world of late, Korea also was unlikely to see a large increase in underlying demand-side inflationary pressures. Core inflation, however, was likely to shift to a modest upward trend soon, and annual consumer price inflation for this year and the next was also forecast to show steady movements at the 2-percent target level. In addition, since the relation between growth and prices could be nonlinear depending upon the output gap, the possibility of stronger-than-expected demand-side inflationary pressures could not be ruled out.

The member noted that the financial and foreign exchange markets in Korea remained stable overall, despite factors such as North Korea-related risk and changes in expectations related to domestic and overseas monetary policies. The member also commented that there was a possibility of a further slowdown of household debt growth as the government's household debt-related policy measures were implemented going forward, but significant concerns remained about the build-up of financial imbalances.

In terms of the monetary policy response to these issues, the member saw that, given the economic outlooks for this year and the next, and the risk of household debt overhang in line for instance with persistent low interest rates, the conditions were in place to reduce the degree of monetary easing gradually. The member then expressed the view, however, that, since North Korea-related risk was still having negative impacts on economic sentiment, it would be better to determine the time for a Base Rate hike after further monitoring of the development of this risk.

One member, meanwhile, expressed the view that it would be desirable to maintain the Base Rate at the current level for the intermeeting period, while examining whether the recent trend of economic recovery would lead to a gradual expansion in underlying inflationary pressures.

The member noted that, as the world economy continued its steady recovery, led by advanced economies, demand for Korean exports had been showing strong growth. The member went on to argue that, although the effect of the Chuseok holiday should be taken into account, both export prices and volume had grown more rapidly than expected in the third quarter, thus easing the remaining concerns about the persistence of the export recovery. The member added that facilities investment was showing faster-than-expected growth, while the correction in construction investment was proceeding at a modest pace and therefore was unlikely to constrain macroeconomic recovery. The member also stated that the negative spillovers of heightened geopolitical risk related to North Korea had not yet reached a serious level.

The member, however, commented that no clear sign of recovery had been detected in the labor market as labor-intensive domestic demand services industries still remained lackluster, although the recent economic recovery was heavily dependent upon the sharp increases in exports and facilities investment of some capital-intensive manufacturing industries, including semiconductors. The member judged that such labor market conditions had been constraining the recovery of private consumption, and noted that, as a result, inflationary pressures were still running below the target at the mid-1 percent range. The member, meanwhile, noted that household debt had soared for the past two to three years but was beginning to show slower growth since the August 2 measures, and the housing market was also showing overall stability, except for some apartment complexes being reconstructed.

The member judged it advisable to maintain the current level of accommodative monetary policy for the time being in consideration of domestic economic conditions, which were lagging somewhat behind the global economic cycle. The member also found it desirable to keep a close watch on whether the foundation for economic recovery would spread to domestic demand, leading to further inflationary pressures, while examining whether risk related to household debt, which had increased sharply in line with the boom in the real estate market, would gradually diminish.

Another member presented the view that it would be desirable to keep the Base Rate at its current 1.25 percent level for the intermeeting period.

The member saw that the world economy and trade had continued their overall trends of improvement, which had led the strong growth of the Korean economy. The member noted that, although facilities investment was showing robustness in line with the sharp increase in exports, there were concerns about the deterioration in service exports, which was partly due to the drop in the number of Chinese tourists visiting Korea. The member commented that private consumption was continuing its modest recovery trend, thanks for example to execution of the supplementary budget. The member also stated that, although the extent of deceleration in construction investment was not as large as expected considering the implementation of the August 2 measures to stabilize the housing market, there was a possibility that the deceleration would continue next year due to a reduction in the government's SOC budget.

The member noted that the Bank of Korea Research Department had revised the growth forecast for this year upward to 3.0 percent, while maintaining next year's forecast at 2.9 percent. It also expected consumer price inflation to rise to around 2 percent for this year and 1.8 percent for next year. If these economic outlooks materialized, the output gap would likely turn positive from the second half of next year. The member asserted that there still was a need for additional examination of the impacts of various uncertainties, such as North Korea-related risk, a deterioration in trade conditions stemming for instance from Korea's deployment of THAAD, and the household debt problem. On the domestic demand front, the member noted that it was also necessary to further monitor the trend of recovery in private consumption, the degree of sluggishness in construction investment and their impacts on economic activity and employment. Particularly, considering the recent low level of core inflation, there was a need to check if the price path would approach the 2-percent target next year as expected.

Based on the economic outlook over a one- to two-year horizon, the member judged that the time to address the buildup of financial imbalances stemming from accommodative monetary policy was approaching. The member, however, stated that a premature change in the monetary policy stance would be just as economically burdensome as a belated resolution of financial imbalances. The member thus found it necessary to maintain the current accommodative monetary policy stance for the time being, while waiting to see whether economic activity would show solid improvement.

With respect to financial stability, the member expected household debt growth to continue to slow, helped by the government's real estate measures. The member, however, expressed concern about the sustained upward trend in apartment prices in some areas. The member argued that, although the financial and foreign exchange markets remained stable overall, if North Korea-related risk continues, attention should be paid to its possible effects on capital outflows. The member went on to call for close monitoring of the impacts of the possibility of a year-end policy rate hike by the US Fed on emerging market economies.

One other member expressed the opinion that the Base Rate should be kept unchanged for the intermeeting period, but it could be necessary to raise the Base Rate soon in overall consideration of the following factors.

On the real economic front, the member noted that, with the growth trend in advanced economies such as the US and the EU improving, the global trade recovery was spreading to advanced economies from emerging market economies. The member stated that this had led to double-digit growth in exports in Korea, led by semiconductors, thus causing an expansion in the growth of related facilities investment. The member commented that there was an increased possibility that the shift to an increase in world trade volume represented a trend, and thus the upswings in exports and facilities investment in Korea, which were currently limited to semiconductors, would likely expand to other major export items. This was assessed as an important determinant for the growth path of the Korean economy in the second half of this year and next year.

On the domestic side, the member asserted that, although construction investment was slowing, consumption was estimated to continue modest growth, even despite remaining uncertainties. The member judged that the Bank of Korea Research Department's upward revision to the economic growth outlook for this year from 2.8 to 3.0 percent had been made in consideration of these factors.

With respect to inflation, the member stated that, in contrast with real economic activity, there had not been any particular change in inflation, and thus the Bank of Korea Research Department's consumer price inflation projections for this year and the next were 2.0 and 1.8 percent, respectively, neither of which deviated greatly from the previous forecasts. The member noted that there had been no clear materialization of inflationary pressures, although the output gap was expected to turn positive. The member went on to argue that this point had the following implications.

The member noted that the factors that had caused a decline in the real neutral interest rate, including the world economic slump and a decline in households' propensity to consume, were gradually disappearing, and so if the Base Rate were held at the current level, the degree of monetary easing was highly likely to be automatically increased. The member thus found it necessary to raise the Base Rate to prevent any negative side effects from this. The member, however, commented that the lack of clarity with respect to inflationary pressures, and the likelihood of the real neutral interest rate increasing at a modest pace, implied that the monetary policy stance should also be shifted at a gradual pace going forward.

On the financial stability front, the member judged that the government's August policy measures to stabilize household debt had taken effect, as household lending was stabilizing, with banks' household lending growth slowing significantly in September. The member, however, asserted that there still was concern in the international financial markets, with the CDS premium rising steadily, albeit slightly, largely owing to geopolitical risks from North Korea's nuclear tests.

Taking these points into overall consideration, the member judged that there was a growing need for a hike in the Base Rate, due mainly to the stronger global trade recovery and the sustained moderate recovery in private consumption. The member, however, did not find it desirable to shift monetary policy without providing sufficient notice, as inflationary pressures had not materialized and there still remained geopolitical risks stemming for instance from the nuclear tests. The member thus noted that it was necessary to keep the Base Rate unchanged for the intermeeting period, while confirming the materialization of the most recent economic outlook and raising the Base Rate soon.

Ⅳ. Results of Deliberation on Monetary Policy Directions

Incorporating the outcome of their earlier discussions, a statement was compiled reflecting the views of the majority.

However, Mr. Lee, Il Houng expressed clear opposition to the idea of holding the Base Rate at its current level, and argued for a 0.25 percentage point raise.

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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 the trend of rising stock prices continuing for example, although government bond rates have risen in line mainly with changes in expectations related to the monetary policy normalizations of major countries. Looking ahead the Board sees the global economic recovery 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 and facilities investment have sustained their high rates of increase and private consumption has also picked up moderately. Employment conditions appear to be sustaining their trend of moderate improvement, although the pace of increase in the number of persons employed has slowed somewhat owing to temporary factors. Going forward it is forecast that the domestic economy will maintain its solid trend of growth. The GDP growth rate for this year is expected to be higher than the July projection (2.8%), and that for next year also to show its potential level. Exports seem likely to sustain their buoyancy, thanks largely to the global economic recovery, and domestic demand activities will also recover moderately due to the expansion in fiscal spending for instance.

□ Consumer price inflation has continued at the 2% level, in line mainly with increases in the prices of agricultural, livestock and fisheries products. Core inflation (with food and energy product prices excluded from the CPI) has stayed in the mid-1% range, and the rate of inflation expected by the general public at the mid-2% level. Looking ahead the Board expects that consumer price inflation will be in the upper-1% range for some time, in line chiefly with the disappearance of the base effect from the reduction of electricity fees last year, and then gradually approach the target level. Core inflation will meanwhile remain in the mid-1% range for the time being, before gradually rising from next year.

□ In the domestic financial markets price variable volatility has expanded. Long-term market interest rates have risen and the Korean won-US dollar exchange rate fluctuated, due mainly to changes in expectations concerning monetary policies at home and abroad and to geopolitical risks. Stock prices have risen, on expectations of improvements in corporate performances for example. Household lending has sustained its higher rate of increase than in past years, but the amount of increase has lessened somewhat. Although housing sales prices have shown signs of rebounding slightly in some parts of Seoul and its surrounding areas, their uptrend has in general slowed since the government's announcement of housing market stabilization measures.

☐ 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 forecast to not be high for the time being, while the domestic economy is expected to continue its solid growth, the Board will maintain its accommodative policy stance while closely checking future economic growth and inflation trends. In this process 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.