Minutes of the Monetary Policy Board Meeting

August 31, 2017

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]
(August 2017)

Ⅰ. Outline

1. Date of meeting: Thursday, August 31, 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

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
   Suh, Bong Gook, Director General of Reserve Management Group
   Chang, Min, Director General of Research Department
   Sohn, Wook, Director of BOK Economic Research Institute
   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
   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

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 recovery of the global economy had generally been sustained, and world trade had also been showing improvement. Members also evaluated that in the **international financial markets**, volatility in price variables had increased, influenced for instance by geopolitical risks and changes in expectations related to the monetary policies of major countries.

Concerning **the domestic economy**, members’ evaluation was that, although exports had remained buoyant and consumption had maintained its trend of modest increase, it was necessary to be mindful of uncertainties, including geopolitical risks. The trend of economic growth was generally not expected to deviate far from the path forecast last July.

With regard to **prices**, meanwhile, members noted that consumer price inflation had risen to the 2-percent level, boosted mainly by increases in the prices of agricultural, livestock and fisheries products and by the base effect from the reduction of electricity fees last year, while core inflation had remained in the 1-percent range.

As to **the domestic financial markets**, members mentioned that price variable volatility had expanded, mostly due to increases in geopolitical risks. Members noted that attention should be paid to the accumulation of financial imbalances, as household lending had continued to sustain its high rate of increase. Further observation was also needed with respect to the effects of the government’s policy measures related to real estate and household debt.

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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 it would be necessary to keep the Base Rate at its current level this month, while analyzing uncertainties related to economic activities and prices, and evaluating the possibility of increased burdens from financial stability issues.

The member noted that international trade had continued to show a clear trend of recovery with the global economy continuing to improve. However, in contrast to such favorable global economic conditions, uncertainties surrounding the domestic economy had expanded since the release of the July outlook, due mainly to a deterioration in trade conditions with China stemming from a conflict with China related to Korea’s decision to deploy THAAD, and risks related to North Korea. The member commented that, although exports had been continuing to show a solid recovery, factors such as the deterioration in trade conditions with China had been working to increase the negative impacts on both goods and services exports, thus requiring ongoing monitoring of trade with China on an item-by-item basis. The member then expressed the view that, in the job market as well, factors such as the decline in the number of Chinese tourists were likely to limit the employment expansion in the services sector, and a relatively large-scale correction in the construction market would inevitably have negative impacts on employment in the construction sector.

The member noted that, in general, economic growth and prices in the second half of this year would likely be consistent with their July forecasts, but various upside and downside risks had been growing of late. The member thus expressed the need to keep a close watch on whether the output gap could be closed earlier or later than originally forecast, and stated that consideration should be given to economic conditions not only of next year, but also of the following years.

Meanwhile, the member's assessment was that, in terms of financial stability, concerns about recent household debt growth and possible capital outflows in line with mounting geopolitical risks had grown since the July meeting. The member pointed out that, although the government's policy measures were likely to slow the increase in household debt, their effects might appear slowly, due mainly to an expected increase in housing availability. The member then stressed that the sharp increase in geopolitical risks related to North Korea called for stepped-up monitoring of foreign capital flows and foreign exchange market trends. The member also emphasized the need to continuously examine the impacts of expected changes in major country monetary policies on EME markets.

Another member presented the view that it would be desirable to hold the Base Rate at its current level in August, in overall consideration of a number of points.

First, the member noted that although the real economy was showing export-oriented and facilities investment-led growth, the buoyancy of exports had been confined to the IT industry, mainly in semiconductors, and since such strength was attributable to increases in unit export prices rather than growth in export volume, it was not likely to stimulate much additional production in related industries. The member stated that with the expected slowdown in construction having been offset by the contribution of facilities investment to growth, household consumption had been continuing its modest trend of growth at the lower-2 percent range. The member noted that, although there still remained uncertainties about improvements in exports and consumption, the Bank of Korea's economic growth rate forecast of 2.8 percent was neutral, and considering the secular decline in the potential growth rate, the output gap seemed to be close to zero.

With respect to prices, the member expressed the view that the increase in consumer price inflation to the lower-2 percent range had been led by temporary increases in prices of agricultural, livestock and fisheries products, but core inflation was still running at the mid-1 percent range, and it was expected to run somewhat below the 2-percent target this year. The member then addressed the pattern of inflation running below the target despite an accommodative monetary policy in which the Base Rate was set lower than the neutral interest rate, pointing to two possible causes of this phenomenon. The first was a structural factor where the neutral interest rate suggested by the potential growth rate on the demand side was much lower than that on the supply side. The second factor was a possibility that the actual inflation expectations of economic agents had fallen substantially. The member stated that both reasons seemed to be affected not only by domestic factors, but also by global factors.

The member noted that the output gap was close to zero and consumer price inflation was nearing 2 percent, which suggested a heightened need for narrowing the degree of monetary easing. The member, however, commented that the causes of low inflation had not yet been resolved. The member thus found it necessary to exercise caution in choosing the timing for adjusting the Base Rate, in order to carry out monetary policy in a manner consistent with the management of inflation expectations.

With respect to financial stability, the member observed that household debt accumulation had increased the exposure of households to real estate price fluctuation risks, and thus there was an increased possibility that a drop in real estate prices could trigger macro risks, such as a decline in household consumption and contraction in the real economy, through the medium of debt. To stabilize household debt, the member judged it desirable to respond with micro-policy instruments first, considering that the overheating of real estate markets differed depending upon the region and its characteristics. With respect to the August 2 measures focused on preventing overheating in the new housing market and curbing the related buildup of mortgage lending, the member judged them as appropriate considering the rapid increase in household debt, particularly in the new housing market and smaller-sized apartment transaction market in the Seoul Metropolitan region over the past two years. The member's assessment was that, in this regard, the signs of a slowdown in construction investment were positive from a financial stability perspective.

One other member presented the view that it would be appropriate to hold the Base Rate at its current level of 1.25 percent for the intermeeting period.

The member noted that the global economy had maintained its trend of recovery and the global trade volume had been improving slightly. The member also mentioned that the US Fed would likely normalize its monetary policy despite uncertainties regarding whether inflation could draw close to its target, and suggested that this was because the US labor market was strengthening and there were concerns about negative side effects from prolonged low interest rates.

The member pointed out that Korea's export volume had rebounded along with the global trade volume and had then started to show slower growth again. Korea's financial markets had been generally stabilizing, while the FX market and foreign investment had been responding sensitively to geopolitical risks. The recovery of the domestic economy had not yet solidified, despite the sustained construction investment and the recently favorable facilities investment. Considering the effects of the supplementary budget, however, the member did not expect the economy to deviate far from the path forecast last July, and core inflation had remained within the mid-1 percent range while consumer price inflation had slightly exceeded its target.

Core inflation was low despite monetary easing, a fact that the member attributed to a number of factors, including the structural weakening of Korea's exports and domestic demand due to changing global demand for trade goods, geopolitical factors, population aging, the slowdown in household income growth and increased savings in line with the surging household debt and income imbalances. With all of this taken into consideration, the member assessed that the current real economic growth rate was not falling short of its potential.

The member stated that in this situation, accommodative monetary policy had not led to a change in the medium-term trend of growth and inflation, and financial imbalances had been swelling excessively. In addition, a substantial portion of household debt had flowed into the housing market, suggesting that there was a strong likelihood of oversupply in the housing market from the end of this year to the year after next, a period when the number of newly completed apartments would rise sharply. In light of this, leverage did not seem to have been used effectively.

Considering this situation, the member judged that the Bank of Korea would have to adjust its monetary policy stance in line with monetary policy normalization by advanced countries, but the situation was not sufficiently urgent to justify a change in course amid steadily escalating geopolitical risks. More time was needed to observe developments of the global economy and financial markets, movements of household debt, and the effects of the recent government measures to stabilize the housing market.

One member, meanwhile, expressed the opinion that it would be appropriate to hold the Base Rate at its current level of 1.25 percent for the intermeeting period.

The member stated that the domestic economy seemed to have sustained a strong recovery and was expected to continue to improve as forecast in July this year — although geopolitical risks related to North Korea and the changing relationship with China could act as negative factors, the global economic recovery and the government’s supplementary budget implementation were expected to serve as positive factors.

Turning to inflation, the member noted that consumer price inflation had risen to slightly exceed its target of 2 percent, but this was expected to be short-lived owing to a lack of demand-side pressures driven by economic recovery.

The member pointed out that the volatility of price variables in the financial and foreign exchange markets had increased, affected mainly by the North Korea risk and changes in expectations of major country monetary policies. The North Korea risk, in particular, had caused foreign portfolio investment to shift to a net outflow recently, despite Korea’s favorable external soundness. Although these changes were expected to have only limited impacts, the member urged that a close watch should be kept on how the high uncertainties of the North Korea risk would affect the financial and foreign exchange markets as well as the real economy. With regard to household lending, its growth was expected to slow, affected by the government measures to stabilize the real estate market and to curb household debt growth, but there remained deep concerns about the buildup of financial imbalances, including the sharp rise in household lending and the already high household debt ratio.

Next, regarding how monetary policy should respond to this situation, the member pointed out that reducing the degree of monetary easing could be considered in economic and financial stability terms. Given the recently heightened uncertainty surrounding the growth path, the fact that further easing was not urgently needed in terms of inflation, and the effects of the government measures to curb household debt, however, the member stated that it would be desirable to keep the Base Rate at its current level this time. Meanwhile, while closely examining developments of domestic and overseas economic conditions, attention should be paid to the degree and pace of monetary easing so as to maintain price and financial stability over a medium-term horizon.

One member assessed that, in overall consideration of financial stability conditions and the real economic and inflation trends, it was advisable to keep the Base Rate unchanged from the current level of 1.25 percent for the intermeeting period.

First, with regard to the real economy, the member stated that, although construction and facilities investment had gone through a gradual correction, the economy was estimated to have sustained growth generally consistent with the pace of potential growth, with exports maintaining a favorable recovery and private consumption continuing to recover gradually. The growth path for the second half of the year was not expected to deviate far from the path forecast last July, but upside and downside risks surrounding it were seen to have increased somewhat from a month earlier.

Second, looking at inflation, the member mentioned that consumer price inflation had risen slightly above its target, affected chiefly by a rise in prices of agricultural, livestock and fisheries products and by the effects of temporary electricity tariff cuts last year. Toward the fourth quarter of this year, however, inflation was expected to decline slightly to around the target level, with the base-period effects from temporary supply shocks and regulations fading away. Core inflation, meanwhile, had remained flat below 2 percent, and despite the recent economic recovery, demand-side inflation pressures were not seen to be significantly increasing in terms of various indicators such as core PCEPI and core inflation with regulated prices excluded.

Third, with respect to the manufacturing sector, the member stated that the average capacity utilization ratio had rebounded and the sales to inventory ratio had remained low, but since export volumes and production had not exhibited solidly based growth, more time was needed to observe developments of the slack in the production sector. In the labor market, the slack in the labor force had continued to increase, with growth in the time gap more than offsetting the lack of substantial changes in the unemployment and participation gaps.

Fourth, looking at financial stability conditions, the member noted that stock prices had fallen and market interest rate volatility had increased, due to the emergence of the North Korea risk and also to the net outflows of foreign portfolio investment, particularly of short-term funds such as those held by banks and global funds. In the credit market, meanwhile, corporate lending had not exhibited substantial growth despite the economic recovery, while household lending had maintained strong growth exceeding the nominal growth rate, led mainly by a rise in housing transactions and demand for lending prior to the implementation of stronger regulations.

Another member expressed the opinion that, taking into consideration the recent overall macroeconomic conditions, it would be desirable to keep the Base Rate unchanged from the current level of 1.25 percent for the intermeeting period.

First, the member stated that the relatively fast pace of economic recovery during the first quarter of the year seemed to have slowed somewhat since the second quarter. Although global trade growth had been accelerating, Korea’s export volume growth had been faltering since the second quarter. The worsening conflicts with China, in particular, had been having increasing negative impacts on Korea’s exports to China, and China’s continued travel regulations were weighing heavily on Korea’s services production growth. Meanwhile, despite a hike in the Consumer Expectation Index, indicators related to real-sector consumption had continued to exhibit only modest improvements, while construction investment was entering a correction phase after having surged over the last couple of years.

Going forward, the member found it difficult to expect faster economic recovery for the time being, considering the negative effects of conflicts with China and the slowing trend of construction investment. The government's supplementary budget was likely to expand aggregate demand, but its effects were difficult to predict, and geopolitical risks related to North Korea were recently increasing.

The member noted that consumer price inflation was exceeding 2 percent, influenced by hikes in prices of some agricultural, livestock and fisheries products and the electricity tariff cuts last year, but with one-off factors excluded, there were no signs of an increase in demand-side inflation pressures. Housing prices had also surged in Seoul and some other regions, but on a nationwide average basis, their growth remained at a level similar to consumer price inflation.

The member also noted that household debt had continued to grow at a worrying pace, but considering the effects of the real estate measures announced on August 2 this year and the announcements of additional household debt measures, it seemed necessary to keep an eye on developments of related indicators. In this regard, the member found it advisable to maintain the current monetary easing stance so as to support the uptrend in prices and help achieve the inflation target, while keeping a close watch on whether household debt growth would make a soft-landing.

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. Global financial market volatility has meanwhile increased somewhat, due mainly to changes in expectations related to the monetary policies of major countries and to geopolitical risks. 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, the movements toward spreading trade protectionism, and geopolitical risks.

☐ The Board judges that the solid trend of domestic economic growth has continued, as exports have sustained their high rate of increase and consumption has recovered moderately although investment has temporarily slowed. Employment conditions have improved moderately, with the employment-to-population ratio having risen as the trend of year-on-year increase in the number of persons employed has expanded, centering around the manufacturing sector. Going forward domestic economic growth is expected to be generally in accord with the path projected in July. The Board judges that consumption will likely continue its moderate trend of recovery, due to the improvement in employment condition and to the execution of a supplementary budget. Facilities investment will likely be above the levels forecast in July, due to expanded IT industry investment. Exports are expected to fall below the July projection, however, as service exports have slowed owing to a decline in the number of foreign tourists, while construction investment will probably also be less than forecast, in consequence of real estate market stability.

☐ Consumer price inflation has risen to the lower-2% level, in line mainly with increases in the prices of agricultural, livestock and fisheries products and with the base effect from the reduction of electricity fees last year. 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 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 show the level (1.9%) projected in July. Core inflation appears likely to be in the mid- to upper-1% range.

☐ In the domestic financial markets price variable volatility has expanded, with stock prices, the Korean won-US dollar exchange rate and long-term market interest rates having fluctuated to considerable extents, in line with increases in geopolitical risks. Household lending has sustained its high rate of increase exceeding past years' levels, although the amount of year-on-year increase has lessened somewhat. In the housing market, the trend of rising sales prices has 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 not expected to be high although the domestic economy is expected to show solid growth, the Board will maintain its stance of monetary policy accommodation. In this process it will closely 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.