Minutes of the Monetary Policy Board Meeting

August 31, 2018

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(August 2018)

Ⅰ. Outline

1. Date of meeting: Friday, August 31, 2018

2. Place : Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:

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

4. Monetary Policy Board members absent: none

5. Participants:

   Lim, Hyung Joon, Deputy Governor
   Huh, Jin Ho, Deputy Governor
   Shin, Ho Soon, Deputy Governor
   Ryoo, Sang Dai, Deputy Governor
   Chung, Kyuil, Deputy Governor
   Suh, Bong Gook, Director General of Reserve Management Group
   Lee, Hwan Seok, Director General of Research Department
   Sohn, Wook, Director of BOK Economic Research Institute
   Shin, Woon, Director General of Financial Stability Department
   Park, Jongseok, Director General of Monetary Policy Department
   Lee, Sang Hyeong, Director General of Financial Markets Department
   Lee, Seung Heon, Director General of International Department
   Kim, Hyun Kee, Press Officer
   Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
   Sung, Kwang Jin, 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:

Members evaluated that, despite slower growth in emerging market economies (EMEs), **the global economy** had continued to show strong growth, led for instance by the buoyancy of the US economy. Members also mentioned that volatility could heighten in **the global financial markets**, as the US-China trade dispute continued, concerns about spreading financial unrest in Turkey and some other EMEs had grown, and the monetary policy normalization of the US Federal Reserve was likely to continue.

Concerning **the domestic economy**, members’ evaluation was that it was continuing to grow at its potential level with the steady growth of private consumption and exports, although facilities and construction investment had been going through corrections. Members, however, noted that it was necessary to keep a close eye on heightened downside risks stemming for instance from the US-China trade dispute, financial unrest in EMEs, and worsening employment sluggishness.

Concerning **inflation**, members noted that consumer price inflation had remained in the mid-1% range, and core inflation had slowed to the 1% range. Members expected the price path to be lowered slightly from the July path forecast.

As to **the domestic financial markets**, members assessed that they had shown a stable trend overall, despite expanded volatility in the international financial markets due mainly to the US-China trade dispute

2) English versions of “Recent Economic Developments” and “Financial Market Trends” are posted on the Bank of Korea website.

and financial unrest in EMEs. Members saw that, although household lending growth had been slowing, attention should be paid to the continued strong growth in sole proprietor loans.

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 domestic and international financial and economic environments, it would be desirable to keep the Base Rate at its current level of 1.50 percent for the intermeeting period.

One member took the view that it would be desirable to raise the Base Rate from the current 1.50 percent to 1.75 percent at this meeting.

The member noted that monetary policy had to be considered within the framework of the global economic outlook, effective utilization of limited policy space, and harmony with other macroeconomic policies, with the goal of minimizing volatility and the width of the inflation gap from a medium- to long-term perspective. First, the member assessed that with respect to the economic situation in Korea, growth seemed to be anchored at the upper-2% range, lower than in the past. The member noted that the potential growth path in Korea still seemed to be going through a correction due to ongoing structural changes, such as a decline in the domestic labor force and a shift into a new global trade order, emphasizing that this could not be easily distinguished from cyclical fluctuations. In this regard, the member saw that the Korean economy was likely to be more influenced by cyclical fluctuations of the global economy, rather than by domestic factors. On the domestic front, the member expected downward pressures on consumption stemming from sluggish employment and income polarization would be offset to some extent by solid growth in total wages. The member, however, presented the view that, on the external front, if the global economy, which had peaked, entered into an economic downturn, this, together with effects from a reduction in dollar liquidity, could weigh cyclically on growth.

Next, with respect to the inflation gap and financial imbalances, the member noted that (i) the price index with administered items excluded, which was a better indicator of demand pressures than the CPI, had already been fluctuating at around its target for months; (ii) inflation expectations among the general public had also remained at the mid-2% range; and (iii) the forecasts of corporations (an important link with the real economy) for consumer prices and for the rate of increase in their product prices seemed to show movements similar to these expectations. The member also noted that the GDP gap was forecast to be positive, albeit slightly, and inflation in OECD countries were projected to be revised upward. Against this backdrop, the member expected that, absent any additional shock, consumer price inflation would gradually near its target. The member, however, emphasized that if a judgement is made to maintain domestic demand pressures, which are slightly above potential growth, in consideration only of the current inflation gap, the resulting deepened financial imbalances would lead to the widening of the mid-term inflation gap due to difficulties in responding to cyclical downward pressures, and more policy space and time would be needed to narrow the inflation gap. The member saw that financial imbalances had been continuing to build up under the current easing stance, pointing out that non-bank sole proprietor loans had been on the rise, that real estate investment was not leading to sustainable income, and that Korea’s household leverage compared to income was very high internationally and had been continuing to increase.

In this regard, the member’s judgment was that, from the perspective of policy coordination, it would be desirable to improve the efficiency of resource distribution and to maintain appropriate incentives for investment by slightly reducing monetary policy easing at this point in time when demand pressures were driven by an expansionary fiscal policy to provide income support for vulnerable groups.

Another member expressed the view that it would be desirable to hold the Base Rate at its current level of 1.50 percent for the intermeeting period, while continuing to observe future economic developments.

First, looking at recent economic conditions in consideration of changes in circumstances since the previous MPB meeting, the member saw that, on the growth front, the economy was judged to maintain growth at its potential level thanks to steady growth in consumption and exports, despite corrections in facilities and construction investment. The member also noted that economic sentiment had weakened considerably, due to growing concerns about downside risks stemming for instance from the US-China trade dispute, financial unrest in EMEs and the deepened employment sluggishness. The member, however, commented that economic agents seemed to have responded somewhat excessively given the coexistence of upside risks, such as fiscal expansion to support job creation and income, government policy measures including a cut in the individual consumption tax, and major large corporations' plans to expand their investment. The member went on to express the view that the excessive weakening of sentiment might amplify adverse effects through a self-realization process, and thus a careful watch needed to be kept in this regard.

In terms of prices, the member expected the price path to be lowered slightly from the July forecast. The member, however, assessed this to be largely attributable not to demand factors but to policy factors, which include the government's welfare policy measures, such as an increase in public heath care benefit coverage, an expansion of free school meals, and temporary cuts in the individual consumption tax and electricity fees. Accordingly, the member anticipated that, although inflation would approach the target somewhat more slowly and reach it somewhat later, the upward movement of inflation toward the target was likely to remain unchanged. The member, meanwhile, presented the opinion that if inflation diverged from its target due to reasons other than demand factors, it would be desirable to further increase the degree of flexibility in operating monetary policy under the inflation targeting regime.

In terms of domestic and international financial and foreign exchange markets, the member's assessment was that these markets had generally remained stable, despite heightened volatility in the international financial markets due mainly to the US-China trade dispute and financial unrest in EMEs. In particular, the member commented that growth of monetary aggregates such as M2 and Lf had been on the rise, as funding to corporations had expanded thanks to improved sales performances and the easing of credit risk aversion, and as household and sole proprietor loans had also been increasing steadily. In addition, the member stressed the need for paying attention to the possibility that these financial easing conditions could work to build up the risk of financial imbalances, as could be seen in the recent growth in credit related to real estate and the run-up in real estate prices in some parts of the Seoul Metropolitan region.

Concerning the monetary policy response, the member's assessment was that, taking current growth, inflation and financial conditions into overall consideration, it was necessary to somewhat reduce the degree of monetary easing from the current level through an increase in the Base Rate, focusing on the risk of financial imbalances rather than the risk of macroeconomic imbalances. The member, however, judged that, given the high uncertainties over external conditions such as the US-China trade dispute and financial unrest in EMEs, and the significant weakening of economic sentiment stemming for instance from more sluggish-than-expected employment indicators in July, a raise in the Base rate at this meeting could have unintended negative effects.

One other member presented the view that it would be desirable to hold the Base Rate at its current level of 1.50 percent for the intermeeting period while examining closely the real economic trend as seen in economic activities, employment and inflation and also constantly monitoring financial stability conditions.

The member evaluated that the global economy had maintained overall growth, boosted chiefly by the strong US economy. However, the member also mentioned a possibility of greater international financial market volatility due to the sustained US-China trade dispute, growing concerns about the spread of financial instability in Turkey and some other EMEs, and the prospect of continued monetary policy normalization by the US Federal Reserve. The member went on to argue that if the US carried out trade protectionist measures as it had already signalled, it would be necessary to closely monitor how these measures would affect the Korean economy.

Looking at the domestic economy, the member did not expect growth to deviate far from the level forecast in July. The member noted that, although private consumption had remained stable and exports had been strong as originally expected, the recent employment sluggishness might restrict private consumption, and facilities and construction investment had been going through corrections, which taken together increased concerns about the real economy as a whole. The member added that it would be very important to analyze the cyclical, structural and policy factors behind the investment and employment sluggishness. The member emphasized that, since inflation was likely to remain lower than originally forecast in July, a close analysis of inflation should be made for the second half of this year and for the first half of next year.

The member noted that, under these real economic conditions, many had pointed not to short-term cyclical factors but rather to structural and policy factors, including the gradually weakening competitiveness of the manufacturing sector, as largely responsible for the recent economic difficulties, and thus the member took the view that more efforts should be made to improve economic fundamentals in the medium and long term. However, the member also judged that, since cyclical factors might have also contributed to the sluggish employment and below-target inflation, it would be necessary to develop monetary policy to cope with short-term economic fluctuations, while considering whether growth would deviate far from its potential level and whether consumer price inflation would gradually approach its target level from the fourth quarter of this year.

In this regard, the member evaluated that more time should be taken to monitor movements of macroeconomic indicators while holding the Base Rate at its current level. The member also expressed the view that, although household debt was expected to remain stable in the second half of this year, largely due to the effects of government measures, more careful attention should be paid to financial stability when making monetary policy decisions at a time when the economy was faced with household debt growth that had continued for several years in the low interest rate environment and with real estate price hikes in some regions. Finally, the member noted that, although there was not much likelihood of financial instability in some EMEs spreading to other EMEs, close examination of international financial market developments should be maintained, while considering the continued rate hikes by the US Federal Reserve and the possibility of the US strengthening its trade protectionist measures, for example through its dispute with China.

One member, meanwhile, expressed the view that it would be appropriate to hold the Base Rate at its current level and take more time to observe future changes in domestic and external economic conditions.

The member's assessment was that the global economy had maintained strong growth and the trade volume had remained large overall despite the rise of trade protectionism and financial instability in vulnerable EMEs, and that upside and downside risks to the future growth path had balanced out each other. The member evaluated that tighter credit conditions had been seen mostly in EMEs whose current accounts had shifted to deficits, and EMEs, unlike the US and some other advanced countries, had seen slower growth, but the member added that it was good to see countries with favorable external soundness announcing modest stimulus measures.

The member assessed that the domestic economy had maintained growth consistent with the potential growth rate in the first half of this year, but the gap between exports and domestic demand had been widening and uncertainty surrounding the future growth path had increased somewhat. The member estimated that exports had been maintaining strong growth overall. More specifically, the member added that the outlook for robust export volume growth was supported by its month-on-month rebound as well as by the partial spread of export improvement, which had been concentrated in the IT sector, to non-IT sectors. The member's judgment was that the total value of customs-cleared exports had exhibited slower growth, but this had been due mainly to semiconductor prices entering a correction phase, and the member added that, considering past examples and the global trade and demand conditions, customs-cleared export growth was highly likely to gradually stabilize.

In terms of domestic demand, meanwhile, the member assessed that its correction phase had been lengthened and major indicators related to the growth path for the second half of the year had been falling short of original forecasts, and went on to point out that employment had remained sluggish since the end of last year owing to structural, policy and cyclical factors. The member estimated that households' consumption capacities had been gradually improving, with total wages maintaining a sharp increase and with household income growth exceeding its average for the past two to three years, but corporate and consumer sentiment indexes had been declining. And thus the member mentioned that considerable attention should be paid to assessing the degree to which labor market policy was affecting consumption and to judging whether incomes were continuing to improve. Meanwhile, the member's evaluation was that the details of measures to revitalize domestic demand, including temporary individual consumption tax cuts, were still in a state of flux, but they were a positive factor for the domestic demand outlook.

With regard to inflation, the member noted that consumer price inflation had maintained growth at around the mid-1 percent level and core inflation had slowed to the 1 percent level, both coming in slightly below the original forecasts, but if irregular factors, policy effects, and base effects were counted out, it would be difficult to rule out the possibility of inflationary pressures remaining higher than what had been suggested by the headline indexes. The member went on to state that attention should be paid to the possibility of consumer price inflation approaching its target more rapidly if cost factors, such as administered prices, that had limited inflation for several years became neutral or shifted to an increase and if the output gap remained positive. The member also expressed the view that constant monitoring and estimation of the underlying trend of inflationary pressures were important considerations in determining the level of the Base Rate that would be consistent with the medium-term inflation trend.

Finally, as to financial stability, the member mentioned that attention was being paid to the fact that household lending had been growing at a slower pace, but risk factors remained and loans to sole proprietors with relatively short maturities had continued to grow rapidly. Looking at the financial markets, the member took the view that, as the US was expected to continue its rate hikes, and trade conflicts among major countries and financial conditions in EMEs had been working to destabilize the financial markets, it would be necessary to continuously monitor the possibility of a spread of related risks.

Another member took the view that it would be desirable to hold the Base Rate at its current level this time.

On the external front, the member noted that the possibility that US-China trade dispute would protract could not be ruled out, and concerns about real economic slowdown in China had been spreading, with its industrial production growth rate for July lower than usual amid heightened yuan volatility and declines in investment and consumption indicators. Looking at the US economy, meanwhile, the member's evaluation was that, with consumption, investment and exports all showing buoyancy, the US seemed to be enjoying a booming economy—the growth rate had stood at 4.2 percent in the second quarter of this year and consumer price inflation had risen to 2.9 percent in July, and thanks to all this the global economy and trade were not showing any signs of slowdown.

On the domestic front, the member judged that there had been negative indicators, with construction and facilities investment continuing to go through corrections and consumer sentiment worsening, but private consumption had maintained modest growth, sustaining domestic demand. The member also mentioned that employment sluggishness had been worsening since the end of last year, with change in the number of persons employed falling to 5,000 in July due to the accelerating decline in employment in traditional services industries, including wholesale & retail and lodging & restaurants, and to the continued sharp reduction in employment in some manufacturing industries. The member added that wages, meanwhile, had sustained robust growth, accelerating month on month in May. The member added that the income distribution among households based on their participation in the labor market might experience negative effects from the conflicting trends of employment sluggishness and wage improvement, but as they offset each other, there remained uncertainties in terms of total household consumption. The member stated that thus it was difficult to conclude that future household consumption growth would be negatively impacted.

The member, meanwhile, noted that in July consumer price inflation had remained unchanged from the second quarter at 1.5 percent and core inflation had fallen to 1 percent compared to the second quarter. And the member evaluated that, despite the sustained positive output gap and the accelerating wage growth, inflation had not been showing a clear upward trend. The member expressed the view that this low inflation trend had been attributable not only to the two factors pointed out at the previous meeting—domestic demand growth had been modest, and not strong enough to build up underlying inflationary pressures, and inflation expectations might have declined somewhat in line with the low inflation that had persisted for a considerable period of time since 2012—but also to other complementary factors. In line with this, the member pointed out that theoretically the US rate hikes would be expected to trigger normal capital outflows, depreciate the Korean won and give rise to inflationary pressures, but thanks to Korea's heightened international credit standing, the US rate hikes and financial instability in some EMEs had encouraged foreign capital to flow into the Korean bond market. The member also argued that any adjustments to the Base Rate going forward should be in the upward direction, considering the fact that a small but positive output gap had been sustained and that the neutral interest rate had risen since the second half of last year, as the decline in export demand in accordance with the sharp decrease in global trade between 2012 and 2015 had been substantially resolved and the decline in consumption demand caused by shocks from the weakening of households' propensities to consume had somewhat eased. However, the member's evaluation was that the timing of a Base Rate hike should be determined while monitoring the pace of growth in inflation in order to be true to the purpose of inflation targeting—controlling inflation expectations—since inflation had remained low and there remained large uncertainties, despite the real economy growing at or slightly above its potential.

One other member expressed the view that it would be desirable to hold the Base Rate at its current level to serve as a buffer against the gradually increasing downside risks to the macroeconomy.

The member's assessment was that the Korean economy had been sustaining growth at around its potential rate until the second quarter, boosted by the global economic boom and increased semiconductor demand, but the economy was expected to face gradually increasing downside risks from the second half of this year. The member mentioned that exports had remained relatively favorable in July and August, but the possibility could not be ruled out of the growth gradually slowing down going forward in line chiefly with the strengthening of trade protectionism, the possibility of a Chinese economic slowdown and the easing of the sharp increase in global semiconductor demand that had led export growth. The member pointed out that the economy had also been burdened by a rapid deterioration of the terms of trade, and noted that added value created through trade had been decreasing, with growth in import prices outpacing that in export prices, implying that, despite favorable export growth, the national purchasing power that could sustain consumption and investment had not been growing as rapidly as GDP. The member went on to state that this slowing growth in purchasing power in line with the worsening terms of trade suggested increasing downside risks to domestic demand. The member expressed the view that construction investment had already entered a correction phase in trend, that facilities investment, having shifted to a sharp decline in the second quarter, was unlikely to rebound soon, and that it would be difficult to expect private consumption, having contributed significantly to supporting domestic demand for the past year, to grow more rapidly from the second half of the year. The member assessed that, considering the rapid slowdown in change in the number of persons employed while wages had increased at a faster pace than usual, as well as the worsening sluggishness of self-employed businesses, it would be difficult to expect overall household income, including business income, to help accelerate private consumption growth enough to expand domestic demand as a whole. The member also commented that the recent and relatively rapid decline in the consumer sentiment index could be understood as representing changed conditions, making it hard to stay optimistic about the prospects for private consumption from the second half of this year.

The member, meanwhile, presented the opinion that, despite cost-side inflationary pressures, such as higher oil prices and a sharp increase in the minimum wage, consumer price inflation had remained in the mid-1 percent range and core inflation had fallen to 1.0 percent, in contrast to the global reflation trend, and went on to state that this implied that the aggregate demand of the Korean economy was sluggish. The member also argued that inflation was unlikely to rebound quickly given the limited prospects for an expansion of domestic demand going forward.

In this regard, the member argued that it would be desirable to keep the Base Rate at its current level this time to serve as a buffer against downside risks to economic activities and inflation. The member also expressed the view that the widening gap between US and Korean interest rates that might arise as a result, as well as the consequent capital flows and exchange rate fluctuations, should be understood as natural consequences reflecting the gap between the US and Korean macroeconomic situations.

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 keeping 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 1.50% for the intermeeting period.

☐ Based on currently available information the Board considers that the global economy has continued its robust growth. In the global financial markets, some emerging market economies with weak external soundness have seen unease again, including capital outflows and sharp depreciations of their currencies. Looking ahead the Board sees global economic growth as likely to be affected by factors such as the movements toward spreading trade protectionism, the paces of monetary policy normalization in major countries, and the directions of the US government's economic policies.

☐ The Board judges that the solid trend of domestic economic growth has continued, as consumption and exports have shown favorable movements although the adjustments in facilities and construction investment have persisted. Employment conditions have become more sluggish, with the extent of increase in the number of persons employed having lessened significantly. Going forward the Board expects domestic economic growth to be generally consistent with the path projected in July and sustain a rate at its potential level. It anticipates that investment will slow but that the trend of steady increase in consumption will continue, and that exports will also sustain their favorable movements thanks to the buoyancy of the global economy.

☐ Consumer price inflation has remained at the mid-1% level as the increases in service fees and agricultural product prices have slowed, despite the accelerating pace of increase in the prices of petroleum products. Core inflation (with food and energy product prices excluded from the CPI) has fallen to the 1% level, and the rate of inflation expected by the general public has been in the mid- to upper-2% range. Looking ahead it is forecast that consumer price inflation, after remaining in the mid-1% range for some time, will pick up and gradually approach the target level. Core inflation will also gradually rise.

☐ The domestic financial markets have been generally stable. Long-term market interest rates have fallen, affected by the financial unease in some emerging market economies and the sluggishness of employment. Stock prices had declined, due mainly to concerns about the US-China trade dispute, but have since rebounded as these concerns have eased somewhat. The Korean won-US dollar exchange rate has fluctuated in line with changes in the value of the dollar globally. Household lending has sustained its higher rate of expansion than in past years, although the amount of its expansion has lessened somewhat. Housing sales prices have remained steady overall, but have risen rapidly in some parts of Seoul and its surrounding areas.

☐ Looking ahead, the Board will conduct monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation can be stabilized at the target level over a medium-term horizon, while paying attention to financial stability. As it is forecast that inflationary pressures on the demand side will not be high for the time being, while the domestic economy is expected to continue its solid growth, the Board will maintain its accommodative monetary policy stance. In this process it will judge carefully whether it is necessary to adjust its accommodative monetary policy stance further, while closely checking future economic growth and inflation trends. It will also carefully monitor conditions related to trade with major countries, any changes in the monetary policies of major countries, financial and economic conditions in emerging market economies, the trend of increase in household debt, and geopolitical risks.