Minutes of the Monetary Policy Board Meeting

November 30, 2017

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]

(November 2017)

Ⅰ. Outline

1. Date of meeting: Thursday, November 30, 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
   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
   Shin, Woon, 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:

Members' assessment was that **the global economy** had been continuing to recover and the global trade recovery had been expanding. Members also evaluated that **the global financial markets** had been showing stable movements overall.

Concerning **the domestic economy**, members' evaluation was that private consumption was continuing to recovery moderately, with exports sustaining their trend of solid recovery and facilities investment maintaining favorable movements. Members also assessed that the trend of real economic growth had been sustained, with the North Korea risk and the possibility of deterioration in trade conditions with China easing somewhat and sentiment indices improving.

Members noted that **inflation** had fallen slightly short of the 2-percent target, but it was forecast to gradually approach the target level and fluctuate at around 2 percent.

As to **the domestic financial markets**, members stated that the markets had been stable overall. Members also noted that, although the household lending growth was slowing somewhat, it was still high compared to past years, and thus a close watch should be kept on the accumulation of financial imbalances.

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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:

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 raise the Base Rate by 25 basis points from its current level for the intermeeting period.

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

The member noted that, in the real sector, the pace of economic growth was accelerating, boosted for instance by strong exports, favorable facilities investment, and the sustained moderate recovery in private consumption, and the real economy had been sustaining its trend of solid growth even after October. The member saw that the expanded recovery in global trade, in particular, amid strengthened improvements in world economic activity had been driving the positive movements of the Korean economy. The member went on to comment that there was a possibility of further improvements in the external real economic environment, thanks for instance to improved conditions related to trade with China. The member evaluated that, since private consumption had been continuing to improve modestly, a faster recovery in private consumption could be expected, but strong exports were still having limited spillover effects on domestic demand. The member then projected that GDP growth for 2017 was very likely to exceed the Bank of Korea Research Department's October outlook of 3.0 percent.

With respect to inflation, meanwhile, the member stated that inflationary pressures had still not yet clearly materialized, and with the price path showing little reactivity to real economic trends, low inflation had recently been a common problem for not only Korea, but also major advanced economies, and had been the focus of discussion and concern for monetary authorities. With respect to the causes of this phenomenon, the member explained that inflationary pressures might be small, despite faster growth, since the output gap was still close to zero; inflationary adjustments might be restrained due to intensified global competition and e-commerce growth; and persistently low inflation might have caused a fall in inflation expectations. The member then expressed the opinion that, since all these factors seemed to be at work to some extent in Korea, the rise in inflation was very likely to be gradual going forward.

The member noted that there were two implications related to the policy rate decision in light of macroeconomic trends. First, real economic trends implied that the factors that had caused a decline in the real neutral interest rate since the global financial crisis were gradually disappearing, and thus if the Base Rate were held at the current level, the degree of monetary easing would likely increase automatically. Therefore, it would be appropriate to raise the Base Rate in reflection of this point. Second, given no clear materialization of inflationary pressures, the monetary policy stance should also be shifted at a gradual pace while checking the movements of the price path, and it should be constantly reviewed whether price inflation was approaching the target level in a stable manner.

The member expressed the view that, taking these points into overall consideration, the factors favoring a hike in the Base Rate as discussed at the last Monetary Policy Board meeting had been confirmed by economic trends, and so it was appropriate to raise the Base Rate to 1.50 percent. The member added that the Board should also consider an additional Base Rate hike in the future, but in choosing the timing for the additional hike, the focus should be placed on the price path rather than real economic trends.

Another member agreed to some extent with the recognition that, with respect to the recent macroeconomic trends, the time was approaching to reflect on the accommodative monetary policy which had been continuing for the past years, and to give careful thought to the future monetary policy direction. The member expressed the view that, while the accommodative monetary policy thus far had been working as a factor causing faster growth in household debt, it was assessed to have contributed greatly to easing deflation concerns by limiting the possibility of further deterioration in domestic economic activity amid difficult economic environments at home and abroad.

The member noted that Korea's export recovery was gradually solidifying due to the consolidation of the world economic recovery, and there were positive factors for domestic demand, such as the government's plans for expansionary fiscal policy and the easing of concerns about the North Korea risk. The member thus assessed downside risks to the macroeconomy to be diminishing somewhat overall.

The member, however, noted that there was significant spare capacity in the labor market, that aggregate demand was still not sufficient as underlying price inflation was running well below the 2-percent target level, and that the spillover effects of the export recovery on domestic demand, employment and prices were relatively unlikely to be great, since the recovery was concentrated in some capital-intensive industries, such as semiconductors. The member stated the opinion that, given these factors, it still seemed uncertain as to whether the Korean economy had reached a state of soundness that necessitated an immediate reduction of the degree of monetary accommodation. The member pointed out that a rapid tightening under these conditions could cause a risk of difficulties in converging underlying price inflation to the target level, and could also work to reduce maneuvering room for a flexible interest rate policy going forward.

The member noted that the continuation of accommodative monetary policy could impose a burden by allowing financial imbalances to accumulate, represented by household debt growth, but assessed that the current composition of household debt was unlikely to undermine the soundness of major financial institutions and thereby threaten the overall financial markets. The member then commented that a close watch should be kept on changes in the housing market, which had contracted since the August 2 measures, and changes in household debt should also be closely monitored. The member went on to emphasize that, from a more fundamental point of view, financial stability should be pursued first through macroprudential policy, and financial stability would be furthered by reducing as much as possible the chance of undermining price stability, which is the primary objective of monetary policy.

The member expressed the view that, taking these points into overall consideration, it would be appropriate to hold the Base Rate at its current level for the month, while monitoring the degree of positive effects of recent changes in conditions on the Korean economy, given the need for a cautious approach to changing the monetary policy stance at this juncture. The member went on to express the opinion that an adjustment to the degree of the monetary policy accommodation should be decided prudently such that the convergence of underlying price inflation to the target level is not undermined.

One other member presented the view that it would be appropriate to raise the Base Rate by 25 basis points to 1.50 percent this month.

The member noted that the global economy had maintained its trend of recovery, and investment and exports had induced improvement in consumption, although such improvement had been relatively limited. The member also stated that, due to several structural problems, it was unclear how long this trend of recovery would last.

The member mentioned that the Korean economy had continued to exhibit growth in line with its forecast path, exports and investment seemed to have led consumption gradually, and it was the right time to reexamine the appropriateness of the current accommodative monetary policy stance. In particular, the member presented the view that there was a need to examine the trade-off between the pace at which financial imbalances widened and the speed at which the inflation gap narrowed. First, concerning the output gap, the member noted that, according to the estimation of the potential growth rate in terms of both consumption and incomes, the output gap was seen to have already turned positive. Second, with regard to financial imbalances, the member argued that financial liabilities had been growing rapidly under the accommodative monetary policy, and that if the degree of policy accommodation exceeds the level that the economic structure can utilize optimally, this could lead to inefficiency of resource allocation. Third, regarding the inflation gap, the rate of growth in prices of items influenced by domestic demand pressures had already remained in the range of 2 to 2.5 percent, but that of items whose prices were determined by items such as industrial and agricultural, livestock & fisheries products had been fluctuating around the target of 2 percent. The member also pointed out that, as domestic demand pressures were expected to grow steadily next year while the average OECD inflation rate was forecast to somewhat exceed 2 percent due largely to a rise in global commodity prices, inflation was likely to fluctuate at around its target of 2 percent, and added that the survey on inflation expectations had also shown that economic agents seemed to be well aware of the 2-percent inflation target.

The member expressed the view that, in conclusion, it would be appropriate to reduce monetary easing somewhat while price stability was being secured to some extent, in order to prevent financial imbalances from expanding further and harmonize monetary policy with the government's fiscal policy to be implemented going forward. The member went on to argue that, with such policy harmonization, it would be desirable to anchor the Korean economy at its potential growth rate, which had decreased, so as to promote medium-term price stability.

One member, meanwhile, expressed the opinion that it would be appropriate to raise the Base Rate to 1.50 percent from the current 1.25

percent this month.

The member stated that, looking at the recent economic situation, the domestic economy seemed to have sustained a strong recovery, boosted by the global economic recovery. The member mentioned that, compared with the October forecast, the GDP growth rate for the third quarter had been higher than projected, major downside risks such as North Korea-related geopolitical risks and the possibility of a continued worsening of trade relations with China had eased, and sentiment indexes for economic agents in the private sector seemed to have been improving. The member also expressed the view that, despite this economic situation, inflationary pressures had not yet appeared, considering the global low inflation due to structural factors, the time lag in the transmission of business activities to prices, and the current output gap remaining at near zero, as Fed Chair Yellen had acknowledged when she referred to low inflation as a 'mystery'. However, the member stated that consumer price inflation and core inflation were forecast to remain close to their target of 2 percent on average this year and the next.

The member noted that, looking at financial markets, market interest rates and stock prices had risen, the won had been strengthening, and household debt had continued to exhibit a slowdown in growth. The member stated, however, that household debt still remained high and, as showed by the results of the systemic risk survey conducted in the second half of 2017, continued to be considered the largest risk factor facing the Korean economy.

Next, regarding how monetary policy should respond to this situation, the member noted that the Korean economy had maintained strong growth at or slightly exceeding its potential growth level, and inflation was overall unlikely to deviate far from its target. The member went on to state that an excessive degree of monetary easing could trigger credit growth and push up asset prices, imposing burdens on promoting financial stability, and in this regard it would be desirable to raise the Base Rate slightly by 25 basis points.

One member assessed that it would be necessary to adjust the degree of monetary easing and raise the Base Rate to 1.50 percent from the current 1.25 percent. With regard to the timing of the rate hike, the member expressed the view that it would be more desirable to monitor financial and FX market conditions at the end of the year and raise the rate early in 2018 when the economic forecasts start to take shape, but the member also agreed with the idea of moving the rate hike forward a month or two by raising the rate this month. The member went on to stress that, after raising the rate, it would be necessary to take time to closely examine financial stability conditions, including trends of business activities, inflation and household debt.

The member assessed that, with the global economy continuing to improve, the Korean economy had maintained its trend of recovery led by exports, and private consumption had been recovering at a modest pace. The member added that the Korean economy was expected to sustain GDP growth at its potential level in 2018 and 2019, with the recovery of private consumption solidifying, household income conditions picking up, and employment conditions showing gradual improvement, particularly in the services sector. With regard to inflation, the member mentioned that consumer price inflation had been fluctuating around its target of 2.0 percent for this year and core inflation had remained below 2 percent, but if the economic recovery continued next year, underlying inflation was expected to rise gradually. The member also took the view that the economy seemed to have reached the point where the degree of monetary accommodation could be reduced, as the output gap had been originally forecast to turn positive in the second half of 2018 but was likely to do so earlier, boosted by the recent faster-than-expected GDP growth, and the inflation gap was expected to narrow with consumer price inflation and core inflation having nearly reached their targets.

In terms of financial stability, the member noted that it was now necessary to cope with the accumulation of financial imbalances caused by the recent accommodative monetary policy, and stressed that if the need to maintain the accommodative policy in terms of business activities and inflation had decreased somewhat, more attention should be paid to dealing with the buildup of financial imbalances, such as household debt. The member took the view that reducing the degree of monetary easing could raise concerns about the household debt burdens of vulnerable borrowers, but the member expressed the hope that the aggressive measures announced by the government to address the problems facing vulnerable groups would take effect.

With regard to financial and FX markets, the member mentioned that, while stock prices and market interest rates had risen, the exchange rate had fallen significantly, affected chiefly by the current account surplus caused by strong exports, and added that some had raised concerns that the rapid appreciation of the Korean won would negatively affect exports and other real economic sectors. The member went on to stress the need to closely monitor FX market trends going forward.

One member expressed the opinion that it would be appropriate to raise the Base Rate by 25 basis points to 1.5 percent from the current 1.25 percent this month and presented the following grounds for the hike.

With regard to the real economy, the member noted that the growth momentum had been strengthening gradually; strong external demand had led exports and facilities investment, and private consumption had exhibited modest recovery, boosted chiefly by the effects of the supplementary budget and improved economic sentiment. The member also assessed that consumer price inflation had slowed and fallen below its target, due mainly to temporary supply-side factors, while core inflation had rebounded from the previous downward trend and overall remained close to the path forecast in October. In terms of slack in the production sector, the member mentioned that the average capacity utilization ratio had continued to decline, with production growth resulting from strong exports seen in some industries only, and as a result there had not been significant improvements in overall production slack, despite the economic recovery. The member went on to state that, in the labor market, with growth in the participation and time gaps more than offsetting a decrease in the unemployment gap, the slack in the labor force had increased but the pace of its growth had slowed for the second consecutive month.

Looking at financial stability conditions, the member noted that, despite government measures, group loans to apartment purchasers, leasehold deposit loans and credit loans had steadily grown and maintained stronger growth than in normal years, and that corporate loans had also increased — individual entrepreneur loans and loans to real estate-related sectors in particular — and the real-estate exposures of private sector credit had continued to increase accordingly.

The member expressed the view that, in overall consideration of real economic and inflation trends and financial stability conditions, the fact that the upward movement of the growth path had helped eliminate the negative output gap earlier than expected and brought about a rebound of core inflation indicated that it was appropriate to slightly adjust the degree of monetary easing in comparison to the neutral interest rate. The member went on to state that, despite this adjustment, the real interest rate remained below the neutral interest rate and the finance-neutral natural interest rate, leading to the conclusion that accommodative financial conditions could be maintained. The member also argued that, as comprehensive household debt measures would take effect gradually with a time lag, the household debt-to-income ratio that had already restricted consumption would continue to rise for the time being, and mentioned that the risk of total private sector credit, including corporate loans, being concentrated in real estate-related areas was likely to remain high. With regard to monetary policy operation, the member argued that there was a growing need to preemptively consider the possibility that the buildup of financial imbalances could restrict appropriate consumption channels, leading to inefficient resource allocation and undermining the bank intermediary function in the medium and long term, having negative impacts on future economic welfare.

Concerning the future monetary policy direction, the member took the view that it would be necessary to maintain the current monetary easing stance until inflation became firmly entrenched and the forecast that inflation would converge to its target became stronger. The member went on to point out that whether, and how fast, additional Base Rate adjustments should be made needed to be carefully determined in consideration of changes in core inflation, the degree of private consumption recovery and the effects of changes in the global financial cycle on the real neutral interest rate.

Ⅳ. Results of Deliberation on Monetary Policy Directions

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

However, Dr. Dongchul Cho expressed clear opposition to the idea of raising the Base Rate by 0.25 of a percentage point, and argued for holding it at its current level.

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Monetary Policy Decision

☐ The Monetary Policy Board of the Bank of Korea decided today to raise the Base Rate by 25 basis points, from 1.25% to 1.50%, 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 stable movements, with stock prices displaying moderate upward trends for example. 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 private consumption has improved moderately and investment has shown favorable movements, while exports have sustained their high rate of increase. The trend of improvement in employment conditions has shown signs of weakening somewhat, with the pace of increase in the number of persons employed in the service sector having slowed for example. Going forward, the Board expects that domestic economic growth will be slightly above the rate projected in October, as domestic demand activities including consumption and facilities investment continue their trends of moderate improvement, and exports also sustain their buoyancy thanks largely to the pickup in the global economic recovery and the improved conditions related to trade with China.

☐ Consumer price inflation has slowed to the upper-1% level, in consequence mainly of declines in the extents of increase in the prices of agricultural, livestock and fisheries products and the disappearance of the base effect from the reduction of electricity fees last year. Core inflation (with food and energy product prices excluded from the CPI) has been rising slightly in the mid-1% range, and the rate of inflation expected by the general public has stayed at the mid-2% level. Looking ahead the Board expects that consumer price inflation will be in the mid-1% range for some time and then gradually approach the target level. Core inflation will also rise gradually.

☐ Although long-term market interest rates have risen, due to changes in expectations related to monetary policy, the domestic financial markets have shown generally stable movements, with stock prices continuing to rise in line for example with improvements in corporate performances. The Korean won-US dollar exchange rate has meanwhile fallen, owing chiefly to the strengthening recovery of the domestic economy. The rate of increase in household lending is slowing somewhat, but is still sustaining a high level compared to past years. Housing sales prices have risen faster in some parts of Seoul and its surrounding areas, although 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 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 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.