Minutes of the Monetary Policy Board Meeting

December 15, 2016

The Bank of Korea

(English version)

Minutes of the Monetary Policy Board Meeting[1)]
(December 2016)

Ⅰ. Outline

1. Date of meeting: Thursday, December 15, 2016

2. Place : Monetary Policy Board Meeting Room

3. Monetary Policy Board members present:

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

4. Monetary Policy Board members absent: none

5. Participants:

Ha, Sung, Auditor
Kim, Minho, Deputy Governor
Yoon, Myun-Shik, Deputy Governor
Lim, Hyung Joon, Deputy Governor
Huh, Jin Ho, Deputy Governor
Jeon, Seung-Cheol, Deputy Governor
Chae, Sun Byoung, Director General of Reserve Management Group
Chang, Min, Director General of Research Department
Shin, Ho Soon, Director General of Financial Stability Department
Park, Jongseok, Director General of Monetary Policy Department
Lee, Hwan Seok, Director General of Financial Markets Department
Suh, Bong Gook, Director General of International Department
Sohn, Wook, Director of BOK Economic Research Institute
Lee, Seung Heon, Press Officer
Chang, Cheong-Seok, Director General of Monetary Policy Board Secretariat
Park, Cheol Won, Head of MPB Team

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1) This English version (summary) of the minutes of the Monetary Policy Board Meeting was produced at a working level, and is not an official document.

Ⅱ. Summary of Discussions on the Current Economic Situation[2)]

After briefings by staff on ‘Recent Economic Developments’, ‘FX and International Finance’ and ‘Financial Market Trends’, the discussions of the Monetary Policy Board (MPB) members covered the following areas:

With regard to **the global economy**, members’ assessment was that the US economy had shown robust growth, the euro area had seen a modest recovery, and the Chinese economy had sustained its stable growth. As to **international financial markets**, members evaluated that global stock prices and interest rates had risen rapidly and the US dollar had strengthened, influenced mainly by the policy rate hike by the US Federal Reserve and expectations concerning the new US government’s policies.

Concerning **the domestic economy**, members assessed it as having continued to grow, albeit slowly, as exports showed a slight increase but domestic demand activities exhibited sluggish movements with facilities and construction investment declining.

With regard to **the domestic financial markets**, meanwhile, members evaluated that long-term market interest rates and the Korean won-US dollar exchange rate had risen, influenced mainly by the steep rise in US Treasury yields, that stock prices had slightly rebounded after having declined, owing in part to the weakening of investment sentiment, and that bank household lending had sustained its persistently high rate of increase, led by mortgage loans.

As to **prices**, members noted that consumer price inflation had registered 1.3%, unchanged from the previous month’s level, and that core inflation had fallen slightly from 1.5% in the previous month to 1.4%.

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, while maintaining the Base Rate at its current level for the intermeeting period, the Bank of Korea should keep a close watch on the future developments of downside risks in line with the recently soaring uncertainties at home and abroad. The member noted that, although the world economy had been continuing its gradual recovery, close attention should be paid to the possibility of financial instability in vulnerable emerging market economies in line with increased protectionism and US interest rate normalization. The member, meanwhile, judged that the domestic financial markets had remained stable overall, and that the recent sharp increases in long-term interest rates were attributable to the normalization of the yield curve. The member also assessed the foreign exchange market as having the capacity to absorb external shocks to some extent, thanks to the current account surplus and a steady fall in the ratio of short-term external debt to official foreign reserves. The member, however, pointed out the possibility of the overall economy falling short of the originally forecast path, considering the trends of decrease in the manufacturing capacity utilization ratio and in services production. The member then went on to emphasize that attention should be paid to the fact that there had been heightened downside risks to the overall macroeconomy stemming from increased uncertainties at home and abroad. Concerning consumer price inflation, the member noted that there had not been any marked underlying upward trend of prices, despite the rebound of oil prices and the easing of concerns about global deflation. The member then raised the concern that, against this backdrop, if downside risks materialize, the negative output gap could increase, thus gradually lowering the possibility of inflation converging to the target. Accordingly, the member stated the view that it was desirable at this juncture to assess the direction of future interest rate policy based on a detailed analysis of the degree to which downside risks to growth and inflation would increase. In addition, to reduce the remaining uncertainty in the markets over the direction of monetary policy amid the US Fed's monetary policy normalization, the member stressed that Korea's monetary policy should be implemented in accordance with Korea's own macroeconomic and financial market conditions. The member went on to add that an active role for fiscal policy should be emphasized, considering the current macroeconomic trends.

Another member pointed out a number of major considerations for the appropriate conduct of monetary policy. First, the member stated that, although the domestic economy was expected to maintain a modest trend of growth, downside risks to growth were judged to have increased, due mainly to growing uncertainties in conditions at home and abroad and to the resulting contraction in economic sentiment. The member then noted, however, that since there was a high level of uncertainty, the Bank should closely and comprehensively examine changes in conditions and the resulting impacts to predict the future growth path. Second, the member stated that it would be necessary to keep a close watch on how that day's Fed rate hike and policy rate projections by the FOMC meeting participants would affect international financial markets and domestic financial and foreign exchange markets. The member also noted that the Bank needed to pay attention to the possibility that heightened volatility in the financial and foreign exchange markets could recur, depending on the pace of the Fed's monetary policy normalization and changes in political conditions at home and abroad going forward. Finally, the member found it difficult to be optimistic that the trend of household debt growth would stabilize next year, since demand for home mortgage lending was expected to be strong, led by apartments under construction that had already been sold, despite policy efforts to curb household debt. Accordingly, the member noted that it would be better to keep the Base Rate unchanged from the current level of 1.25 percent for the intermeeting period. The member, meanwhile, noted that as both downside risks to the macroeconomy and financial stability risks were increasing amid heightened uncertainties, monetary policy alone could not ensure economic and financial stability, and so the role of fiscal policy was important. The member stated that when there was a high level of uncertainty within the economy, fiscal policy, which brings about direct effects, could be a more effective policy instrument than monetary policy, whose effects spread through indirect channels. The member went on to note that monetary easing could increase financial stability risks, for instance by increasing foreign portfolio investment outflow pressures and making it difficult to rein in household debt growth. Therefore, the member argued that the Bank should actively consult with the government to ensure that fiscal policy could be operated in a more expansionary manner.

Meanwhile, one member took the view that it would be appropriate to keep the Base Rate at its current level for the intermeeting period, in overall consideration of factors such as household debt that cause financial instability and the heightened uncertainties concerning domestic and overseas conditions, despite a slight increase in downside risks to the recent real economy and next year's inflation. With regard to the real economy, the member assessed Korea's economic growth as having peaked in the second quarter of 2016 and then having slowed afterwards, with the index of all industry production (IAIP) continuing to decline and domestic demand, including private consumption and construction investment, showing slower growth. On the other hand, the member positively evaluated exports, saying that exports to China and the US had all shifted to increases, led primarily by those of semiconductors, and that exports had become more likely to maintain their upward trend going forward. In terms of prices, meanwhile, the member mentioned that consumer price inflation had accelerated on a rebound of oil prices since September 2016, while core inflation had slowed in reflection of the economic slowdown, and evaluated that factors such as the widening of the negative output gap and the disappearing of the base-period effect from oil price declines could act as downward pressures on inflation from 2017 onwards. Concerning financial stability, the member forecast the household debt growth rate to stabilize gradually, as house buyer sentiment had contracted since the government's real estate measures announced on November 3, 2016 and the upward trend of housing prices in Seoul and its surrounding areas had been showing signs of stabilization, although household debt had maintained strong growth at the 10 percent level in November. However, the member assessed that it was still difficult to expect overall household debt growth to stabilize, due to the sustained growth in other loans extended by the banking sector and in mortgage lending by non-bank financial institutions. The member went on to stress the need for stronger risk management at non-bank financial institutions.

One member mentioned that, although accommodative monetary policy had been implemented in consideration of real economic conditions, this had presupposed financial stability to a certain extent, and that it was therefore time to enhance the comprehensive coordination of policies, including fiscal policy and structural and regulatory reforms. The member also assessed the US Federal Reserve's rate hike that had signalled the end of ultra-loose monetary policy as having provided more maneuvering room for the Korean monetary policy authorities. The member, however, expressed the view that, considering the sustained external uncertainties, the increased downside risks forecast in the domestic economic outlook, and the expectation that the price path would fall slightly below its estimate, it would be desirable to keep the Base Rate at its current level of 1.25% for the intermeeting period. The member also emphasized the following points with respect to the responses of the Korean economy to the trend of low interest rates and the implications of the US rate hike for the Korean economy. First, the member expressed the concern that the recent accommodative policy stance had been supporting the Korean economy but capital had been concentrated in the real estate sector, which could threaten financial stability going forward. Next, the member pointed out that Korea’s yield curve had steepened, affected by US monetary policy, and this could help ease the issue of ineffective distribution in the real economy. However, the member also noted that vigilance was needed against the possibility that rate hikes in advanced countries unaccompanied by real economic recoveries could work to worsen global financial market unrest.

Another member pointed out a number of major considerations for the appropriate conduct of monetary policy. First, the member stated that concerning the trend of growth at home, growth had continued to depend on domestic demand, such as consumption and construction investment, as external demand still had not shown sufficient improvement despite signs that the export sluggishness had eased somewhat. The member went on to note that the downside risks to the growth path had been increasing gradually with manufacturing production continuing to slow down and production in the construction and services sectors weakening somewhat. Second, the member stated that consumer price inflation had remained at the previous month’s level, but core inflation had decelerated somewhat due mainly to a fall in the prices of non-petroleum industrial products. The member commented that, although consumer price inflation was expected to accelerate gradually with the downward trend of import and producer prices coming to an end, there were various upside and downside risks for the future price path on the regulatory and supply sides, such as electricity tariff revision, oil prices, exchange rates and agricultural product prices. Third, the member stated that, although inventory adjustment pressures had been decreasing, the substantially increased slack seemed to have gradually set in, with the average capacity utilization ratio in the manufacturing sector remaining at its record low level and demand-side pressures from facilities investment decreasing for the second consecutive month. The slack in the labor force had been overall showing weaker improvement, with the average time gap, including the time-related underemployed, increasing slightly and the participation gap, including potential job seekers, declining at a slower pace than during the same month last year. Fourth, looking at financial stability conditions, growth in domestic long- and short-term interest rates and the exchange rate had stabilized with the easing of the surge in long-term interest rates immediately after the US presidential election, but market instability had been increasing due chiefly to the resumption of Fed rate hikes and the upward adjustment to the Fed's rate hike projection. Furthermore, despite household debt management measures, household debt had continued to grow regardless of households' income conditions, and rising lending rates had worked to increase debt payment burdens and the risk of vulnerable borrowers going bankrupt. In overall consideration of the above-mentioned real economic and inflation trends, slack in production and financial stability conditions, the member assessed that it was advisable to keep the Base Rate unchanged from the current level of 1.25 percent for the intermeeting period.

One other member expressed the opinion that it would be desirable to keep the Base Rate unchanged from the current level for the intermeeting period. The member mentioned that Korea's economic outlook for next year was not bright, with domestic and overseas risks to the Korean economy increasing further. The member also took the view that amid sluggish private consumption and facilities investment, construction investment, which had contributed greatly to growth, was also expected to slow down. He added that exports were likely to improve compared to this year, boosted by the global economic recovery, but the trend of protectionism was expected to have negative effects. In addition, the member argued that considering employment instability and the level of excess production capacity in the manufacturing sector, the real economy was likely to be sluggish and the situation seemed to require accommodative monetary policy. However, the member pointed out that there also remained uncertainties concerning monetary policy, including US rate hikes and household debt. The member stressed that, although the Korean economy was not likely to be affected heavily by US rate hikes, vigilance needed to be maintained considering the current high uncertainties, and went on to emphasize that, concerning household debt, constant monitoring was needed of real estate market conditions and the effects of various government household debt measures. The member also assessed that, in response to the recent surge in long-term market interest rates, the Bank of Korea had made appropriate measures to ease market unrest by buying Treasury bonds and reducing the issuance of monetary stabilization bonds, and that since excessive interest rate hikes within a short period of time could increase corporate and household burdens and undermine financial market stability, efforts should be maintained to closely monitor their effects and make appropriate responses if needed.

Ⅳ. Results of Deliberation on Monetary Policy Directions

Incorporating the outcome of their earlier discussions, a statement was compiled with the unanimous consent of all the members.

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Monetary Policy Decision

☐ The Monetary Policy Board of the Bank of Korea decided today to leave the Base Rate unchanged at 1.25% for the intermeeting period.

☐ Based on currently available information the Board considers that the trend of steady economic recovery in the US has been sustained and that the Chinese economy has maintained its moderate pace of growth. The euro area has also continued its improvements. The Board forecasts that the global economy will maintain its moderate recovery going forward, while being affected by factors such as the directions of the new government's economic policies and the pace of monetary policy normalization in the US, the uncertainties related to Britain's exit from the European Union, and economic conditions in emerging market countries.

☐ Looking at the Korean economy, exports have shifted to an increase but the improvements in domestic demand activities have been weak. On the employment front, the employment-to-population ratio in November was higher than that in November of last year, as the number of persons employed increased. The unemployment rate meanwhile maintained the same level as in November last year. The Board forecasts that the domestic economy will sustain its trend of modest growth going forward, in line with a recovery of the global economy, but judges that the downside risks to the future growth path have expanded a bit, owing chiefly to the high degrees of uncertainty in recent domestic and external conditions.

☐ Consumer price inflation registered 1.3% in November, the same as in October despite the extent of decline in petroleum product prices having narrowed, as the pace of increase in prices of industrial products other than petroleum slowed. Core inflation excluding agricultural and petroleum product prices fell slightly to 1.4%, from 1.5% in October. In the housing market, sales and leasehold deposit prices have shown upward trends, centering around Seoul and its surrounding areas. Looking ahead the Board forecasts that consumer price inflation will gradually rise, due mainly to the effects of the increases in international oil prices.

☐ In the domestic financial markets since November, influenced mainly by expectations concerning the new US government's economic policies and the monetary policy of the US Federal Reserve, long-term market interest rates and the Korean won-US dollar exchange rate have risen. The Korean won-Japanese yen exchange rate has meanwhile fallen, in line with the yen’s relative weakening. Stock prices have rebounded after having declined, owing in part to increases in global stock prices. The extent of growth in household lending has expanded, led by home mortgage loans.

☐ Looking ahead, the Board will conduct monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation approaches the target level over a medium-term horizon, while paying attention to financial stability. In this process it will closely monitor the uncertainties in domestic and external conditions and their effects, the progress of monetary policy normalization by the US Federal Reserve, and the trend of increase in household debt.