Executive Summary

[Monetary Policy Operating Conditions]

1 A look at economic and financial conditions in Korea and abroad between April and July 2019 finds the following. The pace of global economic growth slowed due to sluggish manufacturing production activities stemming from a contraction of global trade in line with stronger global protectionism. In the United States, economic activity has been rising at a moderate rate, led by consumption, while growth in the euro area and Japan weakened on production and export slumps. Growth in China also slowed due to heightened uncertainties related to the US-China trade negotiations.

Economic growth in major economies[1)]

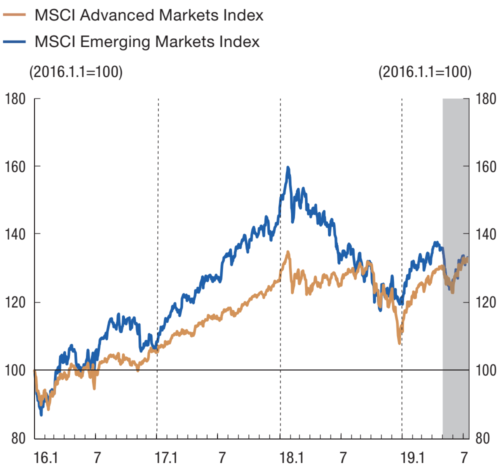
(%)

	2016	2017	2018				2019
			Year	Q2	Q3	Q4	Q1
US	1.6	2.2	2.9	4.2	3.4	2.2	3.1
Euro area	1.9	2.4	1.9	1.6	0.5	1.0	1.6
Japan	0.6	1.9	0.8	2.3	-2.6	1.8	2.2
China	6.7	6.8	6.6	6.7	6.5	6.4	6.4 [6.2][2)]

Notes: 1) The quarterly rates of growth are annualized quarter-on-quarter rates for the US, Japan and the euro area, and year-on-year rates for China.
2) Based on the second quarter of 2019.
Sources: Individual countries' published statistics.

In the international financial markets, stock prices fell significantly in advanced and emerging markets in early May due to the US-China trade dispute, but then rebounded during June to July period owing to expectations of a rate cut by the US Federal Reserve. Long-term interest rates in major countries saw a trend of decline. The US dollar strengthened against major currencies entering this year but then weakened from June onward.

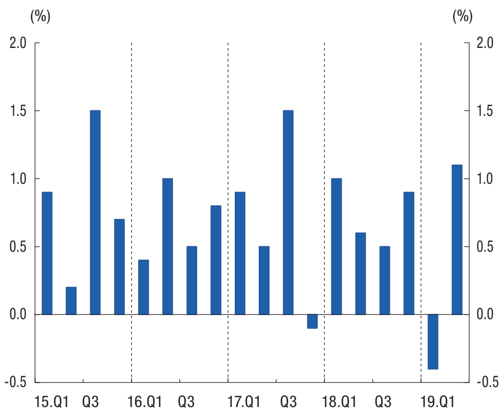
Share price indices of advanced and emerging market countries



Source: Bloomberg.

2 In the Korean economy, growth was weak as the adjustment in construction investment continued and sluggishness in exports and facilities investment persisted, while consumption continued to show modest growth. Meanwhile, employment conditions saw partial improvement with the increase in the number of persons employed having risen, particularly in the service sector. Employment in the manufacturing sector, however, continued to decline.

Real GDP growth[1]

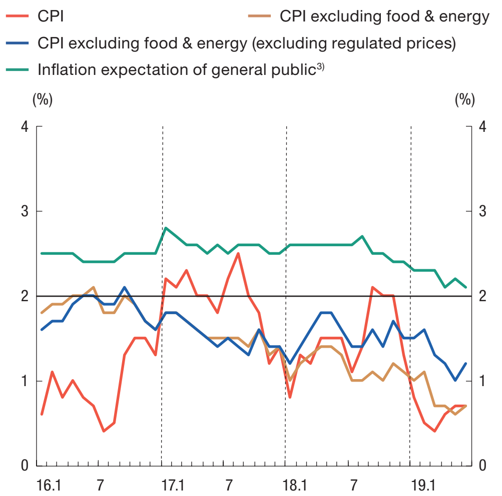


Note: 1) Quarter-on-quarter.
Source: Bank of Korea.

3 Consumer prices rose 0.7% year-on-year in the second quarter, due to increased downward inflationary pressures from supply-side factors and government policy amid weakened demand-side inflationary pressures. Core inflation was low at around the mid- to upper-0% level. Other price indices, excluding the impacts of acyclical factors such as regulated items, were assessed to be at the low- to mid-1% level. The inflation rate expected by the general public was in the low-2% range.

Housing sales prices in Seoul and its surrounding areas continued to decline, influenced by the government's housing market stabilization measures, but those in Seoul rose slightly entering July due to an increase in prices of some apartments undergoing reconstruction. Sales prices declined in the rest of the country, especially in Ulsan, Chungbuk, and Gyeongnam. Leasehold deposit prices remained on a decline due to an increase in the supply of new apartments available.

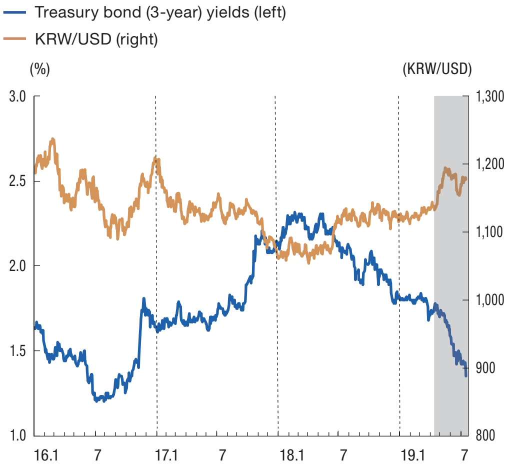
Inflation[1)2)]



Notes: 1) The bold line indicates the inflation target.
2) Year-on-year.
3) Expectations for the CPI inflation rate one year in the future.
Sources: Bank of Korea, Statistics Korea.

4 In the domestic financial markets, long-term market interest rates fell, led by the escalation of the US-China trade dispute, sluggish economic indicators in major countries, and the consequent expectations for monetary policy easing at home and abroad. After falling significantly, stock prices rebounded somewhat but fell again entering July due to Japan's restrictions on its exports of semiconductor materials. The Korean won/US dollar exchange rate rose sharply on concerns about global economic slowdown and the US-China trade dispute since mid-April, but then fluctuated on expectations of rate cuts by the US Federal Reserve and a slowdown in Korean exports.

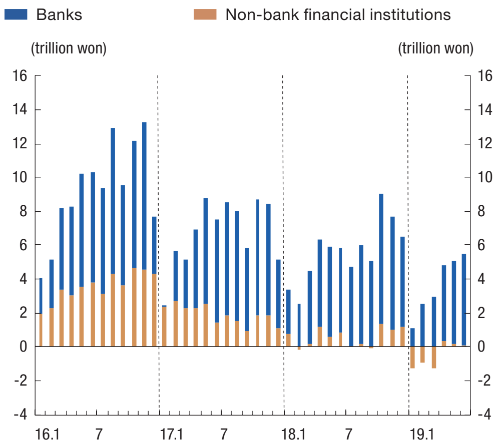
Korean Treasury bond yield and exchange rate (KRW/USD)



Sources: Bank of Korea, KOFIA.

5 The rate of increase in household lending has continued to slow, but the degree of slowing has moderated somewhat as the amount of increase in household lending has expanded since April. Household lending by banks increased by more than in the quarter before, led by group and leasehold deposit loans related to purchasing and moving into newly supplied apartments. Household lending by non-bank depository institutions also reversed to an increase, owing to expanded non-mortgage real estate collateralized loans and credit loans.

Changes in household loans[1)2)]

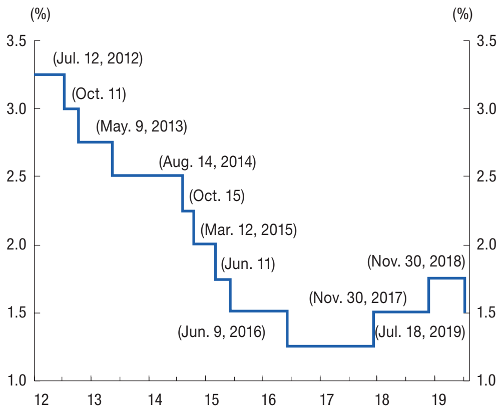


Note: 1) Month-on-month.
2) Including mortgage transfers.
Source: Bank of Korea.

[Conduct of Monetary Policy]

6 The Bank of Korea maintained its accommodative policy stance to ensure that the recovery of growth continues and consumer price inflation could be stabilized at the target level over a medium-term horizon, while conducting its monetary policy with attention to financial stability as well. In this process it closely examined domestic and overseas risk factors such as the US-China trade dispute, changes in the economies and monetary policies of major countries, financial and economic conditions in EMEs, and household debt growth. Under this policy stance, the Bank of Korea decided in July this year to lower the Base Rate by 0.25% point to 1.50% per annum, after having held it at 1.75% since November 2018.

Bank of Korea Base Rate[1)]



Note: 1) Figures in parentheses refer to the dates of Base Rate adjustments.
Source: Bank of Korea.

7 A detailed look at the monetary policy decisions during this period, and the backgrounds behind them, follows:

First, in the May meeting, the Board kept the Base Rate at 1.75%. The Board made this decision in consideration of the following points: it was necessary to monitor the developments of international conditions that have large impacts on growth, such as the US-China trade dispute and the conditions in the semiconductor industry; inflation was expected to pick up gradually, although it continued to run at a low level; and it was necessary to remain alert to financial stability conditions, including household debt. At the time of the policy rate decision in May it was forecast that, following the domestic economy's slight rebound from the slowdown of the first quarter of the year, the growth trend would not diverge significantly from the April economic outlook. However, it was seen that the uncertainties surrounding the future growth path had risen, due mainly to the escalation of the US-China trade dispute. Consumer price inflation remained low at the mid-0% range, but was expected to run at the low- to mid-1% level from the second half of the year, affected partly by diminishing supply-side deflationary pressures. With respect to financial stability, even though household debt growth had continually slowed, it was judged that close attention should be continuously paid to the risks regarding financial imbalances, as the amount of increase in household debt had expanded since April.

In the July meeting the Board decided to cut the Base Rate to 1.50%. This decision was reached based on the judgment that there was a rising need to support economic recovery as growth and inflationary pressures were expected to be weaker than previously projected, owing to the slowdown in global trade affected by the US-China trade conflict and to a delay in the recovery of the semiconductor industry. With respect to the domestic economy, consumption had continued to grow moderately, but the adjustment in construction investment had persisted while slower-than-expected growth had been seen in exports and facilities investments, and it was also hard to be optimistic about future developments. Hence, the domestic economy this year was forecast to grow at the low-2% level, below the April outlook. Consumer price inflation remained low at the mid- to upper-0% level, as demand-side pressures had been weaker than anticipated and the influence of supply-side and government factors had grown stronger. Going forward, consumer price inflation was forecast to fall short of the path projected in April, fluctuating below 1% for some time and then running at the low- to mid-1% level from next year. Considering that the adoption of a more accommodative monetary policy stance in an attempt to stimulate the economy could affect financial stability conditions like household debt, it was agreed at the meeting that the Bank would thoroughly monitor changes in financial stability conditions to ensure that the rate cut would not result in a worsening of financial imbalances.

8 The Bank of Korea continued its efforts for financial and foreign exchange market stability in response to changes in conditions at home and abroad. The Bank kept a close eye on the impacts of external shocks such as the US-China trade tensions and Japan's trade restrictions, while actively taking measures in times of heightened market volatility by activating the emergency response system. When external risks intensified, the Bank convened 「Financial and Economic Condition Review Meetings」, and also set up the 「Foreign Exchange and Financial Sector Review Task Force In Response to Japan's Trade Restrictions」, which monitored Japanese funds circulating in Korean financial market, and closely cooperated with relevant organizations including the government.

The Bank continued its efforts for the preemptive identification of potential risks within the financial system as well. During its June 「Financial Stability Meeting」, it performed careful sector-by-sector assessments of vulnerabilities in household and corporate credit markets, in asset markets, and at financial institutions, and examined financial institutions' resilience against the simultaneous shocks of an escalation of global trade conflicts and a decline in housing prices using a newly developed stress testing model.

[Future Monetary Policy Directions]

9 It is forecast that the GDP growth rate this year will stand at 2.2%. Despite the expectation that private consumption will maintain its upward trend, this year's growth forecast has been revised downward compared to the figure projected last April (2.5%), reflecting the persistent adjustment in construction investment and the slower-than-expected recoveries of exports and facilities investment. The economy will likely show a growth rate of 2.5% next year as the private sector rebounds from its sluggishness. Some of the key risk factors to the future growth path include progress in trade negotiations between the US and China, the pace of recovery in global semiconductor industry, and Japan's trade restrictions.

Economic growth outlook[1)2)]

(%)

	2018	2019^e			2020^e		
		Year	H1	H2	Year	H1	H2
GDP	2.7	2.2	1.9	2.4	2.5	2.6	2.3
Private consumption	2.8	2.3	2.0	2.5	2.4	2.6	2.3
Facilities investment	-2.4	-5.5	-12.6	2.3	3.4	5.6	1.3
Intellectual property products investment	2.2	2.6	2.7	2.5	2.9	2.6	3.1
Construction investment	-4.3	-3.3	-5.4	-1.3	-1.6	-2.4	-0.9
Goods exports	3.3	0.6	-0.8	2.0	2.4	3.6	1.4
Goods imports	1.6	-0.5	-3.3	2.3	2.4	3.0	1.7

Notes: 1) Year-on-year.
2) Figures are the forecast as of July 2019.
Source: Bank of Korea.

The headline consumer price index is forecast to rise by 0.7% this year and 1.3% next year. It appears that the inflation rate will significantly slow this year owing to the greater downward pressures caused by government policies and supply-side factors such as global oil prices and agricultural, livestock & fisheries prices, amid weakening demand-side inflationary pressures. The inflation rate next year is projected to increase year-on-year as the downward pressures from the supply-side factors diminish and the impacts of government policies lessen, but prices are forecast to rise at a slower pace compared to previous outlooks. The upside and downside risks to the future inflation path are mixed. Some of the main upside risks are rising international oil prices due to growing geopolitical risks and sustained increases in import prices as a result of the weakening of the Korean won. The downside risks, meanwhile, include stronger social-welfare polices regarding education and healthcare, and weaker demand-side inflationary pressures affected by slowing growth in domestic demand.

Inflation outlook[1)2)]

(%)

		2018	2019			2020^e		
			Year^e	H1	H2^e	Year	H1	H2
CPI Inflation		1.5	0.7	0.6	0.7	1.3	1.4	1.2
Core Inflation	CPI excluding food & energy	1.2	0.8	0.8	0.8	1.2	1.1	1.3
	CPI excluding agricultural products & oils	1.2	1.0	1.0	1.0	1.3	1.2	1.4

Notes: 1) Year-on-year.
2) Figures are the forecast as of July 2019.
Sources: Bank of Korea, Statistics Korea.

10 In the future as well, the Bank of Korea will conduct its 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.

The Bank will maintain its accommodative monetary policy stance as inflationary pressures on the demand side are forecast to remain low, while growth of the domestic economy will be moderate. In this process it will carefully monitor developments in the US-China trade dispute, Japan's export restrictions, any changes in the economies and monetary policy changes in major countries, the trend of increase in household debt, and geopolitical risks, while examining their effects on domestic growth and inflation.

External uncertainties are expected to remain high for the time being. While the US-China trade dispute and geopolitical risks continue to act as macroeconomic risk factors, concerns regarding negative impacts that Japan's export restrictions on Korean economy are rising. As it is difficult to predict at this time how these external risk factors will develop, it is judged important to continue closely monitoring developments of external conditions, as well as their impacts on the domestic economy.

Recently, major central banks have been taking more accommodative monetary policy stances than before, due to concerns about economic slowdown and sustained low inflation. This shift in major countries' monetary policy stances is likely to work as a positive factor by supporting the global economy and stabilizing the financial markets. However, the positive impacts will likely be limited since these policy changes are being made against the backdrop of weaker growth in individual countries. Close monitoring will be required of changes in economic conditions and monetary policies in major countries and of consequent capital flows in the international financial markets.

In the financial markets at home and abroad, frequent expansions of volatility have been witnessed as major price variables fluctuate considerably depending on changes in external conditions. As uncertainties surrounding the policy environment are high and market participants' sensitivity to risks is elevated, there is a need going forward to be mindful that volatility in the financial markets at home and abroad could expand depending on developments in the US-China trade dispute and Japan's export restrictions and on releases of major economic indicators.

From the financial stability perspective, the amount of growth in household lending decreased year-on-year entering this year, but the slowing pace of growth has moderated since April due to increased demand for funds related to housing. Even though the growth in lending to self-employed business owners has been slowing, it still outpaces that of household lending. Lending to households and to self-employed business owners including the real estate and leasing industry is expected to continue its slowing trend going forward, due to government measures. However, it is necessary to remain alert to its trend of increase, considering the amount of debt already accumulated and factors such as the supply of new apartments and the recent drop in lending rates that may drive up household debt.