Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad between April and July of 2017 reveals the following. The recovery of the world economy has continued to accelerate. The economies in the United States and the euro area have continued to improve, led by domestic demand owing for example to robust employment conditions. Japan has sustained a trend of modest recovery, as exports are showing buoyancy in line with the global economic recovery. China has maintained its trend of stable growth.

Economic growth in major economies[1)]

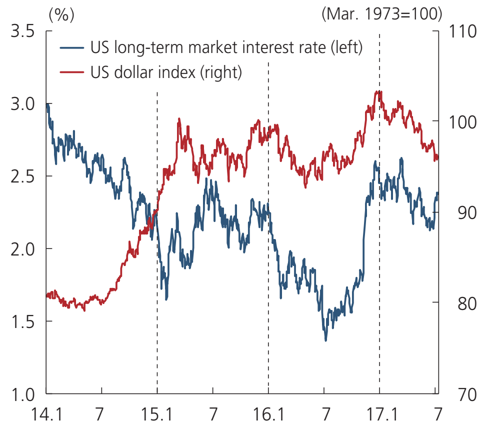
(%)

	2015	2016					2017
		Year	Q1	Q2	Q3	Q4	Q1
US	2.6	1.6	0.8	1.4	3.5	2.1	1.2
Euro area	2.0	1.8	2.1	1.4	1.8	2.1	2.3
Japan	1.1	1.0	2.5	1.6	1.0	1.4	1.0
China	6.9	6.7	6.7	6.7	6.7	6.8	6.9

Note: 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.
Sources: Individual countries' published statistics.

In the international financial markets, long-term market interest rates in major countries including the US have fluctuated slightly as conditions in financial markets have changed, and the US dollar has sustained its trend of weakening overall. Entering May long-term market rates in major countries and the value of the US dollar fell, on the effects for example of increased concerns about a weakening US capacity to carry out its economic policies. Since the end of June long-term market interest rates in major countries have risen, as the likelihood of changes in the monetary policy stances of major central banks including the ECB and the Bank of England has emerged, while the US dollar has continued to weaken against major currencies such as the euro.

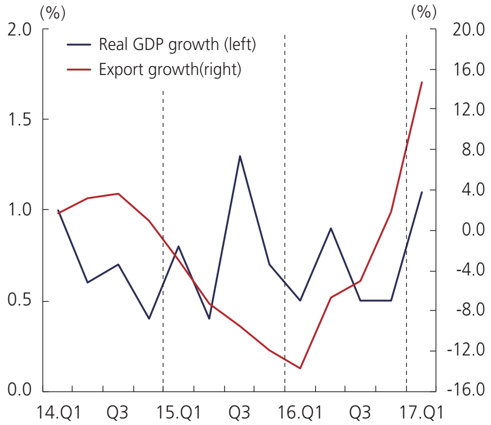
US long-term market interest rate[1)] and US dollar index[2)]



Notes: 1) Treasury bond (10-year) yields.
2) The measure of the value of the US dollar relative to a basket of foreign currencies (EUR, JPY, GBP, CAD, SEK, CHF).
Source: Bloomberg.

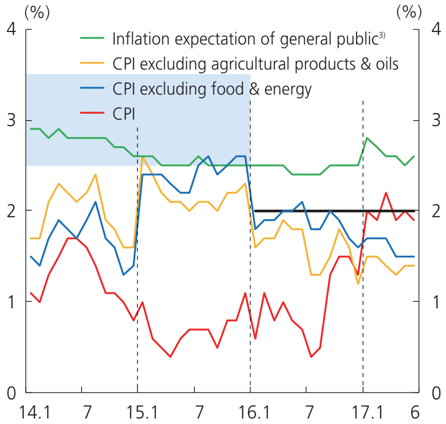
2 The trend of growth in the Korean economy has picked up, thanks to sound exports and investment. Despite sluggishness in private consumption the Korean economy recorded a quarter-on-quarter rate of growth of 1.1% in the first quarter, as facilities investment showed buoyancy amid the ongoing improvement in exports. It is judged that this trend of steady growth continued in the second quarter also, as exports sustained their high rate of growth based mainly on semiconductors, and facilities investment maintained its trend of increase driven by the IT sector.

Rates of growth in real GDP[1] and exports[2]



Notes: 1) Compared with previous quarters.
2) Compared with the same periods of the previous years; customs-clearance basis.
Sources: The Bank of Korea, Korea Customs Service.

CPI inflation[1)2)]



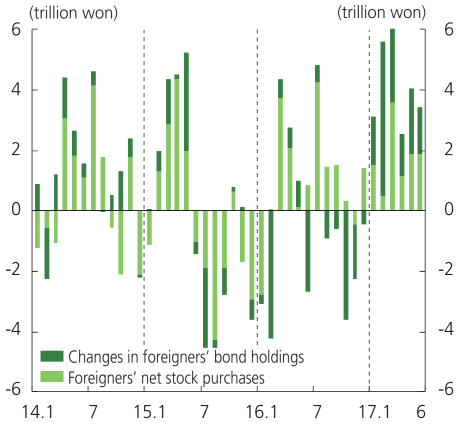
Notes: 1) Compared with the same periods of the previous years.
2) The shaded area indicates the medium-term inflation target range during the 2013~2015 period, and the bold line the medium-term inflation target set for 2016 onwards.
3) Expectations for the CPI inflation rate one year ahead.
Sources: The Bank of Korea, Statistics Korea.

3 Domestic consumer price inflation sustained a rate of around 2% in the second quarter of this year, in line with the continuing high level of international oil prices relative to last year. The inflation expectations of the general public were generally stable in the mid-2% range, while core inflation, indicative of the underlying price movements, fell slightly from 1.7% in the previous quarter to 1.5%.

Meanwhile, the pace of increase in housing sales prices accelerated after Korea's presidential election in May, driven mainly by the prices of apartments scheduled for reconstruction in Seoul and its surrounding areas. However, housing sales price movements differed by region. Leasehold deposit prices meanwhile sustained their overall stability.

4 In the domestic financial markets, stock prices have risen to considerable extents while interest rates and exchange rates have fluctuated within limited ranges. Long-term market interest rates fell slightly in May, influenced by decreases in US Treasury bond yields in line with political uncertainties in the US for example. But they then rose from mid-June, on cautions related to the likelihood of changes in the monetary policy stances of major central banks. The Korean won/US dollar exchange rate, after a period of decline, rebounded in June under the impacts of the policy rate hike by the US Federal Reserve and the US Federal Reserve's announcement of the plan to begin reducing its asset holdings this year. Meanwhile, domestic bond investment by foreigners maintained its upward trend in accord with the continuing incentives for arbitrage transactions for instance, while foreign investors' net purchases of domestic stocks continued as well, affected by inflows of capital from global funds, by perceptions that domestic stock prices are undervalued, and so on.

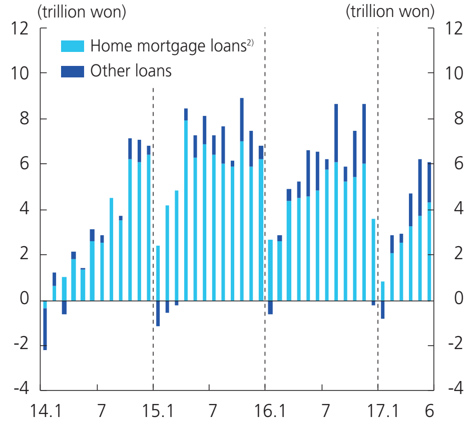
Changes in foreigners' domestic portfolio investment



Sources: Financial Supervisory Service, KOSCOM.

5 The extent of increase in bank household lending expanded in the second quarter of 2017 compared to the first, as group loans increased steadily owing for example to loans for intermediate payments on apartments that have already been sold but are still being constructed, and as demand for individual home mortgage loans also grew, in line chiefly with the expanded housing transaction volume. The amount of increase in non-bank financial institutions' household loans meanwhile fell slightly, influenced by factors such as the government's strengthening of risk management.

Changes in banks' household loans[1]

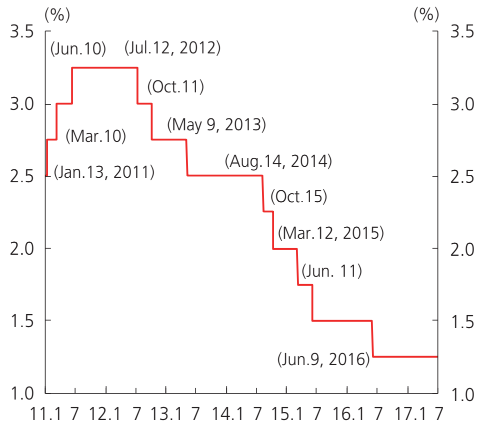


Notes: 1) Compared with the previous months.
2) Including mortgage transfers.
Source: The Bank of Korea.

[Conduct of Monetary Policy]

6 The Bank of Korea conducted its monetary policy during the May to July 2017 period in an accommodative manner, so as to ensure that the recovery of economic growth continues and consumer price inflation stabilizes at the target level over a medium-term horizon. In this process it devoted attention to financial stability as well, and thoroughly considered the trend of monetary policy normalization by the US Federal Reserve, conditions related to trade with major countries, the directions of the government's economic policies, the trend of increase in household debt, and geopolitical risks.

Bank of Korea Base Rate[1)]



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

7 Under this policy stance the Bank of Korea held the Base Rate at 1.25% per annum throughout the April to July 2017 period. A review of the factors considered as most important at the times of the monetary policy decisions follows:

The Bank maintained the Base Rate unchanged during this period for the following reasons. First, it was judged necessary to watch for future changes given the high uncertainties as to the future path of growth, even though the pace of growth in the domestic economy had picked up. Also, consumer price inflation was expected to show stable movements at around the 2% target level. Specifically, it was forecast that the domestic economy would continue its robust growth as exports maintained their high pace of increase driven mainly by semiconductors, and as facilities investment sustained its favorable level led chiefly by the IT sector. Although the domestic economy was expected to maintain its upward trend based on the expectation that the recovery in the global economy will lead to sound exports and facilities investment and the sluggishness in private consumption will lessen, it was judged that the uncertainties concerning issues such as trading conditions with major countries and the monetary policy normalization by the US Federal Reserve would limit the pace of improvement. Inflation pressures from the demand side were considered not high, as core inflation had fallen compared to the previous quarter to 1.5% between April and June, although consumer price inflation was around 2% due to the higher oil prices compared to last year and to increased prices of agricultural and livestock products. It was also judged necessary to keep in mind the possibility of expanded volatility in the financial and foreign exchange markets, given the high uncertainties at home and abroad related for example to the monetary policy normalization by the US Federal Reserve and to geopolitical risks. Meanwhile, continuous vigilance was also called for concerning the risks to financial stability stemming from the increasing household loans as the rate of household lending growth had remained higher than in normal years, although the amount of growth had lessened somewhat relative to the year before, and as the factors exerting upward pressures on household lending had persisted, among them the continuing demand for newly built apartments and the rising housing prices.

8 The Bank of Korea continued its diverse policy efforts to achieve financial and foreign exchange market stability. When geopolitical risks related to North Korea and to Syria emerged in April of this year, the Bank strengthened its monitoring of market conditions including the volatilities of price variables. It also, in response to the policy rate hike by the US Federal Reserve in June, to the missile launches by North Korea in July, etc., convened meetings of its 「Monetary and Financial Task Force」 to examine the reactions of the international financial markets and discuss the possibility of expansion of domestic financial market volatility for example.

The Bank in addition devoted efforts to identify potential risks in the financial system in advance and provide early warnings of such risks. Through its 「Financial Stability Report」 in June it closely assessed the sectoral vulnerabilities in the financial system, including those of households and the financial markets. It also evaluated the resilience of financial institutions for withstanding domestic and foreign shocks, and the domestic economy's external payment capacity. Meanwhile, in line with the rise in market participants' interest in and expectations for the 「Financial Stability Meetings」, held four times a year to examine financial system stability, the Bank made adjustments so as to submit the statutory 「Financial Stability Report」 to the National Assembly and hold the relevant press conference immediately after the 「Financial Stability Meeting」, starting from June.

[Future Monetary Policy Directions]

9 According to the Bank of Korea's 「Economic Outlook Report」 released on July 13, 2017, it is forecast that the domestic economy will continue to improve and record a growth rate of 2.8% in 2017, as exports and facilities investment show robustness due to the global economic recovery and as the slump in private consumption also gradually eases. Next year the growth rate is expected to rise to 2.9%, due to an expansion in the increasing trend of private consumption amid the continuation of the global economy's recovery. Looking at the contribution of each expenditure sector to growth this year, the contribution of exports seems likely to rise a bit and that of domestic demand to fall slightly. With regard to the future path of growth, there is a mix of both upside and downside risks. The former include the economic stimulus measures by the government, such as its supplementary budget expenditures, accelerated improvements in exports and facilities investment in accordance with the strengthening recoveries of the global economy and in IT industry conditions, and a decline in the effects of China's trade-limiting measures related to THAAD. The latter includes a worsening of the trade environment due to a strengthening of THAAD-related trade-limiting measures by China and of protectionism by the US, worsening financial conditions due to an acceleration in the pace of monetary policy normalization by the US Federal Reserve, and a contraction in economic sentiment in consequence of heightened geopolitical risks related to North Korea.

Economic growth outlook[1)]

(%)

	2016	2017[e]			2018[e]		
	Year	Year	1st half	2nd half	Year	1st half	2nd half
GDP	2.8	2.8	2.8	2.9	2.9	2.8	3.0
Private consumption	2.5	2.2	2.0	2.4	2.6	2.7	2.6
Facilities investment	-2.3	9.5	14.1	5.0	3.0	0.5	5.7
Intellectual property products investment	2.3	2.7	2.5	2.9	3.5	3.2	3.7
Construction investment	10.7	6.5	9.9	3.7	0.2	-2.2	2.3
Goods exports	2.2	3.5	4.3	2.7	3.6	3.4	3.8
Goods imports	3.6	5.9	8.8	3.2	3.4	1.9	4.9

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of July 2017.
Source: The Bank of Korea.

It is forecast that consumer prices will rise by 1.9% this year, and during next year they are also expected to increase at this year's level. In terms of the future path of inflation there is a mix of both upside and downside risks. Among the upside risks are those of a strengthening recovery in the domestic economy thanks to improvements in the global economy, of an expansion in the upward trend of wages owing to improved employment conditions, and of a rise in the Korean won/US dollar exchange rate stemming from reversals of their policy stances by major central banks. The downside risks meanwhile include those of weakening oil prices due to increased US shale oil production, and of various measures taken to stabilize prices by the government.

Inflation outlook[1)]

(%)

		2016	2017			2018[e]		
		Year	Year[e]	1st half	2nd half[e]	Year	1st half	2nd half
CPI inflation		1.0	1.9	2.0	1.8	1.9	1.8	2.0
Core Inflation	CPI excluding food & energy	1.9	1.7	1.6	1.7	1.9	1.8	1.9
	CPI excluding agricultural products & oils	1.6	1.6	1.4	1.7	1.9	1.8	1.9

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of July 2017.
Sources: The Bank of Korea, Statistics Korea.

10 Among the major issues that will have to be considered in the future operation of monetary policy, we have looked closely at the discussion of the US Federal Reserve's reduction in its asset holdings and its effects, at the background behind the recent acceleration in the pace of household lending growth and the future outlook, and at the forecasts for exports of major items and the effects of their exports on the economy.

The reduction in the US Federal Reserve's asset holdings can cause upward pressures on US long-term interest rates. In line with this there are concerns from the standpoint of emerging market countries that the risks for example of global investment funds flowing out from them can grow. However, the US Federal Reserve's reduction in its asset holdings is expected to have a limited impact on the financial sector and real economy in Korea, because it is scheduled to be carried out gradually and in a predictable manner, while the global economy has been recovering robustly. However, since there is a possibility of negative impacts from this reduction, such as increased volatility in the international financial markets, it is necessary to closely monitor the changes in the related risk factors, the movements of global investment capital, and so on.

The amount of increase in financial institutions' household loans from April to June was greater than that between January and March, and it was driven especially by bank household lending. This was a result mainly of expanded demand for individual home mortgage loans, owing to the increased housing transaction volume, to expectations of housing price rises, etc., amid a steady pace of growth in group loans due to the effects of the expanded sales of new apartments since the second half of 2014. During the second half of this year it seems likely that the extent of growth in household lending will expand beyond that in the first half, owing to increases in sales of new apartments and in new housing supply, as well as to expectations of rising housing prices in line for example with the economic recovery. Household lending growth is expected to be less than that recorded in the second half of last year, however, owing to the effects of various measures adopted by the government to manage household lending. Because the increase in household lending has a significant influence on financial stability, close monitoring of it is called for along with continuous assessment of the factors driving it and the related risks.

The exports of major items have shown differentiations in their movements since the second half of last year. Exports of automobiles and ships have been sluggish for example, while semiconductors have led the export growth. It is expected going forward that exports will continue their buoyancy for the time being, amid these contrasts in movements among various export items, but that their pace of increase will slow somewhat. The recent trend of sound exports is contributing to the Korean economy's recovery in growth, by for example leading to expanded facilities investment. But it appears that the ripple effects of exports on domestic demand will be weaker than they were in the past.

11 In the future as well, the Bank of Korea plans to conduct its monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation stabilizes at the target level over a medium-term horizon, while also devoting attention to financial stability.

Since it is forecast that the domestic economy will grow robustly, and that the inflationary pressures from the demand side will be not large, the Bank will maintain its accommodative monetary policy stance. In this process it will closely examine developments in terms of risk factors at home and abroad, such as changes in trading conditions overseas and the expanding trend of household debt, as well as any resulting changes in financial and economic conditions. Besides consumer price inflation the Bank will also closely monitor the upward pressures on prices by observing core inflation, expected inflation, international oil prices, global inflation, various auxiliary price indices, the GDP gap, and the spare capacities in employment and in the manufacturing sector.

In addition, considering that the uncertainties as to domestic and external conditions related to the Korean economy remain high, the Bank will operate its monetary policy while continuing to bear financial stability in mind as well. It will strengthen its examinations related to potential risks that can heighten financial market volatility, including changes in the monetary policies of major central banks, geopolitical risks, etc., and closely monitor the trends for example of capital in- and outflows. Along with this it plans to continually check to ensure that household debt does not hinder financial stability.

Meanwhile, if economic conditions show clearer improvements, with the economic recovery being sustained for example, then the Bank may need to adjust the degree of its monetary policy accommodation and will therefore need to carry out a thorough review of this possibility.