

Monetary Policy Report

April 2017



Monetary Policy Report

April 2017



Purpose of Establishment, Vision and Values of the Bank of Korea

Purpose of Establishment

Mission

- To contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary and credit policies
- To pay attention to financial stability in carrying out monetary and credit policies

Vision

Vision

- A global advanced central bank along with full public confidence

To maintain the goal of becoming a globally respected advanced central bank worthy of the public trust by ensuring economic stability through the formulation of effective monetary and credit policies, conducting authoritative research into finance and the economy, and providing financial and economic services for the public convenience

Values

Value

- **Public Interest** : The Bank pursues the interests of the general public and fulfills its duties in an impartial manner.
- **Independence** : We implement our policies effectively, based upon independent and autonomous decision-making.
- **Accountability** : We aim to earn the public's trust by carrying out our work transparently with a sense of ownership and passion.
- **Open Communication** : We are respectful and considerate towards one another, and communicate openly with the public.
- **Professional Excellence** : We exert outstanding capabilities in our work, with professionalism and insight.

The Bank of Korea sets and implements its monetary and credit policy in order to contribute to the sound development of national economy by pursuing price stability and paying attention to financial stability.

The Bank of Korea Act stipulates that the Bank of Korea, to fulfill its accountability corresponding to these mandates, should compile at least twice each year a report on the implementation of its monetary and credit policies.

In line with this the Bank of Korea prepares the Monetary Policy Report containing the details of and backgrounds to its monetary policy decisions, the future monetary policy directions, etc., four times per year, and submits it to the National Assembly. Among these four reports, the Bank publishes its biannual regular reports in April and October, and shortened interim quarterly reports in January and July.

This April 2017 Monetary Policy Report has been drawn up to cover the time period from October 2016 through the date of the Monetary Policy Board meeting for monetary policy decision-making in April 2017.

We sincerely hope that this Monetary Policy Report will be of help in ensuring that the public well understands the Bank of Korea's monetary policy operations and forms rational expectations concerning the future policy directions.

<Bank of Korea Act>

Article 96 (Reporting to National Assembly)

- (1) The Bank of Korea shall prepare an assessment report on progress in implementing monetary and credit policies and macro-financial stability conditions at least twice every year and submit it to the National Assembly.
- (2) The Governor shall attend a meeting and answer questions, when the National Assembly or any of its committees requests him/her to attend the meeting in connection with the report submitted pursuant to paragraph (1).

This Monetary Policy Report is published in accordance with the provision of Article 96 of the Bank of Korea Act, and upon the resolution of the Monetary Policy Board.

April 2017

A handwritten signature in black ink, reading "Juyeol Lee". The signature is written in a cursive, flowing style.

Lee, Juyeol
Governor
the Bank of Korea

Monetary Policy Board

Chairman	Lee, Juyeol
Member	Hahm, Joon-Ho
Member	Jang, Byung Wha
Member	Lee, Il Houg
Member	Cho, Dongchul
Member	Koh, Seung Beom
Member	Shin, Inseok

General Principles of Monetary Policy Operation

The Bank of Korea Act stipulates the goal of monetary policy as follows: “The Bank shall contribute to the sound development of the national economy through ensuring price stability, while giving due consideration to financial stability in carrying out its monetary policy.” In order to enhance transparency, predictability and effectiveness of monetary policy, the Bank will carry out its task by setting specific targets and objectives in accordance with this goal.

- **(Inflation targeting)** The Bank of Korea maintains a flexible inflation targeting system to effectively achieve price stability, which is the primary objective of monetary policy. The inflation target is currently set at 2.0% in terms of consumer price inflation (year-on-year).
 - **(Medium-term horizon)** The inflation target is meant to be achieved over a medium-term horizon, since consumer price inflation is affected not only by monetary policy but also by various other factors at home and abroad, which entail transitory and irregular impacts and the lag in monetary policy transmission.
 - **(Forward-looking operation)** The Bank conducts its monetary policy in a forward-looking manner, while considering symmetrically the risks of inflation remaining persistently above or below the target.
 - The path of convergence of inflation toward the target is assessed on overall inflation and growth outlooks as well as their uncertainties and risks, and on financial stability conditions.
 - **(Flexible operation)** The Bank conducts its monetary policy to support real economic growth to the extent that this does not hinder attaining the inflation target over the medium-term.

□ **(Consideration of financial stability)** In ensuring price stability over the medium-term, the Bank pays careful attention to the impact of monetary policy on financial stability.

○ **(Relationship with inflation targeting)** As persistent financial imbalance could undermine macroeconomic stability, paying due attention to financial stability in conducting monetary policy is consistent with the rationale behind flexible inflation targeting.

○ **(Examination of financial stability)** The Bank examines, assesses and announces financial stability conditions on a regular basis, to prevent excessive buildup of financial imbalances that may be brought about by monetary policy implementation.

○ **(Harmonization with macroprudential policy)** Since there are limits to maintaining financial stability solely by monetary policy that indiscretely affects the whole economy, monetary policy needs to be complemented by macroprudential policies to prevent accumulation of financial imbalance.

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■ Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad between October 2016 and April 2017 reveals the following. In the global economy, signs of a somewhat accelerating pace of recovery appeared. The United States sustained its trend of robust growth, with consumption increasing consistently thanks for example to favorable employment conditions. The euro area and Japan meanwhile maintained modest trends of improvement, and China continued its stable growth.

Economic growth in major economies¹⁾

	2014		2015		2016						
	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	
US	2.4	2.6	1.6	0.8	1.4	3.5	2.1				
Euro area	1.2	2.0	1.8	2.2	1.3	1.7	1.9				
Japan	0.3	1.2	1.0	1.9	2.2	1.2	1.2				
China	7.3	6.9	6.7	6.7	6.7	6.7	6.8				

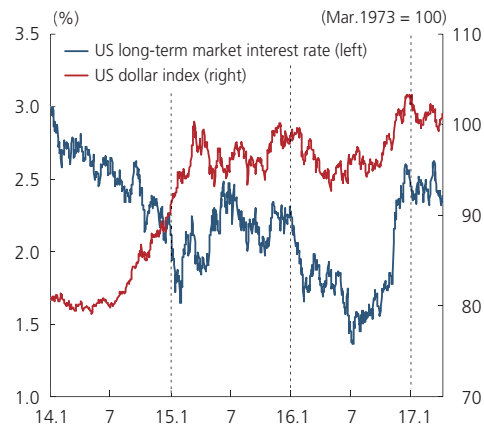
Note: 1) The quarterly rates of growth are annualized quarter-on-quarter rates for the US, Japan and the euro area, and year-on-year rates for China.

Sources: Individual countries' published statistics.

In the international financial markets, long-term market interest rates in major countries and the value of the US dollar rose greatly after the US presidential election in November 2016, but from mid-December then showed generally stable pictures, with their paces of increase slowing for example. Entering March 2017 long-term market rates and the value of the dollar rose again, on forecasts that the US Federal Reserve would raise rates at a pace

faster than had been previously expected, but after the FOMC meeting the markets regained stability as these concerns eased.

US long-term market interest rate¹⁾ and US dollar index²⁾

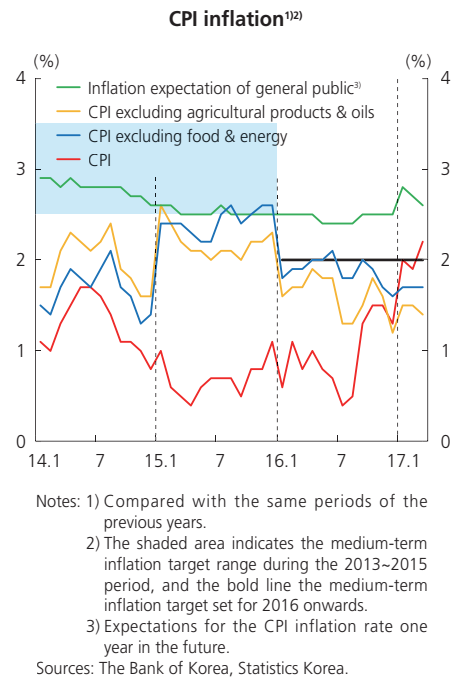
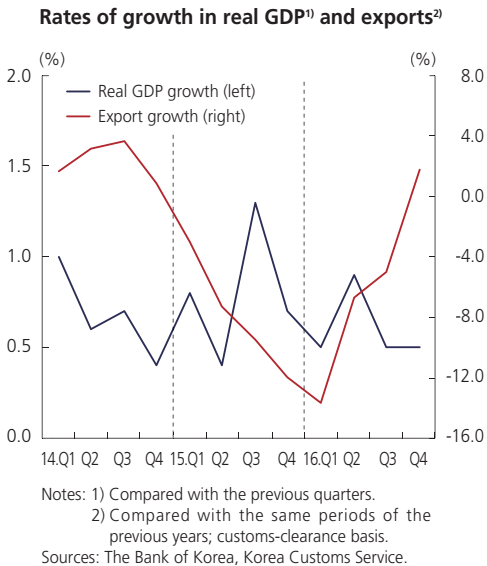


Notes: 1) Treasury bond (10-year) yields.

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 domestic economy continued its trend of modest growth even despite sluggishness in private consumption, owing to improvements in exports and facilities investment. During the fourth quarter of 2016 the growth rate (quarter-on-quarter) was 0.5%, notwithstanding slumps in private consumption and exports, as facilities investment improved. It is judged that the pace of growth then picked up somewhat in the first quarter of 2017 – due to buoyancy in exports mainly of semiconductors and petroleum products, to significantly improved facilities investment, and to a continuing solid trend of growth in construction investment.



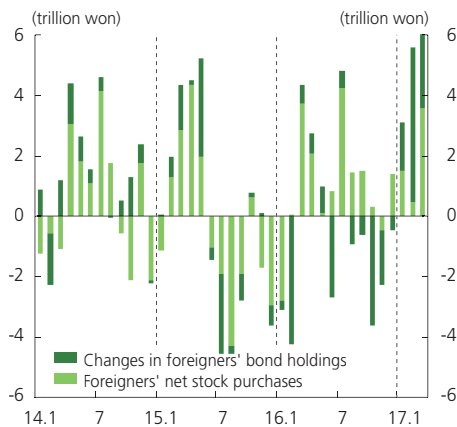
③ The rate of domestic consumer price inflation rose from the mid-1% range in the fourth quarter of 2016 to around 2% during the first quarter of 2017, as a result mainly of supply-side factors such as increases in the prices of oil, agricultural, livestock and marine products. The inflation expectations of the general public also climbed somewhat, but core inflation, which shows the underlying price movements, remained at the mid- to upper-1% level.

The pace of increase in housing sales prices meanwhile slowed greatly from November 2016, on factors such as the government’s housing market stabilization policies including the 11/3 real estate measures, as well as the rise in domestic market interest rates after the December rate hike by the Federal Reserve. Entering 2017 they then showed steady movements. Leasehold deposit prices meanwhile sustained their trend of general stability.

④ In the domestic financial markets, major price variables including interest rates, stock prices and exchange rates showed relatively large fluctuations, influenced for example by changes in international financial market conditions. Long-term market interest rates rose greatly after the US presidential election in November 2016, together with interest rates in major countries, as concerns emerged about inflation due for example to expansionary fiscal policies by the Trump administration. They later stabilized as the Bank of Korea implemented market stabilization measures, including purchases of Treasury bonds and reductions in its Monetary Stabilization Bond issuance. The Korean won/US dollar exchange rate had also shown a rising trend after the US election, but then fell greatly entering 2017 in line for example with the new US

government's statements cautioning against the trend of dollar strengthening, and its protectionist tendencies. Portfolio investment funds of foreigners meanwhile shifted to net inflows, as global financial market volatility eased after December 2016.

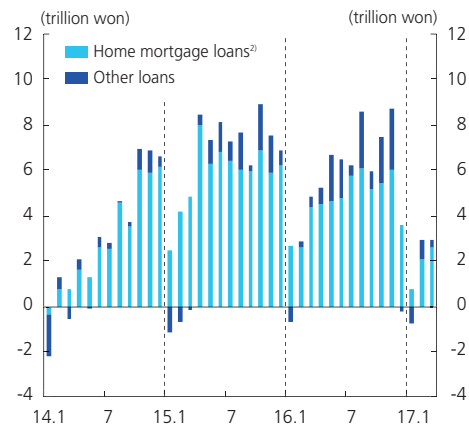
Changes in foreigners' domestic portfolio investment



Sources: Financial Supervisory Service, KOSCOM.

⑤ The pace of increase in household lending by banks slowed – for reasons such as a reduction in the housing transaction volume, the effects of the government's policies concerning household loans and real estate, and rising loan interest rates. Household lending by non-bank financial institutions on the other hand sustained a high rate of increase.

Changes in banks' household loans¹⁾



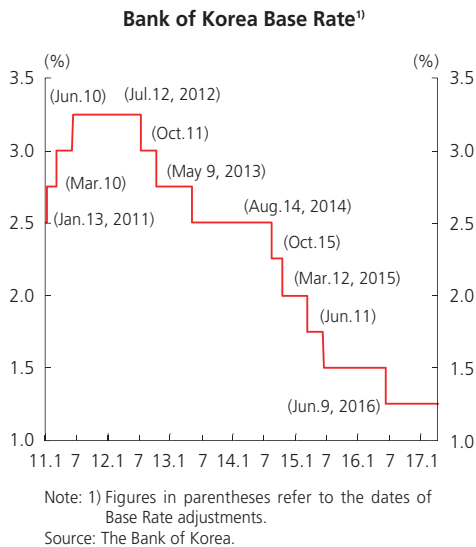
Notes: 1) Compared with the previous months.

2) Including mortgage transfers.

Source: The Bank of Korea.

[Conduct of Monetary Policy]

⑥ The Bank of Korea conducted its monetary policy accommodatively during the October 2016 to April 2017 period, to ensure that the recovery of economic growth continues and consumer price inflation approaches the target level over a medium-term horizon. In this process it devoted attention to financial stability as well, and closely monitored the uncertainties surrounding conditions in Korea and abroad, as well as their effects, the changes in monetary policies of major countries including the US, the trends of growth in household debt, and so on.



7 Under this policy stance the Bank of Korea held the Base Rate at a level of 1.25% per annum throughout this period. A review of the factors considered most importantly at the times of the monetary policy decisions follows:

During the October to December 2016 period the Base Rate was maintained at 1.25% per annum. The decisions to do so were based on the Bank's judgment that, notwithstanding the increased downside risks to the economic growth path, it was desirable to cautiously observe future changes in conditions and their effects on the domestic financial markets and economy, given the high uncertainties about conditions at home and abroad. First, it was forecast that the domestic economy would continue its weak but moderate trend of growth during this period, due to the recovery of the global economy. However, as the trend of recovery in domestic demand had been limited, owing to factors such as a

contraction in sentiment, the downside risks to the growth path were judged to have risen somewhat. There was a need to consider as well the significantly increased uncertainties surrounding domestic and overseas conditions, including the results of the US presidential election and the new US government's policies, the normalization of monetary policy by the US Federal Reserve, and the domestic political situation. The rate of consumer price inflation had shown a level in the low- to mid-1% range, but was accelerating on the effects for example of rising international oil prices, and was forecast to gradually rise to approach the inflation target level. It was in addition judged necessary to be even more mindful of the risks on the financial stability side, as volatilities in the financial and foreign exchange markets at home and abroad were growing due to the uncertainties about domestic and foreign conditions, and as household lending was sustaining high paces of increase greatly above normal years' levels at both banks and non-bank financial institutions.

During the January to March 2017 period the Bank continued to maintain a Base Rate of 1.25% per annum as well. The decisions to hold it unchanged were made in view of the points that the domestic economy was expected to continue its moderate pace of growth and the rate of consumer price inflation to move at around the 2% target level, and that it was necessary to be continuously mindful of financial stability given the very high uncertainties surrounding domestic and external conditions. First of all, it was anticipated that the domestic economy would continue to grow moderately

as exports and investment improved, even though consumption remained sluggish due to weakened sentiment. Another point considered was that demand-side inflation pressures were not great, as core inflation, which shows the underlying price movements, had maintained the mid- to upper- 1% level even though consumer price inflation had reached the 2% inflation target level. On the financial stability side, meanwhile, there was a need for caution related to the rising possibility of an additional policy rate hike by the US Federal Reserve in line with the continuing recovery of the US economy, as well as to the political uncertainties in the euro area. Although household lending had risen at a slower pace, due mainly to a slowdown in lending by banks, the need to wait to observe whether these movements would become a long-term trend was taken into account.

The Bank of Korea held the Base Rate at 1.25% per annum in its April meeting as well. This was a result of comprehensive consideration of several points – that although the pace of domestic economic recovery had picked up somewhat recently the uncertainties concerning the future growth path remained high, that it was being forecast that consumer price inflation would move at around the 2% inflation target level, and that it was necessary to continue focusing on risks to financial stability related for example to the expansion in household debt and to the hikes in interest rates by the US Federal Reserve. Specifically, the domestic economy was expected to record a GDP growth rate slightly exceeding the January forecast figure

(2.5%), thanks to improvements in exports and investment in line with the global economic recovery, but it was assessed that its growth could be hindered by trade conditions vis-à-vis major countries and by inadequate improvements in household real purchasing power. The point was also considered that consumer price inflation was forecast to show a level of 1.9% for the entire year, while upward pressures on consumer prices from the demand side were not high. Meanwhile, it was also judged necessary to bear in mind the possibility of expanding volatilities in the financial and foreign exchange markets, since the uncertainties about domestic and external conditions including monetary policy normalization by the US Federal Reserve and geopolitical risks remained high. In addition, it was considered necessary as well to devote continuing care to the risks to financial stability given the increasing household debt resulting from the high pace of increase in household lending by non-bank financial institutions, although the amount of growth in household lending by banks had lessened compared to the year before.

8 The Bank of Korea continued its policy efforts for achieving financial and foreign exchange market stability. While on the one hand closely monitoring the movements of major price variables including interest and exchange rates, the in- and outflows of foreigners' investment funds, etc., it also responded actively to emergent destabilizing factors at home and abroad by activating its emergency response system, strengthening its communication, and implementing market stabilization measures, and promoted market

stability thereby. At the times of announcement of the US presidential election result (November 2016), the National Assembly's passage of the presidential impeachment bill (December), and the Constitutional Court's decision to impeach the president (March 2017), it convened its 「Emergency Financial and Economic Conditions Review Meeting」 and 「Emergency Executive Meeting」, and closely examined financial and economic conditions in Korea and abroad, while at the same time heightening its communication with the markets to ensure that anxieties in sentiment did not spread. In particular, during the period of greatly increased financial market unrest as long-term market rates surged after the US presidential election, the Bank of Korea devoted efforts to alleviating this unrest and ensuring that market interest rate volatility did not expand, through implementation of market stabilization measures including purchases of Treasury bonds and a reduction in Monetary Stabilization Bond issuance. The Bank also devoted efforts to presenting early warnings and suggesting directions for response through identification in advance of potential risks in the financial system. In December 2016 it reformed the analysis framework used in its 「Financial Stability Report」, and closely assessed the vulnerabilities in financial conditions in the household and other sectors while checking on resilience for withstanding domestic and external shocks. In March 2017 it held a regular Monetary Policy Board meeting for the examination of financial conditions, and analyzed in depth financial stability conditions in various sectors such as the credit markets, the asset markets,

financial institutions, etc., and examined financial system resilience. Moreover, it also released the main contents of this meeting's discussions to the public on the day of the meeting, and thereby strengthened its communication with market participants.

[Future Monetary Policy Directions]

⑨ In the Bank's 「Economic Outlook Report」 released on April 13, 2017, it forecast that the domestic economy will continue its moderate pace of growth, thanks to improvements in exports and facilities investment in line with the global economic recovery, and record a growth rate of 2.6% in 2017. In 2018 the growth rate is expected to then rise to 2.9%, as the world economy's trend of recovery continues. Looking at the contributions to growth of the different expenditure sectors in 2017, the contribution of the export sector will maintain its level of last year, but the contribution of domestic demand seems likely to decrease slightly. Concerning the future growth path, there is a mix of both upside and downside risks. Among the former are an expansion in the external demand recovery due to strengthening trends of improvement in the global economy and in IT business conditions, a decline in the effects of China's measures to limit trade, and economic stimulus policies by the new Korean government. The downside risks meanwhile include those of weakening world trade growth due to strengthened protectionism, of expansions in the effects of China's measures to limit trade, and of increased financial market volatility stemming for example from an upsurge in geopolitical risks.

Economic growth outlook¹⁾

(%)

	2016			2017 ^e			2018 ^e
	Year	1st half	2nd half	Year	1st half	2nd half	Year
GDP	2.8	3.2	2.5	2.6	2.6	2.7	2.9
Private consumption	2.5	2.9	2.1	2.0	1.9	2.0	2.3
Facilities investment	-2.3	-3.7	-0.9	6.3	9.5	3.3	3.4
Intellectual property products investment	2.3	1.9	2.6	2.7	2.5	2.9	3.2
Construction investment	10.7	9.9	11.4	4.5	7.3	2.2	-0.1
Goods exports	2.2	1.3	3.0	3.3	4.0	2.6	3.5
Goods imports	3.6	2.7	4.5	4.0	6.2	1.8	3.4

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of April 2017.

Source: The Bank of Korea.

It is forecast that consumer prices will rise by 1.9% during 2017, and they are expected to show a pace of increase at the same level in 2018 as well. The upside and downside risks to the future path of inflation are also assessed as mixed, with the overall risk neutral. The major upside risks include those of a rise in international oil prices after an extension in the production cuts agreed on by OPEC oil-producing countries, of an acceleration of the domestic economic recovery owing for example to improvements in the global economy, and of worsening weather conditions. Among the potential downside risks to prices are an increase in US shale oil production and a dulling of demand-side price pressures owing for example to increased economic uncertainties in Korea and overseas.

Inflation outlook¹⁾

(%)

	2016			2017 ^e			2018 ^e	
	Year	1st half	2nd half	Year	1st half	2nd half	Year	
CPI inflation	1.0	0.9	1.1	1.9	2.0	1.8	1.9	
Core Inflation	CPI excluding food & energy	1.9	1.9	1.8	1.7	1.6	1.7	1.9
	CPI excluding agricultural products & oils	1.6	1.7	1.5	1.5	1.4	1.6	1.9

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of April 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 effects of monetary policy normalization by the US Federal Reserve, at whether the high extent of growth in household lending will continue, and at global inflation conditions.

The US Federal Reserve's monetary policy normalization will work as a factor heightening capital outflow pressures. However, after comprehensive consideration of past cases of capital outflows, and of current economic conditions at home and abroad, we appraise the likelihood of large-scale outflows to be limited. However, in any case where financial markets in some EMEs with relatively high external vulnerabilities become unstable as global risk factors materialize, a possibility also exists of capital outflow pressures growing in Korea due to contagion, and there is as a result a need for close review of developments related to the various risk factors.

Entering 2017 the pace of increase in household lending slowed. This slowdown, occurring primarily in lending by banks,

seems a consequence mainly of a reduction in housing transactions, of the effects of the government's household lending- and real estate-related policies, and of increases in loan interest rates. In the future as well the pace of lending growth is expected to slow compared to 2016, on the effects of the government's household loan-related policies and of hikes in lending rates. However, if the housing economy improves after the spring moving season, there is a possibility that the extent of slowdown in household lending growth will not be large, and it is hence necessary to sustain close monitoring of household lending trends.

The trend of increase in global inflation will put upward pressures on domestic prices, but it is judged unlikely that the domestic inflation trend will accelerate to a large extent due to this. However, given the point for example that the effects of global inflation on domestic prices have become stronger compared to the past, it is necessary to continue to check for any changes in global inflation and their effects.

11 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 also devoting attention to financial stability.

The Bank of Korea plans to maintain its accommodative monetary policy stance, as the upward price pressures on the demand side are not expected to be significant for

the time being given the moderate economic growth. In this process it will closely examine developments related to domestic and external risk factors, along with any resulting changes in financial and economic conditions, and analyze in depth their effects on the future paths of growth and inflation. Besides consumer price inflation, the Bank will moreover also closely watch the movements of indicators including core inflation, expected inflation, international oil price trends, various auxiliary price indices, the GDP gap, and idle production capacities in employment and in the manufacturing sector.

In view of the fact that the domestic and external uncertainties surrounding the Korean economy recently are higher than ever before, efforts will be made in addition to ensure that financial market stability is firmly maintained. The Bank will strengthen its examinations related to potential risk factors that could heighten financial market volatilities at home and abroad, such as Korea's trading conditions vis-à-vis major countries, geopolitical risks, the trends of monetary policy normalization by the US Federal Reserve, developments related to the new US government's policies, etc., while closely monitoring capital in- and outflows as well. And since it also remains uncertain whether the slowdown in the pace of increase in household debt has become a long-term trend, the Bank will thoroughly monitor household debt to ensure that it does not hinder financial stability.

The Bank will strengthen its policy

communication to ensure the greater transparency and predictability of monetary policy. Efforts will be continued to improve the methods of description and the contents of the monetary policy statement, in ways that maintain consistency with the 「General Principles of Monetary Policy Operation」 announced at the end of 2016 and heighten the statement's coherence with the Bank's economic forecasts. Moreover, while faithfully disclosing the contents of its monetary policy-setting meetings, through its 「Monetary Policy Report」 and press releases for example, the Bank also plans to continue revitalizing its communication with the financial markets, academia, the media, and so on.

I

Monetary Policy Operating Conditions

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1. Global Economy

Pace of Recovery Accelerates Slightly

The pace of recovery of the global economy has shown signs of slight acceleration since October 2016. The United States has sustained its solid pace of growth, driven by domestic demand. Amid a continuing trend of steady growth in private consumption, thanks for example to buoyant employment conditions, facilities investment has shown a recovery owing to improved investment sentiment in line for example with expectations related to the policies of the new government. Growth in the euro area has been modest, led by consumption and exports. Consumption has continued its recovery, on improvements in employment conditions, and exports have also shown a favorable picture due to factors such as increased import demand in natural resource-exporting countries. Japan has sustained its modest growth, based mainly on exports and facilities investment and driven by factors such as the global business recovery and the weak yen. China has continued its stable growth, driven especially by fixed asset investment, while India and the ASEAN-5 countries have shown robust growth on the basis of buoyant domestic demand and improvements in exports. Natural resource-exporting countries such as Brazil and Russia have shown recoveries from their slumps, under the effects for example of increased raw

materials prices.

<Table I - 1> Economic growth in major economies¹⁾ (%)

	2014	2015	2016 ²⁾				
			Year	Q1	Q2	Q3	Q4
World	3.5	3.4	3.1	-	-	-	-
Advanced economies	2.0	2.1	1.7	-	-	-	-
US	2.4	2.6	1.6	0.8	1.4	3.5	2.1
Euro area	1.2	2.0	1.8	2.2	1.3	1.7	1.9
Japan	0.3	1.2	1.0	1.9	2.2	1.2	1.2
Emerging market and developing economies	4.7	4.2	4.1	-	-	-	-
China	7.3	6.9	6.7	6.7	6.7	6.7	6.8
India ³⁾	7.2	7.9	-	8.6	7.2	7.4	7.0
ASEAN-5 ⁴⁾	4.6	4.8	4.9	4.8	5.0	5.0	4.9
Brazil	0.5	-3.8	-3.6	-5.4	-3.6	-2.9	-2.5
Russia	0.7	-2.8	-0.2	-0.4	-0.5	-0.4	0.3

Notes: 1) Based on IMF statistics, apart from individual countries and the euro area which are based on their own published statistics.

2) The rates of growth are annualized quarter-on-quarter rates for advanced economies, and year-on-year rates for the others.

3) The annual growth rates are based on the fiscal year (April of the previous year to March of the current year).

4) Indonesia, Thailand, Malaysia, the Philippines and Vietnam.

Sources: IMF, individual countries' published statistics.

International Oil Prices Fluctuate at around 50 US Dollars per Barrel

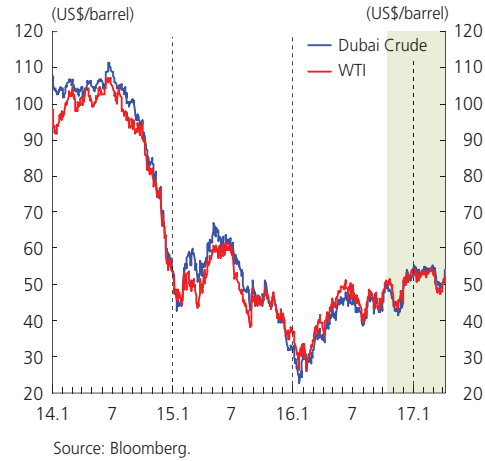
The international oil price fell to the mid-40 US dollars-per-barrel level from the middle of October 2016, on concerns related to the possibility of failure in the OPEC negotiations on production cuts. But as OPEC member countries reached a final agreement on crude oil production cuts at the end of November¹⁾, and non-OPEC countries joined in this as well²⁾, it rose to a level exceeding 50 dollars to the barrel. During January and February of this year the international oil price rose to the mid-50-

1) At the OPEC Meeting of the Conference on November 30, 2016, members agreed to cut their crude oil production by a daily average of 1.2 million barrels compared to its October 2016 level, with effect from January 2017.

2) On December 10 of last year, 11 non-OPEC oil-producing countries including Russia and Mexico agreed to cut their crude oil production by a daily average of 558 thousand barrels by the end of June 2017.

dollar level, due to the implementation of production cuts. Entering March it however fell again to around the 50-dollar level, on concerns about an expansion in crude oil production in the US.³⁾

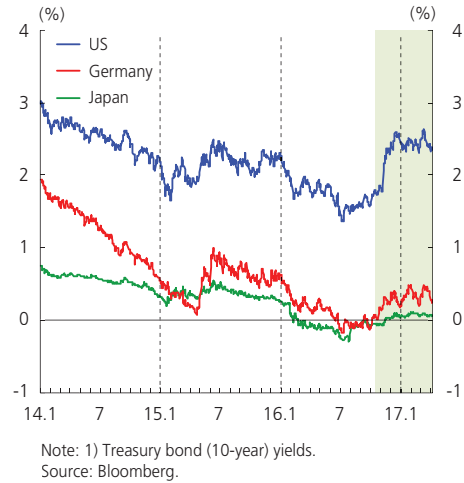
<Figure I - 1> International oil prices



US Long-term Market Interest Rates Fluctuate after a Substantial Rise

US long-term market interest rates rose substantially from November of last year, on forecasts of increased Treasury bond issuance and rising prices due to the expansionary fiscal policies of the new government. Entering this year they have however been fluctuating within a relatively narrow range. Long-term market interest rates in Germany and Japan have meanwhile shown repeated fluctuations, affected by the changes in US long-term market rates.

<Figure I - 2> Long-term market interest rates¹⁾ in major economies

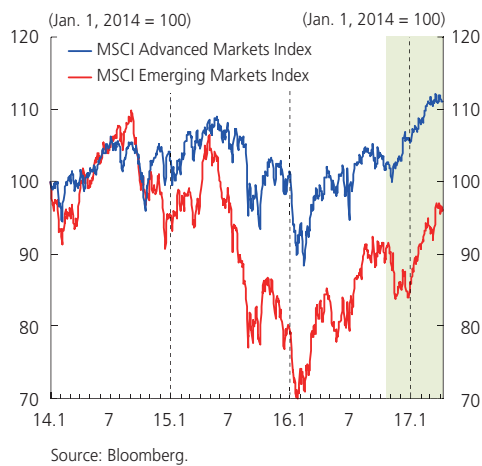


Stock Prices Buoyant in Advanced Countries, Rallying in EMEs

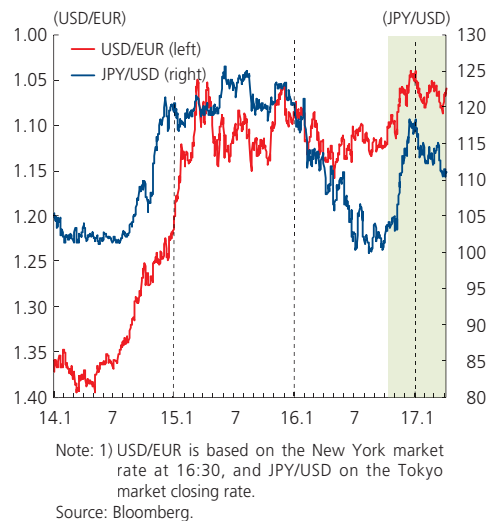
Stock prices in advanced countries sustained upward trends from November of last year, led mainly by those in the US based on favorable economic indicators and expectations for the new government's policies. Stock prices in emerging market economies fell from October, on factors such as concerns about a contraction in trade due to strengthening trade protectionism and forecasts of reduced liquidity following interest rate hikes by the US Federal Reserve. Entering this year they have rallied, however, as the strengthening trend of dollar has eased and prices of oil and other raw materials have risen moderately.

3) The US Energy Information Administration (EIA) has forecast that US crude oil production will increase by a daily average of 330 thousand barrels in 2017 and 520 thousand barrels in 2018 compared to previous years.

<Figure I - 3> Share price indices of advanced and emerging markets



<Figure I - 4> Major exchange rates¹⁾



US Dollar Slightly Weakened after Period of Strengthening

The US dollar's value showed a sharp upward trend from November of last year, in line for example with the policy rate hike by the US Federal Reserve and with expectations of expansionary fiscal policies by the Trump administration, before then reversing to a slight downward trend entering this year, on factors including the new US government's delay in presenting concrete policy plans and its statements cautioning against the appreciation of the dollar. The dollar subsequently strengthened temporarily, largely on concerns about an acceleration in the US Federal Reserve's policy rate hikes, but after the March FOMC meeting it showed a weakening trend slightly again as these concerns eased.

2. Real Economy

Domestic Economy Grows Modestly

The domestic economy continued its modest growth, thanks to improvements in exports and facilities investment and despite the sluggishness of private consumption. Real GDP increased by 0.5% quarter-on-quarter in the fourth quarter of 2016, and in the first quarter of 2017 the pace of growth then accelerated somewhat.

Private consumption showed a trend of weak growth. It grew by a mere 0.2% quarter-on-quarter in the fourth quarter of last year, because of factors such as a contraction in consumption sentiment in line with political uncertainties and despite positive factors including Korea Sale Festa and large-scale discounts on automobile sales prices at the year-end. In the first quarter of this year as well, although private consumption did continue to grow⁴⁾, based on increased consumption of services and consumption overseas, its pace was constrained due to the effects for example of insufficient improvements in income conditions. Facilities investment meanwhile showed a rate of increase higher than originally expected. In the fourth quarter of last year it grew by 5.9% quarter-on-quarter, as investment in machinery was buoyant especially in the semiconductor and display sectors, and as investment in airplanes and other transport equipment also

increased. In the first quarter of this year the upward trend continued as well, due for example to improvements in global IT business conditions and the recovery in exports.⁵⁾ The rapid pace of increase in construction investment seen until now slowed, but in year-on-year terms sustained a high rate of increase. In the fourth quarter last year it contracted by 1.2% quarter-on-quarter, under the influence of a reduction in fiscal spending on SOC, but in the first quarter of this year it showed favorable flows, centering around residential building construction.⁶⁾ Intellectual property products investment rose by 0.6% quarter-on-quarter in the fourth quarter of 2016, as R&D investment in the private and government sectors grew, notwithstanding the decline in investment in other intellectual property products such as software.

<Table I - 2> Major economic growth indicators¹⁾

	2014		2015		2016			
	Year	Q1	Q2	Q3	Q4			
Real GDP	3.3	2.8	2.8	0.5	0.9	0.5	0.5	
				(2.9)	(3.4)	(2.6)	(2.4)	
(Private consumption)	1.7	2.2	2.5	-0.1	0.8	0.6	0.2	
				(2.3)	(3.5)	(2.7)	(1.5)	
(Facilities investment)	6.0	4.7	-2.3	-7.0	2.6	0.9	5.9	
				(-4.6)	(-2.9)	(-3.9)	(2.0)	
(Construction investment)	1.1	6.6	10.7	7.6	3.1	2.2	-1.2	
				(9.0)	(10.6)	(11.2)	(11.6)	
(Intellectual property products investment)	5.4	1.8	2.3	0.2	1.3	0.5	0.6	
				(1.1)	(2.7)	(2.7)	(2.6)	
(Goods exports)	1.1	-0.6	2.2	-1.6	1.9	1.5	0.4	
				(0.4)	(2.3)	(3.9)	(2.1)	
(Goods imports)	0.5	0.7	3.6	-2.8	2.1	3.0	1.3	
				(1.8)	(3.7)	(5.3)	(3.7)	

Note: 1) Compared with the previous periods; figures in parentheses are non-seasonally adjusted year-on-year rates.

Source: The Bank of Korea.

4) During January and February 2017 Statistics Korea's retail sales index fell by 0.8% compared to the fourth quarter of 2016 (+2.4% year-on-year), but its service industry production index rose by 0.7% (2.6% year-on-year).

5) During January and February 2017 Statistics Korea's equipment investment index rose by 3.0% compared to the fourth quarter of 2016 (15.0% year-on-year).

6) During January and February 2017 Statistics Korea's 'Value of Construction Completed' increased by 3.4% compared to the fourth quarter of 2016 (18.0% year-on-year).

Sluggishness in Employment Eases

Employment conditions were sluggish during the fourth quarter of last year, owing to corporate restructuring for example, but in the first quarter of this year the sluggishness eased, thanks to the recovery in exports among other factors. The number of persons employed showed a year-on-year increase of a mere 302 thousand during the fourth quarter of 2016, but in the first quarter of this year the number employed rose by 360 thousand persons year-on-year as the extent of its increase expanded.

<Table I - 3> Major employment-related indicators

	(million persons, %)						
	2015	2016				2017	
	Year	Q1	Q2	Q3	Q4	Q1	
Economically active population	26.9	27.3	26.7	27.4	27.5	27.3	27.1
(Rates of change ¹⁾)	1.4	1.2	1.3	1.0	1.4	1.3	1.4
Number of employed persons	25.9	26.2	25.6	26.4	26.6	26.5	25.9
(Changes ¹⁾)	0.3	0.3	0.3	0.3	0.3	0.3	0.4
Labor force participation rate ²⁾	62.6	62.8	62.8	62.5	62.8	62.9	63.2
Employment-population ratio ²⁾	60.3	60.4	60.4	60.2	60.5	60.6	60.8
Unemployment rate ²⁾	3.6	3.7	3.8	3.7	3.8	3.6	3.8

Notes: 1) Compared with the same periods of the previous years.

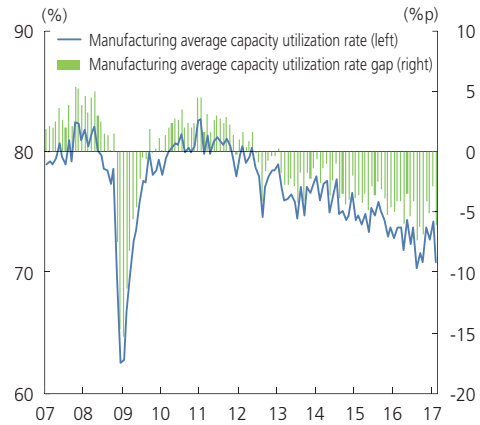
2) Seasonally adjusted.

Source: Statistics Korea.

Idle Production Capacity Continues

The average capacity utilization rate gap in the manufacturing sector has been widening since 2012. And in view of this, it is assessed that Korea continues to have idle production capacity.

<Figure I - 5> Manufacturing average capacity utilization rate gap¹⁾

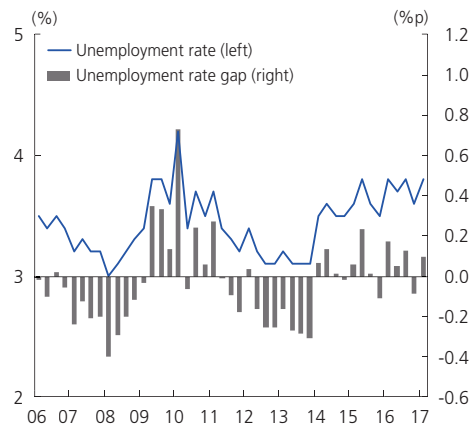


Note: 1) The deviation from the long-run average (during the last 10 years) in the year.

Source: Statistics Korea.

The unemployment rate gap has meanwhile not diverged from its long-term trend and has fluctuated within a narrow range.

<Figure I - 6> Unemployment rate gap¹⁾



Note: 1) Unemployment rate (seasonally adjusted) - Non-accelerating inflation rate of unemployment (NAIRU, estimated by Bank of Korea).

Sources: Bank of Korea estimates, Statistics Korea.

Current Account Surplus Narrows

During the fourth quarter of 2016 the current account surplus narrowed compared to the same period of the previous year, centering around the goods account. Looking at the individual component accounts, the goods account continued a large-scale surplus, of 29.7 billion dollars, but the surplus lessened as imports picked up more rapidly than exports did due to the higher international prices of oil and raw materials. The services account meanwhile recorded a 4.1 billion-dollar deficit, on a continuation of the travel account deficit as well as a worsening of the transport account following for example Hanjin Shipping's entry into court receivership. During this year as well the size of the current account surplus has continued its narrowing⁷⁾ trend, owing to an expansion in the size of the services account deficit.

Exports (customs-clearance basis) reversed to show a slight increase year-on-year during the fourth quarter of 2016. Exports of steel, petroleum products, display panels, etc. expanded, thanks to recoveries in their export unit prices, while semiconductor and petrochemical exports showed buoyancy due to increases in demand. In the first quarter of this year exports grew by a larger extent than in the first quarter of last year, as the increase in export quantities and the rise in unit prices continued this year. However, the slump in mobile phone exports persisted, affected for example by delays in the

launches of new models.

Imports (customs-clearance basis) also increased in the fourth quarter of last year relative to the same period of 2015. This was because imports of consumer goods maintained their upward trends, while those of capital goods and raw materials reversed to increases – as the demand for semiconductors picked up and as unit prices of raw materials including crude oil and steel increased, respectively. During the first quarter of this year international oil prices rose to a large extent year-on-year, leading to a significant expansion in imports of raw materials, while imports of capital and consumer goods sustained their upward trends as well.

<Table I - 4> **Current account**

	(billion dollars, %)						
	2015	2016				2017	
	Year	Q1	Q2	Q3	Q4	Jan.-Feb.	
Current account	105.9	98.7	25.3	26.3	21.5	25.5	13.7
Goods	122.3	120.4	29.0	33.5	28.3	29.7	18.4
Exports ¹⁾	526.8	495.4	115.2	126.0	121.9	132.4	132.3 ³⁾
(Rate of change ²⁾)	-8.0	-5.9	-13.7	-6.7	-5.0	1.8	14.9 ³⁾
Imports ¹⁾	436.5	406.2	93.8	99.3	102.5	110.6	116.2 ³⁾
(Rate of change ²⁾)	-16.9	-6.9	-16.0	-10.1	-5.1	4.1	23.9 ³⁾
Services	-14.9	-17.6	-3.9	-3.9	-5.7	-4.1	-5.6
Credit	97.7	92.8	23.6	22.9	22.8	23.5	13.9
Debit	112.6	110.4	27.5	26.8	28.5	27.6	19.5
Primary income	3.6	1.5	1.2	-2.1	1.3	1.1	1.7
Secondary income	-5.0	-5.6	-0.9	-1.2	-2.4	-1.2	-0.8

Notes: 1) Customs-clearance basis.

2) Compared to the same periods of previous years.

3) Based on the first quarter of 2017.

Sources: The Bank of Korea, Korea Customs Service.

7) During January and February 2017 the current account recorded a 13.7 billion dollar surplus, as the surplus volume contracted by 1.1 billion dollars compared to that in the same period of last year (January~February 2016 + 14.8 billion dollars).

3. Prices

Upward Trend in Consumer Prices Accelerates

The rate of consumer price inflation accelerated greatly, from the mid-1% level during the fourth quarter of 2016 to around 2% in the first quarter of 2017, owing to the effects for example of rising prices of agricultural, livestock and marine products and oil.

<Table I - 5> Consumer prices¹⁾

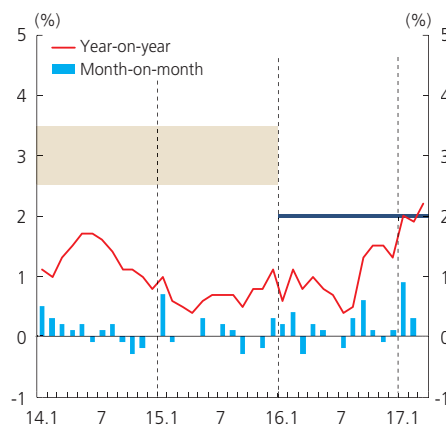
	2015		2016				2017
	Year	Q1	Q2	Q3	Q4	Q1	
Consumer price index	0.7	1.0	0.9	0.8	0.7	1.5	2.1
Agricultural, livestock, and marine products	2.0	3.8	3.7	1.1	3.1	7.5	6.1
Agricultural products	1.2	3.8	4.8	-0.6	2.1	9.1	4.7
Livestock products	3.7	4.4	3.7	3.7	4.2	6.0	8.6
Industrial products	-0.2	-0.5	-1.1	-0.7	-0.5	0.4	2.1
Petroleum products	-19.2	-8.1	-10.6	-11.2	-8.1	-2.3	12.0
Industrial products excluding petroleum	3.3	0.8	0.5	1.1	0.8	0.8	0.7
Electricity, water and gas	-7.4	-9.2	-8.2	-7.0	-13.0	-8.7	-6.9
Services	1.8	2.3	2.4	2.4	2.2	2.1	2.1
Rentals for housing	2.5	1.9	2.0	1.9	1.8	1.7	1.7
Public service charges	1.2	1.5	2.0	1.9	1.0	0.9	1.0
Private service charges	1.9	2.7	2.6	2.7	2.8	2.7	2.7
CPI for living necessities	-0.2	0.7	0.6	0.4	0.2	1.4	2.5
CPI excluding food & energy	2.4	1.9	1.9	2.0	1.9	1.7	1.7
CPI excluding agricultural products & oils	2.2	1.6	1.7	1.8	1.4	1.5	1.5

Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

Agricultural, livestock and marine product prices showed significant upward trends, driven mainly by vegetable prices in the fourth

quarter of last year, and by some items⁸⁾ whose prices rose greatly in the first quarter of this year including eggs and tangerines. The extents of increase in industrial product prices expanded, as prices of petroleum products reversed to increases. Service charges sustained their solid pace of year-on-year growth at the 2% level, led by private services. The extents of decline in electricity, water and gas charges meanwhile lessened continually across the fourth quarter of last year and the first quarter of this year, as the temporary cuts in electricity fees last summer (July-September) ended and gas fees were hiked in November of last year and March of this year.

<Figure I - 7> CPI inflation



Note: 1) 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.

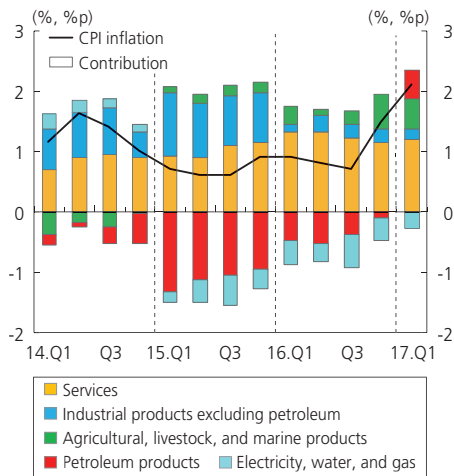
Sources: The Bank of Korea, Statistics Korea.

Looking at the degrees of contribution to the CPI inflation rate of the various individual products, the contribution of petroleum product prices reversed from negative during

8) In the first quarter this year the prices of tangerines and eggs rose by 71.9% and 52.1% respectively year-on-year (and their degrees of contribution to consumer price inflation by 0.1% point each) – due to the impacts of the typhoon in the Jeju Island area in October last year in the former case, and to the effects of avian influenza in the latter.

the fourth quarter of 2016 to positive in the first quarter of this year, while the negative contributions of electricity, water and gas charges and the positive contributions of agricultural, livestock and marine product prices, all lessened. There were meanwhile no great changes in the contributions to inflation of service charges or of the prices of industrial products excluding petroleum.

<Figure I - 8> Contributions to CPI inflation⁹⁾



Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

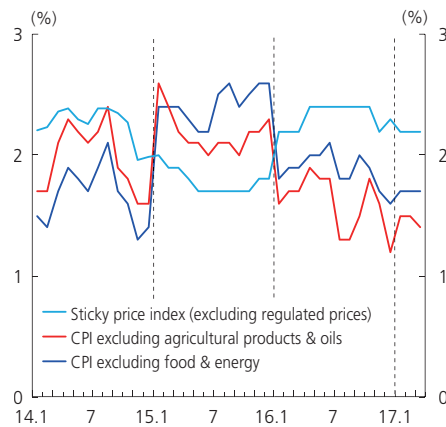
Underlying Price Movements Remain Stable

The great acceleration in consumer price inflation recently has been a result largely of supply-side factors such as the rises in prices of oil and of agricultural, livestock and marine products. With these effects excluded there have been no great changes in the underlying price movements. The rate of core inflation (the index with food and ener-

gy products excluded), indicative of the underlying price movements, has maintained a level in the mid- to upper-1% range since the fourth quarter of last year. The rate of increase in the sticky price index⁹⁾, which excludes regulated prices, has also shown stable movements at the lower 2% level.

Looking at inflation expectations, those of the general public (for the rate of consumer price increase over the next one year) rose from 2.5% in the fourth quarter of last year to 2.7% during the first quarter of this year. The short-term (one year in the future) inflation expectation of economic experts¹⁰⁾ also increased, from 1.5% in the fourth quarter of last year to 1.7% in the first quarter of this year. During this same period the long-term (five years in the future) rate of inflation expected by the economic experts group showed only a slight rise, however, of from 1.9% to 2.0%.

<Figure I - 9> Underlying inflation rates⁹⁾

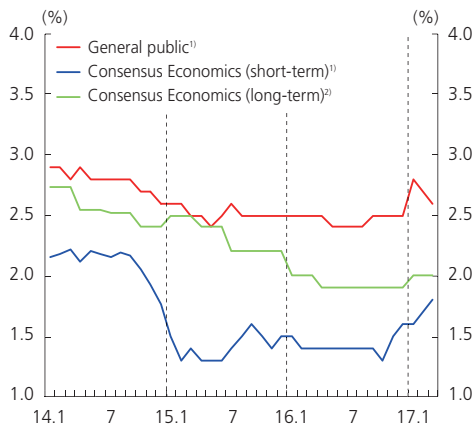


Note: 1) Compared with the same months of the previous years.
Source: The Bank of Korea, Statistics Korea.

9) Sticky prices, as they are calculated using products whose prices do not frequently change, not only reflect inflation expectations well but are known to be useful in predicting consumer prices also. At the time of index calculation regulated prices (public service fees, electricity, water and gas charges, cigarette taxes, school meal fees, childcare charges, etc.), which are greatly affected by regulatory factors, are excluded.

10) Referring to the results of a survey by Consensus Economics of 17 institutions, including investment banks and securities companies, market research and analysis institutions, etc., in Korea and overseas.

<Figure I-10> Inflation expectations



Notes: 1) Expected CPI inflation rate for next 12 months.
 2) Expected CPI inflation rate for next 60 months.
 Source: The Bank of Korea, Consensus Economics.

Extents of Increase in Producer and Import Prices Expand

The extent of increase in producer prices has expanded greatly. This has been because industrial product prices have risen substantially, centering around petroleum and chemical products, as oil and other international raw materials prices have increased.

Import prices (Korean-won basis) also reversed to record an increase in the fourth quarter of 2016, after which their extent of increase then expanded greatly in the first quarter of this year. This was a result of rising international prices of raw materials despite a drop in the Korean won/US dollar exchange rate.

<Table I - 6> Producer prices and import prices (Korean-won basis)¹⁾

	2015	2016				2017		
		Year	Q1	Q2	Q3	Q4	Q1	
Producer prices	-4.0	-1.8	-3.3	-2.9	-1.8	0.8	4.1	
Goods	-6.4	-3.4	-5.7	-5.0	-3.4	0.5	5.7	
(Agricultural, forestry and marine products)	2.3	5.8	5.8	2.3	6.0	9.4	7.8	
(Manufacturing industry products)	-6.7	-3.5	-6.1	-5.2	-3.4	0.8	6.5	
(Electric power, gas and water supply)	-7.9	-8.3	-9.3	-7.9	-8.7	-7.4	-3.0	
Services	1.2	1.2	1.3	1.1	1.3	1.3	1.3	
Import prices ²⁾	-15.3	-4.2	-7.1	-5.7	-7.7	4.0	9.8	
		[-19.5]	[-7.3]	[-14.7]	[-11.6]	[-5.3]	[3.4]	[14.2]
Exchange rate	7.4	2.6	9.1	6.0	-4.2	0.1	-4.0	

Notes: 1) Compared with the same periods of the previous years; the figures for Mar. 2017 are preliminary.
 2) Figures in square brackets are on a contract-currency basis.
 Source: The Bank of Korea.

Pace of Housing Purchase Price Increase Slows

The pace of increase in nationwide housing purchase prices has slowed greatly since November of last year, and early in this year showed steady movements. On top of the government's continued stabilization policies, including the 11/3 Real Estate Measures¹¹⁾, the introduction of the 「Guideline on Customized Mortgage Loan Screening」 for mutual credit cooperatives¹²⁾, etc., the rise in domestic market interest rates following the policy rate hikes by the US Federal Reserve has also worked as a factor strengthening downward pressures on housing prices.

11) On November 3 of last year the government, announced its 「Management Measures for Housing Market Stabilization」, with major contents including an extension of the period during which resales of new apartments are restricted, limits on first priority housing subscriptions, restrictions on housing lottery drawing after winning of previous drawings, etc.

12) This was implemented from March 13 of this year, and requires the presentation of objective proof of income by borrowers from mutual credit cooperatives, community credit cooperatives, the National Credit Unions Federation of Korea, etc., while also introducing an amortizing loan scheme requiring that interest and 1/30 of the principal owed be repaid each year.

Nationwide leasehold prices have stabilized as their extent of increase has lessened compared to the fourth quarter of last year.

<Table 1 - 7> **Housing purchase and leasehold deposit prices¹⁾**

(%)

	2015	2015				2016	
		Year	Q1	Q2	Q3	Q4	Q1
Housing purchase prices	3.5	0.7	0.0	0.1	0.2	0.4	0.1
Seoul and its surrounding areas	4.4	1.3	0.0	0.3	0.4	0.6	0.1
(Seoul)	4.6	2.1	0.1	0.4	0.7	0.9	0.2
Regional metropolitan cities	4.3	0.9	0.0	0.1	0.2	0.6	0.2
Reconstructed apartment purchase prices	9.5	14.9	0.1	6.4	7.1	0.7	1.1
Leasehold deposit prices	4.8	1.3	0.4	0.3	0.2	0.4	0.1
Seoul and its surrounding areas	7.1	2.0	0.5	0.6	0.5	0.5	0.2
(Seoul)	7.2	2.0	0.5	0.5	0.5	0.5	0.2
Regional metropolitan cities	4.1	1.1	0.3	0.2	0.1	0.5	0.2

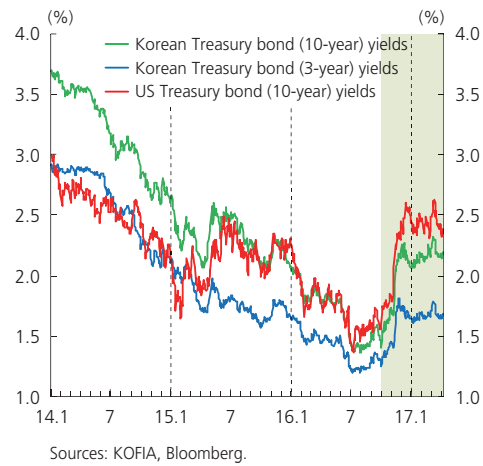
Note: 1) Compared with the last survey dates of the previous periods.
Sources: Korea Appraisal Board, Real Estate 114.

4. Financial and Foreign Exchange Markets

Long-term Market Interest Rates Rise Greatly

The Treasury bond yield (3-year) reversed to an upward trend from October 2016, on the effects for example of robust economic indicators in major countries and the increased likelihood of a policy rate hike by the US Federal Reserve. In particular, it rose significantly along with global interest rates after the US presidential election in November, as expectations of inflation due to the expansionary fiscal policies of the new US government became highlighted¹³⁾, and recorded its high for the year of 1.81% on November 24. After subsequently falling back to a considerable extent, due to market stabilizing measures by the Bank of Korea and the government¹⁴⁾ as well as to the easing of the sharp pace of increase in global interest rates, it fluctuated within a narrow range until February 2017, showing stability. From March Treasury bond yield volatility expanded, rising to a considerable extent at the time of the FOMC meeting (March 14~15), before then falling.¹⁵⁾

<Figure I-11> Korean and US Treasury bond yields



Corporate Bond Credit Spreads Expand Slightly

In the corporate bond market, credit spreads widened to a considerable extent from October of last year, for reasons such as weakening investment sentiment in line with the expanded risks of interest rate volatility.

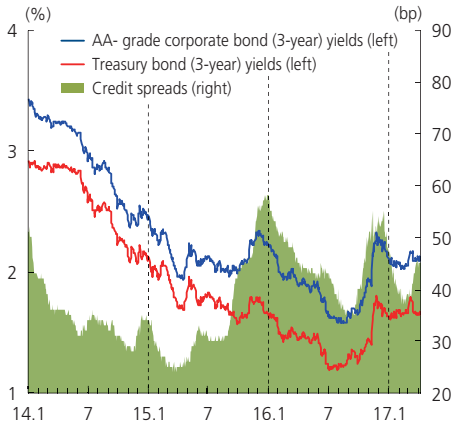
Credit spreads narrowed after the year-end as investment sentiment regarding mainly prime bonds recovered gradually, before then widening again in March of this year as credit concerns grew due for example to the restructuring of Daewoo Shipbuilding and Marine Engineering. Meanwhile, the credit differentiation between prime and sub-prime bonds has persisted this year as well.

13) As expectations formed that the Treasury bond issuance will expand and inflation pressures grow if President Trump fulfills his promises to increase investment in social overhead capital facilities, cut taxes, and so on, US Treasury bond yields jumped sharply.

14) The Bank of Korea implemented outright purchases of Treasury bonds and reduced the amount of its Monetary Stabilization bond issuance, while the Ministry of Strategy and Finance reduced the volume of its Treasury bond issuance.

15) Entering March the Treasury yield rose substantially (+9bp between March 2 and 15), due to hawkish statements by leading US Federal Reserve officials for example, before then falling rapidly (-10bp between March 16 and 22) after the results of the March FOMC meeting in which the forecast 2017~18 policy rate figures were maintained at their December 2016 forecast levels (anticipating three hikes of 25bp each during both years).

<Figure I-12> Long-term market interest rates¹⁾ and credit spreads²⁾



Notes: 1) Treasury bond yields are based on final quotation yields and corporate bond yields are based on the averages of yields estimated by four private credit rating agencies.
 2) Corporate bond (3-year) yields - Treasury bond (3-year) yields.
 Source: KOFIA.

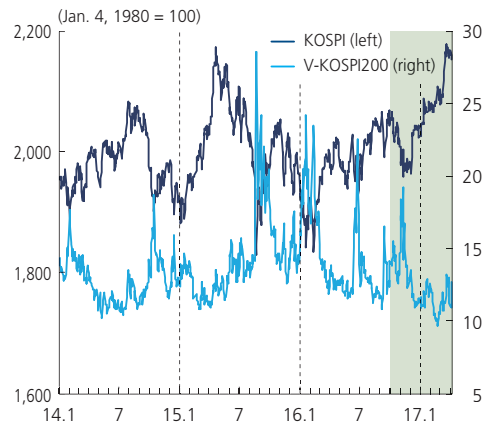
KOSPI Rises Significantly

The KOSPI showed a weakening trend¹⁶⁾ from October of last year, owing among other things to heightened political uncertainties domestically and abroad and to a drop in international oil prices. In December it rebounded considerably, however, on expectations of an extension of its quantitative easing by the ECB, the rise in international oil prices, etc. Entering this year as well the KOSPI continued its upward trend of the end of last year, on factors such as expectations of increased corporate profits, improvements in economic indicators at home and abroad, the upward trend in US stock prices, etc. Its extent of increase expanded greatly during March in

particular, due to the subsiding of cautionary sentiment related to the policy rate hikes by the Fed, to the easing of political uncertainties in Korea and abroad, to strengthening of the export recovery, etc., and on March 21 it recorded 2,178.4, its highest figure in five years and eight months. Entering April it then underwent a slight correction, owing for example to a rise in geopolitical risks related to North Korea and to sales of shares for profit-realization.

The stock price volatility index (V-KOSPI 200) jumped to a large extent at the time of the US presidential election, after which it declined again and in February of this year fell to its all-time low. Entering April however it rose to a considerable extent, as geopolitical risks expanded.

<Figure I-13> KOSPI and share volatility index



Source: Koscom Corp.

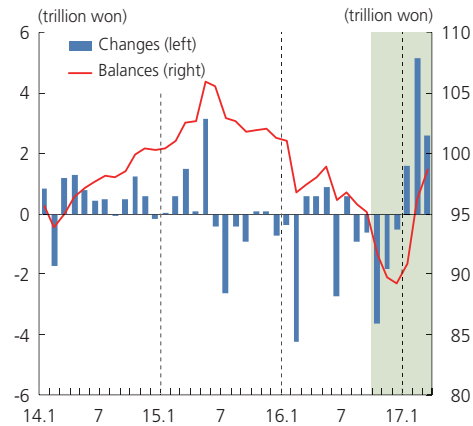
¹⁶⁾ Investor sentiment contracted particularly greatly after the US presidential election as the Korean won/US dollar exchange rate and market interest rates rose.

Domestic Securities Purchases by Foreign Investors Reversed to Net Purchase

Domestic portfolio investment by foreigners declined during October and November of last year, centering around bond investment, before then expanding slightly entering December as stock investment increased. During this year investments by foreigners in both domestic bonds and stocks have expanded greatly.

Between October and December of 2016 bond investment by foreigners continued its declining trend begun in August, as it contracted under the effects of external factors such as rising global interest rates and the trend of US dollar strengthening after the US presidential election. Entering this year it has however reversed to an upward trend, as expectations of Korean won weakening have eased and as the arbitrage incentive has expanded also due to a drop in the swap rate.¹⁷⁾ In February, notably, the volume of foreigners' domestic bond investment jumped to a large extent – owing, in addition to the steady upward trend in purchases by public funds, to increased purchases by banks and global funds as well, due to the rise in the arbitrage incentive¹⁸⁾ and to increases in capital entrusted to global bond-type funds.

<Figure I-14> Changes in and balances of foreigners' bond holdings



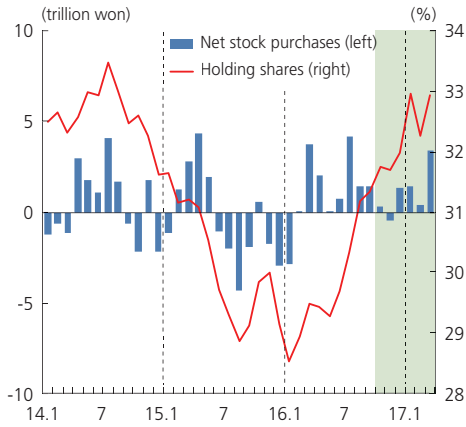
Source: Financial Supervisory Service.

Foreigners' investment in Korean stocks contracted to a small degree during October and November of last year, but from December then showed on going net purchases, for reasons such as capital inflows into global stock-type funds in line with the economic recoveries in major countries, expectations of improved performances at domestic companies, etc. Notably, in March of this year the net purchase volume expanded greatly, due to factors such as easing of political uncertainties at home and abroad.

17) In a foreign exchange swap, two currencies are converted at the current exchange rate, and after a certain time the respective principals may be reconverted at the originally stipulated forward exchange rate. The foreign exchange swap rate is expressed as the annualized rate of the difference between the forward and spot exchange rates as against the spot exchange rate ((Forward exchange rate - Spot exchange rate)/Spot exchange rate).

18) The arbitrage incentive (3-month maturity basis domestic/international interest rate spread (MSB - Libor) - Swap rate) jumped from 59bp at the end of January to 94bp as of February 17.

<Figure I-15> Foreigners' net stock purchases¹⁾ and stock holding shares²⁾



Notes: 1) The sum of the KOSPI and KOSDAQ markets during each period.
 2) Based on period-end and total stock market capitalizations.
 Source: Koscom Corp.

Bank Corporate Lending Generally Sluggish

Bank corporate lending showed sluggishness in general from the fourth quarter of last year, centering around loans to large enterprises. Lending to large firms declined, on credit concerns following the progress in corporate restructuring. Lending to SMEs maintained its upward trend, but the degree of increase lessened slightly year-on-year due to banks' strengthening of risk management. Meanwhile, corporate lending by non-bank financial institutions continued its trend of increase, driven by loans by insurance companies and mutual credit cooperatives.

The amount of corporate funds raised through the direct financial markets (net increase basis) has been showing an upward trend since the fourth quarter of last year. During the fourth quarter of 2016 corporate bonds recorded a net redemption, on a con-

traction in investment sentiment, a rise in the amount of bonds reaching maturity, etc., but entering this year they reversed to a slight net issuance, as the result of factors including long-term fund demand by some large enterprises and resumptions of institutional investment at the beginning of the year.

CP has shown sustained net issuance since the fourth quarter of last year, due for example to increased short-term fund demand from corporations. Financing through issuance of shares expanded considerably during the fourth quarter of 2016, on paid-in capital increases and initial public offerings, etc. The issuance amount then declined during January and February this year, due to seasonal factors prevailing at the start of the year.

<Table I - 8> Corporate loans by financial institutions and corporate direct financing¹⁾

		(trillion won)						
		2015	2016				2017	
		Year	Q1	Q2	Q3	Q4	Jan.-Feb.	
Corporate loans	Banks	50.0	23.9	9.5	8.8	11.0	-5.4	12.9
	(Large firms)	-4.3	-9.9	0.0	-1.3	0.6	-9.2	4.9
	(SMEs)	54.3	33.8	9.5	10.0	10.4	3.8	8.0
	Non-banks ²⁾	18.1	29.8	4.7	8.8	7.7	8.5	3.0
Corporate direct financing	Corporate bond issuance ³⁾	-0.4	-6.7	-0.6	1.6	-4.1	-3.6	0.6
	CP issuance ⁴⁾	-5.4	-2.1	-0.5	-1.1	-0.8	0.4	0.8
	Stock issuance ⁵⁾	7.0	15.9	1.9	1.7	3.3	9.0	0.4

Notes: 1) Based on changes in balances during the periods; figures for Feb. 2017 are preliminary.
 2) Based on loans by mutual savings banks, credit unions, mutual credit unions, community credit cooperatives, and insurance companies (including public and other lending); figures for 2017 based on January figures.
 3) Based on corporate bonds issued through public subscription by non-financial corporations (excluding ABSs but including P-CBOs).
 4) Based on CPs handled by securities firms, merchant banking corporations, and trust accounts of banks.
 5) Initial public offerings and paid-in capital increases.
 Sources: The Bank of Korea, Financial Supervisory Service, Korea Securities Depository, Korea Credit Information Services.

Pace of Household Lending Increase Slows

Household lending (based on depository institutions) sustained a high rate of increase (11.0 trillion won monthly average) during the fourth quarter of last year, but entering this year its pace of increase then slowed to a monthly average of 4.5 trillion won.¹⁹⁾

Bank household lending grew by an average of 2.0 trillion won per month in the January through March 2017 period, with its extent of increase falling greatly compared to that during the quarter before (6.5 trillion won). This was attributable to a decline in housing transactions, to the government's policies related to real estate and household lending, to increases in loan interest rates, and so on. Meanwhile, household lending by non-bank financial institutions rose by a monthly average of 2.6 trillion won in January and February of this year, to sustain its high pace of increase of last year. This appears to have resulted from factors such as buoyancy in non-bank financial sector deposit-taking in line with these institutions' advantageous interest rates, and migration of loan demand due to the strengthening of household loan management in the banking sector.

<Table I - 9> Household credits¹⁾

(trillion won)

	2015	2016				2017	
		Year	Q1	Q2	Q3	Q4	Q1 ²⁾
Commercial & specialized bank loans ³⁾	6.5	5.7	3.3	6.1	6.9	6.5	2.0
(Mortgage loans) ³⁾	5.8	4.6	3.2	4.7	5.7	5.0	1.8
(Other loans including loans through overdraft accounts)	0.7	1.1	0.1	1.5	1.3	1.5	0.1
Non-bank depository institution loans	1.9	3.6	2.5	3.5	3.7	4.5	2.6
(Mutual credit)	0.8	1.6	1.1	1.8	1.6	1.9	1.0
(Credit unions)	0.4	0.5	0.6	0.3	0.6	0.6	0.3
(Community credit cooperatives)	0.4	1.0	0.4	1.0	1.1	1.6	0.8
(Mutual savings banks)	0.3	0.4	0.4	0.4	0.4	0.4	0.5
(Others) ⁴⁾	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	8.4	9.3	5.8	9.6	10.6	11.0	4.5

Notes: 1) Based on average monthly changes during the periods.

2) Figures for banks are based on January to March (advance estimates for March), and figures for non-bank deposit-taking institutions on January to February.

3) Including mortgage transfers.

4) Trust accounts of banks, and postal savings.

Source: The Bank of Korea.

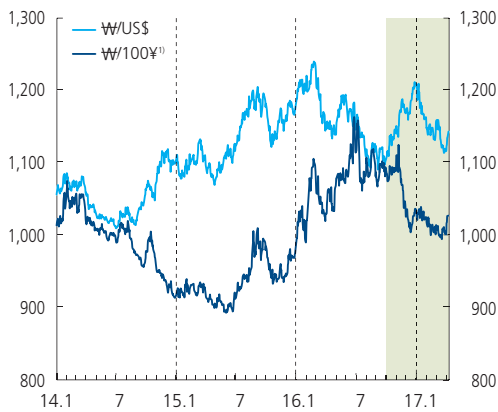
Korean Won/US Dollar Exchange Rate Falls Entering 2017

The Korean won/US dollar exchange rate rose rapidly until the end of last year, on the effects of the strong US dollar in line for example with expectations of expansionary fiscal policies by the new US government and of policy rate increases by the US Federal Reserve. Entering this year the Korean won/US dollar exchange rate reversed to a downward trend, however, affected by the fall in value of the US dollar due among other factors to the Trump administration's protectionist tendencies and statements cautioning about the strengthen-

19) Based on changes in average monthly household loans extended – from January to March for banks and from January to February for non-bank financial institutions.

ing trend of dollar. Subsequently the exchange rate did temporarily rise in early March, on forecasts that the Fed would raise its policy rate more rapidly than had been expected for example, but as these concerns eased after the March FOMC meeting the Korean won/US dollar rate fell again.

<Figure I-16> Exchange rates



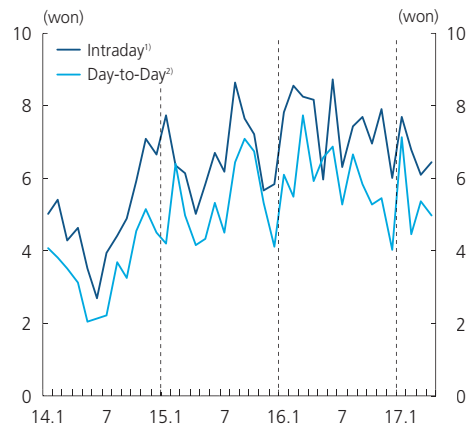
Note: 1) The final transaction standard rate offered to customers posted by KEB Hana Bank during the day.

Sources: The Bank of Korea, KEB Hana Bank.

The Korean won/Japanese yen (100 yen) exchange rate fell, in line with the trend of yen weakening due to the Bank of Japan's continued accommodative monetary policies including the introduction of an additional new QQE with yield curve control at its September 2016 monetary policy decision-making meeting.

The extent of fluctuations in the Korean won/US dollar exchange rate meanwhile sustained a high level, for reasons such as the increased global foreign exchange market volatility after President Trump's election and changes in expectations as to the path of policy rate hikes by the US Federal Reserve.

<Figure I-17> Exchange rate (KRW/USD) fluctuations



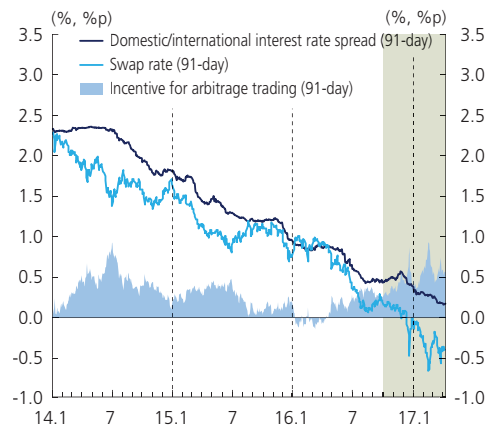
Notes: 1) Averages of daily differences between the highest and lowest rates.

2) Averages of daily absolute changes in closing rates.

Source: The Bank of Korea.

The swap rate (3-month maturity) continued to decline, as, on top of the narrowed domestic/international interest rate spread due to the policy rate hike by the US Federal Reserve last December, there was also increased demand for foreign currency funding for purposes of overseas investment by institutional investors.

<Figure I-18> Domestic/international interest rate spread¹⁾, swap rate and incentive²⁾ for arbitrage trading



Notes: 1) Yield on Korean Monetary Stabilization Bonds (MSBs) (91-day) - US LIBOR (91-day).

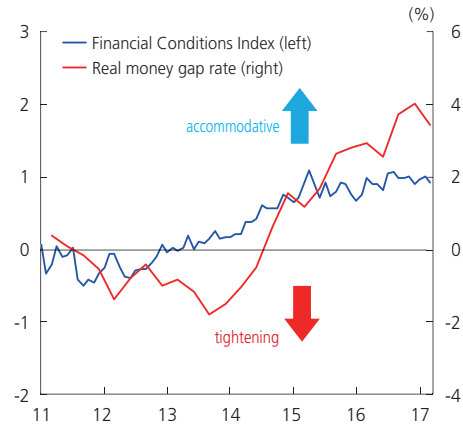
2) Domestic/international interest rate spread (91-day) - Swap rate (91-day).

Source: The Bank of Korea.

Overall Financial Conditions Remain Accommodative

In view of indicators such as the real money gap rate²⁰⁾ and the Financial Conditions Index²¹⁾, it is judged that recent financial conditions have been accommodative. Looking at the real money gap rate, the real money supply has sustained a positive (+) position relative to the long-term equilibrium money supply, as the rate of money supply growth has exceeded the nominal economic growth rate amid the ongoing accommodative monetary policy. As financial and foreign exchange market volatilities have also maintained relatively low levels under these circumstances of favorable financial market liquidity, the Financial Conditions Index has also shown that conditions are accommodative.

<Figure I-19> Real money gap rate¹⁾²⁾ and Financial Conditions Index²⁾



Notes: 1) Based on M2.
 2) If the rate is positive(negative), it means that financial conditions are accommodative (tightening).
 Source: The Bank of Korea.

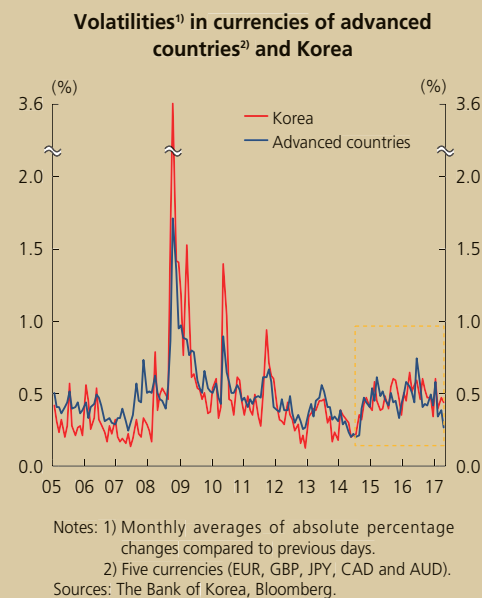
20) This refers to the divergence between the real money supply at a specific point in time and the long-term equilibrium money supply, and is used for judging whether there is an excess (gap rate > 0) or a shortfall (gap rate < 0) of real money supplied compared to the long-term equilibrium money supply:

$$\text{Real money gap rate} = \frac{\text{Real money supply}_t - \text{Equilibrium money supply}_t}{\text{Equilibrium money supply}_t} \times 100$$

21) The Financial Conditions Index (FCI), an aggregate of several financial variables to form one information variable, is used for assessing financial conditions as an index judging whether they are accommodative or tight. It is calculated by including 50 financial variables regarded as important, such as credit indicators, liquidity indicators, market volatility indicators, survey data from financial institutions, and so on. After extraction (through iterative estimation using the least squares method) of the common factors best reflecting common movements among the 50 total financial variables, the index is standardized (mean: 0, standard deviation: 1) and calculated.

Background to Expansion in Korean Won/US Dollar Exchange Rate Volatility

The Korean won/US dollar exchange rate's volatility (day-to-day rate of change), which had lessened gradually after the Global Financial Crisis, has been expanding again since the middle of 2014. The background factors behind this expanded Korean won/US dollar volatility can be seen as largely of the following two kinds:

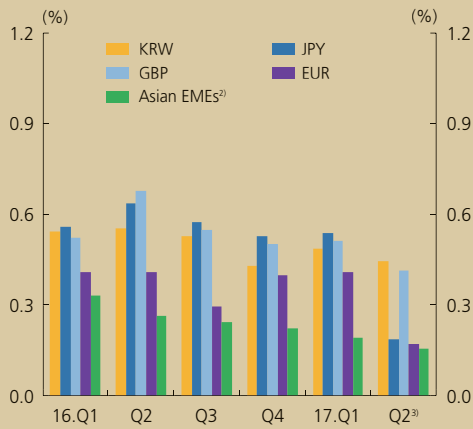


First, it has been a result of increased volatility in the global foreign exchange markets. As the monetary policy normalization by the US Federal Reserve since 2014 has become more apparent, volatilities in the global foreign exchange markets have expanded with the values against the dollar of the euro, the yen, etc. changing rapidly for example, and in line with this Korean won/US

dollar exchange rate volatility has also grown. Moreover, since the US presidential election the uncertainties concerning the new government's economic policies, the changes in expectations about more rapid interest rate hikes by the US Federal Reserve, etc. have caused Korean won/US dollar exchange rate volatility to increase.

Next, the high degree of openness of the domestic foreign exchange market compared to those of other EMEs can be seen as another major cause of the increased Korean won/US dollar volatility. In fact, the recent volatility of the Korean won/US dollar exchange rate is showing movements closer to those of advanced countries' currencies than those of EMEs. Korea's sovereign credit rating is higher than the ratings of other Asian EMEs, on top of which the liquidity of its foreign exchange market is abundant and NDF transactions are also allowed, enabling offshore investors to carry out foreign exchange transactions in the domestic market at low cost. In line with this there is a tendency of increasing Korean won NDF transactions at times of changing international financial market conditions, and there are also cases of offshore investors proxy hedging the exchange risks of their assets in EMEs using these NDF transactions.

Volatilities of major currency exchange rates¹⁾



Notes: 1) Quarterly averages of absolute percentage changes (against USD) compared to previous days.
 2) Averages of changes in exchange rates against USD of CNY, TWD, MYR, SGD, IDR and THB.
 3) Figures for April 1~7, 2017.
 Sources: The Bank of Korea, Bloomberg.

Inasmuch as there are various external factors that could potentially affect the domestic foreign exchange market to a considerable extent, such as the US exchange rate policies, the strengthening of protectionism, etc., it is necessary to bear in mind the possibility of Korean won volatility expanding due to changes in conditions in the future.

II

Conduct of Monetary Policy

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1. Base Rate

Base Rate Operated at 1.25% per Annum

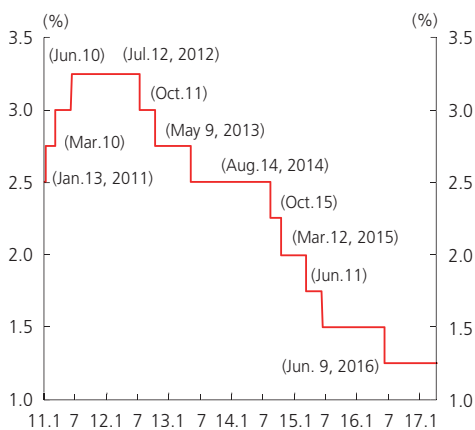
The Bank of Korea conducted its monetary policy accommodatively during the October 2016 to April 2017 period, to ensure that the recovery of economic growth continues and that the rate of inflation approaches the target level over a medium-term horizon. In this process it devoted attention to financial stability also, and closely monitored the uncertainties surrounding conditions in Korea and abroad, as well as their effects, the changes in monetary policies of major countries including the US, the upward trend of household debt, and so on.

Under this policy stance the Bank of Korea held the Base Rate at a level of 1.25% per annum throughout this period.

The details of the points given the most attention at the times of the monetary policy decisions during this period are as follows:

During the October to December 2016 period the Base Rate was maintained at 1.25% per annum. The decisions to do so were based on the Bank’s judgment that, notwithstanding the increased downside risks to the economic growth path, it was desirable to cautiously observe future changes in conditions and their effects on the domestic financial markets and economy, given the high uncertainties about conditions at home and abroad. First, it was forecast that the domestic economy would continue its weak but moderate trend of growth during this period, thanks to the recovery of the global economy. However, as the recovery in domestic demand had been limited, owing to factors such as a contraction in sentiment, the downside risks to the growth path were judged to have risen somewhat. There was a need to consider as well the significantly increased uncertainties surrounding domestic and overseas conditions, including the results of the US presidential election and the new US government’s policies, the normalization of monetary policy by the US Federal Reserve, and the domestic political situation. The rate of consumer price inflation had shown a level in the low- to mid-1% range, but was accelerating on the effects for example of rising international oil prices, and was forecast to gradually rise to approach the inflation target level. It was in addition judged necessary to be even more mindful of the risks on the financial stability side, as volatilities in the financial and foreign exchange markets at home and abroad were

<Figure II - 1> Bank of Korea Base Rate¹⁾



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

growing due to the uncertainties about domestic and foreign conditions, and as household lending was sustaining high paces of increase greatly above normal years' levels at both banks and non-bank financial institutions.

During the January to March period of this year the Bank continued to maintain a Base Rate of 1.25% per annum. The decisions to hold it unchanged were made in view of the points that the domestic economy was expected to continue its moderate pace of growth and the rate of consumer price inflation to move at around the 2% target level, and that it was necessary to be continuously mindful of financial stability given the very high uncertainties surrounding domestic and external conditions. First of all, it was anticipated that the domestic economy would continue to grow moderately as exports and investment improved, even though consumption remained sluggish due to weakened sentiment. Consumer price inflation was rising more rapidly than had been previously expected, on the impacts for example of the climbing prices of petroleum and agricultural, livestock and marine products and had reached the 2% inflation target level, but the point was also considered that demand-side inflation pressures were not great, with core inflation, indicative of the underlying price movements, having maintained the mid- to upper-1% level. On the financial stability side, meanwhile, there was a need for caution related to the rising possibility of an additional policy rate hike by the US Federal Reserve in line with the continuing US economic recovery, as well as to the political uncertainties in the euro area.

Household lending had continued its high pace of increase above normal years' levels at non-bank financial institutions, but the extent of increase in household lending by banks had lessened. Since this slowdown in household loan growth was a result of seasonal factors as well, the need to wait to observe whether these movements would become a long-term trend was also taken into account.

The Bank of Korea held the Base Rate at 1.25% per annum in its April meeting as well. This was a result of comprehensive consideration of several points - that uncertainties concerning the future growth path remained high even though the pace of domestic recovery had picked up somewhat recently, that it was being forecast that consumer price inflation would move at around the 2% inflation target level, and that it was necessary to continue focusing on risks to financial stability related for example to the expansion in household debt and to the hikes in interest rates by the US Federal Reserve. Looking at the domestic economy in detail, it was judged that although consumption remained low the pace of economic growth had accelerated somewhat, as exports and investment had improved. Going forward it was forecast that the domestic economy would continue its moderate growth, and in consequence that the GDP growth rate for this year would slightly exceed the January forecast figure (2.5%). It was also expected, however, that changes in trading conditions vis-à-vis major countries, insufficient improvements in household real purchasing power, etc. could limit the speeds of improvement in exports and domestic

demand. The point was also considered that, although consumer price inflation had risen to the 2% inflation target level due mainly to the rising prices of petroleum and agricultural, livestock and marine product, upward pressures on the demand side were not high, with core inflation remaining in the mid- to upper-1% range for example, and that for the year as a whole consumer price inflation was forecast to show a level of 1.9%. Meanwhile, it was judged necessary as well to bear in mind the possibility of expanding volatilities in the financial and foreign exchange markets, since the uncertainties as to domestic and external conditions including monetary policy normalization by the US Federal Reserve and geopolitical risks remained high. In addition, it was also considered necessary to devote continuing care to the risks to financial stability given the rising household debt in line with the high pace of increase in household lending by non-bank financial institutions, although the amount of growth in household lending by banks had lessened compared to the year before.

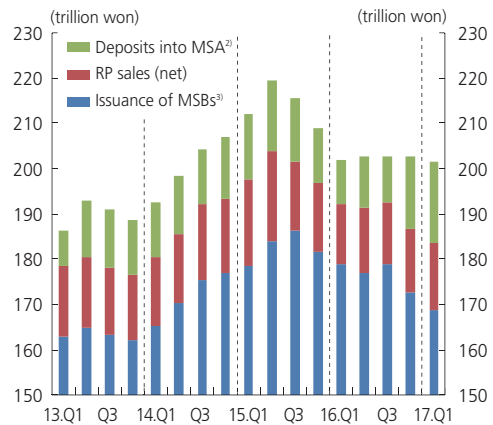
Liquidity Adjusted to Maintain Call Rate at the Base Rate Level

Open market operations are a monetary policy tool through which the Bank of Korea conducts transactions with financial institutions in the financial markets, in securities for example, and influences the levels of market liquidity and interest rates. To maintain the call rate at the level of the Base Rate set by the Monetary Policy Board, the Bank of Korea is adjusting market liquidity utilizing its open market opera-

tions tools including Monetary Stabilization Bond (MSB) issuance, purchases and sales of RPs, and deposits into the Monetary Stabilization Account (MSA).

During the October 2016 to March 2017 period the amount (average balance basis) of liquidity adjustment required maintained a level similar to that in the third quarter of last year. However, in view of the market unrest seen after the US presidential election, with bond interest rates rising substantially for example, the Bank of Korea reduced the amount of its MSB issuance. The Bank meanwhile increased its MSA deposits and RP sales, in order to absorb the surplus liquidity built up during the process of its execution of market stabilization measures.

<Figure II - 2> Liquidity adjustment¹⁾ by means of open market operations

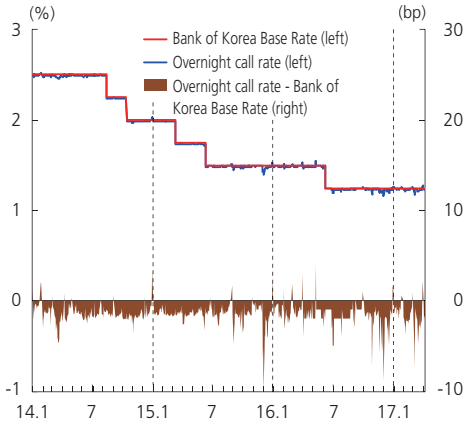


Notes: 1) Quarterly average balance basis.
 2) Monetary Stabilization Account.
 3) Excluding 3.48 trillion won (Mar.27, 2014-Mar.26, 2015) and 3.45 trillion won (Oct.16, 2015-Oct.14, 2016) of MSB sales to Korea Development Bank by negotiated transactions.

Source: The Bank of Korea.

As a result the call rate was stable at around the level of the Base Rate (1.25%).

<Figure II - 3> Bank of Korea Base Rate and overnight call rate



Source: The Bank of Korea.

2. Bank Intermediated Lending Support Facility

Bank Intermediated Lending Support Facility Operated under 25 Trillion Won Ceiling

The Bank Intermediated Lending Support Facility is the lending system that the Bank of Korea operates to support banks' lending to small and medium-sized enterprises (SMEs). The Bank of Korea's interest rate policy has a nondiscriminatory influence on the economy as a whole, and can therefore give rise to not only positive but also negative effects on each economic sector. The Bank Intermediated Lending Support Facility on the other hand has the strong point of enhancing monetary policy effectiveness since it helps to improve the credit channels by ensuring that funds can be allocated to more productive sectors. Within the ceilings set in consideration of factors such as economic and financial circumstances and the funding conditions of SMEs, the Bank of Korea provides low-interest rate funds to banks based on their performances in extending SME loans. The Monetary Policy Board adjusts as necessary the total ceiling on this facility, the ceilings on the different lending programs, and the retained ceiling.

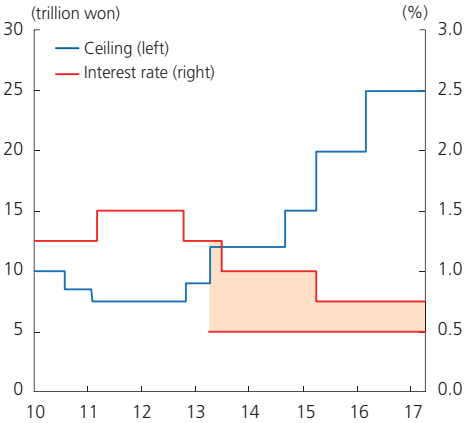
The Bank of Korea, in response to conditions including the accelerating decline in exports and the weakening recovery of domestic demand, raised the Bank Intermediated Support Facility ceiling by five trillion won in March 2016, and decided to operate it at that level temporarily for

one year, to support sectors through which it could promote exports, facilities investment and startups.

However, considering the need to support the recovery of growth as well as the expansion in growth potential, given the inadequate economic recovery and the still high uncertainties at home and abroad it was decided to extend until August of this year the provision of the support to programs that were expiring – those for trade financing, for facilities investment and for other start-up SMEs.

In line with this the Bank of Korea has maintained the total ceiling of its Bank Intermediated Support Facility at 25 trillion won since March of last year. The individual program ceilings have also been maintained at 4.5 trillion won for the Support Program for Trade Financing, 0.5 trillion won for the Support Program for Small-scale Business Owners, 6.0 trillion won for the Support Program for High-tech and Other Start-up SMEs, 8.0 trillion won for the Support Program for Facilities Investment, and 5.9 trillion won for the Support Program for Regional Enterprises, as has the 0.1 trillion won retained ceiling. The Bank Intermediated Lending Support Facility program interest rates range from 0.50 to 0.75% per annum.

<Figure II - 4>Ceiling and interest rate¹⁾ of Bank Intermediated Lending Support Facility



Note: 1) 0.50-0.75% after April 1, 2015.
 Source: The Bank of Korea.

3. Financial Stability

Efforts for Financial and Foreign Exchange Market Stability Continue

The Bank of Korea continued its policy efforts to secure financial and foreign exchange market stability. While on the one hand regularly monitoring the movements of major price variables including interest and exchange rates, global capital flows and the situation of foreign currency in- and out-flows, it also responded actively to emergent destabilizing factors at home and abroad by activating its emergency response system, strengthening its communication activities, and implementing market stabilization measures, thereby promoting financial and foreign exchange market stability.

At the time of expanded uncertainties in the international financial markets in November 2016, with the US presidential election approaching, the Bank revised and supplemented its contingency plan, by for example establishing appropriate response measures should these expanded uncertainties develop into a crisis. Moreover, immediately before and after the US election it convened its emergency 「Financial and Economic Conditions Review Meeting」 on two occasions, to examine the effects of the election results on the domestic financial markets and economy, and decided to actively implement market stabilizing measures when unrest heightens. Especially, when market rates soared after the US election it implemented measures such as outright Treasury bond purchases and a reduc-

tion in the amount of its MSB issuance, and thus ensured that market anxieties did not spread excessively.

After the US Federal Reserve hiked its policy rate in December 2016 and March 2017, the Bank, through operation of its 「Monetary and Financial Task Force」 for instance, examined the reactions of the international financial market and discussed measures for responding to any surge in financial market volatility or other changes in conditions.

At the times of the National Assembly's passage of the presidential impeachment bill in December last year, and of the Constitutional Court's decision to impeach the president in March of this year, the Bank on the one hand convened its 「Emergency Executive Meeting」(four times), while also operating its emergency system in collaboration with its overseas representative offices on 24-hour-a-day basis on the other to examine financial market movements at home and abroad as well as the views of investors overseas. Together with this it devoted efforts to ensuring that volatility in the financial and foreign exchange markets did not expand excessively, owing for example to tipping effects due to market participants' anxieties.

After the Trump administration took office in January of this year the Bank responded to the possibility of financial and foreign exchange market unrest, triggered for example by the protectionist tendencies of the new US government, by devoting efforts in close cooperation with the Korean

government to provide explanations on issues such as Korea's foreign exchange market conditions and the background to its current account surplus, via international meetings for instance.

Efforts Devoted to Identifying in Advance and Responding to Potential Risks within the Financial System

Through identification in advance of potential risks in the financial system, the Bank of Korea devoted efforts to presenting early warnings and suggesting directions for response.

In December 2016 it reformed the analysis framework used in its 「Financial Stability Report」, and closely assessed the vulnerabilities in financial conditions in the household and other sectors while checking on resilience for withstanding domestic and external shocks. While on the one hand examining the recent changes in the financial and business cycles and analyzing their effects on financial stability, it also measured the possibilities of a default at any particular individual bank spreading to affect the banking system as a whole, through the structure of transaction interconnectedness among banks.

In March 2017 the Bank held a regular Monetary Policy Board meeting for the examination of financial conditions (hereafter

「Financial Stability Meeting」²²), and analyzed in depth financial stability conditions in various sectors such as the credit markets, the asset markets, financial institutions, etc., while examining financial system resilience. Especially, by examining in depth the soundness of loans to self-employed business owners, the changes in companies' interest coverage ratios at times of rising interest rates, the major risks of non-bank financial institutions, etc., it devoted efforts to identifying in advance the effects on the financial system caused by increased market interest rates. Meanwhile, in consideration of the points that market participants' interest in the importance of financial stability is rising, the Bank strengthened its communication related to its 「Financial Stability Meeting」. For the March 「Financial Stability Meeting」²³ the Bank distributed a press release reporting the major details discussed and held a press briefing on the day the meeting was held, in addition to releasing the minutes of the meeting two weeks later.

The Bank strengthened its monitoring of the trends of household debt, through means such as meetings of its 「Household Debt Taskforce」, as the persisting rapid growth in household debt aroused concerns not only about it constraining consumption, but also that it might cause a degrading of financial stability. Moreover, the Bank, together with the government and other related institutions, devised measures for responding to

22) Through an improvement in the operational framework for meetings of the Monetary Policy Board, it was decided that, from 2017, four meetings per year of the Board's regular meetings will be devoted to the examination of financial stability conditions.

23) The Bank of Korea publishes its 「Financial Stability Report」 in June and December every year, and since 2015 has also been examining macrofinancial stability conditions in the periods between these publications, during the regular meetings of the Monetary Policy Board in March and September. It has decided to release the major details of these March and September Financial Stability Meetings on the same days that the meetings are held, from this year on.

domestic and foreign factors causing financial sector destabilization, through its 「Macroeconomic and Finance Meeting」. It also participated in the 「Consultative Group for Managing Household Debt」, where it consulted on measures for strengthening the management of household lending for example in the non-bank financial sector.

Efforts to Strengthen Global Financial Safety Nets Continue

The Bank of Korea, by attending meetings of the G20, the IMF, etc., has participated actively in the timely identification of changes in global financial and economic conditions and their effects, as well as in the discussions on major pending issues such as the monetary policy stances of major countries, financial regulation, trade protectionism, etc. In particular, at the G20 Finance Ministers' and Central Bank Governors' Meetings, held in Washington, D.C. in October 2016 and in Baden-Baden, Germany in March 2017, the Bank continually stressed the need for policy cooperation in the international society, to strengthen the global financial safety nets by improving the IMF lending system and by boosting debt sustainability, etc., and to respond to financial regulatory reforms and financial digitalization.

Meanwhile, the Bank also sustained its efforts to expand the financial safety nets by means of currency swap agreements. It extended its swap agreements with the cen-

tral banks of Malaysia, Australia and Indonesia – in January, February and March 2017 respectively - by three years each. Notably, by expanding the size of its currency swap with the Reserve Bank of Australia to twice its previous level²⁴⁾, and by additionally stipulating purposes of securing financial stability to the specified uses of the swap funds, the Bank strengthened the economic and financial cooperation between the two countries, and boosted the financial stability-related function of the swap as well. Together with this the Bank also continued its efforts to encourage the use of regional currencies and currency swaps, by utilizing the Korea-China currency swap funds to strengthen support for companies' trade settlement.

Safety and Efficiency of Payment and Settlement Systems Enhanced

The Bank of Korea continued its efforts to enhance the safety and efficiency of the payment and settlement systems, in response to changes in domestic and overseas conditions.

First, to prevent temporary liquidity shortages of BOK-Wire+ participants from spreading to become settlement risks, the Bank supplied intraday liquidity to participants to cover such temporary shortages of funds for settlement. This liquidity is provided to banks participating in BOK-Wire+ through intraday overdrafts on condition of intraday redemption and to financial investment companies and the Korea Exchange

24) The swap amount was expanded from the previous 5 billion Australian dollars/5 trillion Korean won, to 10 billion Australian dollars/9 trillion Korean won (equivalent to about 7.7 billion US dollars).

through the Bank's sales to them of Repos, also conditional on intraday redemption. During the period from January to March 2017 the Bank provided BOK-Wire+ participants with a daily average of 2.3 trillion won in intraday liquidity.

<Table II - 1> Funds covering temporary intraday liquidity shortages¹⁾

	(billion won, %)			
	2015	2016	2017	(Rate of
			Jan.-Mar.	change)
Intraday overdrafts ²⁾	394.5	380.2	291.5	(-23.3)
Intraday RPs	2,613.7	2,449.8	2,044.4	(-16.5)
Total	3,008.2	2,830.0	2,335.9	(-17.5)

Notes: 1) Daily average basis.

2) Based on average balance of net intraday overdraft loan (Amount of intraday overdrafts loan used - Outstanding balance of deposits only for settlement).

Source: The Bank of Korea.

The Bank also continued its efforts to ensure smooth domestic implementation of the 「Principles for Financial Market Infrastructures (PFMI)」²⁵⁾, the international standards in the field of payment and settlement, and of the 「Guidance on Cyber Resilience for Financial Market Infrastructures」.²⁶⁾ In January of this year it enacted its 「Guidance on the Oversight of Financial Market Infrastructures」 setting out the bearings of the Bank's surveillance duties, which was distributed in advance to the institutions concerned to induce them to strengthen their risk management. Between October of last year and March this year, meanwhile, through joint examinations with

the Financial Supervisory Service of one domestic bank and two financial investment companies, the Bank examined matters such as their compliances with the related regulations, their settlement risk management, and so on. To the institutions whose examination results showed that improvements are needed in the areas of net settlement risk and operational risk, the Bank recommended that they carry out such improvements.

In order to reduce settlement risk, as well as to heighten financial institutions' settlement convenience, etc., the Bank of Korea also decided to extend the BOK-Wire+ operating hours. Accordingly the Bank comprehensively considered the expectation effect due to an extension in operating hours, as well as the impacts on BOK-Wire+ participant institutions, and prepared a plan for extending the closing time for funds transfers by one hour, from 5:30 to 6:30 p.m., which is scheduled to be implemented this year.

Joint Inspections Conducted to Examine Potential Financial System Risks

To examine the potential risks of the financial system the Bank of Korea on the one hand carried out joint inspections of financial institutions and strengthened its regular monitoring and analysis activities, while on the other hand also working to

25) Following the identification after the global financial crisis of the needs to expand the over-the-counter derivatives market infrastructures and to strengthen international standards concerning the operation of financial market infrastructures, the BIS's Committee on Payments and Market Infrastructures (CPMI), jointly with the International Organization of Securities Commissions (IOSCO), integrated the existing international standards, and in April 2012 they were established as the new international standards for payment and settlement.

26) In June 2016 CPMI-IOSCO, in an effort to induce the heightening of financial market infrastructure cyber resilience, established additional guidelines related for example to PFMI 2 (Governance), 3 (Framework for the comprehensive management of risks), 8 (Settlement finality), 17 (Operational risk) and 20 (FMI links).

vitalize its exchanges of information with banks and with supervisory authorities at home and abroad.

During the October 2016 to April 2017 period the Bank carried out two sectoral examinations of domestic banks – one examining commercial banks’ household loans and the other the vulnerabilities of regional banks. Through the household loan-related examination the Bank checked on banks’ household loan risk management, the debt repayment capacities of their vulnerable borrowers, etc. In its examinations of regional banks it looked into the lending conditions and extents of insolvency in the shipbuilding belt region, the potential risks of household mortgage loans due to the differentiations in regional housing prices, etc. Meanwhile, through joint examinations of individual banks (on two occasions) it checked on issues such as the potential risks of their corporate credit and their conduct of risk management.

<Table II - 2> **Joint examinations¹⁾ with Financial Supervisory Service**

(times)				
2013	2014	2015	2016	2017 Jan.-Apr.
8	7	7	6	2

Note: 1) Examinations of banks.
Source: The Bank of Korea.

In parallel with its joint examinations of financial institutions, the Bank actively carried out regular monitoring of them in the forms of visits or telephone interviews, to

identify in advance factors hindering financial stability and to gather information related to financial institutions’ business models. On the one hand, through providing the results of its financial institution examinations to the government and the supervisory authorities and including them in its 「Financial Stability Report」, the Bank ensured that the policy authorities and market participants could recognize and respond to the risks inherent in the financial system. At the same time it strengthened its cooperation with the domestic financial supervisory authorities, through for example workshops with other institutions involved in the joint examinations, occasional meetings, etc. It in addition also devoted efforts to streamlining its communication with financial institutions, through meetings with their section heads in charge of credit and risk management, with their staff responsible for the compilation of statistics, etc.

Besides this the Bank of Korea also participated actively in the Supervisory Colleges²⁷⁾ for Standard Chartered, HSBC, Citi and Deutsche Banks, led by supervisory authorities in major countries, and in the relevant periodic conference calls, and acquired information related to pending financial issues such as the Brexit. In January of this year the meeting of the Supervisory College and Crisis Management Group for Standard Chartered Bank was held at the Bank of Korea. The staff concerned from 10 central banks and supervisory organizations in seven

27) Supervisory colleges are organizations composed of the supervisory authorities of the home countries where large banks’ headquarters are, and of the host countries where their overseas local subsidiaries and branches are operating. They share information related to management conditions of the banks concerned, and discuss the trends of their supervision.

countries including the United Kingdom participated in these meetings, along with executives from the Standard Chartered Group, etc., and, while examining Standard Chartered Bank's management strategy, performance and risk management on the one hand, they also discussed its plans for recovery and resolution in any case of emergency.²⁸⁾

28) The FSB, in its 'Key Attributes of Effective Resolution Regimes for Financial Institutions' established in November 2011, recommended the setting up of Recovery and Resolution Plans (RRPs) for systemically important financial companies for times of emergency.

III

Future Monetary Policy Directions

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1. External Conditions²⁹⁾

World Economic Recovery Forecast to Continue

It is forecast that the recovery of the world economy will continue. Advanced countries' paces of growth will accelerate, led by the US, and natural resource-exporting emerging market economies are also expected to turn around to positive growth.

<Table III - 1> World economic growth outlook¹⁾

	2015	2016	2017 ^e	2018 ^e
World	3.4	3.1	3.5	3.6
Advanced economies	2.1	1.7	2.0	2.0
(US)	2.6	1.6	2.3	2.5
(Euro area)	2.0	1.8	1.7	1.6
(Japan)	1.2	1.0	1.2	0.6
Emerging market and developing economies	4.2	4.1	4.5	4.8

Note: 1) Based on IMF World Economic Outlook (Apr. 2017); 2015-2016 statistics for the US, Japan and the euro area are from their own representative agencies.

Sources: IMF, individual countries' published statistics.

The pace of growth in the US is forecast to accelerate, driven especially by domestic demand. Amid increased household incomes and improved consumer sentiment supporting private consumption, investment is expected to grow thanks for example to government policies including an expansion in infrastructure investment. However, the uncertainties related to policy implementation by the new US government and the strengthening of global trade protectionism are foreseen to limit a pickup in the speed of

growth. It is projected that the euro area economy will continue to improve moderately, as consumption is growing at a moderate pace based on factors such as improvements in employment conditions, and as exports are increasing owing for example to recoveries in import demand in natural resource-exporting countries. There is however a possibility of political uncertainties, related to elections in major countries, to the negotiations over the UK's exit from the European Union, etc., working as downside risks to growth. Japan is meanwhile expected to continue its modest growth, centering around exports and public and private investment for example.

<Table III - 2> Outlook for economic growth¹⁾ in the euro area

	2015	2016	2017 ^e	2018 ^e
Euro area	2.0	1.8	1.7	1.6
(Germany)	1.7	1.9	1.6	1.5
(France)	1.3	1.2	1.4	1.6
(Italy)	0.8	0.9	0.8	0.8
(Spain)	3.2	3.2	2.6	2.1

Note: 1) Based on IMF World Economic Outlook (Apr. 2017); 2015-2016 statistics for the individual countries are based on those published by Eurostat.

Sources: IMF, Eurostat.

The stable growth in China is forecast to continue, as industrial production improves as well, together with solid growth in investment, especially in SOC and real estate and with the recovery in exports. There is however potential for the real estate market to contract in the processes of restraining real estate overheating and reducing corporate debt, and such a contraction could become

29) Part III Sections "1. External Conditions", "2. Growth Forecast" and "3. Price Forecast" have been drawn up based on the Bank of Korea's 「Economic Outlook Report」 released on April 13, 2017.

a downside risk to growth. India and the ASEAN countries are expected to maintain their steady growth, due for example to buoyancy in exports and private consumption and to expansions in infrastructure investment. Natural resource-exporting countries Brazil and Russia seem likely to break free from their negative growth thanks to the increases in international raw materials prices.

<Table III - 3> Outlook for economic growth¹⁾ in EMEs

	(%)			
	2015	2016	2017 ^e	2018 ^e
China	6.9	6.7	6.6	6.2
Brazil	-3.8	-3.6	0.2	1.7
Russia	-2.8	-0.2	1.4	1.4
India ²⁾	7.9	6.8	7.2	7.7
ASEAN-5 ³⁾	4.8	4.9	5.0	5.2

Notes: 1) Based on IMF World Economic Outlook (Apr. 2017); 2015-2016 statistics for the individual countries are from their own representative agencies.

2) Fiscal year basis (April of previous year to March of this year); figures for 2016 are based on the IMF.

3) Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Sources: IMF, individual countries' published statistics.

ments in the value of the US dollar, etc.

<Table III - 4> Outlook for international oil prices¹⁾

	2016	2017 ^e		2018 ^e
		1st half	2nd half	
<Brent>	44.1			
CERA (Mar. 17)		57.8	57.8	57.3
OEF (Mar. 24)		53.5	50.5	52.0
EIA (Mar. 7)		54.2	55.0	57.2

(US\$/barrel)

Note: 1) Period-average; figures in parentheses refer to dates of forecasts.

Sources: CERA, OEF, EIA.

International Oil Price Expected to Fluctuate at Low- to Mid-50 Dollars per Barrel Level

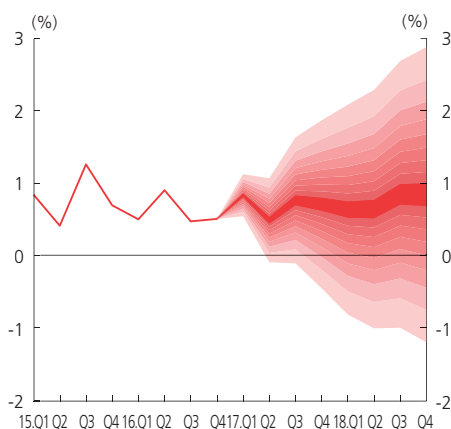
It is forecast that the international oil price will fluctuate at the low- to mid-50 dollars-to-the-barrel level, as the factors pushing it up such as greater crude oil demand in line with improvements in the global economy, and those pushing it down including an increase in shale oil production, will be mixed. There is also a possibility that oil price volatility will expand, however, depending on whether the agreement on oil price cuts is extended and on whether it is implemented or not, on geopolitical unrest in the Middle East and Africa, on the move-

2. Growth Forecast

Domestic Economic Growth Forecast to Continue

It is forecast that the domestic economy will continue its moderate growth, thanks to improvements in exports and facilities investment in line with the global economic recovery, and register a growth rate of 2.6% this year. During next year it is expected to show a rate of 2.9% growth, higher than that of this year, as the recovery in the world economy continues. Looking at the contributions to growth of the different expenditure sectors this year, the contribution of the export sector will maintain its level of last year, but the contribution of domestic demand seems likely to decrease slightly.

<Figure III - 1> Economic growth fan chart¹⁾²⁾



Notes: 1) Compared with the previous quarters; figures are the forecasts as of Apr. 2017.

2) The darkest band in the center of the chart represents a 10% confidence interval including the central projection, and the other colored bands cover confidence intervals ranging from 20% to 90% as the shading lightens.

Source: The Bank of Korea.

Looking at the various sectors, private consumption is forecast to sustain its modest upward trend, owing for example to improved consumption sentiment. Factors that could work to help it increase include a gradual recovery in consumption sentiment in line with households' improved perceptions of the economy due to factors such as the alleviation of political uncertainties, as well as the government's measures to boost consumption including its support for the replacement of old diesel-powered automobiles. However, structural factors restricting consumption do still exist, including the insufficient improvement in household incomes, and the increase in households' debt repayment burdens.

It is forecast that facilities investment will expand to a considerable extent, led by the semiconductor and display sectors and thanks for example to a rise in corporate investment incentives in line with the improvements in global economic conditions, as well as to reduced political uncertainties after the launch of the new government. The pace of growth in intellectual property products investment is projected to rise slightly over that of last year, thanks among other things to an increase in the government's R&D budget. It is anticipated that construction investment will show steady growth, led by building construction, but that the extent of its growth will lessen moving further into the second half of this year. Building construction is expected to show generally favorable movements, in view for example of the greatly increased total area of projects begun during 2015 and 2016, but civil engineering construction is

foreseen to decrease due to the government's reduction in the size of its SOC budget.

Exports are forecast to continue their flows of improvement, as the rate of world trade growth accelerates due to expansions in the recoveries in advanced economies and to recoveries in import demand in natural resource-exporting countries and other EMEs. China's strengthening of direct and indirect measures restricting trade are however foreseen working as downside risks to exports to China. Imports are expected to reverse to an increase, due to rising international raw materials prices, to an improvement in facilities investment, etc. It is projected that the current account will maintain its trend of surplus, centering around the goods account, but that the size of the surplus will decline compared to last year's owing to an expansion in the services account deficit.

Concerning the future growth path, there is a mix of both upside and downside risks. Among the former are an expansion of the recovery in external demand due to strengthening improvements in the global economy and in IT business conditions, a decline in the effects of China's measures to limit trade, and economic stimulus policies by the new Korean government. The downside risks meanwhile include those of weakening world trade growth due to intensified protectionism, of expansions in the effects of China's measures to limit trade and of increased financial market volatility stemming for example from an upsurge in geopolitical risks.

<Table III - 5> Economic growth outlook¹⁾

(%)

	2016			2017 ^a			2018 ^a
	Year	1st half	2nd half	Year	1st half	2nd half	Year
Real GDP	2.8	3.2	2.5	2.6	2.6	2.7	2.9
Private consumption	2.5	2.9	2.1	2.0	1.9	2.0	2.3
Facilities investment	-2.3	-3.7	-0.9	6.3	9.5	3.3	3.4
Intellectual property products investment	2.3	1.9	2.6	2.7	2.5	2.9	3.2
Construction investment	10.7	9.9	11.4	4.5	7.3	2.2	-0.1
Goods exports	2.2	1.3	3.0	3.3	4.0	2.6	3.5
Goods imports	3.6	2.7	4.5	4.0	6.2	1.8	3.4

Note: 1) Compared with the same periods of the previous years; figures are the forecasts as of Apr. 2017.

Source: The Bank of Korea.

3. Price Forecast

Pace of Increase in Consumer Prices Forecast to Accelerate

It is forecast that consumer prices will rise by 1.9% during this year, and they are expected to show a pace of increase at around this year's level during next year as well.

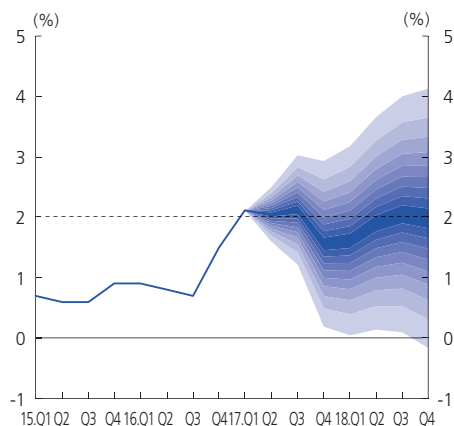
Looking first at the supply side, it is projected that prices of agricultural products will continue their high rates of increase but that livestock product prices will gradually stabilize, amid the international oil price fluctuating at around the lower 50 dollars per barrel level for the time being. On the demand side, the GDP gap ratio is forecast to sustain a negative figure, but the inflation expectations of the general public seem likely to maintain the mid-2% level. Public service charges are meanwhile expected to be a factor pushing prices up in the third quarter, on the base effect of the temporary electricity fee cuts during the summer last year, while the pace of increase in housing rental prices will slow somewhat, centering around leasehold deposit prices.

The core inflation index with food and energy products excluded, one of the indicators of core inflation that remove the effects of irregular factors on the supply side, is expected to rise by 1.7% this year and by 1.9% in 2018.

The upside and downside risks to the future path of inflation are assessed as

mixed, with the overall risk neutral. The major upside risks include those of a rise in international oil prices after an extension in the production cuts agreed on by OPEC oil-producing countries, of an acceleration of the domestic economic recovery owing for example to improvements in the global economy, and of worsening weather conditions. Among the potential downside risks to prices are an increase in US shale oil production and a dulling of demand-side inflation pressures owing for example to increased economic uncertainties in Korea and overseas.

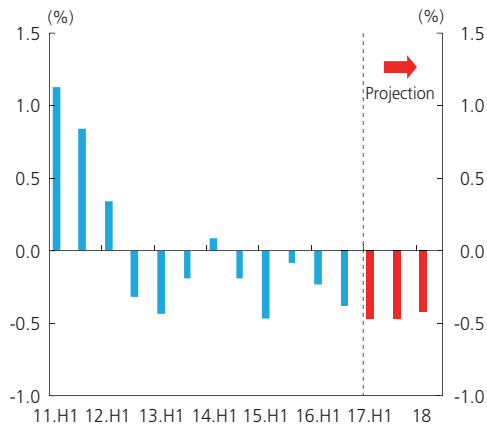
<Figure III - 2> CPI inflation fan chart¹⁾²⁾



Notes: 1) Compared with the same periods of the previous years; figures are the forecasts as of Apr. 2017.
 2) The darkest band in the center of the chart represents a 10% confidence interval including the central projection, and the other colored bands cover confidence intervals ranging from 20 to 90% as the shading lightens.

Source: The Bank of Korea.

<Figure III - 3> GDP gap ratio outlook¹⁾



Note: 1) Figures are the forecasts as of Apr. 2017.
Source: The Bank of Korea.

<Table III - 6> Inflation outlook¹⁾

		2016		2017 ^e		2018 ^a	(%)	
		Year	1st half	2nd half	Year	1st half	2nd half	Year
CPI inflation		1.0	0.9	1.1	1.9	2.0	1.8	1.9
Core Inflation	CPI excluding food & energy	1.9	1.9	1.8	1.7	1.6	1.7	1.9
	CPI excluding agricultural products & oils	1.6	1.7	1.5	1.5	1.4	1.6	1.9

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

4. Major Considerations

Among the major items that will have to be considered in future monetary policy operations, we examine in the following the effects of monetary policy normalization by the US Federal Reserve, the question of whether the high pace of increase in household lending will continue, and the situation of global inflation.

A. Possibility of Capital Outflows Following Monetary Policy Normalization by the US Federal Reserve

The US Federal Reserve's normalization of its monetary policy will work as a factor heightening pressures for capital outflows, but when past cases of capital outflows, as well as current economic conditions domestically and abroad are comprehensively considered, the likelihood of large-scale outflows is assessed as limited. But if financial markets in some EMEs whose external vulnerabilities are relatively high become unstable as global risk factors materialize, then there is a possibility of capital outflow pressures becoming large in Korea as well due to contagion effects. There is thus a need to closely examine developments in terms of such risk factors going forward.

In line with the forecast that the US Federal Reserve's normalization of monetary policy will now begin in earnest, we have examined the likelihood of capital outflows owing for example to an inversion of the domestic/international interest rate spread between Korea and the US. First, the results of analysis through a model of the determinants of foreigners' investment funds in- and outflows show that it is not only the factors directly related to rate hikes by the Federal Reserve, such as the domestic/international interest rate spread, the Korean won/US dollar exchange rate, and global liquidity, but also international financial market uncertainties (VIX) and the gap in growth rates compared to advanced countries that also significantly affect in- and outflows of foreigners' investment funds.

Looking at the effects of these individual factors, in the case where the domestic/international interest rate spread is narrowing it appears that capital, especially that invested in bonds, either flows in at a slower pace or even flows out, as the arbitrage incentive lessens. However, the effects of the domestic/international interest rate spread on stock funds and borrowings³⁰⁾ are not significant. It is observed that capital flows out of Korea as the proportion of global capital invested in EMEs lessens when the US dollar is strong and global liquidity declines.³¹⁾ Moreover, as global market uncertainties (VIX) and narrowing gaps in

30) In the case of borrowings, differently than expected the domestic-foreign interest rate spread variable does not turn out to be significant. This appears to be due to the fact that the proportion of long-term borrowings has increased greatly since the global financial crisis, in addition to the fact that short-term borrowings too are affected substantially by the sales of forward exchange by and clearing of exporting firms.

31) The results of model estimation show that at a time of dollar strengthening (a rise in the Korean won/US dollar exchange rate) stock funds flow in. This is assumed to be due to the fact that, as it leads to expectations of improved performances for exporting companies, a won/dollar exchange rate increase works as a factor causing fund inflows.

growth rates between EMEs and advanced countries result in stronger risk aversion and lower expected rates of return from capital, respectively, they put pressures on foreigners' investment funds to flow out.

<Table III - 7> **Estimated in- and outflows¹⁾ of foreigners' investment funds²⁾³⁾**

Model	All		Bonds		Shares		Borrowings	
	I	II	I	II	I	II	I	II
Domestic/ international interest rate spread ⁴⁾	0.92***	1.00***	0.95***	0.71***	-0.25	0.28	0.22	0.01
₩/US\$	-11.97***	— ⁵⁾	-9.20***	— ⁵⁾	10.31***	— ⁵⁾	-13.08***	— ⁵⁾
Global liquidity ⁶⁾	0.22***	0.27***	0.04**	0.11***	0.08**	-0.03	0.10***	0.19***
VIX		-3.49***		-0.30		-2.08**		-1.11
Difference in growth rates ⁷⁾		0.46***		0.14		0.15*		0.18
R ²	0.65	0.68	0.71	0.52	0.20	0.11	0.73	0.58

Notes: 1) Net flows of foreigners' investment funds/Nominal GDP (quarterly basis, seasonally adjusted).

2) Covers the period from Q1 2001 to Q3 2016.

3) *, ** and *** indicate statistical significances at the 10%, 5% and 1% levels respectively.

4) Treasury bond yields (3-year) of Korea and the US.

5) Omitted due to multicollinearity problems resulting from high correlation between VIX and Korean won/US dollar exchange rate.

6) Changes in depository corporations' overseas financial investment (BIS)

7) Difference in GDP growth between that of Korea and weighted average of US, euro zone, Japan and UK.

Source: Bank of Korea estimates.

Korea has meanwhile experienced three episodes of large-scale capital outflows since the 1990s.³²⁾ If the periods of 1997~1999, 2008~2009 and 2015~2016 are classified as the 1st, 2nd and 3rd periods of capital outflows respectively, and their properties examined, it is judged that the spread of

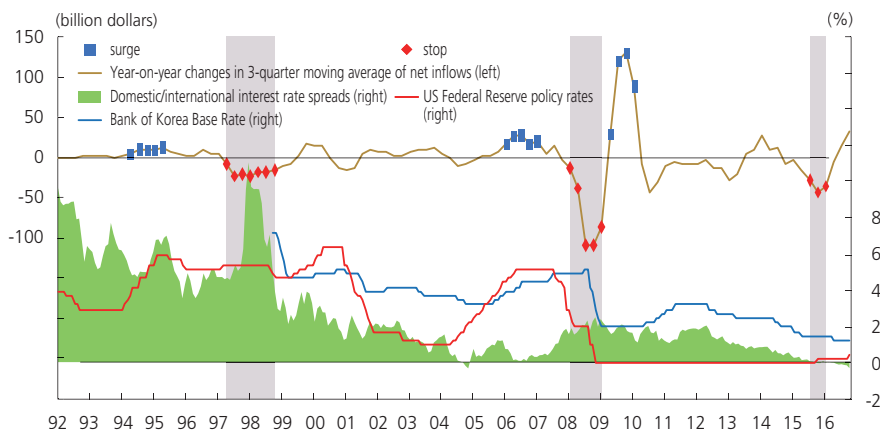
international financial market instability, vulnerabilities in the domestic economy, etc. had stronger effects on large-scale capital outflows than did the domestic/international interest rate spread. First of all, the effects on large-scale capital outflows caused by a narrowing or inversion of the domestic/international interest rate spread appear to have been unclear. At the times of US Fed policy rate hikes and inversions of Korean and US long-term interest rates, the only case of capital having flowed out to a large extent was the 3rd period of capital outflows. Moreover, during the processes of US Federal Reserve rate hikes in the past, even when Korea-US policy rate or long-term interest rate inversions have occurred³³⁾ there have also been cases of foreigners' investment funds flowing in on net. Secondly, all three episodes of capital outflows were triggered by unrest in the international financial markets, either in EMEs or in advanced economies, as it spread to Korea.

32) Referring to Forbes and Warnock (2012), in cases where the amounts of change (year-on-year basis, three-quarter moving averages) in in- and outflows of foreign investor funds exceed (fall below) those during the previous five years by more than two standard deviations, we identify them as cases of excess inflow (excess outflow), and we define the periods during which excess outflows occurred as periods of large-scale capital outflows.

33) During the courses of past policy rate hikes by the US Federal Reserve, Korean-US policy rates were inverted between June 1999 and March 2001 and between August 2005 and September 2007, while the countries' long-term market interest rates (10-year Treasury bond basis) were inverted from October to December of 2004.

<Figure III - 4>

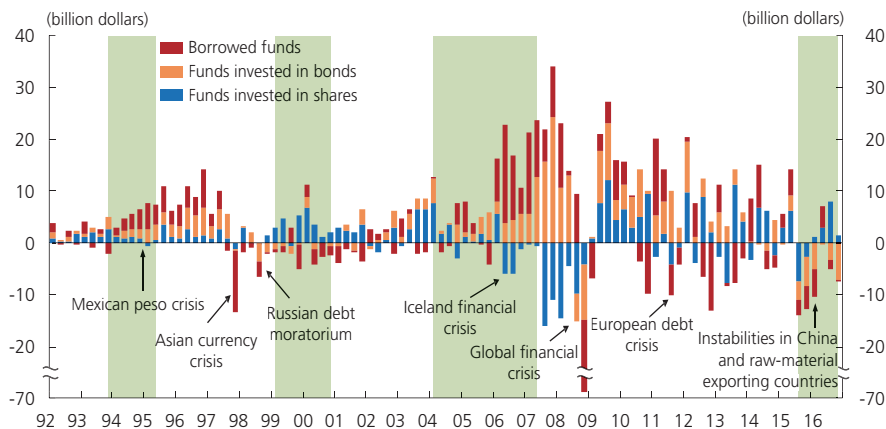
Cycle of foreigners' investment fund flows¹⁾²⁾



Notes: 1) The gray areas indicate periods of capital outflows (the same hereafter unless otherwise mentioned).
 2) Domestic/international interest rate spreads are based on 10-year Treasury bonds; spreads before 2001 are based on 5-year Treasury bonds.
 Source: Bank of Korea estimates.

<Figure III - 5>

In- and outflows of foreigners' investment funds¹⁾²⁾



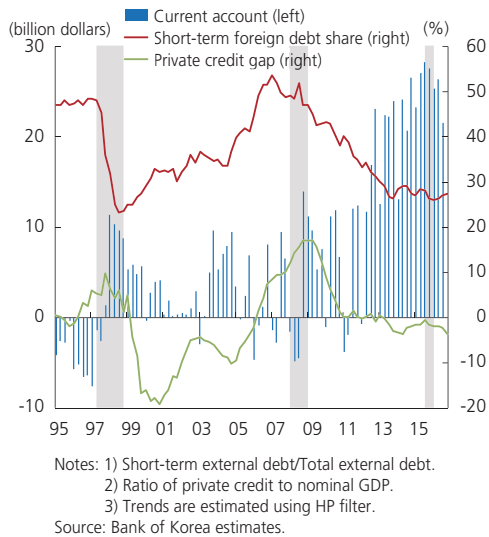
Notes: 1) Excludes funds borrowed from and repaid to IMF during 1997-2001.
 2) The shaded areas indicate periods during which the US Federal Reserve hiked its policy rate.
 Source: Bank of Korea estimates.

During the first outflow period it was the Asian Currency Crisis, during the 2nd period it was the Global Financial Crisis, and during the 3rd period it was economic unrest in China and natural resource-exporting countries that brought about the respective outflows of foreigners' investment funds

as they caused heightened international financial market sensitivities to risk. Third, in cases where the Korean economy's domestic and external vulnerabilities have been high, large-scale capital outflows have led to severe contractions in the real economy, whereas relatively stable paces of

growth have been maintained otherwise. During the 1st and 2nd outflow periods, where at around the times of the outflows the current account worsened and the proportion of short-term external debt and the private credit gap showed high levels, the economic growth rate fell to negative. During the 3rd outflow period, however, when these indicators of domestic and external soundness were favorable, a growth rate of around 3% was recorded.

<Figure III - 6> Current account, short-term foreign debt share¹⁾ and private credit gap²⁾³⁾



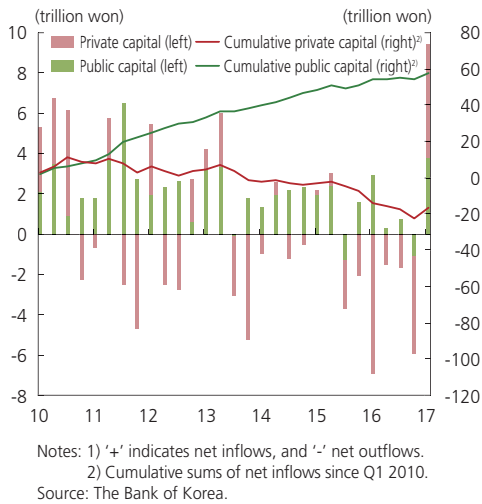
Looking at these results of analysis, and at the current financial and economic circumstances, it is judged that the likelihood is not high of any large-scale capital outflows occurring under a US Federal Reserve stance of raising its policy rate in the future.

First, the possibility of large-scale capital outflows due to an inversion of the domestic/international interest rate spread appears limited. Considering the strong synchronization between Korean and US long-term market interest rates seen until now³⁴⁾, it is expected that any future domestic/international interest rate inversion will progress gradually and that the extent of inversion will also be not large. What is more, in the case of foreigners' bond investment funds (which account for 27% of all funds invested)³⁵⁾, which are affected by the domestic/international interest rate spread, their stability has risen compared to the past as the share of investment by public funds, which tends to be long-term, has increased since the global financial crisis compared to that of private funds, which react sensitively to the domestic/international interest rate spread, and as the remaining maturities of foreigners' bond holdings are lengthening. In line with all of this, some outflows of bond investment funds could occur with a rise in US market interest rates, but the amount is not expected to be so large as to have serious impacts on the bond market.

34) It was calculated that, between January 2000 and March 2017, the coefficient of correlation between Korean and US 10-year Treasury bond yields was 0.89.

35) According to International Investment Position (IIP), as of year-end 2016 54.9% of the funds invested by foreigners in Korea was invested in stocks, while 26.9% was invested in bonds and 18.2% was borrowings.

<Figure III - 7> Changes in foreigners' domestic bond investment, by sector¹⁾



It is assessed moreover that the vulnerabilities of emerging market economies, which worked as factors causing international financial market unease in the past, have lessened recently compared with the 3rd capital outflow period in 2015. In an appraisal of EME vulnerabilities by the Institute of International Finance (IIF), it was assessed that 8 among the 13 countries considered had strengthened their capacities for responding to shocks as their external or financial sectors had improved this year. Korea's external soundness is also at favorable levels - compared both to past periods of capital outflows and to other EMEs. This judgment takes into account the fact that the ratio of Korea's current account relative to its nominal GDP is higher than those of other EMEs and exceeds the IIF's 'least vulnerable' standard (above 3%), that Korea's foreign exchange reserves are showing levels close to its total external debt and that Korea's external solvency is also at a high

level compared to the past.

However, there are still some potential risks that could affect capital outflows - including the uncertainties related to the economic policies of the new US government, the monetary policies of major advanced countries, geopolitical risks, etc., as well as the buildup of household debt.

Looking at the factors determining in- and outflows of foreigners' investment funds, at past episodes of large-scale capital outflows, at current economic conditions at home and abroad, etc., it is judged that the US Federal Reserve's monetary policy normalization will possibly work as a factor heightening capital outflow pressures, but that the likelihood of this leading to large-scale outflows is limited. However, in the case where financial markets in some EMEs whose external vulnerabilities are relatively high become unstable as global risk factors materialize, then inasmuch as there is a possibility of capital outflow pressures becoming large in Korea as well due to the contagion effect, there is a need to closely monitor developments in terms of the related risk factors going forward. In addition, efforts also appear essential in the medium term to boost resilience related to external shocks through reducing the structural vulnerabilities of the domestic economy.

<Table III - 8>

Assessment of EME vulnerabilities¹⁾

	Brazil	Colombia	Mexico	Russia	Czech Republic	Turkey	Korea	Indonesia	Malaysia	Thailand	China	India	South Africa
Foreign sector vulnerabilities ²⁾	(+)							(+)				(+)	(-)
Domestic financial vulnerabilities ³⁾	(+)		(-)		(+)			(+)		(+)			(-)
Policy vulnerabilities ⁴⁾		(+)	(+)	(+)								(+)	

Notes: 1) Assessed as of December 2016; ■ indicates most vulnerable, ■ vulnerable, ■ less vulnerable, and ■ least vulnerable; (+) and (-) indicate 'improved' and 'worsened' respectively compared to November 2015.

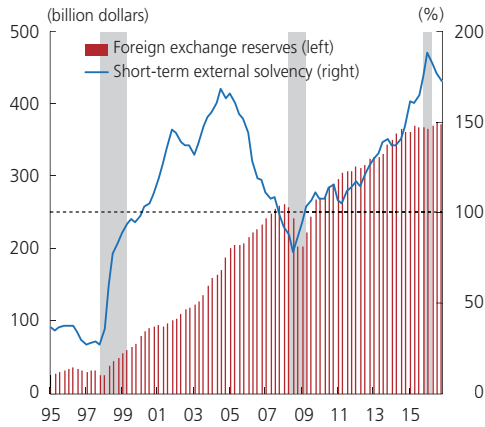
2) Based on an index incorporating ratios to GDP of current account and of external debt, proportions of short-term in total foreign debt, real effective exchange rates, etc.

3) Based on an index incorporating ratios to GDP of household and of corporate debt, rates of growth in real domestic credit, proportions of shares held by foreigners, etc.

4) Based on an index incorporating ratios to GDP of government budget balances and of government debts, real policy rates, Global Competitiveness Indices, etc.

Source: Institute of International Finance.

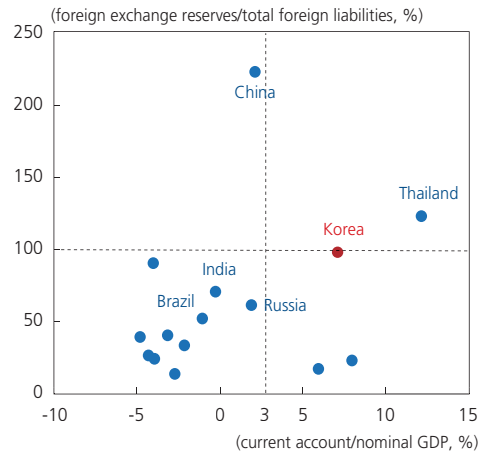
<Figure III - 8> Foreign exchange reserves and short-term external solvency¹⁾



Note: 1) Foreign exchange reserves/(Short-term external debt + 3-month import amount).

Source: The Bank of Korea.

<Figure III - 9> Major EMEs' foreign exchange reserves and current accounts¹⁾



Note: 1) Figures for Korea are as of end of December and Q4 2016; figures for other emerging market economies are as of end of September and Q3 2016.

Sources: The Bank of Korea, IMF, World Bank.

B. Background to Slowing Pace of Household Lending Growth and Forecast

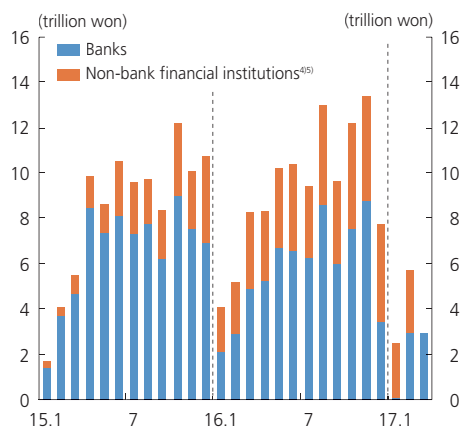
The pace of growth in household lending has slowed recently, centering around banks. This has been a result mainly of a decline in housing transactions, of the effects of government policies related to household lending and real estate, and of increases in lending interest rates. Household lending by non-bank financial institutions has however continued to grow at a high rate, on factors including buoyant deposits in line with their advantageous interest rates, as well as migration of loan demand to them due to banks' strengthened management of their paces of household loan increase. Going forward it is expected that the pace of household lending growth will slow compared to last year, under the influences of the government's policies and of rising loan interest rates. If the housing market improves after the Spring moving season, however, it is possible that the extent of slowdown in the pace of household lending growth will not be great.

During this year household loans of banks and non-bank financial institutions increased by 11.0 trillion won³⁶⁾ as the amount of their increase declined compared to the same period of last year.³⁷⁾

Between January and March of this year banks' household loans (including relief loans

transferred to Korea Housing Finance Corporation) expanded by 5.9 trillion won – an amount 4.0 trillion won short of the 9.9 trillion won increase during the same period of 2016. Non-bank financial institution household loans on the other hand expanded by 5.1 trillion won during the January to February period of this year, 0.9 trillion won more than during that same period last year (amount of increase 4.2 trillion won).

<Figure III-10> Changes in household lending, by financial sector¹⁾²⁾³⁾



- Notes: 1) Including mortgage loans transferred to HF.
 2) Excluding trust accounts.
 3) Figures are based on monthly averages and advance estimates.
 4) Figures for non-bank financial institutions are as of January-February 2017.
 5) Credit unions, mutual savings banks, trust accounts of banks, postal savings.

Source: The Bank of Korea.

36) Based on the amounts of change in household loans from January to March for banks and from January to February for non-bank financial institutions.

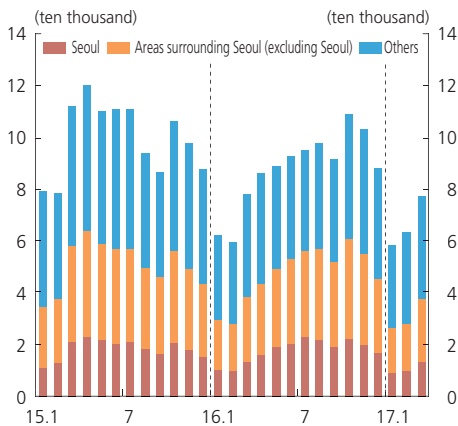
37) However, it remained at a high level compared to the 2010~2014 average amount of increase (0.5 trillion won) from January to March (January to February for non-bank financial institutions).

The background to the slowdown in household lending growth at banks is as follows:

First, the pace of growth in individual home mortgage loans slowed as housing transactions decreased compared to the previous quarter amid a slowing pace of increase in housing prices. The rate of housing price increase has been gradually dropping since November 2015³⁸⁾, and expectations of rising housing prices have weakened greatly since the government's implementation of its real estate-related measures.³⁹⁾ It appears that the recent slowdown has also been due to seasonal factors under circumstances where wait-and-see attitudes have been spreading in the housing market and signs of a slowdown in the housing economy have been observed.

Secondly, the government's policies related to household lending and real estate appear to have also contributed to the slowdown in household lending growth at banks. Until now the government has implemented a variety of measures to improve the structure of household loans and restrain the pace of their increase. In the first half of 2016 it introduced the 「Guideline on Banks' Mortgage Loan Screening」⁴⁰⁾, targeting the banking sector, and in the second half it implemented the 8/25 household debt measures⁴¹⁾ and the 11/3 real estate measures – to manage the upward trend in group loans and to stabilize the housing subscription market respectively. And housing-related loan supply and fund demand seem to have been restrained due to the effects of these policies.

<Figure III-11> Housing transactions



Source: Ministry of Land, Infrastructure and Transport.

Finally, the increase in interest payment burdens due to the rise in lending interest rates appears to have also worked as a factor causing the pace of household lending growth to slow. As the rise in global long-term market interest rates since the second half of last year has affected Korean long-term market rates, home mortgage loan interest rates have increased.⁴²⁾ These higher rates, in a situation in which borrowers' debt repayment burdens are rising since banks are extending mainly amortizing home

38) The rate of increase (year-on-year) in nationwide housing prices has been on a downward trend, having fallen from 4.4% in November 2015 to 3.0% in May 2016, 1.5% in November 2016, and 1.2% in March 2017 (source: KB Real Estate).

39) The Bank of Korea's CSI for prospective housing prices fell from 114 in October 2016 to 99 in March 2017.

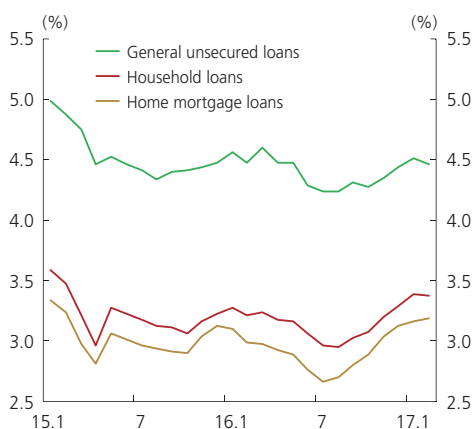
40) In accord with the 「Guideline on Banks' Mortgage Loan Screening」, banks use documentary evidence of income (tax withholding receipts, etc.), whose objectivity is high, so as to identify incomes in order to accurately appraise borrowers' repayment capacities. In the case of home mortgage loans for purchases of new housing, they are in principle extending amortizing loans.

41) In order to strengthen the management of group loans, the government lowered the ceiling on the guarantees (provided by Korean Housing Finance Corporation and Korea Housing & Urban Guarantee Corporation) related to intermediate payment loans (100% → 90%), as well as the number of guarantees allowed (two per institution → two overall), and also strengthened the risk management of banks (by requiring the procurement of borrowers' proof of income, on-site research on business establishments, etc.)

42) The interest rate on bank home mortgage loans (newly issued loan basis) rose by 53bp, from 2.66% in July 2016 to 3.19% in February 2017.

mortgage loans⁴³⁾, seem to have caused household loan demand to contract.

<Figure III-12> Bank household loan interest rates¹⁾



Note: 1) Newly extended loan basis.
Source: The Bank of Korea.

Meanwhile, household lending by non-bank financial institutions has continued to increase, as a result mainly of factors such as the ongoing robustness of non-bank financial institutions' deposit-taking due to their advantageous interest rates⁴⁴⁾, the migration of loan demand (banks → non-banks) in line with the government's policies to manage the trend of household lending increase, and advance demand at mutual credit cooperatives ahead of their implementation of the 「Guideline on Customized Mortgage Loan Screening」.

<Table III - 9> Changes in household lending by banks¹⁾ and non-bank financial institutions

(trillion won)

	2016.Q1	Q2	Q3	Q4	2017.Q1
Banks	9.9	18.4	20.8	19.6	5.9 ²⁾
Non-bank financial institutions ⁴⁾	7.6	10.4	11.1	13.5	5.1 ³⁾
Total	17.4	28.8	31.9	33.1	11.0

Notes: 1) Including mortgage loans transferred to HF.
2) Figures for March are based on advance estimates.
3) Figures are as of January to February.
4) Credit unions, mutual savings banks, trust accounts of banks, postal savings.
Source: The Bank of Korea.

Going forward it is judged that the trend of household lending growth will be influenced by the following factors:

First will be the effects of the government's policies related to household lending. Some of the government's measures related to household lending announced last year are scheduled for full-scale implementation beginning from this year.⁴⁵⁾ On top of this the government has introduced diverse management measures⁴⁶⁾ to also address household lending by non-bank financial institutions, which has been continuously increasing recently. These government policies are seen as likely to cause the pace of growth in household lending to slow for the time being.

Next will be the extent of additional rises in loan interest rates in the future. If domes-

43) In order to comply with the 「Guideline on Banks' Mortgage Loan Screening」 and to meet the targeted proportion of amortizing loans (50% in 2017), banks have increased their proportions of amortizing home mortgage loans.

44) The special interest tax exemption for credit cooperatives (mutual credit cooperatives, community credit cooperatives and credit unions), which was scheduled to expire at the end of 2015, was extended until the end of 2018.

45) Among group loans, those for borrowers' final payments became subject to the 「Guideline on Banks' Mortgage Loan Screening」, beginning with loans for apartments of which construction is announced this year.

46) Including on-site inspections of institutions whose paces of household lending increase have been excessive, upward adjustments of the targeted proportions of amortizing and fixed interest rate loans among non-bank financial institution's home mortgage loans, and strengthened supervision of asset soundness of high-risk loans of savings banks, mutual credit's cooperatives and credit-specialized financial institutions.

tic market interest rates also rise due to the US Federal Reserve's hikes in its policy rate, then this seems likely to lead to increased lending rates. If domestic household loan interest rates rise additionally in the future, they appear likely to work as a factor causing a slowdown in household loan demand just as the rises in rates since the second half of last year have in part influenced the slowdown in household lending growth. Inasmuch as additional policy rate hikes by the US Federal Reserve during this year are expected, there is thus a need to pay close attention to the extent of influence they have on Korean long-term market interest rates and lending rates later on.⁴⁷⁾

The final factor likely to influence household lending growth is the real estate economy. During the January to February period of this year the pace of housing price increase slowed and transactions also declined. But the extent of increase in apartment prices was expanding again entering March, and the transaction volume also appears likely to grow as the Spring moving season arrives, led by Seoul and its surrounding areas. In line with this there is a potential for the pace of increase in financial sector household lending to accelerate again as well.

Moving ahead it is expected the pace of growth in household lending will slow compared to last year under the effects of the government's household loan-related policies and of the increases in lending interest rates.

But if the housing market improves after the Spring moving season, there is a possibility that the extent of slowdown in the pace of household lending growth will not be great.

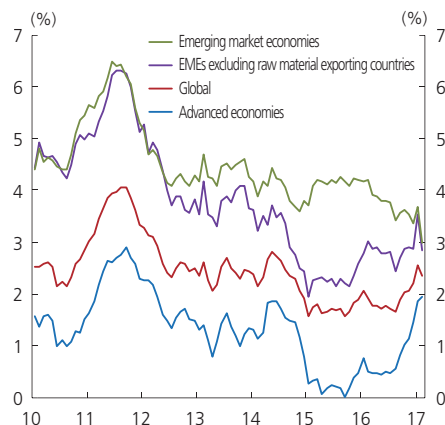
47) There is also an opinion that the upward pressures on Korean long-term market interest rates from the fundamentals and the monetary policy sides can be limited, even despite the rising global market interest rates following the policy rate hikes by the US Federal Reserve.

C. Global Inflation Conditions

The upward trend in global inflation will put upward pressures on domestic prices, but it is judged unlikely that domestic inflation will accelerate greatly due to this. However, given the point for example that the effects of global inflation on domestic prices have grown stronger than they were in the past, it is necessary to continue to check for any changes in global inflation and their effects.

The rates of inflation in major advanced countries, which had remained low since 2015, have recently shown levels of around 2%, and in line with this we have examined whether there will be any changes in the situation concerning the global low inflation that has persisted for a long time, as well as the future effects that inflation in advanced countries will have on domestic prices.

<Figure III-13> Global inflation rates¹⁾²⁾³⁾



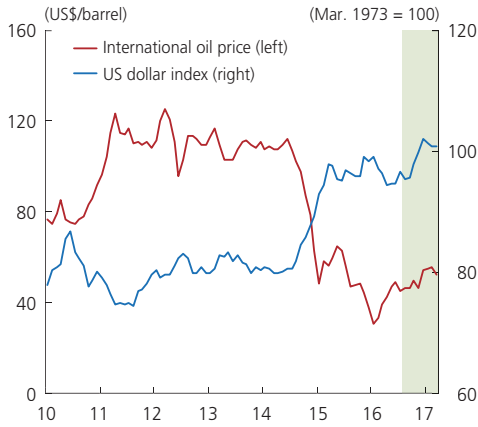
Notes: 1) Consumer price inflation compared with same months of previous years.
 2) Based on weighted averages of the GDPs of 33 major countries (13 advanced economies, and 20 EMEs).
 3) Raw material exporting countries are Brazil, Russia, Indonesia and Chile.
 Sources: IMF, individual countries' published statistics.

It appears that the recent acceleration in global inflation is being driven by supply-side factors.⁴⁸⁾ The international prices of oil and other raw materials, which had until recently put downward pressures on global inflation from the supply side, have been rising since October 2016 to thus exert upward pressures on inflation. Together with this, the trend of a strengthening US dollar since the second half of last year⁴⁹⁾ has also contributed to pushing import prices up additionally in countries other than the US.

48) If we look at the rates of changes in prices in the fourth quarter of 2016 compared to the fourth quarter of 2015, in a group of 15 advanced countries and 20 EMEs, we find that consumer price inflation rates increased in 24 of these countries by an average of 1.1% point. Core inflation on the other hand rose in 19 countries by an average of a mere 0.4% point. These facts also suggest that the recent acceleration in consumer price inflation has been a result largely of supply-side pressures such as oil prices, more than of underlying demand-side pressures.

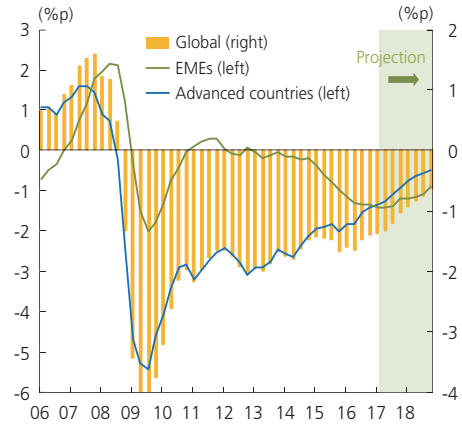
49) As the international oil price and the US dollar are normally in a relationship of being substitute investments (between January 2000 and June 2016 the coefficient of correlation between the two variables was -0.81), they have shown mutually contradictory movements. Since the second half of last year the dollar and the oil price have both strengthened, however, owing to expectations of expansionary fiscal policies by the new US government and of policy rate hikes by the US Federal Reserve.

<Figure III-14> International oil price⁵⁰⁾ and US dollar index



Note: 1) Brent Crude basis.
Sources: The Bank of Korea, Bloomberg.

<Figure III-15> Output gaps of advanced and emerging market economies and outlooks⁵¹⁾



Note: 1) Based on weighted averages of GDPs of 30 countries for which data are available (14 advanced countries, and 16 EMEs).
Sources: Oxford Economics, Bank of Korea estimates.

Looking at the changes in inflation pressures on the demand side, the downward pressures from global inflation are easing as the output gap, indicative of idle production capacity, is narrowing, especially in advanced countries. The extents of negativity of output gaps in EMEs have widened somewhat, as economic activities in natural resource-exporting countries have shown slumps until now. The negative output gaps of advanced economies have however been narrowing modestly since 2013.

It is expected that global inflation will continue its gradual pace of increase in the future as well. According to the forecasts for example of overseas institutions and investment banks, the international oil price appears likely to maintain the mid-50 dollars-to-the-barrel level this year⁵⁰⁾, and it is expected that the US dollar will also show a strengthening trend compared to 2016.⁵¹⁾ On the demand side also, moreover, amid a continuing modest downward trend in idle production capacity in advanced countries it is forecast that slack production capacities in EMEs will also lessen, in line for example with the improvements in economic activities in natural resource-exporters.⁵²⁾ However, it is judged that the likelihood of a substantial rise in global inflation is

50) Major forecasting institutes such as Cambridge Energy Research Associates (CERA), Oxford Economic Forecasting (OEF) and the US Energy Information Administration (EIA) have predicted that during 2017 the international oil price (Brent Oil basis) will maintain a level of between 52 to 58 dollars to the barrel (March 2017 basis), while major investment banks' forecast figures (March 2017, median value basis) have also formed at the mid-50 dollar level.

51) During March and April of 2017 major investment banks forecast that the Japanese yen/US dollar exchange rate would rise from its 2016 average of 108.8 to an average of 114.9 for 2017, and that the euro/US dollar and the pound/US dollar rates would increase from 0.90 to 0.94 and from 0.74 to 0.81 respectively over the same period.

52) According to the World Bank's 「Global Economic Prospect」 (January 2017), it is expected that the rate of growth in natural resource-exporting EMEs will rise from 0.3% in 2016 to 2.3% and 3.0% in 2017 and 2018 respectively, owing to the increases in raw materials prices.

not high⁵³⁾, given the forecast that additional rises in international oil prices will be limited⁵⁴⁾ as well as the gradual paces of decrease in idle production capacity in major countries.

Meanwhile, it is forecast that the upward trend in global inflation will work in part to put upward pressures on domestic prices as well. Analysis of the determinants of inflation, including global factors, suggests that the influence of global inflation on domestic prices has strengthened since the global financial crisis. The coefficients of reaction of domestic prices to the global output gap and international raw materials prices have climbed significantly since 2010, while their coefficient of reaction to the domestic output gap has fallen somewhat. This appears to be related also to the strengthening concordance between global inflation and domestic prices⁵⁵⁾, owing for example to the increase in Korea's degree of trade openness, to the expansion in global value chains, etc.

<Table III-10> Estimation results of inflation determinant factor¹⁾

Dependent variable: Consumer prices	2000-2007	2010-2016
Consumer prices in previous period	0.69***	0.48***
Domestic output gap ²⁾	0.35***	0.18**
Global output gap ²⁾	-0.06	0.15*
International prices of raw materials ³⁾	0.01***	0.03***
KRW/USD	0.04***	0.02**
Constant	0.75***	1.38***

Notes: 1) *, ** and *** indicate statistical significances at the 10%, 5% and 1% levels respectively.

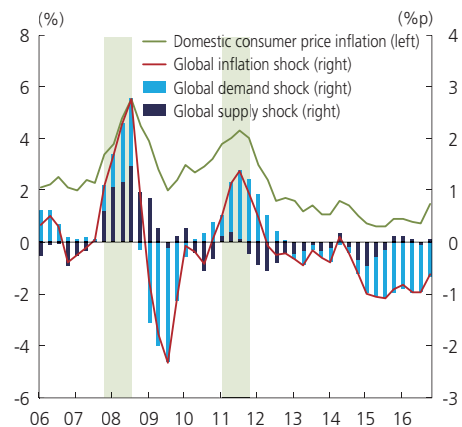
2) 4-quarter moving averages.

3) Rates of change in IMF Primary Commodity Price Index (compared with same periods of previous years).

Source: Bank of Korea estimates.

However, as idle production capacity in Korea is still exerting downward pressures on prices, there is judged to be a limited possibility of global inflation pressures driven by supply-side factors causing the higher level of domestic inflation to become a long-run trend. A look at past cases shows that, during the times when domestic prices rose substantially along with global inflation, global supply-side and demand-side factors were both working as upward pressures. And if we analyze the magnitude and duration of the effects on domestic prices due to global demand and supply shocks, it is estimated that while the short-term effects of a supply shock are greater than those of a demand shock, their duration is not as long.

<Figure III-16> Decomposition of global inflation shocks¹⁾



Note: 1) Used structural VAR with sign restrictions to separate global inflation shocks into demand shocks and supply shocks.

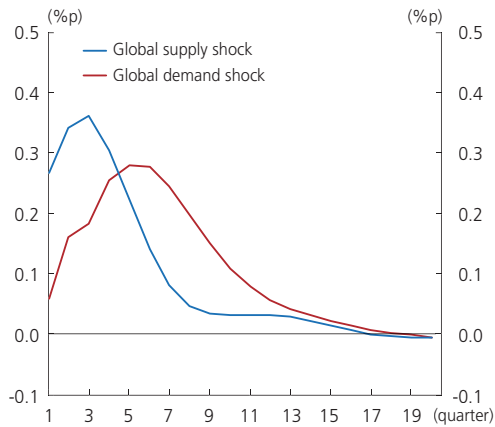
Source: Bank of Korea estimates.

53) The IMF 「World Economic Outlook」 (April 2017) forecasts inflation (CPI inflation basis) in advanced countries for 2017 to record 2.0%, and that in EMEs 4.7%.

54) As the cost of shale oil production is at the 40 dollars per barrel level (based on IMF estimates), its supply can expand if international oil prices rise additionally, and it is forecast that the US Trump administration's energy development policy will also work as a factor causing a shale oil production increase.

55) The coefficient of correlation between the global and the domestic inflation rates has risen greatly, from 0.29 between 2000 and 2007 to 0.88 between 2010 and 2016.

<Figure III-17> Domestic price responses to global inflation shocks, by shock type¹⁾²⁾



Notes: 1) Used a VAR model comprising five variables - consumer price inflation, domestic output gap, global output gap, international oil price, and KRW/USD exchange rate.

2) Responses to shocks from one standard deviation increases.

Source: Bank of Korea estimates.

To summarize the findings of the discussion above, it is forecast that global inflation, which has been showing an upward trend due to the recent reversal to upward pressures from the supply side as well as to reduced downward pressures from demand-side factors, will continue its modest upward trend going forward in line with the movements of international raw materials prices and of economic activities in individual countries.

It is judged that these global inflation movements will put upward pressures on domestic prices, but that the likelihood of domestic inflation accelerating greatly due to them is not high. This is because, if we compare the present situation with those in the past, the extent of the expansion in global inflation pressures is not large, and the downward pressures on the domestic

demand side are in part offsetting the upward pressures from global factors.

However, considering the points that the influence of global inflation on domestic prices has grown and that in the short term supply shocks have larger effects on domestic prices than do demand shocks, the possibility of domestic prices rising more rapidly if the upward pressures from global inflation increase cannot be ruled out. It is in consequence necessary to examine changes in global inflation conditions on the supply side such as international oil prices, together with those on the demand side such as economic conditions in major economies and monitor the impacts that they have on domestic prices.

5. Future Monetary Policy Operational Directions

Base Rate Operation

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 also devoting attention to financial stability.

The Bank of Korea plans to maintain its accommodative monetary policy stance, since the inflation pressures from the demand side are not expected to be significant for now given the moderate economic growth. In this process the Bank will closely examine developments related to domestic and external risk factors, along with any resulting changes in financial and economic conditions and analyze in depth their effects on the future paths of growth and inflation. Besides consumer price inflation, the Bank will also closely watch the movements of indicators including core inflation, expected inflation, international oil price trends, various auxiliary price indices, the GDP gap and idle production capacities in employment and in the manufacturing sector.

In view of the fact that the domestic and external uncertainties surrounding the Korean economy recently are higher than ever before, efforts will also be made to ensure that financial market stability is firmly maintained. The Bank will strengthen its

examinations related to potential risk factors that could heighten financial market volatilities at home and abroad, such as Korea's trading conditions vis-à-vis major countries, geopolitical risks, the trends of monetary policy normalization by the US Federal Reserve, developments related to the new US government's policies, etc. while closely monitoring capital in- and outflows as well. And since it also remains uncertain whether the slowdown in the pace of increase in household debt has become a long-term trend, the Bank will thoroughly monitor household debt to ensure that it does not hinder financial stability.

Heighten Transparency and Predictability of Monetary Policy

The Bank will strengthen its policy communication to ensure the greater transparency and predictability of its monetary policy. Efforts will be continued to improve the methods of description and the contents of the monetary policy statement, in ways that maintain consistency with the 「General Principles of Monetary Policy Operation」 announced at the end of 2016 and heighten the statement's coherence with the Bank's economic forecasts. Moreover, while faithfully disclosing the contents of its monetary policy-setting meetings, through its 「Monetary Policy Report」 and press releases for example, the Bank also plans to continue revitalizing its communication with the financial markets, academia, the media, and so on.

Promote Financial and Foreign Exchange Market Stability

The Bank of Korea will prepare thoroughly for the possibility of expanding volatility in the financial and foreign exchange markets owing to destabilizing factors domestically or abroad. In particular, it will closely examine the uncertainties related to the speed of policy rate hikes by the US Federal Reserve and to its reduction in its asset holdings, as well as their effects. In any case where price variable volatility expands excessively, owing for example to capital outflows, the Bank will also implement in a timely fashion measures for market stabilization. Moreover, it plans to continue revising and supplementing its scenario-based contingency plan prepared for cases of market unrest, in accordance with changes in domestic and overseas conditions.

Strengthen Financial System Stability

The Bank of Korea will prepare thoroughly to ensure that the stability of the Korean financial system is not impeded, through for example regularly checking for vulnerabilities and preemptively identifying potential risks in the financial system, and devising directions for responding. In particular, through its 「Financial Stability Meetings」, held on four occasions each year, it plans to conduct in-depth analyses of financial stability conditions in the various individual sectors including the credit markets, the asset markets, financial institutions, etc., and to examine financial system resilience. Meanwhile, given the upward pressures on market interest rates due to the monetary

policy normalization by the US Federal Reserve, which can aggravate household debt repayment burdens especially among the vulnerable groups, the Bank will closely examine the effects that the rate hikes have on these groups, and if necessary seek directions for responding in consultation with the government and the supervisory authorities.

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Monetary Policy Report

Publisher Lee, Juyeol

Editor Park, Jong Seok

Published by The Bank of Korea

39, Namdaemunno, Jung-Gu, Seoul, 100-794, Korea

www.bok.or.kr/eng

Published on June 16, 2017

Printed by Jeil Printech Co., Ltd.

- This material is posted on the web-site of the Bank of Korea
(<http://www.bok.or.kr/eng> > Monetary Policy > Monetary Policy Reports)
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- This book is available at the price of 8,100 won at the book/souvenir shop (+82-2-759-4805)
in the Bank of Korea Money Museum

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ISSN 2005-2707

