Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions in Korea and abroad between October 2017 and January 2018 finds the following. Global economic growth showed signs of picking up. The high rates of growth in the United States and the euro area continued driven by domestic demand on the back of solid employment conditions for example. Japan sustained its improvement, mainly based on exports and facilities investment, while China maintained its stable trend of growth.

Economic growth in major economies[1]

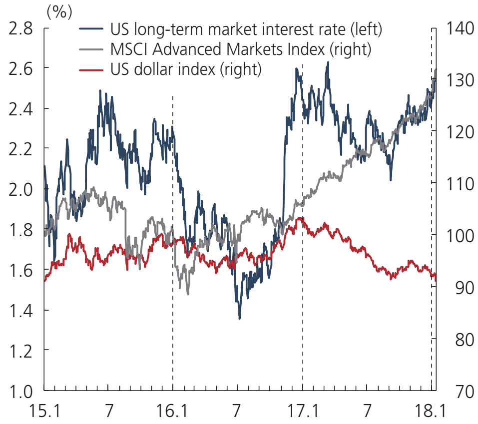
(%)

	2014	2015	2016		2017		
			Year	Q4	Q1	Q2	Q3
US	2.6	2.9	1.5	1.8	1.2	3.1	3.2
Euro area	1.3	2.1	1.8	2.6	2.5	2.8	2.4
Japan	0.4	1.4	0.9	1.4	1.5	2.9	2.5
China	7.3	6.9	6.7	6.8	6.9	6.9	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 rose due to their economies' continued steady growth, to increased expectations of monetary policy normalization, and so on. Stock prices sustained high rates of increase, especially in advanced countries, due to the accelerating growth in major countries, to increases in corporate earnings, etc. The US dollar fluctuated amid the co-existence of factors causing it to strengthen and those making it weaker.

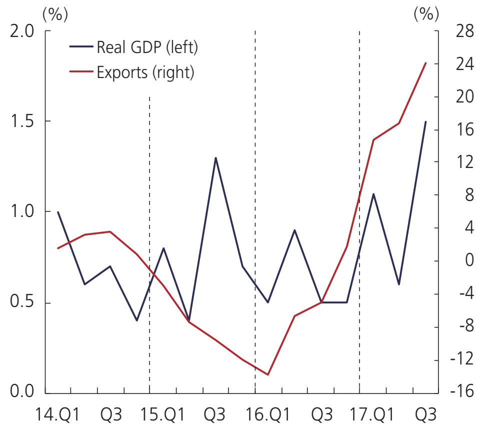
US long-term market interest rate[1], stock prices[2] in advanced countries and US dollar index[3]



Notes: 1) Treasury bond (10-year) yields.
2) January 1, 2014=100
3) The measure of the value of the US dollar relative to a basket of foreign currencies (EUR, JPY, GBP, CAD, SEK, CHF); March 1973=100.
Source: Bloomberg.

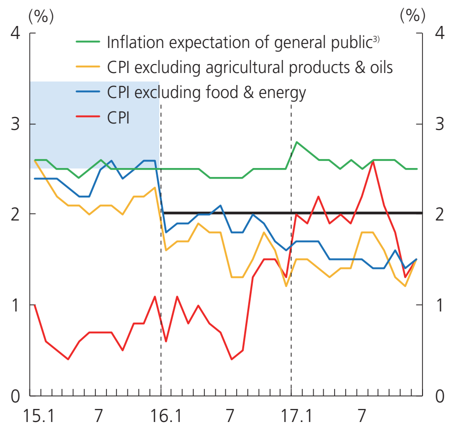
2 The domestic economy continued to improve, in line with the buoyancy of exports and facilities investment. During the third quarter of last year it recorded a quarter-on-quarter growth rate of 1.5%, as the pace of increase in exports picked up and facilities investment also maintained a favorable level. Although the rate of growth slowed slightly in the fourth quarter on the base effect of the high growth in the third quarter and on irregular factors such as the long Korean Thanksgiving holidays, it was still higher than it was in the fourth quarter of 2016.

Major economic growth indicators[1)]



Notes: 1) Rates of growth quarter-on-quarter for real GDP; year-on-year for exports (customs clearance basis).
Sources: The Bank of Korea, Korea Customs Service.

CPI inflation[1)2)]



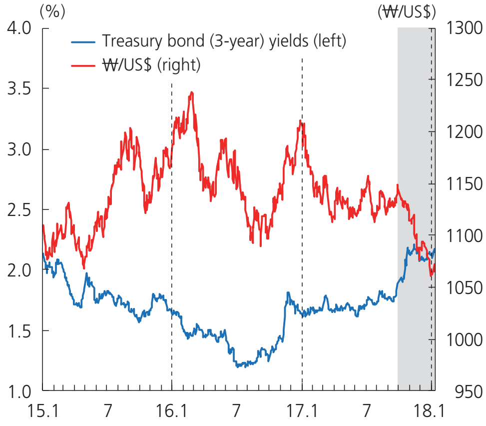
Notes: 1) Compared with the same periods of the previous years.
2) The shaded area indicates the medium-term inflation target range during the 2013~2015 period, and the bold line the medium-term inflation target set for 2016 onwards.
3) Expectations for the CPI inflation rate one year in the future.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

3 Domestic consumer price inflation fell considerably on the effects for example of declines in agricultural product prices and cuts in city gas fees, and recorded a rate in the mid-1% range during the fourth quarter of last year. The inflation expectations of the general public were in the mid-2% range, and core inflation, indicating the underlying price movements, maintained the mid-1% level.

The growth of housing sales prices slowed after the government's announcement of its real estate and household debt measures. However, the upward trends in prices differed by region, as prices in Seoul and its surrounding areas sustained high rates of increase while the paces of increase in other areas slowed. Leasehold deposit prices continued to show stability in general.

4 In the domestic financial markets, long-term market interest rates rose considerably in October in line with the increased likelihood of a hike in the Bank of Korea Base Rate in 2017. The sharp upward trend then eased from late October, owing to the government's and the Bank of Korea's adjustments of their volumes of bond issuance, and to the expectation after the end-November Base Rate hike that any additional adjustment of the accommodative monetary policy would be executed in a gradual manner. The Korean won/US dollar exchange rate fell rapidly from October, on the easing of the North Korea risk, the upward adjustment of the forecast for domestic economic growth, etc. Meanwhile, foreigners' domestic portfolio investment reversed to net sales from November, affected by sluggishness in reinvestment in bonds reaching maturity, by sales of stocks for profit-taking, etc., before then expanding once more entering this year, driven mainly by investment in stocks.

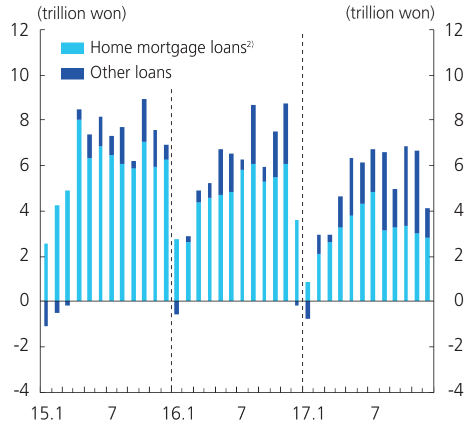
Korean Treasury bond yield and exchange rate (KRW/USD)



Sources: The Bank of Korea, KOFIA.

5 During the fourth quarter household lending increased by an extent similar to that in the previous quarter. At banks the extent of growth in their home mortgage loans lessened under the influence of the government's 8.2 Measures, while growth in their other loans picked up in line for example with the expanded operations of Internet-only banks. Meanwhile, non-bank financial institution household loans also increased by an amount similar to that in the third quarter.

Changes in banks' household loans[1)]

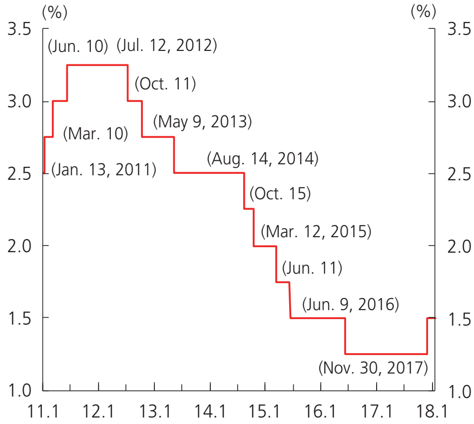


Notes: 1) Compared with the previous months.
2) Including mortgage transfers.
Source: The Bank of Korea.

[Conduct of Monetary Policy]

6 During the November 2017 to January 2018 period the Bank of Korea conducted its monetary policy in an accommodative manner to ensure that the recovery of economic growth continues and that consumer price inflation can be stabilized at the target level over a medium-term horizon, while slightly reducing the degree of its accommodativeness. In the process it devoted attention to financial stability as well, and closely monitored changes in the monetary policies of major countries' central banks, conditions related to Korea's trade with major countries, the upward trend of household debt, geopolitical risks, etc.

Bank of Korea Base Rate[1]



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

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

In November 2017 the Bank of Korea raised the Base Rate, which it had maintained at 1.25% per annum since June 2016, by 0.25% points to an annual rate of 1.50%. This decision was made because the Bank judged that, as the domestic economy was sustaining its steady pace of growth at its potential level and consumer price inflation was also expected to gradually approach the target level, there was a need to adjust the level of monetary policy accommodation that had been expanded in response to the low growth and inflation until that time. It was judged first of all that the domestic economy had continued its sound growth, as consumption was improving moderately and investment also showing favorable movements amid an ongoing high rate of increase in exports. Moreover, the Bank saw domestic demand-related activities such as consumption and facilities investment as likely to continue to improve modestly going forward as well, and exports to also sustain their buoyancy due to a pick-up in the global economic recovery and an improvement in trading conditions vis-à-vis China, etc. In line with this it was expected that future growth would be above the path forecast in October, and that the pace of growth at around its potential level would continue. Consumer price inflation had slowed slightly, to the upper 1% level, owing for example to a decline in the extent of increase in the prices of agriculture, livestock and marine products and to the subsiding of the base effect of the cuts in electricity fees the year before. But it was forecast to gradually approach the target level as the economy recovered. Core inflation was seen as likely to continue at a level in the mid-1% range for some time, before then rising moderately from 2018. The pace of increase in household lending had slowed somewhat, but the level of household loans was still higher than in normal years. Under these circumstances it was judged that the risk of a build-up of financial imbalances could grow even more if the degree of monetary policy accommodation were not adjusted appropriately in accord with the economic recovery.

In the January 2018 Monetary Policy Board meeting the Base Rate was maintained at 1.50% per annum. This decision was made in comprehensive consideration of the following points. It was deemed necessary to monitor the developments and influences of the domestic and external uncertainties that still remained even though the domestic economy was expected to continue its solid growth, the upward demand-side pressures on prices were forecast to be not large for some time, and the need to observe a little further the effects on the economy and the financial markets of the Base Rate hike in November last year. With regard to the domestic economy it was judged that investment, which had shown a high rate of increase to that time, would slow, but that the solid growth would continue as consumption would steadily increase and the buoyancy of exports would also continue. In line with this it was expected that the domestic economy would show a pace of growth at the 3% level during this year as well. The rate of consumer price inflation had fallen to the mid-1% range, on the effects for example of a reduction in city gas fees, and was forecast to show the low to mid-1% level for the time being before gradually rising from the second half. The core inflation rate, indicative of the underlying price movements, was seen as likely to rise moderately. The extent of household lending growth had been lessening recently, but the total volume of household debt was already high and the pace of its increase was also still more rapid than the rate of income growth. It was thus judged, from the financial stability perspective, that a close observation of household debt was necessary.

8 The Bank of Korea continued its efforts for financial and foreign exchange market stability in response to changes in conditions at home and abroad. When North Korea launched an intercontinental ballistic missile last November, and when the US Federal Reserve raised its policy rate in December, the Bank convened meetings of its 「Monetary and Financial Task Force」 and examined these events 'effects on in- and outflows of foreign investors' funds and on the financial and foreign exchange markets, while strengthening its communication by for example making clear its determination to keep the markets stable, so as to ensure that market anxieties did not spread excessively. When bond investment sentiment contracted in October as market rates rose greatly on the heightened likelihood of a Base Rate hike within the year, the Bank flexibly adjusted the volume of its Monetary Stabilization Bond issuance to ensure that market interest rate volatility did not expand.

The Bank also devoted steady efforts to the preemptive identification of potential risk factors within the financial system, and to the presentation of early warnings. In the December issue of its 「Financial Stability Report」 it thoroughly assessed the financial system's vulnerabilities by sector, and examined the system's resilience to any shocks at home or abroad as well as the Korean economy's external payment capacities. To respond to the possibility of financial stability weakening due to the build-up in household debt, the Bank strengthened its monitoring of household debt through for example meetings of its 「Household Debt Task Force」, while also attending the meetings of the 「Consultative Group for Managing Household Debt」 and the 「Macroeconomic Finance Meeting」, where it shared its perspectives on the household debt problem with the government and the supervisory authorities, and contributed to the drawing up of the government's household debt measures.

[Future Monetary Policy Directions]

9 According to the Bank of Korea's 「Economic Outlook Report」 released on January 18, the domestic economy is foreseen showing a growth rate at the 3% level during this year. Although investment is expected to slow, consumption should continue to increase steadily owing to improvements in household income conditions for example, and exports are expected to sustain their favorable conditions as well thanks to the robustness of the global economy. As exports and consumption also continue to increase next year, it is forecast that growth at the level of the potential growth rate will continue. Concerning the future path of growth, there is a mix of upside and downside risks. The former include accelerating growth in exports and facilities investment in line with a strengthening of the global economic recovery, a pick-up in the pace of export growth due to a more rapid improvement in trading conditions vis-à-vis China, and strengthening economic sentiments stemming for example from the government's implementation of economic stimulus measures and from the easing of North Korea-related risks. Among the downside risks, meanwhile, are a worsening of the trading environment due to the spread of protectionism, a deterioration in financial conditions in consequence of the monetary policy normalizations in major countries, and a weakening recovery of domestic demand due to an inadequate improvement in employment conditions.

Economic growth outlook[1]

(%)

	2017			2018e			2019e
	Year e	1st half	2nd half e	Year	1st half	2nd half	
GDP	3.1	2.8	3.4	3.0	3.2	2.8	2.9
Private consumption	2.5	2.1	2.8	2.7	2.9	2.5	2.7
Facilities investment	14.3	15.9	12.8	2.5	2.1	2.9	2.3
Construction investment	7.2	9.4	5.4	-0.2	-0.5	0.0	-2.0
Goods exports	3.6	4.2	3.0	3.6	3.0	4.2	3.5
Goods imports	7.3	9.3	5.3	3.2	2.2	4.1	3.1

Note: 1) Compared with the same periods of the previous years; the figures for 2018 and 2019 are forecast as of January 2018.
Source: The Bank of Korea.

It is forecast that consumer prices will rise by 1.7% this year, and that their pace of increase will quicken next year. The upside and downside risks to the future path of inflation are mixed, and the uncertainties about the price outlook have risen significantly due to the recent sharp movements of international oil prices and the won/dollar exchange rate, to the large hike in the minimum wage, and so on. Among the major upside risks to the path of inflation going forward are those of a strengthening of the domestic economy's recovery in line with the global economic improvements, and of an accelerated pace of increase in service charges due to the hike in the minimum wage. The potential downside risks include a weakening of international oil prices owing to a rise in US shale oil production, and a drop in import prices due to the appreciation of the Korean won.

Inflation outlook[1]

(%)

		2017			2018e			2019e
		Year	1st half	2nd half	Year	1st half	2nd half	
CPI inflation		1.9	2.0	1.9	1.7	1.5	1.8	2.0
Core Inflation	CPI excluding food & energy	1.5	1.6	1.5	1.8	1.6	1.9	2.0
	CPI excluding agricultural products & oils	1.5	1.4	1.5	1.7	1.5	1.9	1.9

Note: 1) Compared with the same periods of the previous years; the figures for 2018 and 2019 are forecast as of January 2018.
Source: The Bank of Korea, Statistics Korea.

10 Among the major items that will have to be considered in the operation of monetary policy, we have examined the distinct features of the past periods of economic recovery, the employment conditions, the underlying price movements, and financial stability.

Based on a comparison of the distinct features of the past economic recoveries in Korea with the current financial and economic conditions, it is judged that the Korean economy is likely to continue to grow steadily at its potential growth rate level going forward. This is because exports and investment are recently increasing at paces similar to those in the past as domestic economic activities have picked up together with global economic activities, while it is expected that major countries will raise their policy rates at moderate paces and implement expansionary fiscal policies unlike during the past recoveries. However, there does appear to be a possibility of the pace of the consumption recovery being relatively slow in comparison with the past, owing for example to increased burdens of principal and interest repayments on household debt.

Despite the positive employment conditions including the improvements in the domestic economy and the job-creating measures undertaken by the government, the speed of the recovery in employment has been somewhat unsatisfactory. This appears to have resulted from an interplay of factors such as sluggish growth in the service industries with high elasticities of employment and in some of the labor-intensive manufacturing industries, the lack of room for additional job creation due to the market saturation by small-scale businesses, and mismatches between supply and demand in the labor market. It seems likely that employment will pick up in the future, thanks to an increase in foreign tourists, to improved service industry conditions due to the government's policies to expand household incomes, and to the government's job creation measures. In line with this it is forecast that the number of employees will gradually rise, led mainly by the service industries, the health and welfare sector and the public administration sector. Going forward as well there is a need to thoroughly examine the improvements in the service industries, developments in terms of the government's measures on job creation, etc., and how they are affecting employment.

Various core inflation indicators, indicative of the underlying price movements, continue to be slightly under 2% (with regulated prices excluded). In this situation it is forecast that the upward price pressures due to the higher oil price level, the continuous improvements in the domestic and international economies, etc. could cause the upward pressures on underlying prices to grow in the future. It is forecast that going forward consumer prices will show a somewhat low pace of increase for the time being, owing to the base effects of the supply-side price increases at the beginning of last year, but then gradually rise moving into the second half. It appears likely, however, that the possibility of a weakening relationship between the economic cycle and prices could restrain the upward price trend. Considering that the uncertainties about the future path of inflation have grown to a considerable extent recently, owing for example to the sharp movements of oil prices and the won/dollar exchange rate, there is a need for close monitoring of the effects that these factors have on prices.

It is assessed that Korea's financial system is in general maintaining its stability, as capacities for absorption of domestic and external shocks have been heightened. But concerns remain about the accumulation of financial imbalances, such as the increased ratio of household debt relative to income, after the prolonged period of accommodative monetary policy. Going forward as well, therefore, the Bank of Korea will have to carefully examine the financial stability situation subsequent to any changes in conditions. While doing so it should also continue to operate its monetary policy prudently, with a focus on the possibility of its prolonged accommodative policy stance causing the financial imbalances to deepen, and on the effects on growth and inflation that this build-up in imbalances may have in the medium to long term.

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 domestic economy is expected to sustain its solid growth, but as it is forecast that the demand-side price inflationary pressures will not be large the Bank plans to maintain its accommodative monetary policy stance for the time being. In this process, as it closely examines the effects of its Base Rate hike in November of last year and any changes in conditions at home and abroad, as well as the resulting changes in growth and prices, it will carefully judge whether an additional adjustment in the degree of accommodation is called for. Besides consumer price inflation the Bank will also closely examine core inflation, inflation expectations, international oil prices, global inflation, various auxiliary price indices, the GDP gap, and the spare capacities in employment and in the manufacturing sector.

In addition, given the still high uncertainties about the domestic and external conditions surrounding the Korean economy, the Bank will in operating its monetary policy also devote care to the risks on the financial stability side. It will strengthen its examinations of developments in domestic and external conditions that can cause financial market volatility to rise, such as the paces of monetary policy normalization in major countries including the US, along with geopolitical risks, and closely monitor the in- and outflows of foreign capital. Together with this the Bank will also pay attention to the possibility of its prolonged accommodative policy stance causing the build-up in household debt and other financial imbalances to deepen, and the effects on growth and inflation that this build-up of imbalances will have in the medium to long term going forward.