Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions in Korea and abroad between February and May 2021 finds the following. The trend of recovery in the global economy accelerated, as vaccination expanded and the restrictions on economic activity were relaxed, particularly in major advanced economies. The US economy showed rapid recovery, backed by large-scale stimulus measures and the reopening of economic activity following the expansion of COVID-19 vaccinations. The euro area gradually emerged from its challenging economic situation last winter, thanks to the lifting of lockdowns following expanded vaccine rollouts. The Chinese economy sustained its trend of solid growth as domestic demand recovered in the midst of buoyant exports. Meanwhile, the trend of improvement in the Japanese economy showed signs of weakening due mainly to strengthened preventative measures in line with the resurgence of COVID-19.

Economic growth in major economies[1)]

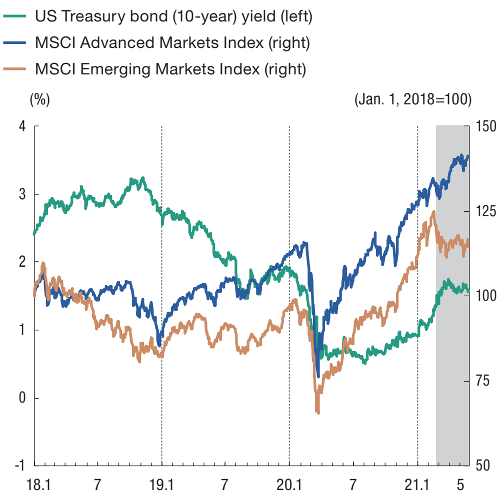
(%)

	2018	2019	2020					2021
	Year	Year	Year	Q1	Q2	Q3	Q4	Q1
US	3.0	2.2	-3.5	-1.3	-9.0	7.5	1.1	1.6
Euro area	1.9	1.3	-6.6	-3.8	-11.6	12.5	-0.7	-0.6
Japan	0.6	0.0	-4.7	-0.5	-8.1	5.3	2.8	-1.3
China	6.7	6.0	2.3	-6.8	3.2	4.9	6.5	18.3

Note: 1) The quarterly rates of growth are quarter-on-quarter (seasonally adjusted) for the US, Japan and the euro area, and year-on-year for China.
Sources: Individual countries' published statistics.

The international financial market generally remained stable. Expectations for the continuation of an accommodative monetary policy stance and announcements of large-scale stimulus measures in the United States, and expansion of the COVID-19 vaccine rollouts in major advanced economies, worked to lift investor sentiment, although the resurgence of COVID-19 in India and some other countries and concerns about inflation in the United States acted to weaken investor sentiment. The US Treasury yield increased by a large extent on expectations for strengthened economic recovery from additional stimulus and on concerns over inflation, and then retraced the rise following expectations of the US Federal Reserve's continued monetary accommodation and some weak economic indicators. Stock prices in advanced economies rose significantly on expanded vaccinations and the United States' announcements of large-scale stimulus measures, and then the upward trend slowed entering May, owing primarily to the reemergence of concerns over inflation and the perception that stock prices were overvalued. Stock prices in emerging market economies fell, due to weaker investor sentiment following rises in US long-term interest rates, and to concerns about a delay in the resumption of economic activity stemming from the resurgence of the pandemic in some countries. The US dollar strengthened relative to major currencies in March, and then weakened after April.

US long-term interest rate, share price indices of advanced and emerging markets



Source: Bloomberg.

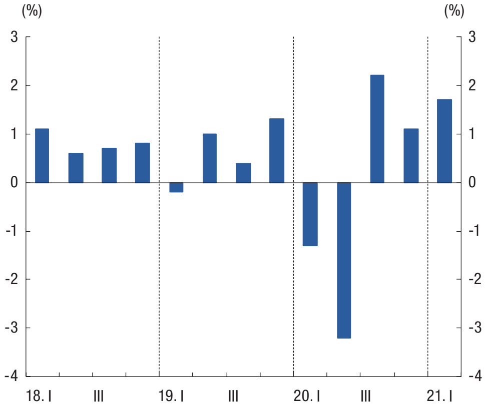
2 The trend of recovery in the Korean economy strengthened. Exports sustained their buoyancy and facilities investment continued to recover robustly, supported by the global economic recovery and improvement in the IT industry. Private consumption gradually emerged from its slump on the recovery in consumer sentiment. Accordingly, real GDP in the first quarter increased by 1.7% compared to the previous quarter.

By sector, private consumption in the first quarter emerged from its slump, led mainly by increased consumption in durable goods and face-to-face service, boosted by the relaxation of social distancing measures and improvement in consumer sentiment. Retail sales increased in April, as sales of semi-durables including clothes and non-durable goods such as cosmetics grew considerably in the preceding month, boosted by the continuation of the relaxed social distancing measures, and as sales of durables including computers and telecommunications equipment also increased. Government consumption rose in the first quarter, due to increased spending on goods stemming from purchases of quarantine goods and vaccines to deal with the pandemic, despite sluggish expenditure on national health insurance reimbursement.

Facilities investment picked up in the first quarter, as investment in machinery sustained high growth, led by special industrial machinery including semiconductor manufacturing equipment, and investment in transport equipment also increased. These ongoing movements led to an increase in the facilities investment index in April. Construction investment saw weak improvement in the first quarter. While building construction, and non-residential building construction in particular, rose, civil engineering fell slightly, affected by worsened weather conditions at the beginning of the year and a delay in supply of construction materials. The value of construction completed decreased in April, as that of civil engineering and of general civil engineering in particular fell, offsetting an increase led mainly by that of construction and of residential building construction.

Exports (FOB basis) grew at a faster pace year-on-year in the first quarter. Exports of IT products, and those of semiconductors and wireless communications devices in particular, remained favorable thanks to strong demand for mobile devices and servers. Exports of non-IT products, led mainly by chemicals and automobiles such as electric vehicles and SUVs, increased significantly, influenced by economic recovery in major economies and rising international oil prices. After April, exports remained strong thanks to expanded growth in exports of non-IT products, such as automobiles, machinery, steel and chemicals.

Real GDP Growth[1)]

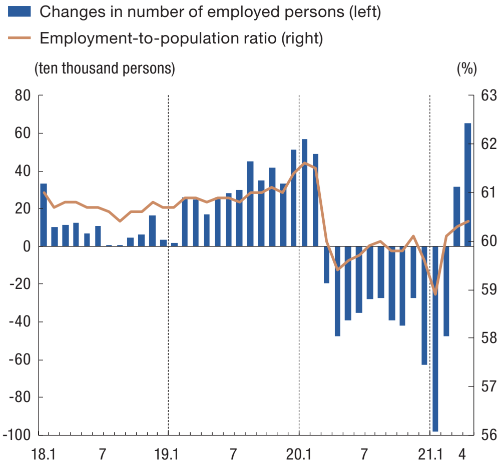


Note: 1) Quarter-on-quarter (seasonally adjusted), reflects preliminary figures.
Source: Bank of Korea

Employment conditions have continued to improve, with increasing trend in the number of persons employed expanding after March. The number of persons employed shifted to an increase year-on-year in March, due to eased social distancing measures and base effects, and grew at a faster pace by 652,000 in April. The (seasonally adjusted) employment-to-population ratio remained on the rise, showing a slight increase.

Nominal wages increased by 4.2% year-on-year in the first quarter of 2021, rising sharply from 2.0% in the fourth quarter of last year.

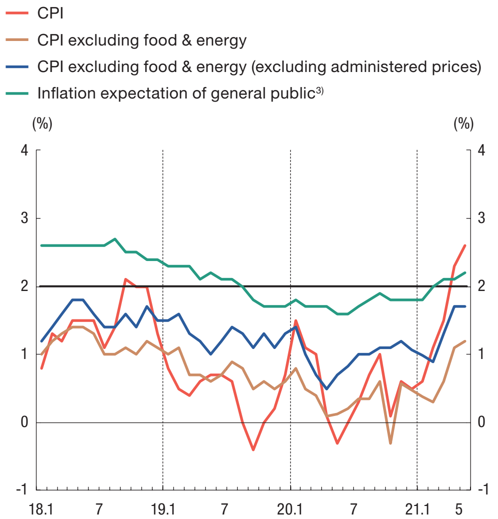
Changes[1)] in number of employed persons and employment-to-population ratio[2)]



Notes: 1) Year-on-year.
2) Seasonally adjusted.
Source: Statistics Korea.

3 Consumer price inflation rose to the 1% level in the first quarter of this year, and then climbed further to run above 2% between April and May. This is mainly due to strong base effects in the second quarter in the midst of greater influences of supply-driven factors, such as worsened weather conditions, the spread of avian influenza, and rising international oil prices. Core inflation (excluding changes in food and energy prices from the CPI) has risen to the lower-1% level in the second quarter of this year after remaining low at the 0% level since March 2019, and core inflation excluding administered prices has gone up to the mid- to upper-1% level. The inflation expectations of the general public have risen to the lower-2% level.

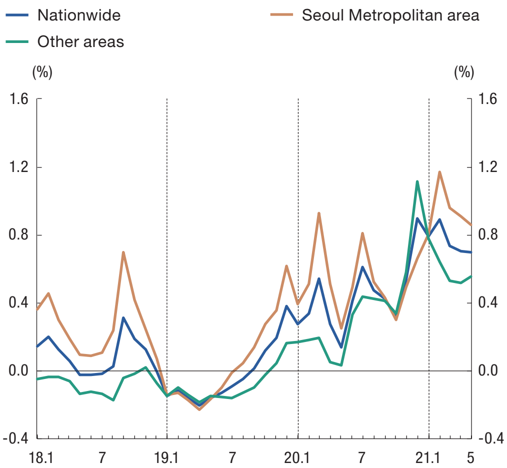
Inflation[1)2)]



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

Housing sales prices showed a slightly decelerated upward trend month-on-month after March, but still continued to increase considerably. Leasehold (*jeonse*) deposit prices rose at a moderately slower pace after the first quarter.

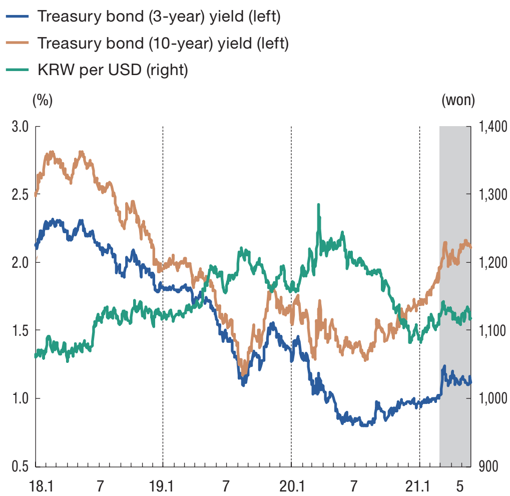
Housing sales price growth rate[1)]



Note: 1) Month-on-month.
Source: Korea Real Estate Board.

4 Korea Treasury bond yields rose significantly on expectations for domestic and global economic recovery, rising US Treasury bond yields, and net selling of Treasury bond futures posted by foreign investors. The 10-year Treasury bond yield, which has continued to rise since the second half of last year, showed an accelerated increase, and the 3-year Treasury bond yield, whose extent of increase had been relatively limited, also rose considerably. However, Treasury bond yields have fluctuated within a limited range after mid-March, in line with changes in US Treasury bond yields, and supply and demand conditions for Treasury bonds. The Korean won/US dollar exchange rate rose following a surge in US Treasury bond yields in early March, and then fell on a decelerated increase in US Treasury bond yields, strong domestic economic indicators, and wider vaccine distribution in major advanced economies. The exchange rate fluctuated in May, influenced by changes in market expectations regarding the continuation of an accommodative policy stance by the US Federal Reserve.

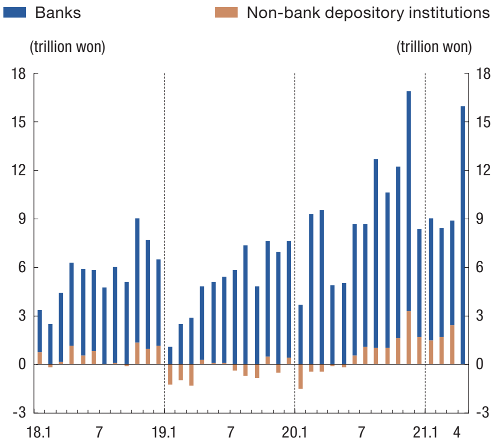
Korea Treasury bond yields and exchange rate (KRW per USD)



Sources: Bank of Korea, Korea Financial Investment Association.

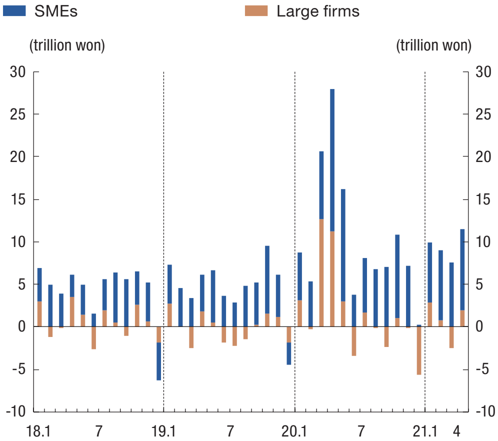
5 Household lending maintained strong growth, led by mortgage loans. However, in April, other lending soared temporarily, due mainly to demand for funds related to subscription deposits for public offerings. Corporate lending remained on the rise, led by lending to small and medium-sized enterprises. Direct funding also increased significantly, influenced by an expansion in bond issuance, and large-scale public offerings and paid-in capital increases by some corporations.

Changes in household loans[1)2)3)]



Notes: 1) Month-on-month.
2) Including mortgage transfers.
3) Figures for April 2021 are based on the Bank of Korea advance estimate for banks and have not been released for non-bank depository institutions.
Source: Bank of Korea.

Changes in corporate loans[1)2)]

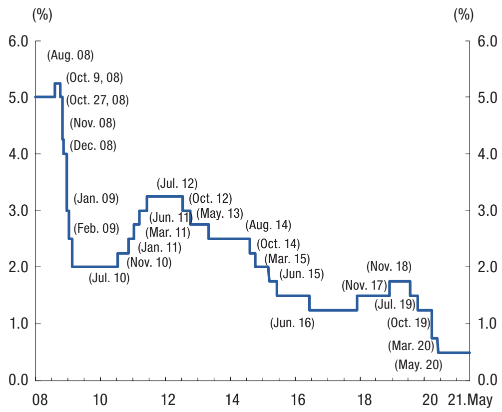


Notes: 1) Month-on-month.
2) Based on banks.
Source: Bank of Korea.

[Conduct of Monetary Policy]

6 The Bank of Korea maintained its accommodative policy stance to support the recovery of growth and to help inflation stabilize at the 2% target over a medium-term horizon, while paying attention to financial stability. In this process, it closely examined risk factors such as the global and domestic development of the COVID-19 pandemic, its financial and economic impacts, and changes in financial stability conditions. Under this policy stance, the Bank of Korea maintained the Base Rate at 0.50%.

Bank of Korea Base Rate[1)]



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

7 A detailed look at the Base Rate decisions during this period, and the backgrounds behind them, are as follows. At the April meeting, the Board left the Base Rate unchanged at 0.50%, judging that it would be necessary to monitor the developments of the pandemic and further examine whether the trend of recovery would continue, although the domestic economy was growing faster than expected, thanks to improvement in global economic conditions. The recovery of the Korean economy strengthened somewhat. Exports sustained their buoyancy and facilities investment continued to recover robustly, while the sluggishness in private consumption eased. It was expected that the domestic economy would sustain this trend of improvement. However, it was judged that high uncertainties still remained, since the pace of the improvement would be heavily dependent upon the evolution of the resurgence of the pandemic and the progress of vaccination. Consumer price inflation rose to the mid-1% level due to an increase in petroleum product prices as well as rising prices of agricultural, livestock, and fisheries products. With respect to financial stability, household loans exhibited a sharp increase, led by housing-related loans, and housing prices continued to increase rapidly in all parts of the country.

At the May meeting, the Board decided to leave the Base Rate unchanged at 0.50%. The Board judged that there was a need to wait and observe the developments of COVID-19 and the progress of vaccination, and the resulting economic recovery, although projections of growth and inflation were revised upward, bolstered by expanded growth in the global economy. Looking at the domestic economy, exports and facilities investment sustained their buoyancy on the strengthened global economic recovery, while private consumption gradually emerged from its slump. Going forward, it was expected that these trends would continue and the recovery would strengthen. Accordingly, GDP growth this year was projected to be the 4% level, significantly above the February forecast of 3.0%. Consumer price inflation rose markedly to the lower-2% level due to the rising prices of petroleum products and agricultural, livestock, and fisheries products as well as the accelerating increase in service prices. In annual terms, consumer price inflation was expected to run at 1.8%, considerably exceeding the February forecast of 1.3%. On the financial stability side, household loan growth remained high, and housing prices continued to increase rapidly in all parts of the country. As a result, the Board saw a growing need to pay attention to the risk of a buildup of financial imbalances.

8 The Bank of Korea is using various policy instruments to promote stability and smooth credit flows in the financial and foreign exchange markets.

The Bank increased the total ceiling on the Bank Intermediated Lending Support Facility on three occasions last year (in March, May, and October 2020) by a total of 18 trillion won, out of which 16 trillion won was allocated to the Support Program for SMEs Affected by COVID-19 and the Support Program for Small Businesses that were operated on a temporary basis (originally set to expire at the end of March 2021). However, as small businesses and SMEs, especially in the face-to-face service industries, continued to have funding difficulties due to the prolonged social distancing measures this year, the Bank extended the operation period of the two programs by six months from March 25, 2021 to the end of September 2021. With such financial support from the Bank of Korea, bank loans amounting to 26.4 trillion won were extended to 117,287 establishments between March 2020 and April 2021 under the Support Program for SMEs Affected by COVID-19. As for the Support Program for Small Businesses, bank loans worth 1.6 trillion won were extended to 13,604 establishments between October 2020 and April 2021, showing steady growth in support loan performance.

Programs under the Bank Intermediated Lending Support Facility

(trillion won, %)

Program	Ceiling	Interest rate
Support Program for Trade Financing	2.5	0.25
Support Program for New Growth Engine Development and Job Creation[1)]	13.0	0.25
Program for Stabilization of SME Lending[2)]	5.5	0.25
Support Program for Regional SMEs	5.9	0.25
Support Program for SMEs Affected by COVID-19	13.0	0.25
Support Program for Small Businesses	3.0	0.25
Total	43.0[3)]	-

Notes: 1) The Support Program for High-tech and Other Start-up SMEs was expanded and reorganized as the Support Program for New Growth Engine Development and Job Creation (September 2017).
2) Includes the support that had been formerly provided under the Support Program for Facilities Investment.
3) Includes reserves of 0.1 trillion won.
Source: Bank of Korea.

In addition, the Bank purchased a total of 11 trillion won worth of Treasury bonds last year for financial market stability. In February this year, the Bank announced (on Feb. 26) another plan to expand outright purchases by a total of 5~7 trillion won during the first half of 2021 to prepare against the possibility of increased volatility in market interest rates, as an increase in Treasury bond issuance is expected with the government's disbursal of the fourth round of emergency relief payments. The Bank purchased 4.5 trillion won worth of Treasury bonds in total on three occasions: on March 9 (2.0 trillion won), April 28 (1.0 trillion won), and June 3 (1.5 trillion won), 2021.

On January 12, 2021, the Bank of Korea provided the second round of lending (1.78 trillion won) to the SPV (established in July 2020) purchasing corporate bonds and commercial paper to support financing of low-rated companies that face difficulties from the COVID-19 pandemic. As of end-April 2021, the SPV has purchased 3.3 trillion won worth of corporate bonds and commercial paper.

In addition, the Bank terminated the liquidity provision measure that expanded the range of eligible collateral for lending facilities on March 31, 2021 as scheduled. It had been implemented on a temporary basis (from April 2020 to March 2021) to improve collateral availability of Korean financial institutions and to expand liquidity provision channels in the domestic financial markets. The decision was made taking into account that improved liquidity conditions had reduced the need for extending the measure, adopted in response to COVID-19. In the meantime, the Bank also ended the broadening of the eligible collateral for guaranteeing net settlements and of the range of securities eligible for open market operations on March 31, 2021 as scheduled, both of which had been implemented on a temporary basis from April 2020 to March 2021.

9 The Bank of Korea strengthened its examinations of financial and FX market movements and financial stability conditions. At the March Financial Stability Meeting, the Bank carried out a multifaceted examination on how the changes in economic conditions brought on by the prolonged COVID-19 pandemic could affect the debt redemption capacities and financial soundness of households and businesses.

The Bank of Korea also continued to strengthen the multi-layered financial safety net, by enhancing global financial cooperation and expanding its bilateral currency swap arrangements with major central banks. When the Bank extended the currency swap agreement with Swiss National Bank in March, “vitalizing the function of financial markets” was added to the purpose of the swap agreement, on top of the existing purpose of “strengthening financial cooperation between the two countries,”and the agreement period was lengthened from 3 to 5 years. This further strengthened the safety net in the FX sector.

In addition, the Bank also made efforts to enhance stability and efficiency in the payment and settlement systems. The Bank also continued its research on Central Bank Digital Currency (CBDC) to preemptively cope with future changes in the payment and settlement environment which could see a growing need for CBDC adoption. The Bank is planning to conduct a pilot test for CBDC in a virtual environment from the second half of 2021, based on the results of the consultations completed this March. For the test, the Bank will create a cloud-based experiment environment and examine basic functions of CBDC and the possibility of its use while carrying out performance tests of related IT system. In the meantime, the Bank of Korea has closely monitored changes in the environment surrounding CBDC, while enhancing information sharing and cooperation with other central banks to share the research results of major economies.

[Future Monetary Policy Directions]

10 The outlooks for growth and inflation are as follows. It is forecast that GDP will record a growth rate of 4.0% this year. The Korean economy is expected to show a stronger recovery, as exports and facilities investment will continue to be robust thanks to the global economic recovery and private consumption is expected to

show improvement. Private consumption is projected to show continued improvement driven by a recovery in consumer sentiment and easing of sluggishness in household income conditions. Facilities investment is forecast to continue its solid recovery, led by the IT sector. Construction investment is expected to recover, centering around building construction on the back of the increase in construction starts that began last year, and exports are forecast to show sustained strength, driven by economic recovery in major countries and continued improvement in the global IT business. It is assessed that a number of latent upside and downside risk factors to the future growth path exist. The upside risks to growth include improvement in consumer sentiment stemming from expanded vaccinations, additional economic stimulus at home and abroad, and stronger improvement in global semiconductor industries. Among the downside risks are delays in normalization of economic activities amid disruptions in vaccinations, continued setbacks in production of some manufacturers, and intensified conflicts between the US and China.

Economic growth outlook[1]

(YoY, %)

	2020[2]	2021e			2022e		
	Year	H1	H2	Year	H1	H2	Year
GDP	-0.9	3.7	4.2	4.0	3.2	2.8	3.0
Private consumption	-5.0	1.0	4.0	2.5	4.7	2.3	3.5
Facilities investment	7.1	10.7	4.3	7.5	2.8	4.2	3.5
Intellectual property products investment	4.0	3.6	5.0	4.3	4.3	3.4	3.8
Construction investment	-0.4	-1.0	3.4	1.3	2.3	2.7	2.5
Goods exports	-0.5	14.8	4.0	9.0	1.9	3.1	2.5
Goods imports	-0.1	11.0	5.9	8.3	3.0	4.0	3.5

Notes: 1) Figures are the forecast as of May 2021.
2) Reflects preliminary figures.
Source: Bank of Korea.

Consumer price inflation is forecast to rise to 1.8% this year, increasing significantly from 0.5% in 2020, as international oil prices are expected to increase at a faster rate than had been expected, and prices of agricultural and livestock products are forecast to show high growth rates. Core inflation excluding food and energy prices is forecast to increase from 0.4% last year to 1.2%. It is assessed that there is a mix of both upside and downside risks to the inflation forecast path. Upside risks to the price forecast include accelerated growth of commodity prices, a continued upward trend in agricultural and livestock product prices, and a stronger recovery in consumer demand with expanded vaccinations. Among the downside risks are a worsening of the demand slump stemming from the resurgence of COVID-19 and delays in electricity and gas fee increases.

Inflation outlook[1]

(YoY, %)

		2020	2021e			2022e		
		Year	H1	H2	Year	H1	H2	Year
CPI inflation		0.5	1.7	2.0	1.8	1.3	1.4	1.4
Core inflation	CPI excluding food & energy	0.4	0.8	1.6	1.2	1.7	1.2	1.4
	CPI excluding agricultural products & oil	0.7	1.2	1.8	1.5	1.7	1.3	1.5

Note: 1) Figures are the forecast as of May 2021.
Source: Bank of Korea.

11 The Bank of Korea will continue to conduct its monetary policy in order to support the economy and stabilize consumer price inflation at the target level (2%) over a medium-term horizon, while paying attention to financial stability.

The Bank will maintain its accommodative monetary policy stance for the time being. While the Korean economic recovery is expected to strengthen and inflation to remain at a high level for some time, there are underlying uncertainties surrounding the path of COVID-19 and inflationary pressures on the demand side are forecast to be modest. In this process the Bank will assess developments related to COVID-19 and economic developments in major countries, while paying closer attention to the buildup of financial imbalances such as fund flows concentrated in asset markets and household debt growth.