Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad between May and August 2021 finds the following. The trend of recovery in the global economy was sustained, as vaccination expanded and the restrictions on economic activity were relaxed in major economies. The US economy continued to recover robustly amid swift improvement in employment. The euro area recovered rapidly as the restrictions on economic activity stemming from preventive measures were largely relaxed. China's growth somewhat slowed due to the resurgence of the pandemic, while in Japan the trend of mild recovery continued as emergency measures were strengthened repeatedly.

Economic growth in major economies[1)]

(%)

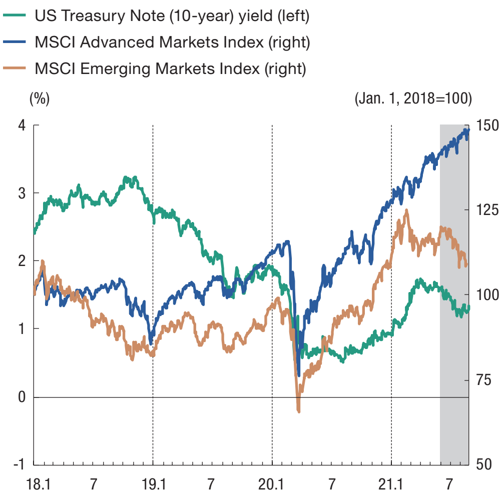
	2019	2020					2021	
	Year	Year	Q1	Q2	Q3	Q4	Q1	Q2
US	2.3	-3.4	-1.3	-8.9	7.5	1.1	1.5	1.6
Euro area	1.3	-6.4	-3.6	-11.4	12.4	-0.6	-0.3	2.0
China	6.0	2.3	-6.8	3.2	4.9	6.5	18.3	7.9
Japan	0.0	-4.6	-0.6	-7.9	5.3	2.8	-0.9	0.3

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.

Despite concerns about the spread of the Delta variant of COVID-19 (hereinafter the Delta variant), the international financial market generally remained stable thanks to the continued economic recovery on the back of expanded vaccine rollouts and the learning effect regarding financial market resilience. The US Treasury yield plunged from June due to the spread of the Delta variant, easing of inflation concerns and uncertainties concerning government debt, and then retraced the decline in August owing to strong employment data and the implementation of stimulus measures. Stock prices in advanced economies sustained their upward trend despite the spread of the Delta variant, supported by abundant global liquidity, forecasts of continued economic recovery, and solid earnings reports by US companies. Stock prices in Japan, however, fell due to the restrictions on economic activity in line with the resurgence of COVID-19. Meanwhile, stock prices in emerging economies generally declined on factors including the toughened corporate regulations in China and the US Fed's possible tapering of its asset purchases within this year. After strengthening against major currencies in June, the US dollar remained somewhat weak in July and then slightly strengthened again in August.

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



Source : Bloomberg.

2 The favorable trend of recovery in the Korean economy continued. Exports sustained their

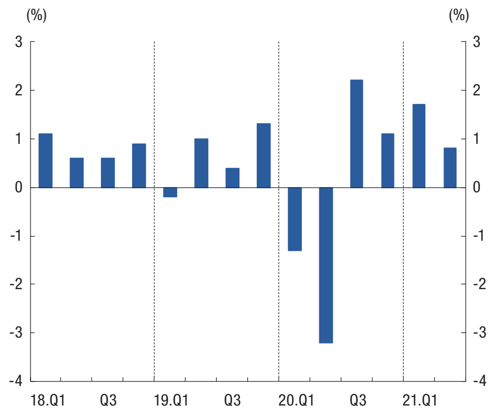
buoyancy and facilities investment showed robustness. Private consumption showed signs of recovery in the second quarter but its trend of recovery stagnated from July following the resurgence of COVID-19. Recovery in construction investment was delayed. The real GDP growth rate in the second quarter of this year was 0.8% quarter-on-quarter.

By sector, private consumption (based on GDP) in the second quarter maintained its recovery, boosted by government support measures and improvement in consumer sentiment. Due to the impacts from the heightened social distancing scheme following the resurgence of COVID-19 in July, however, retail sales decreased, led by clothing and cosmetics. Government consumption rose in the second quarter, due to the increased expenditure on national health insurance reimbursement and on quarantine goods to deal with the pandemic.

Facilities investment remained strong in the second quarter, with investment in machinery sustaining its solid trend and investment in other transport equipment rising as well. In July, the Estimated Index of Equipment Investment increased, as investment in machinery rose, led by semiconductor manufacturing equipment, as did investment in transport equipment such as automobiles and other transport equipment. Improvement in construction investment was delayed in the second quarter owing to the worsening weather conditions and greater disruption in supply of construction materials. The value of construction completed, especially in civil engineering, declined in July, affected by a persistent heat wave.

Exports (customs-clearance basis) grew at a faster pace year-on-year in the second quarter. Exports of IT products remained favorable, thanks to increased demand for semiconductors related to servers and to rising unit prices of display panels. Exports of non-IT goods rose substantially in most sectors including machinery, petroleum goods, and steel products, due to economic recovery in major economies and rises in commodity prices. Since July, exports have continued to rise significantly, affected by solid demand for semiconductors, petroleum and chemical goods and steel and by higher unit prices. Exports of automobiles continued to show a robust trend as supply shortages of automobile semiconductors were partly addressed.

Real GDP Growth[1)]

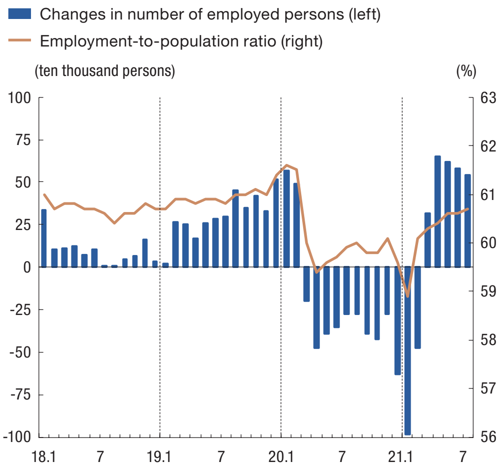


Note: 1) Quarter-on-quarter (seasonally adjusted), reflects preliminary figures.
Source: Bank of Korea.

Recent employment conditions have continued to improve with the sustained growth in the number of persons employed. The number of persons employed has continually risen since March, increasing by 542,000 year-on-year in July in part due to a base effect, despite the heightened social distancing level in line with the fourth wave of COVID-19. The (seasonally-adjusted) employment-to-population ratio remained on the rise, showing a slight increase from the previous month.

Nominal wages increased by 4.0% year-on-year in the second quarter of 2021, maintaining their sharp rise from the first quarter.

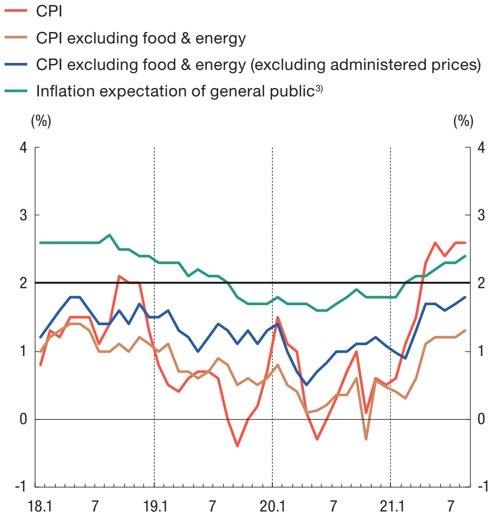
Changes[1)] in number of employed persons and employment-to-population ratio[2)]



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

3 Consumer price inflation has remained significantly above 2% since April this year. This increase in inflation was led mainly by supply-side factors including agricultural and livestock prices and oil prices, and is also attributed to gradually rising inflationary pressure on the demand side accompanying economic recovery. While core inflation (excluding changes in food and energy prices from the CPI) had run slightly above 1% since the second quarter of this year, it climbed to the low-to mid-1% level in August. When excluding administered prices, core inflation rose to the upper 1% level in August. The inflation expectations of the general public have risen to the mid-2% level.

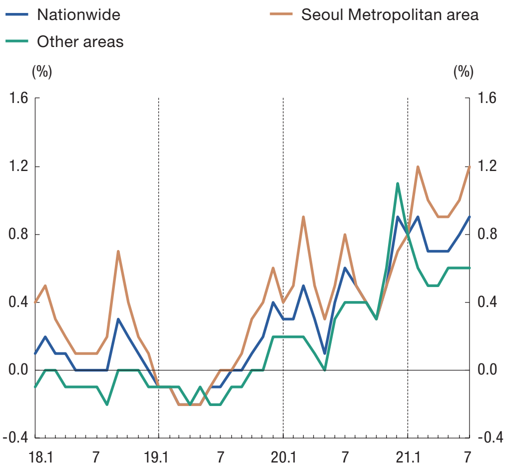
Inflation[1)2)]



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 sustained high rates of increase this year. While leasehold (*jeonse*) deposit prices remained high compared to previous years, their upward trend slowed both in the Seoul Metropolitan area and other areas in the second quarter but then modestly picked up pace in July.

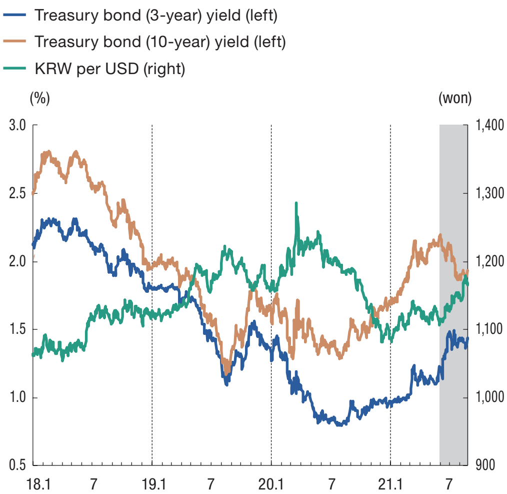
Housing sales price growth rate[1)]



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

4 While the 3-year Korea Treasury bond yield rose significantly, the 10-year yield declined sharply, showing differences in yields by maturity. In general, the 3-year yield moved at around 1.40% after having rapidly increased on the possibility that the policy rate would be hiked this year. The 10-year yield, which has been on the rise, turned to a decline due to the fall in the 10-year US Treasury Note yield and the easing of concerns about Korea Treasury Bond supply and demand conditions. The Korean won/US dollar exchange rate rose to the 1,150 won level on the unexpectedly hawkish June FOMC meeting result, resurgence of COVID-19 in Korea in July, and heightened social distancing level. Entering mid-August, the exchange rate reached a new all-time high for the year (1,179.6 won on August 20), affected by the massive sell-off of domestic stocks by foreign investors out of concerns about the potential sluggishness in the semiconductor industry, the possibility of an earlier start of tapering by the Fed, and the fourth wave of COVID-19.

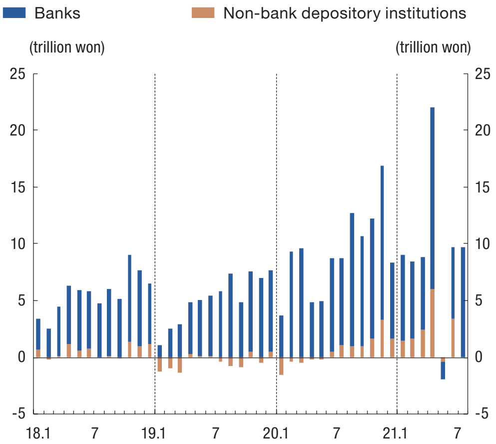
Korean Treasury bond yields and exchange rate (KRW per USD)



Sources: Bank of Korea, Korea Financial Investment Association.

5 Growth in household lending accelerated compared to the previous quarter. With respect to banks' household lending, mortgage loans continued to rise, while other loans led by unsecured loans increased substantially, due to demand for funds related to subscription deposits for public offerings for instance. Growth in household lending by non-bank depository institutions - mutual credit cooperatives and mutual savings banks in particular - expanded, while corporate lending, especially SME loans, sustained their upward trend, and direct funding also remained favorable.

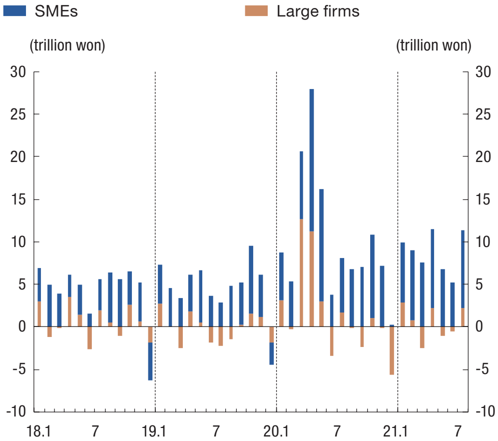
Changes in household loans[1)2)3)]



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

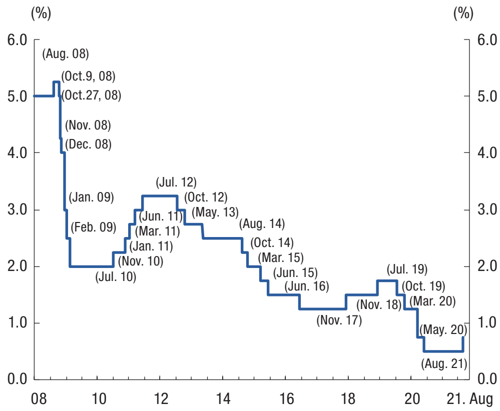
Source: Bank of Korea.

Changes in corporate loans[1)2)]



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

Bank of Korea Base Rate[1)]



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

[Conduct of Monetary Policy]

6 The Bank of Korea conducted monetary policy in order to sustain the recovery of economic growth and stabilize consumer price inflation at the target level (2%) over a medium-term horizon, while paying attention to financial stability. In this process, it thoroughly assessed global and domestic developments related to COVID-19, changes in the pace of growth and inflation, and the risk of a buildup of financial imbalances. Under this policy stance, the Bank of Korea adjusted the degree of monetary policy accommodation in August 2021 by raising its Base Rate by 25 basis points, from 0.50% to 0.75%.

7 A detailed look at the Base Rate decisions during this period, and the backdrop, are as follows. At the July meeting, the Board left the Base Rate unchanged at 0.50%, judging that although the domestic economy continued to recover robustly, it would be necessary to monitor the future developments of the pandemic and the subsequent economic impacts due to the resurgence of COVID-19. The domestic economy continued its favorable trend as exports and facilities investment remained buoyant and private consumption had also rebounded due to improvement in consumer sentiment following vaccinations. It was expected that such trend of economic recovery would continue in the second half as well. However, it was judged that there still remained high uncertainties regarding the pace of consumption recovery due to the resurgence of COVID-19. Consumer price inflation was around the mid-2% level as the upward trend of prices of petroleum products and agriculture, livestock, and fisheries products continued and the increase in service prices had accelerated. With respect to financial stability, household loans had grown considerably while

housing prices continued to exhibit high rates of increase in both the Seoul Metropolitan region and other areas.

At the August meeting, the Board decided to raise the Base Rate by 25 basis points, from 0.50% to 0.75%. The Board took into account the following aspects. The economy was expected to recover robustly on the back of expanded vaccinations and solid exports despite the lingering uncertainties over the pandemic, and inflationary pressure was expected to remain high for the time being, while financial imbalances continued to accumulate. Looking at the domestic economy, private consumption was somewhat sluggish owing to the resurgence of COVID-19, but exports had sustained their buoyancy and facilities investment showed robustness. Going forward, it was expected that these trends of recovery would continue and that private consumption would improve gradually on the back of the expansion of vaccinations and effects of supplementary budget implementation amid the lingering uncertainties related to COVID-19. Therefore, the domestic economic recovery was expected to continue. Accordingly, GDP growth this year was projected to record 4.0% as forecast in May. Consumer price inflation remained at the mid-2% level, and was expected to be 2.1% for 2021, exceeding the May forecast of 1.8%. On the financial stability side, household loans had grown considerably and housing prices also continued to increase rapidly in all parts of the country, indicating a continuous buildup of financial imbalance risk.

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 of Korea increased the total ceiling of the Bank Intermediated Lending Support Facility on three occasions last year (in March, May and October 2020) by a total of 18 trillion won. Of this amount, 16 trillion won was allocated to the Support Program for SMEs Affected by COVID-19 and the Support Program for Small Businesses. The two programs have been operated temporarily until end-September 2021. Looking at the volume of COVID-19-related bank loans supported by the Bank of Korea, bank loans amounting to 29.0 trillion won were extended to 129,395 establishments between March 2020 and July 2021 under the Support Program for SMEs Affected by COVID-19. As for the Support Program for Small Businesses, launched in October 2020, bank loans worth 2.9 trillion won were extended to 24,571 establishments between October 2020 and July 2021, showing steady growth in 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 Korea Treasury bonds last year for financial market stability. In February this year, the Bank announced a plan to expand outright purchases to preemptively prepare against the possibility of higher volatility in market interest rates caused in part by an increase in Treasury bond issuance. The Bank purchased Treasury bonds on March 9 (2.0 trillion won), April 28 (1.0 trillion won), June 3 (1.5 trillion won), and June 28 (1.5 trillion won). Accordingly, the amount of outright Treasury bond purchases in 2021 reached 6.0 trillion won in total.

On June 30, 2021, the Bank of Korea extended the purchasing period of the Special Purpose Vehicle (SPV), which purchases corporate bonds and commercial paper, to the year-end, and approved the relending of the first round of loans provided in July 2020, to keep supporting seamless financing of low-rated companies facing difficulties from the prolonged COVID-19 pandemic. However, the corporate bond and commercial paper markets have recently shown more stable movements compared to the time of the establishment of the SPV, and its capacity for purchasing corporate bonds and commercial paper was judged to be sufficient until the year-end. Accordingly, the Bank of Korea decided not to extend the duration for new loan provision to the SPV beyond July 13, 2021. As of end-July 2021, the SPV has purchased 4.0 trillion won worth of corporate bonds and commercial paper.

On June 17, 2021, the Bank of Korea extended the expiration date of its bilateral currency swap arrangement signed with the US Federal Reserve by three months, from September 30, 2021 to December 31, 2021. The size ($60 billion) and terms of the swap arrangement remain unchanged. The extension is assessed to have contributed to sustaining stability in the domestic foreign exchange and financial markets.

9 The Bank of Korea held a Governor's press conference in June to explain its review of the status of its inflation target operations and released a related report, to help economic entities better understand the recent inflation situation and the future inflation trend, and to strengthen the Bank's accountability concerning price stability. The report included an assessment of the inflation situation in the first half of 2021, and the future price conditions and outlook. It also reviewed major issues such as assessment of the trend of core inflation in Korea, inflation trends in major economies, and the relationship between producer prices and consumer prices.

In addition, the Bank of Korea decided to introduce 3-year Monetary Stabilization Bonds (MSBs) and to cease the issuance of 182-day MSBs from September this year to increase the efficiency of liquidity management. In line with this, the issuance volume and schedule for each maturity have been adjusted, and the periods and dates of fungible issue have been newly set to enhance liquidity.

Meanwhile, the Bank of Korea sustained efforts to enhance multi-layered financial safety nets by running currency swap networks with major central banks in a stable manner. In addition to the aforementioned extension of its swap arrangement with the US Federal Reserve (in June this year), the Bank entered into a new bilateral local currency swap agreement with the Central Bank of the Republic of Turkey in August to promote trade and strengthen financial cooperation between the two countries.

The Bank of Korea continued to do research on and make technical preparation for central bank digital currency (CBDC) to cope with future changes in the payment and settlement environment. Based on the consultation results of a work process completed as of this March, the Bank launched research on a CBDC pilot test in August, which is scheduled to be conducted for 10 months. This year, the Bank will create a cloud-based virtual experimentation environment, examine basic functions of CBDC including its issuance, circulation, and redemption, and carry out tests on related IT systems.

[Future Monetary Policy Directions]

⑩ The outlooks for growth and inflation are as follows. First, it is forecast that GDP growth will record 4.0% this year. The Korean economy is forecast to continue its solid recovery trend thanks to the expansion of vaccinations and steady exports, despite the recent resurgence of COVID-19. Private consumption is expected to strengthen as the expansion of vaccinations leads to the stabilization of consumer sentiment and mitigation of containment measures. Facilities investment is also expected to continue its robust trend thanks to the global economic recovery. Construction investment is projected to show gradual recovery centered around building construction, given the substantial amount of construction starts and sound housing demand. Exports of goods are expected to show sustained strength, thanks to the recovery of major economies and strong demand for IT products. There are still potential uncertainties surrounding the growth outlook. The upside risks to the growth path include the quicker resumption of economic activities in major countries, rapid improvement of COVID-19 conditions in Korea, and domestic and foreign policy support to stimulate the economy. Among the downside risks are intensified spread of COVID-19 at home and abroad, slower growth of the Chinese economy, and delayed recovery of global supply disruptions.

Economic growth outlook[1]

(YoY, %)

	2020	2021e			2022e		
	Year	H1[2]	H2	Year	H1	H2	Year
GDP	-0.9	4.0	4.0	4.0	3.1	3.0	3.0
Private consumption	-5.0	2.4	3.3	2.8	3.3	3.6	3.4
Facilities investment	7.1	12.6	5.5	8.8	0.9	3.3	2.1
Intellectual property products investment	4.0	4.0	4.5	4.4	4.1	3.5	3.8
Construction investment	-0.4	-1.5	3.2	0.9	3.2	2.6	2.9
Goods exports	-0.5	14.4	4.1	8.9	2.5	3.0	2.7
Goods imports	-0.1	12.5	6.7	9.5	2.3	3.7	3.0

Notes: 1) Figures are the forecast as of August 2021.
2) Based on preliminary figures for the second quarter.
Source: Bank of Korea.

Consumer price inflation is forecast to rise to 2.1% in 2021, increasing significantly from 0.5% in 2020, as agricultural and livestock product prices and international oil prices are expected to increase at faster rates than initially anticipated. 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 a sustained strong uptrend in agricultural and livestock product prices, a faster rise in prices of processed foods, and a stronger recovery in consumer demand in line with accelerated vaccinations. Among the downside risks are a slower recovery in demand for consumption resulting from the spread of the Delta variant, a delay in electricity and gas charge hikes, and declines in commodity prices.

Inflation outlook[1)]

(YoY, %)

		2020	2021^e			2022^e		
		Year	H1	H2	Year	H1	H2	Year
CPI inflation		0.5	1.8	2.4	2.1	1.7	1.3	1.5
Core inflation	CPI excluding food & energy	0.4	0.8	1.5	1.2	1.7	1.3	1.5
	CPI excluding agricultural products & oil	0.7	1.2	1.8	1.5	1.8	1.4	1.6

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

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

The Bank of Korea will gradually adjust the degree of monetary policy accommodation as the Korean economy is expected to continue its sound growth and inflation to run above 2% for some time, despite ongoing uncertainties over the virus. In this process the Bank will judge when to further adjust the degree of accommodation while thoroughly assessing developments related to COVID-19, changes in the pace of growth and inflation, the risk of a buildup of financial imbalances, and monetary policy changes in major countries.