

## ■ Executive Summary

### [Monetary Policy Operating Conditions]

1 A look at financial and economic conditions in Korea and abroad between October 2018 and January 2019 finds the following. The pace of global economic growth eased somewhat. The United States showed firm growth as employment and consumption remained robust, while Japan emerged from its temporary sluggishness of the third quarter thanks to increased investment. In the euro area the recovery was somewhat weak, however, as a decline in external demand was followed by production setbacks in the automobile sector due to the implementation of new environmental regulations and by extreme weather events. In China meanwhile the rate of growth fell to 6.4% in the fourth quarter of last year and the economic slowdown continued.

**Economic growth in major economies<sup>1)</sup>** (%)

	2016	2017		2018			
	Year	Q3	Q4	Q1	Q2	Q3	
US	1.6	2.2	2.8	2.3	2.2	4.2	3.4
Euro area	2.0	2.4	2.7	2.7	1.5	1.7	0.6
Japan	0.6	1.9	2.7	1.5	-1.3	2.8	-2.5
China	6.7	6.9	6.8	6.8	6.8	6.7	6.5 [6.4] <sup>2)</sup>

Notes: 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.

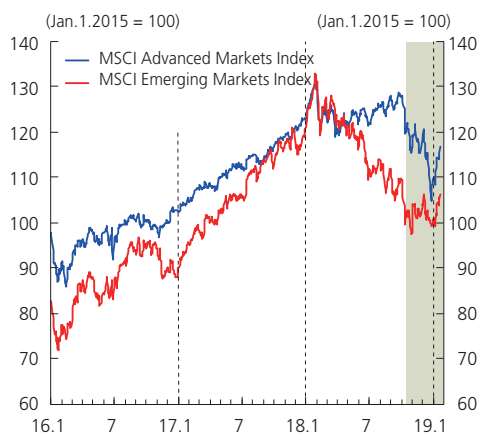
2) Based on the fourth quarter of 2018.

Sources: Individual countries' published statistics.

The volatility in the international financial markets, which had expanded greatly from October of last year, lessened entering this year and the financial unrest in some weak emerging market economies eased somewhat. Long-term market interest rates in

major countries fell, influenced by the likelihood that the US Federal Reserve would adjust the speed of its interest rate hikes and by concerns about a global economic slowdown. While stock prices declined greatly in advanced countries, due to slumps in corporate performances and to concerns about economic slowdowns, stock prices in EMEs, which had fallen greatly until October of last year, showed relatively low volatility. Entering this year stock prices have rallied in both advanced and emerging market countries.

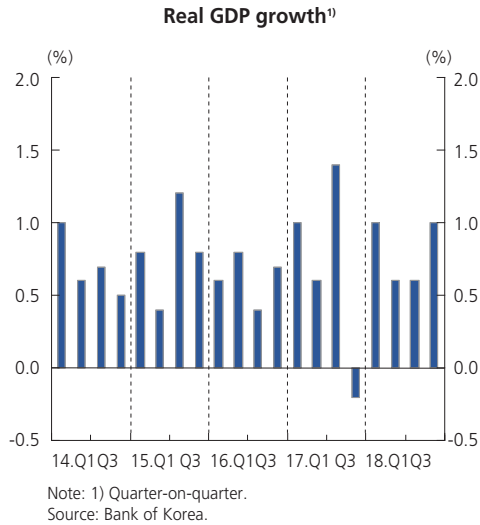
**Share price indices of advanced and emerging markets**



Source: Bloomberg.

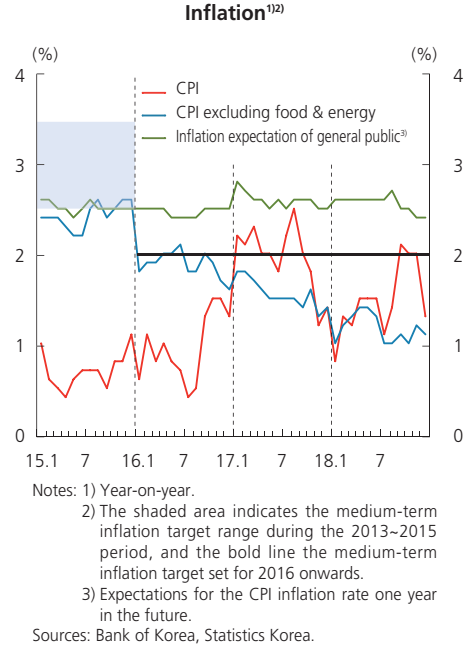
2 The Korean economy has continued to grow at the level of its potential growth rate. The adjustments in facilities and construction investment persisted during the third quarter of last year, but the economy grew by 0.6% quarter on quarter as consumption continued to increase modestly and exports sustained their buoyancy as well. In the fourth quarter the economy recorded a 1.0% growth rate, thanks to an expansion in government expenditures. Employment meanwhile was sluggish in the fourth quar-

ter, with the year-on-year increase in the number of persons employed being a mere 88,000 persons.



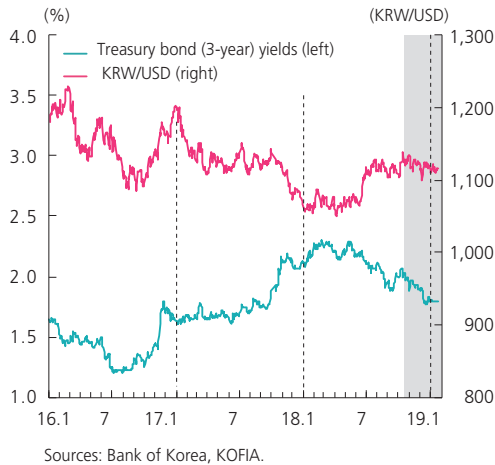
③ The rate of consumer price inflation showed the 2% level over the October to November period of last year, as the increases in agricultural and petroleum product prices accelerated, before in December then slowing to the lower 1% range on the effects of a drop in petroleum product prices. The rate of core inflation remained at the lower 1% level, and the inflation rate expected by the general public was in the mid-2% range.

The pace of increase in housing sales prices in Seoul and its surrounding areas slowed, on the effects of the measures taken by the government, while the extent of sales price decline in the rest of the country lessened as the increases seen in some regions picked up. Leasehold deposit prices continued to fall in both Seoul and its surrounding areas and the rest of the country.



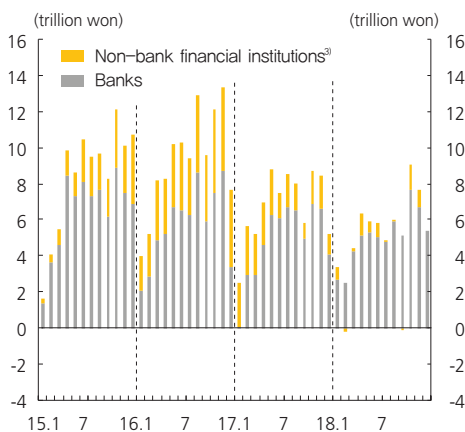
④ In the domestic financial markets, long-term market interest rates continued to fall due to the escalation of the US-China trade dispute, to concerns about slowdowns in growth domestically and abroad, to a decline in the volume of Treasury bond issuance. They then fluctuated within a limited range from the middle of December, as the global risk aversion eased somewhat. Stock prices showed high volatility, and after falling to a considerable extent rebounded, while the Korean won/US dollar exchange rate was generally stable. Domestic portfolio investment by foreigners meanwhile reversed to an increase in November, before contracting this year led by funds for investment in bonds.

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



5 Household lending expanded greatly in October, driven by factors such as demand for funds related to housing, but from November its growth lessened under the impacts of the implementation of the DSR regulation, of a reduction in housing sales transactions. For the year as a whole, the slowdown compared to the high rates of growth seen in normal years (2015-16) continued.

**Changes in household loans<sup>1)2)</sup>**

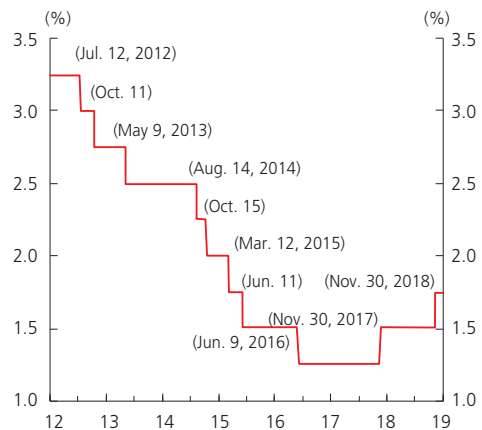


Notes: 1) Month-on-month.  
 2) Including mortgage transfers.  
 3) Data until Nov. 2018 available.  
 Source: Bank of Korea.

**[Monetary Policy Operating Conditions]**

6 During the November 2018 through January 2019 period Bank of Korea maintained its accommodative policy stance, to ensure that the recovery of economic growth would continue and that consumer price inflation could be stabilized at the target level over a medium-term horizon, while conducting its monetary policy with attention to financial stability as well. In this process it closely examined domestic and overseas risk factors such as Korea's trading conditions vis-a-vis major countries, changes in the monetary policies of major countries' central banks, financial and economic conditions in EMEs, and the upward trend of household debt. Under this policy stance Bank of Korea decided in November of last year to raise the Base Rate, which it had maintained at an annual 1.50% since November of 2017, by 0.25% point to operate it at 1.75% per annum.

**Bank of Korea Base Rate<sup>1)</sup>**



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

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

First, the hike of the Base Rate in November of last year was a decision made in consideration of the points that the uncertainties about external conditions were high but the trend of growth not far from the level of the potential growth rate was continuing, while consumer price inflation was expected to fluctuate in the mid- to upper-1% range near the inflation target, and that if the Base Rate were kept low then the risks to financial stability could grow due to an expansion in the financial imbalances. With regard to the domestic economy, it was judged that the adjustments in facilities and construction investment had persisted, but that the trend of growth at the potential growth rate level had generally continued as consumption was expanding modestly and exports were also showing buoyancy, and these trends seemed likely to continue in the future as well. Consumer prices had shown a pace of increase at the 2% level, as the rises in agricultural and petroleum product prices had accelerated, and it was forecast that they would be near the target level for some time before then falling somewhat to fluctuate at the mid- to upper-1% level. On the financial stability side, it was forecast that the pace of growth in household lending would not increase greatly, thanks to the effects of the government policies, but that it would still be faster than that of income. A monetary policy response to the risk of financial imbalance accumulation was thus judged necessary.

In the meeting in January of this year the

Bank maintained the Base Rate at 1.75% per annum. This decision was made in view of the points that the Korean economy seemed likely to grow at a pace similar to that last year, due to the expansion in government expenditures, but there was a need to keep an eye on the increased uncertainties surrounding external conditions, as well as their impacts, and that examination was necessary of the effects of the policy rate hike implemented in November last year to contain the expansion in financial imbalances. The increase in consumer prices had slowed, on the effects of declines in petroleum product prices, and was forecast to fluctuate at the 1% level for the time being before then gradually rising to the mid-1% range from the second half. The amount of growth in household lending had lessened, but there was judged to be a need for attention to financial stability conditions including whether this trend would continue.

⑧ Bank of Korea took into account the increasing difficulties of small-scale business owners due to factors such as the recent slumps in business conditions, and decided in November last year to temporarily extend the operating term of the Bank Intermediated Lending Support Facility's Support Program for Small-scale Business Owners for one year, until November of this year.

⑨ Bank of Korea continued its efforts for financial and foreign exchange market stability in response to changes in conditions at home and abroad. During the times of expanded domestic and foreign financial market volatility, the Bank convened meetings of its 「Monetary and Financial Task

Force」 seven times, to examine financial and foreign exchange market developments and their effects. In addition, in order to respond preemptively to signs of tightening market liquidity at the end of the year it made flexible use of its open market operations instruments.

The Bank continued its efforts for the preemptive identification of potential risks within the financial system as well. During its December 「Financial Stability Meeting」 it closely assessed vulnerabilities by sector, in the household and corporate credit markets, the asset markets, at financial institutions, and examined the financial system's resilience to domestic and overseas shocks. In December it also completed construction of its new Extensive Stress Test model, which reflects all losses within both the banking and non-bank financial sectors and the transmissions of risks across sectors.

### [Future Monetary Policy Directions]

⑩ It is forecast that the GDP growth rates both this year and next will show levels of 2.6%, similar to that last year. This year's growth rate forecast has been revised down slightly compared to the figure projected last October (2.7%), but the economy is expected to sustain a trend of growth that does not diverge much from the level of its potential growth rate. The uncertainties as to the future growth path are high. The major upside risks include a resolution of uncertainties through the reaching of a settlement in the US-China trade negotiations, improvements in domestic demand thanks to the government's expansionary fiscal policies, and increases in corporate investment

in line with the government's economic revitalization policies. Among the downside risks are those of a slowdown in export growth due to intensifying global trade conflicts, of slackening global growth momentum stemming from slowdowns in major economies, and of weakening global semiconductor demand.

### Economic growth outlook<sup>1)2)</sup>

	2018			2019 <sup>e</sup>			2020 <sup>e</sup>
	Year	H1	H2	Year	H1	H2	
GDP	2.7	2.8	2.5	2.6	2.5	2.8	2.6
Private consumption	2.8	3.2	2.5	2.6	2.5	2.7	2.6
Facilities investment	-1.7	1.9	-5.3	2.0	-2.1	6.3	2.3
Intellectual property products investment	2.0	2.8	1.2	2.5	2.2	2.9	2.8
Construction investment	-4.0	-0.1	-7.4	-3.2	-6.1	-0.5	-2.0
Goods exports	3.9	2.8	4.9	3.1	2.4	3.8	3.0
Goods imports	1.7	2.5	0.9	2.3	0.6	4.0	2.5

Notes: 1) Year-on-year.

2) Figures are the forecast as of Jan. 2019.

Source: Bank of Korea.

Concerning the headline consumer price index, it is forecast that the hikes in wages will cause service prices to rise but that the rate of price inflation will be in the mid-1% range during this year and next, as factors including the decline in oil prices put downward pressures on prices from the supply side, amid not large demand-side pressures. By period, inflation is expected to pick up from 1.2% during the first half of this year to 1.5% in the second, as the cuts in the oil and individual consumption taxes are ended and public service charges rise. It is forecast that next year's consumer price inflation rate will be 1.6%. With regard to the future inflation path there is also a mix of both

upside and downside risks. The former include risks of increased cost-side pressures due to the continuation of wage hikes, and of an improvement in domestic demand in consequence of the government's policies, while the downside risks to inflation include the possibilities of strengthened welfare policies related to education and medical services, and of Korean won appreciation due to easing of external risks.

#### Inflation outlook<sup>1)2)</sup>

(%)

	2018			2019 <sup>o</sup>			2020 <sup>o</sup>	
	Year	H1	H2	Year	H1	H2		
CPI inflation	1.5	1.3	1.7	1.4	1.2	1.5	1.6	
Core inflation	CPI excluding food & energy	1.2	1.3	1.1	1.4	1.2	1.5	1.5
	CPI excluding agricultural products & oils	1.2	1.2	1.1	1.5	1.3	1.6	1.5

Notes: 1) Year-on-year.

2) Figures are the forecast as of Jan. 2019.

Sources: Bank of Korea, Statistics Korea.

**11** Bank of Korea will operate its future monetary policy in consideration of developments related to the uncertainties in Korea and abroad and their effects, as it closely checks to see whether growth and prices coincide with their forecast paths, while devoting attention to financial stability as well. In this process it will also carefully monitor the US-China trade dispute, the US Federal Reserve's normalization of its monetary policy, international financial market conditions, and the risks of financial imbalance accumulation.

The trade dispute between the United States and China is showing some signs of easing, but the related uncertainties continue. As concerns about the conflict persist, it is judged that some negative effects on eco-

nomic indicators in the two countries as well as Korea are also appearing. If the trade negotiations between the two countries progress going forward and enter a resolution phase, positive effects due to the easing of uncertainties can be expected. But if the dispute escalates it is likely to cause considerable burdens to world trade and to Korean exports. In view of the Korean economy's high reliance on trade, it is judged important to remain mindful of any changes in global trading conditions.

The US Federal Reserve has implied recently that it will conduct its monetary policy more cautiously going forward, as it monitors changes in economic conditions. If the Fed reduces the speed of its monetary policy normalization, this is likely to work as a positive factor that reduces concerns about capital outflow pressures and causes financial market volatility to subside somewhat. As the rise in domestic market interest rates due to the Fed's policy rate hikes will be limited, the constraints on domestic economic growth can also ease. But since the Fed's recent statements that it will be patient in its monetary policy decision-making are being made against a background of concerns about US economic slowdown, there is a possibility that the increase in growth due to the Fed's adjusting the speed of its monetary policy normalization will be offset to a considerable extent. There is thus a need going forward to continue closely examining financial and economic developments in the US and globally, as well as any changes in the Fed's policy, and the effects that these factors have on the domestic economy.

In the international financial markets,

there have been some differences in the movements of price variables and capital flows between the time before October of last year and the period since then. Prior to October the financial unrest in vulnerable EMEs was quite noticeable, while the volatility in financial markets of advanced countries has been greater since October last year. This appears to have been a result of the fact that, while the concerns about accelerated monetary policy normalization by the Fed had worked as a factor heightening international financial market volatility, of late the concerns about weakening growth in advanced economies including the US, which have been driving world economic growth, are being more reflected in the financial markets. International financial market volatility has been easing somewhat this year, and Korea's domestic financial and foreign exchange markets are also showing general stability, but the uncertainties related to external conditions remain high and a careful eye will have to be kept on any changes in market conditions.

A look at the current situation of the domestic financial imbalances finds that the growth in household debt has been slowing, affected by the government's housing market stabilization measures and by the DSR regulation, and it is forecast that this will continue going forward as well. Particularly, housing prices in Seoul and the rest of its surrounding areas, which have an intimate relationship with the increase in household debt, are being forecast to remain stable for the time being. On the corporate lending side, meanwhile, the pace of growth in lending to self-employed business owners, including loans to the real estate, which had risen greatly,

has been slowing of late under the influence of the government's regulations. However, in view of the fact that the aggregate household debt level is already high, on top of which the pace of slowing of household debt is only modest due to loan demand driven by the increased supply of new housing, there is a need for observation to see whether the slowdown continues. It also appears necessary to monitor future trends of lending related to real estate. In view of these conditions, it is judged that continued attention to the risks of financial imbalance accumulation is called for.

⑫ As the period of application of its 2016~2018 inflation target ended Bank of Korea, in consultation with the government, set the inflation target to be applied from 2019 onward at the level of a 2.0% (year-on-year) rate of consumer price inflation, the same as previously. In order to enhance the stability of its system operation the Bank also did not specify the period of inflation target application, while in a move to strengthen its communication it decided to publish a biannual report examining the inflation target operating situation.

In the future as well, 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.

As it is forecast that the inflationary pressures on the demand side will not be high for the time being, while the domestic economy will sustain a rate of growth that does

not diverge greatly from its potential level, the Bank plans to maintain its accommodative monetary policy stance. In this process it will closely examine the effects of the Base Rate hike in November of last year, the developments of external conditions and the resulting movements of growth and prices, and judge whether an additional adjustment in the degree of accommodation is called for. Since the uncertainties related to the global trade disputes, to the US Federal Reserve's monetary policy normalization, to financial and economic conditions in EMEs, and to geopolitical risks remain high, the Bank will carefully monitor their trends and impacts. Besides consumer price inflation, it will also closely review various auxiliary price indices, inflation expectations, international oil prices, global inflation, the GDP gap, and the spare capacities in employment and the manufacturing sector.

The Bank will in addition continue to operate its monetary policy with attention devoted to financial stability as well. The pace of household debt growth is slowing, but the Bank will watch to see whether this trend continues as it judges the possibility of the financial imbalances worsening.