Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad between May and August 2022 finds the following. The global economic growth slowed, affected by continued high inflation and the ensuing policy rate hikes in major economies, the prolongation of the Ukraine crisis, and lockdown measures in China. The US economy recorded a negative growth rate for a second consecutive quarter following the first quarter, mainly due to sluggish private investment. In the euro area, the trend of recovery continued in the second quarter driven by resumption of economic activity, but production in the manufacturing industry was subdued and consumer sentiment weakened severely due to supply disruptions and high inflation. China's growth slowed sharply, as its consumption and production contracted due to lockdown measures to curb a COVID-19 resurgence, amid the continued slump in the real estate sector. The Japanese economy grew at 0.5% quarter-on-quarter in the second quarter, but its recovery momentum has been constrained recently due to a resurgence of the virus and the global economic slowdown.

Economic growth in major economies[1)]

(%)

	2020	2021					2022	
	Year	Year	Q1	Q2	Q3	Q4	Q1	Q2
US	-3.4	5.7	1.5	1.6	0.6	1.7	-0.4	-0.1
Euro area	-6.3	5.3	-0.1	2.1	2.3	0.4	0.5	0.6
China	2.2	8.1	18.3	7.9	4.9	4.0	4.8	0.4
Japan	-4.6	1.7	-0.4	0.5	-0.5	1.0	0.0	0.5

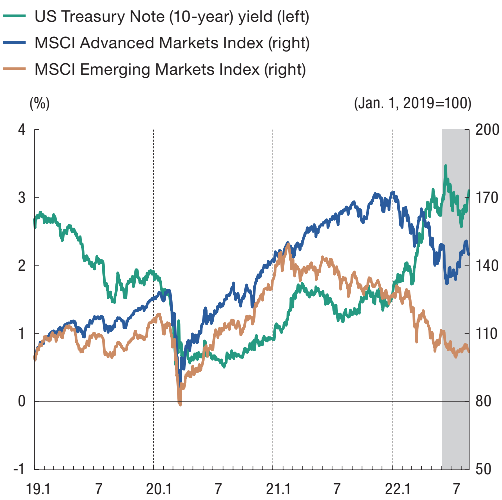
Note: 1) The quarterly rates of growth are quarter-on-quarter (seasonally adjusted) for the US, Japan and the euro area, and year-on-year for China.

Sources: Individual countries' published statistics.

Global inflation sustained its strong upward trend in most countries, driven primarily by energy and food prices, as international commodity prices still stayed high despite moderating to some extent in line with the easing of supply disruptions. Inflation pressures remained high in the US and the euro area, and prices also rose faster in Japan and China owing to the strong depreciation of the yen and to the continuing increase in food prices, respectively.

In the international financial market, major price variables showed severe volatility, with growing uncertainties over the pace of the policy rate hikes by the US Federal Reserve and the global economic outlook. The US Treasury yield rose sharply up until mid-June on expectations for a stronger policy response by the US Federal Reserve to high inflation. The yield generally showed a downward trend afterwards, amid growing concerns about economic slowdown and expectations that the US Federal Reserve could slow the pace of its rate hikes. However, it rebounded rapidly in August, led by the announcement of favorable labor market indicators and expectations for further tightening by the US Federal Reserve after the Jackson Hole meeting. Stock prices in advanced economies, which fell in June reflecting concerns about economic slowdown, rose in July, driven by the announcement of strong corporate performances and the expectations for the US Federal Reserve's adjustment of the pace of its monetary policy tightening. However, they took a considerable downturn again from mid-August, as the Federal Reserve's commitment to further tighten its policy stance was reaffirmed. Affected by global investor sentiment, stock prices in emerging economies moved generally in line with those of advanced economies. The US dollar remained generally strong, reflecting the policy stance of the US Federal Reserve.

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



Source: Bloomberg.

2 The Korean economy sustained its trend of recovery despite worsening conditions overseas. In the second quarter, private consumption recovered rapidly after the easing of COVID-19 restrictions and investment somewhat recovered from its slowdown while exports were sluggish mainly due to China's lockdown measures. The real GDP growth rate in the second quarter rose by 0.7% from the preceding quarter (+2.9% year-on-year).

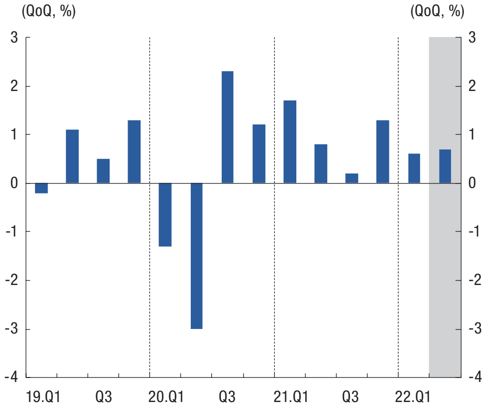
Since July, export growth has slowed led by weaker global demand while private consumption has maintained a moderate recovery.

By sector, private consumption (based on GDP) increased 2.9% in the second quarter from the first quarter (+3.9% year-on-year), as COVID-19 restrictions were lifted in line with the improved pandemic situation. Private consumption continued its growth trend in July, led mainly by consumption of face-to-face services in line with increased face-to-face activities and summer-season demand, although consumption of goods declined. Government consumption climbed 0.7% quarter-on-quarter in the second quarter (+3.7% year-on-year), driven chiefly by increased health insurance reimbursements as doctor visits resumed with the gradual return to normal life.

The sluggishness in facilities investment eased, as investment increased 0.5% from the previous quarter in the second quarter (-6.6% year-on-year). The Equipment Investment Index for July released by Statistics Korea was down by 3.2% month-on-month (-2.2% year-on-year), reflecting an adjustment in semiconductor manufacturing equipment investment, which had soared in May and June. Construction investment also increased 0.2% quarter-on-quarter in the second quarter (-3.7% year-on-year), owing to favorable weather conditions. The value of construction completed for July published by Statistics Korea dropped 2.5% month-on-month (+2.0% year-on-year) led by the government's reduced SOC budget spending.

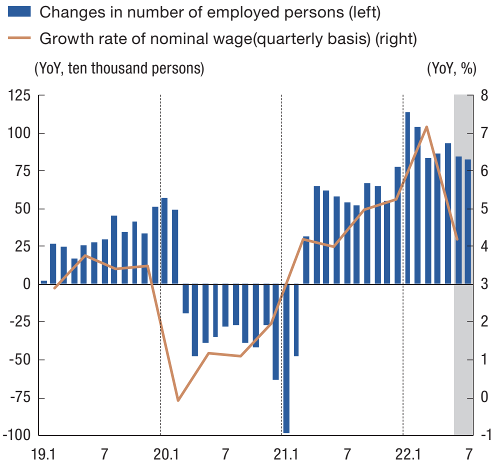
Exports (customs-clearance basis) grew at a slower pace year-on-year in the second quarter. For the IT sector, exports of semiconductors sustained a two-digit growth rate driven by growing demand, while the growth in the non-IT sector weakened, with exports of chemical and engineering products and steel growing slowly and machinery exports shifting to a decline. Trade with China recorded deficits for four consecutive months from May, when it recorded the first ever deficit since 1994.

Real GDP Growth[1)]



Note: 1) Reflecting preliminary figures
Source: Bank of Korea.

Changes in number of employed persons and nominal wage growth



Source: Statistics Korea.

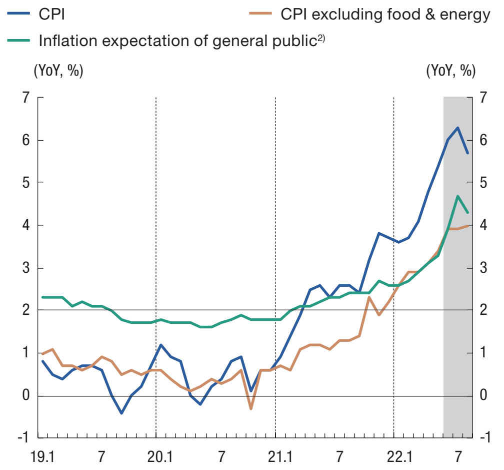
Recent employment conditions have remained strong with a substantial margin of growth sustained in the number of persons employed. In July, total payrolls increased by 826,000 year-on-year, and private nonfarm payrolls (excluding agriculture and fisheries, public administration, and health and social welfare) maintained sharp growth, up by 535,000 year-on-year. As a result, the (seasonally-adjusted) unemployment rate, which plummeted in early 2022, remained low at 2.9% in July. The (seasonally-adjusted) employment-to-population ratio also was high at 62.2%, remaining unchanged from the previous month.

Nominal wages rose by 4.2% year-on-year in the second quarter, showing a smaller increase relative to the first quarter (7.2%) when they increased sharply mainly due to special wage payments. However, amid this high, above-4% growth of nominal wages, the growth trend is spreading from several IT sectors across all industries. By employment status, wages of regular workers, particularly fixed wages, continued to rise, while the wage growth for temporary and daily workers slowed.

3 Consumer price inflation rose rapidly to the range of 6% in June and July. Although it edged down to 5.7% in August, it continues to run high. Looking at overseas factors affecting consumer price inflation, crude oil import price growth declined slightly as international oil prices dropped in July and August on concerns about the global economic slowdown, offsetting the larger increase in the Korean won to US dollar exchange rate. As for domestic factors, demand-side inflationary pressures increased in line with the lifting of social distancing rules, accelerating personal service price inflation. Core inflation (excluding changes in food and energy prices from the CPI) went up to around the 4% level in July and August from the mid-3% level in the second quarter of this year. Given the significant effect that government policies have on core inflation, core inflation excluding administered prices showed an even higher increase to around the mid- and upper-4% level in July and August. The short-term inflation expectations of the general public and an expert group (1-year ahead) rose to the 4% level, while the long-term inflation ex-

pectations of the expert group (5-year ahead) remained stable at around the target level (2%).

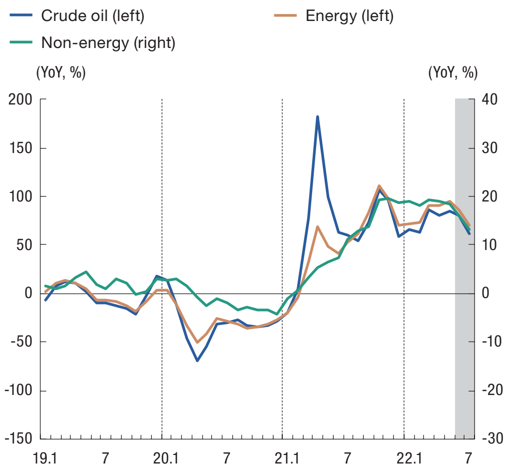
Inflation[1)]



Notes: 1) The bold line indicates the inflation target.
2) Expectations for the consumer price inflation rate over the next 12 months

Sources: Bank of Korea, Statistics Korea.

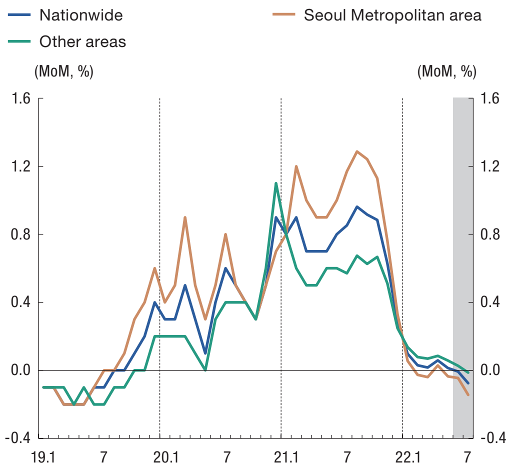
Increase in import prices (Korean won basis)



Source: Bank of Korea.

Nationwide housing sales prices shifted to a decline since June as expectations for price hikes weakened, affected by interest rate hikes and the spread of perceptions that housing prices had peaked. Nationwide leasehold (*jeonse*) deposit prices exhibited slower growth as the demand for *jeonse* shifted to that for monthly rent owing to lending rate hikes, and maintained a modest downturn since May.

Housing sales price growth

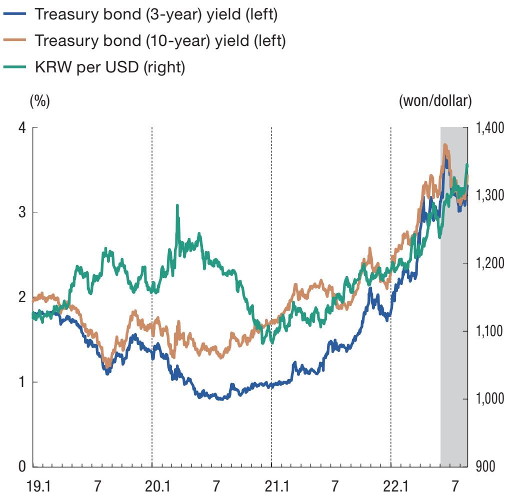


Source: Korea Real Estate Board.

4 Korea Treasury bond yields hit a record high for the year in June for both 3-year (3.75%, June 17) and 10-year (3.80%, June 15) bonds, and then fell significantly in line with concerns about economic slowdown in major economies and expectations for an inflation peak-out. However, they rebounded considerably on strengthened expectations for interest rate hikes at home and abroad following better-than-expected US labor market indicators, hawkish comments by US Federal Reserve officials, and the upward adjustment of the Bank of Korea's inflation outlook. As the yield for 3-year Treasury bonds, which is greatly affected by monetary policy, rose much higher than that for 10-year bonds, the spread between long- and short-term yields (10-year - 3-year) narrowed sharply (30bp at end-May to 6bp on August 25).

The Korean won to US dollar exchange rate declined to the 1,230 won level at the end of May, as investor sentiment improved after China eased lockdown measures. However, it picked up rapidly thereafter as the US dollar continued to strengthen in line with expectations for further tightening by the Federal Reserve in response to high inflation and concerns about economic slowdown in the euro area. It then fluctuated at around the 1,300 to 1,310 won level from mid-July. From mid-August, concerns about the China's economic slowdown, the weakening of the yuan following the accommodative monetary policy by the People's Bank of China, and continued hawkish comments by US Federal Reserve officials pushed up the rate again to exceed 1,340 won around the end of that month. Such a rise in the exchange rate was primarily attributable to the strength of the US dollar in the global financial market against other major currencies, which depreciated to a similar extent.

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

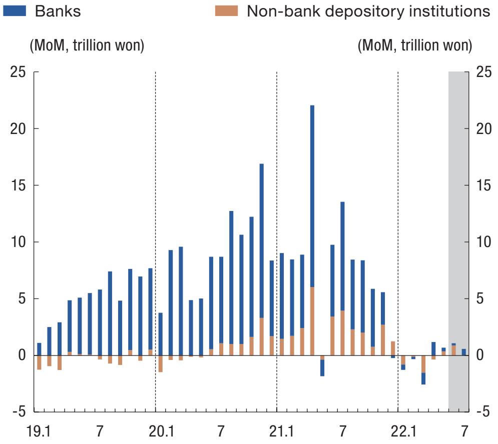


Sources: Bank of Korea, Korea Financial Investment Association.

[5] Household lending grew only moderately in the second quarter, owing to lending rate hikes and the financial sector's continued management of household lending. Despite the eased management of unsecured loans in the banking sector, household lending climbed down in July, led mainly by other loans in tandem with lending rate hikes and the implementation of phase 3 of the individual borrower-level DSR regulation.

Corporate financing sustained its pace of high growth, driven mainly by bank lending. Corporate lending by banks, especially to large companies, increased by a larger margin in the second quarter, and rose sharply in July as well due to seasonal factors such as the relending of loans temporarily redeemed at the end of the previous quarter-end and demand for funds for value-added tax payment. As for direct corporate financing, corporate bonds recorded a net redemption after the second quarter, while net issuance of CP and short-term bonds dropped significantly compared to the first quarter. Stock issuance also declined as the effects of some large-scale IPOs conducted in the first quarter dissipated.

Changes in household loans[1)2)]

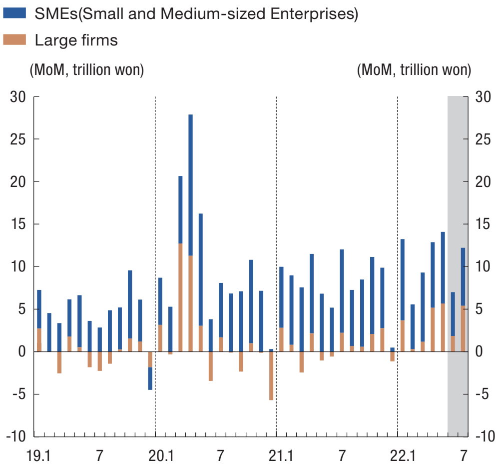


Notes: 1) Including mortgage transfers

2) Figures for July 2022 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)]



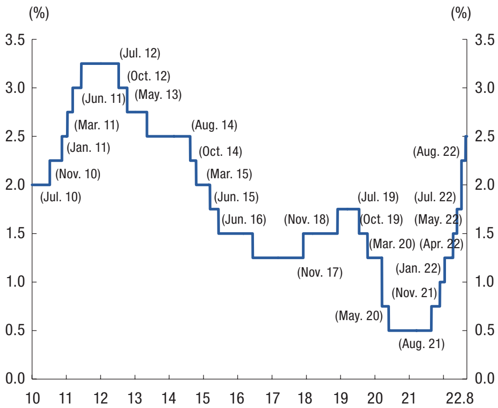
Note: 1) Based on banks

Source: Bank of Korea.

[Conduct of Monetary Policy]

6 The Bank of Korea conducted monetary policy in order to stabilize consumer price inflation at the target level (2%) over a medium-term horizon as it monitored economic growth, while paying attention to financial stability. In this process, it thoroughly assessed the degree of persistence of high inflation, the trend of growth, financial stability conditions such as capital flows, monetary policy changes in major economies and geopolitical risks. Under this policy stance, the Bank of Korea raised the Base Rate by 50 basis points in July and by 25 basis points in August (1.75% → 2.25% → 2.50%).

Bank of Korea Base Rate[1)]



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

Source: Bank of Korea.

A detailed look at the background of the Base Rate decisions during this period is as follows. At the July meeting, the Board raised the Base Rate by 50 basis points from 1.75% to 2.25%, judging that a preemptive policy response to prevent the entrenchment of high inflation was important at a time when inflation had risen significantly and become broad-based, while short-term inflation expectations were rising sharply. In particular, the Bank of Korea decided on its first 50bp rate hike in the Bank's history, judging that a faster rate hike was unavoidable, considering that failure to make a timely policy response would result in strengthened interaction between prices and wages and the prolonging of high inflation, which would make a stronger response necessary later. Despite worsening external conditions, the Korean economy had continued to recover until the first half of this year as originally expected. While export growth had somewhat slowed, private consumption had improved led by face-to-face services, and sluggishness in facilities investment had partially eased. However, GDP growth was projected to be below the May forecast, affected by the slowdown in exports owing to the weakening of economic growth in major economies. Uncertainties surrounding the economic outlook were also judged to be elevated. Concerning inflation, consumer price inflation had risen greatly to 6% in June due to the ongoing sharp rise in the prices of petroleum products and the accelerating price increases in other expenditure categories. Core inflation and the inflation expectations of the general public had increased to close to 4%. Going forward, it was forecast that consumer prices would remain high at above 6% for some time and run substantially above the May forecast of 4.5% for the year overall. Looking at financial stability, household loans continued a slight upward trend, led mainly by mortgage loans such as loans for leasehold (*jeonse*) deposits and group loans while housing prices remained steady.

At the August meeting, the Board decided to raise the Base Rate by 25 basis points, from 2.25% to 2.50%. The Board saw that the policy response to ensure price stability should be continued as inflationary pressures and inflation expectations remained high, although economic downside risks had increased at home and abroad. Concerning the size of the hike, the Board judged that a gradual increase of 25 basis points, as suggested at the previous month's meeting, was appropriate since current economic conditions were not far from the Board's July projections for inflation and growth. GDP growth was projected to record 2.6% in 2022 and 2.1% in 2023, below the May forecast of 2.7% in 2022 and 2.4% in 2023, respectively, as export growth was expected to slow gradually, affected by the global economic slowdown, despite continued recovery in consumption. Consumer price inflation remained high in the 6% range due to the accelerating price increases in agricultural and personal services, although increases in the prices of petroleum products had somewhat moderated. Core inflation and inflation expectations remained high, in the upper 3% the 4% level respectively. Consumer price inflation was forecast to remain elevated in the 5-6% range for a considerable time, as core inflation continues to rise. Consumer price inflation was projected to be 5.2% in 2022 and 3.7% in 2023, far above the May forecast of 4.5% in 2022 and 2.9% in 2023. Looking at financial stability, household loans had decreased slightly, as the sustained net redemption of unsecured loans more than offset a rise in housing-related lending. Housing prices had shifted to a decrease since June.

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

With regard to the Bank Intermediated Lending Support Facility, the Bank of Korea decided not to further extend the temporary financial support measures for enterprises and small businesses hit by COVID-19, which had been scheduled to expire at the end of September this year, considering that small and self-employed businesses had resumed their normal operations after the lifting of social distancing measures in April, and that an exit from emergency support measures taken during the COVID-19 crisis was needed. However, even though temporary financial support measures are ending, the Bank plans to maintain its support for existing loans until their maturities (up to 1 year), and keep the interest rate on such loans at its current low level (0.25%) regardless of future Base Rate changes.

Programs under the Bank Intermediated Lending Support Facility

(trillion won, %)

<table>
<tr><th colspan="2" rowspan="2">Programs</th><th rowspan="2">Ceiling</th><th colspan="3">Interest rate</th></tr>
<tr><th>Before</th><th>1st Adjustment[1]</th><th>2nd Adjustment[2]</th></tr>
<tr><td colspan="2">Support Program for Trade Financing</td><td>1.5</td><td>0.75</td><td>1.00</td><td>1.25</td></tr>
<tr><td colspan="2">Support Program for New Growth Engine Development and Job Creation</td><td>13.0</td><td>0.75</td><td>1.00</td><td>1.25</td></tr>
<tr><td colspan="2">Program for Stabilization of SME Lending</td><td>0.3</td><td>0.75</td><td>1.00</td><td>1.25</td></tr>
<tr><td colspan="2">Support Program for Regional SMEs</td><td>5.9</td><td>0.75</td><td>1.00</td><td>1.25</td></tr>
<tr><td rowspan="2">Ceiling Reserves</td><td>Support Program for SMEs Affected by COVID-19</td><td>13.0</td><td>0.25</td><td>0.25</td><td>0.25</td></tr>
<tr><td>Support Program for Small Businesses</td><td>6.0</td><td>0.25</td><td>0.25</td><td>0.25</td></tr>
<tr><td colspan="2">Total</td><td>39.8[3]</td><td>-</td><td>-</td><td>-</td></tr>
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Notes: 1) Effective as of July 13, 2022
2) Effective as of August 25, 2022
3) Includes 0.1 trillion won Ceiling Reserves(Others)
Source: Bank of Korea.

Meanwhile, as spreading concerns about global inflation resulted in surging domestic bond yields and dampened bond investment sentiment, the Bank of Korea reduced the volume of its planned issuance of Monetary Stabilization Bonds (MSBs) by 1.5 trillion won in June to revive investment sentiment in the bond market and ease bond yield volatility.

To minimize the possible increase in bond market volatility stemming from the implementation of Relief Conversion Loans and increased issuance of mortgage-backed securities (MBSs), the Bank decided to include MBSs issued by Korea Housing Finance Corporation, which had only been eligible for RP transactions, as securities eligible for outright transactions.

8 The Bank of Korea continuously monitored movements in the financial and FX markets at home and abroad. It has also looked closely into the evolution of domestic and global risk factors as well as their impacts on financial and FX markets in the event of increased market volatility by activating an emergency financial market monitoring and response system. More specifically, the Bank held an Emergency Market Conditions Review Meeting (June 14) in response to increased global financial market volatility following the announcement of the US price indicators that exceeded market expectations. The Bank also held Market Conditions Review Meetings (on June 16 and July 28) to discuss the domestic and global financial market responses to and impacts from the results of FOMC meetings.

In addition, at its Financial Stability Meeting, the Bank of Korea conducted an intensive monitoring of the possibility of the financial system becoming unstable due to changes in conditions, such as increased inflationary pressures at home and abroad, accelerated policy rate hikes in major economies, and continued geopolitical risks, amid accumulated financial imbalances.

[Future Monetary Policy Directions]

9 The Korean economy is expected to see its growth trend weaken, as the sluggishness in exports deepens affected by the global economic slowdown in line with a prolonged Ukraine crisis and interest rate hikes in major economies. Accordingly, the GDP growth rate is projected to be around 2.6% in 2022 and 2.1% in 2023.

Private consumption is projected to continue its modest recovery trend, supported by improved income conditions and the continued return to normal life after the lifting of COVID-19 restrictions. Recovery of facilities investment is expected to be delayed, caused by the global economic slowdown and increased cost of funding. Construction investment is forecast to continue growing moderately. Growth in exports is projected to slow further as negative impacts from slowdowns in major economies, such as China and the US, are extended.

There are high uncertainties surrounding the growth outlook path. The upside risks to growth include an early easing of geopolitical tension, strengthened momentum in consumption recovery, and expansion of China's economic stimulus measures. Among the downside risks are an acceleration of interest rate hikes in major economies, a prolonged Ukraine crisis, and sustained zero-COVID policy in China.

Economic growth outlook[1)]

(YoY, %)

	2021[2)]	2022[e]			2023[e]		
	Year	H1[2)]	H2	Year	H1	H2	Year
GDP	4.1	3.0	2.4	2.6	1.7	2.4	2.1
Private consumption	3.7	4.1	3.8	4.0	3.1	2.1	2.6
Facilities investment	9.0	-6.4	-0.2	-3.8	3.1	-1.4	0.9
Intellectual property products investment	4.4	4.6	3.6	4.0	3.2	3.7	3.5
Construction investment	-1.6	-4.5	1.0	-1.5	3.3	1.3	2.2
Goods exports	10.5	6.0	0.8	3.2	-1.5	4.6	1.6
Goods imports	12.8	5.3	0.6	2.9	0.9	3.2	2.1

Notes: 1) Figures are the forecast as of August 2022.
2) Reflects preliminary figures.
Source: Bank of Korea.

Consumer price inflation is expected to record 5.2% in 2022, which is far above the May forecast (4.5%), due to rising demand-side pressures following the lifting of social distancing measures and to increasing prices of agricultural products. Core inflation for items other than food and energy is also forecast to stand at 3.6%, exceeding the May forecast (3.2%), as price inflation in personal services such as dining-out is steadily rising. Meanwhile, consumer price inflation and core inflation in 2023 are projected to record the mid- to upper-3% level and lower- 3% level, respectively.

On the future inflation outlook path, there are both upside and downside risks. The upside risks include the possibility of a rebound in global oil prices, worsening weather conditions, sustained global supply chain disruptions, and continued US dollar strength. Among the downside risks are materialization of a global economic recession, a slower recovery of the domestic economy, improvement in commodity supply and demand conditions, and the curbing of rises in public utility charges.

Inflation outlook[1)]

(YoY, %)

		2021	2022e			2023e		
		Year	H1	H2	Year	H1	H2	Year
CPI inflation		2.5	4.6	5.9	5.2	4.6	2.9	3.7
Core inflation	CPI excluding food & energy	1.4	3.1	4.1	3.6	3.7	2.5	3.1
	CPI excluding agricultural products & oil	1.8	3.6	4.6	4.1	4.3	3.0	3.6

Note: 1) Figures are the forecast as of August 2022.
Source: Bank of Korea.

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

The Bank of Korea sees it as warranted to maintain its stance of Base Rate hikes for the time being, as inflation is expected to remain high, substantially above the target level, despite an increase in economic downside risks and underlying high uncertainties surrounding domestic and external conditions. In this process, the Bank will determine the size and pace of further increases of the Base Rate while thoroughly assessing the degree of persistence of high inflation, the pace of growth, financial stability conditions such as capital flows, monetary policy changes in major economies and geopolitical risks.