

Monetary Policy Report

February 2018



Monetary Policy Report

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The Bank of Korea sets and implements its monetary and credit policy in order to contribute to the sound development of national economy by pursuing price stability and paying attention to financial stability.

The Bank of Korea Act stipulates that the Bank of Korea, to fulfill its accountability corresponding to these mandates, should compile at least twice each year a report on the implementation of its monetary and credit policies.

In line with this the Bank of Korea prepares the Monetary Policy Report, containing the details of and backgrounds to its monetary policy decisions, the future monetary policy directions, etc., four times per year, and submits it to the National Assembly.

This February 2018 Monetary Policy Report has been drawn up to cover the time period from after the Monetary Policy Board meeting for monetary policy decision-making in October 2017 through the date of the Monetary Policy Board meeting for monetary policy decision-making in January 2018.

We sincerely hope that this Monetary Policy Report will be of help in ensuring that the public well understands the Bank of Korea's monetary policy operations, and forms rational expectations concerning the future policy directions.

<Bank of Korea Act>

Article 96 (Reporting to National Assembly)

- (1) The Bank of Korea shall prepare an assessment report on progress in implementing monetary and credit policies and macro-financial stability conditions at least twice every year and submit it to the National Assembly.
- (2) The Governor shall attend a meeting and answer questions, when the National Assembly or any of its committees requests him/her to attend the meeting in connection with the report submitted pursuant to paragraph (1).

This Monetary Policy Report is published in accordance with the provision of Article 96 of the Bank of Korea Act, and upon the resolution of the Monetary Policy Board.

February 2018



Lee, Juyeol
Governor
the Bank of Korea

Monetary Policy Board

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General Principles of Monetary Policy Operation

The Bank of Korea Act stipulates the goal of monetary policy as follows: “The Bank shall contribute to the sound development of the national economy through ensuring price stability, while giving due consideration to financial stability in carrying out its monetary policy.” In order to enhance transparency, predictability and effectiveness of monetary policy, the Bank will carry out its task by setting specific targets and objectives in accordance with this goal.

□ **(Inflation targeting)** The Bank of Korea maintains a flexible inflation targeting system to effectively achieve price stability, which is the primary objective of monetary policy. The inflation target is currently set at 2.0% in terms of consumer price inflation (year-on-year).

○ **(Medium-term horizon)** The inflation target is meant to be achieved over a medium-term horizon, since consumer price inflation is affected not only by monetary policy but also by various other factors at home and abroad, which entail transitory and irregular impacts and the lag in monetary policy transmission.

○ **(Forward-looking operation)** The Bank conducts its monetary policy in a forward-looking manner, while considering symmetrically the risks of inflation remaining persistently above or below the target.

- The path of convergence of inflation toward the target is assessed on overall inflation and growth outlooks as well as their uncertainties and risks, and on financial stability conditions.

○ **(Flexible operation)** The Bank conducts its monetary policy to support real economic growth to the extent that this does not hinder attaining the inflation target over the medium-term.

□ **(Consideration of financial stability)** In ensuring price stability over the medium-term, the Bank pays careful attention to the impact of monetary policy on financial stability.

○ **(Relationship with inflation targeting)** As persistent financial imbalance could undermine macroeconomic stability, paying due attention to financial stability in conducting monetary policy is consistent with the rationale behind flexible inflation targeting.

○ **(Examination of financial stability)** The Bank examines, assesses and announces financial stability conditions on a regular basis, to prevent excessive buildup of financial imbalances that may be brought about by monetary policy implementation.

○ **(Harmonization with macroprudential policy)** Since there are limits to maintaining financial stability solely by monetary policy that indiscretely affects the whole economy, monetary policy needs to be complemented by macroprudential policies to prevent accumulation of financial imbalance.

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■ Executive Summary

[Monetary Policy Operating Conditions]

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

Economic growth in major economies¹⁾

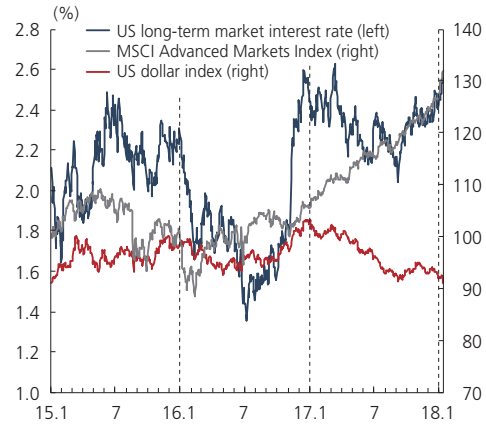
	2014	2015	2016		2017		
			Year	Q4	Q1	Q2	Q3
US	2.6	2.9	1.5	1.8	1.2	3.1	3.2
Euro area	1.3	2.1	1.8	2.6	2.5	2.8	2.4
Japan	0.4	1.4	0.9	1.4	1.5	2.9	2.5
China	7.3	6.9	6.7	6.8	6.9	6.9	6.8

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

Sources: Individual countries' published statistics.

In the international financial markets, long-term market interest rates in major countries rose owing to their economies' continued steady growth and to increased expectations of monetary policy normalization. Stock prices sustained high rates of increase, especially in advanced countries, due to the accelerating growth in major countries and to increases in corporate earnings. The US dollar fluctuated amid the co-existence of factors causing it to strengthen and those making it weaker.

US long-term market interest rate¹⁾, stock prices²⁾ in advanced countries and US dollar index³⁾



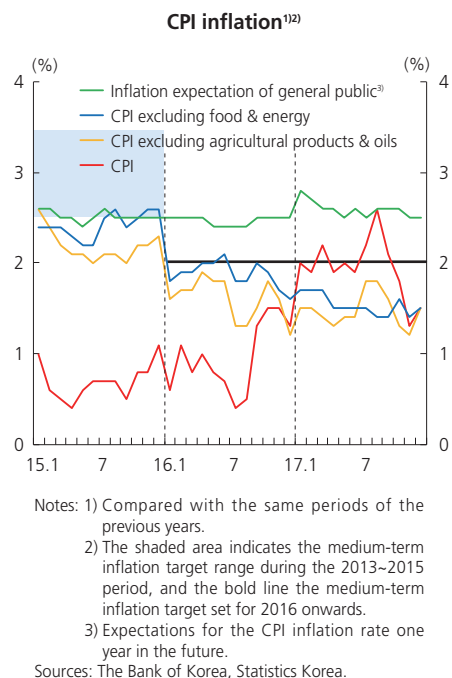
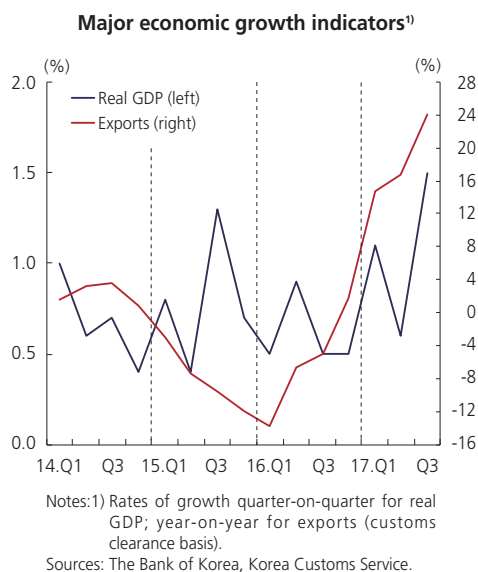
Notes: 1) Treasury bond (10-year) yields.

2) January 1, 2014=100

3) The measure of the value of the US dollar relative to a basket of foreign currencies (EUR, JPY, GBP, CAD, SEK, CHF); March 1973=100.

Source: Bloomberg.

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



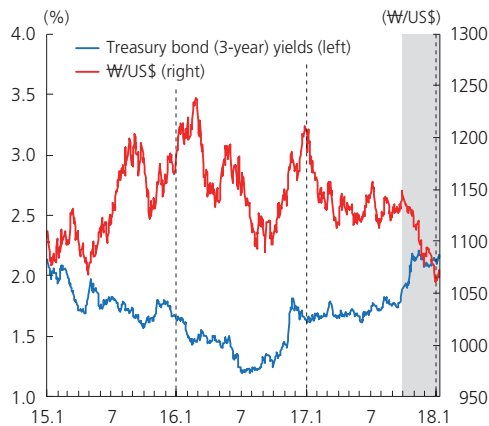
3 Domestic consumer price inflation fell considerably, on the effects of declines in agricultural product prices and cuts in city gas fees, and recorded a rate in the mid-1% range during the fourth quarter of last year. The inflation expectations of the general public were in the mid-2% range, and core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

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

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

profit-taking, before then expanding once more entering this year driven mainly by investment in stocks.

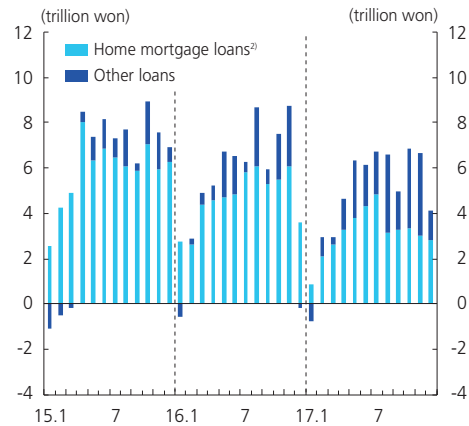
Korean Treasury bond yield and exchange rate (KRW/USD)



Sources: The Bank of Korea, KOPIA.

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

Changes in banks' household loans¹⁾



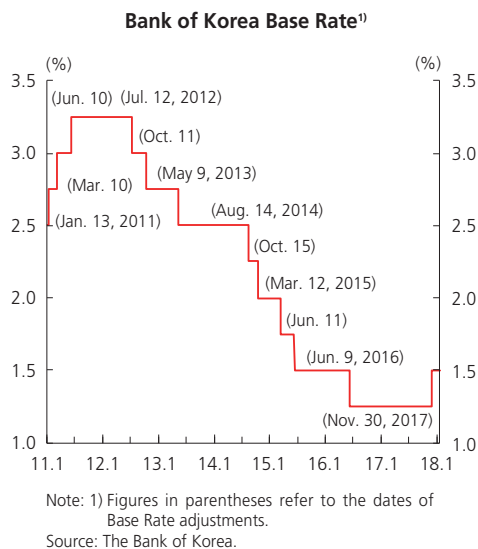
Notes: 1) Compared with the previous months.

2) Including mortgage transfers.

Source: The Bank of Korea.

[Conduct of Monetary Policy]

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



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

In November 2017 the Bank of Korea raised the Base Rate, which it had maintained at 1.25% per annum since June 2016, by 0.25% points to an annual rate of 1.50%. This decision was made because the Bank judged that, as the domestic economy was sustaining its steady pace of growth at its potential level and consumer price inflation was also expected to gradually approach the target level, there was a need to adjust the degree of monetary policy accommodation that had been heightened in response to the low growth and inflation until that time. It was judged first of all that the domestic economy had continued its sound growth, as consumption was improving moderately and investment also showing favorable movements amid an ongoing high rate of increase in exports. Moreover, the Bank saw domestic demand-related activities such as con-

sumption and facilities investment as likely to continue to improve modestly going forward as well, and exports to also sustain their buoyancy due to a pick-up in the global economic recovery and an improvement in trading conditions vis-à-vis China. In line with this it was expected that future growth would be above the path forecast in October, and that the pace of growth at around its potential level would continue. Consumer price inflation had slowed slightly, to the upper 1% range, owing to a decline in the extent of increase in the prices of agriculture, livestock and marine products and to the subsiding of the base effect of the cuts in electricity fees the year before. However, it was forecast to gradually approach the target level as the economy recovered. Core inflation was seen as likely to continue at a level in the mid-1% range for some time, before then rising moderately from 2018. The pace of increase in household lending had slowed somewhat, but the level of household loans was still higher than in normal years. Under these circumstances it was judged that the risk of a build-up of financial imbalances could grow even more if the degree of monetary policy accommodation were not adjusted appropriately in accord with the economic recovery.

In the January 2018 Monetary Policy Board meeting the Base Rate was maintained at 1.50% per annum. This decision was made in comprehensive consideration of several points. First, it was deemed necessary to monitor the developments and influences of the domestic and external uncertainties that still remained, even though the domestic economy was expected to continue

its solid growth. The upward demand-side pressures on prices were meanwhile forecast to be not large for the time being, and there was also a need to observe a little further the effects on the economy and the financial markets of the Base Rate hike in November last year. With regard to the domestic economy it was judged that investment, which had shown a high rate of increase to that time, would slow, but that the solid growth would continue as consumption would steadily increase and the buoyancy of exports would also continue. In line with this it was expected that the domestic economy would show a pace of growth at the 3% level during this year as well. The rate of consumer price inflation had fallen to the mid-1% range, influenced by a reduction in city gas fees, and was forecast to show the low- to mid-1% level for the time being before gradually rising from the second half. The core inflation rate, indicative of the underlying price movements, was seen as likely to rise moderately. The extent of household lending growth had been lessening recently, but the total volume of household debt was already high and the pace of its increase was also still more rapid than the rate of income growth. It was thus judged, from the financial stability perspective, that a close observation of household debt was necessary.

⑧ The Bank of Korea continued its efforts for financial and foreign exchange market stability in response to changes in conditions at home and abroad. When North Korea launched an intercontinental ballistic missile in November of last year, and when the US Federal Reserve raised its policy rate in

December, the Bank convened meetings of its 「Monetary and Financial Task Force」 and examined the effects of these events on in- and outflows of foreign investors' funds and on the financial and foreign exchange markets, while strengthening its communication by making clear its determination to keep the markets stable, so as to ensure that market anxieties did not spread excessively. When bond investment sentiment contracted in October, as market rates rose greatly on the heightened likelihood of a Base Rate hike within the year, the Bank adjusted the volume of its Monetary Stabilization Bond issuance flexibly to ensure that market interest rate volatility did not expand.

The Bank devoted steady efforts to the preemptive identification of potential risk factors within the financial system, and to the presentation of early warnings. In the December issue of its 「Financial Stability Report」 it thoroughly assessed the financial system's vulnerabilities by sector, and examined the system's resilience to any shocks at home or abroad as well as the Korean economy's external payment capacities. To respond to the possibility of financial stability weakening due to the build-up in household debt, the Bank strengthened its monitoring of household debt through meetings of its 「Household Debt Task Force」, while also attending the meetings of the 「Consultative Group for Managing Household Debt」 and the 「Macroeconomic Finance Meeting」, where it shared its perspectives on the household debt problem with the government and the supervisory authorities, and contributed to the drawing up of the government's household debt measures(October 2017).

[Future Monetary Policy Directions]

⑨ According to the Bank of Korea's 「Economic Outlook Report」 released on January 18, the domestic economy is foreseen showing a rate of growth at the 3% level during this year. Investment will slow but it is expected that consumption will continue its steady growth, driven by improvements in household income conditions, and that exports will also sustain their favorable flows in line with the buoyancy of the world economy. The domestic economy is expected to continue to grow at the potential growth rate level in 2019 as well, as the growth in exports and consumption continue. Concerning the future path of growth, there is a mix of upside and downside risks. The former include those of accelerating growth in exports and facilities investment in line with a strengthening of the global economic recovery, of a pick-up in the pace of export growth due to a more rapid improvement in trading conditions vis-à-vis China, and of strengthening economic sentiments stemming from the government's implementation of economic stimulus measures and from the easing of North Korea risk. Among the downside risks, meanwhile, are a worsening of the trading environment due to the spread of protectionism, a deterioration in financial conditions in consequence of the monetary policy normalizations in major countries, and a weakening recovery of domestic demand due to an inadequate improvement in employment conditions.

Economic growth outlook¹⁾

(%)

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

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

It is forecast that consumer prices will rise by 1.7% this year, and their pace of increase in 2019 is expected to be higher than that. The upside and downside risks to the future path of inflation are mixed, and the uncertainties surrounding the price outlook have risen significantly, due to the recent sharp movements of international oil prices and the won/dollar exchange rate and to the large hike in the minimum wage. Among the major upside risks to the inflation path going forward are those of a strengthening of the domestic economy's recovery in line with the global economic improvements, and of an accelerated pace of increase in service charges due to the minimum wage hike. The potential downside risks include a weakening of international oil prices owing to a rise in US shale oil production, and a drop in import prices due to the appreciation of the Korean won.

Inflation outlook¹⁾

(%)

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

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

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

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

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

Various core inflation indicators, indicative of the underlying price movements, remain at slightly under 2% (with regulated prices excluded). In this situation it is forecast that the upward price pressures due to the higher oil price level, and the continuous improvements in the domestic and international economies could cause the upward

pressures on underlying prices to grow in the future. It is forecast that going forward consumer prices will show a somewhat low pace of increase for the time being, due to the base effects of the supply-side price increases at the beginning of last year, but then gradually rise moving into the second half. It appears likely, however, that the apparently weakened relationship between the economic cycle and prices could restrain the upward price trend. Considering that the uncertainties about the future path of inflation have grown to a considerable extent recently, owing to the sharp movements of oil prices and the won/dollar exchange rate, there is a need for close monitoring of the effects that these factors have on prices.

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

① In the future as well, the Bank of Korea will conduct its monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation can be stabilized at the target level over a medium-term horizon, while also devoting attention to financial stability.

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

In addition, given the still high uncertainties about the domestic and external conditions surrounding the Korean economy, the Bank will in operating its monetary policy also devote care to the risks on the financial stability side. It will strengthen its examinations of developments in domestic and external conditions that can cause financial market volatility to rise, such as the paces of monetary policy normalization in major countries including the US, along with geopolitical risks, and closely monitor the

in- and outflows of foreign capital. Together with this the Bank will devote attention as well to the possibility of its prolonged accommodative policy stance causing the build-up in household debt and other financial imbalances to deepen, and the effects on growth and inflation that this build-up of imbalances will have in the medium to long term going forward.

I

Monetary Policy Operating Conditions

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1. Global Economy

Global Economy Continues to Improve

The global economy has continued to improve. The United States has shown a solid pace of growth, driven by domestic demand. Consumption has increased steadily, thanks to improvements in employment conditions, and facilities investment has also expanded to a large extent in line with the buoyancy of business performances and improvements in investment sentiment. The euro area has shown a more robust recovery than expected, as employment conditions and consumption sentiment have improved. Despite sluggishness in private consumption Japan has continued to grow at a pace exceeding its potential growth rate, led by exports and facilities investment. Growth in China has slowed somewhat, affected by its environmental protection policies, but the economy has maintained stable growth as the market has expected. The ASEAN-5 countries have sustained satisfactory growth, as exports and domestic demand have been sound, while Brazil and Russia have continued their recoveries led by exports and private consumption.

<Table I - 1> Economic growth in major economies¹⁾

(%)

	2014	2015	2016 ²⁾		2017 ²⁾	
			Year	Q4	Q1	Q2
World	3.6	3.4	3.2	-	-	-
Advanced economies	2.1	2.2	1.7	-	-	-
US	2.6	2.9	1.5	1.8	1.2	3.1
Euro area	1.3	2.1	1.8	2.6	2.5	2.8
Japan	0.4	1.4	0.9	1.4	1.5	2.9
Emerging market and developing economies	4.7	4.3	4.3	-	-	-
China	7.3	6.9	6.7	6.8	6.9	6.8
India ³⁾	7.5	8.0	7.1	7.0	6.1	5.7
ASEAN-5 ⁴⁾	4.6	4.9	4.9	4.9	5.0	5.3
Brazil	0.5	-3.5	-3.5	-2.5	0.0	0.4
Russia	0.7	-2.8	-0.2	0.3	0.5	2.5

Notes: 1) Based on IMF statistics, apart from individual countries and the euro area which are based on their own published statistics.

2) The rates of growth are annualized quarter-on-quarter rates for advanced economies, and year-on-year rates for the others.

3) The annual growth rates are based on the fiscal year (April of the current year to March of the next year).

4) Indonesia, Thailand, Malaysia, the Philippines, and Vietnam.

Sources: IMF, Individual countries' published statistics.

International Oil Prices Rise to Mid-60 US Dollars per Barrel Level

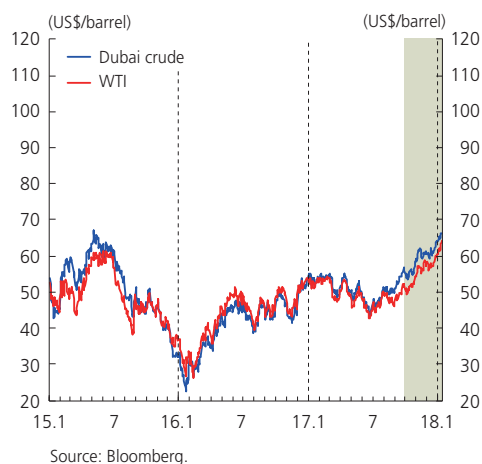
International oil prices had continued to increase from October of last year, as political instabilities in the Middle East had expanded owing to the conflict over Kurdish independence in Iraq¹⁾ and to the United States government's statement that Iran was not complying with its nuclear accord responsibilities.²⁾ Subsequently prices did also temporarily decline, on the possibility of an increase in shale oil production, but entering December they rose to the mid-60 US dollars to the barrel level owing to additional factors such as the re-extension of the period

1) In line with the deepening strife between the Kurds and the federal government of Iraq after the vote for Kurdish independence (September 2017), snags occurred in crude oil production in the oil fields in the Kurdish parts of the country.

2) In October last year the US government announced Iran's non-compliance with its obligations under the nuclear accord, and until the middle of December there were demands in Congress for a decision on whether to resume sanctions against Iran.

of oil production cuts³⁾, suspensions of oil pipeline operations in the North Sea region and Libya, and a drop in US crude oil inventories.

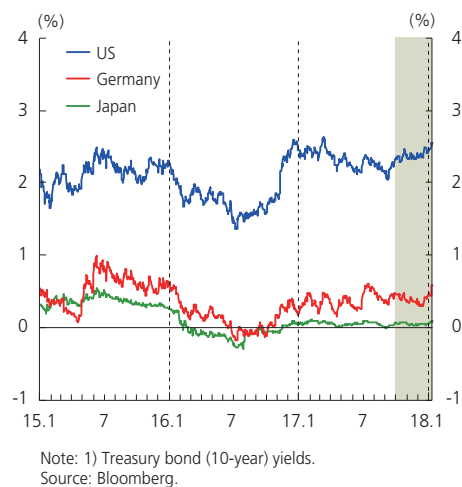
<Figure I - 1> International oil prices



Major Country Long-term Market Interest Rates Rise

Government bond yields in advanced countries have risen, in line with the continuing solid growth in major countries and with spreading expectations of their normalizations of monetary policy. In particular, the extents of increase in yields have widened in the US due to the policy rate hike by the Federal Reserve and to expectations of economic improvements following the passage of the tax reform bill, and in Germany owing to the buoyancy of economic indicators.

<Figure I - 2> Long-term market interest rates¹⁾ in major economies



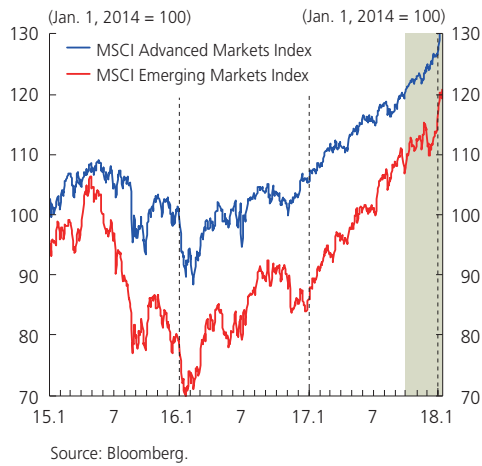
Upward Trend in Global Stock Prices Continues

Stock prices in advanced countries have shown large increases, in line with the accelerating economic growth and rising corporate profits in major countries, and with the passage of the US tax reform bill. Stock prices in emerging market countries have continued their upward trends based on economic recoveries, but the extents of their increases have been limited due to concerns about contractions in liquidity in line with the rate hikes by the US Federal Reserve, and to China's announcement of regulations on asset management products.⁴⁾

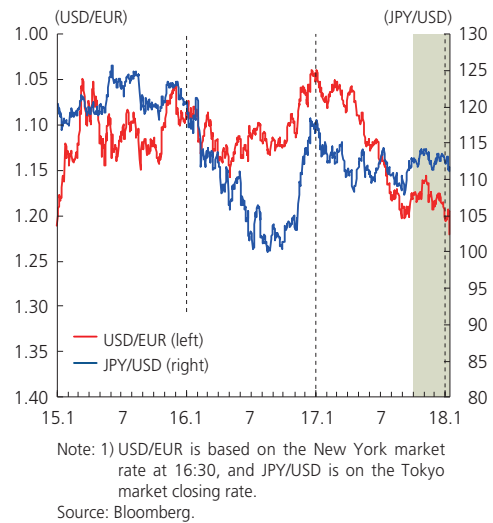
3) At the Meeting of the Conference of OPEC in November of last year, OPEC countries reached an agreement with 10 non-OPEC oil-producing countries including Russia and Mexico to extend the term of the agreement on production cuts until the end of December this year, from the end of March previously.

4) In November 2017 the People's Bank of China, together with other financial supervisory institutions, announced measures to comprehensively regulate the asset management businesses of banks and non-bank financial institutions.

<Figure I - 3> Share price indices of advanced and emerging markets



<Figure I - 4> Major exchange rates¹⁾



US Dollar Shows Repeated Strengthening and Weakening

The US dollar strengthened until November, affected by the Bank of Japan's continuing stance of monetary accommodation and by the Catalan independence movement in Spain. Since then it has been fluctuating, in line with a mix of factors causing it to strengthen such as the passage of the US tax reform bill, and factors causing it to weaken including the more accommodative than expected results of the FOMC meeting (December 2017).

2. Real Economy

Domestic Economy Continues to Improve

The domestic economy has continued its improvements, due to buoyancy in exports and facilities investment. During the third quarter of 2017 the real GDP growth rate (quarter-on-quarter) was 1.5%, its highest figure since the second quarter of 2010 (1.7%). In the fourth quarter the trend of growth underwent a slight adjustment, however, influenced by the base effect from the high growth during the previous quarter and by irregular factors including the lengthy Korean Thanksgiving holidays.

Private consumption continued its gradual expansion. It increased by 0.8⁰% quarter-on-quarter in the third quarter of last year – due to a hike in fiscal expenditures in line with the government’s supplementary budget execution, and to advance demand ahead of the long vacation at the beginning of October. Entering the fourth quarter private consumption continued its gradual recovery, affected by factors such as the ongoing robust consumption sentiment and the launches of new mobile phone products.⁵⁾ The extent of growth in government consumption meanwhile declined. It did rise by

2.3% quarter-on-quarter in the third quarter, as the number of jobs in the social services area increased in line with the government’s supplementary budget execution⁶⁾, and as material costs and health insurance payouts increased. But in the fourth quarter its pace of increase slowed, owing to a reduction in expenditure capacity⁷⁾ after the increase in the rate of fiscal execution in the previous quarter.⁸⁾ Facilities investment continued its higher rate of growth than in the previous year, but underwent a slight adjustment quarter-on-quarter on the effects of the large increase in the first half. During the third quarter investment in transport equipment, and especially in automobiles, contracted greatly to register a mere 0.7% quarter-on-quarter increase, and in the fourth quarter it reversed to a decline.⁹⁾ The slowdown in construction investment continued. During the third quarter construction investment grew by 1.5% quarter-on-quarter as building construction increased and as the extent of decline in civil engineering lessened thanks to the government’s execution of its SOC budget. Entering the fourth quarter it reversed to a decline, however, as the effects of the reduction in building commencements since 2016 reached full scale and the quantity of apartment constructions declined recently.¹⁰⁾

5) During the October to November 2017 period Statistics Korea’s sales index by retail business type rose by 1.6% compared to the third quarter (+3.2% year-on-year), while its index of services maintained its previous quarter’s level (+1.9% year-on-year).

6) The government in July 2017 drew up a supplementary budget, amounting to 11 trillion won (0.7% of nominal GDP in 2016), for purposes including the creation of jobs.

7) The central government’s spending on goods and services increased by 8.0% (year-on-year) in the third quarter of 2017, but entering October it declined to a large extent (-22.9%).

8) During the third quarter of 2017 the rate of execution of the central government’s consolidated fiscal expenditures on goods and services recorded 69.3%, to greatly exceed the rates during the same periods of the preceding three years (65.9% in 2014, 65.5% in 2015, 67.3% in 2016).

9) During October and November Statistics Korea’s index of estimated equipment investment fell by 7.6% compared to the third quarter (+1.4% year-on-year).

10) During the October through November period Statistics Korea’s value of construction completed declined by 2.6% compared to the third quarter (-1.4% year-on-year).

<Table I - 2> Major economic growth indicators¹⁾

	2015	2016		2017		
		Year	Q4	Q1	Q2	Q3
Real GDP	2.8	2.8	0.5 (2.4)	1.1 (2.9)	0.6 (2.7)	1.5 (3.8)
(Private consumption)	2.2	2.5	0.2 (1.5)	0.4 (2.0)	1.0 (2.3)	0.8 (2.5)
(Government consumption)	3.0	4.3	0.6 (3.6)	0.5 (2.7)	1.1 (3.2)	2.3 (4.6)
(Facilities investment)	4.7	-2.3	5.9 (2.0)	4.4 (14.4)	5.2 (17.3)	0.7 (17.0)
(Construction investment)	6.6	10.7	-1.2 (11.6)	6.8 (11.3)	0.3 (8.0)	1.5 (7.6)
(Intellectual property products investment)	1.8	2.3	0.6 (2.6)	0.3 (2.7)	1.2 (2.6)	1.1 (3.2)
(Goods exports)	-0.6	2.2	0.4 (2.1)	2.8 (6.6)	-2.7 (2.0)	5.9 (6.3)
(Goods imports)	0.7	3.6	1.3 (3.7)	4.1 (10.9)	-0.7 (7.8)	4.1 (9.0)

Note: 1) Compared with the previous periods; figures in parentheses are non-seasonally adjusted year-on-year rates.

Source: The Bank of Korea.

Pace of Increase in Persons Employed Slows

The number of persons employed grew by just 279 and 262 thousand persons respectively in the third and the fourth quarters, affected by a decline in foreign tourists and by worsening weather conditions¹¹⁾ during the third quarter, and by the long vacation at the beginning of October in the fourth quarter. The unemployment rate meanwhile fell slightly during the same period, from 3.7% to 3.6%.¹²⁾

<Table I - 3> Major employment-related indicators

	2016		2017				
	Year	Q4	Year	Q1	Q2	Q3	Q4
Economically active population	27.3	27.3	27.6	27.1	27.8	27.8	27.6
(Rate of change ¹⁾)	1.2	1.3	1.2	1.4	1.5	0.9	1.0
Number of employed persons	26.2	26.5	26.6	25.9	26.8	26.8	26.7
(Change ¹⁾)	0.3	0.3	0.3	0.4	0.4	0.3	0.3
Labor force participation rate ²⁾	62.8	62.9	63.0	63.2	63.0	63.0	63.1
Employment-population ratio ²⁾	60.4	60.6	60.7	60.8	60.6	60.6	60.8
Unemployment rate ²⁾	3.7	3.6	3.7	3.8	3.8	3.7	3.6

Notes: 1) Compared with the same periods of the previous years.

2) Seasonally adjusted.

Source: Statistics Korea.

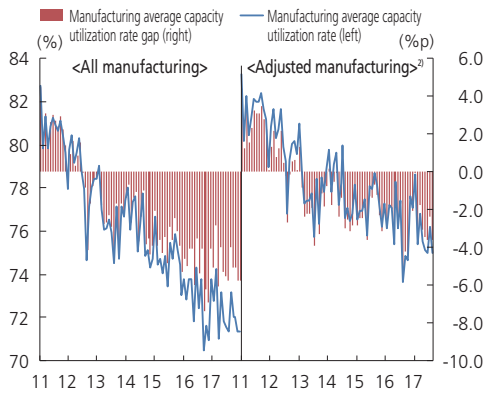
Idle Production Capacity Persists

The substantial negative average capacity utilization rate gap in manufacturing has persisted. In view of this it is assessed that the idle production capacity in the Korean economy remains. However, certain levels of idle production capacity are inevitable in some industries, given their industrial natures, and when this is adjusted for the extent of negativity of the manufacturing capacity utilization rate gap appears relatively small.

11) During July and August the average number of days of rain nationwide was 32.7, up by 10.7 days from the 22 days during the same period of the previous year.

12) However, Statistics Korea's 'Labor Underutilization Indicator 3 [(Time-related underemployed persons + Unemployed persons + Potential labor force) ÷ Extended labor force × 100],' which can be seen as a broader unemployment rate index, stood at 10.5% in the fourth quarter of last year, slightly higher than it was in the fourth quarter the year before (10.1%).

<Figure I - 5> Manufacturing industry average capacity utilization rate gap¹⁾



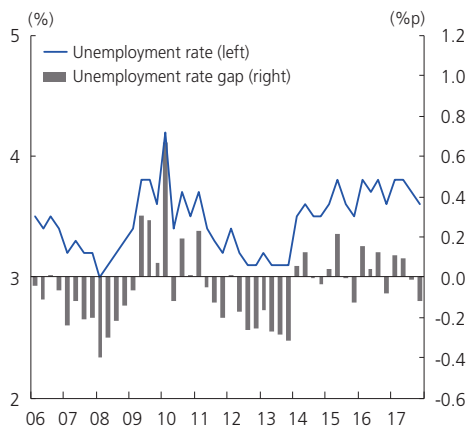
Notes: 1) (Capacity utilization rate - Average capacity utilization during previous 10 years); a figure below 0 indicates the existence of idle production capacity.

2) With electronic products (displays) and communication devices (smartphones) excluded.

Source: Statistics Korea.

The unemployment rate gap has been fluctuating within a narrow range, as the unemployment rate has not diverged greatly from the non-accelerating inflation rate of unemployment (NAIRU).

<Figure I - 6> Unemployment rate gap¹⁾



Note: 1) Unemployment rate (seasonally adjusted) - Non-accelerating inflation rate of unemployment (NAIRU, estimated by Bank of Korea).

Sources: Bank of Korea estimates, Statistics Korea.

Current Account Surplus Maintained

Even though the services account deficit widened due to deteriorations in the travel and transport accounts, the current account surplus expanded year-on-year in the third quarter of 2017 as the surplus in the goods account widened to an even larger extent. From October to November the size of the current account surplus then declined compared to that during the same period the year before (1.6 billion dollar surplus from October to November 2016), as the services account deficit increased driven by a worsening of the travel account.

The pace of increase in exports (customs clearance basis) accelerated during the third quarter, thanks to buoyant semiconductor exports. During the fourth quarter the extent of increase in exports then narrowed, affected by the decline in the number of business days, although exports of most major items, including semiconductors and petroleum products, continued their solid growth.

Imports (customs clearance basis) sustained their high rate of increase during the third quarter last year, as imports of consumer goods expanded to a large extent. In the fourth quarter the extent of increase in imports lessened somewhat as well compared to the quarter before, as the paces of growth in exports and facilities investment slowed.

<Table I - 4> Current account

(billion dollars, %)

	2015	2016			2017			Oct.-Nov.
		Year	Q3	Q4	Q1	Q2	Q3	
Current account	105.9	99.2	22.6	22.7	19.2	16.5	25.6	13.1
Goods	122.3	118.9	28.2	27.3	27.3	29.6	34.8	20.1
Exports ¹⁾	526.8	495.4	121.9	132.4	132.1	147.0	151.1	143.5 ³⁾
(Rate of change ²⁾)	-8.0	-5.9	-5.0	1.8	14.7	16.7	24.0	8.5 ³⁾
Imports ¹⁾	436.5	406.2	102.5	110.6	116.4	117.9	120.8	123.4 ³⁾
(Rate of change ²⁾)	-16.9	-6.9	-5.1	4.1	24.0	18.7	17.9	11.5 ³⁾
Services	-14.9	-17.7	-5.5	-4.3	-8.7	-6.7	-8.5	-6.8
Credit	97.7	94.9	23.7	23.9	21.0	21.1	22.8	14.3
Debit	112.6	112.6	29.3	28.2	29.7	27.8	31.3	21.1
Primary income	3.6	3.9	2.3	0.9	1.4	-4.9	1.9	1.1
Secondary income	-5.0	-5.8	-2.4	-1.2	-0.8	-1.5	-2.6	-1.2

Notes: 1) Customs-clearance basis.

2) Compared to the same periods of previous years.

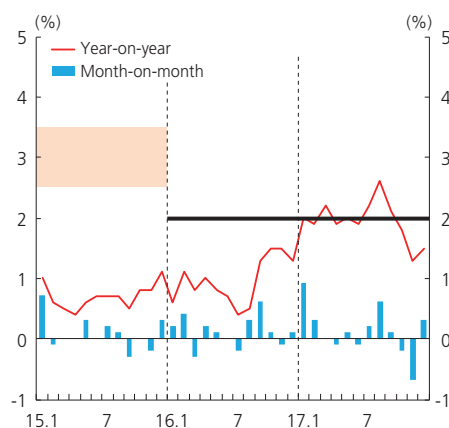
3) Based on the fourth quarter of 2017.

Sources: The Bank of Korea, Korea Customs Service.

3. Prices

Upward Trend of Consumer Prices Slows

The extent of increase in consumer prices narrowed considerably during the fourth quarter of 2017, on the effects of declines in agricultural product prices and a reduction in city gas fees¹³⁾, to record a figure in the mid-1% range.

<Figure I - 7> CPI inflation¹⁾

Note: 1) The shaded area indicates the medium-term inflation target range during the 2013-2015 period, and the bold line the medium-term inflation target set for 2016 onwards.

Sources: The Bank of Korea, Statistics Korea.

The pace of increase in agricultural, livestock and marine product prices slowed greatly during the fourth quarter, on declines in the prices of agricultural products including vegetables. On the other hand, the extent of increase in industrial product prices, petroleum products in particular, expanded due to the impacts of rising international oil prices.¹⁴⁾ Electricity, water

13) Fees for residential city gas were cut by 8.2% from November.

14) The price of Dubai crude rose by 16.8%, from 50.6 US dollars per barrel during the third quarter of last year to 59.1 US dollars per barrel during the fourth quarter.

and gas charges fell, affected by the reduction in city gas fees. Service charges showed an overall pace of increase at the level of the previous quarter, as an expansion in the extent of increase of private service charges and contractions in those of housing rental fees and public service charges offset each other.

<Table I - 5> Consumer prices¹⁾

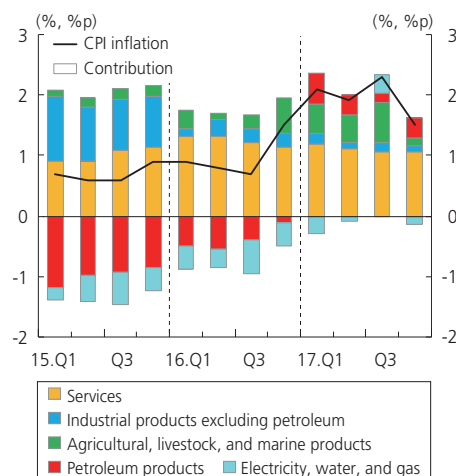
	2016			2017				
	Year	Q3	Q4	Year	Q1	Q2	Q3	Q4
Consumer price index	1.0	0.7	1.5	1.9	2.1	1.9	2.3	1.5
Agricultural, livestock, and marine products	3.8	3.1	7.5	5.5	6.1	6.1	8.4	1.4
(Agricultural products)	3.8	2.1	9.1	4.6	4.7	3.6	10.2	-0.1
(Livestock products)	4.4	4.2	6.0	6.5	8.6	9.6	6.7	1.3
Industrial products	-0.5	-0.5	0.4	1.4	2.1	1.3	0.9	1.5
(Petroleum products)	-8.1	-8.1	-2.3	7.7	12.0	7.7	3.4	8.0
(Industrial products excluding petroleum)	0.8	0.8	0.8	0.5	0.7	0.3	0.5	0.4
Electricity, water, and gas	-9.2	-13.0	-8.7	-1.4	-6.9	-2.4	8.0	-3.3
Services	2.3	2.2	2.1	2.0	2.1	2.0	1.9	1.9
(Rentals for housing)	1.9	1.8	1.7	1.6	1.7	1.8	1.6	1.4
(Public service charges)	1.5	1.0	0.9	1.0	1.0	1.0	1.0	0.8
(Private service charges)	2.7	2.8	2.7	2.5	2.7	2.5	2.3	2.5
CPI for living necessities	0.7	0.2	1.4	2.5	2.5	2.4	3.2	1.6
CPI excluding food & energy	1.9	1.9	1.7	1.5	1.7	1.5	1.4	1.5
CPI excluding agricultural products & oils	1.6	1.4	1.5	1.5	1.5	1.4	1.7	1.3

Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

Looking at the degrees of contribution to the CPI inflation rate of the individual product categories in the fourth quarter last year, the positive contribution of agricultural, livestock and marine product prices fell greatly while that of petroleum product prices grew. The contribution of electricity, water and gas charges reversed from positive to negative, on the effects of the reduction in city gas fees. The degree of contribution of ser-

vice charges meanwhile maintained its level of the previous quarter.

<Figure I - 8> Contributions to CPI inflation¹⁾



Note: 1) Compared with the same periods of the previous years.
Source: Statistics Korea.

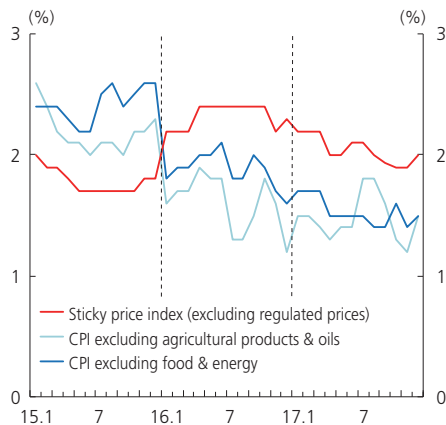
Underlying Price Movements Generally Stable

The recent slowdown in the upward trend of consumer price inflation has been a result largely of supply-side factors such as declines in agricultural product prices, and of systemic factors including the reduction in city gas fees. The underlying price movements with the effects due to these factors excluded have been generally stable.

First, core inflation (the index with food and energy product prices excluded) rebounded slightly in the fourth quarter of last year. During this period the sticky price index¹⁵⁾, which excludes the effects of regulated prices, sustained its rate of increase of around 2%.

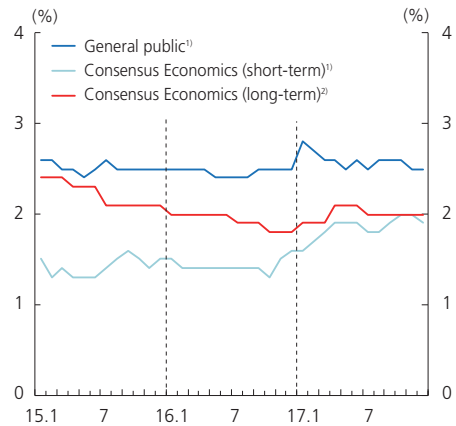
The short-term (for the next twelve months) inflation expectations of the general public fell slightly from 2.6% in the third quarter of last year to 2.5% in the fourth, while those of economic experts¹⁶⁾ rose slightly from 1.9% to 2.0%. In the fourth quarter the long-term (for the next sixty months) rate of inflation expected by the economic experts group maintained its 2.0% level of the quarter before.

<Figure I - 9> Underlying inflation rates¹⁾



Note: 1) Compared with the same months of the previous years.
Sources: The Bank of Korea, Statistics Korea.

<Figure I -10> Inflation expectations



Notes: 1) Expected CPI inflation rate for the next 12 months.
2) Expected CPI inflation rate for the next 60 months.
Sources: The Bank of Korea, Consensus Economics.

Producer and Import Price Increases Slow Slightly

The pace of increase in producer prices slowed slightly in the fourth quarter of last year. This was because the extents of increase in agricultural, forestry and marine product prices and in electricity, gas and water fees declined significantly although the paces of increase in prices of industrial products such as petroleum products and primary metals products picked up slightly, affected by the higher prices of international raw materials including oil.

During the same period the extent of increase in import prices (Korean won basis) also narrowed, on the impacts of the fall in the won/dollar exchange rate.

15) Sticky prices, as they are calculated using products whose prices do not frequently change, not only reflect inflation expectations well but are known to be useful in predicting consumer prices also. At the time of index calculation regulated prices (public service fees, electricity, water and gas charges, cigarette taxes, school meal fees, childcare charges, etc.), which are greatly affected by regulatory factors, are excluded.

16) Referring to the results of a survey by Consensus Economics of investment banks, securities companies, market research and analysis institutions, etc., in Korea and overseas.

<Table I - 6> **Producer prices and import prices (Korean-won basis)¹⁾**

	2015	2016		2017			
		Year	Q4	Q1	Q2	Q3	Q4
Producer prices	-4.0	-1.8	0.8	4.2	3.3	3.4	3.0
Goods	-6.4	-3.4	0.5	5.8	4.3	4.4	3.7
(Agricultural, forestry and marine products)	2.3	5.8	9.4	7.8	8.4	8.1	1.5
(Manufacturing industry products)	-6.7	-3.5	0.8	6.5	4.3	4.1	4.2
(Electricity, gas and water supply)	-7.9	-8.3	-7.4	-3.0	2.1	5.1	0.2
Services	1.2	1.2	1.3	1.3	1.6	1.5	1.7
Import prices ²⁾	-15.3	-4.2	4.0	9.7	5.0	8.4	3.2
	[-19.5]	[-7.3]	[3.4]	[14.1]	[8.4]	[7.8]	[7.3]
Exchange rate	7.4	2.6	0.1	-4.0	-2.9	1.1	-4.7

Notes: 1) Compared with the same periods of the previous years; the figures for December 2017 are preliminary.

2) Figures in square brackets are on a contract-currency basis. Source: The Bank of Korea.

Housing Sales Prices Differ by Region

The pace of growth in nationwide housing sales prices slowed during the fourth quarter last year, due to the real estate and household debt measures announced by the government¹⁷⁾, but there was some differentiation across regions. Prices in Seoul and its surrounding areas continued to rise at high rates, especially those of apartments being reconstructed in the Seoul Gangnam area, while in other parts of the country the pace of increase slowed, affected by factors such as expansions in the amounts of newly occupied residences.

The extent of quarter-on-quarter increase in nationwide leasehold deposit prices fell slightly and remained stable. By region, in

Seoul and its surrounding areas there were substantial increases in newly occupied residences in the southern areas of Kyeonggi Province such as Hwaseong and Pyeongtaek, and the pace of increase slowed. In the parts of the country outside Seoul and its surrounding areas the trends of slight decline in leasehold deposit prices of the previous quarter continued, in line with the sluggishness of regional economic activities.

<Table I - 7> **Rates of increase in housing sales and leasehold deposit prices¹⁾**

	2016			2017				
	Year	Q3	Q4	Year	Q1	Q2	Q3	Q4
Housing sales prices	0.7	0.2	0.4	1.5	0.1	0.5	0.6	0.4
Seoul and its surrounding areas	1.3	0.4	0.6	2.4	0.1	0.7	0.8	0.7
(Seoul)	2.1	0.7	0.9	3.6	0.2	1.2	0.9	1.2
Other areas	0.2	0.0	0.2	0.7	0.1	0.2	0.3	0.1
Reconstructed apartment sales prices	15.8	7.3	1.0	15.0	1.5	4.9	3.6	4.2
Leasehold deposit prices	1.3	0.2	0.4	0.6	0.1	0.2	0.2	0.1
Seoul and its surrounding areas	2.0	0.5	0.5	1.4	0.2	0.5	0.5	0.2
(Seoul)	2.0	0.5	0.5	2.0	0.2	0.7	0.6	0.5
Other areas	0.7	0.0	0.3	-0.1	0.1	0.0	-0.1	-0.1

Note: 1) Compared with the last survey dates of the previous periods. Sources: Korea Appraisal Board, Real Estate 114.

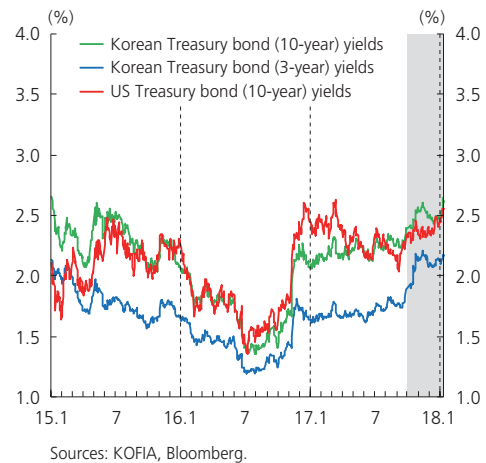
17) The government announced policies including the 10.24 Comprehensive Household Debt Measures, the 11.29 Housing Welfare Roadmap, and the 12.13 Rental Housing Registration Stimulation Plan.

4. Financial and Foreign Exchange Markets

Long-term Market Interest Rates Stable after a Large Rise

The Treasury bond (3-year) yield rose rapidly in October of last year, in response to the heightened likelihood of a Base Rate hike within the year due to the Bank of Korea's upward revision of its forecast for the 2017 economic growth rate (2.8% → 3.0%) and to the announcement of the GDP growth rate in the third quarter (advanced estimate) greatly exceeding expectations. From late October the Treasury bond yield's rapid rise subsided, however, as foreigners net purchased Treasury futures¹⁸⁾ and recognition that the effect of the Base Rate hike had already been priced in spread, while the government and the Bank of Korea adjusted their bond issuance volumes.¹⁹⁾ After the Base Rate was raised at the end of November, the Treasury bond yield stabilized even more as expectations formed that additional hikes would be carried out gradually. The Treasury bond (3-year) yield subsequently fluctuated within a limited range, affected mainly by factors such as changes in US Treasury bond yields and foreigners' transactions of Treasury futures.

<Figure I -11> Korean and US Treasury bond yields



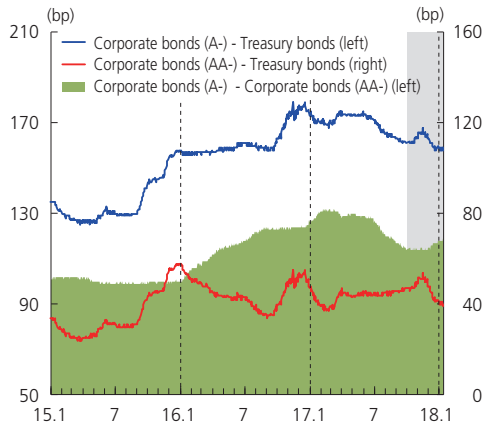
Corporate Bond Credit Spreads Narrow after Widening

Corporate bond credit spreads on both prime (AA grade and above) and sub-prime (A grade and below) bonds widened until late November, under the impacts of the expanded Treasury bond yield volatility. After the end-November Base Rate hike they narrowed again, however, as the favorable sub-prime bond interest rates became highlighted again in line with the stabilization of the Treasury bond yield.

18) During the period from October 26 to November 30, 2017 foreigners net purchased 67,000 Treasury bond (3-year) futures contracts.

19) In November of last year the Ministry of Strategy and Finance reduced the volume of its Treasury bond issuance by 450 billion won compared to the month before (announced October 26), while the Bank of Korea cut its issuance of Monetary Stabilization Bonds by 2.4 trillion won (announced October 27).

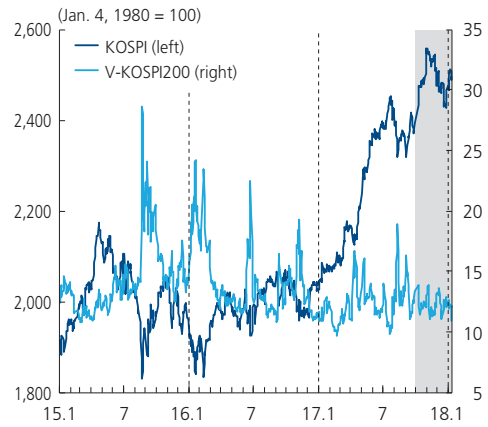
<Figure I -12> Corporate bond credit spreads¹⁾ and spreads across credit ratings



Note: 1) 3-year maturity basis; Treasury bond yields based on final quoted yields, and corporate bond yields on average yields estimated by four private credit rating agencies.

Source: KOFIA.

<Figure I -13> KOSPI and share volatility index



Source: Koscom.

Domestic Portfolio Investment by Foreigners Increases Entering this Year

Domestic portfolio investment by foreigners, and funds invested in stocks in particular, has risen once again this year after having contracted from November of last year.

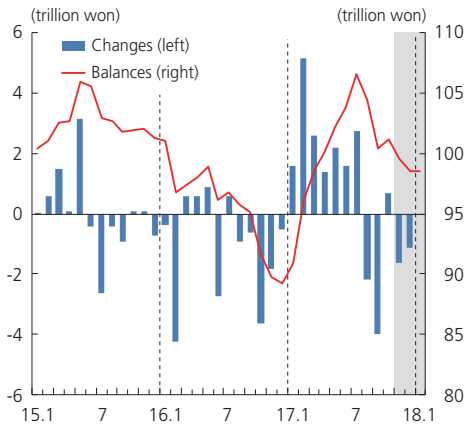
Foreigners increased their domestic bond investment in October, led by funds of central banks and global funds, but from November the reinvestment of funds reaching maturity by most institutions was sluggish and bond investment declined.

KOSPI Fluctuates, after a Large Rise

The KOSPI rose greatly, affected by the economic recoveries at home and abroad, by improvements in corporate performances and by the upward trend of stock prices in major countries, and on November 3 recorded an all-time high of 2,558.0. It subsequently weakened owing to sales for profit-taking, before then rebounding to a considerable extent from the end of December on expectations of improved corporate performances in 2018 and realizations that stock prices had been undervalued.²⁰⁾ The stock price volatility index (V-KOSPI 200) maintained generally low levels, as concerns about uncertainties related to North Korea risk lessened.

20) At the end of 2017 corporations' price-earnings ratio (PER), showing the levels of their stock prices compared to future cash flows (earnings), was 8.5, well below those in major countries (18.7 in the US). This was also a large decline compared to the year-end 2016 PER (10.0), and was a result of the fact that, although stock prices rose to a large extent in 2017, corporate earnings increased even more.

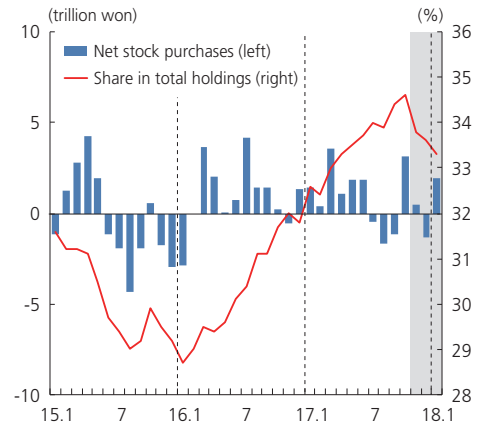
<Figure I -14> Changes in and balances of foreigners' bond holdings¹⁾



Note: 1) Figure for January 2018 is as of Jan.12, 2018.
Source: Financial Supervisory Service.

In terms of foreigners' stock investment, large net purchases of domestic stocks were recorded from October, in line with the easing of tensions between North Korea and the US and the improvements in corporate performances. From the end of November there was then a reversal to net sales, on the effects of profit-taking, and after that a return to large net purchases entering this year due to expectations of continuing economic improvements domestically and abroad.

<Figure I -15> Foreigners' net stock purchases¹⁾²⁾ and share in total holdings³⁾



Notes: 1) Figure for Jan.2018 is as of Jan.12, 2018.
2) The sum of net purchases in KOSPI and KOSDAQ markets.
3) Based on total stock market capitalizations.
Source: Koscom.

Extent of Increase in Corporate Lending Declines

The amount of increase in bank corporate lending contracted greatly in the fourth quarter of last year. Lending to large enterprises reversed to a decrease due to firms' repayments of funds that they had borrowed to manage their year-end financial ratios. The extent of increase in lending to SMEs meanwhile shrank greatly, due to their borrowings in advance at the end of the previous quarter before the long holidays in the first week of October, and to their repayments of borrowings at the end of 2017. The increase in corporate lending by non-bank financial institutions lessened substantially as well.

The amount of corporate funds raised through direct financing (net increase basis) grew to a smaller extent, as corporate bond

issuance was sluggish. Corporate bonds showed a large net redemption, as the bond issuance volume fell in consequence of the advance issuance of bonds until that time in preparation for rising interest rates and of the year-end closings of books by institutional investors. The issuance of CP declined, although CP continued to show net issuance due to firms' demands for short-term funds. The volume of funds raised through issuance of stocks expanded, however, as a result of large-volume paid-in capital increases of some enterprises.

Extent of Household Lending Increases Similarly to in Previous Quarter

Household lending (based on depository institutions) expanded by a monthly average of 7.4 trillion won in the fourth quarter of last year, an amount similar to that (7.5 trillion won) during the third quarter.

During the fourth quarter of 2017 banks' household lending grew by an average of 5.9 trillion won per month, an amount similar to that in the third quarter (6.0 trillion won). In the case of home mortgage lending, individual home mortgage loans increased to a somewhat lesser extent, on the effects of the 8.2 Measures, while the amount of growth in group loans also declined, affected by repayments of intermediate payment loans in line with the completions of construction of pre-sold apartments. Other loans increased to a greater extent, owing to fund demand related to housing transactions and to moving into housing, and to the expanded operations by Internet-only banks. Meanwhile, non-bank financial institutions' household lending increased as well during the fourth quarter, by a monthly average of 1.5 trillion won, an amount similar to that in the previous quarter (1.4 trillion won).

<Table 1 - 8> Corporate funding¹⁾

(trillion won)

	2015	2016		2017				
		Year	Q4	Q1	Q2	Q3	Q4	
Corporate loans	Banks	50.0	23.9	-5.4	12.2	6.7	16.0	3.6
	(Large firms)	-4.3	-9.9	-9.2	1.6	-2.9	0.8	-4.0
	(SMEs)	54.3	33.8	3.8	10.6	9.6	15.2	7.6
	Non-banks ²⁾	18.1	30.0	8.8	8.4	10.9	11.0	2.7
Corporate direct financing	Corporate bond issuance ³⁾	-0.4	-6.7	-3.6	0.2	2.7	-1.6	-4.7
	CP issuance ⁴⁾	-5.4	-2.1	0.4	0.5	0.4	2.5	0.4
	Stock issuance ⁵⁾	7.0	15.9	9.0	1.6	4.5	3.2	5.3

Notes: 1) Based on changes in balances during the periods; figures for November–December 2017 preliminary for banks.

2) Based on loans by mutual savings banks, credit unions, mutual credit unions, community credit cooperatives, and insurance companies (including public and other lending); figure for Q4 2017 based on October figures.

3) Based on corporate bonds issued through public subscription by non-financial corporations (excluding ABSs but including P-CBOs).

4) Based on CP handled by securities firms, merchant banking corporations and trust accounts of banks; figure for Q4 2017 as of Dec.20.

5) Initial public offerings and paid-in capital increases.

Sources: The Bank of Korea, Financial Supervisory Service, Korea Securities Depository, Korea Credit Information Services.

<Table I - 9> Household lending by depository institutions¹⁾
(trillion won)

	2015	2016		2017			
		Year	Q4	Q1	Q2	Q3	Q4 ²⁾
Commercial & specialized bank loans ³⁾	6.5	5.7	6.5	2.0	5.7	6.0	5.9
(Mortgage loans) ³⁾	5.8	4.6	5.0	1.8	3.8	3.7	3.0
(Other loans including loans through overdraft accounts)	0.7	1.1	1.5	0.1	1.9	2.3	2.8
Non-bank depository institution loans ³⁾	1.9	3.6	4.5	2.5	2.1	1.4	1.5
(Mutual credit)	0.8	1.6	1.9	1.0	0.8	0.4	0.9
(Credit unions)	0.4	0.5	0.6	0.3	0.2	-0.1	-0.1
(Community credit cooperatives)	0.4	1.0	1.6	0.8	0.9	0.8	0.6
(Mutual savings banks)	0.3	0.4	0.4	0.4	0.1	0.3	0.1
(Others) ⁴⁾	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total³⁾	8.4	9.3	11.0	4.4	7.8	7.5	7.4

Notes: 1) Based on the average monthly changes during the periods.
 2) The December figures are the Bank of Korea advance estimates for banks, and the Financial Supervisory Service advance estimates for non-bank deposit-taking institutions.
 3) Including mortgage transfers.
 4) Trust accounts of banks, and postal savings.
 Sources: The Bank of Korea, Financial Supervisory Service, Korea Housing Finance Corporation.

Korean Won/US Dollar Exchange Rate Declines

The Korean won/US dollar exchange rate fell rapidly from October, owing to the substantial alleviation of North Korea risk, to the continuous weakening of the US dollar, and to the upward revision of the forecast for domestic economic growth.

The Korean won/Japanese yen (100 yen) exchange rate fell to a considerable extent, as the won strengthened substantially against the US dollar while the yen maintained a steady level.

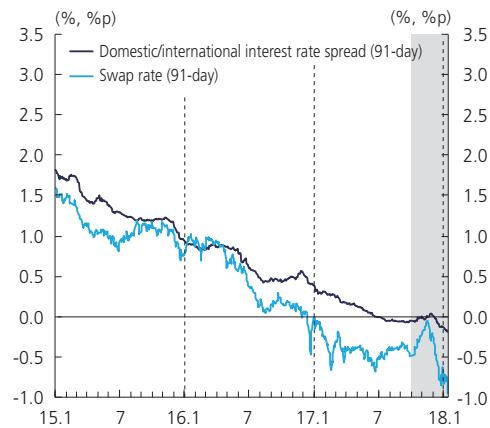
<Figure I -16> Exchange rates



Note: 1) The final transaction standard rate offered to customers posted by KEB Hana Bank during the day.
 Sources: The Bank of Korea, KEB Hana Bank.

The swap rate (3-month maturity), after having increased on the effects of the rise in domestic short-term market interest rates, fell steeply afterwards due to increased demand for foreign currency funds for overseas investment purposes by institutional investors at the year-end and to sales of non-deliverable forwards (NDFs) by non-residents.

<Figure I -17> Domestic/international interest rate spread¹⁾ and swap rate

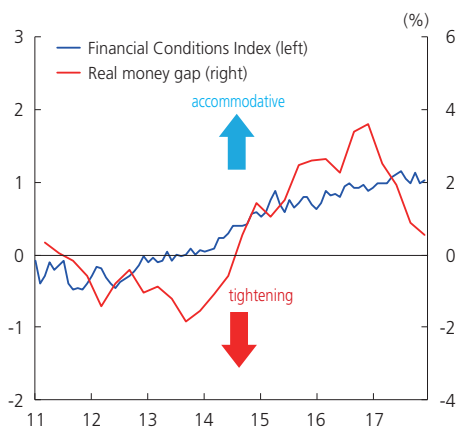


Note: 1) Yield on Korean Monetary Stabilization Bonds (MSBs) (91-day) - US LIBOR (91-day).
 Source: The Bank of Korea.

Degree of Financial Accommodation Lessens Slightly

In view of indicators such as the real money gap²¹⁾ and the Financial Conditions Index²²⁾, it is assessed that the degree of accommodation of financial conditions has lessened slightly. Even though the real money gap has narrowed, the real money supply still remains slightly above its long-term equilibrium level. The Financial Conditions Index has fallen slightly, on the effects of the raising of the Base Rate, but continues to indicate accommodativeness.

<Figure I -18> Real money gap¹⁾²⁾ and Financial Conditions Index²⁾



Notes: 1) Based on M2.

2) If the figure is positive (negative), it means that financial conditions are accommodative (tightening).

Source: The Bank of Korea.

21) This refers to the divergence between the real money supply at a specific point in time and the long-term equilibrium money supply, and is used for judging whether there is an excess (gap > 0) or a shortfall (gap < 0) of real money supplied compared to the long-term equilibrium money supply:

$$\text{Real money gap}_t = \frac{\text{Real money supply}_t - \text{Equilibrium money supply}_t}{\text{Equilibrium money supply}_t} \times 100$$

22) The Financial Conditions Index (FCI), an aggregate of several financial variables to form one information variable, is used as an index to assess whether financial conditions are accommodative or tight. It is calculated by including 50 financial variables regarded as important, such as credit indicators, liquidity indicators, market volatility indicators, survey data from financial institutions, etc. After extraction (through iterative estimation using the least squares method) of the factors best reflecting common movements among the 50 total financial variables, the index is standardized (mean: 0, standard deviation: 1) and calculated.

Main Contents of 2018 Government Budget

The budget for 2018 was approved during a plenary session of the National Assembly in December 2017. In comparison with the main budget last year, the total expenditure is 28.3 trillion won (7.1%) higher at 428.8 trillion won, while total revenues have risen by 32.9 trillion won (7.9%) to a level of 447.2 trillion won.¹⁾

Outline of 2018 government budget

(trillion won, %, %p)

	2017 (A)	2018 (B)	Changes (B-A)
■ Total revenues (national tax)	414.3 (242.3)	447.2 (268.1)	32.9 (25.9)
■ Total expenditures	400.5	428.8	28.3
■ Fiscal balance ¹⁾²⁾	-1.7	-1.6	0.1
■ Sovereign debt ¹⁾	40.4	39.5	-0.9

Notes: 1) Percentages (%) of nominal GDP.

2) Fiscal balance excluding social security fund balance and bail-out funds provided.

Source: Ministry of Strategy and Finance.

Fiscal expenditures have increased in the areas of the government's major focuses in its state administration such as health, welfare and labor, while having declined in the SOC sector. This is because, while the budgets for state administration tasks and additional policies have risen (by 18.7 trillion and 7.5 trillion won respectively),

expenditures for roads and railroads, whose stocks have been built up to this time, have been greatly curtailed as part of the expenditure restructuring to prepare these budgets.²⁾ With regard to fiscal revenues, national tax revenues have expanded greatly. This is a result mainly of the continued high rate of increase in income tax and corporate tax revenues, owing to the tax reform³⁾ and to the robustness of corporate performances.

Main expenditures

(trillion won)

	2017 (A)	2018 (B)	(B-A)
■ Health, welfare, labor	129.5	144.7	15.2
■ Education	57.4	64.2	6.8
■ Defense	40.3	43.2	2.8
■ R&D	19.5	19.7	0.2
■ SOC	22.1	19.0	-3.1
■ Industry, SMEs, energy	16.0	16.3	0.2

Source: Ministry of Strategy and Finance.

It is assessed that the fiscal operations in 2018 are expansionary, with the rate of increase in total expenditures exceeding the nominal growth rate forecast⁴⁾ and the extent of the structural fiscal account⁵⁾ deficit also expanding compared to last year. According to the

1) In comparison with the supplementary budget of last year total expenditures are 18.7 trillion won (4.6%) higher, and total revenues 24.1 trillion won (5.7%) higher.

2) Non-essential expenditures have been restructured in consideration of investment priorities and project results. Expenditures related to the environment including SOC, culture and industry, along with expenditures on welfare projects whose results have been sluggish, have also been cut (by a total of 11.5 trillion won).

3) A revision of the tax law was passed in the National Assembly (in December 2017), establishing additional tax brackets for income and business taxation and raising the maximum tax rates.

4) Since 2013 the rate of increase in fiscal expenditure has continually fallen below the nominal growth rate, but it is forecast that it will exceed it to a large extent this year.

2017~21 medium-term fiscal operation plan, it is forecast that the government will maintain its expansionary stance in the future, with the rate of increase in fiscal expenditures exceeding the nominal growth rate, and the extent of the government budget balance excluding the social security fund balances and bail-out funds also widening.⁶⁾

Evaluation of government fiscal budgetary stance

(%)

	Growth rate of total expenditures (A) ¹⁾	Nominal growth rate (B) ²⁾	(A-B)
2013	5.0	6.9	-1.9
2014	4.4	6.5	-2.1
2015	5.7	6.1	-0.4
2016	3.0	4.2	-1.2
2017	3.7	4.0	-0.3
2018	7.1	4.5	2.6

Notes: 1) Based on main budget.

2) Government estimation as of date of budget submission.

Source: Ministry of Strategy and Finance.

5) This account excludes the changes in revenues and expenditures due to economic fluctuations. According to the Bank of Korea's calculations, it appears that the extent of its deficit will expand compared to last year.

6) The targeted sizes of the future fiscal account deficit (compared to nominal GDP; social security fund balance and bail-out funds provided excluded) are -1.7% for 2017, -1.6% for 2018, -1.8% for 2019, -2.0% for 2020, and -2.1% for 2021.

II

Conduct of Monetary Policy

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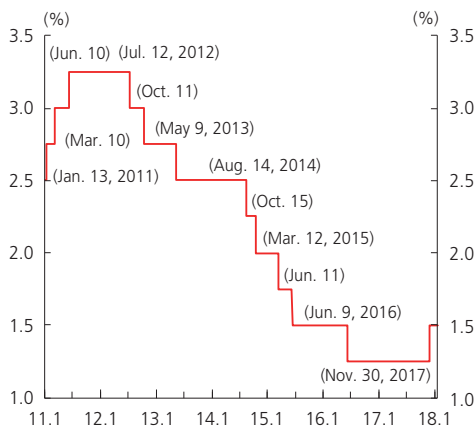
1. Base Rate

Base Rate Raised in November 2017, from 1.25% to 1.50% per Annum

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

In November 2017 the Bank of Korea raised the Base Rate, which it had maintained at 1.25% per annum since June 2016, by 0.25% points to an annual rate of 1.50%.²³⁾ This decision was made because the Bank judged that, as the domestic economy was sustaining its steady pace of growth at its potential level and consumer price inflation was also expected to gradually approach the target level, there was a need to adjust the degree of monetary policy accommodation that had been heightened in response to the low growth and low inflation until that time. It was judged first of all that the domestic economy had continued its sound growth, as consumption was improving moderately and investment also showing favorable movements amid an ongoing high rate of increase in exports. Moreover, the Bank saw domestic demand-related activities such as consumption and facilities investment as likely to continue to improve modestly going forward as well, and exports to also sustain their buoyancy due to a pick-up in the global economic recovery and an improvement in trading conditions vis-à-vis China. In line with this it was expected that future growth would be above the path forecast in October, and that the pace of growth at around its potential level would continue. Consumer price inflation had slowed slightly, to the upper 1% range, owing to a decline in the extent of increase in the prices of agriculture, livestock and marine products and to the subsiding of the base effect of the cuts in electricity fees the year before. However, it was forecast to gradually approach the target level as the economy

<Figure II - 1> Bank of Korea Base Rate¹⁾



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

Source: The Bank of Korea.

23) Monetary Policy Board member Dongchul Cho expressed a dissenting opinion that maintaining the Base Rate at 1.25% was desirable.

recovered. Core inflation was seen as likely to continue at a level in the mid-1% range for some time, before then rising moderately from 2018. The pace of increase in household lending had slowed somewhat, but the level of household loans was still higher than in normal years. Under these circumstances it was judged that the risk of a build-up of financial imbalances could grow even more if the degree of monetary policy accommodation were not adjusted appropriately in accord with the economic recovery.

In the January 2018 Monetary Policy Board meeting the Base Rate was maintained at 1.50% per annum. This decision was made in comprehensive consideration of several points. First, it was deemed necessary to monitor the developments and influences of the domestic and external uncertainties that still remained, even though the domestic economy was expected to continue its solid growth. The upward demand-side pressures on prices were meanwhile forecast to be not large for the time being, and there was also a need to observe a little further the effects on the economy and the financial markets of the Base Rate hike in November last year. With regard to the domestic economy it was judged that investment, which had shown a high rate of increase to that time, would slow, but that the solid growth would continue as consumption would steadily increase and the buoyancy of exports would also continue. In line with this it was expected that the domestic econo-

my would show a pace of growth at the 3% level during this year as well. The rate of consumer price inflation had fallen to the mid-1% range, influenced by a reduction in city gas fees, and was forecast to show the low- to mid-1% level for the time being before gradually rising from the second half. The core inflation rate, indicative of the underlying price movements, was seen as likely to rise moderately. The extent of household lending growth had been lessening recently, but the total volume of household debt was already high and the pace of its increase was also still more rapid than the rate of income growth. It was thus judged, from the financial stability perspective, that a close observation of household debt was necessary.

Open Market Operations to Maintain Call Rate at Base Rate Level

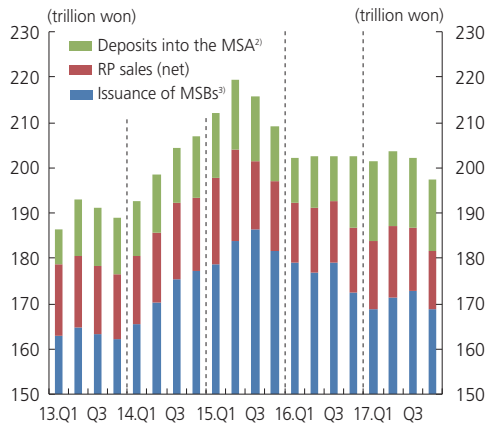
In order to influence the overnight call rate so that it does not deviate greatly from the Base Rate, the Bank of Korea adjusts market liquidity utilizing its open market operations instruments such as Monetary Stabilization Bond issuance, purchases and sales of RPs, and deposits into the Monetary Stabilization Account.

During the fourth quarter of last year the value of liquidity adjustment needed (average balance basis) fell compared to that during the previous quarter, owing to an increase in the value of currency issued.²⁴⁾ In

²⁴⁾ As the effects of the expanded currency issuance in late September (7 trillion won increase over the 10 business days prior to the long Korean Thanksgiving holidays) persisted, the amount of increase in currency in circulation during the fourth quarter of last year (average balance basis) was 4.8 trillion won.

the financial markets, meanwhile, the demand for bonds declined, as market interest rates rose on expectations of a hike in the Base Rate. In response the Bank of Korea adjusted liquidity flexibly through a reduction in its issuance of Monetary Stabilization Bonds.

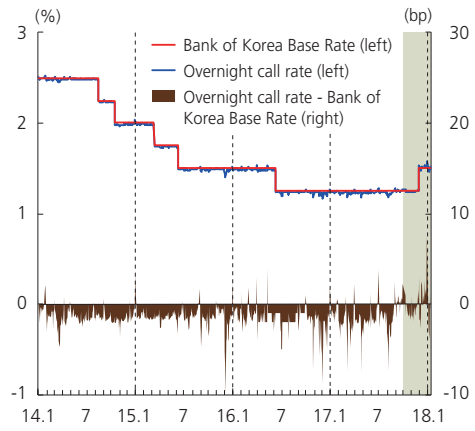
<Figure II - 2> Liquidity adjustment¹⁾ by means of open market operations



Notes: 1) Quarterly average balance basis.
 2) Monetary Stabilization Account.
 3) Excluding 3.48 trillion won (Mar.27, 2014-Mar.26, 2015) and 3.45 trillion won (Oct.16, 2015-Oct.14, 2016) of MSB sales to Korea Development Bank by negotiated transactions.
 Source: The Bank of Korea.

In line with this the call rate showed stability at around the level of the Base Rate.

<Figure II - 3> Bank of Korea Base Rate and overnight call rate



Source: The Bank of Korea.

2. Bank Intermediated Lending Support Facility

The main details concerning operation of the Bank Intermediated Lending Support Facility during the period from October of last year to January of this year are as follows:

In November the period of operation of the Support Program for Small-scale Business Owners, introduced in order to lighten the burdens of small-scale business owners due to high interest rates, was extended. The likelihood was considered that small-scale business owners' financial burdens stemming from the uncertainties of economic conditions and the probability of rising market interest rates would persist for some time, and it was thus decided to extend operation of the program for one year until November of this year.

It was also decided to provide support through the Bank Intermediated Lending Support Facility for SMEs that had suffered damage due to the earthquake in Pohang. It was decided to utilize a total of 10 billion won to this end – 5 billion won from the Bank Intermediated Lending Support Facility's reserves, and 5 billion won of the Pohang Branch's own funds.

The Bank Intermediated Lending Support Facility is being operated with a total ceiling amounting to 25 trillion won, including 1.5

trillion won under the Support Program for Trade Financing, 0.5 trillion won under the Support Program for Small-scale Business Owners, 6.0 trillion won under the Support Program for New Growth Engine Development and Job Creation, 11 trillion won under the Program for Stabilization of SME Lending²⁵⁾, and 5.9 trillion won under the Support Program for Regional Enterprises. The Bank Intermediated Lending Support Facility's support interest rates range from 0.50~0.75% per annum, depending on the program.

<Table II - 1> Programs under the Bank Intermediated Lending Support Facility
(trillion won, %)

Program	Ceiling	Interest rate
Support Program for Trade Financing	1.5	0.50
Support Program for New Growth Engine Development and Job Creation ¹⁾	6.0	0.50
Program for Stabilization of SME Lending ²⁾	11.0	0.50~0.75
Support Program for Small-scale Business Owners	0.5	0.50
Support Program for Regional Enterprises	5.9	0.75
Total	25.0³⁾	–

Notes: 1) Support Program for High-tech and Other Start-up SMEs was expanded and reorganized into Support Program for New Growth Engine Development and Job Creation (September, 2017).

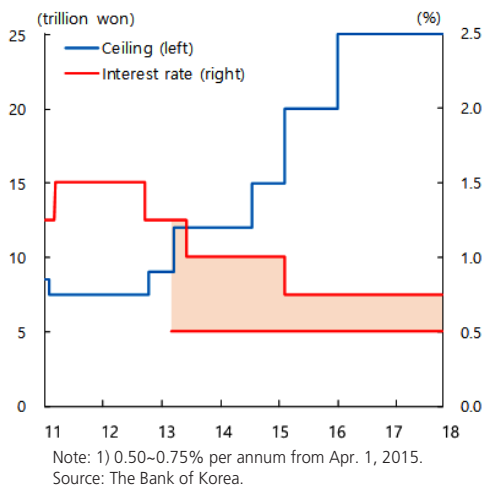
2) Includes the support that had been formerly provided under the Support Program for Facilities Investment.

3) Includes 0.1 trillion won ceiling for reserves, which can be operated when necessary.

Source: The Bank of Korea.

25) It has been decided to operate this program when necessary in consideration of overall financial and economic conditions and SMEs' funding situations, with a focus on strengthening the counter-cyclicality of the central bank's lending facilities during the business and financial cycles rather than providing selected support for specific sectors.

<Figure II - 4> Ceiling and interest rate¹⁾ of Bank Intermediated Lending Support Facility



3. Financial Stability

Efforts for Financial and Foreign Exchange Market Stability Continue

The Bank of Korea continued its efforts for financial and foreign exchange market stability in response to changes in conditions in Korea and abroad. While on the one hand regularly monitoring the movements of major price variables such as interest and exchange rates, the in- and outflows of portfolio investment funds of foreigners and financial institutions' foreign currency funding conditions, the Bank also worked to promote financial and foreign exchange market stability at times of unrest due to factors at home and abroad, through the activation of its emergency response system and flexible open market operations.

When North Korea launched an intercontinental ballistic missile in November of last year, and when the US Federal Reserve raised its policy rate in December, the Bank convened meetings of its 「Monetary and Financial Task Force」 and examined the effects of these events on in- and outflows of foreign investors' funds and on the financial and foreign exchange markets, while strengthening its communication by making clear its determination to keep the markets stable, so as to ensure that market anxieties did not spread excessively.

Meanwhile, when bond investment sentiment contracted in October, as market rates rose greatly on the heightened likelihood of a Base Rate hike within the year, the Bank adjusted

the volume of its Monetary Stabilization Bond issuance flexibly to ensure that market interest rate volatility did not expand.

Efforts for Preemptive Identification of and Response to Potential Financial System Risks

The Bank devoted steady efforts to the preemptive identification of potential risk factors within the financial system, and to the presentation of early warnings.

In the December issue of its 「Financial Stability Report」 the Bank thoroughly assessed the financial system's vulnerabilities by sector, and examined the system's resilience to any shocks at home or abroad as well as the Korean economy's external payment capacities. In particular, it focused on examining the risks that economic agents, who have adapted to the low interest rates, may face in the future due to changes in financial and economic conditions in line with the expanded upward pressures on market interest rates in consequence of the monetary policy normalizations by major countries' central banks. In line with this, the Bank analyzed in depth the changes in the debt repayment burdens of households and corporations that can occur if interest rates rise, and looked closely at the current situation of owners of multiple homes and their financial soundness.

Meanwhile, the Bank also devoted efforts to devising measures for responding to the possibility of weakening financial stability due to the build-up in household debt. It strengthened its monitoring of household debt through meetings of its 「Household Debt Task Force」, while also attending the meetings of the 「Consultative Group for Managing Household Debt」 and the 「Macroeconomic Finance Meeting」, where it shared its perspectives on the household debt problem with the government and the supervisory authorities, and contributed to the drawing up of the government's household debt measures (October 2017).

Extension of Measures Recognizing MBSs Issued by HF as Collateral for Bank of Korea Loans and for Use in Net Settlement

In December of last year the Bank of Korea decided to extend for one year, until the end of 2018, its measures recognizing mortgage-backed securities (MBSs) issued by Korea Housing Finance Corporation (HF) as collateral for commercial banks in obtaining loans from the Bank of Korea and for use in financial institutions' net settlements.²⁶⁾ This was done in view of the facts that the burdens of banks holding MBSs following extensions of Relief Loans²⁷⁾ in 2015 were expected to continue through 2018, and that there was a likelihood of banks' demands for collateral securities increasing.²⁸⁾

26) These measures were adopted in order to ease banks' burdens following their coming to hold large volumes of HF-issued MBSs in the process of their extensions of Relief Loans during the March~May 2015 period.

27) The Relief Loan program, in which existing home mortgage loans with floating interest rates or loans on which only interest was being repaid were converted into fixed rate/amortizing loans, was introduced as a means of improving the household debt structure. A total amount of 31.7 trillion won of Relief Loans (327 thousand loans) were supplied during the March~May 2015 period.

28) In compliance with the international payment and settlement standards prepared by the BIS Committee on Payments and Market Infrastructures, a sequential raising of the ratios of paid-in collateral for use of net settlement is necessary.

Efforts to Strengthen Global Financial Safety Nets Continue

The Bank of Korea took part in meetings of international institutions and consultative bodies such as the BIS and SEACEN, and discussed the timely identification of changes in global financial and economic conditions and their effects, as well as major pending issues such as the monetary policy stances of major countries and financial regulations.

Meanwhile, to respond preemptively to the increased uncertainties domestically and abroad, the Bank also devoted efforts to expanding the multi-level financial safety nets. Notably, in October of last year it extended the maturity of the Korea-China currency swap arrangement, and then in November newly concluded a standing currency swap agreement with Canada, one of the major vehicle currency countries. Since this agreement was concluded under conditions identical²⁹⁾ to those of the network of bilateral currency swap agreements among six advanced country central banks³⁰⁾, it greatly reinforced Korea's shock absorption capacities while also boosting its sovereign credit standing. Moreover, the Bank participated actively as well in the revision of the written agreement on CMIM (Chiang Mai Initiative Multilateralization), the multilateral swap agreement among the ASEAN+3 countries, to improve the possibility of its operation.

Enhanced Safety and Efficiency of Payment and Settlement Systems

In response to the changes in domestic and external conditions, the Bank of Korea continued its efforts to enhance the safety and efficiency of the payment and settlement systems.

First, in order to prevent temporary liquidity shortages of BOK-Wire+ participants from spreading to cause settlement delays for other institutions, the Bank supplied these participants with intraday liquidity support. It provided funds via collateralized intraday overdrafts and sales of intraday repurchase agreements (RPs) to banks and financial investment companies respectively, to support them by covering their temporary shortages of settlement funds. During 2017 the Bank provided BOK-Wire+ participants with a daily average amount of 2.4 trillion won³¹⁾ in intraday liquidity support to resolve their temporary shortages of settlement funds.

<Table II - 2> Funds covering temporary intraday liquidity shortages¹⁾

	2015	2016	2017	(Rate of change)
Intraday overdrafts ²⁾	394.5	380.2	318.2	(-16.3)
Intraday RPs	2,613.7	2,449.8	2,055.9	(-16.1)
Total	3,008.2	2,830.0	2,374.1	(-16.1)

Notes: 1) Daily average basis.

2) Based on average balance of net intraday overdraft loans used (Amount of intraday overdraft loans used - Outstanding balance of deposits only for settlement).

Source: The Bank of Korea.

29) It is a standing agreement, concluded with no specified maturity and with no maximum ceiling set in advance.

30) Referring to the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Canada, the Swiss National Bank, and the Bank of Japan.

31) During 2017 the amount of intraday support provided for institutions suffering temporary settlement fund shortages was 455.9 billion won less than in 2016. This was a result mainly of a 393.9 billion won decline in the amount of intraday support for temporary settlement fund shortages provided via the intraday RP method, in line with a drop in over-the-counter bond transactions compared to the year before.

The Bank also continued its efforts to ensure smooth domestic implementation of the 「Principles for Financial Market Infrastructures (PFMI)」³²⁾, the international standards in the field of payment and settlement, and of the 「Guidance on Cyber Resilience for Financial Market Infrastructures」.³³⁾ It examined compliance with the PFMI and systems for responding to cyber risks at important payment and settlement systems operated by Korea Securities Depository (examinations completed in November 2017) and the Korea Exchange (completion scheduled for January 2018).³⁴⁾ In addition, through joint examinations with the Financial Supervisory Service of one domestic bank and one financial investment company during the October to December 2017 period, the Bank of Korea checked on matters such as these institutions' compliances with the regulations related to payment and settlement and their settlement risk management, and recommended to the institutions that they take supplementary actions to improve their operational risk management.

The Bank of Korea participated in the 「Joint T/F on Virtual Currencies」, and with the government and others contributed to the joint preparation of the 「Virtual Currency-related Emergency Measures」 (December 2017) and the 「Special Measures

for Eradication of Virtual Currency Speculation」 (December 2017). In addition, it newly established a 「Virtual Currency and CBDC Joint Research T/F」, and while it examined the effects of virtual currency on the payment and settlement system and the overall financial system, it also conducted research on the issues related to central bank digital currencies that are now being discussed in international organizations such as the BIS and by some central banks.

Potential Risks in the Financial System Examined

The Bank of Korea examined factors posing potential risks to the financial system, through means of joint examinations, regular monitoring and analysis activities related to financial institutions, and endeavored to strengthen its business cooperation with supervisory institutions at home and abroad as well as its communication with financial institutions.

During the October 2017 to January 2018 period the Bank carried out with the Financial Supervisory Service two joint examinations of banks, including a sectoral examination related to the management of foreign bank branches, and an examination of the risks at individual domestic banks. Through the sectoral examination of foreign

32) Following the identification after the global financial crisis of the needs to expand the over-the-counter derivatives market infrastructures and to strengthen international standards concerning the operation of financial market infrastructures, the BIS's Committee on Payments and Market Infrastructures (CPMI), jointly with the International Organization of Securities Commissions (IOSCO), integrated the existing international standards, and in April 2012 they were established as the new international standards for payment and settlement.

33) In June 2016 CPML-IOSCO, in an effort to induce the heightening of financial market infrastructure cyber resilience, established additional guidelines related for example to PFMI 2 (Governance), 3 (Framework for the comprehensive management of risks), 8 (Settlement finality), 17 (Operational risk) and 20 (FMI links).

34) Where it is found necessary based on the results of these examinations, the Bank plans to recommend improvements to the institutions concerned during the first half of 2018.

bank branches' management situations it examined changes in these branches' operating behaviors, potential risks and the statuses of their risk management. Via its examination of risks at individual domestic banks it checked on the management conditions of the banks concerned, their household and corporate loans and the related risk factors, and their compliances with Bank of Korea regulations.

<Table II - 3> Joint examinations¹⁾ with Financial Supervisory Service

2014	2015	2016	2017	Jan. 2018
7	7	6	6	–

(times)

Note: 1) Examinations of banks.
Source: The Bank of Korea.

Through means such as visits to and telephone interviews of staff at financial institutions, and meetings with their department head level officials, the Bank carried out active regular monitoring of them, and in particular closely examined the effects on the lending markets in Seoul and its surrounding areas and other regions due to the government's housing market stabilization measures.

It meanwhile provided the results of its financial institution examinations to government institutions and financial supervisory authorities, for reference in their policies, while working to strengthen its cooperation with the related institutions through joint examination workshops. Moreover, by convening explanatory meetings on the exami-

nation results for the staffs of the financial institutions concerned, it also devoted efforts to facilitating smooth communication with these institutions.

Besides this the Bank of Korea also participated in the meetings of the Supervisory Colleges and Crisis Management Groups for Standard Chartered Bank, Deutsche Bank and Citi Bank, hosted by financial supervisory authorities in Europe or the United States, and discussed the changes in management strategies and the performances of these large global banks, measures for strengthening their management of risk, and recovery and resolution plans for cases of emergencies.³⁵⁾ It participated as well in frequent discussions of pending global financial issues with other central banks such as the Bank of England, the ECB and the US Federal Reserve, through conference calls and fact-to-face talks.

35) The FSB, in its 'Key Attributes of Effective Resolution Regimes for Financial Institutions' established in November 2011, recommended the setting up of Recovery and Resolution Plans (RRPs) for systemically important financial companies for times of emergency.

III

Future Monetary Policy Directions

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1. External Conditions³⁶⁾

World Economy Forecast to Continue Improving

It is forecast that the world economy will continue its improvements. While advanced countries will maintain their stable paces of growth, the momentums for growth of emerging market countries are expected to pick up, led by India and Brazil in particular.

It is forecast that the US will sustain its steady growth, as private consumption and corporate investment improve owing to the robustness of economic sentiment and to its expansionary fiscal policies. However, factors such as the uncertainties related to monetary policy normalization and the possibility of worsening fiscal soundness are lurking as potential risks. The euro area is foreseen maintaining its favorable pace of growth, as consumption and investment expand thanks to improvements in employment conditions and corporate sentiments, although political uncertainties related to the Brexit negotiations and to the possibility of Euroscepticism emerging after the Italian general election could limit the future pace of growth. In Japan, it is forecast that the economy will continue its pace of growth exceeding the potential growth rate, driven by exports and investment.

<Table III - 1> World economic growth outlook¹⁾

	2016	2017 ^a	2018 ^a	2019 ^a
World	3.2	3.7	3.9	3.9
Advanced economies	1.7	2.3	2.3	2.2
(US)	1.5	2.3	2.7	2.5
(Euro area)	1.8	2.4	2.2	2.0
(Japan)	0.9	1.8	1.2	0.9
Emerging market and developing economies	4.4	4.7	4.9	5.0

Note: 1) Based on IMF World Economic Outlook (Jan. 2018); 2016 statistics for the US, Japan and the euro area are from their own representative agencies.

Sources: IMF, Individual countries' published statistics.

In China the growth rate appears likely to fall somewhat compared to last year, due to the carrying out of structural reforms to promote qualitative growth and to deleveraging policies. However, thanks to the buoyant domestic and external conditions and increasing consumption, the extent of the slowdown in growth is expected to be limited. In India it is forecast that growth will accelerate, driven by consumption and investment, while the recoveries in Brazil and Russia are also foreseen continuing, driven by increases in exports of raw materials and improvements in domestic demand.

<Table III - 2> Outlook for economic growths¹⁾ of EMEs

	2016	2017 ^a	2018 ^a	2019 ^a
China	6.7	6.8	6.6	6.4
Brazil	-3.5	1.1	1.9	2.1
Russia	-0.2	1.8	1.7	1.5
India ²⁾	7.1	6.7	7.4	7.8
ASEAN-5 ³⁾	4.9	5.3	5.3	5.3

Notes: 1) Based on IMF World Economic Outlook (Jan. 2018); 2016 statistics for the individual countries are from their own representative agencies.

2) Fiscal year basis (April of current year to March of next year).

3) Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Sources: IMF, Individual countries' published statistics.

36) Sections "1. External Conditions," "2. Growth Forecast" and "3. Price Forecast" in Part III have been drawn up based on the Bank of Korea's 「Economic Outlook Report」 released on January 18, 2018.

Pace of Increase in International Oil Prices Forecast to Slow

It is forecast that crude oil demand will steadily rise but that the pace of increase in international oil prices will gradually slow, owing to the expansion in shale oil production and to the possibility of an early termination of the agreement on production cuts. Going forward there is a potential for substantial fluctuations, in line with developments in terms of political and economic conditions in the OPEC countries.

<Table III - 3> Outlook for international oil prices¹⁾

	2017		2018 ^a	
	1st half	2nd half	1st half	2nd half
<Brent>	52.1	56.6		
CERA (Dec. 14)			56.1	55.2
OEF (Dec. 19)			60.0	61.0
EIA (Jan. 9)			58.8	60.6

Note: 1) Period-average; figures in parentheses refer to dates of forecasts.

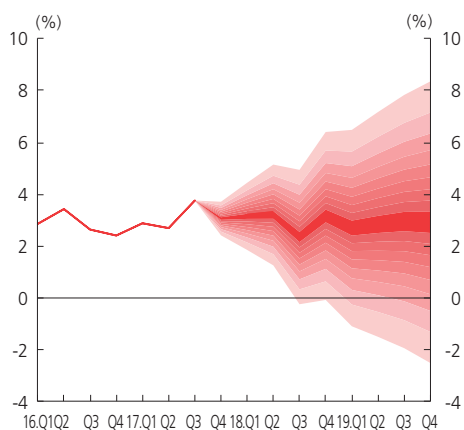
Sources: CERA, OEF, EIA.

2. Growth Forecast

Domestic Economic Improvements Forecast to Continue

The domestic economy is foreseen showing a rate of growth at the 3% level during this year. Investment will slow but it is expected that consumption will continue its steady growth, driven by improvements in household income conditions, and that exports will also sustain their favorable flows in line with the buoyancy of the world economy. The domestic economy is expected to continue to grow at the potential growth rate level in 2019 as well, as the growth in exports and consumption continue. Looking at the contributions to growth of the different expenditure sectors, it is projected that the contribution of exports will rise and that of domestic demand will fall.

<Figure III - 1> Economic growth fan chart¹⁾²⁾



Notes: 1) Compared with the same periods of the previous years; figures are the forecasts as of Jan. 2018.

2) The darkest band in the center of the chart represents a 10% confidence interval including the central projection, and the other colored bands cover confidence intervals ranging from 20% to 90% as the shading lightens.

Source: The Bank of Korea.

As to the different economic sectors, it is forecast that private consumption will continue to expand, thanks to favorable consumption sentiment, to the government's policies and to the stabilization of housing prices. The government's job- and income-led growth policies and housing price stabilization measures are expected to contribute to a pick-up in private consumption, but it seems likely that the rise in interest payment burdens and the delay in improvements in employment conditions will limit any rapid consumption recovery.

It is forecast that the rate of facilities investment growth will fall to a considerable extent during this year, on the base effect from last year's much greater than planned facilities investments by individual corporations in line with the buoyancy of global IT business conditions. It is expected that the increase in intellectual property products investment will continue this year, with R&D investment expanding gradually, especially in the private sector, thanks to the robustness of IT manufacturing industry companies' business performances. Construction investment is forecast to enter a full-scale phase of adjustment, in accord with the declining amount of building construction commencements and with the government's ongoing stance of SOC budget reduction.

Exports are expected to show a rate of growth similar to that of last year, as the steady growth of world trade is foreseen continuing thanks to the ongoing improvements in the world economy and recovery of investment. However, it is assessed that

downside risks do still exist, such as those of a strengthening of protectionism and the possibility of a prolonged trend of Korean won appreciation. Imports will continue to increase, but it appears likely that the extent of their growth will lessen as the pace of increase in oil prices slows compared to last year. It is forecast that the current account surplus will be maintained, but that its size will shrink compared to last year as the extent of the goods account surplus narrows slightly.

<Table III - 4> Economic growth outlook¹⁾

(%)

	2017			2018 ^a			2019 ^a
	Year ^a	1st half	2nd half ^a	Year	1st half	2nd half	
Real GDP	3.1	2.8	3.4	3.0	3.2	2.8	2.9
Private consumption	2.5	2.1	2.8	2.7	2.9	2.5	2.7
Facilities investment	14.3	15.9	12.8	2.5	2.1	2.9	2.3
Intellectual property products investment	3.0	2.6	3.4	2.9	3.3	2.6	2.7
Construction investment	7.2	9.4	5.4	-0.2	-0.5	0.0	-2.0
Goods exports	3.6	4.2	3.0	3.6	3.0	4.2	3.5
Goods imports	7.3	9.3	5.3	3.2	2.2	4.1	3.1

Note: 1) Compared with the same periods of the previous years; figures are the forecasts as of Jan. 2018.
Source: The Bank of Korea.

Concerning the future path of growth there is a mix of upside and downside risks. The former include those of accelerating growth in exports and facilities investment in line with a strengthening of the global economic recovery, of a pick-up in the pace of export growth due to a more rapid improvement in trading conditions vis-à-vis China, and of strengthening economic sentiments stemming from the government's implementation of economic stimulus measures and

from the easing of North Korea risk. Among the downside risks, meanwhile, are a worsening of the trading environment due to the spread of protectionism, a deterioration in financial conditions in consequence of the monetary policy normalizations in major countries, and a weakening recovery of domestic demand due to an inadequate improvement in employment conditions.

3. Price Forecast

Consumer Price Inflation Forecast to Be Slightly Below Inflation Target

It is forecast that consumer prices will rise by 1.7% this year, and their pace of increase in 2019 is expected to be higher than that.

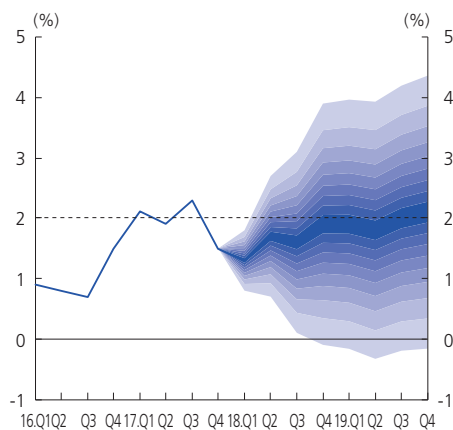
Looking first at the supply side, there is a possibility that international oil prices will fall somewhat compared to their current level, and it is forecast that agricultural product prices will also show a low pace of increase for the time being. On the demand side, it is expected that the positive GDP gap will continue, and that the increase in nominal wages will gradually pick up owing to the improved corporate earnings and to the hike in the minimum wage. Public service charges are meanwhile expected to show a low pace of increase, given the government's price stabilization policy stance, while the growth in housing rental prices is also forecast to slow somewhat on the effects of the large amount of newly occupied apartments.

Core inflation (the index with food and energy products excluded), which removes the effects of irregular supply-side factors on prices, is expected to be 1.8% during this year and 2.0% in 2019.

The upside and downside risks to the future path of inflation are mixed, and the uncertainties surrounding the price outlook have risen significantly, due to the recent sharp movements of international oil prices

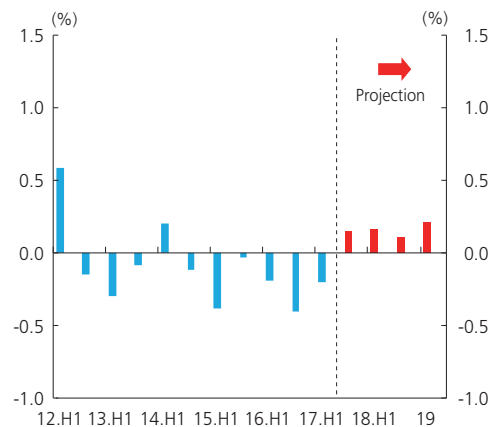
and the won/dollar exchange rate and to the large hike in the minimum wage. Among the major upside risks to the inflation path going forward are those of a strengthening of the domestic economy's recovery in line with the global economic improvements, and of an accelerated pace of increase in service charges due to the minimum wage hike. The potential downside risks include a weakening of international oil prices owing to a rise in US shale oil production, and a drop in import prices due to the appreciation of the Korean won.

<Figure III - 2> CPI inflation fan chart⁽¹⁾⁽²⁾



Notes: 1) Compared with the same periods of the previous years; figures are the forecasts as of Jan. 2018.
 2) The darkest band in the center of the chart represents a 10% confidence interval including the central projection, and the other colored bands cover confidence intervals ranging from 20% to 90% as the shading lightens.
 Source: The Bank of Korea.

<Figure III - 3> Percentage GDP gap outlook⁽¹⁾



Note: 1) Figures are the forecasts as of Jan. 2018.
 Source: The Bank of Korea.

<Table III - 5> Inflation outlook⁽¹⁾

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

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

4. Major Considerations

Among the major issues that will have to be considered in the future operation of monetary policy, we have looked at the distinct features of the past periods of economic recovery in Korea, the current employment conditions, the underlying price movements, and financial stability.

A. Distinct Features of Past Periods of Economic Recovery in Korea, and Implications

Based on a comparison of the distinct features of the past economic recoveries in Korea with the current financial and economic conditions, it is judged that the Korean economy is likely to continue to grow steadily at the level of its potential growth rate going forward. This is because exports and investment have been increasing recently at paces similar to those in the past, as domestic economic activities have picked up along with global economic activities, while it is expected that, unlike during the past recoveries, major countries will raise their policy rates at moderate paces and implement expansionary fiscal policies. However, there does appear to be a pos-

sibility of the pace of the consumption recovery being relatively slower than in the past, owing to the increased burdens of principal and interest repayments on household debt.

The Korean economic recovery has been strengthening recently. In the fourth quarter last year the GDP growth rate adjusted somewhat, due to irregular factors such as the base effect following the high growth in the quarter before and the long Korean Thanksgiving holidays. The solid domestic economic growth is continuing, however, as consumption is gradually improving while exports remain buoyant. Major international organizations also forecast that the Korean economy will continue its steady growth in 2018.³⁷⁾ In this article we look at the features of past Korean economic recoveries³⁸⁾, and on the basis of this assess the recent financial and economic conditions:

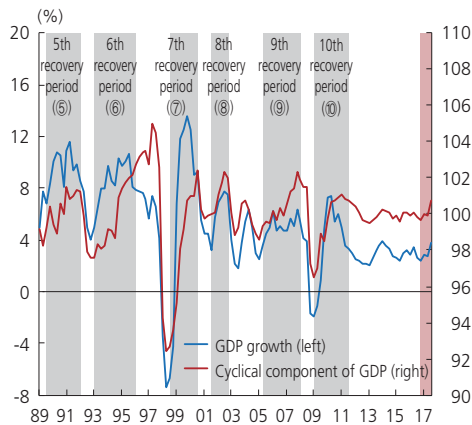
We divide up the features of past Korean economic recoveries into those related to external conditions, to exports and domestic demand, to prices, to fiscal policy, and to credit and housing prices, and find the following. First, the periods of Korean economic recovery have generally coincided with phases of recovery in the world economy; among the total six recovery periods considered, four of them (⑥, ⑦, ⑨ and ⑩)

37) The IMF (October 2017) and the OECD (November 2017) have forecast Korea's 2018 GDP growth rate at 3.0%, slightly higher than its rate of potential growth (2.8~2.9% over the 2016~2020 period; Bank of Korea July 2017 Economic Outlook Report), while domestic private economic research institutes (November~December 2017) are forecasting a 2018 GDP growth rate in the 2.8 to 2.9% range.

38) We analyze here six past periods of economic recovery (those of the 5th through the 10th business cycles; ⑤ to ⑩ hereafter) since 1989, based on Statistics Korea's business cycle phases. However, for the recent period of economic recovery we consider the OECD's judgement of the business cycle phase, the GDP growth rate, and the cyclical component of GDP, and analyze it based on the assumption that it began in the fourth quarter of 2016. For reference, Statistics Korea is maintaining its provisional judgement (June 2016) that the domestic economy passed through the trough of its current cycle in the fourth quarter of 2013.

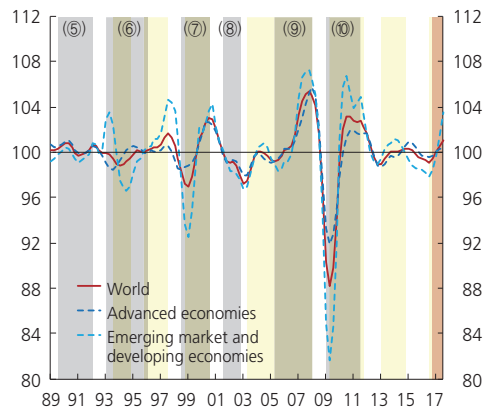
occurred during times of global economic recovery.³⁹⁾ And during these recoveries accompanied by upturns in global business cycles, the paces of recovery were stronger and the periods of recovery also longer than in the cases unlike these.⁴⁰⁾ Meanwhile, during the periods of global economic recovery major countries' central banks have operated their monetary policies so as to reduce their degrees of accommodativeness. In particular, after having reversed their policy stances they have raised their policy rates rapidly to large extents.

<Figure III - 4> Korean business cycles¹⁾, GDP growth rate²⁾, and cyclical component of GDP³⁾



Notes: 1) The areas in gray indicate the periods of recovery in the past, and the area in red the recent recovery period.
 2) Year-on-year.
 3) Calculated by applying HP filter on quarterly GDP growth rates.
 Sources: The Bank of Korea, Statistics Korea.

<Figure III - 5> World business cycles¹⁾ and cyclical component of GDP²⁾



Notes: 1) Areas in yellow are the periods of world economic recovery designated by the OECD.
 2) Calculated using IMF figures for GDPs of the world, advanced economies and emerging market and developing economies.
 Sources: IMF, OECD, the Bank of Korea.

Secondly, the domestic economic recoveries have been driven mainly by expansions in exports and in facilities investment. While exports have shown rapid rebounds against the backdrops of global economic recoveries, facilities investments have also expanded, in responding sensitively to forecasts for business conditions and exports. Notably, as the share in GDP accounted for by exports has risen since the mid-2000s, the net contribution to growth from exports has expanded greatly compared to that in the past.⁴¹⁾ The recovery in consumption has in contrast pro-

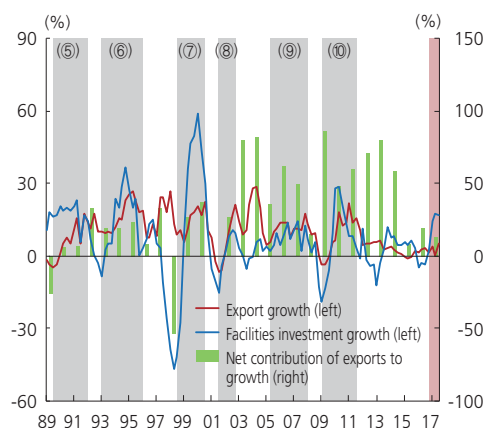
39) In the cases of recovery periods ⑤ and ⑧ the domestic economy showed recoveries even despite slumps in world economic activities, thanks to expansions respectively in construction investment (1st new city construction program) and in private consumption (invigoration of credit card use).

40) The extents of real GDP growth and the periods of continued economic recovery averaged 20.4% and 31.3 months respectively during recovery periods ⑥, ⑦, ⑨ and ⑩, while during periods ⑤ and ⑧ showing respective averages of 17.5% and 23.5 months.

41) The proportion of exports in GDP has expanded from an average of 21.7% during recovery periods ⑤ through ⑧ to an average 46.3% in periods ⑨ and ⑩, and in line with this the net contribution to growth of exports has also risen from 17.8% to 50.8%. Here the rate of net contribution to growth of exports means the contribution to growth of exports calculated with the portion of any increase in imports induced by an increase in exports excluded. Normally the rates of GDP growth contribution by expenditure sector are calculated by dividing the demand item into domestic demand and net exports (exports – imports), and in this case the value of imports is subtracted from the value of exports only, resulting in either over- or undercalculation of the rates of contribution to growth of domestic demand and exports compared to reality. (Imports are involved in both domestic demand and demand for exports). In our calculation of the rate of net contribution to growth of exports we refer to Jung et al. (February 2013), who use the inter-industry relations tables' import inducement coefficients and subtract only the value of imports related to export demand from the value of exports.

gressed more gradually than that of investment, and the extent of consumption growth has also been relatively small.^{42/43)}

<Figure III - 6> Growth in exports and facilities investment, and net contribution of exports to growth¹⁾²⁾

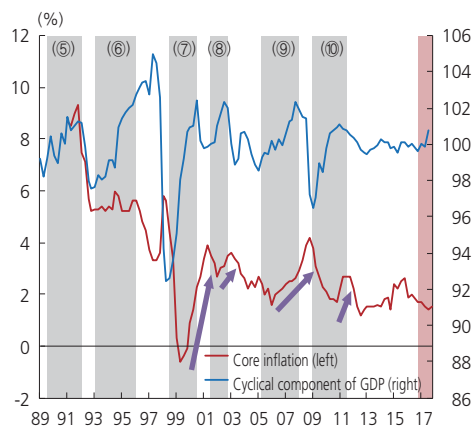


Notes: 1) Growth in exports and facilities investment compared to the same periods of the previous years.
2) Net contribution of exports to growth calculated by subtracting the value of imports associated with an expansion in exports from the total value of exports.

Source: The Bank of Korea.

Third, the paces of inflation have picked up after the economic recoveries, after certain time lags. Comparison of the movements of core inflation with those of the cyclical components of GDP shows that the upward trends of core prices have accelerated after entry into the phases of economic recovery, after some time lags, and also continued to accelerate for a while even after the reversals to contractionary phases.

<Figure III - 7> Cyclical component of GDP and core inflation¹⁾



Note: 1) Excluding food & energy; year-on-year.
Source: The Bank of Korea.

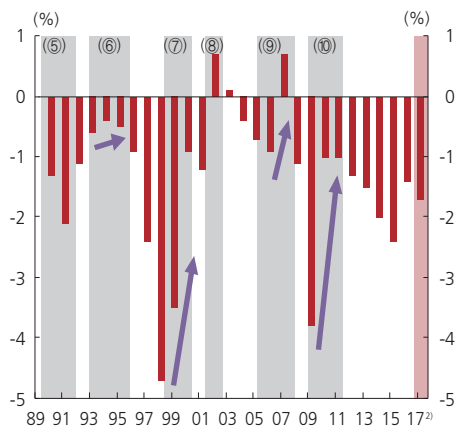
Fourth, during the recovery periods fiscal policies have generally been operated austere. As the rates of fiscal revenue growth during the recoveries have mostly exceeded the rates of increase in fiscal expenditures, the fiscal balances have improved; this is because the government budget basically functions as an automatic stabilizer⁴⁴⁾, on top of which discretionary fiscal policy has also been operated so as to reduce the magnitude of business fluctuations and promote macroeconomic stability.

42) During the periods of economic recovery analyzed, the extent of acceleration in the rate of increase (based on the increase from the lowest to the highest values of the quarterly year-on-year rates of increase) in investment (based on total capital formation, including facilities investment, construction investment and changes in inventories) has been +6.5% points on average, while the extent of acceleration in the rate of private consumption growth has averaged just +2.2% points.

43) This can be seen as a result of the fact that corporations are deciding to invest procyclically, to maximize their profits, while households are smoothing out their consumption for utility maximization (BIS, 2017).

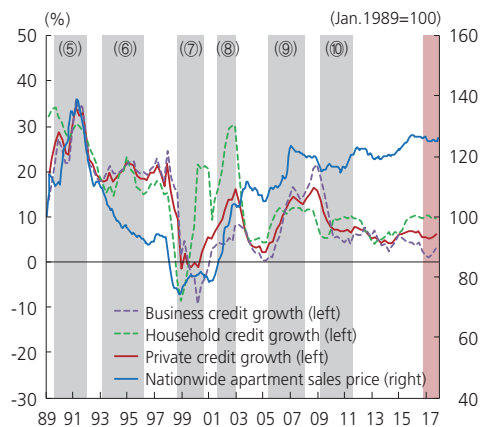
44) Even if the government does not intentionally adjust the tax rate or expenditures, tax revenues such as revenues from income taxes automatically increase (decrease), and government expenditures such as social security expenditures, etc. come to decrease (increase) as economic agents' incomes rise (fall) during economic boom (bust) periods.

<Figure III - 8> Korean government fiscal balance-to-nominal GDP ratio¹⁾



Notes: 1) Government fiscal balance excluding social security fund balance and bail-out funds provided.
 2) Supplementary budget included in 2017.
 Source: Ministry of Strategy and Finance.

<Figure III - 9> Private credit growth¹⁾ and apartment sales price²⁾



Notes: 1) Based on loans, bonds and government financing to households and businesses in the flow of funds tables; year-on-year.
 2) Real nationwide apartment price index created using consumer price index.
 Sources: The Bank of Korea, Statistics Korea, Korea Appraisal Board.

Finally, during the periods of economic recovery credit has generally expanded together with rises in housing prices. The paces of private credit growth picked up during the four recovery periods other than those right after the foreign exchange and the financial crises ((7) and (10)).⁴⁵⁾ Real housing prices⁴⁶⁾ also increased in five of the recovery periods excepting period (6)⁴⁷⁾, and notably drove the expansions in household credit during the recoveries right after the foreign exchange and financial crises, as they rose during those periods.⁴⁸⁾

If we now assess the financial and economic conditions during the recent economic recovery in view of these features of past Korean economic recoveries, we find the following:

First, the recent recovery is taking place against the background of a world economic recovery. The global economy entered its expansionary phase after reaching its trough in August 2016⁴⁹⁾, and the pace of recovery has been picking up more than had been expected.⁵⁰⁾ On the other hand, differently

45) During recovery periods (7) and (10) the paces of increase in credit, corporate credit in particular, slowed for considerable periods as the effects of the foreign currency crisis and the global financial crisis persisted.

46) We used the consumer price index (CPI) to create a real nationwide apartment price index.

47) During the sixth recovery cycle the downward trend of housing prices continued, under the effects of the expansion in housing supply in line with the first new city construction program.

48) Corporate credit shows a relatively high correlation with the business cycle, and household credit with housing prices. In the case of the rate of corporate credit growth, the coefficient of correlation between it and the cyclical component of the coincident composite index (0.34) is higher than its coefficient of correlation with the rate of apartment price increase (0.26), while for household credit the coefficient of correlation with that rate of apartment price increase (0.58) is higher than that with the cyclical component of the coincident composite index (0.41) (Q3 1989 ~ Q2 2017 basis).

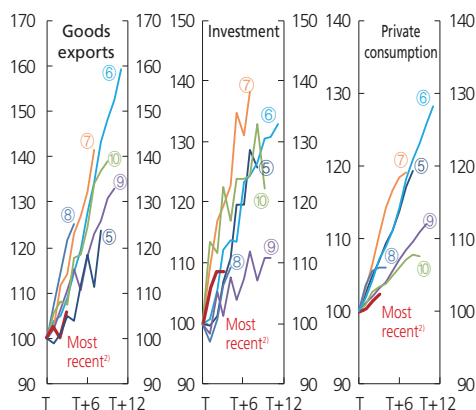
49) Based on the global business cycle phases being announced by the OECD.

50) The IMF has recently been revising its forecast figures for the 2018 world economic growth rate continually upward (October 2016 3.57% → April 2017 3.64% → October 2017 3.70%).

from in the past, major countries appear likely to reduce the degrees of their monetary policies' accommodativeness only gradually even during the global economic recovery⁵¹⁾, and it is thus judged that the possibility of a monetary policy shock causing the pace of economic recovery to weaken is relatively low. In addition, the expectation based on the government's medium-term fiscal plan that fiscal policy will be operated expansively for the time being⁵²⁾ appears likely to be a positive factor affecting the economic recovery. By demand sector, exports and investment have since the fourth quarter of 2017 shown trends of recovery at their average levels seen during past periods of recovery. Consumption, however, is judged to be continuing its slower pace of recovery than in the past, due to the low rate of increase in real wages and to the increases in interest and principal repayment burdens.

If we sum up the discussions above, it is judged that the possibility is high of the domestic economy continuing its solid growth at the potential growth rate level in the future. This is because the ongoing steady increases in exports and investment against the background of an expanding global economic recovery, the forecasts for major countries carrying out of gradual monetary policy normalizations, and the operation of expansionary fiscal policies appear likely to positively affect the economic recovery. However, there does seem a likelihood that the pace of recovery in consumption will be relatively slower than in the past, in line with the increases in households' debt interest and principal repayment burdens.

<Figure III -10> Goods exports, investment and private consumption during recovery stages¹⁾



Notes: 1) T denotes the quarterly troughs.

2) 2016 Q4 ~ 2017 Q3.

Source: The Bank of Korea.

51) During past periods of Korean economic recovery (⑥, ⑦, ⑨ and ⑩) major country policy interest rates (10 country weighted average basis) were raised by an average of 0.18% point per quarter, but it is forecast (based on a December 20, 2017 survey of financial institutions by Bloomberg) that during the 2017~18 period the extent of increase in major country policy rates will average just 0.07% point per quarter.

52) According to the government's medium-term fiscal plan, it is forecast that the government deficit (% of GDP; government budget balance basis) will be -1.7% in 2017, -1.6% in 2018, -1.8% in 2019, and -2.0% in 2020.

B. Examination of Recent Employment Conditions

Despite the positive conditions for employment, including the improvements in the domestic economy and the job-creating measures undertaken by the government, the speed of the employment recovery has been somewhat unsatisfactory. This appears to have been a result of an interplay of factors such as the sluggish growth in the service industries with high elasticities of employment and in some of the labor-intensive manufacturing industries, the lack of room for additional job creation due to the market saturation by small-scale businesses, and mismatches between supply and demand in the labor market.

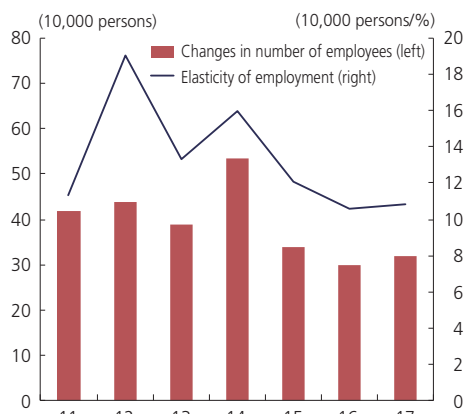
It seems likely that employment will pick up in the future, thanks to an increase in foreign tourists, to improved service industry conditions due to the government's policies to expand household incomes, and to the government's job creation measures. In line with this it is forecast that the number of persons employed will gradually rise, led mainly by the service industries, the health and welfare sector and the public administration sector. Going forward as well there is a need to thoroughly examine the improvements in the service industries and developments in terms of the government's measures for job creation, and how they are affecting employment.

Even despite the positive conditions for employment, such as the improvement in domestic economic activities and the govern-

ment policies to create jobs, the speed of the recovery in employment has been slow.

During 2016 there was an increase of 300 thousand persons employed, and in 2017 also an increase of just 320 thousand persons. In line with this, from the first quarter to the third quarter in 2017 the elasticity of employment (increase in persons employed/GDP growth rate) fell compared to its average level during the 2011~2016 period. Moreover, the rate of youth unemployment also remained at a high level.

<Figure III -11> Elasticity of employment¹⁾ and changes in number of employees²⁾



Notes: 1) Increase in number of employees/GDP growth rate.
2) Compared to the previous years; based on Q1~Q3 for 2017.

Sources: The Bank of Korea, Statistics Korea.

<Table III - 6> Unemployment and youth¹⁾ unemployment rates

	2011	2012	2013	2014	2015	2016	2017
Unemployment (%)	3.4	3.2	3.1	3.5	3.6	3.7	3.7
(Youth)	7.6	7.5	8.0	9.0	9.2	9.8	9.9

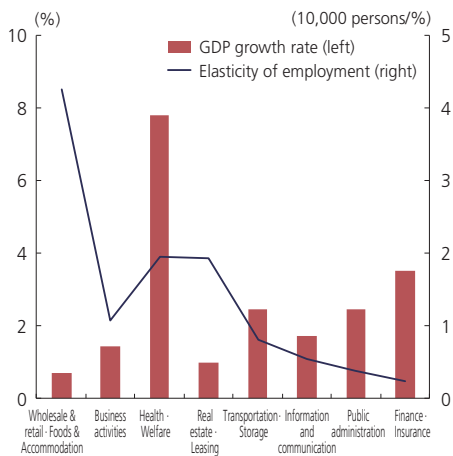
Note: 1) Based on persons aged 15~29.

Source: Statistics Korea.

This unsatisfactory speed of the employment recovery compared to the improvements in economic activities has been a result mainly of factors including the following:

First, it has been because growth in the service industry with its high elasticity of employment has been sluggish.⁵³⁾ The rate of service industry growth was a mere 2.0% year-on-year over the period from the first to third quarter of 2017, as the impact of the decline in foreign tourists was greater than expected, in addition to which household incomes were stagnant.⁵⁴⁾ In particular, growth has been sluggish in service industries with high elasticities of employment such as wholesale and retail trade and food services and accommodation.

<Figure III -12> GDP growth rates¹⁾ and elasticities of employment²⁾, by service industry



Notes: 1) 2017 Q1~Q3; year-on-year.
2) Average elasticities between 2011 and Q3 2017
Sources: The Bank of Korea, Statistics Korea.

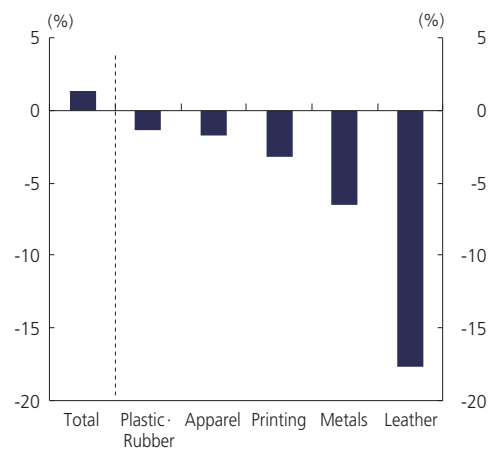
The slow speed of the employment recovery has also been a consequence of the sluggish growth in some labor-intensive manufacturing industries. Outputs in the printing, leather products and apparel industries, where ratios of employment to GDP are relatively large, have shown year-on-year declines owing to shortages in domestic demand, and it is analyzed that this has influenced the delay in the employment recovery.

<Table III - 7> Employment-to-GDP ratios¹⁾

	(persons/billion won)					
	Printing and reproduction of recorded media	Leather products	Textiles and apparel	Plastic products ²⁾	Semi-conductors	Manufacturing total ³⁾
	10.6	5.9	5.2	3.1	1.4	2.6

Notes: 1) Based on 2014 Updated Input-Output Tables.
2) Average of plastic and rubber products.
3) Weighted average based on output by sector.
Source: The Bank of Korea.

<Figure III -13> Rates of output growth, by manufacturing sector¹⁾



Note: 1) Based on the index of industrial products from January to November 2017; year-on-year.
Source: Statistics Korea.

53) During the period from 2011 through the third quarter of 2017 (average) the elasticities of employment (quarterly persons employed in each industry/quarterly percentage growth rate of that industry) were at levels of 125 thousand persons/% in the service industry, 23 thousand persons/% in the manufacturing industry, and 8 thousand persons/% in the construction industry.

54) The rates of change (year-on-year) in real household incomes were 0.8% in 2013, 2.1% in 2014, 0.9% in 2015, -0.4% in 2016, and -0.8% in the Q1~Q3 2017 period.

The decreased capacity for additional job creation as the self-employed business sectors become saturated has been another factor. During the second half of 2016 small-scale businesses reached a point of market saturation, as people who had lost their jobs due to restructuring or to the coming of retirement age opened self-employed businesses in the wholesale and retail trade and food services and accommodation industries. Under these circumstances the number of small-scale business owners decreased in 2017, as a result of slumps in service industry business conditions and a slowdown in the rate of increase in retirees.⁵⁵⁾

<Figure III -14> Small-scale business owners¹⁾

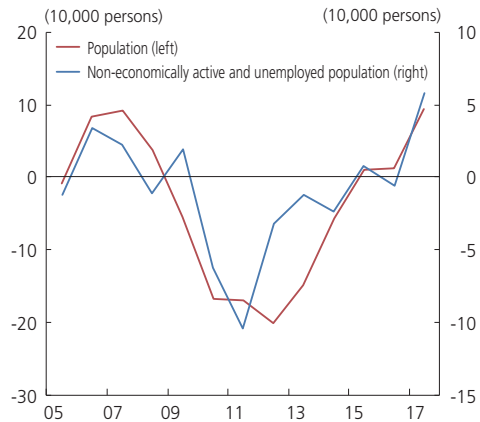


Note: 1) Workers who, working on their own account or with one or more partners, hold the type of job defined as a self-employed job, and have not engaged on a continuous basis any employees to work for them during the reference period; seasonally adjusted.
Source: Statistics Korea.

Amid an increasing population of young people in their upper 20s, who are just entering society, the lack of improvement in the situation of a shortage of quality jobs is

also becoming a factor causing sluggishness in the employment recovery. As the situation of mismatches between job seekers pursuing employment stability and corporations preferring flexibility in their use of labor continues, the youth unemployment rate is remaining high.

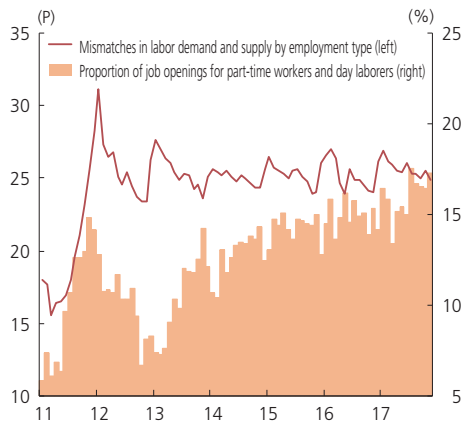
<Figure III -15> Changes in population and employment of youth aged 25~29¹⁾



Note: 1) Compared with previous periods.
Source: Statistics Korea.

55) The population aged 55 and above increased by 719 thousand persons in 2016, but in 2017 grew by just 582 thousand persons.

<Figure III -16> Mismatches in labor demand and supply by employment type¹⁾



Note: 1) The sum of the differences between the ratios of job openings and job applicants for each employment type (full-time, hourly, etc.); the higher the score, the greater the mismatch between supply and demand in the labor market (Jackman and Roper, 1987).
Sources: Bank of Korea estimates, Korea Employment Information Service.

It appears that employment conditions will likely improve going forward, thanks to an increase in foreign tourists, to an improvement in service industry business conditions due to the government policies to expand household incomes, and to the government’s job creation policies. In line with this it is forecast that the number of persons employed will gradually rise, led by the service industry, and the health and welfare and public administration sectors. In the future as well there will be a need to continue to closely watch the improvements in service industry business conditions and the developments in terms of the job expansion policies, and to examine the effects that they are having on employment.

<Table III - 8> Major policies to boost household incomes

Major policies	Note
Increase in minimum wage	Raise minimum wage by 16.4% in 2018
Employment stabilization funds	Provide support with labor costs to firms having less than 30 employees
Insurance discounts	Discounts on insurance fees paid by firms having less than 30 employees
Childcare support	To be introduced in July 2018
Basic pension	Increase from ₩206,000 to ₩250,000 per month
Employment of elderly	Increase from 440,000 to 510,000 persons employed
Allowances to encourage youth job searches	Monthly payments of ₩300,000 for 3 months

Source: Ministry of Strategy and Finance.

C. Assessment of Recent Underlying Price Movements

Various core inflation indicators indicative of the underlying price movements remain at slightly under 2% (with regulated prices excluded). In this situation it is forecast that the upward price pressures due to the higher oil price level, and the continuous improvements in the domestic and international economies could cause the upward pressures on underlying prices to grow in the future.

It is forecast that going forward consumer prices will show a somewhat low pace of increase for the time being, due to the base effects of the supply-side price increases at the beginning of last year, but then gradually rise moving into the second half. It appears likely, however, that the apparently weakened relationship between the economic cycle and prices could restrain the upward price trend. Considering that the uncertainties about the future path of inflation have grown to a considerable extent recently, owing to the sharp movements of oil prices and the won/dollar exchange rate, there is a need for close monitoring of the effects that these factors have on prices.

Last year consumer prices showed a pace of increase (1.9%) approaching the inflation target level⁵⁶⁾, on the effects of the rising prices of oil and of agricultural, livestock and marine products. Meanwhile, core infla-

tion (the index excluding food and energy products) remained at the mid-1% level, even despite the pick-up in the pace of recovery in domestic economic activities.

It is generally believed that for grasping the underlying price movements core inflation is superior to consumer price inflation. And it is thus possible to interpret the fact that core inflation has been below the consumer price inflation rate as suggesting a slowdown in the pace of consumer price increase. At the same time, however, consumer prices are expected to show a pace of increase close to the inflation target even if the effects of upward supply-side factors do gradually weaken. This is based on the view that core inflation will rise after a certain time lag if the recent economic recovery continues, under circumstances in which inflationary price pressures have built up due to the greatly elevated oil prices of the past two years.

In order to try to estimate the future price movements it is necessary to comprehensively examine a variety of core inflation indicators. This is because, given the diversity of the sources that are causing temporary disturbances in prices, trying to apprehend the underlying price flows through one indicator only is of limited effect. Therefore, for this article we have utilized various indicators in addition to our main core inflation indicator, the index excluding food and energy prices (the OECD standard)⁵⁷⁾, and tried to

56) During the period from 2016 through 2018 the Bank of Korea's inflation target, based on the year-on-year rate of consumer price inflation, is 2.0%.

57) Statistics Korea is announcing as its indicators of core inflation the index excluding agricultural and petroleum products and the index excluding food and energy products. The Bank of Korea has since January 2017 been using as its main core inflation indicator the index excluding food and energy products, which is assessed as superior from the standpoints of its being less volatile, having greater predictive power, and enabling easier international comparison.

assess the underlying price movements.

<Table III - 9> Core inflation indicators

Indicator	Method of calculation
CPI excluding food & energy	Calculated after exclusion of food and energy products from CPI basket
CPI excluding agricultural products & oils	Calculated after exclusion of agricultural products and oils from CPI basket
Sticky price index	Calculated using products whose prices do not change frequently
Domestically-generated inflationary pressure indicator	Reduced weights of final goods dependent on significant inputs of imported intermediate goods
Adjusted average	Calculated after exclusion of extreme values from distributions of monthly CPI product's price inflation rates
Weighted median	Weighted median of monthly CPI product's price inflation rates
Underlying inflation gauge-I (UIG-I) ⁵⁸⁾	Extracted long-term common factors from individual product's price inflation rates
Underlying inflation gauge-II (UIG-II) ⁵⁹⁾	Extracted long-term common factors after adding various macroeconomic indicators to UIG-I

Note: 1) UIG-I calculated using the 84 products comprising the CPI, and UIG-II using a generalized dynamic factor model after addition to UIG-I of 129 macro and financial indicators.

Source: The Bank of Korea.

If we look at the trends of these indicators⁵⁸⁾, the normal core inflation indicator (average value) with regulated prices included⁵⁹⁾ is showing sideways movements without any clear directional nature. But because regulated prices are highly subject to the influences (systemic factors), both direct and indirect, of the government, there is a problem in that they do not properly reflect market supply and demand. Therefore, in order

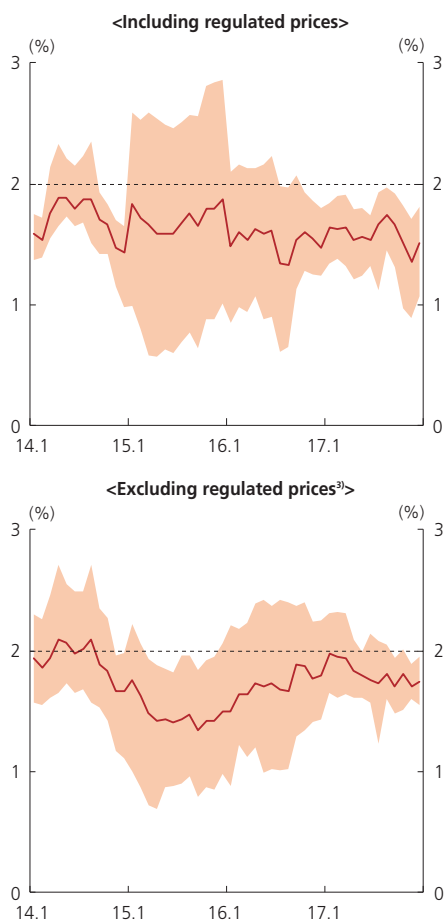
to grasp the underlying price movements there is a need for excluding the effects of regulated prices.⁶⁰⁾ If we look at six core inflation indicators (average value) including the index with food and energy products excluded, after removing regulated prices from them, we find that they have been faltering somewhat recently after having rallied from around the end of 2015. But given that they are maintaining paces of increase at levels slightly below 2%, as before, it is difficult to assess that the underlying price movements have weakened.

58) In <Figure III-17> the shaded areas show the ranges of the eight indicators, while the lines show their average values.

59) Including public service fees and electricity, water and gas charges, cigarette prices, school meal fees, childcare expenses, etc.

60) This is because, compared to core inflation with regulated prices included, core inflation with regulated prices excluded better reflects the demand and supply in the markets and has a closer relationship with domestic economic activities.

<Figure III -17> Core inflation indicator¹⁾ trends²⁾

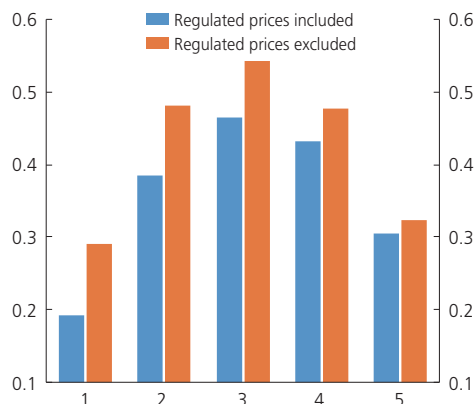


Notes: 1) ① CPI excluding food & energy ② CPI excluding agricultural products & oils ③ sticky price index ④ domestically-generated inflationary pressure indicator ⑤ adjusted average ⑥ weighted median ⑦ UIG-I ⑧ UIG-II
 2) Year-on-year; shaded areas indicate ranges between maximum and minimum values, and lines indicate averages.
 3) Only indicators ① to ⑥ used.
 Sources: The Bank of Korea, Statistics Korea.

Meanwhile, analysis of the lag correlation between core inflation with regulated prices excluded and the domestic business cycle shows that core inflation with regulated prices excluded appears to be a lagging indicator of the percentage GDP gap showing

domestic economic conditions, which it lags about three quarters behind. This suggests that upward price pressures will gradually materialize as the percentage GDP gap reverses to a positive figure going forward.

<Figure III -18> Lag correlation coefficients¹⁾ between core inflation²⁾ and percentage GDP gap³⁾



Notes: 1) Lag correlation coefficient between percentage GDP gap of tth quarter and core inflation rate of (t+n)th quarter (2001 Q1 ~ 2017 Q3).
 2) Average of eight core inflation indicators.
 3) Calculated using HP filter.
 Source: The Bank of Korea.

To sum up the results of the discussion to this point, the underlying price movements as examined through diverse core inflation indicators are maintaining upward trends at levels running slightly below 2% (with regulated prices excluded). In this situation it is forecast that factors such as the upward pressures on prices following the higher oil price level and the continuing improvements in the domestic and global economies will become factors heightening the upward pressures on underlying prices in the future.

Going forward, consumer prices will for the time being show a somewhat low pace of increase, due to the base effect of the rises

in supply-side prices at the beginning of last year, but it is forecast that they will gradually rise moving into the second half of the year. However, it appears that factors such as the seemingly weakened relationship between economic activities and prices will limit the pace of inflation. Considering the point that the uncertainties surrounding the future price channel have risen greatly due to the recent sharp movements of oil prices and the won/dollar exchange rate, there is a need for close monitoring of the effects on prices due to these factors.

D. Assessment of Recent Financial Stability Conditions⁶¹⁾

It is assessed that the Korean financial system is maintaining its stability overall, as capacities for absorption of domestic and external shocks have been heightened. But concerns do remain regarding the financial imbalances built up after the prolonged period of accommodative monetary policy, such as the increased ratio of household debt relative to income.

Going forward as well, therefore, the Bank of Korea will have to carefully examine the financial stability situation subsequent to any changes in conditions. While doing so it should also continue to operate its monetary policy prudently, with a focus on the possibility of its prolonged accommodative policy stance causing the financial imbalances to deepen, and on the effects on growth and inflation that this build-up in imbalances may have in the medium to long term.

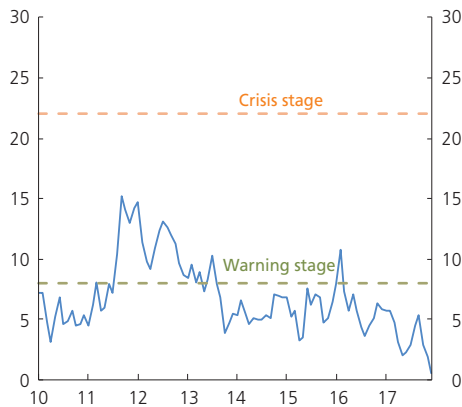
Korea's financial system is assessed to be sustaining its stability generally, as its capacities for absorbing domestic and external shocks have been enhanced. Financial institutions' capital adequacy ratios, indicative of their loss absorption capacities, are greatly exceeding the regulatory standards, while the nation's external payment capacity is also favorable, with the increases in net external assets in debt instruments and in the foreign exchange reserves continuing⁶²⁾, and the short-term external debt ratio main-

61) In writing this we have referred to the June and December 2017 「Financial Stability Report」.

62) At the end of December 2017 the official foreign exchange reserves recorded an all-time high figure of 389.3 billion dollars, having thus increased by 18.2 billion dollars since the end of the year before.

taining a low level.⁶³⁾ The Financial Stability Index, showing the overall financial system conditions, is also falling well below the warning stage level.

<Figure III -19> Financial Stability Index (FSI)¹⁾²⁾



Notes: 1) A composite index (0~100) calculated by standardizing 20 monthly real and financial sector indicators related to financial stability. The warning and crisis stage thresholds are set at 8 and 22 respectively, through application of the 'noise-to-signal ratio' method.
2) The figure for December 2017 is preliminary.
Source: The Bank of Korea.

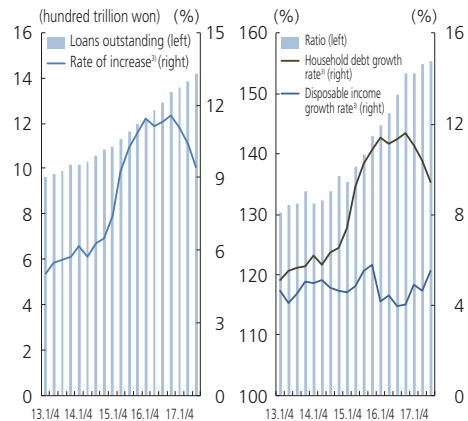
Although the financial system is thus showing stability overall, concerns remain about the financial imbalances accumulated after the prolonged period of accommodative monetary policy to this time, including the increased ratio of household debt relative to income.

The pace of increase in household credit has slowed somewhat, but as it is still at a level higher than in normal years the total volume of household debt is expanding and households' ratios of debt relative to income

have also been continually rising. If lending interest rates gradually rise under the impacts of the monetary policy normalizations by major countries' central banks, then in circumstances in which households' debt repayment burdens are increasing their difficulties in debt repayment can grow, particularly for the vulnerable groups. Moreover, this build-up in household debt can in the long term constrain consumption and there is a possibility of it hindering growth in the real economy as well.⁶⁴⁾

<Figure III -20> Household debt¹⁾ trends

<Volume and growth rate> <Household debt-to-disposable income²⁾ ratio>



Notes: 1) Household credit statistics basis.
2) Quarterly disposable income for 2017 estimated using the average household disposable income-to-GNI ratio during the preceding three years.
3) Year-on-year.
Source: The Bank of Korea.

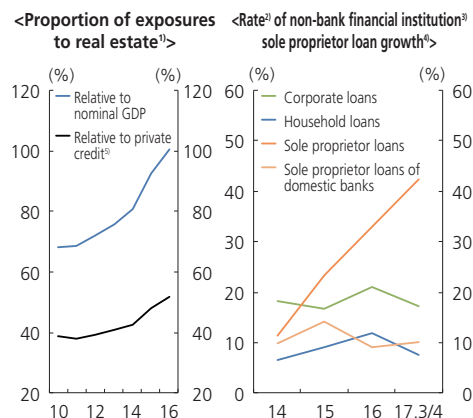
The concentration risk, stemming from financial institutions' excessive lending to certain specific industries or borrowers, has been growing recently. Looking at this situa-

63) As of the end of the third quarter of 2017 the ratio of short-term external debt relative to the foreign reserves was 31.1%, and was still at a low level compared with the past years' average (2010~16: 38.8%).

64) Kang, Jong Ku (2017), in a comprehensive analysis of the flow and stock effects of household debt, drew the conclusion that an increase in household debt can help to stimulate economic activities in the short term, but that in the long run the possibility is high of it burdening economic growth through the stock effect due to a household debt build-up.

tion by industry, the proportion of exposures to real estate-related businesses has been rising greatly. By borrower type, lending to self-employed business owners has persistently shown a high rate of growth⁶⁵, with the extensions of these loans by non-bank financial institutions increasing rapidly. Notably, given that a considerable portion of the loans made to self-employed business owners are also related to real estate⁶⁶, the two types of lending have become closely connected. In the case where lending to a specific sector is excessively large relative to the total amount of loans extended by a financial institution, or is increasing rapidly, defaults in that sector due to hikes in market interest rates or to a worsening of real estate business activities can cause damage to the financial institution's soundness.

<Figure III -21> Concentration risk of financial institutions' loans



Notes: 1) End-period basis; period of analysis starts from 2010 due to incomplete availability of statistics in some sectors before then.

2) Year-on-year.

3) Mutual credit cooperatives (excluding MG community credit cooperatives), credit-specialized financial companies, savings banks and insurance companies.

4) End-period basis.

5) Private credit is the sum of household and corporate debt.

Sources: The Bank of Korea, Financial institutions' business reports.

In response to the low interest rate environment, meanwhile, some non-bank financial institutions have shown increased tendencies in their fund operations of greater risk-taking for the sake of high return. Insurance companies have increased their holdings of available-for-sale bonds on which bond valuation gains are realized⁶⁷, securities companies have taken on burdens of risk and expanded their guarantees of contingent liabilities, which are sources of high returns, and credit card companies have expanded their lending of card loans which have rela-

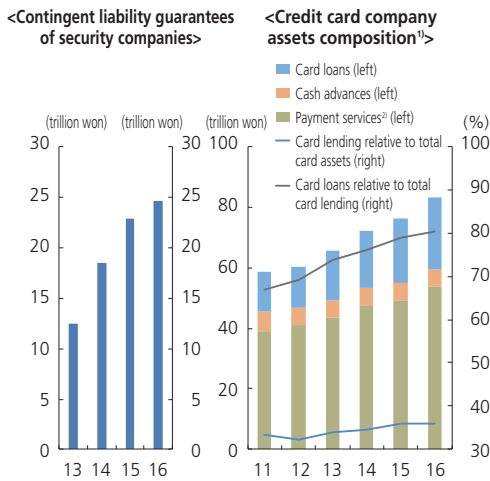
65) Loans to self-employed business owners, which make up 45.2% of all SME loans, increased by 10.1% during the year to end-Q3 2017. SME loans other than those to self-employed business owners meanwhile rose by just 3.8% during this time.

66) Among depository banks' loans to self-employed business owners, loans to the real estate and leasing industry make up 37.1% of the total (end-Q3 2017 basis).

67) Among total bond holdings of insurance companies, the share accounted for by available-for-sale bonds rose by 3.5% points (49 trillion won) between the end of 2013 and the end of 2016, from 68.6% (186 trillion won) to 72.1% (235 trillion won).

tively high interest rates. Given the difficulties for these institutions in changing the structures of their fund operations in a short span of time, there is a possibility that when market interest rates rise going forward the negative effects on non-bank financial institutions' profitability will be large.

<Figure III -22> Expansion in non-bank financial institutions' risk-seeking tendencies



Notes: 1) Year-end basis.
 2) Including revolving charges on payments.
 Sources: Financial institutions' business reports, Korea Ratings.

In circumstances under which the economy is sustaining a pace of growth at its potential level, if the degree of accommodation is not properly adjusted in accord with the economic recovery the risk of a build-up of financial imbalances can grow. Meanwhile, in a case where market interest rates rise rapidly due to the impacts of the monetary policy normalizations by major countries'

central banks in line with the global economic recovery, there is also a possibility of this having adverse effects on the soundness of households and corporations, as well as of financial institutions.⁶⁸⁾ Going forward as well it is thus necessary, on the one hand, to closely examine the financial stability situation following the changes in economic and financial conditions at home and abroad, while at the same time carefully operating monetary policy with attention to the possibility of a prolongation of the accommodative stance causing the financial imbalances to deepen, and to the effects that the build-up of these imbalances will have on growth and prices in the medium to long term.

68) In the analysis in the 「Financial Stability Report」 of December last year, on “Changes in Households' and Corporations' Debt Repayment Burdens at a Time of Interest Rate Increase,” it was assessed that the degrees of increase in the debt repayment burdens of both households and corporations following a 100bp rise in interest rates would generally be at levels that are possible to withstand, when their incomes and amounts of financial assets and operating profits are considered.

5. Future Monetary Policy Operational Directions

Base Rate Operation

In the future as well, the Bank of Korea will conduct its monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation can be stabilized at the target level over a medium-term horizon, while also devoting attention to financial stability.

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

In addition, given the still high uncertainties about the domestic and external conditions surrounding the Korean economy, the Bank will in operating its monetary policy also devote care to the risks on the financial stability side. It will strengthen its examina-

tions of developments in domestic and external conditions that can cause financial market volatility to rise, such as the paces of monetary policy normalization in major countries including the US, along with geopolitical risks, and closely monitor the in- and outflows of foreign capital. Together with this the Bank will devote attention as well to the possibility of its prolonged accommodative policy stance causing the build-up in household debt and other financial imbalances to deepen, and the effects on growth and inflation that this build-up of imbalances will have in the medium to long term going forward.

Enhancement of Monetary Policy Effectiveness

The Bank will work continually to improve its Bank Intermediated Lending Support Facility in directions that enhance the effectiveness of its monetary policy. While on the one hand operating the facility so as to heighten the effectiveness of its monetary policy through the credit channel, it will also work to reasonably improve its method of follow-up management related to the operation of its Bank Intermediated Support Loans and to the application of its recommended SME loan ratio.

The Bank of Korea will in addition work to strengthen its policy communication so as to heighten the transparency and predictability of its monetary policy. In order to enhance its consistency as a tool for communication, and its status as a statutory report, the Bank's Monetary Policy Report, which has until now been published twice annually

in the form of a regular report and twice as a medium-term report, will from this year on be published as a regular report four times per year.

Promotion of Financial and Foreign Exchange Market Stability

The Bank will also continue its efforts to promote the stability of the financial and foreign exchange markets. In its contingency plans prepared for times of financial and foreign exchange market unrest, it will reflect any changes in conditions related to the factors that can cause such unrest and supplement its corresponding response plans, and ensure thereby that it can maintain arrangements for responding rapidly to emergencies. Moreover, at any times of materialization of destabilizing factors overseas it will immediately activate its emergency examination system, and devise appropriate measures for response as needed. With regard to price variables in the financial and foreign exchange markets, the Bank will ensure that they are determined fundamentally by market supply and demand, and when any instability does deepen, owing to the appearance of excessive tipping effects, it will implement timely measures for market stabilization in a step-by-step process, and promote market stability. It will in addition also work to enhance the nation's capacities for responding to external shocks, through strengthening of the regional and global financial stability nets.

Maintenance of Financial System Stability

The Bank of Korea will devote special

efforts to early identification of the effects that changes in financial and foreign exchange conditions at home and abroad are having on financial system stability, and to devising measures in response. It will closely monitor the effects of the government's policies related to the housing market and household debt. It will moreover strengthen its research related to new forms of risk that can occur due to the structural changes in the financial markets in line with digital innovation, and devote efforts to presenting options for responding. Together with this, it will work as well to enhance the level of its assessments of financial stability conditions, through systematization of its financial stability analyses and elevation of its techniques for appraisal of risks.

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I. Monetary Policy Operating Conditions 1. Global Economy 2. Domestic Economy 3. Prices 4. Financial and Foreign Exchange Markets [Box I-1] Main Contents of 2018 Government Budget	Research Dept. Lee, Chang-Kee (Global Economy Analysis Team) Research Dept. Choi, In Hyup (Overall Research & Forecasting Team) Research Dept. Lim, Choon Sung & Kim, Mi Ju (Inflation Monitoring & Forecasting Team) Financial Markets Dept. Na, Young In (Financial Markets Affairs Team) Chae, Kyungrae (Fixed Income Markets Analysis Team) Lim, In Hyuk (Equity Markets & Corporate Finance Team) International Dept. Baek, Bong Hyun (Foreign Exchange Market Team) Research Dept. Sung, Hyungoo & Park, Beom Ki (Macroeconomic and Fiscal Research Team)
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