The Bank of Korea Tightens Monetary Policy

- **The Bank of Korea raised its benchmark interest rate to 1.75% in order to promote domestic financial stability.**
- **While inflation has reached the central bank's target and monetary conditions remain accommodative, we do not foresee another rate hike until the final quarter of 2019.**

The Bank of Korea (BoK) raised the Base Rate by 25 basis points to 1.75% following the November 30 monetary policy meeting, marking the first hike since November 2017. The decision to raise the policy rate was not unanimous, as two members in the seven-member Monetary Policy Board voted for the rate to be kept on hold. Given the economy's headwinds, we do not anticipate another rate hike in the near-term. Nevertheless, as pointed out by BoK Governor Lee Ju-yeol during the press conference, the central bank's monetary policy stance remains accommodative with the policy rate below its neutral level. This, combined with our inflation projection (chart 1), points to another 25 basis point hike in the final quarter of 2019, which is expected to be the final rate increase in the BoK's current tightening cycle.

South Korea's inflation is strengthening; at 2.0% y/y in October, CPI inflation is in line with the BoK's 2% y/y target. The recent pickup largely reflects year-ago base effects as well as higher food and energy prices; core inflation remains low, at 1.1% y/y in October, yet the BoK expects it to rise gradually over the coming months. We forecast headline inflation to close 2018 slightly above the 2% mark. In 2019–2020, inflation will likely remain manageable, averaging 2⅓% y/y.

With the recent pickup in inflation, the BoK's policy rate in real terms has dipped into negative territory. Against this backdrop, the central bank redirected its policy focus on maintaining financial stability in the face of high credit growth by South Korean households, elevated risk aversion globally, the risk of capital outflows, and tightening monetary conditions in the US and in several other economies. Indeed, BoK Governor Lee noted that the widening interest rate differential between the US and South Korea is a concern and that he will keep the capital outflow risk in mind. Governor Lee also pointed out that rising household debt is an indicator of higher financial imbalances, which today's rate hike will help address. Indeed, accommodative monetary conditions have stimulated fast credit growth; lending growth to South Korean households has averaged 13.9% y/y year-to-date (chart 2), pushing household debt to above 160% of disposable income.

The BoK's Monetary Policy Board expects the South Korean economy to expand by 2¾% y/y through 2019—virtually in line with the country's potential—supported by exports and consumption. Nevertheless, the export-oriented economy continues to face downside risks that reflect ongoing trade tensions between the US and China. Despite economic growth uncertainties, the BoK seems determined to prioritize financial stability in its monetary policy conduct while it sees the government taking more responsibility of supporting the economy. Indeed, Governor Lee emphasized at the press conference that the South Korean government needs to conduct expansionary fiscal policy. Given the country's relatively healthy public finances, we consider such division of policy responsibilities to be conducive to South Korea's overall macroeconomic outlook.

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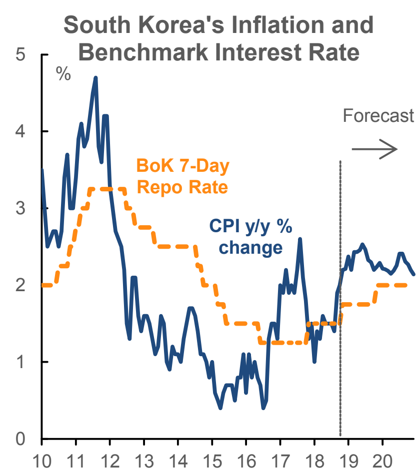
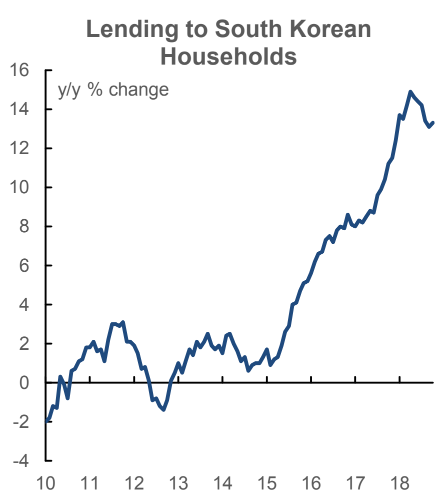
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.