May 28, 2020

Another Interest Rate Cut in South Korea

- **The Bank of Korea cut its benchmark interest rate by 25 basis points to a new record low of 0.50% on the back of sluggish economic growth prospects and weak inflationary pressures.**
- **While the next round of stimulus is set to come from the fiscal side, the central bank is open to using alternative monetary policy tools in the future, if needed.**

The Bank of Korea (BoK) lowered the Base Rate by 25 basis points to 0.50% at the May 28 monetary policy meeting (chart 1), as was widely expected. The decision was unanimous, highlighting monetary authorities' shared concerns regarding the economy's recovery prospects. The BoK has cut the policy rate by a total of 75 bps this year in response to the COVID-19 crisis.

BoK Governor Lee Ju-yeol pointed out that the benchmark interest rate is now close to the effective lower bound, implying that South Korean authorities are not considering taking the key rate to negative territory. We do not expect any further interest rate cuts in the near future. Nevertheless, should substantial economic weakness persist, the BoK may later opt to use unconventional policy tools, such as quantitative easing to keep long-term interest rates low. For the time being, the central bank is buying government bonds in the secondary market only to manage bouts of volatility.

The South Korean economy would benefit from further stimulus. We expect near-term policy efforts to focus on additional fiscal measures instead of monetary stimulus. Indeed, fiscal policy is becoming increasingly expansionary; a third supplementary budget is being prepared—and expected to be unveiled over the next few weeks—adding to the support measures that total KRW 130 trillion so far this year, equivalent to 6.8% of GDP. Fiscal stimulus includes cash handouts to all households, labour market support, as well as financial aid for small and medium-sized enterprises.

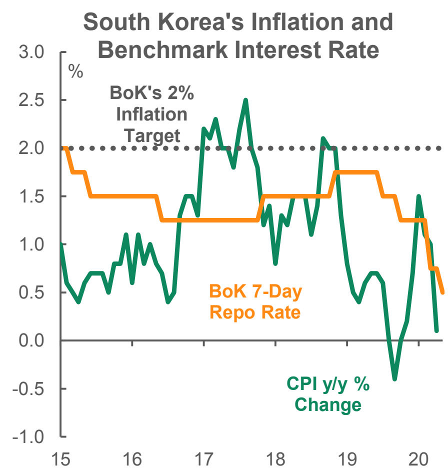
The BoK's policymakers expressed concerns regarding the economy's outlook, given that both domestic demand and export sector prospects remain dim. Accordingly, the central bank lowered the country's real GDP growth projection for 2020 to -0.2% from the earlier forecast of 2.1%. We consider the forecast somewhat optimistic given notable weakness in private sector spending activity and recessionary conditions globally that will limit the external sector's recovery prospects. Accordingly, we expect South Korea's output to contract by 1.6% this year.

Against the backdrop of economic weakness, South Korea's inflationary pressures are weakening. Headline inflation eased to 0.1% y/y in April (chart 1) and will likely continue to trend downward over the coming months, moving further away from the BoK's inflation target of 2% y/y. We expect deflationary pressures to dominate in the second half of 2020, giving a further incentive to the BoK for keeping an ultra-accommodative monetary policy stance in place for the foreseeable future.

CONTACTS

Tuuli McCully, Head of Asia-Pacific Economics
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.