

## Bank of Korea Begins Monetary Normalization

- The Bank of Korea raised the benchmark interest rate by 25 basis points to 0.75%, being the first major Asian central bank to start a monetary tightening cycle.
- Despite persistent uncertainties related to COVID-19, reduced monetary accommodation was needed in South Korea on the back of rising financial imbalances as well as inflation and economic growth considerations.

The Bank of Korea (BoK) opted to raise the benchmark interest rate by 25 bps to 0.75% following the August 26 policy meeting (chart 1). The analyst community was split ahead of the decision with a small majority—including Scotiabank—expecting the policy rate to be left unchanged for now. The BoK is the first Asian central bank to start normalizing monetary policy following the pandemic-triggered recession. Given persistent uncertainties that reflect a resurgence of COVID-19 cases in South Korea, we expect the BoK to take a cautious and gradual approach to monetary tightening over the coming months. Indeed, the BoK will likely stay on hold in the near-term to monitor how the economic outlook and associated risks evolve.

The rate hike decision reflects three key considerations: 1) South Korea's economic recovery outlook; 2) stronger inflationary pressures; and 3) rising financial imbalances. Despite COVID-19 uncertainties, the BoK's policymakers seem confident about the South Korean economic recovery remaining on track. The country's exporters have benefitted from a strong global economic rebound; prospects for the country's external sector remain favourable on the back of continued solid demand for South Korean exports, such as semiconductors. The domestic side of the economy faces downside risks arising from the current COVID-19 wave. Nevertheless, the labour market is recording continued employment gains, providing support to consumer confidence. Moreover, fiscal policy remains growth-supportive and the government aims to speed up the country's vaccination program significantly over the next month, underpinning the outlook for domestic demand. We expect South Korea's real GDP to expand by 4% this year, in line with the BoK's growth forecast.

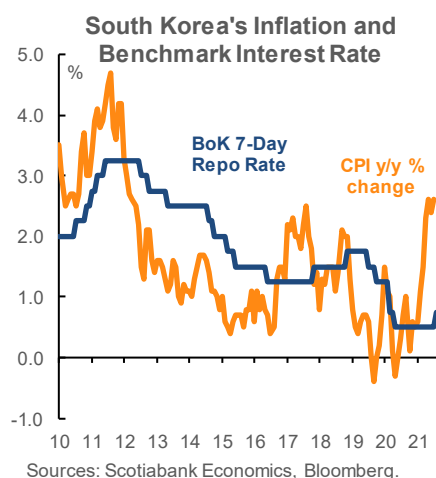
Inflation has accelerated in recent months, reaching 2.6% y/y in July (chart 1). Headline inflation has remained above the BoK's 2% target since April. Meanwhile, price pressures at the core level have intensified as well, with core inflation reaching 1.7% y/y in July. The BoK acknowledged rising price pressures and higher inflation expectations and revised its inflation forecasts up. It expects annual headline CPI gains to remain above the 2% mark through the rest of the year. Our forecast is in line with the BoK's view; we anticipate South Korean headline inflation to close the year at 2.4% y/y.

Due to low interest rates, South Korean household debt burden reached a record high in mid-2021, while house prices have continued to climb rapidly. Accordingly, preventing financial imbalances from worsening significantly has become an increasingly important policy priority. The BoK will pay close attention to financial stability in the face of approaching monetary policy changes in major economies. Indeed, the US Federal Reserve's monetary policy normalization timeline is set to play a key role in the BoK's future rate decisions.

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Chart 1



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