The Bank of Korea Tightens Monetary Policy

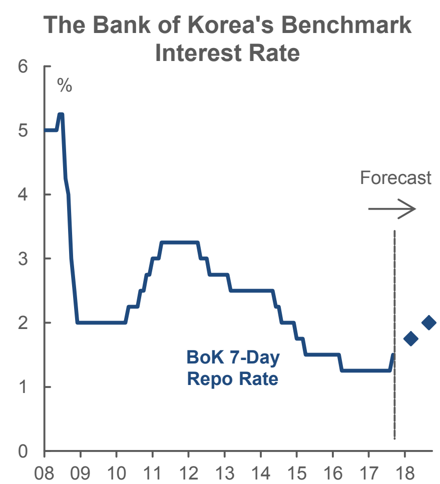
CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

- **In line with our expectation, the Bank of Korea raised its benchmark interest rate by 25 basis points to 1.50% following today's monetary policy meeting.**
- **Monetary tightening in South Korea will likely proceed cautiously; we foresee two interest rate hikes over the course of 2018.**

A monetary normalization phase has commenced in South Korea following the Bank of Korea's (BoK) decision on November 30 to raise the 7-Day Repo Rate by 25 basis points to 1.50%. According to BoK Governor Lee Ju-yeol, the interest rate increase will help prevent future financial imbalances. The central bank will likely adopt a cautious approach to monetary tightening over the coming quarters. We forecast two more rate hikes over the course of 2018—likely to take place in the second and fourth quarters—taking the policy rate to 2.0% by end-2018.

We assess that the South Korean economy is ready for a gradual rate hike cycle. The country's economic growth has proven to be strong. Real GDP advanced by 3.6% y/y in the third quarter of 2017 (preliminary estimate), surpassing consensus and policymakers' expectations. Activity is fairly broadly based with accommodative fiscal and monetary policies supporting domestic demand. Indeed, consumer confidence is strong, implying that household spending will maintain its momentum over the coming quarters. Solid business sentiment and robust external sector activity will underpin facilities investment, while a pick-up in global demand will continue to buttress South Korea's exports. We forecast the country's real GDP growth to average 3.1% y/y in 2017, up from the 2.8% pace recorded in 2016.



Sources: Scotiabank Economics, Bloomberg.

We estimate that South Korea's negative output gap has fully closed following the strong GDP advance in the third quarter. This is expected to trigger a gradual pick -up in demand-driven inflationary pressures over the coming quarters. While we estimate that South Korea's headline inflation will remain slightly under the BoK's 2% y/y inflation target in the near term, price pressures are set to intensify gradually from the second quarter of 2018 onwards. Nevertheless, a tighter monetary policy stance will help keep headline inflation below 2.5% y/y through 2019.

In addition to the BoK's price stability target, the central bank pays attention to financial stability. With this objective in mind, the BoK will likely refrain from increasing interest rates swiftly over the coming quarters. Indeed, the monetary policy statement issued by the Monetary Policy Board today was somewhat dovish, highlighting that the BoK's policy stance will remain accommodative. This reflects the Policy Board's assessment that domestic demand-driven inflationary pressures will intensify only gradually despite solid economic growth. Moreover, rising household debt will remain one of the key domestic risks factors for financial stability, warranting a cautious approach to monetary normalization. In terms of external risks to financial stability, the Policy Board will continue to pay attention to monetary policy actions in major economies, conditions related to global trade, and geopolitical risks.