Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions in Korea and abroad between April and July of 2018 finds the following. The global economy sustained its solid growth. The United States continued to show steady growth, thanks to improvements in employment conditions and to its expansionary fiscal policies. The euro area and Japan went through temporary slumps, due to factors such as abnormal weather conditions, but subsequently showed modest recoveries. China also continued its stable growth.

Economic growth in major economies[1]

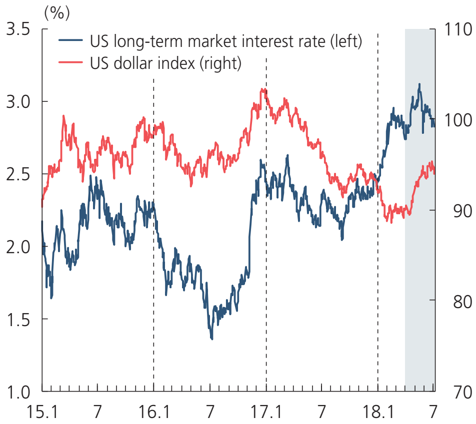
(%)

	2015	2016	2017 Year	2017 Q2	2017 Q3	2017 Q4	2018 Q1
US	2.9	1.5	2.3	3.1	3.2	2.9	2.0
Euro area	2.1	1.8	2.4	3.0	2.9	2.8	1.5
Japan	1.4	1.0	1.7	2.1	2.0	1.0	-0.6
China	6.9	6.7	6.9	6.9	6.8	6.8	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 showed repeated fluctuations, due to a mix of upside factors such as the possibility of the acceleration of interest rate hikes by the US Federal Reserve and downside factors including political unrest in the euro area and the deepening of the trade conflict between the US and China. Stock prices in advanced countries moved somewhat differently from those in emerging market countries. In contrast to their fluctuations in advanced countries, in line with upside and downside factors such as the improvements in US economic indicators and the strengthening protectionism, stock prices in EMEs fell sharply due to the effects of a stock price decline in China in consequence of the US-China trade dispute, and to concerns about financial unrest in Argentina and Brazil. The US dollar reversed rapidly to a trend of strengthening, affected by the continuing US economic buoyancy.

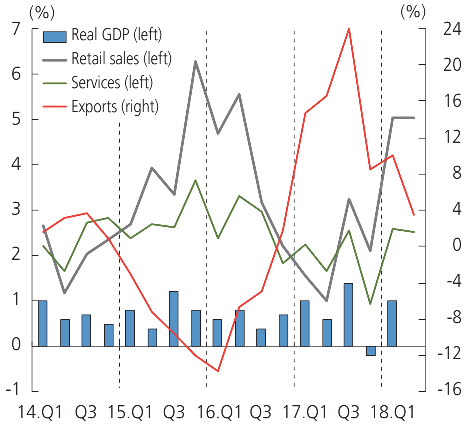
US long-term market interest rate[1] and US dollar index[2]



Notes: 1) Treasury bond (10-year) yields.
2) 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 its solid growth. In the first quarter of this year it emerged from its temporary negative growth of the fourth quarter of last year and recorded a 1.0% quarter-on-quarter growth rate. Despite the ongoing adjustments in facilities and construction investment the domestic economy continued to grow steadily in the second quarter, as consumption and exports showed favorable movements.

Major economic growth indicators[1)2)]

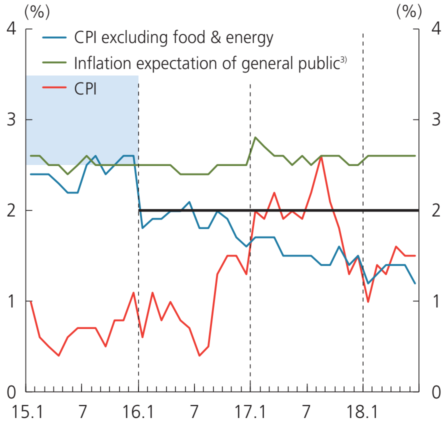


Notes: 1) Rates of growth quarter-on-quarter for real GDP, year-on-year for exports (customs clearance basis), retail sales and services.
2) Statistics Korea's sales index by retail business type and index of services for the second quarter of 2018 based on the averages of April and May's preliminary values.
Sources: The Bank of Korea, Statistics Korea, Korea Customs Service.

3 Consumer price inflation recorded a rate at the mid-1% level during the second quarter, as the paces of increase in prices of agricultural, livestock and marine products as well as petroleum products accelerated. Core inflation remained in the low- to mid-1% range, but the inflation expectations of the general public maintained the mid-2% level.

Housing sales prices began to show horizontal movements in the second quarter, in line with an easing of the rapid rise in prices of apartments being reconstructed in Seoul. The extent of decline in housing leasehold deposit prices expanded, on the effects of a large-scale increase in the number of new apartment units available.

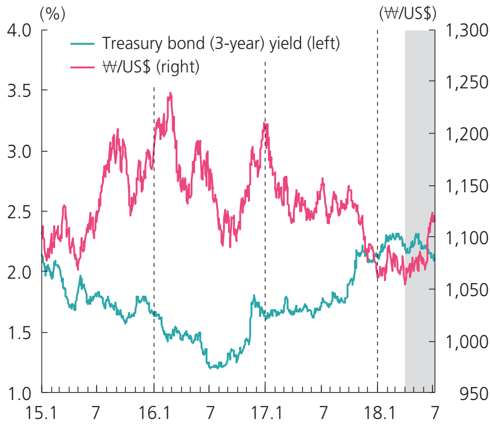
CPI inflation[1)2)]



Notes: 1) Compared with the same periods of the previous years.
2) 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.
3) Expectations for the CPI inflation rate one year in the future.
Sources: The Bank of Korea, Statistics Korea.

4 In the domestic financial markets, long-term market interest rates rose until the middle of May, influenced by the rise in US Treasury bond yields, before then reversing to a decline due to factors such as sluggish domestic employment indicators and the unstable political situation in Italy. The Korean won/US dollar exchange rate rose sharply, owing to the strengthening of the dollar in line with the possibility of accelerated interest rate hikes by the US Federal Reserve and with expanded concerns about the US-China trade conflict. Domestic securities investment by foreigners meanwhile increased, led by investment in bonds.

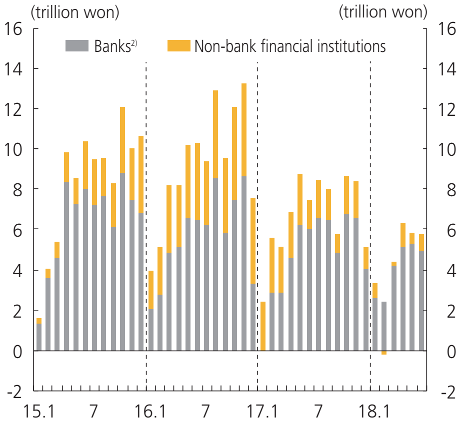
Korean Treasury bond yield and exchange rate (KRW/USD)



Sources: The Bank of Korea, KOFIA.

5 With regard to household lending, the pace of its increase accelerated in the second quarter compared to the first quarter, owing to demand for leasehold deposit funds and for funds related to moving into new apartments. Compared to the second quarter in 2017 it, however, slowed.

Changes in household loans[1]

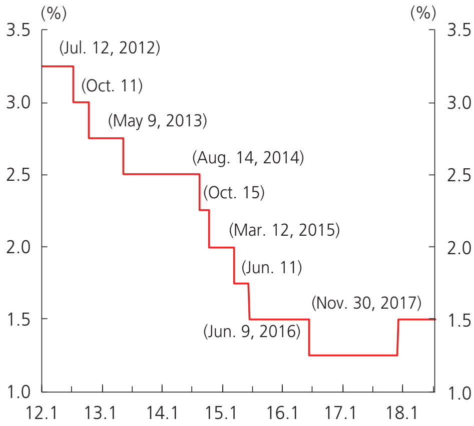


Notes: 1) Compared with the previous months.
2) Including mortgage transfers.
Source: The Bank of Korea.

[Conduct of Monetary Policy]

6 During the May through July 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 is stabilized at the target level over a medium-term horizon. In this process it devoted attention to financial stability as well, and closely monitored changes in domestic and external conditions such as those related to Korea's trade with major countries, changes in the monetary policies of major countries' central banks, the upward trend of household debt, and geopolitical risks. Under this policy stance the Bank of Korea held the Base Rate at a level of 1.50% per annum throughout the period.

Bank of Korea Base Rate[1]



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

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

First, at the May 2018 meeting of the Monetary Policy Board the Bank maintained the Base Rate at its 1.50% per annum level. This was a decision made in consideration of the fact that domestic and external uncertainties were still high and demand side inflationary pressures not strong, although it was forecast that the domestic economy would continue its solid growth. Facilities investment had slowed somewhat, but it was judged that the domestic economy was continuing its solid growth as consumption and exports were showing robustness. Employment had been sluggish, however, with the extent of increase in the number of persons employed remaining at a low level. Going forward it was expected that growth would be generally in line with the path forecast in April even though investment would slow, as consumption would continue its steady increase and exports their buoyant flows. Consumer price inflation had picked up to a level in the mid-1% range, due to rises in agricultural product prices, and was foreseen remaining at this level for some time before then gradually rising from the second half and approaching the target level. Core inflation was also at the mid-1% level, and expected to gradually rise. Meanwhile, the financial markets were generally stable, with the Korean won/US dollar exchange rate fluctuating within a narrow range although long-term market interest rates had risen on the effects of increasing interest rates in major countries. Even though the pace of increase in housing prices had slowed, especially in some parts of Seoul and its surrounding areas, it was deemed necessary to continually watch for any changes in risks on the financial stability side, as household lending was still growing more rapidly than in normal years, led by unsecured loans.

In the July meeting the Bank also kept the Base Rate at an annual rate of 1.50%. This decision was reached after consideration of the point that the domestic economy was expected to sustain its solid growth going forward, but that the uncertainties concerning the future growth path were high while the inflationary pressures on the demand side were still not large. Despite the ongoing adjustments in facilities and construction investment, it was judged that the domestic economy was continuing to grow steadily as consumption and exports appeared favorable. Employment remained sluggish, however, with the extent of increase in the number of persons employed sustaining low levels. With regard to the domestic economy going forward, it was forecast that investment would slow but that consumption would continue to increase steadily and exports would also remain favorable. In line with this it was expected that the rate of GDP growth during this year would be 2.9%, slightly lower than the figure forecast in April (3.0%), but that the domestic economy would continue to grow at the level of its potential growth rate. Consumer price inflation, despite a sharp rise in petroleum product prices, would show a rate in the mid-1% range owing to a slowdown in agricultural and livestock product price inflation, and persist at that level before gradually approaching the target level as it picks up due to the impacts of higher oil prices. The core inflation rate had fallen to the lower 1% level in June, but was expected to show a modest upward trend. The volatility of price variables in the domestic financial markets had meanwhile expanded, on the impacts of large changes in the international financial markets. The won/dollar exchange rate had risen to a large extent, under the influence of the dollar's strengthening, while stock prices and long-term market interest rates had fallen substantially due to increased uncertainties abroad related to factors such as the US-China trade dispute. The amount of household lending growth had lessened somewhat, but household loans were still increasing by greater amounts than in normal years and there was judged to be a need to closely monitor developments in this regard.

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. In May and June it convened meetings of its 「Monetary and Financial Task Force」 immediately after the FOMC meetings, and examined the effects that changes in the US Federal Reserve's monetary policy would have on the financial and foreign exchange markets. Notably, when the Federal Reserve raised its policy rate in June, the Bank closely examined the effects that the widening of the negative gap between Korean and US policy rates would have on the in- and outflows of funds of foreign investors. When the North Korea-US summit meeting was held it monitored the responses to and assessments of financial markets in major countries of the outcomes of the meeting in real time, in collaboration with its overseas representative offices.

The Bank also sustained its efforts for the early identification of potential risks within the financial system. During its June 「Financial Stability Meeting」 it analyzed the conditions related to financial stability in different areas such as household and corporate credit and the asset markets, and examined the financial system's resilience. It also attended the 「Macroeconomic Finance Meetings」, where it analyzed the effects of the Federal Reserve's policy rate hikes while seeking measures for responding together with the government and the supervisory authorities. It in addition examined household debt and the effects of the government measures to control it through meetings of bodies such as the 「Consultative Group for Managing Household Debt」.

[Future Monetary Policy Directions]

9 According to the Bank of Korea's 「Economic Outlook Report」 released on July 12, the domestic economy appears likely to show a growth rate of 2.9% during this year. It is forecast to sustain steady growth even despite slowing investment, as exports will continue their favorable flows in line with the buoyancy of the world economy and consumption will also improve. The domestic economy is foreseen growing at the level of its potential growth rate next year as well, as exports and consumption continue to increase. The upside and downside risks to the future path of growth are mixed. The major upside risks include the effects of more expansionary fiscal policies and accelerated paces of growth in investment in major countries, as well as improvements in domestic demand conditions thanks to the

government's economic stimulus measures. Among the downside risks are those of a worsening of export conditions in consequence of expanded protectionism, and of increased financial market volatility due to accelerated monetary policy normalizations in major countries.

Economic growth outlook[1]

(%)

	2017	2018e			2019e		
		Year	H1	H2	Year	H1	H2
GDP	3.1	2.9	2.9	2.8	2.8	2.8	2.8
Private consumption	2.6	2.7	3.1	2.2	2.7	2.5	2.8
Government consumption	3.4	4.6	5.4	3.9	4.1	3.4	4.7
Facilities investment	14.6	1.2	1.8	0.6	1.7	0.8	2.7
Intellectual property products investment	3.0	2.7	2.8	2.6	2.6	2.7	2.5
Construction investment	7.6	-0.5	0.7	-1.5	-2.2	-2.6	-1.8
Goods exports	3.8	3.5	3.0	4.0	3.5	3.9	3.1
Goods imports	7.4	3.0	2.5	3.4	2.9	2.1	3.7

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

The headline consumer price index is forecast to rise by 1.6% this year, and by 1.9% next year. The upside and downside risks to the future inflation path are mixed. Some of the main upside risks are rising international oil prices due to persisting geopolitical risks in the Middle East, and increases in import prices as a result of Korean won weakening. The downside risks meanwhile include those of a sharp fall in international oil prices owing to increased crude oil production, and of greater deflationary pressures on service prices in consequence of expanded provision of welfare services related to education, medical care, etc.

Inflation outlook[1]

(%)

		2017	2018			2019e		
			Yeare	H1	H2e	Year	H1	H2
CPI inflation		1.9	1.6	1.4	1.8	1.9	2.0	1.8
Core Inflation	CPI excluding food & energy	1.5	1.4	1.3	1.6	1.9	1.9	1.9
	CPI excluding agricultural products & oils	1.5	1.4	1.3	1.6	1.9	1.9	1.8

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of July 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 factors behind the changes in the domestic inflation dynamics, fiscal policy, and the financial unrest in emerging market countries.

There appear to have been substantial changes in the inflation dynamics in Korea since the global financial crisis, with the long-term trend of inflation as indicated by major price indicators falling and the differences in volatility among the various indicators widening. This is thought to have been a result of a complex interplay of factors such as a decline in global inflation, the drop in the Korean won exchange rate, constraints on increasing public utility charges, and the weakening relationship between the economic cycle and prices. Recently, however, it is judged that there have been some shifts in these factors driving the changes in Korean inflation. Amid a continuing modest upward trend in global inflation, the Korean won/US dollar exchange rate has also risen and there is a possibility of this causing inflation of goods prices to pick up. There is also a possibility of the upward trend of service prices gradually accelerating, due to plans to raise public prices and to demand-side pressures in line with the continuing economic growth. It is therefore judged, although the uncertainties concerning the forecast inflation path are high, that the consumer price inflation rate will gradually rise and approach its target level (2.0%) going forward.

Analysis of the government's fiscal policies using diverse indicators such as various fiscal balances and a Fiscal Impulse Measure reveals the following. First, a detailed look at the fiscal balance finds fiscal operations during the last year to have been expansionary as the structural fiscal balance and the fiscal balance with the social security funds excluded showed deficits, even though the consolidated fiscal balance ran a surplus thanks to favorable tax revenues. The contribution to GDP of fiscal policy, as indicated by the Fiscal Impulse Measure, was slightly negative from the first through the third quarters of last year, but turned positive from the fourth quarter as fiscal spending increased substantially. In the future also it appears likely that fiscal operations will continue to contribute to growth, as fiscal expenditures are expected to steadily expand.

Since the middle of April there has been continuing financial and foreign exchange market unrest in some emerging market countries. This appears to have been a result of the highlighting of political and economic vulnerabilities of the countries concerned, together with risk aversion due to concerns about the possibility of accelerated interest rate hikes by the US Federal Reserve and about the strengthening of protectionism. It is assessed that the effects on the domestic financial and foreign exchange markets due to the unrest in these countries have until now been limited, given the robustness of Korea's economic fundamentals. However, if the unrest in vulnerable EMEs spreads going forward, and the uncertainties related to the financial markets in China expand, the negative impacts on Korea can grow, and it is thus necessary to watch closely for any changes in market conditions.

$\boxed{11}$ 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 given the 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 any changes in conditions at home or abroad, and the resulting changes in 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.

The Bank will operate its monetary policy while remaining continually mindful of financial stability as well. As the uncertainties related to global trade conflicts and the speeds of monetary policy normalization in major countries are high, it will closely examine their developments and impacts going forward. Along with this the Bank will devote attention as well to the possibility of its prolonged accommodative policy stance causing the accumulation of household debt and other financial imbalances to deepen, and the effects on growth and inflation that this build-up in imbalances will have in the medium to long term.