

■ Executive Summary

[Monetary Policy Operating Conditions]

1 A look at financial and economic conditions at home and abroad between October and December 2016 reveals the following. The global economy recovered at a somewhat more rapid pace. In the United States a firm trend of growth was seen, with consumption growing steadily owing for example to favorable employment conditions. The euro area also continued its movements of improvement, and China maintained a growth rate in the 6% range as the slump in its exports eased.

Economic growth in major economies¹⁾

	2014	2015		2016		
		Year	Q4	Q1	Q2	Q3
US	2.4	2.6	0.9	0.8	1.4	3.5
Euro area	1.2	2.0	2.0	2.0	1.2	1.4
Japan	0.3	1.2	-1.8	2.8	1.8	1.3
China	7.3	6.9	6.8	6.7	6.7	6.7

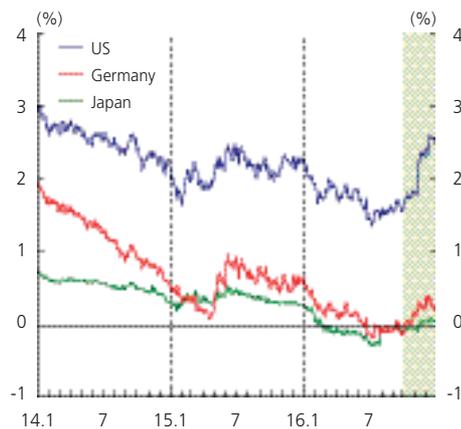
Note: 1) The quarterly rates of growth are annualized quarter-on-quarter rates for the US, Japan and the euro area, and year-on-year rates for China.

Sources: Individual countries' published statistics.

Volatility in the international financial markets expanded greatly, influenced by the unexpected result of the US presidential election, as well as by uncertainties related to the new US government's policy directions and about the speed of policy rate hikes by the US Federal Reserve. While long-term market interest rates in major countries rose substantially and the US dollar strengthened, stock prices in emerging markets fell to large extents owing to factors

such as outflows of global funds. However, volatility in the global financial markets showed signs of easing from the middle of December.

Long-term market interest rates in major economies¹⁾

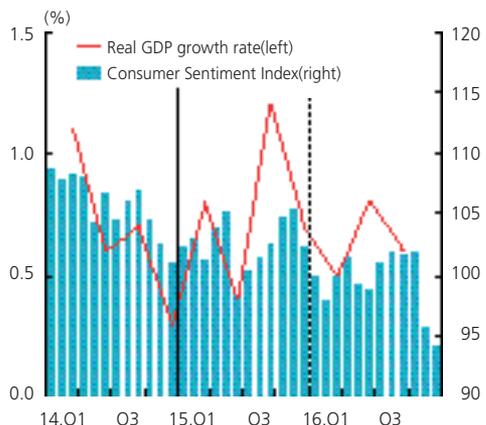


Note: 1) Treasury bond (10-year) yields.

Source: Bloomberg.

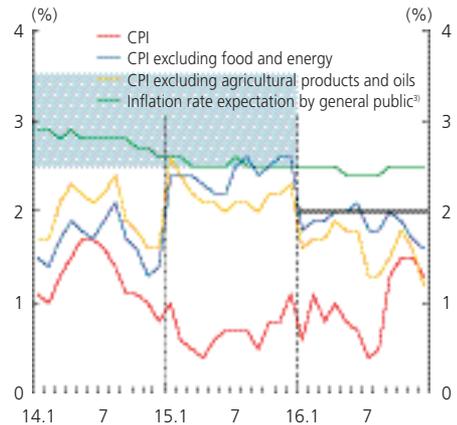
2 Although exports have been sluggish the domestic economy has sustained a trend of modest improvement, and showed a quarter-on-quarter growth rate of 0.6% in the third quarter, thanks to buoyancy in construction investment and an increase in fiscal expenditures for example. Exports reverted to an increase in the fourth quarter, but their pace of growth slowed somewhat as the trend of improvement in consumption weakened due to factors such as the ending of Korea Sale Festa and a contraction in consumer sentiment stemming from expanded political uncertainties.

Real GDP growth rate and consumption sentiment¹⁾



Note: 1) Compared with the same periods of the previous years.
Source: The Bank of Korea.

CPI inflation¹⁾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.

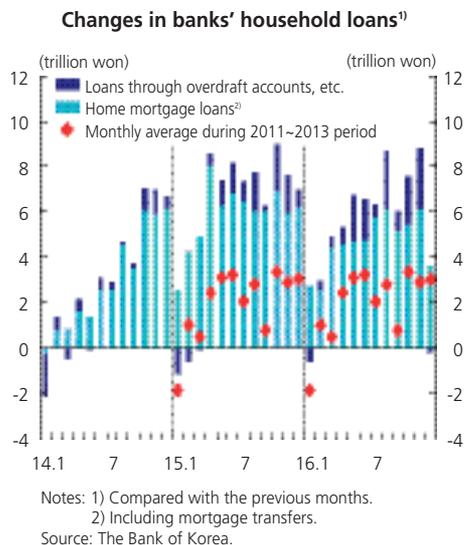
③ The pace of domestic consumer price inflation accelerated to the mid-1% range between October and December, as the impacts of the low oil prices and a temporary cut in electricity charges, etc. waned. The rate of inflation expected by the general public maintained the mid-2% level, while core inflation, indicative of the underlying price movements, remained at a level slightly below 2%.

Housing sales prices meanwhile sustained their upward trend, led by prices for apartments being reconstructed in the Seoul area. From November the pace of housing sales price increase slowed sharply, however, as the market for sales of newly reconstructed apartments cooled off on the effects for example of the November 3 real estate measures. Leasehold deposit prices generally continued their stability.

④ In the domestic financial markets, major price variables including interest rates, stock prices and exchange rates fluctuated to large extents in line with changes in international financial market conditions. In particular, long-term market interest rates, after having risen substantially on the effects of the policy rate hike by the US Fed and rising Treasury bond rates in major countries owing to concerns about inflation after the US presidential election, then stabilized due to factors such as the market stabilization measures implemented by the policy authorities. Meanwhile, bond investment funds of foreigners sustained net outflows, owing to the trend of US dollar appreciation and to a reduction in the amount of global funds in trust for example. The amount of net inflows of foreigners' stock investment funds also shrank to a considerable extent, as the

uncertainties in the international financial market became higher.

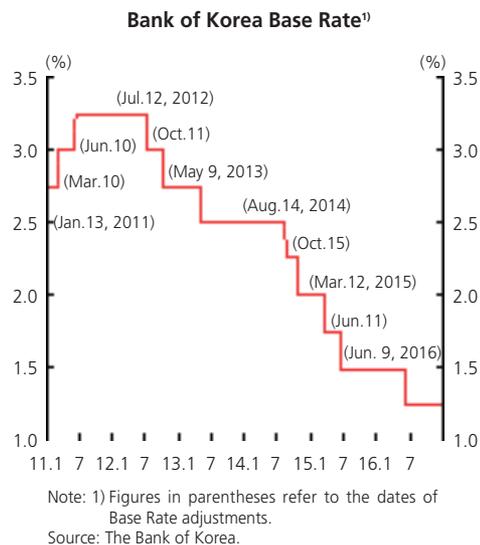
5 Bank household lending continued its high rate of growth exceeding its previous levels, as the pace of increase in home mortgage loans continued, in line for example with steady extensions of group loans, while loans through overdraft accounts increased as well. The volume of increase in non-bank financial institution household loans also rose greatly. In December, the amount of increase in bank household lending lessened.



[Conduct of Monetary Policy]

6 The Bank of Korea conducted its monetary policy in an accommodative manner between October and December 2016 as well, in order to ensure that the recovery of growth continues and consumer price inflation approaches the target level over a medium-term horizon. In this process it also devoted attention to financial stability, and

closely monitored the uncertainties surrounding conditions at home and abroad, along with their effects, the changes in the monetary policy of the US Federal Reserve, the pace of growth in household debt, trends of slack production capacity within the economy, and so on.



7 Under this policy stance, after having cut the Base Rate by 0.25% point in June of 2016, the Bank of Korea maintained the rate at a level of 1.25% per annum through December. The specific factors considered most importantly at the times of the monetary policy decisions during this period were as follow:

The reason why the Bank of Korea maintained the Base Rate unchanged was because, although the downside risks to the economic growth path had grown somewhat, it was judged desirable to maintain a careful watch of future changes in domestic and foreign conditions and their effects on the

domestic financial market and real economy, given the very high uncertainties surrounding these conditions. Consideration was moreover given to the forecast that the consumer price inflation rate, which was in the low to middle 1% range during 2016, would rise and eventually reach its target level by about the middle of 2017 due to factors such as higher oil prices. It was judged necessary to bear in mind the risks from the financial stability perspective even more, since the volatilities of domestic and overseas financial and foreign exchange markets had in addition expanded greatly, in line with uncertainties about conditions at home and abroad for example, while household loans were sustaining a high rate of increase greatly in excess of previous years' levels.

⑧ The Bank of Korea maintained a variety of policy efforts to secure financial and foreign exchange market stability. The Bank strengthened its monitoring of changes in domestic and foreign market conditions and of the movements of price variables including interest rates and exchange rates, and where necessary promoted market stability through active responses. It closely examined financial and economic conditions in Korea and abroad, while at the same time heightening its communication with the markets one step further to ensure that anxieties in sentiment did not spread at the times of the announcement of the US presidential election results in November 2016 and of the passage of the National Assembly's presidential impeachment bill in December, by convening its 「Emergency Financial and Economic Conditions Review Meeting」 and 「Emergency Executive Meeting」. At the

time of greatly increased financial market unrest as long-term market rates surged after the US presidential election, the Bank of Korea devoted efforts to alleviating this unrest and ensuring that market interest rate volatility did not expand, through implementation of market stabilization measures such as outright purchases of Treasury bonds, a reduction in the volume of Monetary Stabilization Bond issuance, etc.

The Bank also devoted efforts to identifying in advance and providing early warnings of system risks. Through its 「Financial Stability Report」 published in December, it on the one hand closely examined vulnerabilities in the various individual sectors including the credit markets, financial institutions, etc., while at the same time also assessing financial institutions' resilience in preparation against domestic and external shocks. In line with the upward pressures on market interest rates in a situation of accumulated household debt, the Bank of Korea strengthened its monitoring of trends in household debt through for example meetings of its 「Household Debt Taskforce」. It in addition held the 「Macroeconomic and Finance Meeting」, with the government and related institutions, to discuss measures for responding to factors driving domestic and foreign financial unrest.

[Future Monetary Policy Directions]

⑨ According to the Bank's 「Economic Outlook Report」 released on January 13, it has forecast that the domestic economy will grow by 2.5% during this year. Private consumption and construction investment will

slow, but thanks to improvements in exports and facilities investment in line with economic recoveries in major countries, the economy is expected to continue a modest pace of growth. In 2018 a growth rate of 2.8% appears likely, as the improvements in exports and facilities investment owing to the world economic recovery continue. As to the future growth path, there is a mix of both upside and downside risks. Among the former are those of a recovery in global economic activities due for example to rises in the prices of international raw materials and to the expansionary fiscal policies of major countries, of economic stimulus measures by the government, etc. The downside risks meanwhile include a weakening of world trade stemming from deepening protectionism, increases in the burdens of principal and interest repayments on household debt due to hikes in market interest rates, and a delay in the recovery of economic sentiment in line with a continuation of political uncertainties.

Economic growth outlook¹⁾

	2016			2017 ^e			2018 ^e
	Year ^a	1st half	2nd half ^e	Year	1st half	2nd half	Year
GDP	2.7	3.0	2.5	2.5	2.4	2.6	2.8
Private consumption	2.4	2.7	2.1	1.9	1.9	1.9	2.3
Facilities investment	-2.6	-3.6	-1.5	2.5	3.0	2.0	3.6
Intellectual property products investment	2.4	1.9	2.9	2.9	2.7	3.1	3.2
Construction investment	10.9	10.3	11.5	4.3	5.9	3.0	0.1
Goods exports	0.9	0.1	1.7	2.4	2.9	2.0	2.8
Goods imports	1.6	0.7	2.5	2.3	4.3	0.5	2.5

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of January 2017.

Source: The Bank of Korea.

It is forecast that consumer price inflation will rise to 1.8% during this year, and it is then expected to accelerate slightly to a rate of 1.9% in 2018. Concerning the future price path, the upside and downside risks are appraised as mixed, with the upside risks including those of an additional rise in international oil prices due to production cuts by OPEC oil-producing countries, as well as of hikes in international raw materials prices owing for example to the global economic recovery, while among the downside risks are risks of an expansion in shale oil production in the US in response to the recent rise in oil prices, and of a slump in domestic demand activities. The overall risk is judged to be neutral.

Inflation outlook¹⁾

	2016			2017 ^e			2018 ^e	
	Year	1st half	2nd half	Year	1st half	2nd half	Year	
	1.0	0.9	1.1	1.8	1.8	1.7	1.9	
Core Inflation	CPI excluding agricultural products & oils	1.9	1.9	1.8	1.6	1.6	1.7	1.8
	CPI excluding food & energy	1.6	1.7	1.5	1.5	1.3	1.6	1.8

Note: 1) Compared with the same periods of the previous years; the figures are forecast as of January 2017.

Sources: The Bank of Korea, Statistics Korea.

⑩ Going forward, it is expected that the main factors considered in the operation of monetary policy will include issues such as the effects on household loans of the rises in market lending rates, the political uncertainties, the monetary policies in major countries, and the flows of global funds since the US presidential election.

With regard first of all to the rises in market interest rates, as they lead household

lending rates to increase they can work as positive factors restraining the trend of expansion in loans to a certain extent. It is judged, however, that they will at the same time also work to push households' interest expenses up and burden consumption. In this process, particular attention should be paid to the possibility of debt repayment burdens growing even larger for vulnerable borrowers such as those having low credit ratings or low incomes, or holding multiple loans.

The expanded political uncertainties have negatively affected service businesses, facilities investment and private consumption for example, but it is analyzed that these effects have been gradually subsiding since the third quarter. Looking ahead, however, it will be necessary to keep in mind that, if risks related to the strengthening of global protectionism, the speed of interest rate hikes by the US Federal Reserve, etc. materialize, while the political uncertainties continue, then the adverse effects on economic sentiment and real economic activities can grow.

It will be necessary going forward to keep close watch on the monetary policies of major central banks, given the possibility of frequently increasing international financial market volatility due to the high uncertainties surrounding them, including uncertainties related to the pace of increase in the US Federal Reserve's policy rate.

If the new US government strengthens its protectionist stance, and the pace of the rate hikes by the Federal Reserve accelerates, then continued outflows of investment fund

capital from emerging market countries can be expected in the future, and it will thus be necessary for Korea also to strengthen its monitoring of the trends of capital in- and outflows.

11 In the future as well, the Bank of Korea plans to conduct its monetary policy so as to ensure that the recovery of economic growth continues and consumer price inflation approaches the target level over a medium-term horizon, while also devoting attention to financial stability.

The pace of future domestic economic growth is expected to be modest, and it is forecast that demand-side inflationary pressures will in consequence not be large, and the Bank of Korea therefore plans to maintain its accommodative monetary policy so as to support the recovery of growth. In this process, while bearing in mind that the uncertainties about conditions at home and abroad have risen, it will closely examine developments in terms of risk factors such as the policy directions of the new US government, the pace of interest rate increases by the US Federal Reserve and the strengthening of global protectionism, as well as any changes in financial and economic conditions stemming from them. The Bank will moreover make use of a variety of indicators other than consumer price inflation, including core inflation, various auxiliary price indices, expected inflation, the GDP gap, and indicators of idle production capacity in employment and in the manufacturing industry, and thereby judge the underlying price flows.

In carrying out its monetary policy the Bank will also devote attention to risks from the financial stability perspective as well, such as any increase in market volatility as a result for example of interest rate hikes by the US Federal Reserve, the accumulation of household debt, and so on. Together with this it will strengthen its examinations related to the trends of capital in- and out-flows, the movements of financial and foreign exchange market price variables, the trends of household debt and corporate credit, etc.

The Bank of Korea will also continue its efforts to heighten the effectiveness of its monetary policy. Through its Bank Intermediated Lending Support Facility the Bank will ensure that fund support is expanded to SMEs suffering temporary difficulties in funding under the influence of corporate restructuring, as well as to those that contribute to increases in employment.

The Bank of Korea will strive to strengthen its communication, so as to enhance its monetary policy's transparency and predictability. It has announced its 「General Principles of Monetary Policy Operation」, specifying matters such as the purposes of monetary policy, the relationships between those purposes and the various factors considered in policy operation, the basic policies employed to meet the purposes, etc., and while on the one hand improving the methods of description and the contents of its monetary policy statements, in a direction whereby their explanations of the policy background and their signalling of the policy directions are strengthened, it will also

expand the scope of the related materials released to the public.